Creating a Resilience and Sustainability Trust (RST) at the IMF: How to Support Climate-vulnerable Countries

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Policy Note by IIED and SOAS to support the V20

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Executive Summary

This policy note by IIED and SOAS discusses the rationale for the establishment of an Resilience and Sustainability Trust (RST) at the International Monetary Fund (IMF) and sets out how it could be designed to best support climate-vulnerable member countries to build resilience and lay the foundations for sustainable development. This policy note was prepared for the V20 at its Senior Officials meeting on 27th-28th September. Following the meeting, the V20 supported this policy note to inform a statement on the RST.

The main recommendations for the establishment of an RST are:

- **Rationale**: The proposed RST is in line with the V20’s demand in its July 2021 Communiqué that climate vulnerable countries be given a greater share in Special Drawing Rights (SDRs) allocations. There is a strong rationale that the proposed RST be focused on enhancing macro-financial resilience to climate change, a goal that is at the core of the Fund’s mandate.

- **Value addition**: Compared to the World Bank and Green Climate Fund (GCF), which tend to be project financiers, the RST can support climate vulnerable countries by linking economic policies with climate vulnerability. Through the RST, the IMF could play an important role in supporting climate vulnerable countries in reducing and managing macro-financial risks stemming from the physical and transition impacts of climate change, leveraging opportunities from climate policies to boost growth, investment and resilience.

- **Size**: With a possible volume of $100 billion and over, the RST is a starting point for the IMF to support the V20’s Climate Prosperity Recovery Agenda which calls for special support for climate vulnerable developing countries in order to build a resilient economic system and to fill resource gaps to deal with non-financial shocks.

- **Criteria for country selection**: Transparent criteria for eligibility need to be applied. The RST should be eligible to low-income and middle-income countries facing high physical or transition risks.

- **Country policy support**: The RST is consistent with the V20’s call made at the July 2021 Summit for “optimizing core economic and climate responses together.”

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1. Objective of this Policy Note

The IMF is currently exploring options for channelling newly issued Special Drawing Rights (SDRs) to countries in need through the creation of a new trust fund, the Resilience and Sustainability Trust (RST). This Trust would aim to support resilient and sustainable growth in the post-pandemic period, including resilience to climate change. It could lend at cheaper rates and longer maturities compared to current IMF lending to provide fiscal space for green reforms and policies. This policy note was prepared for and endorsed by the V20 to inform the IMF how the RST can maximise climate action.

2. Resilience and Sustainability Trust: IMF considerations

The IMF is currently considering options for channelling SDRs and the creation of the RST. Indicative thinking by the IMF is that vulnerability has many criteria, with the COVID-19 pandemic still a priority in many countries. However, climate vulnerability is likely to feature strongly in the RST and cover both low-income and middle-income countries exposed to climate risks.

The RST will need to demonstrate “additionality” to the IMF’s existing lending toolkit and not crowd out its current lending. Moreover, the RST should complement financing by the World Bank, which has traditionally been the largest climate financer among the international financial institutions. A close collaboration with the World Bank on climate and a coherent strategy among international financial institutions is considered important.

The IMF envisages that conditionality would be linked to the RST to preserve the reserve asset characteristics of the SDR. This has been highlighted as important by the G20 earlier this year. Thus, it is envisaged that the RST would focus on policy and structural reforms around climate action with a series of “policy criteria” to receive RST funding.

3. Rationale for the RST

Whilst accepting the urgent need for financing for health and vaccines, there is a strong rationale that the proposed RST be focused on enhancing macro-financial resilience to climate change, a goal that is at the core of the Fund’s mandate. Climate vulnerable countries face considerable macro-financial risks stemming from climate change that threaten debt sustainability, worsen sovereign risk, and harm investment and development prospects. The Fund’s current toolkit does not have the instruments to sufficiently support its climate vulnerable membership.

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The V20 Communique from the July 2021 Summit demands: “The need for a fit-for-purpose initiative of Bretton Woods system to tackle the global market failure of the climate crisis, while adding vitality to a just and sustainable recovery including to deliver on the promise of a new, resilient economy, such as through the proposed V20 Climate Prosperity Recovery Agenda that we call on the IMF to support, especially with the upcoming special drawing rights allocation for the poorest and most climate vulnerable countries to be given greater allocations” (our emphasis).6

This demand was further supported by the G20 Finance Ministers in their Communique a few days later when they called on the IMF to “to quickly present actionable options for countries to voluntarily channel a share of their allocated SDRs to help vulnerable countries finance more resilient, inclusive and sustainable economic recoveries and health-related expenditures, for example through the creation of a new trust fund”.7

4. Value addition of the RST

The main value addition of the RST vis-à-vis World Bank spending on climate and the remainder of the climate finance architecture, including the Green Climate Fund (GCF), is that the World Bank and GCF tend to be project-related, whilst the IMF can support climate vulnerable countries with policy and structural reforms linked to other IMF roles on fiscal and monetary policy.

In particular, the RST could add real value by helping the IMF’s climate vulnerable member countries in climate-proofing their public finances and enhancing the resilience of their economies.8 Through the RST, the IMF could play an important role in supporting climate vulnerable countries in mitigating and managing macro-financial risks stemming from the physical and transition impacts of climate change, leveraging opportunities from climate policies to boost growth, investment and resilience. Such an approach would be in line with the IMF’s Climate Strategy, which was published in July 2021 and which highlighted that “[a]daptation and resilience building are potentially relevant for a large portion of the IMF’s membership.”9

Access to the RST could be linked to comprehensive sectoral and national vulnerability assessments to identify climate-related sovereign risk and support the development of national adaptation plans.10 Countries could receive targeted support to mainstream climate risk analysis into public financial management (including appropriate disclosure, analysis, and management of climate risks to public finances), and in enhancing public sector funding and debt management strategies, including through debt instruments with risk-sharing

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8 A non-representative survey among finance ministries and central banks of V20 countries conducted in summer 2020 indicated the desire among the V20 membership for more support from the IMF in addressing climate risks and vulnerabilities. See Ulrich Volz and Sara Jane Ahmed (2020), op. cit.
10 See Volz et al. (2020), op. cit.
features and linked to climate outcomes, and diversification of government revenue streams away from high-risk sectors.

5. **Size of the RST**

There remains uncertainty on countries’ interest in channelling their SDRs, operational modalities, as well as the magnitude of any channelling to the RST. The IMF Managing Director has referred to a possible size of the RST of US$50 billion, but this should be larger given the identified adaptation financing gap. Annual adaptation costs in developing countries are expected to reach US$140-300 billion a year by 2030 and US$280-500 billion a year by 2050. But these are estimates devised before the latest IPCC report came out on the acceleration of climate change this decade, indicating that costs are likely to be much higher.

This RST size and its proposed focus on adaptation is consistent with the V20 Summit July 2021 Communique which explicitly calls for parties to meet and go beyond the annual US$100 billion climate finance goal, and with the V20 Vision 2025, which states the aim to “leverage trillions of new investments”. In its 2021 Communique, the V20 also request that countries ensure a “50:50 balance between adaptation and mitigation” and urged the IMF and other IFIs to jointly assess gaps and failures in international finance and to propose practical solutions, taking into consideration debt sustainability.

6. **Eligibility criteria for the RST**

The IMF will need to define the qualification criteria for the RST. In its Climate Strategy published in July 2021, the IMF referred to an IMF Policy Paper from 2019 that identified 64 climate-vulnerable countries based on three criteria, including cumulative damage from natural disasters that each caused damage of at least 5 percent of GDP, classification as small states at extreme or high risk of experiencing natural disasters, and disaster vulnerability (Table 1). As noted in the IMF’s Climate Strategy, this list of climate vulnerable countries is likely to increase over time.

The 64 countries on the IMF list comprise 31 V20 member countries, out of a total of 48 V20 member countries. The fact that the IMF list excludes several highly vulnerable small island developing states as well as a larger number of developing countries which face substantial climate risks suggests that criteria for eligibility need to be broadened. Transparent criteria for eligibility need to be applied, taking into account also transition risks. The RST should be eligible to low-income and middle-income countries facing high physical or transition risks.

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The 2021 IMF Climate Strategy concludes that “adaptation to climate change requires strategies to build both physical resilience – i.e., climate resilient infrastructure – and financial resilience – safeguarding the financial capacity to deal with disasters and to build resilience – with the latter firmly in the realm of the IMF’s mandate. It can also include challenges to financial and monetary policies, for example dealing with a higher frequency and amplitude of supply-side shocks and with changes in relative prices triggered by climate change.”

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These IMF objectives if taken as goals for the RST would be consistent with the V20 July 2021 Summit conclusion that: “Our goal is to improve our key socio-economic growth outcomes – national and disposable income, poverty reduction, investment, jobs, economic stability, trade balance, and other critical socio-economic results – by optimizing core economic and climate responses together.” As a group of Finance Ministers, the V20 understands the need for economic policy and public financial management to be “climate proofed”. The RST can support this process by facilitating fiscal and monetary policy to be climate resilient.

The RST could facilitate the V20’s aim to “optimize core economic and climate responses together” through support for member country policies in the following areas:

**Climate proofing expenditure policy**

- Tag climate related expenditure within the budget and set targets for increasing climate related expenditure as a share of the public budget
- Ensure that climate related expenditure in the budget is consistent with National Climate Strategies, Nationally Determined Contributions (NDCs) under the UNFCCC and Climate Prosperity Plans under the V20
- Increase spending on climate related disaster risk reduction to reduce need for such significant spend on post disaster responses
- Create a disaster risk financing facility and ensure it is safeguarded within the budget
- Enhance monitoring of climate financing, e.g. by tracking climate finance reaching the local level (i.e. local government, small and medium scale enterprises, and community-based organisations), and set targets for a majority of climate finance to reach this local level

**Enhancing public sector funding and debt management strategies**

- Diversification of government revenue streams away from high-risk sectors
- Use of debt instruments with risk-sharing features and linked to sustainability outcomes

**Adjusting monetary and prudential frameworks for climate risks**

- Incorporation of climate-related risks in monetary frameworks and operations
- Mainstreaming of climate-related financial risks into macro and micro prudential supervision
- Development of disclosure frameworks for climate and other sustainability risks
- Development of climate stress tests of financial institutions