Summary

In 2020, Latin America and the Caribbean (LAC) will experience the most severe economic recession in decades. This paper looks at the challenges confronted by LAC and proposes a series of actions to structure a recovery plan that minimizes potential moral hazard effects while aligning fiscal, social, and environmental sustainability priorities. High pre-pandemic sovereign debt levels, worsening credit ratings, and low tax revenues limit the much-needed fiscal space to overcome the present health and economic crises. Most countries in the region are at risk of losing two decades of progress in the fight against poverty and inequality, while their upper-middle income status makes them ineligible for debt relief and aid packages from advanced economies. The focus on solving the current crisis may also delay much-needed progress on climate change mitigation and adaptation efforts, as well as overall improvements in the United Nations Sustainable Development Goals (SDG).

We propose a combination of fiscal policy responses combined with new sources of financing to unlock a sharp recovery with minimal harm to fiscal sustainability in the long run. Through expanded public-private partnerships and blended finance structures, governments should be able to leverage private financing in large job-creation undertakings. Additionally, the issuance of SDG-linked sovereign debt and Special Drawing Rights (SDRs) with SDG conditionality could also provide much-needed liquidity at low cost.

1. Introduction

The coronavirus pandemic has had a devastating impact in Latin America and the Caribbean (LAC). The region is not just facing a recession characterized by negative growth and high unemployment. It is at risk of losing at least two decades of social and economic progress.

Of the ten countries with the highest number of Covid-19 cases to date, five are in LAC. In the case of deaths per million people, four countries in the global top 10 are from the region. More strikingly, the region accounts for just 8.4 percent of the global population, but 30 percent of total Covid-19 fatalities to date (half of those deaths in Brazil alone). An unprecedented crisis has struck an already-vulnerable region. The number of cases and deaths has plateaued at a high level, with some exceptions like Uruguay (where the pandemic was much less intense) and Chile (where the peak was observed in July).
The ensuing series of lockdowns—and the associated loss of income and disruption of businesses—has brought on what may be the deepest recession in a century (IMF 2020). As of June 2020, IMF estimates suggest that Latin America and the Caribbean will be the hardest hit region of the world, with an estimated 9.4 percent GDP contraction in 2020. Advanced economies will, on average, contract by 8.0 percent in 2020, while emerging economies are expected to fall by only by 3 percent, mainly because China will continue to grow (IMF 2020). The situation is especially dire for Latin America, considering that in the five years preceding the current recession, economic growth was already the world’s lowest (per capita GDP fell by 0.6 percent per year on average between 2014 and 2019 [Werner 2020]).

According to a recent report from the United Nations Development Program (López-Calva, 2020), the recession is causing a significant reduction in employment in LAC, which could have long-lasting effects. Household surveys show that the number of individuals out of the labor force is surpassing those in it, in countries as diverse as Mexico, Chile, and Peru. The World Bank (2020) expects a ten percentage-point increase in poverty rates in the region because of the pandemic. For example, household surveys from Colombia indicate that 38 percent of the population was below the poverty line in May, relative to 27 percent in the pre-pandemic months.2

High levels of urbanization, population density, and labor informality that leaves workers without income protection, combined with limitations in terms of health infrastructure, explain this outcome. Informal employment, which, according to a recent report from the Inter-American Development Bank (2020), represents 56 percent of total employment, together with the lack of adequate social safety nets (which pushes people into the street in order to make ends meet), have made lockdown measures relatively long and ineffective. According to Google’s Community Mobility Report (Figure 1), lockdowns have lasted longer Latin America relative to Europe, where time spent at home is back to the levels of the pre-pandemic period.3 As infection rates remain high, Latin Americans appear to be unable or unwilling to resume economic activity, suggesting households are experiencing an income crunch. This further reinforces the idea that the recession faced by Latin America will be significantly more severe and profound than in other regions.
Similarly, there is a clear indication that inequality will increase due to a number of factors, including significant job losses in low-paid, unskilled, and informal activities. In addition, there are structural forces at play that could lead to other forms of inequality in the long-term. One example is the digital divide that prevents segments of the population from adequate access to online education. Reports in the press are pointing in the direction that the disadvantaged are suffering the most during the pandemic (Turkewitz and Villamil 2020). In terms of poverty rates and income concentration—as measured by the Gini coefficient—the region has already undone much of the progress observed since the early 2000s.\(^4\)

2. Transitioning from “Preservation” to “Recovery”

Given the magnitude of the crisis, governments are prioritizing the preservation of lives and livelihoods by putting more resources into the health sector, providing subsidies to businesses, and supporting households’ incomes with cash and in-kind transfers. The response has been closer to the type of disaster relief typical of an emergency, rather than to that of an economic stimulus package that deals with a more conventional recession. Transitioning
from “preservation” to “recovery” will be the next phase of the crisis. Although there will be some overlap between the two types of responses, and countries are still primarily focused on disaster relief and preservation because the pandemic is not yet under control, recovery packages will gain an increasing amount of attention. Preparing the design of effective recovery packages is the next main challenge. One possible scenario is that the pandemic does not recede, in which case a protracted recession will require an even more aggressive recovery package. If reaching herd immunity, finding a more effective treatment, or discovering a vaccine is delayed, the transition from preservation to recovery may take months or even years.

In contrast to LAC, sustainability-oriented recovery plans to revitalize the economy, including the adoption of low-carbon growth pathways, are already underway in places where the pandemic has weakened. This is the case of the European Union, where an aggressive spending plan is prioritizing clean energy infrastructure, research and development, connectivity infrastructure, and education (these items account for 25 percent of the recovery efforts). Promoting a green recovery has been central in the stimulus packages not just in Europe, but also to some extent in China and India. In the case of China, the government launched the New Infrastructure Strategy based on renewables, electrification of various industries including transport, and digitalization (also called REED). India has just announced the electrification of the rail system using solar energy as part of its Covid-19 economic recovery strategy. The relevant question is whether this type of green recovery is viable in Latin America once the pandemic recedes.

To prepare the ground for the debate about economic recovery in Latin America, it is crucial to underscore that some of the effects of the pandemic can last longer than those of a typical recession, so sustained and longer-term actions will be required. This is not a typical recession that can be resolved with short-term Keynesian stimulus. Framing the response in terms of prolonged recovery support instead of short-run stimulus is more appropriate.

Long-term recovery strategies are also particularly relevant in order to reconcile the economic growth and employment goals with the low-carbon and climate-resilient development agendas that many countries in the region have set; a looming biodiversity and climate crisis (which also drives instability, inequality, and insecurity in the region) cannot be ignored in this debate. It is also important to acknowledge that part of the reduction in economic activity is the result of supply restrictions, so additional government expenditures should not be the only—or in some cases even the most relevant—driver behind the economic push. An important aspect of the recovery is related to the technologies that allow businesses to operate, even before the pandemic is fully resolved.

Another aspect to consider is that the current crisis comes at a time when waves of social unrest are spreading across LAC. The main drivers of discontent have been lackluster growth, lack of upward mobility, and demands for greater voice and representation. Even in better-performing economies, like Chile, many feel that their expectations and aspirations have not been met and that those at the top of the income distribution have captured most of the gains. Social unrest, which has been hibernating during the “preservation” phase, will likely return with a vengeance and will put social issues at the top of the policy agenda. In other
words, the political dynamics of the region may force governments into avenues that involve the redesign of social pacts—as in Chile—rather than exclusively “recovery packages.”

3. The Covid Middle-Income Trap

The large majority of countries in LAC are middle-income (MICs) where governments cannot afford a “whatever it takes” response and are instead doing whatever they can. But whatever they can do will not be enough.

In contrast to the advanced economies that have no constraints on borrowing, LAC countries seem to be a missing middle in the discussion, namely middle-income countries with high levels of debt, sharp and deep recessions, and very high unemployment. These fiscally constrained countries may not be able to simultaneously cope with the health crisis and ensure an adequate economic recovery. Fiscal space is constrained, forcing Latin American countries to be selective in terms of the size and composition of their recovery packages.

One key aspect of the “missing middle” is that governments lack the resources to increase public investment and depend heavily on access to international finance. So far, LAC countries—with the exception of Argentina and Ecuador—have had adequate access to global capital markets, but this could change without notice. Deteriorating fiscal and economic conditions have already triggered a cascade of credit rating downgrades that could worsen. If markets close or become too expensive, LAC will need to rely exclusively on official lenders such as the Inter-American Development Bank (IDB) or Development Bank of Latin America (CAF). But these institutions have limited capacity to lend to MICs and will require capital replenishments.

4. Designing Recovery Packages Under Multiple Constraints and Objectives

From a macroeconomic viewpoint, first and foremost, recovery packages should focus on bringing back output and employment to long-run sustainable levels. Closing the output gap (i.e., bringing GDP to its potential level) and generating jobs so that unemployment returns to its “natural” level should be the overriding goals. This calls for government expenditures that have the largest fiscal multipliers possible and that are particularly labor-intensive. Although some have mistakenly used the analogy, this is not a war reconstruction effort. Physical capital was not destroyed, and the priority now is to put it in motion again. Barring public health constraints, allowing firms to operate, workers to return to their jobs, and motivating consumers to buy again are the key short-term challenges.

But a response focusing just on these aspects would be short-sighted. Recovery packages should incorporate some structural goals if the goal is really to “build back better” in the sense of seizing the opportunity to improve conditions relative to pre-pandemic levels. One aspect is to promote a more sustainable recovery by ensuring, for instance, that agricultural and forest resources are not degraded and can continue to provide goods and services in the medium-term. More broadly, making the recovery a greener, nature-based, less carbon-intensive one that accounts for climate change should be part of the design.
On the structural side, a crucial aspect has to do with the importance of reducing poverty and inequality in a more decisive way. Considering that the pre-pandemic levels placed the LAC region as one of the most unequal regions in the world, post-pandemic recovery should aim not just at avoiding a reversal in the positive trends that were observed during the previous two decades, but rather at accelerating progress. This is a serious challenge, as preliminary evidence indicates that during the pandemic the region has lost two decades of social progress on this front.

Needless to say, designing interventions that simultaneously meet all these goals is difficult, as there are many examples of conflicts and trade-offs, rather than synergies, among them. Interventions that ease tensions and maximize their complementarities will be essential for the recovery phase.

One good example of the latter is climate-resilient housing. Green social housing can tackle the social, climate, and environment needs and drive job generation. Green housing could include distributed renewable energy solutions and energy efficiency considerations (passive designs, natural lightning, etc.). There are many other examples of measures that can be part of a green recovery, including in the short-run, such as the replacement of poorly targeted energy subsidies and cash transfers targeting the poorest groups of the population.

But complementarities are not always possible. Take, for example, the case of onshore wind energy that, according to the International Energy Agency, creates 1.5 jobs per million dollars in capital expenditures. This means that the green recovery needs to take place, but investments must not crowd-out other sectors that could have a greater expansionary impact on jobs in the short-term.

In other words, given the magnitude of the economic contraction and its expected duration, governments need to have clear guidelines on how to prioritize expenditures and other interventions. In some cases, such as green stimulus and the need to reduce inequality, a long-run perspective is necessary. In others, such as cash transfers to prevent malnutrition, credit guarantees, tax deferrals to avoid bankruptcies, and payroll subsidies to prevent furloughs, short-run interventions are appropriate. Government will need to strike that balance, aiming at “integral” interventions that combine social and environmental impacts with short-term output and employment generation, as in the example of green social housing.

5. The Fiscal Dimension

The pandemic will leave the region with much higher debt levels. According to the IDB (Pineda et. al 2020), gross public debt in Latin America will rise on average to 70–73 percent of GDP in 2022 from 57 percent of GDP in 2019, significantly higher than the 44 percent of GDP observed during the 2008–2009 global financial crisis. In the medium-term, debt service will crowd out other expenditures, and debt-overhang will restrict economic growth. Recent analysis by the IMF suggests there is a looming “debt pandemic” on the horizon as sovereign credit downgrades surpass peaks of previous crises over the past 40 years, and both remittances and private funding decrease the flow of hard currencies to developing economies (Bulow et al, 2020). An eventual wave of sovereign defaults and debt restructuring processes could plague the coming years.
Stimulus packages do not occur in a vacuum and should take into consideration the constraints under which governments operate. Apart from institutional capacity, which limits what governments can actually do, fiscal constraints put limits on the size of the stimulus packages that governments can implement.

In theory, the severity of the economic shock associated with the pandemic in Latin America would suggest the need of a large response, at least relative to other less-impacted regions. In practice, however, the size of the fiscal stimulus packages in Latin America tells a different story altogether. An analysis by Elgin et al. (2020) shows that richer countries tend to adopt larger fiscal stimulus packages. What this means is that, when it comes to crisis-response, factors other than the actual severity of the shock drive the size of the response.

Fiscal stimulus packages in Latin America are constrained by the following factors:

- The region’s track record of procyclical fiscal policies. Investors are less willing to lend in a region where measures that ensure debt repayment (such as running primary fiscal surpluses once economic conditions normalize) are unlikely.
- Social expenditures, in particular, are more procyclical than total spending in Latin America. If history is any indication of future performance, at least a fraction of social programs, such as cash transfers, included in the Covid-19 emergency packages are likely to remain in place, even if they were intended to be purely transitory.
- High initial levels of public indebtedness. Average public debt increased to 45 percent of GDP in 2019 from 30 percent of GDP in 2014 (ECLAC 2020), and it is likely to reach 70 percent of GDP with measures adopted during the “preservation” phase.
- Currency depreciations during the pandemic (resulting from lower commodity and export prices, falling remittances, and the collapse in tourism) have increased external debt measured in local currency, raising public debt-to-GDP ratios.
- Lower expected economic growth, higher sovereign risk, and institutional and political constrains to adopt measures that strengthen fiscal accounts, all of which are likely to occur in Latin America, reduce sustainable levels of public debt.
- Fear of credit rating downgrades or, in some cases, countries’ inability to secure financing from markets.

Given these constraints, moving from the disaster management or preservation emphasis to long-term economic recovery means that responses from governments will need to be particularly selective in terms of initiatives and efficient in the sense that public resources should leverage private spending by incentivizing the private sector to take risks. An example is the use of credit enhancements to de-risk certain investments that can be undertaken by the private sector. In addition, if governments do not have the fiscal space today, they can pre-commit future fiscal appropriations for projects that the private sector can finance now.

Finally, governments should try to open some fiscal space today by adopting measures that will improve fiscal sustainability in the medium-term. A key aspect to consider is that tax revenues in LAC were already insufficient prior to Covid-19 and are far below the OECD average.6
Examples of opening up fiscal space are built-in mechanisms to increase fiscal revenues or reduce expenditures in the medium-term, once economic conditions are normalized. Adopting those measures now sends a credible signal, both to markets and credit rating agencies. This positive feedback loop from reform to improved future fiscal outcomes and greater fiscal space today should be one the guidelines in the design of effective strategies to respond to the crisis more effectively.

The policy mix should not exclusively focus on expenditure items with high fiscal multipliers to get a higher “bang-for-the-buck” in terms of GDP. Rather, fiscal packages should deliver the type of economic growth that would be most effective in terms of fiscal sustainability. This could be done by prioritizing investments in sectors that have large impact on future fiscal revenues or by widening the tax base by reducing informality. Closing loopholes and reducing tax expenditures—and more broadly increasing revenues collected for a given tax rate—are good candidates. The Inter-American Center of Tax Administrations (2017) estimates that in the case of the VAT, tax exemptions cost approximately 2 percent of GDP.

Enacting legislation today to raise taxes (or reduce expenditures) in the future, depending on macro outcomes (such as the output gap or the unemployment rate), is one way to proceed. For example, prolonging cash transfers to vulnerable groups in the post-pandemic phase should be made contingent on legislation that reduces fossil fuel subsidies or VAT exemptions. Greater financial inclusion—which enables the transfer of cash subsidies—has been a positive side effect of the pandemic. This will prove instrumental in refunding taxes paid by low-income households. Another option to raise more revenues is taxation of digital services (de Frutos 2020).

On the institutional side, the challenge is to reform institutions so that they can make credible future commitments to increase taxes or reduce expenditures to reach sustainable debt levels. Fiscal rules may not be strong enough. Maybe constitutional amendments, like the one introduced in Colombia in 2011, which made fiscal sustainability a mandatory constitutional criteria, should be put on the table, along with automatic tax or spending adjustments and credible sanctions.

6. Other Policy Areas Relevant for the Recovery

A sustainable recovery requires intervention in other policy areas, apart from fiscal stimulus. Government responses have to be broad. As mentioned in a recent essay by Bordoff (2020), recovery packages need to go beyond traditional fiscal expansions, and they should include productive development policies (PDPs), also called “modern” industrial policies. These are policies aimed at reducing coordination failures (a certain investor undertakes a project if others take some actions), facilitating the flow of information, providing key essential inputs, etc. PDPs should identify sectors that are particularly important for the recovery and remove constraints that impede their growth.

Although some of those interventions need to be horizontal, in the sense of benefiting all sectors at a national level (like infrastructure), most PDPs are very sector-specific. One key element, underscored by Ghezzi (2017), is the need to coordinate actions between private and public agents. This requires significant interaction and exchange of information between
the relevant parties. Providing the right economic incentives as well as access to low-cost financing are good examples of adequate PDPs.

While PDPs are important, they are just one component of a more radical attempt at accelerating growth. Policies related to labor markets and social insurance are essential. As mentioned above and in the IDB note, informal employment in the region before Covid-19 was already over 50 percent of the labor force and is likely to increase to perhaps close to 60 percent post-Covid-19. During the pre-pandemic scenario, the creation of formal jobs was insufficient to lower informality rates significantly. The recovery needs to incorporate solutions to the very large levels of informal employment, otherwise it will fail to make significant progress on the pressing issues of poverty and inequality.

Tackling inequality will require a redesign of social insurance and social protection policies and changes in the structure of taxation. Social protection, which should be covered with general tax revenues, should not be based on taxes on formal employment. If informality is going to be seriously tackled, it will probably take much of the fiscal space that there is.

A strong recovery that enhances fiscal capacity is crucial in order to enable lasting interventions in areas such as education. Millions of students who are unable to study from home or return to school are already working informally or neither working nor studying. This is a generation-wide risk, which, if not addressed urgently, can have negative and long-lasting impacts.

7. The Climate and Environmental Dimension

As mentioned earlier, a vital aspect to consider in recovery packages is the medium-term improvements in economic and physical resilience against climate change and the continued commitment to low carbon emissions. Le Quéré et al. (2020) report that daily global greenhouse gas (GHG) emissions decreased by 17 percent in early April 2020 compared to that same period in 2019, due to the strict confinement measures imposed by governments worldwide. This reduction in daily GHG emissions is likely to extend into the year as economic activity will continue to be affected by the pandemic. However, it is possible that a recovery in output in the short- to medium-term is met by an even greater increase in carbon emissions, as economic activity is expected to rebound and fossil fuel prices will remain subdued, according to current market projections.

There is some initial evidence (based on air quality in large cities in advanced economies) suggesting that GHG emissions could experience a very rapid uptick as economies recover, mimicking the period immediately following the 2008 global financial crisis when the world experienced the highest annual growth in total emissions ever recorded (Peters et al. 2012). A significant rebound of global GHG emissions, as expected by the IMF (2020) and the OECD (2020), could rapidly exceed pre-pandemic levels.

As argued by Hepburn et al. (2020), recovery packages have the potential of accelerating or retarding progress on climate change. If the right policies are in place—ones that go far beyond what can be included in a recovery package—achieving Sustainable Development Goal 13, climate action, as well as the existential goal of the 2015 Paris Climate Agreement to limit human-induced warming of the global atmospheric mean temperature to 1.5° C could still
be possible, if very challenging. Large-scale climate actions are needed even if all countries comply with their pledged contributions to the Paris Accord, if the goal is to limit warming to 1.5°C. More so because most countries are not even living up to their initial targets.

Therefore, the need to adopt low-carbon and climate-resilient spending pathways is crucial. If the right projects are funded during the recovery, they could bring a double-dividend: economic and social recovery while achieving climate emissions goals. There are some clear candidates, such as fossil fuel subsidy reforms and promoting the energy transition. High-speed internet connectivity that requires labor for installation will also enable more efficient transactions, potentially reducing the per-transaction carbon emissions if applied in certain activities that reduce the need for wasteful analog logistics systems. Moreover, when directed to the poor, these projects could narrow the digital divide in key areas such as access to education. It also has a positive effect on productivity, lowers entry barriers, and enhances competition.

Another component of the green economy is often overlooked: restoring and conserving natural ecosystems can stimulate rural economies, create rural and urban jobs, and help maintain critical ecosystem services vital to the economy, such as water supply. In addition, these activities can strengthen ecosystems’ resilience to climate-induced change. Enhancing the resilience of ecosystems is necessary to help ensure the economic and social well being of communities, particularly the rural poor who are among the most vulnerable to the impacts of climate change in Latin America. Research also suggests that, by measure of per-dollar invested, restoration activities create more jobs than traditional industries (Nielsen-Pincus and Moseley 2010).

In addition, cash transfer programs introduced during the pandemic can be transformed in a way that is more compatible with long-term structural goals. One example is to keep cash subsidies only if other subsidies that are detrimental to climate goals—such as subsidies on gasoline or electricity consumption—are removed. More broadly, additional expenditures resulting from the current crisis should be aligned with robust and improved social and environmental policies. There is an opportunity to reduce energy and gasoline subsidies, with climate change and fiscal benefits.

Solving the economic havoc caused by the Covid-19 crisis must go hand in hand with resilient strategies for climate-induced threats (including droughts, hurricanes, cyclones, floods, and sea level rise), as well as long-term environmental sustainability and biodiversity conservation. With more awareness about the devastating effects of a predictable and preventable crisis like this one, the world would be in a better position to tackle the even more disruptive and lasting crisis of climate change.

But a word of caution is necessary: The recovery should be based on policies that produce the minimum harm possible to climate goals, but reducing carbon emissions is just one aspect to consider. Although governments should refrain from investing in fossil fuel energy infrastructure where technology may be locked in for decades, reducing carbon emission should not be the overriding goal of fiscal stimulus in the short-run. A vigorous expansion is crucial, although clearly not at the expense of water and other ecosystem services. But restoring income is necessary to sustaining long-term interventions, such as green infrastructure, research, development, and demonstration, which are crucial for the climate agenda.
8. Financing the Recovery in LAC

In the case of low-income countries, the International Monetary Fund, multilateral development banks, and the Paris Club of bilateral creditors have responded with timely debt relief packages. This has not been the case for MICs, as higher per capita incomes make these countries ineligible for debt relief. Rather than debt forgiveness, what these countries need is access to new financing so they can adopt more aggressive expansionary spending policies. For countries such Brazil, Chile, Colombia, Mexico, and Peru, among others, debt relief is not the answer.

Given their small size compared to the expected depth of the recession, stimulus packages have not focused on clean infrastructure investing in LAC. This is in sharp contrast with the World Bank's recent Transformative Climate Finance report (World Bank Group 2020), which argues that countercyclical spending could favor blended finance as a tool for economic recovery. Defined as the co-investment of public, philanthropic, and/or aid finance alongside private finance, blended finance can become a major force in economic recovery. By using public funds to take higher risk positions in investment projects, private investors could be attracted to engage in transactions otherwise deemed too risky for their risk-return profiles. This is particularly interesting when thinking about shovel-ready energy and public infrastructure projects that may have become underfunded or have been halted due to public health measures during the pandemic. De-risking this portfolio of projects could be a priority for recovery measures.

While philanthropic aid or impact investors have traditionally used blended finance to leverage private resources in project-based finance, the present crisis presents a unique opportunity for public investment to structurally leverage private funds. Renewable energy and low-carbon transport projects, as well as reforestation, land restoration, ecosystem-based adaptation, and coral reef restoration, may now be unattractive to large private investors. By enacting project-based recovery strategies in which public capital takes a junior position to private debt, governments should be able to decrease the risk profile of desirable projects such that private investors complement the government’s countercyclical spending. Moreover, in most instances the public sector can operate through state-owned financial institutions—such as Colombia’s *Financiera de Desarrollo Nacional*—which are not part of the central government and, therefore, do not put pressure on the fiscal balance.

In essence, by selectively engaging in investment projects that also produce positive environmental externalities, recovery packages could help reduce carbon emissions. While it is likely that current fiscal needs can cause cuts in environmental spending, public-private investments contingent on positive socio-environmental externalities could offset the potentially negative effects of the crisis on climate goals.

Some alternatives include debt-for-climate, debt-for-sustainability and even debt-for-forests swaps where multilateral and private creditors provide debt relief in exchange for climate action, progress in sustainability metrics, and reforestation by debtor countries. However promising these vehicles may sound, they are far from being the ideal tool to provide large amounts of structural financing in the short- to medium-term. Debt-for-nature swaps have existed since the
1980s and have faced severe obstacles, such as limited scalability potential, weak accountability mechanisms for debtor countries, and misaligned incentives where most (if not all) private debt holders are not willing to forgo debt payments in exchange for a public good.

As has been frequently mentioned, a targeted issuance of special drawing rights (SDRs) by the IMF would provide much-needed quick and cost-effective liquidity to members’ foreign reserves without incurring in higher levels of debt. The IMF’s rapid credit and financing instruments are capable of providing $1 trillion in loans, falling short of the $2 trillion estimated to be needed to fund the worst-case economic scenario for the coming months (IMF 2020). According to the Peterson Institute for International Economics (Collins and Truman 2020), a $500 billion general issuance of SDRs would provide $22 billion to the world’s poorest nations, an amount far greater than the $14 billion debt suspension package agreed upon by the G20.

Such a scenario would not be without precedent. In 2009, the G20 summit quickly agreed to a $250 billion general issuance. The ideal scenario would provide a targeted issuance of SDRs to low- and middle-income countries, although this would require amending the IMF’s articles of agreement, something not feasible in the face of a crisis with urgent needs. A valid concern about the issuance of SDRs is the creation of a moral hazard because of the lack of conditional reforms, but countries should tie fiscal spending commitments to the SDGs and climate change goals. While the monetization of SDRs into hard currencies may imply higher costs than concessional loans, these two financing mechanisms could be used in tandem and not thought of as mutually exclusive.

These options, complementing those discussed in Cárdenas (2020) and Velasco (2020), could help countries in the missing middle group which are unable to access debt-relief packages.

**SDG-linked bonds**

One alternative is to issue bonds that are linked to specific subsets of the Sustainable Development Goals. As proposed by Pinzón et al. (2020), these SDG-linked bonds should have a lower cost of capital than conventional sovereign bonds. In principle, by embedding sustainability considerations within sovereign debt, an investor should be able to mitigate environmental, social, and governance (ESG) risk at the country level. Multilateral and regional development banks would contribute concessional capital to a debt fund that could buy these bonds, offer partial guarantees to reduce the risk of the bonds, and offer grants to cover structuring costs. In this sense, the debt fund would be able to provide large amounts of concessional financing for countries interested in issuing SDG-linked bonds.

From the perspective of sovereign debtors, SDG-linked debt issuance would be an ideal vehicle to finance a better recovery. If the goals set out by the terms of the bond are met, countries would have to pay lower coupon fees. Not only could they begin to replace general purpose bonds in terms of size, they would also align long-term fiscal sustainability with economic and environmental sustainability.

Innovative structures can also be used by private issuers. In fact, the $1.5 billion sustainability-linked bond issued by ENEL (the Italian multinational energy company) in late 2019 is a
good example. As opposed to a traditional green bond, proceeds from ENEL’s sustainability-linked bond are not earmarked for specific projects or investments. Instead, much like a conventional corporate bond, the funds can be applied to operating expenses or capital expenditures without any specific ESG requirement. However, ENEL’s bond coupon rate is variable and depends on the company meeting a specific performance target, namely the increased share of its renewable energy installed capacity from 46 percent in 2019 to at least 55 percent in 2021 (BNP Paribas 2019). If the company is unable to meet the aforementioned target, the bond’s coupon rate will increase by 25 basis points. Similarly, Latin America’s first sustainability-linked bond issuance by Brazilian pulp producer Suzano will have a 10-year maturity and embed a 25-basis points coupon step if the company fails to reduce gas emission intensity by 10.9 percent from a 2015 baseline by 2025. This key performance indicator will be reviewed by an independent third party, giving greater confidence to investors.

This structure is thus able to align the incentives of both creditors and debtors to invest in more sustainable projects, while eliminating the need for an earmarked use-of-proceeds approach. Issuers are also able to better administer funds without being limited to specific investments, while the ESG audit burden is reduced, since only initial baseline and end-line assessments of the targets in question are required.

In a world where emerging market governments do not necessarily have shovel-ready projects that meet a minimum of ESG criteria to issue green bonds and where conventional debt issuance may displace the SDGs from the spending spotlight in the short- and medium-terms, SDG sovereign debt financing could be an optimal economic, social, and environmental solution.

The issuance of SDG sovereign bonds will require a transformational change within ministries of finance in emerging markets to a more comprehensive approach to development, wherein improvements in social and environmental performance indicators are at the core of a country’s debt sustainability strategy. Unlike the approach taken by private issuers, an SDG sovereign bond would have to focus on more than one performance metric, likely a combination of SDGs and their respective indicators. As proposed by Pinzón et al. (2020), a multi-actor technical assistance package would have to accompany the issuance of SDG sovereign bonds so that governments are able to build capacity to identify viable key indicators and targets, as well as methodologies to measure their progress. Additionally, to avoid adding to the complexity of existing ESG and green bond standards, anchor investors should establish a common set of principles to make different SDG sovereign bonds comparable among themselves and against other ESG investment vehicles.

An example of this is Mexico’s recent issuance of the world’s first SDG sovereign bond in September of 2020 (Currea and Toro, 2020). The seven-year $890 million bond comes following the development of an “SDG Sovereign Bond Framework” by the Mexican Ministry of Finance and investment bank Natixis. While this is a step in the right direction, it is important to note that despite its seemingly perfect timing, Mexico’s SDG bond was designed in parallel to the current crisis and not in response to it. In fact, it may be a model not well suited to fill the needs brought by the pandemic given its earmarked use of proceeds and impact reporting requirements, both characteristics which may hinder the speed at which other countries are able to structure and issue such bonds, as well as limit the flexibility governments need to overcome the crisis.
One of the opportunities SDG sovereign bond issuances bring is the possibility to counterbalance the credit rating downgrade that will result from higher debt-to-GDP ratios by missing middle countries. In principle, by investing in bonds whose government issuers are keen to improve social, economic, and environmental conditions, the underlying socio-environmental risks associated with the country in question would also decrease in the mid- to long-term. If credit rating agencies are able to incorporate the reduction in socio-environmental risks that result from SDG sovereign bond issuance into sovereign credit ratings, any conventional debt issuance would inevitably result in higher downgrades than its equivalent in SDG bonds.

Ministries of finance will be able to best generate growth, jobs, and long-term income multipliers while maintaining sustainability at the core of the economic recovery by issuing SDG sovereign bonds. By using those funds as part of local blended finance structures, governments would be able to further catalyze commercial investment in SDG-oriented projects.

9. Conclusion: The Path Forward

The economic crisis wrought by the Covid-19 pandemic is likely to cause a serious reversal in developing and emerging economies. While poorer economies may benefit from aid and debt suspensions, upper-middle-income countries representing roughly 40 percent of the world’s population face an impending sovereign debt crisis and are ineligible for current debt suspension programs. Additionally, conventional short-run Keynesian stimulus will probably not be sufficient to offset some of the crisis’s consequences, requiring new and more sustained interventions in order to deliver long-lasting reductions in poverty and inequality.

At the crux of the pandemic, these countries seek to resolve the need to increase fiscal spending, contain development reversals, and not falter in the face of longer-term crises such as climate change. Fiscal sustainability will therefore be essential in order to fund interventions for years, not months. In addition, countries need to emerge better prepared to handle climate and environmental crises. To do that, the focus should not be placed exclusively on government expenditures, but should also include other policy actions in areas such as public-private partnerships and the use of financial instruments to de-risk clean investment projects.

Deteriorating credit ratings are likely to restrain middle-income countries’ access to financial markets. New structures to access global liquidity, such as the issuance of SDG-linked sovereign bonds and the targeted allocation of SDRs with SDG conditionality, could better solve the health, economic, and ecological crises we are going through at present. In the long run, these mechanisms could help create a financial and economic system that is more resilient to exogenous shocks.

Notes

1. This paper is part of a series of contributions from Columbia University’s Center on Global Energy Policy (CGEP) on post-Covid recovery plans in the US, China, Europe, and Latin America.
2. See Núñez (2020) for Colombia and Lustig et al. (2020) for other countries in Latin America.

3. Data from Google is based on mobile use, which could be concentrated in higher income households in Latin America, suggesting that the effectiveness of lockdowns is greater than it actually is. Low income households have probably resumed activities, or suspended them less to begin with, consistent with the fact that informal activities continued, given weak social safety nets.

4. Lustig and Tomassi (2020) and Foschiatti and Gasparini (2020) reach similar conclusions.

5. Although the IMF is projecting a strong recovery in 2021, there is significant uncertainty. In the case of the US, former Council of Economic Advisers Chairman Jason Furman (2020) projects a high unemployment rate for many years. Things will not be very different in Latin America.

6. See, for example, Economic Commission for Latin America and the Caribbean (2020).

7. The reform of fossil fuel subsidies can also reduce price distortions of non-renewable energy and favor clean technologies. Prices of technologies in comparison to fossil fuels can be consulted in IRENA (2020), Global Renewables Outlook, Energy transformation 2050.

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