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Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Utilising Sovereign Wealth Funds for Climate Finance: A Strategic Approach to Enhance MDBs' Role in the Green Sustainable Transition

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Abstract

This policy brief (PB) underscores the urgent need for funds to address the global challenge of climate and environmental crisis, advocating the use of sovereign wealth funds (SWF) as a stable source of funding for Multilateral Development Banks (MDBs). Recognizing the climate crisis as a global issue that experience to date shows will not be adequately addressed through conventional market mechanisms, nor one that individual 'climate-friendly' microenterprise initiatives backed by microcredit can resolve, the PB emphasizes the role of MDBs in acting across borders. It highlights the efficacy of MDBs and suggests leveraging international organizations to complement public resources with private capital, particularly for the Global South, which occupies a subordinate position in the global financial system.

The PB proposes a coordinated approach to sustainable policymaking, instrumentalizing MDBs to go beyond narrow social agendas and induce broader structural change. Given the crisis's transnational nature, MDBs are uniquely positioned to implement policies that transcend national boundaries, promoting sustainable practices globally.

The PB also advocates for the strategic use of SWF to ensure stable and continuous funding. This approach assumes strong national and subnational state intervention in each country that involves coordinated effort with MDBs´ actions to not only mitigate risks but also actively drive public policy, especially when directing resources to Global South countries. Considering that SWF portfolios are mostly allocated in the Global North, the creation of mechanisms could be part of the solution for rebalancing capital flows.

The PB recommends utilizing revenues from current high oil and/or mineral production to finance the sustainable green transition, underscoring the need for MDBs to respond robustly, cross-border, to the pressing crises.

Diagnosing the issue

This Policy Brief (PB) recognizes the limitations of conventional market mechanisms and isolated microenterprise initiatives in tackling the profound threats of the climate, environmental and social crisis.[1] It underscores the need for a coordinated, proactive international approach to mitigate these challenges effectively. In this context, it underscores the indispensable role of Multilateral Development Banks (MDBs) in transcending national boundaries and steering the sustainable transition process. By striving to achieve global objectives such as reducing Greenhouse Gas (GHG) emissions and preserving biodiversity, MDBs can act regionally, bolstering the policies of individual nation-states. Given that these institutions can serve as a crucial tool for the structural transformation of regions and countries, their approach can mirror the successful experiences of national development banks in promoting productivity growth and increased incomes.

Developing a novel financial architecture for MDBs is pivotal in addressing the global climate, environmental and social crises – that underscore the urgency of transitioning towards a sustainable economy. This transition demands tackling multiple challenges simultaneously; it necessitates pursuing innovative social technologies and technical proficiency to enhance production processes for environmental efficacy. The

[1] Microcredit is increasingly being portrayed by the main international development institutions as a financial intervention that can help poor rural communities to individually deal with the climate emergency. Careful examination of this possibility in Cambodia, however, currently one of the world's most microcredit-penetrated countries, revealed it to be an entirely inappropriate measure. (Guermond *et al*., 2022)

accumulation of scientific insight is essential to foster the global green sustainable transition (GST), alongside the mobilisation of adequate financial resources to finance the investments required for the desired socio-economic change. (Feijo, *et al.*, 2023)

The function of MDBs is critical in fulfilling these requirements, primarily because they can serve as the link between globally coordinated States promoting the GST, given their ability to: i) create and sustain a market for the financial system to redirect investments towards cleaner projects; ii) address the loss process in highly leveraged and GHG-intensive sectors; and iii) ensure that this transition does not affect the stability of the financial system. (Bresser-Pereira and Bechelaine, 2019)

Furthermore, given that MDBs are institutions controlled by multiple nation-states, with the majority being members of the G20, this underscores the significance of addressing this topic. As G20 countries are the principal stakeholders in MDBs and these institutions operate beyond the confines of a single nation, this represents the appropriate forum for addressing and strengthening their governance.[2] This is essential to ensure they are fully equipped to tackle the challenge. (Ocampo and Ortega, 2022)

To effectively perform their role, MDBs must be equipped with diverse funding sources and autonomy to act as public policy arms within a new multilateral configuration where the GST is central to the objectives. Moreover, MDBs require stable mandates,

[2] The list of MDBs controlled by G20 countries encompasses: the World Bank Group (WB), the Inter-American Development Bank (IDB); the Asian Development Bank (ADB); the African Development Bank (AfDB); the European Bank for Reconstruction and Development (EBRD); the European Investment Bank (EIB); the New Development Bank (NDB); the Islamic Development Bank (IsDB) and the Asian Infrastructure Investment Bank (AIIB).

professionally trained staff for these specific purposes, and the ability to function as intelligence hubs to promote projects and activities aimed at these ends. This approach represents a novel form of international coordination, acknowledging that the climate, environmental and social crises are not a problem confined to a single country but a global issue, emphasising that there are no individual solutions to collective problems. MDBs should also partner with regional and national development banks, acting as a catalyst for the GST.

Currently, MDBs are predisposed towards dedicating a considerable share of their resources to prioritise the transition, such as renewable energy sources and climate-resilient infrastructure, setting a benchmark in financing sustainable initiatives. Beyond direct financial support, the technical assistance MDBs offer plays a vital role, encompassing everything from environmental impact evaluations to the planning of sustainable initiatives, thus empowering regions to execute and oversee such projects efficiently.

Research and development stand as critical elements within MDBs' financing spectrum. Investing in research on green technologies and innovations can propel the sustainable green transition forward and facilitate the realisation of the Sustainable Development Goals (SDGs). Moreover, establishing explicit standards and criteria for GST investments fosters market benchmarks, motivating additional investors towards adopting more sustainable practices.

Engagement with various stakeholders, including governments, the private sector, and civil society organisations, enables MDBs to extend their impact. The introduction of stringent monitoring and evaluation frameworks ensures the alignment of supported projects with the SDGs and the objectives of a GST, allowing for adjustments in response to the dynamic global environment. (G20, 2023)

However, despite these advancements, cohesive policies remain necessary to ensure the enhanced operation of MDBs and the provision of stable funding sources. These must remain stable and independent from the volatility of the capital markets, as historical experience with resource volatility can constrain the activities of these institutions. (Humphrey, 2016) This consideration underscores the necessity for stable, reliable financial backing to support the comprehensive mission of MDBs in driving sustainable development and climate resilience, which can happen through the involvement of Sovereign Wealth Funds (SWFs).

Proposed recommendations

To fulfil their mission, MDBs need to have a level of capital commensurate with their counterparty risk-bearing capacity and ensure that long-term resources back liabilities. A prerequisite is governmental support, which can take several forms, such as loan guarantees, subsidised interest rates, tax incentives, and so on. The question then arises of whether MDBs have sufficient capital and access to grants or subsidies to support virtuous projects committed to the GST on a global scale. One viable approach to capitalising on MDBs involves attracting SWFs.

SWFs have existed for a long time and are associated with trade surpluses in commodity-exporting countries, but not only. Most SWFs are denominated in US dollars, and three moments are symbolic of the proliferation of these instruments: 1. the oil shocks; 2. the balance of payments crises of the 1990s, combined with the commodity price boom in the 2000s (Griffith-Jones and Ocampo, 2009), and the post-2008 international financial crisis. In 2023, there were more than 100 SWFs across more than 50 countries, managing around US$ 8 trillion in assets. G20 countries hold over 60 national and subnational funds, according to the Sovereign Wealth Fund Institute (SWFI).

The literature lists six major purposes or objectives that are usually placed in the range of options for an SWF: i) intergenerational savings, ii) stabilisation, iii) State funding, iv) portfolio diversification, v) strategic, and vi) development. Furthermore, funds with such characteristics may have more than one objective, and more than one fund can be conformed to meet different goals (Teixeira, 2017).

In general, SWFs are administrated by the federal government usually by hiring an external manager, and there's a 'need' for external management that differs from how central banks deal with international reserves. In other words, most of them are part of

the country's macroeconomic framework, operating at the intersection between the monetary policy (contributing to sterilising domestic currency through external recycling) and the fiscal policy, with specific rules for its withdrawal and use.

Nevertheless, recently, especially in the context of multiple crises (pandemic, inflation, geopolitical conflicts, and so on), the role of SWFs has undergone drastic transformations. On the one hand, funds previously operated primarily abroad have redirected a portion of their portfolio towards domestic projects. Another increasingly prevalent trend is allocating resources to projects associated with the energy transition (Sharma, 2017; IFSWF, 2023). In this sense, SWFs can play a fundamental role in collaboration with MDBs and other financial actors, becoming a catalytic agent for investments in the context of the climate crisis (Schena, Dixon, 2023). On the other hand, the pandemic and the resulting inflationary shocks, as well as armed conflicts, have reduced the risk appetite of these investors (IFSWF, 2022), which preferred the safety and liquidity of allocating their investments in developed markets, thereby reducing exposure to emerging markets.

Support for public funding to private initiatives in energy transition can be summarized in the statement of the head of the Department of Energy of the USA: the “clean energy transition must be private sector-led, government-enabled”.[3] However, from an international perspective, particularly in Global South countries with fewer financial resources, implementing domestic public policies to attract private capital to the right projects is more challenging. At COP28, discussions focused on financing the energy transition in emerging markets, emphasising the crucial role of efficiently using

[3T] https://www.forbes.com/sites/rhettbuttle/2024/01/08/government-enabled-private-sector-led-a-conversation-with-us-department-of-energy-secretary-granholm-on-the-future-of-the-energy-economy/?sh=76866fe32d99

concessional capital from governments and international financial institutions to attract local and foreign private-sector investors. Nevertheless, the optimal structures for risk-sharing and the utility of instruments like green and blue bonds and dedicated investment funds remain debated. MDBs can play a crucial role in this architecture, especially if catalysed by SWFs.

This policy brief proposes that a portion of SWF' portfolios be allocated to fund MDBs to finance investments in GSTs, with a particular focus on directing resources to Global South countries. This would be achieved through the issuance of green bonds by MDBs linked to the sovereign risk of Global North countries, which would be specifically allocated to projects in Global South countries with climate objectives associated with SDGs. The fact that G20 countries hold over 60 funds would facilitate this coordination and could generate a crowding-in effect. By leveraging SWFs as a funding mechanism, MDBs can enhance their financial stability and capacity to undertake impactful development projects.

The PB's recommendation is to adopt the concept of Sustainable Future Bonds proposed by Zucker-Marques and Gallagher (2024), incorporating a new element (SWFs) to make the proposal more viable in the short and medium term. In the cited proposal, the authors suggest the creation of specific instruments to direct international reserves for development purposes, involving four main steps. Initially, MDBs would introduce hybrid capital instruments called Sustainable Future Bonds (SFBs). Subsequently, central banks from advanced and emerging and developing economies would acquire these instruments, offering a portion of their reserves in exchange. Thirdly, MDBs would utilise these newfound resources to expand their balance sheets, thereby increasing client lending. Finally, liquidity for Sustainable Future Bonds would be ensured through agreements among central banks.

Furthermore, Marques-Zucker and Gallagher (2024) argue that this would be a way to incentivise central banks to expand their climate objectives. In the present proposal, however, as for an instrument aimed at attracting investments from SWFs, there is already a movement in this direction, according to the International Forum of Sovereign Wealth Funds (IFSWF) and the One Planet Sovereign Wealth Fund Network (OPSWF) research, to subsidise discussions at COP28 (IFSWF, 2023).

Unlike this proposal, which requires a high level of cooperation and is subject to uncertainties related to international volatility, where countries could choose not to demand these bonds or simply withdraw from the initiative by creating an instrument that has SWFs as the main source of funding (that is, institutional investors with a state nature and patience regarding future returns), multilateral negotiations for the creation of the mechanism would tend to encounter fewer obstacles. In summary, under the current proposal, the funding source would shift from international reserves to SWFs, which already require sovereign bonds from central countries to balance their portfolios.

Scenarios of outcomes

In the complex tapestry of global finance, the role of SWFs is increasingly coming to the fore, particularly in the context of sustainable development and environmental conservation. This discourse explores the potential outcomes of leveraging SWFs as a primary funding source for MDBs, a move that could significantly influence the trajectory of the GST. Given the origins of these funds and the strategic imperatives they serve, however, it is essential to scrutinise the inherent contradictions and trade-offs that such adoption might engender.

SWFs, by their very nature, are state-owned investment vehicles, often derived from revenues of "brown industries" such as fossil fuels and mining. These industries are among the principal contributors to environmental degradation, yet paradoxically, they hold the potential to finance the GST. The scenario presents an intriguing dichotomy where the primary perpetrators of environmental crises could become pivotal in mitigating these challenges, thereby funding initiatives that aim to reduce GHG emissions, enhance biodiversity, and foster social and regional equity.

The use of SWFs to fund MDBs for sustainable development projects encapsulates a transformative approach to mobilizing capital for the GST. This potential redirection of funds signifies a strategic shift from brown to green investments, embodying a practical manifestation of the polluter pays principle. It underscores the capability of SWFs to transcend their traditional investment paradigms, aligning their financial strategies with SDGs.

However, this shift is not without its complexities. On the one hand, it heralds a promising avenue for accelerating progress towards achieving SDGs, particularly in facilitating catch-up development, mitigating structural heterogeneity, and promoting

social and regional equity. It exemplifies how strategic financial reallocation can contribute to narrowing the development gap between nations and fostering a more balanced and equitable global economy.

On the other hand, the deployment of SWF resources in this manner is contingent upon robust governance frameworks, the upskilling of technical personnel, and strategic planning led by national states in cooperation. This calls for a novel form of multilateralism centred around the GST as its core objective. Without such frameworks, there is a risk that these resources could inadvertently perpetuate the problems they aim to solve. This scenario stresses the critical need for transparent, accountable, and strategic utilisation of SWF investments, ensuring they contribute positively to the global transition towards sustainability.

The paradox of leveraging funds derived from environmentally detrimental activities to finance sustainable development encapsulates the intricate relationship between global finance and environmental policy. It illustrates the potential for a radical realignment of financial flows towards investments that yield satisfactory financial returns while generating substantial environmental and social benefits.

Moreover, the strategic reallocation of SWF investments towards sustainable development projects through MDBs represents an opportunity to redefine the essence of sovereign wealth. It challenges sovereign states to reconceptualise the stewardship of national assets, prioritising long-term environmental and social returns over immediate financial gains. This shift demands a reevaluation of national and global priorities, advocating for a financial architecture that is resilient, sustainable, and equitable.

In conclusion, utilising SWFs as a resource for MDBs in the GST presents a compelling yet complex scenario. It offers a pathway towards reconciling the dichotomy between the origins of these funds and the objectives they seek to achieve. However, the

successful implementation of this proposal hinges on establishing rigorous governance structures, enhancing technical expertise, and adopting strategic planning underpinned by a new paradigm of multilateral cooperation. Only then can the potential of SWFs be harnessed to facilitate a just and sustainable transition, transforming one of the key drivers of the problem into a fundamental part of the solution.

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