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Debt-for-climate: hitting three crises with one shot?

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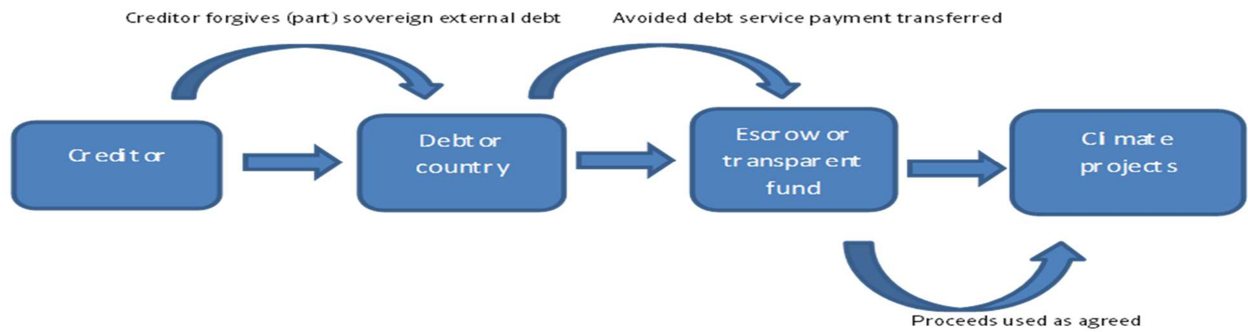
Summary

- Many low-income countries face a triple crisis: the Covid-19 pandemic, rising debt levels and climate change. To tackle these challenges at once one of the solutions could be a debt-for-climate swap.
- The end of the Debt Service Suspension Initiative (DSSI), launched to alleviate the impact of the Covid-19 crisis, raises the risk of debt troubles ahead.
- At the same time, many highly indebted countries are also most vulnerable to climate change. High debt levels reduce the financial room of governments to implement measures to adapt to or mitigate the effects of climate change.
- Developed countries could consider swapping debt for climate measures to support these vulnerable countries and to keep the promises made before.

Many developing countries face a triple crisis. The Covid-19 pandemic hit countries around the world, especially tourism-dependent small island economies. The pandemic aggravated the debt vulnerabilities many already faced before the pandemic as it resulted in deep economic contractions and a further rise in public debt. Next to it, many developing countries feel the burden of climate change and are the most vulnerable to the effects of climate change in the coming years. A country where the triple crisis is clearly visible is the Maldives. The pandemic resulted in a sharp economic contraction and a rise in debt vulnerabilities. In addition, it is one of the many small island states that are vulnerable for a sea level rise.

Recovering from the impact of the Covid-19 pandemic many countries face the effects of climate change, being among others droughts, floods and a rising sea level. Therefore, institutions like the IMF and the World Bank, are promoting a "green" inclusive economic recovery. Investments to tackle the effects of climate change or to cut CO2 emissions can provide an opportunity to reinvigorate growth, create jobs and make economies more climate-resilient. However, as many of these countries have fiscal constraints due to their high debt levels there is hardly any room to make these investments. One of the solutions to support these countries could be that the international community provides debt relief in exchange for investments in climate. Through this so-called debt-for-climate swap, countries can use their freed resources to spend on measures to adapt to or to mitigate the impact of climate change.

Generic structure of debt-for-climate swap



Source: Climate Policy Initiative

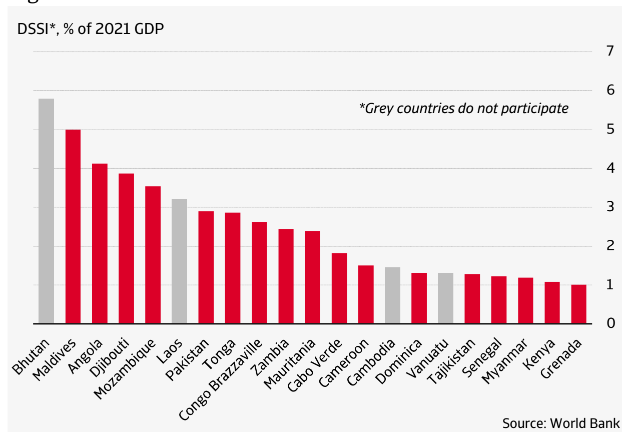
Multilateral and bilateral creditors provide already support to countries to mitigate the impact of Covid-19 pandemic on their economies. One of these initiatives ended December 2021, which could jeopardise debt sustainability in some countries. For these highly indebted countries, more support is needed to tackle climate change.

End of DSSI could raise debt vulnerabilities

At the end of 2021, the G20 Debt Service Suspension Initiative (DSSI) expired. This initiative was implemented to help the poorest countries combat the impact of Covid-19 on their healthcare systems and economies. Through participation, the countries could use their freed payments on debt for spending on social services and healthcare. However, only debt-service payments to their official bilateral creditors were included in the DSSI. Although private creditors were asked to participate on comparable terms, they did not.

The DSSI was only available for low-income countries and least developed countries. About 46 countries of the 73 eligible countries participated. Some countries, like Ghana and Benin, did not participate because of fear for negative consequences for their sovereign external ratings. Others, such as Nigeria and Honduras, did not because the DSSI relief was rather limited as their official bilateral debt was relatively low. According to the World Bank in total more than USD 10.3 billion in relief has been delivered since it took effect in May 2020.

Figure 1 Potential DSSI relief to GDP 2021



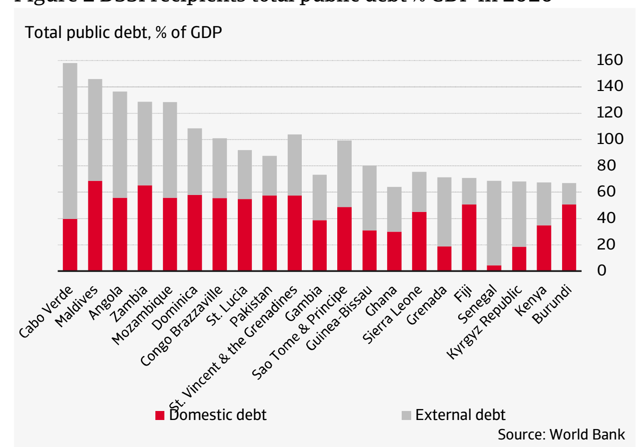
The DSSI could be very beneficial for countries. Although not participating, Bhutan in potential could have a suspension of debt service payments of almost 6% of GDP in 2021.

Of the participating countries, the largest recipient of DSSI in relation to GDP is Maldives, followed by Angola and Djibouti. For these countries, the suspension of bilateral debt repayments provided substantial room to support their economies.

One should keep in mind that the DSSI is only a suspension of debt service payments and that from 2022 onwards countries have to repay these suspended payments. For many of them this could become challenging because of the elevated public debt levels and the related high debt service repayments. All the more in light of the expected rate hike in the United States. A higher interest rate in the United States could pose a threat for highly indebted countries.

Already before the Covid-19 pandemic, some countries faced a high public debt, which only increased further due to the pandemic. Debt vulnerabilities have increased remarkably across developing countries, especially in those where the external debt has the largest share. Of the DSSI participating countries, a few have total public debt levels above 100% GDP and have a large share external debt.

Figure 2 DSSI recipients total public debt % GDP in 2020



The DSSI is actually a temporary solution and does not address the emerging solvency problems in some countries. It only solves the liquidity-issues raised by the drop in government revenues and the increased spending related to Covid-19. To address this the IMF and the G20, together with the Paris Club, introduced the Common Framework in November 2020 to deal with insolvency and protracted liquidity issues.

Stepping up the Common Framework

The Common Framework will go beyond the DSSI, but some argue not enough. On a case-by-case basis, debtor countries can request a debt treatment in the Common Framework. Involvement of all creditors is required for the specific debt treatment and it should be accompanied by an IMF-program. Official creditors of the G20, both members of the Paris Club and new creditors like China, are participating. In addition, debtor countries are required to seek debt relief on comparable terms from private creditors.

However so far, only three countries have announced their interest in participating in the Common Framework: Chad, Ethiopia and Zambia. Many highly indebted countries are reluctant to participate because of the potential adverse rating actions this might inflict. Besides progress is slow because of the complex debt structure each country has and due to domestic issues. For instance, the first country to renegotiate its debt, Chad, needs to restructure a commercial collateralised debt held by a large number of banks and funds.

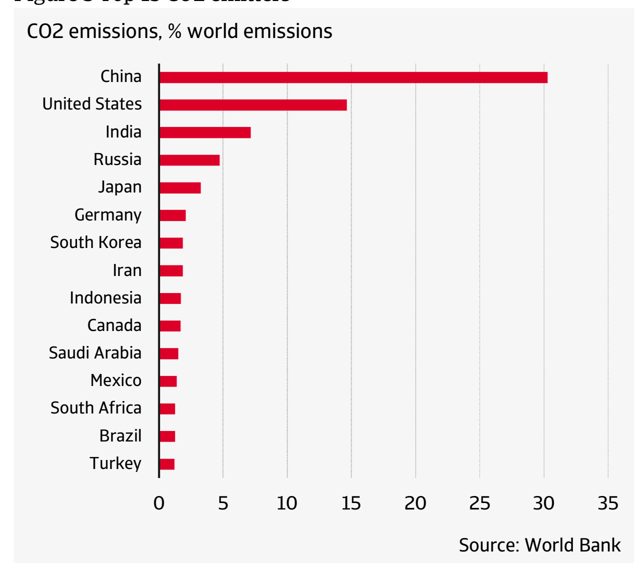
The complex debt structure results in a long negotiating process to have all creditors on board under the same terms. In the past, developing countries mostly borrowed from multilateral creditors and traditional Western official creditors, but currently debt to private creditors and new creditors like China and India, take a larger share.

To include climate...

Some argue to expand the Common Framework to incorporate climate[1] because many of the highly indebted countries are also those that are most vulnerable for the effects of climate change. For instance small island developing countries, like Fiji and Maldives, have high sovereign debt levels and fight for their existence against the rising sea level. Other vulnerable countries are across Africa where changing weather conditions result in droughts, varying rain patterns and floods that have a large impact on the agricultural sector.

Many of these countries have hardly contributed to the rising temperature and have a low carbon footprint, but feel the burden the most. Minor CO2 emitters are small island states like Fiji, Grenada and Dominica, and for instance, Africa as a region contributed only 4% to the global CO2 emissions in 2020. An exception in this region is South Africa, which is Africa's largest CO2 emitter and the world's 13th due to its coal-dependency. About 88% of South Africa's electricity generation comes from coal[2], contributing to its decision to not sign the agreement to phase out the use of coal at the COP26 in Glasgow. It did however receive USD 8.5 billion from the European Union, France, Germany, United Kingdom and United States, to accelerate the transition away from coal. A unique deal, which incorporates grants and cheap loans, to enable South Africa to invest in renewable energy and develop new sectors. The top 15 CO2-emitters were responsible for 76% of total world emissions with China, developed countries and some other large emerging markets being the large emitters of carbon emissions.

Figure 3 Top 15 CO2 emitters



High debt service payments undermine the ability to finance climate adaptation measures or move towards a greener economy. Some countries are in a vicious circle. The limited fiscal space constrain their ability to adapt to climate change, the increasing climate shocks raise their risk premium and thereby increase the borrowing costs on global financial markets. To tackle both the debt crisis and the climate crisis at once, a solution could be the so-called debt-for-climate swaps.

Could debt for climate help?

Debt-for-climate is not a new phenomenon. Already in the 1980s, during the debt crisis in Latin America, the debt-for-nature swaps were introduced. In 1987 Bolivia and a NGO signed the first agreement; in return for debt relief, Bolivia took measures to tackle the deforestation trends. In the early years, these agreements were three-party actions; NGOs bought sovereign debt owed to commercial banks and redirected payments towards nature projects. Over the years, the deals evolved into

[1] Organisations like the Institute for Governance & Sustainable Development (IGSD), but even the IMF, the World Bank and the Organisation for Economic Cooperation & Development (OECD) formed a technical working group to examine how challenges of climate and debt can be integrated.

[2] Coal is one of the most polluting fossil fuel. Phasing coal out quickly is seen as crucial to limit global warming to an increase of 1.5C.

bilateral deals between creditor and debtor governments and became larger. The first debt-for-climate swap (for climate adaptation) was signed in 2016 between the Seychelles and Paris Club creditors. About USD 21 million of debt was converted into investments in coastal protection and adaption.

So far, the deals have been rather small, but it could be one of the instruments to support highly indebted countries, which are vulnerable for climate change. An even more controversial idea would be that debt relief be used to compensate developing countries for not developing the fossil fuels in the ground. Substantial investments to adapt to climate change and to limit their impact by accelerating the use of renewable energy sources are needed. Although the market of green bonds has been growing rapidly in recent years this is often not an option for highly indebted countries, as it does not tackle the debt issues many face.

There's something in it for both sides

Specifics of a debt-for-climate swap could differ from country to country dependent on the needs of the debtor country. International creditors could agree to reduce external foreign-currency debt, by lowering the interest rate, converting it into local currency or writing off some debt. The debtor can then use the saved funds towards measures to adapt to climate change, lower carbon emissions or protect forest or biodiversity. As a result, these investments could stimulate private investments and support these countries' transitions towards a green and inclusive economic recovery. Another benefit is that the creditworthiness of the debtor can improve by reducing debt ratios, resulting in lower borrowing costs.

From a creditor's point of view, a debt-for-climate deal could be an attractive source for climate financing. Currently, advanced economies are nowhere near the promised USD 100 billion a year to support poorer countries to mitigate or adapt to the effects of climate change. These swaps could be one of the many sources of climate financing. It also creates an opportunity to incorporate environmental, social and governance (ESG) considerations in sovereign debt restructuring.

Challenges to overcome

In order to make debt-for-climate swaps successful the participants have to overcome several challenges. The most important one is to involve all creditors. The experience with the DSSI and the slow progress under the Common Framework show that it is challenging to get all creditors on-board. It is however crucial that all creditors -multilateral, bilateral and private- are involved. Because then it would create the maximum fiscal space for a debtor country to push forward to a more climate resilient economy and greener growth. It would also help to address the moral hazard issue, as public creditors would not want to create room for debtors to repay their private debt obligations. It should therefore be a comprehensive initiative. A prominent role for international financial institutions, like the IMF and the World Bank, and the G20 is therefore inevitable. Engagement of credit rating agencies like Moody's, S&P and Fitch is also necessary because mostly rating downgrades follow a debt restructuring or relief. Instead of "punishing" countries by downgrades for participating in a debt-for-climate deal, it could be seen as a positive move necessary for a sustainable future.

Another important challenge is that the debt relief should create sizable room for a debtor country to increase its spending on climate. If a country is already in debt distress, a restructuring or debt relief could perhaps not create enough fiscal space. More relief –topping up- is then necessary to provide room for climate spending.

In the past, it turned out that the long negotiation processes, complexity of the instrument and the high transactions were obstacles for debt-for-climate swaps. In addition, a successful deal depends on good governance of a debtor country. Insurance that the funds are used for the agreed goals and transparent is unavoidable.

Engagement international community necessary

There are still many challenges to overcome, but debt-for-climate swaps could become an attractive tool for both the debtor country and creditors. It may still take some time given the different parties involved. Nevertheless, building on the experience of previous swaps could be a way forward to implement improvements. For the debtor it could address both the debt and climate challenges at the same time. Moreover, the necessary investments in climate could initiate a sustainable economic recovery from the Covid-19 pandemic, which hit countries so hard. Thereby, supporting to tackle the triple crisis many face. For the creditor it shows engagement in and promoting sustainable economic growth by supporting these countries. Mitigating the impact of climate change and adapt to it is an enormous challenge and requires support from the international community.

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