

# The Interim Report of the Expert Review on Debt, Nature and Climate

October 2024

## Executive Summary

**Addressing high and unsustainable debt levels is a precondition for securing a livable planet for all.** Countries need sufficient fiscal space and borrowing capacity to invest in development, climate and nature, particularly given the higher upfront investment needs associated with the transition to more sustainable and resilient economic models. Shifting on to more climate-compatible and nature-positive economic paths is the only way to minimize long-term risks and costs, and secure prosperity for all. Debt is an essential fiscal tool in this endeavor. But many emerging markets and developing countries (EMDCs) are not able to mobilize the necessary resources because of high debt burdens and costs.

**Many EMDCs now face a triple crisis, which is most acute in low-income and other particularly vulnerable countries.** Changing land and sea use, overexploitation, pollution and invasive species threaten the biodiversity and ecosystem services on which life depends. The impacts of climate change are already apparent in the form of more frequent and severe extreme weather events such as heatwaves, cyclones and flooding, as well as slow-onset events such as coastal erosion due to sea-level rise or desertification. Nature loss and climate change also have mutually reinforcing effects. At the same time, many EMDCs have seen both the levels and cost of debt soar. This means that EMDCs can borrow less, at greater cost, at a moment when they need more and cheaper finance to limit the extent of future shocks and stresses through investments in resilience, climate mitigation and nature protection.

**EMDCs have been subject to a series of external shocks that have fueled indebtedness and raised the cost of borrowing.** EMDCs need to do more to strengthen their tax capacity and debt management systems and the efficiency of public expenditure. However, over the last three decades, many significantly improved their public financial management, mobilizing more domestic resources and borrowing more responsibly. While debt levels and costs rose in the late 2010s in most EMDCs, it was the external shocks and stresses of the early 2020s that devastated their people's lives and livelihoods, and accelerated the deterioration of their fiscal positions: the Covid-19

pandemic, fuel and food price inflation, a strengthening US dollar, soaring interest rates and – in many cases – climate and environmental disasters. In some cases, the impact of these external shocks was exacerbated by poor policy choices.

**The debt, climate and nature crises are coming together in a vicious circle for a growing number of countries.** Increasingly frequent and severe environmental shocks and stresses are forcing many countries to borrow more to finance disaster response and recovery. Those same shocks and stresses make borrowing more expensive and slow economic growth. Countries with high debt burdens then have less fiscal space to pursue low-carbon, climate-resilient and nature-positive development paths. This in turn increases their vulnerability to such events – and will increase the severity and frequency of such events in the future. High levels of indebtedness may exacerbate environmental crises because those countries with abundant natural resource endowments may accelerate extraction and degradation to meet their debt servicing obligations and human needs.

**Figure ES1. Representation of the vicious circle of the debt, nature and climate crises.**

*How the climate and nature crises can affect the debt crisis:*

- Increased borrowing to fund disaster response and recovery.
- Increased borrowing to meet the higher upfront costs associated with climate- and nature-positive development
- Shocks and stresses constrain economic growth and public revenues, and therefore reduce capacities to service debt
- Higher borrowing costs due to increased climate- and nature-related risks, higher debt burdens and slower growth rates

*How the debt crisis affects the climate and nature crises:*

- Higher debt servicing reduces fiscal space for investment in nature and climate action.
- Higher debt servicing increases the credit risk profile of countries, which in turn makes it more expensive to borrow for investment in nature and climate action.
- Higher financing costs reduce the viability of capital-intensive climate- and nature-smart measures.
- Higher debt servicing creates incentives and requirements for increased resource extraction.

Source: authors

**Commented [SC1]:** Note to Creative Concern: please note the additional bullet point under "How the debt crisis affects the climate and nature crises".

**A virtuous circle of green and resilient economic growth is possible.** Sustainable infrastructure investment, technological innovation and improved resource productivity

could drive strong, balanced and resilient growth while sustaining the ecosystem services on which economies and societies depend. However, it implies a profound change in our economies and societies, with transition risks and tradeoffs in key sectors. Still, a green growth model is feasible and sustainable. But shifting to this virtuous circle will demand a step change in financing. This will require significant increases in domestic resource mobilization by EMDCs themselves. But it will also require more international concessional finance and an effective response to unsustainable debt burdens and costs to enable countries to invest more in climate- and nature-smart development.

**This Interim Report of the Expert Review on Debt, Nature and Climate seeks to provide a diagnosis of the problems. Our Final Report, to be launched in the spring of 2025, will provide a set of recommendations that could help address the triple crisis and enable developing countries to shift to climate-compatible and nature-positive development.** We anticipate that our recommendations will broadly fall into three categories:

- Whether and how countries can optimize their sovereign debt to ensure sufficient funds for spending on nature protection and climate action, alongside other sustainable development priorities;
- Specific measures to selectively reduce current debt burdens to provide additional resources for sustainable development (such as debt pauses for countries affected by environmental disasters or debt-for-nature and debt-for-climate swaps); and
- Specific measures to ensure that future borrowing and lending redresses, rather than exacerbates, the triple crisis (such as expanding sustainability-linked debt and reducing resource-backed debt).

**An immediate priority is to reform Debt Sustainability Frameworks (DSFs) to provide a better analytical and policy basis for addressing sovereign debt issues in the context of the climate and nature crises.** DSFs provide a set of rules and methods used by the International Monetary Fund (IMF) and World Bank to analyze the risks attached to a country's sovereign debt at a given time. The DSF defines which variables to forecast, what situations will be considered as risky, and how to make sure that the projections are realistic.

**Debt Sustainability Analyses (DSAs) are of critical importance for two reasons.**

1. DSAs determine whether, and the conditions under which, EMDCs have access to funding from the IMF, World Bank and some bilateral lenders.
2. DSAs determine the extent of debt restructuring and relief required when a country is in debt distress. The DSFs therefore have a powerful impact on the economic prospects and fiscal situation of the countries to which they are applied.

**The current DSFs used by the IMF and World Bank do not adequately reflect the relationships between debt, climate and nature.** DSAs need to better reflect the funding and financing needs of countries to address the climate and nature crises. They also need to allow creditors to better anticipate future risks, and tailor their financing terms accordingly. To this end, we offer three recommendations for reform of the DSFs for consideration by the staff, management and boards of the IMF and the World Bank.

**Recommendation 1:** DSA should clearly and consistently incorporate the projected impacts of climate change, including both rapid onset shocks and slow onset stresses, in their underlying baseline macroeconomic and fiscal projections. The analysis should encompass higher potential liquidity risks stemming from environmental shocks, as well as solvency risks stemming from a deterioration in forecast economic growth rates and fiscal positions. The analysis should also account for the likely fiscal savings and greater economic stability associated with pre-arranged disaster risk financing, investments in resilience and other climate actions.

**Recommendation 2:** DSAs should start to incorporate the risks associated with nature loss in their underlying baseline macroeconomic and fiscal projections. Improved data collection and modelling will be necessary to do so robustly. The analysis should also account for the economic and fiscal benefits associated with nature protection and recovery.

**Recommendation 3:** DSFs should make more extensive use of different climate and nature scenarios, including ones with early and ambitious investments in resilience, nature protection and avoided emissions. These scenarios could illustrate how different financing sources and terms for those investments may affect debt sustainability over various time horizons. In data-poor contexts, an alternative approach might be to put a lower weight on debt incurred for climate and nature-related investments, if its implementation can be verified.

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