Advancing reform of development finance for the least developed countries

CHAPTER 5

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A. Moving from crisis to reform

The least developed countries (LDCs) today face a number of interlocked challenges. Climate change, the COVID-19 pandemic, and the war in Ukraine continue to have negative economic and social impacts across the world. However, the fallout from these crises is not equal between and within countries. By definition, LDCs are particularly vulnerable to external economic and climate-related shocks. Therefore, it is not surprising that the ongoing multiple crises have hit the LDCs disproportionately hard, wiping out years of development progress and leaving them in dire need of finance to rebuild and relaunch their efforts towards meeting the Sustainable Development Goals.

As the preceding chapters of this report show, a leading challenge facing LDCs is their lack of the fiscal space needed to ensure the continuity and adequate reach of social safety nets, enable investment in human capital and infrastructure to promote structural transformation, and shoulder the rising costs of climate change. There are several reasons for their lack of fiscal space.

For one, many LDCs are in a protracted debt crisis. In the aftermath of the 2008–2009 global financial crisis, debt in LDCs reached levels not seen since before the implementation of the Highly Indebted Poor Countries (HIPC) Initiative in the 1990s. The widening gap between debt stocks and export revenues, chronic current account deficits and weak domestic currencies have fuelled the risk of debt distress. Debt service costs have also risen to unsustainable levels, exceeding government expenditure on health care and education in an increasing number of LDCs (UNCTAD, 2023), and further constricting their fiscal space.

The COVID-19 pandemic was a main driver of rising spending needs due to increased health-related spending, as well as higher costs of maintaining social safety nets and supporting businesses during the global economic slowdown. The lack of fiscal space during that period of crisis limited the LDCs' ability to mount policy responses similar to those in developed countries. It also meant that they fell further behind in terms of economic growth, poverty reduction and – critically – development of productive capacities.

Costs for climate change adaptation as well as for loss and damage are on the rise. While the LDCs contribute only marginally to global greenhouse gas emissions (both past and present), they are among the most vulnerable countries to the impacts of climate change. Failure to undertake necessary investments

Multiple crises have hit the LDCs disproportionately hard, wiping out years of development progress

in adaptation can have severe socioeconomic consequences. For instance, if urgent investments in adaptation are not undertaken, climate change could reduce gross domestic product (GDP) by 2050 by as much as 6.8 per cent in Burkina Faso, 7.2 per cent in Mauritania, 10.5 per cent in Chad, 10.7 per cent in Mali and 11.9 per cent in the Niger, and push millions into poverty (World Bank, 2022).[1] As the examples cited in this report show, climate-related loss and damage costs present an enormous challenge for LDCs, and with the world off track in efforts to reach the objectives of the Paris Agreement, these costs will only increase in the future.

The increase in revenues required to cover rising costs and expenditure needs has not materialized, because the underlying and preceding fiscal and financing shortfalls have been compounded by the discretionary fiscal spending in response to the COVID-19 pandemic. As a result, many LDCs are facing a vicious cycle of crises and debt, even as their fiscal space is rapidly shrinking.

Existing mechanisms and sources of finance are inadequate to meet the needs of the LDCs to finance their sustainable development. Recent changes in the international aid architecture, pledges to increase public financing for development and/or to respond to climate change, plans to tackle the present external debt crisis, initiatives to raise global levels of liquidity, negotiations to reorient multilateral financial institutions, efforts to woo private investors into LDCs, and other initiatives or proposals have been woefully inadequate in meeting the challenge of financing for the development of these countries. These initiatives have not gone far enough, or not been fully implemented; neither have they addressed the root causes of systemic problems, or adequately considered the specificities of LDCs, as shown extensively in the previous chapters of this report.

Comprehensive reforms in the international financial architecture, coupled with increased commitments and innovative approaches, are necessary to meet the financial needs for sustainable development of the LDCs, and help build their resilience in the face of

[1] These projections are likely underestimates, since not all potential impact channels of climate change are included in the analysis.

global challenges. Debt distress is not solely a financial issue; it is also an acute development dilemma for LDCs. Added to this, climate change poses existential threats to vulnerable populations in these countries. The role of multilateralism in tackling the financial, fiscal and climate-related challenges facing LDCs and in ensuring their greater participation in global governance of these matters is clear. Multilateralism implies international cooperation in finding solutions to transnational problems. Concrete actions need to be taken urgently for LDCs to be able to overcome the interlocked challenges they face.

The following sections outline some priority actions that should be undertaken by LDC governments, along with development partners, international financial institutions and the international community at large, if these countries are to escape from their current development impasse.

B. Strengthening aid effectiveness for the least developed countries

The three key dimensions of finance for development in the LDCs are quantity, quality and access. In other words, finance needs to be available at the required scale, delivered through appropriate instruments, and underpinned by an international financial architecture that is adapted to the specific needs of these countries.

The gap between the commitment of 0.15–0.2 per cent of gross national income (GNI) of member countries of the Development Assistance Committee (DAC) – specified in the Sustainable Development Goal target 17.2 and in the Doha Programme for Action – and actual disbursements of official development assistance (ODA) to LDCs was in the range of $35 billion–$63 billion in 2021 alone. It is important that ODA flows to LDCs be increased, as a first step, to the upper levels committed by developed countries by 2025.

Closing the gap between ODA targets and disbursements should take the form of grants

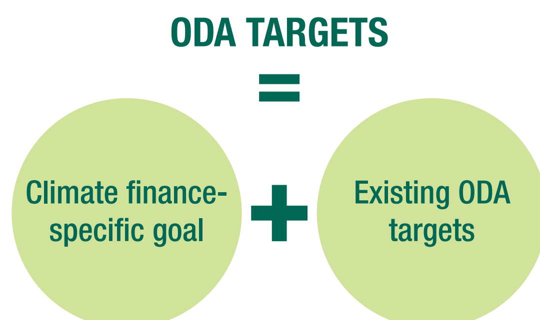
Moreover, the increase should be exclusively in the form of grants to allow the LDCs to rebuild their fiscal space. Beyond the quantitative increase, crucially, the international development community should seek to simplify access modalities and lower the transaction costs of ODA by reducing associated administrative burdens, harmonizing processes and using recipients countries' own administrative systems and structures, rather than establishing parallel systems dedicated to ODA delivery and management. Given the growing complexity of the international aid architecture, ODA would have a greater impact if it adhered to the five principles for smart aid: ownership, alignment, harmonization, managing for results and mutual accountability. In this sense, *The Least Developed Countries Report 2019* made the broader case for an Aid Effectiveness Agenda 2.0, which updated these principles to the realities of the new aid architecture and remains more pertinent than ever (UNCTAD, 2019).

C. Climate finance

There is also a need to enhance the quantity, quality and delivery modes of climate finance for LDCs. Even the most optimistic estimates of climate finance flows to the LDCs show that they are insufficient, not only to meet their growing needs for investments in adaptation, but also to cover the costs of loss and damage from catastrophic weather events. Therefore, the international community should consider complementing the existing ODA target with a specific target for climate finance for LDCs. Developed countries need to commit to a substantial increase in the overall volume of climate finance flows to LDCs, including providing a larger proportion of grants to avoid creating – or exacerbating – a debt trap. Such flows should also focus more on adaptation to climate change, which is a priority for LDCs.

Moreover, greater levels of transparency are needed in reforms and commitments, possibly by moving towards a unified accounting framework for climate finance. Reforms should also include focusing on climate finance flows that are channelled through dedicated climate funds, such as the Green Climate Fund. Since there would be no doubt that funds disbursed by designated climate finance vehicles are indeed climate finance, double counting

A climate finance-specific goal should complement ODA targets for LDCs



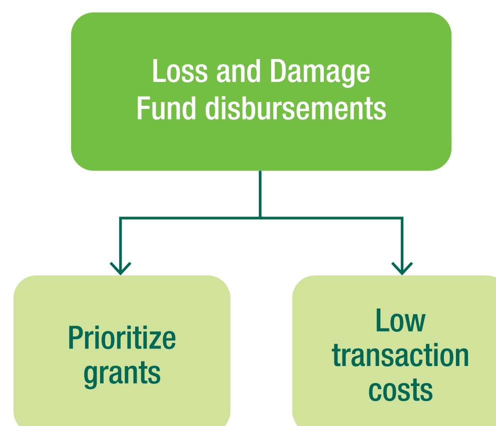
between development finance and climate finance would be avoided. Given the close interlinkages between climate and development, climate change considerations need to be included in development planning and in the programming of ODA. However, accounting of development finance and climate finance should be separated.

"Green" fiscal reforms could unlock financing for climate and other development areas. This would involve redirecting some financing away from subsidies given to activities that generate greenhouse gases in donor countries, and channelling it to finance development and climate resilience in LDCs. These reforms would thereby serve a double purpose of supporting both the environment and development. Political will is key to unlocking this large source of new liquidity.

The international climate finance architecture is complex and fragmented, which constitutes a roadblock for countries with limited institutional capacities, including the LDCs. Thus, priority should be given to simplifying and accelerating access to available funds – both existing climate funds and those provided through newly established climate finance vehicles, such as the Loss and Damage Fund (LDF).

LDCs, being among the countries most vulnerable to climate change, should receive priority access to financing for climate-related loss and damage. Small island developing States (SIDS) should also receive priority financing for similar reasons. The international community should ensure that the LDF becomes operational rapidly, with first disbursements made in 2024.

Loss and Damage Fund disbursements should prioritize grants and involve low transaction costs



In considering climate-related loss and damage, the new LDF could play a pivotal role for LDCs if certain conditions are met. The following conditions would enhance the Fund's impact:

- An adequate volume of additional funds, commensurate with actual loss and damage, should be made available. If existing funds are simply diverted to the LDF, the latter will not have the desired impact. In this regard, developed countries need to guarantee a minimum floor for annual inflows to the LDF, and underpin it with a credible and robust resource mobilization strategy.
- Efforts should be made for rapid operationalization of the LDF, so that it can start disbursing funds quickly, including setting a target for releasing the first disbursements in 2024.
- Access to the LDF should be direct and simple, and transaction costs kept low.
- Access to the LDF should not result in higher debt burdens. Therefore, the funds should take the form of grants (rather than loans) to cover costs of loss and damage caused by the impacts of climate change.
- In the likely scenario that claims exceed available resources, decisions on the allocation of funds should be based on economic and climate-related vulnerabilities. This would enhance the impact of the fund for LDCs that

face multidimensional vulnerabilities but lack fiscal space.

- The LDF should cover both extreme weather events as well as slow onset loss and damage (e.g. from rising sea levels, saltwater intrusion and land degradation), as both can impose significant costs on affected countries. There could be separate funding windows for these two types of loss and damage to reflect differences in financing and processing requirements (emergency funding vs. project funding).
- Additional costs, such as fees or insurance premiums, should be avoided. Designing the fund like an insurance scheme would limit access by the most vulnerable countries, including LDCs.

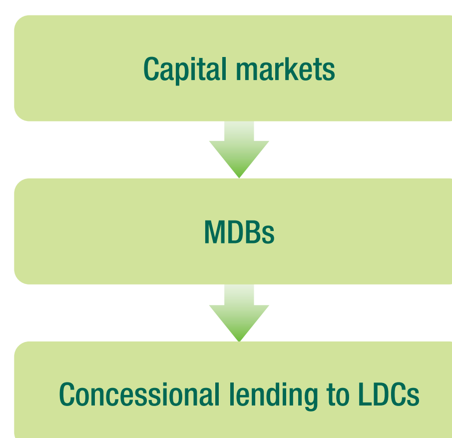
If these conditions are met, the LDF has the potential to significantly boost the resilience of LDCs as they strive to achieve the Sustainable Development Goals while being the most vulnerable to the impacts of climate change.

D. Reforming the international financial architecture

Improvements in financing for development for LDCs should be part of broader reforms of the international financial architecture. In this context, recent proposals by the United Nations for an ambitious programme of reforms need to be implemented. And due consideration should be given to UNCTAD's call for the adoption of an "even-handed" approach between debtors and creditors, including paying greater attention to the role played by institutions and policies in creditor countries in triggering international financial crises.

In view of the key role of multilateral development banks (MDBs) as providers of concessionary finance to LDCs, a large increase in funding through these institutions needs to be part of any meaningful reform of the development finance system. In order to provide more concessional liquidity, MDBs themselves need to borrow more on the capital market. In this regard, the implementation of the recommendations of the Group of 20 Independent Review of MDBs' Capital Adequacy Frameworks (CAF) could help to unlock substantial additional resources that could be made available to LDCs on highly concessional terms.[2] The 15 MDBs included in the Group of 20 independent review held $1.2 trillion of callable capital, corresponding to 91 per cent of their subscribed capital in 2020 (Independent Expert Panel convened by the G20, 2022).[3] Including callable capital in the risk framework of MDBs would enable them to increase their lending on highly concessional terms by hundreds of billions of dollars. For instance, it was estimated that the World Bank and the five largest regional development banks could jointly expand lending by as much as $750 billion while maintaining their AAA rating based on callable capital (Humphrey, 2020). LDCs and other developing countries that face higher borrowing costs on capital markets would benefit from such an expansion, particularly given the further tightening of global financing conditions (United Nations, 2023). Moreover, developed countries will need to ensure that the 21st replenishment of the International Development Association (IDA21) is ambitious and commensurate with the growing needs of LDCs.

Multilateral development banks could tap capital markets to boost concessional lending to LDCs



Special drawing rights (SDRs) of the International Monetary Fund (IMF) are a source of liquidity that can and should be unlocked. The general allocation of SDRs in the wake of the COVID-19 pandemic in 2021 has shown that these instruments can quickly boost

[2] Such channelling of funds from international capital markets to LDC development financing would not jeopardize the AAA ratings of MDBs.

[3] Moreover, the 20 MDBs rated by Fitch jointly have close to $2 trillion of callable capital (https://www.fitchratings.com/research/sovereigns/understanding-callable-capital-28-11-2022).

global liquidity in a period of crisis. However, as SDRs are distributed according to a country's quota of shares at the IMF, liquidity does not flow to where it is needed the most. As mentioned in chapter 1, the LDCs jointly received just over 2 per cent of the $650 billion worth of SDRs in the 2021 general allocation. Reform of the rules for the distribution of SDRs is needed so that these instruments can be used to help respond to the pressing financial needs of the LDCs. Accordingly, due consideration should be given to economic and climate-change vulnerabilities in their distribution. Another, practical way of unlocking liquidity for development finance is by "rechannelling" the SDRs allocated to developed countries. In other words, developed countries that do not need their entire SDR allocation could transfer some to the IMF or to other entities that are allowed to hold them so that they can be used to increase highly concessionary lending to countries in need. In practice this is often already done through the Poverty Reduction and Growth Trust (PRGT) or the Resilience and Sustainability Trust (RST) at the IMF. As at June 2023, the PRGT provided loans at zero interest rates (IMF, 2023), and it is recommended to extend zero interest rates to at least July 2025. In this context, during the Summit for a New Global Financial Pact in Paris in June 2023, the IMF announced that the objective of rechannelling $100 billion in SDRs had been achieved. This is good news, but LDCs need more than a one-off measure; they need a regular, continuous flow of rechannelled SDRs, as their financing needs for meeting the Sustainable Development Goals and climate change costs are long-term in nature. MDBs could be another important avenue for leveraging rechannelled SDRs.

Finally, to build resilience, it is crucial that reforms of the international financial architecture are not only recognizant of the LDCs, but also support their needs in practice. Current power imbalances mean that LDCs face disproportionate costs of the global low-carbon transition. The incorporation of physical risks into the credit models used by credit rating agencies and financial institutions can lead to downgrades of LDCs, thereby reducing their access to finance. This makes it even more difficult for LDC governments and private sectors of climate vulnerable countries to raise finance to invest in climate adaptation and to cover climate-related losses.

Moreover, potential impacts of international standards and guidelines on access to finance by LDCs need to be considered. Ongoing reforms in global financial markets include the global push to implement uniform climate standards in the financial sector. These are at odds with the principle of common but differentiated responsibilities, which is a cornerstone of the global climate regime, and should therefore be revised. Such a revision should ensure that incorporating physical risks into the credit models used by credit rating agencies and financial institutions will not lead to downgrading LDCs, which would further reduce their access to finance.

It is crucial that reforms of the international financial architecture support the needs and priorities of LDCs

E. Debt management

LDCs need a clear path out of their unsustainable debt patterns through a series of lifelines, such as grants, concessional loans and a debt treatment mechanism that is responsive, transparent and efficient in resolving unstainable debt situations. It is therefore critical that developed-country partners do not to substitute debt relief for official development flows, including ODA. Similarly, emergency lending during crises should be sparingly used as a complement to debt relief efforts, rather than treated as an opportunity to inflate debt stocks of the MDBs.

The Debt Service Suspension Initiative of the Group of 20 brought temporary relief to developing countries, including LDCs, but did not address the root cause of the debt crisis. Similarly, the Group of 20 Common Framework for Debt Treatments in its current state is not fit for purpose (chapter 3). Combining these two types of mechanism is a necessary but not sufficient condition for a comprehensive debt workout system, which should involve debt repayments being put on hold once debtors enter negotiations on debt resolution.

Moreover, the long-standing call by UNCTAD and other institutions for the implementation of a comprehensive debt workout system that could help broker negotiations between creditors and debtors should be given greater attention as a matter of priority. At present, such negotiations are characterized by stark power imbalances, in particular in the case of LDCs. Coordination should involve all key players, including private creditors and relevant non-DAC bilateral creditors, such as China. Indeed, China has become a major lender to LDCs, and has extended substantial rescue liquidity to developing countries in debt distress, including LDCs, on a bilateral basis (Horn et al., 2023).

Disaster clauses in loan agreements that allow a pause in debt repayments for countries experiencing natural disasters could help prevent climate-related extreme weather events from triggering debt crises. In this regard, the announcement made by the World Bank in June 2023 to introduce such clauses in its loan agreements with the most vulnerable countries is a step in the right direction.[4] However, these clauses will only apply to new loans, and thus do not address the existing unsustainable debt burdens of many LDCs. Furthermore, in order to be effective, disaster clauses are needed not only in World Bank loans, but also in those of all creditors, including bilateral and private creditors, as well as all MDBs. In addition, the World Bank and other MDBs will need to evaluate options to retroactively include disaster clauses in existing loan agreements with LDCs.

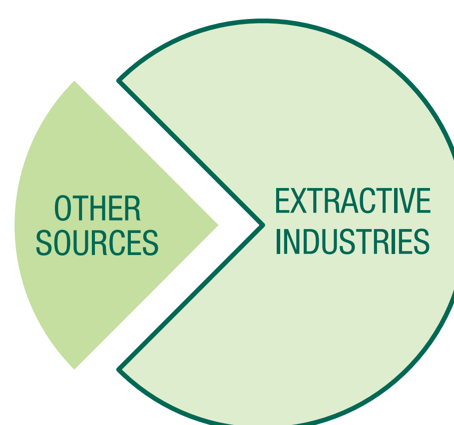
The World Bank has also announced that it will allowcountries the flexibility to redirect a portion of their lending portfolios for emergency response ("rapid response option"). While flexibility is what LDCs need, reshuffling an existing financing envelope would force governments facing disaster to choose between short-term relief and longer term investments in sustainable development. LDC governments and citizens already often face such difficult trade-offs. What is needed in times of disaster is a quick, real expansion of fiscal space to match immediate and additional costs. In other words, natural disasters should trigger debt write-offs commensurate with the incurred losses and damages, in addition to a pause in debt repayments. Proposals made in the Bridgetown Initiative with regard to the new Loss and Damage Fund include an automatic grant release in cases where an external agency assesses that a climate event caused loss and damage equivalent to 5 per cent or more of GDP.[5] Such a mechanism could be backstopped by an arrangement to write off the debt of affected countries in cases of large disasters where available funds are insufficient to cover the full amount of a grant.

F. Improving domestic resource mobilization to build resilience

LDCs need to strengthen domestic resource mobilization by broadening their tax base, reviewing tax exemptions and other fiscal incentives, avoiding race-to-the-bottom tax competition, reducing tax evasion and aggressive tax avoidance as well as other illicit financial flows, improving their tax administration and enhancing tax compliance. International tax cooperation could also help boost domestic revenues (United Nations, 2023b). Furthermore, developing their financial sector could help countries promote domestic retention of resources.

Improved management of natural resources through transparent and accountable governance frameworks, and ensuring that extractive industries contribute a fair share to public revenue through taxes, levies and royalties could help increase domestic revenues significantly. Resource-rich LDCs should carefully negotiate contracts with mining businesses, strengthen governance and review existing tax and other fiscal incentives with a view to maximizing revenues from their extractive industries. In particular, LDCs with reserves of minerals critical for the global energy transition need to ensure that extraction of those reserves contributes to sustainable development by securing a fair share of revenue and profits, and promoting domestic value addition in the production value chain of these minerals.

Extractive industries remain a major source of fiscal revenue and value addition in LDCs



The above-mentioned measures to improve domestic resource mobilization will certainly strengthen the ability of LDCs to negotiate for better financing costs (lower interest rates) and tenures (more longer term debt) that reduce the more short-term, emergency financing cycles. To safeguard growth and progress towards meeting the Sustainable Development Goals, the policy focus should be redirected

4 See https://www.worldbank.org/en/news/factsheet/2023/06/22/comprehensive-toolkit-to-support-countries-after-natural-disasters?intcid=ecr_hp_headerY_en_ext.

5 https://geopolitique.eu/en/articles/breaking-the-deadlock-on-climate-the-bridgetown-initiative/.

towards implementing climate-proofing structural transformation agendas.

Some LDCs could also foster domestic financial deepening to augment domestic resources and attract savings from their diaspora. Financial deepening could enable the mobilization and use of diaspora savings, for example through diaspora bonds, foreign-currency-denominated deposits and syndicated loans using remittances as collateral.

Development partners need to scale up capacity-building in LDCs in critical areas such as tax administration (including resource taxation), and strive to improve international tax cooperation to strengthen international tax norms, combat illicit financial flows and facilitate revenue collection in LDCs.

G. Climate central banking

The central banks of LDCs need to consider the use of central banking climate mitigation and adaptation tools provided that sustainable development and a strong macroprudential approach are part of their mandates, and only if their financial systems are suitably developed and used by a sufficiently large proportion of the population and the non-financial corporate sector. If these institutions introduce climate central banking tools, it is essential for them to be aligned with the industrial and fiscal policy targets of their respective countries. If the central bank of an LDC decides to use such tools, it need to ensure that the financial system will continue to support the priority sectors that have been identified in national industrial policy. The central banks should never be viewed as “fixers” of the climate crisis and as substitutes for interventions that need to be made by their Governments, public authorities and international organizations. They can only play a supportive role in the fight against climate change, and they should always act in coordination with their Governments and other public authorities.

LDCs’ central banks need to develop analytical frameworks that allow them to identify the extent of exposure of their financial system and macroeconomies to risks that might stem from the implementation of climate policies in other countries (especially their export partners) and from climate-related physical events. The international community is called upon to step up assistance in this regard.

H. South–South and regional initiatives

Diversification in the architecture of official financial flows to LDCs has been accompanied by the emergence of other developing countries as important sources of official external finance. Some of these other countries have proved to be important sources of long-term finance, in some cases providing funding for infrastructure projects. LDCs need to further exploit the potential of these sources of finance while making sure that they do not become additional sources of over-indebtedness. Developing-country partners can also serve as intermediaries for long-term investments.

In addition, South–South cooperation could assist LDCs in mobilizing and managing development finance by adopting concerted strategies at regional and subregional levels to bolster access to development finance, including developing common negotiating positions to raise funding and renegotiate debt.

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