Organisation for Economic Co-operation and Development

DCD(2021)17

Unclassified **English text only**

5 October 2021

DEVELOPMENT CO-OPERATION DIRECTORATE

Cancels & replaces the same document of 5 October 2021

Financing the transition to sustainable development in Least Developed Countries (LDCs): challenges and opportunities

LDC Future Forum – Achieving Sustainable Development in the Least Developed Countries
Helsinki, Finland, 4-6 October 2021.

Information Note: Paper submitted to the LDC Future Forum (4-6 October, 2021).

Olivier Cattaneo: Olivier.Cattaneo@oecd.org
Cécilia Piemonte: Cecilia.Piemonte@oecd.org
Abdoulaye Fabregas: Abdoulaye.Fabregas@oecd.org

JT03482245

Financing the transition to sustainable development in Least Developed Countries (LDCs): challenges and opportunities

1. Abstract

In response to the call made in the Addis Ababa Action Agenda (AAAA) to mobilise all available resources in support of the Sustainable Development Goals (SDGs), the Development Co-operation Directorate of the OECD has developed a new work stream on transition finance to explore the evolution and interaction of the various sources of finance at each stage of countries' development. This paper summarises the key findings of three transition finance country diagnostics (TFCDs) conducted between 2018 and 2020 in two Least Developed Countries (LDCs) – Solomon Islands and Zambia –, and one recent LDC graduate – Cabo Verde. The evidence gathered from these country case studies points to the existence of common transition challenges across LDCs. These include high dependence on Official Development Assistance (ODA) coupled with limited capacity to attract or mobilise other financing sources, concerns related to debt sustainability, the risk posed by multiple concurrent transitions (e.g. graduation from concessional windows or income groups) and limited capacity to leverage private investment for development. The paper concludes with a set of policy recommendations that could help development partners improve their support to LDCs.

2. Background

The Addis Ababa Action Agenda (AAAA) called for a holistic approach to financing the 2030 Agenda that would mobilise all available resources (domestic and external, public and private) in support of the Sustainable Development Goals (SDGs). At the same time, it acknowledged the specific needs and challenges faced by least developed countries (LDCs) and reaffirmed that this group of vulnerable countries requires enhanced support from development partners to achieve the SDGs.

In response to this call, the OECD undertook to further explore the evolution and interaction of public[1] and private[2] sources of finance available to countries as they transition through different stages of development. The underlying objective of the so-called "transition finance" work is to advise development partners in preparing countries for transition and in building their resilience – with a particular focus on the role and catalytic/multiplier effects of Official Development Assistance (ODA).

Transition finance country diagnostics (TFCDs) complement Development Finance Assessments (DFAs) and other instruments available in the Integrated National Financing Frameworks (INFFs) toolbox. Transition finance analysis allows providers of development co-operation from the OECD Development Assistance Committee (DAC), country governments and other development stakeholders to leverage the full potential of the financing available for sustainable development.

This paper draws upon a series of TFCDs conducted by the OECD in various countries representative of various transition stages and contexts. More specifically, this paper draws upon three diagnostics conducted in two LDCs (Solomon Islands and Zambia) and one recent LDC graduate (Cabo Verde).

[1] Official development assistance, other official flows, and government revenue.

[2] Foreign direct investment, external portfolio inflows and remittances.

3. The transition finance ABC methodology

The Transition Finance ABC methodology (OECD, 2020[1]) **provides a guiding framework to conduct Transition Finance Country Diagnostics (TFCDs).** It revolves around three key components: Assessing, Benchmarking and Counselling. The first component helps to assess countries' transition context and to highlight the particularities of their financing mix. The benchmarking component helps to identify countries with similar structural characteristics and to highlight opportunities to learn from their financing strategies' successes (over-performers) and failures (under-performers). Finally, the counselling component proposes concrete steps development partners can take to support the design and implementation of partner countries' financing strategies.

The transition finance approach shows that the financing mix available to countries varies according to their level of development as well as their characteristics. At early stages of their development, countries typically struggle to attract private financing and to mobilise sufficient domestic revenue, and thus rely mostly on external concessional finance, such as ODA (Piemonte et al., 2019[2]). As they develop, they become more attractive for private investment, and improve their capacity to mobilise domestic resources. At the same time, as they reach specific transition milestones, countries lose eligibility to specific support measures and instruments, and terms at which they can access loans from bilateral[3] and multilateral institutions[4] become less favourable.

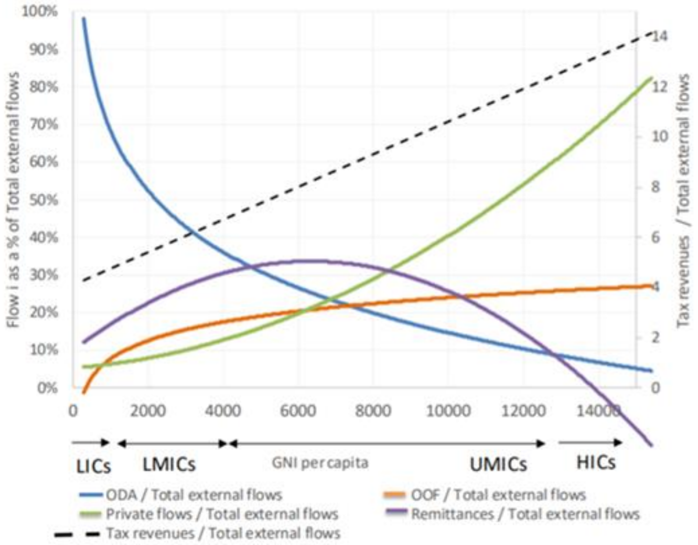
This requires countries to carefully plan for their transition in order to avoid negative repercussions on the country as a whole, or on specific sectors of its economy. Figure 1 illustrates the evolution of the financing mix along countries' development.

[3] The ODA accounting rules incentivise DAC donors to provide more concessional loans to countries most in need. The threshold for ODA eligibility is set at a grant element of 45% when lending to LDCs and other LICs while lower middle-income countries (LMICs) require a minimum 15% grant element and upper middle-income countries (UMICs) a minimum 10%.

[4] See Table 1.1 , https://doi.org/10.1787/2dad64fb-en.

Figure 1. As a country's GNI per capita rises, concessional finance is phased out and needs to be substituted by other financing sources

DAC, non-DAC and multilateral agencies' outflows, 2012-16 net disbursements, 2016 prices.



Note: The plotted lines represent predicted values at each GNI per capita level based on linear (tax revenue), logarithmic (ODA, OOF, private flows) and polynomial (remittances) regressions.
Source: (Piemonte et al., 2019[2]).

Two major trends characterise the evolution of countries' financing mix:

- **First, a substitution of external with domestic resources:** From the onset, domestic resources are the largest source of finance for the economy – with a 4 to 1 ratio of tax revenues/external flows. This ratio keeps increasing, with tax revenues representing more than 12 times the value of external flows as the country reaches high-income status. Domestic resources mobilisation is therefore a key component of financing sustainable development, and should remain a primary objective of ODA.
- **Second, a substitution of public with private resources:** Highly dependent on public external support (mainly ODA) at early stages of their development, countries progressively move towards private financing. Public financing itself evolves, with a progressive substitution of ODA with Other Official Flows[5] (OOF), corresponding to a decline in concessionality as countries transition. By filling the gap between ODA and private finance, OOF are essential to help countries gradually transition towards the mobilisation of private resources[6]. At the lower end of the income spectrum, ODA represents about 96% of external financing, and

[5] Other official flows (OOF) are official sector transactions that do not meet official development assistance (ODA) criteria.

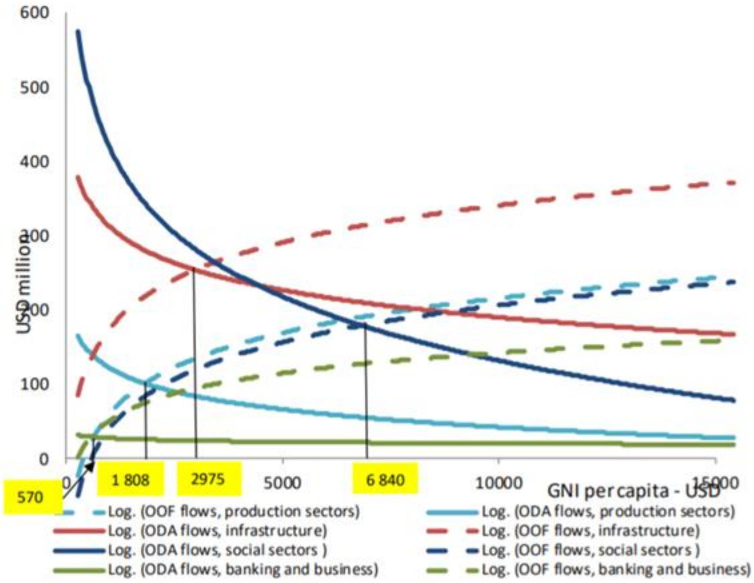
[6] OOF include less- or non-concessional loans from bilateral and multilateral development partners, which play a key role in helping countries develop the skills, capacity and know-how necessary for a successful transition to market-rate commercial loans. They also include instruments that can play a catalytic role to leverage private finance (e.g. blended finance) in countries facing difficulties to attract private investment.

private finance around 5%; at the higher end, when the country reaches high-income status, the sum of ODA (10%) and OOF (26%) represents approximately 32% of external financing, compared to 55% for private finance.

ODA and OOF dynamics reveal that transition finance challenges are sector specific. Substitution takes place at different stages of transition across sectors, and not all sectors are better off in terms of financing as the country becomes richer. In some cases, transition can even result in a financing gap, raising questions about the resilience of Official Development Finance[7] (ODF), and stressing the need for heavy and early investment in building domestic capacity or opening markets in selected sectors.

Figure 2. Substitution of ODA with OOF happens at different stages of transition across sectors

USD million commitments, 2012-2016 average, 2016 prices.



Note: Authors' calculations based on the OECD Creditor Reporting System (2018).
Source (Piemonte et al., 2019[2]).

These sectoral dynamics are apparent through the analysis of substitution patterns between ODA and OOF. Tipping points – the points at which the share of OOF in external finance exceeds the share of ODA – occur at different transition stages across sectors:

- Very early in financial and business sectors (LIC – GNI per capita of USD 570): this demonstrates the clear private sector orientation of these sectors, in which ODA is minimal, or at least not visible (e.g. assistance could be provided through budget support).

[7] Official Development Finance (ODF) consists of Official Development Assistance (ODA), which is concessional, and developmental Other Official Flows (OOF), which are non-concessional. It excludes export credit OOF as their main objective is not developmental.

- At LMIC stage (GNI per capita of USD 1 808) in the case of production sectors: OOF quickly picks up in these sectors, revealing significant potential return on non-concessional funding.
- At a later LMIC stage (GNI per capita of USD 2 975) for infrastructure sectors.
- Substitution happens last in social sectors (UMIC – GNI per capita of USD 6 840): although social sectors are a traditional area of intervention for development partners, the steep slope of the curve suggests that the phasing out of ODA is extremely rapid and that transition finance challenges could thus be more acute in those sectors.

The transition finance methodology recognises that the effects of reaching transition milestones go beyond the decrease in concessionality[8]. For example, countries graduating from the list of LDCs lose differential treatments applicable to LDCs – e.g. for trade remedies or disputes, tariff preferences under the Generalised Scheme or System of Preferences (GSP) or the duty-free and quota-free access for LDCs.

[8] For detailed information on the financial and non-financial impacts of LDC graduation, see: OECD Transition Finance Toolkit (OECD, 2020[16]); UN LDC Portal (OECD, 2020[17]); and Committee for Development Policy (CDP) Secretariat Gradjet portal (OECD, 2020[18])

4. Key insights from transition finance analyses in LDCs

3.1. General trends of transition finance in LDCs

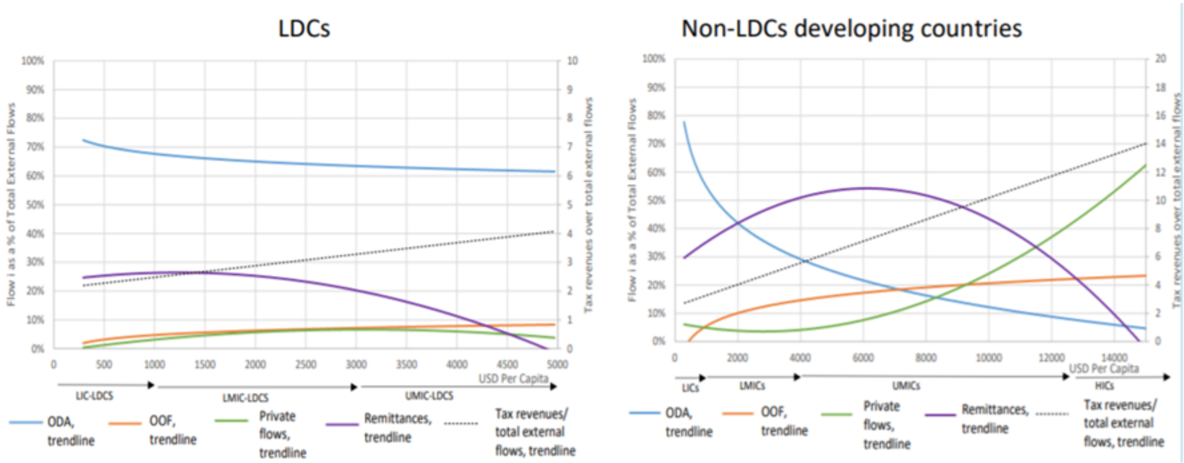
LDCs face specific development challenges with important repercussions on their financing mix. LDCs are characterised by structural handicaps, such as low productivity, low economic base and high exposure to economic shocks and disasters (e.g. commodity price fluctuations, climate change, epidemics and natural disasters). Furthermore, the financing mix of these countries exhibits a particular pattern. Figure 3 compares the trends and dynamics of transition finance in LDCs to those observed in other developing countries (non-LDCs developing countries).

Two main trends emerge from the comparison:

- **The share of ODA in external flows remains higher for LDCs than for other countries across the development continuum**. This could reflect specific pledges made by the development community in favour of LDCs in recognition of their particular vulnerabilities (such as the commitment of OECD DAC members to dedicate 0.15% to 0.20% of their GDP to LDCs), or LDCs' access to certain financing windows independently of their income level.
- **LDCs have, on average, a lower share of OOF and private sector finance.** This mirrors their higher dependence on ODA, as well as reflects their difficulties to access capital markets (Presbitero et al., 2016[3]) and to attract foreign investment, due to their lack of quality infrastructure, institutions and policies (Gelos, Sahay and Sandleris, 2011[4]) (Morrissey and Udomkerdmongkol, 2012[5]). Recent research on blended finance also revealed that LDCs received only 6% of all private finance mobilised between 2012 and 2019 (OECD/UNCDF, 2020[6]).

Figure 3. LDCs remain highly reliant on ODA and struggle to mobilise other financing flows

DAC and multilateral agencies, USD net disbursements, 2014-18, 2018 prices.



Note: Author's calculations based on OECD Creditor Reporting System and DAC databases (2020) for ODA, OOF flows and private flows; and World Bank World Development Indicators (2018) for data on remittances.
Source: (OECD, 2018[7]).

Exogenous shocks add to the financing challenges faced by LDCs. As a result of the Covid-19 crisis, for example, external private flows to developing countries declined by USD 150 billion in 2020 compared to 2019, while Covid-19 additional recovery spending of developing countries reached USD 1 trillion. The SDG financing gap in developing countries is thus estimated to have increased by at least 50%, from USD 2.5 trillion per annum to USD 3.7 trillion in 2020 (OECD, forthcoming[8]). Due to their specific vulnerabilities (e.g. high exposure to the impacts of climate change, lack of economic diversification, lower levels of socio-economic resilience, etc.), LDCs are particularly impacted by external shocks, such as pandemics, natural disasters, commodity price shocks or humanitarian crises. They are also more likely to experience longer-term effects due to fiscal constraints limiting the size of their fiscal recovery packages.

The "green recovery" envisioned in the stimulus packages of advanced economies could have unintended consequences on LDCs' access to finance. New environmental, social and governance (ESG) targets embedded in the recovery plans of advanced economies could generate a standards gap by raising ESG norms and technology requirements for investing. Ultimately, the "green recovery" could divert resources away from least developed countries if specific consideration and support is not provided by development partners to help them meet new ESG standards.

3.2. Lessons from transition finance country diagnostics in three LDC contexts

Transition finance country diagnostics (TFCDs) allow to go beyond the analysis of general trends to analyse country-specific challenges and derive tailored policy recommendations. The three country diagnostics presented in this paper capture some key transition finance challenges faced by LDCs and recent LDC graduates. These diagnostics were produced through a combination of desk research, data and policy analysis, and field missions with interviews with key stakeholders, including OECD DAC providers, non-DAC providers, private sector actors, multilateral organisations, and civil society organisations.

3.2.1. Cabo Verde: transition challenges facing a recent LDC graduate

The Cabo Verde country diagnostic looked at the transition challenges faced by a small island developing state (SIDS) after its graduation from the LDC category. Cabo Verde's economic transition has often been characterised as a "success story". In 2007, the country was the second to graduate from the LDC category (after Botswana in 1994), and its progress to achieve the Millennium Development Goals (MDGs) had also been exceptional.

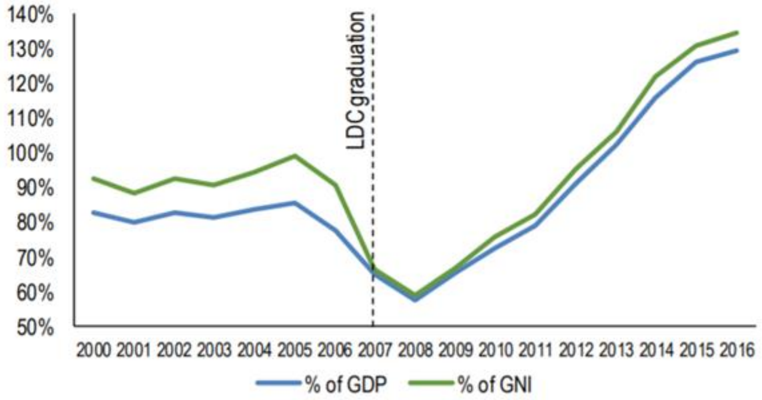
The European financial crisis, which coincided with the country's LDC graduation, deeply impacted Cabo Verde's growth in the years following its graduation. The country's income per capita level declined by USD 500 between 2012 and 2017. At the same time, growing inequalities (rising Gini coefficient), informality (60% of employment) and structural SIDS vulnerabilities (the country graduated with a high Economic Vulnerability Index – EVI – score) all presented major constraints to growth.

Although ODA increased following graduation, the terms and conditions of support tightened considerably. Financing provided by the OECD DAC members shifted quickly from grants to concessional loans, which tripled post-graduation: average loans per year increased from USD 41.9 million before graduation (2000-07) to USD 128.3 million post-graduation (2008-16). Tied aid also became a concern[9], rising quickly, to reach nearly 50% of total ODA commitments in 2011-13. Moreover, in order to finance its national sustainable development strategy (PEDS 2017-21), Cabo Verde pivoted to new actors, particularly the People's Republic of China (PRC) and the private sector. This raised concerns over a growing lack of transparency and coordination regarding the terms and conditions of the country's financing.

External debt substantially increased after LDC graduation, reaching 134% of GDP in 2016. That same year, the IMF classified Cabo Verde at "high risk" of debt distress[10]. Although the volume of loans tripled after graduation, the IMF debt distress warning has since limited Cabo Verde's access to such financing.

Figure 4. Government debt increased quickly following LDC graduation

General government debt over time.



Note: Debt as a percentage of GNI and GDP is calculated by the authors based on World Bank World Development Indicators (GNI) and the IMF World Economic Outlook (government debt and GDP).
Source: (Morris, Cattaneo and Poensgen, 2018[9]).

Cabo Verde's post-graduation financing mix presents new challenges. The country remains highly dependent on ODA and faces challenges to raise other resources to finance its sustainable development. Figure 5 shows that after LDC graduation, ODA still accounted for 41% of total external resources in Cabo Verde. This places the country

9 At the time of Cabo Verde's graduation, countries had to be classified either as LDCs or as HIPCs to benefit from the OECD DAC Recommendation on Untying ODA. In December 2018, the DAC agreed to broaden the country coverage of the Recommendation on Untying ODA to Other Low-Income Countries (OLICs) and IDA-only countries, in addition to the already covered Least Developed Countries (LDCs) and Highly-Indebted Poor Countries (HIPCs). This decision took effect in January 2019.

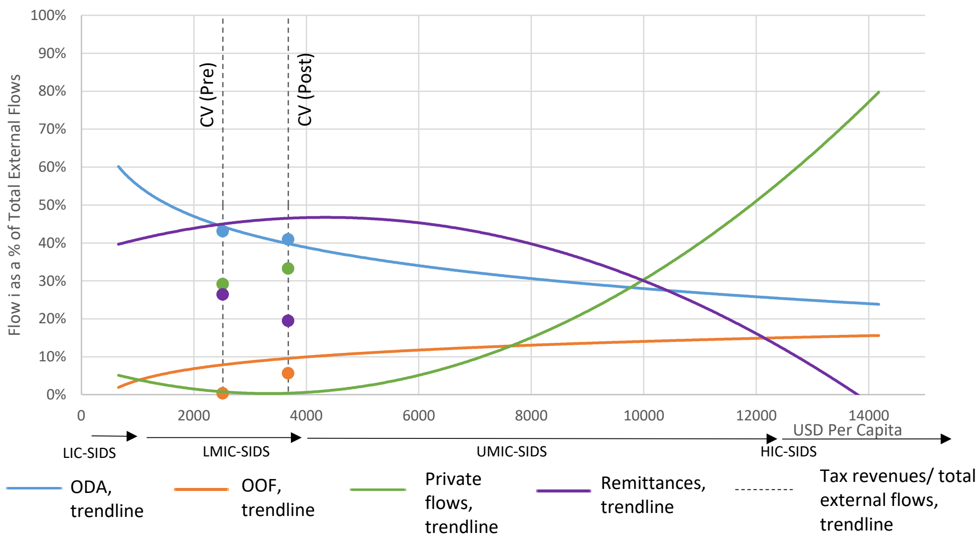
10 List of LIC DSAs for PRGT-Eligible Countries - As of April 30, 2021: https://www.imf.org/external/Pubs/ft/dsa/DSAlist.pdf

largely above the trend for all developing countries, and slightly above the trend for other Small Island Developing States (SIDS) with comparable development challenges[11].

Although the share of OOF has slightly increased, Cabo Verde still struggles to attract this resource across sectors – a trend common among SIDS due to small market size and low productivity. Levels of OOF picked up following graduation. Yet, these flows remain low relative to other developing countries and SIDS (at less than 10% of total external flows).

Figure 5. The mix of external financing sources in Cabo Verde shifted after its graduation

Benchmarking of Cabo Verde's external financing mix against the trends observed in SIDS.



Note: The pre- and post-LDC graduation lines correspond to 5-year averages before and after the 2007 graduation. The ODA and OOF trend lines correspond to DAC and multilateral agencies USD disbursements to SIDS, 2014-18, 2019 prices.
Source: Adapted from (Morris, Cattaneo and Poensgen, 2018[9]) and (OECD, 2018[10]).

The sustainable development footprint of foreign direct investment (FDI) must be strengthened. Private market flows to the country are much higher than the trend observed in lower-middle income SIDS and have continued to grow following graduation. Cabo Verde attracts higher FDI inflows relative to other LMIC, thanks mainly to tourism[12]. Yet, although the tourism sector alone accounts directly for 25% of the GDP, it does not sufficiently benefit the local economy (OECD/UNCDF, 2020[11]).

In terms of domestic financing, Cabo Verde's tax-to-GDP ratio before and after graduation remains above average thanks to strong transparency and good governance. Despite its small size, the country's tax-to-GDP ratio remains at nearly 20%.

[11] In the years following its LDC graduation, Cabo Verde presented a slightly higher dependence on ODA than other SIDS at the same level of development (ODA accounts for 40% of SIDS' external financing inflows at USD 3700 GNI per capita). (OECD, 2018[10])

[12] The country is among a reduced group of SIDS, including Samoa and the Maldives, whose LDC graduation was driven by FDI in the tourism sector.

This ratio is above the average for the 16 African countries covered in the OECD Revenue Statistics (19.1% in 2015). High tax revenues in Cabo Verde are largely attributable to the country's good governance, including effective fiscal policies and strong transparency.

Financing and capacity gaps emerged across key SDG-related sectors. ODA to the education sector decreased most quickly – by 30 percent – since graduation, and was not compensated by a proportional increase in OOF. A similar financing gap emerged in the health sector, increasing pressure on domestic resources mobilisation. Still, the share of government spending in support of social sectors, such as health and education, has been on a downward trend following graduation (-1.5% in education and -0.4% in health over the 2012-16 period[13]).

Finally, LDC support to access climate funds and facilities was also phased out following graduation, placing the country at risk of setbacks from persistent climate-related vulnerabilities. For example, the country lost eligibility to the Least Developed Countries Fund (LDCF), which had funded its National Adaptation Programme of Action (NAPA) in 2007 to help build Cabo Verde's adaptive capacity and resilience to climate change in the water sector. Without NAPA support, many sources of climate finance such as the Green Climate Fund (GCF) can be challenging to access for SIDS with small administrations, such as Cabo Verde. SIDS also face challenges in identifying the risks and impacts of natural disasters and, consequently, in securing resources in their national budgets. At the time of publication of Cabo Verde's TFCD (November 2018), the country had not yet accessed GCF financing due to these constraints, and the amounts received from the GEF remained small (USD 3.46 million in commitments marked as climate-related between 2000-2016).

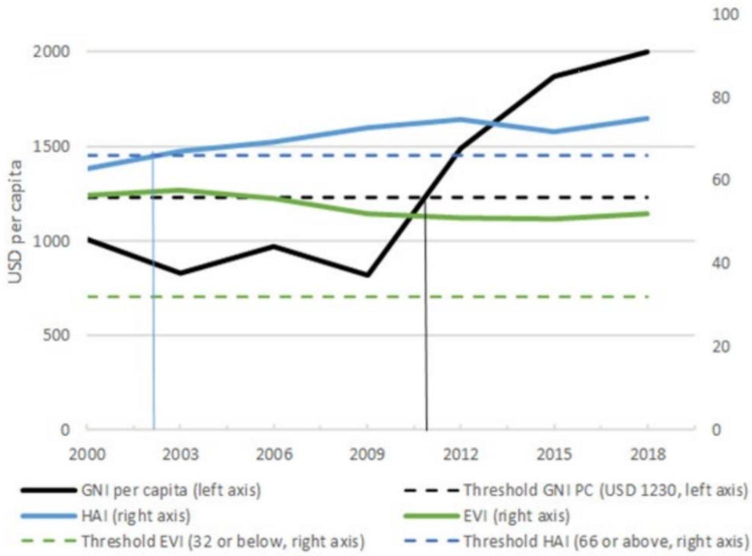
3.2.2. Solomon Islands: a Pacific SIDS scheduled to graduate from LDC status in a challenging transition finance context

The transition finance country diagnostic in Solomon Islands presented the case of a Pacific SIDS scheduled to graduate from LDC status. Prior to the COVID-19 crisis, the substantial economic and social progress achieved by Solomon Islands had put the country on track to graduate from LDC status by 2024. With support from its regional partners, the country was able to transition away from a period of ethnic and political violence, known as the "Tensions" (1999-2003), and was able to put in place sound macroeconomic policies that led the country to significant development achievements over the last two decades.

Significant improvement in living standards allowed the country to meet two out of the three possible criteria for LDC graduation: the GNI per capita and the Human Asset Index (HAI) score. Like many graduating SIDS, however, Solomon Islands does not meet the requirements for the third criteria: an Economic Vulnerability Index (EVI) inferior to 32. The country's weak EVI score shows that it remains deeply vulnerable to environmental and climate-related risks.

[13] According to the World Bank's World Development Indicators (WDI).

Figure 6. Solomon Islands meets two out of the three possible criteria for LDC graduation



Note: Author's calculations based on Ferdi Indicators, World Bank, World Development Indicators and Committee for Development Policy, Data Resources.
Source: (Piemonte and Fabregas, 2020[12]).

The direct implications of the country's LDC graduation are expected to be largely manageable. Solomon Islands' main development partners (Australia, Japan, New Zealand and the United Kingdom) do not anticipate a decline of their official development assistance flows following Solomon Islands' graduation. In addition, one of the main effects anticipated by the government and its development partners – the loss of European Union (EU) trade preferences for the country's exports of fish and agricultural products – has been mitigated through the signing of an interim Economic Partnership Agreement (EPA) with the EU in late 2019.

The real risk for Solomon Islands lies in the multiple transitions the country is simultaneously undergoing. The country's preparation for LDC graduation coincides with major evolutions in the global economy and the national financing landscape. The decline of the national logging industry, the country's new diplomatic ties with China, the transition out of Gavi support and the impact of the COVID-19 pandemic could all have lasting implications on the country's ability to access finance and manage a successful transition from the LDC category.

The entry into force of ambitious logging sustainability targets set by the government represents an important step to ensure the country's sustainable future but is likely to amplify budget pressures in the short to medium term. Logging currently accounts for half of the customs and excise duties collected by the government, making it the main source of government revenue. Although the government's decision to decrease the production and export of logs was necessary to avoid complete depletion of the countries' forests, it is also likely to negatively affect its finances in the short to medium term, and could also have consequences on its capacity to finance key development areas in coming years.

Social sectors, such as health and education, could be the most impacted by the decline in government revenue since they are heavily funded through ODA and government

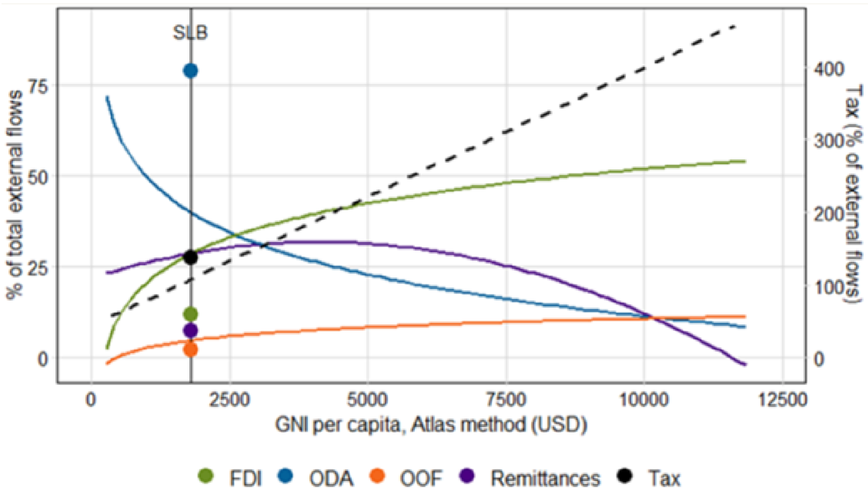
spending. Solomon Islands' health sector is predominantly financed from public sources (domestic and external), which account for more than 90% of current health expenditure. The fact that Solomon Islands has entered into the phase of accelerated transition from Gavi since 2018 and is scheduled to graduate from it in 2022 may pose an additional challenge since the government is expected to completely substitute Gavi funding before then.

China's recent entry into Solomon Islands' financing landscape and the government's interest in novel types of public-private arrangements (such as PPPs) bring new risks and opportunities. Solomon Islands' switch of diplomatic ties from Chinese Taipei to China in 2019 represents an opportunity to fill the country's financing needs in key development areas. However, the experience of other SIDS shows that new financing opportunities need to be managed carefully. Several small island developing states, such as Cabo Verde and Samoa, have experienced a quick surge of their debt levels following graduation, and moved from a moderate to a high risk of debt distress in a relatively short period of time (Morris, Cattaneo and Poensgen, 2018[9]). Development partners have a major role to play in building partner countries' awareness and capacity to navigate the ever-evolving financing landscape, and ensuring they have access to neutral technical expertise to assess and negotiate their access to new financing sources.

The timing of the COVID-19 outbreak constitutes an unfortunate additional risk factor for the country's LDC graduation. The economic uncertainty generated by the COVID-19 crisis represents a serious challenge at a time where Solomon Islands and its development partners must carefully plan to ensure the country experiences a smooth transition from the LDC category. In times of economic tumult, the asymmetry of the LDC reverse graduation process could represent an extra challenge since a deterioration of the indicators used to decide the country's graduation would not automatically lead to a reintegration in the LDC category.

Figure 7. Solomon Islands' ODA flows as a share of total external flows are much higher than in countries with a similar GNI per capita

DAC, non-DAC and multilateral agencies' outflows, average 2012-18, net disbursements, 2018 prices.



Note: Author's calculations based on OECD Creditor Reporting System database for ODA and OOF flows; World Bank World Development Indicators for FDI and remittances; and UNWIDER Government revenue database for tax revenue.
Source: (Piemonte and Fabregas, 2020[12]).

ODA occupies a prominent place in the country's financing mix, even by the standards of other Pacific SIDS. In 2017, ODA from DAC and other providers of development co-operation accounted for more than 80% of the country's external financing mix, well above the average observed in countries with similar income levels (around 55%). The country's reliance on ODA is also higher than the trend observed in SIDS with similar income levels (around 65%), including other Pacific island countries that recently graduated from the LDC category (e.g. Samoa in 2014 and Vanuatu in 2020).

Low levels of OOF raise questions on the country's capacity to achieve a smooth transition towards non-concessional and private finance. The low levels of OOF inflows reflect in part the country's limited ability to attract and absorb financing at, or close to, market terms[14]. The share of private finance also remains low in the country's financing mix; although a comparison with the trend observed in other SIDS shows that its performance in this area reflects the usual handicap attributed to small island countries.

The case of Solomon Islands also demonstrates that efforts to develop economic partnerships can be instrumental in supporting graduating LDCs throughout their transition. The vulnerabilities affecting Pacific SIDS make them particularly vulnerable to the loss of LDC-related trade preferences: their remoteness from major markets, which already translates into higher logistical costs, means that the introduction of tariffs can quickly render their exports uncompetitive. In this sense, the fact that Solomon Islands was able to join the EU interim Economic Partnership Agreement (EPA) represents a very positive development: in fact, this agreement conditioned the survival of the country's exports of fish and palm oil (which are mainly destined to the European market) and hence also the Government's strategy of economic diversification. This example illustrates the significant gains that development partners can unlock for graduating LDCs by strengthening the development co-operation-investment-trade nexus.

3.2.3. Zambia: a commodity-based LDC transitioning from LIC to LMIC status

Zambia's country diagnostic illustrated the case of a resource-rich LDC transitioning from LIC to LMIC status. After years of robust growth in the early 2000s, Zambia transitioned from low-income to lower middle-income (LMIC) category in 2011. However, the country still belongs to the group of LDCs due to its persistent economic and social vulnerabilities. More than half of the population lives below the poverty line and the country has a high reliance on copper, which represents more than 70% of its exports, exposing the national economy to volatile commodity price movements.

Zambia, a landlocked country, joined the lower-middle income group after a period of economic expansion driven by copper exports. The average annual growth rate from 2000 to 2010 was over 7%, mostly driven by an increase in copper prices, which more than tripled during the period. However, only a year after moving into the LMIC category, a slowdown in copper demand from China and plummeting copper prices put a serious strain on the Zambian economy. The annual growth rate fell to 4.7% over the 2011-2017 period, while GDP per capita growth dropped to 1.6%, exposing Zambia's high level of economic vulnerability.

[14] Low OOF levels can also be partly explained by the preferential access of small island developing states to concessional financing windows since they benefit from exceptions in recognition of their particular development challenges (e.g. World Bank IDA small states exception).

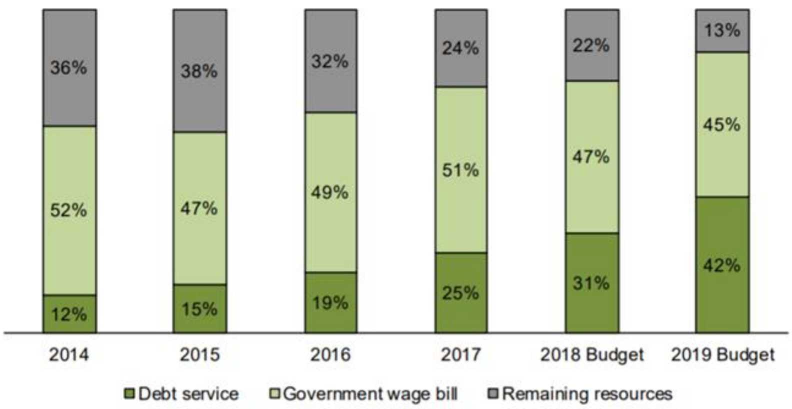
Several development partners scaled down or sharply phased out their ODA when Zambia joined the LMIC category. With growing income levels, the importance of ODF from OECD DAC providers decreased as a share of gross national income, from 23% in 2000 to 12.7% in 2006 and further to 4.9% in 2010. The exit or scaling down of development partners' operations in the country was carried out without co-ordinating or securing the transition of important co-operation activities. As a result, although Zambia's reliance on official development flows was significant up until the early 2000s, the country is now among the LDCs with the lowest share of ODA over GNI.

With the reclassification to LMIC status, Zambia also gained access to a wide range of financing options including international debt capital markets. The Government issued a series of Eurobonds starting in 2012, which amounted to a total of around USD 3 billion, or more than 40% of public external debt. At the same time, Chinese lending, especially in the form of export credit, played a growing role in the country's financing landscape. In 2016, Chinese loans amounted to a quarter of Zambia's total external debt stock.

Rising debt levels and debt servicing costs constrained the countries' ability to finance development projects. Figure 8 shows that as debt levels increased and terms worsened, Zambia started spending larger fractions of its revenue on debt servicing, including interest payments.

Figure 8. Debt servicing costs accounted for one third of Zambia's domestic revenues in 2018

Share of domestic revenue (%).



Note: Based on (Piemonte et al., 2019[13]).
Source: (Kim et al., 2018[14]).

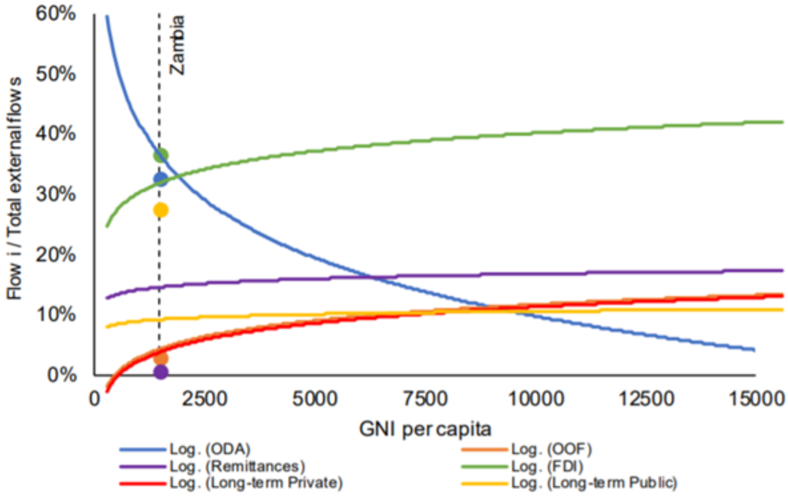
Zambia has developed a high reliance on external non-concessional long-term debt. Zambia's share of public debt in the external financing mix is much higher than for other countries with similar income levels. This reflects the country's issuances of three Eurobonds in 2012 (USD 750 million), 2014 (USD 1 billion), and 2015 (USD 1.25 billion), as well as increased commercial debt from Chinese lenders. While this evolution is consistent with the pattern observed in countries transitioning towards higher development stages, the combination of a quick surge in commercial debt and an abrupt phase out of concessional finance generated significant debt sustainability issues.

In 2020, the Covid-19 crisis pushed the country into default. After having been one of the major beneficiaries of the Heavily Indebted Poor Countries (HIPC) and Multilateral

Debt Relief (MDRI) initiatives in the early 2000s, Zambia is again faced with the need to restructure its debt. In 2020, Zambia was the second country to request debt treatment under the G20 Common Framework (after Tchad and before Ethiopia, two other LDCs). Unlike in the 2000s, however, the majority of Zambia's debt is not held by Paris Club members, which could make the debt restructuring more difficult.

Figure 9. Zambia's external financing mix is highly reliant on long-term public debt

DAC, non-DAC and multilateral agencies' outflows, 2012-16 net disbursements, 2016 prices.



Source: (Kim et al., 2018[14]).

Zambia's tax revenues have not grown to the same extent as in peer countries, adding to its fiscal vulnerability. The growth of Zambia's tax revenue in recent years has been relatively slow in contrast to its geographic peers. Nowadays, Zambia's tax-to-GDP ratio is broadly similar to those of the Republic of Congo, Ghana, and Cameroon, three countries that used to have a lower tax intake but recently increased their revenues.

Compared to other LDCs and LMICs, Zambia receives relatively high amounts of FDI but the latter are highly concentrated and have limited positive spillovers. Between 2015 and 2016, an estimated 72% of FDI went into mining and quarrying. One of the most pressing challenges for the country is to develop upstream and downstream linkages in the mining sector for greater value creation in the domestic economy. At the time of publication of Zambia's TFCD, the upstream linkages to the domestic industry remained underexplored, and the government's efforts in this regard were still at a preliminary stage.

The sectoral disaggregation of the ODF flows received by Zambia reveals that the country's sectors face different financing challenges. The Zambian health sector still receives large inflows of ODA compared to the average trend. On the other hand, some of its productive sectors, such as energy, mining, industry and construction, clearly fail to attract significant volumes of OOF. Zambia's example thus illustrates both the challenge of achieving a smooth substitution between concessional and non-concessional financing, and the fact that substitutions may happen at different times across a country's sectors.

5. Main policy conclusions and recommendations

5.1. Main transition challenges in LDCs

Four major transition challenges for LDCs emerge from the transition finance country diagnostics (TFCDs) conducted in Cabo Verde, Solomon Islands and Zambia.

Transition challenge 1: Achieving a smooth substitution between financing sources

LDCs struggle to diversify their financing sources and adapt their financing mix at each stage of their development. While most LDCs are successful in accessing ODA from development partners, they still have extreme difficulties mobilising domestic resources and attracting private sector investment and non-concessional finance, whether public or private. In addition, the transition finance approach shows that the phase out of ODA is particularly rapid in the early stages of a country's development: LDCs, which make up the vast majority of LICs, are particularly impacted by this trend.

This translates into difficulties to achieve a smooth and gradual substitution of financing sources. Following LDC graduation, Cabo Verde experienced a sharp rise of non-concessional flows as well as an increase in tied aid, with negative consequences on its fiscal position. In Zambia, development partners quickly phased out their support – or exited the country – once it achieved lower-middle income status. The resulting pressure on domestic resources mobilisation with limited tax base could then result in debt problems.

The green recovery envisioned in the fiscal stimulus packages of developed countries could further complicate LDCs' ability to attract diverse financing flows. While "build back better" efforts have boosted sustainable finance innovation, there is also a risk that higher non-financial reporting standards will raise the bar on technical capacities and requirements of host or recipient countries, thus effectively diverting resources away from the countries most in need. Significant technical assistance and capacity building efforts will be needed to give access to innovative financial instruments, such as sustainability bonds.

Transition challenge 2: Managing multiple concurrent transitions

LDCs must frequently cope with the simultaneous impact of various transitions. The LDC category includes countries across the LIC, LMIC and UMIC income groups. This wide range of development contexts means that it is frequent to see LDCs graduating simultaneously from different transition milestones or concessional windows.

Transition and graduation can have a signalling effect with both positive and negative repercussions on countries' access to financing. Benefits of transition include positive views and changes in perception by international financers and investors, potentially leading to increased access to international private sector finance (Cabo Verde after LDC graduation, Zambia after LMIC reclassification). At the same time, however, transitions can also result in loss of eligibility to specific concessional windows (e.g. Solomon Islands faced with the phasing out of Gavi support while it prepares for LDC graduation) or in the hasty phasing out of ODA by some development partners (e.g. the uncoordinated disengagement of several development partners following Zambia's LMIC graduation).

Sometime, the perception of risk is completely dissociated from the actual risk of investment in LDCs and comes with a higher premium.

External shocks happening at, or around, the time of LDC graduation can also impede a smooth transition. The Covid-19 pandemic, which affects all countries, provides a striking illustration. Other examples include commodity shocks (Zambia) and the spillover effects of financial crises (Cabo Verde).

Transition challenge 3: Ensuring debt sustainability

Debt was uniformly observed as a major transition issue in LDCs. The experiences of Cabo Verde and Zambia show that failure to carefully manage the transition from concessional to non-concessional finance, and to properly assess the risk-return trade-off of newly available instruments, can lead to situations of debt distress.

Exogenous factors, such as the COVID-19 pandemic, add to the complexity and volatility of partner countries' financing landscape. For example, the pandemic accelerated the looming debt crisis, with Zambia defaulting on a loan less than 9 months after the World Health Organisation declared Covid-19 a pandemic.

The importance of debt as a transition issue for LDCs has been confirmed by recent events: the first countries to have requested debt treatment under the G20 Common Framework are three African LDCs (Tchad, Zambia and Ethiopia).

Transition challenge 4: Leveraging trade and private investment for development

The three TFCDs conducted in LDC contexts underscore the difficulties faced by these countries to leverage private investment for development. Due to their economic vulnerability, many LDCs fail to attract foreign direct investments and private finance. The case of Solomon Islands shows that countries with specific vulnerabilities (such as small market size, low productivity and remoteness from major markets characteristic in SIDS) struggle to attract investment and commercial finance. Even when LDCs are successful at attracting FDI, these investments tend to be concentrated in a few sectors (e.g. Zambia's mining industry) or to have limited positive spillovers on the local economy (Cabo Verde's tourism sector).

Graduating countries face the additional challenge of losing trade-related special and differential treatment granted to LDCs. These include tariff preferences under the Generalised Scheme or System of Preferences or the duty-free and quota-free access for LDCs. Particular attention is thus required from development partners to ensure that the loss of LDC special support measures by recent graduates does not translate into development setbacks. For example, transition support before graduation was key in helping Cabo Verde to successfully negotiate extended access to the EU's "Everything but Arms" (duty and quota free) programme, EU Special Partnership Agreement and EU GSP+. In Solomon Islands, the signing of an interim Economic Partnership Agreement (EPA) to ensure continued access to EU trade preferences was key to the survival of the country's exports of fish and palm oil.

4.2. Key policy recommendations

Specific action from bilateral and multilateral development partners could help LDCs address these four transition challenges:

Policy recommendation 1: Include a holistic transition finance perspective in LDCs' country-level financing strategies

Financing strategies need to be holistic, integrated, and dynamic. This means that they should consider the evolving roles of different actors and financing sources at each stage of a country's development.

The holistic and integrated dimension of the transition finance approach could allow development partners to better co-ordinate their support with other actors. It could help to determine where each actor can make the best contribution, and how the different financing flows should articulate at country level to produce the greatest development impact. Integrating a transition finance perspective in countries' financing strategies (e.g. INFFs) could also help partner countries better prepare for and anticipate the substitution of different financing sources.

Existing transition support mechanisms can help in the design of holistic and multi-stakeholder approaches. For example, the consultative mechanisms that graduating LDCs are invited to establish with their development and trading partners offer a chance to address some of the challenges identified in TFCDs, such as the multiple concurrent transitions faced by some LDCs. By allowing partners to co-ordinate and align their support to the needs of graduating countries, such mechanisms can play a key role in mitigating the challenges caused by concurrent graduation processes, and can ensure a gradual and smooth transition between financing sources.

Policy recommendation 2: Ensure LDCs have access to sound and neutral technical advice to navigate the financing for sustainable development landscape

The three case studies in this paper demonstrate the importance of helping LDCs anticipate and adapt to changes affecting their access to, or the terms and conditions of, their financing. Partner countries can have a hard time accessing some of the newly available funds, assessing the risk-return trade-offs of innovative instruments, and deciding from among the multiple financing options available (OECD, 2018[15]).

FSD technical assistance and capacity building (TACB) would be particularly useful to help LDCs avoid suboptimal financing decisions that can constrain their future access to finance or lead to situations of financial distress. Such TACB could be useful to help partner countries identify the partners and instruments best fit-for-purpose; build their capacity to access newly available funds and use innovative instruments; and help them find and negotiate the best terms and conditions to meet their financing needs at the lowest possible cost, and at terms that do not jeopardise their creditworthiness.

Policy recommendation 3: Strengthen the development co-operation-investment-trade nexus

Development partners have a major role to play in helping LDCs fill the gap between development co-operation and private investment through private sector development (PSD). Targeted support could help LDCs better anticipate, plan for, and manage, the transition between public and private financing sources. It could also permit better alignment of private investment and finance with the SDGs, thus ensuring that private sector-led growth is both inclusive and sustainable, and contributes to development goals.

Improved resilience of development co-operation efforts could be achieved by building an eco-system for private sector-led development. In particular, development partners could promote foreign investment and trade, with greater emphasis on their qualities or development footprint. This would require investing in private sector development, investment climate, the business environment; improving access to credit; creating markets and building local capacities to attract the "right" foreign investors (i.e. renouncing the race to the bottom to attract investors, and raising local standards to join higher value-added supply chains). Aid for Trade could also be leveraged to create conditions conducive to trade, including by building local capacity and increasing the efficiency of global value chains (GVCs), ensuring that significant value-added is left behind (e.g. developing forward and backward linkages).

Finally, strengthening the development co-operation-investment-trade nexus could also involve working with the private sector to increase the development footprint of trade and investment. This could be achieved through concerted efforts by LDCs and their development partners to increase the qualities of foreign direct investment and the development dimensions of GVCs.

References

Gelos, G., R. Sahay and G. Sandleris (2011), "Sovereign borrowing by developing countries: What determines market access?", *Journal of International Economics*, Vol. 83/2, pp. 243-254, https://doi.org/10.1016/j.jinteco.2010.11.007. [4]

Kim, J. et al. (2018), "Transition Finance Challenges for Commodity-based Least Developed Countries: The example of Zambia", *OECD Development Co-operation Working Papers*, No. 49, OECD Publishing, Paris, https://dx.doi.org/10.1787/feb640fe-en. [14]

Morris, R., O. Cattaneo and K. Poensgen (2018), "Cabo Verde Transition Finance Country Pilot", *OECD Development Co-operation Working Papers*, No. 46, OECD Publishing, Paris, https://dx.doi.org/10.1787/1affcac6-en. [9]

Morrissey, O. and M. Udomkerdmongkol (2012), "Governance, Private Investment and Foreign Direct Investment in Developing Countries", *World Development*, Vol. 40/3, pp. 437-445, https://doi.org/10.1016/j.worlddev.2011.07.004. [5]

OECD (2020), "Transition finance ABC methodology: A user's guide to transition finance diagnostics", *OECD Development Policy Papers*, No. 26, OECD Publishing, Paris, https://dx.doi.org/10.1787/c5210d6c-en. [1]

OECD (2020), "Transition finance ABC methodology: A user's guide to transition finance diagnostics", *OECD Development Policy Papers*, No. 26, OECD Publishing, Paris, https://dx.doi.org/10.1787/c5210d6c-en. [16]

OECD (2020), "Transition finance ABC methodology: A user's guide to transition finance diagnostics", *OECD Development Policy Papers*, No. 26, OECD Publishing, Paris, https://dx.doi.org/10.1787/c5210d6c-en. [17]

OECD (2020), “Transition finance ABC methodology: A user’s guide to transition finance diagnostics”, *OECD Development Policy Papers*, No. 26, OECD Publishing, Paris, https://dx.doi.org/10.1787/c5210d6c-en. [18]

OECD (2018), *Global Outlook on Financing for Sustainable Development 2019: Time to Face the Challenge*, OECD Publishing, Paris, https://dx.doi.org/10.1787/9789264307995-en. [15]

OECD (2018), *Global Outlook on Financing for Sustainable Development 2019: Time to Face the Challenge*, OECD Publishing, Paris, https://dx.doi.org/10.1787/9789264307995-en. [10]

OECD (2018), *Global Outlook on Financing for Sustainable Development 2019: Time to Face the Challenge*, OECD Publishing, Paris, https://dx.doi.org/10.1787/9789264307995-en. [7]

OECD (2018), *Global Outlook on Financing for Sustainable Development 2019: Time to Face the Challenge*, OECD Publishing, Paris, https://dx.doi.org/10.1787/9789264307995-en. [19]

OECD (forthcoming), *Covid-19 and development finance flows: an update*. [8]

OECD/UNCDF (2020), *Blended Finance in the Least Developed Countries 2020: Supporting a Resilient COVID-19 Recovery*, OECD Publishing, Paris, https://dx.doi.org/10.1787/57620d04-en. [6]

OECD/UNCDF (2020), *Blended Finance in the Least Developed Countries 2020: Supporting a Resilient COVID-19 Recovery*, OECD Publishing, Paris, https://dx.doi.org/10.1787/57620d04-en. [11]

Piemonte, C. et al. (2019), “Transition Finance: Introducing a new concept”, *OECD Development Co-operation Working Papers*, No. 54, OECD Publishing, Paris, https://dx.doi.org/10.1787/2dad64fb-en. [2]

Piemonte, C. et al. (2019), “Transition Finance: Introducing a new concept”, *OECD Development Co-operation Working Papers*, No. 54, OECD Publishing, Paris, https://dx.doi.org/10.1787/2dad64fb-en. [13]

Piemonte, C. and A. Fabregas (2020), “Solomon Islands transition finance country diagnostic: Preparing for graduation from Least Developed Country (LDC) status”, *OECD Development Co-operation Working Papers*, No. 86, OECD Publishing, Paris, https://dx.doi.org/10.1787/a4739684-en. [12]

Presbitero, A. et al. (2016), “Sovereign bonds in developing countries: Drivers of issuance and spreads”, *Review of Development Finance*, Vol. 6/1, pp. 1-15, https://doi.org/10.1016/j.rdf.2016.05.002. [3]