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Closing the climate finance gap

How to raise the money
the world needs to support
climate action

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Summary

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- A substantial gap exists between the amount of finance needed to achieve net zero in order to avert catastrophic impacts from climate change and the amount of finance available. The bulk of the finance to close this gap will need to come from the private sector, and substantial progress is being made in increasing the proportion of overall private finance that is going to green investment. But the process needs to happen much faster, and support from governments, central banks, multilateral development banks and other public (or publicly backed) institutions is critical.
 - This research paper focuses on the options for addressing the particularly challenging part of the finance gap that affects emerging markets and developing economies (EMDEs) excluding China. Public international finance¹ has a unique and critical role to play in supporting efforts to achieve climate goals, including through accelerating mobilization of greater amounts of private finance and building trust between advanced and developing economies. But public international finance is in short supply relative to the demand for it.
 - The paper's analysis focuses both on how best to increase public international finance for climate action and on how to use the limited finance available, or likely to become available, more effectively. In particular, the paper looks at the relative merits of mobilizing private finance through conventional use of public finance to improve the business environment versus deploying public finance alongside private finance in risk-bearing arrangements.
 - Many think-tanks and academics have proposed sharp increases in public international finance for climate action. So far, however, such proposals have failed to make a significant difference to the amount of funding available, in large part because they imply a current or future call on official development assistance (ODA) provided by traditional donors. Notwithstanding strong practical, political and moral arguments for financing more climate action, many donor governments are constrained by severe pressures on public finances.
 - Similarly, efforts to use public international finance to mobilize private finance on a larger scale have had only limited success. In addition to the above-mentioned fiscal constraints, key issues include fundamental differences in objectives between the private sector and the public sector, and the fact that

¹ Public international finance includes: official development assistance (ODA); finance provided by multilateral development banks (MDBs) fully guaranteed by public shareholders; finance provided by the IMF fully underwritten by member states; and finance provided by bilateral development finance institutions fully guaranteed by the sponsoring government shareholder. Such finance may take the form of loans, equity investment, guarantees, insurance or outright grants.

the public finance potentially available to catalyse private investment is not being used optimally. Lack of progress in this area has added to the distrust between advanced and developing economies.

- While efforts to increase the overall amount of public international finance available for climate action need to continue, this paper argues that significant progress in closing the climate finance gap will depend on the international policy community² paying much closer attention to *how* currently available flows of public international finance are used, and how such flows can be made more effective. Addressing these twin issues will involve difficult choices: on how much public international finance to devote to climate action vs other high-priority non-climate objectives; on the absolute amounts of finance to be allocated to different climate objectives; and on the different ways of mobilizing private finance.
- Critical to improving the effectiveness of available public international finance will be to increase the proportion used to facilitate *genuine* risk-bearing in conjunction with the private sector. A mechanism needs to be developed under which this can happen without imposing contingent risks on advanced-country donors. Such risks arise, for example, if those donating funds to capitalize climate finance operations are liable for losses over and above the initial funds they provide – a situation likely to deter donors from providing capital for riskier operations.
- The international policy community also needs to understand better why so much private finance is still going to hydrocarbon-intensive investment. This is likely in substantial part to reflect ‘moral hazard’ and other perverse incentives such as hydrocarbon subsidies; urgent steps must be taken by central banks, financial regulators and finance ministries to remove such incentives and, where possible, to repurpose the subsidies.
- A carefully calibrated political process is needed to deliver this fundamental change of approach, and it will not happen overnight. But the ongoing negotiations around a New Collective Quantified Goal (NCQG)³ – the priority agenda item at the UN’s COP29 climate summit, being held in Azerbaijan between 11 and 22 November 2024 – provide an important opportunity to agree a mandate on initial steps. Such a mandate could then be followed up at the Finance for Development Conference and COP30 climate summit in 2025.
- The election of Donald Trump to a second term as president of the United States only reinforces the need for the approach proposed in this paper. While Trump has yet to define his detailed policies in this area, the next president may repeat his previous action in withdrawing the US from the Paris Agreement on climate change. He is unlikely to increase US contributions to public

² The ‘international policy community’ is defined here as consisting of the following groups: policymakers in advanced and developing countries; international financial institutions (IFIs); and researchers in think-tanks and universities.

³ Agreeing a New Collective Quantified Goal (NCQG) on Climate Finance is at the top of the agenda at COP29 in Azerbaijan. At the COP21 climate summit in Paris, in 2015, parties agreed that before 2025 the ‘Conference of the Parties’ (COP) to the United Nations Framework Convention on Climate Change (UNFCCC) would set a new and more ambitious climate finance goal with a floor of \$100 billion a year, and that this goal would take into account the needs and priorities of developing countries.



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international finance, particularly in the area of climate action. He may also use the US's vote at the World Bank and other multilateral development banks to try to constrain such institutions from increasing their conventional climate lending. Meanwhile, his domestic policies are likely to slow, or even reverse, the US economy's shift away from hydrocarbon-intensive investment. In these circumstances it will be critical for other countries to make the best possible use of the public international finance they provide for climate action, and to redouble their efforts to eliminate perverse incentives for carbon-intensive investment.



01

Introduction

The need for more climate finance to drive decarbonization is greater than ever. But while progress is being made, it is not fast enough, particularly in emerging markets and developing economies. Negotiations for a New Collective Quantified Goal at COP29 are a critical step towards stronger climate action.

The latest evidence of climate change from climate scientists makes grim reading. In 2023, average global temperatures exceeded 1.5°C above pre-industrial levels for the first time. Sea level temperatures have regularly broken records.⁴ Serious climate impacts are occurring much sooner than many models have predicted, with damages resulting from severe regional storms reaching \$76 billion in the US and Europe alone in 2023 – of this, \$58 billion in damage was insured.⁵ The cost of insurance against climate-related damage is rising, and the availability of insurance for certain risks and regions is increasingly constrained.⁶ Given the consequences of unchecked greenhouse gas emissions, decarbonization cannot be viewed as in any sense discretionary. Sooner or later, the costs will have to be borne. The faster action is taken, the lower the overall costs from climate warming are likely to be.

Significant progress is occurring on decarbonizing the global economy. Advances are being driven by better information on the risks and opportunities from climate change, by new and cheaper low-carbon technologies, and by government subsidies and regulation. Indeed, some leading experts argue that the low-carbon transition is now irreversible.⁷ The problem is that progress is not happening fast enough, particularly in emerging markets and developing economies (EMDEs).

⁴ Erdenesanaa, D. (2024), 'Ocean Heat Has Shattered Records for More Than a Year. What's Happening?', *New York Times*, 10 April 2024, https://www.nytimes.com/2024/04/10/climate/ocean-heat-records.html?unlocked_article_code=1.Sk4.7Mct.h8bVG-DGyNQJ&smid=url-share.

⁵ Araullo, K. (2024), 'Munich Re reveals total insured global losses for 2023', *Insurance Business*, 9 January 2024, <https://www.insurancebusinessmag.com/us/news/reinsurance/munich-re-reveals-total-insured-global-losses-for-2023-472180.aspx>.

⁶ Smith, I. (2024), 'Insurers face \$151bn in yearly losses from natural disasters, key research forecasts', *Financial Times*, 4 September 2024, <https://ft.pressreader.com/v99c/20240904/281668260334629>.

⁷ Mooney, A. (2024), 'Elections will dictate pace of climate change, warns Gore', *Financial Times*, 19 September 2024, <https://ft.pressreader.com/v99c/20240919/281663965400063>.

A key reason for this is shortage of finance. The enormous scale of the economic transformation involved in shifting away from fossil fuel-based energy systems makes financing essential. The same is true for investment in measures to adapt to climate change and make countries more resilient to its impacts, and for paying the costs of reconstruction following climate-related 'loss and damage'.

On the positive side, average annual climate finance flows, driven by accelerating mitigation finance, are rising. Such flows reached \$1.46 trillion a year in 2021–22, up sharply from 2020–21, and are estimated to have reached \$1.5–1.6 trillion in 2023, according to the Climate Policy Initiative.⁸ The International Energy Agency (IEA) has estimated that more than \$2 trillion will be invested in clean energy in 2024, compared with \$1.2 trillion in fossil fuels.⁹

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However, these figures for current climate investment mask the continuing domination of the stock of energy assets by hydrocarbons, and are still too low compared with projected needs. A middle-of-the-range estimate puts the figure for total needs at \$8 trillion a year, rising to \$10 trillion a year after 2030.¹⁰ Moreover, flows to least developed countries (LDCs) and to most emerging economies are proportionately very small. Less than 3 per cent of total global climate finance in 2021–22 flowed to, or within, LDCs. In the same period, 14 per cent of global climate finance flowed to, or within, EMDEs other than China.¹¹ As a consequence, the climate financing gap for these countries is very substantial. An independent panel of experts appointed by the COP26 and COP27 presidencies has estimated that EMDEs other than China will need to spend an additional \$1 trillion per year (4.1 per cent of GDP) on climate-related goals by 2025, and around \$2.4 trillion (6.5 per cent of GDP) per year by 2030.¹²

Against this background, work has been under way in the run-up to the COP29 UN climate conference – taking place in Baku, Azerbaijan from 11 to 22 November 2024 – to negotiate a 'needs-based' New Collective Quantified Goal (NCQG) on Climate Finance.¹³ This will set out the amount of international public

⁸ Buchner, B. et al. (2024), *Global Landscape of Climate Finance 2024*, Climate Policy Initiative, <https://www.climatepolicyinitiative.org/publication/global-landscape-of-climate-finance-2024>.

⁹ International Energy Agency (2024), *World Energy Investment 2024*, <https://iea.blob.core.windows.net/assets/60fcd1dd-d112-469b-87de-20d39227df3d/WorldEnergyInvestment2024.pdf>.

¹⁰ Buchner, B. et al. (2023), *Global Landscape of Climate Finance 2023*, Climate Policy Initiative, <https://www.climatepolicyinitiative.org/wp-content/uploads/2023/11/Global-Landscape-of-Climate-Finance-2023.pdf>.

¹¹ Buchner et al. (2024), *Global Landscape of Climate Finance 2024*.

¹² Songwe, V., Stern, N. and Bhattacharya, A. (2022), *Finance for climate action: Scaling up investment for climate and development*, Report of the Independent High-Level Expert Group on Climate Finance, <https://www.lse.ac.uk/granthaminstitute/wp-content/uploads/2022/11/IHLEG-Finance-for-Climate-Action-1.pdf>.

¹³ United Nations Climate Change (undated), 'New Collective Quantified Goal on Climate Finance', <https://unfccc.int/NCQG>.

finance and publicly mobilized private finance to be provided by developed countries to developing countries. It will replace the \$100 billion a year target figure from COP15.

A key aim of the new goal is to support higher ambition in the next round of updates to nationally determined contributions (NDCs), which set out countries' commitments to reducing emissions. This next round of NDC updates is due to be submitted by February 2025. Intense negotiations have been under way for some time between developed and developing countries on many key features of the NCQG.¹⁴ The topics being negotiated include: the size of commitments; who should contribute; the time frame for meeting commitments; the types of climate action to be covered; the link between the NCQG and broader efforts to align private finance with climate goals; the balance between the different types of finance to be provided; and monitoring and accountability.

At the time of writing, it is unclear how much of this will be settled at COP29 in Azerbaijan. The uncertainty is increased by the fact that the US government representatives are from a lame-duck administration. There is also an important choice for all parties involved in terms of how ambitious the NCQG should be. Agreement on a highly ambitious goal would not guarantee delivery of funding in subsequent years, despite arguably increasing the likelihood of a large amount of finance being delivered even if the specific goal itself were not met. However, this could come at the cost of much greater uncertainty and further damage to the credibility of the goal-setting process. In contrast, agreement on a less ambitious headline target could realize a smaller figure in terms of actual finance delivered, but could create a more predictable base for planning and for the more detailed NDCs that are seen as critical to general alignment of the financial system with climate goals.

About this paper

This research paper focuses on two of the many factors that may contribute to closing the climate finance gap: (1) the use of public international finance, including as a means for stimulating private climate finance; and (2) the need to reduce the continued flow of private finance to carbon-intensive investments. The first of these factors has been chosen in part because of the uniquely important role of public international finance in supporting climate action, and also because it is the focus of much public debate at present. The second has been chosen because it is attracting far too little attention at present despite its importance.

To keep the scope of the analysis manageable, the role of public *domestic* finance (and of carbon taxes within that field), the role of domestic and international economic regulation, and the role of carbon trading and carbon-related trade measures are deliberately not discussed in this paper, although such factors are of course also important.

¹⁴ Alayza, N., Larsen, G. and Waskow, D. (2024), 'What Could the New Climate Finance Goal Look Like? 7 Elements Under Negotiation', World Resources Institute explainer, 29 May 2024, <https://www.wri.org/insights/ncqg-key-elements>.

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Chapter 2 explains why public international finance is critically important to closing the climate finance gap. It reviews current initiatives and proposals to increase the total amount of public international finance, assessing the viability and scalability of the most significant mechanisms that are either in place or being considered. Chapter 3 discusses how the public international finance that is already available for climate action can be used more effectively, and makes the case for donors to accept higher risk on a clearly delineated portion of the finance they provide. Chapter 4 asks why so much private finance is still going to hydrocarbon-intensive projects, and how this might be reduced. Chapter 5 proposes a political process for delivering recommendations from the earlier sections.

02

Increasing public international climate finance

The policy community has made multiple proposals in recent years for achieving a step change in the flow of public international climate finance into EMDEs. However, achieving a breakthrough will be very difficult because all the ideas ultimately require more official budget support from traditional donor governments.

According to the OECD, developed countries provided \$94.1 billion in public international finance for climate action through bilateral channels, multilateral channels and export credits in 2022.¹⁵ This compares with total climate finance flowing to EMDEs of \$244 billion in the same year.¹⁶ But while the bulk of climate finance in future will need to come from private sources, maximizing available public international finance is critically important to closing the climate finance gap.

This is because it is one of only a few ways – other than through the savings of enterprises and individuals¹⁷ – to finance climate mitigation projects in low-income countries or highly indebted emerging economies. Both categories of country typically lack access to private capital markets. The use of public international finance is often also the only way to fund climate change adaptation projects, even where a country has access to private markets, because the high social returns

¹⁵ OECD (2024), *Climate Finance Provided and Mobilised by Developed Countries in 2013-2022*, Paris: OECD Publishing, https://www.oecd.org/en/publications/climate-finance-provided-and-mobilised-by-developed-countries-in-2013-2022_19150727-en.html.

¹⁶ Buchner, B. et al. (2024), *Global Landscape of Climate Finance 2024*, Climate Policy Initiative.

¹⁷ Jilani, H. (2024), 'Pakistan grid overpowered by China solar panels', *Financial Times*, 19 September 2024, <https://ft.pressreader.com/v99c/20240919/281651080498175>.

associated with measures to adapt to climate change and increase resilience to its impacts may be impossible to convert into commercial returns. Furthermore, public international finance remains a key tool for mobilizing private finance, and is often essential to enabling a country with excessive sovereign debt to reduce the real burden of that debt (as measured by net present value, or NPV) even though there may also be a private sector contribution.

In recent years, researchers in think-tanks and universities, along with some policymakers, have proposed multiple routes to increase the total available amount of public international finance for climate action. Given that the administrative, political and financial constraints on increasing public international finance vary from one donor country to another, having multiple routes to choose from improves the chances of achieving an overall expansion.

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However, while some routes have been partially successful, or may have a reasonable chance of delivering some additional finance in future, achieving a sustained breakthrough in the scale of public international finance provision for climate action will be very difficult. The detailed reasons vary, but ultimately come back to the underlying need for official budget support of all of the approaches proposed. Consider each route in turn:

Official development assistance

The most direct approach has been to lobby for higher levels of climate-related official development assistance (ODA) from traditional (i.e. advanced-country) donors. Bilateral ODA with climate objectives has increased gradually over the past decade, reaching nearly \$50 billion in FY 2021/22¹⁸ – a sum equivalent to 32.9 per cent of total bilateral ODA from members of the OECD's Development Assistance Committee (DAC). However, the severe constraints on public finances in many advanced countries – following the rise in fiscal pressures associated with the COVID-19 pandemic and increased geopolitical tensions, and also the competing non-climate-related demands for ODA, including support for humanitarian assistance and reconstruction in Ukraine – make it unlikely that climate-related ODA provision will rise much more sharply than the current trend rate in future.

¹⁸ OECD (2024), *Official development assistance for climate in 2022: A snapshot*, Paris: OECD Publishing, [https://one.oecd.org/document/DCD\(2024\)20/en/pdf](https://one.oecd.org/document/DCD(2024)20/en/pdf).

Broadening the range of ODA providers

Another approach is to try to broaden the range of countries providing climate-focused ODA beyond the advanced economies. China will not agree to formal climate finance commitments under the United Nations Framework Convention on Climate Change (UNFCCC), but is potentially an important new source of such funding on a voluntary basis; China's outward flows of public grants, interest-free loans and concessional loans for both climate and non-climate purposes averaged \$7.6 billion a year over the five years to 2018.¹⁹ Very large infrastructure investments associated with the country's Belt and Road Initiative (BRI), some of which may be ODA-supported, have been scaled back, but instead the Chinese authorities are now showing greater interest in following global sustainability standards, thereby increasing the potential for a positive climate impact from what is being spent.²⁰ Another potential source of growing assistance is the oil-rich Gulf states. The United Arab Emirates (UAE), for instance, has allocated \$30 billion of public finance to establish the climate-focused Alterra Funds,²¹ of which \$5 billion will help with risk mitigation capital and encourage investment flows into the Global South. It is unclear whether some of this will count as ODA, however. Both the Chinese and UAE contributions are potentially significant, but these start from a relatively low base and appear unlikely to make a big difference to the trend for total climate-focused ODA in the short term.

Special Drawing Rights

Special Drawing Rights (SDRs), a global reserve asset issued by the IMF, have recently been tapped as an additional source of public finance for climate resilience. The IMF established the Resilience and Sustainability Trust (RST) in October 2022 to make 20-year loans funded in large part by 'surplus' SDRs following the global \$650 billion allocation of new SDRs in 2021. This allocation left several major countries with additional SDRs that they did not immediately need. So far, the RST has received contributions worth \$40.9 billion,²² and 17 countries have received commitments of financial support.

¹⁹ *China Daily* (2021), 'China's International Development Cooperation in the New Era', 11 January 2021, https://global.chinadaily.com.cn/a/202101/11/WS5ffb954aa31024ad0baa19e3_4.html.

²⁰ The World Resources Institute has estimated that total climate finance provided and mobilized by China over the period 2013–22 averaged \$4.5 billion a year. Liu, S. et al. (2024), 'China's International Climate-Related Finance Provision and Mobilization for South-South Cooperation', Working Paper, World Resources Institute, doi.org/10.46830/wriwp.24.00036.

²¹ Sengupta, C. (2023), 'Explained: what is Alterra, the \$30 billion fund launched at COP28?', Energy Connects, 1 December 2023, <https://www.energyconnects.com/opinion/features/2023/november/explained-what-is-alterra-the-30-billion-fund-launched-at-cop28>.

²² International Monetary Fund (IMF) (undated), 'Resilience and Sustainability Trust', <https://www.imf.org/en/Topics/Resilience-and-Sustainability-Trust>.

But the scope for using SDRs to deliver public finance for climate action on a much larger scale, as some commentators have advocated,²³ is likely to be limited. One reason is the underlying mismatch between the RST's liabilities, which need to be highly liquid, and the trust's 20-year loan assets. The RST uses a multi-layered risk management framework to maintain the reserve asset characteristics of the channelled SDRs, minimizing the need for direct budgetary contributions.²⁴ But it is not clear that this can be made to work on a very large scale. Indeed, some IMF members – including Germany – have already chosen to fund their contributions to the RST from ODA rather than from rechannelled SDRs, while the US has not as yet made any financial commitment.

A further possible constraint on scaling up the RST is the mismatch between, on the one hand, the IMF's conventional role and expertise in short-term macroeconomic stabilization and, on the other, the focus of the RST on long-term development finance.

A further possible constraint on scaling up the RST is the mismatch between, on the one hand, the IMF's conventional role and expertise in short-term macroeconomic stabilization and, on the other, the focus of the RST on long-term development finance (albeit focused on reducing risks to balance-of-payments stability). Technical support from the World Bank Group, along with proposals to channel a further batch of surplus SDRs directly to the African Development Bank (AfDB) and Inter-American Development Bank (IADB), may partly address this concern. But lending by multilateral development banks (MDBs), even if funded through SDRs, would still need to be secured by risk-bearing capital, the supply of which is constrained. Nor do SDRs represent essentially 'free money', as some have argued. The initial allocation of SDRs does indeed have no cost to the recipients. But as soon as SDRs are converted into hard currency, they incur a risk-free interest rate (currently 3.4 per cent)²⁵ just as other forms of public borrowing do. Loans from the RST charge this rate plus a margin.

²³ For example, the Bridgetown Initiative has called for a \$500 billion global climate change mitigation trust funded from surplus SDRs. See Persaud, A. (2022), 'Bridgetown Initiative calls for new Global Climate Mitigation Trust financed via Special Drawing Rights', guest comment, Bretton Woods Project, 8 December 2022, <https://www.brettonwoodsproject.org/2022/12/bridgetown-initiative-calls-for-new-global-climate-mitigation-trust-financed-via-sdrs>. In addition, at the African Union's Africa Climate Summit in September 2023, leaders called for the repurposing of SDRs, with at least \$100 billion to be rechannelled to Africa. See Ministry of Environment, Climate Change and Forestry, Republic of Kenya (2023), *The Inaugural Africa Climate Summit: Africa Leaders Nairobi Declaration on Climate Change and Call to Action*, 6 September 2023, <https://africaclimate.summit.org/downloads/post-summit/THE-INAUGURAL-AFRICA-CLIMATE-SUMMIT.pdf>.

²⁴ Pazarbasioglu, C. and Ramakrishnan, U. (2022), 'A New Trust to Help Countries Build Resilience and Sustainability', IMF blog, 20 January 2022, <https://www.imf.org/en/Blogs/Articles/2022/01/20/blog012022-a-new-trust-to-help-countries-build-resilience-and-sustainability>.

²⁵ IMF (2024), 'SDR Interest Rate Calculation', https://www.imf.org/external/np/fin/data/sdr_ir.aspx (accessed 3 Nov. 2024).

Lastly, use of SDRs to fund lending by international financial institutions (IFIs) adds to global economic demand and boosts global liquidity. Where the total amount involved is in the tens of billions of dollars, the impact globally is insignificant. But if it is done on a much larger scale, i.e. in the trillions, this could force up inflation and interest rates globally, resulting in significant unintended costs.

Increasing MDB climate finance

Many advocates of climate action argue for an increase in the financial capacity of the MDBs through a general capital increase. They claim that this would be the most cost-effective way of boosting public international climate finance, given the ability of such institutions to leverage ‘paid-in’ capital from shareholders by borrowing on private markets.

However, this route to increasing climate finance is far from straightforward in practice. Paid-in capital contributions to the MDBs typically have to be financed from ODA and are therefore subject to public finance constraints on the banks’ leading shareholder governments. In addition, the bulk of MDB finance consists of loans, equities and guarantees, rather than grant aid. As a consequence, projects and recipients need to meet minimum credit requirements. Furthermore, in most MDBs, the vast bulk of finance provision, including that funded by borrowing on private markets, is effectively guaranteed by public capital. Just 10 per cent of this capital is paid in, while the other 90 per cent is ‘callable’ – meaning that shareholders can be called on to contribute additional capital if the initial paid-in capital is depleted by losses. Shareholders are very reluctant to see any demand made on callable capital. This, together with the need to maintain the lowest possible cost of finance, means shareholder governments expect MDBs to maintain a very high triple-A credit rating, which further constrains the finance they can offer.

Further practical considerations include the fact that the range of MDB financing objectives is much broader than climate action alone. Any increase in general financing capacity needs to be shared between action on climate change mitigation, adaptation, loss and damage, and efforts targeting other Sustainable Development Goals (SDGs). There is also a difficult interplay between a general capital increase and the fraught issue of governance of the MDBs. China and other emerging economies agreed to a general capital increase for the World Bank in 2018, but without an increase in their own voting weights to reflect their growing role in the world economy; the same also happened with the IMF quota increase in 2023. But it is far from clear that such countries would be willing to agree to a further capital increase on the same basis. In addition, any suggestion that China should increase its voting weight and influence in the World Bank is likely to meet strong opposition from the US, particularly from Congress.

The World Bank has often drawn on voluntary contributions from a subset of shareholders (without recognition in formal voting weights) to boost its resources, but such an approach can only go so far. Some of the largest shareholders in the bank – for instance, the US and China – may not take part in such initiatives. Others

will also hold back, on the grounds that it is unreasonable to expect them to fill a gap left by the world's largest economies. Overall, voluntary contributions to the World Bank will not be sufficient to make a significant difference to the climate finance gap.

Ajay Banga's response

At their 2023 summit, G20 leaders called for 'better, bigger and more effective' MDBs.²⁶ But they did not say how this should be achieved. While each MDB has taken its own approach, the response of the World Bank, as the largest MDB, is the most important.

Since becoming the bank's president in 2023, Ajay Banga has sought to increase the contribution it is making to climate action by drawing on its existing capital resources – in some cases, as mentioned above, assisted by voluntary contributions from a subset of shareholder governments. He has also drawn on advice on private finance mobilization from a new Private Sector Investment Lab.²⁷

Banga's approach partly reflects the fact that making better use of existing capital is the most practical way to boost the bank's contribution to climate action in the short term. It also helps him make the case for a general capital increase, on the grounds that all other routes to increasing the bank's financial capability have been fully exploited.

In the autumn of 2023, the World Bank's mission statement was revised (somewhat controversially) to read: 'To create a world free of poverty – on a liveable planet.'²⁸ The World Bank Group has also increased its provision of climate financing by 10 per cent in the year to June 2024, to a record \$42.6 billion.²⁹

Specific policy development and new initiatives at the World Bank and other MDBs have so far focused on the following main areas:

- **Expanding the use of hybrid capital.** This is essentially capital, provided voluntarily by governments, foundations or the private sector, that can be used to support risky lending through the absorption of losses but does not have voting rights associated with it.
- **Enabling private institutions to co-invest in portfolios of World Bank-originated projects** rather than just in individual projects, thereby allowing private institutions to diversify their risk exposure.

²⁶ G20 India (2023), 'G20 New Delhi Leaders' Declaration', 9 September 2023, https://www.g20.in/content/dam/gtwenty/gtwenty_new/document/G20-New-Delhi-Leaders-Declaration.pdf.

²⁷ The Private Sector Investment Lab has two co-chairs: Mark Carney, the UN Special Envoy on Climate Action and Finance and co-chair of the Glasgow Financial Alliance for Net Zero (GFANZ); and Shriti Vadera, the chair of Prudential plc. It brings together 15 CEOs/chairs of major corporations and was established by Ajay Banga, the president of the World Bank, to provide advice on actions to scale up private climate finance. The initial areas of focus are: enhancing regulatory certainty, expanding political risk insurance, addressing foreign exchange risk, and origination and distribution. See World Bank Group (2024), 'Private Sector Investment Lab', 24 October 2024, <https://www.worldbank.org/en/about/unit/brief/private-sector-investment-lab>.

²⁸ World Bank (2023), 'The World Bank's Bold New Vision: Ending Poverty on a Liveable Planet', 13 October 2023, <https://www.worldbank.org/en/news/immersive-story/2023/10/13/world-bank-president-on-ending-poverty-on-a-liveable-planet>.

²⁹ Reuters (2024), 'World Bank climate finance reaches record \$42.6 bn in fiscal 2024', 19 September 2024, <https://www.reuters.com/sustainability/sustainable-finance-reporting/world-bank-climate-finance-reaches-record-426-bln-fiscal-2024-2024-09-19>.

- **Developing a method to sell on matured loans and other assets already on the World Bank’s balance sheet** without triggering an unacceptable increase in required yield (given that it will not be desirable or even possible to pass on the bank’s preferred-creditor status to private investors). This has the scope to free up existing MDB capital for further project origination and lending.
- **Increasing the use of guarantees.** In principle, this should enable the World Bank to deploy less capital, for a given amount of financing mobilized, relative to the amount of capital that would be required with outright lending. This is because the World Bank, as guarantor, can rely on the credit of *both* the recipient and provider of the funds. The bank announced in February 2024 that it would triple its provision of guarantees to \$20 billion a year by 2030.³⁰ It accompanied this announcement with the creation of a one-stop shop to house all of the bank’s guarantee expertise.
- **Improving private investor pricing and perceptions of developing-country risk.** The World Bank announced in March 2024 that it would publish historical default data on public and private projects going back to 1985.³¹

Reflecting this work, in April 2024 the World Bank announced a funding boost of \$11 billion for new financing tools, including a Portfolio Guarantee Platform, a hybrid capital mechanism and a Liveable Planet Fund.³² The bank argued that this initial injection of funding could mobilize a total of \$70 billion over 10 years, implying a leverage ratio of six to 10 times the initial funding allocated on certain elements. However, it remains unclear how much additional risk the public sector will take on as part of the leverage process.

The World Bank is also focusing on securing the largest possible replenishment for the International Development Association (IDA), an arm of the bank that provides concessional financing (including grants and zero-interest loans) to low-income countries.³³ IDA’s resources are replenished every three years through voluntary ODA contributions, and the next replenishment is due to be completed in December 2024. The so-called ‘V20’ group of countries vulnerable to climate change are calling for a tripling in the replenishment, from \$93 billion in the IDA20 replenishment cycle that ended in December 2021³⁴ to \$279 billion in IDA21. Other advocacy groups are targeting a smaller but still ambitious replenishment of \$115 billion.

³⁰ World Bank (2024), ‘Remarks by Ajay Banga at the 2024 G20 Finance Ministers – Global Perspectives on Growth, Jobs, Inflation, and Financial Stability’, 28 February 2024, <https://www.worldbank.org/en/news/speech/2024/02/28/remarks-by-ajay-banga-at-the-2024-g20-finance-ministers-global-perspectives-on-growth-jobs-inflation-and-financial-stabi>.

³¹ World Bank Group (2024), ‘World Bank Group Publishes New Data, Aiming to Boost Investment in Emerging Markets’, press release, 28 March 2024, <https://www.worldbank.org/en/news/press-release/2024/03/27/world-bank-group-publishes-new-data-aiming-to-boost-investment-in-emerging-markets>.

³² World Bank Group (2024), ‘New Financing Tools Receive Major Funding Boost’, press release, 19 April 2024, <https://www.worldbank.org/en/news/press-release/2024/04/19/new-financing-tools-receive-major-funding-boost>.

³³ Romig, S. (2024), ‘Record IDA Replenishment Essential as Debt Crisis Looms’, World Bank Group, 31 January 2024, <https://www.worldbank.org/en/news/feature/2024/01/31/record-ida-replenishment-essential-as-debt-crisis-looms>.

³⁴ World Bank Group (2021), ‘Global Community Steps Up with \$93 Billion Support Package to Boost Resilient Recovery in World’s Poorest Countries’, press release, 15 December 2021, <https://www.worldbank.org/en/news/press-release/2021/12/15/global-community-steps-up-with-93-billion-support-package-to-boost-resilient-recovery-in-world-s-poorest-countries>.

Relaxing MDB capital adequacy requirements

A further potential approach to increasing MDBs' climate financing capacity from within existing resources is to loosen current capital adequacy requirements. This has been discussed extensively following the recommendations of an independent review of capital adequacy frameworks for the G20,³⁵ and could result in a substantially bigger increase in MDB lending capacity than the measures enacted so far.

The capital adequacy framework review argued that the MDBs are too conservative in their risk management. More specifically, the review argued that the banks underestimate (a) the extent to which preferred-creditor status reduces the risk on their loans relative to those of commercial lenders; and (b) the extent to which the existence of callable capital would enable them to lend more without jeopardizing the triple-A credit ratings essential to maintaining low-cost funding. According to modelling by independent researchers in the G20 Independent Expert Group on Strengthening Multilateral Development Banks,³⁶ aggressive implementation of such 'capital efficiency-related' recommendations could boost lending capacity by up to \$40 billion a year.

But, as with deployment of SDRs, there is no free money. Even with no change in average asset quality linked to a rapid expansion in lending – and it seems unlikely that asset quality would remain the same in such a case – MDBs and the shareholders standing behind them would still incur an increased absolute 'expected loss' from MDB operations relative to unchanged capital. While 'normal' losses should be covered from income on the finance provided, exceptional losses would need to be covered by additional financial contributions from shareholders, unless the shareholders were willing to see the total capital resources of the MDBs reduced or, in extreme cases, to see a demand made on callable capital.³⁷ Therefore, another way to look at this proposal for increased lending relative to unchanged capital is that it effectively pre-empts a future contribution to MDBs' capital in line with existing shareholder weightings, thereby avoiding the question of voting shares.

There is no problem with this in principle, but it illustrates that changes to capital adequacy weightings are ultimately also subject to the same public finance considerations as other sources of additional public finance. Leading shareholders in the MDBs are therefore likely to be cautious about using this approach to achieving a rapid scaling up of MDB climate finance operations.

Taken together, the efforts to boost climate finance available from MDBs are clearly worthwhile, but seem unlikely to deliver the kind of step change in public international finance that has been called for.

³⁵ Ministry of Economy and Finance, Department of the Treasury, Italian Government (2022), *Boosting MDBs' investing capacity. An Independent Review of Multilateral Development Banks' Capital Adequacy Frameworks*, https://www.dt.mef.gov.it/export/sites/sitodt/modules/documenti_it/news/news/CAF-Review-Report.pdf; Oteh, A., Karsenti, R., Nelson, E. and Humphrey, C. (2022), 'Reforming capital adequacy at MDBs: How to prudently unlock more financial resources to face the world's development challenges', ODI Expert Comment, 28 September 2022, <https://odi.org/en/insights/proposals-to-reform-capital-adequacy-at-mdbs-how-to-prudently-unlock-more-financial-resources-to-face-the-worlds-development-challenges>.

³⁶ Independent Expert Group (2023), *The Triple Agenda: A Roadmap for Better, Bolder and Bigger MDBs*, New Delhi: Indian Council for Research on International Economic Relations, https://icrier.org/g20-ieg/pdf/The_Triple_Agenda_G20-IEG_Report_Volume2_2023.pdf.

³⁷ For those MDBs whose income usually more than covers normal losses, the increase in exposure and expected loss would slow the rate of expansion in retained earnings, potentially requiring more frequent capital injections by shareholders.

Sovereign debt restructuring

Proposals to address the high levels of existing public debt in many EMDEs³⁸ also represent a potential route to raising public international finance for climate action. Around 60 per cent of low-income countries are at high risk of debt distress or already in debt distress, and in a number of cases their net debt service payments have turned negative. Reprofiting maturities and reducing the NPV burden of outstanding debt outright or through ‘debt-for-climate swaps’ – in which a country receives debt relief in return for environmental commitments – will typically release domestic fiscal resources, some of which may then be devoted to climate action.

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Such transactions can also provide a helpful means to embed new climate commitments in agreements that are legally binding in international law. But this approach typically requires substantial credit enhancement using public finance provided by MDBs or bilateral donors. It may also be linked to a longer pause in private market access for the countries concerned than would otherwise be the case, and the debtor countries will often also require cooperation from ‘new’ sovereign lenders (notably China) and private sector lenders. Thus, while debt relief could be the most effective way to deploy public finance to support climate action in a given country, this will need to be judged on a case-by-case basis. And it is not a way of avoiding the wider constraints on provision of public international finance.

Debt clauses that postpone future debt service payments on export credits and other sovereign financial obligations in the event of climate-related weather shocks³⁹ are similarly a means to step up provision of public climate finance. But since the debt service obligation is only postponed for a relatively short period rather than written off, such clauses may not avoid the need for permanent provision of public finance following the shock.

³⁸ At the African Union’s Africa Climate Summit in September 2023, leaders called for climate-linked debt restructuring and relief to be supported by the private sector. See African Union (2023), ‘The African Leaders Nairobi Declaration on Climate Change and Call to Action’, 6 September 2023, https://www.afdb.org/sites/default/files/2023/09/08/the_african_leaders_nairobi_declaration_on_climate_change-rev-eng.pdf. See also the Bridgetown Initiative, which has called for natural disaster and pandemic clauses in all debt instruments: <https://www.bridgetown-initiative.org>.

³⁹ UK Export Finance (2022), ‘UK Export Finance launches new debt solution to help developing countries with climate shocks’, press release, 8 November 2022, <https://www.gov.uk/government/news/uk-export-finance-launches-new-debt-solution-to-help-developing-countries-with-climate-shocks>. The V20 group has called for a rapid scaling up of debt-for-climate swaps, and for the introduction of climate-resilient debt clauses to be supported by the private sector.

New global taxes

In light of the constraints on established sources of public finance, several proposals have been made to establish new international taxes as a means of raising public finance for, among other goals, climate action. Potential sources of such revenue include billionaires, financial transactions, hydrocarbon producers⁴⁰ and shipping.⁴¹ However, despite the theoretical merits of some of these proposals, and the progress made in recent years on greater tax harmonization (such as the OECD's global minimum corporate tax), the likelihood of such ideas being implemented and raising significant amounts of additional revenue appears low in the present geopolitical environment.

Conclusion on scaling up public international climate finance

The above brief review has illustrated the wide range of approaches being undertaken or proposed to increase the volume of public international finance for climate action. While some of these approaches have been partially successful, none has yet been implemented on a very large scale, nor are most of the approaches free of the constraints on advanced-country public spending linked to current economic conditions.

It is therefore more important than ever to use *existing* public international finance as effectively as possible – particularly with respect to mobilizing private finance, where the potential upsides are very large. This is the subject of the next section.

⁴⁰ The Bridgetown Initiative has called for new 'loss and damage' compensation trusts to be funded through a levy on hydrocarbon producers. At the African Union's Africa Climate Summit in September 2023, leaders also called for a new global carbon taxation regime focused on the fossil fuel trade, maritime transport and aviation, to be complemented by a financial transaction tax.

⁴¹ Zhang, D. (2024), 'UK Shipping Levy: Necessity, Challenges, and possible path forward', Centre for Inclusive Trade Policy blog, 11 October 2024, <https://citp.ac.uk/publications/uk-shipping-levy-necessity-challenges-and-path-forward>.

03

Using public finance to mobilize private finance

Constraints on increasing public international finance mean policymakers must better utilize the finance already available, particularly in mobilizing private finance for climate action in EMDEs. This will require careful comparative assessment of the different routes available, the creation of new institutional vehicles, and a means of holding countries to account.

The IMF has estimated that private finance will need to account for 90 per cent of the mitigation finance (alone) going to EMDEs excluding China.⁴² Anticipating this, in 2015 the major international financial institutions (IFIs) set the goal of ‘moving from billions to trillions’ – that is, using the billions of dollars of international public finance available from bilateral donors and multilateral institutions to mobilize much larger amounts of private funding for meeting the SDGs, including for action on climate change. But the effectiveness of this effort has so far been limited. Of the \$115.9 billion provided and mobilized by advanced-country governments for climate action in developing countries in 2022, only \$21.9 billion was sourced from the private sector (according to the OECD definition, which does not include private finance mobilized through improvements to the local business environment). The latter figure was up sharply from 2021, but still represented only 19 per cent

⁴² IMF (2023), *Global Financial Stability Report*, Chapter 3, October 2023, <https://www.imf.org/en/Publications/GFSR/Issues/2023/10/10/global-financial-stability-report-october-2023>.

of the total. Moreover, it could be argued that some funding included in this figure, such as funds fully guaranteed by the public sector, should strictly have been classified as public finance rather than private finance.⁴³

Why is private finance falling short?

Private lenders and investors may be deterred from supporting certain projects (or demand a very high return for doing so) due to a range of factors. Some of these are generic to all kinds of investment. For example, risk may increase because of perceived macroeconomic or political instability in EMDEs. According to one estimate, at the end of 2023 yields on emerging-market hard-currency debt were around 9 per cent, roughly double the yield paid by the US government (4.8 per cent).⁴⁴ Other generic factors pushing up risk may include regulatory uncertainty or corruption. Meanwhile, costs may also be increased – and hence returns reduced – by lack of local skills, poor infrastructure, discriminatory local taxes and lack of access to the latest technologies.

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Other factors are specific to green investment. These include the presence of distorting fossil fuel subsidies, lack of information on climate risks, and the absence of a well-developed investor base in advanced countries for green projects in the developing world.⁴⁵

In both the non-climate-specific and climate-specific cases, the risks perceived by the private sector may be higher than the actual risk. This could be because asset managers lack experience investing in EMDEs, or because inadequate public data exist on historical default experiences (making it hard for investors or lenders to judge risk). In theory, this gap in risk perceptions should eventually be addressed through competition as the development over time of new information sources enables investors to achieve above-normal returns. But this may take too long to be useful, or may not happen at all due to market failure.

A further constraint on the use of private investment and lending in support of green finance is that a substantial proportion of the projects requiring financing, particularly in low-income countries, are for climate change adaptation rather

⁴³ OECD (2024), *Climate Finance Provided and Mobilised by Developed Countries in 2013-2022*.

⁴⁴ Gey van Pittius, W. and Louw, T. (2023), 'Time to take a closer look at EM hard currency debt', *Ninety One*, 2 November 2023, <https://ninetyone.com/en/insights/time-to-take-a-closer-look-at-em-hard-currency-debt>.

⁴⁵ Ehlers, T., Gardes-Landolfini, C., Natalucci, F. and Ananthakrishnan, P. (2022), 'How to Scale Up Private Climate Finance in Emerging Economies', IMF blog, 7 October 2022, <https://www.imf.org/en/Blogs/Articles/2022/10/07/how-to-scale-up-private-climate-finance-in-emerging-economies>.

than mitigation. Private financing of adaptation is generally thought to be harder to secure than private financing of mitigation. This is because of the difficulty of structuring projects to capture a share of their benefits in a way that pays a return on the capital invested. Total adaptation financing requirements have been estimated at \$600 billion a year by 2050.⁴⁶

The factors above explain the long-standing problem of there being a shortage of 'bankable' climate action projects. However, in the past two years there has been a further deterioration in this situation. This reflects several new developments. First, the sharp rise in international real interest rates has had a disproportionate negative effect on the viability of renewable energy investments relative to hydrocarbon-intensive investments, as the ratio of financing to running costs is typically higher in the renewables sector. Second, public debt in many EMDEs has increased, with the combined external debt stock of countries eligible for IDA support reaching a record \$1.1 trillion in 2022. Third, the movement towards 'de-risking' and 'decoupling' in global markets for goods, capital, labour and technology may disproportionately disadvantage projects in EMDEs by prompting potential partner countries to adopt more insular approaches to trade and investment.⁴⁷ Fourth, the campaign by populist politicians against climate-friendly policies in several advanced economies may increase regulatory barriers and discourage financing.

How can public finance make a difference?

The deployment of public international finance can increase the flow of private finance for climate action by (a) improving the general business environment, and (b) mitigating financial risk in specific projects.

Improving the general business environment

This approach entails using public finance to improve public policy, address infrastructure bottlenecks, strengthen local finance skills or demonstrate innovative financing methods. The idea is that a process of 'fire-starting', as it is sometimes termed, can create an environment in which much larger volumes of private finance will flow to climate-related projects.

This method has long been the traditional approach of MDB finance, and can generate very large multiples of private finance relative to the size of the initial public finance. But the true degree of leverage achieved is difficult to measure with confidence, and interventions often take a long time to implement.

⁴⁶ McKinsey Sustainability (2023), 'COP28: Climate Finance', McKinsey Sustainability blog, 4 December 2023, <https://www.mckinsey.com/capabilities/sustainability/our-insights/sustainability-blog/cop28-climate-finance>.

⁴⁷ The introduction of large subsidies for green investment in advanced economies, notably the US Inflation Reduction Act and the EU's European Green Deal, may have some benefits for EMDEs by reducing production costs (through economies of scale) and accelerating technological change, thereby increasing the viability of certain mitigation projects. However, it is also likely to divert certain types of private sector green investment away from EMDEs.

Mitigating financial risk in specific projects

The second approach is to deploy public finance directly alongside private finance – in what is known as ‘blended finance’ – with the goal of improving the trade-off between risk and return on investment projects. Blended finance can involve the public sector taking on some of the risk that the private sector would otherwise bear, or accepting a below-market return on a given investment in order to subsidize the returns of private sector co-investors.

This kind of intervention has the potential to be faster than traditional MDB finance. It may also generate a substantial leverage multiple (though this may not reach the very high levels that are possible with fire-starting). So far, however, the use of blended climate finance has been limited and has not been introduced at scale. This could partly be due to uncertainty over the underlying mechanisms deployed. With a number of blended-finance mechanisms, it is not immediately clear what the underlying risks are or who is bearing them. Nor is it clear sometimes whether a public subsidy is involved – and, if not, whether this is because the private sector is assumed to have been mispricing the risk previously. For example, proposals for greater use of public sector guarantees are typically unclear as to the extent of risk to be taken on by the public sector, and whether such risk is fairly priced. This lack of clarity over how a mechanism works reduces confidence among policymakers in donor-country finance and development ministries, and limits the scope for scaling up.

Another factor is that new blended-finance techniques are almost always ‘retrofitted’ into existing public international finance institutions. This often results in a high degree of complexity, and stretches the available financial engineering expertise while increasing time delays. Imposing the existing MDB financial architecture on blended-finance transactions may also inhibit the creation of new instruments that could genuinely leverage private finance, and limits the scope to use business models appropriate to the type of financial service required.

As discussed earlier, it is not straightforward for MDBs to sell on matured loans to the private sector (and recycle the underpinning capital) because of the loss of preferred-creditor status this usually entails. MDBs are also tightly constrained from taking on certain assets or types of risk by the necessity of preserving triple-A credit ratings, linked to the need to minimize the risk being borne by callable capital. And MDBs may not have the underwriting skills or financial model required to undertake insurance or certain types of guarantees.

Having both full clarity on risks and the ability to design the most appropriate financial architecture to deliver a given form of finance may not matter too much when the volume of blended-finance transactions being completed is relatively small. But if the approach is to be scaled up rapidly to help close the climate finance gap, both factors will be essential to gain the confidence of the finance and development ministries overseeing MDBs.

Improving how public international finance is used

To date, most advocacy has gone into increasing the total *amount* of public international finance available for climate action. However, as discussed earlier, almost all new public international finance will, in one way or another, represent a call on ODA from traditional donors and is thus likely to be tightly constrained. It is therefore critical now also to think a lot more carefully about *how* the finance that is available is deployed. This includes considering the choice between using public international finance to mobilize private finance and using it for other objectives, and considering the relative merits of different ways of mobilizing such finance.

This is not at all easy. It means facing up to fundamental questions about the objectives and priorities for climate finance, and about the most effective institutions for delivering it. There has been a tendency to duck such questions so far. But even a modest improvement in clarity over objectives, and in the optimality with which public international finance is allocated, could make a considerable difference to the achievement of climate goals – both reducing the overall size of the climate finance gap and increasing the speed with which it can be closed.

The international policy community needs to take three main steps to deliver a more optimal allocation of public international finance:

Step 1: Conduct a comparative assessment of public international finance

The first step is to undertake a comparative assessment of the effectiveness of different ways of deploying public international finance. The assessment should look in particular at the three main areas for climate action – mitigation, adaptation, and loss and damage – and assess, for each one, the optimality of using public finance directly or as a means to mobilize private finance. In the case of the latter, making a judgment will mean weighing the relative advantages of blended finance versus measures to improve the business environment. The comparative assessment will also need to look at the relative effectiveness of deploying public capital to deliver different types of finance – whether loans, equity investment, guarantees or insurance.

The assessment should be as comprehensive as possible. It will require gathering and verifying a large amount of data on the effectiveness of different ways of deploying public international finance to achieve given outcomes. For example, at present different institutions make numerous claims about the leverage ratios achieved when they deploy public finance to mobilize private finance. However, these claims need to be assessed on a comparable basis, taking into account variables such as the cost of finance provided and the amount of risk taken on by the public sector. The assessment will also need to look carefully at differences between

sectors: the optimal way to use public international finance in support of renewable energy generation, for instance, is unlikely to be the same as when funding development of grid infrastructure.

Such analysis may in turn require the introduction of a greater level of detail – setting out precisely where finance needs to be deployed – into governments’ national transition plans than is currently available through NDCs.

Step 2: Rethink institutional architectures

The second step is to look at the current choice of institutional architectures for delivering public international climate finance, and to consider what works best and whether any improvements can be made.

There is an understandable reluctance to consider institutional change because it is typically expensive and time-consuming. It also absorbs a lot of political capital, a particular problem when considering reforms to the international architecture. But to the extent that the current institutional framework is preventing the deployment of public international finance in the most effective way possible, it is critical to examine this issue.

The Brazilian G20 presidency has commissioned a study of the effectiveness of the current climate funds. It is also important to look at whether the current architecture for most MDBs – in particular a design that relies on callable capital and preferred-creditor status, must deliver on a wide range of development objectives, and allocates funds in part according to membership rather than purpose – is best suited for mobilizing private finance for climate action.

Box 1 suggests an alternative architecture which, in contrast to traditional MDB finance, genuinely leverages private finance using publicly financed capital.

Box 1. Using public capital to leverage private finance

Conventional multilateral development bank (MDB) lending – where an MDB makes loans to its members and issues triple-A-rated debt in the private financial markets to fund these loans – does not constitute the use of public capital to leverage private finance. The use of ‘callable capital’, which is typically nine times the size of such banks’ paid-in capital, means that in most cases all loans or investments by MDBs effectively consist of 100 per cent public finance, fully backed by government shareholders. Lending by MDBs is also underpinned by their customary preferred-creditor status; this status is not available to private financial institutions. Moreover, the allocation of MDB funding is constrained by explicit or implicit country quotas, potentially limiting the ability of MDBs to support the most effective climate actions regardless of location.

To leverage private finance, therefore, the international community needs a new design for the lending vehicle. The vehicle this paper proposes would use capital provided by the public sector – from aid agencies and possibly some MDBs themselves in the event that they had surplus capital – and philanthropy. But the vehicle would explicitly *not* be linked to callable capital, enjoy preferred-creditor status, or be subject

to country lending quotas. Doing without callable capital and preferred-creditor status might appear counterintuitive, but it is essential if the vehicle is genuinely to leverage private finance.

The vehicle would raise funds by conventional borrowing in the private markets. The funds would then be lent onwards to investors in climate-related projects. However, in contrast to conventional MDB financing, the risk to the shareholders providing the public capital would explicitly be limited to their initial capital stake. The level of risk to shareholders would depend both on the vehicle's chosen capital ratio – which could be set at a conservative 15 per cent (similar to that of JPMorganChase, the US's largest bank) – and on the quality of its loan portfolio. In contrast to conventional MDB finance, where the necessity of keeping the risk borne by callable capital as close as possible to zero effectively forces institutions to prioritize maintaining their triple-A ratings, the level of risk to be carried by the new vehicle's capital, and the rating to be attached to its fundraising in private markets, would be a policy choice linked to the choice of assets.

The vehicle would differ from a privately capitalized bank because its required return would be significantly below private rates of return (although large enough to cover expected impairments over time).⁴⁸ The vehicle would focus entirely on climate action: mitigation, adaptation, and rebuilding after loss and damage; it would not have the option of investing in other assets.⁴⁹ It would have a sustained focus on developing the right skills base to deliver on its mission, and could also act as a wider catalyst by demonstrating the viability of certain markets to private institutions.

The vehicle would need to insist on strong governance arrangements in the projects it financed, to prevent losses due to corruption. Beyond that, however, it might not adopt the full range of MDB standards. This would be justified by the need for speed in responding to the climate emergency.

The vehicle's main focus would likely be in fast-growing emerging economies such as India, Indonesia, Thailand and Vietnam, where there is most likely to be a steady supply of 'near-bankable' projects in energy transition, transport and adaptation infrastructure. As such, the new vehicle would not address the entire climate finance gap (as it would not be suitable for deployment in LDCs, or in countries in severe debt distress). There might also be only limited scope to deploy the vehicle for climate change adaptation projects, or for rebuilding after loss and damage. But it should still be able to make a substantial contribution to closing the climate finance gap. For example, if \$90 billion of new public capital were accumulated over three years, this could support up to \$600 billion in new climate finance.

The vehicle could seek sovereign guarantees from the countries where its investment projects were located. This would reduce overall risk in its portfolio, and would enable the vehicle to lend for entire infrastructure systems (high-speed rail, etc.) in circumstances where the financial return from individual projects might be hard to establish but where the investment clearly promised to contribute to overall GDP growth and

⁴⁸ The vehicle would not, for example, need to pay dividends and/or achieve share price gains yielding a total 15–20 per cent to shareholders. It would only need to make a large enough surplus to cover occasional losses over time. To smooth out results between years, it could build a reserve, but this would still not require the level of returns of a private institution.

⁴⁹ If necessary to achieve political support, the establishment of the new vehicle could be balanced by new financial commitments to other development objectives.

therefore underpin the repayment of the debt. The instrument would have streamlined operations – similar to those of the Asian Infrastructure Investment Bank (AIIB) – and could co-finance MDB-originated projects.

The same vehicle or similarly designed ones could also be used to publicly capitalize equity investment, or provision of guarantees or insurance, depending on the outcome of the assessment of the most effective forms of climate finance.

The precise institutional framework should be determined through negotiation. Establishing a vehicle as a new window within an existing MDB or as a joint venture among several MDBs (rather than creating a separate institution) would increase the speed with which it could be set up, making use of existing expertise and operational capabilities. This could also help limit opposition from competing entities in the same policy space and encourage a holistic approach to policymaking. But there is also a risk that placing a new vehicle within a larger institution would result in lower priority being given to its development, forcing it to compete for capital and other resources. The host institution may also not have the most appropriate business model for the service being offered. And staff may be resistant to/or feel threatened by the vehicle's underlying principles.

Step 3: Develop decision framework and accountability mechanism

In the light of the above two steps, the third essential step is to crystallize the clearest possible set of decisions on how the available public international finance should be allocated to climate action. This set of decisions should be linked to a mechanism to hold the key parties to account.

While one could imagine a technocratic approach to delivering this third step and the previous two, the reality is that all three steps will have to be the product of political negotiations. Section 5, later in the paper, sets out a possible political process for achieving these steps, as well as for achieving a fourth step on freeing up more private finance for climate action. The latter step is introduced in the next section.

04

Increasing the demand for climate finance

The continuing large flows of private finance to hydrocarbon-intensive investment reflect economic distortions created by subsidies and moral hazard, among other factors. Urgent measures are needed to remove these distortions; such a reform would also increase the demand for green investment projects and climate finance.

Alongside steps to increase the *supply* of climate finance, it is also critical to increase the *demand* for it. According to the IEA, some \$2 trillion will have been invested in clean energy technologies in 2024, but more than \$1 trillion will still have been invested in coal, gas and oil in the same period.⁵⁰

There are many well-developed approaches for incentivizing and facilitating private green investment, including through direct subsidies, regulation, carbon taxation, carbon border adjustment measures, and the development of compulsory and voluntary carbon markets. However, this section focuses on another key approach, which is to reduce the demand for hydrocarbon-intensive investment.

The continued scale of hydrocarbon-intensive investment – whether in the form of consumers buying petrol or diesel cars, or major corporations investing in new oil and gas resources – is very surprising, even if viewed in purely financial terms from the perspective of a typical investor. There is a widening appreciation across

⁵⁰ International Energy Agency (2024), *World Energy Investment 2024*.

much of society that decarbonization is ultimately unavoidable given the enormous human and economic costs of rising temperatures. This realization – combined with the speed of technological change and the threat of radical policy shifts (whether driven by governments or the courts) in the context of popular reaction to extreme weather events – means that the risks inherent in investing in fossil fuels and other carbon-intensive sectors are rapidly increasing.

The continuing flow of funds to carbon-intensive projects is important in frustrating or slowing overall net zero transition efforts.

At the same time, the continuing flow of funds to carbon-intensive projects is also important in frustrating or slowing overall net zero transition efforts. Firstly, such investments not only maintain the level of greenhouse gas emissions in the near term, but also lock in future hydrocarbon use and related emissions. Once made, the initial investment becomes a sunk cost. The related plant and equipment will only be displaced if regulation mandates it or if running costs are permanently undercut by the combined capital and running costs associated with building a new non-hydrocarbon plant.

Secondly, any funds going to hydrocarbon investment are not available for carbon-free and low-carbon investment. This is particularly critical at a time when the terms for private finance have tightened sharply following the global inflation shock.

Finally, it is increasingly likely that hydrocarbon assets will become ‘stranded’ as a result of rapid technological and policy change, with serious consequences for financial stability. These risks are likely to be increasingly concentrated in EMDEs, where the demand for fossil fuel and other carbon-intensive investments remains strongest.

Why are high levels of hydrocarbon-intensive investment continuing?

There are good practical reasons for some continued investment in hydrocarbons and other carbon-intensive sectors. These include: the need to maintain output in hard-to-abate industrial sectors, pending the development of new, economically viable, low-carbon technologies; the need to invest in some existing oil and gas fields in order to extract the remaining output during the energy transition; and the need to provide access to energy in areas where the costs of renewables are still prohibitively high.

But the current scale of hydrocarbon-intensive investment goes well beyond what might be explained by these factors alone. Continued investor enthusiasm appears to be driven by a mix of the following interrelated factors and underlying assumptions:

- **Investor short-termism.** The prospect of high short-term returns from the development of oil and gas fields is still attractive to shareholders in oil and gas companies. But these high returns will only be delivered if the assets have conventional lifespans (40 years for power systems). A sharply accelerated move to net zero would lead to the assets being forcibly retired much earlier, significantly undermining these calculations. Similarly, 80 per cent of the cars which consumers buy globally are still conventional petrol or diesel vehicles. This reflects the lower initial cost of such vehicles, but does not take into account the much lower running costs for electric cars over their 10–15-year lifespan, or the possibility that the use of existing hydrocarbon-based cars becomes sharply restricted.
- **Regulatory and infrastructure bottlenecks.** Investors and consumers are concerned about regulatory obstacles and infrastructure bottlenecks, such as delays to grid connections for new renewable energy investments, or a lack of public charging infrastructure for electric vehicles in urban areas.
- **‘Path dependency’.** Investors may choose fossil fuels and other carbon-intensive assets because such assets are familiar, and because investors feel they know how to manage the risks associated with them.
- **Hydrocarbon subsidies.** In some countries, the returns on hydrocarbon investments are artificially inflated by fossil fuel subsidies. In 2022, the global cost of such subsidies was \$7 trillion,⁵¹ of which around \$1 trillion consisted of explicit subsidies. Political lobbying helps to keep these subsidies in place, as does policy inertia that reflects the complexity and political sensitivity of managing the socio-economic consequences of the energy transition.
- **Financing constraints in EMDEs.** Investors in EMDEs may identify attractive high-return green investment projects but be unable to finance the initial capital expenditure due to high country risk premiums or even a complete lack of availability of finance. The 2022–23 inflation shock, and the accompanying increase in long-term real interest rates worldwide, has exacerbated this situation.
- **Technology optimism.** Some investors may assume that technology solutions – such as much cheaper carbon capture and storage (CCS), direct air capture (DAC), or geo-engineering and solar radiation management (SRM) – will result in current hydrocarbon-intensive investments becoming consistent with preventing catastrophic climate change and hence viable over the long term.

⁵¹ Black, S., Liu, A. A., Parry, I. and Vernon, N. (2023), *IMF Fossil Fuel Subsidies Data: 2023 Update*, IMF Working Paper WP/23/169, <https://www.imf.org/en/Publications/WP/Issues/2023/08/22/IMF-Fossil-Fuel-Subsidies-Data-2023-Update-537281>.

- **Lack of credibility in climate commitments.** Given the history of missed targets and failed promises, and despite the implications for global warming, investors may simply not believe that governments will take the necessary steps to meet the Paris Agreement goals. Investors may assume, for example, that aggressive timetables to decarbonize road transport in Europe and the US will be abandoned in the face of pressure from industry and labour.
- **Moral hazard.** In this case, investors know the high risk of continuing to invest in hydrocarbon assets and recognize that high short-term returns may not continue. However, investors may assume that governments will either choose to bail them out should the risks crystallize, or be forced to do so because the consequences for the financial system and national economy would be too severe.

Investors have long benefited from the special treatment that governments have accorded to the energy sector. But investors' belief in the likelihood of large-scale government bailouts has probably increased since the COVID-19 pandemic and the energy price shock in Europe that followed Russia's 2022 attack on Ukraine. In both cases, governments in advanced economies provided billions of dollars in aid to cushion private firms and consumers from the full impact of these shocks.

Investors may also consider that the most likely cause of financial losses will be policy changes – such as new constraints on the use of hydrocarbon fuels in the economy, carbon taxes, and the removal of existing subsidies. This, they may believe, will enable them to argue – whether there is any legal basis for it or not – that their losses are due to government action and that they are consequently owed compensation.⁵²

Moral hazard could also explain why hydrocarbon investment has continued at such a high level, despite the increasing transparency around climate risk in private financial institutions that followed the launch of climate alignment initiatives at COP26 in 2021. The existence of moral hazard is hard to prove definitively, and its scale is difficult to quantify.⁵³

How can hydrocarbon-intensive investment be deterred?

Responses to some of the factors listed above are already developing. For example:

- A few major oil and gas companies are well aware of the disconnect between what their shareholders want – in terms of reaping short-term high returns from oil and gas investment – and the very uncertain long-term prospects for

⁵² This is permitted under the Energy Charter Treaty (ECT). Although the EU has withdrawn from the ECT, there is a 20-year sunset clause.

⁵³ Data collected by various private sector alignment initiatives (available at Transition Arc) does, however, show a very large gap between what companies typically have committed to on carbon reduction and what they are actually delivering. See, Climate Arc (2024), 'Introducing TransitionArc', 24 June 2024, <https://climatearc.org/news/introducing-transitionarc>. This could be taken as a measure of the scale of moral hazard in the private sector.

the underlying investments.⁵⁴ In response, these companies are hedging their investment strategies between hydrocarbon assets and green assets, and may look for ways to educate their existing investors and/or attract new investors with longer-term perspectives.

- Regulation and planning obstacles to green investment may prove short-lived as the authorities in some countries step up investment to address power bottlenecks and prioritize regulatory reforms.⁵⁵ Private investments in long-term hydrocarbon-intensive assets that have been substituted for green investment in the meantime could then prove to be costly mistakes.
- Path dependency in favour of hydrocarbon-intensive assets (and against green investment) should be declining as the regulatory and technology risks around such assets increase rapidly.
- An increasing number of governments (e.g. in India and Africa) are reducing hydrocarbon energy subsidies despite the risk of political fallout.
- The likelihood of green measures being rolled back in some countries may decline in the face of growing loss and damage costs arising from extreme weather events (although it is also possible that the growing incidence of loss and damage will see some funds being diverted from mitigation to adaptation and dealing with loss and damage). The prospect of intense competition from China across the full range of low-carbon technologies may also act as a disincentive to continuing hydrocarbon-intensive investment, as delaying adjustment to new technologies will become even riskier for other countries in terms of global competitiveness. A further possible deterrent is the growing role of independent courts in forcing governments to keep to their legal commitments on greenhouse gas reduction.
- The World Bank and other MDBs are seeking to improve private sector appetite for emerging-market risk (including green investment) by publishing their own historical project default data.⁵⁶

Step 4: Addressing moral hazard

In addition to the steps outlined in Chapter 3, a further important step that finance ministries and central banks should take is to address decisively the risk of moral hazard distorting investment decisions. This is not only important in its own right, but will also help reinforce a number of the positive trends and incentives described above by forcing the private sector to look at alternatives to hydrocarbon-intensive investment.

No additional finance or complex regulation is required. Instead central banks, financial regulators and finance ministries should simply state as clearly as possible that financial institutions, industrial companies and resource companies cannot rely on being bailed out by the authorities if hydrocarbon-intensive assets are made

⁵⁴ Based on consultations held under the Chatham House Rule.

⁵⁵ As seen in the new UK government's plans for full decarbonization of the power sector by 2030.

⁵⁶ Although the benefits of this may prove limited, as MDB experiences are likely to be different from those of private firms due to MDBs' preferred-creditor status. The growing loss and damage from climate change may also mean that past experience is not as good a predictor of the future as it has been previously.

redundant by technological and regulatory developments – including as a result of future government policy measures. The credibility of such a statement could be enhanced by legislation.

To reinforce the effect of this statement, the authorities should also introduce climate-specific measures in financial regulation. There is a menu of potential options, including: mandatory climate risk disclosure policies for financial institutions (in countries where such policies do not already exist); additional, climate-related, capital adequacy weightings; and conceivably an absolute cap on the amount of climate risk any one institution is allowed to take on in relation to its total assets.

It could be argued that the existing prudential regime already covers risks arising from climate change, and that additional climate-specific requirements would overcomplicate the regulatory system. However, in a world where modelling of the economic and financial aspects of climate risk is widely seen as unfit for purpose, an element of ‘bootstrapping’ to protect the financial system while measurement and modelling techniques are improved can be justified.

05

A proposed political process

Implementing the recommendations of this paper will require a carefully judged political process designed to build trust and deliver substantive outcomes incrementally. The election of Donald Trump to a second term as US president reinforces the need for a shift of approach, but makes the politics even more difficult to manage.

This paper has put forward four main recommendations for the international policy community to help close the climate finance gap, with a particular focus on EMDEs.

These recommendations are:

1. To undertake a regular, comprehensive and authoritative comparative assessment of the effectiveness of different ways of deploying public international finance to promote climate action.
2. To develop new institutional models for deploying public international finance more effectively in support of climate action – specifically, through greater use of ODA from traditional donors in the form of genuine risk-bearing capital.
3. Following from the above, to crystallize the clearest possible set of decisions guiding how the available public international finance should be allocated to climate action; and, linked to this, to establish a mechanism to hold key parties to account.
4. To take decisive steps to address the possibility that moral hazard is distorting private investment decisions in favour of hydrocarbon-intensive assets.

These measures will not close the climate finance gap on their own, but they should make a significant difference. They also have the advantage of not depending on unachievable expectations for increases in the level of public international finance provided by traditional donors.

However, even these recommendations will be hard to achieve in the current geopolitical context, where the political capital necessary for any kind of coordinated international action is limited. There is already a fundamental lack of trust between the G7 and China, and between the G7 and countries in what is often called the Global South. The latter trust deficit has stemmed partly from the constraints on Western aid budgets arising from slow productivity growth and high public debt, making it hard to respond to requests for support from the Global South. But it has also been exacerbated by the strength of populism and far right political movements in the US and Europe, increasing the risk that any commitments made by major developed countries may not be honoured.

Countries will also need to redouble their efforts to eliminate perverse incentives for carbon-intensive investment, given the possibility of the US taking the opposite course.

The election of Donald Trump to a second term as US president is likely to reinforce the lack of trust between the advanced economies and the developing world, but also create additional distrust *among* the advanced economies, given his threat during the campaign to impose 10–20 per cent across-the-board trade tariffs.

While he has yet to define his detailed policies in the area of climate finance, Trump may repeat his previous action in withdrawing the US from the Paris Agreement. He is unlikely to increase US contributions to public international finance, particularly in the area of climate action. He may use the US's vote at the World Bank and other MDBs to try to constrain such institutions from stepping up their conventional climate lending. In addition, his domestic policies are likely to slow the US economy's shift away from carbon-intensive investment, and may even reverse the transition.

In these circumstances, the main recommendations in this paper have even more force for other countries that remain committed to stepping up climate action. These countries will need to do everything possible to make the best use of the public international finance they provide for climate action. They may also need to do more on a 'coalition of the willing' basis, given that universal agreements may be precluded by the stance of the Trump administration. Countries will also need to redouble their efforts to eliminate perverse incentives for carbon-intensive investment, given the possibility of the US taking the opposite course.

The increasing focus in the G7 on economic security, and on industrial strategies designed to preserve competitive strengths and help the West catch up with China on green technologies, is likely to continue during President Trump's second term. As such, this is likely to complicate the net zero transition. In the long term, a focus on economic security and onshoring in the US and other G7 countries could disadvantage EMDEs, although some EMDEs could also benefit from Chinese efforts to diversify supply chains and avoid trade and investment restrictions. In the short term, higher tariffs on Chinese exports could lead to higher costs and hence to critical delays in the adoption of new technologies essential for the net zero transition.

Against this background, four components will be critical to gaining agreement on the above recommendations:

Getting the timing right

The tensions described above are central to the COP29 climate summit, under way in Azerbaijan at the time of writing. The success or failure of negotiations for the NCQG will be judged in large part by the overall climate financing figure that is eventually agreed (or not) at the summit. This could still be a large figure (notwithstanding the likely shift in US policy once the new Trump administration takes office), but even if that is the case, it is unlikely to meet the expectations of developing countries and civil society. A new climate finance goal will also be vulnerable to future shifts in US policy.

However, as the likely outcome for the NCQG becomes clear, there could be an important opportunity for countries seeking to bridge the gap between the different camps to instil the idea among negotiators that putting greater emphasis on how the *available* public international finance is used provides part of the solution. Ideally, increasing policy emphasis in this area would be institutionalized through a commitment in the final COP29 declaration to carry out the comprehensive assessment recommended above.

Developing a more realistic climate finance narrative

In support of this approach, it will be important to develop new themes in the debate, while dispelling a number of myths. A more realistic narrative should include the following points:

- There is no free money. All approaches to increasing public international finance ultimately lead to a call on ODA.
- Even with a good outcome, at the high end of expectations, at COP29, there is still going to be a shortfall in funding compared to what developing countries and civil society have sought.
- The focus in recent years on pushing for the largest possible increase in public finance has been driven to some extent by the difficulty of agreeing priorities between different uses of public international finance: for instance, between adaptation, mitigation, and loss and damage; or between climate goals and other SDG goals. Yet agreement cannot be delayed any longer, as having a clear but realistic plan, albeit one that involves painful compromises, is better than having no plan at all.

- The international policy community can no longer afford to ignore the big differences in impact and effectiveness associated with deploying public international finance through different international institutions and in different forms (debt vs equity vs guarantees vs insurance; traditional MDB finance vs de-risking).
- While the private sector has a critical role to play in closing the climate finance gap, both in terms of expertise and funding, its objectives are not always aligned with the wider public interest. This understanding needs to be factored into the way private sector resources are deployed, and into the role they are expected to play.
- The role of the private sector is to bear risk as well as provide liquidity. If investments go wrong, the private sector cannot expect to be bailed out by the public sector. Private investors will seek risk-adjusted returns comparable to what can be achieved through other investments. As a result, in a number of areas, private sector financing will be too expensive and may have to be replaced by finance from public international and domestic sources willing to accept lower risk-adjusted returns. This further underscores the need for public international finance to be deployed in a more disciplined way.

While many of these points are widely understood across the international policy community, it is likely that some advanced-economy governments will need to take the lead in setting out what will be seen by many as hard truths. While this will not be popular, it is a necessary step to put the discussion on a more realistic and ultimately effective track. The prospect of the incoming Trump administration in the US may also lead to a more receptive audience.

Deal drivers

Several ‘exchanges’ or ‘bargains’ between leading parties could be introduced in the eventual COP29 declaration to help underpin a successful compromise. These could include:

- All parties agreeing that the success of the revised financing strategy should be measured by outcomes rather than inputs.
- An implicit or explicit exchange in which advanced countries agree to deploy a substantially larger proportion of their development finance to provide risk-bearing capital, while recipient countries agree to do all they can to reduce the risks being faced (e.g. by cutting and repurposing hydrocarbon subsidies, and by enhancing transparency and regulatory certainty). Such an exchange would potentially be underpinned by contractual commitments.
- Another implicit exchange in which the MDBs and other international climate finance institutions agree to collaborate on a comparative assessment of the most effective ways of deploying international finance, and to embed the results in their behaviours. In return, ODA providers could agree to provide finance in the most flexible way possible.

Implementation mechanisms

The final component would be the establishment of workable institutional mechanisms and governance structures to deliver on the four recommendations.

With respect to the first three recommendations, establishing new international institutions is typically time-consuming. It is best, where possible, to build on structures that already exist, although sometimes the need for new institutions is unavoidable. Given the focus on finance and the range of national and international institutions that would need to be involved, the G20 would be the preferred body to own and oversee delivery of the four recommendations (although scepticism on the part of the incoming US administration towards multilateral approaches may mean that more reliance has to be placed on non-universal coalitions of the willing).

To undertake the comprehensive assessment of uses of public international finance that this paper proposes, the next country to assume the presidency of the G20 – South Africa – should establish an independent commission similar to that which produced the independent G20 review of capital adequacy frameworks. Such an initiative would need strong support from a wide range of international institutions. This would be a temporary and relatively low-cost solution, particularly if philanthropic climate foundations agreed to support elements of the work.

Once recommendations were produced, it would be critical to follow up with a longer-term framework to ensure decisions are made and that institutions and countries are as far as possible held to account for their delivery.

The G20 has attempted to establish accountability mechanisms before, for example with the 2010 Framework for Strong, Sustainable and Balanced Growth. These efforts have had mixed success, as priorities quickly change with each G20 presidency. It will therefore be critical to keep the overarching accountability framework as simple as possible, with a maximum of three or four high-level targets and clear agreement on how delivery of these would be measured. The framework should also be designed in such a way as to encourage refinement and updating of the targets and measures over time in the light of experience on what is most effective in holding countries to account.

An international institution, or group of institutions, should be tasked by the international policy community with delivering a regular report on progress against the chosen targets. To be useful, this reporting mechanism will need to be as independent as possible. So while the drafters of the progress report should consult extensively with the World Bank, other MDBs, the IMF and climate funds, none of these institutions should be tasked with delivering the report. One option may be to task the OECD – or another international organization without an operational role in climate finance – with this responsibility.

The fourth main recommendation, on preventing moral hazard, is more straightforward. It could be implemented through a clear statement from G20 finance ministers/leaders, or a subset of them if the US is not willing to join, and then followed up through policy guidance adopted in the relevant IFIs and national bodies.

06 Conclusions

Increasing the focus on how the available public international finance is used will not close the climate finance gap on its own. Nor will removing perverse incentives for hydrocarbon-intensive investment. But such steps can make a substantial contribution to progress.

This paper has grappled, in essence, with the trade-off between pragmatism and ambition when it comes to increasing the climate finance the world urgently needs to close the current financing gap. While efforts to increase the amount of public international finance for climate action should continue, and the need for a massive expansion in overall financing of climate action is undeniable, the reality is that the availability of public international finance from traditional donor countries is limited. Moreover, the constraints in this respect are likely to be even greater following the election of Donald Trump for a second term as US president.

The international community therefore also needs to pay a lot more attention to *how* it uses the public international finance *already available* for climate action. Moreover, there is no practical benefit in saying that every potentially helpful action is a priority in responding to the climate crisis and must be supported and financed, not least because there is insufficient time to do so, and because the finance is almost certainly not going to be available.

If the available public international finance is to be used more effectively, one critical step will be to allow a portion of it to bear greater risk as public capital than hitherto has been the case. This requires a change of attitude among traditional providers of ODA. It also requires: (a) the development of new institutional formats that ensure the additional risk taken on is measurable and capped; and (b) greater effort by public authorities in EMDEs to limit investment risks in the areas they can control.

Finally, the international policy community needs to pay more attention to why such a substantial share of private finance is still going into carbon-intensive investment. As far as possible, policymakers in different countries need to unite

Closing the climate finance gap

How to raise the money the world needs to support climate action

in taking steps to ensure that continuing investment in fossil fuels and other high-carbon industries is not the result of distortions arising from moral hazard or other perverse incentives.

These steps on their own will not close the climate finance gap, but they can make a significant contribution to doing so, and every fraction of a degree off global warming matters. Such steps would also offer an important hedge against the possibility that efforts – whether at COP29 or afterwards – to increase the *total* amount of public international finance for climate action will disappoint.

About the author

Creon Butler leads the Global Economy and Finance Programme at Chatham House. Since joining the institute in 2019, he has written and published on a wide range of global economic policy issues, including the interaction between macroeconomic policy and climate change, sovereign debt distress, the challenge of funding global health priorities, and the long-term implications for the international economic system of the COVID-19 pandemic and Russia's war on Ukraine.

Before joining Chatham House, Creon served in the UK Cabinet Office as director for international economic affairs in the National Security Secretariat and as the G7/G20 'sous-sherpa', advising the UK prime minister on global economic policy issues.

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He was also the British deputy high commissioner in New Delhi from 2006 to 2009, and has served in senior positions in HM Treasury and the Bank of England.

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Cover image: Climate activists stage a protest during the 2024 Annual Meetings of the International Monetary Fund and the World Bank Group in Washington DC, United States on 23 October 2024.

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