United Nations Development Programme

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NO SOFT LANDING FOR DEVELOPING ECONOMIES

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No soft landing for developing economies[1]

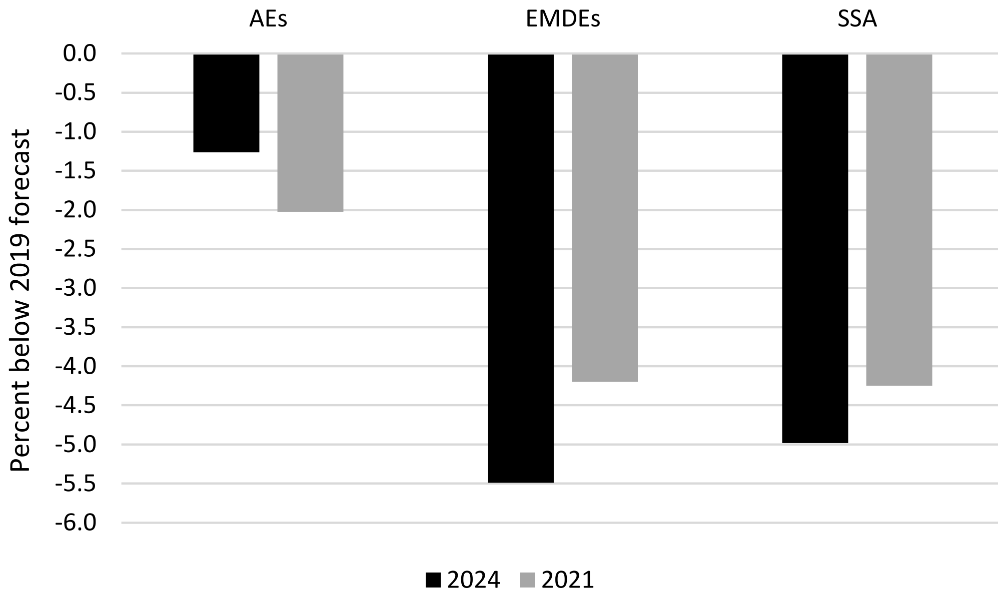
While advanced economies are preparing for a soft landing in 2024, developing economies are struggling. Credit rating downgrades, debt servicing at record levels, and lack of access to new development and climate financing, are making even the lowest threshold of multilateral action -- “protecting the poor and vulnerable during crises”—hard, if not impossible, to achieve. The G20 should heed the Brazilian Presidency’s call to address the links between inequality and economic policymaking. It’s time to reassess criteria for multilateral action.

The global economy will likely avoid a recession as central banks work to rein in inflation now expected to reach 5.8 percent this year down from its peak of 8.7 percent in 2022.[2] Advanced Economies (AEs), most notably the US, are expected to start cutting policy interest rates about halfway through 2024 at the latest --an expectation reflected in the easing of international credit conditions over the past few months. Depending on the source of the forecast, the global economy is expected to grow between 2.4-3.1 percent this year with the IMF and the OECD more optimistic than the World Bank and the UN --all in agreement that growth will likely pick up a bit in 2025.[3] Despite room for cautious optimism, future global growth is expected to remain subdued in the immediate future, and with risk strongly tilted to the downside due to the possible effects

[1] This policy note was prepared by UNDP’s Inclusive Growth team. Many thanks to Pedro Conceição, Philip Schellekens, Raymond Gilpin and Vito Intini for comments on a preliminary draft.
[2] As per IMF’s World Economic Outlook (WEO), October 2023.
[3] In its January update the IMF revised their global growth forecast for 2024 up by 0.2 percentage points (pp) from 2.9% to 3.1%. The IMF forecast for 2025 is 3.2%. The OECD in their November 2023 economic outlook forecast global growth in 2024 at 2.7% and 3.0% in 2025. The World Bank in their Global Economic Prospects report of January 2024 forecast global growth at 2.4% in 2024 and 2.7% in 2025. The UN in their World Economic and Social Prospects report of January 2024, like the World Bank, forecast growth in 2024 at 2.4% and 2025 2.7%.

from conflicts, trade and geopolitical fragmentation, commodity market disruptions, economic slowdown in China and high indebtedness and financial stress.

Figure 1: Scarring – GDP per capita relative to the pre-COVID forecast*



*Source: UNDP based on IMF World Economic Outlook (WEO) October 2023 and October 2019. Note: GDP per capita is measured in constant prices (PPPs). *Datapoints denote how much lower GDP per capita was in 2021, and is expected to be in 2024, compared to the pre-COVID forecasts (from WEO October 2019).*

By 2021, the groups of AEs and emerging markets and developing economies (EMDEs) had already caught up to their pre-COVID (2019) GDP per capita (constant prices) levels, but the poorest region in the world, Sub-Saharan Africa, is only expected to close that gap this year. As a group, AEs are on their way to completely "erasing" the scarring as they have now almost caught up to their pre-COVID growth trajectory. Meanwhile, scarring has only deepened for the group of EMDEs (including the SSA region) with GDP per capita this year expected to reach 5.5 percent below the pre-COVID forecast (cf. Figure 1).

The World Bank has warned of a deepening economic divergence between EMDEs with relatively strong fundamentals and countries with pronounced vulnerabilities amid elevated debt and financing costs.[4] In other words, while advanced economies and strong EMDEs may have pulled off a soft landing, some developing countries seem to be stuck in the mud.

[4] Global Economic Prospects Report, January 2024

Risk perceptions remain high amid large debt servicing needs

Of the 59 developing (low- and middle-income) economies with a sovereign credit rating, 32 (54 percent) are rated below 'non-investment' grade (Figure 2A).[5] Similarly, of the 68 low- and middle-income countries assessed under the low-income countries debt sustainability framework (LIC-DSF), 36 (53 percent) are rated as either in or at high risk of debt distress (cf. Figure 2B).

Figure 2A: Sovereign credit rating

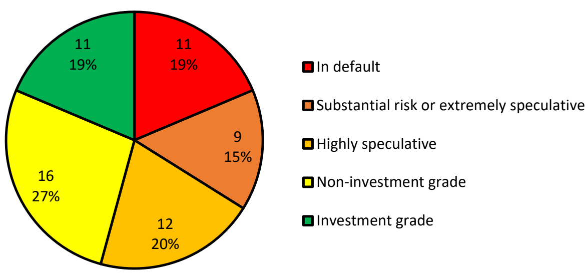
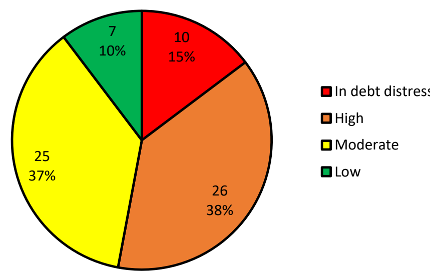


Figure 2B: Risk of debt distress rating



Source: UNDP based on ratings data collected from www.tradingeconomics.com and country debt risk ratings from Debt Sustainability Analyses (DSAs) from the IMF and World Bank. Note: Credit rating categories based on average numerical rating between S&P (SP) and Moody's (M), ultimo December 2023. Investment grade = AAA;BBB- (SP) / Aaa;Baa3 (M), Non-investment grade = BB+;BB- (SP) / Ba1;Ba3 (M), Highly speculative = B+;B- (SP) / B1;B3 (M), Substantial risk or extremely speculative = CCC+;CCC (SP) / Caa1;Caa2 (M), In default = CCC-;D (SP) / Caa3;C (M). Debt distress ratings are taken from latest country DSAs as per November 30, 2023.

Particularly worrying are large chunks of public external debt servicing due this and coming years in the group of poorest (here defined as all low and lower-middle income) countries. After a little respite provided in 2022, mostly due to the now expired Debt Service Suspension Initiative (DSSI), external public debt servicing for the group is expected to peak this year at $175 billion, – a more than 50 percent increase from 2022 – of which $126 billion are principal payments and 54 percent of total owed to official creditors (cf. Figure 3A). This year 22 of the poorest countries (almost one-third of countries with available data) are expected to have external public total debt servicing higher than 20 percent of revenue up from 20 countries in 2023, - a number of countries not seen this high in more than two decades (cf. Figure 3B).

[5] A worse than 'non-investment grade' rating here refers to countries rated in the single Bs or lower by S&P and Moody's.

Figure 3A: Total public external debt service (billion USD)

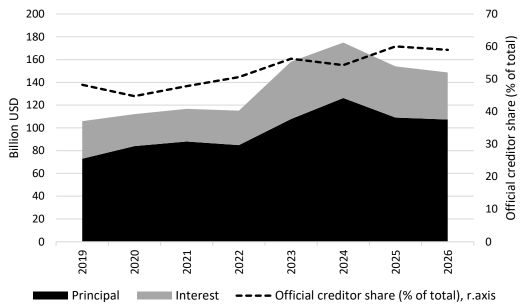
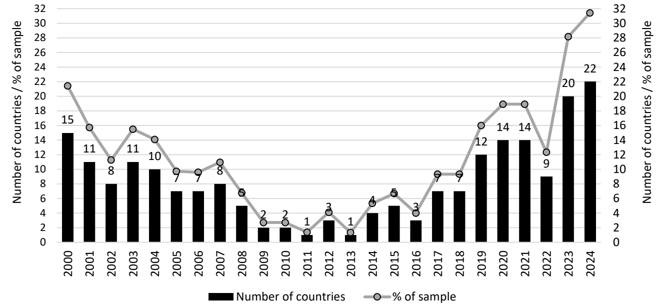


Figure 3B: Countries with public external debt servicing higher than 20% of revenue



Source: UNDP based on [International Debt Statistics](#) (IDS) database 2023 from the World Bank and IMF WEO October 2023. Note: Included are all low- and lower-middle income countries reporting to IDS. Debt covers 'public and publicly guaranteed' long term debt.

Falling interest rates over the past few months have helped reestablish market access for some developing economies shut out of markets since COVID.[6] A significant number of countries, however, still do not have access, and for the most vulnerable countries able to refinance, new debt comes at a high price. As an example, the yield on S&P's Africa USD sovereign bond index is about 10 percent, – still more than 4 percentage points higher than before COVID.[7]

Debt servicing is crowding out development spending

Without liquidity support more countries could easily be added to the long list of defaults since COVID. But even for countries that manage to keep servicing and rolling over their debt in the near term (some with the help from official creditors), high indebtedness and interest rates will continue to weigh heavily on development prospects as resources are directed to debt servicing instead of new investments. Over the past decade, interest payments have consumed an ever-increasing share of government revenue.[8] The median developing economy is this year expected to have net interest payments of 8.4 percent of government revenue, - about double the ratio from a decade earlier (cf. Figure 4A).

[6] Loss of market access is typically considered the case when the bond spread to US Treasuries reach higher than 10 pp.

[7] The average yield on the S&P Africa Hard Currency Sovereign Bond Index was in December 2019 5.84% compared to an average of 10.08% in February (1st to 13th) 2024.

[8] Developing countries here refers to all low- and middle-income countries according to World Bank income classification.

Figure 4A: Net interest payments as a % of revenue

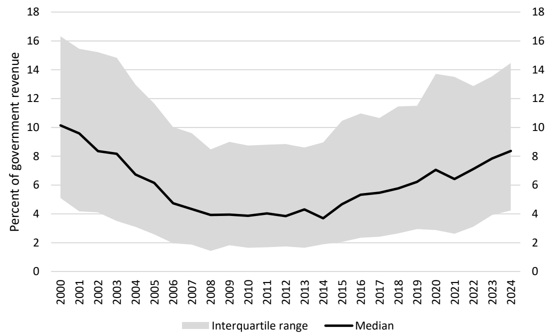
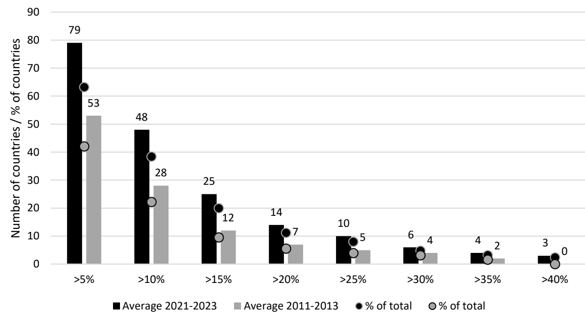


Figure 4B: Countries with net interest payments higher than 5-40% of revenue



Source: UNDP based on IMF WEO October 2023. Note: Countries included are all low- and middle-income countries with available data. Net interest is calculated as the difference between the general government overall and primary balance.

The number of developing economies that now pay more than 10 percent of revenue in net interest payments is 48, - close to 40 percent of countries with available data – up from 28 countries a decade ago (cf. Figure 4B). In ten countries more than one quarter of revenue goes toward interest payments.

The World Bank has estimated that in IDA-eligible countries on average, total (domestic plus external) debt servicing in 2024 will be higher than the combined public spending on health, education and infrastructure.[9] UNDP has estimated that the average low-income country spends 2.3 times more on servicing net interest payments than on social assistance, 1.4 times more than on domestic health expenditures or 60 percent of what it spends on education.[10] UN's Global Crisis Response Group (GCRG) has estimated that in total, 48 countries are home to 3.3 billion people whose lives are directly affected by underinvestment in education or health due to large interest payments.[11]

Debt servicing crowding out effects are particularly concerning given the large spending needs facing EMDEs. As an example, the IMF estimates that in order to reach global net-zero by 2050, EMDEs will need to spend $2 trillion a year by 2030 ($1.2 trillion excluding China) up from $370

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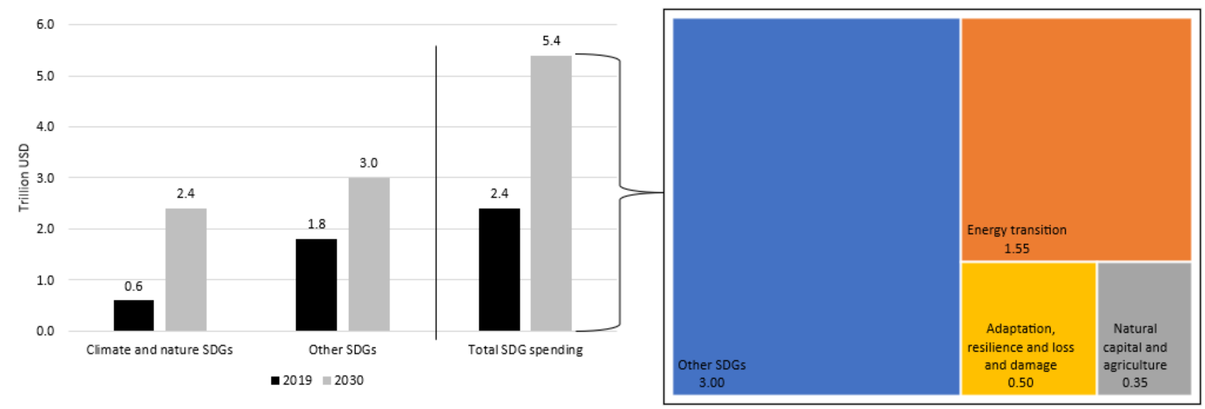
[9] IDA-eligible countries are low and select lower-middle income countries eligible for concessional lending from the World Bank. See World Bank blog 'Urgent need to address liquidity pressures in developing economies', January 24, 2024.
[10] See 'The Human Cost of Inaction: Poverty, Social Protection and Debt Servicing, 2020-2023', July 14, 2023.
[11] See 'A world of debt – A growing burden to global prosperity'.

billion in 2020.[12] But because of widespread debt problems and associated fiscal constraints, countries cannot rely much on public finances.[13]

Mitigation competes with other development needs. By some estimates, EMDEs (excl. China) will, in order to make meaningful progress on the sustainable development goals (SDGs) broadly (including mitigation), need to increase annual spending by at least $3 trillion by 2030 (relative to 2019 levels) where the total spending need will reach $5.4 trillion, – hereof $2.4 trillion for climate and nature related investments (cf. Figure 5). Adding SDG spending needs to expenditure projections is likely to send already high levels of public debt soaring in many countries, even under strong assumptions about private sector contributions, economic growth and revenue mobilization capacity.

Figure 5: Sustainable development goals (SDG) spending need in EMDEs (excl. China), USD trillion



Source: Author based on 'The Triple Agenda, Volume 2'.

This represents one of the greatest challenges of our time; Given high levels of indebtedness and interest rates, how will EMDEs be able to undertake the mitigation action needed for our world to stay within agreed warming limits – the consequence of not doing so potentially catastrophic[14] – and while not having to trade-off progress on other crucial development priorities?

Easing government debt burdens while making progress on development hinges upon a combination of greater access to cheaper (and long term) sources of funding, ability to raise revenue, cut unnecessary and harmful spending, undertake smart growth- and welfare-enhancing

12 See Global Financial Stability Report, October 2023, chapter 3.
13 More specifically, the IMF estimates that in EMDEs (excl. China) the private share of mitigation investments must rise from the current 40 percent to 90 percent by 2030.
14 See Global Tipping Points Report 2023.

public investments, and attract more private capital. Setting countries back on ambitious sustainable development trajectory will require domestic reforms and a much stronger and more responsive multilateral financial system.

Many governments collect a tiny share of GDP as revenue, and not only is the level too low, but it has also fallen over the past decade. As an example, the group of low-income developing countries only collected 14.9 percent of GDP in government revenue in 2023 down from 15.9 ten years earlier.[15] Over the same period, public debt rose by 17.4 pp. Ineffective expenditures must also be redirected. An example would be to move away from subsidy-based ineffective social protection measures (such as fossil fuel subsidies) to adaptive and targeted social protection systems.[16]

Private capital will need a helping hand until reforms take hold

Countries will need to mobilize much more private capital to fund climate and other development investments. This will require large-scale reforms aimed at lowering credit risk and deepening domestic financial markets, etc. But as reforms take time to work, blended finance models must do more of the heavy lifting in the meantime. As an example, the IEA estimates that mobilizing private finance at the scale and speed needed to reach net-zero by 2050 in EMDEs will require at least a tripling in international concessional funds by the early 2030s to help improve the risk-return profile of clean energy projects.[17] There are several promising initiatives in the blended finance space. One example is EMDE-tailored thematic bond models that include credit enhancement and technical assistance provisions.[18] But models require careful design to ensure lower funding costs, access to new/better investors and development impact, - and importantly

[15] Data is for the IMF's group of low-income developing economies (LIDC) as reported in the Fiscal Monitor database.

[16] See for instance UNDP, November 3, 2021.

[17] See IEA's 'Reducing the Cost of Capital Report', February 2024. It can be noted here that the IEA in their estimation make an optimistic assumption that concessional funding will be leveraged by a factor of 6 to 7 up from only 0.3 today.

[18] An example is the Amundi Planet Emerging Green One fund, - a joint venture between the World Bank (IFC) and asset manager Amundi - which has successfully attracted institutional investors to emerging market corporate green bonds using a combination of a de-risked fund structure and the provision of technical assistance to issuers. See 'IFC, Amundi Successfully Close World's Largest Green Bond Fund', March 16, 2018. The European Union has with its global green bond initiative also signaled a willingness to go this route. See 'Global Green Bond Initiative strengthened by a new strategic partnership to foster green capital markets', EIB, September 6, 2023.

they will compete for official sector resources and alternative funding instruments (UNDP forthcoming).

Call to Action: An SDG Stimulus is needed to address global spillovers

Developing economies are unlikely to achieve sustainable development transformations without a much larger multilateral financial support system --given global spillovers from monetary tightening and massive development needs. With severe time constraints for climate action, it would be both a dangerous and unfair strategy for wealthier economies to rely too heavily on the (national) capacity of developing economies to independently undertake (global) climate investments. As a response, the UN Secretary General has called, in his SDG Stimulus report, for a massive scale up of long-term and affordable MDB lending and for more efforts in making sure that countries gain access to effective debt restructuring and liquidity support when needed.[19] Fixing the painfully slow G20 Common Framework is one crucial element of this strategy. So is the scaling up of global climate finance which despite years of negotiations remains disappointing.[20] It should also be noted that it's not just the size of global climate finance commitments that are disappointing, so are the terms of funding provided which ought to be predominantly grants-based and highly concessional.[21]

While financial market conditions have improved lately and the world economy has proven resilient to the continued efforts to bring down inflation, developing economies are not out of the woods yet. Growth is expected to remain subdued in years to come and risk remains strongly tilted to the downside. Even if risks do not materialize, many developing economies are stuck in a negative debt-development feedback loop keeping them from undertaking new growth- and welfare-enhancing investments. For countries to break free of this situation they urgently need to prioritize policy reforms aimed at improving fiscal balances and mobilizing private capital. However, given the scale of spending needed, countries will under no circumstances be able to undertake a sustainable development transformation over the next decade without the support of a much larger and more responsive multilateral financial system. This will have to include both

[19] See 'United Nations Secretary-General's SDG Stimulus to Deliver Agenda 2030', February 2023.
[20] Developed countries in 2009 pledged at COP15 to give $100 billion a year by 2020 to developing countries, - a target that is way too small and has not been met. See 'Climate Finance Provided and Mobilized by Developed Countries in 2013-2021', OECD, November 16, 2023.
[21] See for instance 'Convergence 2.0: How can growth with a hard carbon budget constraint be achieved?', WEF, January 18, 2024, and 'International climate finance – Status quo, challenges and policy perspectives', European Parliament, November 2023.

better access to effective debt restructuring, liquidity support and long-term affordable capital. A failure to get this right not only matters for debt vulnerable countries. It jeopardizes the achievement of global climate and SDG targets with ever-increasing costs, and potentially irreversible outcomes.