CHAPTER 1

Making the international financial architecture work for the least developed countries
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A. Getting the least developed countries back on track towards achieving the Sustainable Development Goals

The world is facing multiple crises, including climate change, geopolitical tensions and a cost-of-living crunch, which are taking a particularly heavy toll on least developed countries (LDCs) as they try to relaunch their economies in the aftermath of the coronavirus pandemic of 2019 (COVID-19 pandemic). The impacts of these crises have resulted in a reversal of years of growth and development progress in LDCs (box 1.1), including in key areas of the Sustainable Development Goals such as poverty eradication, nutrition, health, education and gender equality (DESA, 2022; United Nations, 2023d).

Box 1.1  Multiple crises have undone development progress in the least developed countries

LDCs as a group experienced a sharp slowdown in economic growth in 2020 and 2021. To illustrate the lasting impact of the crisis-ridden environment since 2020, box figure 1.1 shows a projection of what the GDP of LDCs would have been if the growth trend of the 2010s had continued without interruption, and, alternatively, if growth had reached the 7 per cent target set in LDC programmes of action. The estimates indicate that in 2023, the combined GDP of the LDCs was 10 per cent below the level it would have reached if their pre-pandemic (2010–2019) growth trend had been sustained. This gap is wider – 14 per cent – if compared with the level that would have been attained if the 7-per-cent growth target had been realized (box figure 1.1, A). Per capita figures show an even larger setback. After decreasing in 2020 and 2021, GDP per capita in LDCs returned to its pre-pandemic level only in 2023. By contrast, if the 7-per-cent target had been reached from 2020 onwards, GDP per capita would have been 16 per cent higher in 2023 than current estimates (box figure 1.1, B).

Box figure 1.1

Actual and projected gross domestic product (total and per capita) of least developed countries, 2020–2023

A. Gross domestic product

B. Gross domestic product per capita

Source: UNCTAD calculations, based on data from UNCTAD, UNCTADStat database and IMF, World Economic Outlook database (both accessed April 2023).

Notes: Figures are estimates for the 2021–2023 period. Data do not include Afghanistan, Somalia, South Sudan and the Sudan.
Multiple crises have undone development progress in the least developed countries (cont.)

As a consequence of the economic slowdown, the total number of extremely poor in LDCs is estimated to have risen. Estimates suggest that in 2023, almost 15 million more people in LDCs were living in extreme poverty than in 2019 (box figure 1.2). Estimates of poverty measured against higher income thresholds underline this trend: between 2018 and 2023, the total number of people living below $6.85 per day increased by 56 million. These estimates are likely to be on the lower side in terms of actual impacts, as the methodology considers only growth. Crucially, it assumes that income distribution within LDCs remained unchanged since 2019. However, the successive crises are likely to have hit the poor disproportionately, especially through employment, income and health effects related to the pandemic, and to the steep rise in food and energy prices between mid-2020 and mid-2022. Furthermore, due to the lack of data for LDCs with high poverty rates or where conflict has aggravated poverty, many of them are not included in the estimates, including Afghanistan, Eritrea, Somalia, South Sudan, the Sudan and Yemen.

Changes in the number of poor in least developed countries, 2019–2023

Source: UNCTAD secretariat estimates following the methodology used in UNCTAD (2020) and based on data from World Bank (2023), Poverty and Inequality Platform (version 20230328_2017_01_02 PROD), at pip.worldbank.org (accessed April 2023), and IMF (2023) (for 2017, PPP GDP per capita growth).

Notes: GDP growth rates applied to the most recent poverty value. In cases where the most recently available data for poverty value were after 2018, values before 2018 were based on linear interpolation between the most recent poverty value and the second most recent poverty value. Data do not include Afghanistan, Cambodia, Eritrea, Somalia, South Sudan, the Sudan, Tuvalu and Yemen.

Multiple crises caused a drop in UNCTAD’s Productive Capacities Index (PCI) for the LDCs in 2020, followed by two years of slow progress (box figure 1.3). In terms of PCI subindices, information and communication technology (ICT) experienced the largest fall in 2020, followed by structural change and energy. Uganda, the Niger and Burkina Faso were the LDCs with the largest declines in PCI in 2020, each experiencing a fall of more than 4 points relative to 2019. For 22 LDCs, the PCI in 2022 remained below its pre-pandemic level in 2019.

Food inflation affects the poor disproportionately because they tend to spend a much higher share of their income on food than people at higher income levels. Similarly, higher energy prices affect them more, though to a lesser degree.

Source: UNCTAD secretariat calculations, based on data from UNCTAD’s, UNCTADStat database (accessed June 2023).
To get back on track to achieving the Goals, the LDCs need an international financial architecture (IFA)\(^1\) that is at once effective, flexible and adapted to their specific challenges and needs. In this spirit, how to make the IFA work for the LDCs in a crisis-ridden and volatile environment is the focus of this report. The report is timely as it is now that the world needs to move from concepts and commitments to the implementation of the Doha Programme of Action for the Least Developed Countries for the Decade 2022–2031 (United Nations, 2022). Moreover, recently there has been a renewed emphasis on the role of finance and debt in improving the development prospects of LDCs and other developing countries (ODCs), with numerous initiatives under way. Examples include the United Nations SDG Stimulus package (United Nations, 2023c) and the Policy Brief on Reforms to the International Financial Architecture prepared for the Summit of the Future (scheduled to take place in 2024) (United Nations, 2023a), the Bridgetown Initiative, as well as efforts by the international community to reform the multilateral development banks and implement the recommendations of the Group of 20 Capital Adequacy Framework (CAF) Review. These initiatives, along with deliberations at other multilateral forums,\(^2\) are further evidence that the restoration of fiscal space in LDCs through a lasting resolution of the debt crisis, reform of the IFA and mobilization of climate finance are issues at the centre of global efforts to safeguard the realization of the Sustainable Development Goals from the impacts of multiple crises. In addition, 2023 is a crucial year for global climate finance, given that a key agenda item of the twenty-eighth session of the Conference of the Parties (COP28) of the United Nations Framework Convention on Climate Change (UNFCCC) to be held towards the end of the year is the operationalization of the Loss and Damage Fund agreed at COP27. With LDCs falling behind on the path towards the Goals, and as the world approaches the mid-point of the implementation of the 2030 Agenda for Sustainable Development, the messages and recommendations presented in this report are as opportune as they are urgent.

There is a growing realization that the prevailing IFA is ill-suited both to dealing with systemic shocks and, more fundamentally, to mobilizing resources for the LDCs at the required scale. The period of successive crises since the outbreak of the COVID-19 pandemic has highlighted the shortcomings of the present IFA, and prompted several initiatives and proposals to improve it. These range from short-term, stopgap measures, such as the Debt Services Suspension Initiative, to discussions on longer-term solutions (United Nations, 2023b). The latter include debt restructuring rules and mechanisms, as well as the functioning, governance and resources of multilateral development banks (United Nations, 2023a).

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\(^1\) The IFA can be defined as the governance arrangements that safeguard the stability and functioning of the global monetary and financial systems (United Nations, 2023a). It denotes a framework of institutions, rules, policies and practices that govern the global financial system. The IFA comprises an intricate structure of international organizations, including the World Bank and the International Monetary Fund (IMF), regional development banks, international, multinational and national financial institutions, as well as regulatory bodies.

\(^2\) For example, the IMF and World Bank Spring Meetings, April 2023; the 13th UNCTAD Debt Management Conference, December 2022; and the 30th Global Forum on Public Debt Management, OECD, May 2023.
is that the LDCs are not considered systemically critical, as they have only marginal weight in the world economy, international trade and financial flows. They jointly accounted for only 1–2 per cent of global gross domestic product (GDP), international trade, and foreign direct investment (FDI) inflows in 2021–2022. In addition to their minor weight in the global economy, the voice of LDCs in international financial institutions, such as the International Monetary Fund (IMF) and the World Bank, is very limited. For instance, due to their small share of quotas in the IMF, the 46 LDCs jointly received only just over 2 per cent of the general allocation of 456 billion Special Drawing Rights (SDRs) (equivalent to about $650 billion) agreed in August 2021 to provide additional liquidity in response to the global economic crisis. At the World Bank, the LDCs jointly account for only 4 per cent of the voting rights. The picture in regional development banks is not significantly better. For example, LDCs account for more than 60 per cent of regional members of the African Development Bank (AfDB), but jointly hold only 13 per cent of voting rights – less than those of the United States, Japan and Germany combined. Needless to mention, the LDCs are not part of the Group of Seven or the Group of 20. Such power imbalances lead to a situation where the LDCs are frequently mentioned in international discussions on issues essential for their development prospects – such as financing for development and climate finance – but the subsequent outcomes and decisions often do not take into account their specific needs and situations. Therefore, there is an urgent need for the international community to move beyond rhetoric and implement solutions that cater to the financing needs of LDCs.

B. Larger financing needs of the least developed countries in the context of an increasingly complex international financial architecture

1. Growing financing needs of the least developed countries

There was a huge gap in funding for enabling LDCs to realize their SDGs well before the onset of the recent setback since 2020. In a study predating the COVID-19 pandemic, Kharas and McArthur (2019) show that the financing needs for the SDGs exceed the spending projected for 2025 in the vast majority of LDCs (figure 1.1). The Least Developed Countries Report 2021 (UNCTAD, 2021) employed an innovative methodology to estimate the SDG financing needs of the LDCs. The report estimated that, in order achieve a GDP growth rate of 7 per cent (SDG target 8.1), these countries would need to invest $462 billion annually. Eradicating extreme poverty (SDG target 1.1) would require annual investments of $485 billion until 2030. These estimates assume a 50–60 per cent increase in investment relative to actual investments in 2019 (prior to the COVID-19 pandemic). Achieving a more ambitious development goal – structural transformation – would require even larger investments. The LDCs would have to spend an estimated $1,051 billion annually to double the share of manufacturing in GDP (SDG target 9.2), used as a proxy for structural transformation. This would require their economies to grow at an unrealistic annual rate of 20 per cent during the 2020s (UNCTAD, 2021).

SDG investment and spending needs that have also been estimated by some national governments highlight the enormous challenges ahead. For instance, the Government of Bangladesh projected the annual average costs of achieving the SDGs to be $66.3 billion at 2015 constant prices (Bangladesh Planning Commission, 2017). A study on Cambodia estimated that the country would need to invest 5.4 per cent of its GDP annually to end poverty (Alisjahbana, 2019). The Government of Nepal estimated an annual spending need of Rs.2,025 billion ($18 billion) to achieve the SDGs by 2030 (National Planning...
estimates that in 2020, the SDG financing gap in all developing countries increased by 56 per cent, to reach $3.9 trillion, due to a pandemic-related increase in government spending and loss of public revenue. The World Investment Report 2023 estimates that the gap is now about $4 trillion per year – up from $2.5 trillion in 2015 when the SDGs were adopted (UNCTAD, 2023).

LDCs have a marginal influence on decisions over the international financial system

The climate finance needs of LDCs are also growing as countries’ commitments fall far short of the Paris Agreement targets. According to the UNFCCC’s Standing Committee on Finance (2021), the cost of implementing the nationally determined contributions (NDCs) of developing countries amounts to $6 trillion through 2030, a far cry from the $100 billion annual climate finance target of the Copenhagen Accord and the $21 billion–$83 billion of actual climate finance flows in 2020 (see chapter 2). The LDCs have made ambitious plans to address climate change in their NDCs, but implementation depends on external finance, technology transfer and capacity-building (UNCTAD, 2022). As the LDCs are particularly vulnerable to the impacts of climate change, they urgently need more finance for adaptation. However, more climate finance is directed towards mitigation instead, because it focuses on reducing greenhouse gas (GHG) emissions which is easier to define and fund.6 On the other hand, most adaptation initiatives

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As the LDCs are particularly vulnerable to the impacts of climate change, they urgently need more finance for adaptation

focus on building long-term resilience. Adaptation projects are often public goods, characterized by high upfront costs, long investment timelines, the lack of a clearly identifiable revenue stream or unattractive risk and return profiles (e.g. climate-resilient bridges or roads). In contrast, mitigation projects attract international private investors typically in energy transition. For example, technology related to many types of renewable energy (e.g. solar and wind power, electric vehicle manufacturing etc.) is already mature, and costs and returns on investment are relatively stable and predictable. Furthermore, carbon markets which incentivize investment in mitigation do not exist for adaptation.

The contribution of LDCs, as a group, to the climate crisis is and has been negligible. Yet they are likely to suffer the most from the impacts of climate change. Therefore they need support to cover climate-related loss and damage (see chapter 2). However, more than a third of climate finance flows to these countries is delivered through loans, and thus adds to their mounting debt burdens. In order to avoid a climate debt trap, LDCs need grants, rather than loans, to finance climate action. In this context, the new Loss and Damage Fund could play a pivotal role, but only if its design takes into account the specific needs and challenges of the countries most vulnerable to extreme weather events and in particular the least resilient among them. This includes especially the LDCs and the small island developing States (SIDS) (see chapter 2). Seven of the LDCs are SIDS.

2. An increasingly complex international financial architecture

In addition to higher financing requirements to compensate crisis-related development losses, the external financing conditions for LDCs have become more challenging.

A major concern for LDCs is that the international aid architecture is becoming increasingly complex (UNCTAD, 2019). The number of actors has multiplied to include philanthropists, development finance institutions, the private sector and non-governmental organizations (NGOs), alongside traditional donors. Furthermore, other developing countries such as Brazil, China, India and Türkiye have emerged as new sources of public development finance. Also, the number of international vertical funds has been expanding rapidly. In addition, there has been fragmentation and proliferation in the international climate finance architecture (see chapter 2).

While the emergence of new partners and funding vehicles broadens the landscape of development finance, it also raises the associated transaction costs, and exerts further pressure on LDCs’ limited institutional capacities. Each fund and development partner has its own administrative and bureaucratic requirements, including access to financing, disbursement modalities, and systems of monitoring and reporting. Such high administrative burdens and transaction costs limit the LDCs’ ability to access financing by the various institutions, and thus the overall performance of the international financial architecture. In addition to the rise in transaction costs, the proliferation of the international aid architecture makes alignment with national priorities and coordination between donors more burdensome, while maintaining overall debt sustainability has become more complex.

Furthermore, the target space of official financing has increasingly widened to include an array of additional goals and objectives, which often compete with the “traditional” ones for resources. These expanded goals include “traditional” development finance objectives, climate finance and humanitarian aid in a context of extreme weather events that increase in frequency, along with geopolitical tensions that have intensified refugee and migratory flows. In this regard, there has been a blurring of the boundaries between different sources and objectives of development financing, and between public and private financial flows, including towards LDCs. This blurring of boundaries is especially blatant in the context of blended finance. There it is often difficult to distinguish between development finance and purely commercial private investments that are backed by official support (UNCTAD, 2019). Also, the distinction between development finance and climate finance, which is critical for purposes of monitoring and ensuring additionality (box 1.2), is becoming

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5 Vertical fund refers to a specialized development finance vehicle that focuses on a specific sector or thematic area such as climate change, health or education. Examples include the Green Climate Fund, the Global Fund to Fight AIDS, Tuberculosis and Malaria, and the recently established Financial Intermediary Fund for Pandemic Prevention, Preparedness and Response.

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Also, the costs of external borrowing for LDCs have banking sectors of developed countries (chapter 4).

their development finance needs. A case in point may have ripple effects on the ability of LDCs to meet their economies. Therefore, external financial flows can have major impacts on their economies. Therefore, external financial flows are not always aligned with national development goals and objectives.

Furthermore, decisions taken in developed countries can have ripple effects on the ability of LDCs to meet their development finance needs. A case in point may be the implementation of net-zero requirements in the banking sectors of developed countries (chapter 4). Also, the costs of external borrowing for LDCs have been impacted by measures implemented by developed countries since early 2022 to tame inflation (see chapter 3).

In addition, rising geopolitical tensions make it difficult for LDCs to create synergies between the activities of different development partners and different sources of external finance. The importance of this consideration is illustrated by paragraph 14 of the Doha Programme of Action for the Least Developed Countries for the Decade 2022–2031 (D'PoA), which underscores both the ambition of this new Programme of Action, as well as the need for “a reinvigorated global partnership for sustainable development based on scaled-up and ambitious means of implementation and diverse support for the least developed countries in forging the widest possible coalition of multi-stakeholder partnerships” (United Nations, 2022: para.14).

Recent individual initiatives, such as the Summit for a New Global Financing Compact in Paris, signify progress in some areas but remain below the level of ambition needed to address the acute financing challenges LDCs face (chapter 5). For instance, the World Bank announced its intention to introduce clauses in loan agreements that allow for a pause in debt repayments for the most vulnerable countries in

Box 1.2 Development finance or climate finance?

Development finance and climate finance are closely linked. Both aim to promote sustainable development, address global challenges and improve the well-being of people and the planet. While development finance focuses on broad-based objectives, such as poverty reduction and eradicating hunger, climate finance specifically targets activities related to climate change mitigation and adaptation, including the expectation that it will eventually address loss and damage.

However, there are some conceptual, programmatic and institutional overlaps between these two forms of finance. Since climate change poses a major threat to the achievement of the Sustainable Development Goals, in development planning it is important to take an integrated and holistic view that includes climate change. In other words, development plans need to be “climate-proofed”. In tandem, climate policies need to take into consideration potential co-benefits and negative side effects across traditional development areas. This interrelationship is reflected in the framework of the Goals, which includes Goal 13 – the climate change Goal – that calls for “urgent action to combat climate change and its impacts”. Another common feature is that developed countries have made quantitative commitments for both ODA and climate finance. Furthermore, both development finance and climate finance can be provided through grants, loans and technical assistance. The same bilateral donors and international financial institutions fund development projects with and without climate objectives. There can also be overlaps at the project level. For instance, a renewable energy project can simultaneously expand access to energy for the previously unserved, while also contributing to climate change mitigation.

There are also differences, as not all development projects target climate change objectives, and not all climate change projects serve broader development objectives. Accordingly, a share of climate finance is delivered through specialized climate funds that mobilize resources specifically for climate-related projects and technologies (see chapter 2). In this regard, it is crucial that the close links between climate change and development do not lead to the double counting of financial flows. In addition, a critical factor for climate finance is that it should constitute new, dedicated financial resources to address the unique and additional challenges posed by climate change in line with the principle of additionality. Accordingly, climate finance should not divert resources from existing development financing efforts. By adhering to the principle of additionality, climate finance can ensure that resources are channeled towards climate-related activities that would not be covered by traditional development finance, as stressed throughout this report.

increasingly blurred. In addition, an increasing share of official development assistance (ODA) by donor countries is spent on refugees in-country, without triggering any financial flows to developing countries. Preliminary ODA figures suggest that this represents a diversion of ODA flows away from developing countries, including LDCs (see chapter 2).

LDCs also face challenges in terms of their agency over decisions shaping international financial flows, in particular ODA, private credit, portfolio flows and FDI. Such decisions are typically taken in the main financial centres by private agents or donor governments, where a strong LDC voice is conspicuous by its absence. This leads to difficulties for LDC governments to retain ownership of their development agendas and coordinate financial flows that have major impacts on their economies. Therefore, external financial flows are not always aligned with national development goals and objectives.

Furthermore, decisions taken in developed countries can have ripple effects on the ability of LDCs to meet their development finance needs. A case in point may be the implementation of net-zero requirements in the banking sectors of developed countries (chapter 4). Also, the costs of external borrowing for LDCs have been impacted by measures implemented by developed countries since early 2022 to tame inflation (see chapter 3).
times of crisis. Although a step in the right direction, these clauses will only apply to new loans, and thus do not help to address the existing, unsustainable debt burdens of many LDCs. Similarly, the announcement by the IMF that the target of making $100 billion available to vulnerable countries by rechannelling SDRs had been achieved is good news, but it should be seen as a first, rather than the final, step. In this sense, as the following chapters of this report highlight, the international community has so far failed to adequately respond to the looming financing crisis in LDCs. Hence, this report reinforces calls for progress on the reform of the international financial architecture, including across the development financing landscape, which encompasses ODA, climate finance and the international debt architecture. It has become a matter of urgency for the international financial architecture to act as a global safety net and development enabler for LDCs.

C. Structure of this report

The remainder of this report is structured as follows. Chapter 2 highlights the critical need for fiscal space to boost growth and resilience in the LDCs. It shows that in the short to medium term, ODA grants are a major factor for enhancing fiscal space in LDCs, while, over the medium term, domestic resource mobilization can play a larger role. Recent trends in ODA flows to the LDCs are presented, pointing to the crucial need to bring ODA flows to the LDCs up to levels committed by developed countries as fast as possible in order to provide them with the resources needed for achieving the Sustainable Development Goals. The chapter presents the latest figures on climate vulnerability and climate finance flows to the LDCs, which demonstrate the inadequacy of currently available funds.

Chapter 3 considers the evolving and worsening dynamics of the external debt of LDCs. It also assesses several initiatives that have been implemented or proposed by the international community, including debt relief initiatives and debt restructuring proposals to provide relief to indebted countries. It highlights the insufficiencies and inefficiencies of such initiatives to systematically deal with the vulnerabilities of indebted LDCs. The chapter also reviews financing instruments that have the potential to unlock sustainable financing for LDCs.

Chapter 4 examines the role that central banks could play in supporting green structural transformation in LDCs. While the underlying mechanics and the ecosystem imperatives for central banks to successfully fulfil a net zero mandate in developed-country contexts have been discussed for some time, the chapter presents the first-ever discussion of these issues in the context of LDCs. Crucially, it considers the implications of climate central banking for the availability of financing for broad-based structural transformation in their countries. It highlights the constraints on central banks’ climate action due to their typically limited reach in domestic financial sectors, and how the underdeveloped financial sectors, in turn, affect the ability of central banks to perform the function of climate central banking in LDCs. Critically, it discusses potential conflicts between climate central banking with their existing legal mandates. It concludes by proposing a framework to guide the central banks of LDCs in engaging in climate central banking with the view of prioritizing their actions that are developmental and support low-carbon structural transformation in LDCs in their quest to fulfil the UNFCCC’s goals on financial alignment.

Chapter 5 draws on the analysis and conclusions of the preceding chapters, and presents policy options and recommendations for consideration at different levels (multilateral, regional, domestic) by different actors, including LDC governments, development partners and international financial institutions.
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