

Debt and the climate crisis: a perfect storm

Why climate justice must include debt justice

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Summary

The economic shock of the pandemic has plunged many middle and lower-income countries further into a debt crisis that has been building for the last decade. Meanwhile, many of the same countries are experiencing the harsh reality of the climate crisis, from more frequent climate-extreme events like tropical storms and droughts, to rising sea levels and increasing temperatures.

Countries need funds to be able to address the climate crisis now, but many are trapped in repaying vast sums to their creditors every year. In 2020 alone, countries in the global South spent \$372 billion on servicing debt. At the same time, extreme climate events and insufficient grant-based climate finance force countries deeper into debt, creating a vicious cycle that can be impossible to escape.

Key global actors like the IMF and World Bank have acknowledged the link between debt and the climate crisis, but insufficient action is being taken by decision makers like the G7 and G20.

To address the climate crisis, urgent action is needed on the debt crisis in the global South. This includes both debt relief and adequate grant-based climate finance, in recognition of the climate debt owed to the global South by wealthy polluting nations for their role in the climate crisis, as agreed by all UN members in the principle of common but differentiated responsibility.

COP26 presents a vital opportunity to ensure that debt relief is firmly on the agenda as a key ingredient for addressing the climate crisis.

To address the climate and debt crises, we call for:

- **Debt cancellation** for all countries that need it, across all creditors
- **The introduction of legislation** to ensure private creditor participation in debt restructuring
- **Suspension of debt payments and debt cancellation** in the event of a climate-extreme event
- **Adequate climate finance goals of at least \$400 billion per year to be agreed and delivered, with finance provided in the form of grants including a separate mechanism for funding loss and damage, so debt levels do not increase**
- **A significant portion of Special Drawing Rights (SDRs) to be channelled to poorer countries in the form of grants, not loans.**

Understanding external public debt

Governments borrow for a variety of reasons, for example to pay for the costs of unexpected events like pandemics, or to fund large scale physical infrastructure. Many countries have to finance their regular expenditures like health care through borrowing. Since the global financial crisis of 2008 lending has been increasing. Low interest rates in the western world have led financiers to seek to lend to southern governments who they charge higher interest rates for loans. Economic shocks such as falls in commodity prices, climate related disasters and the Covid pandemic cut government revenues and so increase the frequency and seriousness of debt crises. Between 2013 and 2021 the number of lower income countries the IMF says are unable to pay their debts or at high risk of doing so has increased from 17 to 37, while the number at low risk has fallen from 21 to just 7.

Countries can borrow from three types of lenders:

- Foreign governments and foreign public institutions (bilateral creditors);
- The IMF, the World Bank and other multilateral creditors;
- Private actors such as banks and hedge funds.

This paper refers to 'external sovereign debt', which is debt owed by governments to creditors outside their country. Governments can also take on domestic debt by borrowing from lenders in their own country, usually domestic banks.

Why debt justice is key to addressing the climate crisis

How unsustainable debt diverts resources away from tackling the climate crisis

Unsustainable debt levels are undermining global South countries' ability to adapt to and mitigate the climate crisis because vital resources are diverted towards servicing debt repayments.

Countries in the global South have been facing increasingly unsustainable debt since the 2008 financial crisis, with debt payments increasing by 115% between 2010 and 2020, reaching their highest level since 2001. An increasing proportion of global South debt is owed to private creditors (now making up about one third of lower-income country debt), who tend to charge much higher interest rates than other lenders.

The economic shock resulting from the pandemic has exacerbated the situation. Public debt has increased in 108 out of 116 developing countries, resulting in six countries defaulting on their debt repayments, and 52 countries currently in debt crisis.

As a result, resources needed to respond to the pandemic, climate crisis and to meet development goals are increasingly being diverted to debt repayment.

Many countries can simply not afford to invest in mitigating and adapting to the impacts of the climate crisis, including preparing for climate-related disasters such as hurricanes and floods, meaning that climate-related disasters will continue to have devastating effects on unprepared communities.

Sierra Leone's public debt was 76.47% of Sierra Leone's GDP in 2020. Cancelling the debt is one of the best ways to support tackling climate change and will mean the government can invest in mitigating the effects, for example by engaging in innovative reforestation programmes that will help sequester carbon and also investing in climate smart agriculture which will guarantee food security.

Abu Bakarr Kamara, Budget Advocacy Network, Sierra Leone

Exploiting natural resources to service debts

Many countries turn to exploiting their natural resources as a means of generating the finance to repay their debt. For example, some global South governments, including Cote d'Ivoire, Malaysia and Papua New Guinea, have turned to their forests as a source of raw material exports to help finance debt servicing, which in turn can lead to deforestation, soil erosion or biodiversity loss, leaving a country less prepared to deal with climate-extreme events like droughts and storms.

Several African countries such as Uganda have resorted lately to harmful oil extraction for them to generate the resources they urgently need to pay off their external debts. This has gone on without any consideration of the damage these projects impart on the environment. Many of these countries need immediate debt relief if they are to refrain from such detrimental environmental projects. The creditor community should therefore act now by providing timely and adequate debt relief to these countries. There is no climate justice without debt justice.

Ausi Kibowa, Southern and Eastern Africa Trade Information and Negotiations Institute, Uganda

Furthermore, many existing debt contracts are tied to fossil fuel projects that contribute to the climate crisis, such as China's Belt and Road initiative which has funded 240 coal-powered plants through loans to Asian and African countries since it started in 2013. Pakistan's efforts to reduce its reliance on coal-fired power stations has also been obstructed by the outstanding debts owed to China for their construction.

Climate-extreme events are costly

The UN estimates that climate-extreme events are happening at a rate of one per week, with the impacts of the climate crisis set to cost vulnerable countries up to \$300 billion per year.

There is currently no comprehensive and consistently applied method of suspending debt payments for a country hit by a climate-related disaster. This means that in many cases, countries have no choice but to continue servicing their debt in the event of a climate-related disaster, diverting vital resources away from the emergency response and post-disaster reconstruction.

The same is also true for longer-term slow onset processes like increasing temperatures, for example in Zambia where "rainfall variability alone could lead to a loss of 0.9% of GDP growth over the next decade".

Furthermore, in the absence of adequate climate finance for loss and damage, global South governments may have to take out new loans to address the impacts of the climate-related disaster, often at high interest rates reflecting the climate vulnerability they face. Higher interest rates based on climate vulnerability are predicted to cost the most vulnerable countries \$168 billion over the next decade.

Dominica:

In 2017, the Caribbean Island nation of Dominica was struck by Hurricane Maria, which destroyed over 90% of the islands' structures and caused \$2 billion worth of damage, a staggering 330% of the country's GDP at the time. Lacking other sources of finance, the Dominican government took on new loans to finance reconstruction, leading to a sharp increase in the amount of debt the country owed, rising from 68% of GDP in 2016 to almost 78% in 2017.

Mozambique:

In 2019, Mozambique was hit by two subsequent cyclones, Idai and Kenneth. The IMF referred to cyclone Idai as "the worst and costliest natural disaster to ever strike the country". However, rather than grant debt relief, the IMF provided Mozambique with a \$118.2 million loan, adding to the debt burden of the country and unfairly placing the financial onus on recovery and rebuilding on the Mozambicans.

Climate finance means new debts

In recognition of the climate debt owed by wealthy, polluting nations that have caused the climate crisis to countries in the global South that are experiencing the worst impacts, and in line with the principle of common but differentiated responsibilities enshrined in the United Nations Framework Convention on Climate Change (UNFCCC), global North governments committed to provide \$100 billion in climate finance yearly by 2020.

But they have not fulfilled this commitment. Even the inadequate sums reported may be overstated: Oxfam has also estimated that over-reporting means bilateral climate finance could be around two thirds lower than

indicated. Without adequate climate finance, countries are forced to turn elsewhere to access resources for addressing the climate crisis, including taking on more debt.

Furthermore, a significant amount of climate finance comes in the form of loans, contributing to the already unsustainable debt burden of many climate vulnerable countries. More than two thirds of the public climate finance delivered between 2013 and 2018 was delivered through debt-creating instruments. Between 2016-2018, Latin America and the Caribbean received an average annual flow of \$12 billion in climate finance, 90% of which was in the form of loans.

Response of the international community

While the G20 has recognised the urgency of the debt crisis, the initiatives it has put in place are not sufficient to address the scale of the problem.

In 2020 the G20 introduced the Debt Service Suspension Initiative (DSSI) and the Common Framework for Debt Treatments Beyond the DSSI. The DSSI is due to end at the end of 2021 and only suspends debt repayments rather than cancelling them, thereby having limited impact on debt levels in the long run. While the Common Framework does aim to provide wider debt relief to countries that request it, none of the three countries, Chad, Ethiopia and Zambia, that have so far applied have seen significant progress towards debt relief. Many middle income countries, which include many of the most indebted and climate-vulnerable countries in the world, are not eligible to apply to either scheme.

One reason for the lack of progress is that the Common Framework does little to enforce private creditor participation. Debt restructuring can only go ahead if a borrowing government is able to reach a comparable agreement with both bilateral and commercial lenders, so the refusal of private creditors to participate can block any debt relief.

A significant proportion of global South external debt is owed to commercial creditors, often at much higher interest rates than other lenders. Furthermore, if a borrowing government is unable to pay and defaults on its loans, there is currently nothing to stop private lenders taking governments to court to demand a full repayment. Many court cases would take place in the UK – 90% of the bond contracts of countries eligible for the Common Framework (76 of the poorest countries in the world) are governed by English law.

This is why some organisations are campaigning for private creditors to cancel global South debt.

Special Drawing Rights

Special Drawing Rights (SDRs) are a unit created by the IMF which, when allocated, effectively create money for IMF member countries by boosting their reserves, which could potentially be used by governments to finance climate action. In August 2021, an equivalent of \$650 billion in SDRs was allocated by the IMF to member countries based on their IMF quotas, meaning that wealthy countries received the majority of the allocation. This has sparked a global conversation on how wealthy countries could channel their SDRs to poorer countries, including how they could explore options to make grants to existing mechanisms that seek to address the climate crisis.

One likely option is for SDRs to be channelled to poorer countries via the IMF in the form of loans. While this is likely to provide countries in the global South with cheaper sources of finance than other types of lenders, it will still add to their debt burdens. These IMF loans also come with conditions such as implementing austerity, which can restrict a government's ability to invest in climate action, and often are just used to pay off previous lenders such as banks and hedge funds. Furthermore, the amount of SDRs rechannelled to poorer countries is unlikely to match the scale of need, and so cannot be seen as an alternative to grant-based climate finance or debt relief.

Insufficient solutions

A number of ‘silver bullet’ solutions have been proposed to deal with debt and the climate crisis that, in many cases, will not be adequate or could make both issues worse.

Debt swaps

Debt swaps have been around in multiple forms since the 1980s. Most simply, a government has a part of its external sovereign debt cancelled in exchange for committing to mobilise the same amount, or less, for an agreed purpose like health, nature or climate.

In recognition of the links between the debt and climate crises, debt-for-climate swaps (where liberated funds are invested in climate adaptation and mitigation) or debt-for-nature swaps (where funds are invested in conservation goals) have been proposed by some as ‘win-win’ solutions that will both relieve some of a country’s debt burden and free up resources at a national level to address the climate crisis.

However, to date, most debt swaps have not delivered adequately on either of these promises. The amount of debt included in the swap has often been minimal in comparison to the total debt burden, and governments have often faced challenges in mobilising counterpart resources, especially if they were unable to repay the original loan in the first place.

There are also considerable risks associated with debt swaps for global South countries, including conditionality, tied aid (meaning liberated funds must be spent in the creditor country) and lengthy or expensive negotiation periods. Global North lenders applying conditions to poorer countries is of particular concern considering how conditionality has been and is still used today to enforce damaging austerity measures on global South countries. Fundamentally, debt swaps place the financial onus of addressing the climate crisis on climate vulnerable countries, which should instead be on wealthy, polluting countries given their historic responsibility for the climate crisis.

Market-based solutions

Various new forms of debt-creating private finance have been developed in order to provide countries with resources to address the climate crisis, such as green bonds, catastrophe bonds and nature-performance bonds. All three are types of loans given by commercial creditors to governments.

While each initiative is complex and may present some benefits in specific contexts, in general they add to the debt burden of poorer countries while generating profit for private lenders. This once again places the financial onus on addressing the climate crisis on global South governments, and may be counted towards rich country climate finance goals, even though climate vulnerable countries will need to pay the money back.

Despite being presented as innovative solutions, debt swaps and market-based initiatives will not adequately address the debt or climate crises, and in the case of market-based solutions, could exacerbate debt levels, undermining action on the climate crises in the long-run.

Action ahead of COP26

The G7 Presidency was a missed opportunity for the UK to show global leadership on unsustainable debt in the global South. COP26 now presents a vital moment to demonstrate the importance of debt relief for addressing the climate crisis and to defend the economic and social rights of people in the global South.

The UK COP26 Presidency has recognised that the debt crisis needs to be a part of the conversation about the climate crisis, but it is not adequately on the agenda. While issues deeply connected to debt will be discussed, including finance for loss and damage and climate finance goals, we need to ensure that addressing and avoiding unsustainable debt is a firm part of these conversations, as well as being identified as a key area in and of itself. **We need urgently to convince decision makers that there is no climate justice without debt justice.**

- (1) Governments and institutions should provide debt cancellation in line with demands from the global South.** In August 2021, Sheikh Hasina, Prime Minister of Bangladesh & Chair of the Climate Vulnerable Forum, called for climate just debt restructuring for all climate vulnerable countries in recognition that unsustainable debt is undermining climate action and that debt cancellation is the fastest way to free up resources.

In the short term, the Common Framework should be strengthened to force private sector participation, and all countries who require debt relief should be eligible to participate, irrespective of their income status. Beyond this, an independent debt workout mechanism should be introduced to serve as a framework to restructure and cancel all debt for any country that needs it to a level compatible with sustainable development and the ability to address the climate crisis.

Debt relief should come without austerity conditions attached so that governments have space to determine where freed up resources are best allocated. Resources freed up through debt cancellation should also be considered additional to climate finance targets.

- (2) Key jurisdictions such as the United Kingdom and the United States should introduce legislation that prevents private creditors from refusing to engage in debt restructuring.** This legislation would stipulate that a restructuring of a country's debt would be binding on all creditors if agreed by 66% or more of the creditors involved, or alternatively that a debt restructuring agreed by the international community is binding on private creditors.
- (3) There should be debt moratoria and cancellation in the event of a climate-extreme event.** When a climate-extreme event such as a tropical storm takes place that significantly worsens a country's economic outlook, there should be an immediate, interest-free suspension of all debt payments from that country. This should be followed by a debt restructuring, including cancellation if required, via an independent and universally applied framework based on the needs of a country. This should go alongside additional grant-based financing for loss and damage.
- (4) Wealthy, polluting nations should provide more and better-quality climate finance.** They must use COP26 to set and deliver more ambitious climate finance goals to 2025 and beyond of at least \$400 billion per year, and in line with the need and the demands from groups in the global South. Climate finance must come in the form of grants, not loans, so it does not add to the debt burden of climate vulnerable countries. Climate finance must also be accessible to all countries that need it and cover all required areas of financing, including a separate mechanism for financing loss and damage as a form of compensation to climate vulnerable countries.
- (5) Wealthy nations should channel their SDRs in the form of grants.** Wealthy countries should commit to rechanneling a significant portion of their SDRs to low and middle income, climate vulnerable countries who need it the most. It should come in the form of grants at no cost to countries in the global South, without austerity conditions attached, and should be additional to existing climate finance and ODA commitments. SDRs must not be seen as an alternative to debt cancellation.

Top Tips

- DO:** highlight how debt cancellation is needed so that countries have the resources to tackle multiple crises such as the pandemic and the climate crisis.
- DO:** advocate that debt relief and grant-based climate finance are vital for addressing the climate crisis.
- DO:** demand that climate finance should be provided in the form of grants, not loans, so that it does not create more debt.
- DO:** advocate for SDRs to be channelled to countries in the global South in the form of grants, not loans.
- AVOID:** stipulating that resources freed up by debt cancellation must be spent on addressing the climate crisis (i.e. conditionality).
- AVOID:** suggesting that debt cancellation is an alternative to grant-based climate finance.
- AVOID:** suggesting that SDRs are an alternative to debt cancellation, we need both.
- AVOID:** proposing inadequate solutions to both crises which could serve as a distraction from wider calls, and could cause more harm than good.

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