How can countries address the fiscal costs of the effects of climate change and natural disasters, and implications for debt sustainability?

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Good afternoon.

I have been asked to talk about how countries can address the fiscal costs of the effects of climate change and natural disasters and the implications for debt sustainability.

In doing to, I will:

- Briefly review some of the fiscal implications of climate change and natural disasters;
- Examine the small states context within which costs are being incurred; and
- Set out 6 practical policy actions to address growth; debt and debt sustainability in the context exposure to shocks and climate change; as well as provide improved access by small states to the concessional resources to provide resources they need for resilience building, and to avoid debt traps in future.

Of the Commonwealth's 53 member states, 31 of these are classified as small states. This is an important constituency for us, and in the past five years the Commonwealth Secretariat has worked closely with its member states to develop practical, doable proposals for action on **indebtedness** and access to resources to address **climate vulnerability**.

This presentation is based on the work of my colleagues Sam Attridge and Travis Mitchell on debt issues of small states, as well as work that I undertook with the International Centre for Trade and Sustainable Development in Geneva on the trade and climate change concerns of SIDS, SVEs and LDCs. It also draws on a new report by an Expert Group on Climate Finance.

Fiscal Costs of Climate Change

The Fiscal costs of Climate Change are both in terms of government expenditure and loss of income.

Perhaps the easiest way to conceptualise these is within different time horizons, but all these horizons need action *now* to ensure the most cost-effective response to climate change over time.

For government, a critical role is the delivery of institutions, skill sets, policies and investment to minimise costs in the longer term.

One point I want to emphasise here is that adaptation costs (to disasters, to climate change) involve <u>public expenditure</u>, and in the absence of climate financing, countries may need to access loans and incur debt to ensure their infrastructure is secured.

In the first (immediate) time horizon:

The most obvious impact of climate change is **directly, through loss of earnings as a result of disasters, and government expenditures on disaster relief and reconstruction**, which countries will face with greater frequency and severity in future.

In the second time horizon, moving forward to immediate anticipation of events:

Governments are investing in **infrastructure improvements to accommodate new tidal levels and increased impacts of cyclones and king tides** [adaptation]. The World Bank has estimated that developing countries as a whole are already carrying about 80 per cent of the costs of climate change in this way.

Expenditures due to the slow-onset 'disaster' of climate change relate to addressing concerns such as saltwater intrusion into drinking water supplies, necessitating investment in improved water infrastructure, catchment systems and reverse osmosis (with an associated increase in fuel bills); as well as loss of income as climate change begins to have an impact on key trade sectors of small states based on resources that are particularly vulnerable to climate change (agriculture, fisheries, tourism).

In the longer-term:

Fiscal resources for development will be increasingly be diverted to climate-related expenditures. Pacific Island Countries face a choice of public investments to achieve:

- Deep adaptation of sectors (modernisation of agriculture; new crop varieties; greater processes); or
- Adaptation away from vulnerable sectors – yet we know how challenging diversification is within a small states' context.

Both options require investment and dynamic engagement by government.

Climate policy itself with have significant implications for small states:

These are of two kinds:

The first is **market preferences**: both in terms of **demands for low-carbon inputs** in the value chains, requiring alignment to new production requirements; as well as what I call **'reputational risks'** in relation to the sustainability of key sectors, like fisheries and tourism product, which can result in shocks through consumer markets and increased demands for labelling.

The other is related to an **increasing price for carbon** in the longer term affecting the cost of goods produced in remote locations; and necessitating investment in low-carbon, renewable energies to reduce import bills and increase efficiency.

There are **opportunities**, but we have some way to make these a reality. For example, through the capitalisation of what is known as blue carbon – the value of the ocean as a sink for carbon emissions.

Macroeconomic Performance in Small States

As we have heard, small states possess a set of inherent structural characteristics which pose a special development challenge and combine to make them highly vulnerable to external shocks. These proposals have been drafted in close consultation with Commonwealth small states themselves, and with consideration to the ongoing efforts of IFIs to address the issues.

Various **shocks in the past decade have highlighted these weaknesses and contributed significantly to the accumulation of debt within small states**, including the 2006/2008 oil and food price crisis; and the global economic crisis of 2007/2008. Since that time, we have entered a world characterised by increased uncertainty. Much greater attention needs to be paid to **resilience building** and the **development of an appropriate international financial architecture** that can help small and vulnerable economies better manage their structural vulnerability to exogenous shocks.

While small states have attained relatively high levels of income compared to other developing countries – all Commonwealth small states are categorised by the World Bank as lower middle income or above on the criterion of GDP per capita – their GDP growth performance has declined in every decade since the 1980s (though it has been a mixed picture for these countries), and output has been volatile.

Debt burdens in small states have grown in the past decade. Pacific Commonwealth small states have relatively moderate levels of debt, but they have been recipients of ODA and debt has been contained since flows were substantially in the form of grants. This is beginning to change and a number of countries are at a high risk of debt distress.

Practical Policy Proposals

Small states already have limited resources to cope with external shocks. An accumulating debt burden is acting as a drag on growth in some countries, and climate change is likely to further deepen these debt challenges, particularly for those that do not have access to concessional financing.

The Commonwealth Secretariat has been developing a suite of proposals to address these linked concerns. I will summarise six of the key proposals here. I have grouped them into three tranches. You will note, that these proposals fit closely with the resilience framework that Lino presented at the start of the day.

<u>To improve growth prospects of small states:</u>

Policy Approach 1: is to **strengthen resource management**. For example management of ocean resources which have great untapped potential for small island states. The Commonwealth Secretariat is working with a number of member countries in an innovative way to develop new approaches to ocean governance and economic development in a pragmatic step-by-step way that helps to develop environmental security and resilience, while releasing the economic potential of oceans.

Policy Approach 2: is to **improve competitiveness** through the development of renewable energy resources; a more flexible approach to the reduction of tariffs; and Aid-for-Trade initiatives for small states.

To address the debt concerns of small states:

Policy Approach 3: is for **debt relief, using a debt-for climate change adaptation and mitigation swap**. Some PICs continue to face high debt burdens. There is no appetite at present for a HIPC-type mechanism for middle-income small states, but an innovative approach such as a debt swap for climate finance has significant potential. Donors would write-off all or a portion of small states' multilateral debt, using funds committed for climate change adaptation and mitigation. Over a period of 10-15 years, small states would transfer the scheduled repayments on the debt into a Trust Fund set up by the Central Bank of that country, to finance climate change adaptation and mitigation projects.

Policy Approach 4: is for improved access to **counter-cyclical loans** which would allow for a suspension of debt service in times of shock through established triggers and grace periods. If broadly applied, counter-cyclical loans could help to avert unnecessary adjustment costs and further debt accumulation.

To ensure improved access to climate finance and concessional resources for development:

Policy Approach 5: is to **revisit the criteria for access to IFI concessional resources and official development finance** (to give small states cheaper access to crucial development and shock financing). The majority of Commonwealth small states are not eligible for IFI concessional resources or debt relief, despite very high vulnerability to environmental and economic shocks, though some are supported through the small island economy exception. A vulnerability criterion is being employed by the IMF to safeguard against premature and reverse graduation of low-income countries. However, vulnerability has not been used as a criterion for eligibility to use concessional facilities. This would also meet 3 criteria for good aid allocation: effectiveness (marginal effectiveness of aid is higher in vulnerable countries); equity (compensating for vulnerability through equalising opportunities); and transparency (avoids multiplication of exceptions).

Policy Approach 6: is for the **IMF to employ macroeconomic adjustment within a broader policy of resilience building**. The IMF's macro-economic adjustment programmes have been mainly about fiscal restraint, with a view to returning debt to sustainable pathways. However, this approach has been shown to impact growth. So, undertaking macroeconomic adjustment (macroeconomic stability) under a resilience lens would provide a more balanced adjustment and be an investment in long-term sustainability, including through social, governance and environmental actions that build economic resilience.

My final point is that domestic policies must support effective climate financing and shock absorption. Without co-ordinated action the multiple-benefits from policy action are lost. We need to move from project-by-project financing to implementation of programmes of work. Governments need to document the climate change actions needed and implement those actions across the whole of government. The Commonwealth's

Expert Group on Climate Finance highlighted the need to **prioritise a strengthening of public finance system to enable public-led implementation of a climate response;** use of *Peer Reviews of National Systems* (under the Pacific Islands Forum Compact on Development Effectiveness); *Public Financial Management Roadmaps* and *Climate Change Finance Assessment* efforts.

The Commonwealth Secretariat will be taking forward these proposals in the coming months. A just-concluded meeting of Commonwealth Heads of Government in Sri Lanka agreed:

- A ministerial group to progress practical proposals to address priority concerns of small states through SIDS 2014 and development of the post 2015 development framework.
- An open-ended Group of Heads to identify recommendations on the post 2015 development agenda ahead of the 69th UNGA.
- It welcomed Mauritius' offer to host a Commonwealth Climate Finance Skill Hub and will consider a full proposal in 2015; and
- Endorsed the recommendations of a High-Level Mission on Debt and Financing Challenges of Small States, seeking continued engagement on innovative solutions on debt reduction and allocation procedures of international financial institutions.

We will be continuing our research in greater depth, and engaging further on our proposals with member countries and all relevant institutions.

Thank you for allowing me to share these proposals with you today.

Port Vila, Vanuatu
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Further reading:

Improving Access to Climate Finance for Small and Vulnerable States: A Report of the Commonwealth Expert Group on Climate Finance to the Commonwealth Heads of Government Meeting 2013. Commonwealth Secretariat, 2013.

High Level Advocacy Mission - A Time to Act: Addressing Commonwealth Small States' financing and debt challenges. Commonwealth Secretariat, 2013.

Trade, Climate Change and Sustainable Development: Key Issues for Small States, Least Developed Countries and Vulnerable Economies, by ICTSD and Commonwealth Secretariat, edited by Dr Moustapha Kamal Gueye, Malena Sell and Janet Strachan, 2009.