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Blended Solutions for Better Emerging Market Development

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The Conference of the Parties of the United Nations Framework Convention on Climate Change (COP27) presented a number of challenges that nations will face in the coming years. One recurring issue was the funding required for emerging markets to reach their sustainable development goals.

Many asset owners and investment managers are keen to invest in such ventures. However, they have reservations, primarily surrounding the increased risk of these investments. For example, investing in transition strategies—strategies that help to gradually advance the shift toward more renewable methods—and in infrastructure projects within emerging markets presents complex challenges. Many investors do not understand the local risks and lack resources on the ground to conduct the initial and ongoing diligence necessary to managing these ventures. In addition, many asset owners have guidelines that restrict non-investment grade issuers to a certain percentage of their overall portfolio.

Blended finance is one potential solution that could solve many of these problems. Blended finance uses development banks or public sources to secure initial project funding to then attract private capital*, creating a public-private partnership. Many experts agree that blended finance can help bridge the funding gap that is needed to fund the sustainable development of emerging markets.

The World Bank has addressed many of these challenges by engaging local personnel to oversee capital deployment and conduct ongoing due diligence. When the World Bank initially funds a project, it also takes on the initial risk, which may attract private capital down the line. When a development bank like the World Bank issues debt to fund these projects, those bonds often come with an investment-grade credit rating, which can be ideal for many asset allocators.

Importantly, blended finance also can be used to improve existing infrastructure, becoming an important tool in transition investments. We believe these transition opportunities in the global economy should not be ignored. At present, "pure" green activities represent a very small portion of global gross domestic product (GDP), and an even smaller portion of emerging market economies. While pure green investment is certainly needed to address global emissions, we believe the focus also should be on transitioning existing activities such as transport, construction, and mining to more environmentally sustainable practices. Many emerging markets rely on such industries for their livelihood. These are industries that cannot be replaced easily with green alternatives, and instead will require complex, multi-phase transformations and engagement and alignment with multiple stakeholders. Tackling these institutional issues will be difficult. However, because funding these types of projects could have a large impact on greenhouse gas emissions, they are key to the transition to a low-carbon economy. At the same time, emerging markets are projected to increase emissions to support economic development in the coming decades. Therefore, addressing these complex issues will be pivotal in helping developing economies to both meet emissions reduction targets while also advancing more sustainable economic development.

South Africa

South Africa's transition represents several challenges as well as opportunities. Moving one of Africa's largest economies from coal-fired power to a green alternative is estimated to require $250bn over the next thirty

years, according to a report from South Africa's Stellenbosch University and the Blended Finance Taskforce released at last year’s World Economic Forum. At the same time, divesting immediately from Eskom, South Africa’s main electric provider, or even from South Africa broadly would come at a cost. Removing the primary supplier of energy from the power grid at a time when South Africa is dealing with rolling blackouts would have political and development consequences. Additionally, Eskom is a huge employer in the region, and immediate divestiture could have significant socioeconomic consequences, potentially leading to more instability in the country. The question then becomes, how do we solve complex transition problems such as these to reach emissions goals? While investors alone cannot solve this problem, partnering with public entities and development banks may be a step toward a practical solution.

Indonesia

At COP27 last year, a group of countries agreed to mobilize $20bn of public and private financing to help Indonesia move away from coal, bring forward the country’s peak emissions by seven years to 2030, and commit to reaching net zero in its power sector by 2050. The Indonesia Just Energy Transition Partnership (JETP) will eliminate 300 megatons of greenhouse gas emissions through 2030 with a reduction of well over 2 gigatons through 2060. Half of this $20bn will come from public sources, including multilateral development banks and G7 countries, and half from private financial institutions, coordinated by the Glasgow Financial Alliance for Net Zero (GFANZ). It is this $10bn of public sector funds that enabled the next $10bn to be committed with estimates of $20-30bn more private sector money to flow once pilot projects are underway. Given the high coal content of Indonesia’s energy consumption, blended finance can be used to unlock significant private capital to address this problem in the short term and perhaps improve the country’s investment and ESG thesis.

Conclusion

Investing directly in transition or infrastructure projects within developing countries may be difficult in practice or carry too much risk for many investors and asset owners. Without access to private capital, emerging markets have limited avenues for funding much-needed development while also implementing cleaner alternatives. Without financing options, attaining net zero becomes disproportionately more difficult for these nations. Blended finance, partnerships between the public and private sectors, offers an attractive solution. These partnerships provide asset owners and investors more investment opportunities with potentially better risk profiles. At the same time, developing economies gain access to needed capital. Blended finance can help address the complex issues these nations face. Joint programs recognize that a more realistic path to net zero involves the support of multiple stakeholders and practical, phased approaches that consider the critical industries on which developing countries rely and strive to balance basic economic needs with sustainability goals.

**Institute of International Finance. “Blended finance for climate—the time is now”. March 2022*

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