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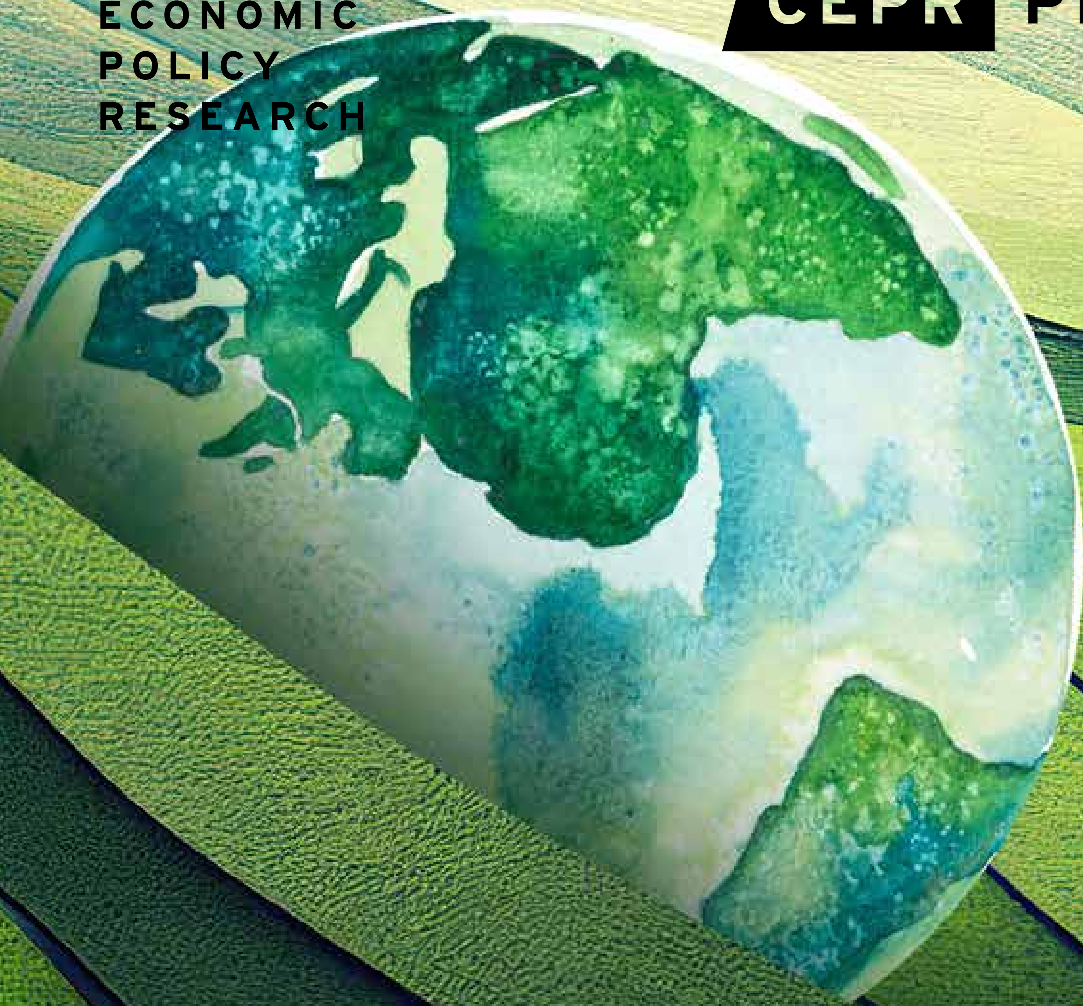

Edited by Dirk Schoenmaker and Ulrich Volz

Scaling Up Sustainable Finance and Investment in the Global South

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CEPR SUSTAINABLE FINANCE

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Foreword

Creating economically and politically legitimate solutions to tackle climate change is one of the most pressing and challenging issues of our time. For emerging and developing economies, the task is made more difficult due to a lack of financing, increasing debt accumulation and the need to address domestic socioeconomic issues.

This eBook provides a comprehensive overview of the financing gap that emerging and developing countries face to meet the Sustainable Development Goals and Paris climate goals. It provides detailed country- and region-level analysis of the challenges and opportunities of scaling up sustainable finance and investment and discusses the range of instruments that could be used to reach these climate and development objectives.

The authors point to the central role of monetary and financial authorities in addressing sustainability risks and scaling up sustainable lending and investment. They also stress the need to mobilise domestic financial resources through local banking systems and capital markets and channel them into domestic investments. Efforts can be undertaken to attract more international capital and governments should explore ways to use digital technologies to develop new, creative fundraising approaches.

It is clear that a substantial financing gap exists in developing countries, which will not be easily overcome. However, the policies proposed in this eBook provide innovative and sustainable solutions for policymakers to make meaningful progress.

CEPR is grateful to the editors of this eBook, Dirk Schoenmaker and Ulrich Volz. Our thanks also go to Anil Shamdasani for his skilled handling of its production.

CEPR, which takes no institutional positions on economic policy matters, is delighted to provide a platform for an exchange of views on this important topic.

Tessa Ogden
Chief Executive Officer, CEPR
October 2022

Introduction

Ulrich Volz and Dirk Schoenmaker
SOAS, IDOS and LSE; Erasmus University Rotterdam and CEPR

Emerging market and developing economies (EMDEs) have enormous investment needs in climate mitigation and adaptation, and other areas to attain better and more inclusive economic, social and ecological conditions and to achieve the Sustainable Development Goals (SDGs). Most countries in the Global South also face significant impacts and risks from climate change and nature loss that need to be accounted for by the financial sector. Monetary and financial authorities, as well as banks and other financial institutions, in developing and emerging economies are increasingly seeking to address sustainability risks and scale up sustainable lending and investment.

The financing gap for climate mitigation is estimated at US$2.4 trillion annually between 2016 and 2035, while adaptation finance needs are estimated at $180 billion annually between 2020 and 2030 (IPCC 2018, Richmond and Hallmeyer 2019). Before Covid-19, the UN estimated that developing countries were facing an annual financing shortfall of $2.5 trillion for advancing the SDGs and the Paris climate goals.[1] The pandemic has widened this financing gap substantially. There clearly is a need to scale up financing for development, and to make sure that all financial flows are aligned with climate and other sustainability goals.

The trajectory to date suggests that international private capital flows are unlikely to fill the gap, despite new ambitious initiatives like the Glasgow Financial Alliance for Net Zero (GFANZ) that aim to mobilise private climate finance to emerging and developing economies. Likewise, official development assistance (ODA) from the member countries of the Organisation for Economic Co-operation and Development's Development Assistance Committee (DAC) – which accounted for $179 billion in 2021 (OECD 2022) – and from other donors can provide important impetus to further economic development and help to leverage private international finance, but it will not be nearly enough to meet climate investment needs and the SDGs. To address the climate investment and SDG financing gap, mobilising domestic financial resources through the local banking system and capital markets and channelling them into domestic investments will be crucial. The successful implementation of low-emission development strategies and National Adaptation Plans or National Adaptation Programmes of Action can only be achieved if domestic resource mobilisation is strengthened.

1 According to the latest edition of Climate Policy Initiative's Global Landscape of Climate Finance, global climate finance flows amounted to $632 billion on average in 2019 and 2020 (Buchner et al. 2021).

Currently, a large portion of EMDEs savings is invested – often at low or negative returns – in financial centres in advanced countries. These capital exports are often channelled back to EMDEs in the form of high-yielding, short-term debt or portfolio investments, which increase financial vulnerabilities. Over the past decades, many EMDEs, particularly in Asia and the oil-producing Middle East, have been running current account surpluses and building up foreign currency reserves as well as overseas assets. Between 2000 and 2021, EMDEs excluding China accumulated current account surpluses of $892 billion ($4.8 trillion including China).[2] These are only net capital exports; gross capital exports are much larger. In other words, while capital should be flowing from advanced countries, where it is abundant, to developing economies, where investment needs are much larger, aggregate capital flows are going in the other direction – they are flowing 'uphill'. Even in countries that are net capital importers (including most countries in sub-Sahara Africa), significant amounts of domestic savings are invested abroad in safe, hard-currency assets, instead of the local economy.

There are various reasons why developing countries may export capital, including a desire to build up foreign exchange reserves to build buffers and cushion against shocks; the repayment of old debt; a diversification of investments; domestic financial and macroeconomic instability; political instability; illicit flows; and a lack of long-term investment opportunities at home due to underdeveloped capital markets. Going forward, efforts need to be reinforced to strengthen domestic financial resource mobilisation for scaling up local climate-friendly, sustainable investments and reducing capital exports from developed to advanced economies. A key element here is the development and strengthening of local currency bond markets. Digital technologies – including artificial intelligence, distributed ledger technologies, and the internet of things – provide an opportunity for emerging markets to develop new, innovative fundraising approaches and reinvent how capital market infrastructure and instruments are built to serve the specific financing needs of companies in emerging markets, as well as the needs of the local investor base (Chen and Volz 2021, Dikau et al. 2022). Fintech and blockchain-based solutions can facilitate domestic resource mobilisation for sustainable investments and at the same time improve the implementation of infrastructure projects throughout the entire life cycle by facilitating processes and enhancing transparency (Chen and Volz 2021). Fintech can help to complement conventional capital markets and help to mobilise financial resources for sustainable infrastructure investments.

The tokenisation of bonds and shares can enable citizens in emerging markets to become investors with smaller amounts of savings, while digital aggregation of these micro-investments helps to raise additional sustainable investment capital. For instance, the Government of Kenya has raised money for infrastructure projects by issuing retail bonds that could be bought by small-scale individual investors on their mobile phone. Such approaches have the added benefit of not only unlocking more local currency

2 Calculations made with data from the International Monetary Fund's World Economic Outlook Database, April 2022.

capital, they also help to diversify the investor base with local investors (Dikau et al. 2022). This also helps to shift accountability and interest payments from often being a relationship between the government (for government securities) and foreign creditors to also becoming a relationship between the government and the national population.

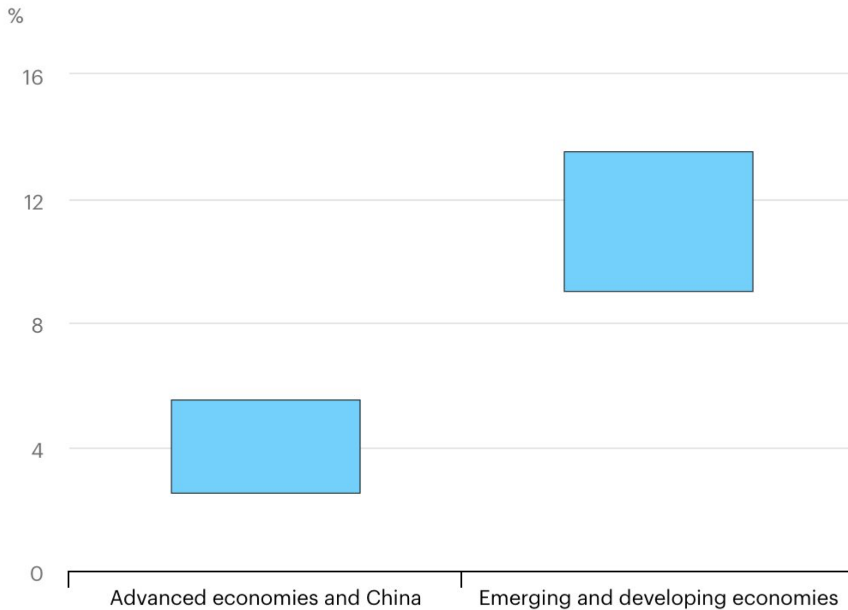
While tokenisation helps to attract a new investor base, there is also a need for aggregation to entice institutional investors, both domestic and foreign, who usually have minimum investment requirements (Schoenmaker and Schramade 2019). Aggregation is needed as many renewable energy and energy efficiency projects are small in scale. Through standardisation and aggregation, smaller loans and assets can be bundled to reach the size institutional investors are demanding. Efforts should thus be undertaken to grow aggregation facilities to enable smaller borrowers (including corporations and municipalities) to tap capital markets. For example, municipal finance agencies, modelled on those in Europe and North America, could be set up to borrow on wholesale markets – supported in an establishment phase by guarantees from the government or multilateral development banks (MDBs) – and channel funds to small and medium-sized cities.

MDBs as well as national development banks (NDBs) need to assume a much greater role in financing infrastructure development and in advancing a just transition to a low-carbon, climate-resilient economy than they have done so far. To achieve the Paris climate target of limiting global warming to well below 2°C and pursuing efforts to limit it to 1.5°C, high upfront investment is needed. This constitutes a big problem for EMDEs given that they face much higher cost of capital (Figure 1), a problem that is further aggravated by their climate vulnerability (Buhr et al. 2018, Kling et al. 2018). Concessional finance by MDBs is even more important at a time when interest rates across the major advanced economies are rising, a large number of EMDEs are facing severe debt problems, and private capital flows to EMDEs are drying up.

Because MDBs can refinance themselves cheaply, they can provide much-needed concessional financing to EMDE governments. Importantly, both MDBs and NDBs – whose missions should be updated with the goal of supporting a just, net-zero transition – can use a tried-and-tested method of leveraging private sector finance for development: they can issue (sustainable) bonds and borrow from markets. MDBs in particular can absorb large amounts of private domestic and international capital at cheap rates and on-lend it to developing country governments at low rates, or directly finance projects through equity or loans.[3] By doing so, they can also create safe, investable local currency assets that can attract domestic savings. This is a much more effective way of leveraging private sector capital than project-based blended finance approaches. As pointed out by Kenny (2022), evidence has been mounting that "project-based 'mobilisation' as a way to leverage small amounts of public money to achieve trillion-dollar transformations" is inadequate.

3 For instance, since 1944, the International Bank for Reconstruction and Development has leveraged the total paid-in capital of OECD DAC countries by a factor of ten (Humphrey and Prizzon 2020).

FIGURE 1 COST OF CAPITAL FOR A SOLAR PV PROJECT, 2021



Source: IEA (2022).

As recently highlighted by the Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks (Boosting MDBs' Investing Capacity 2022), MDBs could unleash hundreds of billions of dollars in new lending if they were to adjust their capital adequacy frameworks and maximise the impact of their capital. Moreover, the firepower of MDBs can be strengthened by general capital increases and a rechannelling of Special Drawing Rights (SDRs) from advanced economies that don't need them. However, a strengthening of MDBs should be accompanied by meaningful governance reforms so they can fulfil their potential (e.g. Chakrabarti et al. 2022).

MDBs and development finance institutions, along with global funds such as the Green Climate Fund, the Global Environment Facility and the Climate Investment Funds, can also capitalise existing or new NDBs and make sure they have high governance standards. They can thus improve the standing and credit ratings of NDBs in capital markets and help them raise further capital in private markets more cheaply. As mission-oriented institutions, national and international public development/climate banks can finance activities with uncertain returns and positive externalities that private finance is unwilling to fund (Griffith-Jones and Ocampo, 2018). Importantly, key areas of development such as physical infrastructure, education, and healthcare will (and should) never generate the returns that private investors are looking for, creating a gap that NDBs and MDBs need to fill.

While domestic resource mobilisation needs to be a priority for most emerging economies, efforts should also be undertaken to attract more patient international capital. Country platforms, which are now being explored by GFANZ, could act as aggregation facilities that attract international private capital. However, expectations need to be set straight. Whereas targeted public subsidies can be catalytic for financing development, limited amounts of ODA must be employed carefully and should not be used to de-risk private investment and guarantee double-digit returns for international banks and asset managers. If public guarantees are involved, the public should also reap the benefits and not merely take potential losses to safeguard private returns.

The availability of capital at affordable cost is just one precondition to unleash the potential for long-term sustainable investment. A critical factor for any kind of private investment, be it national or international, is to get the broader framework conditions right. Besides political and macroeconomic stability, investors need predictable and transparent national laws and administrative procedures for investment operations.

Finally, it will be important to address the looming debt crisis in the Global South that is impeding much-needed investment. Governments that are overindebted cannot invest, and countries facing a sovereign debt crisis will not attract private investment either. Many EMDEs will need to have their debt restructured before public and private investment can resume. The G20 should therefore reform the Common Framework and turn it into a useful structure for delivering speedy and efficient debt relief for all EMDEs (and not just low-income countries) that need it. Debt relief should not only provide temporary breathing space; it should empower governments to lay the foundations for sustainable development by investing in strategic areas of development, including health, education, digitisation, cheap and sustainable energy, and climate-resilient infrastructure (Volz et al. 2020, 2021). Debt relief should hence be linked to reforms that align the policies and budgets of debtor countries with the Agenda 2030 for Sustainable Development and the Paris Agreement.

Concerted efforts are needed to scale up sustainable finance and investment in the Global South. There are no silver bullets, but a host of measures that can help to generate much-needed investment in climate action and other areas needed for achieving the SDGs. There is an urgent need to take stock of current approaches to mobilising and scaling domestic and international climate and development finance; assess the successes, limitations, and failures of these approaches; and put forward policy recommendations for development cooperation for helping partner countries in strengthening domestic financial resource mobilisation and attracting patient international capital.

This eBook brings together a group of eminent scholars and practitioners who examine the challenges and opportunities of scaling up sustainable finance and investment in the Global South, and who review existing practice. The first part of the eBook comprises thematic chapters discussing the role of different stakeholders and instruments. The second part comprises regional and country case studies. Tackling climate change is a

global and urgent issue, and so is the Agenda 2030. We need to join forces, and learn from each other, to scale up sustainable finance and investment in the North and the South.

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