Enhancing Critical Forms of Financing and Aid Effectiveness Through Collaborative Partnerships: A Conversation

Background Note for the Interactive Dialogue 2,
4th International Conference on Small Island Developing States
"Charting the Course Toward Resilient Prosperity"

1. Introduction

The international community is being called on to consider the unique development circumstances of SIDS, to broaden their development financing options and sustainable development opportunities. The Antigua and Barbuda Agenda for SIDS (ABAS) which will be adopted by the Conference, acknowledges SIDS' ownership of their development process over the past three decades and the progress achieved, notwithstanding the dramatic impact of global crises that exposed their extreme vulnerability, seriously retarding their sustainable development trajectory[1].

This interactive dialogue will therefore address the urgent call of the ABAS for the international financial architecture to increase and make concessional finance more accessible to SIDS for critical investment in growth, adaptation and resilience building while improving debt sustainability and promoting sustainable development in pursuit of prosperity[2]. Such calls for special consideration have been made consistently in the Declarations of all SIDS platforms, beginning in Barbados in 1994, followed by Mauritius in 2005 and Samoa in 2014.

The ABAS further acknowledges that the successful pursuit of greater resource mobilization implies enhancing the capacity of national and regional institutions and strengthening regulatory and policy environments. Such indigenous effort would improve SIDS' enabling environment and risk-return profiles, so to attract wider finance and investment opportunities, while ensuring the increased effectiveness of donor and development aid[3].

[1] ABAS Declaration, paras 2, 3
[2] op.cit., para 11
[3] op cit., para 32

This dialogue presents an opportunity for exchange of views on an optimal strategy to enhance critical forms of financing for SIDS, while considering the benefits of leveraging partnerships to address the many capacity challenges in SIDS that undermine the effectiveness of financing for development.

2. Key Challenges

SIDS face key economic vulnerabilities that limit their capacity to finance their development. These include a significant dependence on a narrow economic base, high export concentration, small domestic markets and insufficient economies of scale in production and trade. Their heavy dependence on imports for key goods like food and fuel exposes them to external macroeconomic shocks. The economic challenge is aggravated by severe vulnerability to the impacts of climate change and natural disasters which worsen trade deficits, public debt and debt servicing levels.

These structural challenges are compounded by SIDS' limited access to development resources, including ODA and other concessional finance, and by their ineligibility for debt relief mechanisms, because they are disqualified based on their per capita gross national income. Net ODA, which remains an important source of bilateral concessional support, stood at just under US$3 billion (or 0.79% of GDP) in 2020 for all SIDS. Furthermore, between 2017 and 2021, no more than 1.55 percent of total global ODA flows accrued to SIDS.

The severity of the debt challenge in SIDS is indicated by an average debt to GDP ratio for the AIS countries of 95.2% in 2022, down from 104.3% in 2020 at the height of COVID-19. For the Caribbean it was 78.5% in 2022, down from 93.9% in 2020; and for the Pacific it was 35.1%, up from 33.0% in 2020.

Moreover, debt servicing consumes significant portions of fiscal revenue, limiting resources for financing long-term development, emergency response, and essential social services. For example, debt servicing costs account for 40% of government revenue in Caribbean SIDS Debt sustainability is thus an important goal for SIDS.

The structural challenges faced by SIDS, including vulnerability to exogenous shocks exacerbate their risk profile, negatively impacting their ability to attract diverse affordable private and public international capital. Despite the urgent need for climate-resilient infrastructure and sustainable development projects, many SIDS therefore, continue to struggle to attract low-cost capital investment from international markets.

Further, institutional capacity in SIDS, including human, technical and technological capability, is relatively weak. This leads to poor project implementation, limited absorptive capacity, sub-optimal resource allocation and weak national monitoring and evaluation systems which undermine efficiency in development management at the national level. Improved support in strengthening this capacity, therefore, is considered essential for more effective mobilization and utilization of resources to boost growth and resilience.

3. Potential Solutions and Opportunities: New Pathways for Action

1. Addressing the Debt and Liquidity Challenge for SIDS

    A comprehensive strategy for managing debt is critical for ensuring greater access to affordable financing for SIDS. A more ambitious but flexible approach to sovereign debt restructuring, debt relief and liquidity enhancement is needed. This should address not only existing debt stock but also projected future borrowing. The new approach would also need to consider the structure of individual SIDS' debts and their creditors. Implementation and operationalisation of a SIDS-sensitive approach should be complemented with a rethinking of the methodologies and regulations employed by credit rating agencies. It should also seek to lower debt service payments and increase fiscal space for SIDS.

    In this regard, the Bridgetown Initiative 2.0 for the Reform of the Global Financial Architecture addresses liquidity challenges among SIDS while offering comprehensive solutions to the financing needs of climate-vulnerable countries. The Initiative advances useful solutions in the redesign of the Common Framework for Debt Treatments by G20 creditor countries, to speed up debt relief and cancellation, debt service standstills with reliable timelines, and allowing debt-distressed middle-income countries to utilise the framework. This could help address the debt sustainability challenge in SIDS.

    Reform should also facilitate implementation of debt-for-climate adaptation swaps, systemic debt restructuring, and tools such as low-interest Liability Management Operations (LMOs) aimed at alleviating liquidity challenges in SIDS. Caribbean SIDS are advancing an innovative Resilience Fund that couples debt restructuring with providing needed fiscal space for investment in climate- resilient infrastructure. The IFIs and development finance agencies are encouraged to facilitate the development of this instrument.

    Debt-for-climate and debt-for-nature swaps offer a promising avenue for debt relief and increasing fiscal space, while addressing climate change mitigation and adaptation. These swaps allow SIDS to exchange portions of their debt for investments in climate-resilient infrastructure, renewable energy and other projects.

    Serious consideration should also be given to further capitalising Resilience Funds such as the Caribbean Community Resilience Fund, launched in January 2024, and the Pacific Resilience Facility, scheduled to begin operations in 2025. A similar Fund could also be established in the AIS subregion. These Resilience Funds could play a key role in financing resilient- infrastructure and enhancing liquidity. Such special-purpose financing vehicles can leverage long-term low-cost development financing for SIDS, while providing resources for investment in adaptation, mitigation and green industries.

    These initiatives should be complemented by the restructuring of unsustainable private debt facilitated by IMF programs that include refined Debt Sustainability Analysis based partly on vulnerability profiles. Multilateral development banks (MDBs) must be encouraged to increase lending from their existing capital base, reduce the cost and administrative burden of loan packages, and increase lending in local currencies.

    SIDS and international partners must work to mobilise more private sector financing, philanthropic capital and blended finance, since the private sector in most SIDS is resource and capacity constrained. This is central to enhancing liquidity and facilitating debt sustainability and resilience building in SIDS. In this regard, the Bridgetown Initiative has called for a reduction in the excessive macro-risk premia on developing countries with a $100 billion yearly foreign exchange guarantee for green transition investments.

Given the increasing vulnerability of SIDS to economic and climate-related shocks, sovereign state-contingent debt instruments (SCDIs) such as natural disaster clauses and scaled up parametric insurance should be mainstreamed in debt contracts, debt restructuring and debt relief instruments. Facilitating GDP-linked bonds is crucial in this regard.

To leverage additional financing, SIDS should issue diaspora bonds. The international community should facilitate the lowering of remittances transaction costs. Increasing the capitalization of indigenous banks is also important for mobilizing resources, especially for small businesses.

2. Climate Finance

Climate finance is one of the most critical forms of financing for SIDS, given their high vulnerability to the impact of climate change, and limited access to concessional financing. However, SIDS face several obstacles in accessing climate finance, including limited ability to navigate complex funding mechanisms, stringent eligibility criteria and competition for international grant funds[4]. Further, a lack of harmonisation of requirements among multilateral climate funds and donors often leads to lengthy and cumbersome application processes disbursement timelines. Data limitations for climate projects and high transaction costs given the relatively small size of SIDS-scaled projects limit the ability of SIDS to attract competitive financing[5].
The challenges and opportunities associated with climate finance are covered comprehensively in ID Paper 3. The reference here underscores the capacity constraints which undermine SIDS' efforts to optimize their access to this vital source of financing. SIDS need to strengthen technical and institutional capacity at the national level to better align funding to high-impact climate projects. Effective South-South and triangular partnerships can galvanize this process.

3. Diversifying Access to Development Financing

Beyond the urgent need for debt relief and climate finance, SIDS require access to concessional development finance to pursue sustainable development objectives. Upper-income SIDS such as Antigua and Barbuda, Barbados and The Bahamas that that do not qualify for concessional finance are obliged to turn to capital markets for financing at interest rates significantly higher than the Caribbean subregion's average growth rate[6], further aggravating debt overhang.

Therefore, the concessional financing framework needs to be reformed to account for vulnerability, thus enabling higher income SIDS to access concessional finance. Work on the UN Multidimensional Vulnerability Index (MVI) should be completed, and the index adopted

[4] Bishop et al. 2021; ESCAP 2023
[5] ESCAP 2023
[6] excluding Guyana

to include economic, environmental and social vulnerability and resilience indicators, to leverage increased concessional development financing for SIDS.

The global community should also actively assist SIDS in attracting FDI to stimulate investment in economic restructuring, diversification and climate resilience. Given the low levels of ODA and FDI, regional development banks and national commercial banks in SIDS subregions should be incentivized to provide increased development financing. In this regard, a negotiated loosening of the overly stringent prudential requirements instituted by credit rating agencies for SIDS indigenous banks, with careful oversight, would enable them to invest more in under-served sectors and activities.

In this regard, the international community should capitalize these institutions with additional concessional resources for on-lending for capital projects in energy, food security, and modernising connectivity infrastructure. Credit rating agencies should use more transparent, SIDS-sensitive criteria and engage in more consultations with governments to provide fairer ratings for SIDS.

The international community and IFIs should expedite efforts to reallocate to SIDS of the idle special drawing rights (SDRs) of developed countries. This is an innovative vehicle for delivering development financing at SDRs (0.05%)- interest rates, which can be loaned to regional development banks for investment in resilience building, structural transformation, and social programmes. Reform of the current international monetary and financial system, including the governance and operations of International financial institutions (IFIs) to make them more inclusive and equitable, therefore remains vital.

SIDS should also be supported to mobilize more remittances, and to improve tax revenue collection. Remittances represent a significant and stable flow of funds to SIDS, averaging some US$16.7 billion during 2019-20, representing a total of 54 percent of all external financing for SIDS[7]. It is noteworthy that the G-20 Remittance Initiative seeks to lower the cost of remittances globally to 3 percent and below, a very welcome development for SIDS[8]. SIDS governments should be supported in implementing policies and programs to enhance the impact of remittances, such as the development of diaspora bonds. Measures to improve tax revenue, including upgraded administration, using progressive tax policies and reducing tax avoidance through digital solutions, and limiting transfer pricing, could generate additional revenues for development programs[9].

South-South trust funds such as the India-UN Development Partnership Fund and the India Brazil South Africa Fund are important sources of financing. These are managed by the UN Office for South-South Cooperation, which have 74% and 45% of their portfolio, respectively, allocated to SIDS.

[7] Improving Development Impact in SIDS: Implementing Effectiveness Principles

[8] Encouraging signs of progress have been observed, indicating that efforts to improve cross-border payments are underway. However, there is still much work to be done to meet the targets. Data analysis has highlighted areas where investment and action by both the public and private sectors can have the greatest impact on achieving the desired outcomes. Structures have been put in place to encourage and facilitate collaboration between stakeholders, recognizing that effective cooperation is essential for success. However, it is clear that additional efforts are needed across all key areas for action to overcome the remaining challenges https://www.fsb.org/wp-content/uploads/P091023-2.pdf.

[9] McLean et al. 2021

The growing global movement for reparatory justice, for all previously colonized peoples, can unlock substantial resources for advancing development in SIDS. The CARICOM Reparations Commission (CRC) established by the CARICOM Heads of Government in 2013 is at the vanguard of pushing for restitution for the 300 years of native genocide, chattel slavery and 100 years of colonialism. The CRC maintains that there is an unpaid debt owed to the region for systemic exploitation and psychological harm that have resulted in persistent underdevelopment in the Caribbean up until today. Considering that African and Pacific SIDS suffered similar historical injustices, a comprehensive programme of repair, to secure a sustainable future is needed for all these regions.

Integrated national financing frameworks (INFFs) can help countries navigate the growing diversity and complexity of mobilizing, managing and tracking financing. They can also help countries better articulate their needs to the international community, thereby bridging the gap between national action and global efforts in financing sustainable development.

4. Improving Aid Effectiveness

Maximising the impact of sustainable development in SIDS will depend not only on increased access to affordable development financing but on the more efficient and effective use of these resources. This implies the need to allocate resources to sound national development programmes and projects. Countries should also be equipped to effectively manage, monitor and evaluate the use of these resources.

In the first instance, this would require the IFIs and donor community to more carefully tailor the objectives and design of projects to ensure high impacts in beneficiary countries, facilitating the delivery of resources in line with national capacities. This should be underpinned by a robust, regular consultative framework with international and regional development partners and beneficiary SIDS to foster a more coordinated approach to development cooperation.

South-South and triangular cooperation facilitates the peer exchange of experiences, the transfer or sharing of technical skills, and the leveraging of financial resources. This could accelerate the implementation of global platforms including Agenda 2030 and SIDS.

There is also scope for mobilizing more resources from MDBs and other development banks in the Global South, such as the New Development Bank, Asian Infrastructure Investment Bank and Islamic Development Bank to support infrastructure projects and sustainable development initiatives in SIDS.

Partners should also strive to enhance the institutional capacity and governance and regulatory frameworks that are vital for improving the competitiveness of SIDS. Investing in training and human capital development, strengthening collaboration across government ministries and departments and mainstreaming e-governance can increase the impact of development cooperation. This can help to reduce low levels of implementation and resource assimilation in SIDS. Initiatives like the Climate Finance Access Network should be further supported and enhanced.

To reduce the implementation gap, SIDS need to better frame specific development challenges. Development partners should also take into consideration national priorities and local knowledge to inform technical cooperation interventions in SIDS. The significant capacity constraint that creates barriers to programme and project implementation such as staff retention and labour mobility issues must be addressed head-on[10].[11] Poorly designed projects, improper allocation of funding for different phases of the project cycle, and a lack of funding for infrastructure maintenance and upkeep after a project completion must be addressed.

5. Optimising Collaborative Partnerships

Partnerships are critical in advancing the means of implementation in SIDS. By leveraging the expertise, resources, and knowledge of various stakeholders, collaborative partnerships can enhance the ambition and effectiveness of policy interventions. Partnerships, used strategically, can play a transformative role in SIDS' sustainable development. They can assure greater harmonisation of donor and recipient perspectives through greater equity in partnership, horizontal exchange of knowledge and joint programming, implementation and lessons learned. Streamlining processes among different donors and recipients can reduce the duplication of effort, enhance efficiency, and optimise resource allocation for greater impact[12]. The experiences of non-SIDS like Brazil and India in education and skills development show how collaborative partnerships can be applied to enhance development impact.

Capacity building and institutional strengthening of key development cooperation enablers, such as national development cooperation policies and information systems are essential for enhancing aid effectiveness and improving development implementation in SIDS. By investing in human capital development and strengthening organisational systems and procedures, partnerships can play a key role in helping build the capacity of SIDS to plan, manage, and monitor aid programs effectively. It will also play a role in building trust and increasing partner confidence in investing in local projects. Such effort should include identifying skills gaps, making better use of technical advisers, training courses, work attachments, and mentoring approaches, tailored to meet the specific development needs of SIDS[13].

Broad-based collaborative partnerships (BBCPs) function as coalitions of actors that serve as a springboard for integrated implementation. They bring together diverse stakeholders to collectively address complex challenges faced by SIDS[14].

BBCPs benefit from the establishment of regional Centres of Excellence, Knowledge Hubs, and Vocational Learning Centres focused on education and skills development, essential for capacity building in SIDS. Such centres play a pivotal role in promoting innovation, entrepreneurship, and learning by doing that facilitate sustainable development[15]. BBCPs would need to work with SIDS regional institutions.

[10] CDB, 2017
[11] Persaud, 2023
[12] PIF 2005
[13] PIF 2005
[14] Horan 2022
[15] Shamzzuzoha 2022

4. Recommendations

The foregoing analysis and discussion points to key recommendations for the international community, development partners and IFIs to partner with SIDS to scale up traditional and innovative financing, underpinned by strengthened partnerships and aid effectiveness to advance their development. These include:

1. The international community must design a more equitable and flexible debt restructuring and relief mechanism that better balances the interests of debtors and creditors, that better meets the needs of SIDS. This new architecture should include significant haircuts during debt restructuring, which evidence has shown tends to enable debtors to escape the debt trap, thereby making it more likely that creditors will be repaid in the future.

2. As proposed by the Bridgetown Initiative, an integrated framework is needed at the international level to address the liquidity and solvency challenges in SIDS. This should include accelerating debt relief and extending the Common Framework to highly indebted middle-income SIDS, reducing the high-risk premia on SIDS borrowing by providing substantial foreign exchange guarantees to boost investment in the green transition.

3. The international community must undertake robust reform of the climate finance system to make it more nimble and fit-for-purpose. In the short-term, smaller funds should be merged to reduce administrative costs and smooth disbursement. In the medium-term, the Loss and Damage Fund should be fully capitalised, and a quick disbursement mechanism provided for SIDS, which are constrained by human and technological limitations. To facilitate additionality, the tranche of funds for the GCF and other mechanisms should be scaled up consistent with the severity of the climate and biodiversity challenge in SIDS.

4. Multilateral development banks and other institutions should undertake urgent reform of the eligibility criteria for countries to access concessional development finance. The MVI being developed by the UN should be adopted and used to determine the eligibility of SIDS for soft, concessional financing. This would reinstate access to ODA resources that respond to their vulnerability. Governance frameworks should include adequate representation of SIDS.

5. The international community should facilitate increased access to FDI and remittance flows for SIDS. This could be done by providing guarantees for FDI and lowering transaction costs for remittance flows. SIDS should also create one-stop-shop, efficient FDI attracting agencies.

6. Aid effectiveness should be strengthened through better diagnostics to determine the most impactful delivery, smoothing disbursement, and by addressing the implementation deficit with capacity building and enhanced monitoring and evaluation systems.

7. SIDS should work towards strengthening the quality of their partnerships for development. A more responsive partnership framework should be built on an improved determination of critical projects and their design, better local ownership of programmes, upgraded capacity

building and institutional strengthening to maximise the impact of functional and other forms of cooperation.

8. SIDS should also fully leverage South-South and triangular cooperation to foster sharing of experiences, knowledge and technology transfer. Southern-led multilateral and regional financial institutions could coordinate to scale up innovative and more affordable finance, investing in regional infrastructure and development projects to help promote economic integration among SIDS.

9. The multilateral development banks and related institutions should demonstrate a commitment to supporting the development of innovative debt restructuring instruments tailor-made for SIDS and linked to climate resilience building. Such instruments should have extended repayment periods with built in moratoriums and require beneficiary SIDS to invest a predetermined proportion of the fiscal space gained in climate-resilience projects. Other innovative measures should include loan guarantees from IFIs or regional development banks and scaled up parametric insurance[16].

10. There should be dedicated focus by international development partners on addressing SIDS' implementation deficit through enhanced institutional strengthening and governance for improved project delivery; building capacity for improved project design, implementation, monitoring and evaluation across SIDS subregions.

11. The UN's 2024 Development Cooperation Forum Survey provides an opportunity for SIDS' self-assessment of how country-owned policies, stakeholder engagement and information management affect the quality, impact and effectiveness of international development cooperation. The resulting DCF survey should offer concrete recommendations on improving aid effectiveness in SIDS, including partner actions to strengthen SIDS country ownership.

12. SIDS can consider integrated national financing frameworks (INFFs) to help access all financing sources, strengthen planning processes and overcome challenges to financing for sustainable development.

5. Questions

1. What are the most important vehicles for improving SIDS access to the financing necessary for accelerating structural transformation? What has been the role of INFFs in this regard?

2. What are key capacity gaps in SIDS that could be meaningfully addressed through collaborative partnerships? What role do you see for strengthened regional cooperation?

3. Will application of the UN MVI have the desired effect in making the global financing architecture more responsive to the development needs of SIDS? Where do you see the possible pitfalls? What remedies would you suggest?

[16] E.g., with coverage at least equal to one annual or semi-annual loan payment to debtor governments, in the event that agreed climate event (e.g., hurricane or flooding) triggers are met.

4. Which are likely the most innovative finance instruments best suited for SIDS and most readily accessible? Which do you see as most urgently needed by SIDS as they grapple with their many development challenges?