



COVID-19

Response and Recovery

Mobilizing financial resources for development

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Innovative Financing Instruments in Latin America and the Caribbean

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About the COVID-19 Response and Recovery project

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Abstract

In the aftermath of the Global Financial Crisis (GFC) (2008-2009) the external financing needs of Latin America and the Caribbean have increased significantly reflecting a process of external debt accumulation that has occurred in all developing regions. This process of debt accumulation has been reinforced by the impacts of COVID 19. As things stand, Latin America and the Caribbean (LAC) is the most indebted region in the developing world. LAC's debt profile makes the region highly vulnerable to changes in international lending conditions and to perceptions of risk in issuing countries, increasing their volatility, and making them more liable to sudden reversals. This context has placed a major constraint on government responses to confront the urgency of COVID-19 and, in the medium-term, undermines their capacity to build forwards better. This text focuses on two proposals to address these challenges: (i) expanding and redistributing liquidity from developed to developing countries through innovative uses of Special Drawing Rights (SDRs); (ii) expanding the set of innovative instruments aimed at increasing debt repayment capacity and avoiding excessive indebtedness. The innovative instruments comprise state contingent instruments, hurricane clauses and a multilateral credit rating agency.

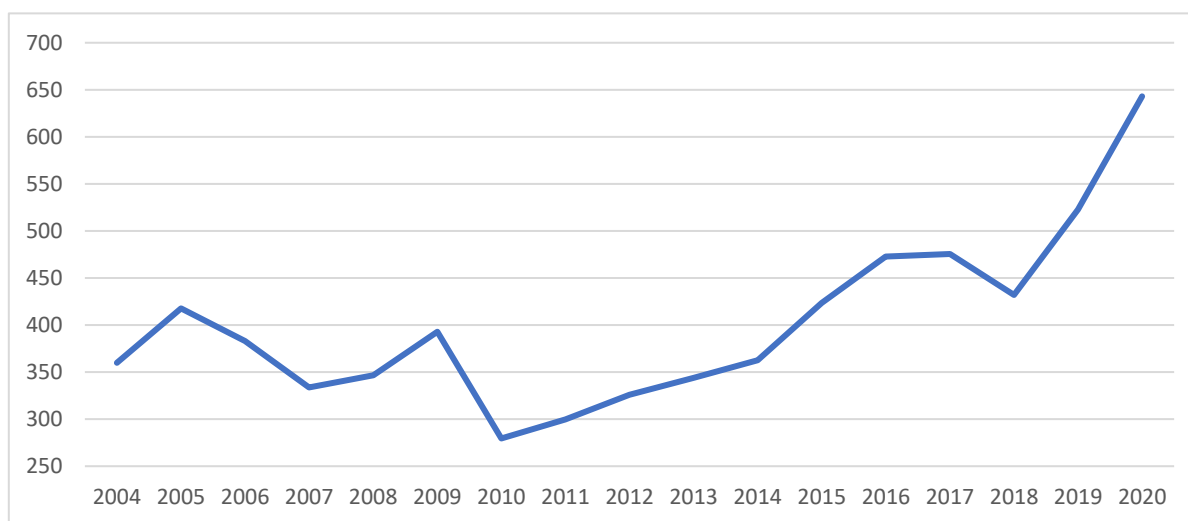
I. Introduction Esteban Pérez Caldentey and Francisco G. Villarreal

A. Latin America's widening financing gap and debt accumulation

In the aftermath of the Global Financial Crisis (GFC) (2008-2009) the external financing needs of Latin America and the Caribbean (LAC)¹ have expanded significantly. Between 2010 and 2020 these increased from US\$279 to US\$643 billion dollars (graph 1). The rise in external financing needs reflects on the one hand, the deterioration of the region's current account position between 2010 and 2018 (-US\$ 99 and -140 billion dollars respectively).

On the other hand, the increase in financing needs captures a more important process of external debt accumulation that has occurred in all developing regions since the end of the GFC. Latin America and the Caribbean is the most indebted region within the developing world and also exhibits the highest debt-service ratio. Between 2010 and 2019 external debt as percentage of exports of goods and services in the cases of Asia, Latin America and the Caribbean, Middle East and Central Asia and Sub-Saharan Africa increased from 60% to 87%, 132% to 192%, 75% to 126% and from 75% to 174% respectively.²

Graph 1
The evolution of the external financing needs of Latin America and the Caribbean
2004-2020. US\$ billion



Note: Financing needs are computed as the sum of the current account balance and private and public debt amortization.

Source: Authors on the basis of IMF (2022)

¹ The external financing needs are computed as the sum of the current account balance plus external debt amortization

² IMF (2021a).

The rise in debt has been accompanied by a change in the composition of debt reflecting the rise in importance of the international capital market relative to cross border loans. Between 2010 and 2020, the share of international securities as a percentage of total external finance for Latin America and the Caribbean increased from 43% to 50%.³

The process of debt accumulation has affected all the different institutional sectors including the central/general government, the non-financial corporate sector, and the household sector. This is a distinctive feature of this period relative to the 1990s and the early 2000s, when external debt was concentrated mainly within the general government sector.

The composition of external debt by sector, based on an analysis of international debt issues, shows that the general government is the largest bond issuer. On average, it accounted for 65 percent of the total stock of debt securities between 1990 and the first quarter of 2021. However, the share of the government's stock of debt securities has declined over time (88.4 in 1990 and 50.8 percent of the total in the first quarter of 2021) (BIS, 2022).

In contrast, nonfinancial corporations, the second most important debt issuer in the region, have increased their debt stock of debt securities both in volume (US\$ 3.5 and 332.2 billion dollars between 1990 and 2021) and as a share of the total (5.7 and 36.3 percent of the total for the same years). Moreover, nonfinancial corporate debt has increased faster than that of any other sector since the GFC.

Although not all countries have access to capital markets, and not all those with access enjoy the same conditions, there has been an increasing number of Latin American economies that since 2009 have turned to the capital market for finance. In 2020, 11 countries issued international bonds.⁴ This is explained from both the demand and the supply side.

On the demand side, low returns on developed country treasuries caused by the adoption of quantitative easing policies have pushed investors to turn to higher return securities in the developing world. Higher returns are accompanied by higher risk. Available data for the period 2017–2020 show that, despite the pandemic, profits continued increasing over the course of 2020. Profits are determined indirectly by calculating the difference between the interest rate on debt issues in the international capital market and the risk-free interest rate on ten-year United States Treasury bonds (ECLAC, 2021a).

On the supply side the countries of the region have been able to secure the issue of bonds with longer-term maturities relative to previous years and at lower interest rates. The average maturity of all bond issues reached 13 years in 2020 with a minimum and a maximum of 2 and 64 years respectively. By comparison in 2010 the average of Latin American and Caribbean bonds was 9 years, with a minimum and a maximum of 0 and 60

³ According to OECD (2020) bonds are the primary form of issuance of securities accounting for 64% of annual issuance between 2000 and 2019. These bonds carry mainly a fixed rate or zero coupon (49% and 43% of the total) for the same period.

⁴ Brazil, Colombia, Chile, Dominican Republic, El Salvador, Honduras, Guatemala, Mexico, Panama, Peru, and Uruguay

years respectively. An analysis by type of debt issuer shows that the longest maturities are found in sovereigns (17.6 years on average), followed quasi sovereigns (15.6 years on average), non-financial sector corporates (12.5 years on average), and banking sector issuers and supra-nationals (6.8 and 5.9 years on average) (ECLAC 2021b).

Similarly, the average coupon rate for the same period equaled 4.3% in 2020 versus 6.6% in 2010, and 4.0% versus 6.6% for sovereign issues. The minimum and maximum values for sovereign coupon rates for 2010 and 2020 are 1.5% and 0%; 12.7% and 9.8% respectively (ECLAC 2021b)

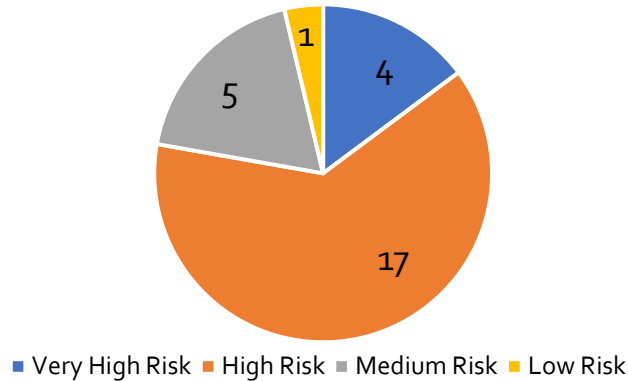
B. The macroeconomic implications of LAC's debt profile

Longer maturities reduce the risk of rollover and lessens the burden of the debt repayment profile. However, longer maturities make bonds more responsive to interest rate changes which increases the interest rate risk. This is compounded by recent evidence indicating that bond flows are much more sensitive to changes in external interest rates than bank loans (Advdjiev et al. 2014). According to their estimations for the period 2009–15, a 25 basis-point increase in the federal funds rate translates into a 57 basis-point fall in the growth rate of cross-border loans to the nonbank sector and 125 basis-point reduction in the rate of growth of bond issues in the international market.

Lower coupon rates lower the debt repayment burden but do not imply that the current debt levels of governments are sustainable. In fact, a simple empirical exercise for 2020 based on projections of GDP and inflation, shows that the real rate of interest on debt tends to be higher than the real rate of growth for some economies -including Colombia, the Dominican Republic, El Salvador, Guatemala, Trinidad and Tobago and Uruguay-, which means countries risk facing liquidity restrictions and situations of outright insolvency (Pérez Caldentey and Vernengo, 2021).

Additionally, most countries in the region are classified as high risk for private investors, and therefore subject to potential credit downgrades and thus higher debt costs. Out of a sample of 27 countries in the region, 17 (63% of the total) are rated as high risk and 4 as very high risk (graph 2). Available corporate debt data for 2012-2020 shows that most bond issues fall in the investment grade category (on average 66% of the total for the period 2012-2020). However, the share of investment grade issues has declined over time (78.8% and 64.9% of the total for 2012 and 2020) while high-yield issues have increased (20.7% and 34.5% for the same period) (table 1). Bonds that are not classified as investment grade are more vulnerable to changes in global conditions (OECD, 2020, p. 40).

Graph 2
Latin America and the Caribbean: groups of countries by sovereign credit risk ratings, 24 May 2021 (Numbers of countries)



Source: CountryRisk.io, "Sovereign Risk", 2021 [online] <https://www.countryrisk.io/platform>

Table 1
Latin America. Bond issues by rating category (2012-2020). As percentage of the total

	2020	2019	2018	2017	2016	2015	2014	2013	2012
Investment Grade	64.9	56.0	58.0	51.6	61.6	78.1	76.2	70.2	78.8
High-Yield	34.6	44.0	42.0	48.4	38.4	21.1	23.1	29.8	20.7
Not Rated	0.5	0.0	0.0	0.0	0.0	0.8	0.7	0.0	0.5
Total	100	100	100	100	100	100	100	100	100

Source: Authors' on the basis of ECLAC (2021b)

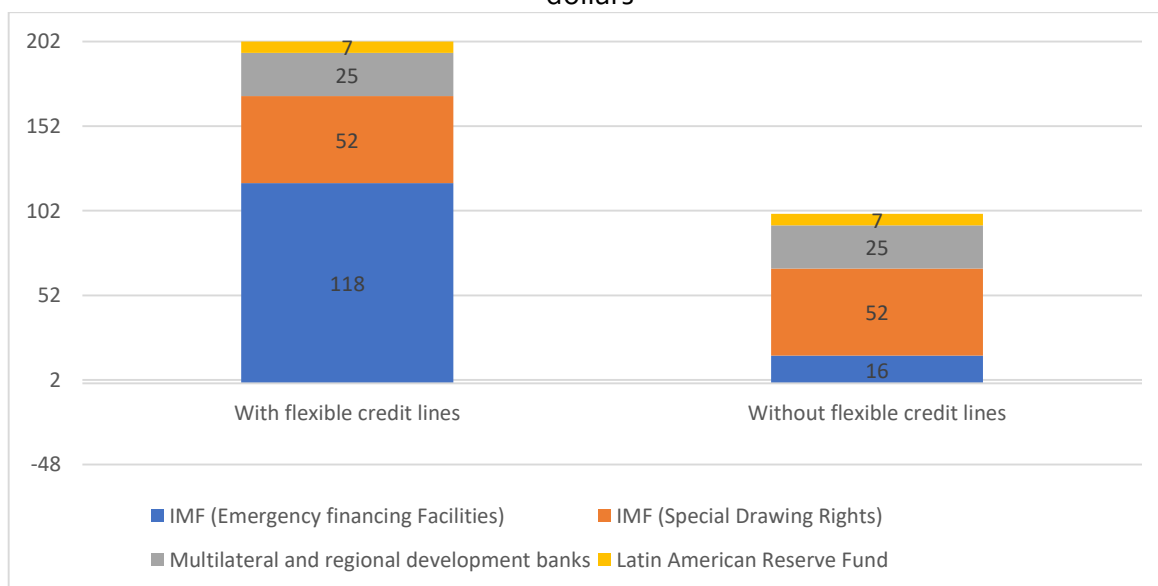
C. The weak response of multilateral financing institutions

The growing dependence on capital markets has also been encouraged by the weak response of multilateral institutions to the growing financing needs of the region, especially due to the impact of the Covid-19 pandemic. The multilateral response fell short of the rising financing needs of developing countries. In 2020, the financial support provided by multilateral institutions reached US\$ 322 and 220 billion dollars (with and without IMF flexible credit lines) covering only 31% and 15% of the financing needs of the region (graphs 1 and 3).

The dependency on short-term flows makes these economies highly sensitive and vulnerable to changes in international lending conditions, as well as to shifts in perceptions of risk of issuing countries, increasing their volatility and making them more liable to sudden reversals. The upward trend in long-term interest rates that have been registered since early 2021 and the actual and forthcoming increases in international interest rates will further reduce the incentive to invest in emerging economies.

The multilateral response has not provided a medium to long-term solution to the debt problematic of developing countries, including those of Latin America and the Caribbean. The Debt Service Suspension Initiative (DSSI), launched by the G20 in April 2020, and which ended in December 2021, 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. It consists of a temporary suspension of debt service (principal or interest) to official bilateral creditors, which account for roughly 38% of the total for DSSI participating countries. Since it took effect in March 2020, only 48 of the 76 DSSI-eligible countries (66% of the total) have been included. As of August 2021, this had reduced the estimated amount of dollar savings from US\$ 11 billion to US\$ 5.7 billion.

Graph 3
Financial response of multilateral/regional institutions to the Pandemic. US\$ billion dollars



Note: Multilateral and regional development banks include the World Bank, the Latin American Development Bank (CAF), the Central American Bank for Economic Integration (CABEI), the Caribbean Development Bank (CDB) and FONPLATA.

Source: On the basis of ECLAC (2021a)

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. Moreover, for participating countries official creditors account for only 20.7%, on average, 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 the DDSI ceases to function countries will 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 to finance higher interest payment outlays.

Although the G 20 Common Framework for Debt Treatment which replaces the DSSI is meant to tackle longer term debt problems, it still suffers from shortcomings that are similar to those that affected the DSSI: lack of participation of relevant stakeholders and limited coverage (applied only to low-income countries and vulnerable middle-income countries). As of January 2022, only three countries had applied to be included in the G 20 Common Framework: Chad, Ethiopia, and Zambia.

D. Proposals to address the debt and liquidity problematic of Latin American countries

Latin America and the Caribbean's predicament reflects the general problematic of middle-income countries. Given their systemic importance (MICs represent 30% of world aggregate demand and account for 96% of developing country debt excluding China and India) the risks faced by middle-income countries could exert a significant drag on world growth and compromise global financial stability.

Although there is considerable heterogeneity in the fiscal situation and debt vulnerability across the region, the reliance on short-term capital flows and thus on debt, have placed a major constraint on government responses to confront the urgency of Covid-19 and, in the medium-term, it undermines their capacity to build forward better. This context has been aggravated by the current rise of inflation which is forcing countries to increase monetary policy rates, and by the uncertain external context created by the war in Ukraine.

To address these challenges, the Economic Commission for Latin America and the Caribbean (ECLAC) has proposed 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 (ECLAC, 2021a).

This text summarizes the proposals related to the expansion and redistribution of global liquidity from developed to developing countries focussing on innovative uses of

Special Drawing Rights (SDRs), and the proposals for long-term debt reduction and debt sustainability through the use of innovative financing instruments. The text is divided into five sections focussing on SDRs, State Contingent Debt Instruments, including an in-depth discussion of Income-linked Bonds and the adoption of Hurricane Clauses, and a proposal for a Multilateral Credit Rating Agency.

E. Special drawing rights as a tool for economic and social development⁵

SDRs are an international reserve asset created by IMF to supplement member countries' official reserves. 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 transactions.

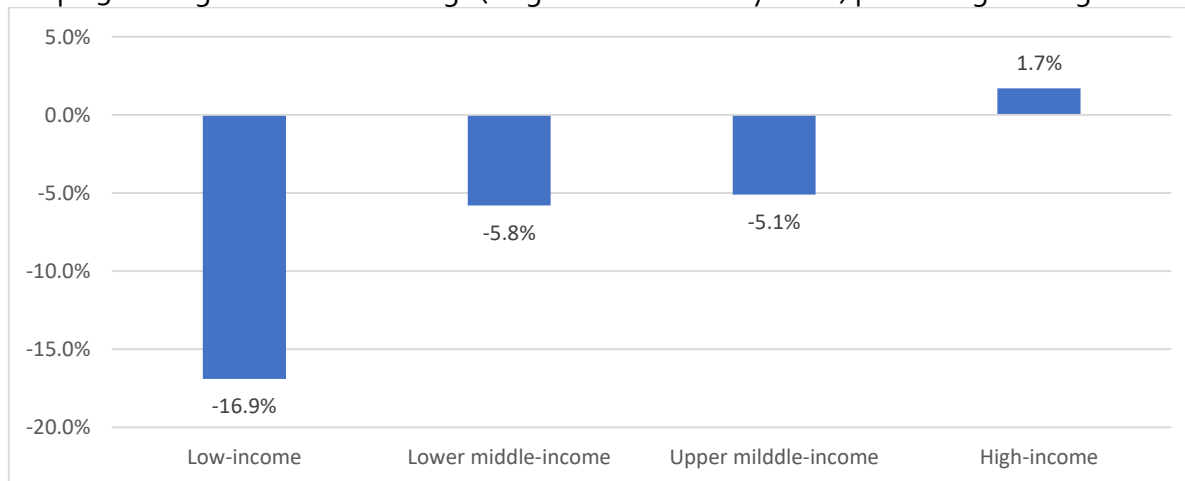
SDRs offer five advantages to IMF member countries. First, they are an automatic line of credit and are available to all countries regardless of their level of income. Second, SDRs do not generate debt, as they do not entail an obligation for repayment of the principal. Third, SDRs do not carry any associated policy conditionalities. 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. Finally, SDRs increase reserve assets without countries having to incur the costs that are normally associated with reserve accumulation.

There is no prescribed use for SDRs. The recommendation is that their use be consistent with macroeconomic sustainability including monetary and external sustainability and stability (IMF, 2021e, 2021k). The available empirical evidence shows that developing countries have a much greater demand for SDR use than developed ones, and that this gap between SDR use in developing and developed countries widens significantly during crises episodes. Between August 2021 and January 2022 only developing countries made use of their stock of SDRs (which includes the SDR allocation of US\$ 650 billion implemented in August 2021) (graph 3).

The evidence shows that SDRs are used for different purposes including fiscal purposes through different schemes, repayment of official debt and reserve accumulation. During the GFC, 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. In the current pandemic context, 39 countries—among them Colombia, Ecuador and Paraguay in Latin America and the Caribbean—have recorded US\$ 37.3 billion worth of SDRs on government balance sheets (Arauz & Cashman, 2021 and 2022).

⁵ This section reproduces work by ECLAC on SDRs that was partly undertaken as part of the Development Account Project and that served as input for ECLAC's 12th Policy Brief (ECLAC 2021a) which was presented at the United Nations Headquarters in November 2021 to Latin American and Caribbean member states.

Graph 3: Change in SDR in holdings (August 2021-January 2022) percentage change



Source: On the basis of Plant (2022)

A further use of SDRs' introduced by the shift from responding to the pandemic to the design of policy initiatives to build forward better is as equity capital to be used by a trust fund or a development bank. ECLAC has presented a preliminary proposal for a trust fund for middle income countries in line with the recommendation of 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 SIDS in particular, in their response and recovery efforts" (United Nations, 2021)⁶. The trust fund would largely be financed using SDRs as capital to leverage resources.

There are also proposals proposals to use SDRs to capitalize development banks and leverage resources. According to Lazard (2022), given the leverage ratio of multilateral banks, 100 SDR could produce SDR 300 or 400 in investments. If this reasoning is applied to regional development banks in Latin America and the Caribbean, 100 SDR could produce about SDR 200 in investments.

Using SDRs as capital is opposed by mainstream economic thinking on the grounds that it conflicts with the reserve asset nature of SDRs which means that it must be highly liquid and carry very low or zero risk for the lender. An illustrative example is provided by the European Central Bank (2021):

"National central banks of EU (European Union) Member States may only lend their SDRs to the IMF if this is compatible with the monetary financing prohibition included in the Treaty on the Functioning of the European Union. Retaining the reserve asset status of the resulting claims is paramount. This requires that the claims remain highly liquid and of high credit quality. The direct financing of multilateral development banks by national central banks of EU Member States

⁶ SIDS is an acronym referring to Small Island Developing States, which are a group of developing countries that are small island countries which share similar sustainable development challenges such as their vulnerability to natural disasters or rising sea levels.

through SDR channeling is not compatible with the monetary financing prohibition."

The liquidity property of an asset means that it "...can be bought, sold for foreign currency with minimum cost and time, and without unduly affecting the value of the asset—that is there needs to be a liquid and deep market for these assets and no major restrictions impeding such transactions." (IMF, 2015). As explained by Lazard (2022), liquidity and credit-risk are not absolute but rather state-contingent concepts. In fact, central banks keep a wide array of reserve assets with different degrees of liquidity and credit quality.

In practice, in existing financing arrangements such as the Poverty and Reduction Growth Trust Fund (PRGTF), the liquidity property of SDRs is guaranteed through an encashment regime. This allows SDR lenders, mainly developed countries, to request early repayment of their outstanding claims in case of balance of payments/reserve difficulties (IMF, 2016). However, these developed countries are least likely to experience balance of payments difficulties relative to developing countries. In particular, the European Union, Japan, and the United States issue reserve currencies and as a result would not need to resort to the application of an encashment regimen to solve balance of payments or reserve difficulties.

F. State-contingent debt instruments: GDP and income-linked bonds⁷

State-contingent debt instruments (SCDIs) are designed to provide automatic, market-based, protection against pre-defined shocks.

These are instruments that either link contractual debt service obligations to a pre-defined state variable (for example, GDP, exports, or commodity prices), or are designed to provide additional creditor compensation in good times and/or provide some form of debtor relief in bad times, such as the occurrence of a natural disaster. Consequently, SCDIs can be broadly divided into two categories: debt instruments featuring continuous adjustment of debt service payments (for instance, a GDP-linked bond, where payments are indexed to nominal GDP), and those involving discrete adjustment, (for instance, instruments with natural disaster clauses where debt service relief is triggered by a predefined natural disaster event, such as a hurricane of given intensity or where the maturity or grace period extends in the face of a shock to exports, as in the case of some official bilateral loans).

By tying the debt service payments to future outcomes, SCDIs may help avoid protracted disputes about current valuations and facilitate quicker agreements between creditors and debtors, thus allowing countries to restore debt sustainability and facilitating their return to market access.

⁷ See the individual papers by Vera Azaf and Hernández (2022).

1. Gross domestic product (GDP) linked bonds

A GDP-linked bond is a sovereign debt instrument indexing the interest (coupon) rate to the issuer country's GDP growth rate. As a result, cash flow payments reflect the evolution of the country's GDP. Thus the value of the bond at the end of the maturity period, the bond's redemption value, would reflect the country's growth performance.

A GDP-linked bond is a counter-cyclical instrument that ties debt repayment to the capacity of a country to repay. The instrument reduces the burden of the debt when the economy is in a low-growth scenario, which is normally accompanied by reduced government revenue. 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.

There are different variants in the design of GDP-linked bonds depending on whether the indexation is applied to the annual interest rate paid on a bond (coupon) or the principal or both; and, whether the indexation is based on the level of GDP, in nominal prices, its rate of growth. Like any other financial instrument, a GDP-linked bond involves two parties, the issuer which in this case is the sovereign, and the investor. 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 and reduction in credit spreads; reduction in servicing costs; increase in fiscal space; mitigation of pro-cyclicality; and improved risk sharing. The main benefit for the investor is that a GDP-linked bond provides a broader, more stable, and less volatile source of income.

The main caveats are found on the side of the investor. These include adverse selection and moral hazard issues, as well as developing a market for a new product. Adverse selection may occur because a government can have an incentive to issue GDP-linked bonds in a context of low expected growth which can lead investors to increase the premium and thus the cost of the bond. Moral hazard refers to the incentive to manipulate data to show a lower growth rate of GDP which, again, could lead investors to increase the premium as a reflection of the loss of confidence in the government data. Finally, the absence of liquid markets to hedge GDP risk and difficulties in pricing can undermine the feasibility of GDP-linked bonds.

Since ex-ante investors face uncertainty regarding the evolution of GDP to which the payouts of the bond are linked, it is safe to assume they would require a premium to hold this kind of instruments. This GDP premium is probably the most difficult component to price. 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 the GDP premium, so that different methodologies can yield different estimates. The existing uncertainty may be an obstacle in finding common ground between the issuer and investors which have differing interests in determining the GDP premium. Finally, in the case of developing countries issuing GDP-linked bonds in foreign currency (which is the most likely option) introduces an additional

source of GDP premium, that is exchange rate risk.

Most of the available evidence on GDP linked bonds focusses on developed countries. 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).

State contingent convertible bonds are another contingent debt instrument that is considered in the literature. These bonds allow payment standstills, either in interest and or principal, as well as maturity extensions when some indicator breaches a given threshold. The objective of the state-contingent bond is to allow governments to face liquidity shortages and liquidity crisis. As such, these instruments could avoid solvency crisis.

In addition, state-contingent convertible bonds provide short-term breathing space as this financial instrument addresses liquidity crises. As in the case of GDP-linked bonds they also improve burden-sharing of private sector creditors. Moreover, they reduce the size of official sector support.

Finally, state-contingent bonds appeal to a broader investor base with a higher risk appetite than investors currently holding risk-free low-yield government bonds. Diversifying the investor base is attractive for two reasons. First, in normal times the sovereign can draw financing from a broader set of investors. Second, during stress episodes the risks are spread more broadly.

2. Gross national income (GNI) linked bonds

Gross national income (GNI)-linked bonds have two 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 national 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 elements, such as remittances and terms of trade, which can be verifiable externally. External data sources on remittances and commodity prices 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 relevant 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.

3. Hurricane clauses⁸

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 in 2017 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 (World Bank, 2017).

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 debt 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 such as the Covid-19 pandemic.

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 available evidence 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 breathing space for the economy, and 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.

⁸ See the individual paper by Seerattan (2022).

G. The limits of credit rating agencies and a proposal for multilateral credit rating agency⁹

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. 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.

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.

1. The limits of credit rating agencies

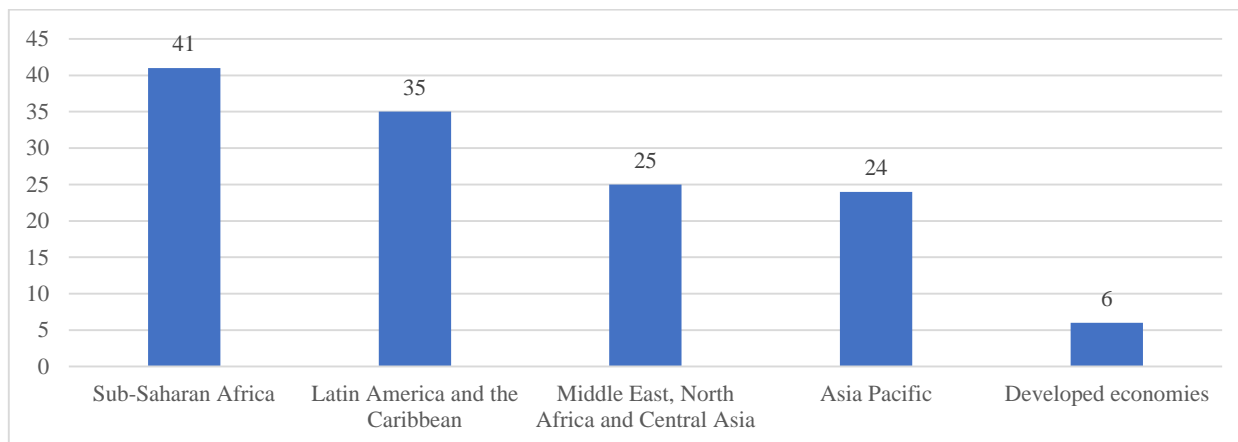
Credit rating agencies have three major drawbacks that need to be addressed: excessive market power, biased procyclicality against developing economies, and the conflict of interest between the private and the public interest.

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.

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. 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 graph 4).

⁹ See the individual paper by Schroeder (2022).

Graph 4
**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>.

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.

2. A multilateral credit rating agency

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.

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.

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.

A MCRA has two main objectives. The first is to improve credit risk assessment for sovereigns. It would begin by providing much needed assistance in validating commercial credit rating agencies' methods. An MCRA can also develop alternative approaches to sovereign creditworthiness, particularly for emerging market and developing economies (EMDEs). A key improvement would be to employ longer time-horizons for EMDE's sovereign risk assessments. Longer horizons are justified by the strong presence of infrastructure investment for their development. This recognition will stabilize assessments and establish resiliency towards instability transmitted from abroad.

The second objective is to facilitate sustainable development goals (SDGs). SDGs must be attained as the global community enters an ecological transition. Both the first and second objectives warrant a role for industrial configuration and policy. Not all activities and industries contribute to the creation of social wealth in the same way. Currently, the rating agencies and multilateral organizations concerned with debt sustainability do not make this distinction. Knowledge of how climate change will impact industries and their configuration assists development of programs to achieve SDGs. This knowledge will also enable better sovereign risk assessments by identifying how industries are affected by climate change.

The MCRA can also advocate the re-orientation how sovereign debt sustainability is achieved. A promising path is a wealth tax on private, gross assets. The size of the tax is set to promote the repayment of net interest outlays, at least, in a consistent way. Any sovereign facing stress in repaying debt obligations can temporarily raise the tax until the period of stress is passed. An MCRA will be an invaluable asset for the United Nations in promoting the global public good of economic, financial and social stability in the face of climate change.

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. ¹⁰

¹⁰ The financing issue was the major obstacle to the creation of an independent European credit rating agency.

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