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May 2016

Shaping sustainable futures

Agence Française de Développement (AFD) is a financial institution and the main implementing agency for France's official development assistance to developing countries and overseas territories.

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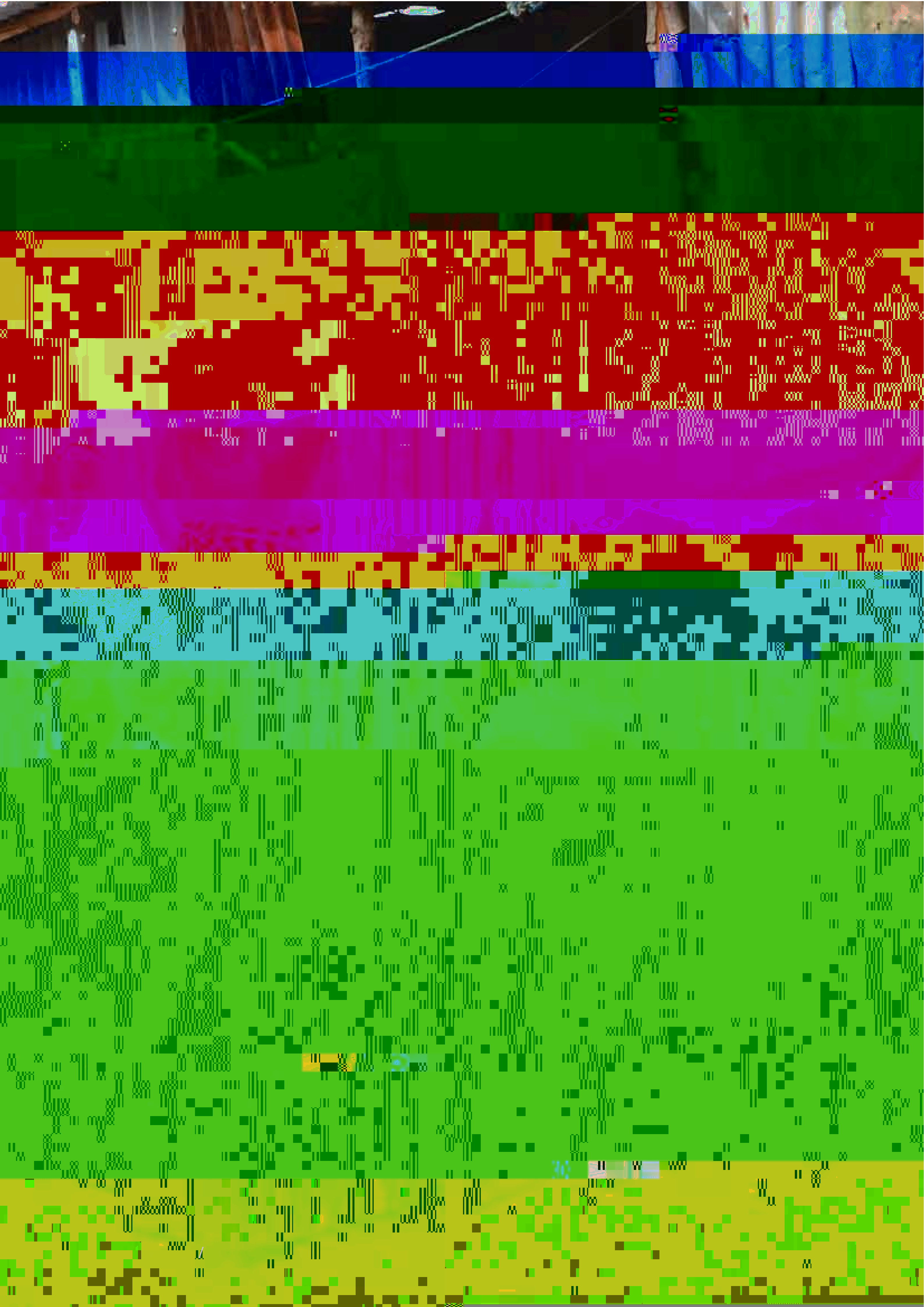
Abbreviations and Acronyms 05

Figure 1.	The Least Developed Countries	18
Figure 2.	Share of population living on less than US$1.90 a day in LDCs	22
Figure 3.	Annual Real GDP Growth in LDCs and other country groups	23
Figure 4.	Composition of external finance in LDCs and other developing countries	24
Figure 5.	What's in the financing tool-box?	32
Figure 6.	Debt Service paid on external debt with official creditors, Actual vs. GDP-I, AcFn8rs	



trillion a year – are more than su   cient to meet the investment requirements

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

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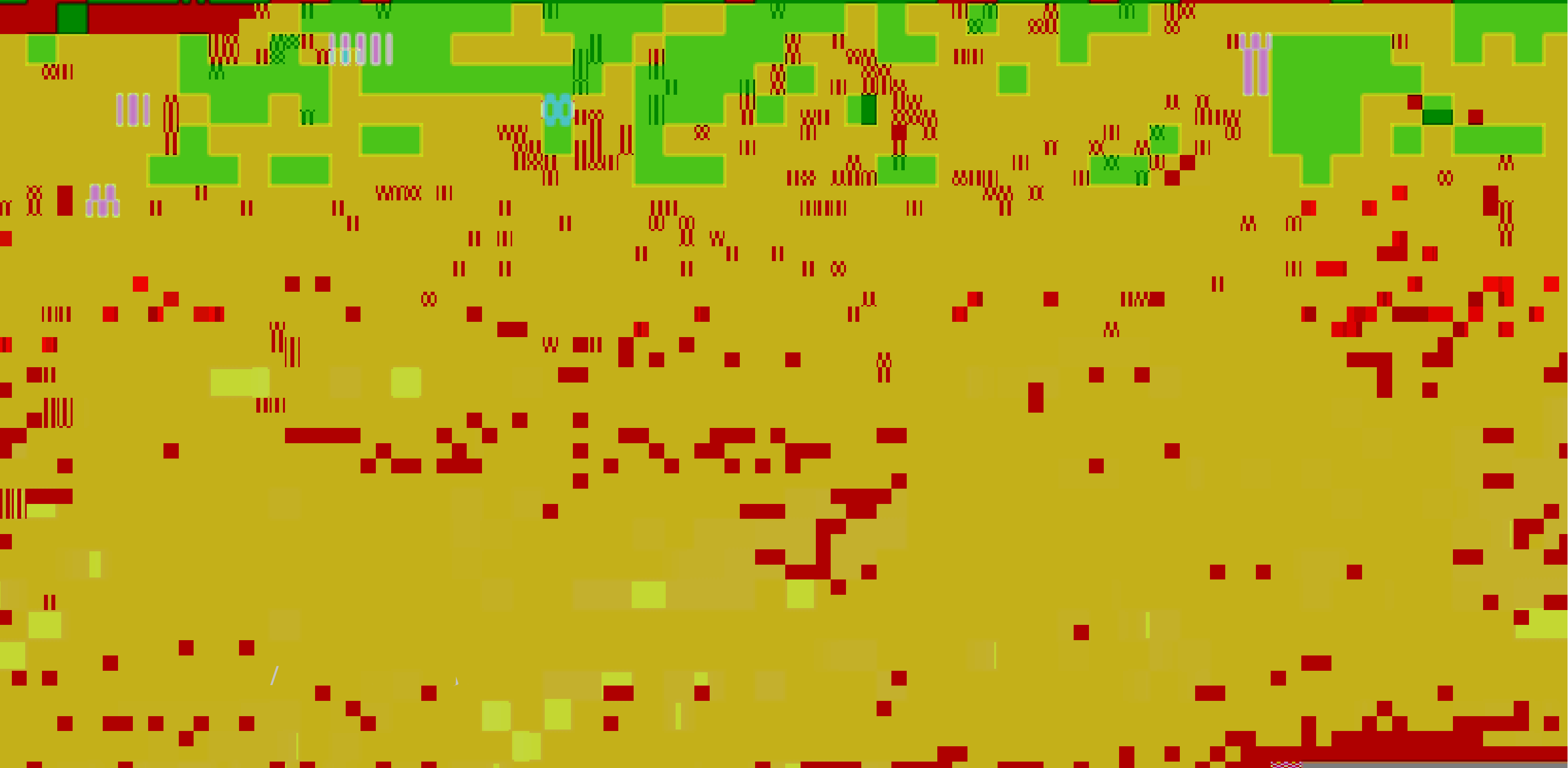


e challenge, then, is how to mobilize and channel nance and technology towards sustainable development. While this is a challenge everywhere, it is particularly relevant for the 48 countries classi ed by the United Nations as "Least Developed Countries" (LDCs). is group of countries includes those with the lowest levels of income per person, low achievements on health, education and other human development outcomes, those where infrastructure is particularly inadequate, and those with economies that are vulnerable to shocks. If we are to ful l the aspiration of "leaving no one be-

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

and their development partners to pursue public policy objectives more efficiently, at lower cost and with higher welfare gains.[8]

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

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

Research shows that as developing countries' incomes climb, concessional official finance tends to fall as a share of GDP and this is not compensated for by rising tax revenues for countries whose income per capita is below US$ 13,000 or by private capital flows. This creates the so-called "missing-middle" problem, whereby domestic private finance picks up the slack and many developing countries – LDCs included – have seen domestic debt

The Least Developed Countries: A Snapshot

1. LDCs have made important social and economic progress

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

While LDCs share many characteristics, they are also a heterogeneous set of countries. Some are land-locked countries – LLDCs (e.g. Afghanistan, Burkina Faso, Niger and South Sudan) while several others are Small Island Developing States – SIDS (e.g. Kiribati and the Solomon Islands). ese structural characteristics are well-known to amplify development challenges (for instance LLDCs and SIDS can nd it more di cult to access world markets). Several LDCs have tiny populations (e.g. Tuvalu has less than 10,000 inhabitants) while others are large (Bangladesh has over 156 million inhabitants).[13] Economic structures also di er across the LDCs: six are fuel exporters, another six are manufacture exporters (largely textiles and garments), while 10 are mineral exporters, eight are agricultural exporters and 10 are service exporters.[14] ese di erences mean that the most appropriate 'mix' of nancing sources and instruments will be different from one country to the next.

Four countries have so far graduated from LDC status: Botswana in 1994, Cape Verde in 2007, the Maldives in 2011 and Samoa in 2014.[15] Equatorial Guinea and Vanuatu are scheduled to be taken o   the list in 2017 (al-

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

e prevalence of HIV/AIDS in the LDCs has also steadily declined since 2000 and the number of people receiving treatment doubled between 2010 and 2014.[18]

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

S . ce: UNCTAD, 2016

LDC

Other developing countries

- Private flows at market terms
- Remittances
- Non-concessional DAC and multilateral
- Private grants
- Concessional DAC and multilateral

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

LDCs as a whole have a weak capacity to cope with shocks and stresses, both at the micro and macro level. At the micro level, households are often forced to sell assets to generate income at a time when everybody is doing the same, leading to fire-sale

Box 3. **Graduating from LDC Status**

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

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

Many LDCs speak of the need for the "structural transformation" of their economies and cite, in particular, the need for a step-change in infrastruc-

Meeting the aspirations of the 2030 Agenda in the LDCs also implies addressing vulnerabilities and managing risks. Shocks are often the reason why families slide back into poverty or

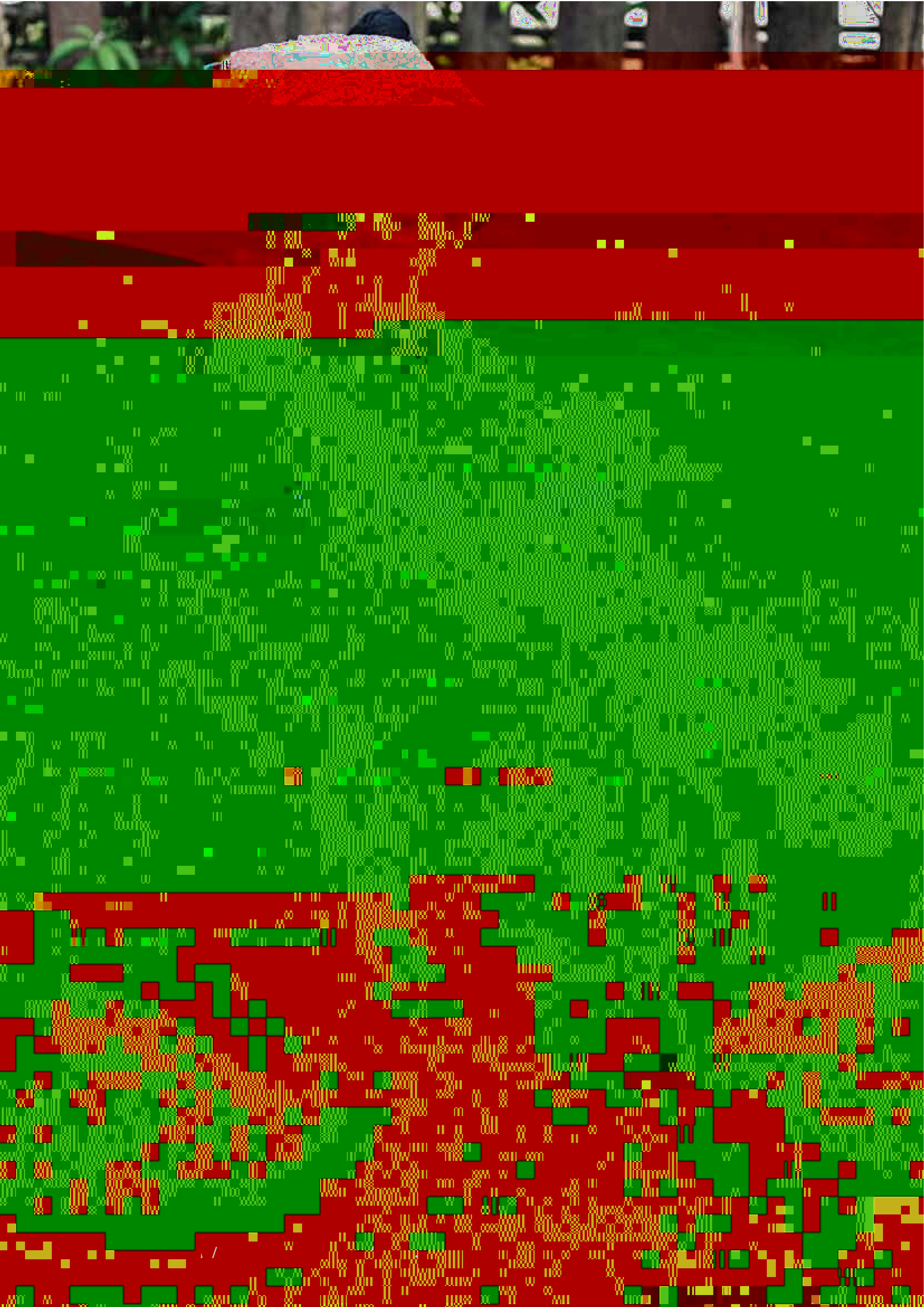
Box 4. **Debt sustainability in the LDCs**

For many Least Developed Countries, the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) dominated public debt dynamics in the late 1990s and 2000s.[34] In total, 31 LDCs were also classified as HIPCs (see

ernment revenues depending on the "strength" of countries' policies and institutions.[44]

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

Notwithstanding these advances, LDCs' debt payment capacities remain weak: economies remain undiversified; exports and budget revenue remain too dependent on (volatile) commodities; tax revenues remain flat; and external shocks have reinforced vulnerability and volatility for many countries.over-indTc3 1Tf(Gs5 ((e) 2 t 7) 11 (er-ir51 (er-ir51 (er-ir514 (giv) 122 tr) -DSAx) -1 6 (–[(ough(su



Today's development nancing landscape is complex and fast-evolving encompassing a wide variety of actors (public and private, national, sub-national and local etc.), with di erent con-

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

ey have been selected because they have the potential to meet development needs that characterize most LDCs. ese include the need for nance at-scale to invest in infrastructure, the need to support the development of the domestic private sector and to invest in local actors, as well as a need to address an on-going vulnerability to shocks and stresses of various kinds.

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

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

S . ce:A [47]

Bonds	Loans and guarantees	Public revenue	Insurance	Funds	Grants
Sovereign bonds issued on international and domestic markets Diaspora bonds GDP-linked bonds Green/blue bonds Social impact bonds Development impact bonds	Loans Including:				

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

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

For instance, the aid agency-backed Infrastructure Project Preparation Facility (IPPF) managed by the African Development Bank (AfDB) provides grants for infrastructure project preparation activities in Africa.[52] By funding project preparation studies and technical advisory services, IPPF has helped to catalyze public and private nancing for critical infrastructure development in energy, water, transport, and information and communication technologies (ICT). Public investors can also participate in blended nance transactions by providing equity or debt nancing at market rates and terms, and in many cases, below-market rates and/or terms to incentivize private nance.

Much blended nance has been used to support investments in infrastructure development. e European Commission has used blending facilities for example to fund projects in the elds of: energy (35 percent), transport (26 percent),

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

e AFD and UNDP examples cited above

Guarantees are undergoing a rapid evolution which may provide important opportunities for LDCs. New combinations of donor agencies and philanthropic investors have been emerging over the last decade. Philanthropic investors for instance have become new partners to the of-cial sector. ey typically have a private sector approach and structure their investments with a rst loss platform to achieve high social returns in exchange for assuming substantial downside nancial risks. ey are willing to take the riskiest part of the capital structure, which is typically equity or quasi-equity. ey use this base to attract others to less risky layers of a fund (and for which they will receive a more limited return). ese investors are used to seeing "waterfall" nancing models where loan tranches are structured according to risks. Guarantees are thus associated with a wide range of nancing vehicles – bonds, loans, equities, insurance – and are also designed to mobilize private sources from the entire spectrum of the econom (r) 0 0 12 30 4 (h) 100l6m /Tc8 1000 (f) 0 (c) 6sour10 c ( )3o4 (r) 0iheq

(where borrowers can transform existing or new foreign denominated liabilities into local currency). Local currency nancing is typically accompanied by other

One area in the green nance domain that has experienced a particularly rapid rise is that of so-called "green bonds". "Green bonds" are instruments which tie the proceeds of a bond issue to environmentally-friendly investments. ey are a relatively new nancial instrument but one which has experienced substantial growth over recent years. Issuers of bonds can be private companies, supranational institutions (such as multilateral banks) and public entities (municipal, state or federal). e Climate Bonds Initiative estimates that bonds explicitly labelled as "green" which earmark 100 percent of their proceeds to a speci

"Blue" bonds are a variation on this theme with particular relevance to Small Island Developing States (SIDS) and countries with large coastal areas. Modelled on green bonds and pioneered by the Seychelles, blue bonds target socially and environmentally responsible investors, with the proceeds used to fund investments in sectors such as sustainable sheries development. e Seychelles plans an initial sale of US$ 10 million in 2016 with the involvement of the

resources and ODA alone; new sources of capital
need to be tapped and institutional investors have

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

Much of the literature has focused on the attractiveness of these instruments to the wider universe of *va* investors, and on the options for emerging economies (with better creditworthiness and less volatile economic performance) to issue such instruments. One challenge is that the countries that may bene t most from these nancial instruments may also nd it di cult to issue them at reasonable premiums owing to markets' questioning their economic and policy fundamentals.

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

In response to these challenges, UNDP has proposed that *a* secET BT 12 0 0 1N20 4dl2 0 0 1N20 4/

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

S . ce: UNDP, R -I ed F a ce De e e , 2015

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

II. When disaster strikes...

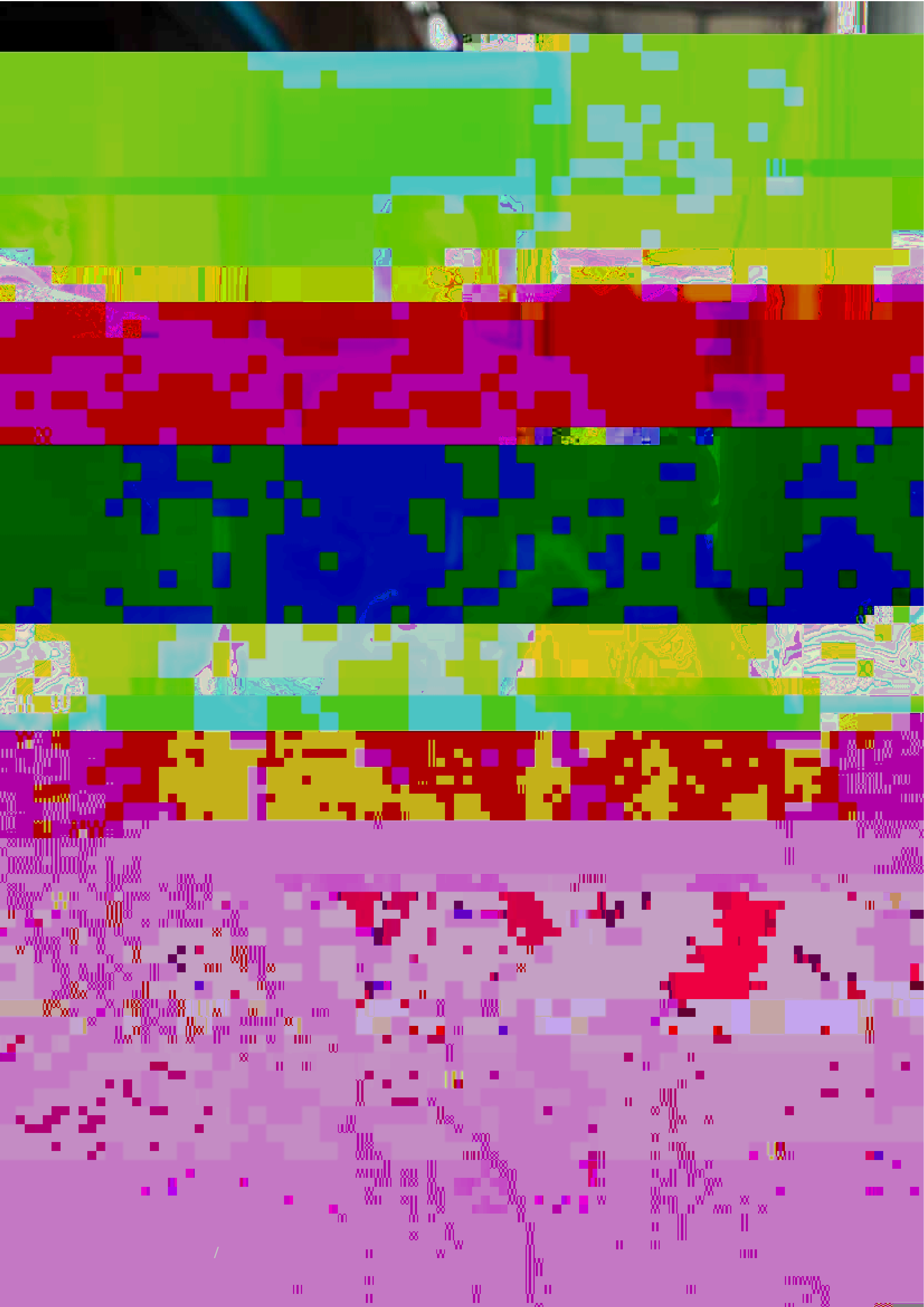
In 2015, the small island state of Grenada restructured approximately US$ 262 million in international and local bonds on which it had defaulted in 2013. [2] It also rescheduled a further US$ 8 million in bilateral debt owed to Paris Club creditors. At the time of the debt restructuring, Grenada's total public sector debt exceeded 100 percent of GDP. [3]

e island's recent debt restructuring was typical of such processes (in that there were complex and lengthy negotiations with creditors). [4] e debt restructuring did however introduce an extra innovative feature, speci cally the introduction of a so-called "hurricane clause", which could allow for a moratorium on debt payments in the event of a natural disaster wreaking havoc throughout the island. [5] e rationale is that a delay in debt service repayments can help to ensure that resources are available quickly to invest in relief and reconstruction e orts. It may also reduce the need to take-on new debt and/or wait for international aid to arrive.

For Grenada, this feature has particular relevance and importance. In 2004, Hurricane Ivan laid waste to Grenada in one of the worst disasters ever recorded on the island. Damages were estimated at over 200 percent of GDP. [6] While the international aid e ort was substantial – both in nancial resources and in-kind – less than a year later, Hurricane Emily struck before the island had had a chance to recover. e combined impact of these disasters – later compounded by the global

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

Under CCLs, it is agreed ex-ante that debt service will



e challenge is that some of the instruments

limit downside loss exposure; eliminate funding shortfalls; provide incentives for successful performance; and improve creditworthiness. Tools such as UNDP's "De-risking Renewable Energy Investment" methodology provide a framework to support policymakers to select public instruments to promote renewable energy investment in developing countries. e methodology acw 1 T

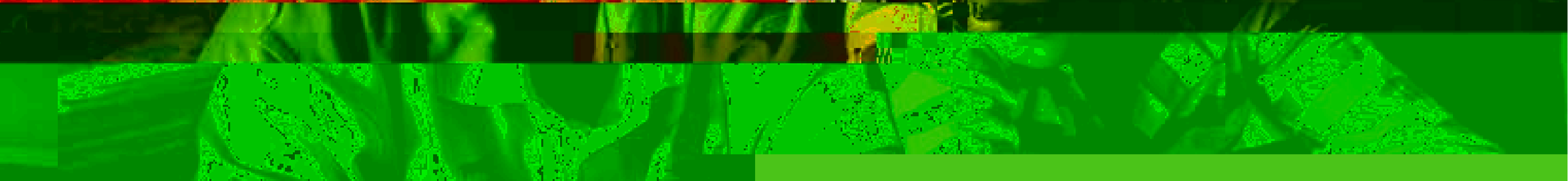


Figure 9. **External debt in the LDCs, % of GDP**

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

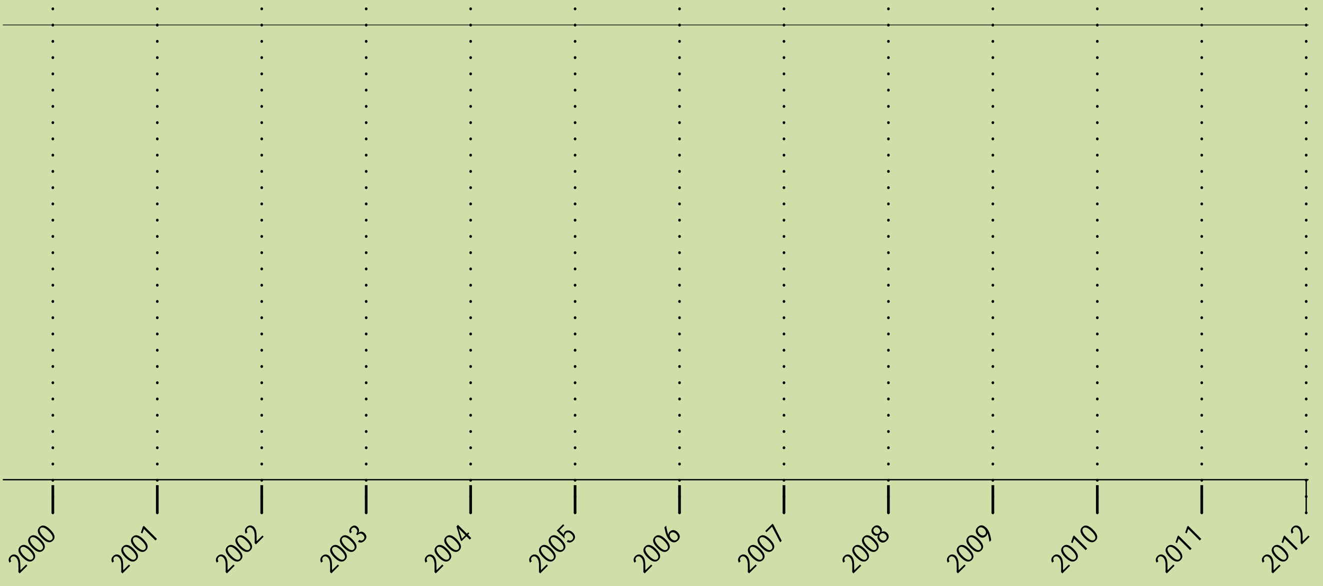
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Figure 13. **Net ODA received (% of GNI)**

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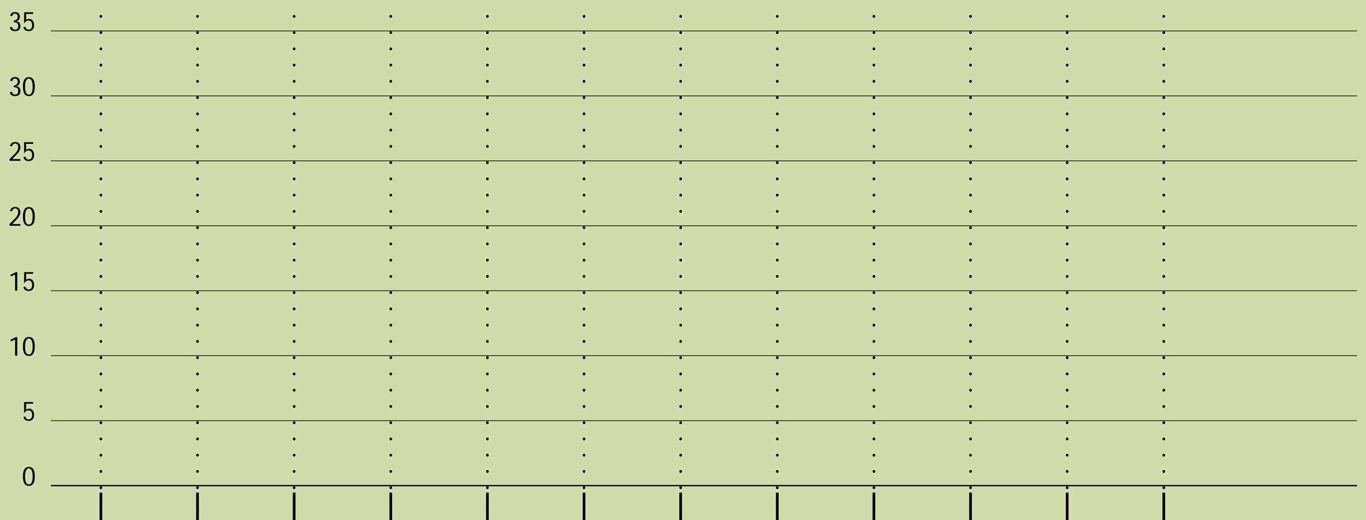


Figure 14. **Trends in climate-related bilateral ODA to LDCs, 3-year averages 2002-13, bilateral commitment, US$ million, constant 2013 prices**

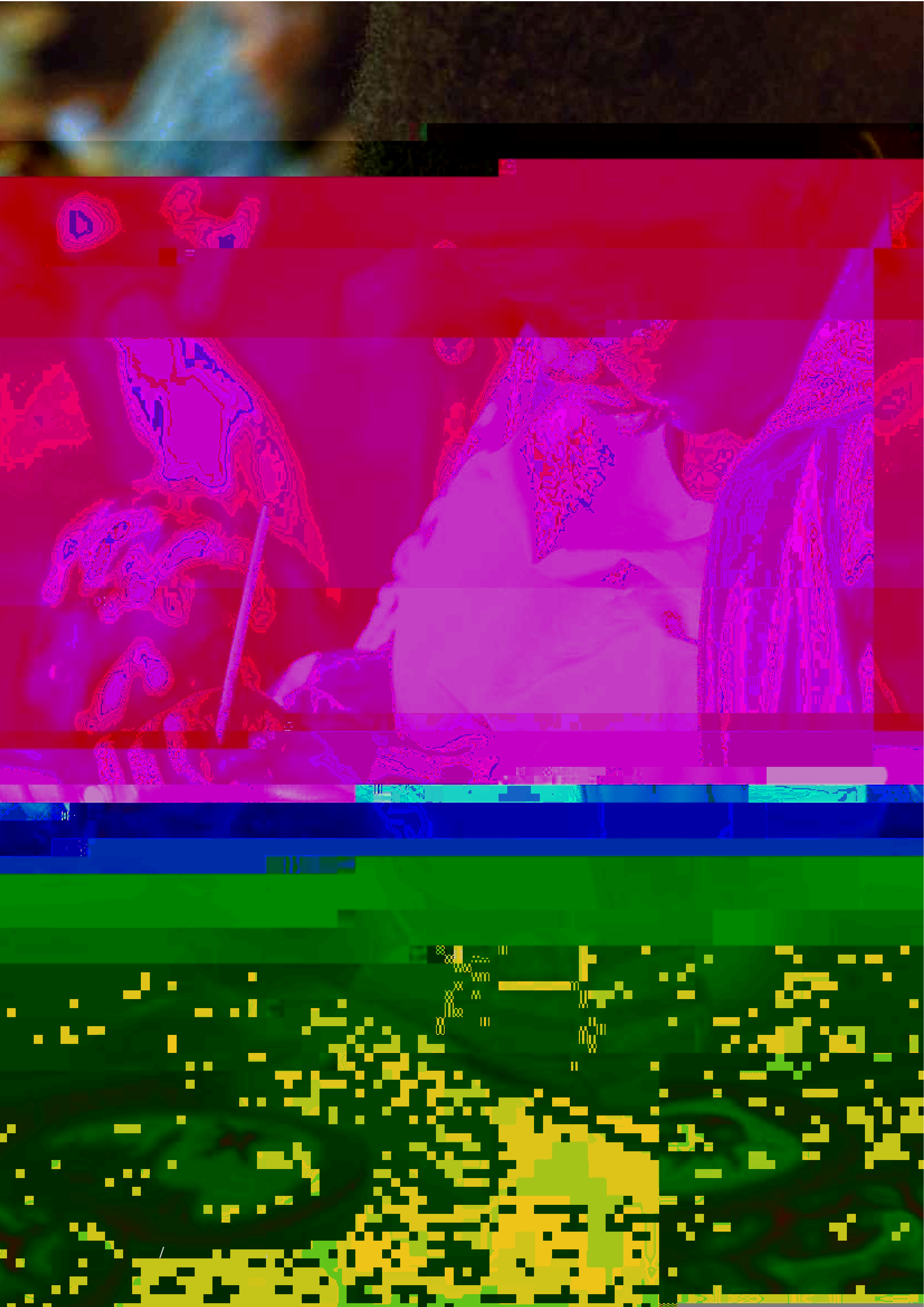
S . ce: OECD, 2015

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

S . ce: UNCTAD, 2016

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

S . ce: UNCTAD, 2016



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23 In 2014, just nine donors met or exceeded the commitment to allocate at least 0.15 percent of GNI in ODA to the LDCs, speci cally: Belgium, Denmark, Finland, Ireland, Luxembourg, Netherlands, Norway, Sweden and the United Kingdom.
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25 UNCTAD, 2016

26 Other O cial Flows (OOFs) are de ned by the OECD Development Assistance Committee (DAC) as: "Transactions by the o cial sector with countries on the list of aid recipients which do not meet the conditions for eligibility as O cial Development Assistance or O cial Aid, either because they are not primarily aimed at development, or because they have a Grant Element of less than 25 percent". For further information, see OECD: // . . / / . 1 54

27 OECD development nance statistics: // . . / / /

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34 For more information about the HIPC and MDRI initiatives, see: IMF, "Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative", 2016:

For the full list of the 31 LDCs that are also HIPCs, see gure 8.

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3 As at 7 April 2016. e 9 countries considered at high risk of debt distress are: Afghanistan, Burundi, Central African Republic, Chad, Djibouti, Kiribati, Mauritania, São Tomé and Príncipe and Tuvalu. e 24 countries at moderate risk are: Bhutan, Burkina Faso, Comoros, Democratic Republic of Congo, Ethiopia, e Gambia, Guinea, Guinea-Bissau, Haiti, Lao P.D.R., Lesotho, Liberia, Madagascar, Malawi, Mali, Mozambique, Niger, Sierra Leone, Solomon Islands, South Sudan, Togo, Vanuatu, Yemen and Zambia. 1 LDC (Sudan) is considered in debt distress. See: IMF, "List of LIC DSAs for PRGT-eligible countries":

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41 ese countries are: Angola, Democratic Republic of the Congo, Ethiopia, Mozambique, Rwanda, Senegal, Tanzania and Zambia.

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