Benefits of ESG Compliance for Cost-Effective Finance Mobilization : Policy Implications for Developing Economies

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ABSTRACT

Despite the rapid expansion of global sustainable finance markets, developing economies continue to face persistent difficulties in accessing ESG-aligned capital under cost-effective conditions, and putting at jeopardy debt sustainability. This paper argues that this gap reflects a structural incompatibility between three objectives: the global availability of sustainable capital, the quality of financing required for long-term development, and limited domestic institutional and technical capacities. Building on the logic of Dani Rodrik's trilemma, the paper shows that while sustainable capital is increasingly abundant, access to high-quality financing remains constrained in capacity-limited environments. Drawing on empirical evidence, the paper demonstrates that ESG compliance, particularly in social and governance dimensions, reduces information asymmetries and sovereign risk premium, while simultaneously contributing to a selective allocation of sustainable capital in favor of ESG-ready jurisdictions. The findings highlight the dual role of ESG compliance as both enabler of financing quality and structural filter shaping global capital distribution.

Keywords : ESG, financing, compliance, mobilization, developing economies

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Introduction : The Paradox of Sustainable Finance Mobilization in Developing Economies

Over the past decade, global sustainable finance markets have significantly expanded with very promising estimations. According to Global Market Insights (2025), the global ESG market size accounted for nearly 6 trillion dollars in 2024 with projections estimated to over 35 trillion dollars in 2034 (inducing a 19,8% compound annual growth rate for the 2024 - 2034 period).

Yet, this growing availability of sustainable capital is not translated into proportional or optimal financing flows toward developing economies. This situation tends to be frequently attributed to unbankable project pipelines or weak investor appetite. However, such explanations fail to fully delineate the persistent mismatch between global capital availability and access to ESG financing for developing countries. This paper argues that the underlying challenge is structural and framed throughout the "Paradox of Sustainable Finance Mobilization".

The "Paradox of Sustainable Finance Mobilization" is an analogy referring to Dani Rodrik's analysis "How far will International Economic Integration will go?"[2]. In the context of this article, this Paradox refers to the mismatch between three (03) conditions (see figure 1) :

- availability of ESG finance ;
- institutional and technical readiness gap ; and
- quality of financing.

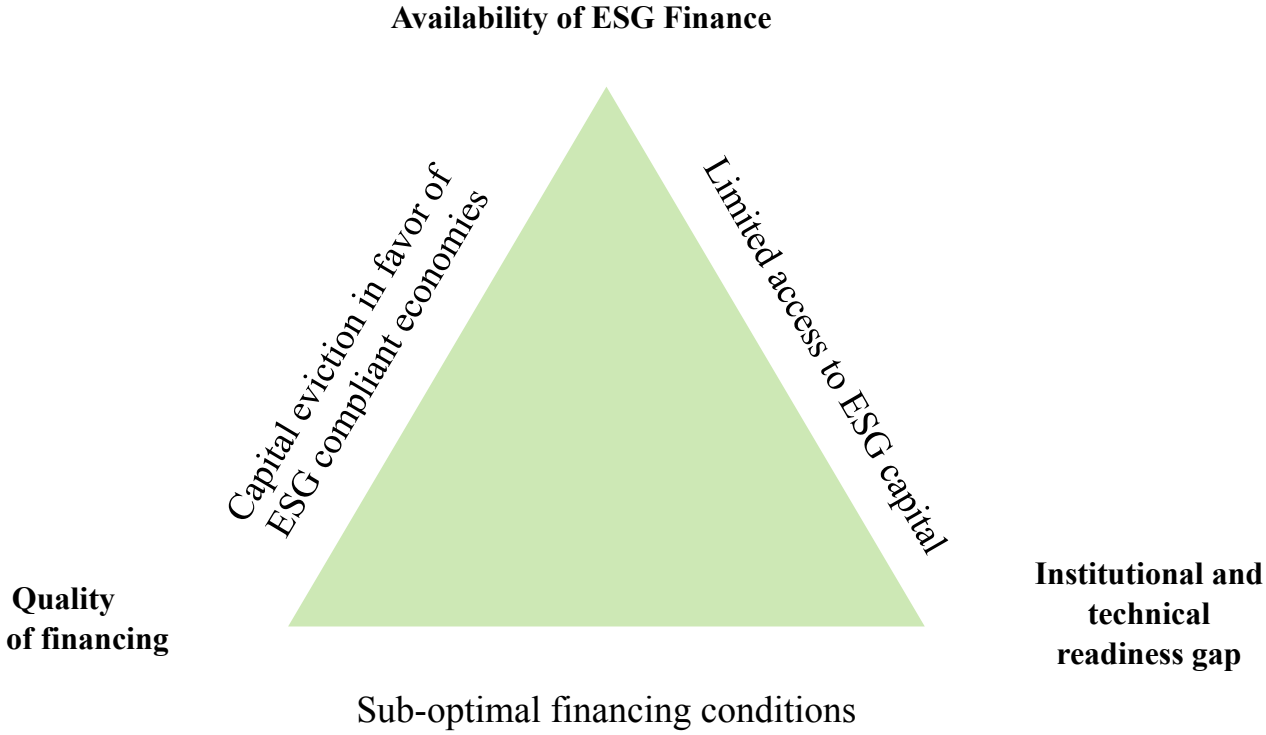
Availability of ESG finance echoes to the size of the global sustainable finance market. **Institutional and technical readiness gap** refer to the domestic institutional and technical capacities simultaneously needed but lacking to attract ESG finance, in a profitable fashion. **Quality of financing** unpacks the determinants of the cost of finance : positive credit sovereign ratings, interest rate, maturity, risk mitigation and ESG infrastructure[3].

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[2] In this analysis (2000), Rodrik indicates the impossibility for countries to achieve three (03) dimensions at the same time : full national sovereignty, democracy and hyper-globalization. States could combine only two of these features jointly.

[3] Includes implementation of green or sustainable taxonomies and ESG compliance

Figure 1. The "Paradox of Sustainable Finance Mobilization"



Sources : Author's analysis building Dani Rodrik Political Trilemma

The combination of each side of the triangle leads to three (03) specific situations described below :

- **Situation 1 :** Availability of ESG finance + Institutional and technical readiness gap = Limited access to ESG capital.
- **Situation 2 :** Institutional and technical readiness gap + Quality of financing = Non-optimal financing conditions
- **Situation 3 :** Quality of financing + Availability of ESG Finance = Capital eviction in favor of ESG-compliant jurisdictions

Situation 1 shows that despite the abundance of ESG capital (a 6 trillion dollars global market), access to financial resources is limited due to domestic institutional and technical unpreparedness. Institutional unpreparedness describes the lack of

coordination between stakeholders[4] regarding sustainable finance priorities (key sectors, trade-off on adaptation / mitigation investments decisions, fragmentation of the national mobilization process, etc.). Technical unpreparedness reflects restricted capacities in critical areas of expertise for effective resources mobilization. These skills-sets are complementary and mainly related to planification, macroeconomics, finance, legal affairs and ESG compliance. It is notably the case of several developing countries, including Senegal, which fail to attract ESG finance despite urgent needs for financing structural projects. According to UNCTAD (2025)[5], developing economies only host around 3% of global sustainable funds. Institutional coordination and technical expertise are essential to translating capital availability into high-quality financing outcomes.

Situation 2 highlights that institutional and technical readiness gap affects quality of financing by mobilizing capital in developing economies. For example, lack of exhaustive knowledge about ESG or climate finance sources, weak ESG standards alignment as well as poor contractual and negotiation skills deter the underlying driving factors of cost of capital. Implications of ESG compliance failure on the quality of finance are discussed in depth in section 2.

Situation 3 reflects the concentration of sustainable capital in ESG-compliant countries. Abundant sustainable capital is preferentially allocated to countries that have adopted ESG norms and beneficial market conditions (plus have strong governance and top-tier expertise needed to attract this sort of finance). As a result, sustainable finance flows concentrate where readiness is highest rather than where financing needs are most acute, leading to a selective and uneven deployment of ESG capital across regions. Our analysis attempted to display the regional distribution of ESG finance by beneficiaries but faced data limitations as most available database focus on capital issuance than allocation or regional distribution of climate finance. In this regard, a Climate Bond Initiative report (2025)[6] informs that Europe and Africa respectively accounted for 45% and 1% of global Green, Social and Sustainability (GSS) issuance in 2024. Figure 2 presents an overview of the global GSS market in 2024.

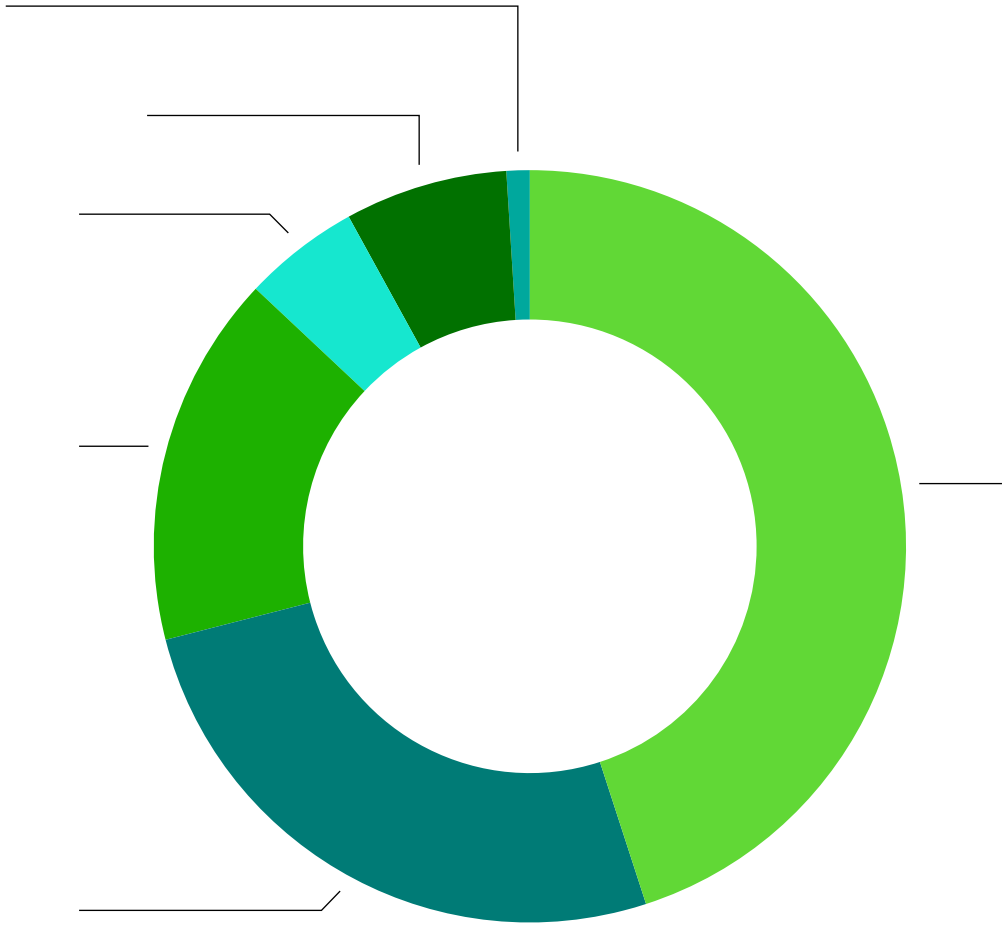
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[4] Ministerial departments, Development partners (bilateral and multilateral) and Private sector

[5] United Nations Conference for Trade and Development - 2025 World Investment Report

[6] Sustainable Debt - Global State of Market 2024

Figure 2. Global distribution of GSS-aligned capital issuance



Sources : Climate Bond Initiative, 2025

1. Why does ESG Compliance Matter for Effective Sustainable Finance Mobilization in Developing Economies

This chapter demonstrates how ESG considerations shapes investment decisions and main underlying components of cost of finance.

1.1 Adoption of ESG Standards reduces informational asymmetry

Compliance with ESG standards plays a critical role in reducing information asymmetries between issuers and investors. In addition, it contributes to reduce financing costs. By enhancing the transparency, consistency, and comparability of non-financial disclosures, ESG compliance mitigates investors' uncertainty regarding long-term risks related to governance quality, social stability, and environmental exposure. Improved disclosure frameworks allow investors to better assess issuers' risk profiles, reduce reliance on costly and lengthy due diligence, and limit adverse selection and moral hazard concerns. As information asymmetries decline, investors demand lower risk premium, which translates into lower spreads and more favorable financing terms. In this sense, ESG compliance functions not merely as a signaling device, but as a risk-reducing mechanism that strengthens market confidence, enhances credibility, and ultimately lowers the cost of capital, particularly in contexts where informational frictions are high.

1.2 ESG determinants influences sovereign borrowing costs in developing countries

This assumption is empirically tested by Avila-Yiptong et al. (2025), who analyze a panel of seventy nine (79) Emerging Market and Developing Economies (EMDEs), including Senegal, over the period 2001–2021. The study gives a particular attention to the role of ESG factors in sovereign risk pricing and yields two (02) major findings :

- **First**, overall ESG performance is linked with a statistically significant reduction of sovereign bond spreads for EMDEs, indicating that stronger ESG components lower perceived sovereign risk.
- **Second**, a disaggregated analysis reveals that the social ("S") and governance ("G") dimensions are the primary factors on risk perception. Weak social frameworks undermine investment perspectives through multiple channels including shortages of skilled labor. Governance quality, in particular, exerts a substantial impact on sovereign spreads through indicators such as regulatory quality, control of corruption, ability to design and implement reliable policies, as well as to ensure an attractive business environment. However, environmental factors are increasingly incorporated into investors' risk assessments. The study identifies a negative relationship between sovereign spreads and greenhouse gas (GHG) emissions, indicating that deteriorating environmental performance is associated with higher borrowing costs.

Box 1. Importance of Sovereign Spreads

"Sovereign spreads reflect the market's perception of a sovereign's risk, which depends on the country's ability and willingness to meet its debt obligations. Investors pay close attention to the sovereign's ability to generate resources through economic activity or fiscal policy, as well as its track record on payments. These perceptions are shaped by both global and domestic factors, which can be broadly categorized into macroeconomic and non-macroeconomic determinants".

Sources: Avila-Yiptong et al. (2025)

These results suggest that investors' pricing decisions are particularly sensitive to social and governance conditions, with EMDEs effectively paying a risk premium for underperformance in these dimensions. Consequently, sovereign borrowing costs are adversely affected by perceived risks related to social instability, weak human capital accumulation, persistent poverty, limited institutional capacity, and deficiencies in public administration.

1.3 Credit Rating Agencies (CRA's) consider ESG risks in their credit assessment

Major sovereign CRA's (Moody's, Fitch Ratings and Standard and Poor's) have embedded ESG considerations into their credit methodologies, treating ESG risks as material determinants of sovereign creditworthiness rather than peripheral or qualitative add-ons. According to the According to the World Bank, nearly thirty (30) common ESG risks are considered in investment decisions, with a focus on governance components accounting for over 39% of the overall risk distribution.

Moody's

Moody's sovereign ratings are anchored in four (04) pillars : economic strength, institutional strength, government fiscal strength, and susceptibility to event risk. These criteria are considered both directly and indirectly in Moody's determination of credit assessment. Moody's evaluates several ESG indicators and establishes their relevance through quantitative correlation analysis with sovereign ratings and the pillars cited below. ESG indicators displaying strong statistical relationships with these factors are embedded in sovereign rating, while those with weaker correlations are incorporated indirectly or excluded. This approach ensures that ESG risks are reflected in ratings, only to the extent that they are credit-relevant.

Fitch Ratings

Fitch operationalizes ESG integration through a dedicated ESG Relevance Score, which assesses the credit materiality of 15 ESG-related risk elements across sustainability dimensions on a scale from 1 (irrelevant) to 5 (key rating driver). "The risk elements are equally split among environmental, social, and governance categories. The score does not evaluate whether a sovereign has positive or negative ESG practices but simply the impact of these practices on its credit rating".

Standard and Poor's (S&P's)

Five (05) components are taken into account in S&P's methodology : institutional, economic, external, fiscal, and monetary. The institutional dimension covers governance topics (policy predictability, crisis management capacity, perceived corruption, rule of law, institutional checks and balances, central bank independence, and statistical integrity). Social factors are also incorporated in institutional the assessment. "Environmental factors may pose more limited risks to sovereign creditwor-

thiness, but they can still impact the economic assessment for countries where the economic activity is vulnerable to constant exposure to natural disasters or adverse weather conditions. ESG-related risks may also trigger supplemental rating adjustments, particularly under event risk scenarios involving social unrest, institutional breakdown, or severe environmental shocks.

Across all three major agencies, ESG factors—particularly governance and social conditions—are treated as structural drivers of sovereign risk, shaping ratings through multiple analytical channels including institutional strength, growth prospects, fiscal resilience, and event risk. In addition to credit ratings, international financial markets have developed sophisticated frameworks to capture implications of ESG factors on and risk assessment. These initiatives rely on datasets and standardized ESG indicators, enabling the systematic integration of ESG dimensions into financial decisions (J.P Morgan Emerging Market Bond Index Global - EMBIG, Thomson Reuters ESG metrics, etc.).

2. Policy Implications to Attract Cost-Effective ESG Finance in Developing Economies

This sections aims at suggesting few guidelines to governments, development partners, regulators and private sector actors, in order to achieve ESG finance mobilization at profitable terms.

2.1 Governments

Governments should prioritize institutional coordination and capacity development as prerequisites for engaging effectively with ESG Investors. Institutional alignment covers an harmonious decision making framework between key ministries (economy, finance, environment, energy, etc.), development partners and private sector actors. It embeds also the creation of climate or sustainable finance units, contributing to develop a domestic expertise required for improving quality of finance. Capacity building could cover every activity related to the creation of an ESG infrastructure : green or sustainable taxonomy, adoption of ESG norms, awareness on sustainable finance sources, etc.

2.2 Bilateral and Multilateral Institutions

It is recommended for development partners to play a catalytic role by supporting capacity-building efforts (in particular for adapting ESG norms to regional / domestic contexts and reporting), diversifying financial sources and expanding investor base.

2.3 Regulators

Standard setting bodies should aim to enhance the coherence and usability of ESG standards, reducing fragmentation and facilitating implementation in capacity-constrained environments. The development of regional ESG norms and their interoperability would support the representation of developing economies in global ESG finance dynamics.

2.4 Private Sector Actors

Investors are encouraged to engage early with stakeholders on ESG disclosure and project structuring to reduce information asymmetries. Financial intermediaries should support the development of local ESG data and reporting systems to lower transaction costs. Together, these actions can enhance financing quality while broadening access to sustainable capital in developing economies.

Conclusion

This paper shows that the paradox of sustainable finance mobilization in developing economies is not driven by capital scarcity, but by a structural incompatibility between capital abundance, financing quality, and domestic capacity constraints. This analysis highlights how ESG determinants simultaneously enhances financing conditions and reshapes global capital allocation in favor of ESG-ready jurisdictions. Prioritizing sustainable finance strategies on financing quality and capacity alignment is therefore essential to ensure that ESG-driven capital flows effectively support long-term development objectives in developing economies.

Declaration non conflict of interest of competing interest

The author declares that she has not benefited from any financial interests or personal relationships that could have appeared to influence the work reported in this paper.

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