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

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3. The transition finance ABC methodology

The Transition Finance ABC methodology (OECD, 2020[1]) **provides a guiding framework to conduct Transition Finance Country Diagnostics (TFCDs).** It revolves around three key components: Assessing, Benchmarking and Counselling. The first component helps to assess countries transition context and to highlight the particularities of their

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

DAC, non- -16 net disbursements, 2016 prices.

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

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

First, a substitution of external with dom0.0000

private finance around 5%; at the higher end, when the country reaches high-income status, the sum of ODA (10%) and OOF (26%) represents approximately

At LMIC stage (GNI per capita of USD 1 808) in the case of production sectors: OOF quickly picks up in these sectors, revealing significant potential return on non-concessional funding.

At a later LMIC stage (GNI per capita of USD 2 975) for infrastructure sectors.

Substitution happens last in social sectors (UMIC GNI per capita of USD 6 840): although social sectors are a traditional area of intervention for development partners, the steep slope of the curve suggests that the phasing out of ODA is extremely rapid and that transition finance challenges could thus be more acute in those sectors.

The transition finance methodology recognises that the effects of reaching transition milestones go beyond t

4. Key insights from transition finance analyses in LDCs

3.1. General trends of transition finance in LDCs

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

Two main trends emerge from the comparison:

The share of ODA in external flows remains higher for LDCs than for other countries across the development continuum

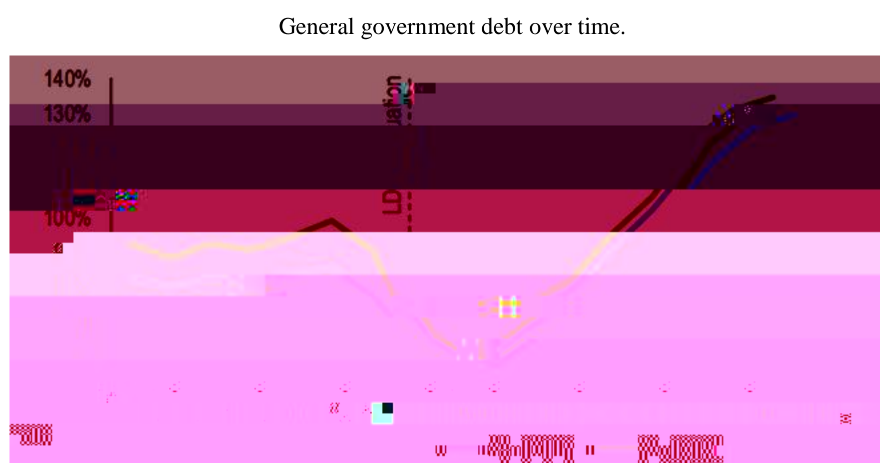
graduation (2008-16). Tied aid also became a concern[9], rising quickly, to reach nearly 50% of total ODA commitments in 2011-13. Moreover, in order to finance its national sustainable development strategy (PEDS 2017-21), Cabo Verde pivoted to new actors,

concerns over a growing lack of transparency and coordination regarding the terms and

External debt substantially increased after LDC graduation, reaching 134% of GDP in 2016. [10].
Although the volume of loans tripled after graduation, the IMF debt distress warning has since limited

Figure 4. Government debt increased quickly following LDC graduation

General government debt over time.



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

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

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to benefit from the OECD DAC Recommendation on Untying ODA. In December 2018, the DAC agreed to broaden the country coverage of the Recommendation on Untying ODA to Other Low-Income Countries (OLICs) and IDA-only countries, in addition to the already covered Least Developed Countries (LDCs) and Highly-Indebted Poor Countries (HIPCs). This decision took effect in January 2019.

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

This ratio is above the average for the 16 African countries covered in the OECD Revenue Statistics (19.1% in 2015). High tax revenues in Cabo Verde are largely attributable to the

Financing and capacity gaps emerged across key SDG-related sectors. ODA to the education sector decreased most quickly by 30 percent

spending.

Several development partners scaled down or sharply phased out their ODA when Zambia joined the LMIC category. With growing income levels, the importance of ODF from OECD DAC providers decreased as a share of gross national income, from 23% in 2000 to 12.7% in 2006 and further to 4.9% in 2010. The exit or scaling down of

ons in the country was carried out without co-ordinating or securing the transition of important co-

reliance on official development flows was significant up until the early 2000s, the country is now among the LDCs with the lowest share of ODA over GNI.

With the reclassification to LMIC status, Zambia also gained access to a wide range of financing options including international debt capital markets. The Government issued a series of Eurobonds starting in 2012, which amounted to a total of around USD 3 billion, or more than 40% of public external debt. At the same time, Chinese lending,

landscape. In 2016, Chinese l

stock.

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

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

Share of domestic revenue (%).

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

Zambia has developed a high reliance on external non-concessional long-term debt.

financing mix is much higher than for other countries with similar income levels. This reflects the country

Debt Relief (MDRI) initiatives in the early 2000s, Zambia is again faced with the need to restructure its debt. In 2020, Zambia was the second country to request debt treatment under the G20 Common Framework (after Tchad and before Ethiopia, two other LDCs). Unlike

which could make the debt restructuring more difficult.

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

DAC, non- -16 mity disbursements, 2016 prices.

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

Zambia's tax revenues have not grown to the same extent as in peer countries, adding to its fiscal vulnerability.

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

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

Transition challenge 3: Ensuring debt sustainability

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

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

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

Transition challenge 4: Leveraging trade and private investment for development

The three TFCDs conducted in LDC contexts underscore the difficulties faced by these countries to leverage private investment for development. Due to their economic vulnerability, many LDCs fail to attract foreign direct investments and private finance. The case of Solomon Islands shows that countries with specific vulnerabilities (such as small market size, low productivity and remoteness from major markets characteristic in SIDS) struggle to attract investment and commercial finance. Even when LDCs are successful at

tourism sector).

Graduating countries face the additional challenge of losing trade-related special and differential treatment granted to LDCs. These include tariff preferences under the Generalised Scheme or System of Preferences or the duty-free and quota-free access for LDCs. Particular attention is thus required from development partners to ensure that the loss of LDC special support measures by recent graduates does not translate into development setbacks. For example, transition support before graduation was key in helping Cabo Verd

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