Challenges of Fiscal Consolidation and Debt Reduction in the Caribbean

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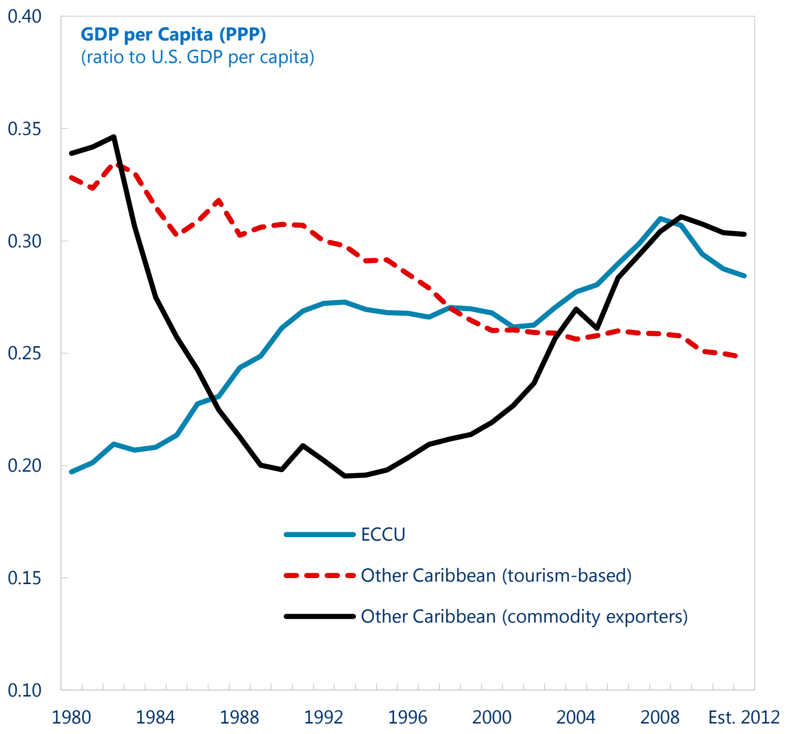
Outline

- The effects of the financial crisis on growth and debt
- Lessons from global experience with debt reduction
- Past efforts at debt reduction in the Caribbean
- Challenges for fiscal consolidation and debt reduction
  - Rigidity of fiscal structures
  - Competitiveness issues
  - High vulnerabilities and low resilience
  - Composition of debt
- Agenda for reform

Caribbean economies have underperformed since 1990

- Growth has stagnated in the last two decades (except for commodity producers)
- Slowdown started in1990s: average 1.5% for tourism oriented; 3.5% others.
  - Loss of trade preferences
  - Deteriorating terms of trade
  - Reduced fiscal space as debt levels have risen
  - Migration of skilled labor
- As a result per capita GDP is lower than in 1980

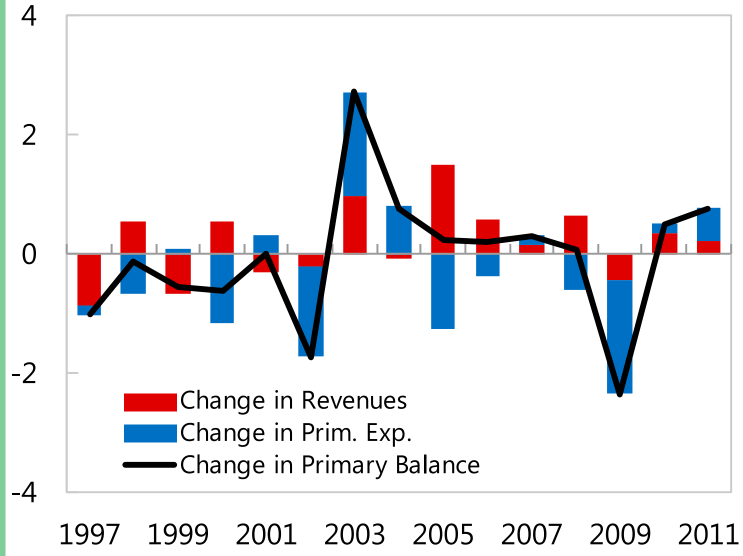


Recovery from the crisis has been slow.

- Economic activity grew by less than 1% in tourism oriented economies since 2008; 3% for commodity exporters
- Slower growth compounded by competitiveness issues
  - Widening external current account deficits 7% => 18%
  - Declining share of world exports
  - Declining share tourist arrivals and tourism receipts
  - Lower total factor productivity

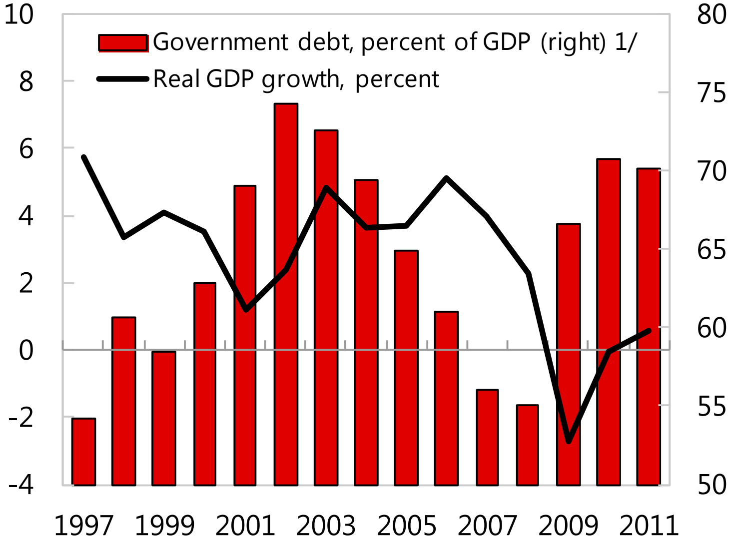
The financial crisis worsened fiscal imbalances and debt increased sharply…

Contributions to Primary Balance Changes 1/
(percent of GDP)



Source: IMF staff estimates.
1/ A decrease in primary expenditures is depicted as a positive contribution to an improvement of the primary balance.

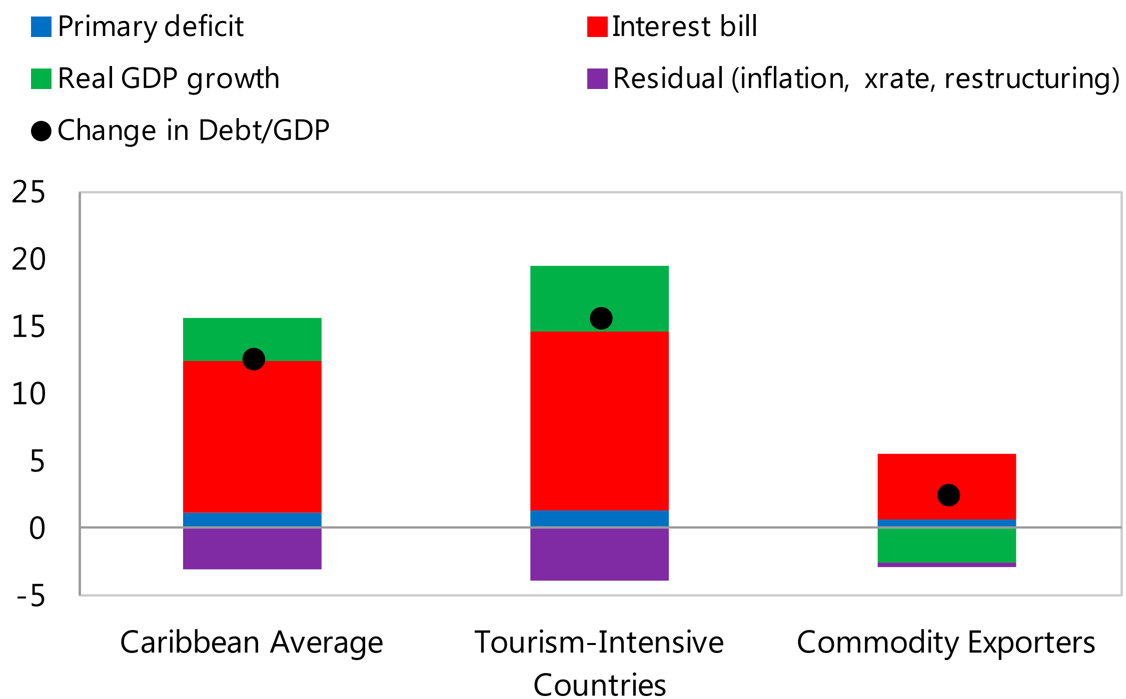
Real GDP Growth and Government Debt



Source: IMF staff estimates.
1/ Weighted average.

High interest bill and slow growth have driven recent debt accumulation

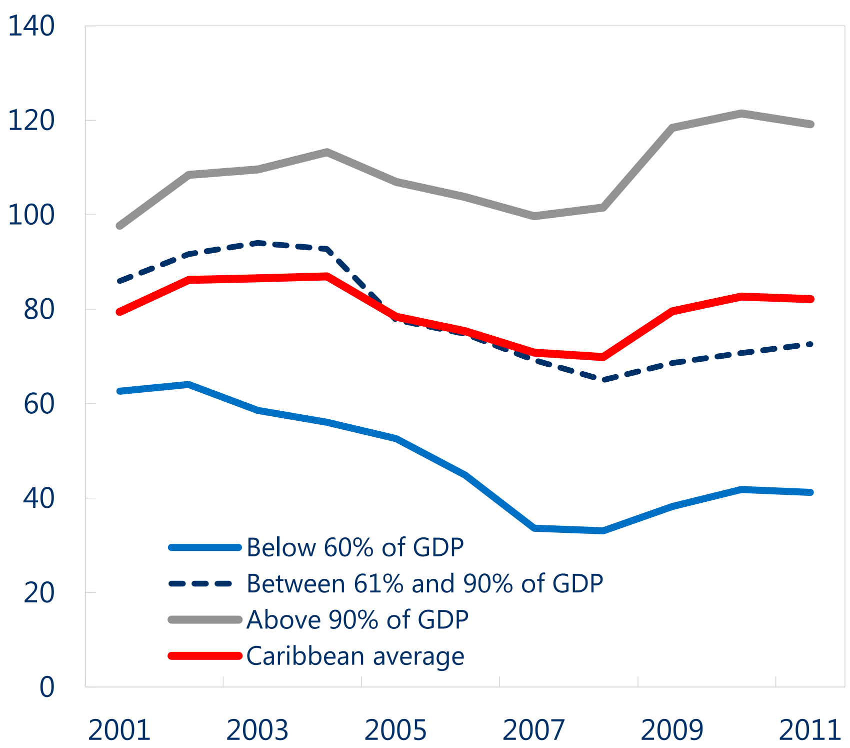
Decomposition of Debt Accumulation, 2008-11
(percent of GDP)



Source: IMF staff estimates.

Public debt was already at very high levels

- Public debt averaged about 80 % of GDP in 2001 and was slightly higher in 2012, after declining 2003-08
- High debt levels were due to:
  - Pro-cyclical primary balances
  - Cost of recovery from natural disasters (1% of regional GDP per year)
  - Financial sector bailout
  - Public enterprise losses



Fiscal consolidation—lessons from global experience

- Easier to build consensus for change in difficult times
- Expenditure-based preferred to revenue-based consolidation
- If adjustment needs are large, a combination is needed
- Consolidation was Front loaded rather than gradual adjustment
- Fiscal rules are associated with larger and sustained fiscal consolidation effort

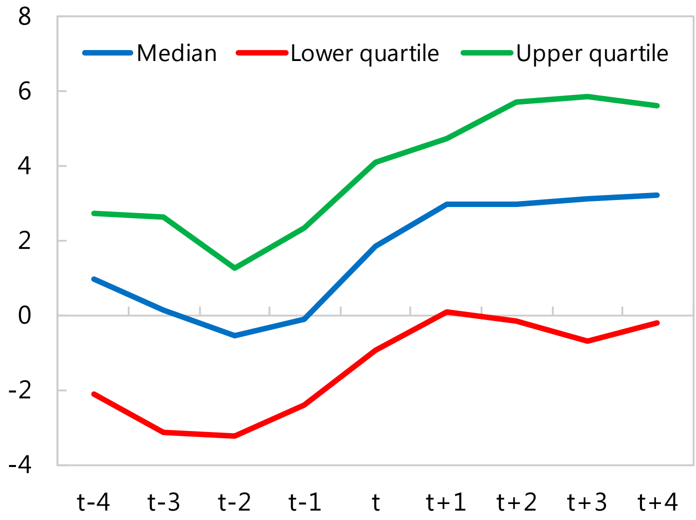
International experience with debt reduction

- Over half of global debt reductions were achieved through fiscal consolidation and just under half through debt restructuring
- The high number of debt restructuring is due to the inclusion of low income countries in the sample. Many of them received debt relief (HIPC and MDRI)
- In the consolidation cases, the median decline in the debt to GDP ratio was 27 percent over a five-year period
- About a quarter of the episodes were preceded or accompanied by fiscal rules

Large debt reductions were driven by decisive fiscal consolidation and strong growth…

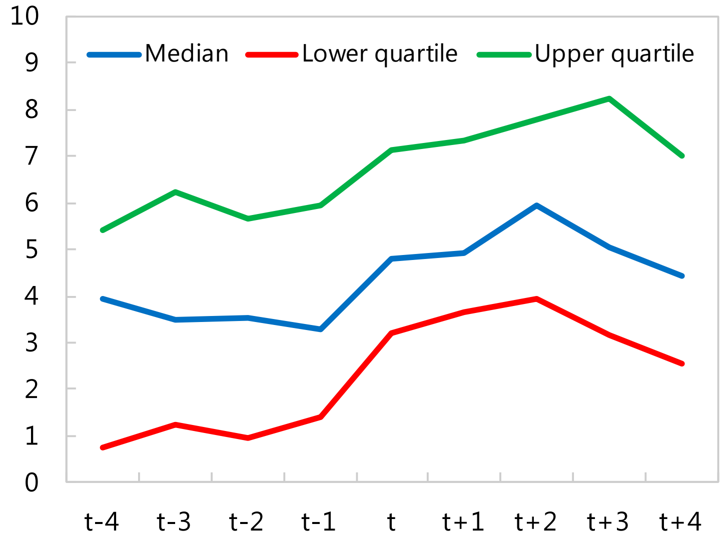
- Primary balance started to improve at least 2 years before debt ratios started to decline, and was sustained during the first 5 years
- Economic growth was sustained during the adjustment. Growth averaged 5 percent a year during the first 5 years of consolidation

Primary Balance
(percent of GDP)



Source: IMF staff estimates.

Real GDP Growth
(percentage change)

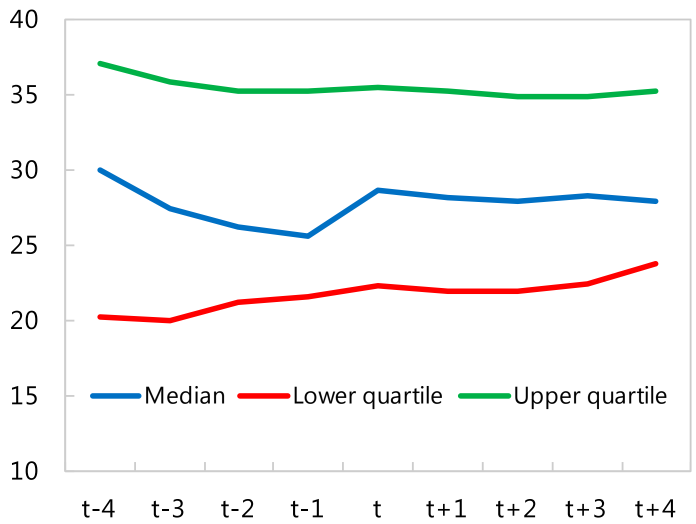


Source: IMF staff estimates.

…fiscal consolidations were due to both spending and revenue actions

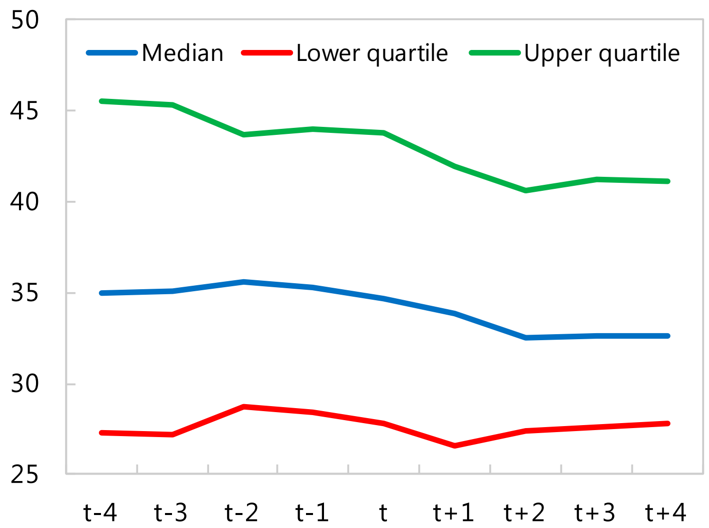
- The revenue effort averaged 3 points of GDP.
- The decline in government spending was 4 points of GDP over a five year period. The reduction came mainly from cuts in current spending. Capital spending was broadly flat

Government Revenues
(percent of GDP)



Source: IMF staff estimates.

Government Spending
(percent of GDP)



Source: IMF staff estimates.

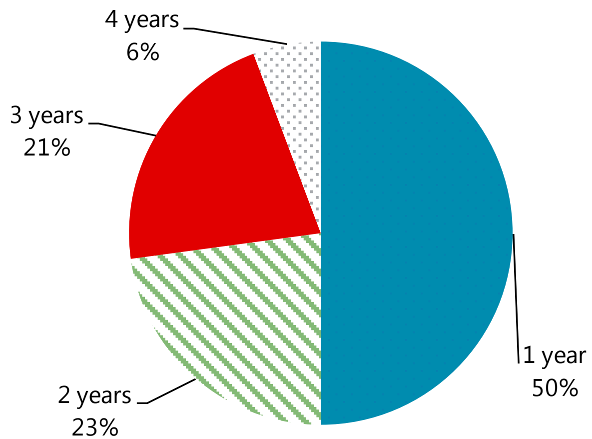
In the Caribbean, the fiscal consolidation has been largely piecemeal with mixed results

- Fiscal adjustments have not been sustained
- Revenue measures have been preferred to spending cuts, except under Fund programs (more balanced)
- Spending cuts have been led by capital spending
- Primary surpluses have not been high enough to reduce debt
- In a few cases, debt restructuring played a role

Fiscal consolidations have been short lived

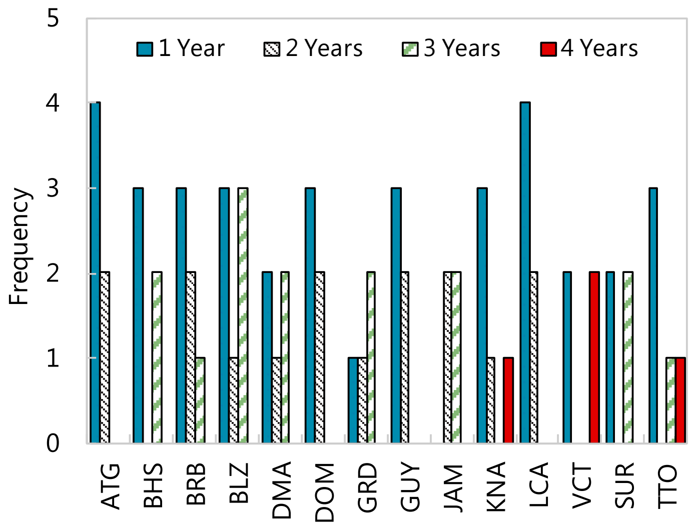
- Attempts at fiscal consolidation in the Caribbean have been infrequent. However, when countries undertook consolidation, they were successful in about half of the cases (success is measured as a decline of at least 5 percent in the debt-to-GDP ratio)

Duration of Episodes



Source: IMF staff estimates.

Consolidation Episodes by Duration



Source: IMF staff estimates.

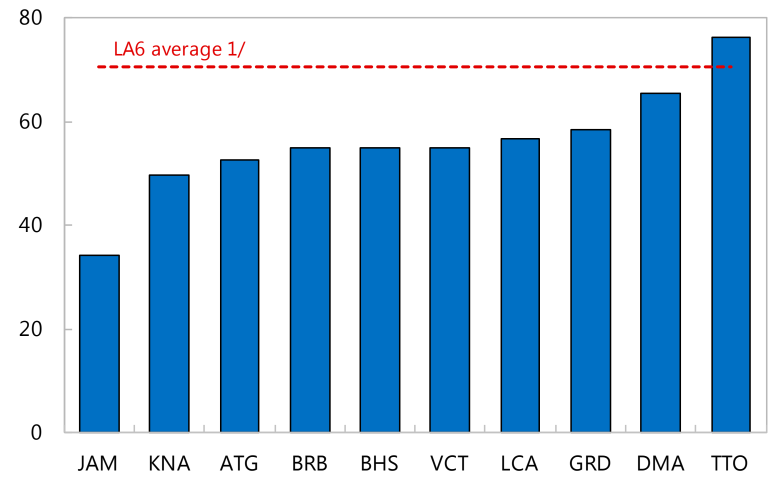
Fiscal consolidation and debt Reduction in the Caribbean is challenging due to…..

- Rigidity of fiscal structures limits adjustment
- Competiveness issues lower growth potential
- So do high vulnerabilities and low resilience
- The structure of the debt constrains restructuring

Fiscal rigidities in the Caribbean are high due to nondiscretionary expenditure and narrow tax base

- Small size implies high fixed cost of public administration
- Wages and debt service payments are high constraining flexibility
- In addition Public enterprise represent a drain on the central government budget
- Revenue base is eroded by tax expenditure

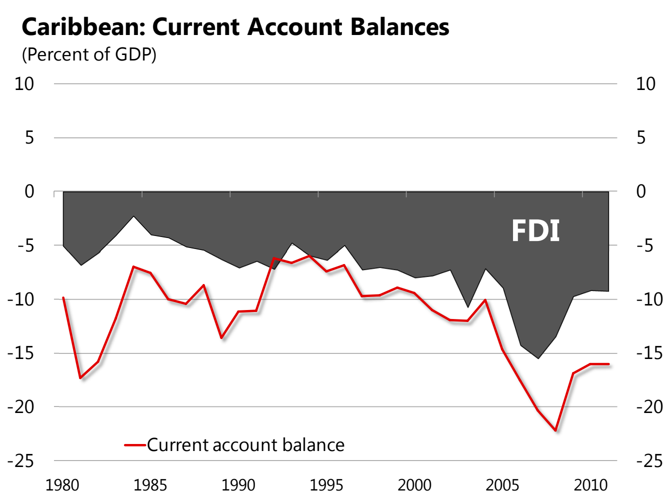
Caribbean: Fiscal Flexibility Index 1/
(100=highest flexibility)

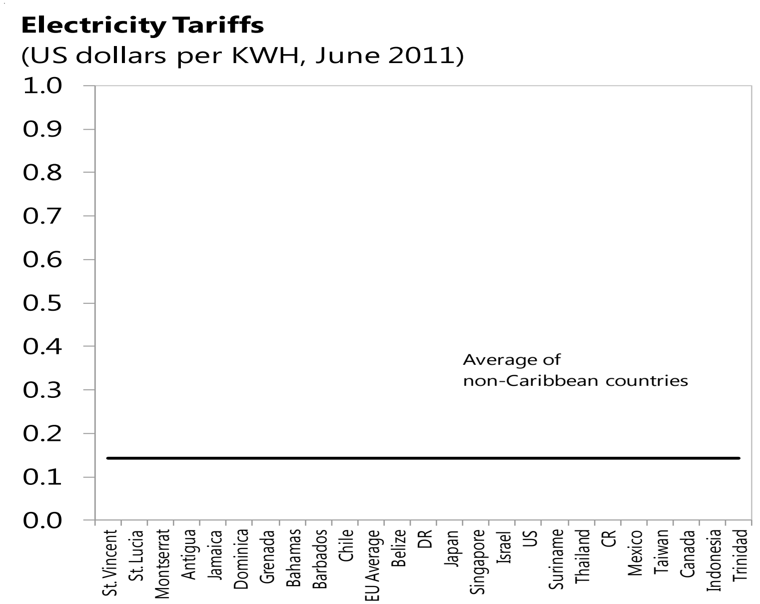


Source: IMF staff estimates.
1/ Simple average for Brazil, Chile, Colombia, Mexico, Peru, and Uruguay.

Real economic growth is stymied by competitiveness challenges

- **External current account is widening reflecting FDI flows and competitiveness challenges**
- **The cost of doing business is extremely high. Example is electricity tariffs, labor cost, security and interest rates**





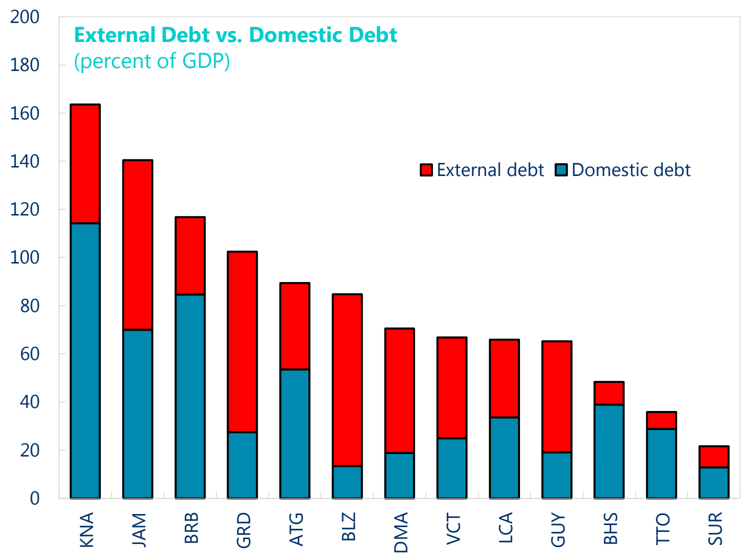
Vulnerabilities and low resilience to shocks push up fiscal costs and limit growth potential

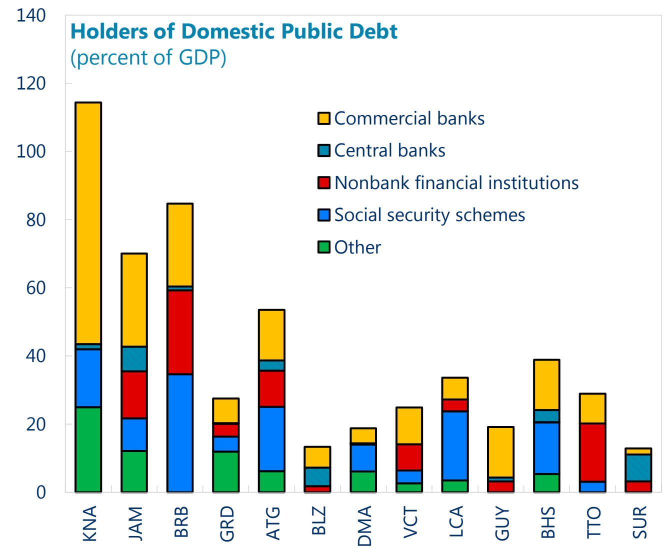
- Vulnerabilities in the Caribbean inhere from:
  - Natural disasters: 6 ECCU in top 10 disaster prone; all others in top 50
  - One percent of GDP per year from natural disasters is a contingent liability that should be provided for
  - Sea level rise will be an emerging challenge in the future

- At the same time there is limited resilience to shocks
  - Natural disasters affect the whole country (as opposed to Sandy which only affected North East of the USA)
  - Financial systems not deep – Lack instruments for income smoothing
  - High debt levels limit fiscal space
  - Generally a lack of both fiscal and financial buffers

Composition of public debt limits the extent of restructuring

- The public debt is largely domestic
- Financial sector holds significant public debt. Debt restructuring has to consider impact on financial sector





Agenda for reform

- There is a clear need for credible medium-term fiscal strategies
- Both spending and revenue sides have a role to play
- It is imperative to protect the poor. To that effect, social safety nets and well-targeted programs need to be enhanced, including by reducing general subsidies
- Fiscal rules will help increase discipline and the credibility of fiscal policy
- Structural reforms to enhance competitiveness and boost growth will be crucial

Thank you