



Working Paper



Breaking the cycle of debt in Small Island Developing States

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Key messages

Small Island Developing States (SIDS) are among the world's most heavily indebted states, although their experiences of accumulation and management of these debt burdens vary widely

High debt is rarely a problem of fiscal profligacy or poor public debt management but rather dramatically heightened exposure to external shocks, exacerbated by deficiencies in the global debt architecture

The report draws on a global comparison of SIDS and on six case studies assessing the distinctive debt histories of Antigua and Barbuda, Cabo Verde, Fiji, Jamaica, Solomon Islands and Tonga

It proposes a series of ambitious short-term recommendations that can make a demonstrable difference to supporting resilient prosperity in SIDS, including the provision of minimum annual climate finance allocations for SIDS and other highly vulnerable countries, scaling up use of 'climate-resilient debt clauses', maximising the potential of debt swaps, creating a debt sustainability support service for SIDS and a global debt transparency compact

In the medium term, major reforms are needed in the global debt architecture, including: the widespread adoption of vulnerability criteria in eligibility and allocation decisions for concessional finance and debt relief; the provision of debt service cancellation for SIDS following a qualifying high-impact disaster; and greater inclusion of SIDS in decision-making on international finance reforms

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Acronyms

AIS	Atlantic, Indian Ocean and South China Sea region
CCRIF	Caribbean Catastrophe Risk Insurance Facility
CCRT	Catastrophe Containment and Relief Trust
CRDC	Climate-resilient debt clauses
DFI	Development financial institution
DMO	Debt management offices
DSA	Debt sustainability analysis
DSSI	Debt Service Suspension Initiative
EURODAD	European Network on Debt and Development
GCF	Green Climate Fund
GDP	Gross domestic product
GNI	Gross national income
HDI	Human Development Index
HIPC	Heavily Indebted Poor Countries initiative
IDB	Inter-American Development Bank
IDS	International Debt Statistics
IFC	International Finance Corporation
IFI	International financial institution
IIED	International Institute for Environment and Development
IMF	International Monetary Fund
LDC	Least developed country*
LIC	Low-income country
LMIC	Lower-middle-income country
MDB	Multilateral development bank
MDRI	Multilateral Debt Relief Initiative
MIC	Middle-income country
MVI	Multidimensional Vulnerability Index
ODA	Official development assistance
SDFP	Sustainable Development Finance Policy
SDG	Sustainable Development Goal
SDR	Special drawing rights
SIDS	Small Island Developing States
UMIC	Upper-middle-income country
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VAT	Value-added tax
WDI	World Development Indicators
WEO	World Economic Outlook

Note: * 'LDC' is a category used across the UN system and in much development literature: <https://www.un.org/development/desa/dpad/least-developed-country-category.html>. In this report, the authors would like to acknowledge current debates that question the use of this terminology and its ahistorical framing. They seek to challenge the power relationships and assumptions inherent in ideas about progress and development. Although in this instance we employ the term 'LDC' to situate this report within the current literature, we will continue interrogating the appropriateness of the term and working with our partners to develop more appropriate language and terminology.

1 Enduring debt in Small Island Developing States

The climate crisis is exacerbating debt sustainability challenges in Small Island Developing States (SIDS) (Slany, 2020; Piemonte, 2021). With projections of increasing loss and damage in SIDS due to both extreme weather and slow-onset events,¹ these debt problems are likely to continue and intensify. High debt levels and debt servicing costs, combined with competing budgetary priorities and limited access to concessional finance, are restricting the ability of SIDS to invest in resilience, climate action and the Sustainable Development Goals (SDGs) (UN, 2023a; Wilkinson et al., 2023a; Fresnillo and Crotti, 2022).

Due to their small banking sectors and limited (or non-existent) capital markets, SIDS often face difficulty in mobilising public and private finance domestically. They therefore rely heavily on external finance that is dominated by remittances, official development assistance (ODA)² and debt financing. Many middle- and high-income SIDS also receive foreign direct investment, but these flows are volatile and do not necessarily translate into sustainable investments (Fresnillo and Crotti, 2022). At the same time, SIDS frequently lack access to concessional development resources as well as debt relief options, because traditional, income-based eligibility criteria are overwhelmingly used in the allocation decisions of bilateral and multilateral funding agencies and international financial institutions (IFIs) (see Bishop et al., 2023; Wilkinson et al., 2023a).³

SIDS need access to international finance, including through debt, to sustain and expand government expenditures on socioeconomic programmes and policies. Increasingly, they also need this financing to invest in green growth pathways, build resilience and adapt to climate change, while constructing the highly skilled economies needed to generate competitiveness. Debt sustainability in SIDS is, therefore, in need of urgent attention from the global development community, especially IFIs and donors.

This study provides useful insights for all stakeholders gathering at the 4th International Conference on Small Island Developing States (SIDS4) in Antigua and Barbuda from 27 to 30 May 2024 and sets out priorities for financing resilient prosperity in SIDS over the next 10 years (see also Bishop et al., 2023; 2024).

1 See Panwar et al. (2023) for estimates of climate-attributed loss and damage in SIDS.

2 'ODA' is a term that is used to capture Official (from governments) Development (not commercial/military) Assistance to track donors' efforts. It aims to capture financial assistance from governments that promotes economic development and welfare of developing countries.

3 Income-based criteria often ignore multiple economic, social and environmental factors that shape vulnerabilities of SIDS. The recently developed UN Multidimensional Vulnerability Index (MVI) captures many such vulnerabilities and shows that 70% of SIDS score above the median, indicating substantial structural vulnerability and a lack of structural resilience (see UN, 2023a).

Drawing on a comparative analysis, the core objective of this study is to understand why levels of debt are particularly high in (some) SIDS, the challenges that this presents, and the different practices and policies that they have adopted to pursue – and attain – debt sustainability. Assessing these strategies can help to identify wider policy measures – at both national and international levels – that could help them to achieve longer-term debt sustainability. By doing so, the analysis aims to inform the SIDS4 conference agenda and the 10-year agenda that flows out of it, in turn helping to shape subsequent discussions on how small states can achieve the SDGs by 2030 and resilient prosperity by 2034.

This paper takes a comprehensive look at the debt situation across all 39 SIDS (complementing reports by Fresnillo and Crotti, 2022; Piemonte, 2021). It uses data on public debt (i.e., general government gross debt, both domestic and external) for the period 2010–2022 in 35 out of 39 UN Member SIDS for which debt data is available. Debt and other socioeconomic data is extracted from multiple global databases, including the World Bank International Debt Statistics (IDS), the World Economic Outlook (WEO), produced annually by the International Monetary Fund (IMF), and World Development Indicators (WDI),⁴ and from the recent report *A world of debt* (UNCTAD, 2023).

To complement this, the report also summarises findings from six in-depth case studies that were conducted by researchers in Antigua and Barbuda (Robinson, 2024), Cabo Verde (Gomes Lopes and Brito, 2024), Fiji (Singh, 2024), Jamaica (Bishop and Lindsay, 2024), Solomon Islands (Orton Romero, 2024) and Tonga (Fonua and Seneviratne, 2024). These six SIDS were chosen precisely because they differ in terms of size, geography, factor endowments, economic profile and, crucially, their distinctive debt challenges. Their diverse historical and contemporary experiences of indebtedness are therefore what make them interesting in a comparative sense and can thereby reveal important lessons for breaking the cycle of debt collectively.

In general, they demonstrate that, despite facing significant economic and environmental vulnerabilities, some SIDS have effectively managed debt challenges by, for example, strengthening legislation on public debt, building debt management capacities and strengthening domestic revenue mobilisation. Our analysis suggests that, in general, high levels of debt in SIDS are not a problem of poor public management but rather one of deficiencies in the international financing and debt architecture. The authors propose a set of short-term and medium-term recommendations that can help rectify these issues and level the playing field for SIDS.

For further reading and a more in-depth country analysis, see the country case studies published alongside this report.

4 Data on debt from these databases does not cover all SIDS and all aspects of public debt. For instance, IDS data covers 23 SIDS and provides more consistent data on external debt. WEO data covers 35 SIDS but does not provide disaggregated data on external debt. Therefore, data on public debt in SIDS from either of these databases is used as appropriate for the context.

2 Debt characteristics of SIDS

This section presents an overview of the rising burden of public debt and high debt servicing costs in SIDS across different regions. The analysis shows how multiple interconnected risks such as the accelerating climate crisis and the global economic slowdown – as well as, in many cases, a lack of access to concessional sources of financing – can have a severe impact on their public debt. Not only does this exacerbate debt problems in SIDS, in turn jeopardising their fiscal resilience and investments in achieving the SDGs, but it is rarely their fault.

Debt build-ups do not generally result from fiscal profligacy (Wilkinson et al., 2023a). On the one hand, SIDS face constraints on borrowing, as they are generally unable to run the kind of expansionary fiscal policy that is visible in larger, richer states. For example, Japan (263%), the UK (96%) or the US (123%) can sustain very high debt-to-GDP ratios by borrowing relatively cheaply in their own currencies domestically and internationally. For most SIDS with limited financial sector development – Jamaica is a partial exception (Bishop and Lindsay, 2024) – this is impossible.

On the other hand, SIDS are compelled to borrow. Because of their acute exposure to exogenous shocks, which can be damaging and costly to a relative extent that is completely inconceivable in larger states – in some cases costing over 200% of gross domestic product (GDP) (Bishop et al., 2021) – they have little choice but to respond to those externally imposed shocks by taking on often-expensive sources of commercial financing to recover and rebuild. At the same time, that financing becomes excessively burdensome. It is relatively more expensive, both in its commerciality and the drastically higher costs of building the capital stock in vulnerable small islands. SIDS face a limited array of options for subsequent debt relief and restructuring, too.

Debt is on the rise around the world. Since the COVID-19 pandemic, there is a broad consensus that there is a new debt crisis in many countries of the Global South (Volz et al., 2022). The pandemic significantly worsened public finances and public debt levels, exacerbating trends that were already under way. Even prior to this, IFIs were already sounding the alarm over record levels of public debt. At the end of 2023, the IMF had classified 52 low-income and lower-middle-income countries as being at ‘high’ or ‘moderate’ risk of debt distress. A further 10 were classified as already ‘in debt distress’. Out of a total of 74 low- and lower-middle-income countries, just 6 were classified as being at ‘low’ risk of debt distress.

This picture is mirrored in SIDS, many of which have had persistently high debt levels over the past two decades or more. In 2023, several had debt levels in excess of 100% of GDP. Out of 35 SIDS, 15 are currently considered at ‘high risk’ of debt distress; 2 are already ‘in debt distress’; and 5 are considered at ‘moderate risk’ (see Table 1).

Table 1 Debt sustainability in SIDS

SIDS	Region	WB income group	WB/IMF debt sustainability
Antigua and Barbuda	Caribbean	HIC	High risk of debt distress
Bahamas	Caribbean	HIC	Sustainable
Barbados	Caribbean	HIC	Sustainable^
Belize	Caribbean	UMIC	Unsustainable
Cabo Verde	AIS	LMIC	Moderate risk
Comoros*	AIS	LMIC	High risk of debt distress
Dominica	Caribbean	UMIC	High risk of debt distress
Dominican Republic	Caribbean	UMIC	Sustainable
Fiji	Pacific	UMIC	Sustainable^
Grenada	Caribbean	UMIC	In debt distress
Guinea-Bissau*	AIS	LIC	High risk of debt distress
Guyana	Caribbean	UMIC	Moderate risk
Haiti*	Caribbean	LMIC	High risk of debt distress
Jamaica	Caribbean	UMIC	Sustainable
Kiribati*	Pacific	LMIC	High risk of debt distress
Maldives	AIS	UMIC	High risk of debt distress
Marshall Islands	Pacific	UMIC	High risk of debt distress
Mauritius	AIS	UMIC	Sustainable
Micronesia, Fed. State of	Pacific	LMIC	High risk of debt distress
Nauru	Pacific	HIC	Sustainable
Palau	Pacific	UMIC	Sustainable
Papua New Guinea	Pacific	LMIC	High risk of debt distress
Samoa	Pacific	LMIC	High risk of debt distress
São Tomé and Príncipe*	AIS	LMIC	In debt distress
Seychelles	AIS	HIC	Sustainable
Solomon Islands*	Pacific	LMIC	Moderate risk
St. Kitts and Nevis	Caribbean	HIC	Sustainable
St. Lucia	Caribbean	UMIC	Sustainable
St. Vincent and the Grenadines	Caribbean	UMIC	High risk of debt distress
Suriname	Caribbean	UMIC	High risk of debt distress
Timor-Leste*	Pacific	LMIC	Moderate risk
Tonga	Pacific	LMIC	High risk of debt distress
Trinidad and Tobago	Caribbean	HIC	Sustainable
Tuvalu*	Pacific	UMIC	High risk of debt distress
Vanuatu	Pacific	LMIC	Moderate risk

Note: * Also a 'least developed country' (LDC); ^ Sustainable with significant risk; AIS extends to Atlantic, Indian Ocean and South China Sea.

Source: World Bank and IMF Debt Sustainability Analysis for LICs as of September 2023, and market access countries,⁵ as of 2022.

5 IMF does not disclose its near-term debt sustainability ranking for the market access countries. These are adapted from Fresnillo and Crotti (2022).

2.1 Debt driven by external shocks

Levels of debt in SIDS are more closely related to external shocks than for other groups of countries because they are small, open economies (Fresnillo and Crotti, 2022). This is true in terms of frequency, timescale and extent – shocks hit them more often, with both physical and economic effects being felt immediately, and the severity of those effects can be truly devastating. Indeed, SIDS experience particularly severe economic impacts as a percentage of GDP (Panwar et al., 2023). For example, Dominica lost 226% of its GDP due to Hurricane Maria in 2017, and Grenada saw losses of 200% of its GDP with Hurricane Ivan in 2004.

These small economies also find it difficult to mobilise domestic resources for adaptation and resilience, as well as response, recovery and reconstruction following a climate-related shock (Wilkinson et al., 2023b). This often forces them to look for external borrowing, something reinforced by the fact that many SIDS – due to their relatively high gross national income (GNI) per capita, a problematic measure of their distinctive development panorama in many ways (Bishop et al., 2021; 2023) – are already excluded from concessional sources of development financing or ODA. Several studies (see e.g., Slany, 2020; Fresnillo and Crotti, 2022; Grigoryan et al., 2022) conclude that climate shocks in the form of extreme weather events increase debt levels and related servicing costs in SIDS.

Using data from the IMF WEO and EM-DAT database, Table 2 presents a preliminary analysis of how public debt (as a percentage of GDP) increases in the years following an extreme weather event. In Dominica, for example, debt to GDP increased by 14 percentage points two years after Hurricane Maria in 2017. In some cases, SIDS have experienced the ‘compounded’ impact of the COVID-19 pandemic and extreme weather events, resulting in a higher and more rapid increase in

Table 2 Impacts of extreme weather on public debt in SIDS

Climate extreme event	Economic damage*		Public debt to GDP (%)			
	\$ mil.	% of GDP	Event year (t)	t+1	t+2	t+3
2019 Hurricane Dorian, the Bahamas	3,400	27	60	75*	100	89
2017 Hurricane Maria, Dominica	1,456	226	84	86	98	113*
2015 Tropical Cyclone Erika, Dominica	483	90	69	77	84	86
2016 Hurricane Mathew, Haiti	2,000	14	22	19	22	25
2018 Tropical Cyclone Josie and Keni, Fiji	60	1	46	49	64*	83
2020 Tropical Cyclone Harold, Tonga	111	24	44*	48	45	41
2021 Hurricane Elsa, St. Lucia	34	2	83	74	74	76

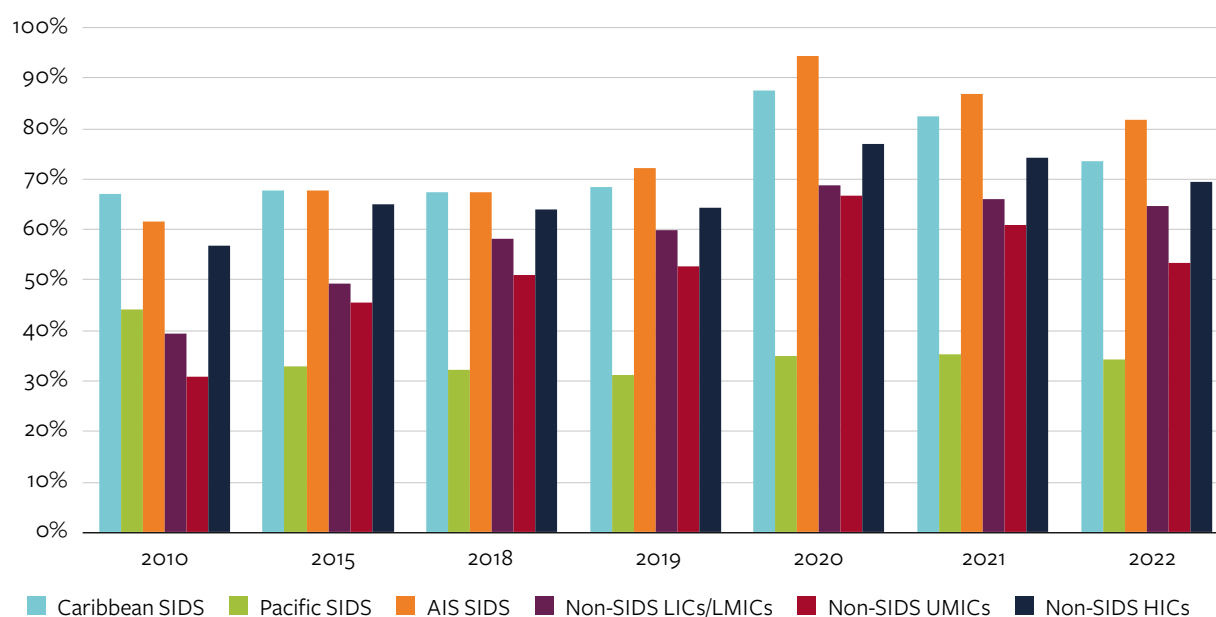
Note: *COVID-19 pandemic year of 2020. Figures after 2022 for Tonga and St. Lucia are based on IMF projections.
Source: Based on disaster impact estimates reported by EM-DAT.

their debt levels (as was the case in the Bahamas with Hurricane Dorian in 2019). Smaller climate-related shocks, such as droughts, receive less widespread attention but also put significant strain on government finances.

2.2 Regional disparities in public debt

Public debt levels vary widely among different SIDS regions and among the different countries within those regions (Figure 1). On average, the public debt-to-GDP ratio was highest in the Caribbean SIDS (71%) over the period 2010–2022, reaching as high as 88% in the pandemic year of 2020 compared with 69% in 2019. Within the Caribbean, public debt in some countries, including Barbados, Dominica and Suriname, was above 100% of GDP on average from 2018 to 2023.⁶ Jamaica's debt burden reached 147% of GDP in the wake of the global financial crisis – making it, at the time, one of the most heavily indebted countries globally – but it has since cut this by half during a decade-long process of fiscal consolidation (Arslanalp et al., 2024). In general, though, public debt (as a percentage of GDP) in Caribbean SIDS has been higher than all non-SIDS across all income groups every year since 2010.

Figure 1 Public debt as a percentage of GDP in SIDS across regions



Note: Analysis includes 35 out of 39 UN Member SIDS.

Source: Authors' elaboration using data from WEO 2023.

Countries in the AIS region have experienced an average annual debt-to-GDP ratio of 70% over the 13-year period, but with a marked increase in 2020 (of 22 percentage points from 2019). In 2022, public debt stood at more than 80% of GDP in Cabo Verde, Guinea-Bissau, Maldives,

6 Dominica and Suriname are also categorised as countries in 'high risk of debt distress' (World Bank and IMF, 2023).

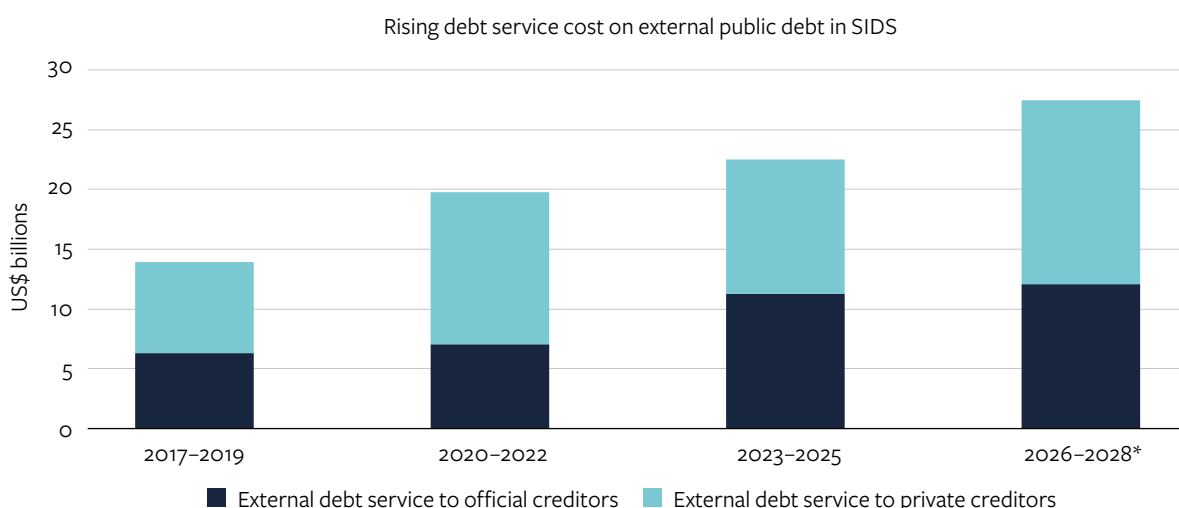
Mauritius, and São Tomé and Príncipe.⁷ Some SIDS experienced particularly high increases due to the pandemic. For example, public debt in the Maldives and Cabo Verde reached 154% (a 75 percentage point increase from 2019 levels) and 145% of GDP (a 35 percentage point increase), respectively, in 2020. As in the Caribbean, the public debt-to-GDP ratio has been higher in AIS SIDS than non-SIDS across all income groups.

Public debt remains low in Pacific SIDS, at on average 35% of GDP, and did not exceed this average even during the pandemic year of 2020. However, external public debt in Pacific SIDS is growing, increasing from 38% of GDP in 2010 to 54% of GDP in 2022. As many as 7 out of the 13 Pacific SIDS analysed for this study are at a ‘high risk of debt distress’ owing to multiple other factors (e.g., revenues, exports), demonstrating their extremely limited debt-carrying capacity (see World Bank and IMF, 2023). Variations exist in public debt levels within the Pacific SIDS group, with Tonga and Samoa both averaging a debt-to-GDP level of 48% from 2010 to 2022, significantly higher than the group average of Pacific SIDS. Similarly, public debt in Vanuatu increased from 20% of GDP in 2010 to 46% of GDP in 2022.

2.3 High debt servicing costs

Debt service on external public debt⁸ is very high on average across SIDS. The 23 SIDS for which data is available paid a collective total of \$25.6 billion in external debt service on public debt between 2019 and 2022 (Figure 2). Most of this was paid to private creditors (62% of the debt

Figure 2 External public debt service in SIDS, by type of creditor



Note: Analysis includes 23 out of 39 UN Member SIDS.

Source: Authors' elaboration using data from World Bank IDS.

⁷ São Tomé and Príncipe is considered to be ‘in debt distress’ (World Bank and IMF, 2023).

⁸ Disaggregated data on debt service for domestic debt was not available, and therefore only external debt service is used in this analysis.

service on external public debt in 2022). According to World Bank estimates, external public debt service will rise even further in the next few years, amounting to a cumulative total of nearly \$50 billion between 2023 and 2028. These numbers are likely an underestimation, however, as they are based on IMF projections and do not include any new debt that will be taken on by SIDS in the next few years.

The IMF-World Bank debt sustainability framework for LICs recommends that public debt service (including both domestic and external) should not exceed between 18% and 23% of government revenue, for countries with medium to strong macroeconomic performance and policies (see IMF and World Bank, 2024). This threshold can also be used as a benchmark for SIDS, given their structural vulnerabilities and socioeconomic and environmental challenges (see Hurley, 2015).

Spending on debt servicing in SIDS is particularly high in relation to government revenues. Average annual spending on external public debt service was more than 20% of government revenue (excluding grants) between 2019 and 2022 in SIDS, peaking at 29% in 2020. There are, however, significant regional disparities (Figure 3). For example, Caribbean SIDS, on average, have allocated 22% of their revenues to external public debt service between 2019 and 2022. Several Caribbean SIDS, such as Belize,⁹ Dominican Republic, Jamaica and Suriname, are paying or have paid in excess of 18% of their revenue in recent years. In the AIS region, Cabo Verde, Guinea-Bissau and Maldives¹⁰ allocated more than 18% of their revenue to external public debt service payments in recent years. The Pacific SIDS of Fiji and Papua New Guinea have also breached the 18% threshold at least once during 2019 to 2022.

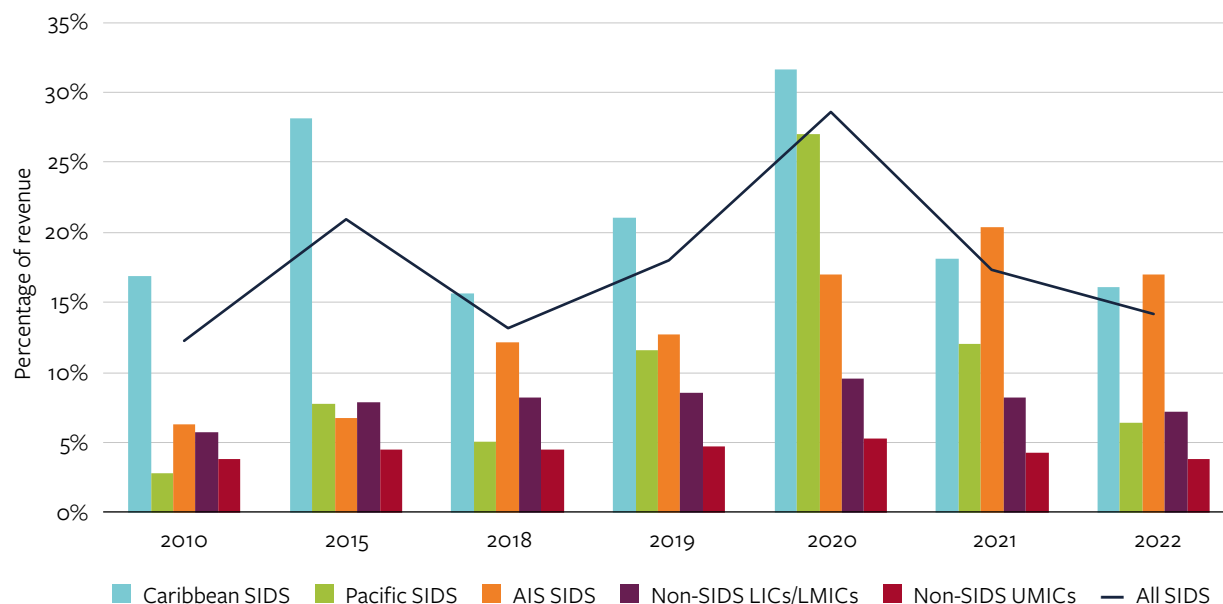
SIDS have been consistently paying more on external debt service compared with other country groups (see Figure 3). Between 2019 and 2022, SIDS on average paid 18% of their revenue in external debt service on public debt, compared with non-SIDS LICs and LMICs at 8% of revenue and non-SIDS UMICs at 5% of revenue.

If we factor in domestic debt service, however, the picture for many SIDS becomes even more challenging. Data on domestic debt is less complete. However, in 30 SIDS for which data is available, debt service on domestic debt in 2023 constituted 47% of total public debt service. As a percentage of revenues, debt service on both domestic and external public debt combined was almost 32%. This picture hides wide variations across SIDS: out of 30 SIDS, 13 spent more than 30% of their revenues on debt service, but 6 spent more than 60% (Antigua and Barbuda, the Bahamas, Guinea-Bissau, the Maldives, Papua New Guinea, and São Tomé and Príncipe).

9 In 2021, external public debt service was 112% of revenue in Belize, as debt service increased seven-fold from 2020 in the aftermath of the COVID-19 pandemic.

10 External public debt service as a percentage of revenue stood at 53% in 2021, due to a three-fold increase in external debt service from 2020.

Figure 3 Debt service payments on external public debt as a percentage of government revenue in SIDS and non-SIDS



Note: Analysis includes 23 out of 39 UN Member SIDS. Government revenues exclude grants.

Source: Authors' elaboration using data from World Bank IDS.

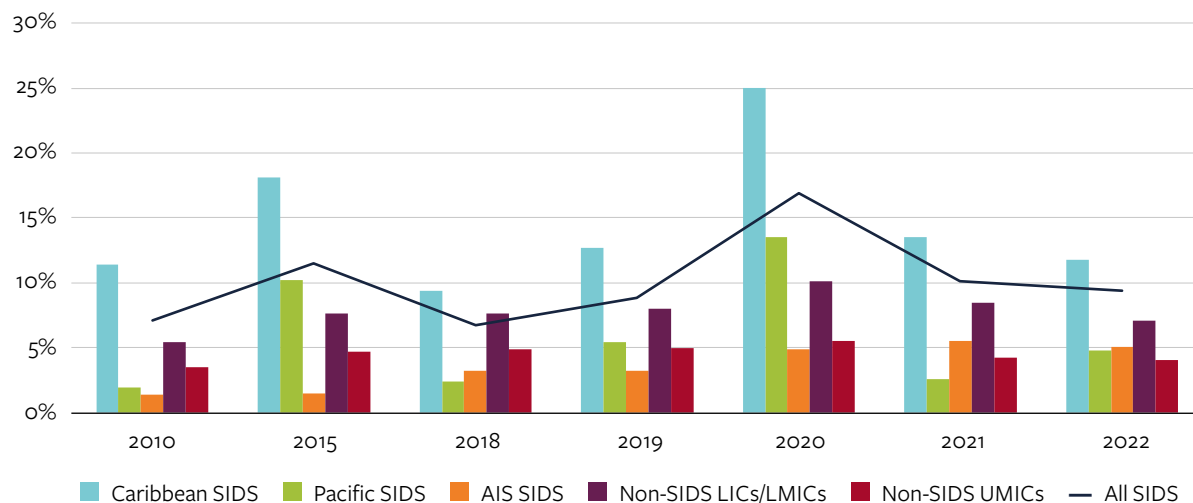
The debt service-to-export ratio is another key economic indicator, revealing the extent to which foreign exchange can cover external debt costs.¹¹ The IMF-World Bank threshold for external debt service to exports is between 15% and 21% for LICs, depending on their debt-carrying capacity (as defined in the debt sustainability framework) (see IMF and World Bank, 2024). Because SIDS have a narrow export base and high vulnerability to external shocks, this threshold is also a useful benchmark for SIDS (Hurley, 2015). Most SIDS have service-based economies,¹² concentrated in tourism and financial services. In these SIDS, debt service payments on external public debt as a percentage of exports are high (9% on average) compared with other service-based non-SIDS (Figure 4). This debt service-to-export ratio across all SIDS is below the 15% threshold, but in the Caribbean it is 16% on average, in some countries exceeding 21%.

In the AIS region, the Maldives has experienced an average external debt service-to-export ratio of 25%, five times the average for AIS SIDS from 2019 to 2022. Similarly, in the Pacific, external debt service to exports averaged 14% in Samoa, two times the regional average during the same period.

¹¹ In order to serve external debt effectively, countries must earn foreign exchange, typically through exports.

¹² There are five export-based SIDS: Guinea-Bissau, Guyana, Papua New Guinea, Solomon Islands and Timor-Leste.

Figure 4 Debt service payments on external public debt as a percentage of exports in service-based SIDS and non-SIDS



Note: Analysis includes 23 out of 39 UN Member SIDS.

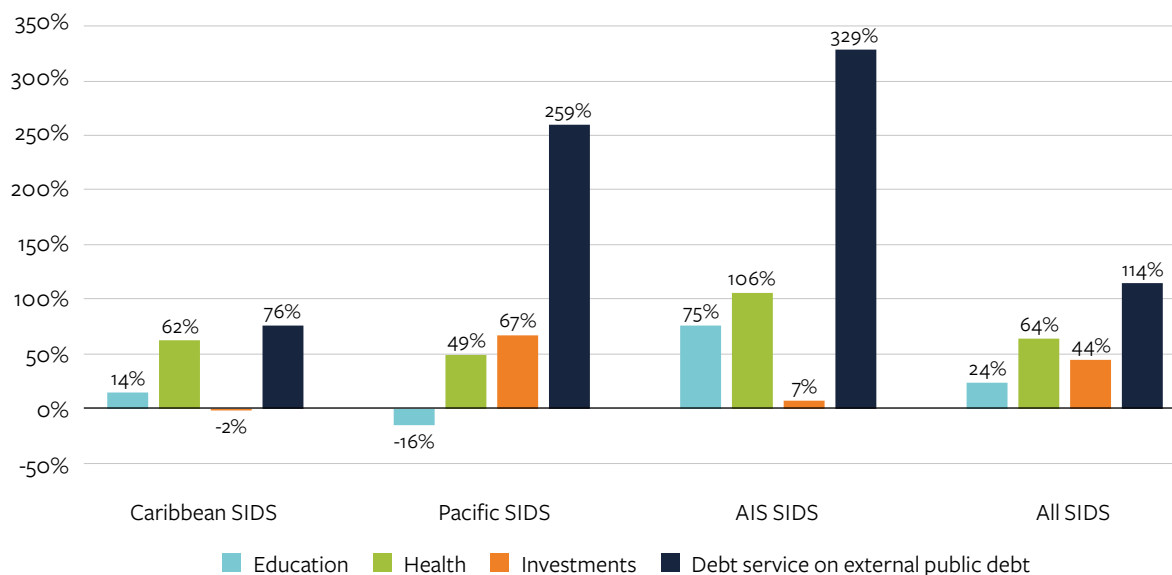
Source: Authors' elaboration using data from World Bank IDS.

2.4 Shrinking fiscal space limiting development progress

Shrinking fiscal space is generating perverse and adverse outcomes in SIDS. A perverse effect is that it forces governments to become even more indebted. SIDS generally have large current account deficits and hence high external financing needs – they require more debt because they rely more heavily on imports than exports, which leaves a trade gap. For example, from 2020 to 2022, SIDS incurred a current account deficit of 6.2% of GDP, which is higher than the pre-pandemic average of 4% of GDP. The situation is particularly alarming for the Caribbean SIDS, where the current account deficit remained at 9.6% of GDP during the same period. Since the pandemic, the fiscal deficit has increased from less than 1% of GDP on average (2017–2019) to 3.6% of GDP (2020–2022).

An adverse, and particularly worrying, effect of rising debt levels and increasing debt service payments is the decrease in public spending on basic services. In the 23 SIDS for which data is available, debt service payments on external public debt have grown several times faster than public spending on education, health and capital investments during the period 2020–2022 compared with 2010–2012 (Figure 5). This is true across all regions, but more so in the case of Pacific and AIS SIDS, where external debt service payments increased 2.6-fold and 3.3-fold, respectively, during the same period.

Figure 5 Nominal change in average government spending against external debt service on public debt 2010–2012 and 2020–2022



Note: Analysis includes 23 out of 39 UN Member SIDS.

Source: Authors' elaboration using data from World Bank IDS and WDI data.

To achieve key SDG targets – in particular targets on health, education, energy, and water and sanitation – SIDS will need to increase government spending on these services by an estimated 6.6% of GDP by 2030 (Tiedemann et al., 2021). In Caribbean SIDS, an increase in spending of 7.7% of GDP by 2030 is required. However, based on IMF projects, total government spending across all sectors is expected to decrease in the next few years – from 42% of GDP on average in 2023, to 39.6% in 2026 and down to 38.8% of GDP in 2028. Overall, government spending as a percentage of GDP is projected to be lower in 2026 than in 2022 in 25 out of 35 SIDS. Even in Jamaica – a country now approaching debt sustainability after a painful adjustment period – debt servicing and repayment costs still constitute a 37% share of government spending, with just 6% available for investment once recurrent expenditure is accounted for (Bishop and Lindsay, 2024).

With high (and in some cases unsustainable) debt levels amid weak economic growth and shrinking fiscal space, SIDS require urgent support to reduce their debt burden through a combination of measures, including debt relief and restructuring, lower borrowing costs and a targeted concessional financial package that would act as an 'SDG stimulus' and free up additional funds at scale for much-needed investments in the SDGs.¹³ However, debt relief and restructuring options for SIDS have been limited and insufficient so far, as discussed below.

¹³ In February 2023, the UN Secretary-General proposed an 'SDG stimulus' to expedite countries' progress towards achieving the SDGs (see United Nations, 2023a).

2.5 Limits to debt restructuring and relief options

Mechanisms for managing sovereign debt restructuring have undergone significant changes since the Bretton Woods institutions were established in 1944. Initially providing very limited debt relief – with a preference for rescheduling debt payments rather than outright reductions – they now provide for debt reductions in some circumstances. However, with the creditor landscape becoming more complex, debt relief initiatives are, similarly, becoming increasingly complex themselves. Some of the more prominent initiatives are assessed in this section.

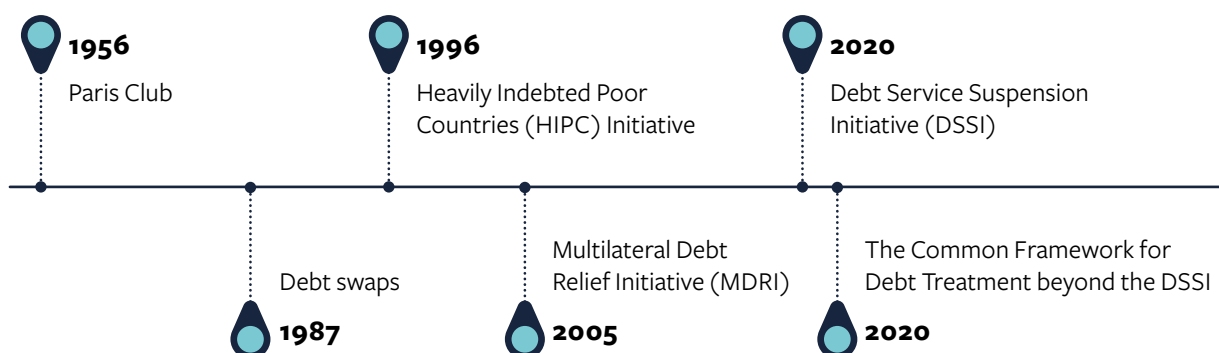
2.5.1 Levels of debt relief in SIDS

Debt forgiveness measures have failed to significantly ameliorate accumulating levels of debt in most SIDS. From 2010 to 2021, SIDS received debt forgiveness amounting to over \$1.56 billion in principal funds and \$288.76 million in interest. This is a small proportion of the total external debt stock, however: total debt forgiveness or reduction (an indicator that includes debt buybacks) as a percentage of external debt stock fell from 3% in 2011 to close to zero in 2022).

2.5.2 Evolution of debt relief measures

In the absence of a sovereign insolvency regime, global debt relief and debt restructuring measures have evolved over time to include more instruments, more creditors and more types of debt, as previous measures consistently failed to restore debt sustainability to severely indebted nations. The first initiative was the Paris Club, set up in 1956 as an informal group of 21 bilateral creditors to renegotiate bilateral debt terms as a collective with debtors in an effort to avoid default. Their overarching aim was not to restore debt sustainability or improve the economic prospects of heavily indebted nations but to ensure that debtors could ultimately repay their loans to Paris Club member countries according to revised terms (Cheng et al., 2017).

Figure 6 A timeline of debt relief mechanisms



Source: Authors' own elaboration.

The debt crises in the late 1980s led to the introduction of ‘innovative’ debt relief instruments. This included debt swaps or debt conversions. From 2002 to 2007, Paris Club creditors concluded more than 376 bilateral debt-swap operations that extinguished \$8.3 billion in claims (Primo Braga and Domeland, 2009). The total volume of debt relief generated by debt swaps has, however, remained modest (d’Chamon et al., 2022), and they often have little impact on overall debt stock levels. More recently, there has been a revival of interest in commercial debt swaps for marine conservation and other investments in nature. Across SIDS, these have been used by Barbados, Belize and the Seychelles.¹⁴

The Heavily Indebted Poor Countries (HIPC) initiative was launched by the IMF, the World Bank and other bilateral and multilateral creditors in 1996, following sustained pressure by civil society organisations around the world. The HIPC initiative provided \$76 billion in debt relief (Aboneej et al., 2022) shared by multilateral creditors, the Paris Club and non-Paris Club bilateral creditors. In 2005, the HIPC initiative was further extended with the Multilateral Debt Relief Initiative (MDRI), which provided further debt relief to eligible countries. Only five SIDS were eligible: Comoros, Guinea-Bissau, Guyana, Haiti, and São Tomé and Príncipe. Combined, these initiatives brought down their debt from an average of 196% of GNI in 2000 to 35% in 2015 (OECD, 2018).

In 2020, the G20 launched the Debt Service Suspension Initiative (DSSI), which temporarily postponed the debt repayments of 73 low- and lower-middle-income countries from May 2020 to December 2021 as a tool to help poor countries deal with the COVID-19 pandemic. In total 22 SIDS were in principle eligible for the DSSI, but ultimately only 13 participated (World Bank, 2022). Despite its positive intentions, the DSSI did not have a major impact on many SIDS. For example, the DSSI suspended less than 3% of debt repayments for participating Caribbean states (Dominica, Grenada and St. Lucia), and the total amount deferred by Paris Club members to all SIDS amounted to \$383 million (of which \$321 million was for Papua New Guinea). The DSSI also did not cancel debt repayments but merely deferred them to a future date while interest continued to accrue.

The Common Framework for Debt Treatment beyond the DSSI, also established in 2020, was set up because it was recognised there was a need to provide further debt relief beyond the DSSI bringing in a wider set of creditor countries, including China. However, no SIDS countries have

14 In 2021, Belize completed a \$364 million debt conversion with The Nature Conservancy (TNC) that reduced debt by 12% of GDP. This debt swap allowed Belize to repurchase \$553 million from external commercial bondholders. The Seychelles debt-for-nature swap in 2015 allowed the conversion of \$21.6 million of public bilateral debt primarily to Paris Club creditors, with the World Bank and the Global Environment Facility as insurers. In 2022, Barbados, with TNC and the Inter-American Development Bank (IDB), announced the completion of a debt swap with a debt conversion of \$150 million that created long-term sustainable financing for marine conservation. Jamaica engaged in a debt swap of \$16 million of bilateral debt to the US government with the support of TNC in 2004 (see The Nature Conservancy, 2022; 2023; Commonwealth Secretariat, 2020; IDB, 2022; Fuller et al., 2018).

yet asked for debt relief via the Common Framework, which has been dogged by criticisms that it is too slow and provides too little too late. Another challenge is that market access countries, like many SIDS, may fear that entry into a scheme like this will negatively affect their credit rating and lead to an increase in their borrowing costs (or lock them out of international capital markets entirely).

Alongside these various debt relief schemes, other initiatives have also been developed, including instruments designed to help countries coordinate private creditors more effectively (collective action clauses – CACs) and, more recently, those designed to manage the risk of shocks. Ex ante instruments such as debt pause clauses (also known as climate-resilient debt clauses – CRDCs) are designed to improve liquidity following a disaster by allowing for a temporary deferral of debt service. Instruments such as parametric insurance products, such as the regional risk pool for the Caribbean (the Caribbean Catastrophe Risk Insurance Facility – CCRIF), and contingent credit facilities have also emerged. These instruments are all useful in providing quick liquidity after a disaster and for building financial resilience in SIDS. The risk, however, is that they are seen as a tool to restore debt sustainability in unsustainable debt situations and will distract from carrying out more meaningful debt restructuring where it is needed. Further assessment and use of these instruments is discussed in the next section.

3 Managing debt sustainability: evidence from six SIDS

3.1 Introduction to the case studies

This section provides an overview of key issues revealed by the six aforementioned case studies of debt sustainability in SIDS: Antigua and Barbuda, Cabo Verde, Fiji, Jamaica, Solomon Islands and Tonga. These countries were selected as case studies because they are distinctive in many different respects, with the overall aim to derive a range of practical insights and lessons learned into what is – and is not – working when it comes to current efforts to foster greater debt sustainability.¹⁵ These insights are then used to formulate action-oriented policy recommendations for both SIDS and the international community.

Many SIDS have relatively high levels of human development, as measured by the United Nations Development Programme (UNDP) Human Development Index (HDI) (UNDP, 2024). In many ways, therefore, they should be considered a development success story. This is also true within the case study cohort. Antigua and Barbuda, for example, is classified as a high-income country and has an HDI rank of 71, out of a total of 191 countries worldwide. Fiji, Jamaica and Tonga are all upper-middle-income countries with high levels of human development and broad access to basic services, including education, health and other services. Cabo Verde, meanwhile, is one of the few countries that has transitioned from ‘LDC’ to middle-income status. Solomon Islands is the exception to this picture. With a per capita income estimated at \$2,205 in 2022 and an HDI rank of 155, Solomon Islands is one of the poorest countries in the Pacific region. It also exhibits a high degree of institutional fragility.

Despite higher human development levels across most of the case study cohort, they all have significant economic and environmental vulnerability (see Bishop, 2012). Most are reliant on just one or two economic sectors or industries for large shares of their revenues. In Antigua and Barbuda, for example, the total contribution of tourism to the economy is about 63% of GDP, and in Fiji it is 40%. In Solomon Islands, timber exports accounted for 65% of export earnings and 20% of domestic revenues in 2017, but with the current decline of this industry, there are ongoing challenges around where alternative sources of revenue and economic growth can be found. When it comes to environmental vulnerability, Antigua and Barbuda, for example, is located in the Caribbean’s so-called ‘hurricane belt’ and has been hit by eight major hurricanes since 2000. By the end of this century, economic losses due to accelerated climate change are projected to reach just under 5% of GDP. Tonga has also experienced frequent disasters, including Category 5 Cyclone Gita in 2018 (leading to a loss of 38% of GDP); Category 3 Cyclone Harold in 2020 (loss

¹⁵ Data in this section is drawn from the individual case studies, unless otherwise indicated. References to primary data sources are provided in each case study report.

of 25% of GDP); and the 2022 Hunga-Tonga-Hunga-Ha’apai volcanic eruption and tsunami (loss of 18.5% of GDP).

The accelerated climate crisis poses an increasing – and indeed existential – threat to the economic viability of SIDS. This will manifest not only in the increasing frequency and intensity of extreme weather events, but through a multitude of slow-onset events, such as sea-level rise and prolonged drought. How economic losses will affect HDI scores, migration patterns and ultimately the long-term viability of many small island states is of great concern to both SIDS and their development partners. SIDS cannot confront these challenges effectively with unsustainable levels of sovereign debt. For some, debt sustainability is already a current challenge; for others, it could become so imminently, with long-term debt risks overwhelmingly tilted to the downside.

In this section, we look at the six countries’ experiences dealing with sovereign debt and consider what new measures are needed to safeguard debt sustainability and support resilient prosperity in SIDS.

3.2 Debt across the six country case studies: a snapshot

On the surface, there seems to be a mixed picture when it comes to public debt across the six case study countries. Four have debt-to-GDP ratios that are higher than 70% (Antigua and Barbuda, Cabo Verde, Fiji and Jamaica), while two are below 50% (Solomon Islands and Tonga).

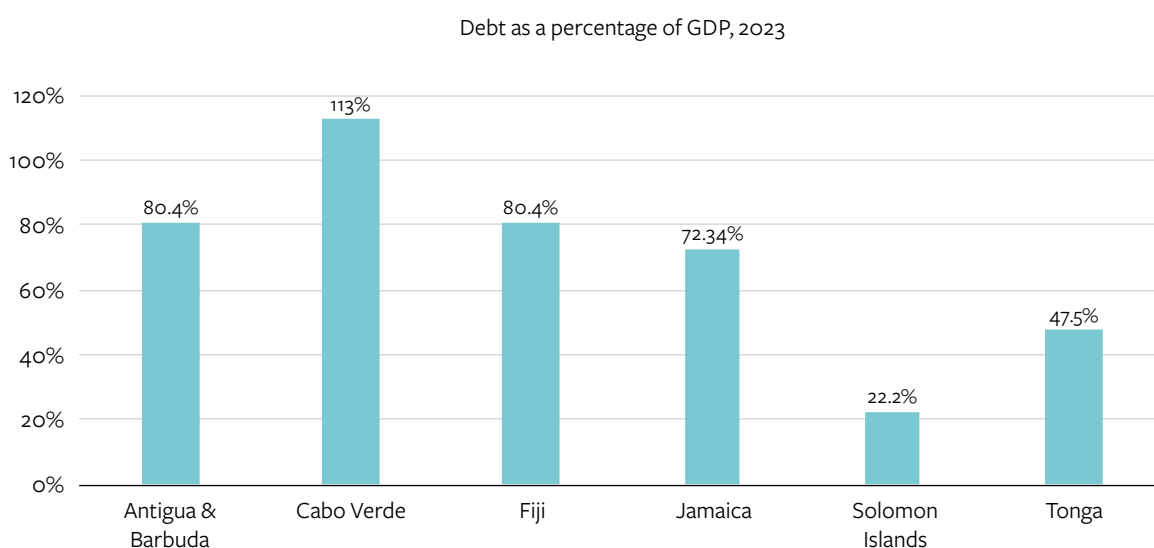
But debt-to-GDP ratios tell us very little about the real challenges faced, in part because SIDS – due to their size, level of economic diversification, patterns of development, including financial sector development, scale and recency of exogenous shocks, relative GNIs per capita and so on – all have quite different finance panoramas. This manifests in distinctive experiences in terms of eligibility for, and ability to absorb, concessional financing; relationships with donors and therefore the availability of aid, including direct budget support; and patterns of foreign direct investment. Therefore, there is a compulsion to borrow from particular creditors, at particular scale, over particular timeframes, with particular conditions and costs. In short, we can learn little about the evolution and impact of a given level of indebtedness by staring at headline debt-to-GDP ratios. We consequently need a more finely grained, qualitative analysis.

For example, despite Jamaica’s perceived high levels of debt currently, it has been on an extraordinary (and rapid) debt-reduction journey over the past decade. After two painful debt restructurings in 2010 and 2013 (see Hurley et al., 2010), it reduced its debt-to-GDP ratio from around 147% in 2013 to 72.2% in 2023, its lowest level in 25 years, and it is projected to fall to 64.4% by mid-2025. It aims to reach 60% by 2027/2028 and has legislated to maintain ‘debt neutrality’ at this level into perpetuity. Cabo Verde has similarly managed to reduce its debt recently from a historic high of 147.5% of GDP in 2021 to 113% in 2023, with its debt position now considered sustainable (albeit highly fragile) by the IMF. Fiji’s debt is also considered sustainable, but it has ballooned over the past decade, climbing from 44.5% of GDP in 2014 to a projected

81% of GDP in 2024. Meanwhile, Antigua and Barbuda's debt can be described as high and unsustainable at almost 87% of GDP at the end of 2022, despite this being one of the lowest ratios recorded over the past two decades. Antigua and Barbuda is in significant repayment arrears to several creditors and has consistently ranked among the 10 most highly indebted SIDS for over two decades.

Debt risks are on the rise in two other case study countries that currently have relatively low debt-to-GDP ratios. Tonga is assessed as being at high risk of debt distress by the IMF, due primarily to high repayment obligations becoming due on loans from China's EXIM Bank from 2024 onwards. Solomon Islands, meanwhile, has enjoyed two decades of consistently low debt levels, following a comprehensive debt restructuring with its external creditors in 2005. Debt is on an upward trajectory again, however, as the country seeks to navigate structural changes to its economy with the decline of the lucrative logging industry and with a large pipeline of debt-financed infrastructure projects on the way.

Figure 7 Debt-to-GDP ratios in case study countries



All six countries in this study owe debt to various creditors, with the creditor mix shifting significantly for most of them over the past decade. In particular, there has been a marked shift away from debt owed to Paris Club creditors towards other bilateral lenders, notably China, which has emerged as the most important bilateral lender for Antigua and Barbuda, Fiji, Jamaica, Solomon Islands and Tonga. While some of this is reported as being concessional, in many cases this is simply not known due to confidentiality clauses contained in these loan agreements.

The share of multilateral debt has also increased for many, particularly Solomon Islands and Fiji, which owe 82% and 78%, respectively, of their external debt to multilateral lenders. Cabo Verde also owes the majority of its external debt to multilateral lenders at 58% of its external debt

portfolio. Tonga owes a large proportion of its external debt to multilateral creditors at 42.8%. Antigua and Barbuda reports that the Caribbean Development Bank has become an increasingly important lender since Hurricanes Irma and Maria hit the country in 2017. While multilateral loans can be slow to disburse, and often come with policy conditionality, they are seen as attractive by many countries, since they are in most cases highly concessional and have been used to fund critical infrastructure. Fiji, for example, reports that it benefited from its most concessional loan ever from the Asian Development Bank at a 1% interest rate, 10-year grace period and 40-year maturity.

The exceptions to this are Antigua and Barbuda and Jamaica, which do *not* have access to concessional finance from the multilateral development banks (MDBs) and have historically been more heavily indebted *domestically* than externally. Fiji has also traditionally relied on domestic borrowing. In these three countries, domestic debt accounts for over 50% of total public debt – and in Solomon Islands it accounts for over 40%. Moreover, in both Fiji and Solomon Islands there is a clear policy to further increase the share of domestic debt as a proportion of overall public debt. This is seen as a way of raising funds quickly and condition-free, of strengthening domestic financial markets, while at the same time reducing the level of foreign exchange risk in the debt portfolio.

Domestic debt is typically more expensive, however, and has a shorter maturity profile, which means that the fiscal burden of this type of debt can be very high. It can also heighten refinancing risk and is more difficult to restructure than external debt, since it can have a negative impact on the domestic financial system (and even precipitate a domestic financial crisis).¹⁶ For these reasons, Antigua and Barbuda (which is in an unsustainable debt situation) reports a strategy to *decrease* the share of domestic debt and rely more heavily on external finance, particularly multilateral finance. Across all six country case studies, debt service on domestic debt represents more than 35% of total debt service, and in three countries it is over 50%.

Overall, many SIDS face a heavy debt service burden, raising concerns that debt may be crowding out critical public spending on human capital development, social spending and much-needed investment in climate-resilient and low-carbon infrastructure. These investments will all be essential if SIDS are to build the highly skilled, resilient, green economies of the future. For example, in Cabo Verde, in 2024, it is projected that debt service will increase to \$258.4 million, while the amount spent on education, the health sector and environmental protection combined will amount to just \$234.4 million across all three areas (\$113 million, \$96.8 million and \$24.6 million, respectively). In 2023, 30 SIDS will spend on average 31.8% of their revenues on debt service (domestic and external). Across the case study cohort the picture varies, but Antigua and Barbuda, Cabo Verde and Jamaica all have ratios above 35%, which is particularly worrying in Cabo Verde and Jamaica, as these countries have brought down levels of debt. Tonga is also set to be hit

16 Refinancing risk is a risk where the borrower cannot replace an existing loan with a new one.

by large repayments to China EXIM Bank over the next few years, putting it under significant fiscal pressure.

Figure 8 External versus domestic debt service in case study countries, 2023

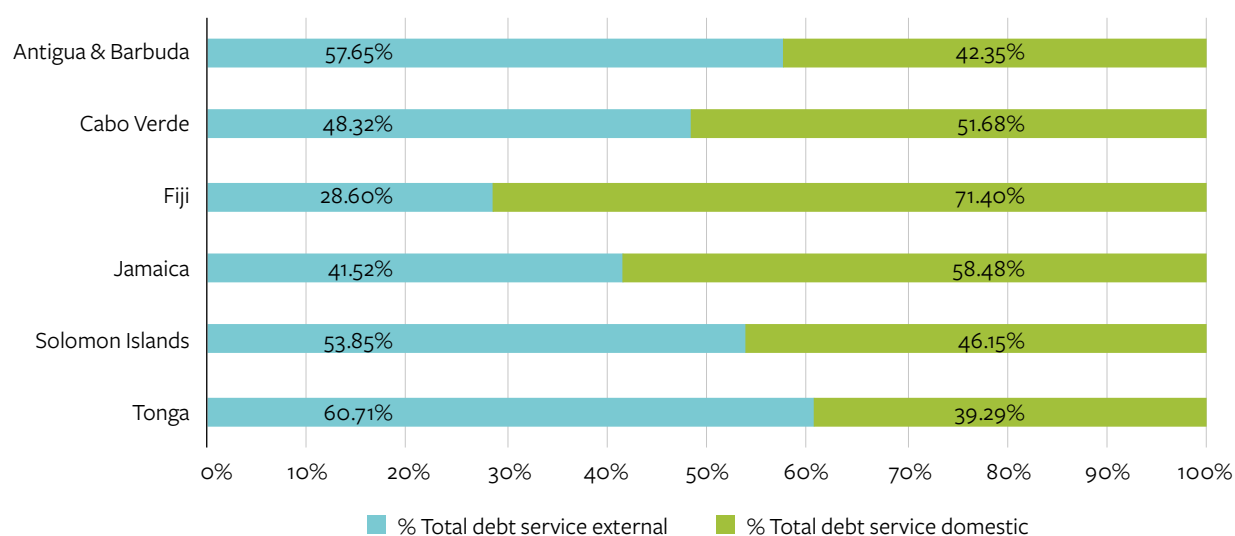
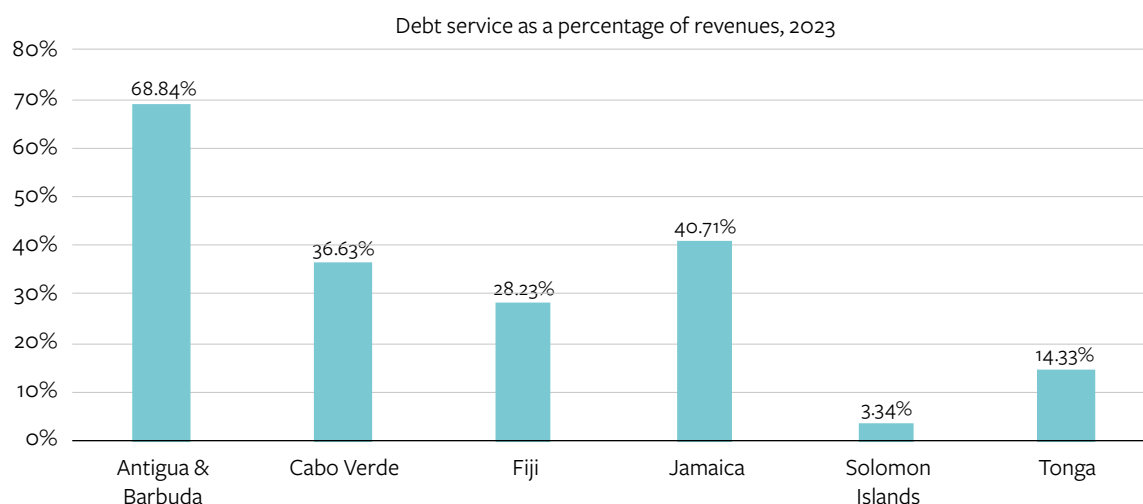


Figure 9 Total public debt service as a percentage of government revenues, 2023



Source: Data from case studies.

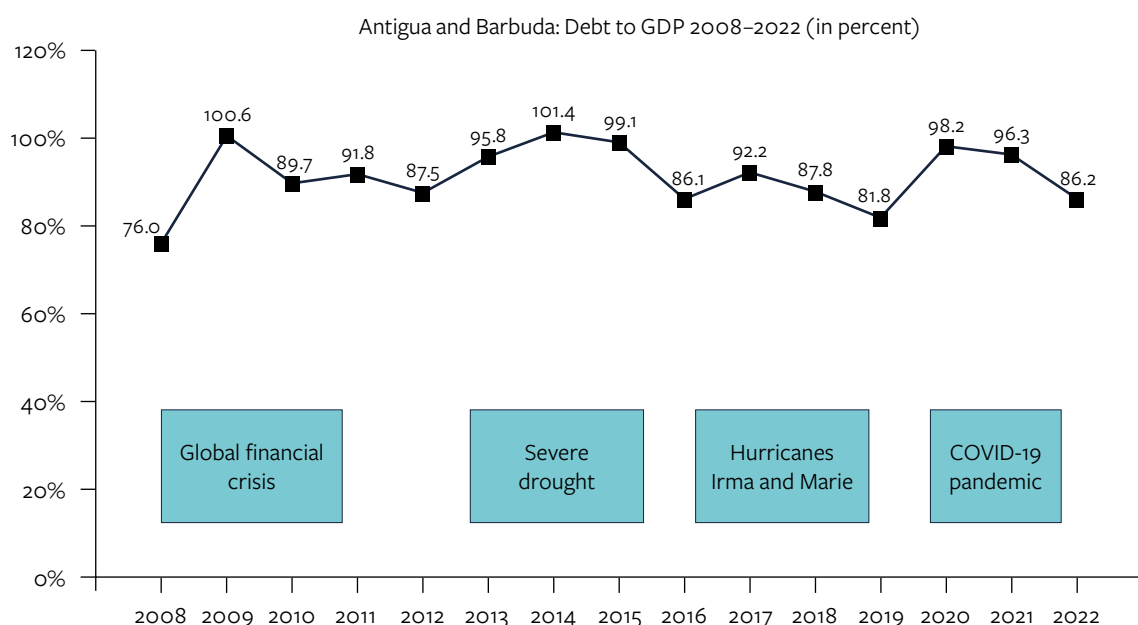
All six case study countries have been hit by multiple external shocks, which have led to often large increases in public debt and undermined previous efforts to reduce debt loads (see Box 1 and Figure 10).

Box 1 Impact of external shocks on debt: evidence from across the case studies

Several case study countries point to repeated cycles of ‘recovery then reversal’ in which debt levels seem to be on a successful downward trajectory before they are subject to another major setback beyond their control. Antigua and Barbuda has been severely impacted by at least four major shocks since 2008, so any economic recovery in between was short-lived (see Figure 10). Its nascent economic recovery from Hurricanes Irma and Maria in 2017, which led debt to climb from 86% of GDP in 2016 to over 92% in 2017, was derailed by a collapse in tourism during the COVID-19 pandemic in 2020. This led debt to jump from 82% of GDP in 2019 to 98% in 2020. Elsewhere, Tonga has experienced a succession of disasters, leading it to take on significant new debt with China.

These shocks have led to dramatically heightened financing needs for relief and recovery, and while support from donors and the MDBs has in most cases been forthcoming, it is rarely of the magnitude that can fully meet reconstruction costs and can be slow to disburse. This has often led to a sharp increase in domestic debt specifically. In the case of Solomon Islands, for example, the recent COVID-19 pandemic saw domestic debt increase from \$19 million in 2017 to \$80 million by 2022, as this was perceived as a way to raise funds quickly and efficiently for the pandemic response.

Figure 10 Impact of external shocks on debt in Antigua and Barbuda, 2008–2022



Source: World Economic Outlook database, October 2023.

3.3 Successes in managing debt and fostering debt sustainability

Despite multiple challenges, the six case study countries have all made significant strides in managing debt and addressing debt sustainability challenges.

Using debt to finance development and recovery

Evidence from across the six country case studies shows that, for the most part, debt has been used well to support development interventions and recovery from shocks. For example:

- Cabo Verde has used concessional loans to finance major improvements in its transportation infrastructure (air and sea), which has massively bolstered its tourism economy, and more recently has focused on investments in the digital economy to build human capital and boost competitiveness.
- In Antigua and Barbuda, external loans have been used to finance projects in road infrastructure, housing, education, transportation and communication, as well as to pay for recovery and reconstruction following the hurricanes in 2017.
- In Jamaica, six years of fiscal consolidation (with a 7.5% primary surplus) reduced debt to 94% of GDP by 2019, but the burden increased again to 110% in the immediate wake of the pandemic, where social protection was prioritised, before the debt-reduction trajectory was then reinstated from 2022.
- Tonga has also used debt to finance recovery, including from the recent catastrophic volcanic eruption and tsunami.
- Fiji has used multilateral debt to finance climate-resilient infrastructure, water and wastewater programmes, the COVID-19 social protection programme and policy-based budget support.

Domestic debt has often been used for cashflow purposes, while multilateral debt has been channelled towards infrastructure, policy-based lending and recovery from shocks. Concessional finance, especially from the MDBs, has been seen as particularly important for countries to ensure debt remains affordable and overall debt risks are minimised. In this respect, the ‘small island exception’, implemented by several MDBs, such as the World Bank, which ensures that some SIDS can access concessional finance from the multilateral lenders despite higher per capita income levels, is commended.¹⁷ Countries also point to the wider range of contingent or emergency financing facilities now available from many MDBs, which provide SIDS with more rapid access to finance when a crisis hits. These have been further bolstered by the establishment of financing facilities designed to provide long-term support for strengthening economic resilience to external shocks, such as the IMF’s Resilience and Sustainability Facility. They are also reinforced by parametric insurance initiatives, such as the CCRIF.

17 For more information on the World Bank’s small states exception, see: <https://thedocs.worldbank.org/en/doc/340031539197519098-0290022019/original/WorldBankSupporttoSmallStatesbooklet.pdf>

Policies to improve fiscal responsibility

Several case study countries report that, to support responsible borrowing, fiscal responsibility legislation or other policies have helped promote discipline and public accountability. Strong public support for countries' debt management strategies is also a critical success factor. For example:

- Jamaica's Fiscal Responsibility Law (FRL) establishes in law the objective of attaining a debt-to-GDP ratio of no more than 60% by 2027/2028. Jamaica's parliament has also recently established an independent Fiscal Commission to assess the realism of the government's fiscal plans and its consistency with the FRL. It has also successfully managed its exposure to contingent liabilities: currently it is below the limit of 3% that was targeted for 2026/2027.
- Another factor that proved critical for success in Jamaica is the strong public support its rapid debt-reduction programme enjoyed within the wider population, despite the significant hardships it entailed in forgone social and capital investment. These recent successes enabled it to build up fiscal buffers and implement countercyclical measures when the COVID-19 pandemic struck in 2020. Cabo Verde also reports that the government's strategy to borrow quite heavily on highly concessional terms for investments in the tourism infrastructure enjoyed fairly widespread citizen support.
- In Solomon Islands, once external borrowing resumed in 2013, various policies were put in place to safeguard the sustainable debt position, including restrictions on non-concessional borrowing, subnational borrowing and guarantees that were widely adhered to. More recently, in 2023, a new Public Investment Management Framework was approved by the Ministry of Finance to add further scrutiny and prioritisation to externally funded investments.
- Cabo Verde and Tonga cite the World Bank's Sustainable Development Finance Policy (SDFP) framework, which restricts these countries to zero non-concessional debt if they wish to retain access to concessional resources from the major multilateral lenders.
- Cabo Verde and Solomon Islands cite the importance of programmes to build the institutional capacities of Debt Management Offices and to strengthen public debt reporting and transparency. In Solomon Islands, long-term and sustained development partner support has helped to build debt management institutional capabilities from scratch, which have helped to build solid foundations for prudent and effective debt management.

Boosting domestic revenues

Alongside this, evidence from the case studies shows that SIDS have also taken important measures to boost domestic revenues, especially since the COVID-19 pandemic. Most saw a significant hit to public revenues due to the pandemic while expenditures increased. For example:

- In Fiji, revenues dipped by close to 50% in nominal terms between 2020/2021 and 2021/2022. At the same time, the government introduced an Unemployment Assistance Programme, which disbursed over \$191 million to over 400,000 people, both in the formal and informal sectors. These policies, combined with other COVID-19 tax relief measures, resulted in a sharp

jump in fiscal deficits and a substantial accumulation of debt. Since then, Fiji has increased the corporate tax rate from 20% to 25% and the value-added tax (VAT) rate from 9% to 15%, alongside other tax measures.

- Antigua and Barbuda's tax revenues are only at 15% of GDP, well below full potential, and significantly lower than its neighbour Jamaica at 28% in 2023. Recent fiscal measures there include an increase in VAT from 15% to 17%, higher taxes on high-end properties, a levy on remittance inflows, and improving tax coordination and administration.
- Cabo Verde has also focused on strengthening the capacities of its tax administration, with a focus on 'formalisation of the economy' to widen the tax base, as well as measures to combat tax avoidance and evasion.
- Solomon Islands has also recently launched an ambitious tax reform programme aimed at updating the tax administration law, introducing VAT and reviewing income taxes. These reforms aim to broaden the tax base and are expected to have a revenue-positive impact over the medium term.

Alongside these measures, the international community has also stepped up its support for SIDS in various ways, including through innovative debt instruments (see Box 2).

Box 2 Innovations in debt instruments

The past decade has seen multiple 'innovations' in financing emerge or increase in prominence, with many SIDS taking a leading role in championing new approaches to debt management. These developments also signal increased awareness on the part of the international community and the MDBs to the specific vulnerabilities of SIDS and the need to work in partnership with them to design policies and instruments that are more tailored and responsive to their needs.

For example, 'hurricane clauses', which were pioneered by Grenada in 2015 and allow for the temporary deferral of debt service when a disaster strikes, have become increasingly mainstream over the past few years, with several multilateral lenders and a few bilateral lenders now incorporating (or committing to incorporate) so-called 'climate-resilient debt clauses' (CRDCs) into their loan agreements. Moreover, the Inter-American Development Bank and the World Bank have announced they will apply these clauses retroactively to old loan agreements. Jamaica was the first small island state to issue a sovereign catastrophe bond in partnership with the World Bank and USAID, which provided the Government of Jamaica with \$185 million in storm protection over three years.

Other examples include Fiji, which in 2017 became the first small island state to issue a green bond, which mobilised \$50 million to support climate mitigation and adaptation.

In 2023, it then issued two blue bonds to fund investments in ocean-related activities. Again, development partners such as the International Finance Corporation, the World Bank and UNDP played a key role in supporting these bond issuances.

There has also been a recent uptick in debt-for-climate and debt-for-nature swap transactions, many of which have involved small island states. Within the case study cohort, Cabo Verde concluded a debt-for-nature swap with Portugal in 2023, which will see €12 million in bilateral debt ‘converted’ into resources for the country’s new Climate and Environmental Fund. There is also the potential to convert more should this first transaction be deemed successful. Across SIDS more widely, Barbados, Belize and the Seychelles have all concluded debt swaps with a focus on marine conservation. The Belize transaction in 2022 led to a debt reduction equivalent to 12% of GDP, which is the world’s second-largest debt refinancing transacted for ocean conservation to date. Indications from the MDBs show that there is appetite to build on these recent successes and scale the approach across more countries in the Global South, including SIDS. As experience grows, the high transaction costs associated with these types of operations could also decline.

Limitations to strategies to manage debt and foster debt sustainability

Notwithstanding these important successes in fostering debt sustainability, evidence from across the case studies points to significant ongoing challenges, with the balance of risks tilted to the downside.

Cycles of debt, shock and recovery

Several countries appear to be locked in repeated cycles of economic recovery then setback. In practice, this means that debt is often not taken out to *advance* sustainable development but to recover from a shock and restore *previous* development levels. For example:

- Much of Antigua and Barbuda’s debt has been accumulated in the aftermath of economic shocks. Debt has been contracted mainly to rebuild as well as, to a more limited extent, foster resilience and development.
- In Tonga, 40% of the debt contracted between 2008 and 2023 has been for disaster recovery. With the outlook for climate-related disasters worsening, this cycle of recovery then setback is only likely to intensify.

Slowdown in economic activity

A major challenge for debt sustainability in many SIDS is the slowdown in economic activity in major tourism markets. For tourism-dependent economies this can have a debilitating effect across the whole economy in terms of the fiscal accounts, economic growth and employment.

This challenging backdrop means that recent gains in debt reduction, such as those achieved in Jamaica, and to a lesser extent in Cabo Verde, remain fragile. This is all the more worrying in light of evidence that these reductions in debt have come at a cost.

- Jamaica, for example, is often touted as the poster child for its remarkable achievements over the past decade in lowering its debt from over 135% of GDP in 2013 to about 72% a decade later in 2023. However, while Jamaica reports that social expenditures were largely protected on its debt-reduction journey over the past 10+ years, debt servicing has nevertheless remained high – it remains at more than 40% of revenues in 2023 – crowding out other essential government spending, including capital investment, which is critical for growth and long-term competitiveness. Jamaica has been one of the slowest-growing economies in Latin America and the Caribbean for decades, and, although growth has picked up in recent years, inflation remains high, eroding its real value.
- Similarly, Cabo Verde's classification as sustainable and at moderate risk of debt distress should be viewed with caution, as its debt levels remain persistently high and above 100% of GDP. The only way this is even remotely manageable is due to the extremely high level of concessional finance across its entire debt portfolio, and should this balance shift, it could be at serious risk.

Lack of access to concessional finance

These considerations illustrate the importance of *concessional* funds for SIDS. While some SIDS benefit from continued access to concessional finance from the MDBs under the small states exception, some do not. This includes Antigua and Barbuda and Jamaica within the case study cohort. For Antigua and Barbuda, this exclusion comes *in addition to* its exclusion from eligibility for ODA on GNI per capita grounds. It relies exclusively on non-concessional debt to finance fiscal deficits and to fund development. Across SIDS as a whole there has been a shift towards non-concessional external debt over recent years, with 74% of debt owed to multilateral and bilateral creditors by SIDS on non-concessional terms in 2022. Given the high levels of vulnerability of SIDS' economies, it is fair to ask whether credit on commercial terms is really the most appropriate form of financing.

The reliance on borrowing is also a symptom of the international community's failure to provide sufficient grant resources to SIDS, combined with widespread complaints that accessing climate finance funds is slow and difficult. To date, SIDS have accessed only \$1.6 billion in funds from the Green Climate Fund (GCF), equivalent to 12% of the GCF's total project portfolio (GCF, 2024). With the international community increasingly placing a heightened focus on climate-resilient projects and a transition to renewable energy, the reality is that many of these costs are being borne by developing country governments, which have made little to no contribution to global climate challenges but are being financed by external loans.

For those countries that do maintain access to concessional finance from the MDBs, the shift towards a larger share of multilateral debt in countries' overall debt portfolios may seem

outwardly positive in view of its high level of concessionality, long maturities and the technical assistance that is often provided alongside it. The flip side is that these loans can often be slow to disburse, come with significant policy conditionality and, crucially, are much more difficult to restructure should a debt crisis hit. Even though current sovereign debt resolution processes are far from adequate, a country in debt distress can always seek to restructure its loans with its private and bilateral creditors should it need to. But because multilateral lenders enjoy preferred creditor status in the international financial architecture, this debt is generally excluded from debt restructuring operations, which means that the higher the share of multilateral debt in a country's debt portfolio, the smaller the benefit may be to restructuring only private and bilateral debt.

Despite recent innovations in financial instruments designed to alleviate repayment pressures and manage debt risks more effectively, they are also not a panacea.

Box 3 Limitations to current debt relief mechanisms for SIDS

Debt relief measures provided by the international community to date have mostly not served SIDS very well. Only five SIDS were eligible for the HIPC and MDRI, the most comprehensive debt relief initiatives to date (Comoros, Haiti, Guinea-Bissau, Guyana, and São Tomé and Príncipe). While many more were eligible for the recent DSSI, this initiative simply deferred debt repayments rather than cancelled them, since it was intended to provide a coordinated response to short-term liquidity challenges rather than resolve structural debt problems. Beyond these initiatives, SIDS have had to seek debt relief via the Paris Club, or on an ad hoc basis with individual bilateral or private creditors. In some cases, these treatments amounted to no more than a reprofiling of the debt and came without any debt reduction in the stock of the debt (e.g., Jamaica's domestic debt exchange of 2010 and Antigua and Barbuda's debt treatment on 'classic' terms with the Paris Club also of 2010). These approaches often proved insufficient to resolve unsustainable debt problems.

A similar 'deferral' approach is also in evidence with current 'innovative' mechanisms to manage debt more efficiently in SIDS. For example, with CRDCs, debt service is only deferred for a limited period, while interest continues to accrue. There is no cancellation of the debt, and debt repayments must resume further down the line. If deferral fees associated with these instruments are not covered by the lenders, they are also likely to be passed on to borrowers. Disaster clauses, while helpful, also will not provide countries with significant relief unless they are widely included in both new and – crucially – existing loan agreements (something that the World Bank and the Inter-American Development Bank have committed to do). Additionally, unless credit ratings agencies are more accepting of these clauses without downgrading countries, market access countries will not rush to have them included in future loan agreements. They are also more challenging when it comes to private-sector lenders,

which may opt to price the debt differently (probably upwards) based on their expectations about whether an extreme shock event is likely to materialise over the lifetime of the loan. It is also important to note that, although welcomed, the various ‘contingent credit lines’ and other emergency response windows created recently by various MDBs all create new debt liabilities for SIDS (albeit mostly concessional).

There are also challenges associated with debt-swap mechanisms, which means that the full potential of the mechanism is far from being realised, despite the international community’s various recent pronouncements in support of scaling up debt-for-climate and debt-for-nature swaps. One challenge in relation to bilateral debt swaps is the informal set of Paris Club rules, which are widely adhered to by Paris Club creditors. These place limitations on the amount of non-ODA-related debt that can be swapped and in many cases require that debtor countries have an IMF-supported programme in place to enter into negotiations. These restrictions are unfortunately leading to a ‘stalemate’ in the case of Antigua and Barbuda, which has expressed an interest in a debt-for-climate swap with some of its Paris Club creditors but does not want to enter into an IMF programme. Moreover, very few bilateral creditors have shown real appetite for these types of transactions, and to provide genuine relief would need the participation of emerging market lenders, particularly China. In relation to private debt swaps, such as those transacted recently in the marine conservation space, these have been complex operations and have required significant external technical and legal expertise at a high cost. These eat into the funds being made available for critical environmental interventions. The need to report on verified impacts over an extended period can also be very onerous for small countries.

Limitations to domestic resource mobilisation

Efforts to boost domestic revenues also have their limitations. While many SIDS recognise the importance of strengthening domestic revenues, in practice they are constrained by a number of factors, including a narrow resource base, the presence of large informal economies, a high unit cost to deliver public services due to small and highly scattered populations, and limited administrative capacities. While there has been increased focus over recent years on eliminating tax exemptions and clamping down on tax evasion and avoidance, Cabo Verde illustrates how challenging it can be to balance a desire to be seen as an attractive and competitive investment destination with a need to tax that investment appropriately. In its case, it saw tax waivers increase to 30% of revenues in 2022, up from 13.7% in 2018. However, the benefits that both state and society derive from these investments are increasingly questioned. Other countries have shown that fiscal efforts can also be derailed by large-scale disasters.

Overall, even with significant revenue effort, the scale of countries’ financing needs is so high that they cannot be expected to be sufficient to meet national sustainable development objectives.

For example, it is estimated that additional spending needs for Solomon Islands to achieve just a subset of the SDGs by 2030 (in health, education and energy infrastructure) will require an investment of around 7% of GDP annually between 2023 and 2030. Similarly, the IMF estimates that an amount equivalent to 140% of Tonga's 2018 GDP, or approximately \$671 million, will be required to deliver climate adaptation projects by 2030 if Tonga is to adapt to accelerating climate change and continue to progress towards the SDGs. In Cabo Verde, the cost of adaptation and mitigation actions is estimated at about \$2 billion over the next decade, representing approximately 6.1% of GDP a year, compared with the 3.8% that is currently set aside for this purpose.

These financing challenges are further compounded by other structural weaknesses in the economies of SIDS. For example, Fiji faces an acute problem of skilled migration, which dilutes its much-needed available *skilled* human capital. This has affected key sectors, such as health, education and tourism, and has negatively impacted Fiji's economic growth outlook, with growth essential if it is to maintain longer-term debt sustainability. In Solomon Islands, the logging industry is now in structural decline, and, without credible alternative sources of growth in the short to medium term, the prospect of relying on heightened levels of debt financing for the foreseeable future is highly likely to materialise. Fiscal pressures are also bound to increase on the back of a large youth population and a high population growth rate, where even at current levels the quality of public service delivery is inadequate. On the expenditure side, many SIDS have high public-sector wage bills (in Tonga, for example, public service remuneration as a percentage of domestic revenue has sat at around 64% of revenues since 2011), but these are not easily reduced in light of the state's role as employer of last resort. Therefore, development projects often bear the weight of fiscal retrenchment, affecting economic growth prospects.

The pressures to increase government spending to meet essential social needs as well as ramp up capital investment and respond effectively to shocks means that there are often short-term political incentives to over-borrow even where it is clear this would put debt sustainability at risk. These concerns make public debt transparency and accountability incredibly important.

The case studies, however, reveal very different public disclosure regimes when it comes to the availability of comprehensive information about public debt liabilities.

Box 4 Transparency and accountability in debt information

A lack of transparency can exacerbate debt vulnerabilities in SIDS. Although many have made efforts to strengthen public debt reporting over recent years, it is nevertheless very difficult to obtain a full and accurate picture of many countries' outstanding debt and contingent liabilities, and their terms and conditions, which makes it extremely difficult to properly assess debt risks over both shorter- and longer-term time horizons. In many cases, debtors can do much more. Jamaica is one of the better ones and is to be commended for the amount of information it publishes online on both its domestic and external debt. This information is both current and comprehensive. Others, however, are much less transparent. This includes Antigua and Barbuda and Tonga, where debt information is not routinely published by these countries' authorities. It was made available for the purposes of this research only in more limited forms. Even in the case of Jamaica, the information published on its external debt lacks key information, such as the amounts owed to individual bilateral creditors and the terms and conditions of those loans. It is important to note, however, that *creditors* also shoulder responsibility for this lack of transparency, as some have insisted on confidentiality clauses. For example, China has become the most important bilateral creditor to several case study countries, but the terms and conditions of most of its loans are not known (Gelpern et al., 2021). The problem is that this opacity compromises public accountability in both debtor and creditor countries, and it can undermine attempts to reinforce responsible lending and borrowing practices.

Overall, the achievements of SIDS to maintain debt at sustainable levels, including across the case study countries, should be applauded in light of the many formidable challenges they face. The international community has also taken some new measures over recent years. On balance, however, it is clear that downside risks prevail for most, due particularly to increasing climate-related risks. With this in mind, are there any other *additional* measures that can be identified that could help to tilt the balance of risks in the opposite direction? What else can be done to help SIDS achieve resilient prosperity?

4 Making the international financing architecture work for SIDS

SIDS want to build the climate-resilient, climate-friendly, high-skilled, competitive economies of the future. The dividends, moreover, of doing so will be extremely high. For example, according to the IMF, the benefits of making 80% of Antigua and Barbuda's infrastructure resilient to climate change would amount to about 13% of GDP.¹⁸ Such investment creates positive spillovers; forgoing it will lead to stagnation, compounding existing vulnerability. But these ambitions cannot be fulfilled under a business-as-usual financing scenario. International organisations have a responsibility to revise their policies and practices to better serve SIDS as equal member states. They need to properly account for the constraints of smallness and vulnerability to external shocks. Bold action is needed to revitalise small island economies and put in place reforms that will support SIDS to finance sustainable development and manage their debt sustainability.

Creditors are keen to emphasise that they are doing more for SIDS than in the past and have made progress over recent years to be more responsive to their distinctive economic needs. This is undeniably true and welcome, but insufficient, as this report demonstrates. Drawing on the global analysis of debt conditions in SIDS and six case studies, a series of practical policy recommendations can be identified that would help SIDS to manage debt sustainably. Some recommendations can be taken forward relatively easily, within the existing institutional constraints faced by donors and IFIs. Others may require more fundamental reforms in the international debt architecture, as well as the assumptions underpinning it, and may face some obstacles and resistance. Further research and feasibility analysis are needed to fully operationalise this agenda and develop the necessary advocacy strategy to sustain it.

4.1 Immediate actions

There are a number of actions that can be taken which do not require significant institutional reform or further research to put into motion. They can therefore be implemented without delay.

4.1.1 Improving access to affordable climate finance at scale

Exposure to intensifying climate risks may increase the cost of capital for many SIDS in the future, despite the fact that they contributed little to the climate crisis. In fact, that crisis – and the very real shocks that they experience viscerally and with greater regularity – is a direct result of the accumulated emissions generated by centuries of industrial expansion elsewhere.

18 IMF, 2023 Article IV Consultation, Antigua and Barbuda.

Grant resources for resilience and recovery in SIDS must be made available at speed and scale in light of historical injustices. Specifically, SIDS have long called for affordable, easily accessible resources that will support development, build resilience and transform their economies. Access to climate finance has, however, proven too slow, and development finance comes at a high cost. This situation is evidently not sustainable.

Grant financing needs to be significantly scaled up for climate action, with minimum annual resource allocations for SIDS. Multilateral climate funds need to drastically simplify their approval processes and instigate minimum allocations for individual countries that are particularly vulnerable, so that they are able to access these funds at speed and scale.¹⁹

This report also recommends using loans sparingly for adaptation in SIDS, and only those with interest rates and maturities that correspond to their vulnerable situation. The international community can support SIDS to secure lower-interest, more affordable private financing by issuing guarantees and other forms of credit enhancement. This will also help those SIDS that are not in debt distress but face increasingly high costs of capital due to climate risks.

4.1.2 Scaled-up use of CRDCs in loan contracts

The recent expansion in the use of CRDCs, particularly by several of the major MDBs, is seen as a welcome development, and these clauses are particularly relevant for small, vulnerable countries. At the same time, there are some concerns that such clauses are likely to have a limited impact where only a small fraction of a country's creditors incorporate such clauses into their loans and where they apply to *new* debt only. In response, the Inter-American Development Bank and the World Bank have recently announced they will broaden the scope of such clauses to cover old loans, not just new ones. However, more can be done to maximise the potential of this instrument.

Given the large increases in multilateral debt seen in many SIDS over recent years, MDBs that have not yet announced their intention to incorporate such innovations into their lending should explore how they can offer these clauses, including what would be needed to protect their balance sheet. At the same time, very few bilateral lenders offer this type of feature in their loan agreements, and they should explore how they can do so. Where possible, they should apply them retroactively to existing loans to enable SIDS to prioritise disaster recovery over debt repayments when disaster strikes. To be true to the spirit of these clauses, lenders should also bear any costs associated with these deferments and commit not to pass them on to borrowers.

19 The authors note that this recommendation is simultaneously one that can be actioned quickly but may also represent a medium- or long-term shift. The OECD revises ODA eligibility criteria once every three years, and the MDBs also have their own review processes on eligibility for different forms of financing. So there are evidently medium-term actions that matter here, but there is much that can be done quickly to unlock finance needed for resilience in SIDS.

4.1.3 Maximising the potential of debt swaps

Debt-for-climate swaps could represent an innovative tool for debt restructuring and to scale up investment in nature and climate resilience in SIDS, but so far few have opted to use them. Some stakeholders remain highly sceptical of debt swaps due to factors such as the time and complexity of these operations relative to the eventual size of the benefit. If debt swaps are to be a genuinely useful tool to support sustainable development, then a different approach is needed.

Currently, very few bilateral creditors actually offer debt-swap instruments, so they will not have a meaningful impact on the fiscal space of SIDS. Multi-creditor debt swaps have more potential, and bilateral creditors should explore opportunities for collaboration on debt swaps in partnership with SIDS and specialised organisations. Informal rules governing bilateral debt swaps, which are implemented in the framework of the Paris Club, are also limiting the potential of bilateral debt swaps. This includes the 20% cap on non-ODA-related credits that can be swapped and the requirement by some MDBs that an IMF programme should be in place. For debt-swap transactions to be effective, more bilateral creditors would need to participate, and greater flexibility is needed. Greater transparency is needed around the terms and conditions of all swaps, to assess whether they are in the best interests of the debtor nation.

The development of debt swaps could usefully learn from recent successes in the conservation space, where guarantees issued by MDBs and development financial institutions (DFIs) have enabled SIDS to issue new debt more cheaply in exchange for the savings being invested in pre-agreed conservation interventions or other development areas. To reduce concerns about the time it takes to process transactions, the elevated costs of legal and technical expertise and the capacities of SIDS to engage, stakeholders in these operations should commit to developing and sharing key resources and best practices to help reduce transaction costs and enable more countries to evaluate whether these approaches are appropriate for them.

4.1.4 A debt sustainability support service for SIDS to build capacities

Many SIDS lack the capacity to understand and model the impacts of climate-related risks on public finances, or negotiate the terms of new financing and investment or debt restructuring terms when debt distress arises. They pay considerable amounts to external advisors to support them in situations such as these. Improved domestic capacities in the legal, finance and insurance areas to manage these situations could yield far-reaching dividends.

A new debt sustainability support service facility for SIDS is currently being developed by a coalition of SIDS and international partners, coordinated by the International Institute for Environment and Development (IIED) (see Bharadwaj et al., 2023) and endorsed in the SIDS4 outcome document. This initiative has the potential to be beneficial to SIDS in several ways, including supporting them in negotiating better terms in debt and investment agreements and mobilising increased ex ante disaster finance for post-disaster rebuilding and resilience. A key

service offer for SIDS could be closed-door, private, impartial and trusted technical, financial and legal advice for SIDS seeking to navigate various debt and investment situations to ensure they can obtain the best deal(s) possible, as well as understand new innovations in the market. It could also act as a forum to learn from peers. The Pacific Region Infrastructure Facility, which provides impartial technical and financing advice to help improve the quality of infrastructure in the Pacific, and the African Legal Support Facility have proven a success and show the essential role that a similar initiative could play for SIDS. The international community should commit sustained resources to enable it to carry out its mandate and ensure it is a success.

4.1.5 A debt transparency compact

Opacity undermines public accountability and can undermine debt sustainability. Both debtors and creditors share in the responsibility for improving the public disclosure of debt information, including contingent liabilities. Given that lending to sovereign states is meant to further the public interest, and loans are repaid through taxpayer (public) funds, there are strong public policy arguments as to why the terms of sovereign lending should be made public in most circumstances. Many civil society organisations are calling for some form of independent global debt registry to be established, which should contain timely and readily accessible debt data at the individual loan level. SIDS and their creditors have an opportunity to show leadership in this area. SIDS can also work to strengthen domestic legal and institutional frameworks for public debt management, which would support greater transparency.

4.2 Medium-term actions

Some measures will require further research or changes to institutional policies in order to operationalise. They can therefore be considered medium-term actions. The sooner work commences on these suggested actions, the sooner SIDS can benefit from an improved ‘SIDS-positive’ international financing architecture.

4.2.1 Using vulnerability criteria in eligibility and allocation decisions for concessional finance and debt relief

SIDS continue to emphasise that income per capita is an inadequate measure of development, particularly in small countries (see Bishop et al., 2021; 2023), and that eligibility for concessional finance must take into account vulnerability metrics. Regardless of their levels of GNI per capita or the specific contours of their vulnerability (including high reliance on a narrow range of outward-facing export sectors), all are highly vulnerable to external shocks. And regardless of their success in resilience-building, all face intensifying shocks of a disproportionate scale that can instantly undermine developmental progress and increase the costs of borrowing and debt burdens. These impacts will intensify with accelerating climate change; for some small islands the climate crisis threatens their very existence as viable states.

Many bilateral and multilateral donors are sympathetic to these kinds of arguments and have on occasion offered higher-income SIDS concessional resources on an exceptional basis. But these ad hoc accommodations by individual lenders are not codified and therefore not guaranteed.

Arguably, all SIDS should be eligible for ODA and debt relief, and fund allocations and debt relief and restructuring instruments should target this group of countries. Making more concessional resources available can reduce the debt burden, create fiscal space for investment in resilience and help to break the cycle of debt in SIDS. Application of the UN's Multidimensional Vulnerability Index (MVI) in the eligibility rules and allocation decisions of concessional funds would be one way of achieving this. Approximately 70% of SIDS are in the top 50% of most vulnerable countries (above the median) according to the MVI scores. But the MVI also has its challenges, including in the choice of indicators: some non-SIDS emerge as being more vulnerable than SIDS, while arguably their challenges are not 'structural'. More broadly, as international development finance is limited, and application of the MVI can result in resources being diverted away from poorer but less vulnerable countries, there has been pushback from larger developing countries, so further work is needed to advocate for the special circumstances of SIDS being actively recognised in international development finance and debt decisions.

Another way to improve access for SIDS to concessional finance and debt relief would be to better take into account countries' debt risks over medium- to longer-term time horizons. Debt sustainability analyses carried out by the IMF and the World Bank focus largely on short-term debt sustainability risks (1–3 years), but if they improved modelling of long-term debt risks, including climate risks, the picture is likely to shift dramatically for many SIDS. This could be used to guide decision-making on the most appropriate forms of financing for a country to preserve debt sustainability.

Technical work is needed to explore how this approach could be operationalised. In the meantime, development partners can demonstrate leadership by incorporating vulnerability criteria in their aid allocation decisions and sharing the results of doing so with the international community to draw lessons learned on different approaches.

4.2.2 Going 'above and beyond' CRDCs to have a real impact

Debt restructuring is costly, uncertain and frequently happens at a glacial pace. Countries can also be concerned about their continuing access to capital markets. It is, therefore, a path that authorities are often reluctant to pursue. From a public accountability point of view, these operations are also secretive and lack transparency. While debt pause clauses have their place, a strong case can also be made that large qualifying disasters or emergencies should lead to the automatic cancellation of debt, as opposed to the simple deferral of debt service. The case studies show that 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 an actual haircut on the stock of debt when there is a qualifying shock. A simple mechanism could be conceived whereby all bilateral and multilateral creditors automatically provide debt service cancellation for a period of three to five years following a qualifying disaster.²⁰ In contrast to a debt pause clause, this debt service would not be deferred but would be written off by official sector creditors. Designed in this way, the mechanism would provide a simple, rapid, automatic, transparent and predictable way to increase the fiscal space of SIDS in times of crisis, and because it would be built into bilateral and multilateral loan contracts, it would be unlikely to trigger a negative market reaction, an important consideration for market access by SIDS. To be as impactful as possible, and in light of the heavy multilateral debt loads of many SIDS, all official creditors would need to participate, including multilateral lenders. While evidently ambitious, there is a precedent for this kind of approach. Under the IMF's Catastrophe Containment and Relief Trust, debt service owed to the IMF can be cancelled where a low-income country faces a qualifying disaster or public health disaster (such as Ebola or COVID-19). The initiative is supported by donors but underfunded.

The rationale for including debt forgiveness for qualifying events in loan contracts with SIDS is clear, but creditors have voiced concerns that the costs of such an approach could be too high (and unknowable). Multilateral lenders would need to be reimbursed for any losses to enable them to preserve their AAA rating. Many are nevertheless sympathetic. However, as SIDS are relatively small borrowers in absolute terms, concerns about costs to individual lenders are probably overstated.

Looking forward, further research and modelling are needed to quantify the potential impact of debt forgiveness clauses under various scenarios, develop triggers, look at how cancellation should be counted, and assess the potential benefits in terms of liquidity, debt management and longer-term sustainability. Further work would also be needed on the possibility of including private debt.²¹

4.2.3 Wider reforms in the global debt architecture

The global debt architecture is clearly not working for SIDS and other vulnerable countries, and reforms are needed to avert widespread debt distress. Key improvements have been proposed and endorsed by many SIDS, including the regular issuance of special drawing rights (SDRs), enhanced debt transparency by both creditors and debtors, and the need to put in place well-developed rules for automatic, fair and orderly sovereign debt restructurings.

20 In the event the disaster is non-qualifying, countries would still benefit from support under CRDCs.

21 A strong argument exists that private creditors should also be subject to similar haircuts, because a debt cancellation mechanism that only applies to bilateral and multilateral lenders would appear to favour private ones unduly. For one thing, there would be an unfair distribution of risk and reward. For another, that distribution of risk would ultimately be underwritten by taxpayers in donor states, representing an implicit public subsidy to private interests.

While these issues are firmly on the international policy agenda, SIDS are not typically represented in many of these discussions. For example, while attempts have been made to improve the Common Framework, SIDS were largely left out. This may be changing, however. At the 2024 World Bank and IMF Spring Meetings, the Vulnerable 20 (V20) Group of 68 climate-vulnerable developing countries made a series of demands, including extending the Common Framework to middle-income countries so that ‘debt relief is directly commensurate with climate change and development investment needs’ (see V20, 2024). This agenda will likely develop under the energetic leadership of Prime Minister Mia Mottley as Barbados assumes the presidency of the Climate Vulnerable Forum and V20 Finance Ministers. It could also be taken up at the UN’s Fourth International Conference on Financing for Development in 2025.

The issues and challenges facing SIDS are not new, and neither are their demands for debt reform; but there is an opportunity now, as a new 10-year agenda for SIDS is established, to ensure they have an equal voice in decision-making and changes in the global debt architecture are fully responsive to their needs and special development situation.

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