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*Contact:*

AFD

5 Rue Roland Barthes

75598 PARIS CEDEX 12

FRANCE

Téléphone : +33 1 53 44 31 31

Email: [site@afd.fr](mailto:site@afd.fr)

Website: [www.afd.fr](http://www.afd.fr)

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UNDP

One United Nations Plaza

New York, NY 10017 USA

Website: [www.undp.org](http://www.undp.org)

# Financing the SDGs in the Least Developed Countries (LDCs): Diversifying the Financing Tool-box and Managing Vulnerability

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## Authors

This report was written by Gail Hurley, Policy Specialist on Development Finance at the United Nations Development Programme (UNDP), Bureau for Policy and Programme Support (BPPS) and Tancrede Voiturez, Director of the Global Governance programme at the Institute for Sustainable Development and International Relations (IDDRI).

## Contributors

Pedro Conceição, Director of Strategic Policy, UNDP; Yves Guicquero, Head of the Development Agenda and International Partners Division, Agence Française de Développement (AFD); Nergis Gulasan, Policy Specialist, UNDP; Erling Kravik, Policy Specialist, UNDP; Marianne Mensah, Development Finance Specialist, AFD; Céline Miannay, Partnerships Specialist, AFD; Armand Rioust de Largentaye, Advisor, AFD.

## About This Report

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## Disclaimer

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# Table of Contents

<b>Abbreviations and Acronyms</b>	<b>05</b>
<b>Executive Summary</b>	<b>07</b>
<b>Introduction</b>	<b>13</b>
<b>I. PAVING THE WAY FOR GRADUATION</b>	<b>21</b>
<b>The Least Developed Countries:A Snapshot</b>	<b>21</b>
1. LDCs have made important social and economic progress	21
2. LDCs remain vulnerable to external shocks and other risks	23
3. The transformation challenge underlying the 2030 Agenda	25
<b>II. MOBILIZING FINANCE TO ADDRESS LDCS' SUSTAINABLE DEVELOPMENT CHALLENGES</b>	<b>31</b>
<b>Seizing the opportunities of a sophisticated development financing tool-box</b>	<b>31</b>
1. Raising 'big-ticket' finance and strengthening capacity with blended finance	33
2. Enhancing access to credit with guarantees for development	37
3. Financing local investment and SMEs, while strengthening financial institutions with local currency lending	39
4. Financing sustainable development with green and blue bonds	40
5. Financial tools to manage vulnerability	43
I. Adjusting debt service with GDP-indexed bonds	43
II. When disaster strikes...	46
<b>III. IMPROVING LDCS' ACCESS TO THE FINANCING TOOL-BOX</b>	<b>49</b>
<b>Statistical Annex</b>	<b>55</b>
<b>References</b>	<b>63</b>
<b>Notes</b>	<b>71</b>

# Table of Figures

Figure 1.	The Least Developed Countries	18
Figure 2.	Share of population living on less than US\$1.90 a day in LDCs	22
Figure 3.	Annual Real GDP Growth in LDCs and other country groups	23
Figure 4.	Composition of external finance in LDCs and other developing countries	24
Figure 5.	What's in the financing tool-box?	32
Figure 6.	Debt Service paid on external debt with official creditors, Actual vs. GDP-linked (US\$ billion)	44
Figure 7.	Counter-cyclical loans in practice	46
Figure 8.	HIPC and MDRI debt relief in the LDCs In millions of US\$; status as at end-August 2015	55
Figure 9.	External debt in the LDCs, % of GDP	56
Figure 10.	Poverty reduction spending in the LDCs	57
Figure 11.	Revenue, excluding grants (% of GDP), LDCs	58
Figure 12.	Gross savings rates in the LDCs (% of GDP)	58
Figure 13.	Net ODA received (% of GNI)	59
Figure 14.	Trends in climate-related bilateral ODA to LDCs, 3-year averages 2002-13, bilateral commitment, US\$ million, constant 2013 prices	59
Figure 15.	FDI per capita: LDCs versus developing countries, US\$	66
Figure 16.	Remittances per capita, LDCs, 2014, US\$	61

# Abbreviations and Acronyms

<b>AAAA</b>	Addis Ababa Action Agenda	<b>LDC</b>	Least Developed Countries
<b>AFD</b>	Agence Française De Développement/French Development Agency	<b>LMICs</b>	Lower Middle-Income Countries
<b>AfDB</b>	African Development Bank	<b>MDBs</b>	Multilateral and Bilateral Development Banks
<b>AGRA</b>	Alliance for a Green Revolution	<b>MDGs</b>	Millennium Development Goals
<b>BCIE</b>	Central American Bank for Economic Integration (Banco Centroamericano De Integración Económica)	<b>MDRI</b>	Multilateral Debt Relief Initiative
<b>CCL</b>	Counter-Cyclical Lending Contract	<b>MIGA</b>	Multilateral Investment Guarantee Agency
<b>CDP</b>	Committee for Development Policy	<b>MFI</b>	Micro-Financing Institutions
<b>CIF</b>	Caribbean Investment Facility	<b>NEPAD</b>	New Partnership for Africa's Development
<b>DAC</b>	Development Assistance Committee (OECD)	<b>NGOs</b>	Non-Governmental Organizations
<b>DSA</b>	Debt Sustainability Analyses	<b>NIF</b>	Neighbourhood Investment Facility
<b>DSF</b>	Debt Sustainability Framework	<b>ODA</b>	Official Development Assistance
<b>EU</b>	European Union	<b>ODI</b>	Overseas Development Institute
<b>EU-AITF</b>	EU-Africa Infrastructure Trust Fund	<b>OECD</b>	Organisation for Economic Cooperation and Development
<b>EURODAD</b>	The European Network on Debt and Development	<b>OOF</b>	Other Official Flows
<b>EVI</b>	Economic Vulnerability Index	<b>PRGT</b>	Poverty Reduction and Growth Trust Fund
<b>FAO</b>	Food and Agriculture Organization	<b>REGMIFA</b>	The Regional Micro, Small and Medium Enterprise Investment Fund for Sub-Saharan Africa
<b>FDI</b>	Foreign Direct Investment	<b>SDGs</b>	Sustainable Development Goals
<b>FISEA</b>	Investment and Support Fund for Businesses in Africa	<b>SIDS</b>	Small Island Developing States
<b>GAVI</b>	Global Alliance for Vaccines and Immunization	<b>SME</b>	Small and Medium-Sized Enterprise
<b>GDP</b>	Gross Domestic Product	<b>SUNREF</b>	Sustainable Use Of Natural Resources and Energy Finance
<b>GEF</b>	Global Environmental Facility	<b>TOSSD</b>	Total Official Support for Sustainable Development
<b>GIIN</b>	The Global Impact Investing Network	<b>UMICs</b>	Upper Middle-Income Countries
<b>GNI</b>	Gross National Income	<b>UN</b>	United Nations
<b>HAI</b>	Human Asset Index	<b>UN REDD</b>	United Nations Collaborative Programme on Reducing Emissions From Deforestation and Forest Degradation in Developing Countries
<b>HIPC</b>	Heavily Indebted Poor Countries	<b>UN-OHRLS</b>	United Nations Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States
<b>ICT</b>	Information and Communication Technology	<b>UNCTAD</b>	United Nations Conference on Trade and Development
<b>IDA</b>	International Development Association	<b>UNDP</b>	United Nations Development Programme
<b>IDDRl</b>	Institute for Sustainable Development and International Relations	<b>UNFCCC</b>	United Nations Framework Convention on Climate Change
<b>IFC</b>	International Finance Corporation	<b>UNFPA</b>	United Nations Population Fund
<b>IFCA</b>	Investment Facility for Central Asia	<b>WB</b>	World Bank
<b>IFFIm</b>	International Finance Facility for Immunization		
<b>IMF</b>	International Monetary Fund		
<b>IPoA</b>	Istanbul Declaration and Programme Of Action		
<b>IPPF</b>	Infrastructure Project Preparation Facility		
<b>KfW</b>	German Development Bank		
<b>LAFCo</b>	Lending for African Farming Company		
<b>LAIF</b>	Latin America Investment Facility		



Photo: Dylan Lowthian/UNDP Sierra Leone

# Executive Summary

**Achieving the 2030 Agenda will be a challenge for *all* countries. It is however particularly salient for the 48 Least Developed Countries (LDCs) where levels of deprivation are acute, infrastructure is inadequate, economies are vulnerable and capital is in short supply. Yet these are the countries we need to reach first if we are to meet the aspiration to “leave no one behind”**

LDCs have made important social and economic progress over the last fifteen years. Poverty has declined, many more children are now in school and health indicators have improved. Many LDCs have experienced unprecedented economic growth recently, helped by high commodity prices and increasing aid flows. Domestic resources have increased, foreign direct investment (FDI) has expanded and several LDCs have even secured access to international capital markets for the first time. Four LDCs have been recommended for “graduation” from the category and a further six are approaching it.

Despite this progress, considerable challenges remain. Economic growth remains highly volatile in the LDCs with countries extremely vulnerable to shocks such as fluctuations in commodity prices, disasters linked to natural hazards, conflict and violence and disease epidemics.

The 2008 financial crisis and its aftermath have shown in particular how LDCs’ economic performance is deeply impacted by economic activity in industrialized and emerging economies and by broader global economic conditions. Notwithstanding the argument that global savings – at around US\$ 22

trillion a year – are more than sufficient to meet the investment requirements of the 2030 Agenda, the aggregate availability of savings does not necessarily mean these resources will flow to where they are needed. Markets respond to perceptions of risk-adjusted returns, and many of the poorest and most vulnerable countries in the world may be perceived as offering poor prospects. With the economic recovery still weak and uneven, capital inflows to these countries may decline or remain short of needs as investors seek higher prospective capital yields in advanced and emerging economies, with more robust track records.

This is cause for concern since many LDCs already struggle to attract private investment in their economies. While FDI flows to the LDCs have increased over the last fifteen years, they are also heavily concentrated in a few resource-rich countries. In reality, many LDCs remain heavily dependent on Official Development Assistance (ODA). It is clear however that the considerable investment requirements of the 2030 Agenda cannot be met through ODA alone. LDCs will also need to make effective use of other official and private flows, including debt and equity.

At the same time, we see that the development financing landscape has become much more diversified and sophisticated over recent years. New funders, public and private, have emerged and/or expanded their international development programmes. New financing instruments have emerged both within, and in addition to, ODA. These include blended finance, green bonds, guarantees, local currency financing, impact investing, diaspora financing, and debt swaps/buy-backs among many others. Financial instruments to help countries more effectively manage risk and vulnerability to shocks have also emerged or been proposed such as GDP-indexed bonds, countercyclical loans and weather/catastrophe insurance. New partnerships between public and private finance providers have become commonplace. It is a dynamic field that continues to evolve rapidly.

While efforts to strengthen domestic resource mobilization and increase aid to the poorest countries must continue, more resources will be needed. A more diverse international financing “tool-box” may provide LDCs with new opportunities to leverage additional public and private resources for sustainable development, as well as manage their continued vulnerability. It is clear however that this financing must be tailored to the specific needs and characteristics of LDCs. Moreover, these instruments can only fully achieve their potential benefits in LDCs if these countries develop the capacity to use and manage them effectively.

This paper examines a variety of financial instruments used by official finance providers, and explores the extent to which they can be used – or are already being used – in the LDCs to finance sustainable development and manage risks. It looks at the opportunities but also risks/limitations that may be associated with different financial instruments. Our focus is on official finance providers because they have a particular role (and responsibility) to support the poorest and most vulnerable countries to make use of different financing instruments in ways that are responsible, minimize risk and secure maximum

development benefits for LDCs. At the same time, the official sector has also been critical to launch and pilot many recent financing innovations demonstrating the importance of public policy and public finance in driving financial innovation and creating instruments that are eventually picked-up by capital markets and private investors.

While the development financing landscape is wide and diverse, the paper is limited to a discussion of financing instruments that have, on the one hand, the potential to deliver resources at-scale and to strengthen local actors, and on the other, to reduce vulnerability. The financing instruments covered by this paper include: blended finance; guarantees; local currency financing; green and blue bond financing; GDP-indexed bonds and countercyclical loans.

We find that blended finance (where aid or philanthropic funds are mixed with other public or private development finance flows) has the potential to unlock significant new resources for development, especially in areas such as infrastructure. Many LDCs have already used blended finance and it is likely to be scaled-up in the future. As our project examples show, blended finance can be used to leverage “co-benefits” across different sectors. Yet these arrangements can be complex and difficult to arrange in ways that serve the public interest. The ability to identify and implement high-return investment projects can also be a challenge. The paper points to local capacity development as critical for success.

Guarantees are undergoing a rapid evolution with new combinations of donor agencies and philanthropic investors emerging over the last decade. Guarantees can be valuable tools to unlock low-cost credit for small and medium-sized enterprises, as well as incentivize investment in perceived (or actual) riskier sectors such as energy, infrastructure or industry. Their use is on the increase and may increase further still with new changes to the ways in which OECD DAC donors count official financial flows for development. Guarantees have many advantages but cannot by themselves overcome problems inherent to a poorly-designed project or an uncreditworthy borrower. They are best combined with capacity development, e.g. of local financial institutions and small businesses.

Local currency financing – to sovereigns, sub-national entities and the local private sector – has expanded over recent years and can reduce exposure to currency risk, expand access to finance as well as support the development of domestic capital markets. There are however some risks for lenders, and this kind of financing may be unlikely in the smallest countries. As with other financial instruments, local currency financing will be most effective when it is combined with capacity development support.

Green financing is evolving rapidly. Green bonds in particular have experienced a rapid rise over recent years. Many national and multilateral development banks are now major issuers of green bonds, while some emerging economies have built dynamic domestic green bond markets. Financing raised through green bonds has been used by development banks to finance or co-

finance projects in several LDCs. To benefit from the expected growth in this area, a high quality green investment pipeline will be needed.

Financial instruments that aim to manage risks – such as GDP-indexed bonds and countercyclical loans – have been discussed at length, but have been used in only a handful of cases. We find there is a strong case for increased use of such instruments in the future because they have the ability to deliver resources in a countercyclical manner and also shift some risk from the borrower to the lender. Because LDCs hold their debt mostly with official creditors, official finance providers could develop GDP-indexed securities as a key financing modality and/or expand lending instruments that automatically allow debt service to fall or become zero when a major shock occurs.

### **Our analysis points to several key observations when it comes to expanding the financing “tool-box” in the LDCs:**

- 1. —→ New financing instruments do not diminish the importance of continued efforts by LDCs to strengthen domestic resource mobilization and to use these resources more effectively.**
- 2. —→ ODA remains vital to LDCs' efforts to achieve the 2030 Agenda and donors must meet their ODA commitments to the LDCs.**
- 3. —→ Harnessing new financing instruments can contribute to development but the effectiveness of the financing “tool-box” depends critically on global economic growth which exerts an influence on LDCs' growth prospects and their abilities to attract private capital. Robust and sustained economic growth in the LDCs is a sine qua non for governments' efforts to reduce poverty and create more and better jobs.**
- 4. —→ Debt sustainability must remain at the forefront. Countries must understand the risks associated with different financing modalities and official finance providers must ensure financing on appropriate terms and conditions.**

5. —→ Financial tools to manage risks and help countries to cope better with shocks are not simply a nice complement but an absolute necessity.
6. —→ Risk represents a key constraint for LDCs and must be reduced. To increase prospective capital yields on investments in the LDCs, development partners have a key role to play at different stages of the project cycle to mitigate risks, manage expected returns and demonstrate the viability of markets. Public and private sources of finance are in this respect complementary.
7. —→ Capacity development is crucial to ensure that different financing options fully achieve their potential in LDCs. Many of these financial instruments will be most effective when they are part of broader efforts to build local capacities.
8. —→ Financing can be used in smarter ways to deliver “co-benefits”; e.g. financing can support the development of the local private sector as well as deliver environmental benefits; GDP-indexed lending helps during shocks, but also imbeds counter-cyclical features that may help with macroeconomic stability.
9. —→ Not all LDCs are the same. Some LDCs, especially larger countries, may have more opportunities than others to access new financing instruments. The official sector must ensure that no country is left behind.
10. —→ Public support and the official sector have a critical role to play. In part because some financial innovations have initially high costs, that no single country, especially an LDC, will be able to support on its own. In part because better information and knowledge exchange are critical to scaling-up successes, and this knowledge constitutes a “public good” that can only be sustained with public support.



Photo: Eric Miller/World Bank Mozambique

# Introduction

**In September 2015, at the United Nations in New York, world leaders adopted the 2030 Agenda for Sustainable Development. This call for “transforming our world” sets out ambitious aspirations to eradicate poverty, protect the planet and ensure peaceful and inclusive societies everywhere.<sup>1</sup>**

There is no doubt that implementing the 2030 Agenda will require unprecedented breakthroughs in areas such as health and nutrition, education, infrastructure development, peace and security and environmental protection. This will require, in turn, commensurate financial and technological resources. The Addis Ababa Action Agenda (AAAA), adopted during the Third International Conference on Financing for Development in July 2015, outlines a comprehensive financing framework to advance sustainable development and the implementation of the 2030 Agenda.<sup>2</sup> The AAAA calls not only for the mobilization of more resources, but also for new ways of providing incentives to channel public and private resources towards advancement of the Sustainable Development Goals (SDGs). A report issued by the World Bank and other multilateral development banks prior to Addis Ababa entitled, “From Billions to Trillions” suggested that the scale of resources needed for the SDGs would need to increase by several orders of magnitude, but also noted that there were also more financial resources and tools available than ever before to support countries in this effort.<sup>3</sup> Indeed, it has been suggested that the financing challenge to meet the SDGs is so great that it calls for the mobilization of every single dollar in the world.<sup>4</sup>

The challenge, then, is how to mobilize and channel finance and technology towards sustainable development. While this is a challenge everywhere, it is particularly relevant for the 48 countries classified by the United Nations as “Least Developed Countries” (LDCs). This group of countries includes those with the lowest levels of income per person, low achievements on health, education and other human development outcomes, those where infrastructure is particularly inadequate, and those with economies that are vulnerable to shocks. If we are to fulfil the aspiration of “leaving no one behind”, as well as pursue the call for “reaching the furthest behind first,” special attention is needed on the LDCs, where, in 2012, nearly half the population – some 400 million people – remained in extreme poverty”.<sup>5</sup>

The ability to attract capital and to mobilize and make effective use of a wide variety of financial resources is severely constrained in most LDCs. Tax revenues are weak and private investment is limited (see figures 11 and 16). In contrast to developed and non-LDC middle-income economies, where foreign direct investment and portfolio investments are major sources of external finance, these flows are small when it comes to most LDCs – and where they do exist they are heavily concentrated in a few resource-rich LDCs. Most LDCs have sizeable financing needs and concessional official finance remains an extremely important source of financing, accounting for about 62 percent of total international capital flows to these countries.<sup>6</sup>

### Box 1. The Istanbul Declaration and Programme of Action for the LDCs<sup>7</sup>

The Istanbul Programme of Action (IPoA) for the LDCs charts the international community’s vision for the sustainable development of the LDCs for the decade 2011 – 2020. It stresses the need to build productive capacities in the LDCs via a step-change in infrastructure investment, as well as a need to focus on the social sectors, strengthen trade capacities and invest in agriculture, food security and rural development. The need to reduce LDCs’ vulnerabilities to economic, natural and environmental shocks and disasters is also underscored.

One of the core aims of the IPoA is bring half of all LDCs (24 countries) to the point of “graduation” by 2020. This is expected to be achieved through, amongst other measures, a drive to attain economic growth rates of on average seven percent per annum.

LDCs’ development partners pledged to support LDCs’ priority areas for action through increased

development assistance, a focus on trade-related support and a commitment to provide enhanced technical and financial support for technological innovation and technology transfer.

The IPoA also recognizes that the lack of access to financial resources represents one of the biggest development constraints facing LDCs. Targets to enhance domestic resource mobilization, improve expenditure, curtail illicit financial flows, attract foreign direct investment, ensure debt sustainability and increase poverty-focused aid are all outlined in the IPoA in an effort to address these challenges.

The Mid-Term Review of the IPoA will assess countries’ progress towards these objectives – as well as the support provided by their development partners – and will propose actions to ensure they are met.

Over the last fifteen years, the development financing landscape has become much more complex and diversified. New funders – public and private – have emerged and/or expanded their international development cooperation activities. This includes South-South Cooperation providers and philanthropic entities. New financing instruments have emerged both within and in addition to Official Development Assistance (ODA). These include: green and blue bonds; diaspora financing vehicles; impact investing; debt swaps/buy-backs; lending in local currencies, and more (see [figure 5](#)). Traditional development aid is now being used in different ways, and in particular “blended” finance (where concessional resources supplied by a donor are blended with non-concessional public or private finance) has become more prominent. Financial instruments that aim to help countries manage volatility and vulnerability to shocks and stresses have become more sophisticated, and include performance-based loan contracts and weather/catastrophe insurance. Partnerships between public and private finance providers to build essential infrastructure and to deliver basic social services have become commonplace. It is a dynamic field that continues to evolve rapidly.

A more diverse international financing “tool-box” may offer LDCs new opportunities to leverage additional public and private finance in support of the aims outlined in the Istanbul Programme of Action, as well as hedge their exposure to different kinds of risk such as disasters linked to natural hazards, commodity price volatility or epidemics. While LDCs must continue to strengthen domestic resource mobilization and the international community must strive to increase development aid to the LDCs – and in particular meet its commitment to allocate between 0.15 and 0.2 percent of GNI as ODA to the LDCs – it is also clear that domestic resources and aid combined will remain insufficient. More resources will be needed, in particular to fund the “big-ticket” investments (e.g. in sustainable infrastructure) needed to support economy-wide transformations in the LDCs. LDCs’ abilities to harness and make effective use of a broader suite of financing instruments will therefore be an important determinant of their ability to make progress towards the SDGs.

It is also clear however that new financing instruments and approaches must be tailored to the specific needs and characteristics of LDCs and must be used in ways that make sense to them. Some of these instruments are complex to understand and/or to implement, especially in settings where capacity is constrained and regulatory oversight can be weak. They may also increase fragmentation and transaction costs, reduce transparency and increase debt burdens (since many are debt instruments). The opportunities and risks/limitations associated with different financial instruments must be carefully evaluated.

There are however numerous examples – from both within and beyond LDCs – where innovative financing approaches have been implemented and have achieved important sustainable development results. Finance from the official sector, often perceived as rules-ridden and stagnant, is on the contrary vibrant and undergoing a continuous process of change and innovation with new collaborations and financing technologies enabling developing countries

and their development partners to pursue public policy objectives more efficiently, at lower cost and with higher welfare gains.<sup>8</sup>

Against this background, this paper examines a variety of financial instruments and approaches, especially those used by official finance providers, and explores the extent to which these new and diverse financing instruments may be useful and/or applicable to LDCs in their efforts to achieve the Sustainable Development Goals. How can the international community use financing in ‘smarter’ and different ways to help LDCs address their key sustainable development challenges? Which financial instruments are best-suited to fulfill different development needs and challenges in the LDCs? Which could potentially be taken to scale? What experiences and lessons learned can we draw from? And are there specific issues that we should bear in mind when it comes to this particular set of countries?

These questions are relevant not only in the context of the mid-term review of the Istanbul Programme of Action for the LDCs and the recent adoption of the 2030 Agenda, but are also timely for other reasons.

Research shows that as developing countries’ incomes climb, concessional official finance tends to fall as a share of GDP and this is not compensated for by rising tax revenues for countries whose income per capita is below US\$ 13,000 or by private capital flows.<sup>9</sup> This creates the so-called “missing-middle” problem, whereby domestic private finance picks up the slack and many developing countries – LDCs included – have seen domestic debt burdens rise over recent years (see [box 4](#)). How the international community can ensure a smooth process for countries that “graduate” from one category to another remains a key challenge.

Recent changes in the ways OECD (Organisation for Economic Cooperation and Development) donors will report on loan financing and other forms of official financial support from 2018 may also change donor incentives and may increase the share of ODA provided as concessional loans. The measure that is currently under development, entitled “Total Official Support for Sustainable Development” (TOSSD) may result in a higher utilization of instruments such as guarantees (see [box 5](#)).

The paper is aimed at LDC policymakers and their development partners as well as development practitioners, specialists and analysts who are active in the development finance field. Our aim is to support LDCs and their development partners to think about a larger “tool-box” of financing instruments that will help the poorest countries to meet their sustainable development needs, as well as better manage their continued vulnerability. It draws on recent experiences and lessons learned with a variety of financial instruments, and considers the opportunities and risks for the LDCs. Our focus is predominantly on the role that the official sector can play since their actions can support the learning curve in LDCs, have an important demonstration effect on financial markets, and official finance can also be used to harness additional private finance in support of sustainable development.

The paper is organized as follows:

————→ Part One provides a snapshot of the LDCs today. We look at recent economic and human development progress, trends in official and private financial flows and challenges for the LDCs looking forward.

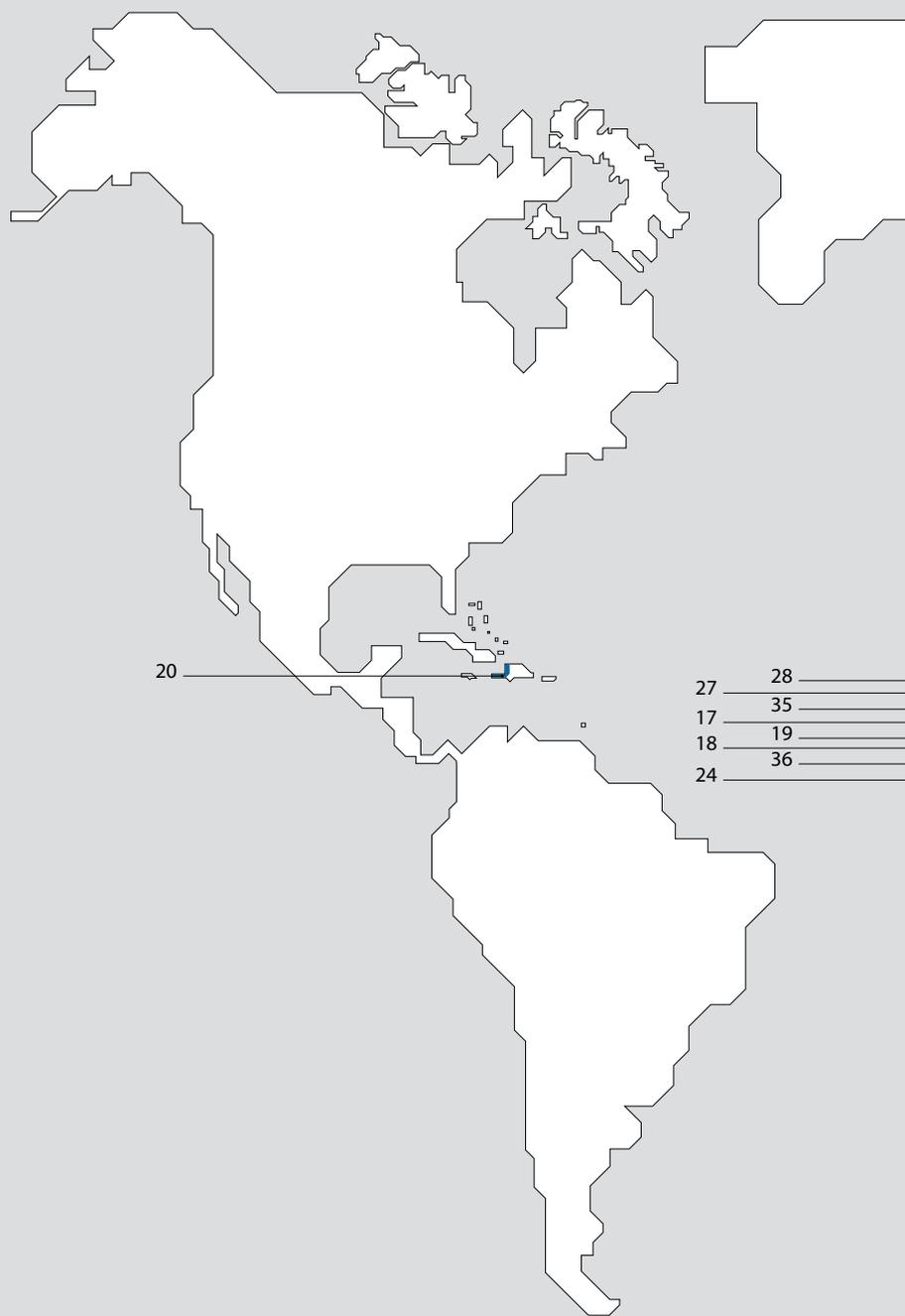
————→ Part Two examines a variety of (mostly official sector) financial instruments that have been used both within and beyond the LDCs and evaluates the opportunities for LDCs. It draws on concrete experiences and projects to draw lessons learned.

————→ Part Three provides some perspectives on improving the use of different development financing options by LDCs.

## Figure 1. The Least Developed Countries

Source: UN DESA / UNCTAD

	Country	Inclusion on List
1	Afghanistan	1971
2	Angola	1994
3	Bangladesh	1975
4	Benin	1971
5	Bhutan	1971
6	Burkina Faso	1971
7	Burundi	1971
8	Cambodia	1991
9	Central African Republic	1995
10	Chad	1971
11	Comoros	1977
12	Dem. Republic of Congo	1991
13	Djibouti	1982
14	Equatorial Guinea	1982
15	Eritrea	1994
16	Ethiopia	1971
17	Gambia	1975
18	Guinea	1971
19	Guinea-Bissau	1981
20	Haiti	1971
21	Kiribati	1986
22	Lao People's Dem. Republic	1971
23	Lesotho	1971
24	Liberia	1990
25	Madagascar	1991
26	Malawi	1971
27	Mali	1971
28	Mauritania	1986
29	Mozambique	1988
30	Myanmar	1987
31	Nepal	1971
32	Niger	1971
33	Rwanda	1971
34	São Tomé and Príncipe	1982
35	Senegal	2000
36	Sierra Leone	1982
37	Solomon Islands	1991
38	Somalia	1971
39	South Sudan	2012
40	Sudan	1971
41	Timor-Leste	2003
42	Togo	1982
43	Tuvalu	1986
44	Uganda	1971
45	United Rep. of Tanzania	1971
46	Vanuatu	1985
47	Yemen	1971
48	Zambia	1991



Least Developed Countries	48
Africa	34
Asia	9
Caribbean	1
Pacific	4

Note: The boundaries and names shown and the designations used on this map do not imply official endorsement or acceptance by the United Nations.

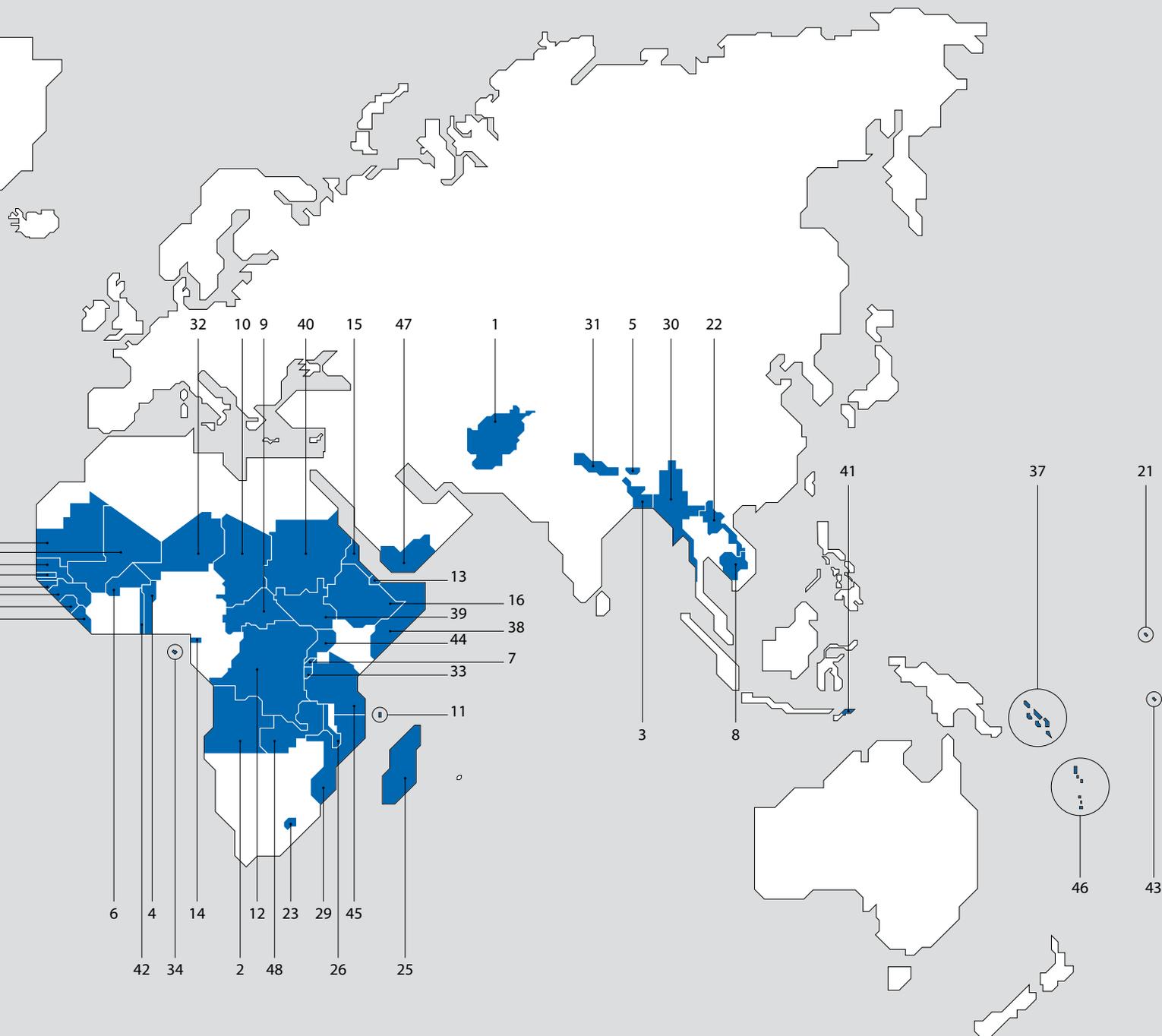




Photo: Scott Wallace/World Bank Tanzania

# I. PAVING THE WAY FOR GRADUATION

## The Least Developed Countries: A Snapshot

### 1. LDCs have made important social and economic progress

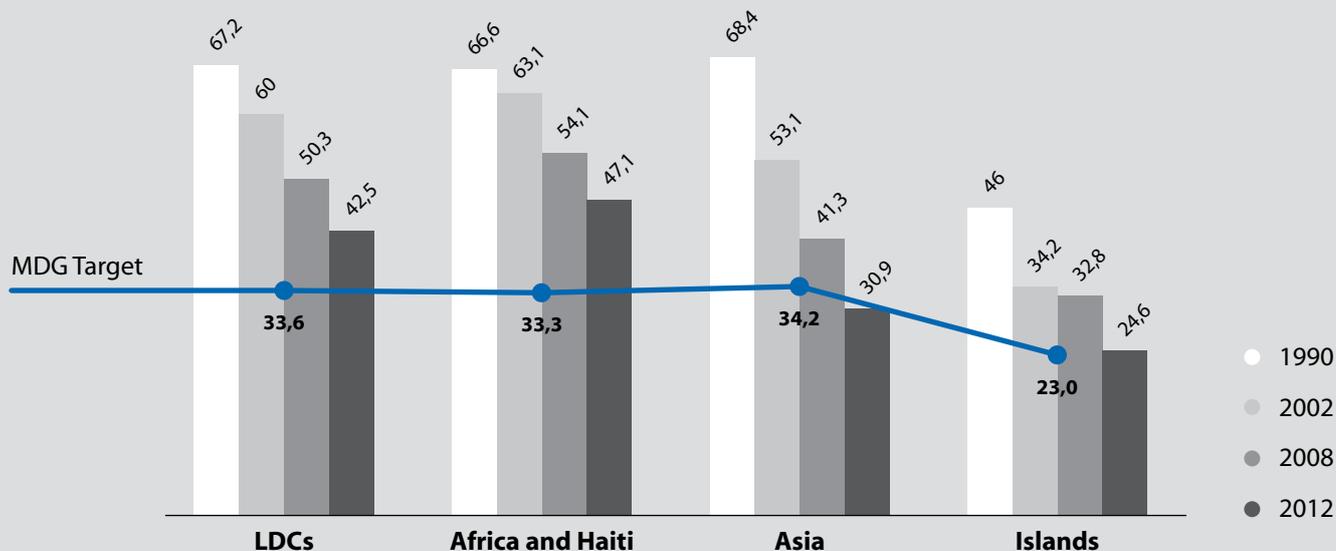
There are three criteria for being classified as a Least Developed Country (LDC): low per capita income; low level of human capital as measured by the Human Asset Index (HAI); and high economic vulnerability as measured by the economic vulnerability index (EVI).<sup>10</sup> Today, there are 48 LDCs, representing approximately 13 percent of the world's population and 43 percent of the world's extreme poor.<sup>11</sup> More than two thirds of LDCs are located in Sub-Saharan Africa (34), with the remainder spread over Asia (nine countries), Oceania (four) and Central America (one) (see [figure 2](#)).<sup>12</sup>

While LDCs share many characteristics, they are also a heterogeneous set of countries.

Some are land-locked countries – LLDCs (e.g. Afghanistan, Burkina Faso, Niger and South Sudan) while several others are Small Island Developing States – SIDS (e.g. Kiribati and the Solomon Islands). These structural characteristics are well-known to amplify development challenges (for instance LLDCs and SIDS can find it more difficult to access world markets). Several LDCs have tiny populations (e.g. Tuvalu has less than 10,000 inhabitants) while others are large (Bangladesh has over 156 million inhabitants).<sup>13</sup> Economic structures also differ across the LDCs: six are fuel exporters, another six are manufacture exporters (largely textiles and garments), while 10 are mineral exporters, eight are agricultural exporters and 10 are service exporters.<sup>14</sup> These differences mean that the most appropriate ‘mix’ of financing sources and instruments will be different from one country to the next.

Figure 2. Share of population living on less than US\$1.90 a day in LDCs

Source: World Bank, 2016



Four countries have so far graduated from LDC status: Botswana in 1994, Cape Verde in 2007, the Maldives in 2011 and Samoa in 2014.<sup>15</sup> Equatorial Guinea and Vanuatu are scheduled to be taken off the list in 2017 (although in the case of the latter this has now been postponed until 2020 due to the devastation wreaked by Cyclone Pam in 2015). Angola is scheduled to graduate in 2021. Tuvalu has also been recommended for graduation by the United Nations. The recent rise in the number of candidate countries for graduation mirrors the important social and economic progress made in many LDCs over the last 15 years.

From 2000 until 2008, LDCs on the whole experienced consistently high economic growth rates (see figure 3). Real GDP growth often exceeded 7 or 8 percent annually, capital inflows increased and exports expanded. As a result, several LDCs started to converge towards the level of income of developed countries at a faster rate than in the past. When the 2008 financial crisis struck, LDCs as a group did not experience the dramatic drop in economic output seen in the developed world and some emerging economies.

Economic growth did slow down but remained above 4 percent throughout the crisis.<sup>16</sup> Reflecting these strong growth dynamics, foreign direct investment (FDI), migrant remittances and diaspora investments all increased sharply over the MDG period, between 2000 and 2015.

For example, from 2000 to 2014, FDI flows to LDCs increased sixfold and stood at almost US\$ 23 billion in 2014. A few LDCs also ‘debuted’ bonds on international capital markets, notably Angola, the Democratic Republic of the Congo, Ethiopia, Mozambique, Rwanda, Senegal, Tanzania and Zambia.

When it comes to human development, while the majority of LDCs may have missed some MDG targets, their performance remains noteworthy when we take into account their initial conditions.<sup>17</sup> Most LDCs achieved impressive results in primary school enrolment, for example up from 50 percent in 1990 to 82 percent in 2013. The LDCs also performed well when looking at various health indicators. The average maternal mortality ratio per 100,000 live births has fallen by about half in LDCs, which is faster than for other developing countries. Likewise, the under-5

mortality rate has dropped close to 60 percent in the LDCs, whereas it dropped 55 percent for other developing countries.

The prevalence of HIV/AIDS in the LDCs has also steadily declined since 2000 and the number of people receiving treatment doubled between 2010 and 2014.<sup>18</sup> The prevalence of undernourishment stood at 40 percent in 1990 (the baseline) and dropped to 26.5 percent in 2015.<sup>19</sup>

## 2. LDCs remain vulnerable to external shocks and other risks

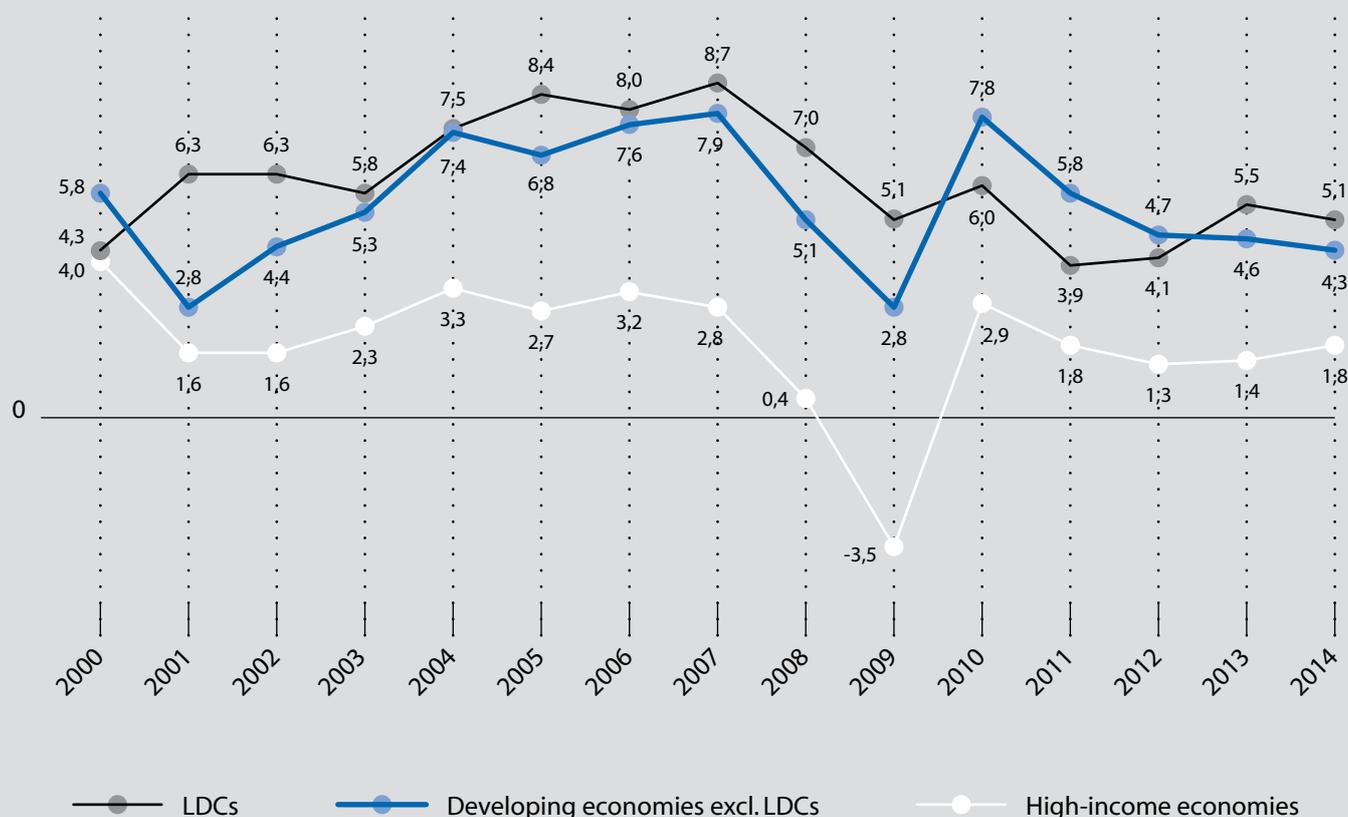
Despite important social and economic progress in many LDCs over the last 15 years, considerable challenges remain. Progress on many social indicators such as undernourishment has been better in Asian LDCs than in African LDCs and Haiti.<sup>20</sup>

Economic growth remains highly volatile in the LDCs with countries extremely vulnerable to external shocks such as sharp swings in term of trade, namely those linked to fluctuations in commodity prices, disasters linked to natural hazards, and disease pandemics (such as Ebola in West Africa).

Growth is also, on average, below the ambitious 7 percent target set out in the Istanbul Programme of Action (2011) and it is unlikely that they will meet the IPoA target of enabling half of all LDCs (24 countries) to meet the criteria for “graduation” by 2020 (see box 3). LDCs may have weathered the ‘storm’ created by the 2008 financial and economic crisis relatively well, but the crisis also underscored how LDCs’ economic performance is closely intertwined with that of the global economy as a whole (see figure 3). Thus a major challenge for LDCs in the implementation of the 2030 Agenda is the extent to which world economic growth is strong and sustained.

Figure 3. Annual Real GDP Growth in LDCs and other country groups

Source: UNCTAD, 2016



When it comes to domestic and international financial flows, there are also a number of key challenges. Domestic resource mobilization has largely plateaued since 2011 and is now stagnating in many countries as a percent of GDP. In the LDCs, tax to GDP ratios stood at on average 18 percent in 2015 compared to 22 percent for developing countries as a whole (see [figure 11](#)). While there may be some scope for revenue increases in countries emerging from conflict or which for other reasons have had a very low level of revenue collection, this would still be insufficient to meet the resource requirements of the 2030 Agenda. And while FDI to the LDCs has increased over recent years, there are large differences between countries; 5 LDCs – Mozambique, Zambia, United Republic of Tanzania, Democratic Republic of the Congo and Equatorial Guinea – received close to 50 percent of total FDI to LDCs in 2014 with most of this investment channelled to the extractive sectors.<sup>21</sup>

In this context, LDCs remain heavily dependent on ODA. For the LDCs as a whole, concessional official finance represents the bulk

of external financial resources, accounting for 62 percent of total external finance in 2014. By contrast, in other developing countries, concessional finance represents only 11 percent of total external finance.<sup>22</sup> Paradoxically, the share of ODA allocated to LDCs has declined over recent years. In 2014, total ODA to LDCs amounted to US\$ 41 billion, equivalent to 0.09 percent of donor countries' Gross National Income (GNI), well below the UN target of allocating at least 0.15 percent of GNI to the LDCs as ODA.<sup>23</sup> Moreover, ODA is heavily concentrated in a few LDCs (e.g. Afghanistan, Ethiopia and Mozambique) while others remain aid 'orphans' (Guinea-Bissau, Madagascar and Togo).<sup>24</sup> Many are also heavily dependent on migrant remittances as a major source of foreign exchange; remittances amounted to US\$ 38 billion in 2014, an amount that is almost as much as the amount of development aid received (at US\$ 41 billion) and higher than FDI inflows (at US\$ 23 billion for the same year) (see [figure 16](#)).<sup>25</sup>

Some LDCs have also benefited from additional official financial flows (the OECD's

**Figure 4. Composition of external finance in LDCs and other developing countries**

Source: OECD, 2015



so-called OOFs category – Other Official Flows) which are predominantly non-concessional financial flows.<sup>26</sup> These amounted to about US\$ 3.5 billion in 2014 to the LDCs, although this figure may exclude some flows which are regional in scope and/or that are otherwise uncategorized.<sup>27</sup> While they are currently quite small (LDCs received just 5 percent of OOFs in 2014), new changes to the ways in which donors will ‘count’ various official financial flows from 2018 may lead to increases in this kind of assistance in the future (see [box 5](#)).

### 3. The transformation challenge underlying the 2030 Agenda

The 2030 Agenda for Sustainable Development calls for a transformation of all economies – rich and poor alike – to move the world towards sustainable development pathways. The 17 Sustainable Development Goals introduce a radical change in the scale and ambition of both individual countries and collective action.

#### Box 2. Vulnerabilities and sources of risk

LDCs as a whole have a weak capacity to cope with shocks and stresses, both at the micro and macro level. At the micro level, households are often forced to sell assets to generate income at a time when everybody is doing the same, leading to fire-sale prices that generate little income. At the same time, prices for food and other essential services can often sky-rocket. These kinds of risk coping strategies erode, in turn, the capacity of families to respond to the next shock, given that they have already depleted their meagre assets. At the macro level, volatile and low public revenue makes it difficult for governments to implement risk-coping mechanisms, like countercyclical fiscal measures. This relates in part to the challenge of addressing the structural drivers of economic and environmental vulnerability, including to natural hazards: lack of economic diversification, in particular a high reliance on primary goods production and export, a narrow fiscal base, and weak institutions.

Amidst these vulnerabilities lie the prospects of heightened risks in the future. These include those linked to the effects of climate change and the continued erosion of environmental assets. Climate change poses particularly significant risks. Poor coastal populations in the poorest countries are among the most vulnerable to sea-level rises and to extreme weather events.<sup>28</sup> The effects of Cyclone Pam, which devastated Vanuatu in 2015, show the devastation that can be wreaked across an entire country by one extreme weather event. The category-five cyclone took eleven

lives, displaced a quarter of the population and destroyed a large share of Vanuatu’s housing stock, infrastructure, tourist facilities, crops, and livestock. Damage and losses to the economy were estimated at more than 60 percent of GDP.<sup>29</sup>

Conflict, insecurity and violent extremism represent additional sources of risk across many LDCs. For instance while West Africa has made impressive human development progress, a recent rise in conflict and violence in some countries (e.g. Mali) as well as violent extremism, and illicit activities (piracy, drug trafficking) has put enormous strain on state institutions and undermined development.<sup>30</sup>

In many LDCs there are also considerable challenges related to demographic trends. The population of the LDCs is expected to nearly double and increase to 1.67 billion between today and 2050. This will result in a large and growing youth population (the average fertility rate of the LDCs is about 4.4 compared with 2.5 in other developing countries). About 60 percent of the population in LDCs is currently under the age of 25, and the number of young people in the LDCs will increase by more than 60 percent over the next 40 years. Young people can be a driver for economic growth and social progress if they enjoy health, education and employment. Young girls are a particularly vulnerable group, but they can also be a very important agent of change if empowered.<sup>31</sup>

### Box 3. Graduating from LDC Status

Every three years, a group of independent experts (the Committee for Development Policy –CDP), recommends to the UN which countries should be added to the LDC list or conversely which can graduate from it. Until now, only four countries have graduated from the LDC category: Botswana in 1994, Cape Verde in 2007, the Maldives in 2011 and Samoa in 2014. The Istanbul Programme of Action set the target of bringing half of all LDCs to meet the criteria for graduation by 2020. During the SDG-period, graduation from LDC status is expected to accelerate. Indeed, the CDP has already recommended four LDCs for graduation: Equatorial Guinea (to graduate in 2017), Vanuatu (2020), Angola (2021) and Tuvalu (graduation date is not set yet). An additional six countries are approaching graduation: Bhutan, Kiribati, Nepal, São Tomé and Príncipe, Solomon Islands, and Timor-Leste.

While this development progress is to be welcomed, it is important to emphasize that vulnerabilities do not ‘vanish’ overnight on meeting the criteria for graduation. Six of the graduating countries are also Small Island Developing States (SIDS), which are highly vulnerable to environmental degradation, climate change and other shocks and disasters. Five are also considered fragile states (namely Kiribati, São Tomé and Príncipe, Solomon Islands, Timor-Leste and Tuvalu) while three (Kiribati, São Tomé and Príncipe and Tuvalu) are also considered at high risk of debt distress.<sup>32</sup> Economic diversification also remains weak which further adds to these countries’ continued vulnerabilities.

Many LDCs speak of the need for the “structural transformation” of their economies and cite, in particular, the need for a step-change in infrastructure investment and technology transfer to enable this transformation. Investments in infrastructure that is ‘sustainable’ will be especially critical. This will need to be accompanied by major investments in areas such as peace and security, health and education, agriculture and nutrition, local private sector development and environmental protection amongst other areas to ensure that the 2030 Agenda aspiration to “leave no one behind” is met.

For the poorest countries – where private investment is still extremely low – these massive investment needs cannot be met through domestic resources and ODA alone. This signals a need to find ways to catalyze other sources of finance – in particular from the local and international private sector – with official sector financiers playing a supportive role in this effort. It is clear however that this will not be easy in a context where countries are subject to numerous downside risks and capacities are weak.

Constraints to private sector investment are also linked not just to the amounts of finance available, but to a variety of other factors that include economic and political instability, crime and corruption, weak institutions, domestic tax structures and poor business regulations. Add to this a weak capacity to identify, develop and implement high quality ‘bankable’ projects for both public and private investment. These factors affect private (and also public) investors’ perceptions of risk leading to increased financing costs and lower expected rates of return on investments (it should be noted however that risk perceptions are often excessively amplified).

Policies to remedy these challenges have traditionally focused on strengthening institutions and policies, but attention has shifted more recently to the ways in which financial innovations and instruments can be used to deepen domestic capital markets, strengthen the capacities of the domestic financial sector and meet the needs of underserved businesses such as small and medium-sized enterprises which can, if supported, be major catalysts for economic development.

Meeting the aspirations of the 2030 Agenda in the LDCs also implies addressing vulnerabilities and managing risks. Shocks are often the reason why families slide back into poverty or countries slowdown or even see reversals in hard won development progress.

Vulnerability to shocks is one of the key criteria used to determine which countries are considered LDCs. When a major shock occurs (such as a natural hazard that wipes out infrastructure or a health shock such as Ebola in West Africa) there is typically a need for more public spending. While the international community will usually supply some aid, this is ordinarily insufficient and countries will also take-on new debt. One of the consequences of shocks in LDCs therefore is that countries are left with high burdens of debt (see [box 4](#)). The response of the international community to high indebtedness is ad-hoc and on a case-by-case basis (debt relief was granted

to the Ebola affected countries, for instance).<sup>33</sup> It makes sense then that financial instruments designed to support countries to manage their exposure to risk – and in particular those which ex-ante trigger automatically downward adjustments in debt service during shocks – may be especially useful to LDCs.

For the LDCs which lack, by and large, access to international capital markets, there is a key role for the official sector to use different financial instruments in ‘smarter’ ways to catalyze additional public and private investment in the LDCs, strengthen local actors and to use financial innovations to reduce vulnerability. In the next section, we explore some of these financial instruments and discuss the opportunities they may offer to LDCs to both mobilize more financing for sustainable development as well as more effectively manage their continued vulnerability.



Photo: Tom Cheatham/UNDP Myanmar

## Box 4. Debt sustainability in the LDCs

For many Least Developed Countries, the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) dominated public debt dynamics in the late 1990s and 2000s.<sup>34</sup> In total, 31 LDCs were also classified as HIPCs (see annex for complete list). The HIPC and MDRI initiatives combined extended over US\$ 88 billion in debt write-downs to these 31 heavily indebted LDCs.<sup>35</sup> The schemes helped beneficiary countries to not only reduce their debts to a more manageable level but also to increase poverty reduction expenditures by on average three percentage points of GDP.<sup>36</sup> Notwithstanding these important successes, many countries complained that the debt relief process was both lengthy and involved heavy conditionality. In many cases, debt relief took many years to be delivered and was dogged by multiple delays.<sup>37</sup>

Today, many LDCs have low to moderate public debt burdens. In 2014, external debt was on average 33 percent of GDP in the LDCs. This is lower than the ratio for developing countries as a whole which stood at 43 percent of GDP in the same year.<sup>38</sup> Debt ratios are however on the rise across many countries and debt vulnerabilities remain high. The IMF has classified one LDC (Sudan) as in “debt distress” with a further nine at “high risk” and 24 at “moderate risk.”<sup>39</sup>

Extreme weather events and the recent financial and economic crisis have all adversely affected debt ratios in many LDCs. Hurricanes/Cyclones and other disasters can lead to costly relief and reconstruction programmes, much of which is funded by new debt. The recent financial crisis meanwhile led to slowdowns in economic growth and increased borrowing to finance fiscal stimulus programmes. Even in “normal times”, many LDCs have taken on more debt recently to finance both capital and current spending as they attempt to grow their economies.

In many cases, these expenditures have been financed via commercial debt and in particular domestic debt. 26 LDCs in Sub-Saharan Africa now have active domestic debt markets.<sup>40</sup> Eight LDCs meanwhile have issued bonds on international capital markets, several for the first time over the last few years.<sup>41</sup> The challenge however is that private debt typically carries short maturity profiles and is more expensive than official sector debt.<sup>42</sup>

When it comes to official finance, the empirical evidence suggests that since 2010, financing terms have ‘hardened’ for some low-income countries deemed at ‘low risk’ of debt distress. Some bilateral and South-South providers have restarted lending to such countries, or offered mixed grants and loans on the grounds of ‘renewed creditworthiness’. And while policies and procedures vary across the multilateral development lenders, ‘graduation’ to middle-income status typically implies harder terms on concessional loans, followed by a ‘blend’ of concessional and non-concessional financing and finally a full switch to non-concessional finance.

Development Finance International recently showed that many LDCs will experience sharp ‘spikes’ in their debt service burdens over the next few years, especially those that have borrowed substantially on non-concessional terms as well as those that have experienced conflict shocks. For example, Bangladesh, Ethiopia, Mozambique, South Sudan, Tanzania, Uganda, Yemen and Zambia are projected to have debt service to revenue ratios of between 20 to 35 percent by 2017. While Rwanda currently has a low debt service to revenue ratio, this will increase to about 25 percent once its Eurobond matures in 2023.<sup>43</sup> For low-income countries, it is worth noting that the IMF and World Bank recommend that debt service should not exceed between 18 – 22 percent of gov-

ernment revenues depending on the “strength” of countries’ policies and institutions.<sup>44</sup>

Despite these concerns, there are a number of key new positive developments for improved debt prevention and management. These include the IMF and World Bank’s debt sustainability framework for low-income countries (which monitors debt ratios and provides an assessment as to countries’ risks of over-indebtedness) and a strengthened focus on technical assistance by the Bretton Woods institutions to help countries develop debt strategies and to manage their debt loads effectively.<sup>45</sup> A broader suite of risk management products (such as weather and disaster insurance and local currency financing) also now exists.

Notwithstanding these advances, LDCs’ debt payment capacities remain weak: economies remain undiversified; exports and budget revenue remain too dependent on (volatile) commodities; tax revenues remain flat; and external shocks have reinforced vulnerability and volatility for many countries. Debt sustainability analyses (DSAs) – though well-intentioned – can never be perfect predictors of future debt crises.<sup>46</sup>

Lessons from previous debt crises underscore how there has been an almost universal over-optimism as regards commodity prices and the high-returns that large-scale costly infrastructure projects are likely to generate. Governments and international financial institutions have also tended to underestimate the long-term negative effects of major shocks and the importance of robust and sustained economic growth in developed economies. As LDCs seek to diversify their sources of development finance, it is essential that these instruments are adapted to their specific circumstances and needs and that they fully take on board the lessons learned from the past.



Photo: Stanislas Fradelizi/World Bank Lao People's Dem. Republic

# II. MOBILIZING FINANCE TO ADDRESS LDCS' SUSTAINABLE DEVELOPMENT CHALLENGES

## Seizing the opportunities of a sophisticated development financing tool-box

Today's development financing landscape is complex and fast-evolving encompassing a wide variety of actors (public and private, national, sub-national and local etc.), with different constituencies (taxpayers, shareholders, trustees etc.), different motivations (development, profit or both), and a multiplicity of financial instruments (grants, loans, guarantees, insurance etc.). [Figure 5](#) provides a snapshot of some of the most well-known and important financing sources and instruments, although there are many more.

The demands of the 2030 Agenda call for utilizing a diversity of financing instruments according to their relative strengths and complementarity. Official finance providers have a particular role to play (and a responsibility) to support the poorest countries to make use of these diverse fi-

nancing instruments in ways that are responsible, minimize risk and secure maximum development benefits for low-income vulnerable countries. Public initiatives and public finance have also been critical to launch and pilot many recent innovative financing initiatives. This shows the importance of public policy and public finance in driving financial innovation and creating instruments that are eventually picked-up by capital markets and private investors.

In this section, we look at a range of financial instruments that have emerged and matured over recent years, and explore the extent to which they could be used – or are already being used – in the LDCs to support sustainable development. What are the experiences so far with these instruments and what are the opportunities and risks looking forward?

It would be impossible to examine the full spectrum of financial innovations and tools now in existence. This paper therefore discusses only a selected few. These are: blended finance; guarantees for development; local currency financing; green and blue bond financing; GDP-linked bonds; and counter-cyclical loan instruments.

They have been selected because they have the potential to meet development needs that characterize most LDCs. These include the need for finance at-scale to invest in infrastructure, the need to support the development of the do-

mestic private sector and to invest in local actors, as well as a need to address an on-going vulnerability to shocks and stresses of various kinds.

It is also likely that many of these approaches will expand over the coming years. Green finance, as our analysis shows, is an area that is experiencing a considerable boom. Recent changes to the ways that OECD donors will ‘count’ and report on various forms of official sector support are also likely to change donor incentives and lead to an increase in the use of instruments such as guarantees, for example (see [box 5](#)).

**Figure 5. What’s in the financing tool-box?**

Source: Authors<sup>47</sup>

<b>Bonds</b>	<b>Loans and guarantees</b>	<b>Public revenue</b>	<b>Insurance</b>	<b>Funds</b>	<b>Grants</b>
Sovereign bonds issued on international and domestic markets	<b>Loans</b> <i>Including:</i> <ul style="list-style-type: none"> <li>• Multilateral and bilateral development banks (MDBs)</li> <li>• Other Official Flows (OOFs)</li> <li>• Counter-cyclical loans</li> <li>• Contingent credit facilities</li> <li>• Development policy loan deferred drawdown options</li> <li>• Catastrophe risk deferred drawdown options</li> <li>• Debt buy-backs</li> <li>• Debt-swaps</li> <li>• Blended finance</li> <li>• Public-private partnerships</li> </ul> <b>Guarantees</b>	<b>Taxes and levies</b> <i>Including:</i> <ul style="list-style-type: none"> <li>• Income taxes</li> <li>• Value added/ consumption tax</li> <li>• Property taxes</li> <li>• Tariffs</li> <li>• Green taxes</li> <li>• Domestic financial transaction tax</li> <li>• Airline ticket tax</li> </ul>	<b>Weather index-based insurance</b>  <b>Catastrophe Risk Insurance Facility</b>	<b>Vertical Funds</b> <i>Including:</i> <ul style="list-style-type: none"> <li>• GAVI Alliance</li> <li>• Global Fund (and UNITAID)</li> <li>• Adaptation Fund</li> <li>• Global Environmental Facility (GEF)</li> </ul> <b>Green Climate Fund</b>  <b>Securities and structured funds</b>  <b>Microfinance investment funds</b>	<b>Official Development Assistance (ODA)</b>  <b>Philanthropic and other private donations</b>
Diaspora bonds					
GDP-linked bonds					
Green/blue bonds					
Social impact bonds					
Development impact bonds					

## Box 5. The Modernization of ODA and the new measure “Total Official Support for Sustainable Development”

In late 2014, OECD DAC donors decided to “modernize” the definition of ODA and in particular revise the ways in which concessional loans are counted so as to more accurately measure and compare donor “effort”.

According to existing rules, once a loan reached a minimum threshold of concessionality, all were “counted” in the same way, irrespective of the size of the concessional component of the loan or the level of development of the beneficiary country.

Looking forward, only the grant element of the loan will be counted as ODA, and different concessionality thresholds have been established for countries at different income levels; loans to LDCs must have a higher grant element to qualify as ODA whereas loans to middle-income countries can have lower grant elements. So in future, loans to LDCs and other low-income countries must have a grant element of at least 45 percent to qualify as ODA, while the minimum grant element for lower middle-income and upper middle-income countries has been lowered to 15 and 10 percent respectively.

The new system will come into effect from 2018 and will create an incentive for donors to allocate more loans to LDCs rather than to other income categories since these loans “yield” more ODA.<sup>48</sup>

Negotiations in the OECD DAC are also taking place around how the ODA measure can better ‘count’ the ways in which other forms of official support help development, such as guarantees and equity.

This measure is not intended to replace ODA but aims to measure all forms of international public finance and their effect on the volume of private sector resources (mobilized through official sector interventions).<sup>49</sup>

## 1. Raising ‘big-ticket’ finance and strengthening capacity with blended finance

Interest in ‘blended’ finance has mushroomed over recent years and it is one of most dynamic fields in the financing for development arena. There are a host of actors now involved in blended finance, from bilateral development agencies to multilateral development finance institutions and philanthropic foundations. Many are also keen to expand their activities in this arena; they see in blended finance an opportunity to scale up both public and private financing for developing countries in an overall context where public resources for development are constrained.

There is no universal definition of ‘blended finance’ but it is broadly understood as the strategic combination of public and/or private development finance flows (e.g. aid and philanthropic funds) with other public or private capital to enhance resources for investment in key areas such as infrastructure. Blended finance can therefore involve public-public financial partnerships as well as public-private partnerships.

The rationale behind blended finance is threefold: (i) to increase capital leverage (aid and philanthropic funds are used to attract/mobilize additional public or private capital); (ii) to enhance impact (the skillset, knowledge and resources of public and private investors combined can increase the scope, range, and effectiveness of

the project), and (iii) deliver risk-adjusted returns (manage risks so that returns are in line with market expectations).<sup>50</sup>

The “grant” element in blended finance packages can be used in a variety of ways. This includes: technical assistance (e.g. for project preparation services, and to provide advice/training to public or private investees to lower transaction costs); risk underwriting (to fully or partially protect the investor against various forms of risk); market incentives (to provide guaranteed future payments to investors in exchange for upfront investment in new or distressed markets, or to stimulate innovation around new products or services).<sup>51</sup> These characteristics make blended finance a very versatile tool and in many ways a “tool-box” in itself.

For instance, the aid agency-backed Infrastructure Project Preparation Facility (IPPF) managed by the African Development Bank (AfDB) provides grants for infrastructure project preparation activities in Africa.<sup>52</sup> By funding project preparation studies and technical advisory services, IPPF has helped to catalyze public and private financing for critical infrastructure development in energy, water, transport, and information and communication technologies (ICT). Public investors can also participate in blended finance transactions by providing equity or debt

financing at market rates and terms, and in many cases, below-market rates and/or terms to incentivize private finance.

Much blended finance has been used to support investments in infrastructure development. The European Commission has used blending facilities for example to fund projects in the fields of: energy (35 percent), transport (26 percent), water (20 percent), support to SMEs (small and medium-sized enterprises) (11 percent), the social sectors (5 percent), and ICT (3 percent).<sup>53</sup>

Examples of the EU’s blended financing facilities include the EU-Africa Infrastructure Trust Fund (EU-AITF), the Asia Investment Facility (AIF), the Investment Facility for the Pacific (IFP), the Neighbourhood Investment Facility (NIF), the Latin America Investment Facility (LAIF), Caribbean Investment Facility (CIF), and the Investment Facility for Central Asia (IFCA).<sup>54</sup> They aim to increase investment principally in infrastructure by blending grants with long-term loans from participating public or private financiers. Grants from these blending facilities can take four different forms: technical assistance to help with the preparation and management of projects; interest rate subsidies; direct grants or investment grants to finance a project component (equipment or services); financial

## Box 6. Catalyzing resources for biodiversity through blended finance: UNDP in Central America

Source: UNDP

In partnership with the Central American Bank for Economic Integration (Banco Centroamericano de Integración Económica – BCIE), UNDP is utilizing blended finance to help catalyze biodiversity-friendly investments in Central America. By blending aid from the Global Environment Facility with the lending facilities of over 30 financial partners, the Central American Markets for Biodiversity project provides funding to small and medium-sized enterprises that integrate the protection and conservation of biodiversity in their business, products and services. The sectors served include agroforestry, organic agriculture,

sustainable forest management, certified aquaculture, sustainable tourism and sustainable fisheries.<sup>55</sup> Funding from the Global Environment Facility enables local financial institutions to provide soft lending to local businesses and entrepreneurs to support them to develop and expand their activities. It is matched with technical assistance for both the businesses served by project as well as the financial intermediaries that serve them. The project is an example of how blended finance can support sustainable development in small low-income countries.

## Box 7. Blended finance for small-scale water and electricity system suppliers, Cambodia<sup>56</sup>

Source: AFD

In 2013, AFD extended a loan of US\$ 15 million accompanied by a risk-sharing guarantee to Foreign Trade Bank, a Cambodian bank, for the financing of small-scale electricity and water suppliers in rural and semi-rural areas. The project received a further US\$ 3 million from the Asian Investment Facility and the European Union.

A large majority of the Cambodian population lives in rural or semi-rural settings, and more than half of all households in these areas do not have access to basic water or electricity services. Improving access to these basic services constitutes a major challenge for social and economic development in the country.

In the absence of public suppliers in rural and semi-rural areas, the private sector has become involved in an ad hoc and spontaneous manner, for instance in the financing and management of the water supply and access to electricity. The further development of these suppliers is however constrained due to a variety of factors which include a limited access to credit from local banking institutions, as well as a lack of management skills and technical expertise.

The objective of the AFD supported project is to strengthen the development of small private sector suppliers in the electricity and water sectors by enhancing their access to credit and by strengthening their technical and financial skills. Through the provision of an enhanced credit line combined with a risk-sharing mechanism implemented in partnership with Foreign Trade Bank, the project supports the creation of financial products and services adapted to the needs of the local private sector, namely a reduction in interest rates, longer maturities and deferred payments.

The project also includes a technical assistance component to support local banks to strengthen the quality of their services and to provide expertise in developing high quality business proposals in the water and electricity sectors. Training in other areas also helps to build the technical and financial capacities of small-scale suppliers.

instruments, such as loan guarantees, insurance premiums and equity or quasi-equity investments or other risk-sharing instruments. Leading development finance institutions engaged in blending include the European Investment Bank (EIB), the European Commission, the French Development Agency (AFD) and the German development bank (KfW) and the European Bank for Reconstruction and Development (EBRD).

The AFD and UNDP examples cited above demonstrate how blended finance can simultaneously support the development of the local private sector as well as deliver on other core sustainable development objectives such as the protection of biodiversity or access to water/energy, i.e. blended finance can be used to leverage “co-benefits” across different sectors.

Despite the potential of blended finance to significantly scale-up resources for sustainable development (in particular in the infrastructure sector) there are also a number of key challenges and constraints. Finalizing a blended finance package deal takes time – on average much more time than the disbursement of grant simply because of the number of financing instruments and institutions/entities involved. Other constraints include limited knowledge and awareness of such instruments and programmes, as well as limited technical capacities to structure, manage and execute these types of arrangement in a way that also takes into consideration the social and environmental impacts of the projects. These are present on both on the supplier side (i.e. within development finance institutions) as well as on the recipient side (i.e. within developing countries

and in particular the LDCs). The experiences with public-private partnerships in financing infrastructure have so far been mixed, especially in contexts where transactions were arranged in ways in which the public financing/risk went beyond initial expectations, resulting in a net transfer of public resources to subsidize private investors.

Some institutions and analysts have also urged significant caution when it comes to recommending less-concessional finance for developing countries, and in particular the LDCs where debt sustainability may be a concern and where capacities to negotiate and mobilize the best financing, identify and implement high-return investment projects which target diversification

and value-added are weaker.<sup>57</sup> It is also the case that some infrastructure investments, in particular in the small LDCs are unlikely to (ever) be commercially viable and may be less attractive to the private sector.

Blended finance and public-private partnerships offer the potential to use public resources to leverage additional capital and share risk, but are often complex to arrange in ways that serve the public interest. This happens everywhere, but it is particularly important to ensure that capacity exists to negotiate and structure these financing arrangements in developing countries, and particularly in the LDCs. Information asymmetries between national authorities in LDCs and

## Box 8. Sustainable Use of Natural Resources and Energy Finance (SUNREF)<sup>58</sup>

Source: AFD

SUNREF (Sustainable Use of Natural Resources and Energy Finance) is a blended green investment finance mechanism developed by AFD for deployment in LDCs and other developing countries.

The mechanism combines both financial and technical tools such as lines of credit to local financial institutions and technical assistance to develop project pipelines and strengthen local banking capacity.

SUNREF programmes support the local financing of energy efficiency and renewable energy investments, and of pollution control. Programmes help implement national policies on climate change and environmental protection by providing assistance to investors in project development, and to banks interested in financing the projects. Assistance includes energy audits, feasibility studies and the selection of efficient equipment. Financial institutions receive support to train their staff in sustainable development, in the technical analysis of projects and in structuring financial packages. To finance green project investments, AFD provides lines of credit to interested financial institutions, typically in the form of sub-sovereign debt.

In 2013, AFD deployed SUNREF in the West African Economic and Monetary Union. Today, technical and

financial partners are participating in Senegal, Côte d'Ivoire, Togo, Benin and Niger, while operations are under consideration in Mali and Burkina Faso. Projects include biomass/biogas development, efficient energy generation (heating systems, engines, refrigeration etc.), small solar plants for rural electrification, and solar equipment for hotels.

There are three caveats to bear in mind when it comes to this kind of initiative in the LDCs:

1. Technical assistance during the initial phase of the project is especially important. In particular, feasibility studies must be financed to ensure quality, a critical requirement for the financing institution in the initial stage.
2. Technical assistance should include capacity development for banks on the unfamiliar aspects of a pioneering activity. Training and multi-sector capacity building must convince local institutions that entering the new field of activity is worthwhile.
3. Lines of credit must offer affordable conditions. Demand for green investments must be stimulated by features such as subsidies and attractive financing conditions.

international investors, in particular, can lead to biased outcomes in favour of private investors. Thus, it is important to ensure that along with the promotion of blended finance, conditions are put in place to support LDCs to negotiate appropriate deals, and continuously invest in capacity to enable them to negotiate, monitor and expand these arrangements.

It is a market that is now maturing, and blended finance is becoming a recognized best practice to mobilize additional public and commercial capital for development projects. A considerable body of experience, evidence and expertise now exists. In the current context of transformation put forward by the 2030 Agenda, blended finance (when done well) represents an opportunity to mobilize considerable additional resources, especially for “big-ticket” items.

## 2. Enhancing access to credit with guarantees for development

Guarantees – a type of “insurance policy” that protects national or sub-national governments, banks and investors from the risks of non-payment or loss of value in case of an investment – have been a mainstay of financial markets all over the world for many years. Guarantees for “development” are those extended with the promotion of the economic welfare and development of developing countries as the principal objective.<sup>59</sup>

Guarantees promise indemnification up to a specified amount in the case of default or non-performance of an asset (e.g. a failure to meet loan repayments or to redeem bonds, or expropriation of an equity stake). There are many private providers of guarantees, but in many developing countries, and for certain types of risks, only public (national or multilateral) providers are available. This includes in particular political

risks. For commercial risks (e.g. credit, regulatory/contractual) that investors are unwilling or unable to bear there is usually a broader range of suppliers. All guarantees help the borrower to obtain financing at better terms than would be possible without the guarantee.

Guarantees for development are a valuable instrument for mobilizing resources from the private sector – be they from private companies, banks, individuals, non-governmental organizations (NGOs), investment funds or others. For a fraction of the potential cost of the risk exposure undertaken, considerable liquid resources can be deployed for investments to support economic development in the developing world. They can be used in a myriad of ways, such as: i) backstopping financing for large-scale, multiyear infrastructure projects; ii) lengthening the maturities of loans to small enterprises; iii) refinancing municipal utilities; iv) enabling local banks to enter new markets such as mortgage or microenterprise lending; or v) deepening capital markets by facilitating local-currency bond issues.<sup>60</sup>

Estimates from the OECD of the amounts mobilized from the private sector through guarantees between 2012 and 2014 exceed US\$ 21 billion, with roughly 15 percent of this amount being mobilized in LDCs. In terms of the *number* of guarantees issued, almost 40 percent of contracts issued benefited the LDCs between 2009 and 2011. However, in terms of *amounts* mobilized, more than 50 percent of the total resources mobilized went to upper-middle income countries. This suggests that contracts were significantly smaller in size in LDCs.<sup>61</sup> Geographically, Africa is the region to benefit most from this financial instrument.

The largest *country* issuers of guarantees for development are the United States, France, Austria and Sweden. The largest *multilateral* issuers are meanwhile the World Bank Group (specifically the Multilateral Investment Guarantee Agency – MIGA), the Islamic Development Bank, and the Private Infrastructure Development Group, but they are used by most MDBs.

Guarantees are undergoing a rapid evolution which may provide important opportunities for LDCs. New combinations of donor agencies and philanthropic investors have been emerging over the last decade. Philanthropic investors for instance have become new partners to the official sector. They typically have a private sector approach and structure their investments with a first loss platform to achieve high social returns in exchange for assuming substantial downside financial risks. They are willing to take the riskiest part of the capital structure, which is typically equity or quasi-equity. They use this base to attract others to less risky layers of a fund (and for which they will receive a more limited return). These investors are used to seeing “waterfall” financing models where loan tranches are structured according to risks. Guarantees are thus associated with a wide range of financing vehicles – bonds, loans, equities, insurance – and are also designed to mobilize private sources from the entire spectrum of the economy.

According to OECD estimates, 40 percent of the resources mobilized by guarantees has targeted banking and financial services, backstopping lines of credit for small- and micro-enterprises, mortgage finance, rural credit co-operatives, small farmers associations and industrial refinancing, amongst other areas.<sup>62</sup> This is followed by energy, infrastructure and industry.<sup>63</sup>

If guarantees are such an attractive instrument, why are they not used more widely? Despite recent increases, their use remains overall rather limited.

There are constraints on both the supply and demand sides. On the supply side, most guarantee products are more complex instruments than loans and generally require more resources to structure and execute, with the possible exception of standard political risk guarantees. This can increase costs. Excessive bureaucracy in the due diligence process is also recognized as a major constraint and disincentive for banks. Consequently, their use is more limited and best-fit larger scale projects. The new TOSSD measure under development by the OECD which will

### Box 9. Alliance for a Green Revolution: Unlocking credit for small farmers

Source: AGRA

The Alliance for a Green Revolution (AGRA)'s Innovative Financing Program is unlocking millions of dollars worth of low-cost credit for smallholder farmers and small agricultural businesses previously considered too risky for lending, giving them unprecedented opportunities to invest in growth. AGRA and other partners (which include bilateral aid agencies, multi-lateral financial institutions, philanthropic foundations and private companies) assemble “loan guarantee funds” that leverage much larger loans from commercial banks. The loan guarantee funds are available to insure against loan defaults. The programme also partners with financial services providers to develop and offer affordable and appropriate saving, borrowing and insurance products and is also combined with financial literacy training for farmers and farmers' organizations.

This initiative has been particularly important to African LDCs; of the 13 programme countries so far, 10 are LDCs.<sup>64</sup>

capture (and give donors' credit for) instruments such as guarantees may incentivize their increased use in the future (see box 5).

On the demand side, despite their advantages, there are also transaction costs for borrowers. Guarantees by themselves also cannot overcome problems inherent to a poorly-designed project or an un-creditworthy borrower. These challenges may be particularly acute in the LDCs. In this context, many experts believe that use of this kind of instrument needs to be part of a broader effort to build the capacity of both banks and SMES; on the one hand banks need to be able to better understand and assess risk and on the other hand, SMEs as borrowers need to better understand how to manage cash flows and assess financing needs. Guarantees alone won't make the difference, if technical assistance or capacity building programmes are left outside the tool-box.

As with blended finance there is a key role for the official sector. Bilateral donors and multilateral financial institutions are particularly well-suited to providing guarantees for developmental purposes: they have relationships with governments over extended periods of time; a strong understanding of the political risks specific to developing countries; the personnel and knowledge to be able to undertake close assessments of a project (including support in project design); and the ability to assess a borrower's ability to pay.<sup>65</sup>

### 3. Financing local investment and SMEs, while strengthening financial institutions with local currency lending

Many national and multilateral development banks (MDBs) now issue loans in local currencies, either directly to national or sub-national authorities, and/or to the local private sector.

The expansion in local currency financing has been driven by a heightened awareness of the risk of borrowing in foreign currencies combined with the need to find better ways to finance sub-national entities and small- and medium-sized companies in the private sector. For governments and firms whose income is denominated mostly in local currency, borrowing in other currencies can lead to a currency mismatch, exposure to real exchange rate volatility and a vulnerability to depreciation. Local currency financing can also stimulate and encourage the development of local capital markets. Sub-national authorities and private sector borrowers often have more limited access to international or local capital markets, which result in limited amounts of project financing at higher costs and shorter maturities. Local currency financing can create more liquidity in the real economy, improve access to finance at reasonable cost, enable loan maturities to be extended and thereby improve the creditworthiness of projects that generate only local currency income.

Local currency financing can be made available in the form of a loan or a local currency swap



Photo: Yosef Hadar/ World Bank Madagascar

(where borrowers can transform existing or new foreign denominated liabilities into local currency). Local currency financing is typically accompanied by other financial products such as partial credit guarantees and risk-sharing facilities. The International Finance Corporation (IFC) is a major player in local currency financing. Bilateral and multilateral development partners are also supporting some LDCs to develop local currency bond markets (LCBMs) by providing “anchor” investments in local currency bonds issued on domestic capital markets.<sup>66</sup>

While marginal when compared to the amount of local currency lending made to emerging economies, local currency financing to some LDCs has been gaining momentum over the last decade. In 2008, IFC committed its first local currency loans in Zambia, while local currency financing for micro-finance or micro credit is gaining momentum among development finance institutions (see [box 10](#)). IFC has also issued debt denominated in West African CFAs, while the African Development Bank is now issuing loans in the West African CFA, Tanzanian Shilling, Ugandan Shilling and Zambian Kwacha.

While there are many benefits associated with local currency financing, there are also several challenges. Local currency financing raises some liquidity and risk management issues for the lenders, which they generally do not face when they borrow and lend in convertible currencies. These risks include lenders’ exposure to a financial loss due to potential movements in exchange rates, credit (default) risk as well as the risk that lenders may not be able to secure the local currencies when the borrower wishes. International demand for local currencies may also fluctuate. These challenges can increase interest costs associated with local currency financing. For these reasons, lending in local currencies is also more difficult (and indeed may be impossible) in the smallest LDCs.

Nevertheless, expanding local currency financing can represent an important tool to reduce sovereigns’ and firms’ exposure to currency move-

ments, expand access to finance and to strengthen the domestic private sector. In most LDCs, a shortage of long-term, local-currency financing for small-scale infrastructure and other projects impedes local economic development. As with other financial instruments, local currency financing will be most effective when it is combined with technical assistance and capacity development support from LDCs’ development partners.

### **Box 10. New lending facility to finance African agricultural enterprises**

*Source: LAFCo and Root Capital<sup>67</sup>*

Announced at the 2015 Grow Africa Investment Forum during the World Economic Forum on Africa, the Lending for African Farming Company (LAFCo) aims to increase smallholder farmer productivity and incomes through better integration in local and regional agricultural value chains, and improved access to formal markets. With a seed commitment from Germany’s Development Bank (KfW), and additional investment by AgDevCo (a social impact investor and agribusiness project developer), LAFCo will accommodate the working capital needs of agricultural enterprises. It will be managed by Root Capital (a non-profit social investment fund that provides loans and financial training to small agricultural businesses in Africa and Latin America) and will provide lines of credit and other flexible debt products in amounts of up to US\$ 4 million, denominated in both U.S. dollars and in local currencies.

## **4. Financing sustainable development with green and blue bonds**

“Green” finance is an area that has experienced a considerable boom over recent years. A plethora of funds, programmes and initiatives now exists in this area, such as the Global Environment Facility, the UN REDD Programme, the Adaptation Fund and most recently the Green Climate Fund.<sup>68</sup>

One area in the green finance domain that has experienced a particularly rapid rise is that of so-called “green bonds”. “Green bonds” are instruments which tie the proceeds of a bond issue to environmentally-friendly investments. They are a relatively new financial instrument but one which has experienced substantial growth over recent years. Issuers of bonds can be private companies, supranational institutions (such as multilateral banks) and public entities (municipal, state or federal). The Climate Bonds Initiative estimates that bonds explicitly labelled as “green” which earmark 100 percent of their proceeds to a specific environmental purpose or project amounted to US\$ 65.9 billion in 2015. A further US\$ 531.8 billion of bonds were issued whose proceeds were used to fund climate/environment solutions but which did not explicitly carry the “green” label.<sup>69</sup>

Multilateral development banks and corporates have been the largest issuers of labelled green bonds to-date. In 2014 and 2015, the European Investment Bank issued US\$ 11.6 billion, the World Bank US\$ 8.5 billion and the German Development Bank (KfW) US\$ 4 billion. Other multilateral development banks have also issued labelled green bonds.<sup>70</sup> In the industrialized world, green bonds issued by municipalities have become a key part of the market. Energy, low-carbon buildings and transport-related projects are the most popular projects to fund with more than 38 percent allocated to the financing of renewable energy initiatives. Several large emerging economies such as Brazil, China, India, Mexico and South Africa have also built dynamic green bond markets at the domestic level over recent years.<sup>71</sup>

The world’s largest issuer is currently the European Investment Bank. It supports mostly energy projects in high-income countries with its “Climate Awareness Bonds” although it has used this financial instrument in one LDC – Liberia – to support the rehabilitation of an inoperative hydro-power plant (Mount Coffee Hydro Generation).<sup>72</sup>

The World Bank is also a major player and reports that as at end-2015 it had carried out over 100 green bond transactions in 18 curren-

cies, supporting about 70 climate adaptation and mitigation projects in the developing world with the proceeds.<sup>73</sup> The vast majority of these have supported projects in large middle-income countries with Timor-Leste being the only LDC to benefit so far from financing raised through World Bank Green Bonds. In Timor-Leste, green bond financing has been used to rehabilitate and improve the climate resilience of a major road corridor susceptible to damage from frequent floods, heavy rains and landslides.<sup>74</sup>

Other multilateral development banks have also started to use this financing modality over recent years. The African Development Bank established its “Green Bond Program” in 2013 to finance or co-finance projects in the areas of renewable energy, energy efficiency, emissions reductions and waste management, amongst other areas.<sup>75</sup> Thus far, projects in three LDCs – Rwanda, Uganda and Zambia – have been supported with the proceeds of green bond issuances.<sup>76</sup> In 2015, the Asian Development Bank launched a programme in this area with a US\$ 500 million inaugural green bond issue that aims to channel more investor funds to Asian Development Bank projects that promote the transition to low-carbon and climate resilient growth.<sup>77</sup> Large middle-income countries such as China, Indonesia and the Philippines have benefited so far from this financing.<sup>78</sup>

Green bond issuers have tapped into a broad spectrum of investors that include pension funds, insurance companies, asset managers, companies, foundations and religious organizations. The World Bank reports that as issuances have increased in size, the types of investors have also become increasingly diverse. Investors’ appetite for these types of securities can also be expected to increase in the future. Several major international banks have recently established dedicated funds to invest in socially and environmentally focused activities such as green bonds. The Climate Bonds initiative reports that most issuances are heavily oversubscribed as investors with over US\$ 45 trillion in assets increasingly make public commitments to climate and responsible investment.<sup>79</sup>



Photo: Tom Perry/World Bank Vanuatu

“Blue” bonds are a variation on this theme with particular relevance to Small Island Developing States (SIDS) and countries with large coastal areas. Modelled on green bonds and pioneered by the Seychelles, blue bonds target socially and environmentally responsible investors, with the proceeds used to fund investments in sectors such as sustainable fisheries development. The Seychelles plans an initial sale of US\$ 10 million in 2016 with the involvement of the African Development Bank and World Bank to help reduce costs and ensure an affordable interest rate. If successful, the Seychelles hopes to expand the project further in the future and incorporate other Indian Ocean island states, such as Comoros, Madagascar and Mauritius (the former two countries being LDCs).

International and national development banks have been the ones to kick-start and shape the green bond market. Public issuance has been essential to establish models, provide initial market liquidity and educate investors about this asset class. They have also been more easily able to

absorb some additional transaction costs associated with these bonds because issuers must track, monitor and report on the use of the proceeds during the lifetime of the bond. In this respect, a series of (voluntary) standards and principles has emerged for both issuers and investors as to what defines a bond as “green”.<sup>80</sup>

While labelled green bonds remain a small proportion of worldwide bond markets (estimated at over US\$ 100 trillion), the amounts are large compared to overall finance available for environmental protection and climate change adaptation and mitigation.<sup>81</sup> If recent trends are anything to go by, the market can be expected to develop even further in the future.

Looking forward, socially and environmentally aware investments such as these offer promising ways to raise additional large-scale resources for urgent investments in areas such as renewable energy, energy efficiency, low-carbon transport and protection of the oceans. In the LDCs, these investments cannot be met with domestic public

resources and ODA alone; new sources of capital need to be tapped and institutional investors have the resources to invest in “green”. Green investment remains overall extremely low in LDCs and the Istanbul Programme of Action points to the need for a step-change in sustainable infrastructure investments and the need to consider ‘innovative’ financing options such as green bonds.<sup>82</sup>

High-quality ‘bankable’ projects are needed that maximize social, environmental and financial returns. For the LDCs, the risk of poorly-designed or implemented projects remains high. Weak institutional capacity may also hinder efforts to closely monitor and report on projects financed in part or in full by these securities. It is clear that most (if not all) LDCs will need to ‘test-drive’ these initiatives in partnership with experienced multilateral or national development banks in the initial phases. International development partners can also help LDCs to develop a green investment project pipeline.

## 5. Financial tools to manage vulnerability

Interest has increased recently in financial instruments that aim in different ways to support countries to manage volatility and vulnerability to different types of shocks and stresses.

In the LDCs, where resilience is weak, the human and economic costs of shocks and crises can be particularly high. IMF research shows that, following financial crises it can take several years for low-income countries to bring economic growth rates back into positive territory.<sup>83</sup> More importantly, in many cases the growth trajectory fails to rebound sufficiently to compensate for the loss during the shock, leaving countries with a permanent loss in income.

Many multilateral and bilateral lenders now offer a variety of risk-management products that enable countries to hedge their exposure to different kinds of risk, including interest rate risk, currency and commodity price risks and weather-related

risk. These allow borrowers, at least in theory, to plan efficient responses to shocks and stresses and to optimize their debt management strategies.<sup>84</sup> There are also ways of tapping capital markets using state-contingent financing, such as GDP-linked sovereign bonds. Other state-contingent financing options include counter-cyclical loans, the inclusion of ‘hurricane’ or ‘catastrophe’ clauses in loan contracts, weather-related insurance schemes and lending in local currencies, amongst others. Here, we explore their applicability to LDCs.

### I. Adjusting debt service with GDP-indexed bonds

There is renewed interest in the idea of GDP-indexed bonds.<sup>85</sup> GDP-indexed debt has been implemented to a limited extent over the years. Mexico has issued bonds indexed to oil prices for example. Costa Rica, Bosnia and Herzegovina and Bulgaria have also issued bonds with an element of indexation to GDP. These bonds contained clauses or warrants that increased the payout to bondholders if GDP (or GDP per capita) of the debtor country rose above a certain level.<sup>86</sup> More recently, Argentina and Greece have issued GDP-linked instruments in 2005 and 2012 respectively. In most cases, these instruments have been issued in the context of debt restructuring agreements.

The basic idea behind GDP debt-indexation is simple: debt service payments increase in times of high economic growth when governments are able to generate additional tax revenue, and they are allowed to drop during periods of economic slowdown when government revenue typically falls. Ultimately, this helps reduce the risk of (costly) sovereign defaults and can increase resilience to external shocks by providing some room for additional public expenditures – although the extent of this benefit is of course determined by the share of debt that is indexed to GDP.<sup>87</sup>

In many ways, GDP-linked debt securities operate like an equity or shareholders agreement, whereby creditors buy into a country’s economic

**Figure 6. Debt Service paid on external debt with official creditors, Actual vs. GDP-linked (US\$ billion)**

Source: UNDP, *Risk-Informed Finance for Development*, 2015



performance. This allows debtor countries to share with debt holders the risks associated with macroeconomic management. On the other hand, it provides creditors with an opportunity to benefit from the proceeds of growth and can lower the frequency of default and financial crises (which often result in costly litigation, renegotiation and/or outright losses).

Much of the literature has focused on the attractiveness of these instruments to the wider universe of *private sector* investors, and on the options for emerging economies (with better creditworthiness and less volatile economic performance) to issue such instruments. One challenge is that the countries that may benefit most from these financial instruments may also find it difficult to issue them at reasonable premiums owing to markets' questioning their economic and policy fundamentals.

For LDCs these challenges are especially acute. Most LDCs have no sovereign credit rating at all and those that do tend to fall in the 'uncertain' or 'high risk' obligation category (for instance Fitch rates just 8 out of 48 LDCs and all rated are as 'speculative').<sup>88</sup> Growth performance is often uneven and debt management capacities are also weaker in the LDCs.

In response to these challenges, UNDP has proposed that *official* sector creditors (rather than market operators) develop GDP-linked securities as a key financing modality.<sup>89</sup> Many of the concerns with GDP debt indexation boil down to uncertainty surrounding the final payouts for debtors and creditors arising from a debt financing modality in which interest payment streams are partly determined by a country's future economic performance, a variable which for the most part is an unknown.

However, when it comes to *official* creditors – both bilateral and multilateral – these concerns may be less problematic. As public entities, official creditors tend to operate with longer time horizons than private investors and are therefore able to better factor in the long-term benefits that may be derived from this type of instrument, especially in terms of reducing the risk of sovereign default. And while profit may be a consideration for official lenders, typically it is not the most important consideration; most official creditors have an agenda for international development and may see this kind of financial instrument as a way to support efforts to increase and improve the quality of finance for development. Use of this instrument by official creditors could also have an important demonstration effect on financial markets by demonstrating the macro- and debt stabilizing effects of this type of financial instrument. Additionally none of the concerns as they relate to pricing, missing markets, liquidity, tradability, callability and complexity of GDP-linked securities apply to government-to-government lending.

Another reason to focus on the official sector is that debt with official creditors constitutes a key source of government finance for most LDCs. It is also likely to rise. New borrowing op-

portunities have arisen with the rise in lending by emerging economies and some traditional donors are also issuing more loans within their aid programmes.<sup>90</sup> Doing this in ways that maximize the development benefit and minimize vulnerability to debt distress will be imperative.

On aggregate, the financial impact of adopting GDP indexation under UNDP's simulation is relatively small for developing countries and the results are highly sensitive to the GDP indexation specification adopted. However the impact for borrowers could increase should LDCs take on more official sector loans in the future (which is probable). Contracts could also be defined on a specific case-by-case basis for debtor countries to maximize the benefits for low-income borrowers.

Overall the results suggest that GDP indexation can improve debt management and debt sustainability outcomes, increase resilience to external shocks and slowdowns, and support states to implement countercyclical policies. Further work is needed to evaluate which design features would be most suitable to LDCs. An agreement by LDCs and their development partners to explore this further could be one of the key outcomes of the mid-term review of the Istanbul Programme of Action for the LDCs.

### Box 11. GDP-linked bonds: What benefit for LDCs?

Source: UNDP, *Risk-Informed Finance for Development*, 2015

UNDP recently simulated the possible benefits of adopting GDP indexation for LDCs' external debt with official creditors. Indicative results showed that debt service payments over the 2003-2014 simulation period would fall by 7.95 percent. This result assumed that all official external debt (concessional and non-concessional, multilateral and bilateral) was indexed to GDP. Among the developing countries studied, the gains were greatest for the LDCs. The report also reviewed the impact that GDP-indexation would have on governments' abilities to pay back their debt and to adopt countercyclical macroeconomic policies. The results showed that countries' debt service-to-

GNI ratios moved more closely to the evolution of their Gross National Income, which would imply an improvement in their ability to pay back their debt.<sup>91</sup>

*"In 2009, at the height of the global financial crisis, developing countries would have seen debt service payments on official external debt as a share of government revenue drop from 4.72% to an estimated 2.10% under our backward-looking simulation exercise, providing for greater fiscal space to implement counter-cyclical policies."*

## II. When disaster strikes...

In 2015, the small island state of Grenada restructured approximately US\$ 262 million in international and local bonds on which it had defaulted in 2013.<sup>92</sup> It also rescheduled a further US\$ 8 million in bilateral debt owed to Paris Club creditors. At the time of the debt restructuring, Grenada's total public sector debt exceeded 100 percent of GDP.<sup>93</sup>

The island's recent debt restructuring was typical of such processes (in that there were complex and lengthy negotiations with creditors).<sup>94</sup> The debt restructuring did however introduce an extra innovative feature, specifically the introduction of a so-called "hurricane clause", which could allow for a moratorium on debt payments in the event of a natural disaster wreaking havoc throughout the island.<sup>95</sup> The rationale is that a delay in debt service repayments can help to ensure that resources are

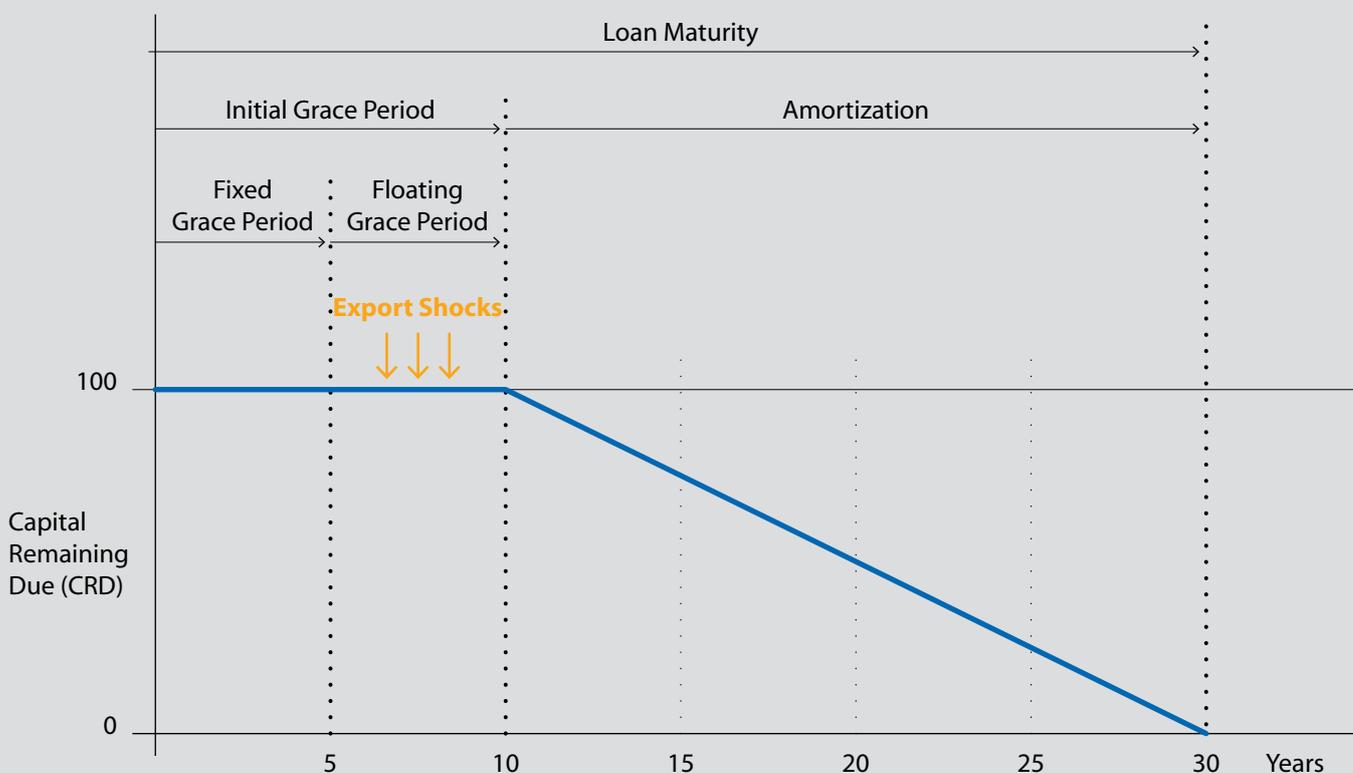
available quickly to invest in relief and reconstruction efforts. It may also reduce the need to take-on new debt and/or wait for international aid to arrive.

For Grenada, this feature has particular relevance and importance. In 2004, Hurricane Ivan laid waste to Grenada in one of the worst disasters ever recorded on the island. Damages were estimated at over 200 percent of GDP.<sup>96</sup> While the international aid effort was substantial – both in financial resources and in-kind – less than a year later, Hurricane Emily struck before the island had had a chance to recover. The combined impact of these disasters – later compounded by the global financial crisis – undermined the Government of Grenada's ability to recover, rebuild its economy and service its debt.

The Grenada example illustrates how measures such as "hurricane" clauses could usefully help vulnerable countries to more effectively manage shocks.

**Figure 7. Counter-cyclical loans in practice**

Source: AFD, 2013



These include, but are not limited to extreme weather events. Another variation on this theme is so-called “counter-cyclical lending contracts” (CCLs), implemented by AFD.

Under CCLs, it is agreed ex-ante that debt service will *automatically* be allowed to fall, or become zero, in periods when external shocks (measured in a particular way, for example a significant fall in the value of exports or increase in the price of imports) hit a country. AFD research shows that 70 percent of low-income countries’ income is derived from unprocessed primary commodities and that the export revenues derived from these commodities fluctuate widely. For example, for a sample of 24 low-income countries, export revenues have fluctuated from 42 percent to 205 percent of their average level between 1970 and 2005. They also show how in 59 percent of cases, debt crises in low-income countries were preceded by some form of export shock.<sup>97</sup>

The basic idea behind the CCL is to ensure that debt service is counter-cyclical. The instrument aims to build flexibility ex-ante for borrowers, and thus reduce the likelihood of a debt crisis. This in turn helps avoid a need for costly ex-post debt restructuring and may also reduce the need for new liquidity facilities in the face of external shocks.

For the debtor country these loans have the important advantages of automaticity (implying no additional conditionality) and predictability (as the conditions under which debt service can be suspended are established ex-ante).<sup>98</sup> For lenders, where the risk of debt default is reduced, it will help to prevent any eventual losses on their claims.

The French Development Agency first used such instruments in 2007 and has extended them so far to six Least Developed Countries – Burkina Faso, Madagascar, Mali, Mozambique, Tanzania and Senegal for projects in the areas of: urban development and road infrastructure; electrification; access to water and sanitation; education and vocational training; and food security.<sup>99</sup> The total of CCL lending implemented by AFD is equal so far to approximately 300 million Euros (US\$ 340 million).

Under the terms of the French counter-cyclical loan, this instrument replaces the classic 30 year concessional loan at 1 percent interest with a fixed grace period (of 10 years) for similar concessional loans, but with a shorter fixed grace period (5 years) and a floating grace period, (also of 5 years); the latter debt service holiday on capital repayments can be used automatically if the debtor country chooses to do so in cases where its merchandise exports fall by 5 percent or more in relation to the moving average of the previous five years.<sup>100</sup> If countries do not use debt capital repayment holiday, within the first 10 years, they get equivalent cash.

The Commonwealth Secretariat has proposed that such instruments could be usefully rolled-out to Small Island Developing States (SIDS) that are vulnerable to shocks such as extreme weather events and sharp drops in tourist numbers.<sup>101</sup> There are nine LDCs that are also SIDS (Comoros, Guinea-Bissau, Haiti, Kiribati, São Tomé and Príncipe, Solomon Islands, Timor-Leste, Tuvalu and Vanuatu).<sup>102</sup> The instrument however has wider applicability to LDCs as a whole as a tool to reduce risk and vulnerability.

The extent of this benefit however hinges on how such features are designed and in particular the “triggers” that are used to determine when a moratorium on debt service payments can kick-in (for instance how large does a disaster have to be and how will it be measured, bearing in mind that there are typically measurement “lags”), as well as the amount of a country’s overall debt that features these kinds of provision. The issue of *automaticity* also matters; the benefits of such provisions are increased if they are automatic versus a requirement to negotiate with each individual creditor during a period of crisis.

Looking forward, a key challenge remains *scale* and the extent to which official (and perhaps even private sector) lenders would be prepared to consider loan contracts that feature this kind of modality in sufficiently large numbers. If lending to the LDCs rises over the next few years and if the frequency and severity of shocks also increases, there may be incentives to make their use more mainstream.



Photo: Morgana Wingard/UNDP Liberia

# III. IMPROVING LDCS' ACCESS TO THE FINANCING TOOL-BOX

LDCs are working hard to overcome the various social, economic and environmental challenges they face. Many have made – and continue to make – major strides. And as this report has shown, many countries are already making use of a wider variety of financing options to support investments in the 2030 Agenda. Investing in the LDCs is an opportunity to not only support better standards of life for the nearly 1 billion people that reside in the LDCs, but can also contribute to economic growth and stability in other countries. UN Secretary-General, Ban Ki Moon describes investing in the LDCs as a “win-win” for all.

In this report, we have reviewed a selected range of financing instruments and discussed their applicability to the LDCs. Our analysis has pointed to several key observations:

## 1. LDCs must be in the driving seat

As this report has shown, the field of development finance is dynamic and diverse. It is important to stress however that new financing opportunities and instruments do not diminish the importance of continued efforts by LDCs to strengthen domestic revenue mobilization and to use these resources more effectively and transparently. Domestic resources still represent the most important and most stable source of financing for sustainable development. Progress is needed to expand tax coverage, make tax systems fairer, better harness revenues from natural resource extraction, redirect state subsidies to activities with positive externalities, reduce illicit capital outflows, strengthen accountability and improve the efficiency of expenditures overall. The availability – and use – of new

financing options is unlikely to lead to better outcomes in countries with weak governance and institutional capacity. LDCs must ensure that all financing is aligned with and supports national development strategies and priority sectors.

## **2. ODA remains important to LDCs**

Expanding new financing modalities to the LDCs does not substitute for efforts by aid donors to meet their aid commitments to these countries as a matter of priority. The decline in the amount of ODA allocated to the LDCs must be urgently reversed. ODA continues to be a vital and stable source of external finance to most LDCs and will remain a critical input to achieve the new sustainable development agenda. It remains a valuable resource to help finance essential social services, and – as this report has shown – to catalyze additional resources from the public and private sectors. Official aid and loan financing has also played an important countercyclical role in the wake of the 2008 financial crisis. Efforts to strengthen the effectiveness of aid must also continue.<sup>103</sup>

## **3. Economic growth is a sine qua non for LDCs' efforts to boost incomes, reduce poverty, increase investment and create more jobs**

Global economic conditions matter. Notwithstanding the opportunities presented by a more dynamic and sophisticated development financing environment, these will not be sufficient in a context where global growth is weak and overall economic conditions are uncertain. The current economic slowdown in many developed and emerging economies continues to impact LDCs through a decline in demand for their exports (and a decline in the prices of those exports), lower aid receipts and a slowdown in investment. Growth in developing economies has slowed not only to its weakest pace since the 2008 financial crisis, but also to a level lower than the trend registered during the two decades before the

crisis. This underscores the importance of better coordination of macroeconomic policies at the international level to stimulate demand and support “high-growth” activities with a particular focus on developing countries.

## **4. Debt sustainability must remain at the forefront**

Increased use of various kinds of loan instrument is likely as countries scale-up their efforts to meet the Sustainable Development Goals. It is also likely in a context where countries are graduating to middle-income status and secure access to new (often debt-based) forms of finance. The challenge is to use debt effectively in risky LDC contexts. While it is positive that the number of financial instruments and tools has expanded and become more sophisticated, it also makes it more difficult for countries to determine which instruments are best to use, in which circumstances and what debt policies to adopt to ensure debt remains sustainable. Debt sustainability analyses conducted by the Bretton Woods institutions can be useful, but technical assistance to support countries to determine the pros and cons of different financing options will be crucial. Financing must, in turn, support national development strategies and priorities. Instruments that shift (at least some) risk from the borrower to the lender may be particularly relevant for LDCs, such as GDP-indexed loans and counter-cyclical loan instruments and could be scaled-up.

## **5. Financial tools to reduce vulnerability are a critical component of the financing “tool-box”**

Vulnerability to shocks and stresses is pervasive in the LDCs. Resources are, by definition, more ‘abundant’ in good economic times than in bad, i.e. they are procyclical. Financial instruments that can deliver resources in a countercyclical manner (such as GDP-indexation and countercyclical-type contracts) will therefore be useful to countries that are particularly exposed to volatility and shocks.

The challenge is that some of the instruments that have the potential to help countries to better manage risk, including GDP-linked bonds, have yet to be developed at scale. LDCs may be particularly reluctant to adopt instruments that others have yet to use regularly. However, the particular vulnerability of LDCs makes the use of these kinds of financial instruments not simply a nice complement, but an absolute necessity. Public finance and official lenders have a particular responsibility to enable and support the deployment of more “risk-informed” financing options.

**6. Risk (both actual and perceived) represents a key constraint for LDCs and must be reduced**

High perceived and/or actual risk (linked to informational, technical, regulatory and other barriers) can increase financing costs and mean that countries need to provide poten-

tially very high returns to investors to attract and secure private investment. Advanced and emerging economies, with a more favourable risk-adjusted return profile and longer track records in sustainable development projects, already attract (and may continue to attract) the lion’s share of investment in the coming years. Public interventions can and should play a critical role in reducing and transferring the investment risks that private actors are unable or unwilling to bear. LDCs’ official bilateral and multilateral development partners have a key role to play at different stages of the project cycle to mitigate risks, manage expected returns and demonstrate the viability of markets. For example public resources can be used to inter alia: provide technical assistance and other advisory services; absorb transaction and project preparation costs; provide leverage; support innovation and risk-taking; top-up returns; insure against unforeseen market and catastrophic events;



Photo: Curt Carnemark/World Bank Yemen



Photo: Curt Carnemark/World Bank Bangladesh

limit downside loss exposure; eliminate funding shortfalls; provide incentives for successful performance; and improve creditworthiness. Tools such as UNDP’s “De-risking Renewable Energy Investment” methodology provide a framework to support policymakers to select public instruments to promote renewable energy investment in developing countries. The methodology acknowledges that investment barriers to renewable energy vary between locations and technologies. Different resource endowments, market conditions and national development goals also mean that there is no one-size-fits-all ‘best’ public instrument mix. UNDP’s framework supports decision-makers and planners to select the optimal instrument mix, which

may include de-risking instruments such as guarantees as well as direct financial incentives such as subsidies.<sup>104</sup>

## 7. Capacity development is critical for the effective use of the financing tool-box

Capacity development is a need that characterizes LDCs. Development results can only be sustained and built-on over time where local capacities are strengthened. Local actors (public and private) have a better understanding of local opportunities, as well as risks. The use of financial instruments such as guarantees and lending in local currencies will be most effective when part of broader efforts to build local capacities. Supporting local enti-

ties, operators and other actors is also a priority in the Addis Ababa Action Agenda.<sup>105</sup>

## 8. Use finance to deliver “co-benefits”

LDCs and their development partners can use different financing instruments in ‘smarter’ ways to simultaneously deliver benefits across multiple sectors. For instance, as [box 7](#) shows, blended finance tools are being used in Central America to provide small businesses that integrate environmental protection and biodiversity conservation into their activities with access to finance. These kinds of initiatives deliver not only valuable environmental benefits but also reduce poverty, create livelihoods and build the capacities of the local private actors, including banks and small businesses.

## 9. Not all LDCs are the same

Some of these instruments and approaches are more likely to be utilized in larger countries with larger populations and larger markets, with programmes in smaller and/or riskier countries being less appealing. There is a particular challenge when it comes to financing for small-scale projects which can rarely be replicated at scale and which can incur significant administrative costs for public and/or private investors. Official

finance providers have a responsibility to ensure that all countries have access to the finance they need on terms and conditions that are appropriate for them.

## 10. Information and knowledge exchange are critical to success

In many cases, there is limited knowledge – among both LDCs and their development partners – about certain financial instruments and the potential benefits that could be derived from them. This helps to explain why some innovations remain relatively small in scale. There is a role for developing countries and for bilateral and multilateral development finance providers to share experiences and lessons learned. Formal and informal coordination platforms can be used to support knowledge, awareness, capacity development and exchanges of experience on these financial instruments. Policy dialogues with governments can foster an enabling environment for public and private investment. United Nations agencies such as UNDP, UNCTAD and OHRLLS can play supportive roles. New tools such as UNDP’s “Financing Solutions for Sustainable Development” web platform provides policymakers with helpful information and advice on a variety of financial instruments for sustainable development.

### Box 12. Financing Solutions for Sustainable Development: UNDP tool-kit

*Source: UNDP*

A major task for policy-makers in financing the 2030 Agenda is to devise financing solutions to attract and direct investments to areas where greater co-benefits and multiplier effects can be achieved. UNDP’s on-line toolkit provides guidance to review and operationalize those financing solutions that can enable the implementation of national sustainable development strategies.

The platform features instruments such as blended finance, development impact bonds, green bonds, trust funds, challenge funds, guarantees, impact investments, and many more. It describes their potential, feasibility, advantages, disadvantages, risks and characteristics. It also profiles case studies and refers to multiple external sources, including e-learning and advanced guidance material, where available.<sup>106</sup>



Photo: Marco Dormino/UN Mali

# Statistical Annex

**Figure 8. HIPC and MDRI debt relief in the LDCs\***  
**In millions of US\$; status as at end-August 2015**

Source: Authors' adaptation from World Bank and IMF, Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Statistical Update March 2016

Country	HIPC debt relief	MDRI debt relief	Total
Afghanistan	1,280	39	1,319
Benin	460	1,115	1,575
Burkina Faso	930	1,185	2,115
Burundi	1,366	88	1,454
Central African Republic	804	294	1,098
Chad	260	792	1,052
Comoros	136	77	213
Congo (Democratic Republic of the)	15,222	1,047	16,269
Ethiopia	3,275	3,279	6,554
Gambia, The	112	375	487
Guinea	800	958	1,758
Guinea-Bissau	790	124	914
Haiti	213	964	1,176
Liberia	4,600	261	4,861
Madagascar	1,900	2,386	4,286
Malawi	1,628	1,567	3,195
Mali	895	1,948	2,843
Mauritania	1,100	869	1,969
Mozambique	4,300	2,026	6,326
Niger	1,190	1,042	2,232
Rwanda	1,316	499	1,814
São Tomé and Príncipe	263	59	323
Senegal	850	2,445	3,295
Sierra Leone	994	656	1,650
Tanzania	3,000	3,821	6,821
Togo	360	706	1,066
Uganda	1,950	3,502	5,452
Zambia	3,900	2,749	6,649
<b>Total</b>	<b>53,894</b>	<b>34,873</b>	<b>88,766</b>

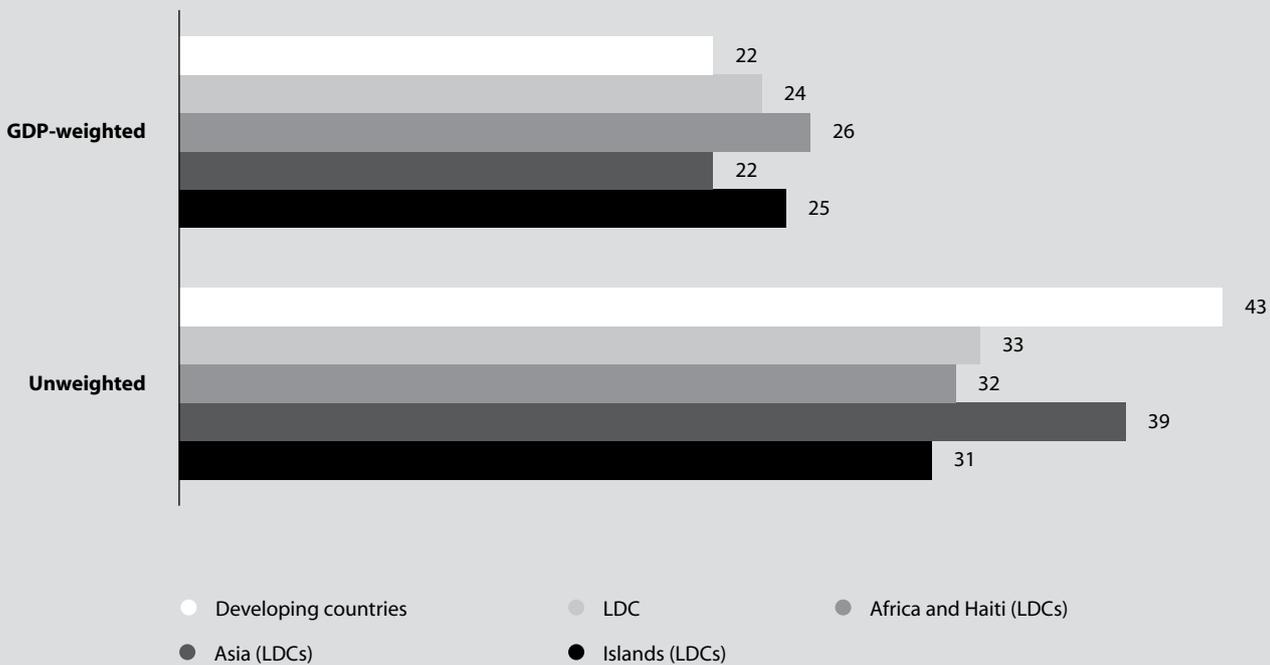
Eritrea, Somalia, Sudan\*

\* Committed debt relief under the assumption of full participation of creditors.

+ Country has yet to start the process of qualifying for debt relief.

## Figure 9. External debt in the LDCs, % of GDP

Source: Authors' calculations from World Bank, World Development Indicators, accessed December 2015



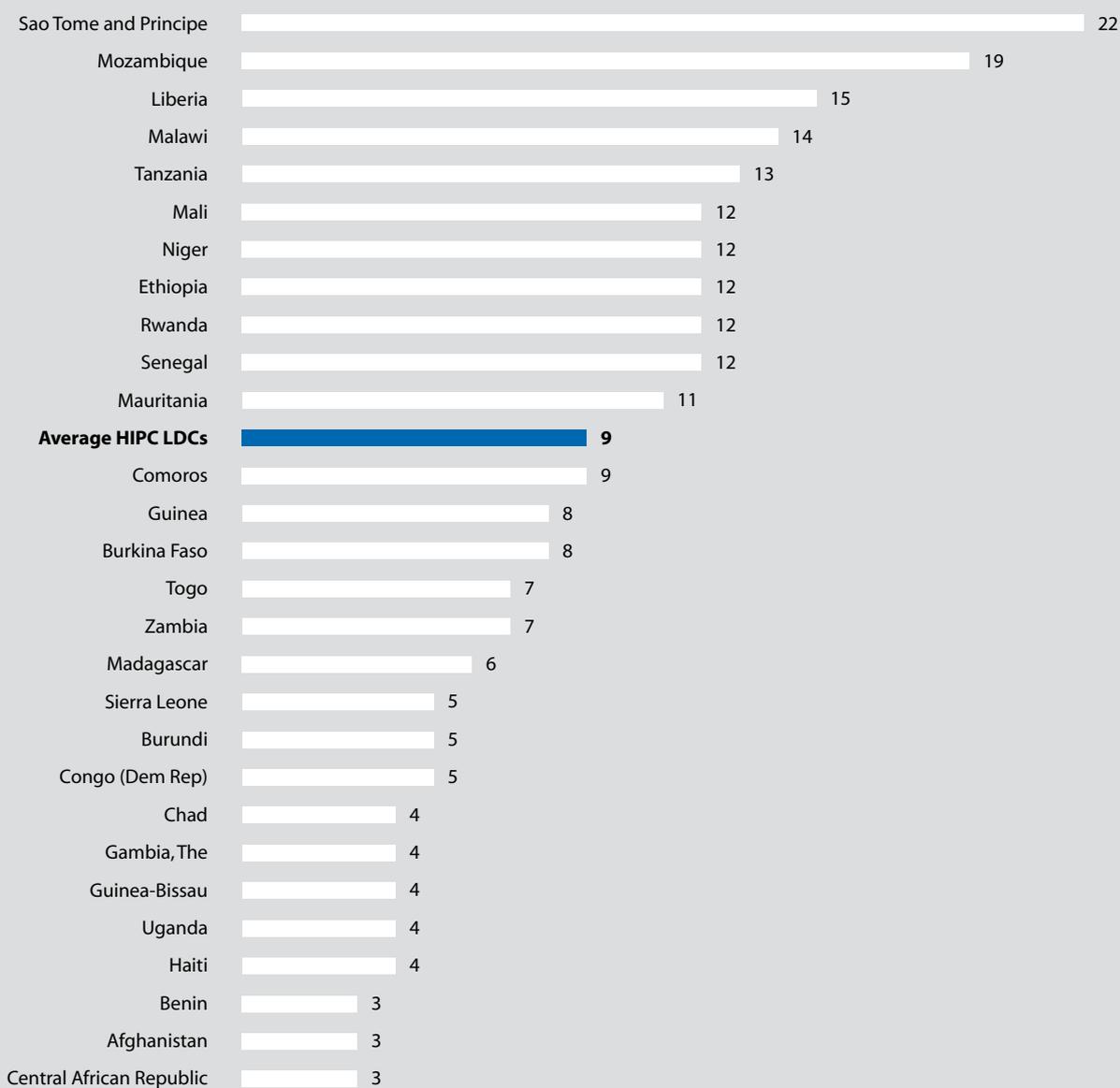
### Box 13. The Paris workshop on financing for development and the concept of “prospective yields of capital”

In order to prepare for the report, AFD and UNDP hosted a workshop on financing for development on 7 March 2016. Some forty experts from UN agencies, least developed countries, development banks, the private sector, think tanks and various international and French administrations assembled at the workshop. The workshop considered two key issues:

1. financing for development should accurately respond to local priorities and demand; and
2. least developed countries are penalized by investors' risk perceptions, which are often exaggerated. In addition, a representative of the private sector emphasized that there need to be better incentives for investment, especially in the poorest countries. This report attempts to reflect these concerns by specifically referring to the concept of “prospective yields of capital” (or prospective capital yield).

## Figure 10. Poverty reduction spending in the LDCs (% of GDP)

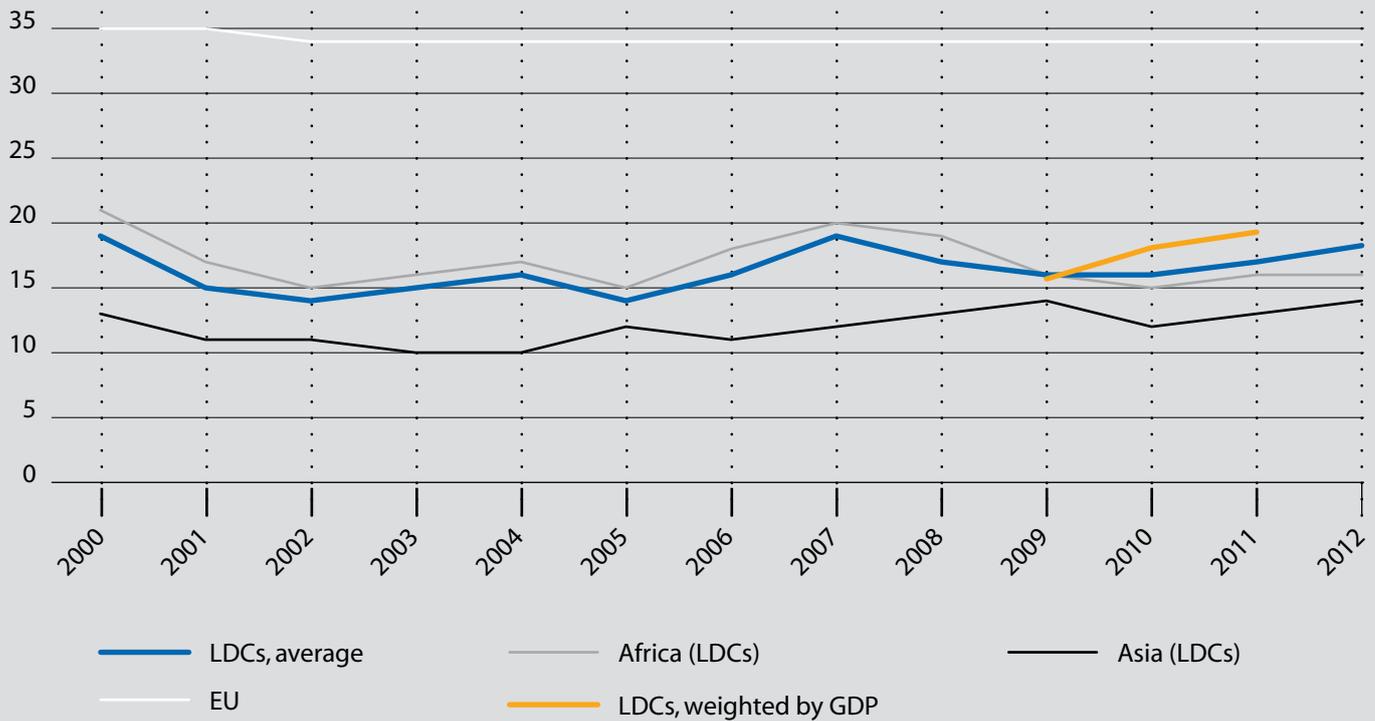
Source: Authors' adaptation from World Bank and IMF, Heavily Indebted Poor Countries (HIPC) Initiative and Multilateral Debt Relief Initiative (MDRI)—Statistical Update March 2016



All data 2014, except for Central African Republic (2012), Comoros (2011), Mozambique, and São Tomé and Príncipe (2013)

**Figure 11. Revenue, excluding grants (% of GDP), LDCs\***

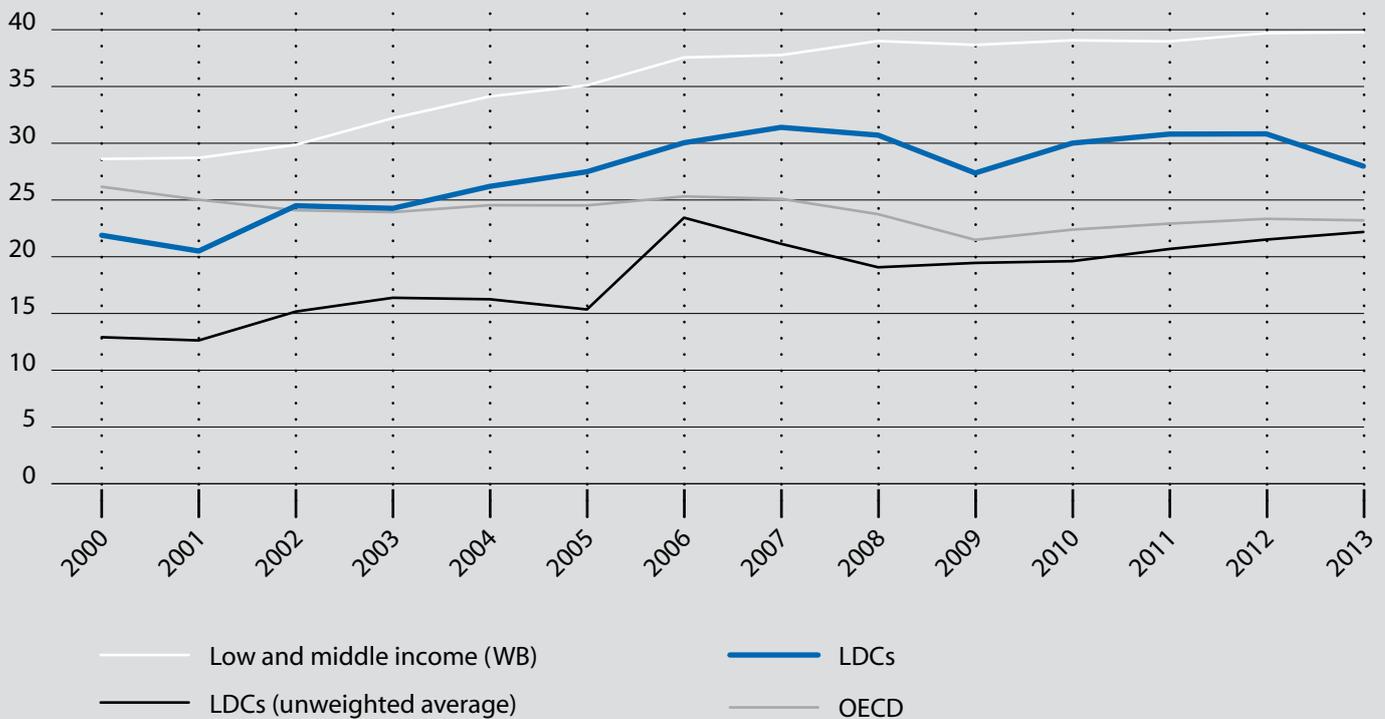
Source: Authors' calculations from World Bank, World Development Indicators, accessed December 2015



\* Data available for a limited number of LDCs (around 20)

**Figure 12. Gross savings rates\* in the LDCs (% of GDP)**

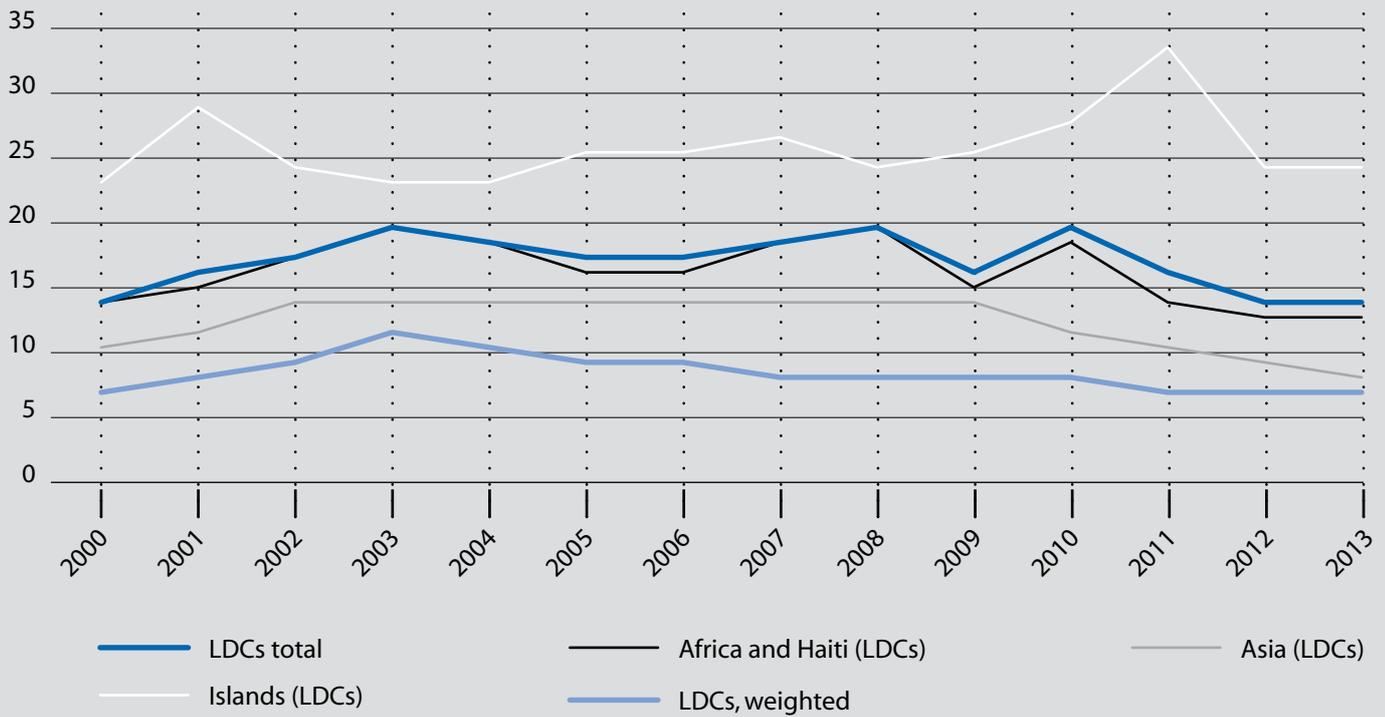
Source: Authors' calculations from World Bank, World Development Indicators, accessed December 2015



\* Gross savings are calculated as gross national income less total consumption, plus net transfers.

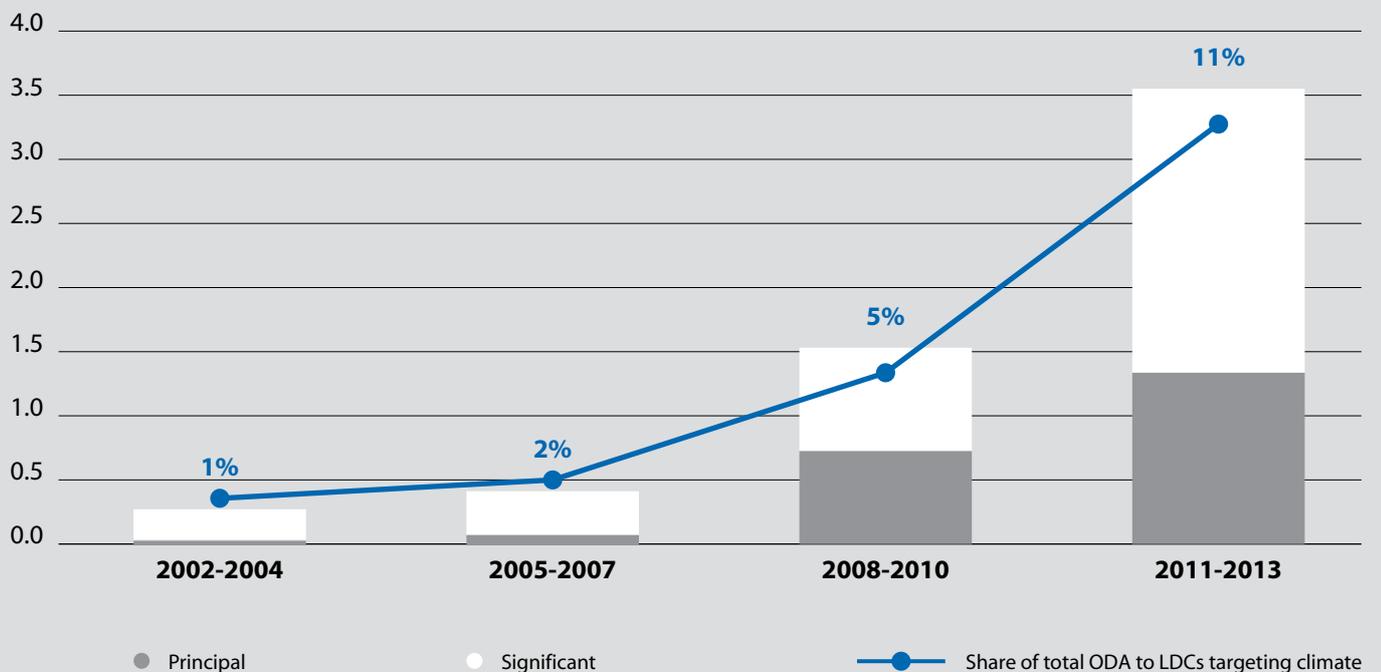
**Figure 13. Net ODA received (% of GNI)**

Source: Authors' calculations from World Bank, World Development Indicators, accessed December 2015



**Figure 14. Trends in climate-related bilateral ODA to LDCs, 3-year averages 2002-13, bilateral commitment, US\$ million, constant 2013 prices**

Source: OECD, 2015



Notes: The chart above presents a trend based on averages over three years, so as to smooth fluctuations from large multi-year projects programmed and committed in a given year, such as observed in 2010. For both graphs, reporting on the mitigation marker became mandatory in 2007, and the adaptation marker was introduced only in 2010, and data on total climate-related ODA for earlier years mainly relates to mitigation and is therefore under-estimated. Source: OECD DAC statistics (2015)

Figure 15. FDI per capita: LDCs versus developing countries, US\$

Source: UNCTAD, 2016

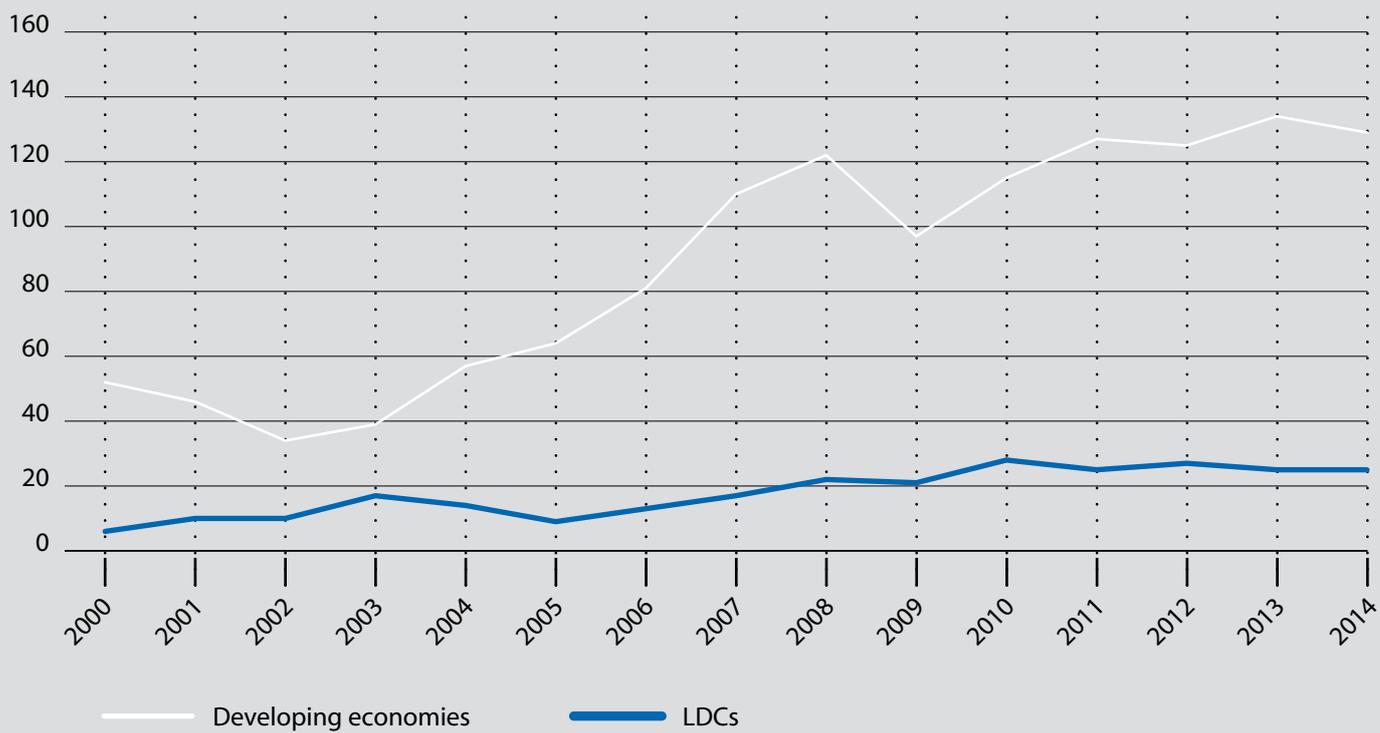


Figure 16. Remittances per capita, LDCs, 2014, US\$

Source: UNCTAD, 2016

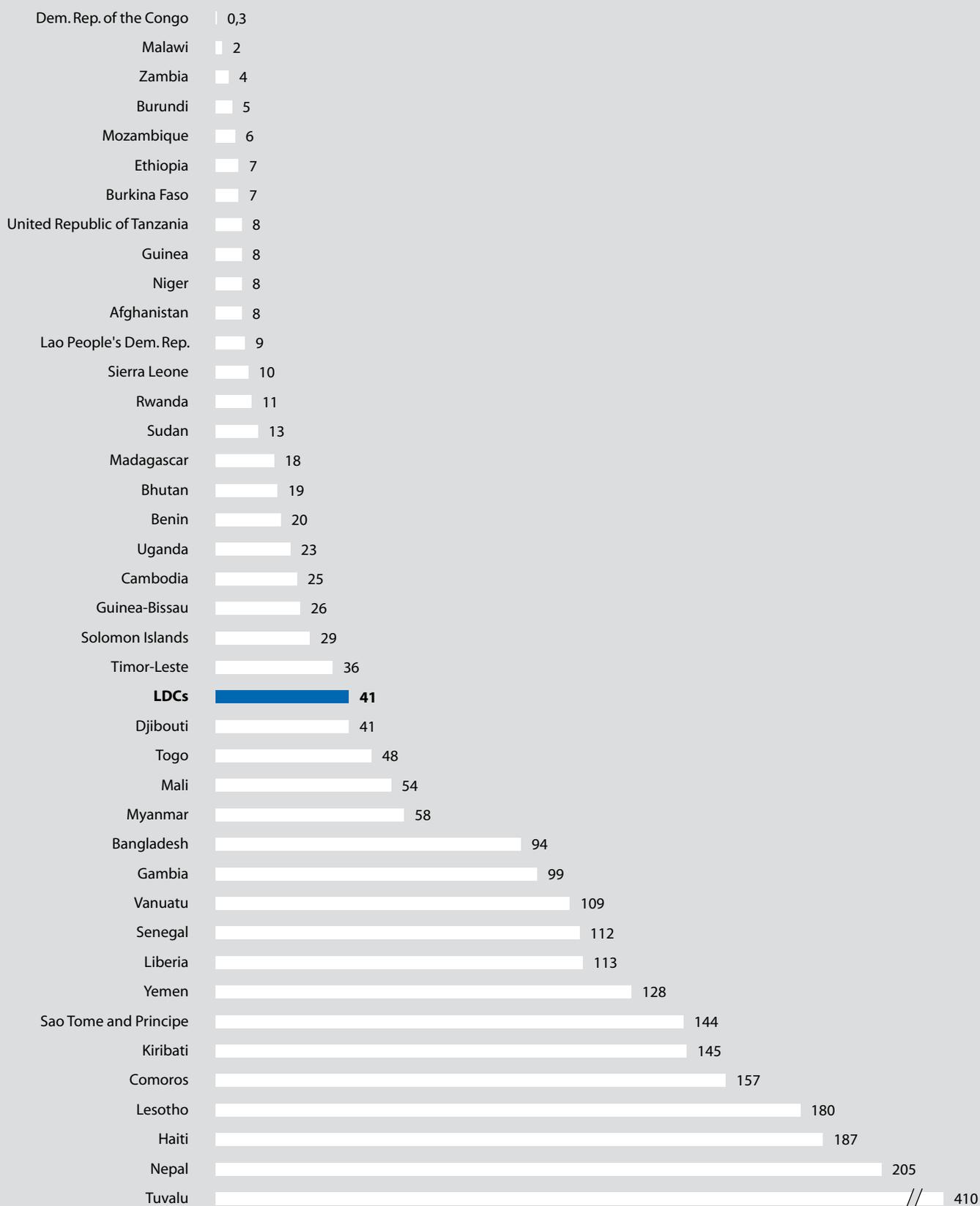




Photo: Eric Miller/World Bank Mozambique

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Photo: Scott Wallace/World Bank Afghanistan

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Traders work on the floor of the Ethiopian Commodity Exchange in Addis Ababa, Ethiopia.  
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AFD  
5 Rue Roland Barthes  
75598 PARIS CEDEX 12, FRANCE  
[www.afd.fr](http://www.afd.fr)



UNDP  
One United Nations Plaza  
New York, NY 10017 USA  
[www.undp.org](http://www.undp.org)