

THE EMERGING DEBT PROBLEMS OF SMALL STATES

**A Preliminary Paper by Dinesh Dodhia* to the
Commonwealth Finance Ministers' Meeting**

Commonwealth Secretariat
Marlborough House
London SW1Y 5HX

August 2005

* Prepared by Dinesh Dodhia, Rappidd Consultancy Ltd, for the Economic Affairs Division. Interpretation of data and views expressed in the paper are those of the author and do not necessarily reflect the official view of the Secretariat.

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EXECUTIVE SUMMARY

While the international attention has been focused on the debt problems of major debtors as well as HIPCs, there has been little international recognition and therefore attention to the growing debt problems of small states, vast majority of which are middle income countries. Since 1990 small states' rate of accumulation of external debt has been much faster than that of low income countries, with the sharpest increases registered among the members of the Organization of East Caribbean States (OECS)/East Caribbean Central Bank (ECCB) and Belize. Moreover, since 1999 rate of external debt accumulation in small states has been more than twice as fast as that of developing countries as a whole, and is the reverse of the situation in the 1990s when developing countries were accumulating external debt at twice the rate of small states

In 2003 four small states- Belize, Dominica, St Kitts and Nevis and Samoa had external debt to Gross National Income ratios exceeding 100 per cent, while a further six, Grenada, Solomon Islands, PNG, Seychelles as well as Antigua and Barbuda and Marshall Islands had ratios over 75 per cent. According to World Bank definitions using Net Present Value (NPV) of external debt thresholds, eight are severely indebted, including Bhutan, Belize, Dominica, Gabon, Grenada, Samoa, Seychelles and St. Kitts and Nevis, while a further seven PNG, Solomon Islands, Cape Verde, Jamaica, Mauritius, St Lucia and St Vincent and Grenadines are moderately indebted.

Governments, and indeed the public sector at large, not only have to service their external debt obligations, but all their debt obligations, including those contracted domestically. But data on total public indebtedness is weak especially in the Pacific and African small states. In the Caribbean, in 2003 Antigua and Barbuda, St Kitts and Nevis and Jamaica had total public debt to GDP ratios in excess of 140 per cent; Dominica and Grenada in excess of 100 per cent; Barbados and Belize in excess of 80 per cent; and St Lucia and St Vincent and the Grenadines in excess of 60 per cent, which is used as a benchmark ratio by the ECCB.

A number of factors, some of which peculiar to the characteristics of small states, are responsible for rising debt indicators in many such states. There has been a significant slowdown in growth, especially in the Caribbean, following decline in traditional exports following the erosion of preferences as well as a decline in private investment in tourism as the industry matures and faces competition from other destinations. Growth rates have also been highly volatile as a result of shocks arising from natural disasters (hurricanes), impact of September 11 terrorist attacks, and domestic conflicts. Slow and volatile growth has impacted adversely on government revenues, while expenditures have continued or increased, especially for public investment, to maintain or boost growth or to rebuild infrastructure following natural disasters and other shocks. At the same time, rising fiscal deficits have been financed on hard terms, both externally and domestically, as concessional flows have declined.

Current approaches to deal with the debt problems of small states call for significant fiscal adjustment, accompanied by growth enhancing measures, and in some cases by debt

restructuring. These fiscal and other reform efforts are either taken as part IMF programmes or by the countries themselves. IMF Poverty Reduction and Growth Facility (PRGF) programmes are currently in place only for Dominica and Cape Verde among the small states. In all other cases, IMF has sought to influence policy through its Article IV Consultations which generally include forward looking public sector and external Debt Sustainability Analysis (DSAs). While such DSAs in many cases show rising and unsustainable debt ratios on current policies and the need for fiscal adjustment, there are questions about the size and pace of adjustment and sustainability of fiscal retrenchment over a prolonged period of time. There is resistance to debt restructuring in some countries, while in others there are also problems of carrying out such restructuring. This is because a large proportion of debt may be owed to non-Paris Club creditors and domestic and regional creditors, while the Paris Club provides debt reduction to non-HIPCs only in exceptional circumstances. DSAs also show that debt sustainability can easily be blown off course by shocks, which tend to hit these economies persistently.

The paper suggests a framework within which small states' debt and other economic problems can be addressed. Such a framework should include:

- Fiscal discipline in small states themselves, underpinned as appropriate by IMF programmes or fiscal responsibility laws;
- Debt restructuring that provides significant debt reduction on an NPV basis, in all appropriate cases;
- Grant financing and insurance mechanisms that respond to the reconstruction and rehabilitation needs following natural disasters in small states, without adding to their debt burden;
- Continued grant and concessional financing for small states, particularly ensuring that this support is not rapidly withdrawn;
- Improved debt recording and debt management in small states;
- Support for the efforts of small states to promote private investment for diversification and growth, and by implication their debt carrying capacity; in particular international support for mitigating their endowed handicaps and lowering the threshold for private investors to ensure a level playing field for small states.

Next Steps

This is only a preliminary paper which has described the nature of the emerging debt problem of small states including the reasons for the problem, based on the data available as of June 2005. Data and information presented here would no doubt benefit from the latest information from the countries themselves and in particular from updated data and other information from small states which have not made IMF Article IV Reports public. It should also be possible to make quantitative assessment of the various factors contributing to the rise in the debt of as many small states as possible. There is also a need to make a more considered assessment of how high levels may be impacting on private investment in small states.

The paper has presented a framework for dealing with the debt problems of small states and much greater elaboration of the various possibilities need to be explored, including by consultations with various governments and institutions. The final paper would need to include much greater focus on solutions rather than the problem itself.

1. INTRODUCTION

1.1. Attention to debt problems of major debtors and HIPCs, but not small states

Ever since the outbreak of the Mexican debt crisis in 1982, which engulfed other major debtors, and which was seen as a threat to the stability of the international financial and banking system, world attention has been focused on the debt problems of these countries. Following a number of initiatives, in 1989, there was explicit recognition, under the Brady Plan, of the need to deal with the commercial bank debt overhang problem through debt or debt service reduction under a menu of options. In the 1990s following a period of capital surges, mostly in the form of portfolio investment, and sudden reversals, the international community recognized the need for quick rescue packages and for prevention of contagion. With a shift to bond financing and the complications this causes in effective sovereign debt workouts, the need for collective action clauses in new bond contracts to cover contingency of debt restructuring have also been recognized and are increasingly being introduced.

The international community was slow to recognize the external debt problems of poor countries, which owed most of their debt to official creditors and mostly on concessional terms. However, from 1988 the Paris Club gradually moved to provide debt reduction, which resulted in 1994 in the Naples terms providing 67 per cent reduction of eligible Paris Club debt stock on a net present value (NPV) basis. But the inadequacies of these measures, especially the problem of the considerable proportion of debt owed to multilateral institutions, led to the launch of the Heavily Indebted Poor Countries (HIPC) Initiative in 1996 and its subsequent enhancement in 1999. Eighteen countries have so far completed the HIPC process, while a further nine countries are in the process, yet to reach completion. These twenty seven countries will have their total external debt on a NPV basis reduced by about two-thirds. A further eleven countries, which are potential HIPCs, have yet to start the process. Inadequacies of even these measures has led to further proposals, and an agreement among the Group of Eight (G8) to provide up to 100 per cent debt reduction on debt owed to the IMF, IDA and AfDF to match those provided by bilateral Paris Club creditors. Full details are to finalized at the Autumn 2005 IMF/World Bank Annual Meetings

While the international attention has been focused on the debt problems of major debtors as well as HIPCs, there has been little recognition and therefore attention to the growing debt problems of small states, vast majority of which are middle income countries. The purpose of this paper is to highlight the nature of this problem and the need for international action to deal with it. But it is important first to define what is meant by small states.

1.2. Defining small states

Size is a relative concept so that there is no single definition of a small state. Population, territory size and GDP are often used as defining criteria, but as population is highly correlated with the other two criteria, it is often used as an indicator of size, highlighting small states' limited resources. At the same time, there is no special significance in the selection of a particular population threshold to define small states. The Commonwealth, in its work on small states, uses a hreshold of 1.5 million people¹. On this definition, 45 developing countries are small, accounting for nearly one third of the total number of

¹ This definition of size was agreed by the Commonwealth Advisory Group in producing its report, *A Future for Small States: Overcoming Vulnerability*, Commonwealth Advisory Group, 1997.

developing countries. They are home to 20 million people, less than 0.4 percent of the total population of developing countries. They range in size from "micro-states" like Niue, Tuvalu, Nauru, Palau, and Cook Islands (with fewer than 20,000 people each) to Gabon, The Gambia, Guinea-Bissau, Mauritius, and Swaziland (with more than 1 million people each) (see Table 1).

The per capita GNP in these countries also ranges widely. They include several African countries with per capita income of less than \$400- Comoros, The Gambia, Guinea-Bissau, and Sao Tome and Principe. At the other extreme, there are some high countries with per capita incomes over US\$9,000 such as The Bahamas, Bahrain, Barbados, Brunei, Cyprus, Malta, and Qatar). In between are the vast majority of small states, which are essentially middle income (see Table 1).

In considering the debt problems of small states, the following adjustments to the list of small states, has been made:

- The list specifically excludes small states which have benefited or will benefit from deep debt relief under the HIPC Initiative. These include all four countries mentioned above with per capita incomes below \$400 as well as Guyana
- Members of the European Union (Cyprus, Estonia and Malta) as well as oil producers: Bahrain, Brunei and Qatar, are also excluded from consideration. All of these countries (except Estonia) are high income countries, which the World Bank does not include in its definition of developing countries.
- For want of data, particularly not being members of the IMF and the World Bank and therefore their data systems, some micro states such as Cook Islands, Nauru, Niue and Tuvalu, are also excluded from analysis. At the same time, there are a number of other small states which do not report to the World Bank's Debtor Reporting System and consideration of these states is only included as far as it is possible to use IMF data.
- The Commonwealth has made some exceptions to the rule of defining small states and included countries with populations above 1.5 million such as Botswana, Jamaica, Lesotho, Namibia, Papua New Guinea, as they share some of the characteristics of small states. These states have therefore been included in the analysis as far as possible. However given these countries' relatively larger debt levels or GNP and the distortions these may cause to aggregate numbers, the aggregates have often been used excluding these countries to give a more accurate picture of the trends in small states. Trinidad and Tobago, an oil producer, which technically falls within the 1.5 million population criteria, but which is more of a creditor than a debtor, is also excluded from aggregates for similar reasons.

Table 1: Small States by Population Size and Per capita Income

Rank by smallness		Population	Per Capita Income	Remarks
1	Niue	2	..	IMF/World Bank Non-Member
2	Tuvalu	11	1,150	IMF/World Bank Non-Member
3	Nauru	11	..	IMF/World Bank Non-Member
4	Palau	19	..	Not reporting to WB DRS
5	Cook Islands	20	..	IMF/World Bank Non-Member
6	St. Kitts & Nevis	41	6,570	
7	Marshall Islands	52	1,970	Not reporting to WB DRS
8	Antigua & Barbuda	68	9,440	Not reporting to WB DRS
9	Dominica	73	..	
10	Seychelles	81	7,050	
11	Kiribati	96	950	
12	Grenada	98	3,770	
13	Tonga	100	1,660	
14	St. Vincent & Gren.	115	2,720	
15	Micronesia,Fed.Sts.	118	2,110	Not reporting to WB DRS
16	São Tomé & Prin.	148	290	HIPC
17	St. Lucia	156	4,120	
18	Samoa	170	1,450	
19	Vanuatu	197	1,150	
20	Belize	240	3,110	
21	Barbados	267	9,250	
22	Maldives	276	1,960	
23	Bahamas, The	303	14,960	Not reporting to WB DRS
24	Brunei	338	..	High Income Oil Producer
25	Malta	390	9,120	EU Member High Income Country
26	Suriname	417	1,890	Not reporting to WB DRS
27	Cape Verde	441	1,330	
28	Solomon Islands	447	620	
29	Equatorial Guinea	457	800	
30	Comoros	558	380	HIPC
31	Qatar	585	..	High Income Oil Producer
32	Djibouti	632	880	
33	Bahrain	691	..	High Income Oil Producer
34	Cyprus	757	12,370	EU Member High Income Country
35	Guyana	761	860	HIPC
36	Timor-Leste	800	..	Not reporting to WB DRS
37	Bhutan	805	590	
38	Fiji	812	1,820	
39	Swaziland	1,045	1,390	
40	Mauritius	1,186	3,750	
41	Guinea-Bissau	1,199	180	HIPC
42	Gabon	1,230	3,190	
43	Trinidad & Tobago	1,301	4,930	
44	Gambia, The	1,303	340	HIPC
45	Estonia	1,369	3,580	EU Member

2. TRENDS IN DEBT INDICATORS OF SMALL STATES

2.1. External Debt

For the 26 small states for which data is available in the World Bank's Global Development Finance (GDF) (see Table 2), external debt in aggregate increased by about 1.6 per cent per annum in the 1990s, but this rate accelerated to 5.6 per cent per annum between 1999 and 2003, with the debt stock reaching \$25.6 billion in 2003. If Jamaica, Papua New Guinea, Botswana and Lesotho as well as Trinidad and Tobago are excluded, the aggregate debt for the remaining 21 countries increased by 3.2 per cent per annum in the 1990s, accelerating to 6.2 per cent per annum in 1999-2003. This latter rate of accumulation is more than twice as fast as that of developing countries, and is the reverse of the situation in the 1990s when developing countries as a whole were accumulating debt at twice the rate of small states. It should also be noted that throughout the period small states' rate of accumulation of external debt is much faster than that of low income countries.

The sharpest increases in external indebtedness between 1990 and 2003 have been registered in the Caribbean, especially among the members of the Organization of East Caribbean States (OECS)/East Caribbean Currency Union (ECCU) and Belize. Belize, St. Kitts and Nevis, St Lucia and St Vincent and the Grenadines saw their debts increase at an annual rate of between 10-14 per cent in the 1990s, and rates accelerated sharply for the first three between 1999 and 2003. The first two as well as Dominica and Grenada, both of which saw only moderate increases in debt in the 1990s, expanded their external indebtedness at the rate of between 22 and 29 per cent per annum during 1999-2003. In fact, external debt stocks of Belize and St Kitts and Nevis are almost seven times as large as those in 1990. Antigua and Barbuda, an OECS high income member not included in the World Bank GDF, also saw significant increases in its indebtedness during 1999-2003.

Among other Caribbean states, in Barbados, Trinidad and Tobago and Jamaica, there was a significant external debt accumulation at the annual rate of between 9-15 per cent in the 1980s. During the 1990s, however adjustment resulted in significant debt stock declines in Barbados and Jamaica, and marginal growth in Trinidad and Tobago. Both Barbados and Jamaica have since seen their external debt levels increase significantly during 1999-2003 at the annual rate of about 13 and 9 per cent.

In the South Pacific, between 1990 and 2003, Samoa has seen its external debt almost quadruple, with over 17 per cent per annum growth in 1999-2003. Vanuatu has similarly seen debt stocks increase two and a half times, with nearly 10 percent annual growth in 1999-2003. Tonga's external debt accumulation has also accelerated, but remains relatively modest at 5 per cent in recent years, while that in the Solomon Islands, which was over 20 per cent in the 1980s, has stabilized at around 3 per cent. Fiji, after the annual declines about 6 per cent in the 1990s, has seen a modest 3 per cent accumulation during 1999-2003. PNG, by contrast, which experienced large debt stock increases in the 1980s, have since seen these stocks stagnate or decline. Among other Pacific small states, not included in the GDF, both Kiribati and Palau have significant increases in debt over 1999-2003 although those of Marshall Islands and Micronesia have fallen.

In Africa, the Seychelles has seen the sharpest acceleration in rate of external debt accumulation (21 per cent in the recent period) compared to less than 4 per cent in the 1990s.

Cape Verde has been accumulating external debt at over 10 per cent between 1990 and 2003, while the rates of accumulation have also accelerated significantly in Djibouti and Swaziland, and to a lesser extent Mauritius and Equatorial Guinea. By contrast recent debt accumulation has been marginal in Lesotho and debt stocks have been stagnant or falling in Botswana and Gabon, in the latter from a very high level.

In South Asia, whereas Bhutan's debt has more than quintupled between 1990 and 2003, with sharp increases of over 23 per cent annually in the recent period. Maldives, which was accumulating debt at around 12 per cent per annum in the 1980s and 1990s, has seen this rate halve in the recent period.

Table 2: Small States: Debt Stock Increases and Debt Exports and GNI Indicators, 1990-2003

	1980	Total Debt Stock (EDT)			Avg Annual Increase (%)			EDT/GNI			EDT/XGS		
		1990	1999	2003	1980-1990	1990-1999	1999-2003	1990	1999	2003	1990	1999	2003
OECS													
Dominica	..	88	118	294	n/a	3.3	25.6	54.5	48.6	123.1	5.6	6.7	14.6
Grenada	20	111	136	376	18.7	2.3	28.9	53.0	38.6	96.8	3.1	5.3	18.0
St. Kitts & Nevis	..	45	138	310	n/a	13.3	22.4	29.3	49.9	103.7	2.9	11.2	34.9
St. Lucia	..	79	196	368	n/a	10.6	17.1	21.4	31.1	57.2	2.1	5.2	8.7
St. Vincent & Gren.	11	61	194	230	18.7	13.7	4.3	32.6	62.5	64.5	2.9	8.1	..
Antigua & Barbuda	..	..	416	570	..	..	..	..	63.8	75.0	..	..	..
Other Caribbean													
Barbados	166	683	444	721	15.2	-4.7	12.9	40.2	18.5	28.7	15.1	6.2	5.2
Belize	63	154	392	1058	9.3	10.9	28.2	37.9	56.6	117.7	7.5	11.5	24.4
Jamaica	1913	4746	3912	5584	9.5	-2.1	9.3	114.2	52.8	74.2	26.9	13.9	16.5
Trinidad & Tobago	829	2511	2612	2751	11.7	0.4	1.3	53.7	40.8	27.1	19.3	13.2	4.1
Bahamas, The	..	..	..	..	..	..	..	..	8	9.8	..	..	..
Surinam	..	..	..	..	..	..	..	..	46.8	39.5	..	..	..
Pacific													
Fiji	281	403	233	264	3.7	-5.9	3.2	30.8	12.7	13.5	12	3.4	..
Papua New Guinea	719	2594	2695	2463	13.7	0.4	-2.2	83.7	70.4	89.9	37.2	9.7	11.9
Samoa	60	92	192	365	4.4	8.5	17.4	56.0	81.9	138.0	5.8	5.1	..
Solomon Islands	19	121	165	186	20.3	3.5	3.0	58.1	46.4	75.1	11.8	4.8	..
Tonga	..	54	69	84	..	2.8	5.0	46.2	43.2	52.2	..	..	..
Vanuatu	..	38	66	95	..	6.3	9.5	23.5	28.7	33.9	2.1	1	1.5
Kiribati	..	..	8	16	..	..	16.9	..	9.2	17.3	..	..	..
Marshall Islands	..	..	99	91	..	..	-2.0	..	101.8	86.5	..	..	..
Micronesia	..	..	84	59	..	..	-8.5	..	42.8	25.2	..	..	..
Palau	..	..	1	19	..	..	92.9	..	1.3	14.8	..	..	..
Africa													
Botswana	136	553	504	514	15.1	-1.0	0.5	15.0	10.6	7.1	4.3	2.2	1.3
Cape Verde	..	134	327	480	..	10.4	10.1	39.3	56.9	61.2	4.8	9.5	5.7

Djibouti	32	205	275	396	20.4	3.3	9.5	..	50.1	61.8	..	..	..
Equatorial Guinea	76												
Gabon	1514	3983	3982	3792	10.2	0.0	-1.2	74.6	104.5	72.8	6.4	18.7	..
Lesotho	72	396	682	706	18.6	6.2	0.9	38.7	59.0	51.2	4.2	10.1	8.8
Mauritius	467	984	1847	2550	7.7	7.2	8.4	41.6	44.5	48.8	8.8	7.1	7.2
Seychelles	84	183	254	548	8.1	3.7	21.2	51.5	42.5	80.8	9	6.2	14
Swaziland	206	243	301	400	1.7	2.4	7.4	26.4	21.3	21.1	5.7	3.1	1.6
Namibia	..	..	794	817	..	..	0.7	..	23.0	17.5	..	..	..
South Asia													
Bhutan	..	84	184	422	n/a	9.1	23.1	31.4	49.2	72.2	5.5	5.4	..
Maldives	26	78	219	281	11.6	12.2	6.4	40.2	39.2	41.3	4.8	4	3.6
Total 1)		18864	21810	27128	..	1.6	5.6	..	..	..	..	..	..
Adj. Total 2)		10575	14017	17861	..	3.2	6.2	..	..	..	..	..	..
Developing Countries		1337033	2346638	2597062	..	6.4	2.6	..	..	..	..	..	..
Low Income		341580	397023	424472	..	1.7	1.7	..	..	..	..	..	..

Source: World Bank, Global Development Finance, 2005; IMF Article 4 Reports for data on Antigua and Barbuda, Bahamas, Kiribati, Marshall Islands, Micronesia, Palau and Namibia

1) All countries from the World Bank GDF data, ie excluding countries with data from Article 4 reports.

2) Excluding Jamaica, PNG, Botswana, Lesotho and Trinidad and Tobago

EDT= Total Debt Stock, GNI= Gross National Income, XGS= Exports of Goods and Services

The overall debt levels (EDT) are meaningless unless they are measured against the capacity for, or the cost of, servicing debt in terms of, for example, foreign exchange or output forgone. In the World Bank's GDF, total external debt is measured against the exports of goods and services, including workers' remittances (XGS) and the gross national income (GNI). Table 2 shows that most countries experiencing sharp increases in debt levels have also seen their EDT/XGS and EDT/GNI ratios increase very sharply, as GNI or XGS has far lagged behind the external debt growth. In the case of OECS/ECCB members, Belize, Samoa and Bhutan EDT/GNI ratios have more than doubled or tripled. In 2003 four small states- Belize, Dominica, St Kitts and Nevis and Samoa had EDT/GNI ratios exceeding 100 per cent; a further six, Grenada, Solomon Islands, PNG, Seychelles as well as Antigua and Barbuda and Marshall Islands had ratios over 75 per cent; and another seven, St Lucia, St Vincent and Grenadines, Tonga, Cape Verde, Djibouti, Gabon and Lesotho, were with ratios over 50 per cent.

In defining the severity of the external indebtedness problems, the World Bank uses the NPV rather the nominal value of debt. This is meant to adjust for the concessional terms of some debt owed to some official creditors, but is also useful to capture debt terms which are harder than normal market terms. In order to avoid yearly distortions, for the denominator the Bank uses three year (2001-2003) averages. It defines severely indebted as those countries with NPV/ XGS ratios above 220 per cent or those with NPV/GNI ratios above 80 per cent. On this definition, of the 26 countries listed in Table 2 above, eight are severely indebted, including Bhutan, Belize, Dominica, Gabon, Grenada, Samoa, Seychelles and St. Kitts and Nevis (see Table 3). Moderately indebted countries are defined as those with NPV/XGS ratios between 132 and 220 per cent or NPV/GNI ratios between 48 and 80 per cent. Under this definition, PNG, Solomon Islands, Cape Verde, Jamaica, Mauritius, St Lucia and St Vincent and Grenadines are moderately indebted. It should however be noted that debt and debt service figures for 2003 do not necessarily reflect the most recent changes. It is also not

clear why Maldives and Vanuatu have been included respectively as severely and moderately indebted.

The liquidity problems facing the severely indebted small states are also exhibited by their high debt service ratios (measured by total debt service- TDS- divided by XGS), which in the case of Belize and St Kitts exceed over 25 per cent and are in double figures for Dominica, Grenada, Gabon and Seychelles. Even among some moderately indebted small states, such as PNG, Jamaica and Solomon Islands, debt service ratios are in double figures. Also, the liquidity problems facing some of these countries may be understated as total debt service paid may not reflect scheduled payments. A number of countries remain in significant arrears, such as Cape Verde, Equatorial Guinea, Gabon, Grenada, Jamaica and Seychelles. At the same time in some countries, such as Samoa, short term debt as a proportion of total debt has risen very sharply, accounting for over one half in 2003.

Table 3: Classification of Small States with severity of External Indebtedness

	EDT/XGS	NPV/XGS	EDT/GNI	NPV/GNI	DS/XGS	IS/XGS
Severely Indebted						
Belize	206	241	125	146	26	13
Samoa	253	209	148	122	9	6
Dominica	243	234	123	119	14	7
St Kitts and Nevis	210	212	102	103	29	14
Grenada	205	190	99	92	17	10
Gabon	111	114	87	89	11	4
Seychelles	100	103	87	89	14	3
Bhutan	270	252	79	74	5	1
<i>Maldives</i>	<i>54</i>	<i>41</i>	<i>45</i>	<i>35</i>	<i>4</i>	<i>1</i>
Moderately Indebted						
PNG	113	104	87	80	14	3
Jamaica	119	131	73	80	18	7
Solomon Islands	224	176	76	60	11	5
St Lucia	106	104	59	58	9	5
St Vincent & Grenadines	128	107	67	56	8	3
Mauritius	83	81	54	52	8	3
Cape Verde	156	107	74	51	7	2
<i>Vanuatu</i>	<i>64</i>	<i>46</i>	<i>39</i>	<i>28</i>	<i>1</i>	<i>1</i>
Less Indebted						
Lesotho	112	80	66	47	11	2
Djibouti	141	95	65	44	6	1
Tonga	106	74	57	40	5	1
Trinidad and Tobago	52	59	31	35	5	3
Barbados	47	53	29	33	5	3
Swaziland	28	28	27	26	2	1
Fiji	25	24	15	15	3	1
Botswana	16	13	9	8	2	0
Equatorial Guinea	15	13	..	..	..	..

Source: World Bank, Global Development Finance, 2005

NPV=Net Present Value of Total Debt, DS=Debt Service, IS= Interest Service; all other symbols as per Table 2. The numerator figure refers to 2003 and denominator 2001-2003 average.

2.2. Total Public Sector Indebtedness

Governments, and indeed the public sector at large, not only have to service their external debt obligations, but all their debt obligations, including those contracted domestically. It is therefore important not only to look at large proportion of debt may be owed to non-Paris Club creditors and domestic and regional creditors the external debt indicators, but indicators that include total public sector debt.

Data on total public indebtedness of countries is largely found in the IMF Article IV Consultation reports, but in a number of countries, especially in the Pacific and Africa, data on domestic debt is weak, and hence not included in these reports. Also some countries do not make Article IV reports public. It is therefore not easy to provide a comprehensive picture on total indebtedness of governments in all small states. It should also be noted that the data from the IMF sources on external debt may not necessarily match with that provided in the World Bank Debt reporting System.

In the Caribbean, where the data is generally good, in 2003 Antigua and Barbuda, St Kitts and Nevis and Jamaica had total public debt to GDP ratios in excess of 140 per cent; Dominica and Grenada in excess of 100 per cent; Barbados and Belize in excess of 80 per cent; and St Lucia and St Vincent and the Grenadines in excess of 60 per cent, which is used as a benchmark ratio by the ECCB (see Table 4). In practically all the OECS/ECCB states public debt to GDP ratios have risen sharply in the recent period, with not only a significant rise in external debt ratios but also domestic debt ratios, which reached, for example 67 per cent in Antigua and Barbuda in 2003. Jamaica has had for a long time high total public debt ratios, with domestic debt ratios hovering around 50 per cent. The Bahamas, Barbados and Trinidad and Tobago with relatively low ratios of external debt, also raise significant amount of resources domestically. Belize by contrast relies mostly on external resources.

In the Pacific, total public or total central government (CG) debt ratios are only available for three countries. In the Solomon Islands CG debt ratio rose sharply to about 100 per cent in 2003, while in Vanuatu and PNG these ratios have remained under 60 per cent. In all cases domestic debt ratios have remained broadly stable. In Africa, data is available for only four countries (Mauritius, Botswana, Lesotho and Namibia). Only Mauritius has public debt ratios in excess of the 60 per cent, while in Botswana, it remains very low at around 14 per cent. No data is available for Bhutan and the Maldives in South Asia.

Table 4: Small States: Total Public Debt Indicators (as % of GDP)

	Total Public Debt			Central Govt Debt			External Debt			Domestic Debt		
	1999	2003	2004	1999	2003	2004	1999	2003	2004	1999	2003	2004
OECS												
Antigua & Barbuda	..	141.8	133.5	107.6	134.1	126.0	63.8	75.0	71.9		66.8	61.6
Dominica	76.8	122.0	115.0				53.7	87.4	76.1	23.1	34.6	38.9
Grenada	56.2 (a)	110.0	129.4									
St. Kitts & Nevis	99.6	157.5										
St. Lucia	38.9	64.7	69.9	26.5	55.6		25.4	47.6	48.2	13.5	17.1	21.7
St. Vincent & Gren.	65.8	73.2										

Other Caribbean														
Bahamas, The	43.2	48.9		33.1	38.1		8.0	9.8		35.2	38.1			
Barbados	73.3 (a)	84.1	83.8	63.4	(a)	75.2	74.1	22.5(a)	26.1	25.8	50.8	58.0	58.1	
Belize	53.1	92.2	89.2					48.3	85.7		4.8	6.4		
Surinam	54.3 (a)	52.3	48.7					46.8(a)	39.5	34.5	7.6 (a)	12.8	14.3	
Trinidad & Tobago	65.1	54.2	46.4											
Jamaica	132.1 c)	144.8	136	126.4	c)	138.2	130.6	79.0 c)	87.3	83.5	47.3 c)	50.9	47.1	
Pacific														
Fiji								14.0	12.2	10.9				
Kiribati														
Marshall Islands														
Micronesia														
Palau														
Samoa								66.1	53.9	50.2				
Solomon Islands				62.5	100.2	92.5		39.3	72.6	66.1	23.1	27.6	26.4	
Tonga								39.0	44.6					
Vanuatu	35.4 (a)	41.0	38.0					28.2	28.8	26.9	7.2	12.2	11.1	
Papua New Guinea				58.2	(a)	63	58	39.3	(a)	38.6	32.2	19.6(a)	24.6	26.2
Africa														
Cape Verde														
Djibouti														
Equatorial Guinea														
Gabon														
Mauritius	65.8	72.8												
Seychelles														
Swaziland														
Botswana	10.3	14.7	13.4											
Lesotho		57.8	54.0						47.0	45.2		12.9	10.8	
Namibia	34.1(a)	41.2	39.6	24.3	30.9	30.1								
South Asia														
Bhutan														
Maldives														

Source: IMF Article 4 Reports

3. FACTORS RESPONSIBLE FOR RISING DEBT INDICATORS IN SMALL STATES

A number of factors, some of which peculiar to the characteristics of small states, are responsible for their rising debt indicators in many such states. In summary these are:

- Slowdown and high volatility in GDP growth following decline in traditional exports and private investment and particularly as a result of shocks arising from natural disasters (hurricanes), impact of September 11 terrorist attacks, and domestic conflicts.

- Impact on public finances, of slow and volatile growth, and government programmes of public investment to maintain or boost growth or rebuild infrastructure following natural disasters and other shocks (i.e. rising fiscal deficits)
- Increased financing of fiscal deficits on non-concessional (hard) terms

3.1. Low Growth and Volatile GDP

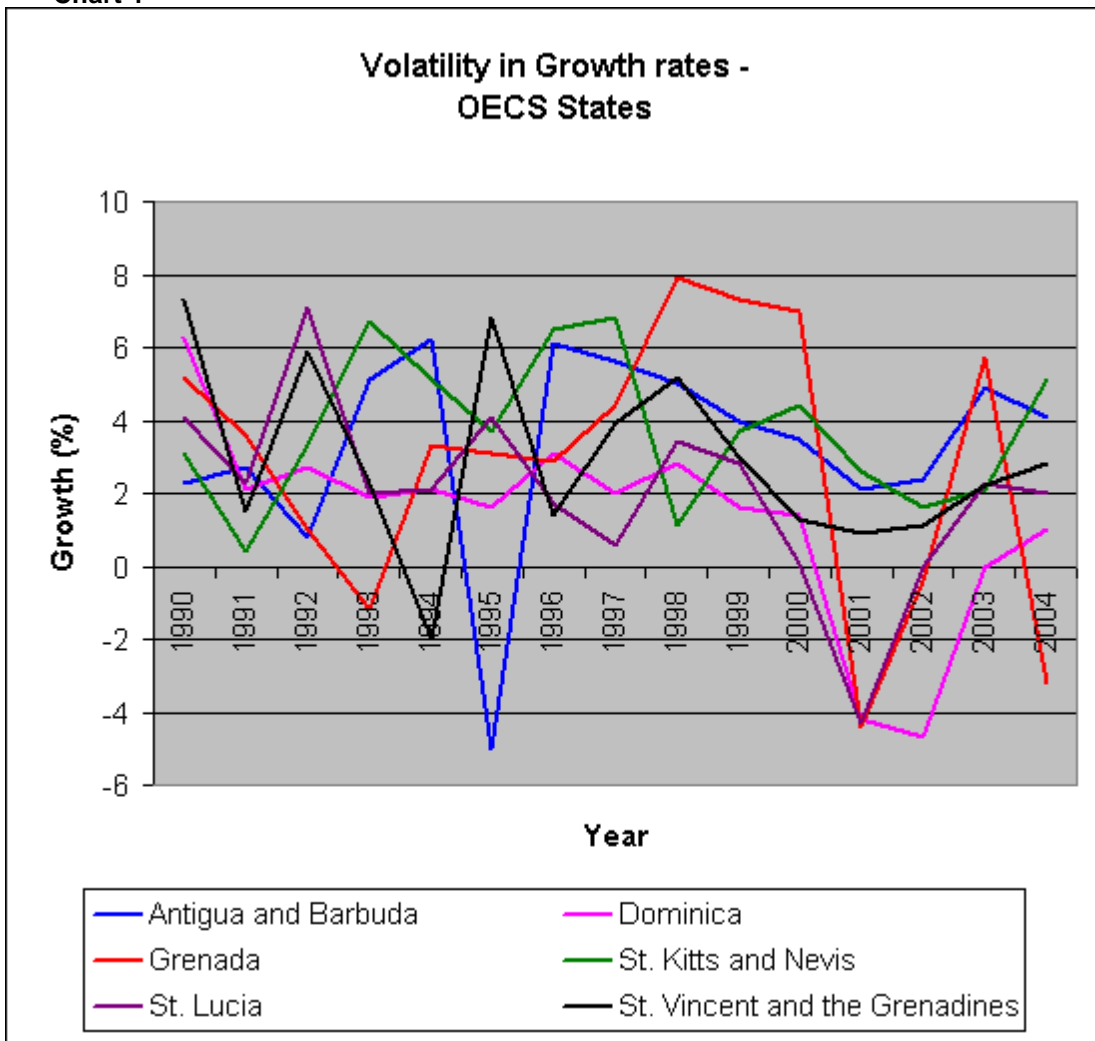
3.1.1. OECS/ECCB States

There has been a sharp fall in growth rates in the OECS/ECCB states, which, as noted above, are classified either as severely or moderated indebted on World Bank external indebtedness classification and which have all accumulated significant amounts of domestic debt. All economies enjoyed strong or reasonably strong growth in the 1980s (Antigua and Barbuda, St Lucia and St Vincent and the Grenadines over 6.5 per cent) but these rates halved or more in these three economies and Dominica and showed significant declines in Grenada and St Kitts and Nevis in the 1990s (see Table 5). In the period 2000-2004 there has been a further decline in five states, with negative or zero growth rates in Dominica, Grenada and St Lucia. Only Antigua and Barbuda maintained the 1990s growth rate.

Table 5: OECS – Annual Average Growth Rates

Country	1980-1990	1990-2000	2000-2004
Antigua and Barbuda	6.7	3.4	3.4
Dominica	5.4	2.1	-2.0
Grenada	4.2	3.9	-0.6
St. Kitts and Nevis	5.7	4.1	2.9
St. Lucia	6.8	2.6	0.0
St. Vincent and the Grenadines	6.6	2.9	1.7

Chart 1



In the 1970s bananas, sugar and cotton predominated the OECS/ECCB economies, which were protected by the preferential arrangements with the EU. High growth rates in the 1980s were produced by the development of tourism supported by high direct foreign investment (FDI) in a number of these economies. In the 1990s while there were continuing pressures on the preferential arrangements, tourism receipts were affected by increased competition from lower priced tourist destinations and a maturing tourist product which was targeting the higher end of the market. Private investment was also affected by high utility costs and real wage increases despite flat productivity and in some cases deteriorating investment climate due to weak institutions and governance.

The September 11, 2001 terrorist attacks also had a profound effect on the growth rates in the OECS/ECCB members. Tourism receipts fell sharply. At the same time global overhaul of offshore regulation with respect to money laundering and terrorist financing and the ban on international gaming also hurt some countries trying to promote the offshore banking and gaming sectors.

There has not only been a long term slowdown in growth rates in OECS/ECCB member states, but their growth rates have also been highly volatile due to shocks, especially the

impact of hurricanes (see Chart 1). The OECS/ECCB members are the most highly exposed countries to natural disasters in the world. The six economies rank among the top eight by land area and top twelve by population affected by disasters from 1970 through 2002, according to the Centre For Research on Epidemiology of disasters (EM-DAT). These hurricanes cause extensive damage to infrastructure and property. For example Antigua and Barbuda was affected by four hurricanes in the 1990s. Hurricane Luis in 1995 was particularly severe. Electricity was cut off for nearly six months, tourism facilities were closed for several months and real GDP declined by 5 percentage points. Hurricane Ivan, which hit Grenada in 2004, was one of the most severe in recent decades with the damage of more than 200 per cent of GDP, with the economy contracting by 3 per cent.

3.1.2. Other Caribbean Small States

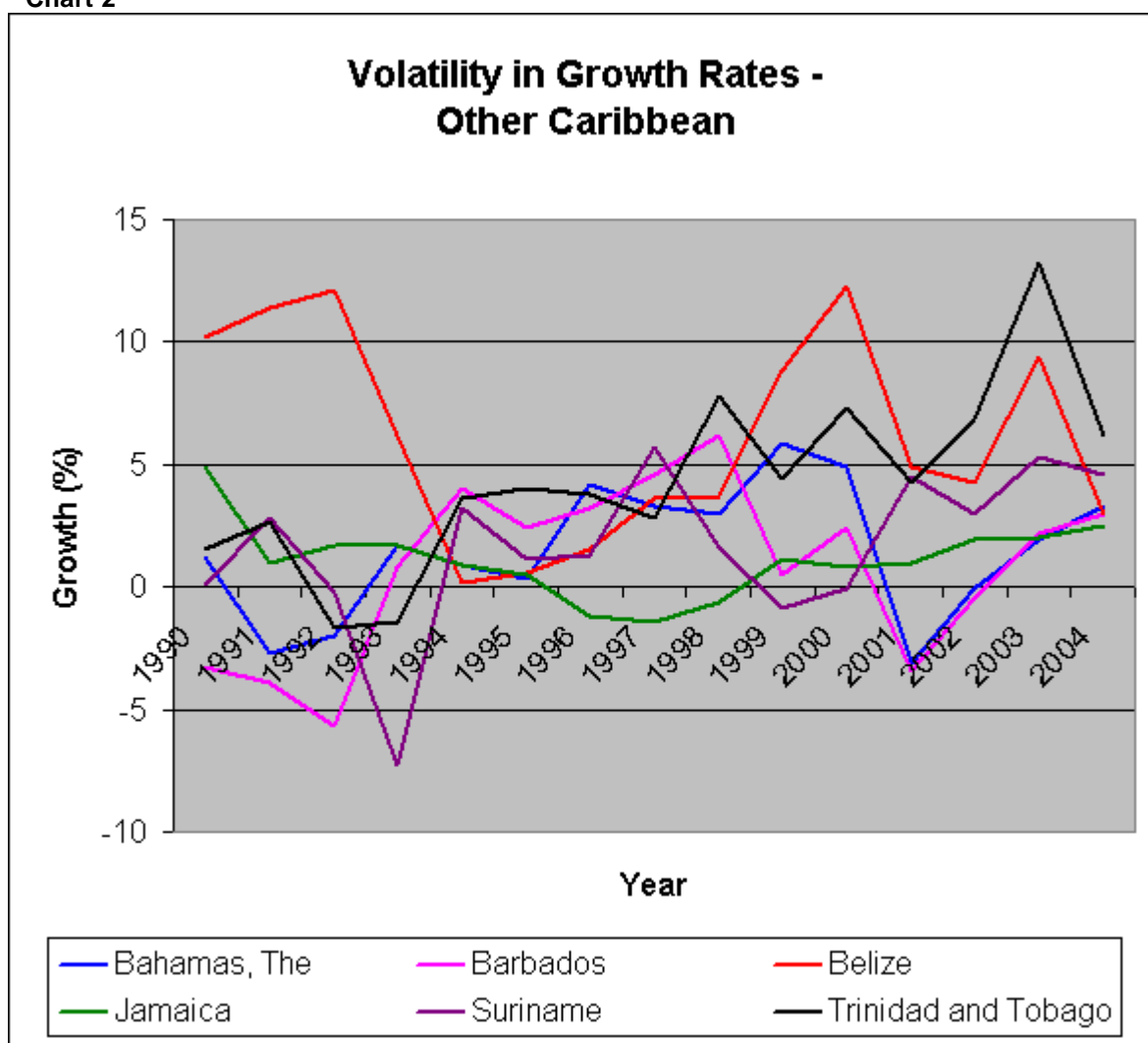
Among other Caribbean small states (see Table 6 and Chart 2), as noted above Belize and Jamaica are classified as severely or moderately externally indebted and their public debt ratios are also high. Belize has maintained reasonably strong growth rates throughout the 1980-2004 period. During 2000-2001 it was also affected by the effects of a hurricane, tourism slump and shrimp virus epidemic, but since then there has been a recovery. Jamaica's growth performance has been generally poor. While liberalization and structural changes have resulted in more openness and market orientation, economic growth has been anemic, averaging 0.5 percent during the 1990s. The major impediments to growth have been the crowding out of the private sector and deterioration in economic infrastructure associated with high fiscal deficits and public debt; weaknesses in the financial sector, culminating in a major banking crisis in the mid-1990s; rigidities in the labour market; and a high incidence of crime.

The fortunes of the Bahamas and Barbados, which have generally been run prudently, are affected by global developments. They were particularly severely affected by the September 11 terrorist attacks, with a cumulative GDP decline over 2001-02 of about 4 per cent in Barbados and over 3 per cent in the Bahamas, offset by the return to growth in 2003-04, to produce a net annual average growth rate of under 1 per cent. Trinidad and Tobago, an oil producer, and Suriname have seen significant improvements in growth rates over 2000-2004, with growth averaging 7.6 per cent in the former and 4.3 per cent in the latter.

Table 6: Other Caribbean – Annual Average Growth Rates

Country	1980-1990	1990-2000	2000-2004
Bahamas, The	2.8	1.9	0.5
Barbados	0.9	1.4	0.3
Belize	4.8	5.9	5.4
Jamaica	3.1	0.5	1.8
Suriname	-0.8	0.7	4.3
Trinidad and Tobago	-2.9	3.3	7.6

Chart 2



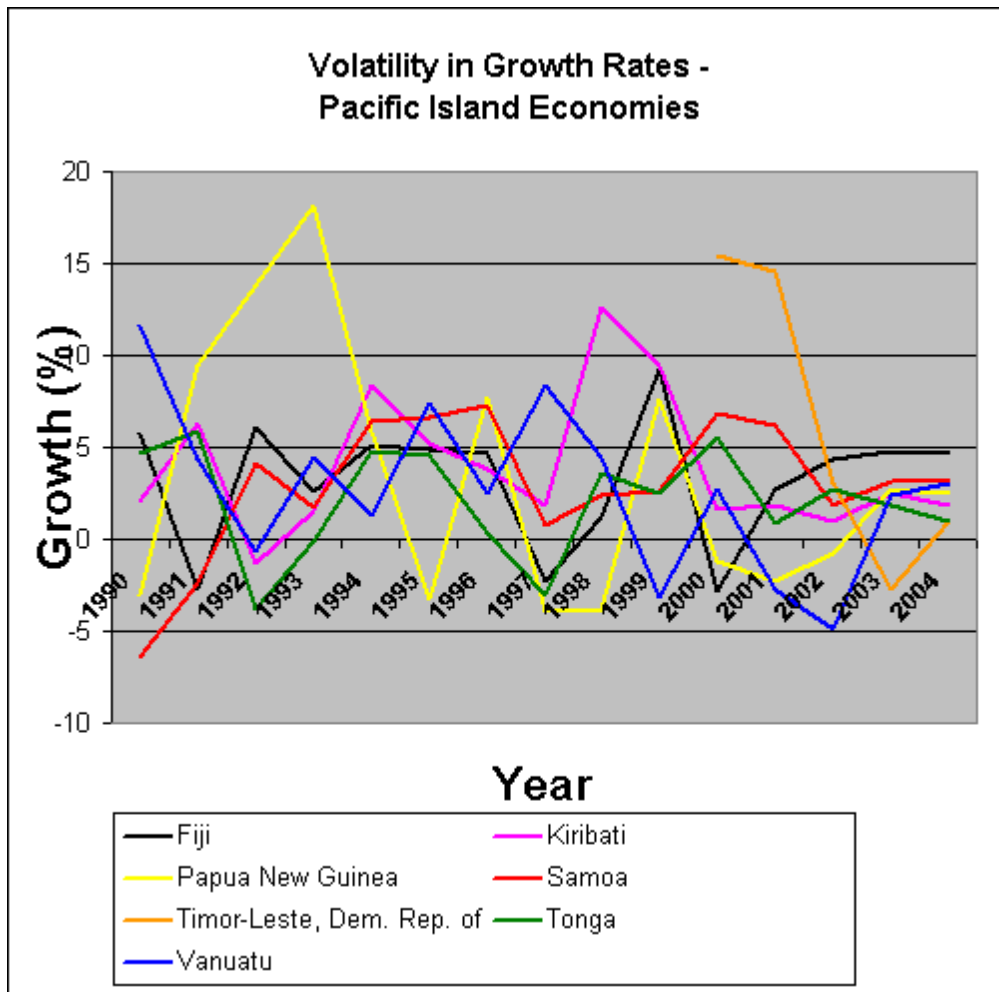
3.1.3. Pacific small states

Most countries in the Pacific experienced a significant slowdown in 2000-2004 compared to the 1990s, with negative or below 1 per cent growth in PNG, Solomon Islands and Vanuatu (see Table 7 and Chart 3).

Table 7: Pacific Islands - Annual Average Growth Rates

Country	1980-1990	1990-2000	2000-2004
Fiji	2.8	2.5	4.1
Kiribati	0.0	4.7	1.9
Papua New Guinea	1.5	4.8	0.5
Samoa	0.5	3.6	3.6
Solomon Islands	1.3	2.5	-0.1
Timor-Leste	..	..	3.8
Tonga	8.9	2.0	1.6
Vanuatu	2.8	3.1	-0.6

Chart 3



During the 1970s and 1980s Samoa, classified as severely indebted, was one of the weakest performers in the Pacific Island economies with episodes of macroeconomic imbalances and economic stagnation. Although growth has averaged about 3.6 per cent over 1990-2004, it witnessed two cyclones in 1990s (which devastated the country’s infrastructure and destroyed its principal crop) as well as a slowdown in 2001-2002. In the Solomon Islands, classified as moderately indebted, early high growth based on logging in the early 1990s was replaced by low or stagnating growth with rising public deficits and the effects of the Asian financial crisis. Conditions worsened with the beginning of the civil conflict in mid-1999, when much of the civil infrastructure was destroyed, real GDP declined by a quarter and exports halved. PNG has always been plagued debt problems and low growth with its per capita GDP lower than at any time since independence in 1975. Although rich in mineral, petroleum and forestry resources, its geographic isolation resulting in high extraction costs, foreign companies operating as enclaves, civil conflict and collapse of a large copper mine in Bougainville, unsustainable forestry practices, deteriorating law and order and governance problems and crumbling infrastructure have all contributed to low growth.

With respect to other countries in the Pacific, in Vanuatu, although there has been a recovery after two years of declining output in 2001-2002, weak environment for private activity, including poor infrastructure, and political instability and rapid population growth have compounded the difficulties that come with a narrow output and export base. Tonga has also seen a marked slowdown in growth since the 1980s, with recent growth particularly affected

by external shocks, poor fiscal management and slow implementation of reforms. After significant improvements in the 1990s, growth in Kiribati has fallen back during 2001-2004 on the back of poor agriculture performance, difficult infrastructure problems and poor private investment climate. Fiji's economic growth in recent years, by contrast, has been high by historical standards and reflects a recovery from the coup in 2000, increased tourism receipts and rising domestic demand.

3.1.4. African small states

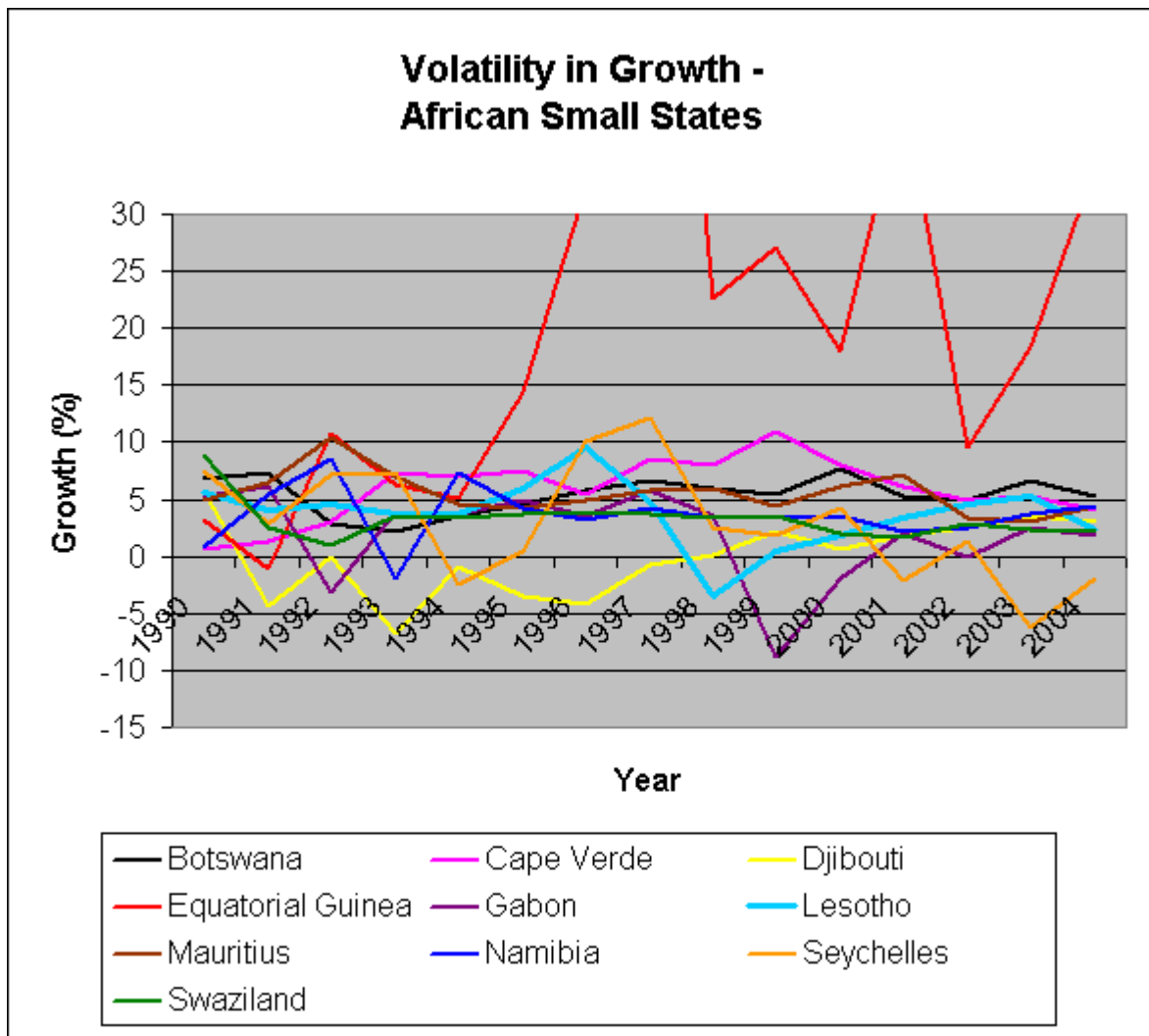
In Africa (see Table 8 and Chart 4), Seychelles and Gabon are classified as severely indebted. Growth rates in Seychelles became sharply negative with a cumulative decline in GDP of about 10 per cent over 2001-2004. It has been affected by the effects on tourism of September 11, weak economic management, and recently the Asian tsunami (Boxing Day 2004). Gabon's economic performance has been uneven, affected by oil booms and political cycles of rising expenditures followed by painful adjustments when oil prices fall. Its long term average growth of 1.6 per cent continued in 2001-2004, despite oil price increases, as oil production has fallen sharply since 1997 with maturing oil wells.

Cape Verde and Mauritius, the two moderately indebted economies, increased their growth rates to over 6 per cent in the 1990s, and although they have fallen back somewhat during 2001-2004 they remained reasonable at around 4.5 to 5 per cent, similar to that in the 1980s. In Mauritius, while tourism and sugar production has revived after the slowdown in 2001-2002, Export Processing Zone (EPZ) production has continued to register negative growth as a result of high domestic production costs and increased competition.

Table 8: African Small States: GDP Growth 1980-2004

Country	1980-1990	1990-2000	2000-2004
Botswana	10.8	5.2	5.5
Cape Verde	5.2	6.7	5.1
Djibouti	1.0	-1.8	2.7
Gabon	1.6	1.7	1.6
Lesotho	4.6	3.5	3.8
Mauritius	4.8	6.0	4.5
Namibia	-1.3	4.1	3.2
Seychelles	3.6	4.5	-2.4
Swaziland	7.8	3.1	2.3

Chart 4



Among the less indebted African small states, growth rates in Botswana of over 5 per cent during 1990-2004 are half of those in the 1980s, when there were large investments in Botswana’s mineral resources. Namibia, another mineral rich country, also saw a recovery during the 1990s from the negative growth rates of the 1980s, although these rates have fallen back somewhat in 2001-2004. Swaziland has seen significant declines in its growth rates over the twenty four year period, while in Lesotho growth has seen modest improvements 2001-2004. Both these economies are severely affected by drought and other adverse weather conditions. With the new oil discoveries, GDP in Equatorial Guinea has been rising rapidly, estimated at about 25 per cent annually in 2000-2004. Djibouti has also seen a revival after negative growth during the 1990s.

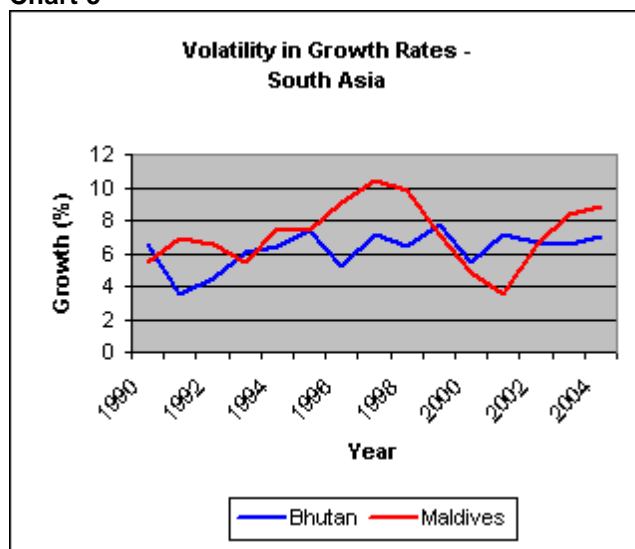
3.1.5. South Asian Small States

South Asian economies of Bhutan and Maldives have continued with high growth rates, throughout the period 1980-2004, and although their growth rates during 2001-2004 are lower than those in the 1980s, at 6.8 per cent in both countries, they are strong. Maldives economy however has been affected by the Asian tsunami, which caused damage to its infrastructure and which is likely to impact on growth in 2005 (see Table 9 and Chart 5)

Table 9: South Asia - Annual Average Growth Rates

Country	1980-1990	1990-2000	2000-2004
Bhutan	7.3	6.0	6.8
Maldives	9.1	7.5	6.8

Chart 5



3.2. High and Increasing Public Sector Deficits

Slowdown in growth would mean that government revenues, even if maintained as a share of GDP, would be less in absolute terms of what they would have been if growth rates had been maintained. In addition, shocks (hurricanes, effect of September 11 attacks) would generally result in government revenues also declining as a share of GDP, with many businesses and individuals paying much lower taxes. While revenues are either maintained or fall as a proportion of GDP, expenditures, which are usually planned well ahead, rise significantly as a proportion of GDP. In addition Governments may face pressures to increase current expenditures, and in many cases governments have sharply increased capital expenditure particularly in infrastructure to repair the damage caused by natural disasters or as countercyclical measures to maintain growth rates. The result has usually a sharp rise in fiscal deficits, which have to be financed.

3.2.1. OECS States

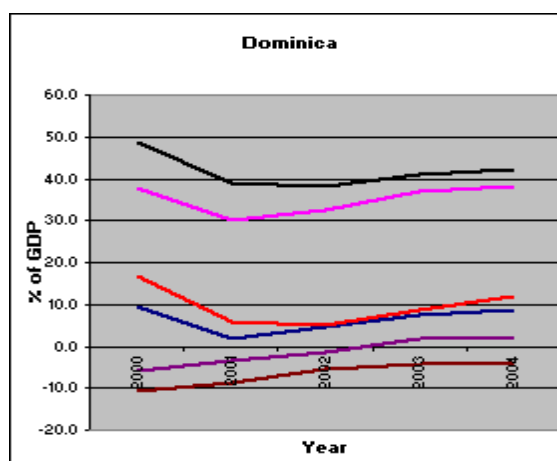
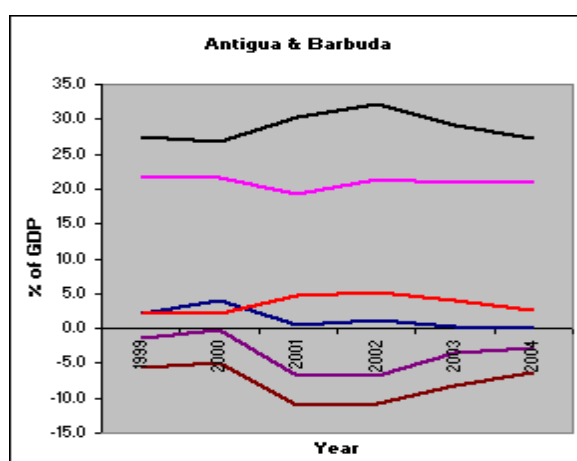
Chart 6 shows how public finances in the OECS states have performed during the recent period. While it appears that in most economies government revenues were maintained as a share of GDP, some such as St Lucia saw a significant decline. At the same time most economies, and in particular Dominica, saw a significant decline in grants over 2001-2002.

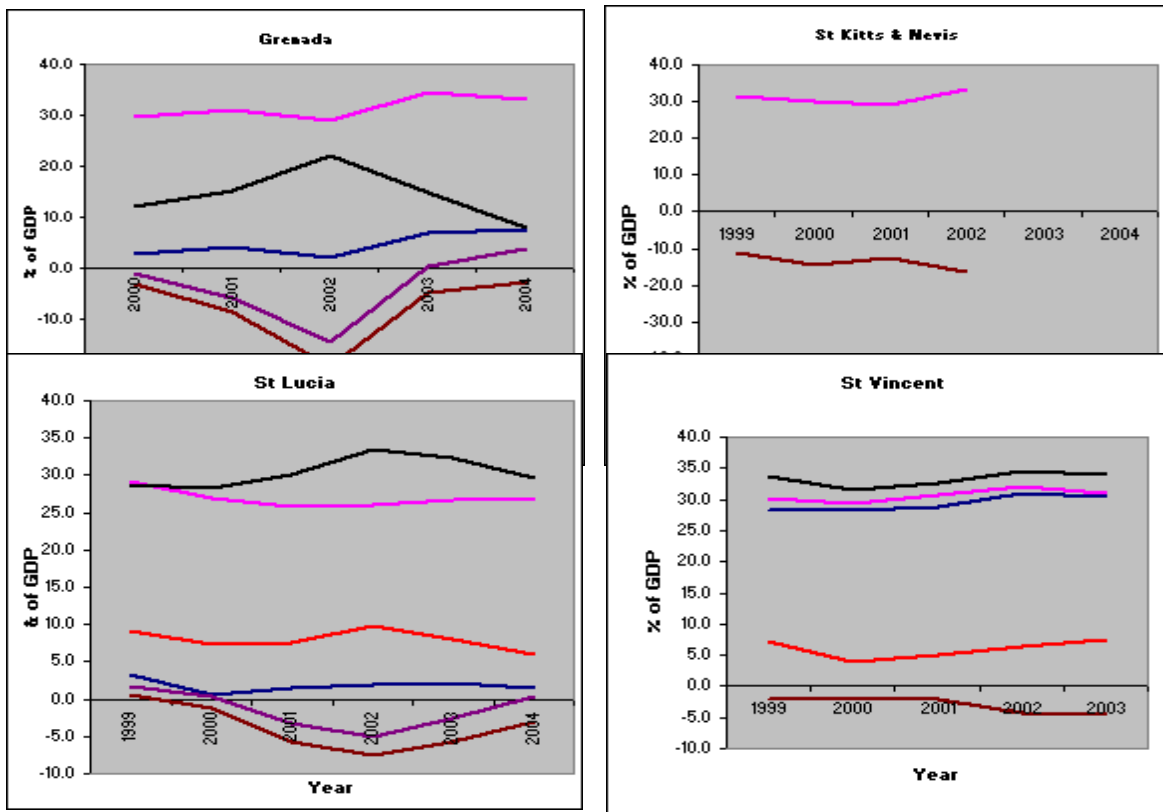
Meanwhile expenditures increased sharply. For example, between 2000 and 2002, current expenditures as a share of GDP rose from 24.6 per cent to 27.1 per cent in Antigua and Barbuda, 31.9 per cent to 33.1 per cent in Dominica, 20.8 per cent to 25.9 per cent in Grenada, 21.0 per cent to 23.7 per cent in St Lucia and 26.6 per cent to 28.3 per cent in St Vincent and the Grenadines. In a number of cases, increases in current expenditure were a result of public sector wage rises, together with an increasing burden of debt service payments. In Antigua and Barbuda, for example, at end 2003 the wage bill amounted to 60 per cent of government revenues and debt service at about 35 per cent leaving little room for other expenditures. Capital expenditures also rose very sharply as a share of GDP, over the period 2000 to 2002 from 2.1 per cent to 5.1 per cent in Antigua and Barbuda, 12.2 to 22.2 per cent in Grenada, 7.3 per cent to 9.8 per cent in St Lucia, 3.9 to 6.5 per cent in St Vincent and the Grenadines. St Kitts and Nevis also saw its overall expenditures climb from 44.4 per cent in 2000 to 49.6 per cent of GDP in 2002. Only in Dominica, exceptional capital expenditures in 2000 fell back in 2002, with the result that overall expenditures, as a share of GDP, fell from 48.5 per cent to 38.2 per cent.

The result has been very sharp increases in the central government overall deficits in most countries. In 2000 these deficits were already high in Antigua and Barbuda, Dominica, Grenada and St Kitts and Nevis and in all except Dominica they rose very sharply to reach in 2002, as a percentage of GDP, about 11 per cent in Antigua and Barbuda, over 19 per cent in Grenada and over 16 per cent in St. Kitts and Nevis. In St Lucia and St Vincent the overall deficit also rose to reach 7.5 per cent and 4.2 per cent of GDP, respectively. Only in Dominica overall deficit halved, but still remained high at 5.4 per cent.

Chart 6: Recent Fiscal Trends: OECS

Legend		
Capital Expenditure	Grants	Overall Balance
Total Expenditure	Revenue & Grants	Primary Balance





With the recovery in place since 2003, and together with adjustment efforts, there has been a significant cutback in expenditures, especially capital expenditures, in Antigua and Barbuda, Grenada, St Kitts and Nevis, and St Lucia, with the result that overall deficits have fallen sharply. In Dominica capital expenditures have increased somewhat, but on the back of rising revenues and grants and falling current expenditures, with the result that overall deficits have been on a declining path. In all these countries, adjustment efforts have been directed at bringing primary budget deficits (excluding debt service payments) back into surplus and in all except Antigua and Barbuda this appears to have been achieved by 2004. St Vincent, where primary budget has always been in surplus in recent years, capital expenditure has increased so that the primary surplus has fallen and overall deficits have increased, but they remain of a much smaller magnitude than other countries.

3.2.2. Other Caribbean Small States

With respect to the other Caribbean small states (see Chart 7), in Belize overall fiscal deficits were large, just under 10 per cent of GDP throughout 2000-2002, with rising revenues in 2001 accompanied by rising current and capital expenditures and falling revenues in 2002 accompanied by falling capital expenditures. Overall deficits appear to have fallen modestly in 2003 and quite sharply in 2004, largely as a result of compression in capital expenditures. While the primary deficit has been falling steadily in Belize and is expected to have reached a surplus in 2004, growing interest burdens have kept budgets in overall deficits.

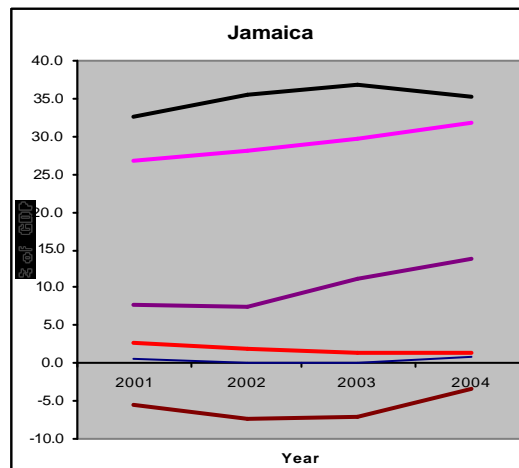
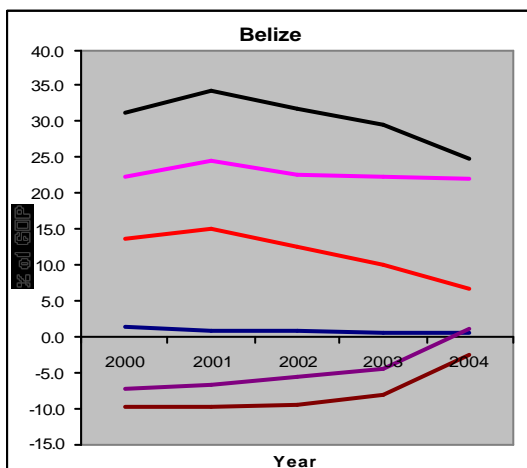
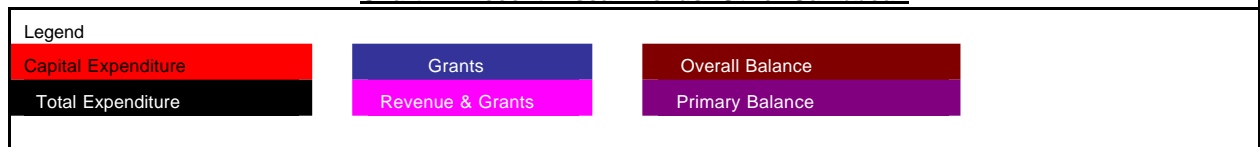
Jamaica, which for a long period, has a large indebtedness burden and has been running primary surpluses, also saw its overall deficits rise in 2002 to 7.6 per cent of GDP. This was a result of rising interest burdens, despite some revenue improvement and capital expenditure

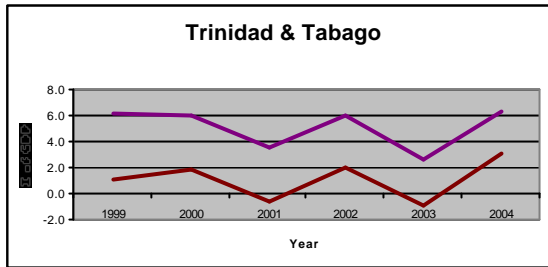
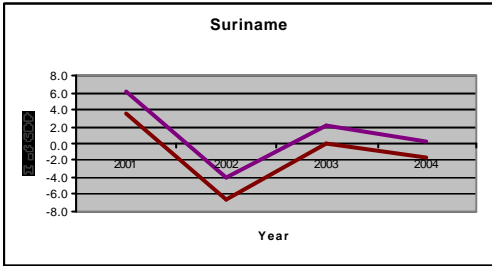
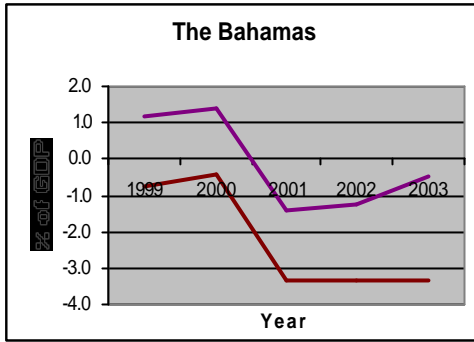
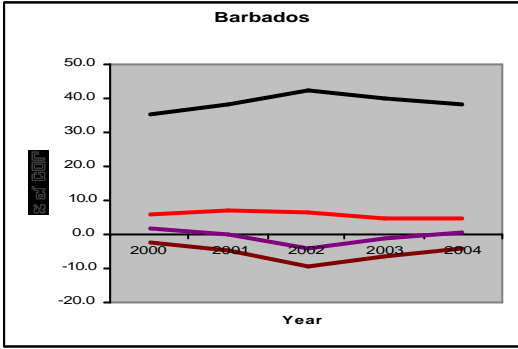
compression, a process which continued strongly in 2003 when Jamaica greatly increased its primary surplus to around 11 per cent of GDP. But overall deficits fell only marginally due to the rising interest burden. In 2004, with a further rise in primary surplus, it is estimated that the overall deficit may have fallen to 3.5 per cent of GDP. Jamaica, which was spending more than half of the government revenue in servicing interest payments in 2001, has greatly increased such spending in 2003-04.

In Barbados, to mitigate the recession, the government adopted a counter-cyclical policy stance with a public investment programme and wage increases for public servants, with the result that primary deficit moved from a surplus to a deficit of about 4.3 per cent and overall deficit widened sharply to around 9.5 per cent in 2002. With the recovery the authorities also tightened capital expenditures, bringing the primary balance back into surplus in 2004. In recent years Barbados has been spending about 5 per cent of its GDP in interest payments.

With respect to other less indebted Caribbean states, in the Bahamas the slowdown resulted in a sharp fall in fiscal revenues, while current expenditures increased due to a five year wage agreement with civil service unions. This led to a sizeable widening of the overall fiscal deficits. Suriname also saw a decline in fiscal revenues and a sharply widening overall deficit in 2002, but with rising revenues in 2003-04, offset to some extent by increased capital expenditure, primary deficits have been brought back into surplus, while the overall deficits remain generally small. Trinidad and Tobago's fiscal revenues are tied to oil production and prices. During the 2000-04 period it has always run large primary account surpluses, and generally also an overall surplus, except for 2001 and 2003 when it was in a small overall deficit of under 1 per cent.

Chart 7 : Recent Fiscal Trends: Other Caribbean

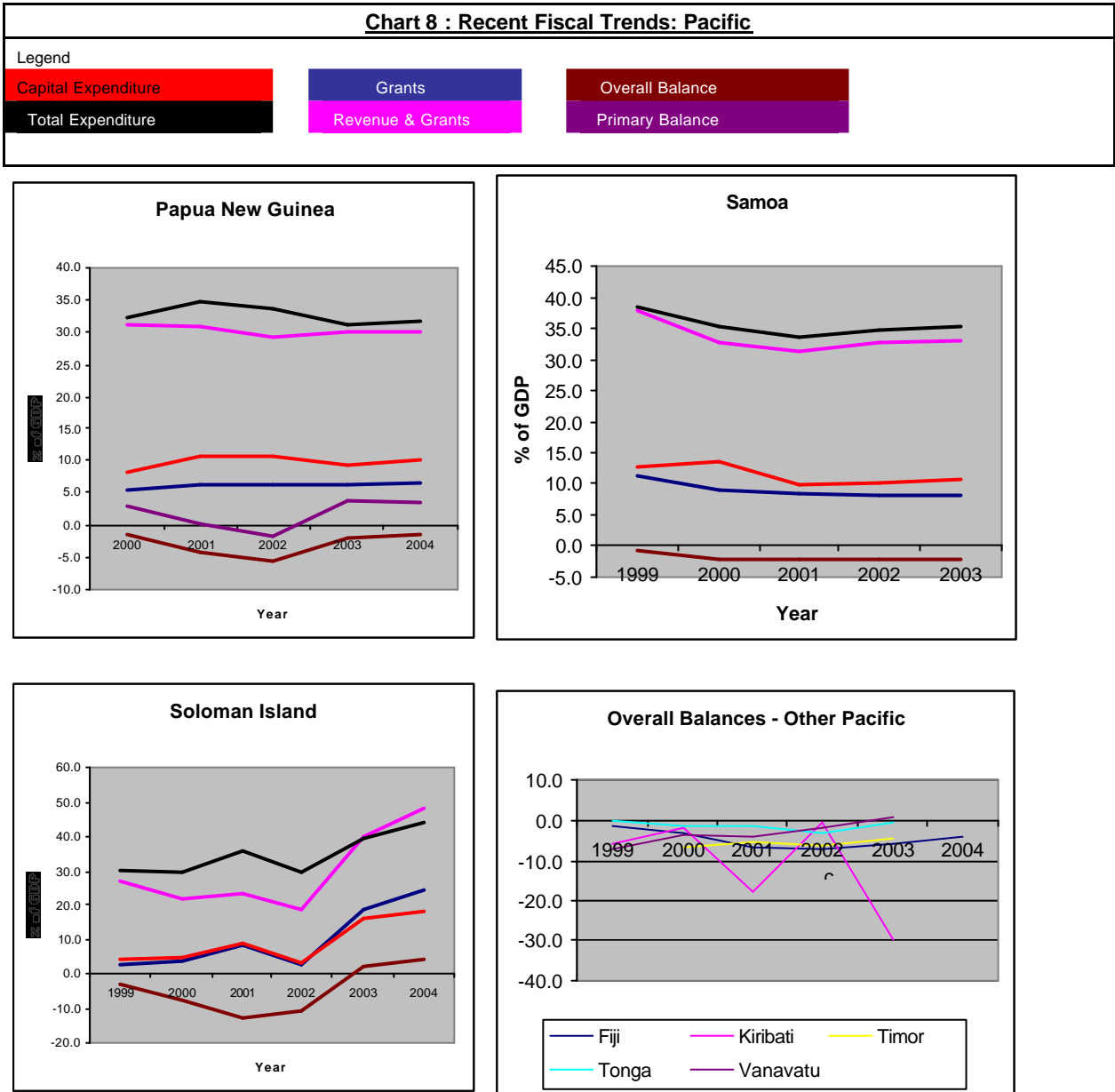




3.2.3. Pacific Island Economies

Among the severely or moderately indebted small states in the Pacific, in Samoa rising overall deficits in the 1990s has given way to deficits being stabilized around 2 per cent of GDP in recent years. In 2001 falling revenues and grants were accompanied by falling capital expenditures. Since then slowly rising revenues, accompanied by stable grants of about 8 per cent of GDP, have also led to slowly rising expenditures.

Chart 8 : Recent Fiscal Trends: Pacific



Solomon Islands, mired by conflict and declining output, saw sharply falling revenues in 2000 and 2001, which were partly offset by increased grants. At the same time, capital expenditures increased sharply, with the overall deficit rising to 12.6 per cent of GDP, which continued at around 11 per cent in 2002. Since then revenues have been recovering, while there has been a large influx of grants (estimated at around 25 per cent of GDP in 2004). This allowed for large increases in capital expenditures, while overall budget balance has moved into surplus. PNG, a long standing indebted country, also saw a sharp rise in overall deficits in 2002, with a move from a primary surplus to a primary deficit, with falling revenues accompanied by rising capital expenditures. Since then current expenditures have been reduced, with primary surpluses in excess of 3 per cent and overall deficits reduced to less than 2 per cent of GDP. All three economies rely extensively on large grant inflows, without which the overall deficits would be very large.

Among the less indebted countries, Fiji also saw declining revenues with rising expenditures, with the overall deficits reaching 7.3 per cent of GDP in 2002. Since then overall deficits have been falling, with sharp cutbacks in expenditures more than offsetting the falls in revenue. Tonga also witnessed rising overall deficits reaching 3.1 per cent of GDP in 2002, largely a result of falling revenues. In 2003, expenditure curtailment brought the overall deficit to less than 1 per cent of GDP. Vanuatu, which had an overall deficit of over 7 per cent in 1999, has seen this deficit turned into a surplus of about 1 per cent of GDP in 2004, due largely to sharp cutbacks in capital expenditure, which has fallen from 8.5 per cent of GDP in 1999 to 1.6 per cent of GDP in 2004.

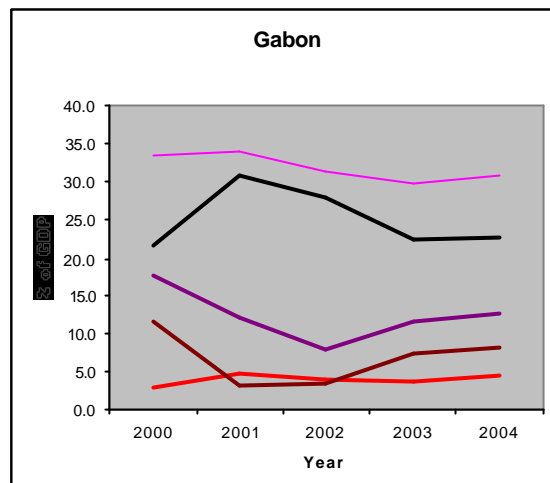
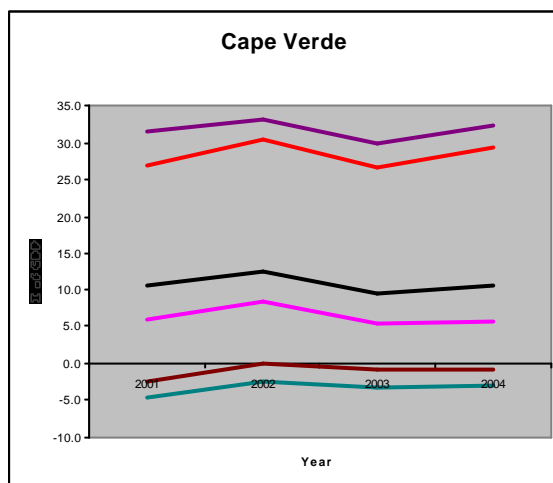
3.2.4. African small states

In Africa, fiscal data on Seychelles, its most severely indebted small state, and that of Mauritius, classified as moderately indebted, is not publicly available. Gabon, a severely indebted oil producer, has been running primary and overall surpluses. It saw its revenue dip in 2002, but with expenditures increasing sharply in 2001-2002, overall surpluses fell. Since then while revenues have marginally fallen on maturing oil production, expenditures have been drastically curtailed, with rising primary and overall surpluses. In 2001 Cape Verde also started with a significant overall and primary deficit, but in 2002 with increased grants it was able to boost its capital expenditure while bringing the primary balance into surplus. Since then it has running a small primary deficit of under 1 per cent, which with interest payments, translates into an overall deficit of around 3 per cent of GDP (see Chart 9).

Among other African small states, Botswana, which has been traditionally running large overall surpluses, saw a drastic reduction in revenues from about 50 per cent of GDP in 1999-2000 to around 40 per cent in 2002-2003 with the result that country dipped into overall deficits of about 3-4 per cent. However since then revenues have been recovering and although expenditures have also increased, the country has been moving back towards an overall surplus. In 1999 Swaziland had a large primary surplus of about 9 per cent of GDP, but with interest payments of about 10.5 per cent of GDP, it ran an overall deficit of about 1.5 per cent. Since then its revenue has declined, with the result that primary surpluses have fallen, while the overall deficits have widened. Namibia has seen its overall deficit widen in 2003, largely on account of falling revenues, but in 2004 it is expected to move back into primary surplus with an overall deficit of about 2 per cent. Lesotho is projected to have turned its overall deficit in 2003 into a surplus in 2004. Djibouti also saw its overall deficit widen in 2002, but since then deficits have narrowed somewhat. Equatorial Guinea, which was roughly in primary and overall balance in 1999, and which has since seen rapid growth on oil production, has been accumulating large primary and overall surpluses, which have been broadly equivalent due to negligible interest payments.

Chart 9 : Recent Fiscal Trends Cape Verde & Gabon

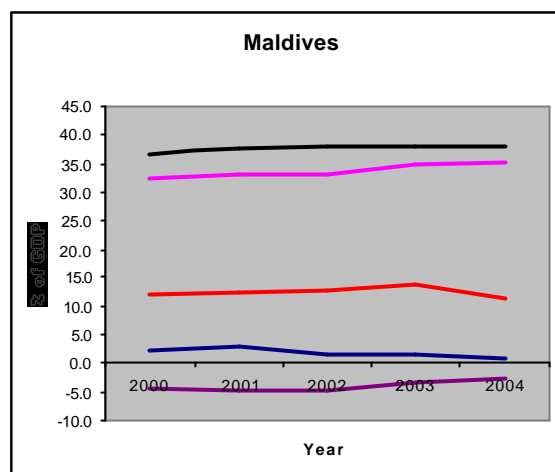
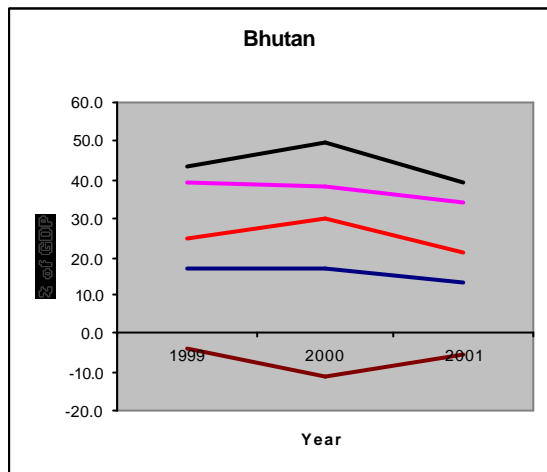
Legend		
Capital Expenditure	Grants	Overall Balance
Total Expenditure	Revenue & Grants	Primary Balance



3.2.5. South Asia

There is only very limited publicly available fiscal data on Bhutan, which saw its overall deficit climb to over 11 per cent of GDP in 2000 on account of a significant increase in capital expenditures. Although these expenditures were reduced, the overall deficits were still about 5.4 per cent of GDP in 2001. The Maldives saw a steady improvement in revenues over 2000-2004, but also witnessed a significant fallback in grants. Although expenditures also increased, it managed to reduce its overall deficit from between 4-5 per cent in 2000-2002 to less than 3 per cent in 2004 (see Chart 10). Maldives however has been severely affected by the Asian tsunami and its revenues could therefore be significantly curtailed in 2005, with detrimental effects on the overall deficit

Chart 10 : Recent Fiscal Trends South Asia



3.3. Hardened Borrowing Terms

While many small states have been experiencing slow and volatile growth and/or rising fiscal deficits, in a large number of them financing of such deficits has been taking place at hardened terms. Donors have reduced concessional finance available to these countries because of their relatively high per capita incomes and these countries have increasingly sought finance on hard terms from both external and domestic sources.

Table 10 shows the change in the concessional external debt profile of small states for which data is available in the World Bank's GDF. It particularly shows that the share of concessional debt in total debt has fallen since 1990 in most economies which are classified as either severely or moderately indebted. For example, in 1990, most external debt owed by OECS countries was on concessional terms, ranging from 87 per cent in Dominica, over 70 per cent in Grenada and St Kitts and Nevis to over 50 per cent in St Lucia and St Vincent and the Grenadines. By 1999 with the reduction in concessional finance to these countries, the share of concessional debt in total debt fell to figures ranging from 74 per cent in the case of Dominica to 47 per cent in St Lucia and St Vincent and the Grenadines. With the large increase in deficits in most economies and with the continuing reduction in concessional finance, by 2003 concessional debt accounted for only 42 per cent of total debt in Dominica and St Vincent and the Grenadines, with the share as low as 28 per cent in Grenada. Other indebted Caribbean economies have also seen a sharp decline in the share of concessional debt, Belize from 52 per cent in 1990 to 9 per cent in 2003 and Jamaica from 30 per cent in 1990 to 18 per cent in 2003.

Table 10: Small States: Trends in Concessional Debt

	Concessional Debt (% of total debt)		
	1990	1999	2003
OECS			
Antigua & Barbuda			
Dominica	87.3	74.2	42.2
Grenada	70.1	64.0	28.7
St. Kitts & Nevis	76.7	65.7	37.7
St. Lucia	53.3	47.1	33.3
St. Vincent & Gren.	56.9	47.1	42.0
Other Caribbean			
Bahamas, The			
Barbados	13.2	20.2	14.2
Belize	52.6	25.8	9.4
Jamaica	30.0	26.8	18.4
Trinidad & Tobago	2.1	0.4	0.1
Pacific			
Fiji	7.4	8.7	12.4
Papua New Guinea	21.6	36.8	36.2
Samoa	90.5	79.7	45.9
Solomon Islands	64.1	69.9	78.5
Tonga	72.2	87.3	91.4
Vanuatu	60.5	97.6	77.4
Africa			
Botswana	32.9	59.1	60.3
Cape Verde	70.2	78.3	81.5
Djibouti	74	90.2	89.3
Equatorial Guinea	49	52.5	48.2
Gabon	10.6	20.8	25.7
Lesotho	73.7	66.5	75.9
Mauritius	35.7	17.1	13.1
Namibia			
Seychelles	45.0	39.5	25.1
Swaziland	61.2	41.3	43.0
South Asia			
Bhutan	74.0	71.2	50.3
Maldives	71.0	68.7	64.1

Samoa in the Pacific, which is severely indebted, has seen the share of concessional debt to total halve between 1990 and 2003 from 90 per cent to 45 per cent. By contrast PNG, Solomon Islands, Vanuatu and Tonga have witnessed a significant increase in the share of concessional debt in total debt. In Africa, Seychelles, Mauritius and Swaziland have witnessed a sharp decline in the share of concessional debt in total debt, but other small states

have seen this share increase significantly. Both Bhutan and Maldives have also witnessed a decline in the share of concessional debt in total debt.

It should be noted that the share of concessional debt in total debt would be much smaller than that indicated above. This is because the figures do not take account of domestic debt, which is contracted on commercial terms. As noted above, such debt has become a significant proportion of total debt in many small states, as these countries have sought to finance part of their rising deficits from domestic sources.

An indication of the rising interest burden of total debt has already been provided above in the assessment of small states' overall and primary deficits, interest payments being the difference between the two. For most of the OECS countries, as well as Belize and Jamaica, this interest burden as a share of GDP has increased quite significantly in recent years. Between 2000 and 2004 it has risen, as a share of GDP, in Dominica from 5.0 to 6.5 per cent, in Grenada from 2.2 to 6.5 per cent, in St Lucia from 1.6 to 3.5 per cent, Belize from 2.4 per cent to 3.8 per cent and Jamaica from 13.4 to 17.3 per cent. In Antigua and Barbuda while the proportion has fallen somewhat from 4.7 to 3.5 per cent, there are mounting arrears. In Barbados also the interest burden has been fairly high at around 5 per cent throughout the period, while in Suriname it has been in the region of 2-2.5 per cent. Only Trinidad has seen a significant decline in its interest burden from around 5 to 3.5 per cent.

Detailed data on the interest burden in most countries in the Pacific, Africa and South Asia is not available. Available data from PNG suggests a creeping up of the interest burden from just over 4 per cent in 2000 to little less than 5 per cent in 2004. Data on Gabon suggests a significant interest burden, which is being reduced. Swaziland had a high interest burden of over 8.5 per cent in 2002, while Cape Verde, Namibia and Lesotho appear to have a stable interest burden of around 2-3 per cent.

3.4. Assessing Contribution of All factors

A proper assessment of the rising debt burden requires consideration of all the factors together including the contribution of the growth rate, interest rate and fiscal deficits. While such exercises are conducted as part of the IMF debt sustainability analysis, these are available for a limited number of countries. An example is provided for St Lucia below (see Table 11).

Table 11: St Lucia - Contributions to Public Debt Accumulation
(Annual Average, in percent of GDP)

	Period 1991-99	Period 2000-03	Period 2000-03 minus Period 1991-99
Public Debt Accumulation	1.8	6.5	4.7
Contribution of:			
Primary Balance	-0.6	1.3	2.0
Interest Payments	1.4	2.9	1.5
Real GDP Growth	-0.7	0.3	0.9
Others	1.7	1.9	0.2

It shows that in the period 1991-99 public debt accumulation averaged 1.8 per cent of GDP, with the main contributors being interest payments and other factors (such as valuation changes, debt relief, accumulation of deposits and assumption of private sector debt by the public sector), offset to some extent by higher GDP growth and by an improvement in the primary balance. In 2000-2003 however debt accumulation averaged 6.5 per cent of GDP,

with the biggest contributors being interest payments, followed by other factors and primary balance deterioration. If the increase in the public debt accumulation between the two periods is compared, it shows that the bulk of the increase was accounted for respectively by the deterioration in the primary balance followed closely by rising interest payments.

Another example below of Antigua and Barbuda shows the contribution to public debt accumulation of various factors year by year over 1999-2003 (see Table 12). It shows that in 2002, an increase in public debt accumulation of 14.6 per cent of GDP was accounted for an increase in primary deficit (6.7 per cent), interest payments (4.1 per cent) and other factors (6.5 per cent) offset to some extent by GDP growth (2.7 per cent).

Table 12: Antigua & Barbuda - Contributions to Public Debt Accumulation
(Annual Average, in percent of GDP)

	1999	2000	2001	2002	2003
Public Sector Debt	107.6	115.8	114.7	129.3	134.1
Change in Public Sector Debt	-4.9	8.3	-1.1	14.6	4.7
Primary Deficit	1.5	0.3	6.8	6.7	3.6
Revenue & Grants	21.9	21.7	19.2	21.5	21.0
Primary (non-interest) expenditures	23.4	22.0	26.0	28.1	24.6
Automatic Debt Dynamics	-1.5	0.4	-0.8	1.4	-1.0
Of which contribution from real interest rate	2.8	4.1	1.4	4.1	5.0
Of which contribution from real GDP Growth	-4.3	-3.7	-2.2	-2.7	-6.0
Other Identified Debt Creating flows (privatization, contingent liabilities, etc)	0.0	0.0	0.0	0.0	0.0
Residual including asset changes	-5.0	7.5	-7.0	6.5	2.2

4. CURRENT APPROACHES TO DEAL WITH SMALL STATES' INDEBTEDNESS PROBLEMS

Current approaches to deal with the debt problems of small states call for significant fiscal adjustment, accompanied by growth enhancing measures, and in some cases by debt restructuring. These fiscal and other reform efforts are either taken as part IMF programmes or by the countries themselves. IMF Poverty Reduction and Growth Facility (PRGF) programmes are currently in place only for Dominica and Cape Verde among the small states. In all other cases, IMF has sought to influence policy through its Article IV Consultations which generally include forward looking public sector and external Debt Sustainability Analysis. The discussion below concentrates only on small states which are either identified by the World Bank as severely or moderately indebted and some others which also are known to have high public debt ratios, and for which Article IV information is available.

4.1. OECS Economies

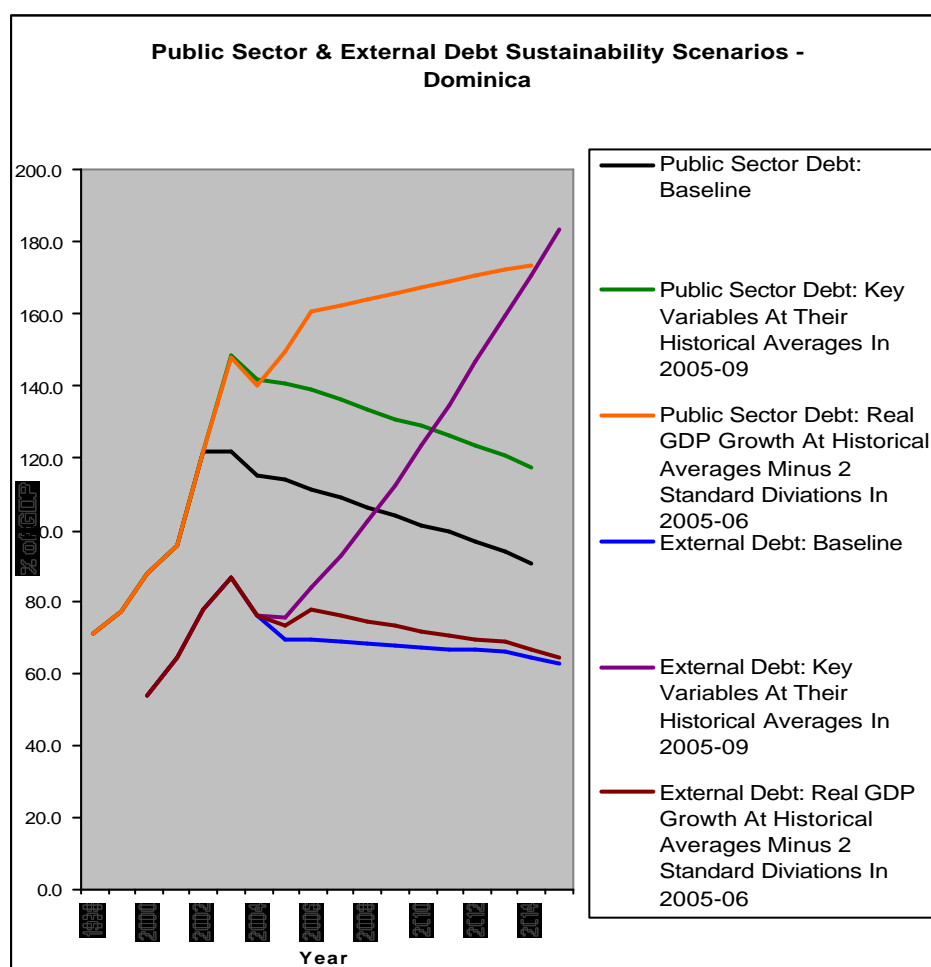
In the case of *Dominica*, a three-year PRGF arrangement was approved by the IMF in December 2003, whose objectives included, inter alia, fiscal consolidation and reduction of the debt overhang. The programme objective was to attain a primary surplus of 0.5 per cent in 2004/05 moving to the medium term objective of 3 per cent in 2006-07. However, to demonstrate the seriousness of their fiscal efforts Dominican government strengthened fiscal policy for 2004/05 raising the target for primary surplus to 2 per cent of GDP, with the aim of reaching the objective of a primary surplus of 3 per cent of GDP in 2005/2006. Fiscal

measures that have been undertaken include, inter alia, reduction of discretionary tax exemptions, reduction in the wage bill and gradual increase in the retirement age and revisions to privileges for public servants.

The programme of fiscal consolidation is based on the expectation that Dominica will achieve a collaborative debt restructuring with its creditors that meets the residual near term financing needs and ensures medium term debt sustainability. The government has undertaken parallel negotiations with the three main classes of creditors. The Caribbean Development Bank (CDB) agreed to restructure bulk of its claims at favourable terms: extending maturities and grace periods and reducing interest rates, which the IMF staff estimates involves a considerable element of NPV debt reduction. Dominica has also been in close contact with official bilateral creditors, outside the framework of the Paris Club. These creditors have been invited to participate either in the debt exchange offer or restructuring of debt that is consistent with inter-creditor equity and delivers a debt reduction of about 50 per cent in NPV terms. While discussions were reported to be at an advanced stage with Barbados, United Kingdom and Venezuela, those with other bilateral creditors have been slow, with some expressing their preference to wait until the completion of the debt exchange with private creditors. Private creditors have been offered three bonds, denominated in local currency with 3.5 per cent coupon: 10 year bullet maturity exchanged at 30 per cent discount of principal; 20 year bullet maturity exchanged at 20 per cent discount of principal; and a 30 year bullet maturity, exchanged at par. The IMF estimates debt reduction implicit in the offer at 50-55 per cent in NPV terms. To date mostly domestic creditors, holders of the Citibank bond and a handful of private external creditors have announced their intention to participate.

With fiscal consolidation and debt restructuring in place it is envisaged under the IMF conducted DSAs that Dominica's public debt would fall from 122 per cent of GDP in 2003/04 to 106.3 percent in 2008/09, and then to 90.8 per cent in 2014/15, and external debt from 86 per cent of GDP in 2003 to 68 per cent in 2009 and then to 63 per cent in 2015. However, while it is possible that Dominica would meet its fiscal consolidation targets, the key question is whether all creditors will participate in the debt restructuring deal. Also, Dominica's progress can easily be affected if its key variables on growth and interest rates do not turn out as projected, and in particular if Dominica is faced with shocks (see Chart 11)

Chart 11

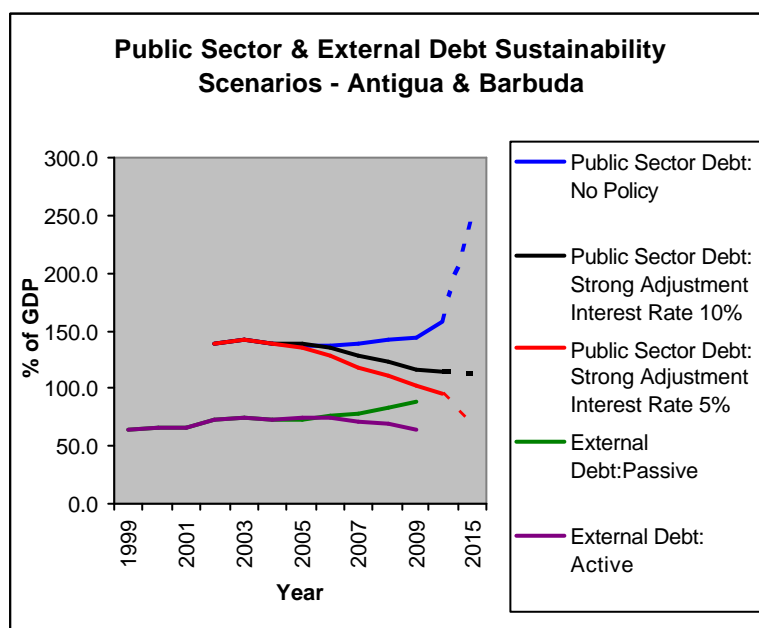


In the case of *Antigua and Barbuda*, DSAs conducted as part of the IMF 2004 Article IV Consultations, indicated that continuation of present policies (with projected growth rates of only 2.3 per cent) would lead to a continuing rise in the public debt to GDP ratio to 145 per cent in 2009 and 252 per cent by 2015 (see Chart 12). External debt would also rise to 88 per cent of GDP. The new government which came into power in March 2004 signaled its intention to undertake significant fiscal reforms beginning with the 2005 budget, stressing that all policy options were on the table including politically difficult measures such as public sector retrenchments and the introduction of the personal income tax. In this context, the IMF Article IV mission recommended a 4 per cent of GDP fiscal adjustment in 2005, with the brunt borne by raising revenues (as these were well below other ECCB economies), with the non-interest expenditures increasing modestly. The mission recognized that would still leave a substantial financing gap, as Antigua and Barbuda had financed its budget for several years by the accumulation of around 10 per cent of GDP a year in arrears. Addressing the arrears, by converting them into a long term bond, would however have significant short term costs: interest cost would rise by 6 per cent of GDP. Nonetheless, such actions would provide a credible signal of the government's intent to address the fiscal problems. According to the mission, with further adjustment over the medium term, with the primary balance moving from a deficit of 3 per cent of GDP in 2004 to a surplus of 8 per cent of GDP by 2009, the debt stock would decline gradually to more manageable levels.

According to the mission the pace of the decline would be critically dependent on the average cost of new borrowing and the terms on which the arrears are cleared. If the interest rate on the bond to clear arrears is assumed at 10 per cent (which is slightly below the rates charged by commercial banks, but above the average rate on external debt), this could result in debt to GDP ratio declining to 115 per cent in 2009 and about 112 per cent in 2015. If on the other hand new borrowing to clear arrears is below market rate public debt/GDP ratio could fall to 101 per cent by 2009 and 66 per cent by 2015.

The mission recognized that even with strong and sustained adjustment effort the debt level will remain high for many years and called on the government to explore all options to reduce debt more rapidly. In this respect the Antiguan government has been conducting some asset sales, while discussions have also taken place with a number of creditors on options for restructuring debt obligations. The clear issues are whether the government would be able to sustain such reform efforts over a prolonged period of time, whether the growth rates (3.9 per cent average) and interest rates assumed under the adjustment scenario actually materialize and whether creditors would be agreeable to below market terms. Given its history, Antigua and Barbuda could also expect large exogenous shocks.

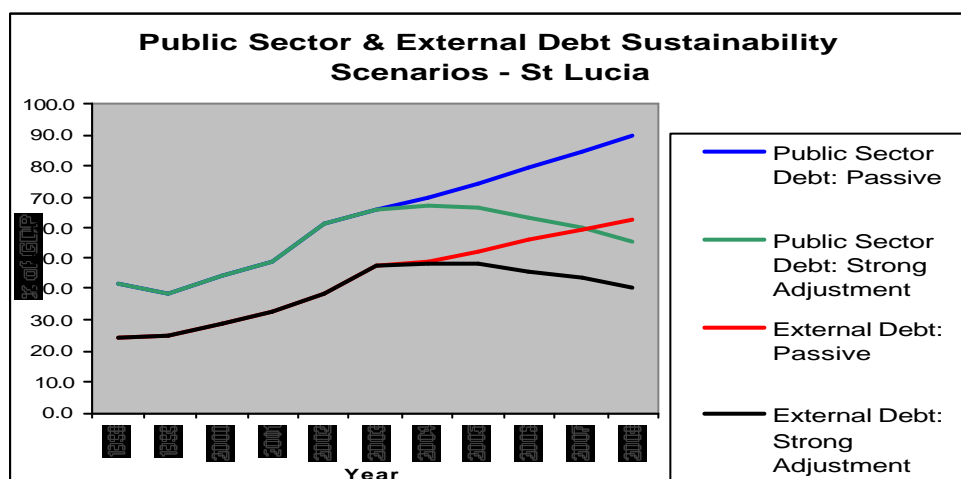
Chart 12



Following the recent developments particularly the havoc caused by Hurricane Ivan in 2004, **Grenada** has been engaged in efforts to restore growth and fiscal sustainability. The 2005 budget showed government determination to fill financing gaps and contained measures yielding 2 per cent of GDP, including a special 5 year levy, increase in the price of fuel and excise duties on alcohol and tobacco. However according to IMF Article IV mission, a further fiscal effort of 5-6 per cent of GDP per year would be needed to contribute to filling the financing gap, which would require extensive national consultations and ownership building. The IMF mission also recognized that reducing public debt was a matter of economic urgency and social responsibility. In January 2005 the government appointed professional advisors to assist in reaching agreement with commercial creditors that would reduce NPV of debt. The government has also requested substantial debt relief from its major bilateral creditors including Taiwan, Kuwait, Libya and Paris Club creditors.

According to the DSAs carried out as part of the Article IV consultations, on unchanged policies, *St Lucia*'s public debt would rise from 65.7 per cent of GDP in 2003 to 89.4 per cent in 2008, with external debt rising from 47.6 per cent to 62.8 per cent. (see Chart 13) IMF mission took the view that to achieve rapid growth, *St Lucia* would need to invigorate the private sector, reduce public debt and preserve macroeconomic stability. In particular, reduction of debt to ECCB benchmark of 60 per cent would require a swing of 7 percentage point in the primary balance over the five year period to 2008. While the government agreed on the need for fiscal consolidation, it was concerned that significant fiscal retrenchment would undermine economic recovery and took the view that expansionary fiscal policies were justified given the severity of external shocks and erosion of preferential markets in the EU. It saw room for cutting capital expenditure and resisting labor unions' demands for wage increases, but remained noncommittal with regard to other specific measures. To illustrate the effects of a more gradual adjustment path, the staff developed a medium-term scenario that would stabilize debt at around 70 percent of GDP. While this would still require a substantial swing in the primary balance of about 5 percent of GDP in the next 5 years, it would nevertheless pose risks if faced with unanticipated new shocks. The staff therefore strongly recommended policies to set the debt-to-GDP ratio on a firmly declining path, as embodied in the more ambitious scenario.

Chart 13



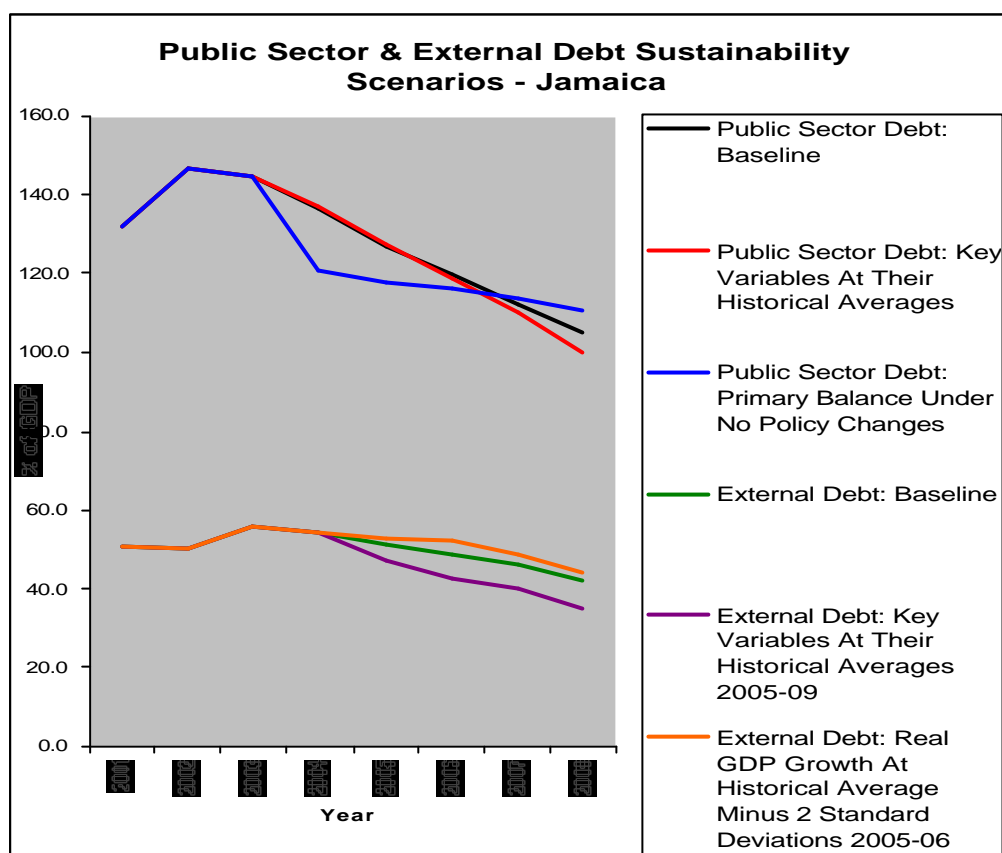
4.2. Other Caribbean Economies

Jamaica's strategy has been to bring down its public debt to GDP ratio, which has become a major vulnerability for the economy. Its fiscal strategy therefore calls for balancing the budget by FY 2005/06, and maintaining small overall surpluses thereafter in order to bring about a sustained reduction in the debt ratio. This strategy is predicated on primary surpluses of about 14 percent of GDP over the medium term. On this basis, the public debt would decline gradually to just above 100 percent of GDP by FY 2008/09 (see Chart 14). As a first step, the government targeted a reduction in the budget deficit to below 4 percent of GDP in FY 2004/05, which according to the IMF Article IV mission, though ambitious, was achievable with a determined policy effort. Hurricane Ivan appears to have affected the achievement of this target. Regarding the medium term, however, the mission's projections pointed to the need for additional measures to secure the authorities' budgetary targets.

Jamaica, which in the past has restructured its external debt, albeit on commercial terms (see Appendix Tables 1 and 2), however, continues to rule out seeking a rapid reduction in the debt ratio through a comprehensive debt restructuring involving a substantial cut in NPV. The government believes that such a debt restructuring would be highly detrimental both in its

immediate impact on the economy given the large holdings of public debt by the financial system and because of the damage it would inflict on Jamaica's access to international capital markets.

Chart 14



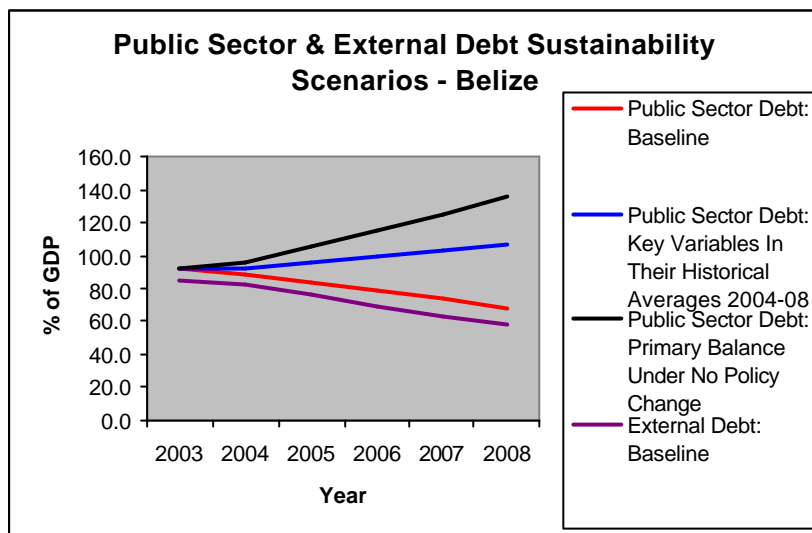
As the IMF mission has underscored, it would be unprecedented for a country to sustain, for a protracted period, the stringent fiscal discipline envisaged by the authorities. In view of the major implementation risks to their fiscal strategy, the mission encouraged the authorities to elaborate a comprehensive fiscal reform agenda to strengthen the budgetary outlook. There is also a question whether debt restructuring with NPV reduction may not in fact be helpful to lift private investment and poor growth record of Jamaica.

According to the DSAs conducted by the IMF as part of Article 4 Consultations with *Belize*, with no change in policy Belize's public debt to GDP ratio would increase sharply to 137 per cent in 2008 (Chart 15). Moreover, even with a rapid and sustained correction of the fiscal imbalance, the economy would remain highly vulnerable to exogenous shocks in light of the already high levels of external debt and debt service, the economy's exposure to natural disasters such as hurricanes and flooding, and its reliance on preferential trade access for its exports of sugar and bananas. The staff stressed that these risks underscored the importance of achieving and sustaining the policy corrections planned for the coming year, and possibly argued for even more ambitious adjustments in subsequent years in order to build up a margin of resilience to withstand future exogenous shocks. On the basis of an increasing fiscal adjustment with the primary surplus reaching 5 per cent of GDP by 2008, the staff project public debt at 67 per cent in 2008.

In 2004-05 the government aimed to reduce the fiscal deficit below 3 per cent of GDP, based on a revenue increase of 2 per cent of GDP, though improved tax administration and a new land tax. However the IMF staff expressed strong reservations on these revenue projections

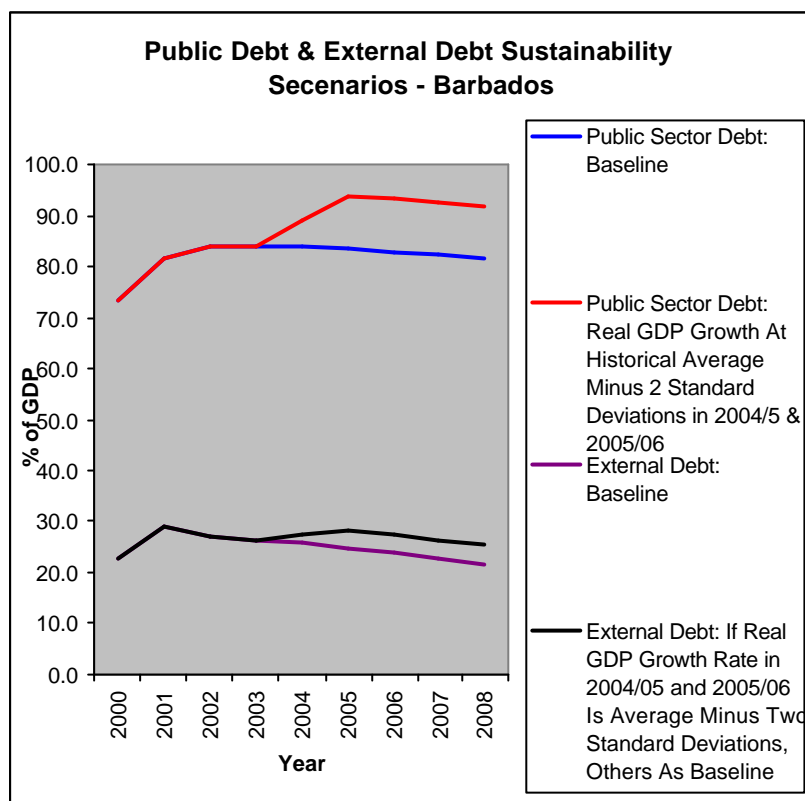
and depth of the adjustment envisaged and emphasized the need for wider-ranging measures. The government however showed commitment to contain the fiscal deficit at the budgeted level and does not see an immediate need for additional measures, but agreed to reassess their projections and consider more comprehensive measures if necessary to bring the fiscal adjustment path back on track.

Chart 15



In the case of *Barbados*, IMF (2004 Article IV Consultations) does not see any significant risk of an imminent debt crisis in the near term because the external position is strong, financial linkages with regional economies are limited, and gross financing requirements—which are projected to be almost fully met from domestic sources over the medium term appear manageable, particularly in view of the abundant liquidity in the banking system. This view is also supported by the external sustainability analysis, which shows that the external debt-to-GDP ratio declines or remains roughly stable for all shocks except those to the exchange rate and the current account. ADSA anchored on the baseline scenario indicates that the public debt ratio could rise markedly in the event of policy slippages or adverse exogenous shocks (see Chart 16). All the stress tests result in rising public debt levels, with some shocks taking the debt ratio above 90 percent of GDP. The IMF staff believes that a stronger fiscal stance, aiming to reduce the public debt to GDP ratio below 60 per cent would significantly reduce vulnerability to external shocks.

Chart 16



4.3. Pacific

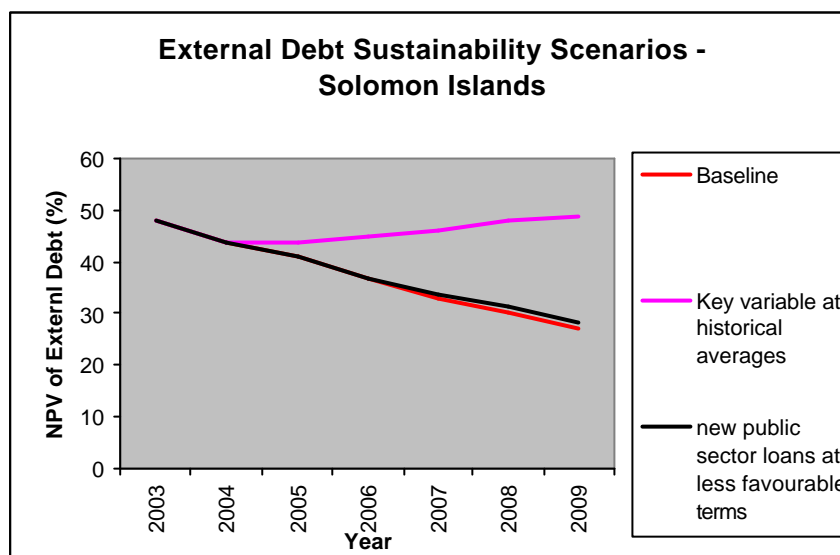
In its 2004 IMF Article IV consultations, the authorities in *Solomon Islands* and IMF staff agreed that the growth of real GDP during 2004–09 could average 4.5-5 percent a year provided appropriate policies are implemented. Economic growth would initially be driven by donor-financed public investment and later by rising private investment and exports provided an early start is made to reducing the current regulatory burden and implementing other critical structural reforms. The current account deficit as a share of GDP would gradually decline as exports increase and the level of project-related imports falls back. Assuming the budget deficit averages 0.5 percent of GDP and the level of new foreign borrowing is contained, the government debt ratio would decline from 100 percent in 2003 to 65 percent of GDP by 2009 (see Chart 17). External debt would decline to 42 percent of GDP and the servicing burden would remain sustainable, although it was recognized that economic shocks could have a major impact on the projected debt dynamics.

To achieve these objectives, the authorities stated that their priority is to adhere to a fiscal framework for 2004 that can restore confidence in the government’s ability to manage its finances and also outlined their approach to strengthen medium-term fiscal finances taking into account the ongoing large rehabilitation expenditures, expected decline in donor flows, and rising operations and maintenance spending associated with the new development projects.

It was also recognized that resources will also be required to regularize and reduce external and domestic debt and arrears obligations. The authorities indicated that they are committed to finalize a rescheduling agreement with their domestic creditors (mainly the commercial

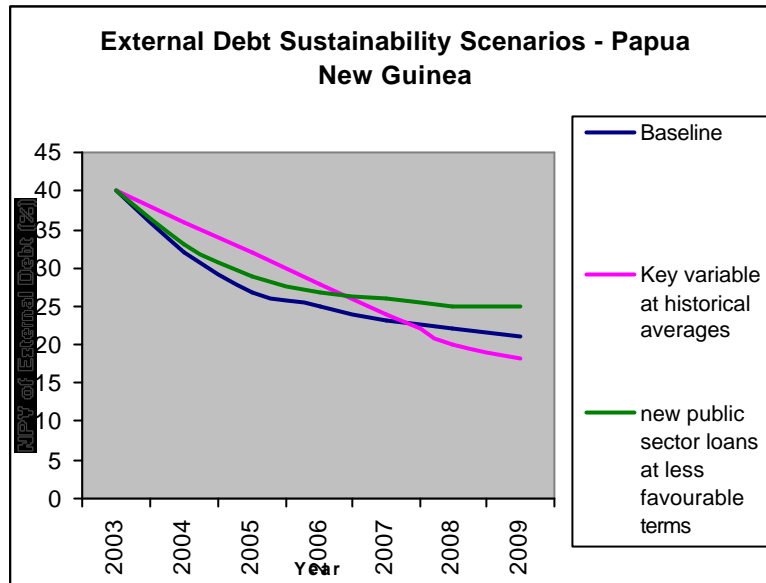
banks, the National Provident Fund, and the central bank) with the terms of the agreement guided by the authorities' intention to ensure that total external and domestic debt servicing not exceed 15 percent of projected domestic revenue. Thereafter, the authorities intend to discuss with their commercial and some bilateral creditors plans to reduce external debt levels and servicing costs. In regard to the stock of expenditure arrears (the bulk of which are due to utility companies, for wage-deductions due to pension, credit, and trade unions, and to trade creditors), once their legitimacy has been verified, these are expected to be paid down as circumstances permit.

Chart 17



The medium-term scenario prepared by IMF staff, in conjunction with the 2004 Article IV consultations, suggests that with continued efforts to strengthen financial policies and deepen structural reforms, PNG's external position would remain satisfactory despite the projected decline in mineral sector output and exports due to the depletion of reserves. The baseline scenario incorporates the government's commitment to achieve a fiscal balance of 1.5 percent of GDP in 2004, and envisages that the deficit would be contained under 1 percent of GDP during the projection period through a further restructuring of the budget, in particular wage bill restraint. While mineral real GDP is projected to decline modestly after 2005, non-mineral production is expected to grow at 3 percent annually, backed by strong structural reform policies. Overall GDP growth is projected to average 2.5 percent a year through 2008 and 3 percent per annum thereafter. The DSA results suggest that under these policies, the NPV external debt-to-GDP ratio would decline from 40 percent at present to about 21 percent by 2009 (see Chart 18). These debt projections are particularly sensitive to negative shocks, applied over two years, to GDP deflator, export value growth, and exchange rate. The impact of shock to each of these variables would leave the NPV of external public debt at about the current high level. Applying a one-half standard deviation shock to a combination of real GDP growth and net non-debt creating flows would also have a more serious effect, causing the NPV of public external debt-to-GDP ratio to rise on average by 10 percentage points through 2009.

Chart 18

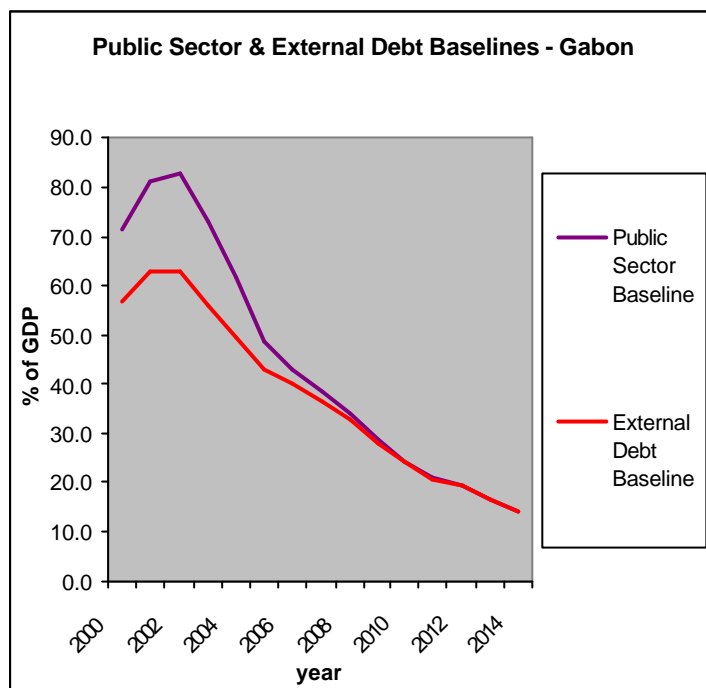


4.4. Africa

For Gabon, an updated baseline DSA indicates that the external debt-to-GDP ratio is projected to decrease by 13.1 percentage points to 36.5 percent of GDP by 2007 mainly on account of significant oil revenues and continuing fiscal discipline and thereafter to 14.1 percent by 2014, additional factors responsible being steady growth of non-oil output and debt amortization in excess of new borrowing (see Chart 19). Reflecting the repayment schedule under earlier rescheduling agreements (see Appendix Tables 1 and 2)), the debt-service ratios peak in 2009 (reaching 18 percent for the debt service-to-exports ratio and 31.6 percent for the debt service-to-revenue ratio) and again in 2012 (reaching 14.6 percent and 22.9 percent respectively). Financing gaps remain minor through 2014 and could easily be covered by drawing on government deposits at the regional central bank. Gabon’s total public sector-to-GDP ratio is projected to decrease from 61.9 percent in 2004 to 38.5 percent in 2007 and further to 19.3 percent in 2012, where it is assumed to be fully repaid.

Gabon’s debt sustainability remains extremely sensitive to shocks to non-oil output growth, to changes in the production and the price of oil, and to the degree of fiscal discipline. For example, should the oil windfalls resulting from the current price levels be spent rather than saved, debt dynamics quickly turn unsustainable and require forceful fiscal adjustment measures. A one-standard deviation shock on the primary balance in 2005-06 results in a public debt-to-GDP that decreases only to about 40 percent by 2014. This is the result of lower domestic debt being retired and more foreign borrowing needed to cover the resulting financing gaps. These results highlight the importance of prudent fiscal policies and of fostering the development of the non-oil economy by encouraging private sector development and the diversification of Gabon’s economic base.

Chart 19



4.5. Digression

The above analysis of countries raises a number of issues:

- Unsustainability of debt on the basis of current policies in a number of countries.
- The need for fiscal consolidation in all countries, but questions about the pace of fiscal consolidation and sustainability of fiscal compression over prolonged periods in a number of countries
- Resistance to debt restructuring in some countries and the difficulties of obtaining debt reduction by countries which so decide
- The threats to debt sustainability in countries, if the key assumptions do not materialize or because of shocks to output and reduction of grants and other concessional flows

5. NEED FOR A FRAMEWORK TO ASSIST SMALL STATES' DEBT PROBLEMS

There is a lack of international recognition of the emerging debt problems of small states, arising mainly due to the unique characteristics or circumstances these states face, in particular the extreme vulnerability of these states to natural and other disasters and, in the face of loss of preferential markets and drastic reduction of concessional financing, the difficulties these countries face due to their smallness and remoteness in reducing essential expenditures and attracting private investment for diversification and growth. Yet, the current approach relies extensively on small states' themselves (and in some cases with IMF adjustment support) to resolve their indebtedness problems, mainly through fiscal

retrenchment and seeking debt restructuring directly from creditors where they think this is appropriate.

What is required is a framework within which these countries debt and other economic problems can be addressed. Such a framework should include:

- Fiscal discipline in small states themselves, underpinned as appropriate by IMF programmes or fiscal responsibility laws;
- Debt restructuring that provides significant debt reduction on an NPV basis, in all appropriate cases;
- Grant financing and insurance mechanisms that respond to the reconstruction and rehabilitation needs following natural disasters in small states, without adding to their debt burden;
- Continued grant and concessional financing for small states, particularly ensuring that this support is not rapidly withdrawn;
- Improved debt recording and debt management in small states;
- Support for the efforts of small states to promote private investment for diversification and growth, and by implication their debt carrying capacity; in particular international support for mitigating their endowed handicaps and thereby lowering the threshold for private investors to ensure a level playing field for small states.

5.1. Fiscal Discipline and Responsibility Laws

The foremost requirement in dealing with the debt problems in small states is fiscal discipline, which ensures that fiscal balances are brought back into reasonable balance over an appropriate period of time. The pace of this adjustment depends very much on the capacity of countries to raise revenues and curtail expenditures, in relation to GDP. In circumstances where countries face immediate exceptional financing needs this is often done through an IMF programme. However, the pace of adjustment in such circumstances is dictated by such a programme, and not necessarily what the government thinks is appropriate.

While the IMF programme can ensure a commitment during the programme period, it does not necessary entrench a commitment of fiscal discipline in the future. In this respect, the ECCB for its members have laid down some benchmarks, including debt to GDP ratio of 60 per cent.

Despite these benchmarks, all ECCB members have exceeded these benchmarks, some by a very wide margin. This has raised the issue whether these benchmarks should not be entrenched into fiscal responsibility laws (FRLs) that ensure discipline by both current and future governments. The experience of countries with FRLs has been mixed, with significant failures in some countries. The problems arise in designing appropriate exit clauses: the purpose of FRLs should be to maintain discipline, but this discipline should not be so rigidly interpreted as to stifle government action in times of genuine need. There is also a question of building a domestic consensus in enacting such laws.

5.2. Debt Restructuring

While indebted small states have moved towards bringing their primary balances into surplus, in a significant number overall deficits continue to be large due to a large debt interest

payments burden. Given the large debt overhang in these countries, restoration of debt sustainability would require a substantial reduction in their debt and debt service burden.

The principle of debt and debt service reduction was accepted as part of the Brady Plan in 1989 for eighteen major debtors, under which commercial banks through a menu of options forgave debt close to \$60 billion, representing 30-35 per cent of its face value. Heavily indebted poor countries benefited for debt reduction under the various initiatives by the Paris Club between 1988 and 1994 and later on under the HIPC Initiative which called on all creditors to provide deep debt reduction on an NPV basis, with comparable treatment by all creditors. The latest proposals seek to provide 100 per cent debt cancellation.

For non-HIPC countries, the Paris Club agreed the Evian Approach in 2003, the purpose of which is to ensure that debt treatment is provided to non-HIPCs that reflects their financing and ensures lasting debt sustainability. For countries which face liquidity problems, but are considered to have sustainable debt going forward, the Paris Club would design debt treatments on the basis of existing terms, using the range built into the terms to adapt to individual country situations. For those countries, whose debt is agreed by the IMF and the Paris Club to be unsustainable, creditors would participate in a comprehensive debt treatment, seeking comparable treatment from other creditors, with the Paris Club resorting to a menu of options. However, debt reduction will be considered only in exceptional cases and where the need is clearly demonstrated. It appears that debt reduction under the Evian approach has so far been granted for political rather than economic reasons (e.g. Pakistan, Iraq)

It is possible that some heavily indebted small states, which are IDA-only (e.g. Bhutan, Solomon Islands) may yet qualify to be classified as HIPCs. But for practical purposes, if they seek Paris Club attention, most small states would be considered under the Evian Approach, and even then may not be considered eligible for debt reduction.

Moreover, a number of small states owe a significant proportion of their debt to non-Paris Club creditors, with only a few Paris Club creditors involved. At the same time, a significant proportion of their private debt may be owed not to international, but to domestic or regional creditors. Paris or London Club (for commercial bank debt) arrangements may therefore be unsuitable to deal with the debt problems of small states. Proper institutional arrangements, perhaps at the behest of the IMF, may be needed to consider debt reduction and restructuring for small states.

Details would need to be worked out as to what is the appropriate level of external debt reduction for individual countries. It is important that certain criteria are followed which in fact should reduce the NPV of debt of these countries to certain pre-agreed thresholds. If the HIPC threshold of NPV of external debt to XGS ratio of 150 per cent is applied, then seven countries- Belize, Samoa, Dominica, St Kitts and Nevis, Grenada, Bhutan and Solomon Islands (see Table 2) would qualify for debt reduction. If the NPV of external debt to GNP ratio of 80 per cent is applied (which is still well above the ECCB benchmark of total debt/GDP ratio of 60 per cent), then Gabon and Seychelles would be included but Bhutan and Solomon Islands excluded.

There is also a question whether comparable treatment is the right approach initially given that in the case of major debtors, it was the commercial banks which provided debt reduction and that in the case of HIPCs, the initial debt reduction (i.e. Naples terms, sometimes also referred to as traditional relief) was provided entirely by official bilateral creditors. Paris

Club creditors have often been the first to provide relief and it may be appropriate to tap this relief initially to ease the concerns of some countries, which have not sought debt relief for fear of losing access to capital markets.

External debt reduction alone may not be seen a complete response when domestic debt constitutes a significant share of the total debt in small states. As noted above, Dominica has sought a significant reduction (of about one half on an NPV basis) in all classes of debt. Since the international community has far not paid much attention to the problem of domestic debt, it would be inappropriate to seek at this stage an international response that includes small states' domestic debt. However, any reduction in external debt should by definition, ease the burden of adjustment on small states and may quicken the process of returning to more sustainable debt ratios. At the same time, small states through their internal efforts, where appropriate should seek NPV debt reduction on domestic debt essentially through mechanisms similar to those extended to external private creditors.

5.3. Grant Finance, Insurance and other Contingency Mechanisms to Respond to Natural Disasters and other shocks

It has been noted above that one of the main reasons for widening fiscal deficits and growing indebtedness is vulnerability of small states to natural disasters as well as to downturns in the tourism and export sectors sector due to adverse international developments or slowdown in the global economy.

Natural disasters can lead to heavy destruction of both private and public property and infrastructure. Some small states have taken a number of steps to reduce the impact of natural disasters, such as stricter building codes, location of utility cables underground and public awareness campaigns. More can be done by countries to better enforce the building codes and land use guidelines. Insurance penetration could also be increased, particularly for government assets, as currently only a small fraction- airports and seaports- appear to be insured. However there are limits to which insurance can be useful, as a large proportion of infrastructure (e.g. road networks) may not be insurable, while insurance costs can be prohibitive in some cases. Governments are thus faced with a huge task of rehabilitating or rebuilding infrastructure and other property. Without generous outside grant assistance, this often means new borrowing and extra indebtedness. Given the extreme vulnerability of small states to natural disasters, especially hurricanes in the OECS region, and their already very high levels of indebtedness, their adjustment efforts would be completely blown off course if they are hit by a natural disaster. There is a need therefore for a properly constituted grant financed mechanism that responds to natural disasters in small states. This will ensure that whatever rehabilitation or reconstruction that can not covered by insurance is met without a significant increase in the indebtedness of small states. The response of the international community to the Asian tsunami was very generous and it is important for the donor community to show similar generosity to assist small states when hit by natural disasters.

With respect to other shocks that emanate from adverse global events or slowdown, small states need to respond to these by a clearly developed contingency plan, perhaps worked out on a regional basis, with detailed responses and responsibilities in the event an adverse shock occurs. The international community should also seek to assist through its compensatory and contingency financing facilities.

5.4. Continued grant and concessional financing for small states

It was noted above that one of the reasons for rapid rise in small states' debt particularly in the Caribbean has been a rapid decline in grants and concessional loans. Because of their relatively high per capita incomes, the World Bank has sought to gradually graduate them out of concessional funds. Yet, they remain only marginally creditworthy for non-concessional funds, and currently a number have been given a blend status whereby they receive part of the funds on concessional and the other part on non-concessional terms. Premature graduation of these countries from concessional funds can be highly detrimental to these countries' debt outlook.

Most small states in the Pacific still rely significantly on grants and concessional flows. These countries would have plunged into the same type of crisis as the Caribbean if grants and concessional loans from these countries had been reduced at a rapid rate. It is important that these countries continue to receive substantial such flows and that any reduction takes place taking full account of their economic development and debt sustainability.

5.5. Improved Debt Recording and Management in Small States

There is particular need to strengthen the statistical data base to ensure that it provides relevant, accurate and timely information for policy makers. In the context of debt recording, this is still poor in a number of countries such as Antigua and Barbuda and the Seychelles and where the Commonwealth Secretariat assistance has been sought. A particular deficiency in many countries, including a number of small states, also concerns domestic debt. In this respect the Commonwealth Secretariat CS-DRMS 2000+ has a domestic debt recording module. It is vital that small states make maximum efforts to remove all the current deficiencies in their debt recording systems.

Proper debt recording together with improvements in macroeconomic data and models, it should be possible for small states themselves to carry out more accurate DSAs under alternative scenarios and stress tests on such scenarios.

5.6. Promoting private investment for diversification and growth

Anecdotal evidence from major debtors and heavily indebted poor countries suggests that high levels of debt and debt service payments can be a deterrent to private investment and by implication growth. Debt is also an important factor taken into account in the risk assessments by credit rating agencies. High levels of debt servicing means that if governments were to borrow to service their ever mounting debts, they would be making a claim on domestic savings thus crowding out private investment. At the same time, high levels of debt means that governments would have at some future date to raise the tax effort to service the debt, which could mean higher tax rates, a major consideration for private sector investors. Thus high levels of debt and debt servicing has made many small states even more vulnerable.

There is already a growing awareness of the problems faced by small vulnerable economies in attracting private investment in small and medium sized enterprises (SMEs) as trade preferences disappear. Commercial investors seek a minimum financial rate of return (the threshold rate) after meeting the additional costs of doing business in such economies. A

Commonwealth Secretariat Study recently identified that to do this the expected profitability of an SME in a small economy generally needs to be double that of a similar business in a larger, less vulnerable economy. In the past trade preferences have made a major contribution to their expectations of success.

Governments have made significant efforts to attract investment in their export sectors for the growth potential and linkages into all other production. Much of this effort has been directed at improving the investment climate and there have been significant achievements, but in most countries there are still unnecessary procedural obstacles and service deficiencies - man-made deterrents adding to the endowed handicaps of small vulnerable economies. However whatever improvements are made to policy and infrastructure, many small economies are unlikely to attract orthodox SME investment for reasons of their small size, remoteness and extreme vulnerability. The cost and the risk impact of its endowed handicaps can outweigh anything that can be done by improving policy and infrastructure.

International financial institutions have developed a range of instruments to reduce private investment costs and risks, but these have not had a significant impact on private investment in small economies. This is because these instruments are mostly at market terms and cannot offset endowed handicaps. IFI interventions in small states also have a low priority. According to the Commonwealth Secretariat study the use of ODA to offset endowed handicaps is a sound development policy and distortionary hazards can be minimized by an appropriate design system. Those components of the investment risk that a private investor cannot avoid: small economy risk itself, exchange rate risk and political risk, can be properly mitigated by a system that makes financing available on non-small vulnerable states terms, absorbs the exchange risk and provides packaged insurance against political risk. Such a system could operate through commercial banks either at cost on lending of IFI funds or on an off balance sheet basis, with the net costs met by IFIs and aid donors. The Secretariat study has proposed a creation of a Model Facility

5.7. Next Steps

This is only a preliminary paper which has described the nature of the emerging debt problem of small states including the reasons for the problem, based on the data available as of June 2005. Data and information presented here would no doubt benefit from the latest information from the countries themselves and in particular from updated data and other information from small states which have not made IMF Article IV Reports public. It should also be possible to make quantitative assessment of the various factors contributing to the rise in the debt of as many small states as possible. There is also a need to make a more considered assessment of how high levels may be impacting on private investment in small states.

The paper has presented a framework for dealing with the debt problems of small states and much greater elaboration of the various possibilities need to be explored, including by consultations with various governments and institutions. The final paper would need to focus much more on the solutions than the problem itself.

Appendix Table 1: Small States: Multilateral Debt Relief Agreements with Official Creditors

Country & Date of Agreement	Contract Cutoff Date	Consolidation Period For		Consolidation		Share of Debt Consolidated (percent)	Amount Consolidated (millions of \$)	Repayment	
		Current Maturities		Includes				Terms	
		Start Date	Length (Months)	Arrears	Previous Rescheduled Debt			Maturity years/months	Grace years/months
Djibouti									
25-May-00		31-Oct-99	24	y		100	17	10yrs 0months	6yrs 0months
Equatorial Guinea									
22-Jul-85	01-Jul-84	01-Jan-85	18	y		100	38	9yrs 0months	4yrs 6months
01-Mar-89	01-Jul-84	Arrears as of 31 Dec 88		y	y	100	10	Menu	Menu
02-Apr-92	01-Jul-84	01-Jan-92	12	y	y	100	32	Menu	Menu
15-Dec-94	01-Jul-84		21	y	y	100	51	Menu	Menu
Gabon									
21-Jan-87	01-Jul-86	21-Sep-86	15			100	387	9yrs 5months	3yrs 11months
21-Mar-88	01-Jul-86	01-Jan-88	12			100	326	9yrs 6months	5yrs 0months
19-Sep-89	01-Jul-86	01-Sep-89	16	y		100	545	10yrs 0months	4yrs 0months
24 Oct 91 ^a	01-Jul-86	01-Oct-91	15	y	y	100	498	8yrs 0months	2yrs 0months
15-Apr-94	01-Jul-86	01-Apr-94	12	y	y	100	1360	14yrs 6months	2yrs 0months
12-Dec-95	01-Jul-86	01-Dec-95	36	y	y	100	1030	13yrs 6months	1yrs 0months
15-Dec-00	01-Jul-86	01-Oct-00	24	y	y	100	687	12yrs 0months	3yrs months
Jamaica									
16-Jul-84	01-Oct-83	01-Jan-84	15	y		100	105	8yrs 5months	3yrs 11months
19-Jul-85	01-Oct-83	01-Apr-85	12			100	62	9yrs 6months	4yrs 0months
05-Mar-87	01-Oct-83	01-Jan-87	15	y		100	124	9yrs 5months	4yrs 11 months
24-Oct-88	01-Oct-83	01-Jun-88	18		y	100	147	9yrs 3months	4yrs 9months
26-Apr-90	01-Oct-83	01-Dec-89	18		y	100	179	9yrs 3months	4yrs 9months
19/07/1991 ^b	01-Oct-83	01-Jun-91	13		y	100	127	19yrs 6months/ 14yrs 6months	8yrs 9months/ 6yrs 0months

25/01/1993 ^b	01-Oct-83	01-Oct-92	36		y	100	291	18yrs 6months/ 13yrs 6months	9yrs 0months/ 5yrs 0 months
Trinidad & Tabago									
25-Jan-89	01-Sep-88	01-Jan-89	14	y		100	209	9yrs 5months	4yrs 11months 3yrs
27-Apr-90	01-Sep-88	01-Mar-90	13			100	110	8yrs 4months	10months

a - This agreement was cancelled

b - Agreement with a Paris Club-designated lower middle-income country with heavy official debt. These agreement also allow for debt conversions, subject to the limit of each creditor country (for non-ODA debt) of US\$10 million or 10% of the debt outstanding as of the beginning of the consolidation period, whichever is higher. Where the two sets of figures for repayment are given, the first set represents ODA and 2nd non-ODA

Appendix Table 2: Small States: Multilateral Debt Relief Agreements with Commercial Banks

Country & Date of Agreement	Consolidation Period		Amount Rescheduled (millions of US dollars)	New Money (millions of US dollars)	Repayment Terms (consolidation portion only)			
	Start Date	Length (months)			Rescheduling	New long-term money	Maturity years/months	Grace years/months	Interest (margin)
Gabon								
Dec-87	01-Sep-86	16	27		10yrs 0months	4yrs 6months	1?	
Dec-91	01-Jan-89	36	75		13yrs 0months	3yrs 0months	?	
May-94	10-Jul-94	6	187		10yrs 0months	2yrs 6months	?	
Jamaica								
Apr-81	01-Apr-79	24	126		5yrs 0months	2yrs 0months	2	
Jun-81	01-Jul-81	21	89	89	5yrs 0months	2yrs 0months	2	
Jun-84	01-Jul-83	21	164		5yrs 0months	2yrs 0months	2½	
Sep-85	01-Apr-85	24	359		10yrs 0months	3yrs 0months	1?	
May-87	01-Jan-87	39	366		12yrs 6months	9yrs 0months	1¼	
Jun-90	01-Jan-90	24	315		14yrs 0months	o yrs 6months	13/16	
Trinidad & Tabago								
Dec-89	01-Sep-88	48	473		12yrs 6months	4yrs 6months	15/16	