BU Global Development Policy Center

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Working Group 1

# Scaling Up Funding and Reforming Financial Institutions

POLICY PAPER

Working group led by Prof. Kevin P. Gallagher, Boston University

## Working Group 1 on 'Scaling Up Funding and the Role of MDBs'

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### Policy Paper

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## Executive Summary

The global community is falling behind and running out of time in meeting our shared development and climate goals. Five years after the onset of the COVID-19 crisis and with only five years left to meet the United Nations Sustainable Development Goals (UN SDGs) and align the global economy with the goals of the Paris Climate agreement, the UN reports that 85% of the SDGs are either off track, stagnating or in regression. 2024 was the hottest year ever, resulting in extreme heat, wildfires, hurricanes, and floods that have wreaked havoc on economies and livelihoods and are triggering new waves of migration. Moreover, income and wealth inequality remain acute. The compounded impact of global inaction on this agenda is impacting both our economic and political systems, fueling populism, extremism, and the breakdown of the social fabric and ecological integrity of the globe.

In the 2024 UN 'Pact for the Future' global leaders committed to scaling up and reforming international financial institutions to make them fit to meet the global challenges of the 21st century (UN, 2024). Moving forward, there are two vital opportunities for the global community to revive global efforts to address these urgent challenges--the Fourth International Financing for Development (FFD) Conference in Spain, and at the G20 in South Africa, each in 2025. Three outcomes are paramount to seizing these opportunities and to put the world economy back on a sustainable path. It is essential that the FFD and G20 deliver on:

01. Increasing the scale and quality of Multilateral Development Banks (MDBs) to generate affordable FFD and climate goals;

02. Enhancing the global financial safety net (GFSN) such that it enables countries to prevent and mitigate the increasing number of shocks in a globalized and climate-constrained world; and

03. Expanding the level of voice and representation of emerging market and developing countries and their citizens in the International Financial Architecture (IFA) to improve the effectiveness and legitimacy of the system.

This policy note has five sections. Section 1 demonstrates that the global community is falling behind and running out of time on financing our development and climate goals. Section 2 addresses the need to increase the scale and quality of MDBs. Section 3 outlines the need to expand the GFSN. Section 4 demonstrates why it is imperative to increase the voice and representation of emerging market and developing countries in the IFA. Section 5 pinpoints specific policy recommendations for each of the three essential actions that need to take place at the FFD and G20 in 2025.

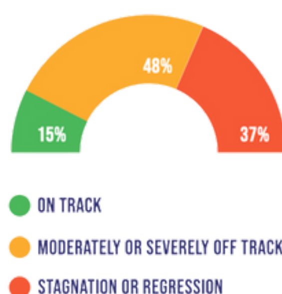
Further regressing on our development, biodiversity and climate goals will have catastrophic impacts on our economies, our social relations, and the environment. Urgent action is needed on MDBs, the GFSN, and voice and representation in the IFA, in tandem with the debt and tax priorities coming out of the Club de Madrid's two other working groups. As former United States Treasury Secretary Henry Morgenthau Jr. said at the onset of the establishment of the contemporary IFA in 1944, 'Prosperity, like peace, is indivisible.'

## I. Falling Behind and Running out of Time

The global economy is increasingly becoming less stable, less equal, and less resilient. This backsliding is in large part due to the lack of political and economic investment in people and the planet. The lack of such investment has begun to result in severe economic, human, and political damage that is reaching a tipping point. The IFA has a central role in providing an enabling environment for such investment, and by preventing and mitigating the inevitable risks associated with an increasingly interconnected, warming, and unequal world. The IFA has proven to not be fit to rise to the global challenges of this century. Moving forward, the IFA needs to be bigger, more effective, and more representative of the planet's people.

In their most recent stock take of progress toward the SDGs, the UN estimated that 85% of SDGs are off track, stagnating, or regressing (Figure 1). According to that study, chronic hunger has increased from 7.9% to 9.2% —or 750 million people— since 2020. One third of the world's people, 2.4 billion, now face food insecurity (UN, 2023). The Pact for the Future recently reaffirmed a commitment to close the SDG financing gap, which the UN has estimated to be $4 trillion per year (UN, 2024).

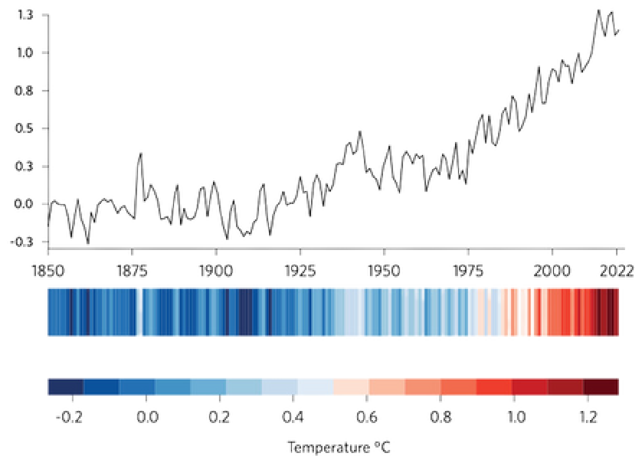
**Figure 1: 85% Of UN SDGs Off Track, Stagnating, or Receding**




Source: UN (2023)

The year 2024 was the warmest year on record and part of an alarming trend (Gaffney, 2024). In its last assessment, the Intergovernmental Panel on Climate Change (IPCC) estimated that global surface temperature had already increased by 1.1 degrees Celsius. Based on the policies announced thus far, it concluded that it was likely for warming to exceed 1.5 degrees in the 21st century and it predicted a global temperature increase of 2.8 degrees by 2100 based on current policy pathways (Rhodium Group, 2023).

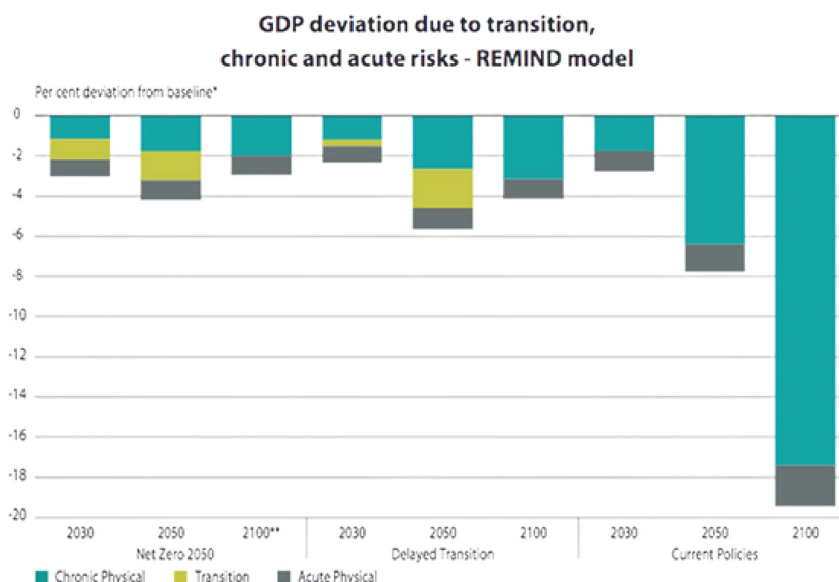
**Figure 2: Increase In Global Surface Average Temperature**




Source: UN IPCC (2023)

The costs of inaction on climate and development are staggering and potentially catastrophic without urgent action. The literature is in strong agreement about the cost of inaction on climate change, while the precise estimates vary due to methodological differences. The Network for Greening the Financial System – a network of 114 central banks and financial supervisors – finds that the economic impact of transition risks and physical risks could be as high as 20% by 2100 if current policies, which are inconsistent with net-zero pathways, are maintained (Figure 3) (NGFS, 2022). Over half of global GDP is dependent on nature. The main driver of biodiversity loss remains humans' use of land, while climate change is playing an increasingly important role (Ranger et al 2023). At the same time, more finance is going to the causes of climate and environmental degradations, with implicit and explicit fossil-fuel subsidies surging to a record $7 trillion in 2023, according to the International Monetary Fund (IMF) (Black et al, 2024).

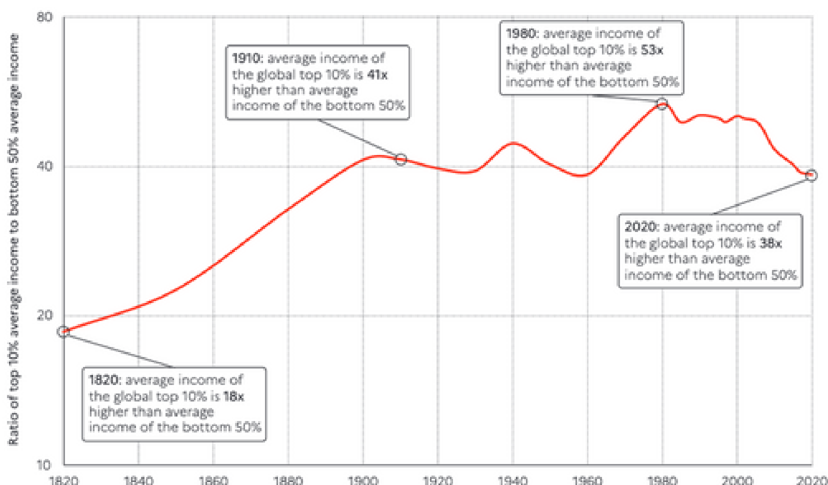
**Figure 3: Climate Risks and Impacts on GDP**




Source: NGFS (2022)

Levels of income and wealth remain alarmingly high. According to the World Inequality Report, the richest 10% of the global population captures 52% of global income, and the poorest half of the world earns only 8.5%. The picture is even worse for world wealth inequality, where the poorest half of the world's people hold just 2% of total wealth while the richest 10% of the global population own 76% of all wealth (See Figures 4 and 5, WID, 2022).

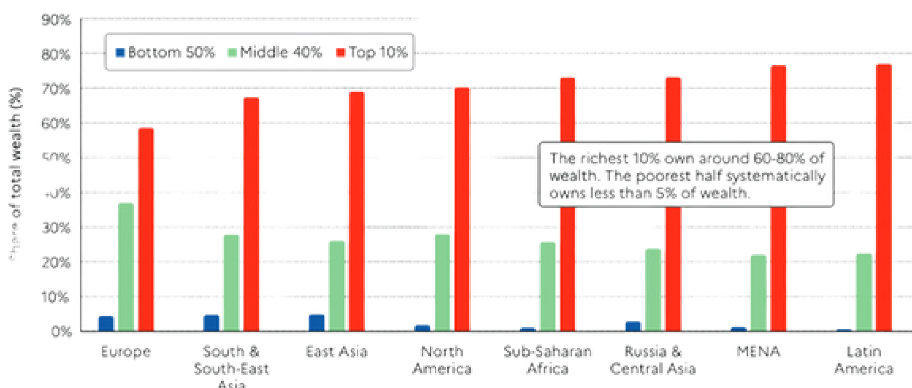
**Figure 4: World Income Inequality, 1820 to 2020**




Source: World Inequality Database (2022)

As shown in Figure 5, the bottom 50% of people living in developing countries have close to no wealth at all.

**Figure 5: Regional Distrubtion, World Wealth Inequality**




Source: World Inequality Report (2022)

The lack of political and economic investment into the SDGs and the Paris commitments is not only causing enormous economic damage and jeopardizing the livelihoods of billions of people on the planet—it is also eroding the social fabric of countries in the Global North and Global South alike. Climate change is producing 'climate migrants' or 'climate refugees' as its victims move both within and across borders (Prange 2022, Ozdemir 2023). A World Bank study on internal migration found that 216 million people could move within borders by 2050 due to slow onset climate impacts (World Bank 2021). A recent Nature study found that climate change is already contributing to migration from Central America to the United States, whereas other work shows how climate refugees are increasingly finding their way to Europe (Linke et al. 2023, Scott 2023). As climate change erodes the right to stay at home, a lack of orderly migration pathways amplifies the possibility that migration will contribute to social disruption.

Inequality, migration, climate change have all been found to be playing a role in the growing levels of political polarization, populism, and extremism in countries in both the Global North and Global South (Rodrik 2021, Guriev and Papaioannou 2022, Franc and Pavlovic 2021). As right-wing populism gains strength, democracy is put under threat and citizens' basic civil and political human rights are put in jeopardy.

The IFA is in part to blame for some of these trends.Despite some progress, the IFA has fallen short in providing the necessary financing for development, resilience, climate and environmental protection, safety nets from external shocks, and adequate voice and representation across the globe. It is urgent that the IFA be reformed. To help turn the tide against these worrying trends, the IFA needs to be bigger, more effective, and more inclusive.

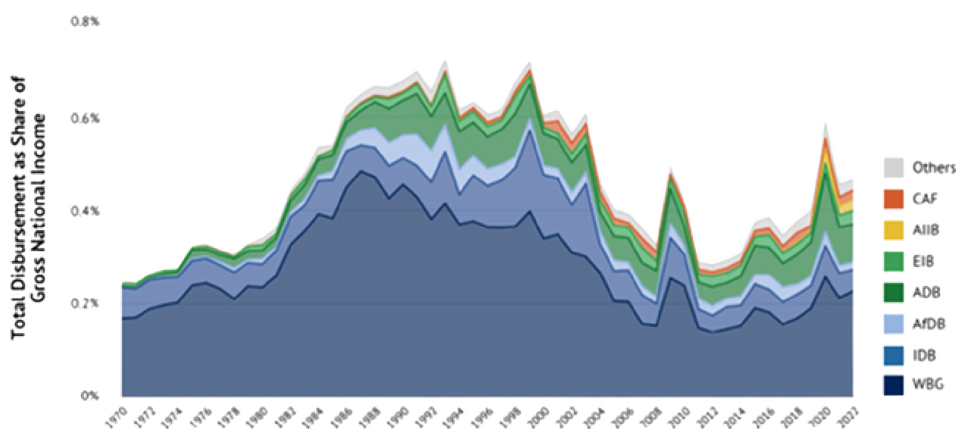
## II. Increasing the Scale and Quality of Multilateral Development Banks

The MDBs have a critical role to play in catalyzing and scaling investments for the SDGs, nature and the Paris Agreement. However, as World Bank (WB) President Ajay Banga said himself, the WB's capital is 'is like a pimple on a dimple on an ant's left cheek' compared to the $3 trillion needed for the SDGs and Paris commitments by 2030 (Reuters 2023).

MDBs have a central role to play in such resource mobilization given their unique business models, their ability to provide direct long run and affordable financing themselves, and their potential for private capital mobilization (PCM) and domestic resource mobilization (DRM) for climate and development goals. Not only is it paramount to generate a stepwise increase in investment but such investment must be at an affordable cost in order to ensure the debt sustainability of emerging market and developing nations as they pursue new growth strategies aligned with the SDGs, the Kunming-Montreal Global Biodiversity Framework and the Paris Agreement on climate change.

Estimates for the levels of investment needed in emerging market and developing countries (not including China) to meet our shared development and climate goals range from $3-4 trillion USD annually by 2030 (Songwe, Stern, and Bhattacharya 2022; Summers and Singh 2023). This investment is necessary to generate low-carbon, socially equitable, and more resilient development, as well as to avoid the costs of not acting in time. On an annual basis, roughly $1 trillion of that financing will need to come from external sources annually, with at least $250-$390 billion coming from the MDBs on an annual basis by 2030 (Summers and Singh 2023). Currently, MDBs are only providing financing of $160 billion per year. MDBs have not kept up with income levels and are down from their peaks in the early 1990s. As shown in Figure 6, on average, lending from MDBs to low and middle-income countries (excluding China) has stood at less than five tenths of one percent of GNI since 1970. Moreover, the MDBs have struggled to catalyze private sector investment for development, which Summers and Singh estimate will have to provide $500 billion of the addition $1 trillion in annual external financing by 2030 (Gallagher et al, 2024; Summers and Singh 2023).

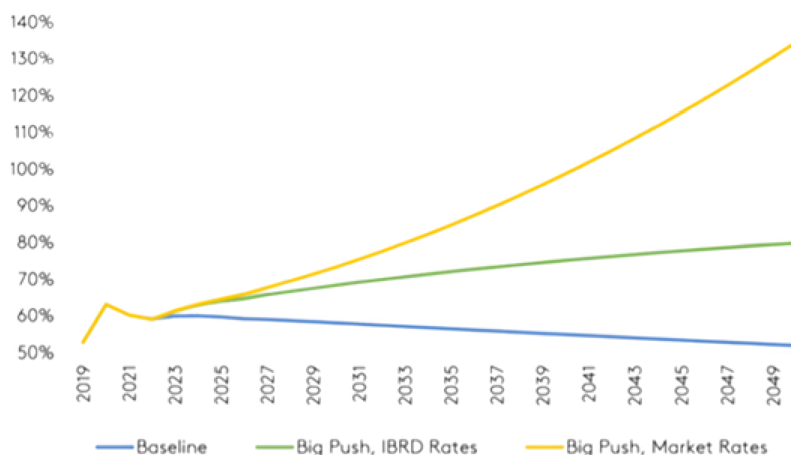
**Figure 6: MDB Financing Not Keeping in Pace with GDP**




Source: Gallagher et al, 2024

Encouraged by the G20, the MDBs are already underway in beginning to implement recommendations from the G20 Independent Review of MDB Capital Adequacy Frameworks (CAF Review), announcing that they plan to mobilize upwards of $300-$400 billion (total, not annually) in new lending from such measures as balance sheet optimization, issuing hybrid capital and guarantees, and beyond. While these first steps in implementing the CAF Review recommendations are significant, they fall far short in providing the $250-$390 billion annually that are needed. To this end, the Brazilian Presidency of the G20 has issued a Roadmap for MDB reform which includes 'resource needs reviews' where each MDB would assess the level of CAF-like measures and new capital that will be needed to meet the SDGs and Paris commitments (on top of existing mandates), and the Pact for the Future encouraged the boards of the MDBs to consider capital increases.

**Figure 7: Reducing the Cost of Capital is Essential**




Source: Songwe-Stern, Bhattacharya, 2022

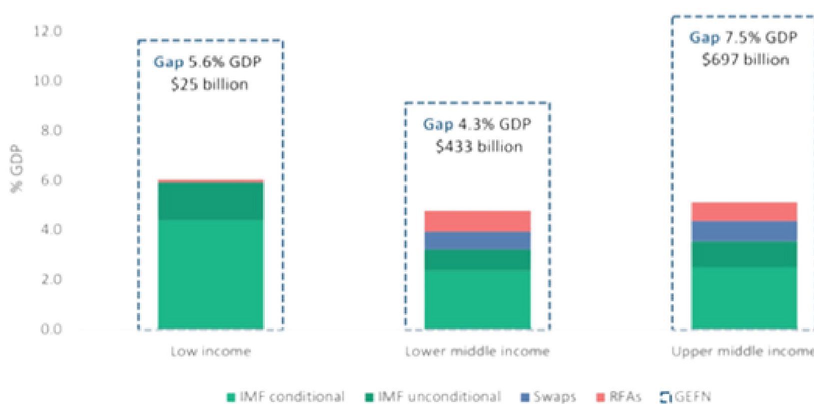
Of equal importance is not only the level of new financing but also the cost of capital. As shown in Figure 7, if the level of financing is closer to market interest rates, it would threaten the debt sustainability of many emerging market and developing countries, amplified by the impact of climate change. Indeed, the majority of low-income countries are already distressed to the point where they cannot meet their climate and development goals, and many middle-income countries are not far (Zucker Marques et al, 2024). In addition, the WB needs to become more growth enhancing, as a swath of recent studies have shown that MDBs are no longer associated with economic growth (Wang and Yinyin, 2024; Xu et al, 2024; Dreher et al, 2021). Moreover, in addition to financial support, some countries in the Global South will need support developing the skills and institutional capacity to develop and implement proposals for projects that are both bankable and contribute to increasing their resilience, adapting to climate change and meeting the SDGs and climate and biodiversity goals.

## III. Enhancing the Global Financial Safety Net (GFSN)

The 21st century has proven to be financially volatile for emerging market and developing countries, accentuating the lack of affordable liquidity available in times of need. It has been well documented that the so-called 'GFSN' is not large or comprehensive enough to prevent and mitigate financial instability in times of need.

Relative to the size of global GDP or global assets and liabilities, the GFSN has been shrinking over time for emerging market and developing countries while our interconnected global economy has become more susceptible to external shocks (Zucker Marques, Muhlich, and Fritz, 2023). Figure 8 outlines estimated gaps in liquidity for different levels of income, with low income, lower middle income, and upper middle income countries facing liquidity gaps of 5.6%, 4.3%, and 7.5% of GDP, respectively. As can be seen in the figure, the GFSN is the 'thinnest' for low income countries (especially in Africa). By and large, for low income countries, their only source of liquidity in times of need are IMF conditional programs. Whereas the upper middle income countries have the largest level of need, their sources are more diversified through swaps and regional financial arrangements.

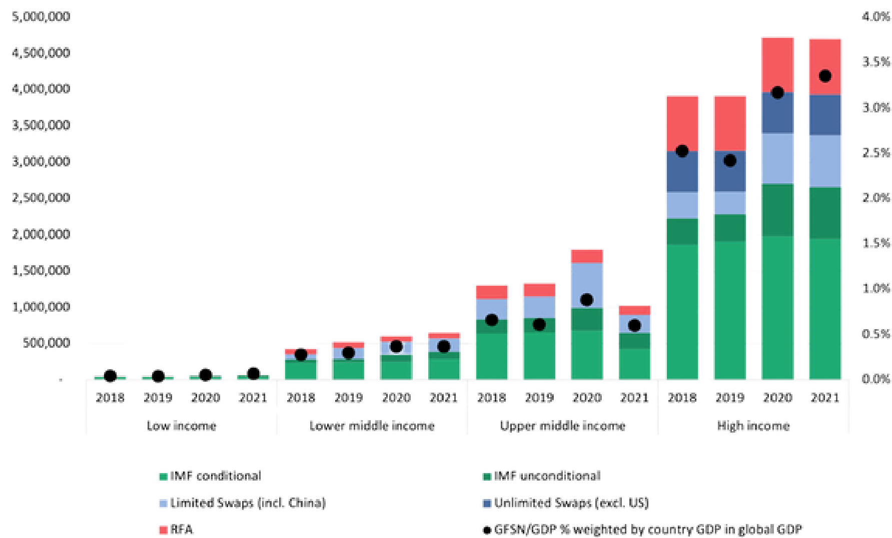
**Figure 8: Gaps in the Global Financial Safety Net**




Source: Muhlich and Zucker-Marques, 2023

Moreover, as shown in Figure 9, the GFSN is highly asymmetrical, with higher income economies having access to the strongest and most diverse forms of liquidity support whereas the most vulnerable countries only have access to the IMF (Muhlich, Fritz, and Kring 2023). Countries in the Global North and a very select group of upper middle income countries have been granted access to swap arrangements with the major central banks in the Global North—without any conditionalities for fiscal consolidation. In fact, such arrangements are usually associated with the ability of such countries to engage in expansionary monetary and fiscal policy (Aizenman et al, 2022).

**Figure 9: Asymmetric Coverage of GFSN**

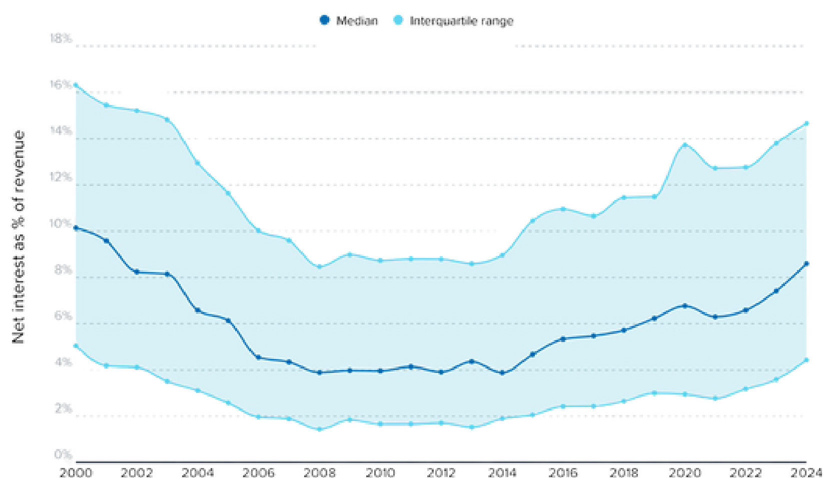



Source: Muhlich and Zucker-Marques, 2023

What is more, conditions attached to IMF loan programs often impose austerity measures and exacerbate inequality without consistently promoting stability and growth (Kentikelenis and Stubbs, 2023). In those cases, many developing countries avoid IMF programs as long as possible and resort to private capital markets at very high interest rates, further accentuating the sources of financial instability.

A rare source of major, countercyclical, and conditionality free liquidity support for developing countries came through the 2021 allocation of $650 billion Special Drawing Rights (SDRs) and proved to be very useful (IMF, 2023). Because SDRs are distributed in line with the IMF's unbalanced quota system, only around $200 billion of those SDRs went directly to developing countries, a very significant sum but still a minority of the whole. While rechanneling SDRs from countries with strong external positions that have no need for SDRs provides an important opportunity, such rechanneling has been slow (ONE, 2024). Other innovations are a proposed 'Emerging Markets Fund' that would be managed by the IMF to lure low-cost liquidity to developing countries in times of need as well, but have not received sufficient attention (CLAF, 2023).

**Figure 10: Net Interest Payment as a Percentage of Developing Countries' Government Revenues**




Source: UNDP, 2024

The World Bank is now referring to a 'silent debt crisis' -silent because it is not being addressed by the global system. The UN shows (Figure 10) that net interest payments as a percentage of developing countries' government revenue is close to the level from 2000- the height of the developing country debt crisis. Moreover, UNCTAD calculates that there are now 3.3 billion people that are living in a country that is paying more on debt service than on health or education investments (UNCTAD, 2023). Least developed countries spent $33 billion servicing debts in 2021 - but received just $20 billion in climate finance (IIED, 2023).

For these reasons it is essential that new liquidity from the public and private sectors, as well as new development financing, enhance debt sustainability moving forward. It is imperative that the weighted average of the cost of capital for this external financing be lower than the projected growth rates of the recipient economies- or new financing will accentuate debt distress such that an increasing number of countries will have to default on their debts and development goals alike, and this will only be worsened by climate change.

## IV. More Transparent and Just Financial Governance

The lack of scale and efficacy across the IFA is in part a function of the fact that the countries that most rely on the IFA have the least amount of voice and representation in the governance of the IFA.

By and large, institutions for global economic governance do not provide adequate voice and representation to emerging market and developing countries and their citizens. This is manifest in the 'gentleman's agreement' whereby the heads of the WB and the IMF are citizens of the United States and Europe, respectively. These institutions also grant veto power to a small handful of advanced economies whose decisions dominate decision-making (Dreher et al, 2015). Within the IMF and the WB there is a significant gender and nationality imbalance of representation as well, especially in senior positions. Finally, there are limited opportunities for non-state actors to meaningfully engage on MDB and IMF policy. Some progress has been made in recent years, most notably with the addition of a third Executive Board chair for Sub-Saharan African countries at the IMF, and the inclusion of the African Union to the G20. However, there have been missed opportunities, too, such as with the 2023 IMF quota increase that did not include a realignment of voting shares.

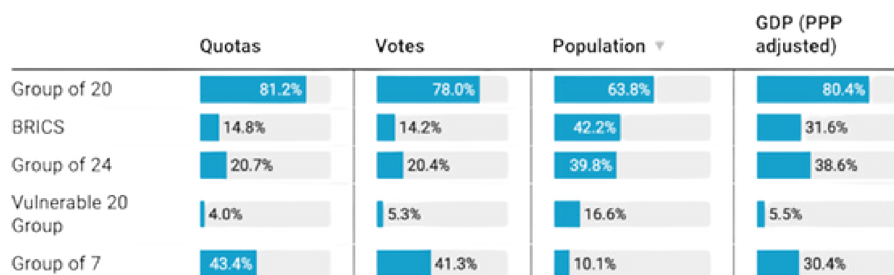
**Figure 11: Percentage of Quotas and Voting Shares in the IMF**

| | Quotas | Votes | Population | GDP (PPP adjusted) |
|---|---|---|---|---|
| **Advanced Economies** | 61.4% | 59.1% | 13.7% | 40.5% |
| **Emerging and Developing Economies** | 38.6% | 40.9% | 86.3% | 57.7% |
| Emerging and Developing Asia | 13.0% | 13.1% | 48.5% | 33.0% |
| Emerging and Developing Europe | 6.6% | 6.7% | 5.0% | 7.0% |
| Latin America and the Caribbean | 7.9% | 8.4% | 8.0% | 7.2% |
| Middle East and Central Asia | 7.6% | 8.1% | 11.0% | 7.3% |
| Sub-Saharan Africa | 3.5% | 4.6% | 13.8% | 3.1% |
| Climate Vulnerable Countries | 4.0% | 5.3% | 16.7% | 5.3% |

Source: Merling, 2022

Figure 11 displays the significant inequities in quota and voting shares at the IMF.Advanced economies have roughly 60% of quotas and voting shares despite having only 14% of the global population and 40% of global GDP.

**Figure 12: No Voice for the Vulnerable: Quota and Voting Shares in Comparative Perspective**




Source: Merling and Kring, 2023

One avenue that developing countries have attempted to pursue to increase their voice and representation across the IFA has been in coalition building. The longest standing developing country coalition within the IFA is the Group of 24, which is officially recognized by the IMF and the World Bank Group (WBG) with offices in the IMF. Despite having four times the population of the Group of 7 however, the Group of 24 only holds half as many quotas and votes as the G7. The V20—the most climate vulnerable group of countries, has only 4-5% of quotas and votes despite having more than 50% of the population of the G7. While basic votes—votes distributed equally to all members—amounted to 11% of all votes at the IMF's formation, they now only account for 5.5% of all votes.

Finally, whereas the MDBs have independent accountability mechanisms for citizens of borrowing nations to monitor MDBs and hold them accountable, the IMF does not have such a body with meaningful clout (Bradlow 2021). To provide greater accountability, an independent ombudsman could be created to report directly to the IMF Board of Executive Directors and be mandated to investigate complaints about the IMF staff's compliance with the IMF's own policies and procedures (Bradlow 2022). The creation of this ombudsman would promote confidence in the IMF, provide the IMF with new knowledge from communities and other non-state actors that currently have no formal channels to provide information, and improve IMF learning over time. Because this ombudsman's work would be initiated by external complaints, it would not duplicate the work of the Independent Evaluation Office.

## V. Making the IFA Bigger, Better and More Inclusive

The IFA needs to become bigger in terms of the size of liquidity facilities and long run development finance and aligned with our shared development, climate and biodiversity goals.However, the system also must improve its policy mix and the level of voice and representation of developing countries. To this end, the Working Group 1 of the Club de Madrid recommends that the following specific policy proposals be advanced by the Club de Madrid leaders at the UN FFD 4 and in the 2025 G20 to advance the three priorities outlined in the executive summary.

### Scaling Up Funding through Multilateral Development Banks

- Fully implement the recommendations of the G20 Independent Panel for Review of MDBs' Capital Adequacy Frameworks (CAF) to optimize their balance sheets and provide hybrid capital (including through the use of SDRs) to increase MDB lending by 2030.
- Conduct regular resource needs reviews across the MDBs to ensure that MDBs can collectively demonstrate a credible path to delivering at least an additional $300 billion annually in affordable, longer-term development financing in a manner that comports with debt sustainability by 2030.
- Provide a stepwise increase in concessional financing, with at least $120 billion in IDA 21 replenishments, an ambitious replenishment of the African Development Fund in 2025, and regular replenishments for concessional lending arms anchored in resource reviews of client needs to meet development and climate goals.

### Improve the Scale and Efficacy of International Liquidity Provisions in Times of Need

- Call for new issuances of SDRs at the IMF in 2025, with a significant amount of those SDRs re-channeled for both liquidity financing to countries in need as well as through hybrid capital for MDBs.
- Enact further IMF quota increases by the end of the 17th General Review of Quotas and consider an IMF-managed emerging markets fund that enables countries to have early access to adequate volumes of liquidity finance at below market rates to manage the impact of adverse currency moves and climate risks, free from onerous conditionalities.
- Encourage the expansion of Regional Financial Arrangements, especially on the African continent where the Global Financial Safety Net is thinnest.

### Enable More Transparent and Just Financial Governance

- Instate a merit-based process to choose the heads of the IMF and the WBG that are open to citizens in all countries of their memberships.
- Link quota and capital increases with a realignment of voting shares aimed at increasing the voice and representation of developing countries, with concrete progress made by the June 2025 deadline for developing approaches for quota realignment and in the 2025 WB shareholding review; and officially recognize the Vulnerable Group of 20 Finance Ministers at the IMF and WB.
- Establish an independent ombudsman at the IMF and enhance such functions within the WBG.An IMF ombudsman should report directly to the Board of such institutions, be independent of management, and that limit its mandate to investigating complaints about IMF compliance with its own policies and procedures.

None of these proposals are new. They echo a range of governmental, intergovernmental, and nongovernmental declarations, including the Pact for the Future, the Bridgetown Initiative, the Nairobi Declaration, the V20 Accra-Marrakech Agenda, G24 communiques, the FFD Forum, the UN Secretary General's SDG Stimulus Agenda, the Paris Pact for People and the Planet, and more. The reforms needed to make international financial institutions work for peace, prosperity, and planet are well known—but 2025 must be the year that leaders find the political will to make these reforms a reality.

## Contributors

This policy paper was commissioned by Club de Madrid and prepared by Professor Kevin P. Gallagher, Director of the Global Development Policy Center at Boston University, as part of the work undertaken by the Working Group of Club de Madrid on "Scaling Up Funding and Reforming Financial Institutions". While the paper reflects the discussions and insights shared within the Working Group, it does not necessarily represent the views or official positions of all members or their respective institutions.

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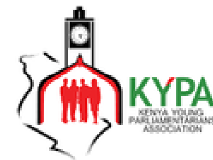

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