Discussion Paper

Achieving Debt Sustainability and the MDGs in Small Island Developing States

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POVERTY REDUCTION

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Executive Summary

This report examines public debt levels across a range of small island developing states (SIDS). An important number of SIDS register extremely high debt stock and debt service indicators, and public debt ratios have increased further still in the wake of the recent concurrent food-fuel-financial crises.

In 2009, 14 SIDS registered public debt to GDP ratios in excess of 60 percent. Eight SIDS, mostly in the Caribbean, registered debt to GDP levels in excess of 100 percent. In 2010, the public debt of St. Kitts and Nevis registered over 192 percent of GDP, one of the highest in the world. For some countries, high public debt levels have been a persistent and unresolved problem for over a decade; in others, rapid debt accumulation is a more recent phenomenon and now gives serious cause for concern.

As small open economies, small island developing states are especially exposed and vulnerable to external shocks. These shocks have helped precipitate sometimes large increases in public indebtedness. In turn, high levels of public debt – and debt service – have constrained governments' fiscal space and abilities to respond effectively to these shocks.

Only five small island developing states have been able to access comprehensive debt relief under the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI) (Comoros, Haiti, Guinea-Bissau, Guyana and São Tomé and Príncipe). Other SIDS have not been considered either poor enough and/or severely indebted enough to benefit from the scheme.

In parallel, many small island developing states are classified as middle-income countries and as such do not have access to concessional resources. Official Development Assistance (ODA) to most SIDS has also declined over the last decade as donors have shifted increased attention towards the Least Developed Countries (LDCs). The proportion of OECD-DAC ODA allocated to small island developing states declined from 3.7 percent in 2000 to 2.8 percent in 2008. This has increased many countries' recourse to private sources of finance (domestic and external). However the dynamics of debt owed to private creditors is crucially very different to that owed to public (concessional) lenders and this has increased debt vulnerabilities in some countries.

However Gross National Income (GNI) per capita is a poor measure of small islands' extreme vulnerabilities to exogenous shocks and increasingly climate change. Frequent natural disasters have wiped out the livelihoods of entire communities and entail substantial reconstructions costs. This in turn has exacerbated some countries' public debt burdens. UNCTAD has shown that natural disasters have added on average 24 percentage points to the debt to GDP ratio in the three years that followed the events.

Small island developing states were severely impacted by the recent food-fuel-financial crises. Most SIDS are highly import dependent and as net food and petroleum importers, the recent food-fuel crises led to steep increases in food and energy prices. The food-fuel crisis then spilled over into the global financial and economic crisis. This further weakened many small island governments' already fragile macroeconomic positions as export prices, fiscal revenues, migrant remittances, foreign direct investment and aid flows all declined simultaneously.

ACHIEVING DEBT SUSTAINABILITY AND THE MDGS IN SIDS

Despite limited fiscal space, many governments implemented countercyclical fiscal policies to mitigate the most severe impacts of the crises. This was undoubtedly the most sensible policy choice from a human development perspective however it placed government finances under even greater pressure. Public debt levels in SIDS increased by on average 9 percent of GDP between 2007 and 2010.

SIDS are also projected to recover from the recent crises more slowly than other developing countries, as measured by forecasts of economic growth over the next few years. Projected GDP growth for SIDS in 2010 is 1.7 percent on average compared to 6.3 percent for developing countries as a whole. When combined with small island developing states' poor historical record in terms of economic growth, this means it will be very difficult for many countries to simply 'grow-out' of high public debt levels.

In 2010 alone, four SIDS have restructured portions of their domestic, bilateral and private external debt (Antigua and Barbuda, Jamaica, the Seychelles and the Solomon Islands). In total, over the last three decades 16 SIDS have concluded more than 49 separate debt restructuring operations. Yet in many cases, debt problems persist.

Concerns over medium-term debt sustainability are exerting pressure on many governments to significantly reduce public expenditures. 9 small island developing states will implement public expenditure cuts of more than three percent of GDP in 2010 and 2011 when compared to 2008 and 2009. While some expenditure cuts may be offset through policy measures which aim to reduce inefficiency and waste and improve targeting, it is imperative that social and anti-poverty expenditures are protected – and indeed increased – as we approach the MDG target year of 2015.

As efforts are taken to accelerate progress towards the Millennium Development Goals over the next five years, the extent to which critically high public debt levels may pose serious challenges to sustainable economic and social development, poverty reduction and human development programmes in several small island developing states is of serious concern. However, the issue of high levels of debt in some small island developing states has so far been largely unaddressed by the international policy community. The approach taken so far has relied almost exclusively on small island developing states to resolve their indebtedness problems themselves, mainly through fiscal retrenchment, increased taxation and seeking debt restructuring with individual creditors on an ad-hoc basis. This approach however has not been sufficient.

SIDS' governments must take important measures to boost domestic resource mobilisation via the development of more efficient and fair taxation systems (with provisions built-in for the poorest sections of the population). However small populations also limit the extent to which domestic resource mobilisation through increased taxation alone will be sufficient to meet governments' considerable fiscal deficits. Given their high import dependence, increased efforts should be taken to strengthen customs administrations. In parallel, it will also be vital for many governments to diversify their economies, significantly improve institutional debt management capabilities and develop credible medium-term debt sustainability strategies.

However the international community must also strengthen the international policy environment for SIDS. The report outlines a series of policy recommendations for international development partners, namely:

- Debt relief initiative for some small islands: in some small island developing states, the size of the public debt overhang is so large that comprehensive debt relief must be urgently taken-up by the international community;
- Debt conversions for climate change adaptation: such innovative financing mechanisms could support the neediest countries to generate additional resources for climate change adaptation;
- Measures to restructure private domestic and external debt: Jamaica's recent debt exchange, supported by UNDP, offers important lessons learned for other countries with large stocks of domestic debt;
- Need for an International Sovereign Insolvency Mechanism: the frequency of debt restructurings across small island developing states lends weight to arguments in favour of a sovereign debt restructuring mechanism at the international level;
- Need for a SIDS-specific approach: SIDS' extreme vulnerabilities to external shocks means that certain trade and development finance concessions need to be extended to them;
- Need for tailor-made financial instruments in recognition of SIDS' vulnerabilities: such innovative financial instruments should reduce the fiscal burden of the debt in the face of external shocks.

This overview report is accompanied by four country case studies: Grenada, the Maldives, St. Kitts and Nevis and Tonga. These reports explore each country's public debt position in more detail as well as outline more detailed policy recommendations in line with country circumstances. They were produced in collaboration with UNDP's country offices in Barbados, Fiji and the Maldives.

1. Introduction

1.1 Debt in developing countries: A downward trend until the crisis

Developing countries entered the global financial and economic crisis in very different situations with respect to their public debt positions. On the positive side, many countries had reduced current account deficits and external public debt in recent years. Developing countries as a whole registered positive current account balances of on average 5.2 percent of GDP in 2006 and 4.2 percent of GDP in 2007. External debt declined from on average 36 percent of GDP in 2000 to 24 percent of GDP in 2008. External debt service as a percent of exports declined from on average 30.6 percent of GDP in 2000 to 20.5 percent by 2008.[1]

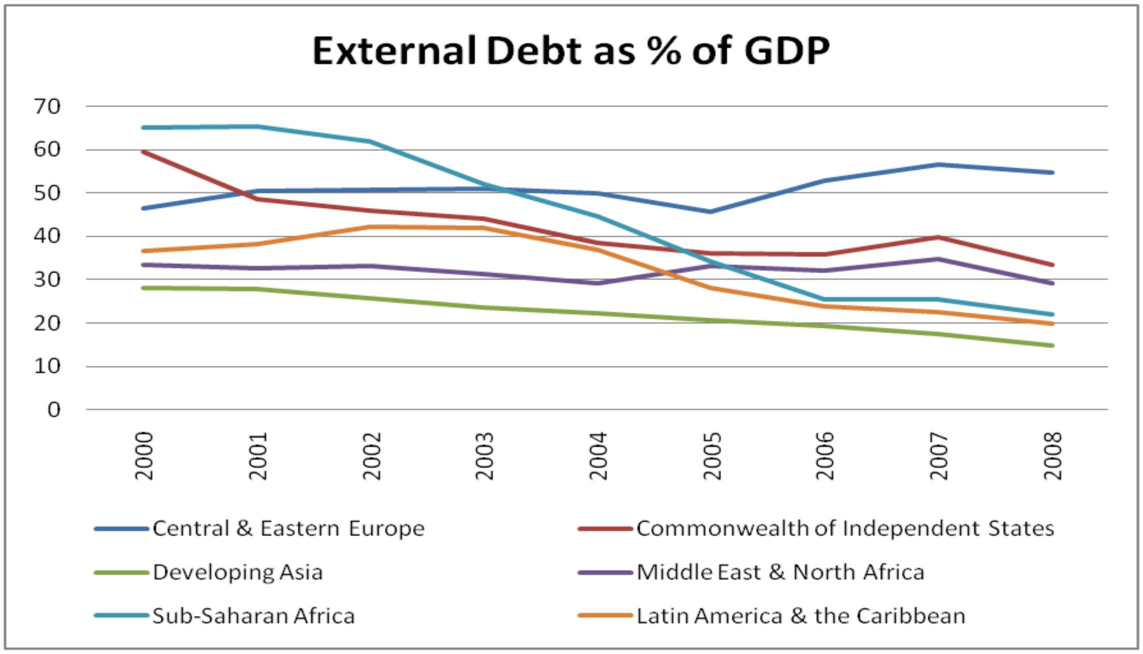
Several factors explain these improved macroeconomic positions. Recent improvements in the size of the public debt in many countries undoubtedly reflect the impacts of favourable cyclical global conditions. For instance, as commodities exporters, many developing countries benefited from the five-year boom in international commodity prices between 2003 and 2008. By mid-2008, energy prices were 320 percent higher than in January 2003, the prices of metals and minerals had increased by 296 percent and internationally traded food prices by 138 percent.[2] This enabled many countries to increase their foreign exchange reserves substantially. Indeed, at the end of 2007, developing countries held more than three quarters of the world's total reserves, estimated at around US$ 4.9 trillion.[3]

In addition, 35 countries – mostly in Sub-Saharan Africa – have benefited from substantial debt cancellation under international schemes such as the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI).[4] Multilateral debt relief combined with bilateral debt relief reduced beneficiary countries' external debt burdens by on average eighty percent.[5] In total, over US$76 billion in external debt has been relieved over the last decade. In parallel, many developing country governments improved debt management capacities, developed medium-term debt sustainability strategies and adopted fiscal responsibility legislation.

In contrast, a considerable number of developing countries entered the global financial and economic crisis with critically high public debt burdens and substantial current account and fiscal deficits. The HIPC Initiative and MDRI combined with additional bilateral debt cancellation provided by the Paris Club (and several other creditor countries) left the world's developing countries at very different levels of indebtedness. Those countries that did not qualify for the initiatives were left with substantially higher external debt levels than those countries which did benefit.

[1] IMF World Economic Outlook (WEO) database, April 2010
[2] World Bank, Global Economic Prospects 2009
[3] Report of the Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, June 2009
[4] For information on the HIPC Initiative and MDRI, see: http://www.worldbank.org/debt
[5] World Bank, Global Monitoring Report 2010, p. 136

Figure 1: Developing countries' external debt stocks (2000 – 2008)



Source: World Bank Global Development Finance 2010

1.2 The exceptions: small island developing states

Of particular concern are the high public debt levels in several small island developing states (SIDS). Bar a few exceptions (notably Comoros, Haiti, Guinea-Bissau, Guyana and São Tomé and Príncipe), most small island developing states have not benefited from multilateral debt relief initiatives and most have managed only to reschedule bilateral credits owed to the Paris Club.[6] Yet several small island developing states demonstrate critically high public debt burdens as measured by both stock (solvency) and service (liquidity) indicators. In 2009, 14 countries registered public debt-to-GDP ratios in excess of 60 percent. Eight countries, mostly in the Caribbean, registered debt to GDP levels in excess of 100 percent.[7] For some countries, high public debt levels have been a persistent and unresolved problem for over a decade or even longer; in others, rapid debt accumulation is a more recent phenomenon and now gives serious cause for concern.

A range of structural weaknesses can explain, in part, a greater vulnerability to high levels of public indebtedness. These include, *inter alia*: slow and volatile economic growth in many countries following the erosion of trade preferences and a subsequent decline in traditional exports; limited natural resources and a highly specialised export structure based on only a handful of products (especially raw materials) which has left many countries exposed to high and volatile international

[6] The Comoros and Guinea-Bissau are also eligible to benefit from debt relief under the HIPC Initiative and MDRI, but have so far not completed the reforms required by the programme. Eligibility to the HIPC Initiative is based on a debt-to-export level above a fixed ratio of 150 percent or debt-to-government revenues above 250 percent. See: http://www.worldbank.org/debt for further information on the HIPC Initiative and MDRI.
[7] IMF Article IV Consultations and Review Documents 2009 and 2010 (country by country)

commodity prices; limited economies of scale and the problem of 'indivisibility'; geographical isolation; high transport costs; small populations and limited human resources; heavy dependency on tourism and/or migrant remittances as important sources of foreign exchange; and a high degree of vulnerability to recurrent natural disasters such as hurricanes and tsunamis which have brought heavy reconstruction costs. These characteristics mean that many small island developing states lack economic resilience and has also meant that governments' efforts to attract foreign direct investment and public private partnerships have met with limited success.

Other non-structural factors have also played a role, such as lax fiscal policies in some countries, weak capacities in public debt management, poor coordination between government ministries with different responsibilities for domestic and/or external debt, poor loan decisions by governments and financial and capital account liberalisation in many countries over the last two decades which led to the development and expansion of domestic financial markets, as well as allowed governments and private enterprises to make more use of international capital markets.

This report examines in detail public indebtedness across a range of small island developing states. Debt stock and debt service indicators are used to assess the extent to which public debt may pose a challenge to economic development, poverty reduction and human development efforts. The report is especially concerned with the fiscal burden of public debt service since the extent to which governments are able to mobilise resources for investments in economic growth, poverty reduction and the MDGs is determined by the fiscal space available to governments. Fiscal space is in turn constrained by public debt service obligations. In this sense, the report takes a holistic approach to countries' public debt; while a country may demonstrate rather low overall levels of public indebtedness, the fiscal burden of the debt may be high with clear implications for governments' capacities to invest in human development and increasingly climate change adaptation.

This report is complemented by four country case studies which examine in detail the public debt and MDG challenges faced by those particular countries. These countries are: Grenada, the Maldives, St. Kitts and Nevis and Tonga. They were selected by UNDP following consultation with the governments of the countries concerned, as well as on the basis of demonstrably high and/or increasing levels of public indebtedness and important MDG challenges.[8]

On the basis of country level evidence supplemented by data on the extent of the problem of public indebtedness faced by many countries, the report formulates practical policy recommendations as to how governments and the international community can work together to reduce debt and accelerate progress towards the MDGs in affected SIDS.

[8] UNDP country offices involved in this initiative are: UNDP Multi-country Office in Barbados, UNDP Multi-country Office in Fiji and UNDP Maldives.

1.3 Methodological approach

The capacity of countries to carry and service debt depends on a wide range of factors which can be grouped into five broad categories:

1. **Current levels of public debt**: the size of the public debt overhang; maturity and degree of concessionality of the debt; creditor composition of the debt; currency composition and exchange rate dynamics; and contingent explicit and implicit liabilities on governments;

2. **External global environment:** conditions in international capital markets; investors' appetite for risk and perceptions of the debtor government;

3. **Domestic political conditions:** political stability in the debtor country; states' policies and institutions; history of sovereign default and institutional capacities of debt management offices;

4. **Structural weaknesses and vulnerabilities:** dynamics in exports and possibilities for economies of scale; natural resource endowment; geographical location and degree of isolation; small populations; vulnerability to external shocks, including natural disasters and increasingly climate change;

5. **Trends in other external financial flows:** levels of external aid, foreign direct investment and migrant remittances.

The way small island developing states are placed, in relation to the factors mentioned above, makes them particularly vulnerable to rapid debt accumulation. For instance, a country's debt can become unmanageable simply because a natural disaster wipes out a large proportion of the population's livelihoods and homes, which in turn causes the economy to contract as well as generates significant reconstruction costs over the short and medium-term. In fact, Reinhart and Rogoff (2009) have found that historically the debt to GDP threshold where nations typically fall into sovereign debt crises has been in the range of 30-35 percent of GDP, i.e. a relatively low overall debt level.[9]

How these diverse factors interact and play out in a particular country context will vary and this makes analyses of vulnerabilities to debt distress extremely complex. While standard macroeconomic frameworks describe the conditions which need to be met in order for debt levels to remain stable, there is no internationally agreed consensus on the sustainable levels of public debt suitable for countries at different income levels and stages of their development. There is simply no way to know for certain when lenders will stop lending and rolling over their claims, or demand ever higher interest rates from borrowers (which ultimately the borrowers are unable to meet). This clearly does not depend on countries' debt ratios alone but a range of other factors which include conditions in international capital markets at that time, history of sovereign default, and market perceptions of the government.

Despite these problems, there have been several attempts by a range of international institutions and organisations to set indicative 'thresholds' of debt sustainability. Although the reliability of these thresholds may legitimately be questioned, they nevertheless serve as a useful guide to illustrate the extent to which many small island developing states breach these thresholds; many by a significant margin.

[9] Carmen Reinhart and Kenneth Rogoff, This Time is Different: Eight Centuries of Financial Folly, 2009

This report therefore uses as a guide benchmarks on debt sustainability established by international bodies such as the United Nations, IMF and World Bank, as well as regional bodies such as the Eastern Caribbean Central Bank to assess the extent to which governments may already be in debt distress or at high risk of it. These rely on a combination of debt stock (solvency) and debt service (liquidity) indicators. The principal indicators used in this report are:

- **Total public debt-to-GDP ratio (domestic and external debt).** This report will look at how many small island developing states breach a total public debt-to-GDP ratio of 60 percent. The Eastern Caribbean Central Bank has set a 60 percent total public debt to GDP ratio as its target for sustainable debt for the region to be achieved by 2020.[10] The IMF recently used a net present value debt to GDP ratio of 65 percent to identify low-income countries at risk of debt distress, although IMF analyses have also suggested that low and middle-income economies are at greater risk of unsustainable debt once their public debt levels exceed 50 percent of GDP.[11] This would seem to suggest that using a debt to GDP ratio of 60 percent would provide a conservative and high level indication as to the solvency of a country.

- **Total public debt service as a percent of government revenues:** International benchmarks suggest that total public debt service (external and domestic) should not exceed 15 percent of government revenue.[12] This ratio is important since the burden of public debt service is borne by governments' budgets, which in turn means that less resources are available to governments to spend in other critical social and developmental areas.

- **Ratio of external debt service to exports of goods and services:** The IMF and World Bank's debt sustainability framework for low-income countries sets the threshold for sustainable *external* debt service at between 15 and 25 percent of exports, depending on the strength of countries' policies and institutions.[13] This ratio is important since in order to service external debt (typically denominated in hard currencies), countries must earn foreign exchange. The largest source of foreign exchange is usually a country's exports (although in some countries migrant remittances and tourism also provide substantial extra foreign exchange resources, especially in some small island developing states). This means that the larger a country's external debt service burden, the more it must earn via exports, including tourism, in order to cover those debt service repayments. This report looks at small islands which breach the lower 15 percent threshold because small island developing states often have a fragile and narrow export base and demonstrate extreme vulnerabilities to external shocks.

[10] Eastern Caribbean Central Bank 2009/2010 Annual Report
[11] IMF, Preserving Debt Sustainability in Low-Income Countries in the Wake of the Global Crisis, April 1 2010. In this paper, the IMF employs a present value debt to GDP ratio of 65 percent to identify economies at risk of debt distress. However the IMF's debt sustainability framework for low-income countries also suggests that debt levels should not exceed 50 percent of GDP in low-income countries with strong policies and institutions. For countries with perceived weaker policies and institutions, the thresholds are considerably lower. See: IMF/World Bank debt sustainability framework for low-income countries. Similarly, the IMF has suggested that middle-income and emerging market economies are at greater risk of unsustainable debt once their debt levels exceed 50 percent of GDP. See, for instance: UNDP, Debt Sustainability and Millennium Development Goals in Emerging Market Economies, Yilmaz Akyüz, 2007
[12] IMF, Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability Framework for Low-Income Countries, 2008
[13] IMF/World Bank debt sustainability framework for low-income countries (2004)

2. Small Island Developing States: A Snapshot

2.1 Small island developing states: who they are

The United Nations has not developed an official list of small island developing states. However 42 countries – of which 38 are independent UN Member States – have formed an Alliance of Small Island Developing States (AOSIS). Membership is by self-selection and countries can be found off the coast of Africa, in the Caribbean Sea, and the Indian and Pacific Oceans (see figure 2 overleaf).[14] The Alliance acts as an ad hoc lobbying and negotiating voice for small island developing states within the United Nations system.

The countries are extremely heterogeneous and vary widely in terms of their levels of economic development, poverty and security levels. Some are classified as least developed countries (LDCs), such as Cape Verde, Comoros, Haiti, Kiribati, Maldives (soon to graduate to middle-income status), Samoa, São Tomé and Príncipe, Tuvalu and Vanuatu. The majority are middle-income countries such as the Dominican Republic, Fiji, Grenada, Jamaica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. Several enjoy even higher per capita incomes and even investment grade status, such as Barbados, the Seychelles, Singapore and Trinidad and Tobago.

SIDS enjoy on average higher income per capita levels than the least developed countries and the least developed landlocked countries (LLDCs). However, high(er) income per capita levels hide the extent to which small island developing states are disproportionately more vulnerable to environmental, economic and social dislocations. For instance, the 'Environmental Vulnerability Index' developed jointly by the South Pacific Applied Geoscience Commission (SOPAC) and the United Nations Environment Programme (UNEP) rates 17 SIDS as 'extremely vulnerable' and 17 SIDS as 'highly vulnerable'.[15]

This report has analysed public debt data relating to the 38 countries which are independent UN Member States, and also members of the Alliance of Small Island Developing States. In several cases, a complete data set has not been available; in others, data is available on external, but not domestic debt. Consequently, the report has had to work with some data limitations but tries to incorporate and compare data across as many small island developing states as possible.

[14] For further information, see: UN OHRLLS: http://www.unohrlls.org/ and Alliance of Small Island Developing States (AOSIS): http://www.sidsnet.org/aosis/about.html

[15] Environmental Vulnerability Index, South Pacific Applied Geoscience Commission (SOPAC), the United Nations Environment Programme (UNEP): http://www.vulnerabilityindex.net/index.htm

Figure 2: List of Small Island Developing States

1	**Antigua and Barbuda**	14	**Guyana**	27	**Singapore**
2	Bahamas	15	Haiti *	28	St. Kitts and Nevis
3	Bahrain	16	Jamaica	29	St. Lucia
4	Barbados	17	Kiribati *	30	St. Vincent and the Grenadines
5	Belize	18	Maldives *	31	Seychelles
6	Cape Verde	19	Marshall Islands	32	Solomon Islands *
7	Comoros *	20	Federated States of Micronesia	33	Suriname
8	Cuba	21	Mauritius	34	Timor-Leste *
9	Dominica	22	Nauru	35	Tonga
10	Dominican Republic	23	Palau	36	Trinidad and Tobago
11	Fiji	24	Papua New Guinea	37	Tuvalu *
12	Grenada	25	Samoa *	38	Vanuatu *
13	Guinea-Bissau *	26	São Tomé and Príncipe *		

*Also an LDC. Source: Alliance of Small Island Developing States (AOSIS)

2.2 Small island developing states: a recognised special case

The UN has long recognised the special needs and challenges that face small island developing states. In 1994, the UN's 'Global Conference on the Sustainable Development of SIDS' in Barbados resulted in a Programme of Action to support sustainable development in small islands. The problem of external debt was one of the issues tackled at the event.[16] The conference also resulted in the creation of a special unit dedicated to small island developing states within UNDESA's Department for Sustainable Development.[17] It monitors sustainable development in small island developing states across the Caribbean, Pacific, Africa, Indian Ocean, Mediterranean and South China Sea. The UN Office of the High Representative for the Least Developed Countries, Landlocked Developing Countries and the Small Island Developing States (UN-OHRLLS) was created in 2001 and is mandated to engage in advocacy and mobilisation of international support and resources for the implementation of the Programme of Action for SIDS.[18]

In 2005, the Mauritius Strategy on the 'Further Implementation of the Barbados Programme of Action' was agreed.[19] It aimed to secure renewed international commitment to support sustainable development in small islands, especially in relation to areas such as international trade. It also signalled a need for more support to help countries deal with recurrent natural disasters and the effects of climate change. In relation to debt, the final report refers to *"the high and increasing debt burden of many small island developing states"* and urges the international community to *"consider cancellation of debt in the most*

[16] United Nations, Global Conference on the Sustainable Development of SIDS, Programme of Action for the Sustainable Development of SIDS (Barbados Programme of Action), 1994
[17] UNDESA Department for Sustainable Development, SIDS Unit: http://www.un.org/esa/dsd/dsd_aofw_sids/sids_abouunit.shtml
[18] For further information, see: http://www.unohrlls.org/en/home/
[19] United Nations, Mauritius Strategy for the Further Implementation of the Programme of Action for the Sustainable Development of SIDS, 2005: See: http://www.un.org/smallislands2005/

heavily indebted countries."[20] Most recently, the special case of SIDS was reconfirmed by the five year high level review of the Mauritius Strategy (MSI+5) in September 2010. The review highlighted the emerging impacts of climate change which have worsened small islands' economic resilience and contributed to rising levels of public debt.

In January 2010, UNDP assisted the Government of Jamaica to restructure its immense domestic debt burden in recognition of the detrimental impact high levels of debt service were having on the government's capacities to invest in infrastructure development, poverty reduction and the MDGs. The country's debt exchange programme relieved the fiscal burden of debt repayments and increased fiscal space by an additional US$525 million in 2010 (more details given later in the report).[21]

Other international and regional bodies have also raised concerns about the high levels of public debt faced by many small island developing states. These include the Caribbean Community (CARICOM), Commonwealth Secretariat and more recently the IMF. These concerns have become even more pronounced in the wake of the international financial and economic crisis which has significantly worsened the public debt ratios of both developed and developing countries around the world.

In April 2010, CARICOM issued a formal statement to the United Nations which cited debt difficulties in Antigua and Barbuda, Grenada, Jamaica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. CARICOM argued that debt sustainability in the region was seriously threatened.[22] The Commonwealth Secretariat has also pointed to the debt problems faced by a broader set of small vulnerable economies (SVEs), and has suggested that debt relief, more grant and concessional finance, insurance and other contingency mechanisms may be appropriate to help affected countries deal with their public debt burdens.[23] More recently, the IMF has identified nine small islands as either already in debt distress or at high risk of it. These include: Comoros, Grenada, Guinea-Bissau, Haiti, the Maldives, São Tomé and Príncipe, St. Lucia, St. Vincent and the Grenadines and Tonga.[24]

2.3 Debt relief for only a handful of small island developing states

While the issue of high levels of indebtedness in many small island developing states has not gone unnoticed, international attention has focused more extensively on the debt burdens faced by the Heavily Indebted Poor Countries (HIPCs) and large debtor countries such as Iraq and Nigeria. This has helped mobilise international efforts to substantially reduce the external debt burdens of these countries. For instance, the HIPC and MDRI Initiatives combined with bilateral debt relief have reduced the debt stock burdens of 35 HIPCs (mostly Sub-Saharan African countries) from approximately US$140 billion to just over US$20 billion.[25] Over the last five years, Iraq and Nigeria have been able to reduce their bilateral debt burdens with Paris

[20] United Nations, Report of the International Meeting to Review the Implementation of the Programme of Action for the Sustainable Development of Small Island Developing States Port Louis, Mauritius 10-14 January 2005

[21] UNDP, Jamaica's Debt Exchange Programme: A Case Study for Heavily Indebted Middle-Income Countries, May 2010

[22] UN General Assembly Statement by H. E. Camillo Gonsalves, on behalf of CARICOM, April 2010

[23] Commonwealth Secretariat, The Emerging Debt Problems of Small States, 2005 and Commonwealth Secretariat, An Overview of the Sovereign Debt Position of Commonwealth Small Vulnerable Economies, September 2010 and Commonwealth Secretariat, Policy Options to Address the Debt problem of Commonwealth Small Vulnerable Economies, September 2010

[24] IMF, Preserving Debt Sustainability in Low-Income Countries in the Wake of the Global Crisis, April 1 2010, p. 17

[25] World Bank, HIPC Initiative update: http://www.worldbank.org/debt

Club creditors by 80 percent and 67 percent respectively.[26] Both countries also reduced external commercial debt with private creditors.

In total, only five SIDS have been classified as Heavily Indebted Poor Countries: Comoros, Guyana, Haiti, Guinea-Bissau and São Tomé and Príncipe. Of these five countries, three have completed the HIPC Initiative and have benefited from substantial debt relief under both HIPC and MDRI (Guyana, Haiti and São Tomé and Príncipe). These countries' multilateral and bilateral debts have been reduced by approximately US$3.6 billion in total. Both Comoros and Guinea-Bissau are at decision point under the initiative and have received interim debt relief of around US$935 million so far. [27] In total, approximately US$4.5 billion in external multilateral and bilateral debt has been relieved for the five SIDS HIPCs.

Figure 3: Total SIDS' HIPC debt relief (in nominal US$ millions)

Country	HIPC	MDRI
Comoros*	145	
Guyana	1,354	712
Guinea-Bissau	790	
Haiti	213	970
São Tomé and Príncipe	263	66
Total reduction	**2,765**	**1,748**

* The amount shown for Comoros is in PV terms

Source: World Bank

Most small island developing states have not however benefited from international debt relief efforts. As a consequence external debt – as well as domestic debt – levels are extremely high in many small island developing states.

[26] Paris Club: http://www.clubdeparis.org

[27] World Bank and IMF Completion Point documents and World Bank and IMF, HIPC and MDRI Status of Implementation Report, September 2009

3. Public Indebtedness in Small Island Developing States

3.1 SIDS' debt stocks: an overview

Out of 31 SIDS for which data was available, levels of public debt vary considerably.[28] Several small islands register overall low levels of public debt, as measured by debt to GDP ratios below 40 percent. For example in 2009, the Dominican Republic, Haiti, Kiribati, Papua New Guinea, the Solomon Islands, Suriname, Trinidad and Tobago and Vanuatu all registered total public debt to GDP ratios below 40 percent.[29] Nevertheless, a not insignificant number register high levels of public debt, as measured by public debt to GDP ratios in excess of 60 percent.

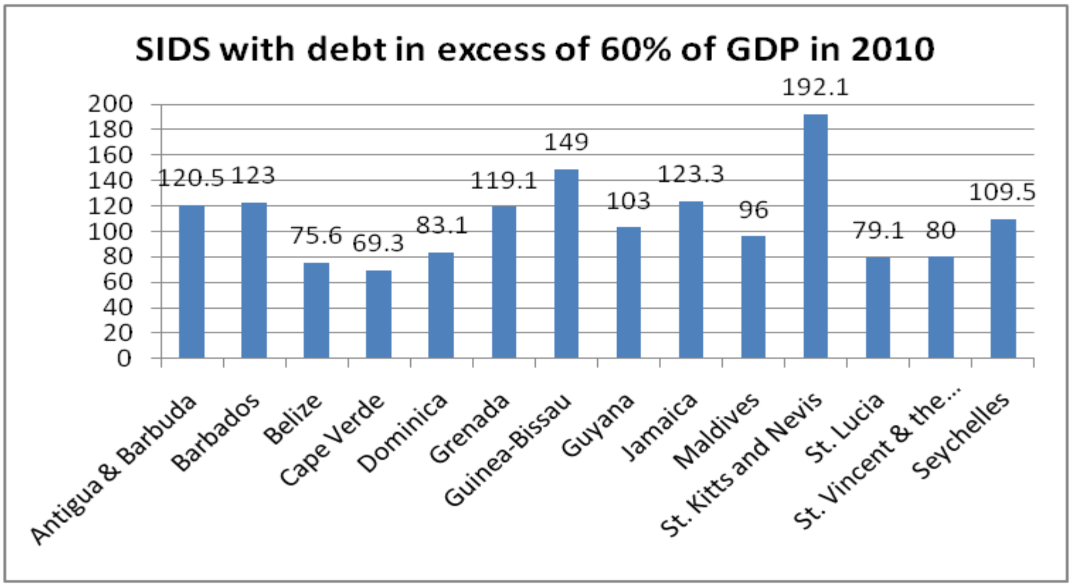
In 2010, 14 SIDS registered public (external and domestic) debt to GDP ratios in excess of 60 percent.[30] Many small islands breach the 60 percent debt sustainability threshold by a significant margin, in particular in the Caribbean. Only one of these countries (Guinea-Bissau with a debt to GDP ratio projected at 149 percent in 2010) can expect to see its debt burden significantly reduced over the short-term as a result of the HIPC Initiative and MDRI. All other countries are not eligible for international debt relief mechanisms. Indeed, Guyana has recently benefited from multilateral and bilateral debt cancellation under HIPC and MDRI, and yet once again registers a high public debt to GDP ratio (estimated at 103 percent in 2010).

The highest levels of indebtedness are registered in the Caribbean region, especially among members of the Organisation of East Caribbean States (OECS)/East Caribbean Currency Union. Counting only independent UN members, these countries are: Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines. In most cases, high public debt burdens have been a persistent and unresolved problem for well over a decade, and although several countries had managed to reduce public debt levels slightly in the years leading up to the concurrent food-fuel-financial crises the recent crises have contributed to rising debt levels once again, as indicated by the chart.

Antigua and Barbuda's public debt to GDP ratio has stood at over 90 percent since 2000. It is projected to stand at 120.5 percent in 2010. Dominica's public debt to GDP ratio has stood at over 80 percent over the last decade and is projected to register approximately 83 percent of GDP in 2010. Grenada's public debt has stood at over 100 percent of GDP since 2002 and is expected to register 119.1 percent in 2010. The public debt of St. Kitts and Nevis peaked at 196 percent of GDP in 2005, the highest in the world. The country's debt levels still remain critically high at a projected 192.1 percent of GDP in 2010. The public debt of both St. Lucia and St. Vincent and the Grenadines have also stood at over 60 percent of GDP since 2004 and debt levels in both countries are on a clear upward trajectory.[31]

[28] Data was unavailable for: Cuba, Federated States of Micronesia, Nauru, Palau, Singapore, Timor Leste and Tuvalu
[29] IMF Article IV Consultations and Review Documents 2009 and 2010
[30] Based on data collected from country by country IMF Article IV Consultations (2009 and 2010)
[31] Data in this section collated from IMF Article IV Consultations (2005-2010) and the Eastern Caribbean Currency Union

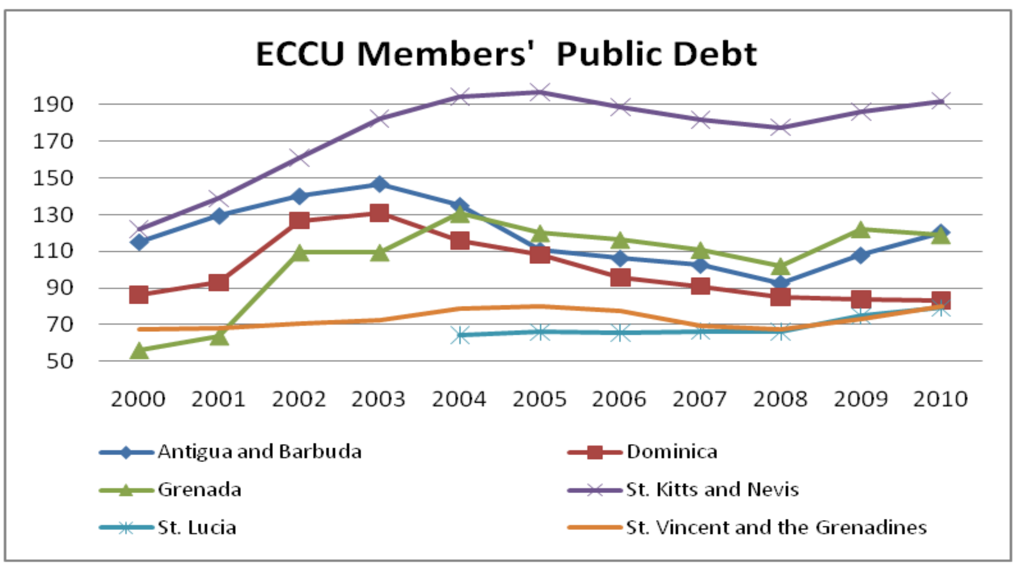
Figure 4: SIDS with projected 2010 debt to GDP ratios in excess of 60 percent



Source: IMF Article IV Consultations and Review Documents.

Note: For Jamaica and Belize, 2009 data has been used

Figure 5: ECCU members' public debt



Sources: Eastern Caribbean Central Bank and IMF Article IV and Review documents

As noted earlier, the Eastern Caribbean Central Bank has set a target of 60 percent total public debt to GDP as a sustainable level of debt for the region to be achieved by 2020. On current trajectories, this target will be missed by most. In fact, forecasts by the IMF show an overall increase in debt to GDP levels for the ECCU countries, from 104 percent in 2010 to 110 percent by 2014. [32]

Figure 6: Forecasts for ECCU debt levels (percent, total public debt to GDP)

Country	2010	2011	2012	2013	2014
Antigua and Barbuda	120.5	128.5	134.0	137.0	139.6
Dominica	74.3	70.3	66.4	62.5	58.8
Grenada	119.1	116.3	111.8	104.5	96.8
St. Kitts and Nevis	192.1	196.1	200.2	206.5	213.2
St. Lucia	79.1	80.7	82.1	82.7	83.3
St. Vincent and the Grenadines	80.0	83.6	84.3	85.6	86.8
ECCU Overall	**103.8**	**106.8**	**108.4**	**109.3**	**110.3**

Source: IMF

Other countries in the Caribbean have also registered increases in public debt over the last decade. Jamaica's public debt has climbed from approximately 88 percent of GDP in 2000 to 123 percent by 2009.[33] Barbados' public sector debt has climbed from 74 percent in 2000 to 123 percent by 2010.[34]

In several other small island developing states, rapid increases in public indebtedness are very recent. This includes the Maldives which has seen its public debt to GDP ratio almost double in just six years from 55 percent of GDP in 2004 to a projected 97 percent by 2010. This is due in part to the devastating impacts of the December 2004 tsunami. Tonga has also experienced a rapid and large increase in its public debt; up from 31.5% of GDP in 2008 to an expected 51% in 2010. According to the IMF, *"Tonga's high public debt now poses a major risk to economic prospects."*[35] Although Tonga's public debt burden does not currently breach the 60 percent threshold, the rapid rate of increase coupled with the country's poor resilience to external shocks and environmental vulnerabilities give serious cause for concern.

Increases in public indebtedness over the last decade have been paralleled by a decline in official aid flows (ODA) to small island developing states when measured as a proportion of total aid flows. The data shows that over the last decade, the proportion of total OECD-DAC ODA allocated to small island developing states declined from 3.7 percent in 2000 to 2.8 percent in 2008.[36] OECD-DAC ODA to SIDS totalled just US$2.4 billion out of a total of US$87 billion in 2008.[37] Most of this aid came from the EU and has been highly skewed towards just a few SIDS, notably Papua New Guinea, St. Vincent and the

[32] IMF, Country Article IV Consultations, IMF Eastern Caribbean Currency Union: 2009 Discussion on Common Policies of Members Countries—Staff Report and IMF Grenada: Fifth Review Under the Extended Credit Facility, May 2010
[33] Government of Jamaica, Ministry of Finance, Debt Management Unit (DMU)
[34] IMF, Barbados 2009 Article IV Consultation and IMF, Barbados 2005 Article IV Consultation
[35] Data from IMF Article IV Consultations 2009 and 2010
[36] UNDP calculations based on data from OECD DAC statistical database (ODA by recipient)
[37] OECD DAC statistical database

Grenadines, Solomon Islands and Timor-Leste; for most others, aid has declined over the past decade.[38] This has led some governments to rely more heavily on market-based non-concessional finance (public and private) to support economic development and meet fiscal deficits.

3.2 Impacts of the concurrent food-fuel-financial crises

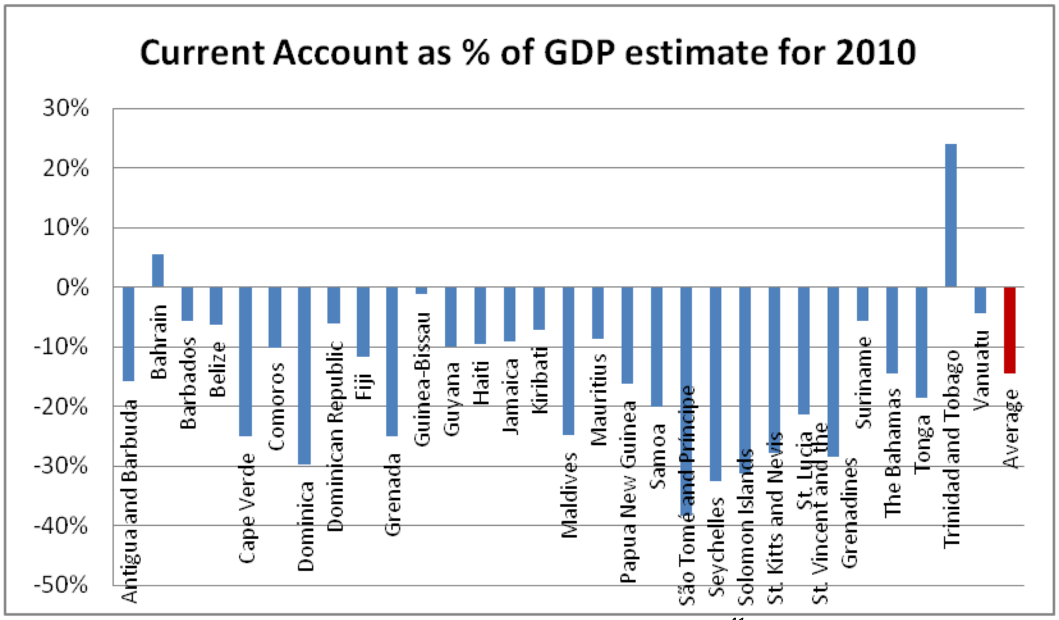
Sharp increases in public debt levels are especially evident over the last three years, as many small island developing states were negatively impacted by the concurrent food-fuel-financial crises. Most SIDS are highly import dependent and as net food and petroleum importers, the recent food-fuel crises led to steep increases in food and energy prices. The food-fuel crisis then spilled over into the global financial and economic crisis. This further weakened many small island governments' already fragile macroeconomic positions as export prices, fiscal revenues, migrant remittances, foreign direct investment (FDI) and official aid flows all declined simultaneously. It should be underscored that these crises came *in addition to* natural disasters such as hurricanes, floods, tsunamis and earthquakes which also affected several countries over the same period. As such, many small islands have faced multiple, severe and simultaneous external shocks over the past three years.

Figure 7 illustrates the extremely weak external position of many small island developing states in 2010. 28 SIDS are projected to register current account deficits of on average 14.5 percent of GDP in 2010.[39] This marks a significant deterioration from current account deficits of on average 6 percent of GDP in 2000. Most SIDS have registered persistent current account deficits over the last decade. This has translated into increased external financing needs, which has in turn been filled by recourse to external debt.

Substantial fiscal deficits across many small island developing states also give cause for concern. 21 small islands for which data was available registered fiscal deficits of on average 5.6 percent of GDP in 2009.[40] The data shows a marked deterioration in fiscal deficits from on average 3.1 percent of GDP in 2007 just prior to the onset of the food-fuel-financial crises. Many small island governments implemented countercyclical fiscal policies in response to the recent global financial and economic crisis. From a human development perspective, this was undoubtedly the best policy response since it enabled governments to mitigate the worst impacts of the crisis. However this fiscal expansion has also been associated with marked increases in public debt levels.

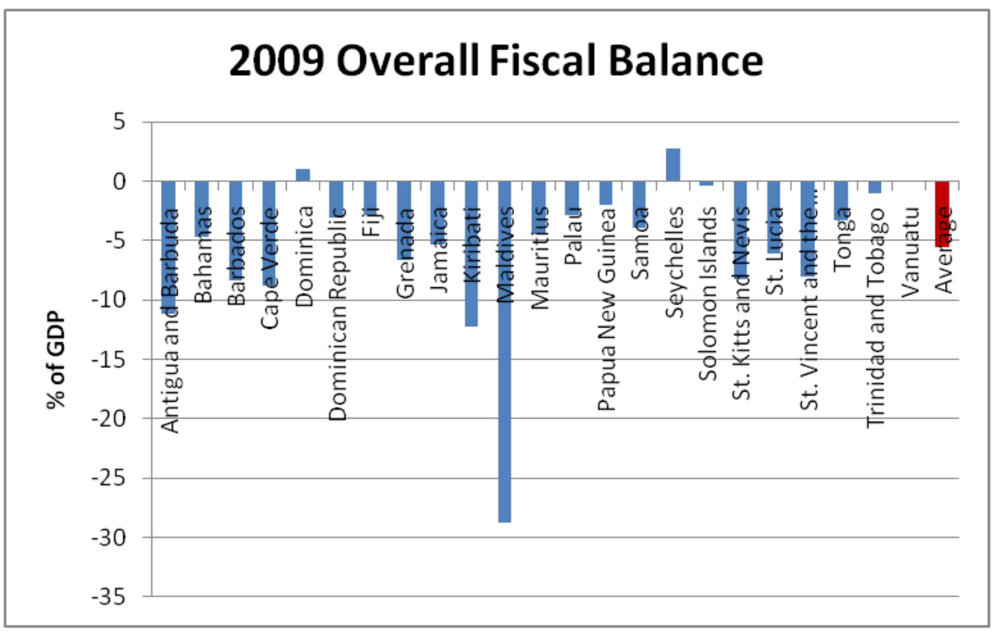
[38] UN General Assembly, Five-year review of the Mauritius Strategy for the Further Implementation of the Programme of Action for the Sustainable Development of Small Island Developing States, Report of the Secretary-General, July 2010
[39] IMF WEO database, April 2010
[40] IMF Article IV Consultations and Country Review Documents

Figure 7: Current account balance selected small islands post- financial crisis



Source: IMF WEO database, April 2010[41]

Figure 8: Fiscal balances selected small islands post- financial crisis



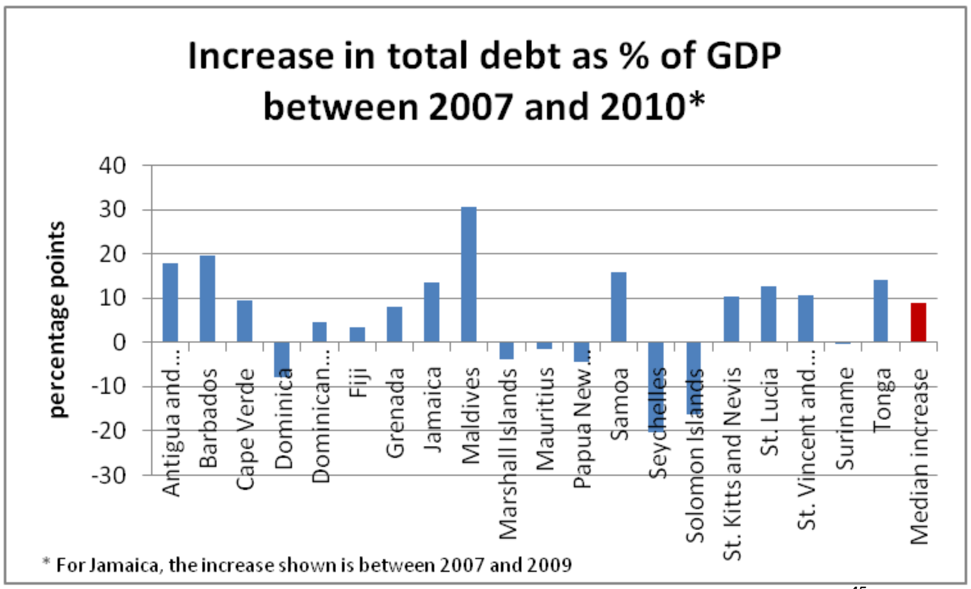
Source: IMF Article IV Consultations and Eastern Caribbean Central Bank

[41] Trinidad and Tobago's large current account surplus can be attributed to the country's substantial oil and gas exports. Trinidad and Tobago contains the majority of the Caribbean's oil production.

The data shows that public debt levels in 20 small island developing states increased by on average almost 9 percent of GDP between 2007 and 2010.[42] However this hides significant variations across countries. In several cases, the increase in public debt is very high. For instance Barbados increased public debt levels by twenty percentage points over three years: from 103 percent in 2007 to 123 percent by 2010. Jamaica's debt climbed from 110 percent of GDP in 2007 to 123 percent by 2009. St. Lucia's debt climbed from 66.5 percent of GDP in 2007 to over 79 percent in 2010.

In other regions, the public debt of the Maldives jumped thirty percentage points between 2007 and 2010 (from 66 percent in 2007 to 97 percent in 2010). Tonga's public debt climbed from 37 percent of GDP to more than 51 percent of GDP by 2010.[43] As a benchmark, the IMF suggests that an annual increase in total public debt levels in excess of 5-7 percent of GDP give cause for concern.[44]

Figure 9: SIDS' increase in public debt between 2007 and 2010



Source: UNDP calculations based on IMF Article IV Consultations (multi-year)[45]

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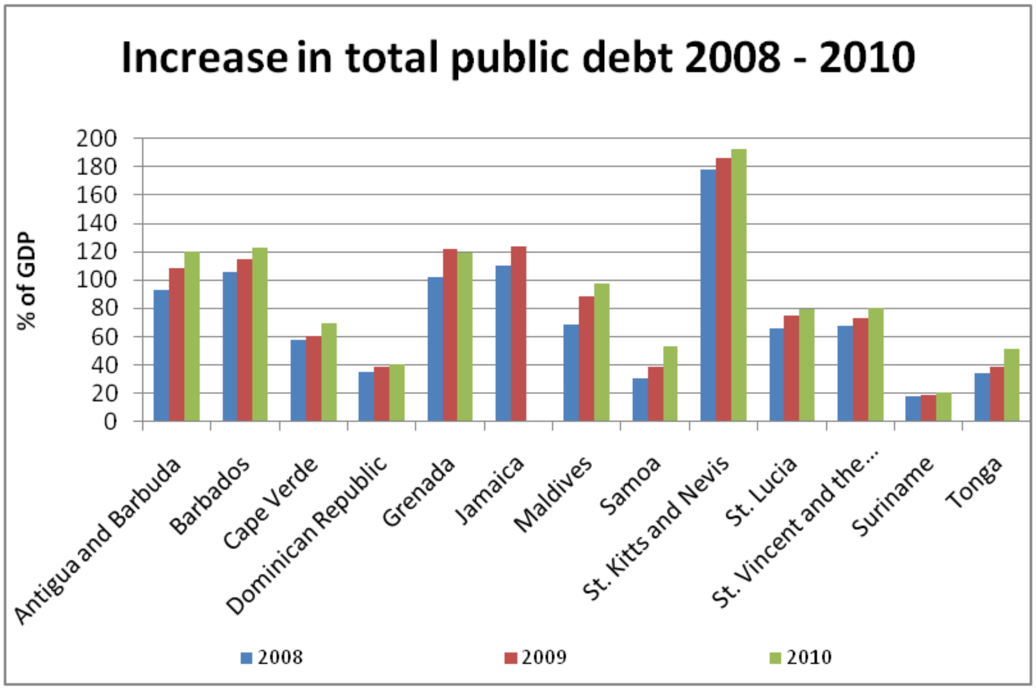
[42] UNDP calculations based on data contained in IMF Article IV and Review documents

[43] Data in this section collated from IMF Article IV Consultations 2009 and 2010 and Government of Jamaica, Ministry of Finance, Debt Management Office (DMO)

[44] IMF, Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief, 2006

[45] Substantial decreases in the debt to GDP ratios of both the Seychelles and the Solomon Islands can be attributed to debt restructuring operations recently concluded by these countries (discussed later in the report).

Figure 10: SIDS' increase in public debt between 2008 and 2010

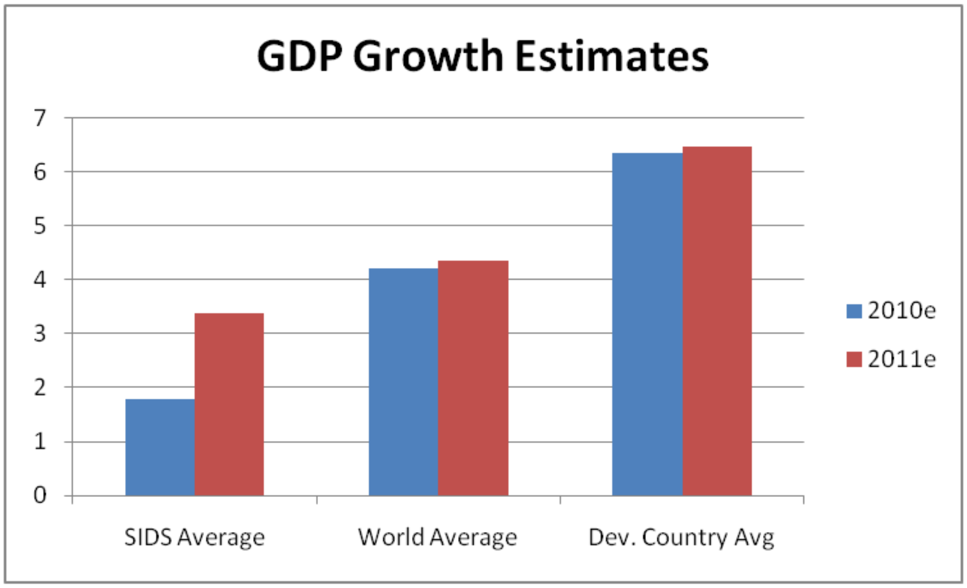


Source: UNDP calculations based on IMF Article IV Consultations (multi-year)

SIDS are projected to recover from the recent financial and economic crisis more slowly than the rest of the world and have consistently experienced slower and more volatile growth over the last decade, due in part to natural disasters and other structural weaknesses. Projected GDP growth for 2010 is 1.7 percent on average compared to 6.3 percent for developing countries as a whole.[46] One of the most important ways through which governments are able to reduce public debt is via sustained economic growth. Small islands' poor record in this area has contributed to many countries' current debt problems and means that for some, it will be very difficult to simply 'grow-out' of over-indebtedness, and additional policy measures may be required to support countries to reduce their public debt burdens.

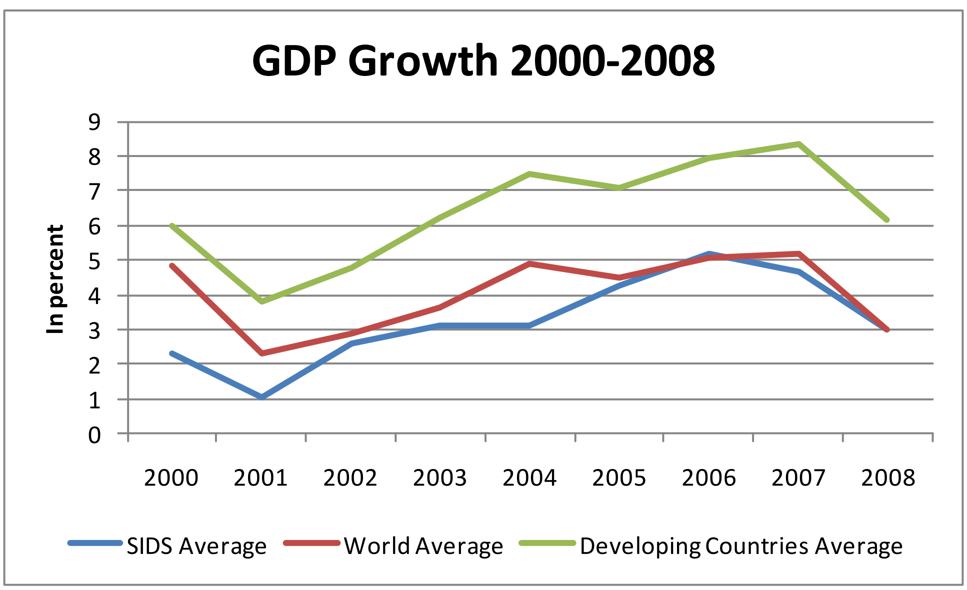
[46] IMF World Economic Outlook database, April 2010

Figure 11: Estimates SIDS' GDP growth in 2010 and 2011 as compared to the world and developing countries



Source: IMF, World Economic Outlook Database, April 2010

Figure 12: SIDS' GDP growth compared to the world and developing countries' averages, 2000-2008



Source: IMF, World Economic Outlook Database, April 2010

SIDS' extreme vulnerabilities to natural disasters

Small island developing states are particularly vulnerable to natural disasters – such as tropical storms, hurricanes, floods, tsunamis and earthquakes – which recur frequently across many countries. The impacts of these events on livelihoods, homes, infrastructure and economic growth are immense, and entail substantial reconstruction costs. As a consequence, it can take years for countries to recover. Natural disasters are directly associated with often large increases in public debt burdens.

An UNCTAD study on the impact on debt sustainability of 21 large natural disasters which struck low-income countries between 1980 and 2008 shows that natural disasters added on average 24 percentage points to the debt to GDP ratio in the three years that followed the events.

The predicted impacts of climate change will further exacerbate the structural vulnerabilities of small island developing states to natural disasters; more variable rainfall, increased tropical storm activity and rising sea levels are all expected. By virtually any measure, the UN considers small island developing states to be among the world's 'hot spots' in terms of special vulnerabilities.

Figure 13: Selected natural disasters 2004-2010: small island developing states

Country	Year	Natural disaster	Cost and damage
Haiti	2010	Earthquake	300,000 people dead, costs estimated at US$7.8 billion, or 120 percent of GDP in 2009
	2004	Hurricane Jeanne	Total direct economic damage of US$5.4 billion
Samoa	2009	Tsunami	Damages estimated at about 10.5 percent of GDP
St. Kitts and Nevis	2008	Hurricane Omar	GDP growth in 2009 lower by 1 percentage point
Fiji	2008	Cyclone Gene	More than FJ$45 million in damages to agriculture, infrastructure, utilities and properties
Jamaica	2007	Hurricane Dean	GDP contracted by 1.5 percent
Suriname	2006	Floods	1,300 families affected. 30 percent of livestock, 65 percent of crops and 90 percent of the fishing industry affected
Maldives	2004	Tsunami	Damages estimated at 62 percent of GDP
Grenada	2004	Hurricane Ivan	Damage equivalent to about 200 percent of 2004 GDP

Sources: UN Economic and Social Commission on Latin America and the Caribbean, 2010, Analysis of Extreme Events in the Caribbean 1990-2008 and UN Food and Agriculture Organisation (FAO), Climate Change and Food Security in Pacific Island Countries: Issues and Requirements, 2008

3.3 SIDS' public debt service: an overview

"The [Caribbean] *region is heading towards bankruptcy if countries could be declared bankrupt. When you have two items, just paying wages and salaries and debt and that's more than your revenue, what remains to run the country? Many governments in the region are approaching that kind of position."*[47]

President Bharrat Jagdeo of Guyana

Many small island governments also demonstrate high debt service (liquidity) indicators, as measured by total public debt service as a proportion of government revenues. The fiscal burden of government debt is critically important since it indicates the extent to which fiscal space is available to governments to mobilise resources for public investment and poverty reduction expenditures. High public debt implies high public debt service costs, the burden of which falls on governments' budgets. This in turn has important consequences for human development and poverty reduction objectives since fewer resources are available to governments to spend on poverty reduction and the MDGs. Additionally, high levels of government borrowing can crowd out bank credit to the private sector, stifling private sector investment and growth.

Of the countries for which data was available, 11 SIDS breach the 15 percent benchmark for sustainable levels of debt service as a proportion of government revenues; some substantially. Most are found in the Caribbean. In Antigua and Barbuda for instance, total public debt service as a percent of government revenues reached 35 percent in 2009.[48] In Jamaica, *interest* payments alone on the public debt reached an unprecedented 66 percent of central government revenues in 2009.[49] This prompted the government to implement a difficult programme to restructure the domestic portion of the public debt burden in January 2010 (discussed later in the paper). Despite the debt exchange programme, the fiscal burden of the country's public debt remains extremely high at 45 cents in every dollar of central government revenues in 2010 and 2011.[50] In St. Kitts and Nevis, debt service costs have increased threefold over the last decade; interest payments alone represented 24 percent of total government revenue in 2008.[51] St. Lucia's public debt service to revenue ratio is projected to increase from 35 percent in 2010 to 43 percent by 2012.[52] In St. Vincent & the Grenadines, debt service as a percent of government revenues is expected to reach 26.5 percent in 2010 and remain at these high levels until 2013.[53]

In other regions, Cape Verde is projected to spend 23 percent of government revenues on public debt service in 2010.[54] For the Maldives, total public debt service as a percent of revenues is projected to reach 35.7 percent in 2010 (up from 14.4 percent in 2006).[55] Papua New Guinea had debt service ratios at 41 percent of government revenues in 2009.[56] In the

[47] UN General Assembly Statement by H. E. Camillo Gonsalves, on behalf of CARICOM, April 2010

[48] Eastern Caribbean Currency Union, Article IV Consultation

[49] Government of Jamaica, Ministry of Finance and Public Service, Debt Management Unit (DMU). See also: UNDP, Jamaica's Debt Exchange Programme: A Case Study for Heavily Indebted Middle-Income Countries, May 2010

[50] Down from 65 cents in every dollar. For a full critical review of Jamaica' Debt Exchange Programme, see: UNDP, Jamaica's Debt Exchange Programme: A Case Study for Heavily Indebted Middle-Income Countries, May 2010

[51] IMF, St. Kitts & Nevis 2009 Article IV Consultation. See also CARICOM UN General Assembly 64th Session Statement by HE Camillo Gonsalves on behalf of CARICOM at the Informal Meeting of the Ad-Hoc Open Ended Working Group of the General Assembly to follow up on the issues contained in the Outcome of the Conference on the World Financial and Economic Crisis and its Impact on Development

[52] IMF, St. Lucia 2010 Article IV Consultation

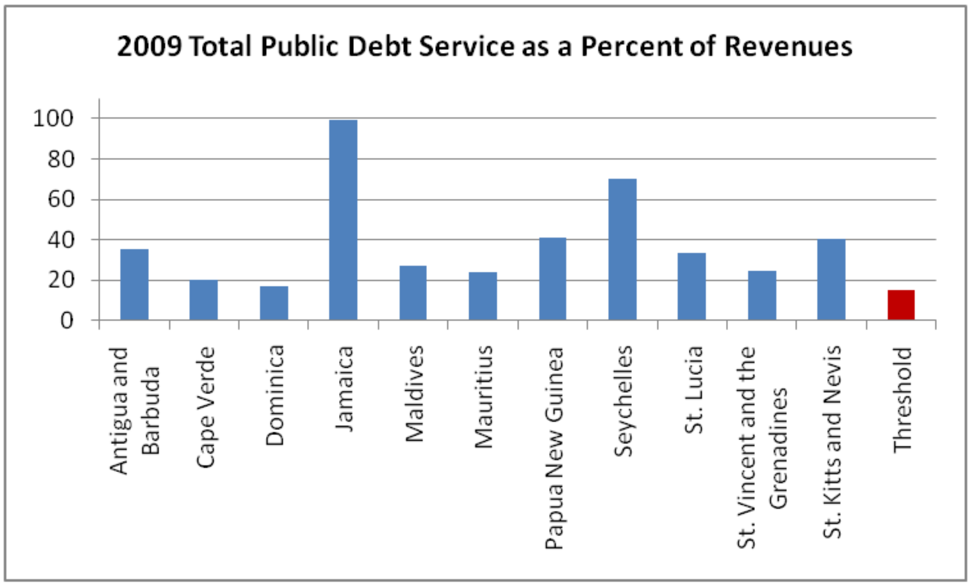
[53] IMF. St. Vincent and the Grenadines 2009 Article IV Consultation

[54] Cape Verde: Eight Review Under the Policy Support Instrument—Staff Report, July 2010

[55] UNDP calculations based on data from IMF, Maldives 2009 Article IV Consultation

Seychelles, interest payments on the public debt reached 32 percent of government revenues and grants in 2009.[57] In 2010, the government restructured some bilateral and private external debts to help alleviate its external debt burden (discussed with the Jamaica case later in the paper). In several cases, high public debt service levels have crowded out social and other development related spending, and leave governments little fiscal space to respond to adverse shocks.

Figure 14: Total public debt service as a percent of revenues in excess of 15 percent



Source: Eastern Caribbean Central Bank and IMF Article IV Consultations

In relation to the external position of small island developing states, the data shows that several small island developing states breach the 15 percent external debt service to exports ratio. The Comoros is projected to register an external debt service to exports ratio of approximately 20.2 percent in 2010, although this is expected to decline significantly once the country completes the debt relief process.[58]

For non-HIPC SIDS, countries which breached the 15 percent external debt service to exports ratio in 2010 include (subject to availability of data): Barbados (25.7 percent), Grenada (15 percent), the Maldives (17 percent), Marshall Islands (59 percent), St. Kitts and Nevis (15.2 percent), and St. Vincent and the Grenadines (18.5 percent).[59] In 2008, the latest year for which data was available, Jamaica's external debt service totalled more than 36 percent of exports.[60]

[56] Commonwealth Secretariat, An Overview of the Sovereign Debt Position of Commonwealth Small Vulnerable Economies, September 2010
[57] IMF, Seychelles: Third Review Under the Stand-By Arrangement, January 2010
[58] IMF and World Bank, Union of the Comoros: Enhanced Initiative for Heavily Indebted Poor Countries - Preliminary document, July 2010
[59] IMF Article IV Consultation documents, 2009 and 2010
[60] World Bank Global Development Finance 2010

A few countries will also see a significant increase in external debt service to export ratios over the next couple of years. For instance, Grenada's external debt service to exports ratio is projected to rise above 20 percent between 2012 and 2014.[61] Tonga's debt service to exports ratio will also increase from 8.7 percent in 2009 to 11.6, 16.6 and 17.5 percent in 2013, 2014 and 2015 respectively.[62]

3.4 Debt restructuring operations in small island developing states

As indicative of sovereign debt difficulties, many SIDS have concluded various forms of sovereign debt restructuring. Of the countries for which data was available, 16 SIDs have concluded at least 49 restructuring operations over the last 30 years involving multilateral, bilateral, private external and private domestic creditors.[63] In 2010 alone, Antigua and Barbuda, Jamaica, the Seychelles and the Solomon Islands have all concluded debt restructuring operations.

In September 2010, Antigua and Barbuda restructured US$117 million in bilateral debt owed to the Paris Club.[64] In February 2010, the Government of Jamaica, supported by UNDP, concluded a programme to restructure the entire portfolio of its domestic debt obligations (56 percent of total government debt). The Jamaica Debt Exchange exchanged high-interest, short-maturity coupons for lower interest, longer maturity debt instruments and in so doing generated an additional US$525 million in fiscal space in each of 2010 and 2011.[65] In February 2010, the Seychelles restructured some external bonds in a programme which offered external bondholders 50 percent of the original face value of eligible external sovereign bonds. This had been preceded in April 2009 by the restructuring of US$163 million in debt owed to eight bilateral Paris Club creditors, as well as Malaysia and South Africa.[66] Despite these operations however, debt problems persist in many countries which suggests that measures taken so far have been insufficient to restore debt sustainability.

[61] IMF. Grenada: Fifth Review Under the Extended Credit Facility, May 2010
[62] IMF, Tonga 2010 Article IV Consultation
[63] This figure undoubtedly severely underestimates the true number since it does not include several countries for which data was not available and does not include a significant number of restructuring agreements concluded with non-Paris Club bilateral creditors.
[64] Paris Club, Antigua and Barbuda, September 2010
[65] UNDP, Jamaica's Debt Exchange Programme: A Case Study for Heavily Indebted Middle-Income Countries, May 2010
[66] See, Paris Club Seychelles Debt Treatment, 16 April 2009. The Evian Approach agreed in 2003 by Paris Club members extends debtor countries treatment on a case-by-case basis. See Paris Club website for full details.

Figure 15: Frequency of debt restructurings of small island developing states 1980s - 2010

Country	Multilateral debt	Bilateral debt[67]	Private external debt	Private domestic debt
Antigua and Barbuda		2010	2008[68]	
Belize				2007
Comoros	At decision point under the HIPC Initiative: interim relief provided	2009		
Dominica			2004	
Dominican Republic		1985, 1991, 2004, 2005	2005	
Grenada		2006	2005	
Guinea-Bissau	At decision point under the HIPC Initiative: interim relief provided	1987, 1989, 1995, 2001		
Guyana	Received full multilateral debt relief under the HIPC Initiative and MDRI	1989, 1990, 1993, 1996, 1999, 2004		
Haiti	Received full multilateral debt relief under the HIPC Initiative and MDRI	1995, 2006, 2009		
Jamaica		1984, 1985, 1987, 1988, 1990, 1991, 1993		2010
São Tomé and Príncipe	Received full multilateral debt relief under the HIPC Initiative and MDRI	2000, 2005, 2007		
Seychelles		2009	2010	
Solomon Islands			2010	
St. Vincent and the Grenadines		2007		
Suriname		2009[69]		
Trinidad and Tobago		1989, 1990		

[67] Refers to restructuring operations concluded within the framework of the Paris Club only unless otherwise indicated
[68] Write-down obtained from Banco de Brasil
[69] Write-down of arrears from Brazil for a total of US$44 million

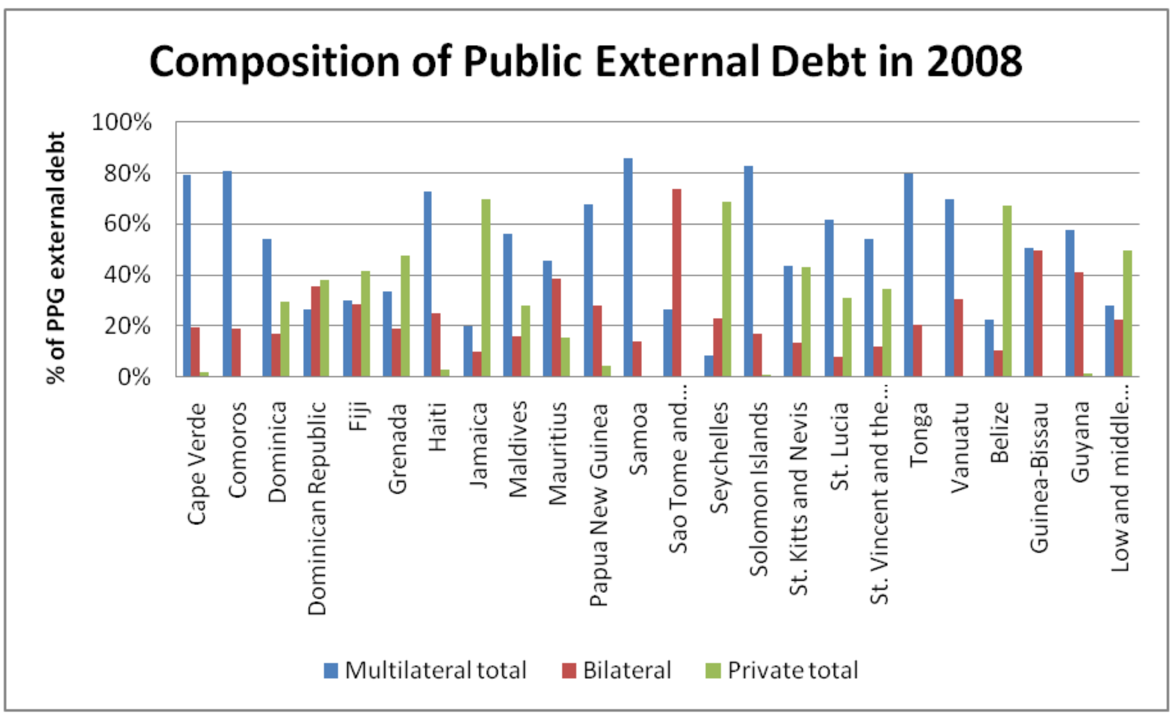
The data shows that an important number of small island developing states are currently experiencing – or are at high risk of – debt distress. The region most severely affected is the Caribbean.

Countries in the Caribbean have tended to rely more extensively on international and domestic capital markets to finance development and meet fiscal deficits whereas countries in the Pacific owe a higher proportion of their public debt burdens to multilateral and bilateral official creditors (such as the World Bank and Asian Development Bank). The extent to which vulnerabilities to sovereign debt difficulties are more closely correlated with certain types of debt is assessed in the next section of the report. This in turn has implications for governments' future choices of finance as well as implications for the international community which should stand ready to provide external finance on terms appropriate to small islands' specific challenges and needs.

3.5 Creditor composition of the debt

SIDS' major creditors vary across different countries and continue to evolve as external political and economic realities change (such as the emergence of new creditor countries and/or the deepening of domestic debt markets). As noted earlier, countries in the Caribbean have relied more extensively on private capital markets to raise resources while small island developing states in the Pacific have utilised more multilateral and bilateral finance.

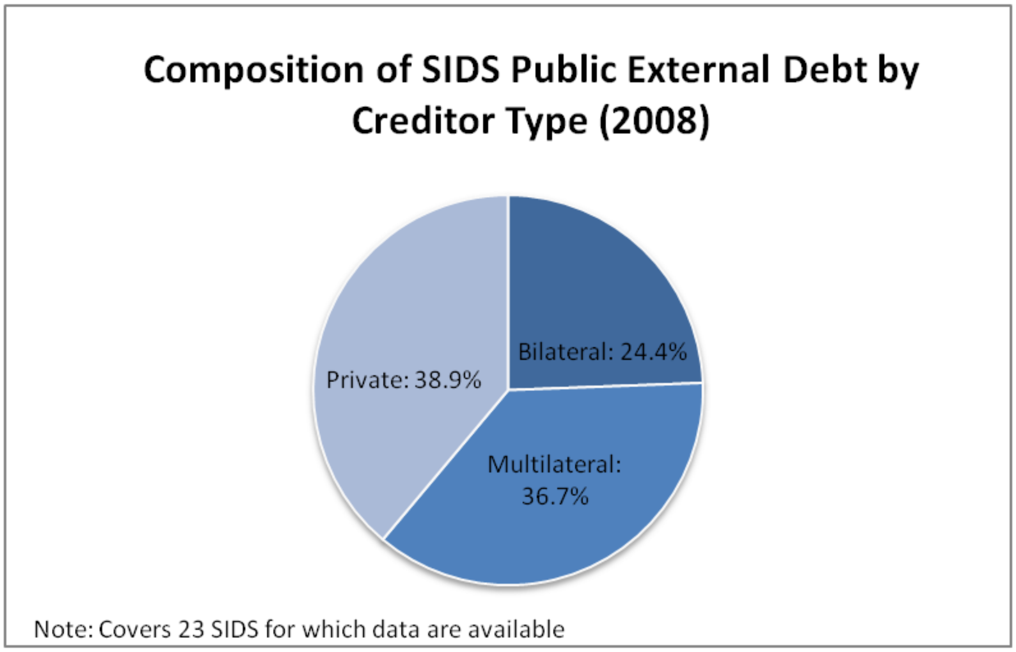
Figure 16: Creditor composition of selected small islands' external debt stocks



Source: World Bank Global Development Finance 2010

In relation to *external* debt, out of 23 SIDS for which data was available, private creditors accounted for 38.9 percent of debt stocks, multilateral lenders for 36.7 percent, and bilateral lenders for 24.4 percent in 2008.[70]

Figure 17: Major creditor groups to small island developing states



Source: World Bank Global Development Finance 2010

Bilateral and multilateral lenders such as the World Bank, Inter-American Development Bank and Asian Development Bank remain the major lending partners to many small island developing states. Recently, the share of IMF debt has also increased as a proportion of total external debt as many small island governments turned to the institution for emergency financial support to mitigate the effects of the recent concurrent food-fuel-financial crises and/or natural disasters. Since September 2008, 17 small island developing states have turned to the IMF for financial support. These include: Antigua and Barbuda, Comoros, Belize, Dominica, Dominican Republic, Grenada, Guinea-Bissau, Haiti, Jamaica, Maldives, Samoa, São Tomé and Príncipe, Seychelles, Solomon Islands, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. Total new IMF debt approved since the outbreak of the recent crisis stands at US$3.6 billion.[71]

In terms of bilateral debt, non-Paris Club creditors are the major bilateral lending partners to many countries. This is in part because some bilateral Paris Club debts have been reduced through the HIPC and MDRI debt relief initiatives to five small island developing states. More significantly, it reflects a changing creditor landscape and several 'emerging' bilateral lenders are now increasingly present in many small island developing states. For instance, Grenada currently owes over 64 percent of

[70] The list of 23 SIDS includes: Belize, Cape Verde, Comoros, Dominica, Dominican Republic, Fiji, Grenada, Guinea-Bissau, Guyana, Haiti, Jamaica, Maldives, Mauritius, Papua New Guinea, Samoa, Sao Tome and Principe, Seychelles, Solomon Islands, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Tonga and Vanuatu. Source: World Bank Global Development Finance 2010

[71] IMF International Financial Statistics and country information pages

its bilateral debt to non-Paris Club creditors which include China, Kuwait and Trinidad and Tobago. The Maldives recently received US$200 million in financial assistance from the Indian government during the course of 2009 and early 2010, half of which was granted on concessional terms.[72] The recent marked increase in Tonga's indebtedness primarily reflects two renminbi loans from China's Export-Import Bank with a face value totalling over 30 percent of GDP.[73] Venezuela has also loaned funds to several Caribbean countries on both concessional and non-concessional terms, mostly through the Petrocaribe accord which supplies Venezuelan oil to neighbouring countries at preferential rates and allows beneficiaries to repay – in part or in full – in local goods and services. Most Caribbean countries are part of this initiative.

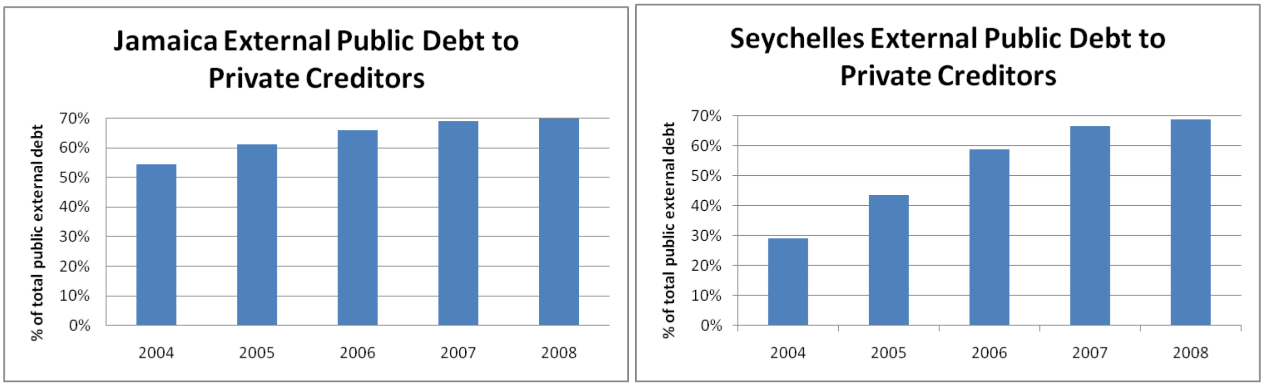
Despite higher per capita-income levels than many low-income countries, several small island developing states have benefited from concessional finance from the major multilateral and bilateral lenders under the so-called 'small island exception'. Nevertheless, some small islands have not benefited from this preferential treatment (for instance Jamaica and the Seychelles) and overall, many countries have substantially decreased the proportion of debt they owe on concessional terms and have increased the amount of private external and/or domestic debt they hold.

For example, decreases in concessional debt as a percent of public external debt between 2000 and 2008 were: 9 percentage points in Dominica (68 percent to 59 percent); 23 percentage points in Fiji (53 percent to 30 percent); 7 percentage points in Grenada (53 percent to 46 percent); 15 percentage points in Jamaica (28 percent to 13 percent); 25 percentage points in the Maldives (77 percent to 52 percent); 29 percentage points in the Seychelles (48 percent to 19 percent); 16 percentage points in St. Kitts and Nevis (60 percent to 44 percent), and; 10 percentage points in St. Vincent and the Grenadines (56 percent to 46 percent).[74]

Out of 23 countries for which data was available, 11 countries owed more than 25 percent of their external debt to private creditors in 2008, including: Belize (67 percent); Dominica (29.3 percent); Dominican Republic (38 percent); Fiji (41.7 percent); Grenada (47.7 percent); Jamaica (69.9 percent); the Maldives (28.1 percent); Seychelles (68.9 percent); St. Kitts and Nevis (43.1 percent); St. Lucia (30.7 percent); and St. Vincent and the Grenadines (34.2 percent).[75]

[72] IMF, Maldives 2009 Article IV Consultation, p. 4
[73] IMF, Tonga 2010 Article IV Consultation
[74] World Bank Global Development Finance 2010
[75] All data from this section: World Bank Global Development Finance 2010

Figure 18: Increases in private external debt in Jamaica and the Seychelles 2004-2008



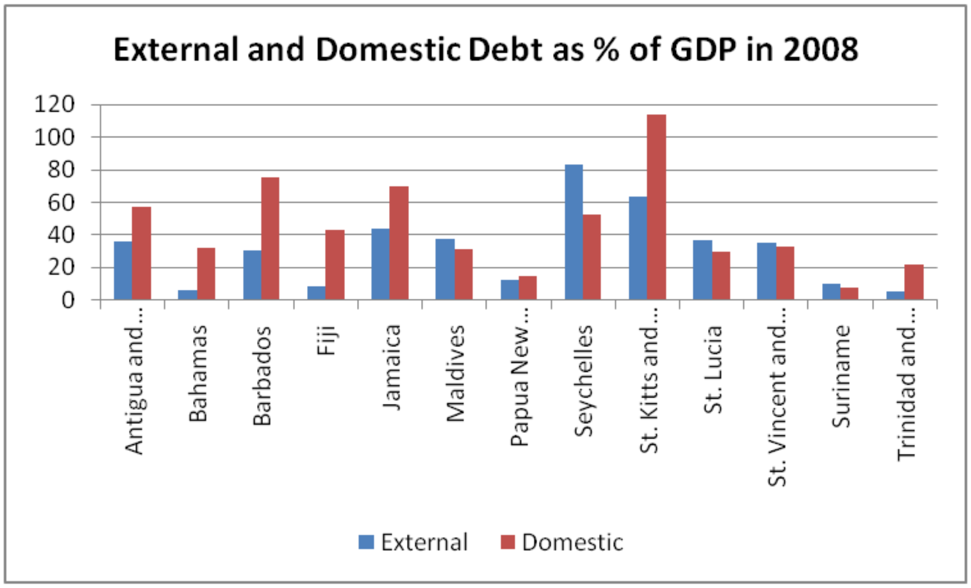
Source: World Bank, Global Development Finance 2010

The shift in composition of the debt from official to private creditors makes a big difference in terms of the vulnerability it represents. The dynamics of debt owed to private creditors (domestic and external) is crucially very different to that owed to official bilateral and multilateral creditors (where the finance is extended on concessional terms). The terms and conditions of private debt tend to be highly volatile, procyclical and subject to abrupt changes due to perceptions of risk by lenders, exchange rate fluctuations and broader conditions in global capital markets. Maturities can sometimes be very short. Consequently, countries which rely more heavily on international capital markets to meet fiscal deficits and fund development are more vulnerable to abrupt and unforeseen interruptions in their access to finance, changes in the cost of that finance and the rapid exit of capital which in turn poses risks of debt default and sharp economic contraction.

Domestic debt levels are also high in several small island developing states and in several countries the stock of domestic debt now exceeds that of external debt. High levels of domestic debt are especially evident in a number of Caribbean countries. In Barbados external debt has remained relatively stable over the past five years at on average 31 percent of GDP, but domestic debt has increased sharply. In 2005, domestic debt amounted to 65 percent of GDP; by 2010 it reached 92 percent of GDP.[76] In Jamaica, 56 percent of the debt stock is held by domestic creditors; this figure was as high as 70 percent in 2008.[77] Most of the public debt burden of St. Kitts and Nevis is composed of domestic debt. While the country was able to reduce its external debt burden by around 25 percentage points of GDP between 2004 and 2010, it increased its domestic debt burden by approximately the same amount over the same period. Domestic debt climbed from 109 percent of GDP in 2004 to almost 132 percent by 2010.[78] In other regions, the Maldives has also seen sharp increases in domestic debt over the past six years. Domestic debt levels have increased from just 15 percent of GDP in 2004 to 54.5 percent by 2010.[79]

[76] IMF, Barbados 2009 Article IV Consultation
[77] Government of Jamaica, Ministry of Finance and Public Service, Debt Management Unit (DMU)
[78] IMF, St. Kitts and Nevis 2009 Article IV Consultation
[79] IMF, Maldives 2009 Article IV Consultation

Figure 19: Selected SIDS' domestic and external public debt



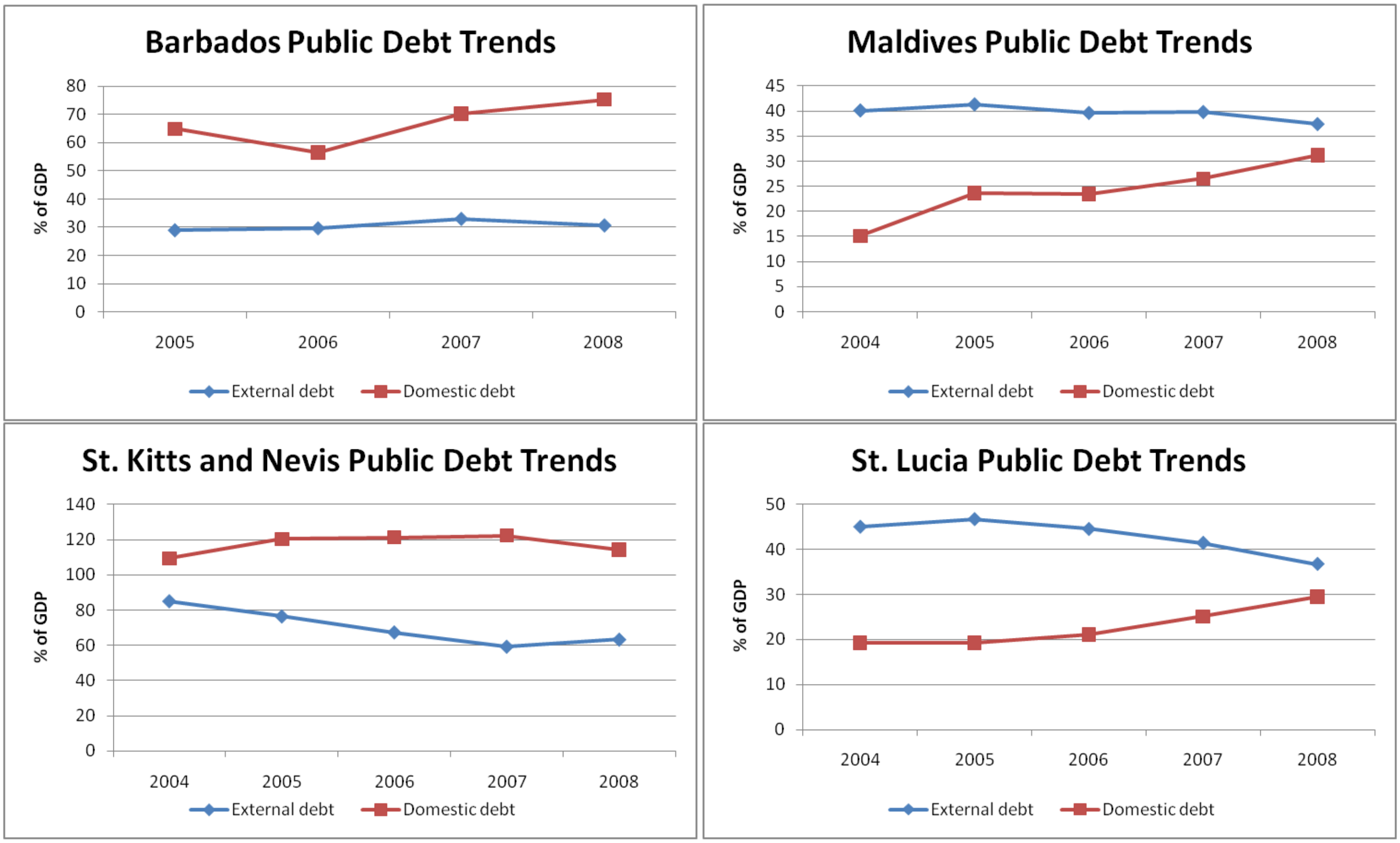
Source: IMF, Individual Country Article IV Consultations and Review Documents

Sharp increases in domestic debt have been driven in part by the implementation of countercyclical fiscal policies in response to the international financial and economic crisis. Throughout low-income countries as a whole, the IMF recently reported that the crisis increased *domestic* debt ratios by on average 3 percent of GDP in 2009 and 2010.[80] Several SIDS registered higher increases in domestic debt than this over the same period. This includes: Antigua and Barbuda (with a 5.3 percent increase in domestic debt as a percent of GDP between 2008 and 2010); Barbados (17.2 percent); Grenada (4.4 percent); Maldives (23.3 percent); St. Kitts and Nevis (17.6 percent); and St. Vincent and the Grenadines (6 percent).[81]

Increases in domestic debt have the advantage that they do not usually carry exchange rate risk (although several sovereigns, such as the Dominican Republic, Jamaica, the Maldives and others, have issued US dollar denominated bonds on domestic capital markets which would then cancel out this advantage). On the other hand, domestic debt instruments often carry shorter maturities than official debt and can carry interest rates in the double digits; in Jamaica the interest rate charged on some domestically issued sovereign bonds has been as high as 28 percent over the last few years.[82] Domestic debt can therefore be a costly alternative to external finance and result in a heavy fiscal burden. It can also crowd out credit to the domestic private sector and be more difficult to restructure than external debt in cases of repayment difficulties. This is because large amounts of sovereign debt are typically held by domestic banks and a sovereign's default can often be followed by a domestic banking crisis. This means that shifts in the composition of the debt towards domestic debt can increase rather than decrease debt vulnerabilities for governments.

[80] IMF, Preserving Debt Sustainability in Low-Income Countries in the Wake of the Global Crisis, April 1 2010
[81] UNDP calculations based on IMF individual country Article IV Consultations and Reviews
[82] Ibid.

Figure 20: Selected SIDS' trends in domestic and external public debt



Source: IMF, Individual Country Article IV Consultations and Review Documents

In sum, many countries have moved away from official sources of finance towards private domestic finance and international capital markets. This has increased sovereign debt vulnerabilities in some countires due to the very different dynamics associated with different forms of debt. There is evidence to suggest that countries that have relied more extensively on international capital markets to raise resources have tended to run into debt repayment difficulties more readily. For instance, Belize (2007), the Dominican Republic (2005), Grenada (2005), Jamaica (2010) and the Seychelles (2010) all owed more than 50 percent of their external debt burden to private creditors at the time of their debt restructuring.[83]

The large number of SIDS' creditors also means that any eventual policy initiatives which aim to help critically indebted small islands to reduce their public debt burdens must necessarily factor-in multilateral, bilateral, private external and domestic creditors alike.

[83] World Bank, Global Development Finance 2010

4. Many Governments Planning to Reduce Expenditures in 2010 and 2011

The recent concurrent food-fuel-financial crises have severely impacted the external and fiscal positions of many small island developing states, and contributed to further increases in public debt (as well as increases in the cost of that finance). In turn, high levels of public debt have constrained governments' abilities to respond effectively to these shocks. Despite fragile fiscal positions, many small island governments nevertheless implemented countercyclical fiscal policies in response to the recent global financial and economic crisis – in some cases amounting to several percentage points of GDP. Now high levels of public debt have intensified pressures on governments to rapidly reduce public expenditures due to concerns over medium–term debt sustainability. Over the next two years, some governments will reduce expenditures by a significant margin.

UNICEF has shown that in 2010 and 2011, nine small island developing states will implement public expenditure cuts of more than three percent of GDP in 2010 and 2011 when compared to 2008 and 2009. These include: Comoros with a 3 percent reduction, Papua New Guinea with a 3.7 percent cut, Grenada with a 4.5 percent reduction, Jamaica with a 4.7 percent cut, Marshall Islands with a 5.3 percent cut, Antigua and Barbuda with a 6.3 percent reduction, Maldives with a 7.7 percent cut, São Tomé and Príncipe with a 9.6 percent cut and Timor-Leste with a 16 percent reduction in government expenditures. [84] Several other small island developing states will also implement smaller public expenditure cuts over the same period when measured as a percent of GDP.

Some cuts in expenditures will involve reductions in capital expenditures, such as Grenada and St. Lucia. Given that sustained economic growth is arguably the most important channel through which reductions in public indebtedness can be fostered, the reduction in capital investments is of particular concern. Additionally, governments will be reducing public expenditures – and potentially investments in the MDGs – at precisely the time that MDG-acceleration is most needed. The next five years will be critical with regard to MDG-acceleration. If there is pressure to curb public expenditures too quickly, there is also the danger that economic recovery could be jeopardised and essential public goods and services will not be funded as a consequence. This will impact most on ordinary citizens. While some expenditure cuts may be offset through policy measures which aim to reduce inefficiency and waste and improve targeting, it is imperative that social and anti-poverty expenditures are protected – and indeed increased – as we approach the MDG target year of 2015.

[84] UNICEF, Prioritizing Expenditures for a Recovery for All, A Rapid Review of Public Expenditures in 126 Developing Countries, 27 August 2010

5. Policy Recommendations

The extent to which high public debt levels may pose a serious challenge to economic development, poverty reduction and human development efforts in several small island developing states has so far been largely ignored by the international policy community, yet the data shows that in many country cases, public debt levels are on an unsustainable trajectory. The region most affected is the Caribbean. Unpredictable external capital flows, such as official development assistance and foreign direct investment, lack of economies of scale, low trade capacities, high transport costs and vulnerabilities to external shocks including natural disasters have combined to contribute to larger debt stocks in many small island developing states.

Governments around the world have pledged to help countries achieve long-term debt sustainability. This promise is embodied in MDG 8 – a global partnership for development – which commits governments to: *"Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term."*[85] The issue was also raised in the UN Monterrey Consensus of 2002, the Doha Declaration of 2008 and most recently at the United Nations 2010 MDG Summit. The Summit's outcome document commits the international community to: *"ensuring long-term debt sustainability* [in developing countries] *through coordinated policies aimed at fostering debt financing, debt relief and debt restructuring."*[86]

Three days later, the UN High Level Review Meeting on Implementation of the Mauritius Strategy for Sustainable Development in Small Island Developing States in September 2010 also noted with concern that: *"Small island developing states have made less progress than most other groupings, or even regressed, in economic terms, especially in terms of poverty reduction and debt sustainability."*[87] It urges the international community and the international financial institutions to take into account the specific circumstances of each small island in addressing long-term debt sustainability.

As noted earlier, many small island developing states will implement expenditure cuts over the next two years. This is to be combined in many cases with taxation reforms to increase taxes and/or the creation of new ones in order to boost government revenues. These measures aim to improve governments' fiscal positions and their abilities to service public debt. Some expenditure cuts will undoubtedly be offset through measures which reduce inefficiency and waste and improve targeting. However it will also be vital to preserve – and increase – essential pro-poor spending in an era of fiscal contraction if progress towards the MDGs is not to be jeopardised.

In some countries, the tax base is extremely narrow and more serious efforts must clearly be undertaken to broaden and strengthen revenue collection (with provisions built-in for the poorest sections of the population). Over the long-term, more effective (and equitable) domestic resource mobilisation will be one of the most important channels through which governments will be able to reduce debt and preserve debt sustainability. However it should also be noted that small populations and the presence of an important informal sector in some countries also limit the extent to which domestic resource mobilisation through increased taxation alone will be sufficient to meet governments' fiscal deficits. Increased

[85] UNDP, MDGs, MDG 8 – A global partnership for development: http://www.undp.org/mdg/goal8.shtml
[86] United Nations, Keeping the promise: united to achieve the Millennium Development Goals, 17 September 2010
[87] United Nations, Draft outcome document of the High-level Review Meeting on the implementation of the Mauritius Strategy for the Further Implementation of the Programme of Action for the Sustainable Development of Small Island Developing States, September 2010, para. 5

efforts should also be taken to strengthen customs administrations. Given their high import dependence, most small island developing states rely heavily on customs duties as important sources of government revenue. Efforts to curtail widespread practices such as trade mispricing which result in significant annual revenue losses to many governments could yield substantial results in terms of increased import revenues.

In parallel, it will also be vital for many governments to diversify their economies, significantly improve institutional debt management capabilities and develop credible medium-term debt sustainability strategies.

However policies to reduce government expenditures and increase taxes will reduce output and may increase unemployment in the short-run. Sustained economic growth is one of the major channels through which public debt levels can be reduced, and yet, as noted earlier, small islands are already projected to underperform in terms of economic growth over the next two years as compared to other developing countries and the rest of the world. This means that other policy measures must be considered in parallel, tailored to SIDS-specific needs and challenges.

The current approach relies largely on small island developing states to resolve their indebtedness problems themselves, mainly through fiscal retrenchment, increased taxation and seeking debt restructuring with individual creditors on an ad-hoc basis. However as this report has shown, adverse fiscal indicators do not just stem from lax fiscal policies, but are also due to structural economic weaknesses and as such requires a more integrated approach which also places emphasis on supportive policy measures which may be taken by the international community to help small islands put their public debts on a sustainable trajectory.

5.1 Measures to resolve existing public debt problems

Debt relief for some small islands must be ruled in

In some small island developing states, the size of the public debt overhang is so large that comprehensive debt relief must be put on the table. While policymakers' attention has focused extensively on public indebtedness in the Heavily Indebted Poor Countries, rising levels of debt in small island developing states has been largely avoided. This cannot continue. In 2005, the public debt of St. Kitts and Nevis peaked at 197 percent of GDP, the highest in the world. The Caribbean Development Bank's Country Poverty Assessment in 2007/8 categorised 23.7 percent of the population as living in poverty.[88] Yet only five SIDS (Comoros, Guinea-Bissau, Guyana, Haiti and São Tomé and Príncipe) have been classified as either poor enough or indebted enough to benefit from international debt relief schemes such as the HIPC Initiative. Moreover, the International Financial Institutions have recently closed the HIPC Initiative to further countries regardless of indebtedness indicators.

The IMF recently reviewed a range of policy options to reduce debt vulnerabilities in low-income countries. The policy options reviewed included: a) receiving better financing terms from donors; b) improvements in countries' fiscal positions; c) improvements in policy and institutional capacities.[89] Even where countries register simultaneous improvements on all three

[88] Caribbean Development Bank, St. Kitts and Nevis - Country Poverty Assessment 2007/2008
[89] IMF, Preserving Debt Sustainability in Low-Income Countries in the Wake of the Global Crisis, April 1 2010

counts, the IMF reported that this will still not be sufficient to reduce debt vulnerabilities in some low-income countries. This includes several small island developing states.

Other measures are required. This must include the option of a SIDS-specific debt relief initiative to incorporate multilateral, bilateral and private external creditors on the basis of fair burden-sharing. Experience from the recent HIPC and MDRI debt relief initiatives shows that where comprehensive debt relief has been implemented, it has supported increases in poverty reduction expenditures and economic recovery and growth in beneficiary countries when combined with other policy measures. Given the poor growth performance registered by many small island developing states (and projections for continued underperformance when compared to other developing countries), removal of the debt overhang could thus provide an important boost to countries' economic growth prospects.

Eligibility criteria as well as the terms and conditions for such an initiative require further work, but could be based on a combination of solvency and liquidity indicators, structural vulnerabilities and assessment of other key development challenges. This report recommends that SIDS governments and the broader international community should convene a high-level meeting to discuss and further elaborate the proposal for a SIDS-specific debt relief initiative.

Debt conversions for climate adaptation

Small island developing states are exceptionally vulnerable to climate change. Crucially, countries' abilities to adapt to climate change depend not just on the actions of national governments but more critically on broader global commitments to tackle climate change, as well as the volume and availability of external finance for climate adaptation needs. As such, exogenous factors are likely to limit countries' progress in this area regardless of national level policies in this area.

Climate change adaptation needs in small island developing states are estimated to be among the highest in the world as a proportion of national output. The capital investments required to finance climate change adaptation initiatives are immense and likely to be beyond the capacities of many small island governments. Innovative financing mechanisms could help contribute to the volume of resources available to fund climate adaptation and mitigation.

One approach is the conversion of official sector debt repayments into climate change adaptation resources (although the scheme could also be open to interested private creditors). While SIDS are among the most vulnerable countries in the world to climate change, high levels of public debt – and debt service – also compromise governments' abilities to channel substantial amounts of domestic resources into climate change adaptation. Competing priorities for limited government resources may mean that adaptation to climate change is relegated to the backseat of the most critical government interventions.

Under the initiative, a central trust account (or adaptation account) would be established into which participating creditors' debt repayments are channelled. These resources would then be effectively 'recycled' into initiatives which support countries' adaptation efforts in line with country developed national adaptation strategies. The trust account could be tapped once every two to three or five years depending on specific country circumstances so that a critical mass of funds can accumulate which could support meaningful interventions.

The precise operational mechanisms warrant further work, although there are many successful examples of debt-for-nature and debt-for-health swaps which could be drawn on for best practice.[90] This scheme is more ambitious in nature since it involves a simultaneous commitment from multiple creditors. Eligibility criteria could be determined through a combination of financial criteria (income per capita and indebtedness levels for instance), poverty ratios and environmental vulnerabilities.

These resources should complement – and not substitute – for commitments to increase aid and to substantially increase resources for climate change adaptation and mitigation in line with the 2009 Copenhagen Accord.[91] SIDS' governments and official creditors should convene a high-level meeting – with the support of the United Nations – to review this proposal in more detail.

Measures to restructure private domestic and external debt

In some small island developing states, domestic debt represents a significant (and growing) problem. The fiscal burden of domestic debt can be very high since interest rates can be higher than on external debt and maturities sometimes very short. Domestic debt is governed by national laws and can be complicated to restructure because domestic banks are often major holders of government securities. Thus a default on domestic debt obligations can lead in turn to a domestic banking crisis. Additionally, measures to restructure domestic debt must be sensitive to the impact on ordinary people who have invested their money in government.

The recent Jamaican Debt Exchange (JDX), supported by technical assistance provided by UNDP's country office, offers a useful experience in this regard. Under the initiative concluded in January 2010, investors were offered a par-for-par exchange on old securities for a range of new debt securities. The new debt instruments carried lower interest rates and longer maturities; average interest rates were reduced from 17 to 11 percent and average debt maturities were extended by 2.5 years.[92] The government was able to implement the programme with almost universal creditor participation, minimal reputational damage and indeed the sovereign's credit ratings improved on conclusion of the programme. Jamaica's public debt position remains extremely fragile, however the programme does show that when carefully designed and implemented, domestic debt can be restructured without severe repercussions on the domestic economy.

Private external debt is also a problem for several countries, as noted earlier. This includes private commercial bank credit and external bondholders. One option to reduce commercial bank debt is through donor financed commercial debt buy-backs. The World Bank's IDA Commercial Debt Reduction Facility has been successfully used to support IDA-only countries to reduce their commercial debt obligations. Under such initiatives, private commercial debt has been bought at deep discounts

[90] See for example: World Wildlife Fund, debt for nature swaps: http://www.worldwildlife.org/what/howwedoit/conservationfinance/debtfornatureswaps.html and the Global Fund, Debt 2 Health initiative: http://www.theglobalfund.org/en/innovativefinancing/debt2health/

[91] Under the recent Copenhagen Accord which emerged from the United Nations Climate Change Conference in December 2009, developed countries collectively committed to provide new and additional resources approaching US$30 billion for the period 2010 – 2012 for climate change adaptation and mitigation efforts in developing countries. The Accord specified that this funding should prioritise the most vulnerable countries, including small island developing states. Developed countries pledged to increase this amount to US$100 billion annually by 2020. UN Copenhagen Accord, 18 December 2009: http://unfccc.int/home/items/5262.php

[92] For a more detailed assessment of the debt exchange programme, see: UNDP, Jamaica's Debt Exchange: A Case Study for Heavily Indebted Middle-Income Countries, May 2010

with donor support, thus helping to reduce commercial debt levels in some of the world's poorest countries. Under the Debt Reduction Facility, 21 countries have benefited from 22 operations which have extinguished about US$8 billion in commercial debt principal, interest and penalties.[93] Such initiatives could be considered for some of the poorest and most critically indebted small island developing states with large exposure to commercial banks. Variations on the basic idea could also be reviewed, such as the purchase by bilateral and multilateral agencies of commercial credit, then extending grace periods, longer repayment periods and/or lower interest rates to the debtor in turn.

As regards external sovereign bonds, several small island developing states have concluded restructuring operations with external bondholders on an ad-hoc basis; most recently the Seychelles in January 2010. The use of collective action clauses (CACs) is an important development in this regard and has helped to minimise disruptive and costly creditor hold-outs. Today the majority of emerging market bonds include collective action clauses which allow a supermajority of bondholders of a particular instrument to enforce a restructuring upon non-consenting bondholders. On the downside, such instruments cannot enforce fair burden-sharing across different categories of creditors (i.e. bilateral, multilateral and private) in the event of a sovereign debt crisis. Additionally, the outcomes of negotiations with bondholders are highly unpredictable and can be long and drawn-out processes. Consequently, a more comprehensive solution to improve equity, effectiveness and efficiency in sovereign debt restructuring is ultimately required over the longer-term. This is taken up in the next recommendation.

An International Sovereign Insolvency Mechanism is required

The proposal for some form of debt relief mechanism for critically indebted small island developing states is necessarily a short-term stop-gap measure. Over the longer-term, structural reform is required at the international level in the way sovereign debt difficulties are resolved.

This report has pointed to at least 49 debt restructuring operations for 16 SIDS over the last thirty years. Repayment difficulties have therefore occurred with surprising frequency but have not necessarily been resolved in the fairest and most efficient manner.

An institutionalised procedure to restructure sovereign debts efficiently, predictably and equitably is required. Currently, no such mechanism exists at the international level. Instead, sovereign debtors negotiate with creditors on an ad-hoc and individual basis which leads, in practice, to large transaction costs, inefficiencies and highly unpredictable outcomes. From a development perspective, this approach has also been costly since sovereigns have had little incentive to resolve emerging debt problems before a crisis through fear of exclusion from international capital markets and reputational costs. Delays in resolving debt problems early-on imply a heavier fall-out later-on.

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[93] See World Bank, Debt Reduction Facility for IDA-only countries:
http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTDEBTDEPT/0,,contentMDK:21288373~menuPK:4876087~pagePK:64166689~piPK:64166646~theSitePK:469043,00.html

Although complex and technical in nature, well-developed proposals for some form of sovereign debt work-out procedure already exist.[94] Suggested models share many similar features, such as:

- Ability of debtor nation to initiate an insolvency procedure;
- Importance of acting in good faith in approved and standardised ways;
- Nomination of independent arbitrators to hear cases of unsustaianable sovereign debt;
- Independence of assessments of public debt sustainability;
- Comprehensiveness of procedure (bilateral, multilateral and private external debts must be incorporated);
- Adequacy of debt restructuring centred on the commitment to development and the concept of a 'fresh start';
- Power to enforce a resolution according to pre-agreed principles, including how much debt relief may be required and how the burden is shared between different classes of creditors.

Currently, no international consensus on some form of sovereign insolvency regime currently exists. However, increasing public debt ratios across both developed and developing countries due to the fall-out of the recent global financial and economic crisis has increased the probability that some countries will run into sovereign debt difficulties at some stage in the future. This increases the timeliness and importance of developing an international consensus around this issue.

In the UN's 2010 Report on MDG 8 – the Global Partnership for Development at a Critical Juncture – the United Nations recommends the setting-up of an expert group of multi-stakeholders to prepare a concrete set of proposals for enhanced approaches to sovereign debt restructuring.[95] This recommendation should be implemented without delay.

5.2 Measures to support SIDS going forward

Need for a SIDS-specific approach

Going forward, a supportive international policy environment must necessarily start with an explicit recognition of small island developing states as a special category of countries in need of SIDS-specific support. So far, this policy issue has been largely ignored. While the United Nations and the Barbados Programme of Action recognise small islands as a special case for both development and the environment, and some multilateral financial institutions retain the 'small island exception' for a small handful of SIDS, most countries are classified as middle-income countries and as such, are not eligible to receive

[94] See, for example: Erlassjahr.de and Friedrich Ebert Stiftung, Resolving Sovereign Debt Crises, Towards a Fair and Transparent International Insolvency Framework, September 2010; IMF, Sovereign Debt Restructuring Mechanism (SDRM), 2003; Acosta Alberto and Ugarteche Oscar, A favour de un tribunal internacional de arbitraje de deuda soberana (2003); Raffer, Kunibert, Applying Chapter 9 Insolvency to International Debts: An Economically Efficient Solution with a Human Face, World Development 18(2), 1990
[95] United Nations, The Global Partnership for Development at a Critical Juncture, MDG Gap Task Force Report 2010

concessional resources. Many SIDS governments contend that income per capita is a poor indicator as to individual countries' extreme vulnerabilities to external shocks and now climate change.

Many SIDS have relied extensively on international and domestic capital markets to fund development and meet fiscal deficits. However even where countries retain 'privileged' access to concessional finance, the data shows that overall, the proportion of debt on concessional terms has declined over the last decade and the proportion of non-concessional debt has increased. This trend is likely to continue given current strains on donor aid budgets and increased attention to the Least Developed Countries. However, given numerous structural vulnerabilities to external shocks, the ability of market based finance to support development in these countries is open to question and pressure to graduate countries out of concessional funds due to higher per capita incomes is likely to have detrimental consequences on many countries' already vulnerable debt outlooks.

The decline in grant resources to most small island developing states must be reversed. This requires reform of the aid allocation criteria to include structural vulnerability as a key criterion in the allocation of development finance. Structural vulnerability results from factors that are beyond a country's control and are therefore not dependent on a government's policy choices. The UN's Economic Vulnerability Index (EVI) and Human Assets Index (HAI) which measure structural impediments to economic growth and have been used to identify the Least Developed Countries should be combined with traditional income per capita measures to assess SIDs' eligibilities for concessional finance.

The case for: a) access to, and b) increased concessional financial support for many small island developing states is compelling. The so-called 'island-paradox' means that although the countries may appear relatively more prosperous on the surface, they are highly exposed to external shocks and especially climate change. These vulnerabilities are a constant challenge to their economic sustainability. This calls for a SIDS-specific approach to many issues which includes trade and development finance related concessions. The provision of SIDS-specific benefits requires, in turn, a more precise definition of SIDS as opposed to the current practice of self-selection. The United Nations could provide technical advice and assistance in the elaboration of such a definition in close collaboration with the countries concerned.

While policymakers have increasingly turned attention towards innovative market-based insurance mechanisms to support countries which are exposed to frequent natural disasters (such as the Caribbean Catastrophe Risk Insurance Facility launched in 2007), such initiatives are complementary and cannot substitute for efforts to provide additional, adequate and sustained concessional resources and trade related concessions to small island developing states. Insurance mechanisms can provide useful additional financial support to governments in times of crisis, however is several cases (for instance Haiti), premiums been financed through concessional loans, i.e. they have been debt-creating. In addition, it is possible that future premiums will rise as climate change intensifies. As a consequence, such initiatives cannot be relied on to meet the special structural challenges faced by small island economies.

Tailor-made financial instruments in recognition of SIDS' vulnerabilities

Additional support measures which should be considered in recognition of SIDS' specific vulnerabilities include greater use of financial instruments such as 'counter-cyclical loans' and/or debt service ceilings. Such instruments reduce the amount of debt service payable on a loan when a severe economic shock occurs.[96] This in turn helps reduce the fiscal burden of the debt in times of crisis and post-disaster recovery. Upper limit debt service ceilings could be established as a proportion of government revenues. There are several ways in which this could be operationalised which include modifications to either the interest rate charged and/or modifications to the maturity of the loan.

One idea is to reduce the grace period of a typical concessional loan, from say 10 to 5 years, and to keep the remaining grace period as an asset on which the country can draw when an external shock occurs. If no such shock happens, the "floating grace" is redeemed to the country at the end of the loan as a repayment in advance without penalties.[97] Another alternative is to maintain standard grace periods, but include provisions for an extra two to three year bankable period.

Such financial instruments do entail some costs for creditors, however in the event that debtors may face repayment difficulties, this situation also entails substantial costs and the outcomes are often unpredictable. This mechanism would introduce some predictability into official sector finance, while helping to support economic recovery in affected countries. So far, discussions over such financial instruments have been limited to the Heavily Indebted Poor Countries which have experienced debt repayment problems in the past. However the high degree of vulnerabilities demonstrated by small island economies means that such instruments may also help to support rehabilitation and recovery in countries frequently impacted by adverse external shocks and which are increasingly vulnerable to natural disasters and climate change.

[96] As piloted by the Agence Française de Developpement for low-income countries

[97] For further elaboration of these proposals, see: Cohen Daniel, Lending to the Poorest Countries: A New Counter-Cyclical Debt Instrument, 2008

6. Conclusion

As small open economies, small islands are especially exposed and vulnerable to external shocks. These shocks have helped precipitate sometimes large increases in public indebtedness. In turn, high levels of public debt have constrained governments' abilities to respond effectively to these shocks. Putting public debt on a sustainable trajectory is therefore critical to reducing vulnerabilities, protecting hard-won development gains and supporting further progress towards the MDGs.

The problem of critically high levels of public debt is especially acute in the Caribbean and while SIDS in the Pacific have so far avoided such high public indebtedness levels, their external position remains fragile and they are also extremely susceptible to external shocks.

Despite higher per capita incomes, SIDS lack economic resilience and it is likely that they will always require some form of external support for problems far beyond their control and capacities. Yet external capital flows in the form of ODA and FDI have been unpredictable and are on the decline across many countries. The need for adequate external support will become all the more acute as the impacts of climate change intensify since SIDS are among the most vulnerable countries in the world to its effects. The threat represented by climate change cannot be emphasised strongly enough; an inability to adapt to climate change could propel many small islands into a negative development cycle which would be extremely difficult to break. Paradoxically, high public debt levels and the scale of capital investments required may limit some governments' abilities to invest meaningfully in climate change adaptation. The argument for SIDS-specific development finance and trade related concessions is therefore compelling.

SIDS' debt problems have so far been largely overlooked by the international policy community, and the emphasis has been placed on SIDS themselves to resolve their debt difficulties through fiscal adjustment, and seeking debt restructuring processes with creditors on an ad-hoc basis. Despite recent debt restructuring, debt problems persist in many countries. This suggests that more comprehensive debt relief may be required in order to increase fiscal space for development-related spending as well as provide countries with a fresh-start. Over the longer-term, the cases highlighted in this report reinforce the need to consider reform of the international debt architecture and in particular the creation of an international sovereign insolvency mechanism.

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