COUNTRY ECONOMIC REVIEW 2017

CAYMAN ISLANDS

Dollars ($) throughout refer to Cayman Islands dollars (KYD) unless otherwise stated
KYD1.00 = USD1.20

OVERVIEW

The Cayman Islands economy has gradually picked up pace since the global financial crisis, which had a significant negative impact on the financial sector. Since 2014, the sector has returned to stable, albeit modest, growth and the economy has reaped the benefits from diversification to professional, scientific, and technical activities. This diversification, together with a boom in tourism, pushed the growth rate of the economy close to pre-crisis levels, and inflation also reached positive levels again. In the meantime, skills shortages in the local economy led to strong growth in the number of work permits issued. The economy remains highly dependent on international developments, including, in particular, legislation and regulation regarding international taxation, financial institutions, and the international business sector in the United States of America (USA) and in the European Union (EU).

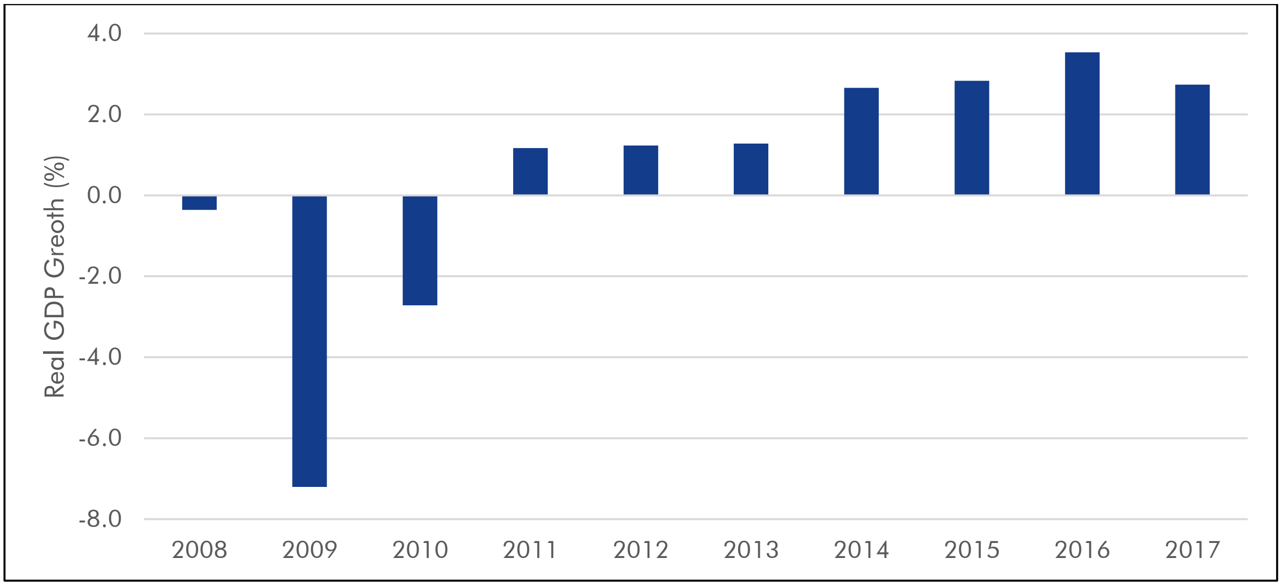
1. REAL SECTOR

1.01 Based on the latest available data, the economy is estimated to have expanded by 2.7% in 2017, representing a slowdown from the expansion of output by 3.5% in 2016. This is still above the average growth rate of 2.1% over the post-crisis period 2011 to 2016 (see Figure 1). The slowdown in 2017 was entirely due to a 2.8% decline in product taxes less subsidies, which was not made up for despite a slight acceleration in the growth contribution of wholesale and retail trade, hotels and restaurants. Not taking into consideration the technical effect of product taxes less subsidies, economic activity expanded by 3.1% in both 2016 and 2017. The economy was not affected by the 2017 Atlantic Hurricane Season, and the estimated 2017 growth rate is significantly higher than initial growth projections for that year. The upward trend in inflation in the USA led to higher inflation in the Cayman Islands. Following a 2.3% drop in the average price level in 2015, prices dropped again by 0.6% in 2016, but are expected to have increased by 2% in 2017.

1.02 The biggest growth contribution of 0.6 percentage points (pp) came from professional, scientific and technical activities, which grew an estimated 4.2% in 2017. The sector benefitted from the increase in the number of businesses on the Islands, as new company registrations rose by 9.9% between June 2016 and June 2017, after a 9.9% year-on-year decline in June 2016. Other major contributors to growth were: the financial sector (0.35 pp), which grew by an estimated 1.8% in 2017; human health and social work (0.3 pp); wholesale and retail trade (0.3 pp); and the construction sector (0.2 pp). Construction activity is estimated to have grown by 5% in 2017, with significant construction work advancing on hotel projects at Seven Mile Beach and West Bay, as well as at Health City and at the Owen Roberts International Airport.

1.03 Tourism-related sectors such as wholesale and retail trade; transport and storage; and hotels and restaurants, are all expected to have contributed to gross domestic product (GDP) growth in 2017, given a boom in stayover visitor arrivals. While activity in wholesale and retail trade expanded by 4%, activity related to transport and storage, and hotels and restaurants, grew by 2.8% and 2.9% respectively. Their absolute growth contributions to economic activity (0.1 pp and 0.2 pp) are lower, as their weight in the total share of the economy is considerably less than that of wholesale and retail trade. The year 2017 was a record one for stayover tourism arrivals, which increased 8.5% year-on-year to 418,402. Total visitor expenditure grew by 9.7% to $637 million (mn), mainly due to the increase in stayover visitors. However, cruise-ship passenger arrivals displayed a more subdued growth rate of 1.1% to around 1,730,000.

FIGURE 1: REAL GDP GROWTH 2008-2017



Source: Caribbean Development Bank (CDB), Cayman Islands Economics and Statistics Office (ESO).

Social Sector

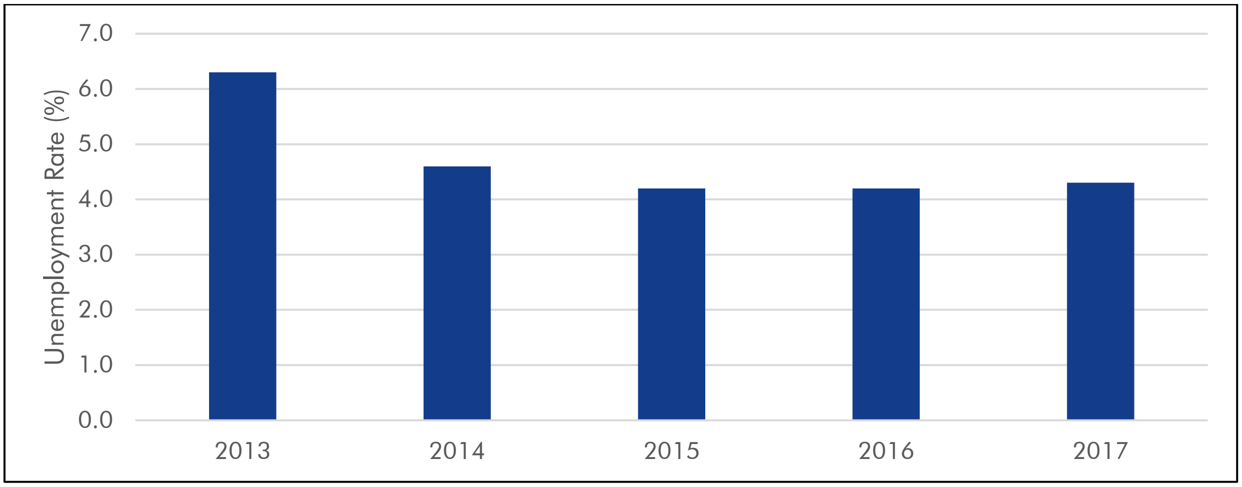
1.04 There are no up-to-date poverty data for the Cayman Islands[1]. The main social issues on the islands include high living costs and the lack of access to affordable housing, increasing levels of crime, and high unemployment levels among Caymanians compared to non-Caymanians, due to skills shortages. Cayman Brac, in particular, faces unique issues, including an ageing population, combined with the need to provide economic and social infrastructure for a population relatively small in size, while Little Cayman is mainly a resort island, with most residents employed by the tourism sector.

1.05 Skills shortages[2], in conjunction with robust economic growth, have led to a strong increase in the number of work permits issued. Since reaching a temporary low at 19,106 in 2010, the number of work permits issued grew by 4.5% on average until 2016, and increased further in the first half of 2017, to 24,880. Notwithstanding the rise in the number of work permits (leading also to very healthy population growth of 1.8% on average between 2010 and 2016), the overall unemployment rate declined from 6.3% in 2013 to 4.2% in 2016 (4.9% for men, 3.5% for women; see Figure 2). According to the Cayman Islands Spring Labour Force Survey 2017, unemployment fell further to 4.1% as of June 2017. The unemployment rate for Caymanians was 6.2% in Spring 2017, significantly above the national average. Especially among younger Caymanians, the higher unemployment rate might create a fear that the local population is largely excluded from the economic development of the Islands.

[1] The National Assessment of Living Conditions (2008) reported a poverty rate of only 1.9%, with the poverty line drawn at a daily income of $10.9, but reported a Gini coefficient of 0.3995, indicating a fairly high level of income inequality.

[2] The local education system does not appear to be providing the economy with a sufficient number of suitable job candidates. KPMG's (2015) Independent Review of Cayman Islands' Public Education System finds that, although improvements in the attained levels of Maths and English were made between 2011 and 2014, "the Cayman Islands is still significantly behind other leading countries…".

FIGURE 2: UNEMPLOYMENT RATE



Source: CI ESO.

1.06 A minimum wage of $6 per hour was introduced in March 2016, in an attempt to address the social repercussions of the very high cost of living. This development, together with the increase in the pension entitlement age from 60 to 65 in May 2016, has led to an increasing number of persons entering or re-entering the labour market, and could account for the upward trend in Caymanian unemployment. In order to gauge the effects of the introduction of the minimum wage on the economy, a mandatory occupational wage survey was carried out in the last quarter of 2017 to provide information on employees' qualifications, nationalities, compensation, and workloads.

1.07 The 2018-2019 Budget stipulates transfer payments to increase to $36.5 mn in 2018 and to $38.9 mn in 2019 (from $34.1 mn in 2016-17[3]).These increases reflect greater funding for poor relief and other social benefit programmes, which are timely given the increase in the general price level.

2. CENTRAL GOVERNMENT OPERATIONS AND DEBT

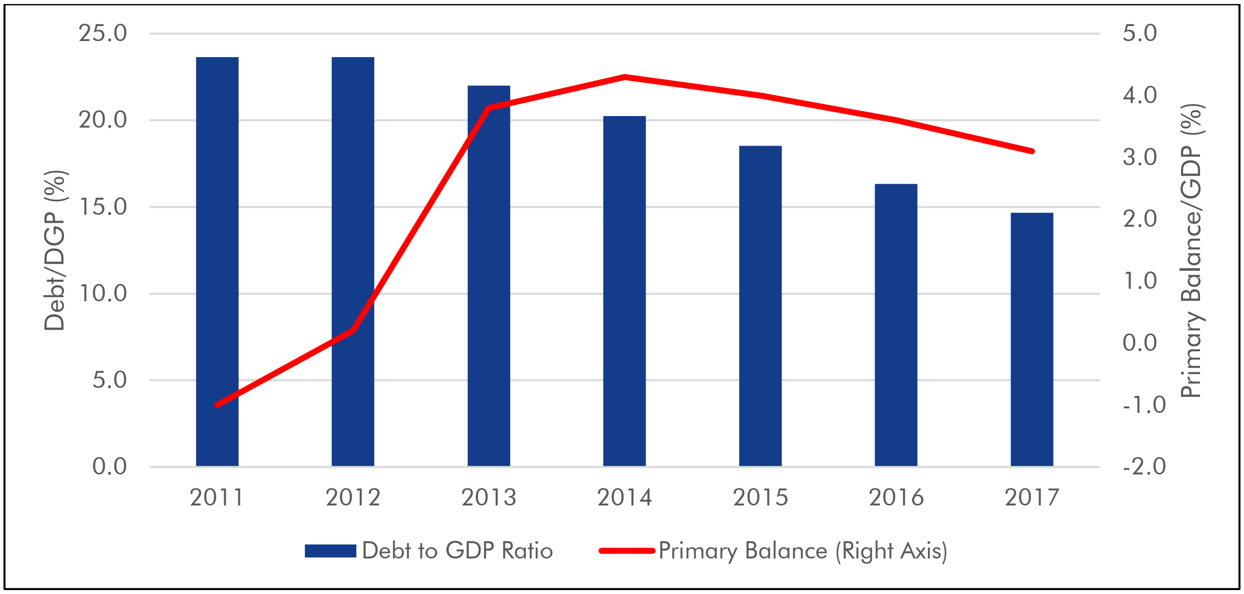
2.01 The Government of the Cayman Islands (GOCI) recorded a $147.1 mn fiscal surplus during the first six months of calendar year 2017, up from a $136.1 mn surplus during the same period in 2016, as revenue increased and expenditure decreased, with lower current expenditure outweighing higher spending on capital goods. GOCI expects the Central Government's (CG) overall balance for Fiscal Year 2016-17 to be in surplus at 1.8% of GDP; the entire public sector balance (which also includes statutory authorities and Government corporations) in surplus at 1.5% of GDP; and the public sector's primary balance in surplus at 2.8% of GDP. CG's debt-to- GDP ratio is expected to have declined to 14.7% (see Figure 3), and the entire public sector's debt ratio will fall to 16.8% during Fiscal Year (FY) 2016-17.

[3] For Budget purposes, the fiscal year changed from July to June, to calendar years, starting from 2018. The fiscal year 2016-2017 ran from July 1st 2016 through December 31st 2017.

2.02 The estimated CG surplus of 1.8% of GDP in FY 2016-17 corresponds to a surplus of $55 mn, which is $8.9 mn higher than initially forecast in the Budget. The entire public sector surplus was lower at $46.1 mn; with public-sector enterprises recording an $8.9 mn deficit, despite the Budget forecast of $0.5 mn profit[4]. As a result of the overall surplus, estimated cash balances of CG were $379.7 mn by the end of 2017, $28.9 mn lower than at the end of FY 2015-16 but $38.5 mn above the Budget forecast. Considering also an estimated increase in Government's total reserves to $170.8 mn at the end of 2017, the net debt for the entire public sector is estimated at negative $32.7 mn, or -1.1% of GDP, at the end of 2017.

[4] The deficit was mainly due to a significant reduction in Cayman Airways' passenger loads on Cuba and Miami routes, which resulted in larger losses than initially expected.

FIGURE 3: DEBT/GDP AND PRIMARY BALANCE



Source: CDB, CI ESO, Moody's Investor Service.

3. EXTERNAL SECTOR

3.01 The estimated 2016 current account deficit of $778.2 mn, or 26.3% of GDP, was significantly below the 2013 – 15 deficits, which averaged close to 36% of GDP following revisions[5]. In 2016, the goods and services balance improved, mainly due to an increase in exports of goods, while lower fuel prices constrained imports. There was a $59.8 mn decline in the services surplus, due to a reduction in the surplus of financial services, although travel, insurance and other business services performed positively when compared to 2015. The primary income deficit declined by $153.3 mn following an improvement in investment income, while increasing remittance outflows due to a rise in work permits weighed on the secondary income balance, of which the deficit increased by $23.5 mn.

3.02 During the first nine months of 2017, total merchandise imports declined by 4.4% compared with the same period in 2016, even though imports of petroleum products increased by 16.1% due to higher prices and higher volumes. As of the publication date of this report, merchandise exports data had not been made available for 2017, and data regarding the services balance are limited. While no data on financial services and other business services are available, the contribution of travel to the surplus in the services balance is estimated to have increased by approximately $50 mn during 2017 due to the increase in stayover tourism arrivals. The data

[5] When the 2016 Balance of Payment figures were published, the 2013 to 2015 current account deficits were revised upwards by $344 mn on average.

available for goods imports and tourism receipts point to a possible further stabilisation in the current account but the deficit will remain large in relation to the size of the economy. Total reserve assets of the Cayman Islands Monetary Authority (CIMA) are estimated to have increased by 5% to $133.9 mn during 2017, which corresponds to an import coverage ratio of 0.9 months of imports of goods and services. While the import coverage ratio clearly falls short of the internationally recommended minimum of three months of reserves, this can be explained by the high degree of dollarisation of the Caymanian economy. At the end of June 2017, net foreign currency deposits in the financial system stood at the equivalent of $4,896 mn, which corresponds to 147% of GDP or close to 44 times the amount of local currency in circulation, underlining the stability of the Caymanian currency board which pegs the value of KYD at USD1.20.

4. FINANCIAL SECTOR

4.01 The financial sector had a mixed performance during 2017, as suggested by the trends for the first half of the year. The number of bank, trust and insurance licenses further decreased, while there was an uptick in stock market activity. Global developments led to increased restructuring activities in the offshore banking sector, with banks placing greater importance on risk management and on cost efficiency. In the year to June 2017, the number of licensed bank and trust companies declined by 10.2% to 158, from 176 in June 2016. Also, the number of insurance licenses decreased very slightly from 738 to 730. The number of registered mutual funds fell by 3.6% to 10,621. Conversely, the number of stocks listed was up by 3.9% to 1,063 and stock market capitalisation increased by 11.6% to USD217.7 billion.

4.02 The operating environment of the financial sector was characterised by a 9.5% increase in broad liquidity (M2) between June 2016 and June 2017. Over the same period, foreign currency deposits increased by 10.1% and local currency deposits by 7.9%. The increase in liquidity was accompanied by an equally solid 9.5% growth in total assets in the banking sector, driven by a strong 13.7% rise in net foreign assets, mainly due to an increase in foreign assets of the commercial banking sector. Additionally, CIMA's foreign currency reserves also strengthened. Domestic credit declined by 1.1%, primarily because of weaker public-sector borrowing due to continued fiscal restraint, as credit to the private sector remained stable. Lending to the business sector contracted by 6.4%, driven by a decline in credit to other financial corporations (-37.8%), the primary production sector (-5%), and trade and commerce (-3.5%); while lending to households increased by 2.1%. Profitability in the banking sector may stabilise amid higher United States interest rates, if these will allow Caymanian banks to increase the lending-deposit spread. The KYD prime lending rate increased by 75 basis points between June 2016 and June 2017, with the average weighted KYD lending rate rising 20 basis points and reaching 7.08%, while the weighted average deposit rate on savings deposits increased only by 5 basis points to 0.17%.

5. OUTLOOK

5.01 The Caymanian economy should pick up pace in 2018, as real GDP is projected to expand by 3.2%. The main sectors expected to contribute to economic growth are: professional, scientific, and technical activities (contributing 0.6 pp), which should expand by over 4%; and human health and social work (0.4 pp), which is expected to maintain 10% growth. Other sectors expected to contribute to growth are: financial and insurance services (0.3 pp), estimated to increase by 1.8%; wholesale and retail trade (0.3 pp), estimated to grow by 4%; and construction (0.2 pp), which could grow by 5% due to ongoing activity in the hotel sector, at the airport, and on the highways.

5.02 The future of the financial sector will remain a key issue. In 2016, the financial sector made a direct contribution of 14.3% to GDP, down from close to 19% in 2007; while the overall contribution of financial sector activities, including the indirect contribution of the sector to GDP, still stood slightly above 40% in 2016, down from a high of over 48%. The future development of this important sector may be largely dependent on regulatory issues in Europe and in the USA. While licenses for banks with European and U.S. backgrounds are declining, they still made up 22.8% and 15.8% of all banks registered in 2017. Against the backdrop of the renewed client data leak from financial offshore centres in 2017, referred to as the "Paradise Papers", and the so-called "EU list of non-cooperative jurisdictions for tax purposes" dated December 2017, the external pressure on the operating environment of the financial sector in the Cayman Islands is likely to further increase[6]. BREXIT continues to be a key risk, as it could result in Caymanian financial institutions losing EU market access. Given the still significant contribution of the financial sector to economic activity, and the high number of European banks in the Caymanian financial sector, a potential loss of EU market access could have serious macroeconomic consequences for the Cayman economy.

5.03 On the fiscal side, GOCI expects to satisfy all five stability criteria set out in the Framework for Fiscal Responsibility in 2018. In 2019, however, the maturity of a USD312 mn bullet bond in November could lead to a breach of the debt service ratio, which currently limits annual payments of interest and principal for the whole public sector to 10% of CG revenue. GOCI is seeking a legislative amendment to change how this ratio is calculated so that large one-time debt repayments do not negatively influence compliance. Currently, GOCI forecasts a debt service ratio of 8.6% in 2018, but 46.7% the following year due to the 2019 bond redemption. In its 2018-19 Budget, GOCI plans to refinance up to $153 mn of the bond (corresponding to 58% of its nominal value). Cash balances are forecasted at $234.9 mn for the end of 2019 by GOCI, as GOCI deems it prudent not to deplete its entire cash balances by avoiding external borrowing amid the maturity of the bond. For the fiscal years 2018 and 2019, CG's debt-to-GDP ratio is expected to decline to 13.1% and 8.5%, while the public sector ratio will decline to 14.8% and 9.5%.

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[6] The Cayman Islands was not listed as un-cooperative jurisdiction for tax purposes by the EU but the EU reported that the territory has committed to address the concerns regarding the "existence of tax regimes that facilitate offshore structures which attract profits without real economic activity" by 2018.

TABLE 1: SELECTED INDICATORS

	2013	2014	2015	2016	2017
Real GDP Growth (%)	1.3	2.7	2.8	3.5	2.7
Average Inflation (%)	2.2	1.3	-2.3	-0.6	2.0
Unemployment (%)	6.3	4.6	4.2	4.2	4.3
Central Government Primary Balance (% of GDP)	3.8	4.3	4.0	3.6	3.1
Central Government Debt (% of GDP)	22.0	20.3	18.5	16.3	14.7

Source: CDB, CI ESO, Moody's Investor Service.