Position Paper

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Instruments to Finance Climate Protection and Adaption Investments in Developing and Transition Countries

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The financing of climate-relevant investments in developing and industrialising countries has become an important element of development cooperation (DC). As global efforts are made to mitigate climate change and its consequences, substantial financial transfers have to take place - particularly from industrialised countries to non-OECD regions. In this context – as for other purposes of DC as well – there is a debate over the choice of suitable financing instruments. It is occasionally argued that, for moral or factual reasons, climate protection and, in particular, climate change adaptation should not, or only in exceptional cases, be financed through loans, which would only worsen the indebtedness of the developing countries, and that additional funds should preferably be made available in the form of grants.
This paper is intended to demonstrate why the choice of instruments should not be about opting for either one or the other, but applying a differentiated mix of instruments attuned to the specific situation of the countries, partners and sectors so as to achieve the best possible impact.

Climate Change and Development
Given the increasing importance of climate change, development policy and climate policy are closely interwoven. Climate change is aggravating the already significant challenges facing developing and industrialising countries. Their development in particular is expected to make growth and prosperity possible, but with the least possible additional impact on the climate. German Financial Cooperation (FC) plays a pivotal role in resolving this seeming contradiction between climate protection and the interests of development.

The industrialising countries have a particular need for energy and climate protection measures because their continuing growth so far has been leading to a substantial increase in pollutant and greenhouse gas emissions.

The existing potential for mitigating greenhouse gas emissions in these countries can only be realised with considerable financial effort because the energy, industry, transport and other sectors need to undergo profound transformation processes despite the still unsatisfactory economic efficiency of low-carbon alternative technologies.

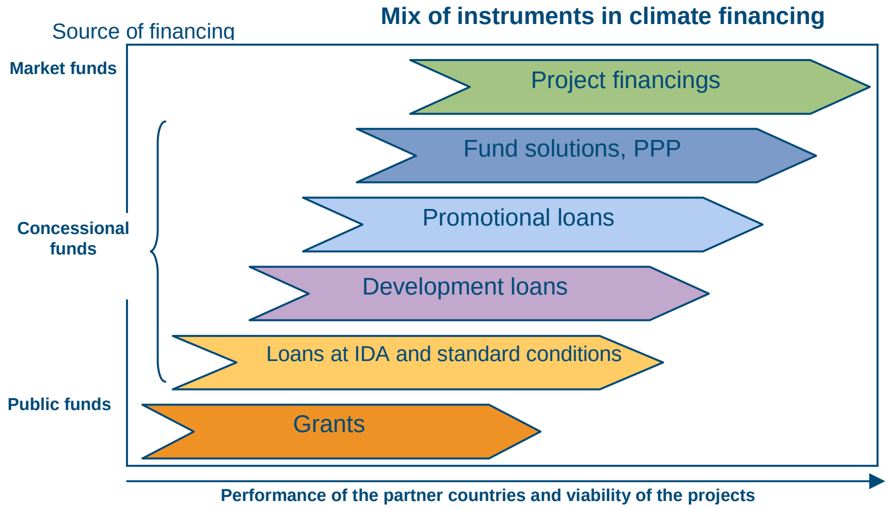
At the same time, it is important to protect developing countries from the negative impacts of climate change and to finance the necessary adaptation measures. Climate financing (which refers to climate protection and adaptation financing) thus touches on many areas and extends from sustainable economic development, energy and water supply, infrastructure, urban development, solid waste management, transport and mobility to healthcare and the protection of forests and biodiversity as well as agriculture and forestry.

The Range of Instruments for Climate Financing
In climate financing, the instruments of German Financial Cooperation (FC) are used first. Accordingly, programmes and projects aimed at emissions reductions, climate change adaptation and technology transfer in developing and industrialising countries are financed with a differentiated mix of grants, low-interest loans with long maturities (for instance as development loans, promotional loans and credit lines) or equity participations. A multitude of special facilities and programmes are available for environmental and climate protection. This range is complemented by innovative approaches such as fund solutions which also encourage private sector investment, while some constellations also permit purely private sector financing of projects.

A Park Ranger in a Nationalpark in Bolivia

The financing conditions offered under FC are consistently more favourable than the market conditions and are staggered in accordance with the sector and the character of the project, the performance capacities of the sectors and partners, the economic situation of the partner country, as well as its level of development, external economic position and debt situation (see graph).

This will further increase the pressure to use the available public funds as efficiently and effectively as possible with the involvement of the partner countries.



In its financing of climate protection and climate change adaptation, KfW Entwicklungsbank combines funds from the federal budget with funds which KfW raises in the capital market, portions of which it also extends on its own risk. This increases the financing volume and, hence broadens the effectiveness of the measures.

The available funds and instruments used in climate financing must be used in coordination with the partner countries in a fair, transparent and efficient way in order to achieve as broad an effect as possible. Impacts of adverse local or international conditions and events such as the current economic and financial crisis also need to be taken into account.

Credit Financing Is Necessary for Support to Be Efficient

In the years ahead, climate finance will require a substantially higher volume of funds than today - at a time that is marked by scarce public budgets, especially in industrialised countries.

Given the volume of funds required, it would be quite unfeasible to provide large sums of finance for climate investments on the basis of grants alone.

Both the transition to a low-carbon global economy, which is imperative for the stabilisation of the earth's climate, and the necessary adaptation measures require substantial investments in developing and industrialising countries. The Copenhagen Accord acknowledges that USD 100 billion must be provided for climate change mitigation and adaptation every year from 2020. According to estimates by the EU Commission, additional costs of some EUR 80 to 100 billion will accrue for global climate protection until the year 2020 alone, of which around one third each is to be provided by public sources in industrialised countries, the private sector in industrialised countries and private and public actors in developing and industrialising countries. Allocating public funds alone, however, will not be sufficient, so that greater contributions by the private and the financial sector will be necessary and sensible as well (see below).

Leveraging Budget Funds

From a purely budgetary perspective, loan financings provide important advantages over grants in that they leverage public funds and can be used on a revolving basis. Mixing capital market funds with budget funds can achieve significantly higher financing volumes at low interest rates – well below the market level – for any given volume of public funds. As the unsubsidised portion of a credit financing flows back again, it can be reutilised for other climate financing measures, thus achieving multiple effects – resembling a revolving fund that grows steadily with new budget funds.

When appropriately and reasonably applied, loans also reinforce the partner countries' sense of ownership, improve their debt management capacities, reduce their dependence on donors and help to draw countries closer to the financial markets[1]. Besides, credit financing activates market mechanisms that induce borrowers to use the funds efficiently since borrowing countries and sectors will seek the most cost-effective solutions to save emissions because they have to repay the loan. In this way, loans ease the burden on the budgets of all sides involved.


Solar power in Ethiopia

Besides, without credit financing a lower volume of scarce public funds would be available for countries and projects that have to rely on grants. The more closely a credit financing is aligned with market conditions, the less the public budget has to contribute and the more funds are available for other programmes and projects. Loans also make it easier to

[1] See World economic situation and perspectives, January 2005: "What form of ODA for the poorest countries - loans or grants?"

mobilise private capital, which is so important for climate financing.

Promote and Challenge

Obviously, not all climate tasks can be financed through loans or at commercial terms of any kind. The precept should always be that a mix of instruments incorporating public funds provides the right incentives for action in accordance with the capacity of the partner country, that is, the support should not be more than what is absolutely necessary.

The objective must be to give sustainable support that is adapted to national and sector needs and capacities, that seizes on and strengthens existing expertise, initiative and responsibility, as well as existing support structures and institutions in the partner countries, and that causes as little distortion to the market as possible.

Windenergy in Morocco

For the poorest and highly indebted countries, grants are the appropriate instrument. The same usually applies to projects in capacity building and to projects that provide for the use of new technologies that have not yet reached the threshold of profitability.

In contrast, care should be taken to avoid creating flawed incentives or misallocating funds by providing grants for projects in more financially capable countries or sectors that could easily be realised through credit financing. Moreover, grants can send out wrong signals to the capital markets of a supposedly too weak "grant only country" rating. This could even hamper the very important mobilisation of private capital and, in addition, reduce the country's scope for obtaining credit to finance important climate projects.

Solar technology in Morocco

Obviously, the credit financing must be staggered between different borrowers. Industrialising countries with high economic growth can service loans at market conditions while for other countries and sectors the grant element must be greater. At the same time, the specifics of the sector and the economic efficiency of the project need to be taken into account. Many different combinations with different degrees of concessionality are generally conceivable.

The Special Facility for Renewable Energies and Energy Efficiency (known as "4E in German") which was created in 2005, was so well received that the target of EUR 500 million in commitments that was originally set for five years was already reached at the end of three years. Further examples are the loan programmes in Eastern Europe, Brazil and Chile, where low-interest loans were made available to enterprises and public applicants for financing investments in the field of energy efficiency and renewable energies and which simultaneously help to develop the banking system.

Furthermore, experience from projects in the field of renewable energies has demonstrated that they can be profitable at the end of a start-up phase and from then on require no further public financing.

Accordingly, grants are the appropriate instrument for projects that generate no returns whatsoever (studies, building of expertise, technical advice, pilot projects). However, as long as projects generate cash flow or the investments in individual sectors are actually self-sustaining, credit financing with a broad spectrum of possible instruments, including project finance instruments, is definitely feasible. Reduced-interest loans are preferably used in the financial sector but also in the area of infrastructure. Typical approaches for reduced-interest loans are credit lines for energy efficiency measures in the industrial sector or the promotion of renewable energies. Typical measures in the area of climate protection that are financed through long-term development loans include, for example, the construction of a hydropower plant, a wind farm or an efficient sewage system.

The use of grants and (concessional) loans differentiated according to these aspects should also help to mobilise private involvement and capital and prevent private capital from being crowded out through excessively high market-distorting subsidies.

Conclusion and Outlook

The experience so far gathered at KfW Entwicklungsbank has demonstrated that using a set of instruments adapted to the highly diverse requirements of the countries and sectors is of proven effectiveness. Many partner countries are prepared and able to invest in climate protection if they receive the necessary credit funds.

Credit financing is an indispensable instrument in climate financing in order to efficiently and effectively deploy scarce public funds. Without leveraging private funds and without the efficient use of the funds on the recipient's side, the tasks ahead of us in climate financing can hardly be solved. The exclusive use of grants would create false incentives and distort the market, and it is therefore inefficient and not financeable.

In order to meet the enormous financing requirements of climate protection and adaptation measures, greater participation by the private sector and the financial sector will be necessary.

A system composed of a mixture of (officially subsidised) loans and grants will secure the transfer of resources or – particularly in combination with innovative approaches – may lead to an increase – also by encouraging the use of private capital.

Given the limited public resources and the great urgency of the problem, in the future an even greater focus will be placed on the efficient use of loan funds, on the scalability of the instruments, on the delivery of proof of effectiveness of the promotional instruments, on speeding up implementation and on the international coordination of diverse promotional initiatives.


Tree nursery in Africa

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