

“CAN WE AFFORD SUSTAINABLE DEVELOPMENT?”

KAPUŚCIŃSKI DEVELOPMENT LECTURE – HELSINKI, 26TH FEBRUARY 2014

Ladies and gentlemen, the answer of course is yes, we can afford sustainable development, and no, we cannot afford not to finance sustainable development.

I am sure this answer comes as no surprise, as it is unlikely that I would have been invited to give this lecture if I was going to conclude anything else.

So if saying “no” was never an option, any value from this lecture must lie elsewhere. I could for example spend time arguing:

- Why and how developed countries should provide *more development assistance*
- Why *improved trade access* would benefit the poor
- Why *fiscal adjustments*, perhaps reduced fossil fuel subsidies, would advance sustainable development.
- How *effective carbon pricing* would drive us towards a low carbon economy and generate finance for other aspects of sustainable development.

All of these things are true and important, but not the topics of my lecture today.

Rather, I want like us to leave the building later this afternoon with three things foremost in our minds:

1. ***Globalization itself*** is going through profound changes that will shift the challenges and opportunities we face in advancing towards sustainable development.
2. ***Aligning financial markets*** to the needs of an inclusive, green economy is a pre-condition to advancing sustainable development.
 - And I want to convince you that the very purpose of the financial system is to do just that.
3. ***Institutional innovation*** is crucial to overcoming barriers, that is, how we organize ourselves, the rules of the game, notably applied to financial markets.

Let me then start by offering some reflections on the characteristics of an emerging new era of globalization.

Our justifiable development concerns should not blind us to recent successes. The last 3-4 decades have seen a staggering reduction in extreme poverty and international inequality. Said simply, the majority have benefited from a period of rapid global growth, driven in large part by the economic dynamic of China and the US, and underpinned by five economic drivers

- The first four are the *internationalization of capital*, the *wider availability of cheap credit*, *innovations in global business organization*, and *information technology*.
- The fifth warrants special mention, and it is the *underpricing of environmental externalities*, without which, paradoxically, globalization as we see it today, and its many successes as well as challenges, may well not have happened.

Globalization, however, is going through some profound changes, which can be seen through the lens of four meta-shifts and their possible implications.

1. **The end of the Era of Cheap**, as *low cost labor*, an under-priced environment and *low cost finance* are no longer driving forces of growth, and indeed development. The implications are; higher priced goods and services, comparative advantage shifting away from low cost labor, higher cost of investing in anything, including sustainable development, but also an enhanced advantage for new environmental technologies.
2. **The onset of the Climate Era**, as yesterday's deeds and inactions translate into a world of rising temperatures of 3 degrees or more, and the mind-focusing realities of an adaptation imperative. Volatility and extremes will become more the new normal, precipitating climate migration, water wars and political instability.
3. **The rise of Robots**, long predicted, and finally with us, with a massive increase in the robotization of routinizable employment. The implications will include reduced opportunities for lower and middle-skilled people, and so also low labor cost economies, production closer to consumption, and labor markets no longer playing their core role in distributing wealth and income and generating demand.
4. **The New Inequality** within, rather than between countries, driven by technology, and the elites' political capacity to capture huge proportions of income and wealth gains. This is likely to lead to greater social and political instability, new forms of mass mobilization, secular and political extremism, and economic protectionism.

Planning for sustainable development without taking into account this changing context is dangerously short-sighted.

- Let no one doubt that the world I am describing is very different from the one we are living in today, or that we are ill prepared to cope with its challenges or opportunities.
- Changes will eradicate the value – that is, strand the assets - of much of our current global economy (ranging from homes and natural resource intensive and polluting industries, to entire communities and possibly nations).

Let me turn to the second of my propositions today, that reshaping financial markets is a pre-condition to advancing towards sustainable development.

I want to talk about private, financial capital, amounting today to about US\$225 trillion. But before doing that I want to make a couple of remarks about public finance allocated for international development.

Official Development Assistance today is not a trivial sum, US\$134 billion in 2011 (since when it has declined somewhat).

- PLUS development assistance from non-DAC countries (US\$12-15 billion in 2011)
- PLUS growing and private aid (US\$60-70 bill a year).
- PLUS ‘Other Official Financing’ which includes non-concessional loans and export credits (\$70 billion/ year)
- PLUS so-called “domestically mobilized resources”, money allocated to these purposes by developing country governments and citizens.

These numbers look pretty good when set against estimates of what is needed to pay for the basics in developing countries.

- The UN Millennium Project assessed in 2005 that ODA financing needs to reach the MDGs add up to some USD 130-190 billion a year
- Sustainable Energy for All initiative estimated that US\$50 billion a year to 2030 is needed to provide universal energy access.
- Education for All Global Monitoring Report \$38 billion per year on education
- Lancet Commission on Global Health 2035 \$57-91 billion per year for health.

My simple point is that if achieving sustainable development is a matter of matching public financial resources with these sorts of expenditure needs, we can declare success and move from a discussion of mobilizing finance to one of execution.

But of course sustainable development is much more than basic education, minimal modern energy and public health (although getting these right would make a mighty difference).

- China's leadership speaks of the need for an ecological civilization
- Others talk of, green and inclusive, low carbon climate resilient, or circular economy

Divided by words, but the message is clear, *despite and because of our recent successes*, our US\$70 trillion global economy needs a refit.

Through this lens, the arithmetic on sustainable development looks different.

Adding up global investment needs in everything from energy to agriculture to mobility and water moves us from billions to trillions, US\$5 trillion a year by most estimates for the foreseeable future. And we need an extra US\$1 trillion a year to ensure those investments incorporate low-carbon technologies.

Public finance, let alone ODA, is not up to this challenge. With the exception of China, at least to date, lots of private capital is needed to meet these needs. And that brings us back to the US\$225 trillion currently allocated through the world's financial markets.

The OECD, the G20 and experts such as the Consultative Group on International Economic and Monetary Affairs, all recognise that *inadequate private capital is flowing into long-term infrastructure development*, let alone investments that are low carbon and natural resource preserving or regenerative. Clean energy investment, for example, has grown to about US\$250 bill from a low base in the last decade, but remains far below what is needed.

Investors complain that green and socially inclusive investments are just not profitable enough. And they are right, financial markets today profit far more from their non-alignment with sustainable development outcomes, than with their promotion.

Conventional wisdom has it that there are four ways to fix this misalignment:

1. *Fix the real economy* through measures such as carbon prices, effective pollution controls or minimum wages. These 'real economy' policies are of course part of the solution, but there are good reasons to believe that they will either not happen or not be adequate to do the job.
 - Fixing the global economy sector-by-sector, and country-by-country is a labor of love, but not one that is working well enough, quickly enough.
 - Despite our best efforts, the vision of effective carbon markets is likely to remain just that, a vision, for the foreseeable future.

- *Shout louder* to convince financial institutions to do the right thing. This strategy is based on the belief that financial market participants would act differently if they were *better informed and more capable* of profiting from investing in a sustainable and inclusive economy. Such a strategy does have merit in moderation, in that we do see a growth at the margin of investors taking climate and other factors into account. Yet it would be wrong to deduce from this that perceptions of first-mover advantages will lead to self-correction of the financial system if the right data was made available to the right, smart, fund managers.
2. *Public incentives*, smartly deployed through innovative financial instruments and collaborative arrangements between the private and public sectors. Much has been done on this count in the last two decades:
- Private finance initiatives have been developed to attract private capital and management to run everything from railways to prisons and schools.
 - Specialized instruments to incentivize green investment, with one recent study indicating public funding leveraging up to 8 times as much private investment.

Some private finance has flowed as a result of these innovations, but with mixed results and often at considerable cost to the taxpayers.

3. *Extending and using public sector balance sheets*. Policy-driven financial institutions are having somewhat of a renaissance.
- Much of China's massive, domestic infrastructure development has been financed by just one state owned bank, the China Development Bank (CDB).
 - The CDB, with Germany's KfW and the European Investment Bank, are amongst the world's largest investors in renewable energy in developing countries.
 - The number and scale of sovereign wealth funds is growing rapidly, with investable funds of US\$10-15 trillion expected by the end of the decade.
 - And there is a growth in "green" public banks, as well as development banks committing to fund less carbon and natural resource intensive investments.

All of these responses are helpful, and should all be part of a comprehensive financing solution.

- However, taken together, they do not drive the global economy towards sustainable development at the scale and speed needed.

- In fact, it is unlikely that they would even stem let alone reverse the main impact of private capital in accelerating a carbon and natural resource intensive, very un-inclusive global economy.
 - a. Carbon Tracker found that the carbon intensities of the main London and New York stock exchanges increased by 7 per cent and 37 per cent respectively over the last 2 years.
 - b. Spending on exploration and development of new fossil fuel reserves by the 200 largest listed fossil fuel companies totaled US\$ 674bn in 2012, almost three times the global investment in renewables for the same year.

Financial market interests are not aligned to the needs of sustainable development. Conventionally, this is sometimes stated as being because of their dedicated service to serving their core purpose; of stewarding shareholders assets, effectively managing, pricing and transferring risk, and driving capital into the most productive uses for the benefit of end-use consumers..

The reality is quite the reverse: financial markets should be, but are not in practice, aligned to the interests of either shareholders or customers, their intended beneficiaries.

- *Direct misalignment* through short-termism and rent-taking endemic in the financial community (along with asymmetrical risks between fund manager and their employee, and between the institutions and taxpayers, policy holders and even shareholders).
- *Systemic misalignment* through an over-emphasis on maximizing financial returns to financial capital results in the cannibalization of other (under-protected) capitals, notably natural and social
 - Over-investment in carbon and natural resource intensive assets
 - Under- or in fact dis-investment in social cohesion and inclusiveness.

So *this is not a matter of private versus public gain*. The misalignment of financial markets with sustainable development is history's greatest market failure. Left unaddressed it will deliver an unmitigated disaster that will devalue many of the very financial assets that today's financial markets seek to exploit.

- In fact, the very purpose of the financial system is to channel our collective assets into the creation of tomorrow's sustainable, inclusive economy as it is this that squares the circle of securing both public and private gains, rather than neither.

So the bottom line is that we can't do without private capital. But its current logic not only does not do the job, but is part of the problem. We have no choice but to change the rules of the game, the very basis on which the financial system is organized... the question is how?

Let me then turn to my third proposition: namely, that we require major innovation in how we organize our affairs – the rules of the game, particularly with regard to financial markets

As Germany's Weimar Republic allowed little freedom of expression, activist intellectuals took to rewriting traditional fairy tales to carry political commentary. One such tale tells of a group of villagers travelling to heaven to appeal to God to do something about their mean and corrupt rulers. After a rather extended and confusing consultation between learned Angels and with various dusty blueprints, God sends the villagers away, declaring: "I do not know what rulers are, I did not invent them, so go and sort them out yourselves".

We have made slavery and exploitative child labor illegal, passed laws that allow us to punish people when they inflict pain on others, and assert that every living person should have social, political and economic rights.

Yet we fear to demand fundamental changes to our financial system that is misusing our money instead of deploying it in our interests.

- We demand effective carbon markets, but remain largely passive when investors price carbon at zero in their asset valuations, effectively betting, indeed encouraging, a world of 6 degree increases in temperature.
- We want revenge on enriched bankers, but we do not demand banks with different mandates.
- We give charity to those in need, but allow financial speculation on the very food we eat, that others (rarely us, so far) cannot afford.

There is no doubt that changing the rules of the game of financial markets is tough, as recent years have amply demonstrated. Change makers have to contend with

- The sheer technical complexity and extraordinary dynamism of financial markets.
- Geographic mobility which allows it to arbitrage between regulatory regimes (skip to easier places) with relative ease.
- The political influence of the financial community, which make changes that create losers amongst the powerful difficult, even where there are many more

winners.

But its not that hard - *what is made by humans can be changed by humans*, and in fact we see the beginnings of a movement to do just that in aligning financial rules with sustainability;

- *Accounting and reporting* requirements could require major businesses to disclose how environmental and social risks are measured and so valued.
- *Incentives*, whether fiscal or remuneration-based, could reduce the value and volume of short term trading.
- *Banking regulations*, such as Basel III, could through capital weighting requirements encourage green investment.
- *Credit ratings*, both corporate and sovereign, could incorporate the solvency implications of intensive natural resource use and carbon emissions.
- *Fiduciary responsibilities* of institutional investors could be broadened to ensure consideration of sustainability impacts.

In fact, there have been policy and regulatory developments in most of these areas, and there is active experimentation policy research in others. Interestingly, it is often emerging market policy makers and regulators that have moved first.

- The *China Banking Regulatory Commission* has advanced its green credit guidelines.
- *South Africa* has established sustainability outcomes as legitimate fiduciary considerations through an extension to its Pensions Act.
- Many stock exchanges have established social and environmental disclosure under listing requirements, and one of *Brazil's* stock exchange has built governance assessments into a tiered set of capital raising opportunities.

Part of the problem is one of accountability. Heads of central banks and financial regulators, and even Ministries of Finance, with some exceptions, profess this to be beyond their mandate and capabilities, pointing to their focus on narrower, shorter-term objectives. Such mandates, and associated institutional capabilities, would have to change for regulators to ensure that financial markets are part of the solution.

Ladies and gentlemen, during Davos last month, the United Nations Environment Program launched an Inquiry into design options for a sustainable financial system.

I have the honor to be co-leading over the next 18 months, although my comments here today are of course mine alone.

The Inquiry takes as its starting point, echoing the views for example of Nobel laureate economists, Robert Shiller and Joseph Stiglitz, that:

- ***the purpose of the financial system is to channel our collective assets into the creation of tomorrow's sustainable, inclusive economy.***

In this lecture, I have set out the reason for the Inquiry's focus on the rules governing the financial system in unlocking financing for sustainable development.

- The Inquiry does not have the answers to which rules should be changed and how, there is a need for real discovery, analysis and invention.
- The Inquiry's job to not invent the right answers, and it does not need to, as my examples of leadership practice demonstrate.
- The Inquiry's job is, then, to identify, catalyze and crystalize this work in ways that can be communicated and digested by the wider policy and regulatory community.

Ladies and gentlemen, at the beginning of the year I wrote an article in the *Guardian* *professing my optimism about the sustainable development agenda*. The article came in for some "surprised criticism", not least from my friends and allies. But I stand by my "skeptical optimism".

Profound change comes at times when continuing to do the same thing is either simply not an option, or is commonly viewed to be an act of foolishness. We are at such a stage in:

- Understanding that incremental moves to finance sustainable development are unnecessarily timid and inadequate.
- Realizing that unlocking private capital is the key to satisfying the right level of ambition in financing sustainable development
- Seeing the visible and growing gap between what our financial system is doing, compared to what it should deliver
- Most of all, knowing that one of our greatest social innovations, financial markets, can be realigned to serve its systemic purpose is in fact to invest in a sustainable, inclusive economy

The Inquiry, hopefully, will play a role in advancing this agenda.

Thank You



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Simon is the co-Director of UNEP's *Inquiry into the Design of a Sustainable Financial System*, a visiting scholar at the Tsinghua School of Economics and Management, a senior fellow of the Global Green Growth Institute and the International Institute for Sustainable Development, and a Distinguished Senior Fellow of the Academy of Business in Society.

Previous roles include non-resident Senior Fellow at Harvard University's J K Kennedy School of Government, founder and Chief Executive of the international think tank, AccountAbility, and Development Director of the New Economics Foundation.

He writes extensively and is author of the award-winning book, *The Civil Corporation*, and of the widely-cited Harvard Business School article, *Paths to Corporate Responsibility*. His recent works have included *Greening China's Financial System* (with Zhang Chenghui) and *South-Originated Green Finance* (with Cassie Flynn).

Simon holds a BSc Economics from the University of Bristol, an MSc. Econ from the London School of Economics and a Phd. in Political Science and Economics from the University of London.

His work can be followed at @SimonZadek and through his regular blog at www.zadek.net/blog. More information on his work is at www.zadek.net, including downloads of many of his publications, and on the Inquiry can be found at www.unep.org/greeneconomy/financialinquiry.

Selected Reading by Simon Zadek

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