Belize: Staff Concluding Statement of the 2017 Article IV Mission

June 15, 2017

An International Monetary Fund team led by Bert van Selm visited Belize from June 6-15 to conduct the discussions for the 2017 Article IV consultation. The team met with Honorable Mr. Dean Barrow, Prime Minister and Minister of Finance; Ms. Carla Barnett, Minister of State at the Ministry of Finance; Amb. Joy Grant, Governor of the Central Bank of Belize; Mr. Joseph Waight, Financial Secretary, and other senior government officials, representatives of the opposition, private sector, and civil society.

The economy is expected to return to positive growth in 2017, but the medium term outlook remains weak. Public debt remains elevated, despite the cash flow relief and NPV gain from the recent debt restructuring agreement with private external bondholders; the current account deficit is sizable, and reserves are projected to remain low. While the tightening of the fiscal stance in the context of the 2017-18 budget is welcome, in the view of the team, further fiscal consolidation is necessary to mitigate risks and put public debt on a clear downward path, and to facilitate external adjustment. Potential further pressure on Correspondent Banking Relationships (CBRs) and low capital buffers in a major bank remain key risks to financial stability.

Recent Developments and Outlook

On March 15, 2017, the Belizean authorities reached a restructuring agreement with private external bondholders. This debt amounts to US$526 million, or about 30 percent of GDP. The agreement reduced the interest rate on the bond to 4.9375 percent (the rate was set to step up from 5 to 6.767 percent in August 2017), and amended the amortization schedule by pushing back principal repayments to 2030-34 (instead of starting semiannual installments in August 2019). The final maturity date of the bond would be brought forward from 2038 to 2034. The agreed terms reduced the NPV of the external bond debt by about 28 percent (based on the exit yield of 9.1 percent).

The agreement with bondholders is anchored by fiscal adjustment. The Belizean authorities have committed to bondholders to tighten the fiscal stance by 3 percentage points in 2017/18, and to maintain a primary surplus of 2 percent of GDP for the subsequent three years (2018/21), essentially implying no additional adjustment effort after 2017/18. The agreement also includes a monitoring mechanism for the fiscal adjustment effort: in the event Belize fails to meet the 2018-21 primary surplus targets, the authorities will submit a report to the National Assembly to explain why the targets were missed. Moreover, in such an event, Belize commits to requesting an IMF technical assistance mission to (i) determine why the primary surplus target was missed; and (ii) recommend remedial measures. The authorities have also committed to publishing the findings of any such IMF technical mission, as well as the annual Article IV consultation reports. Furthermore, if the primary surplus target is missed, interest payments on the bond will become payable on a quarterly rather than semi-annual basis (for the subsequent 12 months that the target is missed).

The economy is expected to return to positive growth in 2017. Output is estimated to have contracted by 0.8 percent in 2016, reflecting a continued slowdown in oil production and setbacks in agriculture, including destruction of crops by Hurricane Earl. The current account deficit decreased slightly to an estimated 9.4 percent of GDP in 2016, while unemployment increased to 11.1 percent in September 2016, from 10.2 percent a year earlier. The external deficit reduced December 2016 gross reserves to US$377 million, or about 4 months of import coverage. Financial sector reforms continue to bear fruit, with the consolidated banking sector's gross NPL ratio declining to 9.8 percent (2.2 percent net of provisions) in March 2017, due to legacy loan write offs and restructuring, while the reported capital adequacy ratio is stable, at 23 percent. Private sector credit declined by 3 percent y/y in December 2016, despite ample liquidity in the banking system. For 2017, growth of 2½ percent is projected, reflecting a rebound in the primary sector combined with continued strong growth in tourism, supported by improved airlift (additional and less expensive flights), better marketing, and new FDI-financed projects. The current account deficit is expected to narrow to 8 percent of GDP in 2017. Inflation is projected to increase slightly to just over 2 percent in 2017, in line with price developments in major trading partners.

The fiscal deficit for 2016/17 was higher than budgeted. Whereas the budget targeted a primary surplus of 1 percent of GDP, the projected outturn is a deficit of about 1 percent of GDP, owing to both expenditure overruns and revenue shortfalls. The primary balance corresponds to an overall deficit of about 4 percent of GDP, excluding large BTL compensation payments (amounting to 5½ percent of GDP in 2016/17, financed by issuing domestic debt).

The budget for 2017/18 aims to tighten the fiscal stance by 4 percentage points of GDP. The budget approved by parliament in March aims for a primary surplus of 3 percent of GDP, corresponding to an overall budget close to balance (not including the large 2017/18 compensation payment for BTL).

- Parliament has passed several revenue-enhancing measures, including (i) higher excises on fuel, beer, sugary drinks, and construction materials; (ii) higher import duties on selected products, including cigarettes; (iii) an increase in an environmental tax (a levy on most imported goods); and (iv) adjustments in the General Sales Tax (GST), including lowering the social exemption for household electricity use. These tax policy measures would be supported by changes in tax administration to improve GST collections, and are aimed to increase revenue by more than 2 percent of GDP.

- On the expenditure side, the authorities are aiming for cuts equivalent to around 2 percent of GDP, mainly from reduced capital spending.

- Financing from Venezuela under the PetroCaribe program is expected to be smaller than in previous years. The sale of government shares in nationalized utility companies to domestic investors and issuance of domestic debt will contribute significantly to financing in FY2017/18.

Loss of CBRs has been a major problem for Belize over the last two years. This has resulted in higher transaction and compliance costs, restricted access to financial services, and delays in settlement of remittances. Since mid-2016, all domestic banks have been able to replace some of the lost CBRs, but some of these new CBRs appear to be temporary solutions.

The medium term outlook remains weak. Growth is projected to average just under 2 percent in the medium-term, reflecting declining productivity, competitiveness, public investment, and oil output. The current account deficit is projected to slowly improve due to a gradual recovery in agriculture and growth in tourism, but would remain significant, reflecting structural weaknesses in the export sector. International reserves are projected to decline to 2.5 months of imports in the baseline scenario, and any negative shocks could push them below that level.

The impact of the expected shift in the US policy mix will likely be limited. The main links to the US economy pertain to tourism and remittances, and higher US growth could boost these, but capital flows and financial integration with the US are limited. An appreciation of the US stronger dollar could have a negative impact on external competitiveness, given the exchange rate peg to the US dollar.

Downside risks remain substantial. A number of contested legacy claims, for a total of about US$100 million or so (or 5½ percent of GDP), could lead to large public and external financing needs. Additional loss of CBRs is possible and could further weaken banks. These vulnerabilities could be exacerbated by external risks, including a loss of PetroCaribe financing, a further decline in sugar prices after the EU sugar reform takes full effect in 2017, a slower than expected recovery in agriculture and the loss of tourism market share to Cuba. On the upside, a successful implementation of the Growth and Sustainable Development Strategy (GSDS) could help mitigate the above-mentioned risks.

Policy Priorities

While the recent restructuring of private external debt provides meaningful cash flow relief, and the agreed fiscal tightening is a step in the right direction, the agreement is just one element of a more comprehensive package needed to lift Belize out of high debt and low growth. The agreement reduces the cost of servicing a relatively expensive part of external debt, and the NPV gain is significant. However, the overall level of public debt remains very high, at about 100 percent of GDP. Moreover, the repeated efforts to restructure debt could undermine Belize's credibility and risks a loss of access to capital markets for an extended period of time, in turn hurting prospects for strong and sustainable growth. To lead to lasting gains, the debt restructuring needs to be underpinned by a credible and sustained program of fiscal consolidation, combined with structural reforms to boost growth.

Further fiscal consolidation (beyond measures taken in the context of the 2017/18 budget) is necessary to put debt/GDP on a clear downward trajectory, and to mitigate risks. A primary surplus of 4-5 percent of GDP would need to be maintained over the medium term to put debt on a path towards 60 percent of GDP by 2025. On the revenue side, reform options include broadening the base of the General Sales Tax (by removing zero-rated items and streamlining exemptions), and/or increasing the GST rate from 12.5 percent to the regional average of 15 percent, each of which could yield about 1 percentage point of GDP. On the expenditure side, a civil service reform could help stabilize the number of public employees and contain the wage bill. Moreover, the public sector pension plan could become contributory and pensions adjusted to be in line with inflation.

The introduction of a fiscal rule could support the consolidation effort. A fiscal rule that targets a reduction in public debt to GDP to 60 percent over the medium term has been introduced elsewhere in the region (ECCU, Jamaica), and has had notable success in bringing public debt on a clear downward trajectory in several cases (e.g. St Kitts and Nevis, Grenada, and Jamaica). In Belize, adoption by parliament of a fiscal rule that targets 60 percent debt to GDP by 2025 could help guide the fiscal consolidation effort and broaden the support for it.

Public Financial Management can be further strengthened. Electronic tax filing and payment could be enhanced, especially in the GST and Income Tax Departments where less than 10 percent of registered tax payers file or pay their taxes electronically. Stronger internal and external controls and more transparent and efficient procurement practices could restrain outlays on goods and services. Stronger monitoring of government-supported entities, especially their payroll, could generate savings on transfers. Timely production of audited government financial statements and their timely approval by parliament in the context of budget review laws will strengthen accountability in the use of public funds.

Government financing by the Central Bank (CBB) should be phased out and replaced by financing using securities markets. Financing government spending by the CBB brings excessive liquidity into the market, which can put pressure on the exchange rate. More active debt management and more frequent auctions of government paper in active securities markets could also generate savings on interest payments.

The financial system must be kept under tight supervision. The banking system remains vulnerable, with non-performing loans as a share of total bank loans remaining high at 9.8 percent (2.2 percent net of provisions) at end-March 2017. Given uncertainties on the value of collateral, provisioning requirements should be raised to 100 percent on loan losses (secured or not). An asset quality review of all banks would help assess the real strength of their capital buffers.

Improving the legal framework and effective implementation of the AML/CFT framework would help reduce the risk of further loss of CBRs. Reforms to enhance entity transparency by making beneficial ownership available and shared in a timely manner is an urgent need. The Central Bank and the International Financial Services Commission should also step-up their supervision efforts based on risks to improve compliance of banks, financial services with no physical presence in Belize, and registered agents and trust services.

Well-targeted structural reforms could raise the economy's long-term growth potential. The country's growth strategy (the GSDS) should focus on raising productivity, especially in the export sector. The strategy envisages removing infrastructure bottlenecks to reduce transportation costs and strengthen trade competitiveness. Labor productivity can be enhanced by improving education and health services. Several initiatives aim to build climate resilience through disaster risk mitigation and green energy projects. Effective implementation of the strategy requires translating it into a concrete action plan, prioritization of projects, estimation of their cost, and the design of realistic project financing strategies, while taking into account the limited fiscal space and working closely with development partners.

Concrete action is needed to improve the business climate. In the 2017 World Bank Doing Business Report, Belize ranked 112 out of 189 countries, down 2 places from its 2016 ranking. There is room for improvement in several areas, notably in starting a business, getting credit, protecting investors, trading across borders and enforcing contracts. Availability of credit to SMEs can be enhanced through broadening the types of eligible collateral and establishing a Credit Bureau.

The team wishes to thank the authorities for their hospitality and for the open and constructive dialogue.