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STAFF GUIDANCE NOTE ON THE FUND'S ENGAGEMENT WITH SMALL DEVELOPING STATES

March 24, 2014

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March 24, 2014

STAFF GUIDANCE NOTE ON THE FUND'S ENGAGEMENT WITH SMALL DEVELOPING STATES

EXECUTIVE SUMMARY

This note highlights the unique economic characteristics and constraints facing small developing states. It provides operational guidance on Fund engagement with such countries, including on how small country size might influence the use of Fund facilities and instruments, program design, capacity building activities, and collaboration with other institutions and donors.

The guidance note draws on the March 2013 Board papers on small states and the associated Executive Board discussion. The findings of the paper and implications for Fund engagement with small states were presented to small states authorities during the 2013 Annual Meetings, as well as in regional IMF conferences with small states in the Bahamas (September 2013) and Vanuatu (November 2013).

Based on the analysis in the Board papers and the above mentioned discussions, five key thematic areas (G.R.O.W.TH.) were identified as central to the policy dialogue:

- **Growth and job creation.** With small states experiencing relative weak growth since the 1990s, Fund staff working on small states should ensure an explicit focus on growth in both surveillance and program-related work.
- **Resilience to shocks.** Small states experience higher macroeconomic volatility and more frequent natural disasters. Staff should be ready to advise on how to tailor macroeconomic policies to provide greater resilience to shocks.
- **Overall competitiveness.** Options to improve relative prices may include exchange rate adjustment (where possible) or measures supportive of internal devaluation (if not), and efforts to improve the business climate, including through regional initiatives.
- **Workable fiscal and debt sustainability options.** With many small states having very high debt burdens, reducing debt to manageable levels requires sustained fiscal consolidation with supporting policies and structural reforms. In cases where the amount of adjustment needed to restore debt sustainability is not feasible or adequate financing is not available, debt restructuring may be needed.
- **Thin financial sectors.** The promotion of deeper and more competitive, yet sound financial sectors contribute to economic growth in a macroeconomic stable environment and more effective policy mechanisms.

In applying this guidance, staff should continue to tailor their engagement to specific country circumstances.

Approved By
Siddharth Tiwari

This note was drafted by Sarwat Jahan, with significant contributions from Xavier Maret, under a project supervised by Peter Allum and Seán Nolan (all SPR). The note benefited from consultations with small states authorities, inputs from members of the IMF's Small Islands Club, and review by Fund departments and the World Bank. Fund departments also provided country case studies and examples of operational best practice (AFR, APD, FAD, MCM, and WHD). Research assistance was provided by Barbara Dabrowska, Sibabrata Das, Emmanuel Hife, Carla Intal, Lisa Kolovich, and Ke Wang, and production assistance by Neri Gomes and Nazma Nunhuck (all SPR).

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Abbreviations and Acronyms

AFRITAC	African Regional Technical Assistance Center
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
CS	Commonwealth Secretariat
CLICO	Colonial Life Insurance Company
DSA	Debt Sustainability Analysis (IMF and World Bank)
ECCU	Eastern Caribbean Currency Union
EMs	Emerging Markets
ENDA	Emergency Natural Disaster Assistance (IMF)
EPCA	Emergency Post-Conflict Assistance (IMF)
ESF	Exogenous Shocks Facility (IMF)
FSAP	Financial Sector Assessment Program (IMF and World Bank)
GNI	Gross National Income
GRA	General Resources Account (IMF)
IDA	International Development Association (World Bank)
IFIs	International Financial Institutions
LICs	Low-Income Countries
MEFP	Memorandum of Economic and Financial Policies (IMF)
MDBs	Multilateral Development Banks
NPL	Non-performing Loan
ODA	Official Development Assistance
OFCs	Off-Shore Financial Centers
PICs	Pacific Island Countries
PFM	Public Finance Management
PPPs	Public Private Partnerships
PSI	Policy Support Instrument (IMF)
PRGT	Poverty Reduction and Growth Trust (IMF)
REO	Regional Economic Outlook
RCF	Rapid Credit Facility (IMF)
RDBs	Regional Development Banks
RFI	Rapid Financing Instrument (IMF)
RGSM	East Caribbean Regional Governments Securities Market
ROSC	Report of the Observance of Standards and Codes
SBA	Standby Arrangement (IMF)
SMP	Staff-Monitored Program (IMF)
SSF	Small States Forum
TA	Technical Assistance
UCT	Upper Credit Tranche (IMF)
WEO	World Economic Outlook (IMF)

INTRODUCTION

1. **This guidance note focuses on small developing countries with populations of under 1.5 million.** This is a common metric in the small states literature, and is also used for the PRGT eligibility framework.¹ The Fund has 42 members with populations of fewer than 1.5 million, of which 33 are small developing countries (hereafter “small states,” Annex Table I).² The guidance note also considers the special macroeconomic challenges faced by “micro” states, with populations of fewer than 200,000. In practice, many countries with populations larger than 1.5 million have characteristics of “smallness,” and this guidance note applies, in varying degrees, to these countries as well.
2. **The note provides operational guidance to staff on the Fund’s engagement with small states.** It reflects the March 2013 Executive Board discussion of small states and the associated background papers.³ The findings of the paper and implications for Fund engagement with small states were presented to small states authorities during the 2013 Annual Meetings, as well as in regional IMF conferences held in the Bahamas (September 2013) and Vanuatu (November 2013).
3. **The Fund has recognized, in various policies and fora, the special characteristics and challenges of small states.** Small size is a factor informing decisions on PRGT eligibility. Fund staff share analytical perspectives through a “Small Islands Club”, cross-country analytical studies and regional conferences that regularly address the needs of small states; and regional technical assistance centers in the Caribbean and the Pacific focus primarily on the capacity building needs of small countries. During the Annual Meetings, the Fund participates in the Small States Forum (SSF),⁴ at which small state members discuss selected thematic issues of interest.
4. **Fund policies and engagement cannot be informed by country size alone.** “Smallness” is one important factor that should influence Fund policy analysis and advice. But small states are very heterogeneous. Some have achieved considerable economic success while others are among the poorest in the world. Staff should focus on the particular economic needs of each country, rather than adopting a standardized approach based on economic scale.

¹ The World Bank’s IDA also includes a small island economy exception linked to countries with populations under 1.5 million. The same cutoff was used to define small states in the influential 1998 Joint Task Force Report on Small States of the Commonwealth Secretariat and World Bank. The Small States Forum includes a handful of countries with populations above 1.5 million.

² This latter figure excludes small states defined as advanced market economies for WEO purposes, as well as fuel-exporting countries classified by the World Bank as “high income” (Bahrain, Brunei Darussalam, and Equatorial Guinea).

³ “Macroeconomic Issues in Small States and Implications for Fund Engagement”; “Asia and Pacific Small States—Raising Potential Growth and Enhancing Resilience to Shocks” ; and “Caribbean Small States—Challenges of High Debt and Low Growth”; and the associated summing up “The Acting Chair’s Summing Up-Macroeconomic Issues in Small States and Implications for Fund Engagement”.

⁴ The World Bank provides secretariat support to the Small States Forum (SSF).

5. **This note focuses on what is distinctive about small developing economies.** For instance, although small states are often poor, poverty is not primarily an issue of scale, and is not addressed here in detail. The note is intended to be a primer for staff new to small states issues, but, by providing a consolidated overview of small states issues, should be of value also to experienced country teams.

6. **The guidance note is organized as follows:** First, it discusses common characteristics of small states. It then covers how small country size should influence the Fund's policy advice, its analytical work, the use of Fund facilities and instruments, program design, capacity building activities, and collaboration with other institutions and donors. The appendices provide country examples and illustrate good practices.

DISTINCTIVE CHARACTERISTICS OF SMALL STATES

7. **Small states do not enjoy the benefits of economies of scale.** Technologies for producing goods and services are commonly subject to indivisible fixed costs. In the case of tradables, these costs represent powerful barriers to entry for firms in small states, causing these countries to instead rely on imported rather than domestically-produced goods and services. This results in high trade openness (Table 1), heavy reliance on volatile trade tax revenues, and high exposure to terms-of-trade shocks. With a narrow economic base and small market size, there is often limited scope to use specialized expertise, which is a factor behind high rates of outward migration (or "brain drain") among the more highly educated.

8. **Scale economies hamper the provision of public goods and services.** Small states do not have populations large enough to support a full range of public goods and services, notwithstanding high levels of public spending in relation to GDP. Where key public infrastructure is under-provided (ports, power, roads, etc), this can adversely impact competitiveness. With public policy agencies that are limited in absolute size, capacity to design and implement policies can also be a challenge.

9. **As a result of narrow production and export bases, as well as greater vulnerability to external shocks, small economies experience more macroeconomic volatility than larger peers.** This is particularly evident in regard to the growth and external performance of micro states (Table 1). Volatility comes from narrow production and export bases, which leaves small states macroeconomically vulnerable to industry-specific shocks. In addition, many small states are vulnerable to natural disasters (such as earthquakes and hurricanes) both because of their location and because they do not have the geographic scale to provide diversification against location-specific shocks. Small islands (atolls) face particular challenges from climate change. The ability of small states to manage such shocks is typically hampered by limited fiscal space, weak fiscal frameworks, shallow financial systems (which gives less scope to rely on domestic financing to weather shocks), and thin administrative capacity (which complicates disaster mitigation and recovery efforts).

Table 1. Selected Indicators of Small States

Country Groups / Indicators	2000-2010, median		
	Micro	Other SS	Other LICs and EMs
GDP Per Capita Growth (annual, percent)	1.8	1.9	3.0
GDP Per Capita (current U.S. Dollars)	5515	2785	1813
(Percent of GDP)			
Trade Openness	90	105	73
Government Expenditure	31	36	29
Government Debt	92	49	47
Net ODA Received	4.2	4.1	4.6
Volatility Measures			
GDP growth	3.4	2.8	2.7
Current Account Balance to GDP ratio	5.5	5.0	3.4
Fiscal Balance to GDP ratio	2.9	2.8	2.0
Aid to GNI ratio	2.3	1.6	0.9
Private Capital Flows to GDP ratio	5.9	3.4	2.2

Sources: World Economic Outlook database; country authorities; and IMF staff estimates.

Note: Volatility is measured as a five-year backward-looking standard deviation of a variable. For example, the volatility reported for the year 2000 is the standard deviation of a variable x from year 1996 to 2000.

10. **Staff analysis of small states needs to pay special attention to the distinction between domestic value-added (GDP) and income accruing to nationals (Gross National Income, or GNI).** Small states typically have high levels of foreign ownership in many sectors of the economy; typical examples include banking, hotels, and resource extraction. As a result, policies that boost GDP via the expansion of predominantly foreign-owned sectors of the economy need not translate into an increase in GNI (which captures the welfare of nationals).⁵ Careful attention thus needs to be given to assessing income distribution effects (in particular the impact on incomes of nationals) in evaluating national policies.

11. **Strengthened growth performance is a priority for small states.** Per capita income levels and social indicators of small states are currently broadly in line with those of larger developing country peers, on average.⁶ But since the late-1990s, the average growth rate for small states has slowed, even as that for larger developing countries has accelerated with commensurate gains in social indicators (Table 1). Microstates have, unsurprisingly, also experienced higher levels of volatility than larger countries.

⁵ As an example, consider a case where all hotels are foreign-owned, the primary input purchased locally is semi-skilled labor, and the sector benefits from significant tax holidays: in such a case, a fall in wage levels, while it may promote additional investment in the hotel sector, could easily leave nationals worse off (unless the elasticity of employment to wage cuts is very high).

⁶ Larger peers are defined as countries with a population over 1.5 million, excluding advanced economies.

12. **High public debt levels are a problem, notably in the Caribbean, which includes some of the world's most highly indebted countries** (measured by debt-GDP ratios; Box 1). The Caribbean debt problems can be traced to the cost of natural disasters, poor fiscal management, loss-making public enterprises, and sub-par economic growth.⁷ Because of the middle-income status of many Caribbean countries, they have not been eligible for debt relief under the HIPC/MDRI initiatives—although some have benefitted from other forms of debt relief, including through the Paris Club. While debt levels for the small Pacific island countries (PICs) are generally modest, rising levels of indebtedness in some countries are a cause for concern.

13. **Financial systems in small states are typically shallow, concentrated, and foreign-dominated.** The economic base in small states is rarely enough to support multiple financial institutions, and lending opportunities for banks are thin.⁸ As a result, banks in small states often lend disproportionately to the government, linking financial sector soundness closely to fiscal sustainability. Residents of small states, particularly in the Caribbean often rely on nonbank financial institutions. Both banks and nonbank financial institutions often suffer from high non-performing loans (NPLs) and low-asset quality (Caribbean credit unions are a case in point), partly because of weak institutions for financial supervision and regulation. Financial system vulnerability poses risks, in turn, for budgets (through potential bailout costs). Regulatory capacity is also an issue for cross-border financial flows, with implications for risks of financial contagion and spillovers to other countries.⁹ It includes the capacity constraints to properly implement relevant international standards, including for AML/CFT and tax transparency purposes, exposing small states to reputational risks. Small states are also poorly served by global capital markets. International investors can be reluctant to take on small states exposure, given the risks posed by economic volatility and the disproportionate costs of administering and monitoring relatively small financial transactions. This can result in illiquid markets for debt in small states.

14. **Pegged or heavily managed exchange rates are typical for small states.**¹⁰ Fixed exchange rates provide a nominal anchor when options for an independent monetary policy are limited by administrative capacity or by weak monetary transmission mechanisms in shallow financial markets (see Appendix Box 2 for details). Tight management of exchange rates is also motivated by a desire to avoid the volatility that can come with thin foreign exchange markets and sizeable foreign exchange inflows and outflows—especially given the high exchange rate pass-through to inflation.

⁷ See Appendix Box 8 and 9 for the cases of Guyana and St. Kitts and Nevis, respectively.

⁸ In some cases, this occurs notwithstanding the existence of large off-shore financial centers (OFCs) serving non-resident markets.

⁹ For instance, the failure of CL Financial and its life insurance subsidiary, Colonial Life Insurance Company (CLICO), and the failure of the Stanford Financial Group had cross-border implications in the Caribbean.

¹⁰ In addition, some small states like Kiribati, adopt foreign currency as tender.

15. **Small states are somewhat more likely to be in fragile situations.** About one-fifth of small states are categorized as being in a fragile situation (Annex Table 1), compared to about one in eight for developing countries with populations of more than 10 million. In these countries, administrative capacity, which is already challenged by small country size, may be further undercut by domestic conflict, a fractious political setting, and questions of political legitimacy. Staff working on small countries in fragile situations can find relevant guidance on dealing with the special challenges in such countries in the May 2012 "Staff Guidance Note on the Fund's Engagement with Countries in Fragile Situations."¹¹

16. **Despite many common characteristics, there is considerable heterogeneity across small states.** Thus, comparing the Caribbean and Pacific island small states, those in the Caribbean tend to have higher per capita incomes but also higher debt burdens. By contrast, Pacific island small states have been growing more slowly and are much more reliant on development assistance (Box 1).

Box 1. Regional Characteristics of Small States¹

Caribbean countries

The majority of small states in the Caribbean are upper middle-income (as defined by the World Bank, see Annex Table 1), and median incomes for the region are almost three times higher than in Pacific island countries (PICs). Against this, median public sector debt (73 percent of GDP in 2012) is almost three times the median for PICs. Per capita growth performance has slumped since 2000, albeit remaining slightly ahead of PICs. The growth slowdown reflects deep-rooted competitiveness problems as well as issues with debt sustainability. Commodity exporters (Guyana, Suriname, and Trinidad and Tobago) are an exception, achieving faster growth.

Although no Caribbean small state is defined by the World Bank as being in a fragile situation, the six ECCU countries are among the top 10 most disaster prone countries in the world as measured by disasters per land area or population (hurricanes are a major threat).² The effects of natural disasters on growth and debt are accordingly significant.

Indigenous banks in the ECCU are structurally weak.³ Poor risk management practices, coupled with inadequate supervision and regulation, have led to capital shortfalls in most of these banks.

Pacific Island Countries (PICs)

The Asia and Pacific region includes some of the world's poorest small states. PICs are notable for being remote, widely dispersed, and lightly populated. With poor connectivity and high transport costs, they are not well integrated into the broader Asian regional economy; remoteness has limited their ability to grow through exports. Like Caribbean small states, PICs are severely affected by natural disasters and are vulnerable to the impact of climate change, including rising sea levels. One-third of PICs are defined by the World Bank as being in fragile situations (Annex Table 1).

¹ This box is limited to the regional characteristics of Caribbean countries and Pacific Island Countries as the sample size from other regions is small.

² See Rasmussen, T., 2006, "Natural Disasters and Their Macroeconomic Implications," pp. 181–205, in: *The Caribbean: From Vulnerability to Sustained Growth*, ed. by R. Sahay, D. Robinson and P. Cashin (Washington: International Monetary Fund).

³ These banks are defined as being locally owned and locally incorporated.

¹¹ <https://www.imf.org/external/np/pp/eng/2012/042512.pdf>.

Box 1. Regional Characteristics of Small States (concluded)

PICs face major capacity constraints, even by small states standards. For example, low rates of school enrollment contribute to low educational achievement. Financial depth is generally below that of other small states, with limited access to private credit a key impediment to inclusive growth.

PICs are much more heavily reliant on aid than Caribbean small states, and also face higher volatility in ODA flows. Typically, PICs face higher volatility than other small states in regard to per capita income growth, terms of trade, current account balances, and fiscal revenues.

Table: Selected Indicators of Small States in the Caribbean and Asia Pacific

Country group	GDP per capita (current US\$)		GDP per capita growth (annual %)		Trade Openness (X+M/GDP)	Net ODA received (% of GDP)	Private Credit (% of GDP)	Public Debt (% of GDP)
	1980-99	2000-10	1980-99	2000-10	2011	2010	2009	2012
Caribbean SS	2452	6088	3.2	1.6	100	3	64	73
PICs	1441	2301	0.9	0.7	94	20	57	28

PRIORITIES FOR POLICY DIALOGUE

This section points to policy issues likely to be particularly important to small states in the Fund's surveillance and program-related work.

A. Growth and Job Creation

Policies to strengthen growth and job creation are a priority.

17. **The Executive Board and management have highlighted the need for an explicit focus on growth in the context of small states.**¹² This discussion and the authorities' policy agenda should be clearly presented in country staff reports. The implications for staff are discussed further below and in Box 2.

18. **Staff teams need to be ready to discuss growth issues for specific sectors and consult appropriately with other development partners.** In discussing the macroeconomic outlook, teams need to be conversant with the economics of the dominant industries (e.g., tourism, resource extraction), often acquiring greater sectoral expertise than would be typical for larger, more diversified economies. Exchange of cross-country experiences would be beneficial in this context. That said, staff should limit policy advice to areas that fall within the Fund's mandate and maintain emphasis on the contributions to growth made by promoting a macroeconomic and financial environment that is conducive to investment and efficient allocation and use of resources. For detailed industry advice, Fund staff will commonly need to rely on expertise from other development institutions.

¹² See recent presentations to small states regional conferences by DMD Shafik in the Bahamas in September 2013 (<http://www.imf.org/external/np/speeches/2013/091913a.htm>) and by DMD Zhu in Vanuatu in November 2013 (<http://www.imf.org/external/np/seminars/eng/2013/PIC/>). The Board has stated, with regard to the Fund's engagement with small states, that fostering improved growth should be an important priority.

Box 2. Explicit Growth Focus on Small States¹

Breadth and reporting of discussions. Fund staff should explicitly discuss the growth agenda with the authorities. The discussion should cover: (i) the effects of fiscal, monetary, and exchange rate developments on growth and employment; (ii) the outlook for economic growth (if data allow, from both the demand and the supply side, and with a discussion of multipliers); and (iii) the envisaged policies to support growth (macroeconomic policies including public investments, structural reforms, etc). These discussions should be given appropriate prominence in the Fund's surveillance and program documentation.

Country specificity. The focus and ambition of the growth agenda will depend on the most critical growth impediments in a given country (e.g., energy costs, overvaluation, crowding out, infrastructure), the goals of a possible Fund-supported program, and the government's preferences and implementation capacity.

Program conditionality. Program conditionality should focus on measures to strengthen growth performance, where this is needed to solve a country's balance of payments problem and achieve medium-term external viability while fostering sustainable economic growth. While Fund staff should help countries design strong pro-growth policies, Management's call for an explicit growth focus in Fund-supported programs of small states is not intended to extend or intensify overall Fund conditionality. Conditionality should remain parsimonious and macro-critical.

Competitiveness. Staff should explore the extent to which public sector dominance and the challenge of scale economies adversely affect competitiveness. It should assess to what extent sub-par growth reflects unduly elevated cost levels, and should explore options to improve the latter, if needed. Policies to improve relative prices should include exchange rate adjustment (if an option) or measures supportive of internal devaluation (if not) (see Appendix Box 3 for details). Efforts to improve the overall business climate could include moving from industry-specific tax incentives to a more generally business-friendly system with a broad base and lower tax rates. Regional initiatives can also be considered, such as efforts to reduce tax competition or to maximize revenue for fishing licensing fees (such as the Nauru agreement² in the PICs). The authorities may want to complement broad-based reforms with steps to remove obstacles to growth for key sectors (e.g., skills, infrastructure, and regulation).

Implications for fiscal adjustment. Efforts to deliver an explicit focus on growth should be consistent with goals for macroeconomic stability needed to underpin confidence and durable growth. Where additional public spending (or delayed fiscal consolidation) could have a positive growth impact, this should continue to be assessed from the perspective of available financing and implications for fiscal and debt sustainability.

Outreach. Clear and upfront outreach will be important—to clarify the role of the Fund and the nature of the Fund's commitment to include an explicit growth agenda in program design.

Jobs and growth guidance note. This guidance note provides details on the circumstances under which the Fund, according to the Articles of Agreement, can focus surveillance, program and policy discussions on inclusive growth.³

¹ Contributor: Jan Kees Martijn.

² The Nauru agreement brings together eight Pacific Island countries to sustainably manage tuna. The members are Federated States of Micronesia, Kiribati, Marshall Islands, Nauru, Palau, Papua New Guinea, Solomon Islands and Tuvalu.

³ For additional guidance on covering growth issues in Fund's surveillance and financial and technical assistance work see Jobs and Growth—Analytical and Operational Considerations for the Fund and Guidance Note on Jobs and Growth Issues in Surveillance and Program Work.

19. **Improved growth performance will typically require a stronger private sector contribution.** Small states tend to feature large public sectors, with state ownership of key economic assets as well as extensive public regulatory and other intervention. This has its origins in efforts to fill gaps where the private sector is deterred by small market size and in steps to provide social protection against external shocks. However, public sector intervention has often reached a scale that deters new private sector investment. Teams working on small states should take these factors into account when advising on growth-promoting strategies. Typically, the process will involve a rebalancing of public and private roles, with a closer working relationship between the two sectors, including leveling the playing field for new private sector entrants. In some cases, public infrastructure investments may be a priority, provided that they are consistent with fiscal and debt sustainability. In identifying impediments to private sector activities, teams should draw on available resources, including the Multilateral Development Banks (MDBs). Given the limited initial private sector role, the supply response to structural reforms may be slow and teams should be appropriately cautious in developing medium-term growth projections.

20. **Job-creation is a priority for small states.** With sluggish growth and undiversified, low-skill job opportunities, small states are characterized by high unemployment rates and outward migration by the better-educated (particularly in PICs). While this generates sizeable inward workers' remittances that help support the balance of payments, it reduces the growth dividend from educational investments. Guidance on macroeconomic policies that can help translate growth into job creation is provided in the *"Guidance Note on Jobs and Growth Issues in Surveillance and Program Work."*¹³

21. **The specific labor market institutions of small states merit attention.** In many small states, there is significant brain drain, the public sector provides the majority of formal sector employment, and wage levels can be relatively high. Staff should investigate how public employment and public wages affect the labor markets and the process of wage settlements and contracting in the rest of the economy. Public wages and high levels of remittances may create a reservation wage that undercuts the ability of the private sector to hire employees at wage rates consistent with competitiveness in domestic or export markets. Accordingly, measures to reduce the cost of the public wage bill may have the added benefit of enhancing overall competitiveness. At the same time, where possible, the long-term goal should be a virtuous circle of a larger economic contribution from the private sector, stronger productivity growth, better-paid jobs, and reduced migration of the better-educated. This typically requires structural transformation and diversification, although opportunities for diversification may be limited because of small scale and other impediments linked to small states.¹⁴ At the same time, migration and remittances will continue to play an important role in the economic development of many small states, and consideration should be given to options for maximizing the associated benefits.

¹³ www.imf.org/external/np/pp/eng/2013/092713a.pdf

¹⁴ See the forthcoming Board paper on structural transformation in LICs.

B. Resilience to Shocks

Staff should advise small states on how to tailor macroeconomic policies to provide greater resilience to shocks and enhance sustainability, with the support of Fund TA and capacity building activities.

22. **Staff's macroeconomic analysis should give prominence to potential shocks.** A first step is to assess the nature and scale of external shocks and their relevant transmission channels, including via the financial sector.¹⁵ Relevant risks include supply and terms of trade shocks to core industries, revenue volatility, vulnerability of workers' remittance inflows to economic cycles in host countries, and natural disasters. Having identified potential risks, consideration can be given to the appropriate balance between self-insurance (through development of strong fiscal and balance of payments buffers), external insurance (through formal sovereign insurance mechanisms or reliance on optional support from the International Financial Institutions and bilateral donors), and pass-through to the private sector (with the latter backed, to a varying degree, by private insurance cover).

23. **Macroeconomic resilience will typically require adequate fiscal and external buffers to weather shocks.** In particular, it is important to strengthen the fiscal framework to help insulate the budgetary spending from revenue volatility, especially as fiscal policies have often been pro-cyclical. Formulating fiscal policy in a medium-term fiscal framework and strengthening revenue collection through broadening the tax base and improving tax administration are important elements to increase fiscal resilience. Shocks that require a period of temporary higher public spending (disaster relief, say) can be covered in part through an explicit contingency in the budget. This will not be adequate to cover the largest shocks, which would require access to debt financing. Where shocks are potentially large, this may warrant contingency financing plans. And where fiscal policy is guided by a public debt ceiling, policies should be geared at maintaining sufficient space below this ceiling to weather a period of elevated borrowing. Where a small state operates a fiscal rule, this should ideally include specific provisions for how targets (such as a deficit ceiling) would be adjusted in the event of an external shock, and how policies would be brought back in line with the fiscal rule in the post-shock period.¹⁶ In addition, natural disaster funds or general budget contingency reserves or insurance policies are used to save resources in case natural disasters happen. From a PFM perspective, the access to these funds and the reporting on its use should be clearly defined and the allocation in the budget should be transparent. In the balance of payments, buffers can be provided by contingent lines of credit or, more likely, by holding an official reserve position that is adequate to allow draw-downs to finance temporary balance of payments shortfalls without destabilizing confidence.

¹⁵ The work of the Pacific Catastrophe Risk Assessment and Financing Initiative (PCARFI) for the PICs provides a useful diagnostic of the small islands' exposure to natural risks.

¹⁶ Absent this specificity, large shocks can lead policies to deviate from the fiscal rule for prolonged periods, with no mechanism to enforce the difficult transition back to compliance (see Appendix Box1).

24. **Aspects of public finance management can also be strengthened to help manage shocks.** Procedures that allow for monitoring and transparent reporting of the use of emergency disaster assistance may be needed to ensure repeated support from development partners. Similarly, the future cost of disaster-related public spending can be treated as a public contingent liability for budgetary purposes, helping to integrate risks into the cash and debt management framework. In addition, containing non-discretionary spending (such as the public sector wage bill) will help to enhance fiscal flexibility in the face of adverse shocks.
25. **Sovereign insurance mechanisms are a new option, but typically provide only marginal risk mitigation.** Under the Caribbean Catastrophe Risk Insurance Facility (CCRIF), 16 member governments are able to (i) transfer a portion of their hurricane and earthquake risk to the Facility at a price lower than what they would pay if they sought coverage individually in international insurance markets and lower than the cost of the capital they would need to hold or obtain in order to self insure; and (ii) receive a prompt cash payout, within two weeks or less, following a covered event.¹⁷ In practice, these facilities and schemes have required donor capitalization to help reduce the cost of premia to participating countries, and even on this basis prove to be an expensive insurance option (see Appendix Box 11 for details of the CCRIF). More recently, Japan, the World Bank, and the Secretariat of the Pacific Community have partnered with Pacific Island Countries to launch the Pacific Catastrophe Risk Insurance Pilot Program, intended to provide limited but rapid budget support following a disaster. The pilot program has established (i) that catastrophe risk insurance to the Pacific economies can be provided at competitive prices, as long as the program follows market standards and (ii) that regional cooperation among countries can halve the costs of insurance premia. The insurance cover needs to be complemented with the use of other financial instruments as it is not designed to cover all disaster losses (it covers only emergency losses but not the loss of assets).
26. **Programs designed to help recovery from natural disasters may also be an opportune time to pursue growth-enhancing reforms.** Inclusive job-creating growth and financial deepening can help countries build social and economic buffers to weather future disasters. To this extent, the period of recovery from a current crisis may represent an opportunity to revisit obstacles to growth that might be difficult to address in a more stable environment.
27. **Climate change poses specific risks for small states.** Low-lying atolls (such as Kiribati, Tuvalu, and the Marshall Islands) are at risk from rising sea levels and countries currently subject to hurricanes, cyclones, and flooding may experience more frequent and more extreme weather events in the coming years.¹⁸ These risks require long-term disaster mitigation plans that can be costly to public resources. Although the global community has pledged sizeable resources to help countries

¹⁷ PICs benefit from the Pacific Catastrophe Risk Insurance Pilot, as well as the Disaster Risk Reduction and Risk Management Initiatives whose implementation is under the purview of the World Bank.

¹⁸ For details see UN-OHRLS, 2009, "The impact of climate change on the development prospects of the least developed countries and small island developing states", Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States.

meet these costs, the flow of resources has been very limited so far, financing arrangements are convoluted, and lack of capacity is a problem in accessing climate change resources. In considering fiscal space, Fund teams should be sensitive to the long-term implications of climate change for the public investment needs of small states and should be ready to consider how these might be financed (e.g., with external resources, if available, or through domestic revenue mobilization, if not).

28. **Resilience building advice will need to be appropriately tailored for small states in fragile situations.** For these cases, teams should also be guided by the *Guidance Note on the Fund's Engagement with Countries in Fragile Situations*.¹⁹ In general, policy advice geared to fostering resilience would need to: (i) pay attention to political economy considerations; (ii) tailor the nature and pace of reforms to the need for security and social cohesion as well as levels of capacity; (iii) promote approaches conducive to sustained engagement with IFIs; and (iv) ensure close coordination with other IFIs and donors.

C. Overall Competitiveness

Staff will need to explore options to enhance competitiveness as the current levels are often inadequate, leading to sub-par growth. Political economy aspects of structural reform design and sequencing may require more careful attention in the context of small states.

29. **Structural inefficiencies, such as high energy and transportation costs, limited private sector development, and labor market rigidities, are key challenges to raising growth and improving competitiveness.** Policy advice to address these challenges could include facilitating domestic wage and price cuts to improve price competitiveness, such as in the tourism sector, and implementing structural reforms to improve the business environment, such as land tenure reform or remittance market reforms (see paragraph 21 for details).²⁰ Staff should also assess the desirability and feasibility of fiscal devaluations to improve competitiveness.²¹ Currency devaluation is another element of the toolkit to address broader macroeconomic imbalances in several countries.

30. **The role of exchange rate policy in strengthening competitiveness merits careful consideration and communication.** The question of when and how to implement exchange rate adjustment in small states is one of the more complex issues that national authorities face, and careful consideration of the country context is needed in addressing this issue:

¹⁹ <https://www.imf.org/external/np/pp/eng/2012/042512.pdf>.

²⁰ PICs face the highest cost of sending remittances in the world; these costs can often be reduced by expanding competition, such as by allowing more remittance service providers or elimination of exclusivity agreements.

²¹ In the Eastern Caribbean Common Union, the option of fiscal devaluation was assessed as unlikely to have a substantive impact on wage costs given limited scope to reduce payroll taxes in the region.

- In assessing competitiveness of tourism-dependent economies, staff should seek to go beyond approaches based on CGER-type analysis that are often not adequately tailored for application in small states.²²
- Where competitiveness issues arise, consideration of exchange rate adjustment needs to weigh the potential adverse impact on inflation discipline against the alternative costs of pursuing cost reductions to restore competitiveness.
- Given the openness of small states, currency adjustment tends to quickly pass through to inflation through imported goods prices. Where domestic production has an import component (e.g., foodstuffs for the hotel industry), this would tend to erode initial improvements in competitiveness.
- The eventual impact of currency adjustment on competitiveness will likely depend on the degree of pass-through to domestic wages. This, in turn, may depend on public sector wage policy, given the signaling role that the state sector has in many small states.
- In some cases, where diseconomies of scale and structural distortions are severe, improvements in price competitiveness may not elicit a large supply response. In such cases, improvements in relative prices would need to be combined with structural policies to help foster a larger supply response.
- Exchange rate adjustment can potentially benefit foreign-owned sectors disproportionately, underscoring the need for staff to assess the impact of adjustment on both GDP and GNI.

Some preliminary staff findings on the impact of exchange rate adjustment in small states are summarized in Appendix Box 3.

31. **Regional trade and cooperation may be of particular value to small states.** The loss of earlier trade preferences in advanced economy markets (exports of bananas, sugar, etc.) has been a key factor behind the less favorable growth performance of small states over the past decade, particularly in the Caribbean. Although Pacific island economies are so remote from each other that the cost of regional trade is very high, regional trade facilitation programs are currently being implemented that can reduce transaction costs. For the Caribbean, there may be scope to benefit from regional trade infrastructure arrangements, including exploiting the prospective growth of regional container traffic following expansion of the Panama Canal and the proliferation of e-commerce, which will circumvent local monopolies and reduce prices paid by consumers. There is also scope to promote regional collaboration in promoting access to common external markets and to reduce the cost of public service delivery in some cases through regional cooperation in air/sea transport (air traffic control, say), marketing the region together, and negotiating as a group with large trade partner countries and companies. The challenge here is that regional institutions can be politically attractive, yet often fail to achieve concrete economies of scale. The potential fiscal

²² More details can be found in External Assessments in Special Cases (2014), Departmental Paper, IMF; and Bilateral Surveillance Guidance Note (2012), IMF.

challenges brought by regional trade integration in terms of lost revenue would have to be addressed by broadening the tax base and strengthening tax administration and compliance.

D. Workable Fiscal and Debt Sustainability Options

Staff will need to find the appropriate balance of fiscal consolidation while promoting growth, particularly in heavily indebted countries.

32. **Restoring fiscal and public debt sustainability are key challenges, notably in the Caribbean.** Given the varied debt and macroeconomic situations of small states, policy frameworks for assuring debt sustainability should be tailored to the individual country. Experience shows that, in situations where debt burdens are excessive, restoring debt sustainability invariably requires stronger fiscal frameworks and sustained fiscal consolidation. Empirically, fiscal consolidation has been more successful when (i) the initial adjustment was larger; (ii) adjustment emphasized spending reductions—in particular, on current expenditure; and (iii) fiscal rules were present (see Appendix Box 1 on fiscal rules).²³ The pace of adjustment will have to be carefully judged by the staff, taking into account the impact of fiscal adjustment on growth and employment as well as the role of the private sector (for an illustrative example, see Appendix Box 4 on Kiribati). Proper consideration should also be given to important factors that determine the composition and pace of fiscal adjustment, such as: the size of fiscal multipliers, a country's position in the economic cycle, and short- vs. long- run concerns. In addition, measures to develop or strengthen social safety nets may be warranted to limit the potential equity implications of the proposed fiscal adjustment. To be successful, fiscal adjustment efforts typically need to be supported by capacity building activities and accompanied by bold growth-enhancing structural and governance reforms; it may also require more exchange rate flexibility. In this regard, public sector reform is likely to be a priority in many small states. Staff are encouraged to recommend sustained fiscal adjustment where needed, with supporting policies and structural reforms. Greater focus can also be given to ROCSs and PEFA's to formulate policy dialogue.²⁴

33. **Staff should be ready to help identify solutions to deal with high debt burdens, including debt restructuring, if needed.** Some individual small states may find that achieving debt sustainability through fiscal consolidation and growth alone is not feasible. The amounts of financing available and the ability to sustain adjustment may prove insufficient to deliver the needed debt reduction. In such cases, debt restructuring may need to be considered, in support of the country's fiscal consolidation and other policy efforts (Annex Table 5 details small states that have undergone debt restructuring). Drawbacks associated with debt restructuring must also be weighed—in particular those related to long-term growth (which may be dependent on future

²³ For example, while Jamaica (with a population of 2.7 million in 2012) does not meet the definition of a small state, it has many of the same characteristics, and the four-year Fund-supported program launched in 2013 included plans to adopt a fiscal rule in 2014 (the specifics are yet to be defined) to strengthen the effectiveness of fiscal discipline.

²⁴ Fiscal ROSCs, for example, have been undertaken in over half of larger countries but only 20 percent of small states.

financial market access) and financial stability (where the composition of debt and links to the domestic financial sector can be critical). The Fund's role in debt restructuring cases is well-established, and applies equally to small states. The Fund always recommends that the member country avoids default by remaining current on all debt obligations to the extent possible. It is up to a member country to decide whether to restructure its debt. When the authorities decide to pursue debt restructuring, the Fund leaves the details of the debt restructuring strategy to the debtor and its legal and financial advisors. The Fund can, however, help the member design an adjustment program to restore debt sustainability and ensure medium-term external viability, and can help determine the financing envelope that informs the deliberations of the debtor and its creditors. For small states with limited capacity, support in designing adjustment programs can be particularly valuable. Finally, the Fund should encourage member countries to include collective action clauses in their international sovereign debt contracts to facilitate orderly debt restructuring.

34. **Staff advice may frequently be sought on public-private partnerships (PPPs).** The main benefits of PPPs are a transfer of technology to the receiving country, an opportunity to ease financing constraints, and improved project management. Despite this, PPPs are not often utilized in small states, reflecting the broader challenges of attracting private sector investment. Where the authorities plan to rely more heavily on PPPs, Fund teams should be alert to the important quasi-fiscal risks that PPPs can bring as well as the implications for monopoly power²⁵ consultations with relevant staff in FAD and the World Bank on these issues is essential.

E. Thin Financial Sectors

Staff will need to ensure that any recommendation for the deepening of the financial sector occurs with adequate supervision and regulation.

35. **Priorities include deeper financial sectors, more competition, better service delivery, and strengthened oversight.** A first challenge for staff teams will be to compile relevant financial sector data to underpin analysis, including performance indicators. Only about a quarter of small states (and no micro states) have had a full FSAP in 2000-10, compared to about three-quarters of larger states. The overall goal for Fund policy advice and capacity development efforts in the financial sector should be to support improved growth performance while providing a financial buffer that can help companies and individuals manage economic shocks. Efforts to promote competition should foster rather than detract from stability, exploiting technological and other opportunities to achieve efficient scale in banking and other financial sector activities. An example is the East Caribbean Regional Governments Securities Market (RGSM), which consolidates the regional trading of debt instruments for member states of the ECCU, thereby creating a single regional financial space. Efforts to strengthen the legal framework for financial services and to

²⁵ A few useful references include, (a) Public-Private Partnerships, Government Guarantees and Fiscal Risk, International Monetary Fund, Washington D.C., 2006; (b) Issues Paper on Public-Private Partnerships and Fiscal Risks, International Monetary Fund, Washington D.C., 2007; and (c) Public Investment and Public-Private Partnerships: Addressing Infrastructure Challenges and Managing Fiscal Risks (Procyclicality of Financial Systems in Asia), edited by Gerd Schwartz, Ana Corbacho, and Katja Funke, International Monetary Fund, 2008.

implement relevant international standards should be tailored to the challenges of small markets, their limited supervisory resources, and reputational risks. Where fiscal positions are especially important to financial development, in view of the sovereign's dominant role in local markets, policy advice on fiscal and debt management should take this into account.

SURVEILLANCE AND ANALYTICAL WORK

Staff teams working on small states may need to explore creative approaches (such as intensified reliance on cross-country work and focus on a narrower set of policy-relevant issues) to overcome staffing constraints and turnover, data gaps, and less frequent missions than for many larger countries.

36. **Cross-departmental approaches to analytical work have proven helpful for strengthening advice and outcomes.** There are often synergies to be gained from bringing together experience from different clusters of small states (Caribbean, Pacific islands, African). This may be particularly important where data limitations constrain the ability to learn lessons solely by looking at small states within one area department. Also, where staffing on a given small country team is limited, a policy issue can be tackled as part of a multi-country study with shared desk resources. To facilitate cross-departmental analysis, periodic sharing of departmental small states work agendas will help identify possible joint projects. Although analytical priorities will evolve, some issues that are currently important are outlined in Box 3.

37. Given limited policy analysis capacity in small states, the emphasis of staff analytical work should be on immediate policy-relevant issues rather than on basic research. The priority for small states governments is analysis with concrete policy implications, usually drawing on lessons from policy implementation in other countries. Some attention to improved information systems and adequate data dissemination with the help of STA might be required in that context. Regional conferences, events linked to the Annual Meetings (including the Small States Forum),²⁶ and area departments REOs have been good options for disseminating such work. Outreach will typically be led by area departments, including regional TA centers. Cross-departmental events should be considered to help broaden the learning opportunities for small states governments.

²⁶ Many small states country authorities do not attend the Spring Meetings, making this less effective as an outreach opportunity.

Box 3. Analytical Priorities for Small States¹

Despite advances in understanding the challenges small states face, a continuing analytical work program on small states will remain important. Possible priorities for analysis include:

The factors behind the relative growth underperformance of small states since the late 1990s. The reasons behind the failure of small states to match the improved growth performance of larger states over the past 15 years are not yet fully understood, and this is a priority for further analytical work. Does this reflect a failure by small states to adopt the macroeconomic and structural reforms that have contributed to stronger, more durable growth in larger peers? Or were small states' pro-growth reforms offset by a conjunction of regional developments (such as loss of trade preferences) that have had their largest impact, coincidentally, on clusters of small states? What are the implications for small states' growth strategies?

The effectiveness of exchange rate adjustments in highly open small states. Are there major differences in the exchange rate transmission mechanism that should inform policy design for small states seeking to achieve external adjustment?

Appropriate monetary and exchange rate regime. What are the factors to be considered in advising small states on desirable monetary and exchange rate regimes? Should small states favor a monetary regime based on a simple monetary rule (i.e., rigid exchange rate or monetary targeting), given the limited administrative capacity in small states to operate an independent monetary policy.

The impact of global and regional spillovers on small states. What are the major transmission channels, and how do these vary across small state regions? The existing strand of work by Fund staff on particular countries and country groups would provide a strong foundation for additional work in this area.

Understanding potential advantages of small size. Much of the attention in this paper has been on overcoming the obstacles associated with small size. There may be important lessons in the development experience of highly successful small states, including in how they have exploited particular advantages.

Overcoming scale diseconomies. Are there precedents and best practices for administrative cost-sharing or outsourcing arrangements that can help to reduce small states' administrative costs—particularly in the case of micro states? For example, in managing small state sovereign wealth funds?

Financial sector benchmarking and vulnerabilities. Benchmarking could help to identify how a country's financial system compares to those of its peers. Diagnostics could clarify which financial services are underprovided and which sub-segments or instruments are underdeveloped. Pinpointing vulnerabilities from the interconnectedness intrinsic to being small and open is also needed.

Designing fiscal rules for small states. How might fiscal rules be best tailored to use in small states, given the volatility they experience in revenues and expenditures?

Understanding and managing high aid volatility. What is behind the higher aid volatility observed in small states? Is there a particular role for the Fund, World Bank, or other IFIs in donor coordination or in helping small state country authorities to manage aid volatility?

Dealing with shocks. Given the susceptibility to external shocks, including natural disasters and climate change, how can small states successfully deal with them?

¹ In selecting analytical work, staff is encouraged to focus on the needs of their respective countries.

38. **Analytical Toolkits.** Fund staff should provide small states authorities with economic tools to help guide their policy analysis. This may be particularly important where the policy making capacity in the country is thin. Where tools are provided, they should ideally be relatively easy to use with standard spreadsheet or econometric software. In cases where Fund tools are more complex (such as the DSA templates and exchange rate assessment tools, for example), the authorities may welcome workshop presentations on their usage. Consideration should also be given to opportunities for developing more streamlined versions of Fund tools that could be used with the more limited data available in small countries. In addition, the traditional toolkits can be augmented to include small state specific issues. For example, DSAs could include a climate change scenario or stress tests calibrated to typical natural disasters.²⁷

PROGRAM DESIGN, AND FUND FACILITIES AND INSTRUMENTS

A range of Fund facilities are available to meet small states needs. The 2013 Review of Facilities for Low-income Countries has benefited small states through increased access to the Rapid Credit Facility (normal and shocks window), increased flexibility of Poverty Reduction Strategy requirements, changed PRGT eligibility requirements for microstates (leading to the entry of three microstates and delayed graduation of two others.)

39. **Building a track record.** Where small states need to establish, or re-establish a track record of policy implementation, consideration could be given to a staff-monitored program (SMP). Over the past ten years, four small states have implemented SMPs (Comoros, Djibouti, Sao Tome and Principe, and Swaziland; see Annex Table 2). All were either lower-middle or lower-income countries with significant capacity constraints. The outcomes of the SMPs were mixed. In three out of the four cases, the SMP was successfully completed and led to use of Fund financing. In the fourth case, for Swaziland, the SMP went off track and was not followed by a Fund arrangement. Staff can draw on a separate note for guidance on the qualification for and design of SMPs.²⁸

40. **Rapid financing.** Rapid financing for urgent balance of payments needs is available through the Rapid Credit Facility (established in 2009 for PRGT-eligible countries, "RCF") and the Rapid Financing Instrument (established in 2011 for both PRGT- and non-PRGT eligible members, "RFI").²⁹ The RCF and RFI provide rapid financing to address urgent BoP needs arising from a variety of circumstances, including natural disasters and shocks to terms of trade and export demand, without ex-post conditionality or reviews. They are well-suited to situations where the financing and adjustment needs are transitory and limited (due, for example, to a temporary shock), or where an

²⁷ All country teams are encouraged to include customized country scenarios in DSAs.

²⁸ See Operational Guidance Note for Staff on Staff Monitored Programs. <http://www-intranet.imf.org/departments/SPR/Surveillance/Pages/SMP-PPM-AssessmentLetters-SMPs.aspx>

²⁹ As of late-2013, there had been no users of the RFI.

upper credit tranche (UCT)-quality economic program is precluded by the member's limited policy implementation capacity or by the urgency of the BoP need. These instruments are attractive to small states in offering quick financing in the event of shocks without the need to implement policies of an upper credit tranche quality. Small states are frequent users of the RCF due to urgent balance of payments needs associated with shocks. During 2003-13, emergency assistance was provided on 19 occasions, to 9 different countries (Appendix Table 3). Countries tend to be multiple users, with St. Lucia, St. Vincent and the Grenadines, and Dominica each making three drawings over the decade. More than half of the emergency assistance was provided following climatic shocks (hurricanes, flooding) and earthquakes, with several cases of financing for terms of trade and export market shocks and one case of post-conflict assistance (Comoros).

41. **UCT-program based financing.** The Fund's financing in support of UCT-quality programs has been used on 16 occasions by 10 different small states over the period 2003-13 (Appendix Table 3). The majority (11 programs) were financed by PRGT resources (under the PRGF, SCF, and ECF) while 5 programs used GRA resources (under the SBA and EFF). For both concessional and GRA financing, the majority of programs were for a three-year period (or longer, in a few instances). Usage has been regionally diversified, and financing has varied from relatively modest levels to large multiples of quota (for Maldives, Antigua and Barbuda and St. Kitts and Nevis in 2009, 2010 and 2011, respectively).³⁰

42. **Policy support instrument (PSI).** The Fund's framework for PSIs is designed for low-income countries that do not need Fund financial assistance but can benefit from close cooperation with the Fund in preparation and endorsement of their policy frameworks. Cabo Verde is the only small state that has used the PSI. Fund support under the PSI for a three-year program was approved in 2006 and subsequently extended to a fourth year. The PSI was successfully concluded in June 2010 and a successor 15-month PSI was approved in November 2010 with a view to assisting the authorities in further consolidating macroeconomic stability.

Box 4. Fund Financing for Small States—Useful References

Handbook of IMF Facilities for Low-Income Countries. This covers options for PRGT-eligible countries, including emergency financing (RCF), UCT-program based financing (SCF and ECF), the PSI, and staff monitored programs. (The underlying Board papers and decisions on LIC facilities and instruments remain the sole legal authority on the matters covered in the Handbook.)

Facilities for Low-income Countries Quick Reference Guide: This quick reference guide summarizes the main policy changes to the LIC Facilities following the Review of the Facilities for Low-Income Countries-Proposals for Implementation that took effect on April 8, 2013.

GRA Lending Toolkit and Conditionality – Reform Proposals . This covers options for PRGT and non-PRGT eligible countries, including the reforms made to the GRA instruments in 2009 as well as modifications to the conditionality for the use of Fund resources, the exceptional access policy, and access limits.

³⁰ In both Antigua and Barbuda and St. Kitts and Nevis the high level of access was necessary to support the debt restructuring operations. In Maldives, however, high level of access was necessary to address the impact of the global economic crisis and restoring macroeconomic stability.

43. **Structural conditionality.** Given the limited depth of small states governments, the structural reform ambitions under Fund-supported programs may need to be more narrowly focused and prioritized, in coordination with other development partners. Capacity for policy design and implementation will be particularly constrained in small states that are also in a fragile situation. As discussed in paragraph 30, conditionality in the latter cases should be consistent with capacity for policy consultation, design and implementation.

44. **Data monitoring and reporting.** Institutional capacity is relevant also for data monitoring and reporting under Fund-supported programs. The lack of high quality data is often a challenge for macroeconomic surveillance, and programs may include strengthened data provision as a key goal. At the same time, program design may need to be tailored to the breadth and timeliness of existing data reporting.

CAPACITY DEVELOPMENT

Investments in capacity development will be needed for many years. Monitoring and evaluation of TA and institutional capacity building would require greater emphasis under surveillance activities.

45. **Absorption capacity and resource availability will be constraining factors.** Officials in small states have over-burdened agendas, and finding time for TA and training is difficult. In addition, return-on-investment considerations lead TA providers (including the Fund) to dedicate more resources to larger countries.³¹ Given these considerations, it is important to make the most of available capacity building resources.

46. **A few guiding principles are relevant in considering capacity development approaches:**

- *TA and training needs to be tailored to each country's needs and absorption capacity.*
- *Not all capacity issues can be resolved through TA and training.* For example, some small states may not meet the necessary prerequisites for implementing an independent and effective monetary policy. Capacity development ambitions need to be realistic. Where national solutions are not workable, it may be necessary to explore regional or other "outsourced" solutions. (For example, reserve or debt management might be delegated to regional financial institutions.)
- *Developing implementation capacity is critical.* Resident or peripatetic regional macroeconomic advisors may be useful in developing hands-on skills, particularly at an early stage, when efficient communication and coordination with the authorities are crucial to kick-start capacity building. Monitoring implementation of TA recommendations is similarly important.

³¹ Small states receive significantly more TA and training than larger peers when scaled by population. But the level of technical assistance provided per country is about half that for larger countries (measured in TA person years).

- *The regional TA centers (RTACs) are critical in providing support to small states.* CARTAC in the Caribbean and PFTAC in the Asia-Pacific region are particularly important in this context. A regional approach has the advantage of offering opportunities for peer-to-peer learning, while maintaining a focus on the specific needs of the region. Regional capacity development is supported by development partners who finance much of the RTAC budget, either in general terms or through dedicated support for specific programs (e.g., Japan's support for the improvement of external sector statistics in the Asia and Pacific Region). South-South cooperation can be supported by drawing on regional experts to deliver TA programs.

47. Other approaches can also be considered to help strengthen small states' macroeconomic capacities:

- *Staff exchanges.* Staff expertise in small states and associated regional organizations could be fostered through staffing exchanges. The options for economists from small states to join the Fund for a limited period as special appointees could be expanded. Similarly, options could be explored for Fund staff to take secondments to work with regional small states institutions.
- *Fund coordination.* There may be scope for Fund staff to play a more active role in coordinating the involvement of other development partners in the macroeconomic sphere. This should be consistent, however, with the Fund's macroeconomic focus, and should not crowd out core activities.

COORDINATION WITH DEVELOPMENT PARTNERS

48. **Support for small states will need to involve other international institutions and development partners.** The Fund will typically need to work alongside financial and non-financial assistance programs managed by other development partners. In this area, good practices have included paying more attention to the following:

- Inter-agency cooperation should reflect the Fund's comparative advantage and the relative expertise of our counterparts. Close collaboration between the Fund and other development partners should aim at establishing areas of comparative advantage and ensuring consistency in policy advice.
- Close collaboration with other institutions would be particularly useful in identifying solutions to regional challenges. The Fund and other partners could also pursue regional approaches to overcome size related challenges, for example, by promoting trans-border financial sector development within a region.
- Staff can involve other IFIs to provide staffing in Fund missions where external expertise would complement the work of the Fund.

- Staff can discuss the timing of aid flows to reduce unnecessary volatility. Without changing the total amount of foreign aid, a reallocation of these aid flows across time has the potential to reduce spending volatility.
- Joint missions may provide benefits with each institution taking a lead role in the area where it has the most expertise. While the Fund is not the central institution for addressing determinants of long-run growth, it can still play a lead role in collaboration among IFIs in their engagement with small states. Even where others take the lead, stepped-up collaboration can help enrich the Fund's policy advice and program design.

49. **Collaboration on capacity building.** The Fund can, and should, remain closely engaged with the country's development partners to help countries design and implement a well-coordinated set of policies and to coordinate responses to TA needs. Where useful, and where requested by the member, staff could produce regular reports on macroeconomic developments and policies and related capacity building efforts for the benefit of the international community.

50. **Fund staff should also be cognizant of other IFIs constraints in engaging with small states.** The World Bank's work program in small states with relatively higher income per capita is very small, so, while it is useful to draw on the Bank's sectoral expertise, Fund staff will likely need to bridge the gap by formulating advice to small states.

Annex Table 1. List of Developing Small and Micro States¹

Caribbean					
Country	Micro State	Fragile Situation²	Island State	Income Group³	PRGT Eligibility
Bahamas, The			Y	UM	
Barbados			Y	UM	
Suriname				UM	
Trinidad & Tobago			Y	UM	
Antigua & Barbuda	Y		Y	UM	
Dominica	Y		Y	UM	Y
Grenada	Y		Y	UM	Y
St. Kitts and Nevis	Y		Y	UM	
St. Lucia	Y		Y	UM	Y
St. Vincent and the Grenadines	Y		Y	UM	Y
Belize				LM	
Guyana				LM	Y
Asia-Pacific					
Country	Micro States	Fragile Situation	Island State	Income Group	PRGT Eligibility
Maldives			Y	UM	Y
Palau	Y		Y	UM	
Tonga	Y	Y	Y	UM	Y
Tuvalu	Y		Y	UM	Y
Bhutan				LM	Y
Fiji			Y	LM	
Solomon Islands		Y	Y	LM	Y
Timor Leste		Y		LM	Y
Vanuatu			Y	LM	Y
Kiribati	Y	Y	Y	LM	Y
Marshall Islands, Rep.	Y		Y	LM	Y
Micronesia	Y		Y	LM	Y
Samoa	Y		Y	LM	Y
Other Regions					
Country	Micro States	Fragile Situation	Island State	Income Group	PRGT Eligibility
Montenegro		Y		UM	
Mauritius			Y	UM	
Seychelles	Y		Y	UM	
Cabo Verde			Y	LM	Y
Comoros		Y	Y	Low	Y
Swaziland				LM	
Djibouti				LM	Y
São Tomé and Príncipe	Y	Y	Y	LM	Y

Note:

- For the purpose of this Guidance Note, Small States are defined as developing countries that are Fund members with populations below 1.5 million while micro states are a sub-group with populations below 200,000 as of 2011.
- Based on the World Bank definition of (a) an average CPIA rating of 3.2 or less, or (b) a UN and/or regional peace-building mission within the country within the last three years.
- Upper middle-income countries (UM) have per capita annual incomes of between \$4,086 and \$12,615; lower middle-income countries (LM) of between \$1,036 and \$4,085; lower-income countries (Low) \$1,035 or less based on the World Bank Atlas method.

**Annex Table 2. List of Small States with Staff Monitored Programs
(as of June 30, 2013)**

Country	Approval Date	Original Expiration Date	Current Expiration Date	Original Length in months	Extension in months	Comments	Subsequent Program
Sao Tome & Principe	1-Jan-02	30-Jun-02	31-Dec-02	6	6	<p>Purpose: Provide a track record of policy implementation that could lead to a new PRGF arrangement.</p> <p>Macroeconomic Objectives. Correct the fiscal and structural slippages that occurred in 2001 causing the PRGF to go off track and reestablish a track record on policy implementation.</p>	PRGF in 2005
Comoros	1-Jan-05	31-Dec-05	31-Dec-06	12	12	<p>Purpose: Provide a track record of policy implementation that could lead to a PRGF arrangement.</p> <p>Macroeconomic Objectives. (i) restore the credibility of its economic management, (ii) put public finances back on a sound footing, (iii) improve financial intermediation, and (iv) accelerate structural reforms.</p>	EPCA in 2008 ECF in 2009
Djibouti	1-Jul-05	31-Dec-05	31-Dec-05	6	0	<p>Purpose. Provide a track record of policy implementation that could lead to a PRGF arrangement.</p> <p>Macroeconomic Objectives. (i) strengthen the fiscal position; (ii) reduce domestic arrears and (iii) establish a track record of policy implementation, including the promotion of good governance and transparency.</p>	PRGF in 2008
Swaziland	4-Apr-11	3-Oct-11	Off-track	6		<p>Purpose. Build a strong track record of fiscal consolidation and structural reforms to support the authorities' possible request for a formal Fund arrangement in late 2011.</p> <p>Macroeconomic Objectives. (i) reduce the deficit which will limit the debt-to-GDP ratio to around 35 percent; (ii) maintain the gross international reserves to safeguard external sustainability; (iii) strengthen public finance management; and (iv) protect priority spending in order to continue to make progress towards achieving the MDGs.</p>	

Note:

SMPs are sent to the Board for information not discussion .

**Annex Table 3. Fund Emergency Assistance in Small States
(2003-2013)**

Country	Approval Date	In millions of SDRs	In percent of Quota	Type	Event
Exogenous Shocks Facility (ESF) and Rapid Credit Facility (RCF)					
Comoros	12/15/08	2.2	25	ESF-RAC	Impact of higher fuel and food prices
St. Vincent and The Grenadines	5/15/09	3.7	45	ESF-RAC	Global economic slowdown effect on tourism and FDI.
Dominica	7/10/09	3.3	40	ESF-RAC	Hurricane & Global economic slowdown effect on tourism and FDI
St. Lucia	7/27/09	6.9	45	ESF-RAC	Global economic slowdown; tourism decline
Maldives	12/4/09	8.2	100	ESF-HAC	Global economic slowdown
Samoa	12/7/09	5.8	50	ESF-RAC	Earthquake & Tsunami
St. Lucia	1/12/11	3.8	25	RCF	Hurricane Tomas
St. Vincent and The Grenadines	2/28/11	2.1	25	RCF	Hurricane
St. Vincent and The Grenadines	7/25/11	1.2	15	RCF	Torrential Rains
Dominica	1/11/12	2.1	25	RCF	Natural Disasters
Samoa	5/15/13	5.8	50	RCF	Cyclone Evan
Emergency Natural Disaster Assistance					
Grenada	1/27/03	2.9	25	ENDA	Hurricane
Grenada	11/15/04	2.9	25	ENDA	Hurricane
Maldives	3/4/05	4.1	50	ENDA	Tsunami
Dominica	2/4/08	2.1	25	ENDA	Hurricane
Belize	2/18/09	4.7	25	ENDA	Flooding
St. Kitts and Nevis	5/15/2009	2.2	25	ENDA	Hurricane
St. Lucia	1/12/11	1.5	10	ENDA	Hurricane
Emergency Post-Conflict Assistance					
Comoros	12/15/08	1.1	13	EPCA	Conflict

Note: The Rapid Financing Instrument has replaced the IMF's previous emergency assistance policy that covered Emergency Natural Disaster Assistance and Emergency Post-Conflict Assistance.

**Annex Table 4. Fund Financing Arrangements for Small States
(2003-2013)**

Country	Arr. Type	Year	Original Duration (Months)	Actual Duration (Months)	Total Amount Approved (in SDR mn)	Actual Approved Amount (% of quota at approval)
Dominica	PRGF	2003	36	36	8	94
Sao Tome & Principe	PRGF	2005	36	36	3	40
Grenada	PRGF	2006	36	48	16	140
Djibouti	ECF	2008	36	44	13	80
Seychelles	SBA	2008	24	13	18	200
Sao Tome & Principe	ECF	2009	36	36	3	35
Comoros	ECF	2009	36	51	14	153
Maldives	SBA	2009	36	36	49	600
Seychelles	EFF	2009	36	48	26	300
Grenada	ECF	2010	36	36	9	75
Solomon Islands	SCF	2010	18	18	12	120
Antigua and Barbuda	SBA	2010	36	36	68	500
St. Kitts and Nevis	SBA	2011	36	36	53	590
Solomon Islands	SCF	2011	12	12	5	50
Sao Tome & Principe	ECF	2012	36	36	3	35
Solomon Islands	ECF	2012	36	36	1	10

Source:

<http://www.imf.org/external/np/pdr/mona/index.aspx>

Annex Table 5. Selected Recent Examples of Sovereign Debt Restructurings in Small States

Country	Start Date of Restructuring	NPV Reduction	Participation Rate	Type of Debt Restructured		Treatment		Interesting Features of the Restructuring	IMF Arrangement at the Time of Restructuring
				External	Domestic	Principal Haircut	Interest Haircut		
Dominica	2003	50 percent	78.5 percent	yes	yes	yes	yes	Mandatory debt-management provision in the bond exchange.	Yes
Grenada	2005	40–45 percent	90 percent (commercial)	yes	yes	no	yes	Restructured debt that had government guarantees.	No
Belize	2006	21 percent	100 percent (bond exchange); 98 percent of eligible debt	yes	no	no	yes	First country since the 1930s to use collective action clause in a bond issued under the New York Law.	No
Seychelles	2009	75 percent	100 percent (bond exchange); 98 percent of eligible debt	yes	no	yes	yes	First time a partial guarantee from a multilateral organization (African Development Bank) was offered in the context of a sovereign restructuring.	Yes
St. Kitts and Nevis	2012	Above 50 percent	100 percent (external commercial debt and bonds)	yes	yes	yes	yes	Partial guarantee from the Caribbean Development Bank on the new debt instruments ; Creation of a Banking Sector Reserve Fund to maintain banking sector stability during the restructuring; Creation of a Special Purpose Vehicle for debt secured by land.	Yes

Source: Jahan, S. (2013), "Experiences with Sovereign Debt Restructuring: Case Studies from the OECS/ECCU and Beyond", in Alfred Schipke et al edited *The Eastern Caribbean Economic and Currency Union: Macroeconomics and Financial Systems*, International Monetary Fund, Washington D.C.

Appendix Box 1. Fiscal Rules for Small States¹

Fiscal rules can help avoid excessive budget deficits and public debt accumulation. However, challenges for the design and operation of fiscal rules are particularly acute for small states, and few have adopted such rules to date. This appendix provides guidance on approaches that could be tailored to small states' needs.

Conceptual overview. Excessive budget deficits and procyclical fiscal policies are often thought to reflect distorted policymakers' incentives (e.g., as a result of myopia—Alesina and Tabellini, 1990), or ineffective coordination of competing demands on government resources (the “common pool” problem—von Hagen and Harden, 1995). While procedural rules mitigate the common pool problem, policymakers have often tried to promote fiscal soundness through fiscal policy rules.² These put a durable constraint on fiscal policy by combining numerical limits on key indicators—most often the deficit, the public debt or both—with provisions making deviations from the limits costly for policymakers. Empirically, well-designed fiscal rules are associated with better fiscal performance (e.g., Debrun and others, 2008).

Regardless of country characteristics, effective fiscal rules generally satisfy one pre-requisite and four conditions:

Prerequisite. Because a fiscal rule is meant to constrain budget preparation and execution, public financial management (PFM) systems should be strong enough to ensure that the budget closely reflects policymakers' plans, and effectively guides their actions. Priorities include a top-down approach to budgeting, solid revenue forecasting, and a medium-term framework.

Relevant objective. An effective fiscal rule should be well connected to the problem it is expected to address. The primary objective of most fiscal rules is to preserve debt sustainability.

Simplicity and transparency. Complicated rules include those with multiple and potentially inconsistent numerical targets, broad exemptions and exclusions, and narrow coverage of the public sector (e.g., applying only to a small part of the government or selected expenditure ceilings not connected to debt sustainability). Such rules are harder to monitor and more easily circumvented.

Resilience in the face of shocks. The rule should allow the budget to buffer adverse exogenous shocks, including the accommodation of cyclical fluctuations in revenues and unforeseeable emergencies. Rules that too often mandate undesirable or politically/socially unfeasible policies are unlikely to be sustained.

Enforceability. Deviations from the rule should entail tangible costs for the government. If the numerical limit only applies ex-ante, this could mean the prohibition for the Executive to submit to the Legislature a budget inconsistent with the rule. If the limit also applies ex-post, this could imply tighter restrictions on future budgets—“debt brakes”³—or direct sanctions for policymakers (beyond reputational effects).

At a generic level, the Fund's advice on fiscal rules reflects the central trade-off between credibility and flexibility. While credibility calls for strict limits on discretion with clear costs in case of deviation, flexibility is needed to ensure the resilience of the rule in the face of changing circumstances. Setting a limit on the general government structural deficit with well-defined escape clauses and some form of enforcement mechanism is the most common expression of the Fund's advice.

That said, the details of an effective fiscal rule are country-specific, as they depend on the nature of the bias embedded in unconstrained policies, the sensitivity of the budget to exogenous shocks, and the characteristics of the political system. In some cases, the risk of side effects might also need to be pre-empted. For instance, a fiscal rule could encourage short-term expedients, such as deferred spending (an example would be underinvestment) or cuts in high-quality discretionary outlays.

¹ Prepared by Xavier Debrun.

² See Kopits and Symansky (1998) and IMF (2009).

³ A “debt brake” is an automatic correction mechanism mandating offsets for past deviations. It is often advised when judiciary enforcement or automatic sanctions lack credibility, which is the case in most political systems.

Appendix Box 1. Fiscal Rules for Small States (concluded)

Designing fiscal rules for small states is challenging because the terms of the credibility-flexibility trade-off are particularly unfavorable. On the one hand, expenditure pressures are often acute, calling for very strict rules. Pressures range from a strong demand for insurance against shocks (including through off-budget instruments such as PPPs and guarantees), the expectation for the government sector to be the last-resort source of growth and job creation, and high production costs for public goods and services. Pressures for sweeping tax exemptions aimed at attracting businesses only add to the problem. On the other hand, large volatility calls for very flexible arrangements. As discussed in the main text, the state budget often the insurer of last-resort because alternative insurance mechanisms are ineffective (monetary policy is constrained by fixed exchange rates or dollarization, the domestic financial sector is shallow and outward oriented, and access to international capital markets is limited).

Not surprisingly in light of this difficult trade-off, fiscal rules are few among small states. To date, only Cabo Verde, Mauritius, Suriname, and most recently the Maldives operate fiscal policy rules at the national level.⁴ However, in the first two cases, the rule is a ceiling on the public debt to GDP ratio, which as elsewhere, has proved too inflexible to be credibly enforced. By contrast, in the Maldives, a cap on the overall deficit (3.5 percent of GDP) will bind from 2016 onwards. It is combined with a debt ceiling to be set for 5 years by the Minister of Finance, starting from 60 percent of GDP in 2016. An explicit debt path places a useful check on a budget balance rule because the long-run debt level implied by a given deficit depends on highly uncertain assumptions about long-term GDP growth and borrowing costs. Explicit escape clauses are a welcome feature of the fiscal rule in the Maldives and Mauritius.⁵

The design of fiscal rules may have to deviate significantly from the Fund's advice for larger economies. Small states' acute common pool problem makes strengthening PFM systems a top priority. Once the budget itself can be deemed credible, then a numerical fiscal rule is worth considering, tailored to the specifics of the country. Country teams should keep in mind the following considerations:

Formulating the rule in terms of headline budget balance may be the only option. Small states typically have no well defined economic cycle, hence no clear definition of the structural balance.⁶ Debt ceilings alone are unlikely to be credible, especially after very large shocks.

In "normal times", consider a budget balance floor that is close-to-balance or in surplus and binding only ex-ante. High volatility calls for large buffers. In normal circumstances, debt should decline. Unexpected shocks during the year should be accommodated to the extent that financing is available.

Set a "debt brake." Large ex-post deviations from the headline balance floor should switch the rules-based system from "normal times" to "adjustment mode" that sets a reasonable adjustment path.

Carefully designed escape clauses are a must. These should not only accommodate significant shocks, but also high-quality policy initiatives, such as sizable investment projects with a clear return.

Ensure a broad coverage, possibly beyond the general government. Given the intense expenditure pressures, the rule should not result in outsourcing fiscal policy to off-budget entities or lead to large contingent liabilities, such as PPPs or private debt guarantees.

Be open to expenditure ceilings on specific categories. Although generally not advised, ceilings on certain expenditure categories particularly subject to pressure (e.g., subsidies, wage bill) might be considered in small states. The reason is that a high-level rule might lead to severe distortions in terms of expenditure composition (crowding out of priority spending by "incompressible" items).

⁴ ECCU member states are also subject to regional benchmarks on their public debt.

⁵ In Mauritius, the debt ceiling can be exceeded in case of "emergency" or for the purpose of financing large investment projects. In the Maldives, the rule makes an exception for natural disasters (imposing hardship on at least 15 percent of the population) and "economic downturns," although the magnitude of the latter remains unspecified.

⁶ Additional complexities arise in the case of a resource-rich economy (see IMF, 2012).

Appendix Box 2. Monetary Policy in Small States¹

Particular challenges for the implementation of monetary policy exist in small states, as discussed below.

Fund research has identified several important preconditions for effective implementation of monetary policy based on inflation targeting or monetary targeting. Many small states have stable macroeconomic environments and sound fiscal policy, but some features common to small states mean other preconditions are frequently not met.²

Shallow and non-competitive financial markets, often dominated by large (in some cases foreign) banks, raise spreads between lending and deposit rates, impeding interest rate pass-through.

Poorly functioning or absent interbank markets increase demand for precautionary holdings of central bank reserves and this may impede monetary policy transmission.

Poorly developed government securities markets reduce the scope of potential open market operations.

Limited technical capacity complicates adequately overseeing financial institutions and engaging in complex central bank operations. Central bank autonomy may also be an issue in small and interconnected political systems.

The exchange rate is thus a common anchor for small states. In addition to the above factors, the high share of foreign trade in GDP and, in many cases, dependence on a single important trading partner, support the case for exchange rate-based monetary policy. This can range from a heavily managed exchange rate, to a peg, currency board, or full dollarization.

A strong international reserves position and prudent fiscal policy can strengthen such regimes. Exchange rate anchors are more credible when central banks have sufficient international reserves to cope with potential adverse exogenous shocks. Prudent fiscal policies are also key, but this can be complicated in small states by highly volatile, unpredictable, or lumpy fiscal revenues, and where limited options for financing public deficits further constrain fiscal policy. Strong oversight of financial sector risks, particularly in countries with extensive offshore financial linkages, are also important, but here, too, limited capacity may be an issue.

Supervisors and regulators should also be aware of other potential issues. The scope for pursuing greater competition is limited by the extent of the market, which often leads to high spreads between lending and deposit rates. Small size also reduces prospects for capital market development, including equity and bond markets, but also hedging instruments and other risk management tools. Finally, risk diversification is problematic in economies with few potential borrowers, tightly interlinked economies, and little geographical or economic diversification. Despite these constraints, limiting interest rate spreads may not produce the anticipated outcome because this can be easily circumvented by higher fees or commissions, and could result in banks not extending credit to willing borrowers. Instead, the recommendation should be in favor of greater transparency about interest rate and lending policy (for instance, requiring banks to publish rates) and ensuring that underwriting standards are robust.

¹ Prepared by C. Visconti and J. Walsh.

² See for instance, *Monetary Policy Implementation at Different Stages of Market Development* (IMF Occasional Paper 244) and *Monetary Policy Transmission Mechanisms in Pacific Island Countries* (IMF WP/11/96).

Appendix Box 3. Devaluations in Small States: How Effective?¹

Exchange rate devaluations in small states typically involve a larger inflation pass-through and smaller output response than in larger states. However, devaluations can effectively support external adjustment, especially with appropriately supportive structural policies, as discussed below.

Small states are often skeptical about the effectiveness of exchange rate adjustment for tackling currency overvaluation. Small states often maintain fixed exchange rate regimes, and both internal and external devaluations entail unpleasant macroeconomic effects, which differ from those in larger economies because of their high degree of trade openness. To understand better whether external devaluations are effective in small states, the results of event and econometric studies on devaluations in small states are discussed in this box.² Our findings suggest that:

External devaluations can be effective in small states, providing a strong boost to growth and the external position.

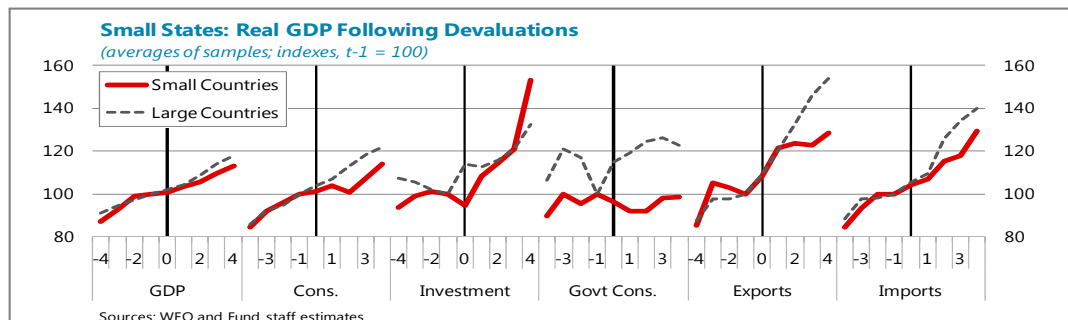
After a decline in the year of the devaluation, growth picks up quickly in small states, driven largely by a very strong pickup in investment and a robust export growth. While this is true on average, it does not happen in all cases: in fact, in about half of the cases three-year average growth slows down in the medium term following devaluations. Such outcomes are not unique to small states, however: the growth pick up as well as the mix of growth outcomes are actually no different from the large states.

In small states, devaluations tend to operate more through the expenditure compression channel than through the expenditure switching one. Due to the structure of the economy in small states: (i) exports respond less because of scale

limitations and higher share of imported inputs; (ii) there is less scope to switch expenditures from imports to domestic

import substitutes due to scale; and (iii) for the same nominal devaluation, the pass-through to inflation is significantly higher in small states due to the larger import content of their consumption basket. As a result, consumption is affected significantly by adverse income and wealth effects, especially in countries with large external current account deficits and debts, reducing labor income and increasing poverty.

Supportive policies are critical to increasing the success probability of external devaluations in small states. In particular: (i) it is important that tight wage policies are maintained after devaluation to ensure that the gains from the nominal adjustment are not eroded; (ii) the devaluation and supporting policies should be credible enough to stem market perceptions of any further devaluation, which can impose large economic costs; an important condition in this respect is the sustainability of the fiscal position; (iii) structural reforms could help remove bottlenecks to investment, to allow its strong growth post-devaluation and address some of the factors underlying weak competitiveness at the root; and (iv) concerns about the undue compression in consumption can be addressed through appropriately targeted social safety nets, including through the use of the net income redistribution from the private sector to the government that frequently occur following depreciations.



¹ Prepared by Geoffrey Keim, based on "Who is Afraid of External Devaluations? (and Should They Be?)," by Sebastian Acevedo, Aliona Cebotari, Kevin Greenidge, Geoffrey Keim, Mico Mrkaic, and Stephen Snudden, IMF, forthcoming.

² The event study conducted by staff considered 78 devaluation events over the past 30 years, of which 20 events in small states. The study also uses an econometric approach and simulations using the Fund's Global Integrated Fiscal and Monetary model, calibrated to the characteristics of small states, which broadly reinforce the findings of the event study.

Appendix Box 4. Kiribati: Donor—Supported Reform Program and IMF Involvement¹

Kiribati's priorities are to strengthen fiscal performance and foster a larger private sector contribution to growth. Its sovereign wealth fund has been only partially successful as a buffer against shocks.

Kiribati is one of the most remote and poorest microstates in the Pacific. It consists of 33 islands spread over a vast ocean area with an overall population of about 100,000. It is highly dependent on volatile fishing license fees, remittances, and donor assistance. Kiribati relies on its sovereign wealth fund—Revenue Equalization Reserve Fund (RERF)—for financing the fiscal deficit. Climate change poses significant challenges because of low elevation of islands above the sea level. Remoteness, dispersion, and climate change risks result in significant impediments to growth and high fiscal costs and imbalances.

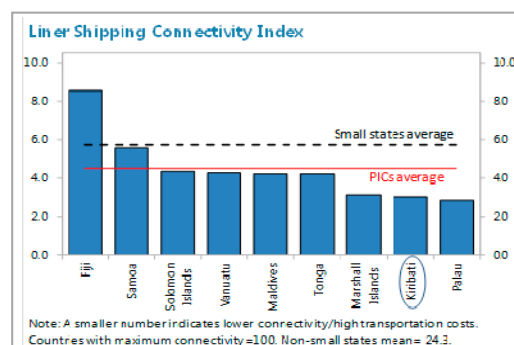
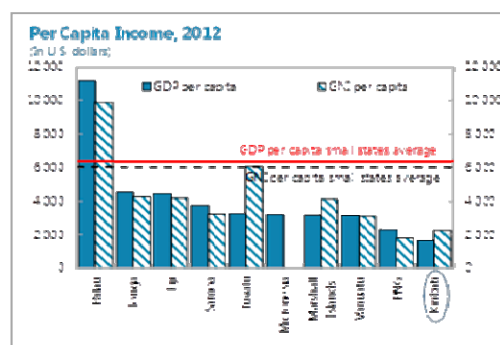
Kiribati's key economic challenges are to reduce large structural fiscal deficits and increase growth opportunities while facing obstacles posed by remoteness, lack of scale, and climate change. Fiscal deficits remain large, while the RERF per capita balance is now less than half of the 2000 level in real terms. Climate change brings additional risks and fiscal costs. Small private sector share in the economy due to remoteness and weaknesses in business climate constrains growth and puts strain on public finances. In this regard, removing obstacles for doing business is very important.

In its policy advice and design of macroeconomic framework to support government reforms, the IMF country team has taken into account limitations posed by remoteness and lack of scale.

For example, the team emphasized that the pace of the fiscal adjustment needs to be gradual and realistic given limited size of the private sector. The macro-framework did not envisage RERF stabilization in the short term, but with successful implementation of reforms it would be possible in the mid-2020s. The team emphasized that increasing private sector opportunities is critical for fiscal revenues and employment growth, and that the focus should be on fisheries and tourism sectors, where Kiribati has comparative advantage. In light of high risks and vulnerabilities, including long-term risks from climate change the team advised that non-concessional borrowing should be avoided.²

The fiscal and structural reforms also took into account Kiribati's unique problems as a small state. In particular the planned introduction of VAT aims at increasing revenue and also reducing reliance on custom duties, which must be decreased in the future according to Kiribati trade agreements. The SOE reforms took into account the fact that private sector does not yet have capacity to provide services in some areas, such as long-range maritime communication. The fisheries policy reform targeted Kiribati's most important natural resource in order to maximize growth and revenue impacts.

Kiribati's reform program and IMF involvement suggests a number of lessons that also relevant for the teams working on other small states. The prevalence of the government sector and limited private sector opportunities due to remoteness and lack of scale may limit the pace and the scope of feasible fiscal adjustment. The growth reforms should identify and benefit sectors where the country has a comparative or resource advantage. The IMF country teams also need to be prepared to go into much more details of the government finances, national accounts, statistical issues, and organization and functioning of important economic sectors.



¹ Prepared by Sergei Dodzin, IMF mission chief for Kiribati.

² For details see Kiribati: Staff Report for 2013 Article Consultation (IMF Country Report No. 13/158).

Appendix Box 5. Samoa: Supporting the Recovery from Natural Disasters¹

Samoa's exposure to natural disasters leaves it vulnerable to large fiscal deficits and debt accumulation. Responding to a tsunami in 2009 and a cyclone in 2012, the Fund provided financing and a macroeconomic framework for the immediate reconstruction effort, together with policy advice for medium-term fiscal consolidation and growth.

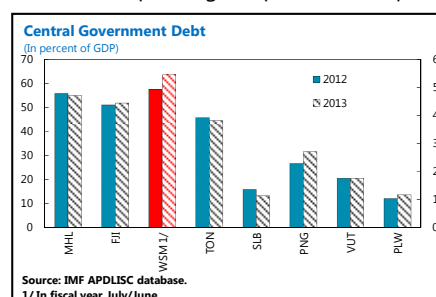
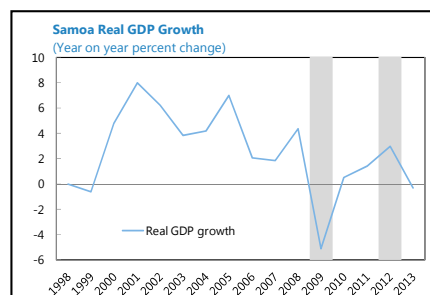
Samoa (population about 190,000) is an island economy, dependent on tourism and agriculture, and highly vulnerable to external shocks. Like other Pacific island countries, its remoteness, small size and high fixed costs for providing public services pose major challenges in raising growth and living standards. The tsunami and cyclone mentioned above had significant effects on growth, and led to a run-up of fiscal deficits and an increase in public debt. As a result, the country is vulnerable to the risk of rapidly accumulating debt that could lead to debt distress.

Short-term reconstruction effort. The Fund provided credit of SDR 5.8 million (50 percent of quota) under the Exogenous Shock Facility (ESF) in 2010 and again under the Rapid Credit Facility (RCF) in 2013. The Fund's analytical framework helped to catalyze aid from other donors and lenders (in the traditional Fund role).

Medium-term fiscal consolidation and growth. The macroeconomic policy framework agreed with authorities was specifically tailored to the challenges of small countries:

- Fiscal policy.** To face the challenge of meeting the financing needs for reconstruction without pushing the public debt up to unsustainable levels, the Fund advised that the authorities should begin to consolidate only after the reconstruction period, and that the pace of consolidation should be calibrated to avoid undue pressure on economic growth, given the large role of the public sector in the economy (as is typical for small states). Less than one year after the cyclone hit, the cost of reconstruction has been lower than expected, but the growth outcome has also been disappointing. As part of the reconstruction effort, staff advised the authorities to reprioritize expenditure in the pipeline project, and seek grant financing to minimize the debt risks resulting in low debt service. To support consolidation technical assistance included the development of a medium-term fiscal framework with multi-year budgets and a public expenditure review (PEFA). An important focus was the reform of management of state-owned enterprises, given their importance in the economy.
- Financial sector policy.** Technical assistance was provided on financial regulation and supervision to prevent a build-up of systemic risk in the system, given repeated weather related shocks. Because of the concentration of loans in a few sectors (mainly tourism) and the vulnerability of the whole economy to weather events, the probability of systemic problems in the financial sector following a cyclone is much higher, and therefore larger buffers and more intensive supervision may be warranted. This was all the more important given the small size and concentration of the financial sector and the existence of a large and hitherto unregulated unit trust (Unit Trust of Samoa) which was taking deposits previously in commercial banks. On banking supervision, the previous assessment by MCM conducted in 2007 stated that Samoa is still exposed to reputation risk, particularly if supervisory standards, including for AML/CFT, are perceived to be lower than acceptable international levels. This is one of the particular problems in small states where international banks are major players.
- Restoring competitiveness.** Staff emphasized the need to regain competitiveness through exchange rate adjustment and structural reforms in a way that was compatible with Samoa's very open and small economy. Staff advised the gradual introduction of exchange rate flexibility only after the recovery had taken hold. To do this, the central bank could make use of rules that allow for exchange rate adjustments of up to two percent at any time, supported by tighter monetary and fiscal policy.

Structural reforms. Advice on structural reforms was also tailored to Samoa's circumstances, and included: SOE reforms (given their dominance of the economy); reform of land title (80 percent of land is under customary title making it difficult to use for collateral); reform of business laws (in particular the competition law); and public financial management (particularly important given the prevalence of the public sector in the economy).



¹ Drafted by Geoffrey Bannister, APD.

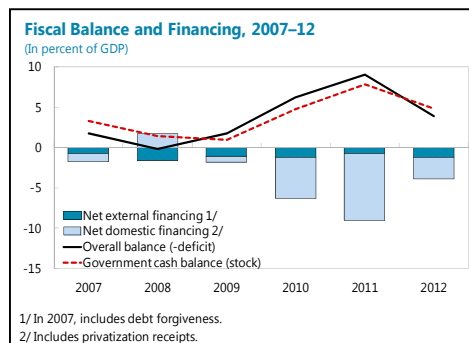
Appendix Box 6. Solomon Islands: Restoring Fiscal Sustainability and IMF-Supported Programs¹

The Fund's recent SCF and ECF arrangements with the Solomon Islands seeks to build macroeconomic buffers and strengthen resilience to shocks, including through greater exchange rate flexibility.

Solomon Islands faces fiscal challenges related to its smallness. The country consists of a collection of small islands in the south Pacific, with a population of about 550,000. Owing to its narrow economic base and small country size, it is heavily dependent on logging exports and thus vulnerable to external shocks. Weak institutions and civil unrest at the turn of this century also contributed to fiscal vulnerabilities. In the absence of sound fiscal management, even moderate budget pressures can erode the government's cash balance (which captures core deposits readily available for fiscal financing) and lead to periodic cash shortages. When this happens, outstanding payment orders have to be delayed and recurrent spending cuts have to be made.

The fiscal position deteriorated during the 2009 economic downturn. Lower revenues, reflecting weak global conditions and a decline of logging output—combined with weak budget discipline—severely tightened the government's cash balance. At end-2009, the net cash balance could provide less than two weeks of recurrent spending. Cash shortages were addressed with payment delays and through across-the-board spending cuts, affecting the government's ability to fund priority areas, including social and development outlays.

With the support of consecutive IMF-supported programs starting in 2010, the government has embarked on a set of reforms to strengthen the fiscal position and reduce external vulnerabilities.² It has taken strong actions to alleviate cash pressures, and implemented structural fiscal reforms to improve revenue administration and collections, and strengthen expenditure oversight and control. Measures include stronger enforcement to collect income tax arrears, a new Customs Valuation Act, and a centralized payroll system for all line ministries. The government has also strengthened the fiscal management framework, and improved budget transparency through extensive consultations with non-government organizations and ministries. Moreover, the recent Parliament's approval of the Public Finance Management Act constitutes an important benchmark in strengthening fiscal institutions. To cushion against exogenous shocks and allow greater exchange rate flexibility, the central bank announced in October 2012 a move from a U.S. dollar peg to an invoice-based currency basket and is currently gaining experience with this transition. The Fund-supported reforms succeeded in strengthening fiscal and external positions, and helped catalyze donor support. The government's cash balance (the program fiscal anchor) increased to an equivalent of almost four months of recurrent spending by end-2011, and has been since largely preserved.



Going forward, the government needs to continue building institutional capacity, enhancing resilience to shocks, and making growth more inclusive. The experiences of IMF-supported programs in Solomon Islands show that the successful implementation of sound economic programs has consolidated macroeconomic and financial stability, and a strong fiscal position and rebuilt policy buffers have helped address fiscal risks posed by volatile revenue—a common problem in small states. Moreover, improving the composition of public spending and providing adequate resources for critical social spending (especially health and education) and infrastructure have fostered inclusive growth. Boosting investor confidence and facilitating private sector development have also been critical for promoting sustainable and inclusive growth beyond the commodity sector. To further achieve inclusive growth, the reform momentum should continue. The government should implement further structural reforms to continue building institutional capacity, maintaining fiscal sustainability, and pursuing a broad-based and more inclusive growth.

¹ Prepared by Yiqun Wu, APD.

² An 18-month Standby Credit Facility (SCF) and a successor precautionary 12-month SCF arrangement were approved in June 2010 and in December 2011, respectively. The current three-year Extended Credit Facility arrangement was approved in December 2012.

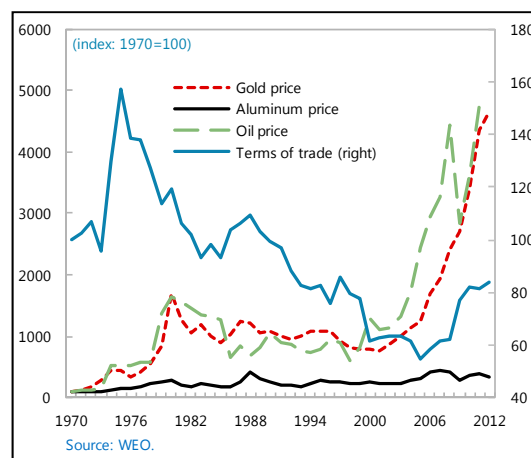
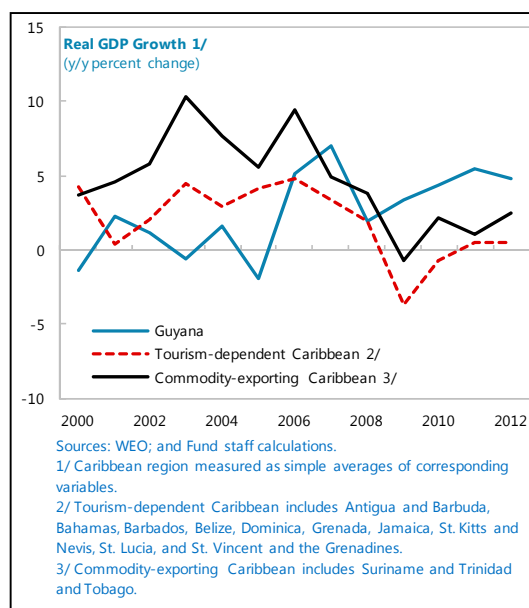
Appendix Box 7. Guyana: From Crisis to Strong Performer¹

This box discusses the recent macroeconomic performance of Guyana, where growth has been significantly higher than in the rest of the Caribbean region.

After years of lackluster growth performance, Guyana has experienced solid growth since 2006 (chart). The turnaround in its economic fortunes reflects multiple positive factors, including economic reform, debt forgiveness, and improved terms of trade. This underscores the strong connectivity of policy environment and the volatility of growth that results from excessive dependence on a narrow range of commodity exports in a small open economy.

Guyana's growth record for the past 40 years illustrates the futility of inward-oriented policies in small states. As a result of the inward-looking (import substitution industrialization), state-led development model pursued in the 1970s and 1980s, Guyana experienced secular stagnation followed by a collapse in output, leading to a 50 percent decline in output per worker; severe foreign exchange shortages; very high public debt; large external payment arrears; and a surge in poverty. Economic growth picked up in the 1990s following the implementation of Fund supported macroeconomic programs that emphasized competitive export production.

Sustained reforms and improved policy implementation restored fiscal sustainability and transformed Guyana into a more market oriented economy. The first round of reforms (1989-2000) included fiscal adjustment, introduction of indirect monetary policy instruments, a flexible exchange rate regime with some smoothing to mitigate price volatility, trade liberalization, and privatization. Selective credit and interest rate controls were eliminated in favor of open market operations; quantitative restrictions on trade were reduced and the import tariffs were lowered significantly in line with the CARICOM common external tariff; and the commercial banks nationalized during the 1980s were privatized along with government entities in the distributive sector. While this led to a markedly better performance in the 1990s, economic activity stagnated again in the first half of 2000s as the terms of trade deteriorated. The second-generation reforms (2000 to present) included further financial sector reforms, the implementation of VAT, the development of a low carbon development strategy to leverage Guyana's forestry and water resources, the modernization of traditional agriculture (sugar and rice) and the implementation or large infrastructure projects (the Berbice River Bridge) to unlock the country's significant growth potential.



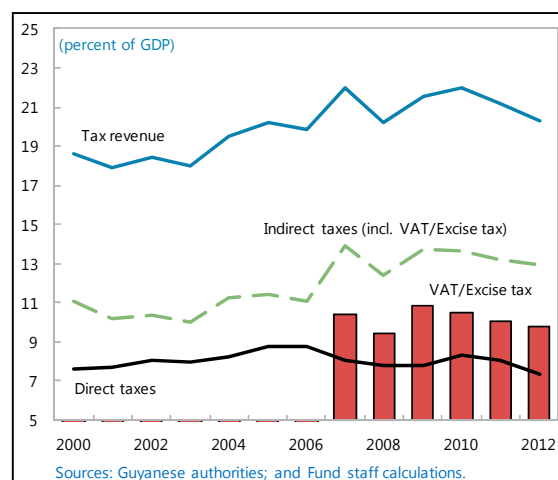
Growth (1970-2012)		
	1970-1989	1990-2012
GDP per capita	-2.0	3.4
GDP per working age population	-3.2	3.5
GDP per worker	-3.4	3.4

Sources: WEO; WDI; and Fund staff calculations.

Appendix Box 7. Guyana: From Crisis to Strong Performer (concluded)

With commodity exports representing over 60 percent of GDP, changes in the terms of trade have an exaggerated impact on real income and consumption. While Guyana is exposed to commodity price fluctuation on both exports (gold, bauxite, sugar and rice) and on imports (oil), on balance, the favorable effects of commodity exports have dominated in recent years. In particular, the price of gold has surged from a low of US\$282.6 per troy ounce in 2001 to a high of \$1,669 in 2012. Oil prices, on the other hand have risen less spectacularly but the price surge has been significant over the same period. On balance the terms of trade has improved since mid-2000s despite its long run deterioration. The effects of gold prices have had a significant trickle-down effect because the gold mining industry is mainly small scale mining so that the receipts and subsequent spending touch a wider cross section of society. The authorities policies are aimed at rebuilding fiscal and external buffers to help mitigate the effects

By themselves, anyone of these factors was significant, but the cumulative effect taken together was more than the sum of the individual measures. For example, increased revenue from VAT and lower debt service due to HIPC debt relief permitted infrastructure investment to eliminate bottlenecks, which allowed a liberalized private sector to invest more in the context of relaxing domestic and external financing constraints. Moreover, with the additional resources from VAT and support from donors, the government finally could provide improved public services like security, healthcare and education that are critical for increasing economic potential. The key lessons from from this experience are: (i) outward oriented policies are more sustainable than inward looking policies for small states because of the size of domestic markets.; (ii) small states with extreme dependence on commodity exports would be subject to greater volatility and should maintain larger fiscal and external buffers to help mitigate the effects; (iii) a flexible exchange rate would help absorb commodity price shocks but some smoothing of exchange rate movements may be required in small states to offset the volatility of commodity prices.



Notwithstanding the significant progress, Guyana remains a lower middle income economy with severe infrastructure shortages, unmet social needs and fragile financial sector, and vulnerable to external developments. The authorities continue to balance fiscal prudence and building fiscal and external buffers to cushion the economy against external shocks (mainly volatile commodity prices) against needs for expanded public investment and poverty reduction. Ensuring proper supervision and transparency of the financial sector is important. Maintaining fiscal and debt sustainability and managing commodity-related output volatility remain key challenges for this small, lower-middle income state.

¹ Prepared by Wendell Samuel.

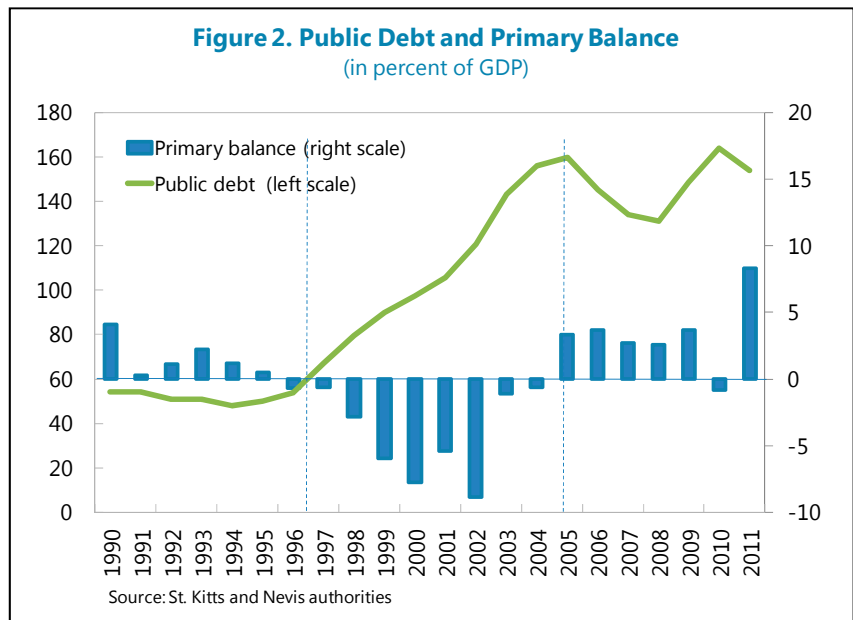
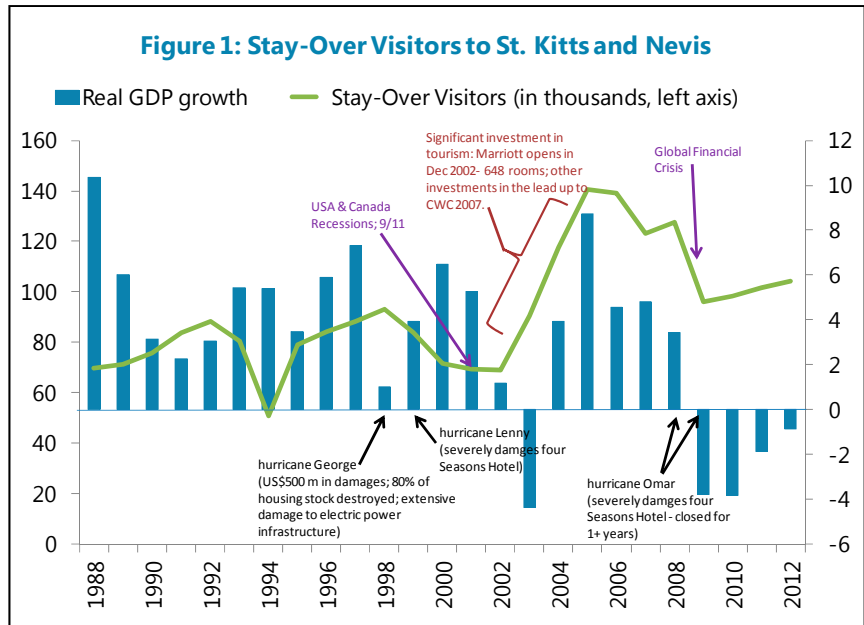
Appendix Box 8. St. Kitts and Nevis: Trials and Tribulations of a Micro State¹

St. Kitts and Nevis, with a population of around 50 thousand, is highly vulnerable to external shocks, and policy decisions taken in light of a series of external shocks and losses from the sugar industry in the 1990s contributed to high levels of public debt.

Lack of diversity. Like many small states, St. Kitts and Nevis has limited options for economic diversity. After an earlier dependence on sugar, its main industry is now tourism, accounting for about half of exports of goods and services over the past 20 years. While investments in a single large hotel can contribute substantially to tourism arrivals and GDP growth, the closure of a single hotel can have a correspondingly adverse impact on the economy. Within tourism, the island is highly dependent on the US market. This is reflected in the decline in tourism after the events of September 11, 2001 and a further downturn during the financial crisis of 2008-10 (Figure 1.)

Natural disasters. Because of its small size, St. Kitts and Nevis is highly vulnerable to hurricanes.² There have been several damaging hurricanes in the past two decades, including the catastrophic Hurricane Georges in 1998 which caused damage estimated at 110 percent of GDP.³ More recently, in 2008, Hurricane Omar forced a two-year closure for repair of the Nevis Four Seasons hotel—one of the island's largest hotels, and its most luxurious.

Government response to shocks. Like many small states dependent on investments and employment in just one or two industries, St. Kitts and Nevis sought to build its economic base and protect it against shocks using tax concessions, loan guarantees, and fiscal subsidies. While well-intentioned, this proved unsustainable in the face of large shocks, leading to rapid accumulation of public debt from the late-1990s. Specifically, the government covered the growing losses of the sugar sector through budgetary transfers and debt guarantees—the latter culminating in assumption of debt of about 23 percent of GDP from the Sugar Company by the time the industry was closed in 2005 (Figure 2). Some fiscal measures that the government implemented, such as the introduction of VAT improved the fiscal position but debt continued to be unsustainable.



Appendix Box 8. St. Kitts and Nevis: Trials and Tribulations of a Micro State (concluded)

Stabilization program. To address the critical debt situation, the authorities began implementing an ambitious fiscal adjustment program from emid-2010. The government's reform effort, together with a debt restructuring plan, was supported by a 36-month SBA for 590 percent of quota, approved in July 2011. Fiscal adjustment, together with a debt restructuring strategy that included a debt-for-land swap, is forecast to reduce public debt to 105 percent of GDP by end-2013. Under the program, tax administration strengthened and public financial management was improved including by establishing a legal framework for procurement, and strengthening monitoring and audit procedures. At the same time, wages were kept at their 2009 nominal level until late 2013, as other expenditures were contained or reduced, including capital spending. The debt-to-GDP ratio is projected to decline to 60 percent by 2020, predicated on the continuation of the fiscal consolidation effort and economic recovery.

Future challenges: St. Kitts and Nevis will remain vulnerable to natural disasters and global economic shocks, and a key priority is to build buffers enabling it to deal with unforeseen events without undermining fiscal performance in the manner of the late-1990s. Debt reduction effort must now be complemented by a sustained focus on the structural reform agenda, the strengthening of the investment climate and the design and implementation of policy and institutional arrangements for the efficient management of accumulated savings. Furthermore, the country's past experience underscores the importance of prudence in the face of external shocks. It must carefully consider what is affordable, taking uncertainty into account, and tailor its policies accordingly.

¹ Prepared by Judith Gold.

² The six ECCU countries, including St. Kitts and Nevis, rank, on some measures, among the 10 most disaster-prone in the world. See Rasmussen, Tobias, "Natural Disasters and Their Macroeconomic Implications" in *The Caribbean, from Vulnerability to Sustained Growth*, edited by R. Sahay, D. Robinson, and P. Cashin, IMF, 2006.

³ Emergency Disasters Data Base (EM-DAT) and IMF WEO database.

Appendix Box 9. The Seychelles: An Example of Successful Adjustment¹

The Seychelles' implementation of Fund-supported programs during 2008-13 provides a positive example of successful adjustment by a small state.

Seychelles' Fund-supported program responded to a severe balance of payments and debt crisis in 2008.² High public spending and an increasingly overvalued fixed exchange rate led to rising public and external debt, as well as foreign-exchange rationing. By 2007, the fiscal deficit reached 7.7 percent of GDP, public debt 131 percent of GDP (two thirds of it foreign), and reserves fell to ½ month of imports. External arrears began to accumulate and the crisis came to a head in October 2008, when the authorities missed a Eurobond payment. The ensuing program was founded on strong fiscal adjustment, debt restructuring, a floating exchange rate, and structural reforms to enhance growth, including supporting the private sector through simplification of the tax system and public enterprise reform and privatization. With strong implementation, these policies largely succeeded—growth soon recovered; unemployment returned to historical low levels; fiscal surpluses continued reducing debt post-restructuring; inflation and interest rates stabilized after initial spikes; reserves grew to 3½ months of imports; and the exchange rate recovered after briefly overshooting.

Seychelles' experience suggests several potential lessons for other small states:

The importance of consensus and ownership: The fiscal adjustment involved a substantial reduction in public spending and employment; despite this, the authorities managed to maintain social cohesion through effective communication to sensitize the population about the benefits of the reform program (often at a local level) and implementing a strong but better-targeted social safety net. Seychelles' smaller size facilitated these successes. Moreover, the private sector was able to absorb many downsized public sector workers (unemployment is low in Seychelles, with many expatriate workers).

The benefits of exchange rate flexibility: This flexibility played an important role in restoring external equilibrium, allowing for the build-up of international reserves, and ensuring that imports were determined by price signals rather than through foreign exchange rationing. In particular, the flexibility facilitated adjustment in demand; in a small tourism and commodity dependent (fish) economy like Seychelles, the supply response from depreciation was inevitably limited.

The importance of external debt restructuring and financial support: Recognizing that the substantial fiscal and current account adjustment alone was insufficient to make debt sustainable, both official and private creditors agreed to a comprehensive debt restructuring early in the programs, reducing stocks by almost 50 percent. Financial support from the Fund (4 percent of GDP) was important to rebuild reserves, and the World Bank, EU, and AfDB provided budget support to the government equivalent to 6 percent of GDP to cushion the adjustment process.

The importance of technical assistance: Seychelles' institutional capacity for implementing reforms was constrained by limited human capacity, reflecting the small size of the country. Extensive TA successfully mitigated this risk to program implementation: most notably, the Fund supported the CBS' adoption of an independent monetary policy targeting reserve money, as well as the fiscal authorities' comprehensive reform of tax policy through the introduction of a VAT and a flat-rate personal income tax. The provision of resident advisors helped to mitigate absorptive capacity constraints in key areas. Further TA was provided by the World Bank, AfDB, and the UNDP.

The importance of diversification: while export diversification remains a challenge for Seychelles as with many small states, Seychelles was able to reduce its reliance on traditional markets through a strategy designed to increase visitor numbers from non-traditional markets in the Middle East, Eastern Europe, and Asia. There has also been some diversification of the tourism product, including through land reclamation and development of villas, leading to an increase in the number of tourism units.

¹ Prepared by Joseph Thornton.

² An SBA was approved in November 2008, with a follow-on EFF approved in December 2009 which expired in December 2013.

Appendix Box 10. Comoros: African Regional Technical Assistance Center (AFRITAC) South Technical Assistance¹

The Comorian economy faces considerable fragility, and its economic institutions are underdeveloped. Given this, capacity building has been a priority.

In spite of significant progress in restoring macroeconomic stability in recent year, Comoros remains a fragile state with, partly due to its small size, a very underdeveloped institutional capacity and limited human skills. The Fund has been providing technical assistance in a wide range of areas led by FAD and MCM, with important support from the regional technical assistance center, AFRITAC South (AFS), in Mauritius.²

AFS is located in relative close proximity to Comoros and through its specialized experts has been able to respond quickly through field missions to provide on-site technical assistance, including follow-up to missions from headquarters, and to organize training in Mauritius.

Reflecting its small size and underdeveloped capacity mentioned above, Comoros' greatest immediate technical assistance needs have been in the area of basic institution building. The bulk of AFS technical assistance in 2012 and 2013 has been, therefore, devoted to helping improve public financial management and tax and revenue administration, including specialized training on customs administration that took place in Mauritius. AFS missions to Comoros provided further TA on improving cash management and internal control, in particular on improving revenue and expenditure projections, re-establishing the steps of commitment of funds, liquidation, and payment in the expenditure cycle, developing appropriate cash management tools, strengthening the institutional framework for cash management and internal control, and gradually introducing the Treasury Single Account (TSA). Much of the planned AFS assistance for the next fiscal year will support implementation of a medium-term public financial management strategy that has recently been developed. On the revenue side, the AFS also provided important recommendations to improve the collection of taxes on the importation and consumption of petroleum products and in tax administration.

While it is too early for a full assessment preliminary signs indicated that Comoros is starting to reap the benefits of this technical assistance, as witnessed by improvement in the budget preparation process and the establishment of a new general tax administration office.

Despite a planned significant increase in AFS technical assistance in FY2014 the needs in Comoros are vast and other TA suppliers will have to assist on issues for which the Fund has no clear expertise. For instance, the World Bank and African Development Bank are active in developing reforms in the energy sector, and other donors are helping the authorities develop strategies in the education and health sectors.

¹ Prepared by Harry Trines.

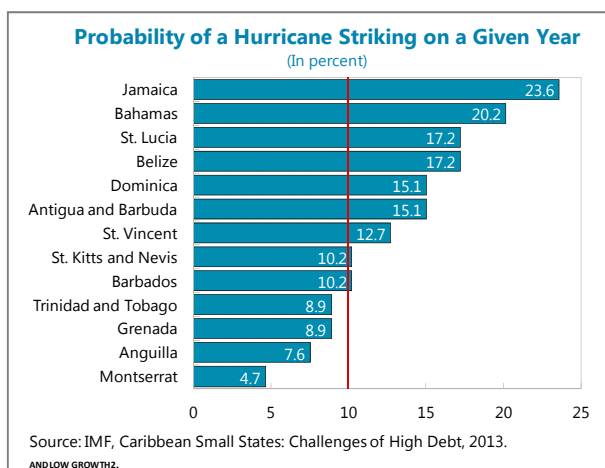
² AFRITAC South member countries are: Angola, Botswana, Comoros, Lesotho, Madagascar, Mauritius, Mozambique, Seychelles, South Africa, Swaziland, Zambia, and Zimbabwe.

Appendix Box 11. The Caribbean Catastrophe Risk Insurance Facility (CCRIF)¹

Sovereign insurance against natural disasters is a new option for some small states, as discussed below.

The Caribbean is one of the most disaster-prone regions of the world with 6 countries in the top 10 and all of them in the top 50 hot spots. Over the last 60 years, the region has suffered from 187 natural disasters mostly hurricanes. Losses from natural disasters averaged about 1 percent of GDP per year since 1960. Following the severe devastation caused by hurricanes in the Caribbean in 2004, the CARICOM Heads of Government requested World Bank assistance in improving access to catastrophe insurance.

The CCRIF, established in May 2007, is the first multi-country risk pool in the world.² The CCRIF is a regional insurance fund that allows Caribbean governments to purchase insurance coverage to finance immediate post-disaster recovery needs. The CCRIF currently includes 16 Caribbean, of which 13 are classified as small and micro states. It is the result of collaboration between the region's governments and key development partners. It was capitalized through contributions to a multi-donor Trust Fund by the Government of Canada, the European Union, the World Bank, the governments of the UK and France, the Caribbean Development Bank and the governments of Ireland and Bermuda, as well as through membership fees paid by participating governments.



Insurance policies are triggered and payouts calculated using a parametric catastrophe risk model (the multi-risk peril estimation system—MPRES) calibrated specifically for the Caribbean. Losses are based on characteristics of a natural hazard event (provided by independent sources) and impacts of the hazard on pre-defined national exposure. This allows the CCRIF to provide quick claims settlement to a participating government affected by an earthquake or hurricane. Payouts are contingent on pre-established trigger events measured in terms of wind speed or ground acceleration and proportional to the estimated loss derived from the hazard impact model.

The CCRIF Functions as a pooled reserve controlled by participating governments. It retains risk from participating governments through its own reserves, and transfers risks that exceed its own capacity to reinsurance markets. The leveraging of its own reserve pool to purchase additional risk financing capacity directly in the reinsurance market allows the CCRIF to secure sufficient financial capacity to finance major losses. This structure also provides participating governments with insurance coverage at about half the price they would face if they approached the reinsurance industry independently. Insurance coverage under the CCRIF is typically capped at 20 percent of total estimated losses, a proportion which is believed to be sufficient to cover a government's immediate liquidity needs to begin emergency operations after an adverse event until other financial resources are mobilized.

The CCRIF covers middle-level weather-related risks, (10-20 year events) and facilitates risk transfer and risk diversification for small vulnerable economies. It allows these countries to access international private insurance markets at a fraction of the cost they would face individually. Still, countries under-insure as catastrophe premiums are high. The parametric model allows payouts to be made very quickly usually within 14 days providing liquidity at a time when government budgets are under stress. However because it is focused on midrange risks more frequent events like flooding which can cause significant financial loss are not covered. To address this, the CCRIF introduced its excessive rainfall product in June 2013 to provide flood coverage.

¹ Prepared by Wendell Samuel.

² The member countries of the CCRIF are, Anguilla, Antigua and Barbuda, Bahamas, Barbados, Belize, Bermuda, Cayman Islands, Dominica, Grenada, Haiti, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago and the Turks and Caicos Islands.

Appendix Box 12. Grenada: Lessons from its 2013 Ex Post Assessment

The December 2013 Ex Post Assessment on Grenada's 2006-13 program engagement with the Fund has some important findings for small states. Specifically, growth-related reforms should be front and center; program design needs to foster resilience to shocks; and reform ambitions should be tailored to country capacity.

Background. Grenada is a Caribbean island state with a population of a little over 100,000. After independence in 1974, it experienced a decade of civil unrest and political turmoil, leading to US invasion in 1983. Subsequently, the country has enjoyed broad political stability. Benefitting from preferential access to EU markets for its agricultural products and entry into the tourism industry, annual real GDP growth averaged more than 4 percent through the late-1990s, and the country moved into the upper-middle-income category (its current per capita income is around \$8,000). It is a member of the ECCU.

Crisis. Grenada has experienced much less favorable economic performance since 2000. Annual GDP growth slowed to less than 2 percent, with sharp contractions in 2001, 2006, and 2009, and stagnant activity since 2010. Multiple factors contributed to slower growth including loss of trade preferences with Europe, terms of trade shocks, hurricane-related losses, food and fuel price shocks, and downturns in the U.S. and U.K. economy after the global financial crisis. Expansionary fiscal policies led to a sharp rise in gross public debt from the 40-50 percent of GDP range in the 1990s to 80-100 percent during the 2000s. Slowing growth also revealed underlying competitiveness problems related to high labor costs, high energy costs, trade protectionism, and shortages of labor skills.

IMF support. After emergency Fund financing for hurricane-related damage in 2003/04, a PRGF-supported program was launched in April 2006 (extended through April 2010), and a successor ECF was approved in April 2010. The latter expired in April 2013 with only one review completed: the second review was put on hold when the authorities informed staff of their intention to pursue a debt restructuring, and remaining reviews were not completed when the government undertook expansionary fiscal policies.

EPA findings. Performance under the PRGF/ECF programs was generally weak, with most program objectives not met. Growth remains stagnant (contrary to initial projections of 4 percent growth); the budget has seen primary deficits (rather than the programmed surpluses); and public debt has risen in relation to GDP (rather than falling as programmed). On the structural front, less than one-third of benchmarks were met on schedule and nearly 40 percent were never achieved. Sources of program slippage included major hurricane-related damage, the global financial crisis, and election-related spending pressures.

Lessons for small states implementing ambitious adjustment programs.

- **Make realistic growth projection and include contingency plans.** Growth projections were consistently too optimistic, and a future program should consider Grenada's growth volatility and exposure to shocks. Staff should develop downside scenarios, contingency plans for possible natural disasters, and possible contingent measures to reduce non-disaster related spending if needed.
- **Growth related reforms should be front-and-center.** While Fund programs had the stated goal of fostering competitiveness, little traction was achieved. When two benchmarks designed to improve the investment climate were missed, the reforms were dropped. The EPA suggests that a new ECF should focus on a few macro-critical reforms with a growth focus. The goal should be to shift to the private sector as the main engine of growth. Business climate reforms should be coordinated with the World Bank and other development agencies.
- **Structural reforms should be tailored to institutional capacity.** The programs of the past decade were relatively ambitious (average of 5 structural benchmarks per review). The EPA suggests that this exceeded the authorities' capacity, and that a new ECF should focus on a few key macro-critical reforms with appropriate sequencing of TA.

Appendix Box 12. Grenada—Lessons from its 2013 Ex Post Assessment (concluded)

- **Ownership is key.** While not exclusively a small states challenge, the EPA identified weak program ownership as a challenge. For example, the general failure of the strategy to address tax concessions can often be attributed to the absence of ownership. This could be addressed under a new program by macro-critical prior actions and monitoring of performance relative to indicative targets for key fiscal variables ahead of a new program.
- **Further efforts are needed on fiscal adjustment and debt restructuring.** Remaining issues include steps to reduce current spending, including the wage bill, and halt recourse to tax incentives. On the latter, the EPA suggests that seeking a regional approach to tax incentive reform may be more successful than at a country level as it may be more politically feasible but it would still be beyond the scope of formal Fund conditionality and therefore may be difficult to enforce. On debt restructuring, past efforts proved to be inadequate in terms of principal reduction, and Grenada is encouraged to engage further with creditors on a consensual debt restructuring.