REDUCING THE HIGH COST OF DEVELOPMENT FINANCE

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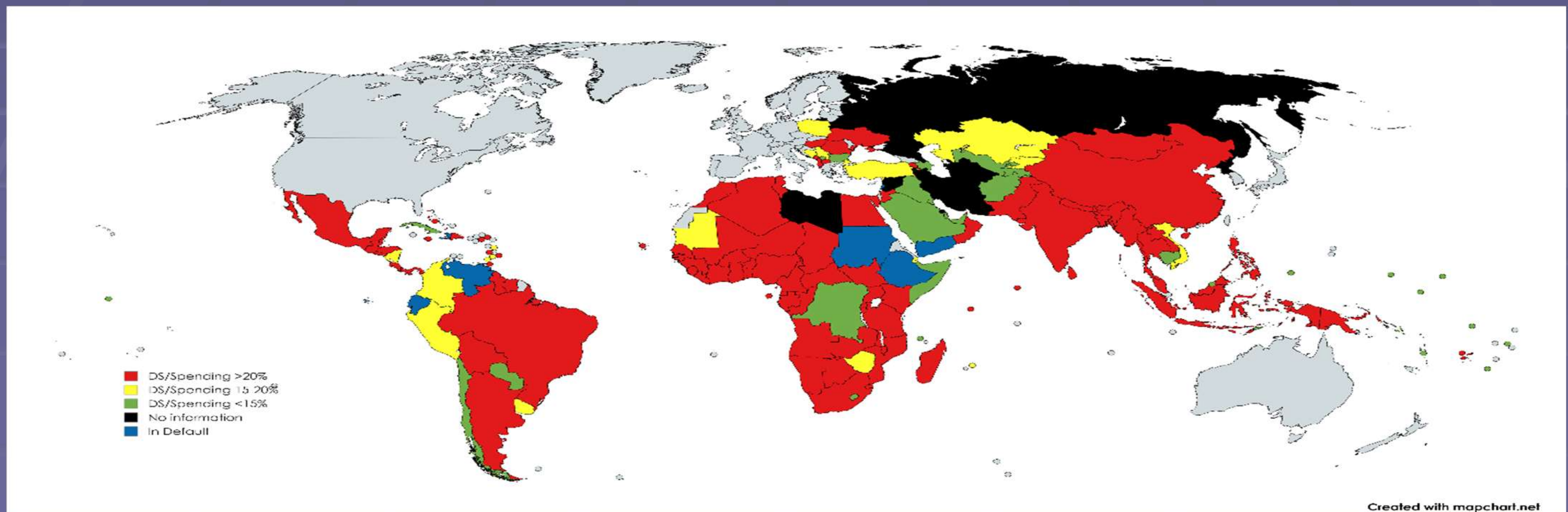
SCALE OF THE PROBLEM

- Worst debt service crisis ever for G77 countries
- ***DFI's Debt Service Watch database***: service will average 47% of budget revenue across 145 countries in 2025: see worst affected below
- Much higher debt service/revenue burdens than LAC had in 1980s, HIPCs had in 1990s
- Long-term burden: 112 countries will pay >20% of revenue over 20% to 2035 (even with IR falls !)



GLOBAL MEASURES: CREDIT ENHANCEMENT

- Most of global discussion dominated by “credit enhancement” measures such as guarantees of country bonds by MDBs/DFIs, cofinancing of private money with public (“blended finance”), but
  1. amount will be woefully insufficient to bring down costs (total MDB lending capacity <2% of G77 borrowing);
  2. even though they remove or cut risk for investor, their record on reducing costs is very poor – eg Ghana WB guarantee bond (+5%), PPPs (rates of return 20% pa)
- So they must be made conditional on major cost reduction so countries borrow close to MDB spreads
- Also major risk that will switch G77 borrowing to global markets, bringing FX risk and undermining financial autonomy, so enhancements would need to be available for domestic/regional markets as well

GLOBAL MEASURES: END “PREMIA”?

- How end unjustified “EMDE”/“Africa”/”LIDC” premia on interest rates in markets?
  - **Independent global or African credit rating agency** – good ideas in principle but would they cut premia ? Might mean narrower range among their country ratings due to better/more diverse information, but would bond issuers/purchasers take any notice ?
  - It’s a broader problem: relationship between credit ratings, issuance & interest rates has broken down: in 1980s, only investment-grade rated G77 borrowed global bonds, got spreads closer to OECD; in 2000s many sub-investment rated G77 encouraged to borrow, with huge spreads (esp first-time issuers eg Rwanda, refinancing needs eg Ghana, or in crisis)
  - Conflict of interest for bond issuance advisers – setting higher IRs to please markets/own departments - should **regulation of issuers be the priority ?**

SOCIAL/ENVIRONMENTAL FINANCE

- Often suggested that socially or environmentally targeted finance will have lower costs (investors will sacrifice part of their return due to their social and environmental motivations), but no evidence that costs are lower on “green”, “blue” or social impact bonds – indeed if anything they have been higher, except in a few examples, such as very closely targeted bonds issued by MDBs themselves. Need more focus on ensuring country costs are reduced
- Better record of lower costs for country bonds targeted at specific communities or motivations eg Islamic finance (sukuks) in many countries with large Muslim communities, or diaspora bonds in Ethiopia or other countries w large diaspora

GLOBAL/NATIONAL: CUT INTEREST RATES

- Bringing down global base rates and inflation – around one third of the current high borrowing costs reflects global inflation (or fear of it)
- Based on past experience, falls in returns on OECD (esp UST) bonds will lead to higher demand for EMDE paper (already happening) and therefore reduce spreads faster
- Relationship between base rates and bond rates in G77 countries ? Lots have raised base rates to combat (largely imported) food and energy inflation, and real interest rates on domestic bonds in most EMDE markets are much higher than those in OECD countries – need to focus on reducing domestic interest rates as well

NATIONAL-LEVEL MEASURES

- Vital not to forget national bond markets – 61% of debt service burden in G77 countries is “domestic”
- Countries which built “healthy” national markets (many in Asia) did so by selling to institutions which wanted longer-term stable returns – public social security & pension funds, national development banks, private investment banks, some SWFs
- Since 2000, massive expansion of domestic bond markets in lower-income and smaller countries, without developing “long-term” institutions
- These “markets” are very distorted: few purchasers, most commercial banks (for selves/clients) which collude to push up interest rates in auctions; + non-resident buyers “arbitraging” prices across regions (eg in EAC, SADC)

NATIONAL-LEVEL MEASURES

- Due COVID and then inflation shocks, + lack of concessional finance/budget revenue, pushed governments increasingly to domestic markets and spreads rose sharply – eg 10-15% real rates
- Even World Bank now suggesting that most lower-income countries are "too financially deep" for their income levels (higher level of financial assets to GDP than desirable), due to government paper
- What to do ?
  - Bring down debt stock sharply to pre-crisis levels – can't be done by fiscal adjustment (scale unrealistic) – use issues of SDRs, IMF/MDB loans, budget support/reserves
  - In extreme cases (30 countries where domestic debt service absorbing >50% of budget revenue), restructure domestic debt – needs careful/differentiated treatment but has been done successfully in many countries

NATIONAL-LEVEL SOLUTIONS

- Issue staggered not bullet payment global and domestic bonds to cut refinancing risk and stop bunching of principal pushing up borrowing costs
- Issue bonds in lower-cost global markets and currencies (eg Japan > US) or in regional markets
- Focus issuance strategies on longer-term lower-return investors (development banks, social security funds) & retail investors buying direct not via banks
- ***Issue bonds at fixed-prices (with low positive real return eg inflation +2-3%), not via auctions (Ethiopia, Rwanda, Turkey have for many years)***
- Wherever possible, borrow high-cost finance only for high-return projects (not necessarily traditional infrastructure – Just Green Transition has higher returns) – to reduce the "net" cost of borrowing

CONCLUSION

1. *Overall, the main immediate changes are likely to come from stronger national policy measures – especially a more determined national policy to do everything to reduce gross and net costs*
2. Credit enhancement can help in some situations (eg when high refinancing risk) but must bring major cost falls & cover regional/domestic debt
3. Diversifying instrument types (sukkuks, diaspora bonds) has helped some countries, could help more if social/environmental instruments cut custs
4. Crucial need for countries to exchange information on their experiences directly among themselves, rather than relying on advice from issuing banks
5. Need longer-term global steps to reassess credit rating methodologies and regulate bond issuance