Financing for Sustainable Development Report 2022

Inter-agency Task Force on Financing for Development

Bridging the Finance Divide

United Nations

Report of the Inter-agency Task Force
on Financing for Development

Financing for Sustainable Development Report 2022

United Nations

This report is a joint product of the members of the Inter-agency Task Force on Financing for Development. The Financing for Sustainable Development Office of the United Nations Department of Economic and Social Affairs serves as the coordinator and substantive editor of the Financing for Sustainable Development Report.

The online annex of the Task Force (http://developmentfinance.un.org) provides additional data and analysis on progress in implementation of the Financing for Development outcomes, including the Addis Ababa Action Agenda and relevant means of implementation targets of the Sustainable Development Goals.

Inquiries about the Task Force or its report and online annex can be sent to:

Financing for Sustainable Development Office
Department of Economic and Social Affairs
2 United Nations Plaza (DC2-2170)
New York, N.Y. 10017
United States of America
+1-212-963-7574

developmentfinance@un.org

http://developmentfinance.un.org

Federal Ministry
for Economic Cooperation
and Development

The production of this report and the online annex of the Inter-agency Task Force are generously supported by the Federal Ministry for Economic Cooperation and Development of Germany.

How to cite this report:

United Nations, Inter-agency Task Force on Financing for Development, *Financing for Sustainable Development Report 2022.* (New York: United Nations, 2022), available from: https://developmentfinance.un.org/fsdr2022.

United Nations publication

Sales No. E.22.I.6
ISBN: 978-92-1-101452-5

Overcoming the “great finance divide”



Chapter II

Overcoming the "great finance divide"

1. Introduction

Fiscal constraints in developing countries are driving a widening "pandemic recovery gap" that threatens achievement of the Sustainable Development Goals (SDGs). Developed countries have been financing a large-scale response to the COVID-19 pandemic at historically low interest rates. Many developing countries—faced with significantly higher borrowing costs in, and intermittent access to, international financial markets—have been more hamstrung in their response. This so-called "great finance divide" contributed to developing countries' diminished ability to finance an appropriate response to a historic shock. If left unaddressed, it will further exacerbate the divergence in development prospects, and pandemic scarring will fatally undermine achievement of the SDGs.

Debt financing enables countries to respond to emergencies such as the pandemic and to fund long-term investments, including in climate action and the SDGs. But if not used well, it can constrain policy space down the line and jeopardize fiscal sustainability and financial stability. Sovereign borrowing allows Governments to ramp up spending and provide assistance during a crisis, when private actors may be unable to do so. It allows countries to invest in the future when productive investment opportunities, which support the public good, arise. Such investments can help to achieve public policy objectives *and* increase the tax base and capacity to service debt over time. But benefits can be sustained only if risks are managed carefully and resources used effectively. Rapid build-ups in debt often end in financial crises. The challenge is to increase access to long-term, affordable and stable financing, and to use proceeds productively so that public policy goals are achieved *and* fiscal capacity is enhanced.

Without addressing financing gaps, countries may forego productive investments to meet economic, social and environmental needs, which is undesirable for reasons of both equity and efficiency. Debt financing is most appropriate for investments that generate direct returns and/or enhance a country's fiscal capacity over relevant time horizons, for example, infrastructure investments. Such investments in sustainable development should find funding from investors with sufficiently long time horizons, such as pension funds and/or public development banks; however, for a variety of reasons, they currently do not. Other forms of public spending may not directly enhance fiscal capacity and are unlikely to be funded by commercial investors, even in the long run, but may be indispensable to avert large costs (climate action), eradicate poverty or achieve other SDGs. These are priorities that the international community has committed to support and that should find funding from concessional sources.

To reverse the divergence in recovery and achieve the SDGs, countries will need reliable access to affordable financing from concessional and non-concessional (public, private, domestic and international) sources. A package of measures can help developing countries to mobilize affordable, long-term financing and spend the resources effectively to achieve policy objectives:

- **Spending mobilized resources effectively on shared priorities** is a precondition for translating additional financing into development impact and enhanced fiscal capacity to service debt. This includes strengthening public investment efficiency and good governance more broadly and also linking investment and development partner support to country-owned, medium-term plans, for example, through an Integrated National Financing Framework;
- **Mobilizing additional public financing** for investment in public policy priorities, such as raising domestic resources (see chapter III.A). Public development banks can play an important role, given their ability to lend long term and countercyclically at affordable rates;
- **Reducing borrowing costs and procyclical volatility of borrowing from commercial sources** through: domestic actions to reduce risks and strengthen the enabling environment and international efforts to reduce volatility in global markets; improvements in the information ecosystem, including longer-term ratings and debt sustainability assessments; and exploiting the growing interest in sustainability issues to reduce borrowing costs; and

- **Addressing debt overhangs** to reduce debt burdens and free up resources for investment in climate action and the SDGs.

These actions cut across the action areas of the Addis Ababa Action Agenda. Some of the detailed analysis and recommendations, as well as key complementary actions, are covered throughout the chapters of the report and referenced below.

2. The great finance divide

Developing countries are confronted with financing at higher costs, shorter maturities and greater volatility. The pandemic has exacerbated the differentiated abilities of countries to respond to the crisis and invest in climate action and the SDGs (section 2.1). This divergence is at least in part due to financing conditions. A range of factors, including investor perceptions and uncertainty over their repayment capacity and structural challenges and constraints mean that developing countries pay elevated risk premia in markets and face debt sustainability concerns at lower levels of debt (section 2.2). Exploring some of the underlying drivers of this financing divide (section 2.3) helps to inform the policy recommendations laid out in the third part of the chapter.

2.1 A constrained response to the pandemic and limited ability to invest in climate action and the SDGs

A divergent pandemic response

The outbreak of COVID-19 delivered a seismic shock to the global economy, but developed countries were able to respond with aggressive macroeconomic policies. The pandemic triggered a contraction in consumption, investment, employment and income at unprecedented speed (see chapter I). Policymakers in developed countries responded in an aggressive and in some respects unprecedented way to mitigate social and economic impacts. They delivered fiscal support at massive scale and backstopped fiscal measures through aggressive and unconventional monetary policy. This macro-policy response achieved its intended short-term objectives. Household incomes and financial markets in developed countries stabilized. For example, there are indications that poor households in particular benefited from fiscal support in the United States, in marked contrast to the recovery from the world financial and economic crisis a decade earlier.[1]

Developing countries were more constrained in their policy response. Fiscal and monetary policy responses were dependent on national circumstances and policy space, as well as on the international support provided. But on average, and compared to developed countries, they were more restrained, with a more limited fiscal response and more limited monetary accommodation to support fiscal policies. In middle-income countries (MICs), fiscal policy was supportive, if at a smaller scale than in developed countries, and is being withdrawn earlier in some countries due to tight borrowing constraints.[2] In least developed countries (LDCs), fiscal policy remained much more limited despite international support. On the monetary policy side, many developing country central banks lowered interest rates and reserve requirements, with some adopting unconventional measures for the first time. But their interventions were smaller in scale and shorter in duration than in developed countries due to concerns over currency depreciations, inflation and capital outflows[3] (see chapter I).

This more limited response, along with a lack of vaccine availability, has led to a more protracted crisis in developing countries, with large and potentially long-term ramifications on SDG prospects. Despite the support the international community did provide, foregone economic losses from the pandemic compared to pre-pandemic projections are much larger in developing countries than in developed countries. These differences are projected to persist over the medium term, translating into major setbacks to sustainable development prospects in health, employment, gender equality and the fight against poverty. As a result, unmet financing needs for the SDGs have further increased with a worsening baseline, with estimates of a 20 per cent increase in spending needs for key SDG sectors.[4]

Long-term investments in climate action and the SDGs

The contrasting pandemic response is mirrored in divergent rates of investment and capital spending. In major developed economies, fiscal responses to the pandemic have focused on supporting and shaping the recovery—for example, in the context of infrastructure legislation in the United States and the European Union's "NextGenerationEU" recovery plan.[5] These public investment packages, which are (potentially) large in scale, emphasize sustainability and climate action. The NextGenerationEU Recovery and Resilience Facility is expected to provide loans and grants of over €700 billion for European Union Member States' public investments through 2026. In sharp contrast, poor countries had to reprioritize public expenditures and cut spending in areas critical to long-term sustainable development. While the G20 Debt Service Suspension Initiative (DSSI) and other forms of multilateral and bilateral support provided them with important breathing space, allowing for additional COVID-19 related expenditure, capital spending among the 43 participating countries fell by 1.1 percentage points on average in 2020 and is projected to remain below pre-crisis levels in 2021. Investment in education fell as well.[6] Total investment rates in developing countries are not projected to return to pre-pandemic levels over the next two years, in contrast to developed countries,[7] with investment recovery particularly subdued in LDCs (see chapter I).

Yet, SDG and climate progress requires a significant scaling up of investments. Public capital stocks have been deteriorating across income groups (with some notable exceptions) over the last 30 years due to falling public investment ratios. Additional investments needed to achieve the SDGs and climate targets are large: in core infrastructure such as roads, electricity, water and sanitation, they amount to around 2.7 per cent of gross domestic product (GDP) in MICs and 9.8 per cent of GDP in LDCs and other low-income countries (LICs) through 2030.[8] Public investments to reach net zero emissions alone are estimated at around 2 per cent of GDP annually over the next decade.[9]

Such SDG investments require access to long-term financing. Financing constraints stand in the way of a "big push" investment drive for recovery, SDG progress and climate action. This investment push will need to include both public and private investment. Private investment is more appropriate for some sectors and investments than others, particularly those that offer competitive, risk-adjusted financial returns. Yet the cost of borrowing for private investment is not independent of that for sovereigns (the so-called "sovereign ceiling", see chapter III.B). Thus, a high sovereign borrowing not only affects public investment; it can also

reduce the attractiveness of otherwise investable or "bankable" projects for private investors. Without addressing financing gaps, countries will forego investments with high social returns, which are critical for achieving the SDGs:

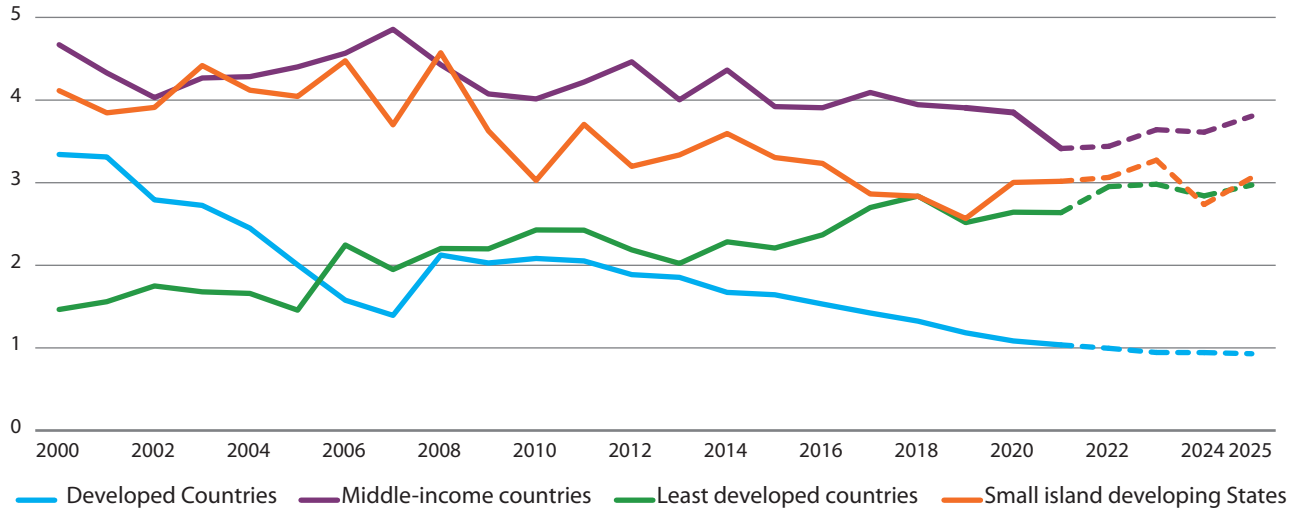
- Many SDG investments, such as productive investments in physical capital and infrastructure have positive financial returns, but long gestation periods. They should thus find financing from investors with sufficiently long time horizons, such as pension funds and/or public development banks (see chapters III.B and III.C). Investments in green infrastructure also have large output and employment multipliers and thus significant co-benefits for sustainable development;
- Other investments may not have expected direct financial returns associated with them but may still stimulate economic growth and enhance fiscal capacity over the medium to long term. Public investments in health and education, for example, not only impact individual welfare but also growth prospects (although over long time horizons of 15 years or more).[10] These will likely need public financing;
- Other investments may not directly enhance fiscal capacity, even in the long run, and may never deliver financial returns. However, they may still have large social returns, be indispensable to avert large costs (climate action) and/or deliver on shared global priorities such as poverty eradication—priorities that the international community has committed to support.

2.2 Costs and terms of capital

Developing countries are typically faced with a relatively high cost of capital. In the low interest environment of recent years, the average interest cost of outstanding sovereign debt in developed countries fell to around 1 per cent. The average cost for developing countries is significantly higher. LDCs, which have access to concessional lending, have increasingly tapped international markets in recent years, dragging up their average borrowing cost and worsening their debt dynamics. For example, in 2021, African and LDC sovereign Eurobonds were issued with yields above 5 per cent, and yields in 40 per cent of African bonds exceeded 8 per cent. While debt service burdens in developed countries remain low, even at high levels of debt, developing countries, including some of the most vulnerable among them, dedicate a large and growing share of their fiscal resources to servicing public debt (see figures II.1a and II.1b).

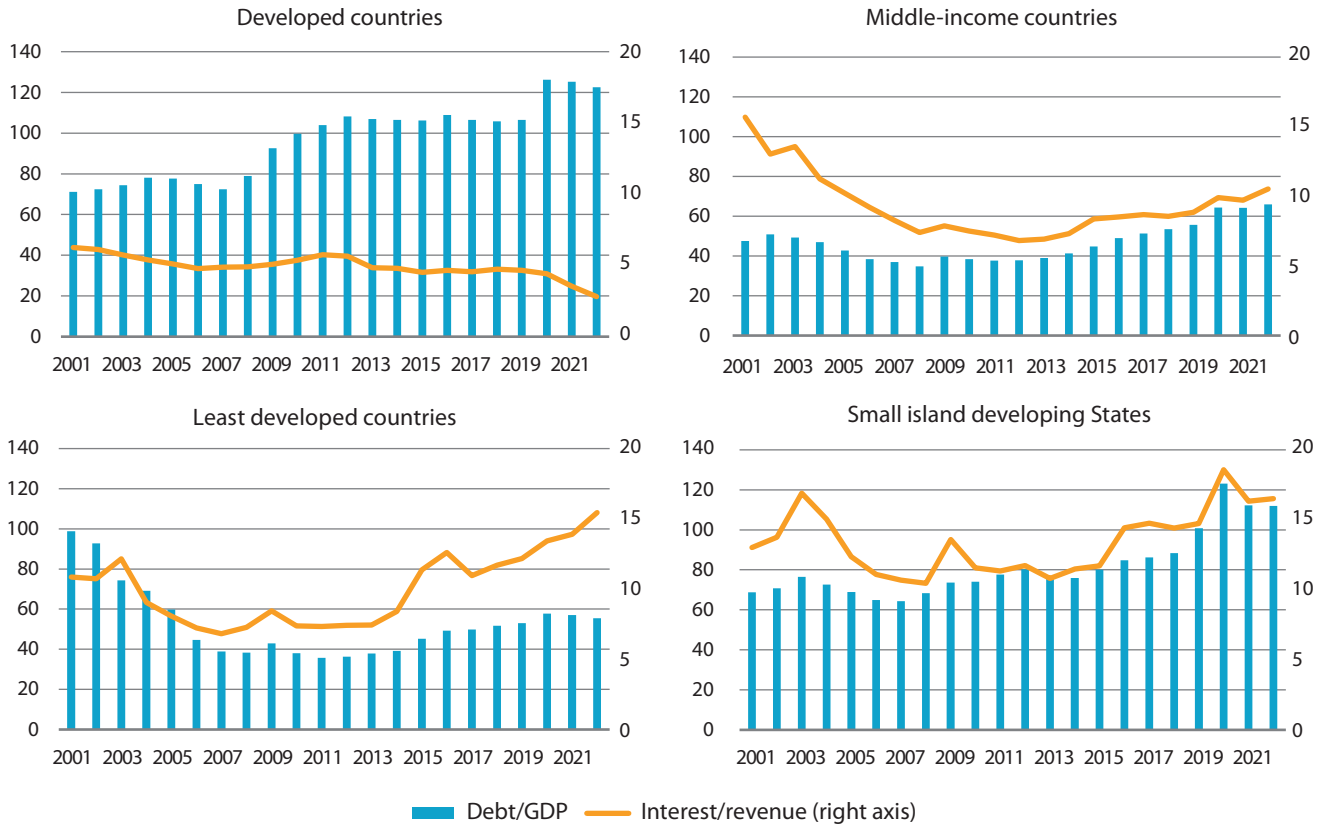
Many developing countries still face limitations in issuing long-term domestic debt. Domestic debt now accounts for almost half of the total debt of all developing countries (up from less than a third 20 years ago). In total, developing countries are increasingly relying on savings from domestic residents to finance deficits, although the share remains significantly lower for LDCs and LICs.[11] But "original sin"—the idea that many countries are unable to raise long-term funding in their domestic currency—has not been fully "redeemed". Many LDCs in particular are still left with suboptimal choices—either to borrow at short maturities domestically, usually from the banking sector (which creates maturity mismatches when financing long-term investments and increases the risk of sovereign banking sector nexus in the event of a crisis), or in foreign currency in international markets (creating currency mismatches for national investments that do not necessarily generate foreign exchange earnings).[12] More generally, issuing domestic debt that is in local currency and/or under domestic law, remains more expensive for countries that are perceived as high risk (including as measured by low credit ratings).[13] This also applies to developed countries—in the Eurozone, sovereign bonds issued under foreign jurisdiction trade at a premium for borrowers perceived as "high risk".[14]

Figure II.1a
Average interest cost of outstanding government debt
(Median, in per cent)



Source: Volz, Ulrich and Damon Aitken. 2022. "Public Debt in the Time of COVID-19 and the Climate Crisis". Background Paper for the Financing for Sustainable Development Report 2022. Figure compiled with data from the IMF and IIF.

Figure II.1b
Debt stocks and debt servicing costs
(Percentages)



Source: IMF WEO data, with UN/DESA staff calculations.

Investors have historically demanded sizeable compensation for investing in foreign currency sovereign debt. While developing countries have reduced reliance on such foreign currency borrowing in recent years, many still face difficulty issuing long-term debt domestically (see also below). Yet, foreign currency borrowing is expensive. Over the last 200 years, the average annual return of foreign currency debt to investors has been around 7 per cent, after accounting for losses from defaults. This exceeded the "risk free" return on US and UK bonds by an average of 4 percentage points (in finance terms, the credit spread, or additional cost of finance for Eurobond issuances is 4 per cent).[15]

Returns for investors have been greater since the mid-1990s in the period of bond financing, compared to returns from bank loans that dominated prior to that. Following the Brady plan in the late 1980s, which securitized bank loans into tradeable securities, developing country sovereign borrowing shifted from commercial bank loans to bond issuances. Since 1995, total returns to investors (net of losses from defaults) have averaged almost 10 per cent—a historical high, with a credit spread of around 6 percentage points over the risk-free rate. To put this spread into context, external sovereign bonds are the best performing asset class, outperforming other asset classes such as equities or corporate bonds. This is true even when adjusted for risk (measured by short-term volatility of secondary market prices).[16] Foreign currency bonds more than compensate investors for the risks they face, even through a period of repeated financial turmoil in developing countries. High investor returns equal high borrowing costs for countries. This raises the question of how much investor "excess returns" has cost developing countries and to what extent "excess borrowing costs" have contributed to debt crises.

High spreads on foreign currency bonds reflect perceptions of high default risk; such perceptions can sometimes become self-fulfilling. Sovereign spreads represent investors' default risk perceptions, primarily determined by country fundamentals. A deterioration in global financing conditions can change risk perceptions and sometimes trigger liquidity crises even in countries that had a sustainable debt trajectory and are solvent. At that point, borrowing costs could rise sharply and default expectations can become "self-fulfilling".[17]

2.3 Underlying drivers of limited policy space

Improving financing terms calls for addressing underlying macroeconomic constraints. More expensive and more intermittent access to financing has constrained developing countries' macro-policy response to COVID-19 and limits fiscal space to invest in climate action and the SDGs. These more challenging financing conditions are linked to a whole host of factors, including institutional and governance quality,

rate and resilience of economic growth, the state of public finances and external balances and monetary flexibility. Macroeconomic constraints—the focus of this chapter—play an important role; addressing these will be key to increasing developing countries' fiscal and monetary policy space.

The aggressive macro-policy response in developed countries reflects a broader shift in the "conventional wisdom" of macroeconomic policy that preceded the pandemic. With ultra-low interest rates unable to avert a slow recovery from the 2008 world financial and economic crisis, conventional monetary policy had appeared increasingly toothless. This led to several key shifts:[18]

- Unconventional monetary policies, such as quantitative easing, and a blurring of the boundaries between fiscal and monetary policies;[19]
- A reappraisal of the role of fiscal policy in what some have called a "new fiscal consensus", which accepts that macroeconomic policy measures are needed to support aggregate demand in light of weak private sector demand; that the onus is on fiscal policy to do so as monetary policy is exhausted at the zero lower bound; and that additional fiscal support is feasible as debt remains sustainable even at higher levels in a low interest environment;[20]
- In parallel, policymakers are paying increasing attention to the links between traditional objectives of macroeconomic policy and broader sustainable development considerations such as inequality and climate change. Inequality has become a central concern in this regard, identified as one of the drivers of growing household indebtedness and depressed aggregate demand.[21] There are calls for a significant scaling up of public investments in physical and social infrastructure, and climate adaptation and mitigation.[22] Both inequality and climate change, for example, have also come into the focus of central banks (see chapter III.F and previous editions of the *Financing for Sustainable Development Report*).[23]

However, there are limits to how well this new-found flexibility "travels" to developing countries due to underlying constraints that translate into less policy space; rising inflation also puts it into question in developed countries. Fiscal space is more limited in many developing countries because debt sustainability concerns tend to arise at lower levels of debt than in developed countries. In addition to the general challenges with assessing countries' solvency noted above, developing countries tend to have less flexibility to adjust their fiscal stance in crises, and there is more volatility and uncertainty over their growth prospects and interest costs. The greater dependence of many developing countries on foreign savings and foreign currency borrowing further exacerbates vulnerability and uncertainty, as it makes countries more vulnerable to the global financial cycle and sudden stops. Together with often less well-anchored inflation expectations, this can limit monetary policy space (see box II.1 for details). As inflationary pressures continue to rise, with global inflation increasing to over 5 per cent in 2021 (see chapter I), and central banks start to tighten their policy stances in response, rising borrowing costs may also become a more pressing concern in developed countries again.

Box II.1
Limits to fiscal and monetary policy space

Fiscal space and debt sustainability

Fiscal space is limited even at comparatively lower levels of debt for many developing countries. Assessments of sovereign debt sustainability focus on public debt trajectories over the near to medium term under reasonable growth and policy assumptions and how those trajectories are affected by different shocks.[24] A stable trajectory requires that primary balances (the difference between public revenue and public expenditure other than interest payments on debt) are sufficient to cover debt service or interest on the existing debt stock. Debt trajectories are thus driven by the fiscal policy stance (primary balances) and the interest rate-growth differential. Because developing countries tend to have less ability to adjust their fiscal policy stance, and face greater uncertainty over future growth and interest rates, they are faced with higher default risk.

- **Primary balances are more challenging to adjust.** Public non-interest expenditure represents a smaller share of GDP in poorer countries. This is for two reasons: first, their public budgets are comparatively much smaller. Second, developing countries dedicate a larger share of their public budgets to interest payments on average. They need to make a larger effort for an equivalent (in GDP terms) adjustment of their primary balance. LDCs, for example, mobilize only half as much revenue as a share of GDP as developed countries, but spend triple the share of that revenue on interest payments. They would have to increase the primary balance by 10 per cent to achieve an adjustment of 1 percentage point of GDP, more than twice the effort that would be required for the average developed country. Observed primary balances are more stable in developing countries, hinting at the difficulty of adjusting them through the business cycle;[25]
- **There may also be a greater level of uncertainty around primary balances.** Greater vulnerability to external shocks and disasters and higher political risk or volatility of terms of trade may all translate into more volatile fiscal balances. Lower levels of debt transparency and large contingent liabilities, which increase uncertainty around "true primary balances", can also contribute and lead to increased risk premia (see also chapter III.E);[26]
- **Interest-growth differentials have become less favourable.** Developing countries on average grow faster than developed countries. LDCs and other LICs in particular also benefit from access to concessional finance, leading to more advantageous interest-growth differentials—their capacity to service debt has grown faster than interest that accrues on it. However, over the last decade with increased market access, their cost of borrowing has increased. While primary deficits, though volatile, stayed in line with historical averages prior to the pandemic, rising borrowing costs and lower growth rates became a major driver of debt increases.[27] This is in marked contrast to developed countries, which have benefited from near-zero interest rates;
- **Developing countries also have more volatile interest-growth differentials, further increasing**

uncertainty. Interest rates are volatile due to shallower financial markets and to reliance on foreign savings and foreign currency borrowing, which makes debt stocks and interest costs vulnerable to exchange rate movements. This volatility is pronounced in periods of financial stress—countries that issue reserve currencies are much less likely to see interest rates spike (safe havens may even see interest rates fall during a crisis). This can lead to sharp increases in risk premia in developing countries.[28]

Monetary policy space

The ability to ease monetary conditions may be limited due to poorly anchored inflation expectations, weak fiscal positions, shallow financial markets and vulnerability to capital outflows. Developing countries and LDCs in particular are much more vulnerable to external price shocks. Approximately three quarters of the variability of core inflation rates in LICs can be explained by external shocks, for example, those emanating from volatile global energy and food prices.[29] As a result, inflation rates are less stable and inflation expectations less well-anchored. Underdeveloped financial markets may also impede monetary policy transmission channels—policy rates may not be passed on effectively to market participants, for example, because of market segmentation, dollarization or limited financial inclusion. All these factors can limit monetary policy space and effectiveness. A weak fiscal position and vulnerability to capital outflows further exacerbate this challenge.

These challenges are heightened in those developing countries that are reliant on foreign savings and that issue debt in foreign currency. Lowering policy rates will put downward pressure on exchange rates (for countries with floating rates). Depreciations will, in turn, increase debt service costs on foreign currency denominated debt. Central banks' ability to act as a lender of last resort in their domestic markets, providing loans to domestic financial institutions when market financing dries up, is also constrained. Foreign currency reserves may not suffice to repay creditors at short notice, potentially triggering currency and banking crises. More generally, developing countries that need to service and roll over foreign currency debt and finance imports, including health-related imports in the context of the pandemic, are vulnerable to volatility in international capital markets. Such vulnerabilities have increased as external debt stocks as a percentage of exports of goods and services and primary income have steadily risen over the last decade across developing countries.

International capital flows are driven by global factors beyond the control of developing countries to a significant degree. Global liquidity conditions and related risk aversion or risk appetite are an important driver of gross capital flows. Portfolio equity and debt flows into different regions and countries are highly correlated with each other and with global factors, such as growth and real interest rates in developed countries and risk aversion and uncertainty in global markets.[30] Such global factors have become more important determinants of capital flows compared to domestic factors over the last decade, such that "keeping one's own house in order is necessary but not sufficient for sustainable capital flows in the new world order".[31] And liquidity problems, be they triggered by domestic conditions or a sudden stop linked to global developments—such as in the early phases of the pandemic—can quickly turn into solvency challenges. An increase in risk premia and borrowing costs, for example, due to decreasing global risk appetite and lower global liquidity, can become "a self-fulfilling prophecy" and turn a liquidity challenge into a solvency crisis and default. This exacerbates both debt sustainability risks and constrains developing countries' monetary policy space.[32]

Source: UN/DESA.

3. A multifaceted policy response

Achieving the SDGs will require access to affordable, long-term and stable sources of financing and their effective use. Financing can come from public sources—development banks, bilateral providers—or from markets. The former are well placed to fund SDG investments because of shared objectives and long time horizons and will thus need to be a primary source. The latter have scale, but are more short-term oriented and demand high risk premia from developing countries. Tapping global savings for SDG investments thus requires addressing underlying drivers of the high cost of capital for developing countries, such as uncertainty and information gaps, volatility in global markets and systemic risks, and short-term incentives. Enhanced access to finance alone will not, however, achieve the desired impact if resources are not used effectively; efforts to reinforce transparency, accountability, risk management and good governance at large must be commensurate to the scaling up of financing, so that public policy goals are achieved *and* fiscal capacity is enhanced.

The policy options listed below aim to support the provision of additional financing from official sources and markets on favourable terms that reduce cost and volatility, address debt overhangs where needed and ensure that resources mobilized are spent effectively for shared priorities. The policy options aim to address the lack of funding, reduce developing country borrowing costs through national and global actions, and lower vulnerability to external shocks and capital flow volatility that further constrain their macroeconomic policy space. They are clustered in four areas:

- **i** Spending mobilized resources effectively and in line with shared priorities;
- **ii** Public finance provision and the role of public development banks;
- **iii** Access to commercial financing at better terms, including both national and global efforts; and
- **iv** Addressing debt overhangs.

These policy options can address both "efficiency" and "equity" issues. In part, they address inefficiencies in both policymaking and in markets by strengthening institutional and policy frameworks; closing information gaps; enhancing transparency; and addressing investor time horizons and gaps in the international policy architecture to lower volatility and uncertainty. However, enhanced efficiency alone will not suffice—the financing gaps are too large, particularly in countries with limited fiscal capacities. Closing these is an equity issue that requires the mobilization of additional concessional finance for shared priorities such as climate action and the SDGs.

The focus of these options is broadly on debt, in light of the current specific challenges laid out above. But debt financing cannot be seen in isolation. It is intrinsically linked to countries' macrofiscal and budget frameworks and their revenue strategies as well as all other action areas of the Addis Agenda. The remainder of the report addresses these in detail and provides relevant recommendations, particularly on: domestic resource mobilization (chapter III.A), which provides the long-term revenue base for servicing debt; private finance and investment (chapter III.B), which is a key complementary or even primary source of financing and investment in core SDG and climate priority areas; and different types of international concessional finance (see chapter III.C).

3.1 Good governance and effective use of proceeds

Achieving the efficiency and equity objectives laid out above will depend on how effectively mobilized resources are used, and on carefully managing associated risks. Equitable and sustainable growth provides the basis for revenue mobilization, reduced reliance on foreign savings and achievement of development objectives in the long run. Higher growth rates also improve debt dynamics—if growth rates exceed interest rates, public debt becomes sustainable at higher levels. Debt financing can support recovery and growth, but it is no silver bullet. Rapid build-ups in debt often end in crises. About 50 per cent of "debt booms"—periods of significant increases in debt-to-GDP ratios—have been accompanied by financial crises.[33] For additional debt financing (or debt relief) to translate into positive long-term outcomes, risks have to be carefully managed and resources used well.

Access to more—and more diverse—sources of debt financing increases the burden on debt managers to carefully manage risk. Despite improvements, debt management capacity in some countries has not kept pace with the rising complexity of the financing landscape. This endangers countries' ability to effectively manage the trade-off between the cost of borrowing and associated risk of financial instruments. Medium-term debt management strategies can help countries to meet their financing requirements, including those associated with investments in recovery, climate action and SDGs, and to manage their debt portfolios in a prudent manner.

Transparency is a precondition for effective debt management. Data gaps undermine countries' ability to effectively manage their debt, and for borrowers and their creditors to assess the sustainability of debt. Enhancing debt transparency and the related capacities of developing countries has been a key focus of the international community, but important gaps remain. Closing these coverage gaps, for example, in relation to state-owned enterprises or on terms and conditions of lending, becomes a high priority when the demands on public financing increase in the context of a crisis response or an expansion of public investment (see chapter III.E).

The scale-up of financing must be accompanied by commensurate efforts to improve governance more broadly. Governance challenges often stand in the way of financial resources and policies being effectively translated into desired development outcomes. Measures of governance quality, such as the rule of law, the absence of corruption and the quality of institutions, are important determinants of the long-term growth prospects of countries and thus also of their capacity to carry debt.[34] The effective management of public resources is a central aspect of good governance. Lack of transparency and accountability, corruption and misuse of public financing undermine public trust in the state; at grand scale, corruption will have significant negative fiscal and macroeconomic implications. Reducing corruption, on the other hand, has been associated with higher tax revenue generation, substantively enhancing countries' fiscal capacity.[35]

Sources of financing and their terms should match the characteristics of the investments or spending they are used for. Debt financing is most appropriate for projects and investments that generate direct returns and/or enhance a country's fiscal capacity over relevant time horizons, such as infrastructure investments. Other SDG priority areas, such as health and education, require increases in recurrent spending and, accordingly, sustained increases in domestic revenues.

The efficacy of additional public investments also depends on strengthened infrastructure governance and related public financial management processes. The efficiency of public investment is a key determinant of its growth and debt sustainability impacts, but evidence suggests that efficiency gaps are sizeable. On average, more than one third of resources are lost in the public investment process (when compared to best performers), with wide variations between countries. The quality of infrastructure governance and public investment management strongly impacts macroeconomic outcomes. In developing countries with strong governance records, additional public investments tend to have stronger positive impacts on growth, crowd in private investment and do not lead to rising debt ratios.[36] Existing assessments suggest that countries' weaknesses tend to be most pronounced in institutions specific to public investment rather than public financial management functions that relate not just to infrastructure but to a broader set of issues. Strengthening public sector capacities in this area, including project appraisal, selection, implementation and maintenance, is thus a priority.[37]

Public investment decisions should be guided by a country's medium-term sustainable development strategies and plans. Public investment priorities should emerge from broader national development priorities, for example, as an investment strategy that is associated with a medium-term plan and that identifies priorities based on development objectives and cost estimates. This is likely to enhance policy coherence toward broader objectives such as structural transformation. Linking public investment decisions to a medium-term fiscal and budget framework and debt management strategy can reduce the volatility of financing for capital expenditure. Stronger medium-term budget practices are associated with higher and less volatile public investment performance.[38] Integrated National Financing Frameworks can help countries to align their investment strategies and related financing decisions with their overall development plans.

Any conditionalities associated with resources provided for the achievement of climate or SDG priorities must be anchored in such nationally determined and owned priorities and plans. There is great potential in exploiting shared interests and objectives around climate action and the SDGs to mobilize additional resources for developing countries. To ensure that such resources are indeed used for their intended purposes in an effective manner, they should be tied to nationally owned and developed strategies and plans, based on lessons learned over many years in the development effectiveness area. Integrated National Financing Frameworks can guide development partners and other actors in their support.

3.2 Additional international public financing and public development banks

International public finance is an affordable and stable source of long-term finance. It must play a leading role in financing investments in recovery, the SDGs and climate action. International public finance is well placed to fund these investments for two reasons: first, public finance providers should have longer time horizons than private investors, allowing them to "engage in market arbitrage" and fund those long-term productive investments that others eschew. That is to say, with many private actors investing with shorter time horizons, there should be long-term investment opportunities that are under-priced and that a patient investor could fund profitable, thus "arbitraging" market behaviour. Second, public finance providers share SDG and climate priorities and are seeking sustainable development impact (possibly combined with financial viability) rather than maximization of financial returns. Hence, they are willing to provide concessional financing for investments that would otherwise not be competitive on a risk-return adjusted basis.

Public development banks can lend long term, at affordable rates and countercyclically, easing financing pressures during crises. Because they have public backing, development banks can fund their activities cheaply and pass this advantage on to their borrowers through lower interest rates and longer maturities, extending up to 40 years for concessional loans by the multilateral development banks (MDBs), for example. Often, they combine financial support with technical assistance and focus on projects and sectors well-aligned with climate action and the SDGs. Finally, they are better placed to absorb and manage rollover risks and have the capacity to act countercyclically. Both the MDBs and national and regional development banks have done so in the current crisis (see chapter III.C).[39] Public development banks already have a large footprint—527 development banks and development finance institutions have total assets of US$13 trillion,[40] with a small number of very large banks holding the vast majority of assets. Public development banks are estimated to finance around 10 per cent of investment globally.[41] But they could do more. In light of large unmet public financing needs, their role could be further strengthened in terms of the scale of their lending, lending terms and their cooperation as a "development bank system".

MDBs can further expand their lending through capital increases and balance sheet optimization. MDBs have been constrained in their COVID-19 response due to limited financial capacity (see chapter III.C of the *Financing for Sustainable Development Report 2021*). To further increase their lending capacity, their capital position could be strengthened and use of their capital optimized. This includes:

- **Capital increases** to non-concessional windows and early replenishments of concessional lending windows. Such capital increases could be tied to specific SDG or climate priorities, as suggested in the climate-dedicated capital increase by the United Nations Independent Expert Group on Climate Finance;[42]
- More **effective use of the existing capital base.** Studies show that MDBs could significantly increase lending without impacting their credit ratings (see chapter III.C). The G20 has initiated a review of MDB capital adequacy frameworks; and
- **Rechannelling unused SDRs** through MDBs that are already prescribed holders. Any proposal for channelling SDRs via MDBs needs to address national regulatory, policy, and institutional arrangements that guide the level of flexibility countries have outside established IMF options. (See chapters III.C and III.F.)

Public development banks can provide lending on terms that support long-term and stable access to finance. Lending on such terms could help to address the key risks and uncertainties laid out above, including rollover and exchange rate risks associated with short-term and foreign currency borrowing, liquidity risks and sudden stops.

- MDBs in particular provide **lending at long maturities** (median maturities for MDB loans are 23 years in MICs and 30 years in LDCs, see chapter III.C); as noted in the *Financing for Sustainable Development Report 2021*, the lengthening of such maturities to 50 years, at fixed interest rates, could be considered, particularly for financing investments with a positive but very long-term impact on growth, including for non-concessional loans such as for health and education. This would need to be accompanied by capital increases to account for the greater need for risk capital;
- **Countercyclicality could be further strengthened.** Public development banks, along with bilateral lenders, should consider greater and more systematic use of state-contingent clauses in their own lending, with a view to providing breathing room to countries hit by shocks (akin to automatizing an initiative like the DSSI in case of a systemic crisis). Thus far, state-contingent clauses have been used at a small scale, for example, through the French Development Agency's Prêt Très Concesionnel Contracyclique (PTCC). They could complement quick-disbursing and insurance mechanisms to provide fiscal space when it is most needed (see the *Financing for Sustainable Development Report 2021*). Development banks could also help to familiarize market participants with such clauses and thus help to overcome first-mover problems in their use in commercial borrowing;
- **MDBs should also consider increasing lending in local currency.** Providing a greater share of their lending to sovereigns in local currencies would contribute to lowering borrowers' debt risk profiles, particularly when lending for projects that are unlikely to generate foreign currency earnings. Both the Asian Infrastructure Investment Bank and the New Development Bank have prioritized such lending. MDBs that have geographically diversified portfolios should be in a better position to manage currency risks. The Addis Agenda encouraged further growth in this area and the use of diversification to manage related risks.

National and sub-regional development banks should be strengthened. Development banks and development finance institutions play an important role in all regions and at all levels. In the Latin America and Caribbean region, for example, financing for the COVID-19 response from sub-regional and national development banks significantly exceeded that by the MDBs.[43] Existing surveys have found that national development banks both lend long term and play a countercyclical role during crises.[44] However, they tend to play a much smaller role in poorer regions. In LDCs and LICs, they are smaller in number and in size, even relative to the size of their host economies, and suffer from governance challenges, constraints in capacity and capital.[45] These challenges are linked. The size of national and sub-regional development banks is constrained by the fiscal capacity of the sovereign that backstops their activities; a poorly run institution that runs into solvency challenges could, in turn, threaten

sovereign balance sheets. They could benefit from capacity and financial support from larger and more established development banks in the context of a strengthened development bank system. Such support had been provided until the 1970s, when the World Bank Group advised and financed a number of national institutions. With renewed recognition of their role, such relationships could be strengthened through financial cooperation and technical assistance.[46] In turn, regional and global institutions can benefit from the local knowledge of national institutions. The "Finance in Common" system can play an important role in this regard, as it is supports closer cooperation between public development banks through strategic dialogue, joint methodologies and measures and innovative co-financing.

Other sources of concessional financing should be scaled up. Development banks play a special role because of their ability to lever public contributions in financial markets. But public financing must be scaled up through other channels as well—starting with traditional donors meeting their overseas development assistance and climate finance commitments, and channelling unused SDRs to LICs and MICs in need, mindful of the challenges noted above; several proposals have been made in this regard (see chapter III.F).

3.3 Enhancing stability and reducing uncertainty in markets

Commercial funding is a large source of financing for long-term investment for a growing number of developing countries, but it is not playing the role it should play. Commercial financing can be costly and volatile. Borrowing terms depend on macroeconomic fundamentals and other idiosyncratic factors such as political risks, climate-related risks and disasters, but also on the global financial cycle. To play its role as a source of stable and long-term financing for sustainable development, efforts are needed to (i) reduce (actual and perceived) risks, including those emanating at both national and global levels; (ii) enhance the information ecosystem to enable longer-term and sustainable investments; and (iii) share risks between public and private actors (e.g., through blended finance mechanisms) for investments in shared priorities when appropriate. Relevant policy options are clustered in actions at the national and global levels.

"Macro-fundamentals" and other domestic factors

Domestic determinants of borrowing costs include but are not limited to macro-fundamentals, domestic institutions and the enabling environment. Sovereign yields are influenced by a range of national and global factors. They include credit risk related to the fiscal situation, debt stocks and growth prospects; inflation, monetary policy and other macro-financial variables; foreign exposure, exchange rate volatility and related factors; domestic financial market conditions, including the size of the foreign investor base; perceptions of political risk and stability; and global liquidity conditions.[47] Beyond macro-fundamentals and global conditions, studies have also found (lack of) transparency and information to impact risk premia.[48]

Growth-oriented and resilient macro-fiscal frameworks reduce risk and risk perceptions. Macro-fiscal frameworks anchor fiscal policies and annual budgets in a medium-term policy framework. Their primary objective is to stabilize economic activity and public service delivery in the short term and through business cycles, and to promote economic growth and sustainable development over the longer term, which ultimately also support long-term debt sustainability. With regard to the former, a key challenge is to overcome the "procyclicality trap" of fiscal policy, which has long plagued developing countries[49] and which has been the main focus of support in the current crisis. Systematically strengthening these capacities on the expenditure side could include strengthening social protection systems and protecting or even expanding capital spending in downturns, for example, through pre-approved public investments that are "shovel-ready". It also includes the ability to save in good times (see also chapter III.A). With regard to the "structural role" of fiscal policy, this is about the ability to contribute to sustained growth in incomes and aggregate demand, for example, by addressing inequalities and supporting technological progress and structural transformation.[50] As such, it links macroeconomic, budgetary and debt sustainability objectives to longer-term sustainable development and growth priorities.

Reducing reliance on foreign currency borrowing can reduce risk premia. In light of large unmet investment needs, many developing countries rely on foreign savings to finance a sizeable share of their domestic investment. But reliance on foreign savings is risky, as episodes of prolonged current account deficits often end in crisis.[51] This speaks to the need to attract more non-debt-creating sources of external financing, in particular foreign direct investment, to deepen domestic financial markets and reduce the reliance on foreign currency debt (see box II.2 and chapter III.B). More immediately, macroprudential measures help to dampen both domestic financial cycles and capital inflow volatility.[52] Capital flow management measures can complement macroprudential policies, particularly in crisis situations. "Pre-emptive" and countercyclical measures aimed at dampening excessive portfolio inflows during boom times lower the risk of sudden stops and risk premia on foreign currency lending during crises[53] (see chapter III.F).

Global sources of volatility and risk

Steps should be taken to mitigate global "push factors". As global factors have become increasingly important in determining capital flows and their volatility, policy actions will also be needed at global level in order to reduce developing countries' vulnerability to sudden stops and to improve their lending terms. Monetary policies in the centre are a key driver of the global financial cycle. Major central banks can contribute to dampening that cycle by increasing the transparency of their decision-making, providing forward guidance to markets and taking into account the spillover effects of their monetary policy decisions. This is increasingly justified even within the terms of their own domestic mandates, as "spillbacks"—the second order impacts of tightening financial conditions through lower growth in developing countries—have increased significantly.[54] This also calls for greater consideration of their global macroprudential responsibilities in financial sector regulation (see also chapter III.F).

More global action is needed to prevent and speedily resolve liquidity and solvency crises. Despite its significant extension in the wake of the 2008 world financial and economic crisis, the global financial safety net continues to face resource constraints and gaps in coverage. IMF emergency lending and the SDR allocation have been the main

Box II.2
Local currency government bond market development

Deep and efficient domestic government debt markets can help to strengthen resilience to shocks in times of financial turbulence. Recent financial crises, including the turmoil in financial markets caused by the COVID-19 pandemic, have shown that efficient Local Currency Borrowing Markets (LCBMs) can increase financial resilience by mitigating currency risk, which is often a source of financial distress. In addition, the development of LCBMs is a cornerstone of broader capital market development that helps to price risk appropriately, allows participants in financial markets to better manage their portfolios and provides a more effective conduit for monetary policy. In turn, these factors help to boost a country's long-term economic growth potential.

Developing domestic debt markets is a complex process that requires multiple and interdependent policy actions. Although broad guidelines and general principles to develop LCBMs are available, their translation into specific reforms is a daunting task because it requires actions from a broad range of stakeholders, including the debt manager; the central bank; regulators; the providers of trading, payment, clearing and settlement systems; and other policymakers. As countries tend to be at different levels of development along these various dimensions, further developing their LCBMs requires a country-specific, customized approach.

To anchor this approach, the IMF and World Bank have developed a guidance note to provide a comprehensive and systematic framework for LCBM development.[a] Recognizing the obstacles that hamper the implementation of LCBM reforms, the guidance note starts with a systematic assessment of the preconditions for success and the stages of market development along the typical six major building blocks of LCBM development: money market, primary market, investor base, secondary market, financial market infrastructure, and the legal and regulatory framework. Applying a series of specific indicators, the guidance note framework allows for (a) the identification of gaps in a country's LCBM, (b) the assessment of a country's stage of market development, and (c) the identification of possible peers that may provide replicable lessons.

Source: IMF.

a International Monetary Fund and World Bank. 2021. "Guidance Note for Developing Local Currency Bond Markets". IMF Analytical Note 2021/001. March.

instruments accessible to most countries, while regional financing arrangements (RFAs) have not lived up to their potential. Beyond expansion of the IMF's financing capacity, a strengthening of RFAs should be considered (see chapter III.F). When liquidity turns into solvency challenges, defaults on external debt are often protracted in the absence of a formal debt resolution framework (see chapter III.E). Formalizing implementation procedures of the Common Framework and addressing some of its shortcomings (timeliness; eligibility; provision of standstills for countries approaching the Common Framework; and clarifying private sector participation through comparability of treatment) would be an important step in the right direction.

Transparency and the information ecosystem

Enhanced debt transparency can reduce uncertainty premia. Challenges remain over countries' disclosure of their full set of liabilities, which can impact borrowing costs. Transparency remains a challenge particularly for debt incurred beyond central government, by, for example, municipalities and state-owned enterprises, and for other types of contingent liabilities, domestic and non-tradeable external debt and resource-backed loans. A more complex debt landscape increases reporting burdens on debt management offices with limited capacities; some creditors also insist on confidentiality clauses that tie debtors' hands. The lack of transparency comes at a concrete fiscal cost, however, in addition to undermining accountability to citizens. While hiding the true extent of debt may lower costs in the short term or help to circumvent fiscal rules, in the long term *more* transparent debt management results in higher credit ratings and ultimately reduces risk premia.[55] Increased transparency across countries can, over time, reduce uncertainty, risk perception and borrowing costs for the entire asset class. Improving transparency will require investments in public debt management and in legal, institutional and operational frameworks and related international support; it will furthermore require creditors refraining from confidentiality clauses and disclosing relevant information, and the international community streamlining and consolidating debt reporting requirements and databases to lower reporting burdens and enhance transparency (see chapter III.E).

Further extending the horizon of credit ratings and debt sustainability assessments would complement the existing information ecosystem and could provide important insights for long-term oriented actors. Credit rating agencies provide information to investors and financial markets to help them price risk. Ratings thus affect the volume, cost and stability of access to market financing. The IMF and World Bank's debt sustainability assessments also monitor relevant country risks and provide early warning for debt distress. For LICs in particular, debt sustainability assessments determine countries' eligibility for and the terms of concessional financing (see chapter III.E). Existing assessments adopt a short- to medium-term time horizon—assessing capacity to service debt is typically three years for credit ratings in practice and somewhat longer (five to ten years) for the debt sustainability assessments. Because (perceived and actual) solvency risks can affect (the terms of) market access, and liquidity crises can turn into solvency crises, short-term-focused ratings do serve a purpose in helping creditors to evaluate near-term risks. But they risk enhancing procyclicality in markets rather than dampening it and would not capture long-term risks such as climate risks. They do not, therefore, fully incorporate many issues that are of critical importance to actors with longer time horizons—public borrowers, a growing number of investors and the international community at large. Several steps are already being taken—and additional steps could be taken—to address these concerns:

- Debt sustainability assessments by international financial institutions increasingly incorporate long-term considerations despite the challenges noted above, including climate and disaster risks for relevant countries and the growth impacts of public investments (see chapter III.E and previous editions of the *Financing for Sustainable Development Report*);

- Few Governments systematically value their public commercial assets, which can create a bias against capital spending. More active management of these public assets, for example, in dedicated public wealth funds or on the balance sheets of national development banks, could lead to more effective use, generate additional income and complement debt sustainability assessments with a better understanding of government net worth.[56] There is evidence that bond markets do take the composition of fiscal policy into account when they have such information, with deficit increases driven by increases in public investment lowering sovereign spreads;[57]
- Related discussions are ongoing in regard to fiscal rules, for example, in the context of the European Union's fiscal framework. A proposed "green golden rule" would exclude public investments in climate action from consideration in existing deficit and debt limits. This would incentive capital spending on climate priorities; in countries that face debt sustainability concerns, it would make the tension between shared political commitment to climate action and budget constraints explicit and facilitate a political solution;[58]
- Long-term credit ratings could be an important complement to existing ratings and assessments. They would be particularly valuable for investors with long-term liabilities such as pension funds, but would help all creditors to better understand the fundamentals of the countries in which they are investing (see box II.3 on credit rating agencies).

Box II.3
Credit rating agencies and sovereign financing

Credit ratings play an important role in international capital markets as they provide creditors with assessments of a debtor's relative risk of default. Inaccurate ratings can impact the cost of borrowing and the stability of the international financial system, as demonstrated during the 2008 world financial and economic crisis. That crisis resulted in regulatory reforms to reduce the mechanistic reliance of financial regulation on ratings and address conflicts of interest, particularly in relation to ratings of corporates and structured finance.

Sovereign ratings are structurally different from corporate ratings in that analysts' judgements about political risks and "willingness to pay" play a much greater role. Since sovereign ratings often act as a country-level ceiling for corporate ratings, they affect both public and corporate borrowing and thus overall investment in the SDGs.

A detailed analysis found that 61 out of 154 rated sovereigns were downgraded by at least one of the big three credit rating agencies (CRAs) during the COVID-19 pandemic. Developing countries accounted for nearly all the sovereign downgrades, negative outlooks and reviews for downgrades, with MICs representing 60 per cent of the downgrades (see figure II.2). Developed countries, which saw much larger debt increases and economic slowdowns, largely escaped downgrades—reinforcing their access to ample, cheap market financing. This discrepancy, which could be due to a host of reasons, underlines the importance of transparent methodologies so as not to undermine confidence in ratings.

In addition to ratings' impact on the cost of borrowing, three additional questions related to developing country sovereign credit ratings stand out: (i) the term of assessments and integration of climate change and other non-economic factors; (ii) incorporation of public sector actions, including official debt restructurings such as DSSI, into ratings analysis; and (iii) potential sell-offs from "cliff effects" and financial market instability.

CRAs are already integrating climate risk into their ratings. Conversely, a country's efforts to invest in the SDGs, including in resilience and climate adaptation, should be viewed favourably in ratings that take a sufficiently long-term perspective—analogous to markets "rewarding" capital spending. The current CRA "long-term" rating is meant to cover three to five years for non-investment-grade issuers and up to ten years for investment-grade issuers. In practice, sovereign ratings use financial and economic forecasts of up to three years, which may over-emphasize near-term economic business cycle expectations and exacerbate volatility. Ideally, rating methodologies would incorporate more long-term factors, such as environmental and social risks and improvements, which could be published in new, long-term assessments that complement existing assessments. The use of scenarios for both economic and non-economic risks could make long-term assessments more manageable to produce. Such scenarios can be derived from stress tests for various adverse shocks and their impacts on debt dynamics or through probabilistic approaches that develop many scenarios and allow for the assignation of likelihoods to different debt paths, including adverse scenarios. Long-term ratings could help to reduce procyclicality and, if well implemented, to capture the positive effects of investments in climate and environmental resilience.

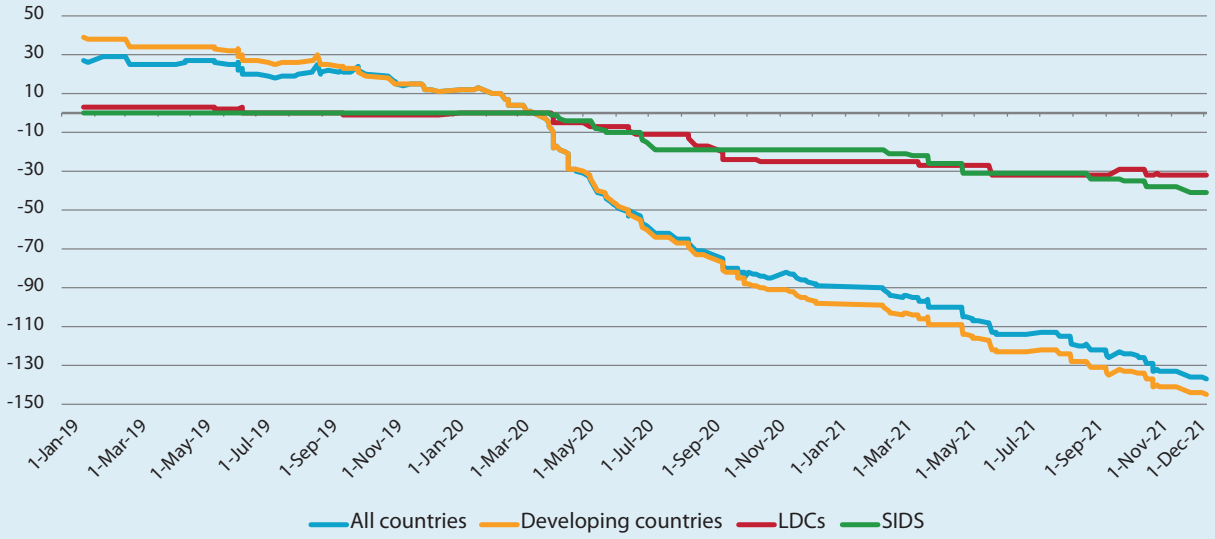
Official sector debt relief can help to strengthen countries' balance sheets and ability to repay all debt in the medium term. Despite no countries ultimately being downgraded for participation in the DSSI, some developing countries, including those with elevated debt distress risks, were deterred from joining the programme due to the fear that participation would trigger rating downgrades. Greater dialogue could have helped to avert such misunderstandings on the part of both countries and CRAs. A standing, formal structure or framework to facilitate continued dialogue could be considered.

Ratings may also be linked to price volatility beyond what would be warranted by fundamental factors, including due to so-called cliff effects. "Fallen angels" are issuers that have been downgraded from an "investment grade" rating to a sub-investment-grade rating. These issuers may face a sell-off of their debt from investors who are precluded from holding speculative grade debt due to either unreformed regulatory rules or rigid mandates of private sector investment funds, especially passive funds. Fund managers do seem to have some discretion about the timing of portfolio rebalancing in periods of extreme market stress. However, increased monitoring of this risk could be helpful. Investment managers could more explicitly adopt a portfolio approach to ratings levels in their mandates, while regulators could work to eliminate the few remaining pockets of mechanistic reliance on ratings.

Several structural factors related to CRAs and their role in the wider capital market ecosystem remain. Efforts to reduce market

concentration, with just three CRAs holding over 90 per cent of the market share, have not been effective to date. This is partly due to the enormous entry barriers for new firms given that the nature of the business is built on reputation and trust. Limited market pressures may reduce incentives to update methodologies and take advantage of new technologies in credit assessments. Structural challenges also have ongoing implications beyond sovereign ratings. Progress on these issues remains limited, as adopting effective reforms remains difficult both technically and politically. Voluntary actions by CRAs, for example, transparently separating quantitative models from value-added judgement, could increase trust and help investors to better assess the quality and objectivity of ratings; such more transparent analysis could complement existing projections and sustainability assessments by the public sector.

Figure II.2
Sovereign ratings movement over time, by country grouping, 2019–2021
(Index)



Source: UN/DESA calculations based on Moody's Analytics.
Note: This figure shows an index of rating actions by Moody's Analytics, with 0 on 11 March 2020, the date the WHO declared the global pandemic. All sovereigns are weighted equally, each positive (negative) outlook is +1 (-1); a review for upgrade (downgrade) is +2 (-2); and a positive (negative) rating change is +3 (-3).

Translating shared priorities into lower borrowing costs

Investors concerned about climate and SDG impacts may be willing to pay a premium for debt instruments that tie the use of proceeds to such priorities. Sovereigns have aimed to exploit this interest in debt issuances and in restructurings (see chapter III.E). A growing number of countries have issued green, social and sustainability bonds, with the number of sovereign sustainable bonds more than doubling in 2020-21.[59] By the end of 2020, issued sovereign green bonds amounted to USD 41.2 billion, a 65 per cent increase compared to 2019. Such bonds have been a fast-growing segment of the broader green bond market, but remain a small part of the overall and vast sovereign bond market. They can help to raise resources for key public policy priorities; sovereigns can also catalyse the broader green finance market by providing benchmark pricing and demonstration effects. Tying the use of proceeds to climate action or the SDGs may help to reduce borrowing costs. Taking advantage of investors' growing interest in sustainability issues, some studies have found that such bonds can be issued at a slightly reduced cost ("greenium").[60] (See also chapter III.B.)

The international community can also provide targeted subsidies to lower borrowing costs in markets for shared priority investments. (See also chapter III.C. for the use of guarantees in blended finance.) Partial guarantees and credit enhancements are most commonly used in sovereign debt restructurings with a view to enticing private creditor participation and acceptance of thus-enhanced newly issued bonds. Policy-based guarantees have been used on a small scale, for example, by the World Bank (but also by some bilateral providers) for borrowers not at high-risk for debt distress, to improve borrowing terms in markets. They have helped countries to diversify their creditor base, securing longer maturities and lower interest rates, in return for commitments to reforms consistent with the World Bank's broader country partnership strategies.[61] Such partial guarantees, while not appropriate for countries at high risk of debt distress, could help to mobilize financing at more attractive terms for countries with low or moderate levels of debt; development finance institutions can achieve high leverage for investments in key shared priorities. Recent research suggests that hypothetical "green sovereign bond guarantees" for climate mitigation investments in select developing countries could produce savings for borrowing countries of up to 23 per cent of the principal amount of guaranteed bonds, significantly exceeding the cost of subsidy for the provider.[62]

3.4 Addressing the debt overhang

High levels of debt mean that additional financing alone will not suffice for many countries, and that measures to address the debt overhang must be part of global efforts. With debt levels spiking across the board since the onset of the pandemic, the related costs—debt servicing, indirect costs from required policy adjustments and default risk—have also increased and reached levels that endanger SDG prospects in many countries. With expiry of the DSSI for LDCs and LICs, no comparable relief on offer for MICs, uncertain growth prospects, rising climate risks, tightening global liquidity conditions and a creditor-friendly international financial architecture, there is a high risk of countries entering protracted debt crises and a need for debt relief for affected countries.[63] Without such relief, the SDGs will be out of reach (see the *Financing for Sustainable Development Report 2021*). Ongoing initiatives such as the Common Framework play an important role in this regard, but existing implementation challenges must be addressed; in case of a systemic crisis, statutory instruments may be needed (see chapter III.E).

Endnotes

1 See for example J.W. Mason, 2021. A C-shaped recover? Available from: http://jwmason.org/slackwire/a-c-shaped-recovery/.

2 See for example IMF. 2021. Fiscal Monitor October 2021.

3 See for example IMF. 2021. Global Financial Stability Report October 2021.

4 Benedek, Dora, et al. 2021. A Post-Pandemic Assessment of the Sustainable Development Goals. IMF Staff Discussion Note.

5 See International Monetary Fund. 2021. Fiscal Monitors April and October 2021.

6 IMF and World Bank Group. 2021. DSSI Fiscal Monitoring Update. September 2021.

7 World Bank. 2022. Global Economic Prospects. January 2022.

8 IMF. 2020. Fiscal Monitor, October 2020.

9 IMF. 2021. Reaching net zero emissions. Note prepared for the Group of 20.

10 See for example Kharas, Homi and Meagan Dooley. 2021. Status check: Managing debt sustainability and development priorities through a 'Big Push'. Brookings Global Working Paper 162. October.

11 IMF. 2021. Issues in the restructuring of sovereign domestic debt.

12 Eichengreen, Barry and Ricardo Hausmann. 1999. Exchange rates and financial fragility. NBER Working Paper 7418.

13 Bradley, Michael. 2016. A Sovereign's Cost of Capital: Go Foreign or Stay Local. Duke Law School Public Law & Legal Theory Series No. 2015-50.

14 Chamon, Marcos, et al. 2018. Foreign-law bonds: Can they reduce sovereign borrowing costs? Journal of International Economics, Volume 114, September 2018.

15 Meyer, Josefin, et al. 2019. Sovereign Bonds since Waterloo. Quarterly Journal of Economics (forthcoming).

16 Return relative to risk (the 'Sharpe ratio') is significantly higher than for other investment classes.

17 See for example Debrun, Xavier, et al. 2020. Debt Sustainability. In Abbas, Ali et al. (ed.) Sovereign Debt: A Guide for Economists and Practitioners.

18 See for example: The Economist. 2020. The covid-19 pandemic is forcing a rethink in macroeconomics. 25 July 2020.

19 BIS. 2020.

20 Blanchard, Olivier, et al. 2021. Does the New Fiscal Consensus in Advanced Economies Travel to Emerging Markets? PIIE Policy Brief.

21 Atif Mian, et al. 2021. Indebted Demand. BIS Working Papers No. 968.

22 IMF. 2020. Fiscal Monitor, October 2020.

23 See for example Bolton, Patrick, et al. 2020. The green swan: Central banking and financial stability in the age of climate change. Bank for International Settlements.

24 The IMF considers sovereign debt of countries with market access as sustainable "when the primary balance needed to at least stabilize debt under both the baseline and realistic shock scenarios is economically and politically feasible, such that the level of debt is consistent with an acceptably low rollover risk and with preserving potential growth at a satisfactory level." See: IMF. 2013. Staff Guidance Note for Public Debt Sustainability Analysis in Market Access Countries.

25 Blanchard, Olivier, et al. 2021. Does the new fiscal consensus in advanced economies travel to emerging markets? PIIE Policy Brief.

26 World Bank. 2021. Debt Transparency in Developing Economies. Washington, D.C.

27 International Monetary Fund and World Bank. 2020. The evolution of public debt vulnerabilities in lower income economies.

28 Kose, Ayhan, et al. 2021. A Mountain of Debt. Navigating the Legacy of the Pandemic. World Bank Policy Research Working Paper 9800.

29 Ha, Jongrim, et al. 2019. Inflation in Emerging Inflation in Emerging and Developing Economies and Developing Economies. Evolution, Drivers, and Policies. World Bank Group.

30 Rey, Helene. 2015. Dilemma not Trilemma: the global financial cycle and monetary policy independence. NBER Working Paper 21162.

31 Carney, Mark. 2019. Pull, Push, Pipes: Sustainable Capital Flows for a New World Order. Speech. See also: Eguren-Martin, Fernando, et al. 2020. Capital flows-at-risk: push, pull and the role of policy. Bank of England Staff Working Paper No. 881.

32 See for example Rey, Helene. 2015. Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence. NBE Working Paper 21162; or UNCTAD. 2021. Trade and Development Report.

33 Kose, Ayhan, et al. 2021. A Mountain of Debt. Navigating the Legacy of the Pandemic. World Bank Policy Research Working Paper 9800.

34 See for example World Bank. 2017. World Development Report 2017: Governance and the Law.

35 See for example 2020 FSDR, Chapter III.A.

36 Schwartz, Gerd, et al. 2020. Well spent. How strong infrastructure governance can end waste in public investment. IMF.

37 Gurera, Daniel, et al. 2019. Some Policy Lessons from Country Applications of the DIG and DIGNAR Models. IMF WP/19/62.

38 Schwartz, Gerd, et al. 2020.

39 See for example in the Latin America and Caribbean Region: ECLAC. 2021. Development Banks' response to Covid-19 and their role in a sustainable recovery. LC/PLEN.36/DDR/1 21 November 2021.

40 tions Fanny May and Freddy Mac are included.

41 Xu, Jiajun, et al. 2021. Mapping 500+ Development Banks: Qualification Criteria, Stylized Facts, and Development Trends. Institute of New Structural Economics, Peking University, and French Development Agency.

42 UN Indendent Expert Group on Climate Finance. 2020. Delivering on the $100 billion climate finance commitment. Available from: https://www.un.org/sites/un2.un.org/files/100_billion_climate_finance_report.pdf.

43 ECLAC. 2021. An innovative financing for development agenda for the recovery in Latin America and the Caribbean. COVID-19 Special Report No. 12.

44 See for example Luna-Martinez, José de and Carlos Leonardo Vicente. 2012. Global Survey of Development Banks. World Bank Policy Research Working Paper, No. WPS 5969.

45 Xu, Jiajun, et al. 2021.

46 Ocampo, Jose Antonio, and Victor Ortega. 2020. The Global Development Banks' Architecture. AFD Research Papers, No. 117.

47 Buzas,Laszlo, et al. 2021. Analyzing the Determinants of EMDE Local-Currency Sovereign Yields: A Simple Comparative Approach. World Bank Group Working Paper.

48 See for example Kubota, M., and M. Zeufack. 2020. Assessing the Returns on Investments in Data Openness and Transparency. Policy Research Working Paper No. 18; World Bank. Washington, D.C.

49 Frankel, Jeffrey, et al. 2013. On graduation from fiscal procyclicality. Journal of Development Economics, 100 (2013).

50 UNCTAD. 2021. Trade and Development Report 2021.

51 Cavallo, Eduardo, et al. 2018. Can countries rely on foreign saving for investment and economic development? Review of World Economics. Vol. 154 (2018).

52 Carney, Mark. 2019.

53 Das, Mitali, et al. 2022. Preemptive Policies and Risk-Off Shocks in Emerging Markets. IMF Working Paper 2022/003.

54 Carney, Mark. 2019.

55 World Bank. 2021. Debt Transparency in Developing Economies. Washington, D.C.

56 See for example: Ball, Ian, et al. 2021. Why Public Assets are Key to Debt Sustainability: A Moral Goal. IMF Blog, April 2021.

57 Debrun, Xavier, et al. (2020). Debt Sustainability. In Abbas, Ali et al. (ed.) Sovereign Debt: A Guide for Economists and Practitioners.

58 Darvas, Zsolt and Guntram Wolff. 2021. A green fiscal pact: climate investment in times of budget consolidation. Policy Contribution 18/2021, Bruegel.

59 Fatin, Lena. 2021. Sovereign Green, Social & Sustainability (SGSS) Bonds - How far and how fast could they grow? Climate Bonds Initiative.

60 Scatigna, Michela, et al. 2021. Achievements and challenges in ESG markets. BIS Quarterly Review, December 2021.

61 2016. Findings from Evaluations of Policy-Based Guarantees.

62 Morris, Scott, et al. 2022. Greening the US Sovereign Bond Guarantee Program: A Proposal to Boost Climate-Directed Sovereign Finance in Developing Countries. CGD Policy Paper 250.

63 Kose, Ayhan, et al. 2021. What Has Been the Impact of COVID-19 on Debt? Turning a Wave into a Tsunami. World Bank Policy Research Working Paper 9871.

developmentfinance.un.org

9 789211 014525