February 20, 2013

CARIBBEAN SMALL STATES:[1] CHALLENGES OF HIGH DEBT AND LOW GROWTH[2]

EXECUTIVE SUMMARY

- **Caribbean small states are a diverse set of countries.** The countries can be grouped as commodity exporters, service-based economies, mainly tourism and financial services, and the micro-states of the ECCU.

- **At the same time, many countries in the region share similar economic characteristics**. They are small economies, very open to international trade, and highly exposed to natural disasters and economic shocks. The Caribbean is one of the most disaster-prone regions in the world.

- **The financial sector in the Caribbean is large relative to economic size and is dominated by banks.** Total assets of the financial systems in the region averaged 320 percent of GDP, with 149 percent of GDP held by banks. However, limited access to credit and high interest rates still stifle private sector business expansion in some countries.

- **Growth in the Caribbean has stagnated in the last two decades, except in commodity exporters.** The last rapid growth spurt in the 1980s was fueled mainly by expansion of tourism, banana production, and public investments.

- **Many Caribbean economies face high and rising debt to GDP ratios that jeopardize prospects for medium-term debt sustainability and growth.** In 2012, overall public sector debt was estimated at about 79 percent of regional GDP.

- **The main challenges for Caribbean small states looking ahead include low growth, high debt and reducing vulnerabilities from natural disasters as well as financial sector weakness.** These are likely to demand innovative approaches to economic policy-making looking ahead.

[1] Caribbean small states include Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago. The paper also refers to other Caribbean countries (over 1.5 million in population, e.g., Jamaica) for the purpose of comparison.

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INTRODUCTION AND OVERVIEW

1. **This paper presents background on Caribbean small states as context for the main paper, "Macroeconomic Issues in Small States and Implications for Fund Engagement."** It draws on recent analytical work presented at a conference for policy makers in September 2012, in Trinidad and Tobago.[3] Caribbean small states, while sharing many features of other small states (size-related macroeconomic vulnerabilities, lack of economies of scale, and capacity constraints) have specific characteristics which merit attention.

2. **To varying degrees and with some exceptions, Caribbean small states are facing extreme versions of the problems described in the main paper—low growth, high debt, significant vulnerabilities, and limited resilience to shocks.** The non-commodity-exporters of the Caribbean were hit hard by the global crisis of 2008–09, through lower tourism arrivals, remittances, and exports. Weak fiscal positions deteriorated further, as policy makers tried to offset lower external demand, while already-heavy debt burdens increased in most countries. The costs of financial sector concentration were painfully illustrated by the transmission of the global crisis to regional financial markets through the collapse of an insurance conglomerate with widespread presence in the region. The reduction of international financial flows following the collapse of Lehman and the recession in the region weakened balance sheets of financial institutions and corporate firms, which are highly exposed to the tourism sector. In the case of Eastern Caribbean Currency Union (ECCU) countries, weak indigenous banks have put the monetary union under considerable stress.

3. **Support to the Caribbean from the Fund and other international financial institutions (IFIs) has expanded significantly, largely in response to the region's difficult financial position.** As described in the main paper, Fund engagement centers on surveillance, programs, and technical assistance from headquarters and CARTAC. Notably, the sharp increase in fiscal TA (much of which is externally financed) aims to strengthen institutions to manage fiscal consolidation. Also, the Fund holds regional discussions on common policies of ECCU countries and sponsors high level conferences on policy issues.

4. **The paper is structured as follows:** We present some stylized facts about the region, composed of diverse countries that nonetheless share some characteristics; outline the region's main vulnerabilities, linked to the frequency and scale of natural disasters, and to financial sector weaknesses and discuss growth and competitiveness. We summarize the debt challenges and fiscal policy issues and conclude with a possible work program for tackling issues of low growth and high debt.

[3] The High Level Caribbean Forum, "Rethinking Policies", was held on September 4–5, 2012, in Port of Spain, Trinidad and Tobago and was attended by policy makers from almost all Caribbean countries. It discussed the challenges of low growth and high debt facing the Caribbean.

STYLIZED FACTS

5. **Caribbean small states are a diverse set of countries.** The countries can be grouped as commodity exporters, service-based economies, mainly tourism and financial services, and the micro-states of the ECCU. Commodities exporters, namely, Belize, Guyana, Suriname, and Trinidad and Tobago together produce oil/gas, minerals, and agricultural goods, and have had an overall better economic performance in the last decade due to the positive impact of high commodity prices. Service-based economies, including the Bahamas, Barbados, and the ECCU countries are heavily dependent on tourism and, in some cases, international business services. Based on the PPP measure, GDP per capita varies significantly in the region, ranging from US$32,000 of the Bahamas to US$8,000 of Guyana. The Bahamas and Trinidad and Tobago enjoy investment grade credit ratings.

6. **At the same time, many countries in the region share similar economic characteristics**. They are small economies, very open to international trade, and highly exposed to natural disasters and economic shocks. Smallness constrains the achievement of economies of scale and economic specialization. In most countries, exchange rate regimes are effectively fixed, and this arrangement constitutes a key policy anchor. Extensive emigration in recent decades has led to the rapid growth of private remittances, which in some countries exceed the value of exports. A number of countries, especially the service-based economies and ECCU, face very high debt levels and low growth, while some indigenous banks have significant capital shortfalls.

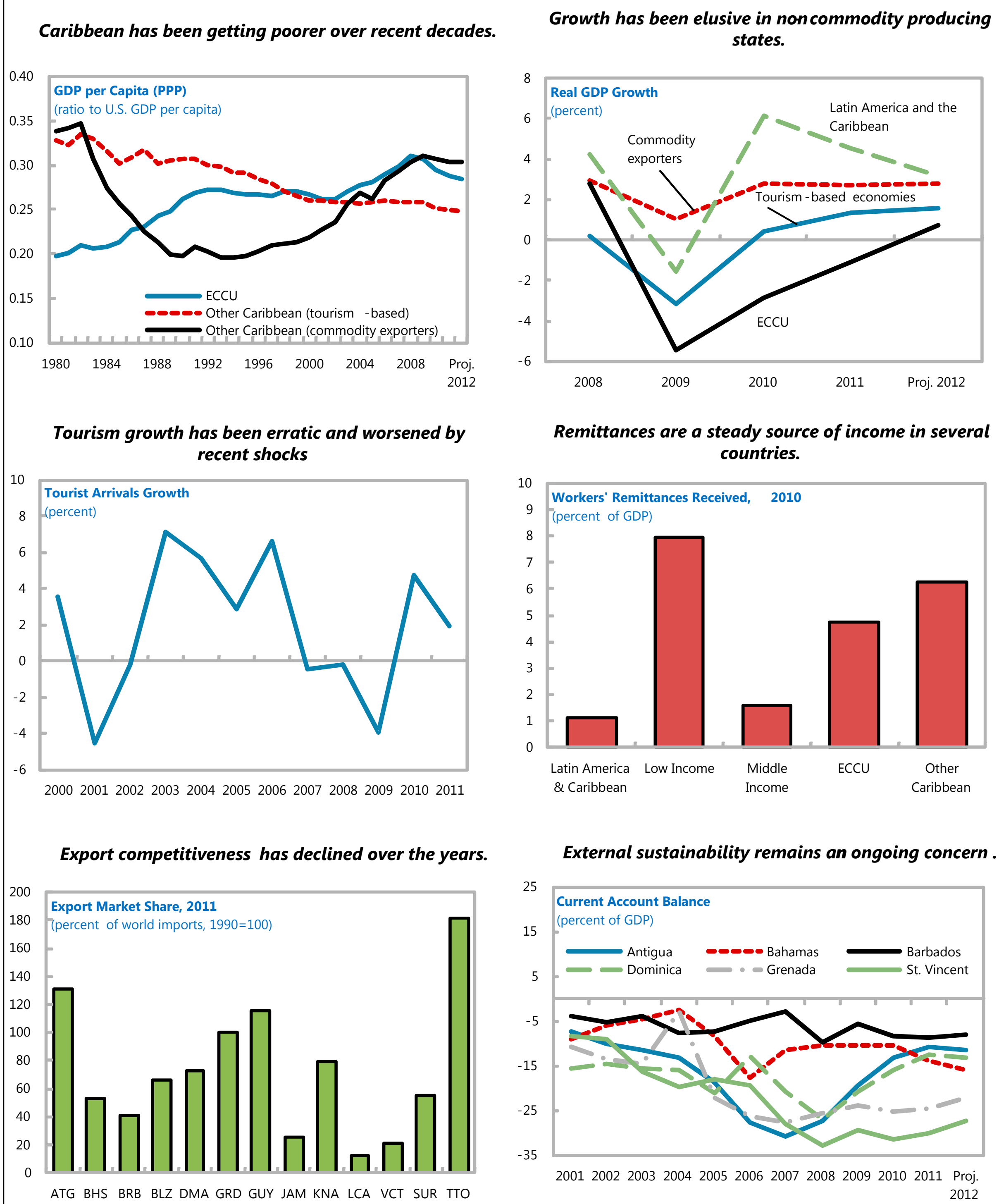
Table 1. Latin America and the Caribbean Region: Selected Indicators, 2012 (Projections)

	GDP (US$, bil.)	Population (mil.)	GDP per Capita (US$)	Output Share of LAC Region (percent)	Real GDP Growth (percent)	CPI Inflation 1/ (percent)	Current Account (% of GDP)	Gross Public Debt (% of GDP)	Gross Reserves 2/ (% of GDP)	Trade Openess (X+M, % of GDP)	Sovereign Credit Rating 3/
The Caribbean 4/	**66.9**	**7.0**	**9,544**	**0.1**	**1.4**	**3.9**	**-23.1**	**70.3**	**20.6**	**164.1**	**...**
Bahamas, The	8.2	0.4	23,417	0.1	2.5	1.5	-16.0	52.6	10.3	102.3	BBB+
Barbados	4.5	0.3	16,307	0.1	0.7	6.4	-7.9	70.4	17.0	96.8	BBB-
Belize	1.5	0.3	4,386	0.0	2.3	1.9	-2.3	81.0	18.8	136.3	C
Guyana	2.8	0.8	3,596	0.0	3.7	4.6	-14.0	60.4	30.6	142.7	...
Jamaica	15.3	2.8	5,526	0.3	0.9	7.2	-11.7	143.3	9.5	80.8	B-
Suriname	5.1	0.5	9,339	0.1	4.0	5.7	-0.1	18.6	17.5	118.2	BB-
Trinidad and Tobago	23.8	1.3	17,935	0.4	0.7	9.0	8.1	35.7	42.1	98.9	A-
Eastern Caribbean Currency Union 5/	5.6	0.6	9,033	0.1	0.7	2.6	-20.5	89.8	19.7	95.0	...
Anguilla	0.3	0.0	17,307	0.0	0.5	4.7	-110.0	21.2	13.5	875.7	...
Antigua and Barbuda	1.2	0.1	13,401	0.0	1.0	3.0	-11.4	97.8	14.7	107.1	...
Dominica	0.5	0.1	7,022	0.0	0.4	3.6	-13.3	72.3	17.6	92.4	...
Grenada	0.9	0.1	8,133	0.0	0.5	2.4	-22.3	105.4	13.9	71.0	B-
Montserrat	0.1	0.0	12,825	0.0	2.0	4.0	-77.7	4.3	36.9	269.4	...
St. Kitts and Nevis	0.7	0.1	12,869	0.0	0.0	1.9	-17.1	144.9	35.4	75.5	...
St. Lucia	1.3	0.2	7,509	0.0	0.7	2.2	-24.0	78.7	17.6	112.0	...
St. Vincent and the Grenadines	0.7	0.1	6,537	0.0	1.2	0.8	-27.3	68.3	13.8	82.5	B+
Latin America and the Caribbean	**5,722**	**584.3**	**9,792**	**100.0**	**3.2**	**5.8**	**-1.7**	**49.1**	**13.9**	**44.5**	...

Sources: World Economic Outlook (Fall 2012); International Financial Statistics; and IMF staff calculations.

1/ End-of-period, 12-month percent change.
2/ Latest available data.
3/ Median ratings published by Moody's, S&P, and Fitch.
4/ The Caribbean includes The Bahamas, Barbados, Belize, Guyana, Jamaica, Suriname, Trinidad and Tobago, and ECCU. GDP and population are sums of individual countries. Output share of LAC region, real GDP growth, CPI inflation, current account, gross public debt, gross reserves, and trade openess are simple averages.
5/ ECCU includes Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

Figure 1. Developments in the Caribbean



Sources: World Economic Outlook (Fall 2012); World Development Indicators; Direction of Trade Statistics; Caribbean Tourism Organization; and IMF staff calculations.

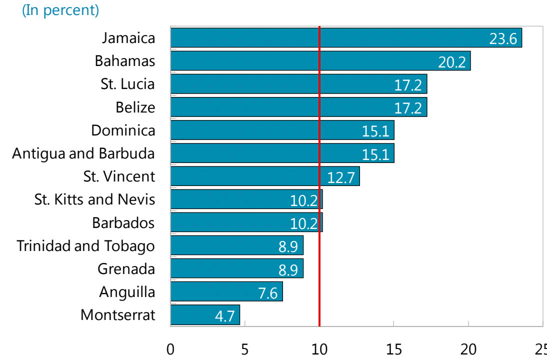
CARIBBEAN-SPECIFIC VULNERABILITIES

Much of the pressure on the region's finances can be linked to natural or financial disasters.

Natural Disasters

7. **The Caribbean is one of the most disaster-prone regions in the world.**[4] Rasmussen (2006) finds that the six ECCU countries rank in the top 10 most disaster prone countries in the world when considering disasters per land area or population. The rest of the Caribbean is not far behind, with all the countries among the top 50 hot spots. Over the last 60 years, the Caribbean countries have suffered from 187 natural disasters, most of them tropical cyclones (usually hurricanes), and floods.[5] The frequency of disasters varies significantly within the Caribbean, with Jamaica and the Bahamas having the highest probability of a hurricane striking in any given year.[6] However, for most countries the probability of a hurricane is high, above 10 percent per year.

Probability of a Hurricane Striking on a Given Year
(In percent)



Sources: EM-DAT; and IMF staff calculations.

8. **The costs associated with the frequent recurrence of natural disasters are high.** Since the early 1960s, the Caribbean has experienced losses equivalent to almost 1 percent of GDP on average in damages each year. In addition, 1.5 percent of the population has been affected each year, and natural disasters have taken the lives of 1,345 people over the past 60 years. The economic costs of the disasters is on the rise. Losses have risen from 0.9 percent of GDP per year in the 1980s and 1990s to 1.3 percent of GDP in the 2000s.[7]

[4] In this analysis, the Caribbean is comprised of: Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago.

[5] The data on natural disasters comes from EM-DAT. For a disaster to be included in this database at least one of the following criteria must be met: (i) at least 10 people killed, (ii) at least 100 people affected, or (iii) a state of emergency was declared or a call for international assistance was made.

[6] The probability of a disaster is calculated assuming that the hurricane arrival process follows a Poisson distribution with arrival rate λ, where λ is the average number of hurricanes per year since 1950.

[7] Table 4 in the main paper shows that the average loss in small Western Hemisphere countries was 3.3 percent of GDP during the 1987–2011 period. The difference with the numbers presented here can be explained by two factors: i) Table 4 calculates simple averages while the numbers presented above are weighted averages for the Caribbean, ii) it is possible that the authors of the main paper included US$1 billion in damages to St. Lucia in 1988 that is in the EM-DAT database but is erroneous.

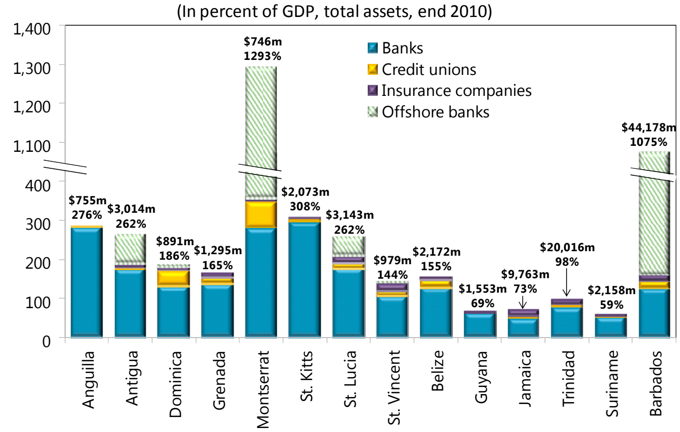
9. **Similarly, the effects of natural disasters on growth and debt are also significant.** In recent studies on the Caribbean, Strobl (2012) finds that the average hurricane reduces output by nearly 1 percent. Acevedo (2013) shows that moderate storms reduce growth by half a percentage point, while severe ones have an impact close to 1 percentage point. Acevedo also finds that in the ECCU, the debt to GDP ratio grows faster, by almost 5 percentage points the year a storm strikes, with a cumulative debt increase of 5 percent of GDP few years later.

Financial Sector Issues

10. **The financial sector in the Caribbean is large relative to economic size and is dominated by banks.** Total assets of the financial systems in the region averaged 320 percent of GDP, with 149 percent of GDP held by banks. Across the region, there is a strong presence of Canadian banks, which operate as subsidiaries, as well as regional financial conglomerates with headquarters in Barbados and Trinidad and Tobago. Some countries stand out as having large credit union sectors (Montserrat, Dominica), or very large offshore banking sector (Montserrat, Barbados, Antigua, St. Lucia). In the ECCU, there are severe long-standing weaknesses across all sub-sectors of the financial system, most of them rooted in poor supervision. In the rest of the Caribbean, financial sector weaknesses are largely prevalent in the insurance sector, which resulted from the 2009 collapse of a large financial conglomerate, CL Financial.

Caribbean: Financial Sector Structure[1/]

(In percent of GDP, total assets, end 2010)



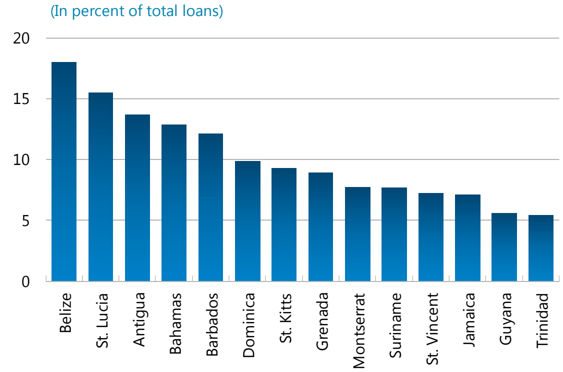
Sources: ECCB, World Council of Credit Unions, IFS, GCI, DB Report, MIC Report, various FSAP reports.
1/ Numbers above bar represent total assets of financial sector in millions of USD and as percent of 2010 GDP.

The banking system

11. **In the banking system, the failure of indigenous banks in the ECCU is the main risk to the region's financial sector, and a major source of stress to the currency union.** The dominance of foreign banks, mostly branches of Canadian banks, has been a source of stability during the global financial crisis due to conservative banking and sound supervision and regulation. In contrast, indigenous banks are structurally weak. Poor risk management practices, coupled with inadequate supervision and regulation, have led to capital shortfalls in most indigenous banks thereby increasing

Non-Performing Loans, 2012 Q3 [1]

(In percent of total loans)



[1] Data for Bahamas is as of 2012 Q2; data for Barbados and Suriname is as of 2012 Q1.

financial sector vulnerabilities. Reflecting the impact of the financial crisis, assets have been further impaired by weak activity, exposures to large borrowers and in one case fraudulent activity. The largest indigenous bank (in Antigua) was recently intervened. In the rest of the Caribbean, the banks have weathered the crisis and remain very well capitalized, although increasing NPLs continue to erode their capital base.

12. **The IFIs and the ECCU authorities have undertaken an in-depth assessment of the banking sector in the ECCU and of the reforms needed to strengthen it.** A joint financial task force was set up in November 2011 to assess the soundness of the financial sector and make recommendations for improving the regulatory and supervisory framework for banks, resolving current bank weaknesses and strengthening the crisis management framework. The task force issued its recommendations in 2012 and the Fund has urged the Eastern Caribbean Central Bank (ECCB) authorities to take decisive actions to implement these recommendations.

13. **Other countries in the region also need to strengthen bank regulatory and supervisory frameworks**, including by introducing consolidated supervision of financial conglomerates and strengthening asset classification and provisioning norms to reflect more correctly true capitalization. In some cases, supervisory practices are hampered by insufficient numbers of skilled supervisors, frequent turnover of staff, and lack of independence from political leaders.

The nonbanking system

14. **Credit unions are important players in the financial sector due to their high penetration and, in some countries large assets.** There are over 340 credit unions in the region, with overall assets of around 8 percent of regional GDP at end-2010. Over one third of the region's population is a member, and nearly two thirds in ECCU countries. In terms of assets, credit unions are very large in selected countries, including Montserrat (66 percent of GDP), Dominica (39 percent of GDP), while their assets in Belize, Barbados, Grenada, St. Vincent and St. Lucia range from 13–19 percent of GDP.

15. **The insurance sector is large relative to population**. The largest insurance sectors are in Barbados, Jamaica, and Trinidad and Tobago, although insurance firms are widespread in the ECCU (61 insurance companies, or 10 per 100,000 inhabitants, 10 times the ratio of Canada, Jamaica or Panama). There are concerns about the soundness and profitability of the insurance companies in the ECCU, and whether the industry can be properly supervised.

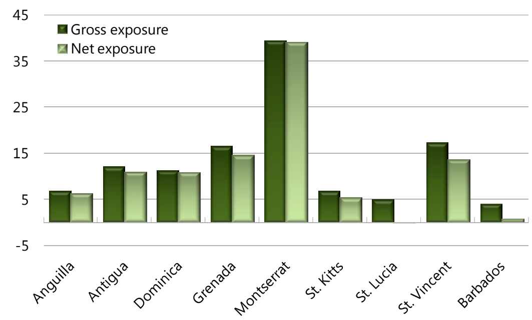
16. **In many small Caribbean states, nonbank institutions are generally poorly capitalized, badly supervised and have rudimentary risk management practices.** Weaknesses—exposed particularly by the 2009 failure of a large regional insurance conglomerate (Box 1) —stem from hitherto poor regulation and supervision by the country authorities, poorly trained staff and poor enforcement. The region has only recently started to make progress in addressing regulatory and supervisory weaknesses in the nonbank sector. Supported by extensive technical assistance from CARTAC and other donors, most of the Caribbean countries have moved to strengthen: (i) the

regulatory framework for credit unions (ECCU); (ii) the regulatory framework for the insurance legislation to address the weaknesses that led to the collapse of CLICO and BAICO (ECCU, Trinidad and Tobago); and (iii) the supervisory framework for all nonbanks, with the set–up of the Financial Services Authorities that would regulate all nonbanking institutions (ECCU, Barbados). However, the small scale in which the supervisory authorities operate means they face severe human resource constraints and continued exposure to political interference, and will likely prevent consolidated supervision of those institutions that have cross-border presence.

Box 1. Failure of Regional Insurance Companies

The January 2009 collapse of the Trinidad and Tobago-based CL Financial Group was a major financial shock to the Caribbean region. CL Financial's insurance subsidiaries—Colonial Life Insurance Company (CLICO) and British American Insurance Company (BAICO)—were active in all 15 CARICOM states except for Jamaica and Haiti. These subsidiaries offered deposit-like annuity products with very high returns while evading stricter banking regulation and supervision, and invested these resources in real estate and other assets that were adversely affected by the rapidly deteriorating global economic conditions in 2008. The collapse reflected a weak insurance regulatory environment and the rapid deterioration in the global economy, and left a hole of about 3½ percent of GDP on average across Caribbean countries, but as high as 12 percent in Trinidad and Tobago and 10 percent of GDP in ECCU countries.

Exposures to BAICO and CLICO: ECCU and Barbados
(2012, percent of GDP)

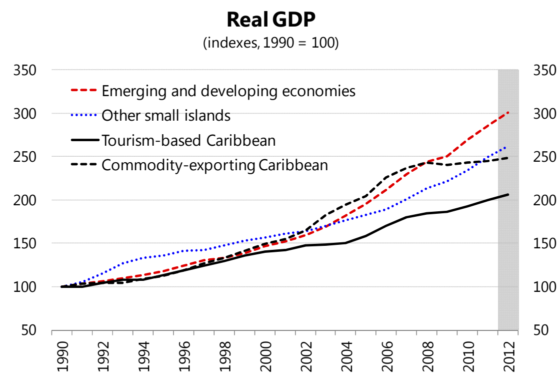


Sources: ECCU country authorities.

The resolutions of CLICO and BAICO are still ongoing and strategies have differed among countries. In jurisdictions with small exposures (Bahamas, Belize, Guyana, Suriname), the failed companies were either liquidated or sold. In countries with larger exposures: (i) CLICO Trinidad and Tobago has recently been resolved, with long-term bonds issued by the government of Trinidad and Tobago to holders of its deposit-like obligations ("annuities"); (ii) the resolution of CLICO Barbados has stalled after several options considered to date turned out to be infeasible, and the authorities are now discussing alternative resolution options; and (iii) the traditional insurance portfolio of BAICO Trinidad and Tobago being sold to a large regional insurance company and its annuity obligations are expected to be fully repaid—both with financial assistance from the government of Trinidad and Tobago.

GROWTH AND COMPETITIVENESS

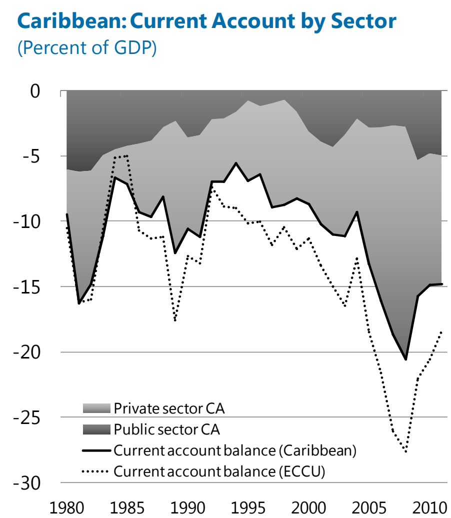
17. **Growth in the Caribbean has stagnated in the last two decades, except in commodity exporters.** The last rapid growth spurt in the 1980s was fueled mainly by expansion of tourism, banana production, and public investments. The slowdown starting in the 1990s was triggered by the loss of trade preferences to European markets and deterioration of the terms of trade, reduced fiscal space, and demographic trends, including emigration of skilled labor. Recurring natural disasters also contributed to lower growth and increased fiscal vulnerabilities.

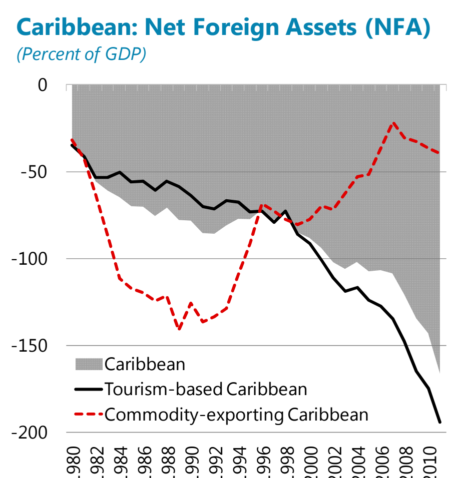


18. **Slower economic growth reflects deep-rooted competitiveness problems.** These have translated into high current account deficits, large indebtedness vis-à-vis the rest of the world, and more generally unsustainable external positions:

- The external current accounts of the tourism-based countries have deteriorated consistently since the early to mid-1990s—from a peak of 7 percent of GDP in 1993 to some 18 percent in 2010. Most of this deterioration is due to the private sector and has been financed in large part by FDI inflows. About a third is due to weak public finances. Currently, the public sector accounts for about a third of the external imbalance in the Caribbean, and is the largest contributor to the deficit in a few countries.

- At these levels, the current account deficits have led to a persistent deterioration in the external position in most countries except commodity exporters, which have been accumulating net foreign assets.

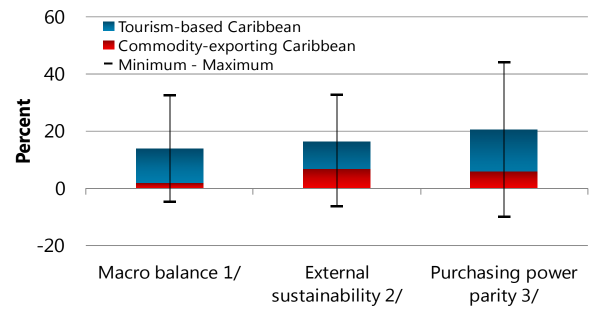




19. **Other indicators also suggest that competitiveness has eroded, underlining the deterioration in the external positions:** (i) a decline in the Caribbean world shares of good exports, with anecdotal evidence of manufacturing lines closing due to the difficulty of coping with high input costs, especially electricity; (ii) a decline in the share of tourism arrivals and receipts; and (iii) a decline in total factor productivity (Figure 2).

20. **While many of the cost disadvantages are structural, some are policy driven.** Labor costs are high in the Caribbean, in part reflecting a high degree of unionization, and have grown faster than productivity. Electricity costs are also among the highest in the world, reflecting sector inefficiencies, lack of investments, and/or monopoly powers of generators and distributors. Trade protectionism is high, not only through tariffs but also non-price restrictions. The high cost of credit derives from poor transmission of easy monetary policies in the U.S., deposit rates floors in selected countries, information asymmetries due to the absence of credit bureaus and lengthy credit recovery processes due to judicial procedures. CGER-based estimates confirm some degree of overvaluation, particularly among ECCU countries. Available computations show that the REER is overvalued by 14 percent on average for the Caribbean and 23 percent for the ECCU economies.[8]

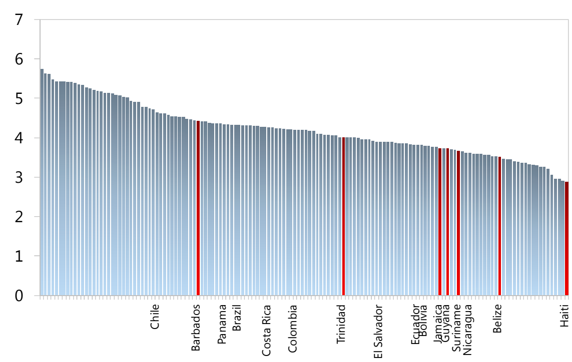
Real Effective Exchange Rate (REER) Relative to Norm



Note: Above zero indicates overvaluation; below zero suggests undervaluation.
1/ REER adjustment required to bring current account balance in line with fundamentals.
2/ REER adjustment required to bring current account balance to sustainable level.
3/ Relative to Balassa-Samuelson prediction; average of 2007-09.

21. **Structural competitiveness is also a bottleneck to stronger growth.** Most Caribbean countries rank poorly on the World Economic Forum's Global Competitiveness Index. Business climate assessments indicate that—in addition to high costs, which in most cases show up as major impediments to doing business—weaknesses include limited access to finance, weaknesses in property registration, contract enforcement, and resolving insolvency. There are also security concerns in some countries.

Global Competitiveness Index, 2011-2012 [1]



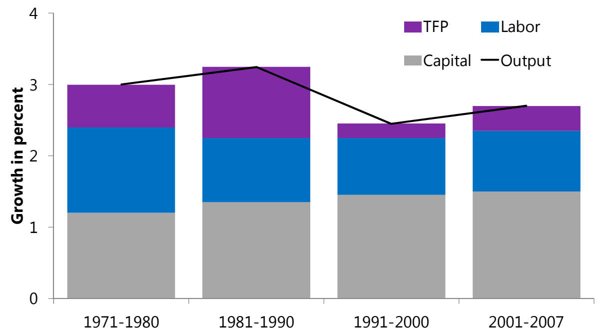
Source: World Economic Forum.
[1] The higher the score, the more competitive the country is.

[8] Staff are investigating whether these computations capture the true extent of over-valuation. Specifically, exchange rate assessments based on historical current account data do not pick up the need for an equilibrium exchange rate to close unsustainable imbalances going forward.

Figure 2. Caribbean: Low Productivity and High Costs 1/

There is general consensus that low and declining productivity has been a major drag on growth in the Caribbean. [1/]

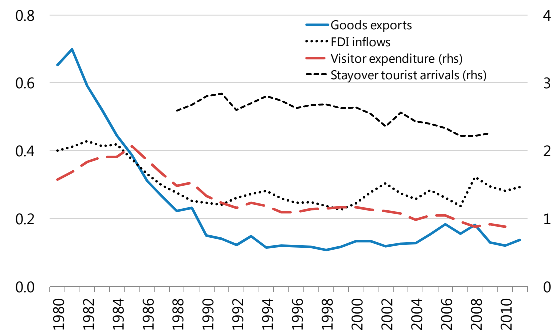
Selected Caribbean Countries [1]



Sources: Heston, Summers and Aten (2009); and IMF staff calculations.
1/ Antigua and Barbuda, Dominica, Grenada, St. Kitts & Nevis, St. Lucia, St. Vincent & Grenadines, the Bahamas, Barbados, Belize, Guyana, Jamaica, and Suriname.

Goods and services exports have been losing ground to competitors, with many manufacturing lines closing due to inability to cope with high input costs.

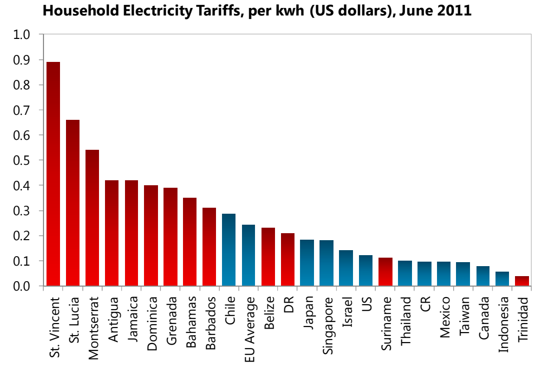
Caribbean: Market Shares
(Percent share to world total)



Sources: IMF (IFS and BOP Statistics) and UNCTAD online databases, accessed on 3/8/2012

Electricity costs are particularly high, in many cases reflecting economies of scale constraints, …

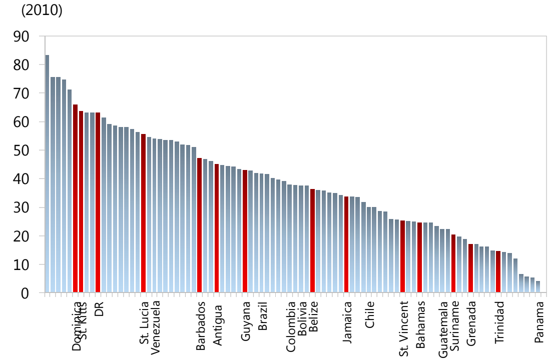
Household Electricity Tariffs, per kwh (US dollars), June 2011



Sources: Utility Companies, International Energy Agency, U.S. Energy Information Administration, Europe's Energy Portal.

… and many firms identify this as a major constraint to doing business.

Percent of Firms Identifying Electricity as A Major Constraint
(2010)

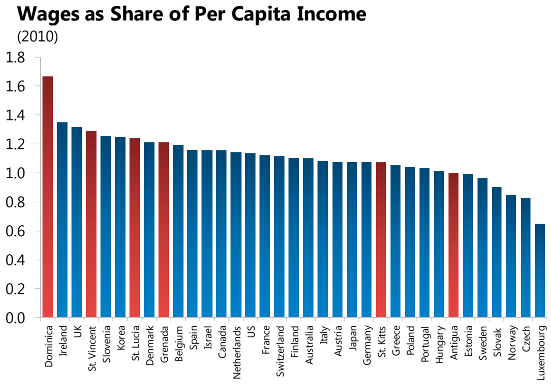


Source: World Bank, Enterprise Survey.

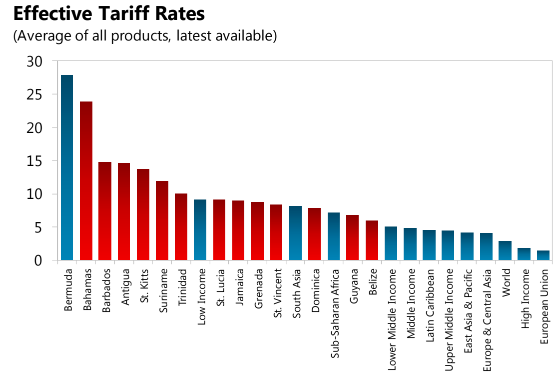
Other high costs include wages, in part reflecting strong bargaining power of trade unions …

… high tariffs, …

Figure 2. Caribbean: Low Productivity and High Costs (continued)



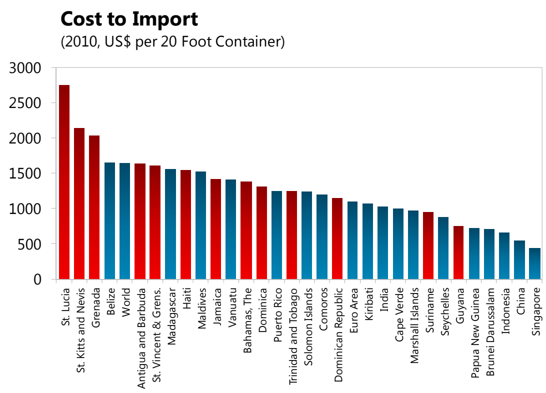
Sources: National pension companies for ECCU countries and OECD.Stat for the rest.



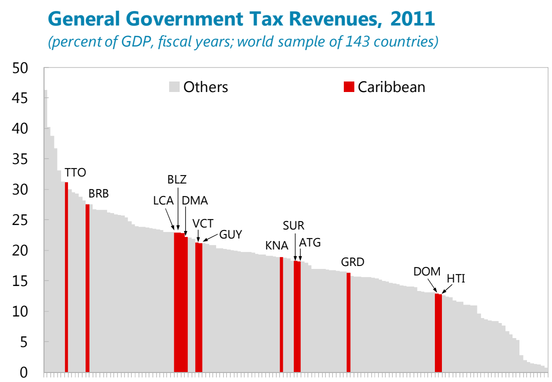
Source: World Bank World Development Indicators Database.

… and high import costs.

Effective business tax rates are also high in many economies, with a significant share of firms identifying the tax burden as a bottleneck to doing business.

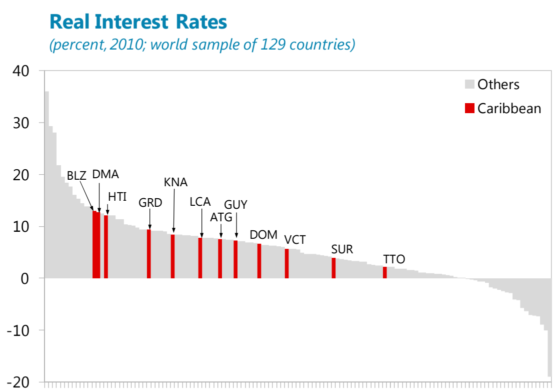


Source: World Bank, Doing Business Indicators



Sources: World Economic Outlook.

The business communities in most Caribbean countries blame access to finance as a major constraint to doing business, possibly a result of high real interest rates (which in many cases reflect mandated floors on deposit interest).



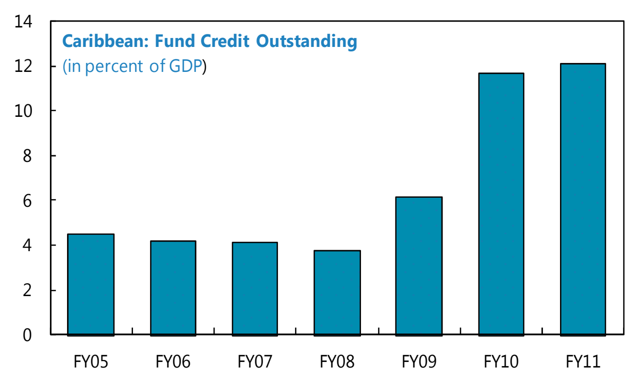
Sources: World Development Indicators.

1/ Thacker, Nita; Acevedo, Sebastian; and Perrelli, Roberto, forthcoming, “Caribbean Growth in an International Perspective: The Role of Tourism and Size” IMF Working Paper.

22. **Fund engagement with country authorities on ways to improve long-term growth and competitiveness is intensifying, including through collaboration with other IFIs**. Staff advice to tackle competitiveness challenges has focused on the need for robust structural reforms and policy options to reduce relative costs. Analytical work on growth and competitiveness is discussed during Article IV consultations, and was recently the focus of a high-level Caribbean forum in Trinidad and Tobago. Options include internal devaluation via fiscal adjustment, fiscal devaluation (though the scope for this is limited because payroll taxes are relatively minor), and exchange rate adjustment. By and large, the authorities expressed a strong preference to recover competitiveness via fiscal adjustment and structural reform rather than by using the exchange rate tool. To try to alleviate the impact of this strategy on growth, Fund programs wherever possible give priority to protecting fiscal space for public investment. Staff is also participating in three recent initiatives (IMF/ECCB Growth and Debt Task Force, the World Bank's Caribbean Growth Forum, and the Fund's Group on Small Island States) which are undertaking additional analytical and consultative work on growth and competitiveness.

IFI Support to the Growth Agenda

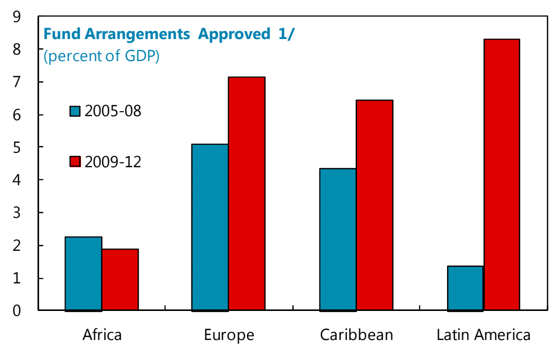
23. **Fund financial assistance to the Caribbean[9] during the global financial crisis increased substantially.** The scale of loans approved was similar in terms of GDP to the rest of the hemisphere and in Europe, and substantially greater than in Africa. However, amounts disbursed at end-2011 were far larger in relation to GDP in the Caribbean than in those regions (see chart). The countries that received this assistance are Jamaica, Haiti, the Dominican Republic, and all six ECCU Fund members, with actual disbursements equivalent to about 4½ percent of those countries' GDP (simple average). The scale of Fund financing to Antigua and Barbuda, Jamaica, and St. Kitts and Nevis, in particular, was larger as a share of GDP than to any other countries in the rest of the hemisphere including Mexico and Haiti.[10]



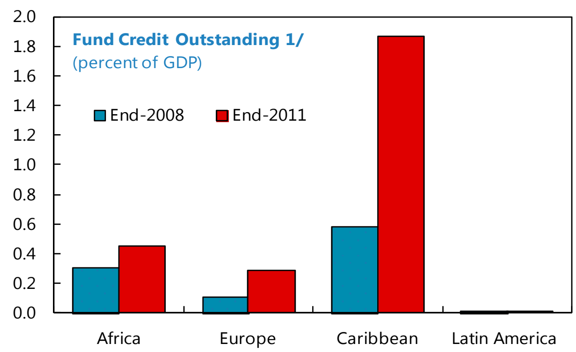
Source: IMF.

[9] Includes wider Caribbean, not just small states.

[10] Grenada and Haiti receive concessional financing; Antigua and Barbuda, the Dominican Republic, Jamaica, and St. Kitts and Nevis have undertaken Stand-By Arrangements, and several other countries have benefitted from natural disaster assistance.

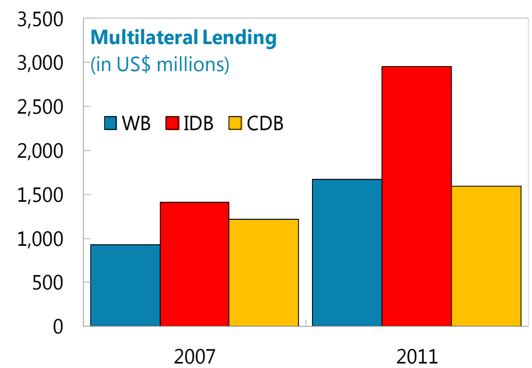


Source: IMF.
1/ Simple average over countries with arrangements. Excludes one-off disbursements of emergency assistance including natural disaster relief.



Source: IMF.
1/ Simple average over all countries.

24. **The World Bank (WB), the Inter-American Development Bank (IDB), and the Caribbean Development Bank (CDB) are the key multilateral development banks (MDBs) active in the Caribbean region.** Like the IMF, the MDBs' engagement in the Caribbean region has increased significantly in recent years. The WB and IDB have concentrated their activity in the larger countries while the CDB lends or provides grants to all the economies excluding Dominican Republic and Suriname. These MDBs often co-finance and collaborate with each other on large initiatives, thus diversifying their credit risk by limiting their exposure in each country.



Sources: IMF and WB.

CHALLLENGES OF DEBT IN THE CARIBBEAN

25. **Non-commodity-exporter Caribbean economies face high and rising debt to GDP ratios that jeopardize prospects for medium-term debt sustainability and growth.** In 2012, overall public sector debt was estimated at about 79 percent of regional GDP. Interest payments on the existing debt stock in the most highly indebted countries with rising debt ratios are already in the range of 16 percent to 41 percent of total revenues. In addition, high amortization exposes some countries to considerable rollover risk that could trigger a fiscal crisis.

26. **Structural fiscal problems have resulted in a sizable accumulation of debt in many countries.** Between 1997 and 2004, the average debt to GDP ratio in the region increased from 54 percent to 84 percent driven mainly by deteriorating primary balances. While, as discussed, part of the build-up can be traced to the cost of natural disasters, successive years of fiscal deficit, public enterprise borrowing and off-balance-sheet spending, including for financial sector bailouts, all contributed to high debt. Prior to the onset of the global crisis, moderate growth rates helped some countries to broadly stabilize and reduce their debt ratios, albeit at high levels.

27. **The global financial crisis worsened the already high debt burdens in the Caribbean.** The crisis and subsequent slow recovery in advanced economies had a significant adverse effect on the more tourism-dependent countries of the Caribbean, undermining growth and exposing balance sheet vulnerabilities built up over many years. These vulnerabilities originated from a strategy of increasing public spending to counteract declining trade performance (partly due to the erosion of trade preferences), and from rebuilding costs after frequent natural disasters. As a result, the ratio of public debt to GDP increased by about 15 percentage points between 2008 and 2010. By contrast, Caribbean commodity exporters rebounded rapidly after the crisis, buoyed by high commodity prices, and their debt ratios have stabilized at relatively low levels.

28. **Past attempts at tackling high debt in the region have not yielded lasting gains.** Several countries have made attempts at reducing debt, mainly through ad hoc restructuring or fiscal consolidation. As most countries have not adopted comprehensive economic reforms to complement these adjustment efforts, the initial gains have been too small or have not been sustained. Further, because of their middle income status, the majority of the region has not been able to benefit from international debt relief.[11] Moreover, only a few Caribbean countries still qualify for concessional borrowing at the World Bank. Consequently, Caribbean economies have been in a high debt-low growth trap for the past two decades—a silent debt crisis.

29. **Reducing the high public debt is crucial.** This is not only because of the risk of a fiscal crisis, but also because of the costs debt imposes on the economy—keeping borrowing costs high, discouraging private investment, and constraining fiscal flexibility. Empirical evidence points to a non-linear relationship between public debt and growth, suggesting that public debt beyond certain thresholds can have negative effects on economic activity. Greenidge et al. (2012) show that, for the Caribbean, at debt levels lower than 30 percent of GDP, increases in the debt to GDP ratio are associated with faster economic growth. However, the effect on growth diminishes rapidly as debt rises beyond 30 percent of GDP, and beyond 55 percent of GDP debt becomes a drag on growth.

30. **Since growth in the current environment is virtually nonexistent, significant fiscal consolidation is inevitable, but may not be enough to bring down such high debt levels.** Views differ regarding the most appropriate route to follow, given that the need to reduce debt comes in a difficult environment of fragile growth and tensions in international financial markets. Based on a survey of country experiences, fiscal consolidation based on expenditure reductions tend to be more effective than tax-based consolidations. However, for countries with large adjustment needs, fiscal consolidation may need to be a balanced combination of spending cuts and revenue increases (Baldacci, Gupta, Mulas-Granados, 2010), along with debt restructuring.

31. **Given the already sizable public sector, most of the fiscal consolidation would have to come from restraining spending, while taking measures to boost revenues.** Better control of the public wage bill, improvements in public sector efficiency and rationalization of transfer

[11] However, a few countries have benefitted from debt relief in the 2000s, see later section V.

spending are obvious targets to reduce spending. These controls must be extended to the proliferation of off-budget agencies. On the revenue side there is significant potential for reducing tax expenditure, eliminating distortions and broadening the tax base. Fiscal consolidation needs to be complemented by a comprehensive strategy to reduce public debt, including tax policy reforms, higher efficiency of spending, containment of contingent liabilities, public sector rationalization and the restoration of a unified budget, active debt management and debt restructuring, and growth-enhancing structural reforms.

32. **In light of the debt composition (mostly domestic), any attempt to restructure debt will be costly.** There is considerable heterogeneity among Caribbean countries as regards type of debt. However, in countries with a large share of domestic debt, mainly held by financial institutions, debt restructuring would need to be mindful of the impact on the financial systems, which in some cases are already weak.

33. **Antigua and Barbuda, Jamaica, and St. Kitts and Nevis are recent case-studies of sovereign debt restructuring.**[12] Before debt restructuring, these countries' debt ratios exceeded 100 percent of GDP, and debt service was 16 percent of GDP. Restructuring provided significant debt service relief for Jamaica, and is expected to do so in St. Kitts and Nevis, reducing debt service on average by 8 percent of GDP.[13] However, despite the debt relief, these three countries remain vulnerable to debt distress, given their still high debt ratios, between 90 percent of GDP (Antigua and Barbuda), and 140 percent of GDP (Jamaica).[14] It is noteworthy that all three recent debt restructurings were supported by IMF programs, with financing of over 300 percent of quota. However, the extent of the debt relief varied widely, ranging from 21 percent NPV reduction in the case of Jamaica to 65 and 73 percent for St. Kitts and Nevis. The reduction in face value ranged from zero in Jamaica to an expected 21 percent for St. Kitts and Nevis and about ⅓ of the eligible debt for Antigua and Barbuda. Jamaica's and St. Kitts and Nevis' debt restructuring was preemptive, while that in Antigua and Barbuda was post-default. Finally, while Jamaica restructured only domestic debt, Antigua and Barbuda restructured both domestic and external debt, as is the case in the ongoing restructuring in St. Kitts and Nevis.

[12] St. Kitts and Nevis successfully concluded a debt exchange with bondholders and external commercial creditors and reached an agreement with Paris Club creditors, and is in process of restructuring its domestic public debt including through a debt/land swap.

[13] For Antigua and Barbuda, debt service fell by about 13 percent of GDP from 2009 to 2011.

[14] As the experience of other Caribbean countries, such as Belize, has shown, fiscal space from debt relief has not been long-lasting without accompanying adjustments in the fiscal policy framework.

Table 2. Caribbean Recent Sovereign Debt Restructurings

Case	Preemptive or Post-Default	Default Date	Final Exchange Offer	IMF Program	Total Debt Exchanged (US$ billions)	Cut in Face Value (percent)	NPV Haircut Estimate (percent)
Antigua and Barbuda	Post-Default	Since the 1990s	2009	Yes	1.0	26%	
Jamaica	Preemptive		Jan. 2010	Yes	6.7	0.0%	21 percent
St. Kitts and Nevis	Preemptive		Feb. 2012	Yes	0.4	22%	65 to 73 percent

Source: IMF staff.

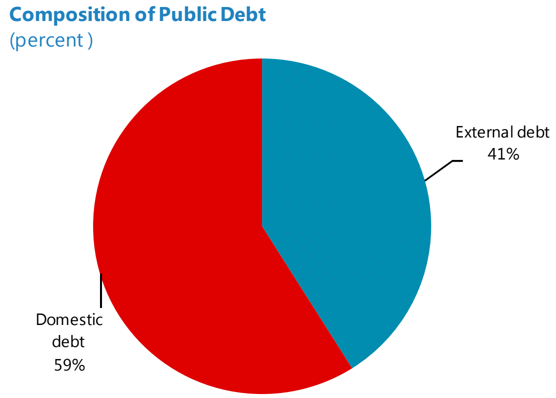
34. **Innovative aspects of these restructurings could be useful also elsewhere in the region.** In the case of Jamaica, specific attention was given to maintaining financial sector stability, with the creation of a financial sector support fund, an approach also adopted in St. Kitts and Nevis. This fund was created to provide liquidity support to institutions in the event of negative spillovers from the debt exchange. An additional innovation in the case of St. Kitts and Nevis was the use of a CDB guarantee (US$12 million) for the new debt instrument's interest and principal payments.

35 **Several lessons can be drawn from these debt restructuring operations:**

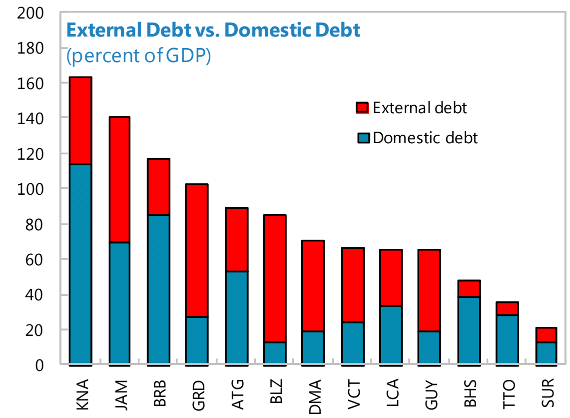
- **A credible economic program** is required to provide a framework for the debt restructuring and gain creditor confidence that debt sustainability will be restored.
- **Ownership of economic policies** is critical for successful outcomes. Antigua and Barbuda and St. Kitts and Nevis have remained committed to fiscal adjustment, even in the face of severe contractions in GDP, while in Jamaica policy slippages in the face of exogenous shock reversed some of the initial gains in debt sustainability.
- **Multilateral support**, including an IMF adjustment program, was key to the success of the recent and ongoing debt restructurings. In addition to financing, the Fund gave policy advice, assessed the sustainability of different policy options, and clarified the financing gaps. Other multilaterals have also made important contributions, such as providing a guarantee on restructured instruments in St. Kitts and Nevis, and financing a contingency fund to safeguard financial sector stability in Jamaica and St. Kitts and Nevis.
- **Effective communication** of the government's economic policy and strategy is crucial to successful debt restructuring. This was particularly critical in Jamaica and in St. Kitts and Nevis, where the authorities explained to bondholders the economic situation and the options available, along with the cost of each.
- **Avoid spillovers and contagion effects** especially in the context of a currency union like the ECCU, or a closely integrated trading arrangement, where spillovers to other banks from debt restructuring in one country could create a systemic regional banking crisis.

Figure 3. Caribbean: Public Debt Composition, 2010 1/

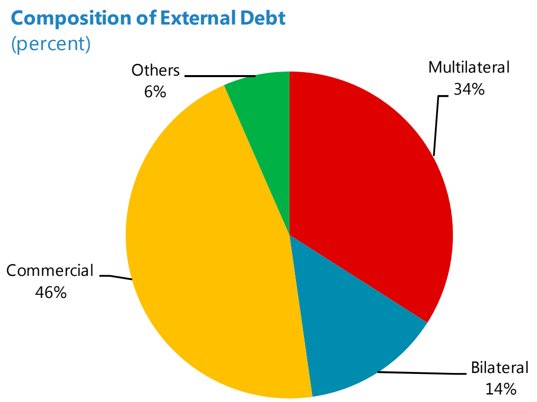
Domestic debt accounts for over three-fifths of the Caribbean's total public debt...



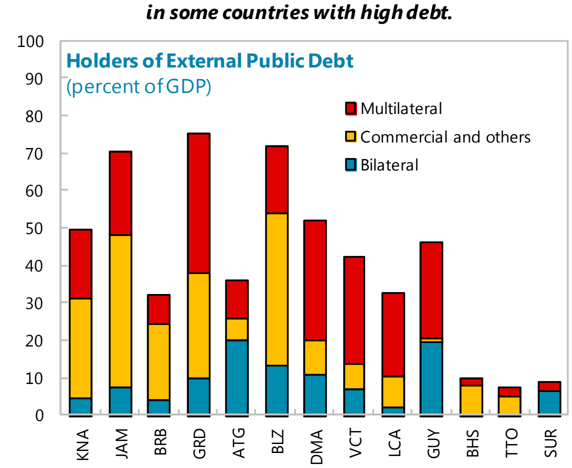
... although the share of external debt is larger in some countries including Grenada, Belize, and Guyana.



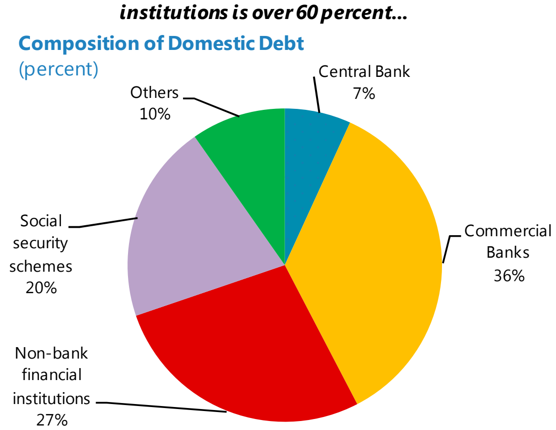
The largest share of external debt is to commercial creditors...



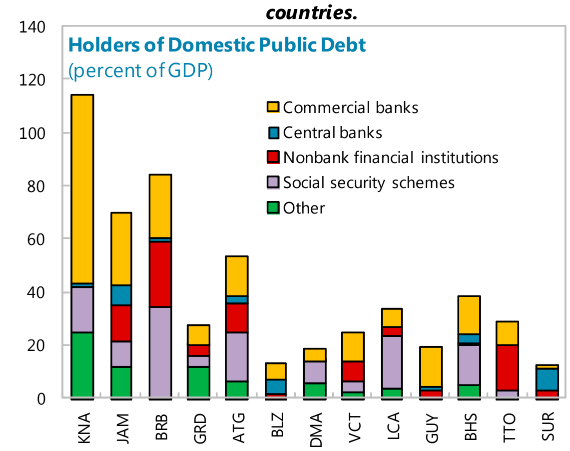
... reducing the scope for traditional debt restructuring in some countries with high debt.



The share of domestic debt held by financial institutions is over 60 percent...



... and that share is particularly large in high-debt countries.



Sources: National authorities; and Fund staff estimates

1/ ATG stands for Antigua and Barbuda, BHS for the Bahamas, BRB for Barbados, BLZ for Belize, DMA for Dominica, GRD for Grenada, GUY for Guyana, JAM for Jamaica, KNA for St. Kitts & Nevis, LCA for St. Lucia, VCT for St. Vincent and the Grenadines, and TTO for Trinidad and Tobago.

- **Case-specific menus of options** must be identified, for a debt restructuring to be successful. Actions and choices must be selected to take into account the different policy constraints in each country (e.g., depending on the vulnerabilities of various debt-holders), so that the overall package is calibrated to deliver optimal results (the greatest possible relief without intolerable economic damage).

- **It is costly for debt restructuring to be 'too small'.** There is a low limit to how often a country can undertake debt restructuring. Hence, partial restructuring that generates only minor gains while eliminating future renegotiation possibilities should, where possible, be avoided.

36. **Since 2000, in addition to debt restructuring, a number of Caribbean countries have received debt relief.** These have involved a combination of debt write-offs, debt restructuring, debt swaps, and debt buy-backs. These operations have taken place at different times, and have benefitted different countries.

37. **Three countries have benefitted from debt write-offs during the 2000s.** In the early 2000s, Guyana received additional debt relief under the enhanced HIPC Initiative and the MDRI, including from the IMF. In 2004, Jamaica received some debt relief from the UK under the Commonwealth Debt Initiative. In 2007, both Antigua and Barbuda and St. Vincent and the Grenadines (US$56 million) benefitted from an Italian debt write-off initiative.

38. **Debt swaps and debt buy-backs have been used by Belize and by Antigua and Barbuda.** Belize benefitted from a debt swap arrangement (US$8 million) with the USA government. In 2005, Antigua and Barbuda engaged in a debt buy-back operation with private creditors, which lowered its external debt by approximately US$500 million.

CONCLUSIONS

39. **Many Caribbean small states are at a critical juncture and bold strategies to address the challenges are essential.** This paper highlighted the major problems that need to be tackled—high debt, low growth, mitigation of vulnerabilities and strengthening financial systems. Given the magnitude of the effort required, no single bullet exists to address all of the challenges in the Caribbean.

- While **fiscal adjustment** is unavoidable given the extent of fiscal and external imbalances and the debt overhang, the smallness and vulnerabilities of these countries make adjustment exceptionally difficult.

- Ideally, **a comprehensive growth strategy** would replace public sector demand with self-financing private sector demand.

- Further work is needed (and is on-going) to assess the appropriateness of the **exchange rate instrument** as an element in jump-starting growth.

- Given the exceptionally high costs of natural disasters, small states in the Caribbean should be seen as frontline candidates for **support from climate-change funding**, as global strategies for mitigation and adaptation to climate change become operational.

- Work should be stepped up, both to anticipate (identify and provision for) the current vulnerabilities of the financial system to the unavoidable rebalancing of the troubled economies, and to **strengthen the supervisory and regulatory framework** to reduce long-run vulnerabilities.

- Finally, **debt restructuring** looks extremely likely to be part of countries' strategy to return to sustainability, given the magnitude of the implied fiscal effort otherwise. However, its success in the region has been partial and inadequate; in some cases, countries have given up important degrees of freedom in partial restructurings without concomitant improvements in sustainability. Hence, more work is needed to clarify when debt restructuring will/will not be worthwhile—as well as to understand the scope for, and dangers of, considering debt restructuring as part of any permanent solution.

40. **This ambitious agenda goes beyond Fund areas of expertise, and would need to involve all development partners at the international and regional level.** The work agenda above enumerates a combination of strategies targeted at each element of the region's problems, implemented at the same time to generate maximum benefit. Hence, it will be important for the Fund to collaborate closely with other IFIs (including the World Bank's Comprehensive Debt Framework, as discussed in the main paper). This collaboration has already started, with staff participation in Growth Forum exercises, and a planned joint Growth Conference in 2013.

41. **Countries would have to overcome important political economy constraints to collaborate with the Fund in such a difficult adjustment exercise.** The collaboration with other institutions envisaged above should help alleviate any 'stigma' attached to Fund programs. Further, there is a case for a Caribbean-wide regional surveillance exercise (building on the ECCU model or Central American one).[15] The success of CARTAC for delivering technical assistance in a regional framework suggests that the Caribbean prefers this approach. A region-wide approach would take the spotlight off any individual country's failure to succeed and could marshal peer support, both for countries to learn from each other and to form a united front against political obstacles. These efforts could be supported also by a regional resident representative to oversee and coordinate a regional strategy.

[15] The question of whether to include commodity-exporters would need to be resolved.

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