Progress and Possibilities in International Financial Reform Today

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Following numerous presentations and discussions, most recently with those around the G20 and Paris Summit, and much listening and understanding, there are signs of the mainstreaming of several reform ideas that were originally promoted as part of the Bridgetown Initiative. Below is an assessment of where the door is opening and consequently where I think we should focus our efforts on pushing through.

Firstly, the idea that we can only swallow the enormous amounts of finance required by the developing world (circa $2trn per year according to Stern, Songwe and Battacharya) by mapping different forms of finance to various activities has proved compelling. People now regularly repeat our system back to us. Following discussions the system has been refined a little to the following. We need to breakdown the financing into three buckets: (1) those things with revenues attached, like much of the climate mitigation and sustainable agriculture agenda, for which we need to find ways to catalyse private savings (circa $1.65trn per year; (2) those things with no current revenues but future savings, like much of the resilience agenda, and some investments in natural capital and public health for which we can borrow to fund if this borrowing is on new, super-long term and low-cost terms (circa $250bn per year); and finally (3) those things for which there no revenues and few savings, like much of the loss and damage, social costs of the just transition and other aspects of public heath, for which we need grant-like money and given current limits to ODA, which we need to raise through new global taxes or contributions (circa $100bn per year).

There is growing support for our position that climatic loss and damage, unlike volcano/earthquake/tsunami risk, is uninsurable. As one of the G20 experts recently said, today's tail risks will become tomorrow's central case, underscoring the need for investments in future resilience and grants for current loss and damage. But ODA is under pressure, and international taxation is a thorny area. There are two openings, however. First is the idea of a global levy on emissions, such as an emissions tax on the shipping, fossil fuel and agriculture sectors and specifically on methane emissions, with the proceeds going to an international loss and damage (L&D) fund. There is the added bonus for fans of voluntary carbon credits international emissions taxes will provide the underpinning to transform that market into something significant - today, the voluntary cross-border market is racked with integrity issues and worth just $2bn versus the $2trn a year task. The second opening is to ride existing trends towards a global minimum tax and cross-border carbon adjustment mechanisms. A proportion of proceeds from these new taxes (which essentially tax overseas activity) should go to the L&D Fund.

Following the finance system described above, there is recognition that to mobilise private savings into developing countries, we must reduce risk premiums. Today's giant risk premiums prohibit private capital from flowing to the developing world, making it impossible for us to hold below the 1.5 degrees warmer limit. There is growing articulation from developing countries in response to the Bridgetown Initiative that much of the premium - I estimate over 75% - is compensation for "macro-risks" like currency and country risk. Yet current risk-mitigation efforts focus on project or sector risks. (The conceit behind this emphasis is the idea that all of our problems could be solved by private finance if only developing countries got their act together - reality is more complicated.) Let micro-risk reduction work continue, but let is add a large-scale effort focused on lowering the macro risk-premium so that a solar farm in South Africa, India or Indonesia has a cost of capital not far from an otherwise identical solar farm in Germany.

This has been very much the ‘Bridgetown’ story. Our original proposal here was the $500bn allocation of SDRs to lower the cost of capital and make profitable developing country investments in climate mitigation through a new and separate institution. Following much discussion and pushback on SDRs, new separate institutions and clarifying the operation, I see support for a modified version of this which could be called a Just Green Transition, Financing Investment Trust or a JGT-FIT: It is a focused agency sitting in the middle of a network of Multilateral Development Banks, perhaps owned by them, with its own capital and access to SDR liquidity held by the MDBs. The JGT-FIT would provide a cheap hedge against currency risk for just green transition projects that have gone through a safeguarding process like the JET-Ps. Using patient capital, access to MDBs' SDR liquidity, scale, diversification, smart hedging and a focus on the most significant impacts, the agency can offer cheap hedges into SDRs for investors by actively managing currency risk and effectively converting diversified market risk premiums into a global public good. Lowering risk premiums sharply will drive investment in the green transformation. The agency would be focused on long-term investors. Offering hedges only for returns, not the balance sheet, and into SDRs, will likely satisfy long-term investors while being cheaper than hedging the whole balance sheet and into dollars. (As a basket currency, the SDR is less subject to strong risk-on, risk-off swings in dollar exchange rates.)

The capital required to kick off, providing currency hedges for the returns of half of the annual investment needed in developing countries (so $0.85bn) is approximately $14bn*. A pilot with a third of that, $5bn, could make a difference and be proof of principle before it expands. There are micro efforts to hedge dollar or euro exchange rates already without much cost reduction but that is because they operate without scale and diversification or as much capital and liquidity as we envisage and in frontier currencies where alternative ways to manage risk are limited.

There is support for the idea that there is substantial lending headroom at the MDBs, potentially as much as $1 trillion, primarily through full consideration by the credit rating agencies of callable capital and re-channelling of SDRs. The MDBs have a point when they respond that much of their callable capital is not very callable, but that would argue for making it so.

There is support for the idea that the MDBs should use part of this new lending to help climate-vulnerable countries bring forward their resilience - there is no point in them being resilient in twenty years. But there is deep concern about tampering with the existing eligibility for concessional funds at IDA. Indeed, this has been the focal point of opposition to ‘Bridgetown’ by IDA members - perhaps fanned by others. A solution that is generally supported is that climate-vulnerable countries investing in climate resilience should have access to new super-long-term, low-cost terms, such as 50 to 100-year debt at IBRD borrowing rates which today are considerably lower than developing country borrowing rates. And to underscore that we are not trying to divert concessional funding away from the poorest countries, we should dove-tail this with a call for a substantial replenishment of IDA - which also has broad support. In addition, it has been clear that in articulating this framework, we must emphasise the increasing inseparability of development from climate; and in particular the inseparable of development from resilience building, climatic loss and damage and the just green transition. Today, in developing countries, development and climate are two sides to the same coin.

In some quarters, there is strong appreciation that the reforms we are pushing are not just about MDBs. The IMF, for one has a role to play. There are three ways they can do so that is generally supported. First is the widening and lifting of access limits in periods of international financial stress like now. There is a sensitivity that the Fund cannot just do this for Ukraine. More broadly offered and inexpensive liquidity during periods of stress is exactly how the Fed has reacted to forestall the spread of a national crises. We need to do so internationally as well.

Countries are finally coming to the Fund, but the reality is that they should have come earlier, so the eventual adjustment will be more difficult. Part of the problem is that countries have a 'fear of fund' and believe the Fund may impose such constraints on social policy that democratic governments will not get re-elected or be overthrown. There needs to be greater transparency and predictability around the scope for governments to achieve sustainable fiscal targets in more acceptable ways. Part of debt sustainability is making private debt restructuring within IMF programs more attractive. And IMF fiscal conventions and targets, used by many others, need a sensible adjustment that allows debt sustainability analysis to weigh more lightly debt that finances investments that build resilience and future cost savings than debt that does not. This would provide headroom for resilience investments.

There is very strong support for adopting natural disaster clauses in financing instruments, for sovereign borrowers and MDB lenders, to make the international financial system fitter for a new world of shocks and to reduce the pressure for more debt on bad terms in a crisis.

Debt sustainability is a useful overarching theme, including cancelling official bilateral debt or debt for climate swaps. We are not against these and have an award winning debt for nature swap but their scope for moving the needle on fiscal sustainability is so far limited.

In summary, then, the following coherent narrative has the potential to be realised:

Development is increasingly inseparable from climate, particularly investments in resilience and the just green transformation and addressing climatic loss and damage. The green transition is often the best national, regional and global development strategy.

1. We call for a substantial replenishment of IDA.

2. We call for a system of international finance to mobilise the more than $2trn a year of finance needed by developing countries as a whole:

(a) we must catalyse private savings to finance those things with revenue attached, like much of the climate mitigation and sustainable agriculture agenda (circa $1.65 trn per year);

(b) we must use new super-long-term, low-cost lending instruments from expanded MDBs to finance those things with no revenues but savings, like much of the resilience agenda, some investments in natural capital and public health (circa $250bn per year);

(c) we must use new sources of revenues for those things for which there are no revenues and few savings, like much natural disaster loss and damage, the social costs of the green transition and some expenditures for public health and biodiversity (circa $100bn per year).

3. To drive private savings into developing countries we propose establishing a **Just Green Transition, Financing Investment Trust or a JGT-FIT**. It would sit within the network of MDBs and provide cheap long-term currency hedges for the local currency revenues of the $1.65trn a year of just green transformation projects. A pilot could start this year with new capital of $5bn.

4. We must expand MDB lending by $1trn for the SDGs by reforming callable capital and re-channelling SDRs.

5. Part of this new lending must be used to give climate-vulnerable countries investing in climate resilience access to super-long-term, low-cost terms, like 50-year debt at IBRD borrowing rates.

6. We need new revenue sources to fund the Loss and Damage fund, such as:

(a) an international levy on GHG emissions not currently captured domestically, such as an emissions tax, including a specific methane tax, on shipping, fossil fuel and agricultural sectors;

(b) 30% of proceeds from the new global minimum corporate tax and the CBAM or other similar initiatives;

7. To make the international financial system fitter for a new world of shocks, we call for adopting natural disaster clauses in all financing instruments, from sovereign borrowers to MDB lenders.

8. In similar vein we call on the IMF to widen and lift access limits and suspend interest rate surcharges in periods of international financial stress like now.

9. We need to make debt more sustainable. Much of today's problem is the level of debt held by private creditors. We need to make private debt restructuring within IMF programs more attractive for countries, in part through greater transparency and predictability around governments' ability to achieve fiscal targets in more locally acceptable ways. IMF debt sustainability analysis, used by many others, should lower the weight on debt that finances investments that build resilience and provide future cost savings compared to debt that does not, giving space for resilience investments.

10. The other part of debt sustainability is around official debt: improving the common framework, co-ordinating with developing country lenders and where appropriate cancelling official debt.

* (20% capital on revenues of 8% on an investment of $0.85bn)