

Ensuring Public Debt Sustainability in the Pacific Small Island Developing States

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About this paper

This paper provides background information for the discussions at the Pacific Regional Debt Conference, co-organized by the United Nations Economic and Social Commission for Asia and the Pacific (ESCAP) and the Pacific Islands Forum Secretariat (PIFS) on 5-8 April 2022.

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Key messages

- The risk of public debt distress in the Pacific small island developing States (PSIDS) had been high even before the COVID-19 pandemic. The pandemic has further pushed up public debt levels and the trend is likely to continue in the coming years, thus putting debt sustainability at a greater risk.
- To ensure public debt sustainability, PSIDS can consider various policy options. Improving tax administration, introducing social/green taxes, and enhancing public spending efficiency will help address fiscal deficit, and thus debt, concerns. Development of domestic capital markets can also be explored, at least in larger economies such as Fiji and Papua New Guinea, to take advantage of innovative financing instruments and modalities for deficit financing over the long term. Prudent and effective public debt management would promote policy credibility and reduce financing costs. Finally, greater use of risk-sharing disaster financing mechanisms would help PSIDS avoid fiscal shocks and a sudden rise in debt sustainability risks.
- Major creditor countries and multilateral development partners can do more to support debt sustainability in PSIDS. Among others, they can (a) offer generous debt relief; (b) make the global debt resolution architecture work better and simpler for debtors; (c) fulfil their commitments on development assistance; (d) consider and support debt for climate swaps; and (e) integrate debtor countries' vulnerability to shocks into concessional loan decisions and debt risk assessments.
- While this issue paper highlights various good practices on fiscal and debt policies adopted by PSIDS, more support on strengthening technical capacity and institutional quality is needed.

Table of contents

1. Introduction.....	1
2. Public debt situations in PSIDS.....	2
2.1 Public debt profile	2
2.2 Review of public debt sustainability assessments	4
3. Policy options for PSIDS as debtor countries.....	6
3.1 Public debt relief measures.....	6
3.2 Enhancing fiscal resources	9
3.3 Developing capital markets.....	11
3.4 Emergency financing mechanism	13
3.5 Public debt management.....	14
4. Possible actions by creditors and international development partners	17
4.1 Public debt relief and multilateral debt resolution architecture.....	17
4.2 Official development assistance	18
4.3 Incorporating multidimensional vulnerability in loan and debt assessments	19
References.....	20

1. INTRODUCTION

Pacific small island developing States (PSIDS) are facing several fiscal and public debt challenges that are likely to intensify in the coming years. In the near term, they are obliged to service public debts that are maturing. Over the next few years, the group will continue to face large fiscal deficits, as economic growth and thus revenues are projected to recover only gradually while spending needs will remain elevated. For example, in Papua New Guinea, gross financing needs (the sum of primary fiscal deficit and maturing debt obligations) during 2021-2023 are estimated at 13.4 per cent of GDP, or 6.4 percentage points higher than pre-pandemic level in 2019 (Munevar, 2020). Amid tighter fiscal space, coping financially with future emergency situations, such as natural disasters and health outbreaks, will remain an ongoing challenge for policymakers.

At the same time, limited progress on attaining the Sustainable Development Goals (SDGs) in PSIDS calls for more public spending. The SDGs on poverty reduction, health care services, and education continue to make a slow progress (figure 1). Worryingly, PSIDS are regressing on Goals relating to clean water and sanitation, reduced inequalities, sustainable cities and communities, climate action, and strong institutions. To accelerate progress on poverty reduction, more public spending on social protection will be needed. For example, delivering a comprehensive social protection package in Kiribati (costing about 4.2 per cent of GDP) would help cut poverty in the country by 3.2 per cent (ESCAP, forthcoming).

Figure 1. SDG progress in Pacific island developing economies



Source: Asia-Pacific SDG gateway (<https://data.unescap.org/data-analysis/sdg-progress>)

Against this background, this issue paper first takes stock of public debt situations in PSIDS (section 2), then highlights selected fiscal and financing policy options that PSIDS can adopt to ensure public debt sustainability (section 3) and reviews policy issues that creditors and international development partners should consider in supporting PSIDS in this regard (section 4).

2. PUBLIC DEBT SITUATIONS IN PSIDS

2.1 Public debt profile

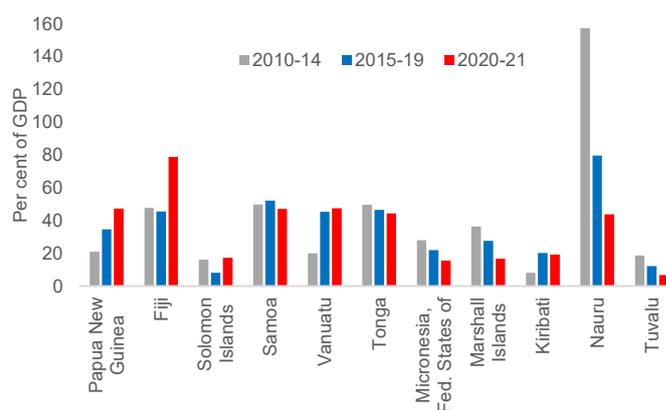
The government debt levels are rising in larger PSIDS with mixed trend in other economies. Based on the GDP-weighted average values, the general government debt level in PSIDS has risen rather notably in the past decade, from around 36 per cent of GDP during 2015-2019 to 49 per cent of GDP in 2020-2021 amid the pandemic (figure 2). This rising trend is driven primarily by higher debt levels in Fiji and Papua New Guinea (figure 3), which are the subregion’s two largest economies, accounting for about 13 and 73 per cent of the combined GDP, respectively. In the case of Papua New Guinea, worsening primary fiscal balance is the major driver of debt rise (compared to contribution by economic growth) (Schneider and others, 2021). Meanwhile, some small economies such as the Federated States of Micronesia, the Marshall Islands, Nauru and Tuvalu have recorded a decreasing debt trend in the past decade.

Figure 2. Average general government debt levels



Source: ESCAP, based on IMF World Economic Outlook database, October 2021 edition.

Figure 3. General government debt levels

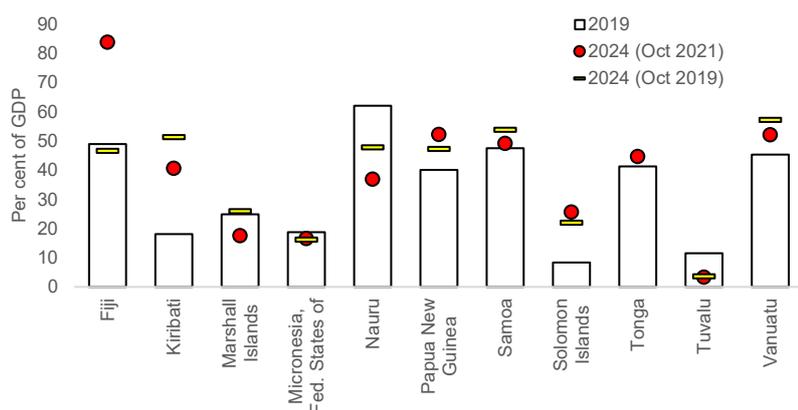


Source: ESCAP, based on IMF World Economic Outlook database, October 2021 edition.

Note: Countries are sorted according to their GDP size from the largest (leftmost) to the smallest.

Looking forward, general government debt levels in several PSIDS are expected to rise. As a result of the pandemic, PSIDS have so far taken on additional government debt of around \$1.6 billion (PIFS, 2021). According to recent IMF projections, Fiji’s government debt level could surpass 80 per cent of GDP by 2024 (figure 4). This is a steep increase relative to the pre-pandemic projections made in October 2019, which suggested that the country’s government debt level would remain roughly stable between 2019 and 2024 at below 50 per cent of GDP. For the coming few years, the government debt levels are also projected to increase rather notably in Kiribati, Papua New Guinea and Solomon Islands.

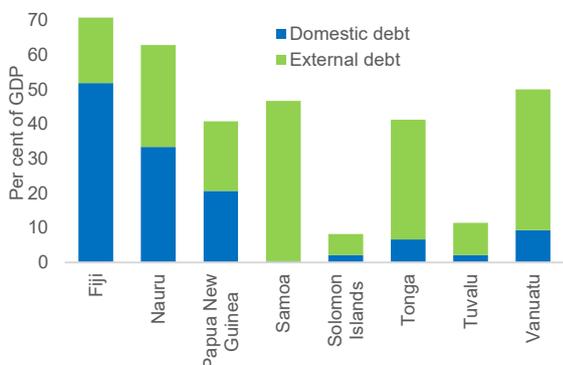
Figure 4. Projected general government gross debt levels in 2024



Source: ESCAP, based on IMF World Economic Outlook databases, October 2019 and October 2021 editions.

For many PSIDS, external debt constitutes a large share of government debt. Almost all public debts in countries such as Samoa, Tonga and Vanuatu are external debts (figure 5). This is reflected in their relatively high levels of external public debt stocks, at about 40-50 per cent of GDP (figure 6). In Fiji and Papua New Guinea where domestic economies are more sizeable, domestic debt (mainly held by superannuation funds) plays a more important role, accounting for about 73 and 51 per cent of their government debts, respectively.

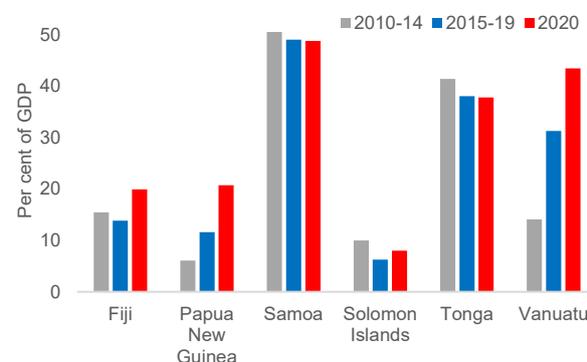
Figure 5. Composition of public debt in 2020 or the latest year



Source: ESCAP, based on various IMF Article IV reports published during 2020-2022.

Note: For Fiji, Nauru and Samoa, this covers central governments only.

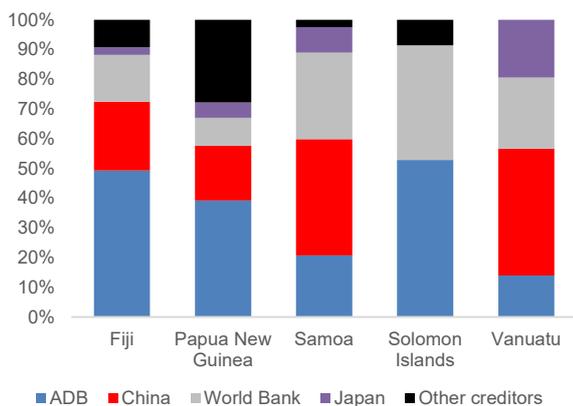
Figure 6. External public and publicly guaranteed debt stocks



Source: ESCAP, based on World Bank World Development Indicators database.

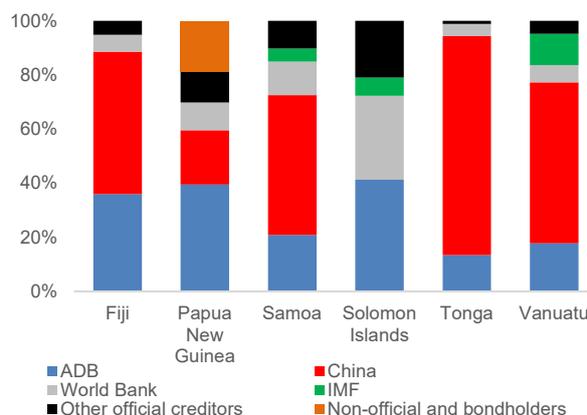
A large part of external public debt in PSIDS is owed to the Asian Development Bank (ADB) and China. For Samoa and Vanuatu, China accounts for around 40 per cent of total external public debt (figure 7). The ADB is another major for PSIDS, accounting for about half of external public debt in Fiji and Solomon Islands and 40 per cent in Papua New Guinea. As expected, the ADB and China together account for a large share of debt servicing obligations that are due in 2022 (figure 8). Both creditors can thus play a significant role in shaping debt relief in PSIDS.

Figure 7. Major creditors of public external debts in 2020



Source: ESCAP, based on World Bank International Debt Statistics 2022.

Figure 8. Major creditors of public external debts that are due in 2022



Source: ESCAP, based on World Bank Debtor Reporting System.

China’s official loans to PSIDS generally have less favourable terms relative to concessional loans provided by multilateral development banks (MDBs). Almost all of China’s loans to PSIDS are renminbi-denominated, concessional loans from the Export-Import Bank of China, with an interest rate of around 2 per cent, a grace period of 5-7 years and a maturity of 15-20 years (Rajah and others, 2019). These terms are more favourable than domestic borrowing costs in Fiji and Papua New Guinea, which stand at around 6 and 11 per cent, respectively.¹ Yet, in general, China’s loans to PSIDS are less concessional relative to concessional lending by Japan and MDBs.

2.2 Review of public debt sustainability assessments

Despite variations in the level and composition of public debts, what is generally common among PSIDS is a high risk of debt distress². While none of the PSIDS are currently in debt distress, most of them are rated as having a high risk of overall and external debt distress³ (figure 9). Except Papua New Guinea where the risk level changed from moderate to high in the aftermath of the pandemic, the high debt risk was already observed prior to the pandemic.⁴ Indeed, the risk level has risen over the past decade, with only 2 of 7 PSIDS with available assessment rated as having a high risk of debt distress in 2010 (Rajah and others, 2019). Over time, countries that have recorded rising risk are Papua New Guinea, Samoa, Tonga and Vanuatu.

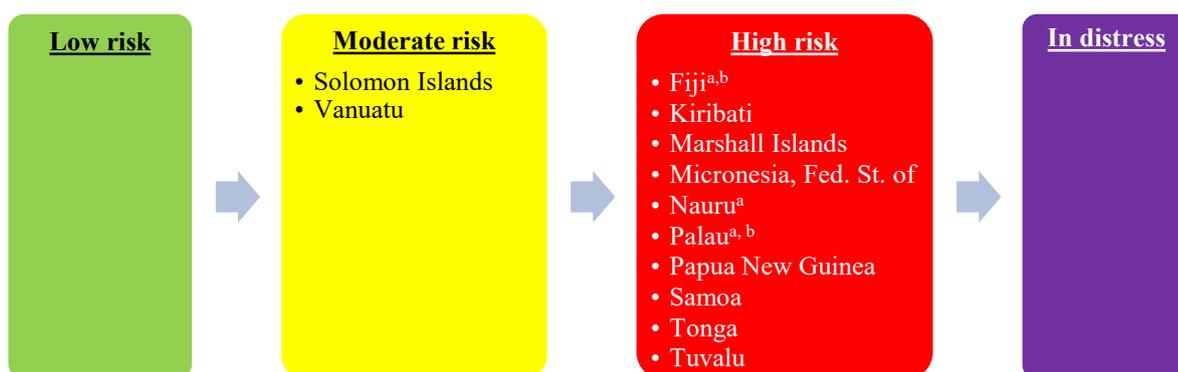
¹ In comparison, the average interest rates on new external public debt commitments during 2018-2020 in Fiji and Papua New Guinea stand at 8 and 16 per cent, respectively.

² A public debt trajectory is generally considered sustainable if a country can meet its debt service obligations without substantial changes in its revenue-expenditure structure, given the current debt level, prospective borrowing and financing cost.

³ In general, “low” risk means that none of the debt burden indicators breach their respective thresholds under the baseline scenario and stress tests. “Moderate” risk means none of the debt burden indicators breach their respective thresholds under the baseline, but this occurs under stress tests. “High” risk means the debt burden indicators breach their respective thresholds under the baseline. A country is in “debt distress” when it cannot fulfill its debt obligations.

⁴ Similarly, as the result of the pandemic, S&P has downgraded Fiji’s sovereign credit rating from BB- (speculative) in 2019 to B+ (highly speculative) in 2021.

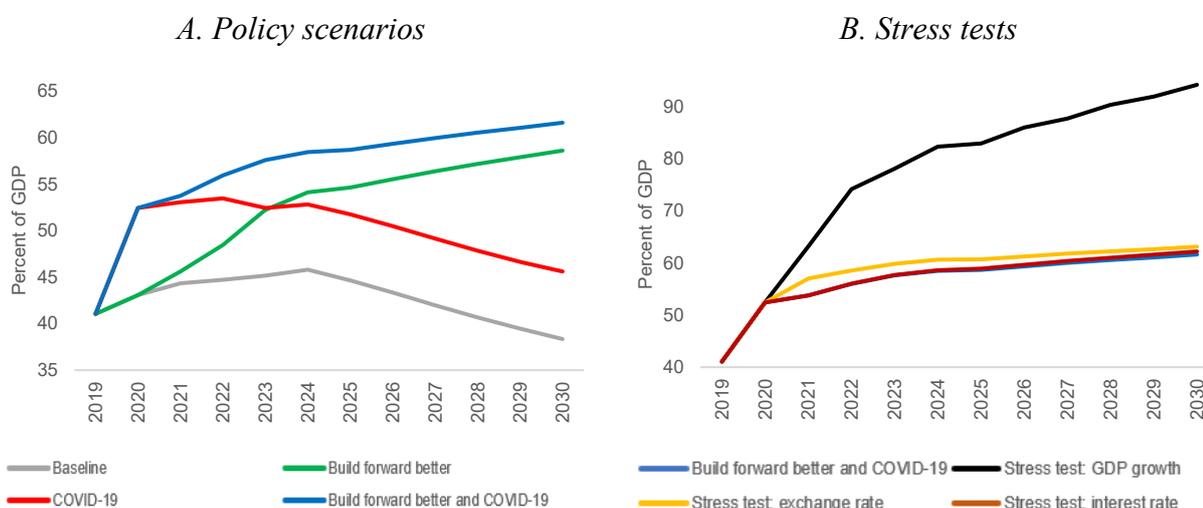
Figure 9. Risks of overall debt distress and external debt distress



Source: ESCAP, based on Debt Service Suspension Initiative and Schneider and others (2021).
 Note: ^a based on Schneider and others (2021). ^b Fiji and Palau are rated as having an “elevated” risk.

As PSIDS combat the pandemic and strive to ‘build forward better’, the public debt level is likely to rise notably. The pandemic alone would push up the government debt-to-GDP ratio by almost 10 percentage points by 2030 (figure 10A). Together with delivering an illustrative ‘build forward better’ policy package that seeks to enhance access to social services, close the digital divide and promote green development (through public and private spending hikes, fuel subsidy cancellation and carbon tax introduction), the average government debt ratio is projected to rise steeply from 40 per cent of GDP in 2019 to about 62 per cent of GDP by 2030.

Figure 10. Projected public debt levels for Pacific island developing economies



Source: Holland and Sirimaneetham (2021).

Public debt sustainability in PSIDS is also highly vulnerable to slower-than-expected economic growth. Under the economic growth shock scenario, which assumes that real domestic demand growth rates in 2021 and 2022 are one standard deviation below the baseline,⁵ the public debt ratio for PSIDS rises by another 30 percentage points, to 94 per cent in 2030 (figure 10B). In general, the

⁵ Under this alternative scenario, the real GDP growth rate in developing Asia-Pacific is 2.7 and 2.4 percentage points below the baseline values in 2021 and 2022, respectively.

PSIDS's public debt trajectory is less sensitive to the exchange rate shock (assuming a 20 per cent nominal currency depreciation) and the interest rate shock (assuming that nominal interest rates are 200 basis points above the baseline).

3. POLICY OPTIONS FOR PSIDS AS DEBTOR COUNTRIES

3.1 Public debt relief measures

Debt service suspension and beyond

Creditor and debtor countries, along with multilateral development partners, can engage in various debt restructuring modalities to defer or reduce debt-service obligations. Among others, these include (a) debt cancellation or forgiveness, which reduces the amount of debt; (b) debt rescheduling or refinancing, which amends the terms and conditions of the amount of debt owed; (c) debt conversion, which exchange the debt title for other things having economic value such as debt swaps; and (d) debt assumption, in which a new debtor assumes the former debtor's outstanding liability (IMF, 2014). Debtor countries should explore these modalities as early as possible because experience from past episodes of debt crisis suggests that debt restructuring that takes place after the default typically results in larger economic losses than pre-emptive restructuring.

The Debt Service Suspension Initiative (DSSI) of the G20 ended in December 2021 with participation by some PSIDS. As a multilateral effort on debt rescheduling in response to the pandemic, DSSI was agreed in April 2020 and aimed at temporarily halting the servicing of official bilateral debts owed to G20 countries by 73 low-income countries around the world until December 2021.⁶ As such, it helps address the problem that debtor countries have to proceed with separate, time-consuming negotiations with different creditors. Globally, 48 eligible countries joined the initiative, including Fiji, Papua New Guinea, Samoa and Tonga (figure 11). The potential debt service savings in 2021 in these 4 countries ranged from 0.3 per cent of GDP in Papua New Guinea to 2.8 per cent of GDP in Tonga. Meanwhile, 6 eligible PSIDS, including 4 at a high risk of debt distress, did not participate. In general, the concern is that such participation may trigger a downgrade of their sovereign credit risk rating.

Figure 11. Participation of PSIDS in the Debt Service Suspension Initiative (DSSI)

		Risk of overall debt distress			
		Not available	Low	Moderate	High
Participation in DSSI	Yes	Fiji (0.5%) ^a			Papua New Guinea (0.3%) Samoa (2.1%) Tonga (2.8%)
	No			Solomon Islands (0.1%) Vanuatu (1.5%)	Kiribati Marshall Islands Micronesia, Federated States of Tuvalu

Source: ESCAP, based on data from World Bank's "COVID 19: Debt Service Suspension Initiative".

Note: ^a Fiji is not covered in debt sustainability analysis for low-income countries. Numbers in parentheses are potential DSSI savings as a share of GDP during January-December 2021, where available.

⁶ See <https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative>.

A Common Framework for Debt Treatments beyond the DSSI has been introduced to further support debt distress in developing countries. The Framework will coordinate Paris Club and other G20 bilateral creditors in the provision of debt relief to DSSI eligible countries on a case-by-case basis. Among others, the Framework stipulates a fair burden sharing among official creditors, while private creditors will be expected to offer treatment that is as favourable as that provided by official creditors. So far only three African countries (Chad, Ethiopia and Zambia) have started negotiating with creditors to receive debt relief through the Common Framework. In addition to the concern that their sovereign credit ratings would be downgraded, countries are reluctant to join because there is high degree of uncertainty about the duration and outcome of debt treatment process (Isgut, 2022).

To help developing countries meet their external debt service payments, the IMF has introduced a new allocation of special drawing rights (SDR) in August 2021. This allocation, which is the largest to date, amounts to SDR 456 billion (or about \$650 billion). As the allocation is proportional to each country's existing membership quotas, only \$430 million was allocated to PSIDS out of about \$133 billion allocated to 48 Asia-Pacific countries. Thus, some re-channeling of SDRs from advanced countries to those in need will be needed to make these new SDR allocations meaningful.

Debt swaps for development

Amid rising public debt levels, there is a renewed interest in debt swaps for development in developing countries worldwide.⁷ For example, the United Nations has launched a climate/SDGs debt swap initiative in the Arab region and is working to operationalize the debt-for-climate swap in the Caribbean, while the World Food Programme is implementing debt-for-food security swaps (United Nations, 2022).

Beyond reducing debt obligations and improving debt sustainability, the swap agreements tend to have more direct benefits for sustainable development. For example, during 1985-2015, debt-for-nature swaps worldwide involved debt amounting to more than \$2.6 billion and resulted in transfers of about \$1.2 billion to conservation projects (UNDP, 2017). Other benefits of debt swaps include reduced exposure to exchange rate risks by debtor countries, potential to attract co-financing by other development partners and increased capacity of local organizations that implement the projects.

Yet, the effectiveness of past debt swaps for development has been rather mixed. Typically, debt swaps are considered effective if they: (a) provide the debtor Government's budget with additional resources; (b) result in additional resources for the target development areas; (c) have a notable effect on debt reduction in a debtor country; and (d) are consistent with the debtor country's policy priorities (Cassimon and others, 2010). In this regard, the first wave of debt swaps were often too small to significantly reduce the debtor countries' debt burden. In many cases, the size of the counterpart fund set up by debtor countries incurred large fiscal costs when compared with the amount of debt relief they received.

⁷ There are two broad categories of swap agreements. The first is bilateral swaps between two Governments, in which a creditor country agrees to cancel the debt of a debtor country in exchange for the debtor's commitment to spend part of the freed-up fund for agreed development purposes. The second type is trilateral swaps, in which a third party (typically a non-governmental organization) purchases the debt title of a developing country in the secondary market at a discounted value and then transfers it back to the debtor in exchange for the Government's commitment to mobilize local currency funds for specific development projects.

All stakeholders can take various actions to realize the potential of debt swaps. First, prepare a term sheet that contains the main terms and conditions of the deal, after determining the level of political interest and conducting a feasibility study. Such term sheet can include the amount and profile of public debt to be swapped, the beneficiary projects, co-financing sources, the debt discount rate, and the payment schedule for project implementor (Grigoryan and others, 2021). For debt-for-climate swap term sheet, this could take advantage of existing taxonomies and standards on sustainable activities. Greater harmonization of these term sheets would help reduce complexity for all stakeholders, speed up negotiations, and reduce the likelihood of disputes (United Nations, 2022).

Second, carefully negotiate the financial details of the deal, such as by seeking to achieve a sizeable difference between the original face value of the debt and the redemption price, negotiating for a full or partial cancellation of the outstanding debt service payments, scheduling payments to the trust fund according to the original repayment schedule to provide a predictable stream of finance, and allocating part of the trust fund to financial assets that would generate financial returns (Grigoryan and others, 2022).

Third, reduce the high transaction costs of debt swaps, which are due to a long negotiation process, feasibility studies, and financial and legal fees. International development partners can prepare guidelines on general terms and conditions of debt swaps, which would help reduce the time cost in finding general information (Steele and Patel, 2020).

Fourth, increase the scale of debt swaps, including by shifting from a project- to a programme-based approach (Ainio, 2020), involving multiple creditors and combining with other debt reduction modalities (Caliari, 2020), and engaging other donors beyond creditor countries to augment the size of counterpart funds (World Bank, 2019).

Fifth, minimize the fund fungibility issue in both debtor and creditor countries. As debt swaps are typically considered as part of their ODA commitments, creditor countries may cut the amount of ODA that was planned elsewhere. On the other hand, debtor countries tend to cut spending on development areas that have received debt swap proceeds or use the proceeds for other purposes. These practices should be discouraged by using historical data on public spending in different development areas as a benchmark to gauge the extent of fungibility.

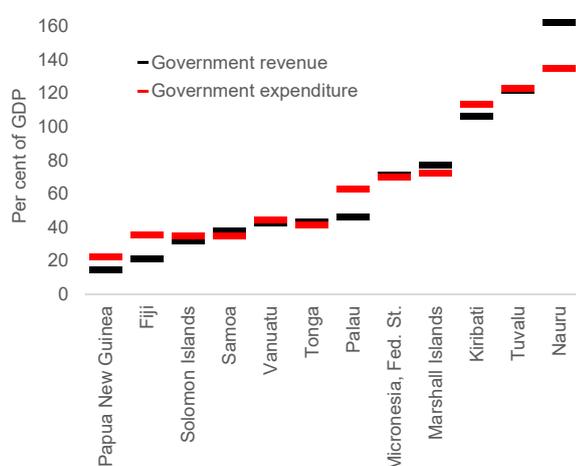
Finally, adopt an effective monitoring, reporting and verification framework to reduce fiduciary risks. Such a framework can be based on sustainability performance targets and key performance indicators, including issues such as land rights (Grigoryan and others, 2021). To increase country ownership, the debtor countries should select projects based on their national development plans and climate commitments, while the interest of local population should be observed. A good practice is to establish a supervisory committee that comprises of representatives of debtor, creditor, NGOs and regional entities (such as the Pacific Resilience Facility⁸) to provide oversight and strategic guidance (Grigoryan and others, 2022).

⁸ Pacific Resilience Facility (PRF) is a multi-donor fund that provides grants to small-scale projects that are aimed at strengthening community resilience to natural disasters, such as retrofitting critical infrastructure and coastal protection projects. The Facility could serve as a trust fund and oversight committee to ensure transparency.

3.2 Enhancing fiscal resources

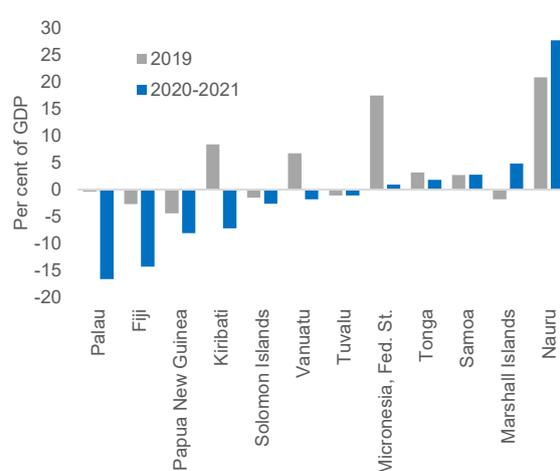
Several PSIDS are facing fiscal deficits and the shortfalls widened after the pandemic. In countries such as Kiribati, Nauru and Tuvalu, the total government revenue (tax and non-tax revenues) is very large relative its GDP (figure 12). This is driven, among others, by revenues derived from fishing licenses. Yet, as the government expenditure-to-GDP ratios are also generally high in PSIDS, several economies have incurred sizeable fiscal shortfalls (figure 13). For example, fiscal deficits in Fiji, Kiribati, Palau and Papua New Guinea are estimated to be up to 7-17 per cent of GDP during 2020-2021. In these countries, the fiscal balances deteriorated notably relative to their pre-pandemic levels in 2019.

Figure 12. Estimated government revenue and expenditure as a share of GDP, 2020-2021 average



Source: ESCAP, based on IMF Fiscal Monitor Database, October 2021.

Figure 13. Estimated fiscal deficits as a share of GDP, 2019-2021



Source: ESCAP, based on IMF Fiscal Monitor Database, October 2021.

PSIDS can consider various innovative ways to finance fiscal deficits. Traditionally, these include raising tax revenue, increasing debt (through borrowing and bond issuance), and receiving financial assistance from multilateral development banks and partners. During the pandemic, however, central banks in Fiji, Papua New Guinea and Solomon Islands⁹ purchased sovereign bonds, including in the primary markets, to finance fiscal deficits. In Fiji, the value of announced purchases stood at close to 8 per cent of GDP (Agur and others, 2022). In Papua New Guinea, the central bank also provided direct lending to the Government. Nevertheless, such support from central banks to fiscal authorities should be considered only an emergency measure and should not become part of a long-term strategy to finance deficits and reduce debt burdens.

Increasing tax revenue

The overall tax revenue-to-GDP ratio in PSIDS is not low but tends to fall short of its potential in some countries. The latest data in 2019 shows that the average tax ratio in PSIDS stands at 21.4

⁹ In Solomon Islands, the central bank purchased sovereign bonds from the national provident fund and state-owned enterprises such as the Ports Authority and the Electricity Authority. Such purchases allow these entities to buy new bonds and promote the development of a secondary market for government bonds.

per cent, which is higher than the average of 16.8 per cent in developing Asia-Pacific economies. While post-pandemic data is generally not available, ESCAP (forthcoming) estimates that tax revenue in PSIDS could fall by almost 6 per cent in 2021 on average, ranging from below 2 per cent in Papua New Guinea and Marshall Islands to about 20 per cent in Fiji.¹⁰ This same study also suggests that there is room for higher tax collection in some PSIDS. For example, the gap between the potential¹¹ and actual tax revenues as a ratio of GDP is around 12 percentage points in the Federated States of Micronesia and more modest at almost 2 percentage points in Fiji.

To increase tax revenue, governments could consider strengthening the capacity of tax administration and expanding the tax base. Low tax revenue collection is often due to widespread tax avoidance and evasion and large informal sectors. Among others, measures to tax administration is possible through introducing effective tax legislation, increasing the use of information technology in tax operations, streamlining procedures, and adopting risk-based compliance control. Meanwhile, governments could consider expanding the tax base by rationalizing existing tax exemptions and introducing new taxes, especially those with social and environmental benefits such as progressive personal income taxes and green taxes.

To highlight as an example, Papua New Guinea has considered various policy initiatives to broaden the tax base. A review reveals that the country's tax system has a narrow base; relies heavily on personal income tax; faces outdated, unclear legislation; and overuses tax incentives on a discretionary basis (Dadu and Azarbajani, 2020). To address these issues, the Medium-Term Revenue Strategy 2018–2022 is being implemented to enhance government revenue mobilization and features plans to reduce income tax rates, rationalize tax incentives, and introduce a capital gains tax. Since 2018, the Government has also published a tax expenditure statement to improve transparency on the use of tax incentives.

Emerging transboundary challenges on taxation require stronger regional and global tax cooperation. New business models and a changing global economic landscape are making taxation based on traditional models, which are territory-based and rely on tangible assets, more challenging. Examples include the rise of the digital economy, illicit financial flows, profit shifting by multinational firms, offshore evasion by wealthy individuals, and a race across economies to offer tax benefits to attract foreign investment. In this regard, the ADB has launched the Asian Tax Hub in May 2021 to foster policy dialogues, exchange of knowledge and best practices, and capacity building on international tax cooperation. This regional platform will help increase the voice of smaller economies like PSIDS, harmonize tax policies and practices, and enhance cooperation among existing sub-regional tax bodies including the Pacific Islands Tax Administrators Association.

Improving spending efficiency

While public health spending efficiency in the PSIDS has improved in the last decade, this can be further enhanced in some countries (Sugden, 2019). In the Marshall Islands, Nauru, Palau and Tuvalu, public health expenditure per capita is much higher than most Asia-Pacific economies at

¹⁰ These preliminary estimates are based on past relationship between tax revenue and GDP growth.

¹¹ The potential tax revenue level is based on factors such as per capita income, share of agriculture in GDP, and the degree of trade openness.

around \$400-\$600. Yet, many other economies achieve similar health outcomes, as measured by infant and child mortality rates, at much lower costs.

Similarly, an assessment on public expenditure frameworks reveals weakness in budget reliability and audit. According to the Public Expenditure and Financial Accountability (PEFA) assessments¹², which are available for Cook Islands, Fiji and Tonga only, the areas with stronger performance are budget documentation and internal control on non-salary expenditure. The lagging areas are budget reliability, including both revenue and expenditure outturns, and external scrutiny and audit.

PSIDS can improve public expenditure management by enhancing both allocative and operational efficiencies. In addition to keeping public spending within its limits, governments should seek to allocate fiscal budget according to a country's strategic priorities and provide public services at a reasonable quality and cost (ESCAP, forthcoming). Enhancing *allocative efficiency* requires linkages between the annual budget and the SDGs and other national development priorities. To this end, budgeting approaches such as gender, green or SDG budgeting can be adopted. Under SDG budgeting, countries may reflect all or several priority SDGs in the budget documents and integrate SDGs throughout the budgetary process or at certain phases (such as planning or evaluation). Meanwhile, improving *operational efficiency* involves better project cycle management, including having effective due diligence, suitable project size, strong project oversight, and measures to curb corruption (Rajah and others, 2019).

Some PSIDS have benefited from good practices on fiscal discipline and expenditure efficiency. On fiscal discipline, Cook Islands adopted fiscal responsibility ratios in the mid-1990s, after its external debt surged to 140 per cent in GDP after years of fiscal borrowing to fund public investments (Tinio, 2019). Adopted as part of the debt restructuring deal, these ratios set targets on public spending, revenue collection and debt that need to be met before taking new commercial loans. As a result of this effort, the target debt ratio of 35 per cent of GDP has been met. Meanwhile, on enhancing public health spending efficiency, the experience of some PSIDS show that reorienting health spending towards preventive care (e.g. diabetes prevention in Vanuatu), providing specialized health services (e.g. diabetes foot clinic in Samoa), and offering early treatments (e.g. for non-communicable diseases in Tonga) can help improve the spending effectiveness (ESCAP, 2017).

3.3 Developing capital markets

Governments in Asia-Pacific countries with underdeveloped financial markets have relied on external loans, while more advanced economies rely more on sovereign bond financing. Even as concessional financing makes external borrowing the only available or the cheapest source of finance, it may not be the most conducive one for long-term development. In contrast, a sovereign bond market can help not only to diversify investors' portfolios but also establish a benchmark yield curve for corporate bonds, which fosters the use of corporate bonds to fund business development. Thus, developing capital markets is one of the main pre-requisites to take advantage of additional financing options and reduce reliance on concessional financing.

¹² Covering 31 specific indicators, the assessments are based on seven pillars: (a) budget reliability; (b) transparency of public finances; (c) management of assets and liabilities; (d) policy-based fiscal strategy and budgeting; (e) predictability and control in budget execution; (f) accounting and reporting; and (g) external scrutiny and audit.

Given that domestic capital markets do not exist or remain underdeveloped in PSIDS, various policy actions may be considered (ESCAP, 2020). *First*, governments should seek to improve their sovereign credit risk rating, which allows them to issue government bonds with relatively low yield rates. *Second*, to promote enabling bond market architecture and intermediaries, financial supervisory authorities should seek to further widen the investor base (e.g. institutional and foreign investors), diversify financial instruments (e.g. thematic bonds), increase secondary market liquidity, improve a credit enhancing mechanism (e.g. tax benefits and insurances), and protect investor rights. *Third*, for smaller countries like PSIDS, regional cooperation schemes could be critical. Examples are initiatives that offer credit guarantees, support the high financial cost of engaging with credit rating agencies, promote regulatory frameworks and common market practices¹³, and provide technical training.

Thematic bonds

PSIDS can consider issuing a thematic government bond¹⁴, including by learning from Fiji's experience. With technical assistance by the International Finance Corporation, Fiji was the first developing country to issue a sovereign green bond in October 2017 and raised \$46.5 million. Both domestic and foreign investors purchased the bond, including commercial banks,¹⁵ the national superannuation fund, and insurance companies. The proceeds were used to finance projects in areas such as renewable energy, energy efficiency, resilience to climate change, and clean and resilient transport. By 2019, the full proceeds had been utilized and benefited over 129,000 Fijians through the generation of 1.4 million kilowatts of renewable energy and an annual reduction of 2,000 tonnes in carbon emissions (ESCAP, 2021). Meanwhile, Fiji also currently plans to launch a blue bond to provide funding in areas such as coastal protection, marine protected areas, and clean marine transport (PIFS, 2021).

To further promote government thematic bonds, some key actions need to be taken (ESCAP, 2021). **First, adopt recognized international standards or frameworks.** These standards, such as those by the International Capital Markets Association (ICMA) and the Climate Bond Initiative (CBI), generally set out a transparent process for information disclosure in areas such as use and management of proceeds and project evaluation, selection and reporting. In addition to the areas funded by Fiji's green bond above, green bond proceeds can also benefit pollution control, natural resource management, biodiversity conservation, sustainable water and green buildings. For social bonds, beneficiary projects may aim to enhance access to affordable health care, education and housing, food security and empowerment.

Second, identify eligible projects. Issuing governments must be able to select, design and implement bankable green, social or sustainable projects. Project feasibility should go beyond adequate financial returns to include socioeconomic consideration resilience of local communities. An effort should be made to develop a pipeline of bankable projects to facilitate potential investors.

¹³ An example is the Asian Bond Markets Initiative launched in 2003 by ASEAN+3 countries. The Initiative aims to establish local currency-denominated bond markets as an alternative source of financing to foreign currency-denominated bank loans by building necessary bond market infrastructure and harmonizing regulatory frameworks.

¹⁴ Examples of thematic bonds are green, blue, social, SDG and sustainability bonds.

¹⁵ In Papua New Guinea, Tonga and Vanuatu, the ratio of cash holdings by commercial banks to total bank assets stands at 40-50 per cent so a proportion of these funds may be allocated to sovereign bond purchases. In Solomon Islands where all commercial banks are foreign owned, such ratio is close to 100 per cent. These banks experienced large financial losses from holding government bonds in the early 2000s so the appetite for investing in government securities remains limited.

Third, establish a methodology to verify the environmental and social impact of the projects. Third-party verification can play an important role in reducing informational asymmetries and avoiding greenwashing. International bond standards such as CBI also provides a list of certified verifier organizations.

Finally, strengthen regional cooperation to support the technical capacity of the issuers. In addition to having broad legal and policy frameworks and market infrastructure, specific technical capacity includes conducting a feasibility study, assessing the yield curves and fiscal capacity to service new debt, and designing the bond attribute (e.g. currency denomination and maturity). As individual bond issuers in PSIDS tend to be too small to attract bond investors, collective debt securitization can be considered, with a guarantee provided by donor countries or multilateral development agencies (ESCAP, forthcoming).

Diaspora bonds

Diaspora bonds tap savings held by emigrants and could offer several benefits. For countries with limited access to foreign capital, these bonds offer a fixed-rate source of income, while enabling citizens to contribute to the development of their origin economies. In general, diaspora bonds' interest rates can be lower than those of sovereign bonds because diasporas often have a lower country risk perception than other international investors. Diasporas are also less likely to cease bond holding during financial panics. In some cases, diasporas may also be willing to accept lower interest rates than the market interest rate for government debt because of their desire to support their home countries. For emigrants, diaspora bonds offer better investment opportunities, as much of their savings are held in bank deposits in destination countries with low interest rates.

Large personal remittances received by some PSIDS present an opportunity for diaspora bonds. As a share of GDP, remittances stood at close to 40 per cent of GDP in Tonga in 2019. Such share was also relatively high in Samoa (17.2 per cent), Marshall Islands (14.3 per cent) and Kiribati (10.0 per cent). On the upside, global remittance flows decreased only slightly amid the pandemic, supported by fiscal stimulus in host countries and a shift towards digital finance.

In addition to relatively developed domestic capital markets, several enabling conditions and policy actions need to be in place to fully leverage diaspora bonds. *First*, prior to the sales, a detailed demand analysis helps increase understanding of the willingness and ability of diasporas in bond investments. Apart from having a large pool of emigrants, their income level and financial literacy also matter. *Second*, issuers should seek to offer some diversity in bond structure, such as maturity, currency denomination, fixed versus floating rates, frequency of interest payments, and minimum purchase amounts. *Finally*, PSIDS may need technical support from international development partners. For example, to understand and comply with regulatory requirements on investment regimes in destination countries, bond issuers normally have to pay high transaction costs. Technical studies to assess financial risks associated with diaspora bonds, such as exchange rate volatility, are also useful.

3.4 Emergency financing mechanism

Countries need to have a mix of financing modalities and instruments that match their exposure to different risks, such as natural disasters. For frequent catastrophes and those with limited impact, such as seasonal floods in some areas, countries could rely on such instruments as government

reserves, contingent funds and budget reallocation. For less frequent catastrophes and those with larger impacts, such as nationwide floods, contingent loans and credits could be initially used, while relying more on tax increase and domestic and external borrowings afterwards. For instruments mentioned so far, Governments retain much of the catastrophic risks, so they primarily bear the cost of policy response. Meanwhile, for occasional catastrophes that have large impacts, such as earthquakes, cyclones and pandemics, countries should explore instruments in which sovereign catastrophic risk is partially or wholly transferred to other entities, such as private investors. Examples of such instruments, which are arranged prior to shocks, are catastrophe bonds and insurances. For large-scale shocks, international assistance is clearly important for less developed countries.

PSIDS have established national and subregional emergency financing mechanisms to cope with natural disasters. There are dedicated national reserve funds in countries such as Fiji, Solomon Islands, Tonga and Tuvalu. The major subregional initiative is the Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI), which has two tracks. The first track is Pacific Catastrophe Risk Insurance Company (PCRIC), which was set up in 2016 in partnership with donor partners and international reinsurance companies as the subregion's first catastrophe risk insurance pool. The second track is assistance to strengthen technical capacity in areas such as climate and disaster risk finance and post-disaster public financial management. So far, the scheme made four insurance payouts to Tonga and Vanuatu, which were together worth \$11 million.

The design and capital adequacy of catastrophe insurance schemes can be enhanced. For PCRIC, the high premiums required for the catastrophe insurance have led to low take-up (PIFS, 2021). More broadly, the scope of most insurance schemes is limited to few risks of disasters and specific categories of damage and losses. The size of the fund is also inadequate. For example, in China and Turkey, only 4 per cent of losses are covered by catastrophe risk insurance schemes (Chakrabarti, 2020). Moreover, the penetration rate of disaster risk insurance is low at only 3 per cent of overall assessed risks of disasters in the region.

3.5 Public debt management

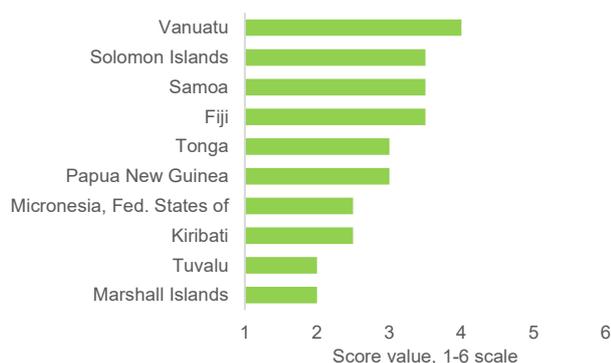
Effective public debt management, which helps reduce financing costs and risks, comprises several aspects. Among others, these include (a) clear debt management objectives and transparent legal frameworks that grant the authority to borrow and issue state guarantees; (b) strong fiscal-monetary coordination; (c) separate and accountable public debt management offices to strengthen policy credibility; (d) timely collection, monitoring and reporting of public debt data; (e) a right balance between debt servicing cost and risk level owing to refinancing risk, realization of fiscal contingent liability and risks stemming from volatile interest rate, exchange rate and market liquidity; and (f) an effective government cash management system that features centralized government bank accounts and an ability to make accurate cash flow forecasts.

Experience suggests that PSIDS that have managed to control debt levels have adopted such a comprehensive approach. Among others, these countries exhibit an overarching debt management strategy, an intergovernmental debt management advisory body, effective investment prioritization guided by strong project due diligence, medium-term fiscal frameworks, and fiscal responsibility ratios (Rabanal and Tinio, 2019).

Several PSIDS exhibit relatively weak public debt management. At a fundamental level, it appears that only 4 PSIDS currently have in place both public management unit and public debt strategy,

namely, Fiji, Samoa, Solomon Islands and Vanuatu (Schneider and others, 2021). Meanwhile, the debt policy rating for PSIDS under the World Bank’s Country Policy and Institutional Assessment (CPIA) suggests that, overall, there is some coordination between debt management and other macroeconomic policies, the analytical capacity of a debt management unit can be enhanced, and annual financing strategies are prepared but usually not part of the medium-term framework (median score of 2.8 on a 1-6 scale, figure 14). Over time, Solomon Islands recorded an improvement during 2005-2019, while the performance deteriorated slightly in Samoa and Tonga and notably in Kiribati.

Figure 14. CPIA score values on debt policy in 2020



Source: ESCAP, based on World Bank Country Policy and Institutional Assessment (CPIA).

Certain aspects of public debt dissemination practices in PSIDS can be improved. According to a heatmap that assesses countries’ public debt dissemination practices in three areas, namely, (a) public debt statistics; (b) public debt management; and (c) publication of other relevant debt data (World Bank, 2021), PSIDS perform more favourably on the area of dissemination of public debt statistics (figure 15 on the next page). This is especially true in terms of accessibility (debt data is made publicly available through a centralized source), instrument coverage (covering external debt, domestic debt and State guarantees), and timeliness (periodic reporting with short time lag). Nonetheless, much less is publicly reported on terms and conditions of recently signed external loan contracts. Meanwhile, PSIDS fare worse in the other two areas, as publications that enhance the transparency of future debt operations and a comprehensive framework on contingent liabilities are not in place in many countries.

PSIDS have demonstrated several good practices on public debt management. For example, to strengthening fiscal-monetary policy coordination, Vanuatu’s central bank provides the Ministerial Budget Committee with views and advice. In Papua New Guinea, the Government made an amendment to the Fiscal Responsibility Act to accommodate the absorption of contingent liabilities and established an interagency office under the Department of Treasury to monitor and clear arrears (Dadu and Azarbajevani, 2020). The Department has also started sharing detailed projections for debt payments, receipts and cash with the central bank to improve debt planning. Finally, in Solomon Islands, the Debt Management Advisory Committee is led by the Secretary of Finance and the central bank governor. Its quarterly meetings screen all borrowing proposals from the Government and state-owned enterprises, determine the annual borrowing limit, and recommend the borrowing threshold for the Cabinet’s approval.

Figure 15. Heatmap on debt reporting

	1. Public debt statistics					2. Public debt management		3. Other debt statistics and contingent liabilities	
	Data accessibility	Completeness			Timeliness		Annual borrowing plan		Debt management strategy
		Information on last loans	Instrument coverage	Sectorial coverage	Periodicity	Time lag			
Fiji	Green	Red	Green	Green	Green	Green	Red	Green	
Kiribati	Green	Green	Yellow	Green	Yellow	Green	Red	Red	
Marshall Islands	Red	Red	Red	Red	Red	Red	Red	Red	
Micronesia Fed. States of	Red	Red	Red	Red	Red	Red	Red	Red	
Papua New Guinea	Yellow	Red	Yellow	Yellow	Yellow	Green	Red	Yellow	
Samoa	Green	Green	Green	Green	Green	Green	Red	Green	
Solomon Islands	Green	Red	Green	Orange	Green	Green	Red	Grey	
Tonga	Green	Red	Green	Yellow	Yellow	Green	Red	Red	
Tuvalu	Green	Green	Green	Yellow	Orange	Red	Red	Grey	
Vanuatu	Red	Red	Red	Red	Red	Red	Yellow	Red	

Source: World Bank Debt Reporting Heat Map (www.worldbank.org/en/topic/debt/brief/debt-transparency-report).

Note: Cells highlighted in red indicate that debt reporting is not publicly available or incomplete/lagging; those in orange mean limited availability; yellow means partial availability; green means full availability; and grey means no information.

There are many other good practices adopted by Asia-Pacific peers that PSIDS can consider.¹⁶

On strengthening fiscal-monetary policy coordination, Nepal set up the Public Debt Management Committee to connect the Public Debt Management Office with the central bank and the Financial Comptroller General Office. On promoting separate and accountable debt management offices, Fiscal Responsibility Act in Maldives requires the Ministry of Finance to prepare and submit a medium-term debt management strategy to the Parliament annually. On managing cash flows and financial liquidity, India has adopted an integrated institutional arrangement where cash and debt management functions are performed by a single department. On enhancing public debt reporting, Malaysia’s 2019 budget document began reporting State guarantees and possible future payments relating to public-private partnership projects, while the 2020 budget document contained debt sustainability analysis. Finally, in response to rising exposure to the exchange rate risk amid decreasing foreign currency earnings, Maldives is seeking to acquire a higher portion of foreign currency funding from international markets and improve fiscal-monetary policy coordination.

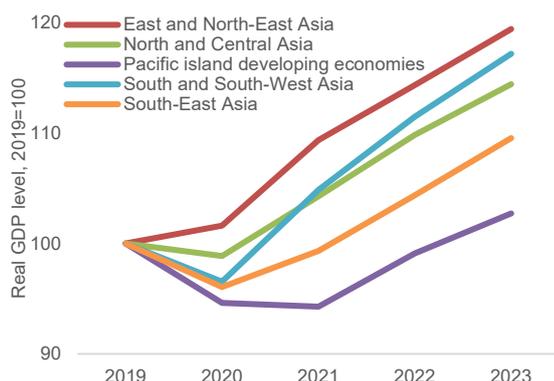
¹⁶ See Singh and Sirimaneetham (2021) for more details.

4. POSSIBLE ACTIONS BY CREDITORS AND INTERNATIONAL DEVELOPMENT PARTNERS

4.1 Public debt relief and multilateral debt resolution architecture

Creditor countries should consider debt relief for PSIDS for several reasons. From an *economic* perspective, the output contraction in PSIDS in 2020 was more severe than other Asia-Pacific subregions and continued in 2021 when others started to rebound (figure 16). By 2023, the aggregate output level in PSIDS would be only 2.7 per cent above the pre-pandemic level. This weaker growth performance took place despite comparable scale of fiscal stimulus and other policy resources launched by PSIDS relative to other Asia-Pacific subregions (figure 17). From a *social* perspective, the pandemic has pushed many more people into poverty. For example, when household consumption is assumed to fall by 20 per cent, the number of people living in extreme poverty in Papua New Guinea are estimated to have risen from 27 per cent of total population in 2018 to 37 per cent (Hoy, 2020). Finally, from an *ethical* perspective, PSIDS contribute only marginally to climate change but are heavily affected by climate-induced natural disasters. For example, the cumulative fiscal cost for one disaster could be up to 21 per cent of GDP (Nishizawa and others, 2019).

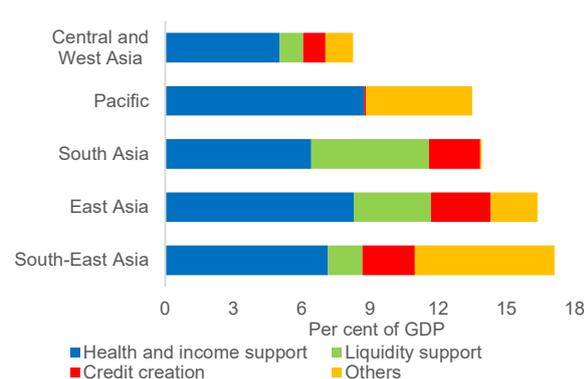
Figure 16. Real GDP levels across Asia-Pacific subregions



Source: ESCAP projections.

Note: North and Central Asia here excludes the Russian Federation.

Figure 17. Scale of policy responses to the pandemic



Source: ADB COVID-19 Policy Database.

Note: “Others” are direct long-term lending, equity support, international assistance provided, and others.

As a major creditor, China can play a significant role in easing public debt burden in PSIDS.

The external public and publicly guaranteed debt amount owing to China ranges from \$944 million for Papua New Guinea to \$108 million for Tonga in 2020. Taken together, external PPG debt in PSIDS owing to China stand at around \$1.6 billion, or only 0.9 per cent of what world economies owe to China.¹⁷ Under DSSI, China has extended debt relief worth at least \$2.1 billion, including debts owed to entities such as the China International Development Cooperation Agency and the Export-Import Bank of China (Reuters, 2020). Over a longer period, China has cancelled about \$3.4 billion of its official zero-interest loans to African countries, while restructuring an additional \$7.5 billion in debt,

¹⁷ Top 5 Asia-Pacific debtors to China (Pakistan, Sri Lanka, Lao PDR, Bangladesh and Cambodia respectively) account for around a quarter of what the world is owing to China.

primarily through maturity extensions, during the period 2000-2019 (Acker, Brautigam and Huang, 2020). Similar considerations can be given in case of PSIDS as well.

Despite multilateral effort on debt relief through DSSI, more work is needed to improve the effectiveness of the Common Framework. Among others, the suggestions are to (a) extend eligible debtors beyond low-income countries to highly vulnerable, indebted middle-income countries; (b) extend eligible creditors beyond official bilateral debts; (c) consider options to reduce the amount of debt stocks; (d) enhance debtor-creditor dialogue; (e) improve coordination within and among official creditors; and (f) ensure transparent operations by all official creditors.¹⁸ Moreover, as DSSI has expired and debt service will resume before debtor countries reach an agreement under the Common Framework, provision of standstills during negotiations should be offered. More broadly, multilateral debt effort would benefit from changes in the underlying concepts (e.g. also taking into account debtor's financing needs for climate action and SDGs attainment when considering the scale of debt relief) and institutional arrangement (e.g. establishing a global sovereign debt coordinating body to issue norms for the prudential issuance of public debt and provide capacity building on debt issues) (Isgut, 2022).

While currently less relevant for most PSIDS, ensuring comparability of treatment of private creditors is a critical issue. Typically, private creditors have incentives to hold out and benefit from stronger debt service capacity due to debt relief provided by official creditors. Although comparability of treatment is a principle of the Common Framework, there is currently no concrete mechanism to enforce private sector participation. To address this, proposals have been made to, among others, limit the amount of debt recovery by private creditors, bind minority creditors to majority decisions on restructuring terms, and consider state-contingent clauses to protect debtors from exogenous downside risks (United Nations, 2022). More broadly, mechanisms that allow debtors to regain market access after debt restructuring is desirable.

4.2 Official development assistance

Official development assistance (ODA) continues to fall short of targets. Although there are instances of dedicated ODA for PSIDS, such as a \$2.2 billion fund set up by Australia in 2018 to provide grants and concessional loans for public infrastructure, globally donor countries have failed to meet their commitments to provide 0.7 per cent of their gross national income as ODA. In the area of climate finance, developed countries pledged in 2009 to scale up funding with a goal to mobilize \$100 billion annually by 2020. The amount increased steadily and reached \$79 billion in 2018, the goal was not met. Donor countries need to fulfill their commitments to help PSIDS under current challenging fiscal and debt scenarios.

Meeting ODA targets would be especially important for some PSIDS that rely more on ODA. For example, during 2015-2019, ODA was equivalent to over 70 per cent of GDP in Tuvalu, and over 20 per cent of GDP in the Federated States of Micronesia, Kiribati, Marshall Islands and Nauru.

The share of the grant component of ODA for climate finance shows a declining trend (ESCAP, forthcoming). In Asia-Pacific small island developing States (SIDS), the grant component (as opposed to loans) stood at 69 per cent of total ODA for climate action during 2015-2019. As this share decreased from 82 per cent during 2010-2014, climate finance has become less concessional over time. During

¹⁸ For more details, see Ellmers (2020), IMF and World Bank (2020), and United Nations (2022).

the 2020 COP meeting, countries agreed in principle to increase the grant component of ODA for climate action. In addition to increasing the size, donors should also allocate more funds to climate change adaptation (as opposed to mitigation), which accounts for around 56 per cent of ODA for climate action in Asia-Pacific SIDS. To benefit from more ODA for climate finance, PSIDS themselves should integrate climate issues across national policies and develop monitoring and evaluation frameworks to track and report the progress of implementing climate policies (Samuwai, 2021).

4.3 Incorporating multidimensional vulnerability in loan and debt assessments¹⁹

Various efforts are being made to reflect a country's vulnerability to external shocks in allocating concessional finance and assessing public debt sustainability. The dominant use of per capita income as a proxy for development stage means that some highly vulnerable countries with higher income level have no access to concessional finance. Yet, higher vulnerability means that capacity to service debt may fall unexpectedly in the aftermath of shocks. To address this issue, the International Development Association grants access to funding for small States that meet specific vulnerabilities even if their income level exceeds the thresholds. The ADB has created an economic vulnerability premium for eligible PSIDS for its Asian Development Fund (PIFS, 2021). Meanwhile, the IMF-World Bank debt sustainability framework for low-income countries also seeks to reflect the effects of natural disasters in baseline macro-fiscal projections and additional stress tests. Finally, the Caribbean Development Bank is implementing a multidimensional assessment of vulnerability in determining country allocations.

The United Nations has set up a high-level panel of experts to finalize a multidimensional vulnerability index (MVI) by end-2022. By reflecting a country's vulnerability to external shocks that are beyond their control but can cause large losses, this index would help to comprehensively assess economic, social, and environmental vulnerabilities of SIDS. For example, an MVI can be used as an eligibility criterion in allocation formula of concessional finance and debt relief initiatives. A debt sustainability analysis that considers an MVI would also reflect greater relief needs for highly vulnerable countries.

¹⁹ This subsection is based mainly on United Nations (2022).

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