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WORKSHOP REPORT 25 FEBRUARY 2021

## FISCAL SPACE & DEBT SUSTAINABILITY IN THE 2021 CLIMATE & DEVELOPMENT AGENDA

### CHAIR'S SUMMARY

*On Thursday 25 February 2021, E3G convened a workshop on fiscal space and debt sustainability with 50 participants from developing and developed countries. The outcomes from that workshop noted in this Chair's Summary will feed into the Climate and Development Ministerial Event being hosted by the UK COP26 Presidency in March 2021. For more information on this chair's summary or the workshop it is based on, please contact [fiscalspace@e3g.org](mailto:fiscalspace@e3g.org).*

#### Top recommendations: what should the ministerial sign-post?

- **Support an SDR issuance and re-allocation.** The issuance and re-allocation should be treated as separate points with the issuance fast-tracked and not delayed by the technical debates around re-allocation. The re-allocation should be defined on the needs of countries and climate vulnerability. However, there should be a recognition of the limitations of this instrument in terms of supporting a high-quality recovery in the medium term.
- **Emphasize the importance of the MDBs in a green recovery and as key players to crowd-in additional capital and stakeholders at both domestic and international level.** This is an opportunity to kick start the conversation on how to make best use of the resources available from the MDBs, and to ensure that these institutions have sufficient capital to fulfill this key and counter-cyclical role; at present MDBs are showing signs of being financially constrained in their crisis response. However, MDB shareholders should require the MDBs to align with the Paris Agreement, shifting financing away from fossil fuels and towards sustainable infrastructure – including both renewables and nature-based solutions.
- **Note that debt remains a challenge for many countries and will hinder a potential green recovery, and that now represents an opportunity to rethink the debt sustainability criteria, and to include climate and nature as productivity drivers.** There was strong agreement that debt sustainability criteria need to be reformed to enable greater investment in climate mitigation and adaptation, and that climate risks need to be considered in the base line assessments. Action on debt should incorporate efforts to use debt instruments linked to performance which could support greater climate and nature ambition (SDG, fossil fuel subsidies reform); this could ensure the conversation around debt shifts from forgiveness to building towards success for the country. A further consideration should be to introduce a debt moratorium triggered by natural disasters, and/or an automatic standstill feature in debt instruments in response to climate events.



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## Top political takeaways: what should government/institutions taking part in the Climate & Development Ministerial be aware of?

- For the global south to have a voice, the G7 and G20 fora are not perceived as optimal. There is an opportunity to bridge the agenda to ensure the Global South has a say - AOSIS, G24, V20, Youth Climate Summit and UN should contribute to this. It was highlighted that the UK could play a key role in supporting this.
- SDRs discussions are moving very fast: the G20 has already taken a position on SDRs, the details of which have yet to be refined. There is still something to be done diplomatically about where recipients of SDRs donate (reallocate) their allocations, and under which terms SDRs can be used. Delaying the issuance to accommodate discussion on the reallocation could be a mistake; the two issues can and should be treated separately.
- Acknowledge that MDBs are starting to show signs of financial strain; do not yet have the capacity to deliver support to a multi-year recovery; and lack shareholder guidance as to the role they should play. The role, and capitalisation, of MDBs to ensure sustain support for a green, inclusive, and just recovery, is a challenging discussion at the political level. It is particularly challenging to persuade their shareholders to rethink the role of MDBs and to decide to take a less conservative approach and have some skin in the game of development and the climate transition. This is an opportunity to ensure the banks are transformational and ambitious.
- There is recognition that low-income countries are a priority, but middle income are facing fiscal constraints as well - any instruments and/or policy should consider those countries as well.

### Background

The COVID-19 crisis and its accompanying fallout is unprecedented in modern times, massive and majorly disruptive across economies globally. The crisis is evolving and coming in waves as reinforced by new COVID variants driving ongoing uncertainty. What began as a health crisis – still unresolved – is now an economic crisis. Most countries have used their fiscal resources to keep their economies afloat. However, as the crisis grinds on, the strain on their resources has been increasing. An increasing number of countries are entering debt distress, compounded in some cases by pre-existing high debt levels. This limits the ability of countries to respond to the health crisis, let alone to invest in a high-quality recovery.

This crisis shows that non-financial risks have macro-economic implications. But it also reinforces that even the existing growth models were not on track to deliver both the Sustainable Development Goals and the Paris Agreement in many countries. This multi-year crisis requires sustained actions to set countries onto a pathway to build forward better. It can't be just a short-term fix to the immediate impacts of the health crisis.

These challenges are set to become more extreme unless we act now, act together and act at scale. Creating fiscal space, both through international and domestic sources is critical for providing the conditions in which countries can recover in a green, inclusive and resilient way.



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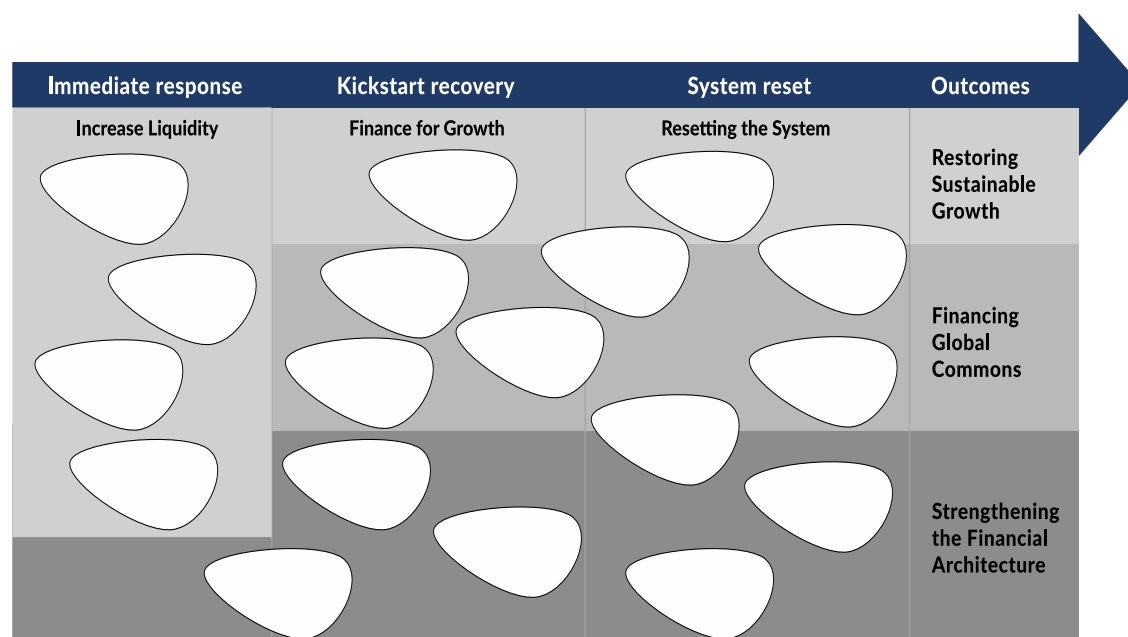
In other words, the flow of resources to and within countries needs to increase, and more importantly countries need to get more value out of both internal and external resources.

In support of this agenda, E3G convened a workshop with stakeholders from developed and developing countries to identify a range of short, medium, long-term and structural solutions to enable sustainable fiscal space for a green, resilient and inclusive recovery. The workshop explored key barriers both at technical and political levels and began to lay down markers for political landing grounds for policy solutions that can be delivered or launched in 2021.

### Policy proposals framework

The aim of the workshop was to gather clearly defined policy options to address the issues of fiscal space and debt sustainability. We structured the discussion using a common framework of three elements of the issue, refined by UNECA in their paper on fiscal space of Dec 2020:

- Immediate response to the crisis
- Kick-starting a sustained recovery
- Resetting the system – ie revisiting the underlying assumptions and framework that could support that sustained growth.



Source: adapted from UNECA (2020).

**These phases are interlocking, and as we move through the phases, policy solutions will need to build on each other to achieve the eventual outcomes; restoring sustainable growth, financing the global commons and strengthening the financial architecture.**

Planning the short, medium and long-term actions together will enhance the reliability that future action will take place.



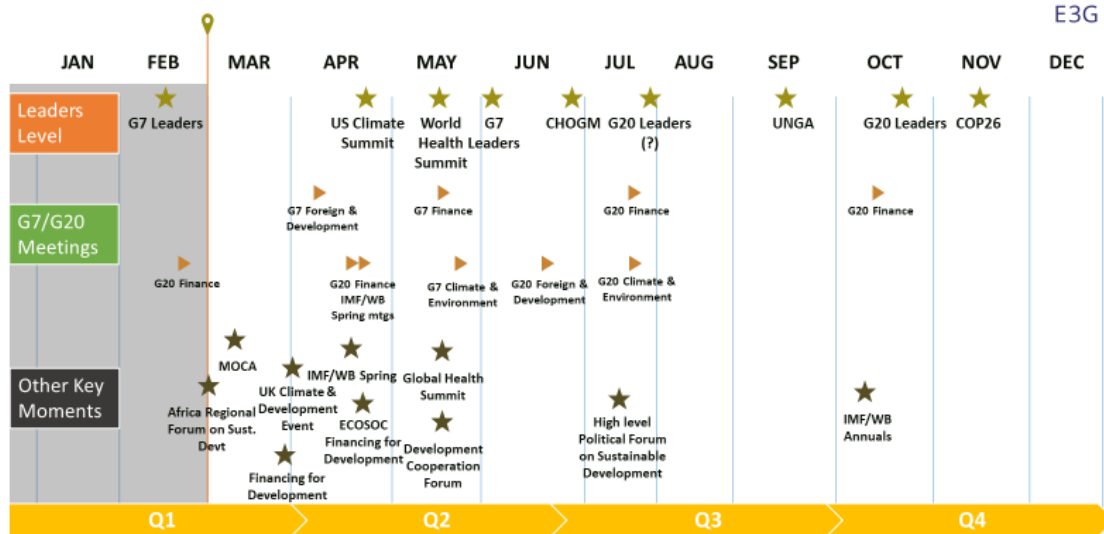
## E3G Political roadmap framework

The 2021 diplomatic calendar presents a convergence of opportunity to amplify adaptation, resilience & solidarity agendas in 2021. Climate-progressive countries lead the major economy macroeconomic forums in 2021 – the UK G7 and the Italian G20 – and share the leadership of the COP26 UN climate conference. At the same time, world leaders are not short of crises to grapple with, which limits their political bandwidth this year. The challenges to the hosts of major-economy-led 2021 decision making forums are to co-design agendas with the global south that can centre conversations about Paris and SDG aligned approaches to fiscal space and debt sustainability issues in 2021 leaders’ level decision making forums. The political roadmap must link between major-economy-led forums and those led by and accessed by climate vulnerable countries.

The timeline below highlights some of the key decision-making moments that could become political landing grounds for the climate and development agenda in 2021. Key phases of the political roadmap could be:

- Using the Climate & Development Ministerial and UN Financing for Development processes to close out Quarter 1 with a clear and joined-up agenda for the rest of the year;
- Establishing trust through Quarter 2 with delivery on urgent needs via the IMF/WB meetings and G7 leaders meetings;
- Building the package of policy implementation and sources of finance through Quarter 3 moments;
- And finally, delivering for the future with new policies, finance and reforms landing in Quarter 4 moments while setting up the agenda to drive through 2022’s Indonesian G20, German G7 and African-nation hosted COP27.

### DIPLOMATIC CALENDAR - 2021 OVERVIEW





## E3G Policy ideas and political roadmaps

### Immediate liquidity solutions

Creating sufficient fiscal space in the short term is essential to ensure countries have resources to deal with the health crisis while keeping their economies afloat and creating the foundations of future sustainable growth. This group focused on policy ideas to address short-term liquidity issues, whilst also providing solutions for countries at risk of or in insolvency. Climate change and nature could be part of this solution and at minimum the response shouldn't jeopardise progress on climate actions in countries.

#### Summary of discussions on policy proposals:

Policy idea raised	Discussion points on technical feasibility
SDR issuance and re-allocation	<p><i>Strong agreement this is a short-term liquidity solution and shouldn't be delayed</i></p> <ul style="list-style-type: none"> <li>- Short-term and long-term use of SDRs, it is important to differentiate between the two – today there is a need for liquidity, longer-term objectives are less relevant</li> <li>- Proposal for SDR500bn issuance. A greater issuance would need US Congress approval – this is unlikely, although there is a proposal for \$2 tn+ in the US House, and some US CSOs are supporting this as this number reflects the needs of countries which are estimated at \$2.5 trillion.</li> <li>- Reallocation of SDRs could be according to climate vulnerability; and also possibly by linking allocations to climate action rather than the quota, with the latter requiring a mechanism for monitoring. This could be through:               <ul style="list-style-type: none"> <li>o The IMF itself is already starting to think about climate considerations so this would be a way to operationalise this</li> <li>o Alternatively, this could be done by placing the SDRs at an existing trust fund at the World Bank</li> </ul> </li> <li>- SDRs conversation has already kicked off at the G20 level but there is a need to ensure sustained support is maintained, bearing in mind SDRs have some limitations.</li> </ul>
Increase MDBs financial capacity	<p><i>Agreement on the need for MDBs to be provided with sufficient financial capacity</i></p> <ul style="list-style-type: none"> <li>- Fair amount of discussion on the different ways to increase funding from MDBs eg. Use SDR to recapitalise MDBs, revisit the capabilities of MDBs to make use of their balance sheet, MDBs need credible rating policies to expand room for lending, and the need to focus on capacity building on regional banks (AfDB, IDB)</li> </ul>
Guarantee instruments for credit enhancement (MDB/bilateral)	<p><i>Agreement on the need for credit enhancement provided by MDBs</i></p> <ul style="list-style-type: none"> <li>- Not suitable for the most indebted countries</li> <li>- Allow sovereigns to issue debt at a more favourable rates, but there will be conditionality on sustainability linked to policy outcomes (not linked to use</li> </ul>



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	<p>of proceeds like green bonds), linking with climate and sustainability ambition more broadly as an alternative to raise new capital.</p> <ul style="list-style-type: none"> <li>- Some interest in MDB or donors to develop guarantee instruments to provide credits</li> <li>- Multilaterally sponsored credit enhancement – need to have budget support from MDBs with guarantee instruments. This risk-sharing is not new and has been implemented before.</li> </ul>
Private creditors role in DSSI/Common Framework	<p>Raised but technical feasibility was not discussed</p> <ul style="list-style-type: none"> <li>- This is the only option at present that countries have to deal with the debt.</li> <li>- There was the sense that if there is going to be a suspension it would be best to go straight into debt restructuring.</li> <li>- There should be new legislation to require private creditors to participate in debt relief and restructuring<sup>1</sup>. There should be further legislative measure to prevent lower income countries being sued in the UK by private creditors if they fail to pay debts<sup>2</sup></li> </ul>
Other instruments (long term approach)	<p><i>Agreement that these instruments are needed in the long term but don't solve the short-term liquidity crisis</i></p> <ul style="list-style-type: none"> <li>- These are financial instruments with sustainability /climate conditionality (SDG, fossil fuel subsidies reform). Some discussions on the conditionality of various performance-linked financial instruments, but the conversation did not go further as these instruments do not address short-term liquidity issues</li> <li>- A proposal for an automatic standstill feature in debt instruments in response to climate events. Caribbean islands for example are very exposed to climate change risk; this does not overlap with the broad debt sustainability debt discussion but will make the response to climate events more rapid and ensure it doesn't increase vulnerability</li> <li>- The international financial architecture ultimately lacks a mechanism that is fit-for-purpose when it comes to resolving debt crises. Prioritising debt services could have serious negative impact on human rights which must be avoided.</li> </ul>

Summary of discussions on political issues:

The discussion focused on two potential policy proposals. These were the SDRs, and ensuring that sustained support will be provided through the MDBs.

<sup>1</sup> Due to high interest rates, some private creditors could be making up to 250%. Debt owed to private creditors such as Blackrock, JP Morgan, HSBC and UBS constitutes 27% of total debt payments of the 73 DSSI-eligible countries, and for some countries this is a lot higher. This is putting pressure on fiscal resources countries have available to address health crisis, and climate action.

<sup>2</sup> If debtor governments default on their repayments to private creditors – as Zambia did in November– they risk being sued in UK courts. 90% of bonds owed by countries eligible for the G20 debt suspension are governed by English law.



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Policy idea	Political barriers	Key stakeholders	Processes in 2021 that can unlock policy implementation
SDRs issuance & reallocation	Concerns around how SDRs would be used – ie China and Iran will be receiving SDRs  This is the historical concern from the US	G20 IMF	<ul style="list-style-type: none"> <li>- G20 has signaled support for an SDRs issuance and has tasked the IMF formulate a proposal.</li> <li>- But, the US has yet to notify the Congress before casting its vote at the IMF Board – the consultation process takes 90 days.</li> <li>- The issuance might take place in August if the consultation with Congress takes place right after the Spring meetings.</li> </ul>
Increase MDBs financial capacity	Not discussed	Donor countries, specifically Finance Ministers.  UK could take the lead	<ul style="list-style-type: none"> <li>- Prioritise the regional banks, IADB and AfDB, and IDA. Regional banks are closer to the needs of countries than global banks.</li> <li>- AfDB capitalization should be paid as soon as possible instead of tranches within the next 10 years<sup>3</sup>.</li> <li>- G7/G20 main space for donors to make the decision.</li> <li>- Spring meetings will be a key moment.</li> </ul>

### Medium-Long Term solutions

Short-term solutions to address immediate liquidity needs must be linked with the longer-term sources and scale of financing that will put economies on a sustainable pathway. As countries seek to stimulate their economies, an inflow of near-term liquidity may prove insufficient; the mobilisation of internal resources and the support of public and multilateral development banks will play a key role. This group focused on policy ideas to address medium-term and long-term sources of liquidity and investment, through Multilateral Development Banks and Public Financial Institutions, amongst other potential solutions.

#### Summary of discussions on policy proposals:

Policy idea	Discussion points on technical feasibility
Increase counter-cyclical	<p><i>Strong agreement</i> that these institutions would play a role in the recovery</p> <ul style="list-style-type: none"> <li>- Paid in capital needs to be increased in general, MDBs don't have sufficient resources to support a multi-year crisis.</li> </ul>

<sup>3</sup> ODI (2020). [Scaling up multilateral bank finance for the Covid-19 recovery](#)





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resources via the MDBs.	<ul style="list-style-type: none"> <li>- AfDB had an increase in paid in capital but this is taking place in tranches within 10 years, this needs to be accelerated</li> <li>- The IDA replenishment should be brought forward</li> </ul>
MDBs need to become more countercyclical	<p><i>Strong agreement that MDBs need to be more countercyclical</i></p> <ul style="list-style-type: none"> <li>- MDBs have room to lend more without affecting their credit ratings. Their capital adequacy needs to be reviewed</li> <li>- There are proposals around commissioning an external agency (like the Basel Committee) to review MDB capital adequacy calculations, this has been supported by the G20 EPG.</li> <li>- MDBs should Work closely with National Development Banks to co-finance projects</li> </ul>
Transformational approach to financing the recovery	<p><i>Strong agreement on the need for MDBs to be more transformational</i></p> <ul style="list-style-type: none"> <li>- There was recognition of the need to shift from project-based alignment with the Paris Agreement to alignment across financed portfolios</li> <li>- This could be facilitated by applying a shadow carbon price; for example the EIB does this</li> <li>- Implement fossil fuel exclusion policies.</li> </ul>
Leverage the private sector via blended finance	<p><i>Point raised in the discussion</i></p> <ul style="list-style-type: none"> <li>- Co-financing and innovative instruments to be deployed to mobilise the private sector. Investment products should target the energy transition and nature-based solutions</li> </ul>
Domestic resource mobilization	<p><i>Point raised but not discussed in detail</i></p> <ul style="list-style-type: none"> <li>- Tax collection is very low in certain countries, this is partly due to the large informal job sector.</li> </ul>

Summary of discussions on political issues:

Policy idea	Political barriers	Key stakeholders	Processes in 2021 that can unlock policy implementation
Increase counter-cyclical resources via the MDBs.	<p>US a potential blockage.</p> <p>EU position wasn't discussed</p>	<p>MDBs shareholders</p> <p>Bank staff at management level</p>	<ul style="list-style-type: none"> <li>- In the context of the WB, WB/IMF Spring Meetings.</li> <li>- Development Committee</li> <li>- The US budget</li> <li>- G7 and G20 could be an alternative venue</li> </ul>
Transformational approach to financing the recovery	Potentially the recipient countries if packages are poorly designed	Donor governments, recipient governments, bank management, and civil society	







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### Specific solutions on debt stock & structural issues

In parallel to policy ideas to address immediate, medium and long-term liquidity, solutions should be explored to ensure that in the long-term countries have the capability to bounce back better after future financial and non-financial crises. In particular, countries’ existing debt stock should be sustainable, i.e. compatible not just with anticipated growth but also with the kind of investment required to ensure long-term resilience of their economies. This group focused on policy ideas to ensure all countries are able to fulfil their economic potential in a resilient and sustainable way. It explored what kind of structural reforms are needed along the way, including to domestic fiscal space and the assessment of debt sustainability, whilst ensuring that the combined demands of servicing long-term debt stock together with issuance of new future debt is supportive of the achievement of the Paris Agreement and the Sustainable Development Goals.

#### Summary of discussions on policy proposals:

Policy idea raised	Discussion on Technical feasibility
Scaling performance-based bonds	<p><i>Strong agreement on the desirability of scalable instruments</i></p> <ul style="list-style-type: none"> <li>- This is a new tool and is scalable, moving beyond the use of proceeds to KPI-linked bonds. This could be an evolution of debt for nature swaps</li> <li>- Scalability is through budgetary support, monitoring, more systemic reporting abilities</li> <li>- There is a need to move from debt stock to debt/equity combinations, which allow risks to be shared in a way that debt markets can’t. An example is Islamic Finance.</li> <li>- Co-financing is key for the success of these type of instruments</li> <li>- However, these instruments shouldn’t replace climate finance.</li> </ul>
Debt sustainability assessments need to incorporate climate risks	<p><i>Strong agreement amongst the participants</i></p> <ul style="list-style-type: none"> <li>- Recognition of the need to review the DSA to account for climate risks. Nature and climate change need to be incorporated in these assessments as productivity drivers.</li> <li>- The IMF has started to look at this, but it was questioned how effective the underlying assumptions the IMF are assessing were.</li> </ul>
Debt Cancellation	<p><i>This was raised but it was not discussed</i></p> <ul style="list-style-type: none"> <li>- This policy should be on the table. There is evidence that debt levels/payments and increasing interest rates are driving cuts in public spending.</li> <li>- Private creditors debt should be on the table<sup>4</sup>. There is a clear need for coordination to ensure that all types of debt are covered and all creditors participate because of the huge number and diversity of</li> </ul>

<sup>4</sup> African governments are expected to pay \$23.4 billion in debt repayments to private lenders alone this year – over three times the cost to purchase vaccines. The World Bank estimates that over 100 million people have been pushed into poverty in 2020 due to Covid, with this number expected to rise to 150 million by 2021.



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	commercial creditors. Resorting back to a country-by-country traditional approach undermines the economic recovery and capacity to respond to the crisis of indebted countries.
Automatic standstill in debt instruments	<i>This was raised but there was not a wider discussion</i> <ul style="list-style-type: none"> <li>- The benefits of Debt Moratoria triggered by natural disasters were noted. This would consist of constructing an automatic mechanism that delivers a debt payment moratorium after a climate change-related event for 6 months to a year. Afterwards a debt sustainability review would be due.</li> </ul>
Domestic Capacity building to increase pipeline of projects directed towards sustainability	<i>This was raised but there was not a wider discussion</i> <ul style="list-style-type: none"> <li>- The importance of this was recognised, with programmes such as the Millennium Challenge noted as having some pros and cons.</li> </ul>
Increase domestic resources mobilization	<i>Agreement on the importance of this but not discussed in detail</i> <ul style="list-style-type: none"> <li>- Beyond increasing taxation, the potential for leveraging domestic savings - ie pension funds - through financial innovation for sustainable public investment was highlighted. This could also help reduce reliance on international capital market</li> </ul>
Illicit financial flows	<i>Agreement on the importance of this but not discussed in detail</i> <ul style="list-style-type: none"> <li>- It was argued that global wealth is hidden in tax havens. This point was hindering the ability of countries to mobilise domestic resources<sup>5</sup>. UNCTAD’s Economic Development in Africa Report 2020 says stopping illicit capital flight could almost cut in half the annual financing gap of \$200 billion that the continent faces to achieve the Sustainable Development Goals.</li> </ul>

Summary of discussions on political issues:

Policy idea raised	Political barriers	Key stakeholders	Processes in 2021 that can unlock policy implementation
Performance based bonds.	Not discussed	IMF – WB – OECD	- A new facility will be launched at the WB-IMF Spring meetings
Debt sustainability assessments need to incorporate climate risks	Not discussed	IMF G20-G7 V20 AOSIS (Association of Islands Developing States)	- The Ministerial could provide a starting point to discuss this and set a timeline - This could inform the G7/G20

<sup>5</sup> Every year, an estimated \$88.6 billion, equivalent to 3.7% of Africa’s GDP, leaves the continent as illicit capital flight, according to UNCTAD’s Economic Development in Africa Report 2020.





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