

Cayman Islands

1. RECENT ECONOMIC PERFORMANCE

A. Overview

Following exceptional growth averaging 5.6% during 2005 and 2006, growth momentum slackened to 3.8% in 2007 (Figure 1), dampened by a cooling in construction activity after two years of sustained post-hurricane Ivan reconstruction work, as well as higher inflation. Growth was fuelled mainly by the strong performance of the international financial and business services sector which continued to attract portfolio flows, in spite of the financial market turmoil that emerged in the US in August from the subprime mortgage crisis which disrupted global money and credit markets. Tourism continued to strengthen following the post-hurricane rebound in 2006, with stay-over arrivals recovering to pre-Ivan (2003) levels. These gains were achieved notwithstanding the current slowdown in the US economy, the major market for visitors to Cayman Islands, as well as some dislocation that stemmed from the introduction of the WHTI on January 23, 2007 that imposed new passport requirements for all travellers including US citizens entering the US via air from Canada, Mexico, the Caribbean Region, and Bermuda.

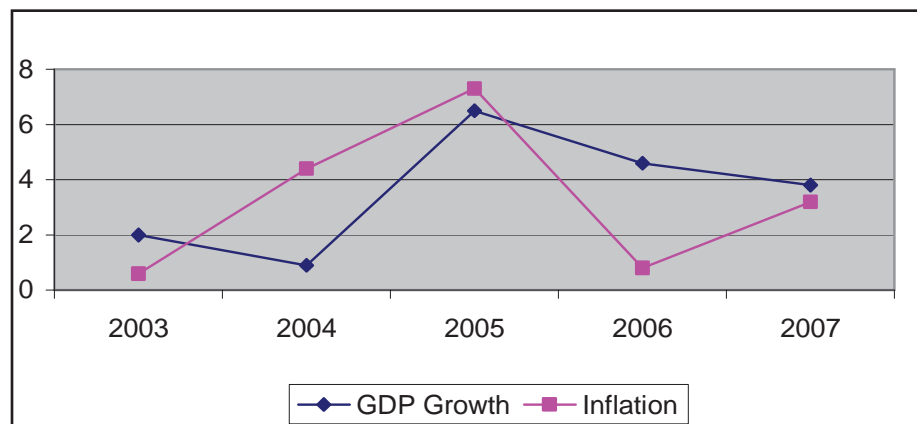
The slower economic growth in 2007 brought some softening in the labour market, primarily within the unskilled and skilled/technical category of workers, consistent with the winding down of labour-intensive construction work. After falling to a low of 2.6% in 2006, unemployment increased to 3.5% in 2007. However, growth in bank credit, visible imports and fiscal revenue all remained robust. Import growth recovered, reflecting the pickup in activity in the services sectors, and the continuing strong growth of private consumption demand which spilled over into rising domestic consumer prices. After decelerating from a high of 7.8% in 2005 to 0.8% in 2006 as hurricane-induced market supply bottlenecks eased, annual average inflation rebounded to 3.2% during 2007, pushed up by higher prices for food, fuel and personal goods and services.

B. Sectoral Performance

(i) International Financial and Business Services

A traditional source of growth, the offshore financial services sector continued to maintain its upward growth trajectory in 2007, reflecting the sustained external demand for the varied private wealth management

Figure 1: GDP Growth and Inflation, (%)

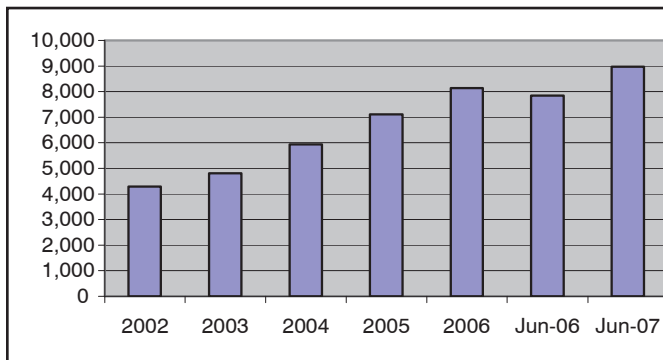


Source: Cayman Islands Government

vehicles within Cayman Islands' well-regulated financial services sector. With the exception of Cayman-licensed off-shore banks, for which issued licences and the number of registered banks continued to contract in line with worldwide restructuring and consolidation in the industry, increases were observed in insurance company licences; mutual funds; stock exchange listings; and market capitalisation.

In the area of investments and securities, Cayman Islands-regulated mutual funds continued to show impressive growth. The ease with which these funds can be established; the absence of a prescriptive regime mandating where providers should be located; and the depth of professional expertise available were highlighted by the monetary authority as the main factors accounting for this performance. During the first two quarters of 2007, mutual funds increased by 14.4% over the comparative period in 2006 to reach 8,972 at the end of June 2007 (Figure 2).

Figure 2: Active Mutual Funds, 2002-07



Source: Cayman Islands Monetary Authority

There continued to be a steady upward trend in the number of restricted trust licences issued. Additionally, insurance licences increased by 17 (or 2.2%) from 763 in June 2006 to 780 as at the end of June 2007. Of this amount, captive insurance licences accounted for 752. By type of business, captive licences continued to be dominated by healthcare (medical malpractice) and workers' compensation (Table 1). Among the licences granted by the monetary authority was one for the Caribbean Catastrophic Risk Insurance Facility. This risk-pooling facility was established to provide parametric insurance¹ coverage to the 17 CARICOM member and associate-member countries, including Cayman Islands,

¹ The parametric insurance product, as against the traditional insurance indemnity product, does not indemnify the pure loss associated with, nor requires a loss adjustment procedure after the insured event. This insurance contract ex ante, agrees to pay a pre-determined indemnity based on the occurrence of a pre-defined, parametric triggering event which is often a catastrophic natural event such as earthquake of a specified magnitude; the passing of the eye of a hurricane over a specified location; or hurricane intensity as measured by wind speed (Category 3 and upwards, for instance). A pay-out would be triggered when such an event enters the insured location.

against windstorms and earthquakes. A "financial safety net"; this facility will provide immediate budget support to the affected country after a natural disaster, once the pre-determined parametric trigger event has occurred.

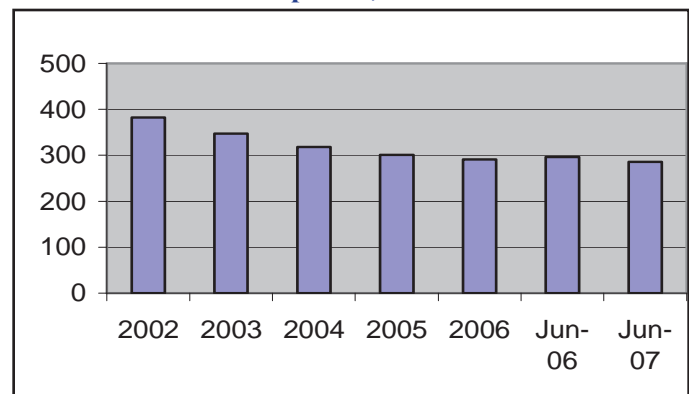
TABLE 1: CAPTIVE INSURANCE LICENCES BY PRIMARY CLASS OF BUSINESS, JUNE 2007

Class	Licences	%
Healthcare	278	37.0
Worker's Compensation	160	21.3
Property	79	10.5
General Liability	69	9.2
Professional Liability	60	8.0
Other	106	14.0
Total	752	100.0

Source: Cayman Islands Monetary Authority

Like most other jurisdictions, Cayman Islands saw a decline in the number of licences of bank and trust companies. In June 2007, there were 12 fewer banks than in June 2006, a 4% decline. (Figure 3). However, as indicated by the increase in total external assets, this was accompanied by a strengthening of the asset profile of existing licensees. The jurisdiction has maintained its prominence as an international banking centre, and has continued to attract top-tier banking groups, hosting branches or subsidiaries of over 40 of the world's top 50 banks as ranked by assets. Cayman Islands ranked as the sixth largest in the world in relation to total bank assets. International assets booked through banks in the Cayman Islands stood at \$1.8 trillion at June 2007 compared to \$1.4 trillion at June 2006. More than half of bank licensees originate from Europe (30%) and the US (27%).

Figure 3: Active Bank and Trust Companies, 2002-07



Source: Cayman Islands Monetary Authority

On the stock exchange, stock listings increased by 282, or 26.5% to total 1,345 at the end of June 2007. For the first six months of 2007, stock market capitalisation totalled \$126.6 bn, up from \$90.6 bn at June 2006 (Table 2). Growth in non-financial offshore business also continued. New company registrations at the end of June totalled 7,064, a 13.2% increase over the similar period in 2006.

TABLE 2: STOCK MARKET CAPITALISATION (\$ bn)		
Item	June-2006	June-2007
Mutual Funds	75.7	88.8
Specialist Debt	8.6	27.1
Eurobond	3.4	8.7
International Equity	2.8	1.9
Domestic Equity	0.2	0.2
Total	90.7	126.7

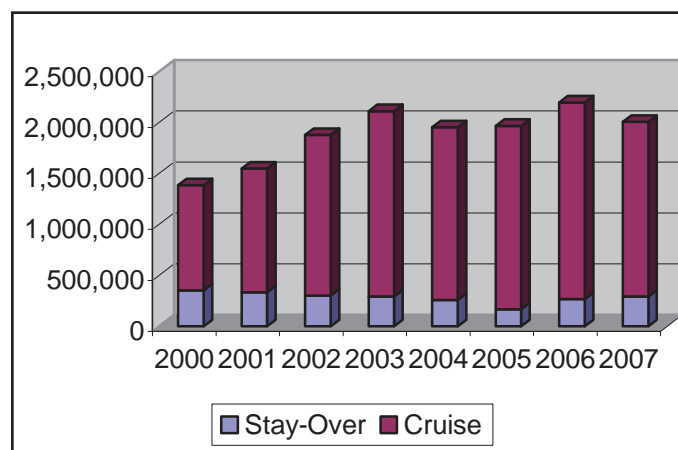
Source: Cayman Islands Stock Exchange

Given the continuing growth and increasing complexity of financial services, the Cayman Islands' Monetary Authority introduced a range of new rules; guidance procedures; and legislative amendments to enhance the soundness of licensee operations and to streamline the regulatory process. These included measures covering internal controls and business continuity management for licensees; risk management; physical presence requirements for banks; and capital adequacy requirements for insurers underwriting non-domestic business.

(ii) Tourism

Total visitors to the Cayman Islands amounted to 2,007,169 in 2007, an 8.7% decline from the 2006 performance (Figure 4). The decline in total arrivals was occasioned by an 11.1% reduction in cruise arrivals, while stay-overs, the higher spending segment of the market, continued to rebound strongly. Stay-over arrivals accounted for 291,503 or 17% of total arrivals, increasing by 9.1% over the number of visitors in 2006. The US continued to be the major source of stay-over arrivals, contributing 79.5% of total arrivals. Against the backdrop of a milder hurricane season, the improved performance stemmed from enhanced air service; strategic marketing initiatives; as well as an increased availability of rooms. The cruiseship sector remained the largest contributor of visitors to Cayman Islands in 2007.

Figure 4: Total Visitor Arrivals 2000-07



Source: Cayman Islands Government

(iii) Construction

The construction sector was the key growth sector in 2006. Leading indicators of construction activity, however, suggest sector decline in 2007. The number of building permits issued during the first half of the year fell by 13.9%, compared with the same period in 2006. Similarly, the number of approved project applications was 10.3% lower in the first half of 2007.

C. Prices, Wages and Employment

Annual average inflation, measured by the CPI, accelerated to 3.2% for 2007, compared to stable prices during 2006 (Table 3). Higher prices for items within the heavily weighted group, Personal Goods and Services, including the cost of helpers and gardeners, contributed most (40%) to the overall increase in inflation. Increases in food prices, as well as prices for household equipment, also contributed to higher overall prices.

Average inflation had decelerated to a negligible 0.8% in 2006 (after rising sharply to 7.3% in 2005 following hurricane Ivan) in 2004, as housing prices moderated in step with an increased supply following the completion of the rebuilding process. A rebound of upward pressure on prices was however evident from the second half of 2006, indicated by the point-to-point measure of inflation which at 1.6% at end-December 2006 was twice the average measure of 0.8%.

TABLE 3: ANNUAL AVERAGE INFLATION RATE BY GROUP

Categories	Weights	2006	2007
Food	119.6	2.7	5.4
Alcohol and Beverages	15.7	1.9	1.4
Housing	310.8	-4.2	-0.3
Clothing	46.1	5.0	4.5
Household Equipment	58.7	-0.1	9.1
Transport and Communication	168.5	4.7	3.9
Education and Medical	64.6	1.6	1.6
Personal Goods and Services	216.0	3.8	5.9
All Items	1000.0	0.8	3.2

Source: Cayman Islands Government

With the easing of economic growth in 2007, the demand for labour contracted, and unemployment edged up to 3.5%. The lower demand for labour was indicated by a 4.6% decline in the number of work permits (21, 272) issued during the first half of the year compared with the previous year. By industry, 'construction' maintained the largest share of 26% of the 20,286 issued work permits as at June 2007. However, reflecting the slowing in post-Ivan reconstruction work, this category registered the largest decrease of 759 work permits, a decline of 12.6%. Permits for the category 'Private Households with employed persons' comprising primarily domestic helpers, declined by 563. The foregoing declines would also have been reflective of the seven-year work-term limit policy stipulated in the Immigration Law (2003). All other categories of workers, including those employed in financial services; restaurants; and bars increased.

D. The Banking System

M₂ reached \$7 bn (\$8.4 bn) in June 2007, an increase of 21.3% over the comparable period in 2006. The source of growth was a 23.4% expansion in quasi-money, and primarily in foreign currency deposits held by residents. M₁, primarily used for transactions purposes, contracted by 12.6%.

On the asset side, the main source of growth was a 26.7% expansion in the net foreign assets of the commercial banks, driven by a rise in bank balances held; foreign investments; and loans to non-residents. Domestic credit provided by the commercial banks also contributed to asset growth, increasing by 15.5% over June 2006, reflecting higher credit allocation to both the public sector and the resident private sector. Credit to households – which accounted for 55.8% of total credit – increased by 13.3%. Mortgage and other property loans continued to be the dominant type of household

loans. Lending to the business sector – which accounted for 37.6% of total credit – rose by 17%. After remaining steady at 8.25% since August 2006, Cayman Islands' average prime lending rate fell to 7.75% at the end of September, in response to the decline in the US Federal Funds rate during the third quarter of 2007. Commercial banks' weighted average loan rate fell in tandem, from a high of 11% at June 2007 to 10.23% in September.

E. External Sector

For the first six months of 2007, the value of imports at \$535.7 mn, was 17.8% higher, than the similar period in 2006. During 2006, the value of imports (\$906 mn or 44% of GDP), fell 9% below imports of 2005, as inflows of construction and consumer goods normalised toward their pre-hurricane levels. However, based on the pace of the rebound observed for 2007, the value of imports is likely to end higher than even the 2005 figure.

The upsurge in import expenditure in 2007 reflects in part higher unit prices consequent on higher oil and food prices from the US, the major import market accounting for 72% of Cayman Islands' imports. Visible exports from the Cayman Islands remained negligible, and comprised mostly re-exports, that is, goods imported and subsequently exported without having undergone any processing, repackaging, or value-added activities, as well as the export of personal effects. Based on these partial estimates for 2007, the merchandise trade deficit is likely to widen. This worsening could, nonetheless, be offset by improvement in tourism receipts, resulting in a lower current account deficit.

2. MAJOR POLICY ISSUES

A. Human Resource Development and Productivity

Access to skills is a necessary requirement for achieving sustained economic growth. Notwithstanding Cayman Islands' demographic characteristics – a small population with a limited skills base – the country has achieved significant rates of economic growth in the past, based on its service-oriented industries, which includes a highly-skilled financial services sector. The Cayman Islands' economy has been successful at overcoming labour market constraints to growth by narrowing its skills gap; accelerating the adoption of technology; and enhancing efficiency and country comparative advantage, through a largely transient labour force. A relatively flexible and open immigration policy has provided access to well-educated and highly-skilled labour, as well as low-skilled manual labour. The country's population has increased steadily from under 15,000 persons in 1976, to 21,300 in 1986, and 51,992 in 2006. The large inflow of highly skilled workers together with virtually full employment conditions has, however, tended to push up labour costs, and has contributed to the country's high price level.

As the population has increased, the number of Caymanians in the labour force has fallen steadily from 75% in 1985 to 65% in 1991 and to 50% in 2006. The labour force survey of 2006 indicated that 35,959 persons were in the labour force. Of that amount, 35,016 were employed. The number of Caymanians employed was 18,303, or 50.9% of the total labour force, while non-Caymanians accounted for 17,656, or 49.1%. The percentage of non-Caymanians in high-productivity, high-paid jobs is significantly higher. As the supply of local, skilled Caymanian labour has lagged behind the demand, the increasing proportion of imported skilled persons has resulted in a skewing of the national income towards non-Caymanians.

The 2006 labour force survey has shown that a mere 4.8% of the Caymanian labour force had a professional qualification; 4.3% had a post-graduate degree; and 10.5% had a first degree. While the country's high wage rates may be a contributing factor, attracting early entry of the local working age population into the labour force at the lower skill end, the fact that under 30% of the country's secondary school students are currently achieving employable certification, suggests that the education system is also a contributing factor. The education system is obviously failing to produce sufficient, suitably qualified candidates with the ability to pursue post-secondary education to meet the demand for skilled labour.

To secure a more equitable distribution of income,

and allow more Caymanians to capitalise on the opportunities from growth, public policy will need to facilitate significant improvements in the training and productivity of the resident, Caymanian labour force. Increasing the participation of the locally-available pool of skills in high-productivity jobs will require a significant upgrading of education, professional and skill levels of the local working population.

The Government of Cayman Islands, through its *"Building Brighter Futures"* programme, is seeking to transform the education system to improve educational outcomes. The strategies adopted in the National Educational Reform Programme aim to improve facilities for teaching and learning; provide for dedicated early childhood education and welfare; an improved national curriculum; better administrative services; a new governance model for the education system; enhanced professional development of teachers; and technical and vocational opportunities. A full review of Cayman Islands' education law is expected to underpin the new education model. Approved by the Legislative Assembly in October 2005, the new national curriculum is expected to be rolled out in schools in 2008. A new governance model has been implemented, and plans are underway to construct three new high schools, and to enhance tertiary and technical/vocational offerings.

B. Sustainable Development and Environment Protection

The significant rates of economic growth achieved in Cayman Islands have resulted in part from a fairly rapid pace of investment and infrastructure development during the past decade and a half. With this have come significant pressures on the country's resource-carrying capacity. Environmental pressures also stem from the increasing demands of a fast expanding population to sustain a living standard that is among the highest in the Caribbean. The existing dated and inadequate environmental legislation; the continued filling of mangrove swamps for commercial and residential property development; inadequate physical planning; the impact of the large, daily influx of cruiseship passengers; and the weak management of solid waste, all highlight the seriousness of the threats to the environment. The country's large and growing landfill, situated in close proximity to the main tourist centre, is a blot on the landscape, and presents a threat to the very industry that has contributed to the significant rate of economic growth in Cayman Islands. With limited land space and capacity for waste absorption, the search for solutions to problems of increasing solid waste, traffic congestion and pressure on infrastructure, further highlight the need for a more integrated approach

to long-term sustainable development planning to promote environment conservation; prohibit environment damage; and to avoid the development of problems related to rapid economic growth.

Added to this are the adverse environmental and economic effects expected with rising sea levels, coastal erosion and diminishing shore lines, and increasing severe weather patterns as a result of global climate changes. Enhancing country capacity to adapt to the impact of climate change will be critical for the Cayman Islands, especially for the continued development of the tourism industry, which is itself heavily natural resource based. Modernising the legislative framework, and strengthening the national institutions responsible for the management of natural resources in Cayman Islands will be necessary to ensure that environmental priorities are reflected in economic development programmes, and that appropriate laws are enforced.

3. MEDIUM-TERM ECONOMIC PROSPECTS

Economic growth is expected to ease to 3%, and could fall lower over the medium term following the downscaling in the economic prospects of the US and

world economy, and the possibility of continuing high inflation. Given that the economy is essentially highly dependent upon US visitors and foreign investments, the attendant downside risks for the Cayman Islands economy appear to have strengthened. The US is a key market for the country's service sectors as well as the main source of consumption goods and production materials. Tourism could be especially impacted. In addition, the risky financial market conditions associated with the unwinding of the sub-prime mortgage market crisis could eventually spill over to Cayman Islands, slowing the growth of the financial services sector. Continued weakness in the US dollar, to which the local currency is pegged, could dampen the demand for local services and properties from residents with depreciating assets and income. The demand from non-US currency holders abroad may, however, increase. Inflation will continue to be influenced by the movement in imported prices for food and oil, but should moderate somewhat with lower domestic aggregate demand. A softening in oil prices could also dampen inflation pressures. In line with slower growth, unemployment is projected to increase somewhat.