

**The CDM:
An Innovative Financial Mechanism
which Promotes Sustainable Development**

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The current negotiations of the United Nations Framework Convention on Climate Change are giving rise to an innovative financial mechanism which seeks to help industrialized countries reach their emission reduction targets in a cost effective manner, while at the same time promoting sustainable development in developing countries. Although still in its design stage, the Clean Development Mechanism has the potential to become a source of capital for the financing of clean, energy efficient economic development, and for addressing environmental issues such as deforestation and loss of biodiversity in developing countries.

CDM enthusiasts argue that the CDM will promote technological leapfrogging whereby developing countries bypass the unsustainable growth patterns chosen by industrialized countries. The question arises however, whether the projected flows through the CDM will be high enough to impact the quality of growth in developing countries.

A quantitative estimate of the potential flows of capital through the Clean Development Mechanism is at this point in time, conjectural at best. There is no agreement on any of the rules and procedures which will have a direct effect on these numbers, and the international community is currently exploring a wide array of options. However, a preliminary “guesstimate” of the potential flows can be attempted on the basis of projected supply and demand of carbon offsets.

If the recently adopted Kyoto Protocol enters into force, industrialized countries will have to reduce their aggregate greenhouse gas emission levels by 5.2% below the level of 1990 emissions. These reductions must be reached during the first commitment period, between 2008 and 2012. Considering the projected business-as-usual emission curves of these countries, the reduction commitments correspond to one billion tons of carbon for each of the five years of the commitment period.

The OECD countries can achieve those reductions through a combination of domestic actions and international emission reduction measures. Those reduction measures pursued in developing countries will flow through the CDM. Most estimates of the quantity of carbon offsets which will be transacted through the CDM hover around 500 million tons per year, for each of the five years. At a projected price of \$36/ton of carbon, this would amount to \$18 billion dollars per annum.

How does this compare to other private capital flows into developing countries?

In 1992 the Earth Summit held in Rio de Janeiro called on industrialized countries to commit an additional US\$125 billion annually to developing countries in order to support their path toward sustainable development. These funds were intended to come from increasing official development aid. The world has seen the exact opposite occur. Since 1992 official development aid has been decreasing, and continues to decrease at an accelerated pace. In contrast, private capital flows to the developing world have been on the rise, and have already exceeded the target established by the Earth Summit¹.

However, increased private capital flows do not necessarily mean improved environmental performance. Investment can increase environmental damage through increased resource use, or it can improve environmental performance through more efficient resource use. In the case of CDM projects, the sale of carbon offsets will act as an effective incentive to implement more greenhouse gas efficient projects than what would otherwise have occurred.

The virtue of the CDM will not lie in the yearly \$18 billion it may channel. Rather, the real impact of the CDM, if appropriately designed, lies in its potential to “green” private investment in developing countries. Investment in the energy sector, transportation, and extractive industries in developing countries will continue. Through the CDM the world may begin to see a trend of investments in the same sectors, even at the same or higher levels, but with choices of cleaner technologies and practices.

From a financial point of view, the CDM represents a clear way to securitize the environment by providing private capital markets with the means to invest in carbon reductions as a commodity. It also will provide an unprecedented opportunity for developing countries. Many of them are reaching a critical juncture in their economic development. Decisions are being made in energy generation that will affect worldwide greenhouse house gas (GHG) emissions for many years to come. Currently, they can only choose a low emissions path of development if there is a clear economic reason to do so. The CDM offers this opportunity.

¹ A leading study estimates the private capital flows into developing countries at \$270 billion for 1996. (Gentry, 1998).