

Transcript

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

Ulrich Volz:

Let me first talk on climate change, sovereign risk, and the cost of capital. Here is a table with the 20 most damaging natural disasters from 1998 to 2019. And you can see that natural disasters can have really terribly damaging effects on economies. So, the most extreme case has been the destruction of Dominica in 2017 through Hurricane Maria which destroyed the equivalent of 260% of the year's GDP.

So, we already see enormous damage caused by climate change, climate related natural disasters. And we know from science that the number and intensity of climate related natural disasters will increase. So, we're going to see much more destruction. But that's only one part of the story. There are many different ways how the physical impacts but also the transition impacts of climate change can have an impact on the economy, public finances, and sovereign risk.

So, there are different transmission channels, how both the physical and the transition impacts can impact on our economy. I'll just going to rush through that very quickly. The first channel that we've identified is the depletion of natural capital and natural services. So, climate change has very profound impacts on the natural habitat and can deplete natural capital which after all provides the basis for all our economic activities. The second channel we have identified is on fiscal impacts of climate related disasters. So, the events I just spoke about before they can cause enormous havoc for economies and this directly or indirectly can have big impact on public finances.

The third transmission channel relates to fiscal consequences of adaptation and mitigation policies. So, for adaptation for boosting resilience, countries need to invest a lot of money to make their economies more climate. Then there will be impacts on the macro economy. So, there's now a growing literature showing how the output can be affected adversely by climate change. Again, physical and transition impacts this can then have impacts on employment, fiscal revenue, and so on and again, in the end there may be an impact on sovereign risk.

There's also growing literature that has shown how climate related risks can translate into financial risk. And that financial institutions are facing material risk from both physical and transition impacts. There's also going to be big impacts on international trade and capital flows originating from climate impacts. And then the last transmission channel that we've identified is the impact of climate change on political stability and rising sovereign risk will translate into a higher cost of capital.

And this is something I just would like to briefly explore with you. So, in 2018, we published a report together with Imperial College and UN Environment on Climate Change and the Cost Of capital in Developing Countries where we were able for the first time to show that climate vulnerable countries already now have to pay a higher cost on their sovereign debt.

And so, we took measures of climate vulnerability and of course we did all climatic testing for that, but this graph shows you basically the positive relationship that we found between sovereign bond yields and this measure of climate vulnerability. And we've estimated in that report that climate vulnerability for a group of 26 climate vulnerable countries already had driven up the cost of sovereign debt by 117 basis points. And for those of you who are not familiar with what that means, it basically means that for every \$10 paid in interest by developing countries, they have to pay an additional dollar on their debt because of their climate vulnerability.

And we also found-- and that's the positive part of the story that there is a negative relationship between the cost of debt and the measure of resilience and of social readiness. And so, this suggests that investing in readiness, in resilience can partially offset these costs. So, we found some climate risk premium because of climate vulnerability and some offsetting effect of climate preparedness. So, there's a bad story but also a little bit of hope.

And we estimated in that report that a group of 40 climate viable countries over the period 2007 to 2016 had to pay an additional \$62 billion in interest because of their climate vulnerability. And we did some projections for the decade ahead where we estimated that around \$150-\$160 billion of additional interest payments would occur because of this climate vulnerability if nothing changes. But if anything, this is a conservative estimate because climate change is heating up.

So, this is of course profoundly unjust because these countries that have not contributed to climate change are really the ones that have to pay the climate risk premium. And so, they're in a way punished twice first by the physical impacts of climate change and then also by capital markets. So, we have been arguing that this situation really is creating a vicious circle where climate vulnerable countries have to pay a climate risk premium on their debt. This higher cost of capital is of course limiting fiscal space, it's limiting the ability to invest in climate resilience, but of course also other areas of development, such as health, education, and so on. So, an already vulnerable economy is going to be even more vulnerable because of underinvestment in these key areas and of course with climate change becoming worse, vulnerabilities will be riding further and so this really is creating a vicious circle.

So, this is a bleak picture. Climate change already is having an effect on cost of capital in climate vulnerable countries. They are facing this vicious circle. And the question is, what can we do to change that to turn it into a virtuous circle. Where we have more investment in climate adaptation and resilience, this is leading to lower climate risk premium, lower cost of capital, more room for fiscal spending investment in climate adaptation and other development areas and greater resilience. And in my mind, the answer for many of the climate vulnerable countries, especially the poorer ones is that without international support it's going to be almost impossible to set off this virtuous circle. So, we need international support and that brings me almost to a proposal in the end.

So, we put forward a proposal last November for debt relief for a green and inclusive recovery and in June this year we had a second follow up report where we fleshed out our ideas. And here is our proposal in a nutshell.

So, the starting point as I said is there are a large number of countries-- developing countries, which have unsustainable debt who are not able to invest in green inclusive recoveries and we need to find ways of changing that. And so, we believe we need to address the debt problem. And so, we need debt relief, but we need to make sure that debt relief is then used for green and inclusive recovery. And the idea is basically that first of all, we need some comprehensive debt sustainability analysis. The current Debt Sustainability Analysis, DSAs, that are conducted by the IMF and the World Bank are not fit for purpose, they don't sufficiently address climate risk, biodiversity risk, they don't address spending needs for achieving the sustainable development goals. So, the starting point is reforming debt sustainability analysis and then based on this climate sustainability enhanced, debt sustainability analysis we need to see how many countries do need debt relief. So, UNDP has put forward a report earlier this year where they suggested more than 70 countries may be in line. So, we're not just talking about a handful, this is really a systemic problem we're having right now.

So, countries that need debt relief should then put forward a strategy for green and inclusive recovery where they basically say, OK, these are the things we want to prioritize, all countries have climate adaptation papers, a sustainable development strategy papers and so on. So, we don't want countries governments to reinvent the wheel, but they basically need to say, OK, these are our priorities and this is what we want to commit to when we get debt relief both in terms of fiscal spending but also and maybe more importantly, in terms of policies that we want to take. And so, these green inclusive

recovery strategies would basically form the basis for a debt agreement where public creditors give debt relief and also importantly private creditors give debt relief on comparable terms.

And private creditors they would then swap their old debt against a significant haircut against green and inclusive recovery bonds. So new debt that is issued and these new green and inclusive recovery bonds they would be guaranteed by a new guarantee facility at the World Bank so that these new debt is safe. And so, the debtor government then would get debt relief, they would implement their green inclusive recovery strategy, and we have put forward some principles for green and inclusive recovery which in a way would provide the framework for these green and inclusive recovery strategies that governments would develop.

For most of these countries, when we talk about climate action, we talk about adaptation. And adaptation is absolutely crucial. So, no adaptation, no investment in resilience means no development. And so, the idea it's not OK. Advanced countries are not cutting their emissions sufficiently, now we are going to force developing countries to cut their emissions. No, this is really about providing fiscal room enabling governments in developing countries to invest in resilience, invest in development, and this development should be green and inclusive.