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# Small States

## Performance in Public Debt Management

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## Abstract

This paper analyzes the status of public debt management performance in 17 small states through the findings of the Debt Management Performance Assessment reports. Empirical evidence indicates that the higher the quality of a country's policies and institutions, the better is its capacity to carry debt and withstand exogenous shocks. Borrowing for productive purposes can be an important element in boosting growth of gross domestic product but, conversely, excessive borrowing or poorly structured debt in terms of maturity, currency, or interest rate composition can quickly offset the positive impact, deter new foreign and domestic investment, compromise reform programs, depress growth of gross domestic product, exacerbate the challenge of meeting debt service obligations, and may induce or propagate economic crises. Arguments in favor of sound debt management are especially compelling for small states that must mitigate the particular risks to which their economies are exposed. Against this backdrop, the paper identifies aspects of debt management where small states do relatively well and those where they perform poorly, relative to other developing countries, and examines the underlying factors at play. It elaborates on some of the successful measures taken by small states to enhance debt management performance and considers how these may be applied more broadly in other small states. The paper offers a number of practical suggestions to strengthen debt management performance.

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# Small States - Performance in Public Debt Management

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**Summary**

This paper reviews and analyzes the status of public debt management performance in small states, defined as states with a population of less than 2 million. The focus of the paper is on small states classified by the World Bank as low- or middle-income.[1] It draws on the findings of the Debt Management Performance Assessment (DeMPA) reports of 17 small states to assess the current state of debt management performance, identify strengths and weaknesses and contrast debt management performance in small states with that of other low and middle income countries for which DeMPA reports have been produced. Based on the 17 sample countries the broad conclusions are;

- Small states lag well behind other developing countries in most dimensions of debt management performance;

- Small states that issue domestic debt have better capacity to manage domestic debt as compared to their capacity to manage external debt despite the fact that, in most small states reliance on external sources of financing is, on average, much greater than on domestic markets;

- The debt management capacity of small states is striking similar, with relatively little difference observed between the strongest and the weakest performers or between small states in one geographic region and those in another;

- Debt management capacity in small states does not correlate to income levels with small states classified as low income exhibiting, on average, better debt management performance (in terms of the DeMPA scores) than small states classified as upper middle income.

Empirical evidence supports the view that the higher the quality of a country's policies and institutions, the better is its capacity to carry debt and withstand exogenous shocks.[2] Borrowing for productive purposes can be an important element in boosting GDP growth but, conversely, excessive or indiscriminate borrowing can quickly offset the positive impact, deter new foreign and domestic investment, compromise reform programs, depress GDP growth and exacerbate the challenge of meeting debt service obligations. Poorly structured debt in terms of maturity,

[1] The World Bank classifies countries by income groupings on their GNI per capita, according to Atlas methodology. For FY13 low income countries: $1,025 or less, lower middle income countries: $1026-$4,035, upper middle income countries: $4,036-$12,475, high income: $12,476 and above.

[2] Kraay, A and Nehru, V, 2006, *When is External Debt Sustainable?*, World Bank Economic Review, Vol. 20, No. 3, pp 341-365. See also, WB-IMF (May 2007), Strengthening Debt Management Practices - Lessons from Country Experiences and Issues Going Forward - Background Paper (Chapter III prepared by A. Prasad and F. Rowe).

currency or interest rate composition, and large unfunded contingent liabilities, has also been an important factor in inducing or propagating economic crises in many countries. Arguments in favor of sound debt management are even more compelling in small states who must mitigate the broader risks to which their economies are exposed: limited economic opportunities, lack of diversity, disproportionately high infrastructure and transaction costs, and high vulnerability to natural disasters, all of which may heighten the risk of significant and rapidly worsening macro-economic and debt dynamics.

Against this backdrop the paper identifies aspects of debt management where small states do relatively well and those where they perform poorly and looks at the underlying factors at play. It elaborates on some of the successful measures taken by small states to enhance debt management performance and considers how these may be applied more broadly in other small states. In this context it offers a number of practical suggestions for policymakers on ways in which debt management capacity could be strengthened. These include drawing on the debt management experience of other countries, using the findings of the DeMPA reports to identity aspects of debt management where some capacity has already been built and small changes could provide a rapid and important pay-off and pooling of resources, through regional cooperation, to get efficiency and cost saving benefits in areas such as preparation of operational manuals, debt reports and bulletins. The paper draws attention to the need to maximize the gains to be got from the application of information technology. It also highlights the importance of proper identification of staff training requirements and appropriate selection of courses as well as concerted follow through on the application of skills and knowledge acquired to improve the national debt management processes. Finally, the report presents some proposals for widening the financing options of debt managers through the development of domestic debt markets, essentially highlighting policy options that have worked in some small states.

**Background: Some Characteristics of Small States**

Forty-eight small states are members of the World Bank[3]. They are located across the globe with 15 in Asia and the Pacific, 12 in the Caribbean, 11 in Sub-Saharan Africa, and 10 scattered across other regions. Thirteen of these 48 small states are classified as high income and fall outside the scope of this paper[4]. Its focus is on the 35 small states classified as low and middle income and, within that group, the 17 small states for which the DeMPA exercise has been

[3] Antigua and Barbuda, The Bahamas, Bahrain, Barbados, Belize, Botswana, Brunei, Bhutan, Cape Verde, Comoros, Cyprus, Djibouti, Dominica, Equatorial Guinea, Estonia, Fiji, Gabon, The Gambia, Grenada, Guinea-Bissau, Guyana, Iceland, Kiribati, Lesotho, Luxembourg, Maldives, Malta, Marshall Islands, Mauritius, Federated States of Micronesia, Montenegro, Namibia, Palau, Qatar, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Samoa, San Marino, Sao Tome and Principe, Seychelles, Solomon Islands, Suriname, Swaziland, Timor-Leste, Tonga, Trinidad and Tobago, and Vanuatu

[4] Saint Kitts and Nevis was reclassified to high income in FY13 but for analytical purposes it is treated in this report as upper middle income, its income classification at the time the DeMPA was conducted.

conducted (Table 1).[5] Hereafter any reference to "small states" should be understood as excluding those classified as high income, absent any indication to the contrary.

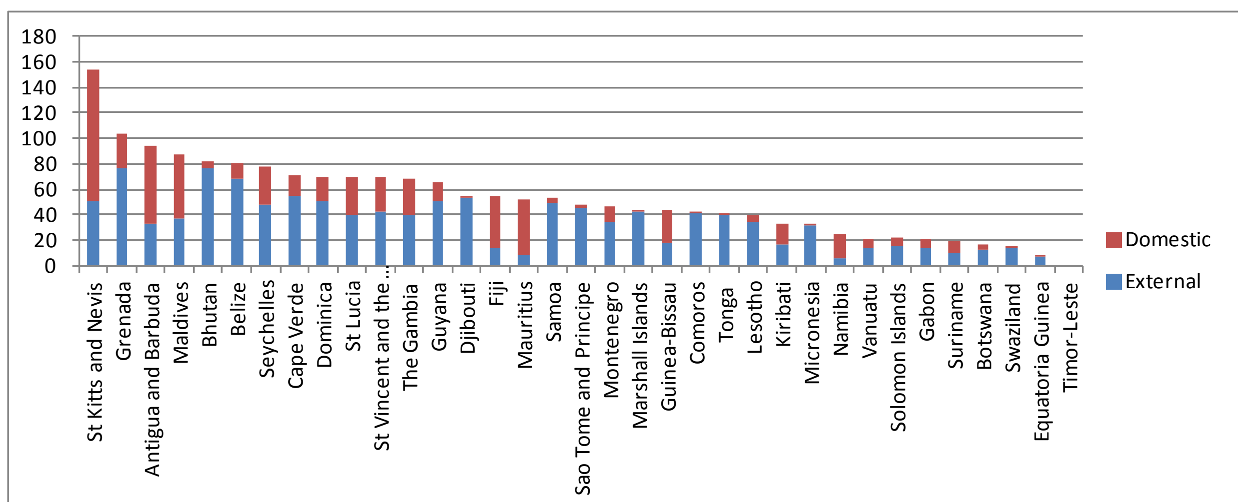
Based on 2011 data the average per capita income of small states was US$4,759 and only 9 percent were classified as low income. By comparison, as a group low and middle income countries had an average per capita income of US$3,631 and 27 percent were classified as low income. Small states often stand out as the richest country in a region, for example in South Asia the per capita income of Maldives (US$6,530) is more than four times that of India, the largest economy in region. There is however, a marked disparity between the per capita income levels of small states. They range from The Gambia, the poorest, with a GNI per capita of US$610 to Antigua and Barbuda with a per capita income of $12,060.

Examined separately, small states exhibit disparate public debt levels. Several including Antigua and Barbuda, Grenada, Seychelles and St. Kitts and Nevis built up very sizeable public debt on account of expansionary fiscal policies and fixed exchange rate regimes. St. Kitts and Nevis has the highest nominal public debt-to-GDP ratio of any small state, 154 percent at end 2011, and the comparable ratio for Antigua and Barbuda and Grenada is in excess of 90 percent, after substantial debt restructuring with official and private creditors[6]. However, almost half of the 35 small states classified as low and middle income have ratios of public debt to GNI below 50 percent and Timor-Leste has no public debt whatsoever. The composition of public debt portfolios also differs. In general small states rely more heavily on external sources rather than domestic markets for their public financing needs but there are some important exceptions. For example in Antigua and Barbuda, Fiji, Mauritius, Namibia and St. Kitts and Nevis domestic debt constitutes by far the largest share of public debt (Figure 1).

**Figure 1: Public Debt Composition and Ratio to GNI 2011**
*Percent*

[5] Small states classified as low and middle income for FY13 are: Antigua and Barbuda, Belize, Botswana, Bhutan, Cape Verde, Comoros, Djibouti, Dominica, Fiji, Gabon, The Gambia, Grenada, Guinea-Bissau, Guyana, Kiribati, Lesotho, Maldives, Marshall Islands, Mauritius, Federated States of Micronesia, Montenegro, Namibia, Palau, Saint Lucia, Saint Vincent and the Grenadines, Samoa, Sao Tome and Principe, Seychelles, Solomon Islands, Suriname, Swaziland, Timor-Leste, Tonga, Vanuatu

[6] St Kitts and Nevis concluded a rescheduling agreement with official and private creditors in 2012.



Source: IMF World Economic Outlook October 2012 and IMF Article IV Consultation Reports

Borrowing patterns are a reflection of access to external sources of capital and the extent of domestic markets. Currently 17 small states, out of the 35 that are the focus of this report, are assessed as not creditworthy for IBRD, or market-based sources of financing and therefore reliant on IDA and other concessional multilateral and bilateral sources for external financing. Twelve of these small states have GNI per capita that exceed the IDA cut-off (US$1,195 for FY13) but have access to IDA resources because of their lack of creditworthiness, including several under the small island exception policy.

**Literature Survey**

Studies related to small states are well represented in the economic literature. The reason for this attention is, in part, to be found in the general belief that being small in a "macro" world is a drawback and that due to their distinct characteristics, small states are particularly vulnerable because they cannot enjoy economies of scale, both in production and public administration and tend to be particularly vulnerable to natural disasters and economic shocks. Yet, there is no unanimity of opinion among researchers. Some regard small as an asset and find that small states have an advantage because the decision-making process can be faster when administrations are small and the populations largely homogenous. This, it is argued, enables small states to respond quickly to the adjustments required by a fast changing global economy.

Aiyar (2008)[7] enumerates a number of advantages enjoyed by small states including relatively homogenous populations, and therefore less ethnic tension; proportionally larger foreign investment and remittance flows; the opportunity to exploit niches such as military bases or offshore banking centers; proportionally larger trade preferences than other developing countries

[7] Aiyar, S. *Small States: Not Handicapped and Under-aided, But Advantaged and Over-aided.* Cato Journal, Vol. 28, No. 3 Fall 2008

and benefits from the Law of the Sea. He also finds small states receive more official development assistance (ODA) relative to size of the economy and population than other developing countries. This is confirmed by a World Bank study[8] which found that from 1999-2003 small states received an annual average of $201 annually per capita in aid, compared to an average of $12 for all developing countries, or $18 per capita when China and India are excluded, and aid to small states averaged almost 15 percent of GNI per annum as opposed to only 1 percent of GNI for all other developing countries.

Domeland and Gil Sander (2007)[9] argue "smallness" is an advantage in the African context. They find that, compared to other Sub-Saharan African countries, small states in Africa have stronger governance, more political stability and lower incidence of armed conflict and state failure. Small populations equate with less ethnic groups and lower degree of ethnic fractionalization which is found to lead to uncoordinated rent-seeking activities, weak central government controls and corruption. The empirical evidence shows that, after controlling for measures of ethnical fragmentation, being small lowers the probability of armed conflict by more than 10 percent. Small states in Africa were not found to be disproportionally affected by crisis caused by natural disaster or terms of trade shocks but when a crisis took place small states recovered much faster than other countries in the region. In contrast the 2008 Growth Report[10] found small states face three important disadvantages: absence of economies of scale, both in production of goods and the provision of public finance; vulnerability to the impact of natural disasters; and the combination of concentrated economic activity and geographic remoteness which pose a barrier to integration into the global economy. Briguglio[11] also argues that small states have relatively larger government costs; higher per unit costs due to problems of indivisibility; frequent natural disasters; erosion of preferential treatment; and persistent fiscal deficits which contribute to higher public debt levels.

Researchers may differ on whether or not "small is beautiful", but there is broad agreement in the literature regarding other characteristics of small states. Social and educational indicators are relatively good and GNI per capita and GDP growth are not found to be systematically worse in small states. On the contrary, researchers tend to argue the opposite. After examining whether income levels in 33 small states with population of less than 1 million are different than other states Easterly and Kraay[12] concluded that, after controlling for location, small states have higher

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[8] Independent Evaluation Group of the World Bank, IEG *Small States: Making the Most of Development Assistance.* Washington DC: The World Bank 2006

[9] Domeland, D. and Gil Sander, F. *Growth in African Small States* Working Paper, The World Bank 2007

[10] Commission on Growth and Development *The Growth Report: Strategies for Sustained Growth and Inclusive Growth and Inclusive Development*. World Bank 2008

[11] Briguglio, L. (2009) Small States: Debt Issues and Forward Strategy. Prepared for the Symposium " Small States: Weathering the Global Crisis". Washington DC: The World Bank

[12] Easterly, W., and Kraay, A. (2000) "Small States, Small Problems? Income, Growth, and Volatility in Small States." World Development 28 (11): 2013–27.

per capita income than other countries, due mainly to productivity advantages. Similarly, Favaro et al[13] found small states had on average, higher median purchasing power parity (PPP) -adjusted income per capita than other developing countries but noted considerable disparity in per capita income across small states with a very wide range between the richest and the poorest. This was corroborated by the World Bank[14] which found the weighted average PPP adjusted income per capita for developing small states in 2010 was $7,831, compared to $1,247 for low income countries, $3,701 for those classified as lower middle income and $9,904 for upper middle income countries.

Similarly, there is little to suggest that small states have lower per capita growth rates than other developing countries although Favaro et. al.[15] underscore the fact that they often experience greater volatility in growth from one year to the next, partially on account of the volatilities in terms of trade. Smaller economies are more open to trade because they have to rely on imports to satisfy their domestic demand and exports tend to be highly concentrated in a few sectors. Easterly and Kraay[16] also note that small states tend to be characterized by higher income volatility. Domeland and Sander (2007)[17] compare 14 small states in Africa with other Sub-Saharan African countries and other small states. They find between 1970 and 2005 the average real GDP growth of African small states was 4.1 percent, compared to 3.2 percent for other countries in Sub-Saharan Africa and 3.5 percent in other small states. The average GDP per capita growth rate in small states in Africa, compared to other Sub-Saharan African countries, was twice as high and their median GDP per capita, US$ 2,217 in 2005, four times higher.

Researchers differ in their perspective of the pace and level of public debt accumulation in small states but find no evidence to correlate being a small state with levels of indebtedness or a "debt problem" specific to small states. Dodhia (2005)[18] documents the movement of external debt indicators in 26 small states from 1990 to 2003 and finds the stock of external debt increased by about 1.6 per cent per annum in the 1990s but the rate of growth accelerated to 5.6 per cent per annum between 1999 and 2003. This increase in indebtedness is attributed to three factors: low and volatile GDP growth; high and increasing public sector deficits resulting from a combination of lower revenues and higher expenditures; and higher borrowing costs as concessional

[13] Favaro, E., Dömeland, D, O'Boyle,W. and Stucka T. (2010) Small States, the Financial Crisis, and the Aftermath. Chapter of "Sovereign Debt and the Financial Crisis: Will This Time Be Different?" Edited by Braga, C. and Vincelette G.. Washington DC: The World Bank

[14] World Bank *Statistics for Small States: A Supplement to the World Development Indicators 2011* The World Bank

[15] Favaro,E, Dömeland, D, O'Boyle,W. and Stucka T. (2010) Small States, the Financial Crisis, and the Aftermath. Chapter of "Sovereign Debt and the Financial Crisis: Will This Time Be Different?" Edited by Braga, C. and Vincelette G.. Washington DC: The World Bank

[16] Easterly, W., and Kraay, A. (2000) "Small States, Small Problems? Income, Growth, and Volatility in Small States." World Development 28 (11): 2013–27.

[17] Domeland, D. and Gil Sander, F. *Growth in African Small States* Working Paper, The World Bank 2007

[18] Dodhia, D (2005) The Emerging Debt Problems of Small States. London: Commonwealth Secretariat.

financing, as a share of total financing, decreased in response to the relatively higher income level of small states. The study highlights that, throughout the period, external debt accumulated much faster in small states than in low income countries and it classified one third of small states as severely indebted on the basis of the net present value of debt to export earnings and GNI. It also found the sharpest increase in external indebtedness between 1990 and 2003 was in small states in the Caribbean.

Favaro et al[19] determined that, since 2000, public debt levels in small states, particularly external public debt, have declined sharply: they fell to an average of 60 percent of GDP prior to the onset of the global crisis in 2008. Several factors to account for this outcome are identified. These include debt relief in the context of the HIPC and MDRI initiatives from which five small states have benefitted, Comoros, The Gambia, Guinea-Bissau, Guyana, and Sao Tome and Principe; debt restructuring and debt forgiveness in a number of other small states including Antigua and Barbuda, Grenada, Kiribati, the Marshall Islands, Seychelles and the Solomon Islands; higher commodity prices in Botswana (diamonds), Equatorial Guinea and Gabon (oil); strong economic growth in small states like Cape Verde and Mauritius and fiscal consolidation in others such as Belize and Dominica. However, the study accurately foresaw the impact of the global economic crisis that erupted in the third quarter of 2008. Many small states saw their economies contract sharply in the wake of this crisis and were forced to borrow externally to finance current account deficits and economic recovery packages. This study concurred with Dodhia and found small states in the Caribbean to be the most indebted with public debt levels averaging 80 percent of GDP often as a result of expansionary fiscal policies, as was the case for example in Antigua and Barbuda, Grenada, and St. Kitts and Nevis. Conversely, Briguglio, Persaud and Stern[20] argue small states saw a rapid increase in external debt in 2000-2005 due to a number of factors including a decline in resource transfers and in capital investment, persistent public sector deficits, averaging over 6 percent of GDP in small states in the Caribbean, natural disasters, weak macroeconomic management, limited success in deepening the tax base and global economic downturns.

Small states confront some specific institutional and human capacity constraints that add to the challenge of developing sound debt management capacity and are found to be an important factor in why so many small states continue to perform poorly. Ministerial portfolios in small states are typically multifaceted, placing a concomitant burden on personnel and often stretching the institutional capacity of the public sector to its limit. This is reflected in the administrative characteristics of small states with staff limited in number, assigned to multiple tasks and

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[19] Favaro,E, Dömeland, D, O'Boyle,W. and Stucka T., *Small States, the Financial Crisis, and the Aftermath.* Chapter of *"Sovereign Debt and the Financial Crisis: Will This Time Be Different?"* Edited by Braga, C. and Vincelette G., Washington DC: The World Bank 2010

[20] Briguglio, L.; Persaud, B.; and Stern, R. *Towards an Outward-Oriented Development Strategy for Small States: Issues, Opportunities and Resilience-Building.* Singapore: 2006 Bank-Fund Annual Meetings

frequently over-extended with little or no reserve capacity. Prospects for promotion and job mobility are scarce, making it difficult to attract or retain well qualified specialists. Constrained financial resources are manifested in poor compensation levels, inadequate or inappropriate staff training and high staff turnover rates which, in turn, lead to a shortage of management skills, limited problem solving capacity. Poor work environments and lack of, or limited alternative employment opportunities, that creates morale problems, low productivity and absenteeism.

Yet, sound debt management is imperative if small states are to mitigate the broader risks to which their economies are exposed: limited economic opportunities, lack of diversity, disproportionately high infrastructure and transaction costs, and high vulnerability to natural disasters, all of which may heighten the risk of significant and rapidly worsening dynamics. Such risks point to the need for small states to structure their debt management objectives and reform programs in ways that minimize the inherent administrative constraints outlined above, and allow them to capitalize on some of the advantages from which small states benefit. These include the integration of information, knowledge and policy coordination that results from a very limited staff performing a range of different functions, and the advantage of having to manage limited public debt portfolios, measured in terms of number of borrowing instruments.

**Measurement of Debt Management Performance**

The Debt Management Performance Assessment (DeMPA) tool[21], provides an objective and comprehensive benchmark for evaluating debt management performance in developing countries. It measures strengths and weaknesses in public debt management through a comprehensive set of 15 debt performance indicators (DPIs) covering six core areas of public debt management (Box 1). The focus of the DeMPA exercise is on central government public debt management and related functions, namely borrowing, issuance of loan guarantees, on-lending, use of derivatives, cash flow forecasting and cash balance management. Performance measures are outcome based and neutral with regard to the institutional arrangements for debt management adopted by each country. Assessments are based on information provided by national authorities, results are discussed with them and any divergent views between the assessment team and the authorities are reflected in the assessment report. Each assessment report is reviewed by an independent group of debt management experts so as to ensure cross-country comparability and objectivity. Transparency is strongly encouraged, but it is the prerogative of national authorities to decide whether or not to disclose the assessment.[22]. No conditionality is attached to a DeMPA assessment; its primary purpose is to serve as a measure of the quality of debt management against international sound practice, to guide the design of actionable reform programs and to facilitate monitoring of performance over time.

[21] Has been developed by the World Bank, with collaboration and support from international partners, notably the International Monetary Fund (IMF),

[22] Five of the small states assessed have disclosed the DeMPA document: The Gambia, Guinea-Bissau, Maldives, Sao Tome and Principe, and Solomon Islands. These are available at www.worldbank.org

**Box 1: DeMPA Performance Indicators and Scores**

The DeMPA assesses six key areas of debt management performance: (1) governance and strategy development; (2) coordination with macroeconomic policies; (3) borrowing and related financing activities; (4) cash flow forecasting and cash balance management; (5) operational risk management; and (6) debt records and reporting. There are 15 performance indicators comprising a total of 35 dimensions each designed to measure the extent to which a government's debt management performance conforms to internationally recognized standards of sound practice (Annex 1).

Each dimension is scored on a four point scale: A, B, C, or D. To meet the minimum requirement of a dimension a score of C is required. Scores of A or B indicates "sound practice" or "strengths" respectively. A score of D

## Which Small States Have DeMPA

Twenty DeMPAs were carried out in 17 small states between 2007 and 2012[23]. Of 17 small states 4 are in the Latin America and Caribbean, 2 in East Asia, 1 in the Middle East and North Africa, 2 in South Asia and 8 in Sub-Saharan Africa. The small states in this sample group have different characteristics with regard to population size, per capita income levels and degree of indebtedness, as measured by the ratio of public debt to GDP (Table 1). Ten of the small states in this group have, at some stage, experienced severe debt crises and forced to restructure obligations to external creditors, as evidenced by their recourse to the Paris Club and other debt restructuring forums and 5 are eligible for debt relief under the HIPC and MDRI initiatives. The sample group includes all (3) small states classified as low income and 6 of those classified as upper middle income. With reference to the latter it is widely recognized that although small states may meet the criteria for classification as middle or upper middle income they often retain many of the characteristics of countries at much lower levels of GNI per capita. Important however, in this regard is that DeMPA indicators are equally relevant as a diagnostic tool regardless of a country's levels of development.

**Table 1: DeMPA Assessments and Country Characteristics**

[23] In The Gambia, Sao Tome and Principe, and Swaziland, two DeMPA missions were carried out.

| Country | 2011 GNI per capita (Atlas methodology current US$) | Income Classification | Public debt/GDP | Date of DeMPA Assessment | Country | 2011 GNI per capita (Atlas methodology current US$) | Income Classification | Public debt/GDP | Date of DeMPA Assessment |
|---|---|---|---|---|---|---|---|---|---|
| | *Africa (8)* | | | | | *Middle East and North Africa (1)* | | | |
| Cape Verde | 3540 | lower middle | 71 | Feb-09 | *Djibouti* | *1280* | lower middle | 55 | Apr-10 |
| Comoros | 770 | low | 43 | Apr-11 | | | | | |
| Gabon | 7980 | upper middle | 21 | May-12 | | *Latin America and the Caribbean (4)* | | | |
| Gambia | 610 | low | 68 | Mar-06 and Jan-10 | Antigua and Barbuda | 12060 | upper middle | 93 | Jun-09 |
| Guinea-Bissau | 600 | low | 44 | Sep-11 | Grenada | 7220 | upper middle | 104 | Jun-09 |
| Namibia | 4700 | upper middle | 25 | Mar-12 | *Guyana* | *3270* | lower middle | 65 | Apr-06 |
| Sao Tome and Principe | 1360 | lower middle | 48 | Feb-08 and May-11 | St Kitts and Nevis | 12480 | upper middle | 154 | Apr-09 |
| Swaziland | 3300 | lower middle | 14 | June-08 and Mar-11 | | | | | |
| | | | | | | *South Asia (2)* | | | |
| | *East Asia (2)* | | | | Bhutan | 2070 | lower middle | 81 | Dec-11 |
| Samoa | 3190 | lower middle | 53 | Jan-10 | Maldives | 6530 | upper middle | 88 | Oct-09 |
| Solomon Islands | 1110 | lower middle | 21 | Feb-09 | | | | | |

Source: World Bank and IMF

Note: countries in italics are eligible for the HIPC and MDRI initiatives

The evaluation of debt management performance in small states presented in this paper is based on DeMPA for the 17 small states listed in Table 1 above and it may not be an accurate reflection of the strengths and weaknesses of debt management performance in other small states. However, the convergence of DeMPA findings in the 17 small states assessed is striking, and indicates broader lessons may apply. The average income, and debt related characteristics, of small states in the sample group is representative of the average for all small states. The average GNI per capita of small states in the sample group is only slightly lower, US$4,329 than that of all small states (US$4,759) and the ratio of domestic public debt to GDP is within the same range (Table 2). As a share of total outstanding external debt of small states, the share owed by those in the sample group has consistently been between 40 and 45 percent throughout the past decade. However, ratio of external public debt to GDP is higher 62 percent (compared to 52 percent) but this is explained by the fact that the sample group includes all five of the most heavily indebted small states, with public debt to GDP levels above 80 percent. A higher share of small states in the sample group had recourse to debt restructuring and this could be taken as an indicator of weaker debt management capacity. However, this is counterbalanced by the fact that almost all of them have ongoing reform programs with the IMF. These programs include a commitment to fiscal consolidation and structural reforms that may be expected to result in improvements in debt management and better coordination with fiscal and monetary policies.

**Table 2: Comparison of Key Indicators**

*Percent*

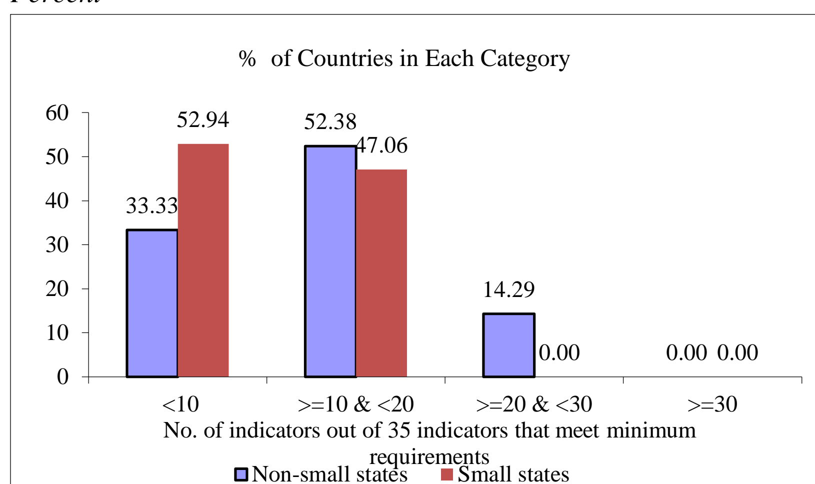
| | All Small States | Sample Group |
|---|---|---|
| Average GNI per capita US$ | 4759 | 4329 |
| Classified as: | | |
| Low income | 9 | 18 |
| Lower middle income | 48 | 47 |
| Uppper middle income | 43 | 35 |
| Average Ratio of Public Debt to GDP | 52 | 62 |
| External public debt/GDP | 34 | 40 |
| Domestic public debt/GDP | 18 | 22 |
| With an IMF program | 43 | 59 |
| Rescheduled with external creditors | 43 | 65 |

Source: World Bank

## Findings from the DeMPA in Small States

The DeMPA findings confirm that most of the 17 small states assessed have rudimentary debt management functions, practices and systems. No small state in the sample group met the minimum requirement for more than twenty of the thirty five DPIs assessed and more than half of them (53 percent) met the minimum requirement for less than ten DPIs. These scores are well below those of the other 42 developing countries for which DeMPAs have been conducted (Figure 2).

**Figure 2: Debt Management Capacity in Small States and Other Developing Countries Compared**
*Percent*



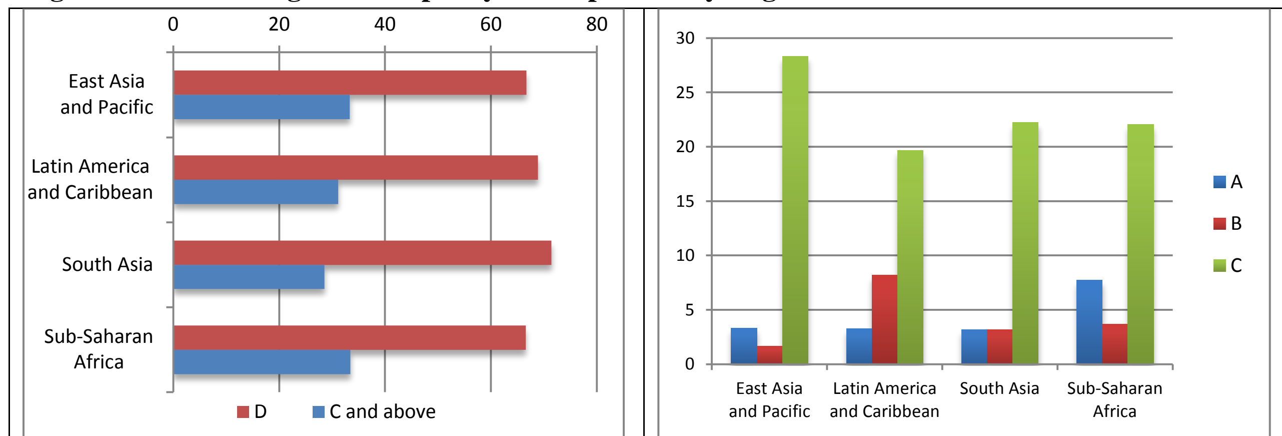

Source: DeMPA reports

Taken as a group the small states in the sample met the minimum requirement for, on average, 32 percent of dimensions assessed, while the non-small states met the minimum requirement for 41 percent. Strengths in debt management practices, indicated by a score of A and B were

limited: with a score A found in only 5 percent of the dimensions assessed and score B in 4 percent. The three small states in the group with the best all round scores also displayed the greatest strengths in debt management capacity. They met the minimum requirement for an average of 54 percent of the dimensions assessed and surpassed it in 22 percent of which score B accounted for 13 percent and score A for 9 percent. In some instances the assessments revealed wide disparity in capacity across different aspects of debt management. As an example, one small state failed to meet the minimum requirement in 78 percent of the dimensions assessed. But, for the remaining 22 percent half were scored A.

Differences in debt management performance of small states due to geographic location were negligible: on the contrary, the assessments found striking similarities in debt management capacity of small states in all parts of the globe. Small states in the Sub-Saharan Africa were found to have the strongest debt management capacity: they met the minimum requirement for, on average, 36 percent of the dimensions assessed. In South Asia small states, where debt management capacity was assessed as weakest, 29 percent of assessed dimensions met the minimum requirement on average. The Caribbean also had the highest percentage of A and B scores, closely followed by Sub-Saharan Africa. Overall however, the difference in scores across regions was limited (Figure 3).

**Figure 3: Debt Management Capacity – Comparison by Region**

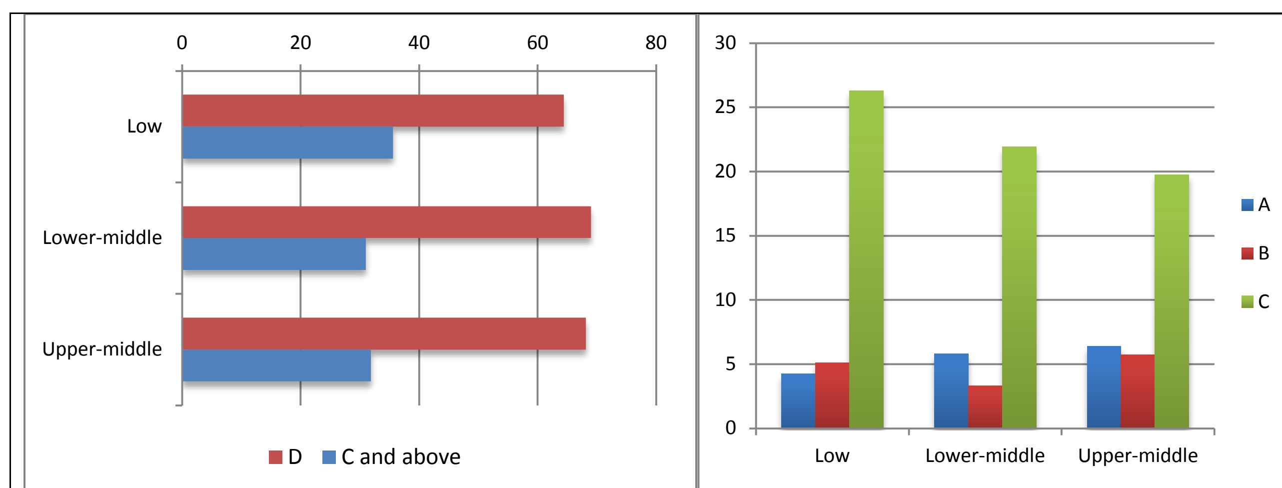



Source: DeMPA reports for 17 sample small states
Note: For purposes of analysis Djibouti is included in Sub-Saharan Africa

As a general rule higher per capita income is found to correlate closely with better policies and more robust institutional capacity. On that basis, richer small states, i.e. those with a higher level of GNI per capita, could be expected to have a stronger debt management performance than poorer ones. However, for the small states in the sample group this did not hold true. The 17 sample small states divide into 3 classified as low income, with an average per capita income of US$660; 8 classified as lower middle income, with an average per capita income of US$2,390 and 6 classified as upper middle income, with an average per capita income of US$8,495. A

comparison of debt management performance in each group finds it does not correlate to income: those classified as low income exhibited the strongest debt management performance (as defined by meeting with the DeMPA scores of at least C) and those classified as lower an upper middle income about the same (Figure 4). On average the first group met the minimum requirement in 36 percent of the dimensions assessed and surpassed it, with a score A or B, in 9 percent: the comparable figures for small states in the upper middle income group were 32 percent and 12 percent, respectively.

**Figure 4: Debt Management Capacity – Comparison by Income Group**




Source: DeMPA reports for 17 sample small states[24]

## How Does the Debt Management Capacity of Small States Measure Up?

A summary of how small states in the sample perform in each dimension of debt management is discussed below and illustrated by the data in Figure 5.

In six dimensions of debt management 10 or more small states, two thirds of those assessed, met or surpassed the minimum requirement for:

- coordination with fiscal policies, specifically accurate and timely forecasts on total debt and debt service under alternate scenarios;
- coordination with monetary policy, in particular the imposition of limits on direct access of resources from the Central Bank;
- managerial structure for borrowings and debt-related transactions;
- existence, coverage, and content of the legal framework;

[24] For analysis purpose, Maldives is classified as lower-middle-income country. Maldives was classified as lower-middle-income country when the DeMPA was conducted, which status was changed to upper-middle-income for FY12 based on 2010 GNI.

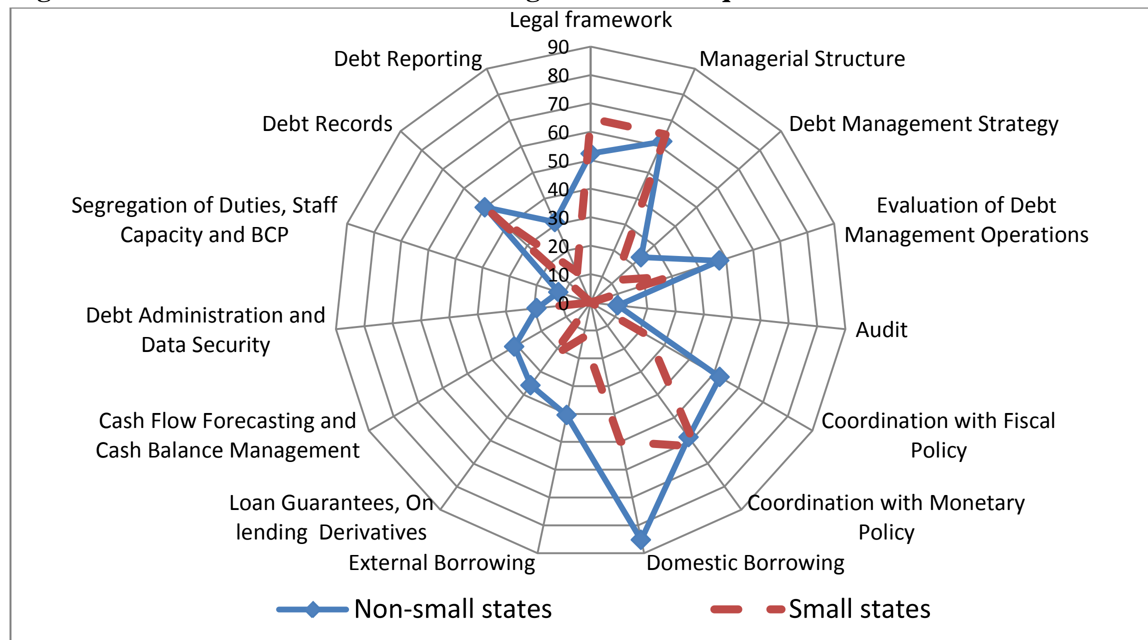
- availability and quality of documented procedures for borrowing in local currency in the domestic market; and
- availability and involvement of legal advisor in external borrowing.

At the other end of the spectrum the dimensions of debt management where small states assessed were found to have the greatest weakness were:

- availability and quality of documented procedures for borrowing in foreign markets;
- quality and timeliness of the publication of a debt statistical bulletin (or its equivalent) covering total central government debt (external and domestic);
- frequency of internal and external audits on debt management activities, policies, and operations and publication of an external audit.

Significant weaknesses were also observed in the quality of the debt management strategy and the lack of an operational risk management plan, including business continuity and disaster recovery arrangements. In each of these Debt Management Performance Indicators (DPIs) only one small state was able to satisfy the minimum requirement of the DeMPA.

**Figure 5: Number of Small States Meeting Minimum Requirements of DPIs**




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

A more detail analyses of the DeMPA findings in small states reveals the following.

***Small states score well with regard to coordination with fiscal policy and monetary policy.*** Coordination of debt management with fiscal policy has been strengthened by the overall improvements in the management of public finances that small states have undertaken, often in

the context of a reform program supported by the IMF. Currently 10 out of the 17 small states in the sample group have an IMF program in place. A strengthening in the management of public finances has also been observed in countries that have completed, or are in the process of completing, the HIPC requirements: all small states eligible for the HIPC initiative (Comoros, The Gambia, Guinea-Bissau, Guyana and Sao Tome and Principe) are in the sample group. The DeMPA findings reveal the appropriate capacity to produce annual forecasts of aggregate debt and debt service payments: 15 of the 17 small states assessed met the minimum requirement for this dimension (DPI6.1).

The DeMPAs also identified good coordination between monetary policy and debt-related transactions (DPI-7). This includes the separation between monetary and debt management operations (DPI-7.1); timely information sharing on debt transactions and government cash flows (DPI-7.2); and the ceilings and tenor placed on governments' access to funds from central banks; (DPI-7.3). The assessments showed that regulated government access to central bank resources was widespread: 11 small states met or surpassed the minimum requirement of this dimension (DPI-7.3), with 2 gaining a score B and 1 a score A. This reflects, in part, the institutional strength of central banks and membership, of several small states in the sample group, in a regional monetary union which brings the benefit of the more disciplined framework such arrangements usually impose on public borrowing. Guinea-Bissau, a member of the Banque Centrale dess Etats de L'Afrique de L'Ouest (BCEAO) and Antigua and Barbuda, Grenada and St. Kitts and Nevis are all members of the Eastern Caribbean Central Bank (ECCB). The assessments also found that regular information sharing mechanisms with the central bank on current and future debt transactions and government cash flow was improving although a much smaller number of small states (8) met the minimum requirement for this dimension.

***A legal framework that governs public borrowing is frequently in place.***

The legal framework sets out the authority to borrow (in both domestic and foreign markets), undertake debt-related transactions (such as currency and interest rate swaps), and issue loan guarantees. As a rule, the ultimate power to borrow on behalf of the government lies with the parliament or congress, stemming from its constitutional power to approve central government tax and spending measures. The DeMPA reports confirmed that 11 small states met the minimum requirement and have the appropriate primary and secondary legislation for effective debt management in place. In many cases the legislation also specifies the purpose for which funds may be borrowed. These include financing budget and cash balance deficits (Bhutan, The Gambia, Guinea-Bissau, Guyana, Namibia, Solomon Islands), refinance and pre-finance of outstanding debt (Antigua and Barbuda, Bhutan, The Gambia); and finance of investment projects (Antigua and Barbuda, Guyana, Solomon Islands). Other purposes include: to honor guarantees that have been called; to fulfill central bank requirements to replenish foreign currency reserves; to issue Treasury bills and Treasury bonds to support monetary policy objectives, for example to drain excess liquidity from the domestic market (Guyana, Namibia);

to maintain credit balance on the Treasury accounts (Bhutan, The Gambia), to finance damages resulting from natural disasters and to obtain foreign currency (Namibia). In some states, borrowing purposes are specific in an annual budget law (Cape Verde) or specified and approved by the Parliament before a loan contract is signed (Maldives).

***Procedures for borrowing in domestic markets are relatively strong.***
Documented procedures for local currency borrowing in the domestic market was also found to be another area of relative strength in debt management capacity, with 11 small states meeting the minimum requirement again, in part, reflecting the institutional strength of central banks (that were responsible for issuing domestic debt in these small states). Progress has also been made in developing effective capacity to maintain a complete and up-to-date record of all holders of domestic government securities in a secure registry system.

On the other side of the balance sheet, the DeMPA determined that deficiencies in debt management performance in small states are many and widespread.

***Lack of capacity to monitor external borrowing and assess cost-effective terms and conditions***
Small states score extremely poorly on dimensions of debt management that relate to determining the most beneficial and cost effective borrowing terms and conditions (DPI9.1) and the availability and quality of documented procedures for borrowing in foreign markets (DPI9.2). Only 3 small states met the minimum requirement for DPI9.1, while one has the appropriate quality of documented procedures for borrowing in foreign markets available. This is a glaring omission given that in the majority of small states external debt is the most important component of public debt and the state's largest portfolio.

***Debt reporting***
The quality of reporting debt data in small states is poor and there is an absence of timely and comprehensive information on public debt. Only 4 of the small states assessed met the statutory and contractual reporting requirement of central government debt to all domestic and external entities (DPI15.1) and none of them met the minimum requirement for the quality and timeliness of a publication of a debt statistical bulletin covering data on total central government debt, domestic and external (DPI15.3).

***Frequency of internal and external audit on debt management activities***
The absence of audits results in lack of accountability and transparency and could result in malpractices, errors and corruption. Not one of the small states assessed met the minimum requirement in this dimension of debt management. In most instances the issue was not one of quality but rather the fact that neither internal nor external audits were being conducted.

***Limited use of market based mechanisms to issue domestic debt***

While documented procedures for borrowing in domestic markets was a dimension of debt management where, on average, small states performed well, very few capitalize on this to prepare, publish and adhere to an annual plan for the aggregate amount of local currency borrowing in the domestic market, divided between wholesale and retail markets. Only 2 small states met the minimum requirement for this dimension of debt management (DP8.1).

***Debt management strategy***

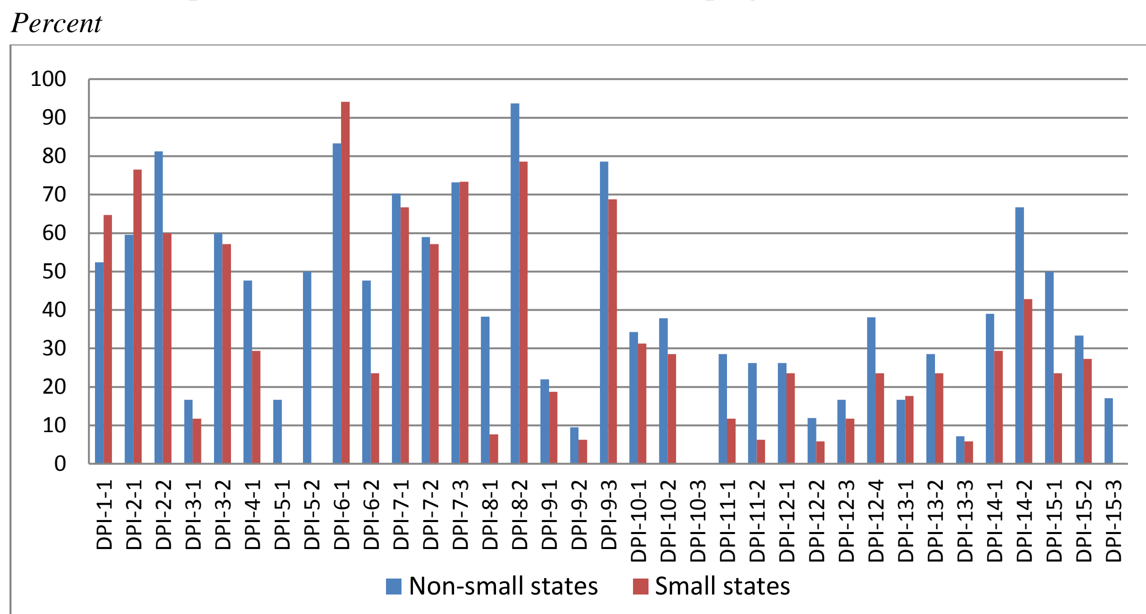
Small states also failed to capitalize on their capacity to coordinate between fiscal and monetary policy to improve monitoring of key fiscal variables and formulate a medium term debt management strategy. Only two of the small states assessed produced a medium term debt management strategy that met the minimum requirements on the DeMPA framework. Of the 17 small states assessed 10 do not formulate and publish a debt management strategy and only four of the seven that do so were found to have proper decision process for developing and updating the debt management strategy regularly(DPI3.2).

## Debt Management Capacity in Small States Compared to Other Developing Countries

The DeMPA findings show that, on average, the share of small states that meet the minimum requirement in each dimension of debt management falls well below that of other low and middle income countries (Figure 6).

**Figure 6: Share of Countries Meeting the Minimum Requirements of Debt Management - Comparison of Small States and Other Developing Countries**

*Percent*




Source: DeMPA reports

## Measures to Improve the Debt Management Capacity of Small States

Nothing in the literature suggests that debt management practices that work well in large states will not work equally well in small ones. The fact that small states have already demonstrated their ability to perform well in some dimensions of debt management bears this out. It is recognized that small states may, on account of their size and other specific features, be impeded by institutional and manpower constraints that it may not be possible to change significantly, or to change only over an extended timeframe. However, these cannot be viewed as insurmountable obstacles (or justification for) resulting in poor debt management and must be simply regarded as constraints that must be factored in to the structure of the debt management processes and addressed in the formulation of debt management objectives, strategies and reform programs. In short, small states must find ways to minimize any of the inherent disadvantages they face. It is also important not to overlook the fact that small size brings with it some advantages. When only a limited number of institutions and staff are engaged in debt management the process of coordination between the different dimensions of debt management, and with fiscal and monetary policy, is greatly simplified. Also, small states typically have public debt portfolios made up of a limited number of instruments and, therefore, relatively easy to monitor.

There are number of practical and, often relatively simple steps, small states can take to improve debt management capacity and many of them are likely to have a rapid payoff. These include (a) benefitting from the experience of other developing countries; (b) tackling the easiest problems first, i.e. picking the low hanging fruit; (c) pooling resources through regional cooperation; (d) maximizing the gains of information technology; (e) realizing the full benefits of staff training; and (f) widening financing options through the development of domestic debt markets.

***Benefitting from the experience of other developing countries***
Instituting new debt management policies or enhancing existing ones can often seem like a daunting process but small states may avoid many of the pitfalls of false starts and failed policies by drawing not just on the debt management literature but also the experience of others. At risk of stating the obvious, there is no better guide for policymakers as to what works well and why than firsthand knowledge and practical experience of their peers in other small states and developing countries. The regular debt managers' forum sponsored by institutions like the World Bank, the Commonwealth Secretariat and UNCTAD as well as ministerial meetings, annual meetings of regional organizations and central banks and multiple debt management seminars offer ample opportunity for discussion and exchange of views: as also the recently set up Debt Management Network (using adobe connect to peer network with debt managers and share experiences). Similarly the DeMPA reports that countries have made public, posted on the World Bank website, offer a rich source of information on what makes for robust debt management capacity, how other countries have met the challenge of instituting sound debt

management policies and what are the common debt management failings that may easily be avoided.

***Picking the low hanging fruit***

One important finding from the DeMPA is that not all weaknesses in debt management capacity are equal. In some instances failure to meet the minimum standard of a dimension of debt management is because that aspect of debt management is simply not addressed, as for example, the widespread absence of internal and external audits in small states. However, the DeMPA also show that frequently the gap between meeting the minimum standard in a given dimension of debt management and failure to do so is in fact relatively small. To give specific examples, a large number of countries failed to meet the minimum requirement with regard to assessing the most beneficial and cost effective borrowing terms from external sources. In most instances this was not the result of absence of capacity to make such as assessment but because borrowing was on concessional terms and the exercise regarded as superfluous, although concessional loans are not all equal, or national authorities did not believe they had borrowing choices. Many countries were found to compile comprehensive information on public debt obligations yet failed to meet statutory and contractual reporting requirements because this information was not available within the required timeframe. Similarly others produced a debt publication or statistical bulletin but with a long time lag. In small states failure to produce a debt management strategy could be rapidly rectified by capitalizing on their proven capacity to coordinate between fiscal and monetary policy.

What this suggests is that small states should, in the first instance, look to areas where instituting relatively small changes to current practice may bring a rapid payoff. In this regard the DeMPA is an important input that can serve as a guide not only to help formulate more robust debt management practices but also to pinpoint areas where weaknesses in debt management can most quickly be rectified. Picking the low hanging fruit will enable small states to enhance the overall assessment of their debt management capacity and clarify the aspects of debt management requiring the greatest amount of attention.

***Pooling resources through regional cooperation***

Small states should exploit more fully the commonality of their legal and institutional approaches to debt management, particular within each region, and the track record of cooperation already established in common regional monetary and custom unions. These offer considerable potential for cost effective improvements in debt management capacity through cross-country coordination. The launch of the Caribbean Debt Management Forum in October with participation from 15 countries suggests this proposal is already coming to fruition.

Multi-state or regional borrowing instruments, while an attractive idea, are likely to be impeded by issues of sovereignty and common currency. However, nothing precludes small states from

pooling their resources to set up many of the key building blocks that underpin debt management. For example the DeMPA found a glaring lack of documented procedures and policies for external borrowing yet these are critical for transparency and rules-based decision making as well as for the preservation of institutional memory and to mitigate the risks of high staff turnover. A common lament heard during the assessment process was that staff was too tied up with day-to-day management issues and did not have time to produce manuals and document procedures. One way in which this situation could be rectified, with gains from economies of scale, is through cooperation and joint development on the formulation and drafting of the core components of operational manuals, documented procedures for borrowing and similarly, for operational manuals and debt reports and bulletins on public (domestic and external) debt. A regional coordinator, or possibly a short-term consultant, could be appointed to direct the process with costs shared among the beneficiaries. Once the core components are in place, ideally in an electronic format, it should require only minimal additional input, at the national level, to reflect the governance structures, legal frameworks and specific aspects of the debt portfolio of each individual small state.

***Maximizing the gains of information technology***
In a similar vein, small states should make far more effective use of the technology available to support debt management than currently appears to be the case, based on the findings of the DeMPA reports. Computer based systems to manage external and domestic debt are readily available from international agencies like the Commonwealth Secretariat and UNCTAD. These systems come with related technical support from the sponsoring agency and a wide range of associated training programs in their use and application in multiple facets of debt management. Opportunities for cooperation and information sharing among small states on the application and experience with using information technology is greatly facilitated by the fact that many of them are members of the Commonwealth and using the same debt management software – CS-DRMS: 28 of the 48 small states that are members of the World Bank are Commonwealth members including 13 of the 17 small states in the sample group.

The debt management software available from both the Commonwealth Secretariat and UNCTAD and installed in many developing countries including small states provides not only a tool for monitoring loan commitments and related transactions for both external and domestic borrowing but also includes features such as report writing, automated interface that satisfy the reporting requirements to international systems such as the World Bank Debtor Reporting System (DRS), capabilities to generate debt service projections, including the impact of future commitments, needed as input the debt sustainability analysis templates and automated calculations of portfolio risk factors.

***Realizing the benefits of staff training***

Staff training, and the associated challenge of staff retention, is high on the agenda of debt managers in small states: anecdotal evidence gathered during the course of DeMPAs suggests this is perhaps the paramount concern. Training opportunities abound with myriad international debt management and training courses and seminars on offer. A review of attendee lists[25] indicate that small states have been well represented at such events. But, follow through and application of the knowledge and skills has proved more of a challenge but where it has been rigorously pursued the payoff has been significant. The case of a debt management strategy is illustrative. It is central to minimizing the costs of the debt portfolio within prudent risk parameters yet a very large number of countries fail to produce one: the DeMPA found only 12 percent (2 out of 17) of small states and 17 percent (7 out of 42) of other developing countries met the minimum requirement of this aspect of debt management. Authorities frequently cited capacity constraints, shortage of skilled staff, and inadequate training as the reasons for this deficiency. The Gambia demonstrates what a very small and poor country can do with focused and concerted application of training. It drew on both international and regional technical assistance (TA) for a dedicated workshop on how to conduct a debt management strategy and then followed that up with a two week lock-down of staff that had benefitted from the workshop during which time they were required to produce a national debt management strategy. Sierra Leona, another small, poor country presents an example of what can be done with debt bulletins. It took advantage of training offered by TA providers to design and implement a bulletin on its public debt, and associated risks, published on the web at www.mofed.gov.sl that set a standard for coverage and quality. Some small states including Dominica, Seychelles and those attending regional workshops in the Caribbean may also soon follow suit having already received the same training as Sierra Leone.

Policymakers have an important role to play to ensure that investment in staff training benefits the country as well as the individual. Close supervision and follow up is needed to ensure that new skills acquired are applied to national debt management processes, procedures properly documented and programs for skills transfer developed. Policies should also be implemented to ensure there is an appropriate quid pro quo from staff that have benefited from training opportunities, for example penalties on staff that do not remain in situ for a prescribed period, post training.

***Widening debt managers financing options – development of domestic debt markets***

The benefits of deep and wide debt markets are well understood for smooth funding of government financing needs, broader access and diversification of funding sources and investors, matching of long-term liabilities with assets, lowering currency risks, and readily available markets for pricing, trading and off-laying risk. For small open economies the presence of deep bond markets in local currencies are particularly important as it allows them to better absorb

[25] Obtained for World Bank – DMF trainings.

volatile capital flows, provide institutional investors with instruments that satisfy their demand for safe and stable long term yields, reduces financial instability associated with asset price bubbles, and provides a reliable source of capital to fund public and private ventures under market discipline and scrutiny. In addition, fixed income securities are crucial for the efficient conduct of monetary policy especially if the central bank has to bring down inflation or maintain inflation target without a peg to a major currency.

With regard to domestic borrowing the DeMPA focuses on primary market aspects to evaluate whether market-based mechanisms are being used to issue debt. The rationale for the indicator is that borrowing activities in local currency in the domestic market—particularly in the primary wholesale or institutional market—should be transparent and predictable to provide the government with a mechanism to finance its expenditures in a cost-effective manner while minimizing the risks (DeMPA, 2009). International practice has shown that the government can benefit from providing market participants and investors with advanced notice of borrowing plans and other market activities and by acting in accordance with their stated intention when issuing new Treasury-bonds or undertaking activities such as buyback of government Treasury-bills and Treasury-bonds. This approach can lead to lower costs by providing certainty for investors, increasing liquidity, broadening the investor base, and creating a level playing field for investors. It entails the publication of a borrowing plan for Treasury bills and bonds, the preparation of an annual plan for total borrowing in local currency market and the availability and quality of procedures for such activity. On domestic debt management, the DeMPA find that small states perform moderately in using market-based mechanisms in domestic borrowing (Dimension 1) and strong on the availability and quality of documented domestic borrowing procedures (Dimension 2) (Table 3)

**Table 3: Domestic Borrowing – Assessment of Each Dimension**

| DPI 8 Domestic borrowing | Score C and above | Score D | Not rated |
|---|---|---|---|
| *Dim 1: Extent of market based mechanisms and the publication of a borrowing plan* | 1 (6%) | 12 (71%) | 4 (24%) |
| *Dim 2:Availability and quality of documented procedures* | 11 (65%) | 3 (18%) | 3 (18%) |

Source: DeMPA reports

## Common Elements in Small States That Have Helped to Develop Debt Markets

Picking up on the DeMPA findings to highlight policy options that have worked well in some small states, this section of the paper selects the development of domestic debt markets as an example for other small states to analyze. Although, developing a debt market in a regional

currency block (e.g. OECS[26] states) with a common currency and a single central bank is much easier than in a single small state without either the investor base or the fungible borrowing amounts. Below, we attempt to identify some common pre-conditions for market development, which could serve as a useful pointer for other small states planning to access domestic markets.

***Issuer*:** The most important requirement is a strong commitment from the government to engage in proactive debt management. A focused issuance program of government securities is central to build large and liquid benchmark bonds. An important step is to announce a borrowing calendar and to then adhere to it. In most of the sample small states, the decision to borrow and issue Treasury bills (or Treasury bonds) including the auction date, the tenor of issue and the amount is made by the Ministry of Finance or the debt management unit. The issuance is usually administered by the central bank or the regional central bank for those states that are part of a regional monetary union, for example Guinea Bissau or the Caribbean islands in the East Caribbean Currency Union (ECCU), see Table 4.

Table 4. Domestic Security Issuance Agency in Small States

| Issuance agency | National Ministry of Finance /Treasury | National central bank | Regional security market | Regional central bank |
|---|---|---|---|---|
| Small states in the sample | ECCU countries for local securities | Bhutan<br>Cape Verde<br>The Gambia<br>Maldives<br>Samoa<br>Solomon Islands<br>Swaziland | ECCU countries for regional securities | Guinea-Bissau |

Source: DeMPA Reports.

***Investors***: The investor base should be well diversified; ranging from long-term players (pension funds with long term liabilities) to broker-dealers, banks with need for shorter term assets. This has been an area of relative weakness across the small states because of the lack of

[26]The Organization of Eastern Caribbean States

long-term investors' viz., pension funds. The main investors have been the banks with demand for shorter duration. In general the capital market in small states is rather shallow. The investor base is dominated by commercial banks with 'buy and hold' characteristics. In the regional capital market, such as ECCU and West Africa Economic and Monetary Union (WAEMU), long term investors, mainly pension funds, have some representation, although again it is rather limited. Overall the market is illiquid and secondary trading is under developed. Financial intermediation ratios also provide a lead indication of the level of market development; small states with high $M_2$/GDP ratios indicate deeper markets compared with those at the lower range. (88.3% within ECCU compared to 22.1% in Gabon) see table 5.

Table 5. Investor Base and Market Depth in Small States

| Small states in the sample | Investor base | $M_2$/GDP (%) | Data Year |
|---|---|---|---|
| ECCU regional market | Commercial banks, pension funds, insurance companies | 88.3 | 2010 for the whole region |
| Cape Verde | Commercial banks, public pension fund and other institutional investors | 77.0 | 2011 |
| Bhutan | Commercial banks, pension fund | 68.8 | 2011 |
| Namibia | Commercial banks, public pension funds and other institutional investors | 67.8 | 2011 |
| Guyana | | 66.3 | 2010 |
| Djibouti 1/ | | 63.8 | 2009 |
| Maldives | Local and foreign commercial banks | 63.7 | 2011 |
| Samoa 1/ | | 47.4 | 2011 |
| The Gambia | Commercial banks, (to less extent) public pension fund and other insurance companies | 44.5 | 2011 |
| Solomon Islands | | 40.7 | 2011 |
| Sao Tome and Principe 1/ | | 35.8 | 2011 |
| Guinea-Bissau (WAEMU regional market) | Regional and international commercial banks and | 35.2 | 2010 for the whole |

| | institutional investors | | region |
|---|---|---|---|
| Comoros 1/ | | 34.9 | 2011 |
| Swaziland | Commercial banks | 30.4 | 2011 |
| Gabon 1/ | | 22.1 | 2011 |

1/These countries had no recent domestic issuance when DeMPA was conducted.
Source: DeMPA reports, WDI, IMF staff reports and staff calculation based on ECCU statistics.

***Instrument***: Although the preference may be for a wide array of instruments, it is better to maintain a degree of simplicity and standardization. For example issuing zero coupon bills at shorter maturities and bonds carrying semiannual coupons for longer maturities, makes it easier to lay the foundation of a yield curve and attract retail investors. Among the small states in the sample group the vast majority of instruments used were Treasury bills, with maturity ranging from one month to one year. For example, of the 223 securities issued via the Regional Government Security Market (RGSM) of the ECCU since its establishment in 2002 up to February 2011, 189, or 85 percent of total issuance, were Treasury bills with maturity of 91-, 180- or 365- days, Treasury bonds of 5-year, 7-year and 10-years have also been issued in the ECCU but in small states outside of those in the sample group[27]. The gross value of Treasury bills amounted to EC$ 3,388 million, and Treasury bonds EC$1,222 million. In 2012, 42 auctions had taken place up to end-October and 9 were scheduled for the rest of the year. Out of these 51 issues, 44 (86 percent) are Treasury bills, and 2 (4 percent) 4-year Treasury notes and 5 (10 percent) Treasury bonds. In some countries**,** such as Guyana and Samoa, longer term securities were issued in the past but the operation was discontinued due to lack of interest from market participants.

***Infrastructure***: This is an essential element that provides the enabling environment for issues in primary and secondary markets, price and market data publication, clearing and settlement systems, physical infrastructure, the legal system and the regulatory framework. As markets develop, issuance will occur further down the credit spectrum and require more transparent accounting standards, similar to the International Accounting Standards [IAS]. A flexible, interlinked and automated registry clearing and settlement system is an imperative. Within the ECCU the RGSM utilizes the platform of the Eastern Caribbean Securities Exchange (ECSE) and its subsidiaries to provide the infrastructure for the primary and secondary trading of member governments' securities, as well as a registry system. The market was established in 2002 and its settlement, clearance and registry system are fully electronic. The instruments on the market include Treasury bills and bonds, with maturity ranging from 91- days to 10- years.

[27] St. Lucia and St. Vincent and the Grenadines government have issued T-bonds with maturity up to 10 years in regional market.

The issuance takes the form of a uniform price auction and settlement takes place at T+1. The securities issued on the market are open to all potential investors, however only licensed brokers (intermediaries) are allowed to bid. The regional central bank BCEAO functions in a similar way, acting as the debt management agent for member countries within the West Africa Economic and Monetary Union (WAEMU). It provides the platform for issuing and trading government securities, mainly Treasury bills, as well as the registry system.

***Incentives*: T**hese provide the catalyst for building and sustaining a vibrant capital market relies on the commitment of long-term stakeholders. The central banks/debt management offices can provide focal points for market development but market makers, in their capacity as liquidity providers, are essential to ensure an active secondary market, particularly during any potential primary market issuance hiatus. There are strong incentives for commercial banks holding government securities in WAEMU for example: interest earned on these securities are tax exempt; such securities give better remuneration than reserves in the regional central bank which earn zero interest; they carry zero risk weight in calculating capital adequacy ratio; and can be refinanced by the central bank to get liquidity.

***Legal and regulatory environment***: Apart from financial inducements and incentives, a proper legal and regulatory infrastructure is necessary to provide incentives to financial institutions to conduct business in a developing financial market. The adoption of rules in line with best international practices is a key to attracting funds; and enforcement mechanisms that are independent of outside influence are equally important. Within the sample group most states (15 out of 17) have clear legal authorization to borrow from domestic markets and the specified purposes for borrowings are also enshrined in legislation (12 out of 17).

Operations in the domestic primary market should be transparent and predictable with borrowing plans published well in advance for issuing new securities in the wholesale market. The rules should apply regardless of the mechanism used for borrowing. In the context of market development the ECCU states and the platform provided by the RGSM provide a good example of how this process can work well in practice. The ECCB acts as fiscal agent to member governments, with responsibilities to provide advice and to facilitate operations on the RGSM for each member government. For the RGSM a yearly issuance calendar is prepared, based on the governments' financing needs, and published on the websites of both the RGSM and ECCB. The calendar, updated monthly, includes information on issuance date, the issue government, tenor and issue amount and is broadly adhered to. For many small states however, setting out a borrowing plan is still not common practice. Only one small state in the sample group meet the minimum requirement, i.e. 90 percent of domestic borrowings is market based and a borrowing plan prepared and published one month ahead (Table 3). The decision to issue Treasury bills is most often based on the government's short term cash need and an announcement to the market of the issuance may be made only a few days before the actual issue date. This approach runs

contrary to the investor demand for predictability and most often the sovereign ends up borrowing at much higher costs.

**Conclusion**

Policymakers in small states are fully cognizant of the risks posed by poor debt management and the costs that high public debt burdens place on the state's resources. At the Small States Forum held in Antigua and Barbuda in 2007 participating states committed to fiscal targets aimed at reducing public debt ratios and drew up an action plan to improve debt management capacity. It prioritized:

- Improving the collection and reporting of government financial statistics;
- Developing more liquid domestic debt markets and broadening the investor base;
- Implementing institutional arrangement to support active debt management and coordination with fiscal and monetary policy.

Like action plans, DeMPA exercises are not a "one-off exercise", or an end in itself. They mark the start of the reform process and can only point the way and provide a roadmap to: (a) guide national authorities in the formulation of more robust debt management practices; (b) highlight areas where policy changes are required; and (c) monitor performance over time against internationally recognized benchmarks. As indicated they are also a rich source of information on how different countries have approached the challenge of instituting sound debt management policies and practices from which others may draw.

## Annex 1. Summary of DeMPA

| Performance Indicator | |
|---|---|
| **Governance and Strategy Development** | |
| DPI-1 | 1. Legal Framework |
| DPI-2 | 1. Managerial Structure: Borrowing and Debt-Related Transactions |
| | 2. Managerial Structure: Loan Guarantees |
| DPI-3 | 1. Debt Management Strategy: Quality of Content |
| | 2. Debt Management Strategy: Decision-Making Process |
| DPI-4 | 1. Evaluation of Debt Management Operations |
| DPI-5 | 1. Audit: Frequency |
| | 2. Audit: Appropriate Response |
| **Coordination with Macroeconomic Policies** | |
| DPI-6 | 1. Fiscal Policy: Provision and Quality of Debt-Service Forecasts |
| | 2. Fiscal Policy: Availability and Quality of Information on Key Macro Variables and DSA |
| DPI-7 | 1. Monetary Policy: Clarity of Separation between DeM and Monetary Policy Operations |
| | 2. Monetary Policy: Regularity of Information Sharing |
| | 3. Monetary Policy: Limited Access to Central Bank Financing |
| **Borrowing and Related Financing Activities** | |
| DPI-8 | 1. Domestic Borrowing: Market-Based Mechanisms and Preparation of a Borrowing Plan |
| | 2. Domestic Borrowing: Availability and Quality of Documented Procedures |
| DPI-9 | 1. External Borrowing: Borrowing Plan and Assessment of Costs and Terms |
| | 2. External Borrowing: Availability of Documented Procedures |
| | 3. External Borrowing: Involvement of Legal Advisers |
| DPI-10 | 1. Loan Guarantees: Availability and Quality of Documented Policies and Procedures |
| | 2. On-lending: Availability and Quality of Documented Policies and Procedures |
| | 3. Derivatives: Availability and Quality of Documented Policies and Procedures |
| **Cash Flow Forecasting and Cash Balance Management** | |
| DPI-11 | 1. Effective Cash Flow Forecasting |
| | 2. Effective Cash Balance Management |
| **Operational Risk Management** | |
| DPI-12 | 1. Debt Administration: Availability and Quality of Documented Procedures for Debt Service |
| | 2. Debt Administration: Availability and Quality of Documented Procedures for Data Recording and Storage |
| | 3. Data Security: Availability and Quality of Documented Procedures for Data Recording and System and Access Control |
| | 4. Data Security: Frequency of Back-Ups and Security of Storage |
| DPI-13 | 1. Segregation of Duties |
| | 2. Staff Capacity and Human Resource Management |
| | 3. Operational Risk Management, Business Continuity, and Disaster Recovery Plans |
| **Debt Records and Reporting** | |
| DPI-14 | 1. Debt Records: Completeness and Timeliness |
| | 2. Debt Records: Registry System |
| DPI-15 | 1. Central Government Debt Data: Statutory and Mandatory Reporting Requirements |
| | 2. Public Sector Debt Data: Statutory and Mandatory Reporting Requirements |
| | 3. Debt Statistical Bulletin: Quality and Timeliness |