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KEY SDS CHARACTERISTICS

OVERALL CHARACTERISTICS

The IMF classifies as SDS those members with populations under 1.5 million, excluding advanced economies (AEs) and high-income fuel-exporting countries as listed by the *World Economic Outlook* (WEO). A total of 34 countries fall into this category (Table 2.1).[3] The IMF list of SDS differs from that of other international organizations. Most notably, the World Bank's Small States Forum (SSF) list adds eight countries with populations over 1.5 million but with similar characteristics to those of countries under the threshold and includes AEs and fuel exporters.

There is significant heterogeneity among SDS: 27 are island states, 5 are coastal, and 2 are landlocked. While they are concentrated in the Caribbean (12) and in the Asia and Pacific region (14), there are 7 in Africa and 1 in Europe. Fifteen are "microstates," with populations below 200,000, 6 of which have populations under 100,000. The smallest SDS has a population of 10,000. Ten SDS are considered to be fragile and conflict-affected states (FCS). In terms of income level, 11 are considered lower-middle-, 16 are upper-middle-, and 7 are high-income countries, according to World Bank criteria.[4] Currently, there are no low-income SDS.

While small states comprise a heterogeneous group, they share many characteristics and vulnerabilities as a result of their small population and economic size. These include narrow production bases, limited diversification of economic activity, output, and exports, and constrained human resources and institutional capacity. Their high dependence on international trade and narrow range of exports make them particularly susceptible to macroeconomic volatility, commodity price fluctuations, and disruptions in world markets, and amplify their exposure to terms-of-trade shocks and volatile trade tax revenues. Many experience high youth unemployment and elevated levels of migration by the highly educated, limiting the skills needed to drive sustained economic growth and development. Many, particularly Pacific small states, are remote, insular, and far from global trade routes and consequently are exposed to high trade-related transportation costs and dependent on fuel imports. SDS are also among the most vulnerable countries to ND&CC, with adverse impacts on growth and other macro-critical effects. The challenges arising from small population and economic size, remoteness, and limited human resource and institutional capacity are amplified for microstates with populations under 200,000.

[3] Andorra joined the Fund in October 2020 and is covered in this evaluation. It is classified as an advanced economy and is therefore not included in the IMF SDS list.

[4] In July 2021, the World Bank classified countries as follows: low-income countries (per capita income of $1,045 or less); lower-middle-income countries ($1,046–$4,095); upper-middle-income countries ($4,096–$12,695); and high-income countries ($12,696 or more).

TABLE 2.1. SMALL STATES AS CLASSIFIED BY THE IMF AND THE WORLD BANK

		AFR	APD	EUR	MCD	WHD
WB SSF (50)	**IMF SDS (34)**	Cabo Verde Comoros* Eswatini Mauritius São Tomé and Príncipe* _Seychelles_	Bhutan Fiji _Kiribati*_ Maldives* _Marshall Islands*_ _Micronesia*_ _Palau_ _Samoa_ Solomon Islands* Timor-Leste* _Tonga_ _Tuvalu*_ Vanuatu _Nauru_	Montenegro	Djibouti*	_Antigua and Barbuda_ The Bahamas Barbados Belize _Dominica_ _Grenada_ Guyana _St. Kitts and Nevis_ _St. Lucia_ _St. Vincent and the Grenadines_ Suriname Trinidad and Tobago
		Botswana (>1.5m) Equatorial Guinea (fuel exp.) Gabon (>1.5m) Gambia* (>1.5m) Guinea Bissau* (>1.5m) Lesotho (>1.5m) Namibia (>1.5m)	Brunei (fuel exp.)	Cyprus (adv.) Estonia (adv.) Iceland (adv.) Malta (adv.) _San Marino (adv.)_	Bahrain (fuel exp.) Qatar (>1.5m)	Jamaica (>1.5m)

Sources: IMF and World Bank.
Note: Microstates are shown in italics. * denotes FCS (fragile and conflict-affected states). AFR = African Department, APD = Asia and Pacific Department, EUR = European Department, MCD = Middle East and Central Asia Department, WHD = Western Hemisphere Department. Adv. = advanced economy. Fuel exp. = fuel exporter.

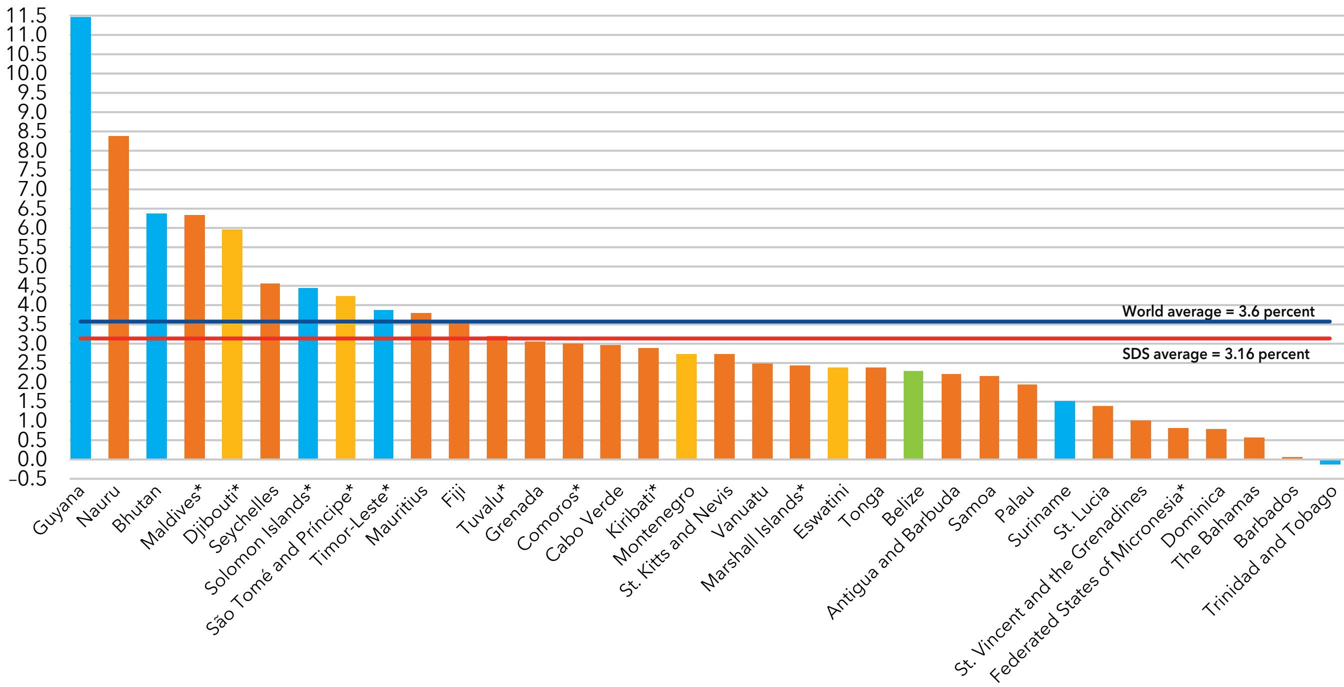
It is worth highlighting up front that there are also considerable variations across the three main regions containing SDS.[5] Caribbean SDS are highly concentrated and 9 of the 12 are islands. Caribbean SDS are typically characterized by higher levels of development (most of them qualifying as upper-middle-income) and institutional capacity, but also high public indebtedness—much of which stems from repair and construction work following hurricanes. Pacific SDS are all insular and while "concentrated" in the same region, they are distributed over a vast oceanic area, distant from each other and remote from neighboring continents. They are also generally smaller (including 8 of all 15 microstates) and more fragile (accounting for 6 of the 10 SDS considered FCS). Pacific SDS are on average less developed and more dependent on external assistance, with an average GDP per capita during the evaluation period around one third that of Caribbean SDS. African SDS tend to be larger; two of them are on the mainland and five are islands off the continent's west and east coasts.

GROWTH

SDS' small populations and economic size have challenged policymakers' efforts to achieve macroeconomic stability, well diversified resilient economies, and sustained growth. Since 1980, growth rates in SDS have persistently lagged those of other emerging markets and developing economies (EMDEs) and fallen short of the global average growth rate. Tourism-dependent SDS, microstates, and Caribbean SDS

[5] Of the 34 SDS, only Bhutan, Maldives, and Montenegro are located outside of these regions.

FIGURE 2.1. REAL GDP GROWTH ACROSS SDS, 2010–2020
(Average, in percent)



Sources: IMF; IEO calculations.
Note: * denotes FCS (fragile and conflict-affected state). Orange = tourism-dependent SDS; blue = commodity-exporting SDS; green = tourism-dependent and commodity-exporting SDS; yellow = others.

have tended to perform particularly poorly in comparison with other SDS and other country groups.

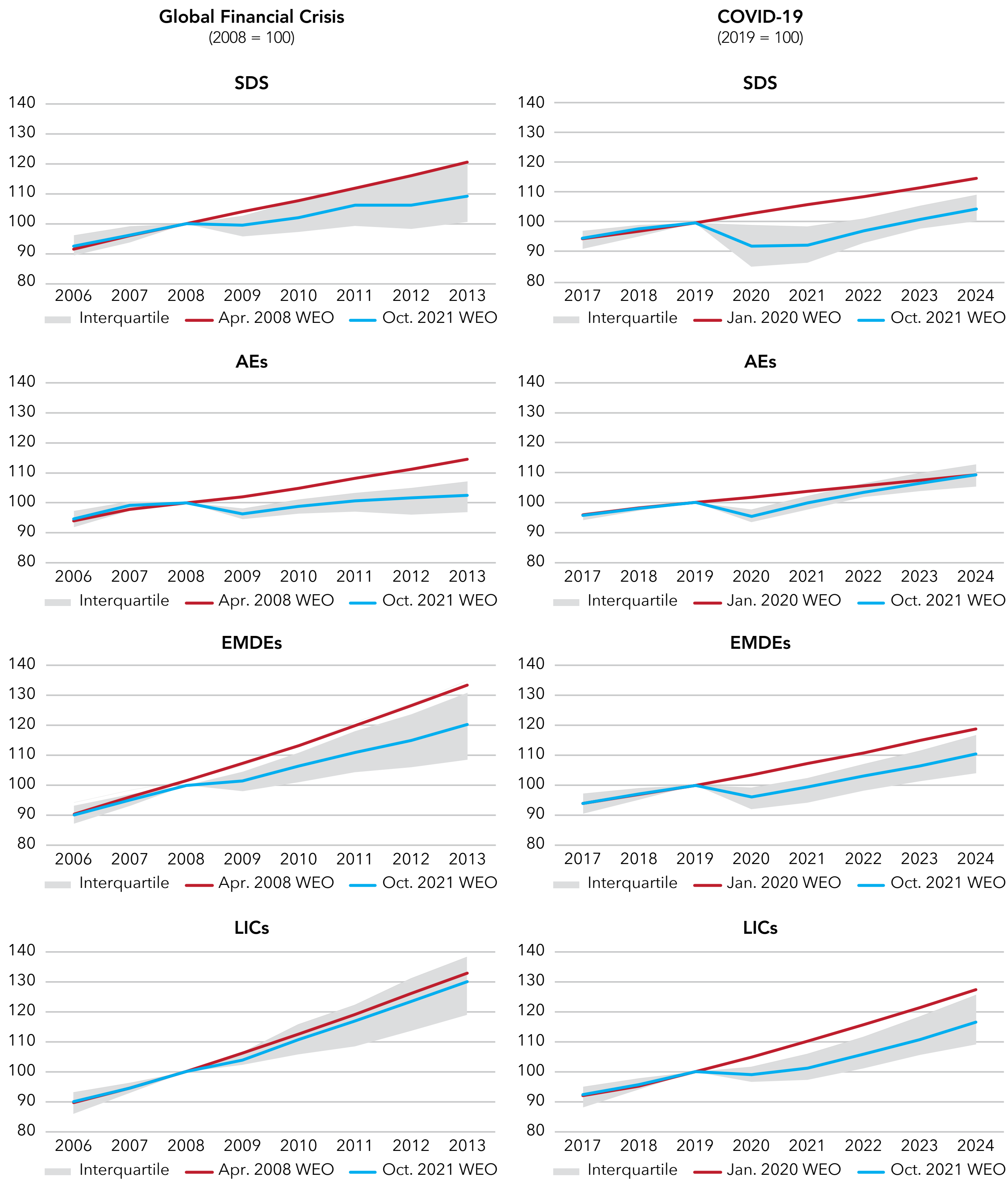
Over the evaluation period 2010–2020, growth experience varied widely among SDS and across SDS regions. Less than a third of SDS—mainly commodity-exporting SDS and a few tourism-dependent SDS (which comprise half of all SDS)—achieved growth rates higher than the global average (Figure 2.1). Of the 15 microstates, 10 experienced much lower growth rates than the SDS average. Among SDS regional groupings, growth rates were particularly low among Caribbean SDS. The Caribbean region has experienced stagnant growth for an extended period. During the evaluation period, GDP growth exceeded the SDS average in only 1 Caribbean SDS, while Caribbean members comprised 7 of 10 SDS with the lowest growth outturns.

SDS' growth performance has been particularly compromised by their proneness to exogenous shocks, particularly the impacts of the Global Financial Crisis (GFC) in the early part of the evaluation period and the COVID-19 pandemic at the end of the period as well as periodic natural disasters. A comparison of the experience of SDS, EMDEs, and low-income countries (LICs) found that SDS were hit much harder by both the GFC and, particularly, the pandemic than were these other groups (Figure 2.2). SDS' activity contracted more sharply, and SDS are expected to recover from the COVID-19 shock more slowly than other groups.

NATURAL DISASTERS AND CLIMATE CHANGE

SDS are among the most vulnerable countries to ND&CC. Indeed, the 2020 World Risk Index exposure to disaster risk ranks 9 SDS (4 Pacific; 3 Caribbean; 1 Africa; and 1 Middle East) among the top 15 countries most at risk in the world. Given their location, SDS are heavily impacted by natural disasters, particularly meteorological events such as tropical storms and hurricanes, especially in the Caribbean and Pacific regions. These events have increased in frequency since the 1980s. Specifically during 2010–2020, 124 natural disaster events were recorded in SDS, representing 3.3 percent of all natural disasters during this period.

FIGURE 2.2. EFFECT OF GLOBAL SHOCKS ON REAL GDP PATHS BY COUNTRY GROUPS



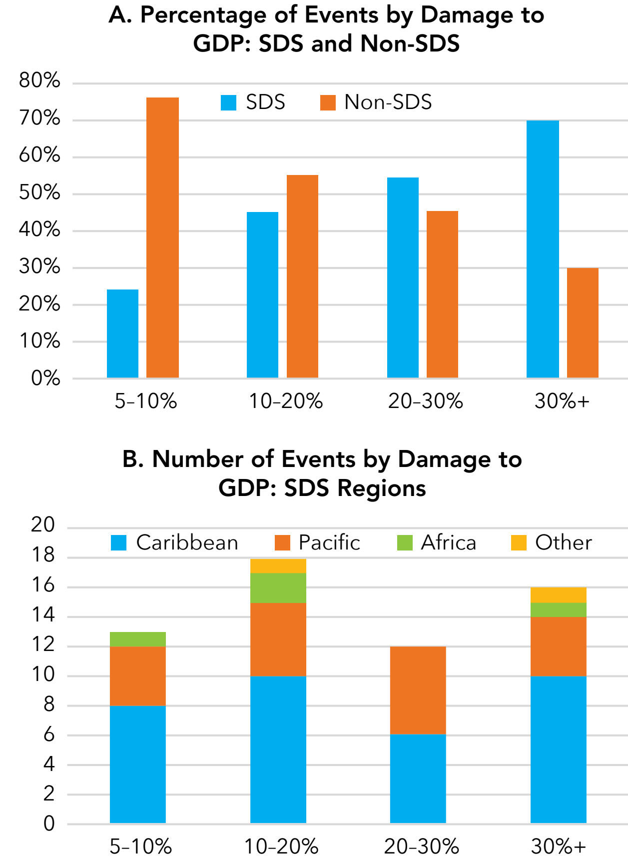
Sources: IMF WEO database; IEO calculations.

Given their small size, which precludes diversification to protect against location-specific shocks, SDS suffer much greater economic and human consequences from natural disasters, and experience them more frequently, than other economies (Lombardi and Rustomjee, 2022). Thus, such disasters have had severe macro-critical effects, including immediate economic disruption from disasters, sizeable contractions in output and exports, disaster-related expenditures for social needs and rebuilding, abrupt declines in fiscal revenues, and increased imports. At the same time, increased vulnerability translates into a need for ample policy buffers to provide resilience against disaster risks, including adequate official reserves, low debt levels, strong fiscal and external positions, effective insurance mechanisms, and reliable access to external financing.

In terms of GDP impact, SDS have been much more affected than non-SDS by almost all types of natural disasters.[6] Over 1960–2020, SDS experienced a higher share of the most severe natural disasters that occurred—55 percent of natural disasters with damages of 20–30 percent of GDP and 70 percent of natural disasters with damages of 30 percent of GDP or more (Figure 2.3, Panel A). Overall, most natural disasters occurred in Caribbean and Pacific SDS, including all natural disasters with damages of 20–30 percent of GDP and 14 of 16 events with damages of 30 percent of GDP or more (Figure 2.3, Panel B). In 2017, the Executive Board established a Large Natural Disaster (LND) window under the IMF's Rapid Financing Instrument (RFI) and the Rapid Credit Facility (RCF) with a 20 percent of GDP damage threshold to qualify for emergency financing under the window. Measured by this metric, SDS have experienced 28 natural disaster events of this scale since 1960, including 5 events during the evaluation period.[7] Based on incidence of large natural disasters since 2000, on average a large natural disaster could be expected to occur about once every two years among SDS members and about once every four years for non-SDS members.

SDS economies tend to be more vulnerable not just to natural disasters but also to climate change. One-third of SDS are highly vulnerable to climate change, which exacerbates the impact and frequency of natural disasters, particularly in the low-lying island states in the Pacific, as changing weather patterns have increased and rising sea levels heightened flooding risks (IMF, 2016a; World Bank and United Nations, 2010; Nurse and others, 2014). As a result, the harmful effects of natural disasters, as well as their relative frequency, have risen compared to the previous decade. Moreover, smallness is associated with high building costs per capita, particularly in infrastructural outlays, thus reducing the ability to adapt to climate change through infrastructure upgrades and redesign (Nurse and others, 2014).

FIGURE 2.3. NATURAL DISASTER EVENTS BY DAMAGE TO GDP, 1960–2020



Sources: International Disaster Database (EM-DAT); IEO calculations.

[6] When large natural disasters have hit, they have also typically affected a larger share of the country's population than in non-SDS, due to their populations being concentrated in a smaller terrestrial area. Since 2000, 6 of the world's 10 largest disasters, ranked by population affected as a percentage of total population, have occurred in SDS, including 3 Pacific, 2 Caribbean, and 1 African SDS. In 4 of these cases, 90 percent or more of the population were affected.

[7] After the evaluation period, St. Vincent and the Grenadines made the first request ever under the LND window of the RCF after a volcanic eruption on July 1, 2021.

FISCAL POLICY ISSUES

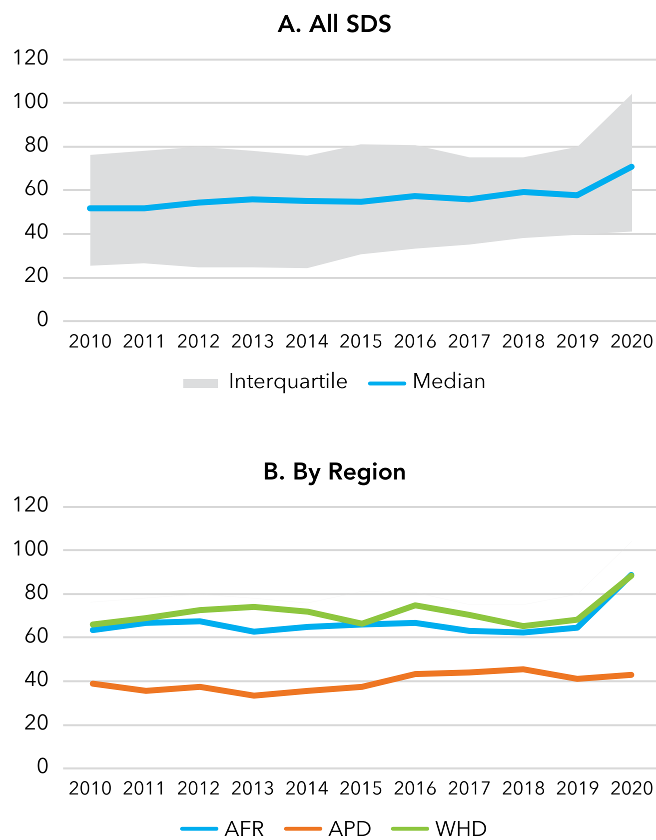
Lack of diversification and the concentration of small economically active populations specializing in a limited number of income-generating sectors have several important fiscal policy consequences for SDS (Heller, 2022). First, the economies of SDS are highly tied to the fortunes of their key sector, and thus potentially subject to significant volatility. Shifts in the commodity prices of key exports or in the global demand for tourism can have an outsized impact on real incomes and similarly outsized effects on fiscal revenue, given heavy reliance on taxes on the incomes derived from the key sector or on customs duties. Shifts in prices of major imported goods (such as oil) can quickly inflate government subsidies on consumption goods. And shifts in employment in the key sector may necessitate active government efforts to assist displaced workers. Almost all small states are also characterized by narrow tax bases and significant inequality in income and wealth, challenging efforts to raise sufficient tax revenues and often forcing reliance on external assistance (grants and concessional loans) or foreign investors. Moreover, ND&CC are likely to have a much more substantial effect on the fiscal position of an SDS than on a larger, more diversified economy and can throw the public finances of an SDS substantially off course from a previously satisfactory fiscal trajectory.

In addition, the costs of providing core public services are higher in SDS than larger states, particularly when the population is scattered over several islands or a considerable land or sea area. At the same time, the human capital of most SDS governments, including those engaged in managing the fiscal sector—formulating macro fiscal policy, collecting adequate tax and customs revenue, managing both the budget and a government's assets and liabilities, assembling fiscal statistics, appraising and managing investment projects, regulating and supervising state-owned enterprises (SOEs), and responding to fiscal and welfare shocks from natural disasters—are stretched thin. Their attention is largely focused on dealing with immediately pressing issues. Efforts to upgrade administrative capacity are hindered by emigration of many well-educated and trained employees. Systems for revenue and customs administration are often inefficient and not up to date.

SDS fiscal policy challenges have contributed to and been exacerbated by high and rising public debt ratios. The increases often reflected the costs of addressing damage due to natural disasters as well as fiscal slippages and were boosted further by the impact of the COVID-19 pandemic in 2020. Overall, average public debt to GDP ratios rose from 57 percent in 2010, at the start of the evaluation period, to 73 percent by the end of 2020 (Figure 2.4). By 2020, based on IMF Debt Sustainability Assessments (DSAs), 65 percent of SDS were assessed to be at high risk of or in debt distress, including virtually all the Caribbean SDS and several African and Pacific SDS (Annex 1).

Additional long-standing legacy issues complicating fiscal management include a lack of maintenance of vital infrastructure, the unsustainable financial position of public pension schemes, and, for some microstates (particularly in the Pacific), efforts to manage a looming "fiscal cliff" in 2024 when important grant transfers are scheduled to end.

FIGURE 2.4. PUBLIC DEBT, 2010–2020
(In percent of GDP)



Sources: IMF, WEO (October 2021); IEO calculations.

FINANCIAL SECTOR ISSUES

Financial systems in SDS are typically shallow, characterized by relatively low intermediation with large operating margins, limited competition, and limited lending opportunities (IMF, 2017a; and Marston, 2022). Relative to low- and middle-income countries, SDS in the Caribbean have higher lending spreads, Pacific SDS have larger liquidity and capital buffers, and all but Montenegro have substantially lower credit/gross domestic product (GDP) and loan/deposit ratios. Relatively low intermediation reduces the capacity of households and corporates to manage the shocks to which they are often exposed, amplifying the need for public intervention to deal with balance sheet strains, often with adverse debt implications. A resulting challenge has been fostering financial depth and inclusion while safeguarding institutional and systemic solvency.

Financial systems in SDS often operate in volatile macro-financial environments. Limited private sector lending opportunities and the typical preferential treatment of sovereign public debt in regulatory frameworks for capital and liquidity have implied disproportionate lending to the public sector.[8] Given their inherent openness and intersection with the global environment through trade financing, remittance flows, and the prevalence of foreign intermediaries, financial systems in SDS are also predisposed to "inward" regulatory and operational spillovers.[9] Moreover, several SDS operate offshore financial centers and face particular challenges in complying with international standards, including in anti–money laundering and combating the financing of terrorism (AML/CFT) and tax transparency issues.

Small size also constrains the development of hedging instruments and markets including capital, equity, and bond markets. Risk diversification is challenging and difficult to achieve in economies with few potential borrowers, high openness, and little geographical or economic diversification. The challenges to ensuring adequate financial intermediation, including for cross-border flows, have been further amplified by changes to the regulatory environment, including to tighten requirements to guard against money laundering and terrorist financing that have threatened to sharply curtail correspondent banking relationships (CBRs).

Finally, access to financial services and efforts to strengthen financial inclusion are important priorities for SDS. Greater access provides a key channel to foster inclusive growth and serves as a shock absorber to mitigate the negative effects of real external shocks on macroeconomic volatility, while greater financial inclusion can reduce poverty and promote financial stability.

IMPACT OF THE COVID-19 PANDEMIC ON SDS

The incidence of COVID-19 in terms of cases and deaths in SDS was comparable to that in other middle-income countries (MICs)—lower than in AEs during the first year of the pandemic but accelerating during 2021 (Maret, 2022). Of the global cumulative COVID-19 cases and deaths, 0.2 percent were recorded in SDS through end-July 2021, most concentrated in a few countries. Contagion varied widely across SDS regions. Asia-Pacific SDS were much less affected than those in other regions, particularly in 2020, most likely because of their greater remoteness and early lockdown and containment measures. Higher aggregate infection rates since end-2020 reflected mainly the pandemic outbreaks in Maldives and Fiji, while other Asia-Pacific SDS continued to avoid such outbreaks. The pandemic was more widespread in Caribbean SDS but there were also large outbreaks in Cabo Verde, Eswatini, Montenegro, and Seychelles. Overall, more than 96 percent of all SDS cases were reported by 10 of the 34 SDS at end-2020.

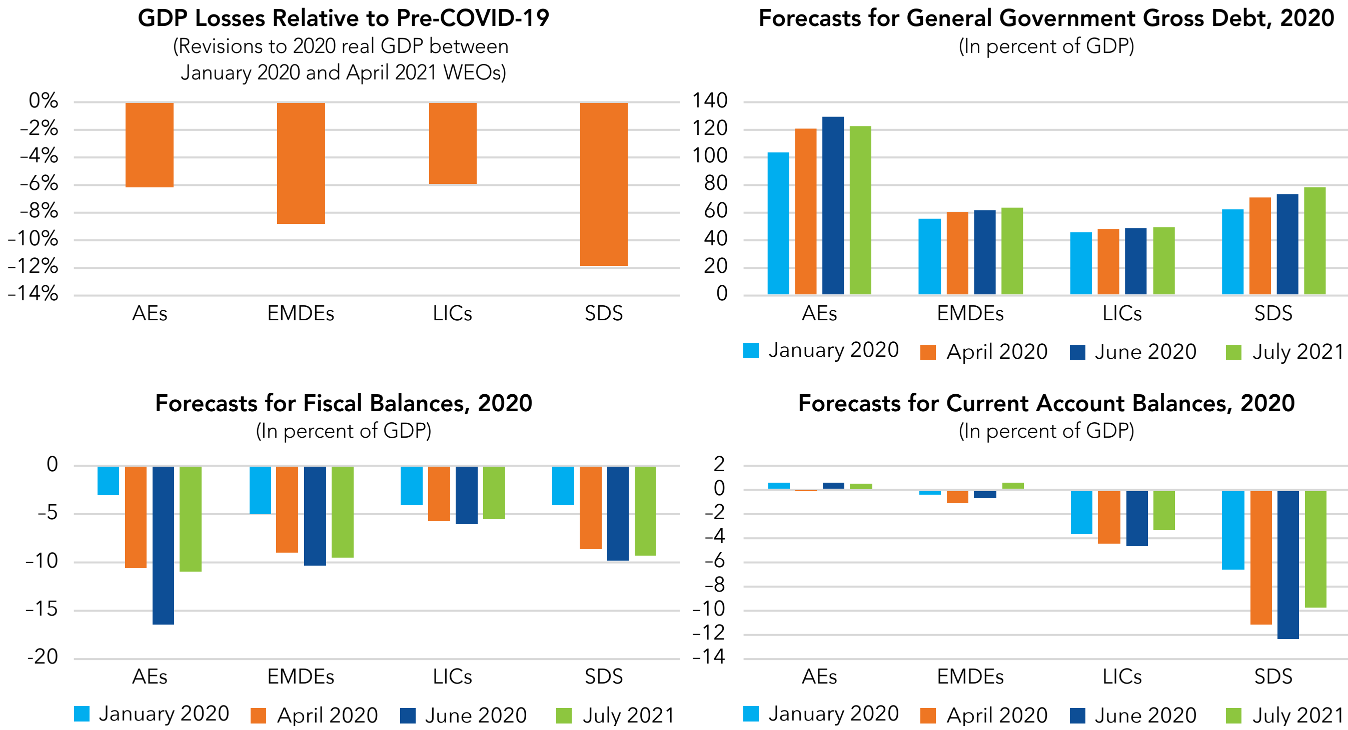
The economic impact of the pandemic on SDS was worse than on other country groups in 2020, the final year of the evaluation period, reflecting disruptions of trade, travel, tourism, capital flows, financing, and remittances. Compared to pre-shock baselines,[10] SDS were the most affected group (Figure 2.5). Their real GDP contracted by around 12 percent, significantly more than that of other

[8] This exposure to the state inevitably links financial sector soundness closely to fiscal sustainability. Financial system vulnerability poses risks, in turn, for budgets (through potential bailout costs).

[9] Between 25 percent (Belize) and 100 percent (Barbados and some Pacific islands) of branches or subsidiaries in the SDS are foreign.

[10] Baselines are proxied by staff projections from the January 2020 *World Economic Outlook Update*.

FIGURE 2.5. COVID-19 IMPACT ON SDS



Sources: IMF, WEO database; IEO calculations.

EMDEs, their debt increased by 17 percent of GDP, their fiscal deficits went up by 5.3 percent of GDP, and their current account balance fell by 5.6 percent of GDP. The impact of the pandemic was greatest in the Caribbean SDS, with severe declines in GDP—in excess of 14 percent—in several countries, including Antigua and Barbuda, The Bahamas, St. Kitts and Nevis, and St. Lucia. Moreover, in some Pacific SDS, the effects of COVID-19 were compounded by other disasters, including in Samoa, which suffered from a severe measles outbreak in late 2019; and in Fiji, Solomon Islands, and Vanuatu, affected by Cyclone Harold in April 2020.

SDS economies began to recover in 2021, but the turnaround was less pronounced than in other regions, and prospects are for slower returns to pre-pandemic growth trends (see Figure 2.2). While recognizing the high uncertainty regarding the longer-term economic impact of COVID-19 and the extent of scarring and transformational changes, half of Caribbean SDS are expected to take at least four years to recover to pre-pandemic income levels, while half of all Asia and Pacific SDS will take three or more years to do so.[11]

[11] Vaccination rates are especially important for SDS given the relative weight of the tourism sector; on average 40 percent of the SDS population was partially or fully vaccinated by October 2021, compared with 45 percent and 70 percent in emerging markets and AEs, respectively.