Addressing Macroeconomic Challenges in Small States

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World Bank
What makes many small states different from larger peers?

<table>
<thead>
<tr>
<th>High Vulnerability</th>
<th>Restricted Policy Space/Limited Resilience</th>
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</thead>
<tbody>
<tr>
<td>• Exposure to international price fluctuations/ concentrated exports &amp; high import dependence</td>
<td>• Diseconomies of scale in delivery of public services</td>
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<tr>
<td>• High costs of trade</td>
<td>• Economic impact of natural disasters large relative to policy buffers</td>
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<tr>
<td>• Vulnerability to natural disasters</td>
<td>• High Debt and Financing Challenges</td>
</tr>
<tr>
<td>• Financial sector vulnerability</td>
<td>• Limited Fiscal Space</td>
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<tr>
<td>• Importance of aid (esp. Pacific)</td>
<td>• Low and volatile growth</td>
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</tbody>
</table>
## Impact of Natural Disasters in Caribbean states

### Natural disasters

<table>
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- **U.S. Recession**
- **Global Financial Crisis**

*Source: WB staff calculations*
Many small states moderately to highly indebted

- Amongst IDA countries, all but one of the small states are at moderate to high risk of external debt distress; among WB clients, 14 out of 53 countries with moderately high to high risk to domestic or external debt distress are small island states.

- 8 of the 15 countries at high risk of external debt distress are small island states.
Some additional issues for small higher-income countries

• Many SIDS are:
  o middle- and high-income countries (according to WB’s income classification)
  o not eligible for IFI concessional resources or debt relief

• Some have had to rely on bonds
  o Complicated debt restructuring process
  o High debt to private creditors

• Several SIDS have also rely heavily on domestic debt
Proposals on financial instruments to small states

- Debt swaps for climate change adaptation and mitigation
  - Challenge: unlikely to represent a comprehensive solution

- Vulnerability as a criterion for eligibility to access concessional resources

- World Bank initiatives:
  - In IDA-17 lending terms to small island states exempted from lowering maturity and grace of regular IDA terms
  - Annual minimum base allocation increased from SDR 3 million to 4 million, which likely benefits mostly small states
  - Countercyclical loans (IDA-17 Crisis Response Window)

- Resilience building as a policy condition for international financial institution lending
The Challenge: Building Resilience

• Macro/budget management
  – Prudent macroeconomic management best positions the economy against shocks and facilitates rapid donor response
  – Sound budget management maximizes value from resources

• Debt headroom
  – Maintaining a cushion between current debt levels and ‘debt distress’ thresholds provides room to use concessional loans to mitigate the impact of shocks on the economy

• Asset buffers
  – Build prudential reserves
  – Catastrophe loans/bonds/contingent credit lines

• Reduce vulnerability
  – Facilitate use of alternative energy to reduce oil dependence
  – Facilitate natural resource/tourism industry development
  – Expand labor market access to secure remittances
The Comprehensive Debt Framework

The framework is structured around four pillars, reflecting the fundamental causes and symptoms of high debt in small states.

4 pillars for reducing long term debt:

- Enhancing private sector led growth
- Improving fiscal management
- Mitigating fiscal impact of natural disasters on debt and fiscal profile
- Restructuring debt portfolios

3 instruments for debt restructuring

A: Debt buy-back operation
B: Debt for debt swap
C: Debt equity/asset swap
Implementation of the CDF and Similar Approaches in SIDS

Grenada
CDF

The Government of Grenada has designed a comprehensive program to boost inclusive growth and restore fiscal sustainability. The program is being supported by the World Bank, IMF, and CDB; discussions are ongoing for an ECF and DPL.

Pacific
Catastrophe Risk Insurance Pilot
CDF Pillar 3

Innovative solutions for SIDS highly exposed to natural disasters:
- Innovative financial products to raise resilience
- Advisory services to strengthen budget planning and execution
- Private sector involvement
- In collaboration with donor partners

Seychelles
CDF Pillars 1, 2, & 4

Crisis Response: High debt, loss of competitiveness and reserve losses led to payments default. Reforms have reinstated high per GNI, standards of living and human development indicators, and better governance than comparators. Reforms included:
- Exchange rate liberalization; significant tightening of fiscal policy;
- Reducing state’s role in economy; debt restructuring; debt relief.