

**REPORT TO CONGRESS ON
THE INTERNATIONAL MONETARY FUND'S
LOAN TO ST. KITTS AND NEVIS**



A Report to Congress

in accordance with

Section 1501 of the
Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010

United States Department of the Treasury
August 2011

Introduction and Overview

This report has been prepared in accordance with section 1501 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act, 2010*.¹ As required, the report provides an assessment of the likelihood that the recently-approved International Monetary Fund (IMF) loan made to St. Kitts and Nevis (SKN) will be repaid in full, including SKN's debt status, vulnerabilities, and debt management strategy. St. Kitts and Nevis's public debt is equivalent to 199.2 percent of its GDP (as of December 2010, the latest date for which data are available) and St. Kitts and Nevis is not eligible for assistance from the International Development Association.

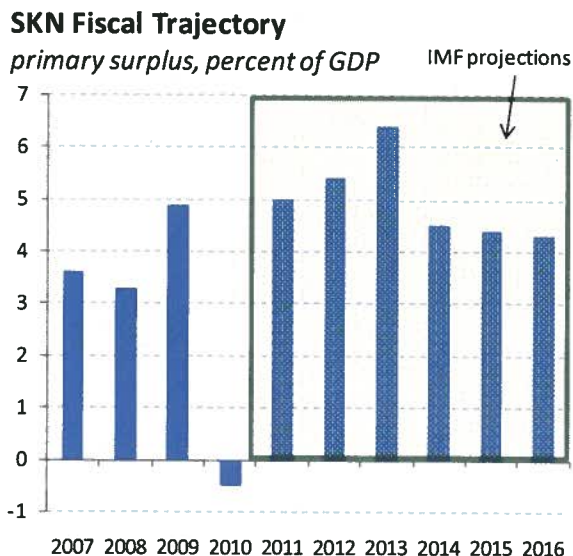
The Office of the United States Executive Director (USED) at the IMF, in close coordination with the Treasury Department, evaluates all proposals for country loans submitted to the IMF Executive Board. This includes a careful examination of a country's macroeconomic situation, debt sustainability, and the quality of the proposed policy adjustment measures to ensure a return to stability. In cases when exceptional access is requested, the USED also takes into account IMF documentation assessing potential financial risks to the Fund, which is prepared for each new program proposal. The top priority of any such evaluation is to verify that IMF resources are adequately safeguarded and that repayment risks are mitigated. USED and Treasury staff meet with IMF staff to discuss the key elements of such proposals in order to inform a judgment on the program on the likelihood of repayment. If repayment is in serious doubt, the USED would not support the proposal.

On July 27, 2011, the IMF Executive Board approved an \$84 million Stand-By Arrangement (SBA) for SKN. The SBA-supported program includes necessary policy adjustments and takes into account restructuring of SKN's debt to creditors, which is under negotiation. Policy measures and financial disbursements will be spread over three years, with IMF disbursements contingent on the SKN government's successful implementation of agreed policy measures and progress in debt restructuring. **Based on aggressive fiscal consolidation measures already proactively undertaken by the government, the linkage of additional IMF disbursements to meeting policy commitments, the initiation of far-reaching debt restructuring discussions with creditors, Paris Club financing assurances, and the IMF's preferred creditor status, the Treasury Department and the USED assess that, while this loan poses somewhat greater repayment risks to the Fund than those normally associated with a Fund program, the prospects for repayment are still strong and the loan is most likely to be repaid in full. As such, the Treasury Department instructed the USED to vote in favor of the program.**

¹P.L. 111-203, July 21, 2010; codified at 22 USC 286tt, section 68(b) of the BWAA: "Within 30 days after the Board of Executive Directors of the Fund approves a proposal [to make a loan to a country whose public debt exceeds gross domestic product and is not eligible for assistance from the International Development Association] the Secretary of the Treasury shall report in writing...assessing the likelihood that loans made pursuant to such proposals will be repaid in full..."

Background

SKN is a small, tourism-driven island economy sensitive to the U.S. business cycle and Caribbean weather patterns. Following several years of strong growth, SKN suffered a deep recession during 2009-10 due to a steep dropoff in tourism from the United States and a 2008 hurricane that damaged significant elements of its tourist infrastructure. The resulting drop in revenues led to a deterioration in the government's fiscal position and a worsening of SKN's already-fragile debt dynamics. The IMF projects a mild economic recovery in 2011 and moderate growth in the medium term. The SKN government has made strong efforts at reining in its fiscal imbalances since late 2010 and anticipates a return to a healthy primary surplus (fiscal balance before interest payments) this year and over the medium term. Based on policies already implemented, the 0.5% percent primary deficit in 2010 has been reversed to a projected surplus of 5.0 percent of GDP in 2011. Based on continued policy implementation, future fiscal surpluses are expected to average about 5.0 percent of GDP over the medium-term.



However, this impressive effort, while necessary, on its own would not return SKN to a sustainable debt path given the large debt overhang. For this reason, the SKN government has initiated discussions on debt restructuring with its commercial and other creditors – primarily the domestic banking system –and intends to seek a rescheduling with the Paris Club group of official bilateral creditors of payments coming due during the three years covered by the IMF program.² The IMF expects that, through a combination of fiscal consolidation, financial support via its program, and comprehensive debt restructuring, SKN can reduce its debt-to-GDP ratio from 199 percent of GDP to roughly 60 percent of GDP by 2020, thus returning it to a sustainable debt path.

Program Description

SKN's IMF program seeks to restore fiscal and debt sustainability and to backstop the local financial sector, which is highly exposed to government debt. IMF financing would partially fill SKN's anticipated external financing gaps – \$73 million and \$90 million in 2011 and 2012, respectively – with additional multilateral concessional financing and fiscal savings from the debt restructuring. IMF financing would also support a \$17 million Banking Sector Reserve Fund equivalent to 15 percent of private banking sector deposits to provide temporary liquidity as needed to solvent domestic banks during the restructuring.

² The United States has provided financing assurances in the Paris Club for rescheduling but not reduction of SKN's debt to the U.S. government.

The IMF program envisages that the SKN government primary surplus will average 5.6 percent of GDP over 2011-13. The authorities have committed to implementing structural reforms aimed at improving public financial management – reforming the civil service, social security system, and public enterprises; and strengthening SKN’s social safety net. SKN has already met preconditions set by the IMF requiring it to initiate debt restructuring discussions with its creditors and establishing the Banking Sector Reserve Fund. Specific fiscal measures already implemented include a Value Added Tax and an electricity tariff increase worth a cumulative 4.6 percentage points of GDP and a freezing of the public sector wage bill for three years beginning in 2011.

Debt Status

The short-term maturity profile of SKN’s debt entails rollover risk and highlights the importance of IMF financing and a successful debt restructuring. SKN’s relatively concentrated creditor structure should help simplify restructuring discussions.

As of December 2010 (the latest date for which data are available), the SKN government’s debt was \$1.2 billion, equivalent to 199.2 percent of 2010 GDP. Roughly two-thirds of SKN’s debt is owed to domestic creditors, primarily the domestic banking sector. These banks hold 46 percent of SKN debt, while the social security administration holds another 10 percent of public debt. Roughly one quarter of SKN’s debt is owed to external creditors, primarily commercial banks (14 percent of its total debt), the Caribbean Development Bank (9 percent), and, to a lesser degree, official bilateral creditors (the largest being Taiwan, which holds 2 percent of public debt). The liabilities of the St. Kitts Sugar Manufacturing Corporation, which were assumed by the SKN government in 2005, represent 11 percent of public debt.

SKN Public Debt by Creditor		
	USD, mn	% Total Debt
Total public debt	1,053	100
External	319	30
Bilateral	30	3
Taiwan	19	2
Kuwait	5	0.4
Other	7	1
Multilateral	124	12
CDB	105	10
World Bank	11	1
Other	8	1
Commercial	165	16
Domestic	734	70
ECCB	10	1
Commercial Banks	488	46
Social Security	114	11
Other	121	12

Source: Government of St. Kitts and Nevis

SKN has relied heavily on short-term financing, with (primarily 91-day) T-bills and overdrafts representing roughly 21 percent of total debt, leaving the government exposed to rollover risk. The average maturity of SKN’s debt portfolio is 5 years – 3.2 years for external debt (including 2.5 years for commercial debt) and 6.1 years for domestic debt (excluding T-bills and overdrafts). SKN has a large portion of medium-term debt maturing over 2012-13, when it must repay roughly \$212 million – equivalent to 21 percent of its outstanding debt stock and 18 percent of cumulative GDP – in bullet maturities and interest (excluding T-bills and overdrafts).

Vulnerabilities

SKN’s primary external vulnerabilities are its exposure to the U.S. economy and natural disasters. Tourism receipts are equivalent to 15 to 25 percent of GDP and the United States is SKN’s primary tourism market. As such, a downturn and/or continued high unemployment in

the United States would negatively impact SKN tourism receipts and foreign investment inflows. Like other small Caribbean island economies, SKN is also vulnerable to natural disasters. For example, the last hurricane to strike SKN, in late 2008, resulted in the extended closure of a major hotel on Nevis, adversely impacting the SKN tourism industry.

Savings gained from planned fiscal consolidation and debt restructuring under the IMF program should help to provide a cushion for the government to guard against and mitigate these vulnerabilities.

SKN's primary internal vulnerability is the large exposure of its banking sector to government debt. Roughly one quarter of domestic bank assets – equivalent to 92 percent of GDP – are comprised of government debt. A debt restructuring that resulted in a large reduction in the value of government debt could adversely affect SKN banks' balance sheets.

The authorities and IMF staff will monitor the impact of the restructuring on domestic banks closely for any signs of strain. Preliminary stress tests were conducted by the Eastern Caribbean Central Bank (ECCB), which will be updated by the time of the first program review in November. Moreover, the Banking Sector Reserve Fund, established with financing from the IMF as part of its program, will provide a liquidity backstop to banks if required to help address vulnerabilities arising in the financial sector.

Debt Management Strategy

The government's primary objective is to place SKN's public debt on a downward trajectory, aimed at achieving a 60 percent debt-to-GDP ratio by 2020. In order to meet this objective, the government is committed to running primary surpluses that reduce the need for additional debt and allow for a reduction in outstanding debt. In addition, the SKN government is launching a debt restructuring process to reduce the level of indebtedness to a sustainable level over the medium-term.

The SKN government has a clear debt restructuring strategy in place that it has already begun to implement. The SKN government has so far: (1) hired financial and legal advisors; (2) publicly announced its intention to seek a restructuring; (3) created a website to provide information to creditors; (4) initiated bilateral discussions with key creditors; (5) established a working group for debt-land swap issues; and (6) received financing assurances from the Paris Club and from major domestic creditors. The restructuring is planned to take place over several months, involving a series of phases across creditor classes (commercial and official).

SKN's planned debt restructuring may also include a land-for-debt swap related to the state-owned sugar company noted above. The SKN government has established a working group to address the legal, accounting, and regulatory issues involved with such a swap and is updating the mapping and valuation of the land.

Overall Assessment

SKN is heavily indebted and vulnerable. However, its IMF-supported program, combined with the debt restructuring, provides the best opportunity for the country to return to a sustainable debt path and mitigate its vulnerabilities. IMF resources will be safeguarded by the following:

- Demonstrated SKN government commitment to implement the policy measures that are a precondition of IMF financing under the program. For example, the government proactively implemented strong fiscal consolidation over the last year and adopted all prior actions required of the government before the IMF program was agreed upon. In addition, the country has already shifted to primary fiscal surpluses and committed to maintaining these over the medium-term.
- Significant progress in the debt restructuring process in an open and transparent manner, with constructive SKN government engagement with creditors.
- IMF financial support and policy guidance, which will help to fill SKN's financing gap, and mitigate vulnerabilities by backstopping the banking sector during the debt restructuring, and ensuring sound policies.
- Strong IMF program conditionality and rigorous quarterly reviews. Program conditionality agreed to by the government focuses on the following areas: maintaining government fiscal surpluses at a level consistent with achieving debt reduction over the medium-term; strengthening public financial management; reforming the civil service; and reforming the pension system.
- The IMF's preferred creditor status, ensuring that it is repaid ahead of all other creditors.
- Financing assurances from the Paris Club to reschedule principal payments over the term of the IMF program.

With these factors in mind, the Treasury Department assesses that the IMF's loan to SKN is most likely to be repaid in full.