BUDGET ADDRESS 2004/5

"MAINTAINING THE COURSE WITH A RESPONSIBLE HAND AT THE TILLER"

DELIVERED BY

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FINANCIAL SECRETARY

TO THE LEGISLATIVE ASSEMBLY AT THE BUDGET MEETING,

FRIDAY MAY 7th 2004

Part 1: Introduction

Mr Speaker, it is my privilege to present the Budget for the 2004-2005 financial year on behalf of the Government. In keeping with the normal practice I will share this responsibility with the Leader of Government Business who will move the budget debate.

Mr Speaker, the title of last year's Budget address was "Charting Our Course For The Future". That speech, together with the address from the Leader of Government Business outlined the Government's plan for the economic and social future of this country.

It was a plan designed to support the local economy and create employment opportunities for Caymanians.

It was a plan designed to increase the educational opportunities available for our young people.

It was a plan designed to ensure that health care and social support are available to those in need.

It was a plan designed to improve the efficiency and effectiveness of government and its agencies.

It was a plan designed to set the foundation for the future of our country.

It was a plan, which as the Leader of Government Business puts it, "charts a course to achieve … our national aspirations".

Mr Speaker, the latest economic data shows that the plan is working. The Cayman Islands experienced higher economic growth, lower unemployment and lower inflation in 2003 compared to 2002. The economic recovery is forecast to continue in 2004 with the latest Labour Force Survey showing unemployment less than half what it was three years ago. A modest increase in the number of tourist air arrivals is also forecast for 2004. This will help contribute to an economic growth rate that is projected to be nearly 50% higher than the 2003 level.

However, Mr Speaker, as Honourable Members of this House know, achieving economic and social prosperity is not a one-year exercise.

Achieving that goal requires sustained commitment and effort.

Achieving that goal requires keeping the destination in sight.

And achieving that goal requires a steady hand on the tiller.

Mr Speaker that is the objective and focus of this year's budget.

It is a "steady as she goes" Budget designed to support the plan for this country established by the Government over the last three years. It is a Budget that ensures the course to prosperity is maintained.

It is also a budget that has been prepared in full compliance with the requirements of the Public Management and Finance Law (2003 Revision), and the first ever budget prepared using accrual rather than cash accounting. This makes the Cayman Islands Government a Caribbean leader in financial reporting, and one of only a handful of countries in the world achieving this level of transparency.

Part 2: Key Aspects of the Budget

Mr Speaker the Annual Plan and Estimates outlines the actions the Government plans to take in 2004 – 2005 to maintain the course it has set.

The Government's Outcome Goals

That course is based around the eleven outcome goals established by Vision 2008 and specified in the Strategic Policy Statement tabled in this House earlier in the year.

I know that Honourable Members are by now familiar with those outcomes but for the benefit of the public I would like to summarise them briefly. The eleven outcome goals are:

1. A strong economy that generates employment, income and a high standard of living;
2. A healthy resident population;
3. A socially supported resident population;
4. A strong Caymanian community and culture;
5. An environment protected for the use of both current and future generations;
6. A well educated and vocationally trained resident population;
7. A safe and secure country for residents and visitors;
8. An open, efficient and accountable Government;
9. Young persons positively involved in the community;
10. Strong family units; and
11. An economically and socially vibrant Sister Islands.

Key Policy Initiatives in 2004/5

The Annual Plan and Estimates specifies the policy actions the Government will be taking this year to promote these eleven outcomes and then allocates funding accordingly.

Those actions include the purchase of 215 different output groups to a total value of $273.5 million. The Annual Plan and Estimates provides a rationale for each of those purchases as each output is specifically linked to the outcome, or outcomes, to which it relates. Many of those outputs will be produced by ministries and portfolios. However 91 statutory authorities and non-governmental output suppliers will also be funded to provide outputs.

This year's Budget also includes 78 non-output policy actions for which approval is being sought from the Legislative Assembly.

The Leader of Government Business will outline the specific policy initiatives for the year when he makes his remarks.

The 2004/5 Fiscal Position

Mr Speaker, the policy actions are one half of the Budget. The fiscal position is the other.

The Government is well aware of the need for fiscal prudence and expenditure control and I am pleased to advise that the Budget is once again a fiscally responsible one. It provides for an accrual operating surplus of around half a million dollars, a cash flow from operating surplus of around $17.5 million, and a net worth balance sheet position of around $366 million.

This result has been achieved even after recognising around $20 million of additional expenditure for the first time. This is a result of the move to accrual accounting. A 2.5% cost of living adjustment for civil servants has also been allowed for in the numbers. Ministries and Portfolios funded almost all of this cost of living adjustment from efficiency savings.

Furthermore, Mr Speaker, the Budget contains no new revenue measures. This is despite the fact that the Strategic Policy Statement targets allowed for an increase in fuel levies to help finance the National Roads Authority. In light of the recent rise in international oil prices, the Government has decided not to proceed with this increase at this time. This means that this is the third budget in a row where expenditure demands have been accommodated within the existing revenue base.

Mr Speaker, importantly, the Budget complies with all of the Principles of Responsible Financial Management including the debt servicing and net debt ratios, and the cash reserve requirements.

The debt servicing ratio is forecast to be 5.9% at the end of 2004-2005, compared to the 10% limit established by the Public Management and Finance Law.

The net debt ratio is forecast to be 56%, which is much less than the statutory limit of 80%.

And the cash reserves ratio is forecast to be 63 days, which is over twice the level of 30 days required for 2004/5 by the Principles of Responsible Financial Management.

Mr Speaker, while accrual expenditure is more than cash expenditure, the amount of accrual revenue is similar to the amount of cash revenue. This means that the achievement of an accrual operating surplus is a significant improvement on the operating position of previous years. As reported in the Strategic Policy Statement, the 2003-2004 cash budget when recasted onto an accruals basis, showed a deficit of $9.6 million. The 2004-2005 Budget therefore represents a turn-around of approximately $10 million.

In order to achieve this, Ministers and Official Members worked hard to ensure that core government expenditure stayed within the allocations established by the Strategic Policy Statement. This was despite the fact that the Government's policy action plan for 2004-2005 involved a significant number of new policy initiatives. This has required a strong focus on efficiency improvements and reprioritisation.

In the case of the Portfolio of Internal and External Affairs, for example, in excess of $1 million of new initiatives, plus most of the cost of living adjustment, has been funded from savings and reprioritisation of expenditures within the Portfolio. This is a testament to both the new financial management arrangements and the dedication and professionalism of the civil service.

Mr Speaker, Ministers have also paid particular attention to the budgets of Statutory Authorities and Government Companies. With the move to accrual accounting, the aggregate net results of their operations are now included as a single line item in the Government Budget. Statutory Authorities and Government Companies were required to carefully examine their budgets to achieve a break-even position or minimise any forecasted deficits. This policy of requiring Statutory Authorities and Government Companies to comply with the same fiscal discipline that applies to ministries and portfolios will continue in the future.

A similar dedication to fiscal control is evident on the capital side.

Equity investments into ministries, portfolios, statutory authorities and government companies have been limited to an amount that can be financed from operating cash flows. The total amount of equity investments is $15.2 million, which is around $2.3 million less than net cash flows from operations. In other words, in cash flow terms, the budgeted operating revenue more than covers both operating costs <u>and</u> balance sheet activity with short term benefit. This is a prudent, responsible and sustainable financial policy.

The level of capital expenditure has also been controlled. It has been limited to projects that have benefits that will be enjoyed by both current and future generations. These include new roads, school classrooms and the new abattoir.

Given the long-term benefit of these projects, it is appropriate that they be financed by borrowing. This ensures that the financing cost is spread over the life of the project. The Budget therefore makes allowance for $37 million of new borrowing in 2004-2005. The repayment of $10.5 million of existing borrowing will also occur during the financial year, resulting in a net increase in public debt of around $26.5 million.

Although further borrowing could have been justified on a cost-benefit basis, the Government has been conscious of the need to keep aggregate borrowing within levels that the country can afford. Accordingly, the amount of new borrowing is $8.8 million less than that allowed for in the Strategic Policy Statement. This has resulted from the careful and deliberate process of capital expenditure prioritisation undertaken by Ministers.

Mr Speaker, the excellent fiscal picture provided by the Budget is an indication of the Government's commitment to responsible financial management. It is also a reflection of the better fiscal management tools provided by the Financial Management Initiative.

Part 3: The Last Big Change to the Budget - the Move to Accruals

Budget Documents

Mr Speaker, the budget documentation is similar in format to last year and consists of four volumes.

The main budget document is the Annual Plan and Estimates, which is the one with the blue cover. This document summarises the planned actions and financial performance at an overall government level. The Estimates part of the book provides the list of appropriation requests.

The three other volumes support the Annual Plan and Estimates by providing information at a more detailed level.

The Annual Budget Statements, which is the book with the green cover, details the output delivery and ownership performance expected of Ministries and Portfolios.

The Purchase Agreements, which is the book with the yellow cover, specifies the outputs the Government plans to purchase from statutory authorities, government companies and non-governmental output suppliers.

The Ownership Agreements, which is the book with the pink cover, contains the ownership performance the Government expects of each Statutory Authority and Government Company.

Accrual Based Budget

Mr Speaker, as the Public Management and Finance Law comes fully into effect for this 2004/5 Budget there are a number of enhancements to the content of the documents compared to previous years. These are the last set of major changes required by the Financial Management Initiative.

The major change is the adoption of accrual accounting. The accrual method provides a more accurate reflection of the financial activity of the Government than the previous cash accounting approach. It results in four major changes to the way the numbers are put together.

First, a strict distinction between operating and capital expenditure is maintained with separate statements prepared for operating activity, assets and liabilities, and cash flows.

Second, operating revenue is recognised in the Operating Statement when it is due, not when the cash is collected. Revenue collected is reported in the Statement of Cash Flows and revenue due but not yet collected is recorded as a receivable in the balance sheet.

Third, operating expenses are recognised in the Operating Statement when the expense is incurred not when the cash is paid out. Cash payments are reported in the Statement of Cash Flows, and expenses incurred but not yet paid are recorded in the balance sheet as a payable.

Fourth, non-cash expenses are also recognised in the Operating Statement. The major non-cash expense is depreciation. This reflects the use, or wearing out, of assets. Any write-off or reduction in the value of assets is also recorded as an accrual expense, as is the increase in any liabilities.

The financial information provided in all the budget documents has been calculated using the accruals method. The budget forecasts themselves consist of a complete set of forecast financial statements that resemble private sector accounts. They include a Statement of Responsibility for their integrity and completeness.

Capital Expenditure

Mr Speaker, the move to accrual accounting and the full implementation of the Public Management and Finance Law means that the terms capital acquisitions and capital development are no longer used. Instead, a distinction is made between entity assets and executive assets.

Entity assets are the assets that a ministry or portfolio uses to produce its outputs. Under the Public Management and Finance Law these assets are controlled by chief officers and are recorded on the entity balance sheet. As part of the move to accruals, the cost of depreciation is included in the output price. This means that over the life of an asset, a ministry or portfolio is automatically funded for the replacement of that asset. This approach means that, as a general rule, it is no longer necessary to specifically fund entity assets.

However, there are two situations when the specific funding of an entity asset may be necessary.

The first is where the assets to be replaced are already depreciated. Many of the assets owned by ministries and portfolios are quite old and are already significantly or fully depreciated. This means ministries and portfolios are receiving little or no depreciation funding for those assets and therefore have no cash to replace them.

The second situation is where the asset to be purchased is new, rather than replacing an existing asset. If an asset is new, it is inappropriate to use the depreciation of existing assets to fund that purchase. To do so would result in no cash being available to replace existing assets when their replacement is due.

In these two circumstances, the Cabinet will provide funding for a ministry or portfolio to purchase an entity asset. Cabinet does this by making an equity investment into the ministry or portfolio. The requests for equity investments included in section 9 of the Annual Plan and Estimates include requests for this purpose.

Executive assets, Mr Speaker, are those assets that are controlled directly by Cabinet. These assets are recorded on the executive balance sheet and include Crown land, roads, public buildings, public recreational facilities, and the Barkers Environmental Park.

Under the Public Management and Finance Law, the purchase or construction of executive assets requires a specific appropriation. Requests for these appropriations are included in section 9 of the Annual Plan and Estimates under the heading “Purchase or Construction of Executive Assets”.

The term capital development is no longer used as it previously referred to both entity and executive assets and as such is now ambiguous.

<u>Inclusion of Statutory Authorities and Government Companies</u>

Mr Speaker, the move to accrual accounting has also resulted in a change to the way Statutory Authorities and Government Companies are reflected in the Budget.

The accrual operating surpluses and losses of Statutory Authorities and Government Companies are now included in the Government’s operating statement as a single line entitled “Net <u>Loss</u> in Investments in Statutory Authorities and Government Companies”. Similarly, the net worth of Statutory Authorities and Government Companies is recognised as a single line in the balance sheet entitled “Net <u>Worth</u> in Statutory Authorities and Government Companies”.

The inclusion of financial information about Statutory Authorities and Government Companies reflects the fact that the Government is the owner of these organisations. Their net worth is an asset of the owner and therefore needs to be recorded on the Government's balance sheet.

The inclusion of the operating surpluses and deficits of Statutory Authorities and Government Companies in the Budget also has a financial and economic advantage. As the aggregate loss is treated as a government expense, this loss needs to be compensated for by reduced core government expenditure. The budgetary decisions of the government therefore automatically need to take account of the financial impact that the wider government sector is having on the economy.

Appropriations to Cabinet

Mr Speaker, with the coming into force of the Public Management and Finance Law, appropriations will now be to Cabinet rather than to chief officers.

This change is consistent with the accountability arrangements under the Law and reflects the role of Cabinet as the purchaser of outputs.

In line with this approach, from 2004/5 the funding that ministries and portfolios receive from Cabinet will only be for the outputs that Cabinet is buying. However, ministries and portfolios will also be able to keep the entity revenue they earn from providing outputs to other government agencies and from third parties. They will then use this revenue to fund their input costs.

Consistent with this change, from 2004/5 ministries and portfolios will charge each other for the services they provide to each other. These include, for example, outputs provided by the Personnel and Computer Services Departments to other agencies of Government. The cost of those central services is allowed for in the output cost of the ministries and portfolios that use the services and the appropriations reflect this.

These changes mean that a number of outputs are no longer being purchased by Cabinet even though they are still being produced. Where this occurs those outputs are now not included in the Annual Plan and Estimates or Annual Budget Statements.

Cash Management Arrangements

Mr Speaker, a new set of cash management arrangements will also operate from 2004-2005.

This will involve ministries and portfolios having their own bank account and managing their own working capital. The bank accounts will be within a suite of accounts overseen by the Treasury and will have no impact on the government's overall cash position because an offset arrangement applies to the overall bank account structure.

The requirement to manage working capital will mean that ministries and portfolios will need to ensure that they collect their entity revenue in a timely manner and manage their debtors and creditors so as to maximize their cash position. Significant aggregate working capital gains are expected from this part of the financial management reform.

In preparation for these new arrangements an entity bank account has been established for each ministry and portfolio and working capital equal to one month's worth of expenses will be placed in those accounts on 1 July 2004. This level of working capital is reflected in the forecast ministry and portfolio balance sheets reported in the Annual Budget Statements.

Part 4: Overview of the Economic and Fiscal Position

Mr Speaker, I would now like to turn to the details of the economic and fiscal position, starting with an overview of international developments.

Economic Position

The World Economy

Global economic growth improved modestly from 3.0 percent in 2002 to 3.2 percent in 2003. This improvement was mainly due to a continued expansion in consumer spending and a recovery in business spending, particularly in the second half of 2003. Generally, global fiscal and monetary policies were supportive of the need to spur economic growth. The recovery was broad-based, with most regions experiencing accelerated growth in 2003.

The US economy grew by 3.1 percent in 2003, up from 2.4 percent in 2002. Consumer spending remained strong last year, fuelled by federal tax cuts, mortgage refinancing, and home equity lines of credit. There was a turn-around in private investment from a 1.2 percent decline in 2002 to a 4.1 percent expansion in 2003. This rebound was due to a recovery in business spending on equipment and software as well as accelerated growth in the housing market.

US corporate profits posted healthy gains in 2003 and financial markets responded positively to this growth, with the S&P 500 index rising by 26 percent.

The labour market showed some weakness, however. The US unemployment rate increased from 5.8 percent in 2002 to 6.0 percent in 2003. And, manufacturing jobs declined for the forty-first consecutive month in December.

The US dollar fell against major currencies for the second year in a row. Against the Euro, it moved from US$1.05 at the start of 2003 to close at US$1.26 at the end of the year. This depreciation resulted from low US interest rates and a growing current account deficit. Another concern in some quarters was the growing federal deficit, particularly in light of tax cuts that the Bush administration wants to make permanent.

The UK economy showed greater resilience than other western European countries. GDP rose from 1.7 percent in 2002 to 2.1 percent in 2003. Economic growth in the Euro Area as a whole, however, slowed from 0.9 percent in 2002 to 0.5 percent in 2003.

The Japanese economy showed signs of a recovery, expanding by 2.7 percent in 2003 compared to 0.2 percent the previous year. The acceleration was led by a turnaround in business investment and exports to the United States and China.

Developing Asian economies continued to show strength in 2003. China's growth accelerated from 8.0 percent in 2002 to 9.1 percent in 2003, driven mainly by inward investments. Strong demand from China for raw materials has impacted positively on resource-rich countries. The Indian economy also accelerated from 4.7 percent in 2002 to 5.6 percent in 2003, benefiting from the outsourcing of services from the United States and other countries.

Closer to home, Latin America and the Caribbean grew by 1.5 percent in 2003, reversing the decline of 0.4 percent experienced in 2002. Argentina grew by 7.3 percent and real GDP growth of over 3 percent was seen in Chile, Costa Rica, and Columbia.

The Caribbean economies, particularly the English-speaking countries, experienced better economic performance in 2003 compared to the previous year. One major factor was the rebound in tourism recorded in the region. Also, strong prices and higher volumes benefited commodity exporters, particularly Belize and Trinidad.

<u>The Domestic Economy</u>

Real GDP growth in the Cayman Islands accelerated for the second consecutive year from 1.7 percent in 2002 to 2.0 percent in 2003. This upward trend mirrored the performance of the global economy. The improvement was reflected in continued buoyant activity in the local construction industry, higher imports, and an increase in government revenue.

Consumer inflation increased by 0.6 percent in 2003 compared to 2.4 percent in the previous year. The inflation rate was influenced by price increases for medical services, household equipment, food and education.   These increases were offset by declines in other areas, namely housing, clothing, and personal goods & services.

Mr. Speaker, the reduction in the unemployment rate provided another piece of good news for the country. The unemployment rate in the Cayman Islands has been steadily decreasing since 2001 when it stood at 7.5 percent. The latest Labour Force Survey results place the unemployment rate at 3.6 percent.

I will now provide an update on the key economic sectors in our country.

The financial services sector, as we all know, is fundamental to our economic well-being. This sector recorded positive results in most areas in 2003. Growth was seen in mutual fund registrations, insurance company registrations, insurance premiums, stock exchange listings, stock market capitalisation, and new company registrations.

One notable exception was the decline in the number of bank and trust licences which fell by 34. The reduction in bank and trust licenses resulted from consolidations within the banking industry and the cost implications of establishing physical presence as required by the law.

A better indicator of the health of the banking sector is that Cayman retained its position as a leading international financial. centre. External assets of banks stood at US$1.02 trillion in June 2003, up by US$4.6 billion from the December 2002 position. External liabilities increased by US$1.5 billion during the same period to US$981.5 billion.

The total number of insurance licences increased to 672 in 2003. This was primarily due to a rise in the number of Class 'B' (captive) licences. Class 'B' licences increased by 44 to 644 in 2003. The net increases were mainly due to professional liability, healthcare, and workers' compensation. Medical malpractice lawsuits in the United States continued to be the driving force behind the growth in captives, followed by workers' compensation.

Premiums for captives grew by US$700 million in 2003 to US$4.9 billion. Net income declined by US$400 million during the same period to US$0.3 billion, mainly as a result of payouts by healthcare and property-related captives.

Mutual funds are another Cayman success story. With over half of the world's hedge funds registered in the Cayman Islands, we remained the leader in this segment of the global financial market in 2003. In recent years, hedge funds have grown in popularity among wealthy individuals and institutional investors mainly due to the attractiveness of potential returns and the fact that they are more nimble than traditional mutual funds. The Cayman Islands continued to capitalise on this global hedge funds growth with fund registrations increasing by 523, or 12.2 %, to 4,808 in 2003.

The Cayman Islands Stock Exchange also posted gains in 2003. Stock listings grew to 735 in 2003 – an increase of 25 from the previous year. Between 2002 and 2003, market capitalisation rose by a healthy 20.9 percent to US$43.9 billion. Most of this increase resulted from the recovery in stock prices in major capital markets worldwide.

Total company registrations increased to 68,078 in 2003, or by 2,819. New company registrations rose for the first time in three years. The continued strengthening of the global economy had a positive impact on registrations.

Ship registrations totalled 1,473 in 2003 with gross tonnage amounting to 3.2 million. The number of new registrations in 2003 amounted to 186, including 152 pleasure yachts.

In relation to international initiatives, the primary one that has been the focus of our attention for the past two years has been the European Union Savings Directive (EUSD). Following intense negotiations with the United Kingdom, we were able to agree a "Framework Document" that contains a number of undertakings by the UK that we expect will help safeguard the interests of the Cayman Islands. It was only after successfully negotiating these undertakings with the UK that the Cayman Islands agreed to the implementation of the Savings Directive.

In accordance with the commitment given to the UK, the Government intends to, following consultation with our financial services industry, introduce legislation under which agreements will be entered into with EU Member States.

The tourism sector is the other pillar of our economy. Over 2 million tourists visited the Cayman Islands during 2003. This figure represented an increase of 12.5% over 2002.

The Cayman Islands was able to capitalise on continued strong growth in the North American cruise market with cruise ship visitors totalling 1.8 million during 2003 - an increase of 15.5%. Two key factors relating to the growth of this segment of the market have been the safety appeal of cruise travel and the availability of affordable and attractive package options.

Air arrivals declined by 3.0 percent from 302 thousand in 2002 to 293 thousand in 2003. Air arrivals were impacted by global events such as the war in Iraq, and the outbreak of Severe Acute Respiratory Syndrome (SARS). As reported by the World Tourism Organisation, a 1.2 percent decrease in international tourism was recorded over the 2003 period. In the Cayman Islands, while stayover arrivals from the United States fell by 12.5 percent in 2003, the number of stayover visitors from the European, Canadian, and Other markets grew.

Of some comfort Mr. Speaker, is the fact that stayover arrivals grew by 4.9% during the last quarter of 2003. Furthermore, that positive trend has continued during the first quarter of 2004. Group bookings are expected to boost the level of stayover visitors in 2004. These bookings extend to August 2004 and include weddings, families, divers, and meetings.

Real estate performed well in 2003 with the value of properties transferred growing by 19.0% to $326 million in 2003. There was also greater activity in the marketplace with the number of properties transferred rising by 596 to 2,143 in 2003. A stronger global economy, historically low interest rates and an indefinite extension of the government's stamp duty concession stimulated investment in real estate.

There was brisk selling of properties located along the Seven Mile Beach. One exceptionally large transaction was the $30 million sale of Vista Norte Vista, a 270-acre prime area property.

Heavy pre-selling of units within the high-end condominium developments such the Meridian, Water's Edge and the Ritz Carlton also contributed to a rise in the value of properties transferred.

The strata apartment units of Frank Hall Homes, Secret Gardens and the Retreat developments also sold well during this period with the Secret Gardens and Frank Hall Homes in George Town being sold out. The sale of single-family homes also rose.

Commercial space continued to be absorbed slowly by the business community. However, in comparison to the previous year, the pace of absorption was a little more rapid.

Real estate prospects for next year remain positive. While investor interest is expected to continue, the onset of higher prices is likely to dampen activity in the market place.

Construction continued to perform well throughout 2003. Favourable conditions such as historically low interest rates, and continuation of the 50 percent concession on building permit and infrastructure fees bolstered activity in the industry. Significant projects slated for completion in the next year are the Ritz Carlton Hotel and the Royal Watler Cruise Terminal. Completion of the Ritz Carlton Hotel will bolster further sale of units within the development.

Economic Outlook

Mr Speaker, let me now turn to the economic outlook.

Since 2001 there has been a steady improvement in economic conditions, as developed countries have adjusted to the fallout from the bursting of the dot com bubble and corporate governance issues. Global growth is projected to accelerate from 3.2 percent in 2003 to 4.1 percent in 2004. This is well above the 1993-2003 average of 3.5 percent.

Leadership in global growth is likely to come from the US where monetary and fiscal stimuli are providing a boost to near-term economic activity. Real growth in the US is projected at 3.9 percent in 2004, up from 3.1 percent in 2003.

Of immediate concern, however, is the jobless nature of the US recovery so far. Households tend to spend more when there is job security and when there is confidence about future job prospects. With the reduction in productivity gains from 5.0 percent in 2002 to 4.4 percent in 2003, there is hope that the unemployment rate will fall.

The Cayman Islands is likely to benefit from continued strengthening of the US economy in the form of inward investments and visitor spending. Real growth for the Cayman Islands is projected at 2.8 percent in 2004, up from 2.0 percent in 2003. Unemployment is expected to hold steady at 3.6 percent in 2004. Inflation is projected at 2.0 percent, up from a low of 0.6 percent in 2003.

Early indications suggest that there will be a modest increase in the number of tourist air arrivals in 2004 – potentially the first annual increase for the Cayman Islands in years. With the perceived threat from terrorism continuing, North American travellers are more confident about travel closer to home. The Caribbean is relatively close and has traditionally been considered to be safe. These are factors that are likely to benefit the Cayman Islands.

Fiscal Position

Mr Speaker on the fiscal front the Government is forecast to collect $338.2 million in 2004-2005. This represents an increase of around $29 million from that budgeted for 2003-2004. It reflects the rebound in government revenue evident in recent months.

Operating expenses are forecast to be $328.2 million in 2004-2005. This number is not strictly comparable with the cash budget number from last year because it has been prepared on the accruals basis. Accordingly it includes some non-cash numbers not recognised in previous years. The largest of these is depreciation which amounts to $13.6 million for the core government in 2004-2005.

The Operating Expense number also includes the aggregate net loss of Statutory Authorities and Government Companies which amounts to $5.4 million. These two items make up around 6% of expenditure.

The net surplus, which is the key operating measure, is forecast to be $473,000. When the size of the revenue and expenditure flows are taken into account, this forecast net surplus is not significantly different from the target of $1 million established in the Strategic Policy Statement.

As a result of the move to accruals, the fiscal forecasts include a balance sheet for the first time. This shows a forecasted net worth position for the Government at the end of 2004-2005 of $366.4 million. This is made up of forecasted assets of $716.7 million, less forecasted liabilities of $350.3 million.

The major asset category on the forecast balance sheet is Property, Plant and Equipment. This consists of physical Government assets such as Crown land, roads and buildings. The projected book value of these assets as at 30 June 2005 is $454 million.

The Government's other major asset is its investment in Statutory Authorities and Government Companies. This is the value of the net assets of those organisations which in aggregate is forecast to be $167.9 million as at 30 June 2005.

The liability side of the balance sheet is dominated by two items: borrowings and the unfunded pension liability.

Borrowings is forecast to be $199.2 million at the end of the Budget year. This represents a net increase of $26.5 million from expected 2003-2004 levels.

The unfunded pension liability, which amounts to $130 million, is the difference between the value of the assets of the Public Service Pension Fund and the value of its future pension payments. Under the Public Service Pensions Law the Government is legally responsible for this difference and makes regular payments to the Fund. Payments towards the past service liability have been budgeted at $10 million in 2004-2005.

The unfunded pension liability figure is likely to be revised upward at some future time as a result of a recent actuarial report received by the Pensions Board. This report is currently under review before being submitted to Cabinet. Following the review, the Government will consider recommendations from the Board of Trustees that could have an impact on the level of past service liability contributions in the future. Any change to the value of the balance sheet liability will be made at that time.

The forecast cash flow statement provides for a net cash inflow from operations of $17.5 million, a net cash outflow from investing activity of $42.9 million and a net cash inflow from financing activities of $26.5 million. The overall impact on the Government's cash position from these activities is an increase in cash of $1.2 million. This results in a forecast cash balance of $48.2 million as at 30 June 2005.

Almost all of this cash balance relates to Funds, Special Reserves and the General Reserve. In aggregate these Funds and Reserves are forecast to be $47.6 million at the end of 2004-2005.

This means that the working capital cash balance is forecast to be $678,000. This represents a very lean working cash position and it is deliberately so. The Government's working capital policy is to seek to begin and finish the year with a minimal working cash position, although the balance fluctuates during the year as revenue flows are uneven.

Mr Speaker, the budget forecasts contained in Part C of the Annual Plan and Estimates contains a wealth of detailed information about the Government's finances. I am sure that Honourable Members will find this information very useful.

Part 5: Reflection

Mr Speaker, as this is my last Budget I would like to take this opportunity to reflect on the many changes that have occurred during my time as Financial Secretary.

Certainly the Cayman economy has changed a lot over the last 12 years. So too has the size and scope of Government activity.

In 1992, nominal GDP was $653 million. The forecast for 2004 is $1,680 million. This means that the size of the economy has more than doubled over that period.

In 1992 operating receipts were $125 million. The forecast for 2004/5 operating revenue is $338 million, an increase of 170%.

In 1992 operating expenditure was $117 million. The forecast for 2004/5 is $328 million, an increase of 180%.

These numbers are interesting because they show that the size of the Government as a proportion of the economy as a whole has not changed a great deal over this time, despite popular belief to the contrary. In 1992 government expenditure as a proportion of GDP was 18%. The forecast for 2004-2005 is 20%. This is still quite low in international terms.

On the capital side, a total of $396 million has been budgeted for capital expenditure over the 12-year period, an average of $29 million a year. This is a significant level of investment for a country of our size. When one recalls that the total outstanding borrowing at the end of 2004-2005 is forecast to be only $199 million, it is clear that much of that capital expenditure has been financed from operating revenue.

Mr Speaker, there have also been some difficult and challenging times.

As a relatively small economy, Cayman is susceptible to global economic influences not of our making. The standout example during my tenure is the impact that September eleven and subsequent related events have had on our economy and Government finances.

This ever-changing world economic situation is guaranteed to keep a Financial Secretary on his toes! So too does a slow down in revenue like the one we have experienced in recent years. This revenue reduction, together with the development pressures that come from a rapidly growing economy such as ours, has meant that each and every one of my 13 budgets as Financial Secretary have been difficult to balance. Nevertheless the commitment of the Governments of the day to achieving an acceptable solution has meant that a balanced budget has always been accomplished – even if it sometimes happened a little too close to the budget deadline.

Mr Speaker, I have also had the privilege to represent this country in a number of international fora. My involvement with the Caribbean Development Bank has been most rewarding and helps put our own situation into the broader regional context. The two years in which I was Chairman of the Bank were a particularly enjoyable experience.

I have also been honoured to host a number of international conferences here in Cayman, most notably the Commonwealth Finance Ministers' meeting and two Annual Meetings of the Caribbean Development Bank. Such opportunities are privileges that one gives God thanks for.

Mr Speaker, as I look back over my time as Financial Secretary two areas of my work stand out.

The first is the three or so years starting in the late 1990s. This was the period when our financial services sector was under significant threat from a range of international initiatives, all of which we are thoroughly familiar with.

This was a particularly difficult time for the country, the Government, and the Legislative Assembly of the day. While I am sure there will be ongoing work in this area, it is pleasing to know that there is now in place the expertise to assess and address these initiatives. In this regards I am very grateful for the willingness of the private sector over the years in working with the Government to address these initiatives.

Mr Speaker, the second area that stands out is the financial management reform.

To tell the truth, a decade or so ago I didn't think there was too much wrong with the way the Government managed itself. Other Members of this House were championing financial reform long before I became an advocate myself.

However, as Members of this Honourable House know Mr Speaker, in early 1998 the Honourable Leader of the Opposition and I attended a Commonwealth Secretariat course on modern government financial management. That was a very intensive, but very interesting experience. I quickly came to understand that the way the government budgeted, accounted and managed itself was not only archaic, it was one of the causes of less than effective performance.

Not long after my return from the course I invited the Honourable Ruth Richardson to visit Cayman and tell us about the New Zealand experience. That was the beginning of what has become known as the Financial Management Initiative or FMI.

Mr Speaker, FMI was launched in May 1998. As with any major change management project, the path has not always been easy, nor the support unwavering. This should be no surprise to anyone. FMI was always going to be an ambitious project. Indeed it needed to be as it had to fundamentally change the way the government manages itself.

Mr Speaker, the benefits of the reform are already clear for all to see, and none more so than in the budget documents presented to this House today. It is a great personal pleasure to be able to present the first accrual budget in my last Budget address.

In many ways this Budget represents the culmination of the financial reform effort. However, there are many more opportunities to improve government performance. I look forward to turning my attention to personnel reform and following on the excellent work my colleague the Honourable Chief Secretary has been doing in this area. Financial and Personnel reform complement each other, and both are necessary for good government performance.

Part 6: Conclusion

Mr Speaker in conclusion I would like to thank all those who have worked so hard to prepare this Budget over the last several months. The move to accrual budgeting and the full implementation of the Public Management and Finance Law has resulted in some new challenges this year. These have required extraordinary commitment and dedication on the part of the civil service and I would like to thank the whole of the civil service for this effort.

I would like to pay special recognition to the staff of the Budget and Management Support Unit and the Treasury who have worked tirelessly for many months to achieve the landmark documents presented to this House today.

I would also like to acknowledge finance staff in departments, and particularly the chief financial officers of ministries and portfolios. They have carried an extra heavy burden in the move to accruals. The benefit of their hard work over the last few months will be evident for many years to come.

Mr Speaker, I would also like to take this opportunity to thank yourself and all the Ministers, Official Members and Members of the Legislative Assembly that I have worked with during my time as Financial Secretary. I am grateful for your courtesy, consideration and support over the years.

I would also like to thank the staff of the Portfolio of Finance and Economics, both those currently in the Portfolio and those who have retired or moved on, for their support. Managing the government's finances is always a difficult and pressured task and I thank them for the dedication to the welfare of these Islands.

Mr Speaker in presenting this Budget it is pleasing to be able to bring to the House a document that is not only fiscally responsible, but one that is also coherent and understandable. The standard and quality of budgetary preparation that has now been achieved leads the Caribbean, and is among the best in the world.

The Cayman Islands is one of only a handful of national governments that budget and report on an accrual accounting basis and in full compliance with internationally set accounting standards. It is something that we should be rightfully proud of. It gives us an international standing that most other countries can only hope to aspire to.

While much has been achieved economically, fiscally and in public management over recent years, we must not rest on our laurels. The search for excellence is never ending and I look forward to seeing how the budget develops in future years.

The policy actions and fiscal position contained in the 2004-2005 Budget continue the Government's plan for the economic and social future of this country. And while it is deliberately a “steady as she goes” budget, it <u>is</u> a budget that ensures active progress towards the Government’s outcome goals.

Mr Speaker, the road to economic and social prosperity is a long, perhaps never ending one.   However, with God’s help I am confident that as a country we can achieve it.

May God continue to richly bless these Cayman Islands.