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An innovative financing for development agenda for the recovery in Latin America and the Caribbean

Introduction[1]

The coronavirus disease (COVID-19) pandemic is the worst global crisis since the Second World War. It has had devastating economic and social effects across the globe, with greater intensity in developing countries, that will likely extend into the medium and long term.

Latin America and the Caribbean, one of the most affected regions in the developing world, registered in 2020 the worst economic contraction on record (-6.8%), which has caused a significant increase in the unemployment rate (8.1% and 10.7% in 2019 and 2020, respectively, representing 44 million people) and poverty levels (the number of people living in poverty rose from 185.5 in 2019 to 209 million in 2020). Moreover, the sharp decline in investment (-20% in real terms) will severely hamper future capital accumulation, as well as the ability of the region's economies to generate growth and employment and recover.

At the same time, the countries of Latin America and the Caribbean face greater limitations in mobilizing domestic and external resources. The high indebtedness resulting from a lower tax intake coupled with increased current transfers to support households and businesses has heightened countries' liquidity needs, despite the considerable heterogeneity in their fiscal situation and debt vulnerability. At the same time, this situation has reduced the fiscal space to implement countercyclical policies, undermining the capacity to build forward better.

Latin America and the Caribbean is currently the most indebted region of the developing world. The gross general government debt averages 77.7% of regional GDP, and debt service represents 59% of exports of goods and services. The increase in debt service represents a significant opportunity cost owing to the diversion of resources from the provision of public goods toward the payment of debt obligations.

[1] The cut-off date for the information used to prepare this report is 31 October 2021, unless otherwise indicated.

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The rebound in growth projected for the region in 2021 (5.9%), which reflects a low base of comparison with 2020 and is driven by consumption against the backdrop of deepening structural problems, is unlikely to persist. It will provide but temporary respite from the current economic situation and will be insufficient to reduce the region's financing gap or improve its debt profile.

Despite these circumstances, international cooperation has been limited and directed primarily to low-income and lower-middle-income countries. Amid the systemic crisis caused by COVID-19, Latin America and the Caribbean has had access to fewer multilateral resources than during other crises such as the global financial crisis (2008–2009), even though the region faces challenges and vulnerabilities similar to those affecting low-income countries.

Moreover, the risks faced by middle-income countries could weigh significantly on world growth and compromise global financial stability given the systemic importance of these countries in the global economy. Middle-income countries account for 75% of the world's population, about 30% of the world's aggregate demand, and more importantly, 96% of the public debt of developing countries (excluding China and India).

COVID-19 has brought to the fore the need to address the problem of financing for development in middle-income countries, which has been characterized by the increasing decoupling of per capita income and the ability to mobilize domestic and external resources, and the disconnect between economic and social needs and the response of multilateral cooperation. This must be urgently addressed, as Latin American and Caribbean countries must recover from the effects of the pandemic and avoid another lost decade.

Middle-income countries, such as those in Latin America and the Caribbean, require multilateral cooperation through the expansion and redistribution of liquidity and debt reduction to enhance their policy space to foster a sustainable recovery and advance their economic and social development. This will help to address the region's medium- and long-term challenges, including falling productivity and investment, which is key to shifting the development model towards productive transformation with sustainability and equality.

To address these challenges, the Economic Commission for Latin America and the Caribbean (ECLAC) proposes an innovative financing for development agenda for the recovery in the region based on five policy actions: (i) expand and redistribute liquidity from developed to developing countries; (ii) strengthen regional cooperation by enhancing the lending and response capacity of regional, subregional and national financial institutions, and strengthening linkages between them; (iii) carry out institutional reform of the multilateral debt architecture; (iv) expand the set of innovative instruments aimed at increasing debt repayment capacity and avoiding excessive indebtedness and (v) integrate liquidity and debt reduction measures into a development financing strategy aimed at building forward better (Caribbean Resilience Fund) (ECLAC, 2021b).

A. First policy action: expand and redistribute liquidity from developed to developing countries

1. The new issuance of special drawing rights (SDRs) should be accompanied by a voluntary recycling of unused SDRs from developed to be used by developing countries

In August 2021, the general allocation of SDRs equivalent to US$ 650 billion dollars (SDR 456.5 billion) by the International Monetary Fund (IMF) became effective. It is the largest in IMF history and the maximum amount that can be issued without the approval of the United States Congress.[2]

SDRs are an international reserve asset created by IMF to supplement member countries' official reserves.[3] They represent a potential claim on the freely usable currencies of IMF members and can be exchanged for these currencies. SDRs can be used by IMF members and prescribed holders for a wide range of operations including payments of financial obligations, loans, pledges, donations, swaps and forward operations.[4]

[2] This corresponds to 95.8455025357% of member quotas (IMF, 2021a). Any allocation amounting to US$ 650 billion or below requires at least 85% of the total votes of IMF member countries and thus that of the United States, which accounts for 16.5% of the Fund's total voting power. To date, there have been four new issuances of SDRs (US$ 13 billion in 1972, US$ 17 billion in 1981, US$ 206 billion in 2009 and US$ 650 billion in 2021).

[3] Official reserve assets include five major categories: gold, foreign currency reserves, IMF reserve positions, special drawing rights (SDRs), and other reserve assets.

[4] See Andrews (2021), Gold (1980) and IMF (2021f).

SDRs offer six advantages to IMF member countries. First, they are an automatic credit line —up to 100% of a country's quota— and are available to all countries regardless of their income level.[5] This distinguishes them from other financing options which depend on given macroeconomic conditions (such as the Flexible Credit Line) or on income level (such as funding provided by the Poverty Reduction and Growth Trust (PRGT)).

Second, SDRs do not generate debt, as they do not entail an obligation for repayment of the principal.[6] In this respect, they differ from all other financial facilities and credit lines provided by IMF, including the emergency lines introduced in 2020 to combat the pandemic, such as the Rapid Credit Line (RCL) or the Rapid Financing Instrument (RFI).

Third, SDRs do not carry any conditionalities. All non-pandemic IMF programmes involve conditionalities with high social and economic costs (see section D.2 on IMF surcharges). In this sense, beyond the agility and financial effects of SDRs, a massive issuance is the only financially inclusive instrument that can expand policy space in developing economies.

Fourth, the use of SDRs generates a very low, below-market, interest rate (0.05%), which is advantageous for countries that have high risk premiums.[7]

Fifth, SDRs increase reserve assets without countries having to incur the costs that are normally associated with reserve accumulation.[8] The increase in reserves will improve IMF members' external position, which has deteriorated in some economies as a result of the pandemic. An improved balance of payments can help to reduce country risk, and thus the cost of domestic borrowing, and enhance countries' ability to access and leverage financing.

Finally, besides improving financial stability, SDRs can be an instrument of economic and social development by freeing up resources for domestic spending on public goods. Consideration has also been given to using SDRs as capital, which would expand the base of available liquid resources through leverage. However, this option entails an unresolved difficulty arising from their status as reserve assets. Because SDRs are reserve assets, they must be highly liquid and carry minimal or zero risk to the borrower. When transformed into capital, SDRs would no longer be liquid assets. The underlying question is whether they would cease to be perceived as reserve assets. This issue is particularly important in the case of SDR recirculation, because a basic condition that SDR-lender countries have so far demanded is that SDRs must maintain their status as reserve assets.[9]

1.1 SDR use is a prerogative and sovereign decision of countries

According to IMF, there is no prescribed use for SDRs.[10] Countries can use them in transactions by exchanging their SDRs for freely usable currencies or in operations authorized by IMF, such as payments of financial obligations, loans, pledges, donations, swaps, and forward transactions (IMF, 2021f, p. 12). In the case of Latin America and the Caribbean, with a few exceptions, SDRs are administered by central banks. Depending on the existing national legislation, central banks can either retain SDRs as international reserves or on-lend the SDRs to their respective governments.[11]

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[5] There are exceptions. The Bolivarian Republic of Venezuela did not receive its 2021 SDR allocation as IMF has not officially recognized its government.

[6] According to the *Balance of Payments and International Investment Position Manual—Sixth Edition (BPM6),* new allocations of SDRs to IMF members are recorded as increases in gross international reserves (holdings of SDRs), with an equal increase in the members' long-term debt liabilities to the participants of the SDR Department (allocations of SDRs)(IMF, 2021f). However, IMF recommends that these long-term liabilities (allocations of SDRs) should not be included in the stock of debt for assessing its sustainability.

[7] A country can hold more SDRs than initially allocated by exchanging SDRs for freely usable currencies of other countries. When a country's SDR holding is larger than its allocation, it earns interest on the difference between its holding and the allocation; when the holding is smaller, it pays interest. The SDR interest rate is variable and may increase as a result of a change in the monetary policy stance of developed countries and especially of the Federal Reserve Board of the United States. However, given the current economic and social conditions, it is unlikely that it will register any significant increase.

[8] Reserve accumulation is one of the main countercyclical instruments used by developing countries, at least since the Asian financial crisis, but it is a costly instrument owing to the domestic/external interest rate spread, and has significant macroeconomic ramifications (for example, quasi-fiscal deficits). Between 2019 and 2020, international reserves in Latin America and the Caribbean rose from US$ 852.2 billion to US$ 891.6 billion. In October 2021, the region's international reserves stood at US$ 937.8 billion.

[9] In its communiqué of 7 April 2021, the Group of 20 (G20) urged IMF to put forward proposals to improve transparency and accountability in the use of SDRs while preserving their reserve asset status (see G20, 2021). As will be explained in more detail later in this report, the Poverty Reduction and Growth Trust (PRGT) has mechanisms that maintain the liquidity of SDRs and minimize the credit risk exposure of countries when they lend SDRs to PRGT.

[10] The policy advice from IMF is that any use of SDR holdings should be designed to preserve macroeconomic sustainability, including monetary and external sustainability (IMF, 2021f, p.14).

[11] IMF (2021f, p. 7) states that "members enjoy a large degree of freedom in how to manage the SDRs allocated to them, including to what extent central banks are involved in their management and whether the budget can directly use them for budget support."

The new SDR allocation has strengthened the international reserve position of all developing regions, benefitting some the smaller and most indebted economies. SDRs are allocated in proportion to each country's paid IMF quota shares. As a result, developed countries received 64.4% of the new SDR issue (US$ 418 billion) and the rest (US$ 231 billion, or 35.6% of the total) was distributed to developing countries. The breakdown of the SDR allocation by developing regions of the world shows that Africa, Asia, developing Europe and Latin America and the Caribbean received US$ 33.8 billion, US$ 139.4, 6.9 billion, and US$ 51.5 billion respectively, representing 5.2%, 21.5%, 1.1% and 7.9% of the total [12] (see table 1).

Table 1 | Country groupings: SDR allocation and equivalent in dollars, share of total and percentage of international reserves, August 2021

Country grouping	***Special drawing rights*** *(billions)*	Billions of dollars	Share of total *(percentages)*	Percentage of international reserves
Developed economies	293.8	418.4	64.4	21.3
Developing economies	162.7	231.6	35.6	27.5
Total	456.5	650.0	100.0	26.2
Africa	23.7	33.8	5.2	65.7
Asia	97.9	139.4	21.5	6.3
Developing Europe	4.8	6.9	1.1	6.9
Latin America and the Caribbean	36.2	51.5	7.9	6.9
South America	23.6	33.6	5.2	4.5
Central America	2.3	3.3	0.5	8.3
Mexico	8.5	12.2	1.9	6.1
The Caribbean	1.7	2.4	0.4	13.4

Source: Prepared by the author, on the basis of International Monetary Fund (IMF), "Guidance note for fund staff on the treatment and use of SDR allocations", *Policy Paper,* No. 2021/059, August 2021 and "General SDR Allocation (in SDRs)", 21 August 2021 [online] https://www.imf.org/en/Topics/special-drawing-right/2021-SDR-Allocation; FMI, "Data Template on International Reserves and Foreign Currency Liquidity (IRFCL)", 2021 [online] https://data.imf.org/?sk=2DFB3380-3603-4D2C-90BE-A04D8BBCE237; and World Bank, "Total reserves (includes gold, current US$)", 2021 [online] https://data.worldbank.org/indicator/FI.RES.TOTL.CD.

Note: The percentage of international reserves refers to the median by region or subregion. The share of the total is calculated on the basis of the reserves held prior to the new allocation, i.e. as of July 2021, or the most recent data. Developed countries refer to those economies that are considered developed but that do not issue an international reserve currency.

As with the distribution between developed and developing economies, the allocation of SDRs within Latin American and Caribbean countries reflects the existing system of quota shares. The lion's share is concentrated in South America —US$ 33.6 billion, representing 89% of the total allocated to Latin America and the Caribbean— and particularly in Brazil and Mexico (US$ 15.1 billion and US$ 12.1 billion, representing 29% and 24% of the total, respectively. Central America and the Caribbean were allocated the equivalent of US$ 3.3 billion and US$ 2.4 billion (representing 6.5% and 4.6% of the total).

Since SDRs are reserve assets, it is important to examine how the 2021 SDR allocation contributed to international reserves. The results show that they increased total international reserves for all regions of the world.[13] In the case of Latin America and the Caribbean, the SDR allocation at the subregional level represents 6.9%, 8.3% and 13.4% of international reserves for South America, Central America, and the Caribbean, respectively. [14] In Mexico, the ratio of SDRs to reserves is 6.1%.[15]

At the country level, Guyana and Suriname have benefited the most, with total SDR holdings representing 26% and 21% of total international reserves. Other smaller economies that have benefited include the Bahamas, Belize, Ecuador, El Salvador, Haiti, Jamaica and Saint Lucia (see figure 1).

Some of these economies, such as Belize, Jamaica and Suriname, are also among the most indebted economies in the region. In 2020, the public debt of the consolidated public sector stood at 122.6%

[12] This differs from estimates in IMF (2021f), which included some countries of Europe, the Russian Federation, and developing economies under the category of emerging and developing economies.

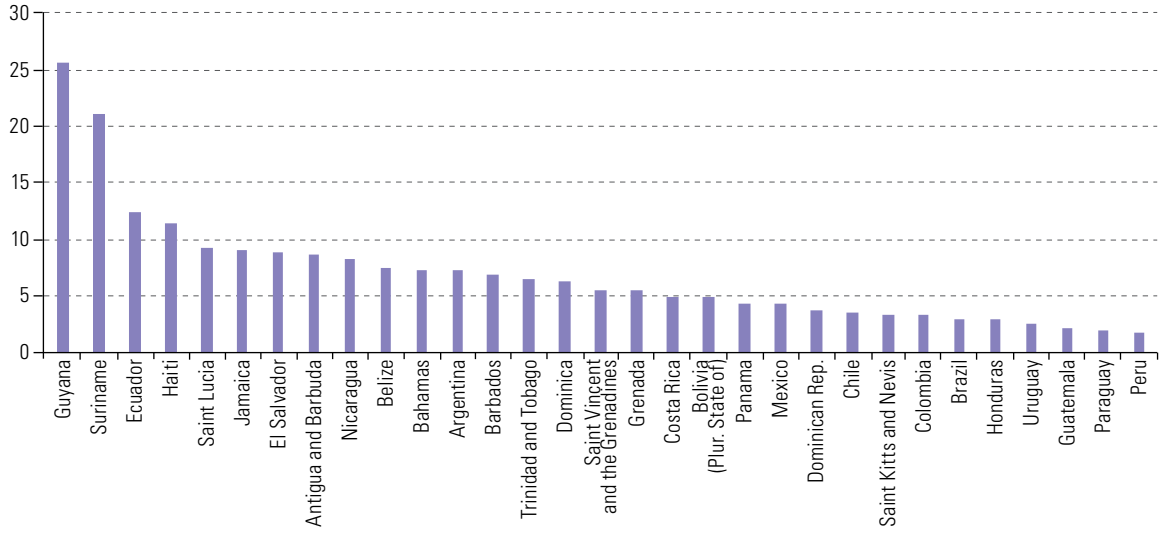
[13] The new SDR issuance increased the international reserves of less developed economies by 12%.

[14] The calculations are based on the latest international reserves data for Latin American and Caribbean countries, available on 31 October 2021.

[15] Data for Latin America and the Caribbean and South America do not include the Bolivarian Republic of Venezuela, which has not received its quota of the new SDR issue because IMF does not officially recognize its government. If the country were to receive its share of SDRs, these would represent 56% of its international reserves.

of GDP, 103.3% of GDP and 99% of GDP for Belize, Jamaica, and Suriname, respectively. The consequent increase in international reserves for these economies will provide an important financial buffer by reducing risk and strengthening their external position (ECLAC, 2021e).

Figure 1 | Latin America and the Caribbean: SDR allocation equivalent to US$ 650 billion as a percentage of gross international reserves, August 2021
(Percentages)



Source: Prepared by the author, on the basis of International Monetary Fund (IMF), "Guidance note for fund staff on the treatment and use of SDR allocations", *Policy Paper*, No. 2021/059, August 2021 and "International Financial Statistics (IFS)" [online] https://data.imf.org/?sk=4c514d48-b6ba-49ed-8ab9-52b0c1a0179b.

Most countries in Latin America and the Caribbean have opted to use SDRs to increase the level of international reserves. Some, including Colombia, Ecuador and Paraguay, have chosen to use their SDR allocation for budgetary purposes, the different modalities depending on the norms and legislation of each country. Argentina, for its part, plans to use its SDR allocation to repay its external debt.

In the case of Colombia, the central bank sold the equivalent of its SDR in dollars (US$ 2.79 billion) to the government in exchange for government treasury bills from the Ministry of Finance and Public Credit. Because the central bank did not exchange its SDRs for dollars, it will not incur interest payments. The central bank's backing of government debt enabled the government to improve its liquidity position and restructure its public debt. Thanks to this transaction, the Government of Colombia, which has one of the highest debt-to-GDP ratios in Latin America (71.5% of GDP for the consolidated public sector for 2020), was able to extend the maturity of part of its debt beyond 2022.

The Government of Ecuador publicly declared its intention to use its SDR allocation (equivalent to US$ 669 million) for budgetary support. The procedure is likely to be similar to that followed in 2009, when IMF issued its second SDR allocation (SDR 161 billion) to address the impacts of the global financial crisis. That year, IMF transferred Ecuador's SDR quota share (the equivalent of US$ 402.45 million) to the central bank. In turn, the central bank exchanged the SDRs for its equivalent in dollars, which was credited to the Ministry of Finance checking account. The Ministry recorded these proceeds in the general government's budget as capital income, which was used to finance fiscal expenditures (see, Latindadd, 2021).

Like Ecuador, Paraguay will use its allocation (US$ 250 million) to fund fiscal expenditure: specifically, SDRs will provide 68% of the total financing required for the implementation of the Economic Consolidation and Social Support Act (*Ley de Consolidación Económica y Contención Social)* adopted on 25 August 2021. The main objective of the Act is to provide resources for the health system and guarantee the continuity of the financial and assistance programmes implemented at the beginning of the pandemic. The bill stipulates that due to exceptional conditions, SDRs are to be directly allocated to the account of the public treasury as a financial asset and that the central bank will provide an advance to the treasury for the equivalent amount in dollars.[16]

[16] See, Proyecto de Ley *Ley de Consolidación Económica y Contención Social*, articles 34–37 [online] http://silpy.congreso.gov.py/expediente/123761.

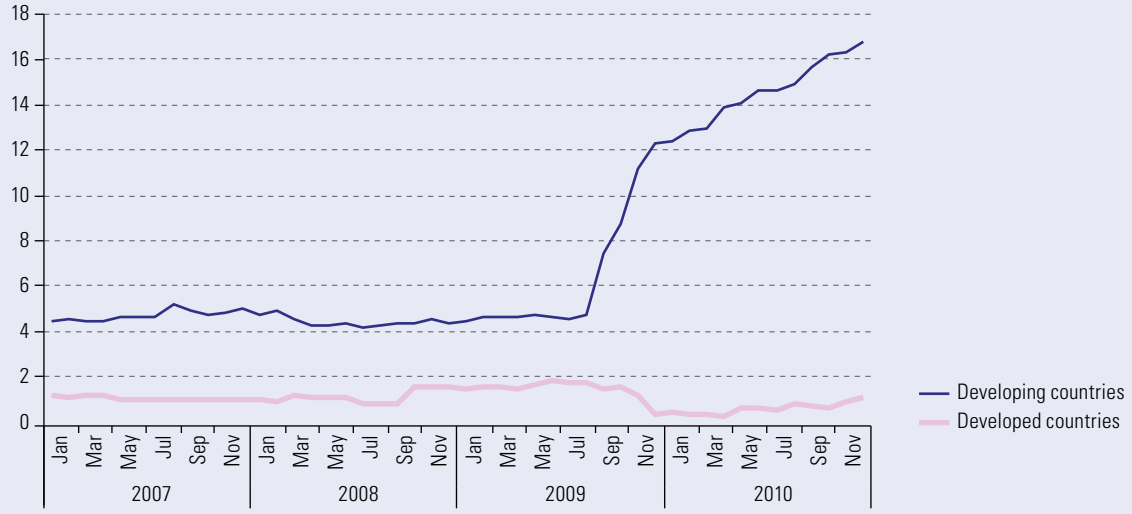
The use of SDRs for budget support is not new. During the 2009 global financial crisis, several economies including Bosnia and Herzegovina, Mauritania, the Republic of Moldova, Serbia, Ukraine and Zimbabwe used a significant part or their entire allocation for fiscal purposes (United States Congress, 2010).[17]

Lastly, another way in which SDRs have been used in the region is in the repayment of external debt.[18] The Government of Argentina has declared it will use its SDR allocation (equivalent to US$ 4.3 billion) to pay down capital and interest on its outstanding debt to IMF maturing in September and December 2021. Argentina is currently in talks with IMF to restructure the credit line of US$ 45 billion granted in 2018.

1.2. Developing economies have a greater demand for SDR use relative to developed countries

There is higher demand for SDR use in developing economies than in developed economies. Developing countries' use of SDR intensifies in times of crises as they face increasing financing needs coupled with tighter liquidity constraints and more limited fiscal space. This was illustrated in the period 2007–2010, which covered the global financial crisis (2008–2009). During this period, the SDR utilization rate (the difference between SDR allocations and SDR holdings divided by SDR allocation) of developing countries remained consistently above that of developed countries. Also, as figure 2 shows, the gap between developing and developed countries' SDR utilization rate as a proportion of their respective IMF quotas widened significantly in 2008–2009.[19] Similar findings are seen in a United States Congress study on the period from September 2009 to June 2010: the annual percentage change in holdings of SDRs by developed countries during the period in question was equal to zero.

Figure 2 | Developing and developed countries: SDR mean utilization rates as a proportion of IMF quota, 2007–2010
(Percentages)



Source: Prepared by the author, on the basis of International Monetary Fund (IMF), "IMF Finances", Washington, D.C. [online] https://www.imf.org/external/np/fin/tad/query.aspx.

Available empirical evidence also shows that prior to and during the COVID-19 pandemic, there was a marked difference in the utilization of SDRs depending on levels of development. Table 2 shows the utilization rates for different developed and developing country groupings for 2019–2021. The results show that, on average, the rate of utilization of SDRs is much lower in developed countries (5.9%) than in developing countries (42.9%). In the case of Latin America and the Caribbean, the rate of utilization hovers at 30%.

[17] It should be noted that the use of SDRs for fiscal purposes does not occur only in developing countries. In the United States, SDRs are allocated to the Exchange Stabilization Fund managed by the country's Treasury. The Treasury has the authority to issue SDR certificates, which can by law be exchanged for cash in dollars by the Federal Reserve. In the 2022 budget, the Treasury plans to use part of the new SDR allocation to fund PRGT. See Schwartz (1997); CRS (2020).

[18] This is one use of SDRs that is provided for by IMF (IMF, 2021k, p. 16).

[19] A similar result is obtained if the utilization rate is alternatively measured using the difference between the SDR allocation and holdings divided by the SDR allocation. According to this indicator for the period January 2007–December 2010, the utilization rates were 14% and 19% for advanced economies and developing countries, respectively.

Table 2 | Selected country groupings: SDR utilization rate, 2019, 2020 and 2021
(Percentages)

Country grouping	Utilization rate (mean)		
	2019	2020	2021[a]
Developed economies	6.0	5.9	6.1
Developing economies	21.9	18.5	16.4
Africa	24.3	14.8	7.7
Asia	16.6	16.8	17.5
Latin America and the Caribbean	27.0	28.7	30.0
Developing Europe	19.6	15.0	15.2

Source: Prepared by the author, on the basis of International Monetary Fund (IMF), "IMF Finances", Washington, D.C. [online] https://www.imf.org/external/np/fin/tad/query.aspx.
Note: The utilization rate is calculated as the difference between SDR allocations and SDR holdings divided by the IMF quota.
[a] Figures through to July 2021.

The empirical evidence on the rates of utilization (see table 2) establishes a baseline for estimating the share of the new issue of SDRs equivalent to US$ 650 billion that could be recycled from developed to developing economies. With a utilization rate of 5.90% in developed economies, US$ 393 billion could be redistributed to developing economies. If the rate of utilization for developed countries were to double to reach 11.8%, the equivalent of US$ 369 billion could be redistributed to developing economies.

Table 3 | Developing regions: SDR redistribution on the basis of utilization rates and IMF quota shares, 2021
(Billion SDRs and billions of dollars)

Regions of the developing world	Recycling according to SDR utilization rate			Recycling according to average IMF quota shares of developing regions		
	Billion SDRs	*Billions of dollars*	*Billions of dollars net of interest*	*Billion SDRs*	*Billions of dollars*	*Billions of dollars net of interest*
Developing economies	276.5	393.7	374.0	276.5	393.7	374.0
Africa	67.5	96.1	91.3	40.3	57.3	52.5
East Asia and Pacific	32.6	46.4	44.1	94.4	134.5	132.2
South Asia	97.1	138.2	131.3	33.2	47.3	40.4
Western Asia	16.5	23.5	22.3	41.3	58.8	57.6
Latin America and the Caribbean	**62.8**	**89.5**	**85.0**	**59.8**	**85.2**	**80.7**

Source: Prepared by the author, on the basis of International Monetary Fund (IMF), "General SDR Allocation (in SDRs)", 21 August 2021 [online] https://www.imf.org/en/Topics/special-drawing-right/2021-SDR-Allocation and "IMF Finances", Washington, D.C. [online] https://www.imf.org/external/np/fin/tad/query.aspx.).

SDRs could be recycled to developing economies on the basis of their respective rates of utilization or, alternatively, their corresponding IMF quota shares. Table 3 shows preliminary estimations by developing region using both criteria. It also includes the share that regions would receive in dollars net of the interest costs associated with the use of SDRs. As the table shows, Latin America and the Caribbean would receive the equivalent of US$ 85.0 billion or US$ 80.7 billion dollars (net of interest) depending on whether the rate of utilization or IMF quota shares allocation criteria, respectively, are used.

1.3. Exploring the possibility of recycling the SDRs through a middle-income country trust fund and regional development banks or financial institutions

In addition to facilitating bilateral SDR exchanges between central banks, the Poverty Reduction and Growth Trust (PRGT) has, to date, been the only vehicle for recycling SDRs since the 2009 allocation. Largely funded with SDRs from developed countries, PRGT is an IMF instrument to give concessional support, subject to conditionalities, to low-income, lower-middle-income, and upper-

middle-income countries that are deemed to be in debt distress. Poverty Reduction and Growth Facility-eligible Latin American and Caribbean countries include Dominica, Grenada, Guyana, Haiti, Honduras, Saint Lucia and Saint Vincent and the Grenadines.[20]

The provision of financial support through SDRs must be expanded to all middle-income countries, including those in Latin America and the Caribbean, and tailored to their diverse economic and social development needs. In line with the recommendation by the Secretary-General of the United Nations that the establishment of a new trust fund to be housed at the IMF should be considered to support middle-income countries, and small island developing states (SIDS) in particular, in their response and recovery efforts (United Nations, 2021), this section presents a preliminary proposal for a trust fund, largely financed through the use of SDRs as capital to leverage resources, to support middle income countries. This option and proposal merits further exploration and development. Another proposal is the use of SDRs by development banks to intermediate and channel resources to middle income countries.

A new trust fund to support middle-income countries: a preliminary proposal

The purpose of the trust fund is to finance sustainable development investment projects to support response and recovery efforts in middle-income countries, and SIDS in particular. Such a fund could leverage SDRs by capitalizing on the growing interest of private financial markets in social and sustainable bonds issued by emerging market economies.[21] Available data from 2013 to 2021 show that social bond issuance has increased from US$ 11.6 million in 2013 to US$ 852 billion in 2021.[22] However, sustainable bond issuances by developing and emerging economies continues to lag behind the global trend. For instance, United Nations Global Compact estimates that the Middle East and Africa account for a mere 1% of global green bond issuance in 2020.

To ensure the proper design and functioning of a new trust fund for middle income countries, several key issues must be addressed: (i) housing; (ii) capitalization; (iii) operation and size of the fund; (iv) additional financing sources. These issues are addressed in the paragraphs below.

If the fund were housed outside IMF, it would have to be granted SDR prescribed holder status, requiring the vote of 85% of IMF Executive Board members. If the fund is housed within IMF, it could follow the PRGT model and not be a prescribed SDR holder. An additional advantage of a fund hosted within IMF is that the SDRs that are recycled to the fund could still be included as international reserves (UNDP, 2021).

In this scheme SDRs would be used to capitalize the fund. The use of SDRs as capital faces two hurdles.

As they are reserve assets, SDRs must be particularly liquid instruments. The use of SDRs as capital would transform them into illiquid instruments. Until now, lending of SDRs (recirculation) has been allowed on the condition that they maintain their reserve asset status. The first hurdle, then, is to reconcile the use of SDRs as capital and their use as a reserve asset. Secondly, the use of SDRs to leverage resources entails risk-taking, whereas reserve asset ownership entails no risk for countries lending SDRs.[23]

One way to overcome the first hurdle is to have an arrangement whereby the country lending the SDRs can withdraw them in the event of a contingency. This type of mechanism exists in the Poverty Reduction and Growth Trust (PRGT) in the form of encashment of SDRs that advanced countries lend to the Trust. In that situation, SDR-lending countries sign an agreement with IMF as trustee of PRGT under which they can encash SDRs when faced with problems concerning balances of payments or international reserves.[24] For this purpose, PRGT maintains a liquid reserve account equal to approximately 20% of its loans. In practice, many of the advanced countries (such as Japan or eurozone countries) that lend their SDRs to PRGT do not have balance of payments or international reserve problems that would lead them to encash their SDRs, since they are issuers of international reserve currencies. Thus, the SDR encashment clause is more of a guarantee to maintain the SDRs' liquidity.

[20] The Poverty Reduction and Growth Trust is not an SDR prescribed holder even though it receives SDRs from contributing countries.
[21] Social bonds are bond issues for projects designed to have a positive social impact. Examples include affordable housing, affordable infrastructure, and community development. Sustainability bonds are bond issues to finance new and existing projects designed to have a positive environmental impact. Examples include projects connected to renewable energy, clean transport, energy efficiency, water/waste management and green buildings. They also include the financing of health-related projects (Mutua, 2021).
[22] See Environment Finance (2021).
[23] See Andrews (2021a).
[24] See IMF (2021e) and Plant (2021).

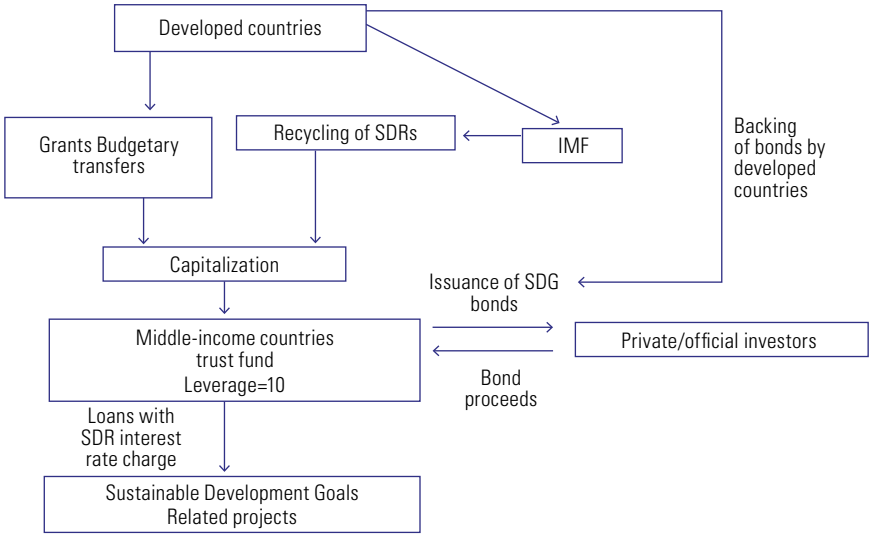
The creation of a reserve fund, together with certain lending policies to minimize credit risk, could help to overcome the second hurdle.

The voluntary recycling of SDRs by developed countries would be assigned according to the quota of participating countries. The fund could offer Sustainable Development Goal Bonds (SDG bonds) in the international capital markets to private investors and institutional holders backed by SDRs. In the case where the trust fund would be located at IMF this would be facilitated by the fact that since 2009, IMF established a framework for issuing securities denominated in SDRs. The sole limitation is that these instruments, which have a five-year maturity, are tradable in the official sector only (Carin, 2013).

The proceeds of the bond issues would serve to finance projects related to the SDGs. The fund could target a conservative leverage ratio of 10, meaning that it could issue one trillion dollars in bonds, which would be backed by one billion dollars in SDR capital. Developed countries would have to guarantee the bonds issued for them to have a AAA or AA rating (see figure 3).

The use of SDRs results in accrued interest on the capital base of the fund, constituting a financial liability that must be repaid. Developed countries would incur interest charges on their debit position in the IMF SDR department. This is a cost that will have to be considered. However, if an SDR interest rate —which, at a low 0.05% amounts to a concessional loan— is charged on loans, the fund could transfer this income as an interest payment to developed countries.

Figure 3 | Proposal for a middle-income country fund



Source: Prepared by the author, on the basis of B. Carin, *Sustainable Development and Financing Critical Global Public Goods*, C. Hurst and Company, 2013; H. Bredenkamp and C. Pattillo, "Financing the response to climate change", *IMF Staff Position Note,* No. SPN10/06, 2010; C. Ferron and R. Morel, "Appendix I-special drawing rights", *Climate Report,* No. 46, July 2014; N. Birdsall and B. Leo, "Find me the money: financing climate and other global public goods", *Center For Global Development. Working Paper*, No. 248, April 2011.

Lastly, the trust fund would need to consider additional sources of financing, such as grants or budgetary transfers, that could be provided by developed countries. Grants could be used to subsidize loans provided by the trust fund and to guarantee repayment to lenders, along similar lines to the Poverty Reduction and Growth Trust.

Development banks and regional financial institutions

Development banks and regional financial institutions that are prescribed holders of SDRs and can receive SDRs could also be part of a mechanism to reallocate SDRs. Among the development banks that are prescribed SDR holders are the African Development Bank, the African Development Fund, the Asian Development Bank, the International Bank for Reconstruction and Development and the International Development Association, the Islamic Development Bank, the Nordic Investment Bank, and the International Fund for Agricultural Development. The intergovernmental monetary institutions that are prescribed holders of SDRs include the Bank for International Settlements, the Latin American Reserve Fund, and the Arab Monetary Fund.

Recirculation of SDRs through development banks can take two forms. The first is the use of SDRs for loanable funds, according to some authors (Andrews, 2021b; Plant, 2021; Andrews and Plant, 2021). In this case, development banks could replicate the PRGT organizational model, which includes three separate accounts: loans, grants, and reserves. The liquidity of SDRs would be maintained through an SDR encashment system. Credit risk could be addressed through policies such as the creation of a reserve fund to reimburse creditors in the event of default. Consideration also needs to be given to how to mitigate risk in the case of loans whose maturity may exceed that of PRGT (10 years). Lastly, although the interest rate on SDRs is to all intents and purposes a concessional rate, it is variable and could be raised. In this regard, it is proposed that a subsidy account be established to make up the difference between a concessional interest rate and the interest rate payable on SDRs.

Development banks that are prescribed holders of SDRs could issue bonds to IMF in return for SDRs, which could then be used for long-term loans at the SDR rate. This would supplement either concessional lending programmes or focus on financing new activities. This would change the way in which concessional programmes are financed, which is through the development assistance budgets of donor developed country governments (Herman, 2020). It would also provide an avenue for concessional development financing for countries at different income levels, including both low- and middle-income countries.

The second form of recirculation is the use of SDRs to capitalize development banks. This would substantially increase the ability to expand available resources and borrowing through leverage. This form faces the same hurdles as those raised in the case of the trust fund for middle-income countries. The analysis of the possible solutions considered in the previous section is also valid for this form. The solutions adopted should reflect a consensus between development banks, SDR-lending countries and IMF.[25]

2. Establishment of multilateral funds: another instrument for redistributing liquidity from developed to developing economies

Liquidity funds financed by developed countries are a complementary policy option to reallocate liquidity from developed to developing countries. Liquidity funds can give developing economies more weight in decision-making regarding recipient countries and the conditions under which such liquidity is reallocated. This is the case of the Fund to Alleviate COVID-19 Economics (FACE) proposed by the Government of Costa Rica.

2.1. The Fund to Alleviate COVID-19 Economics (FACE): purpose and main characteristics

The Fund to Alleviate COVID-19 Economics seeks to provide extraordinary financing to developing countries, including low- and middle-income countries, that do not have the space to expand domestic resources to deal with the effects of the pandemic. In addition to mitigating the social and economic impact of the pandemic, FACE also aims to provide financing for post-pandemic economic recovery It is hoped that FACE will be financed with resources from developed economies which would be channelled through multilateral development banks.

There are four main characteristics of this proposed fund. The first is that it should be of reasonable size, amounting to US$ 516 billion (3% of GDP of developing countries or 0.7% of developed countries' GDP).

The second is that the fund must provide concessional loans rather than "free funding". Concessional lending is not dependent on the income level of countries. In this regard FACE, is similar to the IMF emergency financing facilities in response to COVID-19 that provide concessional lending with limited or no conditions. Funds would be loaned to each country with a term of 50 years and a five-year grace period at a rate of 0% or at the London Interbank Offered Rate (Libor), which is at 0.7%. The maturity of FACE loans is comparable to that of some sovereign bonds issued by Latin American countries in 2020.

The third characteristic is the absence of conditionality. Concessional loans are free of fiscal, monetary or structural conditions. However, there are requirements for good governance that have yet to be specified.

Fourth, FACE is aligned with the 2030 Agenda and the Sustainable Development Goals.

[25] Andrews and Plant, 2021.

2.2 Progress on the FACE initiative

The FACE initiative proposes a financially feasible multilateral fund, whose simple design would facilitate monitoring of its operations. In addition, it could help to strengthen the financial position of development banks and increase their ability to mobilize additional resources.

Implementing FACE will require addressing certain key issues, the most important of which is securing the required resources from developed countries (0.7% of GDP, which is roughly equivalent to the target set forth in the Monterrey Consensus of the International Conference on Financing for Development). Furthermore, a clear strategy is needed to crowd-in development banks. This, in turn, will involve assessing the capacity of development banks to administer US$ 516 billion without charging intermediation and administration costs.

Also, since FACE is designed to benefit all developing countries, independently of their level of income, criteria for allocating resources and identifying recipient countries and sectors must be specified.

Lastly, an agreed mechanism to monitor the use of resources must be established.

B. Second policy action: strengthen regional cooperation by enhancing the lending and response capacity of regional, subregional and national financial institutions, and strengthening linkages with development banks

1. Multilateral funding increasingly concentrates on low- and lower-middle-income countries

Since the end of the global financial crisis (2008–2009), multilateral funding provided by the World Bank has focussed, to a large extent, on responding to the financing needs of low- and lower-middle-income countries.[26]The year in which the pandemic hit was not an exception. In 2020, low- and lower-middle-income countries were recipients of 75% of the funding provided by the World Bank. Similarly, the data show that most of the year-on-year increases in World Bank financing (64% between 2019 and 2020 and 69% between 2020 and 2021) was channelled through the International Development Association (IDA), the World Bank entity that provides assistance to low- and lower-middle-income countries through its concessional finance widow.

In the same vein, a comparison for 2019–2021 shows that most of the funds committed went to regions of the developing world that have a higher proportion of low-income countries or lower-middle-income countries (see table 4).[27]

Table 4 | World Bank commitments by region of the developing world, 2019–2021[a]
(Billions of dollars)

Region	Financing 2019	Financing 2020	Financing 2021
Africa	15.007	20.820	27.069
East Asia and Pacific	5.302	7.270	7.868
Europe and Central Asia	4.332	7.196	5.874
Latin America and the Caribbean	6.139	7.776	10.233
Middle East and North Africa	5.483	3.622	4.634
South Asia	8.860	11.657	10.873
Total	45.123	58.341	66.551

Source: Prepared by the author, on the basis of World Bank, "World Development Indicators", 2021 [online] https://databank.worldbank.org/source/world-development-indicators.

[a] The amounts disbursed to the region by the World Bank for 2019, 2020 and 2021 are US$ 5.187 billion, US$ 6.265 billion and US$ 9.225 billion, respectively.

[26] The increase in lending provided by the World Bank between 2019 and 2020 totalled US$ 13.2 billion which represented more than half of the amount provided to confront the global financial crisis (US$ 28.1 billion). When 2021 figures are taken into account, the increase in lending between 2019 and the average for 2020–2021 is US$17.3 billion. Since the global financial crisis (2008–2009), Latin America's share of World Bank lending has steadily decreased. In 2008 and 2009, the region's share stood at 19% and 30% of the total and above that of any other developing region. Latin America's share of total World Bank lending dropped to 19%, 17%, 14%, 13% and 15% in 2012, 2016, 2019, 2020 and 2021.

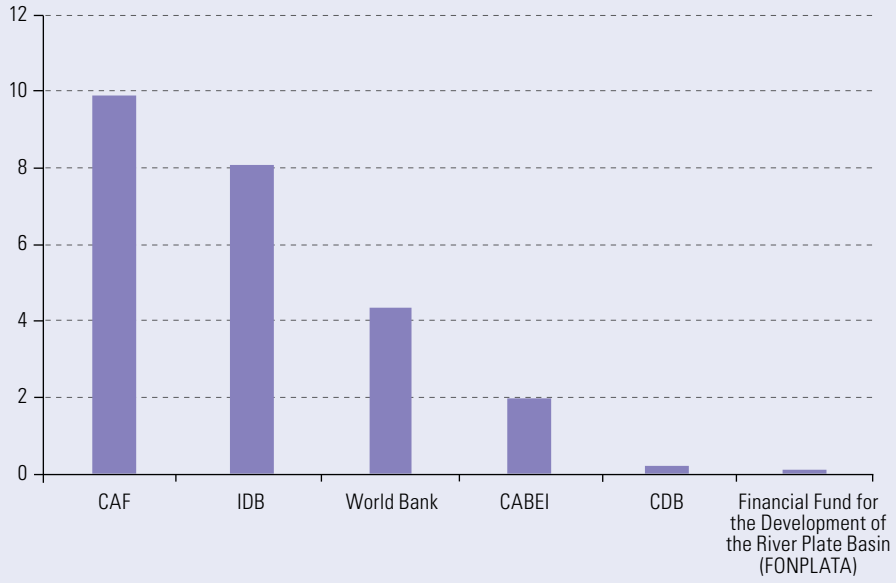
[27] This contrasts with the increase in lending provided by the World Bank to Latin America and the Caribbean during the global financial crisis (2008–2009) which amounted to US$ 9 billion and represented 42% of total increased lending to developing regions.

In 2020, six lower-middle-income countries and vulnerable upper-middle-income Latin American countries (Honduras and the Plurinational State of Bolivia for the former and Dominica, Grenada, Saint Lucia and Saint Vincent and the Grenadines for the latter), together with Haiti, the only low-income country in the region, received concessional financing from the World Bank through IDA, totalling US$ 908 million (12% of total financing). The rest of the countries received non-concessional financing because of their upper-middle-income status. The breakdown by sector shows that the financial sector, public administration, social protection and the health sector received the bulk of the finance provided by the World Bank (64%). Only five countries (Colombia, Dominican Republic, Haiti, Mexico, and Uruguay) received financing specifically earmarked to combat COVID-19, totalling US$ 2.2 billion (29% of the total for 2020).

2. Strongest response to the pandemic came from subregional development banks and national development banks, in particular

Multilateral funding to address the effects of the pandemic have also lagged behind the financing efforts of regional banks (Inter-American Development Bank (IDB)), subregional banks (Latin American Development Bank (CAF), Central American Bank for Economic Integration (CABEI and, Caribbean Development Bank (CDB)) and, especially, national development banks. Between January 2020 and February 2021, CAF became the most important finance provider to the region, with a funding of US$ 9.9 billion dollars to tackle the pandemic surpassing not only the World Bank, but also IDB, which provided US$ 8 billion in loans. Financial support provided by CABEI amounted to US$ 1.96 billion (see figure 4).

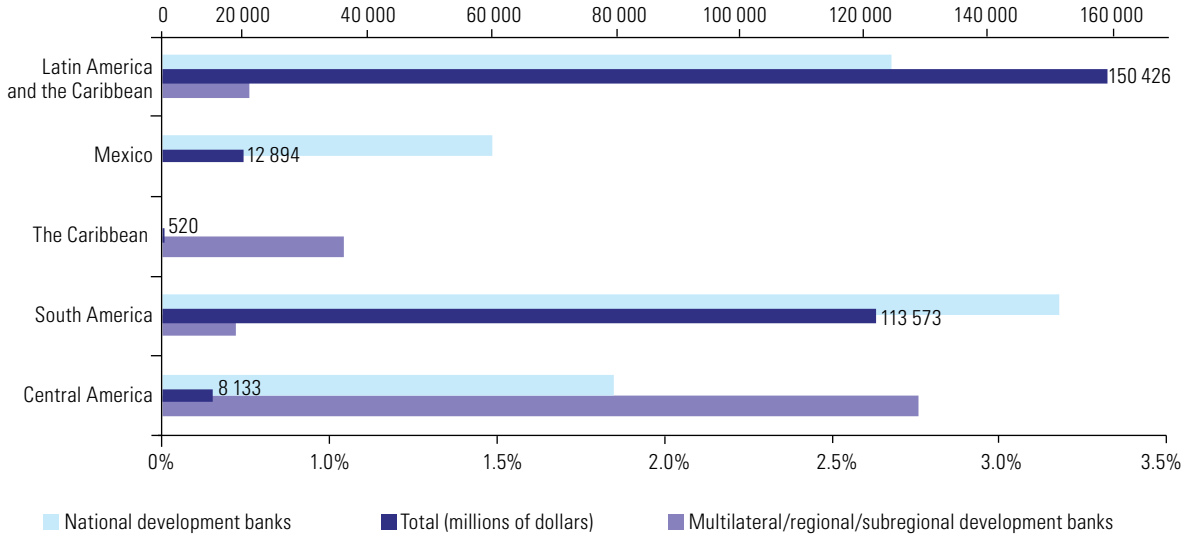
Figure 4 | Latin America and the Caribbean: funding assigned by multilateral, regional and subregional development bank for COVID-19, January 2020–February 2021
(Billions of dollars)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official information from development banks on COVID-19 and press clippings.

The financial support provided by national development banks totalled more than US$ 120 billion (January–November 2020). This has benefited not only some of the larger economies in the region including, Brazil, Chile, Colombia, Mexico and Peru (US$ 68.4 billion, US$ 4.2 billion, US$ 4.5 billion, US$ 12.9 billion and US$ 26.9 billion, respectively) but also the smaller economies. In El Salvador and Panama, the financing provided by national banks represented 6% and 2.8% of GDP (see figure 5).

Figure 5 | Latin America and the Caribbean: financial support by national development banks, by region, 2020
(Percentages of GDP and billions of dollars)



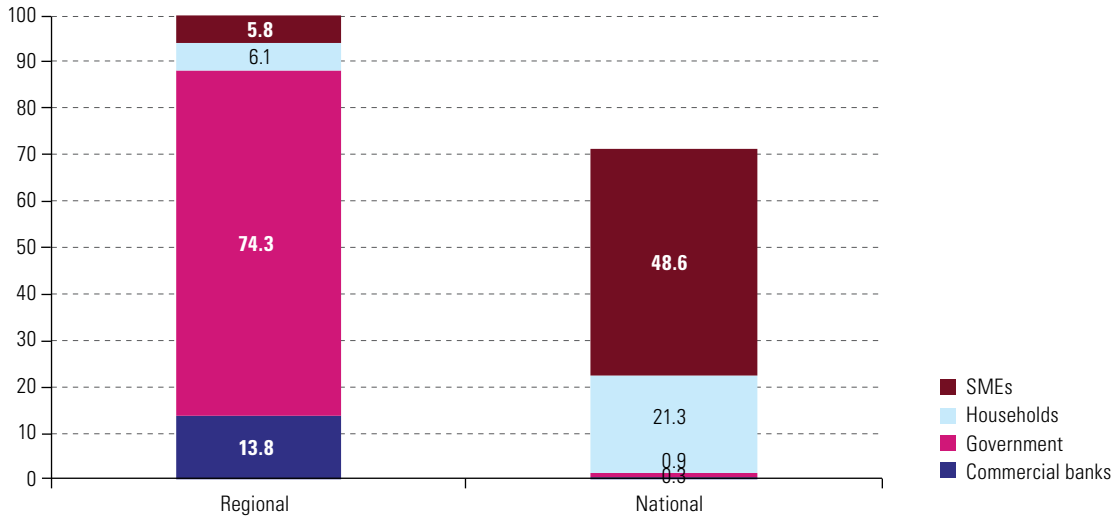
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official information from development banks on COVID-19 and press clippings.

3. National development banks specialize in lending to the productive sector

Two stylized facts characterize the financial support provided by national development banks relative to that of regional or subregional and multilateral lending.

First, regional development banks assigned 74.3% of total COVID-19 financial support to strengthen the government sector, alleviating the tax burden generated by the pandemic, while small and medium-sized enterprises (SMEs) received only 5.8% of the total. The rest of the financing was granted to households and banks (6.1% and 13.8% of the total respectively). By contrast, national development banks provided practically no direct support to governments (0.9% of total financing allocated). Rather they focused on maintaining economic activity by supporting mainly the private sector, with 48.6% of the funds granted to micro-, small, and medium-sized enterprises (MSMEs) and 21.3% to households (see figure 6).

Figure 6 | Latin America and the Caribbean: financial support by national development banks for COVID-19, by sector, 2020
(Percentages of total)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official information from development banks on COVID-19 and press clippings.

Second, this specialization in financial support has shaped the type of instruments used by both types of institutions. In the case of national development banks, the breakdown of funding by type of instruments shows that 60% of the total financing provided was channelled through loans, 27% through suspension of payments, 11% through guarantees and 2% through refinancing. Of these, guarantees had the highest rate of growth. Regional development banks supported economies affected by COVID-19 mainly through loans (99% of total).

4. Guarantee systems must be scaled up and institutionalized as a key instrument used by development banks

Guarantee systems have become very important as an instrument to support micro-, small, and medium-sized enterprises (MSMEs) during the pandemic (see table 5). Guarantee systems have been one of the instruments most used by development financial institutions to support the productive sector in countering the effects of the pandemic. National development banks have provided liquidity support through various instruments. Of the amounts disbursed, 46% was for credit, 2% for refinancing plans, 21% for debt moratoriums and 31% for guarantees to enable producers to obtain new loans to continue operating, the latter being the instrument to reactivate lending to SMEs that underwent the fastest growth (Cipoletta and Abdo, 2021).

Many companies, especially MSMEs, have faced unprecedented liquidity constraints during the pandemic. Given their advantages and despite the financial risks these firms face, guarantee systems have emerged as a potentially effective policy tool to address the liquidity gap facing MSMEs. This instrument is attractive for its speed (where it is already in place), and its low budgetary costs, especially compared to other tools such as loans and grants.

Credit guarantee systems have three important benefits. The first is the increase in the supply of credit from the financial system. With the support of the guarantees, financial institutions can expand their supply of funding for companies that are in suboptimal financing situations, because they are not able to offer sufficient guarantees but do have the capacity to administer a higher level of principal.

The second is that more companies can access the formal financial system. With the support of a guarantee instrument, companies that are not able to offer sufficient guarantees of their own accord, start-ups or companies with little experience in covering their borrowing needs would have access to financing.

The third is the improvement in credit conditions. The interest rates, amounts and terms of loans can improve owing to the mitigation of risks provided by a guarantee mechanism.

Guarantees are mainly aimed at MSMEs. That is the priority defined by MSMEs' vulnerability to the impact of the pandemic and by their effect on employment. However, in some cases (Chile, Colombia, Costa Rica and Uruguay), guarantees have also benefited large companies.

Another important instrument that has been used by development banks to address the challenges of the pandemic is the provision of credit. The 130 loans recorded in the database used by Cipoletta and Abdo (2021) for which amounts were given are estimated to total US$ 85.428 billion. Loans are the most widely used development banking instrument globally (Griffith-Jones and others, 2020). The COVID-19 pandemic in Latin America and the Caribbean was no exception, as loan transactions accounted for 46% of the total financial support provided. While non-reimbursable financing was directed mainly to governments, loans primarily went to the private sector.

MSMEs received most of the loans, for a total of US$ 32.475 billion, spread over 45 different transactions. The rest of the private sector received US$ 23.341 billion, through 30 transactions. In terms of the supply of working capital, loans and grants are often subject to certain conditions, such as maintaining stable levels of employment and wages (Griffith Jones and others, 2020), including during the pandemic crisis. Governments received US$ 22.108 billion through 49 lines of credit, in addition to a US$ 731 million debt moratorium from Brazil's National Bank for Economic and Social Development (BNDES) (Cipoletta and Abdo, 2021).

5. Expanding the lending capacity of development banks requires increased capitalization and flexible lending criteria

The lending capacity of development banks can be increased in two different ways: increased capitalization and greater flexibility in lending criteria. CABEI increased its authorized capital by 40% (US$ 2 billion) in April 2020, and IDB is considering a capital increase that would allow annual lending to reach nearly US$ 20 billion (Martin, 2021).

At the IDB, as at the World Bank, the available capital could also be used more effectively by reducing the equity-to-loan ratio to a level on par with that of commercial banks. Multilateral development banks take a conservative approach to equity levels: major banks have an equity-to-loan ratio of between 20% and 60%, which is higher than that of most commercial banks (10%–15%) (Humphrey, 2020).[28] In other words, multilateral development banks hold US$ 2 – US$ 6 in equity for every US$ 10 in outstanding loans, whereas commercial banks hold only US$ 1 –US$ 1.50 per US$ 10 in outstanding loans. The equity-to-loan ratios of the World Bank and IDB stand at 22.6% and 38.2%, respectively.[29]

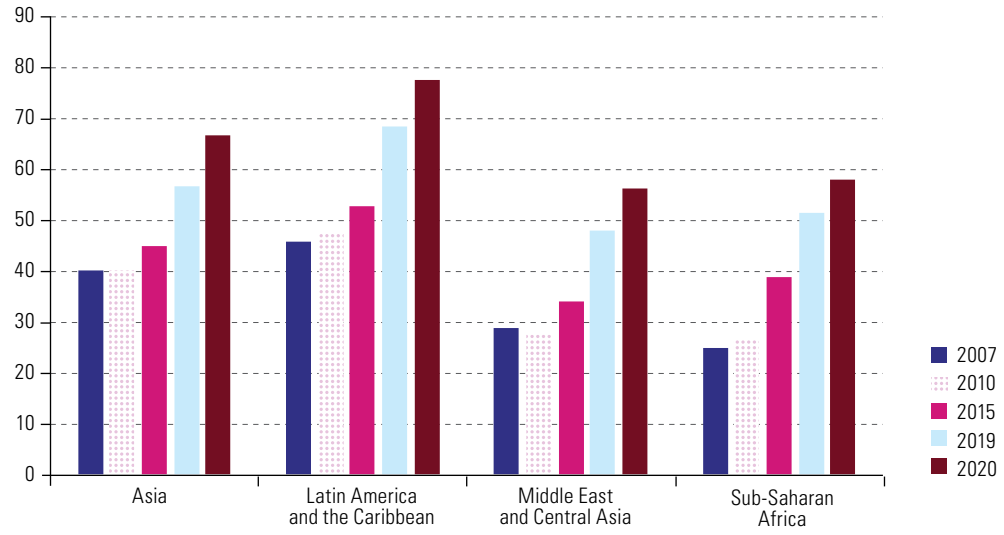
A recent study focused on the World Bank, the Asian Development Bank, the Inter-American Development Bank and the African Development Bank shows that by adopting more flexible criteria for lending and increasing their leverage, these banks could collectively triple their lending capacity from US$ 415 billion to US$ 1.3 trillion. The findings showed that the increase in leverage and risk would have minimal effect on these banks' credit ratings. In July 2021, G20 drafted terms of reference for an independent review of the capital adequacy frameworks of multilateral development banks. [30]

C. The rise in debt and the multilateral response

1. COVID-19 reinforced the uptrend in debt present since the global financial crisis (2008–2009)

Since the end of the global financial crisis (2008–2009) all developing regions in the world have witnessed an upwards trend in their debt levels (figure 7). Between 2010 and 2019, gross general government debt as percentage of GDP in the cases of Asia, Latin America and the Caribbean, the Middle East and Central Asia and sub-Saharan Africa increased from 40.1% to 56.6%, 47.3% to 68.1%, 27.6% to 48.0% and from 26.7% to 51.5% respectively (see figure 7).

Figure 7 | Regions of the developing world: gross general government gross debt as a percentage of GDP, 2007, 2010, 2015, 2019 and 2020
(Percentages)



Source: Prepared by the author, on the basis of International Monetary Fund (IMF), "World Economic Outlook Database", Washington, D.C., April 2021.

[28] Equity includes paid-in capital and accumulated reserves. Loans include loans, guarantees, and equity investments made for development purposes.
[29] Equity includes paid-in capital and accumulated reserves. Loans include loans, guarantees and capital investments for development purposes.
[30] See Setimo (2019), Maasdoorp (2021) and G20 (2021).

The effects of the pandemic have reinforced this trend, as shown by the rise in external debt both measured as a percentage of exports of goods and services and as a share pf GDP for all developing regions.[31] In addition, debt service as a proportion of exports of goods and services has risen for all cases considered.

Latin America and the Caribbean is the most indebted region of the developing world, with general government debt amounting to 77% of GDP and an external debt as a percentage of exports of goods and services equal to 226.7% in 2020. Latin America and the Caribbean also has the highest debt service in terms of its exports of goods and services (59%). Moreover, the region also has the greatest number of countries with a government debt -to-GDP ratio above 100% (47% of the total), most of which are in the Caribbean (see table 5).

Table 5 | External debt indicators for emerging markets and developing economies, 2019-2020
(Percentages)

Region	External debt as a percentage of exports of goods and services		External debt as a percentage of GDP		External debt service as a percentage of exports of goods and services	
	2019	2020	2019	2020	2019	2020
Emerging market and developing economies	116.6	136.4	...	....	42.1	48.2
Emerging and developing Asia	86.0	95.7	18.8	19.5	47.2	50.1
Emerging and developing Europe	120.9	141.9	46.8	51.7	42.5	49.8
Latin America and the Caribbean	192.6	226.7	47.9	56.3	50.9	59.0
Middle East and Central Asia	125.0	176.6	46.8	53.9	22.2	31.8
Africa	102.9	100.9	39.3	43.7	25.0	24.3
Africa (excl. North Africa)	172.5	228.1	42.6	46.1	28.5	35.9

Source: International Monetary Fund (IMF), "World Economic Outlook Database", Washington, D.C., April 2021; for Africa, African Development Bank Group, AFDB Socio Economic Database, 1960-201[online] http://dataportal.opendataforafrica.org/bbkawjf/afdb-socio-economic-database-1960-2019.
Note: Given that most countries experienced an economic contraction in 2020, the external debt-to-GDP indicator may overstate the increase in debt.

The rise in debt and debt service costs has not only significantly reduced the policy space of developing countries to implement countercyclical policies to combat the short-run effects of the pandemic but also constrained their policy autonomy for longer-term economic and social recovery. In contrast, developed countries implemented massive fiscal stimulus packages to complement expansionary monetary measures without regard to their financial conditions and exchange rate parities, reflecting the wide asymmetry in policy space autonomy between developed and developing economies.[32]

Addressing the debt problem, especially for middle-income countries, is key to restore growth and stability to the world economy. Middle-income countries account for 75% of the world's population, and roughly 30% of global aggregate demand. More importantly, middle-income countries account for 96% of developing countries' public debt (excluding China and India).

2. The Debt Service Suspension Initiative, sole available debt-relief initiative, is not a long-term solution to developing countries' debt problem

The Debt Service Suspension Initiative (DSSI), launched in April 2020 by G20, is the only initiative that has been implemented to address developing countries' debt problem and their limited fiscal space to tackle the effects of the pandemic. In effect until December 2021, it consists of a temporary suspension of debt service (principal or interest) repayments to official bilateral creditors, which account for roughly 38% of the total for DSSI participating countries (see table 6).

[31] The external debt-to-GDP ratio may overstate the increase in debt as it also captures the decline in GDP. In this sense, the ratio of external debt to exports of goods and services is a more accurate indicator of the effects of the pandemic on debt levels.
[32] From the outbreak of the pandemic to March 2021, advanced economies mobilized 16.4% of GDP in additional expenditures and tax credits and 11.3% of GDP in loans, capital and guarantees, compared to 10.7% and 7.2%, respectively, in emerging markets. The response capacity in low-income developing countries was even lower, with additional expenditures and tax credits equivalent to 1.7% of GDP and loans, equity and guarantees representing 0.2% of GDP (IMF, 2021c). See also ECLAC (2021a).

Table 6 | Debt service and composition, by creditor for all developing economies, and eligible and participating Latin American and Caribbean countries, 2020–2021
(Millions of dollars and percentages of the total)

Developing Economies	2020 *(US$ million)*	2021 *(US$ million)*	2020 *(percentage)*	2021 *(percentage)*
Bondholders	6 330	7 132	13,8	16,1
Non-official	7 359	6 589	16,0	14,9
Official bilateral	17 682	16 638	38,5	37,5
Official multilateral	14 547	13 969	31,7	31,5
Total	45 918	44 328	100,0	100,0
Latin American and Caribbean eligible countries				
Bondholders	608	57	33,8	4,9
Non-official	75	68	4,1	5,8
Official bilateral	327	265	18,2	22,5
Official multilateral	787	787	43,8	66,9
Total	1 796	1 178	100,0	100,0
Latin American and Caribbean participating countries				
Bondholders	26	19	17,1	15,4
Non-official	3	2	1,7	1,9
Official bilateral	27	26	17,8	20,7
Official multilateral	95	78	63,5	61,9
Total	150	127	100,0	100,0

Source: World Bank, World Bank Development Indicators, Washington, D.C., 2021.

Since it took effect in March 2020, only 48 of the 76 DSSI-eligible countries (66% of the total) have been included. This has reduced the estimated amount of dollar savings (that is used for paying principal and interest to bilateral official creditors) up to from US$ 11 billion to US$ 5.7 billion (up to August 2021).[33]

In the case of Latin America and the Caribbean, only eight countries are eligible to participate in the Initiative owing to their classification as low-income (Haiti), lower-middle-income (Honduras and Nicaragua), and vulnerable upper-middle-income (Dominica, Grenada, Guyana, Saint Lucia, and Saint Vincent and the Grenadines). Four of these (Dominica, Grenada, Saint Lucia, and Saint Vincent and the Grenadines) are currently participating. For the Latin American and Caribbean participating countries, official creditors account for, on average, 20.7% of the total creditors.

The Initiative does not provide a long-term solution for reducing debt and ensuring debt sustainability. The debt deferral considered by the Initiative is based on neutral net present value- and, as a result, does not reduce the total payment debtors will make to participating creditors. Once the Initiative ceases to be in effect, countries will have to pay the capitalized deferred principal and interest over a period of five years following a one-year grace period.

This assumes that after countries will then have the fiscal space to not only face the medium- to long-term effects of the pandemic but also to ensure the sustainability of their debt. However, there are no measures or initiatives at the global level that will ensure that developing countries will be able to grow at rates that guarantee the sustainability of their sovereign debt. Moreover, there are domestic constraints to raising taxes in order to finance higher interest payment outlays.

3. The Debt Service Suspension Initiative stumbling block: including all relevant stakeholders and countries

After more than one year in effect, the Initiative has not been able to attract private sector creditors or multilateral institutions which in many cases are the most important debt holders.

[33] The debt owed to multilateral institutions was estimated at US$ 7 billion in May 2020 (IIF, 2020).

The primary concern of private sector investors is the possibility of debt restructuring and equity loss, as the Initiative will not be able to guarantee the full repayment of their loans once the moratorium is over. Consent solicitation from bondholders is indeed a challenging process. Of the 73 DSSI-eligible countries and territories, 26 have payment obligations due in 2020–2021 for bonds outstanding. DSSI requests from debtor countries may trigger a negative outlook in markets, which would affect credit ratings, bond yields and future refinancing costs.

The main representative body of the private sector is the Institute of International Finance (IIF) whose members include some 450 financial institutions from 70 countries and jurisdictions. In May 2020, IIF issued terms of reference for private creditors' voluntary participation in the Initiative and made subsequent revisions following updates to its terms and conditions by G20. In addition, IIF published a framework agreement for loans and a technical note on bonds, providing technical guidelines for debtor countries and for creditor participation in the Initiative.

Nevertheless, a significant share of private creditors are not members of IIF. In the case of developing countries, middle-income countries, and Latin American and Caribbean countries, the private creditors that are not members of IIF represent 33%, 30% and 56% of bondholders' debt. This lack of representation further undermines the Initiative's potential to tackle the debt problem of developing and middle-income countries, including those of Latin America and the Caribbean.

The major constraint to the participation of the private sector in debt renegotiations or restructuring in developing countries and in the region has been the absence of a multilateral sovereign debt restructuring mechanism that levels the playing field between creditors and debtors. Debt relief initiatives create uncertainty regarding debt payment obligations and can be perceived as equivalent to debt default, leading to downgrades by credit rating agencies and equity loss for private investors.

Multilateral institutions such as the World Bank argue that participation in DSSI may jeopardize their creditworthiness, as debt suspension would impact their own credit ratings and funding costs, unless this is offset by an increase in countries' shareholder contributions. In 2020–2021, DSSI-eligible countries and territories will have to pay US$ 13.7 billion in debt service to the World Bank but will receive only US$ 20.9 billion in disbursement of financial resources up to the end of July 2021, and only US$ 5.6 billion of that is in the form of grants.[34]

Lastly, some countries are concerned that participation in the Initiative will limit their access to private capital markets, which are the main source of sovereign borrowing for developing countries, including from Latin America and the Caribbean.

In April 2021, the Group of 20 indicated that the extension of the Initiative to December 2021 would be the last. Going forward, debt relief efforts for low-income countries will be coordinated under the Common Framework for Debt Treatments beyond the DSSI ("Common Framework") on a case-by-case basis, as endorsed by G20 and Paris Club countries in November 2020.

The Common Framework seeks to fill some of the gaps of DSSI, such as broader inclusion of official creditors that are not part of the Paris Club (i.e. China). It also provides for joint negotiations between official bilateral creditors and a given debtor country. Lastly, it allows for debtor countries to request treatment from the private sector that is comparable to that provided by bilateral official creditors (G20, 2020). To date, Chad, Ethiopia and Zambia have requested debt relief under the Common Framework. However, the Framework does not provide a solution to the main stumbling block to the success of the DSSI: the inclusion of all relevant stakeholders.

4. Debt restructurings in Latin America and the Caribbean provide important lessons for the inclusion of all relevant stakeholders

Four recent cases of debt renegotiation and restructuring involving Argentina (2020), Barbados (2018-2019), Grenada (2013-2015) and Ecuador (2020) provide important lessons on debt restructuring practices. Ecuador and Grenada both successfully negotiated haircuts in the original value of the bonds issued. As an example, after restructuring Ecuador reduced its average rate of interest on the debt from 9.2% to 5.3%.

[34] Data on the World Bank's financial assistance to DSSI-eligible countries and territories are from the World Bank's Fact Sheet on Debt Service Suspension and COVID-19, 28 July 2021.

Debt restructuring requires a compromise between the public and private interest that levels the playing field between debtors and creditors. Debt renegotiation or restructuring initiatives should be led by official creditors and then crowd in private creditors. To that end, the degree of debt relief must be defined prior to the negotiations. The challenge is to avoid the temptation of asking for insufficient or excessive debt relief, since this will lead either to further debt problems or to the view that the initiative is confiscatory.

Private creditors should have a degree of certainty regarding payment commitments, which include avoiding delays and establishing deadlines for the fulfilment of obligations, as delays can increase uncertainty and derail macroeconomic recovery. At the same time, governments must be allowed to fulfil their primary mandate in the provision of public goods and ensuring greater equality, while at the same time, giving the required certainty to private investors.

Achieving a compromise between public and private interests requires a commitment to an effective communication strategy with private creditors that entails sharing relevant data and providing key information on a regular basis. This means that creditor participation and interests must be aligned in order to work towards a mutually agreed solution. To this end, debt restructuring must include collective action clauses (CACs) that accommodate private sector interests and streamline the process, preventing costly delays. Argentina, Barbados, Ecuador and Grenada included collective action clauses in debt negotiations.

While CACs prevent costly delays, without the balancing effect of an international private debt restructuring mechanism, they are not enough to balance the playing field between private creditors and public debtors. In the absence of an effective threat of a legitimate, "chapter 11-type"[35] debt standstill, the upper hand remains in the creditor playing field.

The backing of multilateral institutions is needed to facilitate debt renegotiation and restructuring initiatives. Involving international financial institutions (IFIs) can ensure the necessary backing, confidence and credibility for the private sector to engage. IFIs can provide support in the form of partial credit guarantees. IMF programmes were part of the debt restructuring initiatives in the cases of Barbados, Ecuador and Grenada.

However, this should not require a trade-off between debt renegotiation or restructuring initiatives and governments' growth, employment and well-being objectives. The backing of IFIs, particularly of IMF, often involves adjustment programmes that impose significant reductions in spending likely to compromise the country's future social and economic development and lead to further debt accumulation.

Similarly, in some cases (such as Argentina, Barbados, Ecuador and Jamaica), adjustment programmes also involve surcharges which restrict countries' policy space to foster economic and social development (See section D.2).

D. Third policy action: carry out institutional reform of the multilateral debt architecture

1. Confronting the debt problem requires different solutions tailored to the heterogeneity of debt profiles and debt vulnerability in the region

ECLAC has proposed a strategy to deal with the debt problem in Latin America and the Caribbean along three lines of action.

First, all highly indebted economies should benefit from official debt relief, standstills, or both. Examples of high external public debt are seen in Argentina (102.8% of GDP for 2020 for the central government) and the majority of Caribbean SIDS, including Barbados, Belize, Suriname and the Bahamas (142.8%, 118.2%, 99% and 99.5% for 2020 for the central government, respectively).

Second, economies with short-term debt profiles or a high debt service burden, or both, should also be entitled to some form of debt relief. Caribbean SIDS and Central American countries face significant short-term debt service obligations. The average debt service ratio in the Caribbean is 30% of government revenue and 2.8% of GDP for Central American countries.

[35] Chapter 11 refers to Chapter 11 of the United States Bankruptcy Code (Title 11 of the United States Code), which governs the procedure for reorganization of companies that encounter financial difficulties in the United States.

The case for debt relief in the Caribbean is strengthened by the fact that debt accumulation is driven by exogenous shocks (natural hazards) and structural features related to their small size. The impacts of the COVID-19 pandemic will not only increase the debt burden but also lead to a reallocation of existing budgets.

Third, countries that have —by international standards— greater fiscal space and more solid fiscal or macroeconomic situations (for example, Chile, Colombia and Peru) can take advantage of the historically low levels of international long-term interest rates and the impetus these have provided to the international bond market as a source of funding for developing economies.

2. The IMF policy of debt surcharges affecting Latin American and Caribbean countries disproportionately

Surcharges were introduced by IMF in 1997 with the aim of discouraging extensive and prolonged use of IMF resources. They are meant to encourage early repayment of larger loans — as what is known as the catalytic effect of IMF lending kicks in and member countries regain market access after implementing agreed programmes— and thus to prevent member countries from substituting private financing with IMF loans. In addition, surcharges allow for the accumulation of precautionary balances, which provide a financial buffer to protect the Fund against potential losses resulting from credit, income and other financial risks.

Currently, the bulk of the surcharges burden falls on developing countries. In July 2021, 14 member countries, all classified as middle-income countries, were subject to surcharges. Among these countries, three Latin American and Caribbean countries (Argentina, Barbados and Ecuador), accounted for almost 60% of total surcharges, with Argentina accounting for the lion's share (55%) of total surcharges in 2021 (see table 7). According to ECLAC estimates, if Argentina reaches a new agreement with IMF for an Extended Fund Facility (with a maturity term of 10 years and a grace period of 4 years), it will have to disburse a total of close to US$ 9 billion in surcharges alone between 2018 and 2031 (21% of its current reserve assets).[36] Ecuador is another emblematic case: it will have to disburse a total amount of US$ 556 million in surcharges between 2020 and 2028 (close to 10% of its international reserves).

Table 7 | Main countries subject to surcharges as of July 2021, 2010–2030
(Millions of dollars and percentages of reserves)

Region	Country	Period subject to surcharges	*General Resources Account credit outstanding (millions of dollars)*	Total surcharges	
				millions of dollars	*as a percentage of reserves*
Latin America and the Caribbean	Argentina[a]	2018–2030	45 534	9 062	21
	Barbados	2020–2026	411	16	1
	Ecuador	2020–2028	6 212	556	9
Main non-Latin American and Caribbean countries	Angola	2020–2027	3 821	192	1
	Egypt	2017–2025	20 308	1 759	5
	Pakistan	2015–2023	7 386	373	2
	Tunisia	2015–2024	2 381	117	1
	Ukraine	2010–2023	10 189	1 476	5

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of data from the Finance Department of the International Monetary Fund (IMF).
[a] Stand-By Arrangement for the period 2018–2021 and expected Extended Fund Facility for 2022–2031.

The procyclical and regressive nature of the surcharges system demands that it be reassessed and revised,[37] along with other problematic features of the international financial architecture. Given their importance as a source of funding for IMF, however, a short-term full-scale elimination does not seem feasible. It is necessary, in addition, to redesign the system to make it less harmful for middle-income

[36] This estimate assumes the continued payment of the surcharges accrued under its Stand-By Arrangement in 2021.
[37] As stated by the G20 Finance Ministers and Central Bank Governors in its latest communiqué (July 2021): "We call on the IMF to complete its outreach on a review of access limits and surcharge policy and report to us on its outcome" (https://www.g20.org/wp-content/uploads/2021/07/Communique-Third-G20-FMCBG-meeting-9-10-July-2021.pdf).

countries (Prates and Hawkins, 2021). As a temporary measure, surcharges could be suspended in 2022 to help countries to recover from the effects of the pandemic. In the meantime, other, more long-lasting reforms must be considered. These include the reduction (for example, from 2% to 1%) or the complete removal of level-based surcharges, while keeping time-based surcharges (which are disincentives to the prolonged use of IMF resources), the re-establishment of the level-based threshold to its previous quota of 300%, or the extension of the time-based surcharge threshold to 51 months applicable to all General Resources Account credit facilities, and not just to the Extended Fund Facility (EFF).

3. Proactive fiscal policy can also play an important role in reducing debt and improving debt sustainability

Illicit flows and tax evasion are a major source of foregone revenue severely limiting countries' capacity to mobilize domestic resources. The estimated amount of resource outflows from the region arising from the manipulation of trade prices are equivalent to US$ 85 billion per year (ECLAC, 2021a). For its part, income tax and value added tax (VAT) evasion resulted in 2018 in the case of Latin America and the Caribbean, in a loss of revenue valued at US$ 325 billion (6.1% of GDP). Income tax evasion accounts for a significant portion of this, equivalent to 3.8% of GDP, while VAT evasion accounts for an estimated 2.3% of GDP . Non-payment of income tax is particularly serious, with many countries collecting less than half the revenue that their systems should generate (ECLAC, 2020).

An additional factor limiting countries' capacity to mobilize domestic resources is the scale of tax expenditures, which are preferential tax treatments widely used in the region. They entail a substantial amount of forgone revenue, averaging 3.7% of Latin America's GDP in the period 2013–2017 (ECLAC, 2019). It is important to note that these forgone revenues are equivalent to an average of more than 15% of the budgetary expenditure of the region's central governments (and in some countries more than 25%). However, it is not clear that they produce the benefits for which they were created. Accordingly, it is essential that countries take steps to strengthen the governance of tax expenditures in order to maximize their impact and limit the sometimes-unnecessary losses associated with their use (ECLAC/Oxfam International, 2019).

Besides reducing illicit flows and closing loopholes, another area for strengthening tax collection capacity is through international tax agreements. In this sense, an agreement for the global minimum corporate income tax is one of the instruments that are being considered to avoid the use of aggressive tax planning practices that allow multinational companies to transfer profits to jurisdictions with low or even no income tax.

However, it is imperative to raise the minimum rate to truly benefit developing countries and scale up ambition regarding the minimum rate of the global tax. Existing estimates (Barake and others, 2021) suggest that the additional collection from the global minimum tax in countries such as Brazil, Chile and Mexico would be limited, with a rate of 15% (representing between 200 million euros and 900 million euros per year, depending on the country).

The Independent Commission for the Reform of International Corporate Taxation (ICRICT) has proposed a rate of 25%, above the 21% proposed by the United States. The 25% tax rate would generate significant additional receipts in these countries. For example, Barake and others (2021) estimate that the 25% rate would generate additional tax revenue of 7.4 billion euros per year in Brazil, 1.3 billion euros in Mexico and 1.2 billion euros in Chile.

This is why the region must promote a common regional position on the minimum corporate income tax, make the case for a higher minimum rate, widen the field of multinational companies to which the agreement will apply and achieve a more equitable distribution of revenue between developed and developing countries.

The sustainability and orientation of fiscal policy requires new social and fiscal covenants that contribute to the revival of investment and employment, and to equality, the closure of gender gaps and climate action. These pacts must give an expansionary horizon to fiscal policy, avoiding premature demands for fiscal consolidation and austerity that would severely slow down the economic recovery.

4. The limitations of credit rating agencies in assessing sovereign risk and a proposal for a multilateral credit rating agency

Credit rating agencies are an important component of the financing for development architecture.

They shape to a great extent the conditions under which countries access funding in international capital markets.[38] Their assessments or "opinions" on the creditworthiness of issuers and issues provide potential lenders and investors with information that is otherwise difficult to obtain. Ratings help determine which instruments are investment grade and which are not. Investment grade ratings suggest that a sovereign issuer has the financial capacity to meet its liabilities. Prime ratings are the highest level and suggest that financial capacity is strong and unlikely to be affected by unexpected events. With ratings below investment grade, financial capacity is weaker and economic and financial conditions are less resilient to external shocks. Non-investment grade ratings are indicative of speculative investments. These carry much more risk in terms of an economy's financial performance and ability to withstand unforeseen shocks (Schröeder, 2021).

As a result, credit rating agencies can affect not only the value of assets and collaterals but also market volatility and financial stability. This has especially been the case during the COVID-19 crisis, as private capital markets have become an important source of finance for developing countries, including those of Latin America and the Caribbean. [39]

Credit rating agencies have three major drawbacks that need to be addressed: excessive market power, biased procyclicality against developing economies, and the conflict of interest between the private and the public interest.

The business of credit rating assessment is highly concentrated. It is an oligopoly. The big three credit rating agencies, Moody's, Standard and Poor's (S&P) and Fitch Ratings, control around 95% of all credit ratings in the financial markets and 98.7% of sovereign credit ratings.[40] A more detailed analysis for the case of the European Union shows that around 82% of the market share is in the hands of Standard and Poor's (S&P) and Fitch Ratings (Griffith-Jones and Kramer, 2021).

The market power of credit rating agencies is explained by several factors: the effectiveness in the first decades of their existence which allowed them to gain investors' trust and shape legal provisions sanctioning their dominance; and, also, the existence of economies of scale they have established over the years in gathering, processing, evaluating and disseminating information. This has created strong barriers to entry to the credit rating market. Their market power is reinforced by their Nationally Recognized Statistical Ratings Organization (NRSRO) status in the United States, which is granted to selected rating agencies for regulatory use, such as differentiating between investment-grade and non-investment-grade issuances.

Market concentration has been positively associated with more pessimistic qualitative rating evaluations (Hung, Kraft, and Yu,2019).

Procyclicality refers to the fact that as economic activity softens and a government's fiscal position weakens, sovereign risk increases, and the rating comes under downward pressure. In 2020, all three credit rating agencies registered a record number of downgrades. Fitch was the most active, with 45 downgrades, or 26% of the sovereigns it rates. S&P was next with 37, or 18% of its sovereign ratings, while Moody's lowered the ratings for 33 countries, or 20% of the sovereigns it rates.

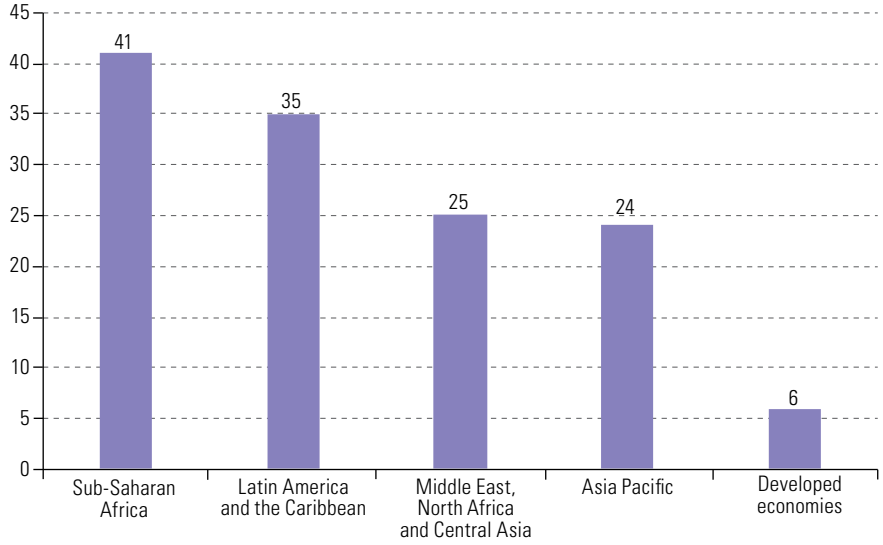
The procyclicality of credit rating agencies is biased against developing economies. Between 31 January 2020 and 28 February 2021, Moody's, Standard and Poor's and Fitch downgraded only 6% of developed economies. In contrast, the share of downgrades for the developing world averaged 31%. Sub-Saharan Africa, followed by Latin America and the Caribbean, are the regions in which there were the highest share of sovereign downgrades (41% and 35%, respectively) (see figure 8).

[38] Ratings improve market efficiency by allowing issue prices to reflect all publicly available information. As a result, investment allocation is more efficient and the cost of capital is more accurate. Ratings also act as benchmarks to validate the internal systems of financial institutions. Sovereign ratings have been used as indicators of an economy's overall performance. A strong rating, for example, is indicative of good management of the economy and resilience to external shocks. A weak rating reflects poor management and vulnerability to such shocks. The ratings reflect the performance of an economy over the business cycle rather than in the short term, unless the economy crashes so suddenly that the structure of the economy begins to change.

[39] Credit rating agencies are generally attributed three traditional functions: (i) to provide an objective measure of the credit risk of a debt issuer and to resolve the fundamental information asymmetry between debt issuers and investors (the risk involved in investing in a security is determined by the likelihood that the debt issuer, e.g. a sovereign nation, will fail to make timely interest payments on the debt); (ii) to provide a means for comparing all issues of embedded credit risk and provide a consistent global rating scale to help build a portfolio (which is essential for the investor); (iii) to provide market participants with a common standard or language to refer to credit risk.

[40] Data at 31 December 2019 (SEC, 2020).

Figure 8 | Share of sovereigns that have been downgraded at least once, 31 January 2020–28 February 2021
(Percentages of total)



Source: Prepared by the author, on the basis of CountryRisk.io, "Sovereign Risk", 2021 [online] https://www.countryrisk.io/platform.

Fitch downgraded Argentina, Ecuador and Suriname, which defaulted on their debt. Besides these countries, Fitch also downgraded Chile, Colombia, Costa Rica, Guatemala, Mexico and the Plurinational State of Bolivia. For its part, Standard and Poor's downgraded Argentina, the Bahamas, Belize, Ecuador, the Plurinational State of Bolivia, Suriname and Trinidad and Tobago. Moreover, the analysis of the sovereign ratings by the three major credit rating agencies shows that more than half of the economies for which data are available are classified with the worst ratings (substantial risk and speculative grades). These include the majority of smaller economies in the region and some of those that were in a weaker position prior to the pandemic (for example, Argentina) (see table 8).

Table 8 | Credit ratings for Latin America and the Caribbean sovereign debt by credit rating agencies, September 2021
(Percentage of total)

Credit rating category	Moody's	S&P	Fitch	CountryRisk.io
Extremely speculative, highly speculative and substantial risk	53.8	45.5	41.2	13.8
Speculative	23.1	27.3	29.4	58.6
Lower medium grade	19.2	22.7	23.5	24.1
Upper medium grade	3.8	4.5	5.9	3.4
Total	100.0	100.0	100.0	100.0

Source: Countryeconomy.com [online] https://countryeconomy.com/ratings and Riesgo Io.
Note: The data are provided for the classification of Moody's, Standard and Poor's and Fitch. Credit ratings are ranked from the worst (extremely speculative, highly speculative and substantial risk) to the best (upper medium grade).

The more vulnerable economies are, the more susceptible to negative credit ratings and downgrades and the more impacted by these ratings from higher costs of issuing debt they will be. In general, the rate of interest on debt issuances for smaller economies tends to be higher than those for the larger economies with more "solid macroeconomic fundamentals". Higher costs of issuing debt implies that countries may face higher-interest debt service for years to come. Countries will have to forego expenditures that could have been allocated to social and economic development to debt service obligations.

Credit ratings by private credit rating agencies can also pose major conflicts of interest between the public and the private interest. The existence of risk evaluation by private credit rating agencies implies transfer of regulatory authority from the government (which is normally entrusted with this task) to the private sector. This can cause major problems since credit rating agencies do not have the mandate to provide information or evaluate credit risk in the interest of public objectives. The objective of credit rating agencies is to maximize profits and shareholder value (Gavras, 2012).

Two other related criticisms are the lack of transparency in credit assessment methods and procedures and the lack of accountability. Since a credit assessment is an opinion on the creditworthiness of a debt issuer, it is difficult to determine who is accountable when that opinion proves to be incorrect.

Credit rating agencies must be designed to serve the public purpose and global public goods rather than private interests. This is a basic argument that can justify the establishment of a multilateral credit rating agency to counterbalance the power of private credit agencies.

A multilateral credit rating agency

The evaluation of credit risk is not only linked to regulation issues but also to the need to maintain financial stability, which is a global public good and should not be left exclusively in the hands of the private sector.

A multilateral credit rating agency would complement private credit rating agencies and have a counterbalancing role. A multilateral credit rating agency is a natural counterpart of a multilateral credit restructuring mechanism (which involves the restructuring of private debt).

The proposals for a public credit agency are not new. In 2011, following the global financial crisis and the euro crisis, the European Parliament adopted a resolution requesting the European Commission to explore and assess the establishment of a truly independent European credit rating agency (Scheinert, 2016). In 2012, the Bertelsmann Foundation proposed the creation of an international non-profit credit rating agency (INCRA).

That same year, IMF considered the creation of a public rating agency, stating very clearly its justification and purpose: the new agency would follow a transparent and approved rating methodology. It would be paid to cover its operating costs, but instead of profit maximization, provision of accurate information to optimize the regulatory process would be its main objective (Gavras, 2012).

In 2013, the United Nations Department of Economic and Social Affairs began discussions on the "creation of a United Nations observatory of credit rating service providers," which would, among others, "certify credit rating products and build consensus on [common] standards for rating methodologies." (United Nations, 2013).

A multilateral credit rating agency aims to improve credit risk assessment of sovereign issuers. This could contribute to evaluation and validation of the methods of private credit rating agencies. It can also develop alternative approaches to government creditworthiness, particularly for emerging market and developing economies. A key improvement would be to use longer time horizons for sovereign risk assessments of developing and emerging countries, which would foster greater stability of these economies and the possibility of attracting long-term investment. Credit risk assessments with a longer time horizon would include analysing how climate change will affect productive activities and government borrowing, which would facilitate achievement of the SDGs.

The challenges for a multilateral credit rating agency include: (i) greater flexibility of criteria for assessing risks through a broad set of indicators, including social, political, and environmental factors; (ii) type of financing; (iii) conflicts of interest; (iv) regulatory capture; and (v) convincing governments and other relevant stakeholders to incorporate its evaluations in their analyses and guidelines. [41]

E. Fourth policy action: expand the set of innovative instruments aimed at increasing debt repayment capacity and avoiding excessive indebtedness

Debt reduction initiatives should be accompanied by innovative financing instruments to link countries' repayment capacity to their risk exposure. Hurricane clauses were included as part of a comprehensive restructuring of Grenada's public debt (2013–2015) and significantly helped to reduce the country's public debt levels, from 94% of GDP in 2013 to 56% of GDP 2019. Hurricane clauses were also part of the debt restructuring (postponement of interest payments) in Barbados (2018–2019).

At a more general level, the experience with hurricane bonds underscores the need to link repayment capacity to the performance of the economy or the business cycle, as is the case with other innovative instruments worth exploring, such as debt and state-contingent debt instruments, including GDP and income linked bonds.

[41] The financing issue was the major obstacle to the creation of an independent European credit rating agency.

1. Hurricane clauses should become a permanent feature of debt relief initiatives for countries, such as those of the Caribbean, which are recurrently exposed to natural disasters

Caribbean SIDS are in a geographical area prone to a growing number of increasingly severe natural disasters. Between 1950 and 2016, the economic cost of natural disasters was more than US$ 22 billion in the Caribbean, compared to US$ 58 billion worldwide. In some countries the estimated damage can exceed the size of the economy. Thus, it is estimated that the cost of Hurricane Maria in Dominica was equivalent to 226% of its GDP, and the damage caused by Hurricane Ivan in Grenada in 2004 was of the order of 200% of its GDP (IMF, 2018).

Given the frequency and destruction caused by extreme weather events, some Caribbean countries have recently begun exploring climate-resilient debt instruments and other innovative means to build financial resilience. One approach to confront this issue is the introduction of a hurricane or similar disaster-linked clauses in debe negotiations. Such clauses are increasingly relevant given growing risks due to climate change and other environmental concerns, and their use could potentially be expanded to larger countries and broader sets of shocks (including public health disasters like COVID-19).

The hurricane clause is designed to provide cash-flow relief at the crucial period after a natural disaster event, just when financing needs are high and new sources of funding may be limited. By embedding hurricane-linked clauses in debt contracts, countries can tap into extended maturity periods in the event of a natural disaster. This would allow a disaster-hit country to defer either interest, or principal payments, or both for a defined period. Theory as well as the short practical available experience show that investors might be willing to accept them, albeit at the cost of higher interest payments.

Disaster-linked or hurricane-linked clauses require first that the issuer and investors agree on quantifiable and externally verifiable indicators of an economic shock upfront. The suspension of principal and/or interest payments will then be tied to those indicators reaching certain pre-defined thresholds. But this deferral is at the option of the debt issuer, providing a degree of flexibility to suspend payments if the issuer needs it. Thus, the clause provides breathing room, with a debt payment moratorium for a prescribed period.

The clauses could help pre-empt the need to restructure debt obligations by reducing debt service burdens at times when public finances are tightest. This provides a breathing space for the economy the time to rebound from the shock before resuming debt service payments. Moreover, the cash that would otherwise be used towards the repayment of debt could be used by the country for rescue, relief, and rebuilding efforts in the wake of a natural disaster.

Further, the ability of the issuer to make the deferral on the debt service payments eliminates the need to seek affirmative bondholder consent and reduces the risk of a disorderly default, thereby avoiding the costs associated with a formal restructuring process.

2. The cases of Grenada and Barbados

In 2015, Grenada became the first country to introduce a clause that stipulated an immediate, albeit temporary, debt moratorium if the economy were struck by a natural disaster. Three years later, in 2018, Barbados introduced a hurricane clause during the debt restructuration of its domestic debt (see box 1). Thus far, these clauses have been included only in restructured debt, not yet in traditional bond sales where resistance to this kind of change tends to occur.

Hurricane clauses have fewer complications than other recent innovations introduced and standardized in bond markets, such as Catastrophe Bonds (CAT); accordingly, some investors might be willing to accept them, but perhaps only at the cost of higher interest payments, which may discourage their use. This has become apparent in the case of Barbados, where international bondholders appeared cool towards the idea of hurricane clauses and needed incentives in the form of higher interest payments.

This is partly attributed to the lack of experience with this type of instruments, in conjunction with the fact that the design may add a degree of complexity that makes bonds with natural disasters clauses more difficult to value than a standard financial instrument. This may be one of the main issues that will determine their future success.

Box 1 | Hurricane clauses: the experiences of Grenada and Barbados

Grenada

Grenada pioneered an innovative "hurricane clause" in its bonds, a move that has gained support from multilateral agencies including the International Monetary Fund (IMF) and the Inter-American Development Bank (IDB), as well as from private trade bodies such as the International Capital Markets Association (ICMA). In 2004, Grenada suffered a devastating blow when Hurricane Ivan swept over the small Caribbean island. The damage amounted to twice the island's annual economic output, and plunged Grenada into a debt crisis that took the country more than a decade to recover from.

In 2015, 11 years after Hurricane Ivan devastated the country and 10 years after a comprehensive debt restructuring exercise triggered by that event, the island state undertook a second comprehensive restructuring of its public debt. In this second debt restructuring, Grenada offered a bond exchange and was prepared to receive all tenders of the 2025 bonds denominated in Eastern Caribbean dollars. Grenada took a proactive step by introducing the first natural disaster clause in its new United States dollar-denominated bonds due in 2030.

The clause allowed Grenada to defer the principal and interest payment due on the next semiannual payment date in the event of a tropical cyclone causing between US$ 15 million and US$ 30 million in losses, and to defer the principal and interest payments due on the next two semiannual payments in the event of a tropical cyclone causing US$ 30 million or more in losses.

The move, endorsed by the influential Paris Club of official creditors, held out the promise of vital financial relief at times of distress. Over the period December 2014–November 2015, debts amounting to US$ 318 million (one third of Grenada's total public debt) were restructured with three creditors. These included the Export-Import Bank (the Eximbank) of Taiwan Province of China, holders of Grenada's previously restructured 2025 sovereign bond, and Grenada's Paris Club creditors. Their provisions differed markedly, with the Eximbank's deal most closely aligned to Grenada's request.

The determination both what of constitutes a qualifying tropical cyclone to activate the natural disaster clause and of the dollar amount of loss incurred is tied to Grenada's parametric insurance policy from the Caribbean Catastrophe Risk Insurance Facility (CCRIF), a risk pool that provides coverage to Caribbean and Central American countries for catastrophic hurricanes, earthquakes and excess rainfall events.

Barbados

In August 2018, the authorities in Barbados rolled out the Barbados Economic Recovery and Transformation (BERT) programme. This economic reform programme also provided the macroeconomic framework for the IMF Extended Fund Facility (EFF) support programme. One of the key elements of the programme included a comprehensive debt restructuring, including both domestic and external debt (while negotiations with external creditors were ongoing, an agreement with domestic creditors was reached on 14 October 2018). The government was able to successfully negotiate natural disaster clauses in its restructured government bonds. In this case, the new bond with a maturity period until 2029 allowed for capitalization of interest and postponement of scheduled amortization falling due over a two-year period, following the incidence of a major natural disaster (see Anthony, Impavido and van Selm, 2020). In the same fashion as Grenada, the trigger for a natural disaster event would be a payout above a prearranged threshold by the Caribbean Catastrophe Risk Insurance Facility under the catastrophe insurance policy.

The Barbados natural disaster clause encompassed not only hurricanes, but also natural events related to earthquakes and rainfall. The minimum claim threshold specified is US$ 5 million, in the case of an earthquake or rainfall event, and US$ 7.5 million in the case of hurricane. Following an event of this magnitude, Barbados had the option to defer for two years any principal or interest payments which would otherwise fall due in following the two-year period. Deferred principal and interest, which is capitalized, continue to accrue interest and are, at the end of the two-year deferral period, added to all remaining principal instalments on a pro rata basis. As a result, the natural disaster clause entitled Barbados to a two-year debt service holiday and the repayment of the deferred amounts would be spread over the remaining term of the bonds. There are some constraints on the use of the deferral right. It cannot be used more than three times nor within the last two years of the bonds with a 2029 maturity date.

Source: Vera, "State Contingent debt Instruments. Draft", 7 September 2021.

IDB plans to include, through its Flexible Financing Facility (FFF), a hurricane clause that allows borrower countries to defer principal payments on eligible loans for two years after a qualifying event. This option would be available for both new and existing loans. No borrower has used hurricane clauses in primary bond markets, but the IDB move could be the first step.

In the IDB Group Country Strategy with Barbados (2019–2023), which provides for up to US$ 300 million in investment loans, IDB proposes the use of its Contingent Credit Line to respond to an emergency caused by a natural disaster. The mechanism would allow for a rapid transfer of funds to cover immediate funding needs that may arise after a natural disaster until other sources of funding become available. In 2018, the Bahamas and Jamaica signed agreements with IDB to access this contingent financing. Suriname signed a similar agreement in March 2019.

3. Hurricane clauses: the lessons learned

Regarding the experiences with hurricane clauses in the case of Grenada and Barbados, a key issue is not only whether these countries benefited from a particular set of circumstances that allowed them to insert disaster-link clauses in debt contracts, but whether such provisions can be replicated with substantial improvements by other economies vulnerable to natural disasters when restructuring their debt or negotiating new agreements.

Successful replication of natural-disaster-linked clauses requires adequate conditions for a mutually beneficial exchange in state-contingent debt instruments between the government and its creditors. Issuer and investor expectations on the expected return of the state-contingent debt instruments may diverge, because of different expectations concerning the evolution and performance of the economy. If the government believes that a given state of the economy will be associated with lower average payouts than investors expect —say for example, because the economy will perform worse than expected— the government will be willing to offer bond characteristics that are more generous to the investor, which will increase the likelihood of sovereign bonds being placed in the private market.

Debt restructurings present an important opportunity for natural disaster clauses to provide future economic downside protection to sovereign debtors. Such clauses would likely be useful in future restructurings, as they provide valuable insurance at low cost against exogenous shocks, something which is not easily incorporated into private contracts.

Nonetheless, there are obstacles to the implementation of hurricane-linked clauses in debt contracts; that is the reason why some financial experts are sceptical regarding the wide use of hurricane clauses. One of the obstacles is the fact that disaster clauses may induce governments to gamble for debt-servicing suspension behaviour and to increase their debt (Mallucci, 2020).

In negotiations and agreements between debtors and creditors, Grenada's experience shows the importance of identifying who will independently assess a catastrophe whose characteristics are included in natural disaster clauses, and who will perform an assessment of "imminent default" and how.

Further, it may be appropriate to tie the cash flow relief that may result from the hurricane clause to the probable maximum loss of an event that occurs once in every given number of years (25 years in the case of Grenada).

Also drawing on the experience of Barbados and Grenada, countries contemplating a hurricane or other disaster linked clauses in their loan agreements should consider assessing whether their debt portfolio compositions are amenable to including such clauses, and whether they would cover a large enough proportion of their debt to deliver adequate fiscal space in the event of a natural disaster. Moreover, the country should determine a trigger and dataset for measuring the type and intensity of a disaster, and ensure that the extent of damage caused can be independently and reliably verified.

The engagement of multilateral organizations in the negotiation processes over the inclusion of hurricane clauses is also important. The design and implementation of clauses associated with natural disasters are likely to require a considerable amount of technical assistance. In the context of the financing assurances assessments mandated for a multilateral programme, debt sustainability analysis and expected medium-term financing and cash flow will be helpful for both debtors and investors.

In the process of restructuring, this will ensure that restructuring and the inclusion of disaster-linked clauses will have a positive material impact on future debt sustainability. Furthermore, close contact should be maintained with the country's debt restructuring negotiators to ensure consistency in financing assumptions and to confirm that the restructuring terms are in line with authorities' programme parameters. Moreover, the support of multilateral agencies regarding the terms of the new debt contracts could provide valuable investor confidence.

Lastly, by postponing debt service payments, a moratorium will lead to greater future disbursements owing to the capitalization of interest payments. Countries must have the required repayment capacity to make ends meet, otherwise a moratorium simply postpones debt distress and default.

4. GDP linked bonds and income linked bonds

The GDP-linked bond is a financial instrument that links either principal or interest payments (or both) to GDP growth. Hence when the economy finds itself in an upwards phase of the economic cycle, interest payments rise. Conversely, when the economy slows down or it is in a crisis, the service of the debt is reduced or even suspended (depending upon its design). In this sense, a GDP-linked bond provides an insurance mechanism in bad times against fiscal liquidity crunches thus reducing the probability of debt default and debt restructuring.

Thus, linking the debt service to an economic performance indicator such as GDP, stabilizes the debt-to-GDP ratio over time. This is so because the need to refinance or rollover existing debt diminishes. At the same time, with indexed debt, its service is reduced during a time of economic distress, a fact that facilitates using the resources to finance pro-growth activities. This inherent feature of a GDP linked bond provides many benefits to both the issuing country and the investors.

However, the use of GDP to link government's repayment capacity with the fluctuations of the business cycle suffers from a major shortcoming. It does not include some of the main determinants of the business cycles for small open economies such as those of Latin America and the Caribbean, including remittances and the terms-of-trade. In the case of Latin America and the Caribbean in 2020 remittances represents more than 20% of GDP for some countries including for El Salvador, Honduras, Haiti and Jamaica, roughly 15% of GDP for Nicaragua and Guatemala, and around 10% of GDP for Belize, Dominica and the Dominican Republic. For their part, the terms-of trade are important sources of fluctuations for commodity producing and exporting countries including mainly South American countries (Bolivarian Republic of Venezuela Chile, Colombia, Ecuador, Peru and Plurinational State of Bolivia).

Replacing GDP with gross national income (GNI) linked bonds may help to correct these shortcomings. GNI includes GDP, and, also, remittances and terms-of-trade effects. In addition, the use of GNI also addresses an information asymmetry problem that is present in the use of GDP, as the evolution of some of its components can be verified independently using external sources.

Thus, the use of GNI can provide more certainty to the private investor. The private investor can easily verify the reliability of the data provided by the government, and thus the stage of the economic cycle in which a given economy finds itself, as data on remittances and terms-of-trade are available from external sources.

5. Advantages and disadvantages of GDP-linked bonds

Like any other financial instrument, a GDP-linked bond involves two parties: the issuer, which in this case is the government, and the investor. The advantages and disadvantages of GDP-linked bonds should be viewed from both perspectives.

The main benefits for the issuer include the reduction of default risk, credit spreads and debt servicing costs. At the same time, GDP-linked bonds increase fiscal space and mitigate procyclicality. Given that this innovative financing mechanism stabilizes the debt-to-GDP ratio, the probability of default goes down, and thus so does the likelihood of a debt crisis. In this sense, GDP-indexed bonds reduce the need for procyclical policies, by acting as an automatic-stabilizer mechanism.[42] This makes it possible to avoid punishing social spending and infrastructure programmes and contain the increase in levels of poverty and precariousness.

[42] See Blanchard and others (2016) and Benford and others (2016).

The investor also benefits, insofar as GDP-linked bonds provide a broader, more stable and less volatile source of income. In addition, they can also serve to diversify risk.

The main disadvantage to the use of GDP-linked bonds lies on the side of the investors and concerns the risk derived from the uncertainty of business cycle fluctuations. This reflects not only the typically greater volatility of GDP fluctuations in developing countries relative to developed countries, but also the degree of reliability of the information available to assess the evolution of GDP over time.[43] Also, issuing GDP-linked bonds in foreign currency (which is the most likely option) introduces an additional source of risk (exchange-rate risk).

Within this context of uncertainty, GDP-linked bonds are an attractive option for private investors if they include a compensation (termed "insurance premium") in addition to the normal return earned. At the same time, the insurance premium represents a cost for the issuing government. Moreover, the costs of issuing a GDP-linked bond increase when the risks perceived by the investor rise, which may occur when the government is most in need of greater fiscal space.[44] Thus, the existing uncertainty and its impact on costs may present an obstacle to finding common ground between the issuer (the government) and the investor, which have differing interests in determining the GDP premium and which, moreover, do not have access to the same set of information.

The evidence on the issuance of GDP-linked bonds is limited to a few countries. The list of countries that have issued bonds with GDP-indexed features include Bulgaria (1994), Bosnia and Herzegovina (1997), Singapore (2011), Argentina (2005) and Greece (2012). The most recent experiment is that of Italy (BTP Futura, 2019). The findings show that GDP-linked bonds can reduce default risk for countries with lower credit ratings, with higher GDP volatility and more constrained monetary policy (Benford and others, 2016).[45] In the case of the European Union, GDP-linked bonds have been able to reduce interest rate payments during sovereign crises, providing greater fiscal space (a summary of experiences with this type of bond is provided in table 9).[46]

6. Making the case for income (GNI) linked bonds

Income (GNI)-linked bonds have three main advantages over GDP-linked bonds. First, for economies, such as those of Latin America and the Caribbean, whose economic performance is constrained to large extent by the external sector, the evolution of GNI is a more accurate reflection of the business cycle than GDP. The income-linked bond is an extension of the GDP-linked bond in developing countries, considering the importance of the external sector, including terms-of-trade, and remittances in determining a country's economic fluctuations.

Second, GNI-income linked bonds can offer, in principle, less risk and thus greater credibility for private investors than GDP-linked bonds, since they include more exogenous elements (such as remittances and terms of trade) which can be verifiable externally. External data sources on remittances and commodity prices (terms of trade) are readily available, thus an investor can verify the information provided by a government on the evolution of the business cycle. Thus, for countries where trade is important and remittances represent a proportion of GNI, in principle a GNI-linked bond may be attractive to investors, as they can easily verify the accuracy of the data and, thereby reducing uncertainty.

One way to determine whether an economy that is open to trade or is a net receiver of remittances is a better candidate for issuing GNI bonds, is to verify whether GNI has a close association over time with exports, remittances and terms of trade. This way, the external factors that determine the rate of growth of an economy can be factored into the analysis.

[43] The literature terms these problems as adverse selection and moral hazard. Adverse selection may occur because a government can have an incentive to issue GDP-linked bonds in a context of low-growth expectations, which can lead investors to increase the premium and thus the cost of the bond. Moral hazard refers to the incentive for public officials to manipulate data to show a lower GDP growth rate.

[44] The most important pricing issue is the pricing of the GDP premium. Since there are few historical precedents and no established market for GDP-linked index bonds, the pricing of the GDP premium is subject to a high level of uncertainty. This is reflected in the wide range of estimates for the GDP premium. Moreover, there is no standard methodology for estimating this premium, so that different methodologies can yield different estimates. Finally, lack of liquidity, lack of markets to hedge GDP risk and difficulties in pricing can undermine the feasibility of GDP-linked bonds.

[45] See Benford and others (2016) and Barr and others (2014).

[46] See Bonfim and Pereira (2018).

Table 9 | Selected experiences with GDP-linked bonds

Country	Duration	Reason for issuance	Type	Instrument	Payment triggering conditions	Pitfalls	Lessons learned
Argentina	2005–present	Debt restructuring	Guarantee	Guarantees linked to real GDP growth	GDP growth exceeds target.	Statistical calculation could be misreported to avoid payments.	Need for an independent statistical agency.
Bulgaria	2004	Debt restructuring	Guarantee	Additional interest payment linked to GDP	(i) GDP at 125% of its 1993 level and (ii) positive annual growth rate.	The government could redeem the bonds unilaterally (repurchase option).	Buyback options undermine investor appetite for the stock.
Bosnia and Herzegovina	1993–2017	Debt restructuring	Guarantee	Bond linked to GDP performance	GDP level and per capita GDP on target.	Reliability of data, the central bank estimates figures but there is a potential conflict of interest.	Data should be transparent and accurate, generated by an independent body.
Greece	2012–2042	Debt restructuring	Guarantee	GDP-linked guarantee	Nominal GDP is equal to or greater than the nominal GDP reference rate.	...	Guarantees traded poorly due to weak post-crisis economic recovery.
Portugal	2013–2018/ 2017–2024	2008 economic crisis	Bond	Treasury certificates linked to GDP growth	Coupon payment based on previous year's GDP performance, plus premium.	...	These certificates are in high demand and can be considered a success.
Singapore	2001–2006	Subsidies for low-income population after a VAT increase	Share	Preferred stocks	Annual dividends above target.	High procyclicality of payments.	Alternative financing is effective if it works in a countercyclical manner.
Ukraine	...	Debt restructuring	Guarantee	GDP-linked guarantees	1% of overall nominal GDP, if GDP reaches target.	Bonds pose a fiscal risk once the cap is removed.	...

Source: Prepared by the authors, on the basis of F. Hernández Trillo, "GDP and income linked bonds", 2021, unpublished.

An econometric estimation for the cases of Argentina, Brazil, Colombia, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Mexico shows a statistically significant association between exports and GNI in all cases. The results also indicate that there is a statistically significant relationship between GNI, terms of trade, and remittances in Colombia, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras and Mexico.

The fact that GNI encompasses a broader set of variables, including exogenous variables, may imply that GNI can exhibit less volatility than GDP. Not all the variables included in GNI move in the same direction during the business cycles, so the upward movement is some of these variables is somewhat compensated by the downward movement in others. Lower volatility leads to a lower insurance premium. This is corroborated empirically for a selected group of Latin American economies, including Brazil, El Salvador, Guatemala, Honduras and Mexico (see box 2).

Box 2 | A first approach to the design of an income-linked bond

When a standard bond is issued, investors expect to receive regular payments (coupon) over the life of the instrument, plus the face value of the bond at its expiration. In its simplest version, the coupon payments of a GNI-linked bond would depend on GNI growth, while its face value remains constant.

One alternative would be for GNI-linked coupons to pay a percentage of the difference between the observed GNI growth rate in a given period, and a pre-specified baseline GNI growth rate, on the condition that the difference is positive, and zero otherwise. Compared to a standard bond, where the coupon interest rates are known in advance, the coupon payments of a GNI-linked bond are uncertain. Therefore, investors will demand an insurance premium. In principle, a smaller insurance premium would incentivize demand for GNI-linked bonds.

The magnitude of the insurance premium can be estimated using the valuation methods that are used to value derivative instruments called call options, which give their holders the right —but not the obligation— to buy a certain security at a given time in the future. In this case, the coupon payment is received if certain conditions are met, namely that observed growth exceeds a certain threshold.

The table below summarizes the insurance premiums that would be required from selected Latin American countries, for a GNI-linked bond whose coupons pay 5% of the difference between observed GNI growth in a given period, and a prespecified GNI baseline growth rate.[a] It also shows the results for a GDP-linked bond.

Insurance premium with GDP- and GNI-linked bonds
(Percentages of bond value)

	Mexico	Brazil	Argentina	Honduras	Guatemala	El Salvador
			GNI			
Insurance premium	0.28975	0.40455	1.7825	0.16965	0.0772	0.18565
Delta	0.9485	0.998	0.998	0.816	0.833	0.907
			GDP			
Insurance premium	0.3497	0.40545	1.76385	0.17665	0.11865	0.23985
Delta	0.762	0.986	0.999	0.784	0.656	0.719

The results show that, for the Mexican case, the insurance premium is about 0.29% of a GNI-linked bond face value and for Brazil this figure reaches 0.40%. For the three Central American countries, the insurance premium is rather small: 0.17%, 0.08% and 0.18% for Honduras, Guatemala and El Salvador, respectively. Argentina is the only country where the premium is high, at 1.79%. Using the standard capital asset pricing model (CAPM), Borenzstein and Mauro (2002) have estimated that the insurance premium is about 0.4%. Both estimates are reasonably low and attractive for investors, with the exception, perhaps, of Argentina.

One of the additional results obtained from the estimation of the insurance premium is the so-called delta, which in the case of an instrument such as a call option measures the sensitivity of the price of

Box 2 (concluded)

the derivative instrument to changes in the price of the underlying security. Delta is often interpreted as the probability that the conditions for the payout, in this case observed GNI-growth exceeding baseline GNI growth, will be met.

The delta is presented in the table above. For Mexico and Brazil, the probability is quite high (95% and 99%). For the Central American countries, the delta is 81%, 83% and 90% in Honduras, Guatemala and El Salvador, respectively. This means that probability that investors will receive interest payments is high. Naturally, it is in economic downturns that investors face the risk of not collecting the coupon. Finally, the results indicate that the insurance premium is lower for a GNI- than a GDP-linked bond.

Source: Prepared by the author, on the basis of E. Borensztein and P. Mauro, "The case for GDP-indexed bonds", *Economic Policy*, vol. 19, No. 38, April 2004.
[a] The computation is carried out on the basis of the evolution of each country's GNI since 1990, as well as the observed yields on their respective long-term sovereign bonds.

F. Fifth policy action: integrate liquidity and debt reduction measures into a development financing strategy aimed at building forward better

Increased access to liquidity and debt reduction must be intertwined with medium- and long-run development objectives and thus with initiatives to build forward better. In this sense, the current crisis should also be seized not only as an opportunity to rethink the financing for development agenda of middle-income and Latin American and Caribbean countries, but also as an occasion to reach wide social and political consensus to implement ambitious reforms to engage in a sustainable and egalitarian building-back process. Building forward better means placing equality and environmental sustainability at the centre of the recovery phase.

1. The need to boost investment with a strategic approach

To build a better future, strategic investment in economic growth must be boosted. The empirical evidence available for the period 1991–2020 reveals not only that investment is highly volatile, and certainly more volatile than GDP, as might be expected, but also that since the end of the global financial crisis (2008–2009) its growth rate has followed a downward trend, averaging 4.1% between 1991 and 2010 and falling to 0.4% between 2010 and 2019 (see figure 9).

Figure 9 | Latin America and the Caribbean: rate of change in gross fixed capital formation and GDP, 1991–2020
(Percentages)

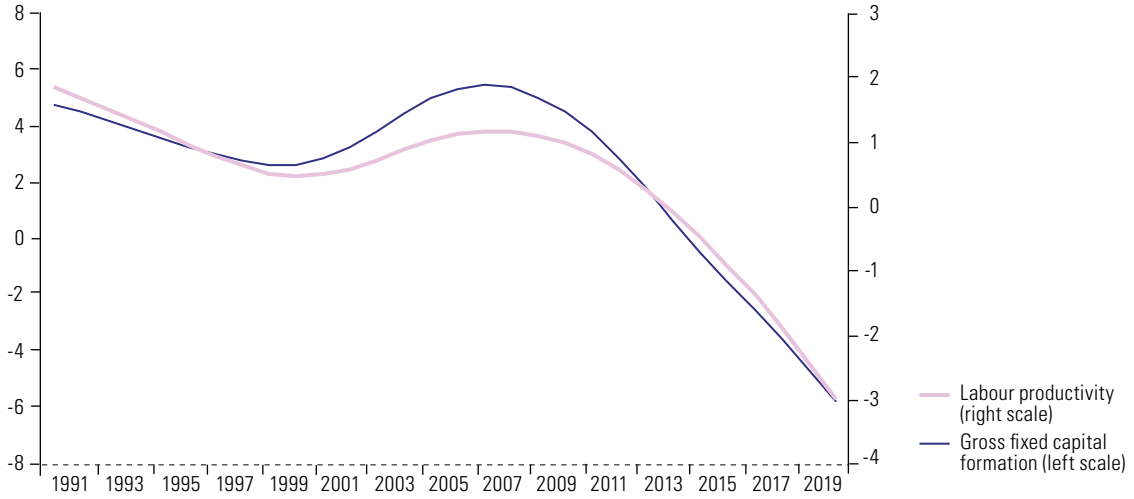
Source: Prepared by the authors, on the basis of World Bank, "World Development Indicators", 2021 [online] https://databank.worldbank.org/source/world-development-indicators.

Note: The statistical significance of the correlation coefficient was determined based on the formula $\rho = \frac{r\sqrt{n-2}}{\sqrt{1-r^2}}$ where r is the simple correlation coefficient and n is the number of observations. ρ follows Student's t-distribution. In this particular case, the calculated value of t for the correlation coefficient between gross fixed capital formation and GDP is equal to 7.1, above the critical level of 1.64, at a 95% confidence level.

The COVID-19 crisis led to a sharp contraction in investment (-10% in 2020), which exacerbated this trend. Moreover, the evidence shows that crises tend to hit investment harder than GDP and hinder its recovery. An analysis of the business cycle based on annual data for the period 1980–2020 shows that in the contraction phase of the cycle, investment contracts three times more than GDP. In the expansion phase of the cycle, GDP expands 27% more than investment.[47] Detrimental patterns in gross fixed capital formation affect capital accumulation and, in turn, productivity.

In the case of Latin America and the Caribbean, as investment has fallen, the rate of change in productivity has trended downward (see figure 10). Available evidence shows that the growth rate of labour productivity slowed from 1.87% to -0.015% between 1970–1979 and 2010–2019. According to Paus (2019), the growth rate of labour productivity in Latin America has lagged behind that of other developing regions over the past 30 years. In addition, the ratio of Latin American labour productivity to that of the United States fell from around 30% in the 1980s to 20% in the 2000s.

Figure 10 | Latin America: trend rates of change in labour productivity and gross fixed capital formation, 1991–2020
(Percentages)



Source: Prepared by the authors, on the basis of World Bank, "World Development Indicators", 2021 [online] https://databank.worldbank.org/source/world-development-indicators.
Note: The trend rate of change was obtained by applying the Hodrick-Prescott filter to the respective time series of labour productivity and gross fixed capital formation.

2. The role of development banks in investment and productive transformation

Regional, subregional and national development banks, in particular, can play a key role in spearheading investment recovery efforts by prioritizing medium- and long-run development objectives. One of the most important components for boosting growth with a strategic approach is green investment and climate-change-related projects.[48]

Increased financing in these areas should be accompanied by changes in the composition of lending portfolios. Regional and subregional development banks have taken a step forward in this direction. IDB has set a target of allocating 30% of its portfolio to climate investment, while CABEI and CAF have set targets of 35% and 30% of their total portfolios, respectively. Furthermore, CAF projects that it will devote 40% of its portfolio to climate investments by 2040 and 50% by 2050. In the case of national development banks, climate investment accounts for a much smaller share of the total loan portfolio. According to a 2017 IDB study, it averaged 1% in domestic banks in Brazil, Chile and Mexico.[49]

Articulating a coherent strategy for the development banking system towards green finance requires the support of multilateral development banks towards subregional and national development banks

[47] Estimates based on the methodology of Harding and Pagan (2002), with annual data from World Bank (2021a). The expansion phase is identified by a positive growth rate of a variable and the contraction phase by a negative growth rate. Amplitude refers to the difference between the peak and trough of the logarithm of a variable, divided by the number of cycles.
[48] ECLAC has identified eight drivers of a new development model that can improve competitiveness and employment, lower the carbon footprint and reduce socioeconomic and gender inequalities. Four of these drivers (sustainable tourism, the bioeconomy and ecosystem services, sustainable mobility in urban areas and the transition to renewable energies) are related to green investment and climate change.
[49] See Abramskiehn and others (2017).

in order to access low-cost funding, long-term capital, and technical capacity to access funds and design projects.

To boost investment and contribute to a transformative recovery, development banks can also explore alternative financing mechanisms such as social and sustainable bonds. This type of financial instrument has grown exponentially since 2012, with global issuances up from US$ 11.6 million in 2013 to US$ 852 billion in 2021. In 2020, 63.6% of the social and sustainable bonds issued were aligned with the Sustainable Development Goals. In the third quarter of 2021, sustainable bond issuances in Latin America and the Caribbean stood at US$ 15.513 billion, accounting for 7.8% of the global total.

Table 10 | Selected regions: sustainable bond issues as a percentage of the total, third quarter 2021
(Millions of dollars and percentages)

Region	Millions of dollars	Percentage
Africa	883	0.4
Asia	29 169	14.7
Latin America and the Caribbean	15 513	7.8
Europe	103 504	52.2
Middle East	1 600	0.8
North America	42 478	21.4
Oceania	5 205	2.6

Source: Environmental Finance, Environmental and Finance Bond Database [online] www.bonddata.org [accessed in 2021].

3. The proposed Caribbean Resilience Fund (CRF)

Central to this endeavour is strengthening the capacity of economies to bounce back and recover and address their long-term structural challenges. The Caribbean Resilience Fund (CRF) proposal exemplifies this objective.

The purpose of the Caribbean Resilience Fund (CRF) is to finance strategic interventions across the Caribbean to alleviate three main challenges affecting the Caribbean. These are unsustainable debt levels due to high debt burdens and rising debt service costs; relatively low economic growth jointly with commitment to comply with the SDGs; and extreme climate vulnerability and exposure to natural disasters.

CRF is a primary regional development tool for the Caribbean with the objective of financing, inter alia, climate adaptation projects and infrastructure, as well as resilience-building and debt reduction. It will serve as a mechanism to attract large-scale funding to promote Caribbean resilience through climate adaptation- and mitigation-related sustainable infrastructure.

The underlying logic of CRF is that long-term climate-resilient economic growth, urgently needed for the implementation of the SDGs, can only be achieved through systematic and broad-based investments in infrastructure assets and resilience-building. While CRF has a single purpose, the sources of funding could vary considerably, which would mean that the Fund should be flexible enough to accommodate the various sources of capitalization which it can access.

CRF would explicitly target remedying the leading challenges facing the Caribbean considering three thematic areas: (i) resilience building; (ii) growth and competitiveness; (iii) liquidity and debt (unsustainability).

It is therefore proposed that CRF be fashioned as a trust fund, to be established as a public-private partnership (PPP) focused on these thematic areas. For this reason, it is also proposed that CRF should be renamed the Segregated Portfolio Caribbean Resilience Trust Fund (SPCRTF).

Importantly, CRF is being proposed for establishment as a fund with a portfolio separated by thematic area because of the constraints imposed on concessional resources for middle-income countries of the subregion and given the need to address the specific preferences of various creditors. This will also ensure that ineligible concessionary funds need not be comingled with other resources meant for resilience-building and growth.

3.1 Resilience-building

A resilience-building fund would provide financing to public and private sector activities that focus on resilience-building. This thematic area would primarily target climate and environment resilience-building activities, but it would also engage in promoting financing for other activities, such as improving physical infrastructure; deepening capital markets, including insurance markets; and identifying and developing the skills required to build climate resilience, among others.

3.2 Growth and competitiveness

To address the thematic areas of growth and competitiveness, it is proposed to establish a growth fund that would finance both public and private sector activities focused on projects with strong backward and forward linkages and with a high environmental and green investment component. The Fund would collaborate with member countries, focusing on economic reform activities, and use the World Bank Doing Business Reforms index as a benchmark for its activities. The fund could also support the modernization of physical infrastructure and the financial inclusion of MSMEs.

2.2 Liquidity and debt service facility

In the third thematic area, it is proposed to establish a liquidity and debt facility to provide debt relief and liquidity support to participating CARICOM governments, with high debt-to-GDP ratios. This facility would have a built-in credit enhancement mechanism geared towards making the subregion's public debt more attractive to private investors, while achieving the following impacts: lowering overall effective interest rates; increasing fiscal space; and providing governments with more time to repay the amortization component of their debt by increasing the debt tenor; and stimulating capital markets where debt could be resold on the secondary market.

Within this thematic window, CRF could also pursue different funding activities associated with debt reprofiling, such as: debt buy-backs; debt swaps such as the ECLAC debt for climate change adaptation swap initiative; swap initiatives based on creditors' support to help Caribbean countries address debt reduction; and liquidity enhancement mechanisms.

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This *Special Report* is the twelfth in a series by the Economic Commission for Latin America and the Caribbean (ECLAC) on the evolution and impacts of the COVID-19 pandemic in Latin America and the Caribbean. The economic and social analysis it offers will be updated as the relevant information becomes available. The preparation of the *Report* was headed by the Executive Secretary of ECLAC, Alicia Bárcena, with the technical support of the Office of the Deputy Executive Secretary, Mario Cimoli, Daniel Titelman, Chief of the Economic Development Division of ECLAC, and Esteban Pérez Caldentey, Chief of the Financing for Development Unit of the same Division.

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