T20 Policy Brief

Task Force 03
REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Improving Focus of Multilateral Development Banks for Better Supporting Modern Challenges of Sustainable Development

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Abstract

International development challenges continue to add to the already ambitious agenda of Multilateral Development Banks (MDBs). They include but are not limited to climate change, rising threats in health, energy, and food security, digitalization, assistance in post-conflict states, and debt challenges. These challenges form substantial financing gaps that exceed available MDBs resources.

The G20 delivered a Triple Agenda Report, and MDBs are working intensively to enhance their mandates, raise additional resources, and improve operational models and eligibility frameworks to address pressing agenda.

The authors emphasize that the G20, together with MDBs, has an ambitious agenda for mobilization of financing in order to address the challenges. As the most obvious option, the G20 should agree on targets and an action plan for MDBs capital increase. In parallel, authors argue that the G20 and MDBs should shift their focus on "assets" side improvements. Specifically, MDBs need to streamline their resource allocation and project selection, and country eligibility frameworks. The G20 could also do more to promote blended finance in development in order to leverage private sector financing to address vast financing gaps.

The policy brief provides recommendations on the following issues. It suggests enhancing MDBs eligibility frameworks by drafting updated vulnerability index to be among criteria for allocation of the MDB resources. It also looks at blended finance as a mechanism to increase MDBs lending within available capital resources by leveraging private sector funds.

Keywords: Multilateral Development Bank; G20 Triple Agenda Report; Development Financing; Concessional Financing; Blended Finance.

Diagnosis of the issue

According to the G20 Triple Agenda Report (G20, 2023), by 2030, an additional spending of around $3 trillion per year is required. The development finance system should aim to provide $500 billion for official external funding annually by 2030, with one-third in concessional resources and non-debt-creating financing, and two-thirds in non-concessional financing. Additionally, it should assist in mobilizing an equivalent amount of private capital, resulting in a total external funding of $1 trillion. Experts estimate that MBDs need to provide $260 bln additional resources annually, of which more than 70 % in non-concessional lending.

In financing for development, the authors distinguish between MDBs' balance "assets" and "liabilities" measures. On the liabilities side, the priority of the G20 is to agree on action plan for capital increase and work further on MDBs capital adequacy frameworks (CAF). Meanwhile, the authors suggest exploring assets side measures, such as MDBs resource allocation and leveraging of private finance through blended finance.

Operational processes of the MDBs have long been discussed in the G20, including at the Investment and Infrastructure Working Group and Sustainable Finance Working Group (SFWG). Both have deliberated on increasing MDBs' capacity, including by boosting operational efficiency. In 2021, SFWG published reported on needed MDBs' actions, including alignment of operations with climate and sustainable development goals (G20, 2021). In 2022, the G20 endorsed an independent MDB' CAF review, comprising recommendations on risk-taking for MDBs (G20, 2022). In 2023, the G20 worked on the Triple Agenda Report, which highlights the necessity to consider at the MDBs' operational models (G20, 2023, p.45).

Project selection and resource allocation is an important part of an MDB operational process. Implementation of Sustainable Development Goals (SDGs) and Conditional nationally determined contributions under Paris Agreement are largely dependent on international finance, including finance from the MDBs. For instance, most of the least developed countries are vulnerable to external shocks and critically dependent on concessional support.

Country vulnerability has been recognized as a major challenge since the beginning of development economics, with an initial focus on vulnerability to exogenous trade shocks, it has become a greater concern in recent decades due to the stronger impacts of global challenges, such as climate change and pandemics.

As the research shows, international aid has a stabilizing impact for vulnerable countries and potentially is more effective in vulnerable countries such as LDCs (Guillaumont, 2008). However, country economic vulnerability is taken into account in operational processes only in Caribbean development bank and in some ways among other criteria in Asian Development Bank (ADB), International Fund for Agriculture Development (IFAD), and European Commission (EC) (UN, 2021, p. 57) as most of the institutions use performance-based criteria for resource allocation.

As a result, Official Development Assistance, including that from the multilateral financial institutions, is not correlating with the economic vulnerability measured by the UN Economic vulnerability index (EVI). Data reveals that the least developed countries with the highest EVI value do not receive more international aid.

Authors suggest to introduce EVI into the resource allocation framework for MDBs with the aim to direct financial resources to countries that are most vulnerable to economic shocks. This approach ensures that financial assistance is both equitable and effective in addressing the needs of the most vulnerable nations.

Blended finance has been on the agenda of the G20, OECD and other global institutions and fora for many years (IDFC, 2019; G20, 2019; OECD 2020). The concept is aimed at risk sharing (de-risking) between public and private partners so that the project is bankable for private sector counterpart. Blended finance has been considered a solution to financing SDGs gaps.

There are three approaches to blended finance. First, technical assistance for capacity of investees and reduced transaction costs. Second, risk underwriting for management of investor' risks and capital losses. Third, market incentives "to provide results-based financing and offtake guarantees contingent on performance and/or guaranteed payments in exchange for upfront financing in new or distressed markets" (OECD, 2015).

The OECD suggested principles for blended finance at its Guidance that were referenced by the G20. The authors see that some of the principles lack implementation.

There is lack of statistics, metrics and performance indicators for blended finance. It also appear that blended finance could benefit from wider public transparency and accountability. Meanwhile, fragmented statistics reveals that climate blended finance is underperforming. According to available data, there is a substantial decline in global blended finance for climate.

Recommendations

In order to increase MDBs ability to address global development challenges, the G20 has been pursuing multi-year agenda on enhancing MDBs capital adequacy framework. However, from the authors' perspective, there is an assets side that merits exploration as well. First, the authors suggest looking at MDBs project selection and resource allocation process in order to suggest how to streamline scarce MDB resources. Second, with limited MDBs resources and the need to mobilize private capital, including for climate, the G20 should strengthen dialogue and implement concrete actions on blended finance.

The authors consider that economic vulnerability index should be a part of MDBs process of resource allocation among their membership. Building the EVI requires a combination of indicators that reflect the sensibility of countries to economic shocks. These indicators may include:

- Exposure Index: factors such as trade openness, reliance on primary commodities, and geographic isolation;
- Shock Index: frequency and impact of natural disasters, terms-of-trade volatility, and fluctuations in agricultural production;
- Resilience Index: institutional capacity to manage and mitigate risks, social safety nets, and diversification of the economy.

Data for these indicators may be sourced from international organizations such as the UN, the World Bank, and the IMF. The EVI could be updated regularly to reflect changing conditions and to ensure that it remains relevant for resource allocation decisions.

Incorporating the EVI into the allocation process can prioritize funding to countries that are most in need and least able to manage economic shocks, especially for sovereign loans. Prioritization of funding may be implemented at the stage of resource allocation to a development institution or at project selection process. This prioritization may be achieved through:

- Targeted Funding or Special Financing Terms: allocating a higher proportion of concessional resources to high-EVI countries at strategic planning or project-specific decision phases.
- Special Programs or Targeted Non-Financial Conditionality: developing tailored programs that address the specific vulnerabilities highlighted by the EVI.
- Monitoring and Evaluation: implementing robust monitoring and evaluation frameworks to assess the impact of EVI-based funding and adjust strategies as necessary.
- In the view of the suggested EVI, the G20 could consider the following:
- Task MDBs to produce a special report on potential benefits and composition of EVI for their operational activities.
- Consider establishing special funds within MDBs that are specifically designed to support high-EVI countries, with clear guidelines on how these funds should be allocated and managed.
- Call MDBs for capacity-building initiatives targeted at high-EVI countries in order to improve their institutional resilience and ability to manage economic shocks.
- Enhancing coordination among G20 members to ensure that their bilateral and multilateral aid efforts are complementary and synergistic, maximizing their impact on high-EVI countries.

The authors consider that the G20 could play a more active role in implementation of the principles on blended finance stated by the OECD and referenced by the G20. The principles state that blended finance should be tailored to local context; and blended finance should be monitored to transparency and results. Approaches to blending vary significantly from country to country, and it is may be relevant for the G20 to take a closer and systemic look at blending practices and cases, specifically for climate-related projects.

Following the OECD Guidance on Blended Finance, the G20 with contributions from and IFC could focus on consolidation of best national models and cases of blending. The G20 could also rely on Global Infrastructure Hub for relevant online instruments that so that stakeholders have a valuable single source for blended finance information and statistics.

The G20 should also consider stock take special funds, such as IDA Blended Finance Facility in order to understand the scope of multilateral financial mechanisms available for blended finance. The G20 could produce diagnostics of how effective there funds serve aims of de-risking and leveraging. This work should also include analysis of climate finance mechanisms ability to use blended financing.

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Scenario of outcomes

Least developed countries, which are most vulnerable according to EVI, will gain most from reforming of operational process. Current international policies towards LDCs are largely based on the premise that these countries are unequally excluded from the global markets. Taking into account vulnerability in aid allocation process and increase of aid to the most vulnerable countries will at least partly compensate less opportunities and promote equality in access to global financial and product markets. This, in turn, will boost realization of SDGs.

However, bringing more attention to economic vulnerability ex ante will also potentially increase efficiency of aid. Allocating aid to the most vulnerable countries will lead to decrease of possible shocks in recipient countries and potentially lead to decrease of ex post financial needs. This will add to bridging the gap between required and provided development assistance.

Introducing the EVI into the resource allocation framework for MDBs can improve the targeting of resources, stabilize vulnerable economies, and enhance the effectiveness of financial assistance. While there are initial risks and potential negative impacts on MDBs' balance sheets, these can be mitigated through risk-sharing mechanisms, blended finance models, and robust monitoring frameworks. Over the long term, the use of EVI can lead to more resilient economies, which will transform into reduced default risks, and a stronger financial position for MDBs.

Strengthening the G20 focus and consolidating information on blended finance statistics and multilateral financing mechanisms should spur the volumes of development financing without considerable increase in MDB resources. As discussed financing gaps for achieving SDG goals cannot be covered within available resources of MDBs.

Focusing work in blending on MDB side could accelerate growth of climate investments through private sector.

If policy-makers decide to undertake work case studies, one should seriously consider how to construct a convenient analytical instrument for stakeholders as a result of this work. A solution could be to set an on-line tool based on the case-studies, as well as to consider incorporating the work into capacity development activities of MDBs.

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Appendices

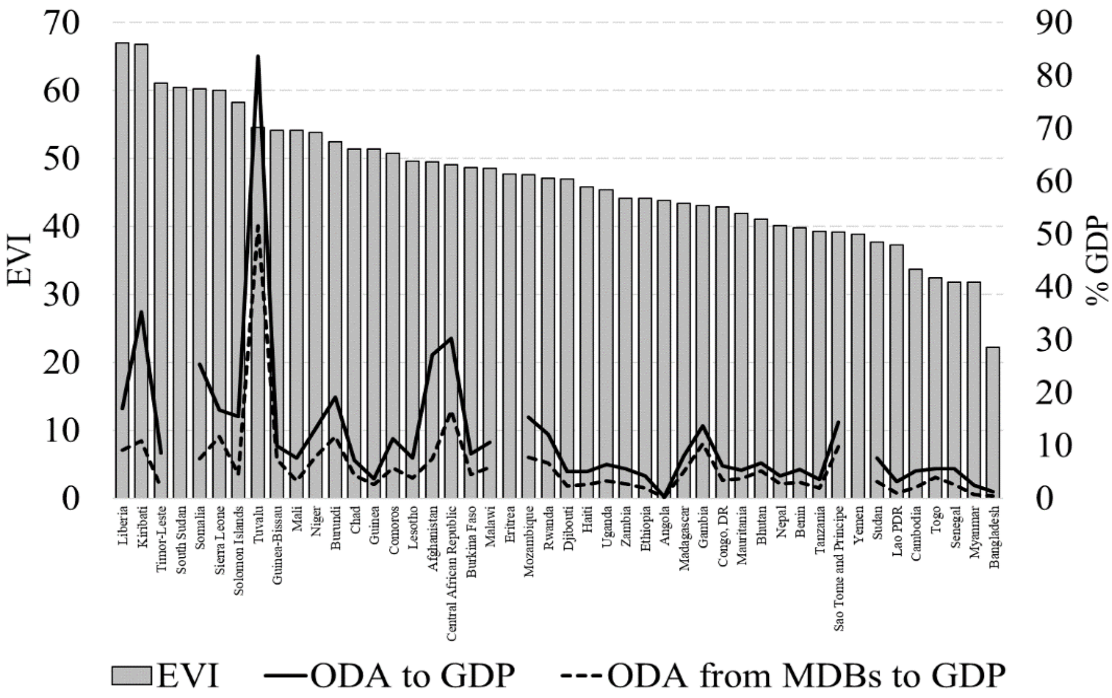

FIGURE 1. Economic Vulnerability Index (EVI), Total Official Development Assistance (ODA) and ODA from Multilateral Development Institutions (MDBs), flows to LDCs, average for 2020-2022

Source: UN DESA (n.d.) LDC Data. URL: https://www.un.org/development/desa/dpad/least-developed-country-category/ldc-data-retrieval.html; OECD (n.d.) International Development Statistics Database. URL: https://stats.oecd.org/qwids/

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