FINANCE, CLIMATE, AND THE WORLD BANK

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At the recent COP 27 in Sharm El Sheikh, climate negotiations have mainly focused on the "finance" dimension. From the perspective of the Global South, rich countries have thus far not delivered on the funding promises made to poor countries. This raises three sets of issues for international cooperation:

- ***fairness***: Voices from developing economies have become louder in demanding that richer countries compensate them for the "loss and damage" that result as defined in the Paris Agreement. Indeed, developing countries are not responsible for most of the past emissions and current concentrations of CO_2 that lead to global warming.

- ***efficiency****:* mitigation efforts in the Global South, if they can be financed, will have strong externalities and benefit the whole planet- with smaller costs than the same efforts in advanced countries.

- ***solidarity and development***. Global warming results in an increased frequency of extreme events that poor countries are ill equipped to absorb on their own resources and which may derail their whole development strategies. To date, a relatively small share of development aid and private capital inflows to developing countries are geared toward adaptation, such as early-warning systems, which can save lives.

The debate on finance and climate change is occurring at a time when the future of traditional development aid is in doubt. Over the past few years, several donors have announced significant reductions in their aid budgets. Political support has been dwindling. High hopes have been placed for private sector-led green investment, but have not yet materialized (Arezki, 2022). Private commitments of investments in green assets have also been scaled down, as actors are quietly reneging on their climate finance promises. .

Two important trends have recently emerged from the international dialogue and negotiations in the fight against climate change:

- A convergence—and possible fusion—between three agendas namely (1) "loss and damage", (2) adaptation and (3) development. They come from different origins. "Loss and damage" results from commitments made in the Paris Agreement by advanced economies to transfer USD100bn to developing economies recognizing the responsibility in past emissions. Adaptation to climate change necessitates significant investment when natural disasters become more frequent. And so does development, in terms of infrastructures. Increasingly, those three policies overlap and mobilize the same financial instruments such as concessional grants, loans and debt restructuring. And, therefore there are benefits to jointly implement them in a single and coherent institutional and operational framework .

- Calls are growing on Bretton Woods institutions, especially the World Bank Group, to fundamentally revise their model and reinvent themselves with increased focus on climate change. The US Treasury Secretary, supported by other advanced economies has requested the World Bank to develop an" evolution roadmap" before the end of the year (Yellen, 2022).

This Policy Brief presents ideas on how to move forward. Some of these ideas are in the form of prescriptions and recommendations; others identify policy issues and questions that need to be explored and debated.

As a starting point, one should note the four characteristics that distinguish the World Bank (hereafter "the Bank") in the general landscape of international institutions : (1) The Bank has a large balance sheet (and even a larger balance sheet potential) ; (2) The staff of the Bank is large and qualified; (3) The Bank, as an organization, has substantial experience, data and knowledge on economic growth and economic development issues (it rightly calls itself a "knowledge bank") ; (4) The Bank has a decades long history of trusted dialogue with its member and client countries. Obviously, its function as a financing institution is central. But the Bank should be more than a bank. It should combine and leverage its comparative advantages to broker systemic transformations necessary to fight climate change.

In that spirit, the Bank could take on five major responsibilities:

1. ***Define and enforce the standards of green finance***. It is now widely recognized that green and climate finance needs more clarity and transparency. The current architecture leaves the actors to define what is "green" with the risk of great heterogeneity, weak enforcement and predominance of pure signaling strategies, the so-called "greenwashing". Recent studies (Bolton et al., 2022) have shown for instance that green bonds generally do not differ from ordinary ones either by their rate of return or their legal structures and covenants. There are deep disagreements, inside the financial sector, on the precise commitments that should be

associated with the green label. The situation may lead to a waste of capital and ultimately undermine the credibility of green finance and its actors. The Bank should be put in charge of developing a clear legal framework and verification mechanisms which would define and characterize, first green sovereign bonds and ultimately the whole spectrum of financial instruments in the sphere of green finance. As a starter, the Finance in Common initiative, which brings together most development banks—together representing $2.2 trillion of lending activity annually—could adopt a common green standard as a group. The catalytic effect of such standard-setting by development banks could be enormous as it spills over to government agencies and private sector actors.

2. ***Conduct climate surveillance and monitoring of national commitment taken under Paris Agreement*** (the so called Nationally Defined Contributions – NDCs). The Paris Agreement has a provision for a "global stocktake" every five years. The Bank could be become the "super implementer" of that climate surveillance working closely with the secretariat of the United Nations Framework Convention on Climate Change (Arezki and Le Houérou (2022). Rather than the current intermittent system of reporting, surveillance based on a continuous process of dialogue would act as a confidence building mechanism between the membership.

3. ***Contribute to country strategies and identify the proper mix of mitigation and adaptation****.* Climate change is a global challenge, but actions and policies to mitigate and adapt are country specific. They have to be made consistent with the stage of development, the financing capacities and the natural endowments. Attempts to define universal timelines have mostly failed, as illustrated by the debate on phasing out coal as well as fuel subsidies. There is a strong interaction between this strategic mission and the traditional "project" functions of the World Bank,

4. ***Define and implement a consistent financing strategy for climate change****.* A wide panoply of instruments are potentially available: grants, loans, sustainability indexed bonds, guarantees, debt for climate swaps or more general debt relief. But, again, their combination is country specific. The key is to ensure consistency, over time, between fiscal , financial and climate policies for each country. The Bank in coordination with the International Monetary Fund is well equipped for that task. It is also well placed to mobilize private finance for climate related investment, a priority in the period to come when public budgets will be significantly constrained by the level of public debt. It would almost certainly mean a larger use of non-conventional tools, such as guarantees, that the World Bank has been reluctant to deploy on a large scale up to now.

5. In a medium-term perspective, ***explore and possibly create global carbon and offset markets***. The Bank is already helping countries and regions converge by making more progress in eliminating fuel subsidies and in the introduction of carbon pricing.

Most of those actions are within reach of the current mandate and capabilities of the Bank. Its Board of Governors could easily adopt the necessary decisions and changes. However two difficult issues have to be explored and assessed:

- ***Should the Bank leverage its balance sheet more?*** The Bank is one the few AAA rated borrowers in the world. Compared to most sovereigns, including advanced economies, it has significant borrowing capacity with a very low risk premium. The Bank could rapidly increase the size of its balance sheet and the volume of its lending as advocated in a recent G20 report (2022). The temptation of such a "Big Push" is strong. Investment needs for the climate and energy transition are enormous and fiscal constraints are increasingly binding in traditional donor countries. On the other side, it is well known that accelerated disbursements may run the risk of waste and misallocation. More fundamentally, a jump in leverage, (just like a sale of gold reserves) is a one-shot exercise. Once the balance sheet has been leveraged, it can neither be reversed and or undone. And most likely, future lending will be more expensive once the AAA is lost.

  The "big push "approach raises fundamental questions about the intertemporal allocation of capital. It relies on assumptions about the return on capital today and in the future, the expected availability of savings and the level of the discount rate. Those assumptions need a reality check against a variety of macroeconomic scenarios to better inform the design and path of lending. The absorptive capacity of recipient countries must be carefully assessed. The sense of urgency, when translated in large scale capital intertemporal redeployment may lead to a long-term reduction of efficiency.

- ***How far should "climate conditionality" go*?** There is a strong tendency in donor countries to tie their aid and financial support to the implementation of strict climate policies by beneficiaries. Obviously, these donor countries have a legitimate interest and motive in doing so. Yet, there is a real danger of a form of "climate colonialism" (especially if lenders do not themselves abide by the requirements they seek to impose on recipients). This tension cannot be resolved by the imposition of strict, uniform, and unilateral conditions. This is one more reason to put an international institution, such as the Bank, in charge of pragmatically and operationally defining the conditions for an efficient climate finance system.

CONCLUSION

Overall, the irruption of finance at the center of the climate agenda may introduce a radical change in global governance. It is possible that crucial tasks of implementation, setting up standards and coordination will be taken over by international financial institutions, partially circumventing the UN framework.

This institutional realignment may not go without frictions. Those countries which are now demanding more climate finance are the same who, historically, have resisted more direct involvement by Bretton Woods institutions.

The most important result of the COP has been the creation in principle of a specific funding source for the compensation of "loss and damages". At this stage, all the features and characteristics (including the amounts) will be defined by a transition committee of 24 representatives of countries. The participation of Bretton Woods institutions seems uncertain and, maybe, subordinate. They are invited "*to consider, at the 2023 Spring Meetings of the World Bank Group and the International Monetary Fund, the potential … to contribute to funding arrangements, including new and innovative approaches, responding to loss and damage associated with the adverse effects of climate change"* (UNFCC)

The next several months will therefore be devoted to building and articulating a new public architecture of climate finance. Hopefully, a consensus will be reached which would bring better consistency and efficiency - and not further dissociate finance from other dimensions of climate policy.

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