Debt in Small Island Developing States: The Case for a Sovereign Insolvency Mechanism

Deutscher Bundestag
Ausschuss für wirtschaftliche Zusammenarbeit und Entwicklung
Ausschussdrucksache
NR. 17(19)0175 TISCHVORLAGE

Information about this handout

This Issue Brief has been prepared for German members of parliament attending the expert hearing on "public debt and the possibility of a sovereign debt work-out mechanism" on 6 April 2011. It summarises the vulnerable debt position many small island developing states, and why a sovereign insolvency mechanism may be useful as a way to address unsustainable debt.

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Public Debt in Small Island Developing States: An Urgent and Unresolved Issue

Introduction

This Issue Brief summarises new research by the United Nations Development Programme (UNDP) into critically high public debt levels across many small island developing states (SIDS). Within the context of addressing MDG 8, target 3, 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,"* this Issue Brief is intended to stimulate discussions at both the national and international level on appropriate policy measures which could be taken to reduce high levels of public debt – and debt service – in many small island developing states.

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 has so far been largely unaddressed by the international policy community. UNDP research illustrates that public debt levels have been on an unsustainable trajectory in several countries for some time and urgent and new policy solutions by both the international community and affected countries are required to resolve the situation.

Public Debt in Small Island Developing States

Many developing countries have reduced their external debt burdens over the last decade, helped in part by favourable global conditions, multilateral and bilateral debt relief and improved debt management capacities. External debt in developing countries 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]

In contrast, public debt levels – domestic and external – in many small island developing states have increased considerably over the last decade, as measured by both debt stock and debt service indicators. UNDP's research shows that in 2009, 14 small island developing states (out of 28 countries for which data was available) registered public debt to GDP ratios in excess of 60 percent (the broadly accepted threshold for sustainable levels of public debt). Eight SIDS, mostly in the Caribbean, registered debt to GDP levels in excess of 100 percent: Antigua and Barbuda, Barbados, Grenada, Guinea-Bissau, Guyana, Jamaica, St. Kitts and Nevis and the Seychelles.[2]

Public debt ratios have risen especially sharply over the last three years, as small islands have battled the impacts of the concurrent food-fuel-financial crises, as well as natural disasters in many cases. Between 2007 and 2010, public debt levels in 20 small island developing states increased by on average 8.8 percent of GDP.[3] In several Caribbean countries, the increase is considerably higher. Antigua and Barbuda, Barbados, Grenada, Jamaica, St. Lucia, St. Kitts and Nevis and St. Vincent and the Grenadines all increased their public debt levels by more than 10 percent between 2007 and 2010.[4] The Maldives and Tonga also increased their public debt burdens substantially during this period (by 30 percent and 14 percent respectively). 15 SIDS turned to the IMF for emergency financial support. Total new IMF debt disbursed since the outbreak of the crisis stands at US$1.18 billion.[5]

Several countries also register extremely high debt service ratios when measured as a proportion of government revenues. Again, the problem is most acute in the Caribbean. In 2009, at least eight small island developing states spent more than 20 percent of central government revenues on public debt service. These countries are: Antigua and Barbuda (35.1 percent), Cape Verde (20 percent), Jamaica (99.2 percent), the Maldives (27.1 percent), the Seychelles, St. Kitts and Nevis (40.7 percent), St. Lucia (33.5 percent), and St. Vincent and the Grenadines (24.4

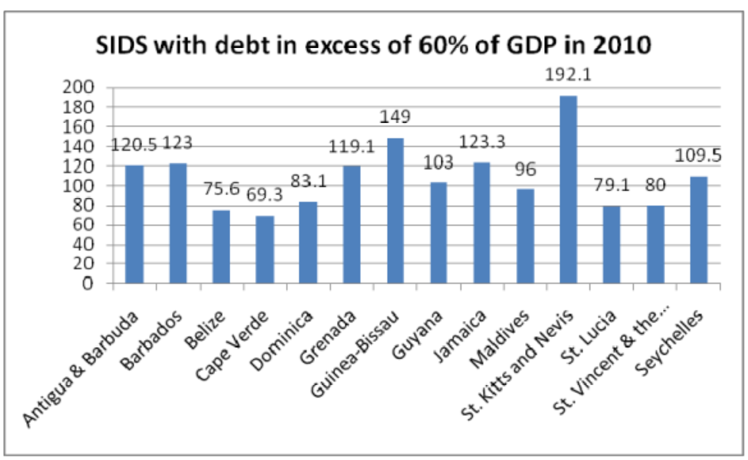
percent).[6] In several countries, these ratios are projected to rise further still over the next few years.

External debt service to exports ratios are also high across several small island developing states. in 2010, SIDS with high external debt service to export ratios (defined as more than 15 percent), include: Barbados (25.7 percent); Comoros (20.2 percent), Grenada (15 percent), Jamaica, the Maldives (17 percent), Marshall Islands (59 percent), St. Kitts and Nevis (15.2 percent), and St. Vincent and the Grenadines (18.5 percent). Tonga's external debt service to export ratio will more than double over the next five years from 8.7 percent in 2009 to 17.5 percent by 2015.[7]

Small island developing states have historically underperformed in terms of economic growth when compared to other developing countries and the rest of the world. Over the last decade, small island developing states have registered average annual economic growth rates of 2.8 percent; this compares to more than 6 percent for developing countries as a whole over the same period.[8] SIDS are also projected to recover from the global financial and economic crisis more slowly than other countries and the rest of the world, as measured by forecasts of economic growth over the next few years (see charts overleaf). As such, it will be very difficult for many countries to simply 'grow-out' of extremely high levels of public debt.

UNDP's report shows that public debt levels are on an unsustainable trajectory across some small island developing states, especially in the Caribbean. Additional policy measures may be required to support these countries to reduce their public debt burdens. The IMF also recently identified nine small island developing states 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.[9]

SIDS with high public debt ratios



Source: Individual Governments and IMF Article IV Consultations and Review Documents

Small Island Developing States: An Overview

There is no official United Nations list of small island developing states (SIDS). However 42 SIDS have formed an 'Alliance of Small Island Developing States' (AOSIS) in order to collectively advance their concerns within the United Nations system and at the international level. Membership is by self-selection and members can be found off the coast of Africa, in the Caribbean Sea, and the Indian and Pacific Oceans.

Small island developing states 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, Seychelles, Singapore and Trinidad and Tobago.

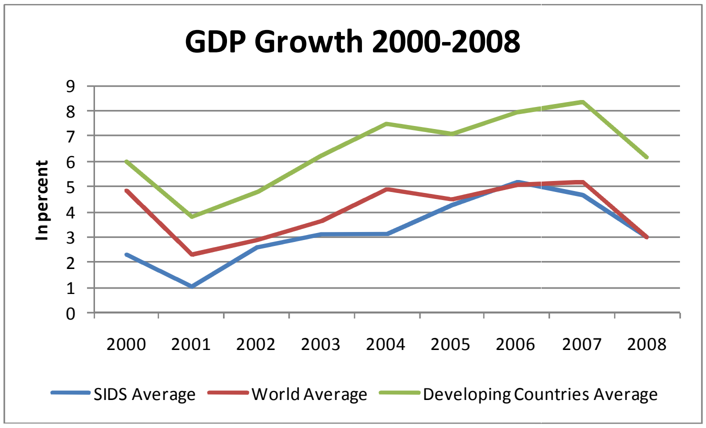
SIDS enjoy on average higher income per capita levels than the least developed countries and the least developed landlocked countries (LLDCs), although this hides the extent to which small islands are especially vulnerable to external shocks and natural disasters. The predicted impacts of climate change will further exacerbate these structural vulnerabilities. By virtually any measure, the UN considers small island developing states to be among the world's 'hot spots' in terms of special vulnerabilities.

Small Island Developing States (UN Independent Member States)

Antigua and Barbuda	Federated States of Micronesia
Bahamas	Mauritius
Bahrain	Nauru
Barbados	Palau
Belize	Papua New Guinea
Cape Verde	Samoa *
Comoros *	São Tomé and Príncipe *
Cuba	Singapore
Dominica	St. Kitts and Nevis
Dominican Republic	St. Lucia
Fiji	St. Vincent and the Grenadines
Grenada	Seychelles
Guinea-Bissau *	Solomon Islands *
Guyana	Suriname
Haiti *	Timor-Leste *
Jamaica	Tonga
Kiribati *	Trinidad and Tobago
Maldives *	Tuvalu *
Marshall Islands	Vanuatu *

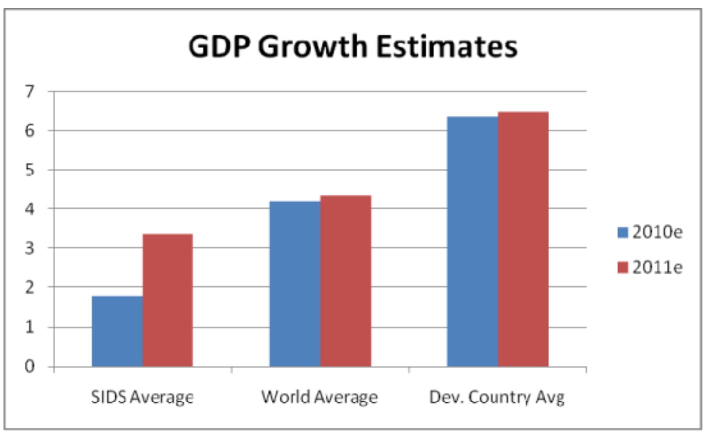
*Also a Least Developed Country (LDC)

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



Source: IMF, World Economic Outlook Database, April 2010

Projected SIDS GDP growth 2010 - 2011 as compared to world and developing countries



Source: IMF, World Economic Outlook Database, April 2010

Small island developing states: a recognised special case but debt relief for only a handful

The UN has long recognised the special needs and development challenges that face small island developing states. it is widely recognised that small island developing states demonstrate a range of structural weaknesses which include, *inter alia*: slow and volatile economic growth; limited natural resources and a highly specialised export structure based on only a handful of products (especially raw materials); limited economies of scale; high transport costs; 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, in turn, heavy reconstruction costs. As such, the United Nations has supported the development of the 'Barbados Programme of Action' in 1994 and the 'Mauritius Strategy' in 2005, which aim to support sustainable development in small islands.[10]

The 'Mauritius Strategy' report emphasised: *"the high and increasing debt burden of many small island developing states"* and urged the international community to *"consider cancellation of debt in the most heavily indebted countries."*[11]

Despite this, only five small islands (Comoros, Guyana, Haiti, Guinea-Bissau and São Tomé and Príncipe) have been considered either poor enough or severely indebted enough to qualify for debt relief under international schemes such as the Heavily Indebted Poor Countries (HIPC) Initiative and the Multilateral Debt Relief Initiative (MDRI). Thanks to HIPC and MDRI, these countries' multilateral and bilateral debts have been reduced by approximately US$4.5 billion.[12] The high (and rising) public debt burdens in other small island developing states have so far been largely unaddressed by the international policy community. UNDP's report suggests this cannot continue.

Impact on human development and poverty reduction objectives

Evidence from several countries suggests that high public debt – and debt service – ratios have severely compromised progress towards poverty reduction and human development objectives.

For instance, in Jamaica, the heavy fiscal burden of the debt coupled with limited access to external finance has meant the government has had little fiscal space with which to increase expenditures in public investment and poverty reduction programmes. In 2009, debt service costs amounted to US$3.55 billion out of a total government budget of US$6.14 billion. Once the costs of public administration were deducted, only US$864 million remained to invest in social programmes and improve the island's infrastructure; under such a scenario, meaningful progress towards poverty reduction is impossible.[13]

In Grenada, the government faces the challenge of having to drastically lower expenditure and rationalise a number of social programmes in order to reduce public debt levels to meet regional debt targets established by the Eastern Caribbean Central Bank (discussed in box overleaf). The limited fiscal space has had a significant impact on Grenada's ability to reduce poverty. Although the incidence of indigence has been significantly reduced, overall poverty increased from 32% to 37% in less than a decade.[14]

Many SIDS have made good progress towards the Millennium Development Goals, as demonstrated by MDG national reports. Nevertheless, pockets of poor and vulnerable communities persist due to low-income levels, insecurity and exposure to natural disasters. Unemployment and the creation of new employment opportunities represent a key challenge for many governments, which have traditionally acted as the 'employer of last resort'. This, in turn, has led to bloated and costly public administrations (as well as helped to exacerbate public debt burdens since public administration and salary costs are borne by the government budget). The social safety net is not well-developed in many countries and the high unit cost of social service provision means that their sustainability is constantly challenged.[15] These development challenges mean that the need for governments to invest more resources in human development and infrastructure remain very high.

Additionally, the report finds that many small island developing states are planning to reduce public expenditures over the next few years. Most SIDS governments implemented fiscal stimulus programmes in the context of the recent global financial and economic crisis, however critically high public debt burdens and 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. 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.[16] Some cuts in expenditures will involve reductions in capital expenditures, such as Grenada, the Maldives and St. Lucia.

Given that sustained economic growth is one the most important channel through which reductions in public indebtedness can be fostered, reductions in capital investments are 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. 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.

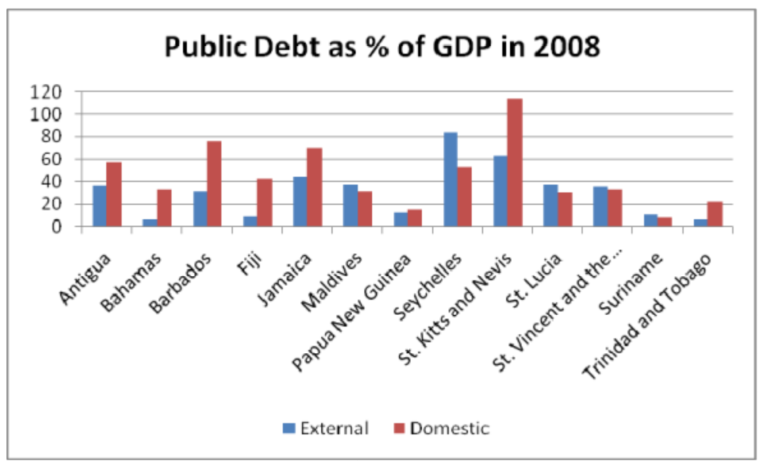
Shifting debt dynamics has increased debt vulnerabilities

A major concern raised by UNDP's report on public debt in small island developing states is the sharp decline in concessional debt as a proportion of total debt, and the increase in non-concessional private – domestic and external – forms of debt. Official Development Assistance (ODA) is also on the decline to most small island developing states.

Several small island developing states benefit from concessional finance from the major multilateral lenders (such as the World Bank and IMF) under the so-called 'small island exception' in recognition of the particular development challenges faced by small island developing states.[17] For several countries, the multilateral financial institutions remain the major lending partner. Nevertheless, some small islands do not benefit from this exception (for instance Jamaica), and overall, UNDP's research shows that concessional debt as a proportion of total public debt has declined considerably in many countries over the last decade. This has been substituted with (more costly) private external and/or domestic debt.

The countries most severely affected between 2000 and 2008 include: Dominica (which saw concessional debt decline nine percentage points from 68 percent to 59 percent; Fiji (concessional debt declined by 23 percentage points from 53 percent to 30 percent); Grenada (with a 7 percentage point decline from 53 percent to 46 percent); Jamaica with a 15 percentage point decline from 28 percent to 13 percent); the Maldives (which saw concessional debt decline by 25 percentage points from 77 percent to 52 percent); the Seychelles (with a 29 percentage point decline from 48 percent to 19 percent); St. Kitts and Nevis (which saw concessional debt decrease by 16 percentage points from 60 percent to 44 percent), and; St. Vincent and the Grenadines (with a 10 percentage points decline in concessional debt from 56 percent to 46 percent).[18] Domestic debt has increased across many countries and in several small island developing states, the stock of domestic debt now exceeds that of external debt, as indicated by the chart.

Domestic and External Debt: Selected SIDS



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

In parallel, ODA has declined to many small island developing states despite overall increases in volumes of official development assistance. The proportion of total OECD-DAC ODA allocated to small island developing states declined steadily from 3.7 percent in 2000 to 2.8 percent by 2008.[19] OECD-DAC ODA to SIDS totalled just US$2.4 billion out of a total of US$87 billion in 2008.[20] Most of this aid has been highly skewed towards just a few small islands and 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.

UNDP's report finds that this shift has increased debt vulnerabilities in some countries. The dynamics of debt owed to private creditors (domestic and external) is crucially very different to that owed to official bilateral and multilateral creditors. Domestic debt may not carry exchange rate risk (although in several countries sovereigns have started to issue US dollar denominated bonds which would cancel out this benefit), however interest rates are usually higher and maturities can sometimes be very short. Domestic debt can therefore be a costly alternative to external finance and has also crowded out credit to the private sector in some countries – such as the Maldives – with implications for private sector development and economic growth. International capital markets, meanwhile, tend to be procyclical and subject to abrupt changes due to perceptions of risk by lenders, exchange rate fluctuations and broader conditions in global capital markets. As a consequence, 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. This in turn increases the risk of debt default and sharp economic contraction. In recognition of these facts and in view of SIDS' numerous structural vulnerabilities to external shocks, UNDP's report questions the appropriateness of market based finance to support these countries' economic development.

More ambitious international policy response required

UNDP finds that over the last 30 years, 16 small island developing states have concluded at least 49 sovereign debt restructuring operations involving multilateral, bilateral, private external and private domestic creditors alike (see figure). 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 number of bilateral restructuring agreements concluded with non-Paris Club creditors since comprehensive data was not available. This year alone, at least three SIDS have restructured important portions of their domestic, private external and/or bilateral debt.

In January 2010, Jamaica restructured its immense domestic debt burden with the support of UNDP in Jamaica. By reducing interest rates payable on domestic securities and extending maturities, the government was able to generate an additional US$500 million in fiscal space in 2010 for investments in poverty reduction and the social sectors.[21] In January 2010, the Seychelles also restructured portions of its private external and bilateral debt.[22] In September 2010, Antigua and Barbuda visited the Paris Club to reschedule approximately US$117 million in principal, interest and arrears.[23]

The recent food-fuel-financial crises which have run concurrently have increased public debt ratios across many small island developing states, as noted earlier. Critically high public debt – and debt service – ratios mean that the need to restructure a portion, or all, of a country's debt portfolio in the near future cannot be entirely ruled out. Indeed, the extent to which high public debt may pose a serious challenge to economic development, poverty reduction and human development efforts in some countries warrants urgent attention by international policymakers and the development of innovative solutions to help countries' put their debts on a sustainable trajectory. This has so far been largely avoided by the international policy community.

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."*[24] However, with respect to SIDS, 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 for many countries.

Moreover, SIDS face a new, and arguably their most serious, challenge to-date; that of climate change adaptation. Small island developing states are among the most vulnerable countries in the world 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. As such, exogenous factors are likely to limit countries' progress in this area regardless of governments' stated commitments to environmental sustainability. High public debt levels may mean that in some countries, climate change adaption takes a back-seat to other critical social interventions due to competing priorities for scarce government resources.

These considerations suggest that the international community – as well as national authorities – must take important measures *together* to address the debt burden in many small island developing states.

For their part, SIDS' governments must take concrete steps to reduce inefficiencies in public expenditures as well as improve targeting towards the neediest populations. Governments must also broaden and strengthen revenue collection (with provisions built-in to protect the poorest). 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. In parallel, many countries must significantly improve institutional debt management capabilities as well as develop credible plans to diversify their economies. The report also highlights the importance of public-private partnerships and the need to create a new set of relationships between the state and the private sector. Emphasis must be placed on the creation of an appropriate environment conducive to the creation of new enterprises and the expansion of existing ones, as well as encouraging governments to make the necessary administrative and legislative changes to support public-private partnerships for development.[25]

The report also proposes several other measures for further discussion by relevant stakeholders.

1. **Need for a SIDS-specific approach:** 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. The case for: a) access to, and b) increased concessional financial support for most 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. Bilateral and multilateral donors must increasingly provide resources in grant form to the most vulnerable and severely indebted small island developing states and the decline in concessional resources to small island developing states must be reversed. An urgent review of the criteria used to establish eligibility for concessional resources and trade related concessions is needed.

2. **A Sovereign Insolvency Mechanism is required:** In some small island developing states, the size of the public debt overhang is so large that comprehensive debt restructuring must be ruled-in in order to support economic recovery and human development objectives. The IMF has recently suggested that even where countries are extended better financing terms from donors and *simultaneously* improve their fiscal positions and policy and institutional capacities, this will still not be sufficient to reduce debt vulnerabilities in some low-income countries. This includes several small island developing states. Debt restructurings have already occurred frequently across a range of small island developing states as indicated by the table. However they are not necessarily resolved in the fairest and most efficient manner. An institutionalised procedure at the international level to restructure sovereign debts efficiently, predictably and equitably is required. Well developed proposals for such a mechanism already exist and must be examined in more detail.[26] 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.[27]

3. **Debt conversions for climate adaptation:** Some small island developing states may not necessarily require comprehensive debt restructuring from all their creditors, but still require extra support from the international community in relation to managing their debt. As the international community seeks innovative ways to boost resources to the developing world to fund climate adaptation and mitigation, one approach which warrants further discussion is the conversion of official sector debt repayments into climate change adaptation resources. Under the initiative, a central trust account (or adaptation account) would be established into which official sector 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. These resources should complement – and not substitute for – commitments to substantially increase resources for climate change adaptation and mitigation. 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.

4. **Tailor-made financial instruments in recognition of SIDS' vulnerabilities:** Going forward, additional support measures which should be considered in recognition of SIDS' specific vulnerabilities include greater use of financial instruments such as 'counter-cyclical loans'. Such instruments reduce the amount of debt service payable on a loan when a severe economic shock occurs.[28] This in turn helps reduce the fiscal burden of the debt in times of crisis and post-disaster recovery. 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.

SIDS debt restructurings: 1980s - 2010

Country	Multilateral debt	Bilateral debt[29]	Private external debt	Private domestic debt
Antigua and Barbuda		2010	2008[30]	
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	NO	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[31]		
Suriname		2009[32]		
Trinidad and Tobago		1989, 1990		

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Acknowledgements

This brief, and UNDP's larger report on public debt in small island developing states, has been produced by the Poverty Group, Bureau for Development Policy, UNDP in New York. UNDP Country Offices involved in the research are: UNDP Barbados Multi-Country Office, UNDP Fiji Multi-Country Office, UNDP Maldives. The author would like to thank the country offices, and in particular the Barbados Multi-Country Office, for their support in this research. Grateful thanks also to UNDP Jamaica.

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Endnotes

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[3] UNDP calculations based on data contained in IMF Article IV and Review documents
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[27] United Nations, the Global Partnership for Development at a Critical Juncture, MDG Gap Task Force Report 2010
[28] As piloted by the Agence Franciase de Developpement for low-income countries
[29] Refers to restructuring operations concluded within the framework of the Paris Club only unless otherwise indicated
[30] Write-down obtained from Banco de Brasil
[31] Write-down of arrears by Italy
[32] Write-down of arrears from Brazil for a total of US$44 million