Debt for Development Swap:

Opportunities & Challenges

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Pre-event of the Pacific Regional Debt Conference
Background

Growing popularity in the idea of confronting debt and other sustainable development issues at once

Debt for Development Swaps (DDS)

Financial Times features Statement on Debt Relief for a Green and Inclusive Recovery

China can help solve the debt and environmental crises

China could implement debt-for-nature and debt-for-climate swaps to protect the environment and reduce global debt

By B. Alexander Simmons, Rebecca Ray, Hongbo Yang, Kevin P. Gallagher

V20 Statement on Debt Restructuring Option for Climate-Vulnerable Nations

Climate vulnerability is driving up the cost of capital and undermining debt sustainability
Background

Existing debt resolution mechanism and financing supports are not enough

• G20 Debt Service Suspension Initiative (DSSI) & the Common Framework for Debt Treatment (CF)
  • Only includes Low Income Countries
  • Lack of private sector participation
  • Debt resolution usually have a negative impact on refinancing

Huge financing gap for sustainable development in developing countries

• The financing gap to achieve the SDGs in developing countries is estimated to be US$ 2.5~3 trillion per year (UNCTAD, 2014)
• The latest accounting of climate finance shows there is a gap of about $70 billion (World Bank 2015)
• The infrastructure gap amounts to US $1-1.5 trillion in developing countries (OECD, 2020)
• Global financing conditions will worsen as the Fed tightens its monetary policy
Background

Debt-for-Development swap may be a way for developing countries to escape the vicious cycle of “Heavier debt burden and larger climate vulnerabilities”

Source: Climate change, Debt and COVID-19: Analysing the Triple Crisis with a New Climate Disaster and Debt Risk Indicator and Building Forward for a Resilient Recovery, Based on Climate Justice. 2021.03. Brot.
History of Debt for Development Swap

• 1980s-1990s Early Stage
  • Ground-breaking invention and applications of DNSs by NGOs who purchase Brady bonds at great discount
  • e.g. DNSs by Conservation International, the Nature Conservancy, and the WWF

• 1990s-2000s Rapid Development
  • Increasing uses of DNSs by Paris Club creditors as a tool for debt relief
  • e.g. Tropical Forest Conservation Act in the U.S.

• 2000s-2019 Slowed Momentum
  • Decreased uses and impacts of DNSs due to the complexity of project implementation and the limited scales of debt relief.
  • Meanwhile, HIPCs and MDRIs gained popularity.

• Beyond 2020 Greater Enthusiasm & Greater Uncertainties
  • Deeper and wider consensus on climate change issues
  • Renewed interest in combating debt and climate challenges at same time, with heated discussions of Debt for Climate Swap (DCS)
Progresses in the design of DDSs

• Early debt-for-nature swaps
  • focused on low hanging fruit, where debt was cheap on the secondary markets and enforcement was limited.

• Contemporary debt-for-development swaps
  • involves a local trust fund to ensure investment over longer periods of time, coordination among multiple stakeholders, and requirement of sufficient enforcement.

• New frontiers of debt restructuring
  • debt swaps for other sustainable development purpose including biodiversity, coal retirement, energy efficiency enhancement, etc.
  • enhanced link between debt sustainability and development sustainability.
# Pros & Cons of Debt for Development Swap

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<th>Pros</th>
<th>Cons</th>
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<td><strong>For Debtor</strong></td>
<td>✓ Reduce debt burdens</td>
<td>✓ Foreign interference with domestic development issues</td>
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<td>✓ Release fiscal resources for sustainable development</td>
<td>✓ Small scale of debt relief</td>
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<td>✓ Institutional benefits (e.g. the establishment of Poland Eco fund)</td>
<td>✓ Risk of credit rating downgrade</td>
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<td>✓ Achieve sustainable development goals</td>
<td>✓ No additional aid funding but more constraints attached</td>
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<td>✓ Crowd out other fundings</td>
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<td>✓ Potential negative externalities to local communities</td>
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<td><strong>For Creditor</strong></td>
<td>✓ Achieve climate goal</td>
<td>✓ Difficulty in project surveillance and outcome evaluation</td>
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<td>✓ Better reputation</td>
<td>✓ Complexity in project selection and implementation</td>
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<td>✓ Less moral hazard than direct debt relief</td>
<td>✓ Risk of debtor country default or inflation</td>
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<td>✓ Less controversial than debt for equity swaps</td>
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<td><strong>In general</strong></td>
<td>✓ Mobilize funds for sustainable development from more resources</td>
<td>✓ Prolonged negotiations</td>
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<td>✓ Combine complementary advantages to generate better outcome</td>
<td>✓ Failure of coordination that leads to project abortions</td>
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New challenges for scaling up DDSs

Dramatic changes in international relations after the Ukraine war
- Sanctions on Russia
- More geopolitical concerns in development finance
- Pursuit of security in all aspects => Deglobalization?

Greater economic and financial risks in the next few years
- For debtors
  - Greater risk aversion sentiment and tighter financial condition could result in less financing supply and higher financing costs
  - Growth recovery lags behind, especially in tourism counties
  - Other uncertainties including financial and social instabilities
- For creditors
  - Greater challenges in maintaining domestic growth in the next two years (China, US, EU, etc. )

Changes in the order of priorities
- Covid 19 pandemic
- Climate adaptation
- Food inflation
- Debt crisis
Challenges for emerging creditors

- Inadequate experience
- Project selection, implementation and evaluation
- Domestic and International coordination
- Problems in large and bundled projects
- Alternative ways of debt restructuring and climate finance

Joint efforts with complementary strengths that have a 1+1>2 effect
Coordination failures that lead to financial and reputational losses
What are the keys to success?

More incentives
- Combining the Clean Development Mechanism (CDM) with DDS
- Combat risks associated with the transition towards net-zero
- More collaboration and less hospital and speculative criticisms
- Successful pilot cases

Improvements in the execution model of DDSs
- Leading role of international organizations
- More efficient coordination implementation support from local agencies like the Pacific Resilience Facility
- Wider range of projects such as coal retirement acceleration program, efficient energy program, and green energy-related infrastructures etc.

Leverage more resources
- Private sector, emerging creditor, etc.
- Developed countries’ climate commitment of $100 billion dollars
Thanks!

More comments or discussions are welcomed at

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