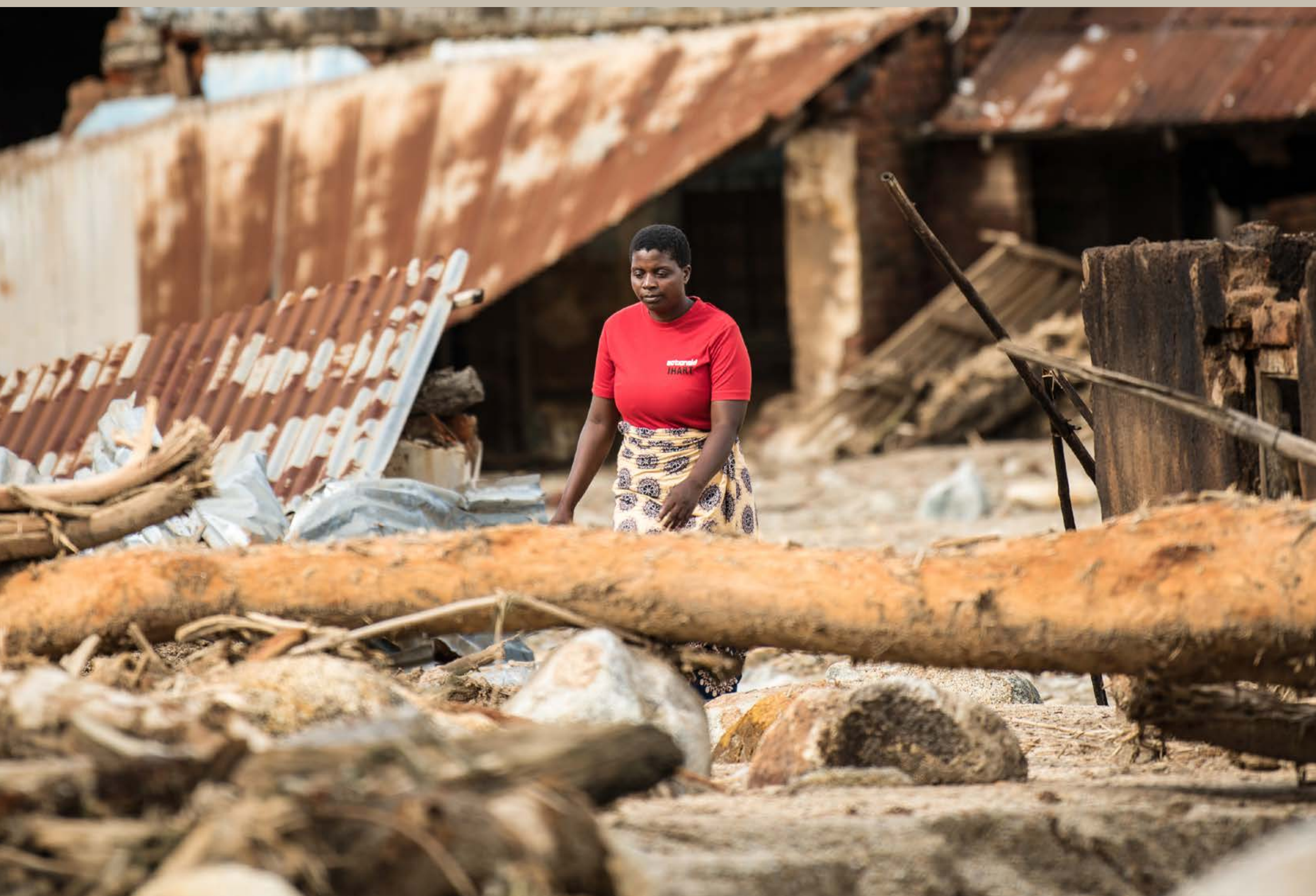
THE VICIOUS CYCLE:

CONNECTIONS BETWEEN THE DEBT CRISIS AND CLIMATE CRISIS

ACTIONAID POLICY BRIEF



SUMMARY

The countries that are most vulnerable to the climate crisis are also facing a debt crisis – and the need to service external debt in foreign currency has become a major accelerator of the climate crisis. There is a vicious cycle between the debt and climate crises, each reinforcing the other. It is thus profoundly contradictory that more than two thirds of climate finance arrives in the form of loans that serve to exacerbate this debt crisis, forcing countries into actions that entrench the climate crisis. The real value of these loans is often over-stated and yet, alarmingly, many of the proposals presently being considered for expanding climate finance seem to be focused on even more loans – rather than exploring fairer and more sustainable alternatives.

THE DATA

ActionAid has analysed multiple sources of data on climate and debt and the results are worrying. We analysed **data from the top third of countries deemed to be most vulnerable to the climate crisis**, based on their level of exposure to climate change and their capacity to adapt to its negative effects on key sectors such as food production, water availability, the environment, key infrastructure, housing, and health.

Our analysis finds that, where data is available, **93% of the countries most vulnerable to the climate crisis are in debt distress, or at significant risk of debt distress** (see detailed table in annex).

Comparing the IMF's own 2022 assessment of countries in debt distress (column 3 in the table in annex) with the list of the 63 most climate-vulnerable countries (column 2), we find that,

- 9 of the countries most vulnerable to climate change are already in debt distress/crisis
- 20 climate-vulnerable countries are at high risk of debt distress
- 20 countries at moderate risk of debt distress (though column 5 shows debt campaigners consider most of these to be at high risk - and even a moderate risk of distress is significant!)
- Only 4 climate-vulnerable countries are at a low risk of debt distress
- Data [on debt distress] was not available for 10 countries

Countries are obliged to service their debts before spending on anything else – so we looked at what percentage of government budgets in these countries is spent on servicing external debt. ActionAid research indicates that when governments are spending over 12% of their revenue on servicing debt, they end up cutting public spending on crucial public services. The IMF estimate that anything over 14% in low and middle income countries means there is a reasonable prospect that the country will default on its debt. **We found that 38 out of 63 most climate vulnerable countries are already spending so much on debt servicing that they are likely to be cutting spending on public services, making it impossible to invest in a feminist just transition.** Women and girls end up triply disadvantaged– being the first to lose access to public services, the first to lose frontline public service jobs and the first to take on the burden of unpaid care which rises when public services fail or when climate-induced disasters hit.

ANALYSIS: THE LINKS BETWEEN DEBT AND CLIMATE CHANGE

The links between the debt and climate crises are clear. External debt always has to be paid in foreign currencies (and mostly in US dollars[1]), and so, to pay back their debts, countries must earn foreign currency quickly - which can only be done by having an export-oriented economy that services the demands of the present global economy. This reinforces a subservient role for most low-income countries, little changed from the colonial era, based on exporting raw materials for low prices whilst having to import processed goods from high-income countries at high prices. In effect this acts as a major accelerator for investing in extractive industries, exploiting fossil fuels and other natural resources. It also accelerates investment in industrial agriculture that can produce commodity exports such as soybeans or palm oil on a large scale (to earn foreign currency). All of these investments are recognised contributors to climate change.

It is external debt that often forces countries to shape their economies to service the global market with its long supply chains. If freed of debt, countries would be able to pursue a more sustainable path, strengthening small and medium sized businesses, investing in renewable sources of energy, smallholder farmers and agroecology. But those sensible choices cannot be made if you are a country in a debt crisis.

There is already a global debt crisis on a scale that is only recently being recognised - with many countries spending more on servicing their debt than they spend on education and health. Inevitably this affects the capacity of countries to respond to the climate crisis, preventing them from investing in adaptation, resilience, or a just transition, and undermining their capacity to prepare for or respond to climate-induced disasters.

In a circular fashion, the loss and damage caused by climate-related disasters can then exacerbate external debt as countries have to borrow, often on commercial terms, with higher interest rates, to recover and rebuild. Outrageously, the most acutely affected small island states end up paying the highest interest rates on loans they take out, as the likely impacts of the climate crisis are deemed to put countries' ability to repay at risk. The assessment of climate risks has become a routine part of debt sustainability analysis. As a result, being more vulnerable to the climate crisis actually makes you even more vulnerable to a debt crisis.

Even highly concessional loans coming in the name of climate finance can contribute to a national debt crisis - as these loans still have to be paid back in dollars or other foreign currencies. Any crisis in exchange rates between the domestic currency and foreign currencies can send the price of servicing these debts rocketing. It is thus alarming that most currencies in developing countries were shrinking in 2022. In this context, sending the majority of climate finance in the form of loans can actually make the climate crisis worse!

High levels of debt make countries dependent on the policy advice and conditions of the **International Monetary Fund** - which is both the lender of last resort and the enforcer of debt repayments, making sure that countries adjust their economies to repay their debt before considering any other investments. For the IMF, paying debts is seen as the top priority for countries, regardless of other priorities that governments might want to raise, whether that is investing in health or education or adapting to the climate crisis. Meanwhile, the near certainty that the IMF will force countries to pay back their debts contributes to private sector banks being willing to make very risky investments in low income countries, encouraging bad practices which themselves accelerate debt crises.

1. Currency composition of external debt: amount owed in US dollars (from World Bank International Debt Statistics database): Low income countries = 66%; Lower middle income countries = 75% Upper middle income = 86%. Much of the rest is owed in Euros or Renminbi.

Despite some shifts in climate rhetoric, in practice the standard package of the IMF forces countries to further open up their markets to international competition, lengthening rather than shortening supply chains and encouraging investments that will quickly yield dollars. In practice the IMF continues to routinely recommend austerity, cutting public spending, further undermining public services and the capacity of countries to respond to the climate crisis. Yet a just transition in the face of the climate crisis should surely involve countries investing more, not less, in social protection, education, health and other public services.

Worryingly, the IMF is presently seeking to position itself as a key actor in climate finance, ignoring the contradictions laid out above and how its own advice undermines a just transition. The IMF proposes to increase its own power and resources by re-allocating Special Drawing Rights to its Resilience and Sustainability Trust - giving it the decision making power over who will get loans for climate finance and on what conditions.

There is a growing risk that ever more climate finance will become loan-based and under the control of the IMF and its sister organisation, the World Bank – ignoring the fact the World Bank has invested $15 billion to support fossil fuel projects and policies since the Paris Agreement. Shifting the locus of climate finance away from the relatively universal and democratic space of the UN Framework Convention on Climate Change and multilateral funds like the Green Climate Fund, to the much less representative, less accountable IMF and World Bank would be a regressive move, handing disproportionate power to a handful of wealthy countries and locking in a vicious cycle between the climate and debt crises.

It is time to recognise the vicious cycle between the debt and climate crises. Countries in debt are forced to pursue extractive economic policies that will accelerate the climate crisis and the consequences of debt make it harder to finance adaptation and a just transition. In turn climate induced disasters increase indebtedness and loan-based climate finance can deepen debt crises. And so the cycle continues.

In this context it is shocking that mainstream discussions about climate finance presently involve the Global North supposedly meeting its climate debt to the Global South by further indebting countries, many of whom are already facing a debt crisis – especially when we know that debt crisis is a key instrument in entrenching a failed economic model that itself accelerates the climate crisis.

Debt cancellation and radical reform to the global debt architecture ought to become central demands of governments in the Global South and the climate justice movement. There is an urgent need for a new UN based debt workout mechanism that breaks with decades of IMF control. Only when their countries are free of excessive burdens of external debt can governments take rational decisions towards pursuing a more sustainable economic model and investing in a just transition.

THE ALTERNATIVES: TAX JUSTICE TO FINANCE CLIMATE ACTION AND PUBLIC SERVICES

The central alternative to loan-based financing to protect communities from climate impacts, and to accelerate the transition to greener pathways, would be to take national and global action on tax to scale up both international climate finance and domestic revenues. As Oxfam have shown, wealth taxes of just 5% on the world's multi-millionaires and billionaires could raise $1.7 trillion a year (£1.4 trillion) – far exceeding the proposals for loan-based climate finance. More targeted windfall taxes on the excess profits of the biggest fossil fuel companies could potentially yield hundreds of billions. Taxing just five big tech companies could raise $32 billion. There is enormous potential to generate revenue from taxing air travel – which could also reduce one of the biggest forms of carbon pollution. Meanwhile the US Congress has estimated that a Financial Transactions Tax fixed at 0.1% could raise $777 billion in revenue over 10 years.

For over 60 years bold action on global tax reform has been hampered by the fact that global rules are set and enforced by the club of rich nations - the OECD (Organisation for Economic Cooperation and Development). This has helped to create a world where resources continue to be plundered from the Global South through aggressive tax avoidance and illicit financial flows (over $100 billion a year from Africa) so vast individual and corporate wealth ends up locked away in tax havens. But in 2022 a landmark vote took place at the UN General Assembly, voting to move tax policy making away from the OECD to the United Nations – where all countries can have an equal say. There is potential for a new UN body to have a clear mandate to develop new global tax rules that are informed by and seek to positively act on the climate crisis. Rather than just taxing to reduce emissions, tax rules could be designed to redistribute resources to those countries that are least responsible for but most effected by the climate crisis.

National action on tax reform can also play a transformative role in helping countries to steer away from economic policies that exacerbate the climate crisis. Looking at how countries could accelerate progress towards the sustainable development goals, the IMF calculated that most low-and middle-income countries could increase their **tax to GDP ratios** by five percentage points by 2030. This would allow a doubling of spending on health and education as part of a just transition or could support truly transformative investments in renewable energy and agroecology, rebuilding agriculture extension services as a public service for smallholder farmers, whose livelihoods are particularly vulnerable to the impacts of climate change. In the context of a cost-of-living crisis there would of course need to be an emphasis on gender responsive and progressive taxes - ensuring the burden falls on those who are most able to pay (the income and wealth of better-off individuals and companies).

Unfortunately, despite the IMF's research showing the immense potential of expanding tax revenues, in practice they almost never recommend bold and progressive tax reform in their advice to Ministries of Finance. The urgency of mobilising sustainable finances to respond to the climate crisis could help to force the IMF to change – if they could free themselves from their dependency on debt and loans.

CONCLUSION

Money that is supposed to help countries respond to the climate crisis should not actually make the climate crisis worse. But when climate finance comes in the form of loans, this is exactly what happens. Debt locks countries into a negative spiral – forcing governments to shape their economies and societies to pay back their debts and further harming the climate in the process. The pursuit of dollars by any means leads to more extraction of fossil fuels, more mining, more chemical-based industrial agriculture, more deforestation, and more environmental destruction that wreaks untold harm on human rights. There are clear alternatives, especially based on tax, but it is hard to justify tax reforms if all the revenue that is raised simply disappears to pay back crippling external debts. It is time for debt cancellation to become a central demand of climate justice advocates everywhere.

ANNEX

CLIMATE VULNERABLE COUNTRIES AND THE DEBT CRISIS

	1	2	3	4	5
	Most vulnerable countries in sequence	**Climate vulnerability index score** (from Notre Dame)	**IMF assessment of Debt Risk in 2022** (from Debt data portal)	**External debt payments** 2021 as % of govt revenue	Debt Justice Campaign comments on countries listed as a moderate debt risk by IMF (debtjustice.org.uk)
1	**Niger**	0.673	Moderate	13.0	*Risk of public & private debt crisis*
2	**Somalia**	0.658	In debt distress	n/a	
3	**Chad**	0.658	In debt distress	16.9	
4	**Sudan**	0.618	In debt crisis	11.9	
5	**Liberia**	0.603	Moderate	9.4	*Risk of public debt crisis*
6	**Mali**	0,598	Moderate	10.2	*Risk of public debt crisis*
7	**Cen.African Rep**	0.593	High	9.3	
8	**Eritrea**	0.591	In debt distress	5.3	
9	**Rwanda**	0.586	Moderate	31.9	*In debt crisis*
10	**DRC**	0.586	Moderate	7.5	*Risk of public & private debt crisis*
11	**Micronesia**	0.585	High	5.2	
12	**Uganda**	0.580	Moderate	17.5	*Risk of public debt crisis*
13	**Tonga**	0.579	High	3.0	
14	**Afghanistan**	0.579	High	1.8	
15	**Benin**	0.572	Moderate	15.5	*Risk of public debt crisis*
16	**Solomon Islands**	0.571	Moderate	2.0	*No risk identified*
17	**Mauritania**	0.571	High	25.9	
18	**Sierra Leone**	0.563	High	16.0	
19	**Ethiopia**	0.563	High	23.5	
20	**Madagascar**	0.561	Moderate	9.0	*Risk of public & private debt crisis*
21	**Yemen**	0.558	Moderate	50.0	*In debt crisis*
22	**Burundi**	0.558	High	3.2	
23	**Zimbabwe**	0.554	In debt distress	4.1	
24	**Vanuatu**	0.548	Moderate	13.0	*Risk of public debt crisis*
25	**Malawi**	0.548	In debt distress	4.9	
26	**Burkina Faso**	0.547	Moderate	6.4	*Risk of private debt crisis*
27	**Gambia**	0.545	High	20.5	
28	**Bangladesh**	0.541	Low	6.3	
29	**Papua New Gui**	0.536	High	12.8	
30	**Senegal**	0.532	Moderate	17.4	*In debt crisis*
31	**Guinea**	0.532	Moderate	8.3	*Risk of public debt crisis*
32	**Haiti**	0.531	High	10.0	
33	**Comoros**	0.531	High	8.5	
34	**Pakistan**	0.530	n/a	30.9	*In debt crisis*
35	**Myanmar**	0.530	Low	6.0	
36	**Sao Tome & Pr.**	0.528	In debt distress	2.6	

37	**Laos**	0.526	High	40.0	
38	**Maldives**	0.525	High	32.7	*In debt crisis*
39	**Kenya**	0.525	High	13.6	
40	**Congo**	0.523	In debt distress	33.1	
41	**Zambia**	0.521	High	45.9	
42	**Togo**	0.521	Moderate	10.3	*Risk of public debt crisis*
43	**Nepal**	0.521	Low	3.5	
44	**Tanzania**	0.520	Moderate	15.1	*Risk of public debt crisis*
45	**Eswatini**	0.519	n/a	9.7	
46	**Bhutan**	0.519	Moderate	14.0	*In debt crisis*
47	**Mozambique**	0.517	In debt distress	25.5	
48	**Cote d'Ivoire**	0513	Moderate	13.9	*Risk of public debt crisis*
49	**Cambodia**	0.507	Low	6.7	
50	**India**	0.506	n/a	3.5	
51	**Angola**	0.505	n/a	62	*In debt crisis*
52	**Timor Leste**	0.500	moderate	1.7	
53	**Nigeria**	0.500	n/a	6.8	
54	**Samoa**	0.487	High	6.0	
55	**Lesotho**	0.484	Moderate	7.8	*Risk of private debt crisis*
56	**Vietnam**	0.483	n/a	7.5	
57	**Djibouti**	0.481	High	15.7	
58	**Cameroon**	0.480	High	21.0	
59	**Sri Lanka**	0.478	n/a	60.0	*In debt crisis*
60	**Antigua**	0.477	n/a	n/a	
61	**Namibia**	0.474	n/a	20.8	*In debt crisis*
62	**Dem Rep Korea**	0.472	n/a	3.9	
63	**Ghana**	0.471	high	44.1	

NOTES:
Column 1 lists the **top third of countries that are most vulnerable to climate change** (in sequence)

Column 2 gives the scoring of the country on **vulnerability to climate change** - based on data from Notre Dame University and their ranking system: *The Vulnerability Ranking measures a country's exposure, sensitivity and capacity to adapt to the negative effects of climate change. ND-GAIN measures overall vulnerability by considering six life-supporting sectors – food, water, health, ecosystem service, human habitat, and infrastructure.*

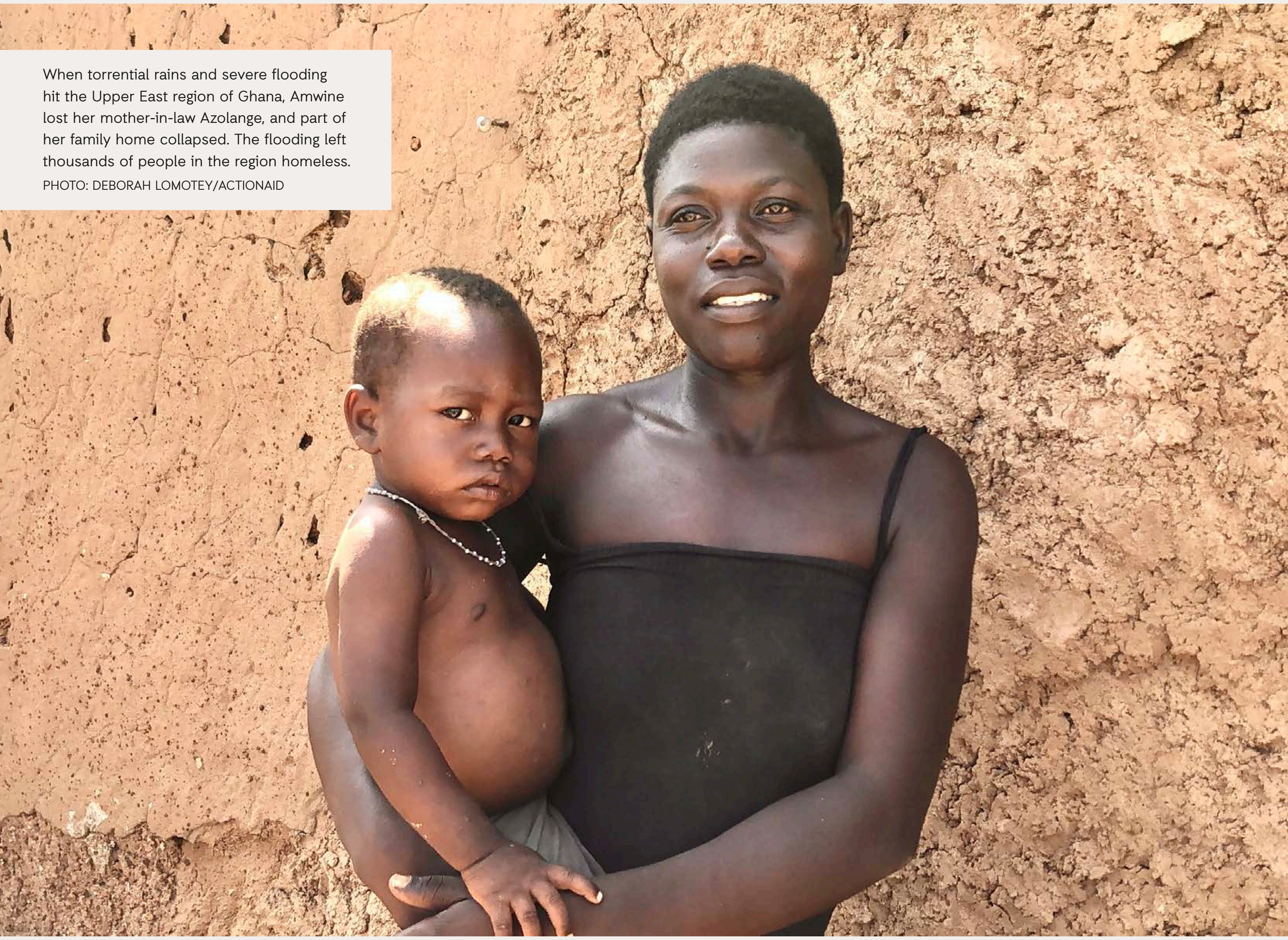
> ***EXPOSURE:*** *Degree to which a system is exposed to significant climate change from a biophysical perspective. It is a component of vulnerability independent of socio economic context. Exposure indicators are projected impacts for the coming decades and are therefore invariant overtime in ND-GAIN.*
> ***SENSITIVITY:*** *Extent to which a country is dependent upon a sector negatively affected by climate hazard, or the proportion of the population susceptible to a climate change hazard. A country's sensitivity can vary over time.*
> ***ADAPTIVE CAPACITY:*** *Availability of social resources for sector-specific adaptation. In some cases, these capacities reflect sustainable adaptation solutions. In other cases, they reflect capacities to put newer, more sustainable adaptations into place. Adaptive capacity also varies over time.*

(See: Rankings // Notre Dame Global Adaptation Initiative // University of Notre Dame (nd.edu))

Column 3: indicates the IMF's assessment of the level of debt risk faced by the country (based on data from 2022). There are 6 possible rankings: 1. Debt Crisis, 2. Debt Distress, 3. High risk of Debt Distress, 4. Moderate risk of Debt Distress, 5. Low risk of Debt Distress, and 6. Data not available.

Column 4: indicates what percentage of the government budget is spent on servicing external debt. ActionAid research indicates that when governments are spending over 12% of their revenue on servicing debt, they end up cutting public spending on crucial public services. The IMF estimate that anything over 14% in low and middle income countries means there is a reasonable prospect that the country will default on its debt.

Column 5: includes comments from Debt Justice on those countries deemed by the IMF to be only at moderate risk of debt distress – to show that in many cases these countries are at significant risk of either a public or private debt crisis. (Debt data portal (debtjustice.org.uk)).



When torrential rains and severe flooding hit the Upper East region of Ghana, Amwine lost her mother-in-law Azolange, and part of her family home collapsed. The flooding left thousands of people in the region homeless.
PHOTO: DEBORAH LOMOTEY/ACTIONAID

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Cover Photo: Loveness Chiwaya, director of Chigwirizano Women's Movement, inspects the damage to Nkhulambe village in Malawi, in the aftermath of Tropical Cyclone Freddy, March 2023. CREDIT: Thoko Chikondi/ ActionAid