T20 Policy Brief

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Task Force 03

REFORMING THE INTERNATIONAL FINANCIAL ARCHITECTURE

Financing Resilient Prosperity in Small Island Developing States

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Abstract

Small Island Developing States (SIDS) are diverse, but all experience acute vulnerability. Many are still reeling from the global financial crisis (GFC) and Covid-19 pandemic, with sluggish growth, insupportable debt burdens and insufficient – even declining – access to stable sources of financing. As global temperatures breach the 1.5°C threshold in the Paris Agreement, accelerating climate change will hit them faster and harder than any other group of nations. SIDS comprise almost 20% of UN members, but – aside from those that are members of the African Union – have no collective or regional representation at the G20. Resolving these momentous challenges, in an increasingly perilous world, is vital.

This policy brief proposes four recommendations for improving access to concessional finance, financial resilience and debt sustainability in SIDS that the G20 is well-placed to support:

1. The G20 should increase SIDS representation by creating a 'G20-SIDS committee' tasked with enhancing access to concessional resources for this vulnerable group of countries, and lead the way in normalising the use of the UN Multidimensional Vulnerability Index (MVI) to supplement GNI per capita measures with consideration of structural vulnerability in their own development assistance programmes;
2. G20 states that are members of the Green Climate Fund (GCF) Board should seek to create a minimum annual funding allocation for SIDS, the most climate-vulnerable states; and
3. The aforementioned G20-SIDS committee should work with the Paris Club to propose new measures to build confidence in the Common Framework, and increase eligibility and uptake from SIDS to improve long-term debt sustainability and increased fiscal space for resilience investments.

Meaningful movement on any or all of these issues could unlock important secondary developmental gains and, crucially, help support SIDS to protect the global public goods of which they are custodians: ocean resources and biodiversity.

Keywords: climate change; climate finance; debt; ODA; SIDS; Caribbean; Pacific; Indian Ocean; coastal Africa

Diagnosis of the Issue

SIDS in the Caribbean, Pacific Ocean, Indian Ocean, and coastal Africa have a particular set of characteristics, including pronounced vulnerability that arises principally from their size, insularity and, in many cases, remoteness. Hence, their condition is defined by commonalities created by structural and climate challenges that call for context-specific solutions (Wilkinson et al., 2023). SIDS are also 'large ocean states', and important custodians of sizeable Exclusive Economic Zones (EEZs) and correspondingly high levels of biodiversity. They will need donor support to protect these critical global public goods (Bishop et al., 2023).

Because of their vulnerability, SIDS are recognised by the UN as a special category of countries.[1] They have been considered a 'special case for sustainable development' since the very first UN SIDS conference and the ensuring Barbados Programme of Action (UNGA, 1994), further enshrined in the Small Island Developing States Accelerated Modalities of Action ('SAMOA Pathway') (UNGA, 2014) and other multilateral agreements.[2] Some multilateral development banks (MDBs) have created a special category for SIDS or small states in recognition of this vulnerability, and they are

[1] Of the countries that belong to the group of least developed countries (based on three criteria: low income, weak human assets and high economic vulnerability), 33 are in Africa, 10 in Asia, 1 in the Caribbean and 5 in the Pacific.

[2] Under the UNFCCC in particular, SIDS and LDCs are recognised as being among the least responsible for climate change, and likely to suffer the most from its adverse effects. SIDS could in some cases even become uninhabitable. SIDS are represented by the Alliance of Small Islands States (AOSIS) in the climate change negotiations.

considered a ‘particularly vulnerable’ category by the GCF and other vertical climate funds. However, with few exceptions, access to concessional finance declines as SIDS achieve higher levels of income – as GNI per capital alone is the basis on which concessionality has historically been granted – so when they graduate from official development assistance (ODA) they are forced to borrow at market rates which generates very high debt levels (UNDESA, 2022).

Yet because of their open and small economies – and limited physical territory – their developmental progress is perpetually at risk of being set back suddenly and drastically. Although they are often ‘wealthier’ than the poorest developing countries in per capita GNI terms, SIDS experience particularly severe economic impacts from external shocks, notably extreme weather events (Panwar et al. 2023). These can be of a relative scale completely unthinkable in larger states – in 2017, Hurricane Maria caused damage worth a staggering 226% of GDP in Dominica – dramatically exacerbating indebtedness and related servicing costs (Slany, 2020; Fresnillo and Crotti, 2022). For SIDS, it is this sheer disproportionality that highlights the extent of their vulnerability.

SIDS are at a critical juncture due a combination of economic stagnation, geopolitical insecurity and climate change that will further compound indebtedness and force them to rely even more heavily on climate finance for adaptation and survival. Economic stagnation has been caused by the twin ‘once in a generation’ shocks of the GFC and pandemic that crippled their tourism-dependent economies. Geopolitical insecurity has increased due to the return of great power competition, especially in the Pacific, where tensions between China and the US and its allies have increased. Climate change threatens the very viability of many SIDS but especially those that are low-lying atoll states, making them high-risk investments (Bishop et al., forthcoming 2024).

These factors compound already high transaction costs created by their geographical remoteness, limited economies of scale, and the distances between islands in archipelagos, which makes building the necessary regional infrastructures to offset small size incredibly difficult everywhere, even in the Caribbean, where islands are reasonably close to each other (Bishop et al., 2021). The same is true in individual archipelago states—especially in the Pacific and Indian Ocean—where small populations are spread over vast ocean distances. They also severely limit investments in resilience for SIDS to make progress on the SDGs. This is further compounded by their explicit exclusion from multilateral institutions like the G20 and their implicit marginalisation within supposedly universal ones like the MDBs that still do not adequately serve them as clients with unique capacity constraints.

Recommendations

Addressing insupportable debt burdens through re-negotiation and cancellation, in specific circumstances, as well as improving access to concessional finance, are key to ensuring this highly vulnerable group of countries can take the lead in investing in resilience and sustaining development gains.

Research by ODI's Resilient and Sustainable Islands Initiative (RESI) finds that significantly less international development and climate finance intended to build resilience is being allocated to SIDS compared to LMICs and LDCs that are not SIDS, even as a percentage of GDP (Wilkinson et al., 2023) (Figure 1).

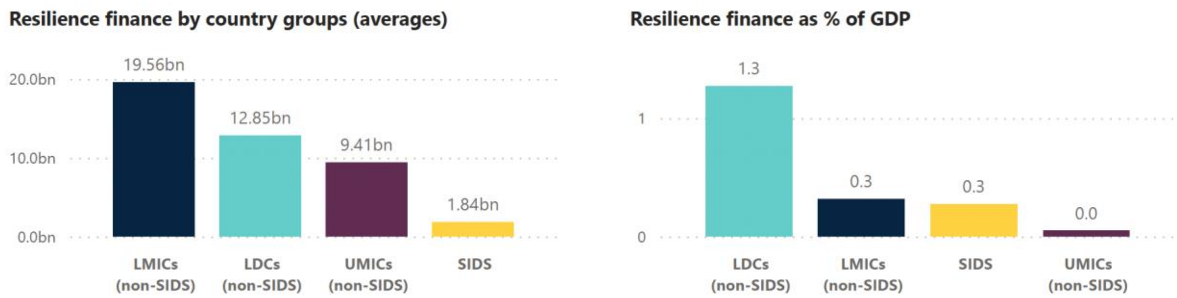

FIGURE 1. Resilience finance to SIDS (annual average from 2013–2021)

The situation is more striking when vulnerability is considered. On average, SIDS receive significantly less resilience finance than other countries in relation to their vulnerability, as measured by the UN MVI (Figure 2).

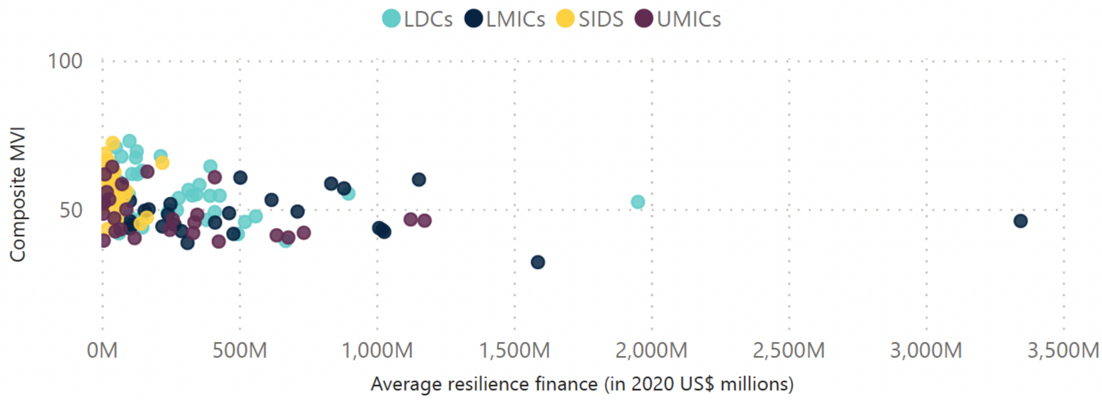

FIGURE 2. Resilience finance in relation to vulnerability (composite MVI scores)

A new 'global bargain' is therefore needed for SIDS to continue to sustain development gains and build resilience in the face of compounding external shocks (Bishop et al., 2023). The G20 can support this in at least three ways.

1. Amplifying SIDS representation in the G20 to reinforce shifts in determining eligibility for development assistance and allocation of concessional resources

SIDS have pushed hard for MVI adoption to complement GNI per capita, which is an intrinsically problematic measure of their development (Bishop et al., 2021: 15-16). The MVI offers a common method for identifying and prioritising countries with severe structural vulnerabilities. It could become a vital tool to help unlock the predictable concessional finance needed for resilience-building (Bishop et al, 2023).

MVI scores could inform the graduation process – i.e. providing vulnerable countries with additional assistance and time to strengthen resilience before graduating – but MDBs and OECD Development Assistance Committee (DAC) members would need to agree to use the MVI in their finance allocations in the face of strong resistance from some quarters. Nonetheless, an OECD DAC-AOSIS taskforce was initiated in 2022 to help more development partners understand the special circumstances of SIDS.

But SIDS cannot advocate alone: they need strong support from within key global bodies where they are presently voiceless. The G20 should facilitate this by forming a shared 'G20-SIDS committee' to pursue MVI implementation and help enhance access to concessional resources for particularly vulnerable countries. G20 members – comprising many powerful donors – should lead the way in normalising the use of the MVI in their own development assistance programmes.

a. Reform climate financing mechanisms to improve access to, and absorption of, promised funds to strengthen SIDS resilience

Unpredictable GCF funding is one of the greatest challenges facing SIDS. Like all per capita measures, the use of 'beneficiary metrics' disadvantages them because project cost-benefit assessments are skewed when already-higher transaction costs are divided between often-tiny populations (Wilkinson et al., 2023b). Moreover, arduous application processes represent a daunting barrier for governments with limited human capacity. Improved governance of these funds would require more consultative and inclusive decentralised programming and decision-making sensitive to the perspectives, concerns and constraints of SIDS stakeholders.

The G20 consequently has a critical role to play in improving climate financing mechanisms, so that promised adaptation funds, in particular, are easier to access and can be more easily absorbed to strengthen resilience by the countries that most desperately need to adapt. One way of doing this would be for G20 states that are members of the GCF board to decide to create a minimum annual funding allocation for SIDS. This would reduce uncertainty and improve access, while not restricting applications to the open category. This would be a proportion of all funding available, so that SIDS are not disadvantaged by the GCF's first-come, first-served approach. A predictable minimum annual allocation for SIDS of, say, $10 million would not materially affect other countries (Wilkinson et al., 2023b).

b. Deploying the G20-SIDS committee to pursue novel ways of alleviating the debt trap in SIDS, releasing funds for resilience investments

Constrained access to concessional development and climate finance leads to higher borrowing costs in SIDS, with shortened maturities, aggravating precarious fiscal positions. Many have had persistently high debt levels in recent decades. Out of 35 SIDS, two are already 'in debt distress'; 15 are considered a 'high risk' of it; five are considered at 'moderate risk'; two are considered 'sustainable' but with significant risks; while 10 are considered 'sustainable'. Crucially, *debt service* costs are far higher in SIDS than elsewhere, crowding-out critical public investment in physical, social and climate-resilient infrastructures. In 2023, SIDS spent on average 31.5% of their revenues on debt service (domestic and external) and some considerably more (Hurley et al., 2024).

The recent expansion in the use of Climate Resilient Debt Clauses (CRDCs) by several of the MDBs is a welcome development. These are particularly relevant for small vulnerable countries. But SIDS can become locked in seemingly endless cycles of recovery then disaster, so simply deferring payments to a future date may have a limited impact. More meaningful support would involve automatic debt service cancellation by official creditors for a period of 3-5 years following a qualifying disaster. The mechanism should be *ex ante*, built into bilateral and multilateral loan contracts to provide a simple, rapid, automatic, transparent and predictable way to increase fiscal space in times of crisis (Hurley et al., 2024).

More generally, SIDS need support on debt management and negotiations with creditors to reduce the cost of borrowing. Because of the unique patterns of externally-induced vulnerability (and limited alternative financing) that drives elevated debt burdens, SIDS argue that heavy indebtedness is neither their fault nor comparable to that of larger countries, in either its management or economic effects. The point, as with ODA and climate finance, is that SIDS need a bargain that reflects their unique condition. So, the aforementioned G20-SIDS committee should work with the Paris Club to propose new measures to build confidence in the Common Framework, and increase eligibility and uptake from SIDS to improve long-term debt sustainability, while advocating for novel methods to alleviate the effects of high debt burdens, increase fiscal space and finance resilience.

Scenario of Outcomes

The set of recommendations proposed above are far-reaching and should help reduce cycles of debt-underinvestment-disaster-debt in SIDS. On their own, individual reforms will not be enough. SIDS themselves will need to demonstrate which investments can generate economic and ecological pay-offs that are self-sustaining, thereby winning the argument for expanded debt relief and improved access to concessional finance. This means that debt management is not just about balancing the books: rather, SIDS will need to develop ambitious resilience and adaptation investment plans that demonstrate the wider economic, social and environmental pay-offs for themselves and the store of global public goods. Increasing their fiscal space, so SIDS can spend on these priorities, is essential but challenging. They will need to move into new, high profit service sectors, which in turn will require new skills and technology transfer. Their capacity to absorb funds will also need strengthening, so support and finance to digitalise governance functions is key. Short-term consultancies are not the answer here; rather, SIDS will need long-term capacity support along the lines of what is currently being envisaged for the SIDS Centre of Excellence, an initiative that will be initiated at the Fourth International Conference on Small Island Developing States (SIDS4) from 27-30 May 2024.

The next ten-year agenda for SIDS will end halfway through the next decade, and the world that greets SIDS at that point in time will likely be quite different from 2024. Economically, deglobalising tendencies may have gathered pace, prompting a further retreat into protectionist blocs (Bishop and Payne, 2021). Geopolitically, the fallout from the conflict in Ukraine and escalating tensions between China and the United States may see the world become more divided along these lines. Environmentally, we may witness a range of critical thresholds breached, with more intense extreme weather events and other pathologies making their presence felt. Overall, the picture is likely to be more mixed: positive tendencies are likely to coexist with malign ones, with some degree of renewal of globalisation for a new era, a new bargain of some kind on shared leadership of the international order, and acceleration of some commitments under the Paris Agreement. From the unique vantage point of SIDS though, even the best-case scenarios may not be sufficient to avoid the worst effects of these interrelated shifts. Seizing the opportunity at this critical juncture to create a radical new bargain for SIDS is paramount.

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