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KEY POINTS

- Almost half of low-income countries at high risk of, or already in, debt distress also has high climate vulnerabilities.
- Under current financing arrangements, the result is a vicious cycle of rising investment requirements for climate change mitigation and, primarily, adaptation, deteriorating debt sustainability and consequent underinvestment.
- A policy agenda designed to propel forward climate-resilient structural transformation should start with a reform of the international debt architecture and with scaling up public-led and affordable development financing for climate investments.

Tackling debt and climate challenges in tandem: A policy agenda*

Climate-related shocks are growing in intensity and frequency while the ability of developing countries to address mounting climate challenges is heavily impaired by unsustainable debt burdens. Achieving climate-resilient structural transformation will require many of them to take on more debt. This policy brief highlights the growing overlap between debt and climate vulnerabilities in developing countries and the urgent need for improved access by vulnerable countries to financing on terms consistent with both long-term sustainable development and debt sustainability. It proposes a policy agenda that focuses on a reform of the international debt architecture and on scaling-up public-led and affordable development financing for climate investments.

* This document has not been formally edited.

Introduction

Climate-related shocks are growing in intensity and frequency across the developing world, as exemplified by the devastating floods in Pakistan, severe droughts, floods and plagues affecting many African nations and hurricanes sweeping through Caribbean Small Island Developing States. The ability of developing countries to address these mounting climate challenges is heavily impaired by rising debt burdens and limited fiscal space, preventing them from mobilising domestic resources when they need to advance their development agenda. At the same time, resources mobilised to date at the international level have been far below what is needed to support mitigation and, primarily, adaptation in developing countries[1], falling shockingly short of the (small) amount promised over a decade ago – when climate shocks were less recurrent and intense.[2] A concern is that most (71 per cent) of climate finance continues to be provided in the form of debt and is primarily channelled into mitigation[3] while recent estimates for annual adaptation costs for developing countries increased to USD 250 billion by 2030[4].

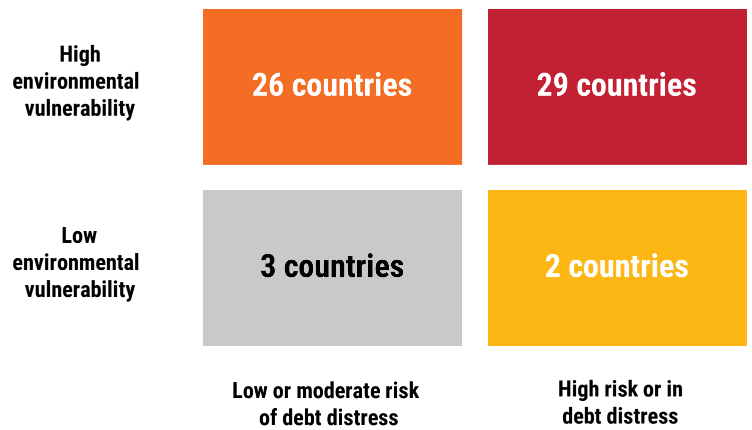
As a result, developing countries with high debt and climate vulnerabilities face a vicious cycle between rising investment requirements for a climate-resilient structural transformation and heavy reliance on increasingly costly debt-financing for this, therefore deteriorating debt sustainability and consequent underinvestment to face climate change challenges. Breaking this vicious cycle of perpetual vulnerabilities and economic stagnation demands an ambitious multilateral policy agenda focused on a reform of the international debt architecture and on scaling-up of public-led and affordable development finance for climate adaptation.

Unsustainable debt burdens in times of climate change

When a climate shock affects already highly indebted developing countries, the damage reduces economic growth and the country's capacity to mobilise domestic resources for investments required for climate adaptation, a pre-condition to decrease climate vulnerability. At the same time, pressure on the government budgets grows due to the damage to infrastructure and increased social costs. As a result, external borrowing generally grows in the aftermath of a climate shock.[5]

Currently 29 out of 69 countries eligible to access concessional finance under the IMF's Poverty Reduction and Growth Trust (PRGT) (42 per cent of the total) are at the intersection of high debt as well as climate vulnerabilities. (see figure 1).

Overlap of debt and climate vulnerabilities in PRGT-eligible countries, 2020



Source: UNCTAD Secretariat calculations based on IMF LIC DSA country list (August 2022) and Notre Dame Gain Climate Vulnerability Index (ND-GAIN)

This overlap is not limited to PRGT-eligible countries for which the IMF disclose the risk of debt distress. Several lower- and upper-middle income countries have high climate vulnerability according to the ND-GAIN Climate Vulnerability Index[6], and face either serious challenges to their external debt sustainability, including some Small Island Developing States (such as Dominican Republic and Fiji) or are already in debt distress, such as Sri Lanka and Lebanon[7].

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1 UNCTAD, 2021. Trade and Development Report, chapter 4. https://bit.ly/3G1LGmn.

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://bit.ly/3hw8dNW.

3 OECD, 2022. Statement by the OECD Secretary-General on climate finance trends to 2020. https://bit.ly/3DVX1I9.

4 UNEP, 2021. Adaptation Gap Report 2021. https://bit.ly/3TILv8I.

5 IMF, 2019. Building Resilience in Developing Countries Vulnerable to Large Natural Disasters. https://bit.ly/38Funcw.

6 ND GAIN, 2020. ND-Gain Country Index 2020. https://bit.ly/3tisDfT.

7 UNCTAD. 2022.Trade and Development Report, chapter 2. https://bit.ly/3DXNOcc.

UNCTAD has warned in the past that growing debt burdens prevent many developing countries from attaining the Sustainable Development Goals (SDGs), including those relating to climate challenges.[8] Today the situation is worse. A series of global shocks, including rising incidents of climate-related disasters, the Covid-19 pandemic, war in Ukraine and the spreading cost of living crisis, have pushed 55 per cent of PRGT-eligible countries and around 30 per cent of emerging market economies to the edge of or into debt distress. [9]

Even when external financial conditions are favourable, there is a spill-over effect of climate risks on borrowing costs, with climate-vulnerable countries facing routine premia on their borrowing costs due to these risks.[10] At present, however, monetary and fiscal policy moves in advanced economies risk pushing the world towards global recession and prolonged stagnation. The combined effects of policy-induced and systemic global crises have resulted in renewed net negative capital flows from developing countries since September 2021, with 90 developing countries seeing their currencies weaken against the dollar. Bond spreads are rising with a growing number posting yields 10 percentage points above US Treasuries. Developing countries have already spent an estimated $379 billion of reserves to protect their currencies this year, almost double the amount of new Special Drawing Rights (SDRs) received in the 2021 general allocation[11].

Addressing climate and debt challenges in tandem: A policy agenda

A policy agenda to address both climate and debt challenges in a way compatible with both long-term development and debt sustainability ought to start from acknowledging three basic facts. First, the existing debt architecture is not fit for purpose. It is unable to facilitate both the mobilization of adequate development financing and an orderly and timely resolution of debt crises. Second, 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.[12] Central to supporting the efforts of developing countries is addressing external debt burdens to free up financial resources for investments in climate adaptation. Third, the costs of inaction to tackle climate and debt challenges compound over time. As such, actions by developed countries dealing with debt burdens and climate challenges in developing countries should be understood as highly effective investment tools.

This policy agenda should include the following:

Incorporating climate considerations into a reformed international debt architecture

i. **Instituting a multilateral legal framework for sovereign debt restructuring and relief:** This is necessary to facilitate timely and orderly debt crisis resolution by all official (bilateral and multilateral) and private creditors. It 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 during a crisis. Participation in such a multilateral framework should be allowed for all countries facing debt challenges – independently to the income level - and incentivized through the provision of debt relief linked to a debt sustainability assessment that incorporates long-term financing needs, including for the achievement of the 2030 Agenda and the Paris Climate Agreement. Based on the United Nations Multi-Vulnerability Index (MVI) – that aims to capture all dimensions of vulnerability (economic, social and environmental) and countries' resilience to external shocks–, such an assessment would identify the impact of climate change-related shocks on debt sustainability and estimate these finance needs.[13]

ii. **Establishing a publicly accessible registry of debt data for developing countries:** Following the UNCTAD Principles on Responsible Sovereign Borrowing and Lending, a registry would allow the integration of debt data by both lenders and borrowers at the level of specific transactions.[14] This would strengthen debt management, reduce the risk of debt distress and facilitate the expansion of Environmental, Social and Governance (ESG) financing.

8 UNCTAD, 2019. Trade and Development Report 2019. https://bit.ly/3huXCmv.

9 Devex, 2022. IMF chief sees "growing risk of a debt crisis". https://bit.ly/3EikONG.

10 Buhr, B., & Volz, U., 2018. Climate Change and the Cost of Capital in Developing Countries: assessing the impact of climate risks on sovereign borrowing costs. https://bit.ly/3NVvjJY.

11 UNCTAD, 2022. Trade and Development Report. https://bit.ly/3fTWpVe.

12 UNCTAD, 2022. Staying afloat. A policy agenda for debt and climate challenges. https://bit.ly/3DWx6K9.

13 Although focused on Small Island Developing States (SIDS), the MVI endeavours to ensure comparability across country groups. This allows developing countries to account for the specific mix of vulnerabilities and different degrees of resilience to external shocks. UN, 2021. Possible Development and Uses of Multi-Dimensional Vulnerability Indices. https://bit.ly/3PXR10v.

14 UNCTAD, 2012. Principles on Promoting Responsible Sovereign Lending and Borrowing. https://bit.ly/3nRdBKM.

iii. **Adopting climate-contingent debt instruments:** The introduction of climate contingent clauses on sovereign lending arrangements across all creditor classes could play a useful role in mitigating debt distress in the wake of a climate event. These clauses would be introduced on all sovereign borrowing from private sources following the International Capital Market Association (ICMA) procedures for Collective Action Clauses (CACs).[15] The clause would allow for the automatic temporary suspension of debt payments following a climate event that causes damages over pre-defined thresholds. Adoption by private creditors would allow official lenders to follow suit without undermining the seniority structure.

Scaling up public-led financing

Addressing the vicious cycle of debt and climate vulnerabilities also requires closing the development finance gap. Several multilateral initiatives could support this, including:[16]

i. **Establishing an Intergovernmental Tax Forum:** Increasing tax revenues and stemming illicit financial flows are key to mobilising domestic 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 Pillar 1 reform will affect fewer than 100 of the world's largest Multinational Enterprises (MNEs) and it has been estimated that only 40 per cent of the additional tax revenue from the global minimum tax proposed (of 15 per cent) under Pillar 2 is likely to go to developing countries.[17] Multilateral efforts need to go further, including through the establishment of a global tax body at the United Nations.

ii. **Boosting Development Finance Commitments:** Scaling-up public finance will also require donor countries not only to meet Official Developing Assistance (ODA) commitments but to boost existing commitments with additional resources targeting climate adaptation. The systemic failure of developed countries to meet their pledges means that developing countries did not receive over $2.7 trillion in developing financing between 2002 and 2017.[18] Moreover, bilateral climate finance provided by developed countries institutions, such as aid agencies and development banks, has stagnated over the years and needs to increase to meet climate challenges.

iii. **Unlocking the Potential of SDRs:** SDRs have the potential to become a key mechanism for development finance through: i) voluntary re-channeling of unused SDRs from developed to developing countries, including by designing wider rules for their transparent and accountable use and broadening the mechanisms currently available to engage multilateral and regional development banks (MDBs and RDBs, respectively) with preserved holder status for SDRs; ii) a new general SDR allocation to respond to ongoing global crises and iii) 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.

iv. **Increasing the capitalisation of MDBs and RDBs:** MDBs and RDBs play a crucial role in providing development finance on concessional terms. Developed countries should use their shareholder power to increase MDBs' capitalisation, while also seeking new members to raise their capital base. This can include the use of re-channelled SDRs (see above). These institutions should also implement applicable aspects of the G20's Independent Review of MDB's Capital Adequacy Framework.

v. **Using an MVI as a criterion for concessional lending:** Climate vulnerable countries require additional financing options. To this end, the MVI should replace income thresholds as a criterion for the allocation of ODA as well as access to concessional borrowing from bilateral and multilateral sources.

15 CACs allow a supermajority of bondholders to agree to a debt restructuring that is legally binding on all holders of the bond.

16 TD/B/EFD/5/2, TD/B/EFD/6/12 and UNCTAD, 2021. Trade and Development Report, chapter. 5.

17 Cobham, A., Faccio, T., et. al., 2021. A practical proposal to end corporate tax abuse: METR, a Minimum Effective Tax Rate for Multinationals. https://bit.ly/3UJa5kz.

18 Blankenburg, S., 2019. The unfolding debt crisis in developing countries revisited: Overview and recent trends. https://bit.ly/3UrNgCh.

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