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Discussion Note

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Exploring financing options to address the vulnerabilities of small states

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1. Context

Small states are disproportionately exposed to economic and climatic shocks, and are further challenged by a lack of resources to aid in building resilience to mitigate the impact of their intrinsic vulnerabilities. Domestic finance is insufficient to address small states' development needs in the context of their exceedingly high vulnerability. Consequently, these countries are highly dependent on affordable external financing to deal with the impact of exogenous shocks.

The available external funding window for concessional development finance is accessed through a well-defined eligibility criterion, mainly gross national income (GNI) per capita. Currently, GNI per capita is widely used to classify states into income groupings of low-, middle- and high-income countries. Small states in the low- and middle-income bracket are able to access official development assistance (ODA) and concessional financial flows with relative ease. Access to concessional finance for a few small states in the upper-middle and high-income bracket is relatively constrained. Based on the criteria used by bilateral Development Assistance Committee (DAC) donors and multilateral institutions, Antigua and Barbuda, The Bahamas, Barbados, The Seychelles and Trinidad and Tobago, all high-income countries, do not have access to ODA.

However, given their inherent vulnerabilities, it is vital that consideration is given to provide specific financial support to small states irrespective of their income classification.

International financial institutions (IFIs) recognise the vulnerabilities of small states and have responded positively with the provision of targeted development finance instruments. The World Bank introduced a preferential window for all IDA-eligible small states under the Small States Exception, which provides access to concessional loans to select small island developing states despite their higher income per capita levels. This is an important signal of the IFIs' increasing awareness of and sensitivity to small states' vulnerability. However, the increased frequency and greater negative impact of external climate shocks presents a powerful case for wider re-examination of the external financing architecture for small states.

2. Financing options

Given the inadequacy of the current development finance architecture in addressing vulnerabilities of small states, there is a need for new emerging mechanisms. Diaspora, climate and disaster finance are among a range of options that could be harnessed to increase the flow of development funds to these countries.

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(a) Diaspora Finance

Diaspora finance has the potential to provide additional resources, expand capital markets, enable access to less costly credit by means of patriotic discounts for government bonds or securitising assets, and provide a reliable flow of capital. Many small states have recognised the potential of diaspora finance and are at different stages of developing initiatives to enhance this funding source. Small states can learn from the successes and failures of other countries when designing their own policies and programmes for attracting diaspora investment.

The Commonwealth Secretariat has initiated a Diaspora Finance Work Programme, focussed on increasing diaspora capital transfers to support economic development in home countries. The initial phase involves research, analysis and scoping to better understand diaspora investment potential.

(b) Climate Finance

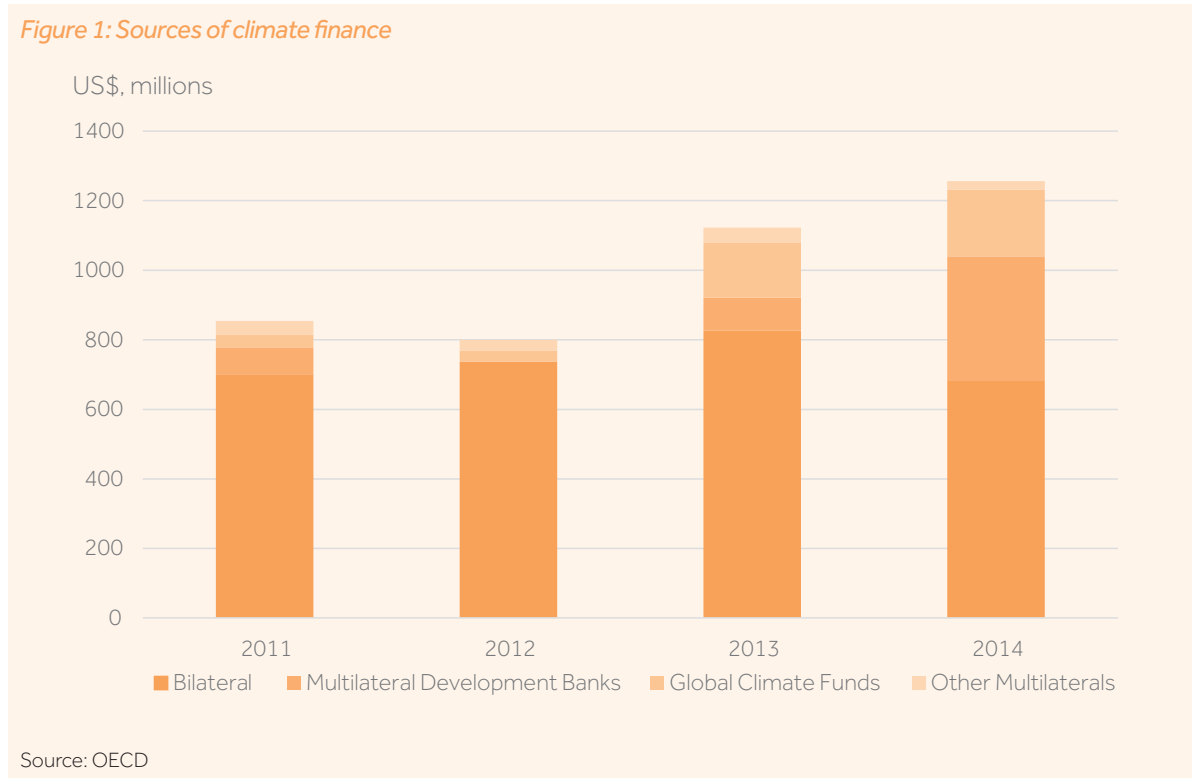
Currently there exists a plethora of public and private actors responding to global calls for increasing climate finance in order to mitigate and adapt to climate change. Bilateral donors and multilateral development banks remain the leading financiers of ODA-related climate finance as shown in figure 1.

The number of global climate funds have increased significantly in recent years. The Green Climate Fund (GCF) is expected to emerge as the single most important source of climate finance based on the amount of resources pledged to the fund. The GCF became operational in 2015 and is available to all developing countries. It channels the highest amount of resources to small states relative to other existing funds, although access remains a challenge.

The complexity of the climate finance landscape - in terms of sources, actors, eligibility criteria and sector focus - coupled with the resource constraints of small states makes it difficult for these countries to access pledged climate resources. In this context, it is important that small states are provided with the support required to build much-needed capacity in order to access available climate funds.

The Commonwealth Secretariat has established the Commonwealth Climate Finance Access Hub (CFAH) to address capacity gaps hindering small and vulnerable states' ability to access internationally available climate funds. The CFAH places long-term advisers in key government departments and provides programmatic support to address constraints at the national level to enhance access to climate finance.

Figure 1: Sources of climate finance



(c) Disaster Finance

Recent trends suggest an increase in the frequency and strength of natural disasters. Small states are severely impacted by natural disasters and bear the burden of significant reconstruction cost. The magnitude of disasters means that small states are unable to effectively build sufficient buffers to absorb costs. Currently, recovery efforts are funded through the diversion of resources from domestic budgets or donor financing. A more effective mechanism to finance reconstruction efforts is required and should include the creation of domestic fiscal buffers, which can be used to leverage international support. Equally important is for IFIs to also relax stringent conditions surrounding access to disaster funds, particularly non-concessional relief funds, such as the Rapid Financing Instrument (RFI).

(i) Rapid Response Instruments

The International Monetary Fund² and the World Bank provide post-disaster financing through various instruments, such as the Rapid Credit Facility (RCF), Rapid Financing Instrument (RFI), Crisis Response Window (CRW) and Immediate Response Mechanism (IRM). These facilities provide financing to shore up the balance of payments and budgetary financing to support immediate disaster response efforts. Regional development banks (RDBs) also have various concessional and non-concessional facilities for disaster response.

Available mechanisms provide critical and immediate support to affected countries. However, the volume of resources provided under both short- and long-term facilities are generally inadequate, impacting debt and fiscal sustainability. It is therefore important to consider the establishment of a disaster reconstruction fund which will raise funds to target immediate reconstruction and rehabilitation efforts.

(ii) Risk-Pooling

Countries that face exposure to similar hazards within a geographical region are encouraged to explore risk-pooling facilities. Africa, the Caribbean and the Pacific have all established such facilities through the African Risk Capacity (ARC), the Caribbean Catastrophe Risk Insurance Capacity (CCRIC) and the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI). Risk-pooling facilities are often based on parametric insurance policies and allow for timely payments to affected entities, as pay-outs are based on environmental triggers and thresholds.

The utilisation of the available instruments across the above-mentioned regions varies. Reasons cited for the level of utilisation include: premium cost, knowledge of the mechanics of these insurance tools and insufficient data to estimate economic value of assets at risk. Development partners can support small states to access risk-transfer and risk-sharing mechanisms. Countries can be encouraged to join these facilities in order to lower premiums for shared risks. Member countries could also be supported to create an enabling environment for an expanded range of insurance products and strengthen co-ordination between risk-pooling and micro-insurance programmes.

² In May 2017, the IMF increased access limits of both funds to 60 per cent of the country quota provided the cost of natural disasters is estimated to be at least 20 per cent of the country's GDP.

