Environmental Protection and

Sovereign Debt Restructuring

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The consequences of the climate change problem are global. Contributions to solving that problem are therefore properly expected to come from every country to a greater or lesser degree depending on their share of responsibility for environmental pollution and their financial resources. But some countries may have a compelling argument for why they should *not* be expected to join the planetary effort to fight climate change. These are countries facing the need to restructure their external debt.[1]

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[1] A potentially long list of which is on the horizon as of this writing. *See* Jonathan Wheatley, *Poorest Countries Face $11bn Surge in Debt Repayments*, FIN TIMES (January 18, 2022).

Sovereigns that cannot pay what they are already contractually obligated to pay are unlikely to be in a position to devote financial resources to environmental conservation or other measures to mitigate the effects of climate change. As incongruous as it may sound, however, it is precisely the subset of countries undergoing a debt restructuring that may have an alternative avenue for funding these projects. An example is Belize's 2021 debt restructuring which resulted in both substantial debt relief and a credible long-term source of conservation funding. In the discussion that follows, and building on insights from the Belize transaction, we describe a restructuring technique that could be used in a wide range of circumstances.[2]

Belize 2021

Belize's debt restructuring in 2021 is a rare example of a deliberate attempt to incorporate environmental protection features in a sovereign debt workout. Belize, a country in Central America facing the Caribbean Sea, had issued only one US dollar-denominated bond in the international capital markets. That bond -- dubbed the "Superbond" -- had a checkered career. Issued in 2007, the bond had already been restructured three times before Belize's economy, more than 50 percent of which is tourism based, was devastated by the Covid-19 pandemic.

Belize was therefore forced to approach its bondholders in early 2021 to seek yet another restructuring of the Superbond. While those discussions were underway, however, Belize reached an understanding with The Nature Conservancy (TNC) under which a

[2] A broader point is that helping ameliorate excessive debt loads makes it likely that there will be access to funding from private sources to assist with sustainable development. This is because that such funding generally does not flow into countries with unsustainable debt loads.

TNC affiliate would raise money in the international capital markets and on-lend the proceeds to Belize in order to permit Belize to make an offer to repurchase, for cash at a heavy discount, the entirety of the Superbond. In return, Belize would agree to accelerate and expand its marine conservation program, with monitoring by the TNC affiliate in Belize. TNC had been actively involved in conservation efforts in Belize for almost two decades and had a credible team in place.

The Government of Belize proceeded to negotiate with its bondholders a cash repurchase of the Superbond at a price of 51.7 cents on the dollar together with payment of all accrued but unpaid interest (for an "all in" price of 55 cents on the dollar of outstanding Superbond principal). As an inducement to the bondholders to accept that offer, Belize also offered to use a portion of the savings it would realize from the transaction (equivalent to 1.3 percent of 2020 GDP) to prefund a so-called Endowment Account to be administered by TNC. The investment earnings on the Endowment Account would be used, in perpetuity, to fund marine conservation projects in Belize.

Press stories about the transaction reported that a number of Superbond holders viewed Belize's commitment to prefund the Endowment Account as a material inducement to the holders' acceptance of the heavily discounted cash repurchase price.[3] That feature thus operated precisely as the Belize authorities had hoped it would; as a form of "ESG sweetener" that, while not conveying any monetary value to the bondholders themselves, nevertheless gave the holders an opportunity publicly to demonstrate their commitment to

[3] *See, e.g.,* Tommy Stubbington, *Belize Leans on Coral Reefs to Drive Bargain with Bondholders*, FIN. TIMES (Sept. 18, 2021).

ESG principles.[4]

The Belize transaction involved a cash buyback of the entirety of the country's only international bond.[5] That situation will not often recur in future sovereign debt workouts. In the garden-variety sovereign debt restructuring, the debtor country will be issuing one or more new series of bonds to replace its existing indebtedness. The trick will therefore be to find a mechanism by which a portion of the on-going debt service payments on those new bonds can be diverted to fund appropriate ESG projects.[6]

Background

In a bond exchange, the sovereign's existing foreign currency-denominated bonds (which it cannot afford to service on their current terms) are exchanged for new bonds whose financial terms reflect the debt relief the bondholders have agreed to provide. That debt relief is normally conveyed through some combination of principal reduction, coupon adjustment and/or maturity extension. The objective of every sovereign debt workout, from the creditors' perspective, is to grant debt relief sufficient (just) to permit the sovereign to regain market access and thus improve the collectibility of the lenders' residual

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[4] *See, e.g.,* Marc Jones, *Belize Offers Ocean 'Blue' Print with Ocean Debt-for-Reef Swap*, REUTERS (Nov. 5, 2021).

[5] This key characteristic made the repurchase immune to the classic Bulow and Rogoff critique of bond buybacks. *See* Jeremy Bulow & Kenneth Rogoff, *The Buyback Boondoggle,* 2 BROOKINGS PAPERS ECON. ACTIVITY 675 (1988).

[6] For discussions of the Belize 2021 restructuring, see *Lee Buchheit and Mitu Gulati on Debt for Nature Swaps*, *Free Range* with *Mike Livermore* (Dec. 15, 2021) https://soundcloud.com/user-311970225/an-interview-with-lee-buchheit-and-mitu-gulati-on-debt-for-nature-deals ; *Jennifer Morris on COP26 and the Importance of Nature*; *Sovereign Debt with Jill Dauchy* (Nov. 22, 2021); https://podcasts.apple.com/us/podcast/sovereign-debt-with-jill-dauchy/id1590877150?i=1000542667626 ; *From Commercial Bank Loans to Blue Bonds*, *Clauses and Controversies* Ep. 56 (Jan 10, 2022), https://podcasts.apple.com/us/podcast/ep-56-ft-antonia-stolper/id1528208049?i=1000547433276

claims. The arguments heard around a sovereign debt negotiating table usually focus on how much debt relief is needed to meet that threshold, how that relief is to be implemented (principal haircut, coupon adjustment, maturity extension) and how much of a contribution to the country's adjustment is to be provided by other stakeholders — the citizens of the debtor country in the form of fiscal adjustment, the official sector players like the International Monetary Fund, and other creditor groups such as bilateral (government) lenders and domestic creditors.

The commercial lenders' primary negotiating objective is therefore to provide the minimal amount of debt relief necessary to improve the borrower's external debt dynamics so that the borrower can return to normal market refinancing of its remaining external debt. A secondary objective is to convey that debt relief in a way that will be the least inconvenient for the lenders. A serious flaw in conventional sovereign debt restructurings is the absence of any effective mechanism for the creditors providing debt relief to monitor or enforce how the sovereign debtor uses the savings that flow from the debt relief. Once the debt relief has been granted, the sovereign borrower is generally free to spend or misspend the savings as it sees fit. If the sovereign enters into an IMF program in connection with the restructuring, the Fund will monitor compliance while the program lasts, but Fund programs are of short duration. If a lender's entire motivation in providing relief is to improve the borrower's debt dynamics and thereby enhance the likelihood that the balance of the loan can be repaid on its restructured terms, there is little or nothing in the conventional debt restructuring arsenal to prevent post-closing backsliding by the sovereign debtor. Such a return to imprudent fiscal behavior will again erode the country's debt dynamics, perhaps triggering the need for yet another round of debt restructuring.

The Range of Restructuring Techniques

The methods by which debt relief can be conveyed to a sovereign borrower can be plotted on a spectrum. At one extreme is outright debt forgiveness, sometimes referred to as debt cancellation, debt write-off, condonation or "haircut". It is a technique much beloved by sovereign debtors. The debt cancelled does not have to be repaid, now or ever, and can be subtracted from the sovereign's reported debt stock with a resulting improvement in the country's ratios such as debt to GDP.

At the other end of the spectrum is debt relief in the form of a short deferment of a scheduled payment date, with interest continuing to accrue on the deferred amount for the period of the extension.

In between these two extremes there are many ways in which debt relief can be conveyed to a sovereign borrower. Interest rates can be reduced, temporarily or permanently. Maturity dates can be stretched out for long periods. Debt service payments can be capitalized. The borrower can be given the ability to prepay the debt on a discounted basis. Or, as in the proposal described below, the creditor can permit the conversion of certain debt service payments originally denominated in foreign currency into local currency obligations dedicated to specific ESG projects.

As creditors tend to see the world, outright debt forgiveness is an extreme remedy to be considered only in cases of unmistakable insolvency (situations in which the likelihood of the sovereign ever being able to repay its debt in full is, absent divine intervention, vanishingly remote).[7] Circumstances of "illiquidity", the creditors will argue, call for less drastic debt relief remedies. That is, remedies that provide breathing space by allowing debtors to stretch out payments but do not lead to large losses in terms of net present value.

The sole motivation for a commercial creditor to consider giving any form of debt relief to a sovereign borrower carrying an unsustainable debt load – what economists call a “debt overhang” -- is to improve the likelihood that the balance of the creditor’s claim can be repaid on its restructured terms. By addressing the debt overhang problem in a convincing way the creditor hopes to increase the market value of its residual (restructured) claim to a level exceeding the value of its claim before the restructuring. Bilateral (government) creditors may sometimes entertain requests for debt relief in order to further their geopolitical objectives such as supporting an ally or major trading partner. Commercial creditors on the other hand can be assumed to have a single, unalloyed motivation -- money. The trick for commercial creditors is therefore to convey debt relief to the sovereign borrower in the minimal amount necessary to achieve the objective of improving the value of the balance of the creditor's claim. Granting any greater debt relief is a waste of the lender's money; giving any less debt relief risks the need for a further debt restructuring down the road.

In modern sovereign finance, the goal of "improving the collectibility of the balance of a creditor's claim" does <u>not</u> mean setting repayment terms that the sovereign debtor can meet out of its current, on-going fiscal resources. It means setting repayment terms that are

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[7] In theory, one can achieve the same reduction in net present value with a principal haircut as with a stretch out of payments. In reality, at the margins, principal haircuts are disfavored in comparison to maturity extensions. *See* Federico Sturzenegger & Jeromin Zettelmeyer, *Creditors’ Losses Versus Debt Relief: Lessons From a Decade of Sovereign Debt Crises*, 5. J. EUR. ECON. ASSOC. 343 (2007).

perceived as sufficiently lenient to restore long term debt sustainability. Achieve that, the theory goes, and new lenders will be prepared to disburse the money that the debtor country needs to repay in full the balance of its restructured debt. This, in the argot of the financial community, defines the blessed state of "market access".

An Environmentally Friendly Restructuring Technique

The trick in marrying debt relief and environmental protection is therefore to find a technique that will enhance the market's perception of a country with a sustainable post-restructuring debt position while at the same time freeing funds that can be deployed for environment friendly projects. In a garden variety sovereign debt restructuring involving an exchange offer, this could be achieved by giving the sovereign debtor an option to discharge a portion of the foreign currency debt service due on the new bonds it issues in connection with the transaction through the payment of the local currency equivalent of that portion to fund a conservation project within its own territory and approved in advance by the lenders. The project could be monitored and administered by an independent third party such as an NGO or a United Nations organization. A failure by the sovereign to fund the project with local currency on any payment date would mean that the sovereign debtor would owe the full amount of the foreign-currency debt service payment due under the new bonds on that date.

An illustration — the Republic of Ruritania needs to restructure a stock of sovereign debt that requires $16 million in coupon payments every six months. There is substantial uncertainty as to the level of Ruritanian debt that will restore market access. Debt sustainability analyses conducted by the IMF, however, suggest that Ruritania could afford coupon payments that range between $10 million and $8 million every six months. The bonds issued under the debt restructuring require a $10 million coupon payment every six months (the upper limit of the debt sustainability range) but provide that, at Ruritania's option, up to $2 million of each of those coupon payments may be discharged in local (Ruritanian) currency by funding a creditor-approved environmental conservation or similar project in Ruritania. Failure to fund the project on any coupon payment date under the bonds means that Ruritania must pay the full $10 million — in U.S. dollars — to its bondholders.

Benefits

The benefits for the creditors:

- By allowing a portion of coupon payments in this example to be discharged in local currency, the bondholders are decreasing the likelihood of a future external debt payment crisis in Ruritania by reducing the call on Ruritania's international monetary reserves needed to service the country's international bonds. Moreover, for at least this portion of the debt relief they provide to Ruritania, the creditors will be able to control and monitor how the savings are used. The beneficiary project must be approved in advance by the lenders and it will be monitored by an independent third party.
- The creditors can point to this feature of Ruritania's debt restructuring as tangible evidence of the lenders' commitment to ESG principles.
- Depending on the nature of the beneficiary project, creditors may be able to obtain income through the sale of carbon offsets linked to the restructuring. This should increase the market value of the restructured bonds.

- A feature allowing a portion of the debt service to be reinvested in the Ruritanian economy may help to mute any local resentment of the debt restructuring, thus lowering the political risk to the transaction. Again, this should increase the market value of the restructured bonds.

- An investment in conservation could have a positive effect on long-run growth in Ruritania, improve debt sustainability and thus increase the value of the restructured bonds.

The benefits for Ruritania:

- The funded project should have ancillary benefits for the Ruritanian economy such as employment, protection of natural resources and possibly an increase in tourism.

- Ruritania should be able to bask in the warm approbation of the international community and official sector actors by taking a concrete measure to mitigate climate change. It may even be able to get financial support from the international community linked to its conservation activity.

The benefits for the planet:

- If the funded project leads to a reduction in emissions, or to an increase in absorption of carbon, the benefits will be felt by all residents of the planet.

<u>Possible Tradeoffs</u>

Assessing sovereign debt sustainability is not an exact science. Judgments will differ on a wide variety of assumptions — growth, export prices, monetary policy in the developed countries and many other factors. Experience suggests that debtors tend to underestimate their future capacity to pay; creditors tend to overestimate it.[8] As a consequence, the same debt relief measure may be viewed by creditors as deeper than necessary to restore sustainability while the sovereign borrower may see it as insufficiently shallow to achieve that same objective.

It is precisely this predictable difference in the bid and asked of debt relief negotiation where a technique such as that proposed above may be of greatest help. After all, if both sides of the negotiating table were absolutely certain that Ruritania could afford $10 million in semi-annual coupon payments, the creditors would have no incentive to accept anything less than $10 million; the prospect of ESG glory notwithstanding. But if everyone were absolutely certain that Ruritania could under no circumstances afford more than $8 million, the Ruritanian authorities could not responsibility sign an agreement promising to pay more and the creditors would be reckless to ask for more.

But, in all likelihood, everyone will <u>not</u> be certain about the right number. In a conventional debt restructuring negotiation the lenders would ask for the full $10 million and take the risk that they were pressing Ruritania too hard (if that risk materializes, the creditors know that they, or their successors in title, may need to undergo yet another bout of debt restructuring). For its part, the sovereign debtor could be expected to insist on a cap of $8 million, arguing that it will be the Ruritanian citizens who will pay the highest price if the lenders' optimism proves unfounded. And if history is any guide, the result may be many months of stalemated negotiations.

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[8] This is not what creditors and debtors are likely to declare in public. For negotiation purposes, creditors have incentives publicly to report higher capacity to pay and debtors have the opposite incentives.

The technique described above would allow the parties to bridge the $2 million difference in their assessments of sustainability. Ruritania pays - in hard currency - only the safer $8 million figure. By allowing Ruritania to discharge the additional $2 million through a local currency funding of an approved environmental project, the lenders simultaneously reduce the likelihood of the need for a subsequent debt restructuring and wrap the new restructured bonds in indelible ESG resplendence. Both should improve the secondary market price of the new bonds and gladden the heart of a mark-to-market holder of those bonds. It is therefore a sensible business compromise all around. The benefit to the planet, and the political approbation that this should garner for both the debtor and the lenders, may be the consequence, but need not be the catalyst, for employing the technique.

The Ruritanian debt restructuring, like all sovereign debt restructurings, involves a series of self-fulfilling prophecies. If the debt relief conveyed by the restructuring is perceived by the market to be insufficient to restore Ruritania to a sustainable debt position, investors will begin to sell their Ruritanian paper. The market price of those bonds will drop, the yield will rise and the country would have to pay a higher rate of interest to issue new debt securities to refinance existing bonds. At some point the interest rate the market would demand for a new Ruritanian bond becomes insupportable. Another debt restructuring becomes unavoidable, thus fulfilling the prophecy of those skittish investors who sold their positions at the outset because they saw trouble in the offing.[9]

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[9] The self-fulfilling nature of the crisis may even lead investors who believe that the debt is sustainable to sell the debt.

Investors who fear a Ruritanian debt crisis are also likely to sell all sorts of other Ruritanian assets, fueling capital flight and a likely depreciation of the Ruritanian currency. Given that debt is denominated in dollars and GDP in local currency, that currency depreciation will lead to an automatic increase in the debt-to-GDP ratio, further raising the probability of a debt crisis.[10] Self-fulfilling crises are less likely in the context of domestic currency debt because a credible central bank can buy local currency bonds and avoid a spike in the interest rate. Under these conditions, the local central bank can act as lender of last resort and prevent a self-fulfilling crisis.

Allowing a portion of Ruritania's restructured debt service to be discharged in local currency and invested in suitable projects in the country thus acts as a safeguard against the risk that skepticism about the adequacy of the debt relief provided by the restructuring may trigger a self-reinforcing downward spiral. Ruritania's external debt dynamics are improved albeit at some fiscal cost to the domestic budget. History teaches, however, that an emerging market sovereign debt crisis is far more likely to be triggered by doubts about the sovereign's ability to service its external debts than it is by concerns about domestic fiscal policies.[11]

Naturally, there are limits. In the presence of fiscal sustainability problems, Ruritania may have to monetize part of the debt (with some consequence in terms of inflation) or use some form of financial repression to convince domestic agents to absorb the debt (with

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[10] This is the original sin issue discussed in Barry Eichengreen, Ricardo Hausmann & Ugo Panizza, *The Pain of Original Sin*, in OTHER PEOPLE'S MONEY: DEBT DENOMINATION AND FINANCIAL INSTABILITY IN EMERGING MARKET ECONOMIES (Barry Eichengreen & Ricardo Hausmann eds. 2005).

[11] For a discussion of these tradeoffs between inflation dilution costs and expected default costs, see Patrick Bolton & Haizhou Huang, *The Capital Structure of Nations*, 22 REV. FIN. 45 (2018).

negative consequence on the efficiency of capital allocation). The cost of these actions will depend on their dosage. High levels of inflation and deep financial repressions can have costs that may even surpass those of a new external debt restructuring. If this is the risk, the technique highlighted above may not be desirable or may need to be employed sparingly.

The foregoing is not the only technique available to countries seeking to reduce their carbon footprint. For countries especially vulnerable to the costs of inflation, other measures are available. In countries where use of this technique could cause inflationary or other domestic fiscal problems, there are measures that the debtor countries can take to minimize or neutralize those effects. For example, the imposition of a domestic carbon tax would take liquidity out of the system. The local currency released through this technique could then be deployed to compensate poor households that are negatively affected by that tax. The result would be an inflationary neutral arrangement fully consistent with the environmentally friendly objectives of the technique.

Using the technique we have described earlier to fund fossil fuel substitution projects (for example, solar or wind) should, over time, reduce the need to use the country's foreign currency reserves to import fossil fuels. If inflation proves to be a problem, those FX reserves can be used to purchase local currency from the system and thereby tamp down inflationary pressures. In the final analysis, however, because these measures would be taken in furtherance of a global effort relating to climate control, the debtor country could seek the assistance of the international community in covering some of the fiscal cost of implementing these arrangements.

A Species of Debt for Nature Swaps?

The technique described in this paper differs from the conventional debt for nature "swaps" in several ways. In a typical debt for nature swap (or any "debt for do-good" variation such as debt for health, debt for education and so forth), the sponsor seeks a donation or heavily-discounted sale of an item of the debtor country's foreign debt from an altruistically-inclined creditor and then agrees to cancel that claim in return for either a conservation commitment from the host government or a release of local currency that can be deployed for conservation purposes in the country. The transaction is marketed to the debtor government as simultaneously accomplishing the objectives of external debt reduction and promotion of a worthy cause in the country.

This conventional structure differs from our proposal in two important respects. First, we do not assume an altruistic spirit on the part of the country's creditors. Those creditors know that they must provide debt relief; the only questions are how much and how. Altruism doesn't enter into it. Second, rather than a one-off debt cancellation, our proposal calls for an on-going -- but optional -- discharge of a portion of the debtor's foreign exchange liability in local currency.

This is both a fail-safe mechanism (because if the sovereign abandons the project, its foreign exchange liability is not affected) and a safety valve mechanism (because if the inflationary consequences of release of the local currency become problematic, the sovereign can simply refrain from exercising its option). Once again, the key point is that, for a country facing the need to restructure its external debt, the ability to discharge a portion of that debt in local currency is a species of debt relief that under certain conditions will improve the sovereign's external debt dynamics and hasten its return to "market access" (the creditors' sole objective in a sovereign debt workout).

The catalyst for conventional debt-for-nature swaps is altruism. Either a creditor must donate the debt claim that fuels the transaction or someone must donate the money needed to buy such a claim. Finding such a big-hearted sponsor, coaxing them into a donative mood and assuring them that their generosity will be used as they intend are time-consuming and often frustrating tasks. This has no doubt contributed to the modest number and size of debt-for-nature transactions over the last 35 years.[12] Relying on altruism as the principal motivation to fund projects intended to help address an existential planetary threat strikes us as naïve. If the goal of environmental conservation is to be married with emerging market debt relief, it must be done on a much larger scale in order to make any significant contribution either to the planet or to the debt stocks of the recipient countries.

<u>Optimality for Whom?</u>

Another question that might be asked about a technique that funds environmental conservation through external debt relief is whether the sovereign, were it entirely free to spend the local currency that displaces a portion of its external debt service in any way the sovereign chooses, would elect to spend it on environmental conservation. A corollary question is whether, from the standpoint of economic efficiency, directing these resources toward environmental

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[12] For a discussion, see William K. Reilly, *Using International Finance to Further Conservation: The First 15 Years of Debt-For-Nature Swaps*, in SOVEREIGN DEBT AT THE CROSSROADS: CHALLENGES AND PROPOSALS FOR RESOLVING THE THIRD WORLD DEBT CRISIS (Chris Jochnick & Fraser A. Preston eds. 2006).

projects is the optimal use of the money. In other words, why not use the money to build a bridge, or a school or some other purpose?

There are two answers to these questions. The first is that the local currency that displaces an external debt service payment under this technique does not belong exclusively to the debtor country. That money was originally owed, as foreign currency, to the country's foreign creditors. It is only with the consent of those creditors that the country is being given the option to discharge a portion of its external liabilities by funding a creditor-approved project in local currency. The creditors therefore have a strong, indeed a commanding, voice in selecting the nature of the beneficiary project. Naturally, the country may try to argue that in the absence of this technique it would have succeeded in persuading its creditors to forgive outright the relevant portion of the debt. But in our hypothesis the country had already exhausted its negotiating prowess and there remained a difference in what the country was offering by way of financial terms and what its creditors were prepared to accept. A bid/asked gap of this kind is common, one might almost say inevitable, in sovereign debt negotiations. The most logical use of this technique is to bridge that gap quickly.

Second, asking "what is the optimal use of the money?" begs the question "optimal for whom?" The whole point of this technique is that foreign creditors are being asked to forgo receipt of a portion of their lending income in order to improve the country's external debt dynamics and thus enhance the collectibility of the balance of their claim (that's the selfish part) <u>and</u> contribute to solving an existential threat to the planet (that's the public-spirited, reputation-enhancing part). Whether there is a better or more politically popular use of the money in Ruritania is thus irrelevant; the question is whether there is a better use of the money for the planet.

Argentina 2022

The announcement at the end of January 2022 that Argentina and the IMF had reached a preliminary agreement on the refinancing of the IMF's $44.5 billion loan to Argentina may provide an opportunity to employ this technique to neutralize a contentious issue in that transaction, IMF surcharges.

The International Monetary Fund and the Argentine authorities announced in January that they had reached an understanding regarding the refinancing of the roughly $44.5 billion loan that the IMF extended to the country during the tenure of former President Mauricio Macri. The brickbats began flying almost immediately.[13] Outside of Argentina, the deal was criticized for its anemic fiscal adjustment conditions.[14] The credit rating agency Moody's went so far as to predict that "the likelihood of a new [private sector] debt restructuring remains very high".[15] Inside Argentina, the detractors argued that any IMF-prescribed fiscal adjustment was too much, given the circumstances surrounding the incurrence of the loan.[16] Both the Argentine legislature and the IMF's Executive Board must now approve the deal. There is at least one way, however, in which the IMF negotiators may be able to add a drop of honey to this medicine

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[13] *See* Patrick Gillespie & Jorgelina Do Rosario, *Maximo Kirchner Quits Argentine Congress Role in IMF Protest*, BLOOMBERG (Jan. 31, 2022).

[14] *See* Alejandro M. Werner, *Argentina and the IMF: A Never Ending Story*, AMERICAS QUARTERLY (Feb. 14, 2022).

[15] Gabriel Torres, Fernando Freijedo & Mauro Leos, *Government of Argentina: Potential New IMF Agreement Will Unlikely Avoid New Debt Restructuring on Private-Sector Debt*, MOODY'S INVESTOR SERVICE (Jan. 31, 2022).

[16] *See* Lucinda Elliott, *Argentina's President Struggles to Sell IMF Deal to a Skeptical Congress*, FIN. TIMES (Feb. 16, 2022).

and improve the chances that the arrangement will receive the necessary approvals.

As befits an institution whose role is to lend to countries facing severe financial distress, borrowing from the IMF is relatively cheap. Unless, that is, you borrow a lot or for a long time. The Fund's normal lending margin on loans from its General Resources Fund (the main lending platform) is just 100 basis points above the IMF's own cost of funds (currently a modest nine basis points). But if the loan exceeds 187.5 percent of the borrowing country's quota at the Fund, add another 200 basis points to the interest rate and if the loan remains outstanding for more than 36 or 51 months (depending on the type of program), add a further 100 basis points. The Fund refers to these supplemental amounts as "surcharges".

The IMF argues that these surcharges are needed to curb an over-reliance by members on borrowings from the Fund and to encourage members to pay back their IMF loans early so that the money can be recycled into loans for other needy countries. A third justification candidly acknowledges that the surcharges are a useful source of income for the IMF, helping the organization pay its administrative expenses like pensions and contributing to the accumulation of cash reserves (called, in the mellifluous euphemism of the IMF, "precautionary balances").

Fourteen countries are currently paying surcharges on their IMF loans. Argentina is, by far, the largest payor accounting for over half of all surcharges being collected by the Fund.[17] IMF loan surcharges are a sensitive subject, criticized both by member country borrowers

[17] *See* Jorgelina Do Rosario, *Argentina Urges IMF to Suspend Surcharges on $45 Billion Loan*, BLOOMBERG (May 11, 2021).

and by civil society groups.[18] We have argued in this article that a portion of the debt service payments on restructured sovereign debt instruments should be discharged by allowing the debtor to fund, in local currency, environmentally-friendly projects in the debtor country.[19] This improves the borrower's external debt dynamics by conserving international reserves while being simultaneously good for the debtor country's economy and the planet. The same technique could easily be adapted to IMF surcharges, particularly on its massive loan to Argentina. All or a portion of the surcharges could, at the sovereign debtor's option, be discharged by the funding of one or more pre-approved and independently monitored environment-friendly projects in the debtor country. That funding would represent the local currency equivalent of the displaced foreign currency surcharge.

Benefits? To the extent that surcharges are intended to encourage member countries to be economical in their borrowings from the Fund and to repay those loans quickly, those motivations would remain, albeit in a muted form. Local currency funding of environment-friendly projects in the debtor's own country — while not as objectionable to the sovereign borrower as shipping foreign currency outside of the country in the form of debt service payments — is still a charge on the public fisc. If the IMF seeks to ration use of its lending capacity by increasing the cost of its loans, allowing a portion of that cost to be paid in local currency remains an expense for the debtor country. In addition, by reducing the demands on the sovereign borrower's foreign currency reserves, this technique should

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[18] *See, e.g.,* Joseph Stiglitz & Kevin Gallagher, *Understanding the Consequences of IMF Surcharges: The Need for Reform*, Boston University Global Development Policy Center, Policy Brief (2021).

[19] *See also* Lee C. Buchheit & Mitu Gulati, *A Green Solution to Sovereign Debt Restructuring*, FIN.TIMES (March 25, 2021).

hasten the day when the member country can return to normal market financing — the objective of IMF programs.

From the standpoint of the IMF, this technique would both dilute a caustic feature of its lending policy and demonstrate the Fund's commitment to the global efforts on climate control. The projects being funded by the displaced surcharges could be administered by independent NGOs or UN agencies. They could involve, for example, fossil-fuel substitution, conservation easements, infrastructure resilience to climate-related events and so forth, all measures that should enjoy the active political support of the Fund's largest shareholders. Finally, applying this technique to the IMF's Argentine loan would give the Argentine authorities a public relations win, which may be essential in this case, without forcing a corresponding public relations or policy loss on the Fund.