Debt swaps for climate and SDG finance in the Arab region

Summary

In December 2020, the Economic and Social Commission for Western Asia (ESCWA) launched its Climate/SDGs Debt Swap Initiative and a debt swap mechanism to assist countries in freeing up fiscal space for meeting essential expenditures, including accelerating an inclusive and green recovery from the COVID-19 pandemic. The Initiative offers an innovative opportunity for middle- and low-income Arab countries, in partnership with developed countries and donor institutions, to enhance global solidarity to overcome the financial distress caused by the pandemic, and alleviate its toll on vulnerable groups.

The opportunity is significant for many Arab States as external debt service constitutes more than 10 per cent of their revenues, going up to 40 per cent in some cases. Furthermore, the region receives climate finance mostly through external debt instruments, which exceed grant finance by a factor of 10. A well-stratified debt swap mechanism can thus direct financial resources towards the achievement of the Sustainable Development Goals (SDGs), in particular climate-related ones, while reducing debt burdens in Arab States. Long term debt swaps can also provide predictable flows of climate finance that can mobilize complementary resources for climate adaptation and mitigation.

The Committee on Financing for Development in the States Members of the Economic and Social Commission for Western Asia is invited to consider the tenets of the Initiative and avenues for its operationalization in national contexts towards improving inclusive and green finance.
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Introduction

1. The COVID-19 pandemic has triggered a sharp increase in debt vulnerabilities worldwide. Large fiscal stimulus packages coupled with a fall in revenues have pushed public debt levels to record highs in both developed and developing countries. The pandemic has exacerbated debt sustainability risks and raised concerns over widespread sovereign debt distress in many developing countries, particularly those that were already facing heavy debt burdens. It also puts at risk the achievement of the 2030 Agenda for Sustainable Development and national commitments under the Paris Agreement. Increasing costs of borrowing and declining concessional loans have contributed to worsening the situation and constraining budgets for development expenditure, including for climate-related investments. Against this backdrop, the provision of debt relief through different financial instruments can help create the fiscal space needed for countries to invest in a sustainable, inclusive and resilient green recovery.

2. United Nations Member States across the world have called for the provision of debt relief for low- and middle-income countries to support these countries’ efforts to recover from the COVID-19 pandemic. The 2020 United Nations High-level Meeting on Financing for the Development in the Era of COVID-19 and Beyond Initiative\(^1\) set out several options for consideration by Heads of State and Government, including the use of debt swaps, particularly to assist countries that are highly indebted but do not necessarily have unsustainable debt burdens.\(^2\) A recent ESCWA policy brief on fiscal space has advocated for debt swaps as an important mechanism to free up fiscal space for meeting essential expenditures and to mitigate the impact of the COVID-19 pandemic.\(^3\) These debt swaps have the twin objective of reducing debt burdens and improving resources for social and environmental expenditures, which can help accelerate implementation of the SDGs and the Paris Agreement.

3. The present document provides an overview of debt levels and climate finance inflows to the Arab region and discusses potential opportunities for debt swaps as an effective and valuable tool for debt relief and resource mobilization to advance climate action and sustainable development in the Arab region. The first section describes the debt situation in the region, the second part discusses climate finance flows and the third proposes an overview of a practical debt swap mechanism (DSM) under the ESCWA Climate/SDGs Debt Swap Initiative that can support formulating and implementing debt swaps with the objective of financing the Sustainable Development Goals (SDGs) and climate action.

4. The Committee on Financing for Development in the States Members of the Economic and Social Commission for Western Asia is invited to consider the contents of the present document and the tenets of the Initiative, and discuss avenues for its operationalization in national contexts towards improving inclusive and green finance.

I. External public debt in the Arab region

5. Economic contraction, conflicts and crises in parts of the Arab region, weak public finance management and the adverse economic impact of the COVID-19 pandemic have shrunk the fiscal space in most countries in the region at a time when demand for financing climate actions and the Sustainable Development Goals

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\(^2\) Ibid.

(SDGs) is high. This limited fiscal space is evident from the fact that economic stimulus packages that were enacted in this region fell short of what is needed; Arab economies’ fiscal stimulus represented nearly 4 per cent of their GDP, significantly lower than the global average of 22 per cent.

6. The accumulation of debt and rising debt service obligations are very high for low- and middle-income Arab countries. In 2019, debt in Arab middle-income countries (MICs) was estimated at around 80 per cent of their GDP and is estimated to have further increased to 91 per cent in 2020. External public debt, measured by public and publicly guaranteed debt, amounts to $202 billion out of a total of $321 billion external debt in 2019 for this subregion. While MICs are struggling with high debt and persistent current account deficits since 2008, COVID-19 and its adverse consequences on the economy have increased debt risks mainly from external sources. To address the adverse impact of COVID-19, Egypt, Jordan and Tunisia taken together have borrowed over $10 billion under IMF short- and medium-term lending mechanisms in 2020. These loans are non-concessional by their definition, thus increasing the debt servicing burden for the upcoming period.

7. The major share of debt in most MICs is from bilateral and multilateral creditors, except for Lebanon where private creditors hold about 94 per cent of external public debt. The debt service burden is high for this group of countries, with the highest being in Lebanon where, on average from 2016 to 2019, nearly 43 per cent of public revenues were spent on debt servicing. Tunisia spent 20 per cent of its revenues during the same period, while Egypt, Jordan and Morocco spent more than 10 per cent on debt servicing.

8. The external public debt of Arab LDCs, taken together, was around $25 billion in 2019, out of a total external debt of $36 billion. Several LDCs remain at risk of debt distress according to the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries (LIC-DSF). In the LDCs, most of the debt is owed to official creditors. Comoros, Djibouti, Mauritania and Yemen have only official external debt. Mauritania obtained substantial debt relief through the Highly-Indebted Poor Country Initiative (HIPC Initiative), which makes it unlikely for its debt to be eligible for a debt swap. The Sudan was suffering from unsustainable debt for decades, but the IMF has recently approved the Sudan to receive debt relief under the HIPC Initiative.

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6 Egypt, Jordan, Lebanon, Morocco and Tunisia.

7 Authors’ calculations based on data from World Bank IDS.


9 IMF financial assistance for emerging and advanced market economies are: Stand-By Arrangements (SBAs) to address short-term or potential balance of payments problems; Extended Fund Facility (EFF) as medium-term support to countries facing protracted balance of payments problems because of structural weaknesses that require time to address; Rapid Financing Instrument (RFI) to provide rapid assistance to countries with urgent balance of payments need to cope with shocks. (See https://www.imf.org/en/About/Factsheets/IMF-Lending). International Monetary Fund (2020). COVID-19 Financial Assistance and Debt Service Relief. Available at https://www.imf.org/en/Topics/imf-and-covid19/COVID-Lending-Tracker#f1n.

10 Authors’ calculations based on data from World Bank IDS 2021 and IMF WEO 2021.

11 Comoros, Djibouti, Mauritania, Somalia and Yemen.

12 This number includes PPG debt for Comoros, Djibouti, Mauritania, and Sudan as per World Bank IDS statistics 2021. The other LDCs are not included due to data unavailability. It may be noted that using $55 billion external public debt for the Sudan, the total PPG for these selected LDCs would be higher.
Under this initiative, the Sudan will cancel more than $50 billion of its debt, equivalent to more than 90 per cent of the country’s total external debt, over a 3-year period.\(^\text{13}\)

9. While increasing revenue mobilization remains a challenge for most countries in the region, the high share of revenues being spent on debt servicing limits fiscal expenditures for development needs, especially for climate actions. Therefore, there is an urgent need to establish debt relief mechanisms. Debt swaps provide a unique way to reduce the debt service burden and generate fiscal space to finance efforts to advance the SDGs and climate actions, especially if the debt swap involves a large share of debt.

10. International action to support debt relief is imperative for most Arab States, especially to build back better from the adverse impacts of COVID-19. The G20 Debt Service Suspension Initiative (DSSI) to defer bilateral debt service payments until the end of 2020, which was extended through mid-2021, is helpful for some LDCs, but it is not enough given that the DSSI does not cover all LDCs, nor does it cover MICs. Opportunities for accessing concessional funding are also limited for the MICs. Indeed, the share of concessional loans to MICs has been declining over the past decade.\(^\text{14}\)

II. Inadequate climate finance flows to the Arab region

11. The region faces a dual challenge in climate finance flows: the first in terms of the volume (quantity) of the inflows while the second pertains to the type of inflows (quality). Climate finance support received does not meet the region’s needs and priorities.\(^\text{15}\)

12. Arab States identified their national priority climate actions in their first Nationally Determined Contributions (NDCs), which were mostly submitted to UNFCCC in 2015 and 2016 as part of their commitments to the Paris Agreement. Most Arab States have not systematically costed all their NDC targets, however, 11 of them have estimated at least some of the costs of NDC implementation. Considering all the reports submitted to the UNFCCC (NDCs, national adaptation plans, among others), thirteen Arab States have identified some of the financial costs of climate action. While an incomplete figure, the estimated costs for NDC implementation total $378 billion, of which $344 billion is conditional on receiving international support,\(^\text{16}\) mostly within the next 10 years.

13. In contrast, based on the most recent reporting, total public international climate finance flows to the Arab region from developed countries through bilateral and multilateral channels have remained around $4 billion (constant 2017 dollars), as shown in figure 1. Thus, the quantity of flows is well below the need.

14. Furthermore, these flows are not well matched to the needs, which is a quality problem. Specifically, from 2014 to 2018, adaptation finance (as opposed to mitigation finance) has consistently remained less than 20 per cent of total flows even though the Arab region prioritizes adaptation over mitigation.\(^\text{17}\) Grants have not


\(^{16}\) United Nations Framework Convention on Climate Change, League of Arab States and United Nations Economic and Social Commission for Western Asia (forthcoming). Technical Assessment of Climate Finance for the Arab States.

\(^{17}\) Unless otherwise noted, information on climate finance flows is calculated by ESCWA, based on OECD, 2020.
exceeded 9 per cent of support over this period, while the share of non-concessional debt finance has increased significantly, despite the lack of fiscal space to finance climate action. There is no sign to indicate that climate finance flows to the Arab region are improving in the aftermath of the 2015 Paris Agreement.

**Figure 1. Annual public international climate finance flows to the Arab region from developed countries between 2013 and 2018 by purpose and type**


Note: This chart evaluates bilateral and multilateral climate finance flows to the Arab region based on reporting to the OECD. It includes bilateral flows with climate marked as a “principle” objective (Rio Tag) and “climate components” reported by multilateral development banks. Bilateral flows with climate marked as a “significant” objective (Rio Tag) are not included.

15. In addition to public international sources, the green bond and green sukuk market is emerging rapidly in the Arab region as an alternative source of public finance, and may provide an important opportunity to mobilize resources for project finance and other needs that are suited to debt finance. However, an important gap remains in mobilizing grant finance for climate action.
16. Quite clearly, climate finance mobilization is more difficult for countries under high fiscal stress that require greater concessionality and grant finance, such as the LDCs and MICs suffering from high debt burdens. In these countries, climate actions may not always be prioritized given the political economy context as other expenditure needs becomes more pressing in the near term, particularly in the aftermath of a pandemic. It is quite understandable that the NDCs of Arab countries therefore include many targets that are conditional upon external support, without which the NDC targets and national priorities will be impossible to achieve. Two critical risks that adversely impact progress on achieving the NDC targets are:

- **Ensuring predictability of climate finance.** Given limited fiscal space, climate finance is often donor driven and *ad hoc*, complicating efforts to budget for climate expenditures. Finance flows to the region present significant year-over-year variation in commitments by country, highlighting the unpredictable nature of public international climate finance at the macroeconomic level.

- **Ensuring co-finance requirements and other mobilization efforts to support national priorities on climate actions.** While multilateral development banks play a catalytic role in mobilizing climate finance, most finance comes from public sources and goes towards mitigation actions, with a minority of co-finance coming from private sources. The sector breakdown is also highly unbalanced, with climate finance mobilized for the energy sector exceeding climate finance mobilized for the agriculture, and water and sanitation sectors by a factor of three and four, respectively. This is a strong indication that high co-finance requirements may complicate efforts to channel finance toward climate actions that rely more heavily on grant and concessional finance, including water and agriculture.

17. Therefore, scaling up concessional public international climate finance and innovative sources of finance is necessary to support Arab States to implement *existing* conditional NDC targets. The need for additional resources is greater if the objective is to further scale ambition of climate action by Arab States, particularly for adaptation. To do so, a significant increase in grant finance is needed in the water and agriculture sectors as well as for nature-based solutions and ecosystems.

18. The trend in grant finance is not encouraging. Scaling up grant finance in the near term is a challenge, especially when the COVID-19 pandemic has adversely affected all economies in the world, including in donor countries. Debt swaps potentially provide a good option that can help debtor countries release part of their foreign currency debt service obligations. The amounts released can be used to finance strategic climate actions which would help their economies recover better from the pandemic. It also allows creditor countries to use part of their debt holdings to meet their climate finance pledges under the Paris Agreement.

**III. Debt swap mechanism for climate and SDGs finance in the Arab region**

19. In December 2020, the ESCWA Climate/SDGs Debt Swap/Donor Nexus Initiative launched the Debt Swap Mechanism (DSM), aimed at supporting Member States that are facing high debt burdens and need additional financing for the SDGs and climate action. The DSM presents an opportunity for creditors and donors to support the efforts of developing countries in the Arab region to accelerate action towards achieving the SDGs and Paris Agreement commitments, and to advance North-South and triangular cooperation.

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20. The objective here is to draft an idea and assess its opportunities and challenges in the expert group meeting.
20. The DSM will be operationalized through technical assistance by ESCWA, as shown in figure 2.

**Figure 2. An illustration of a bilateral debt swap between creditor and debtor countries**

![Diagram of Climate/SDGs Debt Swap]


21. The main actors in the DSM are as follows:

- **Debtor:** Middle-income countries that face external liquidity challenges, suffer high debt burdens and spend a significant share of their revenues on interest payments/debt servicing in external currency. Such debtor countries in the region include Egypt, Jordan, Morocco and Tunisia. Egypt has called for debt swaps to help meet financing needs to mitigate the impact of the COVID-19 pandemic, and to finance long-term projects that can positively impact progress towards the SDGs, which could include climate-related activities. Jordan, Morocco and Tunisia are also candidates for debt swaps, as they are facing increasing debt service burdens that put their recovery from the pandemic at risk.

- **Creditor:** Bilateral creditors whose official development assistance (ODA) disbursements to developing countries are less than their commitments. Scaling up ODA or climate finance pledges in the immediate and near terms can poses a challenge for these countries, especially given the adverse economic consequences of COVID-19 and constraints affecting bilateral cooperation. Several DAC countries that are large creditors to the Arab region could thus use the window offered by debt swaps to enhance their ODA disbursements and climate finance pledges toward accelerating SDGs and climate action.

- **Donor:** International donor organizations operating at the global and regional levels, which can scale up debt swaps by financing climate-resilient projects at scale, for the mutual benefit of achieving the SDGs and the Paris Agreement. Such organizations include the Green Climate Fund, the Global Environment Facility, the Adaptation Fund, multilateral development banks and bilateral donors.

- **ESCWA:** ESCWA is a United Nations regional commission that is mandated to provide technical assistance to member States to advance and accelerate progress towards the SDGs and climate action, including through its Arab Centre for Climate Change Policy. ESCWA has the convening...
power to liaise with member States and has detailed knowledge of national and regional
development challenges. Its standard operating procedures are applied in accordance with United
Nations rules and regulations, which give ESCWA credibility with debtors, creditors and donors to
monitor and implement the swap funds transparently and accountably.

22. Climate/SDG debt swaps can be an effective financial instrument providing win-win results for debtor and
creditor countries. For debtor countries, they generate a direct resource effect by providing relief from the
payment of interest on external debt, while increasing sustainable public investment in climate-resilient projects
that advance the SDGs and the Paris Agreement. In addition, they have positive net indirect effects when such
investments lead to higher net aggregate flows from donors and private and public sources to climate-resilient
projects. Other important socioeconomic benefits include job creation, advancing local community development
and promoting women’s empowerment, all of which contribute to bridging inequality gaps.

23. Debt swaps are also beneficial for bilateral and multilateral creditors, since the amount of the debt swap
allocated for climate-resilient projects increases ODA disbursement/climate finance pledges that accelerate the
implementation of SDGs and the Paris Agreement, without adding extra burdens on their budgets. Furthermore, long-term climate-resilient projects will likely boost economic transformation and the future
economic growth of debtor countries and crowd in complementary grants and investments, which in turn
facilitate the repayment of outstanding debt stocks.

24. There may be several challenges in implementation of a bilateral debt swap. The role of ESCWA would
be to assess these challenges and support the debtor and creditor countries with evidence-based tools to help
them arrive at common ground. Some of these challenges and their mitigation include the following:

- Creditors and debtors must agree to terms, which can take time and resources. This is the first step
in operationalizing the debt swap mechanism. ESCWA can play the role of a facilitator and use its
technical capacities and engagement with member States through intergovernmental mechanisms
to expedite negotiations.

- A potential risk is that debt swaps could undermine country ownership and autonomy if creditors
push for restrictive conditionalities. In this case, the challenge is to ensure that swap funds are used
in line with national development plans including national SDG targets and climate action
commitments articulated in NDCs under the Paris Agreement. At the same time, they must take
into consideration remedial measures for potential fungibility concerns.

- For the debtor, long-term earmarking of funds to convert debt in to climate-resilient investment
programmes can be a challenge financially and can be sensitive to public sentiment since the public
is not always aware of relevant commitments and how funds must be used. Improving transparency
in monitoring and evaluation and through a clear communication strategy regarding the utilization
of these funds, including financial and non-financial returns of the programme and projects, can
sensitize different stakeholders and minimize potential sensitivities. ESCWA can provide technical
assistance in establishing a quality framework for monitoring and evaluation and an effective
communication strategy, including setting eligibility criteria for climate-resilient projects and
investments that are results-based, long-term programmes or multiple projects in one or more
sectors. Setting such a climate-resilient investment programme is easier in countries using results-
based budgeting, which can be supported as well through ESCWA’s regional programme for
technical assistance.

- While a voluntary swap should raise the credit quality of the borrower going forward, a usual
challenge that developing countries may face is that a swap could send negative signals to the
financial market. However, this should not be the case in this context since the debtor is not at
default; rather the debtor is committing to use the debt conversion amount in long-term, climate-
resilient projects and investments that can transform and stimulate economic growth and job
creation. Therefore, the Government’s actions should project positive market signals.
IV. Conclusion and way forward

25. Many Arab States are facing fiscal stress from high and increasing debt, with debt service draining revenues that could have been spent on financing the SDGs and climate-resilient projects. Moreover, limited fiscal space puts the region at risk of being unable to recover from the COVID-19 pandemic. International action to support debt relief is imperative, especially to enable countries to build forward better after the pandemic. This can be achieved by improving the macroeconomic conditions of debtor countries in the short term to manage their outstanding debt liabilities. Debt swaps are a negotiated instrument that can provide debt relief and generate liquidity for fiscally stressed debtor countries to invest in climate-resilient projects, which can also benefit creditor countries.

26. To operationalize the DSM, ESCWA established a network of key reputed experts in the cross-cutting area of debt swaps and climate finance to serve as an Advisory Committee. The Advisory Committee includes high-level experts, who may have formerly held or presently hold public office, who have contributed to implementing bilateral debt swaps, debt-for-nature swaps, or both, in the region or in other parts of the world. The reputed experts also include academics and experts who have networked with creditors and donors. Two Advisory Committee meetings were held so far, the first in March 2021 and the second in August 2021. The meetings addressed hands-on issues related to debt swaps and means to overcome the challenges and provide support on approaching multiple creditors and developing proposals for pools of creditors.

27. ESCWA jump started the DSM by choosing Jordan as a pilot country. In June 2021, the Ministry of Planning and International Cooperation (MoPIC) of Jordan invited ESCWA to meet with senior Jordanian officials in Amman to introduce the Debt Swap/Donor Nexus Initiative. Following constructive exchanges, MoPIC facilitated the formation of an inter-agency task force to follow up on the operationalization of the initiative in Jordan. The Task Force includes officials from MoPIC, the Ministry of Finance, the Ministry of Environment, the Ministry of Energy and the Ministry of Water and Irrigation. This first meeting of the Task Force was held in August 2021 and aimed at taking stock of the debt outstanding to major creditors and climate-resilient projects/programmes in line with national commitments and priorities, and discussed the formulation of a debt swap proposal that could be discussed with creditor(s)/in Paris Club negotiations.

28. ESCWA would be happy to extend such cooperation to other member States to initiate discussion and formulate concrete proposals on operationalizing the Debt Swap/Donor Nexus Initiative, which improves climate finance, supports inclusive and green recovery from the pandemic and acts as an innovative debt relief instrument. In this respect, the Committee Members are invited to consider the tenets of the initiative and its operationalization in their national contexts.

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