INVESTMENT PERSPECTIVES

Climate, Development, and Debt Sustainability: Second in a Series

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Developing countries seeking international climate and development funding face a significant obstacle: if they borrow to finance climate and development needs, they might not be able to repay or refinance their debt, which could become unsustainable.

For years, the International Monetary Fund (IMF) and the World Bank have had a framework for determining when a country's debt is sustainable, based largely on ratios derived from projections of sovereign debt and macroeconomic performance. Depending on the ratios, a country may be at risk of debt distress. If it has no feasible policy options to avoid debt distress, its debt will be unsustainable and might need to be restructured.

Given the stakes, the debt sustainability framework has garnered commentary and criticism, from across the spectrum. Many developing countries argue that the framework should be revised to promote funding for climate and development.

Others, such as U.S. Treasury Secretary Scott Bessent, say the IMF and World Bank should eliminate their climate and social agendas, focusing on their primary missions of macroeconomic support (IMF) and poverty reduction (World Bank).

The dilemma facing many countries is squarely presented by the Bridgetown Initiative, a reform proposal led by the Prime Minister of Barbados. It says the debt sustainability framework should be reformed to promote clean investment for long-term growth, financed "sustainably" in a "fiscally sound manner." But increasing investments while remaining fiscally sound is a challenging objective.

Part of the issue is that not all climate and development expenditures are alike. Some are naturally accounted for in a country's debt sustainability analysis. Natural disaster risks affect macroeconomic projections used in the ratios, while adaptation and resilience investments reduce natural disaster impacts in stress tests applied to macroeconomic projections. The debt sustainability framework incorporates these issues through their impact on projections and would presumably do so even under Secretary Bessent's vision.

What the projections and stress tests do not address is the need for long-term investments in development and mitigating greenhouse gas emissions. As we saw in the first essay in this series, these investments represent most of the announced climate funding needs of many developing countries.

In June 2026, the IMF and the World Bank published a proposal to revise their low-income-country debt sustainability framework. While the proposal mainly focuses on adjusting the ratios and underlying data, it also includes a "long-term module" incorporating climate and development issues in projections in three ways:

1. Debt ratios are adjusted for the impact of physical risks (such as natural disasters) in various warming scenarios, assuming no adaptation investments.
2. Costs and benefits of adaptation and resilience investments are reflected, increasing debt in the short term and reducing the impact of physical risks in the medium term.
3. In a significant new feature, the model assumes investments in development—human and physical capital, infrastructure, and structural reforms, increasing debt in the short term while generating long-term growth in a "second-round effect."

This means the long-term module assumes a country will use part of its fiscal space—debt it can incur sustainably—for adaptation, resilience, and long-term development. The consequence is that the country might have less fiscal space for other needs that may be pressing in the short term.

The assumed increase in debt may also place more countries at risk of debt distress. A 2025 study found that 41 of 62 low- and middle-income countries analyzed would breach solvency thresholds by accounting for climate and development needs. If this makes debt unsustainable, a country might need to seek debt relief in a restructuring.

It is unclear whether creditors would support such debt relief. Some might argue that a restructuring based on the long-term module would effectively (and, in their view, improperly) subordinate their creditor rights to the country's climate and development policy. Climate and development advocates, on the other hand, might view such subordination favorably.

The June 2026 IMF–World Bank proposal only goes so far. Some papers have proposed more ambitious ideas to open fiscal space for sustainable investment: distinguishing "productive" investment debt from "unproductive" consumption debt; encouraging growth-enhancing investments in global public goods by reflecting a country's "net worth" in ratios instead of only debt; or accommodating higher debt ratios for very long-term debt used to fund sustainable investment in countries that adopt plans to increase long-term tax revenues and exports.

The IMF and World Bank have not said whether they considered these ideas or why they are not reflected in the proposal. One issue might be the difficulty of making these ideas practical to implement.

Realistically, under any debt sustainability framework, most low-income countries are likely to have limited fiscal space to borrow for climate and development, absent (or even with) a major international debt relief effort. They need strategies to overcome this constraint.

One possibility is to couple sustainable investment borrowings with initiatives to generate short- and medium-term fiscal savings. For example, a 2023 World Bank (International Development Association) green loan for Bangladesh provides funding for sustainable investment subject to conditions such as revamping procurement procedures, improving national energy efficiency, decreasing fuel subsidies, and eliminating high-cost power generation agreements.

Countries can also promote private sector investment. As the IMF noted in a 2024 debt sustainability framework supplement, debt sustainability analysis calibrates only the government's share of spending on economy-wide climate policies. The IMF suggests that governments focus on a policy mix to encourage the private sector to fund the remainder.

All of this is easier said than done. Governments have long had good reasons to reduce costly subsidies and to encourage private sector investments, but these have often proven politically and practically difficult.

To return to the question from the Bridgetown Initiative, funding climate and development investments in a fiscally sound manner is possible, up to a point. But in most countries, funding needs to come from a combination of government borrowing, fiscal savings, and private sector investment. Debt reduction might be part of the package, particularly in lower-income countries, but to be effective any debt-related initiative must be a component of a broader, multi-pronged strategy.

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