The Role of Alternative Financing Mechanisms to Address Sri Lanka's Debt Overhang

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Introduction

Sri Lanka is facing an unprecedented economic crisis with significant challenges to regain economic stability. With tax revenues falling from an already low 12.7 per cent of GDP in 2017-2019 to 7.3 per cent in 2021, the country's interest payment shot up to an unsustainable level of 95 per cent of government revenue by 2021[1]. The debt-to-GDP ratio has increased to 127 per cent in the first quarter of 2022. Sri Lanka's economy contracted by 7.8 per cent in 2022 and is expected to fall by 3% per cent in 2023[2].

The common path followed by almost all International Monetary Fund (IMF) member countries in response to sovereign debt crises in recent decades, is to enter into an IMF supported stabilisation and structural adjustment programme[3]. Sri Lanka has been a repetitive client that followed this trend, having entered into 16 economic stabilisation programmes during 1965-2020. Recently, Sri Lanka received IMF board approval for its 17th economic stabilisation programme.

According to UNESCAP estimates in 2019 (prior to the pandemic and crisis), Sri Lanka needed to spend an additional 9% of GDP per year to achieve the Sustainable Development Goals (SDGs) by 2030[4]. While, the National Budget for 2023 announced to reduce the budget deficit from a negative 11.6 per cent of GDP in 2021 to a negative 7.9 per cent in 2023. This is mainly expected to be financed by through domestic sources (77 per cent)[5], which can put pressure for higher interest rates.

The country faces significant climate change risks as well. The global climate risk index for 2021, ranked Sri Lanka as the 23rd most affected country from extreme weather conditions during the

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[1] https://www.unescap.org/sites/default/d8files/event-documents/Concept%20Note%20-%20Sri%20Lanka%20Draft%203.pdf

[2] https://www.imf.org/en/Publications/REO/APAC/Issues/2023/04/11/regional-economic-outlook-for-asia-and-pacific-april-2023

[3] https://www.undp.org/sites/g/files/zskgke326/files/2022-11/UNDP-Sovereign-Debt-Crisis-in-Sri-Lanka-Report-2022.pdf

[4] https://www.unescap.org/sites/default/d8files/event-documents/Concept%20Note%20-%20Sri%20Lanka%20Draft%203.pdf

[5] https://www.treasury.gov.lk/api/file/321d137c-231e-4f7f-85f6-e073fcde5259

period of 2000–2019[6]. The country is also expected to see a 1.2 per cent annual GDP loss by 2050 due to climate change[7].

Therefore, moving into a conventional IMF agreement may not reap the full benefits required for Sri Lanka. In parallel to the IMF and negotiations with other multilateral development partners, alternative financing mechanisms should be explored in order to achieve Sri Lanka's development goals while overcoming the debt overhang. Alternative financing mechanisms such as green financing instruments like debt-for-climate or debt-for-sustainability swaps, if effectively implemented, have the potential to provide long-term credit benefits by offering debt relief while also increasing investments that could strengthen Sri Lanka's resilience to environmental risks. This can be a win-win situation for the country to achieve debt sustainability as well promote economic development in the country.

Alternative Financing Options

The Government of Sri Lanka (GoSL) has currently embarked on capacity development programmes for the adoption of alternative financing mechanisms such as green bonds. The Securities and Exchange Commission (SEC) too has developed a policy and regulatory framework governing green bonds and in April 2023, the SEC approved rules for issuing green bonds for listed companies and statutory entities. This was subsequent to the publication of the green taxonomy by the Central Bank of Sri Lanka (CBSL), which provided clarity on economic activities that are environmentally sustainable. Therefore, the landscape for adopting alternative financing mechanisms is being developed, enabling a more favorable environment for the use of alternative financing mechanisms in the future for Sri Lanka.

An array of solutions can be considered for Sri Lanka, some of which are more appropriate than others in Sri Lanka's country context and government priorities. Debt-for-climate or debt-for-sustainability swaps have proven to be a successful debt alleviation tool across globally while promoting investment in green and sustainable projects. Carbon credits too can be a feasible and innovative way to address debt overhang and climate change simultaneously but requires more research on the impacts and scalability.

Concessional and blended finance models too can provide favourable results while linking these to development objectives of Sri Lanka. In the long term, thematic bonds are also a tool that can be used to mobilise domestic and foreign capital. However, prior to a thematic bond issuance, access to the international finance markets should be established. This is expected to be facilitated by the completion of the IMF programme.

Debt-for-climate or debt-for-sustainability swaps

[6] Global Climate Risk Index 2021 | Germanwatch e.V.
[7] https://www.worldbank.org/en/news/press-release/2021/09/20/sri-lanka-world-bank-sign-agreement-to-strengthen-climate-climate-resilience

This is a financial instrument where the country would swap a promise (repayments on debt) with another promise (such as funding SDGs). This has been applied in small economies like Costa Rica, Belize and Seychelles in recent years. Recently, following Sri Lanka's default, a global financial firm too expressed interest in restructuring USD 1 billion of debt for environmental ends.

While grants normally cover the cost of an investment, debt-climate or debt-sustainability swaps typically produce some net debt relief (i.e. debt relief somewhat exceeds the cost of the investment). Therefore, a higher net fiscal transfer can be expected for the debtor governments.

These are agreements between a debtor country and a creditor (usually another country or an international organisation) that involve the cancellation or reduction of a portion of the debt in exchange for the debtor's commitment to invest in environmental conservation or restoration projects. For example, Sri Lanka could negotiate with China, one of its largest creditors, to swap some of its debt for investments in protecting its forests, wetlands and coral reefs, which are rich in biodiversity and provide valuable ecosystem services. This would reduce Sri Lanka's debt burden and free up fiscal space for other development priorities, while also enhancing its resilience to climate change and natural disasters.

<u>Other Country Experience</u>

In 2007 and 2010, Costa Rica carried out its first and second debt for nature swaps with the United States. The first swap allocated USD 26 million for conservation in communities surrounding protected areas, while the second contributed USD 27 million directly to funding protected areas.

In 2016, the Seychelles swapped USD 21.6 million of its debt primarily with the Paris Club creditors for a 20-year commitment to protect 30% of its marine territory and implement a comprehensive marine spatial with the support of the Nature Conservancy (TNC).

In 2017, Mozambique swapped USD 40 million of its debt with Russia for the implementation of a school meals programme targeting 150,000 children in Mozambique over a 5-year period carried out by the World Food Programme (WFP).

In 2021, Belize swapped USD 553 million (government's total external commercial debt) through a blue bond arranged by TNC to the Belize government to finance a bond-for-cash exchange at 55 cents per dollar. This was in exchange for a 20-year commitment to expand and strengthen its marine protected areas network. The US Development Finance Corporation (DFC) provided political risks insurance for the blue bond.

In 2022, Barbados swapped USD 150 million of sovereign debt with guarantees from the Inter-American Development Bank (IDB) and TNC to protect 30% of the waters surrounding the island following a similar model Belize.

In 2023, Ecuador swapped USD 1.6 billion of the country's debt for conservation in the Galápagos Islands. To date, this is the largest debt-for-nature swap completed in the world. It consisted of an USD 85 million IDB guarantee and an USD 656 million DFC political-risk insurance.

Carbon Credits

Carbon credits are certificates that represent a reduction or avoidance of greenhouse gas emissions. They can be traded in voluntary or regulated carbon markets, where emitters can buy credits to offset their emissions or comply with emission reduction targets. It also allows countries or entities that reduce their emissions below a certain level to sell their surplus emission reductions (or carbon credits) to countries or entities that need to comply with their emission targets or voluntarily offset their emissions. The carbon market can provide a win-win situation for both buyers and sellers of carbon credits, as it can lower the cost of compliance for buyers and generate additional income for sellers.

Sri Lanka has already participated in the carbon market under the Clean Development Mechanism (CDM) of the Kyoto Protocol, which was the first global carbon market established under the UNFCCC. Sri Lanka has registered over 100 CDM projects in various sectors such as renewable energy, waste management and forestry. However, the lack of demand for carbon credits has prevented the program from fully realizing its potential until recently. Latter part of 2022, saw Sri Lanka's government approving the implementation of the Joint Carbon Crediting Mechanism between Japan and Sri Lanka.

The Paris Agreement too has introduced a new mechanism for international cooperation on climate action, known as Article 6. This mechanism allows countries to cooperate in achieving their NDCs. Sri Lanka can benefit from Article 6 by engaging in cooperative arrangements with other countries or entities that are interested in purchasing its emission reductions. For example, Sri Lanka can enter into bilateral agreements with countries that have higher emission targets than Sri Lanka, such as Norway, and sell its emission reductions from sectors that are not covered by its NDC, such as agriculture or tourism.

Alternatively, Sri Lanka can participate in a multilateral platform that pools together emission reductions from multiple countries and sells them to buyers through an auction or a trading system.

Accessing the carbon market under Article 6, Sri Lanka can generate additional revenue that can help it service its debt obligations and finance its development priorities. Moreover, by participating in the carbon market under Article 6, Sri Lanka can also enhance its environmental and social benefits from low-carbon development. For instance, by expanding its renewable energy capacity, Sri Lanka can reduce its dependence on imported fossil fuels and improve its energy security. By improving its waste management practices, Sri Lanka can reduce its pollution levels and improve its public health outcomes.

However, more research and experimentation are needed to assess carbon credits potential impacts and scalability, as well as to address its challenges and risks. There is a need for more research and analysis on the feasibility, viability and sustainability of carbon credits, as well as for more stakeholder engagement and participation in the design and implementation of carbon credit projects. If done properly, using carbon credits could be a game-changer for climate finance and a catalyst for a green recovery from the crisis.

Blended financing

This is a financing mode that combines concessional public finance with non-concessional private finance and expertise from both public and private sector is gathered for this process. For example, Sri Lanka could partner with multilateral development banks, bilateral donors or foundations to co-finance projects that have high development impact but low commercial viability or high risks. The concessional funds could be used to provide guarantees, subsidies, grants or technical assistance to reduce the risks or costs for the private investors. This would mobilize more resources for Sri Lanka's development and catalyze private sector participation and innovation. The recently launched UNDP SDG investor Map is step in this regard that highlighted investment potential for blended financing for projects in certain sectors of Sri Lanka.

The renewable energy resource potential in Sri Lanka is substantial and estimated at 133 GW[8]. This potential too can be supported by blended financing mechanisms, which can help diversify the electricity generation mix in Sri Lanka by adding more renewables such as solar and wind to the national grid. Thereby, minimising the vulnerability to vagaries in rainfall to provide electricity, the continuous strain on the import bill and global oil prices.

Thematic Bonds

Thematic bonds are debt instruments that are issued by a borrower (usually a government or a corporation) to raise funds for specific projects or activities that have a positive environmental or social impact. For example, Sri Lanka could issue green bonds to finance projects that support renewable energy, energy efficiency, green transport, waste management or climate adaptation. Alternatively, it could issue social bonds to finance projects that support health care, education, social housing or gender equality. These bonds could attract investors who are looking for both financial returns and social or environmental benefits, such as impact investors, ethical funds or socially responsible individuals. This would diversify Sri Lanka's investor base and lower its borrowing costs.

Other Country Experience

In 2017, Seychelles issued the world's first blue bond, which raised USD 15 million to support marine conservation and sustainable fisheries in the island nation. The blue bond was partially guaranteed by the World Bank and the Global Environment Facility, and offered a lower interest rate than conventional bonds. The proceeds of the bond were used to repay part of Seychelles' debt to its Paris Club creditors, who agreed to cancel 20% of the debt in exchange for the country's commitment to protect 30% of its marine areas.

Another example is Nigeria, which issued Africa's first sovereign green bond in 2017, raising USD 26 million to fund renewable energy and afforestation projects. The green bond was certified by Climate Bonds Initiative, an international organization that sets standards for green bonds, and was oversubscribed by local investors. The proceeds of the bond were used to finance part of Nigeria's

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[8] https://www.energy.gov.lk/images/renewable-energy/renewable-energy-resource-development-plan-en.pdf

Economic Recovery and Growth Plan, which aims to diversify the economy and reduce greenhouse gas emissions.

These examples show how thematic bonds can be a useful tool for countries to address their debt overhang while also pursuing their environmental or social goals. However, issuing thematic bonds also requires a high level of transparency and accountability from the issuers, as they need to demonstrate that the funds are used for the intended purposes and that they generate measurable impacts. To ensure this, issuers should follow internationally recognized frameworks and principles for thematic bonds, such as the green bond principles, the social bond principles, or the SDG bond guidelines. They should also engage independent external reviewers to verify their compliance with these standards and report regularly on their use of proceeds and impact indicators.

Conclusion

By adopting these alternative financing mechanisms, Sri Lanka can not only address the debt overhang but also achieve its economic development goals while also building resilience to avert any future crises. However, while adopting alternative financing mechanisms have risen in popularity amidst negotiations, they come with some limitations and challenges that need to be carefully considered and managed. The implementation of these mechanisms requires strong institutional frameworks, governance systems, monitoring and evaluation mechanisms and technical expertise to ensure transparency, accountability, effectiveness and efficiency. In Sri Lanka, some of these have already begun and are ongoing by the government. It should also be noted that these instruments should not create new forms of debt dependency or conditionality that could undermine its fiscal sustainability or development autonomy for Sri Lanka.

In conclusion, alternative financing mechanisms can offer tremendous opportunities for Sri Lanka to overcome its economic crisis and debt crisis while also pursuing its environmental and social objectives. However, these mechanisms are not silver bullets that can solve all of Sri Lanka's problems. They need to be carefully designed, implemented and monitored to ensure that they deliver the intended benefits.