FOR AGENDA

SM/11/308
Correction 1

November 28, 2011

To: Members of the Executive Board

From: The Acting Secretary

Subject: **United Kingdom—Anguilla—British Overseas Territory—Staff Report for the 2011 Article IV Consultation Discussions**

The attached corrections to SM/11/308 (11/15/11) have been provided by the staff:

Evident Ambiguity

Page 1, para. 2, lines 7–8: for "the government, and the United Kingdom."
read "the Anguillan government, and the Financial Services Commission (FSC) of Anguilla."

Page 6, para. 12, lines 21–22: for "Central Bank, the government, and the United Kingdom."
read "Central Bank, the Anguillan government, and the FSC of Anguilla."

Page 11, para. 39, lines 10–11: for "roles of the ECCB, the government, and the United Kingdom."
read "roles of the ECCB, the Anguillan government, and the FSC of Anguilla."

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 3, para. 1, line 6: for "stability as a UK overseas territory"
read "stability as a British overseas territory"

Page 4, para. 5, lines 8–11: for "…In addition, Anguilla had breached official borrowing guidelines agreed with the UK which prevented disbursement of a US$18 million…"
read "…In addition, the UK Government determined that it was unable to permit disbursement of a US$18 million…"

Page 4, para. 5, lines 13–14: for "Development Bank (CDB) loan approved in 2008 to upgrade the ferry port…"
read "Development Bank (CDB) loan approved in 2008 to upgrade the ferry port because the authorities did not deliver a business case demonstrating Anguilla's ability to repay the expected loan costs and remain within the official borrowing guidelines…"

Page 4, para. 6, line 4: for "achieve an overall balance by 2012…"
read "balance the overall budget by the start of 2013."

Page 8, para. 20, line 5: for "should aim to finalize its recommendations in…"
read "has recently finalized its recommendations…"

Page 28, para. 2, lines 3–4: for "…Nevertheless, achieving a budget balance by 2012 will be challenging."
read "…Nevertheless, balancing the overall budget by the start of 2013 will be challenging."

Questions may be referred to Mr. Monroe (ext. 38020) and Mr. Mrkaic (ext. 36126) in WHD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (7)

Other Distribution:
Department Heads

Corrected: 11/23/11

INTERNATIONAL MONETARY FUND

UNITED KINGDOM—ANGUILLA—BRITISH OVERSEAS TERRITORY

STAFF REPORT FOR THE 2011 ARTICLE IV CONSULTATION DISCUSSIONS

November 15, 2011

KEY ISSUES

Setting: Anguilla has experienced a boom-bust cycle related to the global crisis and has faced a persistent hangover. This has accentuated weaknesses in the financial sector and undermined the fiscal position. After sharp output contractions in 2009–10, growth is still expected to be negative in 2011 and return to positive territory in 2012 with the two major tourism projects getting back on course. The 2011 Article IV Consultation Discussions represent the Fund's first formal bilateral dialogue with this British overseas territory, building on the annual ECCU Common Policies discussions.

Addressing financial vulnerabilities: The most pressing issue is how to deal with weak indigenous banks, as the downturn has placed strains on the financial system, seriously affecting asset quality and liquidity. Continued efforts are needed to enhance nonbank supervision, particularly in light of the failure of two regional insurance companies, and to improve coordination. An action plan for addressing financial sector vulnerabilities is needed that spells out the respective roles of the Eastern Caribbean Central Bank, the Anguillan government, and the Financial Services Commission (FSC) of Anguilla. The offshore financial sector offers some potential to diversify the economy, but the balance between the potential economic benefits and costs need to be weighed carefully.

Rebalancing fiscal policy: A fiscal framework needs to be put in place in line with the resources available and with an appropriate balance between current and capital expenditure. An adequate framework would build buffers in good times to allow countercyclical spending when needed and incorporate a system of tax policy and administration that would yield sufficient revenue to meet established priorities. A comprehensive tax reform to simplify the tax structure and broaden the tax base is needed. Reversing some of the growth in the wage bill, which more than doubled during the 2003–08 boom, is unavoidable. Within this framework, the 2012 budget should restore capital spending, cut current spending including wages, and increase revenue by broadening the tax base.

Enhancing growth prospects: The short-run policy priorities should be to increase capital spending, improve the business environment including through a one-stop shop, and address skills shortages through training and greater labor mobility, while improving access to the island and enhancing diversification in the longer run.

Approved By
David Vegara /s/ and Jan Kees Martijn /s/

Discussions took place in The Valley during July 20–29, 2011. The consultation discussions form part of the Article IV consultation with the United Kingdom. The staff team comprised H. Monroe (head), M. Mrkaic and A. Viseth (all WHD) and F. Yang (FIN) with an overlapping visit by Mr. Akçakoca (MCM expert).

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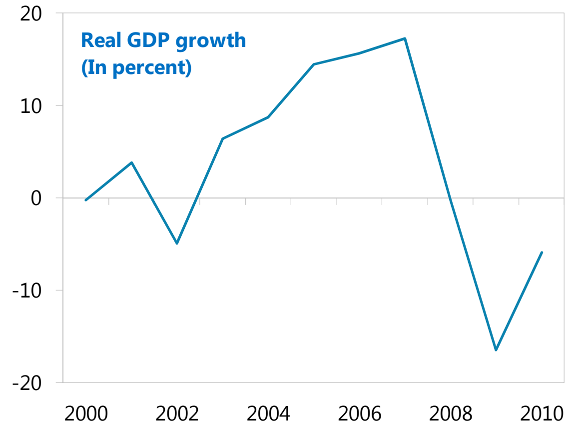
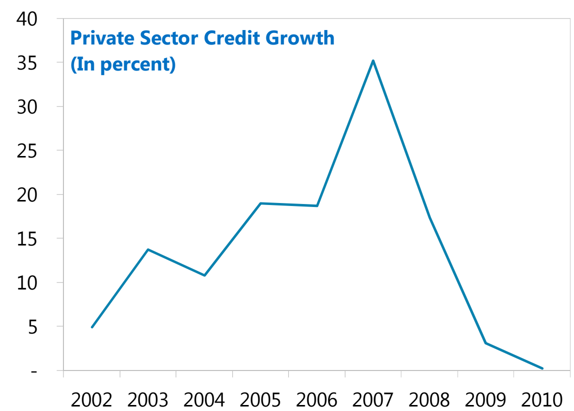
RECENT DEVELOPMENTS AND OUTLOOK

1. **Anguilla's per capita GDP is well above the average for the Caribbean region.** The island has been able to turn its small size and population (16 thousand), natural beauty, relative inaccessibility, and stability as a British overseas territory to its advantage by establishing a reputation as an upscale and exclusive tourist destination. It has also developed a relatively large financial sector in comparison to the size of its economy. However, these features also greatly magnified the boom-bust cycle associated with the global crisis and have contributed to a persistent hangover.[1]





2. **Several large resort projects fueled a FDI boom which doubled nominal GDP during 2003–08.** The boom affected every aspect of the economy, with construction becoming the main driver of activity. Tax revenue of a transitory nature—particularly on real estate transactions, FDI-related imports, and imported labor—increased sharply. Private sector wages jumped, while the construction industry imported labor on a large scale. The government wage bill more than doubled, as salaries increased by two thirds, and headcount increased by 45 percent to meet law enforcement, education, and other needs. In addition, a greater proportion of government expenditure was devoted to transfers. The size of the banking system doubled, with a portfolio concentrated in real estate lending.

3. **The bust has been nearly as dramatic as the boom it followed.** One of the two major FDI projects stalled in 2008 after running out of financing.[2] With the onset of the global crisis in 2009, real GDP fell by 17 percent and the fiscal situation deteriorated sharply. Revenue collapsed while expenditure remained elevated after the increases during the boom years. Despite drastic cuts in capital spending in 2009 and a reduction in salaries of about 7 percent on average, the overall deficit grew to 8 percent of GDP, financed largely by expensive short-term overdraft facilities,

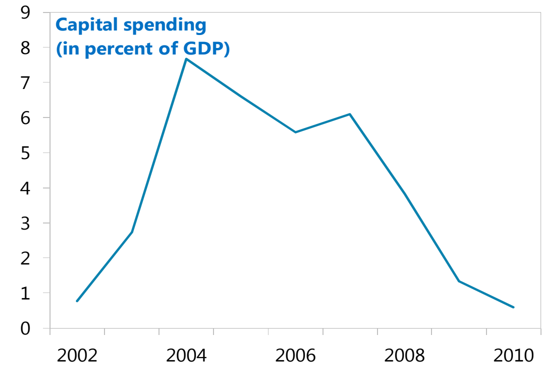
[1] The 2011 ECCU Common Policies Staff Report covers regional issues in greater depth.

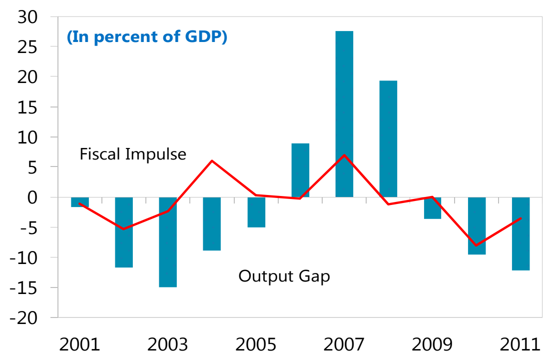
[2] The other major project which was already operating entered receivership in early 2010.

arrears, and a temporary advance from the Eastern Caribbean Central Bank (ECCB).

4. Economic activity and government revenue continued to slow in 2010, despite a recovery of the high-end tourism sector. To stabilize the fiscal accounts, the new government that took office in early 2010 introduced revenue measures, further reduced average salaries by 3.5 percent and froze salary increments, curtailed goods and services spending, and cut capital spending further to an extremely low level. These measures and an European Union grant of over 4 percent of GDP reduced the overall deficit by 6 percentage points of GDP.

5. The reduction in the overall balance in 2010 reflected in part financing constraints. Overall public debt had increased sharply to 25 percent of GDP at end-2010—relatively high for a small undiversified economy (but not high by regional standards). Commercial banks which faced tight liquidity called in loans to government. In addition, the UK Government determined that it was unable to permit disbursement of a US$18 million (6 percent of 2009 GDP) Caribbean Development Bank (CDB) loan approved in 2008 to upgrade the ferry port because the authorities did not deliver a business case demonstrating Anguilla's ability to repay the expected loan costs and remain within the official borrowing guidelines.[3] The government refinanced most of its debt in mid-2010 through a US$55 million (18 percent of GDP) Policy Based Loan from the CDB and borrowed





EC$ 50 million from the Social Security Board as of the end of 2010.

6. The 2011 budget represents a determined fiscal effort by the government to meet its commitment to the UK to balance the overall budget by the start of 2013. The UK delayed approval of the original budget to allow for an assessment by external consultants, whose recommendations were taken to double the customs surcharge and to increase the specific gasoline tax at the import stage.[4] These and other approved measures are aimed at increasing tax revenue by EC$ 21 million (2.7 percent of GDP). The consultants recommended additional revenue measures in 2012 to balance the budget in that year.

[3] The guidelines require keeping: (1) debt below 80 percent of current revenue; (2) debt service below 8 percent of current revenue; and (3) cash reserves for 90 days of operations. The last guideline was the first to be breached.

[4] The UK-appointed Governor of Anguilla has the authority to veto budgets, in addition to being responsible for external relations, nonbank regulation, and the civil service.

7. **The global crisis has placed pressure on the financial sector.** There are 2 indigenous banks and 2 foreign banks operating in the jurisdiction. Total assets amount to 276 percent of GDP, with a market share for indigenous banks of 75 percent. The asset portfolio of the banking system, which is concentrated in construction, tourism, and personal loans, deteriorated during the downturn, with the ratio of nonperforming to total loans increasing to 36 percent by end-June 2011 in the indigenous banks. The liquidity situation also remains tight.

8. **The pickup in inflation due to higher global food and fuel prices is not expected to persist.** Reflecting upward pressure from prices of imported food and fuel, inflation is expected to rise further to 5 percent in 2011 before reverting, given the anchor of the currency peg.

9. **Despite a number of encouraging developments, the staff's outlook for growth is cautious.** One major tourism project has exited receivership into ownership by an established investment group which is well placed to enhance operations. A bid has also been made for another major project, which had been stalled since 2008 before construction was complete. Furthermore, Anguilla's share of ECCU and of Caribbean stayover arrivals is recovering, and the resilience of its high-end tourism sector notwithstanding high unemployment in source countries is an advantage. However, the tepid global outlook will still weigh on the economy. Staff forecast an additional contraction in 2011 reflecting the drag of fiscal policy and lower FDI, and a modest recovery in 2012. Going forward, the growth outlook depends on a recovery of capital spending, implementation of the ferry port project and the pace of global economic recovery.

POLICY ISSUES

The key policy challenges facing Anguilla are addressing financial sector weaknesses, rebalancing fiscal policy, and enhancing growth prospects.

A. Addressing Financial Sector Vulnerabilities

10. **The downturn has significantly affected the banking system.** The system was already suffering before the crisis from a concentrated portfolio which grew rapidly during the boom period. The indigenous commercial banks and their offshore subsidiaries have weak financial positions, and would have large negative capital by staff estimates.[5] They have lending and equity linkages to other ECCU banks which provide a potential channel for contagion. The NPLs of foreign banks have increased sharply in 2011, with low provisioning, but these are backed by the foreign parent.[6]

11. **The most pressing issue is how to deal preemptively with weak banks since a failure of one institution could trigger a generalized loss of confidence in the region.** Furthermore, given the expected slow recovery,

[5] Figure 4 and Table 5 show positive reported capital without adjustments made by staff.

[6] Foreign banks have limited their linkages to indigenous banks.

the banking system will continue to be under stress. The recent intervention in the largest indigenous bank in Antigua and Barbuda underscores the importance of prompt and preemptive resolution.

12. **Staff emphasized that a comprehensive regional approach to problems in the ECCU's banking system is needed.** The authorities are encouraged to support the work of a joint regional task force being formed to determine the size of the liquidity and capital shortfalls in indigenous banks, assess direct and indirect linkages, and develop resolution strategies. Supervision is fragmented, with the parent banks supervised by the ECCB and their offshore bank subsidiaries by the Financial Services Commission (FSC) under the UK-appointed Governor of Anguilla. Recent efforts to improve coordination have had limited success due to limited sharing of information, attributed to confidentiality restrictions. An action plan for addressing financial sector vulnerabilities should therefore also spell out the respective roles of the Eastern Caribbean Central Bank, the Anguillan government, and the FSC of Anguilla.

13. **The authorities concurred that action is overdue to shore up the banking system.** They agreed that a regional approach was needed, and given fragmented supervision that greater coordination as required, with a clear delineation of roles.

14. **The resolution of the failed BAICO and CLICO insurance companies has been a source of continuing uncertainty, and regional efforts to resolve these companies are still ongoing.** Banks have made progress in provisioning for their exposures. A regional strategy is being pursued aimed at maintaining BAICO as a going concern, and a judicial manager has been appointed for BAICO Anguilla as in other ECCU members. In the case of CLICO, Anguilla is relying on the judicial manager appointed in Barbados, the home jurisdiction.

Estimated Exposure to CLICO and BAICO 1/

(In millions of EC$)	
Total	59.2
of which	
Financial institutions	9.1
Public Sector	12.0
CLICO	10.5
of which	
Financial institutions	9.1
Public Sector	0.0
BAICO	48.7
of which	
Financial institutions	0.0
Public Sector	12.0
(In percent of 2010 GDP)	
Total	8.0
CLICO	1.4
BAICO	6.5

Source: Data provided by country authorities.
1/ As of June 2011

15. **The insurance sector appears healthy apart from the difficulties of CLICO and BAICO.** However, the authorities are encouraged to continue progress toward strengthening insurance industry regulation and to enact harmonized insurance legislation now under consideration.

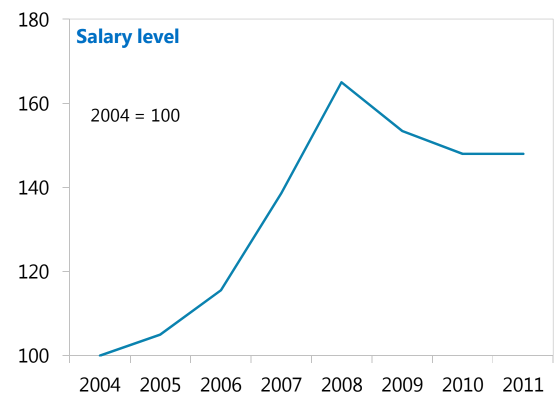
16. **Anguilla is considering expanding its offshore financial sector as part of efforts to diversify the economy.** Recent research has confirmed that strong governance attracts offshore business, and that a well-regulated offshore sector can contribute to growth. However, the economic benefits of expanding the offshore sector will need to be carefully

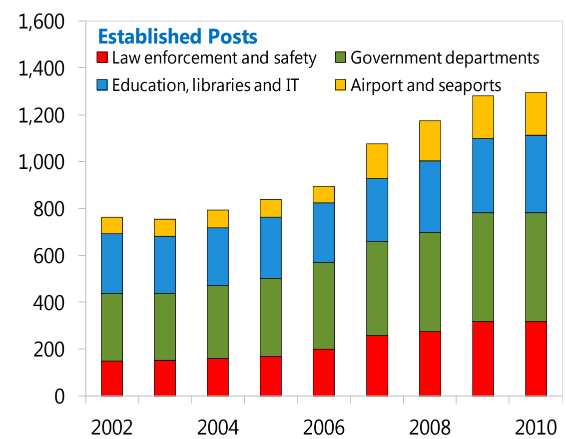
weighed against the associated regulatory costs. While the authorities have made progress in strengthening the anti-money laundering and combating the financing of terrorism regime, they need to implement fully the recommendations made in the June 2010 Caribbean Financial Action Task Force assessment report. In this respect, the plan to review the governance of the company registry is welcome and should aim at preventing the unlawful use of legal persons, and particularly International Business Companies, by money launderers.

17. The authorities supported the regional approach to resolving the CLICO/BAICO issue. They noted that Anguilla was among the first in the region to set up a single regulatory unit for the nonbank sector, and were making progress toward enacting modern insurance legislation. Their strategy for the offshore financial sector is still being defined.

B. Rebalancing Fiscal Policy

18. A fundamental rebalancing of fiscal policy is needed, beginning with the 2012 budget. If not for windfall stamp duty from the sale of a major project, the fiscal outturn for the first half of 2011 indicates revenue would fall EC$ 12 million short of budgetary projections for the full year, due primarily to a weak outturn for taxes on international transactions. The staff projects an overall deficit of EC$ 20 million for 2012 assuming a conservative estimate for the stamp duty revenue, a constant wage bill, and the return of capital spending to the historical average, which the staff recommend. This would imply that the additional revenue measures of EC$ 8 million that were recommended by external consultants would not be sufficient to achieve an overall balance.





19. Reversing some of the sharp growth in the wage bill will be necessary to balance the budget in 2012, as foreseen by the authorities. After the increase of two thirds during 2005–08, salary reductions in 2009–10 lowered the wage bill by about 10 percent. Furthermore, the wage cuts took the form of temporary salary suspensions which do not affect pensions and with the prospect of eventual partial or full reimbursement of suspended salaries. Because full reimbursement has been granted to all retirees since 2009, this has become perceived as an entitlement creating potential future budget pressures.

20. An overall balance could be achieved in 2012 through a combination of revenue and expenditure measures. On the revenue side, the Tax Reform Working Group has recently finalized its recommendations in time for incorporation in the 2012 budget. Making progress with tax reform would be preferable to implementing further ad hoc measures. On the expenditure side, the 2012 budget should begin reining in the wage bill and reflect the findings of the OECS Public Expenditure Review Commission to be published in the near future. While these measures would be a drag on growth, the momentum from major tourism projects is expected to sustain a recovery.

21. Given financing restrictions and economic vulnerabilities, Anguilla needs to put in place a fiscal framework in line with the resources available and with an appropriate balance between current and capital spending. An adequate framework would build buffers in good times to allow for countercyclical spending when needed and incorporate a system of tax policy and administration that would yield sufficient revenue to meet established priorities. An illustrative medium-term projection (Table 6) which holds the nominal wage bill constant while increasing capital expenditure to its long run average underscores that restoring sustainability is feasible but only if there is also early action as discussed above. However, there are significant downside risks if the external environment deteriorates or tourism projects lose momentum.

22. The official borrowing guidelines by themselves are not sufficient as a fiscal framework. A broader Framework for Fiscal Responsibility under discussion with the UK would shift emphasis toward developing a Medium-Term Fiscal Plan as a context for annual budgets, with improved project appraisal and evaluation, more transparent procurement, and stricter management of actual and contingent liabilities. The approach would be embodied in a new public financial management law.

23. The new framework could specify a clear fiscal anchor in the form of a target for public sector debt as a percent to GDP.[7] Given that Anguilla has a small non-diversified economy subject to natural disasters and other shocks, it would be appropriate to set a target which is significantly lower than the 60 percent of GDP target set by the ECCU Monetary Council to be achieved by 2020 by ECCU members. The ECCU Common Policies Discussions Staff Report presents the case that an appropriate target for the region would be toward the lower end of the 25-45 percent range identified in the literature. With a clear fiscal framework in place, Anguilla could consider asking the CDB to reappraise the ferry port loan (6 percent of GDP).

24. A comprehensive tax reform is needed to restructure the current inefficient and inequitable tax system (Box 2). Currently, only about 40 percent of imports bear positive rates of duty, while 20 percent of imports enjoy duty concessions. The tax reform should simplify the tariff structure; impose excise taxes on fuel, alcohol,

[7] The existing borrowing guidelines relate debt and debt service to current revenue, which has been volatile as described above.

STAFF APPRAISAL

38. Anguilla is recovering from severe boom-bust cycle related to the global financial and economic crisis. This has accentuated weaknesses in the financial sector, undermined the fiscal position, and pushed the island into recession. Urgent action is needed to improve the health of the financial sector, to stabilize public finances, and to increase the potential for long-run economic growth.

39. Close cooperation will be needed to address financial sector vulnerabilities, particularly those related to the indigenous banks. A preemptive response as part of a regional strategy led by a joint task force being formed could minimize costs and risks. The strategy will need to strengthen the banks' capital and clean up their balance sheets. An action plan should spell out the respective roles of the ECCB, the Anguillan government, and the FSC of Anguilla.

40. A new fiscal framework is needed with an appropriate balance between current and capital expenditure and in line with the resources available. Fiscal policy should be designed to meet the combined objectives of debt sustainability, deficit reduction, and long-term economic growth. Given financing constraints and economic vulnerabilities, the government needs to accumulate buffers during good times to allow for countercyclical spending during slowdowns. As part of the new framework, the 2012 budget should restore capital spending to historical levels, cut current spending including wages, while ensuring adequate revenue given financing constraints.

41. In this context, the inefficient and inequitable tax system needs to be reformed. A comprehensive tax reform should simplify the tax structure and broaden the tax base. A general consumption-based tax such as a VAT/GST and a permanent income tax would attain both objectives. The complex system of customs duties and exemptions should be replaced with a tariff with few rates and limited exemptions.

42. The tourism sector, the driver of the economy, has begun to recover, benefiting from its high-end focus. Prospects have brightened now that the two major tourism projects are getting back on track. However, air and sea access to the island needs to be improved.

43. A fundamental course change is needed to increase the potential for long-term GDP growth and reduce its volatility. The short-run policy priorities should be to increase capital spending, improve the business environment including through a one-stop shop, and address skills shortages through improved training and greater labor mobility. In the longer run, the focus should be on improving access to the island and enhancing diversification, which would reduce the volatility of real GDP growth rates. There are some indications that the exchange rate is overvalued, but the evidence is not conclusive, and there are significant data limitations.

Box 1. Exchange Rate Assessment

The customer- and competitor-based real effective exchange rates (REERs) have recently been on a broadly declining trend. Following a sharp appreciation in 2008 corresponding to global food and fuel price increases, the customer-based real effective exchange rate has been depreciating, reflecting U.S. dollar depreciation against the major customer currencies, while the competitor-based real effective exchange rate has broadly been on a declining trend since 2007.

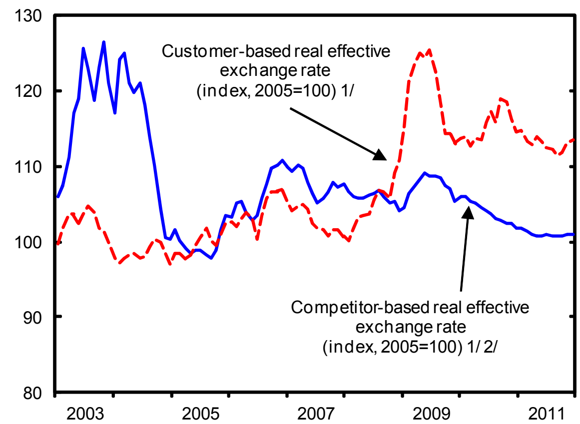
The assessment of the exchange rate using CGER methodologies is constrained by significant data limitations.

The fundamentals-based equilibrium real exchange rate approach suggests that the actual real effective exchange rate has been close to its long-run equilibrium value in recent years.[1] The actual rate has been converging toward its equilibrium from 2004 onwards.

The macroeconomic balance approach points to an overvaluation of the exchange rate. This approach indicates that the current account (CA) norm is minus 18.9 percent of GDP against the underlying CA of minus 25.7 percent. Closing the gap between the norm and the actual CA in the medium term would require a depreciation of 22.9 percent.

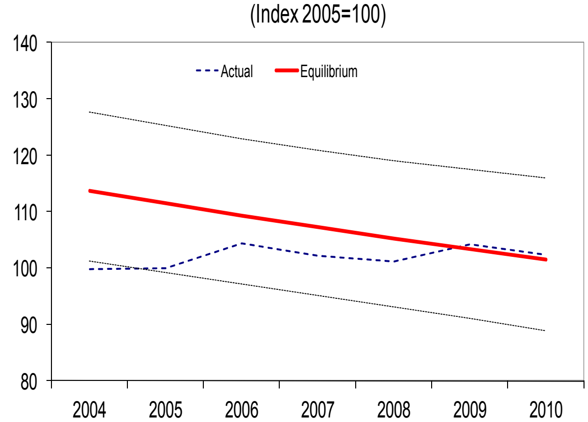
The external sustainability approach indicates an overvaluation of 58.4 percent.[2] The net foreign asset stabilizing CA is minus 8.3 percent of GDP while the underlying CA is minus 25.7 percent difference of about 17 percentage points, reflecting in part the projection of increasing FDI.

Anguilla: External Competitiveness, 2003–2011 (July)



Sources: Fund staff estimates.
1/ An increase (decrease) indicates an appreciation (depreciation).
2/ The sharp movements in the competitor-based real exchange rate in 2002–04 were largely driven by the Dominican Republic's peso.

Anguilla: Actual and Equilibrium REER, 2004–2010 1/ (Index 2005=100)



Sources: IMF, Information Notice System; and Pineda, Cashin and Sun (2009), "Assessing Exchange Rate Competitiveness in the ECCU," IMF Working Paper 09/78 (Washington: International Monetary Fund).
1/ The dotted lines around the equilibrium exchange rate represent 90 percent confidence intervals of the prediction.

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[1] The estimation takes into account productivity differentials in the tourism sector (using per capita tourist arrivals instead of per capita GDP), terms of trade for tourism, government consumption, and net foreign assets. For more details see: Pineda, Cashin and Sun, 2009, "Assessing Exchange Rate Competitiveness in the ECCU," IMF Working Paper 09/78 (Washington: International Monetary Fund).

[2] Unlike the standard CGER methodology, capital account transfers including grants were included in the estimation for the ECCU region, as they represent an important source of financing.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

Draft Public Information Notice (PIN) No. 11/xx
FOR IMMEDIATE RELEASE
November, [ ], 2011

IMF Executive Board Concludes 2011 Article IV Consultation Discussions with United Kingdom–Anguilla–British Overseas Territory

On [November xx, 2011], the Executive Board of the International Monetary Fund (IMF) concluded the first ever Article IV consultation discussions with United Kingdom–Anguilla–British Overseas Territory.[1]

Background

Anguilla has experienced a boom-bust cycle related to the global crisis and faces a persisting hangover. Several large resort projects fueled a FDI boom during 2003–08, which doubled nominal GDP. The stalling of one of these projects and the global crisis led to declines in real GDP of 16.5 percent in 2009 and 5.9 percent in 2010 respectively. The fiscal situation deteriorated sharply as revenue collapsed while expenditure remained elevated after the increases during the boom years, notwithstanding a series of fiscal measures.

The downturn has accentuated strains on the financial system. The asset portfolio of the banking system, which is concentrated in construction, tourism, and personal loans, was

[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. 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.

adversely affected, and the ratio of nonperforming loans to total loans in the indigenous banks increased to 36 percent by end-June 2011.

The growth outlook is improving with the major tourism projects getting back on course, though a slow recovery is only expected to begin in 2012. Risks are tilted to the downside given the global outlook. Nevertheless, balancing the overall budget by the start of 2013 will be challenging.

Executive Board Assessment

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