

Balancing concessional finance and debt distress in African middle-income countries while addressing climate action

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List of Acronyms

AFD	Agence française de développement
CBDR-RC	Common but differentiated responsibility and respective capacities
DSSI	Debt Service Suspension Initiative
EBRD	European Bank for Reconstruction and Development
G20	Group of Twenty
GDP	Gross domestic product
GHG	Greenhouse gas
GNI	Gross national income
IBRD	International Bank for Reconstruction and Development
IMF	International Monetary Fund
JET-P	Just Energy Transition Partnership
KPI	Key performance indicator
LDC	Less developed country
LIC	Low-income country
LMIC	Lower-middle-income country
MDB	Multilateral development bank
MIC	Middle-income country
ND-GAIN	University of Notre Dame Global Adaptation Initiative
NDC	Nationally determined contribution
ODA	Official development assistance
PEFA	Public Expenditure and Financial Accountability
PFM	Public financial management
RST	Resilience and Sustainability Facility (IMF)
SDG	Sustainable development goal
SIS	Small island states
SRDSF	Sovereign Risk and Debt Sustainability Framework
UMIC	Upper-middle-income country
UNFCCC	United Nations Framework Convention on Climate Change
V20	The Vulnerable Twenty Group of Ministers of Finance of the Climate Vulnerable Forum

Summary

Like other developing countries across the globe, many African countries are facing the unprecedented, dual and interconnected crises of high sovereign debt and climate vulnerability that negatively affect their development. Dealing with climate change in any tangible way requires substantial mobilisation of capital. It is estimated that emerging markets and developing economies (excluding China) would need to invest an incremental \$1.3-trillion by 2025 and \$3.5-trillion by 2030 in four areas that are crucial to achieving sustainable development and climate goals, i.e., health and education, sustainable infrastructure and energy transition, adaptation and resilience, and sustainable agriculture and biodiversity.¹

Although least developed countries (LDCs), small island states (SIS) and low-income countries (LICs) are the most in need, lower-middle-income countries (LMICs) also require assistance to access the quantum of grant and concessional finance needed to create the fiscal space and enabling environment for private financing to address pressing development priorities and to respond to crises. Importantly, African governments cannot address the climate crisis and avoid high carbon investments unless African MICs reduce their debt levels and increase the financing of initiatives that promote climate adaptation and mitigation and a just transition to a low-carbon economy.

In light of the above, this policy paper makes the following recommendations:

For bilateral and multilateral lenders providing finance to African MICs:

1. **Increase concessional finance to MICs** by making good on their commitments under the Paris Agreement, on the UN recommendation that developed countries commit to allocating 0.7% of their gross national income (GNI) on official development assistance (ODA) and sourcing finance through proposals, such as reallocating special drawing rights, reducing fossil fuel subsidies, and levying taxes on aviation, shipping, financial transactions and the recent windfall profits of fossil fuel companies.²
2. **Promote transformative investment**, which is needed to deliver the transformation of economies and societies in the context of the current global debt architecture, development needs and multiple crises.
3. **Develop metrics to assess the impact of a country's planned adaptation investments and factor them into financing costs**, to promote much-needed adaptation investments that also decrease sovereign risks and reduce borrowing rates.
4. **Develop standardised and comparable operational efficiency ratios across multilateral development banks (MDBs)** to promote transparency and accountability, and to identify areas where cost savings can be passed onto borrowers.

For African MICs:

1. **Enhance the absorptive capacity of concessional finance** through good governance, financial management and fit-for-purpose financing, to maximise the impacts of financing while remaining accountable to citizens.
2. **Increase the use of results-based financing mechanisms**, in particular to address adaptation needs.
3. **Strengthen project selection and preparation**, to help achieve the scale and scope of investment needed to address development and climate action.
4. **Identify and address human and technical capacity constraints** in the domestic climate finance ecosystem, to ensure country ownership of programmes and domestic alignment.

1 Introduction

In recent years, the global economy has been hit by a slew of shocks, including the COVID-19 pandemic, persistent geopolitical tensions and the effects of the climate crisis. Countries in the developed world, in particular Africa, are the least responsible for climate change and yet are most vulnerable to its impacts, and have a weaker capacity to withstand these shocks. For instance, Africa accounts for 3% of global cumulative carbon dioxide emissions to 2017 on a production basis, compared to Europe's 33%, the USA's 25% and China's 12.7%.³ This picture changes when emissions are considered on a per capita basis: in 2017, the US had the highest emissions at 17.62t CO₂e per person, followed by Russia at 12.88 and South Korea at 12.11. China's emissions per person were 8.14 and Europe's 7.77.⁴

Climate justice recognises that climate change disproportionately affects those least responsible that are at distinct levels of development. Therefore, dealing with climate change in any tangible way requires the substantial mobilisation of resources, including development finance. It is estimated that emerging markets and developing economies (excluding China) would need to invest "an incremental \$1.3-trillion by 2025 and \$3.5-trillion by 2030" in four areas that are crucial to achieving sustainable development and climate goals, i.e., health and education, sustainable infrastructure and energy transition, adaptation and resilience, and sustainable agriculture and biodiversity.⁵

To achieve the sustainable development goals (SDGs), low-income countries (LICs) would need to spend 45–59% of their gross domestic product (GDP).⁶ LICs include least developed countries (LDCs), which are characterised by their comparatively low income levels, limited human resources, and elevated degrees of economic vulnerability. Nevertheless, while LDCs and LICs are the most in need of development finance, lower-middle-income countries (LMICs) also require assistance. This is because although LMICs have achieved notable advancements in economic development and income levels, they would still need to spend over 27–37% of their GDP to achieve the SDGs.⁷

Of the 54 African countries, 28 are classified as middle-income countries (MICs), split between LMICs and upper-middle-income countries (UMICs).⁸ They are facing the dual and interconnected crises of high sovereign debt and climate-change impacts, and already spend between 2% and 9% of their GDP on adaptation, an amount that is "significantly higher than the adaptation resource flow from international sources".⁹ Africa cannot address the climate crisis and avoid high carbon investments unless African LMICs are able to reduce their debt levels and increase the financing of initiatives that address climate resilience and a just energy transition.

1.1 Concessional finance

Development finance institutions and partners provide concessional finance, which “is below market rate finance” that “targets high-impact projects responding to globally significant development challenges”, such as climate-change mitigation and resilience, that “could not go ahead without specialised financial support.”¹⁰ Concessional finance is offered on terms that are not available in the market, with features that include longer borrowing periods of up to 30 years, grace periods, zero-interest loans (equivalent to repayable grants) and lower fees. Types of concessional financial instruments for climate and disaster risk finance and insurance include the following:¹¹

- **Premium financing:** direct grants or concessional loans to countries for a portion of insurance premiums.
- **Capitalisation:** equity or debt with reduced or no interest to improve insurance solvency.
- **Payment of reinsurance premiums:** coupon payments for catastrophe bonds to provide reinsurance coverage of a risk pool.
- **Subsidising operational costs:** administrative, transaction and start-up costs.
- **Technical support and capacity building:** modelling, product structuring, risk know-how and market development.
- **Financing risk reduction:** measures that lead to foreseeable reductions in annual average losses and therefore savings in premiums.
- **Concessional credit:** reduced interests for contingent credit instruments.

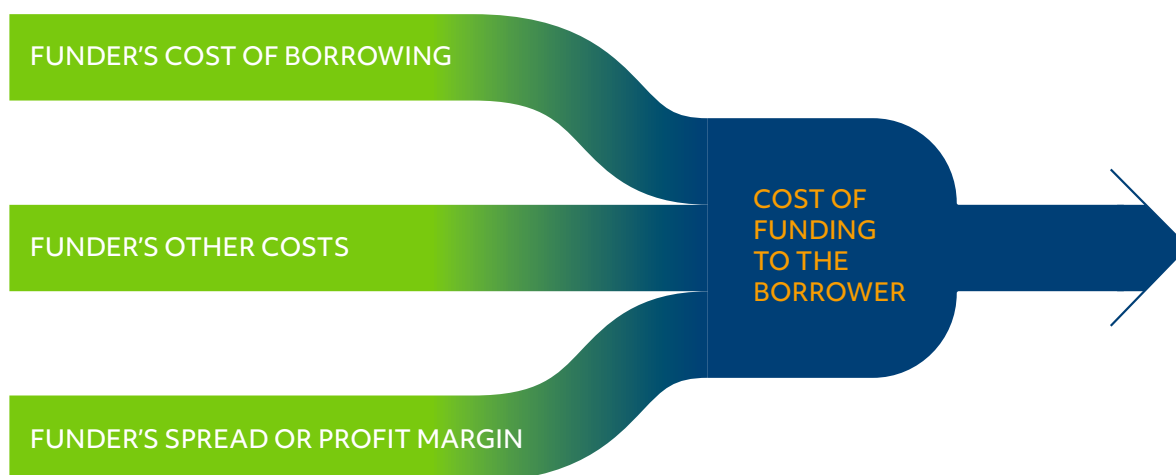
1.2 The benefits of concessional finance

The impact of concessional finance can be significant. For example, in 2022, South Africa, which is an UMIC, borrowed €300-million from the Agence française de développement (AFD) at an interest rate of 3.6% per year. To borrow that amount on similar terms in the market would have cost the South African government 8.9%, or 5.3% more per year. This interest differential will result in significant cost savings over the 20-year loan period, which also has a five-year grace period, meaning that repayments only begin after five years. For South Africa, “replacing market lending with much cheaper concessional loans” reduces “its cost of funding and overall debt burden”.¹²

There are also benefits for the lender. For example, the AFD was still able to make a spread – or profit margin – on its loan to South Africa because France’s 20-year cost of funding at the time of the loan was approximately 3% per year,¹³ meaning that the AFD would earn up to 3.6% more income, depending on the other costs related to the loan. Multilateral development banks (MDBs), such as the World Bank, the Asia Infrastructure Bank and the African Development Bank, that offer concessional finance to sovereign borrowers can also make a spread – or profit – from their loans. This profit margin is influenced by operational costs, which reflect operational efficiency. By improving their operational efficiency, MDBs would lower their cost of funding and allow for a lower lending spread and, therefore, a lower overall cost of funding to borrowers, as reflected in **Figure 1**.

Figure 1

Costs of funding to a borrower



Source: Authors' analysis

1.3 About the paper

This paper argues that Africa's LMICs need access to greater levels of concessional financing, to promote the just transition and climate-change adaptation and mitigation. These countries are facing a dual crisis of debt and climate change, and are unable to finance the required climate-related actions. After exploring the gap in concessional finance for MICs, through examining the global financial architecture and the challenges faced by these countries, the paper provides an overview of Africa's debt landscape and the nexus between debt and climate-change. It then presents three case studies (of Ghana, Kenya and Senegal), to illustrate the current climate change and debt challenges facing African countries. The paper proposes recommendations for addressing the financing gaps and achieving the desired climate outcomes for MICs. These recommendations are intended to guide policy-makers, international organisations and stakeholders in designing and implementing effective financing strategies that align with the specific needs and circumstances of MICs in Africa, with the aim of contributing to the overall objective of enhancing climate resilience and sustainability in these countries.

2 Closing the Concessional Finance Gap

African countries are facing dual and interconnected crises – a debt crisis and climate vulnerabilities – and have limited funding for climate-related initiatives. Given the magnitude of climate-change impacts on the continent – and because addressing climate change is a global public good – the discussion on concessional finance for African LMICs is necessary.

2.1 Build a more equitable global financial architecture

There is a growing acceptance that the existing global economic and financial architecture cannot successfully address global issues, such as climate change, loss of biodiversity, pandemics (e.g., COVID-19) and unsustainable sovereign debt. The architecture does not align with global economic and geopolitical realities, especially the rules, voting structures and decision-making processes that govern international financial institutions, such as the International Monetary Fund (IMF) and the World Bank Group. This makes the architecture not fit for purpose and has resulted in a growing consensus for reforms in many countries, in particular:

- The Vulnerable Twenty (V20) Group of Ministers of Finance of the Climate Vulnerable Forum, which represent countries that face mounting economic threats from climate disasters and debt,¹⁴ is demanding reforms, as encapsulated in the Accra-Marrakech Agenda that was adopted on 16 April 2023.¹⁵
- The Bridgetown Initiative for the Reform of the Global Financial Architecture, which was initiated by Barbados and developed in collaboration with the United Nations, that proposes reforms to global financial institutions and rules.

Version 1 of the Bridgetown Initiative, which was launched in 2022, calls for multilateral financial institutions to first provide emergency liquidity for countries in debt crises through debt repayment standstills, and then to expand their [concessional] lending by US\$1-trillion.¹⁶ This additional concessional lending should be targeted at achieving the sustainable development goals (SDGs) and building climate resilience in vulnerable countries. Following consultations with and feedback from a variety of stakeholders, in 2023 the Bridgetown Initiative was updated and comprises six action points:¹⁷

1. Provide immediate liquidity support, including re-channelling at least US\$100-billion of unused special drawing rights¹⁸ through the IMF and MDBs.
2. Restore debt sustainability, today and in the long term, and support countries to restructure their debt with long-term low interest rates.
3. Dramatically increase official sector development lending to reach US\$500-billion annual stimulus for investment in the SDGs (SDG Stimulus).
4. Mobilise more than US\$1.5-trillion per year of private sector investment in the green transformation.
5. Transform the governance of international financial institutions to make them more representative, equitable and inclusive.
6. Create an international trade system that supports global green and just transformations.

Within the broader architecture, international financial institutions are facing calls to implement new rules and institutional frameworks to make them more fit for purpose and more representative. In this regard, the World Bank Group's Evolution Roadmap seeks to reform the bank's vision, mission, operational model, financial structure and model,¹⁹ while World Bank member countries have called for "a strengthened value proposition for MICs" and "ways to effectively mobilize and allocate concessional resources."²⁰

Such reforms are needed because there is no comprehensive approach to dealing with debt restructuring that both provides an adequate incentive for participating in the restructuring process and results in the equal treatment of creditors and fair outcomes for populations of the debtor country. This gap is a major concern for African countries, and African Ministers of Finance, Planning and Economic Development have reiterated the need for decisive action on sovereign debt through developing an effective, time-bound and transparent debt-restructuring framework that includes private sector creditors, among other things.²¹

2.2 Adhere to principles of equity and common but differentiated responsibilities and respective capabilities

The principles of equity and common but differentiated responsibilities and respective capabilities (CBDR-RC) are recognised in Article 3 of the UN Framework Convention on Climate Change (UNFCCC) and Article 2.2. of the Paris Agreement.²² Broadly speaking, these principles mean that, from a mitigation perspective, parties to the UNFCCC acknowledge that every country has a responsibility to act to address the climate crisis, but some countries produce or cause the production of much larger GHG emissions than others, and countries differ in their ability to undertake mitigation actions. From an adaptation perspective, the principles recognise that countries have different vulnerabilities to climate change and different abilities to increase their resilience to climate impacts. Therefore, countries can be split into several categories, such as developed and developing countries, where developed countries are generally more industrialised and so have contributed more to causing climate change. These countries are also typically richer and so are able to contribute more financially towards addressing climate change. The Paris Agreement also recognises that LDCs and small island states (SIS) are particularly vulnerable to climate change.²³

Nevertheless, a country's capability is not static. Countries that become wealthier typically become better able to respond to climate change, while countries that experience exogenous shocks from climate-change impacts, which negatively affect their economic wealth, are less able to address climate change and other development challenges. Therefore, it is not surprisingly that upper-income countries (with the exception of Tuvalu, an UMIC) have a higher score for readiness to respond to climate impact, irrespective of vulnerability, on the University of Notre Dame Global Adaptation Initiative's (ND-GAIN) Index, i.e., their readiness score is above 0.6 on a scale of 0 to 1, where 1 represents the highest degree of readiness.²⁴

Although countries are at liberty to provide concessional finance to whom they please, this is not the case for MDBs, such as the World Bank. Constraints for MBDs include:

- **Their country lending rules.** For example, the International Bank for Reconstruction and Development (IBRD) bases its loan pricing largely on income classification, with exceptions for small states and countries in fragile and conflict-affected situations.²⁵
- **Their funding envelope,** which is affected by their capital adequacy²⁶ that depends on the official development assistance (ODA) allocations from funders.

These constraints contribute to the development finance gap. In the context of climate change, basing access to concessional finance on per-capita income levels neither honours the concept of CBDR-RC nor helps attain the goal of keeping average global temperature increases to 1.5°C above pre-industrial levels.

2.3 Enhance absorptive capacity

MICs also need access to concessional finance to address distinct economic and climate challenges but have limited absorptive capacity. In this context, absorptive capacity “relates to technical capacity, waste and leakage of resources in the investment process – all of which affect project selection, management, and implementation constraints.”²⁷ MICs often have limited institutional capacity to undertake the coordinated policy approaches across government, economic sectors and stakeholders²⁸ that are required for a just transition to a low-carbon and resilient economy. The result may be resistance at the political level to just transition policies and ineffective implementation. MICs are also characterised by informal labour markets and often dependent on a single commodity, both of which magnify the economic ripple effect of changes in commodity markets. South Africa’s coal sector exemplifies this dependency, as its energy transition away from coal will have significant impacts across large sectors of its economy. Poverty remains another growing challenge, especially since the COVID-19 pandemic. It is estimated that 82% of the newly extreme poor (those living on below US\$1.90/day) will be in MICs.²⁹

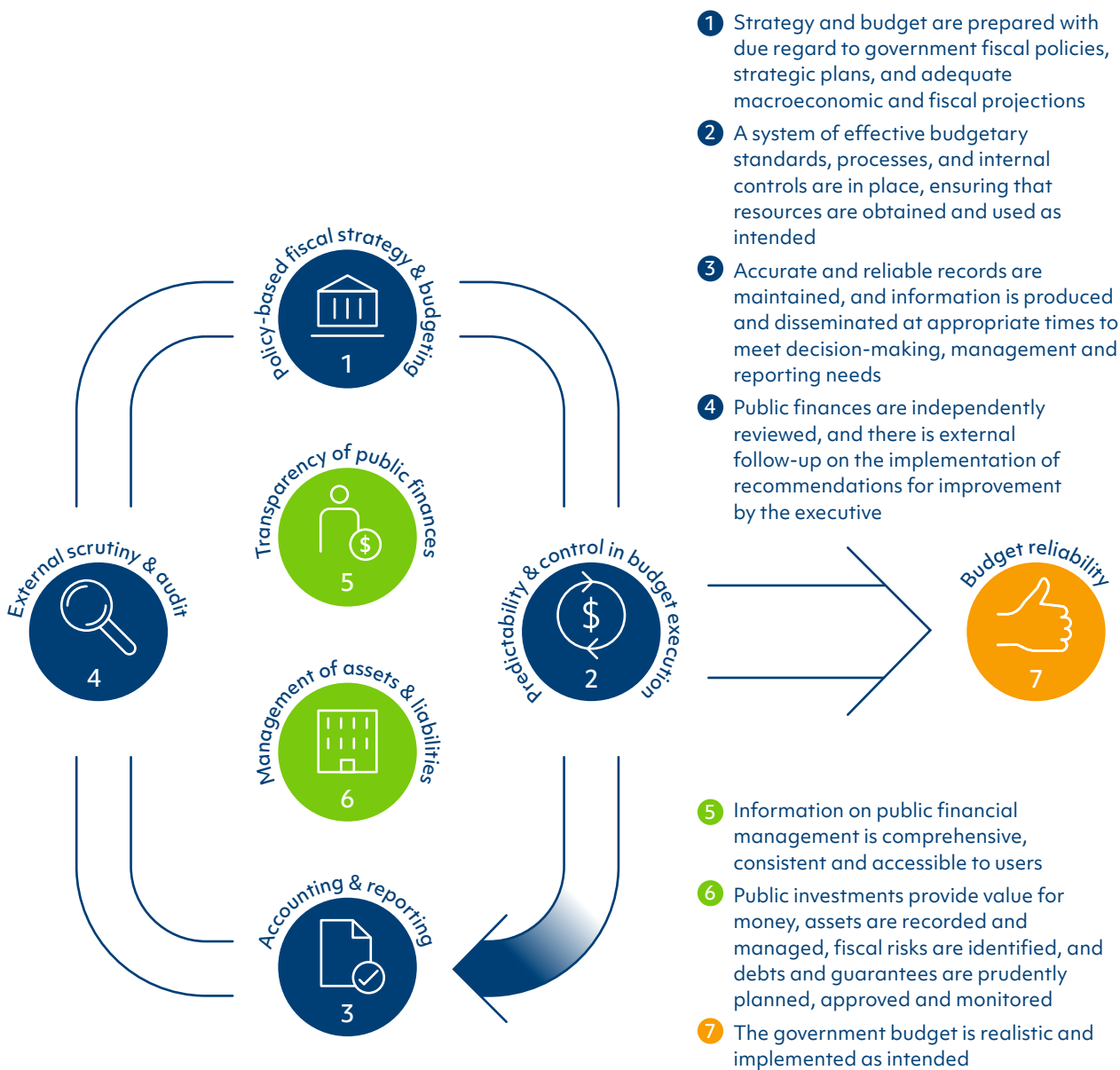
Beyond the climate-change financing gap, African MICs may encounter absorptive capacity challenges that impede the effectiveness of concessional finance (or indeed any external finance). These challenges arise from “economic, policy, and institutional constraints that result in a declining rate of return as the pace of investment rises”.³⁰ Examples include:

- Weak institutional capacity, including the public sector’s governance and bureaucratic structures.
- Human resource constraints, including the lack of skilled personnel, particularly in specialised sectors.
- Project management and planning challenges, such as inadequate project identification and selection, feasibility studies, procurement processes, and monitoring and evaluation during implementation.
- Weak policy and regulatory environment.
- Effects of inflation and foreign exchange rates.
- Inadequate financial management.

Therefore, in addressing the shortfall in concessional financing, the absorptive capacities of African countries must also be prioritised. This is because projects experience longer delays with commensurate inefficiencies in countries that have weak institutions during periods of scaling up public investment.³¹ This indicates that countries need to improve their capacity to employ proficiently and effectively concessional finance for its intended purpose.

A tool that can provide valuable insights into a country’s absorptive capacity is the public expenditure and financial accountability (PEFA) framework, which was developed by the EU, the IMF, the World Bank and several European countries.³² The framework assesses the effectiveness of a country’s public financial management (PFM) systems and evaluates its capacity to effectively utilise and oversee financial resources, such as aid or concessional financing, in order to achieve development goals. It assesses seven pillars of financial management systems (**Figure 2**). Using the PEFA framework to assess a country’s absorptive capacity enables policy-makers to identify areas requiring improvement and to implement appropriate measures to enhance financial management systems.

Figure 2
World Bank 2016 Public Expenditure and Financial
Accountability (PEFA) Framework pillars



Source: Adapted from <https://www.pefa.org/global-report-2022/en/report/what-is-pefa/>

Table 1 shows the seven PEFA framework pillars and 31 indicators. Countries or regions within a country are assessed against the indicators for each sub-category. Performance against each sub-category is based on an alphabetical score, with A being the highest score and D the lowest score, indicating performance that falls below the basic level. D scores may occur when insufficient information is available, and such cases are identified by an asterisk.³³ In the context of absorptive capacity, PEFA scores are not an end in themselves but can be used by policy-makers to prioritise reforms based on development priorities and taking the institutional and political context into account.

PEFA has also developed and is testing the PEFA Climate Framework for assessing climate-responsive PFM. This framework includes additional indicators to assess the extent to which a country’s PFM system is ready to support and foster the implementation of government climate-change policies.³⁴

Table 1
PEFA pillars and sub-categories

Pillar	Indicators
I. Budget reliability	<ol style="list-style-type: none"> 1. Aggregate expenditure outturn 2. Expenditure composition outturn 3. Revenue outturn
II. Transparency of public finances	<ol style="list-style-type: none"> 4. Budget classification 5. Budget documentation 6. Central government operations outside financial reports 7. Transfers to subnational governments 8. Performance information for service delivery 9. Public access to fiscal information
III. Management of assets and liabilities	<ol style="list-style-type: none"> 10. Fiscal risk reporting 11. Public investment management 12. Public asset management 13. Debt management
IV. Policy-based fiscal strategy and budgeting	<ol style="list-style-type: none"> 14. Macroeconomic and fiscal forecasting 15. Fiscal strategy 16. Medium-term perspective in expenditure budgeting 17. Budget preparation process 18. Legislative scrutiny of budgets
V. Predictability and control in budget execution	<ol style="list-style-type: none"> 19. Revenue administration 20. Accounting for revenue 21. Predictability of in-year resource allocation 22. Expenditure arrears 23. Payroll controls 24. Procurement 25. Internal controls on non-salary expenditure 26. Internal audit
VI. Accounting and reporting	<ol style="list-style-type: none"> 27. Financial data integrity 28. In-year budget reports 29. Annual financial reports
VII. External scrutiny and audit	<ol style="list-style-type: none"> 30. External audit 31. Legislative scrutiny of audit reports

Source: Adapted from <https://www.pefa.org/global-report-2022/en/report/what-is-pefa/>

2.4 Prioritise the financing of a resilient and low-carbon transition for African MICs

The development financing gap of MICs is growing, and Africa's MICs need to strategise how to access concessional finance and grants to meet their nationally determined contribution (NDC) commitments under the Paris Agreement, ensure a just transition and develop their renewable energy sectors. To implement Africa's NDC commitments between 2020 and 2030 will cost an estimated US\$2.8-trillion (based on data from 51 of the 53 African countries that submitted NDCs).³⁵ In addition, African MICs hold significant fossil fuel reserves (13% of the world's natural gas reserves and 7% of the oil resources) that cannot be exploited under a scenario of 1.5°C warming.³⁶ They are also home to a significant share of the minerals essential for the production of low-carbon technologies and solutions, with Morocco, South Africa, Gabon, Ghana, Cote d'Ivoire and Zambia all important players.³⁷ Concessional financing can play a significant role in enabling Africa to meet its NDCs commitments, keep these fossil fuels in the ground and create a circular economy centred on renewable natural resources to meet the world's low-carbon energy needs. Most importantly, it would spur economic growth from "a return on large-scale investments in exploration, transportation, geological knowledge and the technologies of mineral extraction".³⁸

3 Africa's Sovereign Debt Landscape and the Climate Nexus

African countries, faced with ever-increasing foreign debt payments, have raised concerns about their debt challenges and climate-change vulnerabilities, and the need for redress. In June 2023, at the Summit on a New Global Financing Pact convened by France, the Presidents of Kenya and Senegal were among the signatories of a joint Heads of State letter that recognised the inextricable link between climate and development and stated, "No country should have to wait years for debt relief. We need greater and more timely cooperation on debt, for low- and middle-income countries".³⁹

3.1 Debt levels in Africa are unsustainable

The COVID-19 pandemic had a profoundly negative impact on Africa's sovereign debt landscape, and its economic and other impacts still linger. In the last decade, sub-Saharan Africa's debt has more than doubled. Between 2010 and 2021, overall foreign debt stock more than doubled, from US\$322-billion to US\$790-billion. This debt is held by official creditors (US\$254-billion, of which US\$150-billion from multilateral creditors and US\$104-billion from bilateral creditors) and private creditors (US\$216-billion, of which US\$145-billion from bond holders and US\$71-billion from commercial banks and other private creditors).⁴⁰ China is the continent's largest-single creditor. In 2020 (during the COVID-19 pandemic), Zambia became the first African country to default on its foreign debt of an estimated US\$17-billion.

Since the pandemic, the credit rating of several African countries has been downgraded, limiting their access to the capital markets. In 2020, Morocco and South Africa saw their credit rating downgraded to "junk" status,⁴¹ and in January 2023, Moody's downgraded Nigeria from Caa1 from B3.⁴² For developing countries, it generally takes an average of seven years to regain their previous ratings.⁴³ Exacerbating the financial burden of borrowing countries is that a significant number of their Eurobonds will mature in the upcoming years. Eurobonds are issued in foreign currency and so subject to exchange rate fluctuations. This risk puts pressure on the borrowing country's foreign currency reserves and capital account, as interest and principal payments are subject to changes in exchange rates.

Debt suspension and debt restructuring are among the economic and financial policy options for counteracting the negative consequences of the pandemic. The Group of Twenty's (G20) Debt Service Suspension Initiative (DSSI) provides temporary suspension of bilateral debt. Of the 73 LICs and MICs that qualified for temporary debt suspension under the DSSI, 48 participated, resulting in the temporary suspension of about US\$12.9-billion between May 2020 and December 2021, when the initiative ended. The DSSI focused on LICs, but the COVID-19 pandemic has also affected MICs, which are recording record levels of private and public debt, with devastating socioeconomic consequences. The World Bank predicted that in 2021, as a result of the pandemic, 88–115 million more people were living in extreme poverty, with the majority (82%) found in MICs.⁴⁴ Yet many MICs were ineligible for the DSSI,⁴⁵ "despite the aggregate higher scale of demand for financial support considering their larger economic size compared to LICs".⁴⁶

Following the DSSI, the G20 introduced the Common Framework for Debt Treatments beyond the DSSI (Common Framework), aimed at facilitating restructuring involving all creditors. Ghana recently joined Ethiopia, Chad and Zambia in requesting treatment under the Common Framework. However, despite promising to offer a comprehensive approach to debt restructuring, the Common Framework has not lived up to its expectations. It has been limited in its scope, slow to facilitate debt resolution and has failed to garner private creditor participation. To date, Zambia is the only country to benefit from the programme, with the restructuring of US\$6.3-billion of central government debt owed to external bilateral creditors.⁴⁷

Furthermore, these restructuring initiatives are G20 initiatives and do not address climate issues. The proposed Emergency Coalition for Debt Sustainability and Climate Prosperity (the Coalition) attempts to address this need, by bringing together stakeholders to develop innovative solutions that promote sustainable debt management while simultaneously advancing climate action and environmental sustainability. In October 2023, the V20 countries will formally launch the Coalition, which will be open to all developing countries.⁴⁸ This collaborative initiative introduces the much needed nexus between the dual challenges of debt sustainability and climate change.

Although Africa's challenges of unsustainable debt pre-date the pandemic, the pandemic has highlighted the need for debt relief and restructuring, as well as the need for concessional funding to support development.

3.2 Debt costs increase with vulnerability to climate change

In 2020, research by the IMF found that “countries that are more resilient to climate change have lower bond yields and spreads relative to countries with greater vulnerability to risks associated with climate change”. In other words, the climate crisis makes debt more expensive for developing countries, as they are less able to adapt and mitigate the consequences of climate change, even after controlling for conventional macroeconomic and institutional determinants of sovereign risk. The research concluded that the impact of climate change on public finances can be improved by “enhancing structural resilience through mitigation and adaptation, strengthening financial resilience through fiscal buffers and insurance schemes, and improving economic diversification and policy management”.⁴⁹

These interventions will require concessional and grant financing, especially as African countries are at high risk from climate change, despite being among the lowest contributors to GHG emissions. The Intergovernmental Panel on Climate Change states with high confidence that global warming of between 1.5°C and 2°C will have widespread and severe negative impacts on Africa, with “reduced food production, reduced economic growth, increased inequality and poverty, biodiversity loss, increased human morbidity and mortality”.⁵⁰

3.3 Risks are amplified through the sovereign–bank nexus

Banks play an important role in any economy, both in terms of the services they provide and their role in macroeconomic policy. However, since the 2008 financial crisis, the interconnectedness between banks and sovereign risk has increased. This interconnectedness is known as the sovereign–bank nexus, where governments issue bonds and other securities to fund their deficits, while banks choose to hold those securities as assets because of the quality of their credit rating relative to other local non-government

debts. In countries where the nexus is significant, the impacts of negative changes in a government's creditworthiness are amplified through the banking sector – a decrease in the value of government securities held by banks reduces the ability of banks to lend to companies and households. This may put a further strain on macroeconomic conditions, creating a negative feedback loop that could end in a government defaulting on its debt. In emerging markets, such as Egypt and South Africa (both MICs), the sovereign–bank risks have increased because of higher government borrowing and debt burdens due to the COVID-19 pandemic and other exogenous shocks.⁵¹

Given the potential negative impacts of climate change on governments and government borrowing, and the existence of the sovereign–bank nexus, economic conditions in developing countries will worsen. Therefore, concessionary financing must be provided to developing countries – including MICs – to allow them to address climate change and other development needs without worsening their debt sustainability.

4 Country Assessments of Three of Africa's Middle-Income Countries

An assessment of the debt and climate vulnerabilities of three African LMICs – Ghana, Kenya and Senegal – provides empirical evidence of the interlinked challenges mentioned in Section 3. The assessment looks at five areas:

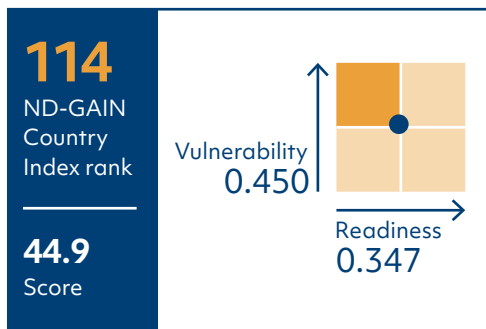
1. **Climate-change vulnerability and readiness**, based on the University of Notre-Dame's Global Adaptation Initiative (ND-GAIN). The ND-GAIN Index consists of two primary dimensions that assess a country's adaptation capabilities: vulnerability and readiness.⁵² Vulnerability is evaluated by examining six crucial sectors that support human life: food, water, health, ecosystem services, human habitat and infrastructure. This assessment takes into account exposure to climate change, sensitivity to climate-change hazards, and adaptive capacity. Readiness is measured by considering three components: economic readiness, governance readiness and social readiness. Together, these dimensions provide a comprehensive evaluation of a country's ability to adapt to climate change.
2. **NDC financing requirements**, including whether the related commitments are conditional or not.
3. **Debt profile and sustainability** using statistics from the IMF and the World Bank.⁵³ However, it should be noted that the IMF and the World Bank only began integrating climate considerations into debt sustainability analyses in 2022, with the development of the Sovereign Risk and Debt Sustainability Framework (SRDSF),⁵⁴ replacing the debt sustainability framework for market access countries, which include Ghana, Kenya and Senegal. At the time of writing, only Kenya and Senegal had undergone an SRDSF analysis.
4. **The sovereign-bank nexus**, to understand the feedback loop from sovereign debt pressures.
5. **Absorptive capacity**, as demonstrated by the country's PEFA scores – the highest score (A) is shown in dark blue and the lowest score (D) in light blue. The purpose of highlighting these scores is not to assess the capacity across all the 31 indicators under the seven categories that make up the scores, but rather to understand if a country's public and expenditure framework has shortcomings that could negatively affect the ability to plan, manage and account for concessional finance.

4.1 Ghana

Climate vulnerability and readiness and the NDC financing requirements

Ghana is highly climate vulnerable and has low levels of climate readiness, scoring 0.471 for vulnerability and 0.351 for readiness on the ND-GAIN Index. The country has made a declaration/pledge to achieve net-zero by 2070.⁵⁵

Figure 3
ND-GAIN index for Ghana



Source: <https://gain.nd.edu/our-work/country-index/rankings/>

In terms of additional finance, Ghana requires between US\$9.3-billion and US\$15.5-billion to finance its updated NDCs for 2021–2030.⁵⁶ To meet its conditional programmes of action, Ghana requires US\$5.4-billion from public, international and private sources, and carbon markets. In addition, it needs US\$3-billion biennially for capacity building and US\$3.9-billion for its unconditional programmes of action⁵⁷.

Debt profile and sustainability

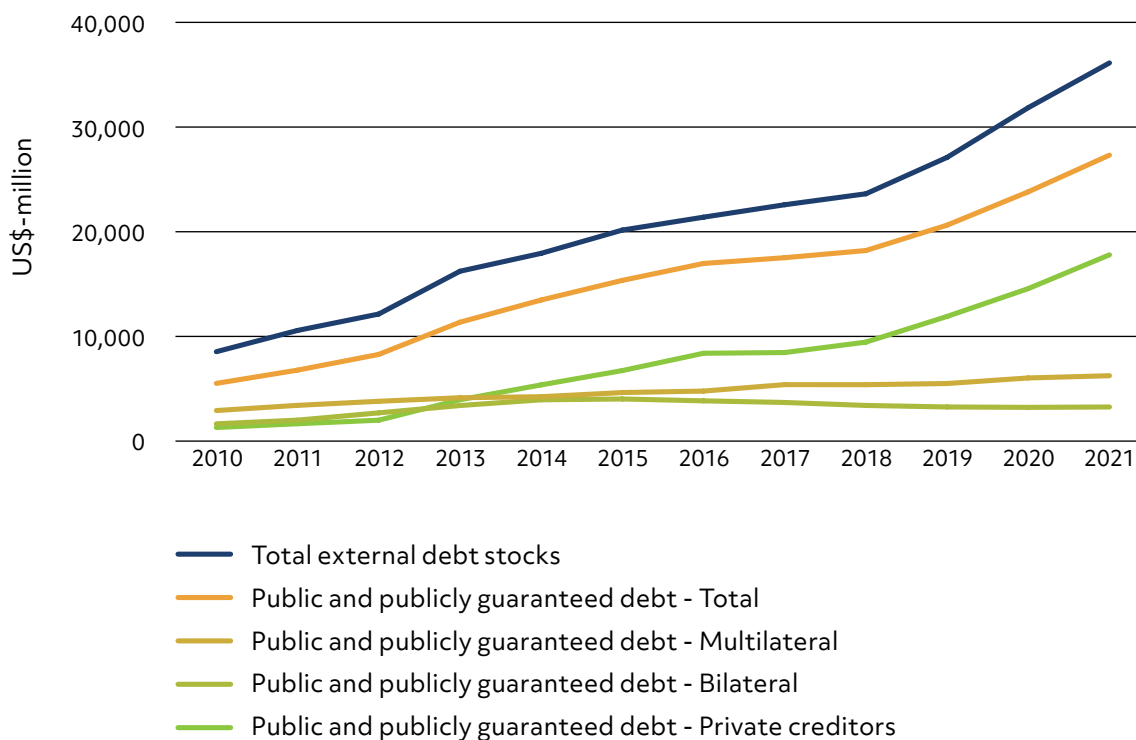
Ghana’s high debt levels limit the financial resources available for climate-change initiatives, as debt repayment absorbs a significant portion of the government’s budget.

The World Bank classifies Ghana as a LMIC that can borrow on blend credit terms.⁵⁸ In 2021, the World Bank–IMF Debt Sustainability Analysis found Ghana to be at high risk of external debt distress and of overall debt distress.⁵⁹ However, these conclusions do not take climate-change impacts into account, as Ghana has not yet undergone an SRDSF analysis.

Ghana is struggling with the worst economic crisis in a generation. In September 2021, Ghana had a debt-to-GDP ratio of 77.5%,⁶⁰ having accumulated massive debt since 2010 (Figure 4), with the energy sector being the biggest driver of national debt.⁶¹ The country has sought assistance from the IMF and has begun restructuring its debt by rolling out a plan to swap US\$10.5-billion in local bonds with new ones.⁶²

Figure 4

Ghana's external debt stock (public and publicly guaranteed debt) 2010–2021



Source: Adapted from World Bank International Debt Report 2022 (updated 12 June 2022)⁶³

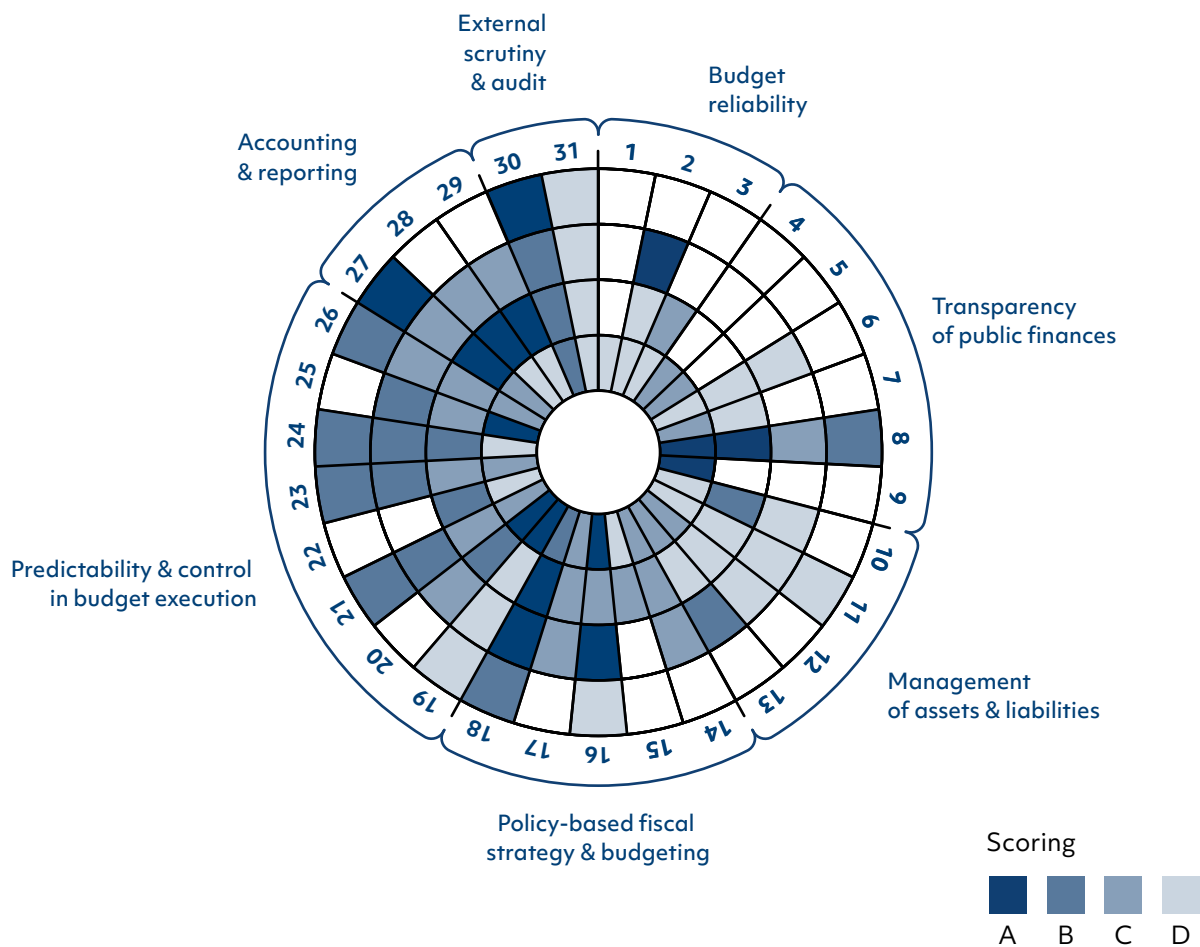
The sovereign–bank nexus in Ghana

In 2023, Ghana's debt swap resulted in two of the country's largest banks reporting a loss due to impairments of government bond holdings.⁶⁴ This demonstrates the importance of the sovereign–bank nexus in amplifying any negative impacts on the country's debt sustainability.

Ghana's absorptive capacity

The national PEFA analysis was carried out in 2018 (Figure 5). Ghana's PEFA assessment notes that "the main strength of Ghana's PFM system derives from its solid legal and institutional setting for PFM, accompanied by a skilled, dedicated, and well-led civil service". However, there is room for improvement, as aspects of Ghana's PFM "pose a degree of fiscal and fiduciary risk, with adverse implications for aggregate fiscal discipline, strategic allocation of resources and efficiency of service delivery".⁶⁵ Weaknesses highlighted included the financial situation of state-owned enterprises; revenue administration; expenditure commitment control; cash management; extra-budgetary operations (lack of transparency); budget preparation; public investment management; and payroll, procurement and payments systems.

Figure 5
PEFA assessment of Ghana



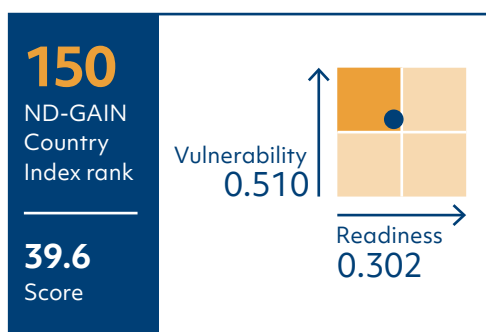
Source: <https://www.pefa.org/assessments/summary/351>

4.2 Kenya

Climate vulnerability and readiness and NDC financing requirements

Kenya is not only at high risk of debt distress but also highly climate vulnerable with low levels of climate readiness, scoring 0.525 for vulnerability and 0.299 for readiness on the ND-GAIN Index. The ongoing drought in the Horn of Africa, which is made “much stronger and more likely” by climate change, is an example of Kenya’s vulnerability.⁶⁶ Repeating patterns of climate-induced hazards, in particular floods and droughts, will likely cost the country 2–2.4% of its GDP per year.⁶⁷ Kenya does not have a national net-zero target.

Figure 6
ND-GAIN index for Kenya



Source: <https://gain.nd.edu/our-work/country-index/rankings/>

Kenya’s updated NDC estimates that over US\$62-billion will be needed across sectors up to 2030 to address climate actions, with 71% required for adaptation and 29% for mitigation.⁶⁸ Kenya requires 87% of this financing from international support and states that any climate finance provided as loans will be counted as part of the country’s domestic contribution to its NDCs. This points to an expectation of approximately US\$53-billion in international concessionary⁶⁹ and/or grant support to 2030.

Kenya’s debt profile and debt sustainability

The World Bank classifies Kenya as a LMIC that is eligible for borrowing from the IDA and also creditworthy for some borrowing from the IBRD on blend credit terms.

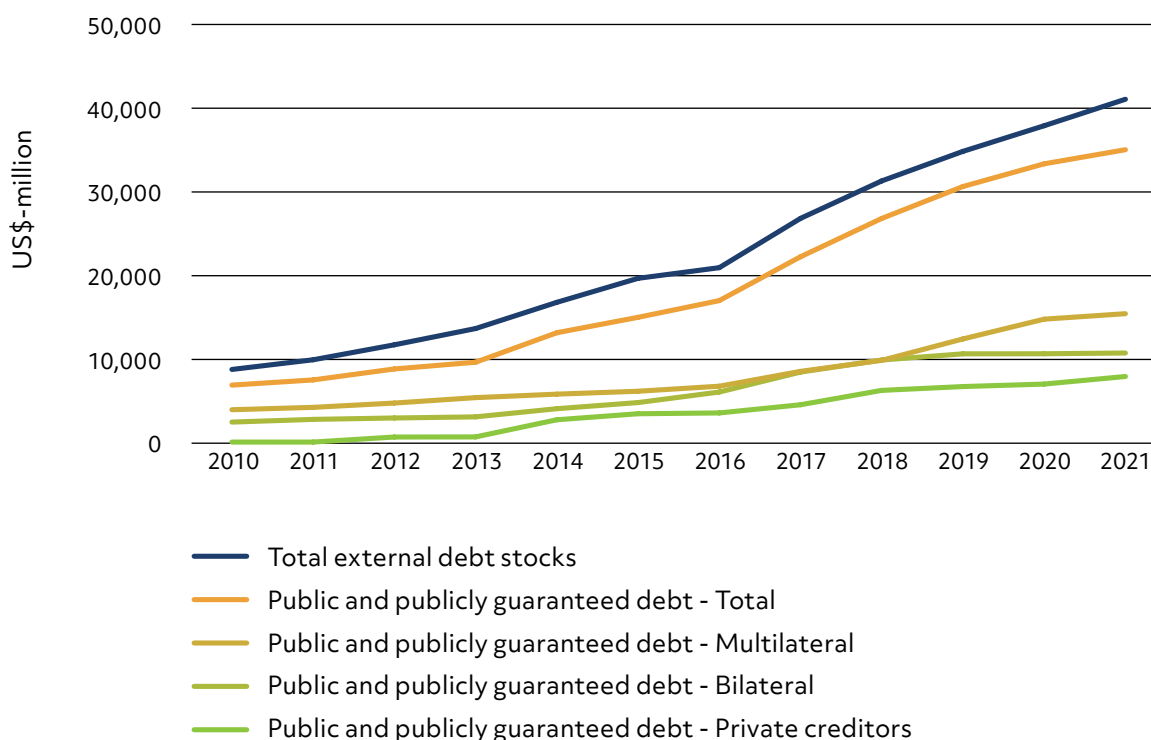
In 2022, the World Bank–IMF Debt Sustainability Analysis found Kenya to be at high risk of external debt distress and of overall debt distress.⁷⁰ The country has a June 2024 Eurobond rollover, and was granted a 20-month arrangement of about US\$551.4-million from the IMF’s Resilience and Sustainability Facility (RSF) to address climate resilience and attract climate financing from the private sector. Kenya also received an additional US\$110.3-million from the IMF’s Extended Fund Facility and Extended Credit Facility arrangements, to help the country reduce its debt vulnerabilities. Both programmes have been extended from 38 months to 48 months, through to 1 April 2025.⁷¹

Between 2015 and 2022, Kenya’s state debt rose substantially, from 48.6% to 63.1% of GDP, as a result of prior infrastructure spending and the COVID-19 pandemic in 2020. By the end of 2022, about half (50.4%)

of Kenya's public debt was owed to external creditors and denominated in foreign currency,⁷² making it at risk of foreign exchange rate volatility. Multilateral creditors accounted for roughly 15% and bilateral creditors for about 9% of foreign debt.⁷³ The majority of Kenya's foreign public debt is official debt provided on concessional terms.⁷⁴

Figure 7

Kenya's external debt stock (public and publicly guaranteed debt) 2010–2021



Source: Adapted from World Bank International Debt Report 2022 (updated 12 June 2022)⁷⁵

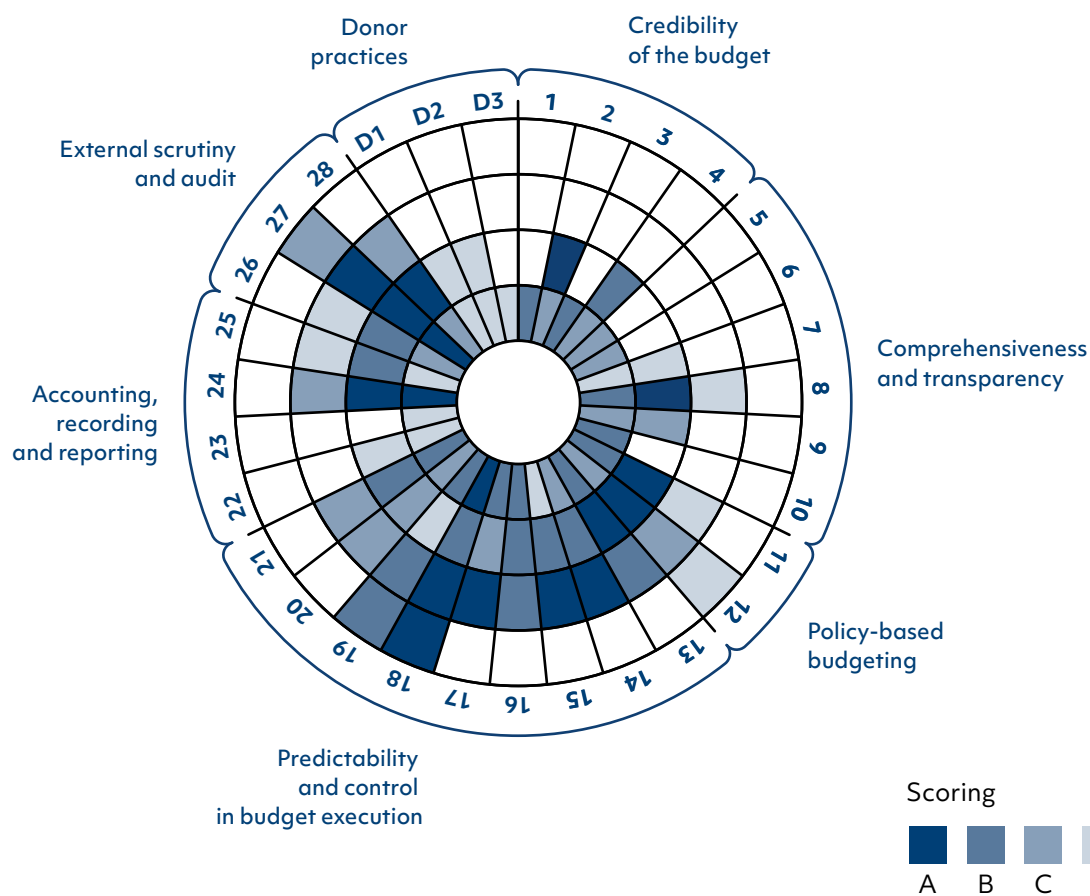
The sovereign–bank nexus in Kenya

Between 2019 and 2021, investment by banks in government securities, as a share of their total capital, rose from 148% to 204%, in line with a steady increase in outstanding government securities.⁷⁶ This demonstrates the importance of the sovereign–bank nexus in amplifying any negative impacts on the country's debt sustainability.

Kenya's absorptive capacity

The PEFA assessment for Kenya was conducted in 2012, so it is possible that there have been significant changes since then. The assessment identified several strengths, including the effective annual budget preparation process, improvements in revenue administration, and the presence of partially effective internal control systems.⁷⁷ However, it also highlighted areas of weakness, particularly in the strategic allocation of resources and efficient service delivery within the Kenyan PFM system.

Figure 8
Kenya PEFA assessment (1 August 2012)



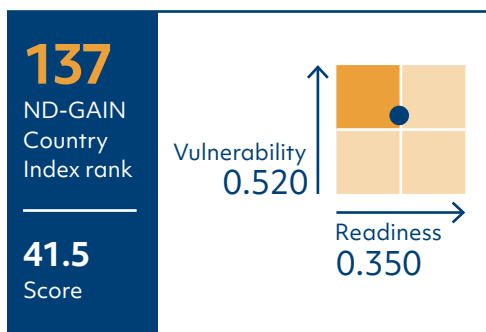
Source: <https://www.pefa.org/assessments/summary/1711>

4.3 Senegal

Climate vulnerability and readiness and NDC financing requirements

Senegal is vulnerable to climate change and has low levels of climate readiness, scoring 0.532 for vulnerability and 0.350 for readiness on the ND-GAIN Index. Senegal has a proposed net-zero by 2050 target that is under discussion.

Figure 9
ND-GAIN Index for Senegal



Source: <https://gain.nd.edu/our-work/country-index/rankings/>

The country’s NDC financing need is estimated at US\$13-billion, of which US\$8.7-billion is required for mitigation (US\$3.4-billion unconditional and US\$5.3-billion conditional) and US\$4.3-billion for adaptation (US\$1.4-billion unconditional and US\$2.9-billion conditional).⁷⁸ To cover its intended climate actions between 2023 and 2030, Senegal will require financing equivalent to about 7% of its GDP per year.⁷⁹

In June 2023, Senegal announced a Just Energy Transition Partnership (JET-P) with France, Germany, the EU, the UK and Canada, which aims to support the country’s just transition and universal access to energy. The detailed investment plan, which will allow the JET-P to be financed, will be an important test of the plan’s alignment to a just transition that is informed by science and the principles of equity and CBDR-RC.

Senegal’s debt profile and debt sustainability

Senegal is classified as a LMIC. The country’s risk of debt distress has increased due to major investments in infrastructure projects and the spillover effects of the war in Ukraine and trade sanctions against Mali, higher external financing costs, and potential delays to hydrocarbon projects.⁸⁰

In 2022, the World Bank–IMF Debt Sustainability Analysis found Senegal to be at a moderate risk of both external debt distress and overall debt distress, but with limited space to absorb shocks.⁸¹ In making this assessment, the IMF and World Bank pointed out that “[m]aintaining debt sustainability in this context requires a prudent borrowing strategy that prioritizes concessional external borrowing and domestic regional financing alongside continued efforts to strengthen debt management”.⁸²

In May 2023, Senegal received funding from the IMF, including US\$237.1-million from the IMF’s RSF to support climate-change mitigation and adaptation objectives, accelerate climate-change adaptation work and mainstream climate-change considerations into the budget process. The RST financing is concessional with up to 20-year loan maturities and a grace period of up to 10.5 years.⁸³ In addition, US\$1,526-billion from the IMF’s 36-month Extended Fund Facility and Extended Credit Facility was provided to support Senegal’s policy priorities, including reducing debt vulnerabilities; strengthening governance, anti-money laundering and financing of terrorism; and delivering more inclusive and job-rich growth.⁸⁴

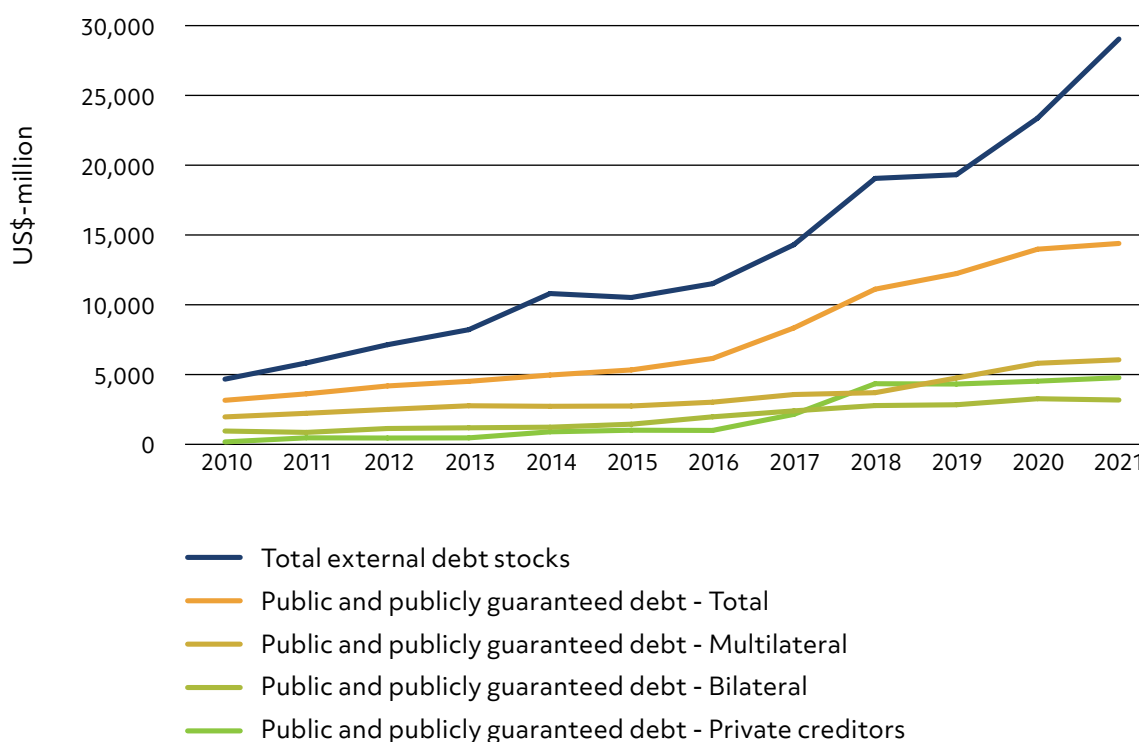
Although this financing is important, the disbursements under the RST amount to just 1% of GDP over a three-year period, when 7% of GDP is required over 10 years to implement Senegal’s NDCs. The IMF’s funding is intended to help “mobilise additional financing and support from development partners [...] in addition to domestic resources”.⁸⁵

In 2021, Senegal’s total external debt stock was 106.99% of its gross national income (GNI). The country may not currently be in distress, but the country’s debt servicing to external creditors has greatly risen (Figure 10). As such, the IMF and World Bank has advised that “given elevated debt service, the authorities should prioritize further efforts to mobilize additional domestic revenues and seek out concessional borrowing in the near term”.⁸⁶

Senegal has one of the largest growth in debt, of over 155% (to US\$17.2-billion) and has seen a substantial increase in the cost of borrowing, of 423% (to US\$1.4-billion).⁸⁷

Figure 10

Senegal’s external debt stock (public and publicly guaranteed debt) 2010–2021



Source: World Bank International Debt Report 2022 (updated 12 June 2022)⁸⁸

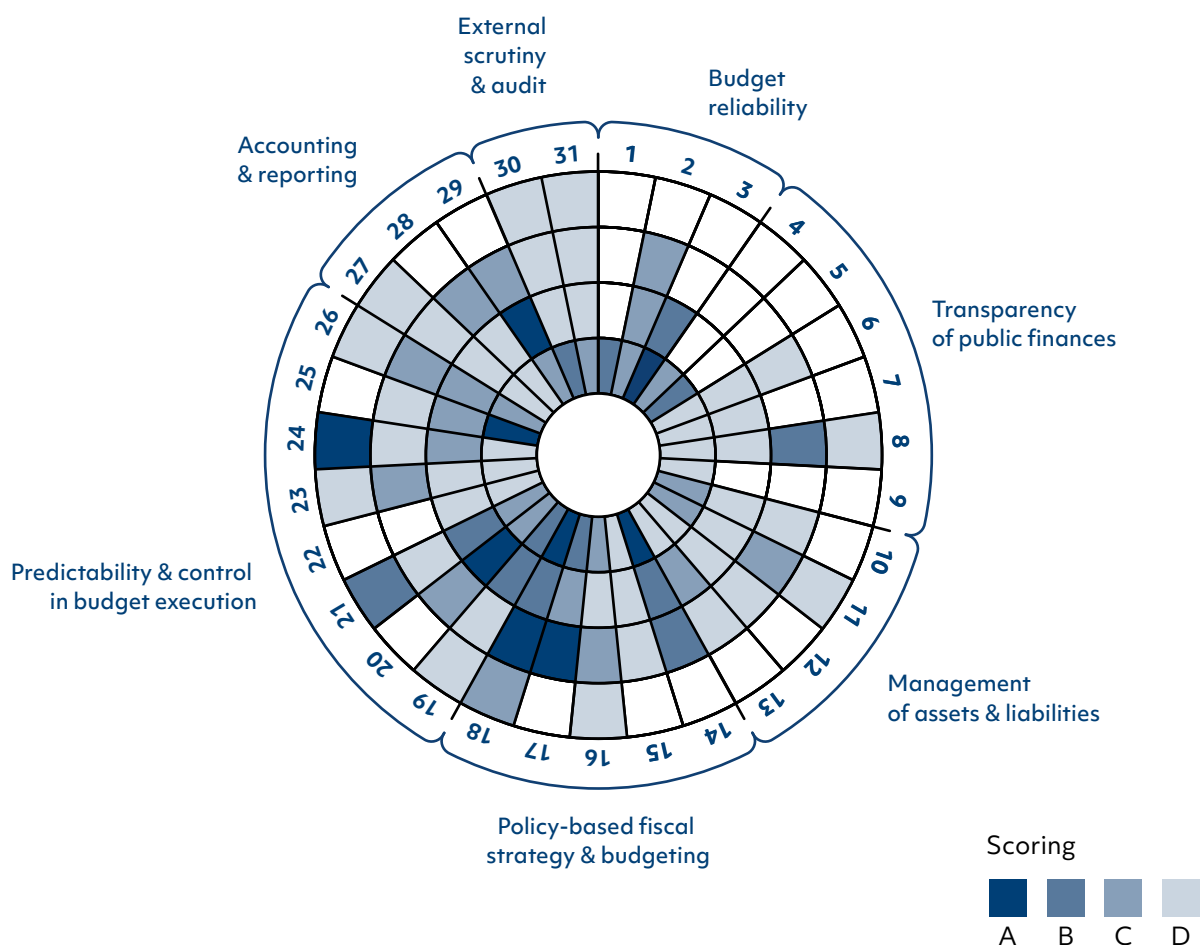
The sovereign–bank nexus in Senegal

Statistics related to the extent of the sovereign–bank nexus are not available. However, in 2022, loans to government comprised 8.3% of total loans by banks in the West African Economic and Monetary Union (UEMOA), which includes Senegal.⁸⁹ This is not substantial.

Senegal's absorptive capacity

Like Ghana, Senegal's last national PEFA assessment was carried out in 2018 (Figure 11). It notes that the country's PFM system performance is still inadequate to ensure the complete achievement of the three primary budgetary goals: budgetary discipline, strategic resource allocation, and effective and efficient provision of public services.⁹⁰ In this regard, shortcomings were found relating to budget discipline, strategic resource allocation and the efficiency of public service delivery. Notably, the evaluation revealed that between 2011 and 2018, the performance of Senegal's PFM system had not substantially improved.

Figure 11
Senegal PEFA assessment



Source: <https://www.pefa.org/assessments/summary/416>

4.4 Summary

The inclusion of climate considerations in the IMF's Debt Sustainability Assessment for MICs is a positive development that allows a more realistic understanding of debt sustainability and areas for additional investment.

As shown in the case studies, Ghana, Kenya and Senegal are all significantly vulnerable to climate change and tripled their external debt between 2010 to 2021. Not surprisingly, the climate actions under their NDCs are conditional on receiving the necessary implementation support (finance but also capacity-building and technology transfer). These gaps need to be urgently addressed without increasing pressure on debt levels, particularly for Ghana whose debt is in the process of being restructured.

The extent of the sovereign–bank nexus varies across the three countries, with Ghanaian banks having most recently experienced the negative impact of this nexus. The secondary economic impacts that result from the nexus reinforce the argument for minimising pressure on debt levels in MICs. Similarly, the strength of public expenditure and financial accountability frameworks varies across the countries, indicating a need for to ensure that a country's absorptive capacity is taken into account when structuring any external financing.

5 Recommendations for Suppliers and Recipients of Concessional Finance

African countries are facing the dual, interconnected crises of debt crisis and climate vulnerabilities, and have limited funding for climate-related initiatives. Therefore, the financial mechanisms used to provide climate finance should not negatively affect debt sustainability. Finance in the form of loans may exacerbate the problem of debt, and increasing unsustainable debt will reduce the financial resources available to address developmental issues, including the climate problem.

In light of the above, this paper offers realistic and actionable recommendations for policy-makers, funders and lenders, based on four criteria: have a positive climate impact, be affordable, be politically viable and open up the fiscal space while maintaining debt sustainability. These criteria provide a framework for evaluating the potential impact and practicability of the recommendations (**Table 2**).

5.1 Supply-side interventions required by MDBs and bilateral agencies

Recommendation 1

Increase concessional finance to MICs

Access to concessional finance depends on a country's level of development, size and vulnerabilities, but generally the focus has been on LICs. The "lack of access to concessional finance for middle income countries is a key missing ingredient", especially to finance projects that have a high climate impact but that may not generate the most cashflow, such as "coal plant decommissioning" or "adaptation by building seawalls".⁹¹

In line with the principle of equity and CBDR-RC, concessional financing can come from developed countries making good on their commitments under the Paris Agreement, on the UN recommendation that developed countries allocate 0.7% of their GNI to ODA,⁹² and on other proposals, such as reallocating special drawing rights, reducing fossil fuel subsidies, and levying taxes on aviation, shipping, financial transactions and the recent windfall profits of fossil fuel companies.⁹³ This funding would complement the increasing levels of South-South concessional flows (in particular from China and India), which in 2011 constituted 12–13% of all resource flows to developing countries.⁹⁴ In 2023, remittance flows to LICs and LMICs were estimated at US\$666-billion and continue to represent a larger source of external finance than foreign direct investment, ODA and portfolio investment flows to those countries.⁹⁵

Recommendation 2

Promote transformative investment

Transformative investments are needed to enable recipient countries to "transform themselves into attractive green economies, while simultaneously adapting and building resilience to ongoing climate change and other external shocks, tackling all the other dimensions of sustainable development,

conserving nature, and preserving biodiversity”.⁹⁶ However, the approach by MDBs and other official lenders has not provided the transformative investment needed to address the current global debt architecture, development needs and multiple crises.

The MDBs and bilateral creditors need to reflect this commitment to transformative investment by improving their internal processes to prioritise climate change. The reform of the global architecture and international institutions is an ongoing process that will require the political will of governments and strategies informed by key stakeholders, including staff. For example, the World Bank will need to

“adapt its mission statement to incorporate the idea that its purpose is to support a transformative investment push to accelerate progress on sustainable development in all countries by driving a strong recovery from the present crisis, restoring momentum on the SDGs, and ensuring that we can keep climate and nature goals within reach”.⁹⁷

Recommendation 3

Develop metrics to assess the impact of a country’s planned adaptation investments and factor them into financing costs

Suppliers of sovereign finance have an opportunity to lower the borrowing cost to countries that invest in adaptation, as empirical evidence shows that adaptation investments reduce sovereign credit spreads. This re-pricing should ideally take place at the outset of the financing and would require the development of measures and metrics to understand the prospects of a country’s adaptive capacity based on its public expenditure plans.

A strong incentive for creditors to adopt this approach is that a lack of investment in adaptation to droughts and floods caused by climate change is predicted to cause negative impacts on GDP,⁹⁸ which could negatively affect investments.

Recommendation 4

Develop standardised and comparable operational efficiency ratios across MDBs

Internal costs partly determine the extent to which MDBs can pass on the benefits of their relatively low borrowing costs due to their AAA credit ratings. Therefore, MDBs need to have the highest possible operational efficiency, while fulfilling their demanding mandates. MDB shareholders should develop standardised and comparable operational efficiency measures for MDBs to promote a cost-containment culture.

While cost containment must be balanced against the significant resources that MDBs require to deliver their mandate, introducing operational efficiency metrics increases transparency, allowing member countries, investors, and the general public to hold MDBs accountable for their performance, and has the potential to improve financing terms to member countries. Publishing cost-to-income ratios is not unprecedented: the European Bank for Reconstruction and Development (EBRD) publishes its cost-to-income ratio in its annual report, with the ratio calculated on a rolling basis to take into account the variability in the EBRD’s equity income.⁹⁹

5.2 Demand-side interventions required by African MIC policy-makers

Recommendation 5

Enhance the absorptive capacity of concessional finance

African MICs seeking additional finance need to strengthen their financial management of concessional funding through improved governance, transparency and stakeholder management. This includes making their development needs clear, maintaining consistent lines of communication, and strengthening the integrity of institutions in order to support the efficient use of concessional finance. This results in fit-for-purpose financing, using existing country systems and enhancing their effectiveness and overall absorptive capacity. Policy change that enhances the structural, administrative and financial capacities of government institutions will in turn enhance climate-change governance. It is cost effective, as it falls within the already existing mandate of policy-makers – what is needed is the political will.

To be optimally effective, financing must be aligned with the recipient country's specific needs and priorities. Fit-for-purpose finance takes into account an individual country's circumstances, capabilities and financing objectives. As such the relevant concessional financial instruments should be tailored to a country's specific context and absorptive capacity.

Recommendation 6

Increase the use of results-based financing mechanisms

Results-based financing, such as sustainability-linked sovereign bonds or performance-based grants that include key performance indicators (KPIs) related to adaptation, can be an effective incentive for efforts that foster resilience and responsiveness. It offers a unique opportunity for governments to secure financing based on achieving specific adaptation targets and outcomes. For instance, sustainability-linked bonds that link the bond's interest rates or principal repayments to achieving predetermined KPIs, thereby incentivising the use of the proceeds for effective adaptation measures, and helping to ensure accountability and transparency in the use of funds.

Including KPIs related to adaptation will also potentially enable financiers to adjust risk and therefore pricing, as countries that invest in adaptation have lower sovereign credit spreads than those that do not.

Recommendation 7

Strengthen project selection and preparation

A better pipeline of projects and viable well-selected projects can result in greater funding flows for climate action. These projects should form part of the broader programme. Targeted concessional finance should match concessional finance to the right projects, with greater focus on project identification, preparation, structuring and procurement. Therefore, grantees need to present project proposals that meet investor criteria, i.e., outline climate and economic benefits, reliability, financial costs, socioeconomic inequalities and affordability assessments.

Recommendation 8

Identify and address

MICs often have limited institutional capacity to implement coordinated policy approaches across government, sectors and stakeholders. Capability gaps vary widely, not only between different governments but also within a single institution. Therefore, a tailored approach is needed that can effectively address any gaps and enhance capacity to address those gaps. The first step is to evaluate the existing resources, skills and capabilities within a government or institution, and how they may hinder optimal performance. The second step is to implement capacity-development programmes using technical assistance from international institutions or partnering with external organisations. This diagnostic and monitoring process should be ongoing, particularly as changes within governments and institutions give rise to new challenges that may require strategies to change.

Although continually tackling challenges in institutional, administrative and structural capacity of the public sector is costly, it will have a climate impact and requires political will and continued commitments by multilateral and bilateral agencies to enhance and support technical capacity. The co-benefit is that it will enhance country ownership of programmes and will help MICs better align country strategies and financing needs.

Table 2
Policy options evaluation assessment

Recommendation	Positive climate impact	Affordability (High = affordable)	Politically feasibility	Potential to open the fiscal space
Recommendations for MDBs and bilateral agencies				
1. Increase concessional finance to MICs	High	Medium	Medium	High
2. Promote transformative investment	High	High	Medium	Medium
3. Develop metrics to assess the impact of a country's planned adaptation investments and factor them into financing costs	Medium	High	High	High
4. Develop standardised and comparable operational efficiency ratios across MDBs	Medium	High	High	Medium
Recommendations for African MIC policy-makers				
5. Enhance the absorptive capacity of concessional finance	High	Medium	High	Medium
6. Increase the use of results-based financing mechanisms	High	High	High	High
7. Strengthen project selection and preparation	High	Medium	High	High
8. Identify and address human and technical capacity constraints	High	Medium	High	High

6 Areas for further research

The following areas were beyond the scope of the paper but require further research:

- The use of concessional finance to mobilise finance from the private sector.
- Common metrics to understand whether funding is fit for purpose.
- Concessional finance in the context of sub-sovereign borrowers, such as municipalities, states and cities, especially with regard to absorptive capacity.

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