The Debt Problem of Small Vulnerable States: A Time to Act

Summary of the Panel Discussion organized by the Financing for Development Office, UN-DESA, during the first meeting of the Preparatory Committee for the third International Conference on Small Island Developing States

24 February 2014

Chair: H.E. Mr. George Wilfred Talbot, Permanent Representative of Guyana to the United Nations

Moderator: Benu Schneider, Senior Economic Affairs Officer, Financing for Development Office, UN-DESA

Panellists: Jeffrey Lewis, Director, Economic Policy, Debt and Trade Department, World Bank

Samantha Attridge, Head of International Finance and Capital Markets, Commonwealth Secretariat

Gail Hurley, Policy Specialist Development Finance, UNDP

Aldo Caliari, Director, Rethinking Bretton Woods Project, Center of Concern

H.E. Mr. George Wilfred Talbot opened the panel discussion by noting that small States face a particular set of challenges with regards to debt. He asserted that it is important for the international community to take a closer look at the situation of these countries. Many of them face severe constraints given their exposure to external shocks and natural disasters and the overall structure of their economies. This reality warrants increased attention by the international community and a focus that goes beyond the traditional measures to resolve debt problems, in order to address the monumental challenges that these countries face.

The Moderator, Ms. Benu Schneider, noted that in recent years the focus has been on the debt crisis of some European countries, such as Greece, or on low income countries that have benefited from the HIPC initiative. Although many small States have had high levels of debt, including some with the highest debt-to-GDP ratios in the world, and despite multiple debt restructurings in some countries, there has been no durable solution to their debt problems. There has been very little attention paid to the debt problems of these countries probably because they do not pose a systemic risk to the global economy, despite the fact that high levels of debt negatively affect growth and development within these countries.

With these realities in mind, Ms. Schneider posed the following questions to the panelists: What is the extent of the problem of debt in small States and has it been further impacted by the financial crisis? If these countries represent special cases, then what are the special policy options
that are needed in order to deal with these cases? Each panellist in their presentations touched upon these key questions and raised other related issues.

Mr. Jeffrey Lewis provided his answer by way of a presentation addressing four main points: why small States are different from other countries; the global context; the ways to reduce vulnerability and increase resilience of small state economies; and how the World Bank is trying to address some of these issues.

He noted that small States differ from other countries in a variety of dimensions, including their high levels of vulnerability, their limited resilience/ restricted policy space and their high cost of trade due to remoteness. Most small States have concentrated exports and high import dependence. Moreover, they are reliant on remittances and particularly vulnerable to natural disasters and climate change which in many cases can have a huge impact relative to the size of the economy. Many small States are also moderately to highly indebted, and have weak debt management capacity, and find it difficult to control inflation. Among World Bank clients, 21 out of 53 countries having moderately high to high risk to domestic or external debt sustainability are small States. Higher-income small States face a unique set of challenges as they are not eligible for International financial institutions (IFIs) concessional resources and many face increased indebtedness to private creditors which makes it increasingly difficult to arrange systematic debt relief.

With regards to the global context, Mr. Lewis stated that there are two trends worth noting: the tapering off of quantitative easing by US Fed and the gradual improvement of the euro area debt crisis as the economic outlook tentatively improves and; falling food and fuel prices. It should be noted that only a few small States with maturing Eurobonds between now and 2017 may be negatively impacted by the tapering off and that due to net food and fuel imports and remittances, many small States may benefit from improved global context. Further strengthening of global recovery could help small States with significant tourism sectors.

In order to build resilience, Mr. Lewis noted that there is a need for prudent macroeconomic management to best position economies against shocks and facilitate rapid donor response, increased debt headroom so as to maintain cushions between current debt levels and ‘debt distress’ thresholds, asset buffers, as well as a need to reduce vulnerability by facilitating the use of alternative energy to reduce oil dependence, diversifying development and expanding labor market access to secure remittances.

In closing, he asserted that there are no magic solutions to the debt problems of small States. However, a number of proposals on financial instruments exist, including increased reliance on debt swaps for climate change adaptation and mitigation although their transaction costs are fairly high, and efforts to make vulnerability a more important criterion for eligibility to access concessional resources. The World Bank has been pursuing a comprehensive debt framework that recognizes that debt problems are only one part of the economic challenges that small States face and that it is important to focus also on the underlying economic drivers that will help economies move towards sustainable growth, with emphasis on the private sector, sounder fiscal management and mitigation of the effects of disasters.

Ms. Schneider then asked Ms. Samantha Attridge to address the issue of structural vulnerabilities in small States, in particular why it is difficult for them to diversify, and how solutions should be tailored to their unique circumstances.
Ms. Attridge began by stating that small States are a very important constituent of the Commonwealth Secretariat and there is a strong belief that growing debt burdens are hampering growth prospects in these countries and exacerbating their vulnerability to exogenous shocks. Small States do not benefit from economies of scale, and are extremely dependent on globalization. In the past, the debt problems of advanced economies and low-income countries have long obscured the deep seated issues faced by small States. There is a systemic issue facing these countries and the Commonwealth Secretariat questions the appropriateness of the market-based financing model given their inherent structural vulnerabilities. Many problems in small States have resulted from external shocks and natural disasters. Traditional menus of fiscal adjustment are seen not to be working. There is need for new solutions.

Ms. Attridge remarked that there are four key challenges facing small States: (1) high debt burdens, debt defaults and the need for debt relief; (2) fiscal adjustments, weak growth patterns and threats to human development; (3) poor access to finance and; (4) structural vulnerability and continuous exposure to shocks. Potential solutions include: debt swaps for climate change adaptation and mitigation; countercyclical loans for mitigation of debt and growth challenges; the use of vulnerability as a criterion for access to IFI concessional resources; and resilience-building as a policy condition for IFI lending. In this respect, if a country is hit by a natural disaster such that its GDP or exports are substantially reduced, then a clause of non-servicing its loan for a certain period of time would automatically be in effect. This will save time and cost for negotiations. The debt problem is symptomatic of a larger problem concerning growth. The Commonwealth Secretariat advocates a two-pronged approach: at the national level, countries must commit to fiscal responsibility but there must also be recognition that the international community needs to be committed to helping these countries. Ms. Attridge also said she was pleased by the recent attention the World Bank has paid to this issue and the Bank’s willingness to collaborate with the Commonwealth for an appropriate solution which will involve other concerned players.

Ms. Schneider then noted that of all the solutions offered thus far, debt restructuring or adequate debt relief had not been presented as a viable resolution to small States’ debt problems, subsequently asking the remaining panelists if there were any strong reasons as to why debt relief/restructuring has not been considered? Also, level of vulnerability is considered for graduation but not for IDA allocations—could this be an option going forward?

Ms. Gail Hurley focused her presentation on whether small States represent “special” cases when it comes to sovereign debt restructuring, noting that there seems to be a lot of special cases concerning sovereign debt crises (600 debt restructuring in 95 countries between 1950 and 2010) indicating more of a systemic problem than simply an issue of “special” cases. There will always be instances when countries will be unable to pay back their debts. But, by looking at a few recent cases (Jamaica, Belize, Seychelles, Grenada, Greece), it is possible to ascertain what has worked well in debt restructuring cases and what could be improved with regards to how sovereign debt management issues are approached.

She noted that there are more shortcomings in current approaches to debt restructuring than there are positive features. Recent efforts to introduce collective action clauses into sovereign bonds have been helpful in some cases to enhance creditor coordination. Some recent cases of debt restructuring of private external debt have secured participation rates in excess of 90 per cent which is a positive observation. However, some countries with relatively lower debt-to-GDP ratios and high interest burdens have been unable to benefit from any cuts in face value of their debts where others with higher debt-to-GDP ratios and lower interest burdens have managed to do so, illustrating one of the main conclusions that there are no rules when it comes to debt restructuring mechanisms. If one
looks at countries that have opted to re-profile their debt (extend maturities etc.) they have typically found themselves in difficulty fairly quickly. But there have been a few lessons learned, including comprehensiveness—often the burden of debt restructuring is borne by one set of creditors which raises the issue of fairness regarding which categories of creditors are forced to ‘take the hit’ and the question of how sufficient is it to maintain debt sustainability if only one chunk of debt is restructured; as the number of creditors grows, a more complex creditor structure leads to greater levels of incoherence; and there is very poor predictability about debt restructuring outcomes—many political and other factors come into play when debts are being renegotiated.

In sum, Ms. Hurley stressed the need for measures at the domestic level to improve governance and financial management but the international community can also play its part to support these countries more effectively. On balance, there is a clear need for debt-cancellation in several cases as an ad-hoc approach can only achieve so much and some countries really do need a fresh start and debt relief. There is also need for longer-term reforms of the international architecture for sovereign debt management. Finally, the criteria for aid allocation and access to concessional funds from multilateral donors needs to be looked at more carefully taking the vulnerability of countries into account.

Mr. Aldo Caliari began by noting that it is clear that many indebted countries are in a very dire situation, particularly small States which shows that the international community is still very far from achieving the objective agreed upon in 2000 to comprehensively address the problems of low- and middle-income countries. The debt issues facing these countries will become more pronounced given the tapering of quantitative easing of the U.S. Federal Reserve.

He stressed that the main issue is the way the target and indicators on debt sustainability were framed in 2000. While the target was comprehensive, the indicators reflected only the HIPC countries effectively excluding small States. The other issue was how the concept of debt sustainability was framed and linked it to the MDGs. A third problem with the debt sustainability framework was that it didn’t really address debt relief but focused more on changing the mix of concessional resources looking forward. He recognized that this was not necessarily a bad idea but this particular framework was applied to countries that had not received any debt relief. When such a framework was applied to countries with a high debt burden, the result would be a financing gap. This deficiency is the one which the debt sustainability framework has been attempting to deal with since 2005.

Mr. Caliari asserted that there is a definite need for a reformed sovereign debt restructuring framework that aligns with a human rights based agenda. For small States this would require significant reductions in debt burdens. There is also a need for substantive change in the way debt sustainability is assessed. A sovereign debt restructuring framework is needed in an efficient and timely manner. The reason the current framework has not worked is because of a lack of neutral arbitrators. When creditors make the decisions, there is always going to be a systematic under-statement of how much debt relief is truly necessary. A comprehensive framework is therefore the solution.

Ms. Schneider then asked Mr. Lewis about the relationship between high debt burdens and growth. asking While debt financing is needed for a country’s development, is there a threshold level for small States at which debt becomes unsustainable? Also, his presentation did not include debt restructuring as a policy option to resolve the debt problem in small States. Is debt restructuring an option to deal with the debt problem in small States?
Mr. Lewis responded by saying that with regards to the debt-growth connection, there will always be an academic debate about the threshold level. However, if one was to pick a number, one could state that anything higher than a debt-to-GDP ratio of 90 per cent is bad. However, that claim doesn’t necessarily mean that anything below 90 per cent is good, nor does it mean that every country over the 90 per cent level will necessarily run into trouble. Thresholds are good as rough guidelines/indicators but the more important consideration is the underlying dynamic—fiscal and policy space for governments to pursue various opportunities, and buffers to prevent complete derailment of countries by external pressures.

He went on to note that it is the World Bank’s institutional view that there is no appetite from the global community to provide resources to pursue systemic debt relief efforts. Therefore the way to pragmatically approach these issues is not to think that there might be some HIPC-like initiative created to address these issues but that each case will have to be taken on a case-by-case basis and addressed individually by looking at circumstances and the structure of the debt for each country. He accepted that rules were lacking and that these countries had to be looked at differently. Ms. Attridge echoed the practicality outlined by Jeffrey Lewis, noting that there doesn’t seem to be an appetite to provide resources for financing debt relief to small States.

Questions from the audience:

A representative of the CARICOM Secretariat acknowledged that debt is a significant problem in the Caribbean. He asked what is meant by resilience-building in the context of the debt problem from the standpoint of the IFIs? He also noted that in the Caribbean there were two groups of countries—those that are goods producing and those that focus on the provision of services. The challenge affects those that are service-oriented when it comes to restructuring or a debt exit. He also commented on the state of Grenada which has lost its major markets as a result of several disasters. It has become difficult to generate the necessary resources to get back to where it was pre-disasters. He stated that there is need for engagements between institutions and stakeholders within countries in the Caribbean. There has been very little interaction and this gap marks an important missing element in trying to come up with a resolution to these issues.

Another question from the floor concerned how much SIDS have owed to big creditors and IFIs? And how much has been paid in interest? Could these debts not be cancelled if, after having made these payments, the majority of the principal amounts owed have been paid?

A comment from the Jamaican mission reflected on the impact of natural disasters on income levels of SIDS. Additionally, many of these countries are highly dependent on international trade and are therefore heavily affected by trans-boundary impacts when trading partners are impacted by disasters. These types of relationships increase macro-economic imbalances. He then asked what the prospects of crafting something similar to the European financial stability facility might be in this context?

Ms. Schneider then provided the panel with the opportunity to answer questions and offer concluding remarks:

Mr. Lewis closed by stating that the World Bank works on fiscal and macro resilience, climate change resilience, etc. The notion of resilience goes far beyond a fiscal measure or a debt sustainability related measure. However, it is important to understand how vulnerable a country’s fiscal position is to the types of shocks that have been mentioned. Therefore there is a need to disaster proof the fiscal approaches as much as there is need to be concerned about low land areas
etc. In some ways, islands are different in terms of opportunities and vulnerabilities. The World Bank is cognizant of that fact and factors heterogeneity into its approaches to dealing with these countries. A final reiteration was also made about the fact that the World Bank is yet to see any real groundswell from the international community to reform the current debt sustainability framework.

Ms. Attridge closed by emphasizing disaster proofing resilience and fiscal and debt positions, noting that the CPIA is still the main determinant of debt carrying capacity. There is need for a stronger consideration of vulnerability to exogenous shocks. There is need to undertake a macroeconomic adjustment within a broader resilience building lens because a pure focus on fiscal adjustment can lead to growth but cuts in social spending. Finally, movement on the debt restructuring architecture issue is going to take a lot of time. It might therefore be more practical to look at access to finance for these countries.

Ms. Hurley closed by speaking about the growth-debt nexus and stated that while debt-to-GDP thresholds matter, they don’t tell the whole story because it is not only the amount of debt, but also the quality of debt that matter—what is debt being contracted for? What are the terms and conditions under which the debt was contracted? With regards to the lack of global appetite for a new debt restructuring initiative those present were reminded that the HIPC initiative was also difficult to achieve but that it came to fruition. The clear objective need for debt relief in some small States was also reiterated as was the need for an initiative similar to HIPC for small States.

Mr. Caliari closed by asking who bears the losses when things go wrong, when there are natural disasters or when countries’ trading partners are hit by external shocks, etc.? If the international community says that there is no appetite for reform, it means that debtor countries are going to continue having to bear the costs of those losses. He concluded by asking if this is the message that we want the post-2015 development agenda to send?

H.E. Mr. George Wilfred Talbot wrapped up the panel discussion by noting two key takeaways from the proceedings: the response to the debt situation of small States has been inadequate and; there is a case for more concerted attention to this issue and a need for a political response that is commensurate to the needs that exist.
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Panel Discussion organized by the Financing for Development Office during the first PrepCom on Small Island Developing States

24 February, 1:15-2:30 pm,
Conference Room A, Conference Building
United Nations, New York

Objective of Panel Discussion

The discussion seeks to highlight and bring international focus to the debt and financing challenges of small states as the international community prepares for the Third International Conference on Small Island Developing States which will be held in Samoa in September 2014. Specifically, the panel will focus on discussion of concrete policy actions that can be taken to address the debt problem in small states.

Background

One of the major challenges facing small, mainly middle-income, vulnerable states is unsustainable debt. This problem is especially pronounced in small Caribbean states where average public debt levels for the region amounted to 84.2 percent of GDP and in some states exceeded 140 percent of GDP at the end of 2012. This together with an inherent vulnerability to exogenous shocks, such as that observed throughout the global financial crisis, as well as the existential threat posed by climate change effects makes their situation very worrying. The high debt burden is hampering growth prospects in these states; is exacerbating their vulnerability to economic shocks and as a result is threatening the achievement of development objectives.

The emergence of the debt issue in small states is that in many cases, a symptom of a bigger problem of low economic growth resulting in deterioration in primary fiscal balances and rising interest costs. If a lasting solution is to be found, a two-pronged approach is required. For their part small states must address the growth issue. They must also commit to fiscal responsibility, reform of policies and institutions; and must borrow smarter and cheaper investing in productive capacity. At the same time, small states need the support of the international community given their inherent structural vulnerability to:

1. **Reduce the debt burden.** Despite the debt restructuring operations undertaken by indebted small states, most continue to face high unsustainable debt burdens. The existing mechanisms within the current international financial architecture have provided some debt relief but for the most part have only temporarily eased these states debt problems. This is because the debt problems of small middle-income countries have been treated largely as a matter of liquidity, requiring measures only to allay their immediate cash problems, rather than as a matter of solvency requiring more far-reaching measures to tackle the structural problems and inherent fragility that characterizes these countries.

2. **Address the future financing challenge** in light of small states inherent structural vulnerabilities. It is clear that securing long term debt sustainability in these countries requires access to stable affordable finance and greater flexibility in the operation of the financial system. Access to financial markets is at high cost to finance their growth and development challenges as well as to aid their recovery from natural disasters and shocks such as the recent global financial and economic crisis, the result of which has been an increase in public debt.