UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT
UNCTAD

No.62
NOVEMBER 2017

POLICY BRIEF

ENVIRONMENTAL VULNERABILITY AND DEBT SUSTAINABILITY IN THE CARIBBEAN: DO WE HAVE ENOUGH TOOLS TO ADDRESS CATASTROPHIC RISK?

The devastating impact in the Caribbean region of the hurricane season in 2017 has put the spotlight on the wide-ranging consequences of environmental vulnerability in developing countries. Rather than being an exception, these types of events are expected to become more frequent and intense due to climate change. In this context, limited capacity to mobilize domestic resources, combined with insufficient multilateral financing facilities, create conditions in which developing countries may be unable to adequately invest in climate change adaptation needs and catastrophic risk insurance. Consequently, large-scale natural disasters put the environmental, economic and social viability of environmentally vulnerable countries at risk. The international community should therefore review the tools available to address catastrophic risk, in order to support successful climate change adaptation in developing countries. This policy brief analyses the interplay of such economic dynamics in the Caribbean.

Key points

- The increasingly frequent occurrence of natural disasters due to climate change put the debt sustainability and socioeconomic stability of vulnerable developing countries at risk.
- The international community should review and enhance the tools available to such countries to maintain debt sustainability and mobilize resources for climate change adaptation and developmental transformation.
- Measures should include the review of the criteria for the prioritization of official development assistance and concessional lending, the improvement of insurance schemes and the establishment of a global disaster mechanism under the auspices of the United Nations.

Introduction

The economic impact of climate change is set to increase over the next century, along with the growing frequency and intensity of climate-related natural disasters. In this regard, countries in the Caribbean are particularly vulnerable, as highlighted during the recent hurricane season. The long-term environmental challenges faced by these countries are compounded by high levels of external economic vulnerability and public debt.[1] These factors combine to create a vicious cycle. Countries in the Caribbean recurrently use public debt to absorb the impact of external shocks and natural disasters.[2] In turn, higher levels of public debt constrain capacity to effectively address vulnerabilities. As a result, each new wave of shocks and disasters simultaneously amplifies vulnerabilities and weakens domestic response capacity.

[1] Economic Commission for Latin America and the Caribbean, 2011, Study on the vulnerability and resilience of Caribbean small island developing States, available at http://repositorio.cepal.org/handle/11362/38568.

Note: All websites referred to in footnotes were accessed in November 2017.

[2] International Monetary Fund, 2013, Caribbean small States: Challenges of high debt and low growth, available at https://www.imf.org/external/np/pp/eng/2013/022013b.pdf.

UNITED NATIONS
UNCTAD

What tools are available to address economic and environmental vulnerability and the catastrophic risks associated with climate change?

Addressing these matters requires a fresh look at several interconnected issues. Beyond the effective mobilization and use of domestic resources, areas to be considered include the following: regional prioritization of climate change funding; an assessment of the current criteria used to assign official development assistance and concessional lending; the relevance of the existing special lending and insurance instruments provided by multilateral organizations; and alternative innovative mechanisms for development and climate finance.

With regard to domestic resource mobilization, in 2016, countries in the Caribbean generally had high levels of government revenue, averaging 26.8 per cent of gross domestic product (GDP). However, these countries have tended to adhere to rigid structures with regard to expenditures, resulting in a trend of widening fiscal deficits and growing public debt over the last few decades. On average, the fiscal deficit in the region has increased from 1.7 per cent of GDP in the 1990s to 3.4 per cent to date in the current decade.[3] In the meantime, in 2016, average public debt in the Caribbean stood at 77.7 per cent of GDP.

International Monetary Fund policy recommendations focus on at least two areas, namely fiscal consolidation through adjustments in expenditures in the range of 3–5 per cent of GDP and the incorporation of budget provisions equivalent to 1 per cent of GDP, to cover the average annual impact of natural disasters.[4] However, given the historical low number of successful examples of fiscal consolidation in the Caribbean region, the potential for countries to pursue such policies and simultaneously invest in climate change adaptation may be limited.

Assistance from the international community should therefore play a key role in addressing economic and environmental vulnerabilities and associated catastrophic risks faced by countries in the Caribbean. The most important initiative in this regard is the Green Climate Fund, established in 2010 as part of the financial mechanism of the United Nations Framework Convention on Climate Change (see http://www.greenclimate.fund/who-we-are/about-the-fund). The Fund is expected to mobilize $100 billion per year by 2020 to be invested worldwide in climate change mitigation and adaptation projects. Countries in the Caribbean should receive special consideration in access to these resources. However, one main concern is that if resource allocation is based on the same approach currently used for the allocation of official development assistance and concessional lending – that is, based on levels of gross national income per capita – most countries in the Caribbean will be excluded since, with the exception of Haiti, they are categorized as middle and upper middle-income countries. This makes them ineligible for official development assistance and under most available concessional lending schemes, and these countries currently receive a small share of international commitments for climate change adaptation.[5] This shows that the current approach to aid eligibility based solely on gross national income per capita levels is increasingly narrow and outdated.

[3] Moody's, 2016, *Caribbean Sovereigns: The Silent Debt Crisis* (New York).

[4] A Schipke, A Cebotari and N Thacker, 2013, *The Eastern Caribbean Economic and Currency Union: Macroeconomics and Financial Systems* (International Monetary Fund, Washington, D. C.); International Monetary Fund, 2016, Eastern Caribbean Currency Union: 2016 discussion on common policies of member countries – press release and staff report, Country Report No. 16/333.

[5] United Nations, Development Initiatives and United Kingdom [of Great Britain and Northern Ireland] Aid Direct, 2015, Improving official development assistance allocation for a post-2015 world, available at http://www.un.org/en/ecosoc/newfunct/pdf15/un_improving_oda_allocation_for_post-2015_world.pdf.

Additional multilateral initiatives to support countries in the Caribbean include facilities made available by the International Monetary Fund and the World Bank. In the aftermath of recent hurricanes, the International Monetary Fund deployed its Rapid Credit Facility, to provide financial support on concessional terms; over the last five years, Haiti, Dominica and Saint Vincent and the Grenadines have borrowed a total of $53.5 million through this facility. The main initiative of the World Bank to address the impact of natural disasters in the region is the Caribbean Catastrophe Risk Insurance Facility, set up in 2007 as a regional catastrophe fund to limit the financial impact of hurricanes and earthquakes by quickly providing financial liquidity when a policy is triggered. The facility operates as a mutual insurance company for 16 countries in the Caribbean, whereby each country pays an annual premium directly related to the risks faced and, in return, receives insurance coverage of up to $100 million for each hazard, namely tropical storms, earthquakes and excess rainfall events.[6]

The facilities made available by the International Monetary Fund and the World Bank play a useful role in providing liquidity support in the aftermath of a natural disaster, yet their overall relevance for countries in the Caribbean remains limited, for reasons related to eligibility, available resources and the debt vulnerabilities faced in the region. With regard to eligibility, for example, only six countries (Dominica, Grenada, Guyana, Haiti, Saint Lucia and Saint Vincent and the Grenadines) may access the Rapid Credit Facility, according to the eligibility criteria of the International Monetary Fund.[7] Moreover, neither facility is able to provide the amount of resources required to deal with a large-scale catastrophic event. The Rapid Credit Facility is designed as an instrument for providing liquidity, but not solvency relief. In other words, even if short-term needs are met in the aftermath of a natural disaster, countries in the Caribbean must still deal with a heavy public debt burden.

Countries in the Caribbean are at the forefront of financial innovation in areas related to the expansion of the catastrophe bond market and the establishment of catastrophe clauses. Catastrophe bonds are instruments issued by insurance and reinsurance companies to transfer the risk associated with catastrophic events. This mechanism allows for a reduction of the cost premiums of insurance services, thereby facilitating the expansion of the market for insurance against large-scale natural disasters. In 2014, for the first time, the World Bank issued a $30 million catastrophe bond, as part of its risk transfer strategy.[8] The market for this type of instrument has experienced significant growth in recent years, reaching $30 billion at end-2016.[9] With regard to catastrophe clauses, Grenada, as part of its debt restructuring in 2015, became the first country to include a clause that enables changes to its debt servicing schedule in the event of a specific natural disaster, allowing the country to redirect debt service payments into reconstruction costs and economic recovery. However, despite their benefits, such instruments are not intended to handle large-scale catastrophic events.[10]

[6] Caribbean Catastrophe Risk Insurance Facility, 2015, Understanding Caribbean Catastrophe Risk Insurance Facility: A collection of questions and answers, available at http://www.ccrif.org/sites/default/files/publications/Understanding_CCRIF_March_2015.pdf.

[7] International Monetary Fund, 2017, Eligibility to use the Fund's facilities for concessional financing for 2017, available at: https://www.imf.org/en/Publications/Policy-Papers/Issues/2017/05/23/pp052317-eligibility-to-use-the-fund-facilities-for-concessional-financing-for-2017.

[8] World Bank, 2014, Facilitating catastrophe risk transfer, available at http://documents.worldbank.org/curated/en/463201468015629255/Facilitating-catastrophe-risk-transfer.

[9] International Monetary Fund, 2017, *World Economic Outlook October 2017: Seeking Sustainable Growth – Short-Term Recovery, Long-Term Challenges* (Washington, D. C.).

[10] T Asonuma, X Li, MG Papaioannou, S Thomas and E Togo, 2017, Sovereign debt restructurings in Grenada: Causes, processes, outcomes and lessons learned, International Monetary Fund Working Paper No. 17/171.

Policy recommendations

Important steps are being undertaken to provide short-term financial relief in the event of a natural disaster. However, the instruments and facilities discussed in this policy brief have clear shortfalls and limitations. The main concern is that countries in the Caribbean remain vulnerable to certain types of extreme events that are expected to occur more frequently with climate change. The current approach based on the domestic mobilization of resources and external insurance mechanisms means that countries in the Caribbean remain prone to systematically underinvesting in climate change adaptation needs. As a result, the long-term costs of dealing with natural disasters in the region are bound to increase beyond what can be humanly, economically and socially supported. Measures to avoid this type of scenario ought to include the following:

1. A joint evaluation by multilateral agencies of the criteria used in targeting official development assistance and concessional lending, to move beyond a narrow approach based on gross national income per capita. As a first step, environmental vulnerability considerations included in the Environmental Vulnerability Index, developed by the South Pacific Applied Geoscience Commission and the United Nations Environment Programme, may be considered. An improvement in this area would lead to an increase in the resources available to environmentally vulnerable countries, to address climate change adaptation and mitigation needs.

2. A joint review by multilateral agencies and donor countries of the insurance mechanisms available for environmentally vulnerable countries. The focus should be on options that provide countries with effective protection against the catastrophic risks associated with climate change.

3. A move towards the establishment of a global disaster mechanism under the auspices of the United Nations, in parallel with the above-mentioned evaluation and review. Such a mechanism could bring together and scale up in a more holistic manner the existing fragmented resources available for large-scale disaster relief. With an initial endowment of $10 billion, the mechanism could support ex ante investments in climate change adaptation and disaster preparedness, as well disaster relief. Subject to a series of pre-defined triggers, based on considerations such as the share of the affected population and economic impacts, countries could receive disbursements of up to 25 per cent of damages. Funds for the mechanism could be based on assessed contributions, with developed countries contributing relatively more than developing countries.[11]

4. Specific measures to address the financial constraints faced by environmentally vulnerable and highly indebted countries. Such measures should include debt relief proposals that ensure debt sustainability in scenarios that explicitly account for climate change adaptation needs and the impacts of natural disasters. One proposal by the Economic Commission for Latin America and the Caribbean involves the creation of an official debt swap mechanism, which would involve the total multilateral debt of countries in the Caribbean on the condition that the States involved placed the equivalent amount of the annual servicing of the debt into a trust fund dedicated to climate change-related investments.[12]

[11] United Nations Department of Economic and Social Affairs, 2008, *World Economic and Social Survey 2008: Overcoming Economic Insecurity* (United Nations publication, Sales No. E.08.II.C.1, New York).

[12] Economic Commission for Latin America and the Caribbean, 2016, *Horizons 2030: Equality at the Centre of Sustainable Development* (United Nations publication, Sales No. E.16.II.G.1, Santiago).

Contact

Ms. Stephanie Blankenburg
Head, Debt and Development Finance Branch,
Division on Globalization and Development Strategies
41 22 917 58 61
stephanie.blankenburg@unctad.org

Press Office
41 22 917 58 28
unctadpress@unctad.org
www.unctad.org

UNITED NATIONS
UNCTAD

UNCTAD/PRESS/PB/2017/11 (No. 62)