3

INSTITUTIONAL FRAMEWORK FOR FUND ENGAGEMENT IN SDS

OVERALL FRAMEWORK[12]

Legal Mandate and Governance

IMF membership is available to any state that meets the eligibility criteria, irrespective of its size. As IMF members, SDS receive policy advice through regular IMF surveillance, have access to support from the Fund's full range of lending facilities and nonfinancial instruments, and benefit from the Fund's provision of capacity development. In line with the principle of uniformity of treatment, small state members should be treated similarly to other members in similar situations. There is no specific mention of SDS in the Articles of Agreement, in the conditionality guidelines,[13] or in the integrated surveillance decision (IMF, 2012b).[14]

The IMF's SDS classification is intended to define an operational group of member countries with particular needs, providing for targeted analysis to determine how the Fund can best meet those needs. The 34 members classified as SDS represent 0.13 percent of global GDP and 0.2 percent of global trade and global population. In the IMF, they currently account for 18 percent of the IMF's membership in number and close to 9 percent of IMF spending on country work, but they make up a much smaller fraction of the Fund based on quota share and voting power (Table 3.1).

TABLE 3.1. SDS FOOTPRINT, 2020
(In percent of global aggregate)

GDP	POPULATION	TRADE	IMF MEMBERSHIP	IMF QUOTA	IMF VOTING POWER	IMF SPENDING ON COUNTRY WORK
0.13	0.20	0.20	18.0	0.39	1.31	8.9

Sources: IMF; IEO calculations.

While SDS' aggregate quota share is only 0.39 percent, there are mechanisms in place to strengthen their representation within the IMF built into the Fund's governance system. The inclusion of basic votes, distributed equally among IMF members in addition to the quota-based votes, raises SDS' aggregate voting power to 1.31 percent. Moreover, the constituency-based governance framework of the IMF provides the SDS with greater scope for influencing decision-making at the Executive Board, where decisions are normally made by

[12] This section draws on Abrams (2022).

[13] https://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm.

[14] Note that for purposes of eligibility for the Poverty Reduction and Growth Trust (PRGT) and support from the Catastrophe Containment and Relief Trust (CCRT), there is a Board-approved definition of "small states," based on a population threshold (i.e., below 1.5 million).

consensus rather than by vote. SDS members are represented in 9 of the 24 constituencies, although most are concentrated in 4 constituencies. Constituencies with SDS members currently account for 28 percent of IMF quota and 30 percent of voting power. Both IMF staff and Offices of Executive Directors interviewees agreed that these constituencies actively brought attention to SDS concerns at the Board during the evaluation period. To strengthen the SDS voice further, in early 2012, a group of Directors representing SDS in the Caribbean, Pacific, and Sub-Saharan Africa established a working group on SDS. Overall, in interviews, SDS officials expressed satisfaction regarding their countries' representation at the IMF.

Certain small states qualify for the "small country exception," which enables access to IMF concessional lending by elevating the eligibility threshold for the Poverty Reduction and Growth Trust (PRGT).[15] At present, 19 SDS are eligible for concessional lending. The exception was originally approved in 2010 for countries with population below one million, as part of the criteria for eligibility for the newly established PRGT. The Board's intention with the exception was "to ensure uniformity of treatment for all members with similar vulnerabilities." Staff justified the exception noting that "[s]mall countries—including but not limited to small islands—are more vulnerable to shocks than large countries given their less diversified economies and exceptionally high degree of openness […] They also have smaller economies of scale, particularly in providing public services. To take into account the higher vulnerabilities facing small countries, the proposed entry and graduation criteria included higher income thresholds" (IMF, 2009). The population threshold was later raised to 1.5 million, and microstates defined as those with populations under 200,000, in 2012, "to extend PRGT eligibility to countries that share the key vulnerabilities of small states (limited diversification, openness, insularity, and susceptibility to natural disasters)" (IMF, 2012a).

Relatedly, while there are no low-income SDS (under the World Bank classification), Debt Sustainability Assessments (DSAs) for the 19 PRGT-eligible members are conducted using the IMF's DSA framework for LICs (LIC-DSA). All remaining SDS are assessed using the framework for market access countries (MAC-DSA). In 2021, the IMF endorsed modifications to the MAC-DSA, now known as the "Sovereign Risk and Debt Sustainability Framework for Market-Access Countries."

Beyond the "small country exception," SDS received no special treatment under the IMF lending framework, although they may benefit particularly from certain facilities where access is related to the size of a shock relative to GDP, given SDS' greater vulnerability to such shocks. This is a key consideration for these members since, as mentioned in the section in this chapter on Natural Disasters and Climate Change, three-quarters of the natural disasters that would qualify as "large natural disasters" under the LND window (i.e., damage greater than 20 percent of GDP) since the window was introduced in 2017, have occurred in SDS. In addition, the Post-Catastrophe Relief window of the Catastrophe Containment and Relief Trust (CCRT) (created in 2010 as the Post-Catastrophe Debt Relief, or PCDR, Trust) provides debt service relief to LICs in the face of extreme natural disasters, including those covered by the small country exception. To qualify, the shock must have directly affected a large portion of the population, normally at least one-third, and destroyed more than a quarter of the country's productive capacity, or caused damage judged to exceed 100 percent of GDP. In 2015, the IMF replaced the PCDR Trust with the CCRT, broadening the range of situations covered to include fast-spreading epidemics, and in 2020, the CCRT was revised further to better cover the circumstances created by pandemics.

In response to the COVID-19 pandemic, the Fund made a series of modifications to its overall framework, including to temporarily increase access to emergency financing, which facilitated a nimble response to SDS needs during the crisis (Maret, 2022).

Recently, the Fund has explored alternative options for enhancing financial support for SDS and other vulnerable members facing large financing needs to build resilience. Proposals to establish a multi-donor Trust Fund specifically for SDS did not receive sufficient support from the donor community. In the summer of 2021, the Managing

[15] Per the small country exception, countries are considered PRGT-eligible if (i) the sovereign does not have the capacity to access international financial markets on a durable and substantial basis; and (ii) per capita gross national income is less than twice the International Development Association (IDA) operational threshold for small states or less than five times the IDA operational threshold for microstates (IMF, 2013b).

Director announced that the IMF was exploring the creation of a Resilience and Sustainability Trust (RST) that would channel resources on a voluntary basis from the anticipated $650 billion SDR allocation. The purpose of the Trust would be to provide affordable long-term financing to support countries as they tackle structural challenges such as climate change, benefiting especially low-income and vulnerable MICs, including all SDS.[16] The trust would offer financing with longer maturities than traditional IMF financing and a favorable interest rate structure. To qualify for RST support, an eligible member would need a package of high-quality policy measures consistent with the RST's purpose and a concurrent financing or non-financing IMF-supported program (which could include a non-financing instrument, such as a Policy Support Instrument (PSI) or Policy Coordination Instrument (PCI), or a precautionary instrument, such as a Flexible Credit Line or Precautionary Liquidity Line) with Upper Credit Tranche (UCT)-quality policies. Design features of the RST were discussed with the Executive Board in January 2022, with the aim of securing approval of the Trust by the IMF–World Bank Spring Meetings in April 2022 and making it operational by the Annual Meetings in October 2022.

IMF Approach and Guidance to Staff on Engagement with Small States

During the evaluation period, increasing attention was paid to how to enhance IMF work on SDS, given rising recognition of the special needs of these countries, building on outside and Fund research.

In 2013, the Executive Board discussed a staff paper (IMF, 2013b) that presented proposals to strengthen the Fund's engagement with SDS. Directors concurred that the Fund's policy advice to these members and the ability to help strengthen the design and traction of economic adjustment programs should be informed by a strong analytical agenda and an active dialogue with authorities. In the paper, staff recommended tailoring the Fund's analytical tools to the needs of small states. The report highlighted a number of important priorities for IMF engagement with small states, including fostering improved growth; promoting debt sustainability; further developing financial systems; assessing the effectiveness of exchange rate policies; and helping small states manage volatility associated with natural disasters and other shocks. The paper also proposed that the Fund could sometimes play a coordinating role with other institutions, including through its resident representative offices; encouraged closer collaboration with other international institutions and development partners in meeting the needs of SDS; and stressed the importance of technical assistance and training in helping them build capacity.

Following the 2013 Board discussion, an initial Staff Guidance Note (SGN) on the Fund's Engagement with SDS was issued in 2014 (2014 SGN) (IMF, 2014). The note discussed the distinctive characteristics of small states and provided operational guidance to staff on how small country size should influence the Fund's surveillance and analytical work, IMF-supported programs, capacity development, and coordination with external development partners. The guidance note set out a new framework for IMF engagement, known by the acronym GROWTh, in which five key thematic areas were identified as likely to be especially important to the Fund's engagement with SDS (Box 3.1). The guidance note also mentioned that in applying the guidance, staff should continue to tailor their engagement to specific country circumstances. While the SGN did not provide distinctive guidance for various types of small states, it recognized the heterogeneous features among small states and referred to the SGN on fragile and conflict-affected states (FCS). The SGN also acknowledged that, in practice, many countries with populations larger than 1.5 million share small state characteristics, and that the guidance could also be relevant for such countries.

In 2016, the Board discussed a staff paper on Small States' Resilience to Natural Disasters and Climate Change and the Role of the Fund (IMF, 2016a). Directors agreed that the Fund had a role to play in helping these countries build resilience to natural disaster risks, while remaining within its mandate and in close cooperation with other international organizations. They saw merit in the Fund assessing macroeconomic policies in support of small state climate change mitigation and adaptation strategies on a pilot basis. Noting that SDS were less frequent users of

[16] The Fund has explored ways to develop an index that would better capture aspects of vulnerability that could provide the basis for access to Fund resources. However, a satisfactory formula was not found.

BOX 3.1. MAIN ELEMENTS OF THE GROWTh FRAMEWORK

The GROWTh framework, as revised in the 2017 SGN, focuses on five main policy issues for IMF surveillance and program work:

- *Growth and job creation.* Policies to strengthen growth and job creation are a priority. Staff teams should discuss growth issues for specific sectors and consult appropriately with other development partners. On job creation, the guidance note emphasizes that specific labor market institutions of SDS merit attention and that staff should investigate how public employment and public wages affect the labor markets.
- *Resilience to shocks.* Staff's macroeconomic analysis should give prominence to potential shocks, considering the appropriate balance between self-insurance, external insurance, and private sector involvement in risk reduction.
- *Overall competitiveness.* Structural inefficiencies such as high energy and transportation costs, limited private sector development, and labor market rigidities are key challenges to raising growth and improving competitiveness. Policy advice could cover structural reforms and facilitating domestic wage and price cuts, and consider the value of regional trade and cooperation for SDS.
- *Workable fiscal and debt sustainability options.* Staff will need to find the appropriate balance of fiscal consolidation while promoting growth, particularly in heavily indebted countries.
- *Thin financial sectors.* Priorities highlighted include deeper financial sectors, more competition, better service delivery, and strengthened oversight. The framework also notes that SDS have recently been challenged by unintended consequences through the disruption of correspondent banking relationships.

Source: IMF (2017a).

Fund arrangements than larger peers, Directors supported increasing the annual limit to the RCF and RFI in the case of large natural disasters, and many Directors supported the expansion of eligibility for the CCRT to members covered under the IMF small country exception. Directors also emphasized the role of Fund capacity building in helping small states build resilience to natural disasters and adapt to the challenges from climate change, underscoring the importance of leveraging regional technical assistance centers and further tailoring capacity building to the absorptive capacity and policy priorities of small states (IMF, 2016b).

In 2017, a revised SGN on the Fund's Engagement with Small Developing States (2017 SGN) was issued (IMF, 2017a), drawing on the 2016 Board paper on ND&CC as well as on a 2015 Informal Session on Macroeconomic Developments in Small States and a 2017 Board paper on enhancing the financial safety net in response to large natural disasters (IMF, 2017c). The revised version highlighted the need for integrating risks emanating from natural disasters in Fund analysis and drew attention to the different tools and practices already developed in the IMF, including the joint IMF–World Bank Climate Change Policy Assessments (CCPAs), incorporation of adverse shocks from disasters in DSAs, consideration of the transmission of shocks through macro-financial linkages, and the need for buffers to cope with this type of vulnerability. The 2017 SGN also provides a series of operational guidelines for surveillance and analytical work—including interdepartmental approaches and the provision to authorities of accessible tools—and recognizes that support for small states will need to involve other international institutions.

In September 2020, staff made an informal presentation to the Board on SDS prospects and Fund engagement beyond the pandemic, which discussed the COVID-19 pandemic's impact on SDS and discussed implications for Fund engagement. The presentation recognized that SDS had been severely hit by the pandemic and that economic recovery could be slow. It emphasized the need for IMF engagement beyond the pandemic to focus on: rebuilding buffers, enhancing resilience against ND&CC, increasing the focus on growth and competitiveness and reorienting capacity development work on emerging needs. It concluded that innovative solutions and close coordination with partners were needed to counter exceptionally large shocks, rebuild fiscal space, and build resilient infrastructure. Subsequently, staff circulated a note to the Board that explored options for enhancing Fund financial support to SDS through a dedicated Trust Fund, but, as already noted, this proposal did not gain sufficient support.

ORGANIZATIONAL BACKGROUND

During the evaluation period, overall management responsibility for IMF work on small states was assigned to a Deputy Managing Director (DMD), although responsibility for individual SDS and other small state member countries continued to be split among DMDs. A senior Strategy, Policy and Review Department (SPR) staff member led the work on the small states guidance note and during most of the evaluation period coordinated work on IMF policies on engagement with SDS working in close collaboration with area departments (ADs).

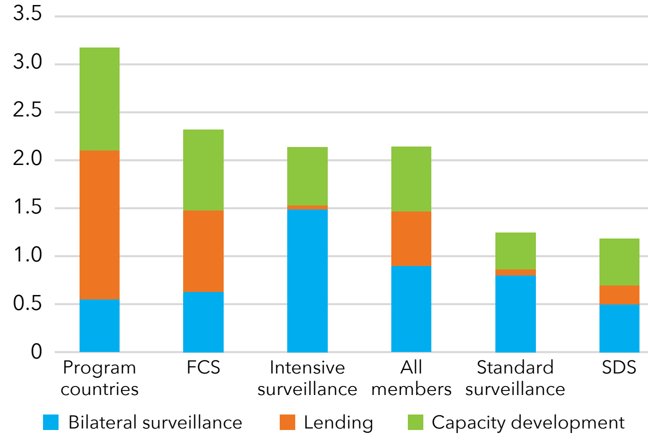
High-level agreements and initiatives between the IMF and other international organizations on SDS matters were limited during the evaluation period. The IMF maintained an Office of the IMF Special Representative to the United Nations throughout the evaluation period that was attached to SPR and was engaged in the 2014 SAMOA Pathway Conference. The IMF also participated in meetings of the World Bank Small States Forum during the evaluation period.

Direct engagement with small states has been handled through respective area (i.e., regional) and functional departments, each of which has taken different approaches to this work. In the Asia and Pacific Department (APD), at the beginning of the evaluation period, there was a Pacific Island Unit, a coordinating unit which functioned without dedicated resources. In 2014, this unit was transformed into the SDS Unit and dedicated resources were allocated. In 2016, the unit was elevated to the SDS Division and in 2019, it became the Pacific Islands Division, which is the largest division in APD in terms of number of staff. In the Western Hemisphere Department (WHD), at the beginning of the period SDS work was handled in two divisions, while by the end of the period it was spread across three divisions. In the African Department (AFR), SDS work was spread across a number of divisions. In many cases, AD staff also worked with regional development bank staff on SDS matters.

In 2011–2012, staff initiated an informal interdepartmental working group. The working group, which included staff from APD, WHD, and subsequently AFR and SPR, began to hold monthly meetings to share knowledge and produce and discuss analytical outputs on SDS. The working group engaged with the DMD responsible for SDS to brief on SDS developments and issues and garner support from management for SDS-related initiatives. It made ad hoc presentations to the Executive Directors' Small States Working Group, which was formed around that time, and also coordinated high-level events such as the Caribbean Breakfast at the IMF Spring and Annual Meetings. Later in the evaluation period, the working group developed a one-stop Knowledge Exchange intranet site on SDS matters, which is regularly updated. According to staff in IEO interviews, meetings of the interdepartmental working group waned in the latter part of the evaluation period, but it has become more active since the onset of the COVID-19 pandemic, seeking ways to help SDS address the economic costs of the pandemic.

The Fund devotes considerable resources to SDS work. In FY2020, total IMF spending on SDS amounted to $40.2 million, or slightly over 10 percent of the IMF's operational budget for country work. Spending per SDS averaged $1.2 million, compared to an average spending across the whole membership of $2.1 million and an average spending of $2.4 million per FCS, but only somewhat less than spending on a standard surveillance case ($1.3 million) (Figure 3.1). The share of spending on capacity development, as opposed to surveillance or lending, is significantly higher in SDS than average across the membership.

FIGURE 3.1. IMF AVERAGE SPENDING BY COUNTRY TYPE, FY2020
(In millions of USD)



Sources: IMF; IEO calculations.