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World Bank Evolution as if Development *and* Climate Change Really Mattered

FOUR FOUNDATIONS FOR SUCCESSFUL REFORM

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EXECUTIVE SUMMARY

Reform is in the air. Developing countries have long called for major reforms to the international financial architecture, especially at the International Monetary Fund (IMF) and the World Bank Group (G24 1972; 2022). After the lackluster response of these institutions to the global financial crisis in 2008, and now to the multiple crises that plague the world economy today, the call for reform is now coming from the very countries that wrote the rules in the first place.

Making parallels to the moment when the United States oversaw the creation of the international financial architecture at Bretton Woods conference in 1944, in April 2022, Secretary of the US Treasury, Janet Yellen called for major change in international trade, at the IMF and at multilateral development banks (MDBs) to deal with today's challenges, especially in providing global public goods like combatting climate change and pandemic preparedness (Yellen 2022). To her credit, as the largest shareholder of the institution, in October 2022, Yellen tasked the World Bank to come up with an 'evolution' plan that reconsiders the mission, operations and financing of the World Bank in order to provide the global public goods that are so lacking in the world economy (Yellen 2023).

It is important that developing countries seize this opportunity for reform. A core principle of the World Bank evolution should be that the Bank be revived to support a global effort that improves the human prospect in a low-carbon, socially inclusive, just and resilient manner. To this end, the

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World Bank should be at the center of catalyzing and globally coordinating the financing necessary for investment-led development strategies for the 21st century that are aligned with shared development goals and climate commitments. This short policy brief is based on a workshop held in the fall of 2022 with development experts in Geneva, Switzerland and advances four foundations of a development-centered evolution of the World Bank:

1. **A mission-driven approach** centered on investing in national development strategies that are equitable, low-carbon and resilient that reduce poverty and provide global public goods.
2. **A better operational model** that minimizes risk and waste and maximizes sustainable development.
3. **A stepwise increase** in the scale of World Bank capital and lending capacity.
4. **Increased voice, representation and accountability** to developing countries and their citizens.

A NEW MISSION: LOW CARBON, SOCIALLY INCLUSIVE AND RESILIENT DEVELOPMENT STRATEGIES

The central aim of the World Bank will need to be to support member countries to develop and implement new development strategies built around a variety of structural change trajectories necessary to achieve low-carbon, resilient and socially inclusive economies. Achieving global net-zero by 2050 and building climate resilience will necessitate significant reforms at the World Bank to bolster the ability of member states to mobilize the resources needed for a 'Big Push' of investment toward shared development and climate goals (Songwe, Stern and Bhattacharya 2022).

There will be no 'one size fits all' approach to the development trajectories that provide global public goods and promote development goals. We identify at least five types of structural transformations that are necessary across the Global South:

- **First Movers,** where states need to mobilize capital to invest in a new capital stock where little capital exists in the first place. For instance, in much of sub-Saharan Africa, there is a lack of manufacturing capabilities and appropriate grid connectivity to harness the abundance of clean energy sources and consumer demand of a rapidly growing continent (IEA 2022).
- **New Winners,** where states that are blessed with the vital 'transition materials' and industries that form the basis of a new economy can work to harness those resources, increase value addition and strengthen economy-wide linkages in a manner that ensures macro-economic stability, shared prosperity and environmental sustainability not only globally, but where these materials are generated (IEA 2021).
- **Large Emitters,** that need to make massive investments to replace the existing capital stock through structural change away from fossil fuel production and consumption patterns.
- **Fossil Fuel Extractors,** whose economies are dependent on exporting fossil fuels and need to diversify their economic base and change the structure of their economies toward new sources of foreign exchange and exports while buttressing themselves from 'transition spillovers' that arise from the global shift away from fossil fuels.
- **Climate Vulnerable Economies,** who have to reinforce their existing capital stock to adapt to climate change, build new climate-resilient capital stock and become more resilient to loss and damage from climate shocks.

Each of these types of investment-led transformations, linked to country circumstances, needs to be the economic project of the 21st century. Some countries may need to pursue multiple types of transformations at the same time as they may have characteristics that cut across the five types. World Bank development policy loans—which are the largest type of World Bank loans—need to be reformed to help member states identify the appropriate structural change trajectories that are needed in each context, and bolster the role of the state to make investments to unlock the binding constraints to putting member states on the right path. The World Bank evolution should not entail 'green conditionalities,' but rather build on member-driven development strategies assisted and globally coordinated through the World Bank. Countries have evolving Nationally Determined Contributions and Climate Prosperity Plans that can be enshrined in these strategies (UN 2023; V20 2023).

A structural transformation approach to World Bank financing will put as much of an emphasis on how to generate positive spillovers across member state economies through the necessary big push public investments in sustainable energy and infrastructure. When tailored correctly, large public investments in sustainable infrastructure can trigger significant green multiplier effects and private sector economic activity downstream, and boost tax revenue to ensure that such investments are fiscally sound and financially stable (Batini et al. 2021). Research by the Asian Development Bank Institute and others have shown that high speed rail projects in Japan, Uzbekistan and South Korea have not only broadened economic activity, but have increased domestic tax revenue as well (Yoshino and Abidhadjaev 2016a; 2016b; Kim et al. 2021).

At present, aligning World Bank lending to the goals of the Paris Agreement is narrowly seen as an exercise involving a series of negative and positive lists of what types of activity development finance institutions will or will not finance, followed by a subsequent accounting exercise that tallies how much of the portfolio went to the climate-friendly projects (Multilateral Development Banks 2022). Clean energy projects in the face of poor policy frameworks—say tariffs or subsidies for fossil fuels—might be touted as 'climate finance,' but may be going against the wind in a country and will not have a real impact on the broader goal of net-zero aligned development trajectories. Financing a wind farm in a country that has massive fossil fuel subsidies and favorable tariffs to fossil fuels will not have the same impact as a wind farm or turbine manufacturing facility in a country with new policy frameworks to encourage this activity. Individual investments or projects in the absence of the proper development strategies and policy frameworks should not necessarily be counted as 'climate finance' - project finance should be the wind in the sail of new policy and planning frameworks and should not have to sail against the wind of policies that entrench fossil fuels.

BETTER OPERATIONS: MECHANISMS FOR QUALITY CONTROL AND ACCOUNTABILITY

Paramount to ensuring that World Bank financing is a source of investment for long run, stable growth is reducing the financial, social and environmental risks associated with financing the 'Big Push' investments that will be needed. World Bank programs need to be reformed to ensure that they do not accentuate social and environmental risk. Streamlined Environmental and Social Risk Management (ESRM) systems will be necessary to ensure that big push investments enhance and protect natural capital and safeguard local voices and communities while significantly speeding up project design and approval (Schydlowsky 2021) .

In parallel, the World Bank's operating model will have to better account for the financial risks faced by member states. Economic growth rates generated by member states pursuing new development strategies should be higher than the interest rates on their foreign debt—the rates of return on external financing in foreign currencies. Preserving and enhancing the credit rating of the World Bank is equally as important as preserving and enhancing the credit rating and debt sustainability of sovereign member states. De-risking projects to attract foreign investors who seek upwards of 20 percent return in foreign currencies has accentuated debt distress in developing countries (Kenny 2022). According to research by the United Nations Development Programme (UNDP) and the IMF, 69 countries are in significant debt distress or in near default, which could cost those countries lost decades in development (Gray Molina and Jensen 2023). The IMF's Debt Sustainability Frameworks will need to be re-tooled to incorporate resource mobilization needs, the propensity of climate shocks, spillover potential and the accumulated level of private capital mobilization and its currency composition. Furthermore, all new loans and associated contracts from the World Bank and the private sector should have natural disaster clauses in them in the event of a climate shock (FitchRatings 2022).

From a Bridgetown Agenda perspective, this also means making loan pricing and returns a function of climate vulnerability and greenhouse gas emissions rather than income (Persaud 2021). At the time of this writing, Small Island Developing States and large middle-income emitting countries pay the most for loans at the MDBs, even though their biggest barrier to clean energy transitions and climate resilience is the cost of capital. Yet, action in these countries would yield public benefits that are globally significant.

Relatedly, global public goods will necessitate a rethink of the concept of income-level graduation at the World Bank. Graduation should no longer be a function of reaching an income level, but rather the extent to which a member state has passed through the necessary economic transformations discussed herein. Likewise, the allocation frameworks of the World Bank should also incorporate climate change needs so that climate vulnerability becomes a key criterion.

A STEPWISE INCREASE IN THE SCALE OF WORLD BANK CAPITAL AND LENDING CAPACITY

The size of the World Bank is not fit for its purpose in the 21st century. The Independent High-Level Expert Group on Climate Finance estimates that $2.4 trillion needs to be mobilized annually by 2030 to meet the UN 2030 Sustainable Development Goals (SDGs) and the Paris Agreement climate commitments in emerging market and developing countries other than China, while $1 trillion annually needs to be invested by 2025 (Songwe, Stern and Bhattacharya 2022). The existing balance sheet of the World Bank, even if utilized to its full potential, alongside an improved record at private capital mobilization, is far from enough. The World Bank's evolution cannot be an unfunded mandate for climate change.

The World Bank needs a capital increase to mobilize $1 trillion in capital to support the achievement of the SDGs and Paris commitments. Financing for climate change, pandemics and other global challenges should not come at the expense of financing from the World Bank for poverty alleviation, education, women's empowerment, industrial development, healthcare and beyond.

The G20 Capital Adequacy Framework (CAF) recommendations should be implemented to effectively optimize the use of the Bank's existing capital (G20 Expert Panel 2022). These recommendations include calibrating risk tolerance to optimize lending, incorporating callable capital in capital adequacy assessments, refining credit rating methodologies to better capture the MDBs' financial strength and providing transparent and comparable data to support analysis (G20 Expert Panel 2022). CAFs should be subject to regular and careful review and should evolve to withstand the stress of changing circumstances and the stepwise increase of capital mobilization that will come with further capital increase and resource mobilization. Leveraging existing capital should not substitute for further capital increases. Furthermore, the World Bank should explore scaling up a variety of other lending instruments such as guarantees, contingencies and beyond.

While private capital mobilization (PCM) is essential for achieving shared development and climate goals, major attention should be focused on bending down the cost of such capital and reducing the macroeconomic risks of private capital flows to member states. The IMF's Global Financial Stability Report has shown that MDBs have only mobilized 1.2 times the amount of private sector finance relative to commitments from the MDB balance sheets themselves, and the World Bank was one of only two MDBs that had a ratio where one dollar of development bank capital yielded less than a dollar of PCM (IMF 2022). The World Bank has fallen short of achieving strong amounts of PCM, and the World Bank's own evaluations have shown that the capital that has been mobilized has brought significant risk to sovereign member states (IEG 2015).

PCM should be complemented with commensurate efforts of domestic resource mobilization, with special attention to catalyzing the more than $15 trillion in assets across the over 500 national, regional and sub-regional development finance institutions (AFD 2020). Programs by the Inter-American Development Bank and the New Development show that such institutions have missions and incentives that are more aligned with MDBs, demand lower rates of return than the private sector, and are better equipped to work with local firms and entrepreneurs, governments and through domestic capital markets in local currencies (Smallridge et al. 2012; NDB 2023).

INCREASED VOICE AND REPRESENTATION AND ACCOUNTABILITY FOR DEVELOPING COUNTRIES AND THEIR CITIZENS

A capital increase should go hand in hand with more voice and representation for developing countries member states. A strong commitment to a capital increase with commensurate adjustments in voice and representation should be part of the World Bank evolution, with a focus on enhancing the voices of the poorest and most climate vulnerable member states and their citizens.

Furthermore, major emphasis should be put on the people who will be affected by the structural transformations that the World Bank will be overseeing. The business owners, workers and stranded communities who benefited from the previous economic structure should not be left behind but put to the front of the line in the new economic transformations that must become the new goal of development finance. New development strategies that provide public goods should by definition alleviate poverty and create shared prosperity at the national level.

Finally, a World Bank that has evolved with the times will have transparent selection criteria for a global, open and merit-based pool of World Bank presidential candidates in succession, rather than having its leadership chosen by major shareholders.

World Bank member states have a unique opportunity to ensure that the World Bank evolves to meet the challenge of the moment. By helping to drive structural transformation through the implementation of climate-aligned development strategies, devising an operating model that reduces risks and incentivizes action, increasing its scale and lending capacity and amplifying voice and representation of developing countries, the World Bank can be an engine at the core of global efforts to achieve shared development and climate change goals.

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