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## 2024 STAFF GUIDANCE NOTE ON THE IMF'S ENGAGEMENT WITH SMALL DEVELOPING STATES

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**International Monetary Fund  
Washington, D.C.**



July 8, 2024

## 2024 STAFF GUIDANCE NOTE ON THE IMF'S ENGAGEMENT WITH SMALL DEVELOPING STATES

### EXECUTIVE SUMMARY

This guidance note provides operational guidance on the Fund's engagement with small developing states (SDS). It highlights the unique economic characteristics and constraints facing SDS, notably in a more shock-prone world. Building on advice that applies to the full membership, the note explains how the characteristics of SDS shape Fund surveillance, financial support and program design, capacity development (CD), and collaboration with other institutions and donors. The note updates the previous [version](#) that was published in December 2017.

The note centers on five thematic areas for policy dialogue with SDS: (i) Promoting Sustained, Inclusive and Resilient Growth and Job Creation; (ii) Confronting Risks and Building Resilience; (iii) Strengthening Fiscal Frameworks and Debt Sustainability; (iv) Enhancing Monetary and Exchange Rate Policy Frameworks; and (v) Deepening the Financial Sector While Ensuring Strong Oversight. It outlines the evolving areas of engagement of the IMF and their applications to SDS, including climate change, gender and inclusive growth, governance, and digitalization. It also provides advice to country teams on tailoring the latest Fund's guidance on surveillance, CD, and lending to SDS circumstances, including on the use of toolkits and addressing data gaps. To enhance strategic engagement and improve traction, which is critical to the success of IMF policy advice, the note also introduces novel guidance for strategic engagement with SDS in the form of a Country Engagement Box for Article IV staff reports.

In applying this guidance, staff should continue to tailor their engagement to specific country circumstances.

### What is new in the 2024 Staff Guidance Note on the IMF's Engagement with Small Developing States?

*This box highlights the main changes from, and additions to, the content of 2017 Staff Guidance Note on the Fund's Engagement with Small Developing States (SDS). This guidance note:*

- Outlines the new areas of engagement of the IMF and their applications to SDS, including on climate change, gender and inclusive growth, governance, and digitalization.
- Helps country teams tailor the latest Fund guidance on surveillance, lending, and capacity development to SDS circumstances, including on the use of toolkits.
- Stresses the importance of traction and discusses good practices in supporting traction with SDS members.
- Provides updated guidance to country teams on engagement with development partners.
- Provides guidance for SDS teams on preparing a Country Engagement Box for Article IV Staff Reports.

These innovations result from the Management Implementation Plan in response to the Board-Endorsed Recommendations from the Independent Evaluation Office Evaluation Report on IMF Engagement with Small Developing States, and are also outlined in the table below:

Topics with Main Updates	Paragraphs
Surveillance: evolving macro-critical issues	
Climate	¶18, ¶120 - 28
Digitalization	¶36, ¶49, ¶68
Growth and Inclusion	¶10, ¶13, ¶15, ¶16, ¶17, ¶35
Industrial Policy	¶14
Gender	¶19, Annex III
Governance	¶11, ¶18
Financial Integrity	¶142 - 48
Integrated Policy Framework	¶40, ¶41
Statistical issues	¶158 - 60, Annex V
CD: integration into surveillance and lending	¶55, ¶56, ¶161 - 63, ¶82, ¶83, Annex II
Lending	
Tailoring program conditionalities	¶180 - 85
Focus on growth and resilience	¶180 - 82
Resilience and Sustainability Facility	¶177 - 79
Climate diagnostics	¶67
Core surveillance toolkits	¶52, ¶53
Coordination with partners	¶86, ¶87
Traction	¶154 - 57

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## CONTENTS

Glossary	6
<b>INTRODUCTION</b>	<b>8</b>
<b>CHARACTERISTICS OF SMALL DEVELOPING STATES</b>	<b>9</b>
<b>PRIORITIES FOR POLICY DIALOGUE</b>	<b>14</b>
A. Promoting Sustained, Inclusive, and Resilient Growth and Job Creation	14
B. Confronting Climate Risks and Building Resilience	17
C. Strengthening Fiscal Frameworks and Debt Sustainability	21

D. Enhancing Monetary and Exchange Rate Policy Frameworks	24
E. Deepening the Financial Sector While Ensuring Strong Oversight	26
<b>SURVEILLANCE AND ANALYTICAL WORK</b>	<b>29</b>
A. Tailoring Surveillance Policies	30
B. Challenges and Opportunities in Engaging with SDS	33
<b>CAPACITY DEVELOPMENT</b>	<b>37</b>
A. Integrating CD with Surveillance and Lending	37
B. Aligning CD with Absorptive Capacity of SDS	38
C. Developing CD in Areas of Special Interest to SDS	41
<b>LENDING AND PROGRAM DESIGN</b>	<b>42</b>
A. Facilities and Instruments Most Relevant for SDS	43
B. Non-Financing Instruments and Track-Record Building	44
C. Resilience and Sustainability Facility	45
D. Key Considerations for Program Design	46
E. Tailoring Conditionality and Leveraging Flexibility in Program Design	47
<b>COORDINATION WITH DEVELOPMENT PARTNERS</b>	<b>47</b>
<b>BOXES</b>	
1. Small Developing States and Subgroupings	8
2. Is the Green Energy Transition a Win-Win for SDS	19
3. Citizenship and Residency by Investment Programs	22
4. Digital Money: Opportunities and Challenges for SDS	29
5. External Sector Assessments for SDS	31
6. Debt Sustainability Analysis for SDS	32
7. Assessing Growth-at-Risk in SDS	35
8. The Use of AIS Data in Surveillance	36
9. Training to Build Capacity for TA, Surveillance, and Lending in SDS: A Regional Approach	40
<b>FIGURES</b>	
1. Growth Decline in 2009 and 2020	11
2. Vulnerabilities to Climate Change	12
3. Median Gender Gaps in SDS	16
<b>TABLES</b>	
1. Selected Indicators for Different Country Groupings	10
2. Selected Indicators for SDS Subgroupings	14

3. Exchange Rate Arrangement of Small Developing States	24
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**ANNEXES**

I. Definitions of Small States	49
II. Guidance on the SDS Country Engagement Box	52
III. Intentional Gendered Policies Can Help Address SDS-specific Issues	54
IV. Recent Fund Program Engagement with SDS	56
V. Data Gaps in SDS	58
References	60

## Glossary

AE	Advanced Economy
AML/CFT	Anti-Money Laundering and Combatting the Financing of Terrorism
ARA	Assessment of Reserve Adequacy
BoP	Balance of Payments
C-PIMA	Climate Public Investment Management Assessment
CARTAC	Caribbean Regional Technical Assistance Center
CBDC	Central Bank Digital Currency
CBI	Citizenship By Investment
CBR	Correspondent Banking Relationship
CD	Capacity Development
CDMAP	CD Management and Administration Program
CES	Country Engagement Strategy
CID	Climate Change Indicators Dashboard
CFM	Capital Flow Management
CMT	Climate Macroframeworks Toolkit
DSA	Debt Sustainability Analysis
DIGNAD	Debt-Investment-Growth and Natural Disasters
DSF	Debt Sustainability Framework
e-GDDS	Enhanced General Data Dissemination System
EBA	External Balance Assessment
ECF	Extended Credit Facility
EM(E)	Emerging Market (Economy)
EF	Emergency Financing
EFF	Extended Fund Facility
ESA	External Sector Assessment
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicator
FSSR	Financial Sector Stability Review
FCS	Fragile and Conflict-affected State(s)
GRA	General Resources Account
ICT	Information and Communications Technology
IDA	International Development Association
IDB	Inter-American Development Bank
IFI	International Financial Institution
IPF	Integrated Policy Framework
IT	Indicative Target
IV	The Institutional View on the Liberalization and Management of Capital Flows
LIC	Low-Income Country
LIDC	Low-Income and Developing Country
LTX	Long-Term Expert
MDB	Multilateral Development Bank
MPM	Macroprudential Measure

MTRS	Medium-Term Revenue Strategy
MTW	Medium-Term Workplan
NDC	Nationally Determined Contributions
ND-DDT	Natural Disaster-Public Debt Dynamics Tool
ODA	Official Development Assistance
OECD	Organization of Economic Cooperation and Development
PCI	Policy Coordination Instrument
PFTAC	Pacific Financial Technical Assistance Center
PIMA	Public Investment Management Assessment
PPFG	Post-Program Financing Gaps
PFM	Public Financial Management
PPP	Public Private Partnership
PRGT	Poverty Reduction and Growth Trust
RBI	Residency By Investment
RBM	Results-Based Management
RCDC	Regional Capacity Development Center
RCF	Rapid Credit Facility
REER	Real Effective Exchange Rate
REO	Regional Economic Outlook
RFI	Rapid Financing Instrument
RM	Reform Measure
RSF	Resilience and Sustainability Facility
RST	Resilience and Sustainability Trust
SB	Structural Benchmark
SBA	Stand-by Arrangement
SDDS	Special Data Dissemination System
SDG	Sustainable Development Goal(s)
SDR	Special Drawing Rights
SDS	Small Developing State(s)
SIDS	Small Island Developing State(s)
SIP	Selected Issues Paper
SNA	System of National Accounts
SRDSF	Sovereign Risk and Debt Sustainability Framework
STX	Short-Term Expert
TA	Technical Assistance
TADAT	Tax Administration Diagnostic Assessment Tool
UCT	Upper Credit Tranche
UN	United Nations
WP	Working Paper



## INTRODUCTION

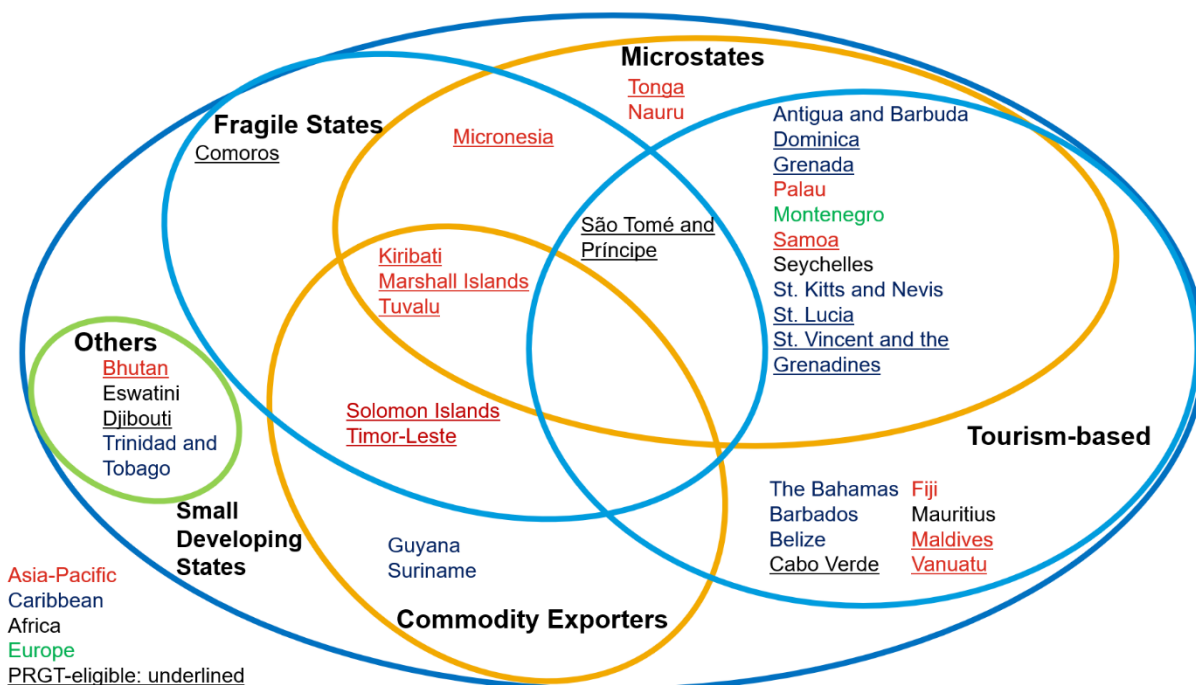
### 1. The Guidance Note (GN) focuses on engagement with small developing states (SDS).

The Fund has 43 small state members with a population under 1.5 million, of which 34 are considered SDS after removing advanced economies and high-income fuel exporters (Box 1; see Annex I for more details). This GN also applies to “microstates,” a subset of SDS with population of less than 200,000. In practice, many countries with population of more than 1.5 million also have characteristics of “smallness” and may find this GN relevant. The World Bank (WB) engages with small states through the Small States Forum (SSF), which includes 50 states, while the Small Island Developing States (SIDS) grouping of the United Nations (UN) consists of 39 UN member states. The concept of SDS is also different from the one of a “small state,” which is used in Fund operational activities. Annex I clarifies the difference between these concepts.

#### Box 1. Small Developing States and Subgroupings

The set of small developing states can usefully be divided into several sub-groupings:

- **Tourism-based countries** are those where international tourism arrival receipts exceed 15 percent of GDP and 25 percent of total exports, based on the World Bank’s World Development Indicators data.
- **Commodity exporters** are SDS that have fuel or nonfuel primary products as the main source of export earnings (SDS in Table D of the World Economic Outlook Statistical Appendix, [April 2024](#)).
- **Fragile states** are SDS classified as Fragile and Conflict-affected States by the IMF ([FY24 list](#)).
- **Microstates** are defined as having populations below 200,000.
- Four countries do not fall into the above analytical groupings—Bhutan, Djibouti, Eswatini, and Trinidad and Tobago.



**2. The GN provides updated operational guidance to staff on engagement with SDS.** It supersedes the [2017 GN](#) (IMF 2018a), as envisaged in the [Management Implementation Plan](#) (IMF 2023c) in response to the Board-Endorsed Recommendations from the [Independent Evaluation Office Evaluation Report on IMF Engagement with Small Developing States](#) (IEO 2022). The update aims to: (i) outline the new areas of engagement of the IMF and its applications to SDS, including on climate change, gender and inclusive growth, governance, and digitalization; (ii) help country teams tailor the latest Fund's guidance on surveillance, lending, and capacity development (CD) to SDS circumstances, including on the use of toolkits; (iii) stress the importance of traction and discuss good practices in supporting traction with SDS members; and (iv) provide updated guidance to country teams on engagement with development partners. The updated GN features country examples and thematic boxes. The GN also includes guidance on a Country Engagement Box for Article IV staff reports (Annex II).

**3. The GN is organized as follows:** section 2 describes the unique economic characteristics of SDS, while noting important heterogeneity across countries, and section 3 presents the resulting priorities for policy dialogue. Sections 4 to 6 outline operational guidance on Fund engagement with SDS on surveillance, CD, and financial support and program design, with reference to existing GNs on specific topics. Section 7 covers collaboration with other institutions and donors. In applying this guidance, staff should further tailor their engagement to specific country circumstances.

## CHARACTERISTICS OF SMALL DEVELOPING STATES

*Smallness is a fundamental characteristic of SDS. It prevents SDS from benefiting from economies of scale while amplifying their vulnerability to shocks affecting the entire country. Capacity constraints are prevalent in many SDS, impeding their ability to conduct policies. SDS are also disproportionately vulnerable to climate change. Nevertheless, SDS remain a diverse country group.*

**4. Smallness—due to both small land area and population size—is the fundamental characteristic of SDS.** It brings about several characteristics that are common to most SDS: lack of economies of scale and higher vulnerability to shocks, a higher degree of openness compared to emerging markets (EMs) and low-income developing countries (LIDCs), high exposure to climate change and natural disasters, and the scarcity of natural endowment compared to larger countries (for instance, arable land, biodiversity, variety of minerals). The public sector has a more prominent role in most SDS, and SDS authorities face more severe capacity constraints than average LIDCs. Table 1 shows selected macroeconomic indicators of SDS versus other country groupings.

**Table 1. Selected Indicators for Different Country Groupings**

Indicators / Country Groups <sup>1</sup>	SDS	AE	EM	LIDC
<b>Average</b>				
Gross National Income per capita <sup>2</sup>	7,270	49,240	7,270	1,370
Real GDP per capita growth <sup>3</sup>	1.7	1.5	2.2	2.2
Inflation <sup>2</sup>	3.1	2.3	3.8	6.0
Primary balance	-0.8	-0.5	-0.3	-1.4
Gross expenditure	30.4	40.9	29.6	20.7
Gross revenue	27.5	38.8	26.7	17.7
o/w: tax revenue	17.6	25.4	17.6	11.3
Gross public debt (2010-23)	55.6	56.7	49.4	40.6
between 2010-19	52.3	56.4	44.8	36.2
Trade openness <sup>4</sup>	98.4	97.2	85.2	58.7
Current account balance	-6.8	1.0	-2.6	-4.6
o/w: trade balance	-15.7	2.0	-3.3	-11.2
Chinn-Ito Index <sup>5</sup>	0.45	0.97	0.49	0.32
Reserve adequacy <sup>6</sup>	4.0	2.3	4.9	3.7
ODA	6.3	N/A <sup>7</sup>	N/A <sup>7</sup>	7.1
Credit to private sector	44.2	105.1	42.1	13.7
Human Development Index <sup>8</sup>	0.73	0.93	0.76	0.55
Gender Development Index <sup>8</sup>	0.98	0.98	0.98	0.92
Gender Inequality Index <sup>8</sup>	0.35	0.07	0.33	0.54
<b>Volatility<sup>9</sup></b>				
Real GDP per capita growth	5.1	3.1	4.2	3.2
Primary balance	4.0	2.9	2.9	2.7
Current account balance	7.8	3.0	4.9	4.7
Trade balance	8.8	3.2	5.8	6.2
Balance of income flows <sup>10</sup>	4.3	1.3	2.9	3.1

Source: World Economic Outlook (April 2024 Vintage) and IMF staff calculation.

1/ Indicators are the average of group median between 2000-23 and in percent of GDP, unless otherwise indicated. Country groups abbreviations: SDS, small developing states; AE, advanced economies; EM, emerging markets; LIDC, low-income developing countries.

2/ For the year 2022, by the Atlas method and in current U.S. dollar.

3/ In percentage points.

4/ Trade openness is defined as the sum of export and import in percent of GDP.

5/ The index (Chinn and Ito 2006) measures a country's degree of capital account openness; normalized to range between zero and one. Mean of 2021 is reported.

6/ In month of prospective imports.

7/ Not applicable to these countries.

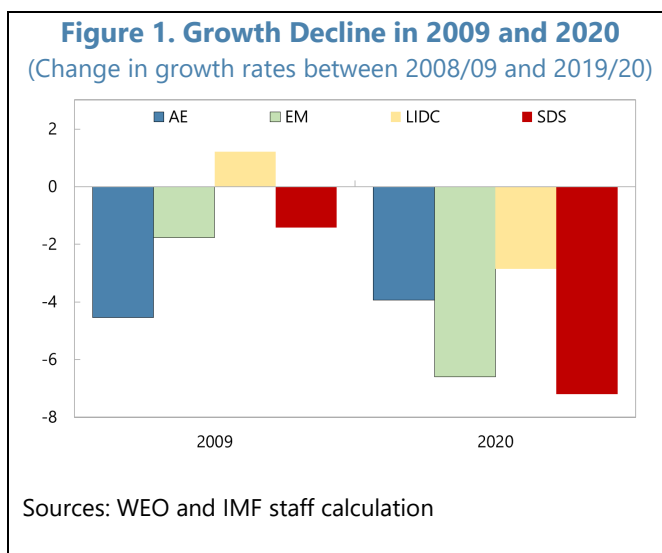
8/ For the year 2022.

9/ Standard deviation of group median over 2000-23.

10/ Sum of primary income and secondary income.

**5. Many SDS are also island countries which face unique development challenges due to their remoteness and internal geography.** Among the 34 SDS, 26 are island countries that are remote, have small land area, or are archipelagos dispersed over a broad ocean area; notably, all 14 microstates are island countries. Remoteness leads to significant distance to global economic activity centers, limiting their access to markets, financing, and technology; while geographic fragmentation hinders the development of domestic markets and institutions, investment in domestic infrastructure (transportation, sanitation, education, communication) and provision of public services in a cost-effective way. These limitations, in turn, magnify challenges originating from smallness.

**6. Due to the lack of economies of scale, SDS often have a narrow economic base which limits their growth potential while amplifying macroeconomic volatility.** The lack of economies of scale in SDS represents a powerful barrier to entry for producers of tradable goods, impeding private sector development and limiting economic diversification prospects. Twenty-one of the 34 SDS rely on a single driver of growth (tourism, agriculture, or exports of a single commodity) with a few more having a large financial sector. While average real GDP per capita growth in SDS is only somewhat smaller than that of EMs and LIDCs, growth in SDS economies is significantly more volatile than in these two country groups. The volatility is reflected in the growth impact of the COVID-19 pandemic and the global financial crisis when SDS experienced a much higher decline in growth rates than those observed in LIDCs (Figure 1).



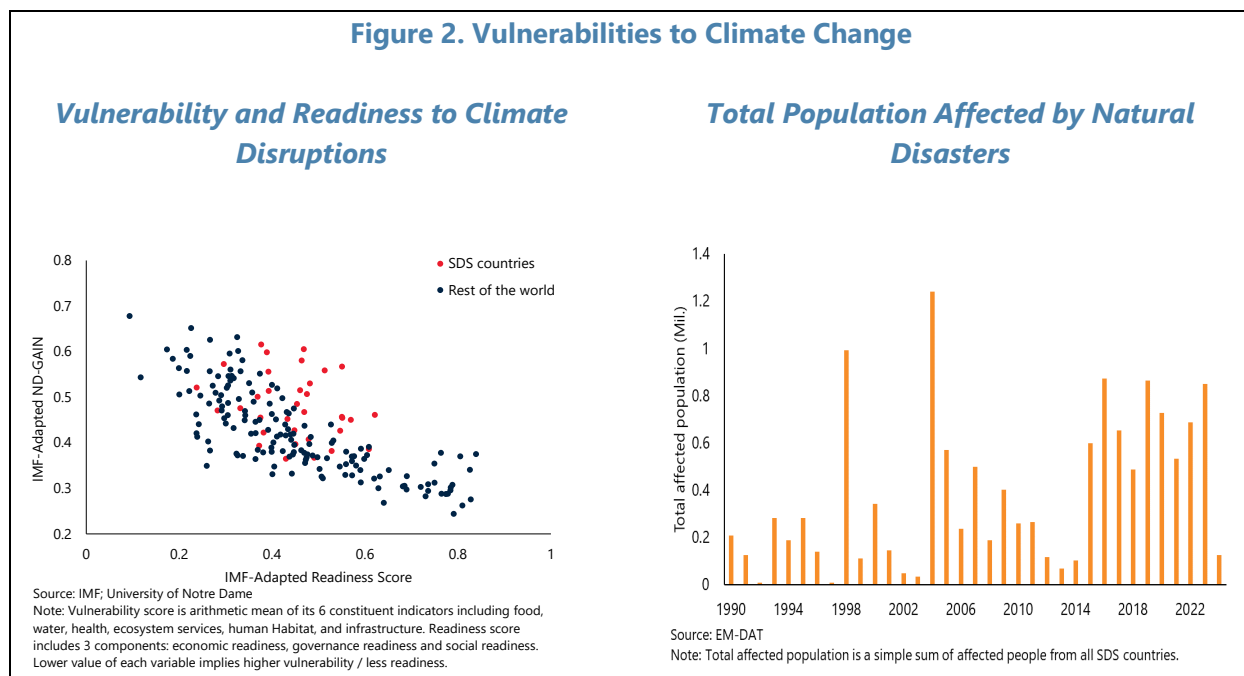
**7. Narrow domestic production base leads to a high reliance on imports, leaving SDS exposed to external macroeconomic shocks.** Trade openness of SDS is nearly twice as high as that of LIDCs, and SDS have higher current account and trade deficits.<sup>1</sup> Between 2000-23, the average trade deficit (in percent of GDP) in SDS was almost 10 percentage points larger than the current account deficit, suggesting a prominent role of income flows (e.g., remittances or official grants from development partners) in financing the current account. The large current account deficit in SDS is characterized by a level of volatility exceeding those in EMs and LIDCs, and is driven by less predictable trade and income flows. Despite a more volatile external sector, SDS tend to hold a similar level of reserves as LIDCs—an average of 4 months of imports between 2000-23, but lower than the 5-month average of EMs.<sup>2</sup> Notably, reserves in SDS have been increasing since the mid-2000s. Most SDS are also highly dependent on imported fossil fuels for their power systems, which makes them vulnerable to oil price volatility, stressing the need for investment in lower-cost and lower-carbon energy production.

**8. Despite their minimal contribution to global warming, SDS are also disproportionately vulnerable to shocks and spillovers originating from climate change (Figure 2).** Small island states are especially vulnerable to risks originating from sea level rise: they may lose a substantial share of their land and capital due to rising sea levels, and their population will be exposed to floods and storm surges. Natural disasters also pose a great threat to SDS: between 1960-2020, SDS

<sup>1</sup> For the 7 SDS classified as commodity exporters, the current account deficit is smaller (an average of 2.4 percent of GDP between 2000-23).

<sup>2</sup> Please see ¶139 and Box 5 for more information on other measures of reserve adequacy.

accounted for 55 percent of global natural disasters causing 20–30 percent of GDP in damages and 70 percent of natural disasters with damages exceeding 30 percent of GDP (IEO 2022). The impact of repeated disasters and potential negative effects of climate change on productivity may contribute to lower medium term growth prospects. On average, severe natural disasters are likely to raise government expenditures: e.g., in a sample of twelve Pacific Island countries, natural disasters raised government spending by 14–21 percent of GDP over three years (Nishizawa and others 2019, IMF 2024c). Climate change and natural disasters may also disrupt food supply, raise food imports and transport costs, fuel food price inflation, and exacerbate food insecurity.



**9. The role of the public sector tends to be large.** The relatively large size of public sectors in SDS—exceeding those in LIDCs—originated in efforts to fill gaps where the private sector was deterred by small market size and to provide social protection against external shocks; high fixed costs associated with providing public services contributed as well. The impact of the public sector on the economy also comes from state ownership of key economic assets.

**10. Employment prospects tend to be weak and the informal economy large due to the under-developed private sector.** In many SDS, the public sector provides most of the formal sector employment while private sector opportunities remain limited. Estimates by the International Labour Organization (ILO) suggest that a median of one-third of total employment is informal.<sup>3</sup> Of the 23

<sup>3</sup> The data are calculated from the [ILO's SDG Labour Market Indicators](#) database. Using data of the latest available year, of which 21 SDS report, the median proportion of informal employment in total employment is 31.5 percent for SDS, compared to 1.7 percent for AEs, 28 percent for EMs and 82 percent for LIDCs. The pattern calculated using self-employment retrieved from the [World Development Indicators \(WDI\)](#), for which the coverage is more continuous, is similar: for the year 2022, the median level of self-employment as a proportion of total employment is 34 percent for SDS, compared to 13.7 percent for AEs, 31 percent for EMs, and 73 percent for LIDCs.

SDS for which the ILO provides unemployment rate estimates, 10 had double digit average unemployment rates between 2000-21, with a mean of 17.3 percent.<sup>4</sup> Unemployment was especially high among youth and women, resulting in low levels of inclusiveness in the economy. On average, the performance of SDS on gender equality appears to be better than LIDCs' as measured by the Gender Development Index and Gender Inequality Index (Table 1). The moderate level of the Human Development Index indicates the equally critical need for development for men and women.

**11. Capacity constraints are common in SDS, presenting obstacles to establishing strong institutional frameworks in many areas.**<sup>5</sup> Many institutions suffer from institutional under-staffing, especially of well-trained staff, which is further exacerbated by high staff turnover and emigration of qualified staff. This may impact institutional ability to conduct fiscal, monetary, exchange rate and financial policies; data limitations also tend to be more acute. State regulation, combined with weak institutional capacity, can increase opportunities for rent-seeking in some SDS, and elevate governance and corruption risks in state functions relevant for economic activity. Taken together, these constraints can hinder private sector development and add to labor market challenges.

**12. Despite many common characteristics, SDS remain a very diverse group.** For example, Caribbean SDS are, on average, richer and rely more heavily on tourism, while Pacific Island SDS are much less developed and host most of the SDS fragile states. Much of variation across these regions is also associated with the difference in income levels. Lower income SDS tend to have larger public sectors, run higher fiscal deficits, and depend more heavily on non-tax revenue. They also receive a larger amount of official development assistance (ODA). Meanwhile, higher income countries have accumulated a larger stock of public debt, which is especially high in the Caribbean SDS. This is possibly due to higher debt carry capacity but could also reflect their closer links to international financial markets. Trade openness is similar across all country groups, but lower income SDS tend to run much higher trade deficits, though only microstates stand out as having higher current account deficits than others. Finally, credit to private sector is particularly low in lower income SDS. Table 2 shows selected macroeconomic indicators of SDS subgroupings.

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<sup>4</sup> The estimates are calculated from the [WDI](#). By subcategory, unemployment tends to be more severe for lower-income and tourism-dependent SDS. ILO has unemployment estimates for only 3 microstates.

<sup>5</sup> In numeric scale, using the average of all the 20 indicators in the World Bank's Country Policy and Institutional Assessment (CPIA) database, the median CPIA score for all SDS covered by the database (19 PRGT eligible SDS plus Guyana and Fiji) is 3.25. As a benchmark, the median for all countries in the data is 3.21 for 2022, with the minimum and maximum values being 1.6 and 4.1, respectively.

**Table 2. Selected Indicators for SDS Subgroupings**

Indicators / Country Groups <sup>1</sup>	SDS	Caribbean	Pacific	Higher income	Lower income	Microstates
Gross National Income per capita <sup>2</sup>	6,675	9,810	4,255	9,360	3,225	8,450
Real GDP per capita growth <sup>3</sup>	1.7	1.4	1.7	1.5	1.7	1.6
Inflation <sup>3</sup>	3.1	2.3	3.2	2.8	3.5	2.3
Primary balance	-0.8	-0.5	-0.8	-0.4	-1.4	0.1
Gross expenditure	30.4	27.3	39.9	29.7	33.1	38.0
Gross revenue	27.5	23.5	40.5	26.5	30.1	36.7
o/w: tax revenue	17.6	18.5	16.1	18.5	14.8	18.4
Gross public debt	51.6	67.9	35.5	58.1	35.6	55.9
Trade openness <sup>4</sup>	98.4	95.5	101.9	103.0	91.6	109.0
Current account balance	-6.8	-7.2	-6.7	-7.8	-4.8	-10.5
o/w: trade balance	-15.7	-4.8	-32.5	-10.5	-22.0	-39.2
Chinn-Ito Index <sup>5</sup>	0.45	0.34	0.47	0.42	0.49	0.49
ODA	6.3	1.9	14.5	2.7	12.4	8.8
Credit to private sector	44.2	51.6	35.8	50.9	24.1	50.5

Source: World Economic Outlook (April 2024 vintage) and IMF staff calculation.

1/ Indicators are the average of group median between 2000-23 and in percent of GDP, unless otherwise indicated.

2/ For the year 2022, by the Atlas method in current U.S. dollar.

3/ In percentage points.

4/ Trade openness is defined as the sum of export and import in percent of GDP.

5/ The index (Chinn and Ito 2006) measures a country's degree of capital account openness; normalized to range between zero and one. Mean of 2021 is reported.

## PRIORITIES FOR POLICY DIALOGUE

*Priorities due to the unique characteristics of SDS in a number of policy areas include promoting inclusive and resilient growth and job creation, confronting risks and building resilience, strengthening fiscal frameworks and debt sustainability, enhancing monetary and exchange rate policy frameworks, and deepening the financial sector while ensuring strong oversight. While tailored to country-specific circumstances and capacity, staff engagement with SDS in individual policy areas should remain guided, in the first instance, by operational guidance for the full membership, including the [Guidance Note for Surveillance Under Article IV Consultations](#) (IMF 2022a).*

### A. Promoting Sustained, Inclusive, and Resilient Growth and Job Creation

**13. Macro-critical reforms that help foster inclusive and sustained growth should focus on sectoral advice and be consulted with development partners where needed.** The frequent reliance on a single key driver of growth in many SDS requires country teams to acquire greater sectoral expertise and necessitates deeper sectoral analysis in staff reports than is the case for larger economies. Policy discussions should recognize growth and diversification challenges and discuss ways to deliver increased efficiency and improved productivity in single sector economies, and to diversify economies where possible. For detailed sector-specific advice, including on the use of industrial policy, country teams should also cooperate with development partners (see ¶¶86, 87). Due

to the typically high levels of foreign ownership in many sectors of the economy, staff analysis should pay special attention to distinguishing between GDP and GNI.

**14. While industrial policy can help address market failures when done right, the need for robust institutions can be particularly demanding in SDS given their capacity constraints.**

Countries may pursue industrial policies (“vertical policies”) to diversify their economies or foster green transition. Nevertheless, staff should first consider if policies that can improve the general business environment for all industries (“horizontal policies”) can be adopted. If industrial policy can be justified by well-defined market failures, staff should follow [IMF \(2024a\)](#) for overall guidance. Specifically, staff needs to evaluate carefully if the policy is well-designed with proper safeguards to mitigate incentives for rent seeking and corruption, where institutional weaknesses and governance vulnerabilities are elevated or macro-critical. For special economic zones, staff should analyze if they are suitably linked to the rest of the domestic economy, since diversification is usually limited in SDS economies ([IMF 2024a](#), ¶¶30, 31). Staff should also assess the fiscal implications from any introduced tax breaks or when state-owned enterprises play a dominating role in implementing the industrial policy ([IMF 2024a](#), ¶¶32-34).

**15. For some SDS, trade integration and cooperation (including within regions) could be of interest as a mechanism to enlarge market size and diversify risks (IMF 2018a, 136).**

Greater trade integration requires sustained efforts to reduce trade costs, including by upgrading trade-related infrastructure, and improving national and regional economic institutions ([IMF 2022a](#)). The importance of trade agreements for SDS—including access to broader and diversified markets, the value of regional trade agreements, their impact on local competition and prices paid by consumers—are useful policy considerations. The [2023 Review of the Role of Trade in the Work of the Fund](#) (IMF 2023h) provides guidance for open, stable, and transparent trade policies. Staff should help country authorities assess and address key trade-related challenges, including to identify opportunities and manage risks associated with trade disruptions and structural changes in the global economy, for example those driven by climate change, new technologies and geoeconomic fragmentation.

**16. Reforms to promote job creation and improve labor market outcomes can be macro-critical.**

Staff should analyze how public employment and public wages affect labor markets, and the process of wage settlements and contracting in the rest of the economy. Public wages and remittances benefit recipients but may create a reservation wage that undercuts the ability of the private sector to hire employees at competitive wage rates. Accordingly, consideration could be given to measures that appropriately calibrate the public sector wage bill to also help enhance the overall level of competitiveness and private sector job creation. At the same time, the long-term goal should be the virtuous cycle of larger contribution to growth from the private sector, stronger productivity growth, more and better paid private sector jobs, reduced informality, and reduced migration from better educated segments of the population. To address youth unemployment, staff should discuss policies to reduce labor market skills mismatches, including investments in education, improving access to secondary and tertiary education, and structural policies to improve labor market institutions, enhance labor market flexibility, and encourage job formality ([IMF, 2019](#)).

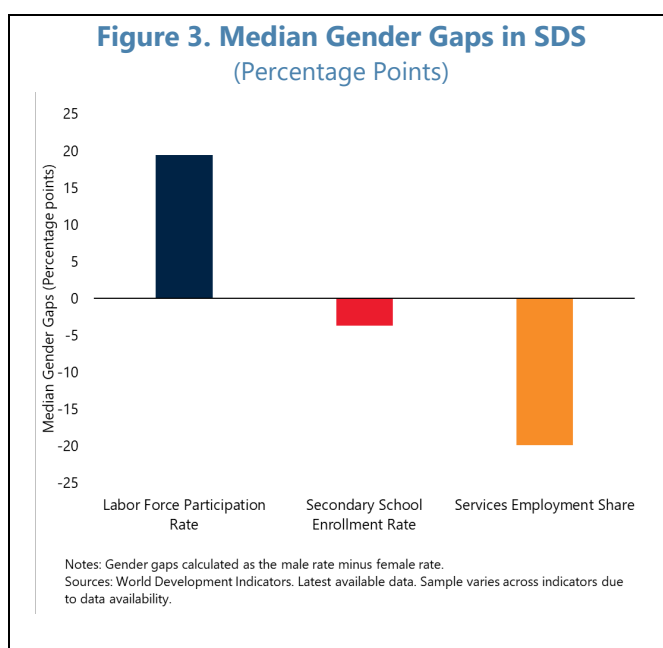


Facilitating access to finance by small- and medium-sized enterprises could also support their growth and strengthen job creation (see also ¶42).

**17. Outward migration could adversely impact labor market outcomes and thereby economic growth, although the associated remittances can mitigate the negative impact.** Staff should discuss policies to optimize opportunities associated with these flows. Challenges in finding jobs domestically cause significant seasonal outward migration and brain drain among the better-educated. Such emigration can limit the availability of skilled workforce needed for private sector-led growth and for public service provision, and reduce returns to education in the society. However, benefits from migration could also be derived, for instance, from remittances, which have helped to soften the pandemic-related shock to the balance of payments (BoP) in many SDS ([Kpodar and others 2021](#)).

**18. Good governance and efforts to address corruption vulnerabilities are critical for fostering sustainable, inclusive private sector led growth.** Staff teams' engagement on governance and corruption issues should be guided by the 1997 policy on [The Role of the IMF in Governance Issues](#) (IMF 1997) and the 2018 [Framework for Enhanced Fund Engagement on Governance](#) (IMF 2018d). Advice should be tailored to SDS characteristics, factoring in political economy constraints. Where capacity is limited, policy advice and program conditionality should be combined with tailored CD (see also ¶34, 36, 43, 49 and 66).

**19. Integrating gender considerations into public policy strategies that tackle SDS-specific issues can significantly enhance macroeconomic outcomes.** Staff advice should be guided by the [Interim Guidance Note on Mainstreaming Gender at the IMF](#) (IMF 2024b). Narrowing gender gaps can significantly increase economic efficiency and productivity, helping boost economic growth and strengthen resilience. By actively promoting female labor force participation, and entrepreneurship and (where relevant) narrowing gender gaps in opportunities (education, healthcare, social protection, access to finance, and legal rights), SDS can unlock the potential of an often-underutilized pool of talent. This can increase productivity, mitigate reliance on single sectors, diversify the export base, and enhance economic stability.<sup>6</sup> Raising women's digital literacy and access to digital finance in SDS can break



<sup>6</sup> As mentioned in ¶10, females in SDS sometimes outperform males on certain dimensions. For instance, the median of mean years of school for females and males are 9.3 and 9.1 years, respectively, compared to 4.6 and 6.3 years for LDCs, and 9.9 years for both females and males for EMs.

down barriers of remoteness and geographical fragmentation, enabling participation of women in the global digital economy. Implementing fiscal policy or infrastructure investment with a gender lens can ensure that reforms benefit the whole economy while addressing gender gaps in SDS (see Annex III). Data limitations may constrain the diagnosis and policy prescriptions.

## B. Confronting Climate Risks and Building Resilience

### *Climate Policies: Adaptation and Resilience Building*

**20. Policies to promote adaptation and strengthen resilience to climate change are most effective as part of a holistic development strategy, involving both the public and private sectors.** To enhance traction, teams could anchor policy advice in the existing plans of the SDS authorities. Fiscal policy reforms should aim to enable climate-resilient investment—important for sustainable growth going forward, and for attracting much needed private investment—and promote efficient private adaptation. Fiscal policy tools could include pricing instruments (e.g., natural resource or water pricing) and market mechanisms and reforms (e.g., establishment of water markets, removal of implicit and explicit subsidies). Reforms should also include programs that strengthen social safety nets, to protect the most vulnerable segments of the population. Adaptation reforms can overlap with countries' broader development agendas, particularly in the areas of clean water, sanitation, agriculture, and infrastructure; and can have synergies with reforms to strengthen institutions and promote better public investment management and infrastructure governance ([Bellon and Massetti 2022](#)). Staff should also discuss policies to remove barriers to adaptation by individuals and private firms, and to provide the incentives for private adaptation investment.

**21. Fiscal measures can help address climate-related risks and promote instruments that transfer and distribute risks.** To comprehensively address macroeconomic risk of climate change and natural disasters, vulnerable countries could develop comprehensive disaster resilience strategies. The strategy, ideally prepared in consultation with development partners and other stakeholders, would be grounded in a clear diagnostic of disaster vulnerabilities and rest on three pillars: structural, financial, and post-disaster/social resilience. Such a strategy would support ex-ante planning, provide a framework for coordinating work of development partners before and after disasters, and help catalyze donor support ([IMF 2019](#)). Country teams are also encouraged to discuss with SDS authorities' strategies to integrate adaptation into macro-fiscal policy frameworks and improve investment environment to attract private sector financing. Discussions on adaptation and resilience should be linked to Debt Sustainability Analysis (Box 5) and should consider policy implementation capacity and country's development context.

**22. Potential large long-term fiscal risks from sea-level rise deserve special consideration in small island states.** Macroeconomic impacts of sea-level rise could be large and even existential to many SDS. Coastal protection can be highly effective, but its public nature requires public financing, which may itself create large fiscal risks. More flexible approaches that include a mix of protection and planned relocation away from the coast can minimize fiscal pressures but would require long-term land use planning and may have complex ethical and distributional implications.

Staff teams could raise the issue of sea-level rise with the authorities and recommend concrete steps to assess risks. Without being prescriptive, teams could recommend the analysis of costs and benefits of alternative adaptation options as the starting point of a complex decision process that involves public spending, societal, and generational trade-offs.

*Climate Policies: Mitigation and Global Transition to Low Carbon Economy*

**23. For SDS reliant on fossil fuels as the main source of energy, policy discussions could focus on domestic emissions reductions and the adoption of low-carbon technologies.** Most SDS are dependent on imported fossil fuels, leaving them susceptible to international price shocks and uncertainties surrounding global fossil fuel demand and supply (Box 2). Many countries plan to increase reliance on renewable energy sources but face high investment costs, need to update accompanying energy policies, and gain access to international financing. Fiscal policy should support domestic emissions reduction, encourage adoption of low-carbon technologies, and help those most vulnerable to changes from the transition.

**24. For fossil fuel exporters, SDS that rely on remittances from fossil fuel exporters, and tourism-dependent countries, discussions could focus on managing the impact of the global transition to a low-carbon economy.** For fossil fuel exporters, the assessment of vulnerabilities arising from the long-term decline in demand for fossil fuels could include impact on revenues, exports, and financial flows, and thus on debt sustainability, as well as SOE finances, employment, and financial sector exposure. Broader macroeconomic risks arising due to the transition to a low-carbon economy could be mitigated by accelerating structural reforms that support economic diversification. Country teams should discuss the authorities' plans to manage the transition, including by establishing fiscal frameworks and maintaining/boosting revenue streams, strengthening debt management, containing financial sector exposures (including exposure to stranded assets, if applicable), and exploring policy options for sustainable finance. For SDS that are heavily dependent on remittances and other financial flows from fossil fuel exporting countries, country teams should discuss the sensitivity of the current account and fiscal revenues, among others, to changes in fossil fuel-related flows. Tourism destination countries may also be impacted by the global transition to the low carbon economy due to their exposure to global fuel price fluctuations, trends in eco-tourism, and the carbon footprint of travel.

**25. For SDS looking to reduce domestic emissions, country teams could discuss carbon pricing reforms.** Carbon pricing can take different forms, such as carbon taxes, emissions trading systems (ETS), feebates, environmental fiscal reforms, and higher excises on fossil fuels based on their CO<sub>2</sub> content. For capacity constrained SDS, carbon taxes can be built into pre-existing fuel excise systems applied at the point of import or refining of fuels, whereas ETS may be too complex to implement and monitor. Carbon pricing can also raise substantial revenues in SDS, often 1 to 3 percent of GDP, which can be used for funding public investments and expenditures to achieve Sustainable Development Goals (SDGs). This is especially valuable in SDS where other tax bases (such as the personal income tax) are constrained by the presence of large informal sectors. A portion of revenues should be used for targeted transfers to the poorest households to alleviate any negative impacts on poverty from increasing energy prices. This could be done by scaling up existing

conditional and unconditional cash transfer programs that are present in many SDS. A well-designed carbon tax can also be simple to administer if building on the existing excise tax regimes.

**26. Fossil fuel subsidy reform could also play a significant role both in reducing emissions and freeing-up fiscal space.** Fiscal measures could include automatic fuel price and electricity tariff adjustments to reflect the real cost of supply. These reforms should ideally be coupled with reforms to help alleviate adverse social and economic impacts, including policies to strengthen the social welfare system, reduce distortionary taxes, and bolster productive investments.

### Box 2. Is the Green Energy Transition a Win-Win for SDS?

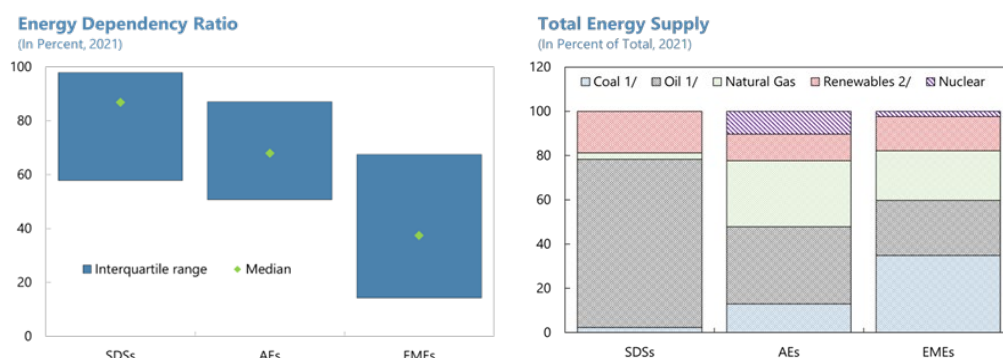
SDS are among the most energy dependent countries in the world (Box Figure 1).<sup>1</sup> They typically rely on imports of oil to supply almost all their energy, and energy prices tend to be much higher as a result. They are also vulnerable to oil price volatility—a surge in oil prices can rapidly cause a deterioration in their terms of trade, an increase in imports, and a surge in inflation. In countries with fuel price subsidies, it can weaken fiscal positions and debt sustainability.

The transition to low carbon energy offers SDS an opportunity to reduce their fossil fuel dependence and move to cheaper, cleaner, and more efficient renewable energy to support their economic development. Increasing domestic production of renewable energy would lower oil imports and improve their current account position. It would also reduce their vulnerability to global oil price fluctuations and lower the negative impact on inflation and fiscal revenues. Renewable energy may also result in lower electricity prices for some SDS, boosting their competitiveness and potentially allowing them to diversify by developing energy intensive industries. This is particularly the case for SDS with geothermal potential where potential renewable energy production could be greater than their current energy needs.

However, SDS face two key constraints to adopting renewable energy:

- **The ability to access finance for investment in renewable energy**, which typically has large upfront costs and uncertain returns. The cost of capital in SDS can be much higher than in advanced economies and can act as a constraint on the faster adoption of renewables. In this context, support from IFIs and Multilateral Development Banks (MDBs) can help accelerate renewable energy installation. Ensuring regulatory frameworks are adequate to accommodate private sector involvement could further spur private investment.
- **The availability of land can be scarce in SDS.** There may be insufficient land space to install the required renewable energy infrastructure such as solar panels and onshore wind turbines. For island economies, offshore wind may be a potential solution.

### Box 2. Figure 1. Energy Dependency and Energy Supply



**Box 2. Is the Green Energy Transition a Win-Win for SDS? (concluded)**

Sources: UN Energy Statistics Database, UN Comtrade, and IMF staff estimates. Energy dependency ratio is defined as net energy imports divided by gross available energy.

1/ Coal is comprised of primary production and related products; oil is comprised of crude oil and oil products.

2/ Renewables include biofuels and waste, electricity, and heat. AEs = Advanced Economies; EMEs = Emerging Economies; SDS = Small Developing States, which includes Antigua and Barbuda, The Bahamas, Barbados, Belize, Bhutan, Cabo Verde, Comoros, Djibouti, Dominica, Eswatini, Fiji, Grenada, Guyana, Kiribati, Maldives, Mauritius, Micronesia, Montenegro, Nauru, Palau, Samoa, São Tomé and Príncipe, Seychelles, Solomon Islands, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Timor-Leste, Tonga, Trinidad and Tobago, Tuvalu, and Vanuatu.

<sup>1</sup> There are some SDS energy exporters, notably Guyana, Suriname, Timor-Leste, and Trinidad and Tobago, which face a different set of challenges regarding the energy transition.

**27. Other emission-reducing reforms could also be considered by fossil fuel producing SDS.** Standards and regulations to restrict non-routine flaring and other measures to require proven, low-cost abatement options, such as leak detection and repair, are an option. These regulations should be coupled with fines for non-compliance and, potentially, a tax on methane and CO<sub>2</sub> emissions on fossil fuel extraction to incentivize operators to reduce their emissions ([IMF 2023b](#)).

*Climate Finance*

**28. Large climate investment needs are not matched by financing, and scaling up will require effective climate policies, innovative financing structures, a list of investable projects, and a larger investor base.** According to the OECD, between 2016–2020 Pacific Island Countries had access to less than \$0.5 billion out of the \$100 billion per year pledged by advanced economies to developing economies ([OECD 2023](#)). SDS also face significant challenges in gaining or increasing access to climate financing from multilateral climate funds ([Fouad and others 2021](#)). In addition, Development Partners play an especially important role, given that private sector and market solutions are not always feasible for SDS.

- Policies aimed at strengthening macroeconomic fundamentals, deepening capital markets, reforming institutional, investment, and governance frameworks, and closing data gaps are a fundamental part of the policy mix needed to attract private climate funding. Such policies can help improve credit ratings and lower the cost of capital for SDS and increase the domestic financial resources available for climate investment. Fiscal CD, including strengthening public financial management (PFM) and public investment management (PIM) through diagnostics like the climate C-PIMA, as well as diagnostics that address climate-related financial stability issues can help SDS by improving their macroeconomic and financial conditions to build a more conducive investment climate.
- SDS authorities may express interest in innovative climate finance instruments that could play a role in financing adaptation and mitigation to climate change. These could include green and catastrophe bonds, debt-for-nature and debt-for-climate swaps, inclusion of climate resilient debt clauses in borrowing agreements, international carbon crediting or climate-related insurance schemes, and others ([Ando and others 2022](#), [Chamon and others 2022](#), [Belianska and others 2022](#)). Each of these instruments will have opportunities and challenges associated with it

that staff should discuss with the authorities, without endorsing their use or their ability to scale up financing for adaptation or mitigation purposes. The choice of the instrument would ultimately depend on the country's macroeconomic situation, policy objectives, and the broader mix of financing options and government policies.

- *While beyond the IMF's remit*, innovative financing structures with greater risk absorption capacity through equity investments and guarantees can help crowd-in private capital. Pooling of projects and resources could create scale (e.g., climate funds), through risk diversification and reduction of fixed costs associated with investments. These instruments must be standardized to enhance scale, tradability, liquidity, and inclusion in broad indexes.

## C. Strengthening Fiscal Frameworks and Debt Sustainability

**29. Managing high volatility and frequent occurrence of natural disasters in SDS economies requires a credible medium-term fiscal framework (MTFF).** Such a framework should recognize the diverse policy priorities countries face, including reducing debt vulnerabilities, enhancing fiscal resilience, and supporting climate adaptation and mitigation. It should then set medium-term aggregate fiscal objectives, for instance debt limits, surplus targets or deficit ceilings, or broad expenditure limits, and create adequate fiscal buffers to allow for an agile response to large adverse shocks. Properly designed fiscal rules with a clear and credible fiscal anchor, provisions to adjust targets in case of shocks, and credible paths to return to targets in the medium term would enhance the robustness and transparency of fiscal frameworks.<sup>7</sup> SDS can also further strengthen the credibility and transparency of their fiscal frameworks by setting up fiscal councils—where capacity allows—and encouraging independent analysis and forecasts. The pace of accumulation of fiscal buffers should be calibrated to the frequency of shocks, development investment needs, country's capacity to borrow and obtain assistance from the IFIs and development partners, as well as the financial cost of maintaining a sizable buffer. Teams are encouraged to link the medium-term revenue mobilization agenda and other spending reforms with the MTFF and tailor it to SDS country circumstances and limited capacity. An effective collaboration with development partners is also crucial to coordinate efforts, avoid duplication, and enhance CD delivery in SDS.

**30. Authorities often face challenges in their ability to conduct fiscal policies, both in terms of revenue mobilization and ensuring efficient spending.** The narrow economic base limits the tax base, which is often concentrated in a few formal sectors, with prevailing informal sectors further eroding the base. More than one-third of gross revenues come in a form of non-tax revenue (resource sector revenue, inflows from citizenship or residency by investment programs, or foreign aid), which are usually volatile, and may be limited or unsustainable in the long term. Tax systems in many SDS are complex, with high tax rates and widespread tax exemptions. Revenue administrations generally suffer from under-staffing, and often lack necessary investment in Information and Communication Technology (ICT) and digitalization. Such an environment creates opportunities for taxpayers to either not meet their obligations or do so with delay. Domestic revenue mobilization in

<sup>7</sup> The choice of the fiscal anchor should align with the current level of PFM procedures and other considerations; see [Ledo and others \(2018\)](#) and [Caselli and others \(2022\)](#).

SDS may also be impacted by their participation in trade facilitation protocols ([IMF 2011](#)). On the spending side, capacity constraints, including on governance, may lead to weak fiscal management and poorly targeted subsidies, leaving substantial room to improve spending quality and efficiency. Consequently, persistent fiscal challenges have led to a rapid accumulation of debt liabilities. High public debt, high output volatility, and elevated country risk, keep interest rates high and increase financing challenges, while reliance on bank financing and the sovereign-bank nexus can also create risks to financial stability and crowd out private sector financing (see also ¶¶42, 43 for financial sector supervision).<sup>8</sup>

**31. Domestic revenue mobilization is a key fiscal policy priority, essential for achieving long-term sustainability of public finances.** SDS can increase domestic revenues through tax policy and revenue administration reforms. Tax policy reform options include broadening the tax base, notably by removing exemptions. Other policy options include removing reduced VAT rates, streamlining tax incentives, strengthening real property taxation, and simplifying legislation and regulations. Revenue administration reforms should aim to strengthen revenue administration management, governance, systems, and core functions, build data management capabilities for risk analysis, enhance tax compliance, and improve taxpayer services, with a focus on actively managing the large taxpayer segment. SDS governments should also consider investing in human capital, ICT, and digitalization.

**32. Anchoring revenue reforms within a medium-term agenda will be crucial.** While the development of medium-term revenue strategies can be challenging for SDS, a holistic reform approach rooted in a medium-term agenda will provide a comprehensive framework for targeted, incremental, and sustainable reform implementation. Whenever possible, a regional approach (e.g., for ICT projects) should be used to account for the similarities of the challenges between countries in the region, and take advantage of economies of scale to cope with the limited capacity of revenue administrations in SDS.

**33. To get a comprehensive picture, teams are encouraged to assess tax policy in a broader macroeconomic context.** For instance, in SDS that are considering joining regional/international trade agreements, staff should discuss with the authorities plans to compensate for revenue losses with other income streams. Conversely, while citizenship and residency by investment (CBI/RBI) programs can be a significant source of revenue, they should be weighed against potential corruption vulnerabilities and economic, financial integrity, and tax risks, in particular those related to governance and Anti-Money Laundering/Combating the financing of Terrorism (AML/CFT) (Box 3).

### Box 3. Citizenship and Residency by Investment (CBI/RBI) Programs

**CBI/RBI programs, which permit people around the world to become new citizens or permanent residents in other countries by virtue of investments, are prevalent in some SDS.** These programs have

<sup>8</sup> According to IMF's Monetary and Financial Statistics [data](#), in December 2022, on average, the fraction of banking sector's asset held by public sector is about 12 percent for SDS, compared to 19 percent in LIDCs.

**Box 3. Citizenship and Residency by Investment (CBI/RBI) Programs (concluded)**

sought to spur fiscal revenue and economic growth by expanding foreign investment channels and by offering wealthy individuals with opportunities to buy citizenship or residency and the associated additional rights (e.g., visa-free travel, attractive tax and wealth management options, ability to flee conflict, political or civil unrest), thereby expediting or bypassing the normal, more lengthy migration processes. Such programs are offered by different countries around the world and include SDS such as Antigua and Barbuda, Dominica, Grenada, Montenegro, St. Kitts and Nevis, St. Lucia, Vanuatu, among others.

**CBI/RBI programs can raise economic, integrity, corruption, tax, and reputational risks for host countries.** Fund staff has raised issues about the CBI/RBI programs during surveillance and program discussions. While windfall gains from CBI/RBI programs can be used to fund much needed infrastructure investment to support resilience, revenues from such programs are uncertain and volatile (e.g., [IMF 2023j](#)). Lack of transparency and mismanagement can prevent the anticipated economic benefits from being realized (e.g., corruption, investments benefiting only a few, distortion of the real estate market, and reputational risks). Criminals have exploited vulnerabilities in CBI/RBI programs to perpetrate fraud, launder proceeds of crime, and circumvent targeted financial sanctions. Tax transparency can also be affected, as individuals can use their residence certificate, bolstered by corresponding passports, to circumvent automatic exchange of information with their original home countries. If reputational and integrity risks are severe, certain jurisdictions (e.g., the EU or the U.S.) can take protective steps to suspend visa-free travel and issue warnings to banks, which impact all citizens negatively (e.g., [IMF 2022f](#)). In some countries, reputational risks associated with CBI/RBI programs have negatively impacted Correspondent Banking Relationships (e.g., [IMF 2023n](#)).

**Going forward, staff should continue to highlight risks of such programs and advise on key safeguards.** These include: risk assessment and risk management (including for the financial sector); effective vetting of applicants and their sources of funds; transparency in the operation and management of the program; enhanced AML/CFT safeguards, and strengthened international cooperation to prevent forum shopping and avoid a race to the bottom.<sup>1</sup> Staff should also encourage the authorities to treat the revenue from CBI/RBI programs in the same way as a windfall gain ([Xu, El-Ashram and Gold 2015](#)). In addition, staff should closely monitor emerging trends such as digital residency programs (e.g., [IMF 2023e](#)).

1/ Additional resources: [FATF/OECD \(2023\)](#) and [Fernando and others \(2021\)](#).

**34. Improving the efficiency of public spending will, in many SDS, require stronger PFM, especially to manage natural disaster-related spending.** Streamlining and reprioritizing recurrent spending is a key measure to create fiscal space for priority spending, including to build buffers for natural disaster-related expenditures. Given its relatively large size in SDS, containing non-discretionary spending (such as public sector wage bill) can be particularly important. Development partners may require procedures that allow for monitoring and transparent reporting of the use of emergency disaster assistance to provide repeated support. Future cost of disaster-related public spending can be treated as public contingent liability for budgetary purposes, helping to integrate risks into cash and debt management frameworks. Enhancing capacity in debt management can also help contain the overall spending envelope.

**35. Staff's advice on social spending needs to take full account of the status of the existing social safety nets (SSNs), capacity to absorb additional social spending, as well as social and political preferences.** Staff should refer in general to the [Operational Guidance Note for IMF Engagement on Social Spending Issues](#) (IMF 2024d). SSNs tend to be underdeveloped in SDS and gaps in PFM and governance set limits to the capacity by the authorities to absorb additional social spending. Fragmented internal geography of SDS adds further to the challenge. Staff should carefully



assess which objectives can be achieved building on the existing systems and which would require more involved efforts. Staff needs to be mindful of data limitations, especially in the early stages of the discussions with the authorities. The already large non-discretionary spending in many SDS underline the necessity of aligning SSNs with fiscal and debt sustainability.

**36. Digitalization can help governments improve revenue collection and spending efficiency, but its use needs to adapt to an environment with low connectivity and exposure to cyber risk.** Digitalization by adopting Government Technology (GovTech) in fiscal operations can strengthen public finance by improving revenue mobilization, expenditure efficiency, service delivery, fiscal transparency, and social outcomes ([Amaglobeli and others 2023](#)). However, benefits from digitalization will materialize only if it is designed and implemented properly and accompanied by efforts to strengthen institutions. Changes in regulations and established processes would need to safeguard data security and privacy to protect sensitive information. Issues that may hinder the adoption of GovTech in some SDS include low internet connectivity and the lack of expertise among government officials.

## D. Enhancing Monetary and Exchange Rate Policy Frameworks

**37. The conduct of monetary policies faces challenges due to susceptibility of SDS to shocks, the underdevelopment of financial markets, and capacity constraints.** Central banks in SDS often have multiple objectives in addition to price stability, including, but not limited to, economic growth, financial sector development, and exchange rate stability; central bank independence tends to be limited as well. Staff teams may also need to assess capital adequacy of central banks. This complicates monetary policy design, and results in inconsistent policy frameworks. Monetary policy transmission is often weak due to low financial development, thin interbank markets, poorly developed government securities markets, and dollarization. In addition, many SDS have in place exchange controls and/or partially closed capital accounts, as can be seen from the Chinn-Ito index in Table 1. To further illustrate it, in 2022, three-quarters of SDS imposed restrictions on capital market securities, direct investment and real estate transactions. Such policies may be needed given SDS' level of financial and institutional development, but can attenuate monetary policy transmission through the exchange rate channel. Finally, in terms of monetary policy frameworks, as of 2022, the vast majority of SDS (30 out of 34) use the exchange rate as the nominal anchor and have fixed exchange rates and only two have floating exchange rates (Table 3).

**Table 3. Exchange Rate Arrangement of Small Developing States**

Exchange Rate Arrangement	Exchange Rate Arrangement		De facto Anchoring Currency	De facto Anchoring Currency	
	Count	Percent		Count	Percent
Hard peg	15	44	U.S. Dollar	18	60
Soft peg	15	44	Euro	4	13
Floating	2	6	Composite	3	10
Residual	2	6	Other	5	17
Total	34	100	Total	34	100

Source: 2022 AREAER Database and IMF staff calculation.

**38. Staff's policy advice on the conduct of monetary and exchange rate policy should account for the prevalence of exchange rate peg and other institutional constraints.** As in other developing countries, SDS' central banks need to prioritize the development of transparent and coherent policy frameworks, with price stability as the primary objective ([IMF 2015b](#)). The use of the

exchange rate as the nominal anchor given SDS characteristics could often be suitable. Monetary and other economic policies need to be consistent with the chosen exchange rate arrangement and geared towards supporting it. Given heightened debt vulnerabilities, staff should also be aware of the risk of fiscal dominance. In this context, it is important for staff to consider the various forms of quasi-fiscal interventions that the central bank could be involved in and how these could affect the conduct of monetary and exchange rate policies. While strengthening central bank independence and adopting prudent fiscal policies are the main measures to contain risks, traditional reserve money targeting can help, especially when domestic financial markets are severely underdeveloped ([IMF 2015b, Box 1](#); see also ¶42). The monetary policy stance should also be evaluated.

**39. When assessing reserve adequacy, staff should properly account for exchange rate pegs and higher volatility of SDS economies.** Staff's policy advice should consider the importance of building strong policy buffers, as having sufficient international reserves is key to coping with frequent and adverse exogenous shocks and maintaining a credible peg. In line with the paper [Assessing Reserve Adequacy—Further Considerations](#) (IMF 2013a), close attention should also be paid to country circumstances (e.g., size and composition of debt, nature of shocks) to ensure that the chosen approach best captures risks and vulnerabilities that a country could face. The small islands metric, which draws on the Fund metric for economies with market access, combines different reserve needs allowing for small island specificities (e.g., vulnerability to natural disasters) ([Mwase 2012](#)). Dollarized SDS may need to hold more reserves, though their sources of external drains and ways of smoothing shocks depend on the nature and degree of dollarization. Policy advice should also account for foreign exchange interventions by the central bank.

**40. The limited shock absorption capacity related to capital inflows, including those arising from climate finance, may require staff to assess the appropriateness of using capital flow management (CFM) and macroprudential measures (MPM).** This work should be guided by [The Institutional View on the Liberalization and Management of Capital Flows \(IV\)](#) (IMF 2022e). The use of Inflows CFMs, CFM/MPMs, outflows CFMs and preemptive CFM/MPMs on debt inflows continue to be guided by the IV. SDS may face tighter policy constraints due to fixed exchange rate regime, which could strengthen the case for preemptive CFM/MPMs; however, these measures should not be used to help maintain unsustainable currency pegs. Supervision capacity over CFMs and MPMs (i.e., closing loopholes), which could be an issue in SDS, is key for the effectiveness of the measures. Guidance on capital flow liberalization should also consider SDS characteristics, including their level of financial and institutional development and the role of CFMs in supporting the exchange rate peg. In line with the [Guidance Note on Macroprudential Policy—Considerations for LICs](#) (IMF 2014), staff's advice on macroprudential policy in SDS should prioritize the use of simple approaches that increase the resilience of the financial system to shocks (e.g., imposing high capital and liquidity buffers) rather than an active recalibration of macroprudential policy settings.

**41. When multiple instruments are used in response to exogenous shocks, staff should consider limited capacity to fully operationalize the [Integrated Policy Framework \(IPF\)](#).** Many SDS are subject to IPF frictions—such as shallow FX markets, unhedged currency mismatches, and inflation expectations de-anchoring from high exchange rate pass-through—that may warrant the

use of additional tools such as FX interventions (FXI), CFMs and MPMs in addition to monetary policy.<sup>9</sup> However, the institutional, policy, communication, and capacity constraints that many SDS face may advocate against the use of such tools. Indeed, multiple policy objectives combined with multiple instruments are harder to implement in this environment. Therefore, in response to external shocks, SDS should generally prioritize the warranted adjustment of monetary and fiscal policies to preserve financial sector and price stability.

## E. Deepening the Financial Sector While Ensuring Strong Oversight

**42. Financial sectors in SDS are often shallow, concentrated, and foreign owned, with under-developed institutional frameworks.** Financial sectors in many SDS have not been developed adequately to play their full role in managing volatility and fostering growth. Shallow and non-competitive financial markets, often dominated by large (in some cases foreign) banks, hinder financial sector deepening, and raise spreads between lending and deposit rates. In many SDS, the lack of credit bureaus is an important gap in credit risk management. The underdevelopment of financial markets hampers the ability of the authorities to assess market conditions and implement regulatory policies. In many SDS, overseeing financial activities is also challenging due to weak supervisory and regulatory capacity and limited data availability. Supervisory agencies, at times, also have conflicting mandates, which can weaken their attention to stability risks. Enforcement actions are infrequent, legal authority often is weak, and there is a notable reluctance to challenge foreign banks over their weaknesses or raise supervisory concerns. At the same time, some SDS are financial centers with relatively sophisticated offshore sectors that serve mostly non-residents.

**43. Efforts to deepen the financial sector should go hand-in-hand with promoting stronger financial regulation and supervision.** The depth and comprehensiveness of financial policies in SDS should be tailored to country-specific characteristics and sources of systemic risk, and where relevant data gaps should be closed. Policy advice and CD efforts in the financial sector should support improving growth performance while increasing the resilience of the system to shocks. CD activities should focus on core stability issues—enhancing supervision of banks, enhancing data collection and analysis and redressing the legal framework.

**44. The Financial Sector Assessment Program (FSAP) and the Financial Sector Stability Review (FSSR) are potential diagnostic tools, helping identify necessary reforms and needed CD support.** The FSAP process is intensive, requires adequate capacity on the part of the authorities to respond to Fund staff questionnaires, provide adequate data for stress testing analysis, and engage the team during the assessment.<sup>10</sup> Thus, it may be appropriate only for larger SDS with more

<sup>9</sup> For more details, see IPF conceptual and quantitative models ([Basu and others 2020, 2023](#); [Adrian and others 2020](#); [Adrian and others 2021](#)) for key frictions identified, and [IMF \(2023d\)](#) for principles and advice articulated for the use of FXI in the context of IPF.

<sup>10</sup> The IMF FSAP focuses on financial stability and involves a deep dive into risks and vulnerabilities as well as assessments of financial supervision, financial stability oversight and crisis management frameworks against international standards. In most SDS, FSAPs are joint with the World Bank, which covers financial development areas. The World Bank can also carry out a developmental FSAP in tandem with an FSSR.

complex financial systems and a strong appetite for engagement. The FSSRs look at the capacity of the authorities to identify, monitor, analyze and mitigate risks to financial stability with the goal of developing a medium-term technical assistance (TA) roadmap to strengthen the financial stability framework. The FSSR can be especially useful in SDS where a low-capacity environment necessitates careful reform prioritization and sequencing. The program can be undertaken in SDS classified as a low- or lower-middle-income but may be considered for other countries on a case-by-case basis.

**45. ML/TF issues can pose significant macroeconomic challenges and risks that need to be effectively mitigated.** Major ML/TF risks and vulnerabilities, including those arising from perception of ML/TF weaknesses, can include a prevalence of higher-risk sectors and activities (e.g., non-resident oriented offshore sectors, citizenship by investment programs), opaque corporate structures established by professional enablers (e.g., lawyers, accountants), and capacity and resource constraints. These risks and vulnerabilities expose SDS to possible illegal activities, financial instability, cycles of bubbles and busts, and reputational concerns and possible naming and shaming, such as public listings by Financial Action Task Force (FATF). Financial integrity issues tend to have a negative impact on the business climate and inclusive and sustainable economic growth.

**46. Staff teams should continue to engage with the authorities on policies to help mitigate financial integrity and ML/TF risks.** Staff should discuss policy priorities (e.g., the national risk assessment, macroeconomic implication of ML/TF risks) and mitigation measures planned or taken by the authorities. Special attention should be paid to higher risk activities (e.g., cross-border business, citizenship by investment programs), the inherent risks of international business activities, and the challenges related to transparency of legal entities.<sup>11</sup> Key policy lines and safeguards should include proper implementation of preventive financial sector licensing, supervisory measures and customer due diligence for the financial and non-financial sectors, transparency of beneficial ownership, and cross-border cooperation and information exchange. Policy advice should focus on how to assess and manage the macroeconomic implications of ML/TF risks and best prioritize mitigation measures in line with identified risks and SDS' limited capacity.<sup>12</sup> Moreover, staff should advise SDS authorities with disproportionately large financial sector or service industries to allocate resources for supervision and enforcement according to the larger size of the supervised sector, rather than the small size of the country.

**47. Pressures on Correspondent Banking Relationships (CBR) continue to be a concern for some SDS and may reduce formal financial flows, remittances, and trade.** Drivers behind CBR pressures vary and can include profitability (volume of transactions compared to cost of compliance), risk perception and reputational concerns (for example, due to EU or FATF listing or general perceptions of lack of transparency), limited financial services and service providers, foreign banks' changing business models, and AML/CFT weaknesses, among others ([Erbenová and others 2016](#)).

<sup>11</sup> For example, offshore-oriented sectors such as corporate services sectors, digital economic zones, and shipping registries (e.g., IMF [2021g](#), [2023f](#)), and international business companies/trusts sectors (e.g., IMF [2023i](#); IMF [2022i](#)).

<sup>12</sup> While the banking sector may generally be the focus of AML/CFT measures, for some SDS the main sectors to focus on would be the regulation and supervision of professional enablers or gatekeepers (e.g., lawyers, trust and company service providers and accountants), who play a key role in company formation and management.

CBRs in SDS have declined significantly more than in most other groups and are continuing to fall. This leads to a rising concentration of remaining CBRs in just a few institutions, an increase in remittance costs, and lower speed of transactions; ultimately, it puts some SDS at risk of a complete loss of CBRs. In turn, limited CBR and higher costs may hamper remittance flows, financial intermediation, financial inclusion, financial stability, and trade.

**48. Staff should continue to support SDS in implementing policies to alleviate CBR pressures, including via innovative approaches.** The basis for any effective AML/CFT system is a comprehensive risk understanding, and subsequent risk mitigation prioritized in line with risks and available resources—the latter being especially important for SDS. AML/CFT supervision of the financial sector should focus on compliance with preventative measures and customer due diligence, particularly for politically exposed persons and beneficial ownership, to properly mitigate the risk of illicit financial flows and the impact of targeted financial sanctions (which are a concern for correspondent banks). In view of SDS' capacity constraints, staff should continue to facilitate dialogue among stakeholders, and provide support through analysis (to identify and address CBR pressures, monitor trends, risks, and drivers of CBRs), targeted policy advice, and tailored CD ([Alwazir and others 2017](#); [Stuart and others 2019](#)). Innovative solutions could help SDS as well, for instance a draft framework proposed by IMF and World Bank staff could enable identification of a safe payment corridor ([IMF-World Bank 2021](#)). That, in turn, could decrease regulatory compliance and costs of cross-border payments, alleviating risk-profitability considerations of correspondent banks.

**49. Proper monitoring, measurement, regulation and supervision will be needed to manage risks associated with digital money adoption.**<sup>13</sup> New digital money and fintech may offer SDS opportunities to improve financial inclusion and efficiency, although challenges are likely to remain (Box 3). Successful adoption of digital money in SDS should generally be done gradually, and will require developing digital technology, business models, use cases, and legal and regulatory compliance. The legal and regulatory framework should be clear on the legal status of digital money, the obligations of relevant service providers, rights and obligations of users, and responsibilities of supervisory authorities and other competent authorities. Decisions on the adoption of digital money should also consider other monetary and financial conditions, such as existence of a national currency, or the level of maturity of the domestic payment systems. Unbacked crypto assets are not suitable as official currency and means of payments, and therefore should not be supported by the official sector for this purpose. Staff should continue emphasizing the need to strengthen the understanding of ML/TF risks specific to digital money, application of AML/CFT preventive measures and supervision, and the investigation into and prosecution of ML/TF activities involving digital money. Staff could use the available Fund TA and training to support SDS in addressing the financial integrity implications of central bank digital currency (CBDC) and crypto assets (Box 4).

<sup>13</sup> Several forms of digital money have emerged or been explored with the advent of digitalization: electronic money (e-money), stablecoins, and CBDC being the three main categories.

### Box 4. Digital Money: Opportunities and Challenges for SDS<sup>1</sup>

**New digital money and fintech may offer SDS opportunities to improve financial inclusion and efficiency.** Digital platforms (such as mobile money, new retail fast payment solutions, or CBDC) may offer lower fees, stimulate competition, or fill gaps among pre-existing services, offer functionality in offline environments, and/or operate on a variety of hardware devices, including feature phones. Digital money has the potential to streamline transactions and redefine domestic payments, as well as to empower individuals in underserved regions, providing them with access to financial services and government support. Moreover, digital money could help facilitate international payments, reduce remittances costs, and mitigate the adverse impacts of CBRs' withdrawals. They may have remote and digital onboarding processes, addressing barriers related to onboarding and geographic location.

**However, challenges with digital money are likely to be more amplified in SDS given low capacity, low scalability prospects, and infrastructure challenges.** Barriers, such as low financial literacy, trust issues, unstable electricity, and other infrastructural challenges may complicate implementation of digital money or realization of its benefits. SDS face heightened challenges related to the scale of viable markets, and limited resources and capacity. Supportive policies, such as developing electricity and telecommunications infrastructure, and improving financial literacy education, may be difficult given resource constraints.

**Robust regulatory oversight and frameworks are also imperative to limit financial integrity, financial stability, and consumer protection risks that may arise with fintech and digital money.** Data protection and cybersecurity threats must also be appropriately managed. Yet, many SDS struggle with the resourcing and capacity constraints for the development of such protections. It is thus important to weigh the opportunities that new digital money and fintech solutions offer with the challenges of the SDS context.

**Without effective measures to safeguard financial integrity and mitigate the ML/TF risks, digital money may result in financial and economic disruptions.** Despite their advantages, publicly and privately issued forms of digital money are susceptible to criminal misuse, particularly where they feature anonymous transacting, have global reach, and are widely adopted as a means of exchange. Without proper mitigation measures, digital money can facilitate serious crimes including ML/TF. Presently, most SDS have inadequate frameworks to address the ML/TF risks related to digital money ([FATF 2023](#)), have weak AML/CFT regimes, inadequate AML/CFT supervision, and limited law enforcement capacity. New or elevated ML/TF risks connected to digital money could exacerbate existing deficiencies, resulting in illicit financial flows, which, in turn, could threaten financial sector stability and contribute to further pressures on CBRs. That warrants cautious adoption of digital money, its strict regulation, and robust supervision.

**Some SDS have introduced or are at advanced stages of development of CBDCs.** The Bahamas pioneered the CBDC with the Sand Dollar in 2020, and the Eastern Caribbean Currency Union (ECCU) followed suit with the Dcash pilot in 2021. These countries adopted CBDCs to boost financial inclusion for communities in remote islands and to strengthen the resilience of the payments system to natural disasters and pandemics. However, a slow take-up and disruptions in access to CBDCs highlight the importance of investing in public awareness and robust infrastructure to promote CBDC adoption. In January 2024, the ECCU [closed the Dcash](#) pilot and initiated development of a more advanced CBDC (Dcash 2.0).

1/ See [Interest in Central Bank Digital Currencies Picks Up in Latin America and the Caribbean While Crypto Use Varies \(imf.org\)](#).

## SURVEILLANCE AND ANALYTICAL WORK

*Staff should tailor surveillance to SDS circumstances. The Fund's core surveillance tools, namely the SRDSF, LIC-DSF and EBA-lite, come with built-in flexibility to allow tailored applications. Partnership with the authorities and coordination with development partners can help enhance traction. Staff should make full use of the Fund's internal resources to bring the cross-country angle to country-*

*specific analysis. Staff should leverage recent technological developments to maintain engagement with the authorities in between regular missions, and to address data gaps.*

## A. Tailoring Surveillance Policies

### 50. Staff should be guided by the surveillance priorities identified by the 2021

**Comprehensive Surveillance Review (IMF 2021c).** While SDS members face many policy issues that warrant a tailored coverage, surveillance must first comply with policies that apply to the entire membership, as laid out in the Guidance Note for Surveillance Under Article IV Consultation. For SDS in fragile situations, tailoring of staff engagement should follow the [IMF Strategy for Fragile and Conflict-Affected States](#) (IMF 2022j) and the accompanying [Staff Guidance Note](#) (IMF 2023k).

### 51. A Country Engagement Box in Article IV staff reports for SDS outlines the engagement strategy between staff teams and country authorities.

The box will elaborate the key factors the teams should consider when identifying policy areas in need of most focus, and the complementarity and sequencing of Fund engagement in surveillance, lending, and CD. The Box aims to enhance the strategic collaboration with SDS and facilitate a shared understanding among stakeholders by presenting an overarching view of how the different policies fit together. The Box is required for SDS while for SDS that are also FCS, the Country Engagement Strategy supersedes the Box. Annex II provides detailed guidance on the preparation, content, and the review process of the Box.

### 52. Debt sustainability analysis (DSA) and external sector assessment (ESA) include built-in features that allow them to be tailored to the characteristics of SDS.

The Fund has two frameworks for DSA: the Sovereign Risk and Debt Sustainability Framework for Market Access Countries (SRDSF) and the joint Bank-Fund Debt Sustainability Framework for Low-income Countries (LIC-DSF).<sup>14</sup> The Fund's framework for ESA is anchored at the EBA/EBA-lite methodologies; all SDS use EBA-lite. The Assessment of Reserve Adequacy (ARA) metric helps staff gauge the adequacy of foreign reserves. Many of the SDS characteristics can be accommodated within the built-in features of the tools, when preparing them, staff should start from and refer to the relevant guidance notes: [Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for Market Access Countries](#) (IMF 2022g), [Guidance Note on the Bank-Fund Debt Sustainability Framework for Low-income Countries](#) (IMF 2018b), [Guidance Note on the Assessment of Reserve Adequacy and Related Considerations](#) (IMF 2016a), and [2022 Update of the External Balance Assessment Methodology](#) (Allen and others 2023).

### 53. Staff should utilize features in the existing tools to account for the limited data quality, elevated vulnerability to natural disaster and climate change, and reliance on a few economic sectors.

As is the case with the overall macro-framework (Annex V), staff should consider how the limited availability and quality of the data may affect the interpretation of the results of surveillance tools; one major issue is the uncertainty of the results. To summarize:

<sup>14</sup> A total of 20 SDS use the LIC-DSF, including all 19 PRGT-eligible SDS plus Guyana, which graduated from the PRGT during the [2020 PRGT Review](#) (IMF 2020a). The remaining 14 SDS use the SRDSF.

- For the **ESA**, the *EBA-lite toolkit* allows staff to apply various adjustors as well as modules to capture salient features of SDS economies, while the standard ARA metric can be also adapted in a simple and transparent way to capture SDS characteristics.
- For the **DSA**, both the *SRDSF* and the *LIC-DSF* contain standard modules and triggered stress tests to account for SDS characteristics.
- For both the **DSA** and the **ESA**, if important SDS features cannot be accommodated by the tools, staff should complement the analysis with other information or results from other tools (e.g., the Debt-Investment-Growth and Natural Disasters (DIGNAD) model, the Quantifying Climate Risk Assessment Fiscal Tool (Q-CRAFT), or publications such as World Bank's Country Climate and Development Reports (CCDR) and IMF's Climate Policy Diagnostics (CPD)) and apply judgement when making the final assessment. Boxes 5 and 6 cover features most relevant for tailoring the ESA and the DSA to SDS in more detail.

### Box 5. External Sector Assessments (ESA) for SDS<sup>1</sup>

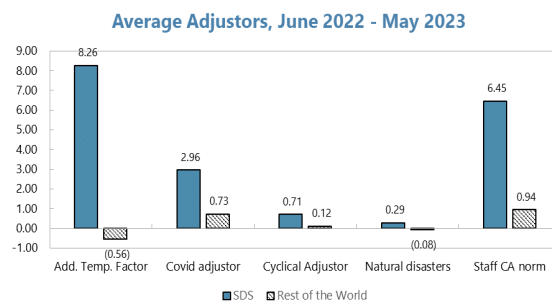
**The external sector assessments of SDS from mid-2022 to end-2023 were similar in magnitude to the assessments for LICs.** On average, SDS countries exhibit a CA gap of -1.7 percent of GDP, slightly lower than the -2.4 percent gap observed in LICs.<sup>2</sup> They exhibited substantial variation: of the 29 SDS that applied the EBA-lite model, 13 countries had a weaker external sector position, 10 were broadly in line and 6 were assessed as having stronger external positions. Similar to LICs, the CA gaps among SDSs were mainly attributed to structural factors such as competitiveness, as measured by the residuals of the model.

**To address the data and macroeconomic challenges of SDS, their ESAs will need to fully leverage the flexibility embedded in the EBA-lite toolkit.** Depending on the country circumstances, the teams can utilize a range of methods in the toolkit such as the current account model, a real effective exchange rate model, the external sustainability approach, investment, and consumption modules designed for commodity-exporters. These results may be complemented with other indicators or measures of competitiveness (e.g., unit labor costs, tourism competitiveness indicators, etc.), and relevant cross- or nominal bilateral rates.

**The EBA-lite model includes features that address some of the key characteristics of SDS.** It includes cyclical adjustors for *natural disasters/conflicts* which are more prevalent among SDS. The model also captures some key characteristics, such as being an exporter of a single commodity. The *terms of trade* adjuster, which is based on disaggregated data for forty commodities, allows the model to be tailored to country-specific circumstances. The model incorporates an adjusted *oil and gas trade balance* as part of the macroeconomic fundamentals determining the current account norm. Where regression-based methods are inadequate due to data constraints, the commodity module offers a non-regression-based approach as an alternative to the CA or REER models. In both cases, the abundance of natural resources is considered in the ESA as medium-term wealth effects and resource availability. To capture the effects of *remittances*, the model also incorporates migrant share in determining the norm.

**The EBA-lite methodology allows for use of additional adjustors, capturing quantifiable temporary events not accounted for by the model.**

Temporary shocks to tourism and remittances may be applied, if appropriate, utilizing the methodology and coefficients calculated in the EBA-lite template for those sectors. SDS have frequently relied on adjustors,



Source: External Sector Assessment Database (February 2024)



### Box 5. External Sector Assessments (ESA) for SDS<sup>1</sup> (concluded)

and their magnitude and frequency have often been higher relative to the average in the EBA-lite sample.<sup>3</sup> For example, the average COVID-19 adjustor for SDS stood at 3 percent of GDP—considerably higher than the global average of 0.5 percent. The adjustors to the norm, with a rate of 1.2 percent was considerably higher compared to just 0.1 percent of GDP for the rest of the world in the sample. In the case of St. Kitts and Nevis, staff considered a current account (CA) norm adjustor of 11 percent of GDP, reflecting an anticipated medium-term decline in remittances despite highly significant outward migration relative to the domestic population. Conversely, in Guyana's ESA for 2022 ([IMF 2022b](#)), a temporary adjustment of 18.4 percent of GDP was incorporated into the actual CA to account for substantial temporary oil-related imports, based on estimates of significant oilfield development costs.

**The flexibility of the ARA Guidance Note enhances the adaptability of ESAs for SDS through modifications to the ARA metric based on countries' characteristics and vulnerabilities.**<sup>4</sup> The adequacy measures allow for country-specific considerations such as (i) countries with long-standing capital flow management measures; (ii) commodity-intensive economies; (iii) dollarized economies and (iv) credit constrained economies. The standard ARA metric can be adapted in a simple and transparent way to capture country characteristics when assessing reserve adequacy. For example, for Mauritius the IMF applies the augmented ARA methodology by adding a term to the standard metric to account for its role as international financial center, which records substantial FX flows through its global business sector, capturing the additional sources of external vulnerabilities to the country. For Montenegro, staff modified the adequacy metric recommended for countries with a fixed exchange rate regimes by replacing the concept of broad money for deposits, while raising the latter's weight from 10 to 15 percent, and eliminating a component for other liabilities.

1/ The ESA for EBA-Lite countries, including SDS, aims at producing a bottom-line assessment of the external position and policy recommendations to address external imbalances (external rebalancing over the medium term) for a particular year. The assessment covers five key areas: external balance sheets (Net International Investment Position, NIIP), the current account, the real effective exchange rate, capital flows (including CFMs), and international reserves (including discussion of FXI).

2/ In comparison, EMs and AEs displayed smaller average CA gaps of -0.3 and 0.5 percent of GDP, respectively. Moreover, both LICs and SDS countries tended to have similar average residuals or structural factors, with LICs at -3.7 percent of GDP and SDS countries at -3.2 percent of GDP. The average policy gap for LICs stood at 1.5 percent of GDP, marginally greater than the 1.3 percent estimated for SDS.

3/ Between June 2022 and May 2023, SDS utilized an average adjustor of approximately 3.4 percent of GDP in their ESAs, notably higher than the averages of 0.2 percent for AEs, 1.2 percent for EMs, and 0.5 percent for LICs.

4/ The Assessment of Reserve Adequacy (ARA) metric estimates the potential FX liquidity needs of a country in adverse scenarios against which reserves are a precautionary buffer. The tools and considerations appropriate for assessing the reserve needs for each economy depend on the extent of its market access, resilience of market liquidity, and economic flexibility. See [IMF \(2016a\)](#).

### Box 6. Debt Sustainability Analysis (DSA) for SDS

**When preparing the DSA for an SDS economy, staff team should ensure that debt perimeter properly reflects the often-large size of the public sector.** Non-financial public corporations (e.g., state-owned enterprises) can be critical to the national economy of an SDS, and therefore bear implicit government guarantee. Staff should include debt liability of these corporations in the DSA. When data on non-financial public corporations are unavailable or are of poor quality, staff should gauge their possible impact on the DSA using the contingent liabilities stress test. By default, the DSA covers general government with a narrower coverage triggering the contingent liabilities stress test.

### Box 6. Debt Sustainability Analysis (DSA) for SDS (concluded)

**Various stress tests can be triggered to assess the risks around the baseline arising from several characteristics commonly observed in SDS.** Among the five stress tests that can be triggered under the SRDSF framework for assessing medium-term risk, three are likely to be relevant for staff working on SDS: *commodity price shocks*, *correction of misaligned exchange rates* and *natural disasters* (the other two, *banking sector instability* and *contingent liabilities due to narrow public debt coverage* can also be relevant for some countries; for example the latter can be used to capture explicit/implicit guarantees to SOEs). The LIC-DSF also contains stress tests for *natural disaster shock* and *commodity price shock*. In particular, the natural disaster stress test is mandatory for SDS identified in IMF (2016b) in both the SRDSF and LIC-DSF. All stress tests are pre-populated with standard calibrations based on cross-country evidence or country-specific historical data; see IMF (2022g, ¶¶89-93) and IMF (2018b, ¶¶65-71) for standard calibrations. Staff can include more accurate data if available while keeping the structure of the tests intact to facilitate cross-country comparison. The LIC-DSF also allows fully customized scenarios to capture idiosyncratic risks. The default horizon for the LIC-DSF is 20-year.

**For countries using the SRDSF, four modules are available to capture long-term risks.** The four modules available to capture risks with significant impact at the 30-year horizon are the *demographics module*, the *natural resources module*, the *large debt amortizations module* and the *climate change module*. Though the use of the modules is optional, decisions to apply the long-term modules should be taken well in advance and agreed between departments. Notably, the demographics, long-term debt amortizations and climate change modules are mandatory for Resilience and Sustainability Facility requests or augmentations, while the climate change module is mandatory for countries highly exposed to natural disasters or undergoing debt restructurings (adaptation submodule); or with an ambitious zero net carbon emission target or the 25 largest CO<sub>2</sub> emitters per unit of output (mitigation submodule).

**Finally, staff could apply judgement to the final bottom-line assessment to account for other country specific factors.** One example for SDS is the bringing into consideration in the final risk assessment of the long-term risks from natural disasters and/or climate change through judgment.

## B. Challenges and Opportunities in Engaging with SDS

### Enhancing Traction

**54. To enhance traction and address SDS-specific policy challenges, tailored approaches are essential.** Following the [2022 Staff Guidance Note for Surveillance](#), Fund teams may recognize SDS-specific challenges (the SDS characteristics section) in surveillance. Staff should ensure continuity of policy advice, and integration of policy matters across a suite of publications and tools (e.g., Article IV staff reports, Selected Issues Papers, FSAP, DSA, Regional Economic Outlook, and flagships) while remaining focused and selective, which would serve as building blocks in encouraging policy action. This should account for institutional, capacity, and data limitations, political economy, and the history of engagement with the Fund. Providing alternative scenarios, in addition to first-best solutions, and analytical work on trade-offs faced by authorities could be useful in most cases, as seen in the case studies of good traction in the [2021 Comprehensive Surveillance Review](#) (IMF 2021a).

**55. Fostering partnerships with authorities can help advance policy action.** This should include maintaining continuous dialogue with the authorities, integrating CD into surveillance to

make policy advice actionable, addressing data gaps and building capacity to expand the policy space, as well as improving outreach to the public and other stakeholders. While in-person missions are the preferred modality of engagement with the authorities, particularly on CD, staff are strongly encouraged to take advantage of virtual missions outside of the standard surveillance intervals and increase the involvement of functional departments. Staff and mission chiefs are responsible for proper assignment handovers to ensure the continuity of the Fund's engagement and policy advice.

**56. Enhanced coordination with IFIs and regional institutions (including MDBs) in cross-cutting issues may help address implementation challenges.** Beyond the collaboration with other institutions on joint assessments (such as FSAPs and DSAs), or the provision of financing, staff should rely more on external partners in macro-critical areas beyond the Fund's core expertise (e.g., sectoral, social and employment policies). Engaging with regional bodies—the Pacific Islands Forum Secretariat or CARICOM—where countries share experiences, build expertise, promote mutual learning, and develop joint policy options could foster learning and enhance impact. Closer coordination on policy advice and CD with other stakeholders present in-country could strengthen the complementarity of the topics covered and lead to better sequencing and facilitate absorption. A forward-looking agenda agreed with the SDS authorities and outlined in the Country Engagement Box should provide space and time to address data needed to support analysis and to increase country knowledge.

**57. Staff is encouraged to make full use of internal resources to bring cross-country angles to their country-specific work.** Staff should explore synergies that could be achieved by bringing together experience from different small states, both within the Caribbean, the Pacific, and Africa, and across regions. For instance, on issues like CBR, Pacific country teams could benefit from the experience of Caribbean countries, whose financial systems tend to be more developed. Staff should explore the opportunities of collaboration between teams and across departments to best utilize limited resources, given data limitations and methodological challenges. Besides standard surveillance tools, often other analytical tools developed by Fund staff are also flexible enough to be tailored for SDS; see Box 7 on the use of Growth-at-Risk (GaR) framework. In addition, recent data innovations offer staff new ways to overcome data limitations (see Box 8 on the use of Big Data).

#### *Addressing Data Gaps*

**58. Severe data gaps, limited capacity, and macroeconomic volatility create special challenges for Fund surveillance.** Data gaps occur not only in standard surveillance areas but also in newer areas like climate, digitalization, and gender, impeding the ability to develop economic and financial policy to address climate change, financial innovation, and inclusive growth. Many SDS face broad-based data limitations that encompass lack of financial and human resources in statistical agencies, and associated weaknesses in source data and compilation processes (see Annex V). Given the limited capacity of the authorities, and problems related to recruitment and retention, staff will need to discuss how to sequence and prioritize policies to achieve best outcomes. Collaboration with development partners on addressing data gaps may also be key for some SDS. Country Engagement Box could help ensure a common understanding (Annex II).

**59. New frameworks for data adequacy assessment and well-designed CD provision could assist authorities in addressing some of these challenges:**

- **Strengthened frameworks for data adequacy assessment.** The new data adequacy assessment framework ([IMF 2024g](#)), endorsed by the Board in January 2024 and being implemented starting from February 2024, will allow a more granular evaluation of areas of data weakness.
- **Statistics CD provision.** Staff should assess the capacity of the authorities in complying with the new requirements and engage with the authorities to explore ways to strengthen data provision and underlying data compilation processes needed for improving data adequacy. The new data adequacy assessment frameworks should therefore inform CD priorities across all topical areas of macroeconomic statistics, as well as in data dissemination.

**60. Alternative sources of data could strengthen the analytical foundation of policy advice.**

Staff should take advantage of innovative and new Fund data initiatives from which SDS can benefit, such as the use of Automatic Identification System (AIS) data (Box 8).

**Box 7. Assessing Growth-at-Risk (GaR) in SDS**

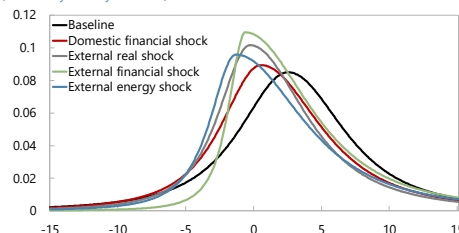
**SDS tend to have a narrow economic base and are highly dependent on a few economic sectors (e.g., tourism, or exports of a single commodity).** This increases their vulnerability to exogenous shocks and challenges their ability to maintain high and inclusive economic growth. These shocks originate either domestically (e.g., from local macro-financial conditions), or externally (e.g., via spillovers from large trade partners, tight external financing, or unfavorable terms of trade in the commodities markets).

**The IMF's GaR methodology assesses risks to the growth outlook (Adrian and others 2019; Prasad and others 2019).** It combines data-reducing techniques, quantile regression, and local projection methods to determine drivers of growth, construct probability of its distribution, and simulate the impact of shocks on the baseline forecast. The GaR methodology offers several advantages. First, it goes beyond traditional point forecasts, drawing attention to the entire growth distribution. Second, it provides a framework for analyzing the key drivers of future GDP growth, including their relative importance, which can vary across the growth distribution and the forecasting horizon. Third, it helps quantify the impact of systemic risk on future GDP growth and therefore can help guide macroprudential policy ([Bespalova and Rousset 2019](#)). Finally, the methodology can be tailored to the specifics of SDS. This is illustrated in applications to the [Eastern Caribbean Currency Union \(ECCU\)](#) ([Komatsuzaki and Brito 2019](#)) and [Trinidad and Tobago \(IMF 2023I\)](#):

- **For the ECCU, the analysis focused on the key drivers of real growth and their differential impact on the future growth across the distribution and forecasting horizons.** Considering the ECCU's sizable financial sector and its vulnerabilities to the external real and financial shocks and natural disasters, the data were divided into five categories: (i) credit growth; (ii) financial soundness indicators (FSIs); (iii) external real shocks; (iv) global financial conditions; and (v) natural disasters. The empirical results yielded several insights. First, credit growth helped boost growth in the short-term (one year ahead) but reduced the medium-term growth (three years ahead), calling for the prudential policies. Second, natural disasters decreased growth concurrently, but had no significant future impact. Third, external real shocks had strong negative impact on the ECCU economy at all horizons, especially when economy was booming. Fourth, tight global financial conditions had strong negative impact on the ECCU growth in the short-term, and especially in "bad" times. Finally, the domestic FSIs did not impact future growth.

- **For Trinidad and Tobago, an energy exporter with a sizable financial sector, the GaR analysis was adjusted to capture various external and domestic sources of shocks (e.g., financial, real, energy).** The results indicated that the modal growth in 2023 could decline relative to the baseline due to a domestic financial shock resulting in higher NPLs, a shock to natural gas price, an external financial shock (proxied by the VIX), and a U.S. growth shock.

**GaR in Trinidad and Tobago: Baseline and Shock Scenarios<sup>1</sup>**  
(Probability Density Function)



Source: IMF staff calculations.

1/ Shows the full conditional probability function of real GDP four quarters ahead as a function of real and financial external conditions, and real and macro-financial domestic conditions.

### Box 8. The Use of AIS Data in Surveillance

**Big Data can strengthen the empirical foundation of policy advice.** Big Data refers to nontraditional data sources characterized by high-volume, high-velocity, and high-variety (commonly known as the “3Vs”), along with other features that differentiate them from survey-based traditional statistics ([Hammer and others 2017](#)). Given its high frequency and granularity, Big Data has the potential to enhance bilateral and multilateral surveillance by providing more timely and granular data on economic activity and emerging risks, particularly for the economies whose statistical capacity is limited ([IMF 2018c](#); [IMF 2021b](#)).

**A prime example of Big Data is Automatic Identification System (AIS) data.** AIS data on vessel traffic have been used to complement official customs data, measure trade flows in more timely manner, and facilitate faster detection of turning points in the economic cycle. The AIS is required by the International Maritime Organization (IMO) for all ships greater than 300 gross tons on international voyages. Onboard, AIS transponders transmit radio messages providing a periodic real-time feed, including a ship’s position, speed, draft, destination, and navigation status. These radio messages can be picked up either by terrestrial stations (if the ship is near a shore) or by satellites.

**AIS data have been utilized in the Fund’s macroeconomic research and multilateral surveillance.** The use of AIS data for trade nowcasting has been explored by [Arslanalp and others \(2019\)](#), [Cerdeiro and others \(2020\)](#), [Arslanalp and others \(2021\)](#), and [Arslanalp and others \(2024\)](#). The October-2023 World Economic Outlook ([IMF 2023o](#)) features an analytical chapter on commodity trade fragmentation which includes a discussion on how the destinations for tanker shipments from Russian ports changed with sanctions imposed since Russia’s invasion of Ukraine. The 2020 External Sector Report ([IMF 2020b](#)) also featured AIS data to highlight a sharp decline in global trade. Staff’s analytical work using AIS data include [Deb and others \(2020\)](#), [Cerdeiro and Komaromi \(2020\)](#), and [Komaromi and others \(2022\)](#).

**The Fund’s SDS surveillance has also benefited from AIS data.** As there is a lag in publication of trade statistics, AIS-based indicators such as port calls and shipments in metric tons provide information on economic activity which can be complementary to official statistics. For example, [IMF \(2023m\)](#) and [Cugat \(2023\)](#) featured monthly nowcasts of trade flows and estimated economic disruptions. Also, [IMF \(2021e\)](#) featured trade nowcasts for an SDS (Djibouti) with a discussion on a port contract dispute and an increasing competition from other ports in the region.

**[PortWatch](#), developed by the Fund in collaboration with Oxford University, aims to provide AIS-derived real-time trade estimates to monitor trade disruptions.** PortWatch has supported surveillance through its alert notifications on shipping disruptions in the Red Sea and the Panama Canal, highlighting vulnerability of the countries reliant on these critical maritime passages, including many SDS countries. The

**Box 8. The Use of AIS Data in Surveillance** (concluded)

platform provides data, maps, and applications and features dedicated pages for each of the 1,469 ports and 24 critical maritime passages like the Suez Canal and Strait of Hormuz. Users can access data through direct downloads, an online interactive query tool for data exploration, and via APIs facilitating programmable integration.

## CAPACITY DEVELOPMENT

*Investments in CD remain critical in meeting the demand and needs of SDS. CD to SDS should be closely integrated with surveillance and lending and tailored to respond to each country's local circumstances and absorptive capacity.*

### A. Integrating CD with Surveillance and Lending

**61. Well-tailored CD is a critical part of Fund engagement, but institutional capacity of the authorities is often a constraining factor.** Institutions in SDS often rely on key officials with overburdened agendas, which limits their ability to make time for CD missions and CD absorption. Experience further suggests that strong institutional leadership and effective reform governance is often lacking in SDS, which impacts the implementation of CD recommendations. The paragraphs below identify guiding principles for CD design and delivery to maximize the impact of CD resources.

**62. Integrating CD with surveillance and lending is critical to maximize the impact of CD and area department country teams should lead the coordination efforts.** In line with the 2018 and 2024 Reviews of the Fund's Capacity Development Strategy ([IMF 2018e](#), [IMF 2024h](#)), it is important to ensure that Fund area departments and capacity-delivering departments working on SDS collaborate: i) on identifying capacity constraints and CD priorities, ii) through the lifecycle of the CD project; and iii) on including CD assessment in the surveillance and program process. Fund teams should also engage in regular dialogue, coordination, and information sharing on CD with other development partners to avoid duplication, increase synergies, and decrease the risk of stretching the limited absorptive capacity of the authorities.

**63. There are other mechanisms that can be leveraged to enhance integration:**

- **The Country Engagement Box and Country Engagement Strategies:** These documents, which are part of the Article IV consultation, should recognize domestic constraints and articulate CD priorities, consistent with the medium-term surveillance and lending objectives for a given SDS.
- **The resource allocation and the Results-Based Management (RBM) processes:** While CD departments design and deliver CD projects, area departments play an important role in articulating regional and country priorities and ensuring projects included in the medium-term workplan are consistent with surveillance/program objectives. Country teams are also expected to provide insights for project managers into the assessment of risks—consistent with those identified in programs and surveillance as part of the RBM framework.

- **Internal CD dashboards:** The recent introduction of internal CD data dashboards, including detailed RBM data and regional and country dashboards specifically geared toward country team needs, makes it easier for area departments to access a wide range of CD data, including volume, themes, and results. Area departments should leverage these tools in: i) the assessment of existing capacity and reform traction; ii) identifying reform priorities; and iii) providing inputs to the design and implementation of CD in SDS.
- **Leveraging field staff.** Resident Representatives and Regional Capacity Development Center (RCDC) staff should ensure that CD project managers are kept informed about changing conditions in the field to adapt accordingly.
- **To strengthen the integration of CD with surveillance and lending, country teams are required to clear CD briefs and review CD outputs.** The degree of country team involvement in CD project implementation, however, depends on the relative importance of the project to surveillance or program priorities. Best practices include country teams (including Resident Representatives) meeting regularly with project managers and CD providers, participating in CD missions, reviewing CD mission outputs, following up on recommendations with the authorities, and engaging on key changes to project design and assessments.

## B. Aligning CD with Absorptive Capacity of SDS

**64. Adapting project design requires calibrating the pace, volume, and ambition of CD to align it with absorptive capacity and SDS-specific challenges.** Tailoring CD involves aligning it with recipient country's absorptive capacity and ownership. The principles of effective tailoring, as articulated in the [Staff Guidance Note on The Implementation of The IMF Strategy for Fragile and Conflict-Affected States](#) also apply to SDS, and include:

- **Consultation:** Staff designing projects should consult with SDS country authorities and other relevant stakeholders when assessing reform priorities and absorptive capacity. Close involvement of national counterparts is essential to building trust and ownership and can help staff understand what can be achieved and what needs to be postponed—thereby setting realistic objectives. This should include an explicit agreement with authorities on targeted results. Further, staff based in headquarters should consult with the field staff, civil society, and other international organizations and development partners. Dissemination of CD outputs such as TA reports can foster greater ownership, improve coordination internally as well as with other CD providers and financing partners, promote accountability, and spread the Fund's contribution to knowledge as a global public good.
- **Realistic interventions:** When analyzing reform needs, staff should consider domestic constraints, including at the institutional level, e.g., staff strength. Reform recommendations and CD interventions should be realistic and practical, and where national solutions are not workable, regional or other "outsourced" solutions may need to be considered.

- Proper sequencing:** When capacity is severely limited, training can help build absorptive capacity, particularly if it is well integrated with TA. For instance, CD aimed to strengthen PFM or tax collection functions could begin with strengthening staff capacity through training, including via courses at regional training centers, the Fund's online learning platform, or customized training delivered by a TA provider. Staff should also first target basic needs and only gradually address more demanding but achievable objectives when required conditions are in place—such as setting up toolkits to develop a medium-term budgetary framework to preserve price and financial stability, or a multi-year project to re-base national accounts. Staff should also be prepared to pause the delivery and sequence of activities on any given CD project to allow more time if prior steps have not been implemented.
- Leveraging flexible CD resources and modalities:** Staff should leverage the relative strength of various resources and modalities to respond to each SDS' local and institutional context in providing CD. This would require being strategic in the deployment of training, in-country resident advisors, RCDCs, or headquarter staff; and virtual, in person or hybrid forms, for CD delivery. For instance, headquarter staff is typically better equipped to provide strategic diagnostics and large multi-year projects, while in the early stages of reform, hands-on assistance often delivered by RCDCs, may prove more effective. Similarly, when major institutional reforms require support that RCDCs cannot provide, consideration could be given to placing in-country resident advisors to support implementation. Where the use of in-country resident advisors is not feasible—for instance, due to resource limitations—peripatetic experts can be considered. In deploying these resources, close collaboration among HQ, RCDC, Long-term Experts (LTXs) and short-term experts (STX) remain critical. In addition, training can be customized to meet SDS institutions' context to the extent possible, for instance, through regional courses (Box 9). Where staff turnover is high, training of trainers may also help to build in-house capacity to train new staff. In terms of modalities, while in-person delivery remain preferred among many countries, staff and authorities can leverage virtual tools—technology permitting—to provide, for instance, follow up and implementation support after in-person missions.
- Emphasizing institutional capacity building in the use of LTX to avoid long-term capacity supplementation:** LTX, in the form of in-country resident advisors or RCDC-based experts are key resources in delivering CD to SDS. LTX, however, should not replace authorities' own staff in performing their functions—although, in some cases, temporary capacity supplementation may be unavoidable before capacity building can be effective. The use of LTXs should thus emphasize country ownership and the sustainable transfer of knowledge and skills to authorities and strong country ownership, including through documenting advice in the form of manuals and other institutional procedures.
- Strengthening leadership capacity to sustain reform implementation:** In addition to developing technical capacity, CD can also target strengthening organizational capacity for effective reform management, including reform governance and change management. This could also be done via peer-to-peer engagements drawing on the RCDC networks.



### Box 9. Training to Build Capacity for TA, Surveillance, and Lending in SDS: A Regional Approach

**The Pacific Technical Assistance Center's (PFTAC) member countries are mostly small developing states that face numerous economic challenges.** Confronting these challenges requires improved macro-forecasting capacity and better tools for macroeconomic management. The recent addition of a macroeconomics frameworks LTX expert from Institute for Capacity Development (ICD) at PFTAC, to complement the work of the macroeconomic advisor from the Asia and Pacific Department (APD), has allowed for a ramping up of CD in this area, with TA well supported with training. PFTAC typically delivers one or two regional macroeconomic training courses for the Pacific Islands countries annually, leveraging its two macroeconomic LTXs and the Singapore Training Institute (STI).

**Training delivered by the regional centers is an efficient way of providing the core tools required by officials to absorb the TA that is being provided by macroeconomic experts from ICD and APD.**

The training and TA are designed to educate officials who can effectively produce and deliver analysis and policy advice to decision makers. In addition, the combination of training and TA enhances officials' ability to competently interact with IMF officials undertaking staff and Article IV visits to member countries. An example of such training is a PFTAC-led customized macroeconomic diagnostics course, supported by STI, that was delivered in Tonga to PFTAC member countries in August 2023. Local examples drawn from Samoa, Vanuatu, and Tokelau were used to illustrate the diagnostic techniques as well as for the practical sessions.

**Joint missions facilitate a closer alignment of CD objectives with surveillance priorities.** The collaboration between the macroeconomic LTXs, who frequently join each other's missions, has been helpful in strengthening the link between CD and surveillance and program objectives.

**65. RCDCs are critical in providing CD.** They identify priorities for member countries in their program documents, subject to funding availability. Nonetheless, while RCDCs may identify CD priority needs, strategy-defining missions from the IMF headquarters remain essential to help the authorities prioritize and program major reforms. In some cases, RCDC-based experts can more efficiently deliver CD than headquarter-based staff. RCDCs are also acknowledged for being regional knowledge hubs and communication channels with CD recipients. A significant proportion of CD to SDS is provided via RCDCs—mainly through the Caribbean Regional Technical Assistance Center (CARTAC) and Pacific Technical Assistance Center (PFTAC). A regional approach for SDS has the advantage of offering opportunities for peer-to-peer learning through workshops, seminars, attachments, and internships, while maintaining a focus on the specific needs of the region (Box 8). While the start-up costs of peer-to-peer workshops can be high, the expected payback over time is a much stronger region cohort. Regional cooperation can also be supported by drawing on regional experts to deliver TA programs. Coordination between area and functional departments is key when reaching out to RCDC LTXs for support.

**66. The focus of Fund CD will remain on building institutional capacity in the core areas of Fund expertise.** CD in SDS will remain focused on the core areas of the Fund's mandate: public finances, monetary and financial systems, macroeconomic statistics, legal frameworks, and macroeconomic frameworks. In addition, Fund CD continues to also be expanded in areas that

present challenges and opportunities to SDS, including climate change, debt, digital money, gender and inclusion, and governance and anti-corruption.

## C. Developing CD in Areas of Special Interest to SDS

### *Climate Change*

**67. CD on climate issues, especially in the context of an RSF, are critical to addressing vulnerabilities.** Available climate CD products include:

- **Fiscal Management.** Fund CD provides resources to help integrate climate considerations in public financial management (green PFM), assess the impact of climate change on public infrastructure through the C-PIMA, analyze climate-related fiscal risks, develop disaster risk strategies and financing, support climate change fiscal risk management (for example, by quantifying climate change fiscal risk using the Fiscal Affairs Department Q-CRAFT tool and reporting on climate change fiscal risks in the Fiscal Risk Statement), and analyze the environmental, fiscal, economic, and distributional impacts of carbon pricing and a wide range of other mitigation policies using the Climate Policy Assessment Tool. To support and inform the design of the RSF as well as complement other available diagnostics, Climate Policy Diagnostics focus on assessing key macro-fiscal issues, including enabling institutions, mitigation policy, and adaptation policy. Following the diagnostics CDs, the Fund also supports countries in implementing the recommendations with hands-on assistance.
- **Financial Sector.** The Fund has integrated climate issues into its financial sector-related CD agenda. Fund departments support the central banks and financial sector regulators by covering climate finance and financial risks in their TA activities. The Fund also provides tools for country analysis of climate risk in the financial sector, stress testing, and in strengthening climate information architecture.
- **Data and Statistics.** The Fund uses its [climate change indicators dashboard](#), macroeconomic statistics, and innovative data collection techniques to anticipate economic shocks. The Fund also provides courses on macro-relevant environmental and climate change statistics aimed at familiarizing country authorities with crucial climate change-related indicators, enhancing their ability to better inform economic and financial policies.
- **Legal Frameworks, Financial Integrity, and Governance and Anti-Corruption.** The Fund provides guidance on legal frameworks, financial integrity safeguards, and governance and anti-corruption considerations relating to climate change policies and programs.
- **Macroeconomic Modeling.** The Fund's CD equips countries with tools and models to help integrate climate change and climate policies (mitigation, adaptation, energy transition) into macroeconomic frameworks. Such tools include, among others, the extension of the Public Debt Dynamics Tool that includes the effects of natural disasters (ND-DDT); general equilibrium models such as the DIGNAD model that quantifies the macroeconomic benefits of investing in

resilient infrastructure amidst natural disasters; and the Climate Macroframeworks Toolkit that helps integrate estimates of the impact of natural disasters on macroeconomic outcomes within a conventional IMF macroeconomic framework.

### *Other Priorities*

**68. The Fund is developing CD on other priorities that can be useful.** The Monetary and Capital Markets Department supports SDS' central banks in building a coherent quantitative framework for monetary policy and improving central banks' operations and communications through tailored program of TA and training activities. It also provides CD on many aspects of fintech and digitalization, including on digital money (such as e-money and CBDC), crypto asset regulation, use of fintech in banks, modernizing payment systems, and CBDC. These areas can be difficult for SDS authorities to navigate because of the speed of change and a shortage of technical skills and capacity. The Fund CD provided by the Fiscal Affairs Department focuses on various aspects of GovTech solutions for public finance. The CD aims to strengthen institutional capacity in countries through direct delivery of strategic and operational support, peer-to-peer activities, training, and the analytical work related to digitalization in public finance ([IMF 2024h](#)). Staff should encourage the SDS to engage early on CD, and to access courses and online resources available on the IMF website.

## LENDING AND PROGRAM DESIGN

*To help SDS choose a Fund facility and design a program appropriately, Fund staff remains guided by policies applicable to the entire membership. While there is no specific facility dedicated to SDS, staff has an ample choice of available instruments and significant flexibility within current lending policies to meet SDS needs. The overarching policy objectives of most SDS, namely sustainable growth and resilience building, can be adequately supported by careful tailoring of program design and conditionality. When designing programs, staff should carefully account for capacity constraint of the SDS authorities and vulnerability of SDS economies to exogenous shocks.*

**69. Staff should leverage the flexibility embedded in the existing policies when engaging with SDS in a program context.** For overall program design, staff should refer to the [Guidelines on Conditionality](#) (IMF 2002), further elaborated in the [Operational Guidance Note on Program Design and Conditionality](#) (IMF 2024e), including on the choice of facilities or instruments. Where relevant, more specific guidance is provided in the [LIC Facilities Handbook](#) (IMF 2023a), the [Operational Guidance Note for Resilience and Sustainability Facility](#) (IMF 2023g), the [Staff-Monitored Programs—Updated Operational Guidance Note](#) (IMF 2022h), the [Policy Coordination Instrument—Updated Operational Guidance Note](#) (IMF 2024f), and the [Staff Guidance Note on the Implementation of the IMF Strategy for Fragile and Conflict-Affected States](#) (IMF 2023k).<sup>15</sup>

<sup>15</sup> Importantly, Board summings-up, decisions and Board papers establishing relevant policies are the controlling legal instruments and these guidance notes do not take precedence over them.

## A. Facilities and Instruments Most Relevant for SDS

**70. The unique characteristics and policy objectives make certain instruments and facilities more suitable to SDS needs.** Historically, SDS made extensive use of the Fund's Emergency Financing (EF) instruments, namely the Rapid Credit Facility (RCF) and Rapid Financing Instrument (RFI). This is due both to SDS' vulnerability to exogenous shocks and higher capacity requirements for implementing Upper Credit Tranche (UCT)-quality programs. Recently, the newly created Resilience and Sustainability Facility (RSF) and the gradual improvement in capacity, have contributed to increased interest in UCT-quality programs, especially those supported by the Extended Credit Facility (ECF) and Extended Fund Facility (EFF). As of May 2024, 19 SDS are eligible to the Fund's concessional financial resources under the Poverty Reduction and Growth Trust (PRGT) and all SDS are eligible for borrow under the Resilience and Sustainability Trust (RST).<sup>16</sup> The BoP needs of SDS, especially following natural disasters, can be very large, which stresses the need for country teams to work with Development Partners to help SDS authorities mobilize external financing.

**71. The Fund's EF instruments provide rapid financial support to address urgent BoP needs arising from a range of circumstances including sudden exogenous shocks.** Examples of these shocks include commodity price shocks, natural disasters, epidemics, or plummeting tourists' arrivals. Urgent BoP needs can also arise from non-exogenous events, such as post conflict or other fragile situations. The use of EF can be appropriate in these cases if a UCT-quality program is either not necessary (when the BoP needs are transitory and expected to be resolved within one year with no major policy adjustments) or not feasible (due to the lack of capacity or insufficient time for a program negotiation).<sup>17</sup> RCF/RFI financial assistance with an outright disbursement/purchase can provide qualifying countries with fast, temporary financial support to reduce the negative impact caused by the shock.

**72. Among UCT quality arrangements, longer-term facilities like the ECF (for PRGT-eligible SDS) and the EFF offer the most flexibility and are typically most suitable to SDS needs.** ECF arrangements under the PRGT can be approved for 3-5 years; their primary objective is to enable members with a protracted BoP problem to *make significant progress* toward a stable and sustainable macroeconomic position, consistent with strong and durable poverty reduction and growth. Therefore, the final goal of macroeconomic sustainability might extend beyond the first ECF arrangement, and successor arrangements can be requested.<sup>18</sup> Notably, ECF-supported programs can include projected post-program financing gaps (PPFGs) if additional time is needed to resolve protracted BoP problems and adequate safeguards are in place. The safeguards usually involve members demonstrating that their prospective capacity to repay remains adequate after the

<sup>16</sup> Notably, small states are subject to higher income threshold for eligibility for both trusts (see Annex I). The graduation threshold is also higher for small states.

<sup>17</sup> The policy objectives behind the RCF/RFI qualification criteria are to ensure that low-conditionality emergency support is not used as a shortcut in cases in which countries could instead receive support through a UCT-quality program to address their BOP needs.

<sup>18</sup> The member will need to meet the qualification criteria for approval of an ECF arrangement.

program and their debt remains sustainable under realistic financing assumptions. The EFF is, broadly speaking, the counterpart of the ECF under the non-concessional General Resources Account (GRA), with two notable differences. First, the maximum duration is 4 years and second, it does not allow PPFs. Higher-income PRGT-eligible countries are presumed to blend PRGT-financing with the GRA resources ([IMF 2021f](#)).<sup>19</sup>

**73. Other Fund instruments and facilities are also available.** The Stand-By Arrangements (SBA) and its PRGT counterpart, the Standby Credit Facility (SCF), are designed to address short-term actual or potential BoP needs but are much less frequently used by SDS. Countries with very strong economic fundamentals and policy frameworks could also request the Short-term Liquidity Line (SLL) or the Flexible Credit Line (FCL). And countries where such fundamentals and policy frameworks are sound can request support under the Precautionary and Liquidity Line (PLL).

**74. PRGT-eligible SDS can also have access to grants for debt relief under the Catastrophe Containment and Relief Trust.** CCRT operates under two windows: one dedicated to catastrophic natural disasters and the other to fast-spreading major public health disasters with international spillover potential.<sup>20</sup> An eligible country, hit by certain catastrophic disasters and experiencing a BoP need due to such a disaster, would receive temporary debt flow/stock relief on their debt service payments (principal and interest) to the Fund.<sup>21</sup>

## B. Non-financing Instruments and Track-record Building

**75. The Policy Coordination Instrument (PCI) is a non-financing UCT-quality instrument that enables members to signal commitment to reforms or unlock financing from other official or private creditors.** It can help catalyze additional financing or secure reform gains. A country with an on-track PCI can request support under the EF if urgent BoP needs arise while the PCI is underway, or receive financial support under an SBA and/or SCF arrangement without cancelling the PCI; see ¶¶11, 12 of IMF (2024f). PCI can be used by SDS requesting financing under the Resilience and Sustainability Facility (see section C below).

**76. When an SDS does not have the capacity to implement a UCT-quality program, the preferred method for track-record building is the Staff-Monitored Program (SMP).** SMPs can

<sup>19</sup> Blending is presumed for PRGT-eligible countries that (i) meet the income criterion for blending and (ii) do not have debt vulnerabilities that limit their access to international financial markets. Notably, for small states, high debt vulnerabilities are sufficient to access PRGT resources exclusively; they do not need to demonstrate lack of access to international market. As of April 2024, three SDS are required to blend: Bhutan, Solomon Islands and Vanuatu. See [IMF \(2021f\)](#) for more details.

<sup>20</sup> The Catastrophe Containment window has been used extensively during the 2020 pandemic to provide several tranches of flow debt relief to qualifying members ([IMF, 2021d](#)). Four SDS benefitted from it: Comoros, Djibouti, São Tomé and Príncipe, and Solomon Islands. The funds, in the form of grants, were used to fulfill the obligations falling due to the Fund while freeing scarce and much needed resources to address the impact of the pandemic.

<sup>21</sup> Such disasters include those that have directly affected at least one-third of the population, are estimated to have destroyed more than a quarter of the country's productive capacity or have caused damage deemed to exceed 100 percent of GDP.

be used concurrently with Fund EF instruments if financing is needed, and the country qualifies. Successful SMPs can pave the way for a new Fund financing arrangement, repeated use of emergency financing, or the resumption of an existing arrangement which has gone off track. SMPs are informal agreements between national authorities and Fund staff, approved by Fund Management, with the objective to monitor the implementation of economic policies to help build a track record of satisfactory performance before requesting Fund financial support. In general, SMPs are shared with, but not endorsed by the Fund's Executive Board. In 2022, the SMP policy was amended to allow for limited Executive Board involvement in selected cases called Program Monitoring with Board Involvement (PMB) ([IMF, 2022c](#)).

## C. Resilience and Sustainability Facility

**77. The RSF provides affordable long-term financing to countries undertaking reforms to reduce macro-critical risks related to climate change and pandemic preparedness and thereby strengthen their prospective BoP stability.** It complements the PRGT and GRA lending toolkits by focusing on structural challenges that need to be resolved over an extended horizon, including those associated with climate change and pandemic preparedness.

**78. The RSF requires a concurrent UCT-quality program to ensure adequate policy safeguards and to support a stable macroeconomic environment.** An RSF arrangement is normally approved concurrently with either the approval of, or the completion of a review of, a qualifying UCT program, either financing (SCF, ECF, SBA, EFF, FCL, PLL) or a non-financing (PCI), with at least 18 months remaining until its expiration. When considering SDS authorities' interest in an RSF, staff teams should review the efficacy of the Fund's wider range of instruments (especially the ECF and EFF) and explore the possibility of UCT-quality programs with targeted conditionality that is aligned with SDS capacity. Notably, drawing arrangements are not mandatory; moreover, an RSF could accompany a non-financing instrument like the PCI. Teams should engage early with the World Bank and other development partners to identify critical vulnerabilities and country constraints and assess potential access to climate finance.

**79. Given the capacity constraints of many SDS members, staff teams should pay particular attention to the design of RSF Reform Measures (RMs).** RMs should be strong, measured by criticality, ambition, and depth, yet they should be tailored to SDS circumstances (Box 4 in [IMF 2023g](#)). Where possible, country teams should build on the analysis carried out in the Country Engagement Strategy (for SDS that are also FCS) and the Country Engagement Box (for the others). Close coordination with key stakeholders and the use of comprehensive diagnostics (Annex III and ¶¶76,77 in [IMF 2022d](#)) would be especially important to ensure that RMs are not only aligned with the broader engagement strategy, but also properly sequenced and tailored to the country's needs and absorptive capacity. Moreover, given the weak capacity in some SDS, teams should also recognize that implementing climate change-related reforms is extremely challenging and requires extensive CD; see the previous section and Box 2 in [IMF \(2024c\)](#). Parsimonious use of conditionality and careful prioritization of RMs that address the key climate/pandemic preparedness challenges is

even more important than in non-SDS. Given their unique circumstances, potentially tailored solutions could be considered for SDS in the comprehensive review of the RST in 2026 (IMF, 2024c).

## D. Key Considerations for Program Design

**80. When determining the pace, timing and composition of macroeconomic adjustment, staff should account for policy tradeoffs that many SDS face due to their limited policy space and capacity.** Staff teams should build macro-frameworks on realistic assumptions to avoid the risks of overoptimism or proposing adjustment that does not internalize social and capacity constraints. For instance, limited fiscal capacity of SDS authorities could reduce the size of adjustment that can be realistically achieved on either the revenue or the spending side, at least in the short run. Lack of well-functioning social safety nets could necessitate linking fiscal adjustment and/or phasing out of distortionary subsidies with social spending conditionality to mitigate temporary negative impact on the vulnerable. In many SDS, external financing from development partners can be a critical determinant of the financing envelope. Hence, staff should liaise with the IFIs and development partners to assess available external financing when projecting the BoP needs and calibrate the balance between adjustment and financing in the program.

**81. High exposure of many SDS to exogenous shocks calls for staff to strengthen the robustness of program design and engage early on contingency planning.** One of the common traits of SDS is their exposure to destructive and recurrent natural disasters, which might disrupt a program and nullify authorities' efforts. As these events are extremely difficult to predict and prevent, staff should aim to ensure that program design is flexible, focuses on actionable mitigating measures and includes robust contingency plans to facilitate a rapid response after the shock to reduce its negative impact. For the contingency plan, staff could prepare in advance, and in collaboration with the authorities, ways to deploy support swiftly when the shock hits, including a plan to rapidly liaise with other IFIs and development partners with complementary expertise. In the event of an exogenous shock like a natural disaster, staff could consider an augmentation of the existing arrangement to create fiscal space needed for the response.

**82. For programs with longer-term objectives, to raise the likelihood of program success, staff should aim to tailor programs to highly uncertain environments by building reform measures incrementally.** The possibility to explicitly recognize PPFs under an ECF arrangement allows for increased realism when preparing the macro-framework; see IMF (2023k) for further discussions. The design of the program should also take full account of the CD delivered over the course of the program, to enable the program to support deep reforms by building foundation through successive intermediate steps and the ramping-up of capacity. When a successor ECF arrangement is requested, staff should take advantage of the Country Engagement Box or Strategy (for FCS) to ensure the consistency and continuity.

## E. Tailoring Conditionality and Leveraging Flexibility in Program Design

**83. Structural benchmarks (SBs) can be tailored to guide the implementation of a carefully sequenced reform agenda that accounts for limited capacity.** Given the capacity constraints of the SDS authorities, staff should exercise judgement in choosing which reform measures should become SBs based on their criticality for achieving program objectives. Staff should consider breaking high-depth reforms into intermediate steps as multiple SBs to facilitate compliance and maintain the parsimony of individual conditionality, especially for contentious or complex reforms. Ambitious SBs could be supported by increased disbursements or purchases under the program. A longer-term structural reform agenda should ideally be consistent with the authorities' homegrown national development plan, country engagement strategy, CD plans and delivery, and be coordinated with other IFIs and development partners.

**84. Limited statistical capacity requires staff to consider the quality and timeliness of data provided under the program.** Weak transparency and governance could limit accountability and monitoring by the authorities. To avoid the risk of non-complying disbursements (misreporting), staff should assess the authorities' capacity to adequately measure and monitor Quantitative Performance Criteria (QPC) and Indicative Targets (ITs). For example, when facing a long lag in the provision of above-the-line fiscal data, staff could explore using below-the-line data to monitor the fiscal deficit. Extensive use of diagnostic tools and appropriate TA could support the building of capacity and provide input for setting up appropriate safeguard mechanisms for program monitoring. Accordingly, it is critical that the Technical Memorandum of Understanding contains detailed and accurate descriptions of the performance criteria under the program.

**85. Staff should consider ahead of time measures that could facilitate program performance for highly volatile economies.** When SDS are exposed to heightened uncertainty or reduced capacity, for instance in the aftermath of a natural disaster, a greater use of ITs could be appropriate in monitoring program performance. If a natural disaster causes lasting or large deviations in the macroeconomic situation and thus requires changes in policy thrust, such unanticipated developments should be dealt with by waivers, modifications of PCs, and adjustments during program reviews.

## COORDINATION WITH DEVELOPMENT PARTNERS

*Coordination with other institutions, development partners and Civil Society Organizations (CSOs) is necessary for consistent and effective Fund engagement with SDS members. The Fund can benefit from expertise in sectoral policies and stronger local presence of other institutions. Better coordination is also critical to accommodate limited absorptive capacity of SDS authorities. In these collaborations, staff remains guided by the existing frameworks.*

**86. Coordination with other international institutions, development partners and CSOs is important for effective Fund engagement.** The economic structure of SDS implies that performance of a handful of sectors can be macro-critical. Thus, Fund engagement can greatly



benefit from expertise and experience with sectoral policies of other institutions, like the World Bank, other MDBs, or regional development banks. Other institutions and bilateral development partners often maintain more local footprint than the Fund, and thus are better aware of developments on the ground. In addition, the limited capacity of SDS to host mission visits and CD/TA require the Fund to coordinate closely with other institutions or development partners not to overburden the authorities. Engagement with CSOs, think tanks and academia can provide useful institutional and analytical background information about SDS members and help enhance of Fund policy advice. In engagement with the World Bank and the Regional Financing Arrangements, Fund's main role is to assess a country's macroeconomic conditions and advise a country on the appropriate actions to restore macroeconomic stability. Staff teams should remain guided by the existing guidelines on the collaboration with different institutions, organizations and in specific areas.<sup>22</sup>

**87. Staff is encouraged to collaborate with other development partners, including bilateral partners, particularly on CD.** For example, to support reform planning and development partner coordination, the Tax Administration Diagnostic Assessment Tool (TADAT) assessments of several SDSs have been conducted with joint IMF and development partner teams, e.g., Bhutan and Maldives jointly with Asian Development Bank staff, Suriname jointly with Inter-American Development Bank and Inter-American Center of Tax Administrations staff, Guyana with US Treasury's Office of Technical Assistance staff, Trinidad and Tobago with the Netherlands Tax Administration staff. The assessment results ultimately being used to inform the country's reform plans and the resulting coordinated development partners' CD interventions.

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<sup>22</sup> See the [IMF-World Bank Concordant in 1989](#), IMF-World Bank ([2001](#), [2007](#), [2022](#)), the [Joint Statement of the IMF Managing Director and of the World Bank President in 2023](#), the [Enhanced IMF-World Bank Framework for Scaled-Up Climate Action](#), IMF ([2015](#)) and IMF ([2017](#)) for guidelines of engaging with different partners.

## Annex I. Definitions of Small States

The IMF uses two concepts to describe countries with less than 1.5 million population. The term Small States is used as one of the qualification criteria in Fund lending operations, while Small Developing States is an analytical group created to facilitate the coverage of issues faced by small and micro developing countries, regardless of their eligibility for certain Fund lending facilities.

The concept of *Small States* was established in the 2010 Board Paper [Eligibility to Use the Fund's Facilities for Concessional Financing](#) (IMF 2010). It aimed to account for the relatively higher volatility of fiscal and external accounts observed in small states. A member was considered a "small country" if it had population below 1 million according to the World Bank's World Development Indicators (WDI) database for the latest year with available data. The population threshold has been used since as an additional criterion to evaluate members' eligibility for the PRGT. Among other criteria, a country is eligible for the PRGT when its income level falls below the World Bank's IDA operational cut-off, and graduates when the income is at least twice the IDA operational cut-off. For small states, the entry and exit cut-offs are set at two and three times the IDA operational cut-off, respectively.<sup>1</sup>

The population threshold for "small states" has been revised twice since. In the [2012 PRGT Review](#) (IMF 2012) it has been raised to 1.5 million to align it with the World Bank's definition of a small state. In the [2013 PRGT Review](#) (IMF 2013b) countries with less than 200,000 population were classified as "microstates." To account for their even greater volatility compared than small states, their entry/graduation criteria were set at five/six times the IDA threshold, respectively. The Fund currently uses this definition.

The concept of *Small Developing States* has been introduced in the paper on [2013 Macroeconomic Issues in Small States and Implications for Fund Engagement](#) (IMF 2013c) for analytical purposes, to account for the diversity of the *small states* group. The *small states* group has subsequently been narrowed to developing countries by excluding 7 advanced economies as defined by the WEO (Andorra, Cyprus, Estonia, Iceland, Luxembourg, Malta, and San Marino) and 3 high-income fuel-exporting countries as defined by the World Bank (Bahrain, Brunei Darussalam, and Equatorial Guinea). In 2017, the SDS group had 34 members. Using the latest WDI data, compared to the 2017, the population Trinidad and Tobago and the Equatorial Guinea exceeds 1.5 million. Applying the same exclusion criteria, Equatorial Guinea was again excluded based on its income levels. Since the population of Trinidad and Tobago is only marginally above 1.5 million according to the WDI Database and below the 1.5-million threshold according to the authorities' own data, Trinidad and Tobago will continue to be classified as an SDS. In conclusion, the list of SDS countries remains the same as in 2017.

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<sup>1</sup> For the RST, the income threshold for eligibility is 25 times the 2021 IDA operational cutoff, as opposed to 10 times for other countries.

Outside the Fund, the UN's [Small Island Developing States \(SIDS\)](#) grouping includes 39 states and 18 associate members of UN regional commissions. The [Small States Forum \(SSF\)](#) is an important platform that the World Bank uses for high-level dialogue on engagement with small states. The composition of both groups can be found in Table I.2

**Annex I. Table 1. Trend in Population of Small Developing States**

<b>Country<sup>1</sup></b>	<b>2013</b>	<b>2017</b>	<b>2021</b>	<b>Growth Rate 2013-21</b>
Trinidad and Tobago <sup>2</sup>	1.44	1.48	1.53	5.9
Mauritius	1.26	1.26	1.27	0.6
Timor-Leste	1.16	1.24	1.32	13.7
Eswatini	1.12	1.15	1.19	6.6
Djibouti	0.97	1.04	1.11	13.8
Fiji	0.91	0.92	0.92	1.2
Guyana	0.75	0.76	0.80	7.6
Bhutan	0.73	0.76	0.78	6.7
Comoros	0.70	0.76	0.82	17.5
Montenegro	0.62	0.62	0.62	-0.3
Solomon Islands	0.58	0.64	0.71	21.5
Suriname	0.56	0.59	0.61	8.7
Cabo Verde	0.54	0.56	0.59	8.9
Maldives	0.40	0.47	0.52	30.1
Bahamas, The	0.39	0.40	0.41	5.8
Belize	0.34	0.37	0.40	16.1
Barbados	0.28	0.28	0.28	1.6
Vanuatu	0.26	0.29	0.32	21.1
Samoa	0.20	0.21	0.22	9.4
Sao Tome and Principe	0.19	0.21	0.22	15.1
St. Lucia	0.17	0.18	0.18	3.3
Grenada	0.12	0.12	0.12	6.6
Kiribati	0.11	0.12	0.13	13.7
Micronesia, Fed. Sts.	0.11	0.11	0.11	4.2
St. Vincent and the Grenadines	0.11	0.11	0.10	-2.9
Tonga	0.11	0.11	0.11	-1.0
Seychelles	0.09	0.10	0.10	10.3
Antigua and Barbuda	0.09	0.09	0.09	5.3
Dominica	0.07	0.07	0.07	5.2
Marshall Islands	0.05	0.05	0.04	-18.1
St. Kitts and Nevis	0.05	0.05	0.05	-0.3
Palau	0.02	0.02	0.02	1.2
Tuvalu	0.01	0.01	0.01	2.6
Nauru	0.01	0.01	0.01	17.0
<b>Summation</b>	<b>14.5</b>	<b>15.2</b>	<b>15.8</b>	<b>8.7</b>

Data source: World Development Indicators.

1/ Ranked by 2013 population, in millions.

2/ The population of Trinidad and Tobago only surpasses the 1.5 million threshold marginally.

Annex I. Table 2. World Bank and United Nations Groupings of Small Developing States

<b>World Bank (50 Small States)</b>					
<b>Africa (13)</b>	<b>East Asia Pacific (13)</b>	<b>Latin America and the Caribbean (13)</b>	<b>Middle East and North Africa (3)</b>	<b>Europe and Central Asia (6)</b>	<b>South Asia(2)</b>
<b>Botswana</b>	<b>Brunei Darussalam</b>	Antigua and Barbuda	<b>Bahrain</b>	<b>Cyprus</b>	Bhutan
Cabo Verde	Fiji	Bahamas, The	Djibouti	<b>Estonia</b>	Maldives
Comoros	Kiribati	Barbados	<b>Qatar</b>	<b>Iceland</b>	
Eswatini	Marshall Islands	Belize		<b>Malta</b>	
<b>Equatorial Guinea</b>	Micronesia	Dominica		Montenegro	
<b>Gabon</b>	Nauru	Grenada		<b>San Marino</b>	
<b>Gambia, The</b>	Palau	Guyana			
<b>Guinea-Bissau</b>	Samoa	<b>Jamaica</b>			
<b>Lesotho</b>	Solomon Islands	St. Kitts and Nevis			
Mauritius	Timor-Leste	St. Lucia			
<b>Namibia</b>	Tonga	St. Vincent and Grenadines			
Sao Tomé and Principe	Tuvalu	Suriname			
Seychelles	Vanuatu	Trinidad and Tobago			
<b>United Nations (39 Small Island Developing States)</b>					
<b>Caribbean (16)</b>	<b>Pacific (14)</b>	<b>Other (9)</b>	<b>Fund SDS not in SIDS (4)</b>		
Antigua and Barbuda	Fiji	<b>Bahrain</b>	Bhutan		
Bahamas, The	Kiribati	Cabo Verde	Djibouti		
Barbados	Marshall Islands	Comoros	Eswatini		
Belize	Micronesia	<b>Guinea-Bissau</b>	Montenegro		
<b>Cuba</b>	Nauru	Maldives			
Dominica	Nieu	Mauritius			
<b>Dominican Republic</b>	Palau	Sao Tomé and Principe			
Grenada	Papua New Guinea	Seychelles			
Guyana	Samoa	<b>Singapore</b>			
<b>Haiti</b>	Solomon Islands				
<b>Jamaica</b>	Timor-Leste				
St. Kitts and Nevis	Tonga				
St. Lucia	Tuvalu				
St. Vincent and Grenadines	Vanuatu				
Suriname					
Trinidad and Tobago					
Note: Countries marked in <b>bold blue</b> are not in the Fund listing of Small Developing States.					

## Annex II. Guidance on the SDS Country Engagement Box

The [Management Implementation Plan on Fund Engagement with Small Developing States \(SDS\)](#) called for the preparation of a Country Engagement Box (Box) in policy notes and staff reports to enhance the traction and focus of the Fund's work on SDS. The aim is to clearly articulate the high-level considerations underpinning staff's engagement strategy with country authorities. To that end, this annex provides staff guidelines for the preparation of a focused and streamlined Box.

1. **The purpose of the Box is to clearly articulate the engagement strategy with SDS.** It seeks to foster the integration of surveillance, lending, and CD activities, transparently recognize domestic constraints and increase support for implementation. The Box should discuss country engagement issues three years into the future, consistent with the medium-term perspective of Article IV consultations. It should present, at a high-level, the key factors that lead staff to formulate their engagement modalities, with an overarching longer-term view of how surveillance, lending, and CD interact. It should not duplicate the Policy Note or Staff Report.
2. **Staff should tailor the scope and depth of the engagement strategy to each country's specificities.** Rather than providing a list of potential topics to be covered (see below), staff should exercise discretion in preparing a streamlined coverage of issues most critical to shaping staff's overall approach. A Box does not need to be prepared for SDS that are also fragile and conflict-affected states (FCS), as the full-scale Country Engagement Strategy for FCS supersedes the Box. Area Departments will lead the preparation of the Box with inputs from Functional Departments.
3. **The starting point should be staff's overarching assessment of the authorities' medium-term policy objectives and priorities.** Strategic documents that can serve as inputs include the authorities' national development plan or poverty reduction strategy (required for programs supported by the Poverty Reduction and Growth Trust). Objectives related to sustaining growth and enhancing resilience are expected to be highly relevant to many SDS.
4. **The Box should recognize and discuss the domestic constraints that SDS authorities face.** It could discuss: (i) capacity constraints (e.g., the lack of trained staff or weak policy analysis capacity), (ii) institutional constraints (e.g., past failed reforms or reform reversals, political economy), or (iii) financing constraints (e.g., the need for financial support to implement certain policies and reforms). These constraints, together with the policy objectives of the authorities, will guide the selection and sequencing of policy priorities, as well as the appropriate engagement modalities.
5. **The Box should specify the staff engagement plan that can best help the authorities accomplish their longer-term reform agenda.** It should include high-level considerations on the policy areas in need of most focus, and the complementarity and sequencing of Fund engagement in surveillance, lending and CD. To the extent possible, the plan should internalize factors that can cause short-term uncertainty, such as vulnerability to natural disasters or the electoral cycle. It can be updated more frequently, if there is a major turning point. For members using Fund resources, it should highlight considerations for Fund engagement originating from the identified implementation constraints and plans to mitigate any downside risks.

**6. Capacity constraints commonly observed in SDS strengthen the importance of CD activities.** Staff could refer to the existing CD Country Strategy Note (mandatory for heavy users) to avoid duplication. In coordination with CD departments and the authorities, staff could identify in the Box a selective list of CD areas that are expected to have the largest impact. Staff could also consult Regional Capacity Development Centers, given their role in providing TA and training to SDS and the additional benefits of bringing a regional angle. Priority CD areas should help fill policy implementation gaps, while being mindful of the authorities' policy agenda and absorptive capacity to maximize ownership and traction.

**7. The Box could also discuss collaboration with other stakeholders, such as key development partners.** For many SDS, the disproportionate exposure to climate risks and reliance on a small number of sectors make collaboration on climate issues and sectoral policies important. When relevant, the Box should discuss coordination in the delivery of climate diagnostics, especially if a member is considering a Resilience and Sustainability Facility (RSF) arrangement. The focus should be on the synergies with the Fund's engagement to enhance complementarity and avoid duplication. Staff could also pay attention to other emerging areas particularly relevant to SDS, such as digital transformation and inclusion.

**8. The Box should be integrated in the regular Article IV process, but at a lower frequency.** The Box aligns with the Article IV cycle and will be a part of the Policy Note and Staff Report. It could be included as either a box or an annex in the Policy Note and Staff Report for the Article IV Consultation and will be reviewed during the standard review process. It should normally not exceed one page. Under the current review guidelines, when included as an Annex, it will not be included in the indicative word limit for annexes; however, when included as a box, the relevant word limit based on the type of country document applies. The Box should be prepared (and updated) once every three years for countries with annual Article IV consultations or every other Article IV Consultation cycle for countries on a 24-month cycle. Area Departments are encouraged to engage early with Functional Departments in preparing the Box. Staff should discuss the strategy with the authorities with the aim of building a shared understanding of the medium-term agenda. The discussion should be held in the same way as other elements of an Article IV Consultation; the Box will be shared with the authorities, Executive Directors, and external stakeholders as part of the Staff Report. Implementation takes effect starting with Policy Notes circulated for review once the SDS guidance note takes effect.

## Annex III. Intentional Gendered Policies Can Help Address SDS-specific Issues

- 1. In many SDS, the geographical challenges of remoteness and fragmentation significantly impede access to education, economic opportunities, and connectivity to global markets.** Tackling these issues through gender-focused digital inclusion and financial access can catalyze important socio-economic transformations. By equipping women with digital skills and access to online banking and mobile financial services, SDS can leapfrog traditional structural barriers, enabling women to participate in the burgeoning digital economy. This empowerment facilitates their engagement in entrepreneurship, e-commerce, and remote work, avenues previously constrained by geographic isolation. Such initiatives not only bridge the digital divide but also create pathways for women to access broader markets, education, and health services online, driving innovation, enhancing productivity, and fostering economic resilience against external shocks.
- 2. The economic vulnerability of SDS, often characterized by their reliance on single sectors such as tourism, agriculture, or fisheries, can be mitigated by enhancing female participation and entrepreneurship and diversifying into new sectors.** Women, when provided with equitable access to resources, education, and training, have the potential to drive economic diversification ([Kazandjian and others 2019](#)) by venturing into underrepresented or innovative sectors, creating a more resilient economic base. Encouraging female entrepreneurship also fosters job creation, stimulates local economies, and contributes to the overall socio-economic development of the community. By addressing systemic barriers that limit women's economic participation, such as access to credit, land, and networking opportunities, SDS can unlock a powerful catalyst for inclusive growth and stability.
- 3. In SDS, where the public sector often dominates employment, creating a balanced and competitive labor market is essential for economic vitality and innovation.** Addressing gender disparities in this context means ensuring that women have equal opportunities for employment and career advancement in both the public and private sectors. By implementing policies that promote gender equality in the workforce, such as equal pay for equal work, gender-sensitive recruitment practices, and support for women in leadership roles, SDS can enhance labor market efficiency and competitiveness. This approach not only elevates women's economic status and empowerment but also stimulates private sector growth by introducing a broader range of skills and perspectives into the economy. When women are equally represented and rewarded in the workforce, it helps to lower artificially high reservation wages in the public sector, making the private sector more competitive and capable of job creation.
- 4. Incorporating a gender lens into fiscal policy and targeted infrastructure investments in SDS is a strategic approach to addressing gender-specific challenges while promoting sustainable development.** By allocating fiscal resources with a gender lens, SDS can ensure that infrastructure projects—such as transportation, information and communication technology (ICT), and energy—meet the needs of women and men equitably, facilitating access to markets, education, and healthcare. For example, safe and reliable public transportation can significantly increase

women's mobility and their ability to participate in the labor market or access educational and healthcare opportunities. This gender-aware approach to budgeting and infrastructure not only enhances the effectiveness of public spending by ensuring it addresses the needs of the entire population but also drives economic growth by enabling full participation of women in the economy. Moreover, by reducing gender disparities, such policies contribute to more inclusive and resilient economic development.

**5. In SDS, where the threats of climate change and natural disasters loom large, empowering women is pivotal for enhancing community resilience (Two-Pager on Climate and Gender, 2023).** Women, deeply involved in agricultural practices and resource management, are inherently positioned to lead in adapting and responding to environmental challenges. By ensuring women have access to education and healthcare, they are better equipped with the knowledge and well-being required to implement sustainable farming techniques and manage natural resources wisely. Moreover, involving women in planning and decision-making processes related to environmental management and disaster preparedness can lead to more effective and inclusive strategies that take into account the needs and strengths of the entire community. Better educated and healthier women are more likely to spearhead initiatives that build local capacity to withstand and recover from environmental shocks, making their communities less vulnerable and more resilient to the impacts of climate change and severe weather events. This approach not only leverages the unique insights and contributions of women but also strengthens the overall adaptive capacity of SDS to face and mitigate the slow-moving risks posed by a changing climate.

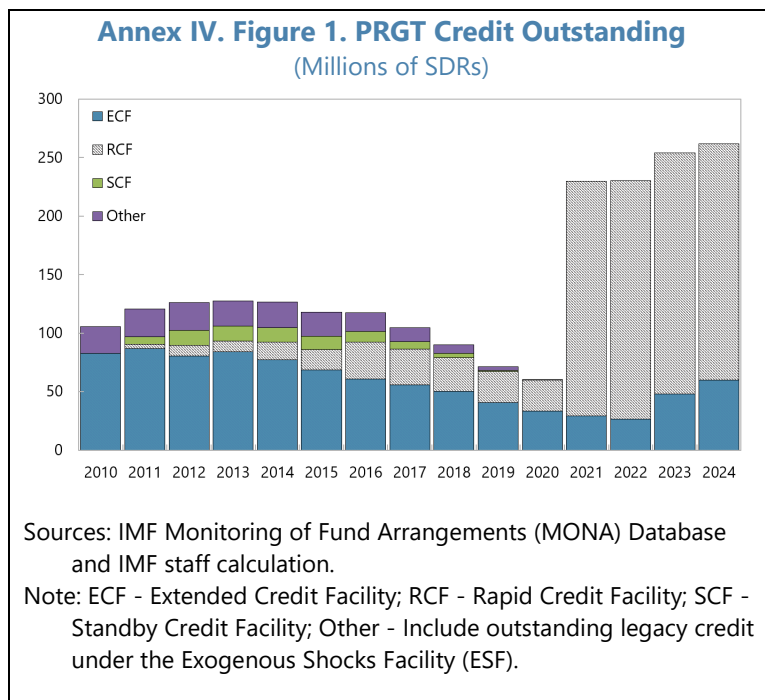


## Annex IV. Recent Fund Program Engagement with SDS

Data on Fund lending to SDS show that emergency financing significantly increased during the COVID-19 pandemic, as in the whole membership. More recently, a transition towards UCT-quality programs has been taking place, coupled by higher rates of implementation of structural conditionality under Fund-supported arrangements, in line with what is observed in Low Income Countries (LICs).

### 1. SDS have made frequent use of emergency financing in the last two decades, with a peak in 2020, in line with global trends.

Since 2011, the Fund approved 27 requests for emergency financing to SDS, including some cases of repeated use. All requests were motivated by external, unpredictable and sudden shocks: 11 as a consequence of large natural disasters and 16 during the 2020 pandemic. Most of the SDS requested access under the PRGT-supported RCF, benefitting from its highly concessional terms (18), five SDS accessed a blend of RCF and RFI, and only four borrowed exclusively under the GRA-supported RFI. Emergency financing has been the most used source of Fund financing by SDS, a trend that could be potentially changed by refining program design to better tailor conditionality to SDS needs, structuring it on CD strategies, CES, and capacity constraints.

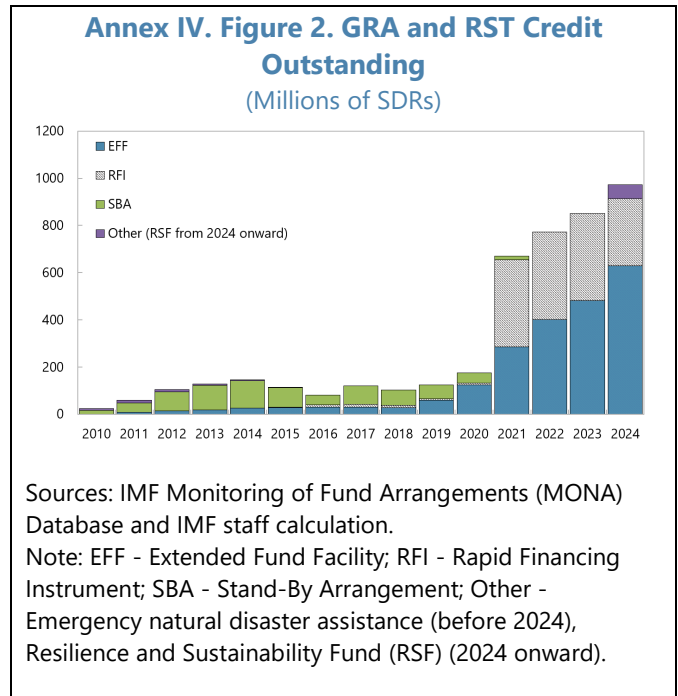


### 2. Fund's financing engagement with SDS increased significantly during the pandemic.

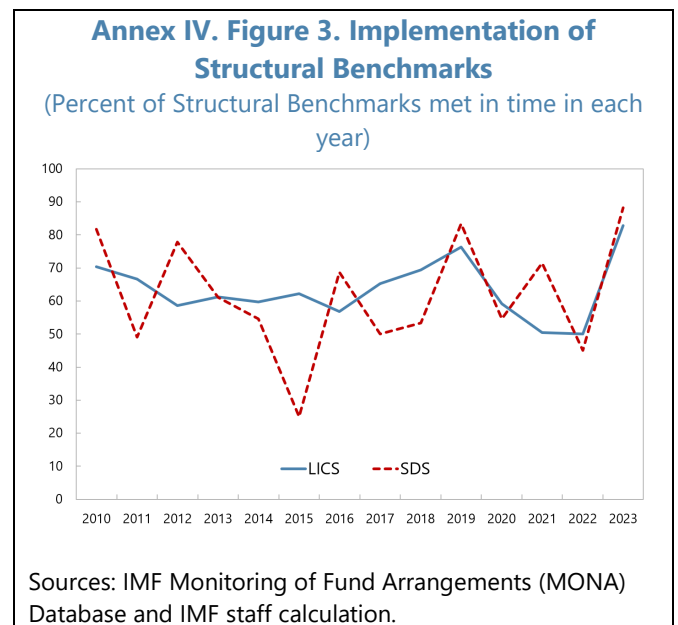
Total credit outstanding almost tripled between January 2020 and January 2021, mostly on account of emergency financing (RCF and RFI), which amounted to 63.4 percent of Fund's exposure to SDS in January 2021 (from 14.6 percent in January 2020). Out of the 18 emergency facilities approved for SDS since 2020, 16 (89 percent) were requested to address urgent balance of payment needs stemming from the impact of the COVID-19 pandemic.<sup>1</sup> As of January 2024, emergency financing accounted for 39.3 percent of Fund's credit outstanding to SDS.

<sup>1</sup> Two RCF disbursements were approved for St. Vincent and the Grenadines and Tonga in July 2021 and July 2022, respectively, to address emergency financing needs from volcanic eruptions and a COVID-19 outbreak.

**3. The number of UCT-quality programs in SDS is increasing amid slow post-pandemic recovery and consecutive shocks.** At the beginning of the pandemic, there were only two SDS under a Fund-supported financial arrangement—Barbados' EFF and São Tomé and Príncipe's ECF—both of which were completed without delay. Since 2021, the Fund has approved 9 additional UCT arrangements in 5 SDS: Barbados (EFF and RSF), Cabo Verde (ECF and RSF), Comoros (ECF), Seychelles (two EFFs and an RSF), and Suriname (EFF). Consequently, there has been a significant increase in ECF- and EFF-related credit outstanding to SDS, from SDR 158.0 million at end-January 2020 to SDR 689.8 million at end-January 2024. While PRGT credit outstanding in SDS remains largely skewed toward emergency lending, GRA exposure to SDS has reverted to a predominance of UCT financing instruments since 2022, partly due to higher access under the GRA (Figures 1 and 2).<sup>2</sup>



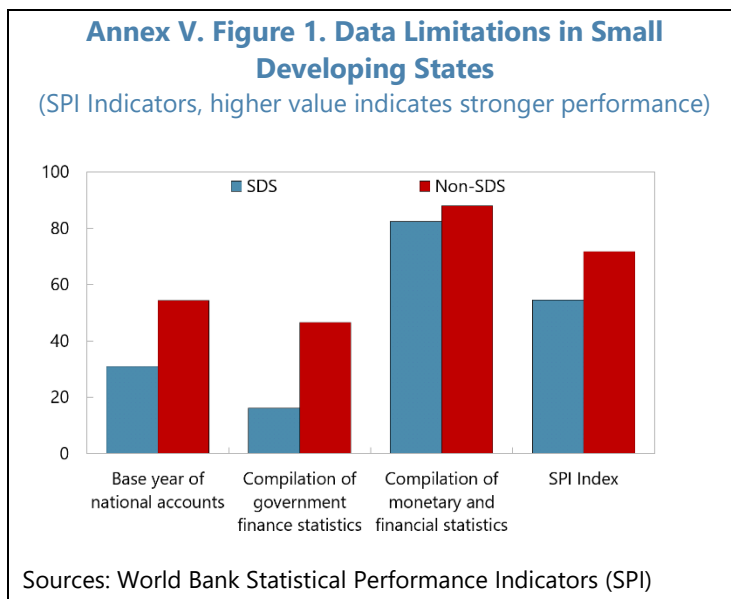
**4. In the last decade, timely implementation of reforms under Fund-supported program conditionality (structural benchmarks, SBs) has been mixed, but recently traction has improved.** SDS performance on structural conditionality has been more volatile than observed in LICs. The percentage of SBs met with no delay in SDS declined to 55 percent in 2020 from 83 percent in 2019, as countries struggled to adjust to the pandemic-led economic shock. SBs implementation has improved over the last few years, with the proportion of met structural conditionality reaching pre-pandemic levels in 2023. Starting from 2022, post-pandemic implementation of SBs in SDS is somewhat aligned to what has been observed in Low Income Countries (Figure 3).



<sup>2</sup> There has been no precautionary arrangement in SDS since April 2017.

## Annex V. Data Gaps in SDS

**1. SDS face severe data limitations.** Key data gaps in SDS data can be observed both in the internal IMF Statistics Department databases devoted to specific issues, like the annual Global Survey on the System of National Accounts (SNA) Statistical Programs and in the WB's Statistical Performance Index (SPI) database. These datasets indicate that the gaps in SDS are broad-based across all aspects of data sourcing and usage. In particular, the SDS Statistical Performance Indicators (SPI) scores are on average weaker than those of non-SDS. Furthermore, only two of the 34 SDS for whom the aggregate SPI indicator for 2022 can be computed are in the top half of global rankings, with the SDS average ranking being only 141 out of the 186 assessed countries and territories. These problems ultimately reflect lack of financial and human resources and associated weaknesses in source data and compilation processes in SDS.



**2. There are significant gaps in key economic statistics in many SDS.** The gaps include: (i) non-availability of certain indicators typically used for surveillance (particularly on poverty and labor market statistics); (ii) reduced frequency of standard economic indicators (e.g., no quarterly GDP or monthly CPI); (iii) outdated methodologies and benchmark years for key macroeconomic data. Box V.1 zooms in on such data gaps in real sector statistics, where, along with government finance statistics, SDS gaps seem to be particularly large.

**3. SDS problems include not only those relating to weaker data, but also more limited mechanisms for their dissemination and use.** Some of the largest relative gaps observed for SDS within the components of the SPI index are with respect to (i) participation in the data dissemination (e-GDDS and SDDS) standards; (ii) technology for dissemination and open access to data, and (iii) the use of the data. These weaknesses further limit the usefulness with which the data can support informed debates and economic decision-making in SDS.

### Box V.1 SDS Data Gaps in Real Sector Statistics

There are significant gaps in real sector statistics compilation in SDS. Quarterly estimates of GDP are not available in 19 of 34 SDS, a rate significantly higher than in both advanced economies and in non-SDS emerging and developing economies. SDS are more likely to have a GDP compiled with a benchmark year older than the maximum recommended lag of 10 years. An outdated benchmark indicates that GDP may not adequately represent the current structure of the economy. The share of SDS that are not yet compliant with the System of National Accounts 2008 (2008 SNA)—the latest internationally recommended conceptual framework—is also substantially higher than for other country groups.

Number of Economies (as of 2021)	Quarterly GDP not compiled	GDP benchmark >10 years old	GDP not consistent with SNA 2008
Advanced Economies	1	9	1
Emerging and Developing Economies	53	89	60
of which, Small Developing States	19	22	16

Source: 2022 Global Survey on the SNA Statistical Programs

Percentage of Economies in Group (as of 2021)	Quarterly GDP not compiled	GDP benchmark >10 years old	GDP not consistent with SNA 2008
Advanced Economies	2.6%	23.1%	2.6%
Emerging and Developing Economies	34.0%	57.1%	38.5%
of which, Small Developing States	55.9%	64.7%	47.1%

Source: 2022 Global Survey on the SNA Statistical Programs

Similar gaps are evident in consumer price index (CPI) compilation. While only around 5 percent of advanced economies and 6 percent of all emerging and developing economies publish their CPI on a quarterly rather than monthly basis, this proportion rises to almost 24 percent for SDS. These economies' CPI weights are also more likely to be older than the recommended guideline of no more than five years.

	CPI weights >5, <10 years old	CPI weights >=10 years old	CPI published only quarterly
Advanced Economies	1	1	2
Emerging and Developing Economies	38	48	9
of which, Small Developing States	9	13	8

Source: 2022 Global Survey on the Prices Statistical Programs

Percentage of Economies in Group (as of 2021)	CPI weights >5, <10 years old	CPI weights >=10 years old	CPI published only quarterly
Advanced Economies	2.6%	2.6%	5.1%
Emerging and Developing Economies	24.4%	30.8%	5.8%
of which, Small Developing States	26.5%	38.2%	23.5%

Source: 2022 Global Survey on the Prices Statistical Programs

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