

# Climate Change, Adaptation, and Sovereign Risk

Sarah Duffy

University of Oxford

January 2026

## Motivation: Adaptation and Sovereign Risk

Climate change is projected to increase the frequency and severity of natural disasters

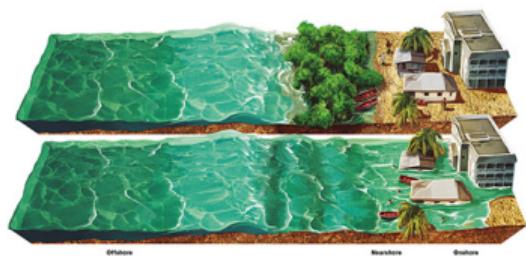
- Climate Policy attention turning towards **adaptation**: adjusting to this 'new normal'
- Adaptation can limit damages, but it is costly

# Cyclone Adaptation

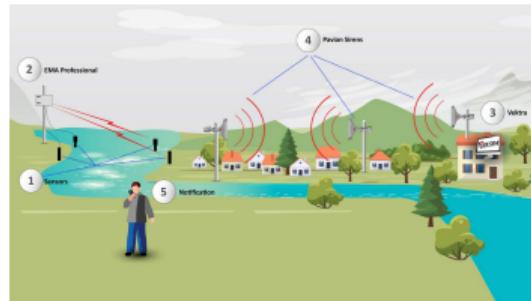
# Cyclone Adaptation



Grey Infrastructure: Sea Wall



Green Infrastructure: Mangroves



Early Warning Systems

## Motivation: Adaptation and Sovereign Risk

Climate change is projected to increase the frequency and severity of natural disasters

- Climate Policy attention turning towards **adaptation**: adjusting to this 'new normal'
- Adaptation can limit damages, but it is costly

Many disaster-prone economies also **fiscally constrained**

- Climate change likely to increase borrowing costs further: climate defaults?
- Calls for '**debt relief for climate resilience**'

# Motivation: Adaptation and Sovereign Risk

Climate change is projected to increase the frequency and severity of natural disasters

- Climate Policy attention turning towards **adaptation**: adjusting to this 'new normal'
- Adaptation can limit damages, but it is costly

Many disaster-prone economies also **fiscally constrained**

- Climate change likely to increase borrowing costs further: climate defaults?
- Calls for '**debt relief for climate resilience**'

This paper:

1. How does sovereign risk affect adaptation (and vice versa)?
2. Could debt relief help?

## Takeaways

- **Analytical Model:** Sovereign default + natural disasters, endogenous adaptation
  - Default risk constrains adaptation of emerging markets: Adaptation Trap

## Takeaways

- **Analytical Model:** Sovereign default + natural disasters, endogenous adaptation
  - Default risk constrains adaptation of emerging markets: Adaptation Trap
- **Data:** Novel adaptation measure from government budgets
  - Adaptation increasing in exposure + ratings (1 SD → \$250m)
  - Hurricane causes default prob ↑, driven by low adaptation economies

# Takeaways

- **Analytical Model:** Sovereign default + natural disasters, endogenous adaptation
  - Default risk constrains adaptation of emerging markets: Adaptation Trap
- **Data:** Novel adaptation measure from government budgets
  - Adaptation increasing in exposure + ratings (1 SD → \$250m)
  - Hurricane causes default prob ↑, driven by low adaptation economies
- **Quantitative Model:** long term debt, adaptation capital
  - Counterfactual: no default option
  - Adaptation investment / GDP in Caribbean is 13% lower
  - GDP effects of hurricanes are 10% higher - increases with climate change
  - Debt relief can help: interest free loan, adaptation linked bond

## Relation to the Literature

- Climate Change and Sovereign Risk
  - Climate Change exacerbates fiscal vulnerabilities (Mallucci, 2022; Phan + Schwartzmann, 2023)
  - **Contribution:** Endogenous Adaptation
- Climate Change and Adaptation
  - Hong et al, 2023; Fried, 2021; Lane, 2024
  - Latent approach: (e.g. Burke et al, 2024). Direct: (e.g. Balboni et al, 2025; Grover and Kahn 2024)
  - **Contribution:** Default risk affecting aggregate adaptation
  - **Contribution:** Direct measure of aggregate adaptation
- Disaster Risk
  - Matters for asset prices and dynamics (e.g. Barro 2009, Gourio 2012)
  - **Contribution:** Additional feedback: protective capital

# Outline

## 1. Simple Model

- Analytical Results: spreads, climate change, and adaptation

## 2. Data

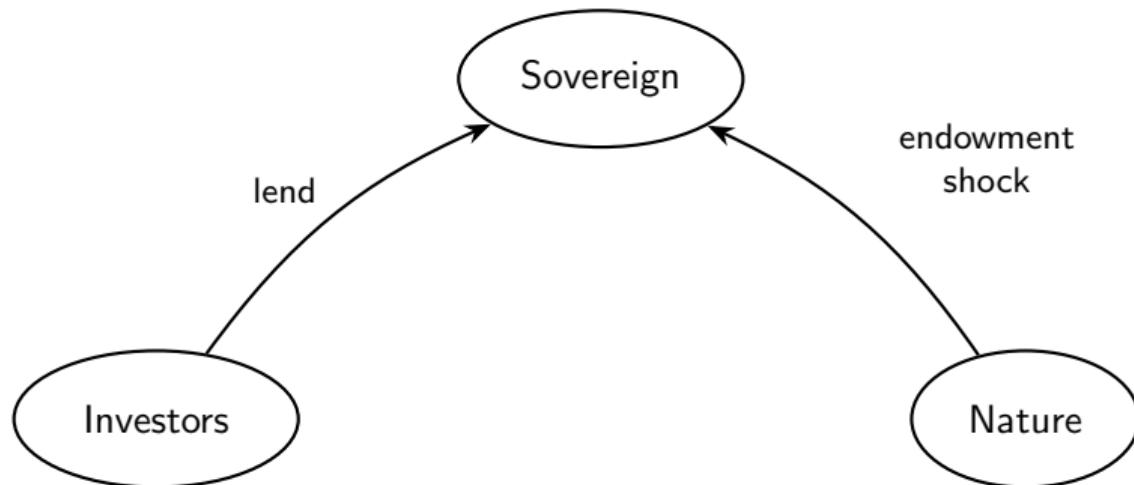
- A new measure of adaptation
- Validating the model

## 3. Quantitative Model

- Calibration using adaptation measure
- Quantitative Results: the adaptation trap
- Debt Relief Counterfactuals

# A Model of Sovereign Default

Objective:  $\max U$   
choices: borrowing, default

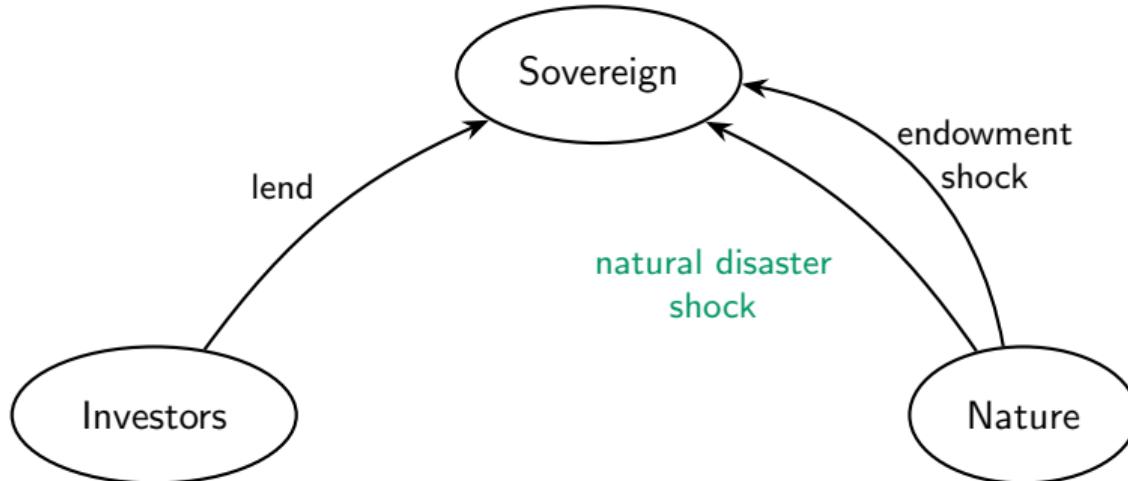


$$q = \frac{1-s}{1+r}$$

$$s = \Pr(\text{default}_{t+1})$$

# Sovereign Risk and Climate Risk

Objective:  $\max U$   
choices: default, borrowing, adaptation



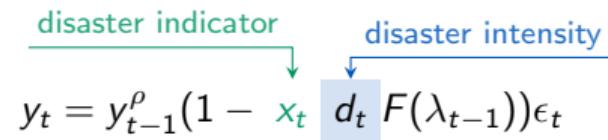
$$q = \frac{1-s}{1+r}$$

$$s = \Pr(\text{default}_{t+1})$$

# Model

$$y_t = y_{t-1}^\rho (1 - \textcolor{teal}{x}_t) d_t F(\lambda_{t-1}) \epsilon_t$$

disaster indicator      disaster intensity



$$\mathbb{P}(x_t = 1) = p$$

where  $d_t \stackrel{iid}{\sim} F_d(d)$ ,  $\log(\epsilon_t) \stackrel{iid}{\sim} N(\mu_\epsilon, \sigma_\epsilon^2)$

# Model

$$y_t = y_{t-1}^\rho (1 - \textcolor{teal}{x}_t) d_t F(\lambda_{t-1}) \epsilon_t$$

disaster indicator      disaster intensity

$$\mathbb{P}(x_t = 1) = p$$

where  $d_t \stackrel{iid}{\sim} F_d(d)$ ,  $\log(\epsilon_t) \stackrel{iid}{\sim} N(\mu_\epsilon, \sigma_\epsilon^2)$

Sovereign maximizes utility:

$$U = \ln(C_1) + \beta \mathbb{E} \ln(C_2)$$

$$C_1 = y_1 + qB - \lambda_1$$

adaptation investment

$$C_2 = \begin{cases} y_2 - B & \text{if } D_2 = 0 \\ y_2 - \phi(y_2) & \text{if } D_2 = 1 \end{cases}$$

## Model: Default

Sovereign chooses to default if:  $B > \phi(y_2)$ .

Assume simple procyclical default costs:

$$\phi(y_2) = y_2 \bar{I} e^{\psi g}$$

## Model: Default

Sovereign chooses to default if:  $B > \phi(y_2)$ .

Assume simple procyclical default costs:

$$\phi(y_2) = y_2 \bar{I} e^{\psi g}$$

Therefore, default if the disaster adjusted growth rate is below an endogenous default threshold:

$$\underbrace{g + \frac{1}{1+\psi} \ln(1 - x_2 d_2 F(\lambda_1))}_{\tilde{g}} < \underbrace{\frac{1}{1+\psi} \ln \left( \frac{B}{\bar{I} y_1^\rho} \right)}_{\bar{g}(B)}$$

## Spread

Continuum of risk neutral investors implies:

$$q = \frac{1-s}{1+r} \quad s = \mathbb{P}(D_2 = 1) = \mathbb{P}(\tilde{g} < \bar{g}(B))$$

Analytical characterization:

$$s(B, \lambda) = (1-p)\Phi_g(\bar{g}) + pE_{d'} \left[ \Phi_g \left( \bar{g} - \frac{1}{1+\psi} \ln(1 - d_2 F(\lambda_1)) \right) \right]$$

# Climate Change, Adaptation, and the Spread

Proposition 1: The Spread is Increasing in Climate Change

$$\frac{\partial s}{\partial p} > 0$$

$$\hat{\Phi}_d \stackrel{\text{fosd}}{\geq} \bar{\Phi}_d \Rightarrow s(\cdot, \cdot | \hat{\Phi}_d) \geq s(\cdot, \cdot | \bar{\Phi}_d)$$

# Climate Change, Adaptation, and the Spread

Proposition 1: The Spread is Increasing in Climate Change

$$\frac{\partial s}{\partial p} > 0 \quad \hat{\Phi}_d \stackrel{\text{fosd}}{\geq} \bar{\Phi}_d \Rightarrow s(\cdot, \cdot | \hat{\Phi}_d) \geq s(\cdot, \cdot | \bar{\Phi}_d)$$

Proposition 2: Spread decreasing in adaptation

$$\frac{\partial s}{\partial \lambda} < 0 \quad \frac{\partial s}{\partial p} < \left. \frac{\partial s}{\partial p} \right|_{\lambda=0}$$

▶ proof

## Adaptation with Sovereign Risk

The optimal choice of adaptation trades off benefits and costs

- Counterfactual: no default option  $\rightarrow MC = MB$  damage reduction
- Now, additional effect through the spread

# Adaptation with Sovereign Risk

The optimal choice of adaptation trades off benefits and costs

- Counterfactual: no default option  $\rightarrow MC = MB$  damage reduction
- Now, additional effect through the spread

FOC( $\lambda$ ):

$$\underbrace{\frac{1}{C_1}}_{MC} = \underbrace{\beta \mathbb{E} \left( \frac{y'_2(\lambda)}{C_R} - s(\lambda) \frac{y'_2(\lambda)B}{y_2 C_R} \right)}_{MB \text{ damage reduction}} + \underbrace{\beta \mathbb{E} (s'(\lambda)(u(c_D) - u(c_R)))}_{MB \text{ reduced default prob}} - \underbrace{\frac{\frac{1}{1+r}s'(\lambda)B}{C_1}}_{MB \text{ lower spread}}$$

# Adaptation with Sovereign Risk

The optimal choice of adaptation trades off benefits and costs

- Counterfactual: no default option  $\rightarrow MC = MB$  damage reduction
- Now, additional effect through the spread

FOC( $\lambda$ ):

$$\underbrace{\frac{1}{C_1}}_{MC} = \underbrace{\beta \mathbb{E} \left( \frac{y'_2(\lambda)}{C_R} - s(\lambda) \frac{y'_2(\lambda)B}{y_2 C_R} \right)}_{MB \text{ damage reduction}} + \underbrace{\beta \mathbb{E} (s'(\lambda)(u(c_D) - u(c_R)))}_{MB \text{ reduced default prob}} - \underbrace{\frac{\frac{1}{1+r}s'(\lambda)B}{C_1}}_{MB \text{ lower spread}}$$

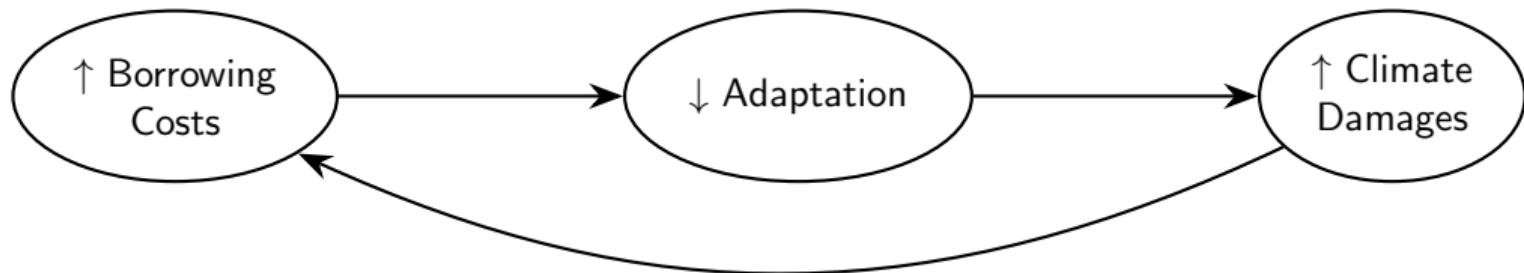
$\lambda^* \gtrless \lambda_c^*$  depends on the relative strength of these channels

For emerging markets:  $\lambda^* < \lambda_c^*$

► numerical

► intensive

## Adaptation Trap



# Roadmap

## 1. Simple Model

- Analytical Results: spreads, climate change, and adaptation

## 2. Data

- A new measure of adaptation
- Validating the model

## 3. Quantitative Model

- Calibration using adaptation measure
- Quantitative Results: the adaptation trap
- Debt Relief Counterfactuals

## Measuring Adaptation

No data on aggregate adaptation across countries

Macro literature: **latent variable approach**. Infer adaptation if (conditional on disaster size):

- High hazard exposure → lower damages
- Or, damages falling over time

# Measuring Adaptation

No data on aggregate adaptation across countries

Macro literature: **latent variable approach**. Infer adaptation if (conditional on disaster size):

- High hazard exposure → lower damages
- Or, damages falling over time

Adaptation is inferred, not observed

- Don't know what actions are taking place
- Panel variation and low power → can't compare across countries

Here: **direct measure** utilising data from government budgets

- Rich source of information on **spending by purpose**
- Generate a **dollar amount** spent

## Measuring Adaptation: Keyword Discovery

# Measuring Adaptation: Keyword Discovery

Approach: transfer learning

1. Supply list of **initial keywords** unambiguously describing adaptation 

# Measuring Adaptation: Keyword Discovery

Approach: transfer learning

1. Supply list of **initial keywords** unambiguously describing adaptation 
2. Build auxiliary corpus of adaptation related text 

# Measuring Adaptation: Keyword Discovery

Approach: transfer learning

1. Supply list of **initial keywords** unambiguously describing adaptation  [keywords](#)
2. Build auxiliary corpus of adaptation related text  [sources](#)
3. Construct **word embeddings** in that corpus  [word embeddings](#)

# Measuring Adaptation: Keyword Discovery

Approach: transfer learning

1. Supply list of **initial keywords** unambiguously describing adaptation [▶ keywords](#)
2. Build auxiliary corpus of adaptation related text [▶ sources](#)
3. Construct **word embeddings** in that corpus [▶ word embeddings](#)
4. Identify terms with high semantic similarity to at least one of the initial keywords [▶ example](#)

# Measuring Adaptation: Keyword Discovery

Approach: transfer learning

1. Supply list of **initial keywords** unambiguously describing adaptation [▶ keywords](#)
2. Build auxiliary corpus of adaptation related text [▶ sources](#)
3. Construct **word embeddings** in that corpus [▶ word embeddings](#)
4. Identify terms with high semantic similarity to at least one of the initial keywords [▶ example](#)
5. Search for instances of the final set of keywords in budgets and record monetary value

# Measuring Adaptation: Keyword Discovery

Approach: transfer learning

1. Supply list of **initial keywords** unambiguously describing adaptation ▶ keywords
2. Build auxiliary corpus of adaptation related text ▶ sources
3. Construct **word embeddings** in that corpus ▶ word embeddings
4. Identify terms with high semantic similarity to at least one of the initial keywords ▶ example
5. Search for instances of the final set of keywords in budgets and record monetary value

Sample: Rated economies in Latin America and the Caribbean with

- English or Spanish budgets
- Machine readable budgets

▶ sample

## Measuring Adaptation

Spend on average **0.31%** (1.1%) of GDP (Total expenditure) on adaptation.

	N	Mean	St. Dev.	Min	Max
Adaptation Total / GDP	163	0.31%	0.0031	0.001	0.0187
Adaptation Total / Expenditure	163	1.1%	0.0100	0.0038	0.0538

Table: Panel of 19 Latin American and Caribbean countries 2014-2025.

# Measuring Adaptation

Spend on average **0.31%** (1.1%) of GDP (Total expenditure) on adaptation.

	N	Mean	St. Dev.	Min	Max
Adaptation Total / GDP	163	0.31%	0.0031	0.001	0.0187
Adaptation Total / Expenditure	163	1.1%	0.0100	0.0038	0.0538

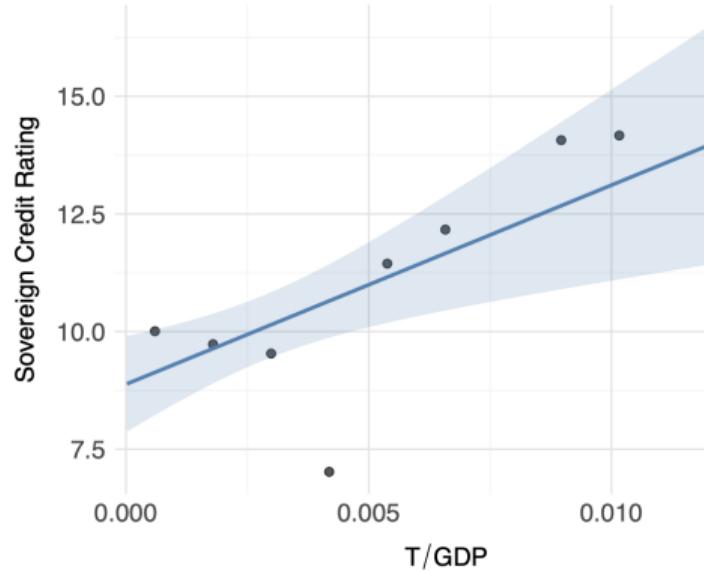
Table: Panel of 19 Latin American and Caribbean countries 2014-2025.

Adaptation Expenditure is:

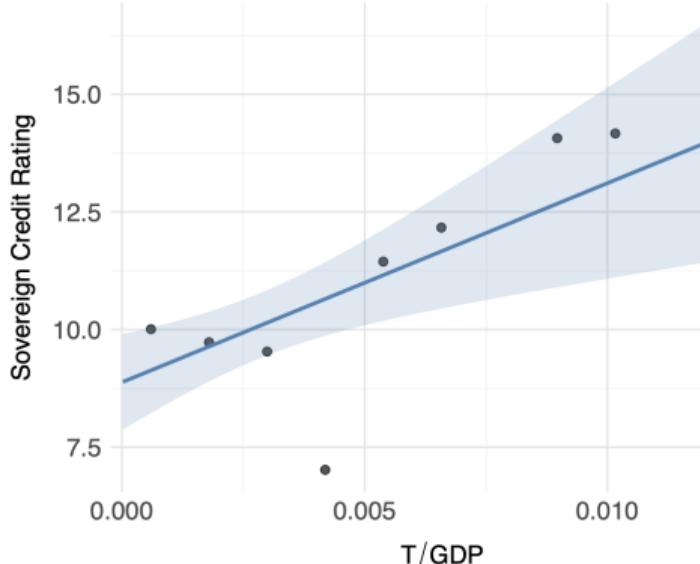
1. Increasing in disaster exposure  [exposure](#)
2. Trending upwards over time  [trend](#)

Possible to disaggregate measure by action  [disaggregate](#)  [line items](#)

## Adaptation Expenditure is Increasing in Rating



# Adaptation Expenditure is Increasing in Rating



▶ data

▶ robustness

	adapt	
sovrate	67,554,921*** (16,647,312)	30,901,342*** (8,924,107)
gdp	0.0022*** (0.0002)	0.0071*** (0.0017)
exposure	143,757,032** (62,519,154)	
government effectiveness	121,350,937** (48,299,257)	
Country Fixed Effects	No	Yes
Year Fixed Effects	Yes	Yes
Observations	98	151
R-squared	0.95	0.97

Note:

\* p<0.1; \*\* p<0.05; \*\*\* p<0.01

# Cyclones and Sovereign Risk

Data:

- International Best Track Archive: hurricane location at 6-hourly intervals
- Map to country units:
- $D_{it} = 1$  if country  $i$  experiences at least category 1 hurricane in month (year)  $t$
- Credit Default Swap spreads (36 countries)
- Default indicators (80 countries)

# Cyclones and Sovereign Risk

Data:

- International Best Track Archive: hurricane location at 6-hourly intervals
- Map to country units:
- $D_{it} = 1$  if country  $i$  experiences at least category 1 hurricane in month (year)  $t$
- Credit Default Swap spreads (36 countries)
- Default indicators (80 countries)

$$y_{i,t+h} - y_{i,t-1} = \alpha_i + \alpha_t + \beta_h D_{i,t} + \epsilon_{i,t+h}$$

# Cyclones and Sovereign Risk

Data:

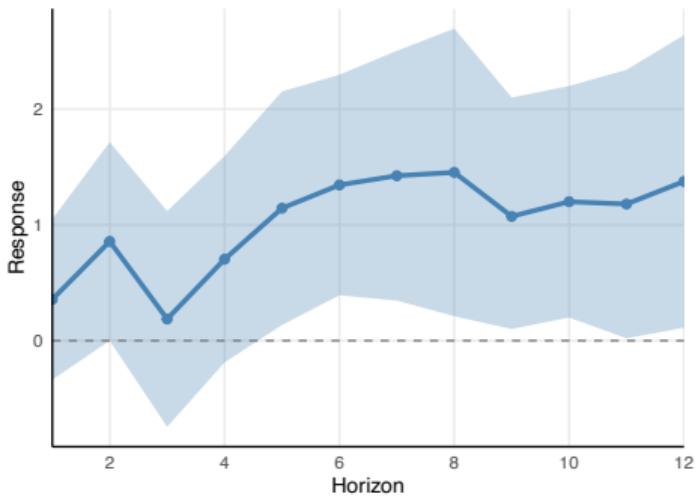
- International Best Track Archive: hurricane location at 6-hourly intervals
- Map to country units:
- $D_{it} = 1$  if country  $i$  experiences at least category 1 hurricane in month (year)  $t$
- Credit Default Swap spreads (36 countries)
- Default indicators (80 countries)

$$y_{i,t+h} - y_{i,t-1} = \alpha_i + \alpha_t + \beta_h D_{i,t} + \epsilon_{i,t+h}$$

Contribution:

- Physical disaster data rather than EMDAT (selection bias)
- Combine with adaptation data

## Cyclones cause sovereign risk to increase ...



**Figure:** Impulse Response Function of CDS spreads to a cyclone shock over a horizon of twelve months. 90% confidence bands are shaded in blue.

▶ default

▶ grade

... mostly for low adaptation economies

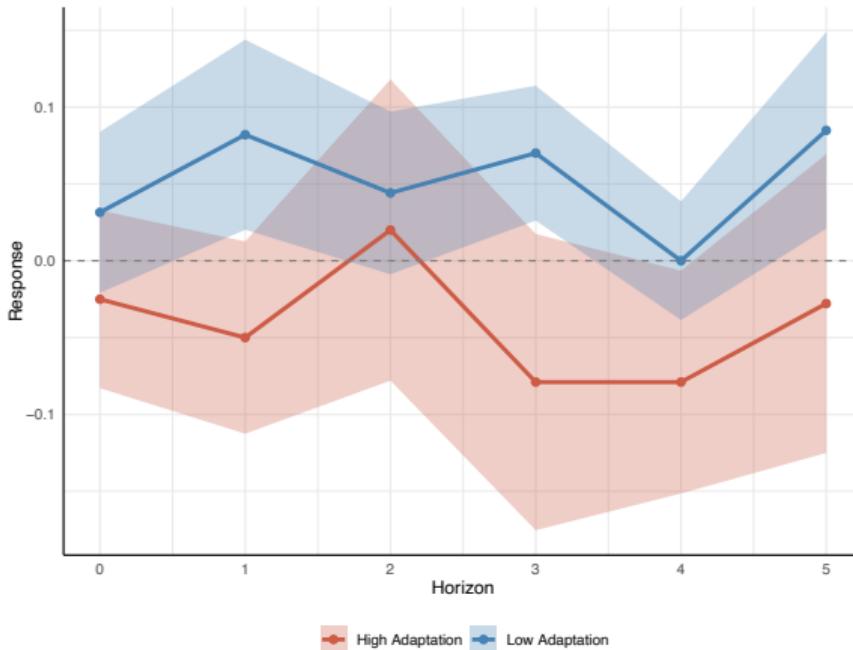


Figure: IRF of Sovereign Crisis dummy to a cyclone shock. 90% confidence bands are shaded.

## Taking Stock

1. Governments invest in adaptation
2. The level of adaptation is increasing in exposure
3. The level of adaptation is declining in sovereign risk
4. Cyclones increase sovereign risk, attenuated by adaptation

## Taking Stock

1. Governments invest in adaptation
2. The level of adaptation is increasing in exposure
3. The level of adaptation is declining in sovereign risk
4. Cyclones increase sovereign risk, attenuated by adaptation

How quantitatively important is this sovereign risk - adaptation channel?

- What does it mean for the welfare effects of disasters? and climate change?
- Could debt relief help?

## Taking Stock

1. Governments invest in adaptation
2. The level of adaptation is increasing in exposure
3. The level of adaptation is declining in sovereign risk
4. Cyclones increase sovereign risk, attenuated by adaptation

How quantitatively important is this sovereign risk - adaptation channel?

- What does it mean for the welfare effects of disasters? and climate change?
- Could debt relief help?

Infinite horizon extension of model

- Long term debt, adaptation capital

## Quantitative Model

Law of motion for adaptation:

$$\Lambda_t = (1 - \delta)\Lambda_{t-1} + \lambda_{t-1}$$

## Quantitative Model

Law of motion for adaptation:

$$\Lambda_t = (1 - \delta)\Lambda_{t-1} + \lambda_{t-1}$$

Bond issued at  $t$  promises an infinite stream of coupons, which decreases at a constant rate  $\psi$

Resource constraint:

$$C_t = \begin{cases} y_t + q_t(b_{t+1} - (1 - \psi)b_t) - b_t - \lambda_t & \text{if } D_t = 0 \\ y_t - \phi(y_t) - \lambda_t & \text{if } D_t = 1 \end{cases}$$

Regain access w.p.  $\eta$ .

## Quantitative Model

Law of motion for adaptation:

$$\Lambda_t = (1 - \delta)\Lambda_{t-1} + \lambda_{t-1}$$

Bond issued at  $t$  promises an infinite stream of coupons, which decreases at a constant rate  $\psi$

Resource constraint:

$$C_t = \begin{cases} y_t + q_t(b_{t+1} - (1 - \psi)b_t) - b_t - \lambda_t & \text{if } D_t = 0 \\ y_t - \phi(y_t) - \lambda_t & \text{if } D_t = 1 \end{cases}$$

Regain access w.p.  $\eta$ .

Bond price:

$$q_t = \frac{1}{1+r} \mathbb{E} ((1 - D_{t+1}) + (1 - \psi)(1 - D_{t+1}q_{t+1}))$$

## Functional Forms

Quadratic costs of default:

$$\phi(y) = \max \{-d_0 y + d_1 y^2, 0\}$$

CRRA utility:

$$U(c) = \frac{c^{1-\gamma}}{1-\gamma}$$

Adaptation benefits:

$$F(\Lambda_t) = \exp \left( -\alpha \Lambda_t^{1/\alpha} \right)$$

## Functional Forms

Quadratic costs of default:

$$\phi(y) = \max \{-d_0 y + d_1 y^2, 0\}$$

CRRA utility:

$$U(c) = \frac{c^{1-\gamma}}{1-\gamma}$$

Adaptation benefits:

$$F(\Lambda_t) = \exp \left( -\alpha \Lambda_t^{1/\alpha} \right)$$

Solution issues with sovereign default models + additional endogenous state

- Augment with extreme value taste shocks [▶ solution](#)

## Calibration Strategy: Population Weighted Caribbean

1. Standard parameters:  $\eta$ ,  $\gamma$ ,  $\delta$

## Calibration Strategy: Population Weighted Caribbean

1. Standard parameters:  $\eta, \gamma, \delta$
2. Calibrated externally from data:  $r, \psi, p, \rho, \mu_\epsilon, \sigma_\epsilon, \sigma_d$

- Estimate:

$$\log(y_t) = \rho \log(y_{t-1}) - \xi x_t + \varepsilon_t$$

- Model counterpart:

$$\xi_t = F(\Lambda_t)d_t$$

# Calibration Strategy: Population Weighted Caribbean

1. Standard parameters:  $\eta, \gamma, \delta$
2. Calibrated externally from data:  $r, \psi, p, \rho, \mu_\epsilon, \sigma_\epsilon, \sigma_d$

- Estimate:

$$\log(y_t) = \rho \log(y_{t-1}) - \xi x_t + \varepsilon_t$$

- Model counterpart:

$$\xi_t = F(\Lambda_t)d_t$$

3. Jointly calibrated to target moments:

- $\mu_d$ : mean GDP loss from disaster,  $\xi$
- $\alpha$ : adaptation investment to GDP ratio
- $\beta$ : debt to GDP ratio
- $d_0$ : mean spread
- $d_1$ : std dev spread

▶ calibration

# Model Performance

	Model	Data
<hr/>		
<i>Targeted</i>		
Adaptation Investment/GDP	0.003	0.003
Debt/GDP	0.401	0.414
GDP loss   Cyclone	0.052	0.050
Mean Spread	502	526
Std. dev Spread	352	374
<i>Untargeted</i>		
Default Frequency	0.048	0.051
Median Spread	121	143
Spread Increase   Cyclone	0.015	0.01
Adaptation Capital/GDP	0.029	
Percent Damages Avoided	0.45	
Market Value Debt/GDP	0.37	
<i>Welfare Loss</i>		
	5.1%	

---

## Sovereign Risk Restricts Adaptation

Simulated Moments: Caribbean		
Moment	Model	No Default Counterfactual
Adaptation Investment/GDP	0.003	+13%
GDP loss per Hurricane	0.05	-10%
Welfare loss from Hurricanes	5.1%	4.62%

- GDP loss from a hurricane is 10% larger due to the sovereign risk- adaptation channel
- This gap increases to 13% with a projected increase in frequency and severity by end of century
  - 29.1% increase in  $p$ , 48.5% increase in  $\mu_d$

## Sovereign Risk Restricts Adaptation

Split sample: high and low sovereign risk

- Re-calibrate debt parameters:  $\beta, d_0, d_1$
- Keep climate and adaptation parameters

# Sovereign Risk Restricts Adaptation

Split sample: high and low sovereign risk

- Re-calibrate debt parameters:  $\beta, d_0, d_1$
- Keep climate and adaptation parameters

	Low Risk		High Risk	
	Model	Data	Model	Data
Adaptation Investment/GDP	0.38%	0.39%	0.29%	0.27%
Debt/GDP	0.49	0.51	0.37	0.38
Mean Spread	460	442	573	559

Model accounts for differences in adaptation expenditure across economies with differing sovereign risk.

## Policy Counterfactual: Interest Free Loan

IMF Resilience and Sustainability Trust:

- New lending facility established 2022
- Long term funding for climate preparedness

## Policy Counterfactual: Interest Free Loan

IMF Resilience and Sustainability Trust:

- New lending facility established 2022
- Long term funding for climate preparedness

Consider loan 10% of pre-loan output, 3 year grace period

- Default free due to seniority → at risk free rate

$$\tilde{F} = r(1+r)^g F$$

## Policy Counterfactual: Interest Free Loan

Simulated Moments: Caribbean			
Moment	Baseline	No Default	Loan Counterfactual
Adaptation Investment/GDP	0.003	+13%	+5%
GDP loss per Hurricane	0.05	-10%	-4%
Welfare loss from Hurricanes	5.1%	4.62%	4.87%

## Policy Counterfactual: Adaptation Bond

Increase in prevalence of 'green bonds'

- Mostly corporate, and 'use of proceeds'
- Now some mitigation outcome-linked bonds e.g. Chile

## Policy Counterfactual: Adaptation Bond

Increase in prevalence of 'green bonds'

- Mostly corporate, and 'use of proceeds'
- Now some mitigation outcome-linked bonds e.g. Chile

Here consider an 'Adaptation Bond'

- $c\%$  coupon reduction if adaptation capital 5% larger

$$q_t^{AB} = \frac{1}{1+r} \mathbb{E} \left( (1 - D_{t+1})(1 - c \mathbb{1}_{A_{t+1} > A^*}) + (1 - D_{t+1})(1 - \psi) q_{t+1}^{AB} \right).$$

## Policy Counterfactual: Adaptation Bond

Two countervailing effects on  $s$ :

1.  $\downarrow$  Default risk  $\rightarrow s \downarrow$
2. State contingency  $\rightarrow$  lenders require a premium

Spread minimizing  $c = 2.2\%$

## Policy Counterfactual: Adaptation Bond

Two countervailing effects on  $s$ :

1.  $\downarrow$  Default risk  $\rightarrow s \downarrow$
2. State contingency  $\rightarrow$  lenders require a premium

Spread minimizing  $c = 2.2\%$

Simulated Moments: Caribbean				
Moment	Baseline	No Default	Bond	Counterfactual
Adaptation Investment/GDP	0.003	+13%		+10%
GDP loss per Hurricane	0.05	-10%		-8%
Welfare loss from Hurricanes	5.1%	4.62%		4.70%

# Conclusion

Sovereign Risk restricts adaptation and increases the costs of disasters

- **Theory:** Framework integrating sovereign risk, climate risk, and adaptation
  - Adaptation Trap
- **Data:** New dataset of adaptation expenditures
  - Robust negative correlation between sovereign risk and adaptation
  - Adaptation attenuates sovereign risk effects of disasters
- **Quantitative:** Quantitative model matches Caribbean data
  - Hurricanes have a 10% larger effect through restricted adaptation
  - This wedge grows with climate change
  - Debt relief can help: adaptation bond, interest free loan

## Proofs: Proposition 1

$$\frac{\partial s}{\partial p} = -\Phi_g(\bar{g}) + \int \Phi_g\left(\bar{g} - \frac{1}{1+\psi} \ln(1 - d(F(\lambda)))\right) d\Phi_d(d')$$

- Support of  $\Phi_d$  is  $[0, 1]$ .
- Therefore  $\frac{\partial s}{\partial p} > -\Phi_g(\bar{g}) + \int \Phi_g(\bar{g}) d\Phi_d(d') = 0$

Suppose  $\hat{\Phi}_d$  first-order stochastic dominates  $\Phi_d$ .

- Let  $\hat{s}$  denote the spread function associated with the damage distribution  $\hat{\Phi}_d$ .
- Since  $\Phi_g\left(\bar{g} - \frac{1}{1+\psi} \ln(1 - d(F(\lambda)))\right)$  is increasing in  $d'$ , it follows that

$$E\left[\Phi_g\left(\bar{g} - \frac{1}{1+\psi} \ln(1 - d(F(\lambda)))\right) \middle| \hat{\Phi}_d\right] \geq E\left[\Phi_g\left(\bar{g} - \frac{1}{1+\psi} \ln(1 - d(F(\lambda)))\right) \middle| \Phi_d\right].$$

## Proof: Proposition 2

$$\frac{\partial s}{\partial \lambda} = p E_{d'} \left[ \phi_g \left( \bar{g} - \frac{1}{1+\psi} \ln(1 - d(F(\lambda))) \right) \cdot \frac{d \cdot F'(\lambda)}{(1+\psi)(1-d \cdot F(\lambda))} \right] < 0$$

- first term inside the square brackets is positive
- Second is negative given the assumption on the domain of  $d$  and  $F(\lambda)$  is decreasing in  $\lambda$

▶ back

## Adaptation Trap

	$p = 0.1, \alpha = 2$	$p = 0.1, \alpha = 1.1$	$p = 0.5, \alpha = 2$	$p = 0.5, \alpha = 1.1$
$\bar{I}$ min	NA	0.91	NA	0.87
implied $s$ (bps)	NA	21	NA	28

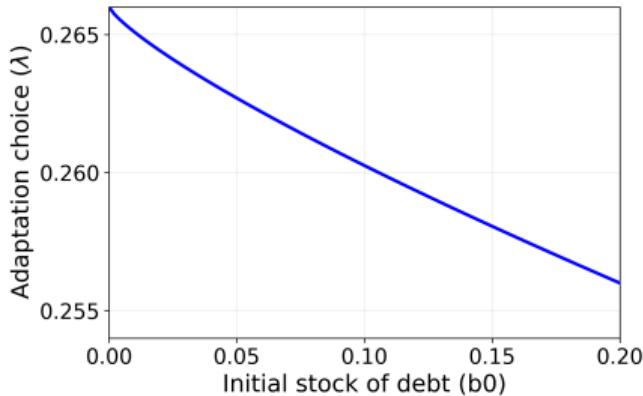
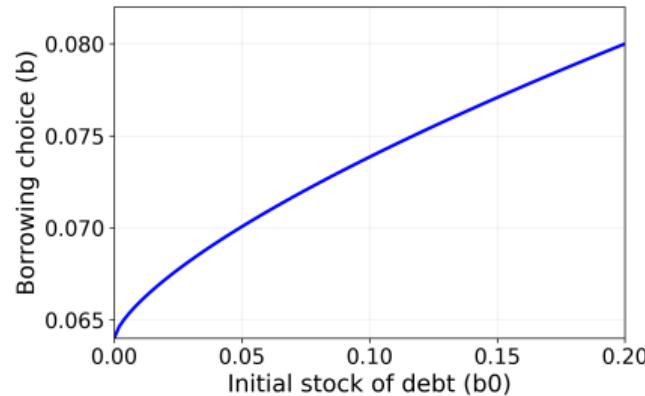
**Table:** The table shows the minimum value for default costs that imply that adaptation is higher under default risk than without for a set of combinations of the probability of a disaster and adaptation effectiveness.

$$F(\lambda) = \exp\left(-\alpha\lambda^{1/\alpha}\right).$$

▶ back

# Sovereign Risk and Adaptation

**Borrowing and Adaptation given initial debt**



▶ back

## Initial Keywords

- adaptation
- climate\_adaptation
- coastal\_protection
- seawall
- shoreline\_management
- coral\_reef\_restoration
- stormwater\_management
- mangrove\_plantation
- coastal\_management
- urban\_green\_area
- air\_conditioning\_system
- shading
- drainage
- flood\_insurance
- agricultural\_insurance
- irrigation
- water\_management
- natural\_disaster\_management
- national\_disaster\_management
- drought\_management
- flood\_management
- hazard\_mapping
- cyclone\_shelter
- storm\_management
- wastewater\_management
- managed\_retreat
- ecosystem\_restoration
- watershed\_management
- wetlands\_management

## Adaptation Text: Sources

Adaptation specific text comes from a number of sources:

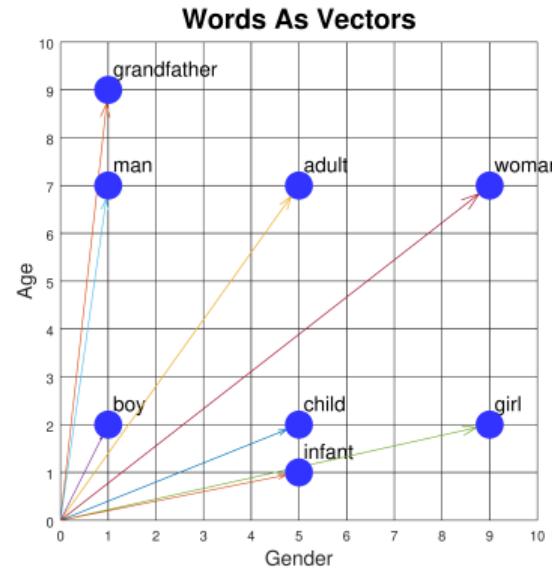
- Adaptation sections of Nationally Determined Contributions, as submitted to the UN
- National Adaptation Plans, as submitted to the UN
- UNEP Adaptation Gap Reports
- UNFCCC Adaptation related reports
- Adaptation Communications, as submitted to the UN
- Country Climate and Development Reports, from the World Bank
- Reports from the Global Commission on Climate Adaptation
- Adaptation specific reports from the World Bank and Asian Development Bank

▶ back

# Word Embeddings

Word embedding: real-valued vector representation of a word

- Words closer in the vector space are expected to be similar in meaning
- Use GloVe model from Stanford NLP group trained on my adaptation corpus



# Word Embeddings

Map co-occurrences of words into a meaningful space

Context of a term  $w_{d,n}$  in a vocabulary  $V$ :

$$C(w_{d,n}) = (w_{d,n-L}, \dots, w_{d,n-1}, w_{d,n+1}, w_{d,n+L}).$$

Co-occurrences are defined by a  $V \times V$  matrix

- Entry  $W_{i,j}$  is the number of times that term  $i$  appears within the context of  $j$ , and vice versa.
- Standard:  $L = 10$ ,  $K = 200$ .

Each term is associated with a vector  $\rho_v$  in  $\mathbb{R}^K$ , chosen to solve:

$$\min_{\rho_v} \sum_{i,j} f(W_{i,j}) (\rho_i^T \rho_j - \log(W_{i,j}))^2$$

$f(\cdot)$  is a non-negative, increasing, and concave weighting function.

# Keyword Discovery

<i>Initial Term: sea wall</i>	
<b>Output Term</b>	<b>Cosine Similarity</b>
sea defense	0.89
groyne	0.86
tidal barrier	0.81
dune restor	0.79
waterfront protec	0.78
gullies	0.72
breakwater	0.71

▶ back

## Sample

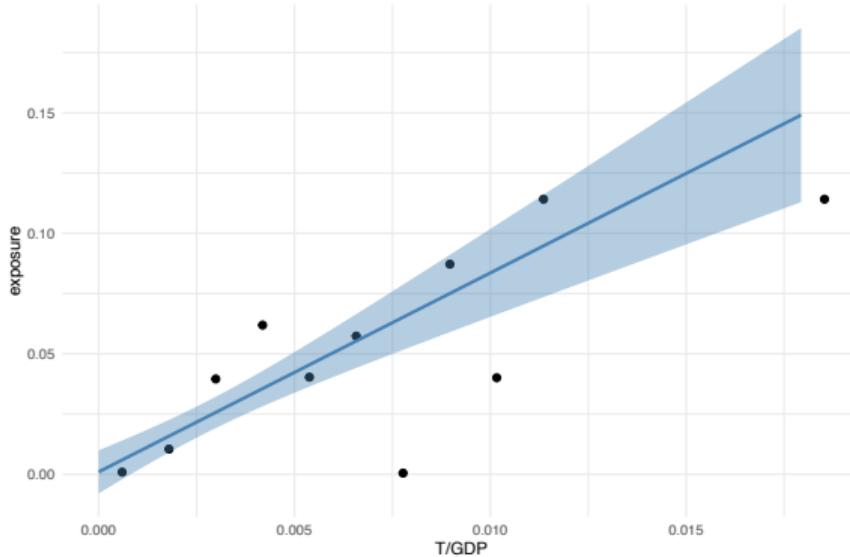
- Latin America: 18 sovereigns. Caribbean: 13 sovereigns
- Lose 2 due to language
  - Haiti, Brazil
- Lose 3 due to lack of rating
  - Saint Lucia, Antigua + Barbuda, Dominica
- Lose 7 due to lack of machine readability
  - Trinidad and Tobago, Cuba, Bolivia, El Salvador, Nicaragua, Paraguay, Venezuela
- Lose 74 country-year observations due to lack of availability

Final sample: Unbalanced panel of 19 economies 2014-2025

- 163 country-year observations

▶ back

# Exposure



▶ back

# Exposure

<i>Dependent variable:</i>				
	T/GDP			
Windspeed	0.033*** (0.005)			
Natural		0.0002** (0.0001)		
Tropical Cyclone			0.0001 (0.0001)	
Drought				0.0002** (0.0001)
Constant	0.002*** (0.0002)	0.001** (0.0005)	0.002*** (0.0004)	0.002*** (0.0003)
Observations	163	163	163	163
R <sup>2</sup>	0.270	0.040	0.006	0.041
Adjusted R <sup>2</sup>	0.265	0.031	0.003	0.032

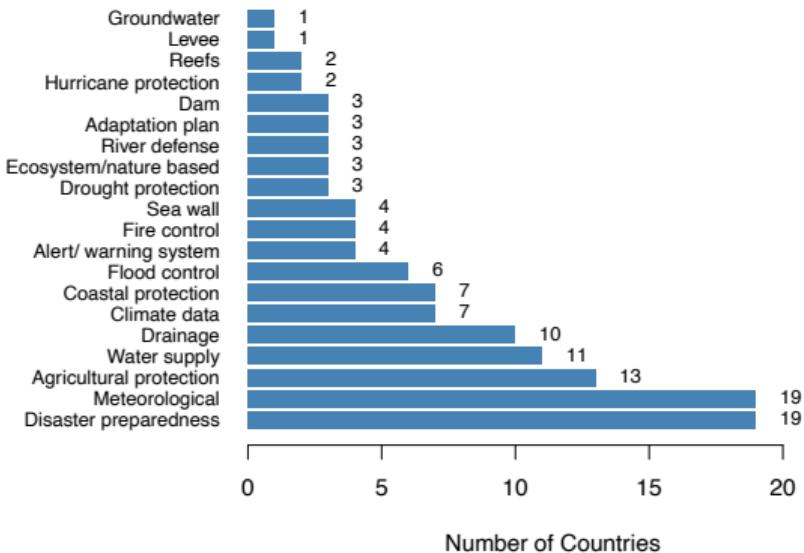
*Note:*

\* p<0.1; \*\* p<0.05; \*\*\* p<0.01

**Table:** Regression Results: Adaptation and Climate Hazards

# Adaptation Measure: Disaggregated

infrastructure development  
change adaptation  
regional disaster reduction project  
current expenditure flood mitigation  
flood control disaster preparedness  
adaptation fund adaptation data  
river defense risk data **climate change**  
prevention response **disaster risk** **sea defence**  
**natural disaster**  
**disaster prevention**  
**vulnerability reduction**  
climate resilience climate vulnerability  
coastal protection response management  
disaster vulnerability  
**national disaster**  
flood protection meteorological services



# Adaptation Measure: Map



■ heat related ■ storm/flood related ■ NA

■ heat related ■ storm/flood related ■ NA

## Line Items: Descriptive Statistics

	N	Mean	St. Dev.	Min	Max
Line Items (country x year)	163	17.7	23.3	3	126
Line Items (country average)	19	20.33	23.4	4.9	75.4

	N	Corr	p-value
(Line Items, T/GDP)	163	-0.0967	0.2489
(avg Line Items, avg T/GDP)	19	-0.131	0.589

▶ back

# Expenditure Comparisons

	Mean
Adaptation/GDP	0.31%
Agriculture/GDP	1.3%
Health/GDP	3.4%

Table: Source: ELAC

▶ back

## Official Debt: Share of Total

Country	Share of Official Debt (%)
Argentina	7
The Bahamas	3
Barbados	20
Chile	3
Colombia	14
Costa Rica	7
Dominican Republic	16
Ecuador	29
Guatemala	26
Jamaica	22
Mexico	4
Panama	25
Peru	8
Uruguay	7
Average	14

Table: Share of Official Debt in Total Public Debt (2018)

# Data

## 1. sovrate:

- Index from 0-21
- From World Bank

## 2. exposure:

- wind speed (maximum yearly), scaled by land area
- From GeoMet database (Felbermayr and Gröschl)

## 3. government effectiveness:

- World Bank Index
- captures “perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies.”
- Sources include: institutional effectiveness from the Economist Intelligence Unit, likelihood of infrastructure disruption, state failure or political instability from S&P Global, and quality of financial and revenue management.

▶ back

# Robustness

- Narrower measures of adaptation:
  - disaster preparedness ▶ dp
  - meteorological services ▶ m
- EMBI ▶ embi
- CDS ▶ cds
- Alternative exposure measures ▶ exposure
- Regulatory Quality ▶ rq
- Narrative evidence
- Validation with hand read budgets
- English and Spanish subsamples
- Drop 10% of sample
- Stricter word embedding cutoffs

▶ back

# Disaster Preparedness

<i>Disaster Preparedness</i>		
sovrate	304,152,674 (254,948,612)	132,705,006 (220,494,310)
gdp	0.0011*** (0.0004)	0.0051*** (0.0005)
exposure	124,464,182*** (12,284,012)	
government effectiveness	140,177,373** (65,775,964)	
Country Fixed Effects	No	Yes
Year Fixed Effects	Yes	Yes
Observations	98	105
R-squared	0.95	0.84

Notes: \* p < 0.10, \*\* p < 0.05, \*\*\* p < 0.01

Table: Regression Results: Disaster Preparedness and Sovereign Rating

# Meteorological

<i>Meteorological Services</i>		
sovrate	268,014,394*** (103,115,274)	786,490,187*** (81,603,371)
gdp	0.0061 (0.0040)	0.0010** (0.00046)
exposure	129,812,401** (64,190,146)	
government effectiveness	715,689,368*** (18,416,559)	
Country Fixed Effects	No	Yes
Year Fixed Effects	Yes	Yes
Observations	98	105
R-squared	0.95	0.84

Notes: \* p < 0.10, \*\* p < 0.05, \*\*\* p < 0.01

Table: Regression Results: Meteorological Services Expenditure and Sovereign Rating

<i>Adaptation Expenditure</i>		
EMBI	–16,641,818*	–1,725,994
	(1,773,254)	(1,510,511)
gdp	0.001 *** (0.0003)	0.001 *** (0.0003)
exposure	109,104,732* (40,190,146)	
government effectiveness	89,042,884 (80,729,185)	
Country Fixed Effects	No	Yes
Year Fixed Effects	Yes	Yes
Observations	76	76
R-squared	0.761	0.758

Notes: \* p < 0.10, \*\* p < 0.05, \*\*\* p < 0.01

**Table:** Regression Results. EMBI spreads and adaptation services expenditure.

<i>Adaptation Expenditure</i>		
CDS Spread	-21,355,235*	-21,412,531*
	(11,963,353)	(11,920,214)
gdp	0.001*** (0.0002)	0.001*** (0.0002)
exposure	97,521,463*** (14,003,729)	
government effectiveness	104,240,907 (96,738,648)	
Country Fixed Effects	No	Yes
Year Fixed Effects	Yes	Yes
Observations	71	71
R-squared	0.612	0.646

Notes: \* p < 0.10, \*\* p < 0.05, \*\*\* p < 0.01

Table: Regression Results. CDS spreads and adaptation services expenditure.

# Regulatory Quality

adapt		
sovrate	198,917,071 *** (76,413,625)	52,498,372 *** (11,142,294)
gdp	0.001 *** (0.0001)	0.0054 *** (0.0011)
exposure	164,980,764 ** (82,519,154)	
regulatory quality	19,071,555 (54,779,990)	
Country Fixed Effects	No	Yes
Year Fixed Effects	Yes	Yes
Observations	98	105
R-squared	0.95	0.84

Note:

\* p<0.1; \*\* p<0.05; \*\*\* p<0.01

## Exposure

	adapt			
sovrate	67,554,921*** (16,647,312)	41,286,883*** (9,241,031)	38,411,248*** (14,524,916)	44,220,882*** (11,551,834)
gdp	0.0022*** (0.0002)	0.001 *** (0.0001)	0.001 *** (0.0001)	0.001 *** (0.0001)
windspeed	143,757,032** (62,519,154)			
natural		81,436,087* (44,013,869)		
cyclone			37,428,812 (45,306,999)	
drought				27,727,914 (43,063,322)
government	121,350,937**	21,131,829	50,668,145	42,115,495

## Model

$$y_t = y_{t-1}^\rho (1 - \textcolor{teal}{x_t} \textcolor{blue}{d_t} (1 - \Lambda_t)) \epsilon_t$$

Law of motion for adaptation:

$$\Lambda_t = (1 - \delta) \Lambda_{t-1} + \lambda_{t-1},$$

## Model

$$y_t = y_{t-1}^\rho (1 - \textcolor{teal}{x_t} \ d_t (1 - \Lambda_t)) \epsilon_t$$

Law of motion for adaptation:

$$\Lambda_t = (1 - \delta) \Lambda_{t-1} + \lambda_{t-1},$$

Bond issued at  $t$  promises an infinite stream of coupons, which decreases at a constant rate  $\psi$ .

Resource constraint:

$$C_t = \begin{cases} y_t + q_t(b_{t+1} - (1 - \psi)b_t) - b_t - f(\lambda_t) & \text{if } D_t = 0 \\ \phi(y_t)y_t - f(\lambda_t) & \text{if } D_t = 1, \end{cases}$$

where  $\phi(y_t)$  is the endowment cost of default. Regain access w.p.  $\eta$ . Bond price:

$$q_t = \frac{1}{1+r} \mathbb{E} ((1 - D_{t+1}) + (1 - \psi)(1 - D_{t+1}q_{t+1})).$$

► recursive equilibrium

► back

## Recursive Equilibrium

Restrict attention to Markov Perfect Equilibria.

Equilibrium defined by:

- 1) a set of value functions for the representative household: total value  $V$ , the value with market access  $V_{nd}$ , and the value in default  $V_d$ :

$$V = \max_D \{(1 - D)V_{nd} + DV_d\}, \quad (1)$$

$$V_{nd}(y, b, \Lambda) = \max_{b', \Lambda'} u(c) + \beta \mathbb{E}[V(y', b', \Lambda')], \quad (2)$$

$$V_d(y, 0, \Lambda) = \max_{\Lambda'} u(c) + \beta \mathbb{E}[(1 - \eta)V_d(y', 0, \Lambda') + \eta V(y', b', \Lambda')], \quad (3)$$

- 2) government policies for default  $D$ , bond issuance  $b$ , and adaptation  $\Lambda$ , and
- 3) a government debt price function  $q$  such that:

- the debt price function is consistent with optimization by foreign lenders,
- the value functions and the policy functions solve the maximization problem,
- and the resource constraint of the household is satisfied.

# Solution Algorithm

Discretize output, debt, adaptation.

Iterative algorithm:

1. Initial guesses for the unconditional debt price function and for the value functions
2. Update the value function  $V_{nd}$  by solving the maximization problem in the market access case
  - Each possible choice associated with an additive taste shock.
  - Sovereign chooses  $b'$  conditional on a particular  $\Lambda'$ , and that  $\Lambda'$  is chosen for a fixed  $b'$ .
  - Probability of choosing a given discrete value is given by the multinomial logit formula.
3. Update the value function  $V$  by solving the discrete choice default problem.
  - Introduce extreme value shocks to the default problem.
4. Update the default value function  $V_d$  making use of the update values of  $V$  and  $V_{nd}$ .
5. Repeat (2-4) until value functions have converged.
6. Update the unconditional debt price function by imposing the default policy and the average equilibrium price function.
7. Repeat (2-6) until convergence of the unconditional debt price function.

▶ back

# Calibration

Parameter	Value	Source/Target statistic
<i>Parameters set Externally:</i>		
Relative risk aversion	$\gamma$	2 Standard
Readmission probability	$\eta$	0.33 Richmond + Dias
Depreciation	$\delta$	0.1 Standard
<i>Parameters Estimated Externally:</i>		
Risk free rate	$r$	0.0451 US T-Bill
Duration	$\psi$	0.0564 Average Maturity
Hurricane Frequency	$p$	0.103 NOAA
Endowment autocorr	$\rho$	0.95 Data
Endowment st dev	$\sigma_\epsilon$	0.021 Data
Disaster st dev	$\sigma_d$	0.031 Data
<i>Parameters Set Internally:</i>		
Discount factor	$\beta$	0.92 Debt/GDP
Default cost	$d_0$	0.621 Mean Spread
Default cost	$d_1$	0.978 Std. dev Spread
Hurricane intensity	$\mu_d$	0.096 Mean hurricane loss
Adaptation benefit	$\alpha$	2.496 Adaptation investment/ GDP

Table: Calibrated Parameters: Caribbean.

## Calibration: Jamaica

Calibrated Parameters: Jamaica			
Moment		Value	Source/Target statistic
Relative risk aversion	$\gamma$	2	Standard
Readmission probability	$\lambda$	0.33	Richmond and Dias (2009)
Depreciation	$\delta$	0.1	Standard
Risk free rate	$r^f$	0.0451	US T-Bill
Duration	$\psi$	0.0564	Average Maturity
Hurricane Frequency	$p$	0.103	NOAA
Endowment autocorr	$\rho$	0.96	Data
Endowment st dev	$\sigma_\epsilon$	0.026	Data
Discount factor	$\beta$	0.89	Debt/GDP
Output cost	$\kappa$	0.67	Mean Spread
Hurricane intensity	$\mu_d$	0.025	Mean hurricane loss
Adaptation cost	$\alpha$	2.1	Adaptation investment/ GDP

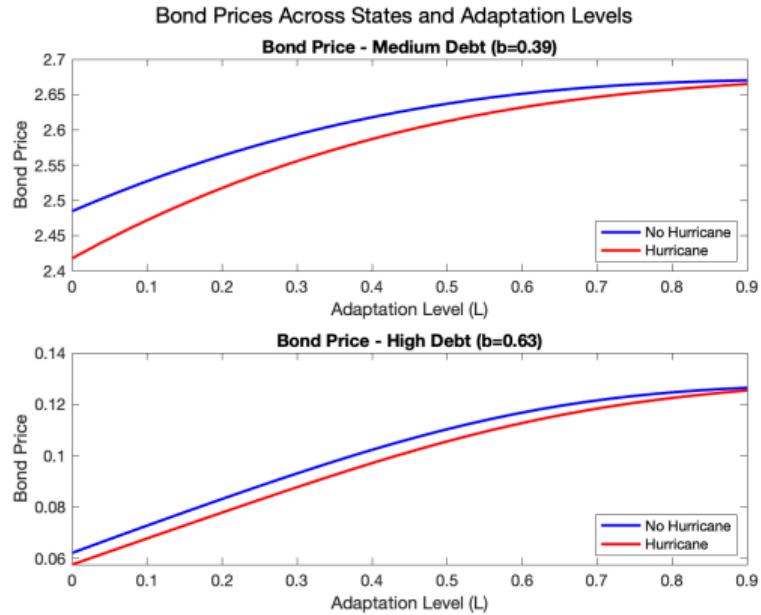
▶ back

# Model Performance

Quantitative Analysis: Simulated Moments		
Moment	Model	Data
Average Spread	554	519
Debt/GDP	0.50	0.49
Default frequency	0.048	0.051
GDP loss per Cyclone	0.023	0.023
Adaptation Investment/GDP	0.0044	0.0044

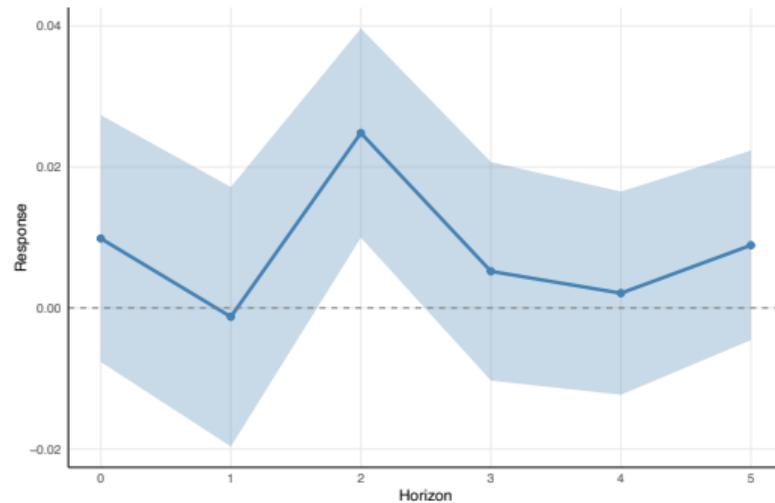
▶ back

# Bond Price



▶ back

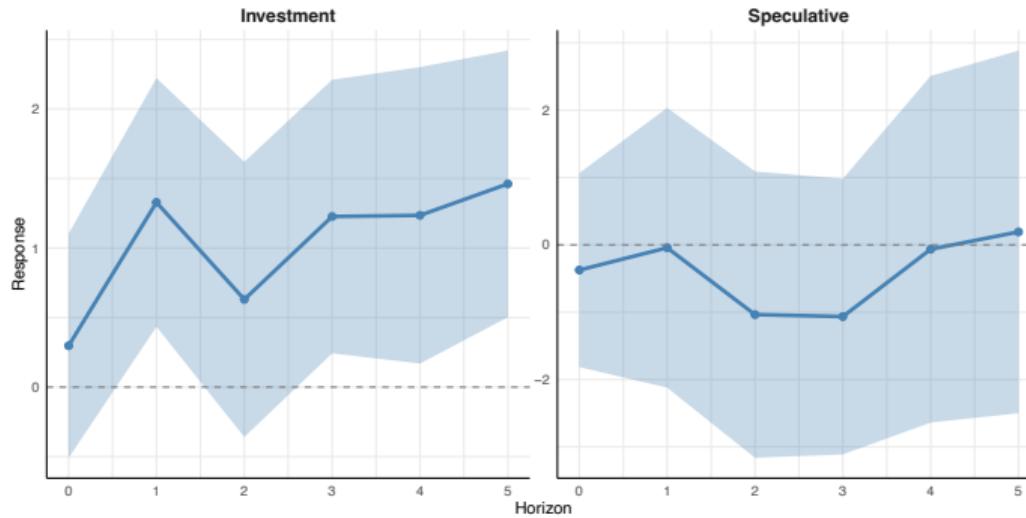
## Default Indicator



**Figure:** Impulse Response Function of Sovereign Crisis dummy to a cyclone shock over a horizon of six years.  
90% confidence bands are shaded in blue.

▶ back

## Split by Investment Grade



**Figure:** Cyclone shock on CDS spreads. Left panel restricted to only investment grade bonds. Right panel only speculative grade bonds.

▶ back