

### Summary

The (re)insurance sector remains the dominant sector on the island of Bermuda, followed by the tourism sector. A slow recovery in the US and Europe therefore weighs on economic growth in Bermuda. Economic growth is expected to be around 1-1.5% this year, which is similar to growth in 2011. Considering the high level of income, a low growth should not pose any problems, but it could hamper swift fiscal consolidation. After public debt doubled between 2008 and 2010, to 20% of GDP, people worried that the government would be unable to get the fiscal situation under control again. However, the direction of the 2011 and 2012 budgets suggests that the risk of public debt spiralling out of control has reduced substantially. Another issue that concerns the inhabitants of Bermuda is rising unemployment, which now unofficially stands at 12%. These issues are expected to play a role in the general elections, which will be held in 2013 at the latest. In the meantime, the Bermuda Monetary Authority has adopted regulation to qualify for Solvency-II equivalency, the new EU standards for insurers. Currently, only Switzerland and Bermuda are seen as candidates eligible for equivalency and a final decision is expected later this year.

### Things to watch:

- Progress on fiscal consolidation
- Unemployment and general elections in 2013 (at the latest)

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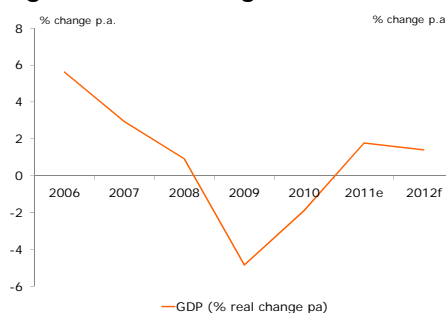


### Economic growth subdued

Economic growth is expected to be rather low this year, around 1-1.5%, which is similar to growth in 2011, but below the growth expectations in our Country Risk Report of April 2011. With a GDP per capita close to USD 90,000, high growth figures should not be expected, but sustained low-to-negative growth figures could lead to pressure on the fiscal balance. A slow recovery in the US and Europe weigh on the insurance sector as well as on tourism, the other major foreign currency earner of the island. In the wake of slow economic growth, official unemployment has increased rapidly from 2% in 2008 to 6% in 2010 (2011 statistics are not available yet). Unofficial estimates put unemployment at 12%.

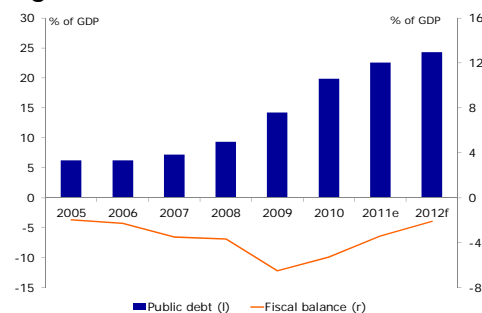
The current account balance tends to show substantial surpluses. The current account surplus in 2010 was around 13% of GDP and is expected to be even higher in 2011 and 2012. The large deficit on the trade balance (around 20% of GDP) is more than offset by the surpluses on the services balance (tourism, business services) and income balance (employee salaries).

Figure 1: Economic growth



Source: IHS Global Insight

Figure 2: Fiscal situation



Source: S&P

### Fiscal worries subside

In the wake of the global financial crisis, the Bermudian government implemented several tax exemptions and additional expenditure to soften the impact. This pushed the fiscal deficit up from around 3% of GDP pre-crisis to 5-6% in 2009/10. Gross public debt jumped to 20% of GDP in 2010, which is rather low in international comparison, but a strong increase from less than 10% of GDP in 2008. Therefore, people worried that the government would be unable to get the fiscal situation under control again. Hence, fiscal consolidation has been on top of the agenda of prime minister (and minister of finance) Paula Cox, since she was appointed in October 2010. The budget deficit is estimated to shrink to around 3% of GDP again in 2011 and further consolidation efforts are expected in 2012/13 (April-March). The government aims to reduce the deficit to 2.9% of GDP by rolling-back tax exemptions, granted in 2009 to stimulate the economy, and reducing spending. This would lead to a public debt level of around 24% of GDP at the end of the current fiscal year. The risk of public debt spiralling out of control has thus been reduced substantially, but low economic growth could hamper a swift fiscal consolidation. There are some contingent liabilities, since the government has guaranteed a bond issue in 2009 by Bank of N.T. Butterfield, the second-largest bank in Bermuda, when this bank faced liquidity issues during the global financial crisis. However, the chance that the commitment will be fully used is rather limited. A mitigating factor in the fiscal situation of Bermuda is that the government manages several pension schemes, worth about 30% of GDP. Although the government cannot –and should not– easily access these funds, it seems to provide comfort to many investors and rating agencies, thereby lowering the perceived risk profile of Bermuda and thus the required interest rate.

### **Opposition party gaining support**

The recently started One Bermuda Alliance (OBA), a merger between the Bermuda Democratic Alliance and a large part of the former United Bermuda Party, has been gaining support at the expense of the ruling Progressive Labour Party (PLP) of Paula Cox. A corruption scandal last year on top of weak economic growth and rising unemployment has reduced public support for the PLP. The next elections need to be called before February 2013, but with growing support for the opposition OBA, Paula Cox is unlikely to call for elections much earlier. While fiscal consolidation and unemployment are expected to be the hot topic of the election campaigns, the discussion around the trickledown effect of the insurance sector (and favourable tax system) will probably surface too. However, all parties agree on the general direction of Bermuda, which focuses on fiscal prudence and maintaining attractiveness for the insurance industry.

Not only elections in Bermuda trigger a closer look at the tax breaks. US elections are also generally accompanied by discussions on changing tax laws to reduce the attractiveness of writing insurance offshore, the key business of Bermuda's insurers. However, the Bermudian insurers have a strong lobby in the US, especially as their business volume is large enough to push US end-user premiums up, if the tax law were to be changed. As part of this lobby, Bermuda has been actively pursuing a change in image from tax haven to expertise hub. In line with this, the BMA has been working vigorously to achieve equivalency for non-EU countries for Solvency II, a set of rules and regulations for insurers operating in the EU. Currently, only Switzerland and Bermuda are seen as countries eligible for equivalency, which would allow companies from those countries to operate in the EU without additional (capital) requirements. A final decision is expected later this year.

Bermuda								
Selection of economic indicators	Source	2006	2007	2008	2009	2010	2011e	2012f
<i>Key country risk indicators</i>								
GDP (% real change pa)	IHS	5.6	2.9	0.9	-4.8	-1.9	1.8	1.4
Consumer prices (average % change pa)	BMA	3.1	3.8	4.8	1.8	2.4	2.7	n.a.
Current account balance (% of GDP)	S&P	23.1	22.1	16.4	11.5	14.1	18.8	14.6
<i>Economic policy</i>								
Budget balance (% of GDP)	S&P	-2.3	-3.5	-3.7	-6.5	-5.3	-3.4	-2.1
Public debt (% of GDP)	S&P	6	7	9	14	20	23	24
Consumer prices (average % change pa)	BMA	3.1	3.8	4.8	1.8	2.4	2.7	n.a.
Exchange rate LCU to USD (average)	BMA	1.0	1.0	1.0	1.0	1.0	1.0	1.0
<i>Balance of payments (mln USD)</i>							Q1-Q3*	
Current account balance*	BMA	1252	1222	915	626	706	568	n.a.
Trade balance	BMA	-1069	-1142	-1136	-1046	-973	-681	n.a.
Export value of goods	BMA	26	25	24	21	15	11	n.a.
Import value of goods	BMA	1094	1167	1160	1067	988	692	n.a.
Services balance	BMA	730	502	423	351	394	393	n.a.
Income balance	BMA	1598	1823	1624	1333	1424	951	n.a.
Transfer balance	BMA	-7	39	5	-12	-138	-95	n.a.
Net direct investment flows	BMA	-201	557	-427	-71	210	-494	n.a.
Net portfolio investment flows	BMA	437	490	2867	-1689	-997	-662	n.a.
Net other investment flows	BMA	1219	-268	-3087	1909	44	582	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>								
Trade balance (% of GDP)	BMA	-19.7	-20.5	-20.2	-19.5	-18.5	n.a.	n.a.
Current account balance (% of GDP)	BMA	23.1	21.9	16.3	11.7	13.4	n.a.	n.a.
Current account balance (% of GDP)	S&P	23.1	22.1	16.4	11.5	14.1	18.8	14.6
Inward FDI (% of GDP)	BMA	-3.7	10.0	-7.6	-1.3	4.0	n.a.	n.a.
Foreign debt (% of XGSIT)**	S&P	-398	-367	-325	-306	-339	-278	-280

Source: IHS (IHS Global Insight), S&P (Standard & Poor's), BMA (Bermuda Monetary Authority).

\* Data on Balance of Payments for 2011 only for Q1 through Q3. Data is not annualized.

\*\* Narrow net external debt/current account receipts (note that a negative number indicates net external lending position).

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