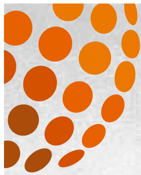


GLOBAL NEWS MATTERS

Caribbean Research.

Marla Dukharan is highly regarded as one of the top thought-leaders in the Caribbean on key economic topics and policies. *Marla* is a Group Economist for **RBC** Caribbean and has extensive experience as an economist working with Caribbean markets at the country and regional level. *Marla's* depth of knowledge has converted her into a key influencer for regional businesses and policy and she is considered by **GNM** as one of the Women to Watch in the Caribbean.

Barbados Budget and Outlook 2017 -An Interview with Leading Caribbean Economist Marla Dukharan by Global News Matters

What are the key themes that stood out in the Barbados budget presentation?

Well, first I want to congratulate the Honourable Minister of Finance on clearly and succinctly outlining his principal concerns, being:

1. High and rising debt levels
2. Too-wide fiscal deficits
3. Fiscal weakness and deterioration restricting growth
4. Social development constrained by rising costs

And I agree with the Minister completely on his policy priorities coming out of these concerns, which are:

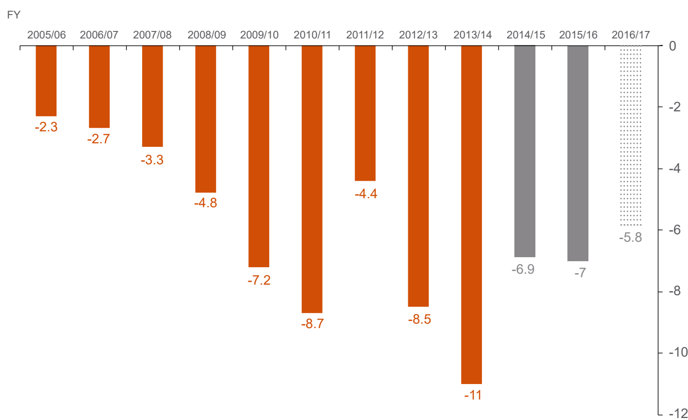
1. The need to stabilize and grow foreign exchange reserves via better fiscal management
2. Generating growth
3. Reducing the fiscal deficit
4. Stabilizing the debt trajectory
5. Maintaining the provision of social services in a fiscally sustainable manner

Finally, I would like to note the emphasis he has appropriately placed on better fiscal management, as the basis for solving other key challenges.

What are the expectations for the FY2016/17 fiscal outcome?

The Minister spoke about reducing the deficit to 4.8% of GDP on an accrual basis, 5.8% of GDP on a cash basis, down from the current projection of 7.9% of GDP. Referring to this "current projection", - I am assuming he means that, as is, with no additional fiscal measures, the deficit could reach 7.9% of GDP – however, with the measures he announced, he anticipates a deficit of 5.8% of GDP.

Assuming I have interpreted correctly, this means that we are planning for a larger fiscal deficit in FY2016/17 than we had planned for, at 4% of GDP in the previous fiscal year, which could be interpreted as planned fiscal slippage.



Source: Source: Central Bank of Barbados, August 2016 Buget Announcement, RBC Financial (Caribbean) Limited

If 7.9% of GDP is the worst-case scenario and 5.8% is the best case, my concern is that there is little room for error, and they could end up with a larger deficit in FY2016/17 versus the 7% achieved in FY2015/16. Incidentally, the IMF's recent staff report shows projections for a fiscal deficit in excess of 6% of GDP in 2016 and 2017.

For FY 2016/2017 the deficit results will depend on execution. I am hopeful and confident however, that they will do their best at executing all of the measures outlined.

But on the issue of the debt load, which will increase as a result of the deficit, the IMF puts central Government debt at 141.6% of GDP, which is the highest in the Caribbean. The IMF further reported Public Sector Debt (less NIS) at 120.5% of GDP in FY2015/16. Debt held by the NIS (which I think is prudent to count, as this is Government debt that they are supposed to pay interest on, even if they roll the principal at maturity) was 36.1% of GDP according to the IMF. So that gives a total Public Sector Debt (including NIS) of 156.6% of GDP. And as if this figure was not shocking enough, the IMF estimated Government arrears at 6% of GDP in FY2015/16. This means that total Public Sector obligations could be considered to be as high as 162.6% of GDP.

Which budget line items will be the most important to track?

The largest line item in the Government's spending is Transfers & Subsidies. The IMF recently reported that Transfers to state owned enterprises increased from 9.8% of GDP in 2005/06 to a peak of 14.4% in 2013/14.

The Minister outlined a few measures aimed at reducing this; to finance and/or reduce transfers by at least BBD50 million per year, in each of the next four years, and BBD25 million cut from all areas of discretionary expenditure this year, as with the past 3 years, plus BBD25 million further cuts following the proposed mid-term Estimates review with all ministries.

The Minister also outlined the possibility of refinancing over BBD1 billion in contingent liabilities, which to me sounds like a possible liability management exercise. This could likely be supported by reforms to the state enterprises themselves seeking to reduce or eliminate future strain on the central government, which I think would be a much-needed positive development.

The second line item I would mention is Wages & Salaries. At roughly 9%, the percentage of GDP that is spent on wages and salaries in Barbados is actually the highest in the Caribbean. Since 2013, based largely on public sector layoffs, the wage bill has fallen to just under 9% of GDP from a high of 10.3% of GDP in 2013. The IMF highlighted in its report that real wages are 11½% lower than in 2008, labour action is increasing, and wage pressures are exacerbated by the recent unwinding of a late 2013 10% voluntary wage cut for ministers and Parliamentary Secretaries.

Despite the layoffs and the decline in the public sector wage bill since 2013, the CBB Governor had reported that productivity still remains a challenge, and this affects competitiveness. It is important to understand whether the policy of reducing the public sector workforce needed to be implemented more strongly, or if a different policy entirely is required, in order to bring about an improvement in productivity and competitiveness, which is critical to generating net foreign exchange inflows and growth in Barbados going forward.

The third thing I want to highlight, is that debt servicing actually currently costs about 26% of total fiscal revenue, which gives the government very little fiscal space for investment in growth initiatives. The size of the deficit and the extent of the debt load determine the debt servicing costs. On the latter specifically, debt is being raised increasingly on a short-term basis domestically, with higher rollover rates. There is also the issue of higher interest rates due to declining sovereign credit ratings.

I think one of the best ways to address the cost of debt servicing is to have a comprehensive domestic debt restructure. I think the government seems to be looking in that direction, as indicated by the announcement that they may refinance about BBD1 billion in contingent liabilities.

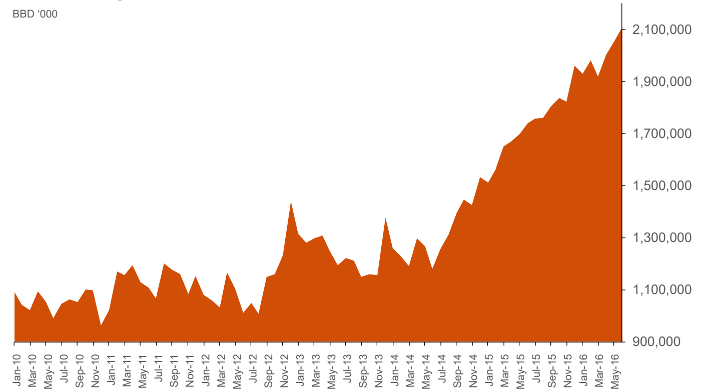
In the meantime, debt servicing costs have just kept increasing, and that has come at the expense of capital expenditure which could generate growth.

Steady fiscal and external deterioration have driven credit ratings down over the years and although some would regard this as unimportant or irrelevant, it is undeniable that this trend has driven the cost of borrowing up, and the availability of financing down, directly affecting debt servicing costs. And given that Barbados has long crossed the debt sustainability threshold of 55-60% of GDP, it means that every additional dollar of debt has a negative impact on growth.

The IMF recently stated about Barbados that "Large cash requirements of the government are a challenge increasingly met by the CBB". What are your thoughts on government financing?

Basically the IMF, as well as the rating agencies, have expressed concern about this. The monetary base, according to CBB data, has expanded by 29% on average year over year for every month since September 2014. So you're seeing the monetary base having gone from about BBD1.2 billion somewhere in the middle of 2014 to about BBD2 billion by the middle of 2016 – almost doubling in two years. That is a significant increase as a result of the mechanism the CBB is using to support government spending.

The CBB announced in its most recent quarterly report that roughly BBD198 million from commercial banks excess reserves deposited with the CBB, was lent to the Government to finance its spending. So the CBB is using liquidity that the commercial banks have placed with them, and is extending that liquidity to the government, when the commercial banks themselves had opted not to lend that same liquidity to the Government.



Source: Central Bank of Barbados, RBC Financial (Caribbean) Limited

Beyond this, the CBB lends some of its own liquidity to finance the government's spending, so much so that CBB total claims on Central Government had increased 59% year over year in June 2016 to BBD1.625 billion, or 61% of total CBB assets, up from 49% one year prior.

So it means the CBB is supporting Government spending to a greater extent.

The major risk of this approach, is that it drives up local currency liquidity or money supply, and all this money wants to find a home. Because higher domestic liquidity promotes higher levels of consumption, and because most of what is consumed is imported, the higher domestic liquidity created by the CBB causes stronger outflows of foreign currency thereby putting pressure on reserves.

So the way the CBB is financing the Government is directly putting pressure on reserves and by extension the exchange rate.

How does this budget then stack up in terms of helping Barbados attain its all-important goal of maintaining the currency peg?

The Minister said "you absolutely cannot manage a small open economy like ours if you do not have reserves. So that any threats or obstacles to achieving that singular national objective must be immediately and if necessary, continuously addressed until it is no longer a challenge."

As outlined by the CBB and the IMF, the current fiscal policy stance does not seem consistent with a fixed exchange rate regime, as persistent fiscal deficits contribute directly and indirectly to higher consumption, driving higher imports, and by extension, outflows of USD. And a planned deficit planned at 5.8% of GDP at best,

is a direct threat in my view, to the precious exchange rate. The fiscal pressure is still very much on!

But the CBB's financing of said fiscal deficit, its current monetary policy stance, also contributes to pressures on the currency. Even the IMF reported back in February 2014 that "Monetary policy has not been consistent with the fixed exchange rate framework. Monetization of the debt has made uncertainty and confusion in defining the objective of monetary policy."

With fiscal and monetary policy forces working in unison against it, it is no wonder therefore that the peg is coming under increasing threat as evidenced by the decline in reserves. And I find this situation very ironic – the fiscal and monetary policy stance directly contradict the stated goal of maintaining the peg.

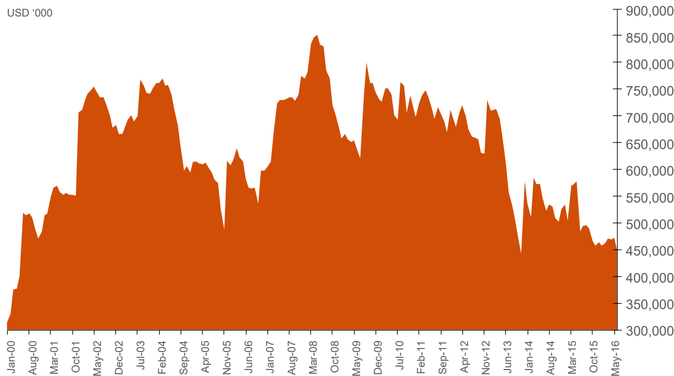
Speaking of which, what trends are you seeing in international reserves therefore, and is coverage adequate?

Reserves have been declining. CBB data show that reserves fell 7% year over year to USD450 million in June 2016. The decline in reserves is due to softer tourism revenue inflows, higher debt servicing costs, and lower FDI inflows, according to the CBB's latest report.

The level of reserves was determined by the CBB to be just over 13 weeks or above three months of imports. The IMF reported that net international reserves dropped to USD469 million at end-April 2016, which they calculate at 2.8 months of imports, which is below the internationally accepted three month precautionary benchmark.

International Reserves

USD '000



Source: Central Bank of Barbados, RBC Financial (Caribbean) Limited

If you look strictly at the absolute level of reserves, USD 450 million is quite low - the lowest since November, 2013.

There is another benchmark that we can look at, which is making sure that you hold 100% of short-term external obligations. The information I have is that in 2016, we are looking at about USD110 million in debt-servicing costs and in 2017, about USD125 million.

So we do have adequate coverage, with respect to external debt-servicing costs this year and next. But with respect to import coverage, at 2.8 months according to the IMF, I would suggest that reserves are currently not adequate, contrary to what the Minister of Finance stated in the budget.

As a matter of fact, the IMF reported recently "Barbados reserves are significantly lower than the estimated threshold using metrics that takes into account capital flight-related risks when capital controls are ineffective—given the level required to cover broad money; and also below "comfortable" levels for small open economies with high debt and fixed-exchange rate regimes."

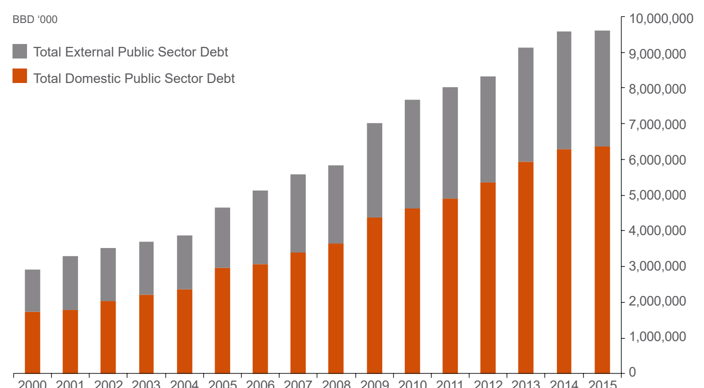
The Minister mentioned impacts of the global financial crisis on the fiscal situation for many countries. Is this the case for Barbados or is there something else at play?

It seems nowadays there is always some issue affecting confidence globally (the global financial crisis, BREXIT, etc.), which will also affect FDI. I think it is unfair to suggest that Barbados' economic situation or challenges has its genesis in the global financial crisis, however.

If you look at the pre-crisis fiscal deficit and debt trajectory, you can actually see that before 2009 the average year over year increase in debt was 9% per annum on average in the six years prior to 2009. But after 2009, the average increase in debt was 5% per annum on average. So it means we were accumulating debt at a faster pace before the crisis than we are afterwards.

Total External and Public Sector Debt

BBD '000



Source: Central Bank of Barbados, RBC Financial (Caribbean) Limited

Total public sector debt went from BBD2.92 billion in 2000 to BBD5.84 billion in 2008, which is basically doubling in eight years. And this was before the crisis.

I think that the underlying problem was the government's fiscal spending pattern which was unsustainable before the crisis. The crisis made things even worse, but the crisis was not the specific cause of the current situation. That much is clear.

What specific budget measures did you find most worthy of further analysis?

There are two items I would like to mention that will require deeper review to truly understand their impacts: the establishment of duty-free zones, and the 2% additional Tax on imports under the National Social Responsibility Act (the Levy).

Regarding duty-free zones, the Minister spoke of the establishment of a committee to research and possibly implement various duty-free zones to encourage more shopping domestically, less travel for shopping abroad, and to encourage more inflows of US dollars.

While this measure might encourage some of the USD being held informally or 'under the mattress' in Barbados, to be spent by domestic consumers in the duty-free zones, I have a bit of concern that this is unlikely to generate meaningful additional foreign exchange inflows into Barbados, because most of the goods that would be sold on a duty-free basis in Barbados to foreigners and locals would be imported anyway.

The second thing about this measure is the earmarking of certain zones where you can shop on a duty-free basis but only in hard currency – which to me means that you are, in effect, dollarizing certain zones in your country, and I am not sure I understand how that is going to work, in practice.

This approach seems somewhat complicated to me, and I actually think that if your aim os to encourage higher net inflows of USD, -it might be easier to just relax some foreign exchange restrictions, allowing USD deposits for example, or to just completely dollarize, or perhaps to even devalue the currency.

But the latter is not a policy option that the Barbados authorities are prepared to entertain. And that's fine - but you have to pick your poison, so to speak – if you are determined to maintain the peg, you must have supportive fiscal and monetary policies. I am looking forward to seeing how this unfolds.

Turning to the Levy that would take effect on September 1 2016 - the Minister quite rightly said that while it is important to maintain quality health care, the cost is increasingly unsustainable, and it is a cost borne by the government.

The move to transfer some of that cost to the beneficiaries - private citizens - I think is a positive move. What government wants to do is twofold:

One, there is a proposal for a health insurance program, that is going to be funded by employers and employees, which I think is commendable. And while it is a positive step, we know there would be impacts on people's livelihood, on their disposable income and their ability to afford a decent living standard. We have to make provisions for this. The Governor of the CBB recently published a paper outlining the mechanism by which Australia finances its health care costs, basically by way of a wealth tax. This is something the authorities can consider.

The Minister also articulated that Levy, which is an additional 2% fee on all imports in addition to existing customs duties (he outlined some exemptions) would be earmarked to help defray the cost of public healthcare.

I am not sure whether this Levy (which I am hearing people are interpreting as an increase in VAT, which it is not) could be interpreted as an increase in customs duties, and could therefore have implications for Barbados' standing in the World Trade Organization.

I think the Levy could be a regressive tax, quite frankly. Barring specific exemptions, the Levy is being applied on all imports, and since most of what is consumed by everyone is imported, it affects the cost of all imported goods to the same degree, 2%, therefore hitting consumers at lower income levels disproportionately harder.

The other impact of this Levy that I think could be seen as a positive, unintended consequence, is that, if you increase the cost of imports, you will tend to see demand, especially for discretionary items, declining. So this Levy could prompt a slowdown in the outflow of US dollars, which the government hopes to engineer anyway.

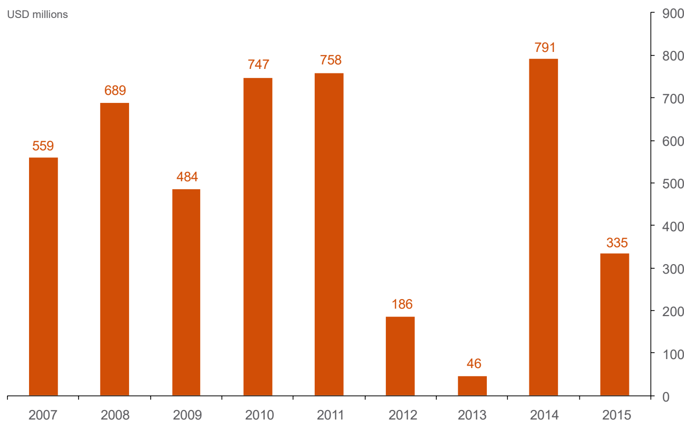
Continue on next page >

Why is foreign direct investment slow in Barbados and what could be constraining investment?

Alongside the fact that the government's capital expenditure budget has been squeezed as a result of increasing debt servicing costs and goods and services spending as well, we saw some softening of FDI inflows in 2015.

FDI fell according to UN ECLAC data, from USD791 million in 2014 to USD355 million in 2015 – a 55% drop in net FDI inflows. I think one of the things that is constraining FDI, in addition to the broader issue of macroeconomic performance, confidence and so on, is the foreign exchange situation, the foreign reserve situation, and the confidence in the currency.

Net Foreign Direct Investment Flows



Source: UNECLAC, RBC Financial (Caribbean) Limited

FDI will be reluctant to find its way to your destination if foreign companies are not confident of being able to repatriate profits when they are due, or if they feel their business can't thrive in the current macroeconomic environment. I think the government could probably look at relaxing foreign exchange controls, especially as they affect FDI, if they want to attract more FDI.

What basic outlook scenarios are you managing for 2017?

We had 0.8-0.9% GDP growth last year, despite the fact that stop over arrivals expanded almost 14% year on year, which is really remarkable growth in the tourism sector. So when you hear a projection of 2.5% growth by the end of 2017, which is what the budget states, it makes you wonder, what would it take to get you to 2.5% growth?

Growth hasn't crossed 1% since 2007, and hasn't crossed 2% in over a decade. So I have some doubts around getting to 2.5% growth by the end of 2017, especially with the amount of fiscal adjustment, primarily higher taxes and some spending cuts outlined in the budget. I think 2.5% growth is a bit ambitious.

I think that there are so many positive policies and initiatives outlined in the budget especially targeted to bringing down expenditure. An optimistic scenario would assume that all those policies and initiatives are implemented, and that all the FDI that the Minister outlined with respect to Sam Lords Castle, and Hyatt and Four Seasons, etc. comes to fruition, and that multilateral lending agency support remains on target. Assuming all of those bear fruit and are actually fully executed and implemented as expected, I think we can have a situation where growth is stronger this year than it was last year.

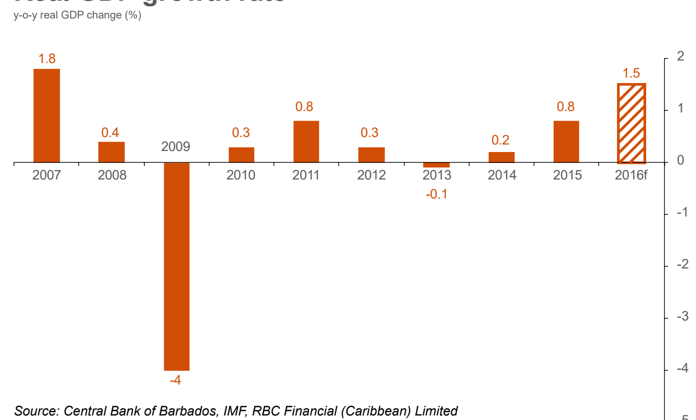
However, reviewing the factors we have discussed:

- Weak and falling reserves
- High and rising debt
- Planning for a wider deficit this year than they had planned for last year

The economy remains on shaky ground and vulnerability is high, in my view. If there are any external shocks (i.e. Brexit does in fact proceed, and there are some repercussions from that, oil prices recover, weather-related crisis, etc.), I think that the level of vulnerability I am seeing right now suggests that we could see things deteriorate quickly.

Barring any unanticipated or unexpected external shocks, I think if everything is implemented as planned, we can expect to continue to see some growth this year and into next year, but unlikely to be stronger than 1.5% in my view.

Real GDP growth rate



Source: Central Bank of Barbados, IMF, RBC Financial (Caribbean) Limited