https://www.wsj.com/economy/global/trillions-in-climate-funds-could-sow-turmoil-in-poor-nations-d3bbbfaa

GLOBAL

Trillions in Climate Funds Could Sow Turmoil in Poor Nations

Plan to channel private investment for climate projects into the developing world risks overwhelming poorer economies

By Matthew Dalton Follow

Sept. 25, 2023 9:00 am ET

Poorer nations are under pressure to switch to renewable energy, so they develop without burning more coal, oil and natural gas. PHOTO: DWAYNE SENIOR/BLOOMBERG NEWS

PARIS—A tsunami of cash is headed for developing countries to address climate change—and with it growing worries that the money will overwhelm the poorer economies it is meant to help.

Wealthy nations are preparing a plan to send more than a trillion dollars each year to the developing world by 2030, a flood of foreign investment that would be unprecedented in modern history. Much of it would come from the rich world's big institutional investors: pension funds, insurance companies, asset managers, private-equity firms and others. The goal is to provide financing on a massive scale for renewable-energy projects in developing countries and infrastructure to protect poor nations from rising seas, drought and other impacts of global warming.

But capital flows of that magnitude risk sowing economic instability, economists and global finance officials say, particularly for smaller, poor countries that lack the financial institutions to channel the money into productive investment. A string of financial crises in the developing world has shown that foreign investment surging into these countries often leaves a mess. Debts balloon, currencies become overvalued and economies face a painful reckoning when foreign investors get spooked.

"Rather than being a boon, it could end up being a curse," said Eswar Prasad, an economist at Cornell University who is advising the Group of 20 major economies on the subject. "This behooves very careful thought in terms of how the financing is structured."

United Nations climate negotiations are the driving force behind the climate finance plan. The financing offered by wealthy nations persuaded poorer countries to agree to Paris accord targets, even though the U.S., Europe and a handful of other nations are responsible for most of the greenhouse gases in the atmosphere that scientists say are causing the earth to warm.

Leaders gathered this week and last at the United Nations General Assembly in New York are negotiating policies to bring private capital into the developing world for climate projects. The ideas range from boosting the lending capacity of multilateral development institutions such as the World Bank to harnessing the IMF's special currency for green energy.

The leaders of wealthy countries—which have failed to meet previous goals for providing climate finance—are trying to muster more of it from their government budgets that would be blended with private capital. Drawing in private investors is crucial for the Biden administration, because congressional Republicans are staunchly opposed to spending government funds for climate projects in the developing world.

Barbadian climate envoy Avinash Persaud says concerns about foreign investment arise when funding comes in short-term debt or portfolio investments that can quickly leave a country. PHOTO: HOLLIE ADAMS/BLOOMBERG NEWS

The plan is gaining political momentum despite a growing body of research that casts doubt on some of the benefits of foreign investment. Prasad and other economists have found that developing economies that rely heavily on foreign capital haven't grown faster than countries that used domestic capital—and faced more volatility from currency and capital flows. The spectacular growth achieved by China and India over the past three decades was largely fueled by domestic savings, not foreign capital, economists say.

Economies that have relied heavily on foreign investment, particularly borrowing from abroad, are vulnerable to crises when investors flee. The list of financial meltdowns includes Latin American countries in the 1980s, Asian economies in 1997 and Russia in 1998. The eurozone crisis of the previous decade was preceded by a rush of capital flowing from the currency bloc's core economies to its poorer, southern rim.

"Do we want these capital flows or not?" said Lesetja Kganyago, governor of the South African central bank, during a recent speech at the International Monetary Fund. "Twenty or 30 years ago, the mainstream view was that financial globalization was good.... Nowadays, the mainstream view has shifted."

In the fight against climate change, officials say, developing countries probably have no choice but to rely on foreign capital. Big developing economies must accelerate their plans to shift away from fossil fuels if the world stands a chance of limiting warming in line with the Paris accord; the poorest nations are under pressure to develop without burning more coal, oil and natural gas. Those shifts will require investment in clean energy to grow exponentially in the coming years.

"We're asking a handful of developing countries to go through a green transformation that is faster than anyone has done before and faster than it might be natural for their economies to do," said Avinash Persaud, an economist who is the climate envoy of Barbados. "So they're going to have to import some capital—not all, maybe not even half, but a significant amount."

Sending these funds as equity rather than debt would reduce the risk for poorer nations, tying foreign investors to renewable-energy projects over the long term, finance officials say. But that means more risk for institutional investors, an unwelcome prospect for them. Big money managers such as BlackRock worry about sudden policy changes in a developing nation that could wipe out their investment. Legal systems lack the independence to stand up to a government that might seek to expropriate a project.

The volatility of developing world currencies is a major problem. Renewable-energy projects in developing nations often have to raise debt denominated in dollars or euros to attract foreign investors. Foreign shareholders of these projects often negotiate deals with local utility companies to be paid in foreign currency.

Barbadian Prime Minister Mia Mottley and her climate envoy have proposed using money from wealthy governments to establish a fund that would help pay for long-term currency hedges. PHOTO: BRYAN R. SMITH/AGENCE FRANCE-PRESSE/GETTY IMAGES

But large obligations in foreign currencies have been one the key ingredients of financial crises of the postwar era. An abrupt devaluation of a country's currency would stress its entire energy sector, officials and economists say. A decision by the Federal Reserve or other rich-world central banks to raise rates could send poorer nations' borrowing costs soaring—as happened since the Fed started raising rates last year.

Persaud said the concerns about foreign investment arise when funding comes in short-term debt or portfolio investments that can quickly leave a country. Persaud and Barbadian Prime Minister Mia Mottley have proposed establishing a fund using money from wealthy governments that would help pay for long-term currency hedges, which are often needed for investments in solar or wind farms that generate revenue for decades.

That would ease investor concerns and limit the instability caused by foreign investors trying to hedge short-term currency risk, Persaud said.

"International capital flows are often feast or famine," Persaud said. "This long-term foreign-exchange guarantee mechanism may help to reduce some of the currency volatility."

Developing-world officials and economists say that this proposal and a handful of others under discussion would unlock more equity financing for green energy. That would help distribute the risk away from poorer economies and avoid inflating the debt burdens of countries that would struggle to repay.

“We have seen many times that the sum of money is secondary to the quality of policies, the incentives they create and capacity of the institutions available to invest funds,” the South African central bank’s Kganyago said. “The capital flow skeptics and the climate justice activists should exchange notes.”

Write to Matthew Dalton at Matthew.Dalton@wsj.com

Appeared in the September 26, 2023, print edition as 'Climate-Fund Plan Poses Wealth of Risks'.