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EM Sovereign Debt 5.0: Nature and Climate

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Still very insufficient funding at global level

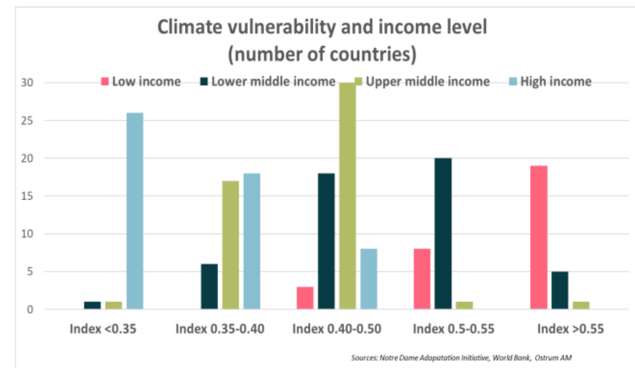
Meeting the Paris Agreement's 1.5°C target (and adaptation targets) requires between $3 trillion and $6 trillion annually until 2050 (according to Mobilizing Private Climate Financing in Emerging Market and Developing Economies, IMF, July 27, 2022) while the current level of investment is only $632 billion. In addition, investments in developing countries must be multiplied by 4 or 8 by 2030.

The amounts mentioned at COP 27 are also very far from these objectives. The United Nations has promised a $3.1 billion plan to strengthen countries' ability to prepare for dangerous weather. The V20 (the club of countries most vulnerable to climate change) and G7 also launched the "Global Shield against Climate Risks", with Germany contributing 170 million euros (179 million dollars). So, we are still very far from the funding needs to achieve the objective, when there is an emergency, especially for poor countries.

A triple crisis for poor countries

Climate crisis…

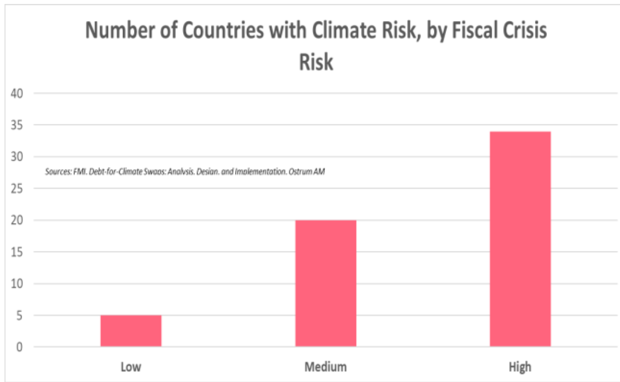
Poor countries are the most vulnerable to the consequences of climate change. The graph below shows climate vulnerability as a function of the country's income level. We take all available Notre Dame Adaptation Climate Vulnerability Initiative (ND) indices and rank countries according to their income level according to the World Bank classification. The higher the ND index, the higher the climate vulnerability of countries.



High-income countries are the least vulnerable to climate change with a ND index below 0.35. Low-income countries are based on an index above 0.5, which is characteristic of high climate vulnerability.

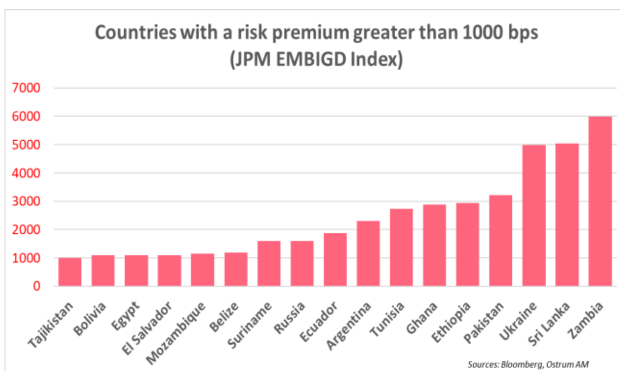
…And the Covid-19 and debt crisis

Low-income countries are also often those that lack the capacity to invest because of their high levels of debt. Covid-19, the Fed's aggressive monetary policy tightening and the war in Ukraine have exacerbated the fiscal position of many developing countries. The graph below ranks the 59 most vulnerable countries according to the International Monetary Fund, based on the risk of a fiscal crisis.



34 out of 59 countries most vulnerable to climate are thus at high risk of budget crisis, but represent only 0.5°% of global carbon emissions! The climate and the problems of debt sustainability are therefore correlated, but not necessarily causal. This simply highlights that many developing countries with a history of debt vulnerability are also the most vulnerable to climate change.

Several countries also no longer have access to capital markets to finance themselves. The chart below shows countries with a risk premium greater than 1000 bps in the JPM EMBIGD (dollar denominated debt) index.



Pakistan and Sri Lanka are two countries that are highly vulnerable to the consequences of climate change, deteriorating their sovereign credit risk. Both countries are in default.

Deadlock of restructuring negotiations and financial support

To help these countries regain fiscal room, the G20 established the Debt Service Suspension Initiative (DSSI) between May 2021 and December 2021. This initiative has benefited 47 countries for $12.9 billion. This has come to an end and should be replaced by the New Common Framework for restructuring the debt, which is slow to be implemented. Only three countries have formally requested debt restructuring: Zambia, Ethiopia, and Chad. This new debt restructuring framework also faces a major challenge in coordinating creditors, particularly with China, the leading creditor of low-income countries. Ethiopia owes 17°% of its GDP to China, 23°% to Zambia, 11.6°% to Pakistan, and nearly 10°% to Sri Lanka. Under the G-20 common framework for restructuring the debt of poor countries, China's guarantee is a prerequisite for the disbursement of IMF financial support. It is in this difficult context that interest in debt-for-nature-swaps has increased.

A renewed interest in the debt-for-nature swaps

The idea of simultaneously solving the debt and climate crisis seems to be emerging, generating renewed interest in debt-for-nature swaps.

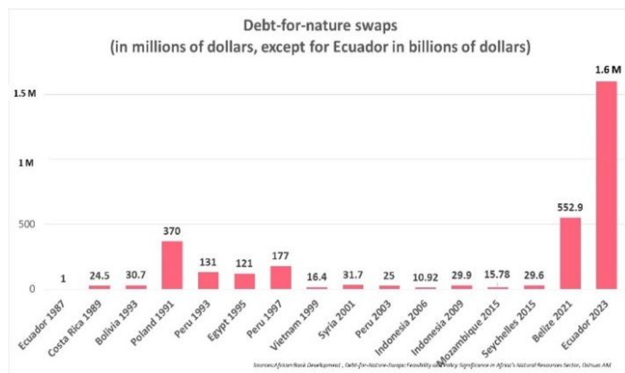
The principle

Debt-for-nature swaps are normally negotiated as part of the restructuring of public debt and long-term public debt guaranteed to official bilateral creditors, such as members of the Paris Club. Debtor countries are eligible if they are heavily indebted (according to IMF standards), if they have exhausted other more favorable debt relief instruments (for example unconditional debt relief), and if they can convince creditors that they are able of allocating a sustainable part

of the resources, that have been budgeted for debt repayment, to the financing of important environmental projects at the national, regional, or global level.

Debt-for-nature swap: an integral part of debt restructuring in Latin America

The debt-for-nature swap began in the 1980s, during the Latin American sovereign debt crisis. The chart below shows debt swaps with a significant amount since the late 1980s.



Of the 140 swaps entered since 1987, only 3 have a value of more than $250 million. The average size is $26.6 million.

Belize's 2021 debt-for-nature swap is interesting to mention because it is the first multiparty debt swap. It included the Government of Belize, the Government of the United States, and the Nature Conservancy (TNC), US Development Finance Corporation (USDFC), and private creditors who held the sovereign bond in default of face value of $553 million, (about 30 percent of Belize's GDP!).
Using a "blue bond" issued on the capital market, a TNC subsidiary had arranged a "blue loan" to the Government of Belize to finance a bond swap with a 55 cents per dollar nominal discount. About 85°% of the debt holders had accepted the offer, but through a class action clause, the debt was fully exchanged.
For its part, Belize agreed to use part of its debt relief to pre-finance an endowment of $23.4 million to support the conservation of the seabed.
The country has also committed $4.2 million a year to marine conservation and to expand its protected ocean area by approximately 16°% to 30°% by 2026. Following the transaction, the S&P rating agency raised Belize's external sovereign rating to B-, previously lowered to "Selective Default". The improved sovereign rating had also enabled Belize to borrow on the capital markets at a lower borrowing rate in dollars.

Ecuador: the world's largest debt-for-nature swap!

Ecuador concluded the largest swap of $1.6 billion on 9 May. The new blue bond of $656 million, issued by GPS Blue Financing DAC, with a maturity of 2041, allows Ecuador to pay a coupon of 5.645°%, with a $85 million credit guarantee from the Inter-American Development Bank and $656 million against the political risks of the U.S. International Development Finance Corp. (DFC). Note that the new "blue bond" has a yield well below an Ecuadorian bond of the same maturity (equator 1.5°% maturity 30/07/2041) whose yield is above 18%!

This allows Ecuador to save $1.13 billion in debt service over the next 17 years, including $473 million invested in conservation and sustainable activities. Ecuador holds $16 billion in bonds that will mature in 2030, 2025 and 2040. The rating agency Moody's has assigned the rating of AAA- to the new "blue bond" which is 16 steps above the current sovereign rating of Ecuador!

Debt-for-nature swap : the solution for solvency problems?

A minimal budget impact…

According to the African Development Bank, debt-for-nature swaps have historically had a minimal fiscal impact on the countries concerned. Since 1987, the nominal value of the debt treated globally by swap is only about 3.7 billion dollars (excluding Ecuador), of which only 318 million dollars for Africa. African countries will have to repay around $242.8 billion in debt service by 2028.
In addition, the study of the International Monetary Fund, Debt-for-Climate Swaps: Analysis, Design, and Implementation, shows that when a country's debt is sustainable, Debt-for-nature swaps are less effective than just climate action through conditional grants, as swaps subsidize non-participating creditors.
Belize, for example, is the exception. The debt-for-nature swap did not fully restore the sustainability of the country's debt, but it did remove the only bond that accounted for 30°% of its GDP, in exchange for a smaller bond with significantly larger fiscal margins than before.

… And a difficult implementation

As the two examples from Belize and Ecuador show, the organization of debt-to-nature swaps is constraining. This requires concerted efforts across government and very thorough preparations: strong pre-feasibility studies, strong fiscal capacity, commitment to transparency and international credibility of domestic spending program that is attractive to the whole of government. However, the debt-for-nature swap can play an important role in integrating the environment into government policies and national environmental financing.

… But debt-climate swaps can be useful instruments when the main constraint on climate investment is the lack of fiscal room.

In such cases, standard climate finance (green loans or government bonds) will not solve the solvency problem of countries, as it would increase indebtedness. Instead, promoting investment to address the consequences of climate change requires fiscal transfers. These could take the form of climate-conditional subsidies, climate-debt swaps, or global debt. Debt-for-nature swap can also be effective when the consequences of climate change threaten sovereign risk, as in Pakistan and Sri Lanka.

… And allow for concessions from creditors

The debt-for-nature swap has an important potential to obtain concessions from private sector creditors. When a country needs comprehensive debt restructuring, climate-debt swaps could encourage reluctant creditors to participate in debt relief, while attracting new players into the development finance system.

Conclusion

Faced with the deadlock in debt restructuring negotiations and financial support for poor countries, the debt-for-nature swap has generated renewed interest from both multilateral and private lenders. These instruments were an integral part of Latin American debt restructuring. Their implementation is constraining, and the budget impact is minimal. However, the debt-for-nature swap makes it possible to obtain concessions from reluctant creditors and brings new players into the development finance system. The debt-for-nature swap can also be useful instruments when the main constraint for climate investment is the lack of fiscal room. They will probably be only part of the solution to the current triple crisis in poor countries.

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