Debt Swap for Green Recovery: Options, Challenges and the Way Forward for Pakistan

Muhammad Umar Ayaz, Sajid Amin Javed and Hina Aslam
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Acknowledgement

We are thankful to the participants of consultation meeting organized by SDPI to identify opportunities and challenges for Pakistan to acquire and implement debt swaps for green recovery and suggest the way forward accordingly. The consultation was chaired by former federal minister and adviser to prime minister of Pakistan for Climate Change, Malik Amin Aslam. Thanks are due to Sara Zafar Cheema of SDPI for initial proofreading of the draft. Support from ECF-TARA is recognized and appreciated.

Participants of the consultation meeting

<table>
<thead>
<tr>
<th>Sr. No</th>
<th>Name</th>
<th>Designation / Organization</th>
</tr>
</thead>
<tbody>
<tr>
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<td>Mr. Malik Amin Aslam</td>
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</tr>
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<td>Chief SDGs, Ministry of Planning and Special Initiatives.</td>
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<td>Senior Joint Secretary, Economic Affairs Division</td>
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<td>Head of Center for Islamic Finance (BIBF)</td>
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<td>Energy and Infrastructure, Principal Resources Future</td>
</tr>
<tr>
<td>7</td>
<td>Mr. Omar Mukhtar</td>
<td>Team Lead, SEED Pakistan</td>
</tr>
<tr>
<td>8</td>
<td>Dr. Sajid Amin Javed</td>
<td>Deputy Executive Director (Research), Head Policy Solution Lab, SDPI</td>
</tr>
<tr>
<td>9</td>
<td>Dr. Hina Aslam</td>
<td>Research Fellow, SDPI</td>
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Abbreviations

ADB  Asian Development Bank
CAREC  Central Asia Regional Economic Cooperation
CCRT  Catastrophe Containment and Relief Trust
DNS  Debt-for-Nature Swap
DSSI  Debt Servicing Suspension Initiative
EFF  Extended Fund Facility
ERF  Ecosystem Restoration
ESG  Environmental Social and Governance
FSB  Financial Stability Board
GHGs  Greenhouse Gases
IDA  International Development Association
IMF  International Monetary Fund
LDCs  Least Developed Countries
NDCs  Nationally Determined Contributions
NEPRA  National Electric Power Regulatory Authority
SASB  Sustainable Accounting Standard Board
SDGs  Sustainable Development Goals
SRI  Social Responsibility Investment Fund
TCFD  Task-force on Climate-Related Financial Disclosures
VRE  Variable Renewable Energy
Abstract:

This study proposes debt swaps for green recovery from COVID-19 in Pakistan. Debt swaps can provide a fiscal space tackling the country’s existing environmental and debt crisis simultaneously. Possible options and challenges faced by Pakistan under these swaps are discussed. G-20 countries have shortlisted Pakistan for debt relief. Linking Pakistan's financing needs to its NDCs while using green financing mechanisms can help benefit from these opportunities. For debt swaps, “ownership within the government” is a major challenge. Although there is a considerable support from the federal government, the ownership dissipates at provincial level. Most importantly, public sector has capacity issues in negotiating and implementing debt swaps, particularly at the provincial level. To benefit from debt swaps, Pakistan must develop a multisectoral approach to institutionalize the process with responsible stakeholder engagements bringing in a plan of action. Finally, Pakistan must adopt Natural Capital Accounting (NCA) into policy making and financing linking-up with debt swaps and nature bonds.
1. Introduction

This study highlights the importance of debt swap as an efficient option in order to stabilize the country’s economy and sustain the green recovery in future especially in the post-COVID era. The COVID-19 pandemic is one of the biggest challenges and a threat to global economy and human achievements. It has given rise to some of the worst socio-economic impacts, as the recession continues to deepen across the globe. Further, it has shrunk the global GDP by 5.2% (World Bank, 2020a). Though lockdowns were imposed to control the pandemic, they resulted in reduced economic activity worldwide, especially in the manufacturing and services sector. According to International Monetary Fund (IMF) a loss of $1.15 trillion has been incurred to global economy during this pandemic. Moreover, IMF estimates show that the COVID-19 outbreak has raised the global public deficit by 10%, which is higher than the global crisis of 2008-09.

During the pandemic, developing nations were unable to effectively deal with the ensuing health and financial fallout, given their limited fiscal stimulus and underdeveloped health facilities. The IMF and World Bank, together with domestic economies, have taken various fiscal and monetary measures to assist and stabilize the world economy, including providing financial aid, delaying debt repayments lowering interest rates. etc. In response to the pandemic, the IMF has provided financial assistance of around $170.57 billion to at least 90 countries in order to stimulate their economies during the crisis\(^1\). Besides, it has also increased its immediate disbursing capacity to meet the expected demand of approximately $100 million from 103 countries. Initiatives like the Catastrophe Containment and Relief Trust (CCRT) have allowed the IMF to delay debt payments, thereby encouraging emerging economies to instead redirect interest payments towards protecting domestic economies during the current crisis. Under this initiative, around $935.29 million has been released for debt relief to 29 economies\(^2\). With the support of G20, the World Bank and the IMF also undertook a bilateral debt relief programme, i.e., Debt Servicing Suspension Initiative (DSSI), to temporarily suspend the debt repayments of 73 low-income and middle-income economies for at least two years.

Even before the pandemic, debt burden across the developing world was extremely high, and was made worse by the onset of COVID-19. By 2019, the debt burden on 73 poor economies was $744 billion (World Bank, 2020b). Likewise, the debt level of emerging economies exceeded $8 trillion in 2019, rising from 110% of the GDP in 2010 to 170% of the GDP in 2019 (Steele & Patel, 2020). Countries like Zambia, Maldives, Rwanda, Ecuador, etc. have proclaimed to face issues in repaying their debt during the pandemic and have requested immediate assistance (Picolotti et al. 2020).

During the outbreak, the primary focus of countries remained limited to tackling health and economic issues in order to stabilize their economies, meanwhile attention was withdrawn from environmental issues, e.g. SDGs pertaining to Clean Environment. With this in mind, the Managing Director of the IMF, Kristalina Georgieva, stressed the need for resolving both the climatic as well as the economic crisis simultaneously by promoting green recovery. To this end, debt-for-climate swaps can provide a possible solution to resolve climatic issues, for example, curbing CO\(_2\) emissions, especially for emerging economies with higher debt levels and biodiversity loss\(^3\).

Debt swaps to protect the climate are an important mechanism in addressing three prominent issues; they can assist in debt sustainability during the current pandemic, support biodiversity and green recovery as well as stimulate sustainable economic growth in the long run (LIU, 2021). Till-date, around 30 economies (mostly in Latin America & the Caribbean) globally have adopted debt-for-climate swaps (LIU, 2021). Between 1987-2015, around $2.6 billion worth of debt swap agreements have been restructured across the globe out of which $1.2 billion

\(^1\)https://www.imf.org/en/Topics/imf-and-covid19/COVID-Lending-Tracker#CCRT
was invested in conventional projects (YUE & Wang, 2021). Moreover, during the pandemic, 29 global economies benefitted from debt swaps.

Debt-for-climate swaps create a win-win situation for all those involved by providing an opportunity to “build back better” especially in a post-COVID era, protecting the climate, human health and by creating more sustainable societies and resilient futures through debt suspensions (Picolotti, et al., 2020). Debt swaps go beyond providing mere funding channels for specific sectors and can help change processes, approaches, and systems towards green recovery (Steele & Patel, 2020). Through such initiatives, sovereign debt can be redirected towards fulfilling climate commitments and making considerable headway in achieving Paris Agreement Goals.

This study has been divided into following sections. Section 1 sheds light on how debt swaps can be used to achieve green recovery. Section 2 provides debt profile of Pakistan showing the need and space for debt swaps. Section 3 outlines Fiscal Stimulus Measures Promoting a Green Recovery. Section 4 provides a discussion on opportunities and challenges of debt swaps. This section is based on consultation meeting with stakeholders from Pakistan engaged in debt swaps. Finally, section 5 concludes the study by drawing way forward for Pakistan.

1.1 How Debt Swap Can Be Used for Green Environment

The idea of a debt-for-climate swap was first presented by Thomas Lovejoy, the Deputy Vice President of the World Wildlife Fund in the 1980s, during the Latin American debt crisis. The concept delineated a shift from indebted countries making external debt payments in a foreign currency to instead making debt payments in their domestic currency, channeled into local environmental projects, on terms settled by creditors. While such debt conversion can create fiscal space, the main objective of this swap remains to protect the climate and achieve the SDG agenda on Clean Environment.

Debt-for-climate swaps allow countries to address climate issues and undertake strategic measures to protect the environment from short-term pollutants like black carbon, methane, fluorinated gases, etc. Decreasing these pollutants can cause a sharp decline in rising temperatures, while raising efficient energy. Enhancing energy efficiency and clean technology infrastructures can, in turn, generate 2.5 times more jobs for every $1 million spent in comparison to fossil fuels (Hepburn et al. 2020).

The success of debt-for-climate swaps is mainly dependent upon the political will of an economy, i.e., its contributions to clean projects under the Paris Agreement. The higher the will of an economy (higher contribution), the higher the chances of success for green recovery (LIU, 2021). By spending more on climate issues, the debtor economy can achieve a sustainable and long-run climate recovery as well as global environmental objectives. Left unaddressed, these climatic issues create risk not only for nature but also for fiscal sustainability and debt burden. World economies together need to spend around $2.4 trillion annually till 2035 in the energy sector in order to keep temperatures below 1.5°C from pre-industrial level (Yeo, 2019).

Ensuring national ownership of these swaps is important for a number of reasons. Firstly, it helps guarantee that swaps fulfil local and national climate and biodiversity criteria. Secondly, locally designed activities (especially those designed with the help of communities directly impacted by these swaps) can be opted for, rather than imposing ideas from external bodies (Steele & Patel, 2021). Finally, support can be more effective if the focus remains purely on strengthening domestic institutions, for instance, managing the swaps through government structures.

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*List of these countries can be found in Appendix 1.*
1.2 How Debt Swap Is Different from Debt Relief

The debt swaps are legal agreements between creditor and debtor economies that provide opportunities to low-income economies to increase their capital for addressing policy challenges such as clean environment, economic development, health etc. at a discount rate. Under debt swaps, instead of paying loan payments to creditor countries in foreign currency, debt swaps allow indebted economies to make debt payments in local currency through alternative means agreed upon by creditor economies, such as investing in the green environment, good health and development, and so on. The major objective of debt swaps is to provide financial assistance on a discounted rate by allowing investments in the domestic economy, in order to sustain macroeconomic activities. Beside all these, there are few risks which are linked with debt swaps as it could decline the credit rating of a country.

On the other hand, under debt relief, the creditor countries can delay debt payments to free up resources, in order to assist domestic economies of indebted nations who are facing difficulties in repaying their debt. The creditor country can also reduce the principal amount of the loan and can also decline the interest rate on the loan. However, calling for debt relief signals a serious liquidity problem in the economy and can adversely affect the credit rating of the country in question, which is ultimately forced to borrow at a higher cost in the future. Therefore, debt relief is a poor option for economies hoping to continue to grow, raise foreign investments and improve international credit rating (OECD, 2007).

BOX 1

Debt Swap agreements are usually signed to provide fiscal assistance to those countries that are not in position to repay their debts. Accordingly, the creditor country usually swaps a portion of interest payment to achieve any specific target in the indebted country. Globally, debt swap agreements have been signed to achieve local development targets, i.e. (development, education, environment, equity, health, etc.).

Few examples of such swaps are given below;

<table>
<thead>
<tr>
<th>Different Types</th>
<th>Purpose of such swaps</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt swap for healthcare</td>
<td>To finance healthcare system</td>
<td>The Global Fund’s Debt2Health</td>
</tr>
<tr>
<td>Debt swap for education</td>
<td>To finance education</td>
<td>El Salvador (2005-2013)</td>
</tr>
<tr>
<td>Debt swap for equity</td>
<td>In order to attract Foreign Direct Investment (FDI)</td>
<td>Chile (1985)</td>
</tr>
<tr>
<td>Debt for nature swap</td>
<td>To ensure green climate including nature conservation programs</td>
<td>The Seychelles (2015)</td>
</tr>
</tbody>
</table>

Source: (LAZARD, 2021)

1.3 Mechanisms of Debt-for-Nature Swap (DNS)

Debt-for-climate swaps are among the few important techniques that can sustainably support the economic growth of a country, while simultaneously utilize domestic expenditures to protect public goods. To attain green recovery, the problem of public debt must be immediately identified in order to provide the fiscal space needed to finance health crises and raise green investments.

Debt-for-environment swaps are positively linked with the economic development of the debtor country to provide assistance in channeling greater investment into the domestic economy. Moreover, sustainable utilization of resources may also create green jobs and helps achieve the green recovery in the post-pandemic era as shown in Figure 1.
The mechanisms through which both highly and lowly indebted economies achieve green recovery are discussed below in Figure 2. Under this mechanism, significant and comprehensive debt swaps can be granted to highly indebted economies by public creditors in order to stabilize their economies. Indebted governments would then need to commit to new reforms and policies that aligns with the 2030 SDG Agenda and the Paris Agreement. Moreover, the involvement of the private sector alongside the public sector, is also mandatory for achieving these goals in the case of highly indebted countries (Figure 2). To protect the participation of the private sector, the involvement of the IMF will be influential (Hagan, 2020). If a debt sustainability evaluation declares the debt of an economy to be of critical concern, the IMF can design conditional programmes by including private creditors for sovereign debt reforms.

Less indebted economies represent those countries that are not under high debt distress, yet still face a decline in their financial resources as a result of the COVID-19 pandemic (Figure 2). For such economies, debt swaps are only additional measures or investments in climate mitigation and adaptation. Moreover, such swaps can be voluntary, and the creditor economy can also deny participating in such kinds of debt swaps.

Channels through which indebted economies can implement debt-for-nature swaps are discussed below in Figure 3. Generally, without debt restructuring, a simple relationship of loans and interest payments exists between debtor and creditor economies. In case of debt swaps, however, the negotiations between creditor and debtor governments can lead towards debt-for-climate swaps.
Under such agreements, creditor bodies can sell debts to environmental organizations at a discounted rate. The indebted economy will then pay interest payments to these funded organizations. Moreover, these environmental trusts also receive funding from international bodies, e.g. NGOs. Later on, this amount is invested into local climate programmes for achieving green recovery.

1.4 Debt-Swap Arrangements

Over time, different debt swap arrangements had been conducted among parties out of which the considerable are mentioned below.

- Bilateral Arrangements: Such arrangements are made directly between the creditor and debtor nations for attaining investment for development.
- Multilateral Arrangements: Such arrangements are jointly agreed upon between several creditor economies and the swapped amount is then deposited in the same exchange value amount, e.g. the 1992 ECO Fund, which was created by creditors from Poland and the Paris Club as well as debt-for-health swaps by the Global Fund.
- Triangular Arrangements: In such arrangements, the debtor economy sells its debt to a development agency or NGO, which later negotiates its repurchasing value with the creditor economy.

1.5 Scope and objectives

The overall purpose of this particular study is to utilize the debt swap as an option to achieve the green recovery in the post-COVID-19. Accordingly, objectives of this study are as follows:

- To explore the status quo of Pakistan's debt profile and current economic situation in the country;
- To highlight the potential of debt swaps for green recovery in context of Pakistan;
- To identify the opportunities and challenges of debt and opportunities for Pakistan;
2. Pakistan’s debt profile

Pakistan is confronted with severe issues of high debt. The debt profile of Pakistan is widening with the passage of time which may not only affect the socioeconomic conditions but also may create uncertainty in the country. Before the pandemic, Pakistan was trying to stabilize its economy, which is faced with both a current account deficit and a fiscal deficit. For this, Pakistan became a part of the IMF’s Extended Fund Facility (EFF) programme with the objective to remove economic vulnerability, maintain sustainable economic growth, and reduce public debt.

Even after the onset of COVID-19, Pakistan faced fiscal instability in the face of higher health and financial demands. To stabilize its economy, Pakistan received financial assistance of around $1.386 billion from the IMF. Additionally, the World Bank also provided $200 million to help Pakistan during the pandemic. An emergency assistance of $300 million was also provided to Pakistan by the Asian Development Bank (ADB). Moreover, Pakistan was also included in the G20’s Debt Servicing Suspension Initiative (DSSI) for 20 months (May 2020 to December 2021). Through this initiative, the country’s debt servicing was dropped by $3.7 billion during the given period. Besides, Pakistan also received debt relief of around $188 million from the World Bank.

According to (IMF, 2022), Pakistan’s total government debt hiked to 81.1 percent of GDP in FY2020-21 which is expected to drop at 78.9 percent in FY2022 as shown in figure 4. Similarly, according to SBP, gross public debt is reached 83.5 per cent of the GDP during FY21, which is lower in comparison with previous year. In FY 2020, it was 87.6 per cent of the GDP.

![Figure 4: General Government debt of Pakistan (%age GDP)

However, the circular debt of Pakistan is also increasing. The average distribution and transmission losses of power sector is around 17% of total GDP, higher than the targetted, i.e. 13.4%. According to NEPRA (2021), the circular debt of Pakistan was reached around PKR 2.28 trillion in 2020-21 from PKR 2.15 trillion during the same period last year. Similarly, in 2018, the accumulated circular debt was around $ 9.5 billion (around PKR 1.14 trillion) that soared to $14 billion (PKR 2.5 trillion) during three years and is expected to be around PKR 4 trillion by 2025, if continues to grow at the same pace. Moreover, it has been observed that the circular debt of Pakistan during initial six months of FY2021-22 is growing at a pace of the gap is expanding by PKR 38 billion every month.

\[\text{List of these countries can be found in Appendix 1.}\]

\[\text{https://www.thenews.com.pk/print/939090-circular-debts#:~:text=In%202018%2C%20when%20the%20PTI,5%20trillion%20(%2414%20billion).}\]

2.1 Current Debt situation: status quo and outlook

The COVID-19 crisis has badly impacted a number of emerging economies, including Pakistan, where it has reversed economic growth by lowering all activities. The real growth rate of Pakistan remained at -0.4% during FY 2019-20 (July-June), which is expected to rise by 4% in the current fiscal year FY2021-22 (IMF, 2022). This lowering of the economic growth occurred due to a slowdown in economic activities, especially in the manufacturing and services sector, which account for around 80% of the total GDP (ICMA, 2020). Moreover, estimates show that during the current crisis, Pakistan has borne an economic loss of around PKR 1.1 trillion during FY 2021 (Rasheed, et al., 2021). According to IMF (2022), the external debt of Pakistan was reached around $108.77 billion during FY2019/20, which was lower ($93.96 billion) during FY 2017/18 and is projected to be rise to $153.81 billion till FY 2025/26 as shown in Figure 5.

![Figure 5: Estimate and Projected External Debt of Pakistan (billion USD)](Source: IMF Country Report Feb, 2022)

According to EAD (2020), two major reasons remain behind getting foreign assistance: 1) to achieve sustainable socio-economic growth, which, in turn, aids in minimizing inequality and poverty, and 2) to finance fiscal imbalance in order to ensure macroeconomic stability. From July 2020 till February 2021, Pakistan received around $7,208 million, which accounted for nearly 59% of its total budget, i.e. $12,233 million (EAD, 2021). The composition of these external inflows is shown in Figure 7. Around 43% of total external inflows were used to pay interest payments while 14% consisted of safe deposits from China, used to assist in economic activities.

![Figure 7: Composition of External Inflows during Jul 2020 – Feb 2021 (Million USD)](Source: Ministry of Economic Affair)
In Pakistan, the major source of external debt remains multilateral and bilateral bodies. Till end-June, 2021, the external debt of Pakistan was stood at $86.4 billion of which the share of multilateral and bilateral bodies remains around 48% and 30% respectively as shown in Figure 6. However, the share for commercial banks stood at 13% of the total external debt.

![Figure 6: Compositions of Foreign Public Debt of Pakistan (Source: Ministry of Finance)](https://www.finance.gov.pk/publications/DPS_2022.pdf)

Similarly, according to IMF (2021a), Pakistan’s outstanding debt has reached to $90.12 billion out of which a greater portion of the debt has been received from multilateral bodies (constituting nearly $33.74 billion). Throughout the EFF period, Pakistan plans on repaying around $38.56 billion till FY 2023 (Table 1). Greater debt repayments of around $21.55 billion will be made during FY2021/22, while the least will be paid in FY 2023.

Table 1: Public External Liabilities and Repayment Schedule (Million USD)

<table>
<thead>
<tr>
<th>Source: IMF Report 2021</th>
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<tbody>
<tr>
<td><strong>Amortization over the EFF Period</strong></td>
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<tr>
<td><strong>Paris Club</strong></td>
</tr>
<tr>
<td><strong>Non-Paris (Bilateral)</strong></td>
</tr>
<tr>
<td><strong>Multilateral</strong></td>
</tr>
<tr>
<td><strong>IDB</strong></td>
</tr>
<tr>
<td><strong>ABD</strong></td>
</tr>
<tr>
<td><strong>AllB</strong></td>
</tr>
<tr>
<td><strong>ECO Trade Bank</strong></td>
</tr>
<tr>
<td><strong>IBRD</strong></td>
</tr>
<tr>
<td><strong>IDA</strong></td>
</tr>
<tr>
<td><strong>Int’l Fund for Agri. Development</strong></td>
</tr>
<tr>
<td><strong>Nordic Development Fund</strong></td>
</tr>
<tr>
<td><strong>OPEC FUND</strong></td>
</tr>
<tr>
<td><strong>Commercial</strong></td>
</tr>
<tr>
<td><strong>China</strong></td>
</tr>
<tr>
<td><strong>Others</strong></td>
</tr>
<tr>
<td><strong>Bonds</strong></td>
</tr>
<tr>
<td><strong>IMF</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

In the light of this, whether or not Pakistan will have abundant reserves to repay all its debt payments remains to be seen. Pakistan’s available financial resources are low compared to its required resources. IMF projections show that Pakistan will face a reserve deficit of around $-2,181 million in FY 2020/21, and around $-3,442 million and $-1,242 million in 2021/22 and 2022/23 respectively (Table 2).

Table 2: Pakistan Gross Financing Requirements and Sources, (Million USD)
Source: IMF Report Feb, 2022

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross External Financing Required (A)</td>
<td>30,005</td>
<td>25,552</td>
<td>23,430</td>
<td>21,551</td>
<td>30,417</td>
<td>35,068</td>
<td>41,882</td>
</tr>
<tr>
<td>Available Financing (B)</td>
<td>23,873</td>
<td>23,103</td>
<td>25,497</td>
<td>26,174</td>
<td>31,275</td>
<td>33,450</td>
<td>41,335</td>
</tr>
<tr>
<td>Remaining Financing Needs (C=A-B)</td>
<td>6,132</td>
<td>4,449</td>
<td>-2,076</td>
<td>-4,632</td>
<td>-858</td>
<td>1,618</td>
<td>546</td>
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<tr>
<td>Borrowing from IMF(D)</td>
<td>0</td>
<td>0</td>
<td>2,834</td>
<td>499</td>
<td>3,056</td>
<td>1,085</td>
<td>0</td>
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<td>Reserve Assets (decrease = +) (E=C-D)</td>
<td>6,132</td>
<td>4,449</td>
<td>-4,901</td>
<td>-5,122</td>
<td>-3,914</td>
<td>533</td>
<td>546</td>
</tr>
</tbody>
</table>

The State Bank reported Pakistan’s total debt servicing at around $13, 424 million during FY 2021, of which the principal payment constituted of $10,187 million, while the remaining amount covered interest payments (Table 3). However, in FY 2022, the debt servicing stood at $15,071 million of which $2,978 million remains the interest payments.

Table 3: Pakistan External Debt Servicing (Principal + Interest) ($ Million)
Data Source: SBP database

<table>
<thead>
<tr>
<th>Description</th>
<th>FY – 20</th>
<th></th>
<th>Total</th>
<th>FY – 21</th>
<th></th>
<th>Total</th>
<th>FY-22</th>
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<th>Total</th>
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<tbody>
<tr>
<td>1. Public debt (1+2+3)</td>
<td></td>
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<td></td>
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<tr>
<td>• Government debt</td>
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<td>9,936</td>
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<td>2,318</td>
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<td>• From IMF</td>
<td>7,118</td>
<td>1,872</td>
<td>8.89</td>
<td>5,856</td>
<td>1,303</td>
<td>7,159</td>
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<td>• foreign exchange liabilities</td>
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<td>160</td>
<td>904</td>
<td>1,079</td>
<td>150</td>
<td>1,229</td>
<td>1,014</td>
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<td>5320</td>
<td>3,000</td>
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*P= Principle Value, **I= Interest Value

Similarly, during July 20- June 21, the debt servicing of Pakistan was stood at $8,393 million out of which the $6,940 million was the principal payment whereas the remaining $1,453 million was categorized as interest payments as shown in Table 4.
Besides the debt crisis, Pakistan is also bearing an economic loss due to climate change. According to GCRI 2021, Pakistan was enlisted as the 8th most vulnerable countries across the globe due to climate change causing an economic loss of around $3.8 billion between 1998 – 2019 due to 173 extreme weather conditions. However, the current flood caused by the climate change incurred an economic loss of roughly $10 billion that accounts for around 3.42 % of the GDP. Similarly, the per annum economic cost of climate change in Pakistan is $3.8 billion, i.e. equivalent to 1.3% of the GDP⁹.

In this context, the post-COVID era has certainly provided Pakistan an opportunity to recover its economy from depreciation while sustaining it with a green stimulus by focusing on two objectives: protecting the environment and creating employment¹⁰. Keeping this in mind, debt-for-nature swaps may be useful in tackling the country’s debt burden, boosting sustainable economic growth and tackling environmental issues simultaneously. Instead of repaying the debt payment, Pakistan can utilize the payment to support renewable energy in the existing exergy sector. It could be easy as Pakistan has already been part of DSSI debt concession initiative.

### 2.2. Debt Swap Agreements of Pakistan

Debt swap is not a new concept for Pakistan as such swaps have already been done with Paris Club members. donor nations. For instance, in 2006, Italy eliminated half of its debt to Pakistan in exchange for projects for Afghan refugees living there, while the rest of the half debt swapped was formed (active as of 2009) for development that included funding environmental protection and basic infrastructure projects. The timeline for the Pak-Italian Debt Swap Agreement (PIDSA) was extended till 2020. Similarly, Pakistan and Canada also inked a debt swap agreement in 2006 for a total of $392 million to be used for anti-poverty programmes and education¹¹.

On the occasion of World Environment Day 2021, Pakistan signed new debt swap MoUs with Paris Club member countries, including Canada, Germany, UK, and Italy for achieving green recovery in Pakistan. Pakistan owned around $11.54 billion from these countries, including $175 million from Italy, $403 million from Canada, $5 million from UK, and $1.42 billion from Germany. Through this MoUs, the debt amount will be utilized for green recovery instead of paying back to creditor economies¹².

Despite this, such swaps are undoubtedly associated with numerous challenges, including the alignment of incentives between potential creditors and lenders, poor governance and monitoring system, poor implementation due to unequal ownerships issues at different governmental level, etc. which on the other hand limits such swap agreements and performance as well.

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¹⁰https://www.weforum.org/agenda/2021/02/pakistan-green-recovery/
¹²https://www.arabnews.pk/node/1867931/pakistan
2.3 Fiscal Stimulus Measures Promoting a Green Recovery

Pakistan took the opportunity provided by COVID-19, to amalgamate its economic development to its environment. For this, it used a number of innovative financial instruments.

2.3.1 The Green Stimulus Package

Introduced early 2020, the ‘Green Stimulus Package’ is a concerted effort to address rising pandemic-induced unemployment, while simultaneously resuming climate action. Expanding on the ‘10 Billion Tree Tsunami’ initiative, the government gave the forestry sector a go-ahead to resume activities by employing thousands of jobless labourers to plant trees and protect national parks (and conversation areas) from illegal logging and accidental fires.

The package has effectively created a pool of employment opportunities, spending nearly PKR 10 billion to generate 85,000 jobs so far, with the plan to bring in 115,000 additional placements in the coming months (Khan, 2021). Furthermore, the World Bank also pledged $120 million this year (2021) to support the initiative (PID, 2021).

2.3.2 ‘Debt for Nature’ Swap Scheme

The ‘Debt for Nature’ swap scheme was introduced as a financing tool to aid countries in making headway on their debt crisis, while concurrently allowing them to continue undertaking climate action. In exchange for some form of debt relief (whether a discount on the principal amount, lowered interest rate or complete debt forgiveness), Pakistan would be able to locally fund domestic conservation and climate change initiatives through money saved from the exchange. The scheme is currently in the pipeline, with efforts being undertaken to attain $1 billion in funding.

2.3.3 Ecosystem Restoration Fund (ERF)

The ERF was launched to help Pakistan incorporate serious restoration and conversation efforts into its post-COVID-19 recovery (Aslam et al. 2021). Initiatives include development of ecotourism, afforestation, ocean and land biodiversity conservation, etc. ERF will also support the ‘Recharge Pakistan’ initiative, which intends to redirect floodwater to restore 14 wetland ecosystems along the Indus basin. Additionally, $188 million have also been signed under “Pakistan Hydromet and Ecosystem Restoration Services Project” for afforestation and ecological preservation efforts.

2.3.4 Green Euro Bond

Pakistan kickstarted its entrance into green and sustainable investment by issuing green euro bonds, with plans already underway to issue bonds for $500 million through WAPDA. These funds will be utilized for the development of hydroelectric power.
3. Financing Needs for a Green Recovery of Pakistan

3.1. Renewable energy

Pakistan’s plan for transitioning towards clean energy involves attaining a 30 per cent share of Variable Renewable Energy (VRE) by 2030. Pre-COVID, Pakistan would have needed a total of $108 billion by 2030 to get its energy sector back on track towards a green recovery. As a result of the pandemic, investment needs have fallen by $10 billion, therefore, the country would now require a total of $98 billion by 2030 (Aslam, et al., 2021). However, investment requirement are likely to increase after 2028, when business-as-usual is no longer a viable option for the country’s energy sector. In this case, an additional $12 billion will be required in 2030, ‘with an increasing trend afterwards’ (Figure 10).

A World Bank (2020) study analyzed 18 different energy scenarios in an attempt to calculate Pakistan’s optimal energy mix and the capital investment needed to achieve it. It found that if the government policy targets for renewable energy are followed, Pakistan could attain a 30 per cent VRE by 2030, through a 9 per cent wind and 21 per cent solar mix, which would cost a total of $110.02 billion (World Bank, 2020b).

However, an optimized energy mix will require a greater utilization of renewables, with VRE constituting 30 to 33 percent of total capacity, through a 7.7 percent wind and 25.3 percent solar mix by 2030. This would cost a total of $106.5 billion (total costs, including emission costs) - 3.3 per cent cheaper than the government policy target scenario (World Bank, 2020). The optimum VRE scenario will not only save costs in the future but would generate lower emission levels, less negative externalities and remain economically and environmentally more beneficial.

3.2. Green transport

A low-carbon transport system is crucial to ensuring cities remain sustainable moving forward, which, in turn, is dependent upon the presence of sustainable and reliable transport infrastructure. To achieve this, a total investment of $38.5 billion will be required till 2030 (Standard Chartered, 2020) - amounting to an annual investment of $3.85 billion, which constitutes almost 1.2 per cent of the GDP. This total investment is higher than that of the recommended for Sri Lanka (Figure 11), while far below than that of Bangladesh or India.

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14 In contrast, the IFC estimates total transport infrastructure investment opportunity for Sri Lanka and Bangladesh at $326 million and $23.7 billion respectively, from 2018 to 2030 - used to catalyze a shift to mass public transport. **Invalid source specified.**
3.3. Climate Smart Agriculture

The agriculture sector of Pakistan is considered as the second largest contributor of GHG emissions, emitting around 43 per cent of total GHG emissions. To overcome this, there is a need for a shift towards Climate Smart Agriculture Innovations. For this purpose, an abundant funding is required which is not possible for Pakistan with a constraint budget. According to the World Bank (2010), funding of roughly around $2.5 billion to $2.6 per annum is needed to spend between 2010 – 2050. According to (UNFCCC, 2008), emerging economies needed around $12.25 billion to $14 billion per annum till 2030 for mitigation from agriculture sector.

3.4. Clean Water and Sanitation

Water scarcity is also becoming a serious issue in Pakistan as it is causing negative impact on public health and economy. Although, Pakistan has the world’s largest glacier but still Pakistan is enlisted as 36th among most water stressed countries. Around 80 per cent of water supply is considered unsafe whereas diseases and water scarcity are incurring an economic loss equivalent to 1.44 per cent of GDP (Kundi, 2017). Similarly, 90 per cent of total water demand is coming from agriculture sector. According to (Watts, et al., 2020), Pakistan needs approximately $12.3 billion per annum with a capital investment of $7 billion and $5.3 billion in operations and maintenance to achieve the SDG goal of clean water and sanitation.
4. Opportunities and Challenges of Debt-for-Nature Swaps (DNS)

While the country has already been working to acquire and implement debt-for-nature swaps and green bonds, there is a potential to expand beyond this. Debt-for-development swaps can free up resources for investment in many crucial areas, e.g., health, education, tackling infectious diseases, such as HIV, etc. Additionally, Debt Conversion Development Bonds allow budgetary room through debt cancelation and by issuing bonds for development in local capital markets.

Pakistan can learn from countries such as Colombia, which deployed Social Impact Bonds to provide support and training to unemployed individuals. Similarly, India undertook Development Impact Bonds to invest in girls' education in Rajasthan (Ortiz, et al., 2017). Overall, such innovative financial tools ensure that more resources are directed towards development still helping Pakistan manage its debt problem.

Debt-for-climate swaps can be used as a tool to assist developing economies like Pakistan achieve sustainable growth while protecting the environment. It is not a new method of financing foreign debt, rather has been used for several decades. For further context in the case of Pakistan, the Sustainable Development Policy Institute organized a roundtable discussion on the topic of debt swaps for a cleaner environment. Ensuing discussions shed light on the significant potential and opportunities that debt swaps provided for Pakistan. These are mentioned below:

4.1. OPPORTUNITIES

i. Linking Pakistan’s financing needs to its NDCs, using green financing mechanisms.

Pakistan faces a huge issue in providing the sufficient financing for climate projects due to limited resources. Around $254.9 billion green financing is needed till 2030 to shift energy, transport, agriculture, and water sector towards carbon resilient technology. The estimated federal expenditures for climate change account for around 5.8% to 7.6% of total expenditures (GCCF 2017). The annual average cost of climate change mitigation and adaptation for Pakistan will vary from $14 billion to $32 billion till 2050. Similarly, annual needs of Pakistan for climate adaptation fall between $7 billion to $14 billion (Mahmood, 2019). Through green financing mechanisms, Pakistan can link its financing needs to its NDCs as well as a mid-century long-term strategy, which it has already started developing. It will create not only greater ownership but also strengthen the national climate action.

ii. G-20 countries have shortlisted Pakistan for debt relief.

Pakistan has been shortlisted for debt relief by the G-20 countries. During first two phases of debt relief programme, Pakistan received an amount of around $2.5 billion and is also expecting an additional $1 billion debt relief in the third phase of DSSI (Rana, 2021a). This relief can be further linked with nature performance and green jobs. Pakistan has already put a “debt for nature” scheme in pipeline that targets $1 billion funding and is subjected to re-negotiations of Pakistan’s increasing debt with countries that are supporting a green recovery. Additionally, in June 2020, Pakistan received funding of around $188 million from the World Bank to support green recovery for the next five years (Pakistan’s Today, 2020). Moreover, restructuring the currently available funding from the ADB can also push things towards a nature-friendly path.

15For the complete list of participating panelists, please refer to Appendix 1.
16Based on the values discussed in the previous section.
iii. Role of Private Sector Financing

Private-sector financing institutions also play a vital role in mobilizing finances for nature-based solutions. They provide incentives for sustainable and responsible investments based on enhanced technological advancements and credible data to prioritize locations and projects. According to the World Bank (2020c), private financing must be utilized for maintaining biodiversity and environmental services globally. Similarly, according to (DCED, 2020), engaging private sector such as small & medium enterprises, informal sector, youth and women-led enterprises for green recovery are more appropriate as they are most likely to be left behind.

iv. The UK Prime Minister has committed £3 billion for green financing

The UK prime minister has committed £3 billion of the UK’s 11.6 billion pounds of international finance to be invested in nature programming in countries like Pakistan. UK stands ready to work with the government of Pakistan to prepare an agenda for action on nature-based financing that can be showcased not only at the COP but also at the policy critical events throughout this year and post-COP 26. Such programmes may last for several years in which investment in climate change activities occur with regular intervals. Therefore, international organizations co-finance such projects in the indebted economies leading them towards more investment in adaptation and mitigation.

v. Climate-Related Financial Disclosure (TCFD) for providing information

There is a taskforce on Climate-Related Financial Disclosures (TCFD), created in 2015 by the Financial Stability Board (FSB) to develop consistent climate-related financial risk disclosures used by companies, banks, and investors, which provides climate-related information to stakeholders. There is also a Sustainable Accounting Standard Board (SASB), which provides opportunities to investors in order to ensure that every financial decision takes climate change into account and all economic decisions are made wisely and sustainably. This TCFD offers an opportunity for enterprises in Pakistan to ensure green activities in order to attract foreign investors in the post-COVID-19 era.

4.2. Challenges

In addition to many opportunities, debt swaps present a number of challenges as well:

i. Ownership within Government – which dissipates at district or provincial level

For debt swaps, “ownership within the government” is a major challenge. Although there is a considerable support from the top federal representation, the ownership dissipates at the provincial level. Similarly, public sector also has capacity issues especially at provisional level. These ownership issues further increase the capacity issues.

ii. Credibility trade-offs

The debt swap affects the credibility of indebted economy. The lending market should take it as signal of “not having capacity to pay” as it can affect the future borrowing by limited availability of resources and rising borrowing cost. Usually, economies call for debt swap or debt relief when they are unable to repay their debt. According to OECD (2007), calling for debt swap can affect the credit rating of the debtor country ultimately rising borrowing cost for future.
iii. Who will lead debt swaps?

The debt for nature swap is a time taking and complex phenomenon as a timeframe is required for designing and implementing the initiative. For this, understanding and collaboration between ministries is mandatory. According to OECD (2007), the finance ministry is essential for this as it leads towards negotiations with the creditor economies. Similarly, it is also not possible without the participation of ministry of climate change. The Ministry of Climate Change needs to highlight the potential and benefits of debt swap to the Ministry of Finance and other ministries concerned for successfully launch the programme. It could be a challenge for Pakistan as both ministries have different opinion on the basis of market credibility and resource availability.

iv. Absence of a committee or any formal authority/body needed to supervise the implementation and monitoring mechanisms of debt swaps

Another challenge in implementing green projects through debt swaps is the absence of a monitoring committee and other formal bodies which are responsible for supervising that how such plans would be implemented at the ground level as well as keeping an eye on the measures needed to improve such plans.

v. Absence of “Environmental Social and Governance (ESG)” standards and guidelines for the private sector and international financing institutes

Another challenge for implementing green projects, and negotiating debt swaps is the absence of environmental standards, which limit the private and international funding. Currently, Pakistan does not have an “Environmental, Social and Governance” profile/framework to clearly outline its ESG standards and goals. This makes it difficult for private sector and international financing institutes to get any views of our green financing mechanisms, economic quality, community engagement, and our expected returns for a long-term.

vi. Issues around the alignment of incentives, especially between international creditors and Pakistan

There are issues around incentive alignment, especially between the international creditors and Pakistan. Before signing debt swap agreements, it should be ensured that the benefits of debt swaps are substantial to the government in terms of debt relief, and are substantially more than the cost of climate commitment as the net gain for the country remains zero if the cost of these swaps would be higher than the benefits.

a. Appropriate mechanism for implementing green projects lack

Another similar challenge is devising a mechanism through which these debt for nature swaps and bonds are used to reduce the reliance on fossil fuels and building infrastructure for achieving climate goals. A just energy transition would also require a multi-stakeholder approach in addressing these challenges and creating a socio-economic multiplier effect for Pakistan. Similarly, implementation of interest-based projects or agreements would be difficult to include in Islamic banking or the “Shariah Law”, which prohibits the use of interest.

vii. Issues of negotiating debt swaps

Negotiations for any debt swap mechanisms are a lengthy process since Pakistan has to convince the creditor country on how to let go off the debt claims and the potential areas where they want the money to be swapped. Furthermore, normally, a third party (such as an NGO or another international organization) is involved, that is willing to buy debt from original creditors as to enter a refinancing agreement with the creditor country.
The mechanisms and institutional arrangements to identify and assess options for debt swaps are inadequate

The effectiveness of debt swap is highly depending on whether the indebted country is financially capable to make long-term commitments for such swaps or not. A sufficient amount is needed to spent on adaptation and mitigation activities through the debt for nature swap. Generally, the amount of debt swaps is not very large as compared to what a country generally wishes for. Hence, despite a lengthy procedure and a hectic homework, spending insufficient amount on green projects may crowd out the public priorities projects which ultimately reduce the impact of debt swap. This will require a proper background work to identify possible debt swaps and their cost-benefit analysis, which seems missing currently.

Preferred partners for debt swaps

As, the debt swaps/reliefs effects the credibility of the indebted economy and hence it is very important to choose the suitable partner. Calling for loss efficient debt swap program with an inappropriate partner will challenges for future borrowings.

4.3. How to minimize challenges

1. During pandemic, debt relief initiatives were given to the LDCs to stabilize their economies. A more systemic global efforts for debt swap for green recovery could minimize the problems and challenges in the post-COVID era.
2. Multilateral institutions such as the ADB, IMF, UN, and World Bank can take lead in promoting debt swaps for nature in the post-pandemic era by establishing more direct approaches such as principle, policy research, and guidance, which lead towards debt swap implementation.
3. Rather to requesting individual countries to submit debt swaps requests, a technical committee should be formed to determine the size and eligibility of debt swap for different countries. The borrowing and lending countries then directly negotiates on such swaps.
4. Temporary debt suspension Initiatives like Debt Servicing Suspension Initiative (DSSI) IMF and WB with G20 has been taken for temporary suspension of debt repayments. It could be used as an efficient platform for swaps for green recovery.
5. Another way to tackle these issues is to engage private sector lenders and State Bank at the early stages. The participation of private sector can generate more fundings.
5. Way Forward for Pakistan

After the COVID-19 outbreak, many developing nations encountered the liquidity issues as they were unable to repay their debts and protect their economies. The IMF and the World Bank took measures to resolve this by providing financial assistance to around 103 global economies. The post-COVID era provides an opportunity for countries to better recover by achieving green recovery. For this, DNS provides a possible solution - fulfilling both environmental and debt obligations simultaneously. Through these swaps, indebted countries can free up their resources to spend into their domestic economy, protecting it against the pandemic.

Pakistan has the potential to improve its options for debt swaps and attain green recovery through DNS. Joining this programme, Pakistan will free up resources, which can be redirected towards attaining green recovery and stabilizing the economy. Moreover, it will also boost domestic investment, raise employment and attract international funding. As an emerging economy, poor governance and instable financial conditions can pose serious challenges for Pakistan in achieving this programme. For this, our recommendations to improve the likelihood of a successful DNS programme are as under:

1. The first issue is how to overcoming the existing coordination gap between different levels of the government. To this end, there is a need to form a coordination committee, consisting of all stakeholders, i.e. federal, provincial and district governments that can aid in implementing such mechanisms at the ground level.

2. Provinces need to come up with their own plans and implementation framework. They need not to wait for intervention from the federal government, as they are independent in their decision-making on environment and climate change. For example, the KP government has recently signed a separate MoU with the IMF.

3. For a successful debt swap project, Pakistan needs to put in place a whole of multi-stakeholder approach to institutionalize a process that brings all players to a table to develop a plan of action. This will provide a more robust, and a transparent plan to link these interventions with NDCs.

4. To enter into private sector debt reduction or debt swap agreements, Pakistan needs to come up with an ESG profile that clearly outlines its standards and views on economic quality and community engagement, sustainable assets, green financing and its expected interests in the long-term. There should also be a very categorical policy stating that Pakistan is going to invest in ESG framework in every infrastructure and energy asset.

5. Further, there should be some sort of conservation trust fund or a multilateral trust fund that should also be part of such straining committee. This will ensure that the activities are more coordinated and monitored for the project to meet its objectives.

6. Along with debt swaps, Pakistan needs to look for social impact bonds, social responsibility investment fund (SRI), green sukuk, etc. where the public and private sectors collaborate to invest in a successful green project. Then instead of paying in cash, the government can also propose to let go the taxes for a particular period.

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17 In this regard, The Global community has already put together and enhance transparency framework that lays down the contours for a robust MRP system.
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Appendix 1

Debt Service Relief from the Catastrophe Containment and Relief Trust (CCRT)

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