Transcript

Climate change, sovereign debt and the looming debt crisis in the global south

Elva Bova:

What we just heard was a very well-developed analysis of the nexus between different factors, including the COVID-19 crisis, climate change, mostly from the adaptation angle, and climate shocks, investment needs related also to a situation of development needs. That would all end up in our looming debt crisis. There is a strong rationale there of countries that did not contribute to climate change needing more support now to address the impacts and the vulnerabilities arising from climate change.

So, I would like to focus a bit more on the proposal, again, because I come from the North and I come from the perspective possibly of those who would be creditors. And they would have to sign off on the debt relief agreement. So, I know the sensitivities and the concerns that could come on their side. And particularly, on the debt relief proposal, there are specific topics that resonate to me. Like the Green and Inclusive Recovery Strategies, they sound somehow like the recovery plans, which should set policy priorities aligned with the SDGs. So, there is somehow a form of SDGs budgeting or SDGs alignment in these plans.

The importance of addressing debt sustainability vulnerabilities. And so how to shape a debt sustainability analysis that could include those vulnerabilities. And then the presentation of targets and metrics, which maybe you've heard, but we are really, like now in the recovery plans, looking a lot milestones and targets.

So, the context I believe is very familiar to you is the capacity of advanced economies and EU member states to respond to the crisis with massive stimulus packages. Full countercyclical fiscal policy, that here you see from the IMF fiscal monitor, is indicated by revenue fully or even more than matched by primary expenditure. So, there is a drop in revenue that is matched by higher expenditure.

This is not the case for emerging markets. It's not the case for low-income countries. And as a consequence, we have protracted recession or slow growth for these economies. Whereas we see a rebound for advanced economies. The scenario is fully matched by the following slide, which shows you the possibility to increase debts of advanced economies. They can get in debt. They can issue more debt. And as you see, they did actually get indebted more.

So, we are now in a situation in the EU of very high debt levels. They were high in the past. They're very high now. But I must say here, I'm reporting that as a share of GDP. Whereas I really like what was shown in the previous presentation, debt as a share of revenue. Where there, you could see more comparability between advanced economies and developing countries. Here comparability is not really there. We see Greece at 200 plus percentage points of GDP in terms of debt, compared to the average of emerging markets, about 64%, or low-income countries, about 50%.

Now these countries, while they can get very indebted, clearly, they have an issue with high debts. So, this situation is aggravated by high financing needs. Here, I'm reporting a very detailed analysis and identification of financing needs that was done by the commission last year to support the recovery package, where financing needs are divided between those for rebuilding investment and the capital stock.

Since at any crisis, we have a tendency to demolish investment. And that's for all countries, not just advanced economies. While keeping those items that cannot be compressed, like health care or social spending. Keeping those. But then in having a negative impact on investment, which in turn has a negative impact on growth.

To this, we add new financing needs, which are those for the green transition and the digital transformation. And also, you see some elements of strategic investment. The green transition goes beyond climate and also takes into account other environmental goals, like protection of landscape, biodiversity, waste management, the circular economy.

When it comes to climate, the emphasis here is clearly climate mitigation as it should be because we do contribute massively to climate change more than climate adaptation. Although member states are vulnerable to climate shocks, the vulnerability is not as high as in developing countries as we know. To the right-hand side of the slide, you see all the types of financing needs. And then there is a breakdown for those related to the green transformation. The commission really indicated what is needed in terms of construction cost, to transform all the buildings into energy efficiency buildings. Then into transport. Changed the transportation into more railway transportation. And you see also an emphasis of environmental protection not just green.

So, we look at physical risks that could emerge from the gradual transformation due to the gradual changes in climate. Increasing sea levels, increasing temperatures, erosion, land erosion. Or extreme events, wildfires, flooding. And then we know all the transmission channels that are also being discussed previously on the supply side, affecting all factors of production, and on the demand side, affected consumption, investment, and trade channels.

On this, we focus on fiscal impacts. And we distinguish them between those direct, like spending exactly for damaged assets or social transfers, to those groups that have been affected directly by climate shock. Explicit contingent liabilities. A guarantee on repayment for floating. And then there are two items here that I have highlighted for climate adaptation, like support the climate proofing of buildings and also the creation of rainy-day funds.

So, is how to react when there is a climate shock? Can we use rainy day funds? This is what Ireland, for example, does. Then when it comes to indirect fiscal impacts, again, we can mention the reduction of the tax revenue to the macro impacts. Increasing spending also to relaunch the recovery after a shock. Implicit contingent liabilities. This can apply on a different array of losses and damages that had not been guaranteed by the state. And an increase in borrowing costs as we see. So, this is the mindset or the framework that we have in mind when looking at debt sustainability analysis with respect to climate.

Money comes also to the linkages from fiscal to climate. There is a number of mitigation policies that we take into account. This could go from carbon taxes to emission trading schemes, public subsidies for energy transition. Or redistributive schemes in support of the transition. When we talk about the fair transition, the idea is also to have social schemes that protect the most vulnerable. And then a carbon adjustment mechanism, which is the carbon adjustment tax that you might have heard that's been just proposed for imported goods.

Now, there is work that is being done in house on how to insert in the debt sustainability analysis climate shocks. And this relates exactly to what was said before. How can we improve our assessment of the sovereign debt going forward?

And how can we include the climate considerations? This has been done at the IMF, at the World Bank, at the European Commission. We all work together on this in different ways. But if you see one way to conceptualize that, is we'd start from a baseline scenario, which is the yellow line. And then we customize a shock, the red line, of negative GDP growth with a rebound that does not go back to the baseline. So, it's a persistent deterioration of the macro economy of our country.

This could be compensated by mitigation and adaptation policies in place and a package of these policies, which you will see adapted and apply to the blue line, meaning a shock that is not as dire as the customized one, the stress tests with the red line. But then there is a rebound of improved the growth scenario due to the mitigation and adaptation policies in place.

This scenario or this climate model is not yet in our analysis that we do every year for the countries, but it's been developed and should be there soon there are other considerations that have to be taken into account, which are the potential impact of contingent liabilities and clearly risk-sharing agreements between private and public sector. And this is very important not knowing who bears the loss at the end. Is there a guarantee? Is there an insurance? If losses are insured by the private sector, then the public sector will not bear all the costs. But usually, this is what happens.

Now, we close with the context and how we do our assessments. And we move to policies. These policies do relate to what has been discussed before because a major concern that we have in the EU is how to demonstrate that what you're doing is really green. Major concern that you can label as greenwashing. And so, there is a lot that is being done also in terms of accountability and transparency to show that what you're doing is having an impact on climate and on the environment. One way to go about that is green budgeting. You see here the definition provided by the OECD. And so many member states, but also countries all over the world, including developing countries. And we work with the UNDP, who's been working with the Philippines, Bangladesh, trying to develop tools for greening their budgets. What does it mean? That you would really be able to tell how much your budget contributes to the environment or to climate.

For developing countries, this is mostly on climate adaptation. And it's a very important tool for transparency and accountability. One of the countries that really excel in this is France. They provide every year in the budget a detailed list of all the programs that have a positive impact on the environment, a negative one, and a mixed. And when it's mixed, it can be because these programs have a positive impact on climate, but then a negative impact on waste, or water, or pollution, or biodiversity. A railway could have a positive impact on climate mitigation, but a negative impact on biodiversity. So, these are all things that in assessing public finance impacts on climate, you have to take into account.

Here again, when you do green budgeting or greening of the budgets, it's also the condition than to do the mainstreaming, the green mainstreaming of your budget. And so, this is something the European Commission does. What they do is they look at the entire budget of the commission. And they indicate program by program how much they contribute to climate.

The idea is that by 2020, so last year, the EU climate budget should have reached a target of 20% of programs favourable for climate. And then for the next budget, it's a six-year budget. So, 2021-2027. The target should be 25%. So, 25% of all the European Commission spending should be favourable for climate. And only if you have an understanding of how each policy impacts the budget you can then go on and do climate mainstreaming.

Then another point that I wanted to raise if I still have a few minutes is a recent proposal that concerns the issuance of green bonds in the EU. But that would be a global standard. So, it's creating a standard where a company if the company wants to issue a bond that is green has to prove that it invests the proceeds of the bond into a green project.

And again, this goes also for governments. If a government wants to issue green bonds, they have to prove that what they spend on with the proceeds is green. So how to avoid, again, greenwashing? Because there are a lot of green standards around. But are they really green? And the new proposal is to align this green bond issuances with what we call the taxonomy.

So, the taxonomy is another standard that provides, you see here in details, technical screening criteria. So, it tells you exactly if that activity is green or not by a scientific standard. So, if you build a

railway, the railway will be considered to be green fully if it reaches a reduction of greenhouse gas emissions by 2%.

But also, not just reaching that goal, but then it does not have a negative impact on all the other environmental objectives. Like OK, you build a railway, but it's not that you are destroying an entire forest to do that. So, the two go hand-in-hand. First of all, how much is the greenhouse gas emission reduction? So, the specific target and is a scientific, very visible target. And then the other one is do not harm other principle, what we call the do not significant harm. And also, it includes minimal social safeguards. You see here the list of all the activities that have been screen to be in line with climate adaptation and climate mitigation, for example.

Now, I'm going to spare you with the details of the recovery package of the EU. There has been a big plan called Next Generation EU. It's loans and grants that are given to the EU member states to support the recovery. And as Julie was saying, this is something that we can do because we have room and fiscal space, and developing countries are not able to do that. So, it's a big stimulus and huge support.

It comes as certain conditions. And I like to tell you a little bit more about the recovery and resilience plans because it's something, again, that member states are looking at. And looking from the creditors' angle, what about considering some of these elements in the green and sustainable strategies, for example? Member states have to prove what they spend with this money. And they have to prove that what they spend meets 37% of climate target. So, 37% of the plan is to have a positive impact on climate.

Finally, and I close here. We said that member states are cash constrained, but still, we managed to issue this big stimulus. Part of it is that for the first time, the commission has issued that green bond based in part on the taxonomy and on another methodology. So, it's the first time that the commission got indebted. So, there is a line debt of the EU, deficit of the OU that wasn't there before.

And just last week, there was the largest EU green bond mission ever, based again on this methodology. So, what is important here is to understand in a perspective on an investor, also private investor, there are some standards that are being created that might become global standards, who knows, but they are important to bear in mind.

On this, just a curiosity. It's not only the first green bond. It's the first bond that the EU has issued. And it's the first time that we sort of neutralize that, which is quite important for the European Union as a step.