ANOTHER LOST DECADE OR A DECADE OF ACTION?

Debt Relief for a Green and Inclusive Recovery

MARINA ZUCKER-MARQUES AND ULRICH VOLZ

DEBT RELIEF FOR A GREEN & INCLUSIVE RECOVERY

ABOUT

A debt crisis is emerging in the Global South at the precise moment when substantial investment is needed to meet shared climate and development goals. Yet, the G20 Common Framework has been unable to engage all creditor classes or link debt relief to climate and development.

The Debt Relief for Green and Inclusive Recovery (DRGR) Project, a collaboration between the Boston University Global Development Policy Center, Heinrich-Böll-Stiftung and the Centre for Sustainable Finance at SOAS, University of London, argues it is time for comprehensive debt reform. Utilizing rigorous research, DRGR seeks to develop systemic approaches to both resolve the debt crisis and advance a just transition to a sustainable, low-carbon economy in partnership with policymakers, thought leaders and civil society from around the world.

PROJECT CO-CHAIRS

Shamshad Akhtar, Former Governor of the State Bank of Pakistan and Finance Minister of Pakistan

María Fernanda Espinosa, Politician, Diplomat and Human Rights Advocate

Kevin P. Gallagher, Professor of Global Development Policy at the Frederick S. Pardee School of Global Studies and Director of the Boston University Global Development Policy Center

Jörg Haas, Head of International Politics at the Heinrich-Böll-Stiftung

Yuefen Li, Senior Advisor on South-South Cooperation and Development Finance at South Centre

Ulrich Volz, Professor of Economics and Director of the Centre for Sustainable Finance at SOAS, University of London; Senior Research Fellow at the German Institute of Development and Sustainability; and Visiting Professor at the London School of Economics and Political Science

Anzetse Were, Senior Economist at Financial Sector Deepening Kenya

BU Global Development Policy Center

HEINRICH BÖLL STIFTUNG

Centre for Sustainable Finance
SOAS University of London

DR GR

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EXECUTIVE SUMMARY

Climate-related shocks are becoming more frequent and severe. More than ever, countries must invest in climate resilience and just transitions, but for many emerging market and developing countries (EMDEs), high debt burdens put achieving climate and development goals out of reach.

Will the 2020s be a decade of action to achieve shared climate and development goals, or will it amount to another lost decade of development?

The Debt Relief for Green and Inclusive Recovery (DRGR) Project has developed a proposal that is in many ways a modern-day version of the Brady Plan and the Highly Indebted Poor Countries (HIPC) Initiative of the 1990s combined. Eligibility for debt relief should depend on the level of a country's debt vulnerability, as determined by an enhanced Debt Sustainability Assessment (DSA) carried out by the International Monetary Fund (IMF) and the World Bank, with inputs from other institutions. DSAs should be enhanced by basing them on realistic assumptions and accounting for climate risks and critical spending needs for climate resilience. Governments receiving debt relief would need to commit to reforms that align their policies and budgets with the SDGs and the Paris Agreement on climate change. The DRGR proposal consists of three pillars:

1. **Public creditors** should grant significant debt reductions that not only bring a distressed country back to debt sustainability but put the country on a path to achieving development and climate goals—in a manner that preserves the preferred creditor status and AAA credit ratings for participating international organizations.
2. **Private bondholders and commercial creditors** should grant a commensurate debt reduction with public creditors. These creditors would be compelled to enter negotiations through Brady bonds backed by a guarantee fund and a payments standstill.
3. **For countries not in debt distress but that lack fiscal space**, credit enhancement should be provided by international financial institutions to lower the cost of capital for a green and inclusive recovery.

The DRGR proposal is designed to address the immediate challenges facing indebted EMDEs, while providing a stepping-stone towards establishing a new global debt architecture that is fair, transparent, efficient and cognizant of the needs of EMDEs. It should be part of a package of new liquidity, grants and concessional finance and is not a substitute for a permanent sovereign debt workout mechanism and deeper reform of the global financial architecture.

Marina Zucker-Marques *is a Postdoctoral Research Fellow at SOAS, University of London and a Researcher for the Debt Relief for a Green and Inclusive Recovery Project.*

Ulrich Volz *is Professor of Economics and Director of the Centre for Sustainable Finance at SOAS, University of London; Senior Research Fellow at the German Institute of Development and Sustainability and Visiting Professor at the London School of Economics and Political Science.*

Based on analyses by the International Monetary Fund (IMF) (2023) and the United Nations Development Programme (UNDP) (2023), the DRGR Project has identified 61 EMDEs that are particularly vulnerable to debt distress and will need $812 billion in debt restructured across all creditor classes (Ramos et al. 2023).

With a clean balance sheet, countries can unlock new investment to achieve the UN 2030 Sustainable Development Goals (SDGs) and the Paris Agreement on climate change. The development story of the 2020s can still be written.

DEVELOPING COUNTRIES: BETWEEN A ROCK AND A HARD PLACE

Climate-related shocks are becoming more frequent and severe throughout the world, bringing devastating humanitarian, ecological and economic consequences (IPCC 2023, OECD 2015). Although developing countries have contributed relatively little to climate change, these countries are bearing the brunt of the ecological crisis as they are often more vulnerable to shocks and lack adequate resources to address environmental challenges (UNCTAD 2021, Georgieva et al. 2022).

Fostering green and sustainable development has never been so urgent, but with debt overhangs and limited fiscal space, many developing countries cannot make the investments necessary to safeguard and stabilize their economies. According to the Independent High-Level Expert Group on Climate Finance, emerging markets and developing economies (EMDEs) excluding China need $1 trillion in external finance per year by 2025 to accomplish the targets in the Paris Agreement on climate change and achieve the UN 2030 Sustainable Development Goals (SDGs) (Songwe et al. 2022). Concomitantly, about two-thirds of low-income countries have high risk of debt distress or are already in debt distress (IMF 2023a). Rising debt risks is not restricted to the poorest nations (UNDP 2023, Ramos et al. 2023).

Although the G20 Common Framework for Debt Treatments is an important effort for coordinating international debt relief, it is currently unfit for purpose. The Common Framework, as it stands, has proven to be slow, excludes middle-income countries and has failed to attract the participation of all creditors. Several key reforms to the Common Framework are needed to transform it into a mechanism that efficiently solves the debt crisis amid increasingly damaging climate events.

THE DEBT RELIEF FOR GREEN AND INCLUSIVE RECOVERY PROPOSAL

The Debt Relief for Green and Inclusive Recovery (DRGR) proposal is an ambitious, concerted and comprehensive debt relief initiative—to be adopted on a global scale—that frees up resources to support sustainable recoveries, boost economic resilience and foster just transitions to a low-carbon economies (Volz et al. 2020, 2021; Ramos et al. 2023).

The DRGR proposal argues that eligibility for debt relief should depend on the level of a country's debt vulnerability, as determined by an enhanced Debt Sustainability Assessment (DSA) carried out by the International Monetary Fund (IMF) and the World Bank, with inputs from other institutions. DSAs could be enhanced by basing them on realistic assumptions and accounting for climate risks and critical spending needs for climate resilience.

If a DSA asserts that the sovereign debt of a country is of significant concern, the G20 should coordinate with all bilateral and multilateral creditors on restructuring the debt, while any IMF programs that may be applied should be conditional on a sovereign debt restructuring that involves private creditors on a comparable basis.

Governments receiving debt relief would need to commit to reforms that align their policies and budgets with the SDGs and the Paris Agreement on climate change. The DRGR Project urges that any reforms tied to debt restructuring be based on the debtor country's own strategies and priorities, rather than imposed by the global community. To that end, countries undergoing debt restructuring would advance their own Green and Inclusive Recovery Strategy (GIRS), a concise document informing policy priorities with key performance indicators that it seeks to achieve. Importantly, the GIRS would build on already existing national strategies, plans and visions, including National Development Plans; National Sustainable Development Strategies; nationally determined contributions (NDCs) and National Adaptation Plans, among others.

The DRGR proposal consists of three pillars aimed at achieving maximum creditor and debtor participation.

As illustrated in Figure 1, the first pillar includes comprehensive debt relief for eligible heavily indebted countries by public creditors that is analogous to, but improves upon, the Heavily Indebted Poor Countries (HIPC) Initiative of the 1990s. For the second pillar, commercial and private sector creditors would swap old debt holdings with a significant haircut for new Green and Inclusive Recovery Bonds—a type of sustainability-linked debt. Finally, the

Figure 1: Three Pillars for Debt Relief for a Green and Inclusive Recovery

Source: Debt Relief for a Green and Inclusive Recovery Project, 2023.

third pillar allows for debt-for-climate or debt-for-sustainability swaps for countries that are not heavily indebted but have reduced fiscal space.

Any new debt issued by countries participating in the DRGR proposal could receive Brady-type credit enhancement. In exchange for commitments to dedicate debt receipts to SDG-aligned spending items, debt repayments would be secured by a guarantee facility. In case of a missed payment, the guarantor would step in to service the debt in the first instance, and later would be repaid by the sovereign. A credit enhancement mechanism would support countries to continue maintaining access to international capital markets, while ensuring new debt is channelled towards achieving shared climate and development goals.

CHARTING A PATHWAY TO SUSTAINABLE DEVELOPMENT

Based on analyses by the IMF (2023) and the United Nations Development Programme (UNDP) (2023), we identify 61 EMDEs that are particularly vulnerable to debt distress and will need $812 billion in debt restructured across all creditor classes (Ramos et al. 2023). Some of these countries, like Sri Lanka and Argentina, are middle-income countries and would not qualify for the G20 Common Framework as it stands now. For these 61 countries, termed "New Common Framework" countries, public and publicly guaranteed debt stock accounts for $812 billion. These countries will initially need a suspension of their debt service while a haircut on their debt in the range of $317 billion to $520 billion is negotiated. Drawing on the historical level of haircuts in the "modern era" (1980-2016), and the more generous level of debt reduction provided under the HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI), we estimate that these 61 countries need debt relief ranging from $317 billion to $520 billion, of which approximately 55 percent would have to be borne by private and commercial creditors, while the remaining 45 percent by official and multilateral lenders.

BACKING UP MULTILATERAL LENDERS AND ESTABLISHING A GUARANTEE FACILITY

For some debt vulnerable countries, sovereign debt is owed mostly to multilateral creditors, meaning their involvement in the debt relief process is essential to alleviating debt burdens. Considering the crucial role multilateral creditors play in financing development, a debt relief process should safeguard their preferred creditor status and AAA credit rating. Multilateral institutions could be backed up by a combination of bilateral contributions—including through the rechannelling of IMF Special Drawing Rights (SDRs)—and internal resources (e.g., a portion of their operational results).

Beyond supporting multilateral creditors, the DRGR proposal foresees the pooling of resources for a guarantee facility supporting debt relief in developing countries. This could either be a new facility, potentially hosted by the World Bank, or the existing Debt Relief Trust Fund that supported the HIPC Initiative and the MDRI. According to our estimates, a fund of about $37.1 billion to $61.9 billion is needed to support debt restructuring for the 61 New Common Framework countries.

As of March 2023, developed countries and China hold more than $650 billion equivalent in SDRs (accumulated holdings) (IMF 2023b). Some of these SDRs could be rechannelled to a guarantee facility, or the World Bank could raise additional resources through the issuance of perpetual SDR-denominated bonds (Paduano and Setser 2023). Perpetual SDR-denominated bonds, which could be also bought by private investors, have several advantages, including bypassing the bureaucratic process of SDR rechannelling and creating new reserve-like assets that could be held by central banks.

Moreover, as in the case of the HIPC Initiative, multilateral institutions could sell part of their gold reserves to finance their share of debt relief. The IMF holds around 90.5 million ounces in gold, which by market prices is valued at over $160 billion (IMF 2022). Resources are available, but political will from shareholders of international financial institutions is needed to support developing countries.

Tackling the debt crisis is vital to enabling EMDEs to realize their development goals and invest in critical climate action. Mobilizing private capital for development will be impossible in the face of a debt crisis. Supporting comprehensive debt relief for green and inclusive recoveries will yield new possibilities for development and enable a "decade of action," rather than another lost decade of development.

With a clean balance sheet, countries can unlock new investment to achieve the SDGs and the Paris Agreement on climate change. The development story of the 2020s can still be written.

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