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Statement by Mr. Bennett on Dominica
Executive Board Meeting
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Dominica is in the midst of a complex economic transformation that aims to resolve destabilizing macro trends and strengthen the basis for sustained robust growth. The three-year PRGF arrangement and preceding SBA have proven important in underpinning an orderly economic transition. The overall strategy is bearing fruit. The severe economic contraction of recent years has given way to a nascent and broad-based economic recovery led by tourism, a rebound in manufacturing, and a recovery in the traditionally important banana sector. Destabilizing fiscal trends have also been reversed – the primary and structural fiscal balance has shifted solidly into surplus, reflecting improved revenue collection, better expenditure controls, and corrective fiscal measures. The recently approved 2004/05 budget looks to build on these gains through the implementation of key structural fiscal reforms that will generate permanent fiscal savings, sending a signal of Dominica's shift towards prudent fiscal management

These favorable economic outcomes reflect the proactive and forward-looking two-staged approach that the Fund adopted in Dominica's case to stave off a major fiscal crisis and restore the basis for sustained growth. Ultimately, however, the bulk of the credit rests with the Dominica authorities and their firm commitment to implement an ambitious set of corrective fiscal and structural reforms. Indeed, policy implementation has been very strong since mid-2003. As a result, program risks have been reduced markedly, particularly relative to the last review. Nevertheless, the economic situation in Dominica remains fragile, and the government has committed to broadening and deepening the process of economic stabilization and growth embedded in the PRGF arrangement.

The Debt Restructuring Process

The immediate priority is to quickly reach a collaborative debt restructuring agreement with creditors that puts debt dynamics on a sustainable track and addresses the problem of debt overhang. While debt negotiations have unfortunately taken longer-than-envisaged to complete, discussions have proceeded on the basis of good faith and in line with international best practices. In fact, Dominica's handling of the debt negotiations could be held up as a model in many respects.

Once a determination was made in late 2003 that the debt burden was unsustainable, the authorities sought and received donor support to engage an internationally respected team of debt advisors. Full information sessions were held with all creditors and the constructive

dialogue culminated in the launching of a formal debt exchange offer in April 2004. The offer included a menu of bond options that the government and its advisors believed would garner widespread support among creditors while accommodating debt sustainability objectives. At the same time, my Dominican authorities have complied fully with the Fund in terms of implementing an ambitious set of corrective fiscal and structural reforms as required under the Fund-sponsored arrangement. Indeed, having careful regard to performance to date as well as projections for the future, and conscious of the calls from members of the IMF Board, the government has advanced the pace of fiscal adjustment as a signal to creditors and the international community of their seriousness in tackling their fiscal problem. Finally, the authorities have shown flexibility in extending the expiration date on the exchange offer to provide creditors with time to reflect on the proposal and/or devise reasonable counter offers.

In the interim, and in line with program conditionality, the authorities have remained current on external debt obligations throughout the negotiation period with few exceptions. Consistent with the Fund's policy on claims in dispute, payments to Citibank and RBTT have not been serviced fully. In addition, a clerical error in the classification of a claim to an external supplier unfortunately resulted in the accumulation of external program arrears which, in turn, has given rise to several instances of non-complying purchases under the predecessor SBA and one non-complying purchase during the PRGF. Fortunately, this unintentional breach in program conditionality was both isolated and minor, and has now been fully resolved as the supplier has tendered these claims in the government's debt exchange offer.

While remaining current on external claims is difficult to justify when debt is clearly unsustainable, it is a concrete sign of Dominica's good faith efforts to reach a cooperative and equitable resolution of the debt problem with its creditors. Of course, this situation cannot continue indefinitely and, at which point, the authorities will seek the Fund's continued support under its lending into arrears policy. This possibility is reflected in the 2004/05 budget which is based on debt service payments consistent with full creditor participation. The principles of good faith, however, will not be abandoned in this instance – payments to non-participating creditors will be made on restructured terms and held in an escrow account until such time as an agreement is reached.

While we should not shy away from lending into arrears given Dominica's proven track record, the authorities are hopeful this option will not prove necessary. As reported, debt negotiations continue and are gaining momentum. On July 15th, the Board of Directors at the CDB –the largest single creditor– endorsed a debt restructuring proposal that approximates a 50 percent debt reduction in net present value terms. Discussions with commercial creditors have also picked up steam; the July agreement by Citibank stripholders to participate in the process marks an important milestone and will hopefully catalyze a similar agreement with RBTT. Finally, negotiations with bilateral creditors have advanced significantly in recent weeks. Regional partners, including Barbados, Venezuela, Grenada, and Belize have proposed rollover options consistent with Dominica's exchange proposal, and Trinidad and Tobago is considering a similar proposal. The United Kingdom has agreed, in principle, to accept a 50 percent NPV debt reduction and the actual repayment schedule is

being worked out. With the participation of these bilateral partners, creditor participation in the debt strategy will account for over 60 percent of eligible debt, giving confidence that a full collaborative resolution to the debt restructuring will materialize. However, the government is aware that debt dynamics will remain fragile even after the successful implementation of the debt strategy. Fiscal consolidation and prudent fiscal management, therefore, remains a program centerpiece and major priority for the government going forward.

Fiscal Adjustment

Performance in the fiscal area continues to be strong; benchmarks were achieved with large margins. The strong performance reflects improved tax collection, better expenditure control, and an overall strengthened culture of fiscal discipline. Indeed, as mentioned above, the 2004/05 budget frontloads the fiscal adjustment effort – it will deliver a 2 percent of GDP primary surplus and the medium-term 3 percent primary surplus target is expected to be reached one year earlier than forecast. Finally, core elements of the agreed fiscal adjustment package remain intact – notably the commitment to reduce public sector employment by 5 percent in 2004/05 and to gradually increase the retirement age of public servants. On the basis of this package, the primary structural balance is projected at 1.5 percent of GDP in 2004/05 as compared to a deficit of 4.5 percent in 2002/03. This swing in the fiscal accounts marks a truly impressive turnaround, particularly as these gains were achieved during years of contracting or flat real GDP growth.

Financial Sector and Monetary Policy Issues

Financial sector developments are generally positive and should help support the economic recovery now underway. The authorities' decision to exclude treasury bills from the debt restructuring exercise has been well-received by market participants – the T-bill market is stable and there are no indications of impending rollover problems. In addition, banking deposits are on the rise and liquidity is abundant. This is expected to feed through into increased private sector credit as the recovery picks up steam. However, the authorities continue to believe that monetary conditions could be more supportive. While there is limited policy scope to pursue this objective within the context of the monetary union, removing the minimum savings deposit rate imposed by the ECCB is one option that would help lower lending rates in support of private sector-led growth.

Structural Reforms

The structural reform agenda aims to address the root cause of macro imbalances and impediments to growth. Given the excessive debt burden and the related problem of debt overhang, the agenda largely consists of structural measures that entrench fiscal sustainability into public accounts. Key among these is civil service retrenchment – which is included in the current budget and expected to be carried forward in 2005/06 – and the pension reform legislation that will shortly be submitted to parliament. In addition, the introduction of three-year rolling budgetary projections in the 2004/05 budget is expected to increase fiscal transparency and, thus, discipline. Finally, the authorities are examining the possibility of

introducing fiscal responsibility legislation (possibly through appropriate amendments to its Finance Administration Laws) and is actively exploring options to strengthen tax policy, including through the introduction of a VAT and the further reduction in discretionary tax exemptions (which have already been reduced significantly).

Conclusion

The authorities are committed to the program and its underlying objectives to restore fiscal sustainability, broaden the basis for strong sustained growth, and accelerate the delivery of poverty reduction. In line with these objectives, the authorities hope to complete a full-fledged PRSP by end-2004. Against this backdrop and given Dominica's strong track record of policy performance to date, I am hopeful that the Board will look favourably on the decision to complete the second review under the PRGF as well as the authorities' request for a waiver on the nonobservance of the performance criterion on external arrears.