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# The Nexus of Climate Vulnerability and Sovereign Debt: Emerging Global Mechanisms and Imperatives for Sri Lanka

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## KEY TAKEAWAYS

- Climate-induced shocks and vulnerabilities are exacerbating globally, and developing countries are particularly affected. Developing countries facing debt sustainability pressures face an additional dimension of vulnerability.
- International financial institutions are beginning to respond through innovative mechanisms including Climate Resilient Debt Clauses, Debt Relief for Green and Inclusive Recovery proposals, and enhanced debt sustainability analyses.
- However, the path to mainstreaming these initiatives remains fraught with institutional inertia, creditor coordination challenges, and political resistance.
- Sri Lanka needs to pay attention to these mechanisms and begin to focus on how a steady return to accessing international capital markets should necessarily consider climate vulnerability issues, and the impacts on GDP, fiscal space, foreign inflows, and so on.
- An IMF report on fiscal risks in Sri Lanka has already identified the fiscal costs of climate vulnerability.
- The recent cyclone that struck Sri Lanka in November 2025 and its impacts across the country with long-term recovery and rebuilding costs, has reinforced the need to focus on these issues.
- This Policy Brief argues that we must focus on the nexus between climate vulnerability and debt distress, explores emerging global mechanisms and prospects for their mainstreaming, and identifies the policy imperatives for Sri Lanka in proactively tackling this agenda at national- and global-levels.

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## 1. INTRODUCTION

The recent cyclone ‘Ditwah’ that struck Sri Lanka in November 2025, and its devastating impacts across the country, has exposed the fragility of Sri Lanka’s economic recovery following a debt default and economic crisis 2022-2024. Cyclone Ditwah’s costs to life, livelihoods, and infrastructure comes at a critical point in Sri Lanka’s recovery and debt repayment pathway, especially considering the ‘Macro-Linked Bonds’ that form part of the agreed restructuring package with international sovereign bond holders. The intersection of climate change and sovereign debt represents one of the most pressing challenges facing developing economies today. As extreme weather events intensify and climate impacts mount, debt sustainability in vulnerable countries faces unprecedented strain<sup>1</sup>. President Anura Dissanayake rightly acknowledged the problem in an interview with Newsweek Magazine shortly after the cyclone - *“We will have to service debt while simultaneously rebuilding from climate disasters. This is why debt sustainability frameworks for climate-vulnerable countries must change”*<sup>2</sup>

International financial institutions are beginning to respond through innovative mechanisms including Climate Resilient Debt Clauses, Debt Relief for Green and Inclusive Recovery proposals, and enhanced debt sustainability analyses. However, the path to mainstreaming these initiatives remains fraught with institutional inertia, creditor coordination challenges, and political resistance.

This Policy Brief explores the case for focussing on the nexus between climate vulnerability and debt distress, discusses the emerging global mechanisms attempting to address this as well as the prospects for their mainstreaming, and explores the policy imperatives for Sri Lanka in proactively tackling this agenda at national- and global-levels.

## 2. WHY SHOULD WE CARE ABOUT CLIMATE AND DEBT?

The numbers are stark. Developing countries spent a record US\$1.4 trillion servicing foreign debt in 2023, with interest costs climbing to a 20-year high<sup>3</sup>. More than half of developing countries now allocate at least 8 percent of government revenues to interest payments - double that of a decade earlier. In 2023, 54 developing countries devoted 10 percent or more of government revenues solely to interest payments, with nearly half located in Africa<sup>4</sup>. Meanwhile, emerging market developing economies (EMDEs) excluding China need to mobilize an estimated US\$3 trillion by 2030 to meet climate and development goals, with US\$2 trillion mobilized domestically<sup>5</sup>.

Climate change and sovereign debt have become locked in what experts call the ‘climate debt trap’ - a self-reinforcing cycle where one exacerbates the other<sup>6</sup>. This dynamic operates through multiple channels that compound over time, creating

increasingly precarious fiscal positions for the world’s most vulnerable nations.

When a climate disaster strikes, governments must immediately mobilize resources for emergency response and reconstruction. This can stretch public finances in already strained circumstances. An analysis by the International Monetary Fund (IMF) of 11 major natural disasters between 1992 and 2016 found that public debt increased from an average of 68 percent of GDP in the year of the disaster to 75 percent three years later<sup>7</sup>. For Small Island Developing States (SIDS) and other climate-vulnerable nations, this pattern repeats with increasing frequency as climate impacts intensify.

The financial burden extends beyond immediate relief and reconstruction costs - climate vulnerability affects sovereign creditworthiness. Higher climate risk vulnerability leads to significant rises in the cost of sovereign borrowing - premia on sovereign bond yields amount to around 275 basis points for economies highly exposed to climate risks, as shown by Volz et al. (2020)<sup>8</sup>.

### SRI LANKA CONTEXT

- Sri Lanka faces severe vulnerability to climate risks, with rising temperatures, sea level rise, floods, landslides, and droughts posing major threats to its ecosystems, communities, and the economy<sup>9</sup>.
- The country currently incurs annual costs exceeding \$310 million for disaster-related losses and relief efforts<sup>10</sup>.
- Floods in particular contribute to approximately two-thirds of Sri Lanka’s annual disaster-related losses, costing the country around \$240 million each year<sup>11</sup>.
- By 2050, nearly 19 million Sri Lankans are projected to live in climate hotspots, with the country facing an estimated 3.86 percent decline in GDP<sup>12</sup>.
- Building resilience will require significant investments - estimated at \$36.5 billion by 2030 and \$54.2 billion by 2050<sup>13</sup>.

## 3. WHAT ARE THE CHANNELS OF IMPACT?

The climate-debt nexus primarily operates through four transmission channels:

**Direct fiscal costs:** Extreme weather events destroy infrastructure, disrupt economic activity, damage homes and businesses, and require immediate government expenditure on relief and reconstruction. Countries that lack fiscal buffers to absorb these shocks, are compelled to borrow at precisely the moment when economic capacity is diminished.

**Revenue erosion:** Climate impacts reduce tax collection capacity through damage to productive sectors, particularly agriculture and tourism - critical revenue sources for many developing economies, including Sri Lanka. The disruptions to business

activity erode the tax base while simultaneously increasing expenditure demands<sup>14</sup>.

**Higher borrowing costs:** Credit rating agencies downgrade climate-vulnerable sovereigns, increasing the cost of capital. This creates a perverse outcome where countries most in need of climate finance face the highest barriers to accessing it. Dryden and Volz (2025) showed that in 118 instances (of the 1,087 large disasters they studied) between 1980 and 2021, the sovereign experienced at least a one notch rating downgrade in the year following the disaster.

**Crowding out climate investment:** Debt service obligations consume resources that could otherwise fund climate adaptation and resilience. Currently, many least developed countries spend twice as much on debt servicing as they receive in climate finance<sup>15</sup>. In Sub-Saharan Africa, external debt service now exceeds climate finance inflows. This prevents the preventive investments that would reduce future climate damages and debt accumulation<sup>16</sup>.

#### SRI LANKA CONTEXT

A recent IMF Technical Assistance report<sup>17</sup> had an explicit section on the impacts of climate events on the country's fiscal space. It noted that:

- Natural disasters cost Sri Lanka an estimated 0.5–1 percent of GDP annually, with total economic losses averaging around 2.5 percent of GDP.
- Floods, droughts and landslides account for over 90 percent of recorded disaster damages.
- Climate change is expected to worsen these shocks, further tightening fiscal space and raising recovery costs
- Most disaster spending remains reactive, funded through budget reallocations or borrowing rather than pre-arranged instruments.
- The IMF urges stronger integration of climate risk into fiscal planning and the upcoming Fiscal Risk Statement.

#### 4. DO CLIMATE RISKS RAISE BORROWING COSTS?

It is now well established in the literature that governments and firms in climate vulnerable countries incur a risk premium on their debt. Research indicates that a 10-percentage point increase in climate vulnerability corresponds to an increase of over 150-basis points in long-term government bond spreads for EMDEs<sup>18</sup>. Dryden and Volz (2025) showed the stark reality of how greater climate vulnerability results in higher sovereign yields (measured by the 10-year yield), and Sri Lanka lies on the exact diagonal of this relationship. Countries that have consistently been 'low vulnerability' to climate change have enjoyed nearly ten percentage points lower borrowing costs

than those with 'high vulnerability'.

Buhr et al. (2018) showed that vulnerable countries pay a climate risk premium, and climate vulnerability raises the cost of debt by 1.17 percent, while preparedness efforts reduces that premium by 0.67 percent. Between 2007 and 2016, 40 climate-vulnerable countries paid an estimated US\$40-62 billion in additional interest payments purely due to their climate exposure, with projections suggesting this could reach US\$146-168 billion over the subsequent decade<sup>19</sup>.

Overall, these mean that climate-vulnerable developing countries would face greater risks of their sovereign debt becoming unsustainable, even if external economic conditions (that support export earnings and FDI) are favourable.

#### 5. ARE CLIMATE CONSIDERATIONS EMERGING IN DEBT FRAMEWORKS?

There is a slow journey of integrating climate considerations into debt frameworks, though progress remains uneven and contested. Three key initiatives illustrate this emerging trend.

##### 1. Climate Resilient Debt Clauses

Climate Resilient Debt Clauses (CRDCs) represent state-contingent instruments that allow automatic postponement of debt service when specified climate disasters occur<sup>20</sup>. These clauses evolved from 'hurricane clauses' pioneered by Barbados and Grenada during their debt restructurings, with Barbados issuing the first pandemic-protected bond covering natural disasters in 2022<sup>21</sup>. Grenada's 2015 hurricane bond was triggered in late 2024, resulting in the suspension of US\$12 million in interest payments, equivalent to 11 percent of the bond's value<sup>22</sup>.

Major multilateral development banks have embraced CRDCs to varying degrees. The World Bank now offers these to Small States and Small Island Developing States, while the Inter-American Development Bank provides two-year principal payment deferrals to a set of eligible countries. The European Investment Bank, African Development Bank, European Bank for Reconstruction and Development, and Asian Development Bank are implementing or piloting CRDC arrangements<sup>23</sup>.

##### Box 1: How do CRDCs work?<sup>24</sup>

When an eligible event occurs – verified through parametric triggers or other objective measures – the borrower may defer principal and/or interest payments for a defined period, typically up to two years. This creates immediate fiscal space for emergency response and resilient reconstruction without triggering default or requiring lengthy creditor negotiations.

A UK-chaired Private Sector Working Group, comprising the IMF, World Bank, G7 countries, borrower nations, and major financial institutions, developed standardized CRDC terms at COP27 in 2022<sup>25</sup>. The International Capital Markets Association (ICMA) published template term sheets to facilitate their adoption. These efforts aim to mainstream CRDCs across both official and commercial lending.

Critical design features include the scope of covered events (initially hurricanes, now expanding to floods, droughts, and pandemics), trigger mechanisms (parametric indices versus discretionary determination), deferral periods, and treatment of accumulated interest. Importantly, CRDCs are designed to be net present value (NPV) neutral and ratings-neutral, addressing concerns about increased borrowing costs or credit events<sup>26</sup>

## 2. Debt Relief for Green and Inclusive Recovery

The Debt Relief for Green and Inclusive Recovery (DRGIR) proposal, advanced by Boston University Global Development Policy Center, Heinrich-Böll-Stiftung, and SOAS Centre for Sustainable Finance, offers a more comprehensive framework for linking debt treatment with climate and development goals<sup>27</sup>. The DRGIR proposal contains three interconnected pillars.

Firstly, it calls for enhanced Debt Sustainability Analyses (DSAs) that integrate climate risks, adaptation costs, and financing needs for sustainable development goals<sup>28</sup>. Current DSAs conducted by the IMF to assess whether a country's debt is sustainable systematically underestimate the fiscal space required for climate resilience. Enhanced DSAs would account for both the risks climate change poses to fiscal trajectories and the investment requirements for building resilience.

Secondly, the proposal advocates reforming the 'G20 Common Framework' to compel participation from all creditor classes - official bilateral, multilateral, and private. The Common Framework has struggled to deliver timely relief, processing only a handful of cases since its 2020 inception. DRGIR proposes a World Bank-administered guarantee facility that would provide credit enhancements for new bonds issued in debt restructurings, creating stronger incentives for private creditor participation. Old debt would be swapped for new guaranteed instruments at haircuts determined by enhanced DSAs<sup>29</sup>.

Third, DRGIR links debt relief to so-called "Climate Prosperity Plans" - strategies developed by countries to articulate a greener and climate-resilient growth trajectory. This ensures fiscal space created through debt relief flows toward climate resilience, decarbonization, and sustainable development rather than perpetuating existing patterns<sup>30</sup>.

The proposal combines "carrots" - guaranteed bonds with enhanced creditworthiness - and

"sticks" - debt payment standstills, lending into arrears, and regulatory pressure on private creditors from major financial centres. An independent mediator would facilitate negotiations and chair steering committees overseeing implementation<sup>31</sup>.

DRGIR analysis using enhanced DSA methodology found that 47 EMDEs with over 1.1 billion people face insolvency problems in the next five years if they attempt to scale up climate and development investment, with another 19 countries lacking liquidity and fiscal space<sup>32</sup>. The 47 countries identified owed US\$383 billion in nominal debt as of 2022, distributed across multilateral creditors (US\$149 billion), private creditors (US\$100 billion), China (US\$55 billion), and other bilateral creditors (US\$54 billion)<sup>33</sup>.

## 3. Green Debt Sustainability Analyses

Both the IMF and World Bank have undertaken efforts to integrate climate considerations into their Debt Sustainability Analysis (DSA) frameworks, though progress has been gradual and inconsistent<sup>34</sup>.

For Low-Income Countries, the IMF/World Bank Debt Sustainability Framework (LIC-DSF) is currently under review, presenting what advocates call a "crucial opportunity" to incorporate climate risks systematically<sup>35</sup>. A 2024 supplement to the LIC-DSF guidance explicitly addressed climate-linked debt instruments and acknowledged the need to account for climate-related debt risks<sup>36</sup>.

Climate impacts on debt sustainability appear in many LIC-DSF assessments for particularly vulnerable nations. For example, DSAs for Pacific Island countries like Solomon Islands and Federated States of Micronesia include customized stress tests based on historical disaster data. The Comoros DSA revised potential growth downward to reflect increasing disaster frequency. Several DSAs treat adaptation financing as simultaneously creating fiscal stress in the medium-term while being necessary for long-term debt sustainability, recognizing that without resilience investments, debt trajectories can worsen<sup>37</sup>.

Yet many recent DSAs contain only minimal climate discussion, and the framework lacks systematic integration of climate scenarios, compound risk modelling, and realistic assessment of climate finance mobilization prospects. Critics argue the methodological approach needs enhancement in four areas: more granular climate risk data collection; utilization of latest-generation climate scenarios tailored to country circumstances; improved modelling of how climate damages affect creditworthiness and interest rates; and better accounting for the compounding nature of climate shocks and cross-boundary spillovers<sup>38</sup>.

For Market Access Countries, the MAC-DSA framework has seen even more limited climate integration. Experimental work applying enhanced methodology to Colombia and Peru demonstrated

that incorporating physical climate risks and transition investment needs significantly altered debt trajectories and stress event probabilities<sup>39</sup>. However, this still remains more in the research domain rather than operational practice. With many middle-income countries facing both debt distress and climate vulnerability, there is an urgent need to make faster progress on integrating 'green DSAs' into MAC-DSAs.

### SRI LANKA CONTEXT

- Sri Lanka defaulted on its debts in 2022 when it faced a severe foreign reserves, debt servicing, and balance of payments crisis. It had to restructure its debt, anchored by an IMF Extended Fund Facility (EFF) programme of macroeconomic stabilization reforms (and some limited governance reforms).
- There was no global debt-workout framework for middle-income countries like Sri Lanka. An ad-hoc bondholder group and an Official Creditor Committee (Chaired by France, Japan, India) led talks. Comparability of Treatment was a key tenet of the negotiations.
- IMF Market Access Country (MAC) Debt Sustainability Analysis (DSA) was used to assess Sri Lanka's current and post-restructuring debt profile. This process does not make considerations of climate impacts to growth, fiscal space, and other key macroeconomic indicators.
- Sri Lanka restructured US\$14.2 billion of ISBs and additional US\$13.6 billion in bilateral debt, concluding agreements by December 2024.
- Macro-Linked Bonds (MLBs) replaced defaulted ISBs, tying repayments to GDP performance. Repayments begin in 2027 after a grace period.

## 6. WHAT PROSPECTS FOR MAINSTREAMING THESE IDEAS?

It remains unclear whether these climate-informed debt mechanisms will become mainstream features of the international financial architecture in the near future. They involve complex political economy, technical feasibility, and international institutional commitment. But several factors hint at good prospects for broader adoption.

The unfolding of a global polycrisis - COVID-19, inflation, geopolitical instability, and intensifying climate impacts - appears to be creating a new political space for institutional innovation that seemed impossible previously. Both IMF Managing Director Kristalina Georgieva and former World Bank President David Malpass publicly committed their institutions to developing schemes linking debt relief with green and inclusive development<sup>40</sup>. The new US administration's hostile stance towards climate change considerations, would however impact this commitment accompanied by the

growing pressure from the Whitehouse on US-funded IFIs to deprioritize climate investments.

Successful precedents are also accumulating. Barbados has demonstrated that CRDCs can be incorporated into market-based borrowing without adverse rating impacts. The 2022 Barbados Eurobond with CRDC features received a rating in line with the sovereign issuer's default rating, proving the concept in practice<sup>41</sup>. Development banks are steadily expanding CRDC offerings, building operational experience and demonstrating feasibility. Already CRDCs have been used in bonds by three Caribbean SIDS: Grenada, Barbados, and the Bahamas. Japan has announced plans to pilot CRDCs in new sovereign lending to Pacific Island countries<sup>42</sup>.

Political momentum is building in key forums. The 2025 Fourth International Conference on Financing for Development (FfD4) in Seville called for mainstreaming standardized state-contingent debt clauses<sup>43</sup>. South Africa's G20 Presidency focussed on debt sustainability, and the African Union adopted the Lomé Declaration on debt reform<sup>44</sup>. Multiple expert groups - including the Expert Review on Debt, Nature and Climate co-chaired by Vera Songwe and Moritz Kraemer - are developing recommendations for systemic reform. The Expert Review's April 2025 final report - 'Healthy Debt on a Healthy Planet' - outlined specific steps for breaking the debt-climate trap, emphasizing the need to fully integrate climate and nature considerations into IMF and World Bank debt sustainability frameworks, reform debt restructuring processes to ensure all creditor classes participate equitably, and establish mechanisms for countries to access both debt relief and new financing for climate adaptation investments<sup>45</sup>. Critically, the report proposed new mechanisms for restructuring and refinancing debt in return for investments in climate adaptation and conservation projects that promote sustainable growth, requiring borrower countries, major global creditors, the IMF, and multilateral development banks to champion such solutions<sup>46</sup>.

## 7. WHAT MIGHT HOLD THINGS BACK?

Creditor coordination remains the central obstacle to scaling debt relief mechanisms. Private creditors, who hold substantial portions of EMDE debt, have proven reluctant to participate in relief efforts without legal compulsion. The G20 Common Framework has processed few cases precisely because private creditor participation is voluntary and collective action problems persist. Even when private creditors indicate willingness in principle, negotiating terms across diverse creditor groups with different legal jurisdictions consumes years. Sri Lanka, however, showed a unique case in concluding debt restructuring with both official and private creditors within two years (even in the absence of Common Framework application), largely due to effective and credible stakeholder engagement by the Government with multilaterals and creditors.

Multilateral development banks have maintained a

firm position viz participating in debt restructuring relief efforts despite holding majority creditor positions in 27 countries, citing their “preferred creditor status”<sup>47</sup>. Some argue that MDBs should lead the adoption of debt pause clauses given their development mandates and lower financial constraints. Yet institutional resistance persists.

Technical capacity constraints in debtor countries pose another challenge. Negotiating complex state-contingent instruments, analysing enhanced DSA methodologies (like ‘green DSAs’), and developing credible Climate Prosperity Plans require sophisticated technical expertise often scarce in countries most needing these mechanisms. Building this capacity requires sustained investment in central banks, debt management offices, and fiscal institutions.

Political resistance in major donor countries may limit concessional finance flows in the near-term, as growth in these economies slow and politicians and their electorates become more hawkish towards foreign aid and overseas climate-related development projects. These flows, though, are essential for making climate-informed debt mechanisms feasible, especially with the provision of credit enhancement facilities.

## 8. WHY IS THIS AGENDA IMPORTANT FOR SRI LANKA?

Following its 2022 sovereign default - the first in the country’s independent history - Sri Lanka concluded debt restructuring agreements with both official creditors and private bondholders by late 2024, achieving this milestone even in the absence of a comprehensive global debt resolution framework for middle-income economies<sup>48</sup>.

The restructuring involved US\$12.5 billion in international sovereign bonds exchanged for new macro-linked bonds (MLBs) and other instruments, with approximately 96-98 percent bondholder participation by December 2024<sup>49</sup>.

Official bilateral creditors, including members of the Official Creditor Committee and China’s Exim Bank, agreed to comparable treatment. The nominal haircut of 28 percent on existing bonds can be reduced to as little as 15 percent if Sri Lanka’s GDP exceeds IMF baseline projections during 2025-2027, with the MLB structure creating upside risk-sharing primarily benefiting creditors<sup>50</sup>. Principal repayments are scheduled to resume in 2027, with debt service obligations projected to peak at \$19.6 billion by 2038 under some scenarios<sup>51</sup>.

This debt profile collides with Sri Lanka’s acute climate vulnerability. The country ranks among the most climate-exposed nations globally, facing multiple, overlapping hazards that threaten key economic sectors. Estimates on climate risk impacts on economic activity vary. The World Bank notes that by 2050, nearly 19 million Sri Lankans are projected to live in climate hotspots, with the country facing an estimated 3.86 percent decline

in GDP<sup>52</sup>. The fiscal costs of natural disasters is estimated by the IMF to be 0.5 - 1 percent of GDP annually, a similar number to the average annual FDI inflows to the country. Building resilience will require significant investments, which the Climate Prosperity Plan estimated to be US\$36.5 billion by 2030 and US\$54.2 billion by 2050<sup>53</sup>.

The Western Province is particularly vulnerable, and consequential. Over 45 percent of the country’s national output is generated here, it is the most densely populated province, it houses the country’s administrative and commercial capital, and the majority of industrial establishments. The province also houses the country’s main international connective infrastructure like the Colombo Port and Katunayake Airport. Ecological risks here are spread across four categories - Climate, Ecosystems, Fisheries, and Geology/Water, and ten of 12 indicators were rated as medium-high risk, according to a 2022 CORVI assessment<sup>54</sup>. The frequency of flood events and nearshore fish stock status were identified as acute ecological vulnerabilities for the Western Province. The capital Colombo could lose 1 percent of GDP on average every year due to flood events<sup>55</sup>. These vulnerabilities manifest through several channels that have been hitherto insufficiently considered in debt sustainability assessments and restructuring negotiations.

### *Agriculture and food security*

Climate change impacts Sri Lanka’s agricultural sector through direct effects such as changing precipitation, extreme weather events, and temperature variability as well as indirect effects like impacts on water resource availability, soil erosion, changes in pest and disease profiles, and decline in arable areas. Extended droughts and floods in 2016-2017 disrupted two rice production cycles, affecting over 2 million people and constraining economic growth<sup>56</sup>. Agriculture, while declining as a share of GDP to 7.8 percent, still employs 27 percent of the labor force<sup>57</sup>. Temperature rise threatens key staples including rice, with downward pressure on yields potentially impacting national and household food security. Crop exports like tea, rubber, coconut, and spices would also be impacted with climate change, and its consequential effects for nature and biodiversity loss, on which the yield and quality of these depend.

### *Tourism sector exposure*

Tourism comprises a major component of Sri Lanka’s service-dominated economy (61.7 percent of GDP)<sup>58</sup>. Climate hazards including extreme heat, coastal erosion, flooding, and ecosystem degradation increasingly threaten profitability of the sector that relies heavily on natural ecosystems and pose additional infrastructure costs.

### *Coastal and infrastructure vulnerability*

Roughly 50 percent of Sri Lanka’s 22 million citizens live in low-lying coastal areas at risk from sea-level

rise. By 2050 there could be a sea level rise of 0.6-2 feet in Sri Lanka which poses a threat to coastal infrastructure and communities. The country's coastal regions, particularly the Northern and Northwestern provinces, represent climate hotspots with populations facing storm surges, flooding, coastal erosion, and saltwater contamination of freshwater sources. Infrastructure damage from extreme weather events disrupts economic activity across sectors, with hydroelectric power generation facing challenges from changing rainfall patterns.

### *Compounding fiscal pressures*

The cyclical pattern of floods and droughts creates recurring fiscal demands for emergency response and reconstruction. Fiscal space for accommodating preventive investments in climate adaptation and resilience (that would reduce future damages and debt accumulation) remains tight. Social security spending in Sri Lanka is already very low, and safety nets to help vulnerable groups manage shocks remain extremely poor<sup>59</sup>.

A recent IMF Technical Assistance report on fiscal risks facing Sri Lanka had an explicit section on the impacts of climate events on the country's fiscal space. The report concedes that, while Sri Lanka's fiscal risk situation has improved following reforms, fiscal risks in areas including natural disasters remain substantial (alongside risks from macroeconomic shocks, state-owned enterprises, guarantees, public-private partnerships, and the financial sector).

The report quantified that the current average annual fiscal cost of natural disasters amounts to roughly 0.9 - 1.1 percent of GDP. Once adaptation costs are added (0.5 percent of GDP - around US\$ 430 million annually), the total future fiscal exposure will be around 1.6 percent of GDP, annually.

The IMF outlined the following key transmission channels:

- Direct costs by way of relief, reconstruction, and compensation;
- SOE losses, especially Ceylon Electricity Board, with hydropower vulnerability to droughts);
- Contingent liabilities due to calling of PPP payment guarantees, and in adverse cases - potential bank recapitalization due to climate-risked lending portfolios;
- Tax revenue losses due to disruptions to tourism, crop exports, and agriculture;

The report asserted there are critical data gaps, impeding more instructive analysis on the fiscal risks. It notes that there is no systematic recording of economic losses after 2017, reconstruction cost data is not always available, there is weak tracking of total disaster spending, and sub-national government spending is not compiled.

The IMF staff noted that prioritization should be given to mitigate climate vulnerabilities, alongside other structural reforms. Some of the other

main recommendations of the report are: a) the establishment of a working-level technical group of key government departments (including the Department of Fiscal Policy, Disaster Management Centre, Ministry of Environment, National Budget Department, and National Planning Department); b) completing a 10-year fiscal cost dataset; and c) integrating climate scenarios into the macroeconomic policy framework.

### *Climate change considerations in debt sustainability*

Despite these manifest vulnerabilities, climate risks received minimal attention in Sri Lanka's debt discussions. The IMF's debt sustainability analysis and the negotiated restructuring terms did not systematically account for the fiscal implications of increasing climate impacts or the investment requirements for building resilience. The growth impacts from adverse weather events (flood events, particularly in the GDP-heavy Western Province, or crop failures due to extended droughts (as observed a few years earlier). The macro-linked bond structure ties debt service to GDP performance but includes no provisions for climate shocks (like CRDCs) that could simultaneously damage growth and increase fiscal demands.

## **9. WHAT ARE THE POLICY IMPERATIVES FOR SRI LANKA?**

- 1. Climate considerations in macro-fiscal frameworks:** Sri Lanka must incorporate climate risk modelling into macroeconomic frameworks like fiscal planning, debt management, and medium-term expenditure frameworks. This includes realistic assessment of contingent liabilities from climate disasters and systematic budgeting for adaptation investments across vulnerable sectors. New skills and capabilities in the Ministry of Finance will be needed.
- 2. Climate-informed debt instruments:** As Sri Lanka plans a phased approach to re-accessing international debt capital markets post-restructuring, it should prioritize instruments that provide fiscal breathing room during climate shocks. This includes advocating for Climate Resilient Debt Clauses in future borrowing from multilateral development banks and exploring their incorporation into commercial lending where feasible.
- 3. Boost adaptation finance:** With principal repayments resuming in 2027 and debt service obligations rising thereafter, Sri Lanka's fiscal space for climate adaptation will remain constrained. The country must maximize access to concessional climate finance, grants, and technical assistance for adaptation projects in agriculture, urban development (especially at Local Authority levels), water management, coastal protection, and climate-smart infrastructure.
- 4. Build evidence on macro-climate linkages**

**and analytical capabilities:** Sri Lanka needs to strengthen data collection and analysis on climate impacts across sectors, to quantify the economic and fiscal implications of climate risks, and the economic returns to adaptation investments. This evidence can support future debt restructuring negotiations and climate finance mobilization. Building up knowledge and awareness on the link between nature loss economic sectors that rely on natural capital (like agriculture, tourism, and crop exports) will also become increasingly important. Building up analytical capabilities in Sri Lanka's Ministries of Finance, Agriculture, and Environment, as well as the Central Bank, will be needed.

5. **Stronger global voice:** Sri Lanka's experience demonstrates the inadequacy of current global debt restructuring processes that ignore climate considerations. The country should join regional and global coalitions advocating for enhanced debt sustainability frameworks that integrate climate risks, reformed Common Framework processes that ensure fair burden-sharing, and new financing mechanisms that link debt relief to climate investments. Sri Lanka's individual voice as a middle-income developing country may carry limited weight in reforming the global financial architecture. However, the country can amplify its influence substantially through strategic engagement with collective platforms and coalitions that share its interests in linking debt sustainability with climate action – like the V20 Group of Vulnerable Economies, the G77 (and sub-groups such as the 'Like-Minded Developing Countries')<sup>60</sup>.
6. **Forge bilateral partnerships:** Countries like Barbados, Kenya, Colombia, and Ghana may seem like unlikely partners for Sri Lanka in traditional areas of trade, investment, and security, but in the climate-debt agenda, they are obvious candidates for forging stronger bilateral relationships. Barbados pioneered hurricane clauses and developed the Bridgetown Initiative for financial architecture reform. Kenya and Colombia initiated the Expert Review on Debt, Nature and Climate. Ghana has led a stronger V20 agenda while navigating its own sovereign debt crisis. Bilateral partnerships with such countries can facilitate knowledge exchange, develop joint reform proposals, and help drive coalition agendas.
7. **Engage large creditor nations:** Sri Lanka's debt restructuring involved China as a major bilateral creditor. Rather than viewing Sri Lanka's debt restructuring with China solely through the lens of negotiation challenges, Sri Lanka could explore whether China (and indeed other prominent creditors like Japan) might support alternative approaches to debt treatment that incorporate climate considerations. Both of these countries have made impressive commitments on the climate agenda, even as some large Western nations have retreated. As such, they may be open to innovation,

particularly if framed around long-term stability and sustainable development outcomes rather than purely maximizing near-term returns.

#### Box 2: How can Sri Lanka take a more active role in V20?

A potential platform for Sri Lanka's stronger global voice is the Vulnerable Twenty (V20) Group, representing 70+ climate-vulnerable countries with 1.81 billion people and US\$4.1 trillion in combined GDP<sup>61</sup>. Sri Lanka was among the founding members and has actively participated in V20 forums, including development of a preliminary Climate Prosperity Plan presented at V20 ministerial dialogues<sup>62</sup>. The V20 has emerged as a powerful advocate for climate-debt reform, having established the Emergency Coalition for Debt Sustainability and Climate Prosperity in 2023. The platform is explicitly designed to coordinate borrower country positions on debt architecture reform and to foster joint engagement with the multilateral system, private sector, and credit rating agencies<sup>63</sup>.

Sri Lanka can deepen its V20 engagement by seeking a leadership role - potentially chairing the V20 or co-chairing working groups on debt restructuring or climate finance mechanisms. Both the current Barbados chair and the earlier Ghana chair have been consequential, and shown how individual countries can shape the group's agenda and elevate specific reform proposals.

Sri Lanka must contribute technical expertise from its recent restructuring experience to inform V20 advocacy positions on enhanced debt sustainability analyses, creditor burden-sharing, and climate-contingent instruments. The V20 has explicitly called for pooling technical knowledge of restructuring processes, creating opportunities for Sri Lanka to inform, and indeed shape, collective demands<sup>64</sup>.

Sri Lanka should also utilize the V20's formal coordination mechanisms ahead of Global Sovereign Debt Roundtable meetings and IMF/World Bank Spring and Annual Meetings. The V20 has institutionalized pre-meeting coordination to present unified borrower perspectives, making it harder for creditors to easily dismiss. The coalition's 2023 statement calling for debt restructuring linked to Climate Prosperity Plans directly echoes Sri Lanka's needs<sup>65</sup>.

## 10. CONCLUDING THOUGHTS

Climate considerations are becoming embedded in sovereign debt discussions because the material interconnections between climate vulnerability and debt sustainability are undeniable. The

channels linking climate shocks to fiscal stress, higher borrowing costs, and constrained policy space operate visibly across the developing world, creating urgency that can no longer be ignored by international financial institutions, sovereign ratings agencies, and official and private creditors.

Sri Lanka's case underscores a broader reality - debt restructuring that ignores climate vulnerability stores up future crises. Without systematic integration of climate considerations into debt frameworks, countries like Sri Lanka face recurring debt crises as climate impacts erode growth, strain fiscal capacity, and render growth trajectories unsustainable.

While the emergence of new mechanisms and instruments discussed in this Policy Brief reflects the growing institutional evolutions, mainstreaming these face substantial challenges. While these mechanisms offer technically sound pathways for aligning debt treatment with climate and development imperatives, supported by growing operational experience and political momentum in key forums, creditor coordination challenges, institutional inertia, developing country capacity constraints, and political resistance in major capitals is likely to limit the pace and scale of implementation.

The most likely trajectory involves partial mainstreaming over the next decade: CRDCs becoming standard in multilateral development bank lending and spreading to some commercial instruments; enhanced DSAs incorporating climate factors more systematically but incompletely; and selective application of climate-linked debt relief frameworks in the most acute crisis situations. This incremental progress may prove insufficient given the urgency and scale of the dual debt and climate crises but represents the realistic institutional path.

Having successfully concluded debt restructuring, relatively speedier than some other ongoing sovereign restructurings, Sri Lanka stands in a stronger position to advocate for a greater alignment of climate vulnerability with debt sustainability. The efforts by earlier administrations to place Sri Lanka on the global stage of conversations around climate vulnerability - for instance the 'Tropical Belt Initiative'<sup>66</sup> can be built upon to foster common positions among vulnerable countries. Sri Lanka also has a Climate Prosperity Plan that has articulated the required investments to boost climate resilience and ensure adaptation needs are met. Sri Lanka can play a greater role in the international reform agenda, building on the previously demonstrated capacity for high-level climate diplomacy by Sri Lankan leaders<sup>67</sup>. Sri Lanka's new political leadership should systematically use UNFCCC COPs, IMF-World Bank meetings, and G77 forums, to advance specific reform proposals grounded in the country's own restructuring experience.

Ultimately, whether the mechanisms discussed in this paper move from periphery to mainstream

will depend on the willingness of major creditor nations and institutions to accept a fundamental premise - that meaningful debt restructuring and true debt sustainability must be linked explicitly to climate resilience and related investments. It delivers not only on ethical imperatives but long-term macroeconomic stability of climate-vulnerable economies.

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