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2017 STAFF GUIDANCE NOTE ON THE FUND'S ENGAGEMENT WITH SMALL DEVELOPING STATES

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2017 STAFF GUIDANCE NOTE ON THE FUND'S ENGAGEMENT WITH SMALL DEVELOPING STATES

EXECUTIVE SUMMARY

This guidance 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 state characteristics might shape Fund surveillance and financial support, program design, capacity building activities, and collaboration with other institutions and donors.

The note updates the previous version that was published in May 2014. It incorporates modifications resulting from Board papers and related Executive Board discussions that have taken place since the March 2013 Board papers on small states, which provided the foundations of the original guidance note.

Based on these inputs, five key thematic areas (G.R.O.W.TH.) have been identified as central to the policy dialogue:

- **Growth and job creation**. With small states experiencing relatively 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 and climate change.
- **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**. Developing deeper and more competitive, yet sound, financial sectors contributes to macroeconomic stability and enhances the effectiveness of policy interventions while strengthening competitiveness by improving business access to financial services.

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

Approved By
Seán Nolan

This update of the guidance note was prepared by Mai Farid and Ermal Hitaj, under a project supervised by Peter Allum and Xavier Maret (all SPR) and in close collaboration with other Fund departments (AFR, APD, EUR, FAD, LEG, MCD, MCM, and WHD). Research assistance was provided by Corinne Stephenson and Yining Zhang, and production assistance by Merceditas San Pedro-Pribram (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
BoP	Balance of Payments
CARTAC	Caribbean Regional Technical Assistance Center
CBR	Correspondent Banking Relationships
CCPA	Climate Change Policy Assessment
CD	Capacity Development
CS	Commonwealth Secretariat
CLICO	Colonial Life Insurance Company
CPIA	Country Policy and Institutional Assessment
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
ECCU	Eastern Caribbean Currency Union
ECF	Extended Credit Facility
EDD	Economic Development Document
EMs	Emerging Markets
ENDA	Emergency Natural Disaster Assistance
EPCA	Emergency Post-Conflict Assistance
ESF	Exogenous Shocks Facility
FAD	Fiscal Affairs Department
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GNI	Gross National Income
GRA	General Resources Account
HIPC/MDRI	Heavily Indebted Poor Countries/Multilateral Debt Relief Initiative
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFIs	International Financial Institutions
IMF	International Monetary Fund
LICs	Low-Income Countries
MDBs	Multilateral Development Banks
MEFP	Memorandum of Economic and Financial Policies
NPL	Non-Performing Loan
ODA	Official Development Assistance
OFCs	Off-Shore Financial Centers
PCI	Policy Coordination Instrument
PEFAs	Public Expenditure and Financial Accountability
PICs	Pacific Island Countries
PFM	Public Finance Management
PFTAC	Pacific Financial Technical Assistance Center

PPPs	Public Private Partnerships
PSI	Policy Support Instrument
PRGT	Poverty Reduction and Growth Trust
PRS	Poverty Reduction Strategy
RTAC	Regional Technical Assistance Center
REO	Regional Economic Outlook
RCF	Rapid Credit Facility
RFI	Rapid Financing Instrument
RGSM	East Caribbean Regional Governments Securities Market
ROSC	Report of the Observance of Standards and Codes
SBA	Standby Arrangement
SMP	Staff-Monitored Program
SSF	Small States Forum
TA	Technical Assistance
UN	United Nations
UN-OHRLLS	UN Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States
UCT	Upper Credit Tranche
WB	World Bank
WEO	World Economic Outlook

INTRODUCTION

1. **This guidance note focuses on small developing countries with populations of under 1.5 million.** The Fund has 43 members with populations of fewer than 1.5 million, of which 34 are small developing countries (hereafter "small states," Annex Table I).[1] 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 is relevant, in varying degrees, to these countries as well. The United Nations (UN) and the World Bank (WB) use slightly different groupings of small states, as presented in Box 1.

Box 1. UN and World Bank Groupings of Small States

- The UN's Small Island Developing States (SIDS) grouping includes 38 UN member states, all of which participate in the Alliance of Small Island States (AOSIS), an ad hoc negotiating body established by SIDS at the UN. The SIDS grouping contains a diverse set of countries, which vary markedly in terms of land area, geographic location, and income levels (from low income to upper middle income status). 1/

- The WB makes use of a small states grouping that includes 50 countries: these countries have a population of 1.5 million or less, or are members of the Small States Forum, a high-level meeting of policy-makers hosted by the World Bank during the IMF-WB Annual Meetings. 2/

- See Annex Table 2 for a listing of the UN SIDS and WB Small States groupings

1/ See UN-OHRLLS.
2/ See *World Bank Group Engagement with Small States: Taking Stock* (WB, 2016)

2. **The note provides operational guidance to staff on the Fund's engagement with small states**. It updates the previous 2014 note, which reflected the March 2013 Executive Board discussion of small states and the associated background papers.[2] To this effect, it incorporates modifications from relevant Board papers and decisions since that time, including:

- the May 2015 Board paper on "*Macroeconomic Developments and Selected Issues in Small Developing States*" (IMF, 2015a), which focuses on fiscal frameworks, external devaluation, and financial inclusion in small states;

[1] The small developing states grouping excludes small states defined as advanced market economies for World Economic Outlook (WEO) purposes, and fuel-exporting countries classified by the World Bank as "high income" (Bahrain, Brunei Darussalam, and Equatorial Guinea).

[2] "Macroeconomic Issues in Small States and Implications for Fund Engagement" (IMF, 2013a); "Asia and Pacific Small States—Raising Potential Growth and Enhancing Resilience to Shocks" (IMF, 2013c); "Caribbean Small States—Challenges of High Debt and Low Growth" (IMF, 2013d); and the associated summing up "The Acting Chair's Summing Up-Macroeconomic Issues in Small States and Implications for Fund Engagement" (IMF, 2013b).

- the December 2016 Board paper on "*Small States' Resilience to Natural Disasters and Climate Change—Role for the IMF*" (IMF, 2016a) which discusses climate vulnerabilities and elaborates on policies to address such challenges through risk reduction, mitigation and adaptation measures, disaster preparedness and response, and financing options; and
- the May 2017 Board paper on "*Large Natural Disasters—Enhancing the Financial Safety Net for Developing Countries*" (IMF, 2017a), which led to Board approval of a new annual access limit of 60 percent of quota under the Rapid Credit Facility (RCF) and the Rapid Financing Instrument (RFI) for members experiencing urgent balance of payments needs arising from severe natural disaster-related damages.

3. **The Fund has recognized, in various policies and fora, the special characteristics and challenges of small states**. Small size is one of the elements of the Poverty Reduction and Growth Trust (PRGT) eligibility framework.[3] 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. Regional technical assistance centers (RTAC) in the Caribbean and the Pacific focus primarily on the capacity building needs of small states.

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. Small states are very heterogeneous (Box 2). Some have achieved considerable economic success while others are among the poorest in the world and in fragile situations. Staff should focus on the particular economic needs of each country, rather than adopting a standardized approach.

5. **This note focuses on what is distinctive about small developing economies**. For instance, although small states are often poor, poverty is not 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 should be of value also to experienced country teams, by providing a consolidated overview of such issues.

6. **The disproportionate vulnerability of small states to natural disasters and climate change has important economic implications for small states.** This vulnerability contributes to lower investment levels, lower per capita income levels, higher poverty and a more volatile revenue base. This note incorporates the main findings of the 2016 Board paper on small states' resilience to natural disasters and climate change (IMF, 2016a), which examined how domestic policies can reduce the direct human and economic costs of climate change and natural disasters.[4]

7. **The guidance note is organized as follows**: the first section discusses distinctive characteristics and vulnerabilities of small states; the second section covers priorities for policy dialogue and engagement of Fund teams with small states; the specific aspects of Fund activities

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[3] The World Bank's IDA also includes a small island economy exception linked to countries with populations under 1.5 million. The same population 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.

[4] See also "*Enhancing Resilience to Natural Disasters in Sub-Saharan Africa*," (IMF, 2016f).

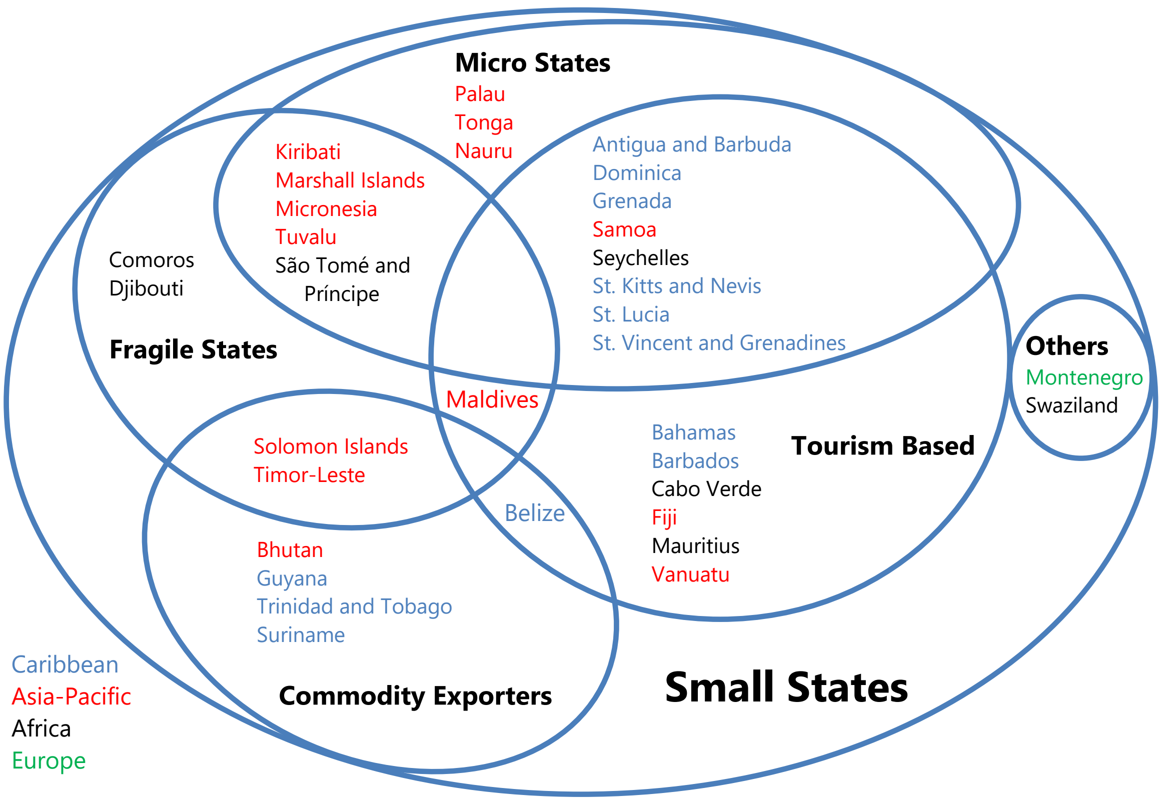
that are most relevant to small states in the areas of surveillance, program design, financial assistance, and capacity development are presented in sections three to five; the final section reviews coordination with other institutions and donors. The appendices present analytical work on selected topics of relevance to small states, including fiscal rules and monetary and exchange rate policy.[5]

[5] The internal Knowledge Exchange site on small states provides additional analytical work, country cases, and database available to country teams. The 2014 guidance note provided country examples illustrating good practices (IMF, 2014a); These are now available on the Knowledge Exchange site.

Box 2. Sub-Groupings of Small States

The set of small states can usefully be divided into several sub-groupings:

- **Tourism based countries** are those where exports of tourism services exceed 15 percent of GDP and 25 percent of total exports. Approximately half of the small states are tourism based, rising to three-quarters in the Caribbean region.
- **Commodity exporters** are those countries where at least 20 percent of total exports in 2008–2012 were natural resources. Twenty percent of small states are in this group, which includes two fuel exporters (Trinidad and Tobago; Timor-Leste) and other diverse commodity exporters: Guyana (gold); Belize (citrus, sugar, and bananas); Suriname (alumina, gold, and oil); Solomon Islands (logs and minerals); and Bhutan (hydroelectricity and steel). Trinidad and Tobago is the only commodity exporter that falls in the high-income group.
- **Small states in fragile situations** are defined as having weak institutional capacity as measured by the World Bank Country Policy and Institutional Assessment (CPIA) score (three-year average of the CPIA score below 3.2 or lower) and/or experience of conflict (signaled by presence of a peace-keeping or peace-building operation in the most recent three-year period (IMF, 2015d). Nearly one-third of small states are in a fragile situation; all except three (Comoros, Djibouti, and São Tomé and Príncipe) are in the Asia-Pacific region.
- **Micro states** are defined as having populations below 200,000. Almost half of all small states are micro states combined, they account for about 10 percent of the total population of all small states. All microstates are islands.
- Two countries do not fall into the above analytical groupings—Montenegro and Swaziland.



Caribbean countries are in blue; Asia-Pacific countries are in red; African countries are in black; European countries are in green.

DISTINCTIVE CHARACTERISTICS AND VULNERABILITIES OF SMALL STATES

This section reviews characteristics of small states that affect macroeconomic policy design and recommendations, such as a narrow economic base, high levels of openness, shallow financial systems, exchange rate regime rigidities, and weaker institutional capacity. These features can contribute to high vulnerability to shocks, subdued growth performance, and unsustainable debt dynamics.

8. **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 tradable goods, these costs represent powerful barriers to entry in small states, causing these countries to rely more on imports than on domestic-production. This results in high trade openness and high exposure to terms-of-trade shocks and volatile trade tax revenues (Table 1). 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.

Table 1. Selected Indicators of Small States

	2000-2016, median		
Country Groups / Indicators	Micro	Other SS	Other LIC and EM
GDP Per Capita Growth (annual, percent)	1.5	2.0	2.7
GDP Per Capita (current U.S. Dollars)	4707	3520	1880
(Percent of GDP)			
Trade Openness	98	103	71
Government Expenditure	34	30	26
Government Debt	57	48	40
Net ODA Received [1]	9.7	4.0	2.7
Volatility Measures [2]			
GDP growth	3.2	2.1	2.2
Current Account Balance to GDP ratio	5.0	4.0	2.9
Fiscal Balance to GDP ratio	2.7	2.2	1.8
Aid to GNI ratio [1]	2.7	1.4	0.7
Private Credit to GDP ratio [3]	3.3	3.9	2.6

Sources: World Economic Outlook database; World Development Indicator database; Ccountry authorities; and IMF staff estimates.

[1] Median of 2000-2014 due to data availability. Data source: World Bank WDI database and staff calculation.

[2] 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.

[3] Domestic credit to private sector (% of GDP). Median of 2000-2015 due to data availability. Data source: World Band WDI database and staff calculation.

9. **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, despite 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.

10. **Because of narrow production and export bases, small states have greater vulnerability to external shocks and experience more macroeconomic volatility than larger peers**. This is particularly evident with regard to the growth and external performance of micro states. Volatility comes from narrow production and export bases, which leave small states macroeconomically vulnerable to industry-specific shocks.

11. **Despite their minimal contribution to global warming, low-income countries (LICs) and small states are often the hardest hit by natural disasters and the most vulnerable to climate change**.[6] One-third of small states are highly or extremely vulnerable to climate change in the lifetime of the current generation partly because it can exacerbate natural disasters and partly because of more gradual effects such as rising sea level and pressures on the ecosystems.[7] In addition, many small states are disproportionately vulnerable to natural disasters (such as earthquakes and hurricanes) compared to larger peers both because of their location and because they do not have the geographic scale to provide diversification against location-specific shocks.[8] The ability of small states to manage such shocks is typically hampered by limited fiscal space, weak fiscal frameworks, shallow financial systems (which give less scope to rely on domestic financing to weather shocks), and thin administrative capacity (which complicates disaster mitigation and recovery efforts).

12. **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).[9] Careful attention needs to be given to assessing income distribution effects in evaluating national policies.

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[6] See "*Small States' Resilience to Natural Disasters and Climate Change—Role for the IMF*", (IMF, 2016a).

[7] Many indicators to assess the vulnerability of small states have been developed, such as the Commonwealth Vulnerability Index. The World Bank has initiated in 2016 a project to operationalize metrics of vulnerability that could complement existing income benchmarks for eligibility to concessional financing. Other indicators include Maplecroft climate change vulnerability index, and Notre Dame (ND-Gain) vulnerability and readiness index.

[8] The Fund developed in 2011 an analytical tool for vulnerability assessment in low- and middle-income countries, which provides an assessment of underlying risks to a severe growth recession in the event of exogenous shocks, including natural disasters, summarized in a growth decline vulnerability index (Dabla-Norris and Bal Gunduz, 2012).

[9] 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).

13. **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.[10] 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. Microstates have, unsurprisingly, also experienced higher levels of volatility than larger countries.

14. **High public debt burdens threaten sustainability, notably in the Caribbean which includes some of the world's most highly indebted countries** (measured by debt-GDP ratios). The Caribbean debt problems can be traced to the cost of natural disasters, fiscal management gaps, loss-making public enterprises, and sub-par economic growth.[11] Because of the middle-income status of many Caribbean countries, they have not been eligible for debt relief under the Heavily Indebted Poor Countries/Multilateral Debt Relief Initiatives (HIPC/MDRI)—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.

15. **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.[12] Banks in small states tend to lend disproportionately to the government, linking financial sector soundness closely to fiscal sustainability; and residents of small states, particularly in the Caribbean, often rely on nonbank financial institutions. Both banks and nonbank financial institutions frequently 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.[13] It includes the capacity constraints to properly implement relevant international standards, including for Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) and tax transparency purposes, exposing small states to reputational risks particularly if they engage in higher risk activities (e.g., offshore sectors, citizenship by investment). 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

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

[11] See specific country case studies on Guyana and St. Kitts and Nevis in Appendix Boxes 7 and 8 of the 2014 Guidance Note (also available at the internal Knowledge Exchange site on small states).

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

[13] For instance, the failure of Colonial Life 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.

administering and monitoring relatively small financial transactions. This can result in illiquid markets for debt in small states.

16. **Pegged or heavily managed exchange rates are typical for small states.**[14] 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 (Appendix Box 1). 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.

17. **Small states are somewhat more likely to be in fragile situations.** Nearly one-third 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*" (IMF, 2012a). In addition, the recent policy paper "*Building Fiscal Capacity in Fragile States*" (IMF 2017f) analyzes the main characteristics of fragile states and assesses technical assistance (TA) and capacity development in building or rebuilding fiscal policy management drawing on key lessons from their experiences.

18. **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 public debt burdens. Over the period 2000–2016, Pacific island small states (PICs) GDP per capita growth doubled whereas income growth in the Caribbean fell markedly relative to previous decades. PICs are much more reliant on development assistance than other Caribbean counterparts (Box 3).

[14] In addition, some small states like Kiribati, adopt foreign currency as tender.

Box 3. Regional Characteristics of Small States 1/

Caribbean countries

Most 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), though this gap has closed over the past decade. Against this, median public sector debt (80 percent of GDP in 2016) is almost three times the median for PICs. While Caribbean small states' per capita growth performance has slumped since 2000, PICs per capita growth almost doubled.

Although no Caribbean small state is defined by the World Bank as being in a fragile situation, the six Eastern Caribbean Currency Union (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.

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	*2000-16*	*1980-99*	*2000-16*	*2016*	*2014*	*2015*	*2016*
Caribbean SS	2452	7439	3.2	1.3	93	2	56	80
PICs	1441	2825	0.9	1.6	101	17	38	32

Note: *Private credit (% of GDP) refers to domestic credit to private sector (% of GDP).

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. About one-third of PICs are defined by the World Bank as being in fragile situations (Annex Table 1).

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. Typically, PICs face higher volatility than other small states with regard to Official Development Assistance (ODA) flows, per capita income growth, terms of trade, current account balances, and fiscal revenues.

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1/ This box is limited to the regional characteristics of Caribbean countries and PICs as the sample size from other regions is small.
2/ See Rasmussen (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.

PRIORITIES FOR POLICY DIALOGUE

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

A. Growth and Job Creation

Policies to strengthen growth and job creation are a priority.

19. **The Executive Board and management have highlighted the need for an explicit focus on growth in the context of small states**.[15] This discussion and the authorities' policy agenda should be clearly presented in country staff reports.[16] The implications for staff are discussed further below and in Box 4.

20. **Staff teams should 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, offshore financial sector, and 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 specific 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.

21. **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 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,

[15] See presentations to small states regional conferences by DMD Shafik in the Bahamas in September 2013 and by DMD Zhu in Vanuatu in November 2013. The Board has stated, with regard to the Fund's engagement with small states, that fostering improved growth should be an important priority.

[16] See Board paper *Guidance Note on Jobs and Growth Issues in Surveillance and Program Work* (IMF, 2013f).

the supply response to structural reforms may be slow and teams should be appropriately cautious in developing medium-term growth projections.

22. **Job-creation is a priority for small states**. With sluggish growth and limited 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*" (IMF, 2013f).[17]

23. **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.[18] 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.

24. **Tourism and remittances could be better leveraged to support growth and stabilize output**. In many small states, tourism tends to be dominated by large operators, and have rather weak linkages to the domestic economy. While these linkages are conditioned by the narrow production base and market size, vocational education and strategic targeting of agriculture and services can help enhance tourism spillovers into the economy. Remittances, typically a-cyclical,[19] could help support consumption stability in downturns, and small states should look for ways to facilitate their inflow, including through mobile banking and improved payment systems. In addition, diaspora bonds remain an option to finance public investment.

[17] See also "*Jobs and Growth—Analytical and Operational Considerations for the Fund*" (IMF, 2013e).

[18] See Board paper on structural transformation in LICs (IMF, 2014b).

[19] De, Kose, and Yousefi (2016).

Box 4. Explicit Growth Focus in Small States 1/

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); (iii) vulnerability of small states to natural disasters and climate change underscoring associated macroeconomic effects (lower investment, lower GDP per capita, higher poverty and more volatile revenue base); and (iv) the envisaged policies and ex ante disaster risk reduction strategies to build resilience and 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.[2/]

Country specificity. The focus and ambition of the growth and resilience building agenda will depend on the most critical growth impediments and vulnerabilities in a given country (e.g., energy costs, overvaluation, crowding out, infrastructure, exposure to natural disasters, and climate change), 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 with a focus on disaster risk reduction and preparedness, 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 5 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 agreement in the PICs)[3/]. 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 and resilience building to withstand exogenous shocks. Where additional public spending, risk-reducing investment and contingency planning for disaster intervention (or delayed fiscal consolidation) could have a positive growth impact, this should continue to be assessed from the perspective of available financing, including contingency financing plan, and implications for fiscal and debt sustainability. More generally, it is important to strengthen growth-friendly fiscal frameworks aimed at: (i) preserving strong fiscal fundamentals; (ii) minimizing fiscal rigidity and lowering recurrent spending to create fiscal space for growth-enhancing capital spending; (iii) improving the spending mix towards human and capital investments; and (iv) adopting budget and investment practices to foster returns on capital spending.[4/]

Climate Change Policy Assessment (CCPA).[5/] On a pilot basis and within their respective mandates, the IMF[6/] and the WB are collaborating to conduct assessments of the macroeconomic and sectoral aspects of climate change policies of small states. These IMF-WB joint assessments could help showcase small states' policy efforts and improve their access to global climate funding in the context of their national climate change strategies to meet commitments under the Paris Agreement. Mitigating carbon emissions—through carbon taxation and energy subsidy reforms—and efficiently managing costly public risk reduction investments are specific areas where Fund analysis and policy recommendations can help small states in addressing the challenges of climate change.

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 and resilience building aimed at ex ante disaster risk reduction strategies in program design.

The **2015 Guidance Note for Surveillance under Article IV Consultation** provides operational guidance on a range of structural issues in surveillance, including climate change.[7/] The note provides detailed guidance, suggestions and references in areas covered in surveillance including risks and spillovers, fiscal policy, macrofinancial and monetary policy, BOP stability, structural policies, including climate change, and data issues.

1/ Contributor: Jan Kees Martijn.
2/ See Board paper *Guidance Note on Jobs and Growth Issues in Surveillance and Program Work* (IMF, 2013f).
3/ The Nauru agreement brings together eight PICs to sustainably manage tuna (Federated States of Micronesia, Kiribati, Marshall Islands, Nauru, Palau, Papua New Guinea, Solomon Islands, and Tuvalu).
4/ See *Macroeconomic Developments and Selected Issues in Small Developing States* (IMF, 2015a).
5/ See *Small States' Resilience to Natural Disasters and Climate Change—Role for the IMF* (IMF, 2016a).
6/ See Managing Director's Statement on the Role of the Fund in Addressing Climate Change (IMF, 2015c) and "After Paris, Fiscal, Macroeconomic and Financial Implications of Climate Change", (Farid and others, 2016).
7/ See *Guidance Note for Surveillance Under Article IV Consultation* (IMF, 2015b).

B. Resilience to Shocks

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

25. **Staff's macroeconomic analysis should give prominence to potential shocks**. A first step is to identify the potential sources of exogenous shocks and their relevant transmission channels. Relevant risks include natural disasters, supply and terms of trade shocks to core industries, revenue volatility, and vulnerability of workers' remittance inflows to economic cycles in host countries. 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 (IFIs) and bilateral donors), and private sector involvement in risk reduction (with the latter backed, to a varying degree, by private insurance cover).

26. **Macroeconomic resilience will typically require adequate fiscal and external buffers to weather shocks**. The 2016 policy paper on small states' resilience to natural disasters and climate change provides a conceptual framework and implementation roadmap to build adequate buffers as a critical part of disaster contingency planning.[20] More generally, it is important to strengthen the fiscal framework to "see through the cycle" and help insulate the budgetary spending from revenue volatility. The pace of accumulation of buffers should be considered from a cost-benefit assessment. Where priority spending would need to be cut to boost savings and build buffers, a more gradual accumulation of buffers could be considered drawing on new revenue measures, or provision for future natural disasters in the annual budget thereby strengthening fiscal buffers. 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, whereas larger shocks would require access to debt financing. In the balance of payments, buffers can be provided by contingent lines of credit or, more likely, by holding an official reserve position to allow draw-downs to finance temporary balance of payments shortfalls without destabilizing confidence.

27. **Fiscal rules should be geared to support recovery efforts while maintaining fiscal sustainability**. Fiscal rules, if adopted, should ideally include specific provisions for how targets (e.g., deficit ceilings) 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 (Appendix Box 2).[21] 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.

28. **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.

[20] "*Small States' Resilience to Natural Disasters and Climate Change—Role for the IMF*", (IMF, 2016a).

[21] 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.

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.

29. **Sovereign insurance mechanisms are a new option, but typically provide only marginal risk mitigation**. 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 (Appendix Box 3). 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).

30. **The Fund can assist countries to identify disaster-related financing needs**. This could involve quantifying financing needs, based on an analysis of disaster risks and vulnerabilities and their possible fiscal impact. Financing needs could be segmented by date, distinguishing urgent financing needs (under three months), short term needs (under one year), and medium term needs (over one year). This would help to identify the necessary scale of fiscal buffers, access to financing, and/or risk transfer arrangements. Appendix Box 4 explores the different elements of the disaster risk financing tool kit in more detail.

31. **Programs designed to help recovery from natural disasters or increase ex ante resilience may also be an opportune time to pursue growth-enhancing reforms**. Climate-smart public investment and financial deepening can help countries build social and economic buffers to weather future disasters. To this extent, disaster planning may represent an opportunity to revisit obstacles to growth that might be difficult to address in a lower-risk environment.

32. **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 extreme weather events in the coming years.[22] 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 meet these costs, disbursements have been very limited so far, financing arrangements are convoluted, and access is limited by lack of capacity. 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).

33. **Resilience building advice will need to be appropriately tailored for small states in fragile situations**. For these cases, teams should also be guided by *Staff Guidance Note on the Fund's Engagement with Countries in Fragile Situations* (IMF, 2012a) and findings of the policy paper

[22] For details see Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States (UN-OHRLLS, 2009).

Building Fiscal Capacity in Fragile States—Case Studies (IMF, 2017f).[23] In general, policy advice geared to fostering resilience would need to: (i) pay attention to political economy considerations; (ii) tailor TA and capacity building efforts in fiscal policy management to achieve fiscal stability, financial control and secure "own" resources with due consideration to the state of fragility—midst of conflict/disaster, most fragile/post conflict or disaster and fragile/stable but vulnerable; (iii) tailor the nature and pace of reforms to the need for security and social cohesion as well as levels of capacity; (iv) promote approaches conducive to sustained engagement with IFIs; and (v) 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.

34. **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.[24, 25] Staff should also assess the desirability and feasibility of internal fiscal devaluations to improve competitiveness.[26] Currency devaluation is another element of the toolkit to address broader macroeconomic imbalances in several countries.

35. **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 (Appendix Box 5):

- In assessing competitiveness of tourism-dependent economies, staff should seek to go beyond approaches based on EBA-lite type analysis that are often not adequately tailored for application in small states.[27]

[23] See also *IMF Engagement with Countries in Post-Conflict and Fragile Situations—Stocktaking* (IMF, 2015d).

[24] 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.

[25] See *Macroeconomic Developments and Selected issues in Small Developing States* (IMF, 2015a).

[26] In the Eastern Caribbean Currency Union (ECCU), 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.

[27] More details can be found in *External Assessments in Special Cases* (IMF, 2014c); and *Bilateral Surveillance Guidance Note* (IMF, 2012b).

- 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 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.

- 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 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.

36. **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 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.

37. **The Fund has stepped up its efforts to better integrate macroeconomic implications of structural reforms into analytical work to support policy dialogue.** A core element of the Fund's analytical work has focused on assessing the impact of structural reforms on economic outcomes (such as, growth, productivity, employment, and inequality). Staff working on small developing states with narrow economic base will need to ensure that Fund analysis and policy advice aims to facilitate structural reforms—e.g., energy subsidy reform, labor market policies, fiscal structural reforms, infrastructure investment, insolvency reform, or financial deepening—which help to

contribute to fostering competitiveness and boosting growth.[28] This, in turn, provides a stronger basis to leverage regional knowledge of policy experiences, while ensuring Fund analysis and policy advice is tailored to small developing states' specific circumstances.

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. In designing growth-friendly fiscal policies, consideration should be given to small developing states' specific needs, circumstances and administrative capacities.

38. **Restoring fiscal and public debt sustainability are key challenges, notably in the Caribbean**. In situations where debt burdens are excessive, restoring debt sustainability invariably would require 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.

39. **Proper consideration should be given to several factors that determine the composition and pace of fiscal adjustment**. These include 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; they may also require more exchange rate flexibility. Staff are encouraged to recommend sustained fiscal adjustment where needed, with supporting policies and structural reforms. That said, fiscal consolidation need to be carefully calibrated in prolonged low-growth environments—for example following the global financial crisis—where fiscal consolidation is likely to have a negative short-term impact on growth with a potential long-term impact on output through low investments.[29] Moreover, countries that are not under market pressure should proceed with gradual fiscal consolidation, anchored in a credible medium-term plan. Greater focus can also be given to ROSCs (Report of the Observance of Standards and codes) and PEFAs (Public Expenditure and Financial Accountability) to formulate policy dialogue.[30]

40. **Citizenship programs can be a significant source of revenue, but their benefits should be weighed against potential drawbacks.**[31] Citizenship programs have been a source of substantial inflows, especially in the Caribbean, where in class-leader St. Kitts and Nevis inflows to the public sector alone neared 25 percent of GDP in 2013. Other small states, such as Dominica, Antigua and Barbuda, and Comoros, have also experienced significant inflows. However, inflows

[28] See "*Structural Reforms and Macroeconomic Performance: Initial Considerations for the Fund*" (IMF, 2015e).

[29] Fiscal Policy and Long-Term Growth (IMF, 2015h)

[30] Fiscal ROSCs have been undertaken in over half of larger countries but only 20 percent of small states.

[31] Gold and El-Ashram (2015).

related to these programs can be vulnerable to sudden stops, exacerbate external vulnerabilities, be misused for criminal purposes and threaten financial stability. As such, they should be managed carefully and be transparent and accountable, with a view to maintaining the reputation of the program and spreading the gains into the longer term.

41. **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 6 reviews selected debt restructuring operations in small states). Drawbacks associated with debt restructuring must also be weighed—in particular those related to long-term growth (which may be dependent on future financial market access) and financial stability (where the composition of debt and links to the domestic financial sector can be critical).

42. **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. 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 in their international sovereign bonds the enhanced collective action clauses and modified pari passu endorsed by the Executive Board[32] to facilitate orderly debt restructuring.

43. **Staff advice may frequently be sought on public-private partnerships (PPPs)**. Despite benefits, such as a technology transfer to the receiving country, an opportunity to ease financing constraints, and improved project management, 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 power.[33] Approaches to control for fiscal risks associated with PPPs include: (i) ensuring control over approval of PPPs and strengthening the gatekeeping role for the Ministry of Finance in assessing risks and fiscal sustainability; (ii) careful appraisal through independent review of project feasibility and charging risk-related guarantee fees

[32] See *Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring* (IMF, 2014d).

[33] A few useful references include, (a) *Public-Private Partnerships, Government Guarantees and Fiscal Risk* (IMF, 2006); and (b) *Public Investment and Public-Private Partnerships: Addressing Infrastructure Challenges and Managing Fiscal Risks (Procyclicality of Financial Systems in Asia)*, (IMF, 2008).

(where provided); (iii) ensuring risk-allocation framework to parties best able to control the risk; and (iv) identifying and budgeting for costs and potential fiscal exposure during the decision-making process.[34] Consultations with relevant staff in Fiscal Affairs Department (FAD) and the World Bank on these issues are 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.

44. **Priorities include deeper financial sectors, more competition, better service delivery, and strengthened oversight**.[35] A first challenge for staff teams will be to compile relevant financial sector data to underpin analysis, including performance indicators. About one-third of small states and one micro states, have had a full Financial Sector Assessment Program (FSAP) since 2000–17, 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 Eastern Caribbean Currency Union (ECCU), thereby creating a single regional financial space. Efforts to strengthen the legal framework for financial services and to 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.

45. **Small states have been recently challenged by unintended financial consequences through the disruption of correspondent banking relationships (CBRs).** CBR withdrawal has already affected the ease and cost of remittances transactions to some small states.[36] Furthermore, it presents risks to financial stability and inclusion, can increase the use of more expensive and less transparent remittances channels, and lead to lower growth and resilience to shocks. Going forward, staff should continue to support its member countries in addressing issues leading to and arising from the withdrawal of CBRs and monitoring risks to help tackle the adverse impacts from the withdrawal of CBRs and ensure financial stability and promote financial inclusion. Through surveillance and FSAPs and providing capacity development which comprises both TA and training,

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[34] See *Analyzing and Managing Fiscal Risks—Best Practices* (IMF, 2016e).

[35] See "Financial Inclusion in Small States" in *Macroeconomic Developments and Selected issues in Small Developing States* (IMF, 2015a).

[36] For more details see "*The Withdrawal of Correspondent Banking Relationships: A Case for Policy Action*", (Erbenova and others, 2016); see also the March 2017 Board Paper on "Recent Trends in Correspondent Banking Relationships—Further Considerations" (IMF, 2017b).

staff can support affected countries to help enhance their monitoring of CBRs and strengthen their legal, regulatory and supervisory frameworks. Small states should seek to improve domestic compliance to international AML/CFT standards. A possible alternative for remittance flow could be to encourage transfers through mobile banking. Consolidation of small-sized banks could help ensure sufficient levels of transaction flows, and economies of scale for due-diligence processes.

SURVEILLANCE AND ANALYTICAL WORK

Country teams working on small states may need to explore creative approaches (such as intensified use of cross-country analysis and focusing on a narrower set of policy-relevant issues) to overcome staffing constraints, data gaps, and, in many cases, lower frequency of missions in comparison to larger countries.

46. **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, and African). This may be particularly important where data limitations and methodological weakness on macroeconomic statistics 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 5.

47. **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), and area departments Regional Economic Outlooks (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.

Box 5. Analytical Issues in Small States 1/

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 their limited administrative capacity 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 note 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 build resilience to deal with them? Adequacy of fiscal and external buffers to cover natural disaster-related shocks? What are the contingency plans in place to strengthen preparedness? What are the financing plans with identified creditors, insurance, catastrophe bonds, or grants in place for small, moderate and severe disasters?

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

48. **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 Debt Sustainability Analysis (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.

49. **The Fund has developed tools to assess small states' risks and vulnerabilities related to natural disasters, including the recent collaboration with the World Bank on Climate Change Policy Assessment (CCPA) providing an assessment of small states' preparedness for climate change.** Approaches for integrating natural disasters and climate change risks into standard Fund analysis are summarized in Box 6. This advice builds on past work on small states, where staff have often explicitly integrated risks and vulnerabilities from natural disasters into projections and policy advice related to climate change. Some small states have participated in the Fund's climate pilots and the CCPA pilots which focused on macro-critical priorities related to climate mitigation and adaptation (Box 7).[37] The CCPA is a joint IMF-World Bank assessment of small states' preparedness for climate change accompanying a country's Article IV consultation or program review document as a stand-alone selected issue paper to the Executive Board. This provides an opportunity to integrate climate issues to help develop a coherent policy framework and catalyze climate change financing.

50. **Debt sustainability assessments take on additional importance in disaster-vulnerable countries**. Post-disaster recovery and rebuilding programs typically often include a debt-financed element, and the amount and terms of such financing should be carefully reviewed. Experience suggests that rapid debt accumulation is not uncommon in countries experiencing a series of disasters. This may reflect a weak underlying fiscal stance, with disaster-related borrowing exacerbating already weak debt dynamics. It may also reflect looser scrutiny of borrowing plans in a post-disaster setting. DSAs should be based on assumptions about trend economic growth and the future fiscal stance that incorporate the risks of adverse shocks from further disasters over the projection period. For projections, such as those used for the LIC Debt Sustainability Framework (DSF) that can cover a period as long as 20 years, adjustments to reflect potential disaster effects are critical.

[37] Climate pilots include Trinidad and Tobago on reforming energy subsidies, Seychelles on improving climate mitigation and adaptation, and St. Lucia on the development of renewable energy sources.

Box 6. Integrating Natural Disasters and Climate Change into IMF Macro-Frameworks and Risk Analysis 1/

- **Macro criticality**. In countries where natural disasters and climate change significantly affect economic performance, Fund analysis (of the macro framework, debt sustainability, external imbalances, etc.) should make specific allowance for such shocks, whether in the short- or medium- to long-term.
- **Data sources and perspectives**. Staff will usually need to combine EM-DAT data, country economic data, and perspectives from country experts to develop a full picture of the potential scale, frequency, and macro transmission channels of natural disasters and climate change. The assumptions adopted for analytical purposes should be clearly documented.
- **Macro baselines**. Medium- to long-term baselines used for assessing policy sustainability (e.g., DSAs) should reflect economic performance not just in good years, but also factoring in the economic impact of future natural disasters. A range of approaches can be used to reflect the "average impact" of disasters, including using historic averages for key variables to develop tailored adjustments based on assumed risks and transmission channels.
- **Alternative shocks scenarios**. The policy implications of adverse scenarios should be assessed. Risks around the baseline and the adequacy of fiscal and external buffers should be evaluated using alternative scenarios calibrated to reflect "average" and/or "tail risk" natural disasters.
- **Financial risks, reserve adequacy, and general equilibrium modeling**. Tailored approaches can be used to explore financial sector risks, following practices applied in recent FSAPs. The current reserve adequacy tool can be readily adjusted to reflect the impact of natural disasters. And the Debt, Investment, and Growth (DIG) model could be used to explore the dynamic adjustment path following a disaster.

1/ See *Small States' Resilience to Natural Disasters and Climate Change—Role for the IMF,* (IMF, 2016a).

51. **The alternative shock scenarios would provide the dynamic response to a large shock**. A standard scenario would involve an "average" disaster, while tail risks could be explored by modelling the sort of disaster that might occur once every 50 or 100 years.[38] The scenario would trace the immediate and subsequent response of key macro variables, typically spanning several years of post-disaster reconstruction. Country teams are encouraged to include customized country scenarios in DSAs. The revised LIC DSF toolkit which will be fully operational in 2018 will provide easier assessment of the implications of natural disasters and climate change shocks on debt.[39]

52. **Macro-financial linkages should be considered.** In principle, savings in the banking system provide an important buffer for the private sector to weather disasters. The quality of bank assets could suffer a serious blow if the natural disaster impacts their clients. For example, crop destruction may make it difficult for farmers to repay agricultural credits, leading to an increase in non-performing loans. Severe disasters may also undermine the normal functioning of the financial system in the short run, acting to delay the recovery process.[40]

[38] Since individual country data are not available to clearly define the scale of "a once in 50 years" disaster, these estimates would typically be informed by data across a range of countries and periods.

[39] *Review of the Debt Sustainability Framework for Low-Income Countries—Proposed Reforms*, (IMF, 2017i).

[40] The staff report for Vanuatu's 2015 Article IV and RCF/RFI requests provided good practice in discussing financial linkages and policy reactions to Cyclone Pam. In this case, commercial banks allowed for voluntary suspension of debt service over two–three months, and an emergency borrowing facility (along with other liquidity measures) was activated by the central bank.

Box 7. Pilots on Climate Change /1

Two sets of climate change pilots are currently underway: (1) the "initiative to operationalize work on the emerging macro-critical issues of inequality, gender, and energy/climate" which began in 2015; 2/ and (2) the Climate Change Policy Assessment for Small States (CCPA) which began in early 2017. 3/

The Operationalizing Emerging Issues pilots required staff to commit to a special focus in the Article IV consultation on climate/energy (or other emerging issue). As of April 2017, nine countries had completed climate/energy pilots, including two small states (St. Lucia and Trinidad & Tobago).

- St. Lucia's 2017 staff report included a discussion of the development of renewable energy sources and of the costs of natural disasters, and their internalization in the macroeconomic framework.
- Trinidad & Tobago's 2016 Article IV consultation included a Selected Issues paper on fuel subsidies. The discussion included a focus on the environmental (and traffic decongestion) benefits of phasing them out—which required estimating the composition of post-tax subsidies, including the contribution of the subsidies to global warming—and some discussion of climate finance.

The CCPA for Small States is a joint IMF-World Bank assessment of small states' preparedness for climate change. The first pilot, for Seychelles, was attached to the 2017 Article IV; the second, for St. Lucia, is expected to be completed in early 2018.

- The CCPA takes stock of small states' general preparedness for climate change, their mitigation commitments under the Paris Accord and strategy for achieving these, their adaptation needs and strategy, national processes, and financing. It integrates the expected impact of climate change on a country and its needed policy responses into the macro-framework and the DSA—key for small states where the costs of confronting climate change risk are very large.
- The CCPA is designed as a Q&A document, intended to be relatively short (with any additional work by Fund or Bank staff attached as appendices). 4/
- The Seychelles pilot was delivered by the Article IV team and an FAD carbon tax mission, both with World Bank participation. As FAD's carbon tax spreadsheet is converted into a user-friendly tool, future pilots will not have to rely on TA support.
- For St. Lucia, the World Bank also fielded a stand-alone mission on climate-modeling, suggesting that the CCPA can be a useful organizational umbrella for pursuing the IFIs' analytical agenda on climate change.
- The CCPA includes a (non-exhaustive) list of the country's priority financing and capacity-building needs, with the goal of signaling to the international community where it can help the country build resilience to climate change.

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1/ Prepared by Adrienne Cheasty and Ian Parry.
2/ See the *Managing Director's Statement on the Work Program of the Executive Board*, (IMF, 2017d).
3/ The CCPA was initiated by the Board paper on *Small States' Resilience to Natural Disasters and Climate Change—Role for the IMF,* (IMF, 2016a).
4/ See *Seychelles—Climate Change Policy Assessment* (IMF, 2017e), pp. 57–58, for the questionnaire.

53. **External sector assessments should take into account buffers needed to cope with vulnerability to natural disasters**. As noted earlier, the balance of payments would typically deteriorate following a natural disaster reflecting lost exports and additional import needs, and its financing would rely on remittances, external grants and borrowing, and possible reserve drawdowns. To the extent that financing is not readily available at reasonable cost, countries vulnerable to natural disasters may need to build higher external buffers.

54. **The Fund's existing reserve adequacy assessment tools can be tailored to countries prone to natural disasters**. Of the Excel-based templates available for assessing reserve adequacy (ARA), the ARA-CC methodology for credit-constrained economies is likely to be the most relevant to small developing states. The guidance note discusses how the tool and approach can take into account country-specific risk and other factors which are also relevant to natural disasters.[41] These

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[41] See Guidance Note on the Assessment of Reserve Adequacy and Related Considerations (IMF, 2016b) and for background and analysis in Mwase (2012).

include: (i) expected shocks (e.g., future disasters); (ii) structural changes (e.g., investing in resilience); (iii) alternative scenarios (e.g., a natural disaster in the next year); and (iv) risk aversion (e.g., precautionary incentives because of higher vulnerability to natural disasters).

PROGRAM DESIGN, AND FUND FACILITIES AND INSTRUMENTS

A range of Fund facilities is available to meet small states' needs. All Fund members are eligible to access the GRA resources, and 20 of the 34 small states are also eligible for concessional financing under the PRGT. New access limits policies under the GRA and the PRGT have been approved over 2015–17; the quota increases agreed under the 14th General Quota Review were largely implemented in January 2016; and the Fund has clarified guidance on existing access policies as they relate to PRGT-eligible members in November 2016.[42]

55. **The Executive Board approved in July 2015 a set of measures that expanded access to PRGT resources in the context of the Fund's Financing for Development initiative.**[43] This initiative was undertaken as part of the wider effort of the international community to support countries in pursuing the post-2015 Sustainable Development Goals (SDGs). The key measures included:

- Raising access norms, annual and cumulative normal access limits by 50 percent in quota terms across the concessional facilities for all PRGT-eligible countries, addressing the erosion of access levels relative to trade, capital flows, and GDP since 2009–10;

- Rebalancing the funding mix of concessional to non-concessional financing under blended arrangements from 1:1 to 1:2 for PRGT-eligible member countries that are presumed to receive concessional financial support from the Fund only in the form of a blend of concessional and non-concessional financing, recognizing that these countries typically have significantly greater access to market funding than envisaged when the current facilities were established;[44] and

- Increasing access to fast-disbursing support under the RCF for PRGT-eligible countries and the RFI to all member countries to assist countries that are in fragile situations, affected by conflict or hit by exogenous shocks, including natural disasters; and increasing the level of

[42] The 2013 Review of Facilities for LICs (IMF, 2013g) had previously benefited small states through increased access to the RCF (normal and shocks window), increased flexibility of PRS requirements, changed PRGT eligibility requirements for microstates (leading to the entry of three microstates and delayed graduation of two others).

[43] *Financing for Development: Enhancing the Financial Safety Net for Developing Countries* (IMF, 2015f).

[44] Blending is presumed for PRGT-eligible countries with either (i) per capita income above 100 percent of the IDA operational cutoff; or (ii) sustained past and prospective market access and a per capita income that exceeds 80 percent of the IDA operational cutoff provided that (iii) they are not deemed to be at a *high risk of debt distress* or in debt distress (as assessed by the most recent joint Bank-Fund LIC DSA).

concessionality of such support to PRGT-eligible countries by setting the interest rate on RCF loans at zero percent.[45]

56. **Broadly similar increases were approved for access under the GRA in February 2016.** To ensure that no member's access to the GRA resources would decline in SDR terms when the 14th Review of Quota increases took effect, access limits in SDR terms under the GRA were increased by an average of 45 percent, and annual and cumulative access limits were set at 145 percent and 435 percent of the new quotas, respectively. This moderate increase of the normal access limits in SDR terms attenuated the erosion of absolute access limits since 2009, while preserving the rigor of the exceptional access framework by maintaining its application at levels (relative to members' economies) that are comparable to 2009.

57. **Despite increases in PRGT and GRA access limits, the revision of individual quotas in early 2016, which aimed at realigning quotas with economic fundamentals, has led to differences in the capacity of small states to benefit from higher access.** The amount of financing a member can obtain from the IMF (the access limit) is set relative to quota. The conditions for the effectiveness of the quota increases under the 14th General Quota Review were met in January 2016 and resulted in a doubling of the cumulative quotas of Fund members to SDR477 billion, as well as a halving of access limits under the PRGT facilities and RFI in quota terms. However, the increase of individual member quotas varied from 39 to 220 percent.[46] Among the 34 small states, the quota increase was greater than or equal to 100 percent for 13 members, ensuring an increase in access in SDR terms by at least 50 percent for the PRGT-eligible members and 45 percent under the GRA. The remaining 21 small states had individual quota increases averaging 41 percent with corresponding access limit increases in SDR terms of 3 and 5 percent under the GRA and PRGT, respectively.

58. **In November 2016, the Board clarified the guidance on existing access policies as they relate to PRGT-eligible members as follows[47]**:

- *Access to GRA resources*. A PRGT-eligible member has the right to access GRA resources on the same conditions as any other Fund member. Given the financial benefits from borrowing on concessional terms, staff will continue to advise PRGT-eligible members considering Fund financial support to borrow from the PRGT up to the applicable limits before seeking GRA resources.

- *Blending*. A third of PRGT-eligible members are presumed blenders, in the sense that they are expected, when accessing concessional resources, to do so in a blend with GRA resources. Other

[45] The Board also decided in October 2016 to lock in interest rates on other PRGT facilities at zero at least until 2018. See 2016 Poverty Reduction and Growth Trust—Review of Interest Rate Structure (IMF, 2016c).

[46] As of March 2017, 179 of the 189 members had made their quota payments, accounting for over 99 percent of the total quota increases.

[47] *Financing for Development: Enhancing the Financial Safety Net for Developing Countries—Further Considerations* (IMF, 2016g).

PRGT-eligible members (non-presumed blenders) are entitled to seek wholly concessional support up to the applicable access limits. These non-presumed blenders may also blend, subject to an assessment, as in all cases of Fund financing, of balance of payments (BoP) need, program strength, capacity to repay the Fund and debt sustainability.

- *Access norms.* Norms provide indicative guidance on what could constitute an appropriate level of access under PRGT facilities, but they should neither formally restrict nor ensure specific access levels. Access should continue to be determined on a case-by-case basis using the standard criteria—that is, size of balance of payment need, capacity to repay, outstanding credit to the Fund and record of past use of Fund resources.

59. **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 13 years, four small states have implemented SMPs on five occasions (Comoros (twice), Djibouti, São Tomé and Príncipe, and Swaziland; see Annex Table 3). All were either lower-middle or lower-income countries with significant capacity constraints. The outcomes of the SMPs were mixed. In four out of the five cases, the SMP was successfully completed and led to use of Fund financing. In the case of 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.

60. **Rapid financing**. Rapid financing for urgent balance of payments needs is available through the RCF (established in 2009 for PRGT-eligible countries) and the RFI (established in 2011 for both PRGT- and non-PRGT eligible members).[48] 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 phasing 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 upper credit tranche (UCT)-quality economic program is not possible, for example as a result of 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 UCT-quality. Small states are frequent users of the RCF due to urgent balance of payments needs associated with shocks. During 2003–16, emergency assistance was provided on 22 occasions, to 10 different countries (Annex Table 4). 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 and flooding) and earthquakes, with several cases of financing for terms of trade and export market shocks and one case of post-conflict assistance (Comoros). To further enhance the financial safety net for developing countries, the Executive Board approved in June 2017 a new annual access limit of 60 percent of

[48] Vanuatu (2015) and St. Vincent and Grenadines (2014) requested RCF/RFI blend in response to natural disasters.

quota under the RCF and RFI for countries experiencing urgent balance of payment needs arising from severe natural disaster-related damages of at least 20 percent of GDP (Annex Table 4).[49]

61. **UCT-program based financing**.[50] The Fund's financing in support of UCT-quality programs has been used on 20 occasions by 11 different small states over the period 2003–16 (Annex Table 5). The majority (13 programs) were financed by PRGT resources (under the PRGF, SCF, and ECF) while seven programs used GRA resources (under the SBA and EFF). For both concessional and GRA financing, most 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).[51]

62. **Policy support instrument (PSI)**. The Fund's framework for PSIs is designed for qualifying LICs that are PRGT-eligible and 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 the two reviews completed to assist the authorities in further consolidating macroeconomic stability and implementing structural reforms.

63. **A new Policy Coordination Instrument (PCI), similar to the PSI but available to all members, has been approved to strengthen the Global Financial Safety Net (GFSN) and the Fund's toolkit**.[52] The PCI is a non-financial instrument designed for countries seeking to unlock financing from multiple sources and/or to demonstrate a commitment to a reform agenda. The PCI has a duration of six months to four years, and may be extended to an overall maximum period of four years. There is no limit on the number of successor PCIs. The PCI is available to *all* Fund members, and with no *ex ante* qualification criteria. A member's request for a PCI may only be approved by the Fund if the Fund is satisfied that: (i) the member's policies in its Program Statement meet the standards of UCT conditionality; (ii) the member demonstrates sufficient commitment to implement the program; and (iii) the member does not need and is not seeking Fund financial support at the time of approval of a PCI. The PCI follows a review-based approach to monitoring program conditionality: deviations from quantitative and reform targets will not automatically disrupt reviews as do PCs, and waivers are not required. The completion of a program review under the PCI would require a Board assessment that any deviation from a quantitative or reform target

[49] See *Large Natural Disasters—Enhancing the Financial Safety Net* (IMF, 2017a).

[50] For PRGT-eligible countries, the *Handbook of IMF Facilities for Low-Income Countries* provides coverage and guidance on emergency financing (RCF), UCT-program based financing (SCF and ECF), the PSI, and SMPs.

[51] 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.

[52] See *Adequacy of the Global Financial Safety Net* (IMF, 2016d) and *Adequacy of the Global Financial Safety Net—Proposal for a New Policy Coordination Instrument* (IMF, 2017h).

was either minor or temporary, or sufficient corrective action has been taken to achieve the objectives of the program.

64. **Poverty reduction strategies (PRS) and social safeguards in IMF-supported programs**. PRS are central to IMF-supported economic programs in LICs and small states. They assess poverty challenges, describe how macroeconomic, structural and social policies and programs can promote growth and reduce poverty, and outline external financing needs and the associated sources of financing. The PRS documentation required under the PRGT for Extended Credit Facility (ECF) and PSI-supported programs was streamlined in June 2015 and replaced by the submission of an Economic Development Document (EDD).[53] The EDD, issued to the Board with an assessment letter of the World Bank, may take two forms: (i) an existing national development plan or strategy documents documenting a member's PRS; or (ii) a newly prepared document on the member's PRS. The Executive Board has also reviewed in May 2017 the experience of social safeguards in PRGT and PSI-supported programs and made recommendations on good practices.[54] Social safeguards examined are split into two groups: (i) use of program floors on social and other priority spending; and (ii) measures designed to protect vulnerable groups. The paper found that there is room to improve the design and the use of program spending floors and that specific reform measures have been used sparingly, yet are often the most effective tool for supporting vulnerable groups. Early collaboration with other development partners (e.g., the World Bank), ideally during surveillance, could strengthen existing social safeguards and help improve the design of specific social safeguards measures under Fund-supported programs.

65. **Structural conditionality**. Given the limited capacity 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 16, conditionality in the latter cases should be consistent with capacity for policy consultation, design, and implementation.

66. **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.

[53] *Reforms of the Fund's Policy on Poverty Reduction Strategies in Fund Engagement with Low-Income Countries—Proposals* (IMF, 2015g).

[54] *Social Safeguards and Program Design in PRGT and PSI-Supported Programs* (IMF, 2017c).

CAPACITY DEVELOPMENT

Investments in capacity development (CD) will be needed for many years. Monitoring and evaluation of technical assistance (TA) and institutional capacity building should receive careful attention in Fund surveillance, and will be facilitated by the ongoing efforts to strengthen the Fund's monitoring and evaluation frameworks for CD activities.

67. **Absorption capacity and resource availability will be constraining factors**. Officials in small states have over-burdened agendas, and finding time for capacity development, including TA and training, is difficult. Other sources of risk to the effective implementation and sustainability of capacity development outcomes are from shifts in political priorities, lack of resources in some small developing states to absorb CD due to high staff turnover and shortages in certain skills. Given these considerations, it is important to make the most of available capacity building resources (Table 2). [55]

Table 2. Fund TA to Small States, FY2015–16

	Technical Assistance (Person Years of Field Delivery)		Training (Participant Weeks)		Training (Number of Participants)	
	FY2015	FY2016	FY2015	FY2016	FY2015	FY2016
Caribbean	12.7	16.3	625.3	765.3	812.0	783.0
Asia-Pacific	8.8	8.8	651.0	521.6	597.0	456.0
Other Regions	8.7	8.1	341.4	494.7	252.0	353.0
Small States Total	30.2	33.2	1617.7	1781.6	1661.0	1592.0
IMF Total	287.6	302.5	14423.3	19518.2	11369.0	14457.0
SS in percent of IMF total	10.5	11.0	11.2	9.1	14.6	11.0

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

- *Capacity development through TA and training needs to be tailored to each country's needs and absorption capacity*.
- *Capacity development needs to be informed and guided by surveillance and possibly provided at the regional level given commonalities found among regional small states*. Capacity development ambitions need to be realistic, with capacity supplementation temporarily unavoidable in some instances before capacity building can be effective. Where national solutions are not workable, it may be necessary to explore regional or other "outsourced" solution—for example, reserve or

[55] Small states receive significantly more capacity development through TA and training than larger peers when scaled by population.

debt management might be delegated to regional financial institutions—given both economies of scale and the strong commonalities found among regional small states.

- *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 and evaluation of capacity development are similarly important. The latter will be facilitated by the ongoing efforts to strengthen the results-oriented approach through the implementation of the new results-based management and the common evaluation frameworks for all Fund CD activities.[56]

- *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 through workshops, seminars, attachments, and internships, 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.

69. **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 as well as resident or regional Capacity Development advisors in RTACs or beneficiary countries.

- *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

70. **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

[56] See *2018 Quinquennial Review of the Fund's Capacity Development Strategy—Concept Note* (IMF, 2017g).

assistance programs managed by other development partners, in particular the World Bank and the United Nations. 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.

- Country teams could find it helpful to draw on World Bank expertise and projects in several macro-critical areas, such as labor market competitiveness, innovative financing (including debt-for-nature), energy, and improving economic linkages with the tourism sector.[57]

- 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.

71. **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 periodic reports on macroeconomic developments and policies and quarterly and annual reports of RTACs—in particular PFTAC and CARTAC—on capacity building efforts for the benefit of the international community.

72. **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.

[57] World Bank Group Engagement with Small States: Taking Stock, (WB, 2016).

Annex Table 1. List of Small and Micro Developing States 1/

Country	Micro States	Fragile Situation [2]	Island State	Income Group [3]	PRGT Eligibility
Caribbean					
Antigua & Barbuda	Y		Y	High	
Bahamas, The			Y	High	
Barbados			Y	High	
St. Kitts and Nevis	Y		Y	High	
Trinidad & Tobago			Y	High	
Belize				UM	
Dominica	Y		Y	UM	Y
Grenada	Y		Y	UM	Y
Guyana				UM	Y
St. Lucia	Y		Y	UM	Y
St. Vincent and the Grenadines	Y		Y	UM	Y
Suriname				UM	
Asia-Pacific					
Country	**Micro States**	**Fragile Situation**	**Island State**	**Income Group**	**PRGT Eligibility**
Nauru	Y		Y	High	
Fiji			Y	UM	
Maldives			Y	UM	Y
Marshall Islands, Rep.	Y	Y	Y	UM	Y
Palau	Y		Y	UM	
Tuvalu	Y	Y	Y	UM	Y
Bhutan				LM	Y
Kiribati	Y	Y	Y	LM	Y
Micronesia	Y	Y	Y	LM	Y
Samoa	Y		Y	LM	Y
Solomon Islands		Y	Y	LM	Y
Timor Leste		Y		LM	Y
Tonga	Y		Y	LM	Y
Vanuatu			Y	LM	Y
Other Regions					
Country	**Micro States**	**Fragile Situation**	**Island State**	**Income Group**	**PRGT Eligibility**
Seychelles	Y		Y	High	
Cabo Verde			Y	LM	Y
Djibouti				LM	Y
Mauritius			Y	UM	
Montenegro				UM	
São Tomé and Príncipe	Y	Y	Y	LM	Y
Swaziland				LM	
Comoros		Y	Y	Low	Y

Note:
1/ 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 micros states are a sub-group with populations below 200,000 as of 2011.
2/ Based on the IMF definition of a) a harmonized average CPIA country rating of 3.2 or less, or b) the presence of a UN and/or regional peace-keeping or peace-building mission within the country during the past three years. Djibouti was dropped in the FY16 list after department discussion.
3/ High-income countries (High) had per capita annual incomes of $12,476 or more in 2015; upper middle-income countries (UM) had income levels of between $4,036 and $12,475; lower middle-income countries (LM) had income levels between $1,026 and $4,035; low-income countries (Low) had income levels of $1025 or less, based on the World Bank Atlas method.

Annex Table 2. United Nations and World Bank: Groupings of Small Developing States (By region)

World Bank (50 Small States)

Africa (13)	East Asia Pacific (13)	Latin America and the Caribbean (13)	Middle East and North Africa (3)	Europe and Central Asia (6)	South Asia Region (2)
Botswana	**Brunei Darussalam**	Antigua and Barbuda	**Bahrain**	**Cyprus**	Bhutan
Cabo Verde	Fiji	The Bahamas	Djibouti	**Estonia**	Maldives
Comoros	Kiribati	Barbados	**Qatar**	**Iceland**	
Equatorial Guinea	Marshall Islands	Belize		**Malta**	
Gabon	Micronesia	Dominica		Montenegro	
The Gambia	Nauru	Grenada		**San Marino**	
Guinea-Bissau	Palau	Guyana			
Lesotho	Samoa	**Jamaica**			
Mauritius	Solomon Islands	St. Kitts and Nevis			
Namibia	Timor-Leste	St. Lucia			
Sao Tomé and Principe	Tonga	St. Vincent and Grenadines			
Seychelles	Tuvalu	Suriname			
Swaziland	Vanuatu	Trinidad and Tobago			

United Nations (38 Small Island Developing States)

Caribbean (16)	Pacific (13)	Other (9)
Antigua and Barbuda	Fiji	**Bahrain**
Bahamas	Kiribati	Cabo Verde
Barbados	Marshall Islands	Comoros
Belize	Micronesia	**Guinea-Bissau**
Cuba	Nauru	Maldives
Dominica	Palau	Mauritius
Dominican Republic	Papua New Guinea	São Tomé and Príncipe
Grenada	Samoa	Seychelles
Guyana	Solomon Islands	**Singapore**
Haiti	Timor-Leste	
Jamaica	Tonga	
St. Kitts and Nevis	Tuvalu	
St. Lucia	Vanuatu	
St. Vincent and Grenadines		
Suriname		
Trinidad and Tobago		

Note: Countries marked in both bold and red are *not* included in the Fund listing of Small Developing States.

Annex Table 3. List of Small States with Staff-Monitored Programs (As of March 31, 2017)

Country	Approval Date	Original Expiration Date	Current Expiration Date	Original Length (in months)	Extension (in months)	Subsequent Program
São Tomé and Príncipe	1-Jan-02	30-Jun-02	31-Dec-02	6	6	PRGF in 2005
Comoros	1-Jan-05	31-Dec-05	31-Dec-06	12	12	EPCA in 2008 ECF in 2009
Djibouti	1-Jul-05	31-Dec-05	31-Dec-05	6	0	PRGF in 2008
Swaziland	4-Apr-11	3-Oct-11	Off-track	6		
Comoros	1-Oct-16	31-Mar-17	31-Mar-17	6	0	

Note: SMPs are sent to the Board for information not discussion.

Annex Table 4. Fund Emergency Assistance in Small States (2003–2016)

Country	Approval Date	In millions of SDRs	In percent of Quota 1/	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	35.8	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	17.7	RCF	Hurricane
St. Vincent and The Grenadines	7/25/11	1.2	10.6	RCF	Torrential Rains and Floods
Dominica	1/11/12	2.1	17.8	RCF	Torrential Rains and Floods
Samoa	5/15/13	5.8	35.8	RCF	Cyclone Evan
St. Vincent and The Grenadines	8/1/14	4.2	35.5	RCF / RFI blend	Floods
Vanuatu	6/5/15	17.0	71.4	RCF / RFI blend	Cyclone Pam
Dominica	10/28/15	6.2	53.5	RCF	Tropical Storm Erika
Emergency Natural Disaster Assistance					
Grenada	1/27/03	2.9	17.9	ENDA	Hurricane
Grenada	11/15/04	2.9	17.8	ENDA	Hurricane
Maldives	3/4/05	4.1	19.3	ENDA	Tsunami
Dominica	2/4/08	2.1	17.8	ENDA	Hurricane
Belize	2/18/09	4.7	17.6	ENDA	Hurricane
St. Kitts and Nevis	5/15/09	2.2	17.8	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.

1/ Reflects the fourteenth quota review of February 29, 2016.

Annex Table 5. Fund Financing Arrangements for Small States (2003–2016)

Country	Arr. Type	Year	Original Duration (in months)	Actual Duration (in months)	Total Amount Approved (in SDR mn)	Actual Approved Amount (% of quota at approval)
Dominica	PRGF	2003	36	36	8	94
São Tomé and Príncipe	PRGF	2005	36	36	3	40
Grenada	PRGF	2006	36	48	16	140
Djibouti [1/]	ECF	2008	36	44	22	140
Seychelles	SBA	2008	24	13	18	200
São Tomé and Príncipe	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
São Tomé and Príncipe	ECF	2012	36	36	3	35
Solomon Islands	ECF	2012	36	40	1	10
Seychelles	EFF	2014	36	36	11	105
Grenada	ECF	2014	36	35	14	120
São Tomé and Príncipe	ECF	2015	36	36	4	60
Suriname	SBA	2016	24	11	342	265

Source: Monitoring of Fund Arrangements (MONA) Database.

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

1/ Includes augmentation.

Annex Table 6. 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 Caribben 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. Monetary Policy in Small States 1/

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 2. Fiscal Rules for Small States 1/

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 2. 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 Public Private Partnerships (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 five 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 (crowing out of priority spending by "incompressible" items).

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

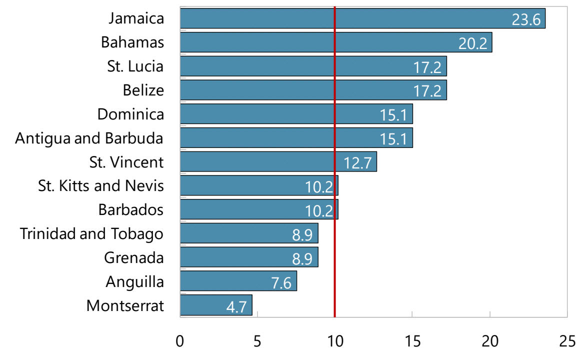
5/ In Mauritius, the debt ceiling can be exceeded in case of "emergency" or for the purpose of financing large investment projects. In the Maldives, the rule makes an exception for natural disasters (imposing hardship on at least 15 percent of the population) and "economic downturns," although the magnitude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

6/ Additional complexities arise in the case of a resource-rich economy.

Appendix Box 3. The Caribbean Catastrophe Risk Insurance Facility (CCRIF) 1/

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

Probability of a Hurricane Striking on a Given Year
(In percent)



Source: IMF, Caribbean Small States: Challenges of High Debt, 2013.
AND LOW GROWTH2.

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.

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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 4. Risk Financing Toolkit

Financing needs could be segmented by date, distinguishing urgent financing needs (under three months), short term needs (under one year), and medium term needs (over one year). This would help to identify the necessary scale of fiscal buffers, access to financing, and/or risk transfer arrangements. This appendix explores the different elements of the disaster risk financing tool kit in more detail.

Domestic financing and deposit buffers. Government deposits and access to domestic bank financing provide buffers for shocks, but have financial sector liquidity implications that need to be managed. They are best suited for less costly disasters.

- **Central and commercial bank financing may provide a limited buffer against shocks**. Central bank financing of the budget should be strictly limited on account of risks of fiscal dominance that could undermine monetary policy effectiveness. Scope to borrow from domestic commercial banks is also likely to be limited, as liquidity in the system may not be adequate to provide additional fiscal financing at a time when the banking system faces other financing and liquidity needs due to the disaster. Overall, domestic borrowing is likely to be most useful in the context of small-scale disasters.
- **Government deposit buffers provide an alternative to domestic borrowing.** In principle, such buffers are designed to cover early disaster response needs without compressing other priority spending until other sources can be mobilized. In some disaster-vulnerable countries in the Pacific, governments aim to maintain a deposit buffer equivalent to three months of recurrent spending. This buffer could be in the form of deposits in the government's general fund, a "virtual" contingency fund within the general fund, or a dedicated fund for natural disasters.

Sources of Post-Disaster Fiscal and BOP Financing

Disaster scale	Large Disasters (more than 35 percent of GDP)	Middle-range Disasters (2 to 35 percent of GDP)	Small Disasters (1 percent of GDP or less)
Sources of financing: 1/			
Reserve drawdown	No	No	No
Domestic bank financing	No	Yes	No
External grant financing	Yes	Yes	No
External loan financing	Yes	Yes	No
Remittances	Yes	No	No
Adequacy of BoP financing to cover losses			
Number of disaster events	8	8	8
Average losses (percent of GDP)	48	3	0.6
Additional ext. financing (percent of GDP) 2/	22	4.5	-1.8

Sources: IMF and EM-DAT data.
1/ Balance of payments data provided information on reserve drawdown and remittances; fiscal data provided information on domestic bank financing; and fiscal and BOP data provided information on external grant and loan financing.
2/ Cumulative change in annual average financing for disaster year and three following years compared to the annual average financing three years prior to the disaster. The over-financing of middle-range disasters is due to one outlier (Seychelles).

Appendix Box 4. Risk Financing Toolkit (concluded)

External borrowing and insurance. Contingent lines of credit help reduce ex ante disaster financing uncertainty, while insurance products allow for risk transfer, at a cost.

- **Contingent lines of credit reduce external financing uncertainties**. Contingent financing arrangements can be arranged with bilateral, multilateral, and commercial creditors. At a bilateral level, for example, the Marshall Islands, Micronesia, and Palau benefit from compact agreements with the United States offering access to emergency support from relevant U.S. agencies. 1/ At the multilateral level, the World Bank's CAT DDO offers a pre-approved line of credit for countries experiencing disasters. Currently, this instrument is available only for middle income countries, and the Seychelles is the only small state that has negotiated coverage. 2/ The World Bank, with G20 financing, also recently established a Pandemic Emergency Financing Facility which could serve as a good model for natural disaster financing. The facility protects poor countries against pandemics using catastrophe bonds, reinsurance, and a cash window. Financing under the IMF's RCF and RFI are not fully contingent, in that they are subject to conditions for access; 3/ however, the fact that these do not entail a Fund-supported program helps facilitate rapid disbursement. One downside to contingent credit is that the ex ante fiscal costs of disaster relief remain uncertain and, even on an ex post basis, the fiscal impact is deferred until debt service falls due.
- **More clarity in budgeting can be provided through insurance and other risk transfer arrangements**. By insuring public assets, governments can reduce uncertainties associated with direct exposure to disaster risks. Similarly, encouraging insurance of private property reduces the risk that the public sector will be called on to cover private losses. Prompt insurance compensation reduces downtime for productive assets, reduces disruption of infrastructure, and indemnifies producers for income losses.
- **Traditional indemnity insurance of physical assets is not widespread in small states.** The cost of indemnity insurance is high, especially where markets are underdeveloped and competition is limited. High premiums can also reflect the high probability and cost of disasters in small states. As a result, uptake is low, with premium payments for non-life cover averaging just 1 percent of GDP for typical small states. That said, Belize and Grenada rely on traditional insurance against severe natural disasters. There is some evidence from developing countries that traditional insurance for disasters has been more successful and sustainable under public-private partnerships than under exclusively private or public options. In considering this option, contingent risks to the budget would need to be carefully monitored and the private market would need better regulation and supervision with some level of mandatory catastrophe insurance.
- **Innovative approaches for sharing natural disaster risks have emerged over the past decade**. Parametric insurance has emerged as a complement to regular indemnity insurance. It is effectively an options contract that pays out in the event of a disaster that exceeds a pre-specified severity. Triggers for payout can be specified, for example, in terms of storm, flood, or earthquake intensity. Parametric insurance is quick-disbursing, but costs can be high because the market for cover is still developing. In some cases, economies of scale have been achieved by pooling cover at a regional level. A second innovation has been the development of catastrophe (CAT) bonds, which are issued as financing instruments by disaster-vulnerable countries. In exchange for a generous coupon payment, investors agree to forgive the bond principal in the event of a disaster (as measured by a parametric trigger). This releases resources from debt service to finance disaster response.

1/ In February 2016, the government of the Marshall Islands declared a state of emergency, citing severe drought conditions, resulting from a protracted El Niño system. A subsequent declaration of emergency by the U.S. administration activated support from FEMA.

2/ Discussions are underway as part of the IDA 18 replenishment to make the CAT DDO available to IDA countries, including small island states.

3/ For example, that the country faces an urgent balance of payments need, and that this is expected to be resolved within one year and that no major policy adjustments are necessary to address underlying balance of payments difficulties.

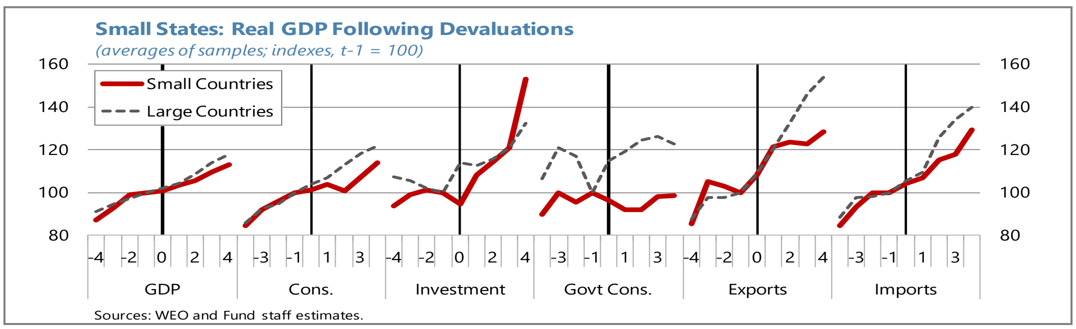
Appendix Box 5. Devaluations in Small States: How Effective? 1/

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.

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