



Growing Out of Debt: The Challenge of Correcting Extreme Levels of Public Indebtedness

Address by

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Observation of protocol,

I thank the Chamber of Commerce of St Kitts-Nevis for inviting me to speak on the nature, prospects and challenges of an IMF borrowing arrangement.

The timing is opportune as I understand that St Kitts-Nevis has recently concluded arrangements for a Standby Borrowing Arrangement with the IMF and Jamaica signed a similar agreement some 16 months before. There are clear similarities as both economies have been severely affected by losses of international preference in agriculture, international recession and weather related shocks. Both have experienced weak economic growth and unemployment and both have recorded large fiscal deficits and had ratios of public sector debt to GDP that are among the highest in the world.

The IMF's Public Information Notice (PIN) at the conclusion of its 2010 Article IV Consultation with the Government of St Kitts-Nevis was the sign of things to come. The assessment of the economy then referred to the impact of hurricanes, including hotel closure in Nevis, negative economic growth, an increase in the fiscal deficit, despite the gains from the value-added tax, and an increasing ratio of public debt to gross domestic product (now approximating 200%). The PIN also cited the high exposure of the domestic banking system to public debt and the impact of the collapse of the CL Financial Group on the non-bank financial sector.

The IMF Executive Board then "recommended the authorities forge a national consensus for reforms to put public debt on a firmly downward trajectory, increase competitiveness, and help sustain the economic recovery". They "emphasized that a combination of both revenue and expenditure measures, including reducing the wage bill and prioritizing capital spending, is needed to maintain primary fiscal surpluses." And "Given that fiscal adjustment alone will not be sufficient to achieve fiscal and debt sustainability, they encouraged the authorities to speed up land sales and to consider seeking financial support from multilateral institutions" They also recommended structural change including enhancement of labour market flexibility and the strengthening of financial sector regulation.

Up to June 2009, the Government of Jamaica had denied the need for and intention to seek a borrowing arrangement with the IMF, relying instead on what appeared to be generous loan financing from other Multilateral Financial Institutions (MFIs; World Bank, IDB, CDB) and grant financing from the EU. The MFIs though are lenders who expect to be repaid and the EU wants to ensure that its grant financing will facilitate policies consistent with its own eventual termination. Once the issue of "debt sustainability" (i.e. the capacity of the government to finance itself and refinance its debts) is raised, these other sources of funding are likely to require the "seal of approval" of an IMF borrowing arrangement to insure, as it were, their own commitment of funds against default.

The experiences of developing countries with IMF borrowing arrangements from the 1970s to the 1990s have been a context for some unease within these countries. The criticisms of IMF lending “conditionalities” have included the IMF having a “one size fits all” dogmatism. For example, balance of payments problems were taken to mean that the country is living beyond its means and that the exchange rate is “overvalued”. Therefore, there should be fiscal compression and devaluation, often as a prior condition for negotiations. The unrestricted operation of market forces was to be relied on for the pricing and allocation of all economic resources. There should be no preferential access to credit at subsidized interest rates by selected sectors like agriculture. Public enterprise was assumed to be inefficient and should be divested. It is not surprising then that IMF borrowing agreements came to be characterized as promoting the “Ds” of “Deflation”, “Devaluation”, “Divestment” and “Debt”.

Despite initially getting it wrong with the market transition of Russia, the Asian and Mexican financial crises and the Argentinian debt default, the fundamental thrust of the IMF had yielded some success by early in the new millennium. Success in getting most countries to rebalance resource use to resource availability meant that the IMF had run out of borrowing members to finance and justify its existence. As the IMF sought to introspect and weigh criticism through its Independent Evaluation Office (IEO), the international financial crisis, emerging in 2008, gave it a new lease on life.

The IMF was chosen and financed by the OECD group of developed countries, to be institution through which the impact of the international financial crisis across countries was to be moderated. This role coincided with the IMF’s effort at a new approach to policy interface with its member countries; a “new IMF”. In approaching its new role dictated by the international financial crisis, the IMF made a distinction between two types of economies. There were those whose economic policy fundamentals were assessed to be sound but may have been experiencing temporary liquidity problems due to the international financial and economic crisis. These were afforded financial support without policy conditionality. The other set of countries were also adversely affected by the international crisis but without sound policy fundamentals, would be subject to policy adjustment. With high fiscal deficits and an increasing burden of public debt, Jamaica and St Kitts Nevis would have been adjudged to be in the latter category.

The “new IMF” appears to be less dogmatic. There is an acceptance of the need of the host government to buy into a programme if it is to have a chance of being implemented successfully. Devaluation is no longer compulsory and the IMF accepts the reality and benefits of Eastern Caribbean Dollar fixed exchange rate. There is more flexibility on directed credit and preferential interest rates with the IMF instead focussing on that the cost of subsidies should be explicitly recognized in the budget. Enterprise ownership by the public sector is tolerable to the extent that it is not generating losses to cost the taxpayer. There is now explicit recognition of the social costs of fiscal adjustment and

even insistence on a “social safety net” for the most disadvantaged in society. There is also more emphasis on the role of structural and institutional factors in the stabilization and growth of the economy.

The new IMF is making an effort to understand local peculiarities, and to foster greater local “ownership” of the economic programme. It is perhaps instructive that the recent mission chief to Jamaica was a Jamaican educated at UWI at Mona and the IMF resident representative to Jamaica is of Eastern Caribbean origin, formerly employed by the Central Bank of Barbados. The mission chief to St Kitts-Nevis first worked on Jamaica and has been associated with the region for two decades while the resident representative, based in Antigua was a long time employee of the ECCB here in St Kitts, and had previously worked on Jamaica.

Despite the efforts at reform there is one fundamental issue that due to arithmetic and the reality of loan financing cannot change. The IMF lends money, expects to be repaid and does not explicitly reschedule its debts. An IMF agreement is a “seal of approval” for the release of loans from other financial institutions that also expect to be repaid. There is a strong logic therefore for institutions lending more money to entities that are already heavily indebted, to demand adjustment on the part of the borrower through cutting expenditure or increasing revenue. The need for adjustment is likely to be supplemented by structural changes to enhance budgetary processes and expenditure management, revenue administration and financial sector regulation.

In circumstances of extreme public indebtedness, concerns may arise regarding the capacity of society and political system to endure the intensity of adjustment required to facilitate the easing of the debt burden. This may then lead to consideration of some form of debt “restructuring”. In Jamaica’s case, the Jamaica Debt Exchange, of old for new government debt securities with lower rates and longer maturities, was a prior condition for Jamaica’s Standby Agreement. IMF Press Release 11/215 of June 3 2011 following the recently concluded negotiations with the government of St, Kitts-Nevis indicates that “the program would include a comprehensive debt restructuring to achieve a sustainable debt service profile and ensure fair burden sharing by all stakeholders.” At the same time, extreme care has to be exercised in the context of the reference in the IMF’s November 3 2010 PIN # 10/145 following its Article IV Consultation with St Kitts-Nevis that “The government’s heavy reliance on financing from a captive domestic market has led to the high exposure of the banking system to public sector debt.”

An IMF programme is also likely to include structural changes to strengthen public sector financial management and financial regulation. In Jamaica’s case, these include a Central Treasury Management System, financial responsibility legislation to increase transparency and facilitate the meeting of targets, reform of taxation structure and

administration and giving the central Bank overarching responsibility for the stability of the financial system. There is also attention to the welfare of the poorest through the expansion of the Programme of Advancement through Health and Education (PATH).

The major policy challenge in correcting for extreme public indebtedness has to do with balancing fiscal contraction (through reduced government expenditure and increased taxation) with an imperative to generate stronger economic growth. To reduce the ratio of debt to GDP, policy seeks to ensure that debt grows more slowly than the current value of output (GDP). To restrict the rate of growth of public debt, policy has to reduce the fiscal deficit towards its elimination. The required cut in expenditure or increase in taxes, unless very carefully managed, is likely to reduce the rate of growth of output measured in current prices. On the other hand, if growth in the current value output is pursued by increased government spending or reduced taxation, this could increase the fiscal deficit and therefore government borrowing and public debt.

This has been the particular challenge of the design of Jamaica's SBA. It appears to have been expected that growth would result from sharp stabilization and the proposed structural changes (which have largely experienced delays in implementation). There has also been concern that economic growth, increasing to 4% in the medium term, would be sufficient to generate sufficient revenue as consistent with reducing the deficit and controlling public debt. The June 3 2011 Press Release 11/215 asserts that: for St Kitts-Nevis **"The main goal of the government's economic strategy is to foster macroeconomic stability and put the public debt on a firmly declining path, which is expected to contribute to higher economic growth and improved living standards for all members of the society."**

Concerns expressed by local commentators about the design and implementation of Jamaica's SBA may be well founded. Most quarterly quantitative targets for March, June and September 2011 were met and deviations were rationalized by reference to May 2010 social dislocation related to the extradition issue and by unbudgeted road rehabilitation. Of more recent concern is the absence of reports on performance at December 2010 and March 2011 although the government admitted that it missed its primary balance target (revenue minus non-interest expenditure) at March 2011. The IMF has been concerned about the pace of implementation of the agreed structural adjustment measures. There was then an announcement by Government of its intention to negotiate an extension of the SBA.

The economy of St Kitts Nevis is heavily dependent on tourism which will continue to be affected by the slow and uncertain pace of international economic recovery. Maintenance of visitor arrivals may require aggressive marketing and the possibility of room rate discounting. In the context of weak economic activity, the Eastern Caribbean dollar fixed exchange rate will facilitate the maintenance of low inflation and interest

rates although there are continuing threats from international oil and food commodity prices. The other side of the fixed exchange rate however, is the challenge to increase the international competitiveness of the economy. Increasing oil and food import prices will offset to some extent, the lower demand for imports occasioned by slow growth in St Kitts-Nevis. Foreign direct investment has been weak and its recovery is largely dependent on the recovery of the international economy. Unemployment will continue to be a problem in the near term.

Government policy is faced with the inevitability of sharp fiscal adjustment. The only options that can ease (not remove) the extent of adjustment required would be a significant increase in grant financing (gifts instead of loans) or a negotiated or unilateral alteration of the terms of the government debt. Unfortunately for St Kitts-Nevis and Jamaica, both highly indebted, they are classified as middle income countries and not qualified for the assistance available to “Highly Indebted Poor Countries”. Debt restructurings may have consequences for the domestic financial system and access to international financial markets.

If fiscal adjustment is inevitable, it is important for government to understand and “own” the programme. “Hiding behind” and blaming the IMF is a basis for half-hearted implementation and likely policy failure. The introduction of the Value Added Tax has enhanced revenue in St Kitts-Nevis but one should avoid the temptation to increase tax rates in a depressed economy. **Resources for expenditure will be scarce so their use has to be very carefully prioritized to strengthen the social and economic foundations of your country.** In this regard, policy should avoid expenditure on expensive edifices and focus on “need to have” rather than “nice to have”. There should also be a critical review of all incentive and entitlement programmes, their resource cost and impact on the wider economy and society. Economic growth has to be an explicit objective of policy choices as it will not flow automatically from the programme.

Policy should also seek to enhance partnerships with the broad non-government sector. This partnership could explore the strengthening and marketing of the brand “St Kitts-Nevis”, including the alternatives to sea, sun and sand, to generate a faster recovery in visitor arrivals. Partnership may more generally explore export market alternatives. In the context of unemployment, it is also imperative that partnerships be developed to encourage medium, small and micro enterprise in domestic services, light manufacturing, agriculture and agro-processing.

In an already depressed economy that is facing the prospect of fiscal adjustment, there inevitably are challenges for the private sector. Regional and international markets are depressed and the adjustment process will mean that domestic demand will not be buoyant in the near term. **But countries do not die and there is every prospect of**

buoyancy in the medium term as the international economy recovers and especially if there is successful growth oriented adjustment out of debt.

In the context of near term challenges and anticipation of medium term easing, the first objective of a company has to be survival. With lower sales, this may require deep organizational and financial restructuring. In this context, “cash is king” to ensure liquidity and for insulation against shocks. Increased equity may also be necessary as a buffer against insolvency. All of this requires tremendous personal sacrifice on the part of business owners. Change may entail the tightening and flattening of the organizational structure where possible and there may be, unfortunate from a national perspective, the lay-off of employees. The perks of owners and managers have to be reviewed including as regards travel and communication.

While facing sharp internal adjustment, business will also be challenged to invest more in understanding and penetrating regional and international markets. In this regard, and in a context of internationally experienced recession, there may be opportunities for the building internal and regional productive partnerships. In this regard, and relative to the need for more equity, business has to consider opening itself to wider local and regional participation, including through public share issues.

We conclude by being realistic about the severity of the challenge faced in trying to adjust from a burden of debt that is more than twice the country’s annual output. While it is very challenging, it is also feasible. Jamaica had earlier reduced its own Debt/GDP ratio from over 200% in the mid-1980s to fewer than 80% in the mid-1990s, prior to the financial sector crisis. The adjustment process is however not painless and demands a large measure of national cohesion. Certainly the matter of correcting a national debt problem should be above political and sectional partisanship. Government has a key role to play in owning and implementing the programme and building public understanding of the narrowness of choice and selling hope beyond the pain. Non-government groups have to survive the pain of adjustment and equip themselves for the prospect of recovery in the medium term.

Your country is a “Land of Beauty” and it is also a land of hope. As reflected in the last words of your National Anthem”

“No sword nor spear can conquer,

For God will sure defend.

His blessings shall for ever

To posterity extend”.

May you all sail on fairer tides.

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