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Alexandros Kentikelenis , Thomas Stubbs
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1 The IMF and the Green Transition

1.1 An Evolving Engagement with Climate Issues

When the world's senior economic policymakers met in Washington DC in April 2022, they were ready to agree on bold action at the intersection of climate change and international financial management. The two years of economic turmoil after the onset of the deadly COVID-19 pandemic gave rise to a sense of urgency for embedding climate considerations into economic recovery efforts. The tone was already set in early policy initiatives by the Biden administration in the United States to 'build back better' and by the European Union's promotion of a 'European Green Deal.' Among such policy optimism, participants in the Spring Meetings of the International Monetary Fund (IMF) and the World Bank celebrated the creation of a new lending instrument to support countries in implementing climate-related economic policies that would help them address the structural challenge of climate change.

But this climate orientation did not immediately or universally appear as an obvious activity for the IMF – the central actor in global economic governance – to be involved in. The IMF's mandate is to underpin global financial stability in two ways: by providing financial assistance to countries' unsustainable balance of payments positions (i.e., those who struggle to meet their external financial obligations), and by conducting periodic monitoring of its members' economic policies to pre-empt macroeconomic problems from emerging. Neither of these roles directly relates to considerations about the environment, and the path toward implementing organizational reforms that foreground climate considerations had been long. As early as 2015, then-Managing Director Christine Lagarde (2015) explained that climate issues are 'macro-critical,' impacting the economy as a whole and, therefore, within the Fund's remit. This led to a flurry of activity – primarily analytical – to spell out economic policy measures to underpin the green transition (Clift 2024). By 2023, the IMF's current Managing Director Kristalina Georgieva could confidently reiterate that "climate risks affect macroeconomic and financial stability" and inform the world that "we are a financial institution, so we put money where our mouth is" (World Bank 2023b). These issues were now dominating the policy agenda, and the IMF was establishing itself at the forefront of debates on the intersection of economic and environmental policies.

To transform high-level pronouncements into concrete organizational action, the IMF has made several strides. At the broadest level, the organization introduced its Climate Strategy in 2021, where it committed to scale up its engagement with macro-critical climate issues, primarily by expanding its analytical capabilities and incorporating climate considerations into its regular

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multilateral and bilateral economic surveillance (IMF 2021d). In the same year, the Comprehensive Surveillance Review committed to expand analyses on climate issues in line with the goals set out in the Paris Agreement, as well as to recruit additional staff with climate-relevant economic expertise (IMF 2021b). And in 2022, the IMF developed a new lending facility – the Resilience and Sustainability Facility (RSF) – to provide financial support primarily to climate-vulnerable countries that face steep adaptation and mitigation challenges.

These are only the direct ways in which the IMF has become a central player in climate debates within the global governance architecture. To be sure, as a financier of climate adaptation and mitigation strategies, the role of the IMF is relatively limited compared to that of development banks (Clifton, Fuentes, and Howarth 2021; Humphrey 2022; Kentikelenis and Babb 2022; Mertens and Thiemann 2017, 2018; Naqvi, Henow, and Chang 2018). However, the centrality of the IMF arises due to its ability to also *indirectly* influence the direction of climate policy. On the one hand, this is linked to the IMF's role in shaping economic policy debates at the national level (Nelson 2014, 2017; Reinsberg et al. 2019). Rather than providing financing for projects – like the development of solar power infrastructures or the restoration of wetlands – that may be expensive but are ultimately clearly demarcated, the IMF's ambition is to help steer macroeconomic policy. This means that its reach can be more thorough and longer lasting than the amount of money it offers would suggest. On the other hand, the IMF's epistemic authority sets the tone of debates and marks the range of 'legitimate' economic policies for combatting climate change (Broome and Seabrooke 2015).

These developments in the IMF's role are important for global efforts to combat climate change, but they also beg important questions concerning the evolution of international institutions to incorporate environmental considerations into their organizational practices. What is the nature of the IMF's involvement with climate issues? Has the organization meaningfully integrated climate considerations into all aspects of its activities? And to what extent has the new modus operandi supplanted previous practices? We tackle these questions using quantitative and case study evidence on the IMF's activities over the 2020–2024 period.

1.2 The IMF at the Intersection of Macroeconomics and Climate

In the aftermath of the COVID-19 pandemic, developing countries have faced not only domestic economic and social fallout but also a highly destabilizing global economic environment. Pandemic-related slowdowns were followed by

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fiscal crises, exacerbated by surging energy and food prices. Interest rate hikes by central banks in high-income countries further intensified these pressures, driving up debt service costs (Chowdhury and Sundaram 2023; Fischer and Storm 2023). By October 2024, thirty-five low- and lower-middle-income countries were in debt distress or at high risk of it, and many more have brewing debt concerns (IMF 2024g). Against the backdrop of intense fiscal and debt pressures and mounting social dislocations, many developing countries have turned to the IMF for support, whether to provide financial assistance (Stubbs et al. 2021) or to offer policy advice as part of its regular economic monitoring function (Breen and Doak 2023; Gallagher et al. 2021).

These activities of the IMF are both influential and controversial. For its part, lending to countries facing economic problems has been the subject of recurring debate due to the IMF's powerful tool of 'conditionality.' That is, in exchange for financial assistance at low interest rates and long maturities, countries that turn to the organization must commit to implement extensive policy conditions that are updated and expanded over the life course of the lending program (generally one to four years and reviewed quarterly or biannually). These conditions invariably cover a range of fiscal and financial targets, like targets for the budget deficit, the nonaccrual of debt arrears, or the level of foreign reserves. But they also include so-called 'structural' reforms: measures that seek to directly alter the economic structures of the borrowing country, like the deregulation of certain economic activities, the privatization of state-owned enterprises, or the liberalization of labor markets (Kentikelenis and Stubbs 2023). Thus, conditionality is the coercive toolkit of the institution and gives this international organization unprecedented power over the domestic policy environments of its borrowers (Simmons, Dobbin, and Garrett 2008).

The IMF's economic surveillance activities are also highly consequential. These are mandated by the organization's founding treaty – the Articles of Agreement (IMF 2020a) – and performed annually for large economies or biennially for most other countries. Teams of IMF staff visit countries to collect and analyze data and conduct consultations with domestic policymakers (primarily from ministries of finance and central banks). Subsequently, they publish their candid assessment of a country's policy environment and provide recommendations on what reforms should be implemented. These are known as 'Article IV reports,' named after the corresponding clause in the IMF's founding treaty. The policy recommendations included in these reports do not have the coercive character of IMF conditionality, but they nonetheless have an important role in shaping both domestic policymakers' priorities and international markets' evaluation of country investment potential and creditworthiness (Breen and Doak 2023).

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1.2.1 Debt, Debt Sustainability, and Climate Risks

The IMF's growing engagement with climate issues takes place against a backdrop of deepening debt problems in developing countries. This is important because of the many transmission channels between climate risk and debt. First, climate change has a range of follow-on implications for fiscal sustainability, financial sector stability, and overall macroeconomic health, which in turn affect debt sustainability (Ramos et al. 2022a; Volz and Ahmed 2020a). Second, countries with high degrees of climate vulnerability also have to pay risk premiums on their sovereign debt, which inevitably increases their overall debt burden (Kling et al. 2021). Indicatively, V20 countries – a group of climate-vulnerable nations – faced average real interest rates of 9% in the mid-2010s, compared to 6% for G20 members, the group of twenty richest economies in the world (Volz and Ahmed 2020a). Third, high levels of debt service hamper the introduction of green transition policies, as public funds get directed to paying off external debt rather than financing climate change adaptation or mitigation projects (Ramos et al. 2022c). Debt problems also prompt countries into development trajectories that are antithetical to green transition objectives. Civil society has pointed to "a debt – fossil fuel production trap, whereby countries rely on fossil fuel revenues to repay debt, and anticipated revenues from fossil fuels are often overinflated and require huge investments to reach expected returns, leading to further debt, eroding long-term development prospects, and causing devastating environmental and human harms" (Woolfenden 2023a).

In other words, there is a deep and reciprocal relationship between climate change and debt, whereby climate risks contribute to debt problems, and debt problems make dealing with climate risks even more difficult in resource-constrained environments (ActionAid International 2023). A closer look at debt service statistics of climate-vulnerable countries reveals the scale of the problem. Figure 1 shows the average of external debt service (as a share of GDP and excluding debt to the IMF) over the decade preceding the pandemic (circle) and compares it to its level in 2024 (diamond). While countries at all levels of climate vulnerability have registered increases in their external debt service, this phenomenon is most pronounced for those that are highly vulnerable. The average highly climate vulnerable country directed 1.2% of its GDP to debt service in the 2010s but now spends 3% for the same function. This inevitably raises important questions around fiscal priorities and suggests that the approach of policymakers to debt problems also matters for their ability to pursue green transition objectives. In a time of ballooning debt service, longer-term investments – like those necessary for meeting climate goals – could be the first to be scaled back.

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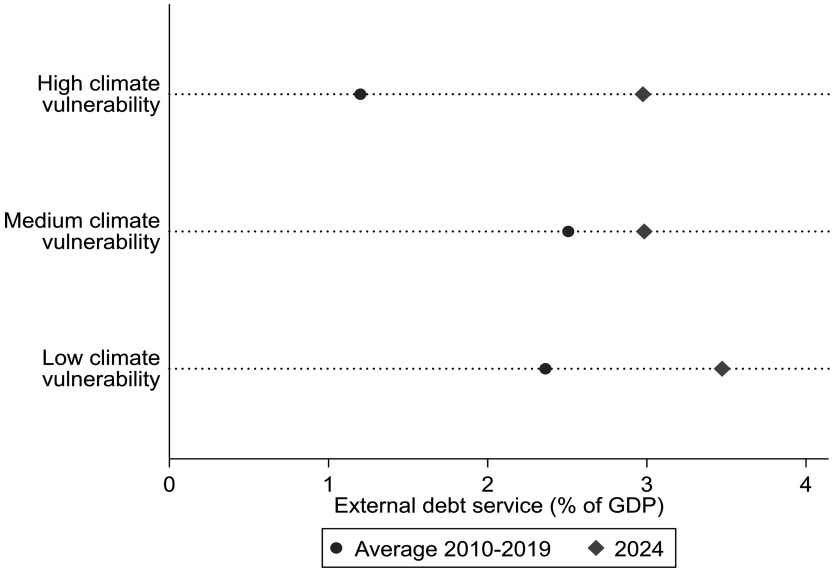

Figure 1 External debt service, disaggregated by countries' climate vulnerability

Source: Authors, using data from the IMF (2023j) and the University of Notre Dame (2023). External debt service includes public and publicly guaranteed debt but excludes IMF charges and repurchases.

Helping countries deal with such debt problems is a core function of the IMF. To this end, the organization employs Debt Sustainability Analyses (DSAs) to shape its activities in this area. The methodology for these analyses depends on the income classification of the evaluated country: one methodology applies to low-income countries, while another to the remaining so-called 'market access' countries. These evaluations are important because if the IMF considers a country's debt unsustainable, it must stop lending and propose debt restructuring. Yet, such negative assessments are uncommon (Rehbein 2023). A pre-pandemic review at the IMF showed that highly debt-vulnerable countries generally did not pursue restructurings, even though the latter were associated with a greater probability of the IMF's lending being successful (IMF 2019a).

Given the macroeconomic implications of the climate crisis, the IMF has started incorporating climate issues within DSAs. For example, the recently updated framework for market access countries ('Sovereign Risk and Debt Sustainability Framework') has introduced a two-part climate change module (IMF 2022m). The first component examines the impact of adaptation

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investments, and the other focuses on mitigation policies. Based on the scenarios pursued in these modules, the outcome is projections for debt-to-GDP and gross financing needs-to-GDP ratios, which – in turn – illustrate debt-related risks from green transition policies. These projections also shape the kinds of reforms that are advocated within IMF lending programs, thus foregrounding the centrality of this debt toolkit in the IMF's engagement with climate issues.

The analyses and assumptions included in DSAs remain the subject of sustained debate. In relation to climate issues, a recent analysis pointed out the limited consideration of different physical or transition risk scenarios in the IMF's modelling efforts (Maldonado and Gallagher 2022). This matters because once different risks are considered, and the introduction of baseline or greener transition policies modeled, then the findings on government financing needs and public debt can vary considerably. Beyond the inclusion of climate issues, debt sustainability analyses are not an exact science but an exercise that entails a high degree of subjective judgement by IMF staff (Hagan 2023), and also one that is heavily politicized due to its momentous implications for opening up a path for debt restructuring (Wheatley 2023).

The climate module within DSAs is not the only set of analytical modules that the IMF has put forth. In recent years, the IMF introduced the Debt–Investment–Growth and Natural Disasters (DIGNAD) toolkit, which examines the economic implications of physical risks. In relation to debt, this toolkit enables an assessment of debt vulnerabilities in scenarios of both the aftermath of a natural disaster and the introduction of "ex-ante policies, such as building adaptation infrastructure, increasing fiscal buffers, or improving public investment efficiency" (IMF 2024c).

The build-up of growing debt vulnerabilities combined with inadequate analytical toolkits pose major challenges for crafting development policies and pre-empting debt crises. Indeed, the forthcoming review of the DSA framework for low-income countries is expected to grapple with how to expand the remit of analysis and make this instrument fit for purpose, in light of the economic challenges posed by climate change (Fresnillo 2024). In following this path, however, the IMF is not alone. In recent years, the World Bank has assumed an ever-greater role in analyzing how countries can integrate the fight against climate change with the pursuit of developmental objectives. In particular, in 2021 the Bank launched its own climate-related evaluations through the Country Climate and Development Reports (CCDR).[1] This matters because

[1] The relationship between the IMF and the World Bank in performing climate policy evaluations has been at times collaborative and occasionally competitive. When the IMF and the World Bank both sought to participate in global efforts to combat climate change in the mid-2010s, one of their key innovations was to introduce a joint analytical toolkit for countries: the Climate Change

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many of the IMF's climate-related measures are drawn directly from these reports.

1.2.2 Fiscal Consolidation, Market-Based Approaches to the Green Transition, and Their Limits

There is a fundamental tension in IMF lending: the organization's programs demand that borrowers introduce far-ranging fiscal consolidation measures – commonly known as 'austerity' – with the hope of improving their macroeconomic positions, yet these are the policies that constrain countries' ability to introduce green transition policies. This occurs through several pathways. First, and most obviously, austerity measures limit available public financing for climate change adaptation and mitigation. Public funds to support a range of green policies – like phasing out coal, incentivizing a switch to cleaner energy sources, scaling up production of renewable energy sources, or providing green subsidies – are likely unavailable for countries introducing extensive budget cuts, and that need to decide between cuts to politically sensitive areas of public spending (e.g., education and health) versus policies that only have a pay-off in the medium- to long-run.

Second, austerity measures are also likely to stunt the introduction of any green industrial policies. Such policies include incentives for research and development and tax relief for green investments by the private sector and require active state policies to appropriately and effectively channel green investments. Absent such investments, countries run the risk of relying primarily on private finance to pursue a green transformation, which may not find it sufficiently profitable to do so or on the financing available through multilateral institutions and bilateral donors, which may come with strings attached.

Policy Assessment (CCPA). Between 2017 and 2020, six such evaluations were conducted for small island developing states on a pilot basis. Given high demand for such a product, the IMF planned to continue and scale up CCPAs to expand the coverage of countries beyond small states. Despite early optimism for the prospects of such cooperation, World Bank leadership decided to pause their engagement with the IMF on the CCPA. This was a source of concern within the IMF, as staffers considered this a duplication of work that the IMF was already performing and a step back for enhancing coordination between the two institutions (Kentikelenis, Stubbs, and Reinsberg 2022). The World Bank launched its own Country Climate and Development Reports (CCDR) in 2021. In response, the IMF developed the Climate Macroeconomic Assessment Program (CMAP) with a focus on its comparative advantage in macro-fiscal analysis, public financial management, and tax policies. Two pilots were conducted between 2021 and 2022. After the review of the pilots, the IMF concluded that the Fund would provide streamlined CMAPs in exceptional cases while expanding targeted capacity development, in order to avoid duplication of the work. The IMF now draws on the World Bank's CCDRs to inform the analyses and policies included in recent loan agreements, while using more targeted toolkits such as the Climate Public Investment Management Assessment (IMF 2024a) and the Climate Policy Diagnostics.

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Finally, austerity also has more insidious effects on the likelihood of the green transition. A long-established strand of academic scholarship has shown that the economic performance of countries implementing IMF programs tends to suffer (Dreher 2006). There are many reasons for this, and they go beyond the observation that countries that resort to IMF programs are generally already going through crisis before resorting to the organization's lending. Ineffective or overambitious IMF-designed policies, inappropriate pacing of reforms, and poor analytical frameworks (e.g., in estimating the fiscal multipliers that inform the design of austerity measures) can all deepen and prolong pre-existing economic troubles (Blanchard and Leigh 2014; Blyth 2013; Kentikelenis and Stubbs 2023). Depressed economic activity has climate-damaging follow-on implications. Households find it unaffordable to shift to greener consumption patterns, with low-income ones being particularly hard-pressed. Private firms struggle to invest in green technologies and adaptation measures, thereby increasing their vulnerability to climate shocks and forestalling reductions in their emissions. And the public sector is further starved of revenue sources.

Beyond fiscal policy, IMF programs also target a broader set of policies that seek to alter countries' economic policy profiles and the relative role of the state versus the market in shaping development policies. For example, the IMF has a track record of promoting carbon pricing as a key policy to underpin climate change adaptation and mitigation. Such policies can indeed be powerful tools in the fight against climate change, but they can only be one part of a broader approach toward the green transition. As the IMF's own research has shown, implementing green transition policies in developing countries also entails increasing low-carbon manufacturing capabilities domestically (Prasad et al. 2022) and providing public support for research and development (Bettarelli et al. 2023).

1.2.3 Subsidies and Social Spending: Tools for a Just Green Transition?

In the IMF's view, removing energy subsidies forms a key plank of the proposed path toward the green transition (de Mooij, Keen, and Parry 2012). This is because such a reduction purportedly has doubly positive effects: it reduces the fiscal deficit by removing a drain on the public budget, and it reduces energy consumption by ensuring that prices reflect the true cost of carbon. While the economic logic of subsidy removal might be compelling and these policies are commonly included in IMF loan conditionality, such measures have clear social and political implications. Indeed, recent political turmoil in Ecuador and Sri Lanka is linked directly to government decisions to remove subsidies (International Crisis Group 2024; Ioanes 2023).

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