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ST. KITTS AND NEVIS

October, 2015

EX POST EVALUATION OF EXCEPTIONAL ACCESS UNDER THE 2011 STAND-BY ARRANGEMENT—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ST. KITTS AND NEVIS

The following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its October 21, 2015 discussion of the Ex Post Evaluation of Exceptional Access with St. Kitts and Nevis.
- The Ex Post Evaluation of Exceptional Access Under the 2011 Stand-by Arrangement with St. Kitts and Nevis, was prepared by a staff team of the International Monetary Fund. Based on information available at the time of these discussions, the staff report was completed on October 6, 2015.
- A **Statement by the Executive Director** for St. Kitts and Nevis.

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October 29, 2015

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IMF Executive Board Concludes Ex Post Evaluation of the 2011 Stand-by Arrangement with St. Kitts and Nevis

On October 21, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Ex Post Evaluation[1] of the 2011–14 Stand-by Arrangement with St. Kitts and Nevis.

St Kitts and Nevis, a member of the Eastern Caribbean Currency Union, requested a three-year Stand-by Arrangement with IMF in the midst of debt crisis following the Global Financial Crisis (GFC). With the exception of a brief period ahead of the GFC, debt had grown steadily over much of the preceding decade, and had been deemed unsustainable since 2006. Public debt peaked at around 160 percent of GDP in 2010, with significant bank-sovereign links resulting from the debt held by domestic banks. The program had three objectives: (i) a comprehensive debt restructuring to address the debt overhang; (ii) ambitious medium-term fiscal consolidation; and (iii) further strengthening the financial sector, and as such sought to address the factors behind the debt crisis and its implications for the financial sector.

Programmed access and phasing reflected the large financing gap created by the sharp downturn following the GFC, and the lack of access to funding from alternative sources. The arrangement was approved on July 27, 2011, and had access of SDR 52.51 million (590 percent of quota). Access was exceptional because of the need for heavily frontloaded disbursements, with 450 percent of quota available in the first year.

Executive Board Assessment[2]

Executive Directors agreed that St. Kitts and Nevis' SBA-supported program had been appropriately designed with conditionality focused on addressing the immediate consequences of

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

the debt crisis and its potential implications for the financial sector. Directors noted the extremely difficult conditions facing St. Kitts and Nevis at program inception, and the limits on implementation capacity in small states. They commended the authorities for their home-grown program, which had allowed for a substantial improvement in macroeconomic conditions, a return to robust growth, and an overall successful program performance. Nevertheless, overly optimistic growth projections early in the program had clouded the assessment of both debt dynamics and the appropriate macroeconomic stance at times.

Directors noted that the debt restructuring, with a steep reduction in overall public debt, had placed debt ratios on a downward path. Nonetheless, the agenda remains incomplete, and the timely sale of land associated with the land-debt swap, as well as efforts to reduce the high level of short-term public debt, remain important going forward. Directors also noted that additional rigorous analysis justifying the prospects for debt sustainability at program inception would have been desirable to clarify program risks. Where a debt restructuring is anticipated, there would be merit in outlining at the outset key debt outcomes that the restructuring should aim to achieve.

Directors welcomed the significant improvement in the headline fiscal and external accounts. In this regard, they noted the important fiscal reforms undertaken by the authorities and the savings accumulated from receipts under the government's Citizenship by Investment Program (CBI), which were much larger than anticipated. Given the potential risks in the event of declining CBI inflows, Directors considered that designing programs to capture unexpected windfalls can help strengthen fiscal buffers.

Directors considered that, going forward, key issues for St. Kitts and Nevis are to make fiscal discipline permanent, including through further efforts to contain the wage bill, and to prudently manage the windfalls from the CBI program, while protecting high quality infrastructure spending. Other priorities include creating a business environment more conducive to private sector activity, permitting a stronger and more active indigenous financial system, and strengthening competitiveness. Directors also encouraged closer coordination between the federal government and the Nevis Island Administration on financial management, capacity building, and policy implementation.

Regarding the lessons learned, Directors highlighted the importance of structuring programs to save upside windfalls which may prove temporary, and to protect capital and social spending. They also broadly agreed that, in the context of capacity constraints faced by many small states, a semi-annual frequency of program reviews could be more appropriate than a quarterly one, with the case depending on country circumstances.

ST. KITTS AND NEVIS

EX POST EVALUATION OF EXCEPTIONAL ACCESS UNDER THE 2011 STAND-BY ARRANGEMENT

October 6, 2015

EXECUTIVE SUMMARY

St. Kitts and Nevis requested a three-year Stand-by Arrangement for SDR 52.51 million (590 percent of quota) in the midst of a debt crisis. Debt peaked at around 160 percent of GDP in 2010, and had been considered unsustainable since 2006. The sharp downturn coinciding with the global financial crisis created a large financing gap forcing a debt restructuring and exceptional access to Fund resources. The programmed mix of financing and adjustment was reasonable—the fiscal adjustment was large and frontloaded, as was the financing from the Fund and through the restructuring.

The program focused on (i) an ambitious fiscal consolidation; (ii) a comprehensive debt restructuring; and (iii) a further strengthening of the financial sector. These goals aimed to address the key issues behind the debt crisis, and the potential financial sector outcomes of the restructuring.

The program had many successes. The debt reduction was one of the largest in recent times, the headline fiscal and current account balances improved substantially, important tax and public financial management reforms were enacted, and sovereign risk was removed from the banks. Robust growth also resumed. The improvement in the headline fiscal and external positions allowed the authorities to treat the program as precautionary (and hence non-drawing) from the combined seventh and eighth review.

The debt restructuring brought about a dramatic reduction in the level of debt, but vulnerabilities remain. Debt is on a declining path but gross financing needs are above the safe level of 15 percent of GDP. The assessment of the exceptional access criteria should have provided greater assurance on the prospects of debt sustainability at high probability. In addition, given the unexpected surge in receipts from the government's Citizenship by Investment scheme, the resulting adjustment in both headline fiscal and current account balances were substantially greater than that in underlying terms. This smaller underlying adjustment presents a risk to the long-term sustainability if CBI inflows decline.

A significant post-program agenda remains. Under the program St. Kitts and Nevis made substantial progress in addressing its debt stock problem, although work remains to ensure sustainability of underlying fiscal and external flows. The ongoing agenda is (i) fiscal policy aimed at a sound underlying primary fiscal position, and the prudent management of CBI-related windfalls; and (ii) structural reforms aimed at strengthening competitiveness and making the private sector the engine of the economy. Completing this agenda would strengthen St. Kitts and Nevis' potential growth and make the country more resilient.

Authorized for distribution by
Adrienne Cheasty and Bob Traa

Prepared by an interdepartmental team consisting of Nathan Porter (head), Diana Ayala, Erica Tsounta (all SPR), Kevin Greenidge (WHD), and Mario Mansilla (MCM). Excellent assistance in the preparation of this report was provided by Gillian Adu and Frank Wallace. A mission comprising Messrs. N. Porter and A. El-Ashram (WHD) visited Basseterre and Charlestown during September 10 and 11, 2015. The mission met with Prime Minister Timothy Harris, the Premier of Nevis, Vance Amory, former Prime Minister Denzil Douglas, other senior officials, and the governor of the ECCB.

CONTENTS

BOXES

FIGURES

TABLES

APPENDIX

Abbreviations

BSRF	Banking Sector Reserve Fund
CBI	Citizenship by Investment Program
CDB	Caribbean Development Bank
ECCB	Eastern Caribbean Central Bank
ECCU	Eastern Caribbean Currency Union
NIA	Nevis Island Administration
SIDF	Sugar Industry Diversification Foundation

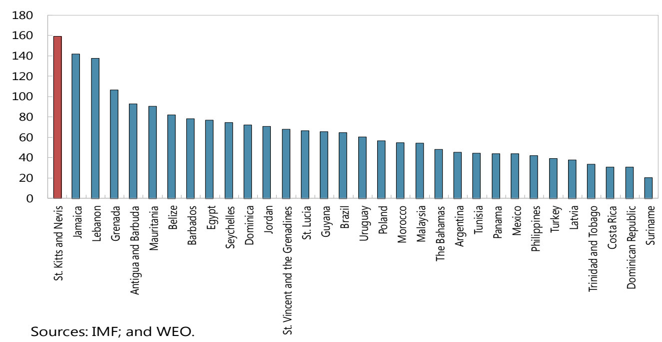
INTRODUCTION AND CONTEXT

1. St. Kitts and Nevis is a microstate in one of the most hurricane affected areas in the world, having suffered 5 major hurricanes since 1990 (one every 3–5 years).[1] With a population of around 55,000 there are natural constraints on capacity and the extent of diversification. Tourism became the mainstay of the economy after the sugar industry closed in 2005.

2. The concentrated economic structure, susceptibility to natural disasters, and large fiscal deficits contributed to the accumulation of unsustainable debt. The debt crisis burnt on a slow fuse (Figure 1), with a series of shocks, both natural and due to changing industrial fortunes (SOE losses and unprofitable sugar production), leading to public debt of over 150 percent of GDP, one of the highest in the world. For a few years this was sustained through domestic finance from the banking system (creating significant bank-sovereign links) as external sources of finance dried up. In 2008, Tropical Storm Omar combined with the global financial crisis brought about a deep recession in St. Kitts and Nevis and its unsustainable situation came to a head.[2]

Public Sector Debt in Selected Countries, end-2010

(in percent of GDP)



Sources: IMF; and WEO.

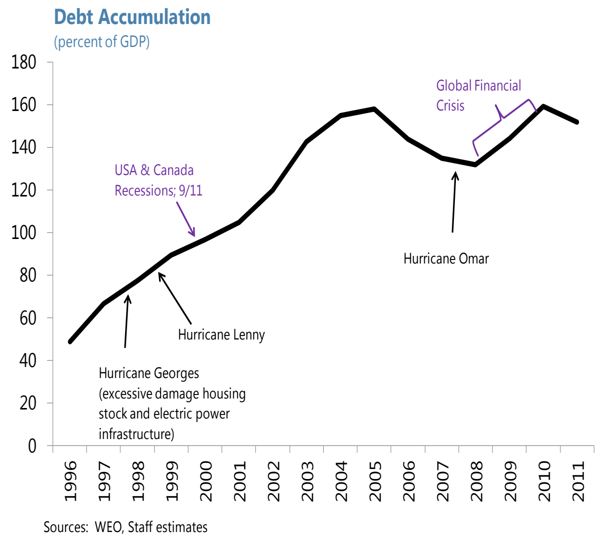
3. Ahead of the crisis, the Federation's banks were relatively sound and while the currency was overvalued, its exports were of high quality (Figure 2). Banks were well-capitalized, although the extent of capitalization was inflated given the banks' significant exposure to a sovereign with unsustainable debt, which under regulatory rules attracted a zero risk weight. However, they had growing NPLs relative to loans and stagnant profitability. While exported

[1] Losses estimated from the most damaging of these were 110 percent of GDP (Hurricane Georges, 1998).

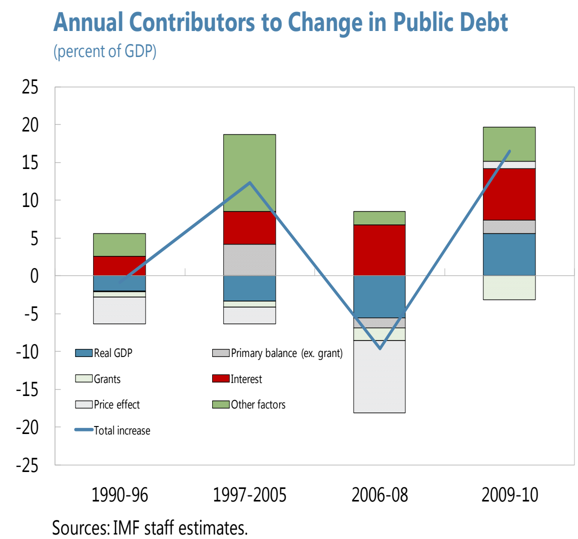
[2] In general, by several different measures, the six ECCU countries rank among the 10 most disaster prone in the world. See Rasmussen, Tobias, "*Natural Disasters and Their Macroeconomic Implications*" in The Caribbean, from Vulnerability to Sustained Growth, edited by R. Sahay, D. Robinson, and P. Cashin, IMF, 2006.

Figure 1. Pre-crisis Debt Developments

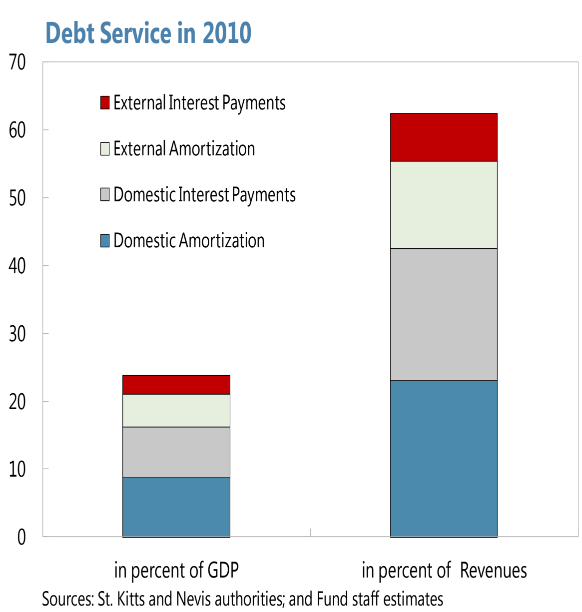
Public debt was unsustainably high for some time and reflected disasters, fiscal deficits and failed enterprises.



In 1997–2005 disasters, losses in the SOE and sugar sectors ("other" factors), and deficits drove debt higher. More favorable dynamics followed until 2008.



With a weak economy and revenues, the debt service became unsustainable in 2010.



The debt structure was complex, with high short-term, FX and bank claims.

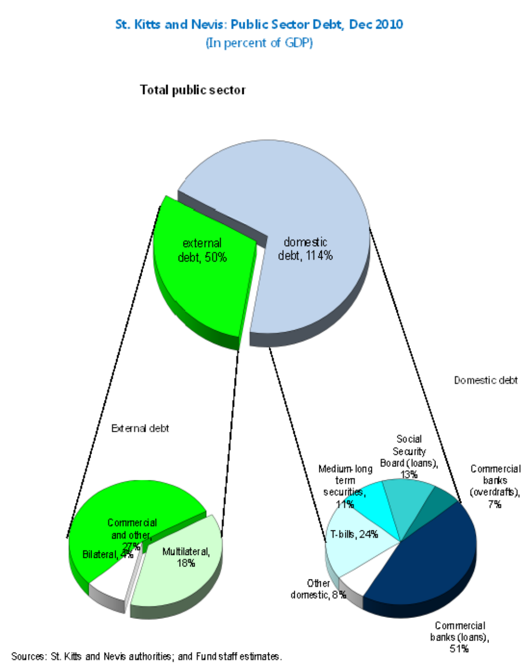
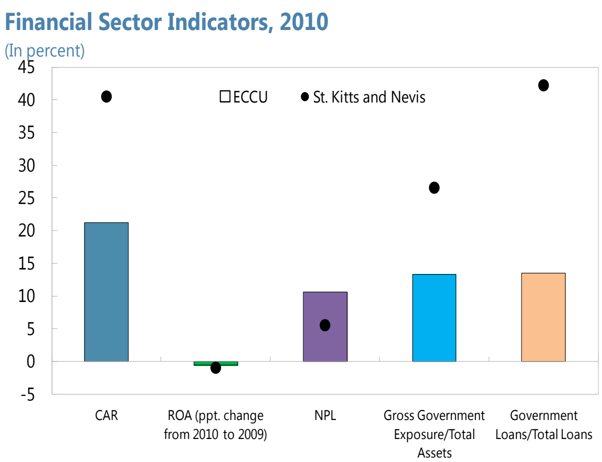


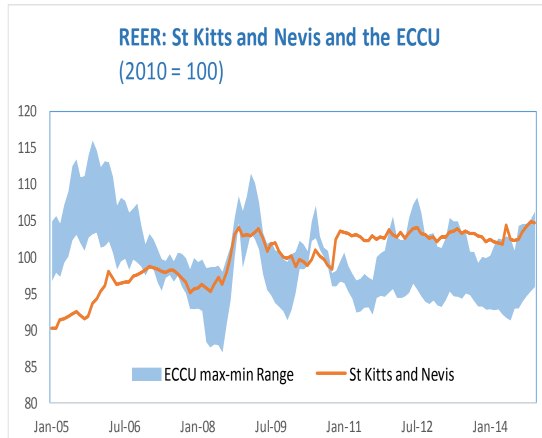
Figure 2. Financial Sector and Competitiveness

Banks were relatively healthy at the beginning of the crisis.

Competitiveness was eroded from 2005, and St. Kitts and Nevis' REER is high relative to peers.

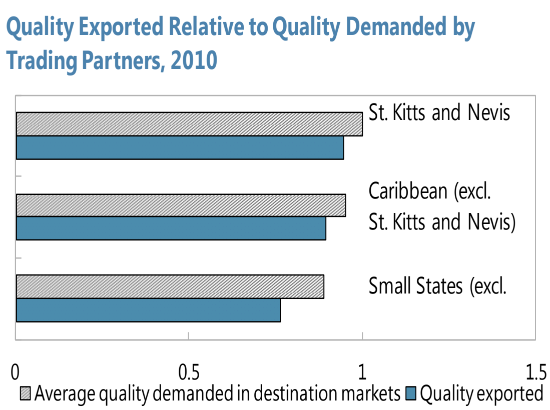


Sources: ECCB; St. Kitts and Nevis authorities; and Fund staff estimates

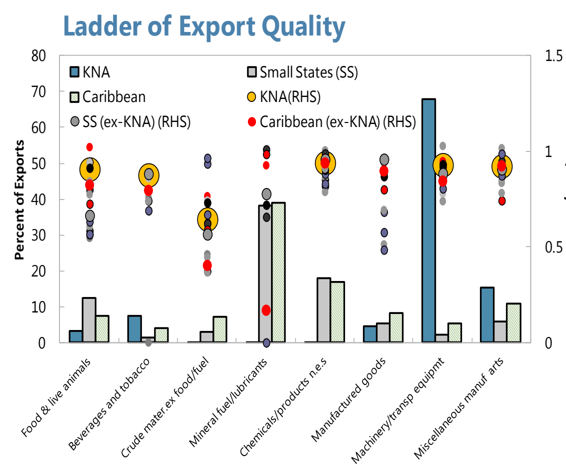


However, the Federation's exports more closely match the quality demanded by trading partners than peers', and ...

... are high on the "quality ladder."



Source: IMF staff estimates.



Source: IMF staff estimates.

products are relatively undiversified, St. Kitts and Nevis produces higher quality products (relative to the demand of its trading partners) than its small state and Caribbean peers. In addition to its size, its limited diversification could reflect weak competitiveness and an overvalued currency (IMF, 2014).[3,4] Indeed, the REER indicates a loss in competitiveness starting in 2005.

4. **After commencing a home-grown program in 2010, the authorities requested a three-year Stand-by Arrangement of 590 percent of quota** (SDR 52.51 million, $84.1 million), and it was approved on July 27, 2011. The objectives were to support the debt restructuring, achieve an ambitious fiscal consolidation, and to strengthen the financial system. The early start of the home-grown program was argued to signal strong ownership. Given the size of the estimated financing gap, the programmed mix of financing and adjustment was reasonable—the fiscal adjustment was large and frontloaded as was the financing provided by the Fund and through the restructuring. Successes under the program included the completion of the debt restructuring, critical fiscal reforms, and the preservation of financial stability with sovereign risk largely removed from the banks. Growth was resurgent, exceeding 6 percent in 2013 and 2014.

5. **Significant improvements in the headline fiscal and external accounts occurred under the program.** In addition, to the impact of the fiscal reforms undertaken, the improvement also reflected the unexpected surge in inflows related to the government's long-standing Citizenship by Investment (CBI) scheme (Box 1). These drove large headline improvements in the fiscal and external positions. The strength of these inflows provided additional financing and meant there could be a relaxation of fiscal targets, particularly in 2013 following four consecutive years of negative growth. However, with the SBA not initially designed to save upside surprises, the additional flows meant the extent of underlying adjustment was reduced. With CBI-related inflows expected to decline, the large fiscal surpluses seen recently will diminish, and this would lead to new fiscal vulnerabilities if the authorities do not undertake additional reforms.

6. **There remains a significant post-program agenda to ensure the Federation's ongoing resilience and competitiveness.** This agenda includes (i) ensuring fiscal discipline through maintaining a suitable structural non-CBI primary balance while prudently managing windfalls; and (ii) structural reforms to boost the private sector's contribution to the economy to raise growth and competitiveness. While more could have likely been done to save and manage windfalls during the

[3] See International Monetary Fund, 2014, "Sustaining Long-Run Growth and Macroeconomic Stability In Low-Income Countries—The Role of Structural Transformation and Diversification," IMF Policy Paper (International Monetary Fund: Washington, DC).

[4] The report for the 2011 Article IV consultation (and program request) placed the extent of overvaluation of the real effective exchange rate, which mainly reflected wage pressures, between 13 and 17 percent.

program, the structural agenda was appropriately focused on fiscal and public sector reforms important to achieve program objectives. Going forward, it will be important to make progress on the real sector reform agenda since the payoffs, which will be broad-based, will take time to materialize.

7. **This paper presents an Ex Post Evaluation of the 2011–14 Stand-by Arrangement** and is organized as follows. The next section outlines an assessment of the program's objectives followed by a discussion of its key outcomes. The evaluation then seeks to assess whether key design elements were appropriate to ensure the program's objectives were met, and whether Fund policies were appropriately applied. The paper concludes by outlining some lessons from this program, both for the Fund's ongoing relationship with St. Kitts and Nevis as well as for IMF program design and execution more generally.

8. **The authorities broadly agreed with the main findings of the Ex Post Evaluation.** Appendix 1 presents the authorities' reactions to this evaluation and the program experience in general. The authorities agreed with the broad conclusions of the evaluation, and emphasized that the program's design was broadly appropriate, correctly identifying and focusing on the critical macroeconomic priorities. They saw the return to stability and the debt restructuring, including the land-debt swap, as major achievements, and noted that the Banking Sector Reserve Fund had served as a valuable safety net. They recognized the positive impact of the Fund's engagement on the successful implementation of their home-grown program, but that additional efforts in capacity building at all levels of the Federation would have been beneficial. They felt the prospects for success under the SBA were good even without the unanticipated rise in Citizenship-by-Investment revenues. They look forward to further engagement to support entrepreneurship and long-term sustainable growth, and noted that careful management of the country's sovereign wealth from CBI inflows was also a priority.

THE 2011–14 STAND-BY ARRANGEMENT

A. Program Strategy and Implementation

9. **Given the origin of the crisis, the program appropriately focused on restoring sustainability and a stronger financial sector.** Specifically, it had three objectives: (i) an ambitious medium-term fiscal consolidation; (ii) a comprehensive debt restructuring to address the debt overhang; and (iii) further strengthening the financial sector. In meeting these objectives, the authorities intended to implement structural measures to underpin the fiscal effort and boost confidence in private sector investment. There was limited focus on improving the investment climate in the program given focus on the near-term crisis resolution, and the prospect that addressing the debt overhang and ensuring the strength of the financial system may also help improve growth and competitiveness indirectly. Finally, the program was designed around quarterly reviews, reflecting the need for close monitoring given concerns over implementation capacity.

10. Conditionality was focused around the three objectives. In particular, action ahead of the program request and prior actions revolved around strengthening the fiscal position, the preconditions for the debt restructuring and arrears monitoring, and agreeing with the ECCB arrangements to manage the Banking Sector of Reserve Fund (BSRF) designed to mitigate potential liquidity pressure on banks (Table 1). Quantitative Performance Criteria (PCs) were focused on the central government fiscal balance, external short-term debt, and domestic and external arrears, and the vast majority were met (Table 2). The fiscal balance targets were adjusted in an asymmetric way for grants above or arrears clearance below expectation, and for lower than expected grants or financial sector recapitalization needs, with the latter two adjustors capped. The fiscal program was exceptionally front-loaded, with a primary surplus of 5 percent in 2011 (following a ½ percent of GDP primary deficit in 2010), and targets of 5.4 and 6.4 percent in 2012 and 2013, respectively. Primary surpluses were assumed to decline slightly from 2014 onwards. The structural agenda (Table 3) focused on:

Table 1. Actions Taken by Authorities Prior to Start of SBA

Home-grown program	Date Implemented
Implemented a freeze on public sector hiring and salary increments.	July 2010
Strengthened auditing and monitoring of duty free shops.	mid-2010
Increased fees for the CBI program.	mid-2010
Introduced environmental levy on new vehicles.	mid-2011
The bill to corporatize the Electricity Department submitted to parliament	April 2011
Implemented a VAT	Nov. 2010
Announced an increase 80 percent increase in electricity tariffs, which was implemented in early 2011	early-2011
Program prior actions	
Authorities commit publicly to undertake a debt restructuring	
Appointment of legal advisors for the due diligence on the existing debt contracts	
Take stock of, and put in place a framework to monitor on a regular basis, expenditure payment arrears	
Agreement between the authorities and the ECCB on the modalities of the Banking Sector Reserve Fund	

Source: IMF staff calculations.

11. Fiscal and Public Sector Reforms. There was an ambitious agenda supported by technical assistance provided by the Fund, the World Bank, and other donors.

- *Facilitation of the debt restructuring*: registration and valuation of land intended for the debt restructuring, establishment of an asset management company for this land, and early creditor consultation.
- *Public financial management*: corporatization of the electricity department; rationalization of the LPG subsidies; reform of the procurement act.
- *Social Safety net*: actuarial review of the Social Security Scheme, and proposal for comprehensive pension reform, and reform proposal the social safety net.
- *Public enterprise reform*: review of the borrowing capacity of public enterprises, and a rationalization of the public land sales and development agencies.
- *Civil service reforms*: Reform plan covering human resources, and a review of the organization and structure of the civil service and wage and payroll management.

- **Medium-term fiscal reforms**: establishment of a medium-term expenditure framework, development of a medium term Debt Management Strategy.

- **Financial sector reforms**: update stress tests of the banks.

Table 2. St. Kitts and Nevis: Quantitative Performance Criteria and Indicative

	2011		2012			2013				2014
	End-Sept.	End-Dec.	End-Mar.	End-Jun.	End-Dec.	End-Mar.	End-Jun.	End-Sep.	End-Dec.	End-Mar. 1/
Performance Criteria:										
Central government overall balance including grants (floor) 2/	√	√	√	√	√	√	√	√	√	√
Stock of central government budget expenditure arrears accumulation (ceiling) 3/	√	√	√	√	√	√	√	√	√	√
Stock of external short term debt (ceiling)	√	√	√	√	√	√	√	√	√	√
Central government or guaranteed external arrears accumulation (ceiling) 4/	√	√	√	√	X	X	√	X	X	X
Indicative Target:										
Central government primary balance (floor) 2/	√	√	√	√	√	√	√	√	√	√

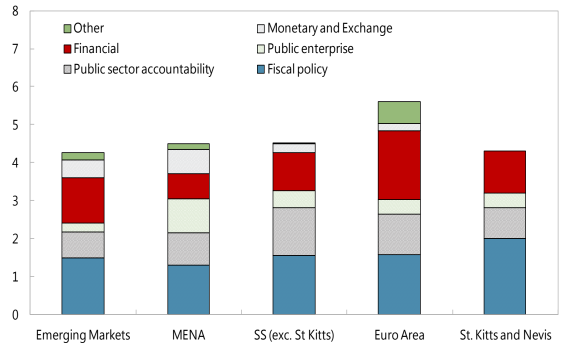
Sources: St. Kitts and Nevis authorities; and IMF staff estimates.
√ means PC was met
X means PC was not met
1/ For the purpose of the 9th Review the controlling PCs are the end-March 2014 PCs.
2/ Cumulative within each calendar year.
3/ Including the estimated stock of expenditure payable on electricity.
4/ To be monitored on a continuous basis.

12. **Compared with other recent (post-2008) programs, structural conditionality was focused on fiscal reforms and front-loaded** (Figures 3 and 4). This partly reflects that its monetary arrangements (member of the ECCU) meant no access to monetary or exchange rate instruments. The financial sector conditionality was limited to a benchmark requiring quarterly stress testing of the banks by the ECCB. Conditionality was heavily frontloaded, reflecting the need to establish the preconditions for the debt restructuring early on, and in line with the front-loading of access. There was also formal conditionality on procurement and public enterprise reform.

13. **During the program there was no change in the scope of conditionality.** Two critical refinements to the quantitative conditionality (in the form of adjustors) were made late in the program to protect capital spending (for the last three reviews) and to save CBI-related windfalls (for the last review). On the structural front, reforms to revenue administration were added, as were the implementation of regulations to the Procurement and Contract (Administration) Act and the Civil Service Act, and reforms to the oversight of public enterprises, while the bank stress tests were made quarterly. One reform measure—liberalization of the retail sector in St. Kitts by closing the government Supply Office—was addressed as a MEFP commitment.

Figure 3.Number of PAs, SBs, SPCs

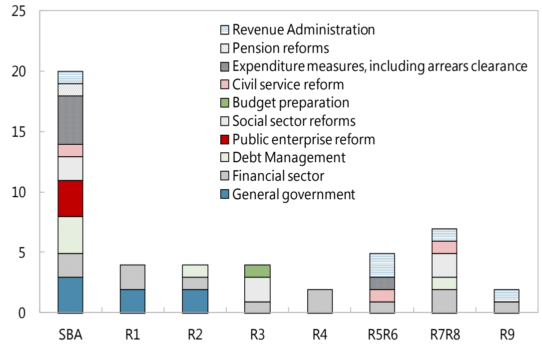
(per review by sector and region)



Source: IMF staff estimates

Figure 4. Number of Conditions by Review

(structural benchmarks and prior actions)



Source: IMF staff estimates.

B. Size and Scope

14. The program was front-loaded with exceptional access. Fund financing was SDR 52.51 million ($84 million or 590 percent of quota). While overall access was lower than the cumulative exceptional access threshold (of 600 percent of quota), the significant frontloading, with access of around 450 percent of quota in the first year (relative to a threshold of 200 percent)—over 75 percent of the total access—made the access request exceptional. While access was around the median share of quota for post-2008 programs, relative to GDP—a better assessment of the risks in a small economy like St. Kitts and Nevis—access was in the largest 5 programs. At over 40 percent, the first disbursement was the second largest share of overall access of any post-2008 program.

Figure 5. Access

(percent of GDP)

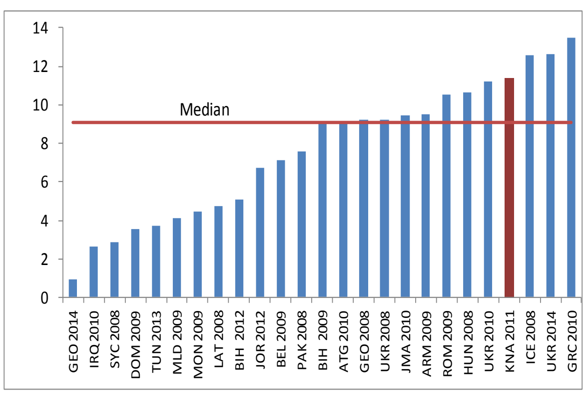
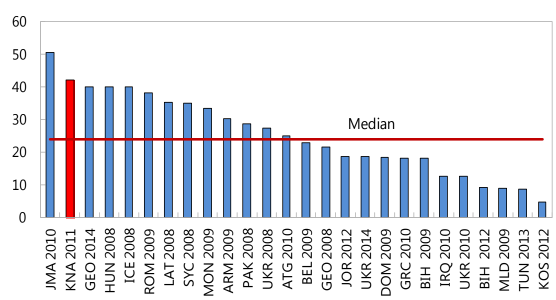


Figure 6. First Purchase Disbursement

(percent of access)



Sources: MONA database and IMF staff estimates.

1/ Program was originally for 2 years .

2/ Program was originally for 1.5 years.

Table 3. St. Kitts and Nevis: Structural Benchmarks

Action	Target Date	Objectives	Status
I. Fiscal and Public Sector Reforms			
Revenue Administration			
Submit to Parliament the new Customs Law	End-May 2014	Strengthen revenue administration	delayed, **new prior action**
Establish and operationalize a unit dedicated to program design, planning and monitoring in the Inland Revenue.	End-September 2013	Strengthen revenue administration	completed
Public financial management			
Submit the bill for the corporatization of the Electricity Department to Parliament	End-September 2011	Strengthen institutional framework	completed
Make Substantial Progress on the consultative phase of restructuring with creditors	End-September 2011	Strengthen public financial management	completed
Review borrowing capacity of public enterprises	End-December 2011	Strengthen public financial management	completed
Submit to Cabinet proposal to rationalize the subsidy on liquefied petroleum gas (LPG)	End-March 2012	Streamline social safety net	completed
Update the registry of at least 600 acres of land	End-September 2011	Strengthen public financial management	completed
Undertake valuation of at least 600 acres of land	End-September 2011	Strengthen public financial management	completed
Update the registry of additional 600 acres of land	End-June 2012	Strengthen public financial management	completed
Undertake valuation of additional 600 acres of land	End-June 2012	Strengthen public financial management	completed
Submit draft of new Procurement Act to Parliament	End-June 2012	Strengthen institutional framework	completed
Draft proposal for the establishment of an asset management company	End-June 2012	Strengthen public financial management	completed
Develop an explicit medium-term debt management strategy that takes account of the cost-risk tradeoff of alternative financing options, within the context of the overall macroeconomic environment	To accompany the 2013 budget	Improve medium-term orientation of the budget	completed
Establish a medium-term expenditure framework with agreed fiscal targets	End-June 2012	Improve medium-term orientation of the budget	completed
Finalize the implementing regulations to the Procurement and Contract (Administration) Act	End-December 2013	Strengthen public financial management	delayed
Civil service reform			
Cabinet to approve a plan for civil service reform covering human resource policy, reviewing the organization and structure of the civil service and addressing wage policy and payroll management	End-June 2012	Strengthen public financial management	completed
Operationalize the implementing regulations of the 2011 Civil Service Act (pertaining to recruiting, discipline, promotion, and standing orders) by amending the general orders accordingly	End-June 2014	Strengthen public financial management	completed
Social Security Reform			
Actuarial review of the Social Security Scheme.	End-December 2012	Strengthen public financial management	met with delay in May 2013
Draft proposal for a comprehensive pension reform	End-June 2013	Strengthen public financial management	delayed
Public enterprise reform			
Rationalize public land sales and development agencies	End-September 2012	Strengthen public financial management	met with delay October 5, 2012
Include in the Finance Administration Act provisions recognizing the Government Entities Oversight Board and strengthening its enforcement authority	End-March 2013	Strengthen public financial management	met with delay in July 2013
Strengthen social safety net			
Submit social safety net reform strategy to Cabinet	End-March 2012	Streamline social safety nets	completed
Develop method for the proxy means testing for the eligibility criteria of the planned consolidated cash transfer program	End-December 2013	Streamline social safety nets	delayed
II. Financial Sector Reforms			
Update the existing stress tests of banks	To be monitored on a quarterly basis	Financial sector stability	completed

Source: St. Kitts and Nevis authorities.

[1/] New target dates refer to the authorities' own reform schedule and do not represent conditionality beyond the program expiration date.

15. Overall access reflected the expected financing gap (after restructuring) of $84 million resulting from the fall in domestic demand and external financing, including $17.1 million to create the BSRF. The underlying case for this access level was sensible, and reflected the absence of the other funding partners, while the programmed size of the BSRF was explained by an assumed loss of 15 percent of deposits less the net liquid assets of the indigenous banking system.

16. The treatment of debt restructuring differs across IMF program documents (Table 4), although **in several other cases the extent of the financing gap expected to be covered by restructuring is clearer.**

PROGRAM OUTCOMES

A. Macroeconomic Outcomes

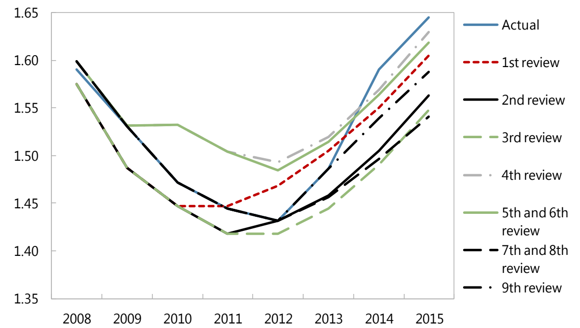
17. The economic downturn was longer and more severe than anticipated and the recovery, when it came, was stronger. Following negative growth in 2009 and 2010, the program was predicated on a V-shaped recovery from its very start. This was optimistic given recent experience in other restructuring cases (Figure 8) where growth had taken longer to recover. In the end, the downturn lasted four years instead of two. For 2011, 2012 and 2013, growth was revised down across reviews and the initial estimates for 2011 and 2012 were worse than expected. In 2013 the outcome was better than expected reflecting the combined impact of the trading partner recovery, CBI-related inflows, and stronger public capital spending.

18. Frequent changes to expectations of both trading partner demand and capital spending were key to the revisions of the overall growth picture.

- *External demand*. The protracted slowdown in both Europe and US led to revisions to the outlook, although not all the revisions occurred in a consistent way (Figure 9). In particular, the Federation's 2012 and 2013 growth was initially only revised downwards slightly at the time of the first (and fourth review for 2013 growth rate), despite significant downward revisions to trading partner growth. The revision in the second review boosting the 2014 growth outlook is also hard to reconcile with the deteriorating outlook for trading partners, suggesting optimistic expectations for domestic demand. Revisions in the Fourth review reflected three large FDI projects.

- *Domestic demand*. Domestic demand recovered more slowly than anticipated at the time the program request. The lower growth largely reflected a significant underperformance in public investment spending, with both private and public consumption having more modest underperformance than investment, and private consumption recovering quickly towards the end of the program, possibly reflecting the influx of CBI flows (Figures 10 and 11).

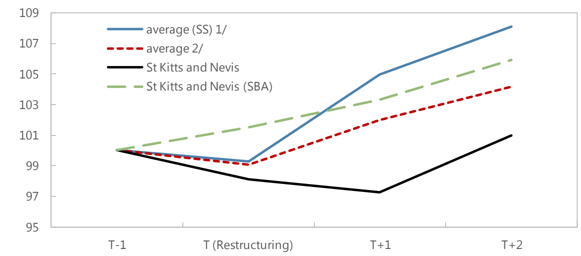
Figure 7. Real GDP Level



Source: IMF staff estimates.

Figure 8. Real GDP Level Surrounding Debt Restructuring

(before restructuring=100)



Source: IMF Staff estimates.
1/ Includes Dominican Republic, Grenada, Jamaica, and Seychelles.
2/ IncludesDominican Republic, Ecuador, Greece, Grenada, Jamaica,

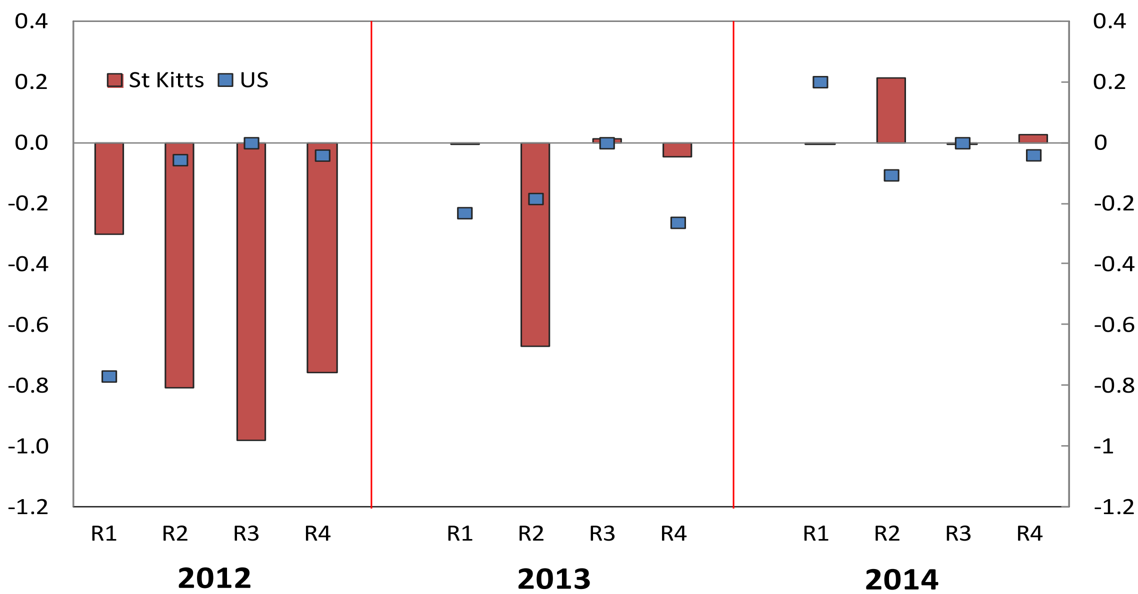
Table 4. Treatment of Debt Restructurings in Fund Program Documents

Country	Date of Arrangement	Discussion at Program Request
Argentina	2003	The financing gap is included in the fiscal table, indicating that it "will be eliminated by debt restructuring or other means."
Cote d'Ivoire	2009	The financing gap is included in the fiscal table showing detailed expected sources of financing (e.g., arrears restructuring and current maturities restructuring from Paris Club and London Club).
Dominican Republic	2005	The financing gap is included in the fiscal table with detailed expected sources of financing (e.g., external commercial bank restructuring, external bond restructuring, and possible Paris IV debt relief).
Grenada	2006	The DSA program scenario assumes that eligible commercial creditors that did not participate in the recent debt restructuring will settle their claims in 2006 on the same terms as the recent debt exchange. In addition, it is assumed that Paris Club debt will be rescheduled on the basis of Houston terms and that the bilateral debt to Taiwan Province of China is restructured on terms comparable to those of the commercial debt exchange.
Rwanda	2002	The PRGT request has explicit assumptions on forgiving arrears (domestic and external) but does not indicate how the remaining financing gap will be covered. The fourth review discusses the financing gap but does not explicitly indicate how much it will be financed by "additional bilateral relief" and "debt relief by Rwanda's non-Paris Club creditors."
Seychelles	2008	In fiscal table and DSA the financing gap is discussed together with recommendations for a comprehensive official and private debt restructuring to close the gap. However, no specific decomposition is provided.
St. Kitts and Nevis	**2011**	**The fiscal table reports the financing gap that is not covered by IMF lending but does not indicate how much should be financed by debt restructuring**
Ukraine	2015	The fiscal Table explicitly shows what should be the planned "debt operation."

Source: IMF staff estimates.

Figure 9. Change in 2012–14 Growth Forecast by Review[1/]

(percentage point)

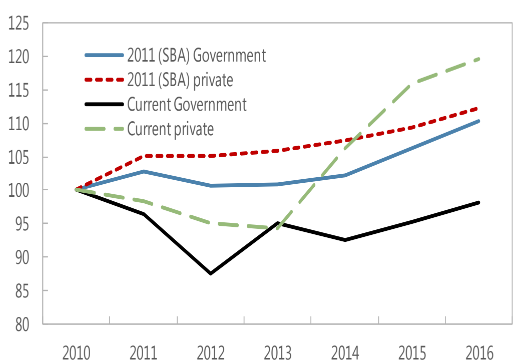


Source: IMF staff calculations.

[1/] For each review, the chart shows the change in growth for each year, relative to the previous review.

Figure 10. Real Consumption[1/]

(2010=100)

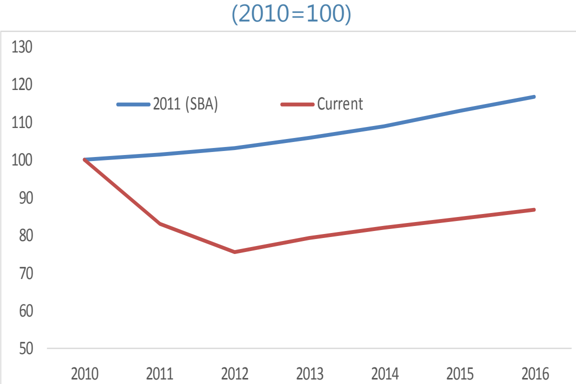


Source: IMF Staff estimates.

1/ All series deflated by GDP deflator.

Figure 11. Real Investment[1/]

(2010=100)



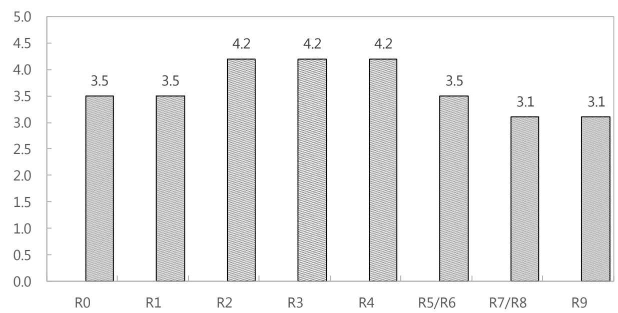
Source: IMF Staff estimates.

1/ All series deflated by GDP deflator.

19. Medium-term growth was also revised considerably, ranging from 3½–4¼ percent during the program, leading to fluctuations in debt dynamics. The upward revisions in potential growth occurred while actual growth disappointed and, together with changing interest rates, improved the projected debt sustainability picture during the program. Through the Fourth review, the estimated debt stabilizing primary balance declined continuously. Only in the Fifth review, when potential growth had been downgraded by ¾ percentage point did growth issues received more attention. Since the program ended, medium-term growth expectations were further revised to 2.5 percent (2015 Article IV), a large revision compared with revisions elsewhere—reflecting a better understanding of potential growth given the risks from lower CBI inflows and natural disasters.

Potential Growth Rate

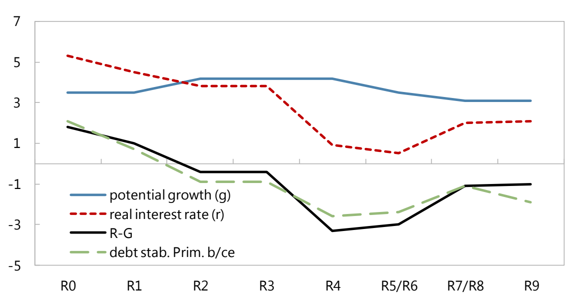
(Percent)



Source: IMF staff estimates.

Figure 12. Debt Sustainability Indicators[1/]

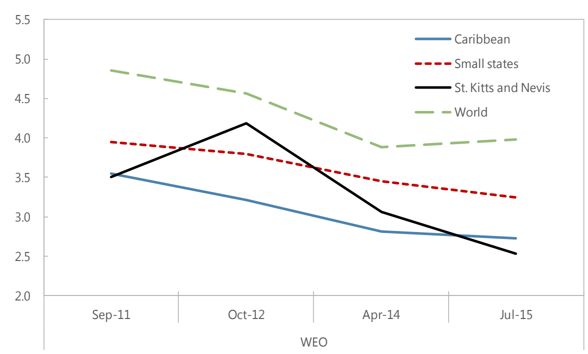
(percent)



Source: IMF staff estimates.

1/ The team took the interest rate asssumptions as given.

Figure 13. Revisions in Potential Growth Rate



Source: IMF staff estimates.

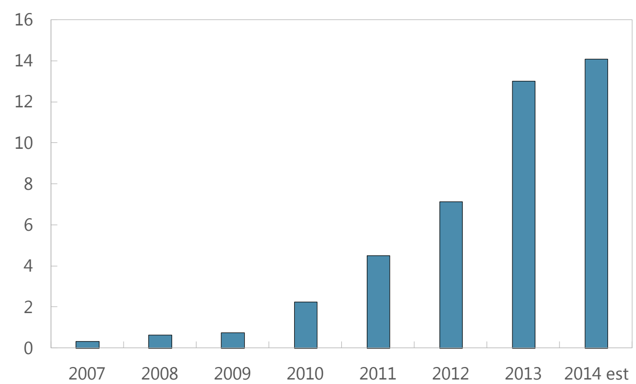
B. Fiscal Outcomes

20. There was a dramatic improvement in the headline fiscal position under the program, and program fiscal targets were met. The overall program strategy was to raise core tax revenue, and accommodate a modest increase in capital spending through current expenditure restraint. As noted above, many critical fiscal revenue reforms were introduced ahead of program commencement (Table 1). These contributed significantly to revenue—the VAT, which raised revenue from domestic goods and consumption by more than 6 ppts on average during 2011–14. However, taxes on income and international trade fell slightly, in part reflecting the ongoing importance of exemptions. Non-tax revenue, especially from the government's CBI program, contributed significantly more revenue than anticipated. On the expenditure side, the authorities committed to undertake expenditure measures in 2012 and 2013, while partially protecting capital spending. Specific measures noted were the freeze of the nominal wage bill and containment of goods and service spending through the program period, as well as a broad-based reform to rationalize the public-sector wage structure and employment.

21. The underlying fiscal position improved by less than the headline, and softened again at the end of the program. The important contribution made by CBI-related revenue (on top of the impact of revenue reforms) meant that the fiscal targets could be met (and exceeded) despite little change in the underlying primary position (excluding grants and CBI) over the program. While much of the unexpected rise in CBI inflows was saved (cumulatively around 40 percent of GDP), the additional space provided by the flows allowed less underlying adjustment than anticipated and seen in other recent programs (Figure 14). Despite revenue reforms, core tax revenue also under-performed reflecting shortfalls in GDP relative to program projections, particularly in 2011 and 2012, and exemptions (which were extended for cyclical reasons in 2012). Under-execution of capital spending early in the program also helped ensure that program targets were met. Goods and services spending tended to come in above expectations, although the wage freeze in 2010–12 contributed importantly to the progress achieved. Spending (both capital and current) was loosened in 2013 reflecting a desire to lift growth after the long recession and given the anticipated output gap. Prior to this, the central government had been unable to fully execute its investment plans (capital budget) and the Nevis Island Administration (NIA) faced financing constraints. In 2013, extraordinary financing for capital spending from CBI receipts to the SIDF (through grants of 2 percent of GDP) assisted in reversing the under-execution of capital spending. This lower level of adjustment poses a longer-run risk if CBI-related revenues decline in future—in which case additional underlying fiscal adjustment would be necessary.

Direct CBI Revenue

(in percent of GDP)

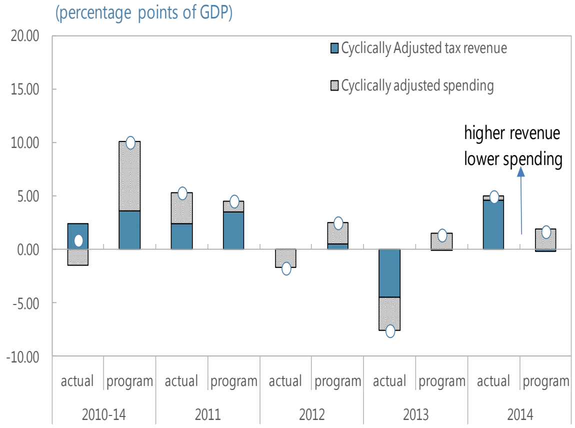


Sources: St. Kitts and Nevis authorities; and staff estimates.

Figure 14. Fiscal Developments

Excluding non-tax revenue, underlying adjustment was less than under the program…

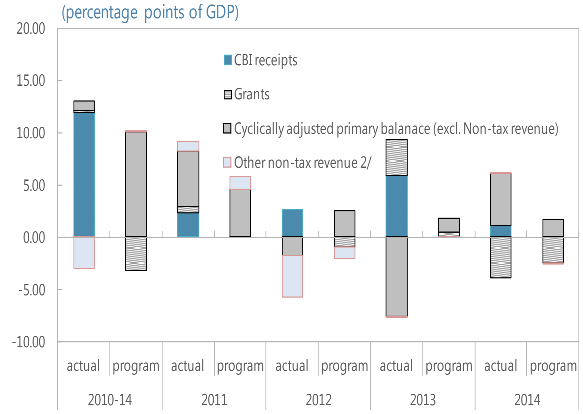
Change in Cyclically Adjusted primary balance [1/]
(percentage points of GDP)



Source: IMF staff estimates.
1/ Excludes grants and non-tax

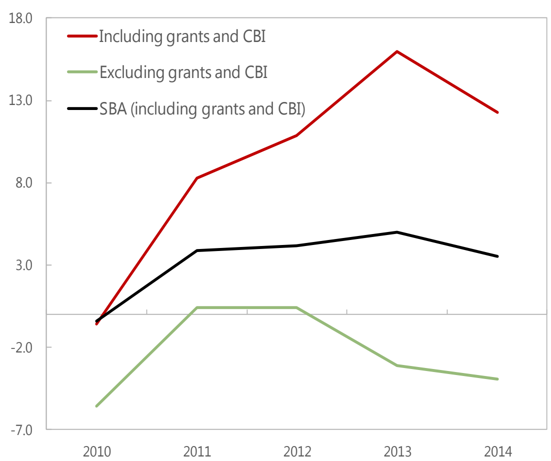
…although non-tax revenue, especially from the CBI revenue "surprise," overperformed significantly.

Change in Cyclically Adjusted primary balance[1], Grants and CBI Receipts
(percentage points of GDP)



Source: IMF staff estimates.
1/ / Excludes grants and non-tax revenue.
2/ The decline in 2012 relates to corporatization of the electricity department.

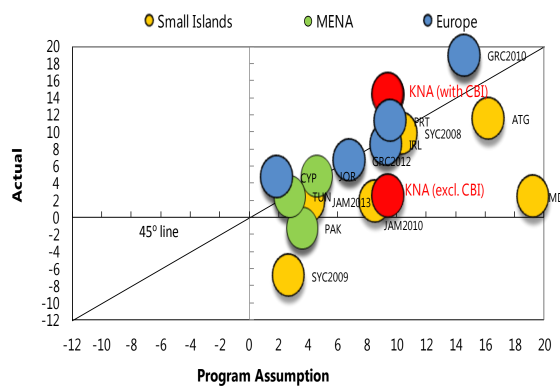
The headline primary balance improvement out-paced program goals. The underlying balance changed little, …



Source: IMF staff calculations.

…and less than in other recent programs.

Change in Cyc Adj. Primary Balance
(percent of GDP), P-1 to P+3



Source: IMF staff estimates.

22. The SIDF, legally a non-government entity, engaged in quasi-fiscal activity at times, particularly in 2013–14. In addition to the public investment grant it provided the budget in 2013, the SIDF undertook considerable quasi-fiscal spending in 2013 and 2014 including public employment programs, electricity subsidies, and loan subsidies (totaling around 2½ percent of GDP in 2013). The quasi-fiscal spending by the SIDF and the loosening of the wage spending (including the payment of the 13th month of salary) undermined overall adjustment. Even though envisioned as temporary, these measures present longer-term risks given the general difficulty in reversing current spending. Unification of the fiscal accounts (incorporation of off-budget activity with the budget), could help ensure the end of the procyclical bias as well as that priority items are financed.[5]

23. The NIA had repeated financing problems, which affected its ability to implement capital spending. In particular, arrears to foreign creditors were incurred at multiple reviews. Although each occurrence was small and temporary (one resulting from a fire at the Treasury building), they suggest broader issues with cash management. Such problems affected implementation of its capital spending program in 2012, and point to the need to strengthen cash management and broader public financial management capacity in the NIA and for greater cooperation between the federation partners. The program could have provided a good setting in which to improve performance in these areas.[6]

24. The inability to spend the capital budget likely harmed both near-term and longer term growth. The low fiscal multipliers associated with small open economies like St. Kitts and Nevis, suggesting the fiscal adjustment had little impact on overall growth over the program period (Figure 15).[7] Given this, the loosening of the fiscal targets (for current spending) at the time of the first and third reviews presumably had only a moderate impact on the economy (with slower than envisioned actual growth in both years). Ensuring that the capital budget in 2011 and 2012 was spent on high priority projects should have raised near-term growth substantially given the estimated 0.6 percent multiplier from capital spending (Figure 16), as well as in the medium-term given the country's modest stock of public capital, which, while above the level seen in much of the region, falls below other emerging markets (Figures 17 and 18).[8] The program could thus have included greater focus on protecting capital spending and ensuring that fiscal institutions were able to implement it.[9]

[5] Bova, Elva, Nathalie Carcenac, and Martine Guerguil, 2014, "Fiscal Rules and the Procyclicality of Fiscal Policy in the Developing World," IMF Working Paper 14/122 (International Monetary Fund: Washington, DC).

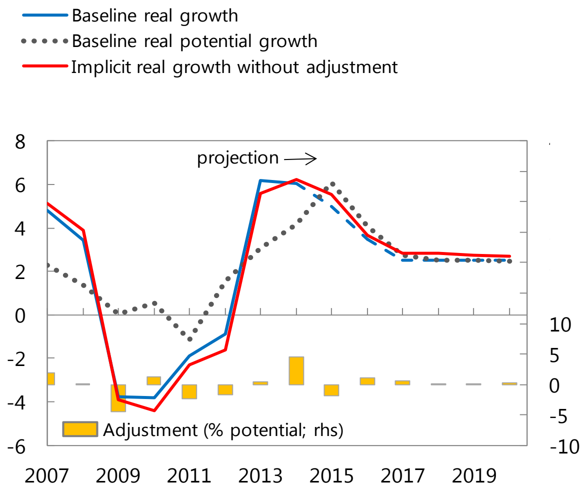
[6] CARTAC TA was provided to the NIA during the program.

[7] Estimates of the recurrent expenditure multiplier is statistically not different from zero, while that for capital expenditure is approximately 0.6. See Chapter 8, in IMF, 2013, "The Eastern Caribbean Economic and Currency Union: Macroeconomic and Financial Systems" (International Monetary Fund: Washington, DC.) The projection line in Figure 19 is constructed by assuming capital and current spending were as initially expected and growth adjusted by the relevant multiplier.

[8] The real per capita public capita stock (2005 PPP terms) in 2013 was $6,400 in St. Kitts compared with $8,300 in emerging markets and $4,880 in Caribbean small island states (IMF, 2015, Making Public Investment More Efficient).

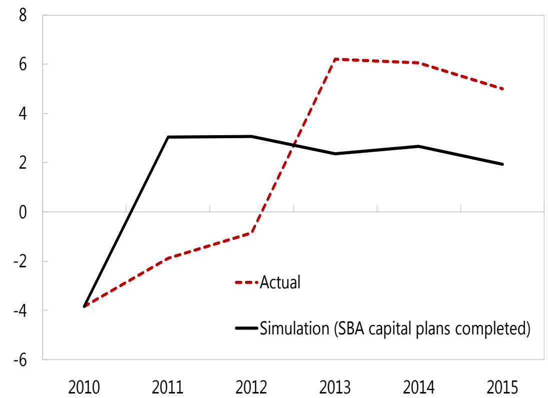
[9] See the June 2015 IMF policy paper Making Public Investment More Efficient. After the program, St. Kitts and Nevis is in a better position in terms of the availability of financing and management of SOEs, although several of the institutional areas identified as important in this paper, such as central-local coordination, budget comprehensiveness, project appraisal, and transparency remains to be strengthened.

Figure 15. Real GDP Growth
(in percent)



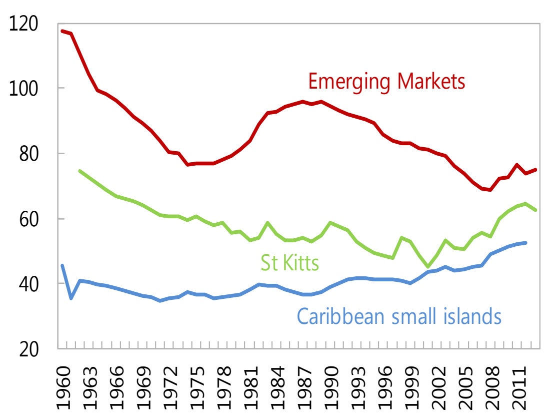
Source: IMF staff calculations

Figure 16. Actual and Multiplier-derived Real GDP Growth
(in percent)



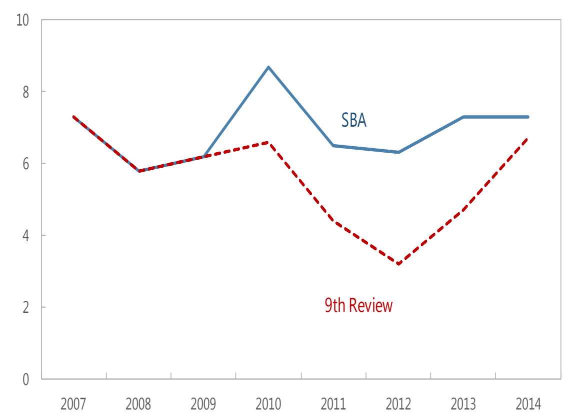
Source: Fund staff calculations
The simulated path is based on multipliers from Gonzalez-Garcia et al. (2013) - "Fiscal Multipliers in the ECCU".

Figure 17. Public Capital Stock
(percent of GDP)



Source: I MF staff estimates.

Figure 18. Public Capital Expenditure
(share of GDP)



Sourc e: IMF staff estimates.

25. Important parts of the fiscal-structural agenda remain incomplete partly because of capacity constraints. These included the completion of civil service reforms, the development of a method for proxy means testing for a cash transfer program, the implementation of regulations for the new Procurement and Contract (Administration) Act, and a proposal for a comprehensive pension reform. Initial steps for the first issue were put in place under the program, but the agenda was not complete. The delays were all linked to exogenous events (either delayed donor-provided assistance or region-wide initiatives).

C. Debt Restructuring

26. St. Kitts and Nevis was known to have unsustainable debt long before the program. The Fund recognized the Federations' public debt as unsustainable in 2006, and the program appropriately took the need for restructuring as a precondition (Box 2). The program included prior actions requiring commitment to the restructuring and steps to facilitate significant progress in creditor consultation by the first review.

27. The debt restructuring had a significant impact on St. Kitts and Nevis' debt stocks and flows, although financing needs remained elevated. By end-2014, total public sector debt stood at 79 percent of GDP, which had been reduced by 56 percentage points on account of the restructuring, one of the largest in recent times. Domestic debt fell 49 percentage points, reflecting mainly the debt-land swap (41 percentage points), while external debt dropped 7 percentage points primarily because of the debt exchange (and external amortization decreases by 7.5 percent of GDP over 2012–20). Short-term debt was reduced from around 40 percent of GDP ahead of the restructuring to close to 15 percent at end-2014. While debt service was reduced, gross financing needs are anticipated to remain above the 15 percent of GDP percent risk threshold incorporated in the Fund's DSA for market access countries despite the reduction in short-term debt.[10]

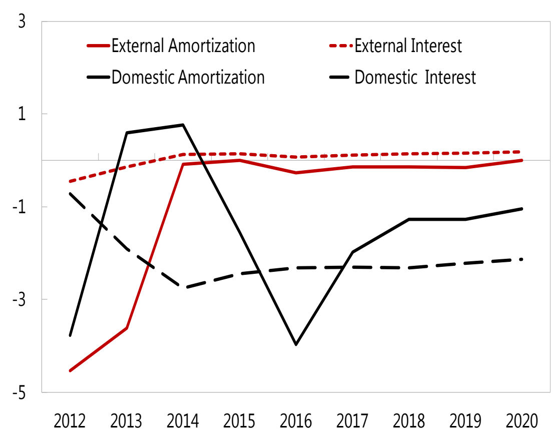
28. The debt exchange for commercial creditors was executed within reasonable time although restructuring the domestic debt took much longer. It took 10 months to complete the debt exchange from the announcement of intent to restructure in June 2011, roughly the average time taken by countries which undergo a debt exchange. However, the land-debt swap took almost 16 months before the first tranche of land was transferred to an SPV to be disposed of on behalf of

[10] The importance of gross financing needs was emphasized in IMF, 2011, Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis (International Monetary Fund: Washington, DC). In terms of treatment in the St. Kitts and Nevis staff reports, staff does not project changes in government holdings of short-term debt (mostly in the form of 91 day Treasury bills); however the issue of high short-term debt was discussed with the authorities in the 2015 Article IV consultation.

domestic creditors, and the entire exchange remained incomplete at the end of the program. This delay mainly reflected limited domestic capacity in terms of setting up the land sales company (the SPV). A motion of no confidence was also filed by the opposition against the government in the context of the land-debt swap.

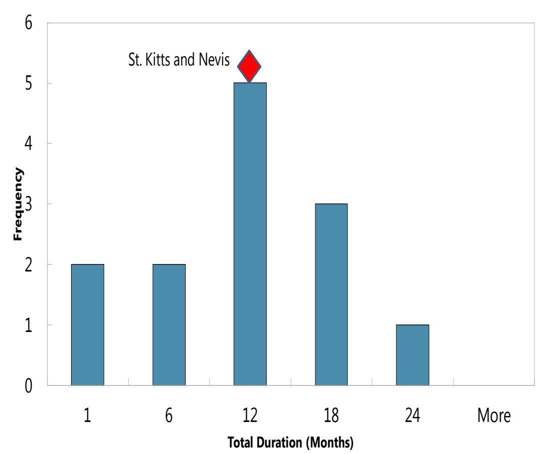
29. The second-stage land-debt swap was an innovative use of the government's balance sheet, although was not equivalent to earlier proposals. The land-debt swap reduced both the government's debt as well as the financial system's exposure to the government. However, it meant that banks continued to hold a relatively illiquid asset (land).[11] An earlier proposal, which had also been mooted in the Fund's 2009 Debt Management TA report, had been for the government to sell the land, allowing the government to provide a liquid asset to the banks. During the program there was concern about the impact of the land-debt swap on banks' income,[12] but the implication of illiquidity for banks' operations received less attention. Another important concern is that banks have no direct ability to divest the land. It is important that the process of land sales are completed to ensure the benefits of the debt reduction are preserved and are fully felt by the banks despite a new government—which had campaigned against the swap—being in power now.

Debt Service: Impact of Restructuring
(in percent of GDP)



Sources: St. Kitts and Nevis authorities; and Fund Staff estimates

Time Taken to Complete Debt Exchange[1/]



Source: IMF staff
1/ data covers 13 cases of debt exchange.

[11] As mentioned above, the land was held in a special purpose vehicle (SPV), which was responsible for its timely disposal.

[12] This concern was addressed by a fixed 3.5 percent dividend based on the value of unsold land in the SPV.

D. Financial Sector Outcomes

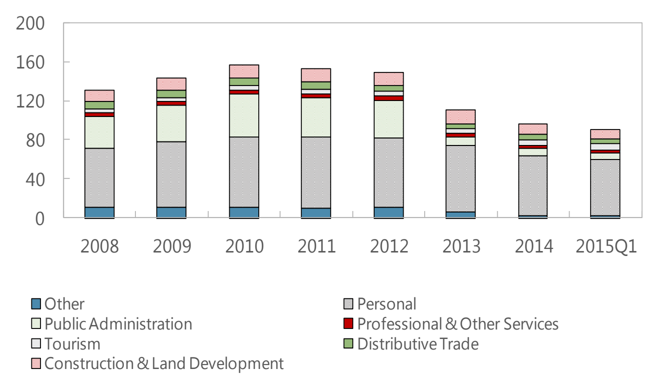
30. Strengthening the financial system was a key objective of the program. This reflected concerns over the impact of the debt restructuring on banks, in terms of liquidity, profitability and capitalization. Indeed, there was considerable concern that the restructuring could lead to a dramatic loss of deposits from the system, and the BSRF was created to address such a risk.

31. Two major events shaped developments in the financial system during the program: (i) the debt restructuring; and (ii) the influx of liquidity due to the rise in CBI program participation. These two factors left local banks weaker in terms of capitalization, the quality of assets, and profitability, although the debt restructuring was always expected to have an adverse impact on key financial soundness indicators (Figure 19). Despite the land-debt swap, liquidity improved due to the surge in CBI inflows and resulted in a dramatic rise in mostly government deposits. In the end, there was no use of the BSRF and liquidity was not an issue. St. Kitts and Nevis' banks remain amongst the strongest in the region and with key indicators above regulatory thresholds.

32. Despite the restructuring, which cleaned bank balance sheets, and the CBI-related rise in liquidity, credit to the private sector did not restart. The restructuring led to a large reduction in the credit to the government, but the additional space in banks' balance sheets, including that created by additional deposits, did not lead to an increase in lending to other sectors, even as they recovered in 2013–14.

Banking Sector Credit

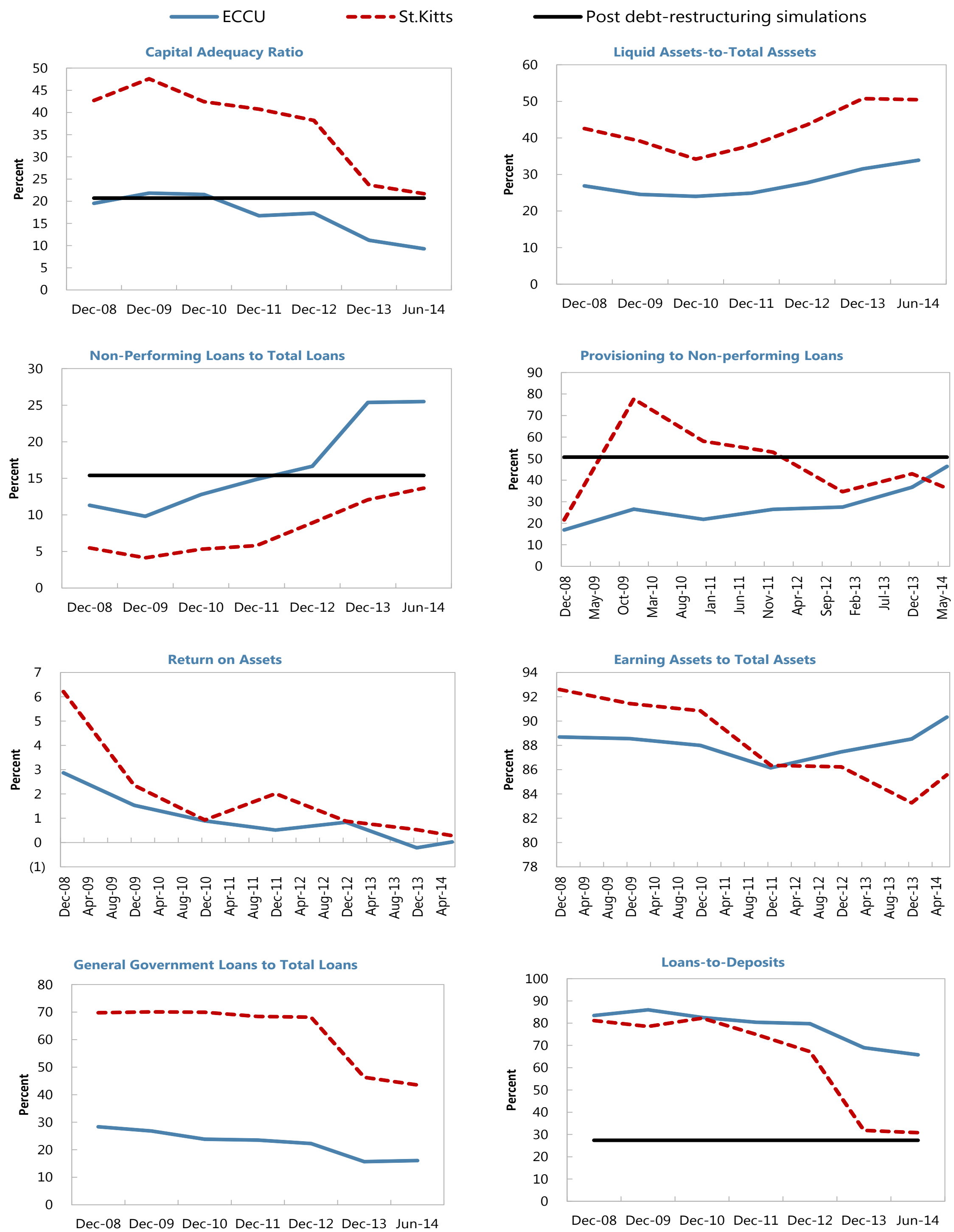
(in percent of GDP)



Source: IMF staff estimates.

33. To provide assurance the financial sector was not in jeopardy as a result of the restructuring, the program included benchmarks on quarterly stress tests. Interestingly, this was a commitment by the authorities but implemented by the ECCB (based on an agreement to undertake the regular stress tests). The initial stress tests were important to provide assurance the restructuring had not adversely affected the financial system more than expected. However, while close monitoring of key indicators the situation was warranted, it is not clear that quarterly stress tests were needed, given little is likely to change within a quarter The authorities and the ECCB agreed that less frequent stress test would have been sufficient.

Figure 19. Financial Soundness Indicators



Sources: ECCB; and IMF staff estimates.

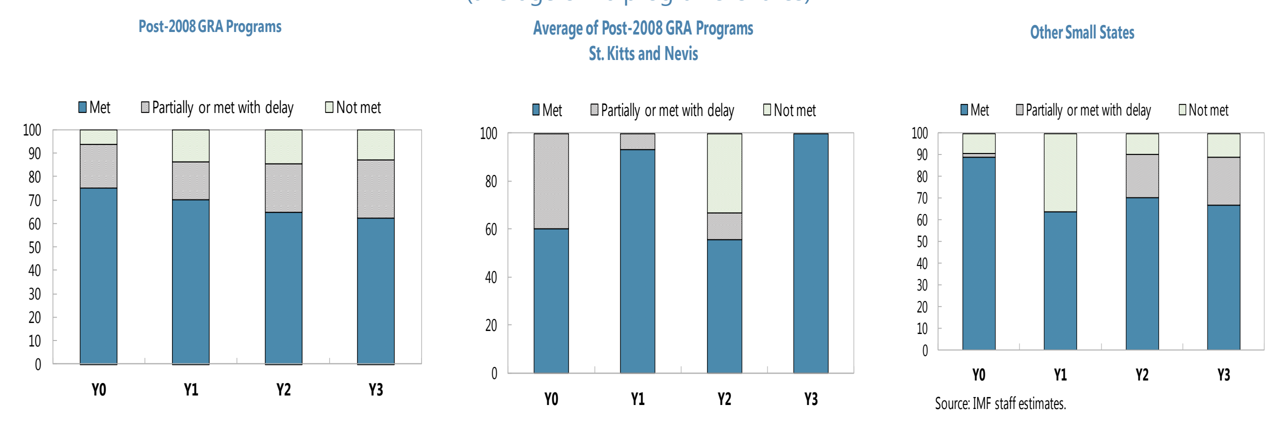
E. Structural Issues

34. The program strategy targeted the macro critical issues of sustainability and financial stability. These efforts should have reduced the drag from the fiscal and encumbered financial system on the private sector and the national risk premium. The program also sought to improve the efficiency of revenue collection and reduce the distortionary impact of tax exemptions. In addition, while not the explicit focus of the program, the program addressed the following issues: (i) deregulation of "retail" sector on St. Kitts through the closing of the government supply store; (ii) corporatization of the electricity company (although its viability was not sealed); (iii) development of a proposal to rationalize the LPG subsidy; and (iv) increased oversight of public enterprises.

35. The vast majority of structural benchmarks were met (Table 3), and implementation performance was in line with many other recent programs (Figures 20 & 21). Compared with other post-2008 programs, early implementation was relatively good (despite a higher share of partially met benchmarks). Implementation suffered most in year 2, when benchmarks related to the implementing regulations for the procurement law, means-tested social assistance, and pension reform were not completed (and ultimately delayed beyond the program). The first two of these reflected capacity constraints and delays in necessary TA provision, while the latter resulted from an alignment of the reform with a region-wide initiative and, the authorities noted, insufficient clarity in the specification of the original benchmark. While the pension-related benchmark was not met, the authorities pointed to significant work undertaken during the Program, particularly related to Civil Service pensions. Other delayed reforms—including those related to the new Customs law, the actuarial review of the social security system, rationalization of public land sale agencies, and improved SOE oversight—also largely reflected capacity constraints, although these were ultimately completed.

Figure 20. Structural Benchmarks Met Status by Program Year

(average of 26 programs' shares)



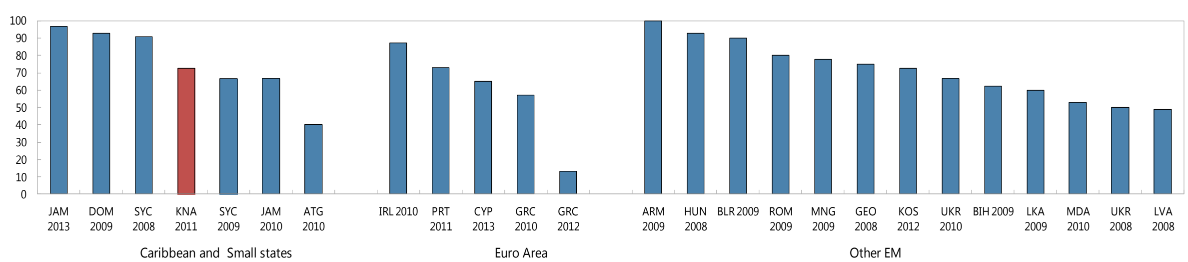
Source: IMF staff estimates

36. The headline current account improved significantly during the program, although changes in underlying terms were smaller, and competitiveness changed little. Overall the current account declined around 10 percent of GDP over the course of the program, compared with a programmed adjustment of around 4 percent. The improvement in the headline external position allowed the authorities to make the program precautionary at the combined seventh and eighth review and, hence, did not draw the related funds. However, CBI inflows (which are counted as service exports) were almost 11 percent of GDP. The cycle played a surprisingly modest role, with the actual and cyclically adjusted current accounts (ex-CBI inflows) moving little (Figure 22). The exchange rate remained overvalued, with the current account gap larger than at the request (Table 5).[13] More underlying adjustment was seen in other recent programs (Figure 23).

37. The need for structural reforms and additional infrastructure to improve competitiveness and longer-term growth remained at the end of the program. The need to improve the investment climate to guarantee sustainable medium-term prosperity was discussed extensively in the combined Seventh and Eighth Review. The decline in credit (after the restructuring) during a period of recovery also suggests the need for effort in these areas. The World Bank's *Doing Business Survey* suggests weaknesses in the areas of paying taxes, and related to financing investment (registering property, getting credit, and resolving insolvency). These issues may, in part, reflect that efforts undertaken during the program (e.g., tax administration reforms) take time to have an impact, but likely also point to the need for additional effort.

Figure 21. Implementation of Structural Conditions

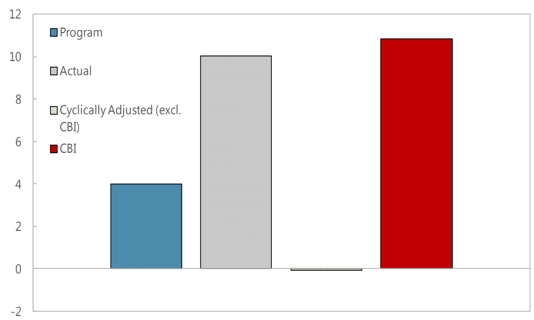
(percent met)



Source: IMF staff estimates.

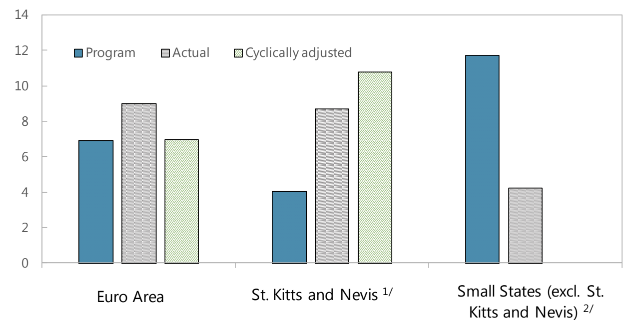
[13] Notwithstanding the usual caveats in measuring competitiveness in small economies like St. Kitts and Nevis, including the poor quality BOP data and methodological weakness in accessing current account norms, all available indicators suggest that competitiveness remains a concern for St. Kitts and Nevis, reflecting mainly high labor and other costs. The authorities recognize this and are making efforts to improve competitiveness including investing in alternative energy sources, targeting high-end tourism and manufacturing, and strengthening the tourism sector.

Figure 22. Programmed and Actual CA Adjustment
(P–1 to P+3)



Source: IMF staff calculations.

Figure 23.Current Account Adjustment
(change from P-1 until program end, percent of GDP at P–1)



Source: IMF staff calculations.
1/ Data includes CBI receipts.
2/ Cyclically adjusted data are not available.

Table 5. 2011 and 2014 External Sector Assessments

			Approach			"Assessment"
			Equilibrium REER	Macroeconomic Balance	External Sustainability	
2011 Article IV	Current Account	Underlying		-21.4	-21.4	
		Norm		-18.3	-18.4	
		Gap		-3.1	-3.0	
	REER Misalignment		17.2	13.2	12.8	"slightly overvalued"
2014 Article IV	Current Account	Underlying		-15.7	-15.7	
		Norm		-8.5	-16.9	
		Gap		-7.2	1.2	
	REER Misalignment		17.8	35.6	-5.8	"overvalued"

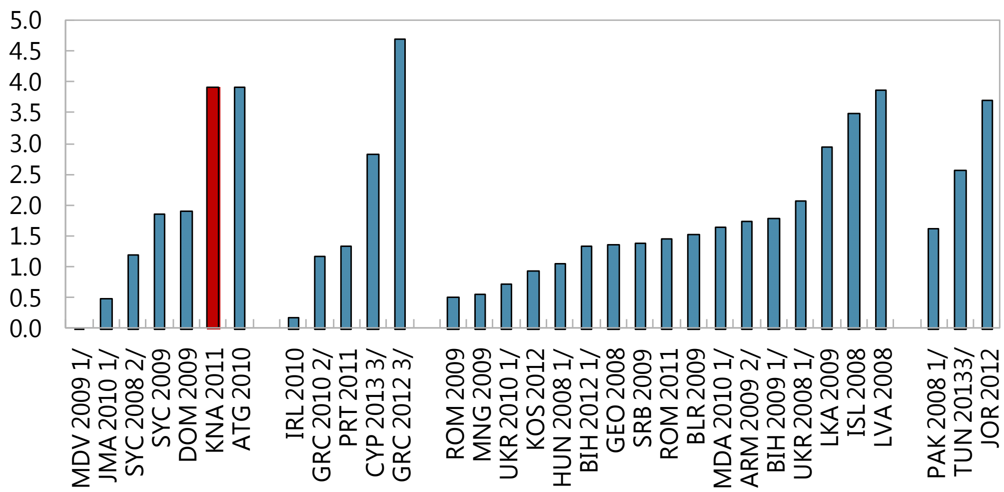
Source: IMF staff estimates.

F. Timing and Delayed Reviews

38. At times there were long delays. On average, delays in the completion of reviews were a little under 4 months per review, which is close to the upper end of recent programs. The delays resulted in combined reviews, and were concentrated in the fifth and sixth review and the seventh and eighth. In the case of St. Kitts and Nevis these were caused by administrative and capacity constraints, with the authorities also noting that the two changes in mission chief also added to delays.

Average Delay per Review

(in months)



Source: IMF staff estimates.
1/ Program was not completed.
2/ Converted to a new program.

PROGRAM DESIGN

A. Was the design sufficient to save windfalls?

39. Despite a difficult start, when the depth of the global recession delayed the recovery, St. Kitts and Nevis benefited from significant positive shocks during the program period. The most significant development was the unexpected explosion of CBI inflows. Saving the upside was a priority of both staff as well as the authorities, as evidenced by the extensive coverage of the savings of these upside "surprises" (see especially the combined Fifth and Sixth Review). Notwithstanding the absence of program adjustors until late in the program, savings from CBI-related inflows were around
40 percent of GDP. The case for saving is strong given that the end of the crisis did not see the end

of debt-related vulnerabilities (especially in terms of financing needs) despite the sanguine baseline path.[14] Staff continue to recommend saving the bulk of receipts, establishing an asset-liability framework to manage the savings in a sovereign wealth fund, and prioritizing their use to pay down debt rather than using them to increase current spending.

40. The importance of saving these additional receipts depends on how permanent they are likely to be. The rise in CBI receipts came as a surprise and was dramatic. Once debt concerns are addressed a permanent increase in revenue could result in additional spending targeted to priority areas. However, it is unlikely that the current rise in CBI inflows can be relied on to permanently contribute to the extent seen since 2011. The continual growth of "competitors" with similar schemes, and the decision by Canada in 2014 to end visa free entry of the citizens of St. Kitts and Nevis suggests these revenues are likely to fall over time. In the meantime, the additional revenues provide an opportunity to build buffers and resilience (in line with the objectives of the Fund's small states strategy) including by further reducing debt, saving resources to smooth public consumption over time and, if possible, increase quality capital spending

41. The initial program design was not focused on ensuring positive surprises were saved or protecting capital spending. The commitment to wage restraint was important to the success early in the program (through 2011–12), when goods and services expenditure was above target, and an under-spending on capital (not financed by grants or loans) was important to meet overall program targets in 2011–12. However, by 2013, reflecting the perceived weakness of the recovery at the time, the government increased both current (including wages) and capital spending to support growth which, in late 2012, was expected to only recover to 1¾ percent. While augmentation of capital spending can be seen as "catch-up" for past years, there is a weaker case to be made for current spending given its low multiplier. Nonetheless, there was no automatic mechanism in the initial program design to limit either the crowding out of capital spending or the spending of windfalls.

42. The program's design was adjusted late in the program. Relevant concerns were raised in earlier program documents, but adjustors to protect capital spending and to ensure saving of stronger than anticipated CBI receipts were only added to the program in the Fifth and Sixth and Seventh and Eighth Reviews, respectively. Consequently, despite significant over-performance by CBI receipts since 2010 and above target current spending in 2011 and 2012, the program structure was only changed for the last two reviews. In many other programs similar adjustments have

[14] The small states strategy (2013–14), created after the program started, highlights many of the issues which have been long recognized as relevant for economies like St. Kitts and Nevis. Two of the five thematic areas identified in the strategy critical to the Fund's engagement with small states are creating resilience to shocks, and workable fiscal and debt sustainability options. Both are directly related to saving windfalls. The strategy is outlined in IMF, 2014, Staff Guidance Note on the Fund's Engagement with Small Developing States (International Monetary Fund: Washington, DC), and IMF, 2013, Macroeconomic Issues in Small States and Implications for Fund Engagement (International Monetary Fund: Washington, DC).

occurred relatively earlier (Table 6). An earlier introduction of these adjustors would have led a stronger incentive to complete the capital spending plan, and strengthened the countercyclicality of fiscal policy, and not unnecessary tightened the program, since the adjustor for CBI inflows would have only had effect when they over-performed.

Table 6. Expenditure Adjustors in Recent Programs

Program	Initiation Date	Type
Kosovo 2010	R0	Ceiling on primary expenditures/revenue will be adjusted by unpredicted project grants and loans, and budget grants.
Ukraine 2014	R1	Ceiling on the cash deficit of the general government adjusted by unplanned external project financing.
Ecuador 2003	R1	Fiscal Deficit and primary expenditure ceiling adjusted by oil revenue.
Ukraine 2008	R2	Ceiling of cash deficit adjusted downwards if project financing falls short of the projections.
Gabon 2007	R2R3	Credit to government and fiscal deficit adjusted by non-programed oil revenue, privatization receipts, and payments of external debt service.
Colombia 2005	R3	Fiscal deficit, adjustor for oil prices.
Gabon 2004	R4	Credit to government adjusted by excess oil revenue.
Belarus 2009	R4	Ceiling on cash deficit adjusted for funds allocated for project support.
Kosovo 2012	R5	Fiscal deficit target, primary expenditure ceilings and floor on bank balance of the gen. government adjusted by unscheduled project loans and budget grantse and unscheduled payment of loans extended to public corporations.
Dominican Republic 2009	R5R6	Credit to government adjusted for shortfalls/excesses in external budgetary financing.
Romania 2011	R7R8	Fiscal deficit target adjusted by capital spending.
St Kitts and Nevis 2011	**R5R6**	**Central government overall floor adjusted upward to the extent of under-execution of revenue financed capital expenditure relative to targets.**
	R7R8	**Central government overall and primary balance adjusted by unscheduled CBI receipts.**

Source: IMF staff estimates.

43. Reflecting practice seen in other programs, incentives to save over-performance would ideally have been built into the program from the beginning. Many programs include expenditure ceilings in addition to quantitative conditionality on fiscal balances (Table 7). These conditions are aimed at saving unexpected revenues and can be designed to protect social and capital spending from the impact of the ceiling. The introduction of such a condition would have been worthwhile, and in line with building resilience and promoting external adjustment.

44. In the post program environment, the Fund's engagement should continue seeking greater resilience through fiscal discipline and savings in St. Kitts and Nevis, and strengthening of the capacity for quality infrastructure spending. The Federation continues to have large infrastructure needs and is vulnerable to natural disasters and external shocks given its narrow export base. The likely temporary nature of the rise in CBI receipts makes them like non-renewable resource revenues. Pursuing a sovereign wealth fund linked to a fiscal rule based on a non-CBI primary balance as well as the unification of fiscal activity—both of which have been advocated by the team—would be important to achieving these goals. Improving the country's net debt position through early repayments is another way to build resilience. The authorities also expressed interest in building buffers and strengthening domestic infrastructure.

Table 7. Stand-by Arrangements with Expenditure Ceilings

	Program Start	Wage bill	Primary spending	Total expenditure	Other	Floors on social
ANGOLA	2010					√
BULGARIA	2004	√				
DOMINICA	2002	√				
DOMINICAN REPUBLIC	2005		√			
ECUADOR	2003		√			
GEORGIA	2008			√		
GEORGIA	2014			√		
GEORGIA	2012			√		
GREECE	2010		√			
GUATEMALA	2002			√		
HONDURAS	2008		√			√
HONDURAS	2010		√ (current)			√
HONDURAS	2014	√				√
IRAQ	2007	√			√	
IRAQ	2010			√ (current)		
JAMAICA	2010				√	
KENYA	2015					√
KOSOVO	2010		√ (recurrent)			
KOSOVO	2012		√			
LATVIA	2008	√				
PARAGUAY	2003	√				
PARAGUAY	2006	√				
PERU	2007				√	
ROMANIA	2004	√				
ROMANIA	2009		√ (current)			
ROMANIA	2011			√ (current)	√	
SERBIA	2015		√ (current, excludes capital spending)			
SERBIA	2009			√ (current)		
SERBIA	2011			√ (current)		
SOLOMON ISLANDS	2011				√	
TANZANIA	2012					√
TUNISIA	2013				√	
TURKEY	2005		√			
UKRAINE	2010				√	
URUGUAY	2002		√			
URUGUAY	2005		√			

Source: IMF staff estimates.

B. Was more progress on fiscal and external adjustment possible?[15]

45. The fiscal adjustment was unusually front-loaded. The primary surplus was envisioned to rise more than 5 percentage points of GDP in the first year of the program, and around a further 1½ points in the following two, with the primary surplus falling subsequently. Typically, adjustment is more even, with primary surpluses building to a new medium-term level. While fiscal multipliers are low in St. Kitts and Nevis, more even phasing could have been desirable, but may not have been feasible since (i) the program began as an unfinanced home-grown effort, and the Fund was the only available multilateral financing source, and its support was already exceptional; and (ii) a large upfront effort was likely an important signal to creditors in the debt exchange operation. Consequently, there was little scope for more even fiscal adjustment at the start of the program.

46. Being a member of a currency union made external adjustment difficult. While challenging to measure, it seems overvaluation—an important feature in the build-up of vulnerabilities before the crisis—continues to hamper the economy. As discussed above, St. Kitts and Nevis saw little change in the extent of its REER overvaluation, and despite a large change in the current account during the program, the underlying current account adjustment (net of CBI) was minimal. For competitiveness to improve in members of currency unions, there must be an internal devaluation, a process which can be costly in terms of the slowdown (and unemployment) required to reduce relative price levels.[16] This could result from structural reforms raising productivity and the underlying fiscal position, or changes in relative labor costs and prices. Structural reforms remain critical to long-term resilience, but take time to bear fruit and were unlikely to yield large dividends within the life of the program. An alternative is measures to ease the process of relative price change. In this regard, the authorities' planned public wage restraint was an important commitment and a broader incomes policy would have also helped and remains necessary. Given the high quality of St. Kitts and Nevis' manufacturing sector, improved price competitiveness could be expected to improve the external position.

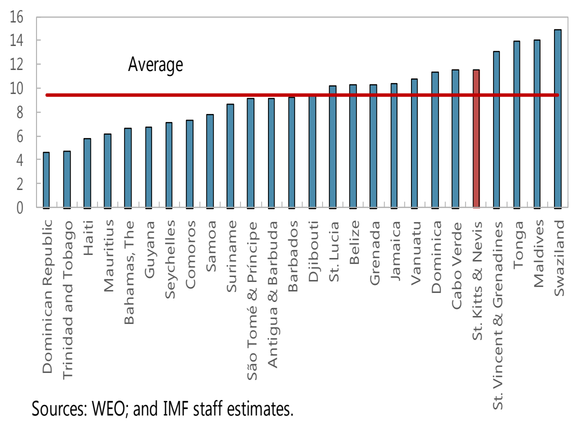
47. Limiting domestic cost pressures is thus key for St. Kitts and Nevis to make near-term progress on competitiveness. Electricity costs are around thrice and twice the averages in the US and Latin America, restrictively, and no better than the average in the Caribbean. At 11½ percent of GDP the government wage bill was the second highest in the Caribbean in 2014 and around 2 percentage points of GDP higher than the average for a large sample of small states (Figure 24). Its minimum wage was also the third highest in the region during the program period. Indeed, the Federation maintained a much leaner public sector following fiscal consolidation in 2006, but there was a considerable expansion in the lead-up to the debt crisis (Figure 25). The authorities' restraint

[15] The Fund's small states strategy described above suggest overall competitiveness, and workable fiscal and debt sustainability options as key areas for Fund engagement with small states.

[16] Given the negative elasticity between the current account and the underlying current balance, a real depreciation would improve the external position.

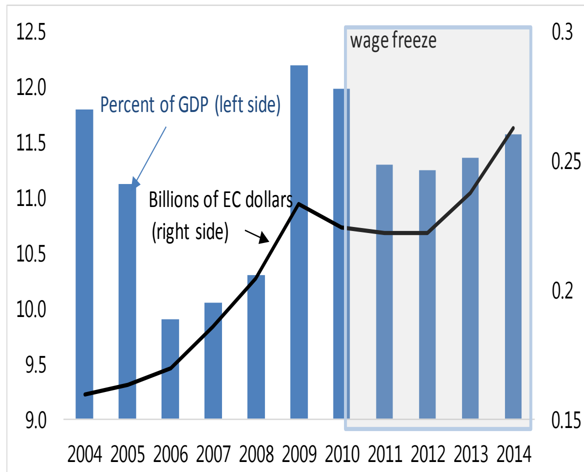
on the nominal wage bill ended after the three year ceiling, in 2013 and 2014, and the public sector remains much larger than its average 2006–08 size (of 10 percent of GDP). Maintaining the nominal restraint (and broader income policy), and completing the public sector reform agenda, could have assisted greater external adjustment during the program (Box 3).

Figure 24. Small States: Wage Bill, 2014
(percent of GDP)



Sources: WEO; and IMF staff estimates.

Figure 25. Public Wage Bill



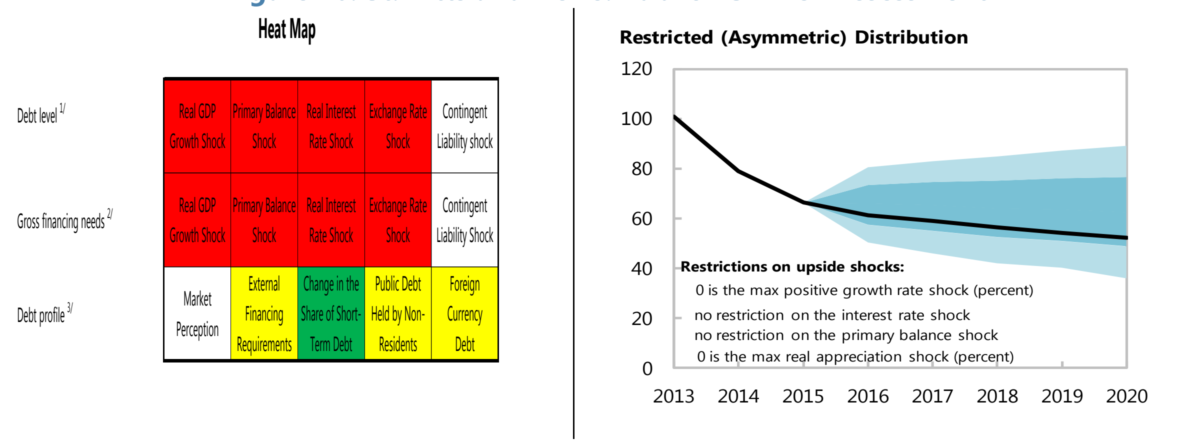
C. Is public debt still vulnerable?

48. The strategy surrounding the debt restructuring was innovative, transparent, and sought to make good use of the sovereign balance sheet. It also brought about a large reduction in the debt of St. Kitts and Nevis. Debt is likely to meet the authorities' medium-term objective (of 60 percent of GDP) ahead of the date expected under the program. The early achievement of this target partly reflects early repayments by the authorities using CBI-related revenues. The use of the land-debt swap and the CDB guarantee were particularly innovative.

49. The program ended with St. Kitts and Nevis still facing a vulnerable debt situation (Figure 26). The debt sustainability analysis heat map from the 2015 Article IV consultation report remained significantly red after the program and the fan chart suggests a significant upside risk to debt dynamics despite baseline debt on track to fall below 70 percent of GDP this year. More troubling is the level of public gross financing requirements, which remain above the high risk debt burden threshold of 15 percent of GDP throughout the medium term (despite early repayment).[17] In this context, an understandable question is whether these flow risks could have been addressed under the program.

50. Despite the significant improvement of the debt path and the speed of the restructuring of external creditors, **the restructuring—which went largely as planned—brought debt down slowly** (the restructuring of the debt held by banks was not completed during the program)**, and the gross financing needs remain high.** Some options to address flow concerns could have been:

Figure 26. St. Kitts and Nevis: Public DSA Risk Assessment



Sources: St Kitts and Nevis: 2015 Article IV Debt Sustainability Analysis.

- ***Greater fiscal adjustment***. Greater fiscal adjustment could have been sought but, as discussed above, greater ex ante adjustment was unlikely feasible.

- ***Scope of restructuring***. The restructuring did not cover all domestic claims (Treasury Bills were excluded) and did not involve a haircut on the claims of the banks. The key banks were highly capitalized and, notwithstanding the impact of the restructuring, capitalization after the land-debt swap remained high, suggesting possible scope for a haircut. Without any haircut, the land-debt swap involved an indirect subsidy to the private shareholders of the affected banks. Nonetheless, there may have been concern that either a voluntary deal was

[17] This reflects the fact that staff does not project changes in the of Treasury bills. Under the 2015 Article IV macro framework, gross financing needs decline to 16 percent of GDP in 2020, and they remain vulnerable to adverse growth, hurricane, and fiscal policy surprises. The debt burden threshold in the debt sustainability framework are estimated on an EM sample of debt distress (restructurings and rescheduling, defaults, and IMF financing) events using a signal extraction approach. This analysis identifies government debt of 60 precedent of GDP and gross public financing needs of 15 percent of GDP, respectively, as levels associated with debt distress. See Annex II of IMF, 2013, Staff Guidance Note for Public Debt Sustainability Analysis in Market-Access Countries for details.

impossible or the capital position was more fragile than apparent in relevant financial soundness indicators. Domestic bonds and Treasury bills could have potentially been included in the restructuring, with these claims receiving a maturity extension to reduce ongoing gross financing needs.[18]

- ***Debt management strategy***. Even without including domestic Treasury bills in the restructuring, there was scope to address short-term funding pressures (by changing the balance between domestic Treasury bills and bonds) through the authorities' 2013 Debt Management Strategy (a benchmark implemented under the program). The desirability of this could have been signaled at the time of the program request, and the success of the restructuring should have paved the way for such a change by making longer-term instruments more attractive.

D. Was the financial sector strengthened?

51. A key objective of the program was to further strengthen the financial sector. The program strategy succeeded in removing sovereign risk from banks' balance sheets, and in preserving financial stability through the debt restructuring and the long recession. Many key FSIs remain above regional peers and regulatory requirements, and there was no use of the BSRF. Nonetheless, the financial sector remains subject to significant challenges (of high liquidity and low lending).

52. Even though the BSRF was never used, there is no way to know how critical it was. The BSRF (created to limit liquidity risk) was not used and, hence, not tested. The sharp ex post rise in deposits (against slow lending growth) likely played some role in limiting any liquidity concerns, but given the timing of the CBI inflows, it was probably not the main reason why liquidity pressures did not arise due to the restructuring. Hence the creation of the BSRF may have been important in allaying these fears, making its creation a sensible precaution. Looking forward, transactions like the land-debt swap could conceivably be made more liquidity-friendly by making the shares in the land holding company tradable, allowing the banks the potential to liquidate (some of) them if needed.

53. The restructuring was expected to reduce reported capital adequacy, bank income and the share of earning assets, and asset quality (as captured by the NPL ratio). In the end, capitalization was in line with expectations, and the underlying change in capital adequacy was overstated by the zero weight applied to government debt. Nonetheless, ensuring a banking system

[18] There are cases where the maturity of Treasury bills were extended as part of debt restructuring. Two relevant examples are provided by Ukraine and Cote d'Ivoire. In Ukraine during 1998–99, a conversion scheme for Treasury bills owned by domestic banks was implemented through an exchange of Treasury bills into longer term bonds of 3 to 6 years maturity. (See F. Sturzenegger, and J. Zettelmeyer (2005), "Haircuts: Estimating Investor Losses in Sovereign Debt Restructurings, 1998–2005," *IMF Working Paper 05/137,* Washington). In January 2011, Cote d'Ivoire Treasury bills were also restructured (IMF, 2015, The Fund's Lending Framework and Sovereign Debt—Further Considerations—Annexes).

flush with liquidity can return to healthy profits, strong asset quality, and safe liquidity levels depends on creating an environment in which there is healthy demand for credit from viable projects—a strengthening of underlying investment demand—which is tied to the ongoing need for reforms to improve business environment. Further reforms to facilitate non-performing loan resolution are also an important piece of the forward looking agenda.[19]

CONSISTENCY WITH FUND POLICIES

A. Was exceptional access justified?

54. The conditions for granting exceptional access were met, although the case for some could have been further strengthen with additional analysis (Box 4). These conditions require additional assurance ahead of lending which would involve more than 200 percent of quota be disbursed in a 12-month period or result in cumulative outstanding credit of over 600 percent of quota. While the overall access request was 590 percent of quota, almost 450 percent of quota was to be disbursed in the first year. Conditionality was front-loaded, but there were still significant risks for the Fund, and the IMF was the only institution that provided direct official financing.[20]

55. Front-loading was inevitable. The BSRF did not, by itself, create the exceptional access need. Even without disbursement to create this fund, disbursements would have been much more than 200 percent of quota. There were also limits to the possibility of obtaining additional financing from other parties. The debt restructuring, which was expeditiously concluded with external commercial creditors, was always going to take some time and while deeper restructuring on domestic creditors may have lightened the load on the public sector it would not have addressed external financing needs. Burden sharing with the Inter-American Development Bank was not possible (as St. Kitts and Nevis was not eligible), the World Bank was constrained, and the CDB had already provided a guarantee to facilitate the debt exchange. Finally, as discussed above, greater adjustment effort was also unlikely given the extent of front-loading already built in.

56. The case for exceptional access was not reconsidered at subsequent reviews as the resulting level of medium-term debt and financing needs became clearer. These criteria must hold at all reviews, and are typically reassessed if program circumstances change. Such reassessment, particularly as ongoing financing needs become clearer or as political developments became more complicated, may have been warranted, permitting changes to the debt structure to ensure both the debt level and financing needs were sustainable, although the authorities noted that political developments did not hinder the government's ability to implement the program.

[19] The Fund's small states strategy identifies growth and job creation, and strengthening thin financial sectors as central to engagement with these economies.

[20] Although the CDB did provide a guarantee to facility the debt restructuring with external commercial creditors.

B. Was the program consistent with the Fund's arrears policy?

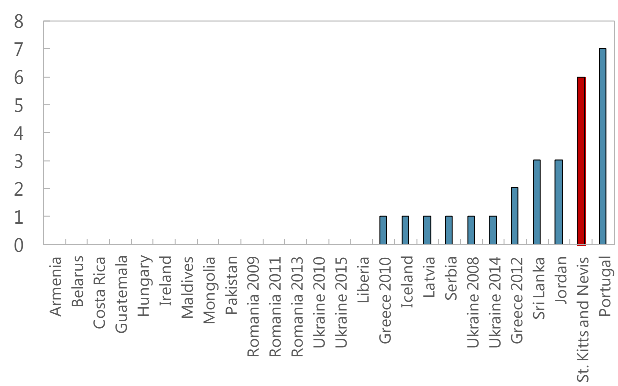
57. Yes. Under the Fund's *Lending into Arrears* policy, the Fund can lend where (i) prompt Fund support is considered essential for the successful implementation of the member's adjustment program; and (ii) the member is pursuing appropriate policies and making good faith efforts to reach a collaborative solution with creditors. Both criteria were met in this program; the involvement of the Fund was critical to resolving an unsustainable situation, and the program envisioned appropriate adjustment, and while the various forms of restructuring were underway, the government's actions were collaborative and in good faith (even if progress was at times slow). External arrears (to both private and official creditors) which arose during the program (relating to the NIA) were resolved quickly after being identified. The dealings with official creditors were also in line with the policy, as the government remained current in its obligations to these creditors while negotiating a restructuring.

C. How could the use of waivers of applicability be reduced?

58. Waivers of applicability were frequently required in this program. These waivers are used when a review is delayed sufficiently that the next PCs becomes controlling but the data to assess these are not yet available. Consequently, the frequent granting of these waivers to complete reviews raises risks to the Fund, and has been a concern for some Directors.

Waiver of Applicability of Performance Criteria[1/]

(exceptional access cases since 2008)



Sources: MONA database; and IMF staff calculations.
1/ For joint reviews, only one waiver is included.

59. St. Kitts and Nevis requested, in total, six waivers of applicability for quantitative performance criteria at seven program (including combined) reviews. Of exceptional access programs since 2008, only Portugal requested waivers of applicability at more reviews (and relative to the number of reviews St. Kitts and Nevis used more). Staff supported each of these requests on the basis that the observance of the PCs was achievable and, notwithstanding the unavailability of the necessary information, the program will be successfully implemented and there is no clear evidence that the performance criterion will not be met, the appropriate standard.

60. The program design could have considered semi-annual reviews as one way to limit the need for these waivers. Delays in the program at times reflected capacity constraints, and holding reviews less frequently would have allowed more time to complete actions between reviews, thus lessening the risk that reviews would need to be completed shortly after a new PC test date is reached. Members of the team noted that given the capacity constraints faced by the authorities, quarterly reviews provided the opportunity for capacity development, but this objective could be met by a staff visit between reviews, and possibly quarterly indicative targets the provide evidence that key indicators are on track.

CONCLUSIONS AND LESSONS

61. St. Kitts and Nevis approached the Fund for assistance at a very difficult time. The economy was half-way through a deep recession due to fallout from the global financial crisis. Its debt had been unsustainably high for a number of years, and the authorities had relied on domestic banks to meet their financing needs. Consequently, while domestic banks were relatively profitable and well capitalized, they were significantly exposed to sovereign risk. The currency was also overvalued, with an underlying current account deficit above 20 percent of GDP. The country was highly vulnerable to natural disasters, and its membership of the ECCU complicated the process of external adjustment. The authorities, thus, wisely commenced their own home grown program in 2010—signaling strong ownership—and approached the Fund in 2011 ahead of the debt restructuring.

62. The Fund program provided critical support—in the form of an exceptionally large and front-loaded program—allowing for the return to stability and robust growth, and for several major achievements. The unsustainable public debt was restructured and reduced substantially, with it now credibly on the path to reach the authorities' medium-term target of 60 percent of GDP assuming fiscal policy discipline holds. Nonetheless, gross financing needs remain higher than desirable, which should have been addressed. Despite one of the largest restructuring in recent times, which had significant implications for the banking system, there were no spillovers to the rest of the region and financial stability was upheld. More recently the financial sector has been flooded with more CBI-related liquidity than it can effectively use without stronger domestic demand for investment, and managing this will be an ongoing challenge. Accelerated debt repayments, and the creation of a sovereign wealth fund invested overseas, would also help normalize the liquidity situation in the banking system.

63. The headline fiscal and external accounts improved substantially ahead of a program expectations, and critical fiscal reforms were introduced, including the introduction of a VAT, tax administration reform, and improved oversight of the public enterprises. Abstracting from CBI inflows, the extent of underlying adjustment in both the external and fiscal accounts was more limited than suggested by the headline numbers, including because some of the CBI-related inflows were used to lessen the pace of adjustment (especially in 2013) given the depth of the recession. An earlier focus on capturing these windfalls, given they are unlikely to be permanent, would have been desirable and likely led to a greater improvement in the underlying fiscal and external positions. Nonetheless, savings from CBI inflows were substantial (around 40 percent of GDP by end-2014). In addition, cash management issues in the Nevis Island Administration were not fully addressed under the program, suggesting the desirability of greater coordination between the two governments on financial management and policy implementation.

64. The forward looking agenda should seek to build on the achievements of the program. The few key planned reforms left undone—civil service, procurement regulation, and means tested social assistance—will hopefully soon be complete. Looking forward, the key issues for St. Kitts and Nevis are finding ways to (i) master fiscal discipline (maintain a suitable structural non-CBI primary balance) and prudently manage the windfalls from CBI while allowing higher quality infrastructure spending; and (ii) pursue structural reforms to create a business environment conducive to greater private sector investment and activity in the country. The latter set of reforms will not only raise growth, it would likely permit a stronger more active indigenous financial system as well as provide scope for a more diversified (resilient) and competitive economy driven by the private sector. Fortunately, these are also the priorities of the authorities and the Fund's Article IV team.

65. Other more general lessons from this program are:

- ***Program robustness to upside surprises and protecting capital spending***. Given the key objectives of Fund engagement with small states, including strengthening resilience and competitiveness, programs in these countries should be designed to automatically save upsides (while protecting infrastructure and social spending). This can be done through the use of carefully designed adjustors or expenditure ceilings. Should the upside surprise become permanent, then program objectives may be adjusted.
- ***Program review frequency in small states***. Quarterly reviews may be too heavy in small states, and other countries facing significant capacity constraints. Semi-annual reviews are likely more appropriate. If the country would benefit from more frequent interaction to support the implementation of the program, quarterly staff visits and/or indicative targets for key quantitative targets could be considered.
- ***Adjustment in small state currency unions***. Lasting external adjustment is not easy in currency unions given that nominal depreciations are impossible. This raises the importance of both structural reforms and limits on a country's cost structure to allow internal devaluation. With structural reforms likely have a long pay-off period, incomes policy can play a critical role.
- ***Debt restructuring parameters***. To provide strong assurance that a prospective debt restructuring will result in sustainability with high probability, staff should outline at the time of the request some key parameters (in terms of post-restructuring level and financing needs) the restructuring should achieve. This was the approach taken in the recent Ukraine program, and does not imply staff being involved in the negotiations. Such an approach will also help make the case for requested access clear.
- ***Land-debt swaps***. Given the strong bank-sovereign link in St. Kitts and Nevis, the land-debt swap was an innovative use of the government's balance sheet. However, if such a tool could be useful in future cases, consideration should be given to limiting the impact of such a transaction on the banks. This could be done by making shares in the land holding company tradable, with sufficient voice in the management of the holding company (SPV) given the owner of the shares, allowing the bank to be able to sell these.

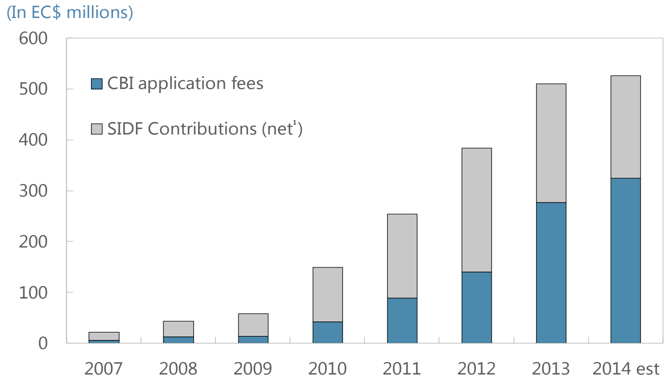
- ***Conditionality in currency unions***. This program included the interesting feature by which conditionality—specifically quarterly bank stress tests—agreed by the authorities was carried out by the central bank for the union. This was facilitated through an agreement between the government and the ECCB. This modality could provide a useful option for future programs with members of the ECCU and other currency unions.

Box 1. The Citizenship-by-Investment and Sugar Industry Diversification Foundation Nexus

The Citizenship-by-Investment (CBI) program was established in 1984 to allow foreign nationals to make an economic contribution to the country in exchange for full citizenship. Applicants can choose to invest at least US$400,000 in designated real estate or make a contribution to the Sugar Industry Diversification Foundation (SIDF) of at least US$250,000. There is a US$50,000 application fee with either option (included in the SIDF contribution) per applicant, with additional lower fees for family members. These fees are recorded as non-tax revenue in the Central Government budget. In recent years both direct government revenue and contributions to the SIDF, net of processing and due diligence costs, have become sizable.

Citizenship-by-Investment Inflows

(In EC$ millions)

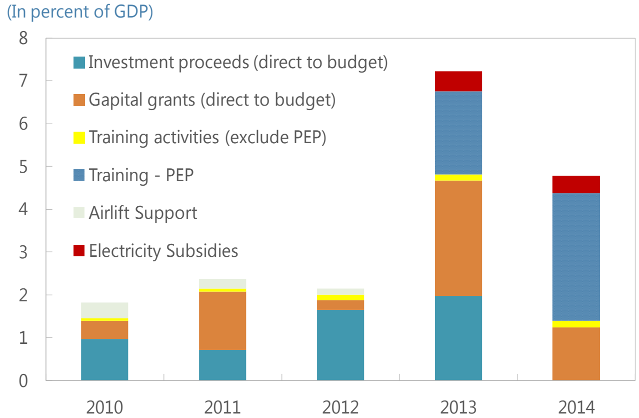


Sources: Authorities and Staff estimates.
[1] Net of processing and due diligence fees.

The SIDF was established in 2006 following the closure of St. Kitts and Nevis' 300-plus year sugar industry. It provides both direct support to the budget, and directly funds a variety of other quasi-fiscal social and economic programs. Both types of support have grown in recent years. Budgetary support consists of investment proceeds and capital grants, which collectively peaked at 4.7 percent of GDP in 2013 as the government accelerated its capital program following the 4-year recession. Its quasi fiscal activities include the People Employment Program (PEP) and electricity subsidies. The SIDF also supports subsidized credit activities through the banking system by providing zero interest deposits, which are then leveraged by banks to provide targeted credit facilities at lower-than-market rates. These credit facilities include those targeted at housing and students.

SIDF Social and Economic Spending

(In percent of GDP)



Sources: St. Kitts and Nevis authorities; and staff estimates.

Box 2. Debt Restructuring

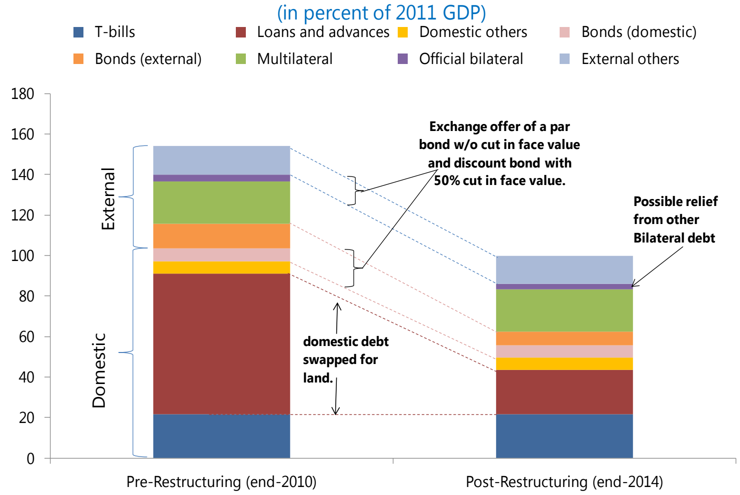
The debt restructuring package comprised three core elements.

- (1) *Bondholders and external commercial creditors had their debt instruments exchanged for new enhanced instruments*, which resulted in them taking deep haircuts. Participation in the first-stage debt exchange amounted to 97 percent of eligible holdings; the activation of collective action clauses allowed hold-outs to be included in the exchange. There was an aggregated NPV haircut on the total exchange of 65 percent (at an 8 percent discount rate), and an overall NPV haircut of around 8 percent on the total debt portfolio. The innovative aspects of the exchange were a guarantee on restructured instruments by the Caribbean Development Bank (CDB); and the debt reduction being partly conditional on the completion of the 6th review under the program. These helped to build confidence in the exchange and encouraged greater participation.
- (2) *Domestic banks, which held about 31 percent of total government debt (around 50 percent of GDP), received government land in exchange for debt relief.*[1.] The government also pledged to identify and transfer additional lands to cover unsecured debts held by the banks, ensuring they were made whole.
- (3) *The government negotiated with Paris Club and other bilateral creditors* for a rescheduling of debt service at lower interest rates.

Despite the complex and sizable restructuring, much of the complexity of the pre-restructuring debt structure remained, although the authorities have attempted to limit contingent liabilities arising from public enterprises. At end-2010 public enterprises had amassed debt of close to 30 percent of GDP, which was either explicitly or implicitly guaranteed by the central government. To date, this cross-lending still exists and the Social Security Board remains highly exposed to the government. The remaining debt held in Treasury bills and as multilateral loans from organizations such as the CDB was not part of the restructuring package.

Debt Restructuring Package - Impact on Debt Stocks

(in percent of 2011 GDP)



Source: St. Kitts and Nevis authorities and Fund staff estimates.

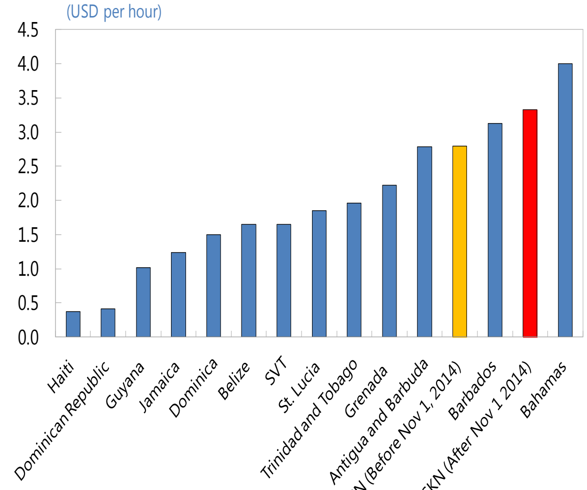
[1.] The *land was placed in a SPV, whose purpose was to sell the land. The funds received from sales would be paid to the banks.*

Box 3. Wages and Competitiveness

The high public wage bill and minimum wage translates into high private sector wages and low competitiveness. Public and private wages are positively correlated suggesting that fiscal decisions have direct and indirect implications on competitiveness. St. Kitts and Nevis has one of the highest minimum wages in the Caribbean. Indeed following the wage increase in November 2014, the minimum wage is now the second highest in the Caribbean, more than eight times that of the Dominican Republic and over 1½ times the ECCU average.

Minimum Wage in the Caribbean

(USD per hour)

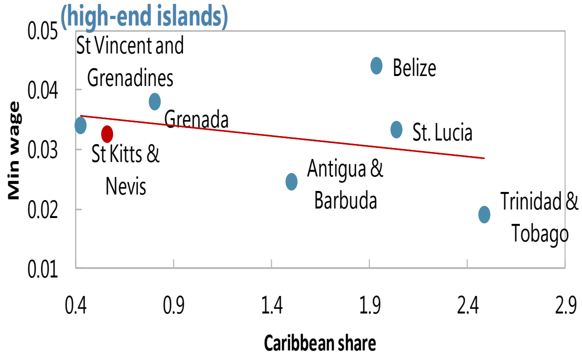


Sources: Authorities and press reports.

Minimum wages are negatively correlated with export and tourism market share and competitiveness. St. Kitts and Nevis' tourism share is relatively low compared to that of its Caribbean peers, partly reflecting the higher wages which are correlated with lower competitiveness. Even among high-end destinations St. Kitts and Nevis tourism performance appears weak with relatively high wages.

Tourism Share and Minimum Wage 1/

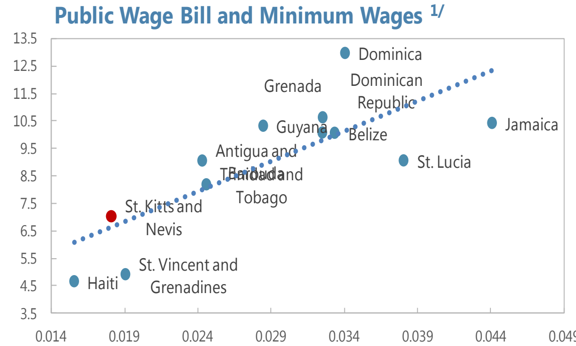
(high-end islands)



Source: IMF staff estimates.

1/ Minimum wage deflated by per capita GDP

Public Wage Bill and Minimum Wages 1/



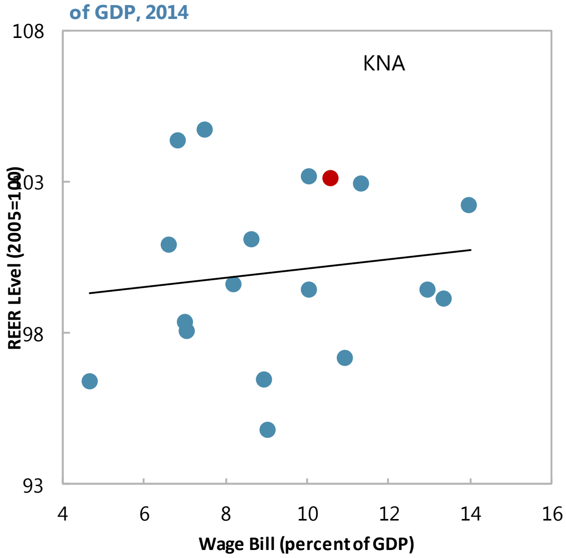
Source: IMF staff estimates.

1/ Minumum wage is deflated by per capita GDP

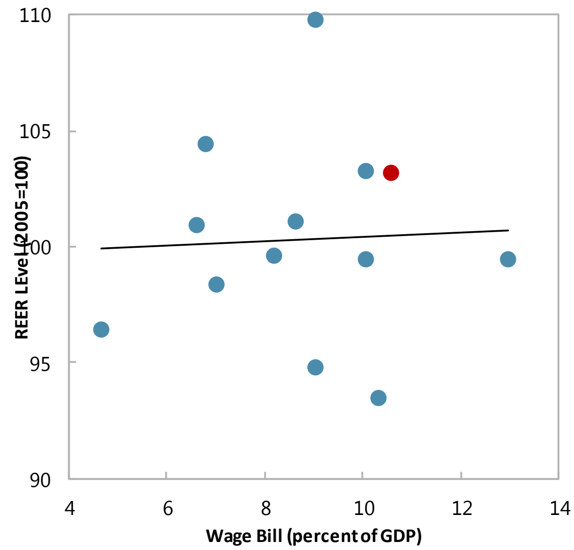
Box 3. Real Effective Exchange Rate and Wage Bill (concluded)

Countries with higher wage bill (as a share of GDP) typically suffer from low competitiveness

Select Small States: REER Level and Wage Bill in % of GDP, 2014

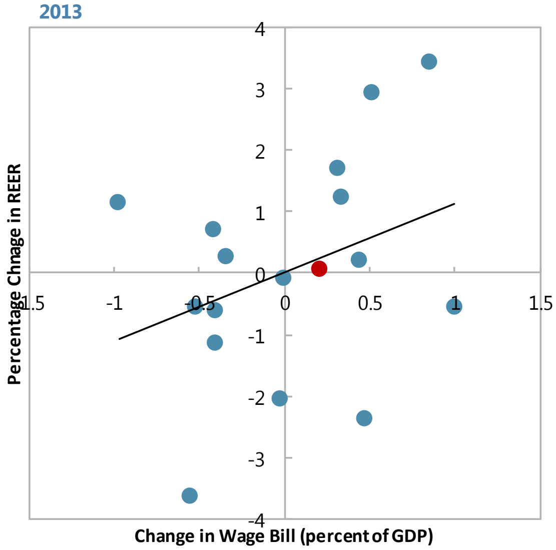


Caribbean: REER Level and Wage Bill in % of GDP, 2014

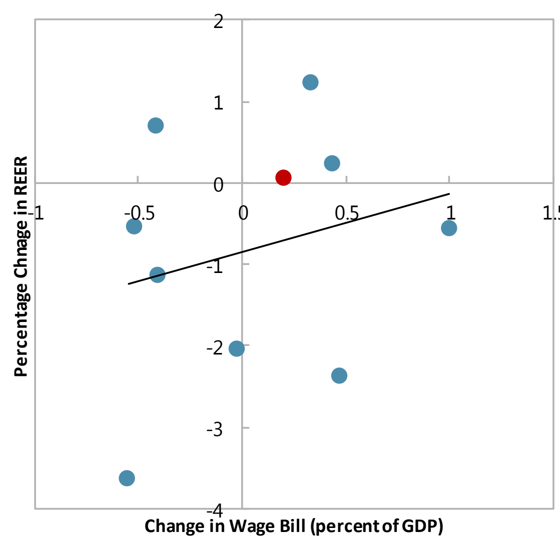


Increases in the wage bill (as a share of GDP) are associated with decllines in competitiveness

Small States: Changes in Wage Bill and REER, 2013



Caribbean: Changes in Wage Bill and REER, 2013



Source: IMF staff estimates.

Box 4. Exceptional Access Criteria

Criterion 1. The member is experiencing or has the potential to experience exceptional balance of payments pressures on the current account or the capital account, resulting in a need for Fund financing that cannot be met within the normal limits.

- It was estimated that the global downturn and the increase in food and fuel prices would lead to a cumulative balance of payments gap of 1,546 percent of quota over 2011–14. Given the peg to the dollar, the large amounts of amortization needs that were due starting in 2011, and the need to restore confidence in the banking system given their large exposure to the public, the program proposed an SBA of 590 percent of quota, of which 470 percent would be used to finance the BOP gap and the remaining to create a BSRF to act as a buffer for the banking system.

Criterion 2. A rigorous and systematic analysis indicates that there is a high probability that the member's public debt is sustainable in the medium term. … Debt sustainability for these purposes will be evaluated on a forward-looking basis and may take into account, inter alia, the intended restructuring of debt to restore sustainability.

- The case for this criterion was overly focused on the level of debt and should have been further elaborated to clearly establish that the criterion was met. The case rested on "(i) strong fiscal adjustment; and (ii) comprehensive debt restructuring, including a debt-land swap" putting public debt on a steeply downward path. The assessment concluded that "preliminary calculations indicate that there is a high probability that the debt is sustainable in the medium term." However, this would seem to fall short of the requirement for "a rigorous and systematic analysis." Indeed, the request did not present any analysis to substantiate the conclusions about post-restructuring debt sustainability. It was only in the ninth review that debt approached authorities' (and ECCU) medium-term target of 60 percent of GDP, and even then the path was sensitive to several stress scenarios.

- The other critical aspect of sustainability—gross financing needs—was not discussed despite very high ongoing needs. Financing needs are still expected to remain above the distress threshold throughout the medium-term, and also remain vulnerable to a variety of shocks (including growth and weather).

- While staff cannot be involved in the details of the negotiations between the authorities and creditors, laying down broad parameters for a successful restructuring—as has been done most recently in the case of Ukraine—would have helped assure an outcome which would meet this criteria.

Box 4. Exceptional Access Criteria (concluded)

Criterion 3. The member has prospects of gaining or regaining access to private capital markets within the timeframe when Fund resources are outstanding.

- Staff projected that the program would boost confidence in St. Kitts and Nevis' ongoing debt sustainability and upon completion of the debt restructuring efforts, it would facilitate a resumption of access to private bond markets, such as the RGSM, which would help lower government's exposure to its domestic financial market. This seems a fair assessment but, so far, it has not been tested. While St. Kitts and Nevis has not attempted to re-access the RGSM, this likely reflects the fact that given large CBI flows there has been no need.

Criterion 4. The policy program of the member provides a reasonably strong prospect of success, including not only the member's adjustment plans but also its institutional and political capacity to deliver that adjustment was also considered to be met.

- Despite the magnitude of the targeted fiscal consolidation, and weaknesses in implementation capacity, the Fund drew comfort from a number of factors: (i) strong policy ownership as many important measures were enacted ahead of the program initiation; (ii) the frontloading of key fiscal measures; (iii) ongoing engagement with debt advisors; (iv) the fact that St. Kitts and Nevis had previously run persistent fiscal primary surpluses; and (v) strong political support for the program. On the structural front, institutional capacity to deliver the core elements of the program were strengthened by technical support from the Fund, CARTAC and other IFIs.

- While the authorities implemented much of the programmed agenda, the political stress which began in 2012 could have put performance at risk. It was never clear whether a new government—should the no confidence vote have been held and won—would have supported the program in place. During such periods of potential political transition, it is common (in the absence of broad political support for the program) for the Fund to seek assurance from the opposition that they will continue to implement the program ahead of completing reviews. Such assurances are commonly, but not always, public, and would have been desirable in this case. It is not clear the team met with the opposition to discuss the program or seek such assurances as a contingency ahead of completing reviews.

Appendix I. The Views of the Authorities

Views of the St. Kitts and Nevis authorities were sought during a visit to Basseterre (St Kitts) and Charlestown (Nevis) during September 10–11, 2015. Meetings were held with the Prime Minister and Minister of Finance T. Harris, the Premier of Nevis V. Amory, senior officials from the Ministry of Finance, and the Governor of the Eastern Caribbean Central Bank. The mission also met with members of the former government under which the SBA was negotiated in 2011 and subsequently implemented. Views heard at these meetings are summarized below.

The authorities broadly agreed with the main findings of the Ex Post Evaluation. They agreed the program's design was broadly appropriate, correctly identifying and focusing on the critical macroeconomic priorities. They recognized the positive impact of the Fund's engagement on the successful implementation of their home-grown program and felt the prospects for success under the SBA were good even without the unanticipated rise in Citizenship-by-Investment revenues.

The authorities noted that capacity constraints and insufficient clarity on one structural benchmark contributed to the three missed benchmarks. They also pointed to actions they had taken to advance these goals. The authorities agreed with the evaluation's finding that a quarterly review frequency strained their limited resources, which sometimes resulted in delays in completing program reviews. They suggested that semi-annual reviews were generally more appropriate for countries like St Kitts and Nevis, but thought that interim staff visits could help maintain progress where there are capacity constraints.

The authorities felt that the program, and the related constructive engagement with Fund staff, had led to a strengthening of capacity in the central government. The authorities welcomed further ongoing engagement in terms of targeted assistance to strengthen some aspects of domestic capacity. In particular, progress with the structural reform agenda would benefit from identifying reforms to raise potential GDP and strengthen the business environment. They also requested broader technical assistance from the IMF, especially in the area of public financial management, to raise the capacity of the Nevis Island Administration. They expressed disappointment that plans to utilize an EU grant to establish a TA fund under the IMF's supervision were not realized.

The central government thought that the program could have usefully introduced specific conditionality on the Nevis Island Administration (NIA), with the aim of strengthening public financial and cash management. They argued that the Fund's monitoring of fiscal performance focused primarily on the general government fiscal position, leaving the central government to bear the brunt of adjustment. They also felt that the pace of reform had been weaker in the NIA as the structural reform agenda had focused on actions by the central government. The Nevis Island authorities agreed that their fiscal discipline was only entrenched late in the program; however, they noted that the former Nevis Island government could have been more involved in program negotiations, resulting in stronger ownership of the program.

The authorities saw the debt restructuring as a significant success, although the Nevis Island authorities and the Governor of the ECCB were critical of the haircuts imposed on external creditors as they felt this would hinder the restoration of the federation's market access for some time. The central government and ECCB agreed that gross financing needs remained too high, although they argued that it would have been difficult to reduce them, particularly through a restructuring of Treasury bills, during the program as this may have damaged the credibility of the instrument and created significant social and financial challenges given the diverse base of Treasury bill holders. However, the authorities agree that lengthening the maturity structure to ease short-term gross financing needs remains important and they are working to do this through regular debt operations in the near-term. Members of the previous government stressed that the program should have been designed to protect the progress made during it, in the face of a subsequent change in government.

Although it was never used, the authorities **reiterated that the Banking Sector Reserve Fund (BSRF) served as a valuable safety net**, strengthening the government's capacity to make decisions which could have affected the financial system. They also recognized that the domestic financial system remained resilient despite the debt-land swap but noted ongoing challenges in managing excess liquidity at banks emerging from banks' high risk aversion and the lack of bankable private sector projects. The ECCB, by contrast, did not see the BSRF as critical to the maintenance of financial stability during the program.

The authorities expressed interest to continue working closely with the Fund on devising plans to enhance private sector development, including through reorienting existing initiatives like the People Employment Program (PEP), to support entrepreneurship and long-term sustainable growth. While they felt that exchange rate overvaluation was not a given, they reiterated the need for a strategy and targeted policies to boost competitiveness of the external sector and enhance the business environment, which would also strengthen the financial system by creating bankable projects. Careful management of the country's sovereign wealth from CBI inflows, including by the early repayment of debt, was also a priority.

Statement by Mr. Serge Dupont Executive Director for St. Kitts and Nevis, and Mr. Kelvin Dalrymple, Senior Advisor to Executive Director
October 21, 2015

Our St. Kitts and Nevis (also referred to as the Federation) authorities thank the staff for including the Government as part of the assessment of the Ex Post Evaluation of Exceptional Access under the 2011 Stand-By Arrangement (SBA) and agree with the main thrust of staff findings. Our authorities consider that this program has been a success, having broadly met and, in some cases, exceeded the three broad objectives of the program, namely the comprehensive debt restructuring, ambitious fiscal consolidation, and strengthening of the financial sector. Having started the adjustment process with strong ownership as a homegrown program, authorities welcomed the SBA IMF design as appropriate and effective in identifying and pursuing macroeconomic priorities. By the end of the program, debt to GDP had fallen to 79 per cent of GDP from a high of 160 per cent; a primary fiscal surplus of 13 per cent had been recorded compared to a small deficit of 0.5 per cent in 2010. The commercial banks were liquid and well capitalized. In addition, the Federation has successfully implemented the components of the regional legislative program for financial sector reform, such steps having been treated as priorities by the new government in 2015 and have passed the comprehensive Eastern Caribbean Currency Union (ECCU)-wide Banking Act. Authorities made significant progress meeting the fiscal targets through the program even without the unanticipated rise in Citizenship by Investment (CBI) proceeds; the CBI allowed the authorities to build sizeable buffers. The authorities are mindful that external conditions as well as flows from the CBI can shift and they are supportive of saving as much of the proceeds of the CBI as possible. In this regard, they are giving consideration to a dedicated fund with a medium to long-term investment horizon.

The government that came into power in February 2015 on an agenda of change is nonetheless committed to completing broadly the agenda started under the program. Given the vulnerability of St. Kitts and Nevis to exogenous shocks, mainly economic and natural hazards, authorities are committed to a medium-term agenda focused on fiscal discipline and debt reduction and an enabling environment for business to grow and thrive. Reform of the civil service is necessary, as is constraining wages as a percentage of fiscal revenue.

Given momentum established under the program, growth prospects are promising. The Federation's small size limits scope for economic diversification and hence authorities aim to capitalize fully on the potential of the tourism industry through attraction of Foreign Direct Investment (FDI). A pipeline of private sector investment in hotel accommodation and amenity projects establish a foundation for growth. In support of, and as complement to those investments, authorities are pursuing diversification of both source markets and product offerings. Increased airlift is an important element to ensuring increased and more consistent arrivals. Specialized services such as the new terminal for private jets at the International Airport as well as proposed yachting facilities at Christophe Harbor would target the highest end of the tourism market. Backward linkages are also explored with a view to ensuring greater local participation in the tourism value chain. In addition, to reduce energy costs and enhance competitiveness, authorities are intensifying efforts to develop alternative energy (solar, geothermal) and to reduce the dependence of the economy on fossil fuel imports.

Continuing with the thrust of the program, efforts to improve the business environment will focus on gaps in competitiveness. Based on global rankings, authorities already have undertaken reform of the tax system, including compliance, as well as property registration and contract enforcement. Capacity constraints require that such efforts be properly targeted and sequenced to ensure best design, implementation and effectiveness.

Looking back, notwithstanding overall positive outcomes, capacity constraints would have been better accommodated through semi-annual, rather than quarterly reviews. Our authorities understand the need for close collaboration and monitoring, especially in the early stages of the program, but believe that other forms of contact could have best substituted for formal program reviews. This would have permitted greater focus by small teams on actual pursuit and achievement of benchmarks. In addition, delays in sourcing technical assistance from development partners, for example on pension reform, compromised achievement of some of the program targets. Going forward, this constituency is pleased that semi-annual targets may be considered for small states, as is indeed the case under the ongoing program of one of our other members in the Caribbean.

Still, the Program has been an important source of capacity building for the Government of St. Kitts and Nevis. Our authorities welcomed the many opportunities for collaboration with staff on the structural agenda. Of particular value was assistance in public financial management which enabled the authorities to implement key reforms for the diligent conduct and monitoring of fiscal policy.

Given that St. Kitts and Nevis is a federation, with important authorities residing with the island of Nevis, upon reflection more attention could have been directed at the sub-national level. Our authorities concur with staff that the fiscal position and structural agenda in Nevis were deserving of greater priority. Indeed, many of the waivers requested under the program were a result of issues arising in the Nevis Island Administration (NIA). The Federal Government and the NIA are drawing lessons from such gaps and working toward enhanced coordination.