SOLVING THE DEBT SERVICE CRISIS: WHAT SIDS NEED

In August 2024, Hurricane Beryl ripped through multiple Caribbean islands, causing billions in economic damage and widespread destruction of people's homes. The scenes of devastation underlined the growing vulnerability of Small Island Developing States (SIDS) to climate disasters. Yet once again, as with all such recent disasters, the countries were forced to rely almost entirely on expensive market-based financing to pay for their reconstruction and recovery. Based on past experience, this is likely to mean that their debt burdens will rocket and they will require debt relief.

This policy briefing, produced by Development Finance International, looks at how this vicious cycle can be ended. Drawing on the ***Debt Service Watch*** database, it shows that SIDS face extremely high levels of debt service[1], rising from 36.5% to 38.7% of their budget revenue between 2023 and 2024. This is more than twice the levels of service considered to be "sustainable" by the IMF and World Bank.

More crucially, debt is pushing aside key spending to confront social and environmental crises. Debt service exceeds combined spending on education, health and social protection by one third in LAC and Asian SIDS, and is 6 times as high as climate spending across all SIDS. This debt service burden will also continue to be high for the next decade – one quarter of SIDS will continue to spend half their revenues on debt service, and one half of them will spend more than 25% - through until 2035.

The international community has acknowledged the special debt and climate vulnerabilities of SIDS agreeing to include Climate Resilient Debt Clauses (CRDCs) – which offer temporary pauses to debt service after disasters – in their loan agreements; and through other measures such as catastrophe binds and debt swaps. However, these measures are woefully inadequate to reduce debt service to levels where SIDS can invest in the SDGs and protect themselves against the climate and nature crises: indeed, insofar as they just postpone debt service and add more interest on top, they are worsening the SIDS debt crisis over the medium-term. SIDS need much more fundamental debt relief, and this briefing proposes a SIDS post-disaster debt service cancellation facility, modelled on the IMF CCRT, to cancel all unsustainable debt service owed to external and domestic creditors, and bring debt service levels down to 15% of debt service/revenue. Using the DSW database, we estimate that the annual cost of such a facility for all SIDS would be US$1.9 billion a year to cancel the unsustainable external service, and US$4 billion to cancel all (external plus domestic) debt service. Especially if accompanied by greater access to concessional new financing, and enhanced efforts by SIDS to increase their progressive tax revenue, this facility would make a massive difference to post-disaster relief and recovery, and to helping SIDS accelerate their progress on the Sustainable Development Goals.

About Development Finance International

Development Finance International is a non-profit research and capacity-building organisation. It has worked for 32 years with more than 60 Global South governments, helping them to mobilise the best development finance and debt relief to reduce poverty and inequality, and confront the climate crisis. It has also provided advice and analysis to intergovernmental organisations, development partners, civil society organisations (including Jubilee 2000), trade unions and parliamentarians. For details, see www.developmentfinance.org

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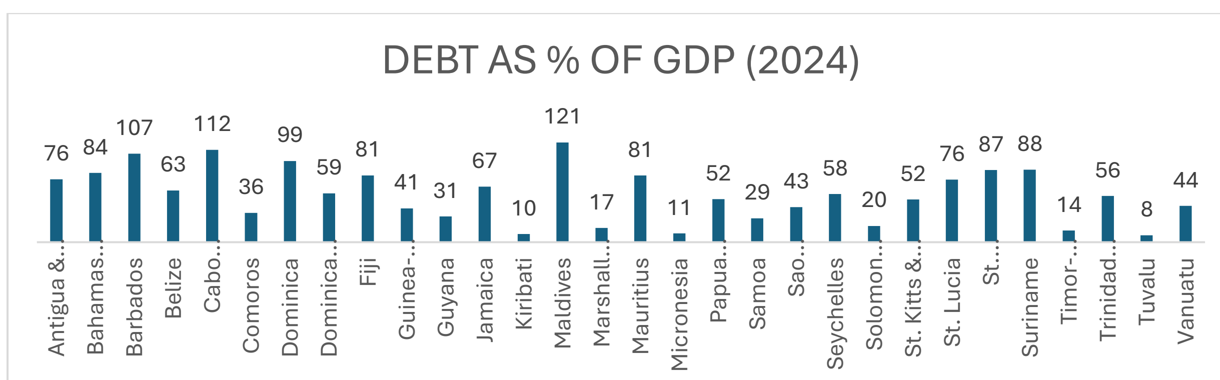
[1] In this briefing and the DSW database, debt service includes principal and interest on external and domestic debt.

1. SIDS Are Increasingly Vulnerable to Climate Disasters and High Debt

In August 2024, Hurricane Beryl ripped through multiple Caribbean islands, causing billions in economic damage and widespread destruction (90% of homes in the Grenadines and 95% in Grenada). It was also the strongest storm in Jamaica in almost 17 years. Many scientists and researchers underlined that Hurricane Beryl was the earliest Category 5 hurricane in the Atlantic on record, fuelled by exceptionally warm ocean temperatures due to climate change. For many SIDS, this latest disaster only underscored their heightened vulnerability due to accelerating climate change (see IPCC 2023). Research by the International Institute for Environment and Development (IIED) shows a clear rise in disaster intensity since the mid-1970s, with the seven years of highest disaster intensity all post-2010.

This heightened vulnerability is already worsening many SIDS' debt crises. The World Bank has shown that, on average in developing countries, debt/GDP grows 2.3 to 3.6 percentage points faster in the three years after a disaster, due to combination of lower GDP and higher borrowing. In SIDS, these increases are often much larger: in Dominica, debt to GDP rose by 14% in two years after Hurricane Maria in 2017; and in Tonga, 40% of the debt accumulated in 2008-23 was attributable directly to disasters (Resilient Sustainable Islands (RESI) 2024). Crucially, most post-disaster borrowing is not to *advance* sustainable development, but only to *recover previous* development levels.

Largely as a resulted of repeated disasters, many SIDS are among the world's most heavily indebted countries. In 2024, out of 19 SIDS for which the IMF publishes a debt sustainability analysis, twelve are at "high risk" of debt distress, two already "in debt distress" and five at "moderate" risk of distress.[2] Many SIDS have also restructured their debt during the last two decades - in some cases more than once. This is especially true in the Caribbean, where Antigua & Barbuda, Barbados, Belize, Dominica, Grenada, Jamaica, St. Kitts & Nevis and Suriname have all restructured at least once since 2010. Several SIDS also received HIPC/MDRI relief (Comoros, Guinea-Bissau, Guyana, Haiti, São Tomé & Príncipe). In spite of these efforts, high debt stock remains a persistent challenge for many SIDS. In 2024, 13 had debt to GDP ratios over 60%, nine over 80%, and three over 100%.



Source: IMF

Another key factor driving debt problems for some SIDS has been the lack of concessional finance from multilateral and bilateral development partners. Antigua & Barbuda, Barbados, Jamaica, Seychelles, and several others are considered too rich for aid despite their myriad vulnerabilities. Even for those which are eligible for concessional resources, post-disaster aid is small compared to need: SIDS received only US$3.1 billion of OECD bilateral aid in 2022 (1.7% of total global aid). As a result, SIDS are forced to borrow at commercial rates: 74% of SIDS debt is non-concessional (RESI-ODI). Domestic debt has risen sharply in recent years to 52% of public debt. As for *external* debt, 43% is owed to commercial creditors (especially bondholders), 38% to multilaterals and 25% to bilaterals (UNCTAD).

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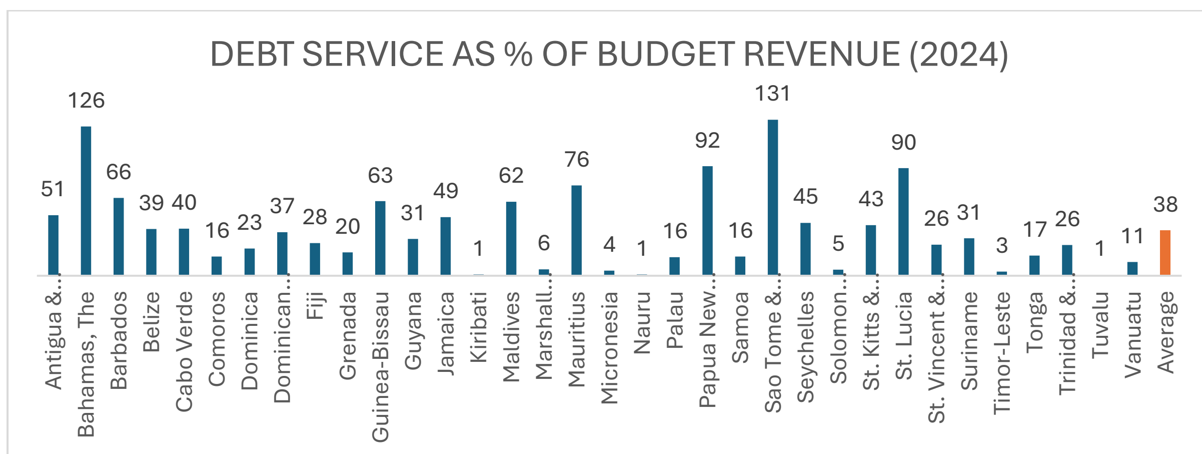
[2] The countries in debt distress are Grenada, and Sao Tome & Principe; at high risk are Comoros, Dominica, Guinea-Bissau, Haiti, Kiribati, Maldives, Marshall Islands, Papua New Guinea, Samoa, Saint Vincent & Grenadines, Tonga and Tuvalu; and at moderate risk are Cabo Verde, Micronesia, Solomon Islands, Timor-Leste and Vanuatu.

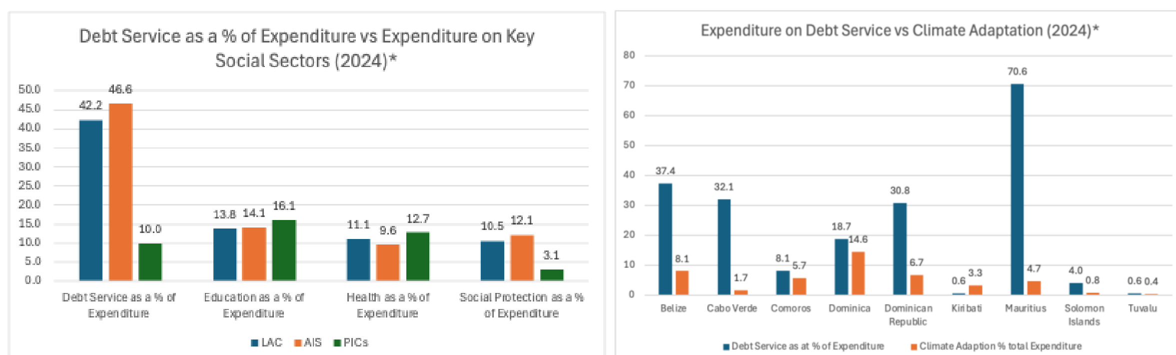
2. Debt Service Is Stopping SIDS from Investing in the SDGs

Recent research by [Development Finance International (DFI)] has sounded the alarm over exceptionally high debt service burdens in many SIDS. In October 2023, DFI found ["The Worst Ever Global Debt Crisis",] that SIDS in 2023 were paying an average of 36.5% of their budget revenue on debt service, massively crowding out spending on the Sustainable Development Goals (SDGs). The post-Hurricane Beryl 2024 update of these data show that the average debt service ratio has risen to 38.7%. Nine SIDS will spend over 50% of revenues on debt service, and 17 over 30%. This is much higher than the HIPC Initiative's initial targeted for a sustainable level of debt service/revenue to free up fiscal space for pro-poor spending (10%) and the current thresholds used by the IMF and World Bank to judge "debt distress" (15-20%). The situation is particularly shocking in the Bahamas, Papua New Guinea, São Tomé & Príncipe and St. Lucia, all of which will spend over 90% of budget revenue on debt service in 2024 !



Source: DFI Debt Service Watch database

The Debt Service Watch database also compares debt service with spending on education, health, social protection and [climate adaptation]. In Latin American and Caribbean (LAC) SIDS and Atlantic, Indian Ocean and South China Sea (AIS) SIDS, debt service is significantly higher than spending on all the social sectors combined: 42% in LAC and 46% in AIS, compared to 35% social spending in both regions. In Pacific SIDS, debt service averages only around 1/3 of social spending, but it is 2.4 times as high in Papua New Guinea, 2/3 of social spending in Fiji, and almost half in Samoa, Tonga and Vanuatu. Data on climate spending is available only for nine SIDS, where debt service is on average 6 times higher, rising to an extreme of 14 times higher in Dominica and Mauritius. In most SIDS, high debt service is pushing aside critical investments in the social sectors and climate resilience.



Source: DFI Debt Service Watch database

Looking forward, high debt service will rise further in LAC and AIS SIDS, staying over 40% of revenue for the rest of this decade. Half of SIDS will spend more than 25% of revenues, and 9 countries will exceed 50% of revenues – Papua New Guinea will be worst affected, spending 70%.

3. A Call to Action: Cancel SIDS Unsustainable Debt Service When Disasters Hit

The international community increasingly recognises that many SIDS are in extremely vulnerable debt positions and urgent solutions are required to help them restore and maintain debt sustainability. Recent years have seen several initiatives, such as contingent credit facilities in the multilateral development banks, climate resilient debt clauses (CRDCs) which offer temporary pauses to debt service, catastrophe bonds which insure against hurricane risks, and debt-for-nature swaps. Indeed following Hurricane Beryl, Grenada became the first country in the world to activate a "hurricane debt pause clause". While these initiatives are welcome, they are woefully insufficient to reduce debt service to levels where SIDS can invest in the SDGs and protect themselves against climate and nature crises. Much more fundamental debt relief is needed, and can be achieved at a relatively low cost.

An increasing number of bilateral and multilateral creditors are offering CRDCs because they recognise that small countries, when hit by a non-economic shock, should not prioritise debt service over relief and recovery. However, their major limitation is that CRDCs only *pause* debt repayments, postponing them to a later date. Because (as shown above) SIDS debt service continues to be high for the next decade, this merely stores up an even worse debt service crisis after the CRDC expires. A more meaningful support mechanism would be one which **automatically *cancels* unsustainable debt service for a minimum period of three years after a disaster.** This would provide permanent extra fiscal space for SIDS, allowing them to spend their revenue on relieving those affected by the disaster and promoting rapid recovery, as well as on the SDGs and on confronting the climate and nature crises. This would also align with the UN Secretary General's call for a US$500 billion per year SDG Stimulus to help developing countries progress more rapidly towards SDG (including climate and nature) goals.

In terms of design, a **SIDS post-disaster debt service cancellation facility** could be modelled on the IMF CCRT facility, which already cancels debt service to the IMF following a non-economic shock (natural disaster or pandemic). A threshold could be set to judge whether a disaster was sufficiently serious in terms of GDP or budget revenue losses to trigger debt relief, and the period for relief based on how long it was estimated it would take for major reconstruction and recovery spending to take place. The level of debt service considered to be sustainable could be the 10% of revenue used in the HIPC Initiative, or the 15% lowest threshold to judge debt sustainability under the LIC-DSF. We assume that given climate vulnerability, all SIDS would be eligible for a facility, regardless of per capita income.

Because of the small size of their debt compared to the global economy, this would be a very low-cost measure, but would have an outsize impact on affected SIDS. SIDS are currently expected to pay a total of US$180 billion in debt service over the next five years. According to EMDAT data, they are likely to be affected by an average of one severe climate disaster during this five-year period, implying that their debt service would need to be cancelled for an average 2.5 years if these disasters are spread evenly over the period. However, the Dominican Republic and Mauritius would be unlikely to apply for such relief given that they access bond markets regularly to fund their budgets, and relief would complicate such access. If service was reduced to 15% of revenue for the three years after the likely disasters, this would cost a maximum of US$4 billion a year to cancel the unsustainable external and domestic debt service, and only US$1.9 billion a year to cancel the unsustainable external debt service. Such funding could easily be found, for example by selling a small fraction of the IMF's gold reserves.

Debt relief would of course be insufficient to allow SIDS to make themselves climate resilient and reach the SDGs. It would need to be accompanied by more concessional financing for SIDS, in the form of grants or highly concessional loans, and regular SDR allocations, as advocated in the Bridgetown Initiative. In addition, it would be reasonable to expect SIDS to enhance their efforts to mobilise budget revenue using progressive taxes, to ensure they can fund spending sustainably after the cancellation period expires. But a SIDS post-disaster debt cancellation facility could make a huge difference to their ability to recover rapidly from disasters, relieve the suffering of their people and accelerate spending to reduce damage from future disasters, thereby transforming their development prospects.