

Addressing *Our* Global Challenges

BY WILLIAM R. RHODES AND JOHN LIPSKY

*Financial innovations
will be key.*

No one doubts that many of the world's biggest challenges—such as mitigating climate change, strengthening financial market stability, and boosting economic growth in developing and emerging economies—are deeply intertwined. Multilateral cooperation will thus lead to better outcomes than uncoordinated national responses. What is less obvious is which of the many proposed approaches to addressing global challenges should be pursued.

Multilateral institutions—notably, the United Nations (including its Framework Convention on Climate Change), the International Monetary Fund, the World Bank, the World Trade Organization, the Financial Stability Board, the G20 (with its Common Framework for Debt Treatments), and the multilateral development banks—have delivered some positive results. But progress has been patchy, and even these institutions' most ardent supporters would agree that a much more concerted effort backed by far greater resources—especially financial resources—is needed.

But how can we mobilize sufficient financing to meet the challenges we face? Given that the sums required far exceed governments' available resources, part of the answer must be to increase private financial involvement. Attracting voluntary private investment,

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however, will require us to develop innovative new financial instruments.

Fortunately, the Bretton Woods Committee has already produced a series of concrete proposals—developed and published by its Working Groups, including those on the Future of Finance, on Sovereign Debt, and on Multilateral Reform—to meet this imperative. The most recent contribution is a report by the Sovereign Debt Working Group (of which we are co-chairs) on the potential of state-contingent debt instruments (SCDIs).

SCDIs rest on the idea that it is possible to create a form of debt in which the repayment burden varies according to the borrower's means. For example, if a country that depends on exports of agricultural commodities faces weather conditions that significantly reduce the sector's output, its ability to service its debts would be severely undermined. But, with a SCDI, its debt-service obligations would be altered according to a formula specified in the debt instrument to account for relevant climate conditions.

If executed well, this approach would sharply reduce the risk of debt restructuring or rescheduling in the case of earnings shortfalls. Crucially, SCDIs also provide additional returns to investors if outcomes are more favorable than anticipated. They can thus be an

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attractive instrument for both lenders and debtors, to be used in situations where the debtor's ability to pay may be significantly influenced by exogenous factors that

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can be reliably measured but cannot be forecast without a meaningful margin of error.

One type of SCDI, known as value recovery instruments (VRIs), has already been used by a number of sovereign borrowers, including Greece, Mexico, Suriname, and Zambia. But if SCDIs—especially VRIs—are to fulfill their potential, their integrity, effectiveness, and marketability must be improved.

The Sovereign Debt Working Group report offers suggestions for how to do just that. For example, the report shows that the “trigger events” and formulas used for adjusting debt-service payments must be defined clearly, and they must accurately reflect changes in the debtor's ability to pay. This means effectively capturing and measuring the cash flows that will be directly available to the sovereign at the time the debt comes due.

Moreover, payout formulas must preserve positive incentives for debtors, thereby reducing the risk of moral hazard. In order to maximize the upside potential of VRIs, they should be embedded in underlying fixed-income bonds, so that the combined instrument is more liquid and more likely to be included in bond indices. And documentation must be standardized, in order to reduce both costs and risks. Standardization would promote mainstream acceptance of SCDIs, much as it has done for collective-action clauses in bond contracts.

Of course, even with an improved design, SCDIs are not a panacea. While they can help attract more private investment to efforts to address global challenges, additional solutions—especially financial innovations—will be needed. Developing a larger menu of potentially useful financial formats should be an urgent priority. ◆