Increasing Sustainable Investment through Global Financial Reform

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The global financial architecture is struggling to facilitate the sustainable investment needed to address climate change. Some argue that if the Basel III global capital rules treated environmentally friendly assets as being safer forms of capital, banks would be incentivized to hold more of these assets on their balance sheets and extend more green debt, promoting sustainable investment. This paper explores the possible impacts of this reform by combining firm-level environmental, social, and governance (ESG) data with a global general equilibrium model. It finds that the reform would result in a significant reallocation of capital, goods, and services across sectors and economies. It finds that while the reform could significantly increase investment, the investment is not necessarily sustainable and not all countries benefit from cooperation. The paper identifies a range of challenges that need to be overcome for these results to hold, including the reliability of ESG data, inconsistencies in taxonomies and methodologies, and further analysis confirming whether green firms are indeed safer borrowers. The paper argues that the G20 is well placed to address these challenges and outlines an agenda to achieve it.