Group of Twenty

Debt cancellation to create fiscal space for addressing climate change

Research Report

Leiden Model United Nations 2023

"let us sing songs of freedom together"

Forum: Group of Twenty

Issue: Debt cancellation to create fiscal space for addressing climate change

Student Officer: Rita Bozlék

Position: Chair of Group 20

Introduction

Climate change has emerged as one of the most pressing challenges of our time, and its effects are being felt across the globe. Addressing this issue requires significant financial investments to transition to sustainable practices and mitigate the impacts of climate change. However, many developing countries, burdened by excessive debt, struggle to allocate sufficient resources to tackle climate change effectively. Debt cancellation is an essential strategy that can create fiscal space for these countries to prioritise climate change adaptation and mitigation efforts. This research report aims to provide a comprehensive overview of debt cancellation to address climate change, discussing the major parties involved, possible solutions, and the need for such actions.

Definition of Key Terms

Debt cancellation:

Debt cancellation refers to the act of nullifying or forgiving the outstanding debts owed by a country or a group of countries. It aims to reduce the financial burden and improve the economic situation of debtor nations. Debt cancellation can be multilateral or bilateral, involving various stakeholders such as international financial institutions, governments, and creditor countries.

Fiscal space:

Fiscal space refers to the capacity of a government to allocate sufficient financial resources for public expenditure. It is crucial for countries to have fiscal space to address urgent needs, including climate change mitigation and adaptation. Debt cancellation can create additional fiscal space by reducing debt servicing obligations, allowing governments to prioritise climate action.

Climate change:

Climate change refers to long-term shifts in weather patterns and global temperatures caused primarily by human activities, particularly the emission of greenhouse gases. Its consequences, such as rising sea levels, extreme weather events, and biodiversity loss, pose significant threats to human well-being and ecological stability. Addressing climate change involves mitigation (reducing emissions) and adaptation (adjusting to its impacts).

Debt overhang:

Debt overhang occurs when a country's debt burden becomes unsustainable, hindering economic growth and development. In such cases, debt servicing absorbs a significant portion of government revenue, leaving fewer resources for vital sectors like healthcare, education, and, crucially, climate change action. Cancelling or reducing the debt burden can alleviate debt overhang, freeing up resources for environmental initiatives.

Sustainable development goals (SDGs):
The SDGs are a set of 17 global goals adopted by the United Nations to address the world's most significant challenges, including poverty, hunger, education, health, and climate change. Debt cancellation can contribute to the achievement of the SDGs by providing governments the fiscal space to invest in sustainable infrastructure, renewable energy, and environmentally friendly practices.

Environmental finance:
Environmental finance involves the mobilisation and allocation of financial resources towards environmental conservation and climate change mitigation. Cancelling debts can redirect funds that would have been allocated to debt servicing towards environmental finance initiatives. This redirection helps finance renewable energy projects, nature conservation efforts, research and development of clean technologies, and green infrastructure development.

Ethical dimensions:
Debt cancellation for climate change raises ethical concerns regarding the responsibility of developed countries in mitigating the impacts of climate change on vulnerable nations. Climate change is often disproportionately felt by developing countries that have contributed relatively less to greenhouse gas emissions. Debt cancellation acknowledges the ethical obligation of wealthier nations to support climate action in poorer regions.

Interconnectivity of Debt and climate change:
Debt and climate change are interrelated phenomena that demand holistic solutions. High debt burdens constrain governments' ability to undertake climate-related projects, while climate change impacts can disrupt economic activities, leading to increased debt vulnerability. Addressing both issues simultaneously, through debt cancellation and climate change initiatives, presents an integrated approach that acknowledges their interconnectivity.

Challenges and limitations:
Creditor nations may be reluctant to cancel debts due to fears of moral hazard or concerns over potential economic repercussions. Moreover, debt cancellation alone cannot address the root causes of climate change, which demands comprehensive and systemic changes in global governance and socio-economic practices.

General Overview

Understanding debt cancellation

Debt cancellation refers to the complete or partial forgiveness of debt owed by a debtor nation to a creditor nation or international financial institution. It aims to relieve the burden of unsustainable debt repayments, enabling countries to redirect funds toward pressing socio-economic and environmental needs, such as climate change initiatives. Debt cancellation can be unilateral, where the creditor nation or institution takes the initiative, or negotiated through multilateral agreements.

Countries facing debt and climate change challenges

Several countries are burdened with high debt levels and simultaneously face significant challenges related to climate change. Small island developing states (SIDS) are particularly vulnerable due to their exposure to rising sea levels, extreme weather events, and limited resources. For instance, countries like Maldives, Kiribati, and Tuvalu face the threat of being submerged by rising sea levels, while lacking the financial capacity to adapt.

Additionally, numerous developing countries in Africa, Asia, and Latin America also grapple with unsustainable debt burdens and climate change challenges. Countries like Mozambique, Zambia, and Bangladesh are prone to cyclones, floods, and droughts, which exacerbate economic vulnerabilities. These nations often allocate a significant portion of their limited resources towards debt repayments, leaving minimal funds for climate-related investments.

Solutions and advocacy efforts

To address the challenges posed by debt and climate change, countries and international organisations have proposed various solutions and advocacy efforts. One approach is to advocate for debt-for-climate swaps, where debt repayments are redirected towards climate change initiatives. This approach has gained traction in recent years, with initiatives such as the Debt for Climate Adaptation Swap proposed by the World Bank. By converting debt repayments into investments in adaptation measures, countries can simultaneously address debt burdens and climate change challenges.

Moreover, some nations advocate for debt restructuring or rescheduling to provide relief from debt repayments, freeing up funds for climate change-related investments. The Paris Club, an informal group of creditors, has been instrumental in facilitating debt restructurings for countries in need. The Debt Service Suspension Initiative (DSSI), led by the G20 and supported by the International Monetary Fund and World Bank, provides temporary debt relief to eligible countries during the COVID-19 pandemic, offering some fiscal space for climate action.

Furthermore, advocacy efforts led by debtor nations, particularly those disproportionately affected by climate change, have pushed for greater international support and debt cancellation. The Alliance of Small Island States (AOSIS) and the Least Developed Countries group (LDCs) have been vocal proponents of debt cancellation to create fiscal space for addressing climate change. They argue that debt cancellation would allow for investments in climate resilience, renewable energy, and sustainable development, ensuring long-term economic stability and environmental sustainability.

Addressing climate change demands substantial financial investments, involving research and development, clean energy infrastructure, and climate adaptation measures. However, many developing countries face the dual challenge of mounting external debts and the urgent need to tackle climate change. Debt cancellation can unlock fiscal space for these countries and allow them to redirect resources towards climate change mitigation and adaptation efforts.

Debt cancellation has the potential to provide immediate relief to financially stressed nations. By eradicating a significant portion of the debt burden, governments can allocate resources that were previously devoted to debt repayments towards long-term sustainable development initiatives. This reallocation of funds can include investment in renewable energy projects, reforestation efforts, and climate change adaptation strategies.

Major Parties Involved

African Union (AU)

As a regional organisation representing African nations, the African Union can play a pivotal role in addressing the issue of debt cancellation. By raising awareness of the challenges faced by African countries in responding to climate change, the AU can advocate for debt relief, enabling these nations to prioritise climate action and sustainable development.
Since many African countries are facing climate challenges and high debt, their cooperation is crucial.

Brazil

Brazil, home to the Amazon rainforest, faces immense challenges in balancing economic development with environmental preservation. The country's debt constitutes a significant impediment to addressing climate change due to budgetary constraints. However, Brazil's perspective on debt cancellation for climate action is complex. It recognizes the potential benefits of relieving its financial burden, but some policymakers emphasise the need for mutual responsibilities and global partnerships. Brazil acknowledges that debt cancellation alone might not be sufficient, highlighting the importance of international cooperation and financial assistance in achieving climate resilience.

Environmental NGO-s

Environmental non-governmental organisations such as Greenpeace, Friends of the Earth, and WWF can actively support debt cancellation efforts to address climate change. By raising public awareness, advocating for policy changes, and mobilising resources, these NGOs can contribute significantly to the global movement for debt relief, creating fiscal space for climate action.

European Union (EU)

The EU, being at the forefront of climate action, can use its economic influence to advocate for debt cancellation. By leveraging its political and economic power, the EU can encourage its member states and other creditor countries to restructure or cancel the debt of climate-vulnerable nations. This will provide much-needed fiscal space for those countries to address climate change effectively.

G7 Countries

The Group of Seven (G7) countries, including the United States, Canada, Japan, Germany, France, Italy, and the United Kingdom, have a collective responsibility to address climate change. These countries possess significant influence over global finance and can contribute to debt cancellation efforts by restructuring the debt of climate-vulnerable nations, thereby creating fiscal space for climate action.

Green Climate Fund (GCF)

The Green Climate Fund, established under the UN Framework Convention on Climate Change (UNFCCC), aims to support developing countries in their climate change adaptation and mitigation efforts. It can actively contribute to debt cancellation by channelling funding toward debt relief initiatives tailored to countries committed to climate change actions. Debt cancellation in combination with GCF's funding can create an ideal fiscal space for addressing climate change concerns.

International Monetary Fund (IMF)

Similar to the World Bank, the IMF can contribute to debt cancellation efforts by incorporating climate change considerations into its lending programs. By acknowledging the importance of environmental sustainability and offering support to countries committed to climate action, the IMF can facilitate debt relief agreements tailored to the specific requirements of combating climate change.

Non-Aligned Movement (NAM)

The Non-Aligned Movement, consisting of 120 member countries, represents the interests of developing nations. NAM can support debt cancellation for developing countries burdened by debt, with a particular focus on those most vulnerable to climate change. By advocating for the restructuring or cancellation of debt, NAM can enable these countries to direct financial resources towards climate adaptation and mitigation.

Peoples' Republic of China

China, another major global player, holds a significant portion of the world's debt and is embarking on an ambitious path towards sustainable development. As the world's largest emitter of greenhouse gases, China acknowledges its responsibility in addressing climate change. The country has made substantial investments in renewable energy and is committed to achieving carbon neutrality by 2060. China's perspective on debt cancellation for climate change is influenced by its efforts to enhance its reputation as a global climate leader. By cancelling debt and utilising fiscal space for climate action, China aims to strengthen its position and demonstrate its environmental commitment.

United Nations

The United Nations (UN) is at the forefront of efforts to address climate change through its various programs and initiatives. In the context of debt cancellation, the UN can play a crucial role by advocating for debt relief for developing countries heavily burdened with debt. By urging creditor nations to cancel or reduce the debt of these countries, the UN can free up financial resources that can be redirected toward climate change mitigation and adaptation strategies.

United States of America

The United States, as the world's largest economy and a major contributor to global debt, plays a crucial role in the issue of debt cancellation for climate change. The country's inclusion and active participation in debt relief initiatives can provide significant impetus to tackling environmental challenges. The U.S. government has recognized the importance of climate change and demonstrated its commitment by rejoining the Paris Agreement under President Biden's administration. Moreover, the United States can leverage its economic power to encourage other nations to support debt cancellation efforts, particularly for climate-vulnerable countries.

World Bank

As a major international financial institution, the World Bank has the potential to support climate change initiatives through debt cancellation. By working in collaboration with the UN and other organisations, the World Bank can encourage debt forgiveness or restructuring for developing nations committed to implementing effective climate action plans. This will create fiscal space for these countries to allocate resources to combat climate change and invest in sustainable development projects.

World Trade Organisation (WTO)

The World Trade Organization can play a significant role in facilitating debt cancellation by examining trade policies that contribute to developing countries' debt burdens. By addressing unjust trade practices, the WTO can help alleviate the financial strain on these countries, enabling them to allocate more resources towards climate change initiatives.

Timeline of Events

2005	The Multilateral Debt Relief Initiative (MDRI) was launched, aimed at providing debt relief to heavily indebted poor countries (HIPCs). While this initiative did not directly consider climate change, it laid the groundwork for the concept of debt cancellation to support sustainable development and poverty reduction.
2015	The Paris Agreement was established to combat climate change, aiming to limit global warming to well below 2 degrees Celsius. The agreement emphasised the need for financial support to assist developing countries in their climate efforts, which sparked discussions on debt cancellation as a means to create fiscal space
2020	The COVID-19 pandemic exacerbated economic inequalities and financial vulnerabilities globally. As countries faced immense challenges in dealing with the pandemic's aftermath and climate change simultaneously, discussions on debt cancellation gained momentum as a potential solution to mobilise funds for climate action.

Possible Solutions

Strengthening international debt relief programs:

International financial institutions need to enhance the effectiveness and inclusivity of their debt relief mechanisms. These programs should account for the unique circumstances faced by countries vulnerable to climate change. Considerations like vulnerability index, climate resilience, and contribution to emissions reduction can be integrated into debt cancellation criteria.

Encouraging bilateral debt cancellation:

Lenders, including individual countries, can voluntarily cancel or restructure debt owed by climate-vulnerable developing countries. This approach can foster international collaboration and demonstrate solidarity in addressing climate change.

Debt-for-climate swaps:

Innovative mechanisms such as debt-for-climate swaps can be explored, where a portion of outstanding debt is forgiven in exchange for climate-friendly investments. This approach aligns the interests of both creditors and debtor countries, providing a win-win scenario to address climate change and relieve debt burdens simultaneously.

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