BARBADOS WHAT'S NEXT?
Q&A WITH MARLA DUKHARAN

MAY 27, 2018

BARBADOS – WHAT NEXT?

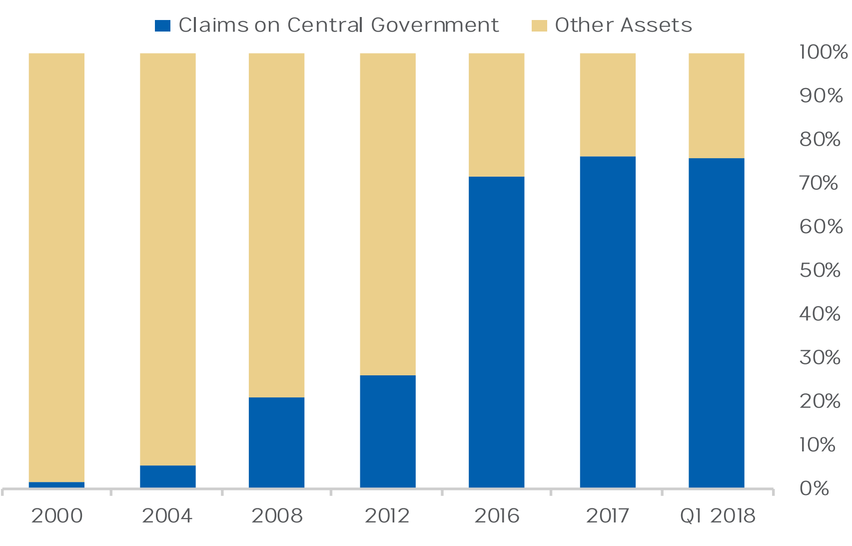
Q - Now that the elections are over, what are the most immediate and urgent challenges for Barbados?

A - The fiscal deficit itself, and the way in which it is financed, are the most immediate challenges for Barbados. In the post-crisis period, the fiscal deficit has averaged between 7-8% of GDP, and this does not take into account the amount of arrears that have been mounting each year, estimated by the IMF at 6% of GDP in FY2015/16.

Last fiscal year alone the Central Bank supported the Government to the extent of almost BB$800 million in terms of financing. As a result of this, since the beginning of 2014, the monetary base has almost doubled. Central Bank claims on Central Government increased to 76% of total Central Bank assets in March 2018, up from 55% in March 2016, severely compromising the role of the Central Bank as lender of last resort.

Central Bank Total Assets: Barbados

% Breakdown of Total Central Bank Assets



Source: Central Bank of Barbados, Marla Dukharan

Q - What are the implications of fiscal overspending and Central Bank printing?

A - Fiscal overspending and central bank printing have contributed to the precipitous decline in foreign reserves - which to me is the most immediate of all the challenges facing Barbados at this time.

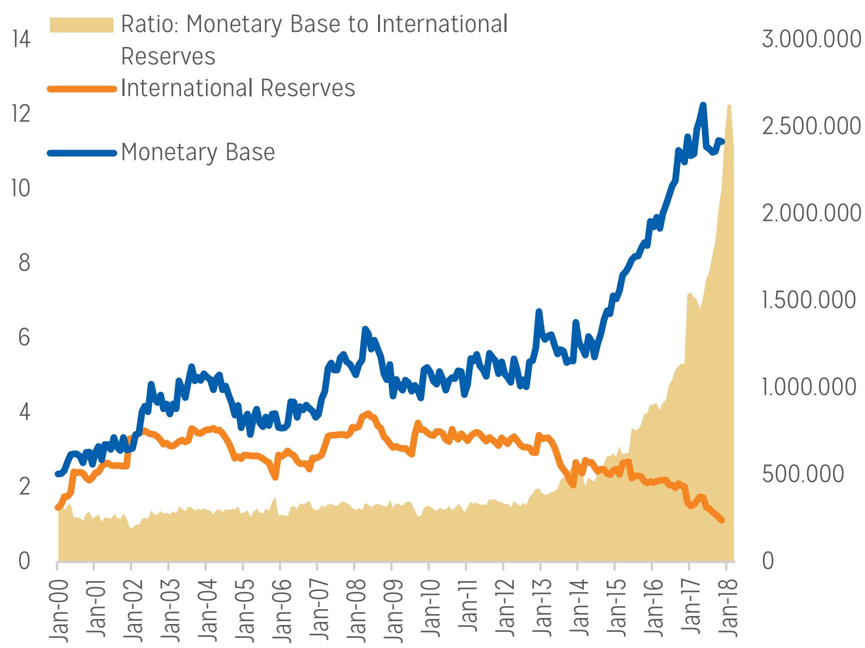
In May 2018, the Central Bank revised the international reserves figures downward for the months of Dec 2017- Feb 2018, showing reserves had reached the lowest level since November 1993 at US$187 million in Jan 2018. International reserves fell 40% y/y to USS211.5 million in March 2018, and while the Central Bank reports this as 6.9 weeks of import cover, in the context of rising fuel prices and foreign debt payments, my estimate would be around 5 weeks. This is the lowest level of reserves in 22 years.

The ratio of the monetary base versus the level of international reserves, reached BB$12.28 per US$1 in reserves in January 2018, improving only slightly to BB$11.12 per US$1 in March 2018, showing just how much pressure there is on the exchange rate.

Another byproduct of printing is the effect on domestic prices / inflation. The Central Bank reported inflation at 4.0% for 2017, rising to 4.5% in January 2018. However, the Retail Price Index showed a 6.6% y/y point-to-point increase at December 2017, suggesting inflation could even be higher. Inflation is expected to continue to be elevated in 2018, with the pass-through effect of higher international oil prices, and the impacts of the election spending and printing / expansion of the monetary base.

Monetary Base (BBD) and International Reserves (USD)

Thousands, Monetary Base/Int'l Reserves (left axis)



Source: Central Bank of Barbados, Marla Dukharan

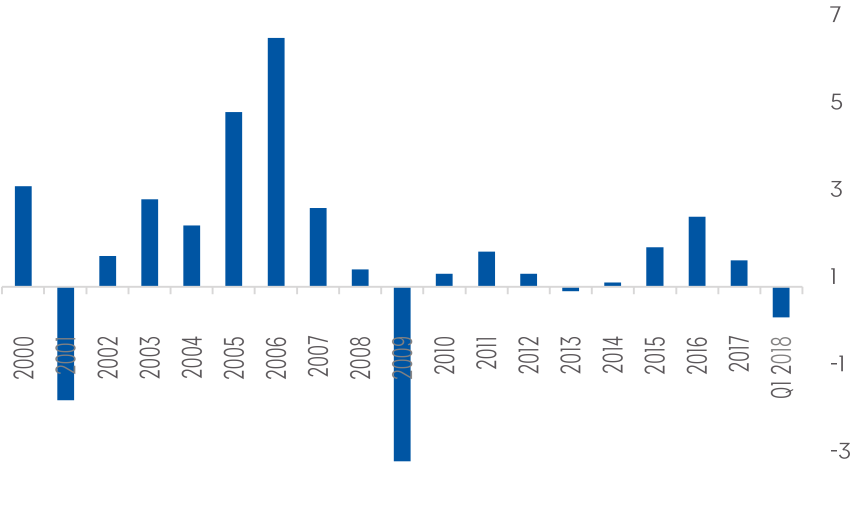
Q – Why is growth so low?

A - To start with, as I expected, the Central Bank recently revised down the 2017 growth estimate from 1.0% reported in January 2018 to 0.6% affirmed in May 2018. Growth has therefore averaged 0.9% since the turn of the century.

For the first quarter of 2018, the picture worsened, as GDP contracted 0.7% y/y. This contraction in the economy was broad-based: tourism value-add

GDP Growth: Barbados

Percent Change y/y (%)



Source: Central Bank of Barbados, Marla Dukharan

contracted 1% y/y in Jan-Mar 2018 despite a 5.8% y/y increase in long-stay arrivals; slower construction activity; a late start to the sugar harvest; and weaker domestic demand, according to the Central Bank. The overall length of stay, particularly for tourists from North America, has been declining, with short-stays from this market now accounting for 42% of total stay-over arrivals – versus 36% in 2014. Construction activity weakened as tourism-related projects concluded and new projects were delayed in starting. The Central Bank attributes the slowdown in domestic demand to the budgetary measures announced in May 2017. The Central Bank has revised its projection for economic growth in 2018 down to 0% +/- 0.25%.

It is important to understand that the slowdown in the economy is mainly being driven by fiscal drag, meaning the extent to which the Government's overspending, borrowing, and printing, have all had an impact on economic activity, confidence and growth.

According to the Central Bank update for Q1 2018, the fiscal deficit was reported to have fallen from BB$524.1 million in FY2017/17 to BB$394.6 million in FY2017/2018. But this improvement in the fiscal outturn must be measured against the budgeted fiscal surplus of 0.3% of GDP, which of course was not met, similar to the fiscal targets of the past several years. In addition, it is not clear how much of the "improvement" in the fiscal numbers is due to the accumulation of arrears, since the government does not report these figures, and although the IMF does, the government blocked the publication of the IMF's most recent Article IV report. One wonders what secrets lie therein.

Gross public sector debt, including debt held by the Central Bank and the NIS, increased to BB$15,168.5 million in March 2018. Using the 2017 nominal GDP figure of BB$9,438.4 million reported by the Central Bank, debt/GDP actually reached 161% in March 2018, not 151% as stated in the Central Bank's Quarterly Economic Review. This is the third highest level of debt in the world, after Japan and Greece.

Q - What next for Barbados?

I expect Barbados will embark on a domestic and possibly foreign sovereign debt restructure, in the context of a broader IMF supported adjustment programme this year.

There are two reasons a country would go to the IMF for help: there is a debt and/or a balance of payments crisis. This means that the country does not have enough foreign currency to meet its foreign currency obligations, either debt or otherwise.

In my view, the government needs AND will benefit from an IMF programme. Regardless of the measures that the government eventually decides to embark on, these measures are more likely to be successful if there is support from the multilateral agencies and development banks—financial support and technical support.

The IMF had prescribed several measures in their last Article IV report (the current report was NOT published by the authorities, for the second time in their administration)—one of these is the recommendation of a primary fiscal surplus of 7.5% of GDP by year 3 of the adjustment.

Fiscal adjustment of at least 3.5% of GDP over the next three years

- Primary fiscal surplus of 7.5% of GDP by FY2020/21.
- Would reduce debt below 100% by FY2019/20, ease the funding burden, support international reserves, and improve the country's credit ratings.
- Market-based debt operations could reduce funding requirements.
- Given the debt structure, the benefits of a restructuring would be small and could have negative repercussions.

A currency devaluation is rejected by the authorities, but according to the IMF

- It may improve competitiveness.
- It could allow for a somewhat less-ambitious adjustment, although substantial fiscal adjustment would still be required.

Other measures included: swift elimination of arrears to the NIS, reform of the Barbados Revenue Authority to include merger with the Customs and Excise department, elimination of arrears on tax refunds, deep and comprehensive state-owned enterprise reforms, including the consolidation, rationalisation, and divestment of the 64 SOEs.

Q - What are the solutions for Barbados?

- The fiscal deficit must be reduced immediately at least to eliminate reliance on the Central Bank for ANY financing.
- The largest line items, all over BB$700 million each per annum are—wages and salaries, interest payments, and grants to public institutions. Perhaps government needs to address these with the most urgency and priority.
- A reduction in the wage bill via a voluntary separation programme initially. It would also be beneficial to agree on a public sector wage cut rather than layoffs if legally permissable.
- A reduction in transfers to state enterprises via divestment/lease.
- To reduce the domestic debt servicing cost: Domestic debt restructure with recapitalisation of NIS and CBB as necessary, as 75% of NIS assets and 76% of CBB assets is government paper. CBB holds 21% of central government domestic debt and NIS holds 33%—so in total about half. The NIS is the single largest holder of central government domestic debt. The other half is held by banks and insurance / pension funds. Propose their component of domestic government paper be put on a longer tenor instrument with a lower interest rate, contingent upon certain conditions being met in terms of reforms and fiscal targets. One such reform would be the implementation of a fiscal responsibility framework.

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