Mobilizing Private Capital Toward Sustainable Development

Daniel Zelikow, Vice Chairman, Global Head of Public Sector and Chairman of J.P. Morgan Development Finance Institution's Governing Board, presents an alternative approach to financing sustainable growth in developing countries.

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Human beings have emitted more than 1.5 trillion tons of CO2 since the industrial revolution, the majority of which have come from today's industrialized economies. The effects of climate change, however, are distributed regressively. Poor countries have less ability to pay for the consequences of climate change and are less able to bear the incremental financial cost of a decarbonized social and economic development path. Indeed, some of the most carbon-intensive industries have migrated to emerging economies during the past few decades. At COP26, rich country governments recognized this issue by signing the 'Just Transition' declaration, which emphasizes the role of the world's developed economies in supporting developing countries to transition to a net zero future while meeting their socioeconomic development priorities.

Despite these pledges, current resource transfers from rich country governments – either directly, via trust funds to which rich countries have contributed, or through the multilateral development banks they fund – are insufficient to finance the achievement of the sustainable development goals by 2030. As a result, these institutions have shifted their focus to using scarce public funds to "catalyze" cross-border capital flows from the private sector. This makes sense, given that the value of investible resources controlled by institutional investors alone is estimated at $154 trillion, far more than what is readily available to public sector lenders. Governments now seek to "crowd in" private investment in the developing world via financial structures that "de-risk" investments in ways that will attract the much larger sources of private capital that, hitherto, had yet to see the financial returns that could be captured from carbon-friendly investments in the developing world.

We believe that such a strategy for financing a net-zero development path may be helpful but is insufficient. It's also difficult to scale with the requisite resources. The reason is that it attempts to address a perceived shortage of finance, while the deeper problem is a shortage of projects to finance. A more effective strategy to bring about a climate-friendly development path in poorer countries would mix policy reforms by host-country governments, a larger commitment to project development by donor countries and development institutions, and the adoption of standards, transparency and monitoring by private firms that will meet the needs of investors who want to achieve social and economic results, without sacrificing financial returns.

The most fundamental component of a successful development strategy is for governments to prioritize sound macroeconomic policies and governance standards that reduce perceived sovereign risk. Financing a well-structured windfarm in Germany costs almost the same as financing a windfarm in Brazil, but for the country risk premium embedded in the financing cost of the Brazilian facility. Driving down country risk premia requires strong macro- and micro-economic policies and overcoming years of implementation challenges in order to earn credibility in the market. But it can and has been done. In recent decades, we have seen dozens of countries – home to billions of people – transition to having lower financing costs than was once the case. Improving the domestic policy framework for development finance should also continue the good work that has been done in creating domestic financial markets, as well as effective systems for mobilizing revenues – both of which remain the most important source of funding for national development strategies, even in poor countries.

National development finance institutions (DFIs) and multilateral development banks (MDBs) remain vital contributors to the design and adoption of sound policies that promote development. Let us continue to support their immensely difficult work and not be distracted by occasional mistakes and failures that inevitably accompany learning and progress. But we also need to recognize, as recent studies and policy statements have, that these institutions require updates to their operations and how they aim to achieve results. For example, the World Bank, the largest multilateral development bank, is no longer large enough to meet a meaningful share of the financing needs of its largest borrowing members, and it is unlikely that it will within the foreseeable future. The Bank, and its regional cousins, should instead focus their financial resources on poorer and smaller countries that have less access to private capital and less ability to pay market interest rates.

This is not to say that the World Bank and other MDBs and DFIs don't have much more to contribute, both to large and small countries alike. They continue to house the largest group of talented development specialists that can be found anywhere in the world. They have immense experience in project identification, design, execution, and evaluation. They enjoy a "trusted adviser" status with their government shareholders that no private firm can hope to achieve. They have the convening power to develop and disseminate global standards of best practice, as they did with the adoption of the Equator Principles for infrastructure investment in 2003 and the Green Bond Principles in 2014. And they have abundant resources in the form of equity capital – both paid in and retained earnings – the returns from which can support significant additional hiring as global needs evolve. In our view, these institutions should focus less on their banking role, particularly in the larger emerging markets where their financial impact is smaller than it once was. Instead, they should focus on development – specifically, project development.

We believe that there is plenty of private capital available to finance bankable projects. As such, donor governments, MDBs, and DFIs should be more targeted in how they deploy their balance sheets – toward poorer countries that are less well known by commercial sources of capital. And they should target risks in other countries that the private sector finds difficult to calibrate; namely, policy and political risks that arise inherently from governmental action (or inaction). Public sources of capital should not chase opportunities in which private capital is willing to invest, especially in "investment grade" countries, where it is extremely difficult to determine whether private capital is being "crowded in" or "crowded out," as we've seen examples of both. Beyond finance, these institutions should hire and deploy the human resources needed to provide policy advice to improve the overall investment environment. And as suggested above, they need more staff (and perhaps staff with new skills) to help governments identify projects, prioritize them, design concessions that place risks with those best able to bear them, help run tenders for project sponsors/investors and then evaluate proposals. They can even help negotiate contracts with sponsors, as needed. The current rise in global interest rates will generate additional operating income for these institutions that could finance an increase in their operating costs, if existing resources are insufficient to redeploy.

Our conviction that the world's MDBs and DFIs can make an even greater difference by deploying their human capital is borne, in part, from our own experience of its value and power to lever private investment. In 2020, J.P. Morgan collaborated with the International Finance Corporation (IFC) to launch our own "Development Finance Institution." The J.P. Morgan DFI applies the methodologies of the IFC and other MDBs to assess the anticipated development impact of some of our firm's wide-ranging products and services. We do so for three reasons. First, it helps our debt-issuing clients identify the specific development outputs and outcomes it seeks when investing third-party capital, all tied back to one or more of the UN's Sustainable Development Goals. As such, we hope to promote greater accountability in finance: something increasingly valued by our clients' own governance structures, as well as by potential investors. Second, this information caters to a cadre of investors that have developed an appetite for "double bottom-line" investing, seeking both financial and social/economic returns that they can describe to their clients and, potentially, provide them opportunities to develop new products to meet their clients' expanded ambitions. Third, by adopting "best-in-class" methods in use by public sector development institutions, we believe that we improve our ability to work with these entities by creating a "blended finance" platform for those projects that do require a quantity of concessional capital.

Standardizing a development impact methodology is the next step to catalyzing private capital for development, including climate-friendly development. From the start, we published the JPM DFI's methodology to enhance its credibility and in the hope that constructive criticism will help us improve. We are now aiming to socialize this methodology across the capital markets ecosystem so that issuers and investors alike have greater transparency as to the definitions, reporting, and evaluation standards that are essential for the emergence of an investible asset class. If we, our clients, and peer institutions are successful in creating an impact investing asset class for emerging markets, the challenge of financing a climate-friendly development path will seem less daunting because only the private sector has the financial resources on the scale needed to bring about a "just transition" for the developing world.