UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

# Crisis-resilient development finance

OVERVIEW

THE LEAST DEVELOPED COUNTRIES REPORT 2023

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# THE LEAST DEVELOPED COUNTRIES REPORT 2023: Crisis-resilient Development Finance

## OVERVIEW

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# OVERVIEW

## Getting the least developed countries back on track towards the Sustainable Development Goals

The world is facing multiple crises of climate change, growing human conflicts, geoeconomic fragmentation and a cost-of-living crunch, all of which weigh heavily on least developed countries (LDCs) as they try to relaunch their economies in the aftermath of the COVID-19 pandemic. The impacts of these crises have led to a reversal of years of growth and development progress in LDCs, including in key areas of the Sustainable Development Goals, such as poverty eradication, nutrition, health, education and gender equality.

LDCs as a group experienced a sharp slowdown in economic growth in 2020 and 2021. In 2023, their combined gross domestic product (GDP) was 10 per cent lower than the level it would have reached if the pre-pandemic (2010–2019) growth trend had been sustained. GDP per capita would have been 16 per cent higher in 2023 than current estimates if growth had reached the 7 per cent target set in LDC programmes of action. As a consequence of the economic slowdown, the total number of extremely poor in the LDCs is estimated to have risen, with at least 15 million more people living in extreme poverty than prior to the pandemic.

To get back on track to achieving the Sustainable Development Goals, the LDCs need an international financial architecture that is inclusive, innovative and adapted to their specific needs and challenges. This is critical at a time when the world needs to move from commitments to implementation of the Doha Programme of Action for the Least Developed Countries for the Decade 2022–2031. At present, there is a renewed recognition of the crucial role of finance and debt in boosting the development prospects of LDCs and other developing countries, as evidenced by the United Nations Secretary-General's SDG Stimulus to Deliver Agenda 2030 and the United Nations Policy Brief on Reforms to the International Financial Architecture prepared for the Summit of the Future (scheduled to take place in 2024). Other examples include the Bridgetown Initiative, efforts to reform the multilateral development banks and implementation of the recommendations of the Capital Adequacy Framework (CAF) Review by the Group of 20. These initiatives, along with deliberations in other multilateral forums, are further evidence that the restoration of fiscal space in LDCs through a lasting resolution of the debt crisis, reform of the international financial architecture, and mobilization of climate finance are issues at the centre of global efforts to safeguard the Goals from the impacts of the multiple crises plaguing the world today.

The year 2023 is key for global climate finance. A major agenda item at the twenty-eighth session of the Conference of the Parties (COP28) of the United Nations Framework Convention on Climate Change (UNFCCC) due to take place towards the end of the year refers to 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 midpoint in implementation of the 2030 Agenda for Sustainable Development, the messages and recommendations presented in this report are as timely as they are urgent.

The prevailing international financial architecture is ill-suited to dealing with systemic shocks and more fundamentally, to mobilizing resources for LDCs at the required scale. The period of multiple crises since the outbreak of the COVID-19 pandemic has not only highlighted the shortcomings of the present international financial architecture; it has also prompted several initiatives and proposals to improve it. These range from short-term stopgap measures, such as the Group of 20 Debt Service Suspension Initiative, to discussions on longer-term solutions, such as the Group of 20 Common Framework for Debt Treatments, as well as the push for reform of the multilateral development banks (MDBs).

Major discussions and negotiations are taking place in parallel in various forums such as the United Nations, the Group of Seven, the Group of 20 and the governing bodies of international financial institutions. These processes directly affect LDCs, given their dependence on external financing and on integration into the global economy through trade and financial flows. And yet the LDCs exert little, if any, influence on the decision-making processes that shape the international financial architecture. One reason for this is that the LDCs are not so-called “systemically critical”, as they carry very little weight in the global economy, international trade and financial flows. Moreover, their voice in international financial institutions, such as the International Monetary Fund (IMF), the World Bank and regional development banks, is marginal at best. For instance, at the World Bank, the LDCs jointly account for only 4 per cent of the voting rights. And they are not part of the Group of Seven or the Group of 20. Such power imbalances result in the LDCs being frequently mentioned in the international discourse on issues essential for their development prospects – such as financing for development and climate finance – but the subsequent outcomes and decisions do not align with their specific needs and characteristics. This untenable situation calls for urgent action by the international community to move beyond rhetoric and implement solutions that cater to the financing needs of these countries.

## Large and growing financing needs of least developed countries

The Sustainable Development Goals were underfunded in the LDCs well before the recent setbacks in the 2020s. T*he Least Developed Countries Report 2021* estimated that, to achieve a GDP growth rate of 7 per cent (Goal target 8.1), LDCs would need to invest $462 billion annually, which implies a 55 per cent increase in investments relative to actual investments in 2019 (prior to the COVID-19 pandemic). To achieve a more ambitious development goal – structural transformation, proxied by the doubling of the share of manufacturing in GDP (Goal target 9.2) – LDCs would have to spend an estimated $1,051 billion annually, which would require their economies to grow at an unlikely annual rate of 20 per cent during the 2020s. UNCTAD estimates that the gap in financing for the Sustainable Development Goals alone in all developing countries, including LDCs, is now about $4 trillion per year – up from $2.5 trillion in 2015 when the Goals were adopted.

Moreover, LDCs' financing needs have further expanded as a result of the multiple crises. In particular, their climate finance needs are growing as the world is lagging far behind in meeting the targets of the Paris Agreement. According to the UNFCCC's Standing Committee on Finance, 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. The LDCs have made ambitious plans to address climate change in their NDCs, but implementation depends on external finance, technology transfer and capacity-building. As these countries are particularly vulnerable to the impacts of climate change, they urgently need more finance for adaptation. Such finance should take the form of grants rather than loans, if LDCs are to avoid a climate debt trap. However, more than a third of climate-related financial flows to the LDCs is delivered through loans, which adds to their mounting debt burdens.

## The growing complexity of the international financial aid architecture poses a challenge to the weak institutional capacities of least developed countries

In addition to their requirements for greater financing to compensate for crisis-related setbacks in development, the external financing conditions for LDCs have become more challenging.

The international financial aid architecture is becoming increasingly complex. The number of actors has increased to include philanthropists, development finance institutions, the private sector and non-governmental organizations (NGOs), alongside traditional donors. Other developing countries have emerged as new sources of public development finance, the number of international vertical funds has been expanding rapidly, and there has been fragmentation and a proliferation of institutions and entities in the international climate finance architecture.

The emergence of new partners and funding vehicles no doubt broadens the development finance landscape. However, the many different sources of funding have their own specific and varying selection criteria, application processes and reporting requirements. This results in high transactions costs and a heavy administrative burden for recipient countries, many of which have limited resources and institutional capacities. Consequently, it effectively limits their access to such finance, and affects the overall performance of the international financial aid architecture.

Moreover, the proliferation of actors within the international aid architecture makes alignment with national priorities and coordination between donors more burdensome and maintaining overall debt sustainability more complex.

At the same time, the scope of official financing has increasingly widened to include an array of goals and objectives that often compete for resources. These goals include “traditional” development finance objectives, climate finance and humanitarian aid in a context of extreme weather events that are increasing in frequency, and geopolitical tensions that have intensified refugee and migratory flows. In this regard, there has been a blurring of the distinctions between different sources and objectives of development financing, as well as between public and private financial flows, including towards LDCs, especially in the context of blended finance. In addition, donor countries are spending an increasing share of official development assistance (ODA) in-country on refugee assistance, without triggering direct financial flows to LDCs.

LDCs also face challenges in terms of their agency over decisions that shape 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 LDCs are conspicuously absent. As a result, external financial flows are not always aligned with LDCs' national development goals and objectives. This means that LDC Governments have difficulty in retaining ownership of their development agendas and coordinating financial flows that have major impacts on their economies.

Moreover, growing geopolitical tensions compound the difficulties for LDCs to create synergies between different development partners and different sources of external finance.

While new initiatives have been taken by the international community that go in the right direction in terms of improving external financing for LDC development, they lag behind the level of ambition needed to address the acute financing challenges confronting these countries. As a result, the international community has so far failed to adequately respond to the looming financing crisis in LDCs.

# Managing fiscal space in the context of multiple crises

## Expanding fiscal space is critical for structural transformation

Fiscal space is the extent to which a Government can increase its spending or sustain a reduction in revenues without compromising its long-term fiscal sustainability. A lack of fiscal space can be particularly damaging at times of heightened economic stress, when Governments need to respond quickly to crises such as the COVID-19 pandemic, global food and energy price shocks such as those caused by the war in Ukraine, and climate-related loss and damage. Multiple crises have led to an erosion of fiscal space in LDCs. The median ratio of general government debt to GDP in LDCs increased from 48.5 per cent in 2019 to 55.4 per cent in 2022 – its highest level since 2005. Rising import bills due to commodity price hikes contributed to this trend. In 2021, the value of net imports of basic food items to the LDCs as a group amounted to $5.4 billion, representing an increase of 26 per cent on a year-on-year basis. Other indicators of fiscal space, such as fiscal balances and the share of concessional loans in total external public debt, have also worsened for LDCs as a group. As a result of these developments, LDCs risk falling even further behind on their path towards the Sustainable Development Goals. Consequently, they urgently need greater support to enhance their fiscal space.

External financial flows remain a critical factor for their fiscal space, although, over the medium term, domestic resource mobilization needs to play a growing and more sustainable role. There is scope for improving domestic resource mobilization through various channels. In particular, LDCs as a group lag behind other country groups in terms of tax revenues collected as a share of GDP. In 2020, the median tax-to-GDP ratio in LDCs was 11.6 per cent, compared with 16.3 per cent in other developing countries and 23.2 per cent in developed countries. Domestic resource mobilization could be improved by broadening the tax base, combating illicit financial outflows, enhancing tax compliance, strengthening international tax cooperation and improving the management of natural resources, including minerals critical for the global energy transition. Domestic resource mobilization in LDCs needs to grow in parallel with more effective implementation of their structural transformation agendas and with efforts to improve their productive capacities, strengthen governance, improve their tax systems and enhance their institutional capacity at both the national and international levels.

## There remains a wide gap in official development assistance

Gross disbursements of ODA to the 46 LDCs as a group amounted to $66.9 billion in 2021, down from a record $72.9 billion in 2020, the year the COVID-19 pandemic started. During the period 2019–2021, ODA flows to LDCs totalled $202 billion, of which the five largest recipients – Bangladesh, Ethiopia, Afghanistan, Yemen and the Democratic Republic of the Congo – received 35 per cent. Despite the crucial role of external finance, ODA flows to LDCs are substantially lower than the commitments made by developed countries. In 2021, those flows accounted for a mere 0.09 per cent of the gross national income (GNI) of Development Assistance Committee (DAC) members, significantly short of the target of 0.15–0.2 per cent of GNI enshrined in Sustainable Development

Goal 17 and in the Doha Programme of Action. The gap between commitments and disbursements amounted to $35 billion–$63 billion in 2021. Thus, increasing ODA disbursements to the committed levels is needed in order to boost growth and resilience in the LDCs.

With regard to the composition of ODA, an important consideration is whether it takes the form of grants or loans. Both grants and loans can help fill funding gaps in critical areas of the Sustainable Development Goals, and help to push forward implementation of the structural transformation agenda in LDCs. However, loans have the downside of adding to the debt burden of LDCs, and can thus fuel a problem in one area of sustainable development while aiming to solve a problem in another area. As a lack of adequate fiscal space is a key concern for LDCs, debt-generating ODA constitutes a trade-off for LDCs. In the period 2012–2021, the share of grants in total ODA to LDCs was 76 per cent, significantly lower than the preceding decade (2002–2011), when their share was 85 per cent. In 2020, the year the COVID-19 pandemic brought the global economy to a grinding halt, the share of grants was 67 per cent, its lowest point since the start of the data series in the Creditor Reporting System of the Organisation for Economic Co-operation and Development (OECD). Thus, although total ODA to LDCs increased in response to the COVID-19 pandemic, there was a pronounced fall in the share of grants in ODA – 6 percentage points vis-à-vis 2019. Yet grants should be the primary means through which ODA flows are scaled up to committed levels in order to counteract the shrinking fiscal space in LDCs without fuelling the risk of debt distress.

There is a rising trend in blended finance flows to LDCs. However, the high level of country and sectoral concentration among and within LDCs warrants caution when considering the potential for blended finance to contribute to the achievement of the Sustainable Development Goals. In particular, donors that aim at mobilizing increasing volumes of blended finance to LDCs should also seek to align those flows with the recipient country’s priorities and national development plans. For their part, LDCs need to ensure that private investments contribute to sustainable development without causing negative side effects by establishing rules and regulations that mitigate potential environmental and social risks, promote transparency and protect local communities.

## Climate finance poses additional challenges

LDCs have contributed only marginally to the climate crisis but are the most vulnerable to the impacts of climate change. In 2020, there were 18 LDCs among the 20 countries with the highest level of vulnerability and lowest level of readiness to tackle the effects of climate change. They are also the country group least able to leverage investments in adaptation actions. Consequently, LDCs require more fiscal space for investments in adaptation and financing to cover the costs of loss and damage resulting from extreme weather events. In this context, climate finance for LDCs needs to improve along each of its main dimensions: quantity, quality and access.

There are often delays of several years between the initial submission of project proposals and the disbursement of climate funds. Despite the large number of such dedicated funds, the bulk of climate finance continues to be delivered through non-climate-specific channels. This gives rise to a lack of transparency and difficulties in establishing a unified and clear accounting framework for climate finance. The quantity of climate finance flows to LDCs has fallen short of international commitments and even shorter of actual needs in LDCs. In spite of their disproportionate vulnerability, LDCs received a share of total climate finance flows in 2016–2020 that roughly corresponds to their population share in the group of developing countries – equivalent to an annual average of $12.6 billion. In the same period, more than a third of climate finance flows to the LDCs was in the form of loans. Climate change adaptation – a key priority for LDCs – accounted for only 45 per cent of total climate finance. This points to the need for significantly scaling up climate finance flows to LDCs, but also for enhancing the impact of existing funding by increasing the share of grants and contributing more to adaptation. Grants, as opposed to loans, are essential for avoiding a climate debt trap.

The Loss and Damage Fund, currently in the making within the UNFCCC, could play an important role if its design and operationalization take into account the specific needs of the LDCs, as suggested in this report. Indeed, if its implementation does take LDC specificities into account, the Fund has the potential t0 significantly boost the resilience of LDCs as they strive to achieve the Sustainable Development Goals while standing at the forefront of the impacts of climate change.

## Debt vulnerabilities of the least developed countries

LDCs need assistance to achieve long-term debt sustainability in line with Sustainable Development Goal target 17.4, and to foster much-needed structural transformation of their economies. Debt finance is necessary for countries to cope with the increased fiscal spending required in times of crisis, and to accelerate structural transformation. However, a looming debt crisis of the magnitude witnessed in the 1990s, before the Heavily Indebted Poor Countries (HIPC) Initiative was implemented, threatens to hamper their progress. The total external debt stock of the LDCs reached $570 billion in 2022, with the public and publicly guaranteed (PPG) component spiralling to $353 billion from just over $100 in 2006. In 2022, all indicators of external debt sustainability deteriorated: the ratio of total debt service to exports of goods and services rose to 18.9 per cent from 18.3 per cent in 2021, and the share of government revenue spent on servicing debt reached 17 per cent from 15.6 per cent in 2021.

## Structural factors result in lingering debt vulnerabilities

Structural factors are the main causes of the debt vulnerabilities of LDCs. Their high level of dependence on primary commodities for export and fiscal revenues increases their exposure to external shocks. As these countries strived to recover from the COVID-19 pandemic, disasters linked to climate change and other global shocks intensified in 2020–2023, further eroding their already constrained fiscal spaces. Strong export performance, coupled with sustained long-term economic growth, improves the capacity of countries to absorb and utilize debt and withstand shocks. However, the lack of fiscal space to bolster government expenditure during crises, and their inability to mobilize private investments, are hurting these countries’ development prospects.

Structurally, the largest component of the PPG debt stock of LDCs is multilateral (42 per cent in 2021), but that share is declining. Bilateral debt in the PPG portfolio also declined, from 39 per cent in 2006 to 35 per cent in 2021. In contrast, commercial banks’ debt and bonds increased from 7 per cent and nil in 2006, to 14 per cent and 7 per cent, respectively. Individual country debt structures also show a substantial increase in private sector debts, including bonds. Compared to 2006–2009, concessional debt in total external debt fell by an average of 20 percentage points in 2017–2021. This affected 36 LDCs, and 26 of them saw concessional debt decline by 10 to 57 percentage points.

## Debt service costs have been rising

The debt service costs of LDCs have surged, as their debt structures have become more complex since the beginning of the twenty-first century, with suboptimal maturity schedules. Since 2018, LDCs have spent more on servicing their external debt than on education. Moreover, their expenditure on external debt service rose from a value corresponding to one third of their health spending in 2009–2011 to three quarters in 2018–2020. During this more recent period, 11 LDCs spent more on debt service than on education and health combined, a development that did not occur for any LDC during the earlier period.

Additionally, LDCs generally pay a higher premium on bonds. Since 2014, debt service to private creditors has exceeded debt service to official creditors. The bond component of debt service more than doubled in 2019–2022 compared to 2016–2018. The average PPG debt-to-GDP ratio for LDCs reached 30 per cent in 2019 and 34 per cent in 2020, before contracting slightly to 32 per cent in 2021. Between the periods 2009–2011 and 2019–2021, PPG debt service as a percentage of exports of goods and services increased in 25 LDCs. The existence of unbalanced debt portfolios between long-term and short-term debts, as well as among different categories of creditors with different risk appetites, has become challenging in the current global economic environment.

## Addressing debt vulnerabilities

LDCs at risk of debt distress require an immediate injection of liquidity to prevent the crisis from degenerating into a socioeconomic catastrophe. Bilateral partners could help increase aid flows to the stricken countries by providing broad debt relief to enable them to deal with debt overhang situations and to free up resources for greater social spending.

LDCs and their partners should implement measures that respond to the structural characteristics of LDC debts. The Doha Programme of Action underscores the urgent need to develop mechanisms to mobilize public and private investments towards achieving the Sustainable Development Goals. Granting all LDCs access to loans from the International Development Association (IDA) would ease the financing pressure and help create conditions for balancing debt portfolios between long-term and short-term debts, as well as among different categories of creditors. This would spread interest rate risks and dampen the effect of speculative investors, particularly in the prevailing global economic outlook of high interest rates and inflationary pressures.

A multilateral debt workout mechanism remains critical, since a large share of LDC debts is owed to countries that do not participate in the Group of 20 Common Framework for Debt Treatments. Emergency lending on concessional and affordable terms, and converting maturing short-term loans into long-term loans on softer terms, could assist LDCs that face liquidity constraints. Critically, an increase in multilateral debt and other official flows – especially grants – as well as long-term financing for investments would go a long way towards enhancing the development prospects of LDCs.

# The role of central banks in supporting green structural transformation in least developed countries

## Aligning financial systems with climate goals

Article 2.i.c of the 2015 Paris Agreement set out the goal of "making finance flows consistent with a pathway towards low greenhouse gas (GHG) emissions and climate-resilient development". While COP26 boosted momentum for the mandatory alignment of global financial flows with climate goals, there is growing concern that global investment behaviour continues to significantly finance carbon-emitting production and its further expansion. Delivering a global transformation to a low-carbon economy will require a transformation of the financial system and its structures and processes, and engaging Governments, central banks, commercial banks, institutional investors and other financial actors in that transformation effort.

Reform of the global financial system to contribute to the low-carbon transition is the subject of an ongoing debate. The conventional view takes a static, risk-based approach to aligning financial flows to net-zero commitments. It largely focuses on the role of central banks acting independently and within narrowly defined mandates of price and financial stability. However, the isolated use of central banks' climate mitigation tools is not recommended in LDCs, because they do not have the same types and levels of development of institutions (including financial systems) or productive capacities as other developing countries or developed countries. Therefore, central bank tools can be used only if they are accompanied by other fiscal, industrial and social policies which can ensure that the target of reducing emissions will not undermine social and developmental targets.

For LDCs, the global low-carbon transition may have important negative implications emanating from both domestic and international actions that elevate the risk of an "unjust" transition. Weak domestic institutional capacities combine with low levels of financial development to limit the transmission of climate central banking policies through monetary policy. This can be exacerbated by competing monetary policy objectives. At the international level, long-standing imbalances in the international financial and development finance architecture introduce higher probabilities of unleashing unintended negative consequences, including making it more difficult for LDC Governments and private sectors to invest in climate adaptation and cover climate-related losses. While trade-offs from climate action are not exclusive to LDCs, they are amplified in these countries, where attendant redistributive impacts of climate central banking choices are potentially harsher and larger. Consequently, climate central banking tends to be more contentious in LDCs. In this context, while finance plays an essential role, certain responsibilities cannot be shifted to the financial sector or delegated to central banks acting on their own.

## Central bank policies should be coherent with development and industrial policies

In order to achieve a just transition in LDCs, their financial sectors should take the lead in contributing to the green transition and climate adaptation within the overall context of achieving fundamental progress on structural transformation. This means that financial realignment in LDCs is best achieved by a green transition-oriented approach, underpinned by industrial policy and a closer alignment of central banking with government policies on development. Such an approach has the highest probability of simultaneously fostering green structural transformation and developmental progress in these countries.

Across all economies, climate mitigation and adaptation require even greater policy synergy than traditional economic policy targets. Historically, central banks coordinated with ministries of finance and other government agencies to proactively steer credit and support major structural change of the type required for tackling the climate crisis, while complementing active fiscal and industrial policy regimes. Such coordination with central banks still exists in many LDCs, and several of them also have a mandate to support development despite the lack of direct mandates on sustainability. The institutional environment in many LDCs is thus more conducive than in countries where central banks act independently of other public authorities. Nevertheless, a significant challenge for LDCs is to ensure that their central banks' climate tools are used to achieve more than one target. A careful design of policy tools is therefore necessary to ensure that multiple targets can be achieved and trade-offs minimized.

Employing the green transition-based approach to financial alignment will help LDCs mitigate and resolve trade-offs from climate action, because it sets an ambitious agenda centred on the use of quantitative and qualitative credit allocation policies that are coordinated with fiscal and green industrial policies. An added advantage is that it expands the focus of financial alignment to encompass adaption. It thus incorporates a more proactive and dynamic alignment of financial systems. Furthermore, it tailors alignment to country-specific scenarios and operationalizes developmental central banking.

Climate central banking represents uncharted territory for central banks of all countries. Consequently, many of them have resorted to peer learning and exchange of good practices to develop banking expertise and know-how in this area. The emergence of regional peer learning initiatives alongside global ones led by developed countries is indicative of the substantial variation in vulnerability of economies and ecosystems to climate change among and within regions. Overall, developing countries face greater physical risks, including more frequent and severe weather events associated with climate change. Thus, central banks and financial systems in those countries are potentially more exposed to climate-related risks and may have more at stake in climate central banking. This translates into a strong incentive for developing countries to join global financial efforts to align their financial systems with climate goals.

Globally, the financial architecture for climate central banking is remains a work in progress, with specific disclosure, assessment and governance tools still under development. In this process, mutually reinforcing and collaborative actions across a variety of ecosystem role players is needed to disincentivize greenwashing, encourage consistency and standardization, provide additional layers of transparency and reduce the costs of regulatory compliance. Ecosystems for climate central banking are the least mature in LDCs; few of their microenterprises and small and medium-sized enterprises are able to respond to pressures from various stakeholders to prove their accountability and commitment through disclosures on their sustainability practices. The time frame to avert a climate disaster implied by scientific evidence means that central banks in developing countries, especially in LDCs, face the Herculean task of simultaneously converging towards global best practices and developing climate change-adapted technical capabilities (human and capital). Unfortunately, progress on climate central banking around the world is not proceeding at the same pace.

Governments of LDCs may wish to consider modifying the mandates of their central banks to make them support climate-aligned development. However, the existence of a specific climate mandate is a necessary, but not sufficient, condition for using certain types of climate central banking tools. Once potential climate policy tools have been identified, central banks need to examine a range of other issues before they can decide if it makes sense for them to use a specific tool. For example, central bank authorities should be mindful that, to be effective, climate central banking tools need to fit the structure of the local economy. Given the risk of unintended negative impacts, climate central banking tools that are not suited to the conditions of the local economy, or that have the potential to undermine other developmental targets, should not be used. Most importantly, in the case of climate mitigation and climate adaptation, central banks run the risk of having too many targets and too few tools. The best way to address this challenge and limit undesirable trade-offs would be to design central banking tools in ways that do not undermine more traditional targets.

Central banks of LDCs may contemplate adopting climate mitigation and adaptation tools only if the following conditions are met: (a) sustainable development or a strong macroprudential approach are part of their mandates, and (b) their financial systems are sufficiently developed and used by a sufficiently large proportion of the population and the non-financial corporate sector. It is essential for such tools to be aligned with the targets of industrial policy and the fiscal authorities.

# Advancing reform of development finance for the least developed countries

## Moving from crisis to reform

LDCs today face a number of interlocked challenges. A leading challenge 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.

The increase in revenues required to cover rising costs and expenditure needs has not yet materialized, because the underlying and preceding fiscal and financing shortfalls have been compounded by the discretionary fiscal policy effects of the

COVID-19 pandemic. As a result, many LDCs are facing a vicious cycle of debt and crisis, 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 failed to overcome 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.

Comprehensive reforms in the international financial architecture, coupled with increased commitments and innovative approaches, are necessary to support LDCs' financial needs for sustainable development and help build their resilience in the face of 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 challenges of LDCs and encouraging their greater participation in global governance of these matters is clear. Multilateralism implies international cooperation to attempt to find 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 underline 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.

## 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.

It is important that ODA flows to LDCs be increased, as a first step, to the levels committed by developed countries. For DAC members this would mean increasing ODA flows to LDCs to 0.2 per cent of their GNI – the upper level specified in the Sustainable Development Goal target 17.2 – by 2025. Moreover, the increase should be exclusively in the form of grants. Beyond the quantitative increase, it is important that the international development community seeks 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. 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.

"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 fund development and climate resilience in LDCs, thereby serving a double purpose. Political will is key to unlocking this large source of new liquidity.

LDCs need a clear path out of 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 for developed-country partners 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 multilateral development banks.

## 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 to meet their growing needs for investments in adaptation and 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 a debt trap. Such flows should also focus more on adaptation to climate change, which is a priority for LDCs. They should also commit to rechannelling $100 billion worth of Special Drawing Rights (SDRs) in 2024 to support efforts to resolve the debt crisis in LDCs and enable them to get back on track to meeting their Sustainable Development Goals.

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 to existing climate funds and those provided through newly established climate finance vehicles such as the Loss and Damage Fund.

Moreover, there is a growing need for reforms and commitments to greater levels of transparency, possibly by taking steps 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 funds disbursed by designated climate finance vehicles are undoubtedly climate finance, double counting between development finance and climate finance would not be an issue. 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 and can be separated.

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

Natural disasters should trigger debt write-offs commensurate with the losses and damages incurred, in addition to a pause in debt repayments. An arrangement should be made for the international community to write off the debts of affected countries in cases of large natural disasters where available funds are insufficient to cover the full grant amount of compensation for losses resulting from the disasters.

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

- 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 disbursement 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 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 process requirements (emergency funding versus 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 Loss and Damage Fund 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.

## Reforming the international financial architecture

Improvements in financing for development of LDCs should be part of broader reforms of the international financial architecture. In this sense, 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 the role played by institutions and policies in creditor countries in triggering international financial crises.

Another long-standing plea has been the implementation of a comprehensive debt workout system. At a minimum, debt repayments should be put on hold once debtors enter into negotiations on debt resolution. In addition, a multilateral debt workout mechanism could help broker negotiations between creditors and debtors. At present, such negotiations are characterized by stark power imbalances, in particular when they concern 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.

In view of the key role of MDBs as providers of concessionary finance to LDCs, a surge in funding through these institutions needs to be part of any meaningful reform of the development finance system. In order to be able to provide more liquidity, and on highly concessionary terms, MDBs themselves would need to borrow more on capital markets. This could be facilitated by including callable capital in their risk frameworks in line with the recommendations of the Group of 20 Independent Review of MDBs' Capital Adequacy Frameworks. They would then be able to increase lending at highly concessional terms by hundreds of billions of dollars. LDCs and other developing countries that face higher borrowing costs on capital markets would benefit from such an expansion, particularly in view of a further tightening of global financing conditions. Additionally, all MDBs – not just the World Bank – should include disaster clauses in new loan agreements with LDCs, and evaluate options to retroactively include such clauses in existing loan agreements with these countries. Finally, developed countries need to ensure that the 21$^{st}$ replenishment of the International Development Association (IDA21) is ambitious and commensurate with the growing needs of LDCs.

Reform of the rules for the distribution of SDRs is needed so that SDRs 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 the distribution of SDRs. 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 of their SDRs to the IMF or to other entities that are allowed to hold them. The latter could then use the SDRs 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. MDBs could be another important avenue for leveraging rechannelled SDRs. LDCs need a regular, continuous flow of rechannelled SDRs, as their financing needs for achieving the Sustainable Development Goals and for covering climate change costs are also long term in nature.

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 does not lead to downgrading LDCs, which would reduce their access to finance.

## Debt management

Coordination and cooperation between MDBs, Paris Club creditors and non-Paris Club creditors should be strengthened to ensure efficient and swift solutions for LDCs in need of debt treatment, and establish a flexible and efficient mechanism for debt treatment, including an immediate standstill on debt payments once a debtor country enters into negotiations. It should also include improved international tax cooperation to strengthen international tax norms, combat illicit financial flows and facilitate revenue collection in LDCs.

Development partners need to scale up capacity-building in LDCs in critical areas such as debt management, tax administration (including resource taxation), climate negotiations and assessment of climate-related loss and damage.

## 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 can also help boost domestic revenues. Furthermore, financial sector development can 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 can also help increase domestic revenues. 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 revenue from their extractive industries. In particular, LDCs with reserves of critical minerals for the global energy transition need to ensure that extraction of these reserves contributes to sustainable development by promoting domestic value addition and securing a fair share of revenue and profits.

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

## Climate central banking

The central banks of LDCs need to consider the use of central banking climate mitigation and adaptation tools on condition that sustainable development and a strong macroprudential approach are part of their mandates, and only if their financial systems are sufficiently developed and used by a sufficiently large proportion of the population and the non-financial corporate sector. If climate central banking tools are introduced by central banks of LDCs, it is essential for them to be aligned with industrial and fiscal policy targets. For example, if the central bank of an LDC decides to use such tools, it needs to ensure that the financial system will continue to support the priority sectors that have been identified in national industrial policy. Central banks should never be viewed as "fixers" of the climate crisis and substitutes for interventions that need to be made by a Government, 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 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.

## South–South and regional initiatives

The diversification of the architecture of official financial flows to LDCs has also seen 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 ensuring against them becoming additional sources of overindebtedness. Developing-country partners can also serve as intermediaries for long-term investments.

South–South cooperation can also assist LDCs in mobilizing and managing development finance by adopting concerted strategies at regional and subregional levels to bolster access to development finance, and develop common negotiating positions to raise funding and renegotiate debt.

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