

The reform of the international financial architecture: an opportunity for scaling up finance for water?

This paper will inform discussions at the ninth meeting of the Roundtable on Financing Water (Geneva, 7-9 February 2023), particularly session 4 on “Changing finance for water: the role of governments and public finance”.

The background note builds on existing literature and OECD’s experience. It may not reflect the opinion of the OECD, UN-Water or their Member Countries.

Introduction

Discussions in recent international fora (G20, COP 27, COP 15...) highlighted the limits of the current international architecture for development finance in a context of interconnected crises (climate change, cost of living, developing country debt crisis...). These recent debates included calls to reassess the adequacy of the current multilateral architecture and governance for development finance (OECD, 2022^[3]) (US Department of the Treasury, 2022^[1]) (Government of Barbados, 2022^[2]).

These limits could also affect the water sector. Emerging and systemic threats related to climate change intensify the challenges of financing water-related investments (Linkov et al., 2019^[4]), including for development finance. Furthermore, evidence suggests that development finance does not always reach countries that most need it. For instance, in Asia Pacific, data suggests that ODA may not be reaching some of the poorest countries, such as Timor-Leste, Bangladesh, Myanmar, Afghanistan and Papua New Guinea (ADB, 2020^[5]). In addition, there is a bias of water-related ODA towards large-scale grey infrastructures, and away from alternative options, such as small-scale green infrastructure, nature-based solutions or distributed water supply and sanitation services.

The water community would benefit from engaging with a set of issues being raised in the context the reform of the international financial architecture. The consequences of such discussions are hardly considered yet, they are likely to be significant. The water community would gain from engaging more directly on such topical issues which are foundational to redirect financial flows so as to effectively contribute to global access to water security, instead of exacerbating water risks.

Recent global discussions (G20, COP 27, COP15...) highlighted the limits of the international financial architecture in the new global context

The current global context poses new challenges to multilateral development finance

The multilateral development system is under stress from the combined effect of successive crises. While multilateral development organisations channelled a large share of the international response to the COVID-19 pandemic, their ability to continue providing exceptional levels of financing is constrained by their current funding and operating models, as well as by the growing complexity and fragmentation of the multilateral architecture. Multilateral organisations are expected to help address a growing list of development challenges, including global and regional public goods, which often compete with their original mandates and stretch their capacities further. Indeed, the demand for multilateral support is likely to remain elevated as the risk of adverse shocks increases due to a combination of new and emerging threats. These include the risk of new pandemic outbreaks, the rise of global poverty and inequality

(including gender based), the spike in food and energy prices, and the twin crises of climate change and biodiversity loss. (OECD, 2022^[3])

Successive bonds issuances, backed by recent capital increases, have allowed multilateral development banks (MDB) to scale up their lending in recent years. However, the increase in multilateral contributions was not enough to meet the growing funding needs resulting from multiple concurrent crises. In addition, the potential for further capital increases appears limited. Donor contributions to MDBs' concessional windows have been stagnating and MDBs' financing headroom could narrow in the future due to the combined effect of tightening financial conditions and member governments' hesitation to further bolster their capital base. Indeed, despite the massive scaling up of disbursements by MDBs and the acknowledgement of persisting financing needs in developing countries, there are hardly any calls to boost the capital base of the main MDBs further (with the exception of the Inter-American Development Bank (IDB), whose Board of Governors mandated in March 2022 a proposal for a capital increase of IDB Invest, its private-sector arm). The strain of successive crises on member governments' budgets may partly explain the lack of support for further MDB capital increases (even though the bulk of capital increases would be in the form of callable capital, which does not directly impact governments' budgets). The other factor that comes into play is the tense geopolitical dynamics among shareholders; in the case of new capital increases these would likely lead to discussions around shareholder reform and the adjustment of voting rights in the main MDBs. As a consequence, MDBs are increasingly under pressure from their shareholders to revisit and optimise their capital adequacy approaches. (OECD, 2022^[3]).

Discussions are ongoing on potential reforms of the international financial architecture

Initiatives are under way to ease the constraints on MDBs by enhancing the efficiency of their capital use. In 2021, the G20 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 counter-cyclical and large-scale financing, the independent review encouraged shareholders to (i) revisit their risk management approaches and align MDB risk appetites with operational priorities and strategies; (ii) recognise the benefits of callable capital; (iii) expand the use of financial innovations, (iv) enhance dialogue with credit rating agencies, and (v) 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^[6]) (OECD, 2022^[3]).

Box 1. MDBs capital adequacy frameworks

MDBs' access to capital markets is backed by the capital contributions from their member governments. MDBs typically have very high, often "AAA" credit ratings, which reflects two factors: (i) the MDBs' multilateral shareholding structure and preferred creditor status; and (ii) their strong levels of capitalisation, which are generally much higher than for commercial lenders. The capital from member governments usually comes in two forms: "paid-in capital," which generally requires the payment of cash to the MDB; and "callable capital," which member governments agree to provide in the case of an imminent default on a borrowing or guarantee payment. Paid-in capital constitutes only a small portion (typically less than 5%) of MDBs' total capital, while the bulk is in the form of callable capital. MDBs' creditworthiness underlies the financial model and viability of their operations. Based on

their high credit ratings, MDBs can raise financing at competitive rates and fund their operations from the spread between the interest rates they pay to investors and the rates client countries pay on the loans MDBs provide them with. For this reason, MDBs have set up capital adequacy frameworks that impose limits on their annual lending.

Source: (OECD, 2022^[3])

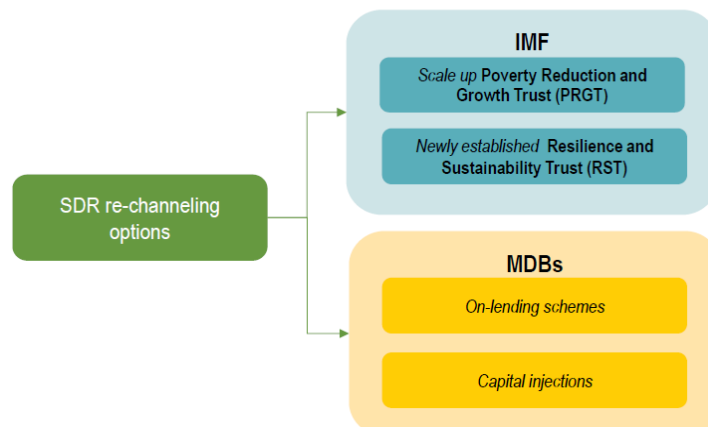
Discussions on reform of the international financial architecture also include options to extend the fiscal space for developing countries (re-channelling Special Drawing Rights and operationalising the Resilience and Sustainability Trust, restructuring debts...). In August 2021, the International Monetary Fund (IMF) issued a USD 650 billion allocation of special drawing rights (SDRs)¹. Since SDR allocations are made in proportion to the IMF quotas of the individual member countries, they disproportionately benefit developed countries². In October 2021, the G20 agreed to re-channel USD 100 billion of SDRs to the benefit of LICs, small states and vulnerable middle-income countries (MICs). As of September 2022, this has not yet materialised. One reason for this delay is the difficulty of setting up appropriate mechanisms to serve as conduits for the re-channelling. (OECD, 2022^[3])

The first and most obvious channel for the SDR reallocation is the IMF itself. Since 2010, several countries have voluntarily lent SDRs to the Poverty Reduction and Growth Trust (PRGT), the IMF's concessional facility for low-income countries. In addition, the IMF approved in April 2022 the establishment of the Resilience and Sustainability Trust (RST), in order to re-allocate SDRs to low-income and vulnerable middle-income countries. (OECD, 2022^[3]) IMF Director Kristalina Georgieva announced during COP27 that the fund would be operationalised quickly. MDBs present another potential channel for reallocating SDRs to support developing countries, provided some measures are taken to preserve their reserve asset nature. Recent analyses point out that a re-channelling of SDRs through MDBs could take two forms (Figure 1): i) On-lending schemes: Developed countries could lend SDRs to the MDBs to increase their available loan funds; ii) Capital injections: SDRs could also be lent or pledged as capital contributions to MDBs, which would allow MDBs to raise more debt from capital markets. (OECD, 2022^[3])

¹ SDRs are a "reserve asset", originally created to strengthen the foreign exchange reserves of countries vulnerable to a balance-of-payments crisis. They can be exchanged for hard currencies among the IMF member countries and their value is determined by a basket of the five freely and most traded currencies – the US dollar, Euro, Japanese yen, pound sterling and the Chinese renminbi. This SDR allocation, the largest in the IMF's history, aimed to "boost global liquidity" and help all members "address the long-term global need for reserves" in the context of the COVID-19 crisis (IMF, 2022^[31]).

² In fact, about two-thirds (USD 420 billion) of the recent SDR allocation were directed to developed economies whose external reserve positions were not constrained and who already had the fiscal and monetary tools to react to the economic downturn. By contrast, only about USD 275 billion went to emerging and developing countries, and low-income countries (LICs) received around USD 21 billion (Mariotti, 2022^[32]).

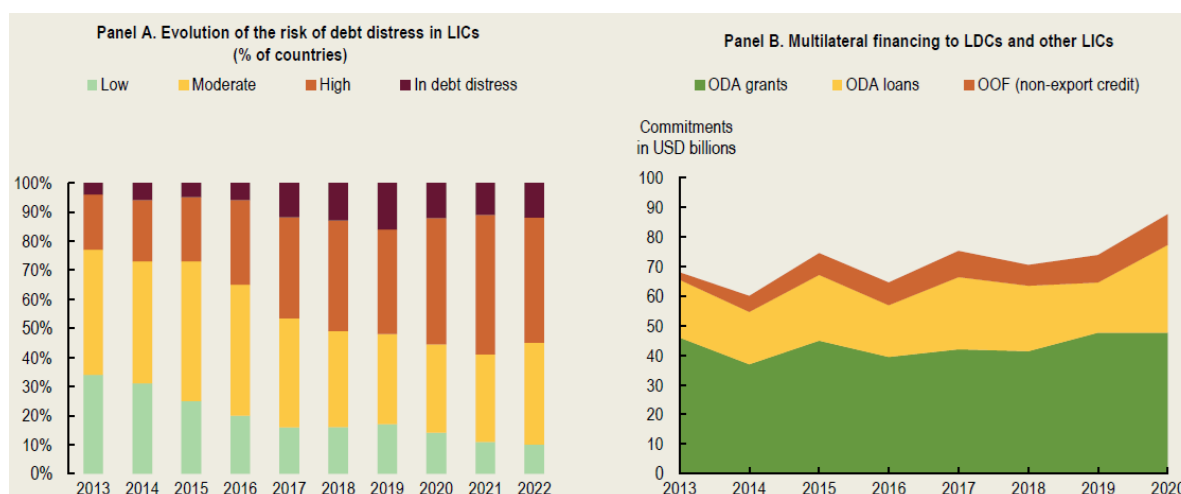
Figure 1. MDBs can be another effective channel to re-distribute SDRs



Source: *Multilateral Development Finance 2022* (OECD, 2022^[3]), <https://doi.org/10.1787/9fea4cf2-en>.

Many countries, including those most at risk from climate change, are facing significant debt overhang, exacerbated by an unfavourable international trade and monetary system. The large and growing number of developing countries facing balance of payment issues raised questions about the role of multilateral development finance in times of crises. A significant share of multilateral development finance is provided to developing countries as loans, raising questions over its role to support countries facing financial liquidity or solvency issues. A key challenge is the need to reconcile the seemingly contradictory objectives of responding to countries financing needs generated by successive crises in the short term while ensuring countries' debt sustainability in the longer term. The main MDBs declined to participate in the Debt Service Suspension Initiative (DSSI) spearheaded by the G20, arguing the need to preserve their triple-A credit rating. Instead, MDBs chose to provide fresh financing to their client countries by frontloading resources and repurposing parts of their existing portfolios (OECD, 2022^[3]).

Figure 2. The growing number of LICs at risk of debt distress coincided with increased multilateral lending



Note: In Panel A, the evolution of the risk of debt distress is calculated as a percentage of low-income countries (LICs) with a debt sustainability analysis (DSA). LDCs refer to least developed countries. In Panel B, calculations are based on commitments, in 2020 constant prices. Source: *Multilateral Development Finance 2022* (OECD, 2022^[3]), <https://doi.org/10.1787/9fea4cf2-en>. Based on data from Debt Sustainability Analysis Low-Income Countries, (IMF, 2022^[7]), <https://www.imf.org/en/Publications/Dsa>; and OECD Creditor Reporting System, (OECD, 2022^[8]), <https://stats.oecd.org/Index.aspx?DataSetCode=crs1>.

Recently, the leaders of some developing countries have called on the G20 to agree on a more ambitious debt service suspension initiative including MDB loans to low-income countries (Government of Barbados, 2022^[2]) (OECD, 2022^[3]). In addition, there have been recent calls for Northern debtor countries, considered as responsible for the majority of environmental damage, to free up fiscal space for Southern creditor countries. This could include debt cancellation, debt restructuring, replacing climate loans with non-repayable subsidies and paying compensation for loss and damage (IIPP, 2022^[9]).

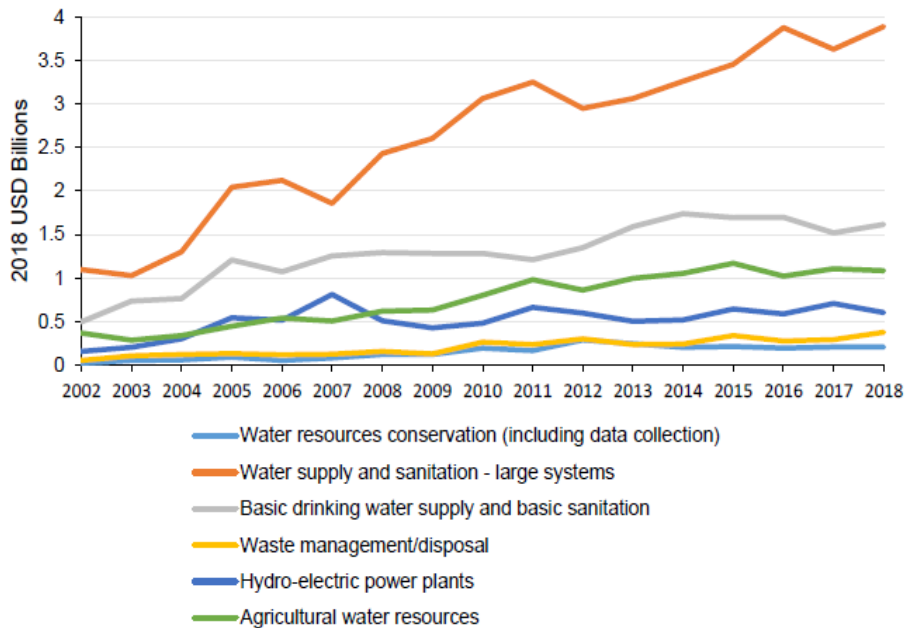
State of play on development finance in financing water

Development finance plays a key role in financing water

Overall, official development assistance (ODA) flows have increased more than 2.5 times since 2002, with ODA for water generally increasing in line with the broader trends. Over the 2002-18 period, USD 120 billion have been allocated to water-related ODA (out of a total of USD 2.4 trillion for all sectors). “Water-related” ODA includes several sub-sectors including water supply and sanitation, waste management/disposal, hydro-electric power plants, agricultural water, and water resource conservation. The share of ODA allocated to water-related sub-sectors remains relatively stable at 4-5% over 2002-18, reaching 5.15% of total ODA in 2018. During that time the split between ODA loans and ODA grants in the water sector is relatively even at 51% for grants and 49% for loans. There is a trend to move away from grants and towards loans. In 2002, loans accounted for 44% of water sector ODA flows and in 2018, they had reached 61% of water sector ODA flows (OECD, 2022^[10]).

Among water-related ODA flows, water supply and sanitation (large systems) accounted for the largest share, capturing 21% of the total flows for water, amounting to USD 45 billion total value over the period 2002-18, followed by water supply and sanitation (basic systems) capturing a 10% of the total flows for water, amounting to USD 22 billion total value of the period (Figure 3). ODA for agricultural water amounts to 6% of total flows for water (USD 13 billion total value) and for hydro-electric plants amounts to 4% (USD 9 billion total value). ODA flows for waste management/ disposal and water resources conservation account for relatively small shares compared to other water-related sub-sectors (OECD, 2022^[10]).

Figure 3. ODA Flow by Water Sub-sector

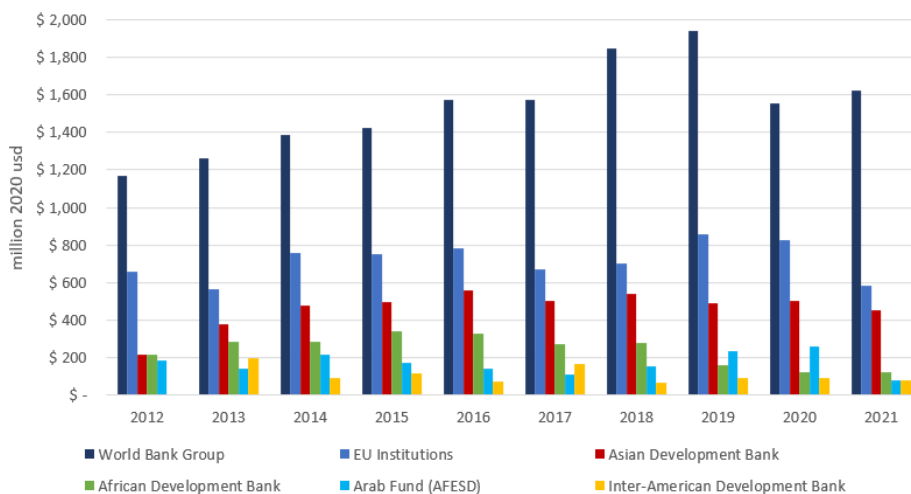


Source: Authors, based on OECD Creditor Reporting System, (OECD, 2022^[8]), <https://stats.oecd.org/Index.aspx?DataSetCode=CRS1>

Multilateral development organisations channel a large and growing share of total ODA. The volume of ODA channelled through multilateral development organisations amounted to USD 78.6 billion in 2020, or 41% of total ODA. Over the past decade, the multilateral development system has channelled growing volumes of ODA to developing countries. Between 2012 and 2019, core and non-core contributions to multilateral development organisations increased from USD 56.8 billion to USD 70.6 billion (up 24%) (OECD, 2022^[3]).

In the water sector, multilateral development banks (MDBs) have also played an important role in the past years. Between 2012 and 2021, multilateral ‘water-related’ ODA flows amounted to over USD 34 billion, with an increase between 2012 and 2019 and a slight decrease in 2020 (figure 4).

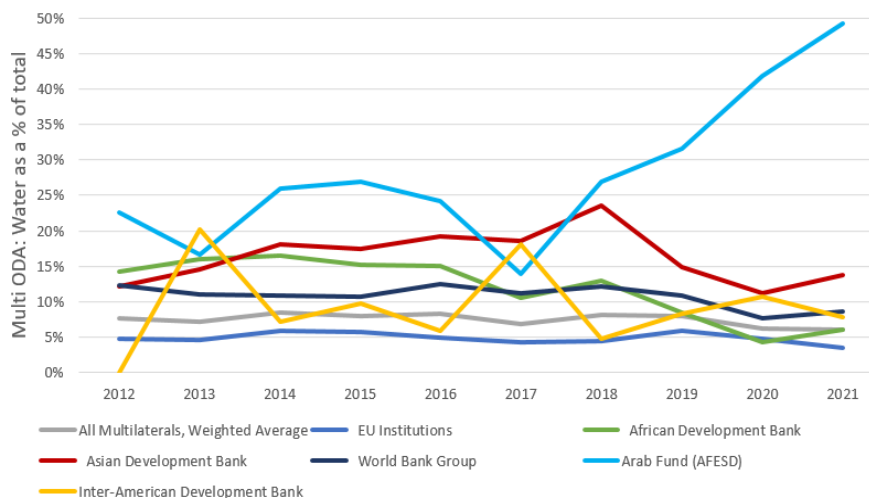
Figure 4. Water ODA flows of the main MDBs



Note: EU institutions include the European Commission, the European Development Fund and the European Investment Bank
 Source: Authors, based on OECD Creditor Reporting System, (OECD, 2022^[8]), <https://stats.oecd.org/Index.aspx?DataSetCode=CRS1>

MDBs accounted for about one third of the total “water-related” ODA between 2012 and 2021. The share of the water sector ODA channelled by MDBs has remained at around 7% between 2012 and 2021 (authors, based on OECD Creditor Reporting System, (OECD, 2022^[8])), with differences between the main MDBs. Between 2012 and 2021, the average share of the water sector in ODA provided by EU institutions (EIB, European Commission and European Development Fund) was 5%, while it was 11% for the World Bank Group and the African Development Bank, and 16% for the Asian Development Bank.

Figure 5. Multilateral ODA: share of the water sector



Note: EU institutions include the European Commission, the European Development Fund and the European Investment Bank
 Source: Authors, based on OECD Creditor Reporting System, (OECD, 2022^[8]), <https://stats.oecd.org/Index.aspx?DataSetCode=CRS1>

The challenges of financing water intensify in a context of heightened uncertainty

Emerging and systemic threats intensify the challenge of financing water-related investments, including for development finance institutions. Climate change poses a systemic threat to the reliable provision of water services, the management of water resources and water-related risks, which vary across regions in terms of the nature and magnitude of impacts (Linkov et al., 2019^[4]). Temporal and spatial climate patterns are changing and, in some cases, projections are highly uncertain, rendering historical trends an inadequate basis for decision-making. Water-intensive assets that have operational lifetimes of many decades, even centuries, need to take a forward-looking approach to investment that address the novel challenges associated with a shifting water cycle (Matthews, 2019^[11]). Project developers are only beginning to explore how to use new metrics, such as the value of resilience in the context of disruption, climate transformation, and high levels of uncertainty about the pace, direction, and types of impacts we can expect (Haasnoot et al., 2020^[12]). Incorporating resilience into water-related investments is needed to ensure that system-wide enhancements are made to help absorb and rebound from residual risks (for which further risk reduction is prohibitively expensive) as well as events that may be difficult to predict. These may include pandemics, social change, political disruption, landslides, cyber-attacks, climate and weather-related challenges such as droughts, storms, floods, wildfires, etc. Combined with optimal investment in risk reduction measures, resilience can minimise the costs of recovery in the event that threats materialise (OECD, 2022^[10]).

Water infrastructure development and adaptation to stressors have historically been guided by designs for robustness - the ability of the infrastructure to tolerate anticipated extremes, minimising disruptions through a risk-based approach emphasising control, armouring, and strengthening (Markolf et al., 2018^[13]). Now, robustness is undermined by climate variability, unpredictability and increasing uncertainty about future conditions. Rather than designing for robustness, water infrastructure development and investment benefit from increasing the ability of water systems to adapt and transform to varying internal and external conditions – to build their resilience to changing futures (Chester and Allenby, 2018^[14]) (Markolf, et al., 2018^[15]). Over recent years there has been a growing effort to situate water-related priorities and investments within a broader resilience paradigm, to promote a “new way of thinking about risk so that we can make wise financial decisions” (Linkov et al., 2019^[4]). Recognising that our vital water systems are not fully suited to cope with the changing climate, scientists and policy-makers have mounted a growing effort to develop and adopt resilience-based approaches to water system planning and investment (Rockström et al., 2014^[16]), with multiple expected benefits (Brown, Boltz and Dominique, 2022^[17]). Governments and regulators should challenge water service providers to consider resilience in their planning and operational activities (see (OECD, 2022^[10]), for a discussion of practical options). A resilience-led way of thinking would entail a shift in water sector financing norms for vulnerable countries and populations, and could help to trigger financial and technological innovation for the water systems of the future (Linkov et al., 2019^[4]) (OECD, 2022^[10]).

Development finance faces certain limitations in financing water in the current context

Evidence suggests that existing funding for water may be poorly targeted, failing to reach the projects that can deliver the greatest benefits and reach the communities most in need (Andres, L. et al., 2019^[18]) (Leflaive, X. and M. Hjort, 2020^[19]). Indeed, prevailing financing models and arrangements favour large, concrete infrastructures (e.g., wastewater treatment facilities, desalination plants, large reservoirs); at the same time, rural sanitation, wetlands and nature-based solutions lack access to finance. There is a conservative bias towards large-scale grey infrastructures with a well-established financing model, and away from alternative options, such as (untapped) small scale green infrastructure, nature-based solutions or distributed water supply and sanitation services. This bias also applies to water-related ODA. The 2017 Global Analysis and Assessment of Sanitation and Water (GLAAS) report found that globally, ODA of “large systems” (including large urban distribution networks and/or treatment facilities) accounted for three quarters of all ODA to the WSS sector in 2015, which amounted to approximately \$5.6 billion of the \$7.4 billion flowing into the sector (WHO, 2017^[20]). According to the same report, assistance in setting up “basic systems” (a category mostly made up of water or on-site sanitation) involved only a quarter of ODA disbursements for water and sanitation in 2015 (about \$1.9 billion) (WHO, 2017^[20]).

Water-related ODA sometimes fail to reach the countries most in need. In Asia Pacific, India and Indonesia received considerable amounts (on average USD 257 and 189 million per year) of water-related ODA in comparison to other countries, and data suggests that ODA may not be reaching some of the countries that most need it, such as Timor-Leste, Bangladesh, Myanmar, Afghanistan and Papua New Guinea. (ADB, 2020^[5]).

Furthermore, public and development finance in the water sector is not used at scale as a catalytic force to crowd in additional capital. The amount of commercial finance mobilised by development for water and sanitation is limited compared to other sectors. Only 1.36% (USD 2.14 billion) of total private finance mobilised from 2012-2017 (USD 157.2 billion) was mobilised in the water and sanitation sector. In terms of blended finance instruments, guarantees accounted for 58% (or USD 1.24 billion) of the private finance mobilised in the water and sanitation sector, followed by syndicated loans at 29% (or approximately USD 0.6 billion) (OECD, 2019^[21]).

Conclusion

Could the reform of MDBs capital adequacy frameworks be an opportunity for financing water?

Current MDBs' investments policies are not always adapted to the specific investment needs of the water sector. Could reforming MDBs capital adequacy frameworks allow them to be less risk adverse and potentially better tailor their investments for water? For instance with: i) Investing in higher risk projects and adapting financing mechanisms to the relatively small-scale and fragmented nature of water-related investments (leading to high transaction costs and perceived high risks); Adopting resilience-based approaches to water-related investments; Extending maturities, as water infrastructure is typically long-lived and with high costs, calling for long pay-back period of about 20 to 30 years; Supporting the inclusion of broader policy objectives than bankability, such as equity, in investment decisions in the water sector?

Towards a reform of the architecture of international cooperation finance? (adapted from (Kaul, 2022_[22]))

Many global public goods (GPGs), including water security, are under-provided and increasingly so. According to Inge Kaul, the reason for this shortfall is that GPGs today suffer from a path dependency: dated theoretical thinking and policy practices. Current governance systems would not be suited to handle the complexity of GPGs. A revitalized multilateralism and contemporary approaches to enhanced GPG provision would be required (Kaul, 2022_[22]). A platform at all relevant levels of concerned state and non-state actors mandated to facilitate the coming together of the myriad of public and private inputs to water security and conservation of the hydrological cycle could be established (adapted from (Kaul, 2022_[22])). This networked platform could be structured and function like the mission-oriented policies and programmes described by Mariana Mazzucato (Mazzucato, 2018_[23]). In this context, one could, for example, look at the current "system" of MDBs, especially in terms of their complementarity in financing GPGs. Furthermore, Kaul argues for the creation of a tripod-shaped architecture of international cooperation finance. Today, the main strands of international cooperation – development assistance, GPG provision, and crisis response and stabilization - tend to be underfinanced. A tripod-shaped architecture for international cooperation finance would allow policymakers to differentiate between the three tracks, encourage mutually reinforcing links between them, and redefine what kind of money and tools are best suited to each type of contribution (Kaul, 2022_[22]).

Financing water: from market fixing to market shaping? (adapted from (IIPP, 2022_[9]))

According to the prevailing view of the role of governments in mobilising large-scale investments, states should employ 'market fixing' strategies to improve price discovery and should adopt a 'de-risking' role to correct price signals (IIPP, 2022_[9]). Some voices challenge this vision for several reasons:

- It assumes that water-related risks are measurable (and that their disclosures will impact financing decisions of private actors), whereas the physical and transition risks related to water are subject to radical uncertainty and complex non-linear dynamics that can hardly be reliably internalised in market prices (IIPP, 2022_[9]).
- In addition, de-risking often involves transferring risks from private investors towards public balance sheets while leaving financial returns fully privatised. Evidence shows that de-risked private investment can sometimes be riskier and more expensive for governments and/or users (IIPP, 2022_[9]).

Mobilising investment on the scale required for water would require a bolder approach: states could embrace their role as financial market shapers, beyond their role as market fixers (IIPP, 2022_[9]). With regards to private finance, this would involve creating a strong regulatory framework to direct private finance away from investments that increase vulnerability to water-related risks (which represents the bulk of private investments nowadays), including via allocative green policy regimes from central banks (IIPP, 2022_[9]). This would also entail:

- Rethinking the relationships and contracts between the public and private sectors to better align the sharing of risks and rewards. Where public entities bear risks to support public objectives, they should also be able to share the associated benefits. This can be done through mechanisms for sharing financial returns, for example by taking public equity stakes in water-related investments (adapted from (IIPP, 2022^[9])).
- Recognising that debt finance (public or private) is not systematically an appropriate substitute for direct fiscal spending. Strategic coordination between fiscal, monetary and industrial policies is thus needed on a large scale to make the required investments, and to ensure a fair sharing of costs and risks. Financial regulation and monetary policy also need to be aligned with this approach, to make sure that private finance meets the same objectives (IIPP, 2022^[9]).
- Supporting the review of the criteria of rating agencies to improve perception of risk globally. Leading rating agencies (which originated in the Global North) are likely to misperceive investment risk. This can lead to misallocation of capital, with, on the one hand, too much money financing projects that increase exposure and vulnerability to water risks; and, on the other hand, high cost of finance or low investors' confidence in countries from the Global South.

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