

Bottlenecks to Access SDG Finance for Developing Countries



Bottlenecks to Access Sustainable Development Goals Finance for Developing Countries

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Foreword

In December 2022, India requested the OECD to prepare an analytical report on the bottlenecks that developing countries are facing in accessing development finance, in order to support the work of the G20 Development Working Group (DWG). One particular area of interest was to understand from a systemic perspective where bottlenecks exist. This report looks at recent trends in economic recovery and development finance and the growing Sustainable Development Goal (SDG) financing* gap, describes aspects related to financing climate transitions, and proposes areas for possible G20 actions.

The report was led and drafted by the OECD, under the strategic guidance of Pilar Garrido, Director of the Development Co-operation Directorate, Haje Schütte, Deputy Director, Development Co-operation Directorate, and Andreas Schaal, Director for Global Relations and Co-operation and OECD Sherpa to the G7, the G20 and APEC. It draws principally on two recent reports, the *Global Outlook on Financing for Sustainable Development 2023: No Sustainability Without Equity* (OECD, 2022^[1]) and the Multilateral Development Finance Report (OECD, 2022^[2]) as well as substantive inputs from the United Nations Development Programme's Finance Sector Hub and additional valuable inputs from two Indian think-tanks, the Research and Information System for Developing Countries and the Council on Energy, Environment and Water.

The Indian DWG team circulated an earlier version of this report to G20 members, and several G20 members provided detailed comments that are incorporated in this version. Many thanks for these valuable inputs and comments.

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Overview and chapter summary

Chapter 1: Uneven world economic recovery stifles the Decade of Delivery and mounting pressures on developing countries jeopardises the 2030 Agenda

Chapter 1 describes what many have termed the “great divergence” emerging between developed and developing countries since COVID-19 and the challenges faced by the poorest countries to regain their former growth trajectories. It touches on their narrowing fiscal and monetary policy space, looming debt crises and increasing costs due to external shocks. Lastly, it notes that even prior to the Covid-19 crisis, the SDGs were off track and that there are now rising inequalities within and between countries, including exacerbated gender inequalities.

Chapter 2: Trends in financing for sustainable development: Growing needs and declining resources

Chapter 2 outlines the impact of the COVID-19 pandemic had substantial impacts on financing for sustainable development that reverberated across all public, private, domestic and international sources of financing and across all country income levels. The effects are lasting longer and cutting deeper in developing countries least able to raise revenues and access external finance. This chapter looks at trends in aligning finance to the Sustainable Development Goals and the implications for developing and developed countries of the widening sustainable finance gap.

Chapter 3: Financing climate transitions

This chapter outlines the specific context of scarce resources and economic uncertainty, which is a key challenge to identify investment opportunities for both development and climate finance and to ensure that climate finance is additional to development finance. This chapter looks at the sources of climate finance, how it can be scaled up to support transitions and how to overcome the limitations of the current climate finance architecture. It also highlights opportunities presented by the climate-development nexus and how investment in climate mitigation and adaptation can reinforce Sustainable Development Goals priorities.

Chapter 4: Towards a more effective architecture to maximise and sustain multilateral development finance

Chapter 4 highlights that while the multilateral development system has proved its relevancy over successive crises, it faces a multitude of pressures. This chapter looks at its emergency responses and provides an overview of some of the limitations of the increasingly unwieldy system, including its fragmentation, that are seen as inadvertently creating additional bottlenecks to expanding access to sustainable development finance.

Chapter 5: Assessing bottlenecks to scaling up and accessing financing for sustainable development

Chapter 5 examines how due to the sustainable financing gap growing and some developing countries struggling with stagnate or declining revenues, removing bottlenecks to financing for sustainable development is of critical importance. This chapter analyses four areas where constraints on developing

countries arise: non-financial regulations, lack of capacity to produce needed data, low financial market depth and complexity of funding instruments. This discussion could inform G20 work on development finance to channel finance to where it is most needed.

Chapter 6: Ways forward: Suggested areas for G20 action to accelerate Sustainable Development Goal financing

This chapter offers options, ideas and recommendations for the G20 and its Development Working Group to strengthen the international enabling environment and identify co-ordinated approaches conducive to a more equitable access to sustainable finance. Removing the bottlenecks to financing for sustainable development requires collective, cohesive effort by all actors along the sustainable investment chain. The G20 has a key, unique role to play in creating synergies across its members and working groups to promote integrated policies and tools that shift the trillions to where needs are greatest.

Executive summary

A “great divergence” has emerged between developed and developing countries. The former have deployed large stimulus packages to fuel recovery and blunt the impact of crises. The latter are pinned down, caught between rising needs and inadequate resources to meet them. As a result, global progress on the 2030 Agenda for Sustainable Development is grinding to a halt.

Developing countries need at least another USD 3.9 trillion to reach their Sustainable Development Goals (OECD estimate), and possibly USD 4.3 trillion (United Nations Conference on Trade and Development estimate). Nearly all of their sources of financing have dropped, especially government revenues and foreign direct investments. How then can they play their part in the global fight against climate change and its consequences, which necessitates mobilising an additional estimated USD 1 trillion in external finance by 2030?

This report identifies two types of bottlenecks -- in developing countries and in the global finance architecture -- to mobilising SDG finance for a more sustainable world.

Developing countries are confronted with the dual challenge of addressing capacity constraints and low business confidence. Group of Twenty (G20) members can help overcome these through bilateral and multilateral public finance, political support for transitions, the mobilisation of more private capital, and capacity building measures. At global level, the development finance architecture remains fragmented, with finance concentrated in a few multilateral development banks (MDBs): ten organisations account for 70% of multilateral development finance. Recent proposals to strengthen the architecture, such as the Bridgetown initiative or the Paris Summit for a new Global Financing Pact, aim to increase multilateral finance flowing to low-income countries (LICs). G20 can lend their support to these initiatives and continue G20 efforts on the MDBs’ Capital Adequacy Framework.

Four specific bottlenecks to scaling up SDG financing stand out, which the G20 can help alleviate:

- **Non-financial regulations and credit ratings.** Developing countries can advance policy and regulatory measures to support long-term strategies for SDG and climate action; G20 Members can support them in this and engage with non-members to promote such policies.
- **Capacity gaps for data and disclosure of non-financial information.** G20 Members can help build capacity in developing countries to collect and disseminate the information needed for SDG investments.
- **Low financial market depth and debt sustainability constraints.** Innovative financing instruments offer opportunities, but local investments and blended finance need to be scaled up; G20 Members and public development banks can help mobilise public finance and additional commercial finance.
- **A proliferation of financial instruments and heterogenous SDG investment opportunities.** G20 Members can build awareness about SDG finance models and offer capacity support on how developing countries could seize the benefits.

Since 2020, the G20 Development Working Group has been promoting a change of mindset towards more SDG financing. This year, India is providing stimulus to G20 actions towards the 2023 agenda through an Action Plan and a Green Development Pact. Addressing the bottlenecks identified in this report requires supporting systemic and transformative solutions, setting out established good practices of international support, and building capacity in developing countries, so that SDG and climate investments can be scaled up.

1 Uneven world economic recovery and mounting pressures on developing countries jeopardises the 2030 Agenda

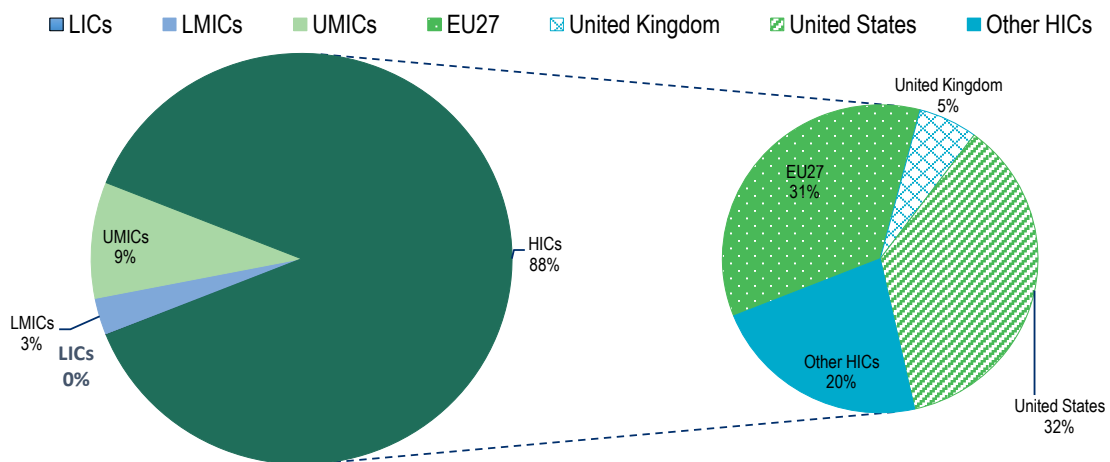
Progress towards the Sustainable Development Goals is in jeopardy. Not only has the COVID-19 pandemic reversed many gains and widened inequalities within and across developing countries. This chapter unpacks what many leaders are calling the “great divergence” that has emerged between developed and developing countries. This trend is fuelled by their uneven capacities to respond to new and emerging threats, a growing concentration of development finance in higher-income countries, and narrowing fiscal space and a deepening debt crisis in countries most in need of investment in sustainable development.

1.1. As macroeconomic disparities between and within countries widen, developing countries are falling further behind in financing and achieving sustainable development

The macroeconomic drivers of the so-called “great divergence” (OECD, 2022^[1]) (Georgieva, 2021^[2]) had stalled progress on financing the Sustainable Development Goals (SDGs) before the COVID-19 pandemic. Now, these factors are widening disparities between the economic recoveries of developed and developing countries. Narrowing fiscal space left developing countries at heightened risk when crises hit

Many developing countries lack the fiscal policy space to respond to growing SDG and climate needs as respond to successive shocks. Over the decade before the pandemic, the fiscal positions of many developing countries deteriorated in response to the successive shocks of the 2008-09 global financial crisis and the 2014 plunge in commodity prices. This left them at a disadvantage compared with wealthier countries when the COVID-19 crisis hit, and they entered the pandemic with little to no fiscal space or spare capacity in their public finances to respond through economic policy support (Figure 1.1). High-income countries (HICs) were able to mitigate the demand and supply shocks by deploying stimulus packages 700 times greater than those of low-income countries (LICs) on per capita basis, 86 times greater than lower middle-income countries (LMICs) and 20 times greater than upper middle-income countries (UMICs). As a percentage of GDP, fiscal support measures in 2021-22 for rescue and recovery were on average three and six times lower in low- and middle-income countries, respectively, than in HICs. Similarly, strong central bank interventions primarily occurred only in HICs and UMICs. Central banks in many LICs and LMICs had limited margin for manoeuvre to implement accommodative monetary policies due to their lower policy credibility, inability to use quantitative easing and weaker macroeconomic fundamentals. The median fiscal balance, or ratio of government revenues to expenditures, in developing countries reached a 20-year low in 2020 of -5.9% of GDP, lower even than these countries’ -3.86% median fiscal balance in the aftermath of the global financial crisis (Figure 1.2, left side).

Figure 1.1. Developing countries had limited fiscal space to implement stimulus measures Share of COVID-19 fiscal measures by income group since January 2020



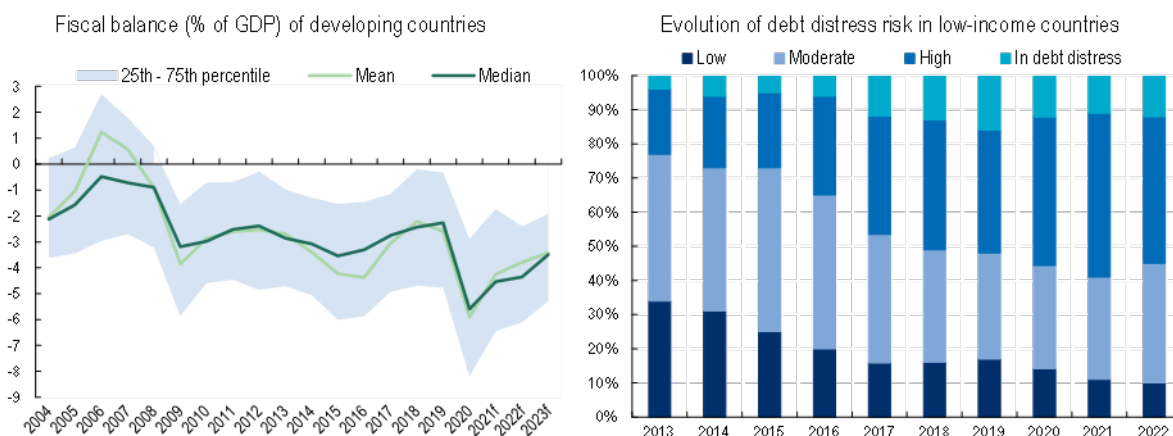
Note: The estimate for the 27 post-Brexit European Union countries (EU27) includes the additional measures implemented by the European Commission (USD 1.361 billion) on top of the EU member states’ average.
 Source: (IMF, 2021^[4])

Debt burdens and rising borrowing costs could limit finance options for developing countries

The accumulation of short-term debt during the COVID-19 crisis and the worsening global economic outlook foreshadow an increase in the cost of debt service, which amounted to USD 387 billion for developing countries in 2022. Between 2020 and 2025, debt service is projected to reach USD 375 billion on average, a dramatic increase over the USD 330 billion on average in the previous five-year period of 2015-19. The share of LICs considered in debt distress or at high risk of debt distress has more than doubled since 2013, from 23% to nearly 60% (IMF/World Bank, 2023^[5]). Developing countries also have higher borrowing costs that may also prevent them from effectively investing in a fair and sustainable recovery. The 54 developing countries in urgent need of debt relief (including comprehensive restructuring including write-offs) represent just over 3% of the global economy and 18% of the population, but more than 50% of people living in extreme poverty (UNDP, 2022^[6]).

Average public and publicly guaranteed (PPG) external debt service could represent as much as 13.1% of total government revenue in LICs, 15% in LMICs and 11% in UMICs over the period. Even before the pandemic, one in eight developing countries was spending more on debt service than on health, education and social protection combined (UNICEF, 2021^[7]), and the Debt Service Suspension Initiative (DSSI) has not produced the expected results (Ahmed and Brown, 2022^[8]). While the DSSI offered the 73 eligible countries a temporary respite in 2020, it did not provide a long-term solution for their debt solvency issues. Developing countries also accumulated large amounts of short-term debt during the pandemic that must be repaid or refinanced by 2024. While the largest share of PPG external debt in most debt-troubled countries is owed to official creditors, 16 developing countries owe more than 30% to private creditors (Molina and Jensen, 2023^[9]).

Figure 1.2. Successive shocks have hurt fiscal balances in developing countries as the number of low-income countries at risk of debt distress has grown



Note: Fiscal balance is defined as general government net lending or borrowing. Fiscal balance values for 2021, 2022 and 2023 are forecasts. The evolution of the risk of debt distress is calculated as a percentage of countries with a debt sustainability analysis.

Source: Left panel: (IMF, 2022^[10]). Right panel: (IMF, 2022^[11]).

Successive crises drive up food, energy and other costs, further diminishing the capacity of the poorest countries to finance sustainable development

Multiple successive crises (e.g., COVID-19, worsening global economic outlook, the war against Ukraine, and rising food and energy prices) have created a growing scissors effect. Geopolitical tensions in particular have driven up global inflationary pressures and are contributing to soaring food and energy prices in developing countries. These are further widening economic disparities between developed and developing countries. Due to their structural characteristics, LICs are also more vulnerable to external shocks such as the commodity price volatility that has followed recent geopolitical tensions. Many LICs and LDCs are commodity exporters, tend to derive a significant portion of their revenue from commodity exports and had high levels of debt prior to the pandemic, making them particularly vulnerable to fluctuations of the global economy. In addition, a future acceleration towards green and renewable energy may lead to global demand shifting to or away from certain commodities and changes in the valuation of productive assets that would benefit some commodity export-dependent developing countries and harm others. The poorer segments of the world's population are experiencing larger welfare losses because higher energy and food prices have a greater impact on their real disposable income. LICs stand to lose the most: For them, the consequences of the war could result in an additional loss of approximately USD 718 billion in 2022 and 2023 (IMF, 2022^[10]).

1.2. Setbacks in meeting the Sustainable Development Goals create new challenges that could have long-term repercussions for developing countries

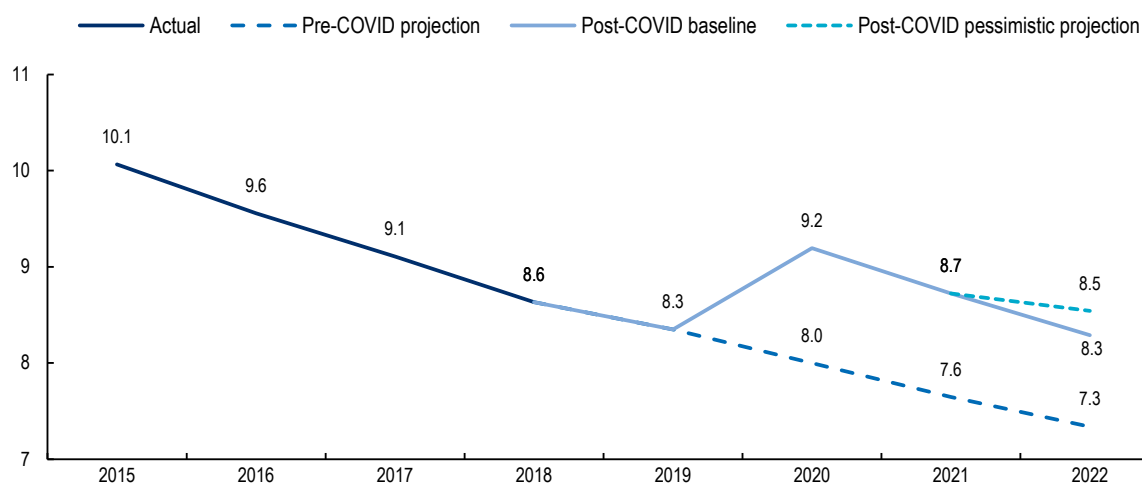
Successive crises have eroded sustainable development progress. The failure to address environmental, social and economic challenges will make them all the more difficult to overcome in the future, with far-reaching consequences in the poorest countries and those most in need such as small island developing states (SIDS), least developed countries and others least able to muster resources and capacity to face new crises. Growing inequalities within countries could make achieving the global goals even more costly over the long term.

The pandemic reversed key development gains but progress towards global goals was already sputtering before the shock of COVID-19. Prior to the COVID-19 crisis, and despite a path of slow convergence, progress on the 2030 Agenda was not on track. Developing countries had made progress in some key development areas such as poverty reduction, maternal and child health, access to electricity, and gender equality but most countries were off track to achieve the SDGs by 2030. Progress in other areas such as reducing inequality, lowering carbon emissions, protecting nature and tackling hunger was stalling and, for some, even backsliding. For example, the world was not on course to stay at or below the 1.5°C target set by the 2015 Paris Agreement, and the number of undernourished people at global level increased by 7%, representing an additional 43 million people, between 2014 and 2019 (UN, 2019^[12]).

Setbacks to the 2030 Agenda, particularly on the goal of eradicating poverty, are more severe in poorer countries

A spike in global poverty was one of the more startling and immediate impacts of the pandemic. After years of steady decline, the rate of extreme poverty worldwide rose to 9.2 in 2020 from 8.3 in 2019, a spike that will set back progress on achieving SDG 1 (no poverty) by at least three years (Figure 1.3). Moreover, the combined effect of the pandemic and the war in Ukraine may have led to 75 to 95 million more people living in extreme poverty in 2022 than anticipated in pre-pandemic projections, setbacks that in turn could erode the social, political and economic foundations necessary to achieve other targets.

Figure 1.3. Following years of decline, global extreme poverty rose in 2020, setting back at least three years of progress



Note: Extreme poverty is measured as the number of people living on less than USD 1.90 per day. The figure is based on official global poverty estimates for 2015-18 cited by (Gerszon Mahler et al., 2022^[13]). Data for 2019 to 2022 are World Bank projections. (World Bank, 2022^[14]).

Despite signs of improvement and a 2.9 percent decrease in 2021 in global poverty (Gerszon Mahler et al., 2021^[15]), the picture remains grim, and progress is highly uneven across income groups.

The COVID-19 crisis worsened gender-based inequalities that could become a drag on developing countries' recovery |

Between 2019 and 2020, women's employment declined by 4.2% at global level, equivalent to the loss of 54 million jobs, while men's employment fell by 3% (International Trade Union Confederation, 2021^[16]), in part reflecting women's over-representation in the accommodation, food services and manufacturing sectors most affected. The gender gap in employment-to-population ratio increased most in LICs in 2020, and there is growing concern that gender gaps in other development areas such as health and education may widen and persist. The resurgence of poverty, particularly among young people, may set off a vicious cycle of lower growth, ever-increasing poverty and deeper inequalities. According to one estimate, globally by 2030, there will be 121 women living in poverty for every 100 men in the same condition, up from an estimated 118 women per 100 men in poverty (Azcona et al., 2020^[17]).

2 Trends in financing for sustainable development: Growing needs and declining resources

The impact of the COVID-19 pandemic had substantial impacts on financing for sustainable development that reverberated across all public, private, domestic and international sources of financing and across all country income levels. The effects are lasting longer and cutting deeper in developing countries least able to raise revenues and access external finance. This chapter looks at trends in aligning finance to the Sustainable Development Goals and the implications for developing and developed countries of the widening sustainable finance gap.

The OECD estimates that the SDG financing gap in developing countries (excluding People's Republic of China) (herein after China) increased by more than 50% as a result of the COVID-19 pandemic, to reach USD 3.9 trillion in 2020 (OECD, 2022^[9]). Although private finance mobilised is just among many sources of financing that could help address the growing financing gap, it is noteworthy that over the same period, amounts of private finance mobilised by multilateral organisations for development increased by 20%, and thus went from representing 1.3% of the SDG financing gap in 2019, to less than 1% in 2020.

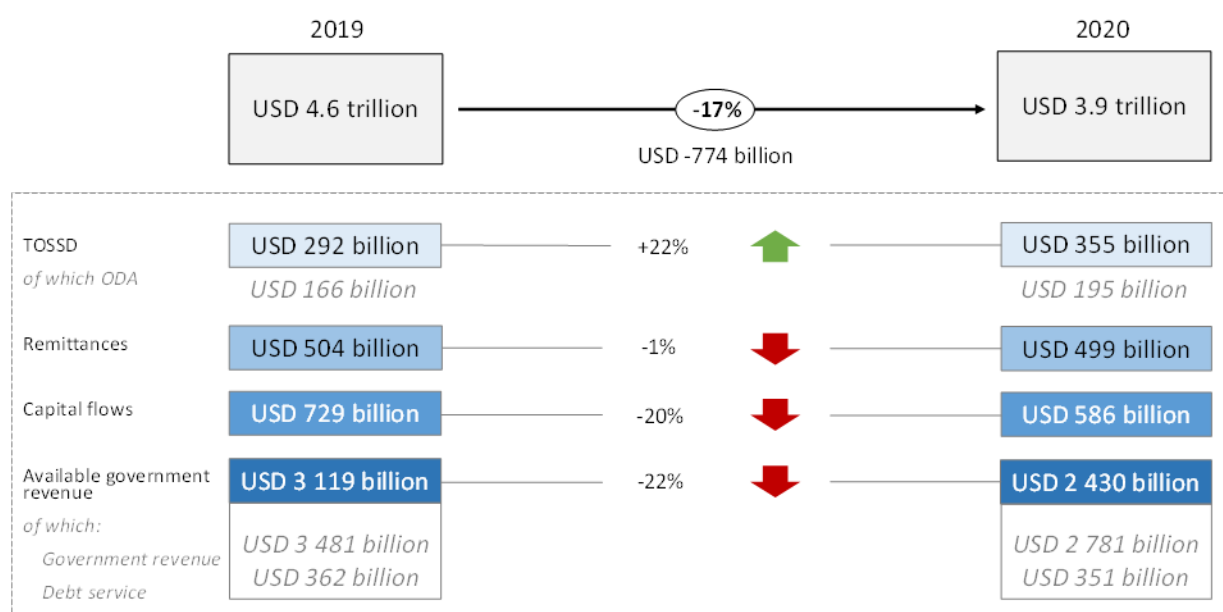
2.1. The pandemic highlighted the persistent instability in the financing for sustainable development landscape

The pandemic caused a significant drop in nearly all sources of financing for sustainable development. Financing flows to developing countries, excluding the People's Republic of China (hereinafter China), declined by 17%, sinking from USD 4.6 trillion in 2019 to USD 3.9 trillion in 2020 (Figure 2.1). The largest drop in absolute terms was in available government revenue (i.e., government revenue after debt service repayments), which shrank by USD 689 billion, or 22%, from USD 3.1 trillion in 2019 to USD 2.4 trillion in 2020. At the same time, official development finance hit record levels over the period, with Total Official Support for Sustainable Development (TOSSD)¹ increasing by 22%, reflecting swift action by development co-operation providers and reflected increased disbursements by multilateral organisations as well as better data coverage in 2020.

Official development assistance (ODA) from members of the OECD Development Assistance (DAC) amounted to USD 162.2 billion in 2020, and to USD 185.9 billion in 2021 and to USD 204 billion in 2022. This helped to reassert the countercyclical role of ODA during a global crisis. Official bilateral development assistance from providers of South-South Co-operation, such as India or China have equally contributed to development finance flows. Reporting to TOSSD has increased by 20% between 2019 and 2021, and the latest TOSSD data shows that USD 394 billion gross disbursements were made in 2021 (OECD, 2022^[18]).

¹ Total Official Support for Sustainable Development (TOSSD) is an international standard for measuring the full array of resources to promote sustainable development in developing countries, and has been recognised as a data source in the UN global indicator framework for Sustainable Development Goals

Figure 2.1. Available financing for sustainable development in developing countries shrank by USD 774 billion, or 17%, in 2019-20



Note: TOSSD includes cross-border support to developing countries and global and regional expenditures for sustainable development (respectively, Pillars 1 and 2 of the TOSSD framework). Amounts mobilised from the private sector are not included in the TOSSD figures here. The definition and scope of Pillar 2 are currently under review, and some of the activities contained may not be directly supporting developing countries. All figures use the largest sample possible for official development assistance-eligible countries excluding China. The rationale to exclude China is based on its outlier status in terms of financing for sustainable development landscape trends, particularly private capital flows.

Source: Authors' design. Data on official resources are based on (OECD, 2022^[18]), Remittances are based on (KNOMAD, 2022^[19]), Capital flows are from (International Monetary Fund, 2022^[20]).

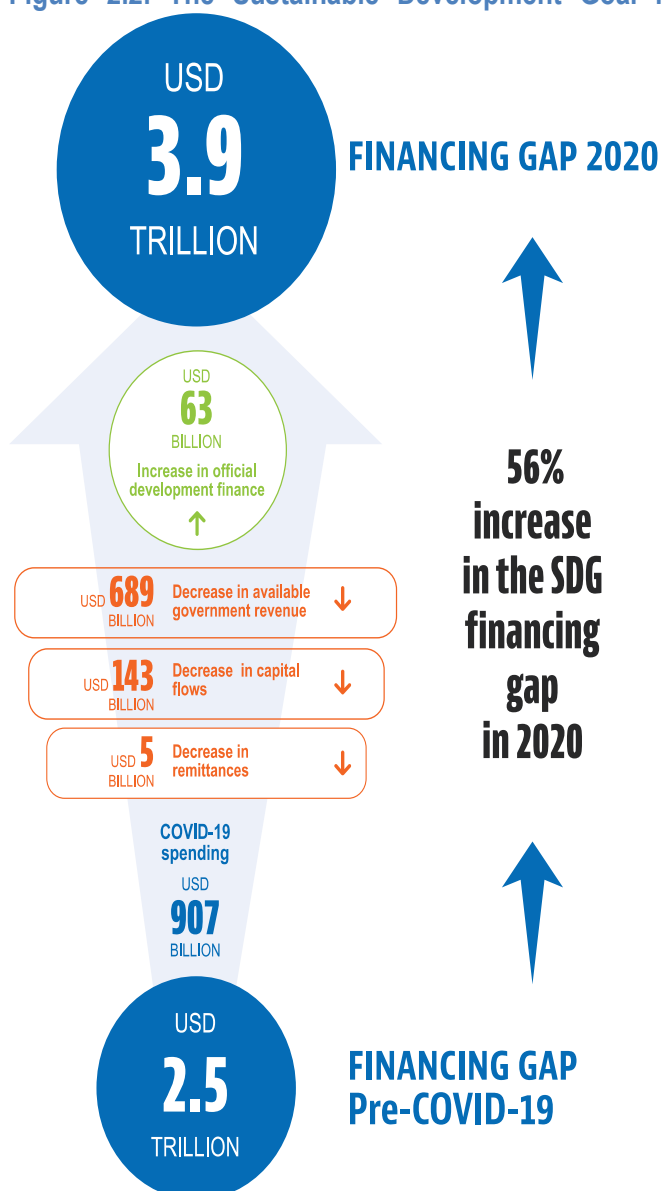
Foreign direct investment (FDI) flows to developing countries, while less volatile than other sources of external capital flows, were already on a downward trend in the decade prior to the COVID-19 crisis and shrank by a further 8% in 2020, but this was much less than the 30% drop observed in the global financial crisis in 2009. However, the decline in FDI particularly affected greenfield projects in developing countries, considered one of the most beneficial forms of investment for development. The decline also severely impacted sectors relevant to the Sustainable Development Goals (SDGs), evidenced by the contraction from the pre-pandemic trend in the volume of announced greenfield projects in water, sanitation and hygiene (-68%); transport services (-59%); food and agriculture (-48%); health (-39%); and education (-36%). The pandemic itself negatively affected job creation by diverting FDI away from labour-intensive industries such as manufacturing and tourism that were the most affected and towards more capital-intensive investments.

Remittances, another key resource, also recovered once host governments began lifting restrictions and deploying fiscal stimulus. Between 2019 and 2020, flows to all developing countries decreased by just 1%, from USD 504 billion to USD 499 billion. Their resilience helped safeguard consumption-related investments and shield some populations from poverty, partly mitigating the drop in other external private resources.¹

2.2. Growing sustainable development financing needs and subsequent gaps

The shocks induced by COVID-19 and geopolitical tensions are widening the SDG financing gap in developing countries, which increased by 56%, to USD 3.9 trillion in 2020 (Figure 2.2). Though capital flows recovered swiftly in the second half of 2020, they could not make up for the precipitous drop in available government revenue. Taking into consideration the expected tightening of global financing conditions, projections by the UN Conference on Trade and Development suggest that the SDG financing gap could reach USD 4.3 trillion per year from 2020 to 2025, an increase of USD 400 billion over OECD estimates in 2019-20 (UNCTAD, 2022^[21]).

Figure 2.2. The Sustainable Development Goal financing gap increased by 56% in 2020



Source: Authors' design. Official development finance data are based on (OECD, 2022^[18]). Remittances are based on (KNOMAD, 2022^[19]). Capital flows are from (International Monetary Fund, 2022^[20]).

Economic and financial uncertainty cloud the outlook for a rebound for developing countries

Mounting geopolitical tensions and the risk of transmission of new adverse shocks to the global economy mean business confidence and investor sentiment are likely to remain fragile, possibly depressing investment in developing countries in the medium to long term.

Furthermore, leakages in financial control systems continue to deprive developing countries of considerable resources. Although illicit financial flows are difficult to measure accurately because they are illicit and there are different definitions of the concept, existing estimates indicate that these flows are of sufficient magnitude to contribute substantially to the SDG financing gap in developing countries. Public spending inefficiency represents an important but often overlooked dimension of the SDG financing gap. Losses due to inefficient public spending across the SDGs could amount to USD 102 billion in LICs, USD 2.7 trillion in LMICs and USD 6.5 trillion in UMICs per year (Cristóbal et al., 2021^[22]).

3

Financing climate transitions

In a context of scarce resources and economic uncertainty, a key challenge to identify investment opportunities for both development and climate finance and to ensure that climate finance is additional to development finance. This chapter looks at the sources of climate finance, how it can be scaled up to support transitions and how to overcome the limitations of the current climate finance architecture. It also highlights opportunities presented by the climate-development nexus and how investment in climate mitigation and adaptation can reinforce Sustainable Development Goals priorities.

Global and national commitments to climate change mitigation and adaptation create additional demands on available financing for sustainable development as well as opportunities to invest in globally just transitions.² It is estimated that USD 1 trillion in external climate finance will be needed by 2030. While there is yet no formally agreed definition of climate finance, it can be understood as local, national and international financing (public, private and blended) to explicitly support mitigation and adaptation. Additionally, climate-aligned finance consists of finance flows that are consistent with a pathway towards low CO₂ emissions and climate-resistant development.

3.1. Investing in the climate-development nexus

Sustainable development and climate action are mutually beneficial and interdependent. Investment in climate-related activities can reinforce Sustainable Development Goal (SDG) priorities and positively contribute to sustainable development and growth.

Climate change stymies economic growth and threatens to further set back development

The effects of climate change disproportionately affect the poor, exacerbating inequalities and undermining poverty eradication efforts (IMF, 2022^[10]). Its impacts on health, land use and food security could precipitate a migration crisis that leads to the displacement of, with hundreds of millions of people, most of from developing countries (Bhattacharya et al., 2022^[23]). Job destruction is likely in carbon-intensive sectors as these activities are replaced by green sectors (OECD, 2017^[24]). In some scenarios, the global economy will be smaller by 4.2% due to climate change by 2050 even if Paris Agreement targets to stabilise global warming are met and by as much as 18% if no mitigating actions are taken (Swiss Re Institute, 2021^[25]).

Least developed countries and small island developing states are among the worst affected countries and those with the least capacity to respond to climate change (Kharas and Dooley, 2021^[26]). Rapid population growth in all developing regions and especially Africa will increase investment need as a higher proportion of the population will be living in high-risk zones (World Bank, 2021^[27]) (Bhattacharya et al., 2022^[23]).

Investing in climate and green transitions is investing in growth

Returns on investments in the green transition are high. Strong climate action can increase long-term growth output by up to 2.8% on average across Group of Twenty (G20) countries by 2050, with a net effect of nearly 5% if mitigated climate impacts are considered (OECD, 2017^[24]). For example, though upfront costs of investing in green infrastructure could be up to 33% higher than for conventional energy infrastructure investment (Rozenberg and Fay, 2019^[28]), the strong positive impact on GDP observed for green investment more than offsets the initial higher investment costs and provides a positive return for countries' GDP.

Moreover, unexpected and rapid technological advancements in low carbon solutions mean that by 2030, they will be competitive with fossil-fuel based investments in sectors accounting for almost three-fourths of emissions (Systemiq, 2020^[29]). With these changes will come new innovations and sources of growth and, with them, new investment opportunities that, if ignored, could lead to trillions of dollars of stranded global capital in defunct sectors (Bhattacharya et al., 2022^[23]).

Trillions of dollars of investment in sustainable development and climate are needed

While the SDGs will require close to USD 4 trillion annually, the climate finance gap is growing faster. An estimated USD 1 trillion in external finance will be needed by 2030 for emerging economies and developing countries other than China, according to a recent report for the Independent High-Level Expert Group on Climate Finance (Songwe, Stern and Bhattacharya, 2022^[30]). Transforming energy systems – primarily in

transport, industry, energy-efficient buildings and power systems – will require the lion’s share of the spending (Infographic 3.1). Separately, the African Group of Negotiators to COP27 called for USD 1.3 trillion a year in climate finance to be made available to African countries starting in 2025 (Kawaye, 2022^[31]).

Figure 3.1. External financing sources for investment and spending priorities for climate action and related development goals

Investment and Spending Priorities			External financing sources needed to support investment and spending					Needs by 2030 in USD
Transforming the energy system	Power system	Zero carbon generation						\$300-400bn
		Transmission and distribution						\$200-250bn
		Storage and back up capacity						\$50-75bn
		Early phase out of coal						\$40-50bn
	Transport system	Transport infrastructure (low emission)						\$400-500bn
		Fleet electrification/hydrogen						\$100-150bn
	Industry	Energy efficiency						\$10-20bn
		Industrial processes						\$10-20bn
	Buildings	electrification						\$20-40bn
		Energy efficiency, GHG abatement						\$70-80bn
	Green Hydrogen	Production						\$20-30bn
		Transport and storage						\$20-30bn
	Just transition	Target programmes, safety nets						\$50-100bn
	Coping with loss and damage							\$200-400bn
Investing in adaptation and resilience							\$200-250bn	
Investing in natural capital		Sustainable agriculture						\$100-150bn
		Afforestation and conservation						\$100-150bn
		Biodiversity						\$75-100bn
Mitigating methane emissions from fossil fuels and waste							\$40-60bn	
			Largely autonomous private finance	Private finance with risk mitigation	Long-term MDB finance	Concessional finance (bilateral and multilateral)	Debt-free finance	
			Well-defined returns, shorter duration maturities	Longer maturities, policy and technology risks	Solid economic returns, long duration and spillover effects	Lack of well-defined returns, weak country creditworthiness	Limited monetised returns, global externalities	

Note: Within each colour category, dark colours represent primary sources of finance and lighter colours represent secondary sources.

Source: Adapted from (Songwe, Stern and Bhattacharya, 2022^[30]).

3.2. Public and private resources to allow for globally just transitions

The Independent High-Level Expert Group on Climate Finance report suggests that just over half (55%) of climate finance needed could be covered by private investment, with the remainder provided 25% by multilateral development banks (MDBs) and 20% by other actors using innovative instruments for low-cost financing. However, the mobilisation of private finance has been relatively modest. And while bilateral public climate finance increased in the last seven years and MDBs are providing record levels climate finance to developing countries, need is growing and outstripping these efforts. To mobilise the resources, annual flows from multilateral development banks and development finance institutions will need to triple over the next five years; concessional finance must double by 2025 from 2019 levels; and the envelope of low-cost finance must expand significantly through special drawing rights, guarantees and other innovative instruments (Songwe, Stern and Bhattacharya, 2022^[30]).

Bilateral public climate finance has increased considerably since 2016

Public climate finance increased consistently year on year since 2015, with multilateral public climate finance attributable to developed countries growing by 138% between 2013 and 2020 and bilateral public climate finance growing by 40% over the same period (OECD, 2022^[32]). This finance was mainly in the form of concessional and non-concessional loans (71%) and, to a lesser extent, grants (26%).

As illustrated in Table 3.1, bilateral and multilateral public climate finance increasing 80% between 2013 and 2020 (from USD 38 billion to USD 68.3 billion). Mobilised private climate finance increased by close to 30% over 2016-20, although comparable data are only available from 2016, with 43% of the total

representing direct investments in companies and project finance special purpose vehicles and 19% in guarantees. The share of small climate-related export credits, while relatively small, increased by 19% over 2013-20. Mobilised private finance and export credits experienced variations between 2013 and 2020, including a notable drop in 2020 over 2019.

Financing for climate mitigation represented the majority (58%) of total climate finance provided and mobilised. Mitigation finance primarily focused on activities in the energy and transport sectors, which accounted for close to half (46%) of total climate finance provided and mobilised between 2016 and 2020. Adaptation finance focused on activities in the water supply and sanitation sector, agriculture, forestry, and fishing, which accounted for 17% of total climate finance provided and mobilised (OECD, 2022^[32]).

In 2021, in advance of the COP26 climate conference, members of the OECD DAC took the further step of formally committing to align their official development assistance with the goals of the Paris Agreement on climate change. However, overlapping global crises have strained both bilateral public climate finance and official development finance budgets overall. In reaction to the COVID-19 pandemic, many providers reallocated resources away from climate mitigation and adaptation in favour of domestic emergency response (Richmond et al., 2021^[33]). This shift led to an accumulation of short-term debt and limited fiscal space in developing countries, tightening government revenues that could be allocated to climate finance.

Table 3.1. Climate finance provided and mobilised by component and sub-component in 2013-2020 (USD billion)

	2013	2014	2015	2016	2017	2018	2019	2020
Bilateral public climate finance (1)	22.5	23.1	25.9	28.0	27.0	32.0	28.7	31.4
Multilateral public climate finance attributable to developed countries (2)	15.5	20.4	16.2	18.9	27.1	30.5	34.7	36.9
<i>Multilateral development banks</i>	13.0	18.0	14.4	15.7	23.8	26.7	30.5	33.2
<i>Multilateral climate funds</i>	2.2	2.0	1.4	2.6	2.9	3.5	3.8	3.5
<i>Inflows to multilateral institutions (where outflows unavailable)</i>	0.3	0.4	0.4	0.6	0.5	0.3	0.3	0.2
Subtotal (1+2)	38.0	43.5	42.1	46.9	54.1	62.1	63.4	68.3
Climate-related officially-supported export credits (3)	1.6	1.6	2.5	1.5	3.0	2.7	2.6	1.9
Subtotal (1+2+3)	39.5	45.1	44.6	48.5	57.1	64.8	66	70.2
Mobilised private climate finance (4)	12.8	16.7	N/A	10.1	14.5	14.7	14.4	13.1
<i>By bilateral public climate finance</i>	6.5	8.1	N/A	5.2	4.0	3.8	5.8	5.1
<i>By multilateral public climate finance attributable to developed countries</i>	6.2	8.6	N/A	4.9	10.5	11.0	8.6	8.0
Grand Total (1+2+3+4)	52.4	61.8	N/A	58.5	71.6	79.9	80.4	83.3

Multilateral development banks have increased climate finance but must scale up spending significantly to meet need

Despite the pandemic, climate finance for low- and middle-income countries from multilateral development banks (MDBs) reached a record USD 50.7 billion in 2021; 92% of the USD 19.2 billion for adaptation finance also was directed to low- and middle-income countries (Songwe, Stern and Bhattacharya, 2022^[30]). Nonetheless, MDBs will need to expand their scope of work and significantly increasing their volume of

financing to fill the gap. Some suggest they will need to triple their levels of spending by 2025 to meet the demands of climate adaptation and mitigation in developing countries and further advance reforms to increase finance (Tyson, 2021^[34]). This means reforming their strategies and operational activity to better leverage the strengths derived from their shareholder structure, policy advice, investment and capacity-building functions.

3.3. Bottlenecks to scaling up climate finance in developing countries

Climate finance flows are unevenly distributed, creating challenges for poor and vulnerable countries that face the greatest risks and bear disproportionately higher costs from the impacts of climate change. The main recipients of climate finance are concentrated in higher-income countries. This is probably because of their stronger institutional, enabling environment and absorptive capacities. Lower middle-income countries (LMICs) and upper middle-income countries (UMICs) are the primary beneficiaries, and Asia is the primary beneficiary region, accounting for 42% of total climate finance provided and mobilised by developed countries. The breakdown by other regions is Africa (26%), the Americas (17%), Europe (5%) and Oceania 1%. The breakdown of total climate finance provided and mobilised by developed countries per income group shows that LMICs accounted for 43%, followed by UMICs at 27%, low-income countries at 8%, and high-income countries at 3%. Over the 2016-20 period, small island developing states accounted for just 2%, least developed countries for 17%, and fragile contexts for 22% of the total climate finance provided and mobilised (OECD, 2022^[32]).

Capacity constraints in least developed countries limit their access to climate finance

Capacity constraints that make it harder for developing countries to achieve climate objectives also are bottlenecks to climate finance. Despite significant investments in capacity development across partner countries to enhance readiness, many of them still lack the necessary capacity to assess climate risks, develop project proposals on climate mitigation and adaptation, and, by extension, access necessary funding. Recent in-depth analysis confirmed the need to further support capacity development and programming capacity support at country level to align and dovetail with countries' priorities for long-term capacity development. Such support is also a key part of a holistic approach to the direct mobilisation of private climate investment (Casado Asensio, Blaquier and Sedemund, 2022^[35]). It plays a key role in providing a basis for the development of pipelines of bankable projects and the de-risking of projects where blended finance approaches can be pursued and the role of public development banks is particularly relevant (G20, 2021^[36]).

A tool to mobilise more private climate finance

OECD instruments for responsible business conduct (RBC), including risk-based due diligence, can be further leveraged by private investors to address some of the identified barriers to mobilising private finance towards green project and asset transactions in LMICs. RBC due diligence incentivises continuous improvement of project and asset performance on environmental and social objectives by providing a framework for identifying, preventing and mitigating potential and actual adverse impacts on people and planet (OECD, 2018^[37]). Conducting RBC due diligence in lieu of relying on environmental, social and governance (ESG) scores can help overcome some of the biases of ESG metrics and scoring that can sometimes not fully capture the potential contribution of projects and assets in LMICs to key climate and development objectives.

The RBC framework can be further be leveraged in regard to catalysing private finance for climate and development objectives. Similarly, the OECD DAC Blended Finance Principles for Unlocking Commercial Finance for the SDGs recognises that blended finance projects should integrate high corporate

governance, environmental and social standards as well as RBC instruments to support the development of functioning and efficient markets (OECD, 2018^[37]).

3.4. Limitations of the climate finance architecture

A large share of global climate finance is currently co-financed through existing institutions of the global development co-operation architecture. By contrast, the institutions with a predominant or exclusive mandate for provisioning climate-related finance make up a small share of total climate finance). In 2020, less than 4% of the total USD 83.3 billion of climate finance towards the USD 100 billion goal was accounted for by the climate funds directly related to the UN Convention and Kyoto Protocol, or less than 5% if mobilised private finance is excluded (OECD, 2022^[1]).

Climate finance challenges reflect those of development co-operation generally

The priorities and incentive frameworks of development co-operation providers largely determine climate finance (Ericsson and Steensen, 2014^[38]) alongside the regulatory and policy frameworks of receiving jurisdictions. As they are dependent on political commitments and individual funding decisions by bilateral and multilateral institutions (OECD, 2022^[32]), climate investments may be undercut by the fragmentation and overlap that sometimes characterises official development finance interventions on the ground. Such fragmentation directly challenges national ownership and alignment and strains the administrative capacities of recipient country governments, leading to uneven distribution of concessional funding (OECD, 2012^[39]).

The investment climate for private sector climate finance is also weak, especially in the green energy sector. Domestic macroeconomic, regulatory and policy frameworks can dissuade private finance (OECD, 2022^[1]), and policy uncertainty and high-risk perception of green energy projects exacerbate offtake and creditworthiness risks (Box 3.1). More broadly, there is asymmetric information stemming from the lack of data that investors require to accurately assess their risk. The ability of shareholders and stakeholders to effectively engage with companies on climate transition priorities depends on them having access to high quality information on how companies are approaching climate risks and opportunities (OECD, 2022^[1]). Taken together, these factors lead to a likely overestimation of risk and discourage the inflow of private finance.

Box 3.1. Offtake risk as a barrier to energy finance in Africa

Offtake risk refers to the risk around payment default or delay by the offtaker (the entity which purchases power) to the energy generator (CEEW, 2019^[40]). It can have a large impact on the cost of capital for renewables and therefore act as a barrier to private investors. In developing countries, because the offtaker is usually a state-owned entity that is financially weak, the investor can encounter contract default; transferring some of this risk away from private investors would be more efficient (CPI, 2018^[41]).

An example of this dynamic is Africa, where state-owned utilities are the main project counterparts buying energy for a pre-agreed price but where financial sustainability is highly unstable (CPI, 2018^[42]). Because of the possibility of negative macro shocks leading to tariff reductions or payment delays, debt investors often include offtaker ability and willingness to pay into their calculation of return, which dampens the levels of debt that projects can attract. Although projects with high risk should yield high returns, the underinvestment in sub-Saharan Africa suggests that a limit exists beyond which higher returns will no longer be accepted.

Without fixing this efficiency and allocation problem, underfunding will continue in the energy sector.

3.5. The developing country perspective on unlocking climate and development finance: The Bridgetown Initiative to reform the global finance architecture

The Bridgetown Initiative offers an alternative framework for climate finance that encompasses the rapid scaling up of investment, a just low carbon transition and building climate resilience. It stemmed from an informal dialogue in 2022 hosted by Barbados Prime Minister Mia Mottley and was subsequently presented to the United Nations General Assembly that year. Its thrust is to call attention to, and address three interconnected crises faced by developing countries: increasing cost of living, debt distress and climate change. It consists of four proposals to reframe the global financial architecture to unlock and scale up climate finance and development:

- A key bottleneck for developing countries is the cost of capital. The Initiative calls the immediate provision of liquidity to stop the debt crisis including a temporarily suspension by the International Monetary Fund of its interest surcharges; rechanneling of at least USD 100 billion of unused special drawing rights (SDRs) to countries that need them; and restoring unconditional rapid credit and financing facilities to previous crisis level.
- It calls on MDBs to expand lending capacities for climate and the SDGs by USD 1 trillion and states that concessional lending should prioritise building climate resilience in countries that are most vulnerable to climate change.
- Noting that countries vulnerable to climate change tend to have very limited fiscal space and are unable to take on new debt, the Initiative calls for using new multilateral mechanisms to activate private sector resources to fund climate loss, damage and reconstruction. These mechanisms should consider low-interest long-term instruments to support multilateral agencies in accelerating private investment for the low carbon transition or the new issuance of USD 500 billion SDRs.
- As implementing these proposals will not be possible without the collective action of all stakeholders, it calls for a co-ordinated response by the international community to effectively respond to the climate crises and adapt the financial system to better support climate-vulnerable countries and the low carbon transition.

4 Towards a more effective architecture to maximise and sustain multilateral development finance

While the multilateral development system has proved its relevancy over successive crises, it faces a multitude of pressures. This chapter looks at its emergency responses and provides an overview of some of the limitations of the increasingly unwieldy system, including its fragmentation, that are seen as inadvertently creating additional bottlenecks to expanding access to sustainable development finance.

4.1 After a pandemic-related surge in financing from the multilateral development system and the private sector, available flows are not keeping pace with expanding need in developing countries

The multilateral development system has provided a lifeline to developing countries in success crises. At nearly USD 230 billion, outflows in 2020 hit a record high as a response to the pandemic (though multilateral financing commitments increased by 37%, less than the 54% increase in the aftermath of the global financial crisis). Despite its unprecedented magnitude, the volume of multilateral financing provided to developing countries was still not enough to meet the needs generated by successive crises. Total commitments from multilateral organisations allocated to low and middle-income countries in 2020 amounted to 1.3% of their 2019 GDP, compared to a 9.6% output loss. For upper middle-income countries, multilateral outflows added up to less than 1% of their GDP, while they were the most affected income group in terms of output, with a 15.6% drop.

A similar picture emerges on private flows for sustainable development. According to the latest (OECD, 2022^[40]) data collected, private finance mobilised by official providers grew by 11% in 2020 from USD 46.4 billion to USD 51.3 billion, following a 4% drop in 2019. Multilateral organisations continued to be the largest contributors to the mobilisation of private finance, accounting for 76% of the total, up by 7% from 2019. While this increase is positive news, the amounts involved remain far from the order of magnitude established by the Addis Ababa Action Agenda for private finance and can only contribute marginally to fill the SDG financing gap. Additionally, an overwhelming majority of mobilised private finance targeted countries with lower risk profiles and sectors associated with higher bankability of projects as in 2018-2020 87% was mobilised for middle-income countries and 62% in economic infrastructures and service sectors. (OECD, 2023^[41]).

International financial institutions were instrumental in providing liquidity and financial support to help developing countries cope with to COVID-19 impacts

During 2020, multilateral development banks (MDBs) took steps to ramp up their lending to developing countries including by accelerating disbursements, establishing new credit facilities and repurposing existing financing for pandemic-related projects. The World Bank Group drew down the International Bank for Reconstruction and Development's USD 10 billion crisis buffer and its concessional window. The International Development Association (IDA) used all the remaining IDA18 resources during its FY2020 and frontloaded about half of the three-year envelope of IDA19 resources in FY2021 by advancing IDA20 by 12 months to enable surge financing to continue in the coming years (World Bank Group, 2021^[63]).

The Asian Development Bank (ADB) disbursed funds through a newly created specialised budget support instrument, the COVID-19 Pandemic Response Option, which provides rapid fiscal support for governments to implement countercyclical expenditure programmes to mitigate the impacts of the pandemic (Sato, Aboneaj and Morris, 2021^[42]). While significant, the increase in MDB lending was less than that observed during the 2008-09 financial crisis, leading to renewed calls to reassess the lending capacity of these institutions (Humphrey and Prizzon, 2021^[43]). The International Monetary Fund (IMF) stepped in with emergency financing, liquidity support, grants for debt relief and a general special drawing rights (SDRs) allocation of USD 650 billion, although only a fraction of the SDR allocation went directly to developing countries (G20, 2022^[44]).

It remains to be seen whether the exceptional levels of multilateral support can be sustained. Some multilateral stakeholders have recently warned that after frontloading resources to address the multiple concurrent crises, their financing flows could experience a drop in coming years if they do not receive additional donor support. For example, the World Bank has announced that it is currently exploring options to avoid a decline of IDA lending in FY2024 and FY2025 (World Bank, 2023^[45]). Moreover, while its capacity to mobilise private finance is a core strength of the multilateral development system, the amounts involved are still well below what is needed.

Despite some progress, the mobilisation of private finance for sustainable development remains below the ambition of the 2030 Agenda

The need to mobilise private resources is a key component of the 2030 Agenda and is clearly established as a priority in the Addis Ababa Action Agenda. Official providers have made significant efforts to better measure private finance through official interventions since the first survey on mobilisation carried out in 2013 by the OECD. Today, the OECD DAC measures private finance mobilised through six financial instruments: credit lines, guarantees, simple co-financing, direct investment in companies and special purpose vehicles, shares in collective investment vehicles, and syndicated loans. Unlike the broader concept of blended finance, the DAC measure of mobilisation uses a restrictive definition, in that it only considers the amounts of private finance that would not have been mobilised without the use of official development finance.

4.2 The multilateral finance architecture is under growing pressure to meet today's complex and overlapping challenges more effectively

The multilateral architecture is a more crowded, complex and fragmented space than ever, and new multilateral funds continue to be established in response to emerging development challenges (OECD, 2020^[47]; World Bank, 2022^[48]). While newly created entities provided the rapid response needed in times of crisis, their continued proliferation also creates challenges of coherence, co-ordination, transparency and accountability (OECD, 2021^[50]). These, in turn, create bottlenecks in access to financing for sustainable development for developing countries.

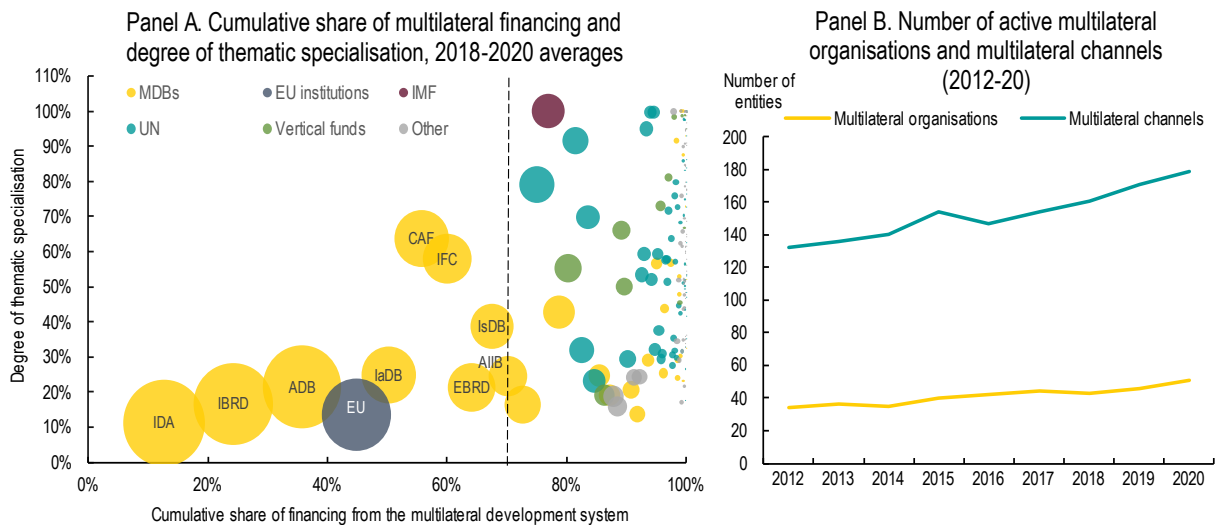
Bottleneck: High concentration in a few organisations

The creation of new multilateral channels in response to emerging crises is resulting in increased fragmentation and complexity of the multilateral architecture. While the multilateral development system is constantly evolving, changes to its architecture tend to take place through incremental adjustments and additions to existing multilateral frameworks. The centre of gravity of the multilateral development system remains in a handful of multilateral organisations. A fraction – just 10 of the more than 200 multilateral development organisations – account for 70% of the outflows from the multilateral development system. Figure 4.1 illustrates the relative weight of the institutions: the IDA, International Bank for Reconstruction and Development (IBRD), ADB, European Union (EU) institutions, Inter-American Development Bank, Development Bank of Latin America (CAF), IFC, European Bank for Reconstruction and Development (EBRD), Islamic Development Bank (IsDB), and Asian Infrastructure Investment Bank (AIIB).

Bottleneck: Fragmentation

However, the multilateral development system also includes a multitude of smaller and more specialised entities. UN funds and programmes, UN agencies and vertical funds account for a large share of the entities within the remaining 30% of multilateral outflows (Figure 4.1), and this part of the system is characterised by greater fragmentation. It includes entities with smaller portfolios and greater thematic specialisation that often channel funds earmarked by bilateral providers. As noted in the 2020 edition of the Multilateral Development Finance report (OECD, 2020^[49]), successive and more frequent crises could either lead to a consolidation of the multilateral system or exacerbate the trend towards increasing fragmentation. The recent creation of new multilateral channels, such as the Pandemic Preparedness and Response Fund hosted by the World Bank and the UN-led COVID-19 Multi-Partner Trust Fund, suggests that the system continues to adapt to new challenges by superimposing new entities onto the existing architecture rather than by undertaking a profound reform.

Figure 4.1. Ten organisations still account for 70% of multilateral organisations' total financing, but the system is increasingly crowded and fragmented



Note: Calculations are based on commitments in 2020 constant prices. In Panel A, the horizontal axis shows cumulative multilateral financing (as a percentage of total financing from the multilateral development system) and the vertical axis shows the degree of specialisation (calculated as the share of the largest sector in each multilateral organisations' portfolio). Bubble size represents the volume of financing to the multilateral development system, which includes both multilateral outflows and non-core contributions channelled through multilateral organisations.

Source: Authors' calculations based on OECD Creditor Reporting System, (OECD, 2022^[52]).

Bottleneck: Competition for resources may inadvertently increase finance gaps

In the long run, further expansion and fragmentation of the multilateral development system could undermine its effectiveness, increasing the risk of duplication, larger funding gaps and greater competition for resources while diluting responsibility across a constellation of entities with their own governance frameworks. The increasingly complex multilateral architecture already makes it difficult to clarify the division of roles and identify potential overlaps across portfolios (Figure 4.2). Further efforts are needed to map the areas of complementarity or overlap between the aid portfolios of multilateral and bilateral actors to ensure greater coherence and co-ordination across their activities.

Figure 4.2. Multilateral organisations form a complex patchwork with diverse but sometimes overlapping portfolios

Number of active multilateral entities by thematic sector (2015-20)

Sector	MDBs	Vertical funds	UN	Other	Total
Action Relating to Debt	7	0	1	4	12
Agriculture, Forestry, Fishing	19	5	13	5	42
Banking & Financial Services	20	5	10	6	41
Business & Other Services	15	2	11	5	33
Communications	17	2	9	5	33
Development Food Assistance	7	1	12	2	22
Disaster Prevention & Preparedness	14	5	13	3	35
Education	17	3	15	5	40
Emergency Response	13	1	15	4	33
Energy	19	6	12	6	43
General Budget Support	6	1	5	3	15
General Environment Protection	15	5	15	6	41
Government & Civil Society	17	5	17	8	47
Health	18	3	18	6	45
Industry, Mining, Construction	20	5	14	6	45
Other Social Infrastructure & Services	17	5	15	6	43
Population Policies/Programmes & Reproductive Health	11	3	15	3	32
Reconstruction Relief & Rehabilitation	13	2	12	2	29
Trade Policies & Regulations	15	1	8	4	28
Transport & Storage	19	4	7	5	35
Water Supply & Sanitation	17	5	14	5	41

Note: Table cells are coloured based on the number of entities in the category, from lowest (green) to highest (red).

Source: Authors' calculations based on OECD Creditor Reporting System, (OECD, 2022^[52]).

4.3 Maximising the potential of the international development finance system to meet sustainable and green development finance needs

The G20 has been pushing for innovative solutions to scale up MDB lending. The MDB Action Plan on Balance Sheet Optimisation, approved in 2015, called on MDBs to work with their respective shareholders on measures to increase their lending through balance sheet optimisation. The plan cautioned that the optimisation should not jeopardise the MDBs' AAA credit ratings or adversely impact their ability to provide countercyclical lending (G20, 2015^[53]). Since then, some of the major MDBs have restructured their balance sheets to increase their financial capacity. Looking forward, continued donor commitments to the MDBs will be necessary to ensure that they can respond to growing country needs.

Adapting current frameworks could help unlock the billions needed for sustainable development finance

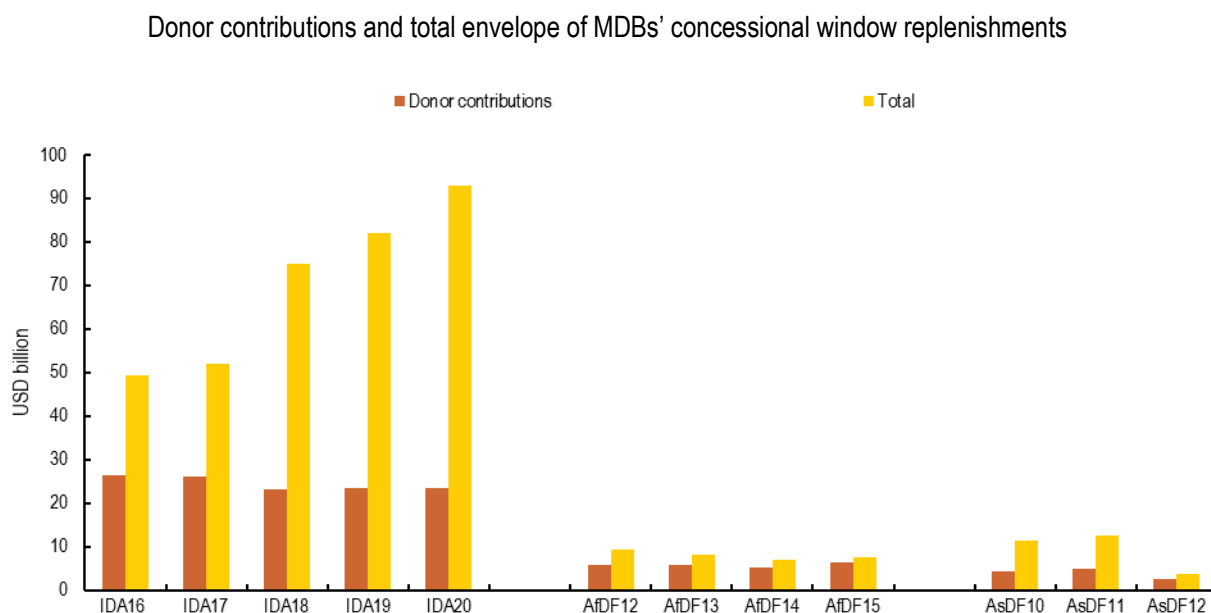
The various approaches chosen by the major MDBs reflect in part the unique institutional set-up and portfolio characteristics of each organisation. In the case of the IDA, the introduction of a hybrid model in 2017 to issue debt in commercial bond markets against its equity base allowed the organisation to scale up its replenishment envelopes. Donor contributions to the IDA, however, remained stagnant or even declined slightly (Figure 4.2).

In 2021, the G20 also commissioned an independent review of MDBs' capital adequacy frameworks (CAFs). The main objective of the review was to enable shareholders to consider adaptations to the current frameworks in order to maximise MDBs' financing capacity, potentially unlocking hundreds of billions of

dollars in additional lending. Recognising that MDBs' highly conservative approaches to capital adequacy may clash with the need to provide countercyclical and large-scale financing, the independent review encouraged shareholders to (1) revisit their risk management approaches and align MDB risk appetites with operational priorities and strategies, (2) recognise the benefits of callable capital, (3) expand the use of financial innovations, (4) enhance dialogue with credit rating agencies, and (5) promote greater transparency regarding MDB credit performance. With regard to the need for more transparency, the review especially called for an improvement of capital adequacy governance by enhancing shareholders' information and understanding of the capital adequacy management approaches of different MDBs. If implemented, such measures could collectively help to free up capital in the range of USD 500 billion to USD 1 trillion (G20, 2022^[47]).

Recent calls for reform of the global financial architecture point to the need to evolve the mandate and increase the financing capacity of the main MDBs. However, balance sheet optimisation measures are unlikely to be sufficient to cover the growing demands placed on MDBs. A recent report on the evolution of the World Bank Group, for example, stressed that increasing the volume of IBRD resources in support of global public goods will require additional and recurrent concessional resources from donors; it also noted that the World Bank is exploring options to avoid a sharp decline of IDA lending in FY2024 and FY2025 after frontloading IDA20 resources to FY23 to address multiple crises (World Bank, 2023^[48]).

Figure 4.3 Donor contributions to the replenishments of multilateral development banks' concessional windows have been flat in recent years and represent a declining share of their total replenishment envelope



Source: (OECD, 2022^[2]), based on replenishment reports of the IDA (, African Development Fund and Asian Development Fund.

Some parts of the agenda for the reform of the multilateral development architecture, such as the UN Funding Compact, appear to have lost steam in recent years

The COVID-19 crisis has prompted a rethinking of the system, including on how to rationalise and improve the coherence of the multilateral architecture and to increase funding to the core functions of the system to build its resilience to deal with future crises (UN, 2022^[53]). However, due to the complexity of undertaking system-wide reforms, the evolution of the system to date has been characterised by continuous expansion and fragmentation rather than integration and consolidation. Multilateral stakeholders tend to use their

influence, leverage and agency to advance smaller ad hoc solutions, often leading to a piecemeal reform approach and resulting in a further expansion and fragmentation of the multilateral development system. Meanwhile, efforts to deepen the integration and co-operation among multilateral stakeholders have largely lagged behind.

Nonetheless, there have been notable collaborative initiatives to address developing countries' needs through co-ordinated initiatives. Bilateral development partners took historic action as creditors through the Debt Service Suspension Initiative (DSSI), which was specifically created as a short-term action during the COVID-19 pandemic. The effort was instigated primarily by bilateral development partners. Multilateral creditors, however, did not take part in the initiative to safeguard their credit ratings, choosing instead to provide fresh financing to their client countries by frontloading resources and repurposing parts of their existing portfolios. In November 2020, the G20 reached an agreement to establish a Common Framework for Debt Treatment with the aim of helping DSSI-eligible countries facing insolvency and protracted liquidity problems.

A decision by developed countries to re-direct IMF SDRs could also increase the resources available to vulnerable developing countries. In October 2021, the G20 agreed to aim to rechannel USD 100 billion of SDRs to the benefit of low-income countries, small states and vulnerable middle-income countries out of the total USD 650 billion allocated to IMF members in August 2021. This was a welcome innovation and offers opportunities to boost finance for sustainable finance (Jensen, 2021^[54]). Other options are also being considered such as channelling the SDRs through MDBs.

5

Assessing bottlenecks to scaling up and accessing financing for sustainable development

With the sustainable financing gap growing and some developing countries struggling with stagnate or declining revenues, removing bottlenecks to financing for sustainable development is of critical importance. This chapter analyses four areas where constraints on developing countries arise: non-financial regulations, lack of capacity to produce needed data, low financial market depth and complexity of funding instruments. This discussion could inform G20 work on development finance to channel finance to where it is most needed.

The G20 Development Working Group (DWG) under the G20 presidency of India is focused on identifying two types of bottlenecks – in developing countries and in the global finance architecture – to mobilise SDG finance for a more sustainable world. The specific bottlenecks identified in this report can be alleviated through G20 actions. This work builds on previous G20 efforts in the G20 DWG³ and complements other G20 actions undertaken in the finance track. The G20 Sustainable Finance Working Group (SFWG) for instance, is working under the G20 presidency of India to advance mechanisms for mobilisation of timely and adequate resources for climate finance; unlock finance for the Sustainable Development Goals (SDGs); and build ecosystem capacity for financing towards sustainable development.⁴ The G20 Sustainable Finance Roadmap adopted in 2022, for instance, includes 5 focus areas and 19 actions; many of these actions (particularly actions 5, 15 and 19) are highly relevant in this regard.⁵

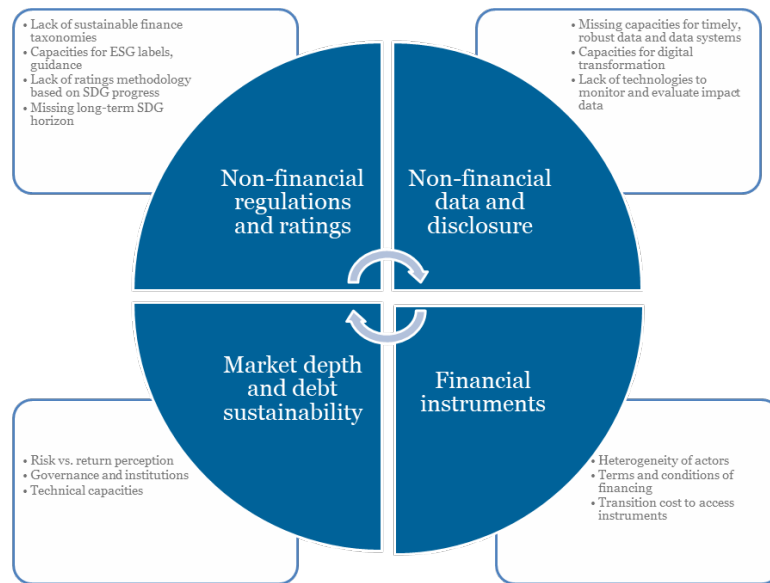
Notably, as part of the Indian G20 presidency priorities, the OECD also will deliver a report to the G20 International Financial Architecture Working Group providing a granular analysis of the links between cross-border capital flows and the climate transition in emerging markets and developing economies that will include a specific focus on investment funds (OECD, 2023, forthcoming^[56]).

Four key bottlenecks to scaling up SDG financing and potential remedies stand out:

1. **Non-financial regulations and credit ratings.** Developing countries can advance policy and regulatory measures to support long-term strategies for SDG and climate action.
2. **Lack of capacity in developing countries for data and disclosure of non-financial information.** The G20 can support building capacity in developing countries.
3. **Low financial market depth and debt sustainability constraints.** Innovative financing instruments offer opportunities, but local investments and blended finance also need to be scaled up. Public development banks can be key enablers in mobilising additional commercial finance.
4. **The proliferation of financial instruments and the heterogeneity of SDG investment opportunities.** Building awareness and capacity about SDG finance models in developing countries can help them better manage and negotiate the financing for sustainable development landscape.

Figure 5.1 illustrates the main categories of bottlenecks, which are discussed individually in greater detail in this chapter.

Figure 5.1. Typology of bottlenecks to access sustainable finance in developing countries



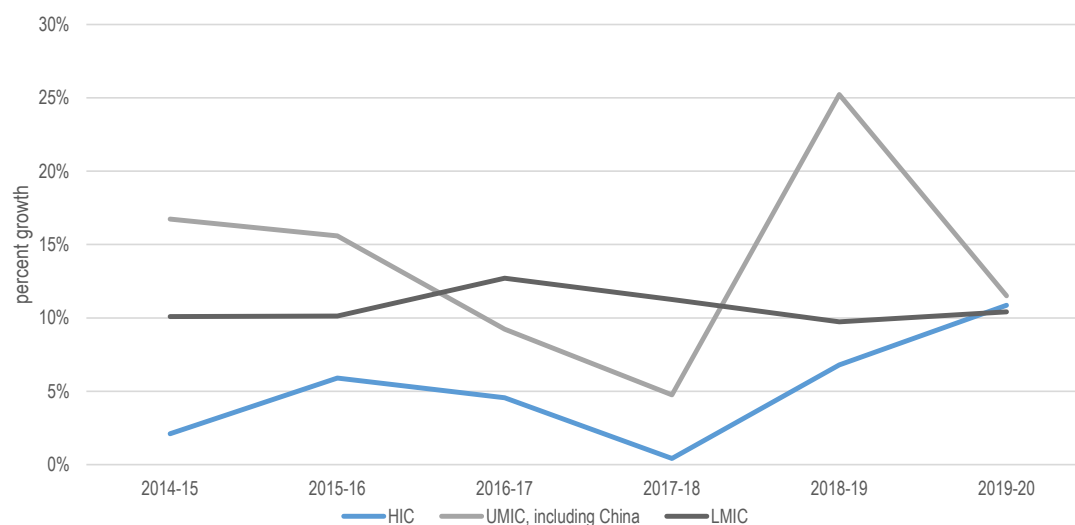
Source: Authors based on (OECD, 2022^[1]).

5.1. Finance will not be sustainable if it does not seek to narrow SDG financing gaps in developing countries

Developing countries held less than 20% of global financial assets, valued at USD 93 trillion, in 2020, yet have 84% of the world's population and 58% of global GDP. Only 5.7% of countries eligible for official development assistance (8 out of 140) are included in reporting on financial assets by the Financial Stability Board and none are low-income countries (LICs), evidence of persistent barriers to deepening financial markets in these countries.

Likewise, during the first years of the COVID-19 pandemic, monetary policy, including quantitative easing by major economies, contributed to an 11% increase in the value of global financial assets, from USD 423 trillion to USD 469 trillion, in 2019-20. Hundreds of trillions of US dollars in stocks and other financial assets held in developed countries rose in value. Yet, assets held in developing countries declined in value or stayed the same during the same period. Thanks in part to the actions of central banks, the growth rate of assets held in high-income countries (HICs) also increased, from 7% in 2018-19 to 11% in 2019-20, while growth in upper middle-income countries (UMICs) declined from 25% in 2018-19 to 12% in 2019-20 and was stagnant at 10% over 2018-20 in lower middle-income countries (LMICs) (Figure 5.2).

Figure 5.2. The growth rate of financial assets fell or was stagnant in developing countries but increased in high-income countries over 2019-20

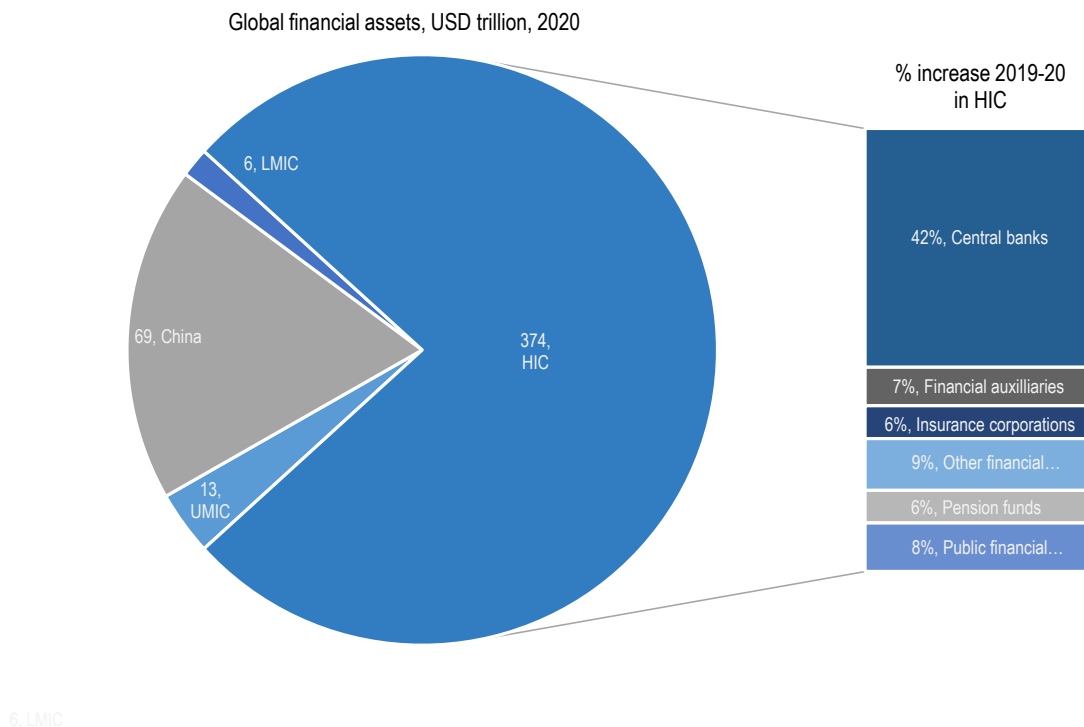


Note: The figure uses World Bank income categories.

Source: Authors based on (Financial Stability Board, 2021^[57]).

The historic COVID-19 monetary response demonstrates the tremendous influence of public sector actors over the allocation of global financial assets. Over 2019-20, the value of financial assets held by central banks increased by nearly USD 20 trillion (Figure 5.3). To respond to COVID-19, central banks in major economies adopted a whatever-it-takes approach to monetary policy. For example, the euro system bought assets worth more than USD 1.85 trillion under the European Union (EU) pandemic emergency purchase programme alone through March 2022 (Schnabel, 2021^[58]). The liquidity support provided by central banks kept interest rates low, reassuring markets, and also buoyed the stock market rebound, benefitting nearly all other financial actors in 2019-20. Public pension funds that hold long-term patient capital were also called upon to go beyond their usual remit to disburse short-term emergency retirement funds or purchase COVID-19 bonds. Public financial institutions such as public development banks (PDBs) and development finance institutions also provided pandemic support. For example, in Latin America and the Caribbean alone, PDBs channelled USD 90 billion in credit support for emergency economic relief (Finance in Common Coalition, 2021^[59]).

Figure 5.3. Central bank asset purchases during the COVID-19 outbreak helped buoy asset valuation across financial sector actors

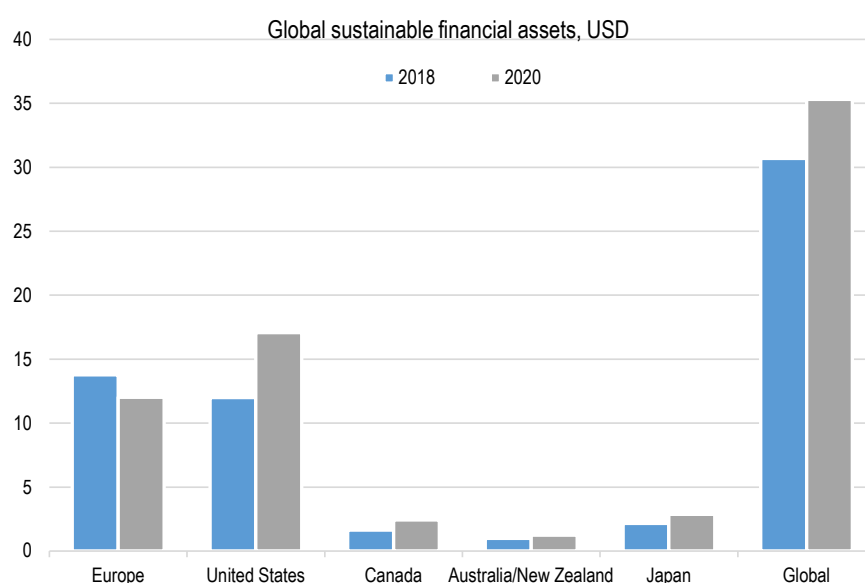


Note: Coverage includes all countries included in Financial Stability Board reporting.

Source: Authors based on (Financial Stability Board, 2021^[57]).

It is estimated that less than 1% of the trillions in global financial assets would raise the quantity of resources needed to narrow the SDG financing gap. However, recent growth in sustainable finance has largely bypassed developing countries and those most behind in achieving the SDGs. The supply of investment labelled as sustainable has registered unprecedented growth in HICs since 2018. Total sustainable investment grew by 15% in just two years, increasing from USD 30.7 trillion in 2018 to USD 35.3 trillion in 2020, according to the Global Sustainable Investment Alliance – faster than the growth of global financial assets. Funds and assets labelled as environmental, social and governance (ESG) assets make up 35.9% of the nearly USD 100 trillion total assets under management in 2020 from institutional investors, asset managers and asset owners (Global Sustainable Investment Alliance, 2021^[60]). The volume of today's sustainable assets implies there is a much wider pool of possible investment that might offset to some degree the market bias of capital away from emerging and developing countries.

Figure 5.4. Global sustainable investment in developed countries reached a new high in 2020 despite the global recession (USD trillion)



Note: The figure is based on currency exchange using 2019 prices. A regional comparison of growth rates is challenging due to a significant change in the definition of sustainable investment such as the new EU anti-greenwashing rulebook. Global Sustainable Investment Alliance reporting on financial assets includes sustainable investments such as impact investing and positive, sustainability-themed, norms-based and negative screening, ESG integration, and corporate engagement and shareholder action. Anti-greenwashing initiatives and rules for labelling finance have resulted in fund managers pre-emptively removing the ESG label from USD 2 trillion of assets under management in the EU, which explains the decline in sustainable investment in the EU between 2018 and 2020.

Source: (Global Sustainable Investment Alliance, 2021^[60]).

Trends in national and international standards and frameworks on finance for sustainable development

The rise in sustainable financing raises and reflects a number of challenges. To deliver the SDG impact required to reach countries most in need, frameworks and standards must operate at the global level and particularly in countries at greatest risk of SDG setbacks. Greater interoperability of standards across capital markets is needed to mitigate cross-border risks. Efforts to design a quantifiable framework that encompasses dimensions of ESG risk are at an early stage. But ESG frameworks alone will not succeed in directing finance to countries most in need and could create significant barriers to access for countries with shallow financial markets. The SDG targets and indicators framework provides metrics to assess global progress across the SDGs.

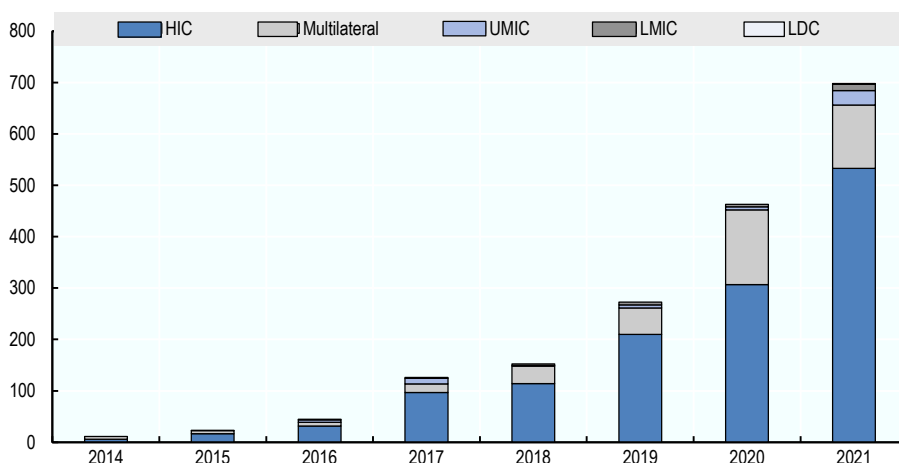
The international community has made significant headway in mainstreaming sustainable finance, including through commitments by finance institutions to align lending and investment activities with the low-carbon economy. At COP26, the Glasgow Financial Alliance on Net Zero – a group of banks, institutional investors and other actors commanding USD 130 trillion in assets under management – committed to align lending and investment with net zero by 2050.⁶ Given the significant SDG financing gap, financial institutions should also be encouraged to broaden their sustainable financing plans beyond climate to the SDGs at large.

But with the proliferation of new initiatives comes the need to ensure their transparency and accountability, which calls for new supply of rating systems, financing instruments, labels, etc. The sustainable finance market can be strengthened to avoid distortions, segmentation and missed opportunities to finance sustainable development in countries with lower market regulation capacities. Integration of non-financial

risks (such as ESG criteria and sustainability-linked frameworks) serves as a key barometer for firms, issuers and investors to assess and quantify the extent to which investments generate financial returns over the long term. However, ESG integration is currently carried out at firm or country level, which raises concerns of cross-border risks.

The emerging green, social, sustainability (GSS) bonds and sustainability linked (SLB) bond market is a new and promising avenue to mobilise additional SDG finance, as these bonds offer financial returns with sustainable development outcomes. The market size of GSS and SLB bond issuances worldwide has almost doubled year on year since 2014, reached almost EUR 700 billion in annual issuances in 2021 (Figure 5.5.). By linking capital raised to commitments towards people and the planet (either through use of proceeds or organisational level targets), GSS and SLB bonds could help bring about systemic change to global finance markets (OECD, 2022^[61]; Dembele, Schwarz and Horrocks, 2021^[62]). However, challenging market conditions amid tightening monetary policy and uncertain growth prospects in 2022 have led to a year-on-year decline of 27% in issuances (Climate Bonds Initiative, 2022^[63]).⁷ Issuances are likely to resume their trajectory of growth in volumes once market conditions improve.

Figure 5.5. Green social, sustainability and sustainability-linked bond issuances by high-income countries and multilateral agencies have increased significantly (EUR, billion)



Note: Country classifications are based on the 2021 OECD DAC ODA-eligibility list.

Source: Authors' calculations based on (Luxembourg Stock Exchange, 2021^[63]).

Green and SDG washing of financial or capital markets also remains a key challenge in assessing even the volume and impact of sustainable finance. The Global Sustainable Investment Alliance estimates sustainable investments total as much as USD 35.3 trillion, while the UN Conference on Trade and Development and others, using a much narrower definition of sustainability, identify only USD 5.2 trillion assets under management as sustainable investment in 2021, an increase of 63% from 2020 (UNCTAD, 2022^[21]). The International Organization of Securities Commissions, the global standard setter for securities market regulation, warns there is a lack of clarity about what ratings or data products intend to measure and lack of transparency about the methods used to produce the ratings (Jackson, 2022^[65]). Recent studies by the OECD also show that climate-related metrics are less strongly correlated with the environment pillar of ESG than factors not directly related to a climate-friendly transition such as market capitalisation or financing for disclosure reporting (OECD, 2022^[66]). In fact, a high score on environmental criteria from certain providers can be positively correlated with higher CO₂ emissions (OECD, 2022^[66]). About 25% of self-declared green funds have an exposure to fossil fuels of more than 5%, and in some cases nearly 20%, which calls into question the greenness of these funds (UNCTAD, 2022^[21]).

The OECD Guidelines for Multinational Enterprises have been integrated in EU regulation on sustainable finance as way to address risk of greenwashing.⁸ The regulation introduces transparency rules for financial institutions on the integration of sustainability risks and impacts in their processes and financial products, including reporting on adherence to internationally recognised standards for due diligence. The EU Taxonomy for sustainable activities also defines the economic activities that can be considered environmentally sustainable.

In addition, most ESG reporting frameworks seek to assess and quantify a company's sustainability performance – that is, the risks that are material to financial performance for investors – rather than assessing how a company risks impacting external considerations (double materiality or SDG impact). The draft European Commission Corporate Sustainability Reporting Directive proposes a social taxonomy, or subset of the EU Environmental Taxonomy, that would reinforce the social and governance dimensions of ESG criteria by setting minimum mandatory social safeguards to mitigate risks to social and human rights violations (Platform on Sustainable Finance, 2022^[67]). The EU social taxonomy would link a country's SDG achievement or lack thereof to its private sector's contribution to the SDGs.

What developing countries need to do to attract sustainable and climate finance to close their Sustainable Development Goal gap

Developing countries, which are devising their taxonomies, should be encouraged to include both environmental and broader social criteria in their approaches to align investments with sustainability. The limited role of financial regulation thus far in aligning investment flows with sustainability represents a missed opportunity to guide resources to SDG sectors. There is a heightened likelihood that sustainable finance will continue to bypass countries most in need in the absence of efforts to facilitate the identification of and linking of capital with credible ESG-aligned investment opportunities. China and South Africa are among the only developing countries to have developed an ESG taxonomy, and South Africa's taxonomy was only adopted in April 2022. Just 25 of 60 developing countries' stock exchanges require ESG reporting (IEA, 2021^[68]).

The G20 Sustainable Finance Roadmap calls for alignment approaches including taxonomies and ESG ratings methodologies to incorporate broader environmental considerations beyond climate. Further, it calls on the International Sustainability Standards Board, the emerging global baseline reporting standard for sustainability risks, opportunities and impact, to extend coverage over time to broader environmental and social issues beyond the initial focus on climate-related issues. To advance these objectives and thereby facilitate the linking of investment opportunities that further SDGs with global capital, emerging alignment and disclosure approaches should incorporate both environmental and social dimensions and strive towards an SDG alignment of these frameworks. Moving to a universal SDG paradigm can enable the design of market incentives that channel capital to where the needs are the greatest.

5.2. Four main bottlenecks are limiting developing countries' access to urgently needed sustainable finance

Bottleneck 1: Non-financial regulatory challenges to scaling up sustainable finance in developing countries

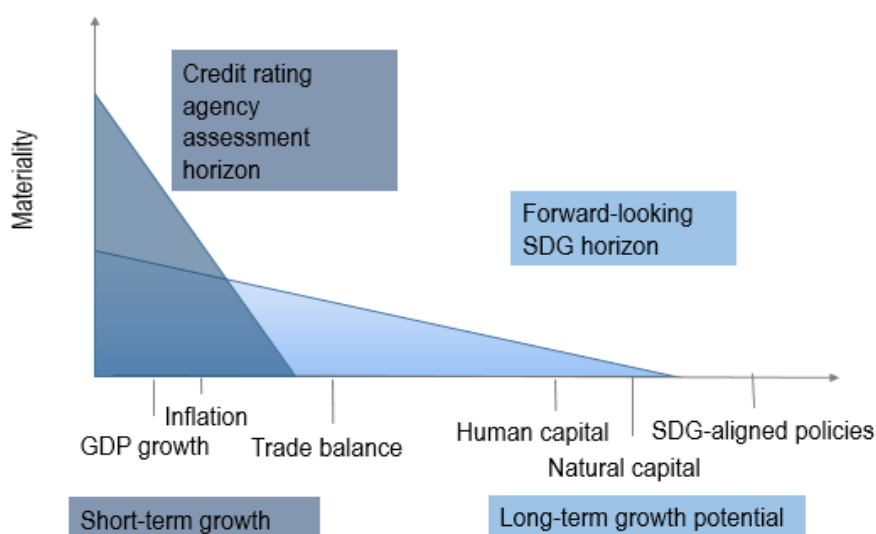
One bottleneck is the lack of complementary non-financial regulatory frameworks and policies to accompany financial regulations on alignment approaches. Removing non-financial regulatory bottlenecks globally and in developing countries can go a long way to ensuring equitable access to finance, particularly in countries most at risk of SDG setbacks.

Capital markets are weighted to direct flows towards countries with the least shortages. For example, 65% of the MSCI emerging market index is held by only 3 of 26 countries covered (Principles for Responsible Investment, 2022^[69]). In a survey carried out by the OECD before the pandemic, institutional investors reported that they were facing investment restrictions related to risk-based capital requirements that prevented resources from being allocated to developing countries or certain segments of the population. In addition, a recent study has found that sustainability-related investment, notably ESG frameworks, currently divert capital flows away from emerging and developing countries due to inconsistency and lack of clarity on ESG reporting, with inclusion in indices being a large driver of such investment (Mobilist, UK Government, 2022^[70]).

Sovereign credit ratings and ESG ratings also lack non-financial regulatory criteria needed to guide investments to countries most in need. A better consideration of social factors, for instance, would influence investment behaviour and incentivise financial actors to invest in opportunities that catalyse social change (i.e. reducing poverty, addressing unemployment and inequalities, and supporting health and education). During the pandemic, some developing countries were penalised for heightened spending on public services, including for emergency health support, and others chose not to borrow for emergency relief to avoid credit downgrades. While developed countries' sovereign credit ratings remained stable throughout the crisis, more than 56% of rated African countries were downgraded in 2020, significantly above the global average of 31.8% (Fofack, 2021^[71]). Of the seven sovereign defaults that occurred in 2020, three (Argentina, Lebanon and Zambia) were already rated in the lowest rating category of CCC/CC. Sri Lanka recently defaulted on debt owed to external creditors valued at roughly USD 50 billion due to rising inflation and energy prices.

At the same time, the credit scores of oil commodity-dependent countries have improved as oil prices increased due to recent geopolitical tensions, highlighting that the incentives imposed by credit rating agencies can force developing countries to choose between investment-grade credit scores and investment in sustainable development over the long term. While ESG ratings issuers often consider long-term risk mitigation strategies and growth potential, the rating agencies focus their evaluation mainly on short-term factors such as GDP, climate vulnerability, debt distress and inflation, among others. Criteria related to a country's long-term sustainability and SDG progress, such as indicators related to human and environmental capital, are less material to a country's credit rating (Figure 5.6), though ratings agencies often lack consistent indicators and data that reflect long-term impact on social and other SDG considerations (Platform on Sustainable Finance, 2022^[67]). To date, only the ratings agency Scope GmbH includes ESG criteria as a standalone category (weighted at 20% of the total score) in its assessments (Gratcheva et al., 2022^[72]).

Figure 5.6. Using credit rating criteria with a forward-looking Sustainable Development Goal horizon



Source: Adapted from Gratcheva et al. (2022^[112]), *Credit Worthy: ESG Factors and Sovereign Credit Ratings*, <https://openknowledge.worldbank.org/handle/10986/36866>.

The green transition can be a new and sustainable engine of growth in all economies – a net generator of decent green jobs that can contribute significantly to poverty eradication and social inclusion. Developing country governments, like other countries, face the challenge of ensuring that they have adequate social protection systems and other non-financial regulations (e.g. in support of social dimensions) to maximise the social and economic opportunities of climate action while minimising and carefully managing any challenges to ensure no one is left behind. The public sector in developing countries play an important role by providing public investment in infrastructure, improving data and disclosures, and incentivising research and development to overcome barriers to climate finance in the absence of adequate carbon pricing that contributes towards generating incentives for desired investments. For example, governments can build a framework to perform a cost-benefit analysis and beneficiary analysis to assess the impacts of the transition on the net economy and differentiated impact on various section of the society such as age, gender and region.

Bottleneck 2: Lack of capacities for data and disclosure of non-financial information

A long-standing lack of data to report on the most basic sustainability criteria in developing countries increases the exclusionary risk and heightens perceived risks over real risks. Relevant data to assess ESG criteria can be costly to compile and require technical competencies to produce data accurately. But without complete and timely data, developing countries face further exclusion and lower scores. The World Bank found that about 90% of a country's sovereign ESG score, for example, can be explained by a country's national income. However, the base year for which GDP is calculated in many developing countries is not updated in a timely manner (at least every five years), which contributes to a lag in determining income level in the poorest countries. This was the case for Ghana: Its GDP was under-reported by 60% until 2010, when it changed its base year and transitioned from the low-income to lower middle-income category (Moss and Majerowicz, 2012^[73]). Presently, it is estimated that 7% of the global economy is missing from GDP data, mainly data for developing countries with low national statistical office capacities and large informal economies⁹ such as those in sub-Saharan Africa (Ritchie, 2021^[74]) (OECD/ILO, 2019^[75]).

SDG labelling requires a broad range of data which poses potentially greater risks of green or impact washing than ESG labels. Gathering the data needed to avoid SDG washing across the goals, and particularly social objectives, remains a significant obstacle. The SDG targets and indicators were first designed for implementation by governments, not firms and asset managers. For instance, environmental goals related to CO₂ emissions reduction have more accessible data for reporting. One survey of 64 asset owners found that 39% lack best practices for assessing impact and 78% consider a lack of capacity to collect impact data as the main challenge (Global Impact Investment Network, 2022^[76]). In another study, 46% of the 347 institutional investors surveyed indicated that social dimensions of ESG criteria are the most challenging to integrate into investment strategies (BNP Paribas, 2019^[77]). The use of artificial intelligence (AI) algorithms provides a new tool for investors to harness big data to align investment standards. For example, BNP Paribas introduced the use of a new AI tool to assess both ESG risks and SDG impact (BNP Paribas, 2021^[78]). However, automatised portfolio allocations, which use AI, could exclude developing countries on the basis of a lack of quality data needed for sustainability reporting. Self-reporting schemas must be fine-tuned to avoid increasing existing inequalities or misleading investors.

Recent evidence points to the lack of monitoring and evaluation data to also assess the social impacts of ESG ratings. Factors such as lack of data and comparability of metrics (e.g., indicators beyond gender equality or CO₂ emissions) currently hinder the establishment of a direct link between ESG scores and real-world SDG impacts such as job creation and investment in human capital in developing countries. For example, a study covering five regions found that not all sustainability taxonomies include social criteria within the definition (OECD, 2022^[61]).

The cost of sustainability products and data remains high. Developing a science-based, tailored and consistent climate information architecture in emerging markets is a prerequisite for the development of sustainable finance markets in emerging economies and to manage risks stemming from climate change and other environmental concerns. The efficient pricing of climate risks, the fight against greenwashing practices, and the efficient allocation of capital towards transition and low-carbon projects all require solid information. Obtaining such external verification involves additional costs ranging from USD 10 000 to USD 100 000 that can sometimes be a barrier, especially for issuers at the sub-sovereign level looking to issue smaller volumes markets (OECD, 2022^[61]). A few emerging market economies have now developed mandatory requirements for climate-related disclosures for corporates. This is a step in the right direction, and company disclosures will definitely lead to an expansion of the policy and financial research analysis beyond pure “green” products.

Bottleneck 3: Low financial market depth and debt sustainability constraints

Many developing countries are excluded from market growth in innovative sustainable financing instruments. New innovative financing instruments such as green, social, sustainability and sustainability linked (GSS and SLB) bonds offer opportunities for governments, financial institutions and corporates to diversify their sources of funding and tap into pools of capital from institutional investors (Dembele, Schwarz and Horrocks, 2021^[62]). The G20, under the Italian Presidency in 2021, highlighted their potential and identified high-level principles on sustainability-related financial instruments (G20, 2021^[79]) (UNCTAD, 2021^[80]).

However, ODA-eligible countries account for less than 7% and least developed countries for less than 1% of cumulative total GSS and SLB bonds issued since 2014 (OECD, 2022^[61]). The use of green bonds differs dramatically across regions: There have been only 16 green bond issuances in sub-Saharan Africa, representing 1.5% of total global green bonds by number and less than 0.3% by value (Tyson, 2021^[34]). Bottlenecks to increasing GSS and SLB bond issuances in developing countries include illiquid domestic capital markets, lack of bankable and relevant projects, limited familiarity with international investors, complex public budgeting processes, and the high level and often voluntary nature of applicable global standards (OECD, 2022^[61]). In LDCs, an additional limiting factor is relative project size, which is in many

cases too small to be attractive for institutional investors (OECD, 2022^[61]). Additionally, shallow financial sector development in the poorest countries is one of the key factors hindering sustainable finance market creation. Many LICs have only limited access to local currency debt financing, further undermines financial resilience as a well-functioning local bond market increases the capacity to respond to shocks and varying global capital flows (IMF and World Bank Group, 2018^[81]).

Their constrained access to credit and larger refinancing needs also expose developing countries to rollover risks and could ultimately lead to sovereign defaults. With 45% of their outstanding debt maturing by 2024 (against 36% for all developing countries), low-income countries (LICs) are particularly exposed to rollover risk (OECD, 2022^[82]). These risks, compounded by higher borrowing costs resulting from tightening global financing conditions and growing geopolitical tensions, increase the likelihood of new debt crises in the medium to long term. Looking ahead, official providers and creditors, including international financial institutions and bilateral development partners, will need to make special efforts to strengthen the debt resilience of developing countries and avoid further credit rating downgrades and sovereign defaults.

Assumptions about the risk-return profile of developing countries create further impediments to access financing. While emerging markets offer attractive investment opportunities, mainstream investors are often cautious about deploying capital out of concern for systemic risks ranging from currency convertibility and taxation to transparency and accountability of capital recipients. Furthermore, investors are most often concerned with risks versus returns, and a prevailing narrative has cemented the view that market rate returns are not to be expected in social innovation. While this can be true, prioritising their own returns can cause investors to work against their own impact objectives and the beneficiaries they seek to support. While development finance institutions and multilateral development banks (MDBs) have a specific development impact mandate, they have to meet financial targets, making the trade-off between financial returns and development impact a continuing challenge. This is why such institutions still primarily invest in the form of loans and in middle-income countries (Attridge and Gouett, 2021^[83]). Another constraint is that commercial clauses of confidentiality in many blended finance transactions limit the availability risk-return data. This hinders mobilisation as their limited track record dissuades new market participants without frontier market expertise to invest in new markets, especially in hard-to-reach sectors and geographies with a limited history of transactions (OECD, 2022^[84]).

Private sector and financial actors in developing countries lack awareness and knowledge of sustainable finance models

MDBs provided 69% of private finance in blended finance arrangements over 2018-20 (OECD, 2023^[44]). While they have the capacity and know-how to structure deal terms, they are not as well versed in the issues and opportunities for blended finance on the ground. Yet local private sector investors, businesses and recipient organisations lack awareness and sufficient finance literacy to seize opportunities for innovative financing instruments. Bridging this knowledge gap quickly enough during potential sustainable finance negotiations is a challenge. The time it takes to educate stakeholders, on top of a general aversion to adding additional complications, can dissuade public-private co-operation. It is essential to identify the challenges to government capacity and regulations to help investors better assess the risks and opportunities of sustainable projects in emerging markets, which can help reallocate capital towards sustainable investments in the future.¹⁰

Another constraint on sustainable finance is the relatively modest size of social and environmental investment opportunities in LICs. Bankable investments in blended finance are too small for the more established development financiers and too large for the local investors. For example, in developing countries, the credit gap for small and growing businesses was estimated at USD 4.9 trillion in 2017.¹¹ Smaller players are better positioned to understand and support recipient needs, whereas larger players

tend to have both the know-how and economies of scale to process a blended finance deal.¹² More ecosystem co-ordination is needed to develop alternative models for sustainable finance.

Bottleneck 4: Proliferation of sustainable finance instruments and resources that are not based on Sustainable Development Goal needs

While an increase in the number of actors and financing instruments aiming to support the SDGs provides opportunities to mobilise more financing, it also adds a layer of complexity and risk that can further limit access to countries most in need of financing. According to OECD research, developing countries have more than 1 000 instruments to choose from to finance their development. These instruments imply varying terms, conditions and technical expertise, which can create barriers to access. For example, small island developing states (SIDS) face many challenges to access vertical climate funds due to low return on investment for CO₂ reduction and to a lack of administrative and human resource capacities to apply for and carry out large projects (Morris, Cattaneo and Poensgen, 2018^[85]). A result is slower uptake. The Green Climate Fund disbursed commitments with a two- to four-year lag in SIDS. The Climate Investment Funds and the Global Environmental Facility had even longer commitment delays of up to eight years (OECD, 2022^[86]).

A rethink is also needed to ensure the current allocation of multilateral development finance better meets the financing priorities of developing countries. Over the past decade, the growth of multilateral outflows has relied on a steady rise of non-concessional finance flows, which since 2016 have exceeded multilateral concessional flows. Recent and ongoing initiatives to increase MDBs' financial capacity and leverage, for example through a review of their capital adequacy frameworks, could further fuel this trend towards less concessional financing for those not eligible for the most concessional. Careful consideration should thus be given to the implications of such an increase. The multilateral response to recent crises has also driven the recent increase in multilateral financing towards middle-income countries. The share of financing provided by multilateral organisations to middle-income countries increased from 68% to 71% between 2018 and 2020. As these countries tend to enjoy greater access to commercial debt and alternative means of financing than LDCs and other LICs, a rethink is needed on whether multilateral organisations, and MDBs in particular, should direct more of their support towards poorer countries that still face barriers to accessing commercial credit.

6

Ways forward: Suggested areas for G20 action to accelerate Sustainable Development Goal financing

This chapter offers options, ideas and recommendations for the G20 and its Development Working Group to strengthen the international enabling environment and identify co-ordinated approaches conducive to a more equitable access to sustainable finance. Removing the bottlenecks to financing for sustainable development requires collective, cohesive effort by all actors along the sustainable investment chain. The G20 has a key, unique role to play in creating synergies across its members and working groups to promote integrated policies and tools that shift the trillions to where needs are greatest.

6.1. Collective action to step up investment in the Sustainable Development Goals is urgently needed to build back fairer, stronger and more resilient to crises

The danger of slipping further behind on the Sustainable Development Goals (SDGs) is not lost on governments, international bodies and leaders around the world. Lessons from successive recent crises, including around economic stimulus, are informing a range of strategies to increase SDG investments and

policies to mobilise and better align resources with key SDG sectors for a greener, more inclusive and resilient future.

Historic economic stimulus and investment aim to address global challenges

SDG alignment of finance remains a prime solution for shifting the trillions towards a better prevention and management of global risks and fulfilling the promise of the 2030 Agenda. Collective action is the way in an increasingly interdependent world in which critical challenges such as climate, health, economics and social emergencies require multilateral action. Flows of finance, people and goods are becoming globalised at a rapid pace, spreading both benefits and risks across nations (Goldin, 2021^[87]). Only seven years remain to achieve the 17 SDGs by the 2030 deadline agreed by the United Nations. Solidarity is key: “Rescuing the SDGs means rescuing developing economies around the world,” as the United Nations Secretary-General António Guterres declared (UN, 2022^[54]). In other words, achieving the SDGs anywhere requires that they be achieved everywhere.

No single country can achieve SDG alignment, for instance in terms of securing global value chains or limiting global warming, as long as there is risk of negative spillovers from activities or delayed action in other countries. Despite great strides to secure a more efficient and impactful sustainable finance market, advances are limited mainly to major economies. If finance is to be sustainable on a global scale, it must be equitable. And if equity is left unaddressed, financing gaps in the most vulnerable countries will widen and ultimately contribute to even greater setbacks for all over the long term. The COVID-19 pandemic and looming climate and environmental emergencies highlight both the interdependence of countries and the high price of failure to co-ordinate globally.

Over the past few years, developed countries have put in place a series of frameworks, initiatives and stimulus packages to boost the recovery. Many of these initiatives, such as the Biden administration’s proposed USD 1.9 trillion Build Back Better Act and the European Union (EU) USD 2 trillion NextGenerationEU, include a focus on green investments and making societies more inclusive and resilient. The OECD has been calling for a quality recovery that is strong, inclusive, green and resilient. The EU has taken the lead to improve sustainability measurement and reporting with the establishment of the Sustainable Finance Taxonomy Framework and regulation on sustainability-related disclosures in the financial sector to. The EU Taxonomy, which includes mandatory reporting by investors, aims to strengthen the sustainable finance market and shift investments to where they can have greatest impact in support of a low-carbon transition, social objectives and economic prosperity (Platform on Sustainable Finance, 2022^[67]).

However, the trillions that developed countries spent on recovery spending could have been better aligned with SDGs and climate goals. Only 20% of the USD 18.2 trillion spent on COVID-19 economic relief (up to March 2022) was spent on long-term build back better recovery; less than 1% (USD 162.2 billion) was spent in support of developing countries in the form of official development assistance (IEA, 2022^[88]). As fuel prices rise and governments implement consumption subsidies to protect the most vulnerable, the proportion of spending that could undermine climate goals could increase. Similarly, major economies are largely responsible for negative transboundary spillovers due to unsustainable trade and supply chains, according to the latest SDG Index by the Sustainable Development Solutions Network (Sachs et al., 2022^[89]). Difficult trade-offs must be made between short-term emergency support and long-term priorities to build back better in developing countries

Striking a balance between short-term support and sustainable development for the long term

Amid historic development setbacks, widening inequalities, a lingering pandemic, and new adverse shocks such as the surge in food and commodity prices, developing countries need to balance a growing number

of priorities. Given their limited resources, they must strike a balance between short-term spending priorities (e.g., to deploy emergency support measures) and longer-term investments (e.g., to build sustainable and resilient infrastructure, strengthen health and education systems, or restore financial buffers to preserve the credibility of their fiscal frameworks).

Due to the limited fiscal space of developing countries and their need to respond to successive crises, there is a risk that short-term relief measures could end up crowding-out much-needed investment for a green, resilient and inclusive recovery. A short-sighted approach could lead to government favouring investments with lower upfront costs to the detriment of better economic returns in the long run. A paradox emerges as short-term financing needs (e.g., debt service costs, humanitarian response, etc.) increase in developing countries. If developing countries were to raise the additional finance needed to achieve a low-carbon transition by 2060 exclusively through higher taxes and borrowing, household consumption in these countries could decline on average 5% per year, rendering developing country households around USD 2 trillion poorer each year between 2021 and 2060 (World Economic Forum, 2022^[90]).

In addition, the cost of guaranteeing basic social protection across low-income countries, lower middle-income countries and upper middle-income countries is estimated at USD 1.1 trillion annually (Bierbaum and Schmitt, 2022^[91]). While it is necessary for these countries to mobilise more in the short term to respond to emergencies, financing for long-term objectives such as social protection and generally, a human-centred recovery (International Labour Organization, 2021^[92]).

Without external, co-ordinated, multilateral support across policy communities (e.g., across fiscal and monetary and finance and investment policy communities), developing countries will face greater sustainability setbacks. Speaking at the Development Committee in February 2023, UN Secretary-General Guterres called on the G20 to lead in the launch of an SDG Stimulus of USD 500 billion a year “to address short-term liquidity issues, speed up the pace of debt relief, and enable investment at scale in the SDGs.”¹³

External financing solutions and instruments must also be tailored to integrated national financing strategies – for example grants, debt swaps, domestic savings and investment among others – to ensure debt sustainability and long-term achievement of the SDGs.

It is clear that the unprecedented scale of global challenges cannot be addressed if left to a single policy community working in a vacuum. The G20 Development Working Group (DWG) has a role to play to raise awareness of the development challenges across the working group tracks to remove the barriers to access to finance in developing countries and to mitigate the risk of future setbacks to a sustainable and equitable recovery.

6.2. In the short term, the G20 Development Working Group could promote financial tools that help leverage public and private efforts to build Sustainable Development Goal sectors in developing countries for more equitable access to finance

The G20 DWG can adopt tools in the short term with all actors for country-owned alignment of financing with the SDGs. An integrated approach to financing helps ensure that innovative finance and other debt financing to respond to emergencies do not come at the cost of sustainable development over the long term. Some key tools that the DWG could advance to create robust SDG sectors in the poorest countries are described in this section.

Promote financing tailored to country-led integrated financing strategies or to mobilise domestic resources. This could include furthering the G20 2021 work on the G20 Framework for voluntary support to Integrated National Financing Frameworks (INFFs) which offer a framework to track budgets and expenditures (G20, 2021^[79]).

- To avoid the fiscal and credit crunch, develop a multi-stakeholder technical support and capacity-building facility (with the support of OECD, UN Department of Economic and Social Affairs, and UN Development Programme) to help developing countries access quality, neutral advice on financial instruments; deepen financial markets and absorptive capacity; and ensure interoperability of sustainability reporting standards.¹⁴
- Explore the use of innovative instruments, including insurance and investment based on results, to mitigate risk and attract external resources aligned to the SDGs without increasing debt distress. Several sovereign developing country issuers have recently developed sustainability bonds, a form of results-based financial instrument.
- An example is Benin, which launched a USD 500 million SDG bond programme in 2021, the first SDG bond issuance in Africa with investment grade ratings by Moody's and Standard & Poor's (Ministry of Economy and Finance of Benin, 2022^[143]). The UN Sustainable Development Solutions Network will monitor the SDG impact of the bond proceeds, and Moody's will assess the environmental, social and governance (ESG) ratings of the proceeds. Nearly 75% of funds are allocated in support of social goods such as education, housing and health-related SDGs.

To lower the cost of de-risking, consider operationalising instruments that pool together risks across countries such as the proposed Global Clean Investment Risk Mitigation Mechanism, which seeks to address non-project specific risks (currency fluctuations, policy uncertainty, offtaker risk) for renewable energy projects in developing countries.¹⁵ The mechanism would have a digital platform to pool demand and establish a marketplace to connect financiers, a project developers and insurers; a common guarantee to mitigate residual risks; and common contractual framework to reduce transaction costs. The pooling of risks across projects and countries offers the benefits of scale and diversification and could facilitate the lowering of the cost of de-risking. Similar approaches could be considered for de-risking SDG financing.

Advance implementation guidance for the G20 Principles to Scale up Blended Finance

- Indonesia during its G20 presidency requested the OECD to start work on developing Implementation Guidance for the 2022 G20 Principles to Scale up Blended Finance in developing countries.
- The Germany development agency, Deutsche Gesellschaft für Internationale Zusammenarbeit GmbH, has held initial consultations with some developing countries that have indicated an interest to further work on this.¹⁶
- This work could be conducted in parallel, and progress could be periodically reported to the G20 DWG.

Build capacity in developing countries to access sustainable finance

- Promote a global information and data architecture to assist in the development of sustainable finance markets, including compliance and double materiality assessment for SDG-aligned finance in developing countries building on existing tools, instruments and frameworks.
- Provide capacity building to translate SDG targets into key performance indicators that tackle SDG washing and enhance SDG impact, particularly social, of private sector actors in

developing countries (e.g., The Global Reporting Initiative and the International Financial Reporting Standards Foundation collaboration)

- Build government capacities to develop information systems to collect and disseminate information needed by investors such as data infrastructure, online platforms, and data partnerships such as data management, labelling activities, and monitoring and evaluation institutions, among others.

6.3. The G20 Development Working Group could help promote policies aimed at strengthening the efficiency and integrity of Sustainable Development Goal sectors in developing countries

The DWG can increase policy coherence in support of SDG-aligned finance, particularly to promote positive SDG impact and avoid negative spillovers. Such an effort could support other leading international initiatives to advance the global development finance architecture.

Engage developing countries in shaping an inclusive global sustainable finance architecture and in financing green transitions

Not only will developing countries drive the global incremental growth in global energy and materials consumption (Bond et al., 2021^[93]).¹⁷ They are also the countries with the largest development needs. Thus, these countries are likely to be the largest destinations of sustainable finance. However, participation by developing country actors in the membership of key bodies guiding the development of the global sustainable finance architecture (e.g., the Taskforce on Nature-related Financial Disclosures and Task Force on Climate-related Financial Disclosures¹⁸) is limited. Greater participation of developing country actors could ensure a more inclusive process of development of the global sustainable finance architecture as well as ensure greater buy-in of the proposed standards and frameworks by the developing world.

The G20 is well placed to convene a dialogue with developing countries to discuss and build consensus around the reform of the global development finance architecture and about financing climate transitions. Such a dialogue could aim to strengthen international development co-operation policies and approaches, including South-South and triangular co-operation, and foster co-ordinated action through transformative partnerships. The G20 can help frame an international understanding that just green transitions need to be tackled through multilateral approaches and need to recognise the interconnectedness of economic, social, environmental and developmental factors.

Raise awareness about demands for reform of the financing for sustainable development architecture to address the bottlenecks faced by those countries most at risk of SDG setback

- Call for multilateral development finance actors to consider changes to their operational models, including in line with the G20 Capital Adequacy Framework review for multilateral development banks (MDBs), to better tackle global challenges, co-ordinate and pool resources, and remain fit for purpose. This could include:
 - Continue to review and monitor MDB financial capacity and assess relevance against evolving mandates (e.g., emergency response in the short-term vs. building resilience and sustainability over the long-term).
 - For resilience, provide sustainable multilateral funding (e.g., renew commitment to UN funding compact, improve quality of funding, strengthen contribution to MDB replenishments).

- To ensure an integrated approach, co-ordinate around principles for effective multilateral donorship (e.g., harmonise funding procedures for improved access to finance, ensure complementarity with bilateral efforts to leave no one behind).

Support the change in mindset from ESG to SDG allocation of finance to incentivise allocation that seeks SDG impact and that moves the frontier of sustainable investment to lower-income and the most vulnerable countries

- For example, new types of collaborative and private sector-led public-private models, such as BlackRock's Climate Finance Partnership (with the Agence Française de Développement, KfW and the Japan Bank for International Cooperation), seek to remove the bottlenecks between two categories of long-term investors – institutional investors and development finance institutions – to mobilise financing for climate infrastructure in developing countries (BlackRock, 2021^[93]). The BlackRock partnership has mobilised USD 400 million of financing (a 4:1 ratio) from institutional investors by deploying a 20 percent first-loss tranche vehicle (that is, the amount of loss that public sector investors are willing to absorb). This was financing that would not have been disbursed otherwise.
- Encourage engagement with private sector financiers to broaden their outlook on sustainable finance from climate to include SDGs. While financial institutions, most prominently the Glasgow Financial Alliance for Net Zero, have committed to align financing with the low-carbon economy, there are no similar large-scale commitments for funding the SDGs. Financial institutions should be encouraged to broaden their sustainable financing plans beyond climate to the SDGs at large.

Conclusion

Overall, and given the priority to take concrete steps to address bottlenecks to sustainable finance and to unlock SDG and climate investment at scale, the G20 DWG could take forward the following actions:

- Continue to work with members, key institutions, non-members and other stakeholders to identify, align and consolidate around concrete options and generate momentum for action on supporting systemic and transformative solutions to overcoming bottlenecks to sustainable finance.
- Set out established good practice for international support to developing countries in taking regulatory and policy measures as well as required capacity building for an overall enhanced enabling environment for SDG and climate investments.
- Identify basic measures for developing countries to reduce risk through policy and regulatory measures and identify how these relate to long-term strategies for SDG and climate action.
- Conduct further analysis that notably identifies the development versus climate specificity – that is, the extent to which bottlenecks are general to the development finance process or specific to the climate investment context – and identifies requirements and constraints for systemic and transformative approaches to overcoming bottlenecks to sustainable finance.

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Notes

¹ The transaction cost of remittances, however, remains more than double the SDG target, depleting the resources of both households and governments. While some factors driving the cost of remittances are structural, specific policy action to promote digitalisation and increase competition among service providers could yield substantial results. According to the World Bank, bringing down the cost of remittances by a further 2 percentage points could generate an additional USD 12 billion per year for migrants from low- and middle-income countries. See <https://www.worldbank.org/en/news/press-release/2022/05/11/remittances-to-reach-630-billion-in-2022-with-record-flows-into-ukraine>.

² See also the G7 Development Ministers' Meeting Communiqué, 19 May 2022.

³ Relevant work of the G20 DWG includes the adoption of a Financing for Sustainable framework in 2020, G20 High-Level Principles for scaling up innovative financing instruments in 2021 (G20, 2021^[23]), and G20 Principles to Scale Up Blended Finance in 2022 (G20, 2022^[143]).

⁴ Previous work done by the G20 SFWG includes the G20 Sustainable Finance Roadmap adopted in 2022 (G20, 2022^[144]) and the G20 Sustainable Finance report 2022 which discusses barriers and recommendations for many actors (G20, 2022^[145])

⁵ Action 5: G20 and relevant IOs to identify opportunities to promote scaling up of climate and sustainable-aligned financial instruments, products and markets, including sustainable capital market instruments. Action 15: Encourage IFIs, including MDBs, other relevant IOs, and public funds more broadly to mobilize private finance. This can be done through assisting developing country partners in helping domestic financial systems align with the goals of the Paris Agreement and national SDGs plans, developing blended financial instruments and mechanisms, engineering de-risking facilities, and taking other actions to eliminate barriers to sustainable investments with the objectives of promoting private sector investment in sustainability. Action 19: IOs and other technical assistance providers should coordinate and align their capacity building efforts with the priorities identified in the Roadmap (G20, 2022^[145]).

⁶ See <https://www.gfanzero.com/press/amount-of-finance-committed-to-achieving-1-5c-now-at-scale-needed-to-deliver-the-transition/>.

⁷ See https://www.climatebonds.net/files/reports/cbi_susdebtsum_h1_2022_02c.pdf.

⁸ See EU Regulation 2019/2088 on sustainability-related disclosures in the financial sector (also known as Sustainable Finance Disclosure Regulation or SFDR), <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32019R2088>.

⁹ In 2019, informal employment represented on average 63% of employment in African countries. In 15 African countries, more than 80% of employment was informal employment.

11 See https://static1.squarespace.com/static/59d679428dd0414c16f59855/t/5bd00e22f9619a14c84d2a6c/1540361837186/Missing_Middles_CFF_Report.pdf.

12 See <https://www.worldbank.org/en/topic/financialsector/publication/whats-happening-in-the-missing-middle-lessons-from-financing-smes>.

13 See <https://www.un.org/sustainabledevelopment/wp-content/uploads/2023/02/SDG-Stimulus-to-Deliver-Agenda-2030.pdf>.

14 As an example, the Luxembourg Green Exchange provides capacity-building assistance i.

15 See <https://globalchallenges.org/wp-content/uploads/2021/11/Coordinating-risk-mitigation-for-exponential-climate-finance-2021-11-15.pdf>.

16 Countries consulted are Egypt, Guatemala, Rwanda, Seychelles and Zambia.

17 See <https://carbontracker.org/reports/reach-for-the-sun/>.

18 See <https://www.fsb-tcf.org/members/> and <https://tnfd.global/about/taskforce-members/>

