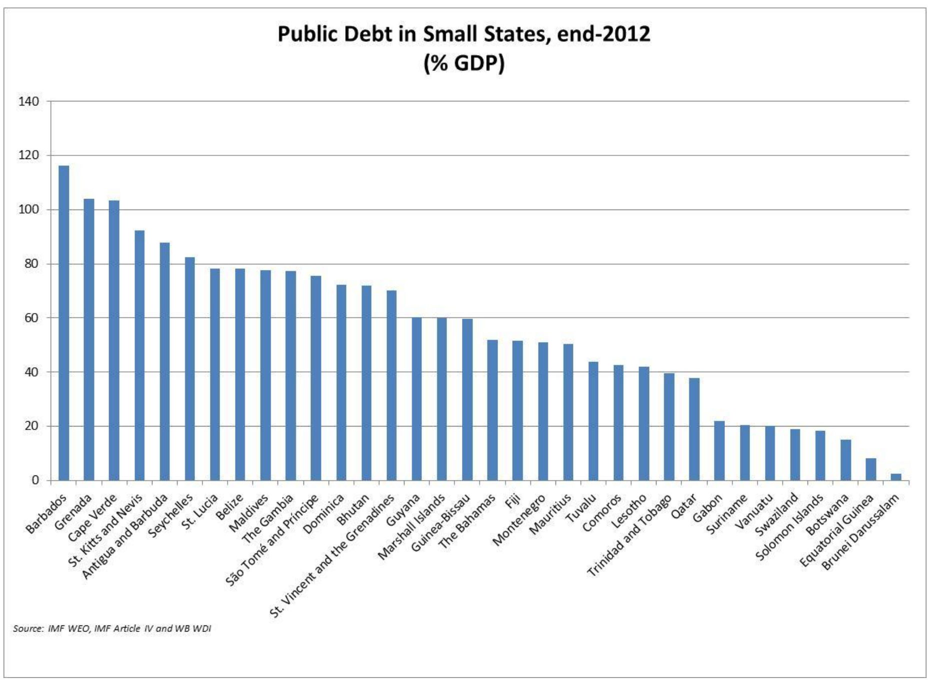
2013 SMALL STATES FORUM
FISCAL SUSTAINABILITY: BUILDING RESILIENCE AND ADDRESSING VULNERABILITY

ISSUES NOTE[1]
SESSION II: PROMOTING EFFECTIVE DEBT MANAGEMENT AND SUSTAINABLE GROWTH

Small states exhibit disparate public debt levels. Several small states built up very sizeable public debt on account of expansionary fiscal policies and fixed exchange rate regimes. For a number of them, debt has remained substantial even after large debt restructurings with official and private creditors. However, almost half of small states have relatively small public debt.

The composition of public debt portfolios also differs. In general, small states rely more heavily on external sources rather than domestic markets for their public financing needs although there are some important exceptions. Borrowing patterns are a reflection of access to external sources of capital and the extent of domestic markets.



[1] This Issues Note draws on the recent World Bank Policy Research Working Paper No 6356 "Small States: Performance in Public Debt Management" (Prasad, Pollock and Li February 2013) and the "Reducing High Debt in the Caribbean" presentation made by Gooptu and Kouame to the Small States Forum in 2011.

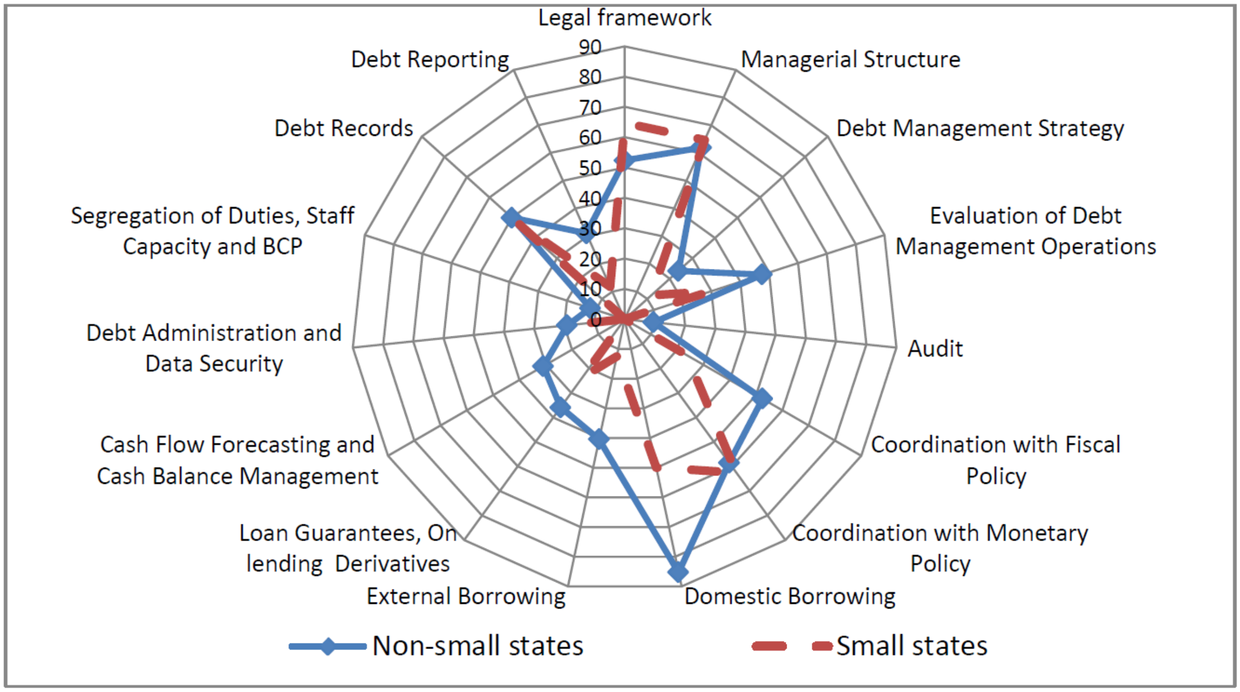
It is necessary to look at debt issues in a holistic manner, taking into account diverse country circumstances and vulnerabilities, including to natural disasters and climate change, depth of the private sector, and health of the macroeconomic situation.

EFFECTIVE DEBT MANAGEMENT

The fact that almost half of small states have relatively small public debt demonstrates the capacity of small states to overcome vulnerabilities with sound economic management. Strengthening institutions and policies by implementing reforms, particularly in macro-financial and debt management areas, is critical to mitigating the broader risks to which small states' economies are exposed: limited economic opportunities, lack of diversification, disproportionately high infrastructure and transaction costs, and high vulnerability to natural disasters. All of these factors can heighten the risk of significant and rapidly worsening macro-economic and debt dynamics.

Poorly structured debt in terms of maturity, currency or interest rate composition, and large unfunded contingent liabilities, has been an important factor in inducing or propagating economic crises. As shown in the Debt Management Performance Assessment (DeMPA) reports of 17 small states, most have rudimentary debt management functions, practices, and systems. Small states perform well below other developing countries for which DeMPAs have been conducted. Significant weaknesses are also observed in the quality of the debt management strategy and the lack of an operational risk management plan, including business continuity and disaster recovery arrangements.

Number of Small States Meeting Minimum Requirements of DPIs



Source: DeMPA reports for 17 sample small states and 42 non-small states

Small states may, on account of their size and other specific features, be impeded by institutional and manpower constraints. However, these cannot be viewed as insurmountable obstacles resulting in poor debt management and must be simply regarded as constraints that must be factored into the structure of the debt management processes and addressed in the formulation of debt management objectives, strategies, and reform programs. The fact that small states have already demonstrated their ability to perform well on some dimensions of debt management bears this out.

There are a number of practical, and relatively simple steps, that small states can take to improve debt management capacity and many of them are likely to have a rapid payoff. In this regard the DeMPA is an important input that can serve as a guide not only to help formulate more robust debt management practices but also to pinpoint areas where weaknesses in debt management can most quickly be rectified. These areas include:

*(a) **Pooling resources through regional cooperation.*** Small states should exploit more fully the commonality of their legal and institutional approaches and other key building blocks that underpin debt management, particularly regionally.

*(b) **Maximizing the gains of information technology.*** Computer-based systems to manage external and domestic debt are readily available from international agencies like the Commonwealth Secretariat and UNCTAD.

*(c) **Realizing the full benefits of staff training.*** Staff training, and the associated challenge of staff retention, is high on the debt management agenda (and other agendas). Training opportunities abound with myriad international debt management and training courses and seminars on offer.

*(d) **Widening financing options through the development of domestic debt markets.*** For small, open economies the presence of deep bond markets in local currencies are particularly important as it allows for better absorption of volatile capital flows, provides institutional investors with instruments that satisfy their demand for safe and stable long term yields, reduces financial instability associated with asset price bubbles (crucial for the efficient conduct of monetary policy), and provides a reliable source of capital to fund public and private ventures under market discipline and scrutiny.

COMPREHENSIVE DEBT FRAMEWORK

Debt sustainability can only be achieved if accompanied by sustainable growth. To this end, the World Bank has rolled out the Comprehensive Debt Framework (CDF) to address the structural interdependent causes of high debt, low growth, and natural disasters. The framework is structured around four pillars:

The four pillars of the CDF

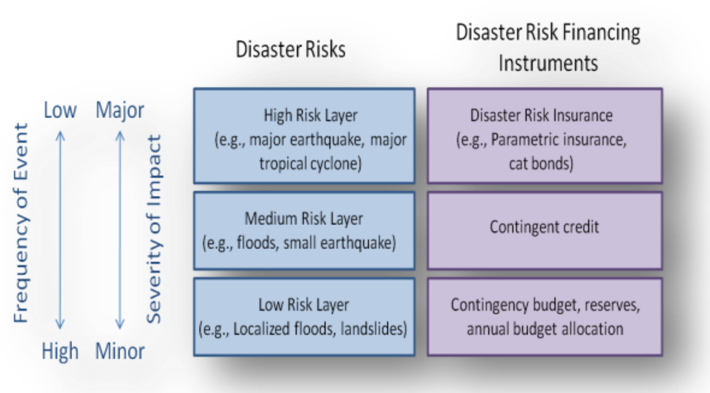
Pillar 1: Promoting private-sector led growth. The inherent economic characteristics of small economies suggest that they face critical challenges in achieving sustained long-run growth. The challenge in the Caribbean is to shift the focus from a subsidy-driven policy to one that provides a conducive investment climate for all

potential investors. Governments need to play a key role in promoting an adequate investment climate that gives the right signals, encouraging productivity improvement and investment in non-traditional areas that create increased spillovers and linkages with the domestic economy.

Pillar 2: Fiscal Management. Private sector-led growth and an attractive investment climate are intimately linked with effectiveness in government expenditures, the tax burden, and non-preemption of resources by government debt. Indeed, there is a clear need to consolidate fiscal balances, manage tight public resources efficiently and public debt strategically. Yet, while short-term fiscal tightening is required in some cases, permanent structural improvements are necessary to place public finances on a sustainable path.

Pillar 3: Resilience to Natural Disasters. *S*mall states are among the most vulnerable countries in the world to multiple hazards, which has significant negative impacts to their economic stability and government's ability to service its debt. In this context, it is critical that policies are put in place that strengthen national capacity to: 1) reduce the base risk to external hazard shocks, and 2) develop a risk financing framework designed to smooth out the impact of disasters on public finances. Reducing the base risk to natural hazards requires a stronger integration of hazard risk in physical planning and building processes through improved territorial planning, design standards and techniques, and regulatory systems in order to slowly reduce base risk over time (through new physical developments or corrective investments on existing structures). On the other hand, developing a risk financing framework requires an assessment of the contingent liabilities of the state to catastrophe risk, and the subsequent elaboration of a strategy to develop tools or mechanisms to address the various risk layers. Currently, most countries in the Eastern Caribbean have some basic risk insurance instruments such as Caribbean Catastrophic Risk

The Disaster Risk Financing and Insurance Framework



Insurance Facility (CCRIF), but nothing that would disaggregate the various risk layers in which each country is exposed.

Pillar 4: Debt Resolution. For most highly indebted developing small states, measures in the first three pillars would be insufficient to achieve debt sustainability. They will need to be complemented with reductions in debt service and possibly debt stock, if the objective is to achieve sustainable solutions. The type of restructuring, the coverage of the restructuring (whether domestic or international), and whether multilateral and bilateral funding is required, depends on countries' debt and creditor profiles.

Thanks to a strong dialogue with the country private and public stakeholders, the CDF has generated a chain reaction of complementary engagement and donor support, which has in return favored new ideas and approaches on how to tackle the long-standing issues of low growth and debt sustainability in the Caribbean as a whole. Focusing on problem-solving with multi-sectoral teams has proven a good way to advance in the challenging environment faced by small island states, which are highly vulnerable to external shocks and that often have limited implementation capacity.

QUESTIONS FOR DISCUSSION:

- *Arguments in favor of improving debt management are especially compelling for small states that must mitigate the particular risks to which their economies are exposed. What do Ministers see as priorities areas for improvement?*

- *While debt restructuring may sometimes be inevitable, it is not always a lasting solution for debt sustainability. What other measures and reforms should be considered to bring debt levels to sustainable levels?*

- *Many of the debt problems faced by small economies stem from their vulnerability to natural disasters and exogenous shocks, which pressure them to respond in a debt-creating fashion. What lessons can be learned from past experience and applied going forward?*

- *For countries facing low growth and high debt, fiscal consolidation may be a painful but inevitable component of a reform program aimed at restoring growth. What are the key elements of a successful fiscal consolidation program that could help long term growth?*
- *What further actions can international financial institutions and other development partners take to assist small states in this area?*