



# INVESTING IN A GREEN RECOVERY

The pandemic is only a prelude to a looming climate crisis

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**T**his crisis is a rupture. A moment of profound turmoil and disruption. Even more than the 2008–09 global financial crisis—which was most directly felt in the United States and in European countries—this pandemic is affecting almost all of humanity. In countries around the world, rich and poor, the COVID-19 crisis has exposed the vulnerabilities of our health and social systems and the fragility of our economies. It has also highlighted in dramatic ways the need for better disaster preparation. Increasing resilience needs to be one of the main guiding principles when rebuilding our economies and societies after the crisis. We need to ensure we are better prepared to withstand future pandemics but also the other major looming threat to humanity—climate change.

Despite long-standing and plentiful warnings from scientists about the risks of a pandemic, the world was woefully unprepared for this crisis. The same is unfortunately true for climate change.

As was the case with pandemics, scientists have long been sounding the alarm about a climate crisis. There can be no doubt that it is here and accelerating. Recent wildfires in Australia and California, the thaw of permafrost in the Arctic, and the increase in the number and intensity of storms, floods, droughts, and other climate-related natural disasters all point to a problem that has already arrived. The earth will soon exceed climate tipping points, presenting a real threat of abrupt and irreversible climate changes.

This pandemic strikes us at a time when—according to the Intergovernmental Panel on Climate Change—we have about a decade left to achieve a low-carbon transition and bring the world economy to a trajectory limiting global warming to 1.5°C above preindustrial levels. The next few years are our last chance to avoid catastrophic global warming. It is imperative that the various crisis response measures amount to a transformative policy response. Short-term crisis responses aimed at protecting jobs



and boosting recovery need to be coupled with longer-term, strategic goals of mitigating climate change and shoring up climate change adaptation and resilience. As much as possible, we need to use economic stimulus and recovery measures to strengthen the resilience of our economies and engineer a just transition. As IMF Managing Director Kristalina Georgieva has said, this is the time to “revive or lose” the Paris Agreement.

### **Enabling sustainable investment**

There is no trade-off between choosing a sustainable recovery and economic progress. Many green technologies have matured, and low-carbon energy is, in most cases, cheaper now than fossil-fuel-based energy. Recent evidence suggests that well-designed green projects can generate more employment and deliver higher short-term returns per dollar spent, compared with conventional fiscal stimulus. Moreover, today’s investment in climate change mitigation and adaptation generates substantial

long-term returns and cost savings, whereas the cost of inaction or late action on climate change is high. Steps taken now to mitigate climate change represent an investment that will generate dividends into the future, while continued inaction will give way to disastrous global warming and much greater costs down the line. Likewise, failing to invest in making our economies and societies more climate resilient undermines our future growth and well-being. The Global Commission on Adaptation calculated that every dollar invested in building climate resilience could result in between \$2 and \$10 in net economic benefits.

There is, however, a major problem: Many countries lack the means to finance a recovery and undertake critically needed investments in climate adaptation and mitigation. The COVID-19 crisis has dramatically worsened public finances, which in many countries were already shaky in the run-up to the current crisis. The IMF projects global public debt to increase to more than 100

# THE COVID-19 PANDEMIC HAS SHOWN HOW QUICKLY A NATURAL DISASTER CAN BRING OUR ECONOMIES TO COLLAPSE.

percent of GDP this year, up 19 percentage points year over year. Going forward, many countries will require debt relief to respond effectively to the crisis and undertake meaningful investment to climate-proof their economies. For now, the international financial architecture still lacks an adequate system for addressing situations where sovereign debt becomes unsustainable. Ways need to be found to systematically deal with the coming debt crisis in developing economies.

Moreover, in the face of stretched public finances, it is crucial to align all public expenditures as well as the tax system with the climate goals. Importantly, this should include the phasing out of all fossil fuel subsidies. According to IMF estimates, global fossil fuel subsidies amounted to \$5.2 trillion, or 6.5 percent of world GDP, in 2017. Putting an end to these would not only deliver significant public savings, but also lower emissions. Furthermore, as shown in the IMF's October 2019 *Fiscal Monitor*, meaningful carbon taxes—the IMF suggests \$75 per ton of CO<sub>2</sub>—are a powerful tool to reduce carbon emissions and generate additional environmental benefits, including lower mortality from air pollution. Carbon tax revenues could be redistributed to support low-income households or communities that are hit particularly hard by the transition to a low-carbon economy or the physical effects of climate change. The currently relatively low level of oil prices would provide a good opportunity to levy or increase carbon taxes at a reduced political cost.

## Aligning finance

Beyond fiscal policy, it will be imperative to align finance flows with a pathway toward low greenhouse gas emissions and climate-resilient development, as stipulated in Article 2.1c of the Paris Agreement. To this end, monetary and financial authorities need to fully integrate climate risks into their prudential and monetary frameworks. Over the past couple of years, a growing number of central banks and financial supervisors have recognized that climate change represents a material risk for individual financial institutions and systemic financial stability. The Network of Central Banks

and Supervisors for Greening the Financial System (NGFS) was established in December 2017 by eight central banks and supervisors and has grown to a membership of 66 central banks and supervisors. In a number of reports, the NGFS highlighted the macroeconomic and financial stability impacts of climate change. It is important that monetary and financial authorities move ahead swiftly in implementing a comprehensive framework for addressing climate-related risks. Such a framework should make the disclosure of climate and other sustainability risks mandatory across the financial sector to help with better risk analysis; require financial institutions to conduct regular climate stress testing that considers multiple transition scenarios; and integrate climate-related financial risks into prudential supervision.

Importantly, central banks and supervisors should also align their current crisis responses to avoid locking in a high-carbon recovery while fulfilling their mandates for financial stability (Dikau, Robins, and Volz 2020). Liquidity-enhancing stimulus measures that are not Paris-aligned can contribute significantly to the buildup of climate-related risks in portfolios of financial institutions and overall in the financial system. Moreover, easing countercyclical and other prudential instruments without considering climate risk can further increase these risks. The implementation of prudential instruments that account for climate risks should therefore not be delayed, but rather strengthened to minimize the potential buildup of additional risks in portfolios.

## Supporting vulnerable countries

International financial institutions, many of which have become observers of the NGFS, have a special role to play in helping member countries align their financial systems with sustainability goals. That includes supporting capacity building and leading by example in developing best practices for integrating climate risks in all aspects of their own operations. For multilateral development banks, this also means aligning their own portfolios with the Paris Agreement and completely phasing out any high-carbon lending and investments. In the

current crisis situation, multilateral development banks as well as national development banks can also assume an important role by providing countercyclical lending that at the same time supports economic activity and employment in the short term, while contributing to the transition to a more sustainable low-carbon economy.

International financial institutions should also ramp up support to climate-vulnerable countries. The sad truth is that the impact of climate change is the greatest in countries that contributed the least to global warming caused by human industry and agriculture. A rapid scaling up of investment in climate resilience is a matter of life and death for these countries. Unfortunately, climate-vulnerable developing economies are those struggling the most to finance adaptation and resilience. These economies are particularly exposed to climate-related financial risks, and both governments and firms are already facing a climate risk premium on the cost of capital (Kling and others 2020; Beirne, Renzhi, and Volz 2020). There is a real danger that climate-vulnerable developing economies will enter a vicious circle in which greater climate vulnerability raises the cost of debt and diminishes fiscal space for investment in climate resilience.

The financial risk of climate-vulnerable countries is already high and is likely to increase further as financial markets increasingly price climate risks and global warming accelerates (Buhr and others 2018). International support for increased funding in climate resilience and mechanisms to transfer financial risks is urgently needed and could help these countries to enter a virtuous circle. Greater resilience funding could reduce both vulnerability and the cost of debt, providing these countries with extra room to scale up investments to tackle the climate challenge.

The IMF and multilateral development banks will also need to develop new instruments, including extended emergency facilities, to support climate-vulnerable developing economies when they are hit by disasters. Over the past two decades, about 20 countries—most of them small island nations—suffered losses amounting to more than 10 percent of their GDP. The most extreme case is Dominica, where Hurricane Maria caused estimated damage in 2017 equaling 260 percent of GDP. In 2004, Hurricane Ivan wiped out about 150 percent of Grenada's GDP. But even in less extreme cases, disasters can wreak havoc on public finances and

make sovereign debt unsustainable. We urgently need a discussion around the treatment of climate debt; that is, public debt incurred as a direct result of climate disasters or necessary adaptation measures.

### Avoiding permanent crisis mode

The COVID-19 pandemic has shown how quickly a natural disaster can bring our economies to collapse. Climate-vulnerable countries have been living with this risk for a long time already. If we don't act now and make a concerted effort to significantly strengthen investment to mitigate and adapt to climate change, many more countries will find themselves in permanent crisis mode. The few countries fortunate enough to be spared will not be able to shield themselves from problems elsewhere. Just as the COVID-19 virus has spread across borders, the impacts of climate change will be felt across the world, not least through an increase in migration in the context of disasters and climate change.

The stakes are high. We have a decade to transform our economies and avoid catastrophic global warming. Collective efforts at all levels—locally, nationally, and internationally—and across all sectors—public and private—are needed to tackle climate change and build more resilient societies and economies. The challenges are enormous. But this crisis also provides an opportunity to rethink our economies and societies. As the IMF's Georgieva rightly said, it is upon us to “choose what kind of recovery we want.” We'd better choose wisely. **FD**

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