Innovative financing for Africa

Harnessing debt for climate and nature

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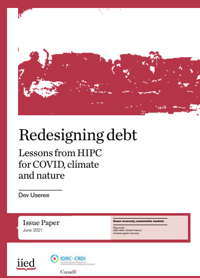

Africa is severely impacted by the triple crisis of debt, climate change and nature loss. The continent's debt now stands at more than 70% of GDP. There is potential to address these crises through 'general purpose' debt financing linked to climate and nature key performance indicators (KPIs). For severely indebted African countries this could be through debt-for-climate-and-nature conversion or swaps. For less debt distressed countries with good market access, the best instrument would be general-purpose performance bonds for climate and nature. There is growing demand for these instruments among African governments, but for this approach to succeed key African creditors including China and the private sector would need to engage, with support from the G20, UN, IMF, World Bank and African Development Bank.

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Summary

Africa's triple crisis of debt, climate and nature

The 54 African states are among the most vulnerable to the triple crisis of debt, climate change and nature loss in the post-COVID-19 context. The average debt-to-GDP ratio in Africa is expected to increase to more than 70% in 2021. Most African countries are projected to lose 2–5% of GDP a year as a result of climate change by 2030 according to conservative estimates.[1] At the same time, the marine and terrestrial biodiversity of Africa is under massive pressure due to habitat loss, climate change, over-fishing and poaching.

Given the decline in public finances, African governments' ability to invest in an inclusive and sustainable post-COVID-19 recovery will largely depend on the availability of external financing, such as:

- debt relief and restructuring
- multilateral and bilateral financial assistance including soft loans/grants and IMF special drawing rights (SDRs)
- access to markets and external private finance.

Safeguarding Africa's climate and biodiversity while debt levels are so high is extremely challenging. Post-COVID-19 economic recovery costs will deplete the financial resources needed to address the climate crisis and environmental degradation. Managing Africa's debt to provide inclusive investment in nature protection and climate could provide a bridge to greater debt sustainability and address the three crises of debt, climate and nature.

Debt instruments for climate and nature in Africa

The type of large-scale debt management instrument that could be used for climate and nature would depend on the debt situation of the particular country. African countries in debt distress could reduce (ie swap or convert) debt – either by conversion to local currency and/or repayment at a lower interest rate, or some form of debt write-off, in agreement with their creditors, or by changing the instrument used through refinancing. The money saved would then be used, through government systems, to achieve agreed key performance indicators (KPIs) on climate resilience or protecting biodiversity that also contribute to poverty reduction. To date only relatively small-scale debt swaps have been tried, such as the Seychelles' debt-for-climate swap for US$28 million in 2015. But some African countries such as Cabo Verde are now aiming for larger programmatic debt-for-climate swaps.

This debt restructuring linked to climate and nature is beginning to gain traction with OECD bilateral lenders and some multilateral organisations, such as the IMF, but Africa's debt is now held by a wider group of creditors including China and private financiers. These newer creditors are still reluctant to engage in debt linked to climate and nature. But growing recognition of the need for more public and private investment to achieve the Paris Agreement goals and to protect biodiversity is beginning to influence private creditors and G20 members.

For less debt-distressed African countries with reasonable access to the markets, the best debt financing option could be issuing new debt or at least rolling over old debt as bonds for climate and nature. These could be 'use of proceeds' green or blue bonds for terrestrial and marine investments respectively where all the funds raised by the bond is used for these environmental purposes. A second and emerging debt instrument is the 'general purpose' performance bond under which some funds are available for general fiscal goals and other sectoral priorities, including health and social protection, on condition that agreed climate and nature key performance indicators (KPIs) are achieved through appropriate investments. In Africa, Benin has already issued a sustainability-linked bond and Ghana and Senegal have expressed interest.

Debt instruments based on key performance indicators

This report focuses on 'general purpose' debt financing instruments linked to climate and nature KPIs (ie debt-management instruments for climate and nature and 'general purpose' performance bonds for climate and nature). The novelty of these instruments is the KPIs, and we highlight three aspects:

- Our emphasis here is on debtor-country ownership by identifying KPIs based on existing national strategies, budgets and plans such as nationally determined contributions (NDCs) for climate (or the national climate strategy equivalent) and national biodiversity strategy and action plans (NBSAPs) for nature.
- We highlight the need for effective monitoring, reporting and verification (MRV) and the need for independent MRV to ensure credibility.
- Finally, we stress the need to involve citizens in the selection and agreement of climate and nature objectives to ensure accountability and effective implementation, and buy-in to positive climate and biodiversity outcomes.

Looking forward

There is increasing demand among African countries for debt instruments for climate and nature outcomes. At the High-Level Event on Financing for Development in the Era of COVID-19 and Beyond[2] in September 2020, Namibia's president Hage Geingob called for debt-for-climate swaps as a key mechanism. Cabo Verde's prime minister called for debt relief for sustainable development in his speech to the UN General Assembly in September 2020, and the president of Gabon called for financial innovations such as debt swaps to better protect carbon sinks and biodiversity in Africa at the Global Center on Adaptation's Leaders Dialogue in April 2021.[3] Benin has issued Africa's first SDG-linked performance bond for €500 million and Ghana is preparing a US$2 billion social and environmental performance bond.

The United Nations Economic Commission for Africa (UNECA) and the International Institute for Environment and Development (IIED) are working together with selected African countries to contribute to the analysis, advocacy and action around debt instruments for climate and nature to improve debt sustainability and promote investment in poverty-reducing climate and nature outcomes.

The IMF and World Bank are playing a key role in highlighting the need for debt instruments to support a green and inclusive post-COVID-19 recovery. With the OECD and United Nations, they are developing a platform that will support countries with debt financing for climate and nature. The United Nations is also engaged in a post-COVID-19 review of 'financing for development' architecture under the Addis Ababa Action Agenda, which also prioritises sustainable debt treatment with debt swaps emerging as a possible part of the solution.[4]

For this approach to succeed, major creditors including China and the private sector will have to engage. This can be taken forward through the G20 and by identifying innovative ways to combine the G20's debt initiatives with achieving climate and nature outcomes.

Africa's triple crisis of debt, climate and nature loss

1

Even before the COVID-19 pandemic, fears were growing over developing countries' debt, which had surpassed US$8 trillion by the end of 2019.[5] The pandemic has made the situation much worse as its economic impact pushes millions more women, children and men in these countries into poverty. This paper builds on Steele and Patel (2020),[6] taking into account the impacts on Africa of the ongoing pandemic, and integrating UNECA's experience from their 54 member states on context, country experience, and the specific risks and opportunities for supporting country-led sustainable development.

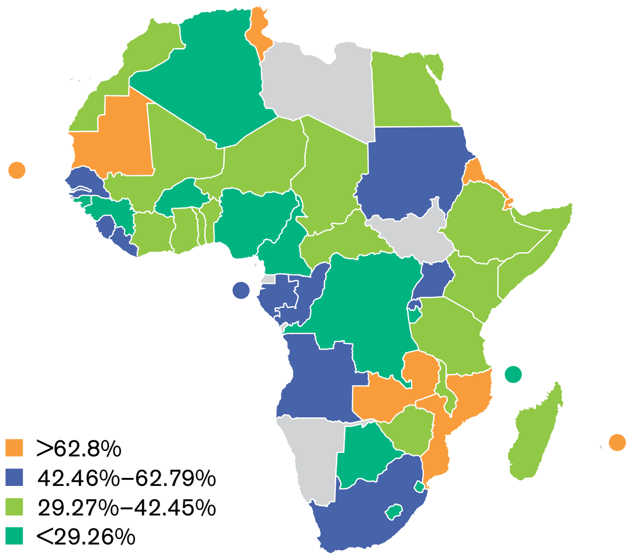
1.1 Africa's sovereign debt

For many countries globally the COVID-19 pandemic has required a major increase in spending on health and welfare, and has resulted in a significant decline in economic productivity, including from tourism and commodity-based sectors, and reductions in diaspora remittances. This has led to both a narrowing of fiscal space and an increase in sovereign borrowing. The least developed countries across Africa have been among the hardest hit.

Of the 54 African states (see Table 1), 23 are low-income countries, also classified as least developed countries (LDCs), and are all International Development Association (IDA)-eligible countries, with 14 of them being fragile or conflict-affected states (FCAS), and one a small island developing state (SIDS). There are a further 23 lower-middle-income countries, ten of which are LDCs, and 15 of which are either IDA-eligible or IDA–International Bank for Reconstruction and Development (IBRD) blend-eligible (discussed further below). Three of these states are SIDS and five are FCAS. Six countries are upper-middle income, among which one is FCAS. There are two high-income countries, and it is notable that these are SIDS and have much higher loss and damage burdens and are therefore at very high climate risk.

The global average external debt stocks across lower-middle-income countries in 2018 was 54% of gross national income (GNI), but within this income group across African countries this ranged from 3% in Algeria and 11% in Eswatini, to 158% in Djibouti. In the low-income group, the global average external debt stocks were 37% of GNI, and across African countries this ranged from 11% in the Democratic Republic of Congo and 19% in Burundi to 108% in Mozambique and 58% in Rwanda (Figure 1).[7]

Figure 1: External debt stocks as a percentage of GNI 2018



Source: World Bank International Debt Statistics data.[7]

Most countries in Africa are experiencing significant increases in their debt-to-GDP ratios. The African Development Bank (2021)[8] estimates that the average debt-to-GDP ratio in Africa is expected to increase to more than 70%, from 60% in 2019. This ratio was around 30% in 2014. Africa's total external debt stock has more than doubled in the last decade as African countries have increasingly turned to the market to fund development needs. Griffith-Jones and Carreras (2021)[9] discuss the composition and complexity of the increasing debt stocks across Africa.

An increase in debt-to-GDP ratio is not in itself unfavourable when it is the result of investment in economic growth-inducing activities. Given that much of Africa's debt now comes from national and international private capital markets, market access is crucial for African economies. Credit agencies whose purpose is to rank countries' ability to pay debt thus wield enormous power. Countries are reluctant to have their credit ratings downgraded or to start negotiations with creditors that may signal a default and thus limit access to the markets for future borrowing.

The economic sustainability of a country's debt burden varies depending on its economic position and growth projections. If a country's growth rate outvalues the repayment burden, there is net value, so the debt burden is economically sustainable. However, crisis-induced

Table 1: Income and other classifications of the 54 African states

Income Classification[a]	Country	Lending (IDA/Blend/IBRD)[b]	LDC?[c]	SIDS?[d]	FCAS?[e]
Low Income	Burkina Faso	IDA	LDC		Medium-Intensity Conflict
	Burundi	IDA	LDC		Medium-Intensity Conflict
	Central African Republic	IDA	LDC		High-Intensity Conflict
	Chad	IDA	LDC		High Institutional and Social Fragility
	Congo, Dem. Rep	IDA	LDC		Medium-Intensity Conflict
	Eritrea	IDA	LDC		High Institutional and Social Fragility
	Ethiopia	IDA	LDC		
	Gambia, The	IDA	LDC		High Institutional and Social Fragility
	Guinea	IDA	LDC		
	Guinea-Bissau	IDA	LDC	AIMS	High Institutional and Social Fragility
	Liberia	IDA	LDC		High Institutional and Social Fragility
	Madagascar	IDA	LDC		
	Malawi	IDA	LDC		
	Mali	IDA	LDC		Medium-Intensity Conflict
	Mozambique	IDA	LDC		
	Niger	IDA	LDC		Medium-Intensity Conflict
	Rwanda	IDA	LDC		
	Sierra Leone	IDA	LDC		
	Somalia	IDA	LDC		High-Intensity Conflict
	South Sudan	IDA	LDC		High-Intensity Conflict
	Sudan	IDA	LDC		Medium-Intensity Conflict
	Togo	IDA	LDC		
	Uganda	IDA	LDC		
Lower-	Algeria	IBRD			