

Policy Paper Summary

The Arab Fund a Role in Development Financing for Arab Countries: Addressing the Debt Crisis and Financing Mechanisms

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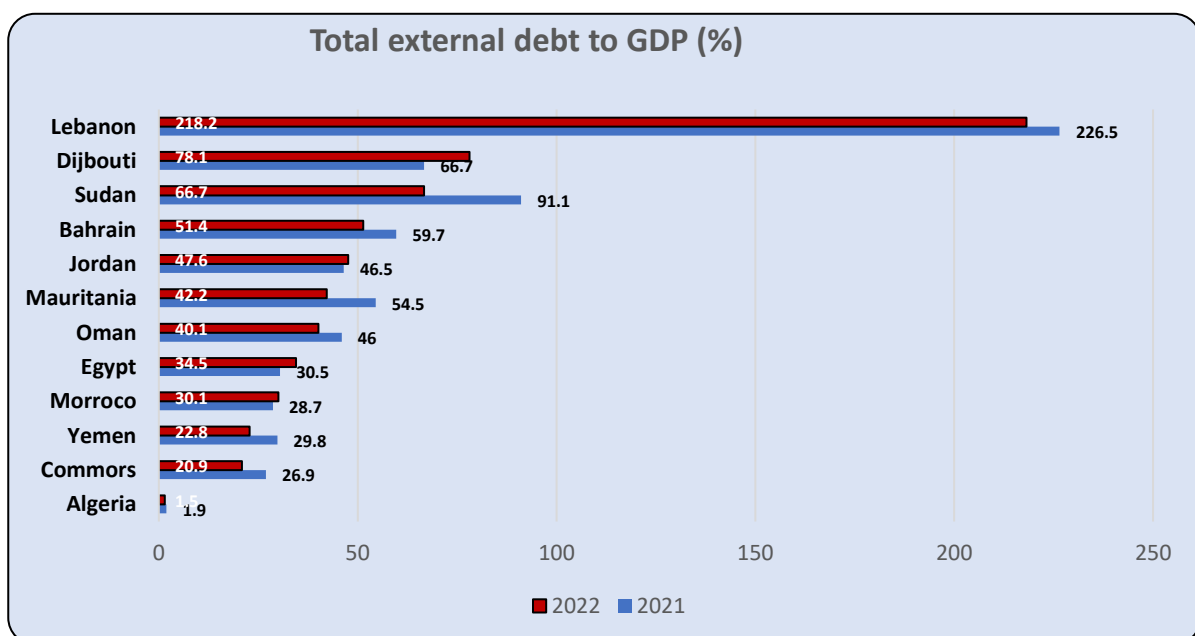
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The Arab Fund for Economic and Social Development (Arab Fund) has allocated financial resources to support development projects in several Arab countries. However, external debt in these countries has been significantly affected by global crises, beginning with the 2008 financial crisis and followed by the COVID-19 pandemic. In response, governments increased public spending across various sectors.

The Russia-Ukraine war has led to a surge in food and energy prices, prompting central banks to raise interest rates to combat inflation. This has significantly increased borrowing costs, further straining Arab economies. To manage these financial pressures, many Arab countries have borrowed from international financial institutions leading to higher external debt and greater debt-servicing burdens.

The External Debt in Arab Countries

In 2022, The total external public debt of borrowing Arab countries increased by 5.5%, reaching approximately \$412.1 billion, up from \$390.6 billion in 2021. As a result, the average external debt-to-GDP ratio in borrowing Arab countries stood at 59.2%. This rise also led to an increase in the debt service-to-exports ratio, which reached 11.2% on average.



Source: Based on data from the Joint Arab Economic Report data

The Arab Fund's exposure to the debt default and the policy paper's recommendations

The number of defaulting Arab Fund's member countries increased from 3 in 2010 to 6 in 2023, significantly impacting its loan portfolio's return and liquidity. In recent years, the Arab Fund's policy paper **proposes many recommendations** to deal with the defaulting member countries:

- Developing a unified global framework for monitoring financial and climate risks to enable early intervention and crisis prevention.
- The United Nations Conference on Trade and Development (UNCTAD) proposed the creation of a UN institution to address sovereign debt solutions in 2015. This proposal was revived by the UN Secretary-General in 2020, alongside a framework for debt relief aligned with sustainable and environmentally friendly economic recovery. This framework is based on three key pillars:
 1. Bilateral debt relief in exchange for government commitments to structural economic reforms that align with SDGs.
 2. Incentives for private sector creditors to participate in bilateral debt reduction efforts.
 3. Ensuring continued financial flows from International financial institutions to cover government expenditures, excluding sovereign debt repayments to private creditors.
- The United Nations Development Program (UNDP) proposed the use of sovereign bonds directly linked to the SDGs to mobilize both public and private financing for national sustainable development strategies.
- Some developing countries have issued GDP-linked bonds, where interest rates increase when economic growth surpasses a predefined threshold

The Arab Fund has proposed a debt swap arrangement involving borrowing countries, the Fund, and the private sector. Under this mechanism, external debt payments are converted into local investments, helping to alleviate debt burdens while allowing creditors to participate in project ownership and management.

Alternative Financing Mechanisms for Development in Arab Countries

International institutions estimate that the financing gap for achieving development goals will reach \$4.9 trillion annually from 2020 to 2025, marking an increase of approximately \$400 billion compared to 2019-2020 estimates.

In this context, the Arab Fund has implemented a private-sector financing mechanism to generate sustainable financial returns, focusing on three key strategic areas:

- Human capital development
- Export support
- Infrastructure development

These mechanisms help narrow the financing gap, promote sustainable development, and reduce reliance on traditional financing sources in Arab countries. Additionally, they encourage private sector investments in specific sectors by offering conditional guarantees to ensure that these investments align with key development priorities identified by the Arab Fund.

Need of New Mechanism for Financing Intra-Arab Trade

The total volume of Intra-Arab trade in goods (exports and imports) remains below expectations, accounting for only 12.04% of total Arab trade in goods in 2021. Additionally, funding for productive and capital goods is the lowest among Arab countries, only 4% of total financing in 2022. In contrast, consumer goods, raw materials, and intermediate goods received a significantly higher share of financing, at 55% and 41%, respectively.

In this regard, **the Arab Fund can launch an initiative** under the Arab Trade Finance Program to develop a financing mechanism aimed at enhancing intra-regional trade opportunities, particularly for small and medium-sized enterprises (SMEs). This initiative would complement the Arab Trade Information Network and align with the advanced financial mechanism established for intra-trade financing among OIC countries. The mechanism would allocate quotas for trade and investments to support economic integration.

Traditional sources of development financing, such as government funding, conventional loans, and private investments, may not be sufficient on their own to achieve the Sustainable Development Goals (SDGs). Therefore, there is a growing need to adopt innovative financing solutions that complement traditional sources, including blended financing, sustainability-linked bonds, and Philanthropic and Islamic financial instruments. In this context, **the Arab Fund can strengthen collaboration** with regional and international development institutions to pool resources and co-finance sustainable development projects. This is particularly relevant for financing public-private partnerships (PPP) funds, which play a crucial role in supporting long-term development initiatives.