DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

BELIZE

MACROECONOMIC AND PUBLIC FINANCIAL SECTOR REFORM PROGRAM

(BL-L1001)

LOAN PROPOSAL

This document was prepared by the project team consisting of: Olver Bernal (RE2/FI2), Project Team Leader; José Justiniano (consultant), Javier Jiménez Mosquera (LEG), Federico Changanaqui (RE2/OD3), Marta Mejía Zampieri (COH/CBL), Susana Sitja (RE2/SC2), Ekaterina Krivonos (RE2/OD3) y Yolanda Galaz (RE2/FI2).

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ABBREVIATIONS

BMC	Belize Mortgage Company
CARICOM	Caribbean Community and Common Market
CBB	Central Bank of Belize
CDB	Caribbean Development Bank
CESI	Committee on Environment and Social Impact
DFC	Development Finance Corporation
EIB	European Investment Bank
FONDEN	Fondo de Desastres Naturales
GDP	Gross Domestic Product
GOB	Government of Belize
IDB	Inter-American Development Bank
IMA	Independent Macroeconomic Assessment
IMF	International Monetary Fund
MOF	Ministry of Finance
MND	Ministry of National Development
NAS	North American Securitization
PBL	Policy-Based Loan
PRODEV	Program to implement the external pillar of the medium term action plan for development effectiveness
SSB	Social Security Board

PROJECT SUMMARY
BELIZE
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Financial Terms and Conditions [1]				
Borrower: Belize Executing Agency: Ministry of Finance (MOF)			Amortization Period: Grace Period: Disbursement Period:	20 years 5 years 2 years
Source	Amount	%	Interest Rate:	Libor
IDB (OC)	US$25 m	100	Supervision and Inspection Fee:	0
Local	-	-		
Other/Cofinancing	-	-	Credit Fee:	0.25%
Total	US$25m	100	Currency: Single Currency Facility	US Dollars

Project at a Glance

Project objective:
The objective of the program is to assist the Government of Belize in implementing a reform agenda aimed at restoring macroeconomic and financial stability, as well as improve investor climate confidence.

Special contractual clauses:
Disbursements will be made in two tranches according to the conditions described in the Policy Matrix. The disbursement of the proceeds of each tranche will be conditional on fulfillment of the policy measures agreed for that tranche, as specified in Chapter V and in the Outcomes Matrix.

Exceptions to Bank policies:
None

Project consistent with Country Strategy: Yes [x] No [ ]
Project qualifies for: SEQ[ ] PTI [ ] Sector [ ] Geographic[ ] Headcount [ ]
Procurement: Not applicable.

Date of CESI verification: The CESI reviewed this operation on 28 July 2006 (meeting CESI 31-06) and agreed that the program will not have direct environmental and social impacts.

[1] The interest rate, credit fee, and inspection and supervision fee mentioned in this document are established pursuant to document FN-568-3 Rev. and may be changed by the Board of Executive Directors, taking into account the available background information, as well as the respective Finance Department recommendations. In no case will the credit fee exceed 0.75%, or the inspection and supervision fee exceed 1% of the loan amount (*)
(*) With regard to the inspection and supervision fee, in no case will the charge exceed, in a given six-month period, the amount that would result from applying 1% to the loan amount divided by the number of six-month periods included in the original disbursement period.

I. FRAME OF REFERENCE

A. Background

1.1 Since 1998 the Government of Belize (GOB) has sought to accelerate economic growth through expansionary fiscal and monetary policies. The economy grew around 6% between 1999 and 2004 at the cost of an annual fiscal deficit averaging 9% of GDP and an increase in the level of external debt to more than 90% of GDP.

1.2 Due to the high levels of public expenditure and debt, as well as some external shocks, since 2004 the macroeconomic situation of the country (8.7% of fiscal deficit and 100.2% of public debt) has been of grave concern for some rating agencies. Consequently, Belize's debt classification has been lowered to Caa3 from B3 and market risk premia have increased. Currently, the sovereign credit ratings of Belize have been sharply downgraded by Moody's and S&P to just a few steps above default, which reflects the concerns of the market about the unsustainable level of the external obligations in the short and medium term.

1.3 One of the policies used by the Government to bolster the economy was to fund credit and investment projects through the Development Finance Corporation (DFC). This caused an expansion of the DFC's loan portfolio, some of them of dubious recovery, which were financed with external and domestic borrowing that the DFC is currently in no position to repay. Thus, the DFC has played a major role in the unsustainable accumulation of debt and has been a drain to public finances. To solve this problem, the GOB has decided to assume the payment of some of the DFC's obligations generating serious problems for public finances.

1.4 Against this background, it can be concluded that the main current problems of Belize are: (i) the need to reestablish macroeconomic stability (ii) the need for relief on the high debt service burden and (iii) the resolution of the failed DFC. To this end, the GOB decided to carry out a macroeconomic adjustment process without a formal IMF support, although in close consultation and advice from the Fund. The authorities' program seeks to strengthen the fiscal position in order to meet the external debt obligations, as well as to improve the investment climate and confidence. This operation aims to help the country in that process, in support of an important structural reform program.

B. Macroeconomic framework

1.5 <u>Growth</u>. Economic growth is volatile in Belize. After several years of booming growth averaging about 6% between 1996 and 2005, the economy is experiencing a slow-down due to fiscal contraction and adverse terms of trade. Real GDP growth has slowed down from 9.2% in 2003 to 4.6% in 2004 and 3.5% in 2005. In 2005 the GDP stood at US$ 1.1 billion[1].

[1] / Exchange rate is: US$ 1.oo = Bz$ 2.oo

1.6 Fiscal deficit. The strong performance of the economy between 1999 and 2004 was largely driven by expansionary fiscal and monetary policies. This was done at the cost of annual fiscal deficits averaging 9% of GDP, which generated an increase in public external debt from 44% to about 90% of GDP. The cumulative effect of these negative fiscal balances is that the GOB is having great difficulty in maintaining a stable macroeconomic environment. In addition, the ability of the GOB to provide outlays for much needed social investment has become severely constrained. During the fiscal year 2005/06, the short term fiscal outlook has improved significantly due to the new revenue that will accrue from oil taxes and royalties. Therefore, the overall fiscal deficit is projected to decrease to 3.3% of GDP compared to 8.7% in fiscal year 2004/05.

1.7 Public Debt. At the end of December 2005, the total public debt stood at US$ 1.1 billion or 98.5 % of GDP. The high external debt has led to a poor country credit rating by the international rating agencies and will complicate the ability to both lower the domestic cost of capital and access long-term financing internationally for all sectors. Belize has been running persistent current account deficits in the recent years, peaking at 18.2% in 2003. Since then the current account deficit has gradually improved to 8.8% of GDP projected for 2006. The debt sustainability analysis shows that debt restructuring may be unavoidable.

Table I-1 Belize – Fiscal Deficit of the Central Government and Public Debt (% of GDP)

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005*
1)Deficit of the Central Government	**2.5**	**2.8**	**4.1**	**5.6**	**9.7**	**9.8**	**9.7**	**8.1**	**8.7**	**3.3**
2) Total Public Debt	**45.1**	**51.4**	**55.8**	**52.3**	**75.8**	**84.7**	**92.0**	**102.3**	**100.2**	**98.5**
a) Domestic	3.2	4.0	6.7	3.9	10.2	8.5	3.2	5.7	9.0	7.3
b) External	41.9	47.4	49.1	48.4	65.6	76.2	88.8	96.6	91.2	91.2
i) Central Government	34.3	36.9	37.5	26.3	36.7	39.9	53.2	72.8	76.8	78.9
ii) DFC, incl. Securitization	0	0	0	9.5	17.0	23.2	27.5	17.0	6.3	5.3
iii) Rest	7.6	10.5	11.6	12.6	11.9	13.1	8.1	6.8	8.1	7.0
3) External Debt Service of the Central Government (a)	**3.5**	**3.6**	**3.3**	**3.2**	**4.9**	**6.0**	**11.1**	**9.4**	**19.4**	**21.6**
Interest payments	1.0	1.1	1.2	1.2	1.6	2.4	3.3	4.2	7.6	7.5
Principal	2.5	2.5	2.1	2.0	3.3	3.6	7.8	5.2	11.8	14.1
4) New External Borrowing of the Central Government (Disbursements)	**8.1**	**2.8**	**4.0**	**6.2**	**15.7**	**9.0**	**23.4**	**27.1**	**32.6**	**5.2**

* Provisional

(a) Fiscal Year (April/March)

Source: Data provided by IMF and Central Bank of Belize

1.8 Monetary policy and inflation. Monetary policy in Belize is geared towards maintaining the fixed exchange rate with the US dollar, which has remained unchanged at the rate of 2Bz$=1US$ since the country's independence in 1981.

The Central Bank of Belize (CBB) does not conduct any monetary programming, nor monitors the evolution of any particular monetary aggregates. Instead, the CBB adjusts monetary policy (mainly reserve requirements and capital controls) to maintain adequate liquidity in the system, and to remove any pressures for foreign exchange.

1.9 Inflation has been historically very low, averaging only 3% in the past 3 years. The forecasts for 2006 show a slight increase in the inflation rate, but most of it is attributable to the rise in the price of oil, of which Belize is still a net importer.

1.10 Banking system. Most of the indicators of the financial system, comprised of 5 similar sized private banks, are generally sound**.** Capital adequacy ratios and liquidity ratios for the financial system, except provisions for non-performing loans, exceed the targets of Basel I.

1.11 Exchange rate policy. The exchange rate peg, which is viewed by the authorities as an important source of stability and the cornerstone of Belize's macroeconomic policy has contributed to the low inflationary environment. IMF projections suggest that the weighted real exchange rate has been depreciating recently, and is not overvalued. The consensus among the Belizean authorities is that an exchange rate devaluation would not have much advantage for the country. Furthermore, a devaluation would worsen the debt situation as most of the external debt is denominated in US dollars.

1.12 Policy actions. Given the build up of unsustainable macro imbalances, the GOB has been self-adjusting since the fourth quarter of 2004, and the short run fiscal situation has improved significantly. Most recently, the combination of an increase in fiscal revenue and a decrease of public expenditures (especially decline of public investment) has helped to raise the projected primary surplus to 3.4% of GDP in 2006 compared with 3% in 2005.

1.13 But servicing the external debt has become increasingly expensive, with interest payments representing about 21.6% of fiscal revenues. In a passive scenario, the Government is projecting to run primary surpluses of about 3.5% of GDP for the period 2007-2010. However, the projected public financing requirements for 2006 and 2010 average about 5.9% of GDP with a spike in 2007 (due to payments amounting to about 12.5% of GDP). Without too much margin for fiscal adjustment and with limited reserves available for debt payments, these are large payments that cannot be paid with internal savings unless there is a large expenditure reduction. As a result, the GOB has argued that it cannot continue its debt service under the current terms, and is trying to renegotiate its private external debt. The GOB commitment to keep spending under control is expected to curb domestic consumption and this will help to improve the current account.

1.14 Debt sustainability analysis. The IMF conducted a debt sustainability analysis (DSA) for both the passive and the active policy scenarios[2].

1.15 Under the passive policy scenario, multilateral financing is assumed to become available in very modest and declining quantities, bilateral financing at a level of US$10 million per year through 2015 and sovereign risk spreads would remain high at 900 basis points. Under these assumptions, the public debt would not stabilize in the longer run.

1.16 Under the active policy scenario, the DSA assumes that bilateral and multilateral lenders are projected to provide additional support for the envisaged adjustment. In particular, there will be policy-based loans from the IDB and CDB of US$25 million each, with disbursements during the last quarter of 2006 through early 2008. Afterwards, it is assumed that Belize can secure a moderate flow of financing support from multilateral lenders of about US$12.5 million per year through 2015. Bilateral lenders are assumed to provide more upfront support, through additional lending of US$25 million in 2007. Domestic financing, by contrast, is assumed to be lower than under the passive scenario as the GOB pays back on its overdraft to the Central Bank to support the accumulation of international reserves. Country risk is expected to decline gradually as the adjustment program takes hold and the debt stock declines. Following a successful debt exchange, spreads are assumed to decline from 550 bps in 2007 to 275 bps by 2015.

1.17 The debt dynamics in an active policy scenario would be significantly more favorable, although the precise trajectory would depend on the terms at which residual financing needs are being covered. Closing the financing needs at estimated market terms would lead the debt to GDP ratio to decline steadily from about 98½ % in 2005 to 67% by 2012 and 54% by 2015. This decline would be largely driven by the higher primary surplus to which the Government would commit in the active scenario. However, even in an active scenario Belize's public debt burden would remain high for a prolonged period of time, and there would be significant vulnerability to adverse shocks.

1.18 **Macroeconomic vulnerability factors.** There are severe risks to the short and medium term outlook. On the one hand, without a successful debt renegotiation the GOB may not be able to avoid a unilateral default. In that case, the outlook is uncertain and it is not clear how the transmission mechanism of the default would work its way into the real economy. Although the GOB's fiscal constraints have

[2] / The DSA assumes standard financing terms for assistance from bilateral and multilateral lender, and domestic financing. Such financing is assumed to carry interest of 6-month LIBOR plus 1%, 20 year term for amortization and a grace period or 3 years. Domestic debt is assumed to be rolled over at existing terms and new financing is being contracted at a flat interest rate of 8%. The residual financing gaps are filled through external financing at market terms. The DSA assumes that this occurs through the issuance of either 5-year notes (passive scenario) or 10-year bonds (active scenario) with a bullet maturity. The projected interest rates on these borrowing equals the current market projections for 5- and 10-year US Treasury bonds, plus a country risk premium or spread.

negatively impacted economic activity in the last two years, the productive sectors so far have been shielded from the threatening balance of payment crisis. This is explained in part, by the fact that the financial sector, the social security system and the private non-financial sector of the economy do not hold much government debt, and the GOB does not intend to restructure the domestic portion of the debt, which represents only 7.3% of the total.

1.19 On the other hand, export credit could be affected with negative consequences for the external accounts, and the default could complicate the ability to both lower the domestic cost of capital and access long-term financing internationally for all sectors. In the medium and long-term, the prospects for growth will be affected by shrinking public resources, as the reduced capital expenditures will eventually have repercussions for investment and growth in the productive sectors. Also, a run on deposits remains a possibility, although the overall soundness of the financial system and its limited exposure to the public sector reduces that risk.

1.20 Another source of vulnerability arises because the country is exposed to the risk of natural disasters**.** Between 1996 and 2005, 12 major storms have been recorded near Belize, of which 4 were hurricanes that hit Belize directly. According to the authorities, the emergency relief and reconstruction effort required after these natural disasters led to a rapid rise in public spending. To limit the vulnerability of the economy to these shocks, the IDB recommended the authorities to explore the possibility of buying insurance against natural disasters, as Mexico did with the "Fonden[3]" in 1996. The Belizean authorities responded that similar mechanisms were being explored in cooperation with other CARICOM members.

1.21 At the structural level, Belize's historically weak fiscal institutions, and the volatility shown by fiscal revenues over the years, reveals how vulnerable the fiscal accounts remain in spite of the government's recent efforts. In an exercise of sustainability analysis, Belize was compared to several Latin American Emerging Economies and under this approach, Belize ranks as the sixth most vulnerable country in the region.

1.22 Last but not least, is the political risk that fiscal discipline may break down either because of the inability to carry out the current plan or a change in economic policy. While we do not envision the latter at the present moment, there is a recognition that the resolution of Belize's macro imbalances will take several years and therefore will require the commitment of not only the current Administration, but also of the subsequent ones.

1.23 For all of the above reasons, the fiscal outlook for Belize remains challenging. In spite of the GOB's recent commendable efforts to improve the fiscal situation, the exposure to natural disasters, and the level of the adjustment that would be required in the hypothetical case of a long sequence of adverse revenue outcomes, suggest that it will remain important to continue with sound fiscal policies.

[3] An insurance facility of US$ 450 million against earthquakes underwritten by a major international insurance company.

1.24 In order to support the continued growth of the Belizean economy, avoid a balance of payments crisis and protect the exchange rate peg, it is therefore very important that the present fiscal and monetary adjustments continue, that efforts to stabilize debt and strengthen credit worthiness intensify, that the real economy, including exports, continue to diversify and expand, and that various supporting and reform measures are implemented.

1.25 **External financing gap**. Recently, large financing gaps have emerged, mainly due to high world fuel prices, declining sugar exports and public debt service. According to IMF projections, the balance of payments financing gap for 2007 will amount to almost US$ 130 million (10% of GDP). The Bank's share of external support to cover this gap will be roughly 19 %. It is expected that Belize cannot expect in the near term to receive the level of foreign financing received in the past five years. This will require a decline in the expenditure-income gap. Therefore, the GOB needs to continue efforts to bring down the current account deficit to a level that can be safely financed.

C. Economic perspectives

1.26 Due to the GOB's adjustment, during 2006 the short run macroeconomic situation has improved significantly**,** and the following results are encouraging: i) the GOB is projected to run a primary fiscal surplus of 3.5% of GDP in 2006, and is committing to run primary surpluses with a floor of 3.5% of GDP for 2007 and onwards; ii) inflation is expected to remain low at around 4%, with a slight increase due to energy prices, but stable; iii) the monetary and liquidity conditions have improved, and iv) the current account deficit is improving. In addition, for 2006 GDP growth is expected higher at about 5.3%, although mainly due to the emergence of new oil production.

1.27 The GOB faces a big challenge to stay the course with its short and medium term fiscal adjustment program. Immediate priority is the successful implementation of the GOB's strategy to obtain debt relief. The GOB will also face a big challenge to avoid a low scenario in which the fiscal adjustment affecting public investment will affect the productivity of the economy, and if private investment also declines due to the uncertainties, this could lower employment and increase poverty. Therefore, the economic perspectives depend very much on a successful conclusion of the process of renegotiation of the external debt and sound management of public finances.

1.28 **Fiscal policy measures**. In fiscal year 2005/06, the GOB implemented a set of measures to increase revenues, including increases in excise taxes (on beer, soft drinks and tobacco) as well as a temporary moratorium on approval of new fiscal incentives. A General Sales Tax (GST) was also implemented on July 1 2006 replacing the sales tax. After three months of its implementation, the GST collections are better than expected. Moreover, the GOB has imposed the GST on electricity sales to households above a monthly threshold of Bz$150 and the business tax on businesses operating in the Commercial Free Zones and Export

Processing Zones. The GOB is also considering additional reforms to the tax system, including reduction of trade taxes and replacement with an increase on the GST. Furthermore, the GOB is also committed to modernize the Customs Department to maximize efficiency in the customs administration, clearance process and increase revenue collection.

1.29 Measures to improve the budget preparation and management process as well as budget presentation to improve transparency have also been adopted. In addition, improvements in payroll systems, strengthening of the budget analysis unit and reduction in domestically financed capital expenditures have been put in place. Most of these actions were recommended by the Bank through two studies on Public Expenditure Review and on Revenue Systems in Belize. The Bank is also assisting the GOB in develop a medium-term macroeconomic and fiscal framework and the institutional capacity to sustain its formulation.

1.30 **Debt restructuring**. On August 2, 2006 the GOB announced its decision to seek the cooperation of the country's private sector creditors for a restructuring of Belize's external debt stock of approximately US$960 million. The objective of this rearrangement is to place the Belizean public sector debt on a sustainable level. To this end, the GOB has hired Houlihan, Lokey, Howard & Zukin as its financial adviser for this program. Currently, the GOB has visited 25 banks and creditors, which account for three quarters of its external private commercial creditors. The GOB plans to launch its debt exchange offer during the course of the fourth quarter 2006, after IMF's Article IV report has been published. It expects to conclude the renegotiation of the debt by the end of 2006, but delay is possible.

D. The Development Finance Corporation

1.31 The Development Finance Corporation (DFC) is a body corporate with limited liability established in 1963 by the Development Finance Corporation Act, Chapter 279 of the Laws of Belize. The principal activity of the DFC is to expand and strengthen the Belizean economy by supplying loans and services for the development of agriculture, forestry, fishing, agro-industry, tourism, education, housing and manufacturing. It also carries out direct investment projects. It operates as a first-tier public sector intermediary, channeling mostly long-term funds obtained from the Government and multilateral organizations, mainly from the Caribbean Development Bank (CDB) to the private sector. It does not take deposits from the public, although it has mandate to do that. In accordance with the DFC Act of 1963, DFC is exempt from all taxes. The Corporation is wholly owned by the GOB. The capital base of the Corporation as of December 2004 amounted to Bz$43 million and had total assets for Bz$551 million (equivalent to about 30% of the country's GDP). The rate of exchange in Belize is 2Bz$=1US$.

1.32 Simultaneously, DFC owns Belize Mortgage Company (BMC), a Cayman Island exempted company with unlimited liability, which was formed in March 2002 for the purpose of issuing Bonds in the North American Securitization (NAS) Market.

BMC issued the following Non-callable Mortgage Collateralized Bonds in 2002, which mature in 2012 at face value: (i) Class A=US$ 40 million sold to Partner Re Investment Inc.; and (ii) Class B=US$4.5 million sold to International Bank of Miami. These bonds are payable solely by the assets of BMC. Interest is at a rate of 8.5% and 12%. The GOB guaranteed all the obligations of the DFC to BMC.

1.33 In October 2004, the GOB requested the Bank's assistance in conducting a Diagnostic Study and Plan of Action for addressing the financial problems of the DFC. The Bank prepared a report whose main conclusions indicated that: (i) *the DFC was critically undercapitalized*. Over the last three years, the GOB covered capital requirements through the injection of public resources, which averaged 1.5 percent of GDP per year; (ii) *it had serious asset quality problems* as a result of a high percentage of non-performing loans (35%), non-productive assets and overvalued assets for sale; (iii) *reserves for probable losses (7%) of the loan portfolio were inadequate*; (iv) *operating expenses were significantly higher than revenues resulting in large losses* (Bz$100.000 per day) that had become endemic in the institution during the past three years; (v) *corporate governance and management were weak*; and (vi) *DFC had not been effectively supervised either by the Government of by the Central Bank* and did not have to follow the regulations applicable to financial institutions in Belize.

1.34 At the end of-December 2004, DFC had liabilities of Bz$364 million from domestic and external sources. The main fund providers for the DFC's loan operations were: 1) GOB (Bz$262 million); 2) CDB (Bz$42 million); 3) Social Security (Bz$41.9 million); CBB (Bz$5.8 million); and 6) International Bank of Miami, EIB, World Bank and others (Bz$12 million). Those funds were used to provide loans to enterprises and individuals for Bz$241 million and to finance large real estate projects for Bz$138 million. Its non-performing loan portfolio accounted for 47% of the total loan portfolio.

1.35 In 2005 the Government decided to orderly liquidate the DFC and, to this end, requested the Bank's support. The Bank provided technical assistance in analyzing the status of the DFC and in making recommendations for action ("Immediate actions for an orderly liquidation of the DFC", April 2005).

1.36 As the wide mandate and lack of effective controls in the operation of the DFC had been a serious problem, the GOB decided that it must be wound down. To this end, its Board of Directors and senior management were replaced in July 2005. The new Board implemented measures to cut costs and eliminate the need for budgetary support from the GOB. This included downsizing the institution by reducing staff and branches and selling real estate assets. Another decision of the new Board was the cleaning up of the balance sheet of the DFC by means of the transfer of assets and liabilities to the Government.

E. Current situation of the DFC and the BMC

1.37 Between December 2004 and May 2006, DFC financial position decreased Bz$ 320 million (from Bz$551 million to Bz$231 million). This value corresponds to the reduction in the loan portfolio and the inventory of assets held for resale, a partial transfer of assets and liabilities to the GOB, loan recovery and the sales of assets. In spite of this improvement in the DFC financial statements, its loan portfolio still was 15% in arrears and 48% in non-performing loans. However, in June and July the GOB was offering write offs and discounts to over fifteen hundred borrowers in student loans as well as in housing loans from the DFC. A recent statement of the IMF indicates that the DFC should be allowed to collect without interference on its loan portfolio. Financial agencies such as the CDB, World Bank, and the EIB all still have loan programs with the DFC. In fact, the CDB has loans outstanding for the amount of Bz$37.5 million.

Table I-2- DFC Balance Sheet 2004-06 (million of Bz$)

ASSETS	**2004**	**2005**	**May 2006**
Cash	5.4	3.9	9.2
Accounts Receivable	133.0	1.5	1.7
Interest Receivable less provisions	3.6	1.3	1.0
Current Assets	**142.0**	**6.7**	**11.9**
Loan to Borrowers less provisions	241.4	223.9	200.1
-Less Provisions for Bad Debts	-28.4	-66.3	-61.1
Assets Held for Resale	138.6	27.8	25.1
Santa Cruz Lodge & Libertad Factory	5.3	0	0
Reserves & Retained Interests	42.5	42.0	45.8
Investments and Fixed Assets	9.9	9.8	9.6
Long Term Assets	**409.3**	**237.2**	**219.5**
Total Assets	**551.3**	**243.9**	**231.4**
LIABILITIES + CAPITAL	**2004**	**2005**	**May 2006**
Loan interest payable	38.4	7.5	7.8
Accounts Payable	24.3	8.2	6.3
Govern. Short Term loans	27.6	0.6	1.2
Other current liabilities	-1.8	0.9	1.0
Current Liabilities	**88.5**	**17.2**	**16.3**
CDB loans	42.0	38.4	37.5
Central Bank loans	5.5	0.2	0.2
Social Security loans	41.9	36.7	34.5
Government loans	262.2	93.4	86.3
Other loans	12.3	20.9	20.4
Long Term liabilities	**419.0**	**189.6**	**178.9**
Total Liabilities	**507.5**	**206.8**	**195.2**
Total Capital	**43.8**	**37.1**	**36.2**
Total Capital + Liabilities	**551.3**	**243.9**	**231.4**

1.38 Since December 2004 to June 2006, the DFC staff has been reduced from 103 to 69 employees, the number of its branches has decreased from 8 to 5 and the number of its loans declined from 9366 to 5610. Based on the September 2006

financial statements and loan portfolio report, the DFC is expected to meet its target of 4,400 loans by December 2006, shrinking its loan portfolio to Bz$168 million.

Table I-3						
	Dec.2004	Jun.2005	Dec.2005	Jun.2006	Dec. 2006	Jun. 2007
Number of employees	103	76	72	69	60	45
Number of branches	8	5	6	5	4	3
Number of loans	9,366	8,747	7,272	5,610	4,400	4,200
Non performance ratio	36.4%	47.2%	48.1%	40.3%	30%	28%
Budget cost (million)			7.2	6.2		4.5

1.39 **Challenges presented by BMC in DFC's liquidation**. The closure and liquidation of the DFC constitutes a bold structural reform and the Government has been committed to adhere to that reform. Nonetheless, according to the GOB's legal advisors (Cleary Gottlieb Steen and Hamilton), its full closure could have some serious legal implications on the administration of the North American Securitization (NAS) bonds. As BMC is owned by DFC, a complete liquidation of the latter could generate a situation that could jeopardize the actual debt restructuring process. Moreover, a risk of default also exists because all the bondholders could request a call of guarantee of the NAS documents from the GOB, threatening its capacity of payment.

1.40 As of December 2005, the BMC is a US$51.5 million company; bond payable total US$31.2 million and loans receivable total US$39.4 million. Because the Bonds are non-callable, BMC must be in existence until 2012. In addition, if DFC/BMC would be liquidated approximately US$65 million of the portfolio would be required to meet the payout. According to the GOB's lawyers, the DFC must retain ownership of BMC. Therefore, the DFC Act should not be repealed because a complete liquidation of the DFC would place both the GOB and the DFC in default under the NAS documents. The required cash flow as of June 2006 to June 2012 (6 years) to cover principal, interest, insurance and operating costs total approximately US$45 million. The liquidation option would require an estimated US$46 million to US$50 million upfront. However, if the bonds are allowed to mature, the US$ currency requirement would spread over 6 years. Therefore, the new GOB's position is to reduce the DFC to the minimum operational capacity required to perform its functions under the NAS documents and the ongoing liquidation process.

F. The oil sector

1.41 The recent oil discover in Belize is expected to contribute to growth and to improve the fiscal position. At the-end-of-April 2006, the company Belize Natural Energy (BNE) characterized the oil findings as of high quality and commercially viable, albeit present production level is only about 2700 barrels per day. Under the current tax regime, BNE pays a royalty of 7.5% of the value of the annual gross production of crude oil, business tax of 1.75%, and a production share of 1.5% of the gross production of crude oil, which together do not generate substantial resources for the GOB. The GOB's target is to reach a 50% of the

gross revenue derived from oil exploration, and even at present production levels, this would have a significant impact in overall fiscal revenue. In order to reach that target the GOB has submitted a new tax law to Parliament which establishes a 40% income tax for oil companies.

G. Remaining agenda for reform

1.42 Despite the progress made in macroeconomic management and the reduction of the size of the DFC as well as the cleansing of its financial statements, the reform agenda in these areas is still incomplete. Looking ahead there is a need to deepen the improvement in the fiscal position through: a) an increase in tax collections, namely from the new oil taxes and royalties; b) a relief of the public debt service burden through a re-profiling of the obligations with external commercial creditors; c) a monetary policy management consistent with the fiscal targets; and d) the termination of the DFC's lending and direct investment project operations.

H. The country's sector strategy

1.43 In the fourth quarter of 2004 the GOB embarked on a comprehensive home-grown fiscal adjustment and structural reform program aimed at stabilizing the fiscal and external debt situation and placing public sector finances on a sustainable path. The process is undertaken in two phases: the short-term fiscal adjustment and the medium term stabilization program.

1.44 During the first phase, implemented between October 2004 and March 2005, a number of short term fiscal adjustment measures were implemented with the main objective to immediately halt and reverse the expansion in the fiscal deficit of the central government. These measures included tax increases and significant cuts in the capital expenditures. The fiscal tightening led to a significant reduction of the overall fiscal deficit from almost 9% of GDP to 3.3% in just one year, as mentioned in Section 1.6. The actions on the fiscal side were complemented by the steps taken by the Central Bank to tighten financial sector liquidity to curtail the demand for foreign exchange, achieved by increasing the cash and liquid assets reserve requirements by one percentage point on three subsequent occasions, most recently on September 1, 2006.

1.45 The second phase of the GOB's program aims at further reduction of the overall fiscal deficit to a sustainable level in the medium term and attaining a sustainable level of the external debt. The medium term stabilization strategy of GOB covers four key areas: strengthening of the public expenditure programming and management systems; comprehensive reform and modernization of the revenue system; definition of a debt management strategy to bring sustainability to Belize's external debt and strengthening the legal and administrative framework for financial accountability and oversight. Important reforms have already been implemented in each of these areas, although returning to sustainability will require additional efforts. On the public expenditure side, the GOB has introduced further expenditure cuts since 2005, defined targets for fiscal performance

(primary surplus and overall fiscal deficit) and has taken important steps to improve the budget preparation and management process. The GOB has committed to the implementation of program budgeting with clearly defined output targets and expected results, with the main objective to enhance transparency and accountability in the public expenditure process. The Bank is supporting the GOB's efforts in this direction through the PRODEV initiative (Program to implement the external pillar of the medium-term action plan for development effectiveness). On the revenue side, the GOB implemented a set of measures to increase revenues, including increases in excise taxes and implementation of the GST, a value-added type consumption tax. The authorities have also committed to modernize the administration of Customs to maximize the efficiency in the Customs clearance process and thus increase trade-related revenue collection. To attain debt sustainability, the GOB has decided to seek a restructuring of the private sector external debt. GOB has begun consultations with its external creditors and anticipates the completion of the process before the end of 2006. Finally, to promote greater accountability and oversight in the administration of public finances, the GOB has passed a Finance and Audit (Reform) Act in 2005 and has taken steps to transform the Central Statistics Office (CSO) into an independent Statistics Institute. More importantly, it has taken crucial steps to liquidate the DFC, as described in the previous section. The GOB has also accepted the recommendations that came out of the investigation of the Social Security Board (SSB) and agreed to strengthen the SSB Act in order to toughen the investment rules of the Board.

I. The Bank's Country strategy

1.46 The proposed program is consistent with the Bank's 2004-2008 Country Strategy with Belize (Document GN-2320 of July 14, 2004), which has as the main objective to assist Belize in its transition towards private sector-led growth. Sustainable economic growth and poverty reduction are the overarching goals of the Strategy. An essential condition for achievement of these goals is the enhancement of macroeconomic stability through reducing fiscal deficits and external debt. This requires reducing fiscal imbalances, attaining debt sustainability and implementing major structural reforms.

1.47 The Strategy establishes two strategic areas for Bank intervention: improvement of the public sector capacity to foster private sector development and private sector capacity- building and specific initiatives. The activities in the first strategic area include helping Belize to attain macroeconomic stability and consolidate public sector policy reforms. This PBL is intended to support the GOB in these efforts. The PBL is complemented by the activities in the Technical Cooperation project for Strengthening Results Based Management in the Public Sector, which is in the Bank's pipeline for 2006 under the PRODEV initiative.

1.48 Subject to successful debt renegotiations and depending on ability of Belize to assume new loans and its overall debt sustainability, the Bank will discuss with

GOB the preparation of other programs contemplated in the Strategy, namely for Trade and Competitiveness and Sustainable Tourism.

J. Lessons learned

1.49 There is no previous Bank participation in sector loans in Belize. A Report on Bank Activities during 2005 and Outlook for 2006 includes the following lessons learned: (i) structural changes and institutional strengthening take time; (ii) the Bank's strategy is always subject to multiple risks, which must be addressed through measures to mitigate their effects; (iii) non-financial products and technical assistance for project preparation and execution are support tools that represent value added by the Bank; (iv) the approval and disbursement schedules for loans have not always coincided with government's cash needs; and (v) the challenge for the Bank is to have ready both the human and financial resources that have had an ongoing involvement in specific sectors and issues, in order to generate and contribute to the reform process and to facilitate identification, preparation and disbursement of PBLs.

1.50 Among the lessons learned and applied in the design of this program are the following: (i) preparation and analysis of the program was preceded by dialogue and sector work at the highest level (the Minister of National Development, the Governor of the Central Bank and the Financial Secretary) to set objectives, measures and strategies for structural reforms; (ii) the program has been carefully evaluated for its suitability in support of specific policies and to ensure that the objectives are consistent with the macroeconomics goals of the national plan; (iii) the executing agency (Ministry of Finance) has the technical capacity needed to carry out the program effectively; and (iv) the activities needed to complete all the program policy measures on schedule have been identified and the government will be responsible for obtaining the necessary technical resources for such purposes.

K. The Program´s strategy

1.51 An essential condition for the economic and social development of Belize is the reinforcement of macroeconomic stability through the reduction of its fiscal deficit and debt overhang. To prevent a crisis of the balance of payments, reduce vulnerabilities, improve private sector investment confidence and help the economy to return to a path of sustained growth and employment, corrective measures to be implemented in the short-term are needed. All these measures are part of an adjustment and reform economic program which would be aided by the international community and, in particular, by the Bank through this policy-based loan in support of the country's balance of payments.

1.52 **Value added**. The Bank has provided continued support to the GOB engaging both in a permanent policy dialogue during the last 2 years and, more recently, by its financial support through this operation. In the past 2 years, specific support was provided for the analysis of fiscal issues, including a Public Expenditure

Review and a Fiscal Study, both aimed to improving public sector fiscal management. In order to support the GOB to address the financial issues related to the DFC, the Bank provided technical assistance for three analytical studies of that institution. These efforts have been part of the permanent policy dialogue between the GOB and the Bank on the design and structuring of a set of complex reforms that will be implemented as part of this program. The set of policies included in the matrix will support the necessary institutional changes to complement the ongoing macroeconomic policies the Government has put in place since 2004; the resources of this loan will contribute to fill the fiscal and balance of payments gap and give the GOB the necessary room to implement their public external debt strategy.

1.53 **Rationale for IDB lending**. In addition to contributing to reducing Belize's financing gap, this operation seeks to improve the overall macroeconomic situation and investment climate by supporting specific policy and institutional reforms. The fiscal balance is a continuing concern for Belize. This operation will bolster the GOB's commitment to maintain fiscal sustainability by including macroeconomic targets as part of its tranche conditions. Given Belize's fiscal position, a policy-based loan will not create pressure on the fiscal deficit compared to investment loans, which directly increase capital expenditure and could have adverse effects on debt sustainability.

1.54 The Country Strategy with Belize stipulates that a PBL loan in support of the ongoing public sector reforms, which would result in a high lending scenario, should depend on the progress made in the reforms geared towards enhancing macroeconomic stability. Recognizing the efforts of the GOB to curtail fiscal deficits, to improve public finances management and to implement a number of important structural reforms, as described in more detail in sections 1.39 to 1.41, the Bank's management recommends that the lending framework of this loan go through a high-case scenario.

L. Coordination with other Donors

1.55 The scope of the Bank's program has been discussed and coordinated closely with the International Monetary Fund. In the past, several joint IMF-IDB missions to Belize have been carried out on the occasion of the Article IV Consultation and staff visits for a country's macroeconomic assessment. The Bank's project team has also maintained close coordination with the Caribbean Development Bank (CDB) on this loan. As a complement to this operation, the CDB is eager to provide to Belize a PBL for US$25 million, under the same policy conditions of the IDB loan, so that there is a complete harmonization and complementarity between the 2 programs. Furthermore, the Bank has kept permanent dialogue with the World Bank about the IDB's future activities in Belize. The World Bank is providing technical cooperation to the Central Statistical Office for improvement in data dissemination, while UNICEF and DFID provided technical and financial support to convert the Central Statistical Office into an autonomous Institute to be named the Statistical Institute of Belize.

II. THE PROGRAM

A. Objectives and description

2.1 The general objective of the program is to assist the Government of Belize in implementing a reform agenda aimed at restoring macroeconomic and financial stability, as well as improve investor climate confidence. Consistent with this objective, the operation is intended to provide support for: a) an improvement in the fiscal position and debt management to reduce external vulnerability; b) implement an action plan to conclude with the primary purpose of lending and direct investment project of the Development Finance Corporation (DFC) and an orderly liquidation of its assets; c) adoption of an oil tax regimen; and d) implementing the General Sales Tax (GST) and reform customs in order to increase revenue collection and reduce the fiscal deficit to sustainable levels.

B. Structure of the Program

2.2 The proposed operation would be implemented as a Policy-Based Loan (PBL). The PBL is intended to support the adoption and implementation of the above mentioned series of reforms gathered in the following components: a macroeconomic framework consistent with the objectives of the Program, closure of the lending and direct investment project activities as well as the liquidation of the assets of the DFC, management of the oil revenues, public debt sustainability and fiscal reform agenda. The policy matrix of the Program describes the expected outcomes and the conditions for each tranche of disbursement.

C. Components and policy conditions

2.3 ***Macroeconomic Framework and Policy Letter***. The objective pursued with this component is the improvement of the fiscal and external positions. Despite the progress made in the reduction of the fiscal deficit of the Central Government and the primary fiscal surplus generated in FY 2005, the continuation of those policies will be requested to reinforce the country's public finances. During the execution of the program, as a condition for the disbursement of the tranches, the Government of Belize should maintain a macroeconomic environment consistent with the objectives of the program. Given the fact that Belize does not have a formal IMF-supported program, the Bank has reached an agreement with the GOB to monitor some key macroeconomic indicators, which will be used to undertake an independent macroeconomic assessment (IMA) on an ongoing basis and prior to each disbursement. The disbursement of the two tranches will be conditional on maintenance of a sound macroeconomic framework as set out in a Policy Letter. The following indicative targets (1 to 3) will serve as inputs for the monitoring of the program as well as indicative paths to the following independent macroeconomic assessment. The targets will be reviewed after the conclusion of the re-profiling of the debt with external creditors. Also, the program includes targets related to the termination of the DFC' lending and

borrowing operations, direct investment projects and all its financing activities, as well as the liquidation of its assets and liabilities.

	Table II-1 Targets for the next 2 fiscal years	
1.0	**Primary Balance**: Floor for the Primary Surplus	3.5% of GDP US$ 42.6 million (2006) US$ 49.9 million (2007) US$ 56.2 million (2008)
2.0	**Minimum Net International Reserves**: Accumulation per year in US$ million	End of 2006 = US$48 million Addition 2007=US$15 million
3.0	**External Debt**: Limits on New Commercial Debt	No new commercial debt for the next 3 years. New concessional borrowings (international ODA definition of concessional debt) will be pursued as policy based loans and/or financing for projects or programs

2.4 ***Management of the oil revenues***. This component is intended to support the adoption and implementation of an oil tax reform, with the aim of ensuring more efficient and transparent fiscal management of the oil revenue. Given the recent oil discoveries and the impact they will have on fiscal revenue, it is crucial to secure a rational management of these resources. Currently the GOB is working to reform the tax regime of the oil sector, in order to increase further GOB revenues from this sector. The GOB also expressed its interest in defining a medium term framework for managing these resources, by the end of the current calendar year, in order to help strengthening the fiscal situation.

2.5 Disbursement of the first tranche will be conditional on the approval by the Parliament of the new oil tax law that will ensure the transparent management of the oil revenue. Disbursement of the second tranche will be conditional on the compliance of the following: a) opening of a special account at the Central Bank to manage the oil resources; and b) the projected oil revenue has been included into the budget.

2.6 ***Public Debt Sustainability***. Debt service obligations place a heavy burden on public finances. The primary objective of this component would be to improve debt management and seek possible debt service relief from external creditors to bring down public debt to sustainable levels. This action would avoid a crisis of the balance of payments and loss of confidence in the exchange rate. To this end, the GOB will seek to reach an agreement with external advisors for a medium-term debt strategy in order to modify debt service commitments to sustainable levels.

2.7 Disbursement of the first tranche will be conditional on the formal presentation to creditors of the Government’s debt restructuring proposal. Disbursement of the second tranche will be conditional on reaching agreement for restructuring of the public debt with must if not all its external commercial creditors.

2.8 ***Liquidation of the Development Finance Corporation (DFC)***. The objective of this component is to ensure that the liquidation of the DFC proceeds in an orderly way and that the DFC does not once again becomes a direct burden on the Central Government. To this end, the GOB will implement a plan for: (i) the termination of the DFC's lending and borrowing operations, direct investment projects and all its financing activities; (ii) an orderly liquidation of its assets; and (iii) paring down its functions to the minimum operational capacity required to perform its role under the North American Securitization (NAS) documents and the liquidation of assets.

2.9 The next steps in this process would be:

i. Drafting and passage of an amendment to the DFC Act which would come into effect not later than December 7th, 2006;
ii. Continued sale of assets –both loans and real estate;
iii. Additional closure of, at least, two more branches by June 2007;
iv. Reduction of the level of staff from 72 employees at December 2005 to 60 employees at December 2006 and 45 employees until June 2007: 22 to perform the functions of NAS and 23 to perform the liquidations of the remained previous obligations;
v. Reduction the current operational budget from US$6.2 million to US$ 4.5 million in June 2007.
vi. In order to establish the main responsibilities on the mismanagement of DFC, the results of a forensic audit of the DFC will be made public.

2.10 [One paragraph omitted at request of the borrower]

2.11 Disbursement of the first tranche will be conditional on the compliance of the following: (a) the DFC Act has been amended to: (i) pare down its functions to the minimum operational capacity required to perform only its functions under the North American Securitization documents; and (ii) extinguish its authority to provide new loans, carry out new direct investment projects, or incur additional indebtedness or any other function not related with those referred in paragraph (i); and (b) a forensic auditor for the DFC has been selected by the Government.

2.12 Disbursement of the second tranche will be conditional on the compliance of the following: a) the DFC has extinguished its lending, borrowing and direct investment project activities and any other activity not related with the NAS documents; b) the DFC has closed, at least, two additional branches and reduced the level of staff to 45 employees to perform only the functions of NAS; and c) forensic audit has been completed, and made public.

2.13 ***Fiscal Reform Agenda***. The objectives of this component would be to: (i) strengthen the current tax regime through the introduction of the General Sales Tax (GST); (ii) implement seven of the most important measures recommended by the public expenditure review and revenue systems studies financed by the Bank (listed in 2.13 for the two tranches); and (iii) establish a master plan for

reforming the custom regime. The GOB has indicated its intention for the preparation of a master plan and schedule for reforming the custom regime (to modernize customs administration to maximize efficiency in the customs clearance process). Tariff reform need to be compatible with the CARICOM Common External Tariff and will be considered in the course of reform of the customs administration. The General Sales Tax (GST) has already been implemented starting July 1st, 2006. Measures to improve budget preparation and its management process, budget presentation to improve transparency as well as rise in business tax rates and sales tax on electricity have also been implemented. These latter measures in aggregate should add 1% of GDP in incremental tax revenue.

2.14 Disbursement of the first tranche will be conditional on the compliance of the following: a) the GST has been implemented; and b) three recommendations of the public expenditure and revenue systems reports have been put in place (raise in business tax rates, sales tax on electricity sales to households and business tax on commercial free zones and export processing zones). Disbursement of the second tranche will be conditional on the approval of a master plan by the Government with the schedule for reforming the custom regime and implementation of four recommendations of the public expenditure review and fiscal studies (modernization of payroll system, strengthening of the budget analysis unit, reduction in domestically financed capital expenditures and a unique taxpayer identification number system).

D. Cost and financing.

2.15 The total cost of the Program is estimated at US$25 million, from the Bank´s Ordinary Capital. According to the importance of the reforms and the balance of payments needs, the resources will be disbursed in two tranches: the first tranche of US$10 million and a second tranche of US$15 million. The proposed amount represents a critical component of the projected US$ 130 million required during fiscal year 2006/07 for externally financed budget support. This operation is especially important given that the flow of funds may be impeded by the limited ability that the GOB has to get new financing of multilateral sources, except the CDB.

III. PROGRAM EXECUTION

A. The borrower and executing agency

3.1 The borrower of the loan will be the Government of Belize. The Ministry of Finance (MOF) will be the executing agency. The MOF will be responsible for execution of the program and use of the resources.

3.2 The MOF's main responsibility will be to monitor compliance with policy conditions and targets indicators and benchmarks, as well as to serve as the single point of contact with the Bank on all administrative matters. In particular, the MOF will be responsible for: (i) monitoring the compliance of conditionality and

performance targets and benchmarks set out in the policy matrix; (ii) reporting on compliance progress to the Bank; (iii) monitoring execution performance; (iv) preparing and presenting disbursement requests; and (v) keeping adequate documentation to support disbursements received.

B. Project execution and administration

3.3 **Disbursement procedure**. For each tranche, the GOB will be required to submit a report to the Bank, which demonstrates that the conditions prior to each tranche have been fulfilled, presentation of evidence of compliance and an appropriate macroeconomic framework has been maintained. The first disbursement of US$10 million is expected to happen immediately after loan approval. Actions for compliance with first tranche conditions are well underway. The second disbursement of US$15 million is programmed for the second half of 2007. Tranche release will depend on the satisfactory implementation of agreed upon policy reforms and institutional changes, as described in the Policy Matrix.

C. External audit

3.4 The Bank may require the audit of disbursements made or the submission of audited financial statements related to the use of the Bank´s financing. This audit would be conducted by independent auditors deemed eligible by the Bank, in accordance with the terms of reference previously approved by the Bank.

D. Disbursement period and schedule

3.5 The disbursement period will be 24 months. The resources will be disbursed in two tranches. Tentative schedule for the first tranche is the fourth quarter of 2006.

E. Readiness of the program

3.6 All the conditions for the first tranche have been met with the exception of the new oil tax law and the DFC amendment act that are in the process to be approved by the Parliament. The first tranche will be disbursed only when both conditions have been met in the terms agreed with the Bank.

F. Monitoring and evaluation

3.7 As required by the guidelines for preparation and implementation of PBL Loans (CS-3633), the Bank must elaborate an independent macroeconomic assessment (IMA) to support this loan, and make the appropriate evaluation of the policy reforms implementation. To this end, the Bank will send technical missions to the country to continue the momentum in support to this reform process. To carry out this assessment, the Bank's staff will also take into account the view of the IMF.

3.8 The Belizean authorities have undertaken to keep the necessary information on the performance indicators in the Outcome Matrix, and to make this available to

the Bank so that, if necessary, it can carry out a Project Completion Report of the program.

IV. VIABILITY AND RISK

A. Institutional viability

4.1 The Belizean macroeconomic and public financial management are weak. Furthermore, the public finances in Belize have been under adjustment pressure that has not only limited the approval of new operations in the last four years, but also has limited the execution of projects in the portfolio. However, the Ministry of Finance has played a key role in leading the discussions about this operation and possesses enough experience in the management of macroeconomic and fiscal policies. The reforms contained in the policy matrix represent the Bank support for a series of institutional changes that the GOB's macroeconomic plan has begun to implement, through the Ministry of Finance, since the fourth quarter of 2004. Consolidation of the fiscal position, as well as improvement in the public external debt situation requires immediate measures. The proposed Bank operation support such measures in specific areas included in the policy matrix. The measures proposed by the GOB entail some important institutional changes (tax policy, oil resources, external debt and the DFC) that have been agreed with the responsible authorities (Ministry of National Development, Ministry of Finance and Central Bank of Belize).

B. Environmental impact

4.2 This operation supports policy reforms and institutional strengthening actions no directed at promoting specific economic sectors or activities. Therefore, no direct environmental and social impacts on the country's environment are expected. The CESI reviewed this operation on 28 July 2006 (meeting CESI 31-06) and agreed that the program will not have direct environmental and social impacts.

C. Benefit

4.3 The actions included in this operation will benefit the country's public finances towards a sound financial macroeconomic situation. By contributing to increase oil revenue, obtaining a relief for the external debt service and removing the primary purpose of the DFC, the Program is expected to reduce significantly fiscal and debt problems as well as to boost the levels of private investment.

D. Risks

4.4 **Liquidation of the DFC**. The main risk for the execution of the program is the lack of progress in the process of liquidation of the DFC due to political or legal reasons. The program mitigates this risk by requesting that the GOB approves and implements a legal instrument for the extinction of the DFC's primary purposes, such as lending, borrowing and direct investment activities. These changes will permit the DFC to function only on a minimum operational capacity for the

management of the NAS documents and the liquidation of assets. In addition, the GOB will submit the DFC's financial statements on a monthly basis in order to monitor the evolution of the institution's size. Furthermore, some indicators (closure of branches, staff reduction) to measure this reform have been included into the policy matrix. The GOB is committed to adhere to this reform with the approval of an amendment to the DFC Act, which will include a date of termination of DFC's lending, borrowing and direct investment activities.

4.5 **Macroeconomic risks**. Another risk is that an appropriate macroeconomic framework is not maintained by the GOB due to a default of the public debt service with external creditors, insufficient fiscal adjustment or both. The program has mitigated this risk by requesting the GOB compliance with some macroeconomic targets over the timeframe of the loan. The GOB has included all these targets in the Policy Letter. Also the IMF, in a recent statement on the conclusion of the mission on Article IV consultation has supported Belize home-grown program that involved revenue measures as well as tight expenditure measures. This assessment will help the GOB in the renegotiation of its public debt with external creditors.

4.6 [One paragraph omitted at request of the borrower]

4.7 **Exogenous shocks**. A fourth risk could arise from external shocks, namely the decline in the price of exports, reduction of tourism as well as hurricanes and other natural disasters. To limit the vulnerability of the economy to the latter shock, the IDB has recommended that the authorities explore the possibility of buying insurance against natural disasters (as Mexico did with the "Fonden" in 1996). In addition, the external sector may suffer from loss of market preferences and declining world prices. To mitigate that risk Belize needs to make efforts to diversify economic activity by penetrating new exports markets, finding niches for particular products and generating higher value-added.

V. POLICY MATRIX

5.1 The policy conditions for the disbursement of each tranche of the loan are detailed in the following Policy Matrix of conditions.

Policy Matrix

	Problems	Program Objectives	Impact	First Tranche [4] Prior actions	Means of Verification	Second Tranche Prior actions	Means of Verification
Macroeconomic Framework	Macroeconomic stability is fragile.	Restore Belize's macroeconomic and financial stability and improve investor climate confidence.	Improve fiscal and external position.	Adherence to a sound macroeconomic framework consistent with the objectives of the Program and the Policy Letter.	Independent macroeconomic assessment with indicative targets.	Adherence to a sound macroeconomic framework consistent with the objectives of the Program and the Policy Letter.	Independent macroeconomic assessment with indicative targets.
Oil Revenue Management	Given the recent oil discoveries and the impact they will have on fiscal revenue, it is crucial to secure a rational management of these resources.	Create a fiscal framework for a more transparent management of the oil revenues.	Increase further government revenues from the oil sector to strengthen the fiscal position.	New oil tax law that will ensure the transparent management of the oil revenues through the national budget, has been approved by the Parliament and is in effect.	Oil tax law published in the Government Gazette and put into effect.	Opening of a special account at the Central Bank to manage the oil resources and inclusion of the oil revenues in the National Budget.	(i) Report from the Ministry of Finance indicating the full oil revenue; (ii) copy of the approved full budget; and (iii) copy of the budget summary published in the Gazette.
Public Debt Sustainability	The viability of the balance of payments is at risk due to the high level of public and external debt. Debt service places a heavy burden on public finances.	Improve public debt management and seek possible debt service relief from external creditors to bring down public debt to sustainable levels.	Avoid a crisis of the balance of payments crisis and loss of confidence in the exchange rate.	The Government has made a formal presentation to creditors of its debt restructuring proposal.	Copy of the revised medium term projections and indicative debt structuring scenarios.	The Government of Belize has reached an agreement for public debt restructuring with most if not all its external commercial creditors.	Report from the Ministry of Finance including all information pertaining to the restructuring of its debt with external commercial creditors.

[4] All the conditions for the first disbursement should be met prior to submission of the loan for Executive Board approval.

	Problems	Program Objectives	Impact	First Tranche [4] Prior actions	Means of Verification	Second Tranche Prior actions	Means of Verification
Fiscal Reform	The fiscal position is unsustainable due to the high level of public debt and weak tax effort.	Strengthen tax and customs regime in order to improve efficiency and to implement the recommendations of the comprehensive review of public expenditure.	Reduce the fiscal deficit.	The General Sales Tax (GST) has been approved and put into effect. The following recommendations from the public expenditure review (PER) and fiscal study funded by the Bank have been implemented: 1)Increase in business tax general rates on average from 1.25% to 1.75%; 2) Sales tax on electricity sales to households from 0% to 10% above a monthly threshold of Bz $150; 3) Business tax applicable to all Commercial Free Zones at a rate of 2% after an initial 10 year tax holiday; 4) Business tax applicable to all Export Processing Zones at a rate of 2% after an initial 20 year tax holiday.	GST Act has been published in the Government Gazette and put into effect. Publication in the Government Gazette of GST Act. Amendment to the Export Processing Zone Act of January 29/2004. A Financial Report from the Ministry of Finance indicating the budget outcome in 2005 and expected outcome in 2006	A master plan and schedule for reforming the Customs administration has been approved by the Government. The following recommendations from the public expenditure review (PER) and fiscal study funded by the Bank have been implemented: 1) Modernization of payroll system; 2) Strengthening of the budget analysis unit; and 3) A unique taxpayer identification number system has been implemented.	Copy of the master plan approved by the Cabinet for reforming the custom regime. By report from the Ministry of Finance.

	Problems	Program Objectives	Impact	First Tranche [4] Prior actions	Means of Verification	Second Tranche Prior actions	Means of Verification
Liquidation of the FDC	Financial position of the DFC is worrisome because of contingent fiscal liabilities and high level of non-performing loan portfolio.	Start the orderly liquidation of the assets of the DFC, eliminate its primary purpose of providing financing, limit the scope of its functions proceeding to its closure and hire a forensic audit of the financial institution.	Eliminate the need for DFC budget support from the Government	An amendment to the DFC Act has been approved by the Parliament and has entered into effect by which: (i) DFC's functions are pared down to the minimum operational capacity required to perform its functions under the North American Securitization (NAS) documents and its liquidation process; and (ii) its authority to originate new loans, carry out direct investment projects, incur additional indebtedness or any other function not related with those referred in paragraph (i) is extinguished. The Borrower has selected the auditing firm which will perform a forensic audit of the DFC and has informed the National Trade Union Congress of Belize of its decision.	A Bill to amend the DFC Act has been approved by Parliament, the Amendment Act is published in the Government Gazette and has entered into effect. The minutes of the selection process of the auditing firm selected to perform a Forensic Audit. And a copy of the letter to the unions informing them of such selection.	DFC is carrying out its liquidation process and therefore has extinguished its new lending, new borrowing and new direct investment project activities not related with the NAS documents: The borrower has carried out and made public the forensic audit of the DFC.	Compared to position at the end of June 2006, monthly financial statements demonstrate reduction in total assets and liabilities and no new lending, borrowing and direct investment projects. Report on the DFC from the Ministry of Finance which includes the following targets: DFC (a) has continued to sell its assets –both loans and real estate; b) has closed, at least, two additional branches and reduced the level to 23 employees to perform the functions related to the NAS and to 22 for the liquidation process; c) has reduced the current operational budget from \$6.2 million to approximately \$4.5 million in June 2007.

	Problems	Program Objectives	Impact	First Tranche [4] Prior actions	Means of Verification	Second Tranche Prior actions	Means of Verification
							GOB's progress report providing evidence of : a) the closure of two branches; and b) the reduction of 24 employees has been implemented by June 07. Report from the forensic auditors available to the public and placed on the Government's Web Page.