

VULNERABILITY AND DEBT IN SMALL STATES

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Key Points

- Small states suffer from a host of inherent vulnerabilities given their small population and economic size. They are also disproportionately exposed to economic and non-economic shocks and crises and the consequences these have for macroeconomic stability and development. In combination — and despite extraordinary macroeconomic, fiscal and structural policy responses — these factors have severely impeded the ability of small states to achieve sustainable development.
- Inherent vulnerabilities and exposure to shocks have also proved to be a costly, stubborn and persistent challenge. In two crucial metrics — growth and participation in international trade — both long-term trends and recent data show that these countries are failing to keep pace with other developing countries and, indeed, many are falling behind.
- Small states, supported by development partners, need to take several steps to address both long-standing and more recent vulnerabilities: developing the blue economy and diversifying production and exports by expanding and accessing regional value chains; building climate-resilient infrastructure; increasing access to innovative sources of financing for development; and — for a growing number of small states — addressing increasingly unsustainable levels of indebtedness. Otherwise, many small states are likely to fall further behind.

Introduction

Now, *here*, you see, it takes all the running *you* can do, to keep in the same place. If you want to get somewhere else, you must run at least twice as fast as that!

– Lewis Carroll, *Through the Looking Glass*

In *Through the Looking Glass*, Alice is admonished by the Red Queen to run “faster! faster!” Like Alice, many of the world’s small states (totalling more than one quarter of the world’s countries, with an aggregate population across all small states of some 29 million people, and typically defined as countries with a population size of 1.5 million or fewer), seem to have done all the running they can, only to stay in the same place.

A heterogeneous and diverse group of just under 50 countries,¹ located predominantly in the Caribbean, the Pacific Ocean and Africa, small states are among the most vulnerable countries in the world, due to their small population and economic size, remoteness, insularity, disproportionate openness and other factors, including susceptibility to natural disasters and other external shocks. Most have pursued macroeconomic, fiscal, trade and other reforms over the years in an effort to break out of their vulnerabilities and to build resilience to external shocks. Structural reforms, implemented as part of small states’ International Monetary Fund (IMF) and World Bank structural adjustment programs since the 1980s, have been extensive. In the Caribbean, for example,

¹ The World Bank Small States Forum includes 49 countries; of these, seven have populations over 1.5 million but many of the characteristics of small states.



these have involved tax policy reform, including simplification of tax administration and improved tax collection; financial liberalization through the privatization of commercial banks, a progressive shift toward indirect instruments for monetary policy, deregulation of interest rates and widespread abolition of controls on credit; and trade liberalization, including a rapid phasing out of quantitative restrictions and substantial reductions in tariffs and in non-tariff barriers to trade (Greenidge, McIntyre and Yun 2016). Yet, notwithstanding continuous reform, many, like Alice, have found themselves back at their starting point. Longer-term trends and recent evidence both point to an even bleaker outlook, with small states as a group now slipping into a pattern of low growth, a declining share of global trade and — for a growing number — increasingly unsustainable debt. Alice’s paradox — running as fast as possible to stay in the same place — is finally breaking. But instead of running twice as fast to get somewhere, or to at least stay in the same place, a disconcerting number of small states are beginning to slip further behind.

Inherent Vulnerabilities

Small states suffer from many inherent vulnerabilities. Limited domestic demand and small production runs mean they are unable to achieve economies of scale in production, and consequently suffer from poorly diversified production structure, characterized by small and medium-sized firms, limited domestic private competition and relatively high levels of public intervention. High and indivisible fixed costs of public service provision in infrastructure, security, education and policy development result in disproportionately higher levels of government spending as a proportion of GDP (Becker 2012). The impact on Pacific small states, which are geographically isolated, widely dispersed and scarcely populated, is most significant. In the island nation of Kiribati, for example, public services must be provided to a population of 100,000, spread across 3.5 million km² of ocean (Jahan and Wang 2013).

Exports are also highly concentrated in a few sectors and industries, increasing vulnerability to trade shocks. Export concentration is particularly acute in Pacific small states, with several countries predominantly reliant on a single commodity or service — tourism in the case of Fiji, Samoa and Vanuatu, and fisheries in the case of Kiribati, the Solomon Islands, Tonga and Tuvalu (Robinson 2015). Caribbean exports are similarly concentrated. Among the 15 Caribbean small states that comprise the Caribbean Community (CARICOM), three — Guyana, Suriname and Trinidad and Tobago — strongly rely on natural resource revenues from commodity exports, aggregating between one-fifth and almost one-third of GDP, and 10 rely significantly on receipts from the tourism sector,

with tourism receipts as a share of total exports in 2012 ranging from 29 percent to 68 percent.²

A narrow production structure and limited natural resources have also made Pacific and Caribbean small states disproportionately reliant on strategic imports, in particular of food and energy. Volatility in international prices of both food and energy has further increased vulnerability to terms of trade shocks. In 2010, small states were more dependent on food imports than other country groupings, with food representing 17 percent of total merchandise imports, in comparison with high-income countries (7.5 percent), middle-income countries (MICs) (7 percent) and countries in Sub-Saharan Africa (SSA) (12 percent). Pacific small states are particularly dependent, due to the limited availability of arable land, with food representing 20.9 percent of total merchandise imports.³ And dependence on strategic food imports has persisted, with several Caribbean and Pacific small states, including Antigua and Barbuda, Belize, Samoa and Tonga, registering food imports exceeding one-fifth of merchandise imports in 2014. Similarly, almost all small states in both the Caribbean and Pacific regions are net energy importers, relying on high-cost imported fossil fuels.⁴

Small states are crucially reliant on international trade as a source of growth, employment and revenue, and among the most open economies in the world, making them disproportionately vulnerable to changes in global trade. Their inability to take advantage of economies of scale and their geographic remoteness have also increased the costs of doing business, driven up trade costs and reduced trade competitiveness. Pacific small states are particularly remote, with five of them located more than 3,000 km from the nearest continent, Australia. And while geographical distance has the greatest impact on trade costs, other factors that affect small states — for example, small consignment size, as well as connectivity to liner shipping — also have a significant impact on overall trade costs (Arvis et al. 2013). Consequently, small states’ trade costs are estimated to exceed those for developing countries as a whole by at least 50 percent (Razzaque and Keane 2015).

Dealing with Shocks and Crises

Inherent vulnerabilities due to size are compounded by disproportionate exposure to multiple shocks and crises, including natural disasters as well as trade-led, economic, food and energy crises. Two among these — natural disasters and macroeconomic shocks from trade preference erosion

2 See World Bank World Development Indicators. <http://data.worldbank.org/indicator/ST.INT.RCPT.XP.ZS>.

3 Ibid.

4 See, for example, CARICOM (2013).

— illustrate the sheer scale of impact on small states. Natural disasters incur disproportionately large damage and costs in small states, often destroying years of developmental gains. The Caribbean is worst affected, with six of the world's top 10 most disaster-prone countries (Rasmussen 2004). In the past 40 years, the region has experienced over 250 natural disasters, predominantly hurricanes and floods, with a loss of almost one percent of GDP per year, and resulting in the deaths of more than 12,000 people and affecting over 12 million more, with estimated damages of US\$19.7 billion (Acevedo 2014). Natural disasters have also had direct and immediate impacts on both growth and debt, reducing output growth by three percent in instances of severe floods and by more than one percent in instances of severe storms. Severe floods have increased debt as a share of GDP by approximately 16 percent due to financing of rehabilitation and reconstruction activities. Small states are also disproportionately vulnerable to climate change, such as the impact of rising sea levels on coastal and small island states. These impacts, together with the increased prevalence of more extreme weather events, are likely to further compound small states' vulnerabilities, and are likely to escalate further given the significant effects of climate change in small states.

Trade preferences granted by developed countries — for example, in permitting entry of developing country exports on a duty-free or reduced-tariff basis — have eroded steadily since the 1990s. This erosion has represented another major shock, in particular for small states dependent on exports of specific commodities — rice, bananas and sugar — to the European Union. Applied over a short period, preference erosion brought about a sharp reduction in growth, employment and efforts to reduce poverty, and forced large-scale macroeconomic, fiscal and structural adjustment. Among all developing countries, small states were the most severely affected: with a population that is two percent of that of all developing countries, they are estimated to have borne between 15 and 29 percent of all losses (Cali, Nolte and Cantore 2013).

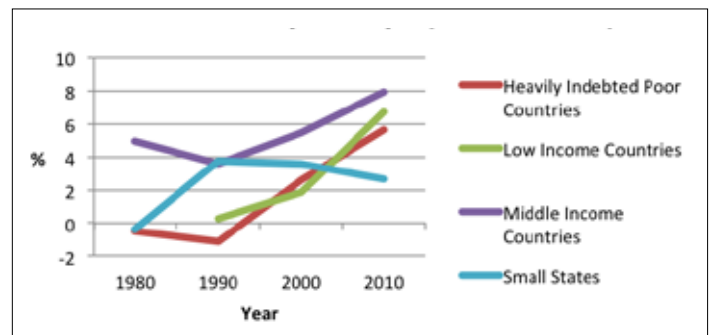
Mounting Challenges for Small States

Small states have responded to vulnerability through continuous macroeconomic, financial and other structural reforms, and absorbed as a matter of course the additional financial, institutional and human resources costs of being small, in national budgets and expenditure. They have adjusted to rapid trade preference erosion, *inter alia* through improved tax performance. Despite ongoing fiscal challenges, Caribbean small states now collect a share of tax revenue to GDP that is more than double that of MICs and over 40 percent more than the share collected by countries in SSA, and they have absorbed the recovery and rehabilitation costs following the multiple natural disasters, in each case seeking to return to a semblance of steady-

state growth and sustainable development. But have they run fast enough — or, like Alice, have they simply stayed in the same place? Three metrics — growth, trade and increasing levels of unsustainable debt — suggest that instead of coping, a number of small states may be falling behind, facing a future of steadily eroding low growth, declining trade share and high debt.

GDP growth rates in small states increased in the 1980s, peaking in 1990 but thereafter steadily declining, reflecting the continuous impact of shocks and lack of both diversification and global trade penetration (see Figure 1). By contrast, in three comparator country groupings — heavily indebted poor countries, low-income countries and MICs — growth rates have all steadily increased. The Caribbean region has been particularly affected, and there is evidence that the region has been getting poorer over recent decades (IMF 2013).

Figure 1: GDP Growth (%) in Small States and Other Comparator Country Groups (1980-2010)



Data source: World Development Indicators, <http://data.worldbank.org/data-catalog/world-development-indicators>.

Small states' share in global trade has also been steadily declining, with some 70 percent of small states experiencing reduced shares of global trade (Razzaque 2011). Since 1970, the Caribbean region's share of world merchandise exports has plummeted from three percent to 0.25 percent, prompting the Commonwealth Secretariat (2015) to suggest that a "deglobalization" of these states may be underway.

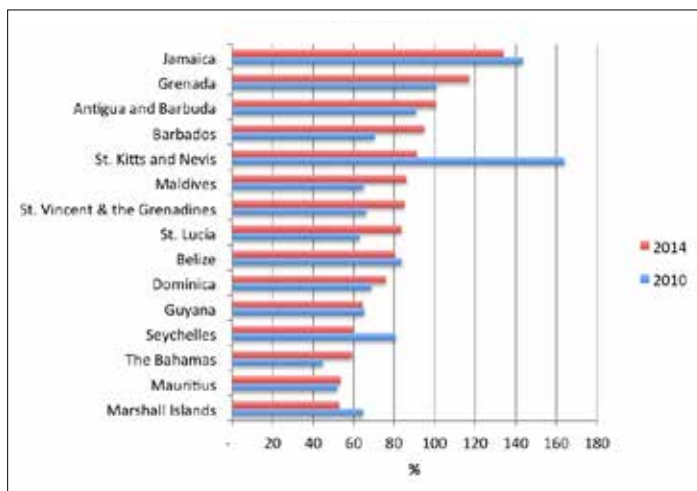
Rising debt and debt sustainability are another growing challenge. Between 2010 and 2014, public debt-to-GDP ratios deteriorated in seven Caribbean countries. Among 15 small states with the largest share of public debt-to-GDP in 2014, 11 were Caribbean countries, with nine of these ranked in the top 10.⁵ They face unsustainable debt levels, with debt in 10 Caribbean countries exceeding the 60 percent debt-to-GDP threshold used by the IMF and World Bank to measure

5 Data is from the IMF's World Economic Outlook (WEO) database, www.imf.org/external/pubs/ft/weo/2014/01/weodata/index.aspx. Note that the database currently excludes two Pacific small states with debt-to-GDP ratios in 2013 of 64.0 percent (Samoa) and 45.1 percent (Tonga).

debt sustainability. Three (Jamaica, Grenada and Antigua and Barbuda) have debt-to-GDP ratios at or exceeding 100 percent; and a further six have debt-to-GDP ratios exceeding 80 percent.

Rising public debt is attributable to several factors, including external shocks — in particular, the impact of international terrorism on tourist-dependent small states; natural disasters, which have both increased debt burdens and also triggered debt crises, including in Dominica (2003) and Grenada (2004); and increased borrowing to achieve trade-induced adjustments (Robinson 2015).

Figure 2: Public Debt-to-GDP Ratios in 15 Highly Indebted Small States (2010 and 2014)



Data source: IMF WEO www.imf.org/external/pubs/ft/weo/2014/01/weodata/index.aspx.

Key policy responses have included a series of debt restructuring operations, and substantial fiscal retrenchment. Since 2004, seven Caribbean countries have undergone debt restructuring. Three — Belize, Grenada and Jamaica — have conducted repeated restructurings, highlighting the inefficiency of these operations and weaknesses in the international debt restructuring architecture (Mitchell 2015). Many countries have also pursued public service reform, containing the public sector wage bill and sharply reducing public expenditure, with several, including Jamaica, Grenada and Dominica, running large and continuous primary surpluses. Jamaica’s success in early 2016 in exceeding extraordinarily high IMF primary surplus targets (McIntosh 2016) suggests that these countries are doing all they can to meet the Red Queen’s injunction to run “twice as fast.” However, generating prolonged, continuous and unprecedented levels of primary surplus — for example, the IMF estimates that Jamaica will be required to maintain a minimum primary surplus of 15 percent to achieve debt sustainability in the long run — is unrealistic and unsustainable, and does not take into account small states’ inherent vulnerabilities, with small states

obliged to spend a disproportionate share of revenue in dealing with natural disasters and crises.

Key Actions

Addressing the combination of unique vulnerabilities and perpetual crises requires several steps. These include identifying new opportunities to diversify production and exports through strengthened regional integration and participation in regional value chains; exploiting opportunities from the blue economy through a wide range of new ocean and coastal industrial and ecosystem services-based opportunities; and increasing South-South trade (Razzaque and Keane 2015).

Development partners can also support small states in their efforts to implement the recently agreed Sustainable Development Goals on infrastructure. These include building climate-resilient infrastructure, energy, forestry and ocean resources, and developing integrated longer-term strategies for sustainable development, thereby allowing for a shift in policy focus from the pursuit of short-term growth.

New international initiatives are also needed to address escalating debt and debt sustainability challenges in small states. Developing these will require both financial innovation and political will.

Conclusion

Most small states have run as fast as they can, seeking to build resilient economies in the face of acute vulnerabilities and while meeting the extraordinary fiscal and human costs of seemingly perpetual crises and shocks. An increasing number of highly indebted small states are now running twice as fast simply to stave off higher levels of debt. Many face an uncertain future; however, collective initiatives by small states and development partners can reverse and transform this prognosis. Specific options include establishing long-term partnerships to develop the blue economy and to shift small states’ energy policies from reliance on imported fossil fuel sources toward low-carbon renewable energy; identifying innovative sources of development financing; and — for a growing number of small states — resolving increasingly unsustainable debt burdens.

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About the Author



Cyrus Rustomjee is a CIGI senior fellow with the Global Economy Program.

At CIGI, Cyrus is looking for solutions to small states' debt challenges and exploring the benefits of the blue economy. His research looks into how small countries in the Pacific, the Caribbean and elsewhere can benefit from greater reliance on the use and reuse of locally available resources, including those from maritime environments.

Based in the United Kingdom, Cyrus is currently managing director at Cetaworld Ltd., an independent consulting practice. He was previously director of the Economic Affairs Division at the Commonwealth Secretariat in London, as well as head of the G-20 Secretariat at the National Treasury of South Africa at the time the country held the rotating presidency of the group. Cyrus also served as an executive director of the International Monetary Fund (IMF) in Washington, DC, representing 21 African countries at the IMF Executive Board. Previously, he was an adviser to the executive director of the World Bank Group.

In addition to the blue economy and domestic resource mobilization, his research has previously focused on diaspora finance and innovative financing for development as well as on migration issues.

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Sarah Burch

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Financing the Blue Economy in Small States

CIGI Policy Brief No. 78
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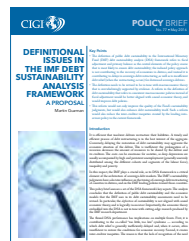
The blue economy approach offers small developing states — countries with populations of 1.5 million or less — the opportunity to diversify from a narrow production base; invest in and develop growth and employment opportunities in a wide range of both existing and new sectors and industries; and shift away from predominantly land-based industries toward those that integrate and sustainably develop a broader range of land-based, coastal and ocean-based sectors.



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CIGI Policy Brief No. 77
Martin Guzman

The definition of public debt sustainability in the International Monetary Fund debt sustainability analysis framework refers to fiscal adjustment and primary balance as the central elements of the policy course that is most likely to ensure debt sustainability; the induced policy approach is not contributing to the recovery of economies in distress, and instead it is contributing to delays in sovereign debt restructuring, as well as to insufficient debt relief (when the restructuring occurs) for distressed sovereign debtors. The definition needs to be revised to be in tune with macroeconomic theory that is overwhelmingly supported by evidence.

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Le CIGI a été fondé en 2001 par Jim Balsillie, qui était alors co-chef de la direction de Research In Motion (BlackBerry). Il collabore avec de nombreux partenaires stratégiques et exprime sa reconnaissance du soutien reçu de ceux-ci, notamment de l'appui reçu du gouvernement du Canada et de celui du gouvernement de l'Ontario.

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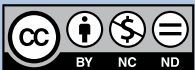
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