A New Concessional Finance Toolkit

CENTER FOR GLOBAL DEVELOPMENT

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What is the issue?

The Sustainable Development Goals (SDGs) are severely off-track. According to current trends, almost 600 million people will still be living in extreme poverty in 2030. Global hunger has increased and is back at 2005 levels. Three in five of the poorest countries are at high risk or already in debt distress, while one in four middle-income countries are at high risk of fiscal crisis. The effects of climate change are becoming more severe, and at a much faster pace than many had anticipated. There are more active armed conflicts involving sovereign states than at any time since World War II. The same is true for forcibly displaced people. Estimates of the SDG financing gap in developing countries now range from USD2.5 trillion to USD4 trillion.

By the end of 2024, people in one out of every four developing countries will be poorer than they were in 2019. That figure rises to a huge 55 percent for fragile and conflict affected states. The COVID-19 pandemic—followed by the war in Ukraine—had disastrous economic impacts on developing countries, reversing years of progress on poverty alleviation. Financing

SUMMARY

- Financing needs in low- and middle-income countries are at all time high as a result of COVID-19 shocks, soaring debts and elevated interest rates.
- At the same time, there is increasing pressure on ODA budgets due to weak economic growth in Europe and conflicting priorities (Ukraine, refugees in donor countries).
- The EU's concessional finance toolkit is not fit for purpose to respond to these challenges (budget support does not take debt levels into account, highly concessional lending for balance-of-payment issues is limited to the EU neighbourhood and EIB sovereign lending is not on par with other MDBs).
- As the EU is about to start the negotiations for the next Multiannual Financial Framework, we suggest three policy innovations going forward:
  - The European Commission should complement the use of grants for budget support with new concessional loans, especially for partner countries whose macroeconomic context and debt carrying capacity are sustainable.
  - The EIB should integrate flexible and liquid concessional lending to support sectoral policy reforms into its financing toolbox.
  - The European Commission should review the use of EU guarantee instruments, including unblocking EIB constraints on sovereign loans to low-income countries via targeted country-risk guarantees.

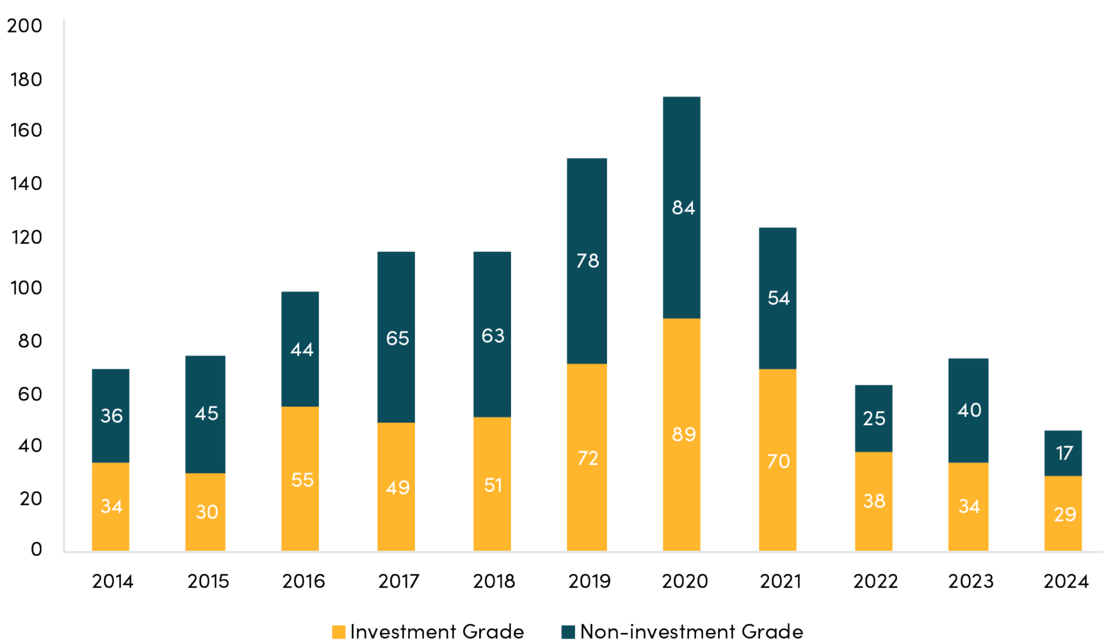
needs have sky-rocketed, as they make efforts to fend off the impact of cascading crises, and by limited alternative sources of financing. They now face a combination of soaring debt, elevated interest rates and energy costs, and inflationary pressures, limiting access to and/or increasing the cost of finance. 2022 and 2023 saw the lowest bond issuance by developing countries in the last 10 years (see Figure 1).

As the cost of servicing debt has soared, and financing options have plunged, LICs and lower middle-income countries (LMICs) face a serious liquidity squeeze. These countries cannot address this financing gap alone. They need concessional finance to mitigate debt vulnerabilities and to continue to invest in human development, infrastructure and the climate transition.

At the same time, amid sluggish economic growth in Europe, fiscal constraints and growing budget deficits, a surge in defence spending and military and economic support for Ukraine, many European countries such as France, Germany, the Netherlands, Finland, Sweden are reducing their aid budgets. In the face of political pressures in some of Europe's largest donor countries, a growing share of official development assistance (ODA) being diverted to firefight crises, less money is available for long-term, predictable, multi-year development programming. As shown in Figure 2, country programmable aid (which excludes the costs of hosting refugees), humanitarian aid, debt relief and administrative costs have decreased from 39 percent of total ODA in 2013 to 33 percent in 2022.

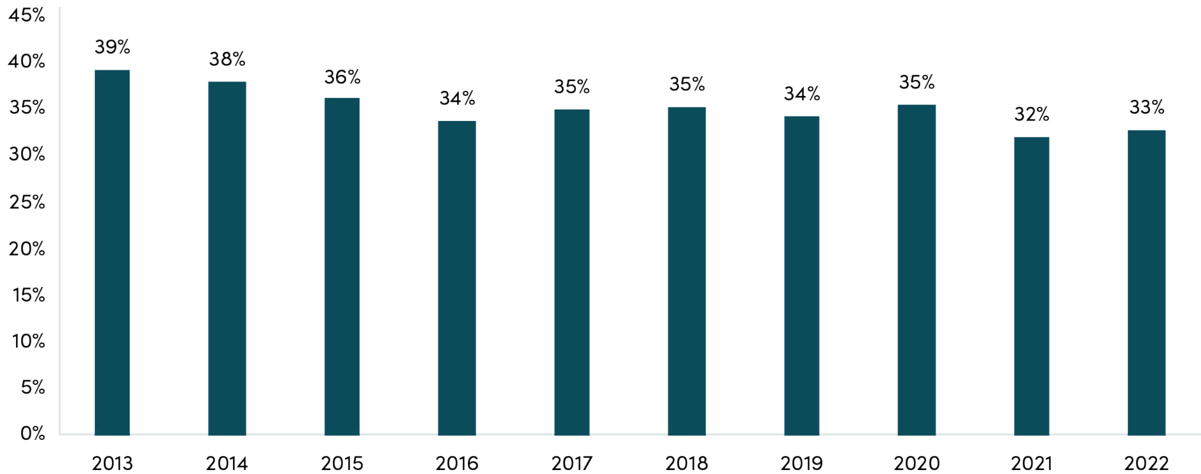
> *Financing needs in low- and middle-income countries are at all time high as a result of COVID-19 shocks, soaring debts and elevated interest rates.*

FIGURE 1 Sovereign bond issuance of developing countries by credit rating grades, USD billion



Source: UNCTAD, Trade and development report update (April 2024)

FIGURE 2 Country Programmable Aid (CPA) as a share of total ODA provided DAC countries



Source: OECD CRS

With migration dominating the political agenda, the EU's development funding is also under threat. As part of the mid-term review of its multiannual budget, the EU shifted EUR4.5 billion within its main external funding pot to tackle increased migration, leaving fewer resources to finance development priorities in partner countries.

Why should the EU address it now?

As many developing countries struggle with limited access to finance, growing debt burdens and a worsening climate crisis, the SDG financing gap continues to widen. With European development budgets in decline, the EU needs to step up in the face of this unfolding development crisis and improve its concessional finance offer to those countries most in need. Yet, its development finance toolkit is currently not fit for purpose and cannot match the scale of the challenge.

Although the European Commission provides budget support in the form of grants of up to almost EUR2 billion per year, it is not linked to countries' creditworthiness, debt vulnerability or income category. This is counterintuitive in a context where grants are of greater strategic and efficient use in countries with no fiscal space but less in countries that can access other financing modalities. In 2022, EU budget support was highly concentrated in middle-income countries (MICs) which accounted for 85 percent of disbursements (EUR 1.58 billion), while only 13 percent (EUR195 million) went to low-income countries (LICs).

Beyond grants, the European Commission provides Macro-Financial Assistance (MFA) to support countries' balance-of-payments issues with concessional loans. These loans—approximately EUR7.5 billion in 2022—are conditional on International Monetary Fund (IMF) programmes and progress on democratic indicators. However, the concessional loans are reserved for countries in the EU's neighbourhood. Up until now, the borrowers have been upper middle-income countries (UMICs).

> *The EU's development finance toolkit is currently not fit for purpose and cannot match the scale of the challenge.*

The European Investment Bank (EIB) conducts sovereign and non-commercial sub-sovereign operations outside of the EU, with a strong focus on the neighbourhood and sub-Saharan Africa. As part of the European Fund for Sustainable Development Plus (EFSD+), the European Commission provides the EIB with grants for blending operations, and a EUR 26.7 billion guarantee, de-risking the bank's investments in partner countries. Nevertheless, the EIB's lending terms offer a significantly lower grant element than, for instance the World Bank's International Development Association, and other similar concessional finance windows. From EUR4.1 billion of ODA-eligible loans to the public sector, the resulting ODA grant equivalent represented EUR1.6 billion—a grant element of only 39 percent. Contrast this to World Bank International Development Association (IDA) loans in which the grant element stands at around 70 percent.

What can the EU do about it?

The EU's Multiannual Financial Framework (MFF) for 2021-2027 has been used to respond to a growing array of challenges with billions of ODA reallocated to supporting Ukraine and investments to reduce Europe's energy dependence on Russia, as well as to thwarting migration. Reduced fiscal space in the 27 Member States and a focus on defence spending and access to critical raw materials for Europe's economic security risk relegating development spending to the bottom of the priority list for the next MFF 2028-2034. This is at a time when financing needs for urgent development priorities are huge and growing, especially for low-income and highly indebted countries. To remain relevant and maintain relationships and influence with partner countries, the EU will have to step up its game when it comes to providing more and more strategic concessional finance.

> *Grants should be used for countries with no fiscal space to invest in sustainable development.*

To lay the ground for the next MFF, the EU must optimise its use of concessional finance. Here are three ways it could do so:

1. Combine concessional loans with grants in the provision of budget support.

The European Commission should complement the use of grants for budget support with new concessional loans, especially for partner countries whose macroeconomic context and debt carrying capacity are sustainable. This does not mean that grants (and grant elements implicit in concessional loans) are not relevant, but rather that they should be used strategically, for countries with limited or no fiscal space to invest in sustainable development.

2. Empower the EIB to engage in policy-based lending.

The EIB, as the "EU Bank," should integrate policy-based lending into its financing toolbox. In doing so, the EIB would provide partner countries with flexible and liquid funding to support policy reforms in given sectors. The EIB could build on its recent experience of results-based lending, which links disbursements to the achievement of policy objectives in a specific sector.

3. Review the use of EU guarantee instruments, including unblocking EIB constraints on sovereign loans to low-income countries via targeted country-risk guarantees.

The European Commission and EU Member States should engage in a strategic overview of the deployment and effectiveness of guarantees at project, sector, and country levels. As part of this review, EU policymakers and EIB shareholders should address the problem of the EIB's country risk profile limiting access by developing countries with low credit ratings to its sovereign lending. Targeted guarantees under the EFSD+ could counteract such country-risk restrictions, as against project risks. Targeted subsidies could also be used to lower the cost of borrowing. This could be particularly helpful for countries with IMF programmes which restrict sovereign borrowing to concessional loans.

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This brief is part of series, The EU's Global Role: Policy Proposals for a New Era. The series will set out a suite of policy proposals designed to shape the international development agenda of the European Union's leadership during the 2024–2029 term.

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