

Innovative climate financing instruments

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Summary

The adequate mobilization of climate finance remains one of the greatest challenges of our time. Under the United Nations (UN) climate agreements, rich countries have pledged to support the global South in the fight against climate change and the associated human rights violations through financial transfers. However, the repeated failure to meet the corresponding target of providing US\$ 100 billion per year has led to diplomatic tensions and is one of the main reasons for the lack of success in the fight against climate change.

The debate on how additional funds can be mobilized – including with the help of innovative financing instruments – is therefore underway. The challenge is constantly growing. As climate change progresses, enormous financial resources are still needed not only for mitigation, but also increasingly for adaptation, and even for loss and damage. For mitigation and adaptation, the funding gap remains at over 80 percent, while for loss and damage there has been no dedicated funding to date. Three new vertical funds are at the centre of the debate.

The International Monetary Fund (IMF) has been involved in climate financing since October 2022. It did so through its new **Resilience and Sustainability Facility (RSF)**, whose loans are mainly financed by Special Drawing Rights (SDRs) – i.e. the international reserve currency that the IMF itself issues.

A second fund is the **Loss and Damage Fund (LDF)**. The decision by the UN Climate Summit in 2022 to create a new fund for loss and damage has been seen as a breakthrough in this area. One of the many unresolved issues is how the LDF should be financed. Among the numerous financing proposals, non-governmental organisations (NGOs) in particular prefer new progressive taxes, from wealth tax to excess profit tax for energy companies.

The third fund is the **Global Mitigation Trust Fund (GMTF)**, part of the Bridgetown Initiative to reform the international financial architecture. This was launched by Mia Mottley, the Prime Minister of Barbados, and UN Secretary-General António Guterres in the run-up to the UN climate summit in 2022. This new fund is also to be fed primarily from SDRs. It aims to reduce the high financing costs for private investments in the global South – for example, in the field of renewable energies – to a comparatively low level, as in Germany. With a capital stock of SDRs worth US\$ 500 billion, the GMTF is expected to mobilize up to US\$ 5 trillion in private investments in the future.

While the new funds are intended to transfer additional money to the global South, there is a simultaneous debate about how the outflow of funds from countries can be stopped so that scarce domestic budgetary resources can be used directly for climate financing. Temporary debt moratoriums are being discussed, which could increase the fiscal leeway for financing loss and damage in the event of climate-related disasters. More far-reaching steps, such as debt swaps of individual creditor's loans or large-scale debt restructuring of a country's entire debt portfolio can permanently release scarce fiscal resources and make them available for mitigation and adaptation.

The selected examples of innovative financing show that there are numerous options for reducing the gaps in climate financing. A combination of additional international financial transfers, innovative tax types and money creation through SDRs, as well as the release of countries' own budget funds through debt relief, has high mobilization potential. The hurdles that need to be overcome are mainly political in nature. The international political calendar offers numerous opportunities over the coming months to initiate the necessary reforms.

An evaluation framework for innovative financing instruments

Innovative financing instruments should help to increase funding substantially for climate financing. If these are to have a lasting and effective impact, qualitative aspects must also be taken into account in addition to the potential of the individual instruments to raise funds quantitatively. The key criteria are:

Additionality: Innovative financing methods for the fight against climate change are useful precisely because the financing should not take funds away from traditional development financing (i.e. it should be strictly additional). Innovative methods can supplement budget funds, but due to their specific deficits, they are no substitute for sufficient budget funds.

Effectiveness: The requirements for the effectiveness of international climate finance are similar to those for development finance. For the latter, comprehensive agreements have been reached by the Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC) to promote aspects such as ownership by the recipient countries, alignment with their national development plans, or harmonization and effective division of labour on the part of the funders.

Debt sustainability: Climate financing faces the dilemma that the need to increase its volume substantially is taking place in the context of extremely high levels of government and foreign debt in many countries in the global South. Financing instruments must therefore also be considered in terms of their impact on debt sustainability and they must not increase the debt risk. Grants are preferable to concessional loans, which in turn are better than high-interest loans at market conditions. In addition, the countries and people affected by climate disasters must not be driven further into debt. Loans should therefore be completely ruled out for loss and damage, and for large parts of adaptation financing.

Human rights-based: The Paris Agreement stipulates that Parties must respect, promote and take into account human rights when taking action on climate change. The implementation guidelines for [human rights-based](#)

climate policy include access to information and participation, transparency and accountability, human rights risk and impact assessments, as well as standards and remedies for cooperation mechanisms.

Legality: The legal principle of common but differentiated responsibilities and respective capabilities (CBDR-RC) applies in the climate area. This differentiates between different groups of countries because, on the one hand, they bear different levels of responsibility for climate change and, at the same time, they have different capacities to respond to it. In addition, the ethical principle that the costs should primarily be borne by the polluters (polluter pays) and that affected countries or individuals are entitled to compensation (reparations) also generally applies.

The three pillars of climate finance: mitigation, adaptation, and loss and damage

Climate finance can be divided into three categories: Financing for mitigation, adaptation, and loss and damage. Specific international agreements apply to each of these three central pillars of climate finance and they pose specific challenges for suitable financing instruments.

Mitigation of man-made climate change is primarily aimed at reducing and ultimately ending man-made greenhouse gas emissions. Since the Paris Agreement, countries have been obliged to submit Nationally Determined Contributions (NDCs) every two years in which they set out, among other things, how they will reduce their greenhouse gas emissions as part of the CBDR-RC.

The aim of **adaptation** is to strengthen the resilience of social, economic and ecological systems in order to avert or minimize the damage caused by climate change. While the effects of the climate crisis are being felt worldwide, they are disproportionately affecting vulnerable countries and people in the global South, who have contributed little to the problem themselves. The pressure to adapt is correspondingly higher in countries in the global South.

In the 2015 **Paris Climate Agreement**, the main drivers of climate change committed to supporting developing countries financially and in the form of knowledge and technology transfer for adaptation. In addition to the Paris Agreement, the **Cancun Adaptation Framework** (CAF) adopted in 2011 is also central to this. The CAF also includes the development of National Adaptation Plans.

The third pillar, **loss and damage**, refers to climate change-related consequences that cannot (or can no longer) be averted through mitigation and adaptation. Loss and damage has long been on the UN agenda and was also addressed in Article 8 of the Paris Climate Agreement. However, it was not until the 27th UN Climate Change Conference (Conference of the Parties – COP 27) in Sharm el-Sheikh in 2022 that the **establishment of a loss and damage fund** and the strengthening of other existing financial mechanisms was agreed. This was considered a **significant breakthrough** in this area. It still remains unclear, however, who will provide the funds and how exactly they will be used.

Financing requirements, status of financing and financing gaps

In its **latest report**, the International Panel on Climate Change (IPCC) warns that the costs of mitigation and adaptation will be higher and greater damage and losses will occur if emissions continue to fall more slowly and the global temperature continues to rise. This link is also reflected in the growing need for climate financing in recent decades, which has been accompanied by an increasing but insufficient supply of funds. Although annual funding for mitigation and adaptation increased by 60 percent between 2013–14 and 2019–20, large funding gaps remain.

According to the IPCC, the majority of climate financing is also spent by wealthier countries within their national borders. In countries that have little financial strength of their own, the funding gaps are glaring. At the 2009 climate summit in Copenhagen, it was agreed that wealthy countries should provide US\$ 100 billion in climate financing for mitigation and adaptation in countries in the global South every year from 2020 to 2025. However, this target has not been achieved in any year to date. In addition, funds are mainly provided for mitigation rather than for adaptation, and the proportion of loan financing is enormous.

Table 1: International climate finance – financing needs and financing gaps

	Annual financing requirements until 2030 in US\$ billion	Financial resources 2020 in US\$ billion (according to OECD)	Financing gap in US\$ billion	Financing gap in %
Mitigation	328,2	48,3	279,9	85,2
Adaption	231,5	28,3	203,2	87,8
Loss and Damage	280–580	0	290–580	100

Researcher's own calculations based on data from OECD, IPCC and Adaptation Gap Report (AGR); financing requirement for adaptation is mean value from highest and lowest estimate of IPCC and AGR; financing requirement for loss and damage is forecast for 2030; real costs in 2021 were US\$ 270 billion.

In the area of adaptation financing, there is a dramatic equity gap, as Brot für die Welt's [Adaptation Index 2023](#) shows. The 14 countries with the highest climate risk are also the 14 most underfunded countries on a per capita basis. When it comes to the allocation of international climate adaptation funding, vulnerability criteria do not play a significant role. In terms of climate risks, fewer than one in four of the 129 countries surveyed received a reasonably fair share in the period 2014–2020.

According to OECD data, international climate finance amounted to US\$ 83.3 billion in 2020. However, the lack of international guidelines for calculating climate finance and a lack of transparency and verifiability mean that this data is not very reliable. For example, a [study by Oxfam](#) concludes that the actual amount of climate finance provided in 2020 was only US\$ 21 to 24.5 billion.

Even using the OECD's figures, the funds raised in 2020 would only represent around 11 percent of the international climate financing required. An additional US\$ 1 trillion would be needed globally every year until 2030, according to a [recent study](#) on increasing climate financing in times of inflation and debt crisis.

The IMF's Resilience and Sustainability Facility

In 2022, the IMF became a new major financier in the field of climate financing. The new [Resilience and Sustainability Facility \(RSF\)](#) is the IMF's first lending instrument that grants loans specifically for the purpose of climate financing. This expansion of the IMF's mandate is not without controversy, as climate-related issues are far removed from its actual core tasks of ensuring financial stability and addressing balance of payments needs. The IMF

The funding requirements and funding gaps differ greatly between the objectives of mitigation, adaptation, and loss and damage (see Table 1). While the gap for mitigation and adaptation is over 80 percent at the current stage of funding mobilization, there are no secured resources for loss and damage so far, only symbolic pledges from a few pioneers.

The financing gap in the area of loss and damage is correspondingly enormous, which is why it is [prominent on the international political agenda](#) and will also be a topic at the Conference of the Parties (COP) in Dubai in 2023. In the run-up to the UN Climate Summit, a UN [Transitional Committee](#) has been working intensively on the design of a new Loss and Damage Fund (LDF). Similarly, a new fund for mitigation, the Global Mitigation Trust Fund, is being discussed as part of the Bridgetown Agenda. In addition, the new Resilience and Sustainability Facility (RSF) began disbursing its first loans for adaptation measures at the start of 2023. This means that innovative financing instruments are currently being developed for all three areas of climate financing, which are each at different stages of the policy process, as will look at in more detail below.

justifies this by stating that climate change has become 'macro-critical' for many countries (i.e. it has significant macroeconomic implications), which is why corresponding IMF programmes and the associated lending are justified.

In fact, the RSF was born out of necessity in the context of the COVID-19 pandemic. A credit instrument had to be created that could be counter-

financed with the reserve currency ‘Special Drawing Rights’ (SDRs), which are issued by the IMF itself, and which could also grant loans to middle-income countries.

In August 2021, at the height of the coronavirus crisis, **the IMF distributed SDRs worth US\$ 650 billion**. However, adhering to the IMF rules, these had to be distributed to the member states according to quotas. Since low-income countries also have lower IMF quotas, only a fraction of this SDR allocation reached them. Germany received a larger share of the allocation than all African countries combined. Rich countries have made a political commitment to rechannel SDRs worth at least US\$ 100 billion to countries in need. However, legal requirements in many countries to preserve the reserve character of SDRs during this rechanneling make it difficult to use SDRs outside of IMF instruments. Hence the establishment of the new Resilience and Sustainability Trust (RST) at the IMF, which is fed with SDRs from the richer member states and from which the RSF loans are financed.

The stated financing target is US\$ 44 billion, which is supposed to consist primarily of the reallocated SDRs. **In September 2023, US\$ 41.1 billion had already been committed**. The German government has pledged a loan from budget funds worth around US\$ 6.7 billion for the RST, as the German Bundesbank is fundamentally opposed to the reallocation of SDRs from German holdings. **Other EU countries** are paying most of their contributions in SDRs.

The major advantage of the RSF is that it has created a significant new source of additional funds for climate financing. Beyond this, however, there is a lot of criticism, especially from civil society. An important point to note here is that the RSF only grants loans, driving the recipient countries even deeper into debt and possibly resulting in permanent dependence on the IMF.

The IMF has also extended its much-criticized practice of linking a comprehensive package of policy conditions to the granting of loans to the RSF loans. A glance at the **list of conditions** shows that neoliberal structural adjustment policies are also being promoted here, this time with a green veneer. For example, the programme for Barbados contains conditions for trade liberalization – in this case, the reduction of import taxes for electric cars – and for the deregulation of markets, in this case the electricity market. With its stringent policy

conditions, the RSF is more akin to a classic IMF facility than a solidarity-based climate financing instrument.

With its entry into climate financing, the IMF has also expanded its toolkit of diagnostic instruments. These include the new Climate Public Investment Management Assessment (C-PIMA) and the Climate Macroeconomic Assessment Program (CMAP). While these can provide useful insights, the practice of some donors – in particular, the IMF – of subjecting recipient countries to ever new donor-standardized diagnostic tools is highly controversial from an aid effectiveness perspective. On the one hand, data collection represents a high bureaucratic burden for the recipients and, on the other, the information collected is often more useful for the funders than for the recipients. Instead, as has already been done in some of the pilot programmes, the country’s own National Adaptation Plans and NDCs could serve as the basis for programme design.

Unlike the UN’s Green Climate Fund, for example, where aid organizations often take over project implementation, the RSF disburses funds exclusively to the governments of the recipient countries. **More direct climate financing, including for NGOs and affected communities**, has long been a demand from NGOs, since it promotes ownership and reduces transaction costs.

Five RSF pilot programmes were approved by March 2023, for Bangladesh, Barbados, Costa Rica, Jamaica and Rwanda – all as loans with a 20-year term and at a variable SDR interest rate plus an administrative cost surcharge (i.e. at current interest rates of just over four percent). The RSF does not meet civil society’s demand that international climate financing should primarily be provided in the form of grants. By October 2023, the **number of programmes** had grown to 11.

The total financing volume of the approved programmes is only US\$ 4.3 billion, of which only US\$ 280 million had been called up by October 2023. Although the new RSF represents an additional source of financing, even if the potential volume of US\$ 44 billion was fully utilized, it would cover less than one twentieth of the need for additional international climate financing. As it only provides loans, RSF debtor countries will suffer a significant outflow of funds in later years.

The Global Mitigation Trust Fund

In the run-up to the UN Climate Summit 2022, Mia Mottley, the Prime Minister of Barbados, presented the Global Mitigation Trust Fund (GMTF). This was part of a package of measures that has since gained widespread recognition as the [Bridgetown Initiative](#).

Similar to the RSF, which has now been realized, a future GMTF is also to be fed primarily from Special Drawing Rights (SDRs). The core of the fund is to be a capital stock of SDRs worth US\$ 500 billion. In particular, countries that have received large amounts of SDRs from the IMF and do not need them are to reallocate them to the GMTF. Countries that face political or legal obstacles could contribute with money or guarantees.

In contrast to the RSF, the GMTF is intended to [leverage additional resources](#). Using its capital stock as collateral, the fund would take out low-interest loans from central banks. These would be on-lent at similarly favourable interest rates for private project financing in order to be invested in the green transformation towards a climate-friendly economy. This would therefore mainly benefit activities in the area of mitigation. While the RSF lends exclusively to governments, the GMTF is primarily aimed at private project implementers and is intended to attract further private capital. The intention is to mobilize up to US\$ 5 trillion (i.e. a leverage effect of one to ten).

The GMTF addresses a problem that has become known as the '[Great Finance Divide](#)': the financial markets only make capital available to countries in the global South – both governments and private project sponsors – on significantly worse terms than those in the global North. The interest premiums for government bonds are on average more than 5 percent, in some low-income countries more than 10 percent, compared to US American government bonds for dollar loans or German government bonds for euro loans. This disadvantage is a central cause of the economic weakness and fragile state systems of the global South in general, as the higher financing costs mean that neither competitive economies nor an adequate supply of public goods can be financed.

The capital required for climate protection investments in the global South is also only available at far less favourable conditions. The primary aim of the GMTF is therefore to reduce the cost of capital in the global South to the level of private projects in Germany or the USA.

Unlike the now operationalized RSF, the GMTF is still a vision. Its realization would require the reallocation of 500 billion SDRs, i.e. significantly more flexibility in dealing with this resource. Even the political commitment of the G7 and G20 summits for rich countries to reallocate SDRs worth US\$ 100 billion to the global South has not yet been [fully implemented due to numerous hurdles](#). In Germany in particular, the reallocation is difficult because it faces the political unwillingness of the Bundesbank as well as legal hurdles.

The GMTF would also only grant loans, but at more favourable interest rates than on the financial markets. Therefore it would primarily be suitable for financing activities that can generate a revenue stream, for example, investments in renewable energies. Using the current stock of SDRs to subsidize private investments would inevitably mean that they would no longer be available for financing public borrowers, for example, via the RSF.

An alternative would be an additional allocation of SDRs by the IMF. In fact, [at the UN Climate Summit](#) in 2022, [Mia Mottley](#) proposed an *annual* allocation of SDRs amounting to US\$ 500 billion in favour of the Fund. Any new SDR allocation is only politically feasible if the vast majority of IMF member states agree. A targeted allocation directly into such a fund would also require a change to the IMF Articles of Agreement. This is because the IMF can currently only distribute new SDRs directly to the member states.

The GMTF has considerable potential to contribute to climate financing in the area of mitigation. However, it is questionable whether the GMTF can actually mobilize private investments of up to US\$ 5 trillion with a deposit worth US\$ 500 billion in public funds (i.e. achieve the intended leverage effect). Since the adoption of the 2030 Agenda, there has been a boom in such blended financing instruments. [Evaluations have shown](#) that most of them have been disappointing in practice.

The Loss and Damage Fund

At the 27th UN Climate Summit in Sharm el-Sheikh in 2022, the international community agreed to create **new financing arrangements for climate-related** loss and damage, including a fund with an explicit focus, the Loss and Damage Fund (LDF). This was an important milestone in the long-running political process to underpin the third pillar of climate finance both financially and institutionally.

For the climate summit in Dubai at the end of 2023, a committee prepared a proposal for operationalization. At the **first meetings of the committee**, the scope of the fund was a particularly controversial topic (i.e. whether only particularly vulnerable and endangered countries should be entitled to funds or whether entitlement should be extended to all countries defined as developing countries by the United Nations Framework Convention on Climate Change – UNFCCC). The civil society Loss and Damage Collaboration presented the committee with a **comprehensive list of demands** for the design of the fund.

In November 2023, **the committee agreed** on the vague compromise that all vulnerable countries could have access to funds. However, civil society criticized the fact that contributions to the fund are only voluntary, not mandatory. There was also criticism that the fund should initially be hosted by the World Bank and not by the UNFCCC.

A central and still unresolved question is how the necessary additional funding can be raised. This is particularly pertinent in view of the fact that sufficient funds have never been made available for the mitigation and adaptation pillars. Many proposals are therefore moving in the direction of innovative financing methods.

Civil society has been talking about **new taxes for loss and damage funding** for some time. The British NGO Christian Aid recently **calculated** that

an annual wealth tax of 0.5 percent on assets over £1 million could fully cover the UK's fair share of the Loss and Damage Fund. This is estimated by Christian Aid to be 3.5 percent of an estimated funding requirement of US\$ 400 billion (i.e. around US\$ 15 billion). Funding from a wealth tax would largely correspond to the polluter pays principle. As Oxfam has shown in a **study on wealthy billionaires**, there is a positive correlation between climate-damaging activities and wealth, which means that richer people make an above-average contribution to causing climate change.

A second tax in the debate is the excess profits tax on the profits of fossil fuel and energy companies. This would also correspond to the polluter pays principle. In addition, corporations have recently also been seen as war profiteers, which gives the tax an additional moral justification in the eyes of many. A study by the Netzwerk Steuergerechtigkeit (the German tax justice network) concluded as early as mid-2022 that such a tax could generate **€30-100 billion** in revenues in Germany alone, given the expected excess profits for 2022. Major climate protection coalitions such as the **Climate Action Network International** have also joined the call for excess profit taxes.

Financing an LDF with contributions that are covered by taxes has the great advantage that it does not create any new debt, either in the financing countries or in the countries affected by loss and damage. The LDF would therefore not repeat the mistakes made with the RSF, which is financed by loans, can only grant loans and therefore contributes significantly to further debt. This is particularly important because vulnerable countries are already among the most indebted countries. In many cases – from small island states such as Grenada to large developing countries such as Pakistan – natural disasters have driven up debt ratios because there were no financial resources available to tackle the loss and damage other than borrowing.

Debt relief and debt swaps

The fact that many countries have reached the limits of their debt sustainability makes the use of credit instruments in climate financing difficult or even impossible. The high debt service that these countries have to pay also represents an opportunity cost. It robs them of scarce resources that could be used to finance their own climate-friendly

development. Countries in the global South now have to **spend an average of 16.3 percent** of their government revenue on servicing their debt, an increase of 150 percent over the last ten years. Debt servicing to private creditors accounts for the largest share of this at 46 percent, followed by payments to multilateral creditors at 30 percent.

In this context, calls to increase the fiscal space for adaptation measures and dealing with loss and damage by means of debt relief have been growing louder in recent years. For example, [the V20](#) – an informal group of particularly vulnerable countries – called for “a major debt restructuring initiative for countries overburdened by debt – a sort of grand-scale climate–debt swap where the debts and debt servicing of developing countries are reduced on the basis of their own plans to achieve climate resilience and prosperity” as early as 2021.

The debt relief initiatives for highly indebted poor countries (HIPC) from the 1990s are seen as a model for climate-related debt relief. At that time, debt relief was explicitly justified for releasing domestic funds to finance poverty reduction programmes. The HIPC initiatives were successful in the sense that participating countries subsequently increased spending in relevant sectors, such as education and health. Debt relief as part of the crisis response in times of increasing climate catastrophes enjoys broad support from civil society. In Germany, for example, the [erlassjahr.de campaign](#) is campaigning for this. Internationally the activist group [Debt for Climate](#), as well as NGO coalitions such as [Eurodad](#) and [Latindadd](#), are calling for the same.

The proposals to mobilize additional climate finance through debt actions can be broadly divided into three categories: debt moratoriums, debt swaps and large-scale debt restructuring. Debt swaps play a role primarily in the areas of mitigation and adaptation, while the discussion on moratoriums and debt relief is focused on coping with loss and damage.

Debt moratoriums allow the indebted country to stop servicing its debt for a certain period in the event of a climate disaster. This frees up financial resources that can be used directly for emergency aid and reconstruction and can therefore help to cope with losses and damages. The Alliance of Small Island States introduced the idea of [debt moratoriums in the context of the COVID-19 crisis](#). The [Debt Service Suspension Initiative \(DSSI\)](#) developed by the G20 allowed low-income countries to suspend debt servicing for two years in order to focus their own resources on fighting the pandemic. However, its effect was limited as loans from multilateral and private creditors were excluded. As a result, only loan payments amounting to US\$ 12.9 billion could be deferred. In the climate crisis, the systematic use of debt moratoriums is still pending.

Debt moratoriums can also be ‘automatized’ by including clauses in loan agreements that allow countries to reduce or stop servicing their debt if they are hit by a disaster and suffer losses and damage. Such instruments are called state-contingent debt instruments (SCDIs). Some pioneers such as Grenada and Barbados have already issued their own government bonds with so-called ‘hurricane clauses’. However, vulnerable countries take out most loans from bilateral creditors or multilateral development banks. Although these solid banks are resilient to financial shocks (i.e. they could easily cope with certain revenue losses), they have so far refused to take the risks of loss and damage off the vulnerable borrowers’ hands and onto their own balance sheets through SCDIs. However, the political pressure for reform is high. In October 2023, [the World Bank announced](#) that some of its lending instruments would include corresponding clauses in the future. Others banks would have to follow suit.

In **debt swaps**, the debtor country is relieved of debt on the condition that the funds released are used for a predetermined purpose. Such debt swaps have been carried out for decades, usually on a small scale of a few million euros – for example, as debt-for-health swaps or debt-for-nature swaps. Debt-for-climate swaps are a relatively new category, but there are already precedents – for example, in the Seychelles (2015) and Belize (2021). The UN Regional Economic Commissions are in the process of developing larger conversion programmes for countries [in the Caribbean](#) and [West Asia](#). One problem with these swaps lies in the relatively high transaction costs, at least if it is to be ensured and monitored that the funds released actually flow into additional financing for climate measures. The relatively low volumes are also problematic, as usually only the debts of a single creditor are converted.

Debt restructuring, on the other hand, is aimed at a country’s entire debt stock. This includes debt to various creditor countries, private debt to banks and investors, as well as multilateral debt to development banks. Some multilateral creditors, such as the IMF, are usually excluded from restructuring as ‘preferential creditors’. The advantage over moratoriums is that the debt service is reduced in the long term and not just deferred. The biggest problem is creditor coordination (i.e. convincing the numerous individual stakeholders of the need for restructuring and persuading them to participate). The private investors in particular can be thousands of individual players who hold government bonds from the global South. A moratorium following a

climate-related natural disaster can also be combined with subsequent restructuring.

Of the three options, only large-scale debt restructuring has the necessary scale to mobilize the huge sums of money needed to tackle the climate crisis effectively. For example, the Debt Relief for Green and Inclusive Recovery Project has used a simulation to calculate that **restructuring is necessary in 61 countries in the global South** because their debt levels do not allow them to make the necessary investments to implement the 2030 Agenda for Sustainable Development and the Paris Climate Agreement. In total, this would result in debt relief of up to US\$ 512 billion.

Although debt relief does not represent a financial transfer from the polluter countries and therefore

does not correspond to the polluter pays principle in the strict sense, it does reduce the financial outflow, which predominantly goes to state and private actors in the major polluter countries, as there is a large overlap between polluter and creditor countries.

Debt restructurings cannot be a substitute for financial transfers from the wealthy polluter countries. However, in countries where the debt burden has become unsustainable, they can create important fiscal space. As a positive side effect, they reduce the pressure to extract and export fossil fuels in order to earn the foreign currency needed to service the debt. As a complementary instrument to climate funds and North-South financial transfers, debt relief measures should therefore definitely be part of the toolkit in the fight against climate change.

Conclusion

The huge and increasing need for climate financing has sparked the debate on innovative financing instruments and has also produced initial results. The Resilience and Sustainability Facility has now begun to operate, the Loss and Damage Fund has been agreed in principle and further instruments are already being considered with concepts such as the Global Mitigation Trust Fund.

In addition to traditional financing through budget funds, which can easily be expanded if the political will is there, such innovative financing vehicles can be fed by various combinations of innovative financing methods. These include fiscal instruments (i.e. new taxes such as the excess profits tax or an earmarked wealth tax), or the creation of new liquidity through the allocation of new or the rechanneling of existing IMF Special Drawing Rights. Debt relief is no substitute for financial transfers from richer countries – which are the biggest polluters – but it can increase the fiscal scope for climate financing in poorer countries. The release of a country's own budget funds then works in addition to financial transfers from abroad.

Both innovative taxes and debt relief can generate additional funds for climate financing. This also applies in particular to IMF SDRs, which represent a genuine creation of new financial resources. The fact that the IMF rules mean that the richest countries benefit disproportionately from every reallocation of SDRs makes SDR rechanneling all the more important in order to take account of the polluter pays principle. The RSF and the GMTF

are instruments that make this SDR rechanneling possible. Depending on the type of tax, innovative taxes can also comply with the polluter pays principle to a large extent. For this reason, the excess profits tax for energy companies and the wealth tax are currently being highlighted in the climate debate.

Debt relief is less clearly focused in terms of its distribution effect. However, it is considered efficient because it releases its own resources and enables ownership, while both old and new climate funds such as the RSF are complex structures with high transaction costs and are heavily donor-driven. For the growing number of countries in the global South where debt sustainability has reached its limits, there are hardly any alternatives to debt relief anyway. This is because innovative instruments such as the RSF and the GMTF are also credit facilities. Although they can lend at the SDR interest rate, which is significantly below the market interest rate for borrowers from the global South, they create additional debt that can no longer be absorbed in many places. For this reason, it is also crucial that the new Loss and Damage Fund must be able to work with grants, not loans.

Innovative climate finance is currently high on the political agenda. The elements of the Bridgetown Initiative were on the agenda of the Summit for a New Global Financial Pact held in Paris in June. The Loss and Damage Fund will play a major role at the UN Climate Summit in Dubai at the end of November 2023. The ongoing negotiations on a

new collective climate finance target, which must be well above the current target of US\$ 100 billion per year if it is to meet demand, highlight the urgency of further expanding innovative climate finance.

However, the meaningful debate on innovative climate finance should not distract from the fact that wealthy countries can and must raise more funds from their current budgets to meet their international commitments and to support more financially vulnerable countries in the fight against climate change.

Imprint

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