



**The Coalition
of Finance Ministers
for Climate Action**

Financing the transition: how can Ministries of Finance build sustainable financial strategies and what analytical tools do they need?

Coalition for Capacity on Climate Action (C3A)

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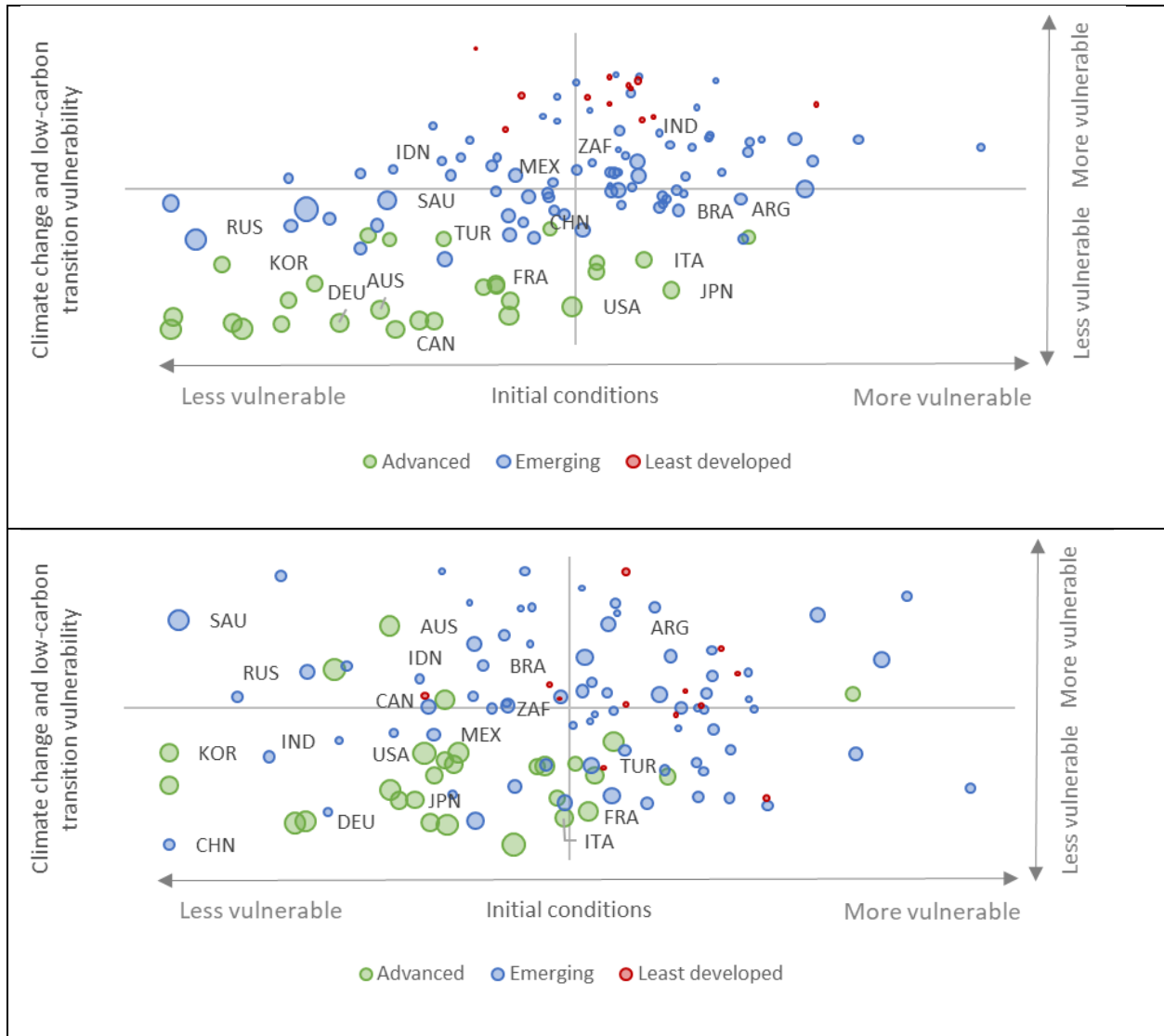
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A recent technical note by the World Bank C3A program reviews the financing needs of Ministries of Finance in their efforts to foster a climate and nature-aligned development strategy as well as the hitherto most widely used financial instruments. It identifies the micro and macro risks that hinder the financing of the low-carbon transition and proposes an analytical framework that MoFs could draw inspiration from in the design of country-specific financing policy mixes. It starts by outlining the existing financing gaps estimated in the literature, ranging from US\$6 trillion to US\$10 trillion annually, and emphasizing the underlying imbalances, in terms of both geographical distribution (most climate finance benefits the Global North) and the purpose of the investments (the bulk of climate finance goes to mitigation rather than adaptation or nature-related financing). It then reviews the risks faced by the financial actors called to drive the low-carbon transition and nature-related investments (public players, foreign or domestic stakeholders, nongovernmental organizations). These risks, from the micro ones (at the technology or project level) to the more macro or institutional ones (e.g., country or policy risks, exchange rate risks), create a situation of finance rationing where desired investments do not transform into effective investments. Green financial sector interventions, such as guarantee mechanisms, direct subsidies for investments, or regulatory reforms, are meant to unlock some of this rationing.

The potential success of these green-sector interventions will, however, depend on a better understanding of the transmission channels from the financing strategies of the desired low-carbon investments to the core macroeconomic variables. Political economy factors may help determine the appropriate combination of financing instruments, depending on the macroeconomic context and the countries' structural and institutional features. All in all, climate finance can make a valuable contribution to the low-carbon transition when accompanied by a mix of structural policies that tackle the roots of countries' economic, social, and environmental vulnerabilities, as well as their specific political economy.

Figure 1, extracted from the technical note, illustrates some of the sources of risk (in this case, the macroeconomic risks) that affect countries' capacity to raise climate finance. Macroeconomic risks can be broadly attributed to fiscal and external conditions. Fiscal conditions have a significant impact on the possibility of raising finance, as Government debt acts as a benchmark for overall credit. Emerging markets and developing economies' external conditions also affect the scope for mobilizing finance by increasing the market's perception of exchange rate volatility (which negatively affects the expected return on long-term investments).

Figure 1: Fiscal (top panel) and external (bottom panel) sources of macrofinancial vulnerability



Notes: Top panel: "Initial conditions" are calculated as the average of Government net borrowing, Government gross debt, and sovereign debt risk, normalized between 0 and 100. "Climate change and low-carbon transition vulnerability" is defined as the IMF adapted ND Gain Index, which measures countries' vulnerability to and readiness for climate disruptions, encompassing factors such as food, water, health, ecosystem services, human habitat, infrastructure, and economic, governance, and social readiness. It is also normalized between 0 and 100. Each sphere represents a country, with the size of the sphere corresponding to GDP per capita. All variables are measured as their 2016–2021 average. Bottom panel: "Initial conditions" are calculated as the average of current account balance, external debt, and sovereign debt risk, between 2016 and 2021 and normalized between 0 and 100. "Climate change and low-carbon transition vulnerability" is defined as the average of the "brown lock-in index" and the "green complexity index" developed by [Mealy and Teytelboym \(2022\)](#), measuring the expected capacities for countries to move away from "brown" products toward "green" ones. These indices are also normalized between 0 and 100 and calculated for the period 2017–2021.

Source: C3A