INVESTMENT PERSPECTIVES

First in the Series: Sovereign Finance, Climate, and Development

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Introduction

Developing countries need trillions of dollars of climate finance to achieve their announced decarbonization and resilience goals. In the Paris Agreement, developed countries committed to provide financial resources to developing countries for both mitigation and adaptation.

The Paris Agreement says this financing should come from a "variety of sources." One of those sources is debt—loans that will one day have to be repaid or refinanced. According to the Organisation for Economic Co-operation and Development, when developed countries first achieved the initial goal of mobilizing over US$100 billion of climate finance for developing countries in 2022, almost 70% of the public finance was loans.

As their climate finance needs grow dramatically in coming years, many developing countries will face a daunting obstacle. How can they borrow to fund their climate ambitions, when many are already at high risk of debt distress? Countries will need debt relief and low-cost funding to invest in clean development and growth.

Issues of developing country debt distress are not new—they have perplexed the international community for decades, although the climate aspect is a novel twist. Solutions to debt distress have been proposed and reproposed, with a dizzying array of studies, research papers, expert group reports, conference outcomes, summit communiqués, and reform packages. As the November 2025 Report on the Baku to Belém Roadmap to 1.3T observes, "many of these solutions have been under discussion for decades."

Over the past few months, I've had the privilege of grappling with these issues with a wonderful group of Master of Science in Climate Finance students at Columbia Climate School. This essay is the first in a series built from this course, intended for the interested non-specialist. My objective is to offer a realistic view of the problem, a critical review of some prominent reform proposals, and a few thoughts on novel and practical solutions to seemingly intractable problems.

An important first step is to recognize that climate finance in developing countries is intertwined with development finance. To take an example, many developing countries don't plan to decarbonize existing power generation facilities, but instead hope to develop new electricity capacity to drive economic growth. If the new capacity is renewable generation, the development objective will align with a climate objective.

To show this, consider Bangladesh's 2035 Nationally Determined Contribution (NDC). In the 2022 base year, total GHG emissions in Bangladesh were 252 $MtCO_2e$, about half from the energy sector. The business-as-usual scenario forecasts emissions of 418 $MtCO_2e$ in 2035, with the energy sector representing almost two-thirds. In its NDC, Bangladesh hopes to eliminate about 85 $MtCO_2e$ of this, bringing 2035 emissions down to 333 $MtCO_2e$. In other words, its objective is to limit the emissions increase from development to 32% (rather than 65%) compared to 2022.

In the NDC, Bangladesh estimates needing about US$117 billion to meet its mitigation targets, of which 78% requires international support. It hopes to get this from grants, concessional finance, and carbon finance. But concessional finance is debt, and some funding will probably come from non-concessional debt (if it comes at all). If Bangladesh borrowed the full amount of international support it says it needs, its external debt would double.

We see the same pattern in many developing countries, including some of the lowest income countries that are at high risk of debt distress (which Bangladesh is not). These countries need international financial support to fund development, decarbonization, and climate resilience, but their borrowing capacity is limited.

There's more. When developing countries borrow, they pay higher interest rates than developed countries, due to both real and perceived risks. In 2024, the average yield at issuance on African government dollar debt was nearly 9% per annum (with several countries above 10%), while the ten-year US treasury note yield hovered between 3.5% and 4.6%. And when private sector developers invest in developing countries, they target higher returns compared to projects in developed countries, also borrowing at higher rates. These costs make it impossible for some climate investments to go forward.

Addressing these issues requires three things that are hard to do: creating sovereign fiscal space for climate and development funding (lower deficits and debt reduction); ensuring the fiscal space is used for climate and development; and reducing the cost of financing public and private climate and development projects.

These things are hard because, for the most part, developing countries can't do them alone. Debt reduction is a poignant example. From a legal perspective debt should be repaid on time. Because countries can't file for bankruptcy, reducing sovereign debt requires the consent of creditors, an often-lengthy process known as debt restructuring. Creditors are not a uniform, coordinated group, and each has an incentive to shift the financial burden onto others. Creditor coordination is difficult, as developing countries have increasingly turned to a broad array of private and public sector creditors (China in particular).

Debt reduction is only one of the problems developing countries face in addressing climate and development needs. They face a host of other obstacles: dependence on conditional funding from multilateral institutions, lower credit ratings, high perceived investment risk, and exposure to exchange rate volatility, to name a few. Many are also hampered by internal political and institutional issues that are sensitive to discuss, but crucial to effectively mobilizing investment.

To finance their climate objectives, developing countries need a way to overcome these issues quickly. Some say this requires fundamental reform of the global financial architecture, but I question this from the perspective of effectiveness, practicality, and especially timing. In this series of essays, I will explain why, and will discuss a number of ambitious yet circumscribed initiatives that can remove bottlenecks in the current architecture, with a view to unlocking sovereign finance for climate and development.

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