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Policy Brief

SUPPORTING ENERGY TRANSITIONS AND COVID-19 RECOVERY: THE ROLE OF INTERNATIONAL FINANCIAL INSTITUTIONS

Task Force 7

International Finance and Economic Recovery

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Abstract

The need to recover from the COVID-19 pandemic has given developing countries the opportunity to embark on an energy transition that supports green growth while rebuilding and reenergising their economies. However, the divergent paces of economic recovery between advanced economies and developing countries are creating a challenging macroeconomic situation. In particular, interest rate hikes may constrain developing countries' ability to access low-cost financing. In this context, the role of multilateral development banks (MDB) is particularly salient.

The Group of 20 (G20) has initiated an important discussion on the capital adequacy framework of MDBs. This discussion needs to be grounded in the need for MDBs to not just live up to their existing commitments to aligning their portfolios with their climate targets, but they must also have the financial headroom to support stepped-up climate action in a manner that is compatible with the goal to limit global warming to below 2 degrees Celsius, with best efforts to limit at 1.5 degrees.

Apart from increasing the scale of finance deployed through MDBs, there also has to be a focus on removing the financial and nonfinancial barriers to transitioning to a low-carbon economy. MDBs will need to proactively help host countries create the optimal policy environments needed to scale up climate investments. Over the longer term, MDBs must also help developing countries identify and capture the benefits of a transition to a low-carbon economy.

Challenge

While the international community has converged on the need to limit global warming to below 2 degrees Celsius while making best efforts to limit warming to 1.5 degrees, countries have yet to put in place policies that will yield the necessary reductions in greenhouse gas (GHG) emissions. Green finance, a key enabler of climate action, continues to be undersupplied.

Previous studies suggest that developing countries will need to spend 2 percent of their gross domestic product (GDP) by 2030 to transition to a clean, energy-based economy. While multilateral development banks (MDB) have been the largest providers of climate finance as a group, their role can be significantly expanded to match the challenge at hand. This need for increased ambition rests on top of the commitments that they have already made to aligning their portfolios with the goals of the Paris Agreement on climate change.

The role of MDBs in fostering a green energy transition is all the more salient given the severe macroeconomic headwinds developing countries are facing. The drawn-out COVID-19 pandemic has exacerbated indebtedness. Many countries face precarious fiscal situations. Solutions offered at the global level — such as the Common Framework for restructuring debts — have not had the desired impact. Similarly, interest rate hikes by advanced economies are likely to have spillover effects on emerging market economies. While many developed economies have exercised monetary and fiscal policy options to help economic recovery, most developing countries do not have the fiscal headroom to implement such policies. As a result, many countries are finding themselves fiscally constrained precisely when the need to accelerate investments is critical.

MDBs have a major opportunity to increase their spending to support the energy transition in developing countries. In this brief, we argue that MDBs can do so through the following. First, shareholders need to enable MDBs to lend greater volumes through capital injections. Even without new injections, shareholders can also encourage MDBs to take on greater risks to increase their investment portfolios. This could even be achieved by lowering the credit rating that MDBs seek to maintain. Second, MDBs need to institute governance changes so that internal incentives are well aligned with their commitments to green lending and increasing the scale of assistance available to developing countries. Third, within the context of energy finance, MDBs also need to target their policy advice directly toward tackling barriers to stepping up utility-scale clean energy and integrating clean energy into the grid. Finally, MDBs must also provide policy advice on how their clients can integrate into the global supply chain and create value-adding industries.

What changes are needed to enable MDBs to scale up energy finance in a significant manner? This brief focuses on the capital base of multilateral development banks, the need to focus on financial and nonfinancial barriers to scaling up renewable energy and the importance of maximising value addition through a focus on clean energy value chains.

Proposal

Group of 20 (G20) members have an important role in governing multilateral development banks. The G20 has a unique opportunity to help MDBs tackle the challenges created by climate change and help member states shift to sustainable development pathways. With the capital adequacy frameworks of MDBs on the G20 agenda this year, G20 members should take concrete steps to bolster the balance sheets of MDBs.

INCREASING THE CAPITAL BASE

MDBs have taken on commitments to increasing the share of their lending that is geared toward climate change. For example, the World Bank Group has committed to fully aligning its portfolio with the Paris Agreement goals by 2025.[1] MDBs have also instituted policies that limit financing to coal and move increasingly away from natural gas.[2] The commitment to changing the composition of finance is a major step forward; however, it is not enough.

The reality, however, is that MDBs are not mobilising enough money in light of what is needed to keep warming to around 1.5 degrees. There has to be an increase in the total volume of investments made by MDBs. As a part of the International Bank of Reconstruction and Development's (IBRD) capital increase, the World Bank has committed to increasing climate change lending from 21 to 30 percent. Climate change in the International Finance Corporation's (IFC) share is also expected to increase to 35 percent through this capital increase.

The United Nations Independent Group on Climate Finance (IGCF) has also called for a capital increase to support climate change investments.[3] The IGCF has called for a climate-focused capital increase that builds on the 2018 capital increase of the World Bank. Estimates suggest that a US$32 billion capital increase would allow the IBRD and IFC to supply $100 billion in extra climate-focused lending through 2030.[4]

Given that the existing commitment of developed countries to mobilising $100 billion has not yet been met, there is a need to identify how climate finance can be scaled up in the most efficient manner as soon as possible. Analytical work shows that MDB financing can be attractive to high-emitting developing countries that face a higher cost of capital in the international markets compared to MDB rates.[5]

Apart from increasing paid-in capital, MDBs must also use the financial headroom that they already have to increase their lending. The Addis Ababa Action Agenda called on MDBs to " make optimal use of their resources and balance sheets". Existing research shows how the methodology used by credit rating agencies to evaluate the financial soundness of MDBs has led to a chilling effect whereby MDBs reduce their financial exposure more than needed. One of the reasons is that MDBs are prone to pro-cyclical lending. Given the imperative to rebuild from the COVID-19 pandemic in a climate-resilient and clean manner, the need for MDBs to lend counter-cyclically is all the more salient. Increasing paid-in capital will help to relieve some of this pressure because MDBs will have more equity to support greater investments. However, even more lending could be untapped if MDBs made greater use of the financial headroom that they actually already have.

G20 members need to use their engagement with MDBs to increase paid-in capital to allow MDBs to increase the total size of their lending, use their voice on the boards of MDBs to make use of the headroom the banks have to increase lending, as well as mandate the MDBs to explore a wider range of instruments that accelerate the deployment of finance while preserving host country ownership. The G20 can send a clear signal to MDBs about their willingness to increase capitalisation and support them as they make use of the financial headroom they already have.

The G20 commissioned a review of the capital adequacy framework of multilateral development banks in 2021. MDBs have taken steps to align their portfolios with low-carbon pathways. The capital expenditure entailed by such a shift needs attention. Along with capital adequacy frameworks, the G20 can play an important role in improving the accountability of MDBs on the goals that they have set. The G20 can also help improve the operational barriers that exist within MDBs that may be constraining scaled-up action on climate change.

MULTILATERAL DEVELOPMENT BANKS SHOULD FOCUS ON FINANCIAL AND NONFINANCIAL BARRIERS TO SCALING UP CLEAN ENERGY.

Strengthening host country policies and regulatory environments is critical. The Independent Expert Group on Climate Finance has called on developing countries to "transform their development pathways and create enabling conditions for both public and private finance to invest consistently in sustainable, inclusive, resilient and transformational infrastructure and socio-economic growth [...]" (Bhattacharya et al. 2020, page 9).[6]

MDBs have to pay closer attention to the barriers standing in the way of mobilis ing finance for renewable energy and energy storage. Multilateral development banks will have to incorporate barrier analyses into their work to help host countries expand their clean energy portfolios. Barrier analyses will also include the hurdles standing in the way of MDBs supporting a phase down of coal.

A focus on financial barriers alone is not sufficient. MDBs and host countries also need to pay due attention to regulatory and governance barriers that may be impeding the scaling up of clean energy. Research examining host country policies indicates that policies that reduce the demand for renewable energy constrain their deployment (Gallagher et al. 2021). While project documents for climate finance often identify the presence of regulatory and policy barriers, there has to be concerted effort to remove them. Removing nonfinancial barriers is where MDBs can also play a significant role in the context of major developing countries. MDB support could be tailored toward helping countries tackle those barriers through instruments such as policy-based lending.[7] A focus on nonfinancial barriers calls for more attention to a larger set of instruments that MDBs should use to deploy clean energy.

Given the imperative of scaling up renewable energy and climate resilience as quickly as possible, MDBs cannot wait for optimal institutional conditions in host countries. In other words, MDBs will need to proactively help facilitate the institutional conditions required for a shift to climate resilient, low-carbon pathways. In this regard, MDBs should also engage in three sets of activities in the short and medium terms. First, MDBs need to actively work with governments, the private sector and related stakeholders to create a pipeline of bankable projects. This involves providing technical advisory functions and project preparation support. Second, MDBs should identify areas and sectors where first-mover activities by MDBs would open up space for a broader range of actors. More specifically, MDBs should build greater risk appetite and focus on long-tenor instruments to increase engagement by other actors. Third, MDBs should help countries exchange good practices so that lessons can be shared and learned across developing countries.

CLEAN ENERGY VALUE CHAINS

Many countries have aspirations to capitalise on the shift to a clean energy economy. Therefore, development finance institutions (DFI) and MDBs will need to support countries to enable them to be a part of the value chain.

Most of the major developing countries have committed to achieving net-zero emissions by around mid-century. The fiscal ramifications of the energy transition that net-zero implies will be immense. In particular, many developing countries have long relied on fossil fuels as a source of revenue, either directly or through taxes. As fossil fuel production and use get scaled down, governments will lose a vital source of revenue precisely at a time when they need to be scaling up investments to meet the investment needs entailed by the shift to a climate resilient, low-carbon economy.

The shift to a low- carbon economy also implies the need for governments to capitalise on the growth opportunities created by the new economy. Many countries have a vision of green growth that does not simply involve importing renewable energy technologies from other places. They also want to participate in the clean energy value chain and move up the ladder of value creation and addition. MDBs need to be attuned to these demands and help these countries devise plans and programmes accordingly.

The G20 has an important opportunity to increase the capital base of multilateral development banks. Countries should also explore opportunities to increase the capital base of national DFIs. MDBs face increased capital requirements, not just to implement their climate plans but also to help support the global transition to net-zero by mid-century. The G20 needs help facilitating this process by paying attention to capital allocations within MDBs for clean energy.

Conclusion

MDBs have taken on commitments to align their portfolios with the goals of the Paris Agreement. Mainstreaming climate change into the lending operation of MDBs is critical. However, this is not enough. G20 members need to play an active role in increasing the paid-in capital of MDBs so that the latter can scale up their lending. G20 members must also work to remove the barriers that stand in the way of accelerating the deployment of clean energy. MDBs should provide the necessary policy advice to help governments formulate appropriate policies and measures. Finally, MDBs should also work closely with governments to harness the benefits of the energy transition by helping countries embed themselves in clean energy value chains, among other strategies.

References

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