Addressing Debt Vulnerabilities in Small States

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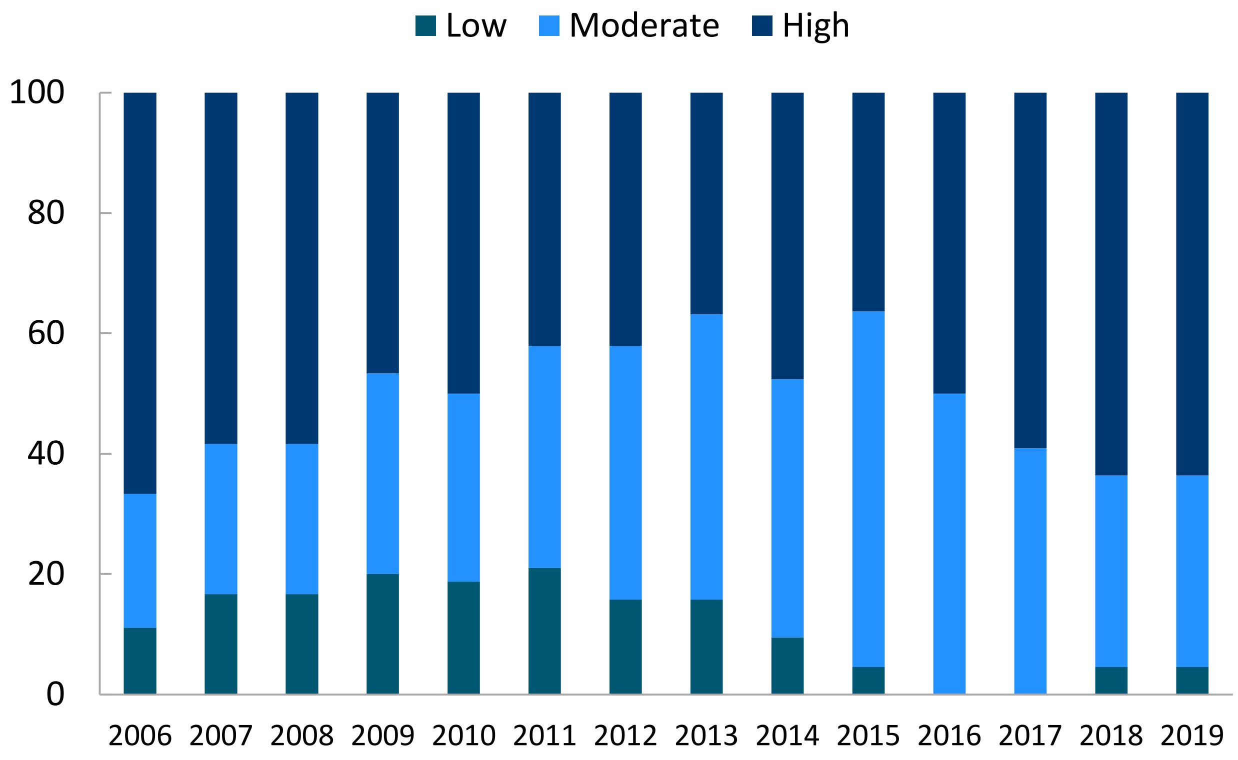
Many small states are at high risk of external debt distress

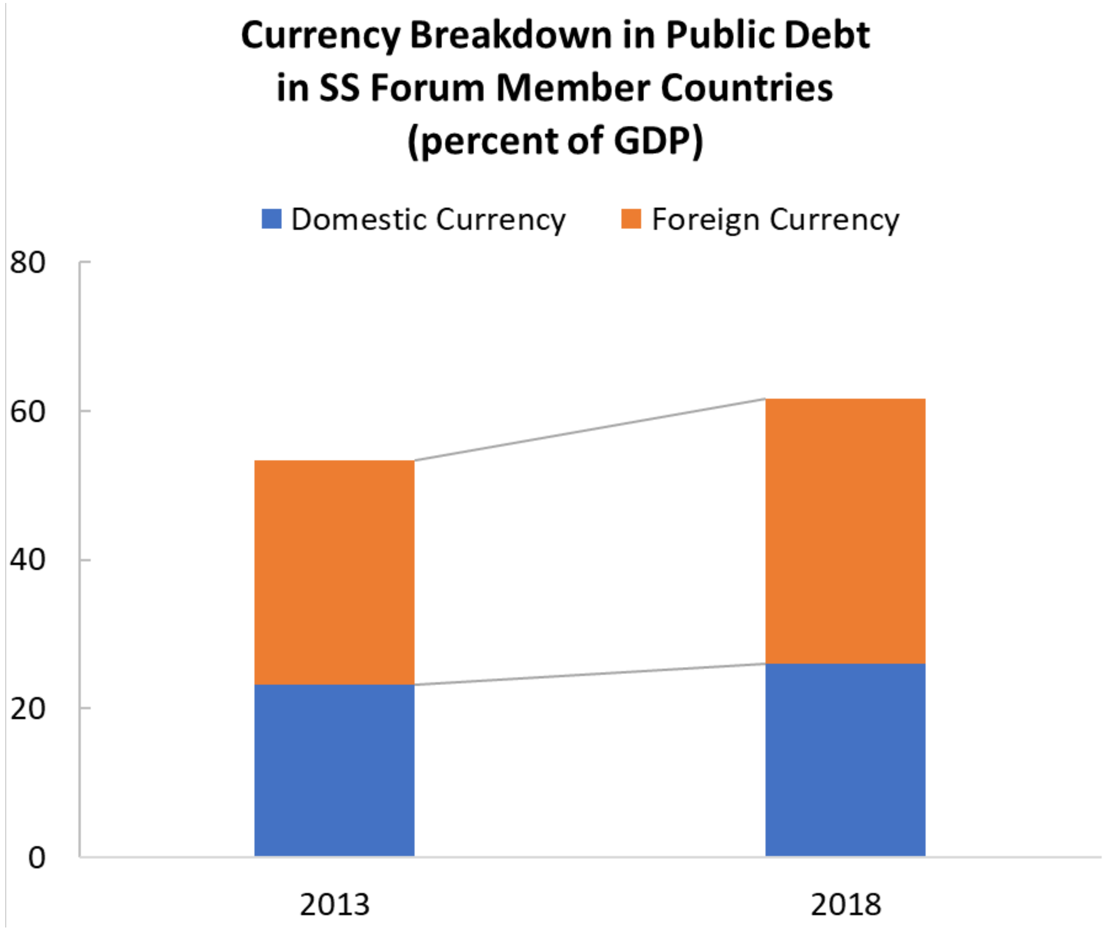
Evolution of the Risk of External Debt Distress
in Small States (SS) Forum Countries
(in percent of total)



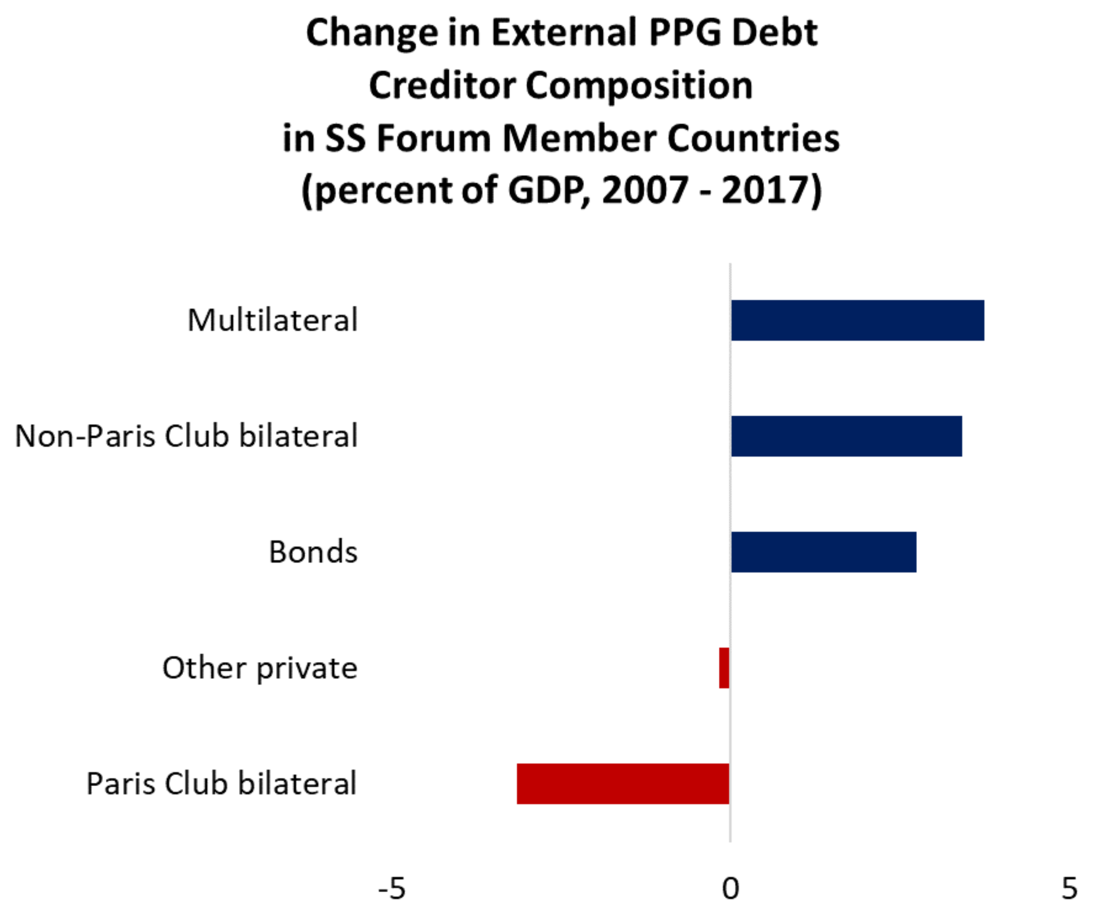
- Share of countries with elevated debt risks has increased in recent years
  - Increase on top of persistently high historical shares
- Current risk of external debt distress
  - One country at low risk
  - Remaining countries either: i) at moderate risk (one third); or ii) at high risk or in debt distress (two thirds)
- Structural factors are key drivers of debt vulnerabilities
  - Small economic size; exposure to external shocks and natural disasters; and climate change impact
- Reflecting debt vulnerabilities, most of IDA financing is provided as grants
  - Out of 13 grant-eligible countries, 8 received 100% grants and 5 received 50% grants in FY20

Source: LIC-DSA database.
Note: As of end September 2019. Chart covers 22 SS forum countries with LIC DSAs.

Debt composition has become more complex…

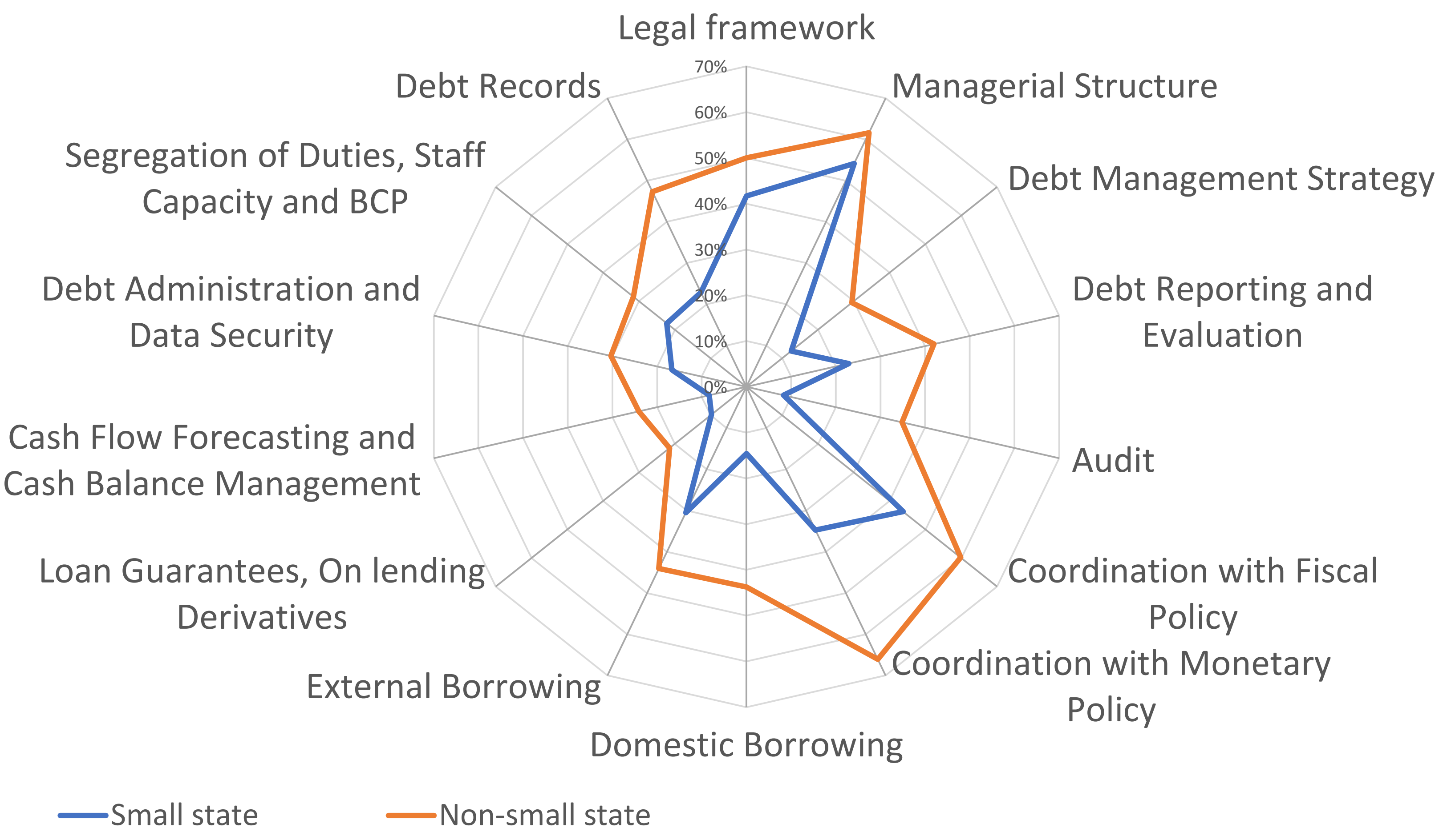


Source: World Economic Outlook, April 2019.
Note: Chart covers 48 SS forum member countries (Part 1 countries are excluded).



Source: International Debt Statistics, 2018.
Note: Chart covers 27 SS Forum member countries.

… while debt management capacity lags behind larger states …

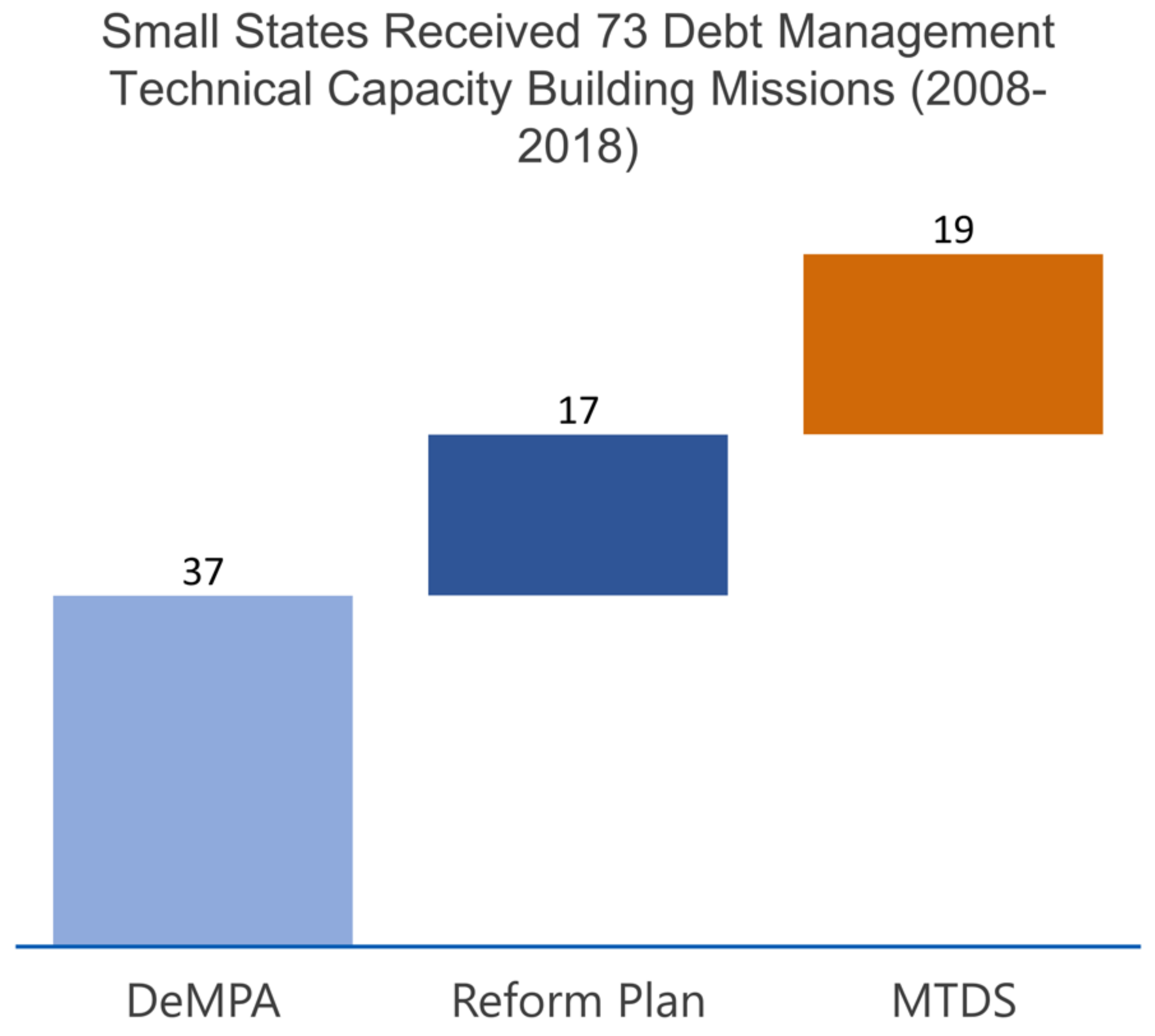


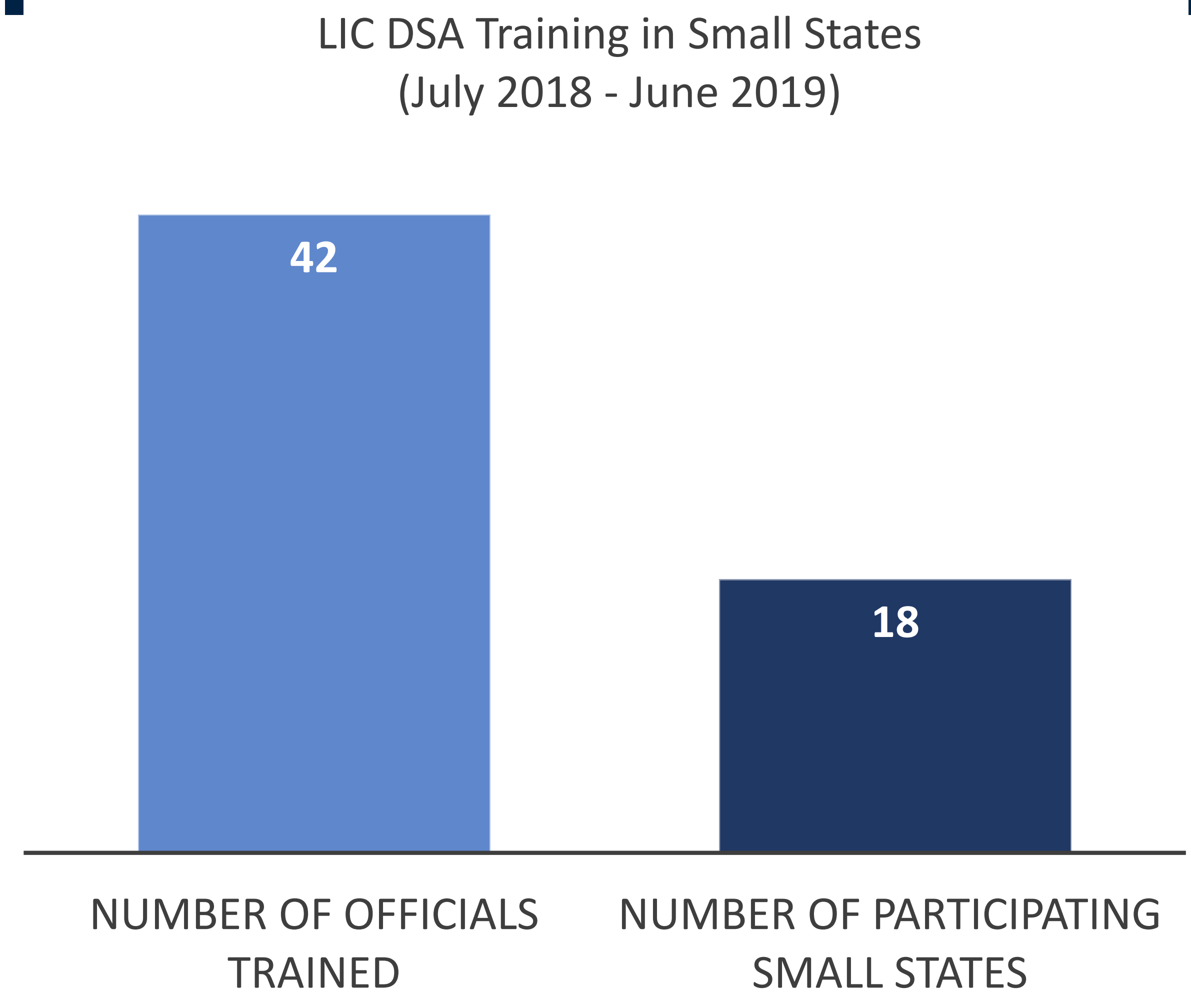
Source: WB's Debt Management Performance Assessments (DeMPA)

… which is often related to institutional challenges small states face.

Common Challenges	Possible Factors
In Small States	
Staff, systems, processes and procedures	
• Short-staffed and small Debt Management Offices (DMOs) (avg. 5) • High turnover • Limited analytical capabilities • Inadequate Debt Management systems, not integrated with others (e.g. payments, grants, budget)	• Weak HR management • “Brain-drain” • Lack of economy of scale justifying DM legal assistance or tailored DM systems
Borrowing and reporting	
• Ad hoc borrowing: not steered by clear strategy based on cost/risk analysis • Domestic debt mostly short term for Treasury purposes • Limited transparency of debt data • Cash rationing instead of cash management	• Shallow domestic market • Limited institutional investors • Limited incentives (scrutiny); limited audit • Challenges in budget formulation and execution

The World Bank provides significant technical assistance to small states





Source: World Bank staff calculation

The revised joint Bank-Fund Debt Sustainability Framework for low-income countries (LIC DSF) takes the specific features of small states into consideration:

I. DSF thresholds: based on new indicator that integrates more country-specific information (growth, reserves, remittances) to complement the Country Policy and Institutional Assessment (CPIA);

II. Realism tools: help examine the credibility of the assessment (e.g, planned fiscal adjustment, public investment-growth relation);

III. Tailored stress tests: allow to incorporate key vulnerabilities facing small states (e.g. natural disasters, volatile commodity prices, market shocks, and contingent liabilities).

Fiscal risk assessment in small states helps manage risks

Many fiscal risks, with several on the rise…

- **Economic growth** - Weaker-than-expected economic performance reduces tax revenue and increases the cost of unemployment insurance and other social protection programs.
- **Commodity prices** - Sudden changes in commodity prices affect government spending, customs duties, and energy, agricultural, and food subsidies.
- **State-owned enterprises (SOEs)** -The poor financial or commercial performance of SOEs may generate contingent liabilities.
- **Public-private partnerships (PPPs)** - PPPs may entail contractual obligations and/or implicit public guarantees with important fiscal implications.
- **Natural disasters** - Disasters can disrupt production in fiscally important sectors and may require large-scale relief and reconstruction spending.
- **Public health emergencies** - Epidemic disease can radically increase health spending and may adversely affect employment, production, and trade.
- **Judicial awards** -Court judgments against the government may result in unexpected spending

- The World Bank's recent assessment of fiscal impacts and fiscal risks from natural disasters in some small states found that high debt service obligations tend to limit the government's fiscal space for spending on poverty reduction and public goods.*
- In addition, the means of financing the government's response to shocks arising from the effects of climate change is more of a critical challenge for these small states.

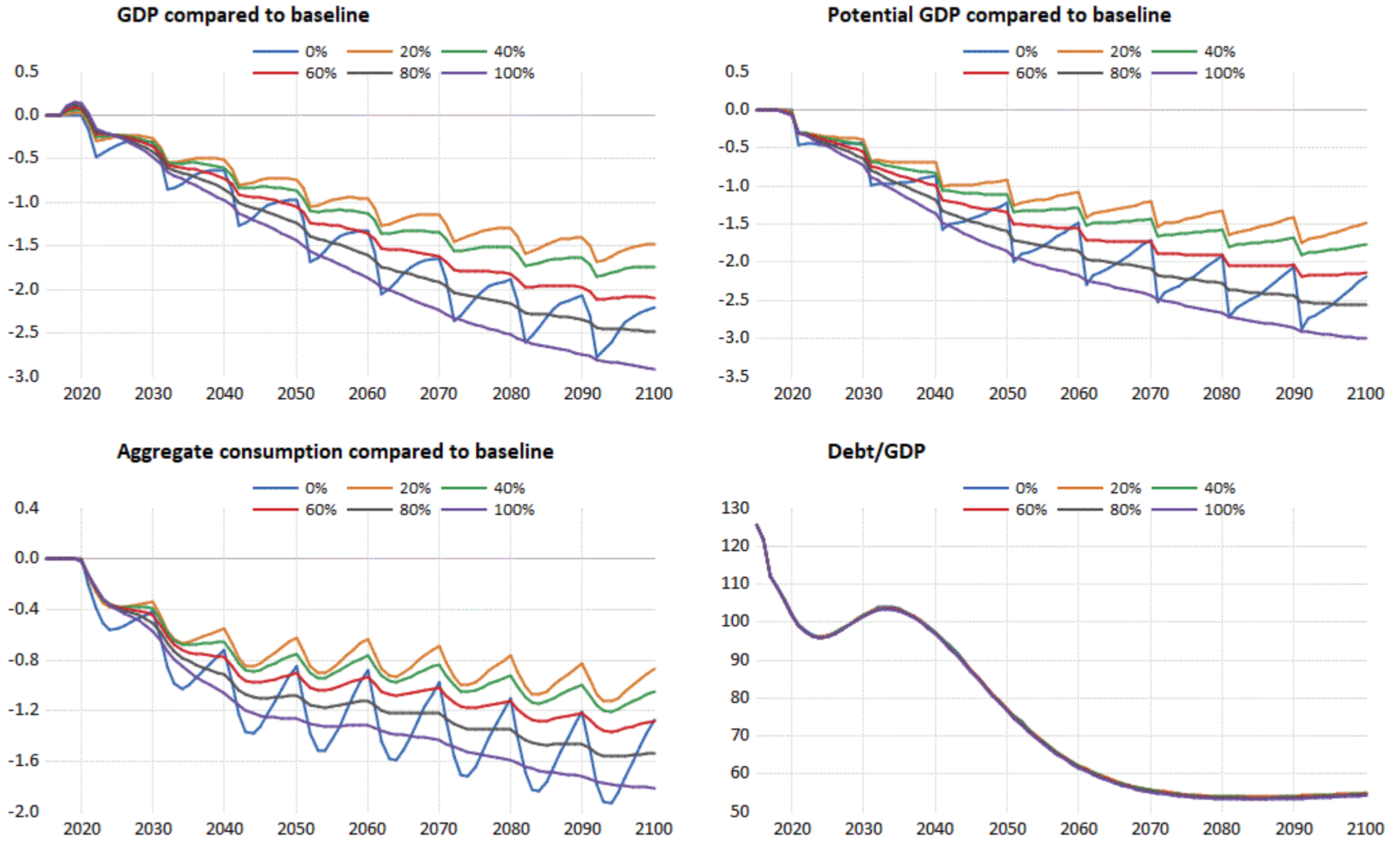
… thus fiscal risks need to be better monitored and managed.

Source: Pigato, et. al (2019), *Fiscal Policies for Development and Climate Action*. International Development Focus. Washington DC: World Bank. Doi:10.1596/978-1-4648-1358-O

Introducing climate change adaptation into macro modeling

The case of Jamaica

Comparison across different amounts of disaster management investment



- Modeling of climate damages (capital destruction) through extreme events
- Country specific parametrization
- Assessment of risk management options (debt repayment/ adaptation)

IDA's Forthcoming Sustainable Development Finance Policy (SDFP)

THE SDFP IS ALIGNED WITH WB-IMF MULTI-PRONGED APPROACH TO ADDRESS DEBT VULNERABILITIES

Two pillars:

Debt Sustainability Enhancement Program (DSEP) to enhance incentives for countries to move toward sustainable financing

Program of Creditor Outreach leverages IDA's global platform and convening role to promote debt transparency, outreach and creditor coordination on sustainable lending practices

- The forthcoming SDFP replaces the NCBP
- SDFP will complement
  - IDA policy commitments (under special themes of Jobs and Economic Transformation and Governance and Institutions)
  - IDA financing tools that support countries' debt sustainability - the Grant Allocation Framework (GAF)
  - Small island economies (SIEs) exception
  - Small states terms

Debt Sustainability Enhancement Program

DSEP will have design flexibility to accommodate special circumstances, including those faced by Small States

Performance-based set aside

- All IDA countries screened annually
- Access to 100% core allocation for low debt risk countries as well moderate and high risk countries that have met agreed policy actions; moderate and high risk countries that meet their previously agreed policy actions also receive any accumulated set aside
- Otherwise, 10% set aside for moderate risk countries and 20% for high risk countries

Performance and policy actions

- Develop annual performance and policy actions for moderate and high risk countries
- For Small States, the reviews will be reduced from annual to once every two years to give enough time to make the necessary progress to access the set-aside
- Policy actions aim to strengthen fiscal sustainability, debt management, and debt reporting/transparency, and are anchored in country programs
- Policy actions tailored to specific circumstances of each country (FCV, low capacity)

Outcomes

- Moderate and high risk countries that consistently meet policy actions maintain full annual allocations
- Moderate and high risk countries that miss policy actions one year but deliver the following year maintain full allocations over the replenishment
- Moderate and high risk countries that consistently miss policy actions get cumulative 10/20% discounted allocations over the entire replenishment

Conclusions

- Small states face debt vulnerability / debt management challenges inherent to their small size
- The World Bank offers various tools to help them mitigate those challenges
- Bank's support to small states, including forthcoming SDFP, takes into account their special circumstances

Thank you.

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