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Financing for development: Mobilizing sustainable development finance beyond COVID-19

Note by the UNCTAD secretariat

Summary

The present background note for the fifth session of the Intergovernmental Group of Experts on Financing for Development, to be convened on 21–23 March 2022, contains a consideration of current developments in the global economy and the implications for an improved and a stronger public sector-led approach to financing development over the years to come. Chapter II sets out lessons to be learned in this regard from the coronavirus disease pandemic. Chapter III considers additional challenges posed by the need for a green as well as inclusive transformation for developed and developing countries alike. Chapter IV discusses a range of policy options and recommendations to help ensure that development financing can be put on a secure footing.

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I. Introduction

1. Following the fifteenth session of the United Nations Conference on Trade and Development, held from 3 to 7 October 2021, member States decided that the topic of the fifth session of the Intergovernmental Group of Experts on Financing for Development, to be held from 21 to 23 March 2022, would be mobilizing sustainable development finance beyond the coronavirus disease (COVID-19). The guiding questions agreed for the fifth session of the Intergovernmental Group of Experts on Financing for Development are as follows:[1]

(a) What lessons can be learned from the COVID-19 pandemic for the stable and reliable provision of long-term development finance?

(b) How can domestic and international, public and private financing instruments be improved to facilitate green industrialization and inclusive structural transformation in developing countries?

(c) Which additional and/or alternative policies and initiatives can contribute to closing the infrastructure gap and, at the same time, promoting inclusive industrialization in developing countries and productive employment?

2. The topic corresponds to that of chapter I of the Addis Ababa Action Agenda (A/RES/69/313, annex), particularly paragraphs 14–17, and to action areas A to C in chapter II. In chapter I, “a global framework for financing development post-2015”, including “establishing a new forum to bridge the infrastructure gap” (para. 14), “promoting inclusive and sustainable industrialization” (para. 15), “generating full and productive employment and decent work for all” (para. 16) and “protecting our ecosystems for all” (para. 17) are outlined. In chapter II (sections A–C), challenges and priorities are set out regarding domestic public resources (chapter II.A), domestic and international private business and finance (chapter II.B) and international development cooperation (chapter II.C).[2]

3. The COVID-19 pandemic is a crisis of a kind not anticipated in the Addis Ababa Action Agenda. Given the topic chosen by member States, in the background note, there is therefore a brief discussion of basic lessons for development financing that might be learned from the crisis (chapter II), before a summary overview is provided of policy challenges posed, at the national and international levels, by combining a strong and even recovery from the pandemic, across the global economy, with promoting green industrialization and inclusive structural transformation in the developing world (chapter III). In chapter IV, there is a more detailed look at what policy initiatives would be needed, nationally, regionally and internationally, to ensure that a large and coordinated investment push towards fully implementing the transformational 2030 Agenda for Sustainable Development can still be realized. Chapter V contains the conclusion.

II. The COVID-19 pandemic and development finance: Main lessons to consider

4. There is, by now, little doubt that the economic fallout from the ongoing COVID-19 pandemic will not be transitory. This is likely to further widen pre-pandemic financing gaps to achieve the 2030 Agenda for Sustainable Development unless the crisis is turned into an opportunity to substantively rethink coordinated policies to scale up development finance

[1] As approved by the Trade and Development Board through a silence procedure, conducted between 8 and 13 October 2021, that was not broken.

[2] See also TD/B/EFD/1/2 and TD/B/EFD/3/2 for relevant contributions and other background notes on domestic resource mobilization, blended finance and development cooperation prepared for previous sessions of the Intergovernmental Group of Experts on Financing for Development.

from public, private, domestic and external sources.[3] While the nature and global reach of the COVID-19 crisis is exceptional for now, combined health, environmental, economic and financial crises may soon become the rule rather than the exception. A first lesson to take on board from the COVID-19 crisis is therefore that separating out exogenous macroeconomic shocks from the longer-term evolution of developmental paths is an artificial exercise: resource mobilization for development will continue to be affected by such shocks unless put on a financial footing that can absorb them.

5. On the domestic front, the combination of high pandemic-related financing needs and falling public revenue due to lower levels of economic activity put fiscal spaces in most developing economies under enormous strain in the initial phases of the crisis. The diminished fiscal spaces in developing countries and, therefore, ability to mobilize domestic resources for development, is likely to outlast the immediate impacts of the COVID-19 pandemic for a number of reasons.

6. On the expenditure side of public domestic finances, slow vaccine roll-outs in many developing countries mean that pandemic-related financing needs will remain high for longer than expected. Other current expenditures that have been postponed during the crisis will need to be revived eventually, leaving little room for public investment in structural transformation and green industrialization. In many countries, high servicing costs on public external debt obligations must be added to this picture. As a share of government revenue, these high servicing costs amounted to 11.4 per cent in least developed economics, 8.5 per cent in middle-income economies and over 20 per cent in small island developing States in 2020, with many countries facing much higher burdens of up to half of their government revenues.[4]

7. On the revenue side, economic growth is the main driver of increased tax revenues, the primary and most reliable source of domestic public resource mobilization. At present, UNCTAD projections of annual global output growth currently rule out a return to pre-pandemic trends before 2030.[5] The International Monetary Fund (IMF) is more optimistic in the short run but more cautious about global growth prospects in the longer run.[6] In either case, there is substantive uncertainty arising from uneven growth dynamics across and within regions, including potentially very damaging spillover effects from higher interest rates in advanced economies on heavily indebted developing countries. Progress made prior to the pandemic, particularly in many poorer economies, to increase tax revenues may therefore be stalling or even reverting, with continuing efforts to improve taxation systems and, more generally, the management of public finances, being thwarted by negative feedback processes from global economic growth dynamics. This comes against a backdrop in which, despite the progress made, many low- and middle-income countries struggled prior to the pandemic to reach tax revenue-to-gross domestic product (GDP) ratios of between 15 and 20 per cent, considered a benchmark for State functioning to promote sustainable development.[7]

[3] See, for example, Organisation for Economic Co-operation and Development (OECD), 2020a, The impact of the coronavirus (COVID-19) crisis on development finance, OECD Publishing, Paris, 24 June; OECD, 2020b, *Global Outlook on Financing for Sustainable Development 2021: A New Way to Invest for People and Planet*, OECD Publishing, Paris.

[4] A/76/214, report prepared by the secretariat of the United Nations Conference on Trade and Development on external debt sustainability and development.

[5] UNCTAD, 2021a, *Trade and Development Report 2021: From Recovery to Resilience – The Development Dimension* (United Nations publication, Sales No. E.22.II.D.1, Geneva), chapter I. Following a 3.5 per cent fall in world output in 2020, UNCTAD projects global growth of 5.3 per cent in 2021 and 3.6 per cent in 2022, implying a cumulative income loss of approximately $10 trillion in 2020/21 alone. On the potentially optimistic assumption of annual global output growth of 3.5 per cent after 2022, this rules out a return to pre-COVID-19 trends before 2030.

[6] International Monetary Fund (IMF), 2021a, *World Economic Outlook: Recovery during a Pandemic – Health Concerns, Supply Disruptions and Price Pressures*, Washington, D.C. The IMF projects the global economy to grow at a slightly higher 5.9 per cent and 4.9 per cent in 2021 and 2022, respectively, and expects most developing countries to return to pre-pandemic growth trends by 2024. However, it also expects the world economy to grow at a marginally lower 3.3 per cent after 2022.

[7] OECD, 2020a.

8. This scenario is reinforced by the prospect of worsening trade balances in developing countries translating into shortages of foreign currency earnings, including to service outstanding international debt obligations, and reducing government revenues from custom duties on imports and exports. A case in point is the virtual collapse of the tourist industry, a lifeline for many low- and middle-income developing countries, including small island development States, with economic losses estimated by UNCTAD to amount to between $1.7 trillion and $2.4 trillion in 2021 alone.[8] More generally, while international trade in goods and services rebounded in 2021, from a 5.6 per cent fall in 2020, this could be short-lived given continued concerns about the spread of new coronavirus variants and unresolved global trade disputes. At the same time, the upward trend of commodity prices since mid-2020 alleviates external constraints for commodity exporters but worsens these for commodity importers. It also contributes to inflationary pressures for commodity importers, many of which are already beginning to tighten monetary policies.[9]

9. Mobilizing external financial resources for development also suffered a heavy blow in the wake of the COVID-19 crisis. As shown in figure 1, net capital flows to low-income countries fell sharply and continuously by 85 per cent, from their pre-pandemic peak of $8.3 billion, to $1.2 billion in the second quarter of 2021. Lower-middle-income countries experienced a similar fall of 75 per cent from their pre-pandemic peak of $68.8 billion to $16.8 billion by the end of the reporting period. In both cases, net capital flows at least remained positive. By contrast, net flows to upper-middle income countries have been negative since the end of 2018. After an initial steep fall of net flows (from -$29.5 billion at the end of 2019 to -$133.4 billion at the end of 2020), the current trend is upwards, reaching -$8.1 billion by mid-2021. However, given the extreme volatility of net flows to this country group, this provides little ground for optimism.

8 UNCTAD, 2021b, COVID-19 and tourism, an update: Assessing the economic consequences, UNCTAD/DITC/INF/2021/3.

9 UNCTAD, 2021a.

Figure 1
Net capital flows by income levels, developing countries, 2000 (first quarter)–2021 (second quarter)
(Billions of United States dollars)

Source: UNCTAD secretariat calculations, based on national sources and IMF balance of payment statistics.
Abbreviations: Q1, first quarter; Q3, third quarter.
Note: Country classification by gross national income (GNI) per capita are World Bank classifications. The figures for upper-middle income countries exclude China.

10. Figure 1 primarily reflects the dynamics of net private capital flows to developing countries. Remittances have proven more resistant to the COVID-19 shock than expected, falling by only 1.7 per cent in 2020 from a record level of $554 billion in 2019 and projected to rise again by 7.3 per cent in 2021.[10] The main private capital flow components to these economies by institutional investors and multinational enterprises – notably portfolio investments, foreign direct investment and derivatives – have, however, been more susceptible to global benchmarking and investment ratings, provided by a few influential investment funds and credit rating agencies.[11]

11. This suggests a second lesson to be learned from the COVID-19 pandemic, namely the need to rethink a financing-for-development model that prioritizes the use of public funds to "unlock" private capital through "de-risking" private investment. This approach, encapsulated in a 2018 report of the Eminent Persons Group on Global Financial

[10] World Bank, 2021, Recovery: COVID-19 crisis through a migration lens, Migration and Development Brief 35, Washington, D.C., November.

[11] A/75/281, report prepared by the secretariat of the United Nations Conference on Trade and Development on external debt sustainability and development, paragraphs 13 and 14.

Governance of the Group of 20,[12] advocates the use of financial innovation to create open and liquid capital that is attractive to global investors. This includes the creation of new large-scale asset classes, such as infrastructure assets, to be securitized through financial products that bundle high- and low-risk investments, the use of blended financing instruments[13] by multilateral financial institutions and development banks (such as public loan guarantees, insurance schemes, public–private partnerships and structured financing instruments that make public entities the first to take on losses) and the promotion of shadow-banking practices to facilitate investment opportunities in economic and social infrastructure.

12. The use of financial innovation to facilitate complex risk management is not new. Securitization, structured finance and shadow banking failed spectacularly in the global financial crisis of 2007/08, begging the question as to why such instruments should be appropriate for the delivery of development finance. They certainly have so far failed to deliver the promised transformation of development finance "from the billions to the trillions".[14] Even prior to the near collapse of private sector financing during the pandemic,[15] claims of leverage ratios of 1:7 (or seven dollars of private finance raised by one dollar of public funding)[16] have proven vastly exaggerated. The reality is closer to leverage ratios of 1:0.37 in low-income countries, 1:1.06 in lower-middle-income countries and 1:0.65 in upper-middle income countries.[17] This should entail serious reconsideration of the effectiveness of this approach to development financing.

13. A third main lesson to be learned from the COVID-19 crisis concerns the response of the multilateral financial system to the clearly urgent and substantive needs of developing countries. The response has been too little too late and, to an extent, also short-sighted. In particular, pre-pandemic, and often already unsustainable, external debt burdens have not been taken into account, with a view to resolving them rather than postponing their resolution, to free a path to affordable, cooperative and large-scale development financing.

14. While the IMF and the World Bank quickly committed substantial resources to new and rapid financial assistance for up to 100 developing countries – $168 billion by the IMF and $157 billion by the World Bank between March/April 2020 and June/July 2021 – this represents new debt, issued predominantly on non-concessional terms, but with a larger share of policy-unconditional lending. Debt relief has been limited to the cancellation of $851 million in debt service payments due to the IMF between April 2020 and the end of 2021 for 29 of the poorest developing countries.[18]

15. Similarly, the scale and scope of the Debt Service Suspension Initiative of the Group of 20 has been disappointing, with calls, including by the United Nations Secretary-General,[19] for its extension to private creditors and to crisis-stricken middle-income countries with high debt burdens going unheeded. The initiative has so far suspended debt service payments by 48 out of 73 eligible countries to participating bilateral creditors, amounting to $10.3 billion in the period between May 2020 and June 2021.[20] This will be

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[12] G[roup] of 20 Eminent Persons Group on Global Financial Governance, 2018, Making the global financial system work for all, available at https://www.globalfinancialgovernance.org/.

[13] See also TD/B/EFD/3/2, chapter III.

[14] See also World Bank, 2015, From billions to trillions: Transforming development finance. Post-2015 financing for development: Multilateral development finance. Development Committee Discussion Note DC2015-0002, Washington, D.C.

[15] OECD, 2020a; OECD, 2020b.

[16] See, for example, Convergence, 2018, The state of blended finance 2018, p. 5, available at https://www.convergence.finance/resource/7LEqTu0YeceaQugSWaSKSk/view.

[17] Attridge S and Engen L, 2019, *Blended Finance in the Poorest Economies: The Need for a Better Approach*, Overseas Development Institute, London.

[18] See https://www.imf.org/en/Topics/imf-and-covid19/COVID-Lending-Tracker and https://www.worldbank.org/en/news/press-release/2021/07/19/world-bank-group-s-157-billion-pandemic-surge-is-largest-crisis-response-in-its-history.

[19] See https://www.un.org/sg/en/node/259892.

[20] IMF, 2021b, Joint IMF–WBG [World Bank Group] staff note: DSSI [Debt Service Suspension Initiative] fiscal monitoring update, Washington, D.C., September.

added to future debt obligations by participating countries, and pales in comparison to the wall of upcoming sovereign debt repayments in international bond markets (including principals and interest payments in main foreign currency denominations) that many developing countries face over the years remaining to implement the 2030 Agenda for Sustainable Development. These sovereign debt repayments alone amount to near $1trillion, on conservative estimates.[21] The extent to which the Group of 20 Common Framework for Debt Treatments beyond the Debt Service Suspension Initiative[22] can alleviate these constraints remains to be seen. For now, in principle, only 3 of 73 eligible countries have joined the framework, which replicates an austerity-focused approach to debt sustainability assessments and policy conditionalities.

16. In addition, the official development assistance commitments of 30 Development Assistance Committee countries fell short again in 2020, relative to the 0.7 per cent of their GNI target,[23] with the 25 countries that did not meet the target contributing on average only 0.24 per cent of their GNI. At $161 billion, official development assistance remained $188 billion short of the 2020 target.[24]

17. Finally, the new allocation of special drawing rights to the equivalent of $650 billion came in late August 2021 but is a welcome exception to the timidity of the international community's overall response to the impact of the COVID-19 crisis on developing countries. Under the IMF quota system, only just short of 40 per cent of this amount (or $243 billion) goes to 150 developing country member States of the IMF, but it still provides an important injection of international liquidity, particularly to low-income countries.[25] In addition, discussions surrounding this new special drawing right allocation have helped to focus attention on how better to utilize special drawing rights for developmental purposes in future, an issue raised by UNCTAD since the very conception of special drawing rights by the international community in the late 1960s.

18. Even so, and as shown in figure 2, financing gaps to achieve the 2030 Agenda are set to widen considerably over the coming years. Based on existing projections at the IMF, UNCTAD and elsewhere, figure 2 provides an estimation of the financing gaps for the period 2020 to 2025 by comparing external financing needs (arising from external debt amortization and current account deficits) and additional financing needs (arising from COVID-19-related spending and the costs of achieving the Sustainable Development Goals, including climate change adaptation and mitigation costs) to expected tax revenues and private capital inflows.[26] Even under an optimistic scenario of no further exogenous shocks hitting developing countries until 2025, the resulting development financing gaps, by income groups, are daunting.

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[21] UNCTAD, 2021a, pp. 22–23.

[22] Group of 20, 2020, Statement, Extraordinary G20 Finance Ministers and Central Bank Governors' Meeting, 13 November, annex I; see also A/76/214, paragraph 33.

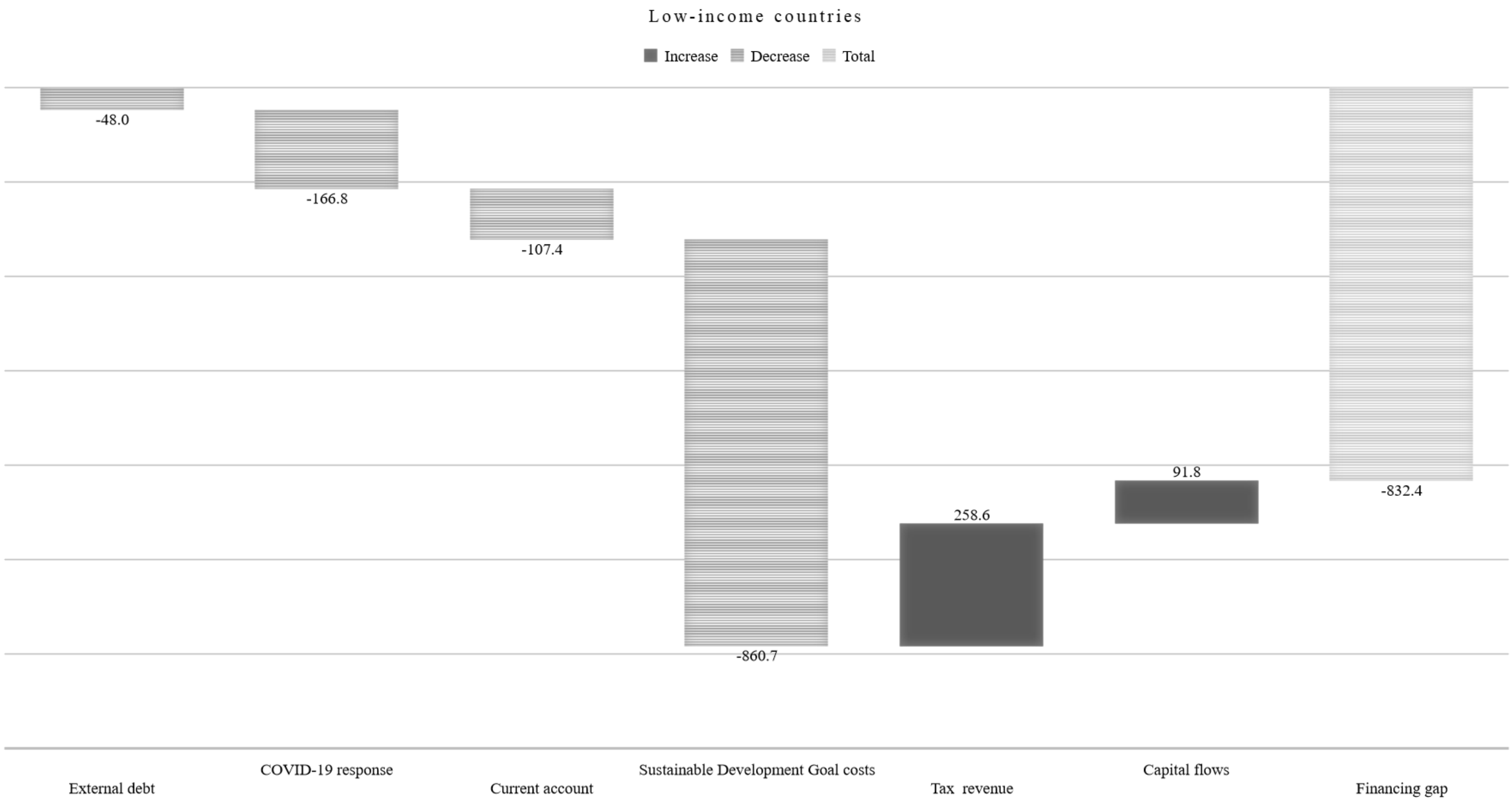
[23] See TD/B/EFD/3/2, chapter II.

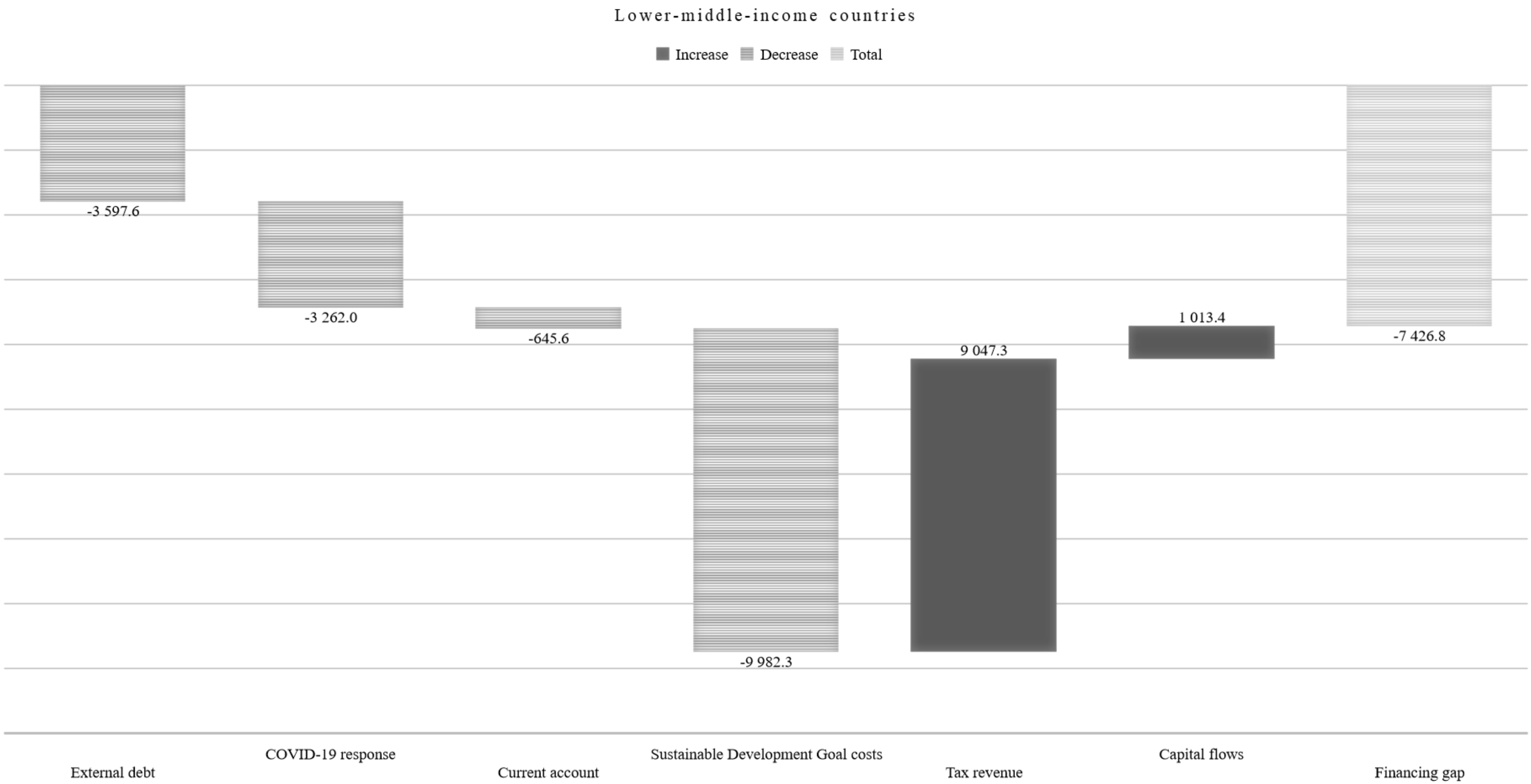
[24] OECD, 2021a, Trends and insights on development co-operation. OECD Publishing, Paris.

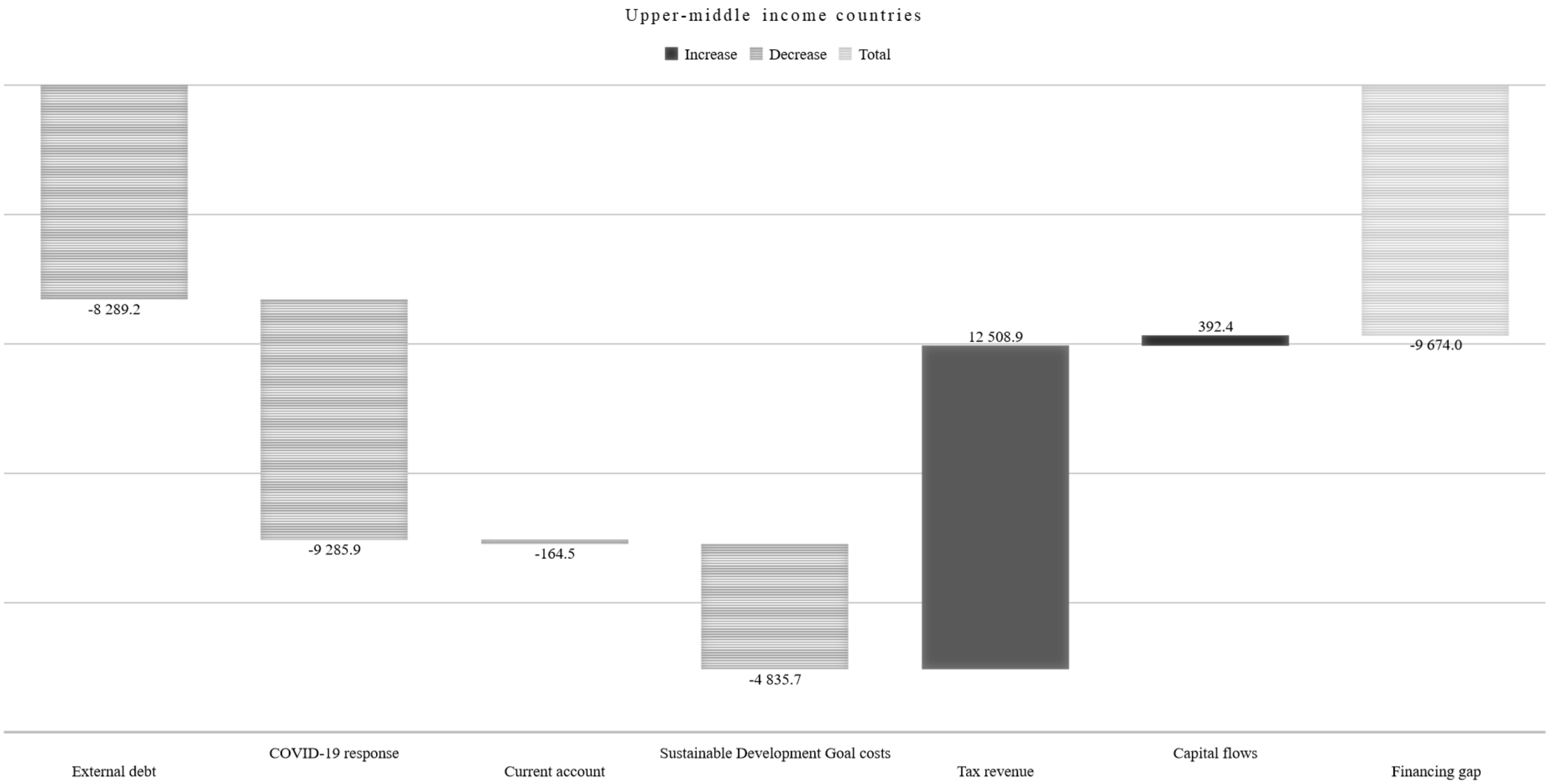
[25] UNCTAD, 2021a, pp.19–20.

[26] See also IMF, 2021c, Macroeconomic developments and prospects in low-income countries, Policy Paper, March, pp. 16–19.

Figure 2
Estimated financing gaps by income levels, developing countries, 2020–2025
(Billions of United States dollars)




Lower-middle-income countries
Increase
Decrease
Total
-3 597.6
-3 262.0
-645.6
-9 982.3
9 047.3
1 013.4
-7 426.8
External debt
COVID-19 response
Current account
Sustainable Development Goal costs
Tax revenue
Capital flows
Financing gap



Sources: UNCTAD secretariat calculations, based on: IMF, 2021a, *World Economic Outlook*; IMF Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic (October 2021); national sources and IMF balance of payment statistics; IMF government finance statistics; World Bank, World Development Indicators and international debt statistics; United Nations University-World Institute for Development Economics Research government revenue dataset; United Nations Environment Programme, 2021, *Adaptation Gap Report 2021: The Gathering Storm – Adapting to Climate Change in a Post-Pandemic World*, Nairobi; UNCTAD *World Investment Report 2014: Investing in the [Sustainable Development Goals] – An Action Plan* (United Nations publication, Sales No. E.14.II.D.1, New York and Geneva); IMF Sustainable Development Goal costing tool, second edition (based on Gaspar V, Amaglobeli D, Garcia-Escribano M, Prady D and Soto M, 2019, Fiscal policy and development: Human, social and physical investment for the [Sustainable Development Goals], Staff Discussion Note, IMF SDN/19/03).

Note: Country classification by GNI per capita are World Bank classifications. The figures for upper-middle income countries exclude China. Sustainable Development Goal costs have been computed as weighted averages by country income group, including power, transport, telecommunications, water and sanitation, food security and agriculture, health, education, and climate change adaptation and mitigation. Calculations for resources required for the COVID-19 response use advanced countries' COVID-19 spending as a benchmark for the needed response. Expected tax revenue is based on averages over recent years of tax revenue as a share of GDP. This baseline scenario assumes that the economies included will not be affected by new exogenous shocks in the period under consideration.

III. From economic recovery to building back better: Promoting green industrialization and inclusive structural transformation in the global economy

19. Financing gaps of the scale described above make "building back better" all the more important. This requires several core steps, at both national and international levels of policymaking.

20. First, policy mistakes of the past should be avoided. Retreating into isolationism, the notion of the primacy of the market over the State and society, and fiscal austerity will stymie an already uneven post-COVID-19 recovery. It will also mean that the chance to rebuild the institutional framework of global economic governance opened by the pandemic is missed. A resilient, inclusive and fair international economy can only emerge from the pandemic if the 2021 rebound of global growth and trade is supported and coordinated in and across all regions, if the economic gains from recovery are skewed towards middle and lower-income households, if health provision, including ready access to vaccines, is treated as a global public good and if there is a massive investment push across all countries into carbon-free sources of energy.

21. Second, and despite the 2021 rebound, pandemic-induced crises are not over. As pointed out in chapter II, in the developing world, external constraints on national policy spaces, worsened by the continuing financial and health crises, prevent Governments from strategically directing resources into sustainable, climate-conscious growth paths. UNCTAD warns that these economies are likely to come under pressure to cut labour costs and public services, in a futile attempt to export their way to recovery, further exacerbating inequality at home. This stands in stark contrast with a rebound in developed countries, where unprecedented fiscal expansion has supported household incomes and monetary policies have ensured that a financial breakdown was avoided.

22. Third, while the monetary and fiscal measures employed during the crisis in advanced economies have prevented a financial crash, they also have fed massive asset appreciations, magnifying income and wealth inequality. International financial institutions appear unable to contain this tendency. In both developed and developing countries, the perception that the benefits from globalization have been unfairly skewed to big players is reinforced by the ability of large conglomerates to pay little or no tax on the rents they extract.

23. Affordable access to reliable long-term financing, targeted equitable integration into international trade and financial systems and, crucially, green industrial policies will help ensure that developing countries move away from the current dogma of having to de-risk their economies and society to attract private funding, and instead use resources to develop diversified, resilient economic systems adapted to the challenges of climate change. Specifically, the pandemic has highlighted three areas where a more central role for the State and public institutions, especially in the developmental context, is essential.

24. The first is public health systems. The world will need to spend $70 billion–$120 billion over the next two years, and $20 to $40 billion annually thereafter, to substantially reduce the likelihood of future pandemics, with international financial support to developing countries of particular importance.[27] At the level of nation-states, countries with strong and universal public health systems have dealt better with the surge in demand for medical tests and treatments caused by the pandemic than countries with solely market-based or out-of-pocket health systems.[28] In the developing world, a national or mission-oriented programme to improve public health, including better water and sanitation for low-

[27] Craven M, Sabow A, Van der Veken L and Wilson M, 2020, Not the last pandemic: Investing now to reimagine public-health systems, McKinsey and Company.

[28] OECD, 2020c, Beyond containment: Health systems responses to COVID-19 in the OECD; Scott D, 2020, Coronavirus is exposing all of the weaknesses in the [United States] health system, *Vox*.

income households, is a priority for progressive fiscal policy that would create jobs, raise productivity and boost innovation.

25. The second area requiring a renewed role for the State is social security, especially in developing countries. The pandemic brought up the need for a more encompassing system of income insurance, covering not only the risk of unemployment for formal workers, but also the risk of income losses for informal and self-employed workers. Evidence from developed and developing countries indicates that emergency cash transfers raised savings and reduced poverty compared with the pre-pandemic period.[29] Therefore, a large government-led investment initiative can accelerate the economic recovery from the pandemic, creating jobs in addition to redistributing income.

26. The third area for fiscal action is public investment and employment, both for economic and social reasons. The UNCTAD *Trade and Development Report 2019* analysed how to finance a Global Green New Deal, that is, an investment strategy to create jobs, promote social inclusion and fight climate change, with a leading role for the public sector. The issue remains as urgent as before the pandemic, and the adoption of such a proposal could accelerate economic recovery and build resilience over the next years. The main opportunities for direct or government-induced investment are the environment, urban development, energy and decarbonization and universal public services, especially in developing countries.

27. Most effective paths towards sustainable growth can be found not through isolated policy initiatives, but rather through the long-term commitment and support of a strong, green development State. Building State capacities through progressive fiscal and industrial policies is key to the successful marriage of environmental and developmental goals along with doing so in light of specific national contexts.

28. Conventionally, industrial policy is understood as “targeted and selective government policies to shift the production structure towards activities and sectors with higher productivity, better paid jobs and greater technological potential.”[30] Green industrial policy has a wider scope and ambition. It is driven by the need for broader socioeconomic support in the face of higher global temperatures and a more disruptive climate. In addition to shifting the economic structure towards higher-productivity activities, it aims at aligning productivity-enhancing structural transformation with shifts from high carbon-intensive to low carbon-intensive resource-efficient activities, with a specific emphasis on exploiting the resultant synergies.[31]

29. Several lessons from recent experiences of successful structural transformations provide useful insights in terms of the State capacities necessary for a green transition.[32] First, a developmental State needs to have strong administrative and institutional capacities for the Government to formulate policy, lead structural transformation and anticipate and navigate uncertainties. One recent suggestion[33] applies such dynamic capabilities to five areas: foresight and anticipatory governance; ability to handle partial and often contradictory evidence; mechanisms for “mesh governance” (governance which includes multiple tiers); quick repurposing of existing infrastructure; and learning from other Governments.

30. Second, a developmental State relies on well-functioning mechanisms of accountability of policymakers and implementation agencies. These include reporting

[29] Duque D, 2020, Auxílio emergencial faz pobreza cairem plena pandemia, Getulio Vargas Foundation, Brazilian Institute of Economics, available at https://blogdoibre.fgv.br/posts/auxilio-emergencial-faz-pobreza-cair-em-plena-pandemia; Gagnon JE, 2020, The 2020 [United States] private saving boom: An unexpected result of COVID-19, Peterson Institute for International Economics.

[30] UNCTAD, 2016, *Trade and Development Report, 2016: Structural Transformation for Inclusive and Sustained Growth* (United Nations publication, Sales No. E.16.II.D.5, New York and Geneva), p.176.

[31] UNCTAD, 2021a, chapter 4.

[32] UNCTAD, 2018, *Trade and Development Report 2018: Power, Platforms and the Free Trade Delusion* (United Nations publication, Sales No. E.18.II.D.7, New York and Geneva), chapter 4.

[33] Mazzucato M and Kattel R, 2020, COVID-19 and public-sector capacity, *Oxford Review of Economic Policy*, 36(S1):256–269.

requirements and other obligations to disclose information, combined with more general checks through auditing, independent courts and the press.

31. Third, close relationships between entrepreneurs and government officials can ensure a mutual exchange of information and common understandings. Embeddedness is particularly important for green industrial policies as climate adaptation involves a systemic societal transition to new economic pathways.

32. A fourth lesson concerns disciplining devices that the State uses to sanction abuse of its support and to discontinue failing projects and activities. Disciplining abuse requires clear objectives, measurable performance indicators, appropriate monitoring and evaluation routines, and government autonomy in deciding where and when to apply disciplining devices, as well as where and what experimental approaches to apply, and where and when to change course if something goes wrong.

33. Investment in infrastructure is central to the re-emergence of a green developmental State (and its varieties). In advanced countries, the revival of interest in infrastructure reflects, in part, a growing acceptance, since the global financial crisis that such spending can have positive short- and long-term impacts on growth and, therefore, an important role in tackling secular stagnation.[34] Also, since 2008, there has been recognition of the central role that large infrastructure projects have played in the remarkable growth and poverty-reduction story that has unfolded in China. Indeed, the high ranking of China (relative to its income level) in the Connectedness Index of the McKinsey Global Institute seems to indicate the faith placed by its leadership on infrastructure-led growth, including building a strategic advantage in the emerging digital economy. [35]

34. In the Republic of Korea, the confluence of technological advance, export promotion, investment and capital accumulation was linked not only to favourable external conditions, but also to multiannual plans, from 1962 to 1992, that set out targets and allocated resources for investments in social overhead capital. Infrastructure investment was a key element of these plans: between 1960 and 2002, it amounted to 14 per cent of GDP, on average.[36]

35. Similarly, in China over the past three decades, the emphasis on infrastructure had the purpose of creating and enabling high-linkage sectors that were critical for generating growth.[37] After the Asian crisis of 1997–1998, the Government of China increased public infrastructure investment rapidly to stimulate domestic demand and promote economic growth. These were the underlying reasons for the increase in public infrastructure investment after the 2008 crisis as well. Public infrastructure investment grew in real terms at an average annual rate of 25 per cent over 1997–2010.[38] This was instrumental in creating two distinct types of external economies. On the one hand, consistent infrastructure investment resulted in reduction in costs for private sector activity and enlargement of the market, as dispersed and fragmented pockets of small demand were converted into larger markets of effective demand. On the other, public investment in strategic sectors created vertical economies in the intermediate stages of production, leading to possibilities of forward linkages between such activities and other lagging sectors to promote growth through "returning" economies.[39]

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[34] Summers LH, 2016, Building the case for greater infrastructure investment, available at http://larrysummers.com/2016/09/12/building-the-case-for-greater-infrastructure-investment/.

[35] UNCTAD, 2018, chapter 4.

[36] Bang, M-K, 2003, Fiscal policy in Korea for building infrastructure and its knowledge-based economy, presented at a World Bank–Viet Nam–Republic of Korea conference on public expenditure, 9 October.

[37] Holz CA, 2011, The unbalanced growth hypothesis and the role of the State: The case of China's State-owned enterprises, *Journal of Development Economics*, 96(2):220–238.

[38] Zhang Y, Wang X and Chen K, 2013, Growth and distributive effects of public infrastructure investments in China. In: Cockburn J, Dissou Y, Duclos J-Y and Tiberti L, *Infrastructure and Economic Growth in Asia*, Springer International Publishing, p. 91.

[39] Sutcliffe RB, 1964, Balanced and unbalanced growth, *The Quarterly Journal of Economics*, 78(4):621–640.

IV. Responding to the challenges: Scaling-up development finance beyond COVID-19

36. Not all of the challenges described in chapter III are of a financial nature. But given current financing gaps, as approximated in figure 2, a sustainable and equitable industrial transformation will require a massive increase in the amount of development finance available as well as a profound change in its direction, both at international levels and in the way developing economies can tap into long-term sources of funding at the national and regional levels.

37. The experience of the COVID-19 pandemic suggests that finance can be found when there is a sense of urgency. However, it does not automatically go where it is most needed. As pointed out in chapter II, currently, the issue is caught between underfunded public mechanisms, on the one hand, and hypercharged but unreliable private financing mechanisms, on the other.[40] This would suggest that efforts to scale up development finance need to refocus on the core role of international public leadership and institutions in coordinating and delivering reliable long-term funding for sustainable development through both public and private channels.

38. First and foremost, unsustainable external debt burdens in many developing countries are a major obstacle to their ability to mobilize domestic resources for development. At present and on average, the servicing of external public and publicly guaranteed debt obligations absorbs around 16 per cent of their export earnings, with this figure reaching 34 per cent in small island developing States in 2020.[41] Moreover, in 62 developing countries, the share of government expenditure spent on public and publicly guaranteed debt service was higher than that going to health, and in many cases also education, expenditures in 2020.[42] To appreciate how unsustainable a burden this represents, it is worthwhile remembering that the Allied Powers, concluding the Agreement on German external debts in London in 1953,[43] felt that the repayment of external debt obligations by the newly founded Federal Republic of Germany should be capped at 5 per cent of its export earnings to avoid undermining its post-war recovery.[44] While serial sovereign defaults in the wake of the COVID-19 crisis have so far been avoided, not least through the provision of new emergency lending by international financial institutions, there is a clear need to resolve external debt burdens in developing countries at the international level. This will require stepping up concerted efforts by all creditors and their sovereign debtors to institute an international platform through which existing claims can be resolved in a coordinated, effective and equitable manner to free up domestic development finance. While the Common Framework for Debt Treatments of the Group of 20 is a first step in this direction, it also represents a de facto return to the 1970s and 1980s when debt relief mechanisms for developing countries were dominated by negotiations with official bilateral creditors, coordinated by the Paris Club with an almost exclusive focus on creditor coordination and interests. Moreover, the framework remains limited to low-income countries.

39. Second, the international community will need to take its public commitments to the delivery of official development assistance and under the Paris Agreement of 2015 more seriously. Not only have official development assistance and climate-related finance left the most pressing development and climate priorities in developing countries underfunded, private finance has also prioritized investment in profitable sectors and climate mitigation,

[40] See also Gutierrez E and Kliatskova T, 2021, *National Development Financial Institutions: Trends, Crisis Response Activities and Lessons Learned*, Equitable Growth, Finance and Institutions Insight, World Bank, Washington, D.C.

[41] A/76/214.

[42] Munevar D, 2020, A debt pandemic. Dynamics and implications of the debt crisis of 2020, Briefing Paper, European Network on Debt and Development.

[43] United Nations, *Treaty Series*, vol. 333, No. 4764.

[44] UNCTAD, 2015, *Trade and Development Report, 2015: Making the International Financial Architecture Work for Development* (United Nations publication, Sales No. E.15.II.D.4, New York and Geneva), p. 134.

rather than poverty alleviation and climate adaptation activities. As pointed out in chapter II (para. 16), official development assistance commitments, yet again, failed to meet their target in 2020. Similarly, climate finance commitments have disappointed, meeting neither the $100 billion per year commitment made in Copenhagen in 2009 nor the rising needs of a warming planet. Of the $62.9 billion public and $14 billion private climate finance mobilized by developed countries in 2019, only $20.1 billion was directed to adaptation, and a mere $6 billion to adaptation in low-income developing countries.[45] Yet again, global public-led leadership that recognizes and sets the policy priorities of an interconnected world and acknowledges the failure of market incentives to direct and deliver on public policy matters is needed.

40. Third, there is a clear need to reconsider the future use of special drawing rights for developmental purposes. From the creation of special drawing rights in the late 1960s, UNCTAD has advocated their primary use for sustainable development.[46] Notwithstanding the financial lifeline that the most recent and largest general allocation of special drawing rights has provided to many developing countries during the COVID-19 crisis (see para. 17 above), it will be important to leverage the potential of special drawing rights not only to firefight international liquidity constraints in times of a global crisis, but also to provide more substantial support for long-term development financing. Recent discussions, including by the Group of 20, about rechannelling unused special drawing rights in advanced countries to developing countries in need are helpful, but are geared more towards boosting IMF lending capacities and therefore creating new debt, rather than towards leveraging the potential of special drawing rights for developmental purposes. This may require delinking the issuance of special drawing rights from the IMF quota system and creating new "special drawing right classes" for specific purposes, such as achieving the Sustainable Development Goals and climate change adaptation in developing countries.[47]

41. Fourth, public banking needs to be strengthened. During the pandemic it was public finance and, more specifically, public banks, that were the engine to economic relief and recovery. The opening salvos came from central banks, which have an essential role as the apex and regulators of a country's financial system. Their rapid response to the pandemic-trigged liquidity crisis illustrates how conventional practices can be adapted and overthrown in an emergency situation. There was a deep asymmetry in this policy shift, however. Those countries with the greatest needs did not have the same capacity to respond, as quantitative easing and credit swaps were available only to a few. Moreover, liquidity enhancing measures needed to align with the Paris Agreement, or they risked exacerbating existing climate risks and undermining Governments' pledges. The corporate bonds purchased on an unprecedented scale to increase liquidity and avoid economic paralysis were often biased towards fossil fuels and did not attempt to tilt away from the sector.[48]

42. Moreover, UNCTAD has long argued that national and regional public banks need to have more reliable and adequate sources of finance and the policy space to lend for developmental purposes. Group of 7 Governments should use their shareholder power to increase the capitalization and policy space to allow their multilateral development banks to support more experimental or green technology and enterprises, while regional and multilateral banks could seek new members to beef up their capital base. Government owners of national public banks should revisit their AAA ratings and leverage straitjackets where these restrict investments with a long-term developmental benefit.

[45] OECD, 2021b, Climate finance provided and mobilised by developed countries: Aggregate trends updated with 2019 data, OECD Publishing, Paris.

[46] UNCTAD, 2004, *Beyond Conventional Wisdom in Development Policy: An Intellectual History of UNCTAD 1964–2004* (United Nations publications, Sales No. E.04.II.D.39, New York and Geneva), pp. 44–48.

[47] UNCTAD, 2019, *Trade and Development Report 2019: Financing a Global Green New Deal* (United Nations publications, Sales No. E.19.II.D.15, Geneva), pp. 90–93.

[48] UNCTAD, 2021a, p. 121.

43. Fifth, coordinated international efforts to stem illicit financial flows from developing countries must be stepped up. In particular, evidence on long-standing practices of corporate tax arbitrage and the exploitation of loopholes and tax havens or low-tax jurisdictions is rich and mounting.[49] The main multilateral response was the launch of the Organisation for Economic Co-operation and Development (OECD)/Group of 20-led Base Erosion and Profit Shifting project in 2013.[50] This aims at an international consensus to establish an up-to-date method to tax the profits of multinational enterprises on the basis of where profit-generating economic activities take place and generate value. The project was given a boost in 2020 with the launch of the Inclusive Framework to deliver a multilateral consensus-based solution to tax challenges arising from the digitalization of the economy. The latest step has been the agreement, in 2021, of a two-pillar solution to address international tax challenges and losses of public revenues due to profit shifting activities.[51] This agreement includes the application of a minimum tax rate to all multinational enterprise groups with consolidated revenues over €750 million. It simplified the scope of negotiations and narrowed the room for further delays. Estimates suggest that the tax could raise up to $275 billion per year.[52]

44. However, the ultimate effectiveness of this tax deal remains unclear. With the specifics of the implementation of the new tax still being finalized, it is likely that the measure will generate a complex system of rules and allowances. The more complex the system, the easier it is to game it. Developing countries, lacking technical capacities and expertise in tax arbitrage, are at a particular disadvantage in the system where corporations create and exploit loopholes. It is also unclear how the existing system of the United States of America of deductions of taxation will work with the new multilateral proposals, and how it will affect the operation of global corporate structures that have relied on United States allowances.[53]

45. Sixth, credit rating agencies are core institutions of the international financial system, influencing the lending decisions of global investors and banks. The COVID-19 crisis highlighted the negative impact of credit rating agencies on the availability, stability and cost of developing finance. These agencies impaired debt crisis resolution, which is essential to scale up developing countries’ capacity to raise external financing for development. The risk of downgrading sovereign bonds deterred many eligible countries from joining the Group of 20 Debt Service Suspension Initiative and its Common Framework. Such risk also hindered the adoption of expansionary fiscal policies that could contribute to economic growth and domestic resource mobilization in many developing countries.

46. Therefore, it is urgent to reshape the credit rating industry and make it more development friendly. Ideally, as part of a reform of the international debt architecture, the international community should consider two main initiatives to address the structural problems of this industry, such as the oligopolistic position of the “big three” agencies, controversial methodologies and the procyclical behaviour of ratings, especially in the case of developing countries. The first is a resounding regulatory reform of existing agencies. In the absence of a supra-national regulator, which would be the best solution,[54] the Group of 20 and international regulatory agencies could collaborate with regional and national regulators in the following main directions: mitigate the influence of ratings on bank regulation and investment guidelines, address the conflict of interest stemming from the “issuer pays” model, introduce monitoring and accountability systems of the agencies,

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49 See, for example, UNCTAD, 2019, chapter V, section B.; UNCTAD, 2021a, pp. 66–68.

50 OECD, 2013a, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, Paris; OECD, 2013b, *Addressing Base Erosion and Profit Shifting*, OECD Publishing, Paris; and OECD, 2015, Base Erosion and Profit Shifting, Final Reports, OECD Publishing, Paris.

51 OECD, 2021c, *OECD Secretary-General Tax Report to the G[roup of] 20 Finance Ministers and Central Bank Governors*, OECD Publishing, Paris.

52 Cobham A, 2021, G[roup of] 20 could improve on “one-sided” global tax reform, *Financial Times*, 11 June.

53 UNCTAD, 2021a, pp. 66–68.

54 Griffith-Jones S and Kraemer M, forthcoming, Credit ratings and developing economies, United Nations, Department of Economic and Social Affairs, working paper.

enhance disclosure of methodologies and compel the inclusion of environmental, social and governance criteria in the ratings and the provision of long-term ratings that consider Sustainable Development Goal-aligned indicators.[55] A more far-reaching solution would be the establishment of an international public credit rating agency.[56] The core role of such an agency would not be to compete with "the big three" in their day-to-day business, but rather to provide neutral, expert-based ratings for sovereign issuers, in particular with regard to their long-term prospects of developmental progress so as to facilitate private development finance.

47. Seventh, it may well be important to invest more systematically into the development of national and regional capital markets. National and regional capital markets can be an important complement to pubic development banks, and some developing regions, notably Asia, have been keen to promote them. The Asian Bond Markets Initiative, for example, saw local currency bonds grow extremely rapidly to provide trillions of dollars for local investment.[57] The question of their effectiveness and transformative impact remains open, however. One of the reasons for promoting local capital markets was to reduce the risks associated with cross-border private capital flows. Yet when the purchasers of local bonds are foreign, these risks remain, and this can undermine the overall transformative impact of this policy initiative.

48. Eighth, there may be space for improved bond financing of development. Hopes have been high for "green bonds", worth at least $1 trillion, or the considerably smaller $100 billion category that is "certified climate bonds".[58] Yet despite expectations, bond financing has not delivered the scale or direction of investments that a green and inclusive transformation entails. Even if such bonds do have an advantageous "greenium", truly transformational activities are less likely to return the highest profits, at least in the short-term, and so are unlikely to be a solution for developing countries.

49. Many developing countries nonetheless have strong expectations for green, blue and nature-based bonds. It is thus essential that regulatory standards are raised to keep pace with the growth in these markets. At present, many disclosure commitments are voluntary, and standards need to be agreed upon to ensure that green bonds stay green and that they meet the needs of local populations. Importantly, mechanisms are needed to offer fair protection to the issuer as well as the investor over the lifetime of the bond. Given the scale of this challenge, the regulatory framework needs to be supported by correspondent levels of financing and staff with expertise, at the national and international levels.

50. Ninth, In the aftermath of the COVID-19 shock, the United Nations Economic Commission for Africa, in partnership with United States asset management firm Pimco, have recently launched a Liquidity and Sustainability Facility that aims at reducing the borrowing costs of participating countries by establishing a repurchasing agreement ("repo") market. Under this arrangement, investors would borrow using their African sovereign eurobonds as collateral, increasing the market's liquidity and stimulating the demand for these assets, including green and Sustainable Development Goal-linked bonds. The expectation is that this will lower the cost of external financing to help African countries recover from the pandemic and achieve the 2030 Agenda. The first transactions are planned for early in 2022 with funding from the African Export–Import Bank and global asset managers, and further efforts by the Liquidity and Sustainability Facility to secure funding, including through the reallocation of special drawing rights.[59]

[55] A/HRC/46/29.
[56] A/76/214.
[57] UNCTAD, 2019, p.162.
[58] Harrison C and Muething L, 2021, Sustainable debt: Global state of the market 2020, Climate Bonds Initiative.
[59] Stubbington T, 2021, [United Nations] launches African repo market in bid to lower borrowing costs, *Financial Times*, 3 November.

51. However, it is uncertain if the Liquidity and Sustainability Facility will achieve its intended objective of lowering borrowing costs. First and foremost, most countries in the region do not face a liquidity problem but rather a solvency problem that requires debt restructuring and relief. Second, given the features of the African sovereign bond markets and the rise of debt vulnerabilities amid the pandemic, few countries may be eligible to participate. Third, for participating countries, the Liquidity and Sustainability Facility will only increase liquidity in good times as repo markets operate pro-cyclically. Fourth, the funding of the Liquidity and Sustainability Facility will rely on affordable sources of financing (such as from special drawing rights and more generally from multilateral institutions), thereby also risking limiting access that African countries need to multilateral concessional finance to "build back better".[60] While the need to lower borrowing costs is well understood, relying on scarce public funds to de-risk private finance may not be the best way forward, if past experience in this regard (see also chapter II above) serves.[61]

52. Finally, an often-raised question concerns the role of financial digitalization during the pandemic. The unprecedented distribution of social grants using financial digitalization during the pandemic underlined the importance of public infrastructure in establishing and maintaining digital ID systems, functional mobile communications, and digital payment systems for the benefits of Government-to-person payments to be realized.[62] The impact on financial inclusion was transient with most benefits being cashed out immediately. While the low-cost Pix payment stream was an ideal mechanism for the Caixa Econômica Federal of Brazil to channel social grants, including to 35 million unbanked people, over half stopped using the facility when grants stopped.[63] Indeed, the logic of shifting from cash is not compelling unless the price is right: regulators in Kenya[64] and Rwanda[65] temporarily reduced the fees of digital transactions and witnessed large increases in usage during the early months of the pandemic, before the fees were reinstated. Notably, the payment of digital benefits without simultaneously addressing employment deficits and gender rights may exacerbate the "digital divide" as women, the rural poor and the vulnerable are excluded from control of the instruments and technology needed to access such payments. The pandemic experience suggests that the reasons for exclusion are far more profound than lack of access to a digital e-wallet and that a range of economic factors – including the utility assigned by the unbanked to digital financial services – need to be addressed for financial exclusion to be sustainably eradicated.

V. Conclusions

53. It is clear that the challenge of closing existing development financing gaps is enormous and has risen considerably with the impact of the COVID-19 pandemic. At the same time, the pandemic has given rise to a range of debates about how best to secure long-term development finance despite current tribulations. While the challenges – both economic and political and both at the international as well as the national and regional levels – remain as daunting as current financing gaps themselves, the COVID-19 crisis opens new platforms to discuss how best to scale up development finance. At the heart of these debates should be ways to refocus on public leadership, backed by the delivery of

[60] Munevar D, 2021, Liquidity illusions: Who really benefits from the Liquidity and Sustainability Facility?, European Network on Debt and Development, available at https://www.eurodad.org/liquid_illusions_who_really_benefits.

[61] Gabor D, 2021, The Liquidity and Sustainability Facility for African bonds: Who benefits? European Network on Debt and Development Eurodad, Heinrich Böll Foundation and Nawi – Afrifem Macroeconomics Collective.

[62] Gelb A and Mukherjee M, 2020, Digital technology in social assistance transfers for COVID-19 relief: Lessons from selected cases, Policy Paper 181, Centre for Global Development.

[63] *Caixa Noticias*, 2021, Caixa tem disponibiliza serviços em conta gratuita para mais de 105 milhões de brasileiros, 27 January.

[64] See https://citizen.digital/business/mobile-money-transactions-soar-9-4pc-covid-19-emergency-measures-333402/.

[65] Carboni I and Bester H, 2020, When digital payment goes viral: lessons from COVID-19's impact on mobile money in Rwanda, Cenfri, available at https://cenfri.org/articles/covid-19s-impact-on-mobile-money-in-rwanda/.

public international development finance and by publicly led and coordinated channels to mobilize private finance in ways that will contribute to a global green transformation and inclusive structural transformation in developing countries. This background note by the UNCTAD secretariat is intended to provide some food for thought on core issues that will need to be tackled by all actors and stakeholders involved at the fifth session of the Intergovernmental Group of Experts on Financing for Development at UNCTAD.