**International Monetary Fund**

St. Kitts and Nevis and the IMF

**Press Release**: IMF Executive Board Completes Fourth Review Under Stand-by Arrangement with St. Kitts and Nevis and Disburses US$ 4.9 Million
November 30, 2012

Country's Policy Intentions Documents

**E-Mail Notification**
Subscribe or Modify your subscription

# **St. Kitts and Nevis:** Letter of Intent, and Memorandum of Economic and Financial Policies

November 15, 2012

The following item is a Letter of Intent of the government of St. Kitts and Nevis, which describes the policies that St. Kitts and Nevis intends to implement in the context of its request for financial support from the IMF. The document, which is the property of St. Kitts and Nevis, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Basseterre, St. Kitts
November 15, 2012

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington DC, 20431

Dear Ms. Lagarde:

Since the approval of the Stand-By Arrangement in July 2011, economic activity in St. Kitts and Nevis has been impacted by the challenging global conditions. The continued contraction in construction during the first semester of 2012 has outweighed the mild uptick in tourism, which leads us to project a further decline in activity in 2012. However, on the basis of FDI gathering momentum, we envisage a modest recovery in 2013. Given our prudent macroeconomic management, we are well placed to meet our 2012 and 2013 fiscal targets under the program. This achievement has been possible thanks to the sacrifice and efforts of the people of St. Kitts and Nevis, and with strong support from the donor community and international financial institutions, including the Caribbean Development Bank and the IMF.

The Government of St. Kitts and Nevis reaffirms its commitment to the success of its home-grown medium-term reform program (supported by the Fund's Stand-By Arrangement (SBA)), which will benefit the people of St. Kitts and Nevis and aims to be a model for other countries in the region. Since the SBA was approved in July 2011, we have been determined to advance our reform agenda and successfully implement our policies. This is reflected in having met our fiscal target and all other quantitative performance criteria and the structural benchmarks for end-June 2012,[1] as well as the structural benchmark for end-September 2012 with a few days' delay. Our debt restructuring process is proceeding well and the domestic debt for land swap has advanced, with the transfer of 1,200 acres of land to the management company responsible for selling the land assets. We have agreed on a board for the company, submitted a short list of candidates for its management, and are elaborating its operational guidelines. We welcome your continued strong support for these initiatives.

In the attached Memorandum of Economic and Financial Policies (MEFP) and the Technical Memorandum of Understanding (TMU), we present our plans through 2013 to achieve the objectives of our program supported by the IMF. Based on the strength of these policies, and

[1] While end-September performance criteria (PC) govern the fourth review, due to unavailability of data to assess them and the absence of clear evidence that the end-September PCs will not be met, the fourth review is based on the end-June 2012 PCs.

given our performance under the program and our continued commitment, we request the completion of the fourth program and financing assurances reviews, waiver of applicability for the end-September 2012 performance criteria, and the release of the fifth tranche of SDR 3.161 million. We request that the availability date for the sixth purchase be moved to December 15, 2012.

We are confident that our policy commitments will support the achievement of our program objectives. However, we need to remain vigilant to downside risks of lower-than expected growth in the global economy and are prepared to address them through policy actions. We will continue to consult with the Fund on the adoption of such actions in advance of necessary revision of policies contained in this letter and the attached Memorandum, in accordance with the IMF's policies.

The Government authorizes the IMF to make public the contents of this letter, the attached MEFP and TMU, and the Staff Report to clearly communicate our policies and to signal the seriousness of our commitment to the program to the people of St. Kitts and Nevis and to the international community.

Sincerely,

/s

Rt. Hon. Dr. Denzil Douglas
Prime Minister and Minister of Finance
St. Kitts and Nevis

## MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

**1.** St. Kitts and Nevis has realized major accomplishments in implementing its home grown economic program supported by the IMF Stand-By Arrangement (SBA). Our economic reform program continues to focus on putting public finances on a sustainable trajectory, finalizing a comprehensive debt restructuring to address the debt overhang, and further strengthening the financial system, in order to boost growth and employment. This Memorandum of Economic and Financial Policies (MEFP) updates these policies in the context of the fourth review under the SBA.

### I. PERFORMANCE UNDER THE PROGRAM

**2.** We have fulfilled our commitments under the program at end-June 2012 as detailed below. In addition, we have met the program's structural reform target on reforming the land agencies on October 5, a few days after the end-September 2012 target and expect the program's end-September quantitative program targets to be met. In this context, we request completion of the fourth program review and financing assurances review and request a waiver of applicability for the end-September 2012 performance criteria.

- **Growth and inflation.** Available indicators point to continued sluggish economic activity in the first half of 2012. Tourism activity continued to recover modestly relative to 2011 while construction continued to contract by an estimated 20 percent. There are some emerging signs of a tepid recovery in the third quarter of the year, notably in the construction and retail sectors. Inflation continued to decline, from 2.9 percent (y/y) at end-December 2011 to 1.4 percent at end June 2012.

- **External sector.** While imports in the second quarter 2012 weakened due to persistent sluggish domestic demand, buoyant receipts from the citizenship by investment program further reduced the current account deficit. As a result, international reserves net of IMF SBA resources declined by about EC$ 10 million during that period.

- **Fiscal performance.** All the fiscal targets were met at end-June 2012[1], despite the continued context of sluggish global environment and the persisting economic contraction. The overall fiscal balance at end-June 2012 reached a surplus of EC$61 million, significantly above the adjusted program floor of EC$-51 million. Similarly, the primary surplus of EC$117 million was well above the adjusted indicative program target of EC$20 million. Key factors to this strong performance were buoyant receipts, from the Citizenship by Investment program and

[1] While the end-September 2012 performance criteria (PCs) are the governing ones under the SBA, the absence of both available data and clear evidence that end-September PCs will not be met justifies the quantitative assessment of the program based on the PCs for end-June 2012.

direct taxes, which compensated for relatively weaker tax collections on goods and services and international trade.

- **Other performance criteria.** The ceilings on central government budget expenditure arrears accumulation, the stock of external short-term debt, and the central government or guaranteed external arrears accumulation have all been met (Table 2).

- **Debt restructuring.** We continue to advance the comprehensive debt restructuring by:

  - **Effecting a debt/land swap with our domestic creditors.** Following the completion of the land registry, we transferred 1,200 acres of land to the Special Purpose Vehicle (SPV) in October 2012. This land will be offered for sale as the SPV becomes operational. The Board of the SPV has been agreed upon and we submitted a short list of candidates for its management. The SPV's operational guidelines and reporting requirements are under elaboration.

  - **Finalizing bilateral agreements with Paris Club creditors**. Our negotiations with the United Kingdom were concluded in July resulting in the cancellation of our debt with the Department for International Development (DFID).

  - **Engaging our other bilateral creditors.** Discussions with our other bilateral creditors continue to proceed. Now that the amount of debt service arrears has been confirmed, we have extended a restructuring proposal to Venezuela and expect to hear back shortly. Negotiations with Taiwan POC and Kuwait are ongoing.

  Upon completion of the debt/land swap, we expect these operations, combined with our fiscal efforts, to reduce total public debt from 154.4 percent of GDP at end-2011 to just under 100 percent at end-2012, in line with our objective to reach the ECCU target of 60 percent of GDP by end-2020.

- **Financial sector**. The capitalization and liquidity of the indigenous financial sector improved modestly through June 2012. The capital adequacy ratio increased from 42 percent to 45 percent in the second quarter of 2012 while net liquid assets increased from 54.3 percent to 54.8 percent of deposits. However, the NPL ratio continued to inch up from 5.9 percent to 6.1 percent, above the regional benchmark of 5 percent, and profitability indicators have softened following the restructuring of government bonds. Updated stress tests as of June 2012, completed by the Eastern Caribbean Central Bank (ECCB), continue to confirm the overall resilience of the banking sector to a range of shocks, including the full impact of the debt restructuring. However, one bank would be vulnerable to a liquidity shock. Following the debt/land swap, the NPL ratio would increase above the prudential benchmark due to the change in asset composition while the capital adequacy ratio would exceed regional norms. There has been no request to date to access the Banking Sector Reserve Fund (BSRF) set up under the SBA.

## II. Policies During 2012 and 2013

3. **A difficult first half-year and tepid global environment presage a contraction of economic activity in 2012.** We now expect economic growth to be revised from 0 percent to -0.7 percent in 2012. The sharp contraction in construction in the first semester will weigh heavily against a mild expected uptick in tourism. Going forward, construction activity should improve, on account of the strength of the Citizenship by Investment program and related FDI projects already in the pipeline as well as projects funded by the Sugar Industry Diversification Foundation (SIDF). As a result, real GDP growth is projected to reach 1.8 percent for 2013 and 3-4 percent over the medium term as tourism and construction continue to recover. Nevertheless, downside risks continue to persist.

### A. Fiscal Policy

4. **We expect to comfortably meet the 2012 program target for the overall fiscal deficit.** We project an overall surplus of EC$48 million and aim to further reduce budgetary arrears. Tax revenue performance will fall slightly short of expectations but will be more than compensated by non-tax receipts from the Citizenship by Investment program. While we project a marked under-execution of the investment budget due to administrative bottlenecks in its implementation and its ongoing prioritization, current spending is projected to remain near program expectations.

5. **The 2013 budget envisages boosting tax revenue, continuing to contain current expenditure and accommodating an increase in capital outlays.** In order to continue to pursue a path of fiscal consolidation consistent with debt sustainability, we project to achieve a fiscal surplus of 1.7 percent of GDP in 2013, corresponding to a primary surplus of 6.0 percent of GDP in 2013.

#### Tax Revenue

6. **In order to ensure sustained increases in tax revenue over the medium term, we will continue to reform and consolidate our revenue administration by:**

- **Strengthening audits.** We are intensifying audits of large taxpayers, including with respect to the VAT, owing to enhanced collaboration between the Customs and Excise Department (CED) and the Inland Revenue Department (IRD). We commit to extending that collaboration to post Customs clearance audits in the near term. In that regard, we plan to activate the Post Clearance Audit (PCA) function of the CED by securing parliamentary approval for the draft Customs bill (that would strengthen enforcement).

- **Further integrating information technology (IT) into our practices.** We aim to raise the ratio of electronic to total Customs declarations from the current 90 percent. With TA support, we will improve the IT system by designing e-filing forms that would be more user-friendly and audit-based, with built-in triggers for more tailored and automated audits, and a better integrated system. This will facilitate the submission of electronic declarations by all large importers and free up staff resources for priority tasks.

- **Overhauling legislation and procedures to enhance staff performance and accountability.** We will harmonize the Tax Administration Procedures Act with the VAT Act to extend best practices in enforcement to other taxes. We will also require that entities benefiting from tax concessions file tax in addition to customs returns, in order to improve our control over non-eligible activities or goods. Finally, we will formulate an Action Plan to integrate already existing indicators into a comprehensive strategy to enhance the accountability of the CED and IRD staff.

**7. We aim to further broaden the tax base.** We will conduct a thorough review of the system of customs duties and tax exemptions, as part of a regional initiative (with TA support). We intend to continue to monitor the revenue cost of these exemptions, estimated at about 2 percent of GDP) in the first half of 2012, and align the provisions in the Small Business Act, the Fiscal Incentives Act, the Hotels Aid Act and the Special Resorts Development Act with international best practices. In particular, we will modify the provisions of these Acts to make them more rules-based, subject to vetting by the Ministry of Finance. We will also rationalize the list of priority sectors eligible for exemptions, streamline provisions pertaining to reduction of consumption taxes, and favor accelerated capital depreciation over tax holidays.

**Expenditure**

**8. We will continue to improve the efficiency of public expenditure by:**

- **Reforming the civil service.** Building on our Action Plan for the modernization of public service, we will undertake an audit of the government payroll, with assistance from the World Bank and expect to complete it by end-2013. The results will inform our strategy to rationalize the wage bill over the medium-term.

- **Improving the management of the price control for basic staples.** We are in the process of closing the government-operated Supply Office and transferring the responsibility of managing the supply of price-subsidized staples to the private sector. Over the medium-term, we plan to phase out the subsidies for basic staples in conjunction with strengthening the social safety net. Concerning our objective of rationalizing the Liquid Petroleum Gas (LPG), we are elaborating a proposal to revise the price formula in the context of our negotiations with the LPG suppliers.

- **Containing transfers to public enterprises.** We have now settled mutual claims that have accumulated between the government and the St. Kitts Electricity Company (SKELEC) since its corporatization in August 2011. To date, SKELEC has been able to cover its operating costs. In order to properly safeguard the budget against any contingent liabilities arising from public enterprises, we plan to amend the Finance Administration Act, in order to formally recognize the Government Entities Oversight Board's investigative and enforcement powers (structural benchmark for end-March 2013) and also widen the list of entities under its purview to include all non-financial companies with government ownership.

**9. Progress has been made in improving fiscal transparency.** We are preparing to begin quarterly publication of reports on fiscal operations by end-2012 and gross financing needs starting in June 2013. We expect the audited financial statements of the Sugar Industry Diversification Foundation (SIDF) for 2011 to be published by end- December 2012.

### B. Debt Restructuring

**10. We are mindful of the importance of promoting land sales to protect the financial position of domestic banks.** We intend to appoint the management of the SPV and outline its operational guidelines by end-2012. We will adhere to best practices concerning transparency, accountability and the design of management incentives.

### C. Financial Sector

**11. We are committed to continue to safeguard the stability of the financial sector, in conjunction with the ECCB.** The ECCB's quarterly stress tests have allowed us to closely monitor the banking sector. We also support the initiatives by indigenous banks to seek out diversified sources of revenue and to intensify recovery of NPLs. The BSRF will remain in place to address any liquidity pressures. Finally, consistent with the IMF's safeguards policy requirement and current practice, we will continue to maintain all foreign exchange balances at the ECCB.

Table 1. St. Kitts and Nevis: Schedule of Review and Purchases

| Date 1/ | Amount of Purchase: Millions of SDR | Amount of Purchase: Percent of Quota | Conditions |
|---|---|---|---|
| July 27, 2011 | 22.150 | 248.9 | Approval of arrangement |
| January 25, 2012 | 11.470 | 128.9 | First review and end-September 2011 performance criteria |
| July 21, 2012 | 3.161 | 35.5 | Second review and end-December 2011 performance criteria |
| August 3, 2012 | 3.161 | 35.5 | Third review and end-March 2012 performance criteria |
| August 15, 2012 | 3.161 | 35.5 | Fourth review and end-June 2012 performance criteria |
| December 15, 2012 | 3.161 | 35.5 | Fifth review and end-September 2012 performance criteria |
| February 15, 2013 | 1.105 | 12.4 | Sixth review and end-December 2012 performance criteria |
| May 15, 2013 | 1.105 | 12.4 | Seventh review and end-March 2013 performance criteria |
| August 15, 2013 | 1.105 | 12.4 | Eight review and end-June 2013 performance criteria |
| November 15, 2013 | 1.105 | 12.4 | Nineth review and end-September 2013 performance criteria |
| February 15, 2014 | 0.913 | 10.3 | Tenth review and end-December 2013 performance criteria |
| May 15, 2014 | 0.913 | 10.3 | Eleventh review and end-March 2014 performance criteria |
| **Total** | **52.510** | **590.0** | |

Source: Fund staff estimates

1/ For completed reviews the dates refer to Board dates and for future reviews the dates refer to availability dates.

Table 2. St. Kitts and Nevis: Quantitative Performance Criteria and Indicative Targets
(In EC$ millions)

| | End-Jun. 2012 | | | | Performance Criteria | | Proposed Performance Criteria | | | Proposed Indicative Targets | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | End-Sep. 2012 | End-Dec 2012 | End-Dec 2012 | End-Mar. 2013 | End-Jun. 2013 | End-Sep. 2013 | End-Dec 2013 |
| | Prog. | Adjusted | Actual | Status | | | | | | | |
| *Performance Criteria:* | | | | | | | | | | | |
| Central government overall balance including grants (floor) 1/ 2/ | -53 | -51 | 61 | met | -91 | -60 | 24 | 8 | 28 | 20 | 35 |
| Stock of central government budget expenditure arrears accumulation (ceiling) 3/ | 0 | 0 | -26 | met | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Stock of external short term debt (ceiling) | 0 | 0 | 0 | met | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Central government or guaranteed external arrears accumulation (ceiling) 4/ | 0 | 0 | 0 | met | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| *Indicative Target:* | | | | | | | | | | | |
| Central government primary balance (floor) 1/ 2/ | 19 | 20 | 117 | met | 8 | 68 | 181 | 32 | 61 | 82 | 124 |

1/ Cumulative within each calendar year.
2/ See the TMU for a description of adjustors.
3/ Including the estimated stock of expenditure payable on electricity.
4/ To be monitored on a continuous basis.

Table 3. St. Kitts and Nevis: Structural Benchmarks

| Action | Target Date | Objectives | Status |
|---|---|---|---|
| **I. Fiscal and Public Sector Reforms** | | | |
| ***Public financial management*** | | | |
| Submit to Cabinet proposal to rationalize the subsidy on liquefied petroleum gas (LPG) | End-March 2012 | Strenghten public financial management | completed |
| Update the registry of additional 600 acres of land | End-June 2012 | Strenghten public financial management | completed |
| Undertake valuation of additional 600 acres of land | End-June 2012 | Strenghten public financial management | completed |
| Submit draft of new Procurement Act to Parliament | End-June 2012 | Strenghten institutional framework | completed |
| Draft proposal for the establishment of an asset management company | End-June 2012 | Strenghten public financial management | completed |
| Establish a medium-term expenditure framework with agreed fiscal targets | End-June 2012 | Improve medium-term orientation of the budget | completed |
| ***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 | Strenghten public financial management | completed |
| **Structural Benchmarks for Upcoming Reviews** | | | |
| ***Actuarial review of Social Security*** | | | |
| Regular review of the Social Security Scheme. | End-December 2012 | Strenghten public financial management | |
| ***Public enterprise reform*** | | | |
| Rationalize public land sales and development agencies | End-September 2012 | Strenghten public financial management | completed on October 5 |
| Include in the Finance Administration Act provisions recognizing the Government Entities Oversight Board and strengthening its enforcement authority | End-March 2013 | Strenghten public financial management | |
| ***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 eligibiity criteria of the planned consolidated cash transfer program | End-September 2013 | Streamline social safety nets | |
| **II. Financial Sector Reforms** | | | |
| Update the existing stress tests of banks | To be monitored on a quarterly basis | Financial sector stability | completed |
| **III. Medium-term benchmark** | | | |
| 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 | End-December 2012 | Improve medium-term orientation of the budget | |
| Draft proposal for a comprehensive pension reform | End-June 2013 | Strenghten public financial management | |

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