

## CHAPTER 4

# SMALL STATES

Overlapping Crises,  
Multiple Challenges



*Small states' economies were hit particularly hard by COVID-19, largely due to prolonged disruptions to global tourism. Now facing spillovers from the Russian Federation's invasion of Ukraine and the global monetary tightening cycle, small states are expected to have weak recoveries with large and possibly permanent losses to the level of output. Small states are diverse in their economic features, but they share attributes that make them especially vulnerable to shocks, including dependence on imports of essential goods, highly concentrated economies, elevated levels of debt, reliance on external financing, and susceptibility to natural disasters and climate change. Policy makers in small states can improve long-term growth prospects by building fiscal space, fostering effective economic diversification, and improving resilience to climate change. There is a need for intensified international cooperation to support small states in addressing their challenges. The global community can assist small states in these efforts by maintaining the flow of official assistance, helping restore and preserve debt sustainability, facilitating trade, and supporting climate change adaptation.*

## Introduction

Small states—countries with a population of 1.5 million or less—were hit particularly hard by the COVID-19 pandemic (World Bank 2022a). They suffered a far more severe recession and a much weaker initial rebound than other emerging market and developing economies (EMDEs; figure 4.1.A). Their recoveries are being slowed by spillovers from the Russian Federation's invasion of Ukraine and synchronized global monetary policy tightening. Most small states are not expected to regain their pre-pandemic level of per capita output until after 2023 (figure 4.1.B).

Against this backdrop, this chapter addresses the following questions:

- What are the key economic features of small states?
- How have overlapping global crises—the COVID-19 pandemic, Russia's invasion of Ukraine, and sharp monetary tightening to offset global inflation—affected small states?
- What are the near-term economic prospects for small states?
- What policy measures can boost growth and improve resilience in small states?

**Contributions.** This chapter presents a comprehensive analysis of recent economic developments in, and growth prospects for, small

states as a group. First, it discusses how current global economic conditions, such as rising financing costs and weak tourism, affect small states. Second, it examines how the typical features of small states amplified the effects of the global recession triggered by the pandemic, and of Russia's invasion of Ukraine, and may now hold back the recovery. Third, the chapter presents a broad set of policy priorities that can help small states build resilience to future shocks and improve long-term growth prospects. In combining analysis of structural features of small states with a discussion of short-term growth prospects and deriving policy priorities for the whole group of small states, this chapter goes beyond the existing literature that focused on narrower topics.<sup>1</sup>

**Main findings.** The chapter reviews the key features of small states and how recent global crises have impacted these countries. It presents the growth outlook for small states, examines the risks to the outlook, and discusses how policy actions can support growth and improve resilience.

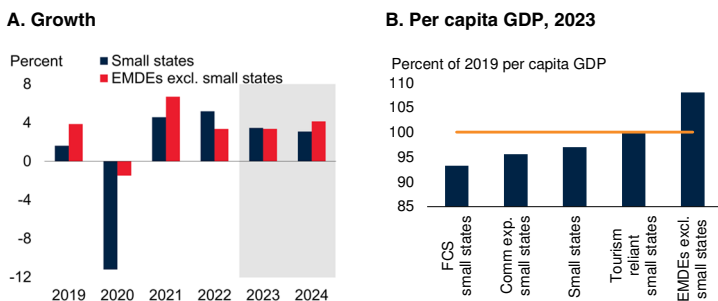
- *Key features.* Small states are a heterogeneous group, but tend to have high levels of economic concentration, and many are challenged by remoteness and lack of connectivity. They have very high levels of

<sup>1</sup>Some recent studies provide economic updates for regional groupings of small states, such as those in the Pacific or the Caribbean (IMF 2022; World Bank 2022b). Other studies examine small states through the lens of their recovery from the pandemic (FAO 2020; OECD 2021) or program effectiveness (Rustomjee et al. 2022), or through a description of characteristics of small states with little reference to recent developments (Briguglio 2022; Piemonte 2021). Other recent work has examined exchange rate regimes in small states and the risks of currency and banking crises (Al-Sadiq, Bejar, and Ötker 2021; Pizzinelli, Khan, and Ishi 2021).

*Note:* This chapter was prepared by Philip Kenworthy, Patrick Kirby, and Dana Vorisek.

### FIGURE 4.1 Growth and income in small states

Small states entered the pandemic with already weak growth prospects, and have been hit particularly hard by the economic effects of the pandemic and the war in Ukraine. They suffered far deeper recessions in 2020 than other EMDEs and the recovery has been slower than in other EMDEs.



Source: World Bank.

Note: EMDEs = emerging market and developing economies; FCS = fragile and conflict-affected states. Country groups are GDP weighted at average 2010-19 prices and market exchange rates.

A. Grey area indicates forecast. Sample includes 34 EMDE small states and 115 EMDEs excluding small states. Guyana is excluded.

B. Descriptions of small state subgroups are in table 4.1. Horizontal line indicates 100. Sample includes 34 small states (of which 11 are commodity-exporters, 6 are FCS, and 22 are tourism-reliant) and 115 EMDEs excluding small states. Guyana is excluded.

trade openness, importing large proportions of their food and fuel, and are three times more reliant on shipping than the world average. Their exports are concentrated in tourism and the production of primary commodities (but in most cases not energy, metals, meat, or grain). As a group, small states tend to run fiscal deficits and depend on a mixture of aid and foreign direct investment to finance large current account deficits. On average, small states have higher public debt levels than other EMDEs. Nearly all small states have fixed exchange rates.

- *Overlapping crises.* The 2020 global recession was especially severe for small states, primarily due to their reliance on tourism. Output contracted by more than 11 percent in small states, seven times as much as in other EMDEs. The recession was even deeper in the three-fifths of small states classified as tourism reliant, which contracted by nearly 13 percent. Recoveries remained weak in 2021 and at least part of 2022, amid new COVID-19 variants and ongoing travel restrictions. In parallel, soaring global prices and supply chain disruptions brought into focus the risks of

depending on imported essentials. From 2 percent in January 2020, inflation in the median small state increased to 7.5 percent in September 2022, even as domestic demand remained weak. With small state debt levels well above the EMDE average, global monetary policy tightening raises debt servicing costs and threatens to further slow small state recoveries.

- *Risks and structural barriers to growth.* The outlook is subject to a range of risks. Food, energy, and shipping prices could surge again, dealing a further blow to real incomes in small states. New COVID-19 variants and virus waves remain a serious risk, particularly given many small states' dependence on tourism. Most small states entered the global tightening cycle with adequate reserve buffers, but an external financing shock could nonetheless prompt financial stress, particularly in small states with highly indebted private sectors. In the long term, small states face structural headwinds that weaken their prospects. Damages from climate and natural disasters, equivalent to nearly 5 percent of GDP annually, on average, are increasing. Remoteness, lack of scale, and limited connectivity raise costs and constrain diversification efforts.
- *Policy priorities.* Policy makers in small states, with support from the global community, can take steps to limit pandemic-related losses and reduce vulnerability to future crises. Improved infrastructure could support diversification into higher value-added sectors and reduce disaster-related losses and the effects of climate change. Curbing public debt would increase fiscal space, enhancing capacity to respond to future shocks. Reducing trade costs and strengthening domestic institutions should help raise productivity. The global community can also help small states through capacity building and financial support as well as actions at the international level: fostering open trade and investment networks, augmenting the institutional architecture for dealing with excessive debt, maintaining the flow of official assistance, and supporting climate change mitigation and adaptation at the global level.

## Characteristics of small states

Small states share many characteristics, while also differing in important ways. Many small states are prosperous and have moved up the per capita income spectrum over the past two decades. As of 2022, 24 percent of small states were classified as high income, up from 9 percent in 2000, and no small states are currently classified as low income, compared to 12 percent in 2000.<sup>2</sup> This chapter covers the 37 small states that are also EMDEs, which have per capita incomes ranging from about \$1,100 (Timor-Leste) to more than \$30,000 (Brunei Darussalam) in 2021.

According to the available data, about one-quarter of the population in the median small state lives on an income below the lower-middle-income country poverty threshold of \$3.65 per day, and another quarter has an income below the upper-middle-income country poverty threshold of \$6.85 per day (these shares are similar to those of South Africa and Indonesia).<sup>3</sup> Median poverty at the \$3.65 threshold declined by about 15 percentage points between the 2000s and the 2010s. There is disparity across small states, however. About 70 percent of the population of Eswatini lives on less than \$3.65 per day, compared to close to 0 percent in Mauritius. Bhutan has achieved especially swift poverty reduction, with the lower-middle-income poverty rate declining by more than three-quarters between the 2000s and 2010s.

Regionally, small states are concentrated in East Asia and the Pacific (EAP), Latin America and the Caribbean (LAC), and to a lesser degree Sub-Saharan Africa (SSA), although there are several in the other three EMDE regions (table 4.1). Three-

<sup>2</sup>Based on gross national income per capita using the World Bank Atlas method. The last small state to transition from low income to middle income, the Comoros, did so in 2018.

<sup>3</sup>The collection of poverty data around the world was disrupted during the pandemic, worsening the sparseness of data for small states (World Bank 2022c). Data using international poverty lines does not exist for any country in the Caribbean, for example, and most countries only have one or two observations per decade. The discussion of poverty here reflects available data for 16 small states collected between 2000 and 2019.

quarters of small states are islands, a much larger share than among other EMDEs, and many of the island small states in EAP are dispersed across large areas. Two small states (Bhutan and Eswatini) are landlocked. Three-fifths are commodity importers, compared to one-third of other EMDEs, and most commodity-importing small states are also reliant on tourism. Of the two-fifths of small states classified as commodity exporters, most produce agricultural and marine products such as fish, fruit, sugar, cocoa, and wood, but six are energy exporters, and two are metal exporters (Bhutan and Suriname). Nine small states, mostly in EAP, are among the most reliant on remittances of all EMDEs. Six small states are considered by the World Bank to be experiencing fragile and conflict-affected situations (FCS, all due to institutional and social fragility rather than conflict), all in EAP. This is equivalent to one-sixth of small states, while one out of four other EMDEs are FCS countries.

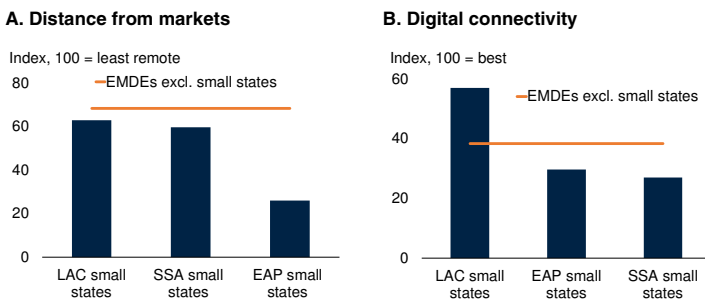
Despite their diversity, several features are common across small states: remoteness, economic concentration, vulnerability to the effects of climate change, openness, large public sectors with limited capacity, indebtedness, and reliance on external financing. These features, together with other country-specific challenges, make small states especially vulnerable to shocks.

**Remoteness and economic concentration.** Remoteness and economic concentration present structural challenges that make it harder for small states to adapt when faced with external shocks. Long distances to potential trading partners, especially when combined with weak transport and digital connectivity, present a barrier to trade and global value chain integration for many small states in EAP and SSA (figures 4.2.A and 4.2.B; Armstrong and Read 2006). Small domestic markets make generating domestic economies of scale and economic diversification challenging. High fixed costs to establish and operate businesses (relative to market size), together with labor market rigidity, can dampen competitiveness and disincentivize diversification.

At the macroeconomic level, small states tend to concentrate output and exports in a limited set of

## FIGURE 4.2 Features of small states

*Remoteness and weak digital connectivity are challenges for small states, particularly those in EAP and SSA.*



Sources: Cantu-Bazaldua 2021; World Bank.

Note: EAP = East Asia and Pacific; LAC = Latin America and the Caribbean; SSA = Sub-Saharan Africa. Bars and line show medians of country groups. Sample includes 13 EAP small states, 12 LAC small states, and 7 SSA small states.

A. The index is a composite measure of distance to nearest neighbor, distance to economic centers, and distance to trading partners.

B. Digital connectivity is a composite measure of Internet access of the population, international bandwidth per Internet user, and latency rate (a measure of network performance).

industries in which they have inherent advantages (for example, primary commodities and tourism). About one-fourth of output is derived from a single economic sector in both tourism-reliant and commodity-exporting small states, and about two-fifths from two sectors (figures 4.3.A and 4.3.B). In some commodity-exporting small states, export product concentration rose between the late 1990s and late 2010s (for example, Cabo Verde, Guyana, the Solomon Islands, and Suriname; figure 4.3.C).

A high degree of economic concentration has contributed to more volatile business cycles in small countries than in larger countries, with deeper cyclical contractions, shorter expansions, and more procyclical exports and inflation (Blanco et al. 2020). Other indicators, such as investment, the current account balance, and government consumption, also tend to be more volatile in small states than in other economies (Hnatkovska and Koehler-Geib 2018). The very large contraction of tourism-reliant economies during the pandemic is the most recent example of the downside of heavy reliance on a particular sector.

**Vulnerability to natural disasters and climate change.** Being mostly islands, many small states are heavily exposed to the effects of rising sea levels, floods, and coastal erosion. Damages from individual disasters can be multiples of GDP,

while the return needed to compensate for the risk of disaster raises the cost of commercial financing. The need to support populations and rebuild after disasters puts pressure on fiscal resources. The mounting costs of long-term climate change adaptation make it difficult for small states to maintain the fiscal buffers needed to respond to periodic disasters.

**Openness.** Small states have very high levels of trade openness and are unusually reliant on trade to obtain essential goods, importing most of their food and fuel (figure 4.3.D; FAO 2020). Shipping intensity of GDP (defined as the ratio of port container traffic to real GDP) in small states is more than three times higher than the world level (figure 4.3.E). Many small states are especially reliant on tourism. Tourism expenditures were equivalent to an average of 18 percent of economic activity in small states prior to the pandemic, and substantially more in several of the 22 tourism-reliant small states (figure 4.3.F). Dependence on tourism does not lend itself to rapid productivity growth, due to the labor-intensive nature of the sector, but it provides a key source of income (Arezki, Cherif, and Piotrowski 2009).

The combination of trade openness, reliance on imported essentials, and economic concentration leaves small states particularly exposed to global developments (Easterly and Kraay 2000). These vulnerabilities are further magnified by the fact that most small states lack two important mechanisms for buffering shocks: floating exchange rates and independent monetary policy. All except two small states (Mauritius and the Seychelles) operate under some form of fixed exchange rate—including conventional pegs, pegs within horizontal bands, crawling pegs, managed arrangements, stabilized arrangements, and currency boards (27 small states, including several that peg to a basket of currencies)—or use the currency of another country (eight small states, most of which use the U.S. dollar or the Australian dollar). The prevalence of fixed exchange rates suggests that reducing exchange rate volatility is more valuable to small states than the loss in monetary policy autonomy, possible because they allow small states to effectively import the credibility of the anchor currency's

institutions, which can help maintain low inflation (Airaudo, Buffie, and Zanna 2016; Imam 2012).

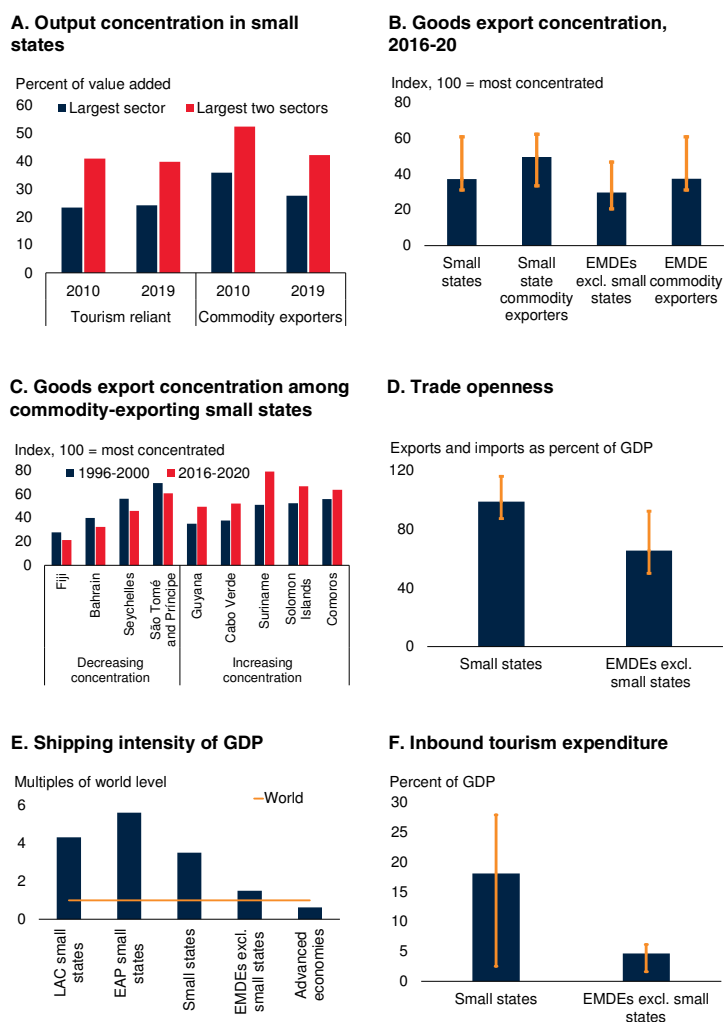
Openness in small states also manifests in the movement of people, with high levels of temporary and permanent emigration. Between 2015 and 2020, the median island small state lost about 1 percent of its population to emigration. The emigration of highly skilled workers has long prompted concerns about the impact of brain drain on small state economies, with evidence that skilled emigration has more adverse impacts on total factor productivity in small states than in other EMDEs (Schiff and Wang 2008). Yet temporary emigration can give individuals the opportunity to boost their education and skills, benefiting home countries if emigrants can be enticed to return, and the promise of skills premia overseas can incentivize the pursuit of more education domestically (Ha, Yi, and Zhang 2016). Remittance inflows provided by emigrants are also a key source of external financing in some countries (Wenner 2016).

**Large governments with limited capacity, persistent deficits, and high debt.** As a share of GDP, governments in small states tend to be larger than in other EMDEs. Both average annual current government spending and tax revenues were about 8 percentage points of GDP higher than in other EMDEs, with public sector wages accounting for a disproportionate share of these funds (figures 4.4.A and 4.4.B). This is partly a reflection that the fixed costs of public administration are high relative to small economies and populations. Frequent natural disasters contribute to periods of reduced revenues and increased expenditures. State-owned enterprises are also prevalent in small states, operating in sectors such as energy generation, transport, and water, and comprise significant shares of GDP in some countries (for example, Cabo Verde, Maldives, Mauritius, the Federated States of Micronesia, the Seychelles, and St. Kitts and Nevis; Heller 2022).

In absolute terms, however, small state governments are often too small to achieve economies of scale and effectively provide many public services, as human resource and institutional constraints

**FIGURE 4.3 Output and trade characteristics of small states**

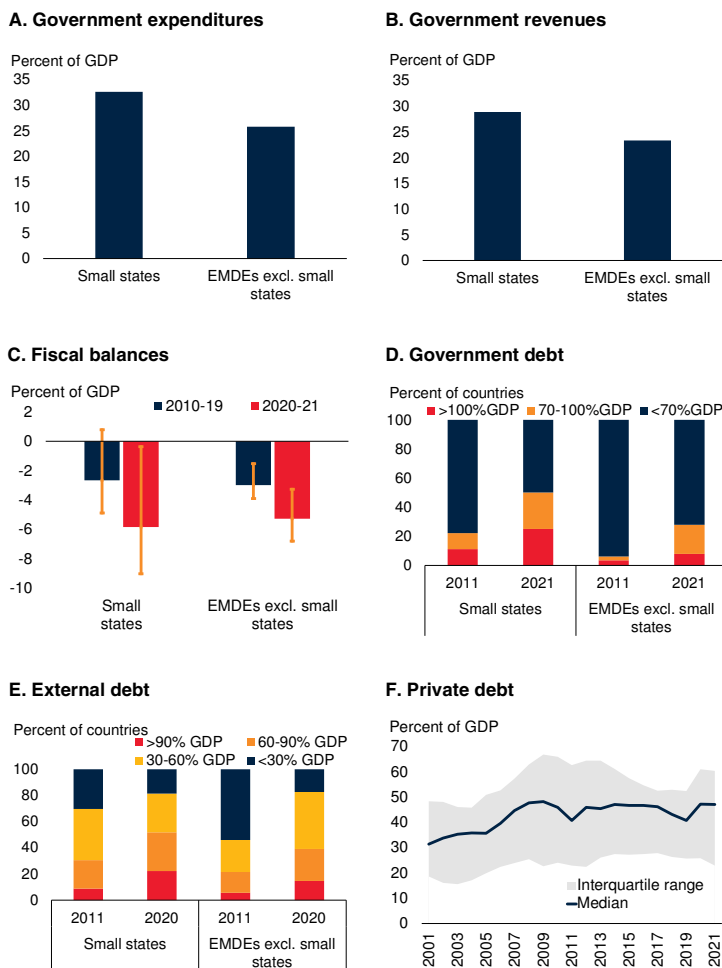
*Output remains highly concentrated in a small number of sectors, although commodity-exporting small states have made some progress at diversification. Small states exhibit higher export concentration than other EMDEs, making them susceptible to shocks to their main industries. Export concentration has increased in some small states. Small states are highly open to trade, and many rely heavily on tourism.*



Sources: national sources; UN Conference on Trade and Development; UN World Tourism Organization; World Development Indicators; World Bank.  
 Note: EMDEs = emerging market and developing economies; EAP = East Asia and Pacific; LAC = Latin America and the Caribbean.  
 A. Bars show averages of country groups. Based on data for 12 sectors. Sample includes 15 tourism-reliant and 10 commodity-exporting small states in 2019 and 9 tourism-reliant and 6 commodity-exporting small states in 2010.  
 B.C. Export concentration is measured as a Herfindahl-Hirschmann index of export product concentration (includes only goods exports).  
 B. Bars show group medians of indicated country groups. Vertical lines show interquartile ranges within groups. Sample includes 37 EMDE small states, 14 commodity-exporting small states, 115 EMDEs excluding small states, and 97 commodity-exporting EMDEs.  
 C. Bars show averages in each country during the indicated years. Commodity-exporting small states where the change in the index between the two-year spans is less than 5 points (Belize, Brunei Darussalam, Equatorial Guinea, and Trinidad and Tobago) are omitted.  
 D. Bars show medians of indicated country groups. Vertical lines show interquartile ranges within groups. Sample includes 25 EMDE small states and 107 EMDEs excluding small states.  
 E. Ratios of port container traffic (20-foot equivalent units) to real 2019 GDP, indexed to world ratio. Data for 2019. Sample includes 36 advanced economies and 155 EMDEs, of which 37 are EMDE small states (12 Pacific Ocean islands and 12 Caribbean small states).  
 F. Bars show averages of indicated country groups. Vertical lines show interquartile ranges within groups. Data for 2019. Sample includes 22 EMDE small states and 81 EMDEs excluding small states.

## FIGURE 4.4 Fiscal positions of small states

Small states tend to have proportionally larger governments than other EMDEs. They typically run fiscal deficits, which have become substantially larger in recent years. Public, private, and external debt levels in small states have increased during the past decade.



Sources: International Monetary Fund; World Bank.

Note: EMDEs = emerging market and developing economies.

A,B. Bars show medians of simple average values for country groups during 2010-19 period. Sample includes 37 EMDE small states, and 110 EMDEs excluding small states for panel A and 115 for B.

C. Bars show medians. Orange whiskers show interquartile range within groups. Sample includes 37 EMDE small states and 116 EMDEs excluding small states.

D. Sample includes 36 EMDE small states and 113 EMDEs excluding small states.

E. Sample includes 27 EMDE small states and 110 EMDEs excluding small states.

F. Sample includes 31 EMDE small states.

may limit their ability to, for example, collect and monitor statistical and supervisory data, or implement reforms (Rustomjee et al. 2022).

In the decade prior to the pandemic, most small states regularly ran fiscal deficits. The average annual fiscal balance was a deficit of 2.1 percent of GDP, compared to an average deficit of 2.8 per-

cent in other EMDEs (figure 4.4.C). Revenue sources in small states differ from those in other EMDEs in important ways, with a much greater reliance on taxes on trade and lower reliance on taxes on capital in small states. Non-tax revenues (for example, aid and royalties) provide important sources of government revenue in many small states, with those in EAP in particular receiving large proportions of GDP in grants. Sovereign rents also account for an important share of small state revenues in some cases, for example, in Kiribati (fishing licensing fees), Tuvalu (domain names) and Nauru (fees for hosting Australia's Regional Processing Centre for refugees).

As in other EMDEs, fiscal positions worsened markedly in small states during the pandemic. Some small states were already in the midst of a prolonged government debt buildup prior to the pandemic, and debt levels jumped further due to a plunge in revenues and a continued rise in expenditures during the pandemic (Kose et al. 2021; World Bank 2019a). Between 2011 and 2021, the share of small states with government debt above 100 percent of GDP rose from one-tenth to one-third (figure 4.4.D). Much of this debt was on concessional terms, such that, in the pre-pandemic decade, the average small state spent about 1 percent of GDP per year servicing debt, compared to 1.5 percent in other EMDEs.

There are notable regional differences in public debt profiles across small states, with LAC and SSA small state governments much more indebted, on average, than those in EAP, some of which receive unusually large proportions of GDP in official development assistance (ODA). In 2021, many small states had public debt above 70 percent of GDP, including about three-quarters of those in LAC, half of those in SSA, and only one (Fiji) in EAP. One of the reasons for the increase in debt has been the costs associated with the increased frequency of natural disasters. Nearly half of small states had external debt of more than 60 percent of GDP as of 2020, compared to 30 percent in 2010 (figure 4.4.E). Most government debt in small states is external, reflecting limited pools of domestic savings.

Private sectors in some small states are also increasingly leveraged. On average, private debt in



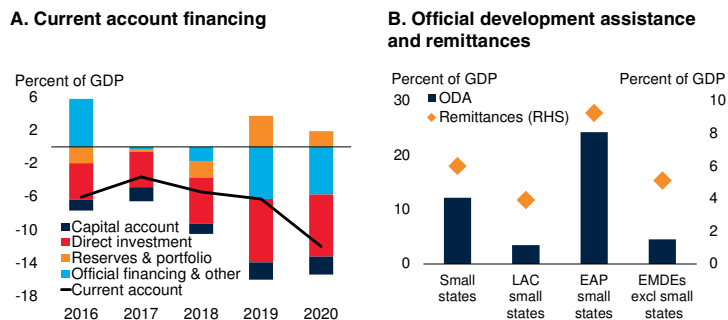
small states was equivalent to 50 percent of GDP as of 2020 (figure 4.4.F), virtually identical to the average in other EMDEs. Private debt stocks rose by more than 10 percentage points of GDP between 2010 and 2020 in some small states (for example, Cabo Verde, Mauritius, and Samoa), and by more than 20 percentage points in others (for example, Bhutan, Fiji, and the Seychelles), increasing these countries' vulnerability to rising financing costs.

**Dependence on external financing.** Most small states run sizeable and persistent current account deficits, which widened considerably during the pandemic. In the pre-pandemic decade, the median current account balance among small states was 5.4 percent of GDP, compared to 3.5 percent of GDP among other EMDEs. Small state current account deficits are mostly financed by a combination of ODA, in the form of capital grants and official lending and, in small states with successful tourism and commodity sectors, foreign direct investment (figure 4.5.A). Some small states, particularly those in the EAP region, are also among the most dependent in the world on remittances, which provide a stable source of foreign income, allowing for consumption smoothing (figure 4.5.B). Net portfolio flows, which tend to be more volatile, comprise a limited part of most small state current account financing. The scale of external financial flows relative to GDP means that even a moderate reduction in foreign exchange inflows (for example, lower tourism earnings, weaker remittances, or diminished aid flows) can result in sizeable financing gaps.

Some small states are, relative to the size of their economies, significant intermediaries for financial flows between other countries. Relative to GDP, gross external assets and liabilities in the median small state were nearly twice as large as in the median EMDE in the years 2015-19. Mauritius, the Marshall Islands, and The Bahamas, in particular, host prominent specialized financial sectors that principally serve non-residents (Pogliani, von Peter, and Wooldridge 2022). Nonetheless, the depth and breadth of domestic financial sectors generally remains limited, and a lack of domestic lending capacity means small

## FIGURE 4.5 External financing of small states

*Small states finance substantial current account deficits mostly through direct investment and official financing. Small states, particularly those in EAP, tend to be far more reliant on official development assistance than other EMDEs.*



Sources: International Monetary Fund; World Bank.

Note: EMDEs = emerging market and developing economies; EAP = East Asia and Pacific; LAC = Latin America and the Caribbean.

A. Positive and negative bars do not net to current account total due to errors and omissions. Sample includes 35 EMDE small states.

B. Simple averages for 2019. For ODA, sample includes 30 EMDE small states, 8 LAC small states, 12 EAP small states, and 101 EMDEs excluding small states. For remittances, sample includes 18 EMDE small states, 7 EAP small states, 4 LAC small states, and 80 EMDEs excluding small states.

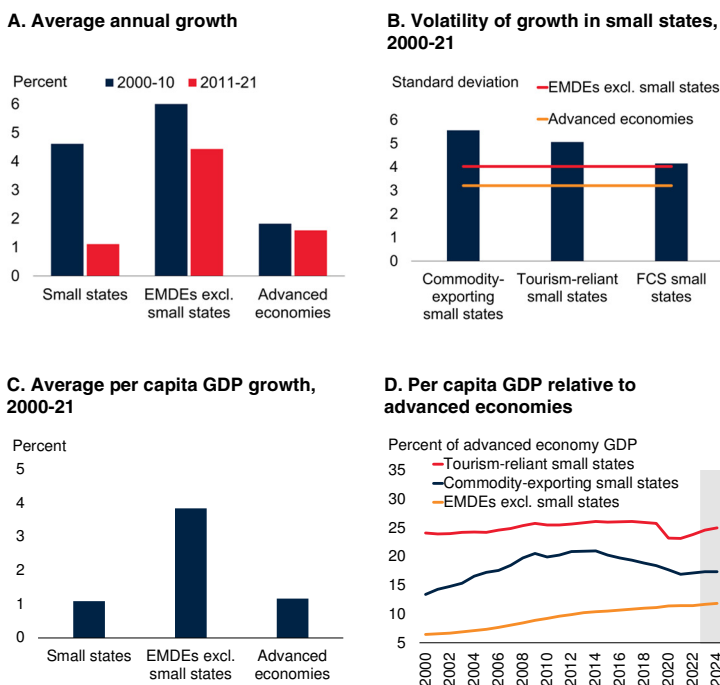
states must rely heavily on external borrowing, often in foreign currencies.

Over the past two decades, private creditors have accounted for a growing share of small state external debt. External debt (relative to GDP) increased in about two-fifths of small states in the decade prior to the pandemic, with particularly sharp increases in Cabo Verde, Mauritius, Montenegro, and Trinidad and Tobago. Some small states have experienced slowing aid flows as donor countries prioritize low-income or conflict-affected countries, and as a result have increased their reliance on private creditors.

The use of currency pegs helps to shield small states from exchange rate shocks that could lead to significant and unpredictable changes in the valuation of foreign-denominated assets and liabilities (Calvo and Reinhart 2000). Historically, small states have been less prone to banking, currency, or debt crises than other EMDEs. For example, between 1950 and 2019 the average small state was in crisis in 14 percent of years, compared to 29 percent for other EMDEs (Nguyen, Castro, and Wood 2022). However, record high debt levels among some small states

## FIGURE 4.6 Growth in small states during the past two decades

Since 2000, growth in small states has been lower and more volatile than in other EMDEs. After some making gains toward advanced economy per capita GDP in the 2000s, most small states stagnated or lost ground during the 2010s and were set back further during the pandemic.



Source: World Bank.

Note: EMDEs = emerging market and developing economies; FCS = fragile and conflict-affected states.

A.C. Average annual growth of aggregate GDP and GDP per capita for groups of countries. Sample includes 35 EMDE small states, 113 EMDEs excluding small states, and 36 advanced economies.

B. Average of standard deviations of growth from 2000-21 for countries in each group. Sample contains 12 commodity-exporting, 22 tourism-reliant, and 6 FCS small states. Sample contains 113 EMDEs excluding small states. Extreme outliers are excluded.

D. Sample includes 34 EMDE small states and 114 EMDEs excluding small states. Guyana is excluded. Grey area indicates forecast.

increase the likelihood that pegs do eventually come under pressure.

## Economic impact of overlapping crises

Since 2000, average growth in small states has been slower and more volatile than in other EMDEs (figures 4.6.A, 4.6.B, and 4.6.C). In the decade prior to the pandemic, growth in small states decelerated to just 1.8 percent per year, in part due to the outsized effects of natural disasters and spillovers from slower global growth, but also due to markedly weak growth in energy exporting

small states following the 2014 commodity price bust. Overall, small states have made no relative gains toward advanced economy per capita GDP levels for an extended period (figure 4.6.D). This lack of convergence was broad-based across small states in all regions. The knock-on impacts of the war in Ukraine and the ongoing global tightening cycle have further set back the recovery to pre-pandemic output levels.

### The COVID-19 pandemic

The COVID-19 pandemic decimated global demand for tourism, small states' largest export and a major source of employment. The extent of the tourism collapse in many small states was compounded by extensive pandemic-related restrictions that were implemented to protect public health in contexts of limited health system capacity. Restrictions in small states generally remained tighter for longer than in other EMDEs, but converged to the EMDE average by mid-2022, with some outliers (figure 4.7.A). Most small states avoided large COVID-19 outbreaks at the beginning of the pandemic, but in the second half of 2021 average case numbers and deaths rose toward the EMDE average as more transmissible variants of the virus became dominant (figure 4.7.B). The pandemic worsened health and education outcomes, with the largest losses among the poor (Schady et al. forthcoming).

As the pandemic progressed, disruptions to global supply chains manifested as a terms of trade shock in small states, contributing to weak economic recoveries. The sharp rise in shipping costs was a particular headwind for small states, and unusual in the aftermath of a global recession. Indeed, in the other two global recessions since 1990 (in 2009 and 2012), shipping costs were substantially lower in the first year of recovery than in the pre-slowdown year. In contrast, in 2021 shipping costs were more than twice their level in 2019.

The economic costs of the pandemic were much more severe for small states than other EMDEs, with activity shrinking more than 11 percent in 2020, compared with less than 2 percent in other EMDEs (figure 4.7.C). The collapse of global travel had a disproportionate impact on the three-

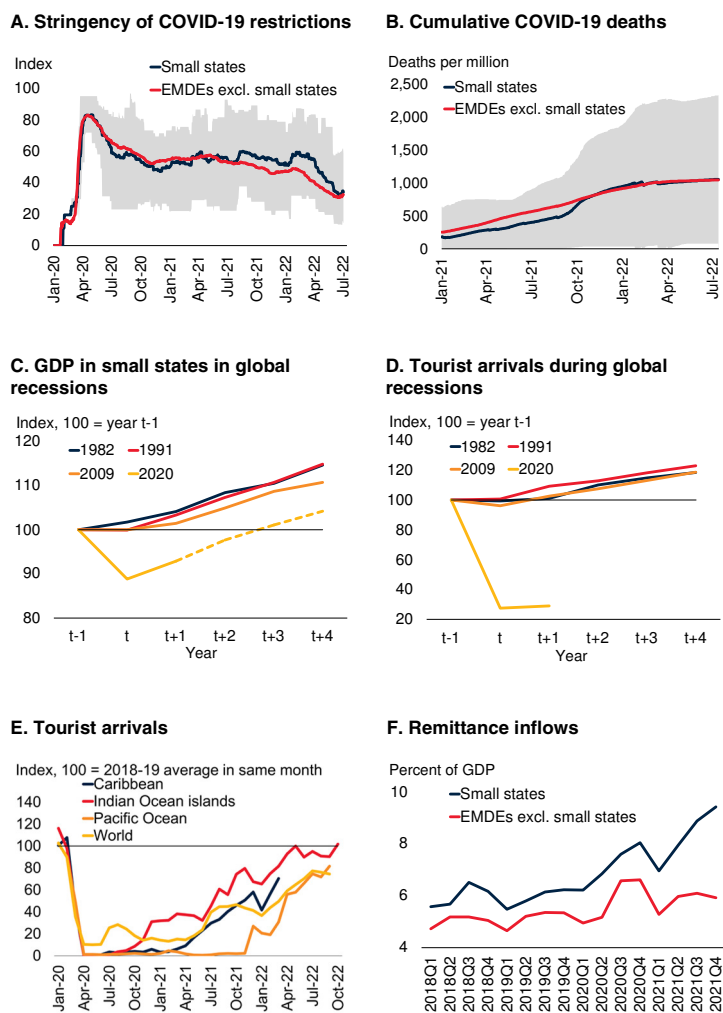
fifths of small states that rely on tourism, as their aggregate output contracted by nearly 13 percent in 2020. During the four global recessions prior to 2020, the largest annual decline in global tourist arrivals was about 4 percent, between 2008 and 2009. In 2020, arrivals fell by more than 70 percent (figure 4.7.D).

Aggregate growth in small states rebounded to an estimated 4.6 percent in 2021. Growth remained weak, in part because an initial recovery in tourism was interrupted by the spread of the Omicron variant of COVID-19 (figure 4.7.E). In all, small state aggregate output in 2021 was about 12 percent below what was projected just before the pandemic. In line with global trends, remittances to small states proved resilient, providing a crucial source of external finance during the early stages of the pandemic, with some small states such as Samoa and Tonga even seeing increases of close to 10 percentage points of GDP (figure 4.7.F). (The increase in recorded remittances in 2020 among most small states with available data was partly because of a shift of remittances from informal to formal channels.) ODA also provides a consistent source of external resources for small states, amounting to 12 percent of small state GDP in 2019, but considerably more for some EAP small states. For example, ODA was equivalent to nearly 80 percent of GDP in Tuvalu and 45 percent of GDP in Nauru. ODA flows strengthened by about 11 percent in 2020-21, according to preliminary donor data, likely implying increased dependence on aid in some small states.

Despite firm remittance inflows, small state current account balances deteriorated markedly between 2019 and 2020 as export performance suffered and government spending responded to the public health emergency. The average small state current account balance weakened by 2.5 percentage points of GDP in 2020, to a deficit of 8.3 percent of GDP, while the average fiscal balance deteriorated by 3 percentage points of GDP, from a deficit of 1.8 to 4.8 percent of GDP. Fiscal balances improved moderately in 2021, to an average deficit of 4.1 percent of GDP, but current accounts deteriorated further as travel remained depressed and the prices of imported commodities began to rise sharply.

**FIGURE 4.7 The COVID-19 pandemic in small states**

*Small states had more prolonged mobility restrictions than other EMDEs, as COVID-19 deaths peaked later. The recession in 2020 was by far the most severe recession for small states in the past four decades and the recovery has been the weakest. The collapse in global travel during the pandemic had a disproportionate impact on small states, though increased remittance inflows partially cushioned the loss.*

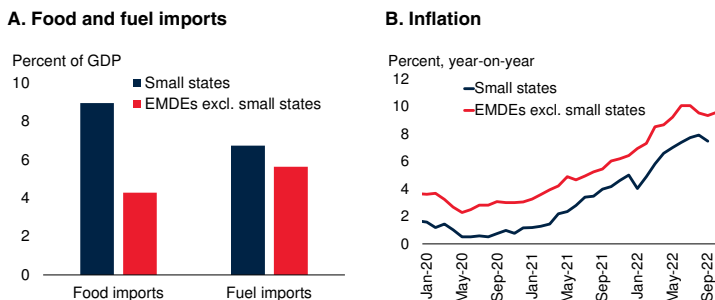


Sources: Hale et al. (2021); Haver Analytics; International Monetary Fund; national statistical agencies; Our World in Data; UN World Tourism Organization; World Development Indicators; World Bank.

Note: EMDEs = emerging market and developing economies.  
 A. Lines show simple averages of countries in each group. Grey shading shows the 5th to 95th percentile range in small states. Last observation is July 1, 2022.  
 B. Simple averages. Sample includes 147 EMDEs, of which 33 are small states. Grey shading shows 5th to 95th percentile range in small states. Last observation is July 12, 2022.  
 C.D. Lines show one year before (t-1) to four years after (t+4) the year of the recession, except where data are not yet available for the 2020 recession. Dotted lines represent forecasts.  
 C. Sample includes 35 EMDE small states.  
 E. Total non-seasonally adjusted visitor arrivals to each country group. Caribbean includes Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. Indian Ocean islands include Maldives, Mauritius, and the Seychelles. Pacific Ocean islands include Fiji and Palau. Last observation is March 2022 for the Caribbean, September 2022 for Pacific Ocean islands and the world, and October 2022 for Indian Ocean islands.  
 F. Simple averages. Sample includes 16 small states and 69 EMDEs excluding small states. Last observation is 2021Q4.

## FIGURE 4.8 Economic effects of the war in Ukraine

Imports of food and fuel account for a larger share of GDP in small states than in other EMDEs. Inflation in small states rose sharply in 2022, partly due to the effects of Russia's invasion of Ukraine on commodity prices.



Sources: Haver Analytics; International Monetary Fund; national statistical agencies; UN Comtrade; World Bank; World Development Indicators.

Note: EMDEs = emerging market and developing economies.

A. Bars show simple averages. Data for 2019. Food imports sample includes 22 EMDE small states and 95 EMDEs excluding small states. Fuel imports sample includes 18 EMDE small states and 78 EMDEs excluding small states. Energy exporting EMDEs were dropped from the fuel imports sample. B. Lines show medians. Sample includes 19 EMDE small states and 45 EMDEs excluding small states. Last observation is September 2022 for small states and October 2022 for EMDEs excluding small states.

### Russia's invasion of Ukraine, inflation, and global monetary policy tightening

**The war in Ukraine.** Even prior to Russia's invasion of Ukraine in February 2022, commodity prices had risen substantially, and global supply chains were strained. The start of the war exacerbated these trends globally, weakening small state terms of trade more than those of other EMDEs.

The additional surge in energy and food prices raised already elevated import costs among small states. Typically, food and fuel imports are equivalent to about one-sixth of GDP in small states, substantially more than in other EMDEs, with some small states spending considerably more than the average (figure 4.8.A). Steep rises in food prices brought on by war-related disruptions to grain, energy, and fertilizer markets have squeezed living standards. In Cabo Verde, the combination of global food price increases and pre-existing local drought conditions sparked an acute food insecurity crisis expected to severely affect about 10 percent of the population (FAO 2022).

The war-induced energy price shock could prove enduring, with oil prices expected to remain well

above their pre-pandemic level throughout the next three years (World Bank 2022d). This contrasts with previous periods of weak global growth, which were generally associated with soft commodity prices (Baffes and Nagle 2022). The terms of trade shock and further damage to small state export prospects have contributed to a renewed deterioration of small state current account balances, to an average estimated deficit of 9.4 percent of GDP in 2022, and more than 15 percent of GDP in nine small states.

**Inflation.** Across small states, rising import prices quickly pushed up inflation in 2022, despite still weak domestic demand. In a consistent sample of 15 small states with available data, median year-on-year inflation in September 2022 was 7.5 percent, up from 2 percent just prior to the pandemic (figure 4.8.B). Several small states, including Mauritius, Montenegro, Samoa, São Tomé and Príncipe, Suriname, and Tonga, are experiencing double-digit inflation. In contrast, annual inflation in the median small state was below 2 percent for most of the 2010s, anchored by fixed exchange rates during a period of low inflation in advanced economies.

**Monetary policy tightening.** Rising price pressures have triggered synchronized monetary policy tightening across advanced economies and most EMDEs. The associated tightening of financial conditions has led to worsening perceptions of the sovereign creditworthiness of many EMDEs, especially issuers with lower credit ratings, as illustrated by a large rise in non-investment grade sovereign spreads since the start of the year. The median sovereign credit rating of small states in mid-2022 was six notches below investment grade (B3 by Moody's), and one notch lower than 2019. Consequently, apart from countries that rely mostly on concessional financing (for example, the Comoros, Samoa, and São Tomé and Príncipe), small states are likely to see much-increased spreads on new commercial borrowing compared to recent years.

Rising interest rates will squeeze non-interest spending in small states with sizeable existing stocks of variable rate debt, such as Fiji and Maldives. Diminished access to credit generally

will test nascent recoveries in a number of countries where private sectors are heavily indebted, including Mauritius and several Caribbean economies. In parallel, more restrictive macroeconomic policies are expected to dampen global growth, leading to softer external demand for small states.

## Prospects for recovery

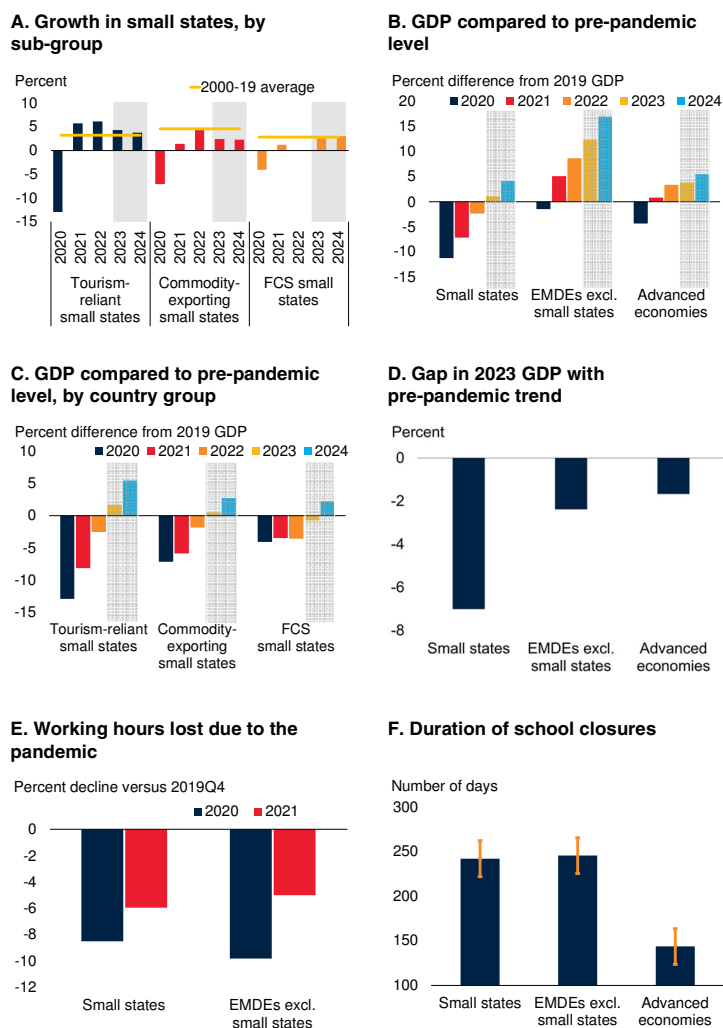
Following an unprecedented economic contraction in 2020, the return to the level of output prevailing before the pandemic has been slow. Small states are forecast to grow 3.5 percent in 2023, slowing from an estimated 5.2 percent in 2022 (figure 4.9.A; table 4.2). The 2023 growth forecasts for about two-thirds of small states have been downgraded relative to the June forecast. Although small states have limited direct trade and financial linkages with Russia and Ukraine, they have experienced the inflationary impacts of the war and the ongoing global financial tightening cycle. At the projected pace of growth, small states will regain their aggregate 2019 level of activity only in 2023, while other EMDEs exceeded this threshold in 2021 (figure 4.9.B).

In tourism-reliant small states, growth is projected to be above the historical (2000-19) average through 2024. However, these growth rates follow a severe recession of nearly 13 percent in 2020. The return of tourism to pre-pandemic levels is incomplete. An incipient recovery at end-2021 was halted as COVID-19 cases spiked. In mid-2022, global international arrivals were still about one-third below pre-pandemic levels (UNWTO 2022). Yet there are clear signs of pent-up demand—global searches for flights and accommodation are well above pre-pandemic levels, and tourist arrivals in small states are rising (figure 4.7.E). Growth in tourism-reliant small states is projected to cool to 4.3 percent in 2023, from an estimated 6.1 percent in 2022, supported by a continued global tourism recovery. Per capita GDP in this group of countries is expected to regain its pre-pandemic level only by 2023.

Growth in commodity-exporting small states is forecast to soften to 2.4 percent in 2023, down from 4.3 percent in 2022. This growth trajectory would leave aggregate GDP in commodity-

**FIGURE 4.9 Prospects for recovery**

After a deep recession in 2020, the economic recovery in small states is projected to be prolonged. Aggregate GDP in small states is forecast to exceed its 2019 level only in 2023, two years after other EMDEs. By 2023, GDP in small states is projected to be about 7 percent below the pre-pandemic forecast, a much larger gap than for other EMDEs. As in other EMDEs, the pandemic caused large losses in working hours and extended school closures in small states, which may have permanently scarred potential growth.



Source: Hale et al. 2021; International Labour Organization; World Bank.  
 Note: EMDEs = emerging market and developing economies. FCS = fragile and conflict-affected states.  
 A.-C. Growth rates are calculated using GDP weights at average 2010-19 prices and market exchange rates.  
 A. Sample includes 22 tourism-reliant, 11 commodity-reliant, and 6 FCS small states. Guyana is excluded. Descriptions of small state sub-groups are included in table 4.1.  
 B. Sample includes 34 EMDE small states, 115 EMDEs excluding small states, and 37 advanced economies. Guyana is excluded.  
 C. Sample includes 22 tourism-reliant small states, 11 commodity-exporting small states, and 6 FCS small states.  
 D. Figure shows percent deviation between levels of GDP in 2023 forecast in the January 2020 and January 2023 *Global Economic Prospects* reports. For 2023, the January 2020 baseline is extended using projected growth for 2022. Aggregate GDP for each group calculated using GDP weights at average 2010-19 prices and market exchange rates.  
 E. Bars show simple averages of countries in indicated groups. Sample includes 26 small states and 116 EMDEs excluding small states.  
 F. Simple averages within groups of the duration, in calendar days, of required school closures at all levels between January 1, 2020 and December 4, 2022. Whiskers show interquartile range within groups. Sample includes 23 small states, 113 EMDEs excluding small states, and 38 advanced economies.

exporting small states only slightly below the 2019 level by 2023, and per capita GDP in commodity-exporting small states more than 8 percent below the pre-pandemic level in 2023 (figure 4.9.C). The prices of agricultural commodities exported by small states—such as fish, fruit, sugar, cocoa, and wood—have mostly decreased since early 2022, while prices of commodities directly impacted by the war in Ukraine, such as oil, gas, coal, and wheat, have risen substantially. As commodity-exporting small states are still mostly net importers of food staples and energy, recent changes to their terms of trade remain unfavorable, with inflation increasingly squeezing real incomes.

The growth outlook during 2022-24 for the six small states classified as being in fragile and conflict-affected situations (FCS) is weaker than for most other subgroups, but output in this group of countries also contracted less than other subgroups of small states in 2020, in part due to their lower reliance on tourism. However, continued institutional and structural vulnerabilities, combined with the rising price of fuel and food imports, is expected to keep growth at a relatively low 2.9 percent in 2023, after a slight recession in 2022.

The forecasts for small states are predicated on several assumptions. Global tourism is expected to remain below pre-pandemic levels in 2023, but will continue to regain ground without major reversals due to, for example, new outbreaks of COVID-19 or further geopolitical turmoil. Central banks across the world are expected to tighten monetary policy in the near term in response to still-high inflation. Energy prices are expected to remain higher than previously forecast, but to ease somewhat over the course of the year.

Like other EMDEs, small states face long-term economic damage related to the shocks of the previous three years (figure 4.9.D). Skills and education losses incurred through extended periods of unemployment and school closures have been similar in magnitude to those in other EMDEs, and are likely to weigh on human capital accumulation and potential growth until they are recouped (figures 4.9.E and 4.9.F). The capital

stock is likely to be permanently lower than it would otherwise have been as a result of weaker investment and lapsed infrastructure maintenance. The protracted nature of the tourism downturn prompts further concerns about the future dynamism of small state economies, given that tourism growth and broader economic growth have been found to be mutually reinforcing in small states (Kumar and Stauvermann 2021; Ridderstaat, Croes, and Nijkamp 2013; Seetanah 2011).

## Risks

Small states face several major risks. Some are common to all EMDEs with distinct impacts on small states, such as the effects of the pandemic, financing shocks, and the inflationary effects from Russia's invasion of Ukraine. Others are more specific to small states, such as exposure to climate-related and natural disasters, and structural and institutional challenges.

### External financing shocks

Small states' high debt burdens and heavy reliance on foreign financing exacerbate the challenges of the current global environment of rising inflation and tightening financing conditions. Historically, financial crises in EMDEs have been more likely when the U.S. Federal Reserve tightens monetary policy, as it is currently doing in tandem with other central banks. The pace of tightening in advanced economies may accelerate further if the current period of persistent and elevated inflation causes inflation expectations to drift upward, requiring central banks to reset expectations to match targets. A credit event in a large EMDE could trigger disruptive, cross-border financial sector dynamics that could spill over to small states, especially those with elevated levels of debt, limited fiscal space, and more tenuous access to capital markets.

Many small states are also vulnerable to the realization of contingent liabilities from state-owned enterprises (SOEs), some of which have faced financial hardship since the beginning of the pandemic. For example, state-owned airlines in several Pacific Islands depend on various forms of government support (for example, direct budget

support, guarantees, and lending from pension funds) and have balance sheets that are large relative to GDP (Balasundharam et al. 2021). Borrowing from China represents another distinct debt repayment risk. Data are incomplete, but eight small states (The Bahamas, Djibouti, Dominica, Maldives, Montenegro, Samoa, Tonga, Vanuatu) are among the 20 countries with the highest estimated stocks of debt owed to entities in China as a share of their GDP (Horn, Reinhart, and Trebesch 2019).

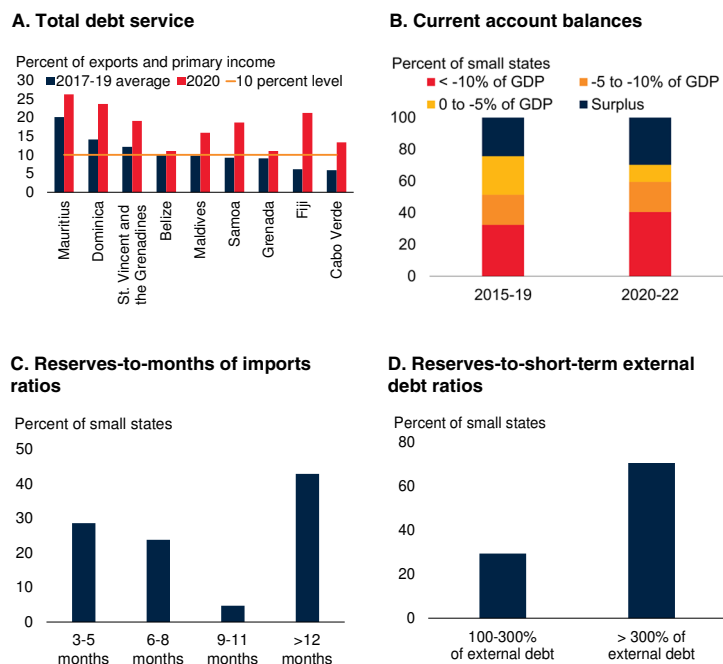
If borrowing cost were to rise sharply, refinancing debt would become increasingly burdensome and subject to risks. Interest payments were equivalent to about 15 percent or more of public revenues prior to the pandemic in some countries (The Bahamas, Barbados, St. Lucia). Officially reported government debt service was already above the threshold of 10 percent of exports of goods, services, and other foreign earnings in several countries prior to the pandemic, and far exceeded that threshold in some countries in 2020 (figure 4.10.A). Indeed, of 19 international development assistance-eligible (IDA) small states for which a Debt Sustainability Analysis was conducted by the World Bank and the IMF between 2019 and mid-2022, 13 were deemed to be at high risk of debt distress or already technically considered to be in distress. Twelve small states requested use of the Debt Service Suspension Initiative in 2020 and 2021, which provided temporary liquidity support by reprofiling debt service payments into the future but expired at end-2021 (IMF and World Bank 2021).

The liquidity and solvency risks from rapidly rising private and public debts may be amplified in some small states by heavy banking sector credit exposure to national governments (IMF 2013). This could allow financial stress in any of the corporate, financial and government sectors to spill into the others, which potentially constitutes a hidden risk even in small states where fiscal and external positions appear adequate to cover foreseeable government liabilities.

In the near term, the need to finance large current account deficits will intensify pressure on small state external financial accounts. From 2020 onwards, current account deficits expanded to

**FIGURE 4.10 External financing risks**

*Debt servicing costs are already elevated for some small states and are likely to rise further as global interest rates rise. The large current account deficits of many small states make them vulnerable to external financing shortages. These risks are often mitigated by sufficient reserve coverage.*



Sources: International Monetary Fund; World Bank.  
 A. Horizontal line shows a threshold of 10 percent of goods, services, and primary income. Montenegro is not shown but its debt service-to-export ratio was about 55 percent of GDP in 2017-19, and more than 100 percent in 2020. Sample includes 18 small states.  
 B. For 2020-22, data are a mix of actuals, estimates, and forecasts. Sample includes 37 EMDE small states.  
 C. Data is the latest available (either 2020 or 2021), which varies by country. Categories sum to 100 percent. Sample includes 21 EMDE small states.  
 D. Data from 2020 due to limited data availability for short-term external debt. Most small states (about 80 percent) increased their official reserves from end-2020 to end-2021. Sample includes 17 EMDE small states.

more than 10 percent of GDP for about half of small states (figure 4.10.B). Much of this larger financing requirement has been met through increased official lending and transfers (which has also enabled some small states to strengthen reserve positions somewhat). Portfolio inflows also increased in 2020, representing about 0.5 percentage points of aggregate small state GDP. In the current environment of tighter financial conditions and still large current account deficits, portfolio flows could reverse, requiring a further increase in other funding sources or sharp reductions in spending.

In part reflecting the recent allocation of increased special drawing rights (SDRs), and strong remittance and donor inflows, reserve buffers

appear adequate to insulate most small states from shortfalls in the near term (figure 4.10.C). Based on recent data, almost all small states hold reserves worth more than three months of imports, which also appear sufficient to cover total short-term external debt liabilities (figure 4.10.D). Nonetheless, if pressures on reserves were to arise, the sustainability of debt and existing currency pegs could come into question, heightening the risk of financial crisis. In the past, small state banking and currency crises have been particularly associated with lower ratios of reserves to money supply, which can compromise confidence in exchange rate pegs, leading to a run on the currency (Pizzinelli, Khan, and Ishi 2021).

### Inflation

Additional disruptions to global energy and food markets could add to inflation, widen current account deficits, and further slow growth in small states. High and rising inflation could stoke social tensions, especially if food insecurity was already present prior to the recent surge in inflation. For example, food insecurity is expected to become even more widespread in Djibouti and Eswatini as food prices rise, adding to the 17 percent and 30 percent of the population, respectively, already in food crisis (World Bank 2022e; World Food Program 2021).

Higher inflation than in trading partners can undermine the fixed exchange rate arrangements used by nearly all small states by generating real appreciation. Persistent real appreciation can widen current account deficits, which have to be financed with unsustainable drawdowns of international reserves. Over time, this may eventually lead to pressure on the peg (MacDonald 2007).

### Global downturn

Given their openness to trade and dependence on foreign sources of financing, small states could suffer severe consequences from a sharper-than-expected slowdown in the global economy. Since 1970, global recessions have been more likely when global growth weakens significantly in the previous year, as was the case in 2022. All global recessions since 1970 have coincided with sharp

slowdowns or outright recessions in multiple major economies, such as the United States, euro area, and China (Guénette, Kose, and Sugawara 2022).

Slower activity in major economies impacts the outlook for small states through multiple channels, including trade, confidence, and commodity markets. Small states are also vulnerable to slowing financial inflows in the form of ODA or remittances. The pandemic-induced recession was unusual in that many host countries provided large amounts of social support that helped prevent remittances from declining. This is unlikely to re-occur in the case of a future slowdown given limited fiscal space and the need to unwind pandemic-related fiscal support in many major economies. Strained fiscal positions may also cause donor governments to reduce ODA as budgets are re-allocated toward debt service, programs to buffer against the impact of recent commodity price increases, and restoring fiscal sustainability.

### Climate change and natural disasters

In part because of their geography, small states are highly vulnerable to natural disasters such as hurricanes or tropical cyclones, floods, and droughts, as well as earthquakes and volcanic eruptions. The frequency and intensity of weather-related natural disasters in these countries has increased in recent decades, and is expected to rise further as a result of climate change (figure 4.11.A; IPCC 2022). Small states already face severe, in some cases existential, threats from a climate-related rise in sea levels and coastal erosion. In The Bahamas, Bahrain, Kiribati, Maldives, the Marshall Islands, and Tuvalu, for example, more than one-third of the land area and one-quarter of the population is located less than 5 meters above sea level. Other small states are highly vulnerable to drought (Djibouti, Eswatini).

Scaled by land mass, natural disasters in small economies dwarf those in large economies (figure 4.11.B; von Peter, von Dahlen, and Saxena 2012). It is not uncommon for the damages from a single disaster to be equivalent to a substantial portion of a country's GDP, or even multiples of GDP in



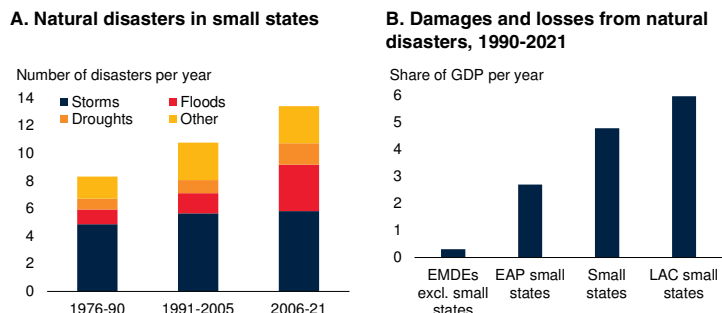
extreme cases. Estimated damages and losses from Hurricane Maria in 2017 in Dominica and Hurricane Ivan in Grenada in 2004, for instance, amounted to 200 percent or more of GDP (Government of Dominica 2017; OECS 2005). Even averaged over a number of years, the cost of damages can be substantial. A severe natural disaster in a small state typically triggers a shock to productivity and substantial temporary disruption in output, alongside a surge in localized demand for public services (for example, healthcare and housing provision) and a decline in public revenues. Reconstruction costs can be well beyond the reach of the domestic budget and contingency funds, requiring substantial additional borrowing at increased capital costs.

The specific channels by which climate change negatively impacts small state economies are many and varied. Increased vulnerability stems in part from the concentration of economic activity near coastal areas, which is likely to intensify in many small states given urbanization trends (Mycoo and Donovan 2017). Direct effects are via damage to public infrastructure and broader capital stocks, but these in turn impede production and disrupt supply chains, causing further economic losses. For example, the ports of small island states, which are essential for both tourism and goods trade, are assessed to be the most vulnerable globally to operational disruption due to climate change (Izaguirre et al. 2021).

Over the long term, rising sea levels and environmental changes pose a severe risk to tourism. Attractions such as beaches and coral reefs could be degraded, while rising sea levels could submerge prime real estate—a 1 meter sea level rise in the Caribbean has been estimated to damage 49 to 60 percent of tourism resorts (Scott, Simpson, and Sim 2012). For agricultural producers, shifting weather patterns could disrupt ecosystems in unexpected ways, with negative impacts on crop yields due to factors such as the emergence of unfamiliar pests and bacteria (Taylor, McGregor, and Dawson 2016). The compound effects of climate change on small states are likely to exacerbate already substantial emigration pressure and curb labor force growth, and to hinder productivity (Dieppe 2021).

## FIGURE 4.11 Climate change and natural disasters

*Small states have experienced an increased frequency of climate-related shocks. Damages and losses from disasters have been substantial, averaging 4.8 percent of GDP per year since 1990, and even more in LAC small states.*



Sources: EM-DAT; World Bank.

Note: EMDEs = emerging market and developing economies.

A. Disasters are counted as the total number in all small states per year. Other disasters include earthquakes, landslides, and volcanic activity. Sample includes 26 EMDE small states.

B. Bars show the sum of damages in each group of countries in each year divided by the sum of nominal GDP in each group of countries, weighted by country-level nominal GDP.

## Policy priorities

Policy makers have options to reverse small state losses from the pandemic and to lower their vulnerability to future crises. Achieving sustainably higher and more stable growth than currently projected will require addressing both immediate and more structural challenges, and appropriately sequencing reforms. Since small states, notwithstanding some common features, are highly heterogeneous, reforms have to be tailored to country characteristics and circumstances. By their nature, small states are highly exposed to global developments over which they have little control. Therefore, while many policy options exist for small states, they have fewer policy levers than larger countries, and the global community has a critical role to play in assisting these countries.

### Domestic policies

In the short-term, small state policy makers can seek to mitigate the effects of global inflation and position their economies to move past COVID-19 and take advantage of a tourism revival. In the longer term, they can pursue structural reforms that reduce vulnerability to external shocks,

increase debt sustainability, foster effective economic diversification, and raise growth prospects.

**Inflation.** With overwhelmingly fixed exchange rates and open capital accounts, small states have almost no scope for reining in inflation through discretionary monetary policy. Small states can use fiscal policy to diminish the negative distributional impacts of inflation, however. Numerous small states have sought to dampen rising domestic inflation by reducing value added taxes on select basic commodities or introducing subsidies on fuel (for example, Barbados, Dominica, Fiji, Grenada, and St. Lucia), or providing subsidies for essential goods like food (Mauritius). Although such assistance can alleviate price pressures for individuals and businesses in the short term, it does not concentrate help on those most in need and comes at a time when budgets are already strained.

The preferred option for policy makers to offset rising food and fuel prices is to implement more targeted protection programs, as Antigua and Barbuda recently did in offering new subsidies to transport operators, and to take advantage, where possible, of fintech solutions to reach households in geographic areas where banks are sparse. Certain structural reforms could help small states buffer future periods of high inflation. These include converting electricity production from imported fossil fuel sources to renewable sources available domestically, or expanding domestic food production, if permitted by land availability and growing conditions, to reduce reliance on imported products. Measures to facilitate trade could also bring down import costs and inflation, as described below.

**Moving past COVID-19.** In the short term, progress on COVID-19 vaccination continues to be a priority given its public health benefits and the need to avoid outbreaks that may discourage tourism or inhibit broader commercial activity. For EAP small states, a larger proportion of tourism demand originates in countries that pursued strict policies to prevent viral transmission. In this context, small states like Tonga and Samoa, both of which fully vaccinated their populations by early 2022, were better placed

to benefit from the tourism recovery than Vanuatu or the Marshall Islands, where broad vaccination coverage took longer. In several small states, particularly in the Caribbean, vaccine hesitancy proved a significant barrier (World Bank forthcoming). Providing accessible scientific information and pursuing communication campaigns that combat such misperceptions and resonate with unvaccinated populations are potentially an effective low-cost way to increase vaccine uptake (Taylor 2022; UNICEF 2021).

In addition, as in other EMDEs, learning and job losses from the pandemic have interrupted the accumulation of skills and human capital and are likely to weigh on incomes and potential growth for years to come. Investments in human capital can allow for greater technology use, bolstering productivity and improving service delivery (World Bank and UNESCO 2022). Small states would also benefit from efforts to improve early childhood development and nutrition coverage. Improving education programs at all levels while also promoting youth employment and entrepreneurship could help recover learning losses caused by the pandemic, reduce education inequalities, and enhance resilience to labor market shocks (Schady et al. forthcoming).

**Fiscal sustainability.** Given the inability of most small states to use exchange rates or monetary policy as a stabilizer, responsibility for counter-cyclical policy rests largely on fiscal policy, making the maintenance of fiscal space especially important. At the country level, medium-term fiscal consolidation in small states, to the extent possible in a challenging global environment, would also help reduce risks from the recent increase in debt burdens. Expenditure restraint—particularly of recurrent spending—would bolster fiscal positions and reduce the need for additional debt. Redesigning subsidy programs in favor of approaches that more precisely target the poor would be one such reform (Heller 2022). Addressing inefficiencies in public sectors could yield substantial fiscal benefits, as could encouraging the transfer of a greater share of the economy from the informal to the formal sector (Ohnsorge and Yu 2021). In some countries, this could be complemented by limiting fiscal risks

related to state-owned enterprises (for instance, in Cabo Verde and Maldives; World Bank 2019b, 2021a). Given country-level capacity constraints, proximate small states could consider pooling some administrative functions and commonly needed services (for example, data gathering and potentially some logistical and regulatory services) to generate better economies of scale.

Although revenues in small states are higher as a share of GDP than in other EMDEs, a phaseout of tax exemptions and improvements in the efficiency of tax administration (including by modernizing the technology used, in many countries) could also help improve fiscal positions. In small states in EAP, for instance, tax revenues could be increased by an estimated 3 percent in the medium term through a combination of improvements to VAT systems, rationalizing tax exemptions, closing loopholes, and reforming tax administration (Sy et al. 2022). Small states in EAP also tend to derive a smaller proportion of revenue from taxing income, profits, and capital gains than other EMDEs. Measures to broaden these tax bases could improve fiscal positions without materially constraining activity. In addition to limiting borrowing needs, fiscal reprioritization could free budgetary resources for critical investments in human and physical capital.

Looking ahead, policy makers can put in place and bolster the fiscal and regulatory frameworks necessary to make the best use of the financial inflows resulting from tourism and commodity exports, and help rebuild room to maneuver when hit by negative shocks. Public financial and investment management reforms are underway in several countries (for example, The Bahamas and Bhutan). Improvements in debt transparency—particularly with respect to private and non-Paris club lending—can reduce risks of debt distress and prevent delays in restructuring should it be needed in the future (Rivetti 2021). Historically, a better policy and institutional environment in small states is associated with higher debt carrying capacity and better ability to withstand external shocks (Prasad, Pollock, and Li 2013). Clear medium-term fiscal frameworks, including appropriately designed fiscal rules and anchors, can create macroeconomic policy room and support investor confidence.

In view of the growing effects of climate change in small states, explicitly incorporating climate adaptation costs into domestic budgets has become increasingly urgent. As of 2021, slightly more than one-third of small states had some type of fiscal rule, about the same share as other EMDEs. These were mostly debt rules. For small states in LAC facing high macroeconomic volatility, however, structural balance rules have been found to be the most suitable (Blanco et al. 2020).

The likelihood of adhering to fiscal rules can be increased by the presence of precautionary mechanisms, such as sovereign wealth funds or access to contingent credit. A substantial number of small states have established sovereign wealth funds or trust funds (for example, Bahrain, Brunei Darussalam, Equatorial Guinea, Guyana, Kiribati, the Marshall Islands, the Federated States of Micronesia, Palau, Timor-Leste, Tonga, Trinidad and Tobago, and Tuvalu), which in principle can support debt sustainability in small states by helping to buffer fiscal shocks and stabilize otherwise volatile revenue and expenditure profiles. Given the differing purposes of sovereign funds (for example, budget stabilization, promotion of intergenerational equity, or transitioning away from donor dependence), a range of approaches to risk and liquidity management may be appropriate (Drew 2016). Varied objectives notwithstanding, sovereign wealth funds can be counterproductive if they are managed in a way that introduces budgeting rigidities and distortions, or is insufficiently prudent. Integrating funds into a coherent and holistic medium-term budgeting framework, avoiding off-budget activities, and establishing transparent and professional governance can support the stability of sovereign wealth funds (Le Borgne and Medas 2007).

The rise in public and private debt and the concentrated nature of small state banking sectors has increased the risk that economic shocks are amplified by financial sector stress. To guard against this, in addition to rebuilding fiscal and external positions, small states can build capacity in financial sector supervision, and ensure banking sectors have ample capital buffers. In assessing specific risks to bank balance sheets (for example, in the context of stress-testing) small states can place particular emphasis on integrating an

assessment of disaster-related vulnerabilities (IMF 2019). Small states can also benefit from financing innovations and contractual clauses to preemptively transfer disaster-related financial risks away from small state balance sheets.

**Diversification.** Greater economic and export diversification is associated with lower growth volatility and higher long-term average growth in small states (McIntyre, Li, and Wang 2018). Diversification efforts must be calibrated, however, to align with areas where small states can realistically build advantages, and must take into account the limitations of small economic size and government capacity. The appropriate strategies for small states in the Caribbean, with their relative proximity to the United States and Latin America, will differ from other groups of small states. By contrast, the Pacific Islands are spread across a vast geographical area, are far from potential trading partners, and have varied circumstances (Fiji is more than 80 times as populous as Nauru, for example).

Facilitating effective diversification could include the development of blue economy activities in island economies, such as aquaculture, carbon sequestration, renewable energy generation, or commercially oriented research (OECD 2021; Patil et al. 2016). The diversification process could also entail differentiation within important sectors—for example, developing high value-added eco-tourism and cultural tourism. The promotion of activity focused on the rich biodiversity of many small states could help preserve natural capital and unlock new sources of finance (similar to the “rhino bond” recently issued in South Africa; World Bank 2022f). Fisheries and associated activities, such as processing and vessel support, could provide sustainable growth, as long as catch limits that maintain the health of fish stock are enforced.

There may also be niche markets where small states, due to institutional or geographic factors, have particular advantages—for example, some Caribbean islands host internationally oriented medical schools. Agricultural producers could benefit from diversifying into production of higher value products or moving agricultural sector production up the value chain (agro-

processing). Belize, for example, has had some success with the former (World Bank 2017). Mauritius is an example of a small state that succeeded through sustained policy efforts in developing new types of services and manufacturing activity over several decades, with GDP per capita nearly doubling (in U.S. dollar terms) in the two decades prior to the COVID-19 pandemic.

**Reforms to support growth.** In general, small states can improve long-term prospects by seeking to enhance the competitiveness and resilience of sectors in which they have advantages, improving access to foreign markets, bolstering the skills of the population, and fostering nimbleness and adaptability to quickly embrace new opportunities (Briguglio 2022). More specifically, reducing trade costs, boosting digital connectivity, increasing financial inclusion, and prioritizing the development of sound institutions could all help to sustainably increase growth, while also building resilience to external shocks arising from disruptions in activity to major trading partners or to global supply chains.

There is considerable opportunity to improve the competitiveness of small states by improving digital connectivity. Ensuring connectivity and a baseline of digital skills in the population could, for example, help small businesses access global markets through integration with online platforms. Digital connectivity, augmented with access to essential services (for example, healthcare), could also help partially offset outward emigration by attracting increasing numbers of “digital nomads,” especially if cultural shifts toward remote working are sustained (World Bank 2021b). In 2020, Barbados and several other island nations instituted schemes encouraging foreigners to work remotely from their territory, in effect diversifying their services exports. Further, the digitization of public services and records could support more streamlined and responsive public sectors that are better able to facilitate private sector growth, while requiring fewer resources.

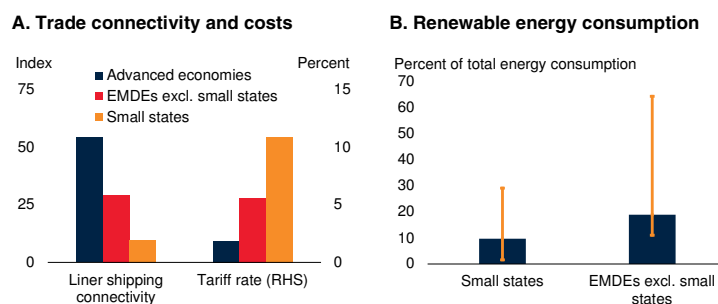
Broadly, lack of access to credit for micro and small businesses is a constraint on private sector growth in small states (World Bank 2022g,

2022h, forthcoming). Bolstering small state fintech sectors could help to address this, complementing other efforts to unlock finance for small firms, such as guarantee programs supported by the Eastern Caribbean Partial Credit Guarantees Corporation. Furthering fintech could also have other growth-enhancing benefits, such as reducing remittance fees, improving credit reporting, facilitating more effective social safety nets, enabling better insurance coverage, and reducing inefficiencies associated with high cash usage (Davidovic et al. 2019). In The Bahamas, for instance, the Sand Dollar, a digital currency backed by the central bank's foreign reserves, was launched with the intention of promoting financial inclusion. In addition, greater digitalization of financial systems could facilitate more efficient anti-money laundering and counter-terrorist financing procedures, which could help address perceived risks that have led to a decline in correspondent banking relationships in small states (Alwazir et al. 2017).

Given high levels of trade openness, small states could support long-term productivity growth by reducing trade costs. Across EMDEs, trade costs double the cost of internationally traded goods in comparison to domestic goods, with the bulk of these costs coming from shipping and logistics, as well as cumbersome trade procedures (World Bank 2021c). Trade costs are almost one-half higher in EMDEs than in advanced economies. Data for small states is limited, but it is likely that their trade costs are even more elevated than other EMDEs. Despite being highly reliant on shipping to distribute exports, small states are comparatively poorly integrated into global shipping networks, due to both remoteness and lack of scale. The average efficiency of customs procedures and quality of trade-related infrastructure in small states is broadly comparable to EMDEs but lags substantially behind advanced economies. Import tariffs in small states, at nearly 11 percent, are notably higher than in other EMDEs (figure 4.12.A). Small states could lower trade costs through deeper trade liberalization, streamlining customs procedures, improving port and other infrastructure, and making logistics and transport services more competitive.

## FIGURE 4.12 Policies to reduce vulnerability to global price shocks

*In the medium term, small states could reduce price pressures and increase living standards through streamlining trade procedures and increased transport connectivity. Increasing the share of renewables in energy consumption could help lessen the vulnerability to global energy price volatility.*



Sources: World Bank; World Development Indicators.

Note: EMDEs = emerging market and developing economies; RHS = right hand side.

A. Simple averages of countries in each group. Liner shipping connectivity is an index based on number of ships, their container-carrying capacity, maximum vessel size, number of services, and number of companies that deploy container ships in a country's ports; data for 2020. Tariff rate is the weighted mean import tariff on all products. Data for 2018.

B. Bars show medians within indicated country groups. Vertical lines show interquartile ranges within groups. Sample includes 37 small states and 111 EMDEs excluding small states. Data for 2019.

Small states could also seek to codify more and deeper free trade agreements, both by negotiating new agreements and by acceding to existing agreements involving larger economies, although in some cases country-level capacity constraints may present an obstacle. Small state participation in free trade agreements is limited. Seven EAP small states have entered, or are about to enter, a trade agreement with Australia. Brunei Darussalam is a member of several free trade agreements, including the Trans-Pacific Partnership. Twelve LAC small states in the Caribbean are part of CARICOM, an intra-Caribbean free trade agreement. The economic benefits of CARICOM could potentially be improved, however, through regional harmonization of investment codes (which has begun, but could be accelerated), and by reducing the common external tariffs on intermediate and capital goods (World Bank forthcoming). More generally, improving regulatory alignment with larger trading partners could encourage companies to expand into small states, helping to boost competition.

Inefficient state-owned enterprises may exert a drag on the broader economy in some small states, given their significant size in the context of small economies. Budget transfers to lossmaking SOEs restrict public resources that could otherwise be made available for productive public investment. SOE wages may also put upward pressure on wages in the broader government sector, contributing to mismatches between pay and productivity (Heller 2022). In some cases, corporate sectors could be made more productive if SOEs were privatized or regulated more effectively. In Fiji, for example, the predominance of SOEs in sectors that are usually private, such as fisheries and agribusiness, may distort competitive dynamics (World Bank 2022g).

Where SOEs are providing essential quasi-public services, it is important that their governance promotes disciplined management. Financial accounts need to be public and subject to rigorous audit, board decision-making needs to be transparent and accountable, and regulatory and commercial functions should be effectively separated. The pricing of SOE goods and services can also be reformed to support efficient use of resources. Offering services at less than cost recovery, for example, is likely to distort private consumption decisions by providing an untargeted subsidy that the government ultimately funds.

Small states are likely to have both advantages and disadvantages in fostering effective public institutions, which are broadly associated with stronger growth in EMDEs (Butkiewicz and Yanikkaya 2006). Smallness may confer challenges in delivering high value-for-money public services, because of indivisible overheads that increase per capita costs and the absence of deep pools of human capital. The risks from administrative missteps may be higher because varied responsibilities may be allocated to relatively few people, and individual projects may represent proportionally large draws on government resources.

On the other hand, smallness means that government is closer to the people, which may promote social cohesion, trust, and resilience, in turn increasing the ability of small states to address coordination problems and local externalities (Brito 2015). While broadly applicable prescri-

ptions to help build stronger institutions—including limiting opportunities for corruption; increasing financial and political transparency; professionalizing public services; curtailing nepotism; and limiting state activities that crowd out private enterprise—are not distinct to small states, the long-term benefits of prioritizing such goals may be greater in small states than in other, comparable EMDEs. Accordingly, small states may be able to benefit disproportionately from leveraging international community assistance in developing sound institutions and governance.

**Reducing vulnerability to external shocks.** As well as bolstering fiscal and external positions, small states can pursue other measures to increase the flexibility of their economies and reduce vulnerability to external shocks.

Given their generally fixed exchange rates, shocks that would usually be cushioned by real exchange rate depreciations need to be met by other adjustment mechanisms. In this context, developing more flexible product and factor markets, for example through increasing labor market flexibility, encouraging competition, limiting the role of the state in production, and improving the regulation of natural monopolies, can help small state economies become adaptable to changing circumstances. Following the pandemic, increased labor market flexibility could be twinned with active labor market policies to facilitate the upskilling and reallocation of workers. Some small states with underdeveloped financial sectors could also augment their capacity to weather income shocks by deepening integration with international capital markets, though additional financial risk exposures would need to be prudently managed.

Small states could lessen the local impacts of global energy price spikes by expanding electrical grids and accelerating their transitions to renewable energy, making greater use of solar, hydro, geothermal, and wind sources available domestically. For some small states, large increases in cost-effective domestic energy generation could be transformative—Fiji, Palau, and the Seychelles import fuel worth more than 10 percent of GDP annually, while the high cost of electricity constrains the competitiveness of many Caribbean islands (World Bank forthcoming). Recognizing

these potential benefits, several small states have committed to dramatically increasing use of renewables. For example, Fiji's national development plan commits to using entirely renewable energy by 2036, while Palau's renewable energy roadmap lays out plans to exclusively use renewables by 2050 (Government of Fiji 2017; IRENA 2022). In Cabo Verde, the recently completed Cabeólica wind farm meets about a quarter of domestic energy requirements and has lowered power generation costs, while reducing the need for fuel imports (InfraCo Africa 2016).

Nonetheless, as a group, small states lag other EMDEs in their share of energy consumption from renewable sources (figure 4.12.B). Low renewable energy shares may reflect challenges securing financing for large up-front capital costs associated with installing renewable energy infrastructure. In this context, it is important for small states to ensure that their energy sector regulatory frameworks are able to attract private investment (World Bank 2022g).

**Reducing vulnerability to climate-related and natural disasters.** There is no way for small states to entirely offset the disruption that climate-related and natural disasters will bring. However, a holistic, integrated approach to crisis preparedness can reduce the economic and human impact of these events by investing in both ex ante disaster resilience (market insurance, self-insurance, and self-protection) and ex post disaster recovery (Ehrlich and Becker 1972). Successfully boosting resilience to climate change without sacrificing broader development objectives requires policy reforms, reallocating public resources, mobilizing private capital, and financial support from the global community (World Bank 2022i).

Postdisaster recovery and reconstruction can be funded by dedicated savings, in the form of sovereign wealth funds or national recovery funds, or by proceeds from catastrophe bonds, disaster- and weather-based insurance mechanisms, and lending with specialized contingency options in case of a disaster. These latter mechanisms can help to pre-emptively transfer disaster-related financial risks to capital markets, via appropriate contractual clauses. Barbados and Belize have issued “blue bonds,” with guarantees from the

international community, to refinance existing debt at lower rates. In the case of Belize, the bonds are linked to marine conservation that includes “catastrophe wrapper” credit insurance in the case of hurricanes. Region-specific disaster risk insurance pools, such as the Caribbean Catastrophe Risk Insurance Facility and the Pacific Catastrophe Risk Assessment and Financing Facility, provide services to numerous small states. Various forms of these mechanisms have been developed with international financial institutions and other development partners.

Regarding ex ante climate change resilience and adaptation, development of a National Adaptation Plan (NAP) is an important step. Some countries have already adopted NAPs (Cabo Verde, Fiji, Grenada, Kiribati, St. Lucia, St. Vincent and the Grenadines, Suriname, Timor-Leste, and Tonga) and others are in the process of developing them (the Marshall Islands). A substantial portion of the needed actions related to resilience involve infrastructure, including constructing and retrofitting infrastructure to be able to withstand the impacts of one-off and long-term disasters; desalinization systems; early warning systems; and adaptations to safeguard certain industries, such as agriculture. Ensuring the resilience of infrastructure has dual benefits, as it both helps avoid large reconstruction costs associated with natural disasters and supports the livelihoods and well-being of people (Hallegatte, Rentschler, and Rozenberg 2019). With limited public resources to dedicate to infrastructure, it is crucial that policy makers in small states prioritize climate-related infrastructure investments in fiscal frameworks and that they take advantage of available sources of climate-related financing (World Bank 2016).

### Policy support from the global community

As policy makers in small states seek to accelerate their economic recoveries, the global community is supporting them in a variety of ways (ADB 2022; Rustomjee et al. 2022; World Bank 2022j). In the short term, the international community can help by scaling up nonconcessional official financing, concessional financing, and grants; helping to leverage private sector financing; continuing to support COVID-19 vaccination

programs; and upgrading the international architecture for dealing with excessive debt. The global community can also assist small states by providing technical assistance to build institutional capacity; enhancing pandemic preparedness; delivering on commitments to tackle climate change; and promoting open, rules-based global trade and investment networks.

**Vaccinations and pandemic preparedness.** In some remote or lower-middle-income small states, limited access to vaccines and the health services to deliver them remains a challenge. For example, vaccination rates in Eswatini and the Solomon Islands remain only about 40 percent. The global community can continue to support small states in sourcing adequate vaccine shipments and ensuring that the necessary health sector staff and logistics requirements are in place to utilize vaccines when they are delivered.

The COVID-19 pandemic has illustrated the extreme vulnerability of small states to extended disruptions to international travel. Future pandemics caused by easily transmissible pathogens represent a severe ongoing risk to small state economies. The global community can help mitigate these risks by continuing to upgrade pandemic preparedness and financing. Establishing stronger global epidemiological surveillance, early warning systems, research cooperation, and rapid response architecture (including procurement facilities and vaccine and therapeutic manufacturing and distribution capacity) can help minimize disruptions from future emergencies (World Bank 2022k). Putting in place such systems across groups of small states, where capacity building and market power is limited, is another area where the international community can play a role.

**Debt sustainability.** The international community has a role to play in addressing the debt burden in small states. This includes the provision of technical assistance on debt management and reduction strategies, as well as identifying and mitigating fiscal risks linked to contingent liabilities. The World Bank Group and the IMF are supporting current initiatives aimed at facilitating effective and comprehensive debt restructuring. In that respect, for eligible small

states, the G20's Common Framework provides a potential route to address debt vulnerabilities that prove unsustainable. The World Bank Group and IMF have advocated for expanding the Common Framework to include middle-income countries (World Bank and IMF 2022). They have also suggested a set of reforms to make the Common Framework process more swift and predictable.

**Official assistance.** In the last two years, increased financial flows from official sources have helped to bolster small state reserves and broader financial positions, partially offsetting reductions in foreign direct investment and tourism revenues and increases in import costs. Even before the pandemic, small states received substantially more international assistance in per capita terms than LICs as a result of their unique vulnerabilities. While sound macroeconomic policies should help small states transition away from aid dependence in the future, in the near term many small states will be more reliant than usual on official assistance. As many advanced economies pursue fiscal consolidation and resource reprioritization in the aftermath of pandemic-era fiscal expansions, it is crucial to sustain assistance to vulnerable communities in countries that have not yet recovered from the pandemic.

Many small states also depend on technical assistance from the World Bank, the IMF, and their development partners to make up for their generally limited government capacity. The global community helps develop the institutional capacity of small states through training in a variety of areas related to governance and policy analysis. This includes providing technical support on specialized subjects such as procurement, financing, data collection, climate change adaptation, integration with the global financial system, and other topics needed for the implementation of structural reforms. As the challenges of climate change become more pronounced, the need for technical assistance on climate-related budgeting and financing is likely to expand.

**Open, rules-based trade, investment, and migration networks.** Very high levels of trade openness mean small states are likely to experience magnified negative effects from disruptions to global trade and investment networks. For



example, the proliferation in food-related export restrictions since Russia's invasion of Ukraine is likely to have severe consequences for the one-fifth of small states that import food worth more than 10 percent of GDP (Espitia, Rocha, and Ruta 2022). The global community can therefore support the revival of small-state economies by promoting open, rules-based trade and investment frameworks, including intra-regional frameworks among small states. Migration policies can also be tailored to ensure mutually beneficial movement of workers where possible—for example, in circumstances where temporary migration can reduce labor shortages in the host country and support human capital formation and remittance flows for the home country (Gibson and McKenzie 2011).

**Climate change.** Small states are responsible for a minuscule proportion of global greenhouse gas emissions but bear a disproportionate share of the costs arising from extreme weather events. The greatest contribution the global community can make to small states' long-term prospects is to fully implement climate agreements reached in international fora to limit the rise in global temperatures, sea levels, and other climate-related changes. Nonetheless, more extreme and more frequent weather events will likely be reflected in rising risk premia for borrowing by small states, which could act as a long-term drag on needed investment to adapt to climate change. Because these costs stem from activity outside small states, the global community should continue to provide concessional insurance and other financing

subsidies to help small states manage climate vulnerabilities.

Providing specialized climate-related financing to small states is already a growing area of activity (Piemonte 2021). Numerous multilateral and bilateral climate financing facilities, such as the Green Climate Fund and the Global Environment Facility, are available to provide grant-based and concessional financing for disaster and climate resilience. With the support of the international community, several small states have been able to issue green (Fiji) and blue (Belize, the Seychelles) bonds to support environmental and climate resilience. However, commitments from these sources have been lower than needs and uneven across countries (Fouad et al. 2021).

With policy frameworks in place to help mobilize climate-related revenue streams and mitigate some lender risks through targeted guarantees, the private sector also has the potential to play a much larger role in providing climate- and disaster-related financing. For example, some small states may be able to develop effective carbon sequestration and offset programs, which can provide new revenue to fund up-front investments (Claes et al. 2022). The international community could also focus assistance on upstream technical capacity and early project preparation, to ensure a pipeline of bankable projects. Such measures could help ensure international financing supports domestic transitions to renewable energy, an area where small states are lagging relative to other EMDEs.

**TABLE 4.1 EMDE small states, by type**

	Tourism reliant (22)	Commodity importers (22)	Agriculture exporters (7)	Energy exporters (7)	FCS (6)	Islands (28)	Land- locked (2)	Fixed exchange rates (35)	Remittance reliant (9)
Antigua and Barbuda	X	X				X		X	
Bahamas, The	X	X				X		X	
Bahrain	X			X		X		X	
Barbados	X	X				X		X	
Belize	X		X					X	
Bhutan				X			X	X	
Brunei Darussalam				X				X	
Cabo Verde	X		X			X		X	X
Comoros			X		X	X		X	X
Djibouti		X						X	
Dominica	X	X				X		X	
Equatorial Guinea				X				X	
Eswatini		X					X	X	
Fiji	X		X			X		X	
Grenada	X	X				X		X	
Guyana				X				X	X
Kiribati		X				X		X	X
Maldives	X	X				X		X	
Marshall Islands	X	X			X	X		X	X
Mauritius	X	X				X			
Micronesia, Fed. Sts.	X	X			X	X		X	
Montenegro	X	X						X	X
Nauru		X				X		X	X
Palau	X	X				X		X	
Samoa	X	X				X		X	X
São Tomé and Príncipe			X			X		X	
Seychelles	X		X			X			
Solomon Islands			X		X	X		X	
St. Kitts and Nevis	X	X				X		X	
St. Lucia	X	X				X		X	
St. Vincent and the Grenadines	X	X				X		X	
Suriname								X	
Timor-Leste				X	X	X		X	
Tonga	X	X				X		X	X
Trinidad and Tobago				X		X		X	
Tuvalu		X			X	X		X	
Vanuatu	X	X				X		X	

Sources: UN World Tourism Organization; IMF Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) database; World Bank.

Note: FCS = fragile and conflict-affected situations. Tourism-reliant countries are those with inbound tourism expenditure as a share of GDP during 2015-19 above the 3rd percentile of the share in all EMDEs, based on UN World Tourism Organization data. Agriculture-exporting and energy-exporting economies are those where exports of agriculture or energy commodities accounted for 20 percent or more of total exports, on average, in 2017-19. Economies that meet these thresholds as a result of re-exports are excluded. The six countries classified as FCS as of the World Bank's fiscal year 2023 were also considered FCS for at least 10 years during fiscal years 2006-23. Fixed exchange rates include managed arrangements, pegs within horizontal bands, crawl-like arrangements, crawling pegs, stabilized arrangements, conventional pegs, currency boards, and the absence of a country-issued legal tender. Remittance-reliant countries are those with remittance inflows as a share of GDP during 2015-20 above the 75th percentile of all EMDEs (that is., above 8 percent of GDP), based on World Bank data.

**TABLE 4.2 Real GDP for EMDE small states<sup>1</sup>**

(Percent change from previous year)

Percentage point difference  
from June 2022 projections

	2020	2021	2022e	2023f	2024f	2022e	2023f	2024f
<b>EMDE small states (excluding Guyana)</b>	-11.2	4.6	5.2	3.5	3.1	0.9	-0.2	-0.1
Bahamas, The	-23.8	13.7	8.0	4.1	3.0	2.0	0.0	0.0
Bahrain	-4.9	2.2	3.8	3.2	3.2	0.3	0.1	0.1
Barbados	-13.7	0.7	10.0	4.8	3.9	-1.2	-0.1	0.9
Belize	-13.7	16.3	3.5	2.0	2.0	-2.2	-1.4	0.0
Bhutan <sup>2</sup>	-2.3	-3.3	4.6	4.1	3.7	0.2	-0.6	-3.0
Cabo Verde	-14.8	7.0	4.0	4.8	5.7	-1.5	-1.3	-0.3
Comoros	-0.3	2.2	1.4	3.3	3.8	-1.4	0.2	0.1
Djibouti	1.2	4.3	3.6	5.3	6.2	0.3	0.1	0.0
Dominica	-16.6	6.5	5.8	4.6	4.6	-1.0	-0.4	0.0
Equatorial Guinea	-4.9	-1.6	3.2	-2.6	-3.4	1.4	0.0	-1.3
Eswatini	-1.6	7.9	1.1	2.6	2.7	-0.9	0.8	0.9
Fiji	-17.0	-5.1	15.1	5.4	3.4	8.8	-2.3	-2.2
Grenada	-13.8	4.7	5.8	3.2	3.0	2.0	-0.2	-0.1
Guyana	43.5	20.0	57.8	25.2	21.2	9.9	-9.1	17.4
Kiribati	-0.5	1.5	1.5	2.3	2.1	-0.3	-0.2	-0.2
Maldives	-33.5	41.7	12.4	8.2	8.1	4.8	-2.0	1.0
Marshall Islands <sup>2</sup>	-2.2	1.1	1.5	2.2	2.5	-1.5	-0.2	-0.1
Mauritius	-14.6	3.6	5.8	5.5	4.2	-0.1	-0.5	0.3
Micronesia, Fed. Sts. <sup>2</sup>	-1.8	-3.2	-0.5	3.0	2.5	-0.9	-0.2	0.6
Montenegro	-15.3	13.0	5.9	3.4	3.1	2.3	-1.3	-0.6
Nauru <sup>2</sup>	0.7	1.5	0.9	1.9	2.8	0.0	-0.7	0.4
Palau <sup>2</sup>	-9.7	-17.1	-2.5	18.2	4.5	-9.7	2.0	0.0
Samoa <sup>2</sup>	-3.1	-7.1	-6.0	4.0	3.5	-5.7	1.5	-0.3
São Tomé and Príncipe	3.1	1.8	1.1	2.1	2.4	-1.7	-0.9	-0.9
Seychelles	-7.7	7.9	11.0	5.2	4.8	6.4	-0.5	-0.2
Solomon Islands	-3.4	-0.2	-4.5	2.6	2.4	-1.6	-2.7	-1.4
St. Lucia	-24.4	11.9	8.9	4.4	3.2	2.5	-0.8	-0.1
St. Vincent and the Grenadines	-5.3	0.7	5.0	6.0	4.8	1.3	-0.4	1.6
Suriname	-16.0	-2.7	1.3	2.3	3.0	-0.5	0.2	0.3
Timor-Leste <sup>3</sup>	-8.6	2.9	3.0	3.0	3.0	0.6	0.2	0.0
Tonga <sup>2</sup>	0.5	-2.7	-1.6	3.3	3.2	0.0	0.1	0.0
Tuvalu	-4.9	0.3	3.0	3.5	4.0	-0.5	-0.3	0.0
Vanuatu	-5.4	0.5	2.2	3.4	3.5	0.2	-0.7	-0.2
<b>EMDE small states memorandum items:<sup>4</sup></b>								
East Asia and Pacific	-10.1	-2.9	5.6	4.4	3.2	2.7	-1.2	-1.1
Latin America and the Caribbean (excluding Guyana)	-19.0	7.2	6.9	4.0	3.3	0.6	-0.2	0.2
Sub-Saharan Africa	-8.8	2.7	4.2	2.2	1.7	0.5	-0.2	-0.2
Tourism reliant	-12.9	5.7	6.1	4.3	3.8	1.1	-0.3	0.1
Commodity importers	-16.1	8.8	6.3	4.8	4.1	0.8	-0.3	0.3
Commodity exporters (excluding Guyana)	-7.1	1.4	4.3	2.4	2.2	1.0	-0.2	-0.6
Fragile and conflict-affected states	-4.1	1.2	-0.1	2.9	3.0	-0.9	-0.8	-0.3

Source: World Bank.

Note: e = estimate; f = forecast. World Bank forecasts are frequently updated based on new information. Consequently, projections presented here may differ from those contained in other World Bank documents, even if basic assessments of countries' prospects do not differ at any given date. Brunei Darussalam, Guyana, and Trinidad and Tobago are excluded from cross-country macroeconomic aggregates.

1. Headline aggregate growth rates are calculated using GDP weights at average 2010-19 prices and market exchange rates.

2. For the following countries, values correspond to the fiscal year: Bhutan (July 1-June 30); the Marshall Islands, the Federated States of Micronesia, and Palau (October 1-September 30); Nauru, Samoa, and Tonga (July 1-June 30).

3. Values for Timor-Leste reflect non-oil GDP.

4. East Asia and Pacific includes Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, Palau, Samoa, the Solomon Islands, Timor-Leste, Tonga, Tuvalu, and Vanuatu. Latin America and the Caribbean includes Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Suriname. Sub-Saharan Africa includes Cabo Verde, Comoros, Equatorial Guinea, Eswatini, Mauritius, São Tomé and Príncipe, and Seychelles. Remaining groups include EMDEs as classified in table 4.1. Commodity exporters include agriculture, energy, and metal (Bhutan and Suriname) exporters.

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