

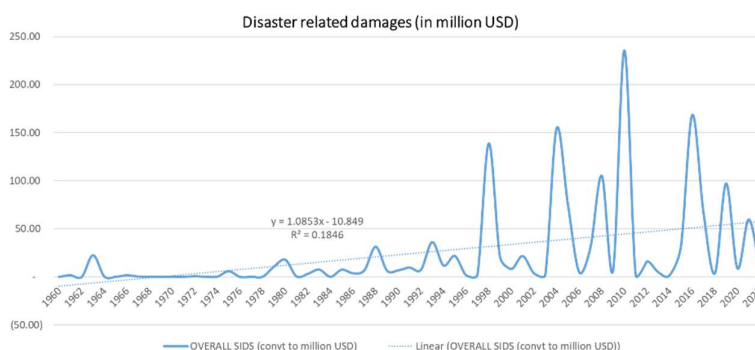
SIDS Debt Sustainability Support Service: A comprehensive framework for shaping resilient prosperity in LDCs and other developing countries

- Ritu Bharadwaj¹

Small Island Developing States (SIDS), while diverse in many respects, share a complex set of social, environmental and economic challenges. These challenges stem from their inherent characteristics: limited populations and confined land areas, widespread geographical separation, and often significant distances from key global markets. For many SIDS, majority of the natural resources they access come from the ocean. Their narrow resource base compels them to rely heavily on external markets for many goods. Many SIDS grapple with high import and export costs because of this, which also makes them susceptible to sudden global economic and political crisis. But these vulnerabilities get further compounded by increasing intensity and frequency of climate change impacts. Many SIDS are situated in areas prone to tropical cyclones, and their remote locations and small economies hinder their ability to cope with these events. The vulnerability of those islands whose elevation is only five meters or less above sea level is heightened by the predicted rise in sea levels, posing an existential threat.

1. Vulnerability of SIDS to climate impacts²

The data for SIDS shows an increasing trend of disaster intensity and frequency. The number of high-intensity disasters affecting SIDS have increased in the last three decades, with a 300% increase in 2012 and a 133.33% increase in 2020. A closer examination of disaster-related damages in SIDS reveals a worrying trend. Since 1960, there has been a consistent increase in the economic costs of disasters, with a noticeable escalation starting in the mid-1980s (see figure 1).



(Source: Authors' calculation based on the EM-DAT database)

Figure 1. Disaster-related damages in SIDS in Million US\$ (1960-2022)

While the absolute financial losses from these disasters may appear small compared to those in larger countries, the relative impact on SIDS economies is immense. A single disaster can be catastrophic, wiping out essential industries, impacting entire islands, or destroying vital infrastructure. SIDS make up two-thirds of

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² The analysis presented in this section is drawn from Bharadwaj, R., Mitchell, T., Karthikeyan, N. and Kumar, B. (2023). Sinking islands, rising debts: urgent need for new financial compact for Small Island Developing States. IIED, London. <https://www.iied.org/21606iied>

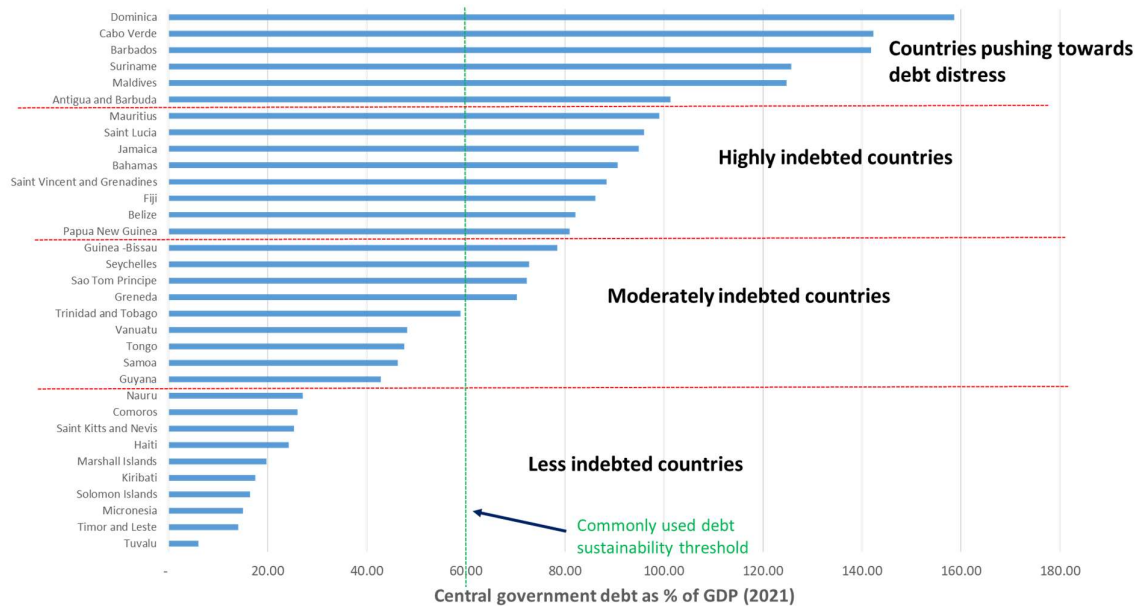
countries that experience the highest relative annual losses from natural disasters, ranging from 1% to 9% of their GDP³.

Impact of climate on debt profile

The International Monetary Fund (IMF) conducts Debt Sustainability Analysis (DSA) to assess a country's ability to meet its current and future debt obligations without needing drastic measures such as debt relief or significant balance of payments adjustments. The analysis covers key indicators, like **the debt-to-GDP ratio**, **fiscal deficit**, **external debt**, and **tax revenue volatility**. We analysed these indicators for 33 SIDS for which most recent debt data was available to understand the impact of climate disasters.

Debt to GDP ratio: The debt-to-GDP ratio is a critical measure of a country's ability to service its debt, especially in SIDS, where climate change exacerbates economic challenges. Climate-induced damage leads to increased borrowing while harming vital sectors like tourism and agriculture. A high debt-to-GDP ratio can indicate a looming debt crisis, particularly in SIDS, where the effects of climate change are sudden and severe.

Post-disaster, SIDS face compounded costs for reconstruction and humanitarian aid due to the need to import materials and logistical challenges. This increases their debt burden, as they repeatedly borrow for rebuilding. Furthermore, adapting to climate change requires significant investments in protective measures, further increasing their borrowings. Long-term environmental changes also harm economies reliant on agriculture and tourism, adding to debt challenges. Global shifts related to climate change, such as altered trade patterns or new regulations, further complicate debt management. In Figure 2, we show a categorisation of SIDS based on our assessment of central government debt as a percentage of GDP.



(Source: Authors' calculation based on The World Bank's International Debt Statistics <https://www.worldbank.org/en/programs/debt-statistics/ids>)

Figure 2. Classification of SIDS-based central government debt as a percentage of GDP

According to our analysis, more than 40% of SIDS are either highly indebted or are pushing towards debt distress, and overall, 70% are above a debt sustainability threshold of 40% debt-to-GDP ratio. Even if we consider a 60% debt-to-GDP ratio as the debt sustainability threshold, close to 60% of countries are above it, an alarming situation for SIDS.

External debt: SIDS often rely on external borrowing to finance development and respond to shocks. From 2011 to 2019, SIDS' average external debt fluctuated between 48% and 51% of GNI, revealing a consistent reliance on external sources of financing. The consistent proximity to the 50% threshold highlights a precarious fiscal position that can be easily tipped into distress by external shocks or changes in global economic

³ UNISDR (2017) Developing Risk Assessment to Support Sovereign Risk Financing and Risk Transfer.

<https://www.undrr.org/publication/developing-risk-assessment-support-sovereign-risk-financing-and-risk-transfer>

conditions, such as climate events, commodity price fluctuations, and shifts in global trade and finance. To further understand the impact of climate disasters on the SIDS' external debt, we examined the correlation between disaster intensity and external debt levels by comparing two distinct periods: Period I (2007-09) of minimal disaster intensity, and Period II (2020-21) of high disaster intensity. The mean external debt of SIDS increased to 58.50% in high disaster intensity period from 45.37% in low disaster intensity period.

Fiscal deficit: The fiscal balance of a country plays a pivotal role in determining its financial health. The fiscal balance can manifest either as a surplus, when revenue exceeds expenditure, or as a deficit, when the opposite occurs. The fiscal balance as a percentage of GDP in SIDS increased to -4.53% in Period II (2020-21) of high disaster intensity from an average fiscal deficit of -2.83% in Period I (2007 to 2009) of minimal disaster intensity, which underscored the trend of worsening fiscal balance during years of high disaster intensity.

Coefficient of variation (CV) of fiscal balance represents standard deviation from the mean fiscal balance, expressed as a percentage. A high CV indicates potential volatility in government revenue and expenditure. Our analysis shows that the CV of fiscal deficit in SIDS is approximately 2.87 times higher than that in LDCs and approximately 1.90 times higher than that in other countries. This situation for SIDS is concerning because high levels of debt can make it difficult for a country to spend money on essential services like healthcare, education and infrastructure.

Tax revenue volatility: Tax revenue volatility refers to fluctuations and unpredictability in the collection of taxes over time. Our analysis of its correlation with disaster intensity showed a strong positive correlation of 0.61 for SIDS. In comparison, LDCs showed a correlation of 0.48 and other developing and developed countries showed the weakest correlation of 0.40, highlighting that disaster intensity has a lesser impact on tax revenue volatility in most developing and developed economies.

Private debt and climate impacts: Private debt often comes at a higher interest rate. Our analysis shows that in the earlier years, specifically in 2000s, the private debt of SIDS was relatively low, averaging around 6.47% of GDP. However, by the 2020s, this average rose substantially to 35.85% of GDP. The private external debt was seen to increase in the years of major disaster or in the years after that.

But the implications of this debt situation are not merely financial. Countries faced with debt crisis become constrained on expenditure in other crucial areas of development and resilience-building. Investments in social protection schemes, which provide considerable safety nets to communities in the face of climate risks, often takes a backseat. Moreover, Sustainable Development Goals (SDGs), which aim to address a range of challenges from health to education to environmental protection, can become increasingly unattainable for debt-ridden SIDS. Funds that could be channelled towards these goals are instead being diverted to service mounting debts. The repercussions of this can be profound, leading to increased poverty rates, widening inequality and social unrest.

2. A way forward: Building fiscal resilience in the face of the climate crisis

For the SIDS, breaking free from this vicious cycle is not just an economic imperative but a question of survival. The interconnected challenges of climate change and debt require a concerted, multifaceted response. The United Nations General Assembly, through a new 10-year programme of action for SIDS, entitled the Antigua and Barbuda Agenda for SIDS (ABAS), endorsed the creation of a Global SIDS Debt Sustainability Support Service (DSSS) with the goal of supporting SIDS in executing a new financial compact for resilient prosperity⁴.

The design of the DSSS⁵ was carried out by the Strategic Advisory Group (SAG) under the co-chairmanship of H.E. Prime Minister Gaston Browne of Antigua and Barbuda and H.E. President Dr Mohamed Muizzu of the

⁴ United Nations (n.d.) Fourth International Conference on Small Island Developing States The Antigua and Barbuda Agenda for SIDS (ABAS) – a Renewed Declaration for Resilient Prosperity. <https://sdgs.un.org/sites/default/files/2024-04/SIDS4%20-%20Co-Chairs%20FINAL%20%281%29.pdf>

⁵ Detailed design document of SIDS DSSS can be accessed here Bharadwaj, R. (2024). *Global Small Island Developing States (SIDS) Debt Sustainability Support Service: a new financial compact for resilient prosperity*. IIED, London. <https://www.iied.org/22426iied>.

Analysis presented In this section has been drawn from the design document

Maldives. The SAG also includes representatives of World Bank, Asian Development Bank, Caribbean Development Bank and United Nations Economic Commission along with international groups and local organisations, sustainable investment firms, finance experts, credit institutions, insurance and risk management and research institutions.

Components of Global SIDS Debt Sustainability Support Service

The Debt Sustainability Support Service has four interconnected elements (see Figure 3):

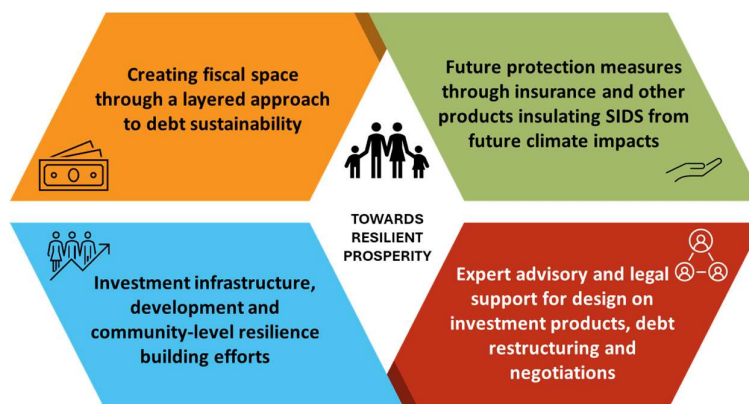


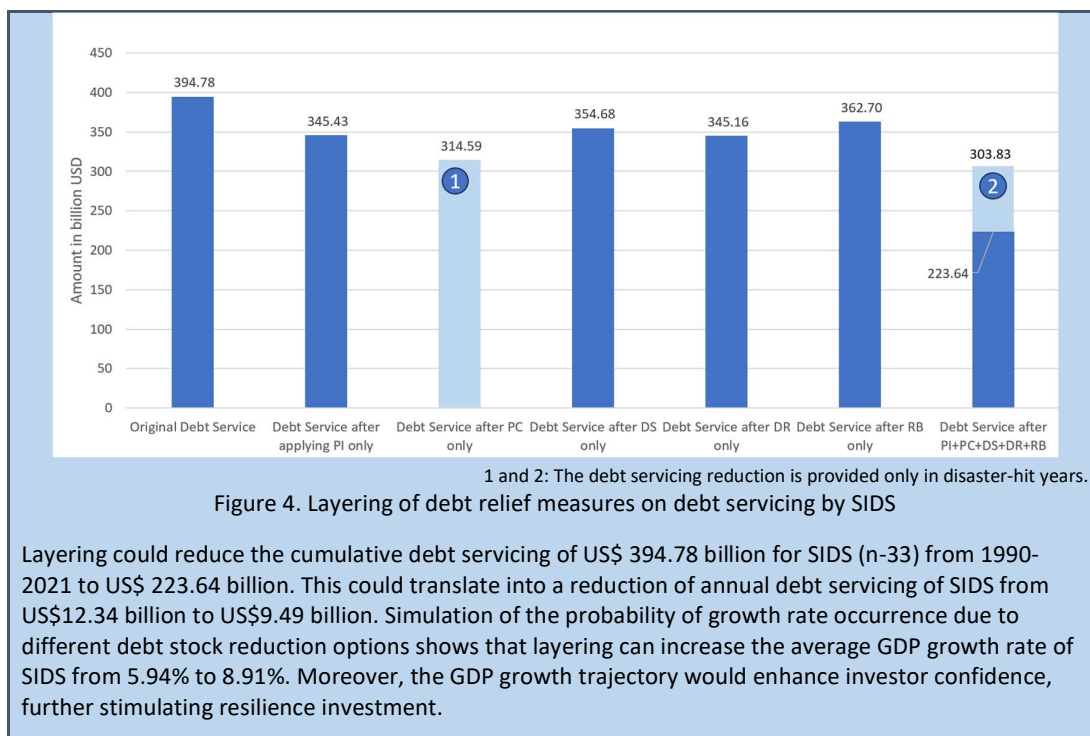
Figure 3. Four interconnected components of the Global SIDS Debt Sustainability Support Service

- (i) **A layered approach to debt sustainability:** This will involve designing multi-layered debt sustainability strategies that combine contingent clauses, parametric insurance, debt restructuring and debt swaps. The approach will be tested through simulation models to assess its impact on debt servicing and overall debt stock with the view to creating fiscal space for resilience investment. It will build on existing efforts to improve debt management and data availability in SIDS, as well as efforts to change the way debt sustainability analysis is structured and applied.

Box 1. The rationale for a layered approach to debt sustainability

When a country is hit by a climate disaster, different types of funding support are needed to help it recover from both climate and debt crises. Funding needs can typically be divided into three phases: immediate relief and support, medium-term recovery and longer-term resilience building. Lack of support in any of these phases can negatively impact the population and the economy, undermine their capacity for coping with such disasters in future and push countries into downward spirals of debt. SIDS need financial assistance in all three phases of post-disaster recovery to allow them to adequately prepare, cope and recover from recurring climate shocks.

To date, no existing debt relief measures have adequately met these needs and helped countries get their economies back on track after being hit by a disaster or series of disasters. Therefore, a combination of debt relief packages would work best in restoring solvency and covering their recovery needs over the short, medium and long term. The impact of such a layering approach of debt relief measures on the debt servicing for SIDS is presented in Figure 4 below.



- (ii) **Future protection measures:** The increasing frequency and intensity of climate-related events pose a continuous threat to the economies and livelihoods of SIDS. SIDS have repeatedly faced devastating economic setbacks due to climate-related disasters. The damages inflicted by a single extreme event have, in some cases, surpassed the affected nation's annual GDP. These shocks have not only reversed developmental gains but also strained their financial capacities, limiting their ability to rebound effectively. Without a more long-term protective measure in place, SIDS will remain precariously exposed. So, along with support for creating fiscal breathing space after such disasters through debt relief, the Support Service will work towards immunising SIDS against future climate-induced financial shocks through insurance and other protective measures. This is designed to be achieved through an integrated approach that combines insurance with other funding mechanisms that help cover the losses from events, including those that are beyond insurable limits, through a guarantee or coverage against economic losses beyond a predetermined threshold.

Box 2. The rationale for the future protection measures

By establishing such a protective mechanism, SIDS could ensure a cap on potential economic damages, introducing a layer of financial predictability amidst the uncertainties of climate change. Post-disaster payouts through insurance and other protection mechanisms would ensure that the economic growth of SIDS is not constrained and they are not pushed into debt due to financial recovery efforts. Moreover, this protective measure would instil confidence, both for potential investors and the community. It will act as a safety net to foster a sense of security and stability, crucial for the future socio-economic wellbeing of SIDS.

Figure 5 shows the cost of parametric insurance to cover SIDS' annual disaster losses at 5% and 20% Loss Exceedance Probability (LEP) to cover 20%, 50% and 100% of the loss and damage value. This analysis is based on the loss and damage to GDP suffered by SIDS in the last 30 years.

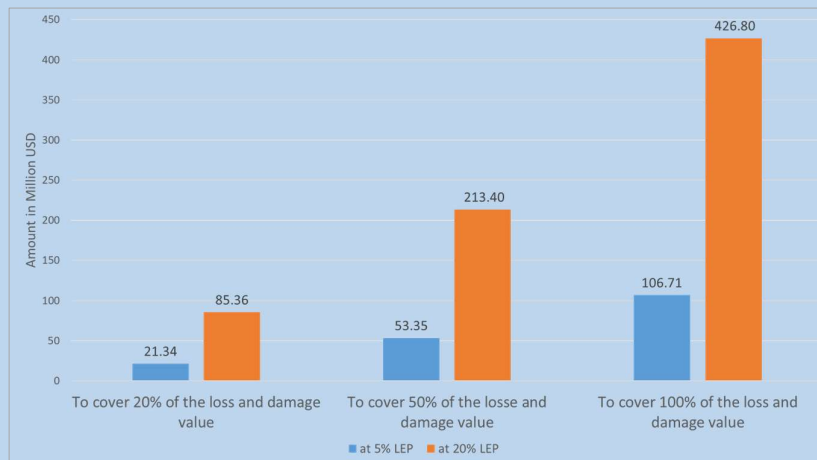


Figure 5. Cost of parametric insurance to cover SIDS' annual disaster losses

The benefit of covering the cost of providing protection against such losses would far outweigh the debt default and the costs of debt restructuring that would need to be undertaken later if such support is not provided.

- (iii) **Resilience investment:** For SIDS, the challenge of climate adaptation and resilience is existential and is exacerbated by the need to manage economic and natural disaster shocks. Investments in infrastructure, development and community-level resilience-building efforts can fortify SIDS against future challenges, ensuring they not only survive but thrive in the face of global challenges. These investments would involve identifying opportunities for issuing resilience bonds, blue or green bonds aimed at funding climate resilience initiatives, while also exploring new solidarity-based resilience finance mechanisms.

At their core, these bonds offer direct financing for initiatives aimed at bolstering resilience to climate-induced impacts. This ranges from funding the establishment of robust infrastructure, such as storm-resistant housing and sea walls, to backing sustainable endeavours like renewable energy projects, reforestation efforts or biodiversity conservation. Resilience-building investments like these can help SIDS manage the immediate impacts of climate change and also pave the way for sustainable economic growth.

From an investment perspective, introducing these bonds would diversify the financing toolkit available to SIDS, offering an alternative to traditional loans or aid. This can alleviate some pressure from their already-strained budgets. Introducing resilience bonds will be combined with existing measures to support access to climate finance for SIDS and build on MVI in offering SIDS improved terms.

- (iv) **Advisory and legal support:** In the rapidly evolving global finance landscape, SIDS may find themselves at the intersection of vulnerability and opportunity. Many SIDS have limited capacity when it comes to navigating the intricate world of debt restructuring, credit agency negotiations and the broader financial ecosystem, which puts them in a disadvantageous position. The intricacies of international finance and debt negotiations, compounded by the nuanced economic and environmental challenges facing SIDS, often tilt the balance against them, resulting in less favourable terms or missed opportunities.

Increasingly, SIDS are also engaging with private creditors, who now hold a significant portion of SIDS debt. Private creditors often employ intricate loan agreements, which may contain terms that may not be immediately clear or favourable to the countries involved. For many SIDS, the fine print and long-term implications of such contracts are hard to decipher, given their limited expertise in this field.

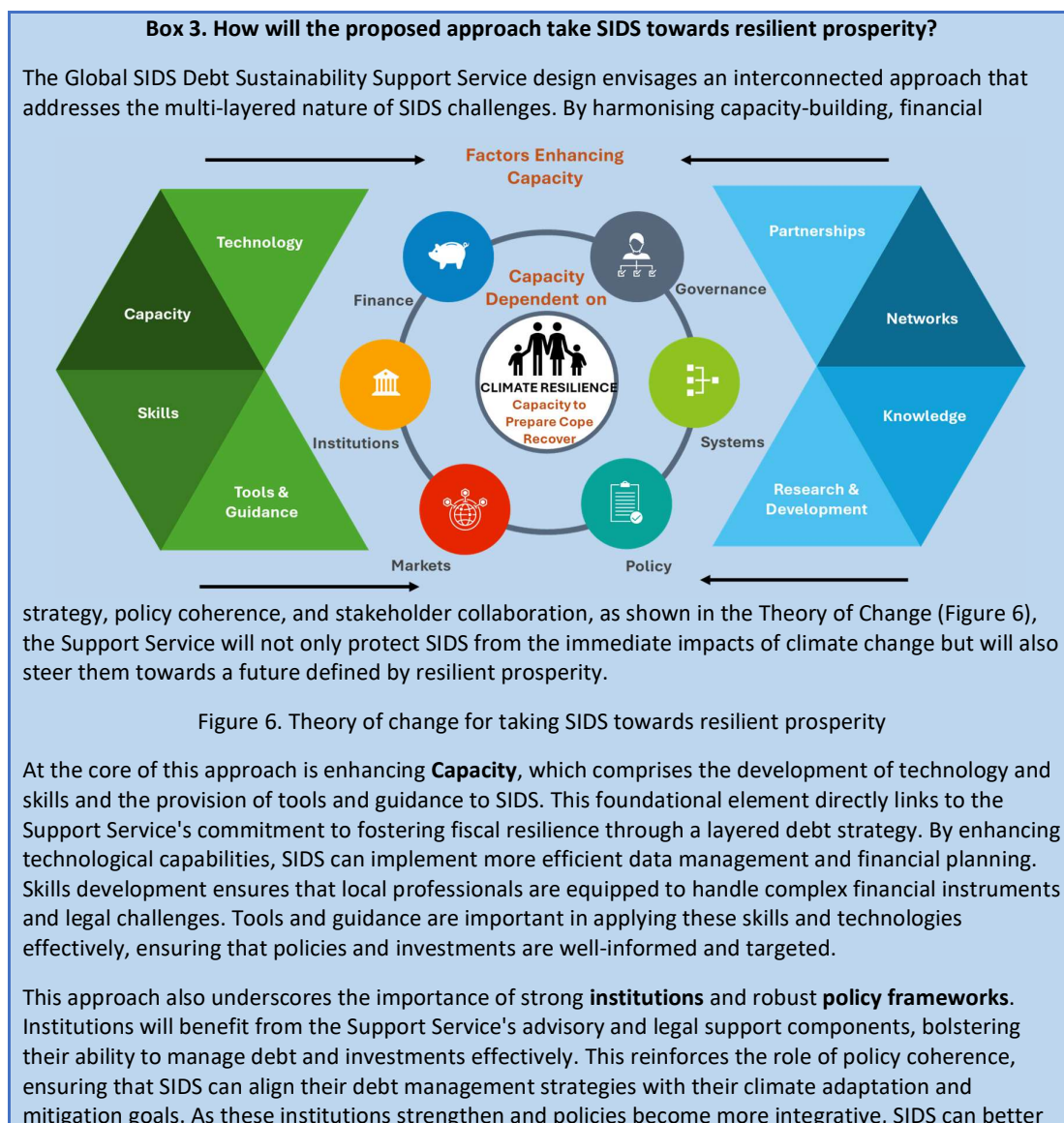
This component will aim to offer specialised legal and commercial negotiation support to SIDS. It will also focus on building long-term legal and commercial capabilities within SIDS and regional hubs, equipping them with the skills and knowledge needed to navigate legal and commercial issues.

Governance, monitoring and operational arrangements

Given the diversity among SIDS – each with its unique set of resources, vulnerabilities and developmental goals – a one-size-fits-all solution cannot effectively address the varied challenges and needs of different countries. Accordingly, a flexible, tailored approach to the governance and delivery of the Support Service has been proposed so that it is adaptive and capable of being customised to meet the specific needs and aspirations of diverse SIDS and ensures that every nation can access the support needed to help them meet their targets for resilience and prosperity. The governance of the DSSS will be inclusive, transparent, adaptable, and collaborative. A Secretariat, supported by regional mechanisms, will cater to the specific needs of the Caribbean, Pacific, and AIS regions.

The DSSS will provide equitable access and high-quality services across all regions. A regional mechanism will ensure accessibility, offering multilingual resources and flexible application methods.

- Services will be tailored to regional needs, ensuring all SIDS can access support.
- Regular evaluations, stakeholder feedback, and continuous monitoring will uphold service quality and responsiveness.
- Clear reporting and feedback loops will ensure fairness and alignment with SIDS' priorities.



access and utilise **finance** options tailored to their needs, such as the suggested resilience bonds and risk-pooling insurance measures. The financial strategies developed through the Support Service will help SIDS manage and recover from climate impacts, preventing catastrophic economic losses and promoting sustainable growth.

Partnerships and **governance** structures, as depicted in the Theory of Change, are vital in linking the Support Service's aims with tangible outcomes. Stakeholder engagement and coordination enhance the collective efficacy of resilience measures. By advocating for equitable premium payments and utilising innovative risk modelling, the proposed approach aligns with the principles of shared responsibility and mutual benefit, which are key to resilient prosperity. Finally, **research and development** facilitated through the Support Service ensures that SIDS can make evidence-based decisions, fostering an environment where climate resilience is continuously improved through innovation and learning.

3. How can the DSSS be expanded to Least Developed Countries (LDCs) and other developing countries – Recommendations for FFD4

The Debt Sustainability Support Service (DSSS) for SIDS offers a comprehensive, multi-layered approach to managing debt and resilience investments in the context of climate vulnerability. However, the framework is equally applicable to LDCs and other developing countries, which face similar interconnected challenges. Expanding the DSSS to other developing countries would offer multidimensional solutions that address their unsustainable debt while simultaneously enhancing climate resilience.

Shared vulnerabilities

Like SIDS, LDCs and number of developing countries are highly vulnerable to climate change impacts, natural disasters, and economic shocks, all of which contribute to their growing debt burdens. Many LDCs rely heavily on agriculture and resource extraction, sectors that are highly susceptible to climate-related disruptions like droughts, floods, and shifting weather patterns. Additionally, LDCs often face barriers to accessing global markets, exacerbating their economic instability.

For LDCs, these vulnerabilities are compounded by limited access to finance and weak institutional capacity to manage debt. According to UNCTAD's 2023 Least Developed Countries Report, six LDCs were in debt distress in April 2023, with another 17 at high risk of debt distress. Most of these challenges are structural, driven by current account deficits and reliance on volatile commodity exports. Sudden price drops reduce government revenues, making debt repayments more difficult. In 2022, LDCs had a total external debt of \$570 billion, with \$353 billion being public and publicly guaranteed debt—more than three times the amount in 2006. Many now spend more on debt interest payments than on education and health⁶.

The need for a multidimensional solution

Expanding the DSSS beyond SIDS is crucial because LDCs and other developing countries require a comprehensive solution. A multi-pronged approach to debt sustainability, incorporating debt relief, insurance mechanisms, and resilience-building investments, would give developing countries a viable path to tackle the compounded challenges they face.

An expanded layered debt sustainability strategy to include other vulnerable developing countries would combine debt restructuring, contingent clauses, and innovative financing mechanisms such as resilience bonds and parametric insurance. For example, resilience bonds could finance critical infrastructure projects like flood defences, while parametric insurance would provide immediate liquidity in response to natural disasters. These mechanisms can be customised to meet the specific needs of vulnerable developing countries, in particular LDCs, ensuring they are better equipped to respond to climate-induced, and other related shocks.

Regional flexibility and governance

To ensure effectiveness, a regional mechanism tailored to the specific needs of LDCs and other vulnerable developing countries would be necessary. The DSSS governance model could be adapted to include sub-regional hubs in Africa, Asia, and Latin America, providing locally contextualised financial solutions.

⁶ UNCTAD Least developed countries report 2023. <https://unctad.org/publication/least-developed-countries-report-2023>

Regular evaluations, continuous monitoring, and stakeholder feedback loops would help align the service with the evolving priorities of each country or region. The governance structure would be inclusive, transparent, and adaptive, offering flexibility to address the unique economic and climate-related challenges these regions face.

A path to sustainable and climate resilient development

Expanding the DSSS would significantly contribute to achieving the Sustainable Development Goals (SDGs). By addressing debt sustainability through climate-resilient financial strategies, developing countries could invest more resources into critical sectors like health, education, and infrastructure, directly advancing SDG 1 (No Poverty), SDG 13 (Climate Action), and SDG 9 (Industry, Innovation, and Infrastructure).

The multifaceted and comprehensive service like DSSS could offer cohesive support that addresses the complex, interwoven challenges confronting SIDS, LDCs and others in the face of climate change and other economic crises caused due to external factors. By providing a holistic support framework, DSSS would empower these vulnerable countries to navigate their unique challenges, enhancing their capacity to adapt, build resilience, and contribute to the global effort towards sustainable development and climate resilience.