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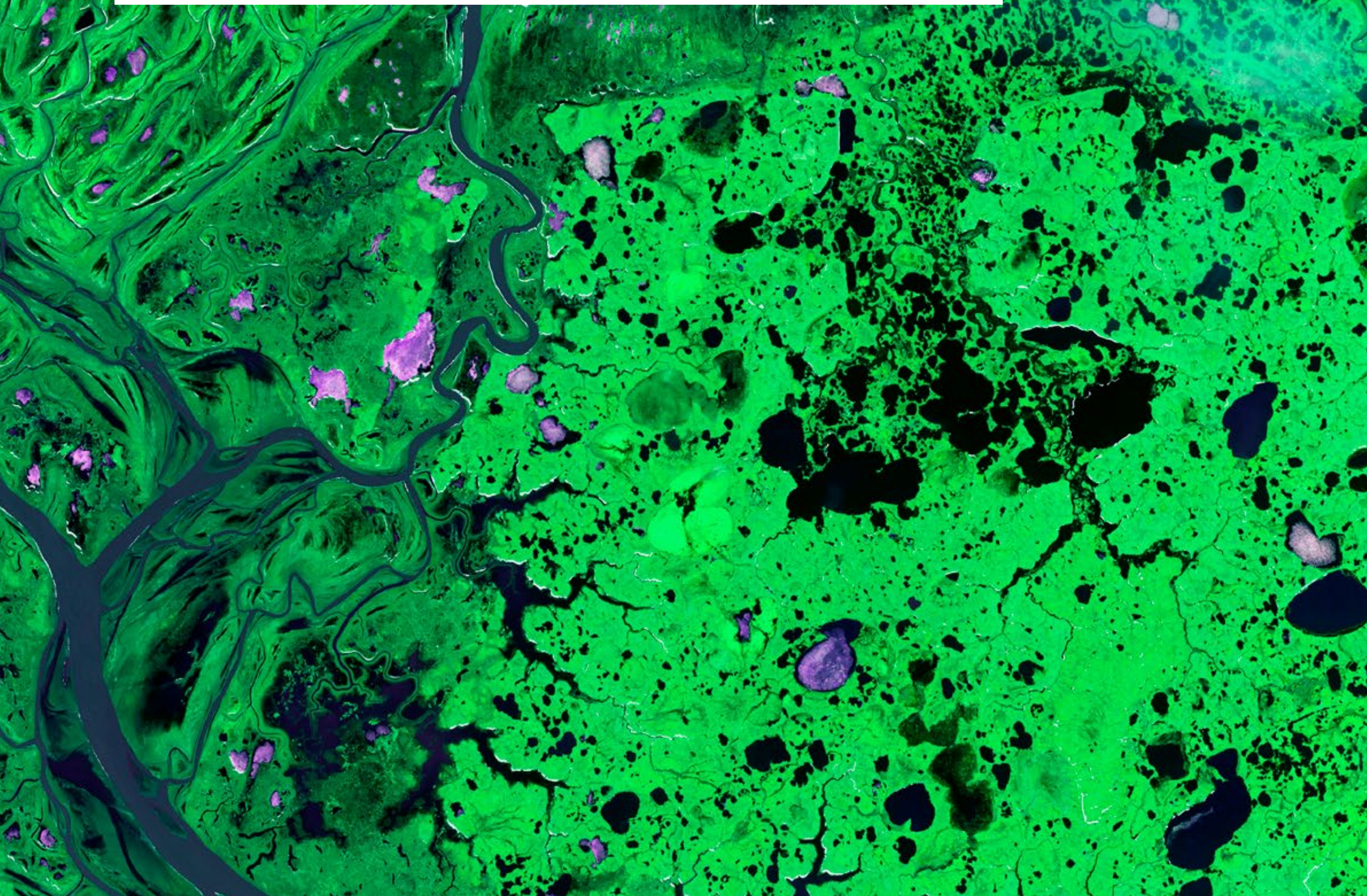
Debt Relief for a Green and Inclusive Recovery

A Proposal

November 2020



Debt Relief for a Green and Inclusive Recovery

A Proposal

By Ulrich Volz, Shamshad Akhtar, Kevin P. Gallagher, Stephany Griffith-Jones, Jörg Haas, with a contribution by Moritz Kraemer

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Contents

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Abbreviations

CPI	Climate Policy Initiative
CRA	credit rating agency
CSIR	Council of Scientific and Industrial Research
DDE	distressed debt exchange
DSSI	Debt Service Suspension Initiative
ECLAC	Economic Commission for Latin America and the Caribbean
F4BI	Finance for Biodiversity Initiative
G20	Group of Twenty
G30	Group of Thirty
GDP	gross domestic product
Gt	gigatonne
HIPC	heavily indebted poor country
IDA	International Development Agency
IEA	International Energy Agency
IIF	Institute of International Finance
IMF	International Monetary Fund
MDRI	Multilateral Debt Relief Initiative
NDC	nationally determined contribution
NPV	net present value
OECD	Organisation for Economic Co-operation and Development

PRSP	Poverty Reduction Strategy Paper
PSI	private-sector involvement
SDR	Special Drawing Right
SEI	Stockholm Environment Institute
TEG	Technical Expert Group on Sustainable Finance
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNEP	United Nations Environment Programme
UNFCCC	United Nations Framework Convention on Climate Change

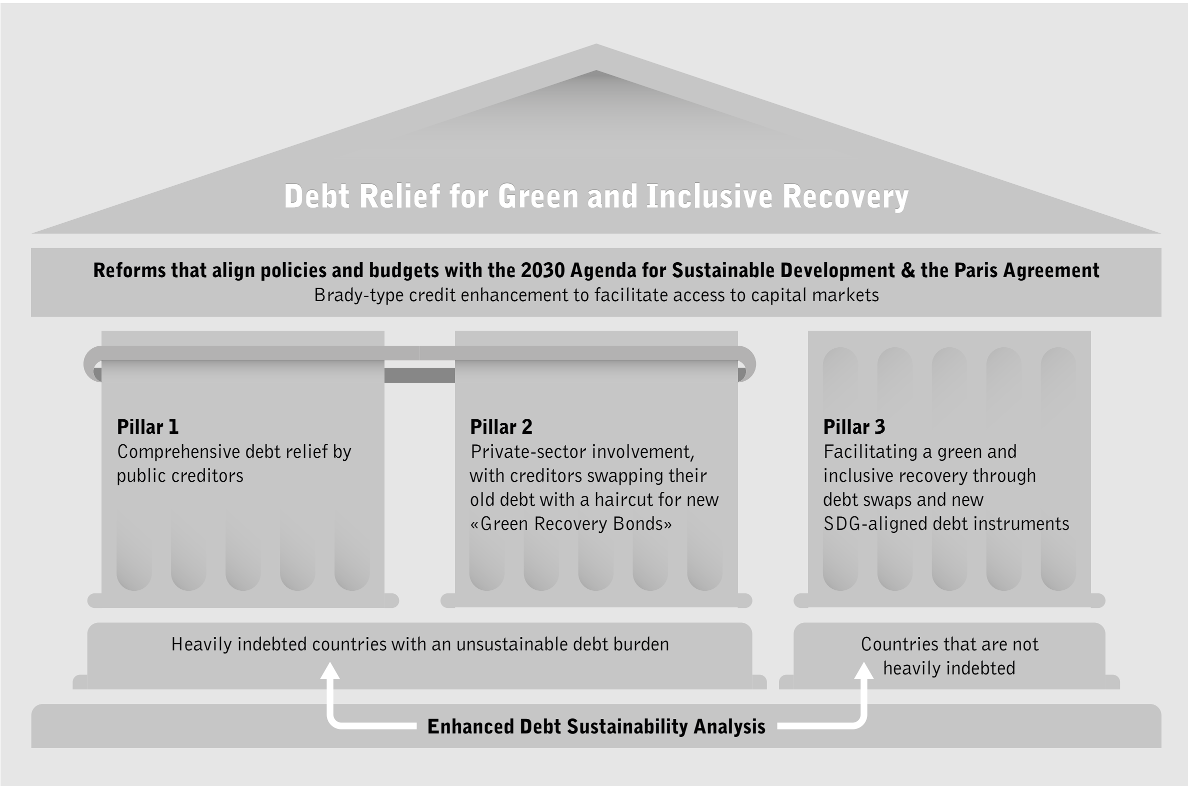
Key Elements of the Proposal

To enable a green and socially just recovery for all countries, public debt problems need to be urgently addressed so that all governments have the fiscal space to finance crucial health and social spending and invest in a green and inclusive recovery.

We propose a Debt Relief for Green and Inclusive Recovery Initiative as an ambitious, concerted, and comprehensive debt relief initiative – to be adopted on a global scale – that frees up resources to support recoveries in a sustainable way, boosts economies' resilience, and fosters a just transition to a low-carbon economy.

Eligibility should be a function of debt sustainability, which should be determined in a Debt Sustainability Assessment carried out by the International Monetary Fund (IMF) and the World Bank, with inputs from other institutions. Debt Sustainability Assessments need to be based on realistic assumptions and account for climate risks.

If a Debt Sustainability Assessment asserts that the sovereign debt of a country is of significant concern, the G20 should coordinate with all bilateral and multilateral creditors about a debt restructuring, and the IMF should make its programmes conditional on a sovereign debt restructuring involving private creditors.



Governments receiving debt relief would need to commit to reforms that align their policies and budgets with the 2030 Agenda for Sustainable Development and the Paris Agreement. Our proposal consists of three pillars and aims at achieving maximum creditor and debtor participation:

Pillar 1: Comprehensive debt relief for eligible heavily indebted countries by public creditors that is analogous to, but improves upon, the HIPC Initiative.

Pillar 2: Private-sector involvement, with private creditors swapping their old debt holdings with a haircut for new «Green Recovery Bonds».

Pillar 3: Debt-for-climate or debt-for-sustainability swaps for countries that are not heavily indebted, but have reduced fiscal space due to Covid-19.

Any new debt issued by countries participating in the Debt Relief for Green and Inclusive Recovery Initiative could receive Brady-type credit enhancement, which would help countries to continue to have access to international capital markets.


Bangladesh

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Executive Summary

The Covid-19 crisis is the biggest threat to human prosperity in close to a century. Many emerging markets and developing economies are facing grave difficulties in obtaining the fiscal space to combat the virus, protect the vulnerable, and mount a green and inclusive recovery. Not only has the global economic slowdown hampered the ability of many developing nations to mobilise resources, many are using 30% to 70% of what little government revenue is coming in to service debt payments. This report calls for a global debt relief effort to grant emerging markets and developing countries in need the space necessary to fight the virus and put together a green and inclusive recovery.

The Group of 20 (G20) were swift to act in the early months of the crisis by establishing the Debt Service Suspension Initiative (DSSI), which is now suspending debt service payments for a group of low-income countries through the first half of 2021. However, the standstill under the DSSI is merely provided some breathing space, but it did not address the core problems: It did not lead to a net reduction of debt, and it did not involve private creditors, who are holding large chunks of developing-country debt. Although it was an important first step, the G20 now recognise that, as the crisis has worsened, there is a need to go beyond the DSSI.

Back in April, when the G20 made its first gestures, the International Monetary Fund (IMF) predicted that emerging markets and developing countries would contract by 2.3% in 2020. As the situation has worsened, the IMF now sees emerging markets and developing countries contracting by 5.7% in 2020. The World Bank adds that upwards of 150 million people worldwide will be pushed into extreme poverty as a result of the crisis by the end of 2020 – with 8 of 10 of those people in middle-income countries. What is more, 2020 is already the second warmest year on record. Cyclones and hurricanes, wildfires, and droughts have been ravaging economies and livelihoods that had already been pushed to their limits. As these factors compound, capital continues to flee from many emerging markets and developing countries, putting downward pressure on exchange rates and ballooning debt levels. As an indicator of the looming systemic debt crisis, there have already been more credit rating downgrades for emerging markets and developing countries in 2020 than in all previous crises over the past 40 years.

In November 2020, the G20 has rightly come to the realisation that debt suspension will not be adequate for a number of countries, and put forward a «Common Framework for Debt Treatments beyond the DSSI». This proposes a reduction in overall debt levels on a case by case basis for those DSSI countries deemed to have unsustainable debt. This move is yet another welcome step in the right direction by the G20 but falls short on three counts. First, there are a number of middle income countries, including small island developing states, that may experience unsustainable debt that should be eligible for relief. Second, the G20's new framework still lacks a mechanism for meaningful private creditor involvement and fails to address the first-mover problem for participating nations. Third, the new framework lacks a commitment by creditors and debtor countries alike to align newfound fiscal space with globally shared climate and development goals.

This crisis wracked the world economy just as it was ambitiously mobilising trillions of dollars annually to meet ambitious development goals and put the global economy on a path to decarbonisation by mid-century. It is not an option to put these goals aside as we attempt to recover from the pandemic. Rather, they have to be put at the centre of the recovery effort. The lack of attention to development goals and to climate change was already triggering social strife and leading to major economic costs before the pandemic.

This report calls on the G20 to move beyond its new Common Framework for Debt Treatments and require all creditor groups to provide substantial debt relief to a broad set of low- and middle-income countries in need in exchange for a commitment to use some of the newfound fiscal space for a green and inclusive recovery. A piecemeal approach to dealing with the current debt problems will not suffice. This is a systemic problem, and we need a global and systemic response. The international community and the G20 in particular need to agree on an ambitious agenda for tackling the debt crisis and providing countries with the fiscal space for sustainable crisis responses.

The G20 need to be bold, and they need to act now. Past experience tells us that delaying the response to debt crises leads to worse outcomes and higher costs. Doing too little, too late will be costlier, for both debtors and creditors. The international community only agreed to a comprehensive initiative – the Heavily Indebted Poor Countries (HIPC) Initiative – after more than two decades of repeated piecemeal debt reschedulings and progressively increasing debt reductions. Postponing inevitable sovereign debt restructurings caused prolonged underinvestment in health, education, and infrastructure, and it resulted in lost decades with increased unemployment and poverty for the mostly African and Latin American countries suffocated by debt.

We need a new architecture that will provide debt relief to countries that require it, while ensuring that the relief is calibrated towards attacking the virus, protecting the vulnerable, and staging a green and inclusive economy.

To this end, we propose a **«Debt Relief for Green and Inclusive Recovery Initiative»** as an ambitious, concerted, and comprehensive debt relief initiative – to be adopted on a global scale – that frees up resources to support recoveries in a sustainable way, boosts economies' resilience, and fosters a just transition to a low-carbon economy. Our proposal consists of three pillars and aims at achieving maximum creditor and debtor participation.

Under **Pillar 1, comprehensive debt relief** would be granted **by public creditors** to eligible heavily indebted countries with an unsustainable debt burden – analogous to, but improving upon, the HIPC Initiative model. These countries would receive debt relief on their bilateral and multilateral debt in order to provide the fiscal space for investment in health and social spending to fight the pandemic and in climate adaptation. Governments receiving debt relief would need to commit to reforms that align their policies and budgets with the 2030 Agenda for Sustainable Development and the Paris Agreement.

Eligibility should be a function of debt sustainability, which should be determined in a Debt Sustainability Assessment carried out by the IMF and the World Bank, with inputs from other institutions. Debt Sustainability Assessments need to be based on realistic assumptions and account for climate risks. If a Debt Sustainability Assessment asserts that the sovereign debt of a country is of significant concern, the G20 should coordinate with all bilateral and multilateral creditors about a debt restructuring, and the **IMF should make its programmes conditional on a sovereign debt restructuring involving private creditors. Debtor countries that seek bilateral haircuts will be required to seek commensurate relief from private creditors, and incentives need to be designed to ensure that private creditors grant such relief. Lending by multilateral development banks and humanitarian assistance will continue to flow, but on condition that it is not used to pay private creditors. Debt owed by multilateral institutions would only be restructured for IDA-eligible countries.** To safeguard the preferred creditor status of multilateral institutions, their losses would need to be financed by bilateral contributions, the proceeds from gold sales, or the issuance of new Special Drawing Rights (SDRs).

Under **Pillar 2**, the same group of eligible countries would be granted **debt relief by private creditors.** Private creditors participating in the debt restructuring would swap their old debt holdings with a haircut for new «Green Recovery Bonds». As in the case of the restructuring of publicly held debt under Pillar 1, a significant portion of the reduced debt service burden from the debt relief by private creditors should be used by the debtor government for spending on a green and inclusive recovery, and governments should commit to aligning their policies and public budgets with the goals of the 2030 Agenda for Sustainable Development and the Paris Agreement.

Any new debt issued by countries participating in the Debt Relief for Green and Inclusive Recovery Initiative could receive Brady-type credit enhancement – suitably adapted to current circumstances – in exchange for committing to dedicating receipts to SDG-aligned spending items. Such a credit enhancement mechanism would help countries undergoing debt restructuring under the **Debt Relief for Green and Inclusive Recovery** Initiative to continue to have access to international capital markets.

Under **Pillar 3**, we envisage **debt-for-climate swaps for countries that are not heavily indebted, but have reduced fiscal space due to Covid-19.** For these, such swaps would facilitate raising climate ambitions in the form of additional actions or investments in climate adaptation or mitigation. Moreover, this could be complemented by an incentive scheme for the issuance of (new) sustainability-aligned sovereign debt.

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For any of these transactions, an independent third party would need to oversee the implementation and monitor the fulfilment of the government's obligations under the arrangement and measure their impact.

Our proposal is aimed at providing developing countries the fiscal space at a critical time to address the three crises they are facing: the health and social crisis, the debt crisis, and the climate and environmental crisis. We highlight climate action on mitigation and adaptation for three reasons. First, without reducing emissions and stabilising our climate as well as investing in adaptation, all other efforts at development will be undermined and countries will find themselves in permanent crisis mode. Second, even if climate mitigation efforts are successful, large-scale investments in adaptation will be needed to protect people from the effects of the global environmental change that is already happening. It is important to emphasise that the effects of climate change will disproportionately harm the poor – scaling-up climate adaptation is also a matter of climate justice. Third, research has shown that greater climate vulnerability is increasing sovereign risk and the cost of capital, and hence undermining public finances. Therefore, investment in adaptation is a good investment and will contribute to future debt sustainability.

But to be clear, neither the efforts aimed at climate mitigation nor adaptation can be successful if the social dimension is ignored. Throughout this report, we stress that it is crucial that the recovery be green, economically inclusive, and socially just. Debt relief needs to be coupled with policies that are aimed at a just transition. To ensure that the recovery is both green and inclusive, investments in sustainable infrastructure and targeted support of key industries are essential, alongside investments in people and innovation to ensure that such a transition generates full employment, decent work, and opportunities for new economic activity.

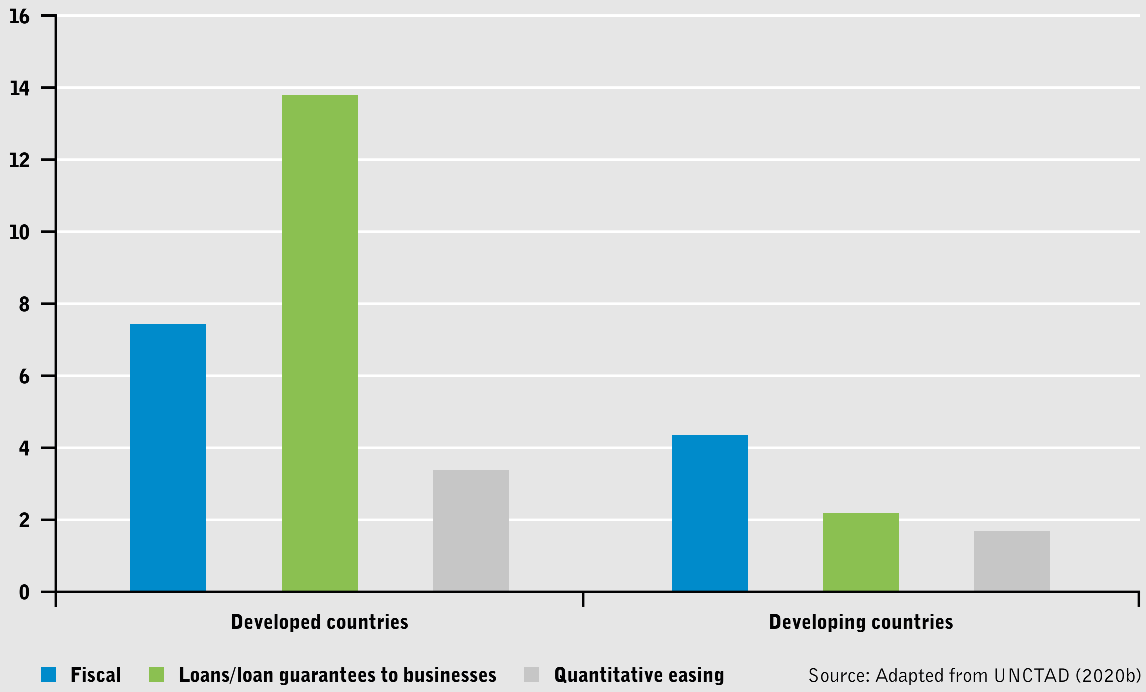
Debt relief has to be part of a broader agenda for enabling green and inclusive recoveries in countries around the world. A debt relief effort such as the one we propose should be coupled with a new and ambitious allocation of SDRs and significant new capital mobilised from development finance institutions. This will provide the fiscal space for emerging markets and developing countries to adopt sustained counter-cyclical responses to the crisis.

Countries share common but differentiated responsibilities in combating the climate crisis. Without large-scale debt relief and efforts aimed at facilitating a green and inclusive recovery, the international community can abandon its hopes of achieving the 2030 Agenda for Sustainable Development and the Paris Agreement. The lives and livelihoods of current and future generations hang in the balance.

1. Introduction

The Covid-19 pandemic strikes us at a time when – according to the Intergovernmental Panel on Climate Change – we have about a decade left to achieve a low-carbon transition and bring the world economy onto the 1.5°C or «well below 2°C» trajectory agreed in the Paris Agreement (IPCC, 2018). The next few years are our last chance to avoid catastrophic global warming. It is hence imperative that the various crisis response measures amount to a transformative policy response (Volz, 2020). Immediate crisis responses aimed at combating the virus and protecting jobs and firms in order to mount a recovery need to be aligned with our longer-term, strategic goals of mitigating climate change and engaging in climate change adaptation and resilience. Economic stimulus and recovery measures should strengthen the resilience of our economies and engineer a just transition. As was recently pointed out by Kristalina Georgieva, Managing Director of the International Monetary Fund (IMF): This is the time «to revive or lose the Paris Agreement» (Georgieva, 2020).

Fig. 1: Magnitude of policy stimulus measures in response to Covid-19 outbreak (% of GDP)



Source: Adapted from UNCTAD (2020b)

There is, however, a major problem: Many countries lack the means to finance a recovery and undertake critically needed investments in climate adaptation and mitigation. Although developed countries have been able to respond forcefully to the crisis by using fiscal policy, loans and loan guarantees to businesses, and quantitative easing policies, the responses of developing countries have been on average much smaller (Figure 1). Covid-19 triggered the worst recession of the global economy since the Second World War (World

Bank, 2020a) and has dramatically worsened public finances, which in many countries were shaky already before the current crisis. According to the Institute of International Finance (IIF), global debt across all sectors had hit 320% of gross domestic product (GDP) in April of 2020, already 40 percentage points higher than at the onset of the 2008 global financial crisis. The crisis has also worsened the foreign exchange constraints facing many developing countries (UNCTAD, 2020a). This is further constraining public finances and the ability of governments to support their citizens and undertake crucial action in climate adaptation and mitigation. There has already been a surge in sovereign debt downgrades since April 2020, more than during any financial crisis since 1980 (Bulow et al., 2020). The debt distress resulting from Covid-19 threatens «another lost decade for climate action» (Estevão, 2020: 273).

Going forward, many countries will require debt relief to respond effectively to the crisis to safeguard lives and the wellbeing of people and undertake meaningful investment to climate-proof their economies. The Debt Service Suspension Initiative (DSSI), agreed by the Group of 20 (G20) in April 2020, merely provided breathing space, but it did not address the core problems: It did not involve private creditors, who hold large chunks of developing-country debt. Importantly, debt relief efforts have to include, but go beyond, low-income countries. Many middle-income countries – which are not eligible for the DSSI – are heavily indebted and urgently need debt relief.

In November 2020, the G20 has rightly come to the realisation that debt suspension will not be adequate for a number of countries, and put forward a «Common Framework for Debt Treatments beyond the DSSI». This proposes a reduction in overall debt levels on a case by case basis for those DSSI countries deemed to have unsustainable debt. This move is yet another welcome step in the right direction by the G20 but falls short on three counts. First, there are a number of middle-income countries, including small island developing states, that may experience unsustainable debt that should be eligible for relief. For instance, in the Caribbean, which is suffering from the pandemic, economic hardship, and hurricanes simultaneously, the levels of debt burden and service are in many cases already unbearable (ECLAC, 2020). Second, the G20's new framework still lacks a mechanism for meaningful private creditor involvement and fails to address the first-mover problem for participating nations. Third, the new framework lacks a commitment by creditors and debtor countries alike to align newfound fiscal space with globally shared climate and development goals.

This report puts forward the proposal for a **«Debt Relief for Green and Inclusive Recovery Initiative»** as an ambitious, concerted, and comprehensive debt relief initiative – to be adopted on a global scale – that frees up resources to support recoveries in a sustainable way, boosts economies' resilience, and fosters a just transition to a low-carbon economy.

The remainder of the report is structured as follows. Section 2 reviews the debt situation in countries of the Global South. Section 3 lays out the nexus between climate vulnerability and debt sustainability and explains why investments in a green recovery that facilitates a just transition are not only urgently needed at this juncture, but also the best economic policy. Section 4 presents our proposal for a new framework for a global and systemic response to the debt and climate crises. Section 5 discusses the crucial importance of private-sector involvement and ways how this can be achieved. Section 6 concludes.

Caribbean

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2. A Looming Debt Crisis

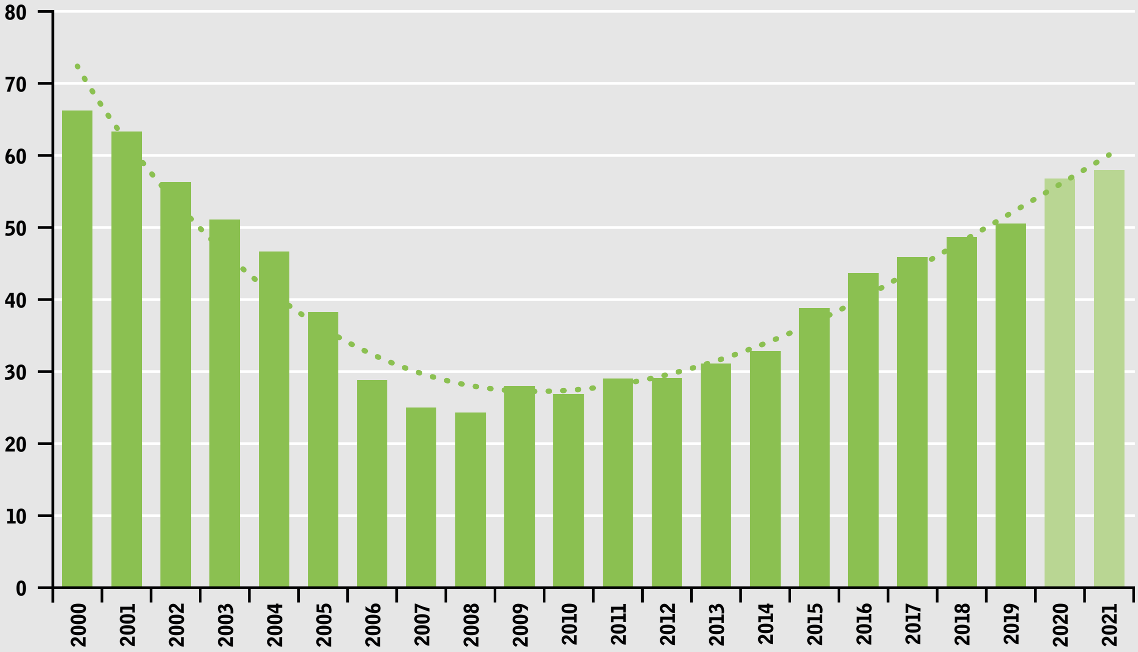
The Covid-19 crisis has dramatically worsened public finances across the globe. Public debt, which was already unsustainable in many developing countries before Covid-19, is increasing rapidly and constraining government responses to the health, social, and economic crises caused by the pandemic. If not addressed, the debt crisis will also hold back recoveries and undermine the development prospects of hundreds of millions of people in the Global South. The World Bank estimates that the Covid-19 pandemic will push an additional 88 million to 115 million people into extreme poverty in 2020, with the total rising to as many as 150 million by 2021 (World Bank, 2020b).

The Covid-19 pandemic is precipitating a long-brewing debt crisis in the developing world, which risks delaying and weakening the recovery from the 2020 global recession.[1] When the Covid-19 pandemic hit, developing-country debt had already reached problematic levels. In 2019, their private and public external debt – the most unstable component of national debt and the hardest to manage – passed US$8 trillion (at current exchange rates), an increase of 125% since the global financial crisis. Of this, at least US$5.8 trillion will be still outstanding in 2021 and 2022, requiring approximately US$1.2 trillion in principal and interest payments. The IMF (2020a) projects the sovereign debt-to-GDP ratio in advanced economies to rise by 20 percentage points – to about 125% of GDP by the end of 2021 – while emerging market and developing economies are projected to see an increase of more than 10 percentage points, to about 65% of GDP.

A sustainable recovery requires investing heavily in the transition away from fossil fuels, including in developing countries. Numerous studies – including the recent World Economic Outlook 2020 (IMF, 2020a) – demonstrate that a green recovery is not only environmentally sensible, but also good economic policy that ensures the foundations for longer-term economic success and debt sustainability. But unless the debt crisis is met with appropriate instruments at the multilateral level, policymakers will be forced to delay or cancel those investments, especially in developing countries. The IMF (2020a) estimates that the ratio of public debt service costs to government tax revenue will exceed 30% in 29% of low-income developing countries in 2020, and in 33% of these countries in 2021. Among emerging markets, 71% of countries face a ratio of public debt service costs to government tax revenue greater than 30% in 2020, and 73% in 2021. In other words, instead of being able to support their people to weather the crisis and invest in a sustainable recovery, governments are required to repay their creditors.

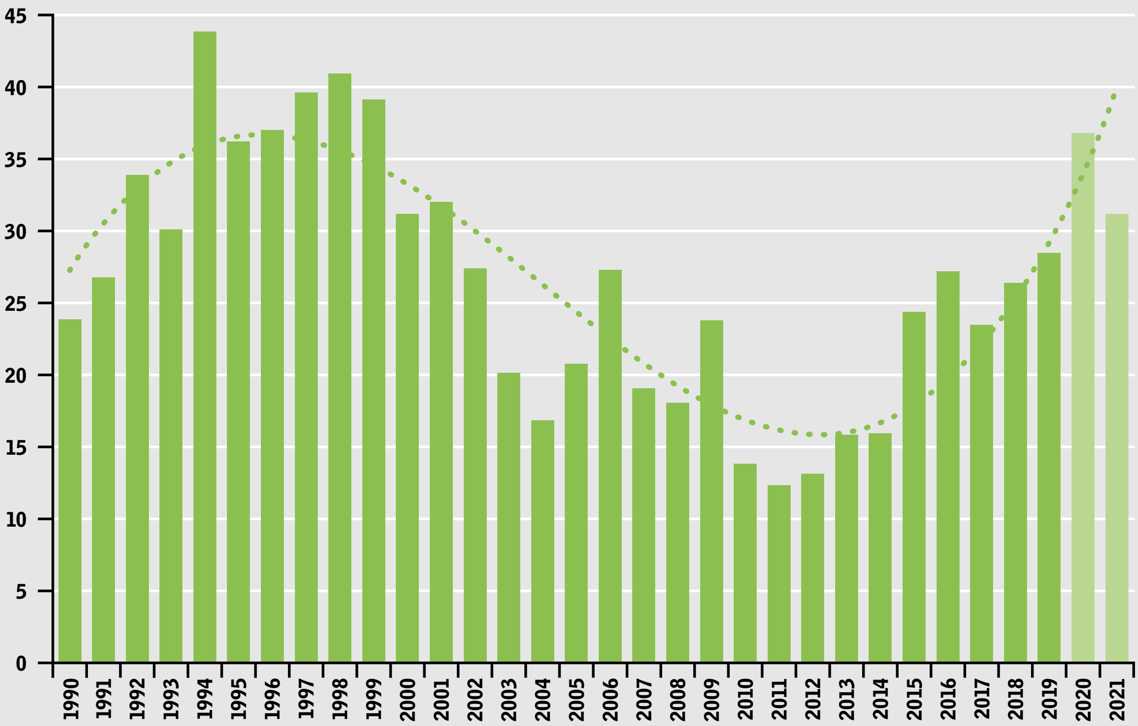
1 For background analysis of the worsening debt situation in the Global South, see Chelva and Capaldo (2020).

Fig. 2: General government gross debt of Sub-Saharan African countries as a percentage of GDP



Source: Compiled with data from IMF's World Economic Outlook Database, October 2020

Fig. 3: Total external debt service of Sub-Saharan African countries as a percentage of exports of goods and services



Source: Compiled with data from IMF's World Economic Outlook Database, October 2020

Figure 2 shows the significant increase in government gross debt of sub-Saharan African countries as share of GDP over the last decade. According to IMF estimates, the total external debt service of sub-Saharan African countries as a percentage of exports of goods and services will reach similar levels in 2020 as during the mid-1990s (Figure 3), when the international community decided that it was time to deliver debt relief to heavily indebted countries.

For many developing countries, private lending has already frozen, making debt rollover impossible and raising the risk of a cascade of corporate and sovereign bankruptcies. As pointed out by the Group of Thirty, no sub-Saharan African country has borrowed in the international capital markets since February 2020 (G30, 2020).


Indonesia

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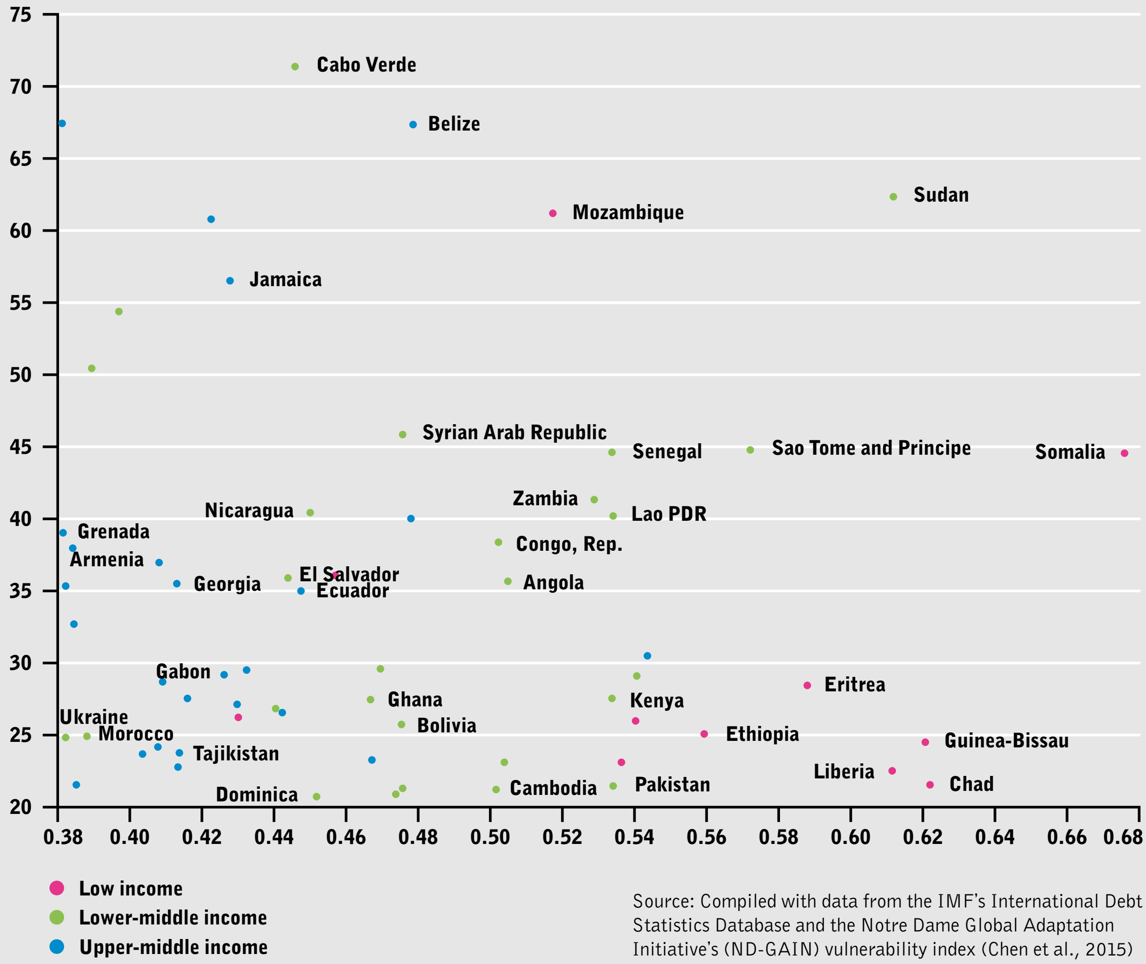
3. Debt Sustainability, Climate Vulnerability, Opportunities for Climate Action, and the Imperative of a Just Transition

Climate vulnerability threatens debt sustainability and increases the cost of capital

Fig. 4: Climate vulnerability vs foreign exchange debt-to-GDP ratio
The horizontal axis shows the ND-GAIN Vulnerability Index, while the vertical axis shows the FX debt to GDP ratio



Source: Compiled with data from the IMF's International Debt Statistics Database and the Notre Dame Global Adaptation Initiative's (ND-GAIN) vulnerability index (Chen et al., 2015)

Climate change can have a material impact on sovereign risk through direct and indirect effects on public finances (Volz et al., 2020). Perversely, the impacts of climate change are the greatest in countries that contributed the least to anthropogenic global warming. For many climate-vulnerable countries, a rapid scaling-up of investment in climate resilience is a matter of life and death. Regrettably, the most exposed developing countries are those that are struggling the most to finance adaptation and resilience. They are often most impacted by climate-related macrofinancial risks, and both governments and corporates are now facing a climate risk premium on the cost of capital (Beirne et al., 2020; Buhr et al., 2018; Kling et al., 2020).

Low- and lower-middle-income economies show the highest propensity to be negatively impacted by climate hazards (Figure 4). As they now have often worrying public debt profiles, these economies are likely to face the economic and social costs of climate change while also grappling with the fallout from the Covid-19 pandemic. It should be noted that the debt-carrying capacities of poorer countries tend to be much lower than for richer countries.

Governments must climate-proof their economies and public finances or potentially face an ever-worsening spiral of climate vulnerability and unsustainable debt burdens (Volz et al., 2020). There is a danger that vulnerable developing countries will enter a vicious circle in which greater climate vulnerability raises the cost of debt and diminishes the fiscal space for investment in climate resilience. As financial markets increasingly price climate risks, and global warming accelerates, the risk premia of these countries, which are already high, are likely to increase further. The impact of Covid-19 on public finances risks reinforcing this vicious circle. For instance, debt service in Caribbean countries, which are among the most climate-vulnerable in the world, currently absorbs between 30% and 70% of government revenues (Bárcena, 2020), providing little room for supporting livelihoods during the crisis, not to speak of much-needed investments in climate resilience.

International support for increased investments in climate resilience and mechanisms to transfer financial risks is urgently needed and could help these countries enter a virtuous circle. Greater investments in resilience could reduce both vulnerability and the cost of debt, providing these countries with extra room to scale-up investments to tackle the climate challenge.

Building back better strengthens recoveries and long-term growth prospects

Today, contrary to outdated economic wisdom, there is no trade-off between choosing a sustainable recovery and economic progress. Fiscal policy can be devised to simultaneously stabilise the economy and public finances while furthering sustainable development (Estevão, 2020). In its latest *World Economic Outlook* report from October 2020, the IMF (2020a, 93) highlights that «the goal of bringing net carbon emissions to zero by 2050 in each country can be achieved through a comprehensive policy package that is growth friendly (especially in the short term)».

Many green technologies have matured, and low-carbon energy is in most cases cheaper now than fossil-fuel based energy (IEA, 2020; IRENA, 2020). Recent evidence suggests that green projects can generate more employment and deliver higher short-term returns per dollar spent, compared to conventional fiscal stimulus (Hepburn et al., 2020; Unsworth et al., 2020; We Mean Business, 2020). A new study by the We Mean Business coalition (2020) shows that the growth impact of a «return to normal» recovery that ignores sustainability considerations is smaller than that of a «green» recovery plan that aims to boost economic activity while simultaneously reducing CO2 emissions. Moreover, while having the same cost for the government, the «green» recovery plan may also deliver long-term economic benefits. Conversely, a lack of public climate policy action, tighter financial constraints, and unfavourable economic conditions can have adverse effects on the environmental performance of the private sector, reduce green investments, and slow down the transition to a low-carbon economy (Guerin et al., 2020).

Importantly, today's investments in climate change mitigation and adaptation generate substantial long-term returns and cost savings, whereas the cost of inaction or late action on climate change is high. Actions taken now to mitigate climate change represent an investment that will generate dividends into the future, whereas continued inaction will give way to disastrous global warming with much higher costs down the line. Equally, failing to invest in making economies and societies more climate-resilient undermines future growth and wellbeing. The Global Commission on Adaptation calculated that for every US$1 invested in building climate resilience, this could result in between US$2 and US$10 in net economic benefits (GCA, 2019). Likewise, investing in the conservation, sustainable use, and restoration of biodiversity can provide jobs, business opportunities, and other benefits to society (OECD, 2020).

Yet, as investments in mitigation and adaptation tend to be more capital-intensive than business as usual, the financing of mitigation and adaptation measures may become more challenging with a worsening debt situation and increasing cost of capital. Due to fiscal constraints, they may be postponed further «until the crisis is over». This would be a huge mistake, as the damage to the global economy caused by each additional ton of fossil carbon exceeds its contribution to growth. The dramatic fall in the cost of renewable energy provides an opportunity to make a big push for investment in zero-carbon energy infrastructure, addressing problems of energy poverty, and enabling sustainable growth.

Box 1: Renewable energy investment for a just transition – a case study from South Africa

South Africa's economy, already precarious before Covid-2019, has been tipped into a full-blown crisis by the pandemic. Gross national government debt, at 63.5% of GDP in FY 2019/20, is expected to rise to 86% within two years. Eskom, the country's state-owned monopolistic and vertically integrated electricity utility, is a key driver of this escalating debt profile, and it lies at the heart of the economy's structural challenges.

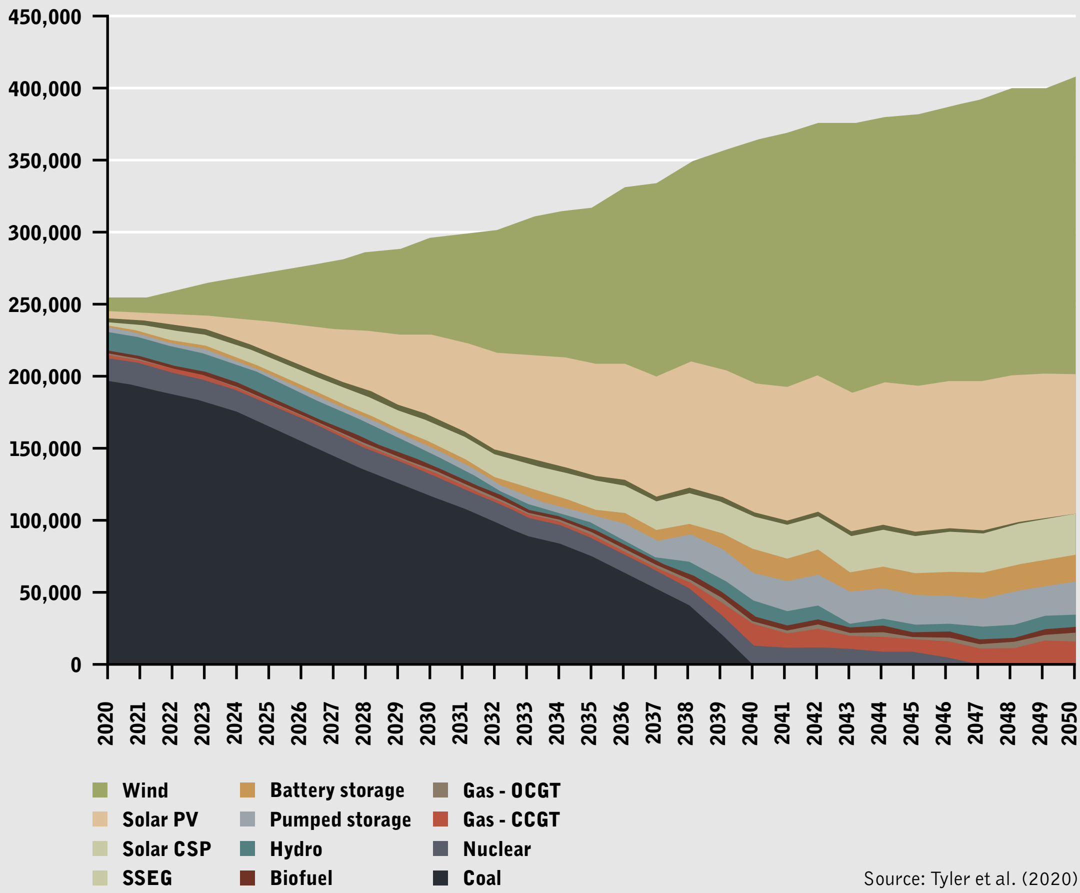
Eskom faces unprecedented financial, operational, and technological challenges, including: a failing coal fleet (which generates 85% of its electricity); a carbon and local pollutant profile that is rapidly becoming intolerable to society; an outdated sector model; constraining policy and regulatory environments; revenue shortfalls and the early stages of a utility death spiral; together with a ballooning debt burden of R480 billion (US$27.9bn). A total of 77.2% of this debt is government-guaranteed, and a significant portion is stranded and cannot be serviced. Over the next three years, Eskom's projected debt maturity profile totals R224 billion (US$13bn), but accessing funding to refinance maturing debt is increasingly difficult. South Africa's National Treasury has committed to a 10-year bailout programme totalling R230 billion (US$13.4bn) to assist. If this is removed due to the fiscal unfeasibility, Eskom's debt will become immediately unserviceable. As shareholder and guarantor, Eskom's risk profile is automatically transferred to the sovereign, impacting the sovereign credit rating and increasing South Africa's borrowing costs.

At the same time, South Africa has a significant and immediate opportunity to pivot its carbon-intensive power sector towards low-carbon energy. Comprehensive modelling by Meridian Economics and the Centre for Scientific and Industrial Research (CSIR, 2020; Roff et al., 2020) finds that system cost is no longer a barrier to decreasing the carbon emissions of South Africa's electricity system by up to 1.5 gigatonnes (Gt) through an ambitious renewables rollout system.

A strategically managed, ambitious renewables rollout will trigger large-scale green industrialisation, providing a sustainable economic stimulus for South Africa's ailing economy. Although such a build programme is commercially financeable given the country's superior renewables resources and mature financing sector, the lack of a credible and clear vision and policy commitment for the electricity sector – together with a stable market and system operator (product of an unbundled Eskom) – are constraining the realisation of this opportunity.

An important political aspect of the South African electricity crisis is the need for a just transition away from coal. Most of South Africa's coal mining and power-related

Fig. 5: Renewable energy build scenario to achieve coal phase down by 2040
Ambitous RE pathway &coal off by 2040: Annual electricity production (GWh)



Source: Tyler et al. (2020)

activities are concentrated in the Mpumalanga Province, which hosts 12 of Eskom's 15 power stations and a large share of the country's coal mines. This has a severe impact on air quality and the health of local populations, but a transition from coal will result in significant disruption in Mpumalanga, with livelihoods at stake. There is a need to support the retraining and retiring of the coal workforce, together with the creation of alternative employment opportunities in the Mpumalanga area. An ambitious rollout of renewables would create the foundation for this just transition. Targeted localisation of renewable energy industrial activities and a portion of renewable energy build can feasibly be managed for Mpumalanga, supporting the absorption of workers from the declining coal industry and stimulating opportunities in value chain activities related to a new, greener local economy. In addition, a just transition enhances the local environmental and health benefits of phasing out coal-fired power.

A combination of debt relief and new transition finance to stabilise the economic and financial situation could be combined with an agreement on creating the necessary policies and regulatory environment for the realisation of such an ambitious proposal.

Source: Based on Tyler et al. (2020)

Phasing out fossil fuels and reducing the exposure to stranded assets

Recognising that countries need to have common but differentiated responsibilities and respective capabilities, the fossil fuel industry will have to go into managed decline in order to meet the goals of the Paris Agreement. Research has documented the gap between the carbon budget that can be spent and the estimated cap needed on CO2 emissions to limit global warming to 2°C, or even 1.5°C relative to preindustrial levels (Carbon Tracker, 2011, 2020; UNEP, 2019). The *Production Gap Report 2019* of the UN Environment Programme (UNEP) – an assessment of the gap between the targets of the Paris Agreement and countries' planned production of coal, oil, and gas – found that «governments already are planning to produce about 50% more fossil fuels by 2030 than would be consistent with a 2°C pathway and 120% more than would be consistent with a 1.5°C pathway» (SEI et al., 2019). The forced decline of fossil fuel emissions is accelerated by technological change, as fossil fuels are increasingly undercut by cheaper renewables and better storage.

According to the International Energy Agency (IEA), the pandemic has led to lower prices and downward revisions to demand that have reduced the value of future oil and gas production by a quarter (IEA, 2020). As a consequence, many oil- and gas-producing countries are now «facing acute fiscal pressures as a result of high reliance on hydrocarbon revenues» (IEA, 2020: 20). Fossil fuel development is an increasingly risky proposition, and fossil fuels are increasingly recognised as potentially stranded assets. The IEA argues therefore that «[n]ow, more than ever, fundamental efforts to diversify and reform the economies of some major oil and gas exporters look unavoidable» (IEA, 2020: 20).

In such an environment, it would be foolish to pursue high risk investments in fossil fuel extraction and infrastructure as part of a recovery strategy. Yet, debt servicing requirements may push countries to pursue export revenue at any cost, including by exacerbating resource extraction – both fossil and other natural resources – in conflict with the goals of the Paris Agreement. Some countries such as Ecuador have even entered into loan agreements with creditors backed by future oil revenues. As previously discussed, in many low-income and lower-middle-income countries, the ratio of foreign currency debt over GDP is dangerously high. This constrains the fiscal space and puts heavy pressure on governments to cut investment and monetise natural resources.

Box 2: Compensating indebted governments for leaving oil and gas in the ground

Effective climate action requires leaving vast amounts of fossil fuels in the ground. Yet, as shown in the Production Gap Report 2019 (SEI et al., 2019), countries across the world are planning a continued expansion of fossil fuel production.

Although fossil fuel development, in particular oil and gas, promised vast riches in the past, today it is exposing fossil fuel producers and their creditors to a massive stranded asset risk. This is particularly true for new, hitherto unexploited reserves, which on average require 10 years and massive upfront investment in infrastructure (pipelines, terminal) before the first oil flows.

Nevertheless, the pressing needs of servicing debt and the prevailing mindset of associating fossil fuels with wealth may still push new producer countries into subsidising fossil fuel development and entering into risky contracts with oil and gas firms.

In an innovative proposal, West (2020) proposes a contract between international creditors and governments to leave certain oil and gas reserves in the ground, for an initial 10-year period. In exchange, a participating government would receive debt relief corresponding to a signature bonus and a series of annual payments. The amount could be calculated based on traditional oil industry methods of asset evaluation, applying them to future revenue profiles of governments with potential oil and gas projects.

The mechanism would allow for an opt-in at the level of individual oil and gas fields. Such an approach globally could prevent up to 400 Gt of CO2 emissions at a cost varying between US$2 and US$10 per tonne, just among the so-called new producer countries. This is equivalent to roughly 13 times the annual emissions from fossil fuels.

The imperative of a globally just transition

The coronavirus has ruptured our world and, as with past global pandemics, raised fundamental questions about the way we organise society and the values that structure our lives. In our highly interdependent and increasingly fragile world, the measure of success cannot just be whether we ward off another financial crisis and avoid increased public debt. Succeeding generations will not applaud higher share prices or fuller treasuries if we fail to meet the challenge of turning a better recovery into a just transition to a fairer and more sustainable world.

Tanzania

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Now is the time to hammer out a plan for global recovery, one that can push even the most vulnerable countries into a stronger position than before the crisis, and at the same time reverse course towards planetary destruction.

It is therefore crucial that the recovery be green, economically inclusive, and socially just. Indeed, it is evident that a transition to an environmentally sustainable economy can only be successful if it is inclusive and in line with social development. The Paris Agreement has therefore acknowledged «the imperatives of a just transition of the workforce and the creation of decent work and quality jobs in accordance with nationally defined development priorities» (UN, 2015).[2] Private markets will not deliver these outcomes on their own. Achieving these goals requires putting sustained investment in public goods, public investment, and public policy at the centre of the recovery agenda.

With the proper fiscal and policy space, a green recovery can better support demand in the short term and create more jobs. While generating higher growth and making us less prone to climate and other shocks, a green recovery can therefore enhance debt sustainability and is in the common interest of both borrowers and creditors. Moreover, because the effects of environmental change disproportionately harm the vulnerable, enabling all countries to scale-up public climate action and protect the environment can ensure a marriage of climate and social justice.

At a time when lives and livelihoods are threatened in countries around the world (UNDP, 2020), the immediate focus of governments needs to be providing income and social support to their citizens – particularly the most vulnerable in society – and bolstering health systems under severe stress. Covid-19 has disproportionately affected the poor, especially in countries where access to health care is not assured (Stiglitz, 2020). UNDP estimates global human development – as a combined measure of the world's education, health, and living standards – will decline in 2020 for the first time since the concept was developed in 1990. According to the World Bank, as many as 155 million people will be pushed into extreme poverty due to Covid-19 by the end of 2021 – with eight out of ten of those people in middle-income countries (World Bank, 2020b).

The world's largest economies have quickly adopted relief packages, in the order of US$13 trillion, to support corporate payroll, mitigate the damage to households from locking down, and increase the response capacity of hospitals. Whether these packages will evolve into the long-term support necessary for a just transition remains to be seen. However, these same governments have, so far, been unwilling to extend a helping hand to developing

2 The United Nations Framework Convention on Climate Change states that «Parties should protect the climate system for the benefit of present and future generations of humankind, on the basis of equity and in accordance with their common but differentiated responsibilities and respective capabilities» (UNFCCC, 1997: §3.1).

countries, where a combination of precarious work conditions, deep debt distress, and insufficient fiscal and policy space have amplified the economic damage from the Covid-19 shock. This was not the response envisaged 75 years ago by those who created the multilateral system.

Achieving global social justice in an interdependent world was a central goal of President Roosevelt's original New Deal in response to the economic carnage and political polarisation triggered by the Great Depression. Achieving that goal required a multilateral response: «Economic diseases are highly communicable,» Roosevelt said at the opening of the Bretton Woods Conference in 1944, «[i]t follows, therefore, that the economic health of every country is a proper matter of concern to all its neighbors, near and distant. Only through a dynamic and a soundly expanding world economy can the living standards of individual nations be advanced to levels which will permit a full realization of our hopes for the future» (Roosevelt, 1944).

Despite those hopes now hanging in the balance in many developing countries, the inability of the international community to put forward comprehensive proposals to alleviate debt distress, institute reliable last-resort lending, and agree on an equitable distribution of any future vaccine are signs that revitalising multilateralism must be an urgent priority if we are to recover better from this crisis.

Alongside the debt relief outlined in this proposal, in the short run and to alleviate immediate balance of payment pressures, Special Drawing Rights (SDRs) should be expanded through a reallocation of unused SDRs in developed economies to developing countries, as well as through a sizable, fresh allocation.

The concessional lending capacity of multilateral development banks will also have to be boosted and mobilised in record time. International institutions will also have to bolster domestic tax regimes and close global loopholes so that revenues can be properly mobilised. At the same time, these institutions should reassess their policy conditionalities so that they are brought more into line with a more sustainable and inclusive development agenda.

A debt relief effort of the appropriate scale – if coupled with a new and ambitious allocation of SDRs and significant new capital mobilised from development finance institutions – will provide the fiscal space for emerging markets and developing countries to adopt sustained counter-cyclical responses to the crisis. In order to achieve a just transition, large and sustained increases in public investment will be necessary.

All nations share common but differentiated responsibilities in combating the climate crisis and should adapt these goals to their country-specific circumstances. In general, stepwise investments in sustainable infrastructure and targeted support of key industries will be essential to the transition, alongside investments in people and innovation to ensure that such a transition generates full employment, decent work, and opportunities for new economic activity. International institutions; multilateral and bilateral trade and investment treaties; national governments; and businesses must align to these transitions while making sure that countries, sectors, and communities disproportionately impacted by these changes are protected and propelled into the new sustainable economy.

Kenya

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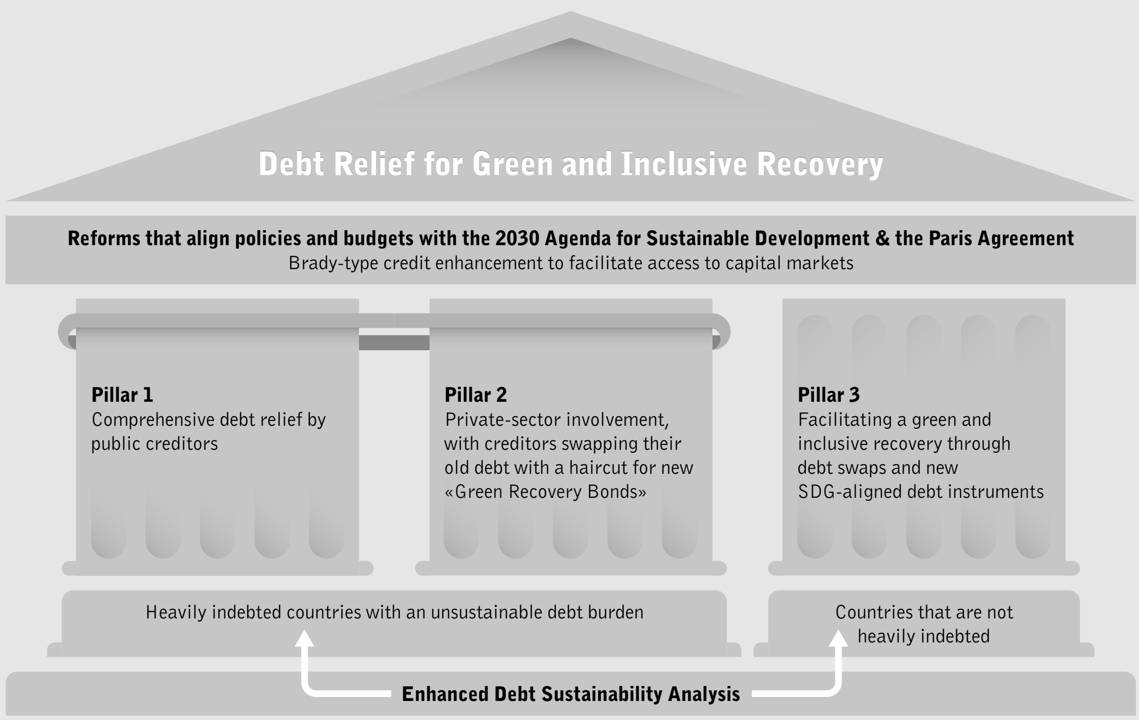
4. A New Framework for a Global and Systemic Response to the Debt and Climate Crises

To enable a green and socially just recovery for all countries, public debt problems need to be urgently addressed so that all governments have the fiscal space to finance crucial health and social spending and invest in a green and inclusive recovery. We are facing an unprecedented challenge in the Global South that requires bold action. A systemic crisis needs systemic answers. We need a new framework that will provide debt relief to countries that require it, while ensuring that the relief is calibrated towards attacking the virus, protecting the vulnerable, and staging a green and inclusive economy.

Important proposals have been made for addressing the debt problem (Berensmann et al., 2020; Bolton et al., 2020), including innovative proposals for debt swaps to alleviate debt, enhance climate action, and prevent further nature loss (Khan, 2020; Leonard et al., 2020; Picolotti et al., 2020; Steele and Patel, 2020), as well as proposals for «nature performance bonds» (F4BI, 2020a, 2020b).

Fig. 6: Debt Relief for Green and Inclusive Recovery



Building on these proposals, we propose a Debt Relief for Green and Inclusive Recovery Initiative as an ambitious, concerted, and comprehensive debt relief initiative – to be adopted on a global scale – that frees up resources to support recoveries in a sustainable way, boosts economies' resilience, and fosters a just transition to a low-carbon economy.[3] Our proposal consists of three pillars and aims at achieving maximum creditor and debtor participation (Figure 6).

Pillar 1: Comprehensive debt relief for eligible heavily indebted countries by public creditors

Under Pillar 1, comprehensive and significant debt relief would be granted to eligible heavily indebted countries with an unsustainable debt burden by public creditors – analogous to, but improving upon, the HIPC Initiative / Multilateral Debt Relief Initiative (MDRI) model (Box 3).[4] The indebted countries would receive significant debt relief on their bilateral and – under certain conditions – also multilateral debt in order to provide the fiscal space for investment in health and social spending to fight the pandemic and in climate adaptation. Governments receiving debt relief would need to commit to reforms that align their policies and budgets with the 2030 Agenda for Sustainable Development and the Paris Agreement.

Eligibility should go beyond the world's 74 poorest countries that are eligible to borrow from the World Bank's International Development Agency (IDA), as was the case with the HIPC Initiative. Eligibility should be a function of debt sustainability, which should be determined in a Debt Sustainability Assessment carried out by the IMF and the World Bank, with inputs from other institutions. Debt Sustainability Assessments need to be based on realistic assumptions and account for climate risks (Guzman and Heymann, 2015; Volz and Ahmed, 2020). If a Debt Sustainability Assessment asserts that the sovereign debt of a country is of significant concern, the G20 should coordinate with all bilateral and multilateral creditors about a debt restructuring, and the IMF should make its

3 Some ideas for this proposal build on Viterbo et al. (2020).

4 It will be important to learn lessons from the HIPC Initiative. See, for instance, de Bruijn and Rehbein (2011), Biti et al. (2016), and Caliari (2020).

programmes conditional on a sovereign debt restructuring involving private creditors.[5] Debtor countries that seek bilateral haircuts will be required to seek commensurate relief from private creditors, and incentives need to be designed to ensure that private creditors grant such relief. Lending by multilateral development banks and humanitarian assistance will continue to flow, but on condition that it is not used to pay private creditors. Private-sector involvement will be treated under Pillar 2, details of which are discussed below. It is crucial that a restructuring of publicly held debt proceeds only under conditions of equal treatment of private creditors.

Debt owed by multilateral institutions would only be restructured for IDA-eligible countries. To safeguard the preferred creditor status of multilateral institutions, their losses would need to be financed by bilateral contributions, the proceeds from gold sales, or the issuance of new SDRs.

As mentioned, countries receiving debt relief would need to commit to using a significant portion of the freed-up resources from reduced debt service to finance a green and inclusive recovery and aligning their policies and budgets with the goals of the 2030 Agenda for Sustainable Development and the Paris Agreement. Commitments to align policies and budgets with the SDGs and the Paris goals would be monitored by a new, inter-institutional steering committee. In line with Article 2.1c of the Paris Agreement, which calls for the alignment of financial flows with the aims of the agreement, participating countries would need to commit to nationally determined contributions (NDCs) that are in line with the «well below 2°C» trajectory and develop a credible long-term strategy to achieve this.[6] Development partners would need to provide capacity-building and financing support to enable implementation. It needs to be highlighted that aligning public finances with the goals of the Paris Agreement does not imply that large proportions of public finances need to be dedicated to climate action.[7]

5 In a recent policy paper, the IMF (2020e) noted: «The conditions under which the IMF may lend to countries whose debt is deemed unsustainable on a forward-looking basis can create incentives for sovereign debtors and their creditors to engage in orderly and speedy debt restructurings. If a sovereign's debt is deemed unsustainable, the IMF is precluded from lending unless the member is taking steps to restore debt sustainability. Post-default, the IMF's Lending into Arrears policy (LIA) ensures that the IMF lends into arrears only if (i) prompt IMF support is considered essential for the implementation of the member's adjustment program and (ii) the member is pursuing appropriate policies and is making a good faith effort to reach a collaborative agreement with its creditors. Pre-default, the IMF requires assurances that a credible process is in train that the debt restructuring will be successful in restoring debt sustainability consistent with the IMF-supported program.» The IMF has announced a review of its practices and policies in both areas in 2021.

6 Article 2.1c calls on countries to «[make] finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development».

7 Abstaining from subsidising fossil energies and creating an enabling environment for private investment in clean technologies and renewable energies will go a long way to transform economies, given that their costs have come down dramatically and are in most cases cheaper than conventional energy sources (IEA, 2020; IRENA, 2020).

Box 3: Debt Relief Under the Heavily Indebted Poor Countries (HIPC) Initiative[8]

Debt relief key to poverty reduction

The HIPC Initiative was launched in 1996 by the IMF and the World Bank, with the aim of ensuring that no poor country faces a debt burden it cannot manage. Since then, the international financial community, including multilateral organisations and governments, have worked together to lower to sustainable levels the external debt burdens of the most heavily indebted poor countries.

In 1999, a comprehensive review of the initiative allowed the IMF to provide faster, deeper, and broader debt relief and strengthened the links between debt relief, poverty reduction, and social policies.

In 2005, to help accelerate progress towards the United Nations Millennium Development Goals, the HIPC Initiative was supplemented by the MDRI. The MDRI allows for 100% relief on eligible debts by three multilateral institutions – the IMF, the World Bank, and the African Development Fund – for countries completing the HIPC Initiative process. In 2007, the Inter-American Development Bank also decided to provide additional («beyond HIPC») debt relief to the five HIPCs in the Western Hemisphere.

Two-step process

Countries must meet certain criteria, commit to poverty reduction through policy changes, and demonstrate a good track record over time. The IMF and the World Bank provide interim debt relief in the initial stage and, when a country meets its commitments, full debt relief is provided.

First step: decision point. To be considered for HIPC Initiative assistance, a country must fulfil the following four conditions:

1) be eligible to borrow from the World Bank's IDA, which provides interest-free loans and grants to the world's poorest countries, and from the IMF's Poverty Reduction and Growth Trust, which provides loans to low-income countries at subsidised rates;
2) be facing an unsustainable debt burden that cannot be addressed through traditional debt relief mechanisms;
3) have established a track record of reform and sound policies through programmes supported by the IMF and the World Bank; and

8 For a review of experiences with HIPC, see Caliari (2020).

4) have developed a Poverty Reduction Strategy Paper (PRSP) through a broad-based participatory process in the country.

Once a country has met or made sufficient progress in meeting these four criteria, the Executive Boards of the IMF and the World Bank formally decide on its eligibility for debt relief, and the international community commits to reducing debt to a level that is considered sustainable. This first stage under the HIPC Initiative is referred to as the decision point. Once a country reaches its decision point, it may immediately begin receiving interim relief on its debt service falling due.

Second step: completion point. In order to receive a full and irrevocable reduction in debt available under the HIPC Initiative, a country must:

1) establish a further track record of good performance under programmes supported by loans from the IMF and the World Bank;
2) implement satisfactorily key reforms agreed at the decision point; and
3) adopt and implement its PRSP for at least one year.

Once a country has met these criteria, it can reach its completion point, which allows it to receive the full debt relief committed at the decision point.

Countries receiving debt relief. Of the 39 countries eligible or potentially eligible for HIPC Initiative assistance, 36 are receiving full debt relief from the IMF and other creditors after reaching their completion points. Three countries that have been identified as potentially eligible for HIPC Initiative assistance have not yet reached their decision points, but Somalia is making progress towards achieving this milestone in the coming months.

Debt relief frees up resources for social spending

Debt relief is one part of a much larger effort, which also includes aid flows to address the development needs of low-income countries and ensure that debt sustainability is maintained over time. For debt reduction to have a tangible impact on poverty, the additional money needs to be spent on programmes that benefit the poor.

Boosting social spending. Before the HIPC Initiative, eligible countries were, on average, spending slightly more on debt service than on health and education combined. Now, they have increased markedly their expenditures on health, education, and other social services. On average, such spending is about five times the amount of debt-service payments.

Reducing debt service. For the 36 countries receiving debt relief, debt service paid has declined by about 1.5 percentage points of GDP between 2001 and 2015. More recently, with the increase in public debt in low-income countries, debt service burdens have started to rise, although they still remain 1 percentage point below the pre-HIPC levels of 2017.

Improving public debt management. Debt relief has markedly improved the debt positions of post–completion point countries, bringing their debt indicators down below those of other HIPCs or non-HIPCs. However, many remain vulnerable to shocks, particularly those that affect exports, as seen during the global economic crisis. To reverse the recent increase in low-income country public debt burdens and reduce their debt vulnerabilities, countries need to pursue cautious borrowing policies and strengthen their public debt management.

Source: Adapted from IMF (2020b)

Pillar 2: Private-sector involvement

The lackluster success of the HIPC Initiative shows clearly that compulsory participation will be necessary from not only official creditors, but the private sector alike. To secure private-sector participation, it will be crucial to involve the IMF (Hagan, 2020) and other multilateral institutions. As discussed under Pillar 1, if a Debt Sustainability Assessment asserts that the public debt of a country is of significant concern, the IMF should make its programmes conditional on a sovereign debt restructuring involving private creditors, and debtor countries seeking bilateral haircuts will be required to seek commensurate relief from private creditors. Such a commitment by public lenders should induce private creditors to participate in and contribute to a debt restructuring process which provides fiscal space to governments to invest in quality and inclusive growth.[9] Section 5 discusses the issue of private-sector involvement in greater detail.

9 Hagan (2020: 8) explains the rationale for involving the IMF as follows: «If [...] implementation of the debt standstill is made a condition for the use of IMF resources, the incentives change and improve the chances of implementation. For a sovereign, it will now be a choice between agreeing to approach its private creditors for a standstill or being unable to obtain IMF resources to continue to service its debt obligations, resulting in a possible default. For private creditors, the choices also change: if they fail to agree to a standstill, they know that the program approved by the IMF will not provide for payments to be made to them during the standstill period, which will result in a default and application of the IMF's [lending-into-arrears] policy. While implementation of the standstill in these circumstances may still adversely affect the country's credit rating, the stigma may not be as great: because it is a condition for the availability of IMF resources, the country will not suffer the stigma of being seen as «choosing» to avail itself of the standstill.»

Namibia

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Under Pillar 2, the same group of eligible countries as under Pillar 1 would be granted debt relief by private creditors. As a minimum, private creditor debt relief has to comply at least with comparability of treatment, as stipulated by the Paris Club of official creditors. Private creditors participating in the debt restructuring would swap their old debt holdings with a haircut for new «Green Recovery Bonds». As in the case of the restructuring of publicly held debt under Pillar 1, a significant portion of the reduced debt service burden from the debt relief by private creditors should be used by the debtor government for spending on a green and inclusive recovery (hence the name «Green Recovery Bonds»), and countries should commit to aligning their policies and public budgets with the goals of the 2030 Agenda for Sustainable Development and the Paris Agreement. Spending will be monitored by the same inter-institutional steering committee that monitors the implementation of Pillar 1 to ensure that spending is aligned with areas that enhance the achievement of the SDGs. The inter-institutional steering committee should involve public and private creditors, the United Nations, as well as civil society representatives.

Any new debt issued by countries participating in debt restructuring could receive Brady-type credit enhancement – suitably adapted to current circumstances – in exchange for a commitment to dedicate receipts to SDG-aligned spending items.[10] Various proposals have been made for principles that could be used for financing a green and inclusive recovery and drawn upon to develop an operational taxonomy (e.g. CPI et al., forthcoming; Philipponnat, 2020; TEG, 2020; World Bank, 2020c). The use of proceeds would be observed by the same monitoring mechanism as in the case of the restructured debt. The credit enhancement could be secured through an issuance of bonds by a multilateral institution with a triple-A rating or SDRs issued by the IMF.[11] In case of missed payments, the collateral would be released and could be liquidated by the private creditor. The missed payment would have to be repaid by the sovereign to the guarantor. Such a credit enhancement mechanism would help countries that are undergoing debt restructuring under the Debt Relief for Green and Inclusive Recovery Initiative to continue to have access to international capital markets. At the same time, it would safeguard that the proceeds of any new borrowing are used for purposes that contribute to sustainable – that is, green and inclusive – economic development, which will also contribute to future debt sustainability.

10 Brady bonds were bonds collateralised by US Treasury bonds issued as a solution during the Latin American debt crisis of the 1980s.

11 There could be a menu of options (as there was in the original Brady Plan) to cater for creditors' different needs and preferences. Creditors could choose between a haircut of principal, or lower interest, or bigger cuts with the offsetting sweetener of partial AAA collateral.

Pillar 3: Facilitating a green recovery in countries that are not heavily indebted through debt swaps and new SDG-aligned debt instruments

Under Pillar 3, we envisage debt-for-climate or debt-for-sustainability swaps for countries that are not heavily indebted, but have reduced fiscal space due to Covid-19. For these, such swaps would facilitate raising climate ambitions in the form of additional actions or investments in climate adaptation or mitigation. Debt swaps under this pillar would be voluntary and not conducted as a distressed debt exchange. In other words, existing creditors can decide not to participate in the debt-for-nature swap offer without having to fear that the alternative to accepting the swap would be a default. Therefore, most swaps would probably be transacted with official – mostly bilateral – creditors, or commercial financial debt bought by non-profit organisations at a discount in the secondary market.[12]

To raise climate ambitions, this could be complemented by an incentive scheme for the issuance of (new) sustainability-aligned sovereign debt (F4BI, 2020a, 2020b; Robins, 2020). Again, an option would be a Brady-type credit enhancement in exchange for a commitment to Paris-aligned NDCs and to dedicate receipts to SDG-linked spending items, to be observed by the same monitoring mechanism as in the case of the restructured debt. As before, the credit enhancement could be secured by an issuance of bonds by a multilateral institution with a triple-A rating or SDRs issued by the IMF. Such a mechanism could incentivise governments to raise their NDC commitments while benefiting from lower refinancing costs.

12 See, for instance, World Ocean Initiative (2020).

5. How to Ensure Private-sector Involvement?

No private-sector involvement in the Debt Service Suspension Initiative to date

When the G20 leaders decided in mid-April 2020 to temporarily suspend bilateral debt service payments for the worlds' poorest countries, it called upon private creditors (such as asset managers and banks) to participate in the DSSI on comparable terms. Since then, the private creditors have engaged in the dialogue through the IIF. Under the IIF's auspices, creditors have agreed on general terms of reference for voluntary private-sector participation. But so far, no private creditor debt service has been suspended. The principal reason for this is that, to date, no debtor government has requested private-sector involvement. Some borrowers have indicated concerns that application for DSSI participation might send a negative signal about their creditworthiness and lead to a sovereign default and prolonged exclusion from capital markets.

Commercial creditors have reiterated market access risk repeatedly, which may have contributed to dissuading borrowers to ask for private-sector involvement. These fears are exaggerated. For several reasons, a potential loss of market access may not be as likely or severe as private creditors insinuate (Box 4).

Some borrowing countries may also have, quite reasonably, concluded that the negative repercussions of requesting the rescheduling of commercial debt (such as a default being declared by rating agencies) are not worth the limited benefits of pushing out commercial debt service payments by only a few months. After all, the DSSI was originally set up to end by 2020. In October 2020 it was extended by another six months until mid-2021.

Such short time frames skew the cost-benefit analysis of debtor countries against requesting private-sector involvement: The cost is fixed (perceived reputational damage hampering market access after reprofiling and the likely declaration of technical default), irrespective of the length of liquidity relief. By setting such short periods for DSSI liquidity relief, the G20 effectively made private-sector participation less likely.

Box 4: Private-sector involvement and sovereign defaults

Debtor nations' fears of defaults are overdone

When the leaders of the G20 countries decided in April 2020 to temporarily suspend bilateral debt service payments for the world's poorest countries, they called upon private creditors to publicly participate in the initiative on comparable terms (G20, 2020). However, private-sector creditors keep sitting on the fence, partly because debtor governments have so far refrained from requesting private-sector involvement (PSI). There are two reasons for this inaction: Firstly, there is concern about a default being formally declared on a country asking for PSI; secondly, the fear of losing capital market access for a prolonged period. Are these worries warranted? In short, the answers are «yes» and «probably not».

Private-sector debt suspension would be a default

Credit rating agencies (CRAs) have two roles: provide independent opinions on relative creditworthiness of borrowers and declare a default in case of non-payment. A missed debt service payment to a private creditor, however small, would count as an outright default. This is not controversial. More nuanced is the case of a so-called distressed debt exchange (DDE). In this case, a default does not require a missed payment. A DDE is a situation in which the issuer offers bondholders a new package of securities that amounts to a diminished financial obligation, or where the exchange has the apparent purpose of helping the borrower avoid default (Moody's, 2002). CRAs do not formally apply a net present value (NPV) calculation when determining whether a material reduction of the terms has occurred. Therefore, suspending debt service now and recovering it in the future in an NPV-neutral way could still be considered a default. A reduction in either face value, interest rate, or a maturity extension would usually suffice to declare default.

The second test for a DDE is a little more complex: How to determine whether a debt exchange is put forward with the purpose of averting an otherwise impending default? After all, opportunistically offering creditors to swap existing bonds for new ones is standard debt management practice. CRAs can use the existing rating as a proxy when assessing whether an exchange is distressed, and therefore tantamount to a default. S&P Global, for example, would ordinarily consider an exchange offer as distressed if the borrower carries a rating in the «B» category or bonds trade at a significant discount.

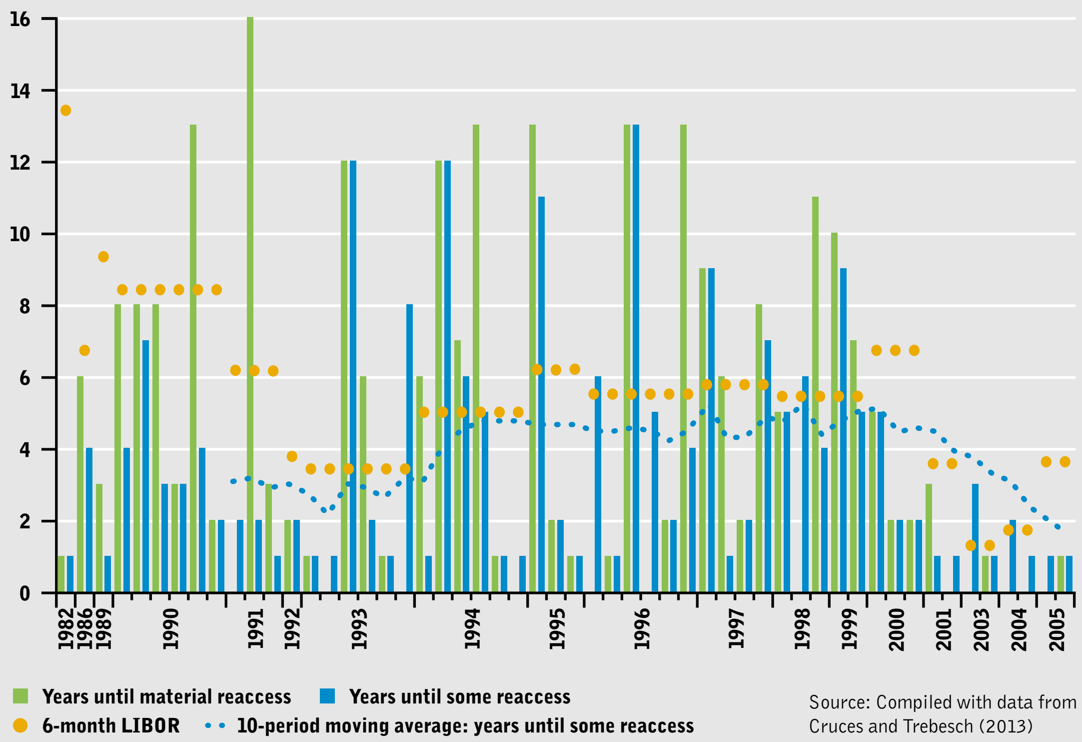
Finally, the declaration of default because of the execution of a DDE does not depend on whether creditors agree to the restructuring. Creditor participation in a DDE is «voluntary» only as far as the most likely alternative; an outright payment default would be even less attractive. What matters is the fact that the obligation is not being fulfilled as originally promised (S&P Global, 2020).

All things considered, there seems to be no possible way for governments to ask for private creditor forbearance without being put into default. In fact, some DSSI-eligible countries have already been placed on a review for a downgrade because of the rising risk that commercial creditors will incur losses (e.g. Moody's, 2020). Any PSI is highly likely to lead to a default by the sovereign requesting it. Which leads us to the second question: How damaging will the defaults be for future market access?

Market access is likely to be restored quickly

The drop in global interest rates, and the concomitant hunt for yield, has coincided with a shortening of the time it takes defaulting sovereigns to regain market access. For sovereign restructuring between 2000 and 2005, some market access was regained after an average of 1.8 years. The equivalent loss of access was 4.4 years for sovereigns restructuring during the 1990s.[13] Therefore, past prolonged market exclusion episodes are a poor guide for our exceptional times.

Fig. 7: Time between restructuring and regaining market access (54 episodes)

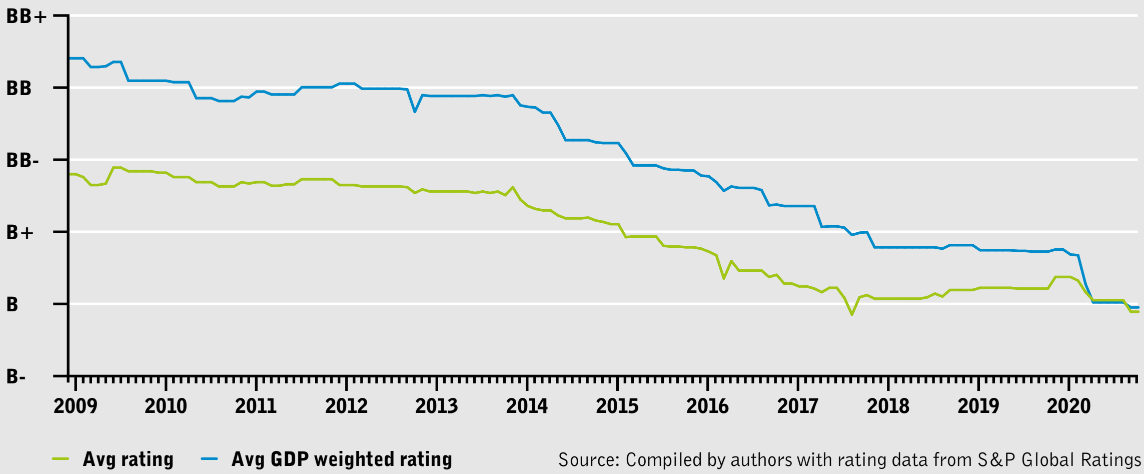


Source: Compiled with data from Cruces and Trebesch (2013)

13 This calculation is based on the database by Cruces and Trebesch (2013), with 11 episodes for the period 2000–2005 and 40 episodes for the period 1990–1999.

Market access is likely to be restored more swiftly if a restructuring comes quickly and orderly. The longer governments hesitate, the deeper the haircuts will need to be and the longer the debt market exclusion will last. Empirical evidence illustrates that a pre-emptive and comprehensive restructuring of sovereign debt can soften the recession in the debtor country (Forni et al., 2016). Avoiding a deeper recession by restructuring early also leads to better outcomes for creditors. Delays and repetitive restructurings have led in the past to larger haircuts (Forni et al., 2016). Evidence from sovereign default episodes suggests that a deeper haircut in turn leads to a longer loss of market access. Following restructurings with haircuts below 30%, there was a 50% probability of overcoming market exclusion within one to two years. On the other hand, in cases where the haircut was over 60%, it has historically taken more than a decade to get to this stage (Cruces and Trebesch, 2013). Procrastination is a lose-lose proposition: The ultimate financial loss for creditors will grow, while borrowing countries' recessions are deeper and longer, and their loss of market access more prolonged.

Fig. 8: Sub-Sahara Africa Rating History, December 2008 – October 2020
Note: This comprises data for the 19 countries in Sub-Sahara Africa rated by S&P Global Ratings



Source: Compiled by authors with rating data from S&P Global Ratings

Yet, the sands are shifting. The perception is gaining ground that this crisis is more than a mere liquidity crisis. For several sovereigns, especially in sub-Saharan Africa, this is increasingly becoming a solvency crisis, as debt service burdens overwhelm the nations' public finances. Some sovereigns, such as Zambia, were in an outright solvency crisis already before the pandemic struck. Credit Rating Agencies, which assess degrees of creditworthiness and solvency, have been consistently downgrading sub-Saharan African countries for years (Figure 8). For example, S&P Global lowered the GDP-weighted average rating of sub-Saharan sovereigns from «BB» in 2013 by over two notches to below «B+». The unweighted sub-Saharan average fell in lockstep to an even lower «B» rating (S&P Global, 2019). Already before the crisis, some sub-Saharan African sovereign bonds traded at interest rate levels signalling elevated default risk. In February 2020, the IMF found half of all low-income economies to be at high risk of debt distress or already in debt distress (IMF, 2020c). That a shock of the magnitude of the Covid-19 crisis should push additional countries towards unsustainable debt burdens should therefore not come as a surprise.

It is encouraging that private creditors seem to progressively subscribe to the same more-realistic assessment of the situation. The IIF sent a letter to G20 leaders in late September, acknowledging that «the issues in some countries are no longer temporary liquidity problems, but rather more fundamental solvency concerns» (IIF, 2020).

How to overcome the collective action problem?

Although private-sector recognition of a solvency crisis is a necessary condition for debt relief, it is not a sufficient one. Most holders of sovereign bonds issued by DSSI-eligible countries are fund managers that invest others' savings. They play a fiduciary role, as the funds they manage are not their own resources, but monies entrusted to them by third parties. The asset managers are the «agents» of the ultimate owners of the funds, the «principal». The Emerging Markets Investors Alliance, an association of asset managers involved in emerging markets, openly expresses the constraints faced by its members:

> *[P]rivate sector investors have a fiduciary responsibility on behalf of clients. In many cases, these are public pension funds and the savings vehicles of working people who have been severely affected by the* ***dual shocks*** *of Covid-19 and the economic recession. Their aim is simply to maximise their investment returns. Investment managers are legally bound to honor their contracts and cannot simply choose to donate their clients' money on their behalf, no matter how pressing the cause.*
>
> (Parameswaran, 2020)

This makes it institutionally harder to agree to a debt relief package as compared to creditor banks, which are the principals themselves: They manage their own resources, for example by granting a loan to a developing country or buying that government's bond.

The fiduciary role and the relatively large number of fund managers make the «free rider» problem particularly severe. In essence this means that each creditor has an incentive to not provide any debt relief in the hope that others will do so instead. There are no easy ways to overcome this collective action problem. The IIF, as the advocacy group of the sector, cannot be expected to proactively rally its members around the flag of offering debt relief. To reach a point where borrowing countries' governments feel incentivised to ask for PSI in debt restructuring, the official sector needs to take on a leading role. The most likely candidate to fill that void is the IMF.

The IMF is precluded from providing financial support to member countries if the sovereign debt is deemed to be unsustainable, unless the programme includes specific mitigating measures such as a debt restructuring to restore debt sustainability. Central to making the call on debt sustainability is the IMF and World Bank's Debt Sustainability Analysis framework. Although the core of the framework is a quantitative exercise, it does require the exercise of analytical judgement. Although debt relief via a restructuring may be a precondition for the IMF's engagement if it believes public debt is unsustainable, the decision to seek debt relief ultimately remains the prerogative of the member country. In cases where the judgement on debt sustainability is deemed to be more borderline, the IMF may not require a definite debt restructuring, but it could demand a more limited reprofiling of existing debt to restore sustainability (IMF, 2015). This would be akin to private-sector participation in DSSI, providing assistance in situations of liquidity stress, but not in cases of outright insolvency.

Although the decision to call for debt restructuring or reprofiling rests formally with the government of the borrowing country, the strained finances of many low-income countries would make it hard to reject IMF funding options, even if the attached condition were one of a debt management operation that might lead to a default being declared. The leverage the IMF currently holds over borrowing members becomes apparent when considering that, since March 2020, it has approved unprecedented financing for more than 80 member states, pledging around US$100 billion (IMF, 2020d).

How can the IMF's role be utilised to prevent governments from kicking the can down the road by treating a potential solvency crisis as one of liquidity? We recommend a way forward for the G20 to request the IMF and the World Bank to perform a new set of Debt Sustainability Analysis assessments for all DSSI-eligible countries, as well as other countries where debt sustainability is not a given. Given the renewed deepening of the global health crisis, this seems to be a reasonable request to make under any circumstances, as some key assumptions will need to be recalibrated. This collective round of Debt Sustainability Analysis assessments should then be used to take decisions on which countries will need to engage in a restructuring or reprofiling of their commercial debt as a precondition for extended IMF financial engagement.

Tunisia

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If not now, then when?

The lesson from the 1980s debt crisis must not be forgotten: By playing for time with an «extend and pretend» approach, the ultimate social and economic costs will inexorably rise. In the 1980s, it took seven years from the Mexican default in 1982 until the unveiling of the Brady Plan, which acknowledged for the first time that some debt relief would be required for debtors to recover. The delay led to the much lamented «decada perdida», or lost decade. In light of the multiple and growing social development and climate challenges, we cannot afford another lost decade, much less so for the most vulnerable nations on the planet. In the 1980s, there was an explanation for delaying the inevitable. Several US money center banks were so exposed to Latin American debtors that a swift round of restructurings would have dangerously diminished their capital positions, risking a financial crisis. Only once their balance sheets were sufficiently repaired could debt be written off. Today, the exposures to DSSI countries are negligible in comparison, and mostly with unleveraged asset management firms. There are no financial stability risks to acting now.

The advantage of such a coordinated approach would be that it helps to short-circuit the disincentives of low-income governments to proactively call for PSI. It would also overcome the coordination problem among borrowers: Apprehension of stigma will be holding governments back to be the first government to ask for PSI. The fear of being singled out, even if others follow swiftly behind, is not unjustified: Until today, the 1980s debt crisis is most often associated with Mexico, which was the first of many nations to declare a unilateral debt service moratorium. If all countries are assessed simultaneously, the first-defaulter stigma will not apply, as several can be expected to be slotted into the «unsustainable» category simultaneously. Only when a restructuring and the concomitant temporary sovereign default are accepted as part of the solution for some countries – rather than part of the problem – will the countries at risk be able to put their focus on the social and environmental development goals that will benefit their citizens and the global population at large. All it takes is for a central process coordinator to step forward and make the necessary call to arms. We believe the IMF, supported by the G20, is the only player in town to take on that role.

6. The Way Forward

The international institutions need to review the debt sustainability of developing countries. This must be followed by coordinated action involving all creditors – public and private – to restructure and, where necessary, reduce debt. The G20 should take a lead in spearheading a bold response to this unprecedented crisis and call on debtors and creditors to implement swift solutions to the looming debt crisis in the Global South.

Debt relief has to be part of a broader agenda for enabling green and inclusive recoveries in countries around the world. A debt relief effort of the appropriate scale should be coupled with a new and ambitious allocation of SDRs and significant new capital mobilised from development finance institutions in order to provide the fiscal space for emerging markets and developing countries to adopt sustained counter-cyclical responses to the crisis. To achieve a just transition, large and sustained increases in public investment will be necessary.

The proposal put forward in this report can help to address the immediate debt challenges facing the Global South. Going forward, however, a broader reform of global debt governance is necessary. As recently highlighted by Georgieva et al. (2020), a «reform of the international debt architecture is urgently needed». The IMF (2020e) has recently put forward reform options for the international architecture for resolving sovereign debt involving private-sector creditors. The international community should explore options for a sovereign debt restructuring mechanism – as was originally proposed by the IMF two decades ago (IMF, 2003) – to deal with debt crises.

Our proposal is aimed at providing developing countries the fiscal space at a critical time to address the three crises they are facing: the health and social crisis, the debt crisis, and the climate and environmental crisis. We highlight climate action for three reasons. First, climate science is clear about the great urgency for scaling-up climate mitigation to avoid catastrophic climate change. Second, even if climate mitigation efforts are successful, large-scale investments in adaptation will be needed to protect people from the effects of the global environmental change that is already happening. It is important to emphasise that the effects of climate change will disproportionately harm the poor – scaling-up climate adaptation is also a matter of climate justice. Third, research has shown that greater climate vulnerability is increasing sovereign risk and the cost of capital, and hence undermining public finances. Therefore, investment in adaptation is a good investment and will contribute to future debt sustainability.

But to be clear, neither efforts aimed at climate mitigation nor adaptation can be successful if the social dimension is ignored. This is why debt relief needs to be coupled with policies that are aimed at a just transition. Without large-scale debt relief and efforts aimed at facilitating a green and inclusive recovery, the international community can abandon its hopes of achieving the 2030 Agenda for Sustainable Development and the Paris Agreement.

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Griffith-Jones is researching and providing policy advice on reforming international and national financial architecture, with emphasis on a development perspective, and a special focus on development banks; capital flows to emerging and low-income economies; debt crises and their management; and debt-for-nature and development swaps.

Jörg Haas is Head of International Politics at the Heinrich Böll Foundation, covering international financial and economic affairs and global governance. He was Director of the European Climate Foundation's Global Climate Policy Program, supporting the global climate negotiations with technical and economic analysis, and in bilateral climate finance initiatives after the Copenhagen climate conference. From 2014 to 2017 he worked at Campact, a progressive digital citizen's movement. From 1993-2008 Haas joined the Heinrich Böll Foundation, where he first headed the Latin America Division and subsequently the Ecology Division, with a focus on climate and energy policy and the ecological governance of globalisation. In the early 1990s, he worked for GTZ in a rainforest project in Ecuador. He has a Diploma in Geography and Ethnology from the University Trier, with postgraduate studies at the Center for Rural Development (SLE) in Berlin.

Ulrich Volz is Director of the Centre for Sustainable Finance and Reader in Economics at SOAS, University of London. He is also a Senior Research Fellow at the German Development Institute and Honorary Professor of Economics at the University of Leipzig. Volz is a director of the Global Research Alliance for Sustainable Finance and Investment. Volz was Banque de France Chair at EHESS in Paris and taught at Peking University, Kobe University, the Hertie School of Governance, Freie Universität Berlin, the Central University of Finance and Economics in Beijing, and the Institute of Developing Economies (IDE-JETRO) in Tokyo. He spent stints working at the European Central Bank (ECB) and the European Bank for Reconstruction and Development and held visiting positions at the University of Oxford, the University of Birmingham, the ECB, Bank Indonesia, and Aoyama Gakuin University in Tokyo. He holds a PhD from Freie Universität Berlin and was a Fox International Fellow and Max Kade Scholar at Yale University. Volz was part of the UN Inquiry into the Design of a Sustainable Financial System, and has acted as an advisor to several governments, central banks, international organisations, and development agencies on matters of sustainable finance and development.

Moritz Kraemer is Chief Economic Advisor of Acreditus, a UAE-based risk consultancy firm, as well as Independent Non-Executive Director of Scope Ratings, the largest Europe-headquartered Credit Rating Agency. Until 2018 he was at S&P Global as the Sovereign Ratings Group' Global Chief Ratings Officer. Before that he started his career as an Economist at the Inter-American Development Bank in Washington, D.C. Kraemer holds a PhD in Economics from the University of Göttingen (Germany). He studied Economics, Latin American Studies and Literature in Frankfurt, Southampton and San Diego. He currently teaches graduate courses at Goethe-University Frankfurt's House of Finance and the Centre International de Formation Européene (Nice).

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