Background Note

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FINANCE IN COMMON SUMMIT—BACKGROUND NOTE

The IMF's vision, of encouraging policies that catalyze a transformational recovery and deliver a more resilient, equitable, and greener global economy, has strong synergies with the goals of the Finance in Common Summit, of promoting multilateralism and resource allocations more favorable to climate goals and SDGs. The COVID-19 crisis has complicated the challenges for emerging market (EM) and low-income developing countries (LIDCs) to meet these development goals, both by setting back progress and by further constraining fiscal resources. Domestic country efforts, including to attract investment, need to be supported by all development actors to help mobilize the necessary financing. Public development banks can play an important role, provided needed standards of governance and operational effectiveness are met.

EMs and LIDCs face high medium-term financing needs to meet SDGs and climate goals

The Sustainable Development Goals (SDGs)—a set of global targets to end poverty and reduce inequality and environmental deprivations—were adopted by the member countries of the United Nations (UN) in September 2015**.** The SDGs are intended to guide the global development agenda through 2030, and reflect the view that development needs to be economically, socially, and environmentally sustainable.

The Paris Agreement, also in 2015, set out long-term temperature goals to keep the increase in global average temperature to well below 2°C (36°F) above pre-industrial levels. Contributions each individual country should make to achieve the worldwide goal are determined unilaterally and known as "nationally determined contributions" (NDCs).

Prior to the COVID-19 crisis, the IMF estimated that achieving the SDGs by 2030 required a substantial scale-up of spending. In key areas such as health, education, and priority infrastructure, the IMF estimates that low-income developing countries (LIDCs) will require sizable additional spending *every year*, reaching half a trillion US dollars in 2030—about 15 percent of their combined projected GDP in 2030. The challenge is more manageable in emerging market economies (EMs), which are expected to face additional spending needs of about $2 trillion in 2030, or 4 percent of their combined GDP.

Investment needs for mitigation and adaptation to climate change are also sizable and crucial. Globally, as part of a policy package to reduce emissions to a level consistent with a target of a 2°C increase in temperature, energy investments, public and private, would have to rise from 2.0 to 2.3 percent of GDP by 2030. The Paris Agreement included a commitment by developed countries to mobilize $100 billion a year in climate finance (from public and private sources) for developing countries by 2020, though whether this target will be reached remains unclear. In 2016, $60bn in annual public climate finance was reported from developed countries (up from $52bn in 2015; UNFCCC 2018). About a third came from MDBs, which has since risen to $42bn in 2019 (Joint Report on MDBs' Climate Finance 2020). However, some public finance may reflect relabeling of existing funds, and much comes in the form of non-concessional loans. COP26 may yield a new quantitative target for 2025. A new IMF staff assessment based on World Bank data finds that LIDCs need about $25 billion annually (1.1 percent of GDP) in public investment for adaptation. (Fiscal Monitor, Box 2.1, Oct 2020).

The pandemic is setting back progress towards sustainable development

The COVID-19 pandemic and its economic repercussions are expected to set back progress toward the 2030 SDGs in most countries. For instance, gains in poverty reduction over the last decade are being reversed, with 80 to 90 million people globally expected to fall into extreme poverty, even accounting for the mitigating impact of social assistance (Fiscal Monitor, Chapter 1, Oct 2020). The pandemic will also exacerbate inequality, including gender inequality. Progress on critical health indicators is being compromised. Health personnel and supplies to fight the virus are being diverted from other health needs, and demand for health services could decline when the population fears the risk of contagion in medical facilities. According to the Gates' Foundation 2020 Goalkeeper Report, worldwide vaccination rates have dropped to levels last seen 25 years ago. At the same time, school closures result in children falling behind in learning, with remote learning remaining out of reach for at least 500 million children, the vast majority of whom live in the developing world.[1]

The COVID-19 recession has temporarily reduced CO_2 emissions, but the long-term impact is negligible. Lower economic activity is estimated to have reduced the flow of new emissions by 8.8 percent in the first half of 2020, but this means the stock of CO_2 in the atmosphere – which is what matters for global warming – has continued to grow apace. And emissions are expected to rise again as economic growth resumes. So far very little of the estimated $13 billion in global fiscal support for economic recovery has been targeted on climate-friendly uses.

While spending needs are at an all-time high, available resources have dwindled, making the SDG timeline more daunting. Countries are suffering severe economic contractions from the pandemic. The associated sharp decline in revenues and financial inflows further constraints countries' capacity to respond. Revenues in oil-exporting countries have been hardest hit, due to the sharp fall in crude prices.

Obtaining additional debt financing is difficult in countries with record-high public debt levels. About 54 percent of the LIDCs are deemed to be in debt distress or at high risk of debt distress (up from 44 percent at the end of 2019). In addition, borrowing on nonconcessional terms can cause more long-term harm than good if funding is not used for projects with sufficiently high returns.

[1] United Nations, The Sustainable Development Goals Report 2020. Available at https://unstats.un.org/sdgs/report/2020/

Need for joint and coordinated efforts by all development actors

Success with the sustainable, greener, inclusive development agenda depends on countries having in place a realistic and well-articulated financing strategy. Domestic revenue mobilization should be a significant part of such a strategy. Mobilizing revenue for development on the back of strong administrative and policy reforms is a central theme of the Addis Ababa Action Agenda. And most EMs and LIDCs will have room to increase revenue, once the economic recovery from the pandemic is well underway. But increased revenues alone will not suffice. Countries should also focus on improving the efficiency of spending, including through improving governance.

Even with these domestic actions, most LIDCs will need greater and coordinated financing support to counter the scarring effects of the pandemic and continue making progress towards the SDGs. Such support can come in different forms:

- **Foreign aid, in the form of grants and concessional lending, remains crucial in supporting the development efforts of poorer countries**. The social and economic returns to well-targeted aid—in the form of poverty reduction, better health and education outcomes, job creation, and improvements in security and stability—are high. Meeting the official development assistance commitment (0.7 percent of gross national income) and better targeting aid would make a substantial contribution.

- **The private sector should be an important part of the financing strategy.** Thus, creating a business-friendly environment is important. "Blended finance" investment approaches that combine public and private interests can help in this regard.

Public development banks (PDBs) can play a role in financing related to climate and SDGs

There is a renewed interest by governments in PDBs and how they can effectively support policy goals. A common stated objective of these banks is to finance socially valuable but financially unattractive or highly risky projects, such as lending to young, small, and innovative firms. For example, the Business Development Bank of Canada and the newly established Small Industries Bank of India aim to address financial constraints of such small businesses. Another is to finance capital-intensive infrastructure projects with positive spillovers to support industrialization or public service delivery (e.g., public utilities). In addition, Mexico's NAFIN is credited for fostering financial development, innovation, and inclusion in the country.

Public banks have also been used to fight recessions and manage crises, including the ongoing COVID-19 pandemic. Public banks can be used to complement government efforts to ameliorate the impact of economic crises especially in cases where private banks are reluctant to lend, even with government guarantees, given risks or operational costs. During the global financial crisis, for instance, several countries injected capital into their public banks to rollover or expand credit to small businesses and exporters (Canada, Chile), large firms (Brazil), or the corporate sector (Poland). Others raised the credit ceilings of their public banks (Finland, Korea) or set up new credit facilities (India, Tunisia) and special guarantee programs (Mexico) for public banks to support key sectors. Likewise, during the Great Lockdown, several advanced economies and emerging markets stepped up credit to the economy through their development banks.

PDBs can play a bigger role, and some are already involved, to support climate goals and SDGs. PDBs can aim to expand infrastructure finance, provide financing for new types of environmentally friendly projects, and mobilize additional financing to meet a wide range of developmental objectives (World Bank, 2017 Survey of National Development Banks). For example, the Development Bank of South Africa is responsible for investing in infrastructure projects to catalyze social and economic development in the country as well as in the rest of the continent. Germany's Kreditanstalt für Wiederaufbau (KfW), among other roles, funds the green energy transformation in the country and in the rest of Europe. More generally, PDBs can provide long-term or concessional resources, initiate knowledge-sharing and technical-assistance programs, and promote private-sector involvement.

The action of public development banks need to be fully integrated in the broader country's fiscal strategy and policy priorities. This will require close coordination between governments and PDBs on (i) identifying the areas where the actions of PDBs will be more effective to promote an inclusive and green development agenda; and (ii) ensuring PDBs are financially sound and appropriately funded. Governments should approve any financial support to public banks—for instance, capitalization, loans, or government guarantees—through the budget process and any quasi-fiscal support given by public banks should be costed and included in budget documents to promote coordination and accountability. Governments should also assess potential fiscal risks (including covering losses of public banks), ensure mechanisms for central approval, and promote a high degree of governance and transparency in PDBs.

PDBs can help develop the "sustainable finance" market segment

Sustainable finance is defined as the incorporation of environmental, social, and governance (ESG) principles into business decisions, economic development, and investment strategies. The development of sustainable finance has been driven by a combination of market forces and policymaker actions to improve disclosure, data, and risk analytics. ESG issues may have a material impact on the financial position of corporates and individuals and may give rise to financial stability risks via exposure of banks and insurers to impacted entities or sectors. The integration of ESG factors into firms' business models—prompted by regulators, businesses' own interest, or by investors— may help mitigate these risks (GSFR, Oct 2019).

Policies to promote sustainable finance have been stepped up, most notably in Europe. Recently, the European Union (EU) has adopted the "New European Green Deal" representing a strategic response to climate change and sustainability issues, seeking actions by public and private entities. For countries outside the EU, the European Commission has developed an "EU External Investment Plan," focusing on increased mobilization of private capital, greater visibility for European development cooperation and closer cooperation between European promotional institutions (including PDBs). The quality requirements for development cooperation are also increasing, coupled with demands for greater transparency and information regarding the results, effects and risks of development cooperation.

PDBs can support sustainable finance through their activities in green bond markets.[2] PDBs typically do not take customer deposits and fund their business activities mostly through international and domestic capital markets (in addition to government funding). A growing number of PDBs are setting new requirements for the allocation of their own funding, setting targets to fund suitable environmental and climate protection projects. PDBs can further support the development of green financing markets by fostering awareness and offering intellectual leadership in assessing climate and SDG (more broadly ESG) related risks in partnership with regulators and central banks.

PDBs, implementing the highest environmental and social standards in their credit policies, can set an example for the market. They can review their investment exclusion list on a regular basis (e.g., new coal related-projects and coal-fired power stations) by applying an appropriate and prudent internal taxonomy (especially until there is an internationally agreed taxonomy). PDBs should voluntarily disclose their contributions to the SDGs.

PDBs require strong governance and risk management practices for efficient use of resources in climate and SDG financing

Strong governance and risk management is critical for PDBs to deliver on SDG objectives. The success of a PDB depends on the design and application of a well-defined mandate; the adoption of best practices in corporate governance; effective risk management; and creation of safeguards to avoid undue political intervention. Generally, a PDB does not aim for profit maximization, but should be financially sustainable over time. Having a qualified and empowered board of directors to effectively carry out their functions of setting strategy and supervising management is important for the performance of the PDBs. The expertise of the board could also include qualifications related to the PDB's specific policy objectives (e.g., climate or SDG). The board could design performance indicators for climate and SDG financing to help ensure the accomplishment of the policy objectives.

A PDB's risk appetite - reflecting its climate and SDG objectives and business models - should be balanced by its capacity to manage risks. PDBs should have a good understanding of climate and SDG-related risks and be effective at pricing such risks. It is important that PDBs have written policies with respect to environmental impact of projects which are in line with internationally recognized or nationally required guidelines. The NGFS guide can be a good reference for effective PDB operation and risk management.[3] PDBs are recommended to:

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[2] For example, the German PDB KfW is among the largest green bond issuers worldwide.

[3] Network for Greening the Financial System, "Integrating climate-related and environmental risks into prudential supervision – May 2020" is a guide for supervisors and can be adopted by PDBs where relevant from the financial institutions' perspective.

- Develop a *clear strategy*, establish an internal organization and *allocate adequate resources* to address climate-related and environmental risks.

- Ensure *adequate management of climate-related and environmental risks* by PDBs and take mitigating action where appropriate; identify and update techniques for risk measurement and management; apply stress-testing as a core of risk measurement.

- Identify the *exposures* that are vulnerable to climate-related and environmental risks and assess the *potential losse*s should these risks materialize.

PDBs should take into account transition and physical risks, and actively manage or mitigate these risks. PDBs need to understand which exposures are sensitive to particular categories of climate risk and to be able to identify transmission channels to traditional categories of financial risks. The outcomes of risk management analyses should inform their credit processes, as well as other activities of business lines, in order to reduce the impact of climate risk on the balance sheet of the PDB. Credit policies supporting ESG- and climate-related agendas require integration of new expertise into their existing structures. In the credit approval process, for instance, PDBs can take into account high-level principles prioritizing investments in climate change mitigation/adaptation, sustainable use and protection and restoration of environment, pollution prevention and control, etc. PDBs should be aware that it requires specific expertise and approaches to achieve ESG goals and maintain strong risk management. The new processes should be integrated to existing structures, rather than establishing separate functions.

While international standards are being developed regarding disclosures, PDBs should consider voluntary disclosures. International bodies such as NGFS, BCBS, IFRS, FSB and IMF are working together to facilitate mandatory adoption of global climate-related disclosure standards. The IMF is co-chairing a workstream in the NGFS on bridging data gaps and facilitating this process. The IMF also favors the development and application of 'green taxonomies', as an important complement to climate-related disclosures. PDBs may consider a transparent approach with periodic voluntary disclosures reporting on core elements of climate-related disclosures – governance, strategy, risk management and metrics and targets. Further, PDBs could report on climate performance, including increases in financing of clean energy, energy efficiency, climate resilience or other climate-related activities and investments, and the climate footprint of the PDBs' own investment portfolio.

Meeting SDGs and climate goals requires comprehensive national strategies and global cooperation

The challenge of delivering a sustainable, greener and inclusive recovery goes beyond resources. Country efforts to respond to the pandemic and for the recovery should focus on strengthening macroeconomic management to foster sustainable, greener, and inclusive growth. Adequate governance is equally important as it is key to ensure that the available financing for the SDG agenda as well as for climate-friendly investments is effectively and efficiently spent.

Cooperation across all stakeholders is crucial. The IMF is committed, within the scope of its mandate, to the global partnership for sustainable development. To help countries overcome the COVID-19 impact, the IMF is providing debt relief to the poorest members, augmenting existing programs and precautionary arrangements, and extending three of the existing flexible credit lines. The IMF also continues to support countries, primarily developing countries, in several areas, including: (i) strengthening national tax systems; (ii) tackling large infrastructure gaps; (iii) promoting economic inclusion; (iv) developing domestic financial markets; (v) intensifying engagement in fragile and conflict-affected states; (vi) improving economic statistics; (vii) expanding the financial safety net for developing countries; and (viii) addressing macroeconomic aspects of climate change.