A SUSTAINABLE FINANCING STRATEGY FOR THE GREEN TRANSITION

Why focusing on ex-ante and ex-post debt instruments is not enough to overcome the double debt and climate crises.

Suramericana Visión
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Summary: *The twin challenge of debt and climate crises developing economies are currently facing requires large-scale, up-front investments that allow countries to implement a well-designed climate action to boost economic growth. While innovative ex-ante and ex-post debt instruments may help at the margins to free up fiscal space in the context of an acute weather event—with Climate Resilient Debt Clauses (CRDCs)—or to align the interests of taxpayers in climate change adaptation and mitigation to those of creditors (with Debt-for-Nature Swaps), they are no silver bullet that will truly make a contribution to resolving the pressing global challenges of high indebtedness and the need to invest in the green transition. The global community's attention should rather be focused on coordinating efforts by leading creditors and multilateral lenders to achieve the scale of investments needed. Achieving a sustainable debt composition, increasing the role of Regional Development Banks, and avoiding bailouts of private creditors with public funds are important intermediate milestones.*

Debt policy as an integral part of fiscal policy. To finance its expenditures, governments have three main options: tax, debt, and monetary financing. How a state finances itself is a political choice, with important implications. If a state chooses to cover a rising part of its expenditure through borrowing, the state acquires a new interest or shareholder group, namely its creditors. In good times, when the economy is growing and debt is assessed to be sustainable with high probability, meeting its obligations vis-à-vis its two shareholder groups (citizens and creditors) does not necessarily become a burden. But in bad times, with a stagnating or recessive economy, the trade-offs become more dire.

- First, given a smaller annual budget, the trade-offs between debt servicing vs. other forms of spending, including social spending or adaptation and mitigation spending for climate change, become more acute. While it is not high debt per se that hampers economic growth and development (as far as it is sustainable and deemed payable with high probability), the allocation of primary surpluses to debt payments in times of recessions can make debt a constraint for economic recovery and development (Guzmán, Ocampo and Stiglitz, 2016).
- Second, the scope of progressive policymaking (from counter-cyclical spending to investment in the green transition, climate adaptation and mitigation), is reduced, as policymakers have to closely monitor market sentiments (Colodenco et al, forthcoming). If the market loses trust in the government's ability to service its debt, debt sustainability problems arise quickly. Bad times thus bring the inherent connection between debt policy and fiscal policy to the fore, making apparent that debt policy is an integral part of fiscal policy.

Climate change exacerbates debt vulnerabilities in developing countries, particularly in the most vulnerable ones.

- First, responding to **acute weather events** can lead to lower revenues and higher public expenditures, and ultimately raise the risk of debt default. Advanced economies are normally large enough to be resilient and absorb the costs of shocks from extreme weather events. However, small or poor countries are potentially

vulnerable. After an acute weather event, most countries have no other option than borrowing to deal with recovery and reconstruction costs. Moreover, adaptation to climate change requires large amounts of resources, such as the building of new, more climate-resistant infrastructure. Therefore, there is a great need for financing, especially for the most vulnerable communities within the most impacted countries.

- Second, **chronic hazards** related to prolonged changes in the climate, such as rising sea levels, rising temperatures and altered precipitation patterns, may have various effects on the real economy and on a country's fiscal policy. The UN shows how chronic hazards result in **decreases in tax revenues** due to changes in economic activity, for example making certain commodity sectors more or less economically feasible, changing tourism patterns, or altering migration within and between countries due to land becoming inhospitable. Chronic hazards may also **increase spending needs** for mitigation and adaptation.

Taken together, acute events and chronic climate hazards have resulted in a greater variance of revenues and expenditures. Their financial impacts are on the downside in the aggregate for most countries. These impacts on the real economy and a country's fiscal policy can, in turn, affect its debt servicing capacity.

Low Income Countries (LICs) are especially impacted because of their location and/ or because their low resources and limited fiscal space make the large-scale spending necessary for adaptation and response to the damage of climate change difficult. The drag on growth is also reflected in higher borrowing spreads and reduced access to private finance for these economies (Rodrik and Stiglitz, 2024).

Despite this gloomy outlook, adapting to climate change also constitutes a growth opportunity for developing countries, if they are able to turn it into an investment strategy. Well-designed climate action can boost growth in developing countries, if large up-front investments are mobilized (Rodrik and Stiglitz, 2024). Key investment priorities related to the green transition

include the transformation of the energy system (from fossil fuels to renewable sources of energy) and of agriculture, as well as the redesigning of cities to include modern transportation systems, efficient housing, and defenses against rising sea levels, desertification, and extreme heat.

The feasibility of these actions depends heavily on the availability of external financial support, at affordable terms. The total investment needed for such strategy amounts to an additional 2 percent of GDP per year by 2025 and an additional 4 percent of GDP per year by 2023 (excluding China) (Songwe et al. 2022). Assuming half of the investment needs is met through domestic resource mobilization (Songwe et al. 2022) developing countries as a group would require an additional 2-4% of GDP of external resource flows in the years ahead. **Without coordinated efforts from all relevant stakeholders, it is hard to envision how this goal could be achieved**.

Implications for discussion on CRDCs and Debt-for-Nature Swaps
What are the relevant implications of this analysis for CRDCs and Debt-for-Nature Swaps?

First, this analysis highlights that **what is needed to tackle the twin challenge of debt and climate crises are large up-front investments that allow countries to implement a well-designed climate action to boost growth in developing countries**. While innovative ex-ante and ex-post debt instruments may help at the margins to free up fiscal space in the context of an acute weather event (with CRDCs) or to align interests of taxpayers in climate change adaptation and mitigation to those of creditors (with Debt-for-Nature Swaps), they alone cannot solve these crises. They may not be enough of a contribution to resolve the pressing global challenges of high indebtedness and the need to invest in the green transformation. As a global community, we need to be mindful of the opportunity costs of championing some topics over others.

That being said, regarding CRDCs specifically, given that market participants need to accept contract clauses, fostering multi-stakeholder participation is an important step to gaining a realistic understanding of the market reception of different standard clauses. Moreover, any innovative instrument,

both ex-ante and ex-post, must be considered in a holistic way, together with other financial tools available for developing countries to avoid over indebtedness.

A second central implication of the preceding analysis is that **greater attention needs to be paid to the composition of debt in developing economies and towards attracting more of the right sort of financing for their climate investment needs.** Without acquiring adequate financing for adapting their economies to the impacts of climate change, their exposure increases, thus requiring more finance to address risks and damages from floods, droughts, wildfires, among others. **This could result in adding a debt burden that would make developing countries more vulnerable**, **rather than more resilient**, to the effects of the climate crisis.

Overall external Public and Publicly Guaranteed (PPG) debt levels increased from 1.25 trillion in 2008 to USD 3.5 trillion USD in LICs and MICs in 2022. Funding from public creditors almost doubled over the last decade and a half from 0.7 trillion to 1.3 trillion USD. However, the main driver of that debt was financing provided by private bondholders, which more than quadrupled from 0.4 trillion to 1.6 trillion USD over the same time span. It now makes up a share of 47% of the total. Multilateral creditors in contrast only provide about 25% of the financing. The proportion of bilateral funding has fallen to 14%. Consequently, the vulnerability of debtor countries has risen. This vulnerability is due to a higher dependency on those external actors and their capital. Accruing too much of a particular type of financing can quickly become unsustainable when the global macroeconomic tide changes and re-financing conditions worsen (Colodenco, Horas and Wiedenbrug 2023).

The conditions of the respective financing also changed. An OECD Report finds that from 2016-2020 72% of international climate finance consisted of loan financing. Of that number, a significant part (75%) corresponds to non-concessional loans. Only 25% of international climate finance over the same period took the form of grants or concessional finance to developing countries. Even further, Oxfam estimates that the proportion of non-concessional finance is growing, adding costs to financing needs. In their Climate Finance Shadow Report (2023), the organization estimates that

the annual average of non-concessional instruments in climate finance had reached US$ 28 billion – 42% – in 2019-20, while concessional lending remained largely at the same level as the previous two years or decreased.

As a global community, our attention should focus on reducing the cost of debt, freeing fiscal space to respond to climate change, and ensuring long-term debt sustainability, ultimately generating enough financing to enable the green transition.

Developing countries need to set off a virtuous cycle of green growth to expand their resources and avoid a 'climate debt trap.' In this context, with the understanding that financial instability in the private sector generally affects public debt sustainability, it is crucial to assist countries in the design of strategies to develop domestic capital markets to foster more stable sources of financing for the public and private sector. Long-term technical support to partner countries to build and strengthen domestic bond markets should also be provided.

Multilateral Development Banks (MDBs) play a substantive role here, as they can provide more affordable financing and can provide resources for adapting to climate change and improving the resiliency of these economies. The role of Regional Development Banks (RDBs) in particular needs to be enhanced given their long-standing relationship with and knowledge of local markets and institutions. RDBs are also better placed to respond to regional needs and demands, as well as potentially be more effective in providing regional public goods, especially those requiring large initial investments and regional coordination mechanisms (Griffith Jones et al 2008).

Finally, r**egarding some of the proposals currently on the table, special attention needs to be paid to the political economy of the proposals made.** Research shows that Debt-for-Nature Swaps are not generally appropriate in countries that have unsustainable debt and require comprehensive debt restructuring. By implication, Debt-for-Nature Swaps are considered a promising policy option for cases facing illiquidity problems. Distinguishing between illiquidity and insolvency, however, is very hard in practice. In particular, if illiquidity is defined as a market failure – as the market

over-reacting negatively to a country that is not technically insolvent – the analyst making the judgment on whether the country is insolvent or merely illiquid would have to have more knowledge about the market's appropriate reaction than investors themselves.

The implication of this is that if the analyst errs on the side of illiquidity, declaring a country merely illiquid but not insolvent, and multilateral financing is not openly and irreversible earmarked to finance green growth, there will be a risk of using public funds to bail out private creditors. If any portion of multilateral financing provided in the context of tripartite Debt-for-Nature Swaps is used to meet scheduled debt payments, and ex-post it turns out that the debtor still has no access to credit markets and debt is finally deemed unsustainable, rather than illiquid, then the multilateral financing will have served to bail out holders of unsustainable debts.

In sum, while CRDCs and Debt-for-Nature Swaps may have a marginal role to play in providing certain debt relief, the attention of the international community must focus on increasing **climate finance** in developing economies, through instruments that do not thwart developing countries' debt sustainability and debt composition. As recently concluded by UNDP (2024), given the scale of spending needed, developing economies will not be able to undertake a green transformation without the support of a much larger and more responsive multilateral financial system, which includes both better access to effective debt restructuring, liquidity support and long-term affordable capital. It is imperative for the international community to focus on fostering green growth agendas, turning them into investment strategies.