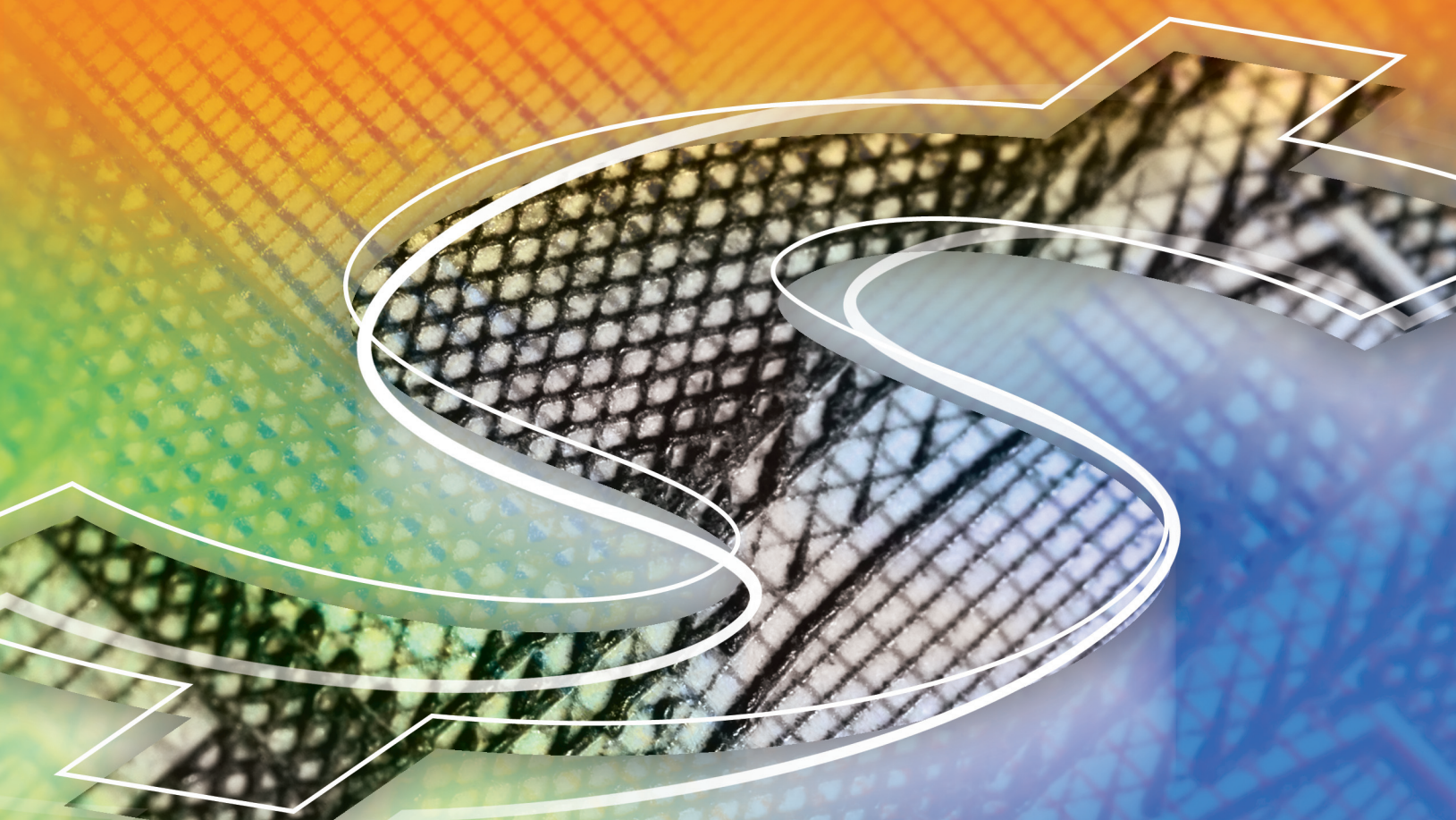
Public Sector Debt in the Caribbean:
An Agenda for Reduction and Sustainability



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Foreword

The issue of debt has emerged as one of the most critical development challenges facing the Caribbean region. Several Borrowing Member Countries of the Caribbean Development Bank (CDB) are saddled with debt burdens that are way in excess of the carrying capacity of their respective economies. As a consequence, the potential for resource allocation to be distorted is significant; development gains are being compromised; and the prospects for growth are diminished.

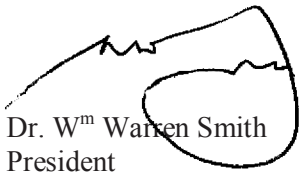
Fiscal outcomes are strongly tied to the quality of policies and the strength of institutions. Significant evidence is available suggesting that if countries are able to undergird their institutional frameworks and make policies more robust, we can increase growth dividends by lowering the probability of debt distress.

Further, the recent global economic and financial malaise very strongly demonstrated that the most resilient countries were those with relatively large fiscal buffers that allowed them to craft credible response strategies. Many Caribbean countries fell outside of this grouping.

The fragile nature of public finances and their potential to compromise sustained growth and development in the Caribbean, is disconcerting. CDB, as an important regional development partner, has a commitment to help fashion policy solutions that are consistent with continued welfare enhancement of the Region. It is this mandate that provides the impetus for this research effort.

This publication entitled "Public Sector Debt in the Caribbean: An Agenda for Reduction and Sustainability" undertakes a comprehensive look at the debt issues in the Caribbean, including the root causes of rapid debt accumulation. It also takes a fairly in-depth look at some of the institutional characteristics of debt management and presents some insights. Through a robust debt decomposition exercise, the study reveals some interesting results that can add value to policy formulation within the Caribbean.

I am confident that this Report will have appeal and utility to researchers and practitioners alike and add significant value to the policy formulation space in the Caribbean.



Dr. W^{m} Warren Smith
President
Caribbean Development Bank
April, 2013

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Abbreviations and Acronyms

%	-	per cent
AfDF	-	African Development Fund
AG	-	Accountant General
BAICO	-	British American Insurance Company Limited
BMCs	-	Borrowing Member Countries
BOP	-	Balance of Payments
BWIA	-	British West Indies Airways
CARICOM	-	Caribbean Community
CSME	-	CARICOM Single Market and Economy
CariCRIS	-	Caribbean Information and Credit Rating Services Limited
CCRIF	-	Caribbean Catastrophe Risk Insurance Facility
CDB	-	Caribbean Development Bank
CET	-	Common External Tariff
CG	-	Central Government
CIDA	-	Canadian International Development Agency
CIPPEC	-	Center for the Implementation of Public Policies for Equity And Growth
CLICO	-	CLICO International Life Insurance Company Limited
CPIA	-	Country Policy and Institutional Assessment
CWC	-	Cricket World Cup
DFC	-	Development Finance Corporation
DMAS	-	Debt Management Advisory Service
DMO	-	Debt Management Office
DMS	-	Debt Management Strategy
DMU	-	Debt Management Unit
DOH	-	Debt Overhang Hypothesis
ECCB	-	Eastern Caribbean Central Bank
ECCU	-	Eastern Caribbean Currency Union
ECLAC	-	Economic Commission for Latin America and the Caribbean
ECSE	-	Eastern Caribbean Securities Exchange
EIB	-	European Investment Bank
EVI	-	Environmental Vulnerability Index
FCO	-	Foreign and Commonwealth Office
FE	-	Fixed Effects
FRF	-	Fiscal Responsibility Framework
FS	-	Financial Secretary
GAAP	-	Generally Accepted Accounting Principles
GCT	-	General Consumption Tax
GDP	-	Gross Domestic Product
GMM	-	Generalised Method of Moments
GNI	-	Gross National Income

HIPC	-	Highly-Indebted Poor Country
IDA	-	International Development Association
IDB	-	Inter-American Development Bank
IMF	-	International Monetary Fund
JDX	-	Jamaica Debt Exchange
JMD	-	Jamaica dollar
LAC	-	Latin America and the Caribbean
LDCs	-	Lesser Developed Countries
LICs	-	Low-income Countries
LS	-	Least Squares
MDCs	-	More Developed Countries
MDGs	-	Millennium Development Goals
MDRI	-	Multilateral Debt Relief Initiatives
MFIs	-	Multilateral Financial Institutions
MOF	-	Ministry of Finance
MTFS	-	Medium-Term Fiscal Strategy
NDA	-	National Debt Act
NPV	-	Net Present Value
OECD	-	Organisation for Economic Cooperation and Development
OEC	-	Ordinary Least Squares
OTs	-	Overseas Territories
p.a.	-	per annum
PBL	-	Policy-based Loan
PDFC	-	Public Debt Financing Committee
PDMC	-	Public Debt Management Committee
PFM	-	Public Finance Management
PFML	-	Public Finance and Management Law
PPPs	-	Public-Private Partnerships
PRGF	-	Policy Reduction and Growth Facility
PRSP	-	Poverty Reduction Strategy Paper
PSIP	-	Public Sector Investment Programme
RGSM	-	Regional Government Securities Market
SDMO	-	Suriname Debt Management Office
SGMM	-	Systems Generalised Method of Moments
SPS	-	Strategic Policy Statement
SSB	-	Social Security Board
T-Bill	-	Treasury Bills
TTD	-	Trinidad and Tobago dollar
UNDP	-	United Nations Development Programme
UNEP	-	United Nations Environmental Programme
USD	-	United States dollar
VAT	-	Value-added Tax
WB	-	World Bank
XCD	-	Eastern Caribbean dollar

Public Sector Debt In The Caribbean:

An Agenda For Reduction And Sustainability

EXECUTIVE SUMMARY

Since the late 1990s, with comparatively low and stable inflation, relative political stability and the deepening of local and regional financial markets, Caribbean governments have largely had easy access to financial resources. Increased access to international capital markets and deepening domestic financial markets encouraged international and domestic borrowing and led to a virtual doubling of average national public debt in the Region since the mid-1990s. This steady debt accumulation has placed Caribbean countries among the most highly indebted middle-income countries in the world. At the end of 2010,[1/] six of the 10 most highly indebted countries were from the Caribbean, while four countries – St. Kitts and Nevis, Jamaica, Barbados and Grenada – ranked among the top five. All six countries had public debt levels in excess of 80 per cent (%) of Gross Domestic Product (GDP).

Among non-Eastern Caribbean Currency Union (ECCU)[2/] countries,[3/] Suriname and Trinidad and Tobago, both predominantly mineral exporters, were the only Caribbean countries that have maintained relatively moderate levels of public debt at or below 40% of GDP for most of the decade. Guyana and Haiti have maintained modest debt levels only since benefiting from substantial debt relief under the Highly Indebted Poor Country (HIPC) and Multilateral Debt Relief Initiatives (MDRI) in 2008-09. Jamaica has had chronically high levels of public debt for more than three decades, while Barbados has witnessed a rapid build-up in its debt since the late 1990s.

These trends raise important questions for the Caribbean region. How detrimental is the debt problem in the Caribbean? What has been the nature and extent of the debt experience? What are the drivers of debt accumulation in the Region? What are the characteristics of the Caribbean that explain its propensity to indebtedness? What are the prospects for debt levels in the Region? These questions are answered in this report.

Debt and Development

Current debt levels are fiscally unsustainable and, even if they were sustainable, are detrimental to the prospects for development in the indebted countries. The Caribbean cannot achieve rising standards of living for its people in the presence of existing debt service obligations and debt-induced economic vulnerability. Intuition and empirical evidence on the relationship between debt and development suggest that, while low levels of debt can be beneficial to developmental outcomes (provided that the borrowed capital is properly used) high levels of debt are obstacles to such outcomes.

[1/] Notwithstanding the fact that this study covers the period 2000-2010 fiscal and debt developments over the two years to 2012 remain extremely difficult in many of the highly-indebted countries in the Caribbean with all six countries remaining in the top ten most highly-indebted middle income countries.

[2/] The ECCU includes: Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

[3/] Excludes associate members and Overseas Territories (OTs) – Anguilla and Montserrat

The accumulation of debt has had implications for growth and development through both sides of the fiscal balance. External and domestic debts are disincentives for private investment given that taxes are needed to service the debt, and any remaining incentives are weakened by debt-induced inflation. High levels of debt also affect governments' decisions on spending. With the large share of tax revenues required to service public debt, many governments have reduced other expenditures, frequently stifling pro-poor spending such as social services, and growth-generating spending like infrastructure.

In shallow financial markets, especially where firms have limited access to international finance, domestic debt issuance can lead to swift and severe crowding out of private lending. This raises the cost of private capital and creates an adverse selection problem for financial institutions as more conservative risk-averse borrowers shy away from the credit market. The stability of the financial system is further threatened by the heightened risk of governments defaulting on domestic debt.

The nexus between fiscal sustainability and financial stability can also impact a country's fundamental macroeconomic indicators. Burdensome domestic debt-servicing requirements increase the incentive to monetise deficits, but the resultant inflationary conditions can foster asset-price bubbles, the bursting of which then threatens financial sector stability. On the other hand, highly-indebted countries which have weak fiscal and financial systems, high fiscal deficits and very limited possibilities for domestic borrowing, have excessively relied on foreign debt. Such countries are particularly subject to sudden stops in capital inflows that can lead to large devaluations, major financial disruptions and output contractions.

Finally, politically costly but necessary policy reform efforts may be postponed where there is a debt overhang, since governments may be less willing to undertake such reforms if they perceive that the benefit, in terms of greater output, will accrue partly to foreign creditors as debt repayments. Countries can thus get trapped in a high debt low growth equilibrium as weak policies and institutions are unlikely to result in improvement. Beyond a certain debt threshold, the debt overhang hypothesis (DOH) suggests that governments no longer harbour the incentive to undertake the costly institutional and policy reforms that would ensure a return to fiscal and debt sustainability.

Many of these consequences of debt impact economic growth through their effect on private investors and entrepreneurs. Debt overhang depresses investment and growth by increasing both cost and uncertainty. The risk of default, fears of devaluation and a cyclical borrowing and rescheduling cycle increase the volatility of private capital flows. Entrepreneurs adjust to uncertainty by opting to wait or reducing their planning horizon thus adversely impacting technological improvement and efficient resource use. When the uncertainty increases beyond a certain point large public debts can also hinder further capital inflows and reduce indebted countries' access to international capital markets. High levels of debt thus negatively affect the productivity and profitability of private investment. This has clear deleterious effects on economic growth and development. It also has implications for debt sustainability as the ability of the public sector to sustain a given level of debt depends on its ability to raise tax revenue from the private sector.

The Caribbean Debt Experience, 2000-2010

Many Caribbean countries have found the structure of their debt changing over the last 20 years. Whereas bilateral and multilateral external debt dominated debt portfolios in the 1980s and early 1990s, there has been a shift to include domestic debt as domestic capital markets have deepened, and

external commercial debt, as countries have positioned themselves to issue sovereign instruments. This process has been propelled by the dwindling of aid from traditional Western donors since the 1990s. Further, favourable conditions in the international capital markets has spurred Caribbean countries, with newly assigned credit ratings from the international ratings agencies, to rely heavily on commercial bond issues as a source of financing. For example, non-ECCU countries, particularly Belize and Barbados, saw an increasing share of their debt owed to private creditors in the international capital markets in the late 1990s and early 2000s.

Non-market access countries, particularly in the ECCU, relied more heavily on the multilateral financial institutions (MFIs) and the share of lending from these sources rapidly displaced official bilateral aid in external debt portfolios. In countries such as Dominica, St. Lucia and St. Vincent and the Grenadines, multilateral loans accounted for over 60% of the total external debt from the mid-2000s onwards. More recently, as emerging market spreads widened in the international markets and debt levels increased, some non-ECCU countries, such as Jamaica, shifted their financing strategy and sought to actively engage the MFIs as a primary lending source.

To better understand the Caribbean debt landscape, the Region can be divided into three groups – the ECCU, the non-ECCU and the OTs. These groupings are analytically useful since the groups have distinct institutional characteristics: the ECCU countries are members of a monetary union with a common Central Bank and adhere to a fixed exchange rate regime; the OTs are all British dependencies and are governed by strict financial management guidelines which restrict, specifically, the extent to which they can borrow; and the non-ECCU, independent countries which can exercise discretion over fiscal policy and public borrowing.

While non-ECCU countries are highly indebted with an average debt/GDP ratio of 76%, they are surpassed by ECCU countries with debt/GDP levels averaging 89%. Public debt levels in the OTs, while rising, remain moderate at an average 22% of GDP.

The non-ECCU group presents a mixed picture, with some highly-indebted countries (Jamaica and Barbados) and some with low debt levels (Suriname and Trinidad and Tobago). Of the five countries in the group with debts of more than 60% of GDP, only Belize and Guyana depend mostly on external debt. Except for the Bahamas, Barbados and Trinidad and Tobago, the others have had to restructure or accept organised debt relief at some point during the last five years.

All of the ECCU countries had debt/GDP levels above the 60% threshold that the grouping established as its benchmark sustainability level. Since 2005, four of the six ECCU countries, Antigua and Barbuda, Dominica, Grenada and St. Kitts and Nevis have restructured their debt indicating the severity of the debt burden and efforts to achieve debt sustainability.

The ECCU countries, with the exception of Antigua and Barbuda, have traditionally relied more heavily on funding from external markets. As a result, four of the six ECCU countries are primarily externally indebted. Grenada's external debt accounts for approximately 75% of the total followed closely by Dominica which owes 70% of its debt obligations to external creditors.

The OTs have traditionally had low debt levels, below 15% of GDP for most of the 2000s. However, since 2008 debt levels have increased in all territories except Montserrat, with the rise in debt/GDP most pronounced in Anguilla, and the Turks and Caicos Islands. Debt almost tripled in the Cayman Islands and more than doubled in Anguilla, the British Virgin Islands and Turks and Caicos Islands. All of the territories are subject to official borrowing guidelines established by the

United Kingdom government's Foreign and Commonwealth Office (FCO). The guidelines require maintaining public debt below 80% of current revenue and debt service at less than 8% of current revenue.[4/] The guidelines also specify that government's cash reserves should be sufficient to cover 90 days of government expenditures.

Over the past two decades the Caribbean debt landscape has changed markedly. At the beginning of the 1990s only three Caribbean countries had public debt levels over 100% of GDP. Since then however, the debt has mushroomed into high and unsustainable debt levels in an additional six countries, placing the Region among the most heavily-indebted regions in the world. Defaults have been avoided only by a series of debt restructurings.

The evolved status quo, like many of the countries' debt profiles, is unsustainable. The Caribbean cannot achieve rising standards of living for its people in the presence of high debt service obligations and debt-induced fiscal vulnerability and volatility.

Sources of Debt

The amassment of public debt can be linked to a number of contemporaneous developments. These developments served to enlarge and widen fiscal imbalances during the late 1990s[5/] and 2000s and coupled with deteriorating external account balances, propelled the increase of public debt.

Several factors can explain the deterioration in the fiscal and external accounts, most of which are illustrative of the Caribbean's high vulnerability to external shocks and natural disasters. The consequences of these shocks on domestic output have been met with a mitigating response that increased fiscal spending to alleviate the impact of the shocks; this, despite the inability of some governments' revenues to keep apace. The Caribbean's exposure to external economic shocks is exacerbated by its vulnerability to natural disasters.

In addition, there are several instances throughout the Region where non-central government liabilities have been assumed by the Central Government (CG). Losses of public enterprises, public-private partnerships (PPPs), and private financial entities have all become the responsibility of the tax payers in various Caribbean countries.

In order to deduce the proximate sources of debt more precisely, we isolate and analyse the years of most rapid and consistent debt expansion in each of the seven largest debtor countries – Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Jamaica and St. Kitts and Nevis. The average increase in CG debt for these seven countries during each of their periods of debt accumulation is 62% of GDP. The largest portion of debt accumulation is accounted for by contingent liabilities – debts that were contracted outside of CG and subsequently assumed by it, labeled as "events" in the decomposition exercise. This factor has been a significant contributor in each country's debt growth.

When the decomposed contributions to debt are averaged over all seven countries, the results are striking. It suggests that primary deficits made no overall contribution to the growth of debt in the Caribbean. It suggests further that real currency appreciation and GDP growth, on their own, would have reduced debt by 13 GDP percentage points. This means some 76% worth of GDP

[4/] In the Cayman Islands, the guidelines stipulate that debt service should be no more than 10% of current revenue.
[5/] Sahay, R. (2005). "Stabilisation, Debt and Fiscal Policy in the Caribbean". Working Paper WP/05/26. Washington, D.C.: IMF.

debt needs to be accounted for (62% of net debt accumulation plus the 14% that debt would have fallen due to revaluation). Of that, 16 percentage points are explained by interest payments and 59 percentage points are due to non-CG liabilities.

Those averages, however, conceal a variety of experiences in the acquisition of indebtedness with no single factor other than contingent liabilities being prevalent in all of the countries. One pattern characterises those countries that have become indebted because of fiscal slippage – running large primary deficits. This group includes Belize, Grenada, and St. Kitts and Nevis. Further, in most of those with fiscal deterioration, it was the growth of non-interest expenditure, in particular capital expenditure, rather than revenue contraction, that was the underlying driver.

The contribution of fiscal imbalances to debt growth in half of the countries begs the question as to why Caribbean governments are prone to these deficits. Fiscal management in the Caribbean may be facilitating, or at best, failing to come to grips with, excessive public expenditure and more efficacious taxation. Where the fiscal imbalances are driven by capital expenditure, capital reconstruction following natural disasters seems to be the motivation.

In Antigua and Barbuda and Jamaica, the cost of debt servicing was significant in further driving the growth of debt once incurred. That only some of the indebted countries suffered from negative debt dynamics is instructive, especially since many of the debt episodes were coterminous. Between 1997 and 2002 five of the seven countries in this study were experiencing rising debt levels. Despite some similarities in the economic and geographic circumstances and having to borrow in the same global environment, the implicit interest rate and the contribution of interest to debt vary greatly across the countries. These variations in magnitude of overall interest to debt suggest that for those countries in which interest was a major contributor to debt, an exogenous factor was not the cause. Had that been the case all countries would have been affected equally. Rather, the salient factor is the role (or absence) of debt management in determining the cost of debt servicing that is accountable and suggests that improved debt management could minimise the effect of debt dynamics on burgeoning debt.

Since the largest contributor to debt is the effect of off-budget events, then neither fiscal consolidation nor improved debt management will be sufficient to remove the threat of rising indebtedness from the Region. Broader issues of public governance need to be addressed, such as the role and management of public enterprises, and the regulation and monitoring of financial sectors. These are especially challenging issues in small countries with already stretched capacities.

The Institutional Framework

Having identified primary deficits, debt servicing and contingent liabilities as the main sources of debt in the Caribbean, the role of institutions for fiscal and debt management in dealing with sources of debt, remains to be explored. Ideally, fiscal policy is expected to be consistent with "debt sustainability", resilience in the face of shocks and macroeconomic stabilisation.[6/] Relative to these ideals however, there may be distorted incentives for fiscal management arising from, *inter alia*, a demand by voters for public goods and social entitlements, and a condensed political opportunity constrained by the electoral cycle.

Caribbean jurisdictions have clearly articulated legislative frameworks for fiscal management and

[6/] Debrun, Hauner and Kumar. (2007).

reflect commonalities from shared colonial experiences. The provisions however, reflect what would have been appropriate in developed countries between the late 1950s and the late 1970s, when independence (or at least autonomy), was granted to most of these islands.

These frameworks have been managed by hierarchical rather than collegial governmental institutions and whereas hierarchical government may facilitate positive change (where there is socio-political commitment for that change), it may also facilitate fiscal irresponsibility. There are several instances in which hierarchical government has facilitated suboptimal fiscal management decisions. Governments across the Caribbean have engaged in public ownership of corporations often with significantly negative consequences for fiscal performance. Public sector employment and emoluments have often been politicised and accompanied by unsustainable commitments. There have been controversies over cost overruns on major debt-financed infrastructural projects and concerns about the transparency of the contract award process. These factors tend to increase primary expenditure, reduce primary balances and ultimately increase public debt.

For debt management, the organisational structures and legislative framework fall short of what is now recognised as international best-practice. Governing legislation, to the extent that it exists at all, is disparate and sometimes oblique, sometimes with only indirect applicability to debt management. There is often no obligation for or habit of transparency. Objectives managing the debt portfolio are often not explicitly articulated or have broad agreement. The actual management of the debt in some territories resides in different offices and, to the extent that quantitative limits and other constraints are embodied in legislation, responsibility and accountability are unclear.

At present many Caribbean countries have their public debt management functions dispersed across a number of institutions. Several ministries, agencies, or departments may be involved in public debt management and responsible for performing some aspect of front office, back office and middle office management functions. Across the Caribbean, country borrowing programmes are often implemented by several institutions. These may include the Ministry of Foreign Affairs, Ministry of Finance (MOF), planning departments, treasuries and Central Banks. Institutional responsibilities for borrowing are often assigned by source of funding (domestic or external) and by instrument type (direct loans or debt securities).

In the absence of public debt management legislation that requires governments to specify a debt management objective clearly and develop a debt management strategy (DMS), governments' borrowing decisions are often not based on any clear or consistent cost or risk objective and, as a consequence, result in very costly borrowing outcomes. As has occurred in many Caribbean countries, governments' pursuit of cost savings has often resulted in short-term savings but exposed public debt portfolios to significant risk, increasing the potential for default.

The absence of modern public debt management legislation in most of the Caribbean undermines the transparency and accountability of fiscal and debt management operations. Where there is no legal requirement for government to account for any variation between its outturn and stated objectives, it does not allow the public to evaluate government's performance against quantifiable benchmarks. Considerable opportunity is therefore provided for imprudent borrowing to occur without appropriate government accountability. In addition, the absence of clearly delineated institutional roles and responsibilities contributes to uncoordinated debt management operations.

Similarly, if provisions for transparency and accountability in debt management are absent, greater opportunities exist for governments to make poor borrowing decisions without the opportunity

for the electorate or financial markets to accurately assess the economic and social implications of those choices. Debt management legislation thus provides not only for the mandatory reporting of government's debt management performance against stated objectives, but for comprehensive reporting on the public debt beyond the financial statements found in annual budget or treasury reports.

Since the start of the decade a small but growing number of Caribbean countries have begun implementing institutional reforms to better manage their debt portfolios, help mitigate the impact of worsening debt dynamics and, in conjunction with attempts at improved fiscal management, achieve long-term debt sustainability. An examination of the institutional arrangements for public debt management and the debt dynamics within the Caribbean supports the conclusion that countries with sound fiscal and monetary management, as well as an enabling institutional framework for public debt management, perform better overall than countries where such arrangements are weak or non-existent.

The benefits of enhanced management are clear but there may be time inconsistency, common pool and incentive misalignment problems that inhibit speedy implementation through the political process. Nonetheless, reforms are needed and it falls to political leadership to legislate and implement them.

Projections

In order to get an understanding of the depth of the debt problem and the imperative for action, the likely future path of the debt in each of the seven highly-indebted countries is simulated. The extrapolation assumes that the respective governments adhere to the policies that are currently being implemented or that are likely to be implemented, based on publicly announced plans. In all the countries examined, some corrective fiscal policies were already adopted or are in the pipeline and on that basis, improved debt/GDP ratios are projected. We assess whether those improvements are sufficient to place the countries on a sustainable debt trajectory by comparing the computed debt/GDP ratios at the end of the projection period with an estimated threshold at which the country would likely default on its obligations. The default thresholds used for countries that have previously defaulted are the debt/GDP ratios existing at the time of their most recent default. For countries that have not previously defaulted, the default thresholds are computed as the debt/GDP ratios consistent with debt servicing costs that are greater than the primary balances, plus an estimate of market support.[7/]

The projections imply that two of the countries studied are likely to default on their debt without additional austerity measures – Dominica and Grenada. Although the levels of debt for Jamaica and Belize are projected to be below the debt default threshold over the forecast horizon, complacency is not advised since high refinance risks exist due to fragile market confidence and significant debt maturities coming due within the projection period.

The projections under the baseline scenario thus suggest that only three of the seven countries studied (Antigua and Barbuda, Barbados and St. Kitts and Nevis) should be satisfied with the fiscal measures that they have already implemented or are planning to implement. That satisfaction should however, be tempered by the knowledge that these projections assume a cessation of new contingent debt, historically the primary source of new debt in the Region.

[7/] The estimate of market support refers to the amount of money a government can borrow from capital markets.

Other scenarios were simulated to round out our understanding of the possible evolution of debt levels. One scenario examines the trajectory of the debt if fiscal authorities roll-back recently implemented or promised fiscal corrections. Under this scenario, the debt/GDP ratios of all the countries examined, except for Belize, breach the threshold that would lead to default at some point during the forecast horizon. With the reversal of the fiscal consolidation measures the primary balance will deteriorate for all countries and will set off a chain reaction that leads to an unsustainable increase in debt.

Another scenario explicates the fiscal policy stance that will lead to a breach of the debt default threshold over the forecast horizon and so establishes a benchmark for fiscal consolidation that must be bettered. From the baseline scenario it was already found that Dominica and Grenada are likely to default at some time before 2020 on the basis of their current fiscal policies. For the other countries, a comparison of the primary balance in this scenario with that of the baseline scenario gives an indication of the fiscal space that is available. For example, with a primary balance to GDP ratio of 3.2% in the default scenario and a marginally higher ratio of 3.4% in the baseline scenario, St. Kitts and Nevis has very little scope for expanding their primary balance. Even a small deviation from its current fiscal path is likely to lead to a default. Belize, Antigua and Barbuda, and Jamaica have a bit more fiscal room to manoeuvre with differences between the baseline and default scenario primary balance ratios of 2.6, 2.0 and 1.5 percentage points, respectively. Particularly for Antigua and Barbuda and Jamaica, this is certainly not sufficient breathing room to make their governments feel comfortable. Barbados is the only country for which the primary balance to GDP ratio in the baseline scenario (2.7%) is significantly larger than that of the default scenario (-0.9%).

The simulations have shown that all the heavily-indebted Caribbean countries, except for Grenada and Dominica, have implemented policies that significantly reduce the risk of default. Grenada and Dominica need to implement additional fiscal austerity measures to strengthen the primary balance to enhance the likelihood of solvency. Although Jamaica and Belize have projected debt ratios that fall below the default threshold, a high risk of default exists in these countries because of high refinancing costs in the case of Belize, and a high volume of maturing debt in the case of Jamaica. Fiscal policy in both Jamaica and Belize should therefore be focused on creating more fiscal room to prevent a liquidity problem.

Notwithstanding the positive results for the other countries there is limited fiscal flexibility in all the countries examined. A reversal of the fiscal policies implemented since 2008 leads to a breach of the default threshold for all the cases except Belize. High refinance risks could precipitate a liquidity crunch that would presage a default. Barbados has the greatest flexibility among the countries studied due to its relatively high debt-carrying capacity, given the depth of its domestic capital market and the greater degree of market confidence.

An Agenda for Reform

Given that the main drivers of debt were fiscal deterioration, adverse debt dynamics driven by high interest costs, and off-budget liabilities and in consideration of the unsustainability of the current fiscal/debt trajectories exposed by the simulations, an agenda for reform is required to place Caribbean countries on a different fiscal path. Many of the debt drivers have their roots in the institutional structure of public decision-making in the Caribbean. An agenda for debt sustainability must therefore address the institutional foundations for fiscal outcomes and debt accumulation.

Fiscal Management

Creating fiscal space is critical to a programme of debt reduction and sustainability. However, given the high demand for public goods and services by an often vocal and impatient electorate, political motivations frequently trounce sound financial management resulting in large fiscal imbalances and a build-up of public debt.

Enacting fiscal responsibility legislation, which specifies fiscal performance targets and requires greater transparency and accountability in the government's fiscal operations, is a means of creating a counterbalance to the demands for seemingly free public services. Sanctions for breaches of the legislation have to be an effective disincentive to public financial mismanagement. This may require the sanction of custodial sentences for violations. Even more important, the rules have to be clearly drawn to avoid ambiguity in interpretation or in the location of responsibility and both the public and the prosecutor must follow through and hold responsible officers accountable for any violations.

Performance budgeting will improve the incentive structure facing budget-holders. Where possible, budgets are to be drawn to elevate outputs (results) to the same status as inputs (financial resources provided). A careful matching of inputs and outputs through corporate plans rising from the departmental level can be the basis for effective departmental "ownership" of budgets and for implementation consistent with resource availability and government's overarching strategic objectives.

Procedural reforms can help to guard against fiscal slippage. It is imperative to enhance systems for financial measurement and control. Accrual accounting is an ideal. Budgets for public bodies should be tabled at the time of tabling the government's budget, along with a corporate plan and an indication of projected financial results. Central Treasury Management will allow more efficient use of government's cash resources and reduce the need for debt. Constitutionally independent institutions (answerable to Parliament) like Auditors General (AG) and Contractors General will be able to carry out their monitoring functions more effectively.

Debt Management

A comprehensive DMS must accompany a government's explicit debt management objectives. Such a strategy should outline the manner in which government intends to achieve its desired portfolio composition over the medium term, based on its cost and risk preferences.

The institutional framework for debt management should assign clear responsibility for each of the important debt management functions:

(a) strategic planning – to determine the portfolio composition that conforms to the high level objectives given concurrent and expected market conditions;

(b) risk management – to design a framework with responsibility for monitoring and managing risk exposures associated with exchange rates, interest rates, market access and whatever events could jeopardise the achievement of the strategic plan;

(c) implementation – to determine and execute a borrowing plan to meet the articulated strategy, mindful of the risk exposures; and

(d) data management – to undertake the accurate recording, accounting and publishing of all debt-related transactions and debt data.

The unit responsible for debt management should be organised along functional lines. The front office, guided by the agreed DMS, is responsible for evaluating and negotiating new loans; the middle office takes care of analytical functions such as portfolio and risk analysis; and the back office executes loan servicing, accounting and data gathering.

Even where debt management is centralised, best practice still requires the establishment of an interagency committee for strategic oversight of debt management. The need for coordination is illustrated by potential conflicts between cost minimisation and risk minimisation, as fundamental objectives of debt management.

Liability Management

The decomposition exercise revealed that budget surprises and liabilities that originate outside of CG, were the main contributor to debt in the Caribbean over the last two decades. The management of contingent liabilities should be pursued on two levels. Wherever possible, identified risks are to be minimised or hedged; where that is not possible, the remainder are to be exposed, estimated and provided for.

The first and easiest way to expunge risks that are not inherent in the business of government is to divest assets and operations that carry such risks. Many contingent liabilities arise from the operations of public enterprises that are not delivering public goods. Where risks cannot be divested, they can sometimes explicitly be insured against. To the extent that explicit insurance, such as that provided by the Caribbean Catastrophe Risk Insurance Facility (CCRIF), is inadequate to sufficiently mitigate the fiscal risk of natural disasters, governments must themselves establish contingency funds in order to self-insure the uncovered risk.

Notwithstanding efforts to minimise the actual risks by way of divestment, insurance and provisions, governments may also recover a part of the cost of carrying these public risks. The Guarantor could be compensated for bearing the risk by means of an explicit payment (a premium); by providing collateral; or by having a contractual claim on a share of the upside such as the profits if the entity is not wholly government-owned. Such a policy will not only compensate for the cost of the government being the insurer of last resort, but also reduce the demand for guarantees by filtering out unviable projects. In cases where a government guarantee is a means of providing a desired subsidy, a better option is to charge for the guarantee and provide the subsidy separately so it can be subjected to the normal scrutiny of public expenditures.

As with other elements of public sector management the institutional framework is pivotal to successful implementation. Contingent liabilities must not only be identified they must also explicitly be accounted for. This will be facilitated by adopting improved accounting standards in the public sector. The use of accrual rather than cash accounting, along the lines specified by the Generally Accepted Accounting Principles (GAAP), should accomplish this. Then contingent expenditure would have to compete with other budgeted expenditures for limited public resources.

The complementary element to a good institutional framework for managing contingent risks is a strong regulatory environment. Many contingent liabilities originate in industries that are serving a public purpose such as utilities or finance. The primary responsibility for monitoring and controlling those entities lie with their statutory regulators.

Finally, governments should occasionally invite outside risk auditors to review both the risks and the risk management process and publish the auditor's report.

Disaster Management

A particularly prevalent kind of risk in the Caribbean and one that has been the source of much fiscal stress, is that from natural disasters, both earthquakes and storms. At present all Caribbean governments prepare inadequately for the risk of natural disasters given the inherent vulnerability of the Region and the history of disasters.

Private insurers may be used to externalise risks that involve property, as is the case with natural disasters. Multilateral insurance schemes can play a major role in this respect. Governments need to ensure that their use of CCRIF is up to the maximum level possible given the risks they face even while CCRIF continues to explore ways of expanding and extending its coverage. Catastrophe bonds also provide a means of mitigating natural disaster risk. The mandate of CCRIF could be expanded to broker the issuance of such securities.

Conclusion

Caribbean economies are being constrained by the public debt they are carrying. Bringing the debt to a sustainable level consistent with long-term economic growth and development is a daunting task. Further, even if debt relief is provided the risk of renewed indebtedness will always threaten to derail the promise of growth, given the economic and financial environment and the high vulnerability of the Region to external economic and natural shocks.

This review of debt in the Caribbean has revealed that there is a lot Caribbean governments can do in the way of better fiscal decision-making. Even more important than better policies and rules, though, is the need to create a climate and an obligation of transparency and financial integrity in fiscal and debt management, and public accounting. Such an environment provides a virtual cloak to constrain excess that can make legislated limits redundant. The objective of the institutional framework is to create a climate of autonomy, responsibility and accountability.

Underpinning these efforts is a desire for improved standards of living for Caribbean people, which can only come about through faster economic growth and more economic development. The focus on growth and development is therefore central. Such a focus will ensure that the efforts at debt reduction do not themselves impinge on the prospects for economic growth.

An agenda for growth is not the subject of this study. However, the broad outlines of a policy programme for such an agenda is not unfamiliar territory and overlaps considerably with the agenda for sustainable debt. It would include, at the very least, fiscal responsibility, infrastructure development and meaningful and effective integration to exploit market size and trade within the Region. However, until public policymakers in the Region take control of the debt problem, rapid growth and better living standards will remain a chimera.

Chapter 1

DEBT AND DEVELOPMENT

A Review Of The Literature

INTRODUCTION

Caribbean governments have had easy access to financial resources since the late 1990s on account of the Region's relatively low and stable inflation, relative political stability and the ongoing deepening of local and regional financial markets. Increased access to international capital markets and deepening domestic financial markets encouraged international and domestic borrowing which led to a virtual doubling of average national public debt in the Region since the mid-1990s.[8/] With the exception of Antigua and Barbuda, Guyana and Jamaica, public debt had not been a major economic problem in Caribbean economies until the mid-1990s. However, by the early 2000s Caribbean countries came to be ranked among the most indebted in the world. At the end of 2010 six of the 10 most highly indebted countries in the world were in the Caribbean, four of which ranked among the top five.

This episode of debt expansion in the Region occurred at a time when the debt ratios of developing countries were generally improving. The average debt-to-GDP ratio of developing countries had stabilised in the first half of the 1990s and subsequently started to decline rapidly in the new millennium, up until about 2007.[9/] Panizza *et al* (2010), however, observe that this trend masks an important cross-country heterogeneity: small countries have debt ratios which are substantially higher than those of larger economies. They further note that this difference has been increasing over time. This heterogeneity is particularly evident in the Latin America and the Caribbean (LAC) region. Despite the fact that weighted regional averages suggest dramatic reductions in indebtedness between 2005-2010, simple country averages indicate that in general, larger countries in this region have markedly lower debt levels than smaller countries.

The difference between small and large countries is also evident in the composition of the debt. Panizza *et al* (2010) note three broad trends in developing country debt composition since 2000: (i) a decline in bilateral lending and increase in multilateral lending; (ii) the increasingly important role of international bonded debt;[10/] and (iii) increasing importance of domestic debt relative to external debt.[11/] These trends are evident in the LAC region, with only 30% of international public debt being owed to official creditors, and most of the remaining 70% owed to private creditors taking the form of sovereign bonds. An important distinction by size of country should be noted: large economies tend to have more debt with private creditors, while smaller economies have more debt with official creditors (Panizza *et al* 2010).

8/ Sahay (2006).

9/ Panizza *et al* (2010).

10/ Panizza *et al* (2010) note that 'in the 1980s, about two thirds of the developing countries' debt owed to private creditors took the form of syndicated bank loans and only 7% took the form of international bonds (the remaining 25% did not fit either of these categories). By 2008, nearly 70% of debt owed to private creditors took the form of bonds and only 25% syndicated bank loans (this reversal in debt composition was the result of the Brady exchanges of the early 1990s).

11/ 'In 1995, international debt represented more than 50% of the total debt of these countries; by 2007, the share of international debt was well below 25%' (Panizza *et al* 2010).

The recent global financial and economic crisis has also significantly impacted public debt levels and trends.[12/] Reinhart and Rogoff (2010) found that between 2007 and 2009, average debt levels increased by about 20% (in real terms) in countries that did not experience systemic financial crises and by about 75% in countries that did. They attribute this to direct bailout costs in some countries, the adoption of stimulus packages in many countries to deal with the recession and substantial declines in government revenues in most countries.

These international trends raise three important questions for the Caribbean region, namely: (i) What has been the nature and extent of the debt experience in the Caribbean? (ii) What are the drivers of debt accumulation in the Region? (iii) What are the characteristics of the Caribbean that explain its propensity to indebtedness?

These questions will be answered in subsequent chapters of this report, as follows:

(a) Chapter 2 examines the debt experience in Caribbean countries and looks at some of the efforts that have been made to manage the debt.

(b) Chapter 3 decomposes the growth of the debt/GDP ratios in order to identify the major sources of debt growth in the most highly-indebted countries.

(c) Chapter 4 highlights several institutional factors that have been critical to maintaining favourable debt sustainability outcomes in some countries and adverse outcomes in others. Lessons and best practices will be highlighted.

(d) Chapter 5 makes projections as to likely future debt outcomes.

(e) Chapter 6 provides an agenda for reaching and maintaining sustainable debt levels in the Region.

This work is critical, as it will be shown in the remaining sections of this chapter that the level and nature of debt have important implications for a country's economic growth and development. This chapter reviews and synthesises the literature to provide a theoretical and empirical background to the issue of debt and development. A brief overview of the literature on debt's impact on growth and development is first provided, followed by an examination of the specific channels through which this impact is felt.

THE IMPACT OF DEBT ON GROWTH AND DEVELOPMENT

It is widely accepted that most developing countries cannot grow without borrowing to finance the technology gains and capital deepening that are prerequisite for economic progress. However, the deleterious effects of high levels of debt on economic development are increasingly being recognised.[13/] Much of the literature in this area focuses on the relationship between external debt and economic growth. A number of more recent articles have examined the impact of domestic debt, specifically highlighting ways in which debt can impact poverty levels and alleviation efforts. This section briefly highlights the different arguments in this debate and summarises the empirical evidence.

[12/] Caner *et al* (2010) note that 'public debt has increased substantially for countries at all income levels as a result of the current global economic crisis' and that 'projections of standard measures of public debt relative to GDP for the next 30 years indicate that debt levels are unsustainable for many countries.' They conclude that 'taking account of the implicit public debt associated with social security, medical care, and contingent liabilities would reveal a substantially magnified debt problem.'

[13/] Imbs and Ranciere (2005).

External Debt and Economic Growth

Several authors have highlighted the positive impact that public debt can have on the effective functioning of an economy. At a very basic level public debt enables fiscal authorities to play their role in stabilising the macro-economy which is a critical ingredient for growth creation. As an example, Bourne (2010) asserts that countering the effects of external economic shocks and natural hazard events are legitimate motivations for debt accumulation. When governments borrow they are able to smooth taxes in the face of variable expenditures. This is because debt helps to 'smooth' both contemporary and inter-generational consumption. To the extent that future generations will be richer than current ones – because they will have a combination of more human capital and more productive technology – a transfer from future to current generations can raise society's inter-temporal welfare (Cecchetti *et al* 2011).

More fundamentally, numerous theoretical works suggest that low to moderate debt levels are positively associated with economic growth. At such debt levels a higher debt/GDP ratio loosens credit constraints, makes more resources available for investments and fosters economic growth (Caner *et al* 2010). This is captured in endogenous growth models through capital stock augmentation which includes enhanced human capital through public investment in education and training and the effect of technical change embodied in new capital goods.[14/] The underlying assumption is that the borrowed funds are used to finance productive investments (Schclarek and Ramon-Ballester 2005). Where this is the case authors such as Aschauer (1989) and Khan and Kumar (1997) show that public investment expenditures have positive and significant effects on economic growth.[15/]

However, the notion of a positive linear relationship between external debt and economic growth does not appear to be empirically supported. As indicated in Appendix 1.1, the majority of the literature points to a non-linear relationship between external debt and growth. In this relationship there is a threshold beyond which the growth-inducing benefits of low to moderate levels of external debt are eventually reversed. This threshold is shown to occur when there is a debt overhang which is defined as 'the presence of an existing inherited debt sufficiently large that creditors do not expect with confidence to be fully repaid' (Krugman 1988).[16/] It is argued that where this occurs, the heavy debt burden reduces a debtor country's incentive to invest. This is because when the country is unable to service its debt in full, the actual payments will depend on its economic performance. In this circumstance, if output increases as a result of higher investment, some of the additional proceeds accrue to creditors in the form of higher debt service payments. In this way debt acts as a marginal tax on investment (Husain 1997).

Deshpande (1997) frames this scenario as the DOH, according to which 'investment is discouraged if the debt burden is so large that the debtor country is unable to meet its payment obligations in a normal way, and involuntary lending takes place.' Clements *et al* (2003) posit that, some of the returns from investing in the domestic economy are effectively taxed away by existing foreign creditors and investment by domestic and foreign investors – and thus economic growth – is discouraged.

[14/] Bourne (2010).

[15/] Bourne (2010), however, notes that 'a problem in some Caribbean countries has been the temptation to take advantage of purpose-unconstrained commercial credit to implement public investment projects of questionable economic growth impact.' This tendency clearly tempers the ability of public debt to foster economic growth creation.

[16/] As quoted in Deshpande (1997).

Subsequent work on the DOH has broadened the scope of this theory by asserting that debt can impact growth through all the main sources of growth.[17/] These theorised channels will be discussed in the next section. Empirical evidence has been found for the impact of external debt on growth through, *inter alia,* reduced physical capital accumulation and lower total factor productivity growth. As highlighted in Box 1.1, eleven reputable empirical studies conducted since the early 2000s have found a robust non-linear relationship between debt and growth.[18/] They confirm the theory that reasonable levels of borrowing by a developing country are likely to enhance its economic growth but that large levels of accumulated debt lead to lower growth.

The wide acceptance of this non-linear relationship has led to much discussion about the levels of debt that are considered to be *'reasonable'* versus *'large'*. Caner *et al* (2010) note that the increase in public debt associated with the current global economic crisis has raised concerns over whether it is starting to hit levels at which it might slow economic growth. They raise questions as to how strong the growth impact would be if debt surpassed the threshold and what would happen if debt stayed at elevated levels for an extended period of time. These have been quite relevant to Caribbean countries for many years.

The penultimate column in Appendix 1.1 highlights the results of studies that have attempted to compute the debt overhang threshold as a percentage of GDP. Whereas they may all not be directly comparable because of different debt measures used, the wide variation in estimates is nonetheless instructive, with figures ranging from 15-100%. Caner *et al* (2010) explain by noting that there are theoretical and empirical reasons why debt threshold levels may vary across countries, particularly by country income. Debt may play out differently in low-income countries (LICs) because of less developed domestic financial markets, a different degree of openness and different institutions. Sahay (2006) however, notes that in general, public debt/GDP ratios over 50-60% are considered high. By that measure, only three Caribbean countries have low debt – the Bahamas, Suriname and Trinidad and Tobago. Four countries – Barbados, the Dominican Republic, St. Lucia and St. Vincent and the Grenadines – have debt in the range of 50-90%. The remaining seven countries – Antigua and Barbuda, Belize, Dominica, Grenada, Guyana, Jamaica and St. Kitts and Nevis – have debt beyond 90%. By these estimates, most Caribbean countries by the early 2000s were either fast approaching or had surpassed the debt threshold levels stipulated in the literature (see Appendix 1.1).

This highlights the importance of determining the effect on growth if debt stays at elevated levels for an extended period of time. In Table 1.1, the results of Caner's *et al* (2010) work are presented. Estimated forgone growth as a result of exceeding the debt threshold is presented for 29 countries. The annual percentage point loss in real GDP growth ranged from a negligible amount for Greece and the Philippines to 4.7% for Nicaragua. This translated to a cumulated loss over 28 years of

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[17/] Pattillo *et al* (2004).

[18/] Although a few studies found a linear negative relationship between debt and growth and a few others found no statistically significant relationships, the weight of the recent empirical evidence clearly points towards a non-linear relationship. Cordella *et al* (2005), while also finding a non-linear relationship between debt and growth, suggest that for HIPCs the relationship is negative at intermediate levels of debt but not at low or high levels. They thus find two thresholds. The first mirrors the traditional debt overhang threshold as it is the indebtedness level above which the marginal effect of debt on growth becomes negative. The second threshold is called the debt irrelevance threshold and is the indebtedness level above which the marginal effect of debt on growth becomes zero. They noted that in HIPCs, indebtedness does not seem to affect either growth or investments as they have crossed the irrelevance threshold. In such circumstances the insignificance of the debt-growth relationship is explained by the fact that donors provide highly indebted countries with additional gross revenues and this avoided the crowding out of public investments. Cordella *et al* (2005), however, further assert that the 'absence of marginal debt overhang at high levels of debt does not imply the absence of average debt overhang… For higher levels of debt, the marginal effect of debt on growth is zero… even though the overall effect of debt remains negative (average debt overhang).'

0.5 and 1.2% for Greece and the Philippines, respectively, and 264.6% for Nicaragua. Jamaica was the only Caribbean country included in that study and her annual percentage point loss in real GDP growth was estimated as 0.2%, which cumulated to a 5.1 percentage point loss over 28 years. Because this is a relatively new area of study these results have not yet been substantiated or refuted. They are nonetheless instructive as to the possible range of negative effects that could be incurred if debt thresholds are exceeded.

TABLE 1.1:

ESTIMATED FORGONE GROWTH AS A RESULT OF EXCEEDING THE DEBT THRESHOLD, BY COUNTRY

Country	How high growth could have been if the debt-to-GDP ratio had been at the threshold level (% real average growth rate)	Annual percentage point loss in real GDP growth	Cumulated loss over 28 years (percentage point loss in real GDP growth)
Angola	3.2	1.2	62.8
Belgium	2.7	0.6	18.4
Bolivia	2.4	0.1	1.6
Bulgaria	2.5	0.6	16.7
Burundi	2.6	0.8	24.3
Canada	3.1	0.4	11.6
Congo, Rep.	5.0	1.0	32.7
Côte d'Ivoire	2.1	1.2	41.1
Croatia	1.5	0.2	6.0
Ecuador	3.0	0.1	1.5
Greece	2.2	0.0	0.5
Guinea	4.0	0.4	13
Hungary	1.8	0.1	3.2
Indonesia	6.8	1.3	45.2
Italy	2.1	0.4	10.9
Jamaica	2.0	0.2	5.1
Japan	2.9	0.6	18.6
Jordan	5.1	0.1	2.3
Lao PDR	6.8	0.8	33
Latvia	2.5	0.1	3.1
Lebanon	5.2	0.4	11.7
Madagascar	2.4	0.5	15.3
Mali	3.3	0.2	5.2
Nicaragua	6.6	4.7	264.6
Nigeria	3.4	0.2	4.7
Philippines	3.2	0.0	1.2
Sierra Leone	3.1	1.0	33.0
Singapore	7.3	0.4	13.0
Tanzania	5.0	0.2	6.3

Note: For developed economies, a public debt/GDP ratio threshold of 77% is applied and for developing countries 64%.
Source: Extracted from Caner *et al* (2010).

Domestic Debt and Economic Growth

The literature on the relationship between domestic debt and economic growth is significantly less voluminous than that on external debt and growth. Abbas and Christensen (2007) note there has been a lack of interest in formally studying the impact of domestic debt on growth because of, *inter alia,* the unavailability of reliable datasets on domestic debt and the small size of domestic debt relative to external debt in most developing countries. Hanson (2007) further notes that external debt issues tended to dominate researchers' and policymakers' attention when developing countries suffered numerous foreign exchange crises that were often associated with large foreign debt. The development of a new cross-country database on domestic debt, along with the recent trend of declining external debt and the corresponding increase in domestic debt in many developing countries have, however, led to a number of relatively new studies in the area.

The growth in government domestic debt reflects both the perceived need for and the benefits of such debt. Hansen (2007) notes that the banking crises of the last 15 years led to substantial issuance of government domestic debt, both to recapitalise banks and to fund governments when the supply of foreign loans declined. Since then governments in both crisis and non-crisis countries have continued to rely increasingly on domestic debt. It is attractive to governments because its costs have fallen compared to the past and relative to foreign debt. These lower costs partly reflect improvements in their macroeconomic situation and the growth of new buyers. Governments also may perceive domestic debt as less volatile than foreign debt after the experience with the crises of the last 15 years. The use of domestic debt to finance budget deficits and implement monetary policy through open market operations are also cited as additional benefits, as is the need to develop and deepen domestic financial markets through domestic debt instruments (Sheikh *et al* 2010).

Some empirical support has been found for the claims as to the relative benefits of domestic debt, as Fry (1997) found that for developing countries market-based domestic debt issuance is the least cost method of financing the budget deficit (when compared to) external borrowing and seigniorage. He however also concluded that all of these methods reduce growth.[19/] Abbas and Christensen (2007) thus observe that issuing domestic debt, whether to finance the fiscal deficit or to mop up monetary liquidity, involves a complex evaluation of the costs and benefits to the economy. The abovementioned benefits must be weighed against costs associated with repercussions on private sector lending in the form of crowding-out, fiscal and debt sustainability, weakening bank efficiency and inflationary risks, all of which can and adversely impact economic growth.

In the cross-country study of 93 developing countries conducted by Abbas and Christensen (2007), a positive relationship between growth and traditional measures of domestic debt was found. However, when public domestic debt was measured as a ratio of deposits, a non-linear relationship with economic growth was discovered. Domestic debt was seen to support growth up to a ratio of 35% of deposits but strangled it at higher levels of this ratio. This result lends support to the crowding out argument. Abbas and Christensen (2007), however, assert that a higher level of domestic debt can be likely sustained without compromising growth if domestic debt is issued in the form of marketable securities, bears positive real interest rates and is issued to investors outside

[19/] As quoted in Sheikh *et al* (2010).

[20/] They note that this result supports 'the hypothesis that institutional and retail participation in the government securities market boosts competition in the financial sector both on the deposit-taking side – as banks have to compete with government for individual and institutional deposits – and, on the investment side – as banks compete with others sectors in public sector securities auctions. This increased competition should put downward pressure on banks' overheads and intermediation margins, partly alleviating the efficiency concerns associated with high bank holdings of domestic debt…'

the banking system.[20/] The channels through which domestic debt impacts on economic growth will be further discussed in a subsequent section. However, the above discussion has illustrated the complexity of this relationship and has highlighted how little has been empirically proven with respect to the nuances of the relationship. The need for careful consideration of the impact of the changing composition of debt in the Caribbean is emphasised as the growth in domestic debt implies changing burdens and risks for the Region.

The Relationship Between Debt and Development

Most of the research on the impact of debt has focused on its effect on economic growth. It is, however, now widely accepted that economic development encompasses the broader objectives of alleviating poverty and reducing inequitable income distribution. Whereas it is difficult (if not impossible) to sustainably achieve these goals in the absence of economic growth, such growth by itself does not guarantee their achievement.[21/] Also important is the fact that the ultimate impact of any policy or shock on development can be felt through its effect on economic growth and/or through a direct effect on poverty or distributional outcomes.

Whilst the effect of debt on growth is well-researched, very little has been written on its direct impact on, for example, poverty alleviation efforts. It is theorised that at high levels of debt increasing debt service requirements could force governments to allocate resources away from developmental initiatives or welfare programmes. Any reduction in public provision of health care and education clearly disproportionately impacts the poor and highlights one possible avenue through which high levels of debt servicing can adversely impact development (independent of its impact on economic growth).

The potential for this occurring in the Caribbean is very high. International benchmarks suggest that total public debt service (external and domestic) should not exceed 15% of government revenue. This ratio is important since the burden of public debt service is borne by governments' budgets, which in turn means that less resources are available to governments to spend in other critical social and developmental areas.[22/] The United Nations Development Programme (UNDP [2010]) notes that most of the small island developing states which breach the 15% benchmark are found in the Caribbean. In Antigua and Barbuda, total public debt service as a percentage of government revenues was 35% in 2009. In Jamaica, interest payments on public debt were extremely high at 66% of CG revenues in 2009. In spite of the debt exchange programme subsequently implemented to address this issue, the fiscal burden of the country's public debt remained very high at 45 cents in every dollar of CG revenues in 2010 and 2011. The extent of the problem and implications for poverty alleviation and developmental efforts in the Caribbean is captured very well by two quotations from embattled Caribbean leaders – the former Prime Minister of Jamaica and former President of Guyana:

> *'Every year for many years, we have been spending more than we earn. Every year, we have to borrow to make up the difference, so, each year, the debt gets bigger and bigger and each year we have to set aside more money to pay the interest on that debt... For the last 10 years, all of the taxes we collect have had to be used to service that debt. So, before we can pay one teacher or nurse or policeman, before we can patch one pothole, before we can put one bottle of medicine in our hospitals or provide one school lunch for*

[21/] Todaro and Smith (2010).
[22/] UNDP (2010).

a needy child, we have to borrow more money, piling up the debt even further and the cost of servicing that debt even higher.'

Prime Minister Bruce Golding, Jamaica, January 2010

'The [Caribbean] region is heading towards bankruptcy if countries could be declared bankrupt. When you have two items, just paying wages and salaries and debt and that's more than your revenue, what remains to run the country? Many governments in the Region are approaching that kind of position.'

President Bharrat Jagdeo of Guyana, April 2010

In an effort to provide empirical evidence to establish the linkage between poverty and debt, studies such as those by Kemal (2001) and Uzochukwu (2003) have found that debt accumulation and servicing have adverse effects on the poor.[23/] Clear evidence as to the channels through which those impacts are felt was however, not derived. This is because whereas some studies found that debt service had a negative effect on total government spending, very few such studies disaggregated public expenditure. Fosu (2007) sought to fill this gap in the literature by examining the effect of increased debt servicing on fiscal allocations in 35 Sub-Saharan African (SSA) economies. The results suggested a strong direct impact on developmental initiatives, as it was found that a debt servicing constraint would shift public expenditure away from the social sectors of health and education and possibly from public investment.

Empirical correlations of the relationship between debt and poverty are likely to understate the impact of indebtedness on needy households. Some of the socioeconomic effects of a debt burden are manifest only when government has to set about reducing it. Whenever governments choose to inflate their way out of domestic debt, rising inflation redistributes income from the poor to the rich and so is associated with rising poverty. It is also often asserted that in instances of forced fiscal contractions, social programmes (for example poverty alleviation projects) are often substantially reduced because the poor tend not to have the organised clout to mount any effective opposition.

Rising public debt then is likely to be a threat especially to the standard of living of the lower socioeconomic groups. Therefore, whatever its effect on economic growth the impact of debt on the other dimensions of development should be a concern for Caribbean governments facing a growing debt problem.

TRANSMISSION CHANNELS FROM DEBT TO GROWTH AND DEVELOPMENT

Whether debt's impact on development is felt through the effect on economic growth or via its impact on poverty alleviation efforts, the intuition and empirical evidence is clear – low levels of debt can be beneficial to developmental outcomes provided that the debt is properly used but high levels of debt tend to be deleterious to such outcomes. This section examines in more detail the various channels through which these outcomes are manifested.

[23/] As quoted in Sheikh *et al* (2010).

Debt and the Fiscal Balance

The subsequent chapters highlight the deteriorated fiscal balances in the Caribbean over the last two decades. In principle, these deficits can be financed through debt accumulation or money creation. Debt has tended to be the preferred option in the Caribbean of late. Printing money has become less tolerable with the increased appreciation for the long run economic costs of inflation. Moreover, many of the countries in the Caribbean are part of a currency union and so do not have the required authority over the Central Bank. Thus, increasing fiscal deficits have precipitated a massive build-up of debt in many countries.[24/]

High levels of debt also impact governments' spending decisions. The large percentages of GDP required to service public debt have forced many governments to reduce expenditures and have crowded-out pro-poor and growth enhancing spending (Abbas and Christensen 2007). Studies have shown that the burden of fiscal adjustment has fallen on social spending and public sector investment.[25/] The added adverse growth impact of a reduction in spending on education must also be emphasised as new growth theorists have highlighted the importance of quality education to human capital accumulation and innovation.[26/] Cuts in public sector investment can also be growth-retarding, as reductions, particularly in physical infrastructure, tend to crowd out private investment, since they are often complementary to private sector activities.[27/]

Where countries are particularly prone to shocks, whether because of their openness or vulnerability to natural disasters, the importance of counter-cyclical fiscal policies is significantly heightened. High debt service requirements reduce the fiscal space that governments have to engage in such counter-cyclical policies and thus constrain their ability to mitigate the adverse growth effects of shocks and crises.

If debt management in a country is weak the relationship between the fiscal balance and public debt is likely to result in worsened growth and development outcomes. The build-up in debt caused by persistent fiscal deficits will ultimately precipitate distortionary and/or austerity measures by governments as debt servicing requirements become burdensome.[28/] If this is so the requisite adjustment measures have to be carefully considered so as to minimise the possible adverse impacts on growth and development.

Debt and the Financial Sector

The spate of banking crises in the 1990s contributed to the rapid accumulation of public debt in many developing countries as domestic debt was issued to recapitalise insolvent banks.[29/] The recent global financial crisis has already put considerable strain on debt in several developed and developing countries.[30/] These episodes of crisis highlight the nuanced relationship between a country's financial sector and its level of domestic debt. (Appendix 1.1 discusses this relationship with particular attention to the ECCU.) In countries that have experienced a financial crisis the issuance of domestic debt fosters the short-term stability of the financial system when the funds

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[24/] Ogunmuyiwa (2011).
[25/] Deshpande (1997).
[26/] Foss (1997).
[27/] Deshpande (1997).
[28/] Scott-Joseph *et al* (2006).
[29/] Hanson (2007) notes '(i) many of the largest increases observed in domestic government debt were in crisis countries or those where state banks were recapitalised; and (ii) the increase in domestic government debt would have been much less in many countries between the mid-1990s and 2004 had there been no financial crises.'
[30/] Checherita and Rother (2010).

are used to resuscitate the failing institutions and restore confidence. Even in non-crisis countries issuance of domestic debt can have positive spill-overs for the financial sector, as it fosters the development of private capital markets and boosts private savings.[31/]

The most severe negative effects of domestic debt are, however, also channelled through the financial sector. The crowding out effect of domestic debt on private investment is a serious concern. Bank credit to the private sector has been empirically proven to be a contributor to economic growth.[32/] However, when governments borrow domestically they use up domestic private savings that would otherwise have been available for private sector lending (Abbas and Christensen 2007).[33/] As increasing public financing needs push up sovereign debt yields, this further causes a net flow of funds out of the private sector into the public sector and pushes up private interest rates.[34/] In shallow financial markets, especially where firms have limited access to international finance, domestic debt issuance can lead to both swift and severe crowding out of private lending.[35/] In most developing countries, only large, well established firms have access to international finance, suggesting that the burden of crowding out falls heavily on small and medium-sized enterprises and rural borrowers (Hanson 2007).

The higher interest rates also affect financial institutions creating an adverse selection problem. As interest rates rise more conservative, risk-averse borrowers shy away from the credit market. A larger proportion of the persons applying for loans are thus those who are willing to take risky bets. The likelihood of default increases and so therefore does the banks' proportion of non-performing loans.

The stability of the financial system is further threatened by the heightened risk of governments defaulting on domestic debt as the debt servicing burden becomes overwhelming.[36/] Because so many financial institutions are heavily invested in government bonds any such default could impact their solvency. Hansen (2007) further argues that the risk for such banks not only arises in the extreme cases of default but also even as government debt managers seek to ease their own risks by extending the maturity of their debt instruments and selling more debt with fixed interest rates. This policy increases banks' liquidity risk systematically to the extent that the changes in government domestic debt create a mismatch with bank deposits. Interest rate risk increases to the extent that the domestic debt instruments increasingly carry fixed rates and are of longer maturity than

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[31/] Abbas and Christensen (2007) summarise these spill-overs by noting that: 'First, government securities are a vital instrument for the conduct of indirect monetary policy operations and collateralised lending in interbank markets; the latter helps banks manage their own liquidity more effectively, reducing the need for frequent Central Bank interventions. Consequently, Central Banks operating in well developed domestic debt markets do not have to rely as much on direct controls like credit ceilings, interest rate controls and high reserve requirements, all of which distort financial sector decisions and lead to financial disintermediation at the expense of private sector savings and investments… Second, yields on government securities can serve as a pricing benchmark for long-term private debt issued by banks or enterprises and, hence, promote the development of a corporate bond market which boost competition in the banking sector… Third, the availability of domestic debt instruments can provide savers with an attractive alternative to capital flight as well as lure savings back from the non-monetary sector into the formal financial system… The possible benefits here can go beyond saving mobilisation and extend to a reduction in the size of the black economy, widened tax base, increased financial depth, de-dollarisation and improved perceptions of currency and country risk.'

[32/] Hanson (2007).

[33/] Clements *et al* (2003) note that 'external debt service… can also potentially affect growth by crowding out private investment or altering the composition of public spending. Other things being equal, higher debt service can raise government's interest bill and budget deficit, reducing public savings; this, in turn, may either raise interest rates or crowd out credit available for private investment, dampening economic growth. Higher debt service payments can also have adverse effects on the composition of public spending by squeezing the amount of resources available for infrastructure and human capital, with negative effects on growth.'

[34/] Checherita and Rother (2010).

[35/] Abbas and Christensen (2007).

[36/] Governments can default on domestic debt either 'explicitly or through holding down interest rates or other changes in the conditions on domestic debt' (Hansen 2007).

deposits. In the case of a major rise in interest rates, these risks from debt management policies translate into actual bank liquidity problems, declines in banks' net income, and reductions in bank capital.

Although Jamaica is the only Caribbean country to have experienced a major systemic financial crisis, Worrell *et al* (2001) note that there have been major failures and intervention of financial institutions accounting for 10 % or more of banking system assets in all the other Caribbean countries except in the Bahamas, Belize, and some Organisation of Eastern Caribbean States (OECS). The link between financial sector stability and fiscal sustainability through the level of domestic debt is thus an important issue for the Region which has to be closely monitored.

Debt and Macroeconomic Policies and Institutions

The abovementioned nexus between fiscal and debt sustainability and financial stability can also impact a country's fundamental macroeconomic indicators. For example, burdensome domestic debt servicing requirements increase the incentive to monetise deficits, thus reducing the real burden of domestic debt in the resultant inflationary environment.[37/] Such inflationary conditions can foster the creation of asset price bubbles, the bursting of which can lead to financial sector instability.[38/]

On the other hand, where highly indebted countries have weak fiscal and financial systems, high fiscal deficits, along with very limited possibilities for domestic borrowing, have led to overreliance on foreign debt. In the 1990s such countries were particularly subject to sudden stops in capital inflows that led to large devaluations, major financial disruptions, and output declines (Hanson 2007). In countries which rely on imports for a large proportion of capital goods, large and sudden exchange rate devaluations can have severe adverse effects on investments.[39/]

It is not only possible for high levels of public debt to precipitate macroeconomic and financial instability but it can also limit governments' ability to adequately respond to such instances of instability. Cecchetti *et al* (2011) explain by noting that when a crisis strikes the ability of government to intervene depends on the amount of debt that it has already accumulated, as well as what its creditors perceive to be its fiscal capacity – that is, the capacity to raise tax revenues to service and repay the debt. Fiscal authorities may become constrained both in their attempt to engage traditional counter-cyclical stabilisation policies and in their role as lender of last resort during a financial crisis.

It is thus argued that high levels of public debt can limit critical government functions. Deshpande (1997) notes that in a situation of debt overhang, with low rates of growth and possibly declining standards of living, a government would find it difficult to shift resources from consumption to investment as the people of the debtor nations would be inclined to believe that this shift would be utilised only to service debts, thus robbing them of potential benefits.[40/] A more broad interpretation of DOH would suggest that any activity that requires incurring costs today for the sake of increased

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[37/] Abbas and Christensen (2007).
[38/] Kirkpatrick and Tennant (2002).
[39/] Deshpande (1997) notes that after the 1980s debt crisis, many heavily-indebted countries (through IMF programmes) sought to use exchange rate devaluation to improve their balance of payment (BOP) position. This resulted in large swings in the current account balances of highly-indebted countries, which were achieved through import cuts rather than increases in export revenues. This had adverse repercussions on investments, as many countries relied on imports for a large proportion of capital goods.
[40/] 'This problem would be more acute the greater are the debt servicing obligations, and politically, explanations of government would be more unacceptable the wider the divergence of interests between the ruling classes and the majority of the population' (Deshpande 1997).

output in the future will be discouraged, as part of the proceeds will be taxed away by creditors. Thus governments may be less willing to undertake difficult and costly policy reforms if it is perceived that the future benefits in terms of higher output will accrue partly to foreign creditors (Pattillo *et al* 2004).[41/] Politically costly but necessary policy reform efforts may therefore be postponed. For example, reliance on domestic debt may delay necessary tax mobilisation efforts.[42/]

Countries can thus get trapped in a high debt, low growth equilibrium. The Caribbean debt experience and prospects must be examined to ascertain whether countries in the Region are either already in or are approaching such a situation. The policy and institutional framework must also be investigated to determine whether policies and institutions contribute to favourable outcomes or whether they concretise the debt trap.

Debt and Private Investors

Many of the aforementioned consequences of debt impact economic growth through their effect on private investors and entrepreneurs. For example, the disincentive effect of the debt overhang led to capital flight from many severely indebted countries in the 1980s debt crisis, as, due to the fear of appropriation of their funds for debt servicing, private investors preferred to send their money out of the country;[43/] crowding out precluded private investors from accessing low-cost domestic funds following many of the financial crises of the 1990s; and, where governments postponed necessary policy reforms, the poorer policy environment affected the efficiency of investment and productivity of private producers in a number of developing countries.[44/]

More subtly however, debt overhang also depresses investment and growth by increasing uncertainty. Clements *et al* (2003) note that as the size of the public debt increases, there is growing uncertainty about actions and policies that the government will resort to in order to meet its debt servicing obligation. Domestic entrepreneurs will adjust to the uncertainty by reducing their planning horizon. Any investment that takes place in an uncertain environment is likely to be allocated to activities with quick returns, rather than long-term, higher-risk irreversible investment which would be more conducive to long-run productivity growth. Misallocated resources and less efficient investment projects could thus contribute to slower productivity growth (Pattillo *et al* 2004). The high levels of uncertainty related to the debt overhang are thus likely to reduce private investors' incentives to improve technology or to use resources efficiently.

Private investors will take more drastic action than opting to wait or shortening their planning horizons when the uncertainty increases beyond a certain point. Clements *et al* (2003) note that rapid accumulation of debt can also be accompanied by increasing capital flight, if the private sector fears imminent devaluation and/or increases in taxes to service the debt. Large public debts can also hinder further capital inflows and reduce indebted countries' access to international capital markets.

High levels of debt thus affect the productivity and profitability of private investment. This has clear deleterious effects on economic growth and development. It also has implications for debt sustainability. This is because the ability of the public sector to sustain a given level of debt depends

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41/ 'The anticipation of future debt relief needed to resolve the debt overhang problem may also reduce governments' incentive to pursue policy reforms that strengthen their capacity to repay, with a similar negative impact on productivity growth' (Pattillo *et al* 2004).

42/ Abbas and Christensen (2007).

43/ Deshpande (1997).

44/ Pattillo *et al* (2004).

on its ability to raise tax revenue from the private sector (Cecchetti *et al* 2011). If the productivity and level of private economic activity diminishes because of the distortionary and unstable debt environment, tax revenues will fall, as will the ability of government to service its debt. The possibility of this unpleasant cycle unfolding in highly-indebted Caribbean countries is yet another reason to raise concerns over the level of indebtedness in the Region.

CONCLUSION

This chapter has reviewed the literature on the relationship between public debt and development. A growing consensus has emerged, based on theoretical reasoning and empirical evidence, that low to moderate levels of debt can be beneficial to development provided that the debt is properly used, but high levels of debt tend to be deleterious to targeted developmental outcomes. The impact of debt on economic growth and development was manifested through numerous channels, including the fiscal balance, financial sector, macroeconomic policies and institutions and private investors and entrepreneurs. Complex relationships were found wherein the channels that caused the build-up of debt turn out to be the same ones through which adverse effects were felt when debt thresholds were crossed.

It is clear from the literature that countries can get trapped in a high debt, low growth equilibrium. This is more likely if the institutional framework within countries is weak. The investigation of the institutional framework in Chapter 4 thus highlights several institutional factors that have been critical to maintaining favourable debt sustainability outcomes in some Caribbean countries and adverse outcomes in others. These outcomes impact the prospects for future growth of public debt in the Caribbean. Chapter 5 forecasts likely outcomes for debt/GDP ratios for the period 2011-2020, and conducts a scenario analysis highlighting the likely impact of various policies. This analysis will inform the sixth chapter of this report, which provides an agenda for reaching and maintaining sustainable debt levels in the Region. As has been shown in this chapter, such an agenda is important if the economic growth and development prospects of Caribbean countries are not to be hindered by unsustainable public debt.

Chapter 2

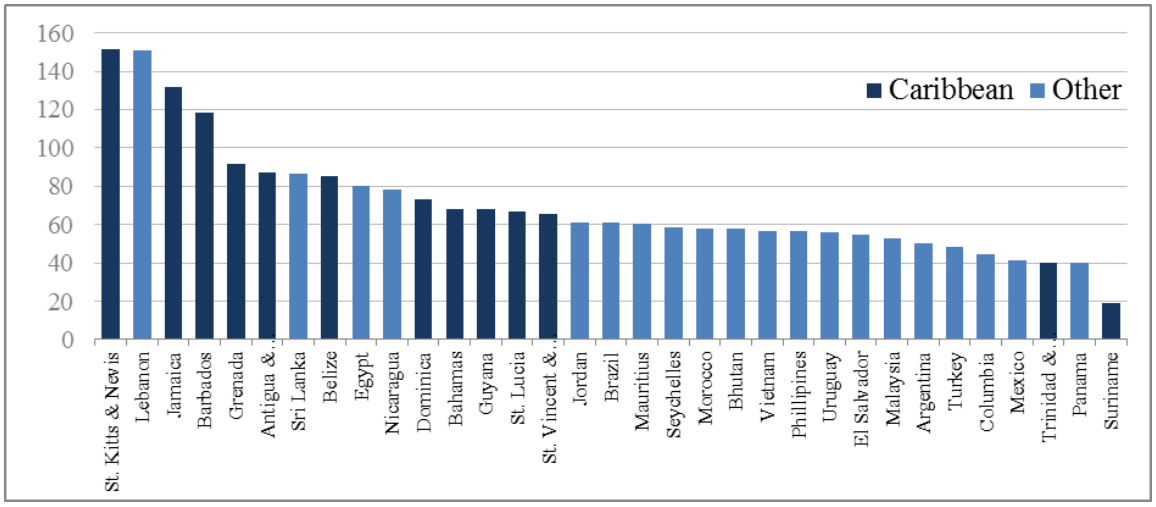
THE CARIBBEAN DEBT EXPERIENCE, 2000-2010

INTRODUCTION

Steady debt accumulation since the late 1990s has placed Caribbean countries[45/] among the most highly-indebted middle-income countries in the world. Between 2000 and 2010, public debt levels of 14 Caribbean states increased on average as a percentage of GDP by 6.4%, while public debt to GDP levels in the five overseas territories more than tripled on average over the period. Notably, the Caribbean was home to the world's two most highly-indebted middle-income countries in 2010 (see Figure 2.1). While the debt burden of most Caribbean countries is high there are notable commonalities and variations in structure and composition in and among the countries. For analytical purposes, it is useful to divide the Caribbean into three analytical sub-groups – the ECCU, the non-ECCU and the Overseas Territories (OTs).[46/] These groupings are analytically useful since ECCU countries are members of a monetary union with a common Central Bank and common currency. ECCU countries adhere to a fixed exchange rate regime with the Eastern Caribbean dollar (XCD) pegged to the United States dollar (USD). The non-ECCU countries have their own central bank and national currency, and greater discretion over their fiscal policy and public borrowing. The OTs are all dependencies of the United Kingdom and are governed by strict financial management guidelines which restrict the extent to which they can borrow. The study utilises these sub-groupings to investigate the Caribbean debt experience over the period 2000-2010.

FIGURE 2.1:

DEBT/GROSS DOMESTIC PRODUCT, MIDDLE-INCOME COUNTRIES, 2010 (%)



Source: CDB, ECCB, ECLAC and NationMaster.com

[45/] The study covers the 18 borrowing members of CDB and one prospective member, Suriname.

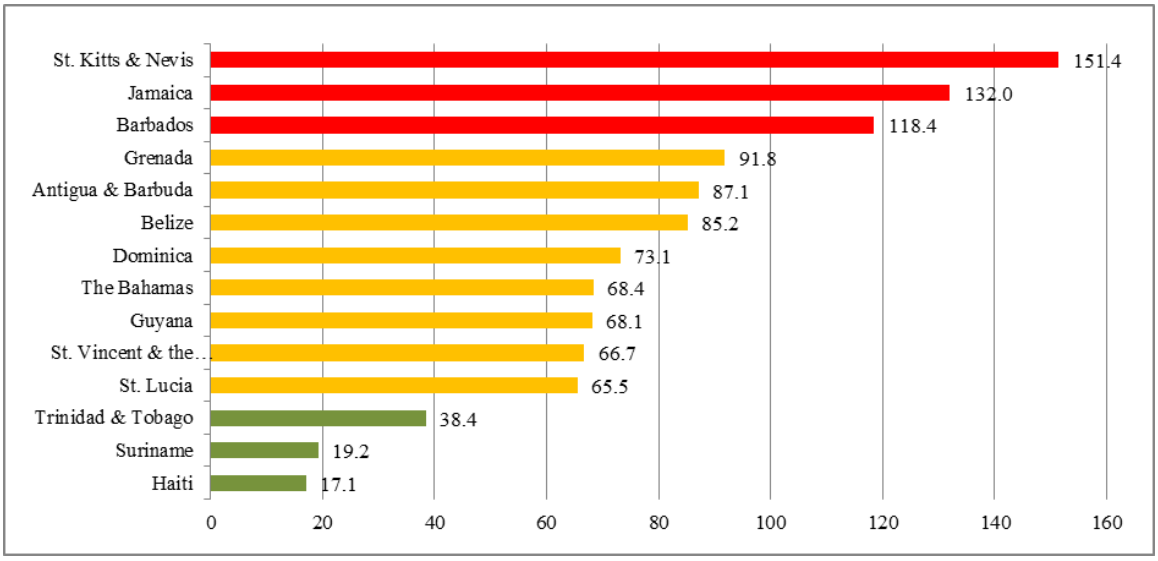
[46/] The members of the ECCU are Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines. The non-ECCU territories comprise Barbados, Belize, the Bahamas, Guyana, Haiti, Jamaica, Suriname and Trinidad and Tobago. The OTs are Anguilla, the British Virgin Islands, Cayman Islands, Montserrat and Turks and Caicos Islands. Whilst Anguilla and Montserrat are overseas dependencies they are also members of the ECCU, for purposes of this study they are treated as OTs.

At the end of 2010, six of the 10 most highly-indebted middle-income countries were from the Caribbean, while four countries - St. Kitts and Nevis, Jamaica, Barbados, and Grenada - ranked among the top five. All six countries had public debt-to-GDP levels in excess of 85% while the top three had public debt-to-GDP levels of over 100%.

A comparison among the main three analytical sub-groups indicates that public debt levels among ECCU[47/] member states are the highest in the Region. At the end of 2010, public debt-to-GDP levels in all ECCU member states exceeded 65% and amounted to an annual average of 89.3%, in contrast to 73.9% at the end of 2000. High public debt levels have persisted in the ECCU for well over a decade and the rise in public indebtedness has led to three of six ECCU member states, Antigua and Barbuda, Dominica and Grenada undertaking comprehensive debt restructuring exercises between 2003 and 2010.

FIGURE 2.2:

CARIBBEAN COUNTRIES: DEBT/GROSS DOMESTIC PRODUCT – 2010 (%)



Source: CDB; ECCB; country authorities

Among non-ECCU countries, Suriname and Trinidad and Tobago, both predominantly mineral exporters, are the only Caribbean countries that have maintained relatively moderate levels of public debt at or below 30% of GDP for most of the decade. Guyana and Haiti maintained modest debt levels only since benefiting from substantial debt relief under HIPC and MDRI in 2008-09. St. Kitts and Nevis, Jamaica and Barbados are the three most heavily indebted countries in the Caribbean as of 2010 (see Figure 2.2). Jamaica has had chronically high levels of public debt-to-GDP for more than three decades, while St. Kitts and Nevis has witnessed a rapid build-up in its debt since the late 1990s. In Jamaica, public debt-to-GDP stood at over 100% since 2005 while in St. Kitts and Nevis the debt ratio has exceeded 100% since 2001 (see Figure 2.3).

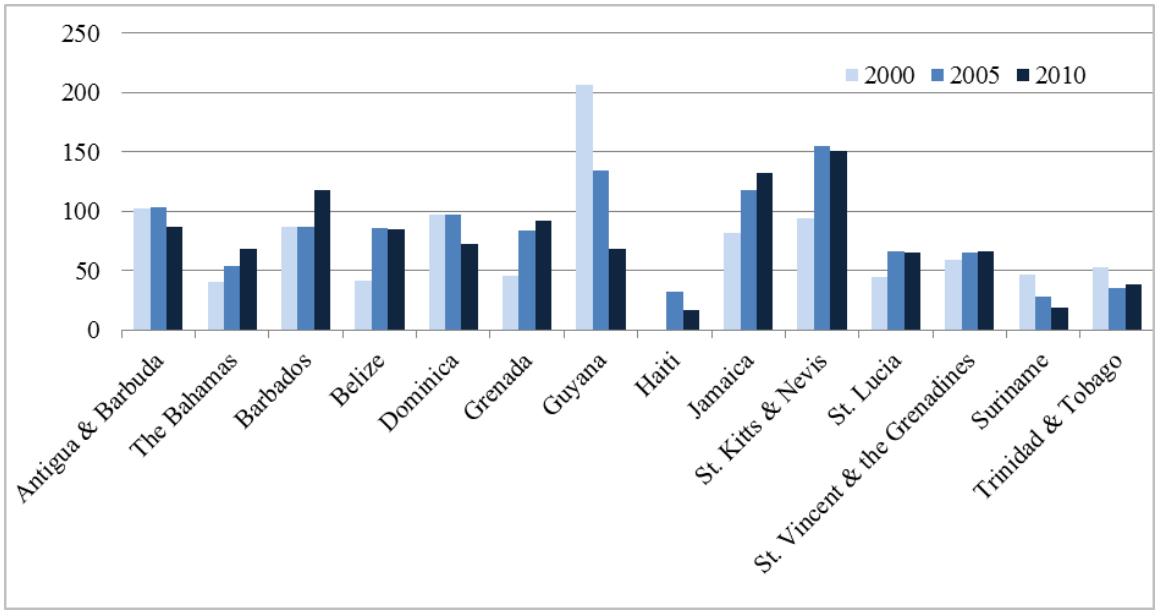
With the exception of Montserrat, public debt has also risen markedly in the Caribbean's OTs. Between 2000 and 2010, the ratio of public debt-to-GDP in the British Virgin Islands and Cayman Islands rose sharply, increasing almost five-fold in the British Virgin Islands and almost tripling

[47/] Excludes associate members and the OTs – Anguilla and Montserrat.

in the Cayman where it increased from 8.3% to 24.5%. Public debt-to-GDP in the Turks and Caicos Islands jumped from 11.5% to 28.5%. At least three territories have breached official fiscal responsibility or borrowing guidelines, and have had to restructure their debt through the refinancing of existing loans. Montserrat is the only territory to have sustained improvements in its public debt-to-GDP levels with the ratio falling from 30% at end 2000 to 5.7% at end 2010.

FIGURE 2.3:

CARIBBEAN COUNTRIES – DEBT/GROSS DOMESTIC PRODUCT, 2000, 2005 AND 2010 (%)



Source: CDB, ECCB, ECLAC, country authorities

THE CONTEXT FOR DEBT

The significant debt accumulation in the Caribbean can be linked to a number of factors. In Chapter 3, a decomposition method is employed to identify specific factors driving the accumulation of debt in selected countries. Here some of the contemporaneous developments that may have contributed to the growth of indebtedness are examined.

Fiscal Imbalances

There have been large and widening fiscal imbalances in most countries during the late 1990s[48]/ which widened further in the 2000s. Already high fiscal deficits in the ECCU at the start of the 2000s grew to 4.4% of GDP in 2005 and rose further to 5.8% of GDP in 2010. Similarly, from a 1996-2005 period average of 17.5% of GDP, the ECCU's current account deficit increased to a peak of 36.9% in 2007, before narrowing to 25.7% of GDP in 2010.

The two most heavily-indebted non-ECCU countries, Jamaica and Barbados also exhibited large and rising fiscal deficits. Over the period 2005-2010, Barbados' overall fiscal deficit rose from

[48]/ Sahay, R. (2005), Stabilisation, Debt and Fiscal Policy in the Caribbean, IMF Working Paper WP/05/26

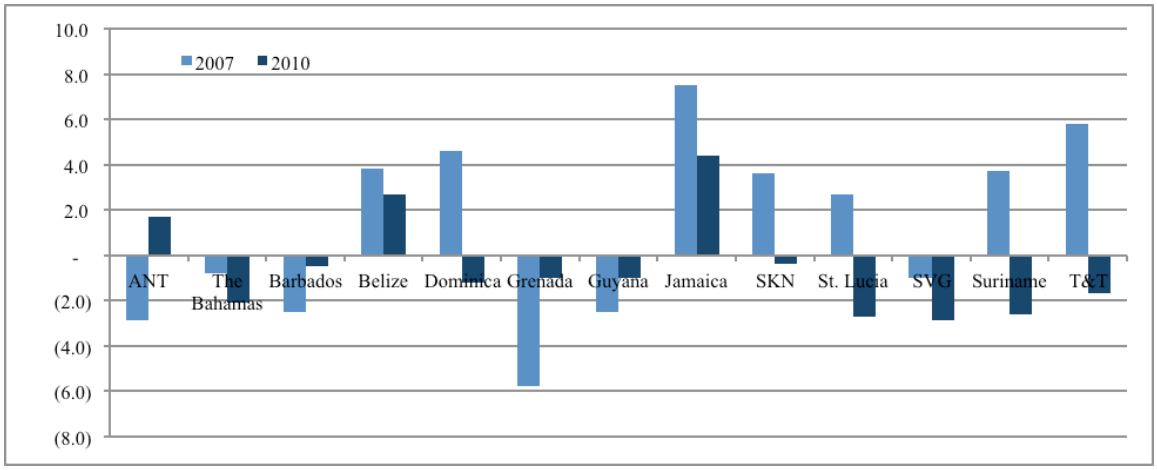
6.9% to 7.2% of GDP, and between 2005 and 2009, Jamaica's deficit as a percentage of GDP increased almost threefold from 3.6 to 10.4% before tapering downwards to 6.1%.

Fiscal imbalances also emerged in some of the OTs, most strikingly in Anguilla where in nominal terms, the overall deficit increased tenfold to 8.1% of GDP in 2009. After enjoying fiscal account surpluses from 2000-05, Montserrat fell into deficits over the period 2006-08 before fiscal consolidation efforts reversed the trend in 2009. While both the British Virgin Islands and Turks and Caicos Islands sustained deficits through 2005-2010, British Virgin Islands' deficits have narrowed over the period while there has been a steady deterioration in Turks and Caicos Islands' fiscal accounts.

The performance of countries' primary fiscal balances indicated the extent to which there was fiscal deterioration. Primary deficits, which exclude interest payments from the overall fiscal balance, give rise to further debt accumulation since budgetary resources are not only insufficient to meet interest costs but recurrent budgetary housekeeping expenditures as well. Governments' typical recourse to debt-financing, gap-filling measures translates into increasing levels of public indebtedness. With the exception of Jamaica, which has maintained high primary surpluses since the 1990s, and Belize and Haiti after 2000, Caribbean countries have recorded primary deficits almost every year since 2005. Dominica, St. Lucia, St. Vincent and the Grenadines, Suriname and Trinidad and Tobago have seen worsening primary balances since 2006 and all had primary fiscal deficits in excess of 1% in 2010 (see Figure 2.4).

FIGURE 2.4:

CARIBBEAN COUNTRIES: PUBLIC SECTOR PRIMARY BALANCE AS SHARE OF GROSS DOMESTIC PRODUCT – 2007, 2010 (%)



Source: International Monetary Fund (IMF) Western Hemisphere Regional Economic Outlook, 2009, 2010, 2011

Once debt levels began to increase interest costs exacerbated indebtedness mostly in those countries that have relied on private market financing in the domestic and international markets. In Jamaica where interest payments absorbed more than 50% of CG revenues a protracted period of high interest rates and low growth intensified the debt burden. Yields on Government of Jamaica securities averaged 18.3% between 2000 and 2005, declining marginally to an average 14.6% from 2006-2010. St. Kitts and Nevis has fared moderately better with interest payments in 2009 consuming over 24% of government revenue.

Deteriorating external account balances also contributed to the build-up of public debt. Caribbean economies have historically had persistent external current account deficits. External deficits had widened well above the 1996-2005 average and with few exceptions current account deficits have worsened over the 2000s. In the face of widening deficits, many Caribbean governments resorted to borrowing to meet their budgetary or external financing.

External Shocks

Several factors explain the deterioration in the fiscal and external accounts, most of which are reflective of the Caribbean's high vulnerability to external shocks and natural disasters. The consequential downside impact of these shocks on domestic output has by and large been met with a mitigating policy response that has sought to increase fiscal spending despite the inability in most instances of government revenues to keep apace.

Europe's phasing out of its preferential trade agreements with the Caribbean had a significant effect on the export income, trade and fiscal balances of the sugar and banana exporting Caribbean countries. ECCU states were particularly hard hit and suffered significantly weakened external positions. Between 1996 and 2005, the external current account deficits of the ECCU amounted to a period average of 17.7% of GDP, significantly higher than the Caribbean regional average deficit of 11.4%.]

Between 2005 and 2010 the current account position further deteriorated to an average deficit of 23% of GDP for ECCU states. The decline in St. Vincent and the Grenadines was the most severe with its current account deficit averaging 26.5% of GDP over the period 2005-2010. The erosion of trade preferences alone is estimated to have caused St. Kitts and Nevis annual fiscal losses equivalent to 3-4% of GDP.[49/] Outside ECCU, cumulative output losses of 6.5% were estimated for Guyana with the dismantling of sugar trade preferences. The output losses and the associated reductions in fiscal revenues, increased safety net expenditures, as well as the worsening external current account positions all contributed to increased financing needs of affected countries.

ECCU and some non-ECCU states (e.g. Bahamas, Belize and Jamaica), which rely heavily on tourism, suffered in the wake of the terrorist attacks in New York on September 11, 2001. Attrition in the number of tourists and associated earnings led to conspicuous reductions in government revenues. The falling demand for tourist-related services, in addition to credit constraints following the 2008 global economic crisis, caused large tourism-related construction projections to be stalled. Dwindling levels of economic activity were accompanied by a significant upturn in debt levels in four of the six tourism-intensive ECCU countries

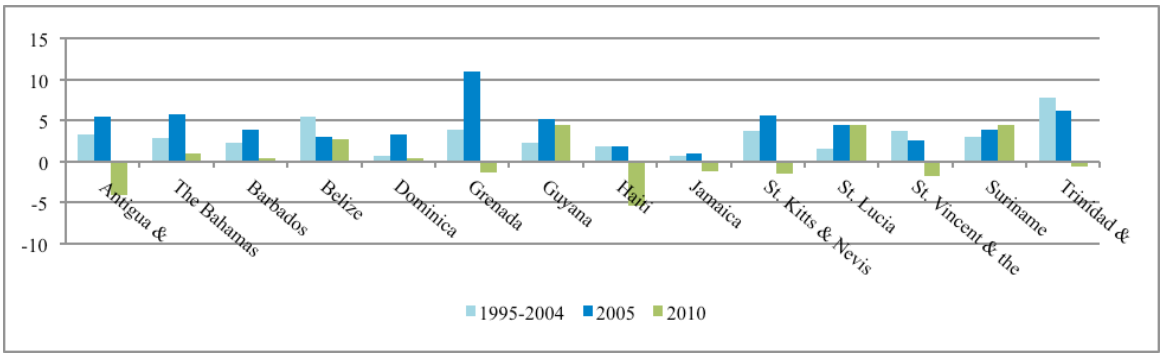
The global economic and financial crisis which began in 2006 also adversely affected Caribbean economies. The slump in external demand from the Caribbean's main trading partners, particularly the US and Europe, led to marked declines in tourism receipts and export income and a corresponding decline in economic activity. Remittances also fell significantly severely affecting countries such as Guyana, Haiti and Jamaica in which remittances exceed 15% of GDP. Many governments implemented counter-cyclical fiscal measures to offset deteriorating economic conditions. In non-ECCU countries, tourism-dependent countries such as Barbados and Jamaica saw public sector expenditures as a percentage of GDP increase by some four percentage points from 39.5 - 43.3%, and 18.4 to 22.4%, respectively, over the period 2006-09. In the ECCU public sector expenditures rose marginally to 34.4% of GDP in 2009 and revenues declined.

[49/] Sahay, R. (2005), Stabilisation, Debt and Fiscal Policy in the Caribbean, IMF Working Paper WP/05/26.

Compared to steady growth over the period 1996-2005 overall economic activity weakened across the Region between 2006 and 2009. In 2009 real output declines were experienced in every Caribbean country except for commodity exporting countries such as Suriname, Guyana, and Haiti (see Figure 2.5). While Trinidad and Tobago was unaffected by the erosion in trade preferences for agricultural commodities it suffered a marked deterioration in its external accounts as the price of oil and natural gas fell on the world market.

FIGURE 2.5:

OUTPUT GROWTH IN THE CARIBBEAN – 1995-2004 (AVERAGE.), 2005 AND 2010, (%)



Source: CDB, ECCB

Constrained by lower growth and widening deficits, public debt-to-GDP levels rose significantly in almost every Caribbean country over the period 2008-2010, as governments increasingly relied on debt to fund their budgets. Only Guyana and Haiti witnessed declines in public debt-to-GDP levels as they benefited from comprehensive debt restructuring agreements which included debt forgiveness.

Sharp increases in world oil prices and in the cost of food had a significant impact on external balances as well. With the exception of Trinidad and Tobago Caribbean countries are net oil importers and the steep rise in oil prices led to a pronounced widening of current account deficits. Increases in food prices also had a severe impact on current account balances particularly for net food importers such as Haiti, Grenada, and Jamaica.

Compared to a current account deficit averaging 17.5% of GDP over the period 1996 to 2005, ECCU current account deficits widened to an average of 31% of GDP over the ensuing five years. In almost all Caribbean countries except Belize, Suriname, and Trinidad and Tobago, current account deficits doubled on average over the period 2006-2010 compared to that of 1996-2005.

Natural Disasters

The Caribbean's vulnerability to external economic shocks is exacerbated by its extreme vulnerability to natural disasters. The Region is vulnerable to tropical storms, earthquakes, volcanoes, and drought. The United Nations Environmental Programme (UNEP) Environmental Vulnerability Index (EVI) shows that two-thirds of all Caribbean countries are classified as "highly vulnerable" or worse (see Table 2.1). Only two Caribbean countries, Guyana and Suriname, are assessed as resilient in the face of natural disasters.

TABLE 2.1:

CARIBBEAN COUNTRIES - ENVIRONMENTAL VULNERABILITY

Extremely Vulnerable	Highly Vulnerable	Vulnerable	At Risk	Resilient
Barbados	Cayman Islands	Anguilla	The Bahamas	Guyana
British Virgin Islands	Dominica[50/]	Antigua and Barbuda	Belize	Suriname
Grenada	Haiti	Turks and Caicos Islands		
Jamaica	Montserrat			
St. Lucia	St. Kitts and Nevis			
Trinidad and Tobago	St. Vincent and the Grenadines			

Source: UNEP and the South Pacific Applied Geoscience Commission Global EVI website

Most of the Region is vulnerable to hurricanes. Since 2000, hurricanes have increased in both frequency and intensity. Over 2000-09, a record number of eight Category 5 hurricanes occurred in the Atlantic. Three of those hurricanes (Ivan, Emily, Dean) tracked through the Caribbean causing substantial damage in their wake. Hurricane Ivan in 2004 had a devastating impact on Grenada causing damage valued in excess of 200% of the country's GDP. Hurricane Emily in 2005 also affected Grenada as well as Belize, and Hurricane Dean in 2007, caused extensive flooding and loss of life in many parts of the Caribbean. The rapid succession of powerful hurricanes in 2008 such as hurricanes Fay, Hanna and Ike, as well as the passage of tropical storm Gustav, caused extensive damage to food crops and infrastructure, and resulted in over 300 deaths in Haiti. Damage inflicted in the Cayman Islands by Hurricane Paloma in 2008 and in Monsterrat by Hurricane Earl in 2010, caused a contraction in economic activity and deterioration in fiscal balances.

The Caribbean is also at risk of earthquakes and volcanoes. Haiti suffered a devastating earthquake in January 2010. Registering a catastrophic magnitude of 7.0, the earthquake caused over 300,000 deaths, displaced over three million people, and made more than a million homeless. Haiti has yet to recover, even with considerable international humanitarian aid and relief effort. In 2007, both Dominica and St. Lucia were affected by a 7.3 magnitude earthquake causing significant damage and leading to an insurance payout by CCRIF. The 1995 eruption of Montserrat's Soufriere Hills volcano left the southern half of the island uninhabitable and debilitated the country's economy. Recovery is still underway more than 15 years afterwards.

In the wake of natural disasters government's efforts at recovery, rehabilitation and reconstruction led to large and unplanned expenditures which are often funded by debt, primarily from external sources. In the past official bilateral donors were a significant source of emergency funding but increasingly, Caribbean countries have sought assistance from MFIs, most notably the IMF, which provides relatively quick-disbursing, emergency assistance under its *Rapid Credit Facility*. Over the period 2000-2010, half of the 10 countries that have obtained IMF assistance under this facility for natural disasters were from the Caribbean (see Table 2.2). Not surprisingly, the share of multilateral debt in countries' external debt portfolios has also increased over those years.

[50/] There were no data available for Dominica in the EVI. However, based on its size and location in relation to its comparators, it is considered to be highly environmentally vulnerable.

TABLE 2.2:

INTERNATIONAL MONETARY FUND EMERGENCY ASSISTANCE TO THE CARIBBEAN FOR NATURAL DISASTERS, 2000-2011

Country	Year	Event
Belize	2009	Floods
Dominica	2008	Hurricane
Grenada	2003, 2004	Hurricane
St. Kitts and Nevis	2009	Hurricane
St Lucia	2011	Hurricane

Source: IMF

Almost two-thirds of Caribbean countries that are highly or extremely vulnerable have public debt-to-GDP levels exceeding 60% (see Table 2.3). Of the other high risk countries, Trinidad and Tobago is the only moderately indebted country and all the dependencies in this category and Haiti have relatively low levels of debt. Strikingly, as of 2010, none of the "resilient" countries were highly indebted, though this was partly due to Guyana having benefitted from debt forgiveness.

TABLE 2.3:

PUBLIC INDEBTEDNESS AND ENVIRONMENTAL VULNERABILITY IN THE CARIBBEAN AS AT 2010

Item	Extremely/Highly Vulnerable	Vulnerable/At Risk	Resilient
Highly indebted (Debt/GDP > 60%)	Antigua and Barbuda Barbados Dominica Grenada Jamaica St. Kitts and Nevis St. Lucia St. Vincent and the Grenadines	Belize	
Moderately indebted (Debt/GDP 30 – 60%)	Trinidad and Tobago	Anguilla Bahamas, The	Guyana
Less Indebted < 30%	British Virgin Islands Cayman Islands Haiti Montserrat	Turks and Caicos Islands	Suriname

THE CHANGING FACE OF DEBT IN THE REGION

Debt Restructuring

Several Caribbean countries took pre-emptive measures to avoid a sovereign default by initiating debt restructuring operations (see Table 2.4). Between 2000 and 2004 only two countries undertook debt restructuring operations. However, over the period 2005-2010, six Caribbean countries conducted debt restructuring exercises involving external multilateral, bilateral and private creditors and private domestic creditors. The restructuring experience of four countries is discussed in Appendix 2.1.

Guyana and Haiti, both beneficiaries under HIPC and MDRI, received substantial debt relief and debt forgiveness. In 2006, Guyana secured relief from its main multilateral creditors under MDRI with the IMF cancelling all outstanding debts contracted by Guyana prior to January 1, 2004. In 2009 Haiti obtained USD1.2 billion in debt relief under HIPC and MDRI. Despite the debt relief, Haiti's remaining debt was still burdensome and debt advocacy groups worldwide were strident in their call for complete debt cancellation. In the aftermath of the January 2010 earthquake, much of Haiti's outstanding multilateral and bilateral debt was cancelled. IMF cancelled in full debt of USD268 million and the World Bank (WB) similarly cancelled all Haiti's remaining debt. The Inter-American Development Bank (IDB), Haiti's largest donor, cancelled all of Haiti's outstanding debt and pledged more than USD2.2 billion in grants over 10 years to help with Haiti's reconstruction and development efforts.[51/] Donor countries including Canada, France, the United States and United Kingdom also wrote-off the relatively small amounts of debt owed by Haiti.

TABLE 2.4:

CARIBBEAN COUNTRIES: DEBT RESTRUCTURING AGREEMENTS, 2000-2010

Antigua and Barbuda	2010: Bilateral creditors – Paris Club and non-Paris Club debt rescheduling. Private and public domestic creditors – debt exchange.
Belize	2006: Private external creditors – debt exchange.
Dominica	2004: Bilateral creditors – individual bilateral rescheduling agreements. Private external and domestic creditors – debt exchange.
Grenada	2005: Bilateral creditors – Paris Club and non-Paris Club debt rescheduling. Private external and domestic creditors – debt exchange.
Guyana	2003: Bilateral creditors – Enhanced HIPC (e-HIPC) debt initiative – debt relief. 2006: Multilateral creditors – MDRI – debt relief.
Haiti	2009: Bilateral creditors – HIPC debt initiative – debt forgiveness. Multilateral creditors – MDRI – debt forgiveness.
Jamaica	2010: Private domestic creditors – debt exchange.
Suriname	2008: Bilateral creditors – individual bilateral rescheduling agreements.

Source: WB, Global Development Finance, IMF Article IV Country Reports, country prospectuses

[51/] Source: IDB website

Grenada in 2005 and Antigua and Barbuda in 2010 undertook comprehensive debt rescheduling of their official bilateral external debt under the aegis of the Paris Club, extending the payment life of a combined USD126 million in current debt maturities falling due. Dominica in 2004 and Grenada in 2005 both restructured their debts with domestic and external private creditors through "cooperative" debt exchanges, swapping existing bonds and credits for longer-term bonds at lower interest rates. Belize concluded a successful debt exchange in 2007 in which all its obligations to private external creditors were consolidated into a single "super" bond with extended maturities and lower coupon rates. In 2010 Jamaica undertook a comprehensive restructuring of its entire domestic portfolio through a debt exchange (the Jamaica Debt Exchange [JDX]) in order to reduce the high interest burden of the debt and lengthen bond maturities.

Significantly, only a few of the countries' debt exchanges involved a principal "haircut" (a reduction of the principal). Dominica issued a 10-year bond with a 30% principal haircut and a 20-year bond with a 20% haircut. St. Kitts and Nevis in its 2012 debt exchange offered a discount bond with a 50% discount on the principal amount. However, none of the middle-income ECCU beneficiaries under Paris Club rescheduling received debt forgiveness. More in keeping with a temporary liquidity problem, the debt restructurings mainly afforded these countries some interim fiscal space to borrow less and grow out their problems. Nevertheless, the persistence of high debt levels post-restructuring suggests that debt deferral is insufficient to deal with the Caribbean's debt burden because the underlying problems may relate more to solvency rather than illiquidity.

Pattern of External Borrowing

Many Caribbean countries have found the structure of their external debt changing considerably over the decade. Aid from traditional Western donors has dwindled since the 1990s as assistance has been directed mainly towards low-income or post-conflict countries or for humanitarian purposes. Caribbean countries assigned credit ratings by the international ratings agencies were able to take advantage of favourable conditions in the international capital markets and rely heavily on this source of financing. Non-ECCU countries, particularly Belize and Barbados, saw an increasing share of their debt owed to private creditors in the international capital markets in the late 1990s and early 2000s.

Non-market access countries, particularly in the ECCU, relied more heavily on the MFIs and the share of lending from these sources rapidly displaced official bilateral aid in external debt portfolios. In countries such as Dominica, St. Lucia and St. Vincent and the Grenadines, multilateral loans accounted for over 60% of the total external debt from the mid-2000s onwards. As emerging market spreads widened in the international markets and debt levels increased, some non-ECCU countries, such as Jamaica, shifted their financing strategy and sought to actively engage the MFIs as a primary lending source. In addition to share-of-debt to regional development banks such as CDB, IDB and WB, the share-of-debt to the IMF has also increased. This is largely due to the spate of natural disasters in the Caribbean and the global economic slowdown which has led to widening and external imbalances.

For many Caribbean countries the composition rather than the share of bilateral aid changed. Increasingly, aid from China replaced lending from Western governments. Several Caribbean countries benefited from increased aid by switching diplomatic ties from Taiwan to the People's Republic of China. On foregoing diplomatic relations with Taiwan in favour of China, and adopting the policy of "one China", Dominica, in 2004, received USD100 million in grant commitments from China for infrastructure and social development projects. Similarly in 2005 the severing of ties with Taiwan enabled Grenada to receive commitments for new infrastructure projects immediately.

Only four Caribbean countries – Belize, St. Lucia, St. Kitts and Nevis, and St. Vincent and the Grenadines – continue to recognise Taiwan.

In November 2008 China released a policy paper on LAC outlining its programme to increase economic and trade cooperation with the Region. In 2011, at the Third China-Caribbean Economic and Trade Cooperation meetings in Trinidad and Tobago, China announced its intention to lend USD1 billion to Caribbean countries to support infrastructural development in the Region.[52/] As a consequence of the shifting political and economic ties there has been a steady ascension of Chinese loans in Caribbean external debt portfolios. While loan terms have been generally long-term and low-cost, a major change has been the growing presence of the Yuan renminbi in the currency composition of external debt portfolios. While Caribbean countries face little interest rate or rollover risk, their exposures to foreign currency risk have increased.

The Caribbean has also seen the share of lending from Venezuela increase as a result of the PetroCaribe initiative.[53/] Under the terms of the PetroCaribe agreement concessional financing is extended to participating countries for oil importation. Countries enjoy loan terms of 25 years with a two-year grace period and an interest rate of 2%. Available financing to countries varies and depends on an import quota negotiated with Venezuela. All ECCU states, as well as the Bahamas, Belize, Haiti, Guyana, Jamaica, and Suriname are participating member countries.

The combined lending of China and Venezuela has surpassed Western aid to the Caribbean in recent years with these creditors accounting for more than half of the total bilateral external debt in most ECCU countries.

Caribbean countries reliant on external financing from the international capital markets found these markets closed since the onset of the global financial crisis as market uncertainty about the length and depth of the crisis increased risk aversion. Caribbean governments have relied more heavily on the domestic capital markets or sought funding from MFIs. Similarly, countries reliant on official development assistance from traditional Western donors also experienced reduced flows as donor countries, particularly the US and the Eurozone, sought to raise funding themselves to finance their own growing fiscal deficits. China and Venezuela have emerged as significant lenders to the Region as a consequence of these developments. Table 2.5 compares the Region's credit ratings by Moody's and Standards and Poor's in 2006 and 2011.

TABLE 2.5:

RATED NON-ECCU MARKET ACCESS COUNTRIES (LONG TERM FOREIGN CURRENCY RATINGS)

	Moody's		Standard and Poor's	
Item	**2006**	**2011**	**2006**	**2011**
Bahamas, The	A3	A3	A-	BBB
Trinidad and Tobago	Baa1	Baa1	A-	A
Barbados	Baa2	Baa3	BBB+	BBB-
Suriname	B1	B1	B	BB-
Jamaica	B3	B3	B-	B-
Belize	Caa3	B3	CC	B-

Source: Moody's Investor Services and Standard and Poor's

[52/] Caribbean life news article, September 23, 2011
[53/] IMF Regional Economic Outlook (Western Hemisphere).

The Regional Government Securities Market[54/]

The global financial crisis has forced Caribbean governments to rely increasingly on financing budget gaps from their domestic markets. In the Eastern Caribbean, ECCU member states[55/] have had access to regional financing through the Regional Government Securities Market (RGSM). Established in November 2002, the RGSM is a facility for participating governments to raise financing at the lowest possible cost and is intended to aid in the development of the money and capital markets in the Eastern Caribbean.

The RGSM is regulated under the Eastern Caribbean Securities Act. All eight participating member countries have passed the act which establishes the rules of the market. In addition, the Eastern Caribbean Securities Regulatory Commission ensures compliance. A Regional Debt Coordinating Committee, comprising the governor of the ECCB and the financial secretaries and financial directors from each of the eight participating governments has direct oversight for the RGSM. It is responsible for ensuring that the market operates efficiently and that governments comply with established disclosure requirements. The RGSM uses the Eastern Caribbean Securities Exchange (ECSE) as the platform for primary market activities, the Eastern Caribbean Central Securities Registry, and the Eastern Caribbean Central Securities Depository for the trading, recording and settlement of securities.

Since the inception of the RGSM, activity within the securities market has increased steadily. The value of securities issued on the RGSM has grown from XCD75 million in 2002 to XCD4,889 million at the end of 2011 (see Table 2.6 and 2.7). With the exception of Anguilla and Montserrat[56/] all participating governments, starting with St. Kitts and Nevis in November 2002, have used the market. St. Lucia and St. Vincent and the Grenadines have been the heaviest users of the RGSM, issuing a cumulative total of XCD1,416.1 million and XCD1,945.3 million, respectively between 2003 and 2011. Since 2009, the Nevis Administration has actively participated in the RGSM issuing a cumulative total of XCD53.3 million in T-Bills.

TABLE 2.6:

EASTERN CARIBBEAN CURRENCY UNION – NUMBER OF REGIONAL GOVERNMENTS' SECURITIES MARKET AUCTIONS, 2002, 2005, 2011

Country	2002		2005		2011	
	T/Bills	Bonds	T/Bills	Bonds	T/Bills	Bonds
Antigua and Barbuda					1	2
Grenada			1		9	
St. Kitts and Nevis		1				
St. Lucia			3	2	8	
St. Vincent and the Grenadines			12		11	
Nevis Administration					1	

Source: ECCB, ECSE

[54/] Source: ECCU; Debt Watch Caribbean newsletter.
[55/] Including Anguilla and Montserrat.
[56/] Dominica made its first issue on the RGSM in 2012.

Two major types of securities are traded in the RGSM: short-term discounted T-Bills and medium- to long-term fixed-coupon bonds with maturities of up to 10 years. Securities are issued through an auction, using a uniform price format. Participating governments have concentrated issuance in short-term T-Bills. However, St. Lucia has regularly issued longer-term securities. For the first time, in 2008, St. Lucia issued two 10-year bonds for a total of XCD116 million. St Lucia made further inroads in the RGSM in 2010 by successfully issuing US dollar denominated 3, 5 and 6-year bonds in the regional market.

The RGSM has aided capital market development and provided a number of benefits to its ECCU members. The volume of issues has risen and has allowed investors to spread their risks across a wider number of governments. Governments have enjoyed the wider investor pool which has allowed them to lengthen the maturity structure of their securities. The market has deepened as the maturity period of government-issued securities has extended. In general, RGSM issues have been over subscribed and the market-determined yields have been comparatively lower than pre-RGSM administered rates.

The ECCB estimated that participating governments were able to reduce their debt service costs by XCD17.7 million in the first five years of the RGSM as yields on average fell by one to two percentage points. Secondary market trading volumes have increased since 2006 with trading most active in relation to St. Lucia and St. Vincent and the Grenadines securities. Since the RGSM's inception, the number of licensed brokers has also increased moving from 6 in 2002 to 10 at end-2011. With the exception of Montserrat, a licensed broker is located in each participating country.

TABLE 2.7:

EASTERN CARIBBEAN CURRENCY UNION - VALUE OF REGIONAL GOVERNMENTS' SECURITIES MARKET ISSUES, 2002, 2005, 2011 (XCD MILLION)

	2002		2005		2011	
Country	**T/bills**	**Bonds**	**T/bills**	**Bonds**	**T/bills**	**Bonds**
Antigua and Barbuda					8.7	60
Grenada			25.0		174.0	
St. Kitts		75.0				
St. Lucia			77.0	75.0	131.0	
St. Vincent and the Grenadines			192.0		245.0	
Nevis					20.0	

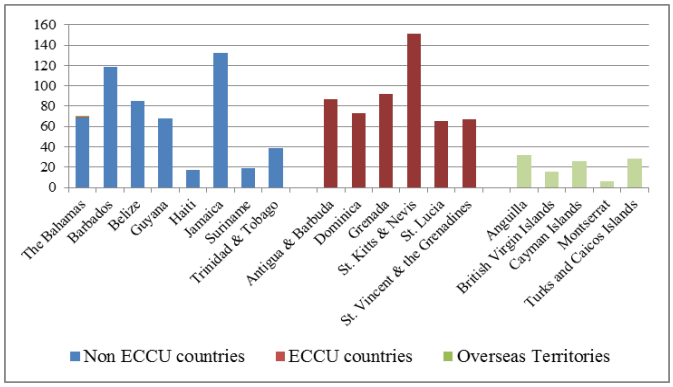
Source: ECCB, ECSE

EVOLUTION OF PUBLIC DEBT IN THE CARIBBEAN

While non-ECCU countries are highly indebted with an average public debt-to-GDP ratio of 75.7%, they are surpassed by ECCU countries with public debt-to-GDP levels averaging 89.3%. Public debt levels in the OTs, while rising, remain moderate at an average 21.9% of GDP (see Figure 2.6).

FIGURE 2.6:

PUBLIC DEBT-TO-GROSS DOMESTIC PRODUCT REGIONAL SUB-GROUPS AS AT END 2010, %



Source: CDB; ECCB

More than half of the 19 Caribbean countries are heavily indebted domestically. However, when the OTs are excluded, there is a more even distribution of external versus domestic debt, among the remaining countries. Among Caribbean countries, as of the end of 2010, The Bahamas had the highest share of domestic debt in its portfolio, accounting for more than 80% of total public debt. Barbados, the British Virgin Islands, St. Kitts and Nevis and Trinidad and Tobago all had shares of domestic debt exceeding 70% of the total. High shares of domestic debt help insulate country's debt exposure to foreign currency risk but it also carries with it other risks as discussed in Chapter 1. This section takes a detailed look at the evolution of debt in the three sub-groups paying attention to relative movements in external and domestic debt in each country covered in the study. In cases in which external debt comprised 50% or more of the total public debt, such countries are classified as externally indebted. If domestic debt constitutes more than 50% of total public debt the country is regarded as domestically indebted.

Non-Eastern Caribbean Currency Union Countries

According to Table 2.8 three of the six non-ECCU countries are classified as highly indebted, with Barbados and Jamaica having a disproportionate share of domestic debt in their public debt portfolio and Belize heavily reliant on external debt. External debt accounted for more than 50% of the public debt in Belize, Guyana and Haiti and these countries are therefore classified as externally indebted and the others as domestically indebted.

Table 2.8:

COMPOSITION OF TOTAL PUBLIC DEBT BY MARKET AS AT END-2010 (NON-ECCU COUNTRIES)

Item	Domestic Debt Share > 50%	External Debt Share > 50%
Highly indebted (Debt/GDP > 60%)	Barbados Jamaica	Belize
Moderately indebted (Debt/GDP 30 – 60%)	Bahamas, The Trinidad and Tobago	Guyana
Less Indebted < 30%	Suriname	Haiti

Source: CDB; ECCB; various countries national debt statistics

Externally Indebted Countries

Belize

Belize's debt is mainly external. At the end of 2010, external debt amounted to 72% of GDP, markedly below the 91.5% of GDP recorded in 2004 just prior to Belize's debt exchange. Total public debt amounted to 85.2% of GDP.

In the early 1990s much of Belize's debt was owed to official creditors, primarily bilateral donors. The external debt burden was moderate amounting to approximately 30% of GDP. However, in the late 1990s the Belizean authorities embarked on an aggressive effort to stimulate economic growth. A sharp rise in public investments combined with a lowering of taxes led to a sharp rise in the overall fiscal deficit of CG. Belize's debt surged and public debt-to-GDP rose from 41% to more than 100% by 2004.

The escalation in the debt was accompanied by a significant change in its composition. With a favourable credit rating obtained by both Moody's Investor Services and Standard and Poor's, Belize shifted its prior reliance on multilateral project financing and bilateral aid towards financing from the international commercial market. The share of private commercial credit rose from 7% to more than 50% of total external debt by 2006. Foreign banks and institutional investors became the major lenders to the Government of Belize. Events in the international capital markets turned less favourable in the early 2000s, and rates on sovereign issues and commercial creditors steadily increased. The weighted average interest rate on external debt stood at 10.1% at the end of 2006. A spate of tropical storms, hurricanes, and associated weather-related disasters spiked increases in public expenditure as growth slowed. Output growth fell to 3.4% in 2005 down from an astonishing 12.1% in 2000.

Belize was unable to sustain its heavy debt burden. By 2002, total debt service exceeded current revenue. Subsequently, it declined to 82.1% in 2005. External debt service was consuming one-third of exports of goods and services, and efforts to address the deteriorating economic conditions through tightened fiscal policies proved inadequate. As a result the debt became increasingly unsustainable so in a pre-emptive move, the authorities met with its creditors to agree on a comprehensive external-debt restructuring and in 2006 launched a debt exchange operation.

The 2009 global economic recession stalled economic growth in Belize that year and raised concerns from rating agencies about the fiscal sustainability of the debt. Even with a rebound in economic activity in 2010, Belize's public debt-to-GDP ratios have not fallen significantly since the debt exchange. The country still faces a large debt overhang. However, there has been an ease in the debt service burden. Total debt service as a percentage of current fiscal revenue amounted to 18.7% at the end of 2009 significantly below the levels recorded in the mid-2000s.

Guyana

Guyana has made significant progress in reducing its debt levels over the period 2000-2010. From a high of 250.4% at the end of 2002, Guyana's total debt-to-GDP has fallen steadily amounting to 68.1% at the end of 2010.

Guyana's debt problems emerged in the 1980s amid a backdrop of low growth, high inflation and large fiscal and external imbalances. In 1982 Guyana defaulted on its debt obligations thereafter accumulating substantial payments arrears. By 1985-86, IMF and WB had both cut off access to financing from their institutions as Guyana continued in default on its payment obligations. Guyana's traditional donors followed suit and aid flows principally from the United States, United Kingdom and CDB were halted. By the late 1980s, not only was Guyana's debt burden severe and its creditworthiness completely eroded but the country's relations with the international community had been virtually severed.

In 1988 Guyana embarked upon a programme of structural adjustment and reform designed to develop more of a market-oriented economy. As a part of its programme of wide-ranging reforms Guyana sought to normalise its relations with its external creditors. Over the period 1989-1993, Guyana restructured debt owed to its bilateral creditors through successive Paris Club rescheduling arrangements. While this provided short-term cash relief over time these arrangements proved costly. The capitalisation of interest arrears from repeated rescheduling led to an overall increase in Guyana's debt levels.

After qualifying for the HIPC initiative in 1997 Guyana was able to benefit from more substantive debt relief as the debt relief operations sought to ensure the long-term debt sustainability of the country. Under HIPC Guyana obtained USD256 million in debt relief in NPV terms and obtained additional relief in 2003 under the HIPC initiative when debts valued at USD334 million in NPV were cancelled.[57/]

In 2006 Guyana was able to secure relief from its main multilateral creditors under MDRI and in early 2006 IMF cancelled in full all outstanding debts some USD65 million, contracted prior to January 1, 2004. Soon after WB's International Development Association (IDA) followed suit by cancelling a USD223 million debt contracted prior to January 1, 2005 and subsequently, the IDB, Guyana's largest creditor, cancelled all outstanding debts (USD357 million), contracted prior to December 31, 2004. In addition and rounding off the largesse both China and India granted additional debt relief to Guyana and Venezuela cancelled all of the outstanding debt in 2007 and 2008, respectively. (After IDB, Guyana's second largest creditor is CDB.)

Since graduating from HIPC and MDRI debt initiatives in 2006 Guyana's debt has declined significantly. From 134.8% of GDP at the end of 2005, the external debt fell to 60.9% at the end of 2007. However, Guyana's debt as a percentage of GDP has since been rising gradually, amounting

[57/] Details of Guyana's HIPC programme are presented in Appendix 2.2.

to 68% at the end of 2010. The debt remains predominantly external as domestic debt accounts for just 3% of the total public debt at the end of 2010. Domestic debt is mostly short-term and concentrated in Treasury Bills (T-Bills). Lending from multilateral institutions constitutes more than half the share of total external debt with bilateral creditors, accounting for a 42% share.

Although Guyana is less heavily indebted it still remains at moderate risk for debt distress. Having been reclassified by WB as a lower middle-income rather than poor country in 2007, her continuing access to concessional financing may be increasingly difficult. Naturally, in the aftermath of substantial debt write-offs traditional donors might be averse to extending new concessional financing. The current global economic slowdown diminished these prospects further and concurrently triggered a deceleration in growth to 3%, in 2008.

Haiti

Haiti is the poorest country in the Latin America and Caribbean Region. Haiti's per capita GDP amounted to USD670 in 2010. Fifty-four per cent of Haitians live on less than USD1 a day and 78% live on less than USD2 a day,[58/] both indicators being well above the regional average. Haiti has had a large and unsustainable debt burden for decades. At the end of 2000, Haiti's total public external debt stood at 46.9% of GDP narrowing only marginally to 45.5% at the end of 2005.

Haiti's debt problems emerged within a context of political and economic instability, low growth, high inequality and poverty. This environment was exacerbated by Haiti's high exposure to natural disasters. External assistance to Haiti in the decades leading up to 2000 has been unstable with periods of high levels of external assistance followed by abrupt withdrawals of support. Despite its poor social and economic indicators Haiti did not initially qualify for debt relief under the HIPC initiative. However, there were strident calls from debt campaigners, especially the Jubilee Debt Campaign, for Haiti's debt to be cancelled. Advocacy groups argued that Haiti's debts were accumulated unjustly and corruptly under the former Duvalier regime.

In 2006 after continued global calls for debt cancellation Haiti became eligible for relief under the IMF/WB HIPC initiative, qualifying for partial debt forgiveness. However, calls from the international community for the immediate wholesale cancellation of Haiti's debt intensified in 2008 as Haiti faced increasing economic and social challenges. Soaring world prices for food and fuel which led to steep cost of living increases precipitated violent civic unrest. Four tropical storms and hurricanes in quick succession caused widespread devastation to farmlands and infrastructure and significant loss of life. In the aftermath of the storms, some 850,000 Haitians (10% of the population) required humanitarian assistance.

In 2009 the country completed the required reforms and other prerequisites for the e-HIPC initiative and benefited from substantial debt relief. Haiti subsequently obtained relief under MDRI with the provision of some USD972 million in relief from IDB and IDA. In 2010 following the devastating earthquake in Haiti IDA and IDB wrote-off all remaining debts owed by Haiti, as did many of Haiti's other donors. The write-offs were financed through a Post-Catastrophe Debt Relief Fund established by IMF. Public debt to GDP fell to 4.6%, from 19.6% a year earlier.

[58/] Source: United Nations Millennium Development Goals (MDGs) Indicators (2001data).

Domestically Indebted Countries

The Bahamas

Despite being the wealthiest country in the Caribbean, The Bahamas has seen a steady increase in its public debt over 2000-2010. Public debt as a share of GDP jumped from 41% in 2000 to 68.4% at the end of 2010. The increase in the debt has been mainly fuelled by rapidly falling revenues. While the Bahamas has access to the international markets and has investment grade ratings of A3 and BBB from Moody's and Standard and Poor's, respectively, it relies heavily on the domestic market for financing. Over 80% of the debt is financed from domestic creditors and the domestic debt to GDP ratio has amounted to 56.5%. On the other hand, since the late 2000s, the Bahamian government has relied on China to fund large tourism-related infrastructure projects and the IDB has been an increased source of external financing.

The global economic slowdown in 2008/09 severely affected the highly tourist-dependent country. The economy contracted by 1.7% in 2008 and by a further 4.7% in 2009, worsening the country's debt. External debt service as a share of exports of goods and services jumped from 6.6% in 2008 to 25.4% in 2009 reflecting the sharp deterioration in the external accounts. Measured as a percentage of government revenue, CG external debt service increased six-fold from 3.4 to 20.4%. Standard and Poor's downgraded the Bahamas twice over the period 2009-2011.

Barbados

Barbados' public debt is largely domestically held. Over 70% of the public debt was domestic at the end of 2010, an increase from the 57% share in 2000. In contrast to many of its ECCU peers, over 80% of Barbados CG domestic debt is long-term, helping to mitigate the rollover risk associated with short-term debt. Official creditors account for just over 52% of Barbados' public external debt. Flows from official creditors have waned and in filling the void, private creditors, in particular, investors from the international capital markets account for a considerable share of the external debt.

Sovereign debt issues from Barbados enjoyed investment grade status for much of the decade with Moody's assigning a Baa2 on long-term foreign currency debt, and Standard and Poor's a BBB+ rating.

The Barbados economy relies heavily on tourism and financial services. Therefore the 9/11 attacks of 2001 in the United States and the global slowdown that followed exposed Barbados' high vulnerability to external shocks and the country went into recession. In response, government embarked on a major public investment programme accompanied by substantial increases in public sector wages. Consequently, the fiscal deficit increased from 2% in 2001 to some 13% two years later. Debt-to-GDP jumped from 87% in 2000 to 107% in 2003.

With a rebound in economic activity in 2003 public debt levels fell to an average 82% of GDP changing little over the ensuing five-year period. However, a significant increase in off-budget activities, particularly PPPs and the deficits of a number of loss-making public enterprises, led to a steep rise in the public debt. Adding to the burden was the sizeable investments in infrastructure to host the Cricket World Cup (CWC) held in 2007. Thus, by the end of 2008, Barbados' public debt-to-GDP ratio had risen to 103% of GDP.

In 2009 and 2010 the Barbados economy contracted by 5.5 and 0.5%, respectively, and there was a widening of the deficits in the fiscal and external accounts. Public debt increased to 118.4% of

GDP. Both rating agencies downgraded Barbados to below investment grade status and, coupled with heightened uncertainty in the international capital market, sovereign issuance was not a viable option. Increased borrowing from the domestic markets was therefore the alternative.

In 2010, the authorities prepared a medium-term fiscal strategy (MTFS) which outlined the country's intentions to achieve fiscal and debt sustainability through a number of fiscal adjustments. The aim was to balance the budget over the medium term and reduce debt-to-GDP levels to 90% by 2015. To lower the cost of debt the strategy document outlined steps to substitute borrowing in the international capital markets with more concessional financing. The authorities also took a number of steps to strengthen institutional arrangements for public debt management.

Jamaica

Jamaica is ranked as the second most heavily-indebted country in the Caribbean and, at the end of 2010, ranked among the top five most heavily-indebted, middle-income countries in the world. Jamaica's public debt amounted to USD17.3 billion or 132% of GDP at the end of 2010. Jamaica had a credit rating of B3 from Moody's Investor Services, and a B– from Standard and Poor's at the end of 2010.

At the end of 2010, Jamaica's public debt was almost evenly divided between external and domestic creditors, with domestic debt accounting for the slightly larger share at 51.6%. Domestic debt has accounted for the greater share of the portfolio since the mid-1990s when, after successive Paris Club and commercial bank rescheduling Jamaica decided to increase its reliance on domestic financing. High interest rates through most of the 1990s and early 2000s, combined with a high share of floating-rate debt has made domestic debt particularly burdensome. Domestic debt service payments consumed more than 90% of CG revenues and 60% of the total government budget in 2009. Domestic interest payments accounted for over 76% of total interest payments.

External debt amounted to 64% of GDP. From USD3.4 billion in 2000, Jamaica's external debt has more than doubled to USD8.4 billion in the past 10 years. Debt is owed primarily to private investors in the international capital markets although this trend has changed since 2007 when Jamaica embarked on a deliberate policy to secure greater funding from MFIs. Jamaica's international credit ratings have been constrained by its high level of indebtedness and payments burden. Her ratings are two notches lower than when first rated in 1998. However, a low external debt service ratio and the legislated priority of making debt the first call on the budget has been a positive factor when assessing the riskiness of the debt.

Jamaica restructured its domestic debt portfolio in January 2010 with the execution of the JDX. The aim of the exercise was to reduce rollover and interest rate risk in the portfolio. Jamaica secured forty two billion Jamaican dollars (JMD42 billion) (USD500 million) in annualised interest savings from the JDX, as well as a considerable lengthening of debt maturities. The restructured portfolio resulted in the rebalancing of the portfolio between fixed- and floating-rate debt with the share of fixed-rate debt increasing by 7% to 41% of total domestic debt.

Suriname

Suriname has had gradually improving debt ratios over the last decade. Second only to Haiti, Suriname's public debt, at 29% of GDP, was the lowest in the Caribbean at the end of 2010. The debt was already relatively modest at 47% of GDP in 2000 and the country has enjoyed steady economic growth throughout the 2000s with real GDP growth averaging over 4% per annum

from 2006-2010. Except for 2009 with the onset of the global financial crisis improved terms of trade have left surpluses on the external current accounts each year since 2006, reflecting strong commodity prices for oil and gold. Fiscal surpluses have also been maintained for much of the second half of 2000.

In 2002, Suriname took considerable steps to strengthen public debt management. New debt legislation, the National Debt Act (NDA), was passed setting a ceiling on total public debt of 60%. Sub-limits of 45 and 15% of GDP were established on external and domestic debt, respectively. A separate debt management office (DMO) was established in late 2003 and entrusted with the responsibility of managing Suriname's debt.

In 2004, Moody's assigned the public debt a B1 rating on the basis of its low level of indebtedness, fiscal surpluses and improving external balances associated with the boom in oil and gold prices. Fitch, for their part, assigned a foreign currency Issuer Default Rating of "B" and a local currency Issuer Default Rating of "B+".

At the end of 2010 less than one-third of Suriname's public debt was contracted from external sources. External debt is long-term and is obtained primarily from official multilateral and bilateral sources. As a result, Suriname's external debt has largely been borrowed on concessional terms with low interest rates and long maturities. As a consequence, external debt service as a percentage of exports of goods and services has been low.

Aid traditionally received from the Dutch government has been replaced by lending from non-traditional donors. Since 2007 China and India have been Suriname's largest bilateral donors and IDB the largest multilateral donor. In 2011 IDB announced a new country strategy for Suriname aimed at supporting efforts to modernise the public sector and diversify the economy. Lending under the new programme is expected to almost triple increasing from USD103 million under the previous country strategy to USD300 million over 2011-15. Suriname also receives funding from the Islamic Development Bank, the only country in the Region to do so.

In earlier years, Suriname had accumulated large external debt arrears which arose as a result of government having had to assume the debts of several private sector companies. In 2008 arrears on that debt amounted to 5% of GDP and were owed primarily to Brazil and the United States. In 2009 Suriname entered into debt renegotiations with Brazil to clear its arrears and repay its debt. Brazil wrote-off approximately 38% of the total arrears outstanding and Suriname, with financial assistance from the Dutch government, repaid the remaining amounts.

Domestic debt accounted for 67% of the debt portfolio at the end of 2010. Suriname has a thin domestic capital market and domestic financing is obtained either through a Central Bank overdraft facility or from the commercial bank sector. Domestic debt is primarily issued as short-term T-Bills and held mainly by commercial banks.

In early 2011 Suriname rebalanced the stipulated exposure limits for its debt. The exposure limit for domestic debt was raised from 15 to 25% and the external debt limit was lowered from 45 to 35%. This makes Suriname less exposed to exchange rates. However, increased borrowing in the domestic markets at short term may increase the country's exposure to rollover risk.

Trinidad and Tobago

The economy of Trinidad and Tobago is heavily dependent on oil and gas production. This sector contributes some 40% to the country's GDP. The twin-island republic, with per capita GDP of USD16,250 in 2010 is one of the wealthier countries in the Region.

Trinidad and Tobago enjoys the highest credit rating among its peers in the Region with an assigned Baa1 from Moody's at the end of 2010 and an A- from Standard and Poor's. The Caribbean Information and Credit Rating Services Ltd. (CariCRIS), the regional credit ratings agency, also assigned Trinidad and Tobago the highest regional rating of CariAAA. In addition to access to the international capital markets, Trinidad and Tobago has a well developed securities market in which a high volume of government securities are traded. Securities are auctioned on a uniform price basis and issued in dematerialised form. Government uses government securities intermediaries to trade in longer-term government bonds either on their own account or on behalf of other investors. Secondary market trading is facilitated through transactions on the Trinidad and Tobago Stock Exchange. Given the relatively deep market, domestic debt constitutes the largest share of public debt. Box 2.1 provides further analysis on the role of Trinidad and Tobago as a creditor in the Region.

After sustained economic growth averaging 7.9% over the period 1996-2005, economic activity slowed to 2.3% in 2008 and then contracted by 3.5 and 1.2% in 2009 and 2010, respectively. Trinidad and Tobago was severely affected by the global financial crisis and the fall in energy prices. These developments were exacerbated by the collapse of a large financial conglomerate, CL Financial Limited, which led to a costly intervention by the Trinidad and Tobago government. The global economic downturn eroded the large fiscal surpluses enjoyed by government and in 2009 negative fiscal balances emerged. The deteriorating fiscal balances caused a general rise in Trinidad and Tobago's public debt. Debt as a share of GDP rose from 23% just before the onset of the crisis in 2008 to 38% at the end of 2010. Total debt service as a percentage of current revenues jumped from 6% in 2007 to 16% in 2009. Similarly, domestic debt increased its share from 73% in 2009 to 78% in 2010 and rose as a share of GDP from 18 to 30%. The increases in official domestic debt were accompanied by a substantial build-up in arrears to contractors.

Trinidad and Tobago's external debt is relatively small, making up less than one-quarter of total public debt. Most of the external debt is long-term and denominated in United States dollars. Since 2010, like elsewhere in the Caribbean, Trinidad and Tobago has made increased use of funding from IDB and has increased borrowing from China.

Substantial contingent liabilities amounting to over 44% of total public debt in 2010 present the greatest risk to Trinidad and Tobago's debt portfolio, especially in the aftermath of the CLICO collapse. Trinidad and Tobago's contingent liabilities comprising explicit guarantees and letters of comfort rose from 10.1% in 2008 to 17% in 2010.[59/]

[59/] These annual figures are at end-September.

Box 2.1 – THE ROLE OF TRINIDAD AND TOBAGO AS A CREDITOR

Benefiting from significant revenues from its mineral gas sector, Trinidad and Tobago has the long-standing distinction of being both a regional donor, as well as a borrowing nation. Since the 1970s ECCU countries and non-ECCU countries such as Guyana and Jamaica have been beneficiaries of significant financial assistance through loans and grants from the twin-island state.

In addition to extending loans, Trinidad and Tobago has also extended substantial debt relief to countries in the Region. Since the early 1980s Trinidad and Tobago has participated as a non-OECD Paris Club creditor in rescheduling, on highly concessional terms, debt owed to it by both Jamaica and Guyana. In 2005, under the terms of the e-HIPC initiative, Trinidad and Tobago rescheduled substantial debts owed to the country by Guyana. These included loans under the Trinidad and Tobago funded CARICOM Oil Facility, as well as loans to Guyana for BOP support.

In 2006, to strengthen and deepen relations within the Caribbean region, the Government of Trinidad and Tobago established the CARICOM Petroleum Stabilisation Fund. The Fund, with an annual allocation of TTD420 million, assists countries in the Region in times of high international energy prices. Trinidad and Tobago has also provided substantial assistance to ECCU member countries both through its contributions to the CARICOM Regional Development Fund and, more recently, by providing liquidity support to countries affected by the collapse of BAICO and CLICO. A USD50 million special facility was established for this purpose.

Trinidad and Tobago has also provided emergency relief to countries throughout the Region. In 2008, the authorities pledged USD4.2 million to three Caribbean countries, Jamaica, Haiti and Cuba affected by hurricanes. While Jamaica and Haiti as CARICOM members received funds through the CARICOM Petroleum Stabilisation Fund, Cuba received funds from Trinidad and Tobago through a special contingency fund. Similar assistance was also provided to a number of countries, particularly St. Lucia and St. Vincent and the Grenadines, after the passage of Hurricane Tomas in 2010. Haiti received significant assistance from Trinidad and Tobago in the aftermath of the January 2010 earthquake. An Earthquake Relief and Reconstruction Account was established by the authorities to specifically assist in relief and recovery efforts and this was further buoyed by a USD1 million contribution from the CARICOM Petroleum Stabilisation Fund.

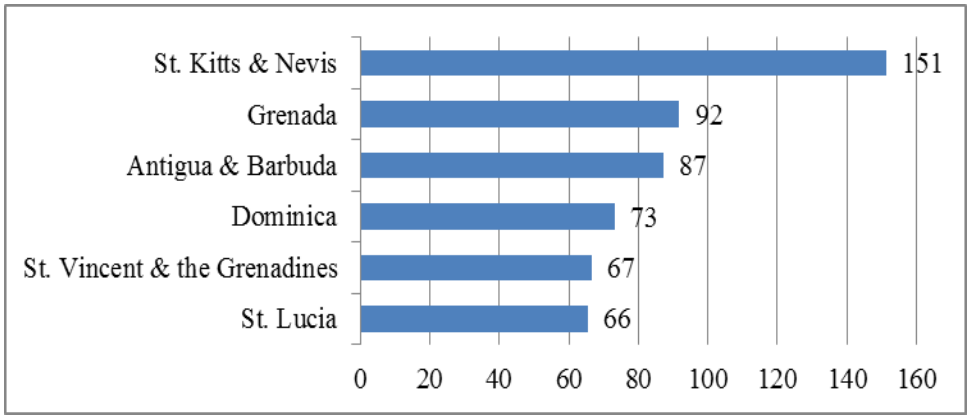
Eastern Caribbean Currency Union Countries

At the end of 2010, the countries in the ECCU were the most highly indebted of the three analytical regional subgroups (ECCU, non-ECCU and OTs). Public debt levels as a percentage of GDP among ECCU countries averaged 89.3%, well above the 75.7% average for non-ECCU countries (excluding Haiti) and vastly higher than the 21.5% average recorded for the five OTs.[60/] All ECCU countries had public debt-to-GDP levels above the 60% that the ECCU has established as its benchmark sustainability ratio and which it aims to achieve by 2020 (see Figure 2.7).

[60/] This is based on a simple arithmetic average for the six independent member states of the ECCU.

FIGURE 2.7:

EASTERN CARIBBEAN CURRENCY UNION COUNTRIES PUBLIC DEBT-TO-GROSS DOMESTIC PRODUCT, END-2010 (%)



Source: CDB; ECCB;

Since 2005, three of the six ECCU countries have restructured their debt indicating the severity of the debt burden and the efforts to achieve debt sustainability. Antigua and Barbuda, Dominica and Grenada have all undertaken a comprehensive restructuring of their debt. In 2011, St. Kitts and Nevis announced its intention to restructure its debt through a debt exchange. With support for the exchange provided by CDB through a partial guarantee, SKN hopes to secure substantive debt relief to address its severe debt overhang.

All ECCU countries have debt ratios exceeding the benchmark 60% and are regarded as highly indebted. All, with the exception of Antigua and Barbuda, have traditionally relied more heavily on funding from external markets. As a result, four of the six ECCU countries are primarily externally indebted. Grenada's external debt accounts for approximately 75% of its total public debt followed closely by Dominica which owes 70% of its debt obligations to external creditors (see Table 2.9).

Table 2.9:

EASTERN CARIBBEAN CURRENCY UNION COUNTRIES - COMPOSITION OF TOTAL PUBLIC DEBT BY MARKET AS AT END-2010

Item	Domestic Debt Share > 50%	External Debt Share > 50%
Highly indebted (Debt/GDP > 60%)	Antigua and Barbuda St. Kitts and Nevis	Dominica Grenada St. Lucia St. Vincent and the Grenadines
Moderately indebted (Debt/GDP 30 – 60%)		
Less Indebted < 30%		

Source: CDB; ECCB; various countries national debt statistics

Externally Indebted Countries

Dominica

At the end of 2010, Dominica had a total public debt of 73% of GDP notably lower than its peak of 105% in 2001 and lower than the 101% in the year immediately prior to its 2004 debt exchange. Since 2005, Dominica's public debt as a percentage of GDP has been gradually declining, dropping to its lowest level of 66% in 2009.

In 2000, Dominica had high shares of both external and domestic debt. Domestic debt accounted for a little more than half the total public debt - largely owed to its social security entity. However, over the course of the early 2000s with steadily deteriorating public finances and a substantial build-up in domestic arrears Dominica increasingly financed its budget from external sources. As a result the debt composition was significantly altered. By 2003 almost 70% of Dominica's debt was external and owed primarily to MFIs with a 64% share. Debts owed to private external creditors accounted for 13% of Dominica's external debt. External debt service payments as a percentage of exports of goods and services rose from 10.1% in 2000 to 11.6% in 2003.

Dominica's external debt structure proved challenging when in 2004 it took pre-emptive action and sought to restructure its debt. Multilateral institutions are generally not a party to debt relief agreements and a large pool of commercial creditors increases the difficulty of agreeing on restructuring terms. However, Dominica was successful in renegotiating its debt with CDB, its largest multilateral creditor, refinancing its obligations with longer maturities and lower interest rates. Dominica found securing agreement among its private creditors more difficult, and at the closing of its debt exchange in 2004 only a 74% participation rate had been achieved. Some private external creditors proceeded with legal action against Dominica to maintain the original terms of their claims. As a "good faith" gesture, Dominica sought to address the problem of holdouts by paying outstanding obligations into an escrow account to be disbursed to claimants on acceptance of the terms of the debt exchange.

While in the last half of the decade Dominica's economic performance was affected by rising international oil prices, adverse weather conditions and a slowdown in the main tourism and agricultural sectors, the debt situation improved as a result of the debt exchange, tighter fiscal management and significant grant inflows. On completion of its debt restructuring Dominica implemented a debt reduction strategy largely predicated on containing recurrent expenditures. Wages, which accounted for roughly 50% of government recurrent expenditures, were more closely linked to productivity increases and the authorities undertook some rationalisation of the public sector. Dominica also sought to rely more heavily on grant rather than loan financing, particularly from China and Venezuela. Increased grant inflows from these sources helped in further reducing Dominica's debt burden. Reflecting these measures, total public debt service as a share of current revenue has gradually fallen by more than half, from 25% in 2000 to 11% a decade on. The country's external debt service as a share of exports of goods and services has also declined over the same period from 10 to 7%.

Grenada

Grenada ranks among the top five most heavily-indebted middle-income countries in the world and the third most highly-indebted country in the Caribbean. Total public debt-to-GDP amounted to 92% in 2010.

External debt has grown steadily through the 2000s accounting for 75% of Grenada's total public debt at the end of 2010, *vis-a-vis* 57% at the start of the decade. Initially, official multilateral and bilateral creditors financed the bulk of Grenada's external debt. With little aid from Western donors, Grenada turned "south" to borrow. Loans from Taiwan formed the major share of official bilateral debt used mainly to fund large infrastructure projects. However, in 2002 Grenada began borrowing heavily from commercial sources through bond issuance. The share of external debt owed to official creditors fell from 72% in 2000 to 36% in 2002 and at the end of 2010 amounts to 54% of total external debt. Debt owed to private commercial creditors which amounted to more than half of the debt in 2002 stood at 37% at the end of 2010.

From 42% in 2000 the share of domestic debt has averaged 26% for most of the decade. Domestic debt has been funded largely by Grenada's public entities in particular the social security system although reliance on commercial sources has increased over the years. Domestic debt amounted to 23% of GDP at the end of 2010.

Grenada's high debt levels originated initially from expansionary fiscal policies adopted in the early 2000s in an effort to stimulate economic activity after the September 2001 terrorist attacks and the consequential slowdown in the global economy. In 2002 Grenada's overall fiscal deficit amounted to a staggering 19.3% of GDP. In 2003 public spending increased further after damage caused by tropical storm Lili and Grenada's public debt surged to 82% of GDP, coming from 46% in 2000. In 2004 Grenada sustained devastating damage with the passage of hurricane Ivan. Damage was estimated at more than 200% of GDP and the economy contracted by 3%. Large hurricane relief expenditures coupled with a 47% drop in revenues gave rise to a further widening of the fiscal deficit. Close to imminent debt default, Grenada declared a debt moratorium at the end of 2004 and in 2005 implemented a comprehensive debt restructuring package with its external and domestic creditors. Overall the debt restructuring was largely successful. However, Grenada, having switched ties to the People's Republic of China in January 2005, was unable to reach an agreement on restructuring terms with Taiwan its largest bilateral creditor.

While public debt-to-GDP levels in Grenada fell in the immediate years after the exchange the decline was not sustained. After falling to 79% in 2008, the debt-to-GDP ratio rose to 90% in 2009, inching higher again in 2010. Total debt service as a share of current revenues more than doubled over the period 2006-09, rising from 12.7 to 25.3% and falling only marginally lower to 21% in 2010. The upturn in the debt indicators largely reflects the sharp 7.7% contraction in the Grenadian economy in 2009, as the global economic crisis deepened.

St. Lucia

St. Lucia depends mainly on tourism since the once-dominant agricultural sector led primarily by banana exports has declined in recent decades. Changes in the European Union trade preference regime in the 2000s, coupled with increased competition from Latin American bananas led to a marked contraction in agricultural sector output. St. Lucia is also vulnerable, even in the Caribbean context, to external shocks, and is categorised by WB as one of the world's most disaster-prone countries. In 2007 St. Lucia suffered from both a devastating hurricane (Deana), as well as a strong earthquake.

Although low relative to other ECCU states, debt as a share of GDP has been gradually rising. At the end of 2010, the debt-to-GDP ratio was 66%, the lowest among ECCU states, in contrast to 45% at the start of the decade. External debt amounted to 33% of GDP and domestic debt accounted for an additional 23%.

Over the decade, St. Lucia's public debt growth has reflected increasing fiscal imbalances. Public sector wage increases, as well as large increases in capital expenditures, led to an increase in the overall fiscal deficit from a mere 1% of GDP in 2000 to 6.4% in 2005. After reaching near balance in 2008 the fiscal deficit widened again reaching 4.3% in 2010.

The debt structure has changed markedly during the 2000s. Aid and grant flows from donor governments have been declining steadily over the decade and, since 2002, external financing from commercial creditors has also fallen. As a result St. Lucia's external funding has come increasingly from multilateral sources, and accounts for over 65% of total external debt outstanding at the end of 2010.

The changes in the external debt structure have been accompanied by a growing share of domestic debt. At the end of 2010 domestic debt accounted for almost a half of total public debt, with commercial banks being the primary source of domestic financing to government. Domestic borrowing has increasingly been through securities issuance and St. Lucia has taken advantage of RGSM to issue both local and foreign currency (USD) securities. While much of the securities issues on the RGSM have been short-term T-Bills, there has been a general move to issue longer-term securities so in 2008 the first 10-year bond on the RGSM was issued.

The global economic slowdown severely affected tourism in St. Lucia and real output contracted by 5.5% in 2009. Debt burden indicators worsened with total debt service as a share of current revenues reaching 33.5%, and external debt payments as a share of exports increasing to 11.6%. Faced with a widening deficit on both its fiscal and external accounts, as well as substantial increases in unemployment, St. Lucia requested financial assistance from the IMF to help mitigate the impact of the global crisis on its economy. In response IMF approved USD10.7 million under the rapid-access component of its Exogenous Shocks Facility. While recent debt sustainability analysis places St. Lucia at moderate risk of debt distress,[61/] concerns remain about St. Lucia's ability to achieve debt sustainability by 2020, given the protracted nature of the global economic slowdown and the country's high vulnerability to external shocks.

St. Vincent and the Grenadines

St. Vincent and the Grenadines is among the least indebted of the ECCU countries. It is among the few ECCU countries with an international credit rating, and since 2007 has been rated B1 by Moody's Investor Services on its domestic and foreign currency long-term debt.

External debt accounted for 68% of St. Vincent and the Grenadines total public debt, changing little from 10 years earlier. Lending from multilateral institutions constitutes the largest share, with just over 62% of total external debt outstanding. Official bilateral donors hold a further 19% of St. Vincent and the Grenadines' external debt.

St. Vincent and the Grenadines has maintained a much smaller share of domestic debt, averaging just over 30% over the decade. In 2010, the portfolio was fairly evenly divided between loans and debt securities. St. Vincent and the Grenadines is the heaviest issuer on the RGSM. In 2010, RGSM securities issues amounted to XCD245 million, up 27% from the value issued in 2005. Issues in the RGSM have been primarily short-term T-Bill issues and as a result St. Vincent and the Grenadines faces fairly high exposures to refinancing risk.

[61/] See 2020 St. Lucia IMF Article IV Consultation Staff Report.

In 2010, after extensive damage by hurricane Tomas, the country requested assistance from its main development partners to help rehabilitate key infrastructure, and received financing from WB, CDB, and IMF under its quick disbursing Rapid Credit Facility.

Domestically Indebted Countries

Antigua and Barbuda

At the end of 2010, Antigua and Barbuda was ranked the fifth most heavily indebted country in the Caribbean with a total public debt-to-GDP ratio of 87%. The ratio, while high, was a significant improvement from 2004 when debt was at its highest for the decade, at 134%.

Antigua and Barbuda's debt composition has changed over time with the share of domestic debt steadily increasing. From a 43% share of the debt in 2000, domestic debt rose to a high of 64% in 2009 before declining moderately to 57% in 2010. Much of the domestic debt is financed by commercial banks (40%) although public statutory bodies including the Social Security Board (SSB) and the Medical Benefits Board also account for a considerable share. While Antigua and Barbuda has issued securities on the RGSM, activity has declined over time and except for two bonds issued in 2010, little other activity has taken place in recent years.

External debt is primarily owed to official bilateral donors. These creditors accounted for almost 95% of external debt outstanding in 2000, with the share shrinking to 60% at the end of 2010. Private commercial creditors held some 15% of Antigua and Barbuda's external debt.

The accumulation of debt in Antigua and Barbuda had its genesis in the 1980s when fiscal balances widened significantly as the sugar industry declined and the economy shifted to tourism. With government acting as employer of last resort the transition led to a significant expansion of the public sector wage bill. This, combined with heavy damage from a series of hurricanes in the 1990s led to a further deterioration in the fiscal accounts financed largely by the accumulation of debt arrears.

In 2004 a number of reforms were introduced by government most notably an overhaul of the tax system and the suspension of discretionary tax concessions. This along with a rebound in economic activity, was expected to help reduce the large fiscal deficits which amounted to 6% of GDP in 2004. Despite these efforts Antigua and Barbuda's fiscal imbalances actually grew to 8% of GDP in 2006.

Large and growing fiscal deficits translated into substantial debt accumulation. Public debt grew from 102% of GDP at the end of 2000 to a peak of 134% at the end of 2004. In 2005 Antigua and Barbuda took the decision to normalise relations with creditors and prevent a further accumulation of arrears. Over the period 2006-09 the debt-to-GDP gradually declined but arrears continued to accumulate. By 2009 debt arrears amounted to 45% of the total public debt outstanding or 53% of GDP.

The collapse of the Stanford Financial Group under fraud allegations and the failures of CLICO and BAICO had a deleterious impact on Antigua and Barbuda's economy, and threatened the overall stability of the financial system. In 2009 alone economic activity contracted by 9% and a primary deficit of 10.9% was recorded in the fiscal accounts. By 2010, the authorities decided to undertake a major restructuring exercise involving both external and domestic private creditors and official overseas donors. Mainly as a consequence of debt restructuring public debt fell from 96% just prior

to the restructuring, to 87% by end-2010. The fiscal burden of the debt diminished also with total debt service as a percentage of current revenue falling from 37% at the end of 2006 to 16% at the end of 2008.

St. Kitts and Nevis

The total public debt-to-GDP of St. Kitts and Nevis amounted to 152% at the end of 2010 placing the country as the most heavily-indebted, middle-income developing country in the world. St. Kitts and Nevis has sustained high debt levels over the whole decade with ratios below 100% only in 2000. In addition to a large debt overhang St. Kitts and Nevis debt service indicators are also onerous. Debt service consumed more than one-quarter of all government's current revenues in 2010 – only moderately lower than the 32.5% share consumed in 2005.

St. Kitts' domestic debt comprises more than 70% of total public debt, and at end-2010 domestic obligations alone amounted to 107% of GDP. In recent years the government has relied increasingly on domestic borrowing as conditions in the international capital markets have made it difficult to borrow externally. Domestic debt is primarily made up of commercial bank overdrafts and short-term T-Bills which account for over 25% of total domestic debt. The twin-island republic also relies heavily on its SSB for debt financing. With the exception of a 10-year XCD75 million bond in 2002, no further issuances have occurred on the RGSM. The Nevis Administration however, has continued to borrow on the RGSM.

Whereas in 2000 the external obligations of St. Kitts and Nevis were mainly to official bilateral creditors, the creditor composition changed over time reflecting declining aid flows. In 2010, MFIs claimed 46% of the country's external debt while official donors claimed less than 10%. St. Kitts and Nevis has accumulated significant external arrears and combined with high domestic debt obligations, public debt has become largely unsustainable. The substantial build-up of debt reflected fiscal deficits and the assumption of liabilities of the former state-owned sugar company.

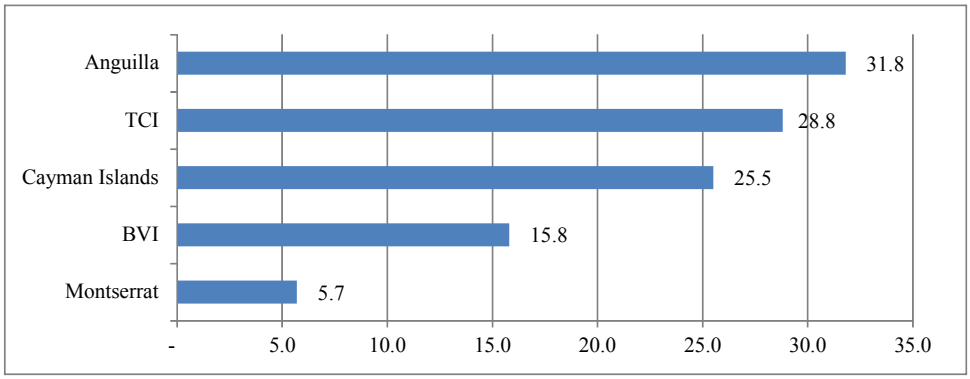
In common with other ECCU countries the St. Kitts and Nevis economy contracted in 2009 and 2010 reflecting the impact of the global economic slowdown on the highly tourism-dependent economy. In March 2012, the authorities comprehensively restructured both external and domestic debt when USD150 million or close to 10% of the total public debt was exchanged for new securities. Under the terms of the exchange, creditors could choose to exchange their existing instruments for either new discount bonds, denominated in US dollars, or new par bonds, denominated in XCD. CDB has provided significant support by guaranteeing the new discount bonds, enabling a 50% reduction in the nominal value of the bond. The new Discount bonds have a 20-year maturity. In addition to the exchange, domestic banks converted USD600 million of debt to equity stakes in a special purpose vehicle holding government assets. The remaining debt outstanding, comprising mainly T-Bills or debts owed to multilateral institutions, was not affected. The debt exchange was highly successful with a participation rate of 97%.

The Overseas Territories

The OTs have had low debt-to-GDP levels at or below 15% for most of the 2000s. However, since 2008, debt levels have increased in all territories except Montserrat, with the rise in debt-to-GDP most pronounced in Anguilla and the Turks and Caicos Islands. Public debt/GDP almost tripled in the Cayman Islands and more than doubled in Anguilla, the British Virgin Islands and Turks and Caicos Islands (see Figure 2.8). Nevertheless, only Anguilla is considered moderately indebted.

FIGURE 2.8:

OVERSEAS TERRITORIES – DEBT/GROSS DOMESTIC PRODUCT 2010 (%)



Source: CDB; ECCB; various countries national debt statistics

All of these territories were affected by the global financial crisis and the ensuing economic contraction in the United States and Europe which severely affected tourism receipts and associated revenue inflows and stalled economic growth in these small island economies. Anguilla's economy contracted by 17% in 2009 and Montserrat's declined by 5.6% in 2010. Natural disasters also contributed to the rising debt ratios during the latter half of the decade. Hurricane Paloma had a devastating impact on the Cayman Islands in 2008, and a small volcanic eruption and the passage of Hurricane Earl in 2010 caused economic dislocation in Montserrat. These events contributed to the territories' weakened economic performance and deterioration in public finances and substantial rise in indebtedness.

All of the territories are subject to official borrowing guidelines established by the United Kingdom government's FCO. The guidelines require maintaining public debt below 80% of current revenue and debt service at less than 8% of current revenue.[62/] The guidelines also specify that government cash reserves should be sufficient to cover 90 days of government expenditures.

Domestically Indebted Countries

Domestic debt accounts for more than 50% of the total public debt in Anguilla, the British Virgin Islands and Cayman Islands (see Table 2.10).

TABLE 2.10:

OVERSEAS TERRITORIES – COMPOSITION OF TOTAL PUBLIC DEBT BY MARKET, 2010

Item	Domestic Debt Share > 50%	External Debt Share > 50%
Highly indebted (Debt/GDP > 60%)		
Moderately indebted (Debt/GDP = 30 – 60%)	Anguilla	
Less Indebted < 30%	British Virgin Islands Cayman Islands	Montserrat Turks and Caicos Islands

Source: CDB; ECCB; various countries national debt statistics

[62/] In the Cayman Islands, the guidelines stipulate that debt service should be no more than 10% of current revenue.

British Virgin Islands

The British Virgin Islands has traditionally borrowed domestically and with a share of over 80% has the highest concentration of domestic debt in its public debt portfolio among the territories. Debt levels in the British Virgin Islands were extremely modest at 16% of GDP at the end of 2010 and the debt burden remained low. Debt service as percentage of current revenue stood at 5.5% at the end of 2010 – the highest level recorded since 2006 but well within the borrowing guidelines.

Domestic debt-to-GDP amounted to 13% of GDP at the end of 2010 two times higher than the 5.6% ratio recorded in 2006. Borrowings were mainly from commercial banks and public bodies including SSB. External debt accounted for just 19% of the British Virgin Islands' total debt, comprising mainly loans borrowed from CDB and the European Investment Bank (EIB). The British Virgin Islands faces some interest rate risk due to the presence of floating-rate debt (linked to the US prime rate) in the portfolio. Some exchange rate risks also exist in relation to the Euro-denominated EIB loans. There is the relatively high share of contingent liabilities in the portfolio reflective of the large number of government-guaranteed loans.

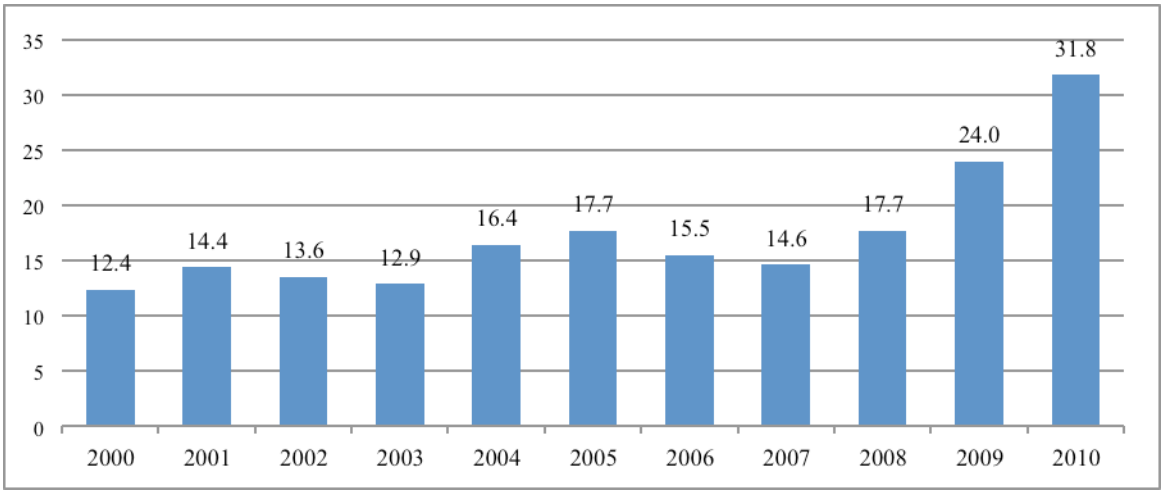
Anguilla

Anguilla, the most heavily indebted of the OTs, had high shares of domestic debt up to 2009 averaging around 75% of total public debt. With thin markets, Anguilla's borrowing has been primarily from commercial banks in the form of short-term loans and overdraft facilities. The Anguillan debt portfolio is primarily subject to refinancing risk.

The composition of Anguilla's debt changed markedly after 2009. In 2010 commercial banks facing tight liquidity called in loans to government. This, coupled with the sharp deterioration in public finances and an overall public sector deficit of 8% of GDP, led Anguilla to seek temporary financial support from ECCB.

FIGURE 2.9:

ANGUILLA – PUBLIC DEBT/GROSS DOMESTIC PRODUCT, 2000-2010 (%)



Source: CDB; ECCB

In 2010 Anguilla refinanced most of its debt through a USD55 million Policy-Based Loan (PBL) from CDB. This loan accounts for over 60% of the total public debt. Anguilla has also borrowed XCD50 million from the SSB and at the end of 2010, Anguilla's public debt rose to 32% of GDP sharply up from 24% in 2009 (see Figure 2.9). Debt service as a share of current revenue amounted to 8.3%.

Cayman Islands

The Cayman Islands enjoy one of the highest credit ratings in the Caribbean and has maintained an Aa3 rating on its long-term foreign currency debt since first rated by Moody's in 1997 (see Table 2.11). The economy is dominated by the services sector and in particular by financial services and tourism. The Cayman Islands' high per capita GDP and relatively low debt levels are significant factors behind this territory's strong credit rating. In 2010 per capita GDP amounted to some USD52,000, the tenth highest in ranking among rated sovereigns. Public debt was 25% of GDP.

TABLE 2.11:

RATED OVERSEAS TERRITORIES AS AT END-2006 AND 2011

	Moody's		Standard and Poor's		CariCRIS
Country	**2006**	**2011**	**2006**	**2011**	**2011**
Anguilla					CariA-
Cayman Islands	Aa3	Aa3	Not rated	Not rated	Not rated
Montserrat	Not rated	Not rated	BBB-	BBB-	Not rated

Source: CariCRIS, Moody's Investor Services; Standard and Poor's

Low by regional standards, the Cayman Islands' public debt has risen sharply since 2008 in the aftermath of Hurricane Paloma. From a mere 10% in 2005 the Cayman Islands debt more than doubled resulting in a significant increase in debt service. CG's debt-service payments, as a share of current revenue in 2010 at 10.4%, were more than twice its level in (pre-Paloma) 2007. Over the same period interest payments as a percentage of current revenue increased from 1.9 to 5.4%. The sharp rise in the debt burden breached the United Kingdom's FCO financial management guideline which specified that annual debt servicing costs should not exceed 10% of current revenue.

In 2011 Cayman Islands authorities signed a new Fiscal Responsibility Framework (FRF) which set out a range of measures to strengthen Public Financial Management (PFM). The framework provides for controlling fiscal expenditures, limiting new borrowing, realigning the revenue base and improving public sector performance.

Externally Indebted Countries

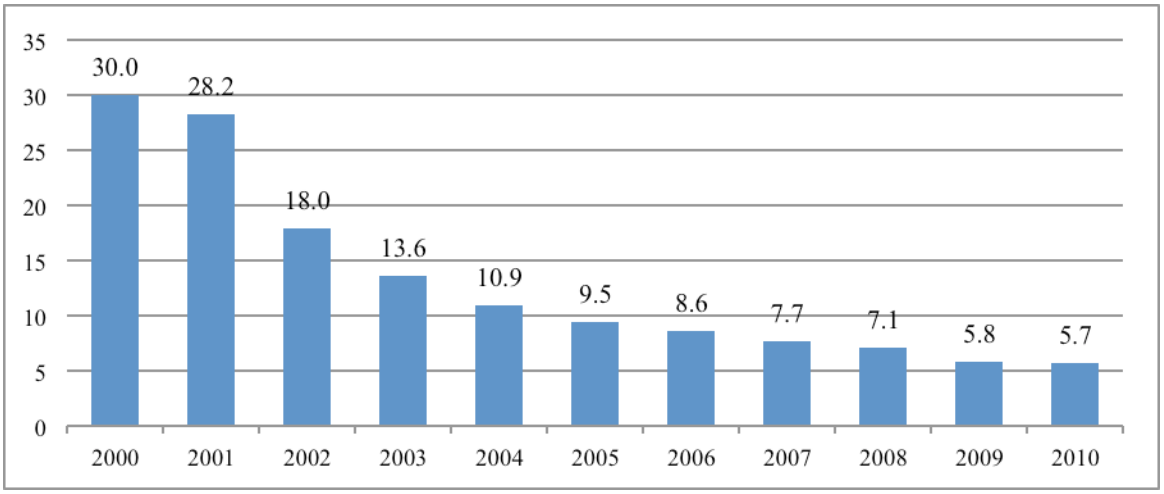
Montserrat

At the beginning of the 2000s, Montserrat was a moderately-indebted territory with public debt-to-GDP levels well above the average for the OTs. However, over the period 2000-2010, Montserrat's public debt steadily declined falling to 6% of GDP at the end of 2010 from 30% 10 years earlier (see Figure 2.10). The decline was most rapid over the first half of the decade when debt-to-GDP fell by two-thirds. The contraction of the debt ratio reflected the combined effect of an upturn in economic activity from 2003-09 along with steady debt amortisation.

Overseas grants from the United Kingdom government finance over 65% of public expenditure. Montserrat's public debt is almost entirely external representing borrowing from CDB. Most of Montserrat's debt is guaranteed debt which is held on behalf of the Montserrat Port Authority. Financing has mainly been for reconstruction and to aid private sector development.

FIGURE 2.10:

MONTSERRAT – PUBLIC DEBT-TO-GROSS DOMESTIC PRODUCT, 2000-2010 (%)



Source: CDB; ECCB

While the debt/GDP ratio is low the portfolio is highly exposed to large contingent liabilities. Government-guaranteed debt accounts for the bulk of Montserrat's public debt. Large contingent liabilities also arise from the collapse of two large financial institutions, CLICO and BAICO and heavy exposures of Montserrat's financial and public sector institutions to these companies. These exposures are equal to half of GDP.

In an effort to improve its economic management and secure ongoing donor aid support in 2011 the government of Montserrat invited the IMF to conduct an Article IV consultation to evaluate the island's economic situation. This step came against the background of the United Kingdom announcing its intention to reduce support over the medium term. The United Kingdom grants are projected to decline by more than 20% from XCD57 million in 2009 to XCD44 million in 2014.

Turks and Caicos Islands

The Turks and Caicos Islands has one of the highest public debt ratios among the territories amounting to 29% at the end of 2010. The Turks and Caicos Islands has a high share of private debt with 85% of total owed to private commercial bank creditors. The average cost of Turks and Caicos Islands' debt is relatively low with the average interest rates of just over 4% in 2010. However, the portfolio has a high share of floating-rate debt comprising 85% of total domestic debt and 44% of external debt in 2010.[63/] The portfolio's high concentration of floating-rate debt has exposed the country to significant interest rate risk. Short-term debt constitutes a large share of the portfolio and exposes the Turks and Caicos Islands to refinancing risk – the risk that resources

[63/] Figure as at end June 2010.

cannot be secured to meet payment obligations when they fall due. Debts are due primarily to external creditors reflecting Turks and Caicos Islands' ability to secure commercial financing in the regional market.

In the last few years of the decade the Turks and Caicos Islands faced serious economic challenges. These have been due in part to external shocks arising from the global economic crisis and to lax PFM prior to the suspension of the constitution. Economic growth slowed and earnings from tourism plummeted reflecting the weakness of the American economy. After 2008 the Turks and Caicos Islands government accumulated significant short-term debt as a result of the widening fiscal deficit. This was exacerbated by a dramatic 34% drop in government revenues in 2009. Despite major cuts in expenditure, including a 10% cut in public sector salaries, the overall fiscal deficit widened and at the end of 2009, there was a substantial build-up of short-term arrears.

As a corollary to the above, the Turks and Caicos Islands was in breach of all the United Kingdom's FCO borrowing guidelines/ratios. In 2010, public debt amounted to approximately 160% of recurrent revenue, significantly higher than the stipulated threshold of 80% and debt service amounted to 37% of recurrent revenue – far exceeding the stipulated threshold of 8%. The depleted government cash reserves were well below the 20% of gross public debt stipulated in FCO guidelines.

Despite graduating from United Kingdom financial support in 2003, the Turks and Caicos Islands sought financial assistance from the United Kingdom to help resolve its fiscal crisis. In 2011, in response to the Turks and Caicos Islands' difficulties, the United Kingdom provided a financial package amounting to USD260 million through the provision of a loan guarantee. The guarantee was to help the Turks and Caicos Islands secure new commercial bank lending to refinance existing debt, as well as to cover further projected deficits until the anticipated achievement of a fiscal surplus in the 2013 fiscal year. The Government of the Turks and Caicos Islands also sought to reduce its overdraft and consolidate and refinance amounts owed to commercial creditors, by refinancing its debt with a USD20 million PBL from CDB.

CONCLUSION

Over the past two decades the Caribbean debt landscape has changed markedly. At the beginning of the 1990s only three Caribbean countries had public debt levels over 100% of GDP – Guyana, Jamaica, and Haiti. Most of the countries in the Caribbean carried modest debt loads. However, moderate debt burdens in many Caribbean countries mushroomed into exceptionally high and unsustainable debt levels in an additional six countries placing the Region among the most heavily-indebted regions in the world. Defaults have been avoided only by a series of debt restructurings across countries in the Region – another category in which the Caribbean is a world leader.

The evolved status quo, like many of the countries' debt profiles, is unsustainable. The Caribbean cannot achieve rising standards of living for its people in the presence of high debt-service obligations and debt-induced fiscal vulnerability and volatility. There is something in the sea that is tempting many countries in the Caribbean to incur so much debt.

Chapter 3

Sources: Decomposing Debt

INTRODUCTION

The last chapter described how, during the last two decades and starting from modest and manageable levels, the governments of several Caribbean countries have accumulated significant amounts of debt. While the periods of debt accumulation did not exactly coincide across these countries in general between the late 1990s and late 2000s these countries added an average of 60% of GDP to their previous debt loads. This chapter seeks to identify the proximate sources of debt accumulation for these countries.

FIGURE 3.1: Central Government Debt/Gross Domestic Product Ratio, Average for Group of Seven Indebted Caribbean Countries, 1992-2010

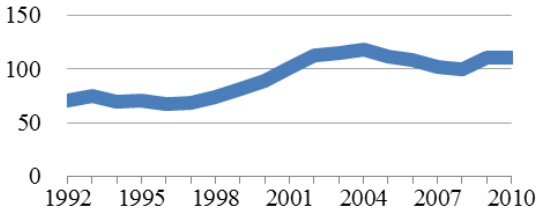
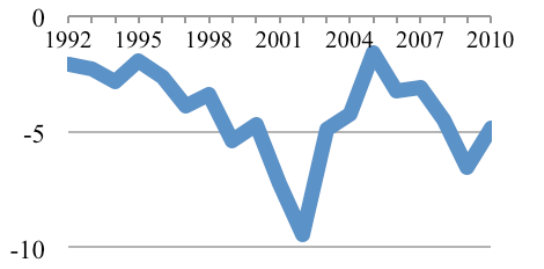


FIGURE 3.2: Fiscal Deficit / Gross Domestic Product Ratio, Average for Group of Seven Indebted Caribbean Countries, 1992-2010



There are four candidate sources for debt: (i) fiscal slippage, wherein governments do not earn tax revenue sufficient to cover primary expenditure – both ordinary recurrent expenditure as well as capital expenditure on asset acquisition or infrastructure construction; (ii) adverse debt dynamics, which necessitates additional borrowing to service existing debt; (iii) revaluation, such that your existing debt can become greater because your unit of measure (such as the exchange rate) increases; and finally (iv) off-budget events, largely consisting of debts incurred outside of CG that are assumed by it along with other contingent liabilities.

The next section provides background data on the accumulation of debt in the seven countries that are studied in this chapter. Following which contemporary fiscal data is decomposed to identify the primary channels of debt accumulation. The final section assesses the findings and their implications.

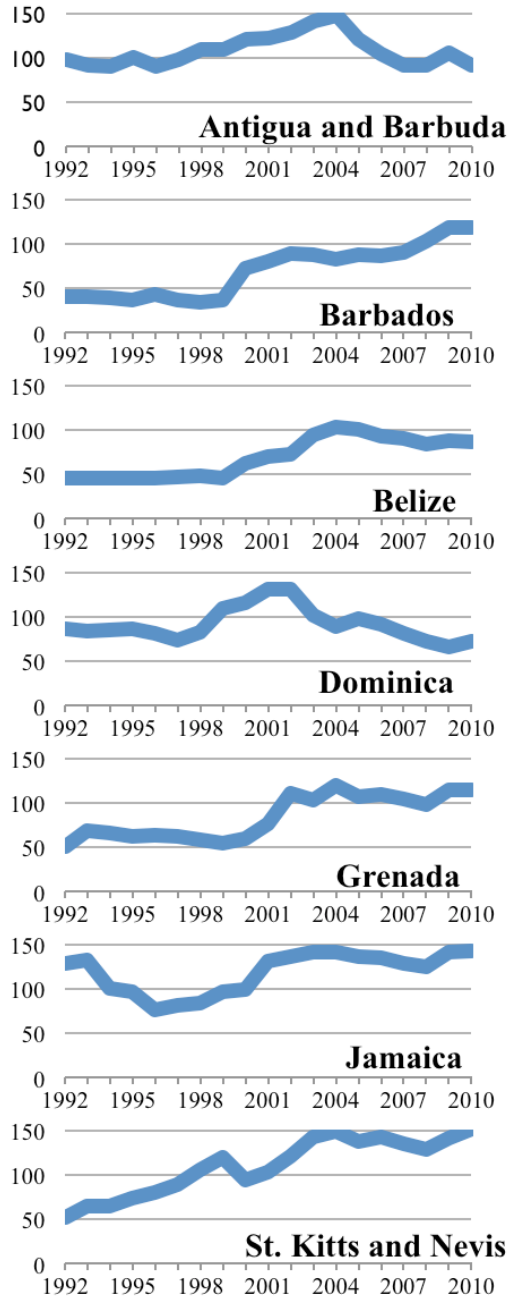
DEBT AND DEFICITS

The seven countries that accumulated public debt levels in excess of their GDP during the last two decades, are Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Jamaica, and St. Kitts and Nevis. [64/] In the early 1990s on average these countries carried debts equal to 63% of

[64/] Guyana is excluded from this analysis of why debt accumulated because Guyana's debt accumulation occurred prior to the 1990s in a different global environment. Indeed, Guyana's debt has declined over the period being currently analysed.

GDP. By the end of the first decade of the new millennium, however, debt loads had averaged a level equal to GDP. Whereas the precise starting points and peak debt years for each of these countries differ the period from 1997 to 2004 is when most of the debt accumulated (Figure 3.1). This coincided with deteriorating fiscal balances in the group as a whole (Figure 3.2), with the average fiscal deficit rising from 2% of GDP to a peak of nearly 10%, throughout the 1990s. Since then there has been fiscal consolidation in some countries but the record varies widely.

FIGURE 3.3: Debt/Gross Domestic Product, 1992-2010



Antigua and Barbuda's debt growth was typical of the group (Figure 3.3). Starting in 1993, when the total public debt was only 90% of GDP, it grew steadily until it reached 148% of GDP in 2004. In the three years leading to 1994 the fiscal deficit was 2.3% of GDP but during the remainder of the decade it had doubled and actually peaked at more than 9% of GDP in 2002. Since then the debt has gradually contracted reaching less than 80% of GDP in 2010.

Barbados' debt is relatively recent and the least dramatic in expansion compared to the other countries in this grouping. Public debt did not start increasing until after 2000 gradually rising from a modest 72% of GDP to 114% over nine years. For most of the period of advancing debt budget deficits were not appreciably worse than in the previous decade. In any case, at less than 3% of GDP in most years, Barbados' deficits were modest compared to its neighbours. After 2007 the fiscal imbalance became considerably worse nearing 10% of GDP.

The rise of indebtedness in **Belize** closely mirrors the median performance of the group of seven. CG debt which was around 44% of GDP until the mid-1990s, rose steadily over the next 10 years and reached just over a 100% as the fiscal deficits worsened. The fiscal deficit seemed to follow the debt growth rather than to cause it. Since then the debt has gradually fallen by nearly 25% of GDP as a result of aggressive fiscal consolidation.

Dominica's debt was one of the fastest growing with debt leaping by 60% of GDP and peaking at 132% by 2002. The fiscal disintegration was equally dramatic. The average fiscal deficit in the three years prior to 1996 was 3.4% of GDP; in the three years before the debt peak, the average was 8.5%. Since the peak, Dominica's debt has steadily declined.

Jamaica had recovered in the early 1990s from astronomical debt levels of over 200% of GDP in the previous decade. However, by 1996, due to fiscal retrenchment, Jamaica's debt was 75% of GDP. Thereafter however, the level of debt rose rapidly despite large primary surpluses breaching 140% of GDP by 2003. After that the debt had moderated somewhat before climbing again.

St. Kitts and Nevis is the member with the sharpest and most relentless rise in government debt. The debt had risen to nearly 150% of GDP by 2010 from 63% of GDP in 1992 with few modulations. The period of the most determined debt accumulation – from 1995 to 2005 – correlated with the most severe fiscal imbalances when the deficits averaged 7% of GDP for more than 10 consecutive years.

In comparing these indebted countries, some commonalities were observed in characteristics and experiences. However, there was far more heterogeneity among them in the timing of the growth of debt, the ability to recover from indebtedness and the correlation between fiscal imbalances and the growth of the debt. In order to determine the precise role of fiscal imbalances in the debt problem a more rigorous methodology is applied.

DECOMPOSING DEBT ACCUMULATION

Several developments in the Caribbean occurred simultaneously in the run-up to indebtedness. Firstly, as alluded to above, fiscal balances worsened significantly in most of the countries under review. The average fiscal deficit in the seven countries tripled as a share of GDP in the 10 years following the early 1990s. Recurrent housekeeping costs and/or public capital expenditure could have been responsible for the deficit. In other words it may have been consumption or investment that accounted for the situation. At the same time, the average effective interest rate on debt rose by a percentage point over the same period. Therefore, some of the costs incurred from newly accumulated debt could have been associated with pre-existing debt. In addition, these countries had been buffeted by an array of economic shocks and natural disasters: from banking crises through loss of preferential market access to hurricanes. Any of these or other factors may have driven the accumulation of debt in the Caribbean.

The Components

In order to disentangle the relative role of different factors in contributing to debt accumulation, the changes in the level of the public debt can be disaggregated into constituent components, each of which represents a separate proximate driver of the stock of debt. The algebraic formulation of the decomposition is described in Appendix 3.1.

One source of debt is borrowing to finance a fiscal gap. Leaving aside interest payments for the moment, the remaining *primary balance* is the first component of the disaggregation and can be divided into recurrent and capital portions. The primary recurrent balance referred to in this chapter as the *basic balance*, reflects the difference between, on the spending side, regular expenditure on programmes and emoluments and, on the earning side, recurrent revenue such as taxes. The basic balance therefore omits from expenditure, debt servicing and capital expenditure, and from revenue, all non-recurrent income such as grant revenue and the proceeds of asset sales. A deficit on the basic balance creates a need to borrow for government *housekeeping*.

The *capital balance*, which incorporates all non-recurrent transactions, infrastructure, and other capital expenditures, is subtracted from grant revenue and the proceeds of asset sales. That difference, the capital balance, if negative, generates the borrowing requirement for *investment*.

Sahay (2005), justifies separating grant revenue from the primary balance in her decompositions by pointing out that grants are not a policy variable. The pattern of public capital expenditure sometimes correlates with the incidence of hurricanes. To that extent, therefore, the expenditure side of the capital budget may not be a policy variable either. For this reason, we extract not only grants but capital expenditure as well, in order to completely separate the capital and current budgets.

Interest payments complete the disaggregation of the fiscal balance and are the second component of the decomposition. The nominal (money value) of total interest payments is of little constructive use for the present exercise because it does not take account of the burdensomeness of those payments or the ability to pay. Instead the decomposition uses real effective interest payments, which are derived from nominal payments by subtracting the effect of nominal GDP increases, whether due to inflation or real economic growth. The justification for this is that an expansion in nominal GDP ought to be reflected, pari passu, in additional tax revenue, which provides the means to pay interest. So if the average nominal interest rate on debt is equal to the rate of increase of the nominal GDP, this component cannot create a need for new borrowing. If however, interest payments exceed the automatic growth of revenue, which is the same as that of nominal GDP, then new borrowing will be required because of the *debt dynamics*.

Quite apart from borrowing to finance fiscal gaps, indebtedness can change without actually borrowing any principal. There are two ways in which this can occur. The amount of debt owed can change simply because an existing debt obligation changes in value. Such *revaluations* occur most commonly when the debt is denominated in a foreign currency and the real exchange rate changes. Further, since we are primarily interested in explaining changes in the debt/GDP ratio, a change in the real GDP, without any change in the dollar value of the debt, will change the value of the ratio. The ensuing decompositions therefore take account of changes in the debt/GDP ratio that derive from changes in both the real exchange rate and real GDP.

Finally, government may assume debt obligations that it did not itself contract. Liabilities that are contracted by public enterprises outside of CG and in some cases by private enterprises often have to be assumed by CG in the public interest. Some off-budget obligations may be anticipatable and controllable, such as when government provides a guarantee on a loan contracted by a quasi-public entity. In the event that the contracting entity does not repay the debt becomes, by virtue of government guarantee, the obligation of CG. At the other extreme a similar circumstance may be difficult to anticipate and is beyond control. This can happen when loans made by the privately-owned, commercial banking sector ultimately become part of the public debt should the government have to help resolve a banking crisis. However, in most cases such off-budget or contingent liabilities arise from publicly-owned enterprises. [65/]

The procedure for decomposing the change in indebtedness between two adjacent years is to use the fiscal accounts to determine the role of the basic balance, the capital balance and debt dynamics. National accounts data on real GDP growth and the GDP deflator, along with exchange rate data are used to calculate the contribution of unit-of-measure revaluations. The residual change in debt not accounted for by these explicitly measured contributory factors is assigned to off-budget events, but in reality can hide a multitude of sins. Any discrepancy between accrued amounts and cash flows will be captured in this residual, as will accounting errors and omissions. Practically, however, nearly all of the residual will be due to contingent liabilities that have been realised.

[65/] The algebra of decomposition also produces a sixth category, referred to as *cross-products,* which represents the revaluation of changes in the debt. This component is usually and, in the present case, relatively small, so it is omitted from the discussion and the results.

Table 3.1

Periods of Sustained Debt Accumulation

Country	Start	End
Antigua and Barbuda	1997	2004
Barbados	2001	2009
Belize	1997	2004
Dominica	1998	2002
Grenada	2000	2004
Jamaica	1997	2003
St. Kitts and Nevis	1995	2004

For each of the seven countries we identify the precise period in which the most sustained debt accumulation occurred. Table 3.1 indicates which years were used for each country. For that period for each country, the decomposition methodology is applied to disaggregate the role of each component in explaining the rise of indebtedness.

Results

The average increase in CG debt for these seven countries during their periods of debt accumulation is 62% of GDP. Barbados was the most modest its debt growing by 46% of GDP between 2001 and 2009, and St. Kitts and Nevis seeing the steepest rise of 85% of GDP between 1995 and 2004.

In total the largest portion of debt accumulation is accounted for by non-CG events which is revealed to be the primary driver of debt growth in the Caribbean. This factor has been a significant contributor in each country's debt growth, with the sole exception of Dominica. When the decomposed contributions to debt accumulation for all seven countries are averaged, the result is striking. It suggests that primary deficits (the sum of the basic balance and the capital balance) made no contribution to the growth of debt in the Caribbean. It suggests further that real currency appreciation and GDP growth, on their own, would have reduced debt by 14% of GDP. This means some 76% of GDP worth of debt needs to be accounted for (62% of net debt accumulation plus the 14% by which debt would have fallen due to revaluation). Of that, 16 percentage points are explained by interest payments and 59 percentage points are due to non-CG liabilities. The latter factor is the larger contributor to debt accumulation in every case. Contingent liabilities are the main source of debt growth in the Caribbean.

The averages conceal a variety of experiences in the accumulation of indebtedness, with no single factor being prevalent in all of the countries studied. In order to get a more accurate picture of the factors driving debt in the Region therefore, a closer look at individual countries is warranted (Table 3.2:). From the decompositions at the disaggregated country level, three patterns of debt accumulation can be discerned. One pattern characterises those countries that have become indebted because fiscal slippage – running large primary deficits – was a major source and contributed to the central role played by non-CG liabilities. This group includes Belize, Grenada and St. Kitts and Nevis.

Table 3.2

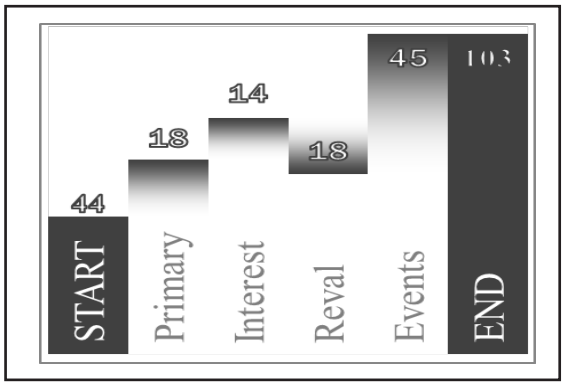
Decomposition of Debt Growth

	Δ Total Debt	Basic Balance	Capital Balance	Interest	Growth	Real Exch Rate	Event
Antigua and Barbuda	58	(20)	3	33	(35)	6	72
Barbados	46	(44)	34	7	2	(5)	49
Belize	59	(41)	59	14	(29)	11	45
Dominica	58	(11)	23	13	1	5	27
Grenada	66	(30)	46	8	(7)	2	47
Jamaica	65	(67)	12	38	(6)	4	84
St. Kitts and Nevis	85	(29)	67	(2)	(33)	(9)	92
Average	**62**	**(35)**	**35**	**16**	**(15)**	**2**	**59**

The decomposition for Belize is illustrated in Figure 3.4. It reveals that, in addition to the large role of outside liabilities, the period of debt growth was characterised by large fiscal imbalances that accounted for 18 percentage points of debt accumulation. Interest payments were a lesser contributor. The growth of the debt/GDP ratio occurred despite economic growth, contributing 29 percentage points to debt reduction (as part of the 18 percentage point revaluation).

Figure 3.4

Contribution to Debt Growth, Belize, 1997-2004



In the case of Grenada (Figure 3.5) the contribution of fiscal imbalances is also apparent, because of a surplus in the basic balance that was inadequate to cover large capital expenditure amounting, in this case, to 46% of GDP. Most of this expenditure was devoted to reconstruction in the years following hurricane Ivan in 2004. As with most of the countries off-budget events were significant.

St. Kitts and Nevis' fiscal imbalances also contributed to debt accumulation in the amount of 38 percentage points (Figure 3.6). At the same time, liabilities outside of CG made a larger contribution to the twin island state's debt than was the case with the other members of this group.

Figure 3.5

Contribution to Debt Growth, Grenada, 2000-04

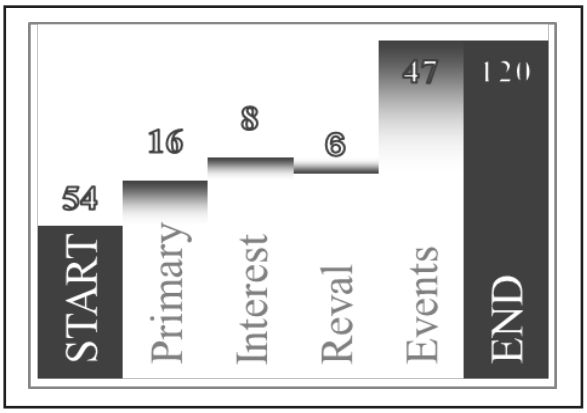
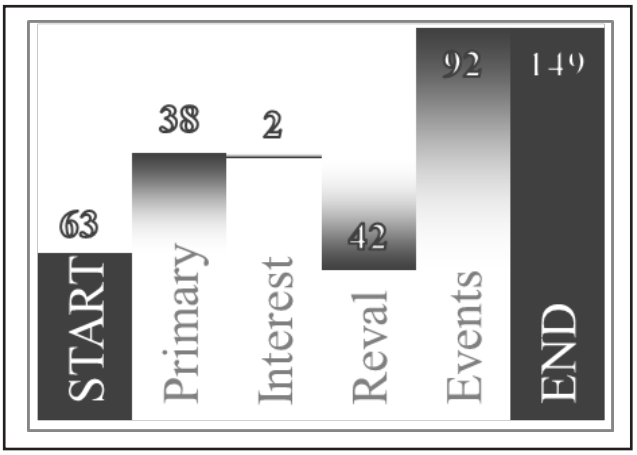


Figure 3.6:

Contribution to Debt Growth,St. Kitts and Nevis, 1995-2004



A second pattern of debt growth applies to countries in which debt dynamics – governments having to increase their borrowing to service debt – played a significant role in the debt build-up. Countries in this group, having experienced primary surpluses on their fiscal accounts, did not therefore evidence any fiscal contribution to the debt problem.

Antigua and Barbuda, whose run-up of debt occurred between 1997 and 2004, exemplified this pattern (Figure 3.7). The absence of significant capital expenditure allowed government to run a primary surplus, but real interest on debt added more than half of the 58% of GDP that was added to the stock of debt during this period.

The other member in this group is Jamaica, who added 62% of GDP to its CG debt between 1997 and 2003 (Figure 3.8). Thirty-eight percentage points of that were devoted to paying interest on existing debt. Jamaica is unique amongst the seven countries for running the largest primary

surpluses while its debt was growing. Jamaica's primary surplus over the period was equivalent to 55 percentage points of debt. Jamaica shares with St. Kitts and Nevis the distinction of having suffered the most with contingent debt.

Figure 3.7

Contribution to Debt Growth, Antigua and Barbuda, 1997-2004

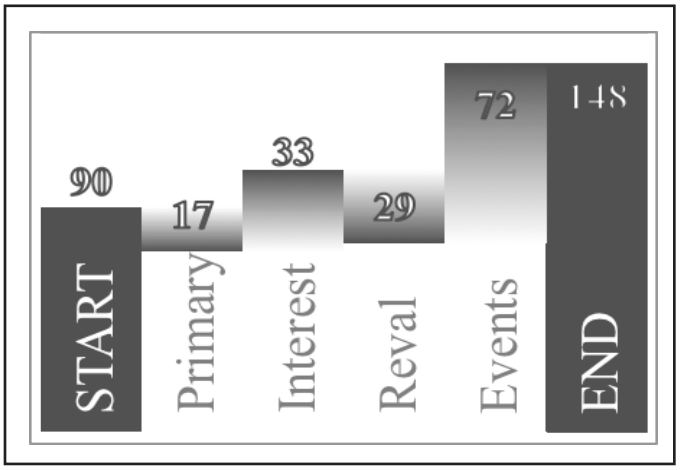
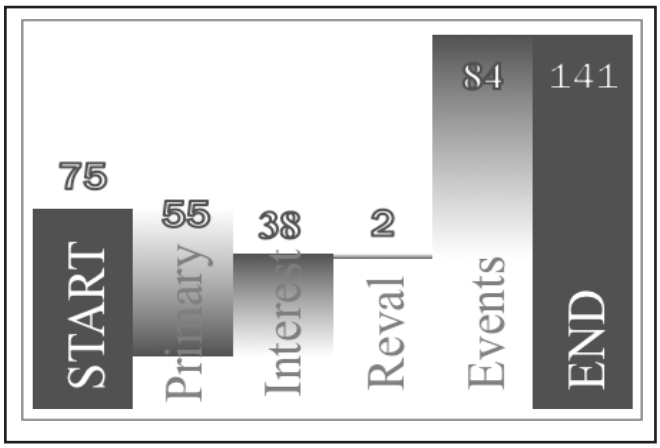


Figure 3.8

Contribution to Debt Growth, Jamaica, 1997–2003



The final two countries, Dominica and Barbados, are less easily categorised. In the case of Dominica (Figure 3.9), all factors seemed to play a role. In the five years of its most rapid debt accumulation from 1998 to 2002 inclusive, each of the four components pushed up the debt with fiscal slippage and interest contributing equally.

The accumulation of public debt in Barbados, as in the case of Grenada, is relatively recent taking place entirely since the turn of the millennium. Barbados also has the smallest debt increase of the seven countries in this analysis, totaling only 46% of GDP (Figure 3.10), from trough to peak. This is the only country in the group for which off-budget liabilities is the only significant contributor to debt accumulation.

Figure 3.9

Contribution to Debt Growth, Dominica, 1998-2002

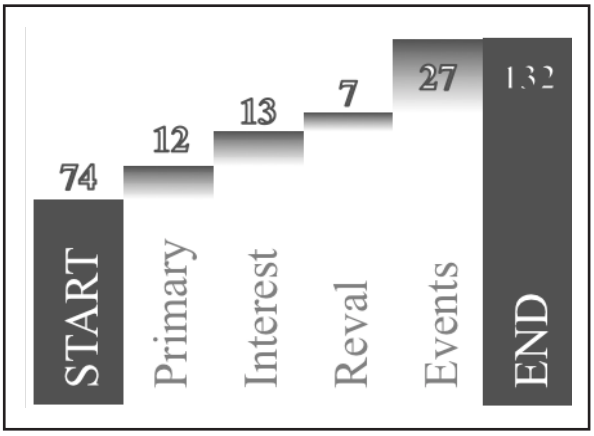
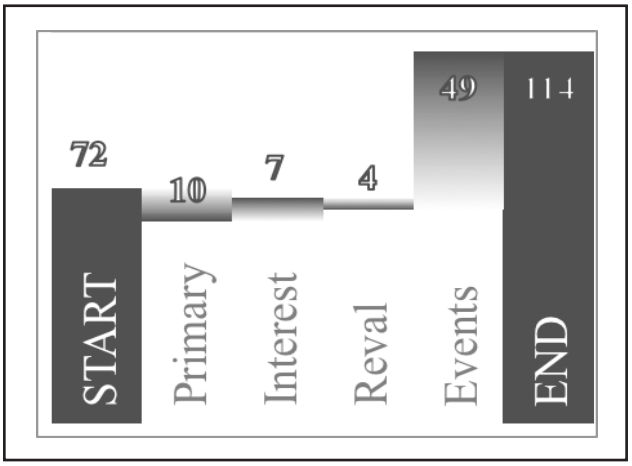


Figure 3.10

Contribution to Debt Growth, Barbados, 2001-09



KEY DRIVERS OF DEBT

Primary Balance

For the countries in which fiscal slippage was a key driver of debt (Belize, Dominica, Grenada, St. Kitts and Nevis), primary deficits accounted for, on average, 21 percentage points of their debt growth. Further, in most of these countries, there was a deterioration of fiscal performance during the years of debt growth, compared to previous years. This suggests that fiscal performance was indeed a significant factor.

During the periods in which debt was growing both Grenada and St. Kitts and Nevis experienced extraordinary expansions of public expenditure that was unmatched by revenue growth. In Grenada, if the 10 years of debt growth are compared to the previous 10 years, primary expenditure in the

later period was 9% higher (measured as a share of GDP), whereas revenue was only 2.3% higher. Much of that was due to capital expenditure necessitated by the impact of two hurricanes, Lilli in 2002 and Ivan in 2004. Ivan was particularly devastating, causing damage of more than a year's worth of GDP. Without those two events the growth of public expenditure may well have matched the increase in revenue.

For St. Kitts and Nevis expenditure growth was even more explosive. Comparing the period of debt growth for this country to the immediately preceding five years, we observe that the ratio of primary expenditure to GDP, at 31%, represents an impressive 19% increase from the earlier period. At the same time the increase in revenue was only 8%. As is the case in Grenada a large portion of the increase was due to capital expenditure in only two non-consecutive years – 1999 and 2002. Unlike Grenada, however, if the expenditure spike in those two years is omitted, there remains a substantial expansion of primary expenditure during that period. So while the hurricanes may be part of the explanation for the deterioration of the fiscal balance in St. Kitts and Nevis, there were other factors at work.

In Dominica the fiscal deterioration was due to revenue contraction rather than expenditure growth. The revenue to GDP ratio fell by 4% during the years of debt accumulation, while primary expenditure was only 1% lower. Belize's fiscal accounts did not get any worse during its years of debt accumulation but the country had been running fiscal deficits from before averaging 4% of GDP in the early nineties.

Interest

The cost of debt servicing played a role in further debt growth in every case except for St. Kitts and Nevis but was highly significant in both Antigua and Barbuda and Jamaica where they contributed about a third of GDP worth of debt. An examination of the implicit interest rate on debt reveals a wide range of values from a low of 3.7% for St. Kitts and Nevis to a high of 12.5% for Jamaica – rates that are correlated with the contribution of interest to debt growth.

There is a correspondence between the countries for which interest cost was a factor in debt expansion and those that have a high share of domestic debt in the total. Both countries, for which interest cost played a significant role, held more than half of their total debt as domestic debt. The domestic debt share during the period of debt accumulation was 57% in Antigua and Barbuda and 52% in Jamaica. (Barbados owes some 70% of its public debt domestically but interest played a much smaller role in debt growth there.)

Jamaica was the extreme case with an implicit interest rate more than double the average of all the other Caribbean countries. This was due to Jamaica's debt having a substantial domestic component while also having at the time the highest domestic interest rates in the Region. Jamaica is unique amongst the group of indebted countries because of its flexible exchange regime and history of depreciation. So its domestic interest rates would reflect an exchange risk that would not apply in the case of any of the other indebted countries all of whom have had mainly fixed exchange rates for more than two decades.

Even without the inclusion of Jamaica's extreme case in the average however, the implicit interest rate in the countries for which interest payments were a contributing factor was still a percentage point higher than for the remaining countries. Indeed, the overall spread of computed rates, from 3.5% for Grenada to 12.3% for Jamaica, on the face of it, suggests that countries face a variety of options for managing their debt portfolios. This realisation has implications for the DMS which is explored in Chapter 5.

Events

In every case off-budget liabilities were the major contributor. It made its most significant contribution to debt build-up in Antigua and Barbuda, St. Kitts and Nevis and Jamaica, where this consideration alone was equivalent to all (St. Kitts and Nevis and Jamaica) or nearly all (Antigua and Barbuda) of the debt increase from trough to peak.

Technically, some changes in debt not originating in fiscal deficits or revaluations could be due to accounting errors and malpractice. Doubtless, both play a part. With limited capacity and the best of intentions Ministries of Finance in the Region struggle to meet the complex statistical and accounting requirements that they face (including the production and dissemination of comprehensive data, such as the present exercise, that meets the needs of research), alongside all the other administrative demands. The frequency with which already published fiscal data is revised implies that errors do creep into fiscal accounting and doubtless some remain there. The use of cash instead of accrual accounting may also contribute to discrepancies between fiscal deficits and debt accumulation, especially in the presence of the habit of deferred payments. Neither errors nor weak accounting practices however, can explain the magnitude of the discrepancies between deficits and debts.

The discrepancy is largely explained by the debts and losses of public and private enterprises that are assumed by CG. This is an unfortunately frequent occurrence in the Caribbean. In Jamaica in the late 1990s, government was forced to take over almost the entire cost, some 40% of GDP, of its banking crisis – all private sector debts. In St. Kitts and Nevis the state-owned sugar industry contributed 3-4% of GDP in losses each year. [66/] In Barbados the explanation can be found in public private partnership arrangements, the losses of public enterprises and capital expenditure ahead of the 2007 CWC. [67/]

The 2009 collapse of CL Financial Limited led to a costly intervention by the Government of Trinidad and Tobago and a marked increase in its domestic debt. The spillover effects of this collapse have affected all ECCU member states, (where the potential cost of the financial failure could be as high as 17% of GDP [68/]), as well as the Bahamas, Barbados, Belize, Guyana and Suriname. Several governments have assumed the obligations of public sector bodies that have failed to make payments as they fall due under on-lending arrangements. Governments have also frequently assumed the foreign exchange risk in on-lending arrangements thus adding to debt servicing costs.

Debt accumulation in the Caribbean has been driven by three factors:

(i) fiscal imbalances, often due to infrastructural reconstruction following a natural disaster;

(ii) unfavourable debt dynamics in which the obligation to service the existing debt requires additional borrowing, casting a spotlight on the structure of debt portfolios across currencies, tenors, and types of lenders; and

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[66/] Sahay (2005).
[67/] Chapter 2.
[68/] See IMF Country Report No 11/274, Trinidad and Tobago: Selected Issues (March 2011).

(iii) contingent liabilities, particularly those from outside of CG, the sources of which are weak, contingent-risk management, public enterprise holdings, inadequate financial sector regulation and weaknesses in public sector management (Chapter 5).

DECOMPOSING NON-ACCUMULATION YEARS

In order to gain greater insight on the key drivers of indebtedness, a similar decomposition exercise was undertaken of changes in the fiscal accounts and debt levels for the same countries for the years in which debt was not accumulating steadily. A comparison with the years in which debt was growing should reveal which factors changed to propel the growth of debt. The results are presented in Table 3.3. The first big difference is the absence of large primary deficits. On average, the fiscal accounts (the sum of the basic and capital balances) are contributing to debt reduction. This underscores that fiscal consolidation should play a major role in any programme for debt sustainability.

TABLE 3.3

CONTRIBUTION TO CHANGES IN DEBT, AVERAGE FOR SEVEN COUNTRIES,

Country	Start	End	Δ Total Debt	Basic Balance	Capital Balance	Interest	Growth	Exch Rate	Event
Antigua and Barbuda	2006	2010	(28)	(19)	20	9	14	(14)	(38)
Barbados	1994	1999	(4)	(37)	20	8	(7)	(1)	13
Belize	2006	2020	(14)	(29)	15	14	(11)	(0)	(4)
Dominica	2004	2010	(28)	(36)	35	5	(16)	2	(18)
Grenada	2000	2004	(1)	(33)	39	(4)	(17)	(3)	17
Jamaica	2004	2010	2	(80)	22	32	(2)	(14)	45
St. Kitts and Nevis	2006	2009	5	(28)	6	(2)	3	(8)	34
Average			**(10)**	**(37)**	**23**	**9**	**(5)**	**(6)**	**7**

The other significant observation from the data is the role of non-budget events. It shows that contingent liabilities are an ongoing fiscal risk in the Region. Most countries continue to evidence changes in debt levels that can be due only to realised contingent liabilities. The foregoing suggests that managing non-CG liabilities is an ever present threat to fiscal stability in the Region.

CONCLUSION

Isolating the periods of rising debt for the Caribbean countries that have experienced significant debt growth over the last two decades has revealed both differences and commonalities. There are constructive conclusions to be drawn from both.

The need for fiscal consolidation in most of these countries is compelling. Except for Antigua and Barbuda all countries experienced a significant worsening of their fiscal balances as an accompaniment to the accumulation of debt. While the correlation itself does not confirm causation, the decomposition exercise implied that the fiscal contribution was large and significant in four of the

seven countries. In most of those it was the growth of non-interest expenditure rather than revenue contraction that was the underlying factor in the fiscal degeneration. The significant contribution of fiscal imbalances to debt growth begs the question: Why are Caribbean governments prone to these deficits? Fiscal management in the Caribbean may be facilitating excessive public expenditure or unable to harness it while concurrently administering an effective tax regime.

That only some of the indebted countries suffered from negative debt dynamics is instructive. Many of the debt episodes were coterminous. Between 1997 and 2002 five of the seven countries in this study were experiencing rising debt levels. However, despite some similarities in the economic and geographic circumstances and borrowing in the same global environment, the implicit interest rate and the contribution of interest to debt varies greatly across the countries.

The same is true of the two countries for which the accumulation of debt was entirely in the current decade, Barbados and Grenada. Grenada's implicit rate of interest due on public debt during its three most indebted years was only 3.5% while Barbados' was 6%.

The variation in the significance of interest as a contributor to growth suggests that for those countries for which it was a major contributor, this was not the result of an exogenous shock. An exogenous interest rate shock would have affected all the countries equally. Indeed, while most of these countries were experiencing rising debt levels, global interest rates were falling sharply. Between 2000 and 2004 the London Inter-Bank Offer Rate plummeted from some 6.5% to almost 1%.

There is some evidence, then, that debt management in many countries in the Region could be improved to minimise the role of debt dynamics in pushing already high debt levels further up. In this regard debt management is not only a matter of portfolio management (front office matters) but also the timing, structure and management of sovereign issues (back office matters).

Since the largest contributor to debt by far is the effect of off-budget events, then neither fiscal consolidation nor improved debt management will be sufficient to remove the threat of rising indebtedness from the Region. Broader issues of public governance need to be addressed such as the role and management of public enterprises, as well as the regulation and monitoring of financial sectors. These are especially challenging issues in small countries with already stretched capacities.

At the same time large indebtedness itself creates even greater challenges to public sector management. As discussed in Chapter 1, it is also detrimental to the prospects for economic growth. Therefore, it is incumbent on the political directorate in the Caribbean to find ways to meet the challenges of being debt prone.

This investigation of the sources of debt among the most highly-indebted of the countries has identified a few main drivers. Those, in turn, have raised questions about the role of management – fiscal, debt, and contingent liability – in facilitating debt. In order to answer those questions, Chapter 4 probes the extent to which management and the institutional structure within which management operates, can account for the propensity for indebtedness in the Caribbean.

Chapter 4

Causes: Institutions And Organisations

INTRODUCTION

The previous chapter identified escalated primary deficits, recurrent expenditure on interest on public debt and an accumulation of liabilities incurred outside of the budget as the primary proximate determinants of fiscal deficits in the Caribbean. The persistence of these factors then contributes significantly to the increase in public debt to unsustainable levels. This chapter will explore the role of institutions for fiscal and debt management in driving these sources of debt.

THE ROLE OF INSTITUTIONS IN FISCAL AND DEBT MANAGEMENT

The literature on the reform of PFM has examined the role of distorted incentives in driving the inappropriate use of discretion in the design and application of fiscal policy. Ideally, fiscal policy is expected to be consistent with "debt sustainability", resilience in the face of shocks and macroeconomic stabilisation. [69/] Relative to these ideals there may be distorted incentives for fiscal management arising from, *inter alia*, an unbounded demand by voters for public goods and "social entitlements" and a relatively short-term political time horizon bounded by the electoral cycle.

These distorted incentives are further compounded by a gross misunderstanding of the meaning and applicability of Keynesian aggregate demand stimulus policies. The quality of public expenditure, including the current-capital expenditure balance, is an important determinant of economic growth. Excessive expenditure leading to fiscal deficits may (or may not) stimulate growth in the near term. In the medium term however, the burden of that elevated debt and its associated servicing stifle the growth process that it initially established.

The analysis then focuses on effective alignment of the incentives of principals and agents. In this regard, politicians are taken to be agents of the voting public who are presumed to embrace ideals of sound financial management. At another level public officials are agents of the political directorate and implicitly of a fiscally prudent voting public. There is some division as to whether these incentives are more effectively aligned by the use of legislated performance targets (performance rules) or by a regime that consists of enhanced transparency regarding fiscal objectives and policy mechanisms to attain these objectives.

Beyond this "rules vs transparency" discussion there is consensus that the institutions of public administration matter. For example, a hierarchical political-executive-legislative process is seen as being more effective than more collegial processes in making and implementing socially and politically difficult political decisions. Fiscal budgets should be as focused on outputs (direct delivery from the budget) and outcomes (broader economic and societal consequences) as on inputs (the amount of money allocated and spent). This focus on outputs and outcomes lends itself to programme budgeting where line items, rather than standing alone, may be grouped together relative to their expected contribution to a specific result.

[69/] Debrun, Hauner and Kumar (2007).

Regarding the delivery of output, public servants should be given more responsibility for their budgets and expenditure (including for personnel) in order that they may be held accountable for the delivery of budgeted outputs. Accounting systems need to be international standard "best practice" including especially the use of accrual rather than cash accounting. Accrual accounting avoids the creative use of cash accounting in the non-transparent accumulation of payment arrears. New Zealand, as a small developed economy with a highly educated population and effective public administration institutions, was in the vanguard of international public sector institutional reform. This was entirely consistent with its radical reform of its monetary policy arrangements in holding the Governor of a more autonomous Central Bank responsible for inflationary outcomes through an Economic Policy Agreement. Accordingly, New Zealand focused on outputs and outcomes and budgetary allocations were made on the basis of formal contractual agreements to deliver outputs. The Fiscal Responsibility Act of 1994 specified the use of GAAP, including the employment of accrual accounting and required the regular (intra-year) release of short-term fiscal forecasts and pre-election fiscal and economic updates.

Regarding incentives for "better behaviour" on the part of political and public administrative leadership, New Zealand opted for transparency over legislated quantitative fiscal targets. There was no perception of a theoretical justification for any specific target to be maintained over time. Inflexibility could undermine the capacity to respond to special circumstances or lead to an unwarranted loss of credibility for minor deviations. Without political will (driven by societal commitment) human ingenuity can rationalise avoiding legislated targets.

The capacity of developing countries to replicate the New Zealand experience is bounded by their educational, institutional and technological capability. Contracting at the agency and departmental level, without a tradition of a technically-capable, politically-and-functionally-independent public service, is likely to be ineffective. Accrual accounting solves many problems in theory but without adequate databases, accounting systems and capabilities, and electronic data processing facilities accelerated transition could be problematic.

The spate of financial and economic crises across the globe in the past two decades and their verified correlation with risky debt structures led the international financial institutions along with the worldwide community of debt managers to develop, in the early 2000s, specific guidelines for public debt management. [70/] The guidelines, among other things, recognise and emphasise the need for a sound institutional framework for public debt management. The rationale is straightforward: while a weak institutional framework may not have been the only or principal cause of financial crises in the past, imprudent debt management and unsound institutional structures significantly contributed to the severity of financial crises.

The guidelines are clear as to the institutional requirements for public debt management. Governments' debt management operations should be underpinned by a sound legislative framework; clearly defined and distinct responsibilities for the institutions involved in debt management; and the strong management of internal operations. These institutional arrangements must be part of a broader framework of sound monetary and fiscal management, a well-designed and executed Debt Management System (DMS) and debt market development.

[70/] See IMF/WB Guidelines for Public Debt Management (Washington, D.C., 2001).

LEGISLATIVE FRAMEWORK FOR FISCAL MANAGEMENT

The structure of government in the Caribbean is hierarchical rather than collegial. There is usually a dominant cabinet led by an executive President or Prime Minister. There is usually direct rather than proportional representation leading to a legislature dominated by two political parties where the representation of the majority party is likely to be dominated by the executive and expected to vote along party lines.

The budget cycle usually begins with a determination by Cabinet as to its policy priorities for the next fiscal year. This is followed by a budget call from MOF for other Ministries to detail their requirements for funding for the next budget. These spending plans are expected to differentiate between statutorily required expenditure (e.g. establishment remuneration and debt servicing) and discretionary programmes. Expenditure amounts are expected to be matched to specific objectives or statutory obligations.

Efforts to reduce fiscal deficits in a context of severe debt-induced resource constraints are likely to mean that allocations fall short of requests by implementing ministries. Where resource constraints force cuts in budgets and care is not taken to adjust policy objectives, there may be a weakening of budget "ownership" on the part of implementing ministries.

The tabling of the expenditure budget followed by its means of financing lays the basis for examination by the legislature and the passing into law of an Appropriations Bill. It is this law that will facilitate spending by government in the course of government's financial (fiscal) year. Spending is not permitted outside of the appropriations bill and funds appropriated for a specific purpose may not be reallocated without the expressed authorisation of Parliament in the form of supplementary estimates.

The administrative head of MOF ("Financial Secretary" or "Permanent Secretary") is recognised in legislation as the officer charged with ensuring that government resources are expended in keeping with the law. Beyond responsibility for preparation of the budget on advice from Cabinet and guidance of the warrant process, this officer also has a responsibility to ask the government's chief auditor (the "Auditor-General" in some instances) to investigate concerns about the disposition of government resources. The administrative heads of the other ministries are similarly charged with responsibility for the disposition of resources allocated to their Ministry. The capacity to hold public servants accountable is severely compromised if there is a blurring of the lines of responsibility between administrative and political leadership. This confusion of roles is likely where the political neutrality of the appointment process and the operational independence of the public servant within the law are compromised.

The role of an Auditor General is usually explicitly recognised in legislation. Among other functions, an Auditor General ensures that appropriations, warrants and expenditure are in keeping with laws governing PFM. The Auditor General will undertake routine audits of government ministries, departments and agencies, not all of which are so audited in a given financial year. The Auditor General may also undertake special audits on the basis of concerns raised by observation or information received or requests from the Minister of Finance, other portfolio ministers, or from the Financial Secretary. Findings are submitted to the authorised entity requesting the report, the Minister of Finance and FS, and to Parliament. Senior public servants have to provide written responses and may have to answer in person to the legislature.

The legacy enabling legislation in some instances dates back to the 1950s. As such the reports and information specified is largely consistent with the use of cash rather than accrual accounting. Information generated on this basis is therefore mostly limited to cash expenditure, cash receipt, cash deficit and net cash financing (cash borrowing minus cash amortisation). This traditional use of cash accounting recognises outlay when cash is paid rather than when the liability is incurred (e.g. when supplies are received). Thus it facilitates the accumulation and consequent non-recognition of payment arrears and hence the under-reporting of true fiscal deficits and public debt accumulation. Cash accounting therefore facilitates the abuse of deferred financing discussed above. Cash accounting does not permit even a simulation of either an income statement or balance sheet for the state.

Most modern reform of PFM subscribes to the use of GAAP central which is the use of accrual accounting. Efforts to reform PFM have spoken to an imperative to introduce accrual accounting across the public sector. For example, Jamaica sought to start with a pilot project using accrual accounting across a few Ministries. Barbados has introduced the use of a system to integrate accrual accounting of inputs and outputs and the deployment of human resources.

While the transition from cash to accrual accounting is an ideal, the intensity of the information processing and technical requirements suggest that governments' best approach would be to phase it in carefully. As such, Barbados initially employed their system to generate information on outstanding payments, an essential and valuable step towards full accrual accounting.

THE ROLE AND IMPACT OF FISCAL INSTITUTIONS

Caribbean jurisdictions have clearly articulated legislative frameworks for fiscal management of the type mentioned in the previous section. Commonalities tend to arise from shared colonial experiences and the provisions would have reflected what would have been considered appropriate in developed countries between the late 1950s and the late 1970s.

As noted above, these frameworks have been managed by hierarchical rather than collegial governmental institutions. Whereas hierarchical government may facilitate positive change where there is socio-political commitment for that change, it may also facilitate fiscal irresponsibility where the system of incentives does not demand that positive change.

There are several instances in which hierarchical governments have facilitated suboptimal fiscal management decisions. Governments across the Caribbean have engaged in public ownership of corporations often with significantly negative consequences for fiscal performance. Public sector employment and emoluments have often been politicised with unsustainable commitments being made from political platforms. There have often been controversies over massive cost overruns on major debt-financed infrastructural projects and concerns about the transparency of the contract award process. These factors tend to increase primary expenditure, reduce primary balances and increase public debt.

The OTs stand in some contrast to the politically independent jurisdictions (See Appendix 4.1). In those territories the system tends to be even more hierarchical with fundamental executive authority being resident in the colonial power. The colonial power may retain direct responsibility not only for external affairs and external defence but also for internal security, justice and the civil service. The stronger hierarchical system, albeit a product of colonialism, facilitates more transparent commitment to positive outcomes but has not absolutely prevented concerns about

mal-administration. The ultimate constraint on fiscal mal-administration is externally resident in the colonial power.

In a formalistic sense, politically independent jurisdictions do engage in budgeting for both inputs (expenditure) and the purposes of the expenditure. The voluminous "Estimates of Expenditure" tabled in the legislature, outline in fine detail the amounts to be expended in association with specific objectives. With the possible exception of specific social and infrastructural projects, however, there may be no clear indication of the nature of the outputs to be anticipated. Ministries of Government are often expected to have corporate plans but there is at best weak reflection of the relationship between recurrent allocations and the output of those plans. Even if there is an association a priori, there usually is no evaluation *ex post* in transition to the ensuing budget.

Spending within the amount budgeted but not accomplishing policy objectives is practically equivalent to accomplishing the objectives on the basis of over-expenditure. In the latter case, pursuit of the same objectives will require additional allocations in ensuing years to accomplish that which ought already to have been accomplished. This repeat budgeting increases the tendency towards weakening primary balances and increasing fiscal deficits and public debt.

Legacy accounting systems, perhaps adequate in the 1950s and 1960s, have been on a cash rather than accrual basis. As such they have not been consistent with the evolution of GAAP that emphasises accrual accounting. The use of cash accounting to record expenditure only when payment is made has been used to obfuscate/under-represent fiscal expenditure in the Caribbean.

With deferred financing, government guarantees repayment of financial resources used by a non-government entity (own resources or bank loan) to undertake a project on behalf of government. In the year of execution there is an increase in government guaranteed debt but an under-representation of government expenditure. By the end of project implementation government has to start servicing the loan but recognition of the loan then demands the contra-entry of recording the expenditure undertaken. There may then be an increase in recorded expenditure and the deficit where the practical expenditure and debt accumulation had already been undertaken.

Cash accounting has also been used in the Caribbean to obfuscate expenditure through the accumulation of payment arrears. In a liquidity or fiscal crisis non-payment or delayed payment of public sector emoluments or of contractors appears to represent fiscal compression under cash accounting. These arrears still represent public sector indebtedness and may cause explicit or implicit interest charges by the involuntary creditors of the public sector. Where a culture of arrears develops, creditors price the time value of money into contracts thereby increasing government expenditure and deficits.

The operation of public corporations has also facilitated the increase of fiscal deficits and public debt. Caribbean political jurisdictions have owned corporations involved in air and ground transportation, tourism, agriculture, mining and public utilities. Some of this arose historically from a philosophy of national ownership through the public sector. In some instances (public utilities including ground transportation) public ownership was driven by a perspective of social entitlement to basic needs at minimal cost. In other cases, including agriculture, national airlines and resort hotels, public ownership was informed by either a perceived imperative to support the private sector or to fill a vacuum created by the retreat of the private sector.

Public enterprises have often been a burden to the public purse in the Caribbean. Social and political objectives undermine economic pricing and operational profitability. Public ownership on the basis

of unwilling private enterprise is often an indicator of fundamental unviability. Where loss-making tendencies appear to be secularly irreversible, either through inadequate capitalisation or weak management, losses are often obfuscated through government guarantees, effectively disguising fiscal expenditure, primary balance deterioration and de facto public debt. At privatisation or closure the debts of loss-making public enterprises are brought unto CG books having the same effect as deferred financing and arrears. The Government of Jamaica, for example, has formally absorbed significant debt from its divestments of Air Jamaica and the Sugar Company of Jamaica and the Government of Trinidad and Tobago has absorbed losses from BWIA West Indies Airways and continue to provide fuel subsidies.

Auditors General have had wide powers of investigation of the financial stewardship of government departments and agencies, as well as public bodies and their reports are placed in the public domain through the Parliaments. Despite their efforts in turning up breaches of the enabling legislation, this has not been an effective deterrent to a repeat of these breaches. Resource constraints prevent the possibility of exploration of all entities on an annual or sufficiently frequent basis. Surcharges may apply where a loss is traceable to the actions of a specific officer but the discretionary nature of the charges may weaken the effect. The effectiveness of resort to the criminal justice system is bounded by case backlogs and delays in that system.

Despite a frequency of controversies and scandals regarding contracting for and cost overruns in public projects, it has been a rarity for either senior public servants or politicians to face judicial processes for financial mismanagement. The specification of offences under enabling legislation in the Caribbean speaks more to the role of public (civil) servants rather than to the role of politicians. This is consistent with the letter of the law that makes public servants responsible for the management of public funds. Where public servants either allow or are enjoined to have politicians share this responsibility, public servants are still legally accountable. This ambiguity is avoided in the OTs where public servants, the police and the judiciary are not answerable to the indigenous political directorate. This has facilitated criminal investigation and even conviction of political representatives at the highest level.

The legacy system in the Caribbean has procedural rules regarding the preparation, presentation, debating and legislation of the budget but there may be aspects of ineffectiveness. Resource constraints and an unwillingness to reduce the scale and scope of government may imply budgets being imposed on spending entities. In this context an absence of detailed quantification of outputs causes lack of "ownership" and indifference to outputs and outcomes.

There is substantial documentation on budgetary intentions ostensibly placed in the public domain. Closer examination suggests that this falls far short of the canons of transparency embraced by current trends in public sector financial reform. The "Estimates of Expenditure" are not either easily accessible or comprehensible by members of the general public. Hard copy availability is prohibitive but there is very often no substitution by electronic access. The form of presentation often shows a lot of detail but very little about the aggregate meaning and macroeconomic implications. There is also a tendency to represent total cash outlay (including repayment) and total cash receipt (including borrowing) to the exclusion of net expenditure financed by net borrowing. As indicated above and despite the best efforts of enhanced procurement guidelines, there has been limited information on the nature of public contracting and contract implementation and on the operations and fiscal implications of public enterprises. In general there is a paucity of information on pre-budget strategic intentions, macroeconomic goals, long-term targets, how these objectives are to be achieved, risks to the projections, and periodic intra-year analytical reports in forms easily accessible and comprehensible by the public.

Any discussion of the generation and containment of weakened primary surpluses and higher interest costs in the Caribbean would be incomplete without reference to financial system stability, and external market and natural disaster shocks. The financial crisis in Jamaica in the 1990s is the major cause of its increased burden of public debt and increased interest costs in the new millennium (Chapter 3). The more recent failure of CL Financial has had negative personal and potential fiscal implications across the Caribbean. Natural disasters from hurricane, earthquake, flood and drought have created major fiscal costs. Caribbean economies and their public finances were negatively affected by and are now only slowly recovering from the global economic crisis beginning in late 2008.

LEGISLATIVE FRAMEWORK FOR DEBT MANAGEMENT

Institutional arrangements for public debt management require a sound legal framework. Modern debt management legislation, typically embodied in a single integrated law, promotes good governance through greater transparency and accountability; provides strategic direction to borrowing decisions and clearly specifies the roles and responsibilities for the institutions involved in debt management.[71]/ Good debt management legislation includes: provisions for an explicitly stated public debt management objective; the requirement to develop a debt strategy; and the mandatory reporting of government's debt management performance against stated objectives. The modern legal framework also explicitly establishes an efficient institutional structure for debt management with the roles and functions of debt management agents clearly delineated. Increasingly debt management legislation includes quantitative limits on debt levels, especially if there are no fiscal rules in other financial management legislation. Quantitative limits are also frequently specified for guarantees and other contingent liabilities in view of the significant impact they can have on the fiscal budget and debt levels.

In the absence of public debt management legislation that requires governments to clearly specify a debt management objective and develop a DMS, governments' borrowing decisions are often not based on any clear or consistent cost or risk objective and, as a consequence, result in very costly borrowing outcomes. As has occurred in many Caribbean countries governments' pursuit of cost savings has often resulted in short-term savings but exposed public debt portfolios to significant risk increasing the potential for default.

The absence of modern public debt management legislation in most of the Caribbean undermines the transparency and accountability of fiscal and debt management operations. Where there is no legal requirement for government to account for any variation between its outturn and stated objectives, it does not allow the public to evaluate government's performance against quantifiable benchmarks. Considerable opportunity is therefore provided for imprudent borrowing to occur without appropriate government accountability. In addition, the absence of clearly delineated institutional roles and responsibilities contributes to uncoordinated debt management operations. Each institution is able to operate unaccountably to implement a strategy outside the framework of a single debt management objective. In such an environment there is little obligation for the institutions to exchange information or to coordinate their activities.

Similarly if provisions for transparency and accountability in debt management are absent greater opportunities exist for governments to make poor borrowing decisions without the opportunity

[71]/ Arindam Roy and Mike Williams, Government Debt Management : A Guidance Note on the Legal Framework; (Commonwealth Secretariat, 2010)

for the electorate or financial markets to accurately assess the economic and social implications of those choices. Debt management legislation thus provides not only for the mandatory reporting of governments' debt management performance against stated objectives but for comprehensive reporting on the public debt beyond the financial statements found in annual budget or Treasury reports.

Over the decade both Suriname in 2002 and Jamaica in 2011 have significantly overhauled their debt management legislation consolidating and integrating various pieces of debt legislation into a single debt law. The enactment of Suriname's National Debt Act (NDA) sought to accomplish five objectives. First, NDA sought to clearly define public debt and more specifically those liabilities that constituted a direct or contingent obligation of the government of Suriname. NDA also sought to clearly delegate sole authority to borrow and enter into financial obligations, such as guarantees, to a single agent – the Minister of Finance. The third objective was to establish clear exposure limits for the Suriname's public debt as a means of ensuring long-term debt sustainability. A fourth objective was to establish an efficient institutional structure for public debt management by centralising the debt management functions within a single entity. NDA's final objective was to ensure greater transparency and accountability in debt management operations.

Legally required to adhere to its debt exposure limits, Suriname is one of the few Caribbean countries that, since 2003, has maintained its public debt at sustainable levels. Debt legislation has contributed in a number of ways. First, NDA defines total public debt as "the total outstanding legally valid established debt service obligations issued by the State, inclusive of the amounts of contracted debts not yet drawn, as well as arrears of interest and costs…and those implying a guarantee commitment of the State." This public debt definition in conjunction with legally stipulated borrowing limits, subjects the authorities to much tighter borrowing constraints. Since the definition of public debt includes amounts that have not yet been disbursed, Suriname's actual public debt outstanding is often lower than the reported debt. Correspondingly, Suriname's risk and debt sustainability indicators overestimate the actual level of indebtedness conventionally defined.

Suriname's NDA provides for explicit exposure limits on its public debt. The Act provides that the public debt shall be a maximum of 60% of GDP per annum, of which external debt will not exceed 45% of GDP, and domestic debt 15% of GDP. These exposure limits provide a clear operational framework for debt management within which to develop a borrowing and DMS. Suriname has stayed well within its stipulated exposure limits since 2003.[72/] A major benefit of establishing a global borrowing limit rather than specific borrowing limits for certain types of instruments or creditors is that it allows government greater flexibility in implementing its funding strategy. Borrowing in various instruments or from various markets is determined by the country's medium-term DMS, rather than by a specific legal rule which has no underlying cost or risk rationale.

The NDA has also sought to contain debt levels by, firstly, delegating the sole authority to borrow to the Minister of Finance and, secondly, by imposing explicit penal provisions should there be a breach in the stipulated exposure limits. The Minister of Finance is liable to imprisonment of up to 10 years and to a fine of up to (the local currency equivalent of) USD750,000 should there be an intentional breach of this provision which results in the exposure limits being exceeded.

[72/] In 2011, in an effort to reduce foreign currency exposure, Suriname rebalanced the exposure limits for its debt, increasing the upper limit on domestic debt from 15 to 25% of GDP and lowering the external debt limit from 45 to 35%.

Jamaica's public debt management law patterns Suriname's in several ways. There is commonality in delegating power to the Minister of Finance to borrow and specifying clear purposes for borrowing. Both debt laws mandate comprehensive reporting on the public debt to Parliament and require an evaluation of debt management performance. Both include provisions that authorise the Minister of Finance to issue loan guarantees.

However, there are two areas in which these countries' debt laws diverge. Suriname's debt act does not require the government to clearly state its public debt objectives expressed in terms of cost and risk, or to develop and implement a medium-term debt strategy consistent with those goals. Jamaica's public debt act provides for the efficient and effective management of the public debt to meet cost minimisation objectives and to develop a medium-term debt strategy consistent with government's macroeconomic objectives. Significantly also, the Suriname debt act does not provide for the development of the domestic debt market whereas Jamaica's debt law identifies this as a key objective. The absence of these provisions may provide less of an incentive to Suriname to pursue risk management activities or domestic market development, operations that may further reduce borrowing costs and increase public savings. Nonetheless, in both cases, debt management legislation provides the underpinnings for more effective public debt management.

THE ROLE AND IMPACT OF DEBT MANAGEMENT INSTITUTIONS

Since the start of the decade a small but growing number of Caribbean countries have begun implementing institutional reforms to better manage their debt portfolios, help mitigate the impact of worsening debt dynamics and, in conjunction with sound fiscal management, achieve long-term debt sustainability. An examination of the institutional arrangements for public debt management and the debt dynamics within the Caribbean would support the argument that countries with sound fiscal and monetary management, as well as an enabling institutional framework for public debt management, perform better overall than countries where such arrangements are weak or non-existent.

Sound debt management practice requires institutional arrangements that clearly delineate the roles and responsibilities for all relevant institutions involved in public debt management. [73/] The roles of the Central Bank, MOF, the Treasury and the DMO must be known and the debt management functions performed distinct and separate to avoid a duplication of effort. The duplication of effort generally dilutes accountability and imposes significant costs of public budgets.

Institutional Structure

Debt Management Office

The preferred practice internationally is to consolidate debt management functions into a single location, typically a DMO which either stands alone or is located within MOF. The value of a single operating entity is that it contributes to the overall effectiveness and quality of public debt management. It avoids a duplication of effort, allows for more efficient decision-making and facilitates the development and implementation of comprehensive strategy for the entire debt portfolio.

[73/] IMF/WB Guidelines for Public Debt Management (2001, amended 2003), Graeme Wheeler, Sound Practice in Government Debt Management (WB, 2004).

Widely dispersed and fragmented debt management functions generally give rise to higher public costs especially in the execution of government's borrowing programmes. In the absence of a unifying or a coordinating mechanism and a clear overarching debt management objective and strategy and without formalised information management and sharing arrangements, each ministry, department, or agency tends to narrowly focus on its own objectives. Institutional choices about borrowing in terms of choice of currency, interest structure cost or instrument type are often uncoordinated, leading to inconsistencies in government's implementation of its funding programme. Often, risk considerations may be subordinated to immediate cost considerations leading to portfolio structures with high shares of foreign currency, short term or floating rate debt. These structures over time frequently increase the long-term borrowing costs of governments.

Increasingly the global practice is to establish DMOs that reflect the organisational structures of private financial institutions. Work is divided functionally across front, middle and back offices; each with clearly defined objectives, responsibilities, reporting lines and accountabilities. Work organised along these functional lines generally allows for more streamlined debt management functions. The structure provides effective checks and balances to debt management operations by ensuring there is a separation between the functional area that develops the debt strategy, that which implements the borrowing plan and executes transactions and that which confirms and records the transactions.

At present, many Caribbean countries have their public debt management functions dispersed across a number of institutions. Several ministries, agencies or departments may be involved in public debt management and responsible for performing some aspect of front office, back office and middle office debt management functions. Across the Caribbean, country borrowing programmes are often implemented by several institutions. These may include the Ministry of Foreign Affairs, MOF, planning departments, treasuries and Central Banks. Institutional responsibilities for borrowing are often assigned by source of funding (domestic or external) and by instrument type (loans or debt securities). Typically, Central Banks are engaged as fiscal agents with responsibility for issuing debt securities on behalf of government.

The risk associated with such fragmentation is that the sum of the parts may not add up to a cohesive and consistent debt strategy focused around a single debt management objective. Short-term cost considerations may factor more significantly in the Ministry's or Treasury's borrowing considerations, with less concern about refinancing risk associated with short-term debt or the exchange rate risk associated with foreign currency debt. Central Banks concerned about their reserves position may place more weight on relatively less expensive external borrowing despite the associated exchange rate risk. Project units, in seeking to secure funding from new donors, (for example, China or India) may increase currency exposures in the portfolio that over time may add significantly to the overall debt burden. Discordant borrowing programmes have exposed Barbados to higher levels of long-term debt, service costs and risks.

In the Caribbean back office functions are also often widely dispersed across ministries, agencies and departments with each institution maintaining separate and partial databases for the public debt. Central Banks may frequently maintain their own database for domestic debt securities, as well as maintain parallel records on external debt. MOF may have comprehensive records for medium and long term external debt but rely on their Treasury Departments for information on the remainder of their portfolio. The main disadvantages to such an institutional arrangement include the following. Firstly, a government seeking to craft a comprehensive DMS is unable to obtain a full and integrated view of its debt portfolio and thereby actively understand and manage its costs

and risk. Secondly, the maintenance of parallel systems and different compilation puts the accuracy and reliability of the country's public debt data into question.

Since 2000 a number of Caribbean countries have taken steps to reform their organisational structures to more closely align them to international best practice. Suriname has been preeminent in undertaking significant institutional reforms in this area as well. In 2004, widely dispersed debt management functions were consolidated and centralised in a single debt management entity – the Suriname Debt Management Office (SDMO).

The SDMO was established as a separate institutional entity outside MOF. SDMO reports directly to the Minister of Finance and a Supervisory Board provides oversight. SDMO was structured along functional lines into front, middle and back offices. SDMO's front office is responsible for assisting in loan negotiations and in evaluating new loans; the middle office undertakes the analytical function including debt portfolio and risk analysis; and the back office is responsible for debt payment servicing and accounting, as well as for debt recording.

In 1998 Jamaica initiated its first steps to consolidate debt management functions by transferring all debt management functions except for the externalisation of debt payments and primary market securities issuance, from the Bank of Jamaica to the Debt Management Unit (DMU) in MOF. The consolidation led to more structured primary market issuance, a better evaluation of borrowing costs and more timely dissemination of data. Despite the progress made, it was increasingly recognised that further reforms were needed. In 2011 major changes were initiated to reform the organisational structure of DMU to enable it to better develop and execute a DMS. As in Suriname, the organisation was established with front, middle, and back offices. However, the centre point of Jamaica's reform programme was to develop the middle office capability within MOF. The intent was to build on the successful execution of the liability management programme (the Jamaica Debt Exchange, discussed in Appendix 2.1) and ensure a comprehensive medium-term debt strategy which aimed to further reduce Jamaica's borrowing costs and risk exposures.

One immediate benefit of centralised debt management functions and a DMO organised along functional lines is that it better allows for governments to recruit and develop staff with the appropriate skill set for each functional area. Governments face considerable limitations in formulating debt strategies, assessing risk and executing a funding strategy if their debt offices are staffed by non-specialists. By organising work units by function, specialists in each functional area – risk management and portfolio analysis, debt statistics compilation and accounting, and primary market issuance and development – can be recruited allowing for more skillful management of the debt portfolio and its associated risks.

Debt Management Committee

In some Caribbean countries the consolidation of debt management functions within a single institutional entity with back, middle and front offices, while ideal, may not be practical in the short-term or feasible in the long-term, given human and financial resource constraints. However, even where responsibilities are dispersed across a number of institutions, there is scope for Caribbean countries to manage their debt effectively. While maintaining fragmentation is not the ideal arrangement it can be managed if the roles and functions performed by each institution are clearly delineated, the institution responsible for overall debt management decisions is clearly identified and there is active and ongoing coordination among all the involved debt management agencies. In this situation debt management can be supported by forming high-level coordination committees,

as well as technical working groups which make decisions about government's debt strategy and provide guidance on debt management operations. Such debt management committees are useful even when debt management functions are consolidated. In these circumstances such committees facilitate coordination between monetary, fiscal and debt management policy.

High-level debt policy committees can act as a unifying body that provides oversight to government's formulation and implementation of its debt strategy. The debt policy committee formulates or approves government debt policies and strategies, including the borrowing plan and ensures coordinated operations among the main institutions involved in debt management. Such committees are usually chaired by the Permanent Secretary in MOF, and will comprise heads of the principal debt management agencies, the Treasury, the Central Bank and the Planning Ministry. Technical committees are often formed concurrently with the high-level debt policy committee to provide analytical support and to address operational issues related to public debt management. Responsible for coordinating information flows across the main debt management institutions, the technical committees generally ensure efficient debt management operations.

A small but growing number of countries have established public debt management committees. In 2010, Barbados implemented a number of measures to strengthen the institutional framework for debt management including creating debt management committees. In lieu of centralising all the debt management functions within MOF, Barbados instead created a "virtual debt office" by establishing two high-powered debt management committees that provided oversight and strategic direction to the existing institutions engaged in debt management. A high-level debt management committee, the National Debt Advisory Committee, was established to act as an advisory group on debt management and provide oversight for all public debt management operations; while a Technical Debt Management Committee was formed to support the work of the Advisory Committee. The Advisory Committee's main mandate was to articulate government's debt management objective and establish a policy framework for debt management, oversee the implementation of DMS and assess debt management performance. The Committee was also expected to oversee the management and sharing of public debt information across all relevant agencies.

Public debt management in Barbados has improved notably with the establishment of public debt management committees. Firstly, there has been greater collaboration and coordination among institutions in public debt management. A significant outcome has been the dedication of more resources to public debt management within MOF with the establishment of a DMU. Secondly, improved information cross-flows have focused attention on better maintenance and use of public debt management systems. It has also led to greater scrutiny of the timeliness and accuracy of debt statistics. Sittings of the Advisory Committee have also led to closer examination of debt portfolio risks and the opportunities for cost savings. This has led to the drafting of a comprehensive medium-term debt strategy which quantifies the opportunities for cost and risk minimisation.

Similar to Barbados, Jamaica, in 2011, established two debt management committees. The first, a high-level Public Debt Management Committee (PDMC) was established under the provisions of the 2011 Public Debt Management Act. The primary role of PDMC is to monitor the implementation of government's public DMS and provide oversight to government's debt management operations, including its policies, strategies and management of contingent liabilities. PDMC comprises the Financial Secretary as Chair and includes the Deputy FS responsible for economic management, the Governor of the Bank of Jamaica, the Accountant General, the Head of the Planning Institute, and the Head of the Debt Management Branch. The second Committee, the Public Debt Financing Committee (PDFC), is responsible for monitoring and providing technical advice to the FS on

government's funding strategy. PDFC is mandated, inter alia, to review and monitor issues related to the cost or pricing of contingent liabilities and to evaluate the funding requests by public bodies. The immediate benefit derived by Jamaica from the PDMC is a shared understanding across all institutions of government's medium-term DMS, and the constraints associated with implementing various funding strategies.

Management Strategy and Principles

Debt Management Strategy

A clearly-articulated debt management objective is critical to defining government's debt strategy and debt management operations. Governments must not only focus on cost considerations but must assess the risks associated with their debt portfolio structures since these exposures could lead to higher debt service costs over the long term.

The absence of a clear debt management objective can be costly to governments. Poor or inconsistent borrowing decisions may occur and borrowings may be based solely on minimising short-term costs without due regard to potential longer-term risks. Basing a debt strategy solely on a cost minimisation may lead government to pursue a borrowing path that relies heavily on short-term debt because of the lower interest costs associated with shorter maturities. Such a strategy pursued without commensurate consideration given to refinancing risks – the risk that debt is rolled over at high cost or cannot be rolled over at all – can give rise to significant losses in the long run. Antigua and Barbuda and Jamaica's need to restructure their domestic debt portfolios were due largely to the high concentration of short-term maturities in their portfolios exposing government to significant refinancing risk. Belize's debt restructuring was triggered to some extent by the repeated refinancing of external bonds raised in the international capital market at increasingly higher international market yields.

Governments without a risk minimisation objective may opt to borrow heavily in external markets, as opposed to accessing domestic funding, because of the relatively lower interest rates and longer maturities. Similarly, governments may also choose to issue and accumulate high shares of floating rate debt in a low interest rate environment. However, these cost considerations may not give due regard to the impact of currency movements that could add significantly to future debt servicing costs, or to the volatility of interest rates that could give rise to significant increases in interest costs. The steady appreciation of the Euro vis-à-vis the US dollar in the early 2000s led to significant increases in debt-servicing costs in those Caribbean countries that had increased their share of Euro borrowing. Local currency depreciation, as well as cross-currency movements had a significant impact on Guyana and Jamaica's external debt-servicing costs in the past, due to significant exchange rate movements of their local currency vis-à-vis the US dollar, and the increased share of other foreign currencies in their portfolio.

The portfolio composition of most Caribbean countries indicates high exposures to refinancing, interest rates and foreign currency risk. Belize, Guyana and Haiti, with shares of external debt exceeding 50%, all have high exposures to foreign currency risk. Antigua and Barbuda and St. Kitts and Nevis have high shares of short duration domestic debt and are exposed to significant refinancing risk. Jamaica's high share of short-term, floating-rate, domestic debt has exposed the country to both refinancing and interest rate risk and largely explains the significant rise in debt-servicing costs that necessitated its 2010 debt restructuring.

Over the past decade, several Caribbean countries have set medium-term debt sustainability targets. Barbados has stated its aim to achieve a target debt-to-GDP ratio of 70% by 2017, while ECCU member countries seek to achieve debt-to-GDP ratio of 60% or less by 2020. Jamaica in its 2010 fiscal responsibility legislation, has set itself a debt-to-GDP target of 100% by 2016. However, few countries, at the time accompanied these targets with a clear debt management objective or a comprehensive DMS.

Since the late 2000s there has been growing recognition in the Caribbean that governments need to define a clear debt management objective for government's cost and risk preferences and develop an explicit and medium-term debt strategy along with their fiscal objectives. Notably, ECCU member countries, through the support of ECCB's DMAS, have embarked on a comprehensive programme to establish clear debt-management objectives, and develop medium-term debt strategies, to quantify the risks and costs in their portfolios. Antigua and Barbuda prepared its DMS in 2006 and with the assistance of DMS published its first comprehensive assessment of government's debt portfolio and its risk exposures in 2011. Outside ECCU, in 2011, Barbados took steps to strengthen its public debt management by undertaking a thorough review of its debt portfolio, and preparing a comprehensive medium-term debt strategy. Jamaica, which since 1998 has consistently produced an annual DMS, has moved to a more rigorous assessment of its portfolio and quantification of its risks. Jamaica produced its first medium-term debt strategy in 2011.

Management of Contingent Liabilities

Contingent liabilities represent a significant risk to fiscal and debt sustainability. Sound debt management requires close monitoring of explicit contingent liabilities, especially government guarantees and on-lending arrangements. Prudent debt management also requires monitoring of conditions that could trigger implicit contingent liabilities such as possible financial rescue associated with financial sector or public enterprises.

Chapter 3 exposed the significant contribution of contingent liabilities to the growth of debt in nearly every severely indebted Caribbean country. Jamaica and Trinidad and Tobago have adopted a number of measures to better manage the risks associated with contingent liabilities. Jamaica since 1996, has strengthened its prudential supervision and regulations and introduced deposit insurance schemes to help prevent or mitigate large financial losses. Jamaica's establishment of the Financial Services Commission, in 2001, to monitor and regulate non-deposit taking institutions was largely responsible for the decision by CLICO not to operate in Jamaica, sparing Jamaica from the CLICO crisis. Trinidad and Tobago has embarked on reforms to strengthen its regulatory framework, including new legislation and stronger supervision so as to avoid a future crisis.

Jamaica, under its new *Public Debt Management Act*, has established explicit benchmarks for government-guaranteed debt with the long-term objective of lowering the share of guaranteed debt. Under the terms of the Act exposure limits for government-guaranteed debt have been prescribed at 8% of GDP at the end of 2016/17, 5% at the end of 2021/22, and 3% after financial year 2026/27. Jamaica's government-guaranteed debt amounted to 13% of GDP at the end of 2011. The public debt act also provides for increased monitoring of public bodies beneficiaries and increases the reporting obligations of such bodies including the requirement to report on the status of all debts on a monthly basis. Jamaica has also adopted further measures to improve the monitoring of on-lending beneficiaries and loan guarantee recipients under the revised 2011 *Public Bodies Management and Accountability Act.*

Management of Internal Operations

Sound practice in public debt management requires staff with a combination of finance, economics and public policy skills. [74/] Moreover, front office staff must have extensive market knowledge, as well as the technical skills to secure funds in each market segment. They must be familiar not only with the markets but with the range of borrowing instruments and hedging techniques applicable to each market. Middle office staff must have a sound understanding of financial portfolios. They must be able to rigorously quantify the risks and costs embedded in the portfolio and develop a strategy to achieve the appropriate portfolio composition based on government's debt management objectives. They should have a sound understanding of macroeconomic relationships. Debt management staff in the back office must have a professional knowledge of loan agreements and must be able to interpret them so as to properly extract and key in their information in a debt recording system. They must be trained to competently operate a debt recording and reporting system and must understand debt compilation principles and practices. Back office staff must also have well developed accounting skills in order to settle and account for debt transactions and adhere to accounting rules and procedures.

Despite the enormity of the challenges facing Caribbean countries with respect to public debt management, many countries do not have a DMU with specialist staff. Antigua and Barbuda established a DMU in the mid-2000s, and Barbados established one only in 2011. Significant investment and innovation is needed to recruit and retain staff in public debt management. Many Caribbean governments face serious constraints in recruiting staff because of their country's small size, and the general scarcity of specialists with the required financial or economic skills throughout the public sector, or in the larger society.

Many Caribbean DMOs are exposed to significant key-person risk. This is the risk that only one or two persons have expertise in a certain work activity thereby severely disrupting debt management operations when they are absent or leave the unit. Given the small size of many Caribbean debt offices, innovative ways will have to be found to retain staff or build a body of expertise beyond the DMOs. Suriname with a small debt office of less than 10 persons has attempted to address this by establishing a working collaboration with its universities. This has helped in building and retaining middle office capability in debt management. Barbados, by establishing a technical working group that is cross-institutional and includes fiscal specialists in MOF, Central Bank, and debt management staff, has created a shared pool of expertise that has strengthened debt management capacity.

Although ongoing capacity building is also required to build levels of expertise in debt management, training and development is often constrained by limited budgets. More flexible and innovative approaches to capacity building can be adopted by debt management entities, by seconding staff from the Central Bank or the private sector, on-the-job mentoring, online learning opportunities, work and career development programmes and staff internships and attachments. In the quest to build debt management capacity and recruit professional staff with the right skills set, public sector institutions may also have to deviate from existing public service salary structures and create skill-based salary structures to recruit and retain debt management staff.

The DMAS programme for ECCU member countries is a major initiative to build debt management capacity in the sub-region. The goal of DMAS is to "improve the capacities of ECCU governments

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[74/] IMF/WB Guidelines for Public Debt Management (2001, amended 2003), Graeme Wheeler, Sound Practice in Government Debt Management (WB, 2004).

to effectively corral their debt to sustainable levels in line with the fiscal targets established by the ECCB Monetary Council." [75/] To date DMAS has been instrumental in undertaking debt management performance assessments in member countries, assisting in portfolio analysis and in developing debt and risk management strategies.

The Quality of Public Financial Management

The record of public sector financial performance across the English-speaking Caribbean has been mixed. Most of the economies at some point in time have faced macroeconomic crises characterised by growing fiscal and current account deficits driven by unfavourable external influences, natural disasters or inappropriate internal policy management.

In the 1970s and 1980s it was not only Jamaica and Guyana but also Trinidad and Tobago and Barbados that experienced fiscal deterioration and needed corrective adjustment. There were oil price shocks adversely affecting the oil importing economies but creating a basis for fiscal expansion in Trinidad and Tobago. Reversal of oil price spikes would then have exposed the fiscal balance net of petroleum revenue as being unsustainable. Fiscal deficits in Jamaica in the 1970s were driven by social reform but were ultimately unsustainable in the face of an adverse external environment. In the early 1980s there were continuing fiscal deficits with delayed adjustment in the face of a continuing external environment. Barbados also had fiscal deficits but driven to a greater extent by capital expenditure for infrastructural development. The loss of preferential market access, and revenue from import tariffs and the impact of natural disasters also had a negative fiscal impact on some economies in the Region.

In 2009 and 2010, most of the economies experienced higher fiscal and current account deficits, lower growth and an increasing burden of public debt. Jamaica's debt/GDP ratio having declined slowly in previous years again increased to 130%. The ratio in St. Kitts and Nevis exceeded 180% and in Barbados the ratio (including guarantees) exceeded 100%.

The impact of increasing public debt has driven critical re-evaluation of the systems and processes of PFM. This has been especially likely where fiscal and debt crisis has required financial support from MFIs, as has been the case, and for an even more protracted period, in Guyana. While recognising the impact of international market shocks and natural disasters, it is imperative to evaluate the systemic effectiveness of internal financial management.

The summary of the typical legislative framework suggests that there is a legacy rule-based system that should facilitate sound financial management. Closer examination may suggest that there is room for abuse and inefficiency. The severe debt constraint presents leadership with difficult choices between increasing taxes (in stagnating economies,) or cutting expenditure (in the face of the need for better public services). In that situation, there may be a temptation to underestimate expenditure and overestimate revenue, leading to higher than programmed fiscal deficits.

International assessments suggest a moderate quality of economic management for most Caribbean economies. The WB Country Policy and Institutional Assessment (CPIA) Database includes an index for Public Sector Management which includes property rights, rule-based governance, quality of budgetary and financial management, efficiency of revenue mobilisation, quality of public

[75/] See ECCB Annual Report.

administration, and transparency, accountability and corruption in the public sector. On a scale from 1 (low) to 6 (high), the scores reported for Caribbean economies are presented in Table 4.1. Similarly the CPIA database reports on Economic Management including macroeconomic management, fiscal policy and debt management, shown in Table 4.2 for St. Lucia and St. Vincent and the Grenadines.

Table 4.1

World Bank Public Sector Management Index
(Scale: 1-6)

Country	2007	2008	2009	2009
Dominica	3.8	3.8	3.8	3.9
Grenada	3.7	3.7	3.7	3.7
Guyana	3.1	3.1	3.1	3.0
St. Lucia	3.9	3.9	3.9	4.0
Haiti	2.4	2.4	2.5	2.5
St. Vincent and the Grenadines	3.8	3.8	3.8	3.8

Source: WB Group, CPIA database.

Table 4.2

World Bank Economic Management Index
(Scale: 1-6)

Country	2007	2008	2009	2010
St Lucia	4.0	3.7	3.7	3.7
St. Vincent and the Grenadines	3.7	3.7	3.7	3.7

Source: WB Group, CPIA database.

Miguel Braun in "Fiscal Reform in Latin America" (IDB and CIPPEC (2007) reports on the relationship between institutional factors and fiscal outcomes as follows:

(a) Fiscal deficits are seen as being positively related to legislative fragmentation with Barbados, St Lucia and Trinidad and Tobago having low fragmentation and low deficits and Guyana having high fragmentation and high deficits.

(b) Fiscal performance improves as an index of budget institutions (the rules by which budgets are drafted, approved and implemented) increases, with Suriname reported as having weak fiscal performance and a low budget institutions index.

(c) Fiscal deficits fall as accountability (transparency) increases, with Jamaica and Guyana having high deficits with low accountability, while Barbados and Belize are reported as having low deficits with high accountability.

Caribbean economies also experience other structural problems due in part to small size. There are diseconomies of scale in public administration leading to disproportionate expenditure in small economies. The Civil Service emerged from colonialism as a major means of employment with a continuation of public sector emoluments exceeding 10 % of GDP in many Caribbean economies. Public sector pensions have been traditionally paid from the current budget and are becoming increasingly unaffordable. Revenue collection is hampered by exceptions, waivers and incentives that are kept in place by influence of interest groups on the political process.

There have been several concerns raised regarding suboptimal public expenditure management across several Caribbean jurisdictions. In some instances expenditure projects were chosen in an effort to accelerate economic growth in a context of an increasingly unfavourable economic environment. In other instances these projects may have been driven by perceptions of enhancing national image and prestige. Regardless of the motivation, expenditure was often not informed by any rigorous evaluation of the projects ability to pay for itself or of medium-term fiscal and debt management implications, relying instead on the emotional appeal of the project.

In an increasingly unfavourable international economic environment, including the loss of preferential access for bananas to European markets, Caribbean governments have often been elected on the basis of accepting responsibility for accelerating economic growth. Even where some growth has resulted, there has been an increase in public debt effectively threatening the sustainability of that growth. In the first years of the new millennium, St. Vincent and the Grenadines managed to increase growth to 4% per annum, while the ratio of public debt to GDP increased from about 50 to 79%. As a result of expansionary macroeconomic policies from 1999-2004, the fulfilment of electoral campaign promises, Belize's growth accelerated from 4% in 1999 to 11% in 2000. Belize's public debt increased to 92% of GDP by 2006, of which the especially problematic external debt represented 84 percentage points.

CONCLUSION

This chapter explored the role of institutional and organisational structures in conditioning fiscal and debt outcomes. It examined the nature of legislation governing fiscal and debt management in the Caribbean and sought to explore the effectiveness of the institutions established for the performance of these functions.

The objective logic of international best practice in legislation and institutions is clearly understood. In some instances, structural factors (including small size and inadequate databases) militate against immediate or accelerated implementation of best practice (accrual accounting and specialised independent debt offices). But even with those considerations, significant gaps exist between the present and the feasible, never mind the optimal. The prevalence of exogenous shocks in the Caribbean only underlines the imperative for more effective fiscal and debt management to enhance the financial resilience of these economies.

PFM in the Caribbean, sometimes with the most noble of intentions, has often fallen short of international best practice. In particular, some efforts to accelerate economic growth, especially on the basis of deficit financing, may increase public debt and inhibit the capacity for sustainable growth.

The benefits of enhanced management are clear but there may be time, inconsistency, common pool, and incentive misalignment problems that inhibit speedy implementation through the

political process. Nonetheless, reforms are needed and it falls to political leadership to legislate and implement them. The next chapter extrapolates the path of debt levels in the most highly-indebted economies under various policy scenarios.

Chapter 5

Prospects: Extrapolating The Future

INTRODUCTION

This chapter examines the sustainability of the debt of selected Caribbean countries in a consistent macroeconomic framework to ascertain whether additional policy actions are needed to prevent debt default in the medium term. It uses a modified version of the debt sustainability framework, proposed by the IMF to project likely outcomes of debt/GDP ratios for the period 2011-20, for selected borrowing member countries (BMCs) of CDB. The countries included in the study are Antigua and Barbuda, Belize, Barbados, Dominica, Grenada, Jamaica, and St. Kitts and Nevis. These countries were chosen on the basis of their public debt levels being greater than 80% of GDP.

The study yields mixed results for the state of debt sustainability in the selected countries. Although economic growth remains a concern for all selected BMCs; countries such as Antigua and Barbuda, Barbados, and St. Kitts and Nevis have implemented or are about to implement policies that significantly reduce the risk of default. By contrast, although countries such as Jamaica, Grenada, Dominica and Belize have all implemented corrective measures, the magnitude of the measures implemented are either inadequate to curb the continued rise in the debt levels or are insufficient to generate the pace of reduction that significantly lowers refinance risks over the forecast horizon.

METHODOLOGY

The IMF (2001) proposed a framework for carrying out debt sustainability analyses for emerging market economies based on a two-pronged approach. In analysing the public debt, the trajectory of domestic currency denominated debt and foreign currency denominated debt are demarcated to reflect exchange rate dynamics and different levels of credit risk. The evolution of the budget deficit is examined to assess the sustainability of the public debt, while the evolution of the current account is examined for the external debt (which includes public and private external debt).

This study adopts the basic approach of the IMF, but modifies the methodology to reflect certain nuances of the debt structure of the Caribbean economies being studied. For example, in many of the countries, the level of private external debt is miniscule relative to the size of total external debt. Additionally, information on private external debt is usually very difficult to source. Debt sustainability in this study is therefore assessed by way of the dynamics of CG's budget rather than the two-pronged approach that includes the BOP. In the countries where the size of the public external debt creates significant BOP pressures, a bird's eye assessment of BOP prospects is conducted. For most of the selected countries, the evolution of public debt is influenced heavily by operations of CG. Within this context and for comparability purposes, our study focuses on the dynamic evolution of CG's debt. Historical data show that multilateral and bilateral debt is usually large relative to the total debt of the selected countries. These sources of debt usually have discounted interest rates and favorable amortisation profiles relative to commercial debt.

The technical objective of this chapter is to execute the exercise conducted in Chapter 3 in reverse. Instead of starting with the observed change in public debt and breaking it down into its constituent

components to explain the growth of the debt, this chapter establishes scenarios for the components then aggregates their effect on the debt to chart the future evolution of the debt stock. The technicalities of the aggregation along with its algebraic justification are provided in Appendix 3.1.

While off-budget events such as contingent liabilities were a major contributor to the accumulation of debt in the Caribbean, the absorption by CG of future liabilities was not included in the extrapolations below because they are entirely exogenous to the dynamics of fiscal deficits and debt service. Whatever debt outcome is projected an assumption about the amount of future-realised contingent liabilities can simply be added. This chapter's focus, instead, is on the effect of different expectations about fiscal performance and interest rate paths on the evolution of the debt stock. In so doing, we will be able to draw conclusions about the degree of fiscal consolidation required for a sustainable debt profile.

SCENARIO DESCRIPTIONS

Projected debt/GDP ratios are computed for each of the countries examined in this chapter and are compared across the scenarios articulated below.

(a) In the **baseline scenario** the status quo is estimated by assuming that the respective governments adhere to the fiscal policies that are currently being implemented, or are likely to be implemented, based on publicly-announced plans. In all the countries examined, some corrective fiscal policies were already adopted or are in the pipeline, and, on that basis, improved debt/GDP ratios are projected. We assess whether those improvements are sufficient to place the countries on a sustainable debt trajectory, by comparing the computed debt/GDP ratios at the end of the projection period with an estimated debt default threshold. The default thresholds used for countries that have previously defaulted are the debt/GDP ratios existing at the time of their most recent default. For countries that have not previously defaulted, the default thresholds are computed as the debt/GDP ratios consistent with debt-servicing costs that are greater than the primary balances, plus an estimate of market support. [76/]

(b) A path of **least resistance scenario** was also created to project what would have happened to each country's debt/GDP ratio if governments had done and continue to do nothing about their deficit positions. This scenario assumes that due to political exigencies or social pressures the respective governments rollback the corrective measures now being implemented and revert to the path that resulted in the currently high debt positions. The projected debt/GDP ratios are compared with the debt default threshold and demonstrate the increased likelihood of default. This scenario is useful as it highlights the dangers associated with fiscal profligacy and/or indiscipline.

The results of the above two scenarios are supplemented by additional analyses in which the focus is shifted away from projecting debt/GDP ratios, to ascertaining the fiscal policy stances that will lead to two pre-determined debt/GDP outcomes during the projection period. These two supplemental exercises are outlined below:

[76/] The estimate of market support refers to the amount of money a government can borrow from capital markets.

(c) The default scenario is computed to ascertain the primary balance that is likely to cause each country to just cross the debt default threshold in any year in the projection period. It highlights, for the respective governments, the minimum primary surplus or maximum primary deficit that they need to maintain in order to avoid defaulting on their debt over the medium-term through to 2020.

(d) The target scenario focuses on the opposite end of the range by indicating the primary balance that is required to get countries to the targeted debt/GDP ratio of 60% within the projection period. It thus shows what is required to get each country to a debt level consistent with strong economic growth by 2020.

THE BASELINE SCENARIO

The macroeconomic and policy assumptions and results of the baseline scenario are presented below. The sensitivity of the baseline results to macroeconomic shocks is also analysed.

Assumptions

The macroeconomic assumptions represent the path that inflation, real GDP growth, the exchange rate and the interest rates are expected to take over the forecast horizon. These variables are expected to have the most significant impact on the trajectory of government's debt. To project the paths of these variables, the average forecasts from Standard and Poor's Rating Services, Business Monitor International, Caribbean Information and Credit Rating Services and the IMF are used. The macroeconomic assumptions are presented in Table 5.1.

The baseline scenario seeks to identify policies that have been implemented or are likely to be implemented based on the practicality of communicated medium-term fiscal policies. Budget presentations, medium-term fiscal policy documents (where available) and historical data provide the pool of information used to formulate the main policy assumptions. The assumptions for each country are outlined in Appendix 5.1

Results

The projections under the baseline scenario are presented in Table 5.1. Under this scenario only two of the countries studied are likely to default on their debt if additional policy measures are not implemented in the near term. Dominica and Grenada have a high probability of default, as projected debt/GDP ratios exceed the debt default threshold at some point over the forecast horizon. In the case of Grenada the projections suggest that the debt default threshold will be exceeded from as early as 2012, indicating that a default is imminent if nothing further is done about the country's debt position. For Dominica the default threshold is exceeded by 2014, which suggests that CG has at most one to two years to implement the necessary remedial measures.

Although the level of debt for Jamaica and Belize are projected to be below the debt default threshold over the forecast horizon, high refinance risks exist due to fragile market confidence and significant debt maturities coming due within the projection period. In the case of Jamaica, over 78% of total domestic debt (USD8 billion) and over 50% of total external debt (USD4.4 billion) mature over the next 10 years. Belize's weak credibility in international capital markets makes it challenging to raise the necessary foreign currency resources to fund foreign currency liabilities when they come due. Bond yields on Belize's US-dollar-denominated super bond have moved into the high teens.

There is a risk that stress points can lead to a default scenario from 2019 onwards when the super bond, which is 2.5 times larger than projected Net International Reserves, begins amortising.

The projections under the baseline scenario thus suggest that only three of the seven countries studied (Antigua and Barbuda, Barbados and St. Kitts and Nevis) should be satisfied with the fiscal measures that they have already implemented or are planning to implement. That satisfaction should, however, be tempered by the knowledge that these projections do not include contingent liabilities, historically the primary source of new debt in the Region. Additionally, even for these countries, the sensitivity analysis below indicates that certain macroeconomic shocks can significantly increase their vulnerability.

TABLE 5.1

BASELINE SCENARIO

	Baseline Debt/GDP Trajectory									Default Threshold	Baseline Assumptions[a]			
Country	2012	2013	2014	2015	2016	2017	2018	2019	2020	≥ Debt Ratio	Exch. Rate[b]	Interest Rate	Real GDP	Prim. Balance
Antigua and Barbuda	75.0	71.7	67.6	63.9	59.9	55.3	49.9	44.3	38.9	77.0	0.0	3.8	3.8	2.8
Belize	78.6	78.5	77.7	75.8	73.7	71.0	67.8	64.9	62.4	91.0	0.0	6.5	2.4	3.0
Barbados	97.1	96.8	94.0	93.0	91.6	90.4	89.8	88.1	84.6	122.0	0.0	6.7	2.6	2.7
Grenada	87.0	91.2	94.6	98.9	101.0	102.9	105.8	108.7	111.9	76.6	0.0	4.6	2.5	(3.4)
St. Kitts and Nevis	85.5	80.9	78.0	74.4	69.7	64.0	58.0	51.4	45.0	113.0	0.0	2.7	2.1	3.4
Jamaica	126.6	124.4	123.0	120.8	119.9	119.8	120.0	118.5	115.2	130.0	5.0	8.0	1.4	4.1
Dominica	75.8	81.5	82.9	82.9	82.7	81.0	78.5	75.6	72.2	82.0	0.0	2.8	1.4	(0.9)

Source: Author Estimates

[a] In absolute percentages except for the primary balance which is in per cent of GDP

[b] Per cent depreciation for each country's respective currency

Sensitivity Analysis

The sensitivity analysis examines the responsiveness of baseline fiscal indicators to shocks to baseline assumptions on key macroeconomic variables, such as real GDP growth, nominal interest rates and the exchange rate. For comparative purposes, the size of each shock is standardised, except in cases where there are one-off shocks. The results of the sensitivity analysis are presented in Table 5.2 and are discussed below.

A Permanent Shock to Real Gross Domestic Product Growth

For the countries that were most likely to default under the baseline scenario (Dominica and Grenada), a half of a standard deviation permanent shock to baseline real GDP growth causes a significant worsening of the debt/GDP ratio, and increases the likelihood of default. By 2020 the debt/GDP ratios of Dominica and Grenada are projected to increase by 28 and 54 percentage points, respectively. The fragility of the Jamaican debt situation was highlighted in the baseline results and is confirmed here. This shock to GDP growth is projected to raise Jamaican debt levels by 22 percentage points of GDP by 2020, and thereby pushes the country over its debt-default threshold.

TABLE 5.2

SENSITIVITY ANALYSIS

Country	Exchange Rate Shock[a]		Interest Rate Shock[b]		Real GDP Shock[c]	
	Debt/GDP	Change	Debt/GDP	Change	Debt/GDP	Change
Antigua and Barbuda	46	7	41	2	95	56
Belize	86	24	67	5	84	22
Barbados	94	9	92	7	107	22
Grenada	131	19	116	4	166	54
St. Kitts and Nevis	44	6	41	3	74	36
Jamaica	128	13	125	10	137	22
Dominica	85	13	74	2	100	28

Source: Author's Estimates

[a] Fiscal year 2020 debt-to-GDP ratios

[b] One-off shock of 30% depreciation for all countries except Jamaica where a permanent 4% is applied

[c] 0.5 Standard Deviation Shock

Antigua and Barbuda is also particularly vulnerable to this shock, as it was not projected to default under the initial baseline assumptions, but is projected to cross the debt-default threshold by 2020 with the specified shock to GDP growth. A half-standard-deviation permanent shock to baseline real GDP growth raises Antiguan debt levels by approximately 56 percentage points of GDP. As was the case for Jamaica, a similar shock to Barbados' and Belize's baseline real GDP growth raises debt levels in fiscal year 2020 by approximately 22 percentage points of GDP. This is the mildest response to this shock to baseline real GDP growth, and for these countries does not lead to projected defaults. So the largest responses were recorded by Antigua and Barbuda and Grenada (56 and 54 percentage points, respectively, of additional debt), followed by St. Kitts and Nevis (36 percentage points), with Jamaica being the least.

A Permanent Shock to Interest Rates

This shock consists of a 250 basis point increase in the interest rate on commercial debt. The susceptibility of the Grenadian government to default on its debt is also highlighted by this hypothetical event, as it is once again projected to cross the debt-default threshold by 2020, when this shock is introduced. For Grenada, this threshold is crossed even though the shock results in a relatively small change to the debt/GDP ratio of four percentage points. Projected changes in the debt/GDP ratio of two percentage points for Antigua and Barbuda and Dominica, and 3 and 5 percentage points for St. Kitts and Nevis and Belize, respectively, do not similarly precipitate a crossing of the threshold. Even the countries which were most responsive to changes in the interest rates (Jamaica and Barbados with increased debt/GDP ratios of 10 and 7 percentage points, respectively) were not projected to default as a result of this shock.

Exchange Rate Shock

The size of the exchange rate shocks applied to the selected countries depends on the exchange rate regime of the countries examined. For the six countries that have a fixed exchange rate regime, a

one-off 30% devaluation is applied to capture the possibility of a stressed exchange rate adjustment in times of severe BOP pressures. For Jamaica, which has a flexible exchange rate regime, a permanent shock is applied.

A 30% devaluation in the XCD pushes both Dominica and Grenada over their debt-default thresholds by 2020, with increases in the debt/GDP ratios of 13 and 19 percentage points, respectively. Although the exchange rate shock is not projected to cause the Jamaican government to cross its default threshold, it significantly increases its vulnerability by pushing the country's debt/GDP ratio to within two percentage points of the threshold. A quarter-standard-deviation shock to the rate of depreciation of the JMD results in a 13 percentage point increase of debt-to-GDP. Belize is most responsive to the exchange rate shock, with a one-time 30% devaluation in the Belizean dollar resulting in a 24 percentage points rise in the debt ratio by fiscal year 2020. By contrast, St. Kitts and Nevis, Antigua and Barbuda and Barbados are least impacted by the exchange rate shock. A 30% devaluation of the XCD and Barbadian dollars increases the debt/GDP ratios of these countries by 6, 7 and 9 percentage points, respectively, and does not dramatically heighten the likelihood of default.

Special Case Shock: St. Kitts and Nevis

In the baseline scenario for St. Kitts and Nevis it was assumed that a debt-for-land swap would be successfully implemented. If this assumption does not hold, and there is no debt-for-land swap, the simulations show that (ceteris paribus) the 2020 debt/GDP ratio for this country could increase by 27 percentage points over that which was initially projected in the baseline scenario. The debt-for-land swap is thus important, as the amount of secured debt is approximately 25% of total CG debt, and all secured debt holders are eligible to participate in the swap.

LEAST RESISTANCE SCENARIO

The path-of-least-resistance scenario examines the trajectory of the debt/GDP ratio if fiscal authorities roll back the fiscal austerity and other remedial measures that were implemented post-recession, with the aim of strengthening political appeal in the pre-election period. The macroeconomic variables stay the same as in the baseline scenario. The results of this scenario are presented in Table 5.3.

Under the path of least resistance scenario, the debt/GDP ratios of all the countries examined, except for Belize, breach the debt default threshold at some point during the forecast horizon. With the reversal of the fiscal consolidation measures, the primary balance will deteriorate for all countries and will set off a chain reaction that leads to a substantial increase in debt. The rolling back of the fiscal measures leads to the most severe worsening of the primary balance (as a percentage of GDP) in St. Kitts and Nevis (with an 8.3 percentage points reduction in the primary balance to GDP ratio), Barbados (5.5 percentage points), Dominica (3.7 percentage points) and Antigua and Barbuda (3.6 percentage points). In this scenario, all of these countries, with the exception of Barbados, are projected to cross the debt default threshold from as early as 2012. Barbados crosses its threshold in 2016, and the debt/GDP ratio is projected to continue to rise rapidly thereafter. Although Grenada and Jamaica experience the least severe worsening of their primary balances in the path of least resistance scenario (with reductions in the primary balance to GDP ratio of 1.1 and 2 percentage points, respectively), they are also projected to equal or cross their default thresholds from as early as 2012. In both countries the debt/GDP ratios are projected to continue to increase through to 2020.

TABLE 5.3
LEAST RESISTANCE SCENARIO

Country	Baseline Debt-to-GDP Trajectory									Default Threshold	Baseline Assumptions[a]			
	2012	2013	2014	2015	2016	2017	2018	2019	2020	≥ Debt Ratio	Exch. Rate[b]	Interest Rate	Real GDP	Prim. Balance
Antigua and Barbuda	78.4	78.3	77.3	76.7	75.5	73.5	70.5	67.2	64.1	77.0	0.0	3.8	3.8	(0.8)
Belize	81.4	84.3	86.7	87.9	89.0	89.4	89.1	89.3	89.9	91.0	0.0	6.5	2.4	0.5
Barbados	102.8	108.7	111.8	117.2	122.1	127.6	134.3	139.5	142.3	122.0	0.0	6.7	2.6	(2.8)
Grenada	88.2	93.4	97.9	103.4	106.5	109.5	113.4	117.4	121.7	76.6	0.0	4.6	2.5	(4.5)
St. Kitts and Nevis	119.7	125.2	132.8	140.1	145.7	149.9	153.2	154.9	156.4	113.0	0.0	2.7	2.1	(4.9)
Jamaica	130.0	131.0	133.1	134.4	137.2	141.0	145.5	148.1	148.6	130.0	5.0	8.0	1.4	2.1
Dominica	89.8	99.8	106.1	111.4	117.4	122.4	126.7	130.8	134.6	82.0	0.0	2.8	1.4	(4.6)

Source: Author Estimates

[a] In absolute percentages except for the primary balance which is in per cent of GDP

[b] Per cent depreciation for each country's respective currency

DEFAULT SCENARIO

The default scenario highlights the fiscal policy stance that leads to a breach of the debt default threshold over the forecast horizon. The baseline forecasts for the macroeconomic variables are used. The results are presented in Table 5.4.

TABLE 5.4
DEFAULT SCENARIO

Country	Baseline Debt-to-GDP Trajectory									Default Threshold	Baseline Assumptions[a]			
	2012	2013	2014	2015	2016	2017	2018	2019	2020	≥ Debt Ratio	Exch. Rate[b]	Interest Rate	Real GDP	Prim. Bal.
Antigua and Barbuda	76.9	75.4	73.0	71.1	68.6	65.5	61.5	57.2	53.1	77.0	0.0	3.8	3.8	0.8
Belize	81.5	84.5	87.0	88.4	89.6	90.1	90.0	90.3	91.0	91.0	0.0	6.5	2.4	0.4
Barbados	101.0	104.6	105.6	108.7	111.4	114.6	118.8	121.5	122.1	122.0	0.0	6.7	2.6	(0.9)
Grenada	87.0	91.2	94.6	98.9	101.0	102.9	105.8	108.7	111.9	76.6	0.0	4.6	2.5	(3.4)
St. Kitts and Nevis	114.4	113.8	114.7	114.9	113.3	109.4	104.4	98.1	91.3	113.0	0.0	2.7	2.1	3.2
Jamaica	128.2	127.5	127.8	127.2	127.9	129.5	131.6	131.8	130.1	130.0	5.0	8.0	1.4	2.6
Dominica	75.8	81.5	82.9	82.9	82.7	81.0	78.5	75.6	72.2	82.0	0.0	2.8	1.4	(0.9)

Source: Author Estimates

[a] In absolute percentages except for the primary balance which is in per cent of GDP

[b] Per cent depreciation for each country's respective currency

From the baseline scenario it was already found that Dominica and Grenada are likely to default at some time before 2020 on the basis of their current fiscal policies. For the other countries, a comparison of the primary balance to GDP ratio in the default scenario, with that of the baseline scenario, gives an indication of the fiscal space that is available. For example, with a primary balance to GDP ratio of 3.2% in the default scenario, and a marginally higher ratio of 3.4% in the baseline scenario, St. Kitts and Nevis has very little scope for expanding their primary balance. Even a small deviation from its current fiscal path is likely to lead to a default at some time over the projection period. Belize, Antigua and Barbuda and Jamaica have a bit more fiscal room to maneuver, with differences between the baseline and default scenario primary balance-to-GDP ratios of 2.6, 2 and 1.5 percentage points, respectively. Particularly for Antigua and Barbuda and Jamaica, this is certainly not sufficient breathing room to make their governments feel comfortable. Barbados is the only country for which the primary balance-to-GDP ratio in the baseline scenario (2.7%) is significantly larger than that of the default scenario (0.9%).

TARGET SCENARIO

The target scenario indicates the primary balance that each country will have to achieve if a sustainable debt/GDP ratio of 60 % is to be realised by 2020. The baseline forecasts for the macroeconomic variables are again reused. The results are presented in Table 5.5.

TABLE 5.5

ACHIEVING A DEBT/GROSS DOMESTIC PRODUCT RATIO OF 60 percent

	Baseline Debt-to-GDP Trajectory									Baseline Assumptions[a]			
Country	2012	2013	2014	2015	2016	2017	2018	2019	2020	Exch. Rate[b]	Interest Rate	Real GDP	Prim. Bal.
Antigua and Barbuda	76.9	75.4	73.0	71.1	68.6	65.5	61.5	57.2	53.1	0.0	3.8	3.8	0.8
Belize	78.2	77.8	76.6	74.3	71.7	68.6	65.0	61.7	58.8	0.0	6.5	2.4	3.3
Barbados	94.3	91.3	86.0	82.4	78.1	73.9	70.0	65.1	58.8	0.0	6.7	2.6	5.2
Grenada	80.9	79.2	76.8	75.1	71.6	68.0	65.0	62.1	59.5	0.0	4.6	2.5	2.5
St. Kitts and Nevis	85.5	80.9	78.0	74.4	69.7	64.0	58.0	51.4	45.0	0.0	2.7	2.1	3.4
Jamaica	120.5	112.1	104.4	95.8	88.3	81.2	74.1	65.6	55.6	5.0	8.0	1.4	11.1
Dominica	82.0	84.2	82.5	79.7	77.0	73.2	68.8	64.3	59.7	0.0	2.8	1.4	2.9

Source: Author Estimates

[a] In absolute percentages except for the primary balance which is in per cent of GDP

[b] Per cent depreciation for each country's respective currency

To meet the targeted debt/GDP ratio by 2020, Jamaica has to make the largest adjustment to the primary balance. Jamaica has to run a primary surplus of approximately 11.1% of GDP, which is considerably larger than the 4.1% projected in the baseline scenario. Barbados also requires a relatively large primary balance of 5.2% of GDP to meet the target, but it must be noted that in the baseline scenario her primary balance was already projected to be 2.7% of GDP. By contrast, whereas Grenada only requires a primary balance of 2.5% of GDP to meet the sustainability target, that country was running a primary deficit of 3.4% in the baseline scenario, and so requires significant adjustment. Dominica is similarly required to move from a deficit of 0.9% in the baseline scenario, to a primary surplus of 2.9% of GDP to achieve the targeted debt/GDP ratio. The other countries in the study require relatively small adjustments to their primary balances to achieve the 60% debt/GDP target, with St. Kitts and Nevis projected to meet the target with the same primary balance that was incorporated into the baseline.

CONCLUSION

This Chapter has shown that all the heavily-indebted Caribbean countries studied, except for Grenada and Dominica, have implemented policies that significantly reduce the risk of default. Grenada and Dominica need to implement additional fiscal austerity measures to strengthen the primary balance so as to enhance the likelihood of solvency. Although Jamaica and Belize have projected debt ratios that fall below the default threshold, a high risk of default exists in these countries because of high refinancing costs in the case of Belize, and a high volume of maturing debt in the case of Jamaica. Fiscal policy in both Jamaica and Belize should therefore be focused on creating more fiscal room to prevent a liquidity crunch.

Notwithstanding the positive results for the other countries there is limited fiscal flexibility in all the countries examined. A reversal of the fiscal policies implemented since 2008 leads to a breach of the default threshold for all the cases except Belize. However, even in Belize caution and political strength is called for. High refinance risks could precipitate a liquidity crunch that would presage a default. Most countries have very limited flexibility around policy implementation, with the difference between the projected baseline and default primary balances being very small. Barbados has the greatest flexibility among the countries studied due to its relatively high debt-carrying capacity, given the depth of the domestic capital market and the greater degree of market confidence.

If the countries investigated in this Chapter are to achieve the targeted debt/GDP ratio of 60%, the most significant policy adjustments would have to be made by Jamaica, Grenada and Dominica. While smaller, the requisite adjustments to the primary balance in Antigua and Barbuda and Barbados are not negligible and should be carefully planned. Belize requires a fairly small adjustment, but it faces the aforementioned high refinance risks. Even St. Kitts and Nevis which does not have to make any adjustments in the projection period to meet the targeted debt/GDP ratio, has to ensure that all the policy measures included in the baseline scenario are implemented, as it was shown to be susceptible to significantly higher-than-projected debt/GDP ratios if the planned debt-for-land swap is not successful.

Chapter 6

Solutions: An Agenda For Sustainability

INTRODUCTION

This study has been conducted to deduce the imperatives and institutional structures for achieving and maintaining debt sustainability in the Caribbean. The preceding chapters have:

(a) investigated the evolution of public debt in Caribbean countries;

(b) decomposed the growth of the debt in search of the proximate causes of debt expansion;

(c) appraised the underlying institutional issues that emerge as the fundamental causes of debt; and

(d) assessed the prospects for the growth of the debt in the highly-indebted countries.

These important issues warranted this study's rigorous treatment since the level and nature of debt have critical implications for a country's economic growth and development. The theoretical and empirical literature makes it clear - some amount of debt can be beneficial to developmental outcomes provided the capital borrowed is properly employed, but high levels of debt tend to be inimical to such outcomes. The now well-established debt overhang hypothesis posits that the growth-inducing benefits of low to moderate levels of external debt are eventually reversed if debt accumulates beyond a certain threshold. This threshold is theorised to occur when there is debt overhang: the presence of an existing, inherited debt so sufficiently large that creditors do not confidently expect full repayment.

DEBT AND DEVELOPMENT IN THE CARIBBEAN: PRESENT, PROSPECTS AND PROBLEMS

Present: Have Caribbean Countries Crossed the Debt Overhang Threshold?

In Chapter 2, we saw that Caribbean countries are among the most highly-indebted, middle-income countries in the world. Between 2000 and 2010, public debt levels of the 14 Caribbean states increased on average, as a percentage of GDP, by 6.4%, and public debt to GDP levels in the OTs more than tripled, on average, over the period. At the end of 2010, six of the 10 most highly-indebted countries were from the Caribbean, and four countries - St. Kitts and Nevis, Jamaica, Barbados and Grenada – ranked among the top five. All six countries had public debt-to-GDP levels in excess of 85% with the top three having public debt-to-GDP levels of over 100%. As of the end of 2011, St. Kitts and Nevis, with public debt twice the country's GDP, ranked as the most heavily-indebted middle-income country in the world.

Prospects: Are Caribbean Countries on a Sustainable Debt Path?

These high levels of debt have necessitated numerous debt restructuring exercises throughout the Region. Such exercises have been implemented in Dominica, Grenada, Belize, Jamaica, Antigua and Barbuda, and St. Kitts and Nevis. Projections of the debt/GDP ratio to 2020 show that in spite of these exercises, debt sustainability remains a challenge in some countries (Chapter 2). The need for fiscal policy initiatives to reduce deficits and curb the growth of the debt has been recognised in most countries.

Such initiatives have been implemented with mixed results. Countries such as Antigua and Barbuda, Barbados and St. Kitts and Nevis have implemented or are planning to implement initiatives that, if successful, are projected to improve debt ratios and maintain sustainability. Grenada and Dominica need to implement additional fiscal austerity measures to strengthen the primary balance in order to enhance the likelihood of solvency. Although Jamaica and Belize have projected debt ratios that fall below the threshold at which the countries would default, a high risk of default nevertheless exists in these countries because of high refinancing costs in Belize, and a high volume of maturing debt in Jamaica.

In spite of the positive trends exhibited in some of the highly-indebted countries, governments in the Region should not be lulled into a state anywhere short of political urgency. There are a number of scenarios in which debt default is not a far-fetched possibility. If, for example, any of the countries (with the exception of Belize) choose to reverse the prudent fiscal measures that have been implemented since 2008, the likelihood of default increases significantly. Even if no widespread policy reversals occur, flexibility around policy implementation is limited because the gap between projected fiscal balances, arising from the current policies, and policies which can result in crossing the default threshold is narrow. In all cases, slow rates of economic growth can threaten debt sustainability.

On the other end of the spectrum, if Caribbean countries are to expand their vision beyond simply avoiding default to actually achieving a sustainable debt/GDP ratio of, for example, 60%, most of the highly indebted countries will require further adjustments. Jamaica, Grenada and Dominica will have to make the most significant adjustments to their primary balances. Though Belize requires a fairly small adjustment, it faces high refinancing risks that should not be ignored. Even St. Kitts and Nevis – which does not have to make any adjustments in the projection period to meet the targeted debt-to-GDP ratio – has to ensure that all the policy measures included in its current programme are implemented, especially since they appear to be susceptible to significantly higher-than-projected debt/GDP ratios if the planned debt-for-land swap is not successful.

Problems: What are the Challenges Associated with High Debt Levels?

If debt sustainability is indeed compromised, severe consequences for economic growth and development can be expected. As indicated in Chapter 1, international experience has illustrated that unduly high debt levels have forced many governments to reduce expenditures and have crowded-out pro-poor and growth-enhancing spending. Often, the burden of fiscal adjustment has fallen on social spending and public sector investment.[77/] If domestic debt features heavily in the debt profile of the country, the crowding-out effect on private investment is also a concern.

[77/] See for example Fosu (2007).

Similarly worrisome is the heightened threat of instability of the domestic financial system exposed to the risk of government defaulting on, or restructuring its debt portfolio. More subtly, debt overhang, by its increasing uncertainty, also depresses investment and growth. This causes private investors to either wait or shorten their planning horizons when considering domestic investments.

These potential threats to the Region's growth and development should not be taken lightly. This Chapter draws on the lessons gleaned in previous chapters, in order to develop an agenda for reaching and maintaining sustainable debt levels in the heavily-indebted Caribbean countries. The next section will very briefly summarise our findings on the composition and nature of the accumulation of debt, with a view to contextualising the recommended proposals. This will be followed by a brief summary of the remedial actions that a number of highly-indebted Caribbean Countries have already undertaken. Our concluding section highlights recommendations for the future, and provides the foundation for CDB's and regional governments' discussion on an agenda for further action.

THE COMPOSITION AND NATURE OF DEBT ACCUMULATION IN THE CARIBBEAN

The composition and nature of the accretion of debt in any country give an indication as to how the country got into its debt position and suggest the remedial measures that are now open to government. In Chapter 1, three recent trends in developing country debt composition were highlighted: an increase in multilateral relative to bilateral debt, the heightened importance of international bonded debt, and the increasing importance of domestic debt relative to external debt. The existence of these trends in the Caribbean region was largely confirmed in Chapter 2. Over the last two decades, an increasing number of Caribbean governments have relied more heavily on domestic capital markets, international commercial markets and/or MFIs for their financing needs.

Composition: From Whom are the Caribbean Governments Borrowing?

Of the nine most indebted countries of the Region, four (Barbados, Jamaica, Antigua and Barbuda, and St. Kitts and Nevis) have domestic debt exceeding 50% of the total debt. Whereas domestic debt helps to insulate a country's exposure to foreign currency risk, growth in such debt implies different burdens and risks. Private sector crowding-out, inflationary risks, weakening bank efficiency, and higher interest costs are some of the consequences of heavy reliance on domestic debt, that these countries must consider.

Five of the Region's highly-indebted countries have external debt comprising more than half of their total debt (Belize, Dominica, Grenada, St. Lucia, and St. Vincent and the Grenadines). The composition of this external debt has changed in recent decades, with a shifting away from bilateral aid towards multilateral project financing in some instances, and financing from the international commercial markets in others. Such shifts were designed to take advantage of favourable credit ratings and/or to lessen the impact of declining bilateral flows. While maintaining (and at times increasing) the inflow of foreign financing, the changing composition of external debt has implications for the options now open to these countries, as they seek to move on to a sustainable debt path. Multilateral institutions are generally not a party to debt relief agreements, and a large pool of commercial creditors increases the difficulty of agreeing on restructuring terms.

Even the composition of the dwindling share of bilateral financing has changed in the last two decades. As lending from Western governments has declined, aid from China has increased.

Although the Chinese loan terms have generally been long-term and low-cost, the growing presence of the Yuan renminbi in the currency composition of external debt portfolios changes the character of foreign currency risk.

Debt Accumulation: Why are Caribbean Governments Borrowing so Much?

Regardless of the composition, very high levels of debt have adverse economic and social consequences. Although the benefits of low to moderate levels of debt are acknowledged, many Caribbean governments have long passed those thresholds, and continue to accumulate debt. Why is this so? What are the driving forces behind the Caribbean governments' high debt appetite?

Chapter 3 examined the source of debt accumulation for the seven highly-indebted Caribbean countries that had public debt levels in excess of GDP during the last two decades (Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Jamaica, and St. Kitts and Nevis). The period during which most of the debt was accumulated coincided with a dramatic deterioration in the fiscal balances of these countries, an increase in the average effective interest rate on debt, and a number of economic and natural shocks (including banking crises, loss of commodity markets and hurricanes).

The decomposition of the evolution of the debt-to-GDP ratio indicated that with the exception of Dominica, non-CG liabilities have been the primary driver of debt growth in the Caribbean. An average of 75 GDP percentage points worth of debt was due to the residual factor - off-budget liabilities. This is because many Caribbean governments have had to absorb non-CG debts or assume the responsibility for government-guaranteed debts.

These averages, however, conceal a variety of debt accumulation experiences. Three patterns of debt accumulation were highlighted from the disaggregated data:

(a) Belize, Grenada and St. Kitts and Nevis became highly indebted because fiscal slippage (running large primary deficits) contributed to the role played by non-CG liabilities.

(b) Even though Antigua and Barbuda, Barbados and Jamaica generally had primary surpluses on their fiscal accounts, debt accumulated beyond the assumption of outside liabilities due to adverse debt dynamics, wherein governments have had to borrow to service debt.

(c) Finally, Dominica was unique in that liabilities outside of CG did not play a significant role. Most of CG's debt accumulation was due equally to capital expenditure and interest payments.

Debt accumulation in the Caribbean was thus shown to have been driven by: fiscal slippage, often due to infrastructural reconstruction following a natural disaster; unfavorable debt dynamics in which the obligation to service the existing debt requires additional debt; and contingent liabilities, particularly those from outside of CG. Each of these drivers of debt accumulation has implications for the remedial measures now available to the respective governments.

Fiscal slippage due to natural disasters highlights the limited fiscal space available to regional governments and underscores the need to explore alternative sources of emergency financing.

Unfavorable debt dynamics casts a spotlight on the structure of debt portfolios both across currencies, tenors, and types of lenders. The high levels of contingent liabilities indicate a need for further attention to be placed on contingent risk management, public enterprise holdings, financial sector regulation, and the strength of public sector management.

RECENT REMEDIAL ACTION IN HIGHLY-INDEBTED CARIBBEAN COUNTRIES

Governments of the highly-indebted Caribbean countries are quite aware that their debt trajectories are unsustainable and that they face a heightened risk of default. Attempts to avoid such have largely focused on debt restructuring operations, which have increased in frequency over the past few years. Whereas between 2000 and 2004 only two Caribbean countries undertook debt restructuring operations, seven countries conducted such operations in the period 2005-2010. These restructuring exercises have included bilateral creditors, private external creditors, and public and private domestic creditors. Guyana and Haiti also benefitted from MDRI.

Most of the restructuring exercises involved debt exchanges (for example Antigua and Barbuda 2010, Belize 2006, Dominica 2004, Grenada 2005, and Jamaica 2010). Importantly, however, none of these debt exchanges included principal reduction, so-called "hair-cuts". Similarly, none of the middle-income ECCU beneficiaries under the Paris Club rescheduling received debt forgiveness. These debt restructurings sought to address a temporary liquidity problem by giving the countries some interim fiscal space.

Further, the ECCU has implemented several initiatives to help tackle its debt problems. In September 2009, as a response to the recent global financial crisis, ECCU implemented an "Eight-Point Stabilisation and Growth Programme" aimed at achieving stabilization, stimulus and structural reform. The Programme's key target areas included financial programming, fiscal reform, debt management, public sector investment programmes (PSIP), social safety net programmes and financial sector reform. Considerable advances have been made under the debt management programme. An ECCU ministerial committee on debt, comprising finance ministers of Antigua and Barbuda, Grenada, St. Kitts and Nevis and St. Vincent and the Grenadines, was established with a mandate that includes exploring strategies for addressing the debt burden of member countries, facilitating a coordinated approach to debt restructuring, and providing advice to the ECCB Monetary Council on the efficient utilisation of RGSM. The inaugural Committee meeting was held in July 2011. Also established was a Task Force on Debt, Growth and Development with responsibility for examining the prospects for growth and recommending a path to stimulate and sustain growth in a high debt environment.

However, the persistence of high debt levels post-restructuring suggests that debt deferral is insufficient to address the Caribbean's debt burden. This may suggest that the underlying problems may relate more to solvency rather than liquidity. The broader issues indicated in the previous section must be addressed if highly-indebted Caribbean governments are to return to a sustainable debt path. A suggested agenda for addressing these issues follows.

AN AGENDA FOR REFORM

The analysis in this study identified the key elements of the context for debt accumulation in the Caribbean. Globally, it is increased access to deeper global and domestic capital markets; locally, it is vulnerable, small economies with hazardous geographies. The research contained herein also identified the main drivers of debt accumulation. These were fiscal deterioration, usually due more

to expenditure increases than revenue shortfalls, debt dynamics driven by high interest costs, and off-budget liabilities due to both natural disasters and financial sector risks.

Some of these drivers have their roots in the institutional structure of public decision-making in the Caribbean. The degree to which finance ministries have autonomy within the public sector, and authority over other ministries, will influence how they respond to the demands for expenditure and the ability to finance it. Their technical capacity will also have bearing on decisions about financing and debt management. An agenda for debt sustainability must therefore address the institutional foundations for fiscal outcomes and debt accumulation.

Fiscal Management

Creating fiscal space is critical to a programme of debt reduction and to achieving debt sustainability. However, given the high demand for public goods and services by an often vocal and unforgiving electorate, political motivations frequently trounce sound financial management structures, resulting in large fiscal imbalances and a build-up in public debt. Enacting fiscal responsibility legislation that specifies fiscal performance targets, and requires greater transparency and accountability in government's fiscal operations, is a means of creating an electoral counterbalance to the otherwise unlimited demands for seemingly free public services.

At present, few Caribbean countries have enacted fiscal responsibility legislation. However countries that have specific fiscal rules or borrowing guidelines, such as the OTs, or have explicit debt exposure limits, such as Suriname, have had comparatively lower debt levels than their Caribbean peers. Improved fiscal performance is dependent upon both the establishment of quantitative rules, and the requirement for increased transparency regarding fiscal performance.

Procedural, quantitative and transparency requirements have been advanced as means of cementing the basis for public sector financial reform. Effective utilisation of quantitative rules requires independent and technically-equipped institutional oversight to preclude abuse by the majority party in Parliament. The effectiveness of transparency is dependent on public interest and support for reform, and a willingness and ability to read, interpret and critically respond to an enhanced information flow.

Where sanctions are employed, they have to be an effective disincentive to public financial mismanagement. This means more than putting draconian fines and incarceration on the books. The rules have to be clearly drawn to avoid ambiguity in interpretation or in location of responsibility, and both the public and the prosecutor must hold responsible officers accountable for violations. While the relevant laws suggest a demarcation of responsibility between public servants and the political directorate, any political encroachment on the administrative responsibilities of public servants makes it virtually impossible to locate responsibility, demand accountability and impose effective sanctions. The public service as in the Westminster ideal needs to be separated as far as possible from political influence. The capacity to hold public servants accountable is severely compromised if there is a blurring of the lines of responsibility between administrative and political leadership. This confusion of roles is likely where the political neutrality of the appointment process and the operational independence of the public servant within the law, are compromised.

Budgets need to be drawn more clearly to elevate outputs (results) to the same status as inputs (financial resources provided). A careful matching of inputs and outputs through corporate plans rising from the departmental level can be the basis for effective departmental "ownership" of

budgets, and for implementation consistent with resource availability and government's overarching strategic objectives. A contrary tendency to cut departmental budgets without reviewing the role, structure, and functions of government, tends to weaken ownership and undermine implementation.

It is imperative to enhance systems for financial measurement and control. Accrual accounting is an ideal, but resource and institutional constraints suggest a carefully phased process of implementation. The recording and reporting of unpaid commitments on an ongoing basis offers significant enhancement at relatively low cost.

Other procedural reforms can help to guard against fiscal slippage. Budgets for public bodies should be tabled at the time of tabling government's budget, along with a corporate plan and an indication of projected financial results. These budgets should include estimates of projected dependence on CG resources. Until accrual accounting is fully implemented, vigilance is required against the use of deferred financing. Government guarantees must be granted through Parliament with full transparency.

Central Treasury Management will allow more efficient use of government's cash resources and reduce the need for some debt. Its implementation must, however, be balanced with the need to locate responsibility to ensure accountability. Constitutionally independent institutions (answerable to Parliament) like Auditors-General and Contractors-General need to be supported, and are likely to require a greater infusion of financial, technical and human resources for enhanced effectiveness. Stronger and more effective links with more efficient prosecutorial judicial systems are also required.

Public sector records (including financial accounts) across the Caribbean are not fully computerised. Given the voluminous nature of these records, their computerisation is essential to effective budgeting, management of financial flows, auditing, deterrence and systemic design and correction.

A debt crisis constitutes a severe challenge for macroeconomic policy. While fiscal contraction is a logical response to fiscal deficits and debt application as a "blunt instrument" may undermine the effectiveness of public administration and weaken the contribution of the public sector to enhancing productivity and growth. Weakening growth will iteratively undermine the capacity for fiscal adjustment. The emotively-appealing alternative of Keynesian expansionary stimulus is not only infeasible without external generosity, but will also be ineffective in small open economies with very high marginal propensities to import. Policy then has to seek to spend more effectively while spending less. This may imply an additional need for political fortitude in reducing the size and functional scope of the public sector.

Successful implementation of reforms and the reaping of the intended benefits of reform demands political understanding, ownership and commitment. If reforms are presented as being "imposed" by MFIs or bilateral sources of financing, there is less likelihood of effective policy application. Adjustment is likely to have short-term costs at the promise of benefits in the medium to long term. There is therefore a clear time inconsistency problem where the electorate wants to see benefits now and politicians want to get elected or re-elected.

Appealing to political statesmanship may therefore be necessary but far from sufficient. There needs to be a realignment of incentives to create consistency between the ideals of PFM, the interests of a multi-dimensional electorate, and the electoral interests of politicians. It is popular support for sound financial management that will drive political leadership that is consistent with these

managerial ideals. This requires a more informed and better educated public with a willingness to take a longer view with a clear tendency to punish suboptimal fiscal management.

The challenge is exacerbated where there is extreme socioeconomic inequity. Minority special interests may well become the effective principals extracting disproportionate returns from the common pool of public financial resources. This may be addressed by special effort to redress socioeconomic inequity including educational and income earning opportunities and by greater transparency in campaign financing.

Debt Management

A comprehensive DMS must accompany a government's stated debt management objective. Such a strategy should outline the manner in which government intends to achieve its desired portfolio composition over the medium term, based on its cost and risk preferences. Moreover, sound debt management practice requires governments to consider several alternative strategies to assess the potential variations in the cost of debt servicing based on various debt profiles.

It is important for the relative roles of different public sector institutions to be carefully identified and delineated to avoid wasteful duplication of effort. For example, while a Central Bank may act as an agent of the Treasury in marketing and settling debt instruments, there is no logical basis for the Central Bank to duplicate record keeping, analysis, and articulation of debt policy. International best practice suggests a centralisation of the core of debt management functions. This has often been within the Treasury but a DMU may be established external to MOF. This seeks to separate debt management from fiscal policy, between which there are potential conflicts (for example, with respect to cost versus risk minimisation).

The institutional framework for debt management should assign clear responsibility for each of the important debt management functions:

(a) Strategic planning: to determine the portfolio composition that conforms to the high level objectives given concurrent and expected market conditions;

(b) Risk management: to design a risk management framework with responsibility for monitoring and managing risk exposures associated with exchange rates, interest rates, market access, and whatever events could jeopardise the achievement of the strategic plan;

(c) Implementation: to determine and execute a borrowing plan to meet the articulated strategy mindful of the risk exposures;

(d) Data management: to undertake the accurate recording, accounting, and publishing of all debt-related transactions and debt data.

Organisationally, the Unit responsible for debt management is optimally organised along functional lines. The front office, guided by the agreed DMS, is responsible for evaluating and negotiating new loans; the middle office takes care of analytical functions such as portfolio and risk analysis; and the back office executes loan servicing, accounting, and data gathering.

The disadvantages of small scale in the Caribbean may undermine the capacity to establish a centralised debt office with "firewalls" between centralised functions. Where this precipitates

a division of debt management functions between different institutions, there has to be a clear delineation of these functional responsibilities with unambiguous identification of the lead agency. This lead agency would preferably be located in MOF.

The accumulation and effective management of public debt is associated with a wide range of public sector institutions, including the Central Bank (due to the fiscal costs of monetary policy and market operations) and the planning office (responsible for capital budget planning). Even where debt management is centralised, best practice still requires the establishment of an inter-agency committee for strategic oversight of debt management. This is especially important where there is fragmentation of the function between institutions, but is still essential where there is a centralised DMO.

The need for coordination is illustrated by potential conflicts between cost minimisation and risk minimisation as fundamental objectives of debt management. Fiscal policy under pressure for short-term fiscal adjustment may prefer short-term and external financing. This may expose public debt to refinancing risk, as well as foreign exchange risk. This potential for conflict informs the ideal of an independent DMO, and the imperative for an inter-agency strategic management committee.

While there is potential for conflict between fiscal and debt management, there are areas in which there is consistency in their objectives. The fiscal objectives of the introduction of accrual accounting are entirely consistent with debt management objectives to avoid the disguised accumulation of public debt. Debt management would also be supportive of the avoidance of deferred financing, the careful management of other private sector expenditure on behalf of government (Build, Own, Operate and Transfer projects), the careful monitoring of public enterprises, and more effective treasury management systems. In general, short to medium-term fiscal targets, legislated or otherwise, need to be consistent with medium-to-long run debt management objectives.

Debt management needs to be seen broadly in terms of a country's entire portfolio of public assets and not narrowly in terms of debt instruments only. Therefore, if there are public assets yielding a lower social and economic return than the highest cost debt, those assets should be privatised and the resources used to retire high cost-debt. In a similar vein, if the returns to public capital expenditure at the margin exceed the interest cost of marginal debt, then surpluses should be dedicated to capital expenditure rather than paying down debt. These are the kinds of calculations that debt management with a sufficiently broad responsibility should consider. Such considerations, however, depend critically on the specific mix of assets and opportunities in each country, so broad prescriptions are not feasible.

As indicated above, effective debt management demands a high level of specialised technical and public policy expertise, but scale and limited training budgets may militate against sufficiency of such skills in each jurisdiction. Proposals have been raised regarding secondments, inter-agency pooling of skills (although inconsistent with separation of specialised functions), on-the-job training, and attachments. Again, entirely consistent with fiscal policy reform, incentives to attract and retain relative specialised skills must be considered. Regarding the disadvantages of scale and the shortage of skills, the DMAS programme through ECCB for ECCU countries, has been identified as a major and creative initiative.

Liability Management

Chapter 5 revealed that budget surprises, liabilities that originate outside of CG, were the main contributor to debt in the Caribbean over the last two decades. The financial sector crisis in Jamaica led to the assumption of huge debts on government's balance sheet. PPPs and other off-budget activities in Barbados were liabilities ultimately assumed by government. The collapse of CLICO, a large financial conglomerate, led to a costly intervention by Trinidad and Tobago and increased their debt levels, and the impact of that collapse still threatens the balance sheets of many other governments in the Eastern Caribbean.

Even when such contingent risks do not manifest, credit ratings agencies increasingly pay attention to them in determining the full risk of investing in a country's bonds, so these potential risks can raise the cost of debt. The Region will never have moderate, sustainable debt profiles without better management of contingent liabilities.

The starting point for improved risk management in the public sector is to recognise and categorise the different types of contingent risks. One important distinction is that between inherent risks, such as arises when a natural disaster strikes and public expenditure is obligated, and acquired risks, exemplified by the issuance of government guarantees on non-CG borrowing: some contingent risks are incurred because government is obscuring explicit expenditure in order to create the appearance of better fiscal accounts.

The management of contingent liabilities is pursued on two levels. Wherever possible, identified risks are to be minimised or hedged; where that is not possible, the remainder are to be exposed and accounted for.

The first and easiest way to expunge risks that are not inherent in the business of governing is to divest assets and operations that carry such risks. Many contingent liabilities arise from the operations of public enterprises that are not delivering public goods. Air Jamaica was an example. It behooves Caribbean governments to examine their list of public enterprises delivering private and non-essential services and divest those that carry excessive risk.

Where risks cannot be divested, they can sometimes explicitly be insured against. Once risks are identified and quantified, governments can seek explicit insurance, preferably internationally, against the particular risk. While private insurers within the country may be impaired by precisely the event that causes government to exercise its claim, countries may be able to insure each other.

To the extent that explicit insurance, such as that provided by CCRIF, is inadequate to sufficiently mitigate the fiscal risk of natural disasters, governments must themselves establish contingency funds in order to self-insure the uncovered risk. Such funds may either be explicitly set aside, which would then be invested in the capital market, or they may be virtually set aside where the actual funds are available as part of government's total treasury management.

Notwithstanding efforts to minimise the actual risks by divestment, insurance, and provisions, governments may also recover a part of the cost of carrying these public risks. The Guarantor could be compensated for bearing the risk by explicit payment (a premium), by providing collateral, or by having a contractual claim on a share of the upside. Such a policy will not only compensate for the cost of government being the insurer of last resort, but also reduce the demand for guarantees by filtering out unviable projects. In cases where a government guarantee is a means of providing

a desired subsidy, a better option is to charge for the guarantee and provide the subsidy separately, so it can be subjected to the normal scrutiny of public expenditures.

As with other elements of public sector management discussed in this chapter, the institutional framework is key to successful implementation. Contingent liabilities must not only be identified, they must also be explicitly accounted for (either as an annual cost in the budget or on a NPV basis in the balance sheet) in public sector accounts. This will be facilitated, indeed obligated, by adopting improved accounting standards in the public sector. The use of accrual rather than cash accounting, along the lines specified by GAAP, should accomplish this (Chapter 4). Then contingent expenditure would have to compete with other budgeted expenditures for limited public resources. Both Barbados and Jamaica have piloted limited initiatives in this direction already (Chapter 4).

Guidelines for better risk management can be culled from internationally-accepted accounting standards for the public sector. This would strengthen the disclosure framework, as these standards require the identification, measurement, and disclosure of liabilities. The IMF's Code of Good Practices on Fiscal Transparency and the OECD's Best Practices for Budget Transparency, also provide guidance.

The institutionalisation of improved management of contingent liabilities should include centralised monitoring of these risks in an office with clear responsibility. That office should act on the basis of published guidelines for public enterprise borrowing, and for the issuance of government guarantees. These guidelines will be based on the objective weighing of expected benefits with the level and cost of the risks. The decision process should be formal and transparent, preferably by a committee with membership outside the civil service based on professional qualifications. Finally, either the individual recommendations of the committee or the annual liability budget should require Parliamentary approval.

The final element of a good institutional framework for managing contingent risks is a strong regulatory environment. Many contingent liabilities originate in industries that are serving a public purpose, such as utilities or finance. The primary responsibility for monitoring and controlling those entities lie with their statutory regulators. The legislative framework and technical capacity of the regulators should be equivalent to the responsibilities.

Chapter 1 highlighted the bi-directional nexus between fiscal sustainability and financial stability, as deterioration in either undermines the integrity of the other. Each side of that nexus is a source of vulnerability for the other side. It follows that the scope of the fallout from a crisis on either side, either a debt restructuring or a financial crisis, could be constrained by de-linking the two spheres of activity and strengthening the respective institutions. Large financial institutions should limit their exposures to highly-indebted governments. At the same time, financial regulators should ensure better provisioning and higher capital adequacy requirements in their respective financial sectors where the sector is heavily exposed in government securities.

Finally, governments should occasionally invite outside risk auditors to review both the risks and the risk-management process, and publish the auditor's report.

Disaster Management

A particularly prevalent kind of risk in the Caribbean, and one that has been the source of fiscal stress, is that from natural disasters: earthquakes and storms. At present, all Caribbean governments

prepare inadequately for the risk of natural disasters, given the inherent vulnerability of the Region and the history of disasters. Private insurers may be used to externalise risks that involve property, as is the case with natural disasters, and multilateral insurance schemes can play a major role in this respect.

At the behest of Caribbean governments, WB together with other partners, including CDB, established CCRIF in 2008 as a regional catastrophe-insurance fund for Caribbean governments. Governments in the Region are able to purchase insurance from the Fund, which, in the event of the insured disaster (currently, earthquake or hurricane) triggers a swift payout to remove any liquidity constraint on the delivery of public services. More importantly, the payout mitigates the fiscal consequence of disasters by helping to smooth the cost over time and over the entire region. There is also the Caribbean Disaster Responsive Fund funded by CIDA, and a similar facility provided by WB, which also provides automatic emergency funding in the event of natural disasters in the Region.

Governments need to ensure that their use of CCRIF is up to the maximum level possible given the risks they face, even while CCRIF continues to explore ways of expanding and extending its coverage. Catastrophe bonds also provide a means of mitigating the effect of natural disaster. The mandate of CCRIF could be expanded to broker the issuance of such securities.

From the above menu of management options, governments have to make choices. With limited resources, it is unlikely that progress can advance on all fronts simultaneously. This is especially so since there are inherent trades-off among some of the recommended programmes. Fiscal consolidation, for example, may compromise economic growth if infrastructure expenditure is squeezed. At the same time, given the magnitude of the debt in many countries, debt management will require simultaneous, multidimensional effort in many of the above areas.

OTHER CONSIDERATIONS

The Default/Restructuring Option

Highly-indebted countries often exercise the option to default or restructure their debts. As Chapter 2 has recounted, there have been several restructurings in the Caribbean already. Sovereign immunity always allows the repudiation of debt, with some degree of impunity, since the assets of a sovereign cannot be attached to creditors.

Capital markets have historically been surprisingly forgiving of defaults/restructurings. Defaulters generally regain access to global capital markets after around three months, and the interest premium for defaulters and restructurers is not prohibitive. Indeed, it is common for countries that restructure to receive a ratings upgrade, as was the case with Jamaica following its restructuring in 2010.

Restructuring, however, is not a sustainable management option. Despite the large number of Caribbean governments that have restructured their debt, the debt problem persists. The reason for its persistence is that restructuring does not address the underlying causes of the propensity for indebtedness. More radical restructuring, involving haircuts, may reduce outstanding debt in the present but will still leave the country susceptible debt accumulation in the future.

Further, the restructured debt often only delays payment obligations that eventually come due, and therefore is not a long run solution. Meanwhile, the pool of debt that is amenable to restructuring

will shrink if a government tries to pull this trick too often, because the conditions of restructuring may restrict eligibility for future restructuring and the creditors may become less sympathetic.

Moreover, the country suffers consequences from debt default/restructuring in other areas besides the cost and access to credit. Rose (2005) finds that trade declines following a restructuring by an average of 8% and lasts up to 15 years. This is perhaps due to the difficulty of getting trade credit following a sovereign restructuring. We have already identified (Appendix 4.1) that debt default/restructuring threatens the stability of the financial sector, but Rose also points out that the effort to rebalance asset portfolios over the medium term impairs the performance of the financial sector. Finally, restructuring carries political risks, as evidenced by the frequency with which administrations that engage in debt restructuring lose power shortly after.

The conclusion is that the status quo of debt accumulation which necessitates restructuring, and is followed by renewed accumulation is not sustainable in the long run. Before long, the high-risk premium that is concomitant with this approach will be built into the interest rate at which Caribbean governments can borrow, and the long-run cost will be manifested even in the short run. Further, the economic and political consequences of actual and threatened restructurings will impair the prospects for long-run growth. Governments should, therefore, opt for better fiscal, debt, liability, and disaster management instead of the otherwise inevitable restructuring.

The Role of Regional Cooperation

In many of the discussions in this study and even in the agenda outlined in this chapter, opportunities for constructive regional cooperation have arisen. The role of CDB, the operations of the ECCB RGSM, and the establishment of CCRIF are all examples of regional cooperation that help Caribbean governments in the management of their debt.

Regional cooperation is especially useful where there are numerous small countries in which the constraint on public administrative capacity is especially severe. Cooperation and centralisation can exploit economies of scale in administration, and facilitate the rapid expansion of best practices. Governments in the Region therefore need to intensify efforts at cooperation, as they seek solutions and provide mutual assistance.

One opportunity for further cooperation is to deepen the Regional capital market. While the RGSM has proven to be effective in facilitating the absorption of securities, it faces challenges. The response by governments in entering the market has been slow; the marketing of issues has been weak; and the disclosure of information has not been as timely as it should be. Further, the investor base remains narrow and secondary market trading has been limited.

Efforts towards more effective capital markets can be made through extensive marketing of government securities to other Caribbean countries. This could be augmented by publishing a calendar of issues thereby enhancing information dissemination and transparency and by governments intensifying dialogue with the market. Some progress has been made in this regard with the Regional rating of two participating ECCU countries (Dominica – CariBBB and St Lucia – CariBBB+) and with the calendar of proposed securities issues posted and routinely updated on the ECSE. Deepening the RGSM further will help lower government financing costs in the ECCU and reduce the reliance on dwindling external aid flows.

Additionally, if governments established a regional institutional vehicle through which their expertise in debt management could be pooled, then the quality of debt management could be

improved. Such an initiative could be pursued through an extension of the mandate of one of the existing regional bodies.

CONCLUSION

Caribbean economies are severely constrained by a massive accumulation of debt. Bringing the debt to a sustainable level, and one consistent with long-term economic growth and development, is a daunting task. Further, even if debt relief is provided, the risk of indebtedness will always threaten to derail the promise of growth, given the economic and financial environment and the high vulnerability of Caribbean countries to external economic and natural shocks.

This comprehensive review of debt in the Caribbean has revealed that there is a lot Caribbean governments can do. A more disciplined fiscal regime, more active debt management, careful management of contingent liabilities, and an enabling institutional framework are steps that Caribbean governments can take to help manage, reduce, and prevent crippling debt.

Even more important than better policies and legislated rules, though, is the need to create a climate and an obligation of transparency and financial integrity in fiscal and debt management and public accounting. An environment of transparency provides an invisible cloak to constrain excess that can make legislated limits redundant. It should become both the obligation and practice of finance ministries to publish all information material to fiscal outcomes and the public debt. In so doing, the capital markets will automatically provide the implicit constraint of a swift response to unsound policies.

The objective of the institutional framework is to create a climate of autonomy, responsibility, and accountability. Public officials must be given the autonomy and authority to effect desired outcomes in their areas of responsibility. The framework should clearly identify where responsibility for each policy and outcome lies. While that responsibility can operate at different levels, to ensure accountability it must converge at a single point. Once a unit or officer has both autonomy and responsibility, then he or she alone is accountable for the results. This arrangement would motivate better public policy-making.

Underpinning these efforts is a desire for improved standards of living for Caribbean people, which can only come about through higher economic growth and more economic development. The focus on growth and development is therefore central. Such a focus will ensure that the efforts at debt reduction do not themselves impinge on the prospects for economic growth.

The focus on the ultimate goal of economic growth and development is merited for a far more important reason as well. GDP is the denominator in the debt/GDP ratio. Debt/GDP reduction can be achieved most easily through economic growth. So the efforts outlined here to manage debt must not distract governments in the Region from the obligation to promote economic growth and development as a fundamental component of debt reduction. An additional one percentage point of annual GDP growth can take 20 percentage points off the debt/GDP ratio in 10 years, roughly evenly divided between numerator reduction and denominator expansion. [78/]

[78/] A higher GDP arithmetically reduces the debt/GDP ratio, but then stimulates virtuous debt dynamics in less debt merits lower interest rates on government securities which therefore further reduces future debt.

An agenda for growth is not the subject of this study. But the broad outlines of a policy programme, to that end, are not unfamiliar territory and indeed, overlap considerably with the present agenda for sustainable debt. It would include, at the very least, fiscal responsibility, infrastructure development, and meaningful and effective integration, to exploit market size and trade within the Region. This in turn would call for institutional and constitutional reform towards improving regional coordinating mechanisms.

APPENDIX 1.1

SUMMARY OF THE EVIDENCE ON THE RELATIONSHIP BETWEEN DEBT AND ECONOMIC GROWTH

Author(s)	Primary Debt Indicator Used	Data	Methodology	Results				
				Relationship			Debt Overhang Threshold (% GDP)	Channels
				Linear	Non-Linear	Incon-clusive/ None		
Fosu (1996)[79/]	External Debt	SSA countries (1970-1986)	Ordinary Least Squares (OLS)	-ve				
Clements *et al* (2003)	External Debt	55 LICs (1970-99)	Fixed Effects (FE) and Systems-based Generalised Method of Moments (SGMM)		X		50%	Efficiency of resource use
Pattillo *et al* (2004)	External Debt	61 Lesser Developed Countries (LDCs) (1969-1998)	OLS, SGMM, diff-Generalised Method of Moments (GMM)		X			Physical capital accumulation; total factor productivity growth.
Schclarek and Ramon-Ballester (2005)	External Debt	20 LAC countries (1970-2002)	Dynamic system GMM	-ve				Capital accumulation growth.
Shabbir	External Debt	24 LDCs (1976-2003)	Linear panel data model	-ve				Crowding out.
Cordella *et al* (2005)	Nominal Debt and a proxy for Net Present Value (NPV) of External Debt	79 LDCs (1970-2002)	OLS, SGMM		X		15-30%[80/]	Quality and volatility of investment and policy incentives.
Elbadawi *et al* (1997)	Nominal debt	99 LDCs	Quadratic equations		X		100%	
Imbs and Ranciere (2005)	External debt	87 LDCs (1969-2002)	OLS, FE and GMM		X		60%	Quantity of investments and conduct of government policy.
Kumar and Woo (2010)	Public Debt	38 DCs and 22 emerging economies (1970-2007)	OLS, FE and SGMM		X		90%	Labour productivity growth; quantity of investment
Reinhart and Rogoff (2010)	Public Debt[81/]	44 DCs and LDCs (spanning two centuries)	Correlations		X		90%[82/]	
Caner *et al* (2010)	Gross public debt	101 DCs and LDCs (1980-2008)	Threshold LS, Pooled LS		X		77% (full sample); 64% LDCs)	
Schclarek (2004)[83/]	Gross government debt	24 DCs (1970-2002)				X		
Checherita and Rother (2010)	Gross government debt	12 Euro Area countries (1970-2010)	Panel FE		X		90-100%	Private saving, public investment; total factor productivity; sovereign long-term interest rates.

[75/] As quoted in Qureshi and Ali (2010).
[76/] This is for countries with good policies and institutions. Countries with bad policies and institutions have lower thresholds. Cordella et al (2005) also specify a debt irrelevance threshold of 70-80% of GDP.
[77/] Defined as gross CG debt, and includes domestic and external public debts.
[78/] This figure represents total public debt/GDP. For emerging markets there is a more stringent external debt/GDP ratio of 60%.
[79/] As quoted in Sheikh et al (2010).

Cecchetti *et al* (2011)	Total non-fin debt	18 DCs (1980-2010)	Growth regression		X		85%[84/]	
Abbas and Christensen (2007)	Public Domestic Debt	93 LICs and emerging markets (1975-2004)	Granger causality regression		X		35% of bank deposits	Monetary policy; financial market development; crowding out.
Singh (1999)[85/]	Domestic Debt	India (1959-1995)	Co-integration			X		
Maana *et al* (2008)[86/]	Domestic Debt	Kenya (1996-2007)	OLS	+ve[87/]				
Sheikh *et al* (2010)	Domestic Debt	Pakistan (1972-2009)	OLS	debt stock: +ve; debt service: -ve				
Adofu and Abula (2010)	Domestic Debt	Nigeria (1986-2005)	OLS	-ve				

[80/] This figure is for government debt and household debt. The corporate debt threshold was computed at 90% of GDP.
[81/] As quoted in Sheikh et al (2010).
[82/] As quoted in Sheikh et al (2010).
[83/] The result was positive but insignificant.

APPENDIX 1.2:

THE FISCAL SUSTAINABILITY FINANCIAL STABILITY NEXUS – THE CASE OF THE EASTERN CARIBBEAN CURRENCY UNION

The global financial crisis and the subsequent recessions across ECCU member states have led to the need for closer analysis and monitoring of financial sectors, government fiscal balances and the complex linkages between the two. Further, recent experience in the Caribbean has created a heightened appreciation for these linkages, which are bi-directional. Unsustainable fiscal imbalances can have impact on financial sector balance sheets in the event of a government default. In the other direction, losses stemming from reduced profitability, higher loan defaults or other major stresses to individual financial institutions often have to be assumed by government if the alternative would cause severe dislocation within the financial system. Either of these scenarios could have significant spillover effects both within the country and for the wider ECCU area.

These bi-directional risks have been observed to varying degrees across the ECCU. On the fiscal side, depressed economic growth has narrowed regional tax bases reducing revenues and contributing to widening fiscal deficits. Financing of these deficits has relied on both domestic and external sources with much of the domestic budget support coming from commercial banks and non-bank financial institutions. These investments by indigenous and foreign-owned commercial banks have been facilitated by the limited alternative investments available to these private institutions. Consequently, these institutions' exposure to government has risen over the recessionary period. The risk associated with this increased exposure should be seen in the context of notable expansions in the debt ratios of some of these countries and the accompanying likelihood of debt distress.

A recent example of this is the sovereign default in St. Kitts and Nevis. Recession-related fiscal pressure exacerbated an already tenuous fiscal position and pushed the debt to GDP ratio up to around 200% GDP by the end of 2011. As commercial banks continued to provide financing for government operations, by November 2011, loans to government accounted for around two-fifths of total commercial bank loans and overall government debt made up a quarter of total commercial bank assets (Table A.1.1). Even with major efforts at fiscal consolidation supported by CDB and IMF, which led to historic primary surpluses, Government was unable to meet its overall financing requirement effectively defaulting on its obligations. Following a series of consultations with local and international stakeholders a debt restructuring programme was executed in 2012 which resulted in institutional investors receiving as much as a 50% "haircut" on holdings of government paper. Given the aforementioned exposures to government this discounting will have a significant impact on domestic financial sector asset values. While the exposures of other ECCU commercial banks to their respective governments are relatively low compared to the corresponding situation in St. Kitts and Nevis, any further fiscal deterioration which is financed by the domestic financial sector could pose similar difficulties in these other territories.

Conversely, imbalances originating in the financial sector also have significant implications for government finances and debt. The collapse of the regional conglomerate CL Financial Group in 2009 represents one such challenge to regional policymakers. Through various subsidiaries, in particular British American Insurance Company Limited (BAICO) and Clico International Life Insurance Limited (CLICO International), the firm sold a suite of investment instruments and insurance policies throughout the Caribbean in which thousands of individuals and institutions were invested. These included several commercial banks, social security funds, credit unions and public utilities. After several years of rapid expansion of its operations in the Region, IMF

(2011) placed the exposure of ECCU policy and deposit holders to the CL Financial subsidiaries at two billion Eastern Caribbean dollars (XCD2 billion), the equivalent of 17% of ECCU GDP.

TABLE A.1.3

EXPOSURE OF COMMERCIAL BANKS IN THE EASTERN CARIBBEAN CURRENCY UNION TO PUBLIC SECTOR BORROWING

	Public Sector Lending (% of Total Loans)			Public Sector Exposure (% of Total Assets)		
Country	**2009**	**2010**	**2011**	**2009**	**2010**	**2011**
ECCU	15.5	13.9	13.3	13.6	13.5	12.8
Anguilla	8.9	1.3	1.4	7.0	1.6	1.7
Antigua and Barbuda	16.7	14.7	15.4	11.2	12.8	12.8
Dominica	5.6	4.9	5.8	9.4	10.9	11.4
Grenada	8.9	7.7	7.4	10.5	10.0	10.0
Montserrat	0.9	7.7	0.3	5.6	8.4	10.3
St. Kitts and Nevis	40.4	42.2	41.2	26.4	27.3	24.8
St. Lucia	6.2	5.8	5.3	9.5	8.7	9.1
St. Vincent and the Grenadines	21.4	13.8	6.7	19.1	14.8	8.9

Source: ECCB

Soon after its collapse the Group's operations were placed under judicial management in the ECCU and Barbados and some of its business portfolios have been taken over. Nevertheless, many policyholders are still unable to realise returns from their investments or receive payments from their insurance policies.

In response, regional governments established a Liquidity Support Fund designed to provide additional liquidity to the financial sector of the ECCU. This Fund was capitalised by the Governments of Trinidad and Tobago (USD50 million), Barbados (USD5 million), ECCU-members (USD15 million) and other regional and international agencies (USD15 million). In the ECCU, the support of this Fund allowed for the creation of the ECCU Health Insurance Support Fund which restarted payments on insurance policies which had ceased since 2009. While this helped cushion the impact of CLICO's demise on policyholders, it put an obvious strain on the already limited resources of regional governments. The underlying risk is that these ECCU-member governments may be forced to inject further capital to protect policyholders before the debacle is resolved.

Ultimately therefore, the financial stability and fiscal sustainability of ECCU countries are inexorably linked and instability in one can have substantial impacts on the other and may result in cascading effects throughout the Region. As such, the work of the ECCB, in collaboration with CDB, the Caribbean Regional Technical Assistance Centre and other agencies will have to focus simultaneously on enhancing oversight, improving provisioning and ensuring capital adequacy in the financial sector.

How this might be accomplished has been much discussed. Numerous consultations with the IMF have provided the most comprehensive recommendations. It is clear the financial system requires proactive measures aimed at strengthening weak banks via administering stress tests and rectifying identified weaknesses. Additionally the co-dependence on domestic banks and government should be reduced by lowering the public debt held by private institutions. This may best be accomplished by substituting domestically held debt with debt sources from external sources. Clearly, this will best be accomplished via a regional approach.

There are no easy solutions to the current situation created by the failure of BAICO and CLICO. Money was lost and money is owed. All involved will eventually sacrifice. Perhaps the most important lesson to be learned going forward is to realise the failure of these firms was due to a combination of ineffective regulations and poor enforcement. Regulations can be reformulated to be more effective. The more daunting challenge will be changing the institutional framework that resulted in poor enforcement. Private non-bank financial institutions play an important role in the financial milieu. But they must be regulated in an effective manner without placing undue burden on their ability to operate efficiently.

Ultimately the key going forward for ECCU member states hinges on implementing the requisite policies to enhance economic growth in the Region. The key here is on implementation. What needs to be done is well known, reducing government wage bills, streamlining policy implementation, improved vetting of capital investments, rationalising the tax system, improving education to match the requirements of the private sector and so on. The challenge is for governments in the Region to have the political will and conviction to undertake what are tough policy actions. Doing so will signal to the larger international community that the Region is serious about placing its fiscal house in order, and will no doubt facilitate access to international resources required to accomplish this goal.

APPENDIX 2.1

DEBT RESTRUCTURING IN THE CARIBBEAN, 200-2010

Reflecting the breadth of the Regional debt crisis, eight Caribbean countries have restructured their debt since 2000, seven of them between 2005 and 2010. The experiences of four of these countries are summarised below.

Antigua and Barbuda

Debt levels averaging 117% of GDP between 1998 and 2009 and arrears close to half the total public sector debt by 2009 propelled Antigua and Barbuda into undertaking debt restructuring in 2010. Over 70% of Antigua and Barbuda's public and publicly guaranteed debt was owed domestically, primarily to statutory bodies and indigenous banks, with most obligations in arrears. External debts owed mainly to bilateral creditors – both Paris Club and non-Paris Club – totalled approximately 25% of the total public debt. Obligations to external commercial creditors were a further 13% share. Amounts owed to multilateral institutions though small were mostly in arrears.

The goal of the restructuring was to reduce interest payments to the target level of 4.5% of budget revenue, half its previous level, to be achieved through normalising outstanding arrears, rescheduling debt service payments, and securing reduced interest rates on the restructured debt. Authorities opted against principal reductions (haircuts) deeming financial sector stability and continued external aid inflows the greater priority.

The authorities' cooperative approach emphasised information transparency, inter-creditor equity and dialogue will all creditors. All debts were eligible for restructuring except those owed to "preferred multilateral creditors" – CDB and IMF – and debt securities issued under the RGSM. These exclusions aimed to ensure continued access to funding over the medium term.

In September 2010 authorities obtained comprehensive debt relief from bilateral Paris Club creditors. Debts owed to Japan, the Netherlands, United Kingdom and United States, among others, were consolidated and rescheduled over 12 years, including a 5-year grace period. Eligible debts included outstanding arrears as at August 31, 2010 and maturities falling due from September 1, 2010 up to April 30, 2013. Subsequently, the United Kingdom government cancelled all its debts.

The authorities sought comparable Paris Club terms from its non-Paris Club creditors – China, Kuwait and Trinidad and Tobago. In 2011, China agreed to restructure its claims over 15 years on an interest-free basis. Priority was given to normalising outstanding arrears with those multilateral creditors eligible to participate in the restructuring, including EIB and the Organisation for Petroleum Exporting Countries Fund for International Development. Primarily a prerequisite for obtaining IMF and CDB funding, these negotiations also ensured ongoing medium-term financing for public programmes. While debt securities issued under RGSM were not eligible for debt restructuring, the authorities refinanced maturing securities into longer term tenors, achieving de facto restructuring of outstanding liabilities.

In restructuring debt owed to domestic creditors, the authorities considered the short-term liquidity challenges, as well as more structural vulnerabilities faced by some domestic institutions. Agreements with financial institutions extended maturities to 20 years from an average of 5 years and reduced coupon payments by cutting interest to 8% from an average of 13%. Contractor and supplier negotiations involved asset swaps and the clearing of penalty arrears. Debts owed to statutory bodies, including the Social Security System, were restructured by issuing a long-term bond with stepped-up interest rates, capped at 5%, over the life of the bond.

Antigua and Barbuda's debt restructuring provided significant interim cash relief. At end-2010, arrears outstanding declined from 56 to 20% and debt to GDP fell from 110 to 94%.

Belize

A rapid build-up in debt in the early 2000s led to Belize's debt exchange. Severe imbalances in the fiscal and external accounts, fuelled by expansionary macroeconomic policies over the period 1999-2004 and exacerbated by weather-related shocks, were financed mainly through external debt raised in the international capital markets. A steady depletion of foreign exchange reserves and increasing threat of imminent default led to a pre-emptive debt restructuring to restore long-term debt sustainability.

In 2005, just prior to Belize's debt restructuring, total public debt amounted to USD1.1 billion or approximately 100 % of GDP, surging from 72% in 2000. External creditors held close to 90 % of the total external debt, more than half of which was owed to private creditors holding bonds and notes.

Targeting private external creditors, the largest holders of financial claims, an offer to exchange USD144 million of privately held external debt, some 50% of GDP, for a new bond, was launched on 18 December 2006. Maturing in February 2029, this extended Belize's external debt maturity profile by some 14 years. Annual interest payments had a stepped structure, with the initial rate of 4.25% for the first three years after issuance of the new bond, increasing to 6% for years four and five, then rising to 8.5% thereafter. A cash payment was offered at the closing of the transaction equal to unpaid interest on tendered claims accruing up to the closing date. While the voluntary participation rate was only 87%, achieved participation was 98% as a collective action clause was invoked.

Ultimately, Belize's service burden was reduced and overall creditworthiness improved. In NPV terms the exchange achieved a 21% reduction in debt. Interest costs dropped to 5.5% of GDP in 2007 from 7.7% in 2006. Overall savings were estimated at USD301 million over five years from the date of the exchange. However there was no principal haircut.

Belize's international credit rating immediately improved. Standard and Poor's raised Belize's credit ratings to B on both its long and short-term debt from CCC immediately before the exchange, while affirming a stable outlook. Moody's subsequently upgraded Belize's sovereign debt to B3.

Debt indicators declined promisingly after implementing the exchange. Public debt-to-GDP fell from 100% in 2005 to 76% in 2009, easing Belize's debt service considerably. Over the period 2005-09, debt service as a share of government recurrent revenue fell from 91% to 25% and debt service as a share of exports dropped from 39% to 12%.

However, the step-up interest rate on the restructured bond began to create further resource constraints for the Government of Belize. Therefore, a decision was taken to undertake a second debt restructuring. This debt restructuring was finalised in March 2013 and involved a 10% principal haircut and a reduction in the coupon to 5% until 2017 and 6.8% thereafter.

Grenada

Expansionary fiscal policies prompted by weather-related and external financial shocks led to Grenada's significant public debt accumulation. However, devastating hurricane damages in September 2004 largely precipitated Grenada's comprehensive public debt restructuring.

Hurricane Ivan inflicted unprecedented damage amounting to over 200% of GDP. Large-scale government expenditures directed towards hurricane relief and recovery severely compromised the

budget. By October 2004, the public debt was unsustainable and a pre-emptive debt restructuring was unavoidable. An immediate moratorium on debt service payments was announced.

In 2004, Grenada's total public debt totalled 129% of GDP. External debt obligations claimed 73% of the total, owed predominantly to private bondholders (54%). Commercial credits, both bonds and loans, formed the majority of the domestic portfolio.

In November 2005, Grenada invited external and domestic commercial creditors to participate in a debt exchange, swapping USD190 million of external debt (including one global bond of USD100 million) and USD86 million of domestic debt for new bonds. More than 54% of the total eligible debts were private.

Grenada offered two new bonds, in USD and XCD, with a bullet maturity of 20 years and interest rates of 1% for the first 3 years, gradually increasing to 9% from year 14 onwards. Lower interest rates and longer maturities created a 45% reduction in NPV terms. There was no principal haircut.

Both bond issues included collective action clauses allowing full restructuring to proceed once a critical mass of creditors, representing 75% of outstanding claims, accepted any proposed restructuring terms. Additionally, both bonds included mandatory debt management clauses, allowing authorities to repurchase the new bond at any time after issuance if financial circumstances improved.

An overall participation rate of 91% of eligible claims, approximately USD237 million of affected debt, was achieved. Claims of non-participating creditors were not paid; the exchange provided for honouring such claims only on government's ability to pay. Grenada's international credit rating improved, earning B- in 2006 from Standard and Poor's, up from its 2004 Selective Default standing.

In May 2006, after receiving IMF support under the Poverty Reduction and Growth Facility (PRGF), Grenada approached its Paris Club creditors for debt relief. Creditors agreed to restructure USD16 million or 3.75% of total debt and reduce Grenada's debt service by 90% for the duration of the PRGF. Paris Club debts falling due from January 2006 to December 2009 and arrears as at end-December 2005 were rescheduled. Repayments occurred over 12 years and included a 5-year grace period.

Restructuring agreements with non-Paris club creditors were less successful. Grenada's political realignment with China led Taiwan, Grenada's largest bilateral creditor, to refuse to restructure on comparable Paris Club terms. Instead, the Ex-Im Bank of Taiwan sued Grenada demanding full and immediate payment of USD25 million in outstanding obligations, 3.7% of total outstanding debt.

Given their status as preferred creditors, in lieu of debt restructuring, multilateral institutions provided substantial new financing for hurricane reconstruction and rehabilitation. Similarly, Grenada continued to honour debts issued on the RGSM, ensuring continued access to short-term financing.

The stepped interest rate increases, within the context of protracted sluggish growth, began to increase the debt burden of the Government of Grenada beyond its payment capacity, leading to payment difficulties in the second half of 2012. Consequently, on March 8, 2013, the Government of Grenada announced that it would initiate discussions with its creditors with respect to restructuring of its debt.

Jamaica

Jamaica undertook comprehensive restructuring of its domestic debt in January 2010. Undertaking a domestic debt exchange, Jamaica's restructuring was propelled by protracted economic decline, large fiscal deficits and an unsustainable service burden.

Jamaica had a compelling case for a restructuring. In 2009, Jamaica's public and publicly guaranteed debt was at 130% of GDP. Domestic debt exceeded half the total public debt, with approximately 40%

due to mature within the two subsequent years. Domestic debt service amounted to 99% of government revenues, of which 60% was consumed by interest payments.

Jamaica aimed to significantly lower interest costs and extend debt maturities through the exchange while ensuring continued financial sector stability. Marketable domestic debt securities eligible for restructuring included variable rate bonds and bonds denominated or indexed in foreign currency. Only T-Bills and short-term instruments issued after December 31, 2009 (the cut-off date) with less than two months of remaining maturity were excluded from the exchange.

The JDX opened on January 18, 2010. The restructuring operations resulted in the exchange of over 340 domestic debt securities equalling JMD700 billion or 65% of GDP, for 24 new "benchmark" bonds with longer maturities and lower interest rates.

Allocation rules, specified that existing fixed rate bonds could only be exchanged for new fixed rate bonds and old US dollar bonds for new ones. Variable rate bonds could be exchanged for fixed, variable and inflation-indexed bonds. Domestic obligations were exchanged for Jamaica dollar fixed rate notes with maturities extending to 2040 and coupon rates in the range of 11 to 13.25%, US dollar fixed rate notes with 3 to 6 year maturities and priced near 7%, Jamaica dollar variable rate notes with maturities ranging from 2011 to 2032, and long-term inflation indexed bonds with coupon rates ranging from 2 to 4.25%. The bonds were exchanged at par, preserving their principal value. Retail investors holding low value bonds had the option of exchanging old bonds for a single new bond denominated either in Jamaica or US dollars and maturing in 2013.

"Substantially" 100% participation in the exchange was a pre-condition for USD1.2 billion in funding under a Standby Agreement from IMF and for receipt of substantial exceptional financing from other MFIs. Jamaica actively sought high participation, with acceptance of the offer conditional upon an over 90% participation on all debt securities, including a nearly 100% participation rate of old securities with a remaining maturity of less than two years and a nearly 100% of all fixed rate securities. A landmark 99.2% participation rate was achieved under the voluntary exchange, among the world's highest.

The JDX was a success. Substantial interest savings were achieved as interest payments fell to 11.5% of GDP for 2010/11 fiscal year. The average interest rate on outstanding domestic debt dropped from 19 to 12.5% and the volume of debt maturing between 2010 and 2012 fell by nearly two-thirds.

The improvement in debt dynamics notwithstanding, significant vulnerability to income shocks remained as a result of the high debt stock. Consequently, the sluggish growth that ensued after the debt restructuring exercise resulted in increases in the debt-to-GDP ratio and also threatened the achievement of medium-term debt indicator targets. In light of this, the Government of Jamaica announced, on February 8, 2013, the launch of a further debt restructuring. The outcome of this exercise was a further reduction in coupons and an extension of maturities by between three and five years, but there was no principal haircut.

APPENDIX 2.2

THE HIGHLY INDEBTED POOR COUNTRY INITIATIVE: THE CASE OF GUYANA

Guyana is one of the poorest countries in the Western Hemisphere. In the early 1990s, it was also one of the most heavily indebted countries in the world, with an external debt burden of approximately USD2 billion – a figure equivalent to seven times the official GDP. In 1997, Guyana became eligible for substantial external debt relief under the HIPC initiative. Since then, some USD1 billion in debt has been written-off under this initiative.

THE HIGHLY INDEBTED POOR COUNTRY INITIATIVE

Originally launched in 1996, the HIPC initiative is a joint venture between IMF and WB to tackle the issue of debt reduction in extremely poor countries (IMF, 2011a). The programme was designed to ensure that no poor country faced a debt burden deemed unsustainable using traditional debt management strategies. Since its inception other members of the international financial community, including multilateral organisations and bilateral creditor governments, have voluntarily joined forces with the founding two institutions to lower the external debt burdens of qualifying highly-indebted poor countries. [88/] As of December 2011, the HIPC initiative has orchestrated debt reduction packages for 36 countries (two in the Caribbean – Guyana and Haiti) providing USD76 billion in debt-service relief over time.

The HIPC Initiative is touted as a comprehensive approach to debt reduction. Ultimately, the initiative aims to facilitate poverty reduction and strengthen social policies in the most vulnerable countries. In keeping with this mandate, the original programme was revised in 1999 and extended to what has been dubbed e-HIPC which provides "faster, deeper, and broader debt relief" to meet the goal of poverty reduction (IMF, 2011a). In accordance with the broader focus of the initiative, a country must first meet certain criteria in order to qualify for debt relief. There are two distinct stages in the approval process. The first, known as the 'Decision Point', requires a country to fulfill four specific conditions: A qualifying country must: (i) be eligible to borrow from WB's IDA and the IMF's Extended Credit Facility, both of which provide subsidised or interest-free loans to the poorest countries; (ii) be facing an unsustainable debt burden that cannot be alleviated through standard debt relief measures; (iii) have displayed a history of targeted reform and sound policies under IMF and WB supported programmes; and (iv) develop a Poverty Reduction Strategy Paper (PRSP).

Once these conditions have been met, a decision is taken by the Executive Boards of the IMF and WB to grant eligibility status. At this point the country is cleared to start receiving interim relief on its debt servicing. However, it is not until reaching the end of the second stage, the 'Completion Point', that the country is able to receive the maximum debt relief approved under the programme. In order to successfully complete the second stage, the country is expected to: (i) continue to display outstanding performance in IMF and WB-supported programmes; (ii) satisfactorily implement the reforms agreed upon at the Decision Point; and (iii) adopt the PRSP for at least one year.

To date, 39 countries have been deemed eligible or potentially eligible for assistance under the e-HIPC initiative. Of these, 32 have already arrived at their Completion Point and so qualify to receive the full amount of relief approved. Guyana and Haiti are among this group. Of the remaining seven countries, four have completed the first stage, while three await decisions on their eligibility.

[88/] The other major multilateral organisations involved in the initiative include the African Development Fund (AfDF) and IDB. Other creditors comprise members of the G8 and Paris Club, as well as other bilateral and private commercial lenders.

In June 2005, another complementary debt relief initiative came on stream. MDRI is a proposal by the G8 countries that the IMF, WB's IDA, AfDF and (as of 2007) IDB should cancel 100% of their debt claims on countries that have reached, or will eventually reach, the Completion Point under the HIPC initiative (IMF, 2011b). This is significant because whereas the HIPC initiative aimed to reduce external debt to sustainable levels, MDRI goes further by providing full debt relief on eligible debt.[88/] It is intended that the resources freed up will be used to advance low-income countries toward achieving the MDGs.

The Case of Guyana

In the first half of the 1990s, Guyana's external debt stock averaged USD2,003 million (565% of Gross National Income (GNI)), with an average debt servicing cost of USD101 million (28.6% of GNI) p.a. (see Table A.2.1). It was felt by the IMF and WB that Guyana's massive stock of public debt was a major deterrent to poverty reduction and economic growth. In December 1997 both multinational institutions announced that the country had met the first stage requirements and was deemed eligible for debt relief under the HIPC initiative. At the time of the decision, Guyana was approved for external debt reduction of USD256 million in NPV terms as at the end of 1998. Of this amount, multilateral creditors accounted for 61% of the relief and bilateral creditors the remainder. While interim reductions in debt-servicing were allowed, Guyana did not officially qualify for the full amount until it satisfied all remaining conditions and reached the Completion Point in May 1999 (see Table A.2.2). The debt relief offered under the original HIPC initiative reduced the NPV of Guyana's external debt to 280% of average CG revenues, the required threshold (IMF and IDA, 2000).

TABLE A.2.1

GUYANA-SELECTED DEBT INDICATORS, 1991-2010

Item	1991-95	1996-2000	2001-05	2006	2007	2008	2009	2010
External debt stocks (USD million)	2,003.3	1,489.9	1,338.5	1,141.2	735.6	828.8	1,036.8	1,353.6
External debt stocks (% GNI)	565.5	227.8	194.2	76.0	36.3	36.8	44.6	52.8
Debt service (USD million)	100.5	104.9	49.9	31.3	27.4	26.7	20.0	31.2
Debt service (% GNI)	28.6	16.0	7.3	2.2	1.6	1.4	1.0	1.4

Source: World Development Indicators databank.

Having successfully completed the first programme in November 2000, Guyana was deemed eligible for further debt relief under the e-HIPC initiative, qualifying for USD335 million in NPV terms (USD590 million in nominal value) in order to reduce its debt-to-revenue ratio even further to 250% (IMF and IDA, 2000). By the time Guyana reached the Completion Point of the e-HIPC initiative at the end of 2003, it had qualified for debt relief totaling USD560 million in NPV terms (nominal USD1,030 million), implying a reduction in debt stocks of some 54%. Table A.2.3 shows the significant reductions in debt-servicing costs Guyana experienced as a result of the HIPC initiatives. These figures help to explain the tremendous drop in Guyana's debt service ratio from 28.6% of GNI during 1991-95 to 7.3% of GNI a decade later (see Table A.2.1).

[89/] It should be noted that MDRI relief covers the full stock of debt owed at end-2004 that remains outstanding at the time the country qualifies for such relief. There is no provision for relief of debt disbursed after January 1, 2005.

TABLE A2.2

DEBT RELIEF APPROVAL TIMELINE

Date	Action	Debt Relief Approved (USD million)	
		Net Present Value (end 1998)	Approximate Nominal Value
December 1997 May 1999	Decision point: original HIPC initiative Completion point: original HIPC initiative	256.0	440.0
November 2000 December 2003	Decision Point: e-HIPC initiative Completion point: e-HIPC initiative	334.5	590.0
Total HIPC	Total HIPC	590.5	1,030.0
December 2006	MDRI: IMF, IDA		254.0
June 2007	MDRI: IDB		357.0

Source: World Development Indicators databank.

TABLE 2.14

ANNUAL DEBT SERVICE RELIEF, 2001-2010, (USD million)

Item	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Original HIPC	29	22	24	24	23	20	21	19	17	15
E-HIPC	15	29	19	34	38	26	19	20	19	21
Total HIPC	44	51	43	58	61	46	40	39	36	36
MDRI						19	34	32	31	32

Source: Bank of Guyana Annual Report, various years.

In the post-HIPC environment, Guyana qualified for further debt relief under MDRI, intended to assist low-income countries achieve the MDGs. In late 2006, Guyana was one of the initial 19 countries to receive complete debt write-off from the IMF and WB under MDRI, qualifying for approximately USD254 million in nominal terms. Later in mid-2007, IDB contributed an additional USD357 million to Guyana under MDRI, at which point Guyana was no longer considered a highly indebted poor country (Bank of Guyana, 2007). With the substantial relief afforded by MDRI, Guyana's debt service ratio continued to fall, averaging 1.5% of GNI in the late 2000s.

EVALUATION OF THE INITIATIVE

An examination of Guyana's recent debt statistics shows tremendous decline in the amount of outstanding external debt since the early 1990s (see Table 2.12). The external debt-to-GDP ratio in the post-HIPC environment is less than one-tenth of that which obtained in the early 1990s. Debt service indicators have also been dramatically lowered. While there has been substantial reduction in Guyana's external debt levels as a result of successive debt forgiveness initiatives, the country still has a large debt stock with which to contend. Of particular concern is the noticeable uptick in the external debt stock level since 2009, which has mainly been driven by new loan disbursements received under the PetroCaribe Initiative and from IDB (Bank of Guyana, 2010).

In evaluating the impact of the HIPC Initiative in Guyana, it is paramount that one also examines the effects that the relief has had on poverty and social indicators since the ultimate aim of the initiative is poverty reduction via debt sustainability. The 2005 PRSP Progress Report indicates that social sector spending as a share of GDP increased from 15% in 1997 to 20% in 2004 (IMF, 2006). It made note of improvements in leading indicators for education, health, employment creation and poverty reduction. The most recent available data indicate that the share of the population living in extreme poverty declined from 29% in 1993 to 19% in 2006 (UNDP, 2011). Given these statistics, Guyana is on track to meet the MDGs of halving the proportion of people living in extreme poverty by 2015.

Despite these positives, it is felt that the HIPC social programmes have not been sufficiently comprehensive in scope, with benefits skewed to urban dwellers while most rural residents remain poor. For example, after HIPC relief was granted in 1999, Misir (2004) documents that while Guyana as a whole saw a 26% reduction in poverty depth, in Georgetown and other urban areas the average reduction was 45%, contrasted with 21% in rural coastal areas and only 2% in the rural hinterland. The PRSP has also been criticised for weak monitoring and evaluation, which has impeded the overall success of the programme (IMF, 2006). Bedi and de Jong (2011) concur with this assessment. They investigate whether the HIPC Initiatives and the accompanying PRSP have translated into increases in the level and quality of social expenditure. They confirm that there has been a substantial increase in social spending since 1997. However, in terms of the quality of expenditure, they lament that without further strengthening of institutions responsible for oversight of public expenditure, debt forgiveness is unlikely to provide more than temporary relief.

APPENDIX 3.1
DEBT DECOMPOSITION FORMULATION

The following derivation provides a justification for the debt decomposition used in this chapter as well as for the scenario modeling used in Chapter 5.

Variables

D_t = *total public debt in local currency*

D_t^d = *domestic debt in local currency*

D_t^f = *external debt in local currency*

d_t = *total public debt in GDP units*

d_t^f = *domestic debt in GDP units* = αd_t

d_t^d = *external debt in GDP units* = $(1 - \alpha)d_t$

e_t = *nominal exchange rate, domestic currency per unit of foreign currency*

EVT_t = *new, non-borrowed debt*

F_t = *external debt in foreign currency*

g_t = *rate of real economic growth*

GDP_t = *gross domestic product* = $(1+g_t)(1+\pi_t)GDP_{t-1}$

i_t = *average interest rate on total debt* = $(1-\alpha_t)i_t^d + \alpha_t(1+s_t)i_t^f$

i_t^d = *average interest rate on domestic debt*

i_t^f = *average interest rate on external debt*

PB_t = *primary balance*

s_t = *rate of nominal depreciation, such that:* $1 + s_t = \frac{e_t}{e_{t-1}}$

s_t^r = *rate of real depreciation, such that:* $1 + s_t^r = (1 + s_t)\frac{1+\pi^*}{1+\pi_t}$

α_t = *share of external in total debt*

π_t = *GDP deflator*

Derivation

(1) $$D_t = -PB_t + EVT_t + \left(1 + i^d_{t-1}\right)D^d_{t-1} + \left(1 + i^f_{t-1}\right)e_t F_{t-1}$$

Equation (1) states the total debt in any year is the sum of the financing needs of the primary deficit, new non-borrowed debt, and the stock of inherited debt along with interest due on that stock, disaggregated into domestic and external components, everything expressed in local currency.

Dividing through by GDP_t and using lower case to represent variables in GDP units yields

(2) $$d_t = -pb_t + evt_t + \frac{(1+i^d_{t-1})D^d_{t-1}}{(1+g_t)(1+\pi_t)GDP_{t-1}} + \frac{\left(1+i^f_{t-1}\right)e_t F_{t-1}}{(1+g_t)(1+\pi_t)GDP_{t-1}}$$

Substituting the total debt/GDP ratio, d_t, for the domestic and external debt variables, the equation becomes

(3) $$d_t = -pb_t + evt_t + (1 + i_{t-1} + \alpha_{t-1}s_t)\frac{d_{t-1}}{(1+g_t)(1+\pi_t)}$$

Subtracting d_{t-1} from both sides

(4) $$\Delta d_t = -pb_t + evt_t + (1 + i_{t-1} + \alpha_{t-1}s_t)\frac{d_{t-1}}{(1+g_t)(1+\pi_t)} - d_{t-1}$$

(5) $$\Delta d_t = -pb_t + evt_t + [i_{t-1} - \pi_t(1 + g_t) - g_t + \alpha_{t-1}s_t]\frac{d_{t-1}}{(1+g_t)(1+\pi_t)}$$

Substituting $s_t = (1 + s^r_t)\frac{1+\pi_t}{1+\pi^*} - 1 = \frac{(\pi_t - \pi^*)}{1+\pi^*} + s^r_t\frac{1+\pi_t}{1+\pi^*}$ and rearranging

(6) $$\Delta d_t = -pb_t + evt_t + \left[i_{t-1} - \pi_t(1 + g_t) + \alpha_{t-1}\frac{(\pi_t - \pi^*)}{1+\pi^*} - g_t + \alpha_{t-1}s^r_t\frac{1+\pi}{1+\pi^*}\right]\frac{d_{t-1}}{(1+g_t)(1+\pi_t)}$$

The above equation states that the change in debt is the sum of the following sources, in order of appearance: the fiscal balance, outside liabilities, the interest rate effect (consisting of the first three terms inside the square brackets), a real growth effect, and a real exchange rate effect.

For the debt decomposition in Chapter 3, but not for debt extrapolation in Chapter 5, the primary balance, pb_t, is further decomposed into a primary recurrent balance, bb_t, and a capital balance, kb_t.

The third part of the interest rate effect, the term $\alpha_{t-1}\frac{(\pi_t + \pi^*)}{1+\pi^*}$, represents the difference between a nominal and real depreciation of the currency.

APPENDIX 4.1

PUBLIC FINANCIAL MANAGEMENT IN THE CAYMAN ISLANDS

The political entity of the Cayman Islands is a colony of the United Kingdom of Great Britain and Northern Ireland. The United Kingdom in the late 1990s moved to institutionalise provisions for fiscal responsibility through a "Code for Fiscal Stability" as legislated in its Finance Act (1998). Like New Zealand, the United Kingdom has a strong emphasis on transparency and avoids legislation of specific quantitative targets. Objectives are described in terms of general principles of transparency, policy and outturn stability, managerial responsibility, distributional and inter-generational fairness and efficiency in managing both debit and credit sides of transactions (output as well as expenditure). GAAP for the United Kingdom, including accrual accounting, is utilised. There is no micro-contracting but a general commitment to the public through "the Code". Implicitly, sanctions are expected to be largely reputational or electoral which may be sufficient in the United Kingdom.

ECONOMIC BACKGROUND

Historically, the economy of the Cayman Islands rested upon the exploitation of marine life, fishing and turtles. The turtle population has been exploited to the point of extinction. Over the past 50 years, the economy of the Cayman Islands has come to be dominated by services. In 2009, "Goods Producing Sectors" contributed only 6.7% of real GDP. "Agriculture and Fishing" contributed only 5.8% of the real output of goods.

The 93.3% contribution of the Services-producing Sectors to real GDP in 2009 was dominated by "Finance and Insurance Services" which contributed 42.9% of the output of the economy. This sector is also the most important source of government revenue. Tourism is seen as being the other significant service sector but this is not explicitly and collectively represented in the national accounts. A crude summation of other explicitly represented sectors including "Hotels and Restaurants", "Transport and Storage", and "Other Services" would suggest that tourism contributes less than 20% of real GDP. Other significant service contributors include "Wholesale and Retail Trade" (also related to tourism), "Professional, Technical and Scientific Activities" and provision of services by government. The sum of "Public Administration and Defence", "Education Services" and "Health and Social Work" (with the caveat that some health and education services are provided outside of government) represent13% of GDP.

With its relatively small size and population and a strong and disproportionately large service sector, the Cayman Islands enjoy a per capita income that exceeds that of most developed and developing countries. Per capita GDP in current dollars is approximately USD55,000.

The exchange rate is pegged at a rate of one Cayman dollar being equal to 1.2 United States dollars (C$1 = USD1). This is supported by conservative monetary arrangements through the Cayman Islands Monetary Authority where local currency issue is backed by strong foreign currency reserves. With these conservative monetary arrangements, inflation has been relatively low. Having increased from 0.8% in 2006 in 2008, there was negative inflation of 3.3% in 2009 and inflation of 0.6% in 2010.

Fiscal revenue declined progressively from 20.5% of nominal GDP in 2006 to 18.5% in 2009. The decline in 2009 would have been influenced by the international financial and economic crisis.

Concurrent with the decline in the ratio of revenue to GDP, expenditure increased from 17.69% of GDP in 2006 to 24.39% in 2009. As a result, what had been a fiscal surplus in 2006 became a deficit, increasing from 1.5% of GDP in 2006 to 5.9% in 2009. The fiscal deficit then declined in 2010 and again in 2011.

INSTITUTIONAL FRAMEWORK FOR PUBLIC FINANCIAL MANAGEMENT

Constitutional Arrangements

As a colony of the United Kingdom, ultimate administrative responsibility is vested in the Crown and exercised through the FCO of the United Kingdom. The colonial constitution of the Cayman Islands provides for a Governor, appointed by the Crown through FCO, a Legislative Assembly and a Cabinet. Ultimate executive authority resides in the Governor acting on the advice of Cabinet. Accordingly, executive decisions are referred to as being made by "the Governor in Cabinet".

Ultimate executive authority resides in the Governor but unless there are exceptional reasons, the Governor acts on the advice of Cabinet. The constitution is the gift of the Crown which retains the right to suspend that constitution and institute "direct rule" through the Governor in very exceptional circumstances. This occurred in the Turks and Caicos Islands on the basis of perceptions by FCO of internal "misgovernment".

The "Governor in Cabinet" negotiates with the various heads of expenditure, the financial inputs to be given by the Cabinet through the budget, and the outputs to be expected from the employment of these financial inputs. It also holds the administration of these heads of expenditure accountable for the delivery of outputs "paid for by the Cabinet". There is therefore a highly implicit if not explicit contractual arrangement.

The Cayman Islands therefore has a strong hierarchical rather than a collegial political administration. Colonial authority through the Governor retains responsibility for the police, defence and external affairs. It is especially worthy of note that the civil service is answerable to the colonial executive being effectively independent of the indigenous elected representatives.

Core Principles of Public Financial Management

Financial management by the "Governor in Cabinet" in Cayman Islands is to be consistent with the following principles outlined in Section 14.3 of the Public Finance and Management Law (2005 Revision) (PFML 2005R):

(a) core revenue should exceed core expenditure;

(b) core assets are to exceed core liabilities;

(c) borrowing is to be consistent with keeping debt service (including amortisation) below 10% of core revenue;

(d) net debt should not be allowed to exceed 80% of core revenue;

(e) cash reserves are to be at least equal to core expenditure projected for the following 90 days; and

(f) financial risks are to be managed prudently.

Any departure from these principles is expected to be temporary, justified by the "Governor in Cabinet" and followed by a return to the principles in as short a timeframe as feasible. By PFML 2005R Section 14.4 any departure from the principles requires the "Governor in Cabinet" to lay a paper in the legislature specifying:

(a) The reasons for departure from the principles.

(b) The approach to be taken in returning to core principles

(c) The timeframe for return to the principles.

In outlining these core principles, the Cayman Islands fully replicate the ethos of the United Kingdom's "Code for Fiscal Stability" in outlining principles and broad objectives rather than enshrining specific fiscal and debt targets in law.

The Role of the Legislative Assembly

The responsibilities of the Legislative Assembly are also outlined in PFML 2005R. For example:

(a) There should be no incurring of expenses, borrowing or investment without appropriation (an approved appropriation bill passed) by the Legislature. (Section 7)

(b) No guarantees should be given without approval by the Legislature. (Section 8)

(c) Appropriations are given for specific output groups and cannot be reallocated without approval of the Legislature. (Section 9)

(d) In an emergency, the "Governor in Cabinet" may authorise expenditure of up to 5% of budgeted revenue but this has to be regularised in the legislature through supplementary estimates. (Section 11.5)

(e) Any expenses outside of the appropriations bill need to be approved by the legislative sub-committee of the Assembly and legalised through a supplementary appropriations bill. (Sections 12.2 and 12.3)

(f) In a state of emergency, the "Governor in Cabinet" may approve emergency expenditure but then regularise it through a supplementary appropriations bill

The Role of the Financial Secretary

The PFML 2005R gives the FS extensive power over the management of the public finances of Cayman Islands. The FS has overall authority over public spending but may delegate aspects of this authority to a member of "Government in Council (Section 33). Specific powers of the FS include the following:

(a) The FS may on behalf of "Government in Council" borrow, lend, give guarantees and do transactions to protect public net worth. These powers are constrained by the appropriations law, the legislated statement of borrowing and lending and by the FCO. (Section 35)

(b) "Government in Cabinet" is dependent on the advice of the FS regarding regulations on spending, borrowing lending and taxation. (Section 35)

(c) The FS may give directions to operational heads of Ministries and agencies including the public complaints authority and the audit office to protect the financial interest of core government. (Section 36)

The FS may not however give directions in contravention of public officers' statutory responsibilities unless the actions of these officers violate government's financial interest, there has been serial non-compliance and notice has been given to the non-compliant officer.

The Role of Ministries, Portfolios and Statutory Bodies

Ministries and portfolios are expected to deliver the outputs agreed to with the "Governor in Cabinet" as represented in the annual budget statement. They shall also supply outputs to other entities and individuals as agreed in the annual budget statement. They are also expected to assume full responsibility ("ownership of") for generation of these outputs (PFML 2005R Section 37).

The Chief Budget Officer of a ministry or portfolio prepares and executes an annual budget statement in consultation with the "Governor in Cabinet". Such a budget statement includes a specification and details of the outputs to be sold to the "Governor in Cabinet" including quantity, quality and delivery dates. There is also included a specification of the "ownership performance" (responsibility and accountability) of the ministry or portfolio relative to the delivery of the specified outputs (Section 42).

The law also makes similar provisions for the provision of outputs by statutory bodies and government- owned companies regarding outputs to be supplied to "Governor in Cabinet", the supply of outputs to third parties and "ownership performance". Furthermore, the Boards of Directors of statutory bodies and government companies are held to the same standards of fiduciary responsibility as applicable to the boards of privately held companies (Section 46).

Accounting Standards

Section 9 of PFML 2005R specifies that all appropriations are to be strictly on an accrual basis. Appropriations are to be for specific outputs. This avoids the abuses allowed by cash accounting such as the accumulation of payment arrears by recognising expenditure only on the basis of cash outlay. The tying of appropriations to specific output groups avoids the arbitrary shifting of expenditure between heads of expenditure outside of the letter and spirit of the appropriations bill.

Procedural Timetable

The procedural timetable for the preparation of the budget is clearly outlined in law. By October 1 the FS outlines a timetable for the budget process to include phases for strategic outline, detailed planning and budgeting, review by "Governor in Cabinet", legislation and documentation phases (PFML 2005R). During the strategic phase the "Governor in Cabinet" shall determine for the ensuing financial year and the subsequent two financial years:

(a) Strategic outcomes.

(b) Specific outputs.

(c) Revenue and expenditure.

(d) Executive expenditure per Minister or Portfolio Head

(e) Forecasts for the Complaints Authority and Audit Office.

These forecasts for the next financial year and for the medium term are encapsulated in a formal "Strategic Policy Statement" (SPS) that is to be tabled in the Assembly by December 1. Legislative action is expected within two months, in the absence of which the SPS is automatically approved. On the basis of the SPS, a detailed Annual Budget Plan is to be tabled by May 1 (in advance of the beginning of the financial year on July 1.)

The law (Section 26) also requires a pre-election economic and financial update to be presented 28-42 days before general elections. This document is to include the nature and impact of all recent "Governor in Cabinet" decisions.

Provisions for Transparency

Provisions for transparency are embodied in Sections 13, 26, 28, 44 and 51 of the Law. Quarterly and annual reports are expected to be provided by government and by statutory bodies. For government, a quarterly report is to be gazetted no later than eight weeks after the end of the first three quarters of the financial year. These quarterly reports are to include information specific to the quarter being reviewed and cumulative information from the beginning of the financial year. An annual report is to be gazetted no later than five months and two weeks after the end of the financial year. These reports and the pre-election report discussed above are to be publicly available at a cost.

Individual ministries and portfolios are expected to present to "Governor in Cabinet" similar quarterly reports (specific quarterly and cumulative performance) no later than four weeks after the end of the first three quarters of the financial year. These are tabled with government's own quarterly reports and so become public documents. Annual reports are similarly presented to "Governor in Cabinet" no later than four months of the end of the calendar year and become public documents by being tabled with government's own annual reports.

Statutory authorities and government companies are expected to provide half-yearly reports to "Governor in Cabinet" no later than four weeks after the end of the first half of the financial year. These are then to be tabled at the same time as government's quarterly report for the half-year and so become public documents. An annual report for these entities is to be provided to "Governor in Cabinet" no later than four months after the end of each financial year and presented to the legislative assembly in the next two weeks or at the first sitting thereafter. By being tabled, the annual report becomes a public document.

The definition of offences and the specification of sanctions in the Law focus largely on failures to provide information to the AG. The AG reports to the Legislative Assembly. The AG has wide powers of access to information from public servants, public bodies and companies with the exception of information held by a member of the "Governor in Cabinet" or a member of the Legislative Assembly. Where a person fails to comply with a direction for information from the AG within the time specified (minimum of three days), the AG may apply to a court for an order for compliance. The AG may also apply to court to have a person examined under oath.

Summary Overview

The Law governing PFM in the Cayman Islands is strongly influenced by international best practice as reflected in the United Kingdom's Code for Fiscal Stability. There is strong emphasis on the role of fiscal transparency and an avoidance of legislated quantitative rules. The system goes beyond

the rudiments of budgeting expenditure (input) revenue and net borrowing to the specification of outputs that are to be expected. This then defines a strong contractual mode of operation where public officers participate in defining the relativity of inputs and outputs and are given ownership of (responsibility for) delivery of outputs on the basis of inputs received.

There is a strong "hierarchical" executive flowing from "Governor in Cabinet" which may help to ease executive decisions through the Legislative Assembly. There is however, potential for tension in the executive between indigenous elected representatives and executives appointed by the Crown through the FCO. This is especially likely as the Civil Service, the Judiciary and the Police Force are answerable to the Governor and not to the elected representatives.

The independence of the Civil Service, Police and Judiciary from political influence is likely to be a positive for governance in general and for PFM in particular. This independence that is taken for granted in many developed countries is a gift of the peculiarities of colonial administration in CI. Independent developing countries need to embrace the independence of these institutions as contributory to enhanced governance and fiscal management.

The emphasis on transparency assumes that there is an educated public that reads and processes public information and cares about the quality of outputs and outcomes. Transparency may not be so effective in ensuring "good behaviour" in politicians and public servants where there is illiteracy and apathy and where politicians are able to directly influence the allocation of public financial resources to buy political influence. This is avoided in the Cayman Islands by having an independent civil service responsible for spending. It is also worthy of note that although the Cayman Islands has the resources to afford education, it is ultimately the vigilance of the Crown that guarantees "good behaviour".

Other jurisdictions, most notably Brazil, have opted for a combination of transparency provisions, quantitative rules and criminal sanctions for the breaching of statutory quantitative limits. This combination has been effective in enhancing the quality, effectiveness and impact of PFM.

The record shows that despite strong systems, Cayman Islands have not been able to entirely avoid fiscal deficits. The impact of natural disasters and the international financial crisis has exposed a structural inflexibility in public expenditure that has been characteristic of many Caribbean jurisdictions. There are implications here for budgeting with margins and for mitigation of and effective insurance against natural disasters.

APPENDIX 4.2
REVENUE REFORMS IN THE CARIBBEAN

Social organisation requires government to provide, at minimum, internal security, dispute resolution mechanisms, and protection against external threat. These functions are paid for mainly by taxation, supplemented by grants. To the extent that these means are insufficient, governments have to borrow.

Textbooks often cite equity (horizontal and vertical), efficiency (avoidance of distortion of expenditure patterns), transparency (as to desired impact and outcomes), simplicity (as to ease of compliance and administration) and flexibility (as to automatic adaptability to changing circumstances) as desirable characteristics of a country's system of taxation. Theory recognises that there are trade-offs between equity and the avoidance of distorting patterns of expenditure. In economies that have chronic fiscal deficit and debt problems, anaemic economic growth and forecasted increased entitlement payments, the system of taxation also has to be assessed on the basis of revenue yield and the ability of the tax system to facilitate the allocation of resources to industries/sectors that generates high levels of economic growth.

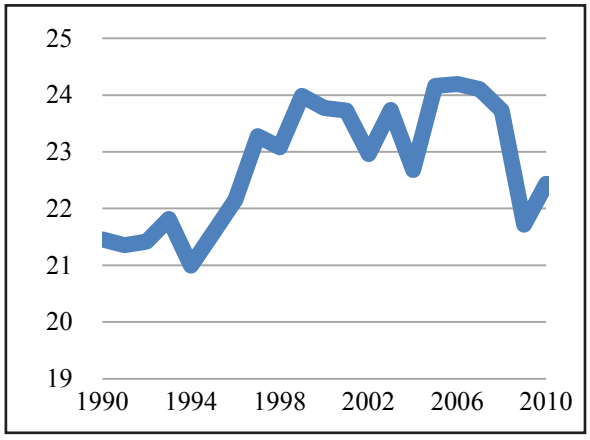
TAX SYSTEMS IN THE CARIBBEAN

Despite negative shocks and ad hoc tax policy intervention, tax revenue appears to have performed creditably across Caribbean jurisdictions over the past fifteen years. Figure A.4.1 shows that the simple average of Tax Revenue/GDP across Caribbean jurisdictions increased from 21.5% in 1990 to about 24% in 1999. After some fluctuation and deterioration in the new millennium, the regional average exceeded 24% in 2005, 2006 and 2007. As the global financial and economic crisis broke, there was a modest deterioration in 2009 followed by a sharper decline to below 22% in 2009, however, there was some recovery by 2010.

A look behind this regional trend reflects variation in the performance of the tax to GDP ratio by country. For example Barbados' tax-to-GDP ratio has generally increased over the period from 25 to more than 30%. Whereas on the other hand, St. Kitts and Nevis, St. Lucia, St. Vincent and

Figure D.4.1

Regional Average Tax Revenue, 1990 – 2010



the Grenadines and to some extent, Trinidad and Tobago, have experienced increases towards the end of the period. In Jamaica the ratio is on a downward trend ending below the regional average, just slightly above 20% from a high of 28.1% in 1990. Haiti has struggled to collect revenue but its tax-to-GDP ratio has recovered from a low of 3.2% in 1993 to 33.2 in 1998. Apart from some spikes during the period, the tax-to-GDP ratio has remained fairly constant in Dominica, Grenada and Montserrat.

Generally speaking, Barbados and Jamaica have average tax revenue to GDP ratios that are above the regional average whilst Anguilla, Antigua and Barbuda and the Bahamas have ratios below the regional average. Dominica, Grenada, Montserrat, St. Vincent and the Grenadines and St. Lucia have ratios that are very close to the regional average. Trinidad and Tobago and Guyana have experienced fluctuations in revenue to GDP based on changes in world prices of the natural resource-based products on which their economies are heavily dependent; oil in the case of Trinidad and Tobago and sugar, rice, and forestry products for Guyana. Belize, Haiti and St. Kitts and Nevis ratios began below average and improved over the period.

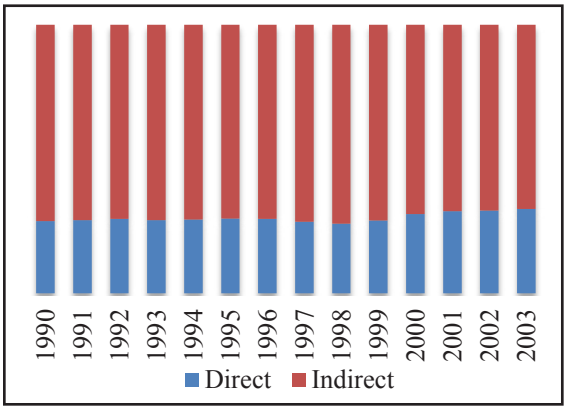
Figure A.4.2 shows that on average, indirect taxes have contributed approximately 70% of regional tax revenues between 1990 and 2003. [90]/ The share of indirect taxes fell below 70% in 2001 due partly to the negative impact of international trade reform on revenue flows.

Most Caribbean tax jurisdictions are primarily dependent on indirect taxes (relative to direct taxes) but there are variations in the extent to which each country is dependent on indirect taxes across the Region. Anguilla is almost entirely dependent on indirect taxes whereas Trinidad and Tobago receives only 40% of its tax revenues from indirect measures. Indirect tax dependence for most other Caribbean tax jurisdictions has been between 50 and 70% over the period (Figure A.4.3).

As small open economies the Caribbean has been highly dependent on international trade particularly with the US and Europe, and as a result the fiscal accounts of each country have been highly dependent on taxes collected at the border in relation to this trade. Collecting taxes on imports

Figure A.4.2

Direct vs Indirect Tax Shares, Regional Average



[90]/ This is computed as a simple average of the jurisdictions as the focus is on performance across countries rather than a weighted average that may be dominated by larger jurisdictions.

in these relatively small countries is easier as the ports are centralised, small and easy to monitor (ECLAC, 2006 pp.7). [91/] Historically, these taxes on international trade were dominated by import tariffs but with international and intra-regional trade liberalisation, there has been an increasing relative importance of consumption type taxes (including VAT), stamp duties and user fees which have replaced custom duties and tariffs over time.

FIGURE A.4.3

INDIRECT TAX SHARE OF TOTAL TAX REVENUE
(%)

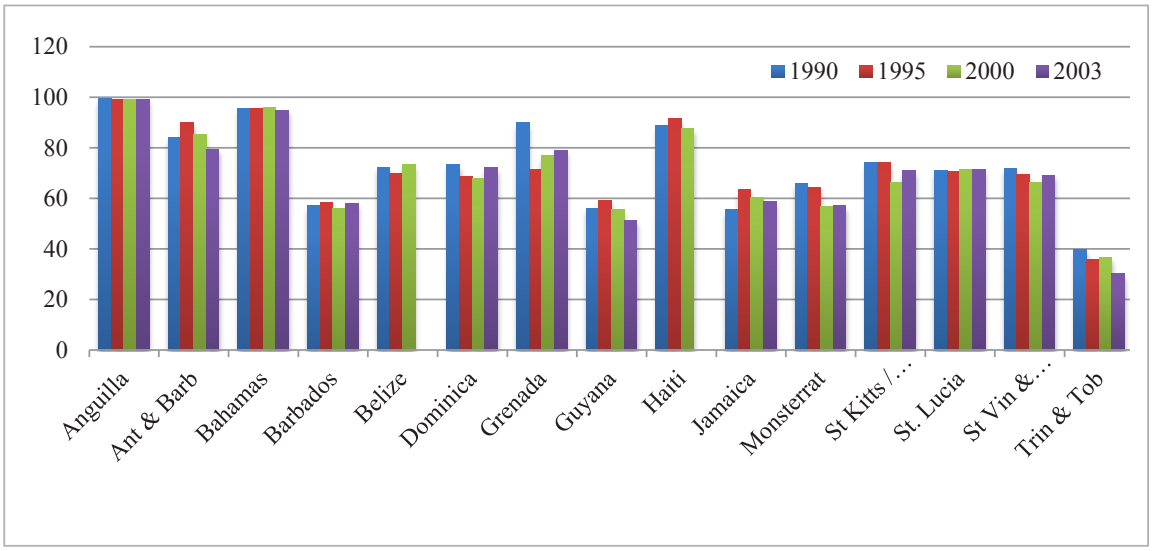


Figure A.4.4 indicates that between 1990 and 2003, international trade taxes contributed more than 40% of the total tax revenue of most Caribbean jurisdictions. Figure A.4.5 shows that the exceptions to this were: Barbados (below 20%), Jamaica (30-40%) and Trinidad and Tobago (under 10%). At the other end of the spectrum, international trade taxes contributed over 70% to tax revenue in the Bahamas and over 50% in Anguilla and most of the Eastern Caribbean countries. For the most part however, the trend in this dominance has been downward. In the Bahamas for example, the share of international trade taxes fell from 90 to just above 80% from 1990 to 2003. In Dominica the share fell from just under 60 to 45% and in St. Vincent and the Grenadines from 55 to 45% over that same period. There was a subsequent decline in the contribution of international trade taxes by 2003. This decline is attributed to reduction in flows from import tariffs despite an increase in the relative importance of other taxes collected at the border.

Figure A.4.6 shows that regionally the contribution of company taxes to direct taxation has declined from 50 to 43% whereas there has been increased intake in individual income taxes. This implies that either individual workers are less able to avoid income taxes when compared with firms, or that administrative/policy or other measures have facilitated tax avoidance by companies or a combination of both. There has been very little change in the contribution of property taxes

[91/] Exports tend to be exempted from tax in an attempt to promote exports (over imports).

Figure A.4.4

Composition of Indirect Taxes, Regional Average

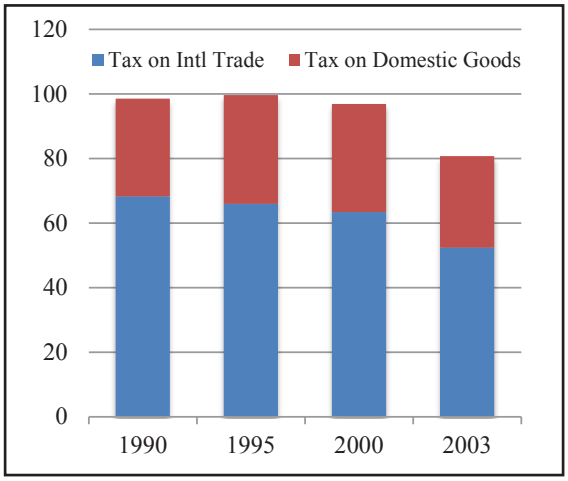
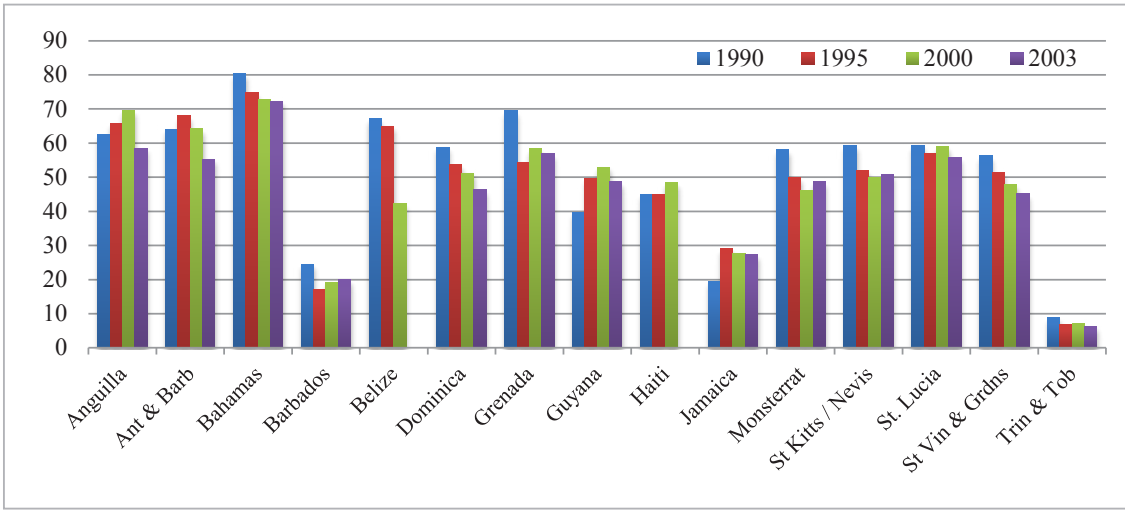


FIGURE A.4.5

INTERNATIONAL TRADE TAX SHARE OF TOTAL TAX REVENUE



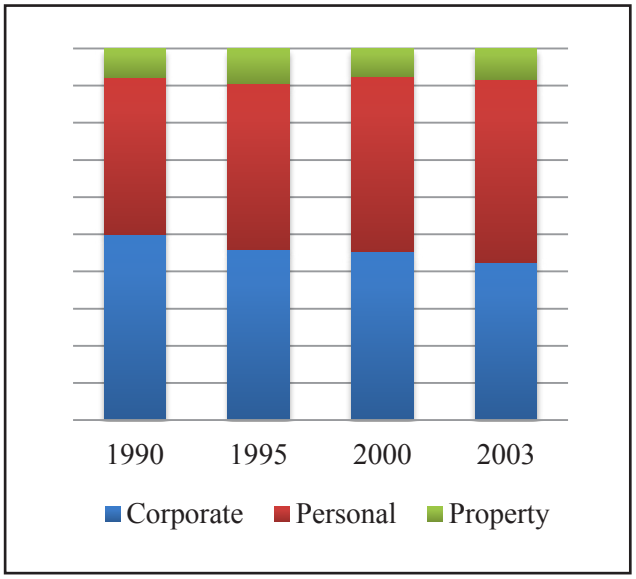
regionally. This is possibly associated with the post-colonial issues surrounding property ownership and disenfranchisement which would have reduced the likelihood that post-independence leaders would have adjusted the valuation rolls.

TAX REFORMS IN THE CARIBBEAN

The pace, size and scope of tax reforms across the Region reflected differences in tax policy adjustment among Caribbean economies. The revenue reforms in the Region have aimed to maximise revenue intake whilst minimising negative economic consequences. The aim has been to improve the efficiency of tax administration, increase the vertical and horizontal equity of the systems and maximise fiscal revenue (Howard, 2004).

Figure A.4.6

Composition of Direct Taxes



Direct Tax Reforms

The scope of direct tax reform across the Caribbean region has focussed largely on raising additional revenue, while improving efficiency, transparency and competitiveness. Jamaica and Barbados undertook major direct tax reforms from as early as the 1980s, while the other territories followed during the 1990s and 2000s.

The reform process began with reductions in high marginal personal income tax rates, the introduction of thresholds and the removal of costly allowances and deductions. In Barbados, Jamaica and Trinidad and Tobago, the multi-tiered systems, featuring prominently in the 1980s gave way to flatter income tax structures, with two rates in Barbados and a single rate in Jamaica and Trinidad and Tobago.

The governments in the majority of countries have also lowered corporate tax rates. In Barbados, this process began in 2002 with a maximum rate of 40% – an effective rate of 25% due to incentives and holidays [92/] – reduced over five years to 25%. Trinidad and Tobago implemented a four-tiered corporate tax regime with rates ranging from 50% (oil and gas companies) to 25% for non-oil companies. Small businesses and approved enterprises were exempt from paying taxes for five years.

Property tax regimes saw some reform as well. In Barbados, where property values have been rapidly rising, the property tax bands were expanded to reduce the tax liability of residential homeowners. In 2009, Trinidad and Tobago introduced property tax reforms with the objective of being more equitable than the previous regime.

[92/] See Alleyne and Howard, 2004.

Table A.4.1 shows the proportion of total tax revenue contributed by taxes on income profits and capital, for selected countries, over the past two decades. Of particular note is Trinidad and Tobago, whose direct taxes on income and profits account for almost two-thirds of tax revenue during the period of reform between 2006-09. Other countries with high ratios are Suriname, Guyana, Jamaica and Barbados. In contrast, direct taxes account for a small proportion of total tax revenue in Antigua and Barbuda and Grenada.

Table A.4.1

Taxes on Income, Profits and Capital
(% of tax revenue)

	1990-95	1996-00	2001-05	2006-10	Average
Barbados	30.5	34.6	37.0	38.1	35.1
Antigua and Barbuda	11.4	11.0	14.8	16.7	13.5
Belize	30.2	23.1	27.4	32.2	26.9
Dominica	26.3	31.1	23.9	18.5	25.0
Grenada	20.3	15.7	17.4	19.5	18.2
Guyana	36.8	39.7	46.1	39.6	40.9
Jamaica	39.0	37.5	39.9	37.8	38.8
St. Kitts and Nevis	22.0	26.4	28.9	30.4	26.9
St. Lucia	29.1	29.9	27.0	28.9	28.7
St. Vincent and the Grenadines	30.0	31.7	29.3	26.0	29.3
Suriname	53.4	43.2	40.2	-	45.6
Trinidad and Tobago	58.3	55.1	69.3	76.2	64.7

Source: Roland Craigwell

Indirect Tax Reforms

The international trade tax reforms across the Caribbean were driven by the regional integration process of the CARICOM Single Market and Economy (CSME) and the subsequent move toward greater multilateral trading arrangements.

The Common External Tariff (CET), [93/] which was to be implemented by all CARICOM members, resulted in exceptionally high levels of tariff protection, particularly for manufactured goods originating outside the Region. More critically, however, while intra-regional goods were intended to benefit from the CET, the imposition of high duties on goods originating in other Member Countries was also prevalent during the early years of implementation ostensibly to preserve fledgling domestic industries. (ECLAC, 1999)

[93/] Since its formation in 1973, and under its mandate to liberalise intra-regional trade as a vehicle for economic growth and development, one of the core elements of the CSME was the implementation of the CET and the accompanying freedom of movement of goods enshrined in the Articles 80 through 90 in the Revised Treaty of Chaguaramus

This, coupled with overvalued exchange rates, small domestic markets and limited export opportunities resulted in the ultimate collapse of this import-substitution model to generate the efficiencies envisioned by its proponents and led to widespread institutional reform across the Region including the phased decrease in the CET. [94/] The phased reduction in CET was to be accomplished in four steps and would result in a lowering of the top CET rates from 45% to between 0 and 20% for non-exempt, industrial goods.

Table A.4.2

Taxes on International Trade (% of tax revenue)

	1990-95	1996-00	2001-05	2006-10	Average
Barbados	20.1	12.3	10.9	10.6	13.5
Antigua and Barbuda	66.5	65.7	61.1	42.9	59.1
Belize	64.2	41.3	37.0	28.3	47.5
Dominica	57.0	52.3	51.4	22.9	45.9
Grenada	60.3	62.2	58.6	50.5	57.9
Guyana	45.9	51.4	48.3	52.6	48.5
Jamaica	23.7	28.3	28.0	25.5	26.7
St. Kitts and Nevis	53.7	51.6	49.5	46.0	50.2
St. Lucia	58.6	55.9	56.0	53.4	56.0
St. Vincent and the Grenadines	52.7	48.5	47.0	26.0	43.6
Suriname	32.7	31.5	21.2	-	28.5
Trinidad and Tobago	8.8	8.3	6.6	5.1	7.9

Despite the commitment to CET reduction, numerous exemptions and deviations from this agreement persist in addition to the country-specific exceptions to the CET. This results in a wide divergence between the agreed rates and the rates actually imposed and this is "not clear how many product lines are in the lowest category and how many high tariffs remain" (Chaitoo, 2002, pg. 43).

Sadikov (2008) reports that between 1992 and 2002, the more developed countries (MDCs) [95/] in the Region had made significant progress in tariff reductions. The results presented in Table A.4.2 further suggest that the impact of the reduced CET was mixed, as Barbados and Trinidad and Tobago both experienced the higher levels of extra-regional imports expected while Guyana and Jamaica both saw the proportion of imports from regional sources increase over the period. On the other hand, for the LDCs modest contraction in the CET rates had negative

[94/] As various authors have noted (Sadikov, 2008; Mascoll, 1992) this decline was also driven by increased international pressures for countries to cut tariffs as part of the broad global trade liberalisation agenda.

[95/] The MDCs are Barbados, Guyana, Jamaica and Trinidad and Tobago.

implications for revenue and fiscal balances given their limited ability to introduce and administer equivalent domestic taxes to offset the potential losses. These countries therefore maintained generally higher CET levels than their MDC counterparts.

The primary source of indirect tax reform in the Region, involved the consolidation of an array of taxes on goods and services into a VAT to maintain robust revenue flows and improve simplicity. VAT was introduced in a number of economies yielding mixed outcomes as reflected in Table A.4.3.

Implementation in Barbados, Jamaica and Trinidad and Tobago was relatively successful at simplifying the tax code and improving efficiency. In Jamaica the General Consumption Tax (GCT) replaced eight separate taxes [96/], 11 in Barbados [97/] and a number of taxes in Trinidad including the Purchase Tax. This consolidation in taxes reduced also the accounting complexity associated with filing.

Table A.4.3

Taxes on Goods and Services (% of tax revenue)

	1990-95	1996-00	2001-05	2006-10	Average
Barbados	36.2	51.0	47.8	48.1	45.8
Antigua and Barbuda	20.7	21.7	22.1	38.2	25.7
Belize	37.3	31.4	44.2	38.6	37.6
Dominica	4.9	34.9	34.7	43.6	29.5
Grenada	15.2	15.5	22.8	24.1	17.8
Guyana	16.9	19.3	18.4	22.6	18.2
Jamaica	15.7	7.2	3.2	25.8	8.7
St. Kitts and Nevis	29.7	29.5	32.1	21.5	28.2
St. Lucia	21.6	19.8	19.6	17.2	19.6
St. Vincent and the Grenadines	12.1	13.8	16.0	47.4	22.3
Suriname	16.3	18.7	22.6	-	19.2
Trinidad and Tobago	13.2	17.9	37.0	17.9	21.5

In Barbados in the five years post implementation VAT, revenue was equivalent to 9.6% of GDP, exceeding the relevant ratios for the taxes it replaced. Since implementation VAT revenues have been 30% of tax revenue in Barbados.

Similarly, in Trinidad and Tobago, the VAT ratio has been 3-5% of GDP due to high levels of exemptions resulting in refunds of 40% of collections (Krelove and Khadka, 2004). The Trinidad and Tobago rates are low also because oil and natural gas are zero-rated, however, they are a major component of GDP. In Trinidad and Tobago, VAT has accounted for around 19% of total revenue narrowing to 14%.

[96/] These were excise duty, CARICOM duty, retail sales tax, telephone service tax, entertainment duty, hotel accommodation tax, consumption duty, and additional stamp duty on imports

[97/] Consumption tax, stamp duty on imports, luxury tax on goods, entertainment tax, hotel and restaurant tax, service tax on pleasure cruises, tax on quarriable minerals, the travel ticket tax, the airline business tax, tax on overseas telephone calls and the surcharge on rental income.

In Jamaica, the GCT initially yielded 2.5% of GDP due to the high initial number of zero-rated items (eventually reduced) as well as the fact that retailers were given a stock-in-trade credit for goods. As a percentage of total tax revenues the GCT in Jamaica has increased from 20 to 40% in fiscal year 2009/10.

In contrast to the experience in Barbados Jamaica and Trinidad and Tobago, the outcome of the implementation of the VAT in Grenada was quite different. Implemented in 1986, VAT in Grenada was overwhelmed by administrative issues due to poor planning and a high number of concessions to various sectors limited the effectiveness (see Bain, 2002). In addition, VAT is applied to 100% of the value of imports but only 40% of the value of domestic sales (see Tait, 1998). VAT revenue in Grenada accounted for just 9.3% of revenue and 3% of GDP throughout the 1990s, well below the outcomes of other CARICOM counterparts. Grenada reintroduced VAT in 2010 which yielded 36% of tax revenue in that year. Similarly, in Belize, despite accounting for nearly 30% of revenue during the implementation year, VAT was abolished two years later as part of the fulfilment of the campaign pledges of the newly-elected party and replaced by a Sales Tax. This Sales Tax is less efficient than VAT and the experience of Belize and Grenada in relation to the implementation of VAT reflects the perennial impact of political economy events on areas of major reform in the Caribbean.

Prospects and Challenges for Further Reform

There is a persistent lobby from private sector interests for lower corporate income tax rates, retention of tax incentives, reduced taxation of interest income from saving, and lower property and transfer tax rates. Property tax systems across the Region are in need of enhanced administration to improve effectiveness and the volume of revenues that the system is able to yield.

While these objectives are important in the context of anemic regional economic growth, it is important to note that the substitution of indirect for direct taxes is essentially regressive. For example, the broadening of the VAT base should be counterbalanced by lower income tax rates and higher income tax thresholds and a deepened social safety net to protect the lowest income earning deciles. Tax reform has also sought to reduce taxes associated with owning and transferring property the release (transfer) of idle resources for productive processes.

A pervasive theme also is in need for the reform of tax incentives and waivers granted by discretionary government fiat. These distort the structure of production by cementing traditional sectors and simultaneously discouraging new sector growth. Selective granting or application of tax incentives also reduces net corporate tax rates for beneficiaries allowing them to potentially experience negative tax rate and thereby reducing vertical equity since middle taxpayers income are unable to avoid or similarly shift the taxes on their wage income. [98/] [99/]

Until they are phased out, existing incentives need to be carefully monitored for avoidance of abuse. Over time, they need to be progressively replaced by a system of tax credits tied to explicit deliverables (that is, become performance based incentives). This could finance some compensating reduction of corporate tax rates across the board. It will also reduce the tendency for tax avoidance and evasion.

[98/] Bahl and Wallace for example, estimated that "tax expenditure" in Jamaica (through thresholds, incentives, waivers and exceptions) was 61% of the amount of tax revenue actually collected.

[99/] The foregoing of tax revenue through incentives, waivers and exceptions.

The pressure on tax authorities to match or exceed incentives given in other Caribbean jurisdictions creates a basis for a "race to the bottom" regarding who can offer the lightest tax burden for business. The actual and potential severe loss of revenue suggests an imperative for greater intra-regional collaboration in the granting of fiscal incentives. The potential for this and other forms of regional fiscal harmonisation will continue being complicated by country-specific economic, structural and fiscal concerns.

More broadly, tax systems in the Region are negatively affected by avoidance and evasion which derive from legal loopholes, high tax rates (an incentive to evade), weak administration (reduced likelihood of being caught), and ineffective sanctions. Avoidance and evasion may help to explain the apparent underperformance of direct (and especially corporate income) taxes in the Caribbean. The problem has to be addressed through legal reform to tighten loopholes, including the reduction of incentives and preferential rates and treatment. Incentives for evasion have to be corrected through lowering rates and generalising the base to which these rates are applied.

It is important therefore that while efforts are being made to fine-tune VAT systems, there should be continuing effort to increase direct tax compliance by a confluence of lower rates (as affordable) and enhanced tax administration in addition to the expansion of the social safety net. The former may be facilitated by a requirement for compulsory filing of tax returns which may then be audited.

TAX REFORM AND PUBLIC DEBT MODERATION

In developing countries, and especially fiscally-challenged and debt-burdened economies like many in the Caribbean, economic growth and revenue yield have to be central considerations in the reform discussion given the need to fund social services, as well as to reduce the debt.

Proposals for tax reform for most of the Caribbean are not likely to be revenue neutral in the context of the high debt-to-GDP ratios and the increasing demand for public services. These constraints limit the rate at which income tax rates can be reduced and the need to protect the most vulnerable reduces the extent and pace of VAT base broadening. Many of the proposals for tax reform discussed above have the potential for growth and revenue enhancement but will require a dedicated process operating simultaneously to deliver on the promise of an improved system both in terms of revenue yield, as well as in relation to the tenets of good tax systems. While economic activity may not be perfectly inelastic relative to the withdrawal of tax expenditures, revenue enhancement is likely to result from the fundamental reform of incentives, waivers and exceptions. The improvement of revenue performance is likely to be enhanced by shifting from an underperforming income base towards a more reliable consumption base supported by a broadening of the VAT base through the elimination or reduction of exceptions. It is possible that the reduction of tax expenditures, as associated with tax incentives and waivers, and the broadening of the consumption tax base may be able to finance part of the reduction in both income tax and VAT rates.

Tax policy and administrative reform to reduce tax evasion and avoidance would also increase tax revenue. Taking tax from profits does not affect profit maximising output but may affect investment decisions at the margin. As with the reduction of tax expenditure, some of the increased revenue should be invested in reducing corporate and income tax and VAT rates to moderate potential disinvestment.

Lower corporate and interest income tax rates and lower property transfer tax rates may facilitate more saving, investment and economic growth and therefore an enhancement of fiscal revenue.

This depends on the importance of the tax system relative to other binding constraints on saving, investment and economic growth. Tax reform should not be viewed as the singular solution to the problem of anaemic economic growth. Other constraints including bureaucracy, crime and security, human resource development and productivity, enterprise and capacity to penetrate new markets also have to be considered.

Finally, the multifaceted nature of the economic growth challenge in the Region suggests that tax reform has also to be supported by expenditure reform in order to ensure debt moderation/reduction, as well as improved efficiency in public sector operations. Rather than blanket tax expenditure on a non-reciprocal basis, as represented by current systems of tax incentives, the expenditure of scarce resources needs to be carefully prioritised and directed to have maximum impact on the potential for economic growth and minimal negative impact on the economic decision-making that is critical for broad-based growth and serviceable/sustainable debt accumulation.

APPENDIX 4.3
DEBT MANAGEMENT – THE CASE OF JAMAICA

Jamaica is one of the most highly-indebted countries in the Caribbean and among the five most heavily indebted middle-income countries in the world when measured in terms of GDP. Unlike many currently indebted countries, Jamaica has had high levels debt for almost all of its post-independence history with debt to GDP exceeding 100% for the better part of four decades. The unsustainable nature of Jamaica's debt is a central challenge to economic policy and, in particular, to public debt management.

EARLY DEBT MANAGEMENT – THE FIRST DEBT CRISIS

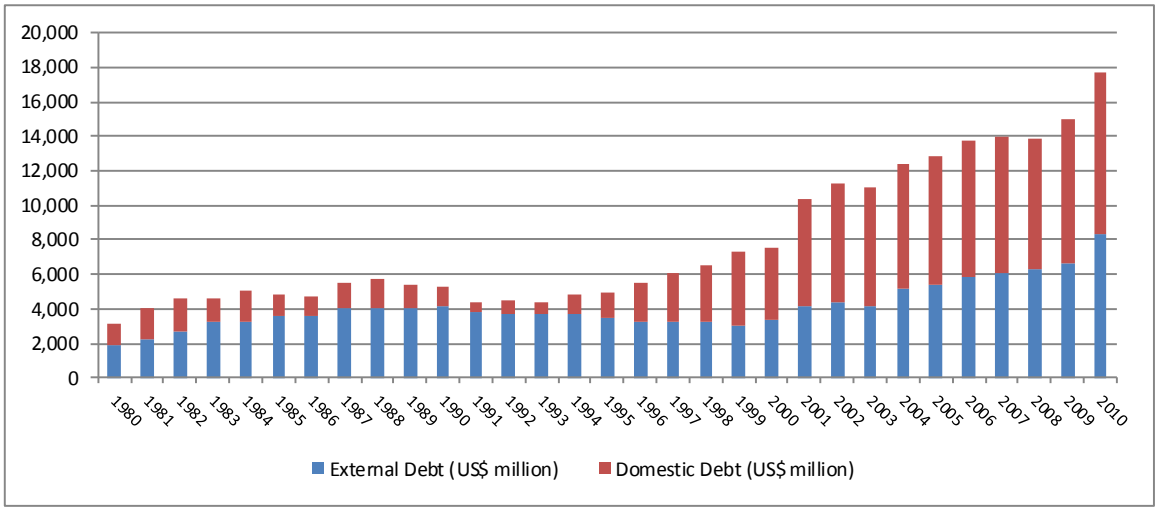
Origins of the Debt Crisis

Jamaica's debt problems emerged in the mid-1970s when a series of external shocks, including two major oil shocks, a sustained increase in world interest rates and falling commodity prices in overseas markets, led to a rapidly widening current account deficit funded mainly through external borrowing.

Domestic developments exacerbated Jamaica's emerging external debt problem. A new socialist administration in 1972 substantially expanded the state's presence in the economy. Large social expenditures were not matched with commensurate increases in revenues. Jamaica's fiscal deficit as a percentage of GDP grew markedly rising from 7% in 1973/74 to 17% by the end of the decade. Jamaica's external borrowing was easily facilitated during this period as the international capital

FIGURE A.4.7

EVOLUTION OF JAMAICA'S TOTAL PUBLIC DEBT, 1980-2010



Source: MOF

markets, were flush with petro-dollars and international banks were anxious to lend. The early structure of Jamaica's debt portfolio reflected the reliance on commercial bank financing as more than 60% of the debt accumulated in the 1970s came from that source. There was significant growth in both external debt and debt service. Between 1975 and 1985 Jamaica's debt service as a percentage of exports of goods and services, increased from 7% in 1970 to 24% in 1980, rising further to 58% in 1985. Jamaica's external debt was also predominantly short-term. Further, with debt contracted at mainly floating rates of interest, Jamaica's debt servicing was highly sensitive to movements in international interest rates.

The early 1980s were characterised by large scale foreign capital inflows from multilateral and bilateral donors and lenders engendered by a change to a more market friendly political administration. Aid inflows from official bilateral donors, particularly the United States increased significantly. WB project and structural adjustment loans, as well as BOP support from the IMF were the main pillars of financial support during this period.

Between 1980 and 1985, Jamaica's external debt doubled in nominal terms and, as a share of GDP, rose from 63% to a historical high of 156% in 1984 before declining marginally to 153% in 1985. Debt service payments as a share of exports of goods and services grew from 24% to 58%. By 1985, there was a pronounced shift in the debt structure as much of the debt outstanding was owed to MFIs and donor governments and their agencies.

Debt Management and the Search for Debt Relief

Debt management throughout the 1970s and the 1980s was primarily concerned with obtaining short-term debt relief given significant payment difficulties. Jamaica initially sought relief on its commercial borrowings and subsequently on its borrowings from bilateral donor countries. The broad policy assumption was that with economic stabilisation and adjustment, Jamaica, over the medium term, would be able to grow its way out of its debt problem. The rescheduling of commercial bank and bilateral debts became the centrepiece of Jamaica's debt management programme.

Rescheduling of Commercial Bank Debt

Jamaica first refinanced its commercial bank obligations in 1978. Multi-year reschedulings began in 1985 when commercial bank obligations falling due over a number of years were consolidated and payments deferred. Jamaica's 1987 commercial bank refinancing package was a landmark agreement as it provided for the debt-to-equity conversions.

Jamaica's debt conversion programme aimed to reduce Jamaica's commercial bank debt by USD185 million, or approximately one-half of the total restructured commercial bank debt. The debt conversion programme targeted investments in high priority areas of the economy, primarily the export and tourism sectors.

Bilateral Debt Relief

Jamaica's debt management programme involved requesting relief on its bilateral debt obligations through the Paris Club, an informal association of creditor governments and their agencies. Between 1984 and 1993, Jamaica sought debt relief from the Paris Cub seven times. The debt service ratio prior to and after rescheduling is indicative of the impact of the restructuring exercise. Over time, the DMS of repeatedly deferring bilateral debt service payments met with diminishing success. The quantity of bilateral debt relief waned over successive reschedulings.

TABLE A.4.6

JAMAICA'S DEBT RESTRUCTURING AGREEMENTS WITH COMMERCIAL BANKS

				Terms	
Date of Agreement	**Amount Restructured (USD mn)**	**Consolidation period (months)**	**Grace (years)**	**Maturity (years)**	**Interest margin**
April 1981	126	24	2	5	2
June 1981	89	21	2	5	2
June 1984	164	21	2	2	2.5
September 1985	359	18	3	10	1.875
May 1987	366	39	9	12	1.25
June 1990	315	24	0	14	0.8125

Source: WB-Global Development Finance (various issues)

TABLE A.4.7

JAMAICA'S DEBT RESTRUCTURING AGREEMENTS WITH THE PARIS CLUB

			Terms	
Date of Agreement	**Amount Restructured (USD mn)**	**Consolidation period (months)**	**Grace (years)**	**Maturity (years)**
July 16, 1984	105	15	3.9	8.4
July 19, 1985	67	12	4.0	9.5
March 05, 1987	124	15	4.9	9.4
October 24, 1988	147	18	4.7	9.2
April 26, 1990	179	18	4.8	9.3
July 19, 1991	127	13	6.0	14.5
January 25, 1993	291	36	5.0	13.5

Source: Global Development Finance (WB), Paris Club

Debt Reduction

The serial debt rescheduling coupled with the debt conversions allowed good progress in reducing Jamaica's external debt burden. With the exit from the Paris Club in 1993 and the full servicing of external debt obligations, there was a marked decline in Jamaica's external debt.

The cancellation of debts by a number of Jamaica's international donors during the 1990s also led to significant inroads in external debt reduction. Canada was the first creditor government to cancel debts owed by Jamaica when it forgave C$93 million owed to CIDA. The United States government

followed in 1991, when under the Enterprise for the Americas Initiative, it forgave 80% of the debt owed by Jamaica under the United States (PL480) Food Aid Programme. Approximately USD270 million was written-off by the United States government. Later, in 1993, the United States provided additional forgiveness with the cancellation of just over 20% of USAID debt. The governments of Netherlands and the United Kingdom also extended debt forgiveness during the 1990s. Between 1990 and 1995, USD454 million or over 12% of Jamaica's external bilateral debt was forgiven.

The steady decline in the external debt and the improvement in Jamaica's external debt indicators led WB, in 1999, to reclassify Jamaica as a moderately rather than highly external indebted country.

RECENT DEBT MANAGEMENT – THE SECOND CRISIS

Developing the Domestic Capital Market

With lower levels of external indebtedness and a substantial ease in the debt service burden, debt management could broaden its attention away from just management of the incumbent debt to broader issues, of which two became the focus. The first was to contain the level of external debt and avoid the overhang that had led to repeated debt restructuring exercises. The second was to diversify the portfolio mainly through increased reliance on the domestic securities market given the sustained decline in external aid flows and lack of access to the international capital markets.

The volume of government securities increased exponentially. Between 1990/91 and 1999/2000, T-Bills increased from JMD3.2 bn to JMD9.6 bn while Jamaica's medium and long-term government securities, Local Registered Stock (LRS), grew from a modest JMD7.5 bn to JMD126 bn. Total domestic debt increased from JMD9.3 bn to JMD175.8 bn or 51% of GDP by 1999/2000. Overall, Jamaica's total public debt grew to 89% of GDP.

The factors behind the renewed demand for debt are uncovered in Chapter 5. But the demand was met with a ready supply of funds as a recently liberalised financial sector savoured the opportunity to both hold and retail government securities. The number of commercial banks expanded and they were joined by new financial intermediaries, most notably, dealers in government securities. The growth in this sector allowed Government not only to increase the volume and frequency of issues but to offer new instruments to the market.

By the start of the 2000s, Jamaica's offerings of debt securities had markedly expanded. In 2000, Jamaica introduced a USD indexed bond to the domestic market. The instrument, designed to provide a hedge against local currency depreciation, proved highly attractive to the market. However, a downside consequence was the increased foreign currency exposure in the domestic portfolio.

Jamaica also introduced a market-based auction mechanism to sell Government's medium to long-term securities, LRS. The competitive demand for the securities markedly reduced the differentials in interest spreads between long and short-term instruments. Buoyed by the success of market-based issuance, Government sought to lengthen the maturities of its instruments. Instruments issued with maturities of 5 years began to be issued with some regularity and by August 2000, a milestone was reached when the first 10-year LRS was successfully auctioned in the domestic market.

Accompanying these market developments was the further institutional strengthening of debt management. In March 1998, the debt management functions were transferred from the Bank of

Jamaica to MOF. The centralisation of Government's debt management functions came on the heels of the 1996 collapse of the financial sector. Greater emphasis was placed on managing contingent liabilities, as well as the increasing exposures to exchange rate, interest rate and refinancing risk in the debt portfolio.

Global Market Access

Jamaica's efforts at rebuilding its external creditworthiness after serial debt rescheduling were highly successful. A track record of honouring its servicing obligations was established and reinforced by Jamaica's repeated emphasis of its constitutional obligation to treat debt as the first charge on its budget. Jamaica's payment fidelity coupled with a low external debt service ratio and other improved external debt indicators opened the door to the international capital markets by 1996.

Jamaica's first foray into the international capital markets was with a small (USD100 million), unrated, regional sovereign bond issue. The issue met with success and in 1997 Jamaica approached the international capital markets with a 5-year USD200 million sovereign bond issue. Jamaica's re-entry into the international capital markets was subsequently buoyed by credit ratings from Moody's Investor Services (Ba3) and Standard and Poor's (B) in 1998 and 1999, respectively.

Building on its success in the Euro dollar market, Jamaica focused on diversifying the portfolio by broadening the geographic distribution of its overseas investors. In December 2001, Jamaica entrenched its access to the international capital markets by filing a Schedule B Registration Statement with the US Securities and Exchange Commission. The filing enabled Jamaica to more speedily to take advantage of market opportunities in the international capital markets.

A Second Debt Crisis

The shift from external concessional financing to borrowing in the capital markets, both domestically and internationally, led to a significant change in the composition of Jamaica's debt. Bonds rather than loans comprised the major share of both the domestic and external debt portfolios. Repayments periods on the external debt shortened leading to a marked change in the portfolio's maturity structure. The large one-time "bullet" payments at maturity that characterised Jamaica's sovereign bond issues exposed Jamaica to significant refinancing risk.

The currency composition of Jamaica's external debt also changed noticeably. The share of external debt denominated in US dollars fell from to 85% in 2000 to 60% in 2010 and by 2009 the Euro had became the second largest currency behind the US dollar in the external debt portfolio. With Jamaica's loan portfolio denominated in US dollars, the steady appreciation of the Euro vis-a-vis the US dollar led to the significant revaluation of the portfolio in US dollar terms and added to the overall increase in the external debt stock and debt service costs.

Substantial domestic debt accumulation in the 2000s was as a result of significant risk exposures, principally the growth in domestic contingent liabilities. The conversion of substantial contingent liabilities (40% of GDP) to direct CG liabilities arising from the restructuring of the financial sector led to the ratio of domestic debt to GDP rising from 49% in 2000 to 70.5% in 2001. The assumption of the debts of loss-making public enterprises, as well as off-budget liabilities created through "deferred financing" PPPs further contributed to the debt build-up. For the first time in over a decade, total public debt exceeded 100%.

TABLE A.4.8

JAMAICA – PUBLIC DEBT KEY RISK INDICATORS

External debt	**2007/08**	**2008/09**	**2009/10**
% share of floating rate debt	18.8	23.1	22.5
% share of Euro	20.8	13.0	16.1
% share maturing in 5 years or less	21.9	18.9	27.2
Domestic Debt			
% share of floating rate debt	62.3	59.2	43.6
% share of foreign currency debt	12.1	13.4	13.2
% share maturing in 5 years or less	n.a.	67.4	52.3

Note: n.a. = not available

Source: Various GOJ Budget Memorandum – MOF

Debt management was also challenged by the increased exposures to interest rate, exchange rate and refinancing risk in the domestic debt portfolio. High shares of floating rate domestic debt, over 60% of the total in 2007/08 and 2008/09, left the portfolio extremely vulnerable to increases in interest rates. Similarly high shares of foreign currency debt in the domestic portfolio had given rise to significant foreign currency exposures in the domestic portfolio. By 2004/05, foreign currency debt accounted for almost 20% of total domestic debt. This exacerbated the already substantial risks arising from a completely foreign currency denominated external portfolio.

At the end of 2009 Jamaica's total public debt stood at USD13.4 bn or 130% of GDP. More than half of the public debt was domestic with only 44% owed to external creditors. Over 15% of domestic debt was denominated in foreign currency while over 55% was variable rate debt. In addition, more than a quarter of domestic debt was due to mature within two years. Total debt service accounted for 63% of total government outlays with domestic interest payments alone absorbing over 35% of recurrent expenditure.

The global economic slowdown imposed a severe drag on the Jamaican economy, leading to revenue shortfalls and widening the fiscal imbalances to 9% of GDP. By 2009 Jamaica's high levels of debt and debt service had become fiscally unsustainable. After widespread consultations and agreement to enter a borrowing relationship with the IMF in January 2010, the authorities launched the JDX. The JDX aimed at comprehensively restructuring the domestic debt portfolio and sought explicitly to achieve interest savings equivalent to 3% of GDP in 2010/11; substantially reducing the debt that would mature over 36 months and increase the fixed rate share of domestic debt. Jamaica met all its objectives under the JDX.

DEBT MANAGEMENT REFORMS - A NEW BEGINNING?

Jamaica's 2010 debt exchange was a landmark event mainly for two reasons. First, it was highly successful. Almost the entire stock of domestic debt was restructured into longer-term instruments at substantially lower interest rates. Jamaica benefited from interest savings equivalent to 3.5% of GDP, reduced principal payments in 2010-12 of JMD300 bn, as well as an almost doubling of the average maturity of domestic debt from 4.7 to 8.3 years. Voluntary participation, at 99.2%, made

the JDX an exceptional success both nationally and by world standards. The high participation rate, arguably for many investors in enlightened self-interest, was reflective of the concerted efforts at consensus building, considerable stakeholder participation and the transparency of the process. Second, JDX acted as a catalyst for initiating fiscal reforms in Jamaica, as well as strengthening the effectiveness of public debt management.

On the fiscal side, promised reforms are aimed at reducing debt propensity through a sustained reduction in the fiscal deficit. With no provisions for a principal haircut in the Jamaica debt exchange total public debt as a share of GDP remains unsustainably high at 129% at end-2011. The aim of the authorities is to reduce the overall fiscal deficit to near balance in the near term (FY2013/14) thereby decreasing the need to sustain fiscal imbalances through borrowing.

In addition to fiscal consolidation, through conventional cost-cutting and taxation measures the authorities committed to a series of structural reforms. The reforms center on implementing a FRF aimed at improving fiscal management and transparency; consolidating responsibility for Treasury management in one agency and establishing a Treasury Single Account to enhance cash management. Comprehensive reforms to tax policy and administration are also pending.

On the debt management side, Jamaica's reforms seek to create a sound framework within which to develop and implement a medium-term debt strategy so as to better manage the composition of the debt and its associated costs and risks. Debt management reforms are based on three pillars: (i) legal reform – to ensure a sound, supportive and streamlined legal foundation for effective public debt management; (ii) institutional reform - to improve debt management operations; and (iii) reform of the strategic framework – to create a more rigorous framework for debt strategy formulation and implementation.

Reforms of the legal framework for debt management were initiated in July 2011 with the tabling of the Public Debt Management Act. The Act repeals, updates and consolidates into a single piece of legislation some 20 separate laws governing Jamaica's public debt management.

Institutional reforms have concentrated primarily on the reform of the DMU in MOF, the principal entity responsible for public debt management in Jamaica. Parliamentary approval was received in April 2011 for the Unit to be formally restructured along functional lines to conform to the organisational structures found in modern DMOs worldwide.

Reforming the strategic framework is focused on ensuring that Jamaica has the institutional capacity essential to design and implement a medium-term DMS. The emphasis on developing a debt strategy within a risk management framework has emanated from widespread international consensus that many countries' debt crises have been triggered by the failure to manage risk exposures in the debt portfolio. Managing contingent liabilities as well as exchange rate, interest rate and refinancing risk are therefore central to effective public debt management.

Institutional reforms also involved the establishment of a high-level public debt management committee. Chaired by the FS, the Committee is responsible for advising on debt policy, monitoring the implementation of Jamaica's medium-term debt strategy and overseeing public debt management implementation. The Committee serves a valuable function in ensuring the coordination of monetary, fiscal and debt management policy and facilitates a smooth information flow across institutions.

With debt management reforms, it is expected that Jamaica will better manage the composition of its public debt and limit the portfolio's risk exposures. This, while necessary, is not sufficient. Since the debt exchange Jamaica's public debt has continued to increase and remains unsustainable. Reducing debt to sustainable levels requires an ongoing commitment to fiscal prudence and most importantly a return to sustained economic growth.

APPENDIX 5.1

BASELINE SCENARIO ASSUMPTIONS – BY COUNTRY

Antigua and Barbuda: It is assumed that the recently-imposed wage freeze lasts until fiscal year 2012. Thereafter, the wage bill grows at the rate of inflation. Expenditure on programmes grows at the rate of inflation in 2012, but for 2013 onwards the wage bill increases by 2% above the inflation rate. Public sector transformation and pension reform yield incremental benefits over the long run. Capital expenditure is increased gradually from 2.4% of GDP in 2012 to 5% of GDP by 2020. As economic growth accelerates and fiscal slippage declines, the revenue-enhancing measures already implemented lead to a gradual increase in the tax revenue-to-GDP ratio from 20.7% in 2012 to 23.5% by 2020. The overall primary balance strengthens from 1.5% of GDP in 2012 to 4.1% by 2020.

For this scenario, it is further assumed that the negotiations to reschedule and normalise the remaining 15% of debt that is in arrears are concluded by the middle of 2012. Accumulated credit due to suppliers is reduced over the medium term. The negative investor sentiments following the debt restructuring exercise, and the fragility of the international capital markets, force government to finance approximately 85% of its fiscal deficit through multilateral and bilateral debt. Short-term instruments issued to ECCB and on the RGSM (see Chapter 2) remain a source of financing, albeit small, as these creditors were excluded from the debt restructuring exercise that began in 2011.

Belize: It is assumed that no additional fiscal austerity measures are implemented. The tax revenue-to-GDP ratio remains largely unchanged at 23.3% throughout the forecast horizon. Wages and salaries grow at the rate of inflation, and capital expenditure remains largely unchanged at 4.2%. Programmed expenditure grows at 2% above the rate of inflation. The primary balance remains in a deficit position, gradually widening from -2.8% of GDP to -3.2% of GDP. Just over 83% of the fiscal deficit is financed from external sources, of which bilateral and multilateral borrowings account for close to 50%.

Barbados: It is assumed that some of the fiscal measures outlined in the nation's MTFS document are implemented, [100/] without any additional revenue measures over the forecast horizon. Tax revenues increase gradually from 26.7% of GDP in 2012 to 27.1% of GDP by 2020, as fiscal slippage declines. Wages and salaries remain constant in 2012 and 2013 but increase at the rate of inflation from 2014 onwards. The recent divestment of a public body, public sector transformation and pension reform yield incremental benefits over the long run. Given the fiscal policy initiatives, the primary balance strengthens from a deficit of 1.2% of GDP in fiscal year 2012 to a surplus of 3.8% of GDP by fiscal year 2020. Government finances 70% of its fiscal deficit mainly through domestic debt, of which 82% are fixed rate instruments. Approximately 30% of the total deficit is financed by external debt, mainly through multilateral and bilateral loans.

Grenada: A minimal number of austerity measures are implemented. The tax revenue-to-GDP ratio fluctuates mildly around a central tendency of 17.7% of GDP through to 2020. Wages and salaries grow by approximately 2% above the inflation rate, while expenditure on programmes grows by approximately 2.5% above the inflation rate. Fiscal authorities gradually reduce capital expenditure to 8.9% of GDP over the forecast horizon, from a budgeted 10.2% in 2012. Given

[100/] See MTFS 2010-14, pages 11-16

the fiscal policy stance, the primary balance gradually decreases from -4.4% of GDP in 2012 to almost -2.5% of GDP by 2020. Approximately 80% of the fiscal deficit is financed through external sources of which bilateral and multilateral loans account for over 90%.

St. Kitts and Nevis: As economic growth accelerates fiscal slippage is assumed to gradually decline leading to a modest increase in the tax revenue-to-GDP ratio. Tax revenues increase from 21.3% of GDP in fiscal year 2012, to approximately 24.2% of GDP in fiscal year 2020. The wage bill remains constant in fiscal year 2012 and 2013; thereafter it increases by 2% above the rate of inflation. Expenditure on programmes grows at one percentage point over the inflation rate. Public sector transformation and pension reform yield incremental benefits over the long run. Capital expenditure gradually increases from 5.9% of GDP to 7.5% of GDP by fiscal 2020. The fiscal policy initiatives lead to a primary balance that ranges between 2.4 - 3.6% of GDP over the forecast horizon.

The baseline scenario for St. Kitts and Nevis also assumes that there was 100% participation in their recently-implemented debt exchange programme. / In this programme, two-thirds of the debt holders opted for a 50% reduction in principal, and the remaining one-third opted for no reduction in principal. The 50% discount bonds are based on a monthly mortgage-style repayment structure with no grace period on principal. The discount bonds have a final maturity of 20 years, with the last payment due in March 2032. The coupon on these instruments is 6% for the first four years, dropping to 3% from March 2016 onwards. The par bonds have a final maturity of 45 years and are also based on monthly mortgage-style payments. The coupon on the par bonds is 1.5%, with a grace period of 15 years applying to principal payments. Fiscal authorities complete the second stage of the debt exchange programme by the third quarter of 2012. The second stage of the debt exchange programme is a debt-for-land swap where all secured debt holders exchange bonds for land through a special purpose entity.

Jamaica: The assumption for Jamaica is that fiscal authorities neither roll back existing revenue-enhancing measures nor implement any additional revenue-enhancing measures. Clarendon Alumina Partners is divested by the end of calendar year 2012. Tax revenue as a percentage of GDP fluctuates mildly around an average of 22.8%. The wage bill increases at the rate of inflation, while expenditure on programmes increases at 3% above the inflation rate. Pension reform and public sector reform take place over the long run but do not significantly impact the fiscal numbers over the forecast horizon. Capital expenditure remains largely unchanged at approximately 3.9% of GDP through to 2020. The fiscal policy stance leads to a primary surplus that fluctuates mildly around an annual average 4.1% of GDP.

The exchange rate depreciates by approximately 4.5% annually. Just over 51% of the fiscal deficit is financed through domestic sources, of which variable rate or short-term fixed rate debt instruments account for approximately 52%. External private capital market support remains constant for the first two fiscal years but strengthens from the fourth year onwards. Multilateral and bilateral debt accounts for over 80% of total deficit financing from external sources, declining to approximately 40% from the fourth year onwards.

Dominica: As for Jamaica, we assume that policymakers neither roll back existing fiscal austerity measures nor implement any additional revenue enhancing measures. Tax revenues remain largely unchanged at 24.3% of GDP, and wages and salaries increase at the rate of inflation. Expenditure on programmes increases at one percentage point above inflation. It is further assumed that 70.3% of the fiscal deficit is financed from external sources of which multilateral and bilateral debt account for 90%.

APPENDIX 6.1

FISCAL LEGISLATION IN JAMAICA AND GUYANA

Jamaica in 2010, under the umbrella of a borrowing agreement with the IMF, agreed to initiate wide-ranging fiscal reforms including measures to modernise and strengthen debt management legislation, institute a medium-term expenditure framework, establish a centralised treasury management system, and improve fiscal governance including the adoption of FRF. Fiscal responsibility legislation was intended to strengthen fiscal management and improve fiscal outcomes. The existing *Financial Administration and Audit Act* was modified to incorporate FRF provisions, while Jamaica's *Public Bodies Management and Accountability Act* was amended to ensure consistency with the FRF.

The FRF delegates sole responsibility to the Minister of Finance for overall fiscal policy; expands the powers of the FS to obtain fiscal information from all public sector entities; mandates that the FS receive prior notification of any policy having budgetary implications; and requires Government to explicitly discuss its medium-term intentions. The powers delegated to the Minister of Finance are augmented by provisions to increase transparency and strengthen fiscal accountability. The Minister of Finance is required to report twice yearly on fiscal performance to Parliament. A comprehensive set of reports must be tabled including a Macroeconomic Framework; a Fiscal Responsibility Statement; a Fiscal Management Strategy; and a Tax Expenditure Report. To ensure compliance, the AG is required to report to Parliament on whether the conventions and assumptions of the Fiscal Policy Paper comply with the principles of prudent fiscal management

Jamaica's FRF also stipulates three specific benchmarks to be achieved by the end of March 2016. These are: a balanced fiscal budget; a ratio of wages to GDP of 9% or less; and a debt to GDP ratio of 100%. The FRF further stipulates that these targets should be maintained or improved beyond end-March 2016. Jamaica, like other Caribbean counterparts with legally imposed quantitative limits, may find compliance difficult in the face of any further financial stresses caused by economic shocks.

Other Caribbean economies facing increasing debt and/or seeking access to external financial and technical assistance, have initiated reforms to their systems of PFM. These have included Belize, St. Kitts and Nevis, Dominica and Barbados. The reforms have generally sought to replicate best practice, including clarifying roles and responsibilities, specifying clear procedural timetables, engaging multi-year budgeting with specific fiscal objectives, moderating public sector employee emoluments, tax reform (see Appendix 4.2) increasing public availability of information, incorporating public bodies and companies in measurement and increasing the robustness of information, accounting and auditing systems.

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