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CARIBBEAN DEVELOPMENT BANK

THIRD FORMAL NEGOTIATION MEETINGOF CONTRIBUTORS

TO THE SPECIAL DEVELOPMENT FUND (UNIFIED)

TO BE HELD IN BARBADOS

JULY 19 & 20, 2012

SPECIAL DEVELOPMENT FUND 8: A FRAMEWORK FOR THE CONTINUATION OF RESOURCES TO ADDRESS FISCAL DISTRESS (REVISED)

The attached Paper has been revised based on comments/questions from the Contributors at the Special Development Fund (SDF) Negotiations in the Cayman Islands on May 22, 2012. Contributors are asked to note the following:

(a) revisions to the document are highlighted for ease of reference; and

(b) a comprehensive matrix pursuant to Section 3 of the Paper will be presented to the Contributors prior to the Board Meeting.

CARIBBEAN DEVELOPMENT BANK

SPECIAL DEVELOPMENT FUND (UNIFIED)

SPECIAL DEVELOPMENT FUND 8: A FRAMEWORK FOR THE CONTINUATION OF RESOURCES TO ADDRESS FISCAL DISTRESS (REVISED)

<u>JULY 2012</u>

CURRENCY EQUIVALENT

Dollars ($) throughout refer to United States dollars (USD) unless otherwise stated.

ABBREVIATIONS

ANT	-	Antigua and Barbuda
BAH	-	Bahamas (The)
BAICO	-	British American Insurance Company Ltd.
BAR	-	Barbados
BMCs	-	Borrowing Member Countries
bn	-	billion
BOP	-	Balance of Payments
BZE	-	Belize
CDB	-	Caribbean Development Bank
CG	-	Central Government
CLICO	-	Colonial Life Insurance Company Ltd.
CPA	-	Country Poverty Assessment
DOM	-	Dominica
DSA	-	Debt Sustainability Analysis
ECCU	-	Eastern Caribbean Currency Union
EU	-	European Union
GDP	-	Gross Domestic Product
GOBD	-	Government of Barbados
GPRS	-	Growth and Poverty Reduction Strategy
GRN	-	Grenada
GUY	-	Guyana
HRD	-	Human Resource Development
IMF	-	International Monetary Fund
JAM	-	Jamaica
MDGs	-	Millennium Development Goals
MfDR		Managing for Development Results
mn	-	million
NPRSs		Poverty Reduction Strategies and Action Plans
NGOs	-	Non-Governmental Organisations
NIS	-	National Insurance Scheme
OCR	-	Ordinary Capital Resources
OECS	-	Organisation of Eastern Caribbean States
PBL	-	Policy-Based Loan
PFM	-	Public Financial Management
pp	-	percentage point
PRS	-	Poverty Reduction Strategy
PSIP	-	Public Sector Investment Programme
%	-	per cent
SDF	-	Special Development Fund

SIDS	-	Small Island Developing States
SKN	-	St. Kitts and Nevis
SSNAs		Social Safety Net Assessments
STL	-	St. Lucia
SVG	-	St. Vincent and the Grenadines
TA	-	Technical Assistance
T&T	-	Trinidad and Tobago
UNDP	-	United Nations Development Programme
US	-	United States
VAT	-	Value-Added Tax
WB	-	World Bank

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APPENDICES

EXECUTIVE SUMMARY

1. The Caribbean Development Bank's (CDB) Borrowing Member Countries (BMCs) are confronting unprecedented social and economic challenges. Notwithstanding social gains achieved over the past four decades, poverty levels have remained relatively high in many BMCs and in some instances have risen in the wake of the global economic crisis. Indeed, there are challenges in accelerating the pace of poverty reduction and these can become acute given the deceleration in regional growth, which started prior to the global crisis, and the less than sanguine prospects going forward. The global crisis also imposed significant fiscal hardships, exacerbating already large deficits and high debt and pushing public debt to unsustainable levels in many BMCs. The acute socioeconomic and fiscal challenges confronting most of the BMCs reinforce the case for continued technical and financial assistance, particularly concessionary resources from development partners. This support is important to help countries consolidate socioeconomic progress already achieved and to reduce the risks of regression so as to ensure that most of the Millennium Development Goals (MDGs) are met. Indeed, development gains are under threat of reversal in the absence of ratcheted-up assistance from the donor community.

2. The Special Development Fund (SDF) set-aside for fiscal distress is one such means of support. However, as budgets of development partners are squeezed, scarce resources must be allocated to areas where they will have the greatest development impact. Support to address fiscal distress is considered an important area for support, given that acute fiscal and debt problems threaten the sustainability of the Region's development process. Accordingly, the case for continued allocation of the set-aside is premised on the following imperatives: (a) special and continued support, given the acute fiscal and debt challenges in the Region and implications for poverty; (b) sustaining development results attained through interventions of SDF 6 and 7; and (c) mitigation of the economic and social costs of adjustment to prevent further increases in poverty.

3. Consistent with the SDF objectives and in order to structure the allocation process, two criteria for access to the fiscal distress set-aside are proposed:

(a) BMCs in fiscal distress, as defined by a fiscal distress score above zero;[1/] and

(b) BMCs have a medium-term economic and social adjustment programme (home-grown or otherwise) supported by development partners (including IMF) aimed at restoring fiscal and debt sustainability, while seeking to safeguard social gains and protect the most vulnerable and lay the basis for long-term growth and advancing social development.

4. Indeed, three important conclusions have emerged from the discussions that form the basis of a recommended agenda for the way forward:

(a) the current levels of poverty are too high and the pace of poverty reduction is slow in many BMCs. Hence, there is continuing need for: (i) strong social protection systems and strategies for minimising the adverse economic and social consequences of various shocks; and (ii) accelerating the pace of economic growth and poverty reduction;

(b) the current level of indebtedness in BMCs, with the general exception of the Overseas Territories, is too high and there is continuing need for growth-sensitive fiscal and debt adjustments in most BMCs; and

[1/] The Paper develops a composite fiscal distress index based on standard debt sustainability indicators. Positive scores indicate fiscal distress and the higher the score, the higher the degree of fiscal distress.

(c) BMCs will need substantial technical and financial assistance, in some cases for extended periods, given the negative economic consequences of high debt accumulation, together with the challenges and risks of the fiscal consolidation process. Beyond this remain the potential fiscal cost of resolving financial sector instability and the challenging and very costly and unfinished task of repositioning BMCs in the context of trade liberalisation and globalisation, which will require high levels of budgetary resources.

5. Management supports the critical and expanded role for SDF in enabling the Bank to assist with the resolution of fiscal distress in its BMCs. Contributors are requested to approve the proposed criteria for accessing the SDF set-aside for fiscal distress, the mechanism for allocating the resources, and the indicative results and monitoring framework.

1. INTRODUCTION

1.01 Caribbean economies are not only confronting fiscal and debt challenges, given the depth and protracted nature of the global crisis, but also facing structural hurdles that weigh heavily on productivity; competitiveness; and, by extension, economic growth. Additionally, levels of poverty and vulnerability in many countries remain unacceptably high. Indeed, there are challenges in accelerating the pace of poverty reduction, and these can become acute, given the deceleration in regional growth in recent years and the less than sanguine prospects going forward. Development gains are under threat of reversal in the absence of fundamental reforms to prevent further socioeconomic unravelling. Reforms are ongoing and will require ratcheted-up assistance from the donor community to ensure sustainability. Technical and financial support to address fiscal distress is considered necessary, given the acute fiscal and debt problems that threaten the sustainability of the Region's development process. Indeed, the socioeconomic consequences of high fiscal deficits and debt are well established both theoretically and empirically.[2/]

1.02 During the SDF 7 replenishment, Contributors felt compelled to make a separate set-aside for fiscal distress. This was done because Contributors were acutely aware of and sensitive to various additional factors that were weighing on BMCs' fiscal performance. These factors included: (i) the budgetary requirements of seeking to address unacceptably high levels of poverty; and (ii) the substantial economic dislocations attendant upon the shifting trade and economic trends related to trade liberalisation and the need for economic restructuring. The allocation for the fiscal distress set-aside and the immediate response interventions was forty-seven million United States dollars ($47 mn).

1.03 Fiscal distress is defined as any form of fiscal and debt unsustainability. Simply, a country is deemed to be in fiscal distress if it is unable to pay its debt and or finding it increasingly difficult in meeting its debt obligations. Some of the standard indicators of fiscal unsustainability/fiscal distress are the debt-to-GDP ratio, primary balance, and the real interest rate on the debt portfolio. Fiscal sustainability incorporates two key concepts: solvency and liquidity. Solvency implies that a government is able to comfortably repay its debts sometime in the future. Liquidity requires that a government's liquid assets and available financing are sufficient to meet its maturing liabilities. A country's fiscal policy is unsustainable if: (i) Government's budget cannot be easily financed without a large future correction in revenue and/or expenditure or without resorting to debt default or excessive debt monetisation; and (ii) external shocks result in acute debt repayment difficulties (fiscal/debt distress).

1.04 The purposes of this Paper are to make the case for the continuation of the set-aside; to establish the criteria for accessing the resources; and to propose a mechanism for strengthening the governance arrangements underpinning the set-aside in order to maximise development results. In this context, the Paper makes proposals for establishing the conditions under which the funds are allocated and indicates how the resources will be utilised, consistent with the Managing for Development Results (MfDR) framework.

1.05 The paper is divided into six sections. Section 2 lays out the social and fiscal context, while Section 3 reviews the effectiveness of past fiscal distress interventions. Section 4 presents the case for continued SDF support to address fiscal distress. Section 5 proposes an enhanced framework for SDF resources to reduce fiscal distress and poverty, and Section 6 concludes with recommendations for the way forward.

[2/] For a theoretical and empirical discussion of fiscal and debt sustainability, see Appendix 1.

2. CONTEXT

Social Context

2.01 Poverty levels remain high in BMCs notwithstanding the socioeconomic gains achieved over the past four decades. Country Poverty Assessments' (CPAs) findings for the past 15 years indicate that while indigence has been decreasing in some countries and the severity and persistence of poverty vary widely across BMCs, overall, poverty continues to be a major development challenge. In excess of 25 per cent (%) of the population in eight of the BMCs are living below national poverty lines (see Appendix 2). Poverty in the Caribbean is predominantly rural, but there is increasing incidence in urban areas. Additionally, high income inequality or skewed income distribution is one of the critical factors contributing to poverty in the Caribbean.[3/] High poverty levels are recorded among persons employed in low-skilled and low-paying jobs such as in agriculture, construction, light manufacturing, and among those in the informal sector who make up the increasing numbers of the working poor. Poverty is also over-represented among deprived or at-risk groups such as: indigenous people; the elderly living alone; the disabled; school-aged youth (especially those in female-headed households); and households with large numbers of youth and elderly dependents. Vulnerability to natural hazards and economic shocks is also one of the critical factors associated with poverty. BMCs are vulnerable to hurricanes; tropical storms; seismic and volcanic hazards; global economic cycles; and terms of trade and other shocks. When these events occur, they frustrate social and economic progress and pose significant challenges to the Region's development.

2.02 Small size and resource constraints limit BMCs' ability to consistently deploy the required human and financial resources to anti-poverty investments. Consequently, persistent poverty poses a major challenge to their development. This challenge is exacerbated during times of economic crisis and fiscal distress and, as such, intensifies as a major threat to the sustainable development of the Region. A recent study on the effects of the current global economic crisis on Caribbean countries by United Nations Development Programme (UNDP)[4/] indicated that the crisis is creating a decline in "tourism, construction sector activity, remittances, and constrains the Governments' fiscal space." It indicated further that the impacts of the crisis have tended to be greater in countries with the following characteristics:

(a) relatively large share of tourism and offshore financial sectors in the economy;

(b) high reliance on single export markets;

(c) high reliance on exports that fall into the category of discretionary spending (e.g.) tourism and bananas;

(d) little diversification of economy with high dependence on one service, commodity or company;

(e) little access to international capital markets; and

(f) less ability to resort to countercyclical spending.

[3/] CPA findings show that in some countries the richest 10% of the population account for 30% of total consumption expenditure, while the poorest 10% of the population account for a mere 5%.

[4/] *Social Implications of the Global Crisis in Caribbean Small Island Developing States: 2008/09*, Synthesis of the Findings of Seven Country Studies, Final Draft, February 27, 2010, UNDP, Barbados and the Organisation of Eastern Caribbean States.

2.03 The report identified unemployment and under-employment as the most common social impacts of the economic crisis. Prior to the crisis (2005-08), unemployment levels ranged from 4 to 19% within BMCs. While current data are unavailable, it is expected that those percentages would have increased with the onset of the crisis and that those at the bottom of the labour market, particularly young women and seasonal workers, would be affected most. In many countries, self-employed persons working in the tourism sector, hotel and restaurant employees, small contractors, persons employed in the informal sector, and other non-public sector employees who have either been laid off or operate with reduced working hours, have experienced a significant drop in income. Threats to job security and reduced household income have major implications for social development in key areas such as education, health, nutrition, crime and overall wellbeing, and could lead to further marginalisation and long-term unemployment of socially excluded persons.

2.04 As a result of the crisis, households once able to support elderly parents and children, either from their own incomes or remittances, are forced to turn to Government for assistance; but this is happening at a time when access to such support is becoming more difficult. In order to curtail public expenditure, governments cut their budgets and this, in many cases, results in reduced funding of the social services needed by the most vulnerable members of the population. With the reduction in household income, applications for assistance to social welfare and other government public assistance programmes have increased at a time when funding of these services has been reduced. Non-Governmental Organisations (NGOs) also experience increased applications for assistance, but they too are less able to satisfy the increased demand due to difficulties in acquiring the funds needed. As a consequence, the poorest and most vulnerable groups are at further risk of deprivation. In addition to reducing expenditure, several governments have also increased taxes and fees, including Value Added Tax (VAT), in order to increase revenue. The regressive nature of such indirect taxation produces increased cost of living effects at a faster rate for low income families than for high income households. This, in some cases, has resulted in increased deprivation, indebtedness in relation to utilities such as water and electricity and increased evictions.

2.05 Therefore, without access of BMC governments to resources to implement countercyclical measures and to provide continued access to key social services and social protection measures, the economic crisis could result in an increased group of people being at risk of becoming more marginalised and more distant from the labour market.[5/] This is particularly an issue for women and children, unemployed young people, people with low level qualifications and skills and other vulnerable groups such as indigenous people, the elderly and disabled who are already being affected disproportionately by the lingering effects of the crisis.

Fiscal Context

2.06 The global economic and financial crisis imposed significant fiscal hardships on many of CDB's BMCs, exacerbating already large deficits and high debt. While public revenues plummeted in some countries, constrained external borrowing further limited the scope for countercyclical fiscal policies. Certain expenditures that are vital for poverty reduction and growth (infrastructure, for example) were significantly reduced. Moreover, the situation prompted concerns about medium-term fiscal and debt sustainability and heightened fiscal distress risks and as such necessitated fiscal adjustment. Indeed, the countercyclical fiscal policy that began in 2009, for the most part was reined in during 2010, with concerted efforts at expenditure reduction (primarily, but not exclusively, capital expenditure) and the introduction of new taxes and/or increases in existing tax rates and/or fees in some countries. VAT was introduced in Grenada (GRN) and St. Kitts and Nevis (SKN), while there were increases in tax rates in

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[5/] *Social Impact of the Crisis and Developments in the Light of Fiscal Consolidation Measures*, Hugh Frazer and Eric Marlier, European Union (EU) Network of Independent Experts on Social Inclusion, February 2011.

Antigua and Barbuda (ANT) (stamp duties and embarkation tax); the Bahamas (BAH) (stamp duties and departure tax); Barbados (BAR) (increase in VAT); and Belize (BZE) (business and excise tax).

2.07 Though the fiscal situation improved in 2011 relative to 2009 and 2010 in the majority of the 12 independent BMCs that this analysis focuses on, the fiscal challenge still remained acute in many of the BMCs. The overall fiscal deficit as a percentage of Gross Domestic Product (GDP) remained high and unsustainable in 7 of the 12 BMCs, exceeding 4.5% of GDP in 4 of the 7 countries. The average deficit for the Region as a whole averaged 3.9% of GDP, down from the 2010 average of 5.1% of GDP. Regarding the primary deficit, though the regional average remained virtually unchanged at 0.6% of GDP in 2011, there were deteriorations in the primary balance positions in 4 of the 12 BMCs. Public debt as a ratio of GDP ranged from 48.9% in BAH to 151.3% in SKN. The regional average of the public-debt-to-GDP ratio increased to 87% in 2011, two percentage points (pp) above the average in 2010.

2.08 At the country level, there were several BMCs with low or very low debt ratios prior to the crisis which rose sharply. Most notable in this regard are BAH, St. Lucia (STL), St. Vincent and the Grenadines (SVG), and Trinidad and Tobago (T&T). BAR debt-to-GDP ratio prior to the crisis was relatively moderate but has since risen sharply. As Appendix 3 shows, 5 of the 12 BMCs recorded an increase in their debt-to-GDP ratio in 2011. The largest pp increase occurred in STL, followed by T&T. In 10 of the 12 BMCs, the debt-to-GDP ratio exceeded 60% at the end of 2011. Of the 10 countries, 4 (Dominica [DOM], Guyana [GUY], STL and SVG) had ratios ranging from 61 - 80%. Three BMCs (ANT, BZE and GRN) had ratios ranging from 81 - 99% and three (BAR, Jamaica [JAM] and SKN) had ratios surpassing 100%. In only two countries (BAH and T&T) were the ratios less than 60%. In nominal terms, public debt in the Region was estimated at a total of $45 billion (bn) in 2011, up from $31 bn in 2008. In per capita terms, the large stock of public sector debt in the Region equated to a debt burden of around $7,000 in 2011.

2.09 Disaggregating the debt dynamics (Appendix 4) shows that primary deficits and interest costs were the largest contributors to the rise in the debt ratio in 2011. For example, interest costs contributed 8.4 and 8.3% to the build-up in the debt ratios in STL and SVG in 2011, respectively. In the remaining BMCs where the debt ratio fell, increases in nominal GDP were the main contributors in most of the countries. In JAM and SKN, the decline also reflected strong fiscal adjustment measures, which in the case of JAM also included debt restructuring.

2.10 The baseline fiscal and debt outlook shows only gradual improvement in the majority of countries. Taking into account country-specific fiscal adjustment measures ongoing and/or announced, the medium-term fiscal and debt projections (Appendix 5) show that by 2015, overall deficits will still exceed 3% of GDP in five of the BMCs, suggesting that large financing needs will persist. Primary surpluses are projected for 7 of the 12 BMCs with the regional average estimated at 1% of GDP over the medium term. However, the sizes of the primary surpluses only allow for gradual debt reduction over the medium term. The regional average for the public debt is projected at 80.5% of GDP in 2015, representing a cumulative decrease of 6.5pp. In BAR, JAM, and SKN the public debt ratio will still exceed 100% of GDP in 2015. The baseline fiscal outlook and debt profile are vulnerable to shocks related to the global economic recovery and natural hazards; higher-than-anticipated fuel and commodity prices; and fiscal costs associated with financial sector interventions in connection with the Colonial Life Insurance Company Limited (CLICO), British American Insurance Company Limited (BAICO) resolutions and restructuring of the financial sector in the Eastern Caribbean Currency Union (ECCU). It is estimated that the financial costs associated with the CLICO crisis is about 10-15% of regional GDP.

2.11 An illustrative Debt Sustainability Analysis (DSA), the results of which are presented in Appendix 6, shows that primary surpluses in the range of 1-14% of GDP are required to significantly reduce debt-to-GDP ratios over the medium to long term. Consequently, in many BMCs, large-scale fiscal adjustment will be required to reduce debt to 60% of GDP by 2020 for countries where the ratio exceeded 60% of GDP in 2011. Alternatively, for countries where the ratio was less than 60% of GDP in 2011, a 25pp reduction is assumed. The magnitudes of fiscal adjustment are for example, 11.4% in ANT; 9.7% in BAR; 8% in GRN, 7.3% in SKN; 7.1% in STL; and 6.3% in BAH. BZE is the only country that will not require fiscal adjustment because of the favourable interest/growth differential and primary surplus position. However, with debt restructuring that is planned for 2012/13, coupled with stepped-up interest costs associated with its super bond (not captured in the DSA) BZE's actual medium-term outturn could be vastly different to the DSA estimates. Primary surpluses needed to stabilise debt-to-GDP ratios at the 2011 level, range from 1.2% of GDP in BAH to 7.1% of GDP in ANT. However, favourable growth will reduce the fiscal effort required. The sustainability indicators[6/] (Column 9, Appendix 6), which were at/or exceeded one, suggest that the fiscal stance at the end of 2011 was on an unsustainable path in all countries.

2.12 Figures 1 to 12 in Appendix 7 illustrate the trajectory for public debt in each BMC based on the following assumptions: (i) the 2011 fiscal outturns with no policy change going forward;[7/] (ii) an extreme growth shock equivalent to a 1pp reduction in the 2011 real GDP growth rate; and (iii) the country's own medium-term growth projections. With the exception of BZE, GRN, GUY and JAM, the trajectory for public debt is upward and in some cases explosive (ANT, BAR, SKN, and STL) under the scenario of an extreme growth shock. Even with more favourable medium-term growth assumptions, there is still an upward trajectory for public debt in BAH, BAR and STL. DSA estimates reinforce the fact that the fiscal outlook is highly vulnerable to shocks. Indeed, in some countries the fiscal challenge is more acute (ANT, BAR, GRN, JAM, SKN and STL). In countries such as BAH, SVG and T&T, debt ratios, while low in the pre-crisis period, have risen sharply and are on an upward trajectory over the medium tem in the absence of fiscal adjustment.

2.13 The fiscal challenge appears less acute in BZE, DOM and GUY, but risks to the outlook are tilted to the downside. The DSA illustration reinforces the case for continued technical and financial assistance from development partners to support economic and fiscal adjustment programmes to firmly entrench fiscal and debt sustainability. The DSA illustrates that continued economic restructuring and fiscal adjustments are mandatory in order to put BMCs on a sustainable fiscal and debt trajectory. In this context, the support of development partners is critical to maintaining and increasing the momentum of economic restructuring and fiscal adjustment. Such support will be particularly critical in the context of weak growth prospects that are highly susceptible to downside risks. Economic growth for the Region as a whole is projected to average 2.5% over the medium term. It is important to underscore that support for reforms go beyond fiscal consolidation to the inclusion of policies more directly supportive of growth. Donor support should concentrate on both short and medium-term interventions but must also pay attention to the longer-term policies and initiatives essential to enhanced growth performance, employment and poverty reduction. Indeed, the adjustment process must not be inimical to growth.

[6/] Values greater (less) than one implies that the current fiscal policy is unsustainable (sustainable) and inconsistent (consistent) with the debt-to-GDP ratio converging to a lower target.

[7/] Given the static nature of the DSA tool being used, policy reforms that will be implemented in the medium term are not captured in the framework.

3. EFFECTIVENESS OF PAST FISCAL DISTRESS SET-ASIDE INTERVENTIONS AND LESSONS LEARNT

Effectiveness of Past Interventions

3.01 The fiscal distress set-aside has been used, in conjunction with Ordinary Capital Resources (OCR), to provide policy-based support to BMCs. Since 2006, BMCs benefitting from the blending of OCR and SDF funds from the fiscal distress set-aside include: BZE (2006); GRN (2009); STL (2008, 2010); SKN (2007, 2011); and SVG (2009). Table 1 shows the distribution of the fiscal distress set-aside under SDF 6 and 7. In these BMCs, the use of the Policy-Based Loan (PBL) and more specifically of the fiscal distress set-aside was occasioned by the intensification of fiscal and debt unsustainability, accompanied by a deterioration in social conditions.

TABLE 1: DISTRIBUTION OF THE SPECIAL DEVELOPMENT FUND FISCAL DISTRESS SET-ASIDE

(mn)

SDF 6 Total Fiscal Set-Aside: $45 mn				SDF 7 Total Fiscal Set-Aside: $47 mn			
Country	Period/Purpose	Total Loan Amount	Fiscal Set-Aside Amount	Country	Period/Purpose	Total Loan Amount	Fiscal Set-Aside Amount
BZE	Dec-06/PBL	25.0	10.0	SVG	May-09/PBL	25.0	9.0
SKN	Dec-06/PBL	20.0	8.0	GRN	Oct-09/PBL	12.8	8.0
STL	Jul-08/PBL	30.0	8.0	STL	May-10/PBL	15.0	6.0
				SKN	Dec-11 Exceptional Financing	17.8	13.6
% of Total Set-Aside			**58%**	**% of Total Set-Aside**			**78%**

Note: Under SDF 7, $6.75 mn was used for emergency funding for natural disasters.

3. 02 In the case of BZE, there were growing concerns about fiscal, debt and external unsustainability. BZE's public sector debt at the end of 2005 had reached 103.7% of GDP with Central Government's (CG) debt amounting to 88.4% of GDP and its debt service equivalent to 82.1% of recurrent revenue. Also, foreign exchange reserves had fallen to less than one month of imports. Meanwhile, two CPAs (1995, 2002) had indicated that the poverty level had remained stubbornly high at 33%.

3.03 GRN, with a public sector debt-to-GDP ratio of 114% in 2009, was already in an adjustment programme with the IMF, which required a concessionary element in GRN's borrowings of 35%. Consistent with this grant element rule, GRN required resources from CDB on concessionary terms in order to bring its public debt onto a sustainable path.

3.04 SKN, with a public sector debt-to-GDP ratio of 151.2% in 2006, intensified fiscal pressures resulting from the closure of the sugar industry in 2005, increased unemployment, and the need to fund substantial severance payments, was in severe fiscal difficulties at the time of its first PBL. By 2011, SKN's inability to meet its debt commitments and to plug very large financing gaps, estimated at $120 mn over the period 2011-13, necessitated an IMF Standby Arrangement and a request from CDB for financial assistance to facilitate debt restructuring with external commercial creditors.

3.05 In STL, looming fiscal risks, in part prompted by a surge in capital expenditure related to World Cup Cricket in 2007 and attempts to pursue broad based growth through expansion in infrastructure, forced a pre-emptive PBL intervention in the context of a slowing economy and rising unemployment in 2008. The deepening impact of the global recession forced a return to CDB for further assistance in 2010 as fiscal and socioeconomic conditions deteriorated. By this time, STL's public sector debt had risen from 59.3% of GDP in 2008 to 64.5% of GDP in 2010 and debt service as a percentage of recurrent revenue had surged to 37.9% from 20.4%.

3.06 In SVG, growing concern about fiscal and debt sustainability prompted Government to take pre-emptive action in 2009 with the support of a PBL. Following growth of 7% in 2007, the economy had contracted by 0.6% in 2008 with expectations of a deeper contraction in 2009. The effects of the economic contraction were beginning to be felt through a significant decline in revenues amidst a growing need to at least maintain social spending in a deteriorating economic environment. By 2010, significant liquidity constraints had emerged, forcing Government to request earlier than anticipated disbursement of the second tranche to alleviate severe payment difficulties. An additional consideration was the possibility of significantly increased borrowing in case promised concessional financing for the new airport had not materialised.

3.07 An overriding consideration in the use of the fiscal distress set-aside was the desire to mitigate the debt repayment burden on these BMCs, given their existing level of indebtedness, and to provide them with the breathing space to implement much needed reforms to address their fiscal and debt situation in order to place their economies on a sounder footing. The concessionary nature of the SDF resources reduced the average effective interest rate and extended the repayment period. These SDF financed PBLs contributed to providing much needed liquidity support at a time when BMCs were experiencing severe liquidity constraints, occasioned by sharp declines in revenue. Importantly the PBLs not only provided much needed financing but also gave momentum to the governments' reform efforts to enhance fiscal and debt sustainability. PBLs have provided the incentive for countries to undertake reforms to strengthen government finances and improve the management of public debt. These loans have been usually accompanied by a package of CDB-financed technical assistance (TA) to support the implementation of policy reforms and institutional strengthening. Appendix 8 gives examples of fiscal, structural and social reforms that are ongoing in BMCs. The benefits of the policy and institutional reforms have been masked, to some extent, by the impact of the global recession and are likely to be much more evident as BMCs emerge from the recession with a significantly stronger policy and institutional framework. Through a careful analysis of some of the outcomes to date, Table 2 provides some initial assessment of development effectiveness of the PBLs and by extension, the use of SDF fiscal distress set-aside in the assisted countries.[8/]

[8/] At a broader level, a comprehensive matrix which gives a preliminary assessment of the development effectiveness of all PBLs since 2006 will be presented to the Directors prior to the Board Meeting.

TABLE 2: PERFORMANCE OF POLICY-BASED LOANS WITH SPECIAL DEVELOPMENT FUND FISCAL DISTRESS SET-ASIDE FUNDING

Country	Fiscal Distress Set-Aside (US mn) Funds Channelled Through	Country Context at the Time of Intervention	Caribbean Development Bank's Support	Achievements: Baseline Data (Year of Intervention) vs. Milestone Year			Effectiveness of Caribbean Development Bank's Support
				Item	**2006**	**2011**	
BZE	10.0: PBL with TA (2006)	Fiscal and external unsustainability, coupled with rising poverty.	The PBL supported Government's efforts to correct fiscal and external imbalances and to provide parallel TA support, in the form of a programme of additional loans and grants to assist the authorities with institutional strengthening and macroeconomic reforms. Accompanying TAs focussed on: (a) improving the institutional framework for macroeconomic management; (b) modernising Customs; and (c) strengthening financial regulations.	Debt-to-GDP Ratio	92.9%	80.4%	The macroeconomic adjustment programme that CDB supported was successful in helping Government correct the unsustainable fiscal and external imbalances which posed a threat to sustained economic growth and maintaining social progress. In the absence of the adjustment programme, BZE would have done much worse in 2008-2010, given the impact of the global financial and economic crisis. Further, Belize was able to maintain the level of provision of social services. Accordingly, the project is rated as highly satisfactory with a composite performance score of 6.8.
				Interest Rate on Public Debt	6.4%	4.0%	
				Overall Fiscal Balance Ratio	(1.8%)	(1.2%)	
				Item	**2009**	**2011**	
GRN	8.0: PBL with TA (2009)	Sharp decline in revenue occasioned by lingering effects of two hurricanes and the onset of the global crisis.	The PBL supported reforms in revenue administration, expenditure management, debt management, public enterprise oversight, poverty reduction and growth. This support was in the context of a wider donor support, including that of the IMF, World Bank (WB) and EU. TA was provided to conduct a CPA and to design and implement a Growth and Poverty Reduction Strategy (GPRS).	Debt-to-GDP Ratio	114.0%	88.7%	This PBL is still under implementation and the interim project performance composite index of 6.1 suggests highly satisfactory progress to date. Indeed, with respect to poverty relevance, poverty reduction initiatives were streamlined with the completion of the GPRS. Additionally, social safety net programmes were consolidated. Moreover, improvement in debt management continues to have positive impact on government finances.
				Overall Fiscal Balance Ratio	(6.6%)	(4.6%)	
				Social Safety Programmes	No reforms	Reforms ongoing: three programmes condensed into one for greater efficacy and effectiveness and service delivery. GPRS approved in principle.	

<table>
<tr><th>Country</th><th>Fiscal Distress Set-Aside (US mn) Funds Channelled Through</th><th>Country Context at the Time of Intervention</th><th>Caribbean Development Bank’s Support</th><th>Achievements:
Baseline Data (Year of Intervention) vs. Milestone Year</th><th>Effectiveness of Caribbean Development Bank’s Support</th></tr>
<tr><td rowspan="2">SKN</td><td>8.0: PBL and TA (2006)</td><td>Acute fiscal and debt distress as a result of the cost related to the closure of the sugar industry, as well as reconstruction costs associated with a series of natural disasters.</td><td>The PBL supported a programme of fiscal reforms that are aimed at improving public financial management (PFM) and overall performance outcomes.</td><td><table><tr><th>Item</th><th>2006</th><th>2011</th></tr><tr><td>Primary Balance Ratio</td><td>4.7%</td><td>6.7%</td></tr><tr><td>Social Sector Reform</td><td>Initiated</td><td>Completion of the United Nations Children’s Fund /WB assessment of social safety net systems resulting in the consolidation of three programmes into one; increasing effectiveness and service delivery.</td></tr></table></td><td>Fiscal reforms have progressed steadfastly and social sector reforms have been deepened, both with positive results.</td></tr>
<tr><td>4.1: Provision of Exceptional Financing (2011)</td><td>Debt default and the need to restructure external commercial debt.</td><td>CDB’s intervention was designed to assist Government in achieving debt sustainability by facilitating debt restructuring as part of a comprehensive strategy that includes revenue enhancement and expenditure reducing measures.</td><td colspan="2">CDB’s support contributed to the orderly debt restructuring of the country’s debt. As a result, SKN has benefited from improved debt dynamics and, going forward, the country is expected to further benefit from: (a) enhanced public sector management systems; (b) greater fiscal sustainability; and (c) improved macroeconomic stability that safeguards hard-won social gains.</td></tr>
<tr><td rowspan="2">STL</td><td>6.0: Additional Loan (2010)</td><td>Acute fiscal and social distress brought on by the global economic and financial crisis.</td><td>PBL that supported reforms that sought to foster sustainable fiscal balance and debt dynamics, and improve the policymaking and institutional framework for effective economic and social protection.

TAs were provided to design a medium-term economic development strategy and to review the framework for public sector investment.</td><td colspan="2" rowspan="2">This PBL is still under implementation. While progress with respect to fiscal reforms have been slower than expected, in part, underpinned by capacity limitations and the impact of hurricane Tomas, social sector reforms have progressed commendably. Indeed, Government’s ability to address major poverty and vulnerability issues highlighted in the 2006 CPA will be enhanced with the implementation of the National Poverty Reduction Strategy (NPRS) and the completion of the diagnostic study for the Ministry of Social Transformation, Youth Affairs and Sports.</td></tr>
<tr><td>8.0: PBL and TA (2008)</td><td>Looming risks in the wake of planned significant capital investments designed to spur broad-based island-wide growth. Acute slowdown in economic growth, as well as rising unemployment and poverty.</td><td></td></tr>
<tr><td>SVG</td><td>9.0: PBL</td><td>Deteriorating public finances, coupled with deep economic contraction.</td><td>PBL that supported macroeconomic reforms designed to: (a) strengthen; and (b) consolidate and streamline revenue systems and diversify the economic base to increase resilience to external shocks</td><td><table><tr><th>Item</th><th>2009</th><th>2011</th></tr><tr><td>GDP Growth</td><td>(2.3)</td><td>0.8</td></tr><tr><td>Current Revenue Ratio</td><td>27.9</td><td>29.9</td></tr></table></td><td>The PBL contributed to helping the country pursue fiscal and debt sustainability by supporting initiatives to minimise fiscal imbalances. Moreover, by supporting Government’s efforts to increase employment and growth opportunities, the PBL also contributed to Government’s poverty reduction initiatives. The project is assessed as highly satisfactory based on the Composite Project performance score of 6.7.</td></tr>
</table>

Lessons Learnt

3.08 Two useful lessons have emerged from previous Bank-supported policy-based operations that were partly funded with the SDF fiscal distress set-aside. The first lesson is the importance of having clearly defined criteria for accessing the set-aside, as well as an equitable and transparent method for determining individual country allocations. In addition, identifying reforms that will be specifically supported with the fiscal distress set-aside resources is necessary to facilitate monitoring the effectiveness of resource use. Reforms need to be constantly monitored, assessed and periodically adjusted to ensure maximum effectiveness. In this regard, focussed and constant monitoring by CDB staff is important to enhance the probability of achieving the intended outcomes.

3.09 The second lesson is the need to give greater prominence to social sector analysis and social impact assessments in the appraisal of PBLs. Such analyses will better expose gaps in BMCs' social protection architecture and improve CDB's ability to design appropriate interventions to optimise development effectiveness. Indeed, with the exception of the PBLs for ANT, STL, and to some extent BAR, GRN and SVG, PBL conditionalities have generally been linked to the attainment of macroeconomic targets with social sector reforms not given equal attention. Past regional experiences with fiscal consolidation and the impact on social and political stability do justify greater sensitivity to the social impact of the policies that the Bank is funding. Social safety net issues, which are critical in the current environment of intensified economic pressure on the population and particularly on the poor and vulnerable, have generally not been systematically addressed. An analysis of social investment and the capacity, effectiveness and efficiency of institutions responsible for the delivery of social services such as social welfare, education and health systems is also important. While increased control over the quantum of government expenditure from the point of view of the fiscal balances and the impact on debt is important, so also or even more so is an evaluation of what is achieved with the expenditure. Such analyses require BMCs to have undertaken at least NPRSs and Action Plans, Social Safety Net Assessments (SSNAs) or Poverty and Social Impact Analyses (PSIAs) prior to the PBLs but these have not always been available. A few BMCs have since conducted NPRSs with the Bank's support and as part of wider social protection reform programmes, SSNAs with the assistance of UN Agencies and WB. If the foregoing were available, the Bank would have been better positioned to incorporate an assessment of potential social impacts in PBLs. In countries where NPRSs were under preparation during PBL appraisal, approval of the NPRS and implementation plans were included in the PBL as a pre-disbursement condition. In instances where such information is not available, it will be necessary for the Bank to support these BMCs in conducting such assessments as part of preparation of the PBL.

4. THE CASE FOR CONTINUED SPECIAL DEVELOPMENT FUND SET-ASIDE TO ADDRESS FISCAL DISTRESS

4.01 The current high levels of poverty and indebtedness in the Caribbean Region are particularly serious development issues that require the earnest attention of regional policymakers and the wider development community. Several BMCs with high debt stock and onerous repayment burdens have found themselves severely constrained with respect to resources required for: (i) investment and growth; (ii) social development; and (iii) direct poverty reduction interventions. The BMCs are mainly small island economies very vulnerable to exogenous shocks (natural disasters; terms of trade [for example, oil and food prices, prices of key exports]; global trading arrangements, which they are powerless to influence and which have decimated their main exports; and global economic and financial crises not of their own making).

4.02 In the last two decades, all of the foregoing challenges have confronted these economies simultaneously and in some cases with close to overwhelming intensity. Note for example, the impact of the current global and financial crisis which is still unfolding amidst hurricanes and high food and oil prices. The debt challenge is accentuated, given BMCs constrained borrowing capacity and limited access to multilateral concessional financing. BMCs have had to borrow extensively on commercial terms (both externally and domestically), adding to the debt build-up. Indeed, high interest cost is one of the main contributors to fiscal and debt unsustainabilty. The problems of fiscal and debt unsustainability, which BMCs currently confront, will not be easily resolved by the BMCs themselves, given their resource limitations. Assistance to address fiscal distress is considered an important area for support, given that the acute fiscal and debt problems have serious implications for poverty reduction and threaten the sustainability of the Region's development process. However, as budgets of development partners are squeezed, scarce resources must be allocated to areas where they will have the greatest development impact. Accordingly, the case for the continuation of SDF resources specifically to address fiscal distress is premised on the following:

(a) The Need for Special and Continued Support, Given the Acute Fiscal and Debt Challenges in the Region and the Implications for Poverty

4.03 The acute socioeconomic and fiscal challenges confronting most of the BMCs reinforce the case for continued technical and financial assistance, and particularly concessionary resources from development partners. Support is required because countries' balance sheets simply cannot accommodate an overweighting of non-concessional financing. Indeed, concessional financing is critical to prevent further deterioration in debt dynamics. Sufficient concessional resources are critical to cater to the acute development needs of BMCs, especially given the constraints they face in accessing external commercial financing, and moreover, to curb the reliance on domestic financing that can have serious implications for financial sector and macroeconomic stability. Additionally, concessional donor funding is also needed to compensate for the decline in international private capital inflows (especially since the global financial crisis) and to ensure that long-term fiscal sustainability is achieved and maintained. Indeed, concessional financing has become a critical source of development financing. It is also important to help countries to consolidate socioeconomic progress already achieved and reduce the risks of regression, enabling attainment of most of the MDGs.

(b) The Need to Sustain Development Results Attained Through Interventions of Special Development Fund 6 and 7

4.04 In some countries, recent (2006 onwards) fiscal and economic reforms, which have been supported by CDB through the SDF set-aside, have yielded positive results in the areas of revenue administration and tax reform; expenditure management and waste reduction; debt management and

PFM. Reforms in these areas have intensified in recent years, especially in the wake of the global crisis. In all countries, the ongoing reforms are being pursued to ensure the maintenance of macroeconomic stability and advance social development. To a lesser extent, there have also been improvements in the governance arrangements that underpin social protection frameworks. However, reforms in certain strategic areas, especially public enterprise governance; debt management; financial sector stability; and social sector development need to be deepened so as to firmly underpin macroeconomic stability as a key precondition for accelerating the Region's development process. Indeed, pushing ahead with the reform agenda in this uncertain global environment will require sustained donor support as the Region seeks to lock in the positive development results achieved thus far.

(c) The Need to Mitigate Economic and Social Cost of Adjustment to Prevent Further Increases in Poverty

4.05 Fiscal and debt unsustainability impose the need for fiscal consolidation with all of its attendant economic, social and political uncertainties. Imprudent fiscal and debt management that have necessitated harsh adjustments measures have often had significantly adverse effects on the poor and vulnerable. While fiscal and debt unsustainability can inflict substantial macroeconomic instability with deleterious consequences, the uncertainties inherent in the consolidation process itself can be broader and deeper, occasioned by social and political instabilities emanating from the consolidation process. The consolidation process needs to be initiated as early as possible before macroeconomic instability reaches crisis proportions. This would reduce substantially the costs of adjustment by avoiding a long, burdensome and uncertain process. Moreover, there is also a need for concessional resources to enable Governments in fiscal distress to provide for the poor and vulnerable during the adjustment process. Indeed, the fiscal space in CDB's BMCs needs to be enlarged so that appropriate policies can be pursued and the adverse effects of the crisis on the attainment of the MDGs and long-term poverty reduction and development goals can be mitigated. This requires stepped-up, timely and adequate transfer of technical and financial resources to BMCs.

5. ENHANCED FRAMEWORK FOR SPECIAL DEVELOPMENT FUND RESOURCES TO REDUCE FISCAL DISTRESS AND POVERTY

5.01 The Bank's interventions in its BMCs, with the aid of SDF resources for fiscal distress, have played an important role in helping to narrow financing gaps. However, as was discussed in Section 3, there is scope for the Bank to increase the development effectiveness of its interventions. Going forward, the Bank's interventions can be even more of a strategic catalyst for the consolidation and advancement of progress and for effecting positive, structural and social change that can deliver solid and durable development dividends. This will require a revamping of CDB's lending and administrative frameworks as they pertain to fiscal distress interventions. This section proposes an enhanced framework to underpin the use and administration of the fiscal distress set-aside so as to maximise the development effectiveness of the Bank's interventions. The framework covers the criteria under which the SDF fiscal set-aside can be accessed; an allocation method that ensures equity, transparency and reduces potential perverse incentives; and types of interventions and instruments of delivery that are better aligned with the poverty reduction objective of SDF. This section also makes the case for an increase in the fiscal distress set-aside.

Criteria for Access

5.02 It is proposed that the fiscal distress set-aside be applicable to Groups 2 and 3[9/] BMCs and Group 1 BMCs with a debt-to-GDP ratio exceeding 60%. The following two criteria for access by eligible countries are proposed:

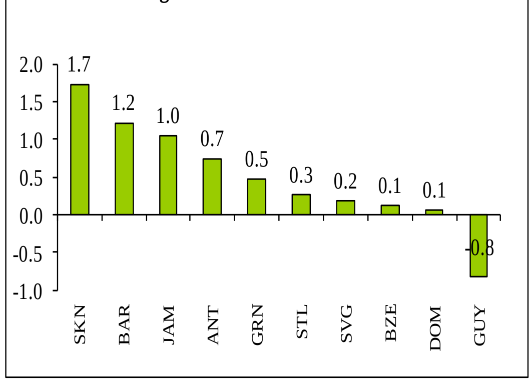
(a) BMCs in fiscal distress, as defined by a fiscal distress score above zero (Appendix 9 provides details on the calculation of the composite fiscal distress index); and

(b) BMCs have a medium-term economic and social adjustment programme (home-grown or otherwise) supported by development partners (including IMF) aimed at restoring fiscal and debt sustainability, while seeking to safeguard social gains and protect the most vulnerable and lay the basis for long-term growth and advancing social development.

Fiscal Distress Score

5.03 Based on a composite fiscal distress index (Figure 1), of Group 2 and 3 BMCs (according to the new categorisation for SDF 8) and Group 1 BMCs with debt-to-GDP ratios in excess of 60%, only those with a fiscal distress score above zero qualify for access to the fiscal distress set-aside. A score above zero suggests that BMCs are in fiscal distress, with a higher score indicating a greater degree of fiscal distress. The eligible BMCs for access to the fiscal distress set-aside, ranked in order of highest degree of fiscal distress, based on the index are SKN, BAR, JAM, ANT, GRN, STL, SVG, BZE, and DOM. Only GUY has a score less than zero which suggests that, relative to its peers, it is not in fiscal distress, thus making it ineligible for accessing the fiscal distress set-aside.

Figure 1: Fiscal Distress Index



[9/] BZE, DOM, GRN, GUY, JAM, SKN, SLU, and SVG.

5.04 The Index will be calculated annually on a rolling basis, that is, data for the latest period added and dropped for the least recent period. The fiscal distress set-aside will be allocated to countries based on the Bank's established SDF allocation formula, combined with the fiscal distress score. This approach is proposed to ensure that individual country allocations are not only based on the degree of fiscal distress but also the strength of the policy and institutional environment, thereby minimising the potential for perverse incentives. The allocation method also ensures equity in allocation and transparency of process. The identification of fiscally distressed BMCs, based on the fiscal distress score, allows for a clearer and transparent process to underpin *ex-ante* allocations. Indeed, the establishment of a set of agreed and transparent governance arrangements within the context of the wider SDF would minimise the inherent uncertainties that accompany an *ad hoc* process. A more structured approach also helps Contributors to ensure accountability to their principals.

<u>Medium-term Economic Adjustment Programme: Social Protection, Poverty Reduction, and Growth-Sensitive Fiscal Adjustment</u>:

5.05 It is envisaged that use of the fiscal set aside will be conditional not only on the BMCs being identified as experiencing fiscal distress, but also on them having a medium-term economic and social adjustment programme that aggressively addresses the fundamental issues critical to the restoration of fiscal and debt sustainability, while seeking to minimise the poverty effects. Therefore, it is envisaged that such programme will include: (i) social protection and poverty reduction initiatives; and (ii) growth-sensitive fiscal adjustment, at the heart of which are orderly debt reduction and strengthening of financial sector governance in relevant countries. Such programmes should incorporate the following:

(a) Short-term social protection initiatives (food security, short-term employment, access to basic services – health, utilities, housing etc.).

5.06 One basic objective should be to determine the impact on the poor of the specific socioeconomic circumstances and to respond if necessary with emergency financing in order to protect the livelihoods of the poor in times of fiscal distress. Equally important, is the impact of various policy and institutional changes being undertaken within the context of fiscal consolidation needs to ascertained and support provided for the formulation and implementation of countermeasures to protect the poor. This would be consistent with the Bank's and SDF Contributors' overarching goal of poverty reduction.

(b) Poverty reduction programmes and the strengthening of social protection systems.

5.07 In terms of enhancing the life chances of the poor, the following are critical: (i) ensuring the existence, effective implementation and evaluation of the outcomes of NPRS in all BMCs; (ii) ensuring social protection system provide households and communities with protection against key risks and vulnerabilities and promotes their access to new opportunities, that is, their coverage and effectiveness; and (iii) enhancing the capacity, efficiency and effectiveness of public sector institutions that deal with the poor. The SDF set-aside for fiscal distress should be leveraged to ensure attention is given to those in BMCs' economic adjustment programmes.

5.08 The SDF set-aside for fiscal distress should be used to directly support the implementation of NPRSs; the strengthening of safety nets in BMCs and the putting in place of appropriate policies and measures to address deficiencies; and improvements in the efficiency and effectiveness of social expenditure.

(c) Social sector reforms with particular emphasis on human resource development.

5.09 An important underlying assumption in the link between growth and poverty reduction is a developed human resource base. Growth can and does generate employment. However, the quality of skills, and hence of employment and remuneration, is critical to determining whether one merely increases the ranks of the working poor. For example, in several BMCs with a large tourism industry, employment is largely seasonal, sometimes just a few months of the year. Even though there is much mention of growth and poverty reduction in economic adjustment programmes, there are generally no policies or institutional development initiatives probing and strengthening this critical link via which poverty reduction is achieved – human resource development (HRD). This will require removal of constraints to equitable access and effective participation in HRD. Note also that in the long run HRD is an important determinant of fiscal and debt sustainability both through the provision of adequate skills in the public sector, particularly in areas critical to good macroeconomic management, and also through the attainment of higher growth and income levels which provide a much more expanded revenue base.

(d) Structural/productive sector reforms that address the binding constraints on economic growth and the identification of new growth sectors, as well as strategies for broad-based growth, inclusive of the poor.

5.10 Policies are needed to identify the binding constraints on economic growth and the attendant policy priorities in addressing the imperatives of employment creation and poverty reduction. Economic adjustment programmes should include productive sector development policies that address structural impediments that undermine economic transformation and, by extension, constrain economic growth and development. Additionally, the character of the drivers of growth, particularly as regards the quantity and quality of employment generation is also critical. While economic growth is fundamental for poverty reduction, the relationship between economic growth and poverty reduction is not necessarily linear. The impact of economic growth on poverty reduction hinges crucially on how the gains from economic growth are distributed. To ensure that high economic growth results in significant reductions in poverty, unemployment, and income inequality, economic growth has to be inclusive. Therefore, adjustment programmes should not only include growth promoting strategies but more fundamentally, strategies to promote inclusive, pro-poor, broad-based growth.

(e) Orderly mechanism for debt reduction

5.11 Given the high opportunity cost of maintaining onerous debt repayment levels over extended periods in terms of growth foregone, together with the substantial adjustment and welfare costs involved in meeting repayment requirements in the form of reduced consumption in the context of high levels of poverty, an integral part of the support for fiscal consolidation should be reduction of regional debt repayments towards more manageable levels. BMCs have engaged in negotiations with commercial creditors to obtain debt restructuring through the markets, with other creditors through the Paris Club and/or bilateral discussions so as to reduce the debt stock and debt servicing burdens. For example, SKN is currently engaged in all three types of debt restructuring. Generally, the larger the debt stock the greater the need for debt restructuring. However, as indicated by the experience of Greece, debt restructuring can be a long painstaking process in which the debtor nation often needs substantial technical and financial support. In the context of acute fiscal challenges across BMCs, the Bank, SDF and other donors ideally should decide what structured role collectively they can play and the amounts and types of resources that they can make available in order to accelerate the reduction process, thereby reducing the prolonged instabilities and uncertainties that can accompany this process. This would reduce *ad hoc* approaches and optimise the outcomes for BMCs. The main thrust of the suggestion is that BMCs ideally would emerge better off and more quickly from the restructuring process if adequately supported in the negotiation process rather than engage in the process alone. While the foregoing arguments focus on donor coordination with respect to debt reduction, particularly for BMCs with very high debt, the arguments for donor technical and financial support are equally valid for the fiscal consolidation process as a whole.

(*f*) *Strengthening of financial sector governance*

5.12 A casualty of the global economic and financial crisis has been the stability of the financial sector. The crisis compounded weaknesses in governance, which contributed to financial sector instability. This situation is particularly acute in the ECCU's indigenous banking sector. The inability by some governments to repay debts owed to these institutions, among other factors, has placed several of them at risk. Examples include the National Bank of SKN, which is the major creditor to Government and also the Bank of Nevis, which has also extended substantial levels of credit to Government. The Government of SKN has also borrowed substantial sums from the National Insurance Scheme (NIS). NIS and the wider private sector have become a significant source of credit to Governments in many BMCs, raising concerns in some cases about liquidity and solvency. The issue of financial sector instability in some BMCs clearly has implications for the level of resources, both technical and financial, to which BMCs must have access to aid resolution of the problems of fiscal and debt unsustainability.

5.13 Additionally, several Governments in the Region currently face large contingent liabilities as a result of the CLICO and BAICO crisis, the resolution of which is still unfolding. The recent episodes of financial failures in some of CDB's BMCs also brought to the fore the critical and urgent need to reassess existing approaches to financial sector supervision and the governance regimes that underpin regulatory agencies. Given that the fiscal impacts of financial failures can be massive, threatening fiscal and debt sustainability, it is critical that mechanisms be established that incorporate financial sector monitoring, risk management in large institutions, and contingency planning for financial sector failures into the PFM process. Moreover, financial failures have profound implications for the deepening of poverty in the Region through the reduction of fiscal policy space and the erosion of private sector savings and other assets. In the wake of recent crises, financial sector problems can no longer be delinked from fiscal and social issues and development issues more broadly.

Mechanisms for Maximising and Monitoring Development Effectiveness

5.14 CDB's interventions, using the SDF set-aside will be grounded in its country strategy for the particular BMC and designed to support reforms that maximise development effectiveness. While in the past the fiscal distress set-aside was blended with OCR to provide assistance through PBLs that supported adjustment programmes (IMF arrangements, home-grown adjustment programmes, etc), going forward CDB will adopt a more focused approach in the use of the fiscal set-aside to better monitor expected outcomes, especially as they pertain to poverty reduction and other important social development initiatives. While qualifying BMCs' reform programme should focus on the elements listed in paragraphs 5.05 to 5.11 which are considered key for long-term socioeconomic development, given the narrow focus of the fiscal distress set-aside, it is proposed that starting with the SDF 8 Cycle, the fiscal distress set-aside interventions be delivered through TAs (stand-alone interventions or twinned with PBLs), as well as other instruments that support social development reforms and selective fiscal structural reforms within the context of a credible economic adjustment programme. Additionally, it is proposed that the set-aside can also be used to provide exceptional financing in the case of economic and financial emergencies.

5.15 The mechanism for monitoring the results of fiscal distress set-aside interventions will be based on the MfDR framework that links reforms to expected outcomes and monitoring indicators. In keeping with the Bank's monitoring and evaluation framework, implementation progress of fiscal set-aside funded reforms will be carried out by tracking developments in the outcome indicators proposed. Country authorities will also be required to submit to CDB quarterly progress reports. Monitoring and evaluation will be a joint effort. At the country level, supporting data will be required to be submitted to CDB on a quarterly basis to facilitate easy tracking of performance. CDB staff will also carry out periodic field visits, as well as work closely with development partners who may be providing complementary support. Table 3 gives examples of the proposed types of reforms/initiatives that the fiscal set-aside will support; proposed instruments of delivery; and the development outcomes to be achieved. It is expected that the ultimate impact of the supported reforms will be poverty reduction and socioeconomic upliftment. The proposals are broad outcomes that CDB's interventions will be designed to achieve. However, each country intervention will have its own results and monitoring framework.

TABLE 3: INDICATIVE RESULTS AND MONITORING FRAMEWORK

Desirable Reforms/Initiatives	**Proposed Instruments of Delivery**	**Expected Outcomes**	**Proposed Outcome Indicators**
Evaluating the impact of specific fiscal adjustment programmes on the poor. Strengthening monitoring and evaluating systems to assess the impact on the poor.	Stand-alone TA/ twinned with PBL.	• Minimisation of negative policy impacts on the poor.	• % of poor negatively impacted by policy.
Provision of counter cyclical support directed at the poor.	Emergency Line of Credit.	• Enhanced socioeconomic conditions	• Number of recipients of social assistance. • Unemployment rate.
Implementing SSNAs and poverty reduction strategies.	Stand-alone TA/ Social Sector PBL.	• Inclusive social development and poverty reduction.	• Poverty rates, indigence rates, Gini Coefficients.
Consolidating social safety nets/social protection programmes.	Stand-alone TA.	• Enhanced cost effectiveness and quality of service delivery. Improved targeting of social spending. • Improved robustness and quality of social protection programmes.	• Administration cost per person served. • Number of social safety net programmes. • Number of profiled recipients of social assistance (% of total recipients).
Building capacity and strengthening governance arrangements of social development ministries.	Stand-alone TA.	• Enhanced efficiency and accountability of social spending. • Improved targeting of beneficiaries. • Improved responsiveness of ministries to better address poverty reduction.	• Public spending on social services (% of total public expenditure). • Staff complement at ministries (% of total staff requirement). • Number of internal audits of ministries.
Strengthening debt management units and/ designing and/or implementing debt reduction strategies	Stand-alone TA twinned with PBL.	• Enhanced debt management, risk management and reduced debt servicing cost. • Strengthen macroeconomic stability through improved fiscal and debt sustainability.	• Debt servicing (% of revenue). • Debt-to-GDP Ratio.
Strengthening budget discipline and credibility	Stand-alone TA twinned with PBL	• Enhanced PFM through improved performance budgeting.	• Variance between budgeted revenue/expenditure and actual revenue/expenditure.

Proposed Amount for the Set-Aside

5.16 It is proposed that the total amount of the fiscal distress set-aside be expanded to range within $100 - $125 mn for the following reasons. First, given the magnitude of the fiscal problem that still exists and the need for concessional financing because of limited access to the international capital market, there is a need for more resources. Second, the existence of a larger number of fiscally distressed BMCs relative to the period 2006-2010 also requires expanded resources to address the potentially greater social distress brought on by the fiscal challenges. Indeed, based on past interventions, for those PBLs which used blended resources, the SDF component totalled $87 mn during 2006-2010. This was significantly greater than the allotted amount of $47 mn for fiscal distress and immediate response loans under SDF 7, highlighting the critical importance of concessional resources. Third, increasing downside macroeconomic risks also imply a greater need for resources. The intensification of the crisis in the Eurozone; the slowing of EU economic growth (in fact, the EU is already in recession); the anaemic economic and employment growth in the United States (US), which can be exacerbated by the possibility of a fiscal tightening as US attempts to resolve its fiscal crisis in the not too distant future; and the slowing of growth in China and India suggest that the global slowdown can be even more protracted than is currently anticipated, with the possibility of a double-dip recession. Given the foregoing, the SDF amount of $87 mn allocated during the Great Recession must, therefore, be seen as a minimum requirement. Fourth, with a more structured approach to the use of fiscal distress resources focussed mainly on poverty reduction, there is greater likelihood of more effective inventions with increased resources, especially within the context of the mechanisms being proposed for maximising development effectiveness.

6. CONCLUSIONS AND RECOMMENDATIONS

6.01 Based on key lessons that have emerged from past interventions, together with analyses of recent and projected socioeconomic performance, the Paper has sought to make the case for continued and expanded SDF support to address fiscal distress and has proposed a framework for allocating the resources and enhancing CDB's interventions. The three pillars of the argument in support of the continuation of the SDF set-aside are the imperatives for: (i) special support to BMCs, given the acute fiscal and debt challenges in the Region and the implications for poverty; (ii) sustaining development results attained through interventions of SDF 6 and 7; and (iii) mitigating the economic and social costs of adjustment to prevent further increases in poverty. The Paper also proposes two criteria under which the SDF fiscal distress set-aside resources can be accessed; an allocation method that ensures equity and transparency and reduces potential perverse incentives; and a mechanism for maximising and monitoring development effectiveness.

6.02 Indeed, three important conclusions have emerged from the discussions that form the basis of a recommended agenda for the way forward:

(a) the current levels of poverty are too high and the pace of poverty reduction is slow in many BMCs. Hence, there is continuing need for strong social protection systems and strategies for accelerating the pace of economic growth and poverty reduction;

(b) the current level of indebtedness in BMCs, with the general exception of the Overseas Territories, is too high and there is a continuing need for growth-sensitive fiscal and debt adjustments in most BMCs; and

(c) BMCs will need substantial technical and financial assistance, in some cases for extended periods, given the negative economic consequences of high debt accumulation together with the challenges and risks of the fiscal consolidation process. Beyond this remain the potential fiscal cost of resolving financial sector instability and the challenging and very costly and unfinished task of repositioning BMCs in the context of trade liberalisation and globalisation, which will require high levels of budgetary resources

6.03 Management supports the critical and expanded role for the fiscal set-aside in enabling the Bank to assist with the resolution of fiscal distress in its BMCs. Contributors are requested to approve the proposed criteria for accessing the SDF set-aside for fiscal distress, the mechanism for allocating the resources, and the indicative results and monitoring framework.

APPENDIX 1

THE ECONOMIC CONSEQUENCES OF FISCAL AND DEBT UNSUSTAINABILITY

The relationship between real income growth and the Central Government budgetary balance/public sector debt is by no means unambiguous. In fact, it has two theoretical strands. The first is the Keynesian approach of anticyclical governmental stimulus to economic growth through deficit/debt financing, a strategy embraced by many Borrowing Member Countries (BMCs). The second is of more recent vintage and relates in part to the findings of Landau (1986), Barro (1991), Easterly and Rebelo (1993) and others of a negative relationship between government spending and growth. It is a policy stance also echoed in the Washington Consensus and the policy positions of the major international financial institutions as regards the role of Government in the economy – less is better.

While the Keynesian model is well-known, the arguments for the new model of government intervention in the economy are not as familiar. One of the best presentations in this regard is that of Fischer (1993). He couched his argument for a stable fiscal policy essentially within the framework of the positive spinoffs of a stable macroeconomic environment which he defined as comprising sustainable fiscal policy; low, predictable inflation; healthy balance of payments; and a competitive and predictable exchange rate. Fischer (1993) also argued that reduced economic uncertainty as a result of macroeconomic stability stimulates investment through a decline in risk. In an uncertain macroeconomic environment, investors are likely to adopt a wait and see attitude. Economic uncertainty can also lead to capital flight. It can also lead to a flight of skills. Additionally, Fischer (1993) argued that fiscal deficits are likely to affect growth, in part, through crowding out.

Reflective of the foregoing theoretical line of thought, international credit agencies (Moody's; and Standard and Poors) attach much significance to fiscal policy in assigning credit ratings to countries. Fiscal distress generally leads to a lowering of credit ratings, to higher cost of international finance or even reduced access to capital markets as happened recently in the case of Barbados and Grenada. In some cases, fiscal distress has led also to reduced access or even denial of funds by international and regional financial institutions. As the highly indebted BMCs have found, sustained pursuit of expansionary fiscal policy can lead to unsustainable debt, unhealthy balance of payments, substantial loss of international reserves and exchange rate instability, thus engendering the macroeconomic instability and its consequences to which Fischer (1993) alluded. Notable examples of this are Jamaica and Guyana in the late 1980s and 1990s.

Using a slightly different line of argument, Sachs (2002) similarly concluded that high debt is a major contributor to poor growth performance in heavily indebted countries. He argued that huge debt stocks lead to high debt payments, a substantial outflow of resources in the case of external debt and also contribute to the vicious circle of high budgetary deficits, yet higher debt stock and increased economic uncertainty. WB and the International Monetary Fund (IMF) (2012) indicate that high interest rates have been a leading cause of the deterioration of debt ratios in the Eastern Caribbean Currency Union (ECCU).[1/] The expectation of increased taxation to repay the debt can also scare away private investment (debt overhang theory), stimulate an increased appetite for short-run investments especially in financial assets or even induce capital flight [Alesina and Tabellini (1989)]. The debt overhang theory additionally argues as noted in several BMCs [for example, St. Kitts and Nevis (SKN), Jamaica (JAM)] that the process of fiscal consolidation can lead eventually to cuts in productive public capital expenditure thus reducing economic efficiency, investment and growth.

[1/] WB, IMF, 2012, p.16.

Against these negatives is the counter argument that efficient use of debt can lead to enhanced capital accumulation and increased productivity in the private sector through productivity-enhancing infrastructure investment, thereby stimulating growth. Additionally, proponents of debt financing point to the substantial constraint on growth imposed by a lack of foreign exchange. Foreign savings play an important complementary role to domestic savings. Given the foregoing arguments and counterarguments, it becomes necessary to resort to the empirical findings on country experiences to assess the validity of these competing hypotheses. A review of the empirical analyses is also very important, given the centrality of real income growth *vis-a-vis* the cost of borrowing in fashioning the dynamics of the debt accumulation process and hence the sustainability or lack thereof.

A number of empirical studies have tested the relationship between the external debt stock, external debt servicing and growth (Chowdhury (1994); Scott (1994); Choudhury (2003); Patillo, Poirson and Ricci (2002), (2004). Chowdhury (2004) and Pattillo et al (2002; 2004) found a negative relationship between the external debt stock and the growth rate of per capita income. In fact, the preponderance of empirical studies so far have found a negative relationship between the foregoing variables and growth. As noted in the World Bank, IMF study of ECCU economic performance, there has been a trend decline in growth performance since the beginning of the 1990s with growth averaging 6.2 per cent (%) in the 1980s, 2.9% in the 1990s and 1.6% in the 2000s at a time of increasing public sector debt accumulation across the Region.[2/11/]

This observation is consistent with the findings of the non-Keynesian theoretical paradigms and empirical literature on the relationship between public sector debt and economic growth discussed above. Public sector debt in the ECCU increased from an average of 59% in 1995 to 109.1% in 2004 and currently averages more than 80% of Gross Domestic Product (GDP) (83%).[3/] On the basis of the empirical evidence, WB, IMF (2012) has argued for a reduction in the debt stock in the ECCU region to boost economic growth. Recognition of the deleterious effects of high debt accumulation clearly led to the establishment by the ECCU of the target of 60% of GDP by 2020, a policy which was itself predated by the European Union's Growth and Stability Pact of a target of 60% of GDP as the limit for public sector debt accumulation, among other macro targets to achieve macroeconomic stability.

However, of particular interest, and some would argue, closer to expectations, are the empirical results of Pattillo et al. (2002, 2004). Using a panel of 93 developing countries for the period 1969-98, Pattillo et al (2002, 2004) found a non-linear relationship (inverted U) between the stock of external debt and per capita income growth. However, they admitted difficulty in estimating with certainty the point at which indebtedness begins to impact negatively on growth performance. They estimated the turning point between 5 and 50% of GDP, but thought that the range was most likely between 35 to 40% of GDP. They concluded that high levels of indebtedness depress growth performance both through reduced investment and lower factor productivity, but particularly through the latter channel. The expectations of higher taxes to repay debt and the crowding out of private sector investment may also be contributing factors.

Kendall (2006) who investigated the relationship between growth and debt of a sample of the Caribbean Development Bank's BMCs (Antigua and Barbuda, Belize, Dominica, Grenada, JAM, and SKN) during the period 1993 to 2002, using panel data, also encountered that the relationship between the stock of external debt and growth was that of an inverted U. In Kendall (2006), the estimate of the point

[2/] WB, IMF, 2012, p.1-2.
[3/]Op. Cit, p.6, p.38.

of negative impact of external debt accumulation varied between 42 and 54% of GDP. WB and IMF (2012) estimated that the average sustainable level of debt for ECCU is 54.7% of GDP and argues that the target of 60% of GDP may be too high for the ECCU region.[4/] Kendall (2006) also found a negative relationship between external debt servicing and growth and between fiscal deficits and growth.

[4/]Op. Cit, p.43.

APPENDIX 2

BORROWING MEMBER COUNTRIES (Excluding Haiti) WITH POVERTY LEVELS EXCEEDING 25 PERCENT

No.	Country	Year	Poverty Indicators: % below Poverty Line	Poverty Indicators: % below Indigence Line	Gini Coefficient
		1996	33.0	13.4	n.a
		2002	33.5	10.8	0.40
1	BZE[+]	2009	41.0	16.0	0.42
		2002	39.0	15.0	0.35
2	DOM[°]	2009	28.8	3.1	0.44
		1999	32.1	12.9	0.45
3	GRN [°]	2008	37.7	2.4	0.37
		1993	43.0	29.0	n.a
		1999	35.0	19.0	n.a
4	GUY*	2006	36.1	18.6	0.35
5	Montserrat	2009	36.0	3.0	0.34
		1996	25.1	7.1	0.50
6	STL	2006	28.8	1.6	0.42
		1996	37.5	25.7	0.56
7	SVG	2008	30.2	2.9	0.40
8	Turks and Caicos Islands	1999	25.9	3.2	0.37

n.a not available
[°]CPAs conducted by CDB; *****Government of Guyana; [+]Government of Belize (GOB)

APPENDIX 3

FISCAL PERFORMANCE: 2010-11

(% of GDP)

Countries	Overall Balance		Primary Balance		Public Debt	
	2010	**2011^p**	**2010**	**2011^p**	**2010**	**2011^p**
ANT	(2.3)	(1.7)	3.0	(1.0)	83.2	92.0
BAH	(4.4)	(4.7)	(2.4)	(2.4)	45.4	48.9
BAR	(7.9)	(6.7)	(3.7)	(1.0)	117.8	116.0
BZE	(1.3)	(1.2)	1.7	2.2	83.3	80.4
DOM	(2.6)	(1.7)	(1.2)	(0.3)	67.3	67.3
GRN	(2.9)	(4.6)	0.3	(5.5)	93.0	88.7
GUY	(4.3)	(3.1)	(2.8)	(0.9)	60.2	60.4
JAM[1/]	(12.7)	(7.5)	5.3	3.0	143.4	140.0
SKN	(7.8)	(2.1)	4.6	6.7	157.9	151.3
STL	(6.3)	(6.1)	(2.4)	(3.5)	65.5	78.9
SVG	(5.7)	(3.2)	(2.9)	(0.3)	61.5	69.5
T&T	(3.0)	(4.5)	(5.8)	(3.8)	40.1	50.0
Caribbean Average	**(5.1)**	**(3.9)**	**(0.5)**	**(0.6)**	**84.9**	**86.9**

Sources: CDB, IMF, Country Authorities.
Notes: p means preliminary

[1/] Fiscal year, April-March

APPENDIX 4

DEBT DYNAMICS

	Public Debt-to-GDP Ratio (%)			Annual Change in Debt Ratio (pp)	Change in Debt-to-GDP Ratio in 2011 due to: (%)		
Countries	**2006-09**	**2010**	**2011^{p}**	**2011/2010**	**Primary Balance**	**Growth**	**Interest Rate**
ANT	85.4	83.2	92.0	8.8	1.0	(4.6)	3.9
BAH	32.7	45.4	48.9	3.5	2.4	(2.3)	2.4
BAR	96.2	117.8	116.0	(1.8)	1.0	(7.2)	6.9
BZE	85.4	83.3	80.4	(2.9)	(2.2)	(4.0)	3.2
DOM	72.5	67.3	67.3	0.0	0.3	(2.1)	4.5
GRN	85.5	93.0	88.7	(4.3)	5.5	(4.1)	4.4
GUY	69.0	60.2	60.4	0.3	0.9	(5.4)	4.0
JAM	124.7	143.4	140.0	(3.4)	(3.0)	(12.9)	10.8
SKN	143.6	157.9	151.3	(6.6)	(6.7)	(7.9)	8.3
STL	63.8	65.5	78.9	13.4	3.5	(3.5)	8.3
SVG	58.6	61.5	69.5	8.0	0.3	(0.8)	8.4
T&T	30.3	40.1	50.0	9.8	3.8	(3.9)	3.7

Sources: CDB, IMF, Country Authorities.
Notes: p means preliminary.

BASELINE FISCAL OUTLOOK

Countries	Fiscal Indicators (% of GDP)[PF]											
	Overall Balance				Primary Balance				Public Debt			
	2012	2013	2014	2015	2012	2013	2014	2015	2012	2013	2014	2015
ANT	(0.8)	(0.1)	0.3	(0.6)	3.8	4.2	4.2	3.2	90.2	88.5	86.8	85.1
BAH	(5.0)	(4.4)	(4.3)	(4.3)	(2.3)	(1.9)	(1.7)	(1.7)	49.9	51.8	53.4	54.8
BAR	(5.6)	(4.5)	(3.4)	(1.9)	0.2	1.2	2.1	3.4	116.3	114.8	112.6	110.0
BZE	(1.8)	(2.2)	(2.1)	(2.1)	1.9	1.9	2.0	2.0	78.1	76.5	74.9	73.4
DOM	1.4	(0.8)	(1.0)	(1.0)	0.1	0.7	0.4	0.4	66.7	65.4	64.2	63.1
GRN	(0.3)	0.6	0.9	1.4	3.3	4.0	4.4	4.8	86.7	84.8	83.0	81.2
GUY	(3.2)	(3.1)	(3.0)	(3.0)	(1.8)	(0.8)	(1.7)	(1.6)	61.4	61.4	61.4	61.6
JAM[1/]	(6.6)	(5.7)	(5.6)	(5.5)	2.8	3.3	3.3	3.3	136.2	132.4	128.8	125.2
SKN	(3.0)	(2.1)	(3.5)	(3.2)	3.4	4.7	3.2	3.4	148.2	143.0	138.5	133.4
STL	(3.0)	(1.7)	1.4	(1.4)	1.4	2.7	2.9	2.9	76.8	74.7	72.4	70.2
SVG	(3.7)	(2.6)	(1.7)	(0.9)	(0.8)	0.0	0.8	1.5	71.9	70.5	67.6	64.7
T&T	(2.3)	(0.1)	2.3	3.6	(4.1)	(4.2)	(4.2)	(3.5)	50.7	48.1	45.5	43.1
Caribbean Average	**(2.8)**	**(2.2)**	**(1.6)**	**(1.6)**	**0.7**	**1.3**	**1.3**	**1.5**	**86.1**	**84.3**	**82.4**	**80.5**

Sources: CDB, IMF, Country Authorities.
Notes: PF means preliminary forecast.

[1/] Fiscal year: April-March

APPENDIX 6

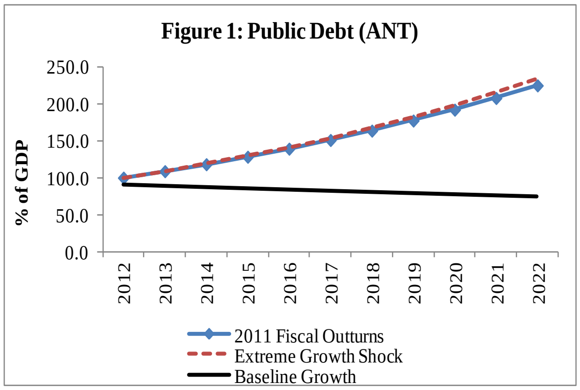
ILLUSTRATIVE DEBT SUSTAINABILITY ANALYSIS

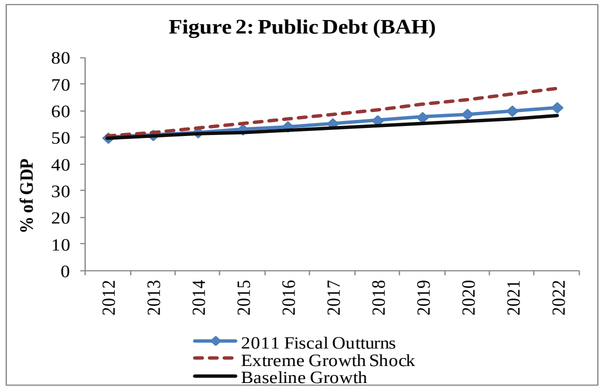
			% of Gross Domestic Product						
	Real Growth/Interest Rates in 2011 (%)		Fiscal Outturns in 2011		Public Debt in 2020	Primary Balance Required to Reduce Debt/GDP to 60% by 2020 ^(or by 25 pp) by 2020	Fiscal Adjustment Required for Debt Reduction	Sustainability Indicator	Primary Balance to Stabilise Debt/GDP at 2011 Level
Countries	**Growth[P]**	**Interest rate[P]**	**Public Debt[P]**	**Primary Balance[P]**	**Estimates**				
ANT	(5.5)	1.8	92.0	(1.0)	192.1	10.1	11.4	1.6	7.1
BAH	2.0	4.5	48.9	(2.4)	59.0	4.1	6.5	1.3	1.2
BAR	0.5	2.3	116.0	(1.0)	146.0	8.7	9.7	1.2	2.1
BZE	2.3	1.6	80.4	2.2	56.2	2.1	(0.2)	1.0	(0.6)
DOM	0.9	1.9	67.3	(0.3)	76.4	1.5	1.9	1.3	0.7
GRN	1.1	(0.4)	88.7	(5.5)	77.4	2.5	8.0	1.2	(1.3)
GUY	5.4	0.9	60.4	(0.9)	40.8	1.0	1.9	1.0	(2.6)
JAM	1.5	(0.8)	140.0	3.0	114.0	3.3	0.3	1.0	(3.2)
SKN	0.0	2.3	151.3	6.7	185.7	14.0	7.3	1.1	3.5
STL	2.0	3.8	78.9	(3.5)	92.4	3.6	7.1	2.3	1.4
SVG	0.8	3.9	69.5	(0.3)	89.2	3.2	3.5	1.0	2.1
T&T	(1.4)	3.0	50.0	(3.8)	74.0	4.9	8.7	1.6	2.3

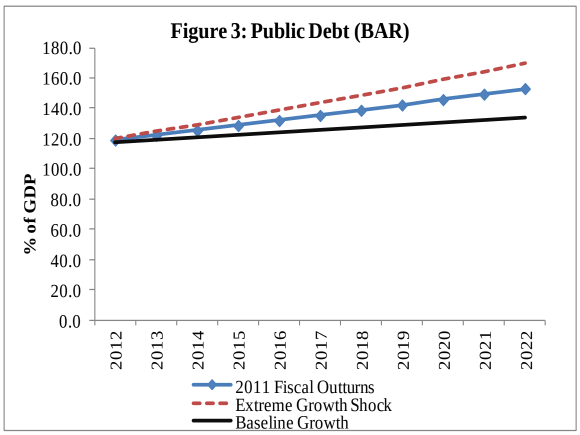
Sources: CDB, IMF, Country Authorities.

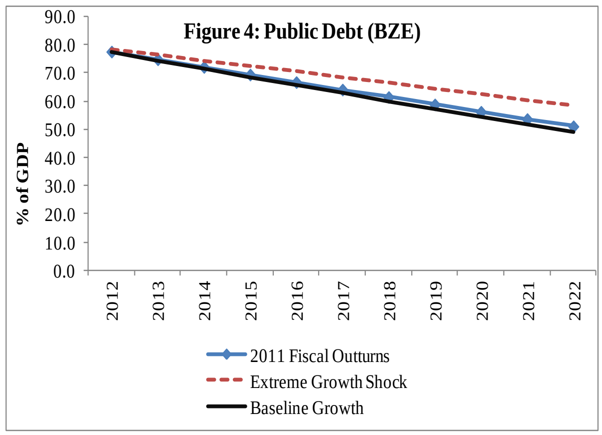
Notes: P means preliminary. Estimates are calculated as at April 2012. ^ relates to countries with public debt less than 60% of GDP in 2011.

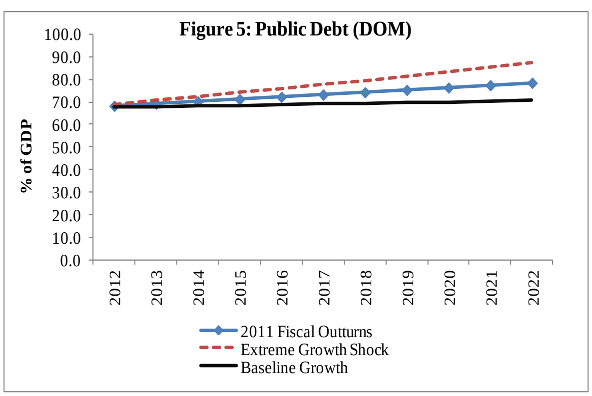
ILLUSTRATIVE DEBT TRAJECTORY OF BORROWING MEMBER COUNTRIES

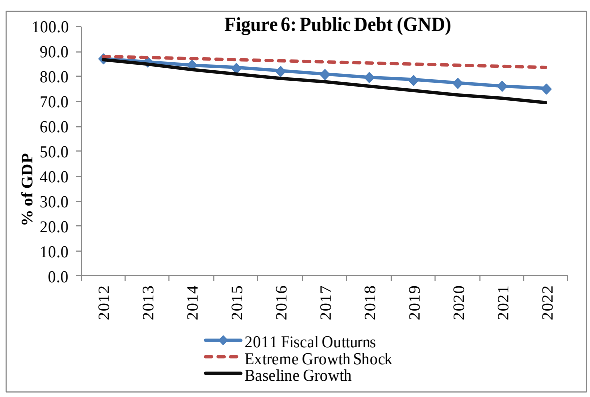












ILLUSTRATIVE DEBT TRAJECTORY OF BORROWING MEMBER COUNTRIES

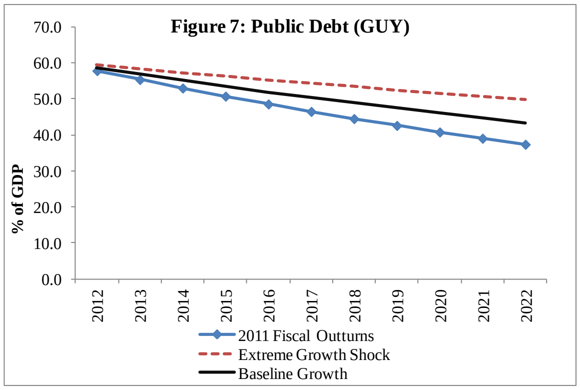


Figure 7: Public Debt (GUY)

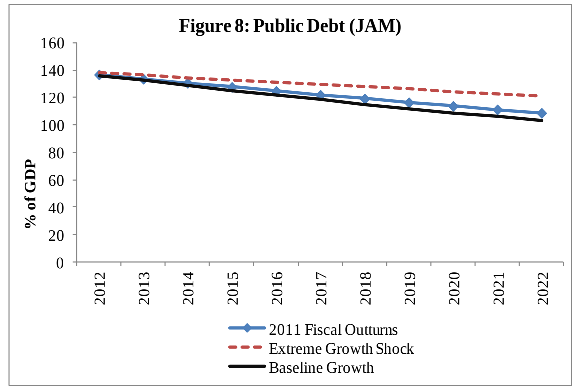


Figure 8: Public Debt (JAM)

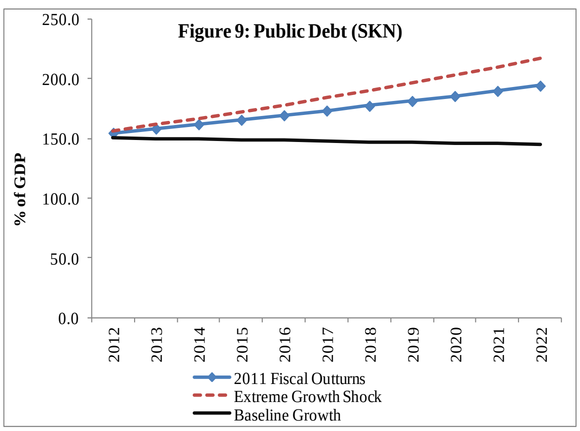


Figure 9: Public Debt (SKN)

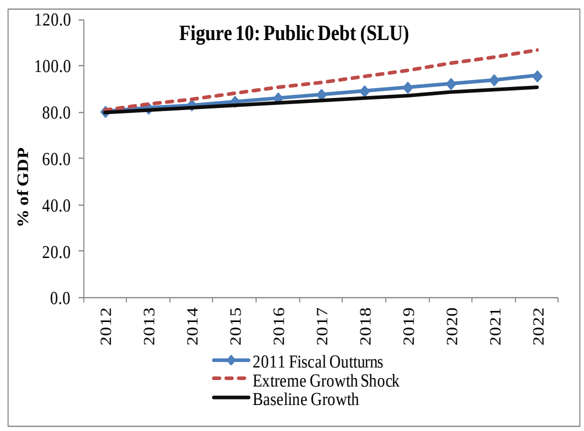


Figure 10: Public Debt (SLU)

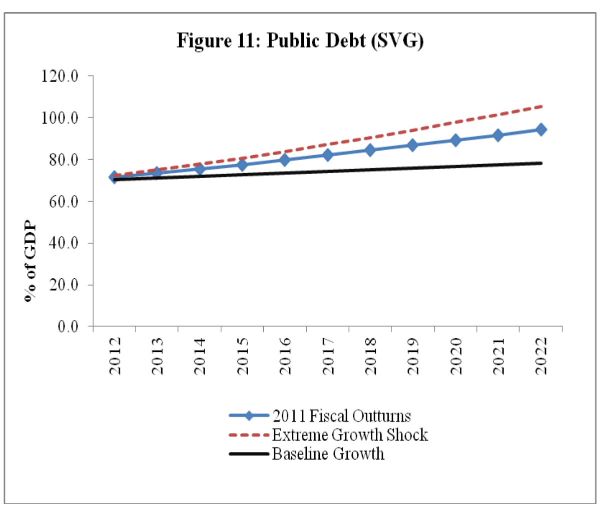


Figure 11: Public Debt (SVG)

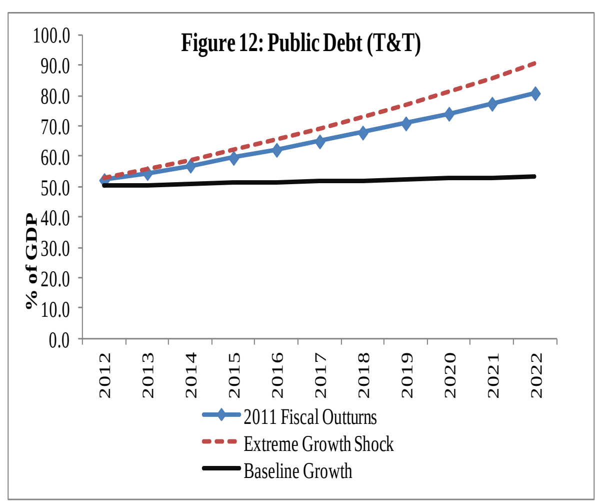


Figure 12: Public Debt (T&T)

APPENDIX 8

FISCAL, STRUCTURAL AND SOCIAL REFORMS

Revenue Administration and Tax Reform

In recent years, revenue performance has generally improved, underpinned by tax reforms and enhancements in revenue administration. Since 2006, most countries have introduced new taxes and/or have increased existing tax rates as they shifted from the reliance on border taxes in the face of trade liberalisation. The General Sales Tax and VAT were introduced in BZE and DOM, respectively, in 2006. ANT introduced the ANT Sales Tax in 2007 as part of the first phase of its fiscal adjustment programme that began in 2005. During the period 2010-11, fiscal stimulus provided during the crisis period was unwound through the introduction of new taxes and/or the increase in existing tax rates and/or fees. VAT was introduced in 2010 in GRN and SKN, while there were increases in existing tax rates in ANT (stamp duties and embarkation tax); BAH (stamp duties and departure tax); BAR (increase in VAT); and BZE (business and excise tax). STL plans to introduce VAT in September 2012. Countries have also sought to enhance revenue/tax administration. In 2010, a Risk Management Unit for Customs was set up in ANT, and in BAH a Tax Administration Department was established. DOM undertook the final phase of its income tax reform programme, while JAM and GUY increased the income tax thresholds. BAR is in the process of establishing a Central Revenue Authority. Several countries have also sought to modernise Customs and Excise Departments (ANT, BAR, BZE, DOM, GRN, JAM, STL and SVG).

Expenditure Management

Expenditure management reforms have typically focussed on reducing wasteful spending and improving the cost effectiveness and efficiency of service delivery. Several initiatives were undertaken during the pre-crisis and crisis periods. ANT introduced a voluntary separation package for public employees (2005-07) and a freeze in employment and wages (2009); BAR undertook reforms to improve public procurement; while BZE carried out reforms to the governance of its Public Sector Investment Programme (PSIP). GRN established a Waste Reduction Unit in 2009. Reforms in 2010-11 involved explicit expenditure cuts in some countries. In 2010, BAH introduced a wage freeze and pay cuts for government ministers; subsidies and grants were reduced in BAH and BAR; JAM lowered discretionary tax waivers; and SKN reduced/capped allowances and overtime for public servants. In other countries more structural expenditure management reforms continued. For example, GRN established a Procurement Unit in 2010 and STL carried out a functional review of government ministries and introduced the automatic pass through of fuel prices.

Public Financial Management and Debt Management

PFM reforms have generally focussed on improving fiscal planning and budget discipline and credibility. The Caribbean Technical Assistance Centre and the World Bank (WB) are the main donors providing technical assistance (TA) in this area. In 2010, BZE introduced a Fiscal Responsibility and Transparency Act, while JAM established a fiscal responsibility framework. Other countries have sought to improve PFM following Public Expenditure and Financial Accountability assessments (BAR, BZE and SKN). With respect to debt management, several countries have undergone debt restructuring in recent years: ANT (2006-08, 2010); BZE (2008); GRN (2006); JAM (2010); SKN (2012); and SVG (2010 - refinancing). Additionally, formal debt management units have been set up in BAR (2010) and GRN (2009). The Canadian International Development Agency and the Commonwealth Secretariat have been the main providers of TA in the area of debt management.

Social Sector/Structural Reforms

Social sector reforms have been focussed on streamlining social assistance programmes. Indeed, each country has a plethora of social programmes. Some of these include: conditional cash transfer programmes; food assistance programmes; free text books programme; low income housing support; and welfare assistance programmes, to name a few. Some countries have recently completed poverty/living conditions assessments and in some cases have developed a poverty reduction strategy (PRS) (ANT and GUY), while others (BAR and SKN) have initiated the process. Regarding structural reforms, several countries have undertaken reforms to address some of the key constraints on economic growth. BAH, BAR and STL established small business development funds in 2010 with a view to improving the business climate. GRN's ranking jumped five places in the 2011 global rankings for doing business owing to reforms in the following four areas: (i) starting a business; (ii) registering property; (iii) trading across borders; and (iv) paying taxes. GUY, JAM and SVG also undertook reforms to improve their business climate, notably a lowering of corporate tax rates. Financial sector reforms have become particularly important in the wake of the global crisis. All countries, particularly BAR, BAH, T&T and those in the ECCU have been making concerted efforts to strengthen supervision and regulation of the banking and non-bank financial institutions. However, deeper financial sector reforms are needed to protect against any financial failures in the future. It will be important to anchor such reforms by strong and coherent governance arrangements.

APPENDIX 9

MEASURING FISCAL DISTRESS

A fiscal distress index[1/] is calculated to assess the degree of distress among fiscally challenged SDF eligible BMCs (countries in Groups 2 and 3 based on the new categorisation for SDF 8) and Group 1 BMCs with a debt-to-GDP ratio in excess of 60%. The Index is calculated based on standard fiscal sustainability indicators consistent with the definition of fiscal distress in paragraph 1.03. Fiscal distress is not only viewed in terms of past or current fiscal and debt performance but also expected performance in the medium term. The index is intended to assess the ease or difficulty with which a BMC will be able to meet its future debt commitments, taking into consideration its: (i) historical trends in the debt-to-GDP ratio (2007-11); (ii) the 2011 debt-to-GDP ratio in relation to the internationally acceptable sustainable level of 60% used by the IMF; (iii) fiscal adjustment needed to reduce the debt-to-GDP ratio to 60% over the medium term; and (iv) projections for the primary balance, real interest rates and real growth GDP growth over the medium term.

Defining Variables used in the Index

The standard sustainability variables used are: (a) debt-to-GDP ratio; (b) primary balance-to-GDP ratio; (c) real GDP growth; and (d) real interest rate. The debt-to-GDP ratio is used to calculate a distance variable to better capture governments' solvency. The debt distance (DD) variable is defined as the distance between the actual debt-to-GDP ratio in 2011 and the internationally accepted sustainable level of 60%. To eschew the impact of cyclical factors on the debt-to-GDP ratio in 2011, the historical average for the debt-to-GDP ratio over the period 2007-11 (D) is included to capture past trends in debt performance. A fiscal adjustment variable (FA) is calculated to assess the relative magnitudes of adjustment required for debt reduction. FA is derived from the Debt Sustainability Analysis in Appendix 6 and is calculated as the difference between the primary balance required for debt reduction and the actual primary balance achieved in 2011. The projected average primary balance over the period 2012-15 (PB) is included to gauge governments' ability to reduce indebtedness over the medium term. The likelihood for debt reduction is increased with the generation of primary surpluses. A differential variable (DF), calculated as the difference between the average real interest rate and real GDP growth of the over the period 2012-15 is included as a key factor that influences the trajectory of public debt and by extension, the distance to a sustainable level.

Calculating the Fiscal Distress Index based on z-Scores and Equal Weights

For each BMC and each variable, a z-score is calculated as $z=(v-\mu)/\delta$, where v is the particular variable by each BMC as defined above, μ is the mean value of the particular variable across all BMCs and δ is the standard deviation of the particular variable across all BMCs. The z-score captures the distance between the particular variable and the mean value of the particular variable across all BMCs, in units of standard deviation. It captures relativity, which is apt in this case, as it effectively measures degrees of fiscal distress among fiscally challenged BMCs.

Using the z-scores and equal weights, the Distress Index (DI) (Figure 1) is calculated as follows:

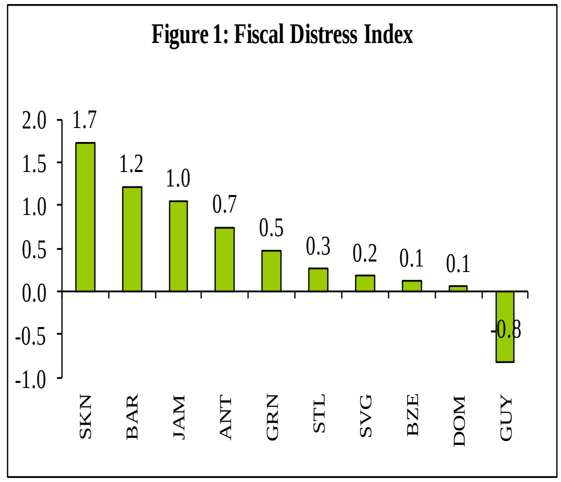
$$DI = w_1 (DD) + w_2 (D) + w_3 (FA) + w_4 (PB) + w_5 (DF), \text{ where } \sum w_i = 1.$$

[1/] The methodology follows that of the IMF 2011. "Measuring Fiscal Vulnerability and Fiscal Stress: A Proposed Set of Indicators." IMF Working Paper, WP/11/94. However, for this exercise, the variables used are tailored and defined to suit the BMCs' context.

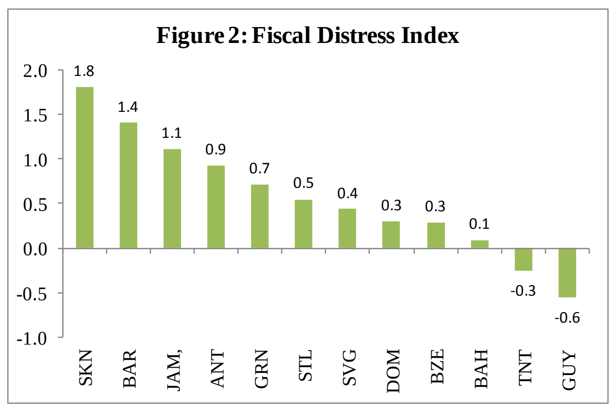
Positive values imply fiscal distress and the higher the score, the greater the degree of fiscal distress. The index will be updated annually on a rolling basis, that is, data for the most recent year added and dropped for the least recent year.

Robustness of the Model used to Calculate the Fiscal Distress Index

There are several approaches to measuring fiscal distress. This approach was chosen because of its theoretical underpinnings (it is grounded in the debt sustainability literature); relative simplicity; manageable data requirements; and easy interpretability. However, the model has no predictability powers in that it cannot foretell debt default. Several robustness checks have been applied to the model to assess the reliability of the results. For example, varying definitions of the variables have been used and sample periods have been varied (results not shown for brevity). After several permutations, the model consistently indentified those BMCs in fiscal distress (implied by positive scores) and was also fairly consistent in ranking BMCs with respect to the degree of fiscal distress. The results in Figure 1 were deemed to be the most reliable and intuitive based on our knowledge of the countries.



For illustrative purposes, Figure 2 shows the Fiscal Distress Index for all independent BMCs.



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