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DEVELOPMENT CO-OPERATION DIRECTORATE
DEVELOPMENT ASSISTANCE COMMITTEE

Transition finance: update on ongoing discussions and work

DAC Meeting, 1 February 2018

The present document is submitted for DISCUSSION under item 6 of the draft annotated agenda [DCD/DAC/A(2018)2] for the DAC meeting of 1 February 2018. The Secretariat will present data and initial analysis to inform a discussion on transition finance. The DAC will be invited to react and provide guidance on this work going forward.

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BACKGROUND

1. In the 2014 DAC High Level Meeting (HLM), Ministers recognised the need to better target concessional finance and agreed to "allocate more of total ODA to countries most in need, such as least developed countries (LDCs), low-income countries, small island developing states, land-locked developing countries and fragile and conflict-affected states". The DAC reaffirmed this commitment at the 2016 DAC High Level Meeting, where it also acknowledged the need to better tailor development co-operation instruments and approaches to different country circumstances and needs.

2. In its May 2017 meeting[1], the DAC discussed the issue of transition finance in general and in particular how it relates to countries most in need. The Secretariat proposed DCD to work on unpacking the implications of graduation processes and explore how the international community could better support countries as they transition through the development continuum. "DAC members expressed great support for the Secretariat's proposal to conduct work on the implications of different graduation processes and on how to best support countries' development pathways in the SDG era. In particular (…) the need to unpack the consequences of graduation and to identify how co-operation approaches and instruments can be adapted to the new realities of global poverty and vulnerability" (para.26). Some members expressed interest in specific focus for the work, including on trade and non-concessional finance.

3. More recently, the 2017 DAC HLM Communiqué called for "analytical work to help identify where ODA is most needed (such as in least developed countries, low-income countries, small island developing states, land-locked developing countries, and fragile and conflict-affected contexts) and where additional actions may be required" (para. 19), and recognised "the need to ensure that development co-operation approaches and tools can effectively respond to the new complexity of sustainable development by providing appropriate support to countries as they transition through different phases of development", calling for review and reflection "on the evidence base that documents the consequences of different graduation processes on access to development finance from all sources, and (…) policy analysis on the different patterns of co-operation, including financing, channels, and objectives in countries in transition" (para. 20).

4. Therefore, it is essential that development co-operation approaches and tools are tailored to respond to varied country contexts, and that new evidence and policy advice is developed to promote a broader understanding of the challenges that countries face at different junctures of their development.

5. The 2017 DAC HLM Communiqué also called for a better understanding of "the interlinkages among ODA, partner countries' domestic resources, private investment, remittances, philanthropy, trade finance and export credits, and other sources of finance". A better grasp of the financing for development ecosystem would help DAC members tailor ODA spending in countries most in need and increase ODA catalytic effects and effectiveness. As it appears, these interlinkages and the role to be assigned to different actors and tools might also vary along the development continuum.

[1] DCD/DAC/M(2017)4/FINAL para. 26

1. Problem Statement

6. Since 2000, many developing countries have recorded strong economic growth and 26 countries have transitioned from a low-income to a middle-income status; four countries have graduated from the least developed country (LDC) status; two countries are scheduled to graduate in the next five years; and five countries are potential candidates to graduate from the LDC category in the next decade[2].

7. However, for many countries, economic growth has not been inclusive: there still exist large pockets of the population in extreme poverty, and a large share of the world's poorest live for the first time ever in lower and upper middle-income countries (LMICs and UMICs). Almost half of all middle-income countries (MICs) have high levels of inequality. Key social outcomes, health indicators, as well as indicators for literacy and the quality of the urban environment, show that many middle-income countries face the same or even more severe challenges than low-income countries. In a quarter of middle-income countries, over half of the urban population lives in conditions qualified as slums by the United Nations. 16 LMICs and 2 UMICs are still part of the LDC group.

8. Overall, increased levels of national income can mask large and persisting development challenges; and yet as countries transition through different national income levels (the "development continuum"), countries lose access to specific instruments and sources of concessional finance (e.g., trade preferences). If international assistance tapers faster than improvements in domestic resources mobilisation and the public policies that help a country avoid or escape from middle-income traps are not timely adopted (boost in productivity, innovation) these countries may struggle to maintain adequate levels of financing in support of core development needs and to continue to make progress. A shift in external financing could also, for example, affect their level of debt and creditworthiness.

9. After reaching higher levels of national per capita income, several countries have fallen back to lower income categories, while many lower and upper middle-income countries remain trapped, unable to make a transition to the high-income status. In fact, from the 1960s, only 13 MICs, including South Korea, have been able to move to high-income status, while others, such as the Philippines, remain unable to make that transition. With regard to the poorest, since the International Development Association's(IDA) founding, 44 countries have graduated and nine of these graduates have since re-entered ("reverse graduated") IDA eligibility[3]. So DAC members, as they grasp the non-linear character of development, need to adjust their financing strategies to a long-term perspective beyond ODA.

[2] Cabo Verde graduated from the least developed country status in 2007, the Maldives in 2011 and Samoa in 2014. Equatorial Guinea recently graduated (June 2017). For Tuvalu the decision on its graduation was deferred to take place in 2020. Angola is scheduled for graduation in 2021. A recommendation on the graduation of Kiribati was deferred by the Committee for Development Policy (CDP, body officially mandated by the UN to identify and make recommendations on which countries should belong to the LDC category) to the 2018 triennial review. Five additional least developed countries met the graduation thresholds for the first time in 2015: Bhutan, Nepal, Sao Tome and Principe, Solomon Islands and Timor-Leste.

[3] Eligibility for IDA support depends first on a country's relative poverty, defined as GNI per capita below an established threshold updated annually ($1,165 in fiscal year 2018). IDA also supports some countries, including several small island economies that are above the operational cut-off but lack the creditworthiness needed to borrow from the International Bank for Reconstruction and Development (IBRD).

2. The DAC perspective

10. The issue of transition has been drawing increasing attention among members of the development community. In December 2016, at a meeting convened in Brussels by the EU, the Development Centre and ECLAC, the DCD Director discussed how DAC members could continue to support countries beyond ODA, through new strategic partnerships and innovative forms of co-operation. Following up on this event, the DAC discussed the issue at its May 2017 meeting (see above and document DCD/DAC(2017)17), and with support of its members, the OECD Development Centre's Governing Board 4th High Level Meeting (October, 2017) discussed "development in transition" under the overarching theme of "embracing development's complexity".

11. An initial literature review suggests that areas of focus of research and discussions have been: graduation criteria (eligibility/definitions for ODA and other sources of financing for development, such as IDA, procedures for graduation, etc.) and recipient country strategies with a clear focus on policies rather than financing (e.g. DEV country diagnostic tools, UNDESA "smooth transition" strategies, UNCTAD support to countries in transition).

12. The OECD/DAC's role is central to the Transition Finance agenda and the new political dialogue associated with it. The OECD/DAC has the opportunity to collectively provide a critical source of accountability, transparency and mutual learning on development co-operation issues, including by serving as norm- and standard–setters for effective policies and practices. By supporting the OECD/DCD work on Transition Finance, the OECD/DAC can help fill the evidence gap on Transition Finance. DAC members and other development partners can integrate this evidence in financing and exit strategies, and use it as a basis for policy dialogue and strategic engagement with partner countries to achieve more co-ordinated and effective actions with other development partners. The OECD/DAC has a role to play to ensure that the value of this work for partner countries is maximised. This work can help developing countries put in place strategies and actions for successful transitions and for the achievement of inclusive growth and self-sufficiency, including by identifying financing options and channelling international support towards enablers of strong and inclusive development.

13. The OECD/DAC and DCD could add value by exploring the financing for development dimensions of the transition issue, in line with the ODA modernisation and 2030 agendas, supporting and influencing efforts done in the UN and the development community at large. Questions that the proposed work stream could usefully answer include the availability of different sources of financing for development along the development continuum (holistic or integrated approach), the catalytic role of ODA, policy coherence and interlinkages. For example:

- How could the DAC help the phasing out of ODA and secure the progressive growth of other sources of financing (e.g. private or domestic), securing transitioning countries' long-term sustainable financing (e.g. by preserving debt sustainability)?

- How could the DAC increase the effectiveness of ODA, identifying the best and most innovative tools, policies and partnerships available along the development continuum to best serve the financial needs of transitioning countries?
- How could the DAC design long-term support strategies that go beyond ODA? In other terms, how could DAC members continue supporting countries after ODA graduation to preserve the benefits of ODA in the longer term and avoid setbacks?
- What kinds of capacity building efforts, promotion of transfers of all kinds (from private investment to technologies or knowledge) could be fostered by ODA during phasing out in anticipation of transition?

3. Preliminary work

14. This project will be the first contribution to the implementation of the roadmap to "support countries' development pathways in the SDG era" [DCD/DAC(2017)17] discussed during the May 2017 DAC Meeting, and an immediate response to the HLM call.

15. It is aimed at supporting the DAC to adapt development co-operation approaches and tools to the new realities of global poverty. It will do so by providing new evidence to develop a broader understanding of the challenges that countries face at different junctures of their development, and by studying how development co-operation tools and instruments can best support countries through transitions. A particular attention will be paid to development innovations (in process and instruments) and partnerships that would allow smooth transitions. The ultimate aim is that development gains are maintained and setbacks avoided, increasing the long-term impact and effectiveness of development co-operation.

16. Applying an holistic and integrated approach to financing for development (i.e., considering the respective roles of actors/sources of finance as developing countries move along the development continuum), the proposed work will zoom in on specific transition phases and/or country cases.

17. Initially the work will focus on concrete and empirical observations that will investigate the implications of countries transitioning through income levels and will study the paths they follow, and the respective evolutions of sources of financing for development (see Annex). It will then draw policy conclusions and recommendations for the DAC, and be brought up to scale according to available resources.

18. This work will lay the ground for additional analytical work on transition (in the 2019-20 PWB), and explore new approaches that measure the diversity of situations that developing countries face in their road to sustainable development. In particular, more deep-dives or concrete pilots could be prepared, building on the below pilot country case story suggested for year 2018.

Questions for the DAC:

1. Are the issues raised in the Annex of relevance and aligned with international processes? Which additional issues should be explored in future work?

2. How could the DAC support the Secretariat's efforts to carry the Transition Finance work forward, including at country level?

Annex A. Setting the scene: an empirical analysis

1. The first steps of the work will consist in a literature review on transition – with a focus on the donors' perspective and the respective roles of various actors and sources of financing – and an empirical analysis of financing for development flows along the development continuum. Next steps will introduce policy analysis, and draw conclusions and recommendations for the DAC, including policy coherence considerations.

2. This annex provides a snapshot of some of the ongoing research, setting the scene for further empirical and analytical work. It highlights some emerging questions of relevance to the DAC, and articulates around three axes or levels of granularity:

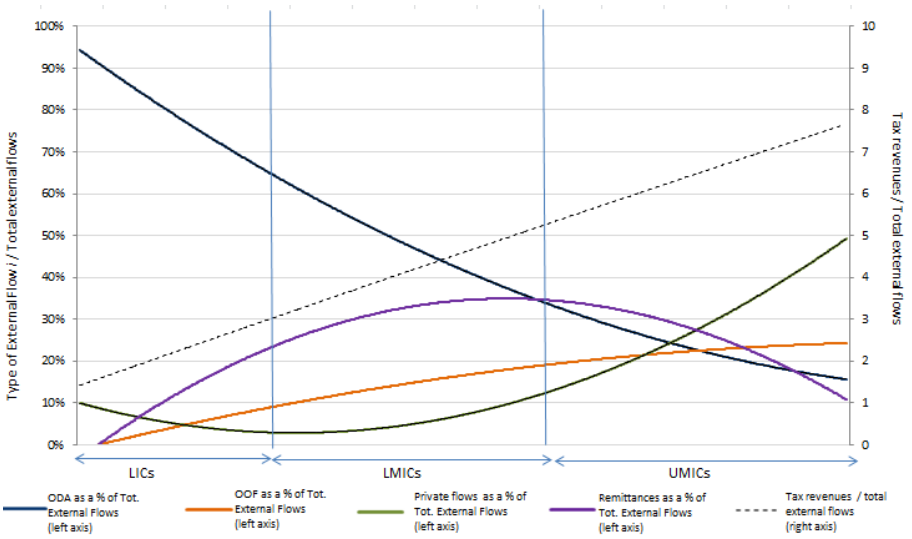
- Elements of an overview of financing for development along the development continuum;
- Elements of an analysis of some key stages of transition;
  Elements of a country-focused analysis of transition finance.

1. An overview of financing for development along the development continuum

3. The improvement of data, e.g. on other official flows (OOF), allows for an increasingly accurate picture of transition finance. As countries experience growth and transition through the development continuum, it is possible to observe some distinctive patterns for each of the financial flows composing the global set of external flows to developing countries (Figure 1)[4].

[4] *What does Fig. 1 tell us?* Low Income countries are highly dependent on ODA flows, and show very low levels of non-concessional flows (OOF), private flows and remittances (between 95% and 65% of total external flows are concessional flows). When approaching LMIC status, the share of ODA flows in total external flows decreases, and remittances take a more prominent role (reaching a peak of 35% of total external flows when income levels reach USD 3500 per capita, on average). Non-concessional flows and private flows also increase but at a slower pace. When moving to a higher income level (UMIC status), ODA continues to decrease, to finally reach a bottom base of around 15% of total external flows; OOF continues to grow, at a decreasing rate, fluctuating from 20% to 25% of total external flows; remittances decrease, and private flows take a more prominent role, growing exponentially. Across this development continuum, tax revenues (i.e. domestic resources) over total external flows grow steadily: they represent two times the external flows' level for lower income countries to reach 8 times the amount of external flows for the richest UMICs (see dotted line, right axis in Fig. 1).

Figure 1. External flows to developing countries, 2012-16, 2015 prices



4. This picture raises (and provides some initial elements of answer) a number of questions of relevance to the DAC and the development community at large. For example:

- What happens to the different sources of finance when countries move along the development continuum? (see footnote 4)
- What happens to the overall volumes, sectoral distribution and composition of sources of ODA at different junctures of development? Is the evolution of financing for development a linear process? (see figures 2 and 3)

Figure 2. External flows to Kenya, 2000-16. 2015 prices

(Kenya transitioned from the LIC to the MIC category in 2011)

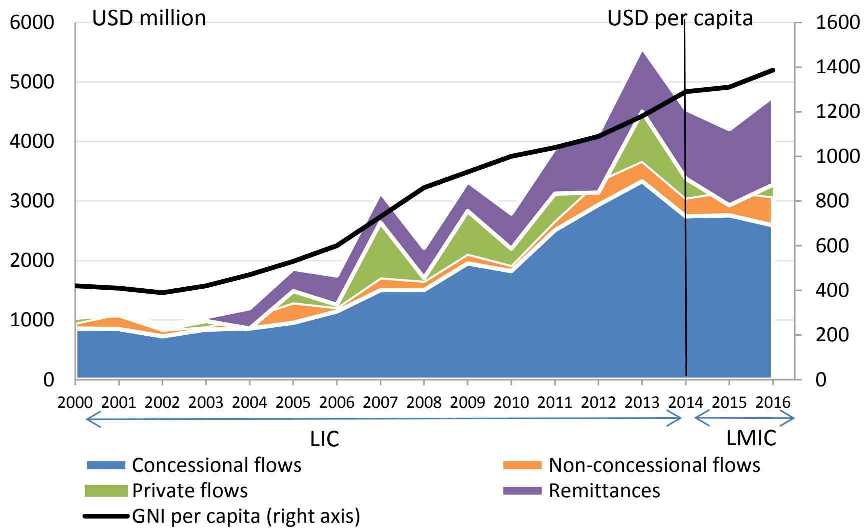
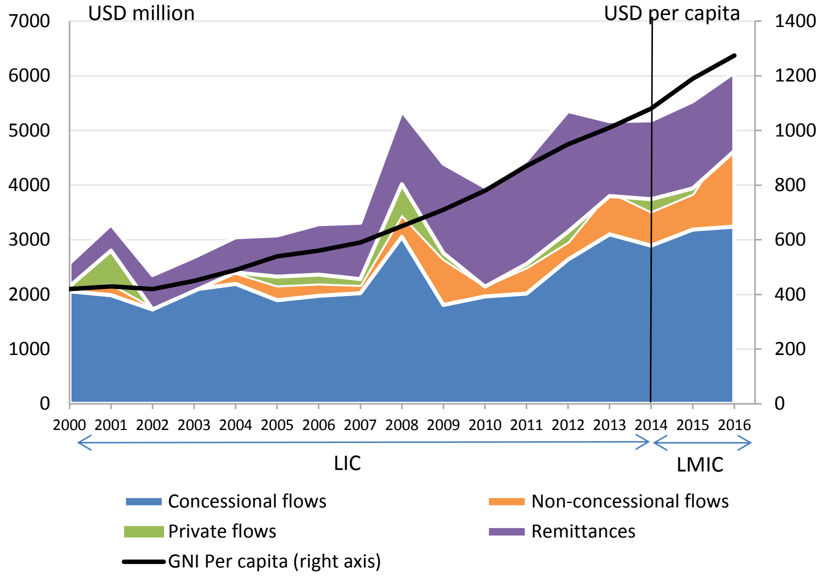


Figure 3. External flows to Bangladesh, 2000-16. 2015 prices

(Bangladesh transitioned from the LIC to the MIC category in 2013)



- How to use ODA to prepare transitions and avoid economic setbacks? What matters from a DAC perspective is to ensure long-term sustainability of financing for development as the country transitions. It is about using the right instruments to allow a smooth transition, and also building capacity so that non-ODA sources of financing (both external and domestic) can pick up and play their role: e.g. financial sector reforms, reduction of cost of remittances, improvement of the tax system, increasing trade and investment backward and forward linkages, etc. It is about accompanying countries as they transition (e.g. by introducing blended finance).

5. Building on recent data improvements on financing for development and other ongoing work in DCD (e.g. recent survey on sectors), could this picture be improved? For example:

- Does transition equally affect all sectors? It appears that some sectors, in early stages of development in particular, are more dependent than others on ODA. Hence, the impact of transition from one category of income to another (and graduation) is likely to be different across sectors, suggesting different needs for ODA focus and technical assistance.

6. This analysis also suggests that, if an holistic approach to financing for development and long-term financing sustainability is to be adopted for the design of transition strategies, the lack of available data after ODA graduation could be an obstacle.

7. The strategy of accompaniment should go beyond ODA with other forms of support, partnerships, transfers and sharing of knowledge or technologies, etc.

8. Additional empirical analysis could focus on the observation of "outliers", i.e. countries that managed to attract more and better sources of financing for development in each of the different income categories, and attempt to draw lessons for donors or recipient countries:

- Who are the best performers for each of the income categories? (See Charts 2.1, 2.3 and 2.5 showing the OOF flows to LICs, LMICs and UMICs, respectively, and Charts 2.2, 2.4 and 2.6 presenting private flows to LICs, LMICs and UMICs, respectively)
- How to explain their performance? Is it due to endowments, e.g. natural resources triggering more foreign investment, or policies?
- What lessons could be drawn for best practices and successful policies and donor support?
- Can lessons learnt from good performers be applied to counteract bad performances and correct trends?

Figure 4.1 OOF to LICs, 2012-16, 2015 prices

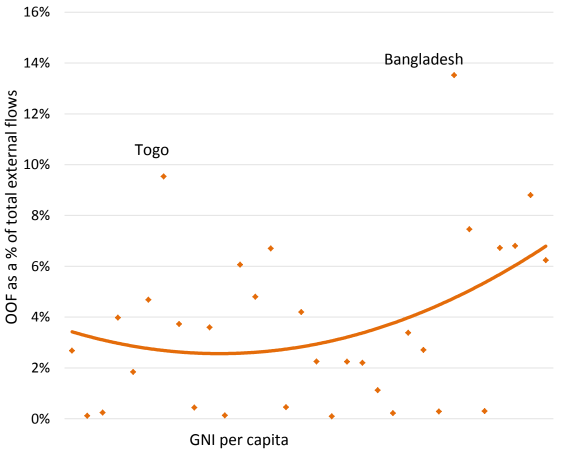


Figure 4.2 Private flows to LICs, 2012-16, 2015 prices

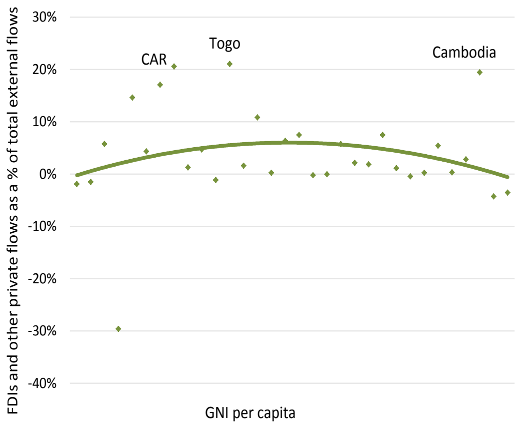


Figure 4.3 OOF to LMICs, 2012-15, 2015 prices

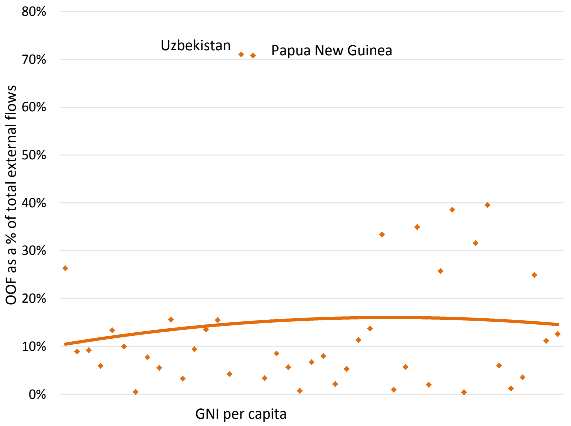


Figure 4.4 Private flows to LMICs, 2012-15, 2015 prices

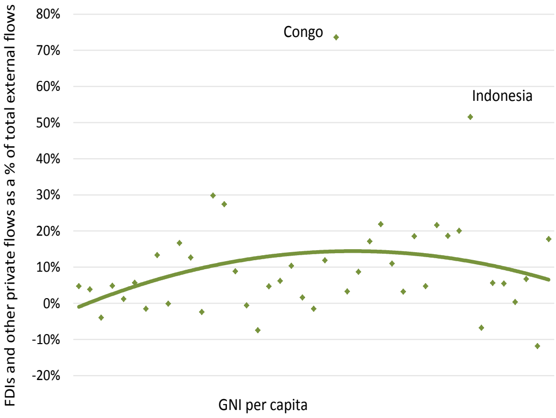


Figure 4.5 OOF to UMICs, 2012-16, 2015 prices

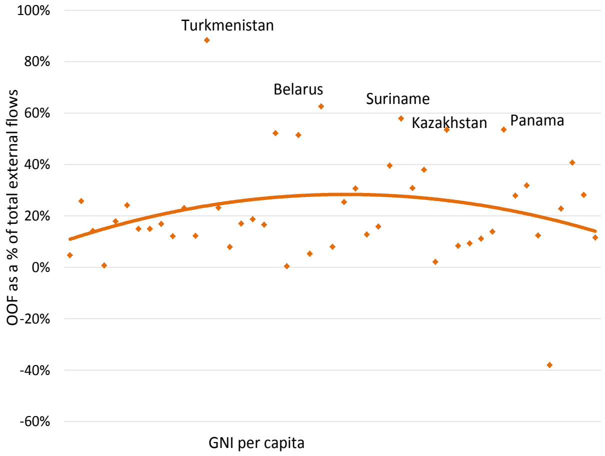
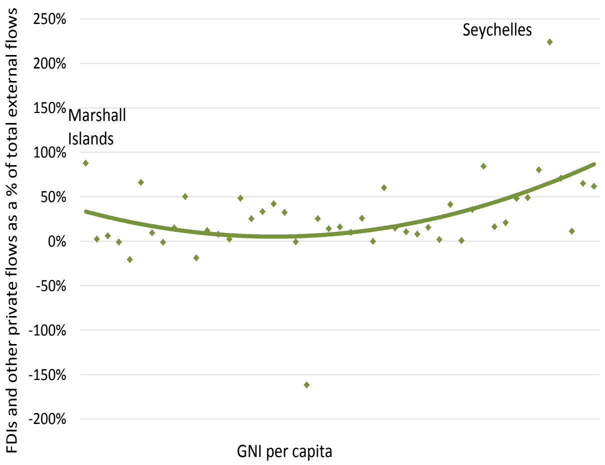


Figure 4.6 Private flows to UMICs, 2012-16, 2015 prices



2. Financing for development patterns at key stages of transition

9. Not all transition stages are necessarily as relevant from the donors' perspective since eligibility of countries to different financing, such as IDA, or preferences, such as tariffs, schemes varies according to a number of criteria that include but are not necessarily limited to national income. The case of LDCs, explored below, provides a good example.[5]

10. Key stages of transition that could be explored include: transition from LIC to MIC, IDA graduation, transition from LDC category, ODA graduation, etc.

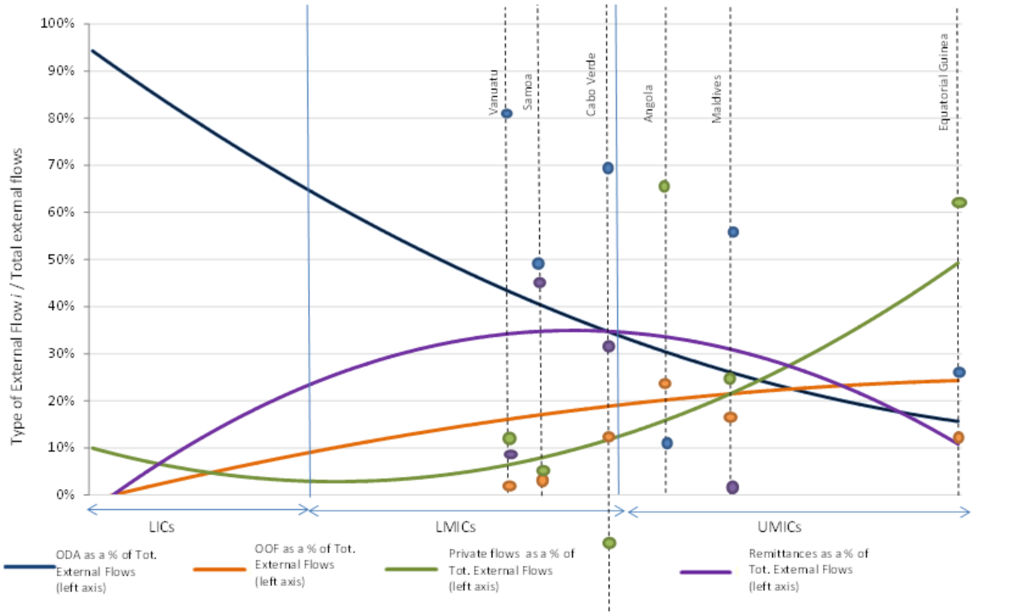
The example of transition from the LDC category

11. This example builds on the overview of external financing for development patterns for countries that graduated from the LDC category in the last ten years, as well as those scheduled to graduate in the following years (See Figure 6).[6] From its creation in 1971, and despite several improvements to the criteria definition of LDCs, to date only five countries have graduated from the LDC category (Botswana in 1994, Cabo Verde in 2007, Maldives in 2011, Samoa in 2014 and Equatorial Guinea in 2017). Additionally, two other countries are eligible for graduation in the coming years: Vanuatu in 2020 and Angola in 2021.

[5] The LDC category contains 47 developing countries categorised as having long-term structural handicaps measured by three indicators, recorded simultaneously. A country can join the LDCs category if at the moment of its examination: its GNI per capita (atlas method, World Bank) is considered to be lower than USD 1 035 (i.e., to join the LIC category in 2015); has a Human Asset Index (HAI) lower than 60; and has an Economic Vulnerability Index (EVI) above 36. For complete details on LDCs criteria see Handbook on the LDC category

[6] To protect its transitioning and avoid setbacks, the LDC graduation criteria states that a country eligible for graduation must cease to meet two of the three inclusion criteria, and that this eligibility must be observed over two consecutive triennial reviews. There is also an income-only criterion: when GNI per capita is at least twice as much as the graduation threshold and deemed to be sustainable (this criterion was introduced in 2006 in response to rapid growth in certain LDCs — notably some oil-producing countries — which continued to perform poorly on the other graduation criteria). There is also an income-only criterion: when GNI per capita is at least twice as much as the graduation threshold and deemed to be sustainable (this criterion was introduced in 2006 in response to rapid growth in certain LDCs — notably some oil-producing countries — which continued to perform poorly on the other graduation criteria).

Figure 5. External flows to developing countries identifying LDC graduated countries and those scheduled for graduation, 2012-16, 2015 prices



Note: For Equatorial Guinea and Angola, no purple dot is shown as data for remittances are incomplete or inexistent for these countries.

12. A number of policy questions arise from this snapshot of financing for development as LDCs graduate. For instance:

- How to explain differences in performance of LDC graduates in attracting the various types of financing for development as they transition? (see example of the contrasting performances of Samoa and Vanuatu in making the most of remittances)
- How much could targeted DAC interventions change the picture? (by contrast to exogenous factors such as endowments or classification in categories of exception for eligibility)
- How to combine long-term financing and resilience strategies with the high volatility of certain flows (see example of private sector investment for Cabo Verde)?

13. Recommendations for the DAC could go beyond ODA considerations to include policy coherence considerations – for example, the Reserve Bank of Vanuatu explained its poor performance on the remittances front compared to Samoa in part by delays in the implementation of a Recognized Seasonal Employer (RSE) scheme, which could be for its New Zealand partner a win-win-win (for Vanuatu, New Zealand and the migrants) development strategy in preparation of the transition and beyond.

Figure 6 to 11 show in the last 16 years how external flows fluctuated for each of the LDC-graduated countries (and those eligible for graduation).

Figure 6. External flows to Cabo Verde, 4-y moving average, 2000-16, 2015 prices

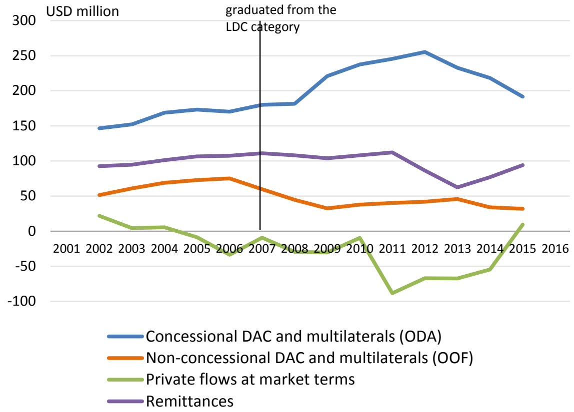


Figure 7. External flows to the Maldives, 4-y moving average, 2000-16, 2015 prices

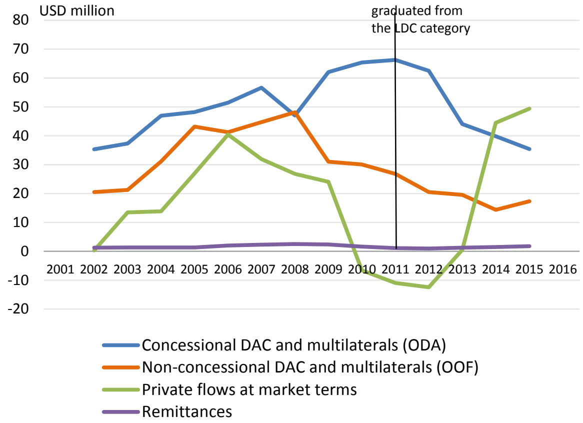


Figure 8. External flows to Samoa, 4-y moving average, 2000-16, 2015 prices *(data on remittances available from 2007 onwards)*

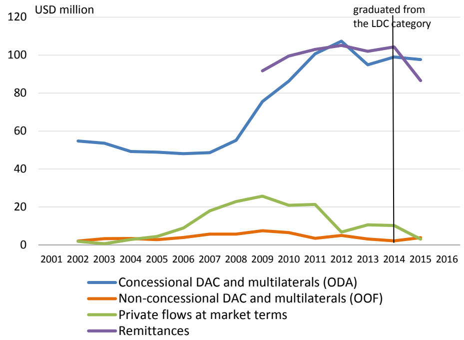


Figure 9. External flows to Equatorial Guinea, graduated in 2017, 4-y moving average, 2000-16, 2015 prices *(no data on remittances)*

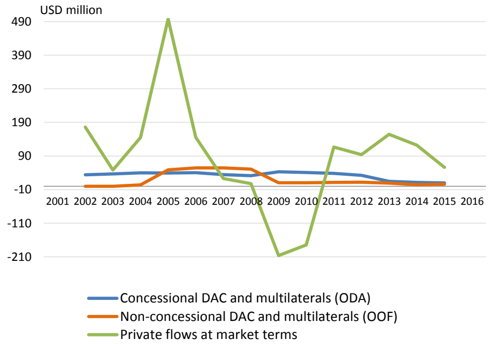


Figure 10. External flows to Vanuatu, 4-y moving average, 2000-16, 2015 prices *(to be graduated in 2020)*

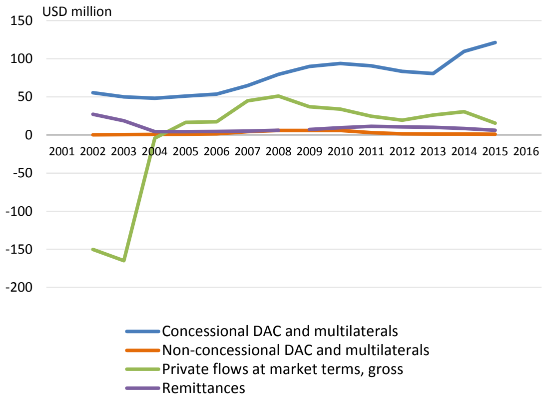
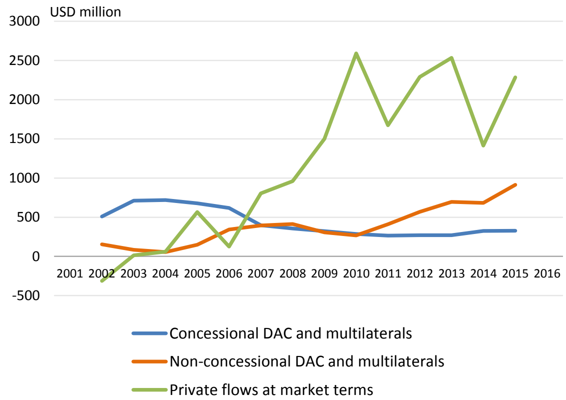


Figure 11. External flows to Angola, 4-y moving average, 2000-16, 2015 prices *(to be graduated in 2021)*



3. Country-specific transition finance analysis

14. Against this background, transition finance strategies could be defined at the country level – supplementing other "smooth transition" programmes offered by development community partners with the DAC perspective, and responding to an increasing demand for technical assistance on financing for development strategies that are tailored to the specific needs and context of transitioning countries, at all levels of development.

15. In line with the holistic approach described in the upcoming *Global Outlook on Financing for Development*, financing strategies should take into account all sources of financing as well as all levers and policy interlinkages that allow maximizing development finance. This prevails even more so during transition when ODA is phasing out. What do exit strategies involve for both the donors and the recipient country?

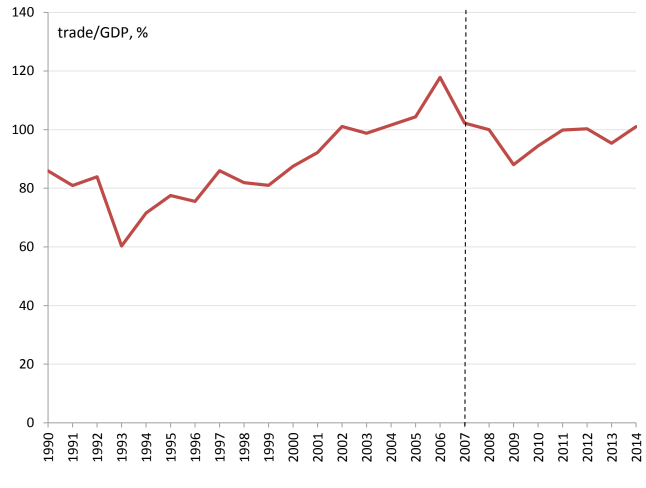
16. Increasingly also, such diagnostics should take into consideration regional dimensions (e.g. ECOWAS in the example of Cabo Verde below), given that relevant policies and sources of financing or capacity building efforts might be regional.

17. As mentioned above, the granularity of the analysis is also important, since individual sectors might rely more or less on specific sources of financing.

The example of Cabo Verde

18. Beyond the analysis of external finance flows (Figure 6), a number of additional indicators could be looked at that pertain to elements of particular relevance to SDG graduation such as trade – eligibility for preferential market access[7], special and differential treatment regarding WTO obligations[8] and trade-related capacity building. Figure 12 below shows the rate of trade as a % of GDP over time for Cabo Verde.

Figure 12. Trade openness for Cabo Verde



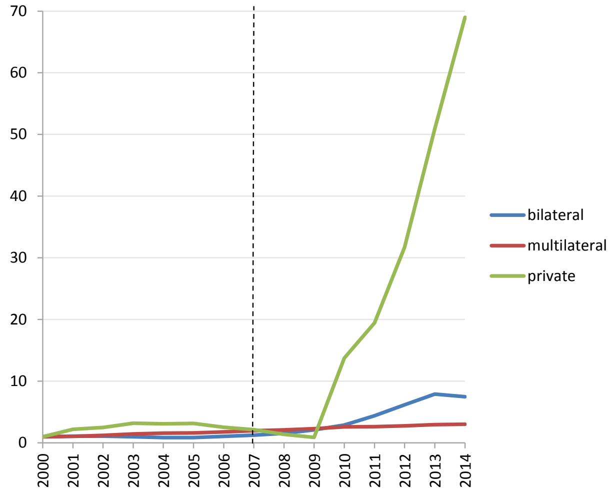
Source: World Bank.

[7] This entitles exporters to pay lower tariffs or to have duty-free and quota-free (DFQF) access to third country markets.

[8] LDCS that are members of the WTO may benefit from special considerations in the implementation of the organisation's agreements. 33 of the 47 countries included in the list of LDCs are WTO members, 8 others are in the process of acceding and 6 are not seeking accession (Eritrea, Kiribati, Somalia, South Sudan, Timor-Leste and Tuvalu).

19. Often, the question of transition raises questions about debt vulnerability and sustainability, when a country faces changes not only in the cost but also the conditions of loans. Figure 13 below shows the debt stocks: multilateral debt stocks in Cabo Verde grew by 50% after its graduation from the LDC category in 2007, bilateral debt stocks grew by 5 times or 500% over the same period and that private debt saw its level multiplied by 32 between 2007 and 2014. (In 2014 private debt stocks accounted for USD 379 million, bilateral debt for USD 600 million and multilateral debt for USD 682 million).

Figure 13. Debt stocks, Cabo Verde
(index, 2000=1)



Source: World Bank