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Tackling sovereign debt for effective climate action:

TOWARDS A EUROPEAN AGENDA

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This policy brief provides eight recommendations that the EU could pursue to tackle debt sustainability in the Global South and maintain the momentum for ambitious climate action.

There has been no shortage of warnings on the unsustainable debt burden in the Global South. 40% of African countries today are in, or at high risk of, debt distress. This debt crisis is linked to the climate crisis. The effects of climate change push countries to borrow more and drive up the costs of capital, leading to a vicious cycle between sovereign debt and climate risk.

Effective global climate action requires a rapid increase in the mobilisation of international climate finance, as well as fiscal space and affordable capital to implement far-reaching economic reforms. Both are increasingly out of reach for a growing number of countries.

While EU member states only hold some of the cards when it comes to debt restructuring and relief, they can play a role in moving the agenda out of its current deadlock. However, they will need to shift gears in their diplomatic action ahead of COP27, coordinating positions and working towards strong new commitments on debt reform.

Introduction

More than 25 years after the launch of the multilateral Highly Indebted Poor Countries initiative (HIPC), the Global South is facing a new debt sustainability crisis. The debt service obligations of developing countries not only constrain their economic recovery and development, but also limit the prospects for building back better and lower the ambitions for global climate action.

The current debt crisis is linked to the climate crisis. The effects of climate change push countries to borrow more and drive up the costs of capital, leading to a vicious cycle between sovereign debt and climate risk. Five of the top ten countries most at risk from climate change-related disasters are already in debt distress or at high risk of becoming so (IEED 2022). Effective global climate action requires a rapid increase in the mobilisation of international climate finance, yet it also requires fiscal space and affordable capital to implement far-reaching economic reforms and climate mitigation/adaptation measures. Both are increasingly out of reach for a growing number of countries.

Things will get worse with the global fallout of the Ukraine war. Food and energy price shocks are hitting cash-strapped economies harder, increasing the risk of countries defaulting. Sri Lanka was the first country to default on its payments in 2022, and may be followed by Egypt, Tunisia, Ghana and Ethiopia later this year (Donnan at al. 2022).

While there has been no shortage of warnings on the unsustainable debt burden in the Global South and African countries, actions have been slow and incomplete. Multilateral institutions, countries and the private sector will need to move quickly and decisively to tackle debt sustainability in the Global South to maintain the momentum for ambitious climate action. However, this is easier said than done.

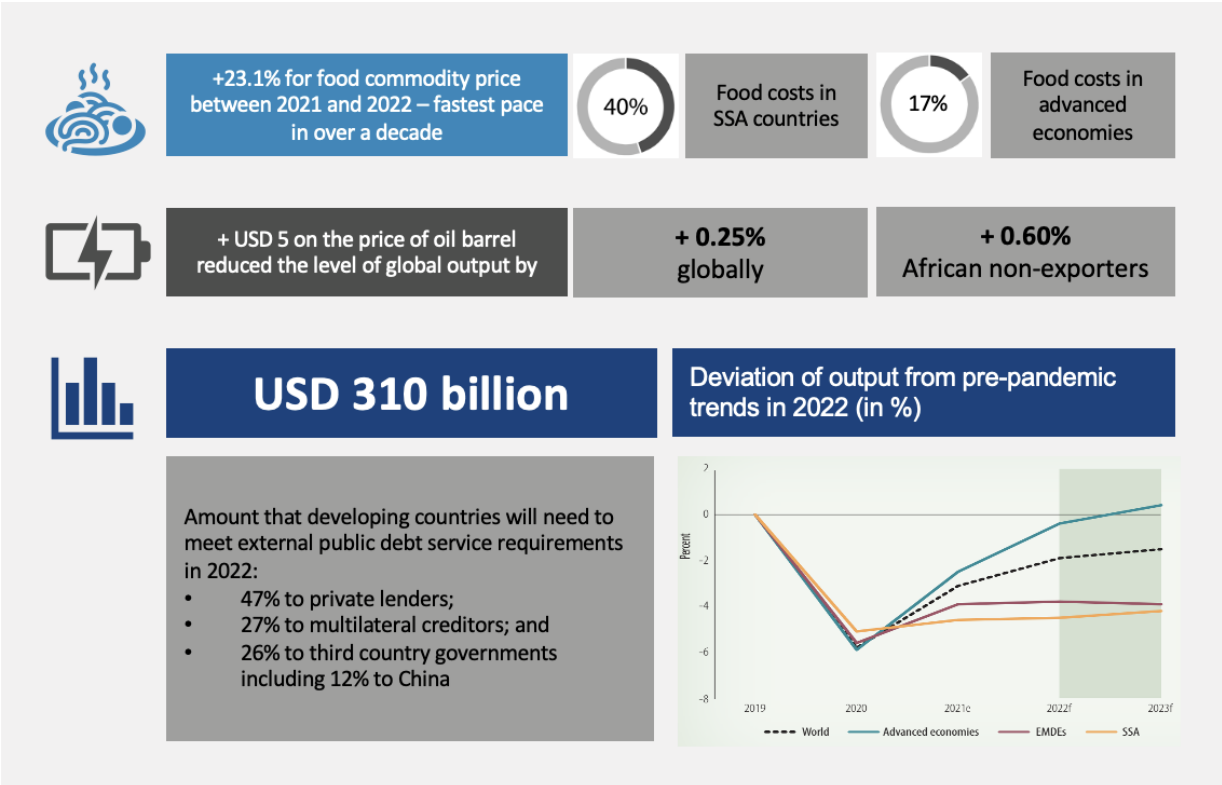
This note takes a closer look at the debt sustainability of African countries, 40% of which are already in, or at high risk, of debt distress (IMF 2022). It examines current multilateral initiatives for debt relief and explores options for a European agenda to tackle sovereign debt for climate outcomes.

1. Starting from the back: Africa’s sovereign debt landscape in 2022

Sovereign debt levels in Africa were on the rise before the COVID-19 crisis. Between 2013 and 2018, the number of countries at high risk of debt distress had more than doubled, from 8 to 18 (World Bank 2018). Countries like the Central African Republic, Chad and Ethiopia entered the pandemic with record levels of sovereign debt (World Bank 2022).[1]

Many African countries further increased their sovereign debt throughout the pandemic in order to mitigate the social and economic impacts of the crisis (Heitzig et al. 2021). Africa is also particularly vulnerable to the economic fallout of the Ukraine crisis through rising food and fuel prices, lower tourism revenues, and potentially more difficulty accessing international capital markets (Georgieva 2022). Weakened growth prospects of emerging markets and developing countries will translate into reduced government revenues and will see the economic recovery of developing countries further lag behind that of advanced economies (Pazarbasioglu and Reinhart 2022; IMF 2022b; World Bank 2021). The relatively stronger US dollar in the first half of 2022 also affects (African) developing countries with weaker currencies, and their capacities to pay back dollar-denominated debt (Stubbington and Duguid 2022).

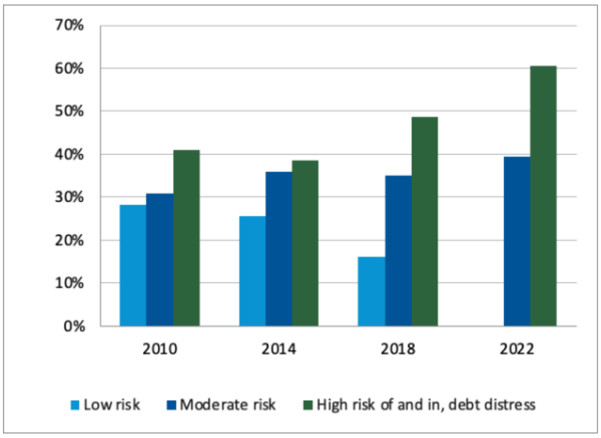
Figure 1: Impact of the Ukraine-Russia conflict on African economies[2]



Source: Data from McNair 2022; McNair 2022a; World Bank 2022a

Debt is not bad per se, but it has to be sustainable. To ensure the sustainability of sovereign debt, loans need to be linked to projects that provide economic (and ideally social and environmental) returns measured with an output multiplier greater than one (Calderón and Zeufack 2020). Debt for consumption is rarely sustainable, it shifts the risks and needs faced today to future government revenues, most of which will be used for servicing debt. Between 2015 and 2020, the external debt service obligations of 16 African countries more than doubled, and the average Sub-Saharan African external debt service to exports ratio increased from 13% to 21% (World Bank 2022b). Today, Ghana, Zambia and Angola are paying more than 25% of their government resources alone, 9.7 % more than in 2015 (Volz et al. 2021). As a result, the average debt-to-GDP ratio of those countries jumped from 49.2% in 2015 to 67.4% in 2020, while 23 African countries are now considered to be at high risk (or already in) debt distress (IMF 2022a) (see figure below).

Figure 2: World Bank and IMF debt sustainability assessment ratings for Sub-Saharan Africa



Source: Based on IMF (2022) and World Bank (2018)

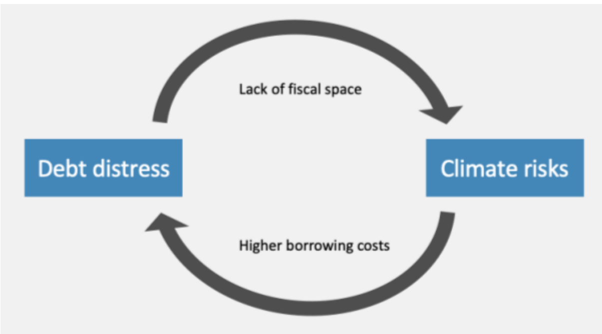
The cost of capital for African countries also continues to go up. During the pandemic, over 60% of African sovereigns suffered from credit-rating downgrades[3], which is the highest regional average (Fofack 2021). Moody's in February downgraded Ghana from B3 to a CAA1 rating[4] (Sovereign 2022). The persistently overinflated risk perception assigned to the region by credit agencies like Standard and Poor's, Moody's and

Fitch has been shown to underestimate African economies' macroeconomic fundamentals and growth prospects (Fofack 2021). These 'perception premiums' severely limits access to affordable capital, putting African countries at a structural disadvantage compared to parts of the world.[5]

1.1. The vicious cycle between debt and climate risks

African countries and economies are disproportionately affected by climate impacts (IPCC 2022). According to a recent estimate, the costs of adaptation in Sub-Saharan Africa alone will be between USD 30 billion and USD 50 billion each year for the next decade (WMO 2021). This will drive governments to further borrow to mitigate climate impacts. The weak sovereign credit ratings and therefore higher costs of most African countries means they are more likely to accumulate unsustainable debt when faced with climate shocks (Buhr et al. 2018). This can lead to a vicious cycle between debt distress and climate risks, where the effects of climate change gradually drive up the costs for countries to build climate resilience in the first place (See Figure 3). Recent analysis has also shown an existing correlation between climate change and the cost of capital, estimating that climate vulnerability increases the average cost of debt of developing countries[6] by 1.17% (Buhr et al. 2018). This so-called 'climate risk premium' is again a self-reinforcing dynamic, as the relatively higher cost of capital for climate vulnerable economies continues to constrain their ability to invest in adaptation and resilience, further increasing their vulnerability to increasingly frequent future climate shocks.

Figure 3: Vicious circle between debt distress and climate risks



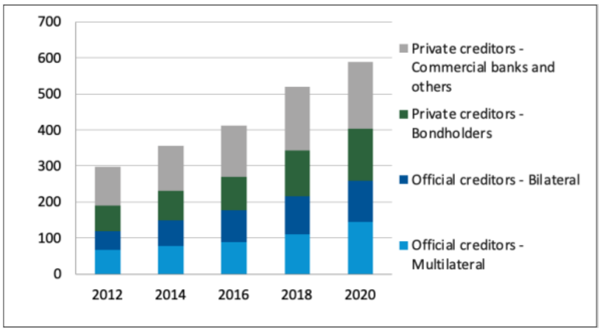
Source: Adapted from Essers et al. 2022

The interactions between climate risk, sovereign debt and the cost of both public and corporate capital are increasingly well understood. Yet climate risk is not systematically factored in traditional debt sustainability tools. The IMF and World Bank's Debt Sustainability Assessment (DSA) is criticised for failing to account for climate or other sustainability risks, and therefore employing overly optimistic scenarios (Volz et al. 2021). Others deplore that it lacks an assessment of the quality of sovereign debt stocks (Ryder 2021). Debt for quality investments resulting in an output multiplier greater than one in terms of economic, social and economic returns should not be assimilated to debt for consumption - going to non-productive assets. This should be considered when assessing debt sustainability.

1.2. A new debt landscape

The debt landscape has radically changed over the past decades. At the start of the Heavily Indebted Poor Countries (HIPC) Initiative in 1996, the Paris Club of 'traditional', Western bilateral creditors accounted for most of the sovereign debt of developing countries. Since then, developing countries have radically diversified their portfolio of creditors, relying heavily on Chinese loans and privately owned debt (through the issuance of bonds in capital markets). Addressing the question of debt sustainability therefore has become infinitely more complex, not only in the amount of bilateral and private creditors, but also in the modalities and terms these lenders apply.

Figure 4: Evolution of the Sub-Saharan debt creditor landscape (in USD billion)



Source: Based on World Bank 2022b

Chinese bilateral loans

Chinese loans have increased considerably in Africa since 2000. Boston University's Chinese Loans to Africa (CLA) Database tracked a total of 1,188 loan commitments worth USD 160 billion with 49 African governments between 2000 and 2020 (Hwang et al. 2022). While Chinese lending peaked in 2013[7] with the launch of the Belt and Road Initiative, the country remains the biggest bilateral lender in Sub-Saharan Africa, accounting for an estimated 62.1% of the region's bilateral external debt in 2020 (Bertrand and Zoghely 2022). Its official and commercial lending has been instrumental to the development of key infrastructure projects in Africa, however, it has also contributed to unsustainable debt accumulation in a number of countries, which might explain the more hesitant approach of Chinese lenders in the pre-pandemic years.

Chinese lending is substantially different from Paris-club lending, which in the past has made it very difficult to associate China to collective debt restructuring efforts. Chinese loans, particularly since 2015 tend to include confidentiality clauses preventing the debtor to reveal the term of the debt contracted (Gelpern et al. 2021). Loan contracts tend to be constructed in a way that maximises their repayment prospects. This includes for example controversial collateralised and resource backed loans[8], using lendercontrolled revenue accounts (Gelpern et al. 2021; Usman 2021), but also so called 'no paris club clauses', which prohibit the borrower from seeking restructuring through any multilateral process. This approach in essence allows China to seek preferential repayment, it is also a decisive rejection of what it calls a "global debt governance system dominated by the 'Paris Club - IMF - World Bank' structure of the West" (Unofficial statement 2021).

Box 1: Debt transparency

While multilateral and Paris Club loans are fairly easy to track, this is not the case for Chinese and other non-Paris Club creditors. This also means that the full extent of the liabilities of developing countries is often unknown, both to (potential) creditors and to credit rating agencies (Pazarbasioglu and Reinhart 2022). The issue of hidden debts also extends beyond bilateral loans to for example the external borrowing by state-owned or guaranteed enterprises, which is not always present in standardised reporting. In addition, the rise of these hidden debts has also led to an increasing number of 'unrecorded' defaults and restructurings of Chinese held debts (Horn et al. 2022). Global debt transparency is a moving target, and in absence of a legitimate and jointly owned global framework, analysts tend rely on partial evidence, even if a growing number of research initiatives[9] is helping to lift the veil off of public debt in developing countries.

China does not eschew debt restructuring, but it has long preferred a bilateral and case-by-case approach. Since the pandemic, China has reportedly cancelled interest-free loans to 15 African countries that were set to mature in 2020[10], and offered up to USD 4.9 billion in repayment deferrals to Angola (CARI 2022). More recently, however, under the G20's Debt Service Suspension Initiative (DSSI), China has suspended over USD 1.3 billion in debt service payments worldwide, including in 16 African countries. China also participates in the Common Framework for debt treatment beyond the DSSI (CF), and recently agreed to participate in the creditor committee for Zambia (Ryder 2022).

Private creditors: bonds and banks

Following the cancellation of most debts owed to traditional creditors under the Heavily Indebted Poor Governments Initiative (HIPC) and Multilateral Debt Relief Initiatives (MDRI) in 2006, many African countries began issuing bonds in international markets to obtain a new line of credit (Sokpoh et al. 2022). In the early 2000s, African 'eurobonds' had low interest rates, yet after the 2008 financial crisis rates started going up, making private debt often more expensive to service than traditional public debt (Mukhopadhyay 2022).

Private creditor lending to Sub-Saharan African countries in 2020 amounted to USD 300 billion in 2020 (World Bank 2022c). Most private creditors - mainly bondholders and commercial banks, are based in G20 countries, and include large investment companies such as JP Morgan, Amundi, Blackrock, Alliance Bernstein and UBS Asset Management. For instance, Blackrock manages at least USD 15.6 billion in developing country bonds, representing 0.2% of its assets under management and returned USD 3.8 billion to its shareholders after making a record profit in 2020 (Vander Stichele 2020).

Private creditors, under the umbrella of the Institute of International Finance (IFF) or the Africa Private Creditor Working Group (AfricaPCWG), have so far declined to participate in debt relief and/or restructuring efforts, despite the calls from civil society organisations and IFIs. In Chad, for example, the World Bank has urged Glencore to participate in the debt restructuring (Diagana 2021). In Zambia, CSOs have called on Blackrock to participate in debt restructuring since the company owns USD 220 million in Zambian bonds (Debt Justice 2022; Inman 2022).

Private creditors are not part of the DSSI, which raises the concern that part of the relief efforts would be used to service private debt (Vander Stichele 2020).

The IFF proposes a voluntary participation (IFF 2022), claiming it maintains countries' access to intentional capital markets, (even if at very high interest rates), and that the contractual, legal, and logistical challenges would make it difficult to involve dispersed private bondholders in debt restructuring (Vander Stichele 2020). Neither the G20 nor the International Monetary Fund / World Bank have managed to secure any more ambitious private creditor involvement, which drives up the cost of multilateral and bilateral restructuring and further constrains efforts for tackling the debt crisis.

2. The limits of the multilateral solutions - an increasingly unavoidable crisis?

While there is increasing awareness of the current debt crisis, the international community's response has been hesitant and partial. Since the pandemic, however, a number of initiatives have been taken in the framework of the International Monetary Fund (IMF) and World Bank, and through the G20. Table 2 below gives a brief overview of the main multilateral initiatives.

Table 1: Overview of multilateral initiatives led by IMF/WB and the G20

Instruments	Description
Debt Service Suspension Initiative - DSSI (G20)	The Debt Service Suspension Initiative (May 2020 to December 2021), and offered temporary debt service suspensions to 73 eligible low and middle income countries. While only 46 of those applied, 31 out of the 37 eligible SSA countries did, generating just up to 1.8 billion in savings in 2020 - far below the USD 5.5 billion initially envisaged (Fuje et al. 2021). In some countries the DSSI allowed generating savings up to 4% to 5% of GDP (Angola, Mozambique and Dem Rep of Congo), the average projected savings for 2020-2021 for all African countries was below 1% of GDP (Fuje et al. 2021). While the DSSI was put in place very quickly, its overall impact fell short of its ambition, partly because private creditors refused to take part (Mukhopadhyay 2022).
Common Framework for debt treatment beyond the DSSI - CF (G20)	The Common Framework for debt treatment beyond the DSSI (CF) introduced in November 2020 aims to provide longer-term debt restructuring for DSSI eligible countries, consistent with debtor's capacity to pay and maintain essential spending needs (Ahmed and Brown 2022). A critical benefit of the common framework was the inclusion of China (and other newer creditors) along with the mostly Paris-club bilateral lenders. In theory, the common framework also calls on private creditors to provide comparable debt relief, yet it is unclear how this can be assured. Since its introduction, only Zambia, Chad, and Ethiopia have requested debt relief under the common framework. Thus far, none of the three countries have been able to complete the process (creditors committees have been formed in Chad and Ethiopia[11]), raising serious questions about the credibility, and political support base of the common framework.

(Re-)allocation of Special Drawing Rights - SDRs (IMF)	In August 2021, the IMF allocated USD 650 billion worth of special drawing rights (SDRs) – the Fund's reserve asset meant to boost its member countries' official reserves and liquidity in times of need. Since SDRs are allocated based on IMF quotas LICs received just USD 21 billion, with the lion's share (USD 375 billion) allocated to advanced economies. China pledged to reallocate 10 billion (25%) of its SDRs to Africa, while France, the G7 and the G20 have expressed the global ambition to reallocate USD 100 billion for countries most in need. This is yet to materialise, and many EU members are slow to strengthen their commitments (Bilal 2022). In April 2022, the IMF set up its Resilience and Sustainability Trust, a structure meant to help rechannel unused SDRs. So far, a total of USD 59.54 billion has been pledged by 13 countries, including five EU Member States (USD 22.7 billion) (ONE 2022). While this can be seen as a positive step, limited progress has been made in exploring alternative delivery mechanisms, for example using multilateral development banks.
The World Bank crisis response financing package (WB)	During the 2022 Spring Meetings, the World Bank announced a USD 170 billion crisis response financing package. This package, to be implemented by June 2023, focuses on supporting countries' fiscal, monetary, financial, social and structural policies and responses to the parallel crises of the COVID-19 pandemic, and the economic fallout of Russia's invasion of Ukraine (World Bank 2022c).

Progress through these multilateral channels has been slow and did not reach the needed (and expected) scale. Over a year after the introduction of the Common Framework, just three of the 73 eligible countries opted for this process, and none has yet completed the process. The SDR reallocation has not reached the scale announced, with less than USD 60 billion pledged out of the USD 100 billion and only 12 countries involved. As a result, African countries seem to be heading towards an unavoidable crisis.

The lack of progress, particularly under the common framework is due to a combination of technical and political issues that create disincentives for both creditors and debtors to engage. Contrary to the name, the common framework essentially operates on a case-by-case basis. There is also no precedent for the common framework, making it more difficult and risky for both creditors and debtors and creditors to engage. On the debtor side, countries fear that engaging in the common framework will downgrade their sovereign credit rating, making it harder for them to access international capital markets. In absence of a stronger coordination between borrowers, the disincentives to ask for restructuring tends to trump the benefits that could come from tackling debt sustainability earlier on.

On the creditor side, China favours bilateral solutions focusing on its own portfolio in a given country. While it responded to Zambia's request to join a common framework creditors committee, overall, it has limited direct incentives to engage with other creditors given that it uses its own set of tools (such as resource-backed loans) to reduce the repayment risk of its country portfolios. This also helps explain why China tends to go with an ad hoc approach to restructuring, independently of Paris Club restructurings (Chorzempa and Mazarei 2021).

Private creditors in turn have almost no incentive to join the common framework on a voluntary basis. On the contrary, high-risk jurisdictions offer potentially very high returns, especially if the bulk of investor risk is taken up by bilateral creditors. Private creditors are among the ones that are paid first in the event of a default. It is therefore highly unlikely that major private creditors will step in the absence of large-scale public pressure or an enforceable framework.

Box 2: When a country defaults, who collects first their due?

When governments borrow money, they are contractually obliged to pay interest and capital on those loans. If a payment is missed, governments (technically and/or contractually) default. Since the 1960s, around 147 governments have at some point defaulted on their debt service obligation (Beers et al. 2020). In the event of a sovereign default creditors will generally be paid in the following order (Schlegl et al. 2019):

1. Private creditors, including bondholders;
2. Senior creditors (often multilateral institutions such as the IMF and World Bank); and
3. Junior creditors (bilateral official creditors, banks and trade credit).

This ranking has been consistent over time, and affects the incentives for creditors to engage in debt restructuring. Private creditors in particular are least incentivised to contribute to collective solutions, an assessment that has been confirmed by the lack of private sector participation in the DSSI and common framework.

While the common framework shows a clear awareness of the more diverse debt landscape of developing countries today, it is very difficult to bring these all together in a way that meets their interests and expectations. While all have an interest in avoiding defaults, private creditors, and to some extent Chinese lenders risk losing out with a more concerted approach, especially one in which Paris club lenders and IFIs exert their dominance. The tools of the trade of the Paris club and IFIs are also not easily applicable to this more diverse landscape, making it very difficult to create a new momentum for collective debt relief.

As multilateral solutions fall short of their stated ambitions, the attention of the international community has all but fully shifted towards the Russian war in Ukraine. EU member states in particular have turned both eastward and inward, as they struggle to mitigate the energy shocks and food price crisis, towering inflation and the risk of further escalation of the war. In terms of external spending, the focus is now firmly on Ukraine and the Eastern neighbourhood, leaving little room for new and ambitious action in the Global South.

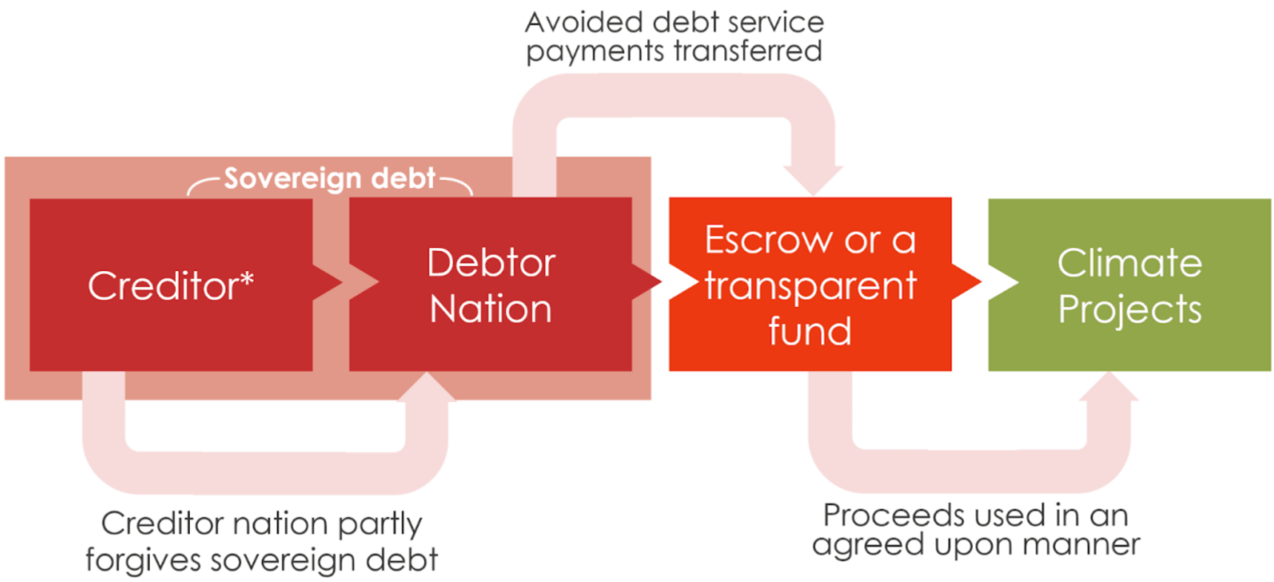
Overall, stakeholders looking to rekindle the multilateral momentum for debt restructuring (HIPC) are faced with not only a more complex sovereign debt landscape (involving new actors with different mandates and incentives), but also an ill-conducive environment for collective action. Multilateral initiatives addressing debt relief as they are designed and implemented, and given their pace of implementation and scale, do not seem to be fit for addressing the looming debt crisis in emerging and developing countries (including Africa), let alone investing in the green recovery.

3. Scaling up climate and nature-specific instruments

In 2020, climate objectives became central to the global economic recovery narrative, especially by the EU, the US, the G20, the IFIs, and the UN system. In practice, they remained peripheral to the overall structures for sovereign debt reform that were set up in the wake of the pandemic. In the margins of the global financial architecture, however, a number of steps were taken to explore a more structural link between climate action and sovereign debt which could set a precedent for future action on debt reform for climate outcomes.

Interest in climate-specific debt interventions, particularly debt-for-climate and debt-for-nature swaps has re-emerged in 2020. Swaps are a way to redirect funds from unsustainable debt servicing towards domestic action, thereby reducing indebtedness while freeing up fiscal space for much-needed green investments. A debt-for-climate swap is an agreement between a debtor country and its creditors, where the debtor gets i) to reduce its sovereign debt by agreeing with the creditor to cancel in full or partially its debt; and ii) redirect the debt service payments - through e.g. a special purpose vehicle (SPV), an escrow account or a trust fund - to finance investment in climate mitigation or adaptation projects (ESCAP75 2021). To ensure that such investments take place, a monitoring, reporting and verification framework is put in place (see figure below).

Figure 5: Debt-for-climate swaps explained



Source: Singh and Widge 2021

The idea of debt-for-climate/nature or debt-for-development swaps emerged in the 1990s. Bilateral Paris Club creditors used swaps to incentivise investments in the environmental, health and education sectors (Essers, 2022). However, the scale of these interventions was limited, and their use over time decreased. A recent critical example took place in Seychelles in 2018, where the government partnered with a private foundation the Nature Conservancy, UNDP and GEF, on a swap of USD 22 million official debt owed to Paris Club members. The swap involved a partial buyback of debt at discounted rates, as well as debt service payments feeding into a local trust that funds marine conservation efforts (Steele and Patel 2021; SSCOE 2019). The Seychelles deal serves as a proof of concept for the climate action community, and is often cited as a scalable example.

In 2021, the IMF put swaps back on the agenda with a commitment to work with the World Bank to 'advance' the option of debt-for-climate swaps ahead of COP26 (Shalal 2021). While this was warmly welcomed by civil society and climate activists, the institutions are yet to deliver a proposed workable architecture for green debt swaps (Shalal 2021a). In the past two years, civil society organisations have sought to facilitate the scaling up of debt-for-climate swaps by making technical proposals and guidelines. Notable examples include the Climate Policy Initiative's 'blueprint' for debt-for-climate swaps (Singh and Widge 2021), IIED's Guide for linking sovereign debt to climate and nature action (IIED et al. 2021), and SOAS' proposals for Brady-bond like transactions based on a climate-enhanced debt sustainability assessment (Volz et al. 2021). Several concrete initiatives are also underway. The Nature Conservancy worked with Belize on an upscaled swap following the Seychelles example (Owen 2022), which reduced the country's external debt by a significant 10`% of GDP (Owen 2022). The IIED is also working on designing concrete debt swap options with four West African countries: Cabo Verde, Guinea Bissau, Senegal and Mauritania (Kelley 2022).

Box 3: Blue and green bonds as part of the debt-for-climate swap modality.

The Seychelles and Belize swaps include a blue bonds scheme, which is a debt instrument earmarked for marine projects such as promoting biodiversity or contributing to sustainable fisheries. In both cases, the blue bonds came with a guarantee covering the interest payments, minimising risks for investors. Green bonds increasingly generate interest from development finance institutions (DFIs) and governments, for their potential to mobilise private capital towards (long-term) investments in the green recovery. Developing countries and emerging markets increasingly issue green bonds, creating a market that is forecasted to reach over USD 100 billion by 2023, more than double the USD 40 billion in 2020 (Dembele et al. 2021[12]). Development partners and international financial institutions (IFIs) actively support the development of the Green bond market in SSA countries, for example with the forthcoming EU Global Green Bond Initiative, as announced under the Global Gateway (EC 2022).

Debt-for-climate swaps in perspective

Debt-for-climate swaps have the potential to contribute to a global green and economic recovery and address climate change. They can help creditors strengthen their position and leadership in the sphere of climate finance, and offer an additional political incentive for international and European lenders to engage in a more ambitious debt relief agenda.

Using swaps as a climate-specific instrument, however, has a number of critical effects. Scaling up the use of debt swaps for climate outcomes can be counted as part of the developing countries' commitment to invest annually USD 100 billion in climate mitigation and adaptation in developing countries (ESCAP75 2021). A key risk therefore is that swaps become a substitute for fresh climate finance rather than an additional measure.

In addition, the focus on green / climate may not necessarily reflect domestic priorities for public expenditure, which are often more linked to social and economic transformation. This is often echoed by African stakeholders, some of which perceive this focus on green transition and climate action as a form of carbon colonialism (Ramachandran 2021), effectively claiming natural space in the developing world for reducing global emissions. In order to better link up to African and developing country priorities, international and European creditors could consider swaps with a larger scope including social and economic transformation objectives, ensuring that a debt swap for 'building back better' does not substitute other initiatives and commitments.

Looking at debt-for-climate swaps as major debt sustainability measure also comes with a number of technical difficulties, including:

- Debt-for-climate swaps tend to be small in scope and while they can have a key impact on climate outcomes, they tend to have a limited impact on the total debt burden of developing countries in question (Essers et al. 2022),
- Debt-for-climate swaps do not always build on existing mechanisms and structures. In some cases, they require the creation of highly complex parallel project structures, bypassing debtor's policies and systems.
- To create fiscal space, debt swap instruments require significant discounts and an adapted debt service schedule, which may not always be available.
- It is not always clear whether debt swaps generate additional resources for climate action in comparison to what governments had already planned. Essers et al. (2021) also highlight the risk of "greenwashing", i.e. presenting already budgeted climate activities as new projects.
- A debt swap could crowd out other sources of finance (such as ODA) that in some contexts may be more effective than a debt-for-climate swap instrument (ESCAP75 2021).

Debt swaps, therefore, are not a silver bullet for effective climate action in the context of debt distress. Given their generally limited scope and interest of creditors in this instrument (Shalal 2021a), they are also not an alternative for comprehensive debt restructuring for countries that face an acute risk of default. In small island developing states (SIDS) and (smaller) LICs like the Seychelles and Belize, they are seen to play a role in liberating funds for conservation and climate change adaptation, an experience that might be replicated in the Pacific (ESCAP75 2022). Beyond small economies they are perhaps best suited as a climate specific complementary measure, and specifically in middle income countries which do not have access to debt restructuring under for example the Common framework (Singh and Widge 2021).

One way to scale debt swaps is to use a system of green brady bonds, building on the experience of Latin American countries where USD 60 billion debt was forgiven in the 1990s (Vásquez 1996), and bringing private creditors into the debt restructuring process (Qian 2021; Weder Di Mauro 2021 Volz et al. 2021). In short, under a brady-style debt swap, indebted countries would be supported (partially guaranteed) to set up green brady bonds. Public and private creditors would then swap their bonds for these green brady bonds at a heavy discount, creating fiscal space for countries to spend on climate action (Weder Di Mauro 2021). Overall, while expectations for scaling debt swaps are high, the IMF and World Bank have been slow in proposing a framework for debt-for-climate swaps (Shalal 2021a). At the same time, privately-driven precentedents show that debt swaps can play a key role for climate and nature outcomes. While they should not become the central offer of international climate finance, they should be seen as part of a menu of climate interventions, to be used as a key additional measure.

4. Towards a European agenda on global green recovery and sovereign debt reform

While analysts and CSOs have raised the alarm since the start of the COVID-19 pandemic, progress on debt relief has been painstakingly slow, and the traditional coalitions and multilateral organisations appear to be unable to effectively address the changing global environment for sovereign debt.

If the EU wants to lead the pack on global climate action and climate finance, it will need to respond to the debilitating effects of debt distress in many developing countries. A structural lack of fiscal space can delay or severely limit the necessary domestic reforms and public investments for a green transition. This will eventually limit the returns and scalability of European green investments in developing countries, and lower the credibility of the EU as a global climate actor.

Timing is of the essence - the likelihood of developing country defaults increases as time goes by. Short-term measures can create temporary respite, yet rapid progress is needed to breathe new life into the multilateral debt relief agenda in order to avoid a new swathe of defaults. With COP27 around the corner, the EU and developed countries will need to address the failure of COP26 to respond to developing countries' demands. A forward-looking approach to global climate finance should include a response to debt distress in developing countries, and specifically Africa, where the EU has strong developmental as well as commercial interests in a swift and effective green transition.

At the same time, it is clear that the EU member states only hold some of the cards in this game[13]. Debt relief efforts since 2020 have been plagued by a severe collective action failure among both public and private creditors. EU actors can play a role to move the agenda out of its current deadlock, but they will need to shift gears in their diplomatic action ahead of COP27, coordinating positions and working towards strong new commitments on debt reform. They will also need to send a clear message on the need for private sector participation.

EU member states have a particular interest in:

1. **More effectively addressing short-term needs:** Rechanneling SDRs can provide in the short-term relief in the form of liquidity and balance of payment support. EU member states should rapidly meet their stated commitments, and push for innovative thinking on the mechanisms for rechanneling the SDRs beyond the IMF's Resilience Sustainability Trust, and through Multilateral Development Banks.

2. **Building a long-term vision and commitment for debt relief and reform of the international financial architecture**: The common framework provides an architecture that is available now, but it is held back by strong disincentives on both the creditor and debtor side. To avoid losing momentum, EU actors should seek new high-ambition coalitions for linking debt interventions with global climate action objectives, and work to address the administrative and political barriers within and beyond the international financial institutions for ambitious debt relief. This includes reforming debt sustainability assessments, accounting for a climate risk dimension, but also addressing the perverse effects of the dominant sovereign credit rating systems.

3. **Working with China towards a jointly owned agenda for debt restructuring:** while China is willing to participate in the G20's DSSI and common framework, it has little interest in participating in a Paris club and IMF/WB's led process. Instead of trying to bring China into existing debt governance structures, European creditors should work with China to design a new system for tackling debt sustainability collectively from the start.

4. **Rethinking the role of private creditors in debt restructuring**: Private creditors have thus far refused to take part in multilateral debt relief. The EU and member states could explore reform measures to incentivise or push private creditors to engage, including: encouraging or even mandating public disclosure by private creditors and bondholders and creating new mechanisms for public-private dialogue and collective action on debt restructuring; and supporting civil society organisations applying pressure on private creditors failing to take part in effective debt restructuring.

5. **Working with the IMF and World Bank to develop and use climate-specific debt instruments**: EU member states should work through the World Bank and IMF to operationalise debt for climate/nature swaps and exert pressure on the IMF to deliver its long-awaited architecture for debt swaps ahead of COP27. EU member states should also coordinate their positions and messaging on the need for climate-specific debt interventions in various other coalitions including the G20, and UNFCCC.

6. **Contributing to the implementation of debt swaps:** The EU and member states can help scale up debt for climate swaps, by using the EFSD+ under its External Action Guarantee (EAG), or member state mechanisms to cover interest payments of green bonds, de-risking the participation of creditors[14]. When supporting debt swaps, the EU and its Member States should prioritise using existing structures to help partner countries build their capacities both in managing debt and also investing in climate/nature.

7. **Supporting African and developing countries' agency in debt reform discussions:** Debt restructuring is traditionally a creditor-driven process that does not always take full account of the debtors' needs and priorities. To create a new momentum for ambitious debt reform, new initiatives should radically strengthen the capacity of African partners to engage in restructuring negotiations, and work with African institutions to develop a jointly owned agenda. This is critical for the sustainability, but also the credibility of any future debt intervention. Climate-specific instruments are even more dependent on country ownership, and should therefore not be presented as a top down form of conditionality, but as a collaborative way to address a common agenda. This also means aligning to debtor country priorities where possible and working through existing country structures.

8. **Strengthening EU leadership on climate finance:** Debt-for-climate/nature instruments should not be a substitute to EU climate commitments, but part of a radically more ambitious external climate finance agenda. Ahead of COP27, the focus should be on securing new commitments that can help regain the trust of developing countries, and strengthen the credibility of the EU in this field and its influence. The EU can mobilise a wide range of European actors, including the EIB, which is a leader in climate finance, and the experience of its Member States in greening their economy in a way that is both financially and environmentally sustainable.

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Endnotes

[1] The external debt stock in Sub-Saharan Africa increased on average by 57.4% between 2015 and 2020, reaching USD 702 billion in 2020 with heavily indebted poor countries like Senegal or Benin experiencing the largest increases (Heitzig at al. 2021). As a result, the average debt-to-GDP ratio of those countries jumped from 49.2% in 2015 to 67.4% in 2020, while 23 African countries are now considered to be at high risk (or already in) debt distress (IMF 2022a). While more recent data is not yet available, these trends are likely to be reinforced in 2021 and 2022.

[2] While this paper looks at the dynamics in Africa as a whole, a lot of the available statistics, particularly from the World Bank and the IMF continue to delink Sub-Saharan Africa and group North Africa with the Middle East. This provides a skewed image of African economic development, yet requires a broader methodological shift in research and institutions to address.

[3] Rating agencies also cautioned African countries against adopting large pandemic stimulus packages (Landers and Aboneaaj 2022).

[4] The decision was contested by Ghana (Ministry of Finance of the Republic of Ghana 2022), and while S&P maintained its B rating, the move still led to a fall by 3.4 cents on the dollar of some of Ghana's sovereign bonds and risks locking the country out of more affordable international capital markets.

[5] To address these so-called 'perception premiums' the African Union plans to set up an independent African Credit Rating Agency to provide alternative and complementing rating opinions for the continent (Sovereign 2022).

[6] Based on a sample of 25 developing countries across the world. See Buhr et al. 2018.

[7] Controlling for Angola, the continent's single largest Chinese borrower, which peaked in 2016. See Hwang et al. 2022.

[8] Resource-backed loans commit a borrowing country's future resource revenues to secure repayment.

[9] These include the AidData research lab at *William & Mary's Global Research Institute* (global), the China Africa Research Initiative at John Hopkins University (Africa) and more recently also *the China Overseas Finance Inventory Database* developed by Boston University in collaboration with WRI, all of which aims to address the lack of data on Chinese loans and investments in developing countries.

[10] Chinese interests-free loans tend to be small, and account for less than 5% of Africa's debt to China.

[11] Following the 2022 International Monetary Fund/World Bank Spring Meetings, China announced that it would participate in the creditor committee of Zambia, which is a step forward in terms of coordination between the Paris Club and non Paris Club creditors (Savage and Do Rosario 2022).

[12] African countries', including Ghana (African Markets 2021) and Benin (Caumes and Merle 2021) are also launching more general social and sustainability (SDG) bonds.

[13] Looking at the current state of play there is a need for further and in-depth analysis of the political economy of European positions and agendas in various fora (Bretton Woods Institutions, Paris Club, G20 and G7). There is also a need for better understanding the specific concerns and disincentives of EU member state treasuries, banks, DFIs, private creditors and how they might be overcome.

[14] The blue bond issued as part of the 2018 Seychelles debt swap was partially guaranteed up to USD 5 million by the World Bank.

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