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Will Private Finance Support Climate Change Adaptation in Developing Countries?

Historical Investment Patterns as a Window on Future Private Climate Finance

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Cover Photo: Cow dung drying in Haryana, Northern India, for use as a domestic energy source amongst rural households.
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Historical Patterns as a Window on Future Private-Sector Climate Finance

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ABSTRACT

Private-sector finance has been widely embraced as an important part of efforts to scale up resources for developing countries to respond to climate change. Yet there has been very little analysis of what private finance means for developing countries, and whether it will really deliver what is intended. This paper explores what historical patterns of investment reveal about the potential for the private sector to play a significant role in raising and delivering climate finance, specifically in the context of the adaptation needs of developing countries. It finds that private-sector finance is unevenly distributed among countries and among sectors, and it often does not match developing countries' most pressing needs. It also notes that it is important to differentiate between different financial flows – foreign direct investment equity vs. portfolio equity, for example, and equity vs. lending – and more closely scrutinise both financial flows and outcomes. These observations have important implications for those tasked with designing an international regime that will stimulate, govern and account for climate finance flows to developing countries. It should not be taken for granted that the private sector will succeed in tackling adaptation challenges where in the past it has, on the whole, failed to alleviate poverty and livelihood threats in many of the poorest parts of the world. More robust analysis is needed of what the private sector can actually contribute towards adaptation efforts, and who will benefit.

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EXECUTIVE SUMMARY

The importance of private finance amongst efforts to scale up resources for developing countries to respond to climate change is touted enthusiastically by multilateral finance institutions, international climate negotiators, United Nations agencies, the research community and the finance industry itself. Yet there has been very little analysis of what private finance means for the intended recipients – developing countries – and whether it will really deliver what is intended.

This paper asks the question: *What do historical patterns of investment reveal about the potential for the private sector to play a significant role in raising and delivering climate finance, specifically in the context of the adaptation needs of developing countries?* It examines the historical distribution of both equity and debt flows (including foreign direct investment, portfolio investment and international bank lending) between regions and countries, sectors, and between new projects ("greenfields") and existing activities. Its findings illuminate broad behavioural patterns among private investors that are likely to have consequences for the delivery of climate-relevant private finance in developing countries.

It is clear that both equity and debt finance are heavily concentrated in a relatively small number of countries rather than evenly spread across the developing world. The major share of foreign direct investment (FDI) inflows to developing countries is directed to major emerging economies in East Asia (China), Latin America (Brazil and Mexico) and South Asia (India). Least Developed Countries (LDCs) see around 3 per cent of total FDI flows to developing countries. International bank lending follows a similar pattern.

Some key sectors in terms of livelihoods and adaptation needs in developing countries, such as water and agriculture, have either been relatively unattractive to private investment (for instance, water infrastructure in Africa), or seen investment in large-scale export-oriented activities but not in the small-scale production that sustains local populations (as with agriculture in Africa). Investment flows have instead tended to favour natural resource extraction over tertiary sectors such as health or education.

It is also clear that different parts of the developing world are less successful than others in attracting different types of finance, and this in turn has implications for their ability to invest in certain kinds of activities. Africa appears to have lower access to debt finance than other regions, as a portion of overall foreign capital, which is problematic since many adaptation measures are probably unsuited to attracting equity investors.

What also becomes clear once private flows are brought under the microscope is that not all are equal. Foreign direct investment (FDI) equity is not the same as portfolio equity. Equity is not the same as lending. Furthermore, some statistics on FDI and lending capture events which on the surface appear to be increased financial flows, but in reality simply reflect a change in ownership of assets or debts in developing countries rather than the provision of new resources. The climate finance discussion needs to better consider how to more closely scrutinise both financial flows and actual adaptation outcomes.

A recent trend towards quantification of "private climate finance" reflects a worrying feature of much of the broader climate finance discussion, that it proceeds without first giving proper and full attention to *what outcomes finance is intended to deliver*. In this respect, the discussion among research and policy communities needs to shift from "what can we measure, and therefore, what should we report?" (an approach taken by almost all of the efforts to date at quantifying private financial flows) to "what do we *need*, and therefore, what should we measure and report?"

The gaps in delivery of private finance also pose a major challenge for public finance, which must not only leverage new resources specifically for adaptation but also redirect investments to countries and sectors that currently miss out. At the same time, the fluctuating nature of investment flows, the

complicated behavioural patterns of private investors, and fundamental differences among financial instruments are not always clearly captured in simplistic statistics, which makes it difficult to meaningfully account for private finance. Nonetheless, accounting is crucial in the context of political commitments to drastically scale up resources to support developing countries.

These observations have important implications for those tasked with designing an international regime that will stimulate, govern and account for climate finance flows to developing countries. Even this coarse examination of investor behaviour raises questions about whether the private sector could succeed in tackling adaptation challenges where in the past it has, on the whole, failed to alleviate poverty and livelihood threats in many of the poorest parts of the world. More robust analysis is needed of what specifically the private sector might actually contribute towards adaptation efforts – both what this contribution will look like and who will benefit.