The debt and climate crises:

Why climate justice must include debt justice

A Discussion Paper

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This paper pulls together key information on the debt and climate crisis nexus, and outlines policy positions on solutions with recommendations for policy makers to act.

This paper is prepared and supported by the following cooperating organisations as a tool for further exploration into the debt climate nexus, and potential future positions of the CAN Network:

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Summary

The failure of global decision makers to adequately respond to the economic shock caused by the pandemic has plunged many global south countries further into a debt crisis that has been building for the last decade. Meanwhile, many of the same countries are on the frontline of the climate crisis, experiencing devastation from more frequent climate extreme events like tropical storms and droughts, to rising sea levels and increasing temperatures.

Countries need funds to address the climate crisis now. However, many global south countries are trapped repaying vast sums to their creditors every year, hampering their ability to respond to the mounting impacts and costs of the climate crisis. At the same time, extreme climate events and insufficient grant-based climate finance are forcing indebted countries deeper into debt, keeping many locked in fossil fuel production, as the main source of income to guarantee debt service payment, and creating a vicious cycle that can be impossible to escape. What's more, climate finance itself continues to push vulnerable countries into debt as over 70% is provided as loans. **Countries which have done the least to create the climate crisis are stuck paying the most.**

Without finance for addressing Loss and Damage, and adequate finance for adaptation, over the next 10 years we calculate that Sub-Saharan African countries will have to take on an additional $996 billion in debt - a 50% increase on current debt levels as a percentage of GDP

Global south governments, civil society and even key global institutions like the World Bank and IMF have been highlighting the links between debt and the climate crisis, including at COP26, but this has not translated into adequate action by decision makers such as the G7 and G20.

To address the climate crisis, urgent action is needed on the debt crisis in the global south. This includes debt relief and new, additional and adequate grant-based climate finance, in recognition of the climate debt owed to countries in the global south by wealthy polluting nations for their role in creating the climate crisis from colonialism to the present day. This finance is absolutely necessary to support vulnerable countries as they attempt to adapt to the impacts of climate change, address the Loss and Damage arising from such impacts that have gone beyond what can be adapted to, and manage the climate transition.

The provision of climate finance from the global north to countries in the global south lies at the heart of the international cooperation framework for climate action under the UNFCCC and its Paris Agreement, and is enshrined in the principles of common but differentiated responsibility and respective capability (CBDR-RC) within the UNFCCC.

COP27 presents a vital opportunity to continue to raise the importance of the debt issue and its close and direct linkage to the climate crisis, ensuring it is factored into key decisions moving forward and to move decision makers beyond words to action. While we recognise that the UNFCCC does not have the mandate to manage debt levels or provide debt relief, the UNFCCC does have the ability to ensure that climate finance provided (or not provided) does not force vulnerable countries deeper into debt to ensure the instruments and mechanisms deployed follow climate justice principles and are fit for purpose.

To address the climate and debt crises, wealthy governments such as the G20 and key institutions such as the International Monetary Fund and World Bank urgently need to:

- **Provide debt cancellation** for all global south countries that need it across all creditors, including ensuring that private creditors take part, to free up resources for climate action and other national needs, and to insure that countries are not trapped in fossil fuel and other extractive sectors.
- **Cancel debt when climate extreme events strike.** Suspend and cancel debt payments when a climate extreme event takes place, so countries have the resources they need for emergency response and reconstruction without going into more debt.
- **Provide significantly more, better-quality, new and additional climate finance** so countries are not forced into more debt to pay for a crisis they did not create, including establishing and delivering on a new climate finance goal as a part of the New Collective Quantified Goal for climate finance, and a Loss and Damage Finance Facility.

Understanding External Public Debt

Governments borrow for a variety of reasons, for example to pay for the costs of unexpected events like pandemics, to smooth economic shocks, and to fund investment or current public spending. In some cases there is a lack of adequate accountability or transparency to the public. Many countries have to finance their regular expenditures like health care through borrowing. In the 2010s there was a large increase in lending. Low interest rates in the western world following the 2008 financial crisis led financiers to seek to lend to global south governments who they charge higher interest rates for loans, and thus potentially make high profits. Meanwhile, global south governments, continue to be encouraged to take on more debt to fund their development efforts by key institutions like the World Bank and IMF. Economic shocks such as falls in commodity prices, climate extreme events and the Covid pandemic cut government revenues and so increase the frequency and seriousness of debt crises. Between 2013 and 2021, the number of global south countries the IMF says are unable to pay their debts or are at high risk of doing so has increased from 17 to 39, 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

Harmful debt diverts resources away from tackling the climate crisis

Harmful 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 over addressing the climate crisis or other national needs.

Countries in the global south have been facing increasingly unsustainable debt since the 2008 financial crisis, with debt payments increasing by 120% between 2010 and 2021, reaching their highest level since 2001. An increasing proportion of global south debt is owed to private creditors , who tend to charge much higher interest rates than other lenders. Almost half of external debt and interest payments by low and lower middle income countries are to private lenders.

The economic shock resulting from the pandemic has exacerbated the situation. Public debt has increased in 108 out of 116 global south countries. 54 countries are currently in a debt crisis and this number looks set to grow as countries are further impacted by the food and fuel crisis resulting from the Ukraine war and rising US interest rates.

As a result, resources needed to respond to the climate crisis, pandemic and other national needs are increasingly being diverted to debt repayments.

Countries in the global south are currently spending 5 times more on debt repayments than they are addressing the impact of the climate crisis.

Faced with the need to meet debt repayments, many global south countries simply can't afford to invest in adapting to and mitigating the impacts of the climate crisis, including transitioning to cleaner energy and preparing for climate extreme events such as hurricanes and floods. As a result, the impacts of the climate crisis will continue to mount up, with devastating effects on unprepared communities.

Flooding in Pakistan

In August 2022, Pakistan - which contributes less than 1% of annual global gas emissions causing the climate crisis - was hit by devastating floods causing a humanitarian crisis of epic proportions. Rapid attribution analysis by the World Weather Attribution Group found it is likely that human-caused climate change was behind the extreme monsoon rainfall which led to such devastating impacts. Over 1,200 people have died as a result of the floods and a significant amount of the country is now underwater, while the economic damage is set to cost the country over $40 billion. Pakistan urgently needs resources for its emergency response and reconstruction, but is stuck paying vast sums in debt repayments to its external creditors. Even before the floods, Pakistan's external debt totalled $136 billion with 40% of government revenue ($18 billion) expected to be allocated to external debt interest and repayments in 2022[1]. These vital resources could instead be used to respond to the devastation caused by the flood, as well as other national level needs.

1. Calculated by Debt Justice from World Bank International Debt Statistics.

Existing international responses to the debt crisis are inadequate

While the G20 has recognised the urgency of the debt crisis, the initiatives it has put in place to respond to rising debt levels resulting from the pandemic have left many climate vulnerable countries trapped in unsustainable debt.

In 2020, the G20 introduced two schemes for 73 of the world's poorest countries. The first was the Debt Service Suspension Initiative (DSSI), which ended in 2021 and aimed to suspend debt payments temporarily so countries could use resources to respond to the pandemic rather than on debt repayments. However, the scheme only suspended 23% of debt payments for participating countries, primarily because there was nothing forcing private creditors to take part - collectively private creditors only suspended 0.2% of what was owed to them. It also excluded many middle income countries, many of which have unsustainable debt levels and require relief.

The second initiative introduced by the G20 was the Common Framework for Debt Treatments Beyond the DSSI (Common Framework), which aims to provide wider debt relief to countries that request it across their external bilateral and private debt. Three countries have applied - Chad, Ethiopia and Zambia - but so far no agreements for debt relief have been made. One of the key reasons for the lack of progress is that the Common Framework does little to enforce private creditor participation in the scheme. As per the rules of the Common Framework, a debt restructuring can only go ahead if a borrowing government is able to reach a comparable agreement with both bilateral and commercial creditors, meaning that the refusal of private creditors to play ball can derail the whole process.

While actors like the G20, IMF and World Bank have called on private creditors to participate in debt relief, so far no real action has been taken to enforce them, essentially allowing private lenders to continue to profit off debt repayments while countries and communities struggle to respond to multiple crises.

A significant proportion of global south 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 stopping private lenders taking governments to court to demand a full repayment. Many court cases would take place in the UK or New York as virtually all international debt contracts are governed by New York or English law.

Zambia

Zambia defaulted on interest payments to some of its private lenders in November 2020 when private creditors refused to suspend debt payments. In February 2021, Zambia applied for a debt restructuring through the Common Framework, but little progress has been made on the negotiations as large private creditors, such as BlackRock, have so far refused to reach an agreement on debt relief. BlackRock, headed up by Larry Fink, is the largest of a number of bondholders who are refusing to cancel Zambia's debt, despite lending to the country with interest rates as high as 9% (in comparison to wealthy countries like Germany, UK and USA who were given loans at 0-2% interest in the same time period) potentially making huge profits. Debt Justice estimates that BlackRock could make up to 110% profit if repaid in full. Meanwhile, Zambia is experiencing devastating impacts of the climate crisis such as flooding, extreme temperatures and droughts, which are causing significant disruption to livelihoods and severe food insecurity. Unsustainable debt levels mean the country lacks many of the resources required to address these impacts. **This decade, Zambia is due to spend over four times more on debt payments than on addressing the impacts of the climate crisis.**

Unsustainable debt keeps countries locked in the exploitation of natural resources, including fossil fuels

Some global south countries turn to natural resources as a quick way to increase exports and, therefore, revenues in a foreign currency to service their debt. This can have devastating environmental and human impacts, and leave countries even less prepared for the effects of the climate crisis.

For example, many global south countries are trapped in a **debt-fossil fuel production trap** whereby countries rely on fossil fuel revenues to repay debt, anticipated revenues from fossil fuels are often overinflated and require huge investments to reach expected returns, leading to further debt alongside the environmental and human harms caused by such projects.

Furthermore, many lenders continue to promote fossil fuel production as a way to generate revenue to repay debt and develop economically, either by

Fracking in Argentina

The IMF and Argentinian government are pushing the development of fracking in the Vaca Muerta oil and gas field in Northern Patagonia as a way to solve the country's debt crisis and wider economic problems. They propose that foreign currency could be saved by supplying oil and gas domestically while additional foreign currency can be generated through oil and gas exports (the 2022 agreement between the IMF and the Argentina government includes the creation of a special tax regime for export sectors to increase exports). The former economy minister, Martin Guzman, suggested that exports could hit $15 billion by 2027, part of which would be used to pay down the country's debt which has been at unsustainable levels for a number of years. Those supporting the project include banking institutions, export credit agencies (like UK Export Finance, the investment arm of the UK government) and private banking institutions (such as HSBC). Many Argentinian groups are campaigning against these activities, highlighting the potential damage to both communities and the environment, including Indigenous groups who filed a lawsuit against the plans in 2018. Others have also highlighted that the proposed benefits are not likely to materialise given the risks of relying on fossil fuel revenues (including fluctuating prices on the global market and possible declining prices given the transition away from fossil fuels) and given the huge amount of investment required to scale up extraction in the next few years which will require taking on more debt from external creditors. The country's strategy to reduce debt may end up adding to debt levels without generating adequate revenue to repay.

directly providing loans for fossil fuel projects (such as the Asian Development Bank and World Bank), or pushing new fossil fuel production as a part of loan programmes (such as the IMF and World Bank). Research by the Bretton Woods Project and ActionAid found that between 2015 and 2021 (after the Paris Agreement was signed), the IMF endorsed or directly supported the expansion of fossil fuel infrastructure in 55% of member countries. Investments into fossil fuel power by Japan, China and the USA in the global south between 2000-2018 are expected to result in 24 gigatonnes of carbon dioxide emissions by 2060.

Liquified Natural Gas in Mozambique

In 2010, large natural gas reserves were discovered in Mozambique. Following this, the government gave the go ahead for a number of Liquified Natural Gas (LNG) projects to begin, actively encouraged by the IMF as a part of a loan program. One of the projects given the green light includes the Rovuma Basin Area 1 Mozambique development plan (Mozambique LNG) in the Cabo Delgado Province which is being developed by the world's 7th largest oil and gas company, TotalEnergies. TotalEnergies have secured around $15 billion in investments for the project so far from commercial and public entities. The Mozambique government have also guaranteed $2.25 billion of the state-owned ENH's (Mozambique's state-owned oil company) equity share.

The anticipated revenues were huge - up to half a trillion dollars over the LNG project's life span. Petroleum Review magazine said that the projects could "catapult the country from being one of the poorest African nations to one of the richest". However, these anticipated benefits for Mozambique have not materialised, and in fact, no gas has yet been extracted or exported. There is also a strong chance that the LNG projects may add to the country's debt burden given the billions of dollars of guarantees issued by the government to enable its state-owned oil company to participate in the LNG projects. Furthermore, the human and environmental impacts of the project have been devastating, causing the militarisation of the region, displacement of over 350,000 people and 2,000 deaths. Despite this, the IMF still continues to see the LNG projects as critical for the country's debt sustainability. With the current energy crisis, there has been a renewed push in promoting gas as a bridging fuel for the energy transition. It is more likely a dangerous impediment locking in significant future emissions. In Mozambique's case, onshore and offshore projects are likely to increase emissions by 8 percent. Furthermore, such expansion of fossil fuel infrastructure increases climate-related and direct impacts from the fossil fuel industry and has significant implications to the African states' obligations to protect human rights.

Recommendation 1
Debt cancellation

Governments and institutions must provide debt cancellation in line with demands from countries in the global south which are particularly vulnerable to the adverse effects of climate change.

In August 2021, Sheikh Hasina, Prime Minister of Bangladesh & former 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 for adaptation and mitigation. Others, including the V20 have also made similar calls. As well as freeing up resources for adaptation and mitigation, debt cancellation is vital so countries in the global south are no longer reliant on the exploitation of natural resources, such as fossil fuels, to meet debt repayments or the conditions of creditors.

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. Key jurisdictions such as the United Kingdom and New York should also introduce legislation that compels private creditor participation in debt restructurings and prevents private lenders from suing global south countries if they cannot meet their repayments. Multilateral creditors, such as the IMF and the World Bank, should also participate in debt relief. Beyond this, an independent UN-led debt workout mechanism should be introduced to serve as a framework to restructure and cancel debt for any country that needs it, across all creditors, to a level compatible with sustainable development and the ability to address the climate crisis.

A key concern that can prevent countries from seeking debt relief is the view that this can hamper accessibility to capital markets. However, past experience has shown that debt restructurings are actually the best way to borrow from private markets again. As Scope Ratings has said:

"If an economy's debt sustainability is adequately enhanced via public and private sector debt relief, this could support stronger market access and lower borrowing rates longer term and, with this, potentially a stronger credit rating long term."

Debt relief should be provided free from austerity conditions so that governments and the public have space to determine where freed up resources are best allocated. Resources freed up through debt cancellation sshould not be counted as climate finance because these resources are not new and additional.

"Sierra Leone's public debt was 77.3% of Sierra Leone's GDP in 2021. Cancelling the debt is one of the best ways to support tackling climate change and will mean the government can invest in adapting to and mitigating the effects."

Abu Bakarr Kamara
Budget Advocacy Network, Sierra Leone

Vulnerable countries are forced to pay for a crisis they did not create through debt

Failing to provide for adaptation and mitigation

The climate crisis has been created by wealthy governments, institutions and private companies from colonialism to the present day, and yet it is countries which in the global south who are experiencing the worst impacts of the climate crisis. Furthermore, because of the disproportionate atmospheric space taken up by polluters, countries in the global south are not able to develop using fossil fuel energy sources like wealthy countries if we are to avoid climate breakdown. Because of this, wealthy polluters owe a climate debt to the global south. Despite this being a core part of the international cooperation framework for climate action under the UNFCCC and its Paris Agreement, and being enshrined in the UNFCCC principle of common but differentiated responsibility and respective capabilities, polluters are not paying up.

In 2009, wealthy nations agreed to give $100 billion in climate finance a year by 2020 and formalised it a year later. In 2015, wealthy governments agreed to extend the commitment to provide $100 billion of climate finance to global south countries every year from 2020-2025, a woefully inadequate amount that falls far short of the levels of finance required. According to the most recent Needs Determination Report from the Standing Committee on Finance (SCF), and based on the assessment of just 78 Nationally Determined Contributions (NDCs), countries in the global south will require at least USD 5.8-5.9 trillion cumulatively to reach their individual NDC commitments for adaptation and mitigation by 2030.

But even the inadequate $100 billion goal has still not been reached, and is not likely to be met until 2023, breaking the trust of global south countries. Furthermore, research by Oxfam raises serious methodological concerns with the OECD's climate finance reporting which has been shown to be prone to overcounting. According to Oxfam's research, bilateral climate finance could be around two thirds lower than indicated. Due to the persistent failure to reach the yearly target, global north countries are

responsible for withholding US$ 381.6 billion, or 48% of pledges made, in bilateral and multilateral public climate finance between 2013 and 2020.

Furthermore, applying an equity and fair shares lens, assessments have further shown the disparity between what is considered fair international cooperation and the reality of what is being provided. The fair share assessment for the US's international climate finance contribution is estimated to be US$800 billion between 2021-2030 equally split amongst finance for adaptation, mitigation and addressing Loss and Damage (USCAN, 2021). This is a far cry from the US$4.4 billion in tracked international finance provided by the US. At COP26, France pledged €7.1 billion in annual climate finance until 2025 to support partner countries. However, the fair shares assessment for France's international climate finance contribution is estimated to be €399.1 billion for the period 2021-2030 with €36.7 billion towards Loss and Damage and the €181.2 billion each for adaptation and mitigation.

Without adequate climate finance, countries are forced to find resources for adaptation, mitigation and addressing Loss and Damage elsewhere, including taking on more debt or by individual, often poor, households funding their climate action needs (often by going into debt). In Bangladesh for instance, it is rural households who are bearing the brunt of costs, spending almost US$2 billion a year on repairing the damage caused by climate change and on prevention measures.

"Many assume small island developing states and developing countries have large debt stocks because of corruption and profligacy when in fact... a lot of that debt has come as a result of the climate crisis"

Mia Mottley
Prime Minister of Barbados, March 2022

Loans to countries vulnerable to the impacts of the climate crisis are also often at high interest rates because of their vulnerability. Higher interest rates based on climate vulnerability are predicted to cost the most vulnerable countries $168 billion over the next decade, providing a long-term source of income, and potentially profit, for creditors.

Refusing to pay up to address Loss and Damage

The lack of climate finance is most stark when it comes to addressing Loss and Damage - the harms of the climate crisis that have not been or cannot be adapted to. There is currently no official intergovernmental finance for addressing Loss and Damage as wealthy governments continue to block long-standing efforts to secure it, including at COP26 where the G77 and China - a coalition of 134 developing countries representing 85% of the global population - demands for the establishment of a Loss and Damage Finance Facility were watered down to a three-year dialogue process.

Furthermore, high debt levels and the inadequate levels of climate finance for adaptation and mitigation mean the harms of the climate crisis keep mounting as countries are not able to adequately prepare for and protect against the impacts.

The UN estimates that climate-extreme events are already happening at a rate of one per week, while slow onset processes like temperature increases continue to cause increasing harm at huge cost to impacted countries. For example, the impacts of the climate crisis could cost African countries alone $415 billion annually by 2030. In Zambia, "rainfall variability alone could lead to a loss of 0.9% of GDP growth over the next decade". According to the WMO World Weather Research Programme, "weather, climate and water-related disasters has increased by a factor of five over the past 50 years, causing US$ 202 million in losses daily".

Without adequate finance for addressing Loss and Damage, countries vulnerable to the climate crisis are forced to pay for these costs themselves through debt. This keeps vulnerable countries locked in a debt-climate extreme event cycle where they must borrow to recover and reconstruct, only to have efforts wiped out again by the next extreme event, forcing them to borrow once more and creating ever-mounting debt levels.

Without finance for addressing Loss and Damage, and adequate finance for adaptation, over the next 10 years we calculate that Sub-Saharan African countries will have to take on an additional **$996 billion in debt** - a 50% increase on current debt levels as a percentage of GDP

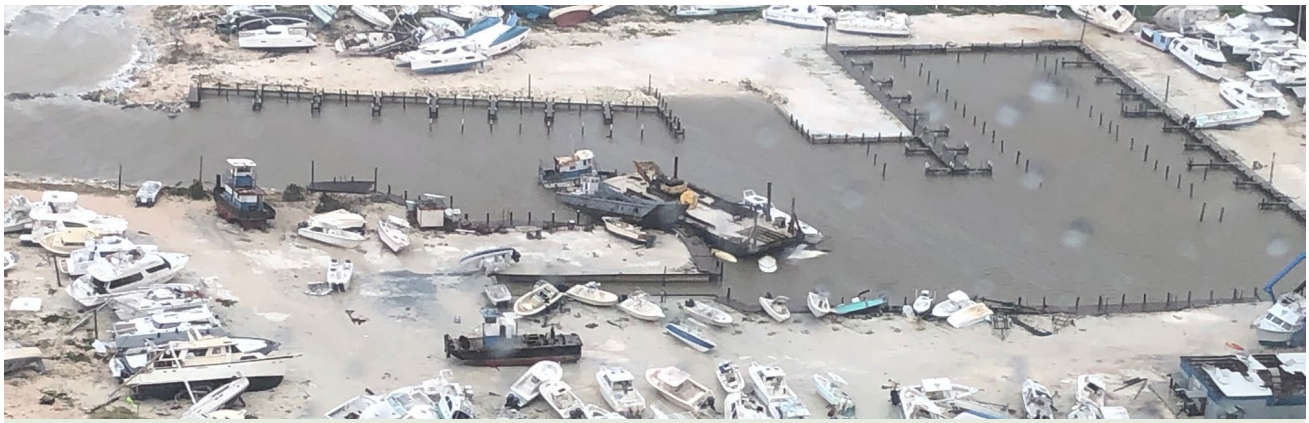
Furthermore, there is currently no comprehensive and consistently applied method of suspending debt payments when a country is hit by a climate extreme event.

This means that in many cases, countries continue servicing their debt when a climate extreme event strikes, diverting vital resources away from the emergency response and reconstruction.

One instrument that does exist to address debt in the context of a climate extreme event is 'hurricane clauses'. This is a form of state contingent agreement included in a loan contract stipulating that a borrowing government can suspend or reduce their debt payments in the event of an extreme event or shock (like a hurricane), for example by extending the maturity date of a loan or reducing the interest payments. While these clauses do currently exist, they are not included in contracts systematically and do not cover all forms of extreme events or factor in the compounding impact of multiple shocks and stresses. There is also a risk that these clauses result in higher interest rates for the borrowing country.

Dominica

In 2015, the Caribbean Island nation of Dominica was struck by Hurricane Erika causing damage worth 90% of the country's GDP. Just 2 years later, Dominica was struck again 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 adequate sources of finance from the international community, 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. Furthermore, just days after Hurricane Maria struck, the Dominican government had to find several million dollars for a debt repayment that fell due.



The Bahamas

After Hurricane Dorian hit the Bahamas in 2019, there were more than $3.2 billion in losses on the islands of Grand Bahama and Abaco. The government required hundreds of millions of dollars to fund the emergency response and reconstruction, including clean up activities, shelter and food for people who were displaced by the hurricane, and the purchase of supplies for rebuilding. The lack of finance from the international community meant that the Bahamas had to rely on increased borrowing to fund these activities, including a $100 million loan from the Inter-American Development Bank. In early 2020, K. Peter Turnquest, the Bahamas finance and deputy prime minister, said the country would likely need to borrow as much as $500 million in response to the Hurricane, including through issuing bonds on the international market. As a result, the Bahamas saw debt levels increase from 62% of GDP in 2019 to 72% in 2020.

Mozambique

In 2019, Mozambique was hit by two cyclones in a short space of time, 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.

Recommendation 2

Debt cancellation when a climate extreme event strikes

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, via an independent and universally applied framework based on the needs of a country. This should go alongside additional grant-based financing for addressing Loss and Damage.

Existing climate finance means new debts

Not all climate finance is equal. A significant amount of climate finance comes in the form of loans, contributing to the already unsustainable debt burdens and outsourcing the cost of the climate crisis onto the most vulnerable countries.

The most recent figures from the OECD show that in 2020, just 26% of climate finance was grants. Of the remainder, 71% is loans and 3% is equity. 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.

Instrument split of public climate finance in 2016-2020 (USD billion)

Furthermore, many of the most vulnerable countries are precluded from accessing the small amounts of grant-based finance that are available because of their higher income status. This is especially true of many small island states who experience some of the worst impacts of the climate crisis, but are considered middle or high income.

Note: The sum of instruments may not add up to totals due to rounding. Source: Based on Biennial Reports to the UNFCCC. OECD DAC and complimentary reporting to the OECD. Aggregate Trends of Climate Finance Provided and Mobilised by Developed Countries in 2013-2020, OECD

Recommendation 3

Provide adequate levels of grant-based, new and additional climate finance

Wealthy polluters must provide more, better-quality, new and additional climate finance so countries are not forced into more debt to pay for a crisis they did not create.

The current climate finance architecture is not fit for purpose. It does not address Loss and Damage, and adaptation has been under-financed and deprioritised, hindered further as the Global Goal on Adaptation (under Article 7 of the Paris Agreement) is yet to be defined. The quantity of finance is also too low, with mechanisms skewed towards increasing debt burdens in global south countries.

Global north country governments that have historically and currently polluted the most must deliver on and increase the $100 billion climate finance goal now to start to rebuild trust with countries in the global south, and establish and meet a significantly scaled up climate finance goal moving forward as a part of the New Collective Qualified Goal on climate finance, the need of which is likely to be in the trillions as highlighted by African negotiators at COP26 and the Standing Committee on Finance. It must also come in the form of grants, not loans, so it does not add to the debt burden of climate vulnerable countries, and be additional to existing financial commitments such as aid. The process to set a New Collective Quantified Goal on climate finance (NCQG) by 2024 for the period post-2025 represents an opportunity to do things differently and to ensure climate finance responds to the needs of vulnerable communities in a just and equitable manner. Delivering a rights and justice oriented new climate finance goal that is built on the premise of trust and ownership by developing and vulnerable countries is critical to enable the deep systemic transformation needed for a climate safe world.

In line with demands from the G77 and China, a new Loss and Damage Finance Facility must also be established at COP27 and become fully operational by the end of the Glasgow Dialogue in 2024. The amount provided through this facility must be in line with need and again, come in the form of grants not loans. Whilst we are seeing some governments pledging finance for Loss and Damage, such as the Danish governments' DKR 100 million pledge this year, such finance is not fit for purpose to address Loss and Damage unless it is through a dedicated Facility as an Operating Entity under the Financial Mechanism of the UNFCCC.

Wealthy nations have veered away from agreeing on an operational definition of new and additional climate finance. This has been an impediment to drawing a line between Official Development Assistance (ODA) and climate finance. There is also a general lack of accountability mechanisms. All climate finance flows need to be transparent, accountable, and properly reported and tracked with the establishment of a monitoring and reporting framework that is used to regularly review climate finance flows to ensure they are responding to the needs of vulnerable countries.

Climate finance for adaptation, mitigation and addressing Loss and Damage must be accessible to all countries that need it. This requires replacing the arbitrary indicator of income status as a way of determining which countries can access grants, and instead introducing a multidimensional vulnerability index to determine the unique needs of each country across areas such as macroeconomic stability, climate resilience and debt management, while ensuring that all vulnerable countries are eligible for climate finance support under the UNFCCC and its Paris Agreement.

There is an increasing chorus of calls from global south countries at the frontlines of climate impacts for climate reparations. The Commission of Small Island States on Climate Change and International Law is seeking reparations for the damage of climate change alongside debt cancellation, whilst Pakistan's Minister of Climate Change has made it clear that climate reparations are owed by wealthy polluter countries.

Both debt relief and additional grant-based climate finance should be understood as compensation for the destruction and harm caused by wealthy polluters from colonialism to the present day. It forms one part of reparations for colonialism, neocolonialism and slavery, alongside other vital structural reforms that will create a more just world in light of past, present and future locked-in harms. Within the framework of the multilateral climate regime, climate finance needs to be based on international cooperation and solidarity reflecting the principle of CBDR-RC. In this way, a coordinated and unified solution to the climate crisis can be developed in order to foster the transformational change required for intergenerational equity on a global scale.

"As Africa, we need to accelerate actions to combat climate change but this requires wealthy governments to urgently scale-up climate financing so we can build resilience of vulnerable communities"

Peninnah Mbabazi
Southern and Eastern Africa Trade Information and Negotiations Institute, Uganda

Other responses from the international community

Special Drawing Rights

Special Drawing Rights (SDRs) are a unit created by the IMF which, when allocated, effectively creates money for IMF member countries by boosting their reserves, potentially creating resources that could be used by governments to finance their 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. Despite the uneven distribution, roughly $200 billion in debt-free support was received by low and middle income countries, becoming the most substantial form of debt-free support provided to global south countries in response to the Covid-19 pandemic.

In an effort to redistribute the unused SDRs of wealthy countries to countries in the global south, the IMF has established the Resilience and Sustainability Trust (RST) which has just started agreeing its first loans in autumn 2022 (over a year after the SDRs were originally allocated by the IMF). The RST is intended to provide low interest loans to countries in the global south for "longer-term structural challenges" such as pandemic preparedness and climate change. While this is likely to provide global south countries with cheaper sources of finance than other types of lenders, it is still adding to debt burdens and outsourcing the cost of addressing the climate crisis onto vulnerable countries. These loans are also likely to come with conditions which, alongside causing harm to the most marginalised people and communities, are also likely to restrict

a government's ability to invest in climate action in the long run. Some have also raised concerns about the RST sitting within the IMF, given that climate is beyond its mandate and it lacks experience in this area. Furthermore, without adequate debt cancellation, there is a risk that loans from the RST will simply be used to pay off previous lenders such as banks and hedge funds.

Wealthy governments have pledged about $40 billion to the RST as of May 2022 (still only a fraction of the finance required for vulnerable countries to respond to the climate crisis). Many are planning to allocate their contributions against aid budgets and/or international climate finance pledges, effectively reducing aid/climate spending elsewhere and meaning that a greater proportion of aid/climate finance could now be spent on IMF loans. It is worth noting that depending on the national legal context, there may not be any barriers to wealthy governments redistributing their SDRs to global south countries as grants outside of the IMF, (thanks to the work of CAFOD, we know this to be the case with the UK government where it would be consistent with fiscal rules on debt and borrowing).

What to do with SDRs?

Wealthy nations should channel their SDRs in the form of grants where technically and legally possible. Wealthy countries should commit to rechannelling a significant portion of the SDRs they already have from the 2021 allocation to climate vulnerable countries who need it the most. It should come in the form of grants at no cost to global south countries, without austerity conditions attached, and should be additional to existing climate finance and aid commitments as they are essentially new funds with no cost to wealthy governments.

Additional or repeat future allocations of SDRs could provide climate vulnerable countries with additional resources to address the climate crisis (as suggested by Mia Mottley, Prime Minister of Barbados), but there would need to be a significant change in how SDRs are allocated within the IMF so that they go directly to countries that need it, rather than the vast majority going to wealthy countries.

Dangerous distractions

A number of debt-related proposals are being made to fill the climate finance gap (often referred to as "innovative sources of climate finance"). While each proposal is unique and may present some benefits in specific contexts, they cannot be seen as adequate solutions on their own. Many also present risks, such as adding to debt burdens, placing the financial onus of addressing the climate crisis onto vulnerable countries, and opening the door to conditionality which historically has involved introducing austerity measures at a national level, causing immense harm to communities.

Debt for climate/nature swaps

There have been growing calls for debt swaps to address the climate crisis in recent years, including from global south governments such as small island states. Most simply, a debt swap is when a government has a part of its external sovereign debt cancelled or otherwise restructured 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 has not included a sufficient degree of debt cancellation to have an impact on total debt levels. Furthermore, governments have often faced challenges in mobilising counterpart resources, especially if they were unable to repay the original loan in the first place or if the agreed investments at a national level are scheduled to be invested in a shorter timeframe than the debt would have been repaid (potentially creating cash flow issues for the borrowing government).

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), lengthy or expensive negotiation periods, become a way for lenders to avoid making their own emissions cuts domestically (by receiving carbon credits from engaging with debt swaps), and monetising nature/climate/the environment. Furthermore, there is a risk that odious or illegitimate debt that should not be repaid (often taken on by oppressive regimes) is included within a debt swap, thereby legitimising the debt and essentially forcing the cost of this debt onto the citizens of that country.

Indonesia's debt to health swap

In 2007, a Debt2Health agreement was signed between Germany and Indonesia. As part of the agreement, the German government cancelled $50 million of bilateral debt, in return for Indonesia mobilising $25 million in local currency ($5 million each year from 2008 to 2012) to put into the Global Fund, which would then be used to fund health activities in Indonesia. The remaining $25 million was essentially debt cancellation. At the time of the agreement, Indonesia had a total external debt burden of $133 billion, making $50 million look like a mere drop in the ocean. Furthermore, the cash flow gains Indonesia made from the swap were made over a 10 year period, while the counterpart investments into the Global Fund were due over a 5 year period, potentially creating a temporary deficit in the budget or meaning the government had to borrow more or divert resources from other budget areas to meet the agreement.

Although this swap happened a few years ago, it has been included here as a relatively straightforward example. There have been other more recent examples that are more complex, but also present similar challenges and risks such as Belize 2021 and Barbados 2022.

It is clear that the existing model for debt swaps is insufficient at both alleviating debt levels and freeing up resources for climate finance, especially for countries experiencing unsustainable debt levels. Debt swaps will only be useful for debt sustainability if they include a substantial element of unconditional debt cancellation, if there is a large-scale increase in the level of debt considered for the debt swap, and the risks of a swap are carefully mitigated so they do not cause harm.

Green bonds

Green bonds are loans supposedly provided to the issuer to fund projects that have climate or environmental benefits. They enable the issuer to raise financing for projects linked to climate change adaptation and mitigation, such as renewable energy, ecosystem protection and restoration, and energy efficiency. Green bond issuances have been on the rise in recent years within capital markets, with some global south countries, such as Indonesia, the Seychelles, and Colombia, also participating as a way to access capital for climate action.

Green bonds are a debt-creating instrument, and while they may enable access to finance from capital markets, interest rates are likely to be high, once again adding to debt burdens and forcing the cost of the climate crisis onto the most impacted countries. The Egyptian government, for example, has highlighted how its green bond has ended up costing it more than its traditional Eurobonds. It is also unclear if green bonds will meaningfully contribute finance for the climate crisis as bonds are often issued by global south governments to refinance existing projects.

Furthermore, there is currently no internationally agreed standard or verification to determine what constitutes 'green' within a green bond, opening the door for greenwashing by the private sector. According to research by Oxfam Hong Kong on 249 green bonds issued in Asia in 2018 and 2019, only 6% adopted a process to measure the social impact of their bonds, and only 4% implemented a process to manage social risks.

As well as green bonds, there are a series of other loan-based instruments that aim to raise finance for climate, environment or nature related issues from capital markets, all which present similar risks. These include:

Blue bonds - issued to support investments in healthy oceans and blue economies. For example, the Seychelles and Belize have both issued sovereign blue bonds. Some have raised concerns about the harmful impact that blue bonds can have on local

communities and businesses, such as subsistence and small-scale fishers, as governments are likely to prioritise the privatisation of public goods and the interests of lenders with their investment over public interests.

Catastrophe (cat) bonds - Catastrophe bonds function as a normally issued bond (i.e. interest rate paid annually, and principal paid at the point the bond reaches maturity) unless a climate extreme event takes place during the lifespan of the loan, in which case the borrowing country can keep the invested funds. This acts as a form of disaster risk financing for the climate vulnerable country, and a high-risk high-reward investment for lenders who could potentially make large profits given the higher interest rates they charge for these types of bonds. The definition of a climate extreme event in this case is often defined by a parametric trigger, such as wind speed or earthquake intensity, rather than the actual impact of an event. They also tend not to factor in the cumulative impact should multiple events take place in a given time period.

Nature performance bonds - where governments raise financing by issuing a bond, and then are incentivised to work toward climate goals with the opportunity to reduce interest rates of principal payments on the bond if they meet those goals, opening the door to creditor conditionality. At the time of writing, no global south government has yet issued this type of bond, although the former government of Pakistan was considering one in 2021.

Mobilising private finance

Private loans and investments should not and cannot, from a justice oriented approach to climate finance, be counted towards the climate finance obligations of global north countries under the UNFCCC and its Paris Agreement. Despite this, there is a growing emphasis on mobilising private finance to reach climate finance goals, with a number of supporting initiatives announced at COP26. Although the details of many of these initiatives are not yet clear, we expect some of them may entail using official climate finance to mobilise private sector loans to climate vulnerable countries.

For example, at COP26 the International Just Energy Transition Partnership (JETP) was launched between South Africa, France, Germany, UK, US and EU. JETP aims to provide $8.5 billion to South Africa to support the country in decarbonising its economy. While the details of the programme have not yet been finalised, early information suggests that public climate finance could be used to guarantee private sector loans to South Africa, as well as being used to provide loans and equity for private sector investment, ultimately adding to debt levels and undermining South Africa's ability to respond to the climate crisis in the long run.

Providing publicly backed guarantees for private sector loans can, in theory, mean lower interest rates for the borrowing government as the provider of the guarantee takes on some of the risk. However, this has not always been the case. For example, in October 2015 the Ghanaian government borrowed $1 billion though a 15-year dollar-denominated bond. Despite the World Bank guaranteeing $400 million of the repayments, the interest rate on the loan was 10.75%, an exceptionally high interest rate which the IMF referred to as "worse than expected" within the programme.

There are also a number of associated risks with private finance. For example promises of private finance often fail to materialise, meanwhile, the role of private sector finance has also been shown to have harmful outcomes for local populations, such as loss of access to public services, increased user costs and forced displacement. Given the risks outlined, it is concerning that the UK government has been suggesting that this type of programme could be used to fund decarbonisation efforts in other global south countries too.

Risk insurance

Risk insurance refers to a country insuring itself against climate extreme events. It has become one of the dominant methods of providing financial protection against Loss and Damage offered by wealthy countries.

However, insurance is not well suited as a protection against the impacts of the climate crisis. This is because insurance generally works best when risk is unpredictable, diversified and random. This is simply not the case for the climate crisis where climate extreme events are reliably growing in number and frequency. Furthermore, insurance programmes are designed to provide a targeted and financially limited response to fast-onset events in their immediate aftermath, but they are inappropriate for providing ongoing assistance and sustained payments over longer time periods to address slow-onset Loss and Damage events and Non-Economic Loss and Damage. Whilst insurance can be a tool in a diversified toolkit, it is by no means fit for purpose to address Loss and Damage, especially given that such an approach is incompatible with a climate justice understanding of financing for Loss and Damage as it places the responsibility on those who have contributed the least (even when the premiums are subsidised by development actors such as the World Bank).

Furthermore, while insurance policies may not be taken out to cover 100% of Loss and Damage experienced as a result of a climate extreme events

(in part because that would be incredibly expensive to do), insurance schemes often pay out significantly less finance than is required to respond to the scale of need, primarily because they are based on the scale of the event, not the scale of damage caused. For example, the Caribbean Catastrophe Risk Insurance Facility (CCRIF), created with the support of the World Bank in 2007, provides insurance to several countries in the Caribbean region. In 2017, Dominica was hit by hurricane Maria which caused $2 billion worth of damage. While the scheme paid out quickly, the country only received $19 million from the CCRIF, 1% of the total damage, leaving Dominica to cover much of the costs of recovery and reconstruction itself. (Although it is worth noting that in some cases, payout and coverage have been converging).

Between launching in 2007 and 2018, the Caribbean Catastrophe Risk Insurance Facility received $293 million in premium payments from Caribbean governments and grants from donors, but paid out just $131 million in claims, while paying $105 million in profit to private insurance companies. If the premiums and grants had been paid into a public fund to pay out following disasters, far more money would have been available to Caribbean countries.

Recommendations

There has been growing recognition of the need to act on, and consider, debt as a part of efforts to achieve climate justice. At COP26 we heard many leaders from the most impacted countries highlighting the needs to address indebtedness, such as Prime Minister of Barbados Mia Mottley and President of Sierra Leone Julius Maada Bio, but decision makers have still not taken action.

COP27 presents a vital opportunity to raise the importance of debt within key climate spaces, and to push decision makers into action. We urgently need to show decision makers that there is no climate justice without debt justice.

Cancel the debt

- Governments like the G20 and institutions like the IMF and World Bank must provide debt cancellation to free up resources to invest in climate adaptation and mitigation, alongside other national needs.
- The United Kingdom and the United States should introduce legislative reform that compels private sector participation in existing debt relief initiatives.
- In the long-run, an independent multilateral debt workout mechanism should be introduced to serve as a framework to restructure and cancel all debt for any country that needs it.

Cancel the debt when a climate extreme event strikes

- Immediately suspend and cancel the debt of a country when a climate extreme event takes place to free up resources for recovery and reconstruction.

Provide adequate levels of grant-based, new and additional climate finance

- Wealthy polluting governments must provide adequate, better quality, new and additional grant-based climate finance so vulnerable countries are not forced to pay for a crisis they did not create. This includes:
    - Establishing and delivering a new climate finance goal as part of the New Collective Quantified Goal on climate finance
    - Establishing and delivering a Loss and Damage Finance Facility
- Introduce a multidimensional vulnerability index to enable all vulnerable countries to access grants irrespective of income status.

Top tips when advocating for climate justice to include debt justice

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, including for addressing Loss and Damage.

Do: advocate for SDRs to be rechannelled 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) or counted towards official climate finance flows.

Avoid: suggesting that debt cancellation is an alternative to grant-based climate finance.

Avoid: proposing inadequate solutions to both crises which could serve as a distraction from wider calls, and could cause more harm than good.