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Addressing the Financing and Debt Challenges of Commonwealth Small States

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Introduction

Economic performance in small states has been poor in the past two decades despite seemingly high levels of GDP per capita. This has been partly due to their size, which leaves them more vulnerable to challenges posed by unexpected and uncontrollable external events. The global financial crisis has served to highlight these challenges.

Small states are now among the most indebted countries in the world. In addition, they continue to face acute exposure to more frequent and severe natural disasters, which have the potential to further increase administrative costs and public debt.

The severity of the situation is evidenced by a sharp increase in the frequency of sovereign debt restructuring and a heightened probability of sovereign debt default. This is because insurmountable liquidity constraints observed across a number of small states has rendered the usual fiscal adjustment process unfeasible. Small states do not have favourable access to necessary development financing, and donors are reluctant to engage with debt relief given their own resource constraints and debt burdens. In fact, annual official development assistance (ODA) to small states has been in steady decline since the 1990s (except for a temporary increase in 2009-2010 due to the response of the international financial institutions to the economic crises).

The Commonwealth comprises 53 member countries of which 31 are categorised as 'small states'. Commonwealth Heads of Government and Commonwealth ministers of finance and environment have considered the financing and development challenges in these countries and made recommendations to address them. The Commonwealth Secretariat, which has been mandated to assist with the development of strategies to reduce small states' public debt and to improve their access to finance, has been engaged in analysis, research and advocacy on these issues since the outbreak of the global economic crisis in 2007.

The Commonwealth comprises 53 member countries of which 31 are categorised as 'small states'

The objective of this discussion paper is to raise awareness on the debt and financing challenges in Commonwealth small states and to stimulate debate on Commonwealth Secretariat proposals for resolving the issues in these countries.

The discussion paper is organised in three parts:

- An overview of the characteristics of small states and their macroeconomic performance;
- An outline of the most pressing development challenges; and
- Commonwealth proposals to help address the debt challenges of member small states.

The paper draws on collective Commonwealth research (Commonwealth Secretariat 2013a) and analytical material as well as other relevant and recent papers as listed in the Bibliography.

The World Bank classifies most Commonwealth small states as middle- and high-income

Characteristics of Commonwealth small states

While there is no internationally agreed list of small states, they are usually defined as countries with populations of 1.5 million or fewer. The IMF and World Bank recently endorsed this definition, having previously supported a figure of 1 million or fewer. Small states can be found in the Caribbean, Pacific, Africa, and Asia and European regions.

Small states have special characteristics that underpin their shared development challenges. These include:

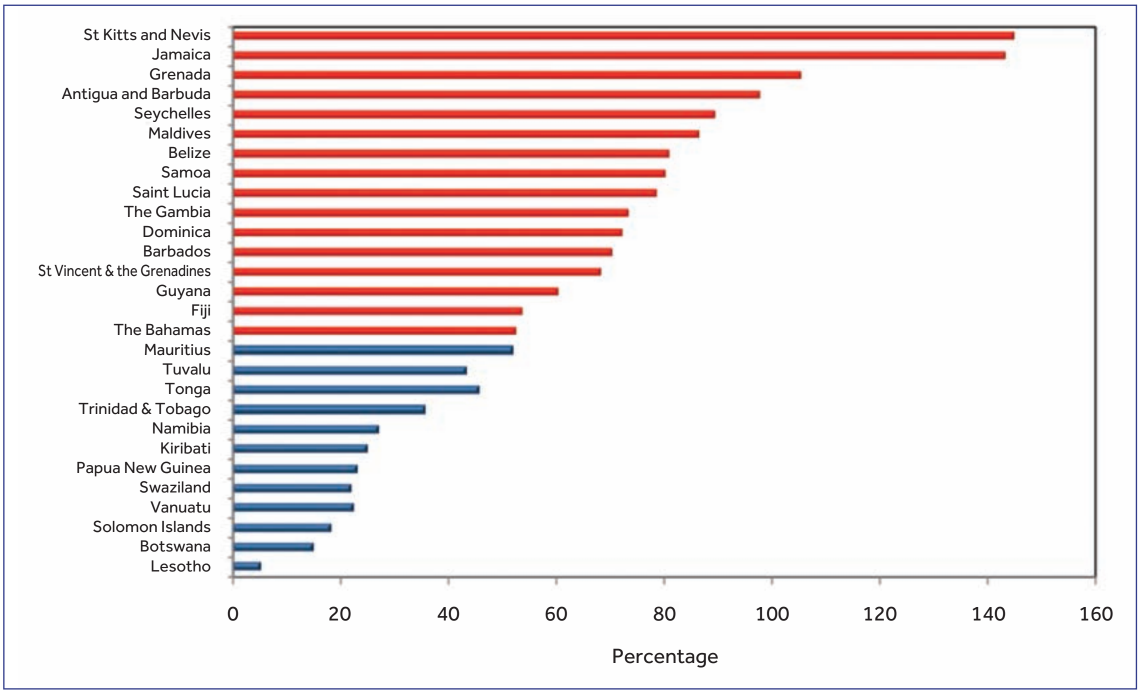
- Small populations give rise to diseconomies of scale in the production process and high fixed costs in the provision of public and private services;
- Their remoteness (a feature of Pacific island nations in particular) results in disproportionately high transportation costs and creates hurdles for regional integration;
- Narrow production and export bases limit diversification and leaves them susceptible to terms-of-trade shocks;
- A high degree of openness makes them more vulnerable to economic shocks originating from their major trading partners;
- Underdeveloped financial markets in combination with the above challenges, precipitate a disproportionate dependence on external aid and debt;
- High environmental vulnerability as they are prone to natural disasters, and
- Limited institutional capacity underpinned by skill shortages.

According to the World Bank annual income classification of countries, estimated on a gross national income (GNI) per capita criterion, the majority of Commonwealth small states fall in the middle-income and high-income brackets. Only The Gambia[1] is classified as a low-income country. The Caribbean region has a majority of upper-middle income and high-income countries while countries in the Pacific are mostly ranked as lower-middle income.

As a result of this broad middle- to high-income classification, most small states are not eligible for concessional resources or debt relief from the international financial institutions (IFIs) despite being extremely susceptible to both environmental and economic shocks. There is a small island economy exception available to microstates from which Dominica, Saint Lucia, and St Vincent and the Grenadines have

1 *The Gambia renounced Commonwealth membership in 2014 after completion of the background paper (Commonwealth Secretariat 2013a) on which this discussion paper is based.*

Figure 1. Public debt to GDP in Commonwealth small developing states, 2012[3]



Source: International Monetary Fund Regional Economic Outlooks and various country reports

benefited but not all small states can obtain this kind of aid.[2]

The pressing development challenges

High debt, insufficient restructuring and risk of default

The debt burdens in Commonwealth small states have grown rapidly within the last decade, particularly in the Caribbean, and are now at unsustainable levels. At the end of 2012, 17 of the 28 Commonwealth small states for which data was available had debt-to-GDP ratios of over 50 per cent and 14 of those exceeded 60 per cent (Figure 1).

Conversely, over the same period debt levels have fallen by more than half in low-income countries classified as small states (most of them in sub-Saharan Africa), due to the Heavily Indebted Poor Countries debt initiative (HIPC), the Multilateral Debt Relief Initiative (MDRI) and the enhanced HIPC initiative. Public debt to GDP levels fell by one-third in Pacific small states, while these levels rose by 3 per cent in Caribbean small states from 2000 to 2012.

Asia-Pacific Commonwealth small states have relatively moderate levels of public debt to GDP, averaging 44.3 per cent. Asia-Pacific small states

2 *'Microstates' are defined as countries with populations of fewer than 200,000 people. They include ten Commonwealth small states (Dominica, Grenada, Kiribati, Maldives, Saint Lucia, St Vincent and the Grenadines, Samoa, Tonga, Tuvalu and Vanuatu) and three non-Commonwealth small states (Cape Verde, Marshall Islands and Micronesia). Microstates that benefit from the small island economy exception are granted access to World Bank International Development Association (IDA) and IMF Poverty Reduction and Growth Trust (PRGT) resources even if their gross income surpasses gross national income (GNI) eligibility thresholds. This exception was introduced in 1985 to reflect the view that microstates face a range of challenges that are typical of low-income countries (IMF 2013a).*

3 *This includes the debt of public sector entities.*

rely heavily on official development assistance rather than on public debt to finance their budgetary and balance of payments requirements. As such, public debt in these countries has remained relatively contained since aid from their main donors (Australia, New Zealand and the USA) has been substantially in the form of grants. With the ascent of China as a major economic power, aid to small states in this region, also in the form of grant resources, has been increasing.

Debt burdens are near distress levels in most Commonwealth small states

Frequency of debt restructuring rises

Since the start of the 2000s, seven Commonwealth small states (Antigua and Barbuda, Belize, Dominica, Grenada, Jamaica, Seychelles and St Kitts and Nevis) have restructured their debt as a result of steady debt accumulation (Table 1). All of them are tourism dependent economies with the exception of Belize, which is a commodity exporter. Most are extremely or highly vulnerable to natural disasters, and all are very open economies and highly exposed to external economic and financial shocks.

Despite the generally successful implementation of debt exchanges and subsequent declines in debt ratios, debt, albeit lower, remains at unsustainable levels in all seven countries. An analysis of the post-exchange outcomes (excluding St Kitts and Nevis)[4] indicates that while public debt to GDP fell in four of them that had debt restructuring operations, after two years public debt to GDP levels had again risen in half the group.

A high probability of debt default emerges

The prevailing research suggests that debt will rise further in a number of Commonwealth small states (Moore et al., 2013). Debt expansion is projected to occur in the Caribbean and in sub-Saharan Africa, but much less so in the Pacific and Europe. According to Moore and others, in the expansion cases the debt increases are expected to result from an acceleration of permanent expenditure over permanent revenue.

Approximately 30 cents of every dollar owed by the indebted small states is attributable to a multilateral lending agency. Although the actual dollar value of the group's debt is a small proportion

Table 1. Public debt-to-GDP pre- and post-debt exchange in Commonwealth small states

	Year	3-year pre-relief average	Year-3	Year-2	Year-1	Restructuring year	Year+1	Year+2	Year+3	3 year post-relief average
Antigua & Barbuda	2010	90.7	93.3	76.9	102.0	90.6	93.4	97.8	n.a.	95.6
Belize	2007	96.9	100.1	98.4	92.2	88.6	79.4	82.5	84.6	82.2
Dominica	2004	111.6	92.7	111.4	130.8	116.0	108.1	95.7	90.9	98.2
Grenada	2005	111.7	112.3	102.2	120.6	110.3	116.5	111.0	83.7	103.7
Jamaica	2010	127.5	115.0	126.2	141.2	143.0	140.0	143.3	n.a.	141.7
Seychelles	2010	138.0	146.0	139.5	128.6	82.5	77.8	64.6	n.a.	71.2
St Kitts & Nevis	2012	155.6	148.5	163.9	154.3	144.9	n.a.	n.a.	n.a.	

Source: Compiled from each country's most recent IMF Article IV Publications, 2012-2014

4 St Kitts and Nevis was not included since it had undergone a debt exchange less than two years before.

of the overall portfolio of most international lenders, research suggests that the potential risk to multilaterals is not negligible. Nonetheless, on average, the data shows that indebted small states owe, on average, most of their debt to domestic and external private creditors.

Inadequate access to concessional and other financial resources

Concessional finance has dried up

Since the 1990s and graduation to middle-income status, most Commonwealth small states have not had access to concessional resources. The IMF and World Bank continue to base eligibility to concessional lending facilities on income thresholds,[5] which excludes a majority of middle-income small states from access to World Bank International Development Assistance (IDA) and IMF Poverty Reduction and Growth Trust (PRGT) resources, whereas access to these institutions' non-concessional resources has been limited by small states' relatively small quotas.

The IFIs should use vulnerability levels over income status to determine access to concessional resources

The Commonwealth has been arguing that the Bank and Fund should use the level of a country's vulnerability rather than its income status to determine access to concessional resources. Interestingly, both institutions have included a vulnerability criterion to prevent premature graduation of eligible countries from the World Bank's IDA and IMF PRGT facilities but have not found vulnerability suitable for determining eligibility to use their concessional resources. Graduation from IDA and PRGT facilities occurs when countries surpass the IDA operational income cut-off for more than five successive years, show signs of sustained market access and have no short-term vulnerabilities (Box 1).

Owing to the decline in concessional finance Commonwealth small states have had to rely on commercial instruments, particularly bonds. This has increased their indebtedness to private creditors and complicated the debt restructuring process. Not only is public debt in small states heterogeneous (i.e. multilateral, bilateral and private), private creditors to small states are also fragmented due to the widespread use of bonds. Consequently, debt restructuring has become more difficult given the associated inter-creditor equity and negotiation issues. With growth in some domestic capital markets, some small states have relied heavily on domestic debt and this too has had implications for debt restructuring operations, including potential negative impacts on the domestic financial system.

Reduced concessional resources and inadequate IFI shock financing

Overall lending by multilateral and regional development banks to small states had strong growth in response to the global financial crisis. The multilateral development banks (MDBs), comprising the World Bank and four regional development banks (RDBs),[6] increased annual lending to small states from US$1.1 billion in 2007 to US$4 billion in 2009.

But although this lending increase appeared to be a positive response, it was actually concentrated in just a few select countries. The large aggregate increase in financing had a high concentration, with

5 A country can be added to the PRGT list if it has an annual GNI per capita income that is below the World Bank's International Development Assistance (IDA) operational cut-off (US$1,195 in FY 2013).

6 The African Development Bank (AfDB), Asian Development Bank (ADB), Caribbean Development Bank (CDB) and Inter-American Development Bank (IDB).

Box 1. Low income countries' criteria for entry and graduation from PRGT eligibility

Entry

- Annual per capita GNI below the operational IDA cut-off (as defined); and
- No capacity to access international financial markets on a durable and substantial basis.

Graduation

Countries should meet at least one of the following two criteria and satisfy the vulnerability assessment:

Income criterion requires that annual per capita GNI:

- Has been above the IDA operational cut-off for at least the last five years (qualifying data required);
- Has not shown a declining trend over the same period (comparing the first and the last relevant annual data); and
- Currently is at least twice the operational IDA cut-off.

Market access criterion requires that the country has the capacity to access international financial markets on a durable and substantial basis.

Absence of serious short-term vulnerabilities as assessed by the following requirements:

- No risk of a sharp decline in income or of a loss of market access (where relevant);
- Limited debt vulnerabilities as indicated by the latest debt sustainability analysis (DSA); and
- Confirmation that debt vulnerabilities remain limited overall, taking into account developments and prospects since the DSA.

Source: IMF 2013a

the five largest recipients receiving 74 per cent of funds. These countries were Botswana,[7] Gabon, Jamaica,[8] Mauritius and Papua New Guinea. Hence, most small states received little or no active financing between 2007 and 2009.

Debt overhang, persistent weak growth and threats to human development

The IMF (2013b) has reported that the increase in public debt and other macroeconomic factors had likely contributed to slowing growth, although some factors may have been structural. A number of empirical studies have tested this relationship with most confirming the validity of the debt overhang hypothesis. However, there are considerable differences in opinion as to the point at which debt begins to negatively affect growth. Pattillo et al. (2004) found an inverted U-shared relationship between these variables and argued that a ratio above a certain threshold would depress growth performance through reduced investment and lower factor productivity as well as the expectations of higher taxes to repay debt and the crowding out of private sector investment. Greenidge et al. (2012), investigating the relationship between growth and debt in a sample of Caribbean

7 Botswana received a US$1.5 billion Economic Diversification Support Loan (EDSL) from the AfDB to create competitive conditions for accelerated private sector growth, economic diversification and poverty reduction. This was a stimulus package responding to the global financial and economic crisis and the country's need to reduce dependence on its mineral revenues.

8 Jamaica received funds from both the World Bank and the CDB. The World Bank funding included a US$100 million Fiscal and Debt Sustainability Development Policy Loan and smaller amounts for extending conditional cash transfer programmes. The CDB financed a number of infrastructure projects.

countries, reached a similar conclusion, finding that a debt/GDP ratio exceeding 54 per cent was likely to slow growth.

Human development improvement is weakening

Although the empirical results of a negative impact of debt on economic growth are debatable, there are signs that a high debt-low growth nexus in small states is beginning to impact these countries' human development. In one estimate, the UN Human Development Index (HDI) captures countries' wellbeing by combining sub-indexes measuring education attainment, life expectancy and income. Although the average HDI for small states has been increasing in levels, human development improvements in small states has been growing at a significantly slower rate compared to the period between 1980 and 1990 when their HDI grew by 6.5 per cent. During the early 1990s and mid 2000s small states' HDI growth slowed tremendously and it has slowed further since 2008, reaching as low as 0.2 per cent in 2012.

Structural vulnerability and continuous exposure to external shocks

The spotlight is again on 'lack of resilience'

The September 11, 2001 attacks on New York and Washington DC, USA precipitated a major downturn in the economic activity of small states. The USA is the predominant tourism source market for many small states, particularly those in the Caribbean. In the wake of the attacks, the weak demand for the tourism product and the precipitous drop in tourist arrivals, from Canada and the UK as well as the USA, led to sharp contractions in small states' growth rates and a concomitant rise in average public debt.

A second wave of global shocks in the latter half of the decade also had a severe impact. Counter-cyclical policies were adopted in almost all indebted Commonwealth small states in response to the food and fuel price crisis, so as to offset the sharp contraction in economic activity arising from the global economic slowdown. Only in Seychelles did public expenditure fall, due mainly to a programme of fiscal reforms implemented in 2008 to stave off an impending debt crisis.

Natural disasters have contributed significantly to the high levels of indebtedness in small states. As an immediate response to natural disasters, small states' governments have increased spending to aid recovery, rehabilitation and reconstruction efforts. Typically these unplanned for expenditures have been funded directly from government budgets, as it can take too long for overseas aid to be delivered.

Commonwealth proposals

In light of small states' pressing development challenges and the shortcomings of available financing and other mechanisms, the Commonwealth has developed the following proposals to address small states debt and financing burdens.

Debt swaps for climate change adaptation and mitigation

The Commonwealth proposal for a multilateral debt relief-for-climate swap (Commonwealth Secretariat 2012) illustrates that there is ample scope for small states to find innovative solutions to address their debt challenges, in spite of the

> *The Nature Conservancy*, a leading global conservation organisation, is using *debt swaps* to relieve commercial debt in an innovative way. The model combines different resources, including official and impact capital, to buy commercial debt and to finance adaptation activities. The Nature Conservancy is involved in negotiations with several indebted small states, most recently opening dialogue with Seychelles.

resource constraints of international financial institutions (IFIs). The proposal has the potential to provide small states with significant debt relief and to assist them with unlocking pledged climate funding to finance climate change adaptation and mitigation projects.

While there remains an ongoing need for additionality of resources to finance development in poor, small and vulnerable developing countries, this proposed mechanism does not require additional donor resources. On the contrary the proposal:

- Increases the disbursement of pledged funds quickly in order to help reduce the climate finance implementation gap;
- Allows for debt relief to be counted as ODA, which helps donors to meet internationally agreed targets; and
- Gives donors flexibility in the design and hence the amount of debt relief provided.

The multilateral debt relief for climate finance initiative is essentially a variant of a debt-for-nature swap. There are three actors involved: multilateral institutions, donor countries and small states debtor countries. Under this initiative multilateral institutions gradually write off 100 per cent of small states' multilateral concessional debt stock, contingent on donor approval. States would deposit the annual payment of existing multilateral concessional debt service, in local currency, into a trust fund over a period of 10-15 years. The trust fund would be governed by respective central banks and the funds would be used to finance climate change adaptation and mitigation projects.

Based on 2010 data and assuming 100 per cent write down of small states' multilateral concessional debt stock, the total cost of the initiative is estimated at between US$4.5 million and US$4.5 billion depending on donors' preferred eligibility criteria. In terms of feasibility within a solely Commonwealth context, this is within the US$5.78 billion of total climate funds pledged by the UK, Canada and Australia since 2003. Should this aid be forthcoming, a Commonwealth multilateral debt relief initiative could translate into between US$0.4 million and US$277.2 million in climate financing for small indebted countries. To put it simply, by facilitating the debt write down of small states' multilateral concessional debt, contributing donors would in effect help to convert future debt obligations into climate finance for these countries. Over the life cycle of the debt swap (the suggestion is 10-15 years), the initiative could be expected to generate between US$6 million and US$4.2 billion worth of climate financing.

Vulnerability as a criterion for accessing concessional resources

Vulnerability should be urgently added to the criteria for eligibility to access concessional resources and official development finance from international financial institutions. Small states' vulnerability has been the basis for the World Bank's 'small island economy exception' and the IMF's inclusion of a small economy exception for access to resources from its Poverty Reduction and Growth Trust (PRGT). The IMF has also included small states' vulnerability as a criterion to determine graduation from PRGT resources in an effort to safeguard against premature and reverse graduation. Paradoxically, however, neither institution has thus far considered vulnerability as a criterion for eligibility to use their concessional facilities.

This is surprising, even in the context of financing constraints, given that some middle-income small states are now ranked among the most vulnerable in the world. For example, the Caribbean states of Jamaica and St Kitts and Nevis are ranked among the countries that are most vulnerable to natural disasters and have experienced a significant decline in performance over the past four decades in spite of relatively high per capita incomes. Meanwhile they are confronted with high and unsustainable debt, in part because of their inability to access concessional funds.

In the framework of the Commonwealth's proposal, a standard similar to the 'absence of serious short-term vulnerabilities' criterion used by the IMF to determine graduation from PRGT funding (Box 1) could be added to the eligibility criteria for use of IFI concessional resources. If this were implemented there would be three rather than two criteria used to determined eligibility to concessional resources:

1. Income below the IDA cut-off point;
2. No sustained access to financial markets; and
3. Signs of significant short-term vulnerabilities (as in Box 1).

In determining whether to grant use of IMF and World Bank concessional resources, where a country fails on criteria 1 and 2, the third criterion could be used to make the assessment. This would assist in preventing the rapid accumulation of debt witnessed in small states during 2009 and 2010 and it could also help to minimise the instances of untimely debt default, thus leading to more timely and orderly debt restructurings.

In terms of the impact on IFI concessional envelopes, the addition of a vulnerability criterion would not necessarily imply a need for an increase in the total financial envelope or a reduction in concessional resources for already eligible low-income countries. As seen in the recent crises, not all countries have been affected equally by external shocks. In fact, LICs managed to weather the crises much better than their middle-income counterparts, to which concessional finance is not extended. Hence, if a vulnerability criterion were added, concessional resources would only have to be committed to the most affected vulnerable countries, which at any point is highly unlikely to include all LICs and all small states. To control access levels, IFIs would simply have to establish vulnerability thresholds for loss of income, debt and market access as in the case of graduation.

Counter-cyclical loans to mitigate debt accumulation, growth challenges

Broad based implementation of counter-cyclical loan mechanisms to reduce debt accumulation episodes and consequent growth challenges in small states could help countries better cope with external shocks without unnecessarily interrupting growth and development. Particular focus has been placed on counter-cyclical lending contracts, in which it is agreed ex-ante that debt servicing will automatically be allowed to fall, or become zero, in periods when external shocks (measured in a specific way, such as fall in value of exports) hit a particular country (Griffith-Jones and Tyson 2010).

In light of the continued sovereign debt crisis in Europe and the slowdown of the world economy, it would be both important and timely to scale-up and expand the stock of instruments that help developing countries when they are hit by shocks.

Agence Francaise de Development (AFrD) has been applying counter-cyclical lending in a creative way since 2007. AFrD's *counter-cyclical loans (CCLs)* pay for the borrowing countries' debt holidays through a fixed grace period of five years and a floating grace period, also of five years. The latter debt holiday, on capital repayments, can be used automatically if the debtor country choses to do so. This allows the debtor country to suspend debt servicing if its merchandise exports fall by 5 per cent or more in relation to the moving average of the previous five years. These debt service holidays are unconditional and are equivalent in cash terms to conditional new compensatory financing for those countries that have borrowed previously. Lack of conditionality for debt holidays, although seen as an attractive feature for developing countries, is only relevant for countries that have borrowed fairly significantly in the past.

Counter-cyclical lending, if more widely applied, would represent an important instrument to complement existing shock absorber mechanisms. The IMF, World Bank and Inter-American Development Bank (IDB) have been studying the application of counter-cyclical/precautionary lending for some time but none of the instruments developed (e.g. IMF precautionary lending instruments and IDB counter-cyclical loans) deliver the type of assistance that would meet the specific needs of small states. For example, the IDB precautionary mechanisms carry various commitment fees and add to the debt stock during crisis episodes.

Resilience building as a policy condition for IFI lending

The international financial institutions should open macroeconomic adjustment programmes to resilience building and allow resilience building to serve as the main policy conditionality for small states access to IFI resources.

Resilience is defined as a country's ability to cope with external shocks, i.e. to withstand the effect of harmful external economic events and recover quickly from such shocks (Briguglio et al., 2009).

Resilience building in macroeconomic adjustment programmes would be accompanied by social, political and environmental reforms as well. Such reforms would involve implementation of macroeconomic stability, market efficiency, social development, good governance and environmental management (Briguglio et al., 2009).

Typically, given its function, the IMF has only focused on macroeconomic adjustment but this approach has been widely criticised for its negative effects on growth and development. Additionally, for access to international and bilateral aid and in debt restructurings, most countries have had to agree to an IMF programme that does not give due consideration to strengthening developmental elements. Resilience building, even though containing an element of macroeconomic adjustment, is more politically palatable and could help to avoid issues such as debt restructuring 'too little, too late'. To design this type of reform, the IMF would need to collaborate closely with the World Bank and regional development banks, which are better placed to consult on social, political and environmental policies.

Recognising that the poor economic performance and debt issues of small states have stemmed primarily from their exposure to external shocks, Commonwealth Finance Ministers, meeting in Tokyo, Japan in 2012, called for measures to improve their resilience. Meanwhile, the Commonwealth Secretariat's Small States Office has an entire work programme devoted to developing a resilience index for small states.

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