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Delivering development finance to achieve the 2030 Agenda for Sustainable Development: Making development finance contribute to environmentally sound industrialization

Note by the UNCTAD secretariat

Summary

The financing of an environmentally sound industrialization strategy through an integrated policy approach, whereby addressing climate challenges requires a developmental perspective, is considered in this note. Green industrial policy should form a central pillar in the redirection of public sector-led policies. Much of the support for a transition towards low-carbon industries will be at the domestic level and involve a wide range of institutional changes, public investment, direct subsidies and expansionary macroeconomic policies. For development finance to support such a transformation, the full range of measures at the regional and international levels, as envisaged in the Addis Ababa Action Agenda, is required.



I. Introduction

1. The substantive topic and guiding questions for the seventh session of the Intergovernmental Group of Experts on Financing for Development were approved by the Trade and Development Board through a silence procedure that concluded on 26 April 2023.¹ The approved guiding questions were as follows:

(a) What policies, initiatives and instruments (domestic, regional and international) can be considered to promote and facilitate inclusive and sustainable industrial development and the green transition in developing countries?

(b) What best practices can be identified for supporting sustainable business models and their related challenges?

(c) How can international cooperation support structural transformation and aid countries to identify and leverage finance that contributes to the 2030 Agenda for Sustainable Development and Paris Agreement objectives?

2. This topic corresponds to that of chapter I of the Addis Ababa Action Agenda of the Third International Conference on Financing for Development, particularly paragraphs 15 and 17, and to action areas A, B, C, E and F in chapter II. In chapter I, on a global framework for financing development post-2015, consideration is given to “promoting inclusive and sustainable industrialization” and “protecting our ecosystems for all”. In chapter II, challenges and priorities are set out with regard to domestic public resources, domestic and international private business and finance, international development cooperation, debt and debt sustainability and addressing systemic issues.²

3. The global context is considered in chapter II. Addressing climate-related challenges and structural transformation in an integrated manner is discussed in chapter III. The contribution of sustainable business models and environmental, social and governance-related investment is considered in chapter IV. The need for stronger international cooperation to support structural transformation and leverage development and climate finance is addressed in chapter V. Lessons from debt-for-climate instruments are noted in chapter VI. Possible national, regional and international policy initiatives, to close the financing gap and achieve the 2030 Agenda, are discussed in chapter VII.

II. Global context

4. Developing countries currently face a challenging global outlook. As at June 2023, over half of low-income countries (36 of 69 countries) were either at high risk of or already in debt distress, twice as many as in 2015.³ In addition, 52 developing countries, which account for half the global population living in extreme poverty, are estimated to have severe debt problems and high borrowing costs.⁴ As many as 3.3 billion people live in countries that spend more on debt servicing than on health and education.⁵ These countries are home to 40 per cent of the global poor and are among the most vulnerable with regard to the climate. In 2022, debt servicing levels for low-income countries rose to almost 23 per cent of export revenues and, for middle-income countries, remained at 13 per cent. Such a situation is unsustainable.

¹ See TD/B/70/4, annex IV.

² A/RES/69/313. See TD/B/EFD/1/2, TD/B/EFD/3/2, TD/B/EFD/4/2, TD/B/EFD/5/2 and TD/B/EFD/6/2 with regard to domestic resource mobilization, development cooperation, multilateral finance, responses to the pandemic and interrelated and global crises.

³ See <https://www.imf.org/external/pubs/ft/dsa/dsalist.pdf>.

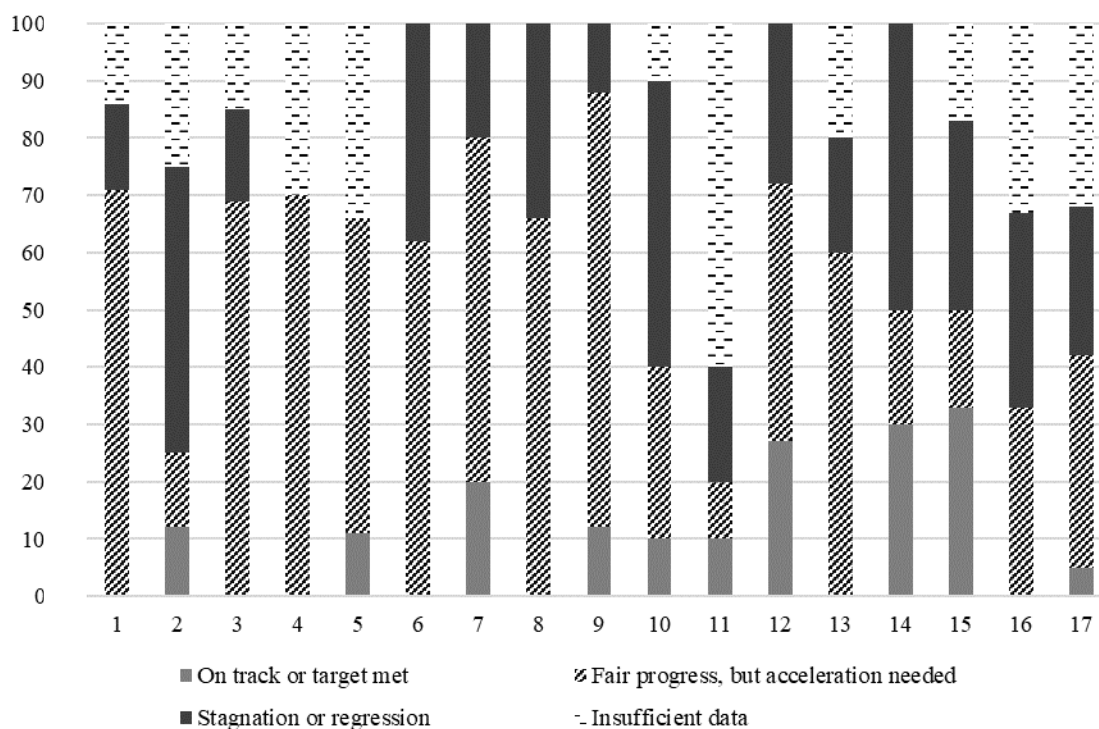
Note: All websites referred to in footnotes were accessed in August 2023.

⁴ United Nations, Inter-agency Task Force on Financing for Development, 2023, *Financing for Sustainable Development Report 2023: Financing Sustainable Transformations* (United Nations publication, Sales No. E.23.I.6, New York).

⁵ See <https://unctad.org/publication/world-of-debt>.

5. Concomitantly, at the midpoint of the 2030 Agenda, progress on the Sustainable Development Goals remains behind schedule. Cascading global crises, namely, the pandemic, the war in Ukraine, a deepening climate crisis and the cost-of-living crisis, have further reversed progress. The latest global-level data and assessments reveal that, of the 140 targets that can be evaluated, half show moderate or severe deviations from the desired trajectory; and there has been no progress on over 30 per cent of these targets or, worse, progress towards the targets has regressed relative to the 2015 baseline (see figure). The risk of not achieving the Goals by the end of the decade, without renewed commitment from both Member States and the international community, is real.

Progress on the Sustainable Development Goals, 2023



Source: A/78/80-E/2023/64.

6. Recovering momentum on implementing the 2030 Agenda requires the consideration of climate action as an integral part of development and industrialization. Climate challenges and structural transformation need to be addressed in a complementary way, and synergies need to be maximized. The options available for already debt-burdened countries need to be considered, in undertaking the development investment necessary for the structural transformation that underpins the achievement of the Goals, including the green transition. Adopting sustainable business models and investment standards based on environmental, social and governance-related criteria can provide some contributions, yet making development finance contribute to a green structural transformation implies reconsidering the entire spectrum of financing instruments, to support development. Current problems are not limited to insufficient size, as the required scale is not large compared with global resources; some estimates show that it would take less than 1 per cent of global finance to fill the gap that hinders the achievement of the Goals in developing countries.⁶ Rather, the direction and regulation of finance and its terms also need to be considered. Addressing the latter requires moving beyond mobilizing and increasing traditional forms of development finance, to give greater attention to neglected and potentially controversial measures, including reforming the international debt architecture, linking debt relief to development and climate finance, including through innovative

⁶ See <https://www.oecd.org/finance/global-outlook-on-financing-for-sustainable-development-2023-fcbe6ce9-en.htm>.

instruments, closing tax loopholes exploited as part of illicit financial flows and making greater access to concessional loans and grants possible through the recapitalization of multilateral development banks and the issuance of development-related special drawing rights.

III. Policies for inclusive and environmentally sound industrial development

7. In most countries, achieving inclusive and sustained income growth has traditionally relied on industrialization. Vertical shifts of output and labour, first from agriculture to industry and later from industry to high-end services, combined with horizontal moves of resources from lower to higher productivity and more capital-intensive activities within sectors, played a major role in the development of advanced economies and of developing economies in East Asia that have moved from low-income to high-income status.⁷ However, such industrialization processes relied on the ever-greater use of fossil fuel-based sources of energy, which is not consistent with the contemporary necessity to keep emissions and resource consumption within the ecological limits of the planet. There is a need for a new development agenda that emphasizes a climate-conscious structural transformation, characterized by achieving inclusive industrialization (productivity growth, technological upgrading, more and better paid jobs) and simultaneously reaping the benefits of environmental preservation (avoiding the negative effects of global warming).

8. In increasing climate investment in developing countries and mobilizing private investment in resilience and protection mechanisms, one approach is de-risking, based on the concept of risk management used in finance, to avoid risk creation and to build resilience by improving data gathering and risk assessment techniques.⁸ Application of this approach requires a comprehensive understanding of the interconnectedness and concurrence of risks, which the uncertainties of the current cascading crises may render challenging. Better data gathering is important, yet the reduction of risk in policymaking will require other methods.

9. A more lasting solution to climate-related challenges is likely to result from a process of structural transformation that is proactive and strategic, by aiming at establishing more resilient economies and reducing dependence on a small number of climate-sensitive activities, that is, “a specific type of rapid structural change where low-emission industries grow and high-emission industries decline due to deliberate policies, changing preferences and technological change”.⁹ Pursuing such a low-emission development path, which is compatible with catch-up growth and industrialization, requires an integrated approach, whereby climate and development-related challenges are addressed in a complementary way and solved jointly.

10. Climate-conscious structural transformation is a global requirement, yet there is no one-size-fits-all solution. There may be divergences between global climate objectives and immediate national interests, particularly in countries with large fossil-fuel sectors. Globally, policies to reduce emissions will inevitably depress fossil fuel demand and the revenues of fuel producers, many of which rely on fossil fuels as a source of foreign exchange. Some fossil fuels will remain important energy sources in future. For example, the use of natural gas may provide a bridge to a renewable future by replacing coal, yet the implementation of international emissions-related commitments will lead to stranded assets and make billions of dollars in existing and planned investments in fossil fuels obsolete¹⁰.

⁷ Herrendorf B, Rogerson R and Valentinyi Á, 2013, Growth and structural transformation, Working Paper No. 18996, National Bureau of Economic Research.

⁸ UNCTAD, 2021, *Trade and Development Report 2021: From Recovery to Resilience – The Development Dimension* (United Nations publication, Sales No. E.22.II.D.1, Geneva). See <https://www.undp.org/publications/risk-informed-development>.

⁹ Magacho G, Espagne E, Godin A, Mantes A and Yilmaz D, 2023, Macroeconomic exposure of developing economies to low-carbon transition, *World Development*, 167.

¹⁰ See <https://www.iea.org/reports/world-energy-outlook-2021/>.

11. Developing countries need financial and technical assistance to manage related adjustments, with the international community required to find answers to the following three critical questions: how can the fossil fuel production gap be closed to meet climate-related ambitions? Do the countries with unused fossil fuels merit compensation to ensure a just and equitable transition? If so, how can resources be found to pay for this?¹¹

12. There may be few national incentives in most of the developing countries to keep fossil fuels in the ground. These countries have contributed little to global emissions and long delays on international decisions on the provision of climate finance, and the increasing influence that increasing geopolitical tensions may have on such decisions could lead to sizeable developmental risks for fossil fuel-endowed developing countries. In addition, most of the developing countries, in particular the least developed countries, may view the exploitation of fossil fuels as the only way to service foreign debt.

13. The use of a “grow-now-clean-up-later” approach, whereby fossil fuels continue to be exploited and polluting industries enabled rather than a switch being made to pioneering green technologies with associated up-front investments, appears shortsighted. First, doing so could worsen climate mitigation and adaptation inaction that, as measured through the proxy of loss-and-damage costs, may rise to \$580 billion per year by 2030, by which time up to 130 million people could have been pushed into poverty by the impacts of climate change. Advanced economies have historically created the most carbon emissions and these economies are the most impactful in targeting reduced emissions, yet global warming cannot be halted unless all countries change carbon use levels. Second, “green windows of opportunity” are time-bound and, if developed countries benefit from green technological opportunities, then developing countries could lose out on crucial first-mover advantages. This implies that developing countries should aim to join the green technology revolution early on and act as users and innovators, not only as consumers. However, taking advantage of green windows of opportunity requires proactive policies.¹²

14. Moving in the direction of green technology is complicated by the path dependency of earlier production techniques, that is, their direction towards the sectors in which most innovation activity has occurred, which tends to be those related to the use of fossil fuels.¹³ Such path dependence generally results from factors that include knowledge spillovers, network effects and complementarities. In the context of green technologies, path dependence mainly relates to switching costs, that is, the cost of shifting to clean technologies, which generally require different infrastructure and the need to overcome incumbent interests. One consequence of path dependence is the need for government intervention, whereby the longer government action takes, the greater the cost of the technology transition becomes, along with the increasing urgency of the need for policies that reduce the cost difference between clean and “dirty” technologies.¹⁴

15. Experience suggests that green industrial policies are most effective when focused on institutional changes, such as renewable energy legislation, public investment in research and development and green infrastructure, direct subsidies for research institutions and private companies and demand stimulus.¹⁵ One form of demand policy is feed-in tariffs, aimed at creating competitive parity between green sources and fossil fuel sources by subsidizing demand. Another is public procurement, particularly of green building materials in construction. Direct public support and demand stimulus, particularly when

¹¹ See <https://www.iisd.org/publications/production-gap-2021>, <https://www.oxfamamerica.org/explore/research-publications/climate-change-equity-and-stranded-assets/> and Muttitt G and Kartha S, 2020, Equity, climate justice and fossil fuel extraction: Principles for a managed phase out, *Climate Policy*, 20(8):1024–1042.

¹² UNCTAD, 2023, *Technology and Innovation Report 2023: Opening Green Windows – Technological Opportunities for a Low-Carbon World* (United Nations publication, Sales No. E.22.II.D.53, Geneva). See <https://unctad.org/publication/trade-and-development-report-update-april-2023>.

¹³ Acemoglu D, Aghion P, Bursztyn L and Hemous D, 2012, The environment and directed technical change. *American Economic Review*, 102(1):131–166.

¹⁴ See <https://newclimateeconomy.report/2014/wp-content/uploads/sites/2/2014/11/Path-dependence-and-econ-of-change.pdf>.

¹⁵ UNCTAD, 2020, *Trade and Development Report 2020: From Global Pandemic to Prosperity for All – Avoiding Another Lost Decade* (United Nations publication, Sales No. E.20.II.D.30, Geneva).

targeted at financially constrained companies, help increase the scale of low-carbon activities, thereby making them economically more profitable.¹⁶ They can also provide clear indications of the direction of change, thereby increasing certainty with regard to the economic payoff of long-term green investment and provide a better basis for withstanding resistance from high-carbon industry lobbies.

16. Green industrial policy is more ambitious than traditional industrial policy. It aims to align productivity-enhancing structural transformation with shifts from high carbon-intensive to low carbon-intensive and resource-efficient activities and to exploit the synergies between these two processes. Green structural transformation leads to new policy priorities and investment and technological change towards low-carbon activities. Experience with traditional industrial policy suggests that this direction should be well-defined and include clear intermediate goals and deliverables, as well as strong monitoring and accountability processes.

17. Such policies are already being implemented. In the United States of America, the Inflation Reduction Act, aims to provide \$369 billion in public investment in climate-related solutions and technologies.¹⁷ The Act favours subsidies and local content requirements over bans, regulations or carbon taxes; however, in developing countries, a combination of the latter three may need to be used, to begin to emulate this kind of industrial policy, given relatively constrained fiscal space. Enlarging the tax base and alleviating constraints on domestic resource mobilization, through closing tax loopholes, may be necessary.

18. Green industrial policies should also take local and sectoral considerations into account, to diversify the economic structures of countries, reduce dependence on high-carbon activities, create new domestic sources of development finance, internalize externalities, such as chemical and plastic pollution, and address biodiversity loss. However, domestic markets in many developing countries may be too small for green production and innovation to scale up. The intensification of cross-border production and market linkages through regionally oriented physical infrastructure, particularly in the form of customs, transport, energy and communications networks, as well as regional value chains supported by regional development banks, could address such constraints.

19. However, regional green industrial policies involve difficult trade-offs. First, achieving a more efficient regional division of labour enables economies of scale but also implies that countries should specialize in particular activities or products. In the short term, this may lead to the location of high value added activities in some areas, with others specializing in more basic activities, leading to divergent economic performance. Second, entrenched business interests and established practices in the financial system of a country are inclined to reproduce established production and investment structures, potentially complicating the provision of finance required for the creation of regional value chains. Addressing such trade-offs requires clear communications of the objectives and directions of regional integration agendas, as well as of complementarity and comparative benefits.

20. With regard to multilateral action, the international transfer of low-carbon technologies to developing countries is complicated by economic, financial and technical barriers, including insufficient access to development finance.¹⁸ Over the past three decades, trade in low-carbon technologies has increased more than global trade, and developed countries continue to account for most of both imports and exports in this regard. However, China has become the largest importer and exporter of low-carbon technologies, and a study shows that intellectual property rights protection can enhance the market power of patent holders and create monopolistic price distortions that disadvantage local

¹⁶ See Howell ST, 2017, Financing innovation: Evidence from research and development grants, *American Economic Review*, 107(4):1136–1164.

¹⁷ See <https://www.energy.gov/lpo/inflation-reduction-act-2022>.

¹⁸ See <https://unepccc.org/publications/mapping-barriers-and-enabling-environments-in-technology-needs-assessments-nationally-determined-contributions-and-technical-assistance-of-the-climate-technology-centre-and-network/>.

competitors.¹⁹ This finding shows the need for a reform of the international intellectual property rights system, to allow manufacturers in technologically weak and less diversified economies to more easily access the technologies used or developed in technologically more advanced economies.²⁰

21. Subsidy and local content programmes in countries have raised questions about the validity and enforceability of current multilateral trade rules. Given the global public goods character of climate action, trade rules should, in principle, permit developing countries to nurture nascent green industries through tariffs, subsidies, local content requirements and public procurement, to allow for local demand to be met and for the economies of scale to be reached that make such industries more competitive. To support such efforts, the World Trade Organization may review trade rules, to make them more consistent with the Paris Agreement under the United Nations Framework Convention on Climate Change, such as by allowing local content requirements or reintroducing non-actionable subsidies on research and development and renewable energy projects, as well as regional development and environmental compliance, under the Agreement on Subsidies and Countervailing Measures and the Agreement on Trade-Related Investment Measures.²¹

IV. Sustainable business models and finance

22. The achievement of the Goals also involves action aimed at changing how business and finance works. The statement that the business sector should contribute to environmentally sound industrialization may be based on narratives that see companies as the crucial actors in climate mitigation, since they develop and implement the required new technologies.²² Related action may be divided into consumer and regulatory demand that drives companies to adopt sustainable business models and into financial investor demand that drives banks and asset managers to include in their portfolios companies that meet environmental, social and governance-related standards.

23. Adopting sustainable business models requires companies to assess the degree to which current models create positive environmental and social impacts and to improve such performance over time. Best practices for such directional change may require a better understanding of the broader stakeholder system and of how environmental and social issues might influence the long-term value creation of company, as well as developing metrics (in all business areas) that allow for the tracking and measuring of the value created and the adherence to environmental, social and governance-related standards. Such efforts should be combined with governance changes that provide the capabilities, accountability and incentives required to attain targets under such standards.²³ Such changes might improve the existing cost advantage of companies through better response to customer expectations while meeting environmental criteria. Sustainable business models could also facilitate finance for new companies, as adopting such models has contributed to equity

¹⁹ See <https://www.worldbank.org/en/topic/macroeconomics/publication/technology-transfer-and-innovation-for-low-carbon-development>.

²⁰ A proposal has been made that flexibilities under the Agreement on Trade-Related Aspects of Intellectual Property Rights should be given for environmentally-sound technologies, to make the trade regime more consistent with climate change agreements; World Trade Organization, 2013, Contribution of intellectual property to facilitating the transfer of environmentally rational technology, Communication from Ecuador, IP/C/W/585, Geneva, 27 February.

²¹ Lee K, 2019, *The Art of Economic Catch-Up: Barriers, Detours and Leapfrogging in Innovation Systems*, Cambridge University Press, Cambridge, United Kingdom of Great Britain and Northern Ireland, and World Trade Organization, 2023, A case for rebalancing the Agreement on Trade-Related Investment Measures: Policy space to promote industrialization and structural transformation in developing countries, WT/GC/W/896, Geneva, 13 July.

²² See <https://www.cesifo.org/en/publications/2023/working-paper/analyzing-climate-change-policy-narratives-character-role-narrative>.

²³ See <https://www.bcg.com/publications/2021/four-strategies-for-sustainable-business-model-innovation>.

crowdfunding, which can play a significant role in supporting innovative green technology and production.²⁴

24. However, research indicates that, in particular, large established companies lag behind in adopting sustainable business models.²⁵ Over 90 per cent of the companies on the Standard and Poor's 500 stock market index published sustainability reports in 2021, compared with 20 per cent in 2011.²⁶ However, most firms have yet to achieve a sufficient visibility of supply chains and put in place processes to allow them to undertake meaningful action commensurate with mission or purpose statements.²⁷ Such increased visibility could be achieved by companies joining voluntary initiatives, such as the United Nations Global Compact, that attest to their adherence to sustainability standards. It could be further supported by regulators demanding stronger company sustainability disclosures, with reporting based on common sustainability metrics, and by developing credible sustainability ratings.²⁸ To add pressure to the demand for companies to disclose how climate change affects their business and to help regulators stem greenwashing, a new set of global standards, issued by the International Sustainability Standards Board, will take effect on 1 January 2024.²⁹ However, countries will need to decide whether to require listed companies to apply these standards. An example of national regulation in this regard is the Act on Corporate Due Diligence Obligations in Supply Chains in Germany, which became effective on 1 January 2023 and requires companies with over 3,000 employees working in Germany to adapt and update compliance, purchasing and contract processes on human rights and environmental matters.³⁰ Similar laws have been enacted in Australia, Canada, France and Italy. In addition, on 23 February 2022, the European Commission adopted a proposal for a directive on corporate sustainable due diligence.³¹

25. Environmental, social and governance-related criteria have also been promoted to align private finance to targets under the Goals. There have been sizeable net inflows to environmental, social and governance-related funds, particularly since mid-2019, peaking at \$405 billion in 2021. Net inflows remained positive in 2022, amounting to \$89 billion, despite net outflows in broader markets, as well as in the first quarter of 2023, amounting to \$19 billion, despite an outflow of \$11 billion in March.³² The increase in reported environmental, social and governance-related investment has been facilitated, inter alia, by the Finance Initiative of the United Nations Environment Programme, which established the principles for responsible banking, sustainable insurance and responsible investment.³³ This has been accompanied by the signing up of a number of banks and asset managers to voluntary sustainability principles, such as the principles for responsible investment, established in 2006 by some of the world's largest institutional investors with support from the United Nations Global Compact; at end-2021, the initiative had nearly 4,000 signatories, with combined assets under management of over \$120 trillion.³⁴ Other initiatives include the Glasgow Financial Alliance for Net Zero. However, research

²⁴ Caputo A, Schiocchet E and Troise C, (2022). Sustainable business models as successful drivers in equity crowdfunding, *Business Strategy and the Environment*, 31(7):3509–3522.

²⁵ Ritala P, Huotari P, Bocken N and Albareda L, 2018, Sustainable business model adoption among [Standard and Poor's] 500 firms: A longitudinal content analysis study, *Journal of Cleaner Production*, 170:216–226.

²⁶ See <https://www.ga-institute.com/2022-sustainability-reporting-in-focus.html>.

²⁷ See <https://hbr.org/2020/03/a-more-sustainable-supply-chain>.

²⁸ United Nations, Inter-agency Task Force on Financing for Development, 2023.

²⁹ See <https://www.ifrs.org/projects/completed-projects/2023/general-sustainability-related-disclosures/>.

³⁰ See <https://www.bmz.de/resource/blob/154774/lieferkettengesetz-faktenpapier-partnerlaender-eng-bf.pdf>.

³¹ See https://commission.europa.eu/business-economy-euro/doing-business-eu/corporate-sustainability-due-diligence_en.

³² See

<https://www.imfconnect.org/content/dam/imf/News%20and%20Generic%20Content/GMM/Special%20Features/Climate%20Finance%20Monitor.pdf>.

³³ See <https://www.unep.org/explore-topics/green-economy/what-we-do/finance-initiative>.

³⁴ See <https://www.unpri.org/about-us/about-the-pri>.

suggests that improved adherence to environmental, social and governance-related criteria does not always follow the signing of such principles.³⁵

26. The improved quality of environmental, social and governance-related ratings, and stricter supervision of adherence, could reduce greenwashing, as such ratings play a crucial role in measuring the related attributes of a company, guiding the investment of environmental, social and governance-related funds and thereby linking investor preferences for environmental, social and governance-related standards to portfolio choices. Data on environmental, social and governance-related investment flows face challenges related to diverging data quality, measurement and reporting and rating methodologies, which differ widely due to different ways of choosing, aggregating and measuring such attributes.³⁶

27. Many funds that brand themselves as respecting environmental, social and governance-related criteria are not fundamentally different from traditional funds. One reason for this similarity may be the tendency of fund managers to diversify portfolios and include the “best” companies from a variety of sectors, including those, such as the oil sector, that face challenges with regard to such criteria. Others state that, rather than disregarding them, investing in companies with poor environmental, social and governance-related ratings is a critical way of driving change in company policy towards respecting environmental criteria.³⁷

28. One of the central tenets of the integration of environmental, social and governance-related elements into asset management is that purpose and profits overlap, that is, environmental, social and governance-related investment makes sense because it increases returns and reduces risks. However, assessments of such investment strategies usually compare how they have fared relative to brown investment, rather than related to their impact on environmental, social and governance-related indicators.³⁸ This suggests that environmental, social and governance-related investing may deliver better financial returns for investors but not necessarily on the intended impact of solving environmental problems.³⁹

29. The creation of data related to environmental, social and governance-related elements and their diffusion in the form of indices may have created a false sense of accomplishment.⁴⁰ For example, the majority of environmental, social and governance-related funds are in developed countries and include developed country companies, and therefore have limited impact on climate action in developing countries.⁴¹ This may relate to scarce company-level sustainability data in developing countries. In addition, most investments in these countries are too small for mainstream institutional investors to consider. Microenterprises and small and medium-sized enterprises form the backbone of most low-income and middle-income economies, yet are hindered by a “financing trap”, whereby they cannot grow without access to finance yet are not large enough to raise finance. This shows the importance of international cooperation and public finance in making development finance contribute to environmentally sound industrialization.

³⁵ See <https://cepr.org/publications/books-and-reports/role-institutional-investors-responsible-investors>.

³⁶ Berg F, Kölbel JF and Rigobon R, 2022, Aggregate confusion: the divergence of ESG[environmental, social and governance-related] ratings. *Review of Finance*, 26(6): 1315–1344.

³⁷ See <https://www.morningstar.com/sustainable-investing/toward-sustainable-funds-20>.

³⁸ Berg et al., 2022.

³⁹ See <https://www.institutionalinvestor.com/article/2bswn8kfmcaiqcfm0b6yo/opinion/the-trillion-dollar-fantasy>.

⁴⁰ An environmental, social and governance-related index is a type of stock market index that incorporates the performance of companies in this area in its evaluation, the main purpose of which is to provide investors with a comprehensive understanding of the environmental, social and governance-related performance of a company. See <https://www.financestrategists.com/wealth-management/esg/esg-indices/>.

⁴¹ UNCTAD, 2023, *World Investment Report 2023: Investing in Sustainable Energy for All* (United Nations publication, Sales no. E.23.II.D.17, Geneva).

V. International cooperation and blended finance

30. International cooperation in climate finance has promulgated a narrative of “millions to trillions”, with the assumption that blending aid and finance, backed by multilateral development banks, could mobilize private investment in low-income and middle-income countries at a 9:1 ratio and that such investments would allow for the achievement of the Goals by spurring development and addressing climate change.⁴² Experience has shown that this is not always the case; estimates are closer to a 0.7:1 ratio.⁴³ Ambitions have been adjusted to state that “each dollar of lending by multilateral development banks should be complemented by at least \$1 of private finance”, that is, a 1:1 ratio.⁴⁴

31. More transparency and regulation related to the direction of such finance is also needed. Recent analysis of the World Bank climate portfolio, including over 2,500 projects in the period 2000–2022, suggests that “hundreds of projects tagged climate, many in poorer countries, appear to have little to do with climate change mitigation or adaptation [and] a plain reading of these project documents sheds no light on why they are labelled as climate change projects”.⁴⁵

32. Environmentally sound industrialization will require a significant increase in the amount of public development finance. The incorporation of climate considerations into a reformed international debt architecture is necessary to improve the way developing economies can tap into long-term sources of funding, along with cooperation by multilateral development banks and private investment banks to generate desired green industrialization (see box).

Mozambique: Solar power development through multilateral development banks and public investment banks

Mozambique has abundant renewable energy potential, estimated to be the greatest of all countries in southern Africa, including 2.7GW of potential solar power resources.

Significant investment in the first commercial utility-scale solar power plant in Mozambique has been financed by international public investment banks in close cooperation with the International Finance Corporation. The plant, which generates 40MW of power, has been operating since 2019, at a total cost of \$76 million, with funding through loan financing from the International Finance Corporation (\$21 million) and the Emerging Africa Infrastructure Fund (\$21 million), as well as equity investment from the public development bank of Norway. Ownership is divided between the public development bank of Norway (22.5 per cent), the State-owned public power utility (25 per cent) and Scatec Solar, an independent renewable energy specialist in Norway (52.5 per cent).

The engagement of the public development bank of Norway has offered significant support and the availability of financing, including through a feasibility study and project guarantees. In addition, two important financial components were the fact that the project was underwritten by the bank, including a contingent equity guarantee in the event of construction overruns and a performance guarantee to underwrite the plant if it failed to perform as expected.

A separate business support facility was established by the three main partners to provide \$80,000 in additional support for environmental and social goals, in line with the environmental, social and governance-related commitments of the public development bank of Norway. About 200 households were identified as being directly affected by the project

⁴² For details, see <https://www.blendedfinance.earth/>.

⁴³ See <https://odi.org/en/publications/development-finance-institutions-the-need-for-bold-action-to-invest-better/>.

⁴⁴ See <https://www.elysee.fr/en/emmanuel-macron/2023/06/23/the-paris-agenda-for-people-and-the-planet>.

⁴⁵ See <https://www.cgdev.org/publication/what-counts-climate-preliminary-evidence-world-banks-climate-portfolio>.

and liable for relocation, and compensation mechanisms were developed and implemented in consultation with these households, including monetary provision for the loss of any physical assets and the provision of replacement land to allow affected households to continue to farm.

Source: UNCTAD, based on information available at <https://disclosures.ifc.org/project-detail/ESRS/36787/mocuba-solar>, <https://www.mckinsey.com/industries/electric-power-and-natural-gas/our-insights/powering-africa>, <https://www.norfund.no/central-solar-de-mocuba/> and <https://www.power-technology.com/marketdata/power-plant-profile-mocuba-solar-pv-park-mozambique/>.

VI. Financial innovation: Lessons from debt-for-climate and debt-for-nature swaps

33. Debt-for-climate and debt-for-nature swaps are financial instruments that provide conditional debt relief involving one creditor, or a creditor class, to the debtor country that undertakes particular investments and policy actions, either on climate mitigation and climate adaptation (debt-for-climate) or on biodiversity conservation (debt-for-nature). They have been considered with regard to addressing both debt and climate-related vulnerabilities in developing countries. Therefore, they are one instrument in a broader toolkit of climate-conditional financial operations, which also involves concessional loans, grants and comprehensive debt restructuring, aimed at freeing up fiscal resources for such investments.⁴⁶

34. Some suggest that it might be more effective to address debt and climate or nature separately. A climate-conditional grant may be more efficient without the added complexity and high transaction costs of a debt swap operation. In addition, debt swaps provide an implicit subsidy to non-participating creditors since they make remaining debt service commitments more sustainable. Analysts suggest that for countries with unsustainable debt, such instruments are not substitutes for comprehensive debt restructuring, encompassing all creditors, and substantial debt relief.⁴⁷ However, debt-for-climate swaps can be useful in increasing the fiscal space of countries, towards achieving environmentally sound industrial development. On the one hand, grants and concessional loans from bilateral donors and multilateral development banks are scarce relative to the significant need for climate financing, particularly in middle-income countries that are less likely to receive grants. On the other hand, restructuring is often unavailable to countries until debts become unsustainable and they lose market access.

35. Debt-for-nature swaps have been part of sovereign debt restructuring since the debt crises in Latin America in the 1980s. These instruments became less popular in the 2000s, but have had a comeback in the face of increasing debt and climate-related challenges. To date, there have been two classes of such swaps, namely bilateral debt swaps, in which previously committed debt service to official bilateral creditors is redirected to the financing of mutually agreed projects; and tripartite swaps, which are more complex, involving buybacks of privately held debt financed by donors and/or new lenders, usually intermediated by an international non-governmental organization where, in the most common type of operation, the organization lends the funds to the debtor country at below-market interest rates on the condition that the debtor uses the funds to buy back commercial debt at a discount and that a portion of the resulting debt relief is used to fund nature-related actions or investments. Some tripartite swaps have involved political risk insurance provided by either multilateral development banks or development finance corporations

⁴⁶ International Monetary Fund, 2022, Debt-for-climate swaps: Analysis, design and implementation, Working Paper No. 162, available at <https://www.imf.org/en/Publications/WP/Issues/2022/08/11/Debt-for-Climate-Swaps-Analysis-Design-and-Implementation-522184>.

⁴⁷ See <https://www.imf.org/en/Blogs/Articles/2022/12/14/swapping-debt-for-climate-or-nature-pledges-can-help-fund-resilience>.

from developed countries.⁴⁸ The first tripartite swap, with the Plurinational State of Bolivia, took place in 1987, led by Conservation International. Since then, some 90 bilateral debt swaps and 50 trilateral debt swaps have been conducted, up to 2022. The incidence of debt swaps has been high, yet the volume has been modest, with transaction values (in dollars) averaging in the double-digit million range. Estimates show that, in this period, debt-for-nature swaps amounted to \$3.5 billion and debt restructurings, to \$700 billion.⁴⁹

36. Debt-for-nature swaps conducted by Cabo Verde and Ecuador in 2023 could provide lessons for future debt-for-climate swaps in other countries with high debt burdens and a lack of fiscal space with which to achieve environmentally sound industrial development.

37. Cabo Verde signed a bilateral debt swap in January 2023, to redirect debt with Portugal (\$153 million), the main creditor, towards environmental investments. The swap was based on a novel approach proposed by the International Institute for Environment and Development for such swaps, applied in pilot projects in Cabo Verde and Senegal. The debt swap is linked with national climate and nature priorities, including national action plans, and is innovative as it is associated with a government programme rather than an individual project that more directly involves communities directly impacted by climate change. The swap is tied to certain outcomes that, when achieved, can release fiscal space for investment with regard to other national development priorities.⁵⁰

38. Ecuador concluded the largest tripartite debt-for-nature swap to date in May 2023, at \$1.6 billion, with support through a guarantee from the Inter-American Development Bank (\$85 million) and a loan from the United States Development Finance Corporation (\$656 million) providing political risk insurance, the first time such a combination has been employed. The guarantees allowed Ecuador to purchase existing debt and issue new bonds at investment grade, creating fiscal space to direct towards conservation, as well as providing protection to buyers of new bonds in the event of sovereign debt difficulties. The swap will result in \$1.126 billion in savings while enabling Ecuador to allocate \$323 million to marine conservation in the Galapagos Islands. Some analysts have noted that the operation had high transaction costs and that the value is low relative to the total national public debt (around \$70 billion). However, the swap shows the potential for such swaps to be scaled up to provide greater fiscal space for climate-related investments.⁵¹

VII. Policy recommendations

39. Policy options at the national, regional and international levels, based on the development finance vision in the Addis Ababa Action Agenda, to transform and reorient development finance to achieve the 2030 Agenda, are provided in this chapter.

40. A multilateral legal framework for sovereign debt restructuring and relief that facilitates timely and orderly debt crisis resolution by all official (bilateral and multilateral) and private creditors can help address debt overhangs that remain an obstacle to the achievement of both the Goals and the green transition. A mechanism that allows for temporary standstills, stays of litigation, exchange and capital controls and lending into arrears, to protect the capacity of debtor countries to meet economic, social and human rights obligations during a crisis, has been set out by UNCTAD in the road map on sovereign debt workouts.⁵² All countries facing debt challenges should be allowed to participate in such a multilateral framework, independent of income level, and incentivized through the provision of debt relief linked to a debt sustainability assessment that incorporates long-term financing needs, including for the achievement of the 2030 Agenda and the Paris Agreement. Addressing the shortcomings of the Group of 20 Common

⁴⁸ International Monetary Fund, 2022.

⁴⁹ See <https://cepr.org/publications/books-and-reports/geneva-25-climate-and-debt>.

⁵⁰ See <https://iied.org/21371iied>.

⁵¹ See <https://www.iadb.org/en/news/ecuador-completes-worlds-largest-debt-nature-conversion-idb-and-dfc-support>.

⁵² See <https://unctad.org/publication/roadmap-and-guide-sovereign-debt-workouts>.

Framework through the global sovereign debt round table would contribute in this direction, yet remain insufficient.⁵³

41. Multilateral efforts towards increasing tax revenues and stemming illicit financial flows are critical in domestic resource mobilization. They should go beyond the base erosion and profit shifting project led by the Group of 20 and the Organisation for Economic Co-operation and Development.⁵⁴ Considering the formation of a global tax body at the United Nations, undertaking more comprehensive measures towards closing tax havens and tax loops and adopting common global measures for the country-by-country reporting and collection of tax, as well as global asset registries to avoid evasion and avoidance, could be promising ways forward.⁵⁵ In this context, the Committee of Experts on International Cooperation in Tax Matters has developed a fast-track instrument for speedier adoption of key United Nations Model Tax Convention provisions on taxing the digitalized and globalized economy.⁵⁶

42. Such initiatives could be enhanced by new and evolving measures for regional, international and public development banks. For example, improving the capital base of multilateral development banks could be combined with a more efficient use of their balance sheets, to generate more concessional finance. Reviewing their capital adequacy frameworks, such that they take account of the creditor treatment preferred by such banks and available callable capital, could generate substantial additional lending among such banks. Increasing the share of lending to Governments in local currencies and taking currency risks on balance sheets could allow such banks to lower the debt risk profiles of borrowers and thereby provide finance at better terms.⁵⁷

43. Most multilateral grants and other concessional finance for climate is provided by climate financial intermediary funds, such as the Climate Investment Funds and the Green Climate Fund. Financing volumes remain low compared with investment needs, yet there is also need to improve the allocation of available funds. The absence of consistent criteria regarding measuring and reporting on results and impacts complicates donor decisions as to where best to direct grant resources.⁵⁸ A possible way forward could be to consolidate the fragmented financial intermediary funds system into fewer entities with complementary mandates and to pool their funds as guarantees of climate-related multilateral development bank lending, whereby the latter could significantly leverage the current lending capacity of international financial institutions, to leverage, in turn, more private sector finance.

44. A deliberate and strategic direction for fiscal policies could support climate and development-related goals, such as a shipping levy noted at the Summit for a New Global Financing Pact, held in June 2023. Intergovernmental talks at the International Maritime Organization on the proposal for such a levy have been delayed; however, outstanding issues raised by developing countries regarding the disproportionate impact of such a levy on developing economies warrants further consideration of how such policies are designed and implemented.⁵⁹ Other recent options include a passenger flight levy, similar to the solidarity levy already used by a group of countries, and a multi-country financial

⁵³ See <https://www.imf.org/en/News/Articles/2023/04/12/pr23117-global-sovereign-debt-roundtable-cochairs-press-stmt>.

⁵⁴ See https://read.oecd-ilibrary.org/taxation/2023-progress-report-on-tax-co-operation-for-the-21st-century_d29d0872-en#page1.

⁵⁵ See <https://www.icrict.com/press-release/2020/12/16/oecd-response-to-the-oecd-consultation-on-the-review-of-country-by-country-reporting-beps-action-13>.

⁵⁶ For estimates of potential additional revenues accruing to developing countries, see <https://www.southcentre.int/research-paper-156-1-june-2022/>.

⁵⁷ United Nations, 2023, United Nations Secretary-General's SDG[Sustainable Development Goals] Stimulus to Deliver Agenda 2030, available at <https://www.un.org/en/conferences/SDGSummit2023>.

⁵⁸ See <https://cgdev.org/publication/concessional-climate-finance-mdb-architecture-working>.

⁵⁹ See <https://www.imo.org/en/MediaCentre/PressBriefings/pages/Revised-GHG-reduction-strategy-for-global-shipping-adopted-.aspx>, http://www.repec.eae.fea.usp.br/documentos/Pereda_Lucchesi_Diniz_Wolf_04WP.pdf and <https://www.theguardian.com/environment/2023/jul/07/shipping-emissions-levy-delayed-but-goals-for-greenhouse-gas-cuts-agreed>.

transactions tax; and countries can also deploy tax policies to foster environmental protection and greater energy efficiency.⁶⁰

45. Providers of official development assistance need to meet their commitments. Finance at concessional terms and on long-term maturities is best suited for development and climate finance. Official development assistance averages only half the United Nations target of 0.7 per cent of donor country gross national income; in 2021, the figure was 0.33 of gross national income.⁶¹ Improved access to condition-free financing facilities of the International Monetary Fund, such as envisaged in the Bridgetown initiative, a three-step plan to mobilize short-term liquidity for crisis response and long-term funding for sustainable development, would be another important step in the same direction.⁶²

46. The potential of special drawing rights to become a key mechanism for development and climate finance remains unrealized.⁶³ Efforts to encourage a review of the mechanism for allocating special drawing rights, rechanneling unused rights, including through multilateral development banks, ensuring their timely countercyclical issuance and increasing their developmental link, need to be stepped up. The rechanneling of unused special drawing rights could be a key mechanism for the urgent increase of the capitalization of regional development banks and multilateral development banks and could be supported by a more general increase in the capital base of these institutions.

47. At the twenty-seventh session of the Conference of the Parties to the United Nations Framework Convention on Climate Change, a loss and damage fund was set up to provide funding for vulnerable countries affected by climate-related disasters. In this regard, both the fund and new funding arrangements need to be operationalized and, in doing so, consideration should be given to upholding the principle of common but differentiated responsibilities, making funds available to developing countries, in particular the least developed countries, in a reliable, transparent and predictable way, with access based on parametric triggers that also reflect the cumulative effect of multiple disasters.

48. Along with debt-for-climate and debt-for-nature swaps, other innovative finance instruments could help developing countries address climate and debt-related challenges. Climate contingent clauses on sovereign lending arrangements across all creditor classes could mitigate debt distress following a climate-related event.⁶⁴ Such clauses allow countries to temporarily suspend debt repayments (generally by 1–2 years) in the event of a predefined exogenous shock, such as a natural disaster that causes damages exceeding a certain threshold. At the Summit for a New Global Financing Pact, the World Bank announced that it would place greater emphasis on existing climate contingent clauses in its lending operations.⁶⁵ Such clauses provide breathing room and allow countries to reallocate financing to emergency responses during climate crises; however, when used for single loan instruments, they have high transaction costs and do not involve debt reduction.

⁶⁰ See <https://www.ecb.europa.eu/pub/pdf/scpops/ecb.op315~c279c7c290.en.pdf>, <https://www ldc-climate.org/wp-content/uploads/2018/02/LDC-paper-series-17.pdf>, <https://www.orfonline.org/research/reviving-the-iftt-agenda-for-the-g20/> and https://www.wifo.ac.at/publikationen/publikationssuche?detail-view=yes&publikation_id=61805.

⁶¹ United Nations, Inter-agency Task Force on Financing for Development, 2023.

⁶² See <https://www.foreign.gov.bb/the-2022-barbados-agenda/>.

⁶³ See <https://www.cgdev.org/blog/declaring-hollow-victory-sdrs-would-further-undermine-g20-credibility>.

⁶⁴ UNCTAD, 2022, Tackling debt and climate challenges in tandem: A policy agenda, Policy Brief No. 104.

⁶⁵ See <https://nouveau-pactefinancier.org/en.php> and <https://www.elysee.fr/admin/upload/default/0001/15/4748a23641c5b2d55a47d63d7ed2e16963c11195.pdf>.

49. To induce fossil fuel-producing countries to leave resources in the ground, debt-for-climate swaps have been discussed, building on lessons learned from, for example, the experience of an oil field initiative in Ecuador.⁶⁶ More recent proposals in this area focus on an extension of central bank mandates beyond monetary stability to climatic stability, including using central bank funds to absorb stranded assets from fossil fuel companies in exchange for funds that must be invested in additional renewable energy capacity.⁶⁷

50. Just energy transition partnerships are new climate finance agreements aimed at facilitating the early decommissioning of coal-fired power plants, mobilizing private sector capital to finance decarbonization efforts and delivering on a just transition for citizens.⁶⁸ The successful advancement of such partnerships should provide new funds, impose minimal conditionalities and allow for localization provisions, such as the use of local firms and local expertise to help create useful productive capacities and long-term development benefits. In addition, such partnerships need to be sizeable and aligned with industrial policies that can ensure that transitions are affordable and just.

51. Finally, member States should consider enacting domestic legislative changes, to facilitate timely and orderly sovereign debt restructuring processes. In the meantime, contractual tools, such as enhanced collective action clauses, majority voting provisions, State contingent clauses and climate resilience debt clauses, should be widely incorporated into debt and loan contracts. Well-designed debt-for-climate swaps may also play a role in this regard.

⁶⁶ Sovacool BK and Scarpaci J, 2016, Energy justice and the contested petroleum politics of stranded assets: Policy insights from the Yasuní-ITT Initiative in Ecuador, *Energy Policy*, 95:158–171. See Firdaus N and Mori A, 2023, Stranded assets and sustainable energy transition: A systematic and critical review of incumbents' response, *Energy for Sustainable Development*, 73:76–86.

⁶⁷ See <https://www.worldfuturecouncil.org/wp-content/uploads/2018/02/Stranded-Assets-Climate-Bailout-Paper-02-2018.pdf>.

⁶⁸ See <https://www.iisd.org/gsi/policy-briefs/making-leap-need-just-energy-transition-partnerships-support-leapfrogging-fossil-gas>.