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**Trade and Development Board**  
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## **Addressing the cost of development finance to achieve the Sustainable Development Goals**

**Note by the UNCTAD secretariat**

### *Summary*

Against the background of systemic drivers of the high cost of development finance, development banks (multilateral, regional and national), particular tools (including in the areas of food security, the energy transition and the digital transition) and the credit rating system have roles to play in ensuring affordable development finance for developing countries. These areas are explored in this note, and policy initiatives at the international, regional and national levels are suggested.



## I. Introduction

1. The substantive topic and guiding questions for the eighth session of the Intergovernmental Group of Experts on Financing for Development were approved by the Trade and Development Board through a silence procedure that ended on 30 April 2024. The guiding questions are as follows:

(a) Which policies at the national, regional and international levels could contribute to addressing the high cost of development finance?

(b) Are there specific tools that can address the high cost of development finance, including in the areas of food security, the energy transition and the digital transition?

(c) What role and how can international financial institutions, multilateral development banks and development finance institutions contribute to ensuring affordable development finance for developing countries?

(d) What are the elements that impact sovereign credit ratings and their role in development financing?

2. This topic corresponds to action areas A, B, C, E and F in chapter II of the Addis Ababa Action Agenda of the Third International Conference on Financing for Development, in which challenges and priorities are set out regarding domestic public resources, domestic and international private business and finance, international development cooperation, debt and debt sustainability and addressing systemic issues.<sup>1</sup>

3. An analysis of critical systemic drivers of the cost of development finance in developing countries is presented in chapter II. The roles of multilateral development banks, regional development banks and national development banks in ensuring affordable development finance are addressed in chapter III, with a view to progressing on the achievement of the Sustainable Development Goals. Tools with which to address the high cost of development finance are considered in chapter IV, including in the areas of food security, the energy transition and the digital transition. The determinants of sovereign credit ratings and their role in development financing are discussed in chapter V. International, regional and national policy initiatives are suggested in each chapter.

## II. Systemic drivers of the cost of developing finance

### A. Non-issuance of international currencies

4. A key feature of the current international monetary system is the role of the United States dollar as the leading international currency used in trade invoicing, payments and settlements, financial transactions and foreign exchange reserves. According to the international currency usage index, in 2023, the dollar was used in around 70 per cent of international transactions. The currencies of other developed jurisdictions, primarily the yen, the pound sterling and the euro, are also international currencies, which is reflected in their use as currencies of denomination of multilateral development bank loans alongside the dollar. Developing country currencies do not serve as international currencies except for the renminbi; it has had an international role since October 2016, when it was added to the International Monetary Fund (IMF) special drawing rights basket of currencies.<sup>2</sup>

5. The fact that developing economy currencies do not serve as international currencies is a critical driver of the risk and cost of development finance due to the following:

(a) Higher risk of exchange rate volatility;

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<sup>1</sup> A/RES/69/313.

<sup>2</sup> See <https://www.imf.org/en/News/Articles/2016/09/29/AM16-NA093016IMF-Adds-Chinese-Renminbi-to-Special-Drawing-Rights-Basket>.

(b) Higher risk premium when borrowing abroad, leading to costlier international securities and loans;

(c) Higher domestic policy rate required to attract capital inflows in normal times or curb capital outflows in times of global monetary tightening or financial uncertainty.

6. Consequently, developing countries have attempted to reduce vulnerability through a self-insurance strategy of accumulating international reserves, which can be costly.<sup>3</sup> The following could assist in reducing the costs associated with the non-issuance of international currencies: setting up multicurrency wholesale central bank digital currency platforms, to reduce the need for currency conversion and holding of international currencies by developing countries;<sup>4</sup> strengthening other forms of South–South monetary cooperation, such as regional reserve swaps and pooling arrangements, to bridge liquidity constraints;<sup>5</sup> and increasing the role of special drawing rights through regular annual allocations or alternative allocation criteria.<sup>6</sup>

## B. Asymmetry of global financial integration

7. The financial integration of developing countries since the 1990s has delivered mixed outcomes related to access to the affordable development finance required in order to achieve the Sustainable Development Goals. There are three profiles of global financial integration among developing countries, namely, emerging-market economies, which are mostly upper middle-income developing countries that have been integrated into global capital markets since the 1990s; frontier-market economies, which are mainly low-income or lower middle-income countries, which began to tap into global capital markets following the global financial crisis of 2008/09, and other developing economies, which are, with a few exceptions, associated with lower levels of exposure to private creditors and rely mainly on concessional finance and grants.

8. The creditor composition of the public and publicly guaranteed debt of each group of developing countries reflects their different profiles of financial integration. Other developing economies are mainly exposed to multilateral and bilateral creditors, with private creditors making up 17 per cent of their debt in 2022. The private sector exposure of frontier-market economies has almost doubled since 2010, making up 32 per cent of the total in 2022. Emerging-market economies have had the longest exposure to financial markets, yet private creditors accounted for 67 per cent of total public and publicly guaranteed debt in 2022.

9. Frontier-market economies, which issue speculative grade sovereign bonds, face greater spread volatility and, consequently, access global capital markets at higher costs than emerging-market economies. The surge in bond issuance since 2010 has been at the core of the threefold increase in the accumulation of external public and publicly guaranteed debt among this group. Bonds made up 56 per cent of the total debt of frontier-market economies in 2023, 36 per cent of the total debt of emerging-market economies and 23.5 per cent of the total debt of other developing economies.

10. Both frontier-market economies and other developing economies experienced sharp increases in external interest payments in 2023, with that of the former rising by 42 per cent and of the latter by 112 per cent. In addition, the external interest costs of frontier-market economies increased on average by 15.5 per cent per year in 2010–2023, that is, twice as fast as the rate of increase among the other groups. Similarly, in the same period, the

<sup>3</sup> UNCTAD, 2019, *Trade and Development Report 2019: Financing a Global Green New Deal* (United Nations publication, sales No. E.19.II.D.15, Geneva).

<sup>4</sup> Mayer J, 2024, De-dollarization: The global payment infrastructure and wholesale central bank digital currencies, working paper No. 102, Forum for Macroeconomics and Macroeconomic Policies.

<sup>5</sup> UNCTAD, 2022a, *Trade and Development Report 2022: Development Prospects in a Fractured World – Global Disorder and Regional Responses* (United Nations publication, sales No. E.22.II.D.44, Geneva).

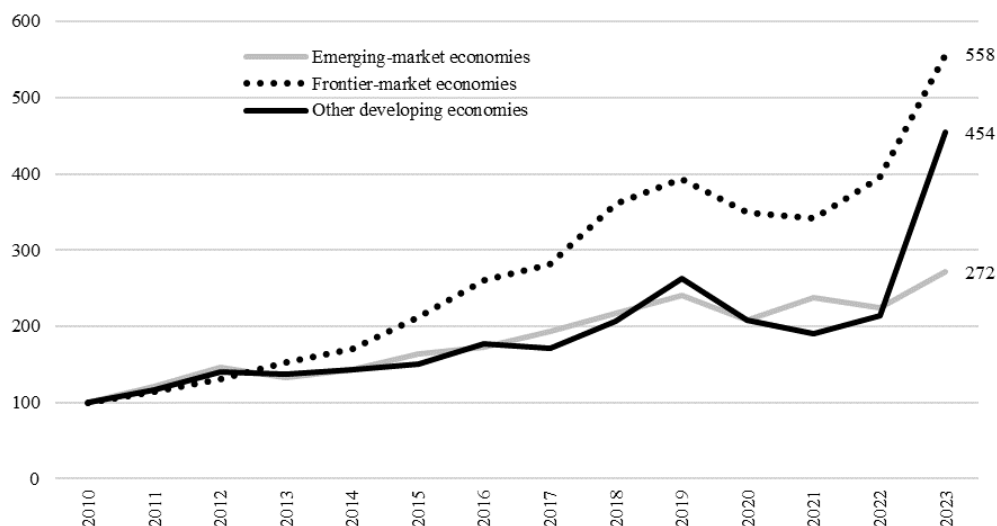
<sup>6</sup> See <https://www.piie.com/publications/working-papers/imf-should-enhance-role-sdrs-strengthen-international-monetary-system>.

principal repayments of frontier-market economies rose higher than that of emerging-market economies and other developing economies (figure 1).

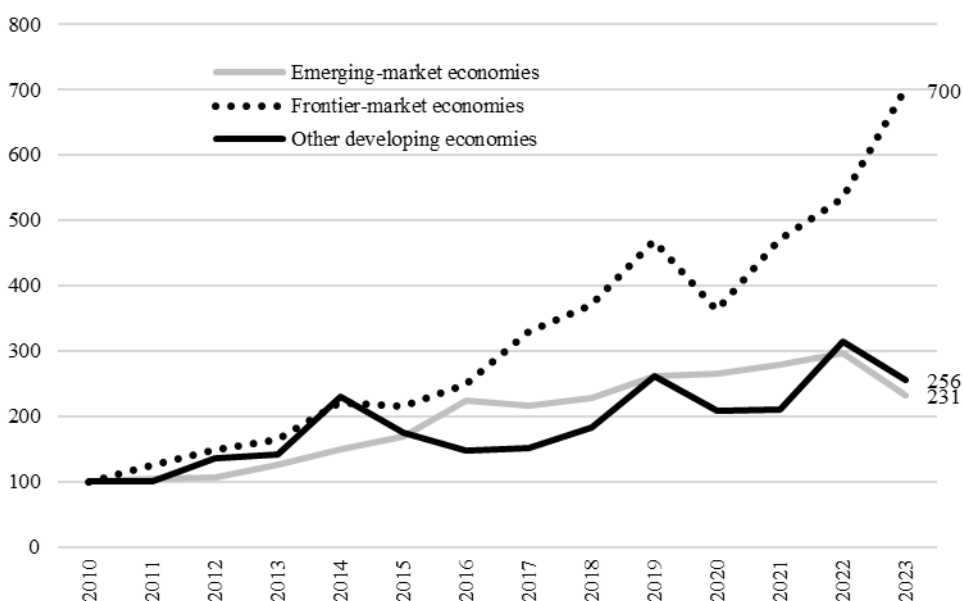
Figure 1  
**Relative trends in long-term external payments and repayments**

(Index: 2010 = 100)

(a) **Interest payments**



(b) **Principal repayments**



Source: UNCTAD secretariat calculations, based on data from the World Bank international debt statistics.

11. The cost of development finance is a critical determinant in the sustainability of external and public sector debt. The sustainability of a particular stock of debt is threatened if the growth rate of the associated debt service costs is higher than the growth rate of the revenues generated for servicing the debt.

12. With regard to external debt, if a country’s debt service costs increase more quickly than exports and remittances, then debt sustainability will deteriorate. In 2017–2023, this occurred among most frontier-market economies and other developing economies, but not among emerging-market economies. The median rate of the annual increase in external debt

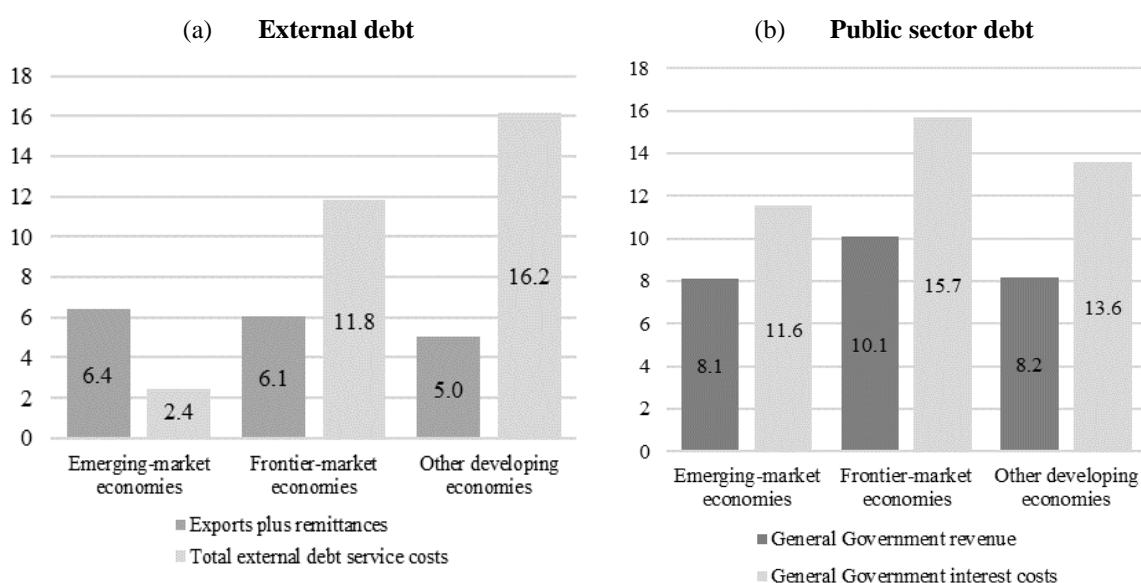
service costs among emerging-market economies in this period was lower (2.4 per cent) than that of frontier-market economies (11.8 per cent) and other developing economies (16.3 per cent), and growth in exports and remittances was higher among emerging-market economies (6.4 per cent), compared with frontier-market economies (6.1 per cent) and other developing economies (5 per cent).

13. If public debt service costs increase more quickly than tax and other revenues, then public sector debt sustainability will deteriorate. Growth in interest costs outgrew public sector revenues among most countries in each grouping. In 2017–2023, the median annual increase in public sector revenues among emerging-market economies was 8.1 per cent and interest costs rose by 11.6 per cent; the figures for frontier-market economies were 10.1 and 15.7 per cent, respectively, and, for other developing economies, 8.2 and 13.6 per cent (figure 2). The groupings diverged with regard to external debt positions, yet converged with regard to public sector debt. The external integration profile of emerging-market economies in global capital markets, global trade and global value chains resulted in a general, but not universal, improvement in external debt sustainability, underpinned by much lower increases in debt service costs and slightly higher growth in exports and remittances. Frontier-market economies performed better than other developing economies, yet their external debt service costs rose at a faster rate than that of emerging-market economies and at almost twice the rate of the exports and remittances of frontier-market economies.

Figure 2

**Median average annual changes in debt sustainability components, 2017–2023**

(Percentage)



*Source:* UNCTAD secretariat calculations, based on data from IMF government financial statistics, IMF World Economic Outlook and World Bank international debt statistics.

14. Overall, the external and public sector debt sustainability of two thirds of developing countries worsened in 2017–2023, as external debt servicing costs rose more quickly than foreign exchange earnings and interest costs outgrew government revenues. This raises concerns about the sustainability of external and public debt in developing countries and how debt servicing diverts resources from development, particularly given the significant financing gap for achieving the goals of the 2030 Agenda for Sustainable Development and the Paris Agreement under the United Nations Framework Convention on Climate Change.

15. Policy initiatives involving development banks, financial tools and the credit rating system that could help reduce development finance costs are examined in chapters III to V.

### C. Climate vulnerability and the debt and climate cycle

16. Besides asymmetries in the international monetary system, the cost of development finance is also affected by the greater climate-related vulnerability of developing countries and by the debt and climate cycle.

17. The climate crisis has intensified in recent years and the transition towards a low-carbon and climate-resilient economy is urgent, yet there is a significant gap between available affordable climate finance and what is needed to support the transition and cover climate-related loss and damage in developing countries. The Organisation for Economic Co-operation and Development estimates that \$6.9 trillion a year is needed annually up to 2030 in order to meet targets under the Paris Agreement, yet only \$653 billion was available annually in 2019 and 2020.<sup>7</sup>

18. In some developing countries, a vicious cycle is emerging whereby increasing climate-related investment needs lead to costly debt, worsening debt sustainability and limited further investments. Of the 67 countries eligible to access concessional finance under the IMF Poverty Reduction and Growth Trust, 28 are at the intersection of high debt and high levels of climate vulnerabilities (figure 3). In addition, other middle-income countries also have a high level of climate vulnerability, which raises borrowing premiums. Climate-vulnerable countries pay nearly 10 per cent more in overall interest costs on international bonds.<sup>8</sup>

Figure 3

**Overlap of debt and climate vulnerabilities in Poverty Reduction and Growth Trust-eligible countries**

<b>High level of environmental vulnerability</b>	30 countries	28 countries
	4 countries	5 countries
<b>Low level of environmental vulnerability</b>		
	<b>Low or moderate risk of debt distress</b>	<b>High risk of or in debt distress</b>

Source: UNCTAD secretariat calculations, based on data from the IMF debt sustainability analysis low-income country list as at April 2024 and the Notre Dame Global Adaptation Initiative country index.

19. In highly indebted developing countries, climate shocks hinder economic growth, disrupt tourism and reduce the ability to mobilize domestic resources for climate adaptation, weakening climate resilience. Such damage also strains government budgets due to infrastructure repair costs and increased social expenses. Following a climate shock, external non-concessional borrowing costs tend to rise due to higher perceived creditor risk, as foreign exchange revenues drop, further deepening debt vulnerability.

20. Many developing countries face heightened obstacles in transitioning to a low-carbon economy, including a greater reliance on environmentally harmful activities and less competitive high-technology sectors, leading to a need for more significant investments in climate mitigation and economic diversification. If developing countries heavily depend on exports from emissions-intensive sectors with declining prices and demand, then capacity to generate foreign currency for green technology and capital goods, as well as to service increasing external debt burdens, may be jeopardized. Access to affordable developing

<sup>7</sup> See <https://www.climatepolicyinitiative.org/publication/global-landscape-of-climate-finance-a-decade-of-data/>.

<sup>8</sup> UNCTAD, 2022b, Tackling debt and climate challenges in tandem: A policy agenda, policy brief No. 104.

finance is therefore critical for these countries to achieve the transition to a low-carbon economy.

21. Addressing the greater climate vulnerability of developing countries and the debt and climate cycle requires including climate analysis in debt sustainability assessments, boosting affordable climate finance by development banks and expanding the use of appropriate and innovative financial tools for climate-related investments.

### **III. Role of development banks in ensuring affordable development finance for developing countries**

22. International financial institutions are intergovernmental organizations created by States for a public purpose, and their authority and mandates are based on an international agreement to which all member States are party.<sup>9</sup> The best known international financial institutions are IMF and the World Bank (Bretton Woods Institutions).

23. Multilateral development banks and regional development banks are international financial institutions whose mandate is to finance development-oriented projects in sectors, activities and regions that would otherwise not receive financing from private lenders due to high levels of risk, low returns and/or uncertainties associated with lumpy investment requirements with high costs and long gestation periods. To fulfil this mandate, such institutions provide loans with more favourable costs and maturities than profit-seeking private banks and prioritize long-term social and economic goals over financial returns.<sup>10</sup> Multilateral development banks include the World Bank, as well as the African Development Bank, the Asian Development Bank and the Inter-American Development Bank, which lend to particular developing regions. The shareholding of the World Bank Group is controlled by major developed countries and, for the other banks, major developed countries account for 30–50 per cent of shareholds. Regional development banks are international financial institutions primarily owned by, and with loans directed towards, developing countries in a particular region, such as the Development Bank of Latin America and the Caribbean, the East African Development Bank and the West African Development Bank. National development banks are development finance institutions with a similar mandate as multilateral and regional development banks but are created for national purposes by a national Government.<sup>11</sup> Multilateral, regional and national development banks are classified as public development banks.<sup>12</sup>

24. The Sustainable Development Goals Stimulus of the United Nations Secretary-General calls for a massive boost in investment in crisis response and the Goals in developing countries, including financing climate action.<sup>13</sup> Given their mandate, public development banks are uniquely positioned to play a critical role in accelerating Goals-related investment that private institutions do not finance, since they can scale up long-term concessional and non-concessional financing to developing countries at rates closer to those paid by developed countries. Projects at the technological frontier may yield highly uncertain returns and projects aimed at ensuring food security may deliver low returns. In addition, financing gaps arise because of the public nature of some investment projects, the limited financing capacity of national and subnational governments to undertake large projects and unwillingness in the private sector to undertake long-term large-scale projects perceived as too risky. A significant obstacle to commercial financing for public investment is that it is typically not used because it does not generate direct financial returns on

<sup>9</sup> Bradlow DD, 2010, International law and the operations of the international financial institutions, in: Bradlow DD and Hunter DB, eds, *International Financial Institutions and International Law*, Kluwer Law International, Alphen aan den Rijn, Kingdom of the Netherlands:1–30.

<sup>10</sup> UNCTAD, 2019.

<sup>11</sup> Ibid.

<sup>12</sup> Public development banks include 522 development finance institutions. See <https://financeincommon.org/fics-2022-progress-report>.

<sup>13</sup> United Nations, 2023, United Nations Secretary-General's SDG [Sustainable Development Goals] stimulus to deliver Agenda 2030, available at <https://www.un.org/en/sdg-stimulus>.

investment yet can deliver greater economic growth over the longer term, from which debt service costs can be paid.<sup>14</sup>

25. The Stimulus states that multilateral development banks can increase lending from \$100 billion per year to at least \$500 billion per year by 2030, through stronger capital bases and better use of existing capital.<sup>15</sup> The unique capacity of multilateral development banks to use their high credit ratings to borrow long-term at low costs in global capital markets, to leverage resources, spread and mitigate risks between creditors and borrowers and offer countercyclical financing, makes them core institutions of international development cooperation and in facing new global challenges.<sup>16</sup> They complement efforts, in particular by the poorest and most vulnerable countries, to mobilize public resources domestically.<sup>17</sup>

26. Besides concessional, non-concessional and blended loans, public development banks provide other financial products, such as guarantees, grants and conversion mechanisms, to manage risks in order to enable investments in development-oriented projects. The significant currency risk faced by developing countries in borrowing abroad makes the local currency conversion instrument a critical mechanism in reducing risk for longer-term investments, including for climate adaptation and mitigation (box 1).<sup>18</sup> Public development banks also play a countercyclical role during external shocks.<sup>19</sup> This can help a country achieve resilience by sustaining the level of income, economic activity and capacity to import following shocks. For example, multilateral development banks played a significant countercyclical role during the pandemic, either by significantly increasing lending compared with in previous years, redirecting lending to other uses or serving as the primary sources of lending in the absence of other finance sources from national lenders (in lower-income countries) or from global financial providers (in middle-income countries).<sup>20</sup>

#### Box 1

#### **The cost of financial products provided by the main multilateral development banks**

##### **Loans**

Multilateral development banks provide concessional, non-concessional and blended loans to sovereign and sovereign-guaranteed borrowers. Concessional loans are offered to countries with a gross national income per capita below a specified threshold and/or countries lacking the creditworthiness required to access non-concessional loans. Such loans have fixed lending rates that are significantly lower than prevailing market rates or even set at zero and may include a service fee on the disbursed balance and a commitment fee on the undisbursed balance. Non-concessional loans are offered with flexible lending rates, comprising a market-based reference rate, an interest spread and fees; the main currencies of denomination are the yen, the pound sterling, the dollar (United States of America) and the euro, along with the respective reference rates. The interest spread for such loans includes a funding cost margin and lending spread, including a premium depending on the maturity of the loan and the income group of the country. Multilateral development banks charge a one-time front-end fee when a non-concessional loan is contracted and a commitment fee on the undisbursed balance, annually. Blended loans are offered to countries eligible for both concessional and non-concessional resources; such countries pay a slightly higher interest rate when accessing concessional finance than countries eligible only for concessional loans (see figure).

<sup>14</sup> UNCTAD, 2015, *Trade and Development Report 2015: Making the International Financial Architecture Work for Development* (United Nations publication, sales No. E.15.II.D.4, New York and Geneva).

<sup>15</sup> United Nations, 2023.

<sup>16</sup> See <https://www.adb.org/news/viewpoint-note-mdbs-working-system-impact-and-scale>.

<sup>17</sup> A/RES/69/313.

<sup>18</sup> UNCTAD, 2022a.

<sup>19</sup> Ibid; Ocampo JA, Kregel J and Griffith-Jones S, 2007, *International Finance and Development* (United Nations publication, sales No. E.06.IV.7, New York).

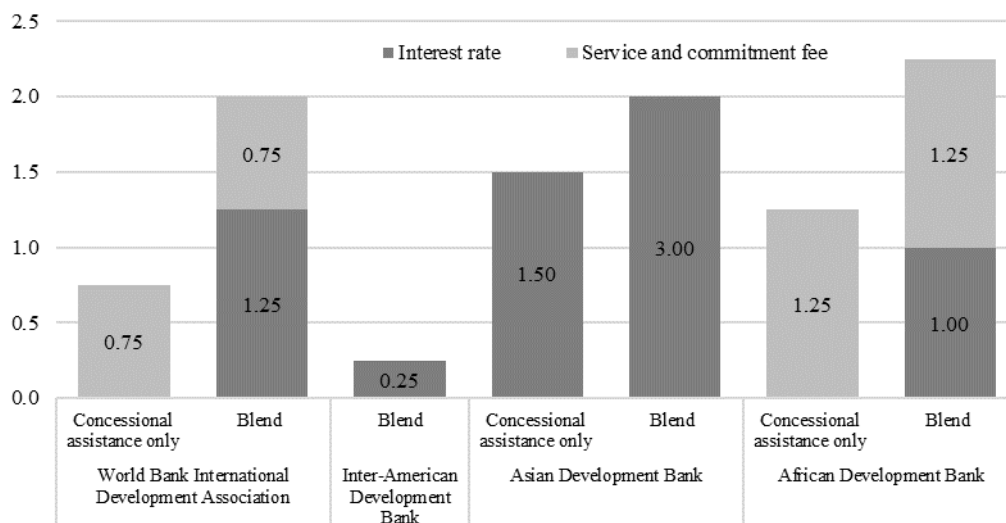
<sup>20</sup> Griffith-Jones S, Barrowclough D and Mishra V, 2022, Countercyclical responses: How development banks helped the COVID-19 recovery, and lessons for the future, paper presented at the Finance in Common Summit, Abidjan, Côte d'Ivoire, 19–20 October.



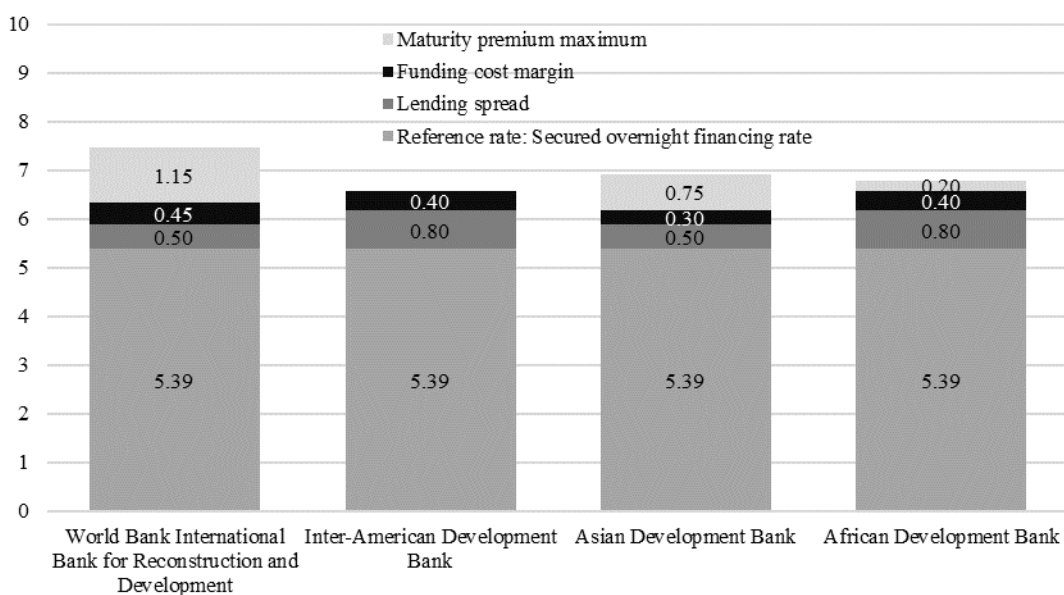
**Multilateral development banks: Composition of costs and lending rates, 1 July 2024**

(Percentage)

**(a) Concessional lending costs**



**(b) Range of non-concessional lending rates on United States dollar loans**



Source: UNCTAD secretariat calculations, based on data from the African Development Bank, the Asian Development Bank, the Inter-American Development Bank and the World Bank.

Note: The total cost of non-concessional loans is the lending rate plus front-end and commitment fees; maximum lending rates include the maturity premium.

**Guarantees**

Guarantees enable multilateral development banks to employ high credit ratings to cover certain risks that their sovereign, sovereign guaranteed and private borrowers cannot easily absorb or manage on their own. The price structure of guarantees generally includes fees (guarantee, front-end and standby) that are usually determined by whether the financial resources are sourced from concessional or non-concessional funds and by the type of borrower. Guarantee fees vary between 0.75 and 0.8 per cent (plus a premium); front-end fees vary between 0 and over 1 per cent; and standby fees vary between 0 and 1 per cent. When a guarantee is contracted, the total cost varies between 0.5 and 2.8 per cent.

### **Conversion mechanisms to manage financial risks**

Under non-concessional loan agreements, borrowers have the option to apply for various conversion mechanisms, to manage financial risks, including currency or local currency conversion, interest rate conversion and interest rate cap. Banks generally impose a transaction fee on accessing such services. Such conversion options help alleviate financial pressures on borrowers and mitigate the risk of default during periods of currency or interest rate volatility. The costs vary between 0.01 and 0.125 per cent.

### **Grants**

Multilateral development banks mainly provide grants to low-income and lower middle-income countries, with a 100 per cent grant or a 50-50 combination grant and loan to their member countries based on the respective country classification. The World Bank provides grants to international development assistance-eligible countries that are at higher risk of, or in, debt distress. The African Development Fund of the African Development Bank provides grants based on a country's debt sustainability as measured under the Debt Sustainability Framework for Low-Income Countries of IMF and the World Bank. The Asian Development Bank provides grants funded by the Asian Development Fund, based on per capita gross national income and creditworthiness. The Inter-American Development Bank uses its grant facility exclusively for Haiti, its only least developed country member.

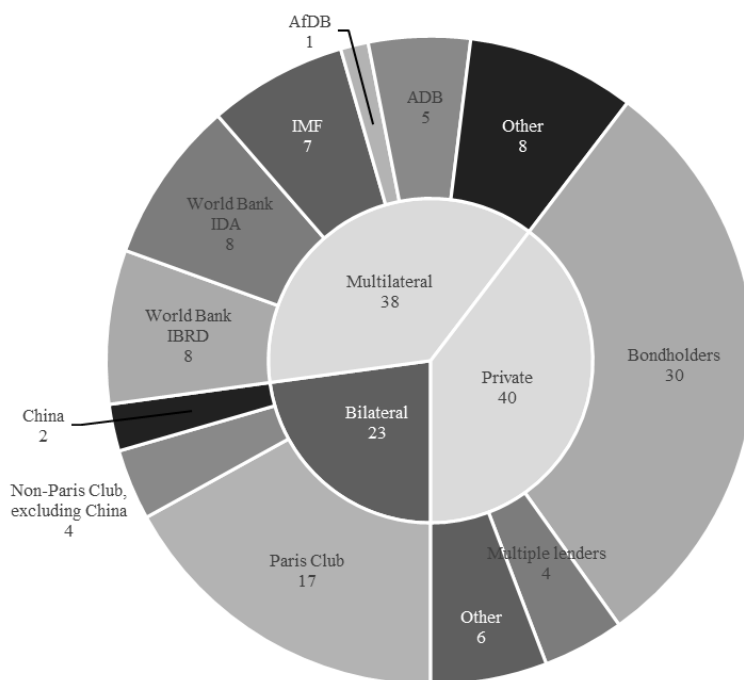
*Source:* UNCTAD.

27. Despite the importance of multilateral development banks in financing development and mitigating the impact of external shocks on developing countries, the share of multilateral creditors (multilateral and regional development banks) in the public and publicly guaranteed external debt of developing countries has fallen in the past decade. In 2022, such creditors accounted for 33 per cent of such debt, compared with 38 per cent in 2010. Over this period, the share fell across the three groups of developing countries, reflecting a trend of decreasing borrowing from multilateral creditors and increasing borrowing from private creditors, such as bondholders. For emerging-market economies, private creditors were already the main source of credit in 2010, with 50 per cent of the total; this share increased to 67 per cent in 2022. Simultaneously, the share of multilateral creditors decreased from 31 to 27 per cent of the total. For frontier-market economies and other developing economies, multilateral creditors have remained the primary creditors, accounting for around half (45 and 52 per cent, respectively) of the total. However, the share of private creditors increased more significantly for frontier-market economies than for other developing economies due to their different profiles of financial integration. For frontier-market economies, the share rose from 17 per cent in 2010 to 32 per cent in 2022 and for other developing economies, from 13 to 17 per cent (figure 4). A similar trend may be observed in concessional lending by the World Bank International Development Association, which decreased to 5 per cent of the total public and publicly guaranteed external debt of developing countries in 2022, compared with 8 per cent in 2010. However, in 2022, the share was 1 per cent for emerging-market economies, 13 per cent for frontier-market economies and 18 per cent for other developing economies.

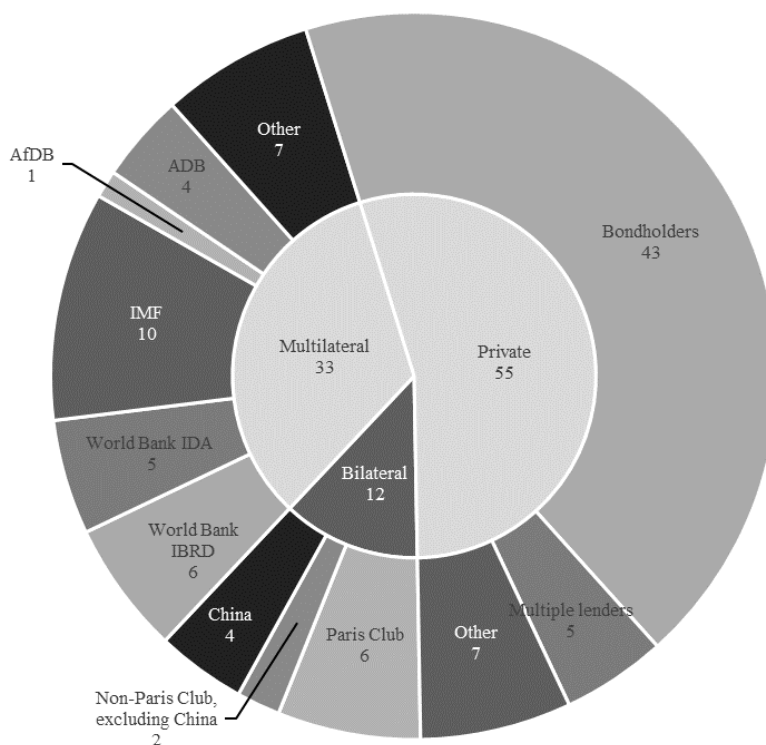
Figure 4  
**Public external debt creditor base for all developing countries and groups of developing countries**  
 (Percentage)

(a) **All developing countries**

(i) 2010

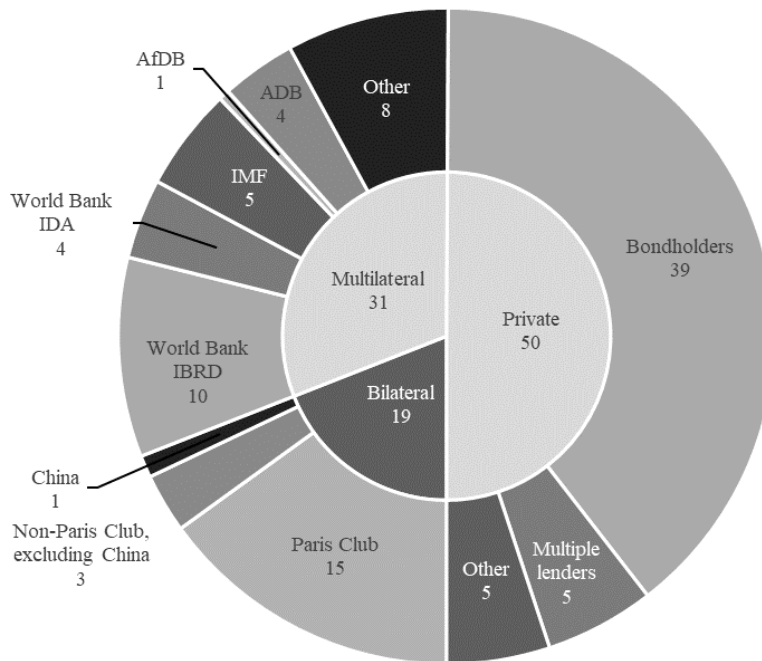


(ii) 2022

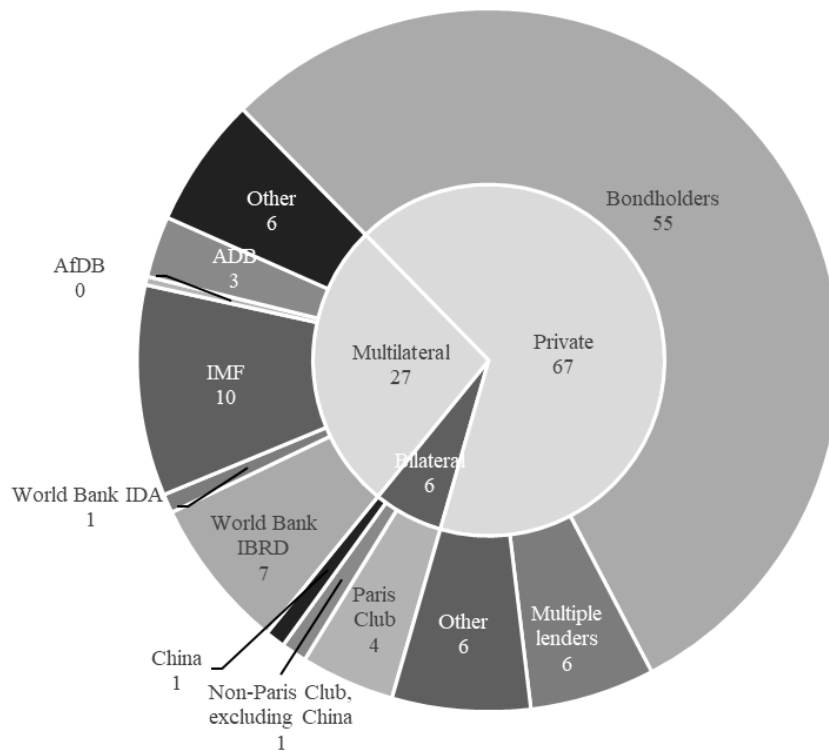


(b) **Emerging-market economies**

(i) 2010

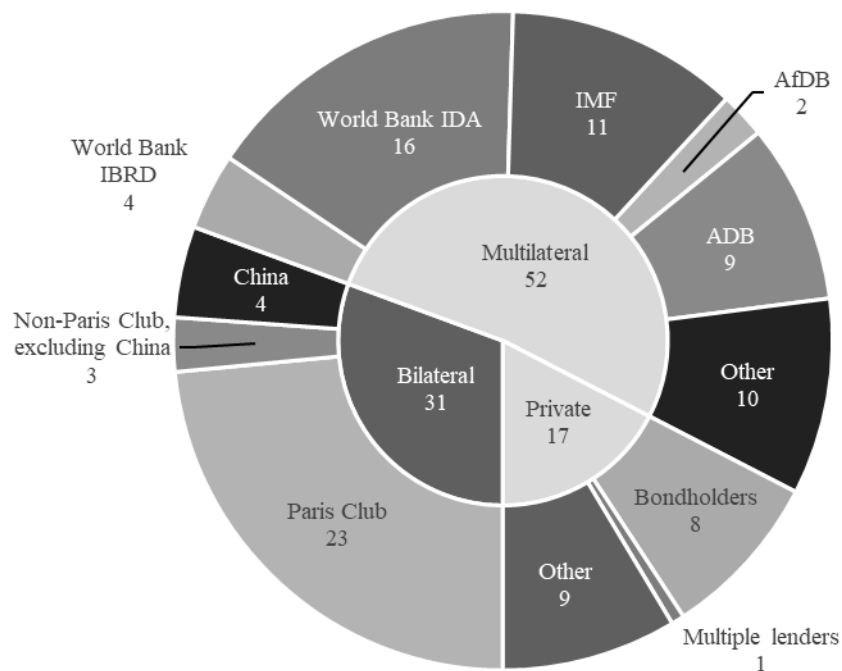


(ii) 2022

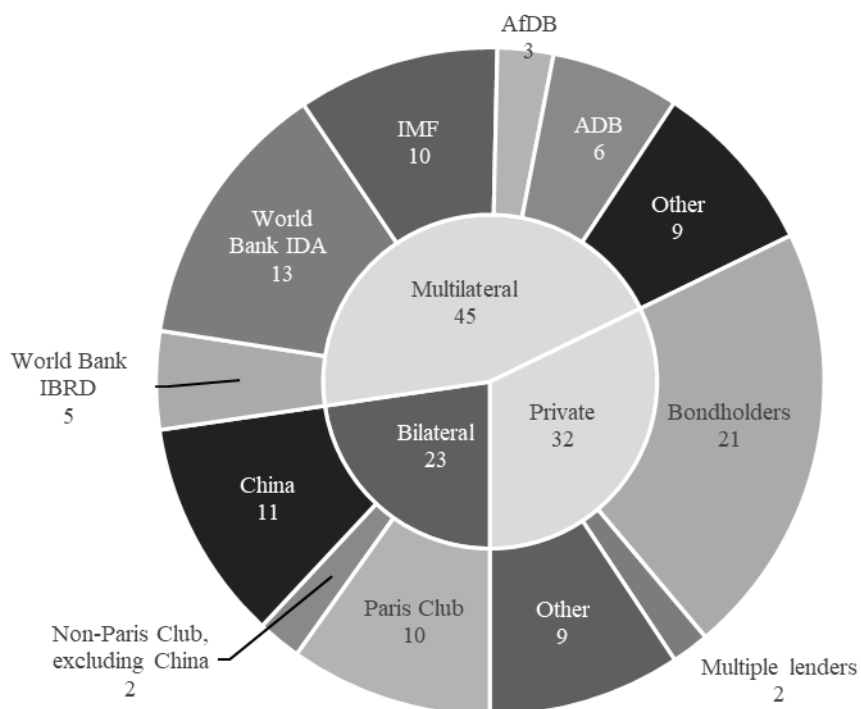


(c) **Frontier-market economies**

(i) 2010

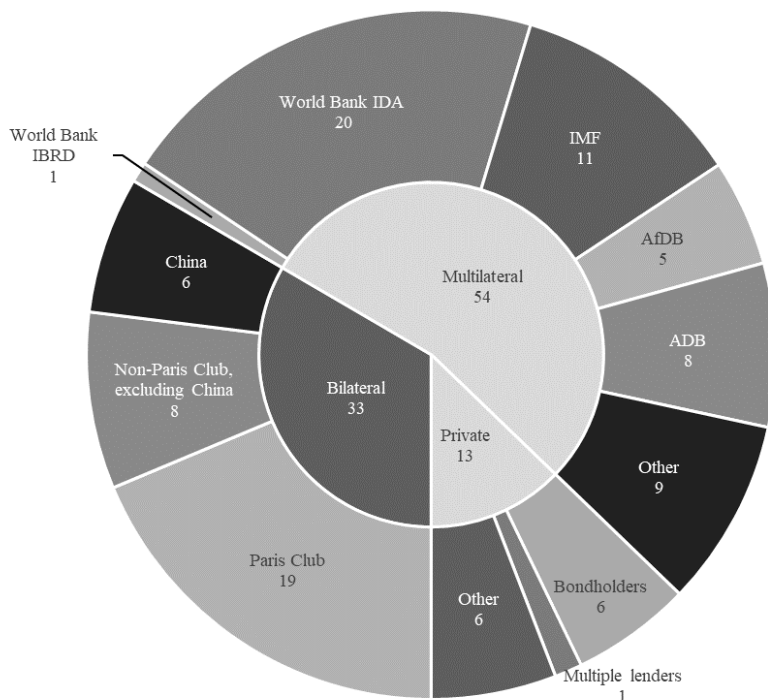


(ii) 2022

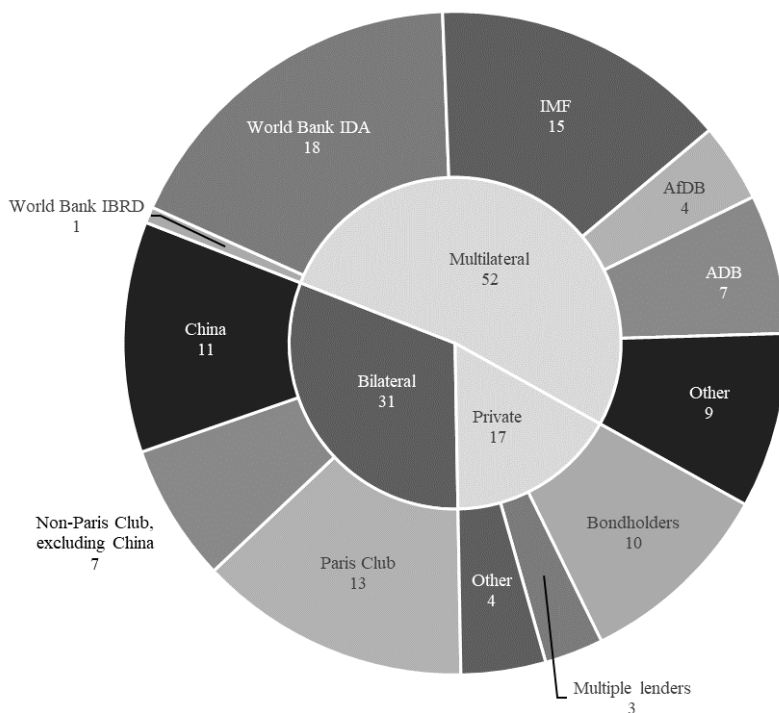


(d) **Other developing economies**

(i) 2010



(ii) 2022



*Abbreviations:* AfDB, African Development Bank; ADB, Asian Development Bank; IBRD, International Bank for Reconstruction and Development; IDA, International Development Association.

*Source:* UNCTAD secretariat calculations, based on World Bank international debt statistics.

28. National development banks complement the role of multilateral development banks and regional development banks at the national level, including through on-lending of the loans of multilateral and regional development banks. Over 90 per cent of development banks worldwide are at the national or subnational level.<sup>21</sup> During the global financial crisis of 2008/09, as lending from private-sector banks declined, national development banks became sources of long-term and countercyclical finance for investment in infrastructure, public facilities and strategic sectors. The crisis underscored their enduring importance in transforming economies. National development banks can also play a proactive role by utilizing research, technical support and institutional capabilities to shape and create markets and by acting as investors of first resort in anticipation of demand and the coordination of domestic supply responses.

29. With regard to instruments with which to address the high level of currency risk faced in developing countries, multilateral development banks and regional development banks could (partially or entirely) bear this risk through different mechanisms. Besides local currency conversion mechanisms, most multilateral development banks lend in the local currency of the borrower, but in many cases the amounts are relatively small or focused on countries with more developed financial markets. Modalities tend to be inflexible, with a predominance of back-to-back hedging, a mix of onshore and offshore products and synthetic instruments. Some multilateral development banks have also created currency liquidity pools with the aim of bridging market gaps between the desired maturity of lending and the maturity of liquidity available in a local currency. However, efforts remain largely uncoordinated. The World Bank Group, in collaborations through the Private Sector Investment Lab, is developing a package of innovative and scalable solutions to address the need for local currency financing and more affordable hedging options in order to facilitate private investment, particularly for the green transition.<sup>22</sup> In addition, the Inter-American Development Bank has launched a pilot project in Brazil, to support the foreign private capital mobilization and currency hedging programme under the national climate change fund, with a \$2 billion line of credit and technical support.<sup>23</sup>

30. Multilateral development banks and regional development banks could expand such mechanisms (local currency conversion, lending to Governments in local currencies, liquidity pools and other innovative solutions), as feasible and suitable, to all three groups of developing countries, depending, for example, on the degree of development of domestic financial markets. Another initiative could involve the establishment of a joint foreign exchange guarantee mechanism.<sup>24</sup>

31. New eligibility criteria that go beyond income level in determining access to loans from multilateral development banks and regional development banks (such as under a United Nations multidimensional vulnerability index<sup>25</sup>) need to be adopted in order that more developing countries can benefit from affordable sources of development finance. This could help reduce the asymmetrical access of the three groups of developing countries to development finance.

32. The role of public development banks could be strengthened through the better use of existing capital through reforms of the Group of 20 Capital Adequacy Framework reviews<sup>26</sup> and stronger capital bases, including recapitalization. The Secretary-General's Stimulus states that multilateral development banks should develop a concrete instrument to allow countries to channel unused special drawing rights through the banks.

<sup>21</sup> Xu J, Ren X and Wu X, 2019, Mapping development finance institutions worldwide: Definitions, rationales and varieties, development financing research report No. 1, Institute of New Structural Economics at Peking University.

<sup>22</sup> See <https://www.adb.org/news/viewpoint-note-mdbs-working-system-impact-and-scale>.

<sup>23</sup> See <https://www.iadb.org/en/news/idb-brazils-ministry-finance-ministry-environment-and-climate-change-and-central-bank-join>.

<sup>24</sup> Persaud A, 2023, Unblocking the green transformation in developing countries with a partial foreign exchange guarantee, Climate Policy Initiative.

<sup>25</sup> See <https://www.un.org/ohrlls/mvi>.

<sup>26</sup> See <https://www.g20.org/en/news/multilateral-development-banks-deepen-collaboration-to-work-as-a-system>.

33. The strengthening of South–South cooperation, including through the inclusion of new members, could contribute to scaling up regional sources of development finance through the creation of new regional development banks and scaling up of existing ones.

34. Multilateral development banks and regional development banks should strengthen financial cooperation (using on-lending, co-financing and risk-sharing mechanisms) and technical assistance provided to national development banks. At the same time, multilateral development banks and regional development banks can benefit from the local knowledge of national institutions, as noted in the Stimulus.

#### **IV. Tools with which to address the high cost of development finance, including in the areas of food security, the energy transition and the digital transition**

35. Some of the most significant factors that contribute to the high cost of development financing for developing countries include the costs that arise from their integration profiles, dependence on loans denominated in international currencies, exposure to climate risks and reduced access to grants and concessional funds from official creditors and the resulting increase in reliance on more expensive funding from private creditors. Addressing such factors in a systematic way can help reduce financing costs for development priorities. Particular tools with which to address the high cost of funding in order to achieve the Sustainable Development Goals, including food security, the energy transition and the digital transition, are discussed in this chapter.

36. It is important to distinguish between sources of funding that may directly relate to these objectives, such as the International Fund for Agricultural Development of the United Nations, the Global Agriculture and Food Security Programme of the World Bank and the Fund for International Development of the Organization of the Petroleum Exporting Countries, which have some focus on food security, and more generic financing instruments, such as debt swaps and green, social, sustainable and sustainability-linked bonds, which may be used interchangeably across priority areas.

37. The suitability and availability of individual financing instruments depends on the levels of integration into global capital markets and on the nature of the projects and programmes being funded. For example, debt-for-development swaps only constitute a financially efficient source of funds if the country concerned does not have access to alternative sources of funding at better rates and is not at a high risk of default. UNCTAD estimates that debt-for-development swaps would have been a financially efficient funding option for 8–15 per cent of developing countries at the end of 2023, depending on the extent to which associated transactions costs could be contained.<sup>27</sup>

38. The Food and Agriculture Organization of the United Nations (FAO) estimates that funding for food security and nutrition averaged around \$121 billion per year in 2017–2021, comprising, per year, funding from philanthropic donors of \$4 billion, official development assistance and other official flows of \$26 billion, cross-border remittances of \$29 billion and foreign direct investment of \$62 billion.<sup>28</sup>

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<sup>27</sup> UNCTAD, 2024, Sovereign debt-for-development swaps, presented at the Joint Finance and Health Task Force meeting, 6 June.

<sup>28</sup> FAO, International Fund for Agricultural Development, United Nations Children’s Fund, World Food Programme and World Health Organization, 2024, *The State of Food Security and Nutrition in the World 2024: Financing to End Hunger, Food Insecurity and Malnutrition in All its Forms* (FAO, Rome).



39. According to the International Renewable Energy Agency, in 2021, finance of over \$15.4 billion was provided in support of the transition to affordable and clean energy in developing countries.<sup>29</sup> However, the Independent High-Level Expert Group on Climate Finance has estimated that by 2030, \$1.3 trillion–\$1.7 trillion may be required annually to finance the energy transition in developing countries.<sup>30</sup>

40. The digital transition plays a critical role in the achievement of the Sustainable Development Goals. However, the digital divide between developed and developing economies is widening; In 2023, 2.6 billion people did not have Internet access and 850 million people did not have any form of official identification.<sup>31</sup> The International Telecommunication Union estimates that investments of \$428 billion will be required by 2030 in order to deliver universal Internet access.<sup>32</sup> Additional funding will also be required to develop supporting digital infrastructure, particularly to transform public services delivery.

41. Generally, grants and concessional loans are the most suitable financing options for countries with the lowest level of access to international financial flows (that is, other developing countries), and greater domestic resource mobilization through expanded tax revenues may be an option for countries with a moderate level of access to international capital markets (frontier-market economies). Such tax revenues can then be used to leverage blended finance options using guarantees and other de-risking instruments. For example, the Global Agriculture and Food Security Programme Private Sector Window of the International Finance Corporation uses blended finance and concessional funding to help improve the conditions of small and medium-sized agribusinesses and, through this window, the International Finance Corporation leverages \$6.5 of private sector funding for every \$1 invested.<sup>33</sup> Countries that are well integrated into global capital markets (emerging-market economies) can use instruments such as green, social, sustainable and sustainability-linked bonds.

42. Different financing instruments form part of the toolbox available to developing countries (see table). Some instruments may be used in combination; for example, guarantees can be used to de-risk multiparty debt-for-development swaps, to make them more attractive to private investors. Certain instruments may be more, or less, suited to individual countries and the prevailing circumstances.

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<sup>29</sup> World Bank, 2024, *Tracking SDG [Sustainable Development Goal] 7: The Energy Progress Report* (Washington, D.C.).

<sup>30</sup> See <https://www.lse.ac.uk/granthaminstitute/publication/finance-for-climate-action-scaling-up-investment-for-climate-and-development/>.

<sup>31</sup> See <https://www.worldbank.org/en/topic/digital/overview>.

<sup>32</sup> International Telecommunication Union, 2020, *Connecting Humanity: Assessing Investment Needs of Connecting Humanity to the Internet by 2030* (Geneva).

<sup>33</sup> See <https://www.ifc.org/en/what-we-do/sector-expertise/blended-finance/blended-finance-agribusiness>.

**Indicative availability and appropriateness of financing instruments for developing countries based on levels of integration into global capital markets**

		Financing instrument	Level of integration into global capital markets												
			Low (other developing economies)			Medium (frontier-market economies)			High (emerging-market economies)						
Source of finance	Official/Philanthropic	Grant	■	■	■	■	■	■	■	■	■	■	■	■	■
		Concessional loan	■	■	■	■	■	■	■	■	■	■	■	■	■
		Non-concessional loan	■	■	■	■	■	■	■	■	■	■	■	■	■
		Bilateral debt-for-development swap	■	■	■	■	■	■	■	■	■	■	■	■	■
	Blended (risk-sharing/leveraging)	Loan buy-down	■	■	■	■	■	■	■	■	■	■	■	■	■
		Guarantee	■	■	■	■	■	■	■	■	■	■	■	■	■
		Subsidy	■	■	■	■	■	■	■	■	■	■	■	■	■
		Advance market commitment	■	■	■	■	■	■	■	■	■	■	■	■	■
		Multiparty debt-for-development swap	■	■	■	■	■	■	■	■	■	■	■	■	■
	Private	Targeted taxation (e.g. solidarity tax)	■	■	■	■	■	■	■	■	■	■	■	■	■
		Credit allocation policy	■	■	■	■	■	■	■	■	■	■	■	■	■
		Green, social, sustainable and sustainability-linked bond	■	■	■	■	■	■	■	■	■	■	■	■	■
		Sovereign bond	■	■	■	■	■	■	■	■	■	■	■	■	■

Source: UNCTAD secretariat calculations.

Note: Countries most suited to each instrument depending on level of integration into global capital markets are depicted; the darker the colour, the more suited that instrument is likely to be to countries in the respective grouping.

43. A new approach to blended finance is needed, as stated in the Stimulus, including a focus on development impact rather than bankability. This may involve the use of non-concessional loans, sovereign guarantees and other structures, whereby the public sector can share both risks and rewards fairly, aligned with the Addis Ababa Action Agenda.

44. Sovereign guarantees can help lower the cost of capital through various credit enhancing mechanisms, such as partial risk, first-loss and liquidity guarantees. Governments could focus the use of guarantees on covering risks that the market cannot absorb. Guarantees carry liability risks due to the uncertainty of timing and amount, which can affect fiscal management. Therefore, guarantee provision should be aligned with the prudential risk management practices of a jurisdiction. The use of a centralized facility to coordinate guarantees and ensure that they do not exceed the balance sheet capacity of a country may be considered.<sup>34</sup> In the green finance sector, for example, the Green Guarantee Company was launched in February 2024 as the first climate guarantee company, with the goal of assisting borrowers in developing countries in improving credit ratings and accessing global capital markets. The initiative will provide guarantees for climate bonds; aims to create a market that connects local issuers in developing countries with international investors; and seeks to de-risk mitigation and adaptation projects in developing regions, to attract international private sector investments.<sup>35</sup>

45. A range of fiscal policies can also serve to mobilize sustainable finance. For example, tax incentives can be a cost-effective means by which to create incentives for investors to invest in sustainable debt instruments, particularly in underdeveloped financial markets, for example through the following:<sup>36</sup>

(a) Tax credit bonds that provide bondholders with tax credits in lieu of interest payments for bond issuance. This model has been used in the United States with regard to municipal bonds, federal clean renewable energy bonds and the qualified energy conservation bonds programme;

(b) Direct subsidy bonds that provide cash rebates to bond issuers by the Government, to subsidize net interest payments;

<sup>34</sup> Asian Development Bank, 2024, *Fiscal Policy and Sustainable Finance: Enhancing the Role of the Financial Sector in Achieving the Sustainable Development Goals* (Manila).

<sup>35</sup> See <https://www.greenclimate.fund/project/fp197>.

<sup>36</sup> See <https://www.climatebonds.net/policy/policy-areas/tax-incentives>.

(c) Tax-exempt bonds that lower interest rates by exempting bond issuers from income tax on the interest on the bonds. This model has been used in Malaysia.

46. Green finance subsidies are another fiscal tool with which to reduce costs and attract climate investments, and include interest rate subsidies, stamp duty exemptions, verification cost reimbursements and direct grants. Interest rate subsidies may be less expensive to implement compared with thematic bonds. The feasibility of such subsidies in a country depends on budgetary constraints, capacity to develop subsidy programmes and processes, ability to avoid creating market distortions and ability to effectively monitor and evaluate systems.<sup>37</sup> Subsidies for fossil fuels are estimated to exceed \$7 trillion.<sup>38</sup> IMF and the World Bank have advocated the repurposing of environmentally harmful subsidies towards supporting a green and just transition.<sup>39</sup> Subsidies may also be used to reduce the cost of development finance as part of other Goals-related investments. Sustainable debt instruments are discussed in box 2.

#### Box 2

##### **Sustainable debt instruments**

Sustainable debt instruments are gaining increasing attention from investors among countries with access to global capital markets and/or well-developed domestic capital markets. Such instruments have been most widely used for green finance, but are also being employed in the social and sustainability sectors. Thematic bonds encompass green, social, sustainability and sustainability-linked bonds and have predominantly been issued in the following two forms:

(a) Use-of-proceeds instruments, whereby the proceeds are allocated to thematic objectives such as green, social or sustainable projects. According to the principles of the International Capital Market Association, eligible projects for thematic bonds include renewable energy, climate change adaptation, clean transportation, food security, housing, gender equality and education. Issuers benefit from a “greenium”, that is, a discount on borrowing costs for a green bond compared with a conventional bond. This discount reflects the willingness of investors to accept lower yields in order to finance green projects. The issuance of sovereign green bonds is a relatively recent development and the empirical evidence supporting lower associated yields is mixed. Green bonds are prevalent in developed countries and have also been issued in emerging-market economies. Studies have found significant variations in the estimation of the greenium across sovereign issuances, with factors such as the stage of development and currency denomination contributing to the variability, whereby foreign currency-denominated bonds issued by developing countries were found to have larger greeniums;

(b) Target-linked instruments, which are forward-looking performance-based instruments whereby the issuer commits to achieving particular goals within a predetermined timeline. In contrast with use-of-proceeds instruments, target-linked instruments do not restrict the use of the proceeds but may include interest rates or financial terms linked to target-based environmental, social and governance-related metrics. They are designed with incentives and penalties linked to the achievement of sustainability performance targets, which may include interest rate stepups, interest rate stepdowns, redemption premiums at maturity, the purchase of carbon emission credits and provisions for early redemption.

The associated benefits of issuing such debt instruments are manifold for issuers, since they serve to broaden the investor base and increase demand, boost the credibility of environmental, social and governance-related initiatives and, potentially, lead to lower interest rates, stemming from the greenium.

Sustainable debt instruments represent a new and growing asset class, yet account for a small fraction of the bond market. The growth is encouraging, yet the investor base is

<sup>37</sup> Asian Development Bank, 2024, pp. 9–11.

<sup>38</sup> UNCTAD, 2023, *Trade and Development Report 2023: Growth, Debt and Climate – Realigning the Global Financial Architecture* (United Nations publication, sales No. E.23.II.D.24, Geneva).

<sup>39</sup> See <https://www.worldbank.org/en/topic/climatechange/publication/detox-development>.

limited. Access to the market for such bonds is constrained for developing countries with low credit ratings and high levels of perceived risk. In addition, the issuance of such bonds is more expensive and complex than that of conventional bonds, since they have resource-intensive monitoring, reporting and verification requirements, and because the design, management and issuance of such bonds may require external resources.

*Sources:* Asian Development Bank, 2024; IMF, 2023, How large is the sovereign greenium? Working Paper No. 80; World Bank, 2024, Green, social, sustainability and sustainability-linked bonds: Market update – January. See <https://www.climatebonds.net/policy/policy-areas/tax-incentives>, <https://www.climatebonds.net/resources/reports/sustainable-debt-market-summary-h1-2024> and <https://www.winston.com/en/blogs-and-podcasts/capital-markets-and-securities-law-watch/green-bonds-in-international-capital-markets>.

## V. Determinants of sovereign credit ratings and their role in development financing

47. A sovereign credit rating is an opinion issued by a rating agency that reflects its perception of the probability that the issuing country will be able to service debts fully and in a timely fashion. The three dominant global rating agencies (Fitch, Moody's and Standard and Poor's) use a 21-level ordinal ranking scale that ranges from investment grade to speculative grade, to signal this opinion to participants in financial markets. To inform the opinion, the agencies have rating committees that use individually developed but similar methodologies and scorecards that incorporate both objective and subjective indicators, judgments and sentiments. In addition to "soft information" related to institutional strength and governance, as well as cultural and proximity variables, rating agencies also consider macroeconomic and other indicators that reflect the economic strength, fiscal strength and susceptibility to risk of the country being rated. As noted in one study, all three major rating agencies state that qualitative judgments play a significant role in ratings.<sup>40</sup> This is evident not only in relation to the institutions and governance strength component, which cannot be measured quantitatively, but also with regard to data gaps and data quality differences among other scorecard components. Lower confidence in the quality and scope of data, which is more common among developing countries, allows rating committees to rely more on expert judgments when rating these countries. In addition, while the initial indicators used to determine economic and fiscal strength, for example, may rely on quantitative indicators that embody some level of objectivity, how the indicators are interpreted by rating committees in considering economic resilience, government financial strength and susceptibility to event risk is not consistent across countries and also requires judgment.

<sup>40</sup> Slapnik U and Lončarski I, 2023, Understanding sovereign credit ratings: Text-based evidence from the credit rating reports, *Journal of International Financial Markets, Institutions and Money*, 88.

48. Numerous studies identify different types of bias inherent in sovereign ratings, including home bias, bias designed to preserve the market power of the three major rating agencies, bias arising from differences in how indicators used in rating scorecards are applied and interpreted and bias arising from differences in the marginal impacts on ratings that changes in indicators give rise to.<sup>41</sup> The subjective nature of the rating process creates significant scope for bias, yet this cannot automatically be assumed to affect developing countries consistently and systematically. Developing countries rely on ratings to access global capital markets, and striving for an investment rating may reinforce costly behaviour. For example, rating agencies accord little significance to reserve levels in the case of developed countries, yet these are deemed highly relevant to the ratings of developing countries and this may contribute to overinvestment in such low-yield assets by developing countries.

49. An examination of the relationship between sovereign ratings and market yield spreads (the difference between the prevailing return on a rated country's issued bonds and a comparative financial instrument such as United States treasury bills) suggests that capital markets take account of much more than credit ratings and that the impact of these considerations on bond-pricing and borrowing costs tends to be more material than both the level of and changes in sovereign ratings. Market movements may lead or follow ratings decisions, and a reliance on ratings is reduced if institutions and data systems in a rated country act to improve data transparency.

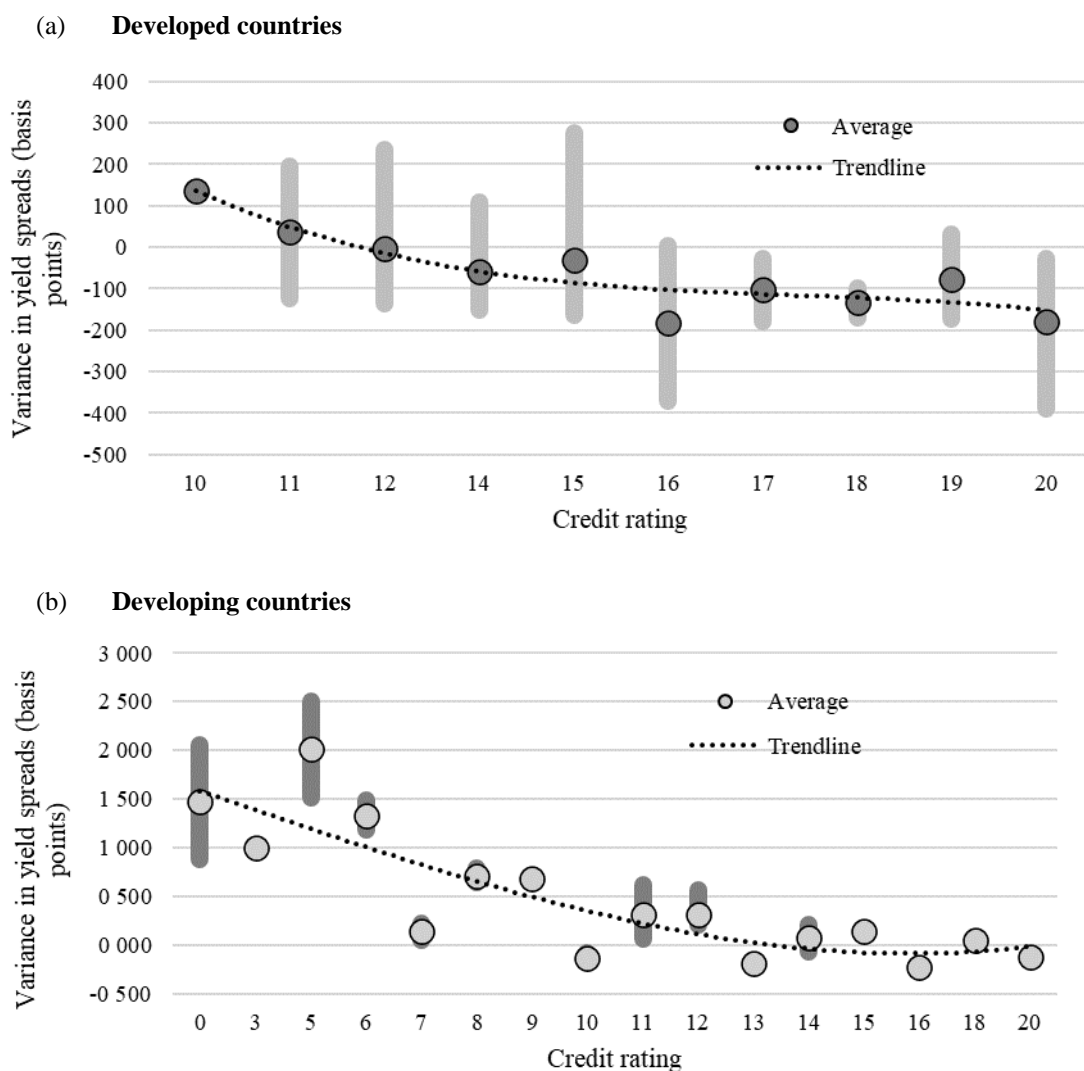
50. Significant variations in yield spreads between developed and developing countries with the same ratings undermine the thesis of a consistent impact of rating bias (figure 5). Comparisons of the yield spreads on 10-year government bonds in developing countries relative to similar United States government bonds show that there can be significant differences in the pricing of sovereign bonds in financial markets, even when the countries concerned have the same credit ratings and are in the same region. This indicates that financial markets tend to price the risks associated with the debt instruments of countries independently, even when rating agencies assess their risks of default to be similar. Markets also price the yields of developing countries higher than those of developed countries with the same credit rating, suggesting other more systemic forms of bias with regard to developing countries.<sup>42</sup>

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<sup>41</sup> Ellis C, 2022, Are sovereign ratings biased against Africa? *Applied Economics and Finance*, 9(1):29–36; Fuchs A and Gehring K, 2017, The home bias in sovereign ratings, *Journal of the European Economic Association*, 15(6):1386–1423; Gültekin-Karakaş D, Hisarcıklılar M and Öztürk H, 2011, Sovereign risk ratings: Biased toward developed countries? *Emerging Markets Finance and Trade*, 47(supplement 2):69–87; Luitel P, Vanpée R and De Moor L, 2016, Pernicious effects: How the credit rating agencies disadvantage emerging markets, *Research in International Business and Finance*, 38:286–298.

<sup>42</sup> UNCTAD, forthcoming, Sovereign credit ratings bias: Does it exist and how should it be addressed?

Figure 5  
**Variations in yield spreads of countries with same credit ratings, mid-April 2024**



Source: UNCTAD secretariat calculations, based on data from World Government Bonds.  
 Note: Ratings reflect the arithmetic average of ratings by Fitch, Moody’s and Standard and Poor’s; AAA rating = 20 and D rating = 0.

51. Between the start of 2012 and May 2023, developing countries paid a premium on internationally sourced capital that averaged around 200 basis points, relative to developed countries.<sup>43</sup> The premium for certain developing regions, such as Africa, was significantly higher. Addressing the systemic reasons behind such differentials could have a more significant impact on the ability of developing countries to access sufficient global capital at prices commensurate with development needs and objectives than a narrow focus on sovereign ratings, particularly since 54 developing countries do not currently have a rating.

52. Rating processes cannot correctly and objectively anticipate all crises and default risks. Adopting measures that increase market reliance on ratings and encourage the further outsourcing of regulatory judgment by investors, issuers and regulators is likely to exacerbate the amplitude and impact of future crises and shocks, particularly in developing countries.

<sup>43</sup> Ibid.

53. Several initiatives could help improve the sovereign ratings process and limit its negative impacts on the cost of and access to development finance among developing countries, including the following:

(a) Prioritizing the development of a more effective global financial safety net as a key element of the fundamental reform of the global financial architecture that can provide quick and automatic access to liquidity at a relatively low cost, in order to limit the need for developing countries to maintain unnecessarily high levels of reserves;

(b) Establishing a United Nations-convened credit rating technical assistance process that provides guidance and issues rating opinions that allow currently unrated member States an opportunity to obtain indicative ratings and identify and progressively develop the institutions, data and debt management systems and financial sustainability, including the assessment of climate risks, necessary in order to access domestic and global capital markets more formally in future;

(c) Expanding technical assistance that assists countries in adopting better and more transparent data and debt management systems, in order to reduce the importance of rating agencies, improve policy formulation and decision-making by the countries concerned and, in the process, help reduce investment risk premiums;

(d) Adopting regulatory changes that emphasize that ratings are opinions, not certifications, and that address potential conflicts of interest within rating agencies;

(e) Developing a supportive rating approach for countries that choose to engage in debt restructuring, including under the Group of 20 Common Framework, in order that the credit rating impasse does not discourage debt distressed countries from restructuring debt, and which could include a possible separate rating track conditional on a more efficient and rapid conclusion of the debt restructuring process.

## VI. Final remarks

54. Addressing the high cost of development finance for developing countries is critical in order to achieve the Sustainable Development Goals, the financing gap for which is currently estimated at around \$4 trillion per year.<sup>44</sup> Crucially, doing so involves the expansion of the pool of development finance available, since the costs depend on the adequacy of the sources of funds and on the judicious use of financing instruments in concert with sound policies. Without this, any emphasis on particular priority areas, such as food security, might result in reduced funding for other development goals.

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<sup>44</sup> UNCTAD, 2023, *World Investment Report 2023: Investing in Sustainable Energy for All* (United Nations publication, sales no. E.23.II.D.17, Geneva).