UNDP Latin America and the Caribbean
#COVID19 | POLICY DOCUMENTS SERIES

UNDP LAC C19 PDS Nº. 21

Planning a Sustainable Post-Pandemic Recovery in Latin America and the Caribbean

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Abstract

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 in order 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 crisis. 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 Sustainable Development Goals. 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-creating undertakings. Additionally, the issuance of SDG-linked sovereign debt and Special Drawing Rights (SDRs) with SDG conditionality could also provide much needed liquidity at a low cost.

* 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.

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Introduction to the series:

Evidence, Experience, and Pertinence in Search for Effective Policy Alternatives

The COVID-19 pandemic is one of the most serious challenges the world has faced in recent times. The total cost in terms of human lives is yet to unfold. Alongside the cost of lives and deep health crisis, the world is witnessing an economic downfold that will severely impact the wellbeing of large parts of the population in the years to come. Some of the measures that are currently being used to counteract the pandemic may impact our future lives in non-trivial ways. Understanding the association between different elements of the problem to broaden the policy space, with full awareness of the economic and social effects that they may bring, is the purpose of this series.

Thus far, the impossibility of targeted isolation of infected individuals and groups has led to policies of social distancing that impose a disproportionately high economic and social cost around the world. The combination of policies such as social distancing, lockdowns, and quarantines, imply a slowdown or even a complete stop in production and consumption activities for an uncertain period of time, crashing markets and potentially leading to the closure of businesses, sending millions of workers home. Labor, a key factor of production, has been quarantined in most sectors in the economy, borders have been closed and global value chains have been disrupted. Most estimates show a contraction of the level of output globally. For the Latin America and Caribbean region, the consensus forecasts are at -3 to -4%, and it is not until 2022 that the region is expected to go back to its pre-crisis output levels in scenarios that foresee a U-shaped crisis pattern. According to ECLAC, more than 30 million people could fall into poverty in the absence of active policies to protect or substitute income flows to vulnerable groups.

We face a crisis that requires unconventional responses. We are concerned about the level-effect: the impact of the crisis on the size of the economies and their capacity to recover growth after the shock. But we are equally concerned about the distributional impact of the shock. The crisis interacts with pre-existing heterogeneity in asset holdings, income-generation capacity, labor conditions, access to public services, and many other aspects that make some individuals and households particularly vulnerable to an economic freeze of this kind. People in the informal markets, small and micro entrepreneurs, women in precarious employment conditions, historically excluded groups, such as indigenous and afro-descendants, must be at the center of the policy response.

UNDP, as the development agency of the United Nations, has a long tradition of accompanying policy-making in its design, implementation, monitoring and evaluation. It has a mandate to respond to changing circumstances, deploying its assets to support our member states in their pursuit of integrated solutions to complex problems. This series aims at drawing from UNDPs own experience and knowledge globally and from the expertise and capacity of our partner think tanks and academic institutions in Latin America and the Caribbean. It is an attempt to promote a collective reflection on the response to the COVID-19 health crisis and its economic and social effects on our societies. Timeliness is a must. Solutions that rely on evidence, experience, and reasoned policy intuition –coming from our rich history of policy engagement– are essential to guide this effort. This series also contributes to the integrated approach established by the UN reform and aspires to become an important input into the coherent response of the United Nations development system at the global, regional, and national levels.

Ben Bernanke, former Governor of the US Federal Reserve, reminds us in his book *The Courage to Act* that during crises, people are distinguished by those who act and those who fear to act. We hope this policy documents series will contribute to the public debate by providing timely and technically solid proposals to support the many who are taking decisive actions to protect the most vulnerable in our region.

Luis F. Lopez-Calva
United Nations Development Programme
Regional Director, Latin America and the Caribbean
New York, March 2020

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 the 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 LAC. In the case deaths per million population, 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 in response to the pandemic –and the associated loss of income and the 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 9.4percent GDP contraction in 2020. Advanced economies will on average contract by 8.0 percent in 2020, while emerging economies are expected to fall only by 3 percent, mainly because China and India 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 (on average just 0.4 percent per year).

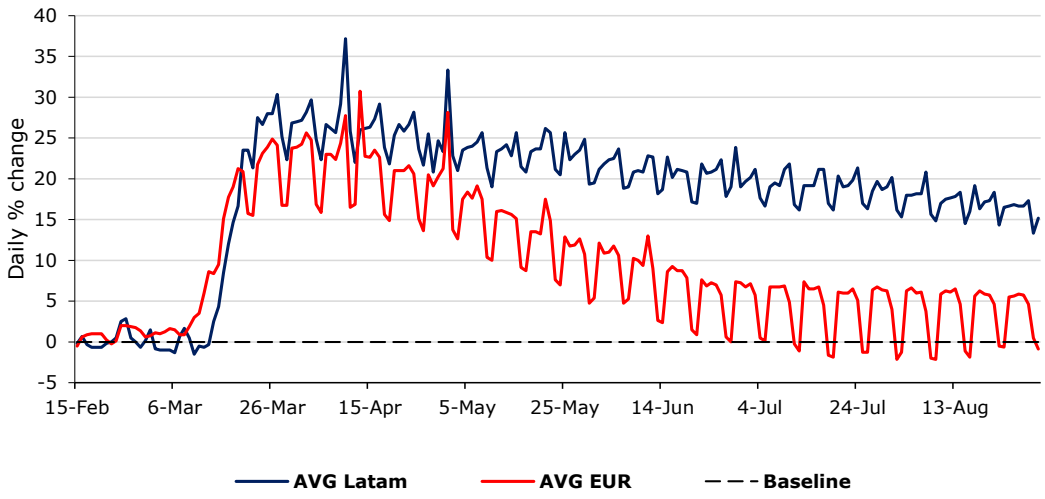
According to a recent report from UNDP, the recession is causing a significant reduction in employment, which could have long-lasting effects. Household surveys show that the number of individuals out of the labor force is surpassing those into it, in countries as diverse as Mexico, Chile, and Peru. The World Bank 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 population was below the poverty line in May, relative to 27 percent in the pre-pandemic months.[1]

High levels of urbanization, population density, and informality, 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 represent 56 percent of total employment, together with the lack of adequate social safety nets that push 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.[2] As infection rates continue to be 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 the Latin America will be significantly more severe and profound than in other regions.

[1] See Núñez (2020) for Colombia and Lustig et al. (2020) for other countries in Latin America.

[2] 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 that 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 safety nets.

Figure 1. Time Spent at Household.



The baseline is the median value, for the corresponding day of the week, during the 5-week period Jan 3–Feb 6, 2020. **AVG EUR** is defined as the average daily change from the baseline in France, Germany, Italy, the Netherlands, Poland, Spain, Sweden and the United Kingdom. **AVG LATAM** is defined the average daily change from baseline in Argentina, Brazil, Chile, Colombia, Mexico and Peru. Data extracted from Google Community Mobility Report (2020).

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 that the disadvantaged are suffering the most during the pandemic. 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.[3]

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 an economic stimulus package to deal 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 the disaster relief and preservation as 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 either herd immunity is reached, a more effective treatment, or a vaccine are delayed then the transition for preservation to recovery make take months and even years.

[3] Lustig and Tomassi (2020) and Foschiatti and Gasparini (2020) reach similar conclusions.

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, R&D, 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 that sustained and longer-term actions will be required.[4] 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 adequate.

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 drive 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 driver –and in some cases not even the most relevant one-- 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 front of the policy agenda. In other words, the political dynamics of the region may force governments into avenues that involve the re-design of social pacts –as in Chile—more 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 cope with the health crisis, while at the same time ensuring and adequate recovery. Fiscal space is constrained, forcing Latin American countries to be selective in terms of the size and composition of the recovery packages.

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

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 IDB or 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 in bringing back output and employment to the 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 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 what is meant is really to "build back better" in the sense of seizing the opportunity to improve conditions relative the pre-pandemic. 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 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 at not just avoiding a reversal in the positive trends that were observed during the previous two decades, but accelerating the progress that has been achieved. This is a serious challenge, as preliminary evidence indicates that on these fronts the region has lost during the pandemic two decades of social progress.

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 both 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 others examples of measures that can be part of a green recovery, including in the short-run, such as eh replacement of poorly-targeted energy subsidies, for cash transfers targeted to 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 spent in capex. This means that the green recovery needs to take place, investments have to be careful of not crowding-out other sectors that potentially 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 and 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, gross public debt in Latin America will raise 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 GFC. In the medium term, debt service will crowd out other expenditures, and debt-overhang will restrict economic growth.

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 to 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, other factors different 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 to 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, social programs such as cash transfers included in the COVID-19 emergency packages are likely to remain in place, or a fraction of them, 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 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, their 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.[5]

Examples of these 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 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 widening the tax base, by reducing informality. Closing loopholes, reducing tax expenditures – and more broadly increasing tax productivity – 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 should be made contingent on legislation that reduces fossil-fuel subsides or VAT exemptions. Greater financial inclusion –to enable the transfer of cash subsidies-- has been a positive side-effect of the pandemic. This will prove instrumental in order to refund taxes paid by low income households. Another option to raise more revenues is taxation of digital services.

On the institutional side, the challenge is to reform institutions to 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, making fiscal sustainability a mandatory constitutional criteria, should be put on the table, with automatic tax or spending adjustments and credible sanctions.

6. Other policy areas relevant for the recovery

A sustainable recovery requires the intervention of other policy areas, apart from fiscal stimulus. Government responses have to be broad. As mentioned in a recent essay by Bordoff, recovery packages need to go beyond traditional fiscal expansions, and 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, provide key essential inputs, etc. PDPs

[5] See, for example, www.cepal.org/en/news/latin-america-and-caribbean-tax-revenue-gains-under-threat-amid-deteriorating-regional-outlook

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 – through regulation – 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 to close to 60 percent post-COVID. 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 should not be based on taxes on formal employment, which should be covered with general tax revenues. 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. Already millions of students who are unable to study from home or return to school are either 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 Queré et al. (2020) report that daily global greenhouse gas (GHG) emissions decreased by 17 percent by early April 2020, when 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 mid-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 uptake as economies recover, mimicking the period immediately following the 2008 global financial crisis (GFC) when the world experienced the highest annual growth in total emissions ever recorded (Peters et al., 2012). A significant rebound, as expected by the IMF (2020) and the OECD (2020), global GHG emissions could rapidly exceed the 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 – 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 but very challenging. Largescale 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 degrees. More so, given that most countries do not even live up to their initial targets.

Therefore, the need to adopt low-carbon and climate-resilient spending pathways is crucial. If the right projects during the recovery are funded this could bring a double-dividend: economic and social recovery while achieving climate emission 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, and, when directed to the poor, narrows the digital divide in key areas such as he 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 the resilience of ecosystems 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 amongst the most vulnerable to the impacts of climate change in Latin America. Research also suggests that, by the measure of per dollar invested in restoration activities create more jobs than traditional industries.[6]

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 which are detrimental for the 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.[7]

Solving the economic havoc caused by the COVID-19 crisis must go hand-in-hand with resilient strategies to 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 ecosystems, water and other ecosystem services. But restoring income is necessary income to sustain long-term interventions, such as green infrastructure, research, development, and demonstration, which are crucial for the climate agenda.

[6] See Nielsen-Pincus and Moseley (2010).

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

8. Financing the recovery in LAC

In the case of low-income countries, the IMF, MDBs, 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, that 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 along private finance, blended finance can become a major force in the economic recovery. By using public funds to take higher-risk positions in investment projects, private investors could be attracted to engage in transaction 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 the public health measures during the pandemic. De-risking this portfolio of projects could be a priority of 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, coral reef restoration, may now be unattractive for large private investors. By enacting project-based recovery strategies where 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 also 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 sever 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 member's 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, failing 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, 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 by the G20.

Such 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 with 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 being 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. Countries in this category are also fearful of credit rating downgrades and the eventual loss of market access.

SDGs-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 ESG risk at a country level. Multilateral and Regional Development Banks would contribute concessional capital to a debt fund that could buy these bonds, offers 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 to 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 to at least 55 percent in 2021 from 46 percent as of 2019 (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 triggered if the company fails to reduce gas emission intensity by 10.9 percent from a 2015 baseline by 2025. This KPI (key performance indicator) will be reviewed by ISS, 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 by only requiring an initial baseline and end line assessment of the targets in question.

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 run, 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 where 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 such that governments are able to build capacity to identify viable key indictors 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.

One of the opportunities brought by SDG sovereign bond issuances 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. 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 impeding 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' 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. Restoring 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 the climate and environmental crisis. To do that, the focus should not be placed exclusively on government expenditures, but also include other policy actions in areas such as public-private partnerships, and the use of financial instruments to de-risk clean investment projects. Other elements like extended producer responsibility and polluter pays principles can help making the green investments more sustainable.

Deteriorating credit ratings are likely to restrain the access of middle-income countries 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 in the future.

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We acknowledge the kind support of the Spanish Cooperation.