T20 Policy Brief

G20 BRASIL 2024

T20 Brasil 2024 Let's rethink the world

Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Debt And Climate: Empowering Debt for Climate Swaps to Finance the Green Transition in Africa

Malancha Chakrabarty, Senior Fellow and Deputy Director (Research), Observer Research Foundation, India

Karim El Aynaoui, Executive President, Policy Center for the New South, Morocco

Youssef El Jai, Economist, Policy Center for the New South, Morocco

Badr Mandri, Economist, Policy Center for the New South, Morocco

Manish K Shrivastava, Senior Fellow and Associate Director, The Energy and Resources Institute (TERI), India

TF03

Abstract

In a global context marked by unprecedented economic and environmental challenges, Africa stands at a crossroads. The rapid rise in public debt, coupled with the climate emergency, imposes a dual constraint on the continent's countries, severely limiting their ability to pursue sustainable development and mitigate the effects of climate change. This critical situation calls for innovative and effective solutions capable of transforming obstacles into opportunities for a more resilient and prosperous future.

In the face of this reality, it is imperative to rethink traditional financing mechanisms and explore innovative approaches that promote both debt relief and climate action. In this context, Debt-for-Green Swaps are emerging as a promising strategy, offering a viable path to reduce financial vulnerability while accelerating investments in environmental sustainability.

Keywords: Climate Distress, Climate Finance, Debt Swaps, Green Bonds

Diagnosis

The rapid increase in public debt in Africa poses a growing challenge for the continent. Since 2010, African debt has significantly risen, nearly doubling to reach 65% of GDP in 2022, compared to 32.7% in 2010 (Afrodad 2023). This alarming debt growth is accompanied by a diversification of creditors, thus reducing the share of concessional debt. Non-Paris Club creditors, notably China, now play an increasingly important role, representing a substantial portion of the continent's external debt[1]. Africa's bilateral debt with China represented around 10% of its external debt and has been steadily growing since the GFC. Concurrently, private actors have become the primary funders in Africa. With a total issuance stock of $140 billion in eurobonds by African states since 2007, private debt now accounts for 30% of African external debt (Afrodad 2023)

The burden of repaying this debt is worsening, as highlighted in the latest World Bank report. In 2021, the poorest countries, mostly located in Africa, had to allocate $46.2 billion to the service of their long-term public debt and state-guaranteed debt. This amount represents 10.3% of their exports of goods and services and 1.8% of their gross national income, marking a significant increase compared to 2010, where they represented 3.2% and 0.7% respectively (World Bank 2022).

Faced with this unsustainable financial pressure, several African countries are in default or nearing default, desperately seeking to restore macroeconomic stability. According to the International Monetary Fund (IMF) and the World Bank, 23 low-income African countries are classified as high-risk or already in debt distress (World Bank 2023).

[1] ONE. "How Much Debt Is Owed to Whom?". https://data.one.org/topics/african-debt/#how-much-debt-is-owed-to-whom.

Zambia, Mali, Ghana, and Mozambique, among others, have stopped paying their external debt and are turning to the IMF for assistance.

Many heavily indebted countries are also on the front lines of the adverse effects of climate change. This dual exposure creates a vicious cycle where each phenomenon exacerbates the other. On the one hand, climate shocks such as droughts, floods, or cyclones can cause significant economic damage, requiring massive public interventions for reconstruction and support for affected populations. These interventions increase the financial burden on already limited budgets. On the other hand, the debt burden limits countries' ability to invest in climate adaptation and resilience measures, making them even more vulnerable to future shocks. This constitutes a debt-climate feedback loop International Monetary Fund 2022).

In the face of these challenges, Africa faces a significant climate finance gap. The financial needs to adapt its growth model to climate requirements are estimated at $2.8 trillion for the period 2020-2030. However, current financial flows for climate action in Africa amount to only $30 billion per year, leaving a major deficit (African Development Bank Group 2023).

In this difficult context, Africa is desperately seeking solutions to alleviate both the debt burden and address climate emergencies. Debt-for-climate action swaps emerge as a promising strategy, offering a mechanism through which creditors can grant debt relief in exchange for green commitments, such as investment in climate-resilient infrastructure or biodiversity protection. This innovative approach represents an opportunity to simultaneously address Africa's twin problems of debt and climate vulnerability, paving the way for more sustainable and resilient development.

Debt-for-climate action swaps are financial instruments whereby a portion of a country's debt is canceled in exchange for its commitment to undertake specific green

investments. These investments may include climate-resilient infrastructure projects, biodiversity protection, decarbonization of the economy, or other sustainable initiatives. This mechanism offers a dual benefit: it reduces the debt burden of developing countries while supporting their ecological transition.

Debt-for-nature swaps can be categorized into two main types. The first type is the bilateral swap, where a creditor country agrees to cancel part of a debtor country's debt in exchange for the debtor's commitment to use the freed-up funds to finance approved projects. If multiple creditor countries participate in the agreement, it is referred to as a multilateral swap.

The second type, which is more common, involves a third party. In this case, a non-governmental organization (NGO) acts as an intermediary between the debtor and its creditors to facilitate the deal. Specifically, the third party purchases a developing country's debt on the secondary market at a discounted value and then transfers it back to the debtor in exchange for the government's commitment to mobilize funds for specific projects. A notable example of this type is the debt-for-nature swap concluded by the Seychelles in 2018, with support from The Nature Conservancy, a US-based environmental group.

During the 1980s and 1990s, when the debts of developing countries with private banks were traded on secondary markets at steep discounts, third parties facilitated debt-for-nature swaps by purchasing these distressed debts from commercial banks. An early example of this practice is Bolivia in 1987.

In all cases, these swaps allow debtor countries to fund committed projects in domestic currency, thereby alleviating foreign exchange constraints. This mechanism not only helps countries reduce their debt but also contributes to environmental protection by financing specific ecological initiatives.

Recommendations to the G20

As African countries are increasingly seeking a debt resolution mechanism with green conditionality, we build on the proposal of a debt for climate relief by exploring the different financial products that can be used to enhance the efficiency of climate swaps and attract private sector participation. Besides their complexity and length, current debt resolution mechanisms are hampered by the difficulty to guarantee comparability of treatment across the creditors. Thus, resolving to green and sustainable financial products can be a way to circumvent the problem, by leveraging on the consolidated appeal of private creditors to green financial products.

Recommendation 1: Through their efforts to push for more funding for climate, G20 and MDBs can lay the foundation for a debt for climate swap arrangement

Under this mechanism, debtors and creditors require a strong underwriter that can guarantee the stability of the swap and its credibility. As things stand, the multilateral development system is well placed to play this role as it can mitigate multiple risks: (1) operational risks, stemming from the lack of technical capacity required to properly structure these financial products, (2) financial risks, through the development of guarantees, preferably with limited contingencies to reduce the scope for moral hazard, that can lead to lower risks. MDBs can also push for an enhancement of country-driven guarantee schemes.

At the early stage of the process, MDBs, in close coordination with debtors, can contribute to project origination and capacity development, through regular technical assistance missions and data-driven policy choices, which will capitalize on the extensive

knowledge origination function of multilateral development banks. Awareness about climate risks has pushed many countries to adopt nationally determined strategies to foster sustainable growth and development. With the technical assistance of the World Bank and regional MDBs, these countries can further convert these commitments into practical project pipelines.

Recommendation 2: The G20, in collaboration with the MDB system should create an independent green monitoring agency.

After the swap occurs, countries are expected to provide a regular audit of their accomplishments and a projection over the longer horizon of the green projects. We propose the creation of a G20 led green monitoring agency, hosted at the World Bank or the United Nations. The role of this agency would be to provide an annual rigorous facts-based audit of the realization of the debtor countries. This exercise needs to be conducted by research and development practitioners drawn every year through a blind process from a multidisciplinary pool of experts.

Recommendation 3: Debt swaps should leverage on african economies experience on the sustainability debt markets and blend in green and sustainability-linked bonds

African countries favor social, sustainability and sustainability-linked bonds which align with their development priorities and can leverage their experience on the sustainable market to construct green financial products. In particular, in the event of a debt for climate swap, savings from debt restructuring should be put in a blend of green

bonds and sustainability linked bonds. Structured this way, creditor countries retain a limited scope to earmark their investment, through the stringent key performance indicators put in the contract of the green bond. At the same time, the inclusion of sustainability-linked bonds, which are not constrained by use-of-proceeds clauses, provides more space for debtor countries to channel the fund towards their own priorities, thus promoting growth-enhancing green country platforms.

Recommendation 4: Wherever possible, projects pipelines need to capitalize on local policy objectives

Efforts to mitigate the impact of climate change and adapt to an increasingly changing environment require a complementary mix of large-scale national projects and locally driven initiatives. Hence, local politics matter. Indeed, as many emerging markets and developing countries are pushing towards bottom-up approaches to policy implementation, a double-dividend of debt for climate swaps can come in the form of enhanced participation at the regional or municipal levels. As sub-sovereign markets in Africa are relatively less developed, green development plans at the basis of climate swaps need to reflect local priorities. Achieving this role requires clear communication channels between local communities and national decision-makers. The role of the G20 is to encourage and enforce platforms within countries that foster this dialogue by empowering civil society organizations, including the think tank community. These entities often have an important local imprint and a much realistic knowledge at the granular level, and therefore can help identify the key climate bottlenecks that green projects can address.

Scenario Of Outcomes

Africa needs an international financial architecture that supports its fundamental development values and meets its common challenges, particularly in terms of climate needs.

A debt-for-climate swap mechanism could play a key role in this. By involving the G20 and the multilateral development banks (MDBs) in the creation of a dedicated fund, African countries could obtain significant financing for their climate initiatives.

The role of guarantor played by the multilateral development system strengthens the credibility of the mechanism and attracts the participation of the private sector.

Additionally, debt-for-climate swaps need to be considered under the lens of an additional financial arm that can be used among the multiple financial innovations that a reform of the global financial architecture can offer. They will be relevant and useful in cases where countries are under moderate debt risk, in which case the swaps need to involve green financial products. In bleaker circumstances, countries will need to prioritize debt restructurings over debt swaps. Also, the mechanic around debt swaps needs to be fully transparent and in pushing for these swaps, the G20 also needs to work on a clear taxonomy and standardization of the contract.

However, strong MDB involvement could lead to a scenario where their interests and priorities influence the direction and nature of projects. This could limit debtor countries' autonomy in project selection and implementation, creating a mismatch between local needs and the initiatives financed.

On another note, the G20-driven green rating agency can contribute to the harmonization of practices in green project management, beyond its role as guarantor of the perennity of the swap arrangement. At a technical level, the agency can also contribute

to contractual harmonization of some of the emerging financial products, notably sustainability and sustainability-linked bonds.

References

African Development Bank Group. 2023. "The African Leaders Nairobi Declaration on Climate Change." September. https://www.afdb.org/sites/default/files/2023/09/08/the_african_leaders_nairobi_declaration_on_climate_change-rev-eng.pdf.

Afrodad. 2023. "Breaking the Cycle of Debt: Addressing the Reasons Behind High Indebtedness in Africa and Recommendations for Sustainable Solutions.". https://afrodad.org/breaking-the-cycle-of-debt-addressing-the-reasons-behind-high-indebtedness-in-africa-and-recommendations-for-sustainable-solutions/

International Monetary Fund. 2022. "Debt for Climate Swaps: Analysis, Design, and Implementation." August 11. https://www.imf.org/en/Publications/WP/Issues/2022/08/11/Debt-for-Climate-Swaps-Analysis-Design-and-Implementation-522184.

World Bank. 2022. "Debt Service Payments Put Biggest Squeeze on Poor Countries Since 2000." Press Release, December 6. https://www.worldbank.org/en/news/press-release/2022/12/06/debt-service-payments-put-biggest-squeeze-on-poor-countries-since-2000.

World Bank. 2023. "Africa's Pulse: An Analysis Of Issues Shaping Africa's Economic Future". October. https://openknowledge.worldbank.org/server/api/core/bitstreams/f5b186fb-4a64-4b9a-a658-287c6ad73d6f/content.

G20 BRASIL 2024
BUILDING A JUST WORLD AND A SUSTAINABLE PLANET

T20 Brasil 2024
Let's rethink the world

Let's rethink the world

CEBRI Rethink Tank

FUNDAÇÃO ALEXANDRE DE GUSMÃO

ipea
Instituto de Pesquisa Econômica Aplicada