IMPOSSIBLE TRADEOFFS: RESPONDING TO COVID-19, ADAPTING TO CLIMATE CHANGE, OR REPAYING DEBTS?

Working Paper and Initial NGO Recommendations on Sustainable Finance Policy for Current and Future Challenges

INTRODUCTION

To date, the COVID-19 pandemic has cost over 6 million lives worldwide and has been an immense shock to developed and developing economies. The economic downturn has exacerbated existing debt vulnerability and brought countries into debt that did not previously struggle with covering their spending needs, including a number of middle-income countries. Over 51 countries (including 44 emerging economies) have suffered a downgrade of their sovereign debt credit rating. Global extreme poverty is on the rise for the first time in 20 years, and up to 163 million people are estimated to have slid back into extreme poverty by the end of 2021.At the same time, the global economy currently needs to be mobilizing trillions of dollars for an unprecedented low-carbon economic transition and preparing for the mounting costs of climate adaptation.

Developing countries are faced with the impossible trade-off of repaying accumulating debts, accepting additional loans with predatory qualities, or deferring payments and spending to support their citizens' immediate needs around climate change and COVID-19. Such pressures contributed to developing country governments repaying billions to private creditors in the global north while poverty continued to rise. While initiatives aimed at relieving developing countries' debt burden during COVID-19 suspended debt payments for some countries between April 2020 and December 2021, the lack of a comprehensive approach continues to leave the door open for developing country debt and assets to be increasingly owned by the People's Republic of China (PRC), its affiliates, and private creditors that have much less accountability compared to bilateral or multilateral lenders.

Especially at a time of compounding global crises, deferred spending on essential services in favor of meeting repayment obligations is the difference between life and death for millions of people, and increasingly so, as climate change poses an existential threat. These dynamics are at the heart of the future of poverty alleviation efforts globally.

There may be key windows of opportunity in the near future to shape debt policy to catalyze these changes. However, this issue will remain important until the root causes of debt distress are addressed. To support stakeholders in seizing this moment, this brief unpacks the tensions related to crisis-time spending and long-term challenges for sustainable finance in the face of climate change and COVID-19. It also provides a set of initial recommendations for a range of stakeholders. This paper is not intended to be read as the consensus of the NGO community, but rather as one indication that our community is wrestling with this issue in search of viable solutions.

DEFINING THE PROBLEM

Policies addressing the spending needs of developing countries have ebbed and flowed over time. Approaches in the 1980s and 1990s were characterized by a series of debt restructures until debt was deemed unsustainable on a country-by-country basis and ultimately canceled. Efforts at the turn of the 21st century began to consider ways to get ahead of this level of default with bilateral government donors relieving debt through efforts such as the Heavily Indebted Poor Countries (HIPC) Initiative in 1999 and the Multilateral Debt Relief Initiative (MDRI) in 2005. These interventions were very costly, and in many cases, creditor countries, including the U.S., are still making payments to these mechanisms to relieve previous developing country debt.

Since the 2008 global financial crisis, debt vulnerabilities have been intensifying. In 2010, developing countries′ debt was 110% of their GDP on average, which increased to 170% of GDP on average by 2019. Different from before, the rising debt stock during that time period came predominantly from private creditors, not from governments or multilateral development banks. About one-third of developing country debt is now owned by private creditors.

Prior to COVID-19, the fact that certain countries were able to take on debt from private creditors to expand their spending on key issues was seen by many as an indicator of progress. Countries were attracting a new set of public and commercial creditors beyond bilateral government donors giving overseas development assistance. Even countries considered fragile were increasingly able to attract the interest of investors to support essential sectors.

The 2020 economic collapse spurred by COVID-19 left many developing countries unable to spend on the things that matter most—vaccine roll-out, economic recovery, climate adaptation, and other basic services.

PREDATORY LENDING

At the same time that this new constellation of creditors appeared, the Government of the PRC policy banks and its associated creditors entered the arena with a set of obfuscated, predatory lending practices.[1]

In recent work exploring the terms of 100 Chinese loans to developing countries, the Center for Global Development, AidData at William & Mary, Kiel Institute for the World Economy, and Peterson Institute for International Economics highlight:

> First, the Chinese contracts contain unusual confidentiality clauses that bar borrowers from revealing the terms or even the existence of the debt. Second, Chinese lenders seek advantage over other creditors, using collateral arrangements such as lender-controlled revenue accounts and promises to keep the debt out of collective restructuring ("no Paris Club" clauses). Third, cancellation, acceleration, and stabilization clauses in Chinese contracts potentially allow the lenders to influence debtors' domestic and foreign policies.

PRC ownership of Chinese private creditors is a central tenet of this practice, as is their primary focus on getting repaid with little expression of interest in loan forgiveness as a public good. As a result, the scope of Chinese debt relief is narrow, and their interest in global cooperation on debt restructuring is limited. They have at times deferred the debt by extending out the terms of the loan, but like any debt suspension, this, too, has the potential to add to the debt burden of the country over time. While their financing nominally has conditions, their messaging does not align with their actions.

This phenomenon is creating a perfect storm whereby mounting needs and shrinking public financing are incentivizing developing countries to turn to either private creditors or to the PRC for financing that has less oversight, less incentive to cooperate, and potentially harmful terms.

THE IMPACT OF COVID-19 ON DEBT

---

[8] Banks that are owned by the government that also offer financing to developing country governments. These "policy banks" are policy arms of the government and can be held to a different level of accountability than private creditors.

The leading policy response to debt distress during COVID-19 has been to delay requirements for repayment through the G20-led Debt Service Suspension Initiative (DSSI). The DSSI has provided about $12.9 billion to 48 out of 73 eligible countries that requested extensions between 2020 and 2021. Originally scheduled to end in December 2020, the DSSI suspension period was extended through December 2021. However, this mechanism pertained only to bilateral creditors. Private creditors and multilateral development banks—holding nearly two-thirds of the global debt—chose not to participate in the DSSI, and as a result, it is estimated that developing countries (excluding China) paid billions in net repayments to those creditors located in the global north in 2020 during COVID-19. Despite the assistance provided through the DSSI, the flow of resources still favored the mighty.

Although some countries will continue to need debt suspension, and in some cases, cancellation, the DSSI was designed to be a crisis response mechanism, not a long-term solution. Its inherent policy of deferral forged among bilateral creditors had the short-term objective of increasing the ability to spend, consistent with policies in developed countries that provided stimulus packages in response to economic shutdowns spurred by COVID-19. The DSSI aimed to address immediate spending needs during the pandemic, which was an important part of the global crisis response. The policy delayed the need for repayments to other governments to allow the economies much-needed time to rebound, but it was not designed to cancel debt for countries that could otherwise manage some level of debt appropriately. The DSSI expired in December 2021 and countries with debt were required to resume repayments starting in January 2022, including new debt that has been acquired during the COVID-19 pandemic. It is estimated that low-income countries will have to repay $11 billion to bilateral and private-sector creditors in 2022.

Another response aimed at supporting liquidity-constrained countries during COVID-19 was IMF's allocation of 456 billion Special Drawing Rights (SDRs) in August 2021. This historical allocation, equivalent to $650 billion, was meant to boost liquidity and foster global economic resilience by building up global reserves. However, because of the IMF's quota structure, most of the SDRs will flow to high- and middle-income countries whose liquidity challenges are not as severe as those of other developing countries. In light of this, G20 countries pledged $60 billion through the SDRs as voluntary contributions for the most vulnerable states. But there are currently no viable options for countries to voluntarily channel SDRs to developing countries. On October 2021, the G20 called for the creation of a new Resilience and Sustainability Trust (RST) to "provide affordable long-term financing to help low-income countries, small developing states, and vulnerable middle-income countries to reduce risks to prospective balance of payment stability, including those stemming from pandemics and climate change." The IMF continues working towards the development of a RST framework ahead of the 2022 Spring Meetings.

As a further attempt to take a sustainable finance approach, the G20 recently approved the Common Framework for Debt Treatments beyond the DSSI (Common Framework) to go beyond debt suspension and into debt restructuring. The Common Framework acknowledges the unsustainability of debt and opens the door for further work by allowing for debt re-profiling to change the time period and interest rates associated with existing debt. However, current debt structuring negotiations for the poorest countries that fall within the Common Framework have stalled. Furthermore, this framework avoids the issue of actual debt reduction.

Many countries are now standing at the edge of a "fiscal cliff," considering what it means for their ability to continue to respond to COVID-19 and its numerous simultaneous and long-lasting impacts.

NEEDS COMPOUNDED BY CLIMATE CHANGE

Squarely focusing on debt issues and COVID-19 without considering climate change, however, misses a major existential threat and the urgent need for decarbonization. The opportunity stems from shaping crisis-time spending through COVID-

19 recovery plans and financing to achieve the Paris Agreement goals of keeping average global temperature increase at or below 1.5 degrees Celsius and investing in climate change adaptation. As the IPCC's Sixth Assessment Report shows, climate change impacts are already more widespread and intense in every region of the world than previously predicted. With every tenth of a degree of additional warming, the threats to people, species, and ecosystems increase dramatically. With every year that goes by, reducing greenhouse gas emissions at scale gets harder and adaptation needs grow. The financing needs for emissions reduction and adaptation are far outstripping what is currently available. The 2021 UNEP Adaptation Gap Report estimated that climate adaptation needs will grow between $140-300 billion by 2030 and to $280-500 billion by 2050. There are also trillions needed in infrastructure to prepare for current and new impacts of climate change.

The 40 least developed countries contribute less than 10% of global greenhouse gas emissions, yet are bearing the brunt of the impacts through extreme weather, food insecurity, loss of livelihoods, forced migration, and more. Under the Copenhagen Accord on Climate Change in 2009, developed countries committed to jointly mobilizing $100 billion a year by 2020 to address the needs of developing countries. This was, in part, a way to resist direct compensation to developing countries for climate impacts that they were experiencing and did not create themselves. This goal was not reached. In 2019, the amount actually raised was $79.6 billion new and additional funding, and it is not expected that the 2020 or 2021 numbers will reach the $100 billion goal. Still, 75% of climate finance is delivered in the form of loans, not grants or concessional financing.

Traditional overseas development assistance (ODA) has also remained flat. Of the ODA that is available, only a fraction focuses on climate-related goals, and even less actually ever makes it to the local level in the places hardest hit by climate change. The immense amount of capital needed to address these multiple crises will not come exclusively from overseas development assistance. A fulsome climate finance strategy—one that addresses the needs of the poor—requires diverse sources, collective action, and a comprehensive approach that takes multiple, time-sensitive priorities into account.

Current approaches that couple climate and debt issues have been piecemeal, such as through debt-for-nature or debt-for-climate swaps. While critical as proof of concept, these very specific instruments at the project level need to be reimagined and combined with other types of financial support and aligned with much bigger climate goals.

In this uncertain moment when the DSSI has recently expired and climate and COVID-19 response needs continue to mount, there is a collective need to answer the longer-term question that will determine the world's poverty alleviation trajectory for at least the next decade. The following recommendations begin to tackle this problem.

RECOMMENDATIONS

The following recommendations, a product of three InterAction convenings of sustainable finance experts and senior advocates, fall within two main categories: how to deal with existing debt and how to incorporate climate-friendly mechanisms and processes when dealing with new debt. The recommendations are organized by stakeholders.

All Stakeholders Should:

- **Increase overall political will to take a systematic approach to large-scale debt and climate issues.** With many low-income countries facing continued economic disruptions and some potentially defaulting on their sovereign debt in 2022, we could be looking at a global political crisis. Before the COVID-19 pandemic, several countries (from Ecuador to Egypt) were facing local political crises due to rising inequality. While COVID-19 put a pause on some of those political movements, the global economic crisis that it has led to has only worsened inequality on a global scale. The impact of the war in Ukraine on global food prices could lead to further destabilization. Moreover, previously localized political crises could soon merge into a global political crisis. Therefore, it is imperative that global leaders push for comprehensive solutions to the debt crisis that also incorporate climate financing.

- **Avoid reinstating conditionality models based on lessons learned from previous efforts to link nature and financing goals to debt restructuring.** Even on climate-related goals, prevent new conditionality as much as possible by ensuring governments and local civil society are making the decisions and influencing the process. Tie more debt cancellation to other topics without succumbing to conditionality or contractionary policies. Incorporate lessons learned from **debt-for-nature swaps** that would allow the price of the debt to decrease.

- **Support country ownership and civil society oversight and participation in debt restructuring/solutions such that the terms of debt management are defined by the debtor countries and less susceptible to predatory lending.** Differentiate debt issues in each country through multistakeholder convenings involving civil society and the creation of regular platforms that shift accountability to national citizens and link to performance-based payments based on agreed upon changes. Allow for debt solutions to be linked to adaptation, nature conservation plans, and national development plans and create the space for debtor countries to set those terms. This will make debt, as an instrument, sustainable in the long run. Include specific indicators of change for shared accountability among creditors and debtors, and have the indicators overseen by civil society. Ensure frequent local consultations and independent dissent channels.

- **Ask for increased transparency and accountability of private creditors in developing countries and their participation in debt reform issues.** Having accurate information, especially around contingent liabilities and hidden or undisclosed debt, is critical for determining existing debt risks. Even though increased debt transparency does not guarantee more efficient debt restructuring, it can **assist in identifying debt sustainability problems** earlier on. **Much progress is needed** in increasing transparency around contract secrecy, as well as collateralization.

- **Debunk the myth among private creditors that debt restructuring scares other private entities from investing in developing contexts.** Once debt is restructured, states do return to markets.

The U.S. Government should:

- **Through Congress, double annual enduring bilateral and multilateral foreign economic, health, and humanitarian assistance by 2025, beginning with a 302(b) allocation for Fiscal Year 2023 State and Foreign Operations that amounts to at least $69.1 billion.** New additional funding is essential to staving off the impacts of the climate crisis, COVID-19, and on-going debt risk. Funding must increase over time to support ongoing work and to meet increasing needs. In terms of the ability to effectively use foreign assistance, there is very little risk of spending too much given the sheer scale of issues the U.S. and the world currently face.

- **Devise a comprehensive strategy for managing global debt. Congress is well-positioned to work with agencies to define the U.S. approach to managing global debt.** In addition to increasing ODA, an overarching strategy should bring private creditors to the table to discuss debt restructuring, SDR allocation and flexibility, increasing funding for the MDBs, and more. Support for global debt relief should not come at the expense of existing foreign assistance.

- **Through the Treasury, utilize the leverage of the U.S. Government at the G20 and other multilateral forums to hold China accountable to the Common Framework, especially related to their own lending practices, and**

expand who has a seat at the table. The Common Framework could provide a possible "off-ramp" for countries that were deemed eligible for DSSI and an area ripe for policy advancements. China's participation is essential, as is that of private creditors, middle-income countries, and large ocean developing nations—many of whom are currently excluded from the dialogue.

- **Issue executive orders to bring private creditors into the debt restructuring process for countries facing significant climate risk.** Precedent for this action exists when the U.S. government engaged private creditors during the Iraq War to restructure Iraq's debt, although this was an exception and controversial.

The G20 (or its successor if it evolves) should:

- **Work with multilateral development banks and other stakeholders to create an official definition of unsustainable debt.** Currently, debt distress is often viewed narrowly by creditors as the lack of capacity to make payments; however, signals and anticipated spending needs due to climate change can be seen long before a country defaults on payments. An agreed upon definition of unsustainable debt should include current limitations on fiscal space, particularly spurred by crises, and climate and global health risks. Even if countries have the capacity to repay debt, the requirements for repayment need to consider current and future spending needs. The G20, through the Common Framework, could be in a prime position to get ahead of the next debt crisis by defining how to support fiscal space and to view spending needs in the context of the very time-bound climate crisis. However, more progress is needed for its successful implementation.

- **Expand the types of creditors involved in debt restructuring, starting with the Common Framework, and incentivize their participation in sustainable finance to avoid current debt relief from servicing and benefiting non-compliant creditors.** Currently, the only way for developing countries to ask for debt restructuring is through the **Paris Club**. Private creditors and the PRC fall outside of the Paris Club, and yet are possible sources of restructuring. The Paris Club should seek to expand participation to include these other actors. This would be a welcome change, though it does not address the fact that countries that receive debt relief from a bilateral or multilateral creditor may use that additional fiscal space to repay other private or Chinese debts that they might have. The success of a longer-term approach to debt depends on some level of collective action and providing the right incentives to encourage the private sector and the PRC (who have been reluctant to participate in debt restructuring) to be part of the solution.

- **With a new definition and an expanded set of participating creditors, shift the current reactive approach on debt to a preventative one grounded in sustainable finance.** All categories of creditors—bilateral, private, and multilateral—need to develop upstream approaches for what to do when countries are showing the initial signs of debt distress. There are often **more options available earlier on**, such as grant-supported concessional financing at more favorable rates that more equitably share the burden, than there are at the moment of default. Creditors should look at the full spectrum of financing options in coordination with their peer lenders and act as soon as the signals appear. These decisions could be organized using previously proposed **debt resolution frameworks**.

- **Create binding responsible borrowing and lending rules to prevent this level of unsustainability in the future.** There should be defined rules around: 1) transparency, 2) debt management, 3) civil society oversight of debt, and 4) availability of concessional financing.

International Financial Institutions should:

- **The World Bank and International Monetary Fund (IMF) can launch a technical resource platform on funding climate interventions as part of debt restructuring.** This platform, still under development, would function by creating memorandums of understanding among creditors and debtors that are then implemented on a country level. Designed and executed properly, it has the potential to unify the U.N., OECD, and the IFIs in their approach to the climate and debt crises, add scale to climate-resilient debt management by reducing transaction costs, and safeguard debtor countries against piecemeal approaches, lack of transparency, and lack of creditor accountability.

- **The OECD, IMF, and World Bank should continue to develop a standard country categorization and financial instrument matching tool based on level of fiscal distress, ability to borrow and access financing, degree of biodiversity, climate risk, and level of human need.** This would help answer the empirical question of geographic difference in debt burden, climate, nature, and adaptation needs, and economic and COVID-19 response needs. This tool should incorporate the extent to which human rights of land and environmental defenders are negatively impacted by private or public interests as a consideration.

- **Enhance collaboration with national development banks to better align financing with national level planning. The 463 development finance institutions worldwide have a collective balance sheet of $11.5 trillion.** Most of that financing is located in national and sub-regional development banks. Regional and local banks bring different things to the table, namely closer understanding of local context and ability to support short-term asks. Better collaboration between MDBs that have the potential to fund long-term transformation and regional and national development banks would support better deployment of capital.

- **Work with countries to articulate what a green recovery from COVID-19 looks like and engage in country-specific transition plans to foster longer term growth.** Part of the work currently needed is envisioning and promulgating what it looks like to integrate support for biodiversity and resilience into national strategy planning. These plans should consider both the short-term and long-term changes in the energy, utilities, food, and transportation sectors to support economic growth that benefits the extreme poor and the middle class. Align funding to priorities within countries' NDCs, national biodiversity and adaptation plans, and national human development plans. Explore the Least Developed Country Initiative for Adaptation and Resilience. Take longer term biodiversity and environmental degradation into account in economic models. Do not delay investment in renewables and coal phase-out.

- **Couple debt swaps with debt relief and budget support for countries to best put money toward climate and COVID-19 recovery priorities.** The budget support that is provided by the World Bank should aim to truly follow a partnership-based approach. As such, it should allow countries to decide how best to invest the money. This could allow countries to seek opportunities to couple debt swaps with initiatives or programs focused on climate and COVID-19 recovery. Truly successful budget support should aim to be inclusive and holistic in order to lead to more effective development.

Multilateral climate funds[2] should:

- **In collaboration with countries in debt, help determine their suitability for climate-debt transactions and projects.** The governments of Uganda, Costa Rica, Pakistan, and Jamaica have requested the ability to swap debt for climate-related work, and the interest for such transitions should originate with developing countries. Climate funds are in a position to support those requests and work with those countries to determine what approach might make sense. Given that such projects would be seeking to both create fiscal space and address climate needs, they should be cross-ministerial, involving ministries of finance, central banks, ministries responsible for climate and environment, and development.

- **Use the same country categorization and finance matching tool that OECD, IMF, World Bank are developing.** Aligning country categorization and financial matching tools among multilateral climate funds can support more transparent and efficient co-financing. An additional benefit to the sharing financing tools among multilateral climate funds could be compilation of data on the types of climate-related projects that are being implemented.

CONCLUSION

COVID-19 will not be the last paradigmatic shock in our lifetime. Approaches that build resilience against these shocks require accelerated policymaking on managing global debt. Absent this urgent work, developing countries will continue to have to make difficult decisions to scale back social safety nets and climate adaptation, often to repay debts to private creditors and the PRC. Stakeholders have a key window of opportunity to build political will for expanding the set of creditors involved, mechanisms for addressing the climate crisis through debt restructuring, and taking a proactive approach to debt distress.

ABOUT THIS BRIEF

This brief synthesizes three InterAction convenings of sustainable finance experts and senior advocates within InterAction Member NGOs. These convenings took place on March 23, 2021 and May 26, 2021, and explored the state of play for debt management during COVID-19 and upcoming opportunities to help countries create additional fiscal space and achieve their climate mitigation and adaptation goals. These convenings have been supplemented with research and conversations from early 2022. Expert views incorporated into this brief include those from Scott Morris, Senior Fellow, Center for Global Development; Sejal Patel, Climate Change Researcher, International Institute for Environment and Development; Iolanda Fresnillo, Senior Policy and Advocacy Officer, European Network on Debt and Development (EURODAD); Ilmi Granoff, Director for Sustainable Finance, ClimateWorks Foundation; and Kevin Gallagher, Professor at Boston University Pardee School of Global Studies and Director of Boston University Global Development Policy Center.

The brief was written by Lindsey Doyle with contributions from Claudia Sanchez de Lozada, Lisa Peña, and Jenny Marron, and reviewed by Noam Unger, and InterAction's Climate Advocacy Working Group. Special thanks to Erin Landy and Maia Sparkman for early support on producing this brief.

This working paper is part of InterAction's **NGO Climate Compact** commitment to learning and addressing the needs of those hardest hit by climate change.

---

[2] Such as the Green Climate Fund, Global Environment Facility, U.N. Adaptation Fund, or the Climate Investment Fund.

ABOUT INTERACTION

InterAction is a convener, thought leader, and voice for NGOs working to eliminate extreme poverty, strengthen human rights and citizen participation, safeguard a sustainable planet, promote peace, and ensure dignity for all people.