

**EXECUTIVE
BOARD
MEETING**

SM/21/41

Correction 1

April 22, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **Eastern Caribbean Currency Union—Staff Report for the 2021 Discussion on Common Policies of Member Countries**

Board Action: The attached corrections to SM/21/41 (3/31/21) have been provided by the staff:

Evident Ambiguity

Pages 1 and 65

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Pages 3, 19, 23 (heading title), 43 (section 7)

Typographical Errors

Pages 4, 10, 12, 23 (para. 25 chart), 29, 30, 43 (section 8), 48, 50

Questions:

Ms. Munoz, WHD (ext. 36653)



EASTERN CARIBBEAN CURRENCY UNION

March 29, 2021

STAFF REPORT FOR THE 2021 DISCUSSION ON COMMON POLICIES OF MEMBER COUNTRIES

KEY ISSUES

The fallout from the COVID-19 crisis is hitting ECCU economies hard. Tourism receipts (accounting for nearly 40 percent of GDP) have dried up, as tourist arrivals have come to a grinding halt. The authorities successfully contained the spread of the virus at the onset of the pandemic by largely closing the borders, but a reopening of the economies since the summer has led to a surge in COVID cases. The ECCU economy is projected to contract by 16 percent in 2020 and by a further near ½ percent in 2021. Fiscal positions have deteriorated sharply, and public debt is projected to reach near 90 percent of GDP in 2021 and remain at an elevated level for years to come. Headline indicators suggest the financial system is relatively sound with ample liquidity buffers, but ~~this is likely a mirage since~~ nonperforming loans are expected to rise significantly. The outlook is clouded by exceptionally high risks, including from the uncertainty concerning the evolution of the pandemic.

Main Policy Recommendations:

The ECCU faces the difficult challenges of protecting lives and livelihoods, ensuring medium-term fiscal sustainability, and safeguarding financial stability and the quasi-currency board. Staff recommend a near-term strategy to tackle the crisis, limit permanent scarring, and protect the vulnerable based on:

- Maintaining fiscal support by accommodating critical COVID-related spending and strengthening regional and national fiscal frameworks to safeguard the credibility of the regional debt target of 60 percent of GDP, which has been extended by 5 years to 2035.
- Supporting financial institutions' capacity to weather the near-term pandemic impact and preparing comprehensive crisis management plans at the regional and national levels.
- Keeping a robust backing ratio to safeguard the quasi-currency board.

Once a post-pandemic recovery is entrenched, policies should focus on resuming fiscal consolidation, strengthening the financial system, and implementing other structural reforms to achieve resilient growth.

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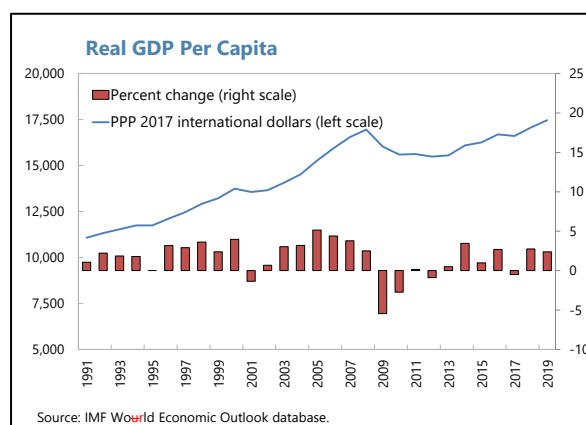
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PRE-COVID-19 CONDITIONS

1. Real GDP per capita in the ECCU had barely exceeded the pre-global financial crisis peak when the COVID-19 pandemic struck.

Following the global financial crisis, the ECCU had several years of lackluster growth, due to structural frictions and weak price competitiveness. Growth finally took off around 2014, supported by strong global growth and increased tourism demand. The authorities pursued a pro-growth strategy that included a strengthening of human capital, improving investment climate, and building infrastructure. Although progress in implementing reforms has been slower than desired, the governments' policy direction has been broadly in line with past staff recommendations (Annex I).



2. The ECCU's tourism-dependent economies have various vulnerabilities.

All countries are micro-states that are vulnerable to natural disasters with significant socio-economic implications. Prior to the COVID-19 shock, many countries were already highly indebted, led by Antigua and Barbuda and Dominica with debt levels at around 80–90 percent of GDP. Several are highly dependent on uncertain Citizenship-by-Investment (CBI) revenues, which could complement domestic revenue but are also prone to sudden stops. The financial sector also poses a major vulnerability due to its large size and persistent loan quality weaknesses.

	Tourism dependence (stay-over tourists, '000, 2019)	Natural disaster risk	Public debt (in percent of GDP; 2019)	Dependence on CBI revenue (in percent of GDP, 2019)	Banking sector soundness (NPLs in percent of total loans)
ATG	301	H	82	3.2	5.3
DMA	89	H	91	9.9	12.2
GRD	163	H	60	2.9	2.2
KNA	117	H	56	15.4	24.0
LCA	424	H	61	0.5	8.2
VCT	80	H	75	No CBI	6.4

H High risk **MH** Medium high risk
M Medium risk **L** Low risk

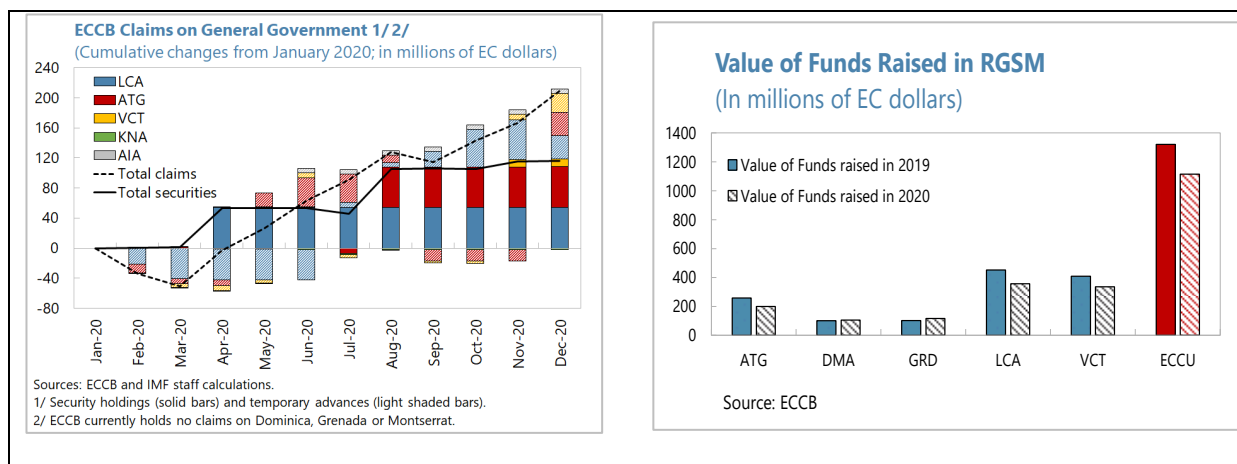
Sources: ECCU authorities and IMF staff estimates.

COVID-19 IMPACT AND POLICY RESPONSE

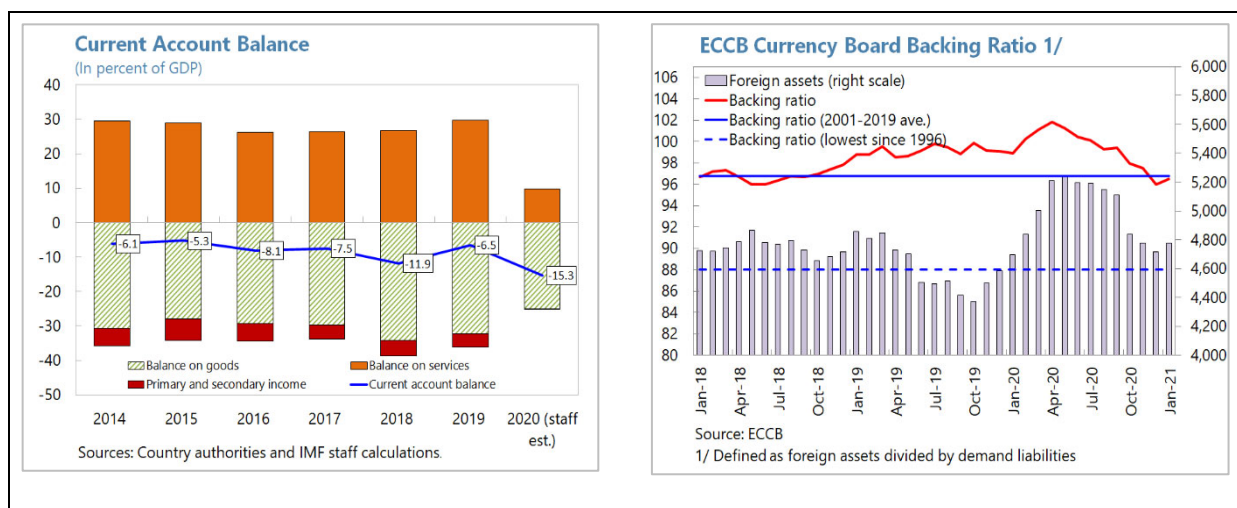
3. The health impact of COVID-19 in the ECCU was initially well-contained, but the situation deteriorated following a reopening of borders, with a sharp uptick in cases in early 2021. At the onset of the pandemic, ECCU countries moved quickly to restrict inbound travel and imposed strict lockdown measures.¹ By early summer, the spread of the virus had been under control, with very low infection rates. Subsequently, some authorities relaxed containment measures and reopened their borders, following which COVID-19 cases rose along with an increase in mortalities. A sharp increase took place in early 2021, reflecting the renewed global wave, the

¹ St. Vincent and the Grenadines has neither declared a state of emergency nor introduced economic lockdown measures.

and financing from the Regional Governments Securities Market (RGSM) which remained relatively stable. In addition, countries that faced more intense financing difficulties have tapped the ECCB's credit facility.



9. The current account deficit is estimated to have widened sharply in 2020. Staff estimates that the current account deficit more than doubled to 15¼ percent of GDP in 2020, reflecting lower tourism receipts partially offset by reduced imports. While net FDI inflows weakened, increased official flows helped finance the widened current account deficit, and the ECCB's foreign asset position held up relatively well.⁵ The currency backing ratio under the quasi-currency board mechanism stood at 96 percent at end-January 2021.⁶ The real effective exchange rate (REER) depreciated by nearly 3½ percent in 2020, due to the weakening of the U.S. dollar.



⁵ The external assessment is based on staff's estimates, as the ECCB has not published balance of payments data since 2018.

⁶ The backing ratio is defined as the ratio of foreign assets to demand liabilities at the ECCB.

financial contingent liabilities would also constrain authorities to implement counter-cyclical policies.⁸

12. Weak conditions in the financial sector would add to recovery challenges. The ongoing tourism shock is projected to almost triple bank NPLs in the next three years (see policy section), weighing on credit activity and raising fiscal contingent liability risks. These could be amplified by shocks to other asset exposures or materialization of operational risks.

B. Elevated Downside Risks

13. The outlook is subject to exceptionally high downside risks (Annex II):

- *The primary downside risk is a longer and more widespread global pandemic and a sharper-than-anticipated contraction in trading partners.* A deeper and longer recession would put additional strain on the public finances (as revenue collection weakens and needs for health spending and income transfers increase) and financial institutions (as NPLs rise, profitability falls, and so-far-benign liquidity conditions reverse). In a tail scenario this combined weakening of the real, fiscal, and financial sectors' fundamentals could undermine confidence, trigger liquidity pressures and capital outflows, and result in a loss of ECCB international reserves and potential pressure on the currency. Moreover, the ECCU is subject to the ripple effects of instability in global financial markets related to the COVID-19 pandemic. Staff's estimates suggest that an increase in global risk aversion would result in a negative growth impulse to the ECCU over two consecutive years (Box 2). Recurrent natural disasters, cyber-attacks, and the loss of CBRs remain significant risks.
- *On the upside, recovery from the pandemic could be faster than expected due to the swift dissemination of an effective vaccine that boosts confidence and economic activity.* Capital flows under CBI programs may also continue to surprise on the upside.

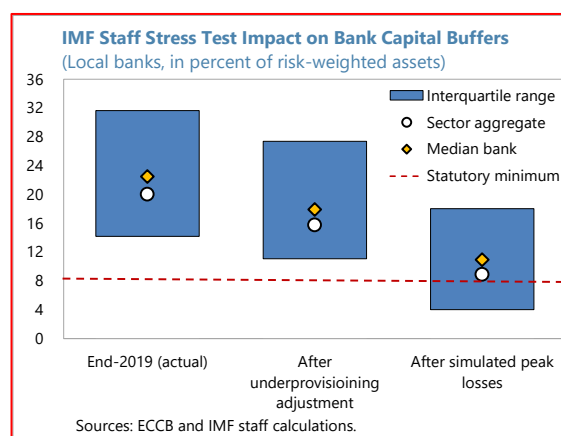
⁸ Grenada and St. Kitts and Nevis hold significant government deposits, which could mitigate their financing constraints.

be successful only if they are well-tailored and supported by improved capacity and resources. Priority should be placed on better annual budget processes and macro-fiscal forecasting, with a focus of anchoring the medium-term fiscal frameworks (MTFFs) to achieve the revised debt target.¹³ In parallel, the authorities should upgrade their public investment management, oversight for SOEs, internal audit function, fiscal reporting, and capacity to assess debt sustainability, on which they are currently receiving TA from CARTAC and the IMF. National Disaster Resilience Strategies would be an additional tool to internalize climate-related and potentially other shocks. State-contingent debt instruments triggering automatic amortization rescheduling and refinancing after large shocks, including natural disasters or pandemics, could further support fiscal sustainability (Annex IV).

B. Safeguarding Financial Stability

20. Financial system risks are gradually increasing as the crisis persists. In particular, the depth of the economic contraction and the likely protracted pace of a recovery will significantly raise credit risk and may eventually test financial institutions' liquidity buffers.

- The pandemic shock will compound banks' legacy NPL problem.** Several banks still carry large portfolios of longstanding and insufficiently provisioned NPLs.¹⁴ Regional efforts to reduce NPLs through purchases by the Eastern Caribbean Asset Management Corporation (ECAMC) have been hampered by funding constraints, and the ongoing crisis will further challenge recovery and resolution.¹⁵ Meanwhile, the high share of deferred loans and staff's stress testing suggest new NPLs could rise well above levels reached after the global financial crisis (Box 5). If the estimated loan losses materialize, it would leave much of the ECCU banking sector with thin capital adequacy margins against further losses and could result in capital shortfalls in some banks. Credit risks for the credit union sector may be further exacerbated by their earlier rapid lending growth on the back of less stringent lending standards, as well as typically limited loan diversification. In general, credit institutions' loss-



consolidation, while being robust to shocks such as natural disasters and potential materialization of contingent liabilities in the financial sector.

¹³ Countries should also explain deviations from their forecasts and the corrective actions to get back on track.

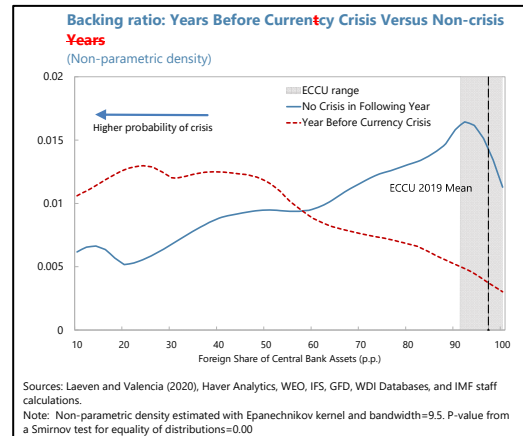
¹⁴ These include in particular majority state-owned banks with also more limited loan loss provisions coverage (Figure 4).

¹⁵ The ECAMC was established in 2017 with the dual mandate for resolving failed banks and acquiring NPLs from approved financial institutions (AFIs) including banks. Following prolonged negotiations, the ECAMC signed its first set of agreements for acquisition of NPLs in October 2020, funded by a mix of ECAMC capital and selling institutions' financing. However, this funding model is not sufficient for further scaled up NPL acquisitions.

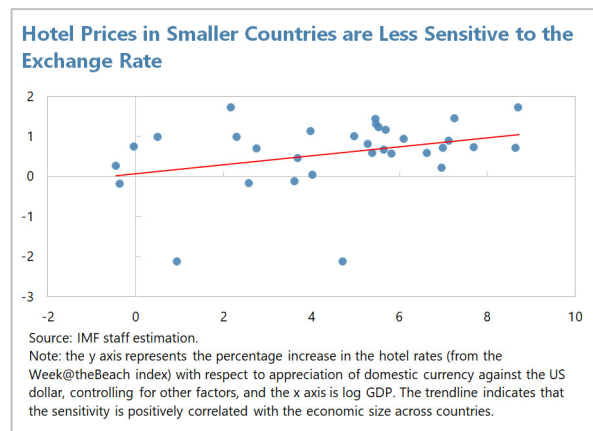
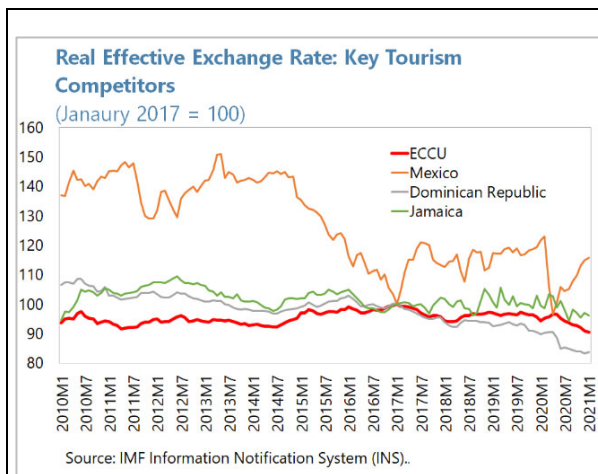
necessary prerequisites; particularly given the pandemic’s still highly uncertain balance sheet implications across banks.

C. Safeguarding the Quasi-Currency Board and Strengthening Competitiveness

25. The ECCB should keep a robust backing ratio by continuing to strictly limit credit provision. The backing ratio has remained in the range of 95–100 percent, above the legislative requirement of 60 percent and the operational benchmark of 80 percent. This prudent practice has lent credibility to the quasi-currency board arrangement. Staff’s analysis looking at past crisis episodes suggests a strong link between the backing ratio and crisis likelihood and that the ECCB’s backing ratio, currently at 96 percent, can be considered adequate (Box 6). Given the uncertainty concerning the evolution of the pandemic, the authorities should also enhance the monitoring of foreign exchange movements and prepare scenario-based policy responses, including estimation of financing needs and sources of concessional financing.



26. The COVID-19 shock has put significant pressure on output and employment, while exchange rate depreciation in neighboring economies could add to ECCU’s external competitiveness challenges over time. The EBA-lite current account model suggests that the external position in 2020 (adjusted for the COVID impact) is estimated to be moderately weaker than what is consistent with fundamentals, implying an exchange rate overvaluation (Annex III). Staff’s empirical analysis also found that smaller tourism economies (such as the ECCU countries) benefit less from exchange rate flexibility in the short run, likely due to *dominant currency pricing* (Annex V), but external competitiveness challenges may arise over the medium term.



necessary, allow for temporary breaches from minimum regulatory requirements provided the concerned institution has a credible corrective action plan. It is also essential to rapidly address remaining gaps in the supervision of non-banks and continue strengthening their stress-testing.

44. Crisis management plans need to be formalized expeditiously at regional and national levels to ensure system-wide risks can be effectively contained. These should be readily implementable with prioritized policy responses to identifiable contingency scenarios. They also need to clearly identify the responsible agents, coordination requirements and enforcement mechanisms while ensuring the adequacy of the requisite legal powers. The plans should also include the scope and modalities of any ECCB or government interventions and, in the case of non-banks, resolution options consistent with sound practices.

45. Credible strategies to support reduction of troubled assets should be started now. The pandemic is expected to increase significantly already elevated levels of non-performing loans in the financial system, which may constrain lending and thereby limit the financial system's longer-term ability to support the regional economies. The authorities therefore need to revisit sustainable funding options for the Eastern Caribbean Asset Management Company and/or explore alternative troubled asset resolution strategies, while also addressing long-standing deficiencies in national legal asset recovery frameworks.

46. The broader financial sector reform momentum should be maintained at a balanced pace. National authorities should complete long-standing financial sector reforms, including on the credit reporting and insolvency frameworks, centralized AML/CFT supervision for the banking system, and harmonized legislation for co-operative societies. The pandemic has also highlighted the importance of developing a regional macroprudential framework, transitioning toward Basel II/III regulatory regimes, reducing infrastructure gaps and regulatory fragmentation, and further mitigating CBR risk. However, implementation timelines should avoid unduly burdening supervised institutions.

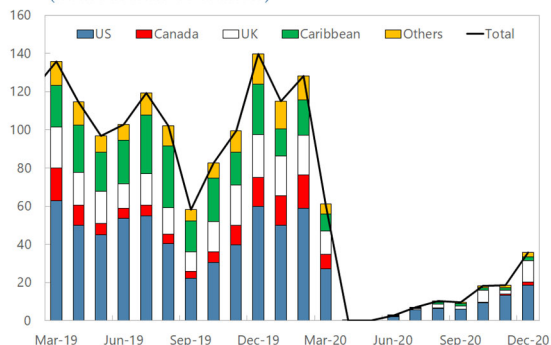
47. The ECCB should maintain the current prudent practice of keeping a robust backing ratio. By strictly limiting credit provision, the ECCB has maintained the backing ratio in the range of 95–100 percent, which has lent credibility to the quasi-currency board arrangement. Given the uncertainty concerning the evolution of the pandemic, the authorities should enhance monitoring of foreign exchange movements and prepare scenario-based policy responses. Bringing back the economy to a strong and sustainable recovery path quickly is also critical to ensure macroeconomic stability. To this end, the authorities should continue to make concerted efforts to implement structural reforms to make the economic structure more competitive and resilient.

48. The discussion with the ECCU authorities will be on the 12-month cycle in accordance with Decision No. 13655-(06/1), as amended.

Figure 1. ECCU: External Sector Developments

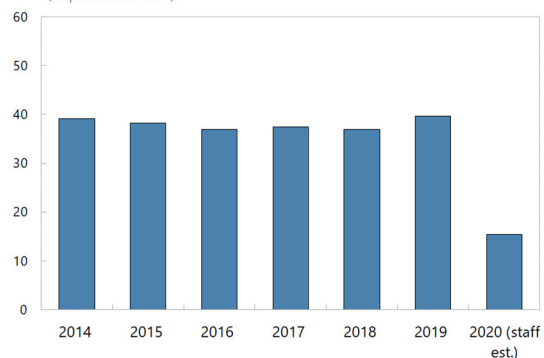
Tourism exports have collapsed...

Tourist Arrivals by Source Countries
(In thousands of tourists)



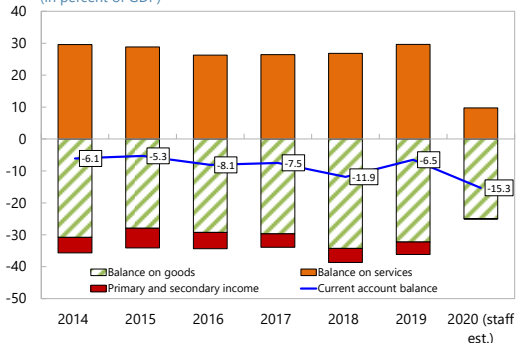
...resulting in a sharp decline in tourism exports...

Tourism Exports
(In percent of GDP)



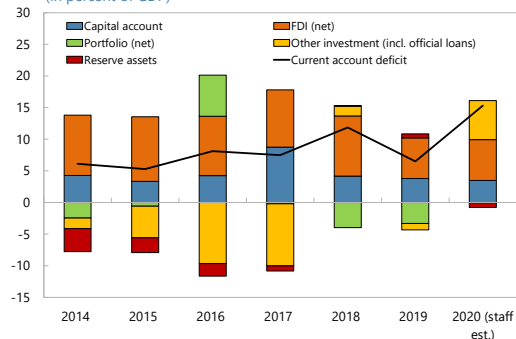
...and a widening of the current account deficit.

Current Account Balance
(In percent of GDP)



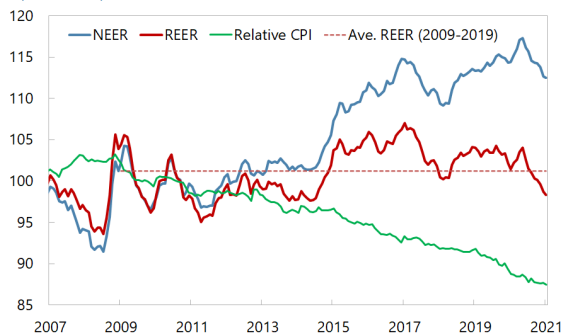
The current account deficit is expected to be financed by increased official capital inflows.

Current Account Deficit and Sources of Finance
(In percent of GDP)



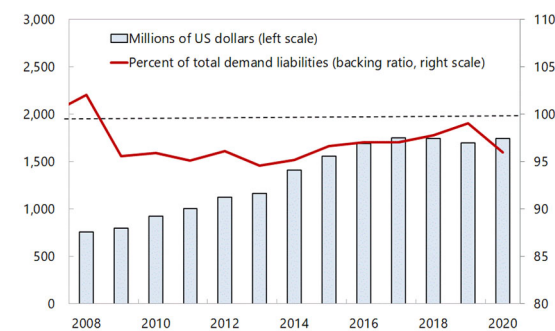
The real exchange rate has been volatile...

ECCU: Effective Exchange Rates
(2010 = 100)



...while the international reserve backing ratio has fallen slightly but remains high.

ECCB's Foreign Assets and Reserve Backing Ratio

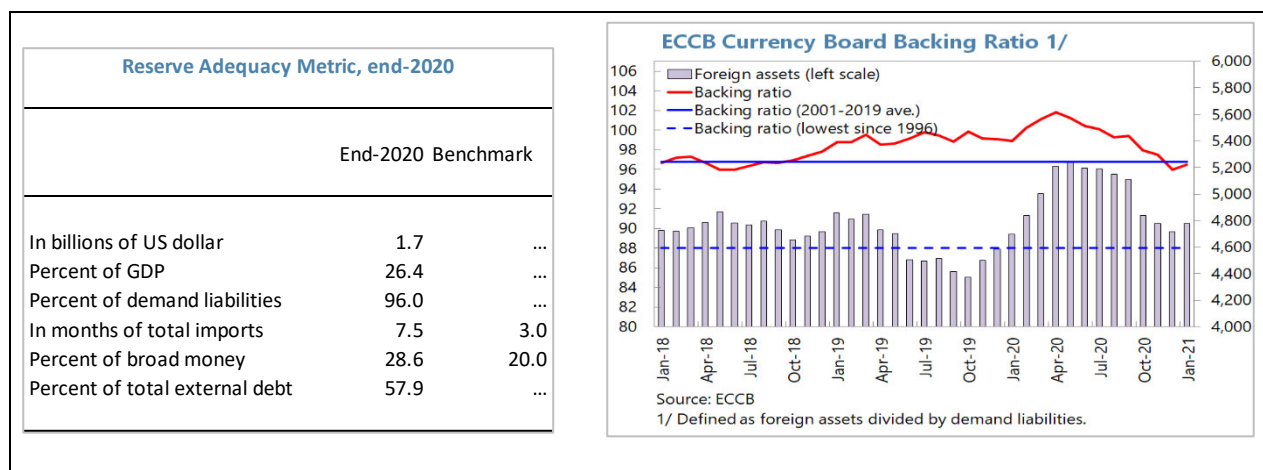


Sources: ECCB, IMF Information Notification System and IMF staff calculations.

Recommendations from the 2019 Common Policies Discussion	Authorities' Actions
6. Further strengthen oversight of nonbanks	In progress. Regional intra-regulatory collaboration and cooperation has been deepened through the financial sector Regulatory Oversight Committee (comprising national and regional regulatory authorities, chaired by the ECCB) and the <i>Optimal Regulatory Framework for the ECCU financial sector</i> includes work to address previously identified infrastructure gaps, finalize and strengthen a regional macroprudential framework and harmonize standards of financial supervision. Some SRUs are adopting guidance for credit unions similar to the ECCU's treatment of impaired assets standard.
7. After banks' balance sheets are strengthened and the fiscal backstop is functional, proceed toward a fuller resolution and crisis management framework.	In progress. The financial stability pillar of the <i>Program of Action for Resilience, Recovery, Resilience, and Transformation</i> highlights continued roll-out of key and long-outstanding reforms, while other proposed framework reforms, including for a regional deposit insurance scheme, are set out in the Monetary Council's recent <i>Optimal Regulatory Framework for the ECCU financial sector</i> .
Solidifying the currency union by raising payments' efficiency	
8. Building on the successful launch of the Electronic Funds Transfer, the ECCB, national authorities, and financial institutions should continue concerted efforts to modernize the payment system.	In progress. Legislation to strengthen the payment system legal framework is under preparation.
9. Proceed cautiously with the digital currency pilot project, as planned.	In progress. The ECCB [launched] the Phase II of its digital currency project (pilot issuance of digital currency within the controlled environment) in March 2021.
Structural reform	
10. To ensure external sustainability and boost potential growth, continue efforts to advance the structural reform agenda and foster private sector activity	In progress. The ECCB issued <i>Program of Action for Recovery, Resilience and Transformation</i> which includes action plans for structural reforms.
Statistical issues	
11. Continue to improve the ECCU area statistics.	Limited progress.

FX Intervention and Reserves Level

Background. Despite the sharp fall in tourism receipts, the international reserve position has remained above the post-global financial crisis average. At end-2020, the international reserves stood at US\$1.7 billion, equivalent to 7½ months of total imports of goods and services (above the benchmark of three months), 29 percent of broad money (above the benchmark of 20 percent), and 58 percent of total external debt. The ECCB has also maintained a high level of the reserve backing ratio (defined as the stock of the international reserves a percent of the ECCB’s demand liabilities) at 96 percent.



Assessment. To ensure the credibility of the quasi-currency board arrangement, the ECCB has limited the provision of credit to the economy (including both fiscal authorities and banks), which helped maintaining a relatively high level of the backing ratio. This practice should continue.

- Creditors extend new loans to the debtor optimally, keeping the borrower engaged in the contractual relation with creditors. This contains the pressure on the sovereign borrower to reduce concurrent spending to avoid a default.
 - Governments agree to some pro-cyclical downward expenditure adjustment to contain the accumulation of debt. This adjustment is smaller than the one needed to avoid default under non state-contingent debt instruments.
- The optimal stock of debt of the sovereign debtor is lower than in an economy with commitment to never default under any state of nature. This provides space for additional borrowing in case of future extreme negative shocks materialize.
 - Borrowing interest rates are close to the international risk-free international rates—because there is no default in equilibrium with automated rescheduling of debt service payments and financing—increasing welfare.

6. The results above imply that SCDIs are found to be optimal from the creditor perspective outside of debt restructurings, given creditor’s interest to prevent asset loss in a sovereign default. Issuance of SCDIs are optimal at all times, good and bad, not just during debt restructurings. In practice, however, their issuance has been limited, mostly in light of the reluctance of sovereign bond investors to accept complex instruments of difficult valuation and uncertain payout, which would be reflected in excess risk premia. The result above implies that, if SCDI are issued in sufficient critical mass and for specific and verifiable extreme negative events, interest rates could decline—in the model SCDIs pay the risk-free international interest rate because creditors have no loss in equilibrium. This could be implemented in the ECCU context and Caribbean more broadly, with a coordinated switch to the issuance of SCDIs in the regional bond market.



INTERNATIONAL MONETARY FUND



Press Release No. 21/xx
FOR IMMEDIATE RELEASE
[April XX, 2021]

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

Appendix I. Draft Press Release

IMF Executive Board Concludes 2021 Discussion on Common Policies of Member Countries of the Eastern Caribbean Currency Union

On April 26, 2021 the Executive Board of the International Monetary Fund (IMF) concluded the 2021 discussion on the common policies of the Eastern Caribbean Currency Union (ECCU) in the context of the Article IV consultations with member countries.¹

The fallout from the COVID-19 crisis is hitting ECCU economies hard. Tourism receipts (accounting for nearly 40 percent of GDP) have dried up, as tourist arrivals have come to a grinding halt. The authorities successfully contained the spread of the virus at the onset of the pandemic by largely closing the borders, but a reopening of the economies since the summer has led to a surge in COVID cases. The ECCU economy is projected to contract by 16 percent in 2020 and by a further near ½ percent in 2021. Fiscal positions have deteriorated sharply, and public debt is projected to reach 90 percent of GDP in 2021 and remain at an elevated level for years to come. Headline indicators suggest the financial system is relatively sound with ample liquidity buffers, but ~~this is likely a mirage since~~ nonperforming loans are expected to rise significantly. The outlook is clouded by exceptionally high risks, including from the uncertainty concerning the evolution of the pandemic.

Executive Board Assessment²

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¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of these bilateral Article IV consultation discussion, staff hold separate annual discussions with the regional institutions responsible for common policies in four currency unions—the Euro Area, the Eastern Caribbean Currency Union, the Central African Economic and Monetary Union, and the West African Economic and Monetary Union. For each of the currency unions, staff teams visit the regional institutions responsible for common policies in the currency union, collect economic and financial information, and discuss with officials the currency union's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis of discussion by the Executive Board. Both staff's discussions with the regional institutions and the Board discussion of the annual staff report will be considered an integral part of the Article IV consultation with each member.

² At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.