COP27 High-Level Event Series

Background Note

Staying afloat

A policy agenda for climate and debt challenges

Executive Summary

Climate-related shocks are growing in intensity across the developing world, as exemplified by the devastating floods in Pakistan, while severe droughts are affecting many African nations as well as China in recent months. The ability of developing countries to address these challenges is heavily impaired by rising debt burdens and limited fiscal spaces that prevent them from mobilizing domestic resources exactly when they need to advance their own development agenda, including to combat climate challenges.[1] To date the resources mobilized at the international level have not only been far below what is needed to support mitigation and adaptation efforts in developing countries[2] but even short of the (much smaller) amount promised over a decade ago.[3]

Already in 2019, UNCTAD warned that the growing burden of debt would prevent many developing countries meeting their Sustainable Development Goals (SDGs), including those relating to the climate challenge.[4] Since then, compounding crises and the ongoing fallout from monetary tightening in advanced economies have pushed sixty per cent of

[1] See https://ourworldindata.org/co2-emissions#cumulative-co2-emissions. Note: all websites in footnotes were accessed in August 2022.

[2] UNFCCC Standing Committee on Finance, 2021. First report on the determination of the needs of developing country Parties related to implementing the Convention and the Paris Agreement. https://unfccc.int/topics/climate-finance/workstreams/needs-report

[3] See https://www.oecd.org/dac/financing-sustainable-development/development-finance-topics/climate-change.htm

[4] UNCTAD, 2019. Trade and Development Report 2019: Financing A Global Green New Deal. https://unctad.org/webflyer/trade-and-development-report-2019

low-income countries and thirty per cent of emerging market economies into or on the edge of debt distress.[5]

Increasingly unsustainable external debt burdens together with rising climate challenges are forming a vicious cycle of perpetual vulnerability and economic stagnation (or worse still, regression) in many developing countries. This vicious cycle between debt and climate change in a context of already high and unsustainable debt burdens suggests a new development paradox: undertaking the significant investments in mitigation and adaptation to achieve climate-resilient structural transformation will require many developing countries to take on more debt. But this is neither realistic nor desirable under current financing arrangements.

This paradox and the profound and widespread nature of an impending global debt crisis demands a multilateral response. However, responses to date have not been sufficient to either alleviate short term pressures or build a more resilient system to handle future shocks and support sustainable development. Ending the vicious cycle demands a policy agenda comprising a transformed international debt architecture, debt relief and expanded multilateral financing.

At the precipice of a global debt crisis

Record sovereign debt levels exacerbated by global instability are endangering development and climate ambition. Monetary tightening and commodity price fluctuations have renewed net negative capital flows from developing countries since September 2021, with 90 developing countries seeing their currencies weaken against the dollar this year, a third of these by more than 10 per cent. Bond spreads are rising with a growing number posting yields 10 percentage points higher than US Treasuries. Developing countries have already spent an estimated $379 billion of reserves defending their currencies this year, almost double the amount of new Special Drawing Rights (SDRs) they received in the recent 2021 general allocation.[6]

Analysis of two core indicators of external debt sustainability by income-groups highlights the risk of debt crises facing developing countries.

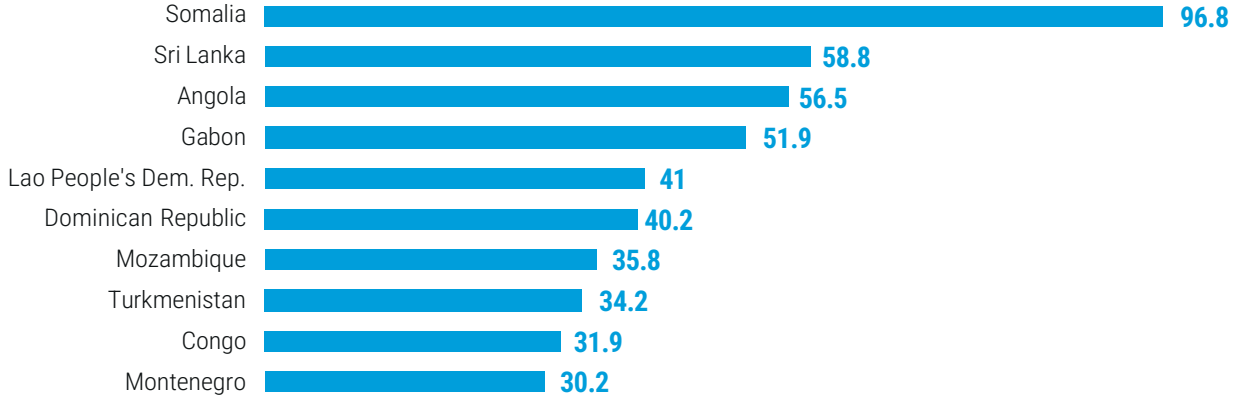
The first – the ratio of total external debt stocks to exports – provides an indication of countries' solvency given the importance of export revenues to service foreign-currency denominated debt obligations. Low-income countries (LICs) have been facing the most severe constraints, with their external debt stocks still exceeding export revenues by a factor of 2 in 2021.[7] Lower-middle income countries (LMICs) saw their external debt sustainability eroded substantially as their ratio of total external debt to exports rose steeply from a relatively low value in 2013 to 118 per cent in 2021.[8] Upper-middle income countries (UMICs) have fared better on average but have also seen their ability to service external foreign-currency denominated debt obligations through export revenues decline over the past decade.

The second core indicator is the ratio of debt servicing costs on public and publicly guaranteed debt (PPG) to government revenues. This indicates not only governments' ability to marshal domestic resources to repay debt but also the changing costs of servicing such debt. As Figure 1 shows, a steeply increasing share of government revenues was needed to service PPG debt in the period 2010 to 2020. This is the case, on average, for all

[5] See https://www.devex.com/news/imf-chief-sees-growing-risk-of-a-debt-crisis-103628.
[6] UNCTAD; 2022, Trade and Development Report 2022.
[7] Ibid
[8] Ibid

developing countries as well as for specific income groups, and is a clear reflection on the cost borne by many developing countries due to their integration into international financial markets. This has proved a double-edged sword for many and, especially, poorer and more vulnerable developing countries: On the one hand, largely private financing provided much-needed immediate relief from external financing constraints not readily available through multilateral channels. On the other, (re-) financing in international financial markets has arguably worsened external financial constraints in these economies in the longer-term, due to their heightened exposure to market risks and associated high and highly volatile debt servicing costs. A significant number of both LICs and MICs have seen their external public debt servicing costs rise well above 20 per cent of their government revenue, squeezing fiscal space to invest in climate-resilient development.[9] These figures portend a global debt crisis without immediate and systemic action.

Figure 1 Servicing costs on public and publicly guaranteed external debt to government revenues, developing countries, 2010-2021 *(percentage)*



Source: UNCTAD secretariat calculations based on World Bank data.

Such figures suggest the deterioration of developing countries' external debt sustainability was more widespread across developing countries than indicated by the International Monetary Fund (IMF) LIC Debt Sustainability Framework. The pandemic, along with increasing climate-related shocks, the war in Ukraine and the current tightening of global financial conditions, has led many economies – particularly those which were already

[9] Ibid

facing high pressures on their external debt positions prior to 2020 - to the brink of debt distress or to default. This means that the current situation, although very worrying, is different from the 1980s and 1990s when a few but very large developing countries faced acute financial and debt crises.

Of the 37 LICs in or at high risk of debt distress, 22 are in Sub-Saharan Africa (SSA), eight in East Asia and Pacific (EAP), four in Latin America and Caribbean (LAC); and two in South Asia (SA).[10] Across different regions, PPG external debt has roughly doubled in the last decade, with a dramatically higher share of this debt held by private creditors, particularly in LAC, with shorter maturities and interest rates many times higher than those of official creditors.[11] [12] Consequently, the share of government revenues spent on PPG debt service increased in the four regions, reaching 16 per cent in SSA, around 10 per cent in LAC and EAP, and 6.7 per cent in SA. However, it is crucial to remember that these regional averages hide "outliers", including many lower middle-income countries (LMICs) in much more dire straits than averages would suggest.

While spiraling sovereign debt crises have thus far been avoided in most countries, underlying solvency issues have not been addressed. Across all income groups and all regions, government deficits and gross government debt, both as a share of Gross Domestic Product (GDP), have ballooned during the COVID-19 pandemic, negatively affecting countries' future ability to mobilize and direct public investment towards the SDGs and climate change.[13] Monetary tightening in advanced economies is negatively impacting on the economic outlook of developing countries, while having limited impact on addressing inflationary pressures such as commodity speculation.

The response from the international community to the rising tide of debt distress has largely been to postpone the issue, favoring partial payment standstills and emergency lending over a coordinated and comprehensive approach to secure debt sustainability. With a significant proportion of sovereign bonds maturing in the coming months and IMF repayments for emergency COVID financing coming due, the price of inaction will accelerate rapidly.[14] Continuing down this path is delaying the inevitable need for restructuring in many countries, prolonging and deepening the damage to economic and climate outcomes.

Draining resources, damaging resilience

With fiscal space squeezed by the ballooning burden of debt and fluctuations in resource mobilization, capacity for climate action is deteriorating. LICs are spending an estimated five times more on debt servicing than on climate adaptation every year, undermining future resilience and growth prospects.[15]

When climate disasters strike, the outlook is even more bleak, with damage sometimes costing more than a country's GDP, derailing development plans and diverting resources into servicing debt rather than financing a resilient recovery. Borrowing generally increases to rebuild in the aftermath of a climate disaster[16], but borrowing costs are hiked as creditors raise rates to reflect a higher risk premium.[17] Moreover, even when external financial conditions are favorable, sovereigns from climate-vulnerable countries pay nearly 10 per cent more on overall interest costs due to climate change effects on sovereign credit profiles through weaker economic activity, damage to infrastructure, rising social costs and population displacement.[18]

The existing international debt architecture has proven counterproductive to debt sustainability initiatives that

[10] See https://www.imf.org/external/pubs/ft/dsa/dsalist.pdf

[11] Eurodad, 2021. Sleep now in the fire: Sovereign Bonds and the Covid-19 Debt Crisis. https://www.eurodad.org/sovereign_bonds_covid19;

[12] Kiel Institute for the World Economy, 2022. Who Lends to Africa and How? Introducing the Africa Debt Database. https://www.ifw-kiel.de/fileadmin/Dateiverwaltung/IfW-Publications/-ifw/Kiel_Working_Paper/2022/KWP_2217_Who_Lends_to_Africa_and_How_/KWP_2217.pdf

[13] UNCTAD calculations based on IMF data. UNCTAD; 2022, Trade and Development Report 2022.

[14] Eurodad, 2021. Sleep now in the fire: Sovereign Bonds and the Covid-19 Debt Crisis. https://www.eurodad.org/sovereign_bonds_covid19;

[15] See https://jubileedebt.org.uk/wp-content/uploads/2021/10/Lower-income-countries-spending-on-adaptation_10.21.pdf

[16] IMF, 2019. Building Resilience in Developing Countries Vulnerable to Large Natural Disasters. https://www.imf.org/en/Publications/Policy-Papers/Issues/2019/06/24/Building-Resilience-in-Developing-Countries-Vulnerable-to-Large-Natural-Disasters-47020

[17] Buhr, B., & Volz, U., 2018. Climate Change and the Cost of Capital in Developing Countries.

[18] Buhr, B., & Volz, U., 2018. Climate Change and the Cost of Capital in Developing Countries.

could bolster productive climate investments. Market makers, like credit rating agencies and asset managers, for example, often contribute to macroeconomic instability by amplifying and spreading crises, as seen during the pandemic when countries availing themselves of the G20's debt initiatives were faced with downgrades – and thus higher borrowing costs – despite attempting to achieve a more sustainable fiscal position.[19] Furthermore, IMF guidance on conducting Debt Sustainability Assessments (DSAs) still does not comprehensively integrate climate adaptation, mitigation and disaster considerations into every country's assessment, leaving these as optional despite the global and systemic nature of climate change.[20]

Projected costs for less than half[21] of developing countries' Nationally Determined Contributions (NDCs) amount to USD 5.8 trillion up to 2030.[22] In contrast, only USD 83.3 billion was provided and mobilized by developed countries for climate initiatives in developing countries in 2020, USD 16.7 billion short of the annual USD 100 billion goal. As well as continuing to fall short of this commitment and the realistic financing need, the majority (71 per cent) of this finance continues to come in the form of loans and is primarily channeled into mitigation.[23]

Climate change has already caused economic losses, reduced growth and increased inequality in low- income countries, despite their historical contribution to CO2 emissions being so far below that of advanced economies.[24] With high emissions and no reduction of vulnerability, climate change could push 35-132 million more people into extreme poverty by 2030.[25] Inaction on the vast gap between current flows and need is not an option.

Addressing climate and debt challenges: A policy agenda

The capacity of developing countries to borrow their way out of health, climate and economic shocks has been exhausted. Debt in many countries is already beyond what can be considered economically or socially sustainable. These debts stand in the way of unlocking the scale of financing required to address climate challenges. A policy agenda designed to address climate and debt challenges ought to start from acknowledging three basic facts:

1. The existing debt architecture is not fit for purpose

The self-reinforcing nature of the global shocks we have witnessed over the last years, be it health, economic, social, climate or geopolitical in nature has revealed the limits of the current debt architecture. On the one hand, a country-by-country approach to multilateral lending is ill-suited to a world where an increasing share of the financial challenges faced by developing countries are the result of a systemic crises. On the other hand, lack of a multilateral framework to address debt crises shifts the costs of financial distress onto vulnerable debtor countries.

2. Climate change is a common but differentiated responsibility

Climate change is a universal problem that all countries have an obligation to address, but one in which individual capabilities of each country should guide the extent of such efforts and thus simultaneously address inequalities. Central to strengthening these efforts is tackling the debt burden of developing countries as a mechanism to free up resources for climate investments.

[19] See https://www.project-syndicate.org/commentary/credit-rating-agencies-could-derail-economic-recovery-by-jayati-ghosh-2021-03?barrier=accesspaylog

[20] IMF, 2022. Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for Market Access Countries. https://www.imf.org/en/Publications/Policy-Papers/Issues/2022/08/08/Staff-Guidance-Note-on-the-Sovereign-Risk-and-Debt-Sustainability-Framework-for-Market-521884

[21] The figure is less than half because only around 41% of developing countries' NDCs have been costed.

[22] UNFCCC Standing Committee on Finance, 2021. First report on the determination of the needs of developing country Parties related to implementing the Convention and the Paris Agreement. https://unfccc.int/topics/climate-finance/workstreams/needs-report

[23] See https://www.oecd.org/newsroom/statement-by-the-oecd-secretary-general-on-climate-finance-trends-to-2020.htm

[24] See https://ourworldindata.org/contributed-most-global-co2

[25] IPCC, 2022. Climate Change 2022: Impacts, Adaptation and Vulnerability. https://www.ipcc.ch/report/sixth-assessment-report-working-group-ii/

3. The costs of inaction on climate and debt compound over time

The economic costs of delaying actions to address debt distress and finance climate investments increase substantially over time. Debt overhangs severely limit the capacity to mobilize resources towards investments that increase long-run growth. In the case of climate, early investments on adaptation and mitigation produce substantially larger returns over time, being substantially more cost effective than investments made later. As such, policies to address debt burdens and climate challenges in developing countries should be understood as highly effective investment tools.

Against this background, a policy agenda designed to tackle climate and debt challenges ought to focus on transforming the international debt architecture, supporting necessary debt relief and expanding multilateral financing.

Recommendations

1. Reform of the international debt architecture

- ***Establish a multilateral legal framework for debt restructuring to facilitate timely and orderly debt crisis resolution with the involvement of all official (bilateral and multilateral) and private creditors.*** The framework should allow for temporary standstills, stays of litigation, exchange and capital controls and lending into arrears to protect the capacity of debtor countries to meet their economic, social and human rights obligations towards their population during a debt crisis.
- ***Establish a publicly accessible registry of debt data for developing countries.*** Following the UNCTAD Principles on Responsible Sovereign Borrowing and Lending, this registry would allow the integration of debt data by both lenders and borrowers at the level of specific transactions. Transparency would reduce the risk of debt distress and facilitate the expansion of Environmental, Social and Governance (ESG) financing.

2. Expand routes to debt relief

- ***Debt Relief.*** Participation in the multilateral framework for debt restructuring should be incentivized through the provision of debt relief linked to a debt sustainability assessment that incorporates long-term finance needs, including for the achievement of the 2030 Agenda and the Paris Climate Agreement. Financing envelopes for a debt restructuring should be required to include explicit short-term targets for climate investments.
- ***Debt Swaps.*** For countries at low and moderate levels of risk of debt distress, climate debt swaps may encourage increased climate-related investments. However, the usefulness of these instruments should not be overplayed, as in themselves they are not a game-changer. The impact of debt swaps on the debt sustainability of countries at high risk or in debt distress tends to be marginal. In these cases, comprehensive debt relief is a better tool to increase climate investments.
- ***Contingent instruments.*** Introduction of climate contingent clauses on sovereign lending arrangements across all creditor classes (private, bilateral and multilateral) could play a useful additive role in mitigating debt distress in the wake of climate-related shocks. The climate clause would be introduced on all sovereign borrowing from private sources and would allow for the automatic temporary suspension of debt payments following a climate event that causes damages over pre-defined thresholds. Adoption by the private sector would allow bilateral and multilateral lenders to adopt the same type of clause without undermining the seniority structure. This would provide for comprehensive automatic debt standstills for developing countries in the aftermath of climate events.

3. Scaling up public-led financing for development and climate adaptation

The vicious cycle between debt and climate change in a context of already high and unsustainable debt burdens suggests a new development paradox: the need for *more* debt to achieve climate-resilient structural transformation to withstand and overcome the long-term dependence on debt. Addressing the climate-debt paradox thus points to closing the development finance gap.

At the end of 2021, UNCTAD estimated that the cumulative development finance gap over 2020-2025 - including the achievement of the SDGs (that encompasses climate adaptation and mitigation), debt amortization, capital flows and the impact of external shocks like COVID-19 or a war, balanced against resources of general government revenue and Foreign Direct Investment (FDI) - amounted to 31 per cent of the GDP of LICs, and 13.4 per cent of the GDP of lower-middle-income countries (LMICs).[26] Progress on closing this gap has been reversed in the last two years and will only get worse with anticipated future shocks.

Hopes have been high for "green bonds" that recorded rapid growth in the last years with accumulated annual issuances reaching USD 1.9 trillion over 2010-2021. Yet, LICs and MICs accounted for only 16.7 per cent of this total and, excluding China, 4.2 per cent. Despite expectations, bond financing has not delivered the scale or direction of investments that a green and inclusive transformation demands. Even if such bonds may have an advantageous "greenium", they are, by nature, more suitable for green investment in mitigation activities with high profitability. On top of that, they carry the possibility of "greenwashing", with little proof that they are channeled into 'greener' development initiatives.

An alternative avenue to stimulate the involvement of private investors is to increase the use of innovative financing instruments that address external debt burdens, such as state-contingent debt instruments (SCDIs) and aforementioned debt swaps. The problem of closing the climate adaptation gap is likely to persist, however, as financing climate adaptation is not likely to generate the same income-earning opportunities and high profits as mitigation, but is instead focused on preventing future costs.

Therefore, scaling up public-led, affordable financing is necessary to achieve climate adaptation and maintain sustainable debt burdens. This financing should be used to develop diversified and resilient economies adapted to the challenges of climate change instead of prioritizing the use of public funds to "unlock" private capital through blended financing instruments that "de-risk" private investment.[27] The paradigm needs to shift from de-risking to risk-sharing, acknowledging that these investments also bring reward to private investors. From a development perspective, grant-based finance and highly concessional mechanisms should be prioritized as they are essential to climate adaptation. The following initiatives at the multilateral level could scale up public-led financing in general, and these modalities in particular,[28]:

- ***Establish an Intergovernmental Tax Forum.*** Mobilizing domestic resources is crucial to facing the current development challenge. Increasing tax revenues and stemming illicit financial flows are key to scaling up these resources. The main multilateral response in this direction has been the OECD and G20-led Base Erosion and Profit Shifting (BEPS) project launched in 2013. However, the reform will affect only 78 of the world's 500 largest Multinational Enterprises (MNEs) and only 40 per cent of the additional tax revenue from the global minimum tax proposed (of 15 per cent) is likely to go to developing countries. The complexity of the proposed measures will also create a significant burden for tax administration in developing countries. The multilateral efforts need to go beyond this initiative and establish an intergovernmental tax forum[29] or a global tax body[30] at the United Nations - for which one proposal has recently been presented by civil society organizations.[31]

[26] See TD/B/EFD/5/2.

[27] See Trade and Development Report 2019 and Trade and Development Report 2021, UNCTAD.

[28] For more details, see TD/B/EFD/5/2, TD/B/EFD/6/12 and UNCTAD (2021) Trade and Development Report, ch. 5.

[29] As called for by the G77; see A/C.2/76/L.28

[30] As recommended by the High Level Panel on International Financial Accountability, Transparency and Integrity for Achieving the 2030 Agenda; see https://factipanel.org/docpdfs/Implementation%20Note%20-%20Intergovernmental%20tax%20body%20-%2014B.pdf

[31] Eurodad, 2019. Transparency of Loans to Governments. https://www.eurodad.org/transparency_of_loans_to_governments

- ***Boost Development Finance Commitments.*** Developed countries need not only to meet their Official Development Assistance (ODA) commitments (of 0.7 per cent of GNI in general and of 0.15 to 0.20 per cent to Least-Developed Countries) but boost these commitments to allow for an increased share of resources for climate adaptation and resilience building. Grant equivalent total ODA for G7 countries was $122 billion in 2020. Had all G7 members met the 0.7 per cent commitment, that total would have been $273 billion – a shortfall of $151 billion.[32] Clearly, this would go a long way to addressing the development financing gap, especially in LICs.
- ***Unlock the Potential of SDRs.*** SDRs have the potential to become a key mechanism for development finance, a proposal supported by UNCTAD since their creation in the late 1960s. This could be done through three simultaneous approaches. First, the voluntary re-channeling of unused SDRs from developed to developing countries should be facilitated, including by designing wider rules for their transparent and accountable use. However, questions remain about the precise modalities of re-channeling, since through the IMF trusts – the Poverty Reduction and Growth Trust (PRGT) and the recently created Resilience and Sustainability Trust (RST) - SDRs reach developing countries in the form of new and policy-conditional lending, rather than as policy-unconditional reserve assets. The IMF need to reconsider these limitations, discarding the role of upper credit tranche conditionalities in favor of country ownership though National Adaptation Plans. Options to engage multilateral development banks (MDBs) with preserved holder status for SDRs should also be explored. Second, a new SDR allocation to respond to ongoing global crises – such as the war in Ukraine and ongoing climate disasters – should be initiated. If initiated, however, the poorest countries would benefit the least; LICs received only USD 9.89 billion, or 1.52%, of the 2021 allocation. Thus, a third and further-reaching option to increase the developmental impact of SDRs – requiring substantial but necessary governance reform in the IMF – would be delinking the issuance of SDRs from the IMF quota system for new SDR asset classes with specific purposes, such as achieving the SDGs and climate adaptation.
- ***Increase Capitalization of MDBs.*** UNCTAD has long stressed the crucial role of MDBs and regional development banks (RDBs) to provide development finance, on concessional or at least favorable terms. These banks have a long-term horizon and counter the pro-cyclical tendencies of private finance as well as local knowledge and expertise to forge solutions across countries and regions. Developed countries should use their shareholder power to increase the capitalization of their MDBs, while MDBs and RDBs could seek new members to get additional capital - following the example of the New Development Bank (NDB) - to support more green investments. As mentioned before, another option is to use re-channeled SDRs to beef up MDBs' capital base. MDBs and RDBs should also revisit their commitment to AAA ratings to leverage loans for climate adaptation. The NDB experience shows that a one-notch downgrade only marginally increases the cost of funding in the international capital market.

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This document has not been formally edited.

[32] UNCTAD secretariat calculations based on OECD data; see https://www.oecd.org/dac/financing-sustainable-development/development-finance-data/

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