International climate finance
Status quo, challenges and policy perspectives

SUMMARY
To limit global temperature rise to well below 2°C above pre-industrial levels, as agreed in the Paris Agreement, all countries must cut their emissions, requiring substantial investment. Developed countries committed collectively to supporting developing countries in their climate mitigation and adaptation measures, with US$100 billion annually by 2020. However, the figure was not reached by 2020, nor is it deemed sufficient to cover the needs of developing countries. Beyond the level of financing, there are claims of an unjust distribution of funds. Moreover, most of the money is given as loans, exacerbating debt problems in many developing countries.

In response to these issues, numerous actors have proposed policy changes for financial institutions, governments and other stakeholders. To allow all developing countries to access climate finance, climate funds are called on to become more accommodating to resource constraints, which hinder successful funding applications. Additionally, they are urged to address the needs of small island states, some of which are excluded from official development assistance but require concessional finance to cover costs linked to climate change.

Proposals for raising climate finance contributions include tapping into the potential of carbon market mechanisms, scaling and reforming climate action by multilateral development banks and mobilising more private finance. The latter may be achieved through better information provision and risk-sharing mechanisms by public finance institutions to encourage private investors.

Finally, the institutions and initiatives for debt relief and restructuring are deemed to be too slow and limited to allow developing countries to deal with climate change. Various stakeholders are demanding reforms for debt relief and increased liquidity support.
Introduction

At the 15th UN Climate Change Conference (COP15) in 2009, developed countries committed collectively to support developing countries in their climate mitigation and adaptation measures with US$100 billion annually by 2020. The Paris Agreement of 2015 enshrines the necessity of international climate finance in Article 9, stating that ‘developed country Parties shall provide financial resources to assist developing country Parties with respect to both mitigation and adaptation’, while other parties are encouraged to do so voluntarily. Article 9.4 holds that financing should aim for a balance between contributions for mitigation and adaptation.

Regarding the role of different countries, the United Nations Framework Convention on Climate Change (UNFCCC) distinguishes between three groups. On the one hand, Annex I countries have specific responsibilities concerning climate action and Annex II countries, a subset of Annex I, share an obligation to provide international climate finance. On the other hand, Non-Annex I countries are mostly developing countries and potential climate finance recipients. Special consideration is given to least developed countries (LDCs), due to their limited capacity for climate action, and to small island developing states (SIDS), due to their high vulnerability to climate change impacts.

Recognising that not all climate change impacts can be addressed through mitigation and adaptation, the need for a distinct finance mechanism for unavoidable loss and damage emerged. At COP27 in 2022, a dedicated ‘loss and damage’ fund for vulnerable countries was agreed upon. Operationalisation and details of the fund will be discussed at COP28, based on a proposal by the dedicated UNFCCC committee suggesting the World Bank as the interim host for the fund. A separate briefing explains loss and damage in more detail, while this document focuses on climate finance primarily for mitigation and adaptation, i.e. avoidance of loss.

State of play

International climate finance is directed from developed to developing countries through various channels. These include bilateral public climate finance, multilateral finance primarily through multilateral development banks (MDBs) and dedicated funds like the Green Climate Fund, and private climate finance mobilised by public financing interventions. Additionally, there are climate-related export credits provided by developed countries’ export credit agencies.

The most recent data from the OECD indicate that public finance, bilateral and multilateral, makes up the vast majority of the flows, totalling US$68.3 billion or 82% of international climate finance in 2020. Publicly mobilised private finance amounted to US$13.1 billion and export credits were valued at US$1.9 billion (Figure 1). Total contributions have increased in recent years, but US$83.3 billion in 2020 still falls short of the US$100 billion commitment. As official data by the OECD are published with significant delays, comprehensive figures since 2020 are not available yet. Numbers on MDBs’ climate finance commitments to low- and middle-income economies, which are available until 2022, show significant increases since 2020 (from US$38.0 billion to US$60.7 billion). The Council of the EU expects the US$100 billion target to be met in 2023 for the first time.

While the OECD is the official data provider for international climate finance, its calculations have been heavily criticised by developing country representatives, academics and other observers such as the European Court of Auditors and Oxfam. Oxfam’s Climate Finance Shadow Report 2023 estimates the real value of financial support to be less than half of the
amount reported by the OECD. Part of the discrepancy arises due to the large share of loans in climate finance, particularly the high proportion of non-concessional loans (provided at market conditions with standard terms and interest rates), relative to concessional loans (with more favourable terms than the market would offer). As non-concessional finance is not counted as official development assistance (ODA), Oxfam argues that it should not count towards official climate finance contributions either.

The OECD’s latest data (2016-2020) show that loans made up 72% of international climate finance. Among the loans from MDBs, 75% were non-concessional, among those from climate funds it was 52%, and among bilateral loans it was 20%. Grants made up 25% of total international climate finance, with higher shares in LDCs and SIDS. Lastly, 3% of climate finance was in the form of equity investments, i.e. investments in companies, organisations or funds in exchange for an ownership stake (see Figure 2).

Concerning the use of funds, 67% was dedicated to mitigation, 24% to adaptation and 9% to cross-cutting activities covering both areas. The share of adaptation finance increased significantly between 2016 and 2020, especially in Africa, where it rose from 25% to 45%. The largest share of climate finance targeted Asia (42%) and middle-income countries (70%). LDCs received 17%, representing US$14 per capita, compared to an average of US$21 across all recipient countries.

Regarding contributing regions, the EU and its Member States are the largest provider of public international climate finance, accounting for €28.5 billion in 2022. In addition to developed countries, which are obliged to provide climate finance, some other countries have decided to contribute. China has pledged US$3.1 billion for a South-South Climate Cooperation Fund. However, according to analysis by E3G, the country has delivered only 10% of that amount as of 2023. The United Arab Emirates pledged at the African Climate Summit in September 2023 to support Africa’s clean energy transition with US$4.5 billion in financial support.

**Challenges**

**Access and distribution issues**

The Paris Agreement (Article 9.4) stresses that adaptation finance should take into account the needs of the most vulnerable countries, in particular LDCs and SIDS. Nevertheless, in practice, there are challenges in channelling funds effectively to these groups. According to analysis by the OECD, the amount of adaptation finance a country received between 2016 and 2020 does not correlate with the level of vulnerability. One issue is that some institutions in LDCs lack the capacity or resources to navigate the complexities of funding application processes. Even the simplified approval process for the Green Climate Fund has been described as lengthy and burdensome by the World Resources Institute. In 2022, Garschagen and Doshi found that the Green Climate Fund prioritised LDCs and SIDS, but many of the most vulnerable countries still had not been able to secure any funding, partly due to low institutional capacities.

The majority of flows between 2016 and 2020 went to middle-income countries in Asia, while LDCs received below-average per capita funding. With regard to sectors, the majority of climate finance targeted the energy and transport sectors (46%), reflecting the large share of mitigation funding.
Projects in water, sanitation, agriculture and forestry – sectors crucial for adaptation – remained under-funded, with only 17% of total funds. A 2022 report by the Global Alliance for the Future of Food shows that food systems, although accounting for almost a third of global greenhouse gas emissions, receive only 3% of public climate finance.

Finally, grants and concessional loans are largely distributed based on income levels. Middle-income SIDS face eligibility issues when it comes to concessional finance, despite their increasing structural vulnerability to climate change impacts.

**Insufficient funds**

Besides distributive issues, the total level of climate finance is insufficient to cover the needs of developing countries. The goal of mobilising US$100 billion annually by 2020 has not been met since its establishment in 2009. A report by the Overseas Development Institute found that, in 2020, only seven Annex II countries provided their fair share towards the US$100 billion goal: Sweden, France, Norway, Japan, the Netherlands, Germany and Denmark. The report concludes that the United States, providing merely 5% of its fair share, is overwhelmingly responsible for the 2020 gap. Additionally, there is no clear definition of what counts as climate finance, leading to ambiguity and mislabelling. There are claims of climate finance funds being directed, for example, to a coal plant in Bangladesh, an airport expansion in Egypt and ice cream stores across Asia.

In 2023, the US$100 billion goal may finally be achieved. However, various analyses suggest that the needs of developing countries are likely to be substantially higher. According to the latest IPCC report, mitigation finance for developing countries needs to increase by a factor of between four and seven annually. For adaptation financing, the annual cost estimates reported by the IPCC vary widely, between US$14 billion and US$411 billion until 2030. The Adaptation Gap Report 2023 determines a central range of between US$215 billion and US$387 billion annually. The UNFCCC’s report on the determination of the needs of developing country Parties concludes that developing countries require over US$5.8 trillion to cover their climate action plans (nationally determined contributions) by 2030. As this only includes the plans with financial estimates, which are 42% of the total, the actual figure is probably much higher. Finally, the Independent High-Level Expert Group (HLEG) on Climate Finance estimates annual needs of US$1 trillion (see Figure 3).

Beyond the shortfall in the funds provided, the majority of funds do not appear to be ‘new and additional’ as agreed in Article 4 of the UNFCCC. An estimate by CARE suggests that, between 2011 and 2020, over half of international climate finance comprised funds diverted from development...
assistance budgets. Only 8% was additional to the previous commitment to provide 0.7% of gross national income to development assistance.

**Debt and liquidity problems**

Deeply intertwined with the topic of climate finance is the indebtedness of many developing countries. Half of all low-income countries (36 out of 73) are either in or at high risk of debt distress, according to the [International Monetary Fund](https://www.imf.org) (IMF). In African countries, a Development Finance International report finds that governments spend over half of their revenues (53.4%) on debt service, i.e. to pay back debt or interest on debt (see Figure 4). In 2023, the [International Institute for Environment and Development](https://www.iied.org) analysed data available from 59 LDCs and SIDS and found that, in 2021, they collectively spent over 50% more on servicing public debt (US$33 billion) than they received in climate finance (US$20 billion). Since then, interest rates have risen, further increasing the debt burden.

The levels of debt make it difficult for countries to finance climate mitigation and adaptation projects. Most LDCs have [poor credit ratings](https://www.imf.org), which have been systematically lowered since the COVID-19 pandemic. Low credit ratings can mean high borrowing costs or difficulties in receiving any loan. Some countries are facing a situation of debt overhang, where their debt levels are so high that they cannot receive any further loans, even for profitable projects.

Vulnerability to climate change exacerbates the indebtedness of developing countries. They are forced to borrow more to afford the increasing costs of climate adaptation and to repair and rebuild after damage. While this effect is expected to become stronger as climate change intensifies, an IMF study found that climate vulnerability already has a significant negative effect on creditworthiness. If international climate finance continues to consist primarily of non-concessional (market-rate) loans, it risks worsening the debt issues.

The Common Framework, an initiative by the main creditor countries ([G20, Paris Club](https://www.g20.org)), aims to help some developing countries struggling with debt. Under the framework, creditors get together to discuss debt restructuring (changing the terms of the repayment, such as extending the loan period or reducing interest rates) and potential debt cancellation (partial forgiveness of a debt). Despite its ambitions, the initiative faces criticism for excluding climate-vulnerable middle-income countries and for not requiring multilateral development banks (apart from the World Bank) to participate, even though they hold the largest share of external debt in many countries. Furthermore, the negotiations have so far been slow, with the [first deal](https://www.imf.org) being reached in July 2023 for Zambia. As the landscape of creditors evolves, with China and private bondholders emerging as substantial lenders, the diversity of creditor interests and perspectives adds to the difficulty of negotiations.

**Liquidity**

Besides countries burdened with significant debt, many developing countries have growing difficulties with liquidity. Liquidity refers to the ability to quickly and efficiently access cash or resources that can readily be converted into cash. It is important when countries face sudden and substantial financial obligations – for example, when large debt repayments become due or when they need to urgently respond to natural disasters or address economic shocks. Developing countries struggle particularly with liquidity problems as they often have less developed financial markets, less stable currencies and limited access to credit. As an increasing share of developing...
countries’ debt is owed to private sources with usually less flexible repayment terms, liquidity problems are becoming harder and more expensive to manage.

To address this, initiatives such as the Liquidity and Sustainability Facility (LSF) have been introduced. Launched in 2021 by the United Nations Economic Commission for Africa (UNECA), the LSF aims to bolster short-term liquidity for African countries by facilitating the rapid sale of sovereign bonds at fair prices. However, these initiatives, while valuable, often have difficulties securing the necessary support and resources to be truly effective.

Special drawing rights (SDRs) provide another avenue for addressing liquidity issues. SDRs are similar to credit from the International Monetary Fund (IMF) that countries can convert into major currencies quickly to address immediate financial needs. For countries facing liquidity constraints, SDRs can be a valuable resource, as they alleviate the need to take on new high-interest debt during financial emergencies. However, developing countries have access to a relatively small proportion of SDRs, as the allocation is mainly based on the economic strength of a country.

Policy perspectives

Numerous stakeholders have proposed policies for addressing the challenges regarding climate finance. The policies require the participation of a large group of stakeholders, especially MDBs, the IMF, climate funds and the governments of UN member states. The coordination of efforts is driven by the annual climate conferences (COP), as well as numerous other events and working groups. At the forthcoming COP28 in Dubai, 'fix climate finance' is one of the four priority areas.

Allocating funds more fairly and effectively

One set of proposed policies is directed at climate funds, primarily the Green Climate Fund, to ensure that all developing countries have access to financial support. The World Resource Institute observed in 2021 that more than two-thirds of accredited developing country institutions have not managed to receive any funding. It recommends simplifying the funding process (beyond the Green Climate Fund’s ‘simplified approval process’), offering initial financial support to develop project proposals and providing more access to expert advice. A 2023 UN report also stresses that funding mechanisms must better accommodate LDCs' limited capabilities and provide support for capacity building. Tools such as the integrated national financing frameworks, which guide LDCs in effectively mobilising and managing funds, should be used and expanded.

To ensure SIDS that are not eligible for concessional finance from ODA can still access necessary funds, there are calls to redefine ODA eligibility and to ensure those countries receive sufficient funding through climate funds. A 2022 UN report recommends the establishment of a dedicated funding pool for SIDS under the Enhancing Direct Access pilot of the Green Climate Fund.

Increasing public and private finance

The European Parliament resolution concerning COP28 calls for developed countries to ensure that financial flows between 2020 and 2025 make up, on average, US$100 billion annually, to compensate in the coming years for past shortcomings. In 2025, a 'new collective quantified goal' is expected to be set. The European Parliament believes the new goal should be higher and 'take into account the needs and priorities of developing countries for additional and adequate climate finance'. Deliberations are ongoing, and are continuing at COP28, with the final goal to be set in 2024 after a second determination of needs by the UNFCCC, also due in 2024. In the meantime, policies for increasing public climate finance and mobilising private funds are also being discussed.

One proposed approach for generating additional resources is by utilising the potential of carbon market mechanisms. On the one hand, there is a growing call to facilitate greater participation by developing countries in carbon markets, as envisaged in Article 6.4 of the Paris Agreement. While carbon markets are not a replacement for climate finance commitments, they can provide important support, with potential flows of up to US$40 billion by 2030. On the other hand, there is a suggestion
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– put forward by Wopke Hoekstra, the European Commissioner for Climate Action, among others – to channel revenues generated from established emissions trading schemes, such as the EU emissions trading system (ETS), to international climate finance. In 2022, global revenues from carbon taxes and ETSs grew to almost US$95 billion. Some of the revenues are earmarked for climate projects, but few of the funds are currently directed to developing countries.

A second proposed lever to increase public funds is to scale and reform climate action by international financial institutions. MDBs have driven much of the increase in climate finance over the past years; however, the HLEG on Climate Finance argues that there is room to enhance contributions further. One suggestion is improved risk management. A G20 expert panel found MDBs to be overly cautious in preserving their AAA issuer ratings, leading to under-utilisation of their lending capacity. The Climate Overshoot Commission recommends that international financial institutions, including MDBs, grow their balance sheets and take more risks.

A third proposition concerns the selection of countries obliged to contribute to international climate finance. Given the ‘principle of common but differentiated responsibilities and respective capabilities’ in Article 2 of the Paris Agreement, many argue that Annex II, being based on the situation in 1992, does not constitute a fair classification. Based on per capita income and historical climate change contributions, the Overseas Development Institute asserts that Qatar, Singapore and Israel, for example, would also have to contribute to climate finance. Possible expansion of the number of countries expected to contribute will likely be further discussed at COP28.

Regarding the mobilisation of private finance, the latest assessment report by the IPCC, among other sources, stresses the effectiveness of information provision and risk-sharing. Public institutions can help identify potentially profitable climate projects and cover some of the risk. The Bridgetown 2.0 Agenda, laid out by Mia Mottley, the Prime Minister of Barbados, for example, calls for US$100 billion per year of foreign exchange guarantees. Such guarantees, provided by institutions such as the IMF and MDBs, would encourage private investors by taking over any potential costs arising from currency fluctuations. The HLEG on Climate Finance points towards numerous existing initiatives that could be expanded to streamline and scale up public-private cooperation.

Addressing the debt burden and liquidity problems

In June 2023, following the Summit for a New Global Financing Pact, the World Bank announced a set of measures aiming to help some vulnerable countries deal with debt, including a clause to pause debt repayments during extreme climate events. Beyond such specific provisions, systemic change may be necessary. The Global Stocktake report finds that, to meet the Paris Agreement, the financial system, including its structure and processes, needs to be transformed. It mentions fundamental improvements to existing institutions and possible new institutional arrangements.

Many countries stand behind the Bridgetown 2.0 Agenda, which demands a redesign of the Common Framework (discussed above). It calls for faster debt relief and cancellation as well as the inclusion of debt-distressed middle-income countries in the framework. The November 2023 European Parliament resolution on COP28 considers it ‘essential to advance the Bridgetown Agenda without delay’, a position that is also backed by UN Secretary-General António Guterres. The Vulnerable Twenty (V20) Group and UNECA, among others, have also issued statements highlighting the need for ‘reform and transformation’ of the current debt architecture. The V20 argues that the focus of debt relief must shift from mere stabilisation to enabling climate and development goals. In line with this, a 2020 European Parliament resolution highlighting that debt relief measures need to be extended to allow developing countries to deliver on the Sustainable Development Goals. The Parliament has also repeatedly called on donors to ‘prioritise grant-based financing’.

One instrument addressing both debt and climate is debt-for-nature swaps. These arrangements typically allow a country to have a portion of its debt forgiven in exchange for commitments to
invest in climate adaptation and mitigation projects. The largest such swap was completed in May 2023 in Ecuador, where US$1.6 billion of existing debt was converted into a US$656 million loan. In exchange for the partial debt forgiveness (~US$1 billion), Ecuador committed to providing around US$323 million to the conservation of the Galapagos Islands (see Figure 5). The European Investment Bank, too, is discussing potential debt-for-nature swaps, for example with Barbados.

![Figure 5 – Illustration of Ecuador’s debt-for-nature swap](source: EPRS illustration based on Financial Times, 2023.)

Most debt-for-nature swaps are initiated by public creditors; however, Ecuador’s debt conversion involved almost exclusively private investors, raising hopes for a rise in new debt-for-nature swaps.

Besides debt relief, developing countries are calling for liquidity support. In June 2023, the IMF announced that it had met its 2021 objective of mobilising US$100 billion in SDRs for vulnerable countries, 60% of which has been made available. Bridgetown 2.0 urges the IMF to accelerate the distribution of SDRs and economist Joseph Stiglitz is advocating for a further US$300 billion in SDRs per year for developing countries to tackle climate change. Many also call for a reform of the SDR system. The HLEG on Climate Finance, as well as African Finance Ministers, argue that the system should return to its original design, whereby allocation is based not only on IMF quotas but also on liquidity needs. Furthermore, they urge for SDRs to be channelled through MDBs, to improve flexibility and accessibility.

EUROPEAN PARLIAMENT SUPPORTING ANALYSIS


Sahakyan M. and Eisenberger S., Background information for the BUDG-CONT joint workshop on ‘The Role of the EU Budget in International Climate Finance’, Policy Department for Budgetary Affairs, European Parliament, January 2023

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