Rethinking environmental protection: IMF Special Drawing Rights could finance the energy transition

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The threat posed by climate change is increasing and it is high time the world switched to renewable energies. But politics has not yet succeeded in investing sufficient funds quickly. There is an alternative though: create new money to spend on climate projects.

A glimmer of hope: the Green Climate Fund

It is December 2011 and yet another climate conference is underway. But the media have lost interest after the conference in Copenhagen two years ago failed to fulfil the world's huge expectations. Most states continue to refuse point blank to agree to any binding CO_2 reduction targets. Negotiations progress in slow motion at best, although according to the latest figures from the IPCC the climate catastrophe is moving ever closer.

Since the climate summit in Cancún at the end of 2010 though, there's been a kind of plan B: setting up the Green Climate Fund. Many see this as a chance to start protecting the climate despite stagnant negotiations and drive the switch to renewable energies. As of 2012, 30 billion US dollars are to be paid into the Green Climate Fund each year and earmarked for climate projects. By 2020 the fund is scheduled to grow to 100 billion US dollars annually.

While it is questionable whether 100 billion are truly enough to fund the fight against climate change and if we can afford to wait another nine years, the fund clearly represents a considerable step forward compared to the present situation. For the very first time annual funds would reach a level that could really make a difference in protecting the climate.

Where should the money for an energy transition come from?

As one might be inclined to expect, the most important question remains unanswered: How is the Green Climate Fund to be financed? The deeply indebted industrialised countries will hardly be able to find such sums in their public budgets. Suggestions have been made to raise the money through a financial transaction tax on CO_2 emission trade or duties raised on air and sea transport. But every dollar procured this way would have to be taken away from another institution. In all likelihood this approach – very welcome on principal – would run up against strong pushback from lobby groups. It is unlikely that the required sum could be raised this way.

What is needed then is an international source of funds that could make the full amount available without having to take them from a national budget or another institution. And there happens to be just such a global source of funds: the International Monetary Fund (IMF).

The IMF can allocate new, internationally exchangeable reserve assets – referred to as Special Drawing Rights (SDR). Which has led the World Future Council to suggest that the IMF could finance the Green Climate Fund with SDR.

Creating new money is realistic

This method of generating money is not an unrealistic request. Back in April 2009, at the height of the financial crisis, the member nations of the Group of Twenty (G20), which comprises the most important industrialized and emerging nations, decided to allocate new SDR with a value of 250 billion dollars. This was intended to increase exchangeable global liquidity. If the G20 countries can commission the IMF to create money to combat the global financial crisis, then they are also principally capable of doing the same to combat the climate crisis.

The IMF reserve currency, rather oddly named Special Drawing Rights, is an artificial currency. It was introduced in 1969, but was soon forgotten again with the end of the Bretton Woods System in 1973. SDR do not represent "real" money like banknotes or coins, but rather currency assets that the IMF can allocate to the central banks of member countries. The central banks can then use these to purchase foreign currency from other countries – that is convert the foreign reserve asset into "real" currency reserves.

The economic power of the IMF member countries ensures the value of SDR. It is calculated based on a currency basket consisting of the dollar, euro, pound and yen. This provides a huge advantage, in that SDR can be exchanged for any other currency without causing significant exchange rate fluctuations. This means SDR are like the wild card among the currency standards. They have a balancing effect and as such the potential to counteract turbulence on the international currency markets.

Recently discussion about giving SDR a larger role in international currency systems has flared up again globally. This is something the BRICS countries (Brazil, Russia, India, China and South Africa) demand regularly. But in order for SDR to have more impact, there would need to be more of them in circulation. Financing energy projects with SDR would support this goal, since it would ensure that the IMF created more SDR and allocated them to member countries.

SDR for the Green Climate Fund

In practical terms, it could go something like this: A group of IMF members who have an at least 85% proportion of voting rights – such as the G20 – commission the IMF to allocate 100 billion dollars of SDR annually. The SDR are allocated to the countries' budgets or the related national central banks. The countries involved would in turn agree to pass their new SDR on to the Green Climate Fund as soon as it needed money for a concrete project.

The Green Climate Fund then exchanges SDR for whatever national currency the project requires. This means that the respective central bank gives new money in its own currency to the Green Climate Fund and receives new SDR in return that it can book as additional currency reserves. So allocating new SDR results in new money creation in a national currency. Economically this process functions like an export and should be particularly attractive for countries with a low level of industrialization and chronic trade deficits. Since the Green Climate Fund will invest in energy projects in many different countries, the money creation driven by the SDR will be distributed across many different currencies.

The Green Climate Fund would not just influence the financial world though; it would also impact the real economy. By investing in climate projects, the Green Climate Fund would also increase real demand for "green" capital goods and the services associated with them. This would also be distributed across overall global supply.

Creating money without inflation

This effectively rebuts the inflation argument that generally arises at the mention of creating money. Many fear that as soon as the amount of money, and with it demand for goods, rises more rapidly than real production, money loses value – in other words inflation occurs. But while the above mentioned additional demand of 100 billion represents a significant amount for climate protection, taken in view of the entire global gross domestic product of around 60 trillion, it is still a very small sum. Global demand would directly increase by only 17 percentage points. Even if we assume a multiplier effect caused by new demand, no sincere economist could derive a significant danger of inflation from that. It has to be seen as more of a small stimulus programme for green growth.

Furthermore, the amount of money generated is only the usual amount created between the central bank and the banking system anyway – plus just as much as is required for climate protection investments. Money is simply generated through another avenue. The amount of money grows in accordance with production and not faster, as would be the case with inflation.

It is still important to ensure that new money is only created when an investment in renewable energy has been successful, for only then does the new amount of money correspond to a true increase in production. One way of guaranteeing this would be through feed-in tariffs. These compensate energy producers for all the power generated from renewable energy sources that they feed into the grid. So the money does not flow until the actual electricity from renewable sources has been generated. The Green Climate Fund could pay these tariffs.

Killing two birds with one stone

When one takes a closer look, it is soon clear that there is no threat of inflation despite the act of creating money. It is much more a case of solving two problems at once: Through the annual allocation of new SDR, their importance in the international monetary system grows and their stabilising effect grows with it. At the same time, these new financial means for funding regenerative energies make a considerable contribution to stabilizing the climate.