FOR AGENDA

SM/07/403

December 27, 2007

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Eastern Caribbean Currency Union—Staff Report for the 2007 Discussion on Common Policies of Member Countries**

Attached for consideration by the Executive Directors is the staff report for the 2007 discussion on common policies of member countries of the Eastern Caribbean Currency Union, which is tentatively scheduled for discussion on **Monday, February 4, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the members of the Eastern Caribbean Currency Union indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Mr. Cashin (ext. 36104), Ms. Khandelwal (ext. 39767), and Ms. Tsounta (36826) in WHD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, January 8, 2008; and to the Caribbean Development Bank, following its consideration by the Executive Board.

This document, together with a supplement providing an informational annex, will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities. The supplement, which is not being distributed in hard copy, will also be available in the Institutional Repository; a link can be found in the daily list (http://www-int.imf.org/depts/sec/services/eb/dailydocumentsfull.htm) for the issuance date shown above.

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INTERNATIONAL MONETARY FUND

EASTERN CARIBBEAN CURRENCY UNION

Staff Report for the 2007 Discussion on Common Policies of Member Countries

Prepared by the Staff Representatives for the 2007 Discussion with the Eastern Caribbean Currency Union

Approved by Markus Rodlauer and Matthew Fisher

December 26, 2007

EXECUTIVE SUMMARY

- **Background.** Private construction to expand tourism capacity is driving regional economic growth, which averaged 5 percent in 2006–07. Tourism arrivals, however, have fallen short of expectations, attributable in part to difficulties in intra-regional airlift and new passport requirements for U.S. visitors. Inflation has picked up—reflecting higher food and energy prices, and the depreciation of the U.S. dollar against major currencies—and is expected to reach 3¾ percent at end-2007.

- **External stability and competitiveness.** The level of the real effective exchange rate is broadly in line with fundamentals. While current account deficits are projected to remain above estimated equilibrium levels for an extended period, they are expected to decline over the medium term to a sustainable level. Nevertheless, maintaining competitiveness will be a challenge. Structural reforms and decisive fiscal consolidation are necessary to maintain external stability and underpin the quasi-currency board arrangement.

- **Regional integration**. The Eastern Caribbean countries have agreed on the formation of an Economic Union, envisaging the creation of a single economic and financial space, with free movement of labor and strengthened functional cooperation in many areas of governance.

- **Fiscal and debt sustainability**. Public sector debt at end-2006 was 104 percent of GDP, and many ECCU economies rank among the most indebted countries in the world. While revenues have benefited from important reforms, expenditure has also risen and fiscal positions have deteriorated in recent years. The region has committed itself to medium-term fiscal consolidation—in the form of the ECCB's public debt target of 60 percent of GDP by 2020—but national authorities are yet to establish a clear link between that goal and national fiscal policies.

- **Financial sector**. The ECCB has strengthened banking sector supervision and adopted many of the recommendations of the 2004 FSAP, yet some vulnerabilities remain. While the recent expansion in private sector credit has been accompanied by improved prudential indicators, the quality of bank assets needs to be closely monitored. Supervision of the rapidly-growing nonbank financial sector needs to be bolstered, by establishing single regulatory units as planned by the authorities.

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ACRONYMS

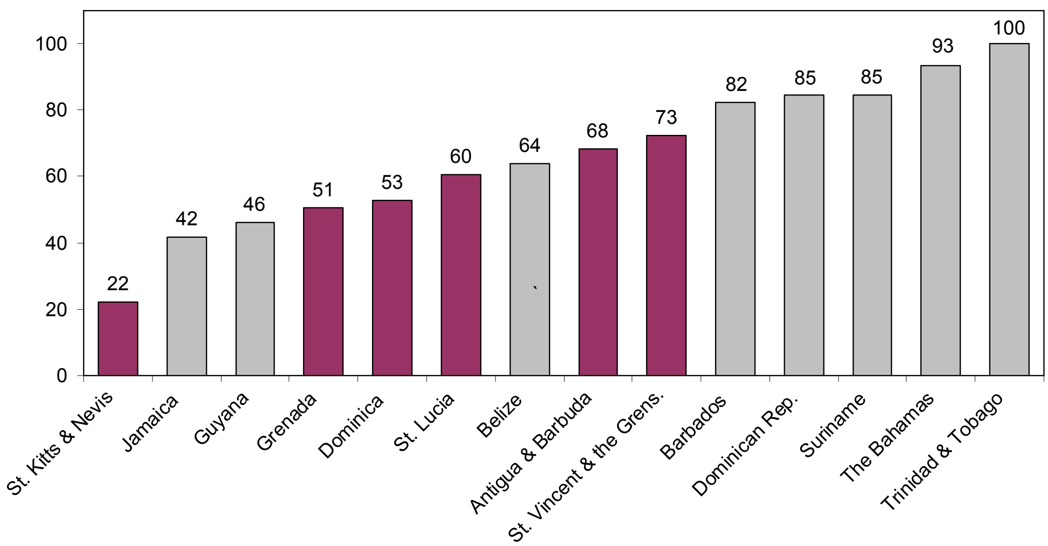
ACP	Africa, Caribbean and Pacific
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
ASYCUDA	Automated System for Customs Data
CARICOM	Caribbean Community
CARTAC	Caribbean Regional Technical Assistance Centre
CBA	Quasi Currency Board Arrangement
CCRIF	Caribbean Catastrophe Risk Insurance Facility
CDB	Caribbean Development Bank
CFATF	Caribbean Financial Action Task Force
CSME	CARICOM Single Market and Economy
CTO	Caribbean Tourism Organization
CWC	Cricket World Cup
DSA	Debt Sustainability Analysis
EC	Eastern Caribbean
ECCB	Eastern Caribbean Central Bank
ECCU	Eastern Caribbean Currency Union
ECSE	Eastern Caribbean Securities Exchange
EPA	Economic Partnership Agreement
EU	European Union
FAD	Fiscal Affairs Department
FDI	Foreign Direct Investment
FSAP	Financial Sector Assessment Program
LEG	Legal Department
LIAT	Leeward Islands Air Transportation
MCM	Money and Capital Markets Department
NBFI	Nonbank Financial Institution
NPL	Nonperforming Loan
OECD	Organization of Economic Cooperation and Development
OECS	Organization of Eastern Caribbean States
PRSP	Poverty Reduction Strategy Paper
PSIA	Poverty and Social Impact Analysis
PSIP	Public Sector Investment Program
RDF	Regional Development Fund
REER	Real Effective Exchange Rate
RGSM	Regional Government Securities Market
SRU	Single Regulatory Unit
STA	Statistics Department
VAT	Value Added Tax
WHD	Western Hemisphere Department
WTO	World Trade Organization

I. BACKGROUND AND SOCIAL SETTING

1. **ECCU countries are small, open, tourism-dominated island economies that are highly vulnerable to external shocks and natural disasters** (Figures 1 and 2).[1] Tourism accounts for three-fifths of exports, and the import content of consumption and investment is high. While the share of value added from agriculture has declined sharply in recent decades, crops (particularly bananas) remain important in supporting rural incomes.

2. **Over the last decade the ECCU's macroeconomic performance has deteriorated relative to the rest of the Caribbean.** Growth has declined since the mid-1990s, and debt levels increased substantially as fiscal deficits rose, partly as a result of many shocks, including natural disasters, the 2001 terrorist attacks, the erosion of trade preferences, and collapsing aid flows (Figure 3). Besides shocks, political cycles have also influenced national fiscal outcomes. Governments have repeatedly eased fiscal stances—chiefly through expansions of the civil service wage bill and increased capital spending—in the lead up to elections.[2]

The Caribbean: Relative Ranking on Macroeconomic Performance 1/
(Comparison of Average Performance during 1990–97 and 1998–06)



Sources: World Economic Outlook; country authorities; and Fund staff calculations and projections.
1/ The ranking is based on total public debt in 2006, absolute change in public debt from 1990–97 to 1998–2006; average overall fiscal balance from 1998–2006, absolute change in overall fiscal balance from 1990–97 to 1998–2006; average CPI inflation from 1998–2004, absolute change in CPI inflation from 1990–97 to 1998–2006; average real GDP growth from 1998–2006, and absolute change in real GDP growth from 1990–97 to 1998–2006. Countries are ranked from 1 to 14 in each category, with the best performer receiving the highest scores. The scores are then summed for each country, with equal weight to each category of macroeconomic performance. Finally, the summed-up scores are normalized so that the scores for all countries range from 1 to 100. Haiti is excluded from the comparison since the data on the primary balance in period 1990–97 are not available.

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[1] The Eastern Caribbean Currency Union (ECCU) comprises six Fund members: Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines; and two territories of the United Kingdom, Anguilla and Montserrat. Fund relations are summarized in the Informational Annex.

[2] There is evidence of a negative correlation between the fiscal primary balance and proximity to elections in the ECCU. For additional details, see Duttagupta, R. and G. Tolosa, "Is the Eastern Caribbean Currency Union a Free-Riding Paradise?", in *The Caribbean: From Vulnerability to Sustained Growth*, Sahay, Robinson, and Cashin (eds.), IMF, 2006.

3. **The ECCB-operated quasi-currency board arrangement (CBA) has continued to deliver price and exchange rate stability.** The ECCB has kept lending to member jurisdictions well within statutory limits, and international reserve coverage is near 100 percent of demand liabilities (the legal floor is 60 percent). There have not been any exchange rate pressures, and inflation has been anchored around the U.S. rate.

4. **The region has strong social indicators, but poverty, health and crime remain concerns.** An entrenched tradition of democracy has nurtured a strong social commitment in the ECCU to public health, education and protecting the vulnerable. As a result, the ECCU countries rank high on the Human Development Index relative to their income levels. While most social indicators are comparable to the OECD average, the region suffers from high unemployment and emigration rates. In addition, there has been a rapid acceleration in the spread of diabetes and hypertension, with associated implications for health spending. One quarter of the region's population lives in poverty, and crime is a growing problem.

ECCU: Social Indicators

	Antigua and Barbuda	Dominica	Grenada	St. Kitts and Nevis	St. Lucia	St. Vincent and the Grenadines	ECCU
Poverty headcount index, 2000 1/	12.0	33.0	32.0	31.0	25.0	38.0	28.5
HDI rank (2007), of 177 countries	57	71	82	54	72	92	...
Life expectancy (years), 2005	75.0	77.0	73.0	71.0	74.0	72.0	73.7
Adult illiteracy rate (percent), 2004	14.0	12.0	4.0	2.2	5.2	11.9	8.2
Mortality rate, infant (per 1000 live births, 2005)	11.0	13.0	17.0	18.0	12.0	17.0	14.7
Gini coefficient	0.525	0.488	0.504	0.445	0.468	0.448	0.480

Sources: ECCB; Fund staff estimates and projections; United Nations, Human Development Report 2007/08; http://www.sdnp.org.gy/ghdr/BOX1.1.html; and the World Bank, WDI 2006.
1/ Percentage of population living below each country's locally-defined poverty line in 2000.

II. Recent Economic Developments and Near-Term Outlook

5. **Growth was buoyant in 2006** (Table 1). Real GDP growth in the ECCU was close to 6 percent, the highest in more than 15 years, driven by construction, tourism, and financial services. Construction activity reflected significant expansions in hotel capacity, cricket stadia and supporting public infrastructure, in preparation for the Cricket World Cup (CWC) held in March–April 2007.

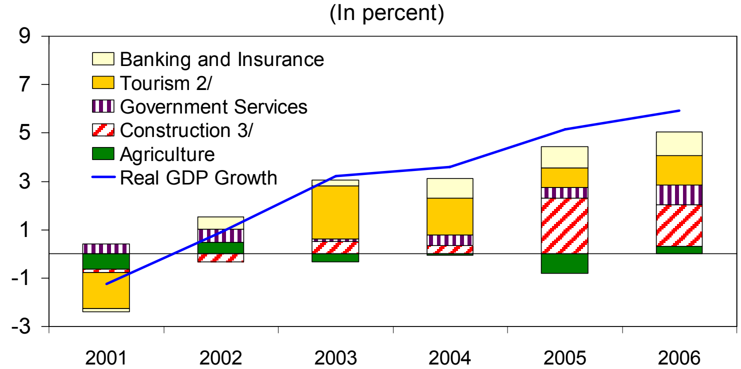
ECCU: Selected Economic Indicators, 2003–08 1/

	2003	2004	2005	Prel. 2006	Proj. 2007	2008
	(Annual percentage change)					
Real GDP	3.2	3.6	5.2	5.9	4.1	3.3
CPI inflation, period average	1.6	2.1	3.1	3.4	3.6	2.6
CPI inflation, end of period	1.8	2.5	4.4	1.9	3.7	2.4

Sources: Country authorities, and Fund staff estimates.
1/ Excluding Anguilla and Montserrat.

6. **Output is presently estimated to be above potential** (Figure 4). In 2007, output is estimated to remain above trend in all countries, although the pace of economic activity is uneven—Antigua and Barbuda and St. Vincent and the Grenadines are expected to continue their strong performance, while growth in Dominica is expected to be minimal following the passage of Hurricane Dean.[3]

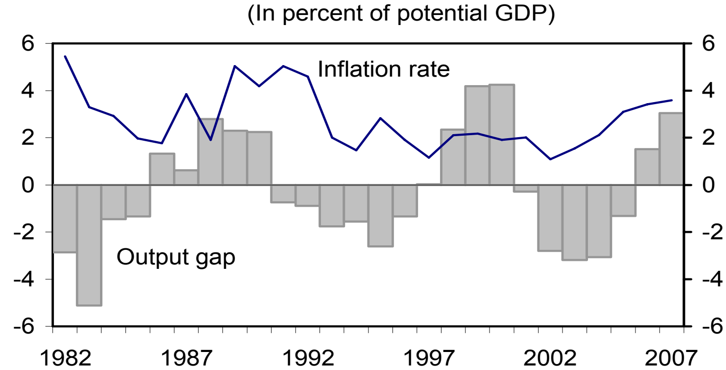
ECCU: Contribution to Real GDP Growth by Sector, 2001–06 1/
(In percent)



Sources: ECCB; and Fund staff projections.
1/ Excludes Anguilla and Montserrat.
2/ Includes wholesale and retail trade, hotel and restaurant, air transport, and half of local transport.
3/ Includes mining and quarrying.

7. **Despite the CWC, tourism performance in 2007 has been weak.** Notwithstanding strong tourism arrivals from Europe—partly reflecting the depreciation of the U.S. dollar (and thereby the EC dollar) against major currencies—U.S. and intra-Caribbean tourist arrivals have disappointed (Figure 5). This performance reflects CWC-related disruptions during the peak winter tourist season; more stringent rules on Caribbean travel for U.S. nationals; and problems with intra-regional airlift (¶24).[4]

ECCU: Output Gap, 1982–2007 1/
(In percent of potential GDP)



Sources: ECCB; and Fund staff estimates and projections.
1/ Data for 2007 are Fund staff projections.

8. **Inflation has picked up.** Rising world food prices, the depreciation of the U.S. dollar against major currencies, and the pass-through of higher world oil prices have put upward pressure on prices in the ECCU in 2007 (Figure 6 and Box 1).[5] Inflation is expected to reach 3¾ percent by end-2007, nearly twice the level at end-2006. The ECCB's Monetary Council

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[3] Preliminary reports indicate that Dean, which passed between Dominica and St. Lucia in August 2007, caused damage equivalent to about 20 percent of GDP in Dominica, while damage in St. Lucia was less than 1 percent of GDP.

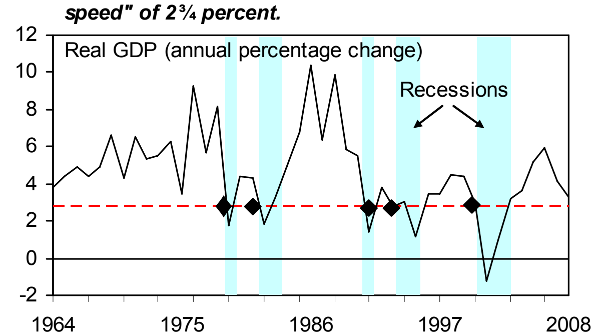
[4] The U.S. Western Hemisphere Initiative requires all citizens returning to the U.S. from the Caribbean to possess passports (from January 2007 for air and January 2008 for cruise).

[5] See "Price Dynamics in the Eastern Caribbean Currency Union" by Y. Sun and R. Duttagupta, Chapter II in *Eastern Caribbean Currency Union—2007 Selected Issues*.

has established a working group to further investigate the inflationary pressures on a regional level, and CARICOM leaders have agreed on the elimination or reduction of the Common External Tariff on a selected group of items (by end-January, 2008). Individual countries have responded differently to rising price pressures, including by intensifying profit margin controls (Grenada, St. Kitts and Nevis), considering the provision of import duty concessions on food and other basic necessities (St. Kitts and Nevis), reducing taxes on certain products (Antigua and Barbuda, Dominica), providing limited subsidies to vulnerable groups (Grenada), and having national budgets absorb world price increases on petroleum products (St. Lucia).

9. **For 2007–08, indications suggest a 'soft landing' of the ECCU economy.** Growth is expected to reach around 4 percent in 2007—closer to estimated trend growth of 3¼ percent—reflecting continuing strength in private construction, and despite disappointing tourism arrivals. Activity is expected to moderate further in 2008, to just above trend, due to the slowing world economy and moderating construction activity. Growth is thus likely to remain above the 2¾ percent "stall speed" associated with past regional recessions.

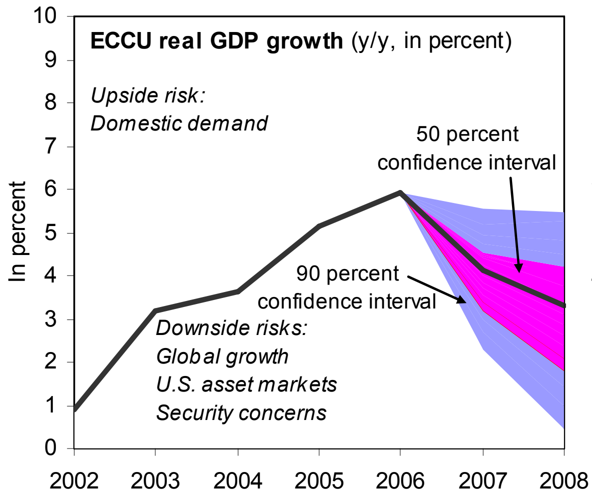
The forecast is for a soft landing, as growth is estimated to remain above the historical "stall speed" of 2¾ percent.



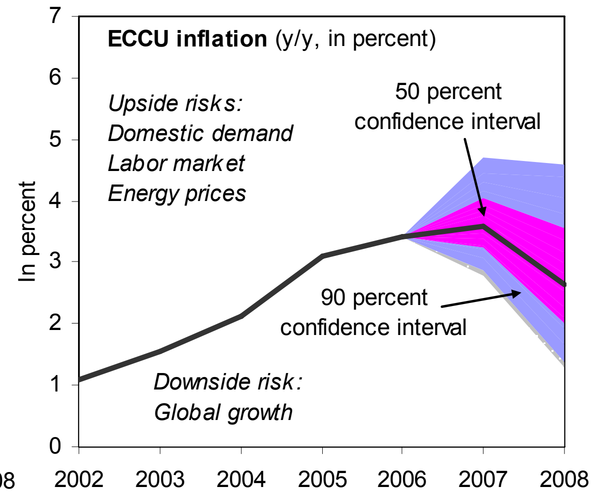
Sources: IMF, International Financial Statistics; World Economic Outlook; and Fund staff estimates.

10. **However, there are risks to this outlook.** The upside potential from strong domestic demand due to the private construction boom is more than offset by downside risks as the turbulence in global financial markets may dampen consumption and tourism demand. In addition, construction activity may be affected by weaker expectations for real estate sales and tourism inflows. With oil import prices high, further dollar depreciation, and structural rigidities in the labor market, cost pressures could continue to elevate inflation.

Growth is expected to decline towards potential, with risks mostly on the downside...



...while risks to the inflation outlook are biased to the upside.



Source: Fund staff estimates.

11. **Despite the implementation of ambitious revenue reforms, limited progress has been made towards fiscal consolidation** (Table 2). Stronger growth and far-reaching tax reforms have improved tax revenues, benefiting from broader tax bases and better tax collections, especially the introduction of new VATs.[6] Nevertheless, a surge in capital spending associated with the CWC led to a deterioration of actual and structural fiscal balances in 2006 (Figure 4). In 2007–08, lower spending is projected to improve primary balances before grants, but declining aid flows and higher interest rates are likely to more than offset this improvement, leaving the ECCU-wide overall deficit at around 5 percent of GDP.

ECCU: Selected Fiscal Indicators, 2003–08 1/

	2003	2004	2005	Prel. 2006	Proj. 2007	2008
	(In percent of GDP)					
Revenues	26.3	26.4	26.5	27.5	27.5	27.5
Grants	2.4	1.7	3.1	3.2	2.7	1.7
Noninterest current expenditures	21.7	21.6	21.5	21.7	21.6	21.3
Interest	4.4	4.5	4.1	4.2	4.4	5.0
Capital expenditures	7.8	6.2	8.4	10.6	9.1	8.0
Primary balance (excluding grants)	-3.2	-1.6	-3.4	-4.8	-3.3	-1.9
Primary balance (including grants)	-0.8	0.1	-0.3	-1.6	-0.5	-0.3
Overall balance	-5.2	-4.3	-4.4	-5.8	-4.9	-5.3
Memorandum items:						
Public sector debt	107.7	111.2	104.5	104.2	101.8	102.9
Interest (as share of revenues)	16.7	17.1	15.5	15.3	15.9	18.2

Sources: Country authorities; and Fund staff estimates.
1/ Excluding Anguilla and Montserrat.

[6] VATs have been successfully implemented in Dominica (March 2006), Antigua and Barbuda (January 2007), and St. Vincent and the Grenadines (May 2007); and preparations are ongoing for introduction in St. Lucia (late 2009), Grenada, and possibly St. Kitts and Nevis.

12. **Debt levels and debt servicing costs remain large.** Notwithstanding recent strong economic growth and debt restructurings and writedowns in several countries, public sector debt is expected to remain above 100 percent of regional GDP (Figure 3). Debt servicing absorbs a substantial portion of revenues in most countries—the exceptions being Dominica and Grenada, reflecting previous debt restructuring agreements with creditors. In addition, St. Vincent and the Grenadines benefited in 2007 from a debt write-off from Italy equivalent to about 10 percent of GDP. The high burden of debt servicing is limiting fiscal space for much-needed social and poverty-reduction spending.

ECCU: Selected Indicators of Debt Burden, 2004–08

			Prel.	Proj.	
	2004	2005	2006	2007	2008
	(In percent of current revenues)				
Interest payments					
Antigua & Barbuda	21.0	19.8	19.5	19.8	28.1
Dominica	17.9	16.3	6.9	7.0	6.7
Grenada	25.2	8.3	8.3	8.9	8.9
St. Kitts & Nevis	20.8	22.1	26.6	26.6	27.0
St. Lucia	11.9	14.0	13.7	14.5	15.2
St. Vincent & the Grens.	8.6	10.4	10.8	12.0	13.7
Debt service 1/					
Antigua & Barbuda 2/	46.8	101.7	25.5	26.8	35.0
Dominica	35.5	24.1	11.4	12.3	12.2
Grenada	40.4	12.3	13.3	16.3	17.7
St. Kitts & Nevis	33.2	34.9	36.9	39.3	42.1
St. Lucia	14.8	22.6	28.9	36.7	27.6
St. Vincent & the Grens.	19.4	21.3	22.0	22.6	24.1

Sources: Country authorities; and Fund staff estimates.
1/ Includes only external amortization.
2/ For 2005, the debt service incorporates amortization in relation to debt relief received by Antigua and Barbuda from Italy.

13. **Credit has continued to expand rapidly.** Broad money has grown faster than nominal GDP, and banks have run down their net foreign assets (Figure 7 and Table 3). Private sector credit expansion has accelerated, reflecting increased lending to tourism, construction, and consumers. As construction activities wind down in 2008, credit growth is expected to return to more sustainable levels. Reserve coverage of demand liabilities rose to above 100 percent at end-September 2007.

ECCU: Selected Monetary Indicators, 2003–08

				Prel.	Proj.	
	2003	2004	2005	2006	2007	2008
	(Annual percentage change)					
Broad money	9.5	13.2	8.4	11.6	11.0	6.4
Net foreign assets 1/	8.7	6.8	1.2	2.0	-1.2	0.9
Net domestic assets 1/	0.8	6.4	7.2	9.6	12.2	5.5
Of which						
Private sector credit 1/	2.0	5.1	9.2	14.6	12.0	5.7
Currency backing ratio, in percent	95.3	96.2	96.5	98.7	...	...

Source: ECCB.
1/ Twelve–month change in percent of broad money at the beginning of the period.

14. **Prudential indicators of the financial sector have strengthened** (Figure 8 and Table 5). Nonperforming loans (NPLs) of local banks have continued to decline and are close to the ECCB's prudential target (5 percent of total loans). However, provisioning has continued to fall, and the decline in the NPL ratio partly reflects the ongoing rapid credit expansion—raising the importance of effective financial sector supervision. Exposures to government remain high, and are concentrated in some state-owned local banks (Figure 9).

ECCU Banking System: Financial Soundness Indicators, September 2007
(In percent)

	Antigua & Barbuda	Dominica	Grenada	St. Kitts & Nevis	St. Lucia	St. Vincent & Grens.	ECCU
Capital adequacy 1/	10.6	16.4	14.1	38.3	16.3	17.7	17.0
NPLs/total loans 1/	16.1	5.2	3.8	5.7	8.6	2.3	8.4
Gross government exposure/total assets	9.5	9.9	11.1	29.0	11.6	15.8	13.6
Loans to households/total loans	43.6	58.6	58.9	34.5	34.3	49.8	43.7
Liquid assets/total assets	41.1	47.9	26.2	37.2	19.1	35.9	26.2
(Pre-tax) return on average assets 2/	0.4	0.6	0.6	0.9	0.7	0.5	0.6

Source: ECCB.
1/ Local banks.
2/ Quarterly return.

15. **The ECCB has strengthened banking sector supervision, but vulnerabilities remain.** The uniform Banking Act has been implemented in all ECCU jurisdictions, offsite reporting and data verification have been strengthened, new prudential guidelines have been issued (on provisioning for government arrears, corporate governance, liquidity risk management, and related-party transactions) and corporate governance has been enhanced. Some progress has been made in establishing national single regulatory units (SRUs) for the supervision of nonbank financial institutions (NBFIs), but legislation providing for uniform regulation (of ECCU credit unions, money transfer institutions, and domestic insurance companies) has not yet been introduced in all ECCU jurisdictions. While several countries have enhanced supervision of their offshore financial sectors, there has been little progress in aligning the prudential regimes of offshore banks with those of domestic banks, as recommended by the 2004 FSAP.[7]

16. **The external current account deficit widened in 2005–06, accompanied by strong capital inflows** (Figure 10 and Table 4). The increase in the deficit since 2004 has been driven by imports related to hotel construction and public capital expenditure for the CWC, rising energy imports, and disappointing tourism receipts. Hotel construction is financed mostly through FDI, and is expected to slow in the medium term as new tourism capacity comes online. CWC-related construction was financed largely through external grants. In 2007–08 the current account deficit is expected to narrow, due to slowing CWC-related imports. Gross international reserves are expected to continue to grow, reaching about US$770 million by end-2007 (over

ECCU: Selected External Indicators, 2003–08

	2003	2004	2005	Prel. 2006	Proj. 2007	Proj. 2008
	(In percent of GDP)					
External current account balance	-21.9	-14.1	-19.2	-23.4	-23.1	-21.6
Direct investment (net)	17.7	13.3	14.6	21.0	16.9	16.9
Gross international reserves (US$m)	539.9	632.4	600.8	696.0	770.5	816.8
	(Annual percentage change)					
Exports of goods	3.8	10.2	8.4	-2.9	-2.6	4.9
Imports of goods	16.7	2.8	15.2	10.0	4.3	4.6
Travel (net)	18.0	12.2	4.7	4.1	3.9	8.2
Stayover arrivals 1/	9.9	10.0	0.4	3.4	-4.8	...
Real effective exchange rate	-4.1	-3.3	-0.7	-0.1	...	...

Sources: ECCB; and Fund staff estimates.
1/ The 2007 estimate is the realization at June 2007.

[7] A new round of CFATF evaluations has recently been initiated, and will focus on the effectiveness of AML/CFT frameworks.

4½ months of imports), with capital inflows (chiefly FDI flows) largely covering the current account deficit.

17. **There is renewed momentum towards economic integration in the Eastern Caribbean region, while Caribbean-wide integration is proceeding more slowly.** In May 2007, OECS member countries approved a draft Treaty for the establishment of an Economic Union (Box 2).[8] Progress in implementing the CARICOM Single Market and Economy (CSME) has been slow, and ECCU countries' participation has been predicated on a US$250 million Regional Development Fund to support their development needs, which is not yet operational.[9]

18. **The region has maintained access to new financing, despite recent debt restructurings and debt write-downs.** Governments have increasingly tapped commercial borrowing arranged by financial institutions in Trinidad and Tobago, as well as the ECCU Regional Government Securities Market (RGSM).[10] Bond placements on the RGSM have typically been oversubscribed at interest rates that have fluctuated in a very narrow range, with limited discrimination among countries, reflecting high levels of bank liquidity and the cash-flow surpluses of the region's social security systems (Figure 11).[11] Debt restructurings (Dominica, Grenada) and write-downs (Antigua and Barbuda, St. Vincent and the Grenadines) have been described in the respective country staff reports.

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[8] The Organization of Eastern Caribbean States (OECS) is a nine–member grouping comprising Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines, with Anguilla and the British Virgin Islands as associate members.

[9] For an analysis of regional trading and integration arrangements, see Mlachila, M., W. Samuel and P. Njoroge, "Integration and Growth in the Eastern Caribbean," in *The Caribbean: From Vulnerability to Sustained Growth*, Sahay, Robinson, and Cashin (eds.), IMF, 2006.

[10] The RGSM is a regional, auction-based system for marketing government securities of ECCU members. The market has been in operation since November 2002, and market capitalization has grown to almost EC$800 million (7⅓ percent of regional GDP) as at end-November 2007.

[11] The absence of a link between U.S. and ECCU interest rates may reflect restrictions on portfolio allocations by national social security schemes (the largest savings vehicles in the region).

III. Policy Issues[12] [13]

19. **The ECCU countries have implemented many important policy initiatives in recent years, but challenges remain.** The current, still favorable economic environment provides an opportunity for the region to address longstanding economic and social challenges and reduce vulnerabilities. Discussions with the national and regional authorities focused on three broad areas:

- Enhancing growth prospects and maintaining competitiveness.
- Ensuring a sound and dynamic financial system.
- Reducing vulnerabilities.

A. Growth and Competitiveness

20. **Discussions focused on the increasing dependence of the ECCU region on tourism, and the need for policies to ensure sustainable growth.** The current economic expansion has been driven by construction to boost tourism capacity in many ECCU countries, at a time when the erosion of European Union trade preferences has weakened traditional exports. As a result, the ECCU is becoming increasingly dependent on tourism, but growth rates in travel receipts since the 1990s have been only about one-third of those in the 1980s, and have fallen below world growth rates (Figure 12).

21. **Enhancing the ECCU's growth potential is the region's overarching challenge.** The staff emphasized the need for reforms to lower the cost of doing business and raise the ECCU's growth potential. The additional hotel room capacity being created could exert pressure on the older hotel stock, unless arrivals expand accordingly. The authorities acknowledged that tourism arrivals are sensitive to price competition, and were keen to enhance efficiency through improvements in the investment climate.[14] Staff suggested that the authorities address issues highlighted in the World Bank's *Doing Business Indicators*

[12] The consultation discussions took place between September–November and comprised, at various stages, P. Cashin (Head), P. Khandelwal, E. Tsounta, J. Chai, K. Nassar, M. Dehesa, N. Wagner, and C. Pattillo (all WHD). M. Rodlauer (WHD), J. Fried, P. Charleton and M. Morgan (all OED) also participated in key discussions. The mission visited each of the six Fund-member countries of the ECCU, and met with Prime Ministers, Ministers of Finance, other senior government officials, opposition parliamentarians, representatives of the financial and tourism sectors, and senior officials at the Eastern Caribbean Central Bank (ECCB), the Caribbean Development Bank (CDB), the Organization of Eastern Caribbean States (OECS), the Caribbean Tourism Organization (CTO), and bilateral donors.

[13] This report covers regional topics, highlighting the common policy issues of members of the currency union, and provides a regional perspective on economic policies relevant for Fund surveillance for which responsibility lies at the national level. Analysis of the developments and prospects of individual ECCU countries, with a focus on national fiscal and structural policies, can be found in bilateral Article IV staff reports.

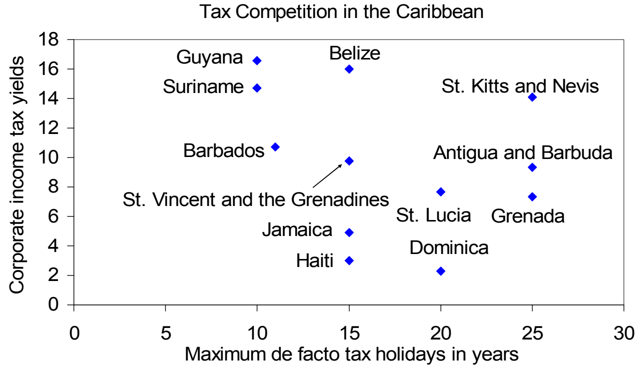
[14] See "Tourism Demand in Small-Island Economies" by N. Mwase, Chapter V in *Eastern Caribbean Currency Union—2007 Selected Issues*.

2008: the high cost of imports (arising from high trade barriers and weaknesses in customs administration); difficulties in accessing credit and credit information; weak contract enforcement; and the lack of flexibility in regional labor codes (Figure 13).

22. **OECS Economic Union is at the center of the authorities' growth strategy, and implementation will be key.** The authorities believe that, building on a history of cooperation, the nascent Economic Union should enable the region to better compete within CARICOM, and also better prepare it for increasing globalization. The Economic Union Treaty envisages the creation of a single economic and financial space in the region, and strengthened functional cooperation in many areas, including joint diplomatic representation, provision of security services, tax and customs administration, utilities, transport, health, and education. Staff urged the authorities to accelerate the simplification and harmonization of the legislative and regulatory framework at the regional level, to help reduce transaction costs. The authorities agreed, and emphasized the importance of liberalizing labor movements, as this could yield significant benefits including better allocation and retention of skilled workers in the region.

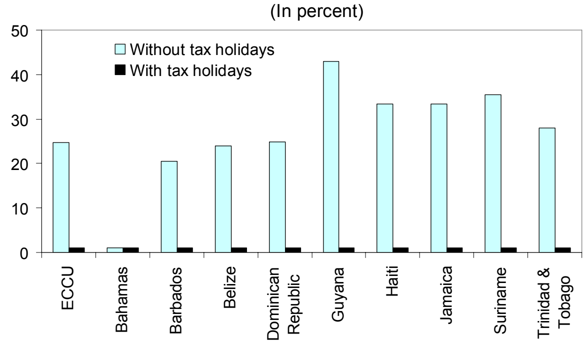
23. **Tax concessions have eroded the corporate tax base across the Caribbean—preserving the integrity of the newly-introduced VATs is a key priority.**[15] Governments in the region compete through generous tax concessions for foreign direct investment and employment. The authorities recognized that tax concessions have eroded their corporate tax bases. However, while they viewed a regional harmonization agreement—such as a voluntary code of conduct or a regional treaty on tax incentives—as potentially useful, in practice they saw it as not achievable and extremely difficult to enforce. The staff recommended that, in order to limit the distortionary impact from concessions, they be granted in a nondiscretionary and transparent manner, clearly identifying estimated costs and

Tax Competition in the Caribbean



Source: Fund staff calculations, based on 2006 data for the ECCU, Suriname, and Haiti and 2003 data for others. The tax yield is revenue as a percent of GDP divided by the tax rate.

Average Effective Tax Rate on Investment, 2005
(In percent)



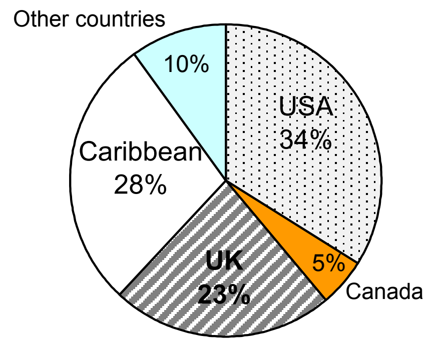
Sources: Country authorities; and Fund staff estimates.

[15] Estimates of additional annual revenue from the removal of exemptions from corporate and import-related taxes average about 9 percent of ECCU GDP. See Chai, J. and R. Goyal, "Tax Concessions in the ECCU," in *The Caribbean: From Vulnerability to Sustained Growth*, Sahay, Robinson, and Cashin (eds.), IMF, 2006. See also "Corporate Income Tax Competition in the Caribbean" by K. Nassar, Chapter VI in *Eastern Caribbean Currency Union—2007 Selected Issues*.

beneficiaries. The authorities agreed, pointing to ongoing initiatives in that direction in Antigua and Barbuda, Grenada, and St. Kitts and Nevis. They also broadly agreed on the need to limit concessions to investments and not extend them to consumables, ensuring the integrity of the new VATs being introduced in the region.

24. **Difficulties in intra-regional air travel have adversely affected tourism.** The recent merger between the two regional airlines (LIAT and Caribbean Star) has created a near-monopoly on intra-Caribbean air transportation—air fares have risen sharply, while capacity has been scaled back. The merged airline now has a requirement to operate on a commercial basis, and is seeking efficiency gains to limit future capital injections from major shareholder governments (Antigua and Barbuda, St. Vincent and the Grenadines, and Barbados) and minimize operating costs.[16] The national authorities expressed a wide range of views on the best manner to operate a publicly-owned airline that is required to serve remote locations and unprofitable routes, but all agreed that intra-regional air transportation is an essential public good, vital for maintaining connectivity and facilitating intra-Caribbean trade and tourism.

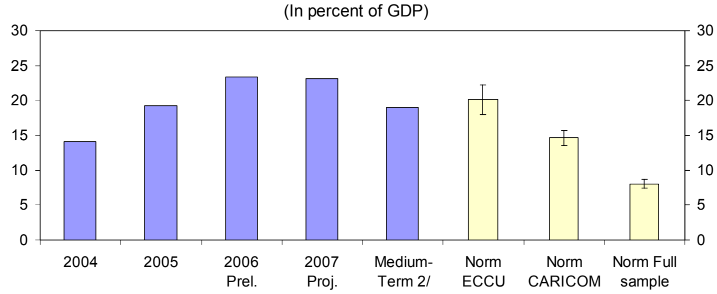
ECCU: Tourism Stay-Over Arrivals by Source Country or Region, 2000–06



Source: ECCB.

25. **Current account deficits in the ECCU are projected to remain above estimated equilibrium levels for an extended period, as the economies continue to adjust from agricultural to tourism-based economies**. Using the macroeconomic balance approach, Fund staff estimate the equilibrium current account deficit (the current account 'norm') at between 9–15 percent of GDP, using sample sets consisting of tourism-based economies. Estimates based only on ECCU countries give a norm of about 20 percent of GDP, though this may overstate the equilibrium level as the

ECCU: Current Account Deficit, Actual and Estimated Norms 1/
(In percent of GDP)



Sources: ECCB; Fund staff estimates and projections; and Pineda and Cashin "Assessing Exchange Rate Competitiveness in the ECCU," ECCU Selected Issues Chapter.

1/ In computing the norms, medium-term values of the fiscal balance, oil-balance, output growth, and relative income are drawn from staff projections. Band is ±1 standard error of the prediction. ECCU sample inludes only the 6 ECCU countries. CARICOM sample includes ECCU countries and The Bahamas, Barbados, Belize, and Jamaica. Full sample includes 21 tourism-dependent economies as defined by Bayoumi and others (2005).

2/ Based on Fund staff estimates. Medium-term is 2012.

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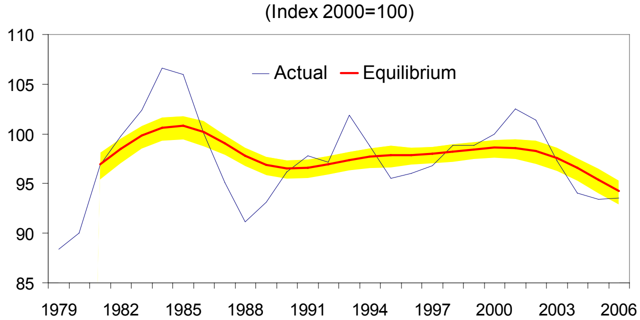
[16] In 2007, the governments of Antigua and Barbuda, Barbados, and St. Vincent and the Grenadines borrowed US$21.8, US$32.7, and US$5.4 million, respectively, from the CDB in support of LIAT.

estimation covers a period of rapid debt accumulation.[17] The recent increase in current account deficits reflects, in large part, preparations for the CWC and expanding tourism capacity as ECCU countries develop their tourism sectors. The size of future current account imbalances is expected to taper off in line with the decline in the construction of new resort facilities, though much of the decline is likely to occur after the end of the projection period. This implies that despite their apparent high levels, medium-term current account imbalances in the ECCU appear sustainable.

26. **The structure of the financing of ECCU current account imbalances is stable.** The large projected current account deficits are not expected to be financed by the accumulation of external sovereign debt (which has been declining in recent years) or by resources intermediated through domestic financial systems, but rather by private capital inflows (particularly FDI). Tourism sector investment, particularly for hotel construction, continues to be overwhelmingly financed by FDI. These tourism investments are often large in relation to the size of the ECCU economies. As tourism-based investment opportunities in the ECCU decline over the medium term, capital inflows and current account imbalances will narrow. While any adverse shift in investor sentiment may lead to a sharper than envisaged decline in foreign investment, so will the level of current account imbalances (given the high import content of construction activities), with only limited dislocation to the domestic economy.

27. **The level of the real exchange rate appears to be appropriate, although there are challenges in maintaining external competitiveness.** Staff analyses indicate that in the ECCU countries the actual real exchange rate is slightly below its equilibrium level, reflecting the depreciation of the U.S. dollar against major currencies.[18] Indeed, the real exchange rate—measured relative to either trade weighted, tourism

ECCU: Actual and Equilibrium REER, 1979–2006 1/
(Index 2000=100)



Sources: IMF, Information Notice System; and Pineda and Cashin, "Assessing Exchange Rate Competitiveness in the ECCU," ECCU Selected Issues Chapter.
1/ The shaded band around the equilibrium exchange rate represents ±1 standard error of the prediction.

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[17] Macroeconomic balance-based estimates of the equilibrium current account position are typically subject to uncertainty, reflecting the large variation in current account imbalances across countries and over time, and the limits of the common specification imposed across a diverse set of countries.

[18] An exception is St. Kitts and Nevis, where higher inflation led to an appreciation of the REER in 2006. Time series models linking the REER to measures of the ECCU region's fundamentals (productivity differentials, terms of trade, government consumption and net foreign assets) suggest that there is little evidence of overvaluation of the EC dollar. The text figure shows developments only through end-2006, as annual data are used to calculate the equilibrium REER—the continued depreciation of the U.S. dollar in 2007 has further depreciated the ECCU REER. For additional details see "Assessing Exchange Rate Competitiveness in the Eastern Caribbean Currency Union," by E. Pineda and P. Cashin, Chapter I in *Eastern Caribbean Currency Union—2007 Selected Issues*.

competitors, or tourism source markets—is currently at its most depreciated level in almost 20 years (Figure 14). However, besides the real effective exchange rate, there are challenges in maintaining external competitiveness, as suggested by the weakening in regional exports, the ongoing deterioration in the terms of trade, and the recent decline in the ECCU's share of Caribbean tourist (stayover) arrivals. In addition, given the ECCU's large stocks of public and external debt, decisive fiscal consolidation is necessary to assist competitiveness, support debt sustainability, and underpin the EC dollar's peg to the U.S. dollar. The authorities reiterated their strong commitment to the exchange rate peg and the currency union, noting that planned structural reforms (particularly increased flexibility of labor and product markets) should help generate efficiencies and enhance productivity to strengthen competitiveness.

28. **Staff calculations suggest that the ECCU's balance of payments position is consistent with external stability.** As noted, there is no evidence that the exchange rate level is fundamentally misaligned. Based on available data (which are mainly for the public sector), the level and structure of capital flows appear sustainable: under current policies, external public debt is forecast to remain roughly constant (as a share of GDP) over the medium term (see Table 7 and the Appendix). Regarding private sector flows, following the recent increase in FDI, they are projected to decline over the medium term toward a sustainable trajectory (albeit beyond the period covered by the projections). Nevertheless, the high levels of current account imbalances, public debt and associated financing needs do pose risks that warrant careful monitoring and continued efforts at fiscal consolidation (Section III.C). The authorities view FDI—the dominant and historically stable source of external flows—as a sustainable and reliable source of capital flows. They agreed with the need to closely monitor private sector capital flows and asset positions, and to improve the statistical data in this and other areas.[19]

B. Ensuring a Sound and Dynamic Financial System

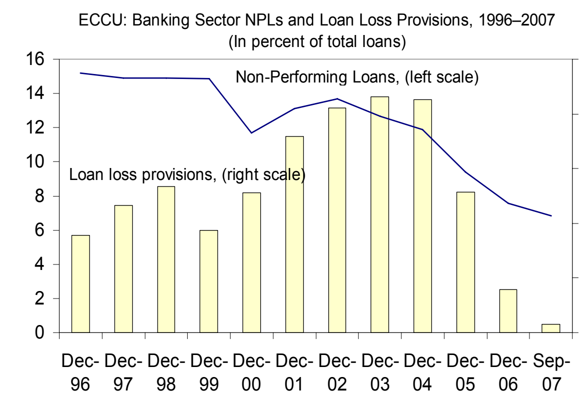
29. **The ECCU region remains relatively insulated from world capital markets, and has not been directly affected by the recent financial markets turmoil.**[20] The region's equity and bond markets are thin and illiquid—the U.S. subprime mortgage crisis and repricing of credit has not and is not likely to have a discernable impact. ECCU banks, on the other hand, are highly liquid, with limited interbank exposures—liquid assets are typically held in the form of large balances with foreign banks and foreign investments. The authorities did not view the risk of an impairment in the quality of foreign assets as significant, due to stringent prudential rules for portfolio investments by banks. Data limitations hamper an assessment of the impact on private and nonbank financial sectors.

[19] Data on the ECCU's overall net external asset position, and the level and structure of the stock of external assets and liabilities, are not available.

[20] Most ECCU countries have borrowed on the RGSM since the recent turbulence in world financial markets, with yields largely unchanged from pre-turbulence levels.

30. **Banking sector supervision has been strengthened significantly, but risks remain.** Stress tests indicate that while prudential indicators have improved, some indigenous banks remain vulnerable (Box 3). Key risks include high government exposures, as well as credit risk, exacerbated by potential under-provisioning. These weaknesses appear to have persisted over time, emphasizing the need for enforcement of the ECCB's strengthened regulatory powers. In this regard, resource constraints have adversely affected the frequency of the ECCB's onsite bank inspections, and further progress needs to be made toward enhanced capacity building and the establishment of a comprehensive risk-based supervisory framework. The staff emphasized the need to use the risk-based supervisory framework to target onsite inspections at vulnerable banks. Another area where more progress is urgently needed relates to enhanced supervision of cross-border financial flows, given the growing integration of Caribbean financial markets.[21]

31. **Rapid credit expansion calls for heightened supervision to ensure that the longstanding resilience of the ECCU banking system is not compromised** (Box 4).[22] Private sector credit has expanded rapidly in recent years, accompanied by sharp declines in NPL ratios as well as low loan provisioning levels (Table 5). As the experience in many other countries has shown, the improvement in prudential indicators may be largely temporary, reflecting growth in credit, unless there is an improvement in the underlying quality of loan portfolios. In the event that expectations of increasing tourist arrivals are not realized or real estate prices decline, the quality of bank assets could be impaired. The authorities considered this risk not to be significant on account of improved credit underwriting practices in the region's banks, as well as the ECCB's adoption of a prudential benchmark requiring NPL ratios not to exceed 5 percent. Moreover, the



Source: ECCB.

ECCU: Private Sector Credit
(Annual percentage change)

	2002	2003	2004	2005	2006	Sept. 2007
Antigua and Barbuda	8.0	2.4	1.1	10.4	20.4	18.4
Dominica	-1.4	-2.9	7.1	6.0	11.2	3.8
Grenada	1.1	4.1	6.8	9.2	12.5	15.6
St. Kitts and Nevis	-2.4	4.3	8.9	7.5	11.8	12.3
St. Lucia	0.8	-3.6	10.2	16.2	24.5	26.1
St. Vincent and the Grens	4.6	0.6	0.9	5.5	14.3	17.7

Sources: ECCB; and Fund staff calculations.

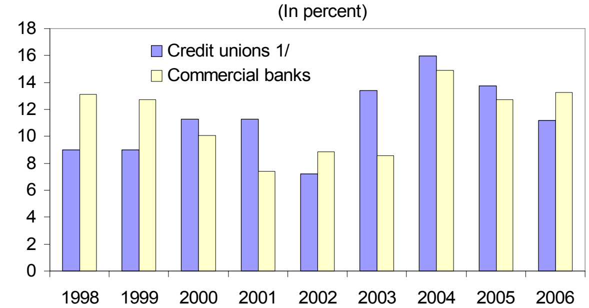
[21] The ECCB should also implement a risk-based approach to AML/CFT supervision, drawing on previous Fund (LEG)-provided technical assistance.

[22] See "How Vulnerable is the Eastern Caribbean Currency Union to a Banking Crisis?" by R. Duttagupta and P. Cashin, Chapter IV in *Eastern Caribbean Currency Union—2007 Selected Issues*.

authorities did not expect the weaknesses in the U.S. housing market to translate into diminished demand for real estate in the ECCU, given the increasing number of European investors attracted to the region due to ongoing currency depreciation.

32. **The rapidly-growing nonbank financial sector remains largely unsupervised.** Some insurance companies are reportedly offering high interest rates on time deposits, and assets of credit unions have been growing rapidly. All countries are planning to establish single regulatory units (SRU) for the nonbank financial sector, but so far Grenada is the only Fund-member country to have done so. The authorities shared the staff's view that establishing SRUs is a priority, and are committed to accelerate the passage of the enabling legislation, and ensure staffing by adequately-trained personnel.

ECCU: Growth Rates in Financial Sector Assets, 1998–2006
(In percent)



Sources: Caribbean Confederation of Credit Unions; Eastern Caribbean Central Bank; and World Council of Credit Unions.
1/ Growth rates for 1998 and 2000 have been interpolated from the data.

33. **Increasing dollarization in deposits will require enhanced risk management by banks.** Dollarization has increased following the suspension of ECCU exchange and capital controls in 2004, leading to a decline in commercial banks' coverage of liquid foreign currency liabilities. Thus, the observed increase in dollarization should not be indicative of a lack of confidence in the local currency. Nevertheless, the staff pointed out that given the growing cross-border flows as a result of liberalization and increased regional integration, the ECCB would need to develop guidelines to ensure that banks manage well the associated exposures and risks.

ECCU: Coverage of Liquid Foreign Currency Liabilities

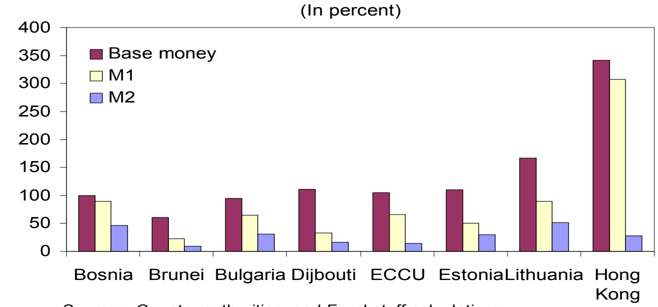
	2002	2003	2004	2005	2006	2007 1/
(In percent of liquid foreign currency liabilities)						
Liquid foreign currency assets	75.6	95.0	98.6	95.2	83.8	80.0
All foreign currency assets	84.8	103.8	107.2	106.1	98.8	90.1
In millions of EC dollars						
Liquid foreign currency liabilities	2,378	2,506	2,963	3,291	3,988	4,588

Source: ECCB.

1/ Data refer to end-September.

34. **The prudent management of reserve coverage by the ECCB has served the region well.** Staff and the authorities agreed that conducting an active monetary policy could dilute reserve coverage, limit the ECCB's potential lender of last resort capacity, and undermine the hard-earned credibility of the EC dollar's currency

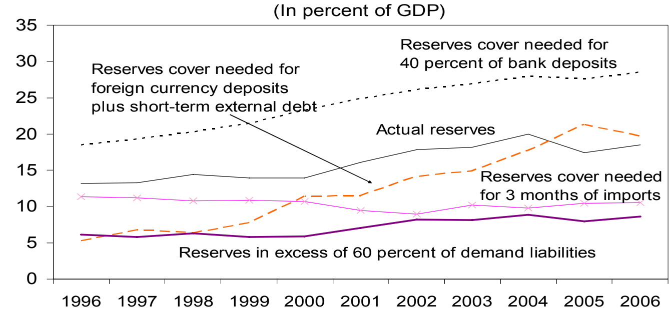
Foreign Reserve Coverage of Monetary Liabilities, 2005
(In percent)



Sources: Country authorities; and Fund staff calculations.

peg.[23] In this regard, operating like a traditional currency board arrangement (involving minimal lending to member governments and rising foreign reserve coverage), as the ECCB has done since the early 1990s, has helped in maintaining exchange rate and price stability, and in limiting any potential systemic impact during past episodes of banking sector stress. Staff enquired about plans to augment reserve coverage, as the ECCB's potential lender of last resort capacity is limited by the amount of reserves in excess of the minimum 60 percent requirement for backing of demand liabilities.[24] The ECCB viewed the current level of reserve coverage as broadly adequate for the purposes of its potential lender-of-last-resort role, noting that the banking system was dominated by large foreign banks, with limited systemic risk from local banks. The ECCB also pointed to the forgone investment costs associated with a further expansion of reserves, and explained that the authorities would examine other options for resolving bank stress and building depositor confidence, prior to stepping in as a lender of last resort.

ECCU: Optimal Level of Reserves Given Different Shocks
(In percent of GDP)



Source: Fund staff calculations.

35. **There is scope to improve the efficiency and effectiveness of regional capital markets**. Improvements in the legal and regulatory infrastructure of regional markets have the potential to reduce the cost of capital for borrowers and provide better risk allocations for investors. While the RGSM helps lower the costs of funds for member governments, trading on the Eastern Caribbean Securities Exchange (ECSE) is thin (Figure 11). Key areas for strengthening capital markets include:

- *Disclosure requirements.* Firms listing on the ECSE are required to report financial results only once a year, which contributes to information asymmetry and risk for market participants.

- *Credit information and legal infrastructure.* The World Bank's *Doing Business Indicators 2008* point to the lack of public or private credit registries and bureaus. Reforms are also needed to ease foreclosure laws and expand markets for collateral.

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[23] See "The ECCB: Challenges to an Effective Lender of Last Resort" by P. Druck and M. Dehesa, Chapter III in *Eastern Caribbean Currency Union—2007 Selected Issues*.

[24] At end-September 2007, these excess reserves amounted to about EC$810 million. Reflecting the deep monetization of the ECCU, this international reserve coverage is small relative to the banking system's private sector deposit liabilities (over EC$10 billion).

- *Cost of capital*. Steps to lower the cost of capital would include increased competition in the financial sector leading to a reduction in banking spreads, and the removal of the deposit floor in the banking sector.
- *Listing requirements and transaction costs.* Minimum capital requirements for listing on the ECSE are the highest in the Caribbean. Transaction costs and bid-ask spreads are also very high, deterring trading activity and contributing to thinness in the market.
- *Alien land holding restrictions.* In ECCU jurisdictions, licenses are required for nonresidents to purchase shares in companies that own land. There is a move to exempt shares purchased on the ECSE from these requirements, but legislation remains to be approved in four countries.
- *Credit ratings.* Caribbean capital markets are largely dominated by sovereign debt securities, yet many do not carry any credit ratings. Credit ratings for sovereigns (including through a regional ratings agency) could help establish pricing benchmarks and yield curves for local capital markets.[25]

C. Reducing Vulnerabilities

36. **While the medium-term outlook for the ECCU region appears favorable, it remains vulnerable to exogenous shocks.** Growth is expected to remain above potential and moderate in the medium term as construction activity winds down. In addition, under current policies, fiscal consolidation is expected to be limited and public debt levels will increase slightly. Major vulnerabilities include: high public debt; further erosion of trade preferences; the region's exposure to natural disasters; population ageing; reliance on high-priced energy imports; and dependence on tourism.

Fiscal imbalances and debt sustainability

37. **A fundamental overhaul of government expenditures is needed to achieve fiscal sustainability and preserve the stability of the currency union**. Sustained weakness in fiscal performance has led to high levels of indebtedness, potentially undermining the stability of the currency union. While revenue measures are being undertaken in many ECCU countries—in particular, introduction of VATs, market-valuation based property taxes, flexible fuel pricing, and strengthened tax administration—expenditures are also rising, limiting progress with fiscal consolidation (Figure 15).

38. **The ECCB's revised fiscal benchmarks have yet to be made operational.** In mid-2006 the ECCB's Monetary Council agreed to a revised system of fiscal benchmarks that

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[25] In mid-December 2007, Moody's Investor Services assigned a rating of B1 for long-term foreign and local-currency issuances of St. Vincent and the Grenadines.

places increased emphasis on integrating annual budget objectives with the medium-term goal of reducing public debt to 60 percent of GDP by 2020. However, national authorities have yet to take decisive ownership of the revised benchmarks as key guideposts for national fiscal policies. They expressed little desire for an enforcement mechanism based on economic sanctions to assist in achieving the benchmarks, with a clear preference for peer review and enhanced transparency. The staff encouraged the authorities to establish appropriately ambitious, yet achievable, annual budget targets set within multiyear macroeconomic frameworks, consistent with the revised ECCU benchmarks. The targets should be published and allow for adverse shocks by aiming for stronger fiscal consolidation in periods of above-average growth.

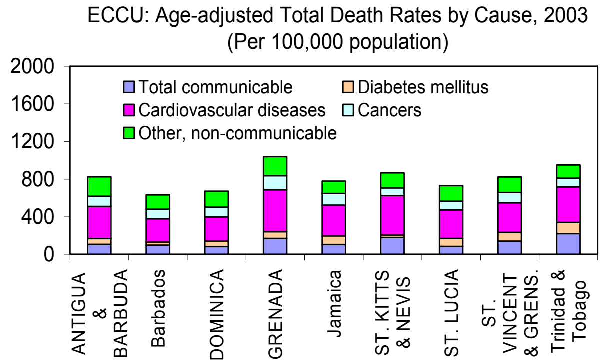
39. **The ECCB Monetary Council's recent decision to establish a Public Expenditure Commission is a welcome step, and can help forge regional consensus on expenditure priorities and the role of government.** Analogous to the positive experience with the earlier OECS Tax Reform Commission, a broad social dialogue should help establish expenditure priorities consistent with available fiscal resources and the overarching importance of fiscal prudence. Staff noted that the Commission could usefully examine: the optimal role of government, scope for civil service reform and privatization; instruments to better target social safety nets; and ways to better prioritize capital spending with optimal utilization of grant financing and strengthening of PSIP processes. Regional provision of government services could be an important source of efficiency gains, as envisaged under the OECS Economic Union, provided there are corresponding economies in government services at the national level.

40. **The authorities expressed concern that fiscal adjustment alone would be inadequate to ensure debt sustainability in the region.** Several of the national authorities perceived the magnitude of fiscal adjustment required to achieve the ECCB benchmarks as daunting, and perhaps not socially feasible. They explained that while many fiscal measures had been undertaken, vulnerabilities to natural disasters, trade preference erosion, and infrastructure requirements had created social and capital spending needs that could not be deferred. To address the debt situation, they considered that the region would need to formulate debt strategies, seek assistance from debt advisors to conduct comprehensive reviews and management of their debt stock, as well as tap debt relief wherever possible.

Ageing and social spending

41. **Ensuring adequate health care coverage will require a multi-pronged and innovative approach to contain costs and manage outcomes** (Figure 16). Due to rapid population ageing and changing lifestyles, the incidence of non-communicable diseases (such as heart disease, diabetes, and hypertension) is rising in the ECCU. The region's health care systems are largely publicly financed, and although there are pressures to move towards

universal health care, the authorities are concerned about the fiscal costs this may entail.[26] They are considering a multi-pronged approach, including promoting healthier lifestyles; improving preventive primary and secondary health care; and regional sharing arrangements in the provision of tertiary and capital-intensive medicine, in order to exploit economies of scale. Alternative financing options being considered for higher healthcare spending include an increase in the VAT rate, as well as private insurance and well-targeted user fees.[27]



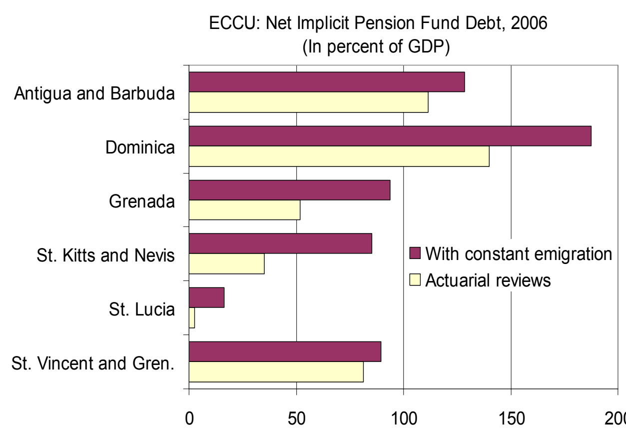
Source: World Health Organization.

42. **Action is needed to ensure the sustainability of social security systems.** Governments in the region have used social security funds as a captive source of financing (at below market rates of interest), which has exacerbated the impact of rapid population ageing and high emigration. As a consequence, social security systems have large unfunded liabilities, and their reserve assets are projected to be depleted soon in several countries.[28] Parametric adjustments to social security schemes (increasing the retirement age and contribution rates, changing the benefits formulae), as well as greater international portfolio

ECCU: Projected Year of Pension Fund Reserve Asset Depletion

	Scenarios		
	Actuarial Reviews	With Emigration 1/	Using Only Private Performing Assets
Antigua and Barbuda	2029	2027	2011
Dominica	2033	2029	2022
Grenada	2046	2038	2034
St. Kitts and Nevis	2053	2044	2030
St. Lucia	2064	2059	2052
St. Vincent and Grenadines	2030	2024	2021

Sources: Actuarial reviews; financial statements; and Fund staff estimates.
1/ This projection assumes constant emigration at historical levels.



Sources: Actuarial reviews; financial statements; and Fund staff estimates.

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[26] Universal health care is currently available in Antigua and Barbuda and entails the free provision to all residents of health services related to a specified list of common diseases. St. Kitts and Nevis and St. Lucia are currently considering health care reforms.

[27] See "Financing Universal Healthcare: Lessons for the Eastern Caribbean and Beyond" by E. Tsounta, Chapter VIII in *Eastern Caribbean Currency Union—2007 Selected Issues*.

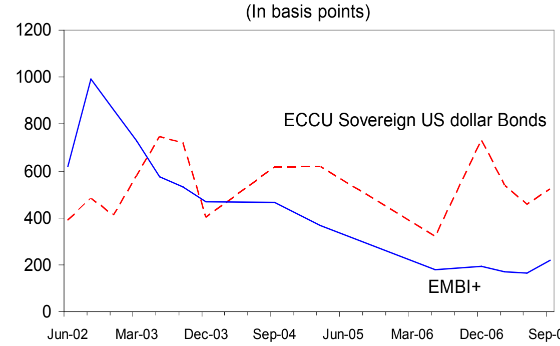
[28] See "Can the ECCU Afford to Grow Old?" by H. Monroe, Chapter VII in *Eastern Caribbean Currency Union—2007 Selected Issues*.

diversification of scheme assets, are essential to ensure the long-term viability of social security. Staff were encouraged by reforms already enacted in Dominica and St. Lucia, and those under active consideration by other governments (such as St. Vincent and the Grenadines). The current political momentum should be used to enact the necessary reforms as soon as possible, as well as to address the issue of noncontributory double pensions for civil servants in some ECCU countries. Staff also welcomed the ECCB Monetary Council's establishment of a Social Security Commission, to spearhead work on this important issue.

Financing issues

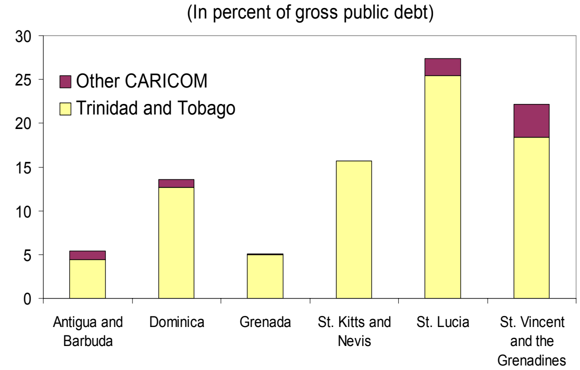
43. **The high debt and debt servicing burdens of ECCU countries make them vulnerable to a tightening in global liquidity conditions.** Enhanced debt management capacities could help in managing such vulnerabilities. Staff pointed out that ECCU governments have increasingly borrowed on commercial terms in Trinidad and Tobago and other CARICOM countries (Table 6). Interest rate spreads for such borrowing have not followed the decline of emerging market spreads in recent years, probably reflecting the region's elevated debt levels as well as the impact of debt restructurings. As global liquidity conditions tighten and world interest rates rise, it may become more difficult and burdensome for ECCU governments to borrow commercially. The authorities agreed that rising interest rates could pose a challenge in an already difficult fiscal situation. They emphasized the need for Fund technical assistance to enhance debt management capacity—as planned for St. Lucia and St. Kitts and Nevis—to improve cash flow budgeting, extend debt maturities, and replace more expensive debt with cheaper debt.

ECCU: Sovereign Bond Spreads in Trinidad and Tobago 1/
(In basis points)



Sources: Bloomberg; Caribbean Money Market Brokers; and Fund staff calculations.
1/ Spreads are computed relative to U.S. bonds of comparable maturities.

ECCU: External Borrowing from CARICOM, End 2005
(In percent of gross public debt)



Source: Fund staff calculations.

44. **Grants from donors need to be utilized optimally, with better prioritization of capital projects.** In recent years, ECCU countries have been able to access concessional loans and grants from nontraditional donors (including China, Taiwan Province of China, Cuba, Mexico, and Venezuela) to finance large-scale capital investments, in addition to grants from the European Union (EU) and loans from the Caribbean Development Bank (CDB). Trinidad and Tobago has created a Petroleum Fund which has provided disaster relief

to Grenada and grants to support LIAT (the region's state-owned airline), and Venezuela has established an Alba-Caribe Fund to provide grants to recipient countries, in addition to the concessional oil import financing arrangement under PetroCaribe. However, PSIP processes in ECCU countries are weak, with little economic evaluation or prioritization of projects. To optimize the grant assistance, donor-funded projects need to be carefully evaluated, prioritized, and properly phased based on a revamped formal PSIP mechanism. The staff also recommended that ECCU governments draw on CDB and World Bank expertise to evaluate the efficacy of all PSIP-listed projects.

Preference erosion and donor assistance

45. **The decline in preferential access to EU markets has had an adverse impact on rural populations and social stability in ECCU countries.** The region's banana sector is likely to continue to contract due to competitive pressures and the erosion of trade preferences in European markets (following the conversion of EU quotas into tariffs in January 2006). St. Kitts and Nevis closed its sugar industry in 2005. The staff emphasized the need to create appropriate and well-targeted safety nets for displaced farmers and agricultural workers, focusing on time-bound measures such as income transfers, retraining programs to promote alternative employment, noncontributory pensions, and limited subsidies on agricultural inputs (to encourage agricultural diversification). Fund technical assistance will review the impact of preference erosion on poverty in the Windward Islands, through a FAD Poverty and Social Impact Analysis in early 2008.

46. **The ECCU region continues to be frustrated with traditional development partners**. The authorities were particularly concerned about the European Union's (EU) slow disbursement of previously-committed development funds, aimed at mitigating the adverse impact of trade preference erosion and facilitating the transition out of agriculture.[29] They also regretted the World Trade Organization's insistence on accelerated erosion of EU trade preferences, and the retreat of many developed-country donors from the region. The authorities generally agreed with the mission's recommendations on easing the transition of the ECCU economies from agriculture to tourism, but stated that donor financing for investment in health, education and social spending had fallen sharply, just at the time it was most needed. Given the large amount of undisbursed EU assistance, the staff strongly encouraged ECCU countries to work with the EU on developing ways to unlock these funds. In a positive step, on December 16, 2007 the EU and CARICOM countries agreed to a new

[29] Although banana production in the Windward Islands is small as a share of GDP, the sector employs significant rural populations. Donors (principally the EU and CDB) have offered assistance to facilitate the social and economic transformation of the ECCU economies away from (banana and sugar) agriculture. See also "The Macroeconomic Impact of Trade Preference Erosion on the Caribbean," Chapter III of *Caribbean—Selected Regional Issues: Background Paper*, SM/07/320.

Economic Partnership Agreement (EPA), the first between the EU and any ACP region, which will come into force on January 1, 2008.[30]

ECCU: Status of EU Banana Support (Special Framework of Assistance), End-September, 2007

	Dominica			Grenada			St. Lucia			St. Vincent and the Grens.		
	Amount Committed	Amount Disbursed	Percent Disbursed	Amount Committed	Amount Disbursed	Percent Disbursed	Amount Committed	Amount Disbursed	Percent Disbursed	Amount Committed	Amount Disbursed	Percent Disbursed
	(In € million)			(In € million)			(In € million)			(In € million)		
1999	6.6	3.9	59.1	1.0	0.5	50.0	8.7	6.7	77.0	6.3	4.7	44.7
2000	6.5	0.4	6.2	0.5	0.4	80.0	8.9	6.7	75.3	6.5	3.4	5.6
2001	6.7	3.4	50.7	0.5	0.4	80.0	9.4	4.2	44.7	6.4	1.4	21.2
2002	6.4	1.8	28.1	0.5	0.0	0.0	8.8	1.3	14.7	6.1	1.4	23.0
2003	5.9	1.8	30.5	0.5	0.1	24.0	8.0	2.1	25.7	5.6	1.7	29.5
2004	5.3	0.0	0.4	0.5	0.2	45.0	7.3	0.0	0.1	5.3	1.7	31.4
2005	4.5	1.3	28.9	0.5	0.1	27.4	6.2	0.0	0.0	4.5	0.3	7.0
2006	3.8	0.0	0.3	0.5	0.0	0.0	5.4	0.0	0.0	3.9	0.0	0.0
2007	3.3	0.0	0.3	0.5	0.0	0.0	4.6	0.0	0.0	3.3	0.0	0.0
Total	**49.0**	**12.6**	**25.8**	**5.0**	**1.8**	**36.0**	**67.3**	**21.0**	**31.1**	**47.9**	**14.5**	**30.3**

Source: Delegation of the European Commission, Barbados.

Natural disasters

47. **Natural disasters continue to constitute a significant risk to the region.** A variety of natural disasters afflict the region, including tropical storms and hurricanes, earthquakes, volcanoes, floods and storm surges (Figure 1). ECCU countries are among the most disaster-prone in the world, and the socio-economic impact of disasters is aggravated by weakness in disaster mitigation and preparedness, including underinsurance of public and private sector assets. The authorities considered that progress had been made with respect to insurance of revenue streams through the World Bank-facilitated Caribbean Catastrophe Risk Insurance Facility (CCRIF). However, they argued that the operation and modalities of the CCRIF need to be reviewed, given the disappointing experience with the noncoverage of agricultural sector losses in the Windward Islands arising from Hurricane Dean.[31] In addition to the CCRIF, staff encouraged the authorities to build up contingency funds, that could be drawn upon in the event of more frequent natural disasters. Disaster mitigation through strengthening building codes, greater insurance of public infrastructure, developing disaster response plans, and bolstering disaster response agencies can reduce disaster-related losses, and should be developed further.

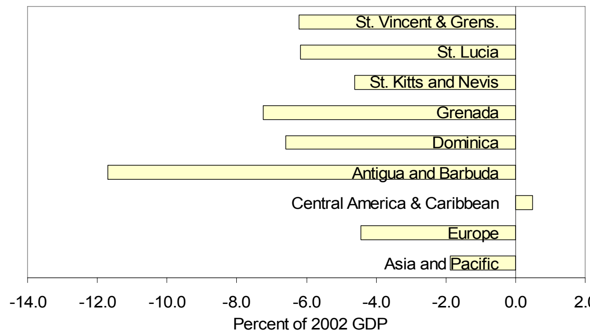
[30] Trade between the Caribbean ACP countries and the EU is currently governed by the 2000 Cotonou Agreement—which provides a waiver for trade preferences granted to ACP countries that is due to expire at end-2007. The new EU-Caribbean EPA will allow Caribbean goods to enter the EU duty free from January 2008, while there is a phased period of between 3–25 years for European goods to enter Caribbean markets duty free.

[31] No Caribbean country received compensation from the CCRIF for Hurricane Dean, as wind speeds did not reach the required thresholds. In contrast, the earthquake of late-November 2007 is likely to trigger a payment under the CCRIF to Dominica and St. Lucia of about US$0.5 million each. In November, 2007 Dominica requested a purchase under the Fund's policy on Emergency Assistance for Natural Disasters, in the wake of Hurricane Dean.

Oil prices

48. **ECCU countries are highly dependent on oil and energy imports, and have experienced a large adverse terms of trade shock due to the rise in world oil prices.** Some ECCU countries have implemented the ECCB Monetary Council's 2005 recommendation to adopt a flexible fuel pricing mechanism (Dominica, Grenada, and St. Kitts and Nevis), while other countries have opted for ad hoc price adjustments (often at long intervals).[32] A move toward a flexible fuel pricing mechanism for the latter countries would help alleviate fiscal costs, and, more broadly, facilitate adjustment by promoting conservation and constraining domestic consumption (Figure 17). The authorities agreed with the need to protect fiscal positions, but were also concerned about smoothing domestic consumption. The PetroCaribe Agreement with Venezuela, involving concessional financing to cover 40 percent of the cost of fuel imports, has had only limited impact in the ECCU, as fuel imports remain constrained by storage and transportation problems.

ECCU: First -Round Current Account Impact of Changes in Oil Prices, Cumulative 2000–06

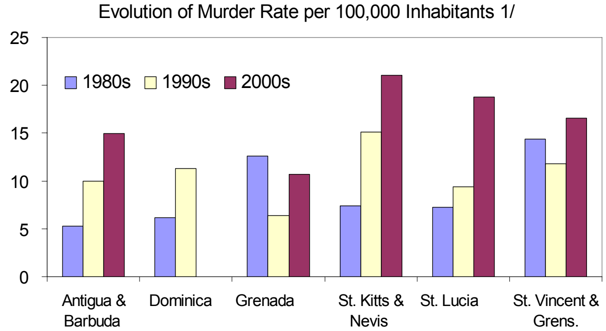


Source: IMF, World Economic Outlook.

Crime

49. **Combating crime has become a growing issue for tourism, and is a key priority for ECCU policymakers.** The authorities acknowledged that rising criminality is a potentially serious threat to tourist arrivals. Governments are taking a comprehensive approach to the problem, tackling the social context with programs for disaffected youth, strengthening law enforcement agencies and improving information sharing across the region.

Evolution of Murder Rate per 100,000 Inhabitants 1/



Sources: National Police Departments; Interpol, United Nations Surveys of Crime Trends; and World Health Organization.

1/ Average for available years. No data are available for the 2000s for Dominica.

IV. Capacity Building

50. **Implementing the region's reform agenda will require substantial technical assistance and capacity building.** While progress is being made in enhancing institutions, the authorities acknowledged weaknesses and sought additional technical assistance in key

[32] These countries have a consumption tax on petroleum products, but in recent years the government has absorbed the additional cost of higher world oil prices in order to peg the retail price of fuel.

areas such as tax administration (including customs), public expenditure management (particularly public sector investment planning); and debt management. The staff encouraged the authorities and donors to address key institutional constraints at the regional level and set priorities for future technical assistance. The authorities welcomed the technical assistance provided by the Fund, donors and particularly CARTAC in supporting both the design and implementation of key measures (Box 5).[33]

51. **Efforts are underway to improve data quality, including timeliness and dissemination of statistical information.** The ECCB has taken several initiatives to strengthen its statistical capacity, including implementing many recommendations of the 2007 monetary statistics ROSC. However, data weaknesses are a key constraint on effective policymaking and surveillance. Particular concerns relate to data on consumer prices; the coverage of tourism and FDI in the national accounts and balance of payments; noncentral government revenues and expenditures; public sector debt; private sector capital flows; the international investment position, and labor market and social indicators. The staff urged the national and regional authorities to bolster statistical practices and data management, and increase budgetary resources devoted to these tasks. In the wake of an International Conference on Statistics in September 2007 (co-sponsored by the ECCB and the Fund), an initiative is being launched to create an integrated regional statistical system for the ECCU.

V. Staff Appraisal

52. **Economic growth in the ECCU region has been strong, and the challenge is to sustain this performance in 2008 and over the medium term.** Significant expansion in tourism-related construction, sporting facilities, and public infrastructure associated with the 2007 Cricket World Cup underpinned the recent growth surge. While a soft landing of the ECCU economy in 2007–08 appears likely, there are significant downside risks, including from continuing high world energy and food prices, shrinking trade preference and development assistance flows, a slowing world economy, and rising public debt and debt-servicing costs.

53. **The authorities remain strongly committed to the fixed exchange rate regime, and its level appears broadly consistent with external stability.** Notwithstanding a recent up tick of inflation, the exchange rate peg has been a strong anchor for prices and expectations, which has contributed to the economic and financial development of the region, and enjoys wide popular support. Staff analyses indicate that the EC dollar is close to its equilibrium level, international reserve coverage of monetary liabilities continues to rise, and large new private construction investment in tourism points to continuing strong prospects in this key sector of the economy. The ECCU balance of payments position appears consistent with external stability—while current account deficits are projected to remain high for an

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[33] Detailed descriptions of the assistance provided by CARTAC, the World Bank, and the CDB are contained in the Informational Annex.

extended period, capital flows and current account imbalances will decline over the medium term. Both tourism-sector investment and current account imbalances will continue to be financed largely by FDI.

54. **Fiscal and debt positions need to be brought to more sustainable levels.** Disappointingly, the above-trend regional growth of the recent past and debt restructurings in several ECCU countries have engendered only a modest reduction in the region's high public debt stock. Overall fiscal deficits remain high, and the increasing burden of debt servicing is limiting the fiscal space for undertaking much-needed social and poverty-reduction spending. Key fiscal goals include:

- *Governments need to make good on their commitments to fiscal consolidation by achieving the ECCB's revised fiscal benchmarks.* A strong and transparent link needs to be established between achievement of the ECCB's medium-term benchmark and the setting of national fiscal policies.

- *Complete and sustain revenue reforms.* Tax systems have been strengthened and tax bases broadened throughout the region, and staff encourage countries to complete the reforms, in particular by introducing VATs and more flexible domestic fuel pricing. To ensure the integrity of consumption taxation, it is vital to avoid weakening the new VATs through exemptions and tax concessions.

- *Role of government and expenditure reforms.* The ECCB Monetary Council's recent decision to establish a Public Expenditure Review Commission is a welcome step, as it should help in forging a regional consensus on expenditure priorities and the role and size of government. Greater prioritization of capital spending and civil service reform are key to expenditure consolidation, while allowing for strengthened social safety nets.

- *Debt management.* Capacities need to be enhanced to manage the vulnerabilities arising from high debt-servicing burdens and tightening global liquidity conditions.

55. **Structural reforms are needed to raise the region's growth potential and competitiveness.** Enhanced competitiveness is most durably achieved by strengthened structural reforms designed to raise productivity in the production of both tradables and nontradables. Priority should be given to growth-enhancing measures that secure long-term fiscal savings, increase the flexibility of labor and product markets, improve the investment climate, and lower the cost of capital. Fiscal consolidation is not only fundamental to enhancing competitiveness, but also necessary to maintain external stability and provide support to the currency board arrangement.

56. **Financial sector supervision continues to be strengthened, but vulnerabilities remain.** Given the rapid growth in private sector credit, credit quality and risk management in banks warrant close monitoring. Although supervision of the banking system has been enhanced, further progress is needed in strengthening the risk-based supervisory framework

and targeting onsite inspections to vulnerable banks. Supervision of the rapidly-growing nonbank financial sector should also be bolstered, primarily through the establishment of single regulatory units in all ECCU jurisdictions.

57. **Transparency of public policymaking continues to be enhanced, yet weaknesses in the coverage, quality, and dissemination of statistics constitute major hurdles to effective economic management.** Staff welcomes the growing efforts in many ECCU countries to increase transparency, consult, and foster public consensus on reforms. Staff shares the authorities' concern that data deficiencies compromise the quality of policy analysis and design, and urges improvements particularly in the data on consumer prices, the national accounts, noncentral government fiscal accounts, and debt stocks. The recent initiative to strengthen regional collaboration in data collection, analysis and dissemination is well placed.

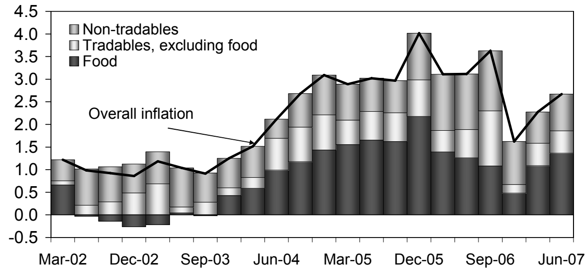
58. **The economies of the ECCU are at a crossroad**. The overarching goal is to build on the economic success of the period since 2001 to entrench high growth, increase the flexibility of the ECCU economies and enhance their resilience to external shocks. Key factors in the achievement of durable strong growth will be disciplined national fiscal policies, structural reforms to bolster competitiveness, and continued strengthening of national and regional institutions. The nascent OECS Economic Union provides an important opportunity to enhance regional coordination and integration, further liberalize factor and product markets, and improve the efficiency of the region's decision-making structure.

59. **It is proposed that the next discussion on ECCU common policies takes place in 12 months.**

Box 1. Recent Inflationary Pressures in the ECCU

Recent inflationary pressures in the ECCU have been mostly driven by developments in the external environment, including: rising world food prices; the continued depreciation of the U.S. dollar against major currencies; and the pass-through of higher world oil prices. The introduction of the VAT system in Antigua and Barbuda (January 2007) and St. Vincent and the Grenadines (May 2007) also had one-off impacts on the CPI level. Accordingly, most of the recent inflationary pressures are reflected in increases in prices of tradable goods.

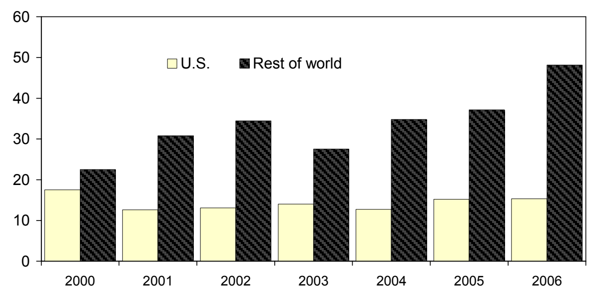
ECCU: Contribution to Overall Inflation, 2002–07 1/



Sources: ECCB; and Fund staff calculations.
1/ Tradables in the ECCU comprise food, alcoholic drink and tobacco, fuel and light, clothing and footwear, household and furniture equipment; non tradables include medical care and expenses, education, personal services, housing and utilities, miscellaneous and transportation and communication.

Variations in measured inflation across the region partly reflect the lack of a harmonized CPI basket. In particular, the weight of food in CPI baskets differs across the ECCU countries. Thus, inflation measures may understate the true cost of living increases in some countries.

ECCU Imports by Partner, 2000–06 1/
(In percent of GDP)

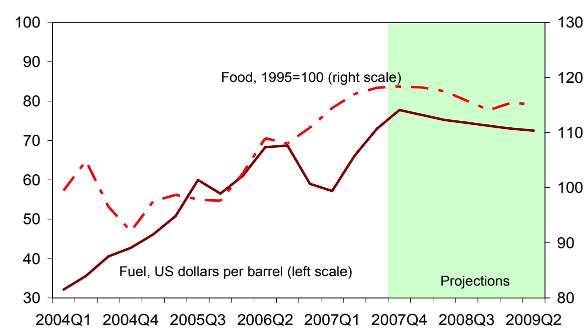


Source: IMF's Direction of Trade Statistics.
1/ Excludes Antigua and Barbuda.

The continued depreciation of the U.S. dollar against major currencies has affected the cost of non-U.S. imports to the ECCU. During the period January to November 2007 the U.S. dollar depreciated by 11¼ percent against the euro. Between December 2001 and September 2007, the EC dollar REER depreciated by almost 14 percent.

High fuel prices are also causing inflationary pressures, but pass-through has been limited in some countries. Fund staff calculations suggest that prices in most ECCU countries, with the exception of Antigua and Barbuda and Dominica, experience a less-than-full pass-through from high oil prices. For the period 2004–06, pass-through coefficients ranged from close to 1 in Antigua and Barbuda and Dominica to 0.3 in Grenada and St. Lucia—the small coefficient reflecting limited retail fuel price adjustments in response to oil price fluctuations.

World Price Indices for Food and Fuel, 2004–09



Source: IMF, World Economic Outlook.

Inflationary pressures are expected to moderate going forward. WEO projections suggest moderate declines in fuel and food prices, which should be reflected in diminishing inflationary pressures in the ECCU.

Box 2. OECS Economic Union

The Forty-Fifth Meeting of the OECS Authority in May 2007 approved a draft Treaty on OECS Economic Union, to pave the way for the creation of a single economic and financial space. Heads of Government also agreed to begin in early 2008 an intensive process of public education and consultations on the new Treaty, which is expected to be completed within one year. Once the necessary revisions are made following the consultations, the OECS Economic Union Treaty will replace the Treaty of Basseterre (which established the OECS in June 1981).

The Treaty involves additions to the decision-making and consultative organs of the OECS. The new governance structure will comprise: (i) *an OECS Authority*—the supreme policy-making organ of the OECS with responsibility for the general direction and performance of the OECS. It will comprise Heads of Government and have powers to legislate in well-defined selected areas, with binding effect on OECS member states; (ii) *an OECS Assembly*—comprising government and opposition representatives of national parliaments and legislatures, to whom pending legislation will be referred for debate (acting as a legislative filter) and to whom annual statements from regional institutions could be directed to; (iii) *the Council of Ministers*—to be charged with preparing subsidiary legislation and issuing related regulations in OECS member states; (iv) *the Economic Affairs Council*—comprising ministers with the responsibility for overseeing the Economic Union Protocol; and (v) *an OECS Commission*—to incorporate the current OECS Secretariat as its administrative arm, responsible for the general administration of the OECS, including providing secretariat services to the organs of the OECS, preparing draft legislation for the approval of the Authority, and monitoring the implementation of acts and regulations. The OECS Commission will be the critical link between the member countries and the arrangements at the regional level and will be chaired by the Director-General.

The Treaty's objectives would be facilitated by abolishing the barriers to free movement of persons, services, and capital. In addition to the creation of an Economic Union-wide labor market, protocol provisions include the progressive harmonization of investment and development policies; the progressive harmonization of taxation policies and incentive legislation, including setting up fiscal and debt benchmarks which would be reported and published on an annual basis by the Monetary Council; and the elimination of custom duties and quantitative restrictions.

The Treaty is part of a continued process of integration and cooperation among the OECS countries. Existing OECS institutions include the Eastern Caribbean Supreme Court; the Eastern Caribbean Central Bank; and the Eastern Caribbean Civil Aviation Authority. Existing regional markets include an interbank market; a Regional Government Securities Market; an Eastern Caribbean Securities Market; and an Eastern Caribbean Secondary Mortgage Market. There is also joint regulation for banking and securities, telecommunications and civil aviation; joint procurement of pharmaceuticals; and joint diplomatic representation in some countries. The ECCB is currently promoting other institutions including the Eastern Caribbean Enterprise Fund, the Eastern Caribbean Unit Trust and an Eastern Caribbean Statistics network to assist with the dissemination of statistical information.

Box 3. Banking System Vulnerabilities and Results of Stress Tests

The ECCU banking system is well-capitalized, but vulnerabilities are concentrated in local (indigenous) banks. Deposits held with indigenous banks comprise about 60 percent of total deposits. In recent years, as credit has expanded rapidly and the ECCB has put in place a benchmark requiring banks to limit their NPLs to no more than 5 percent of their total loans, NPL ratios have declined. The indigenous banks appear well-capitalized: the capital adequacy ratio (CAR) stood at 19.2 percent at end-September 2007, more than double the 8 percent prudential requirement. However, the capital adequacy of these banks may be overstated by potential under-provisioning. Indigenous banks also have much higher exposures to government, possibly reflecting moral suasion or the lack of suitable investment opportunities.

ECCU: Financial Soundness Indicators, September 2007
(in percent)

	Capital Adequacy 1/	NPLs/ Total Loans 2/	Provisioning/ NPLs 2/	Gross Government Exposure/ Total Assets	Largest Sector/Total Loans
Aggregate banking system	…	6.8	30.4	13.6	47.6
Foreign branches	…	4.9	38.9	6.1	51.3
Locally incorporated	19.1	8.4	26.2	19.4	44.5

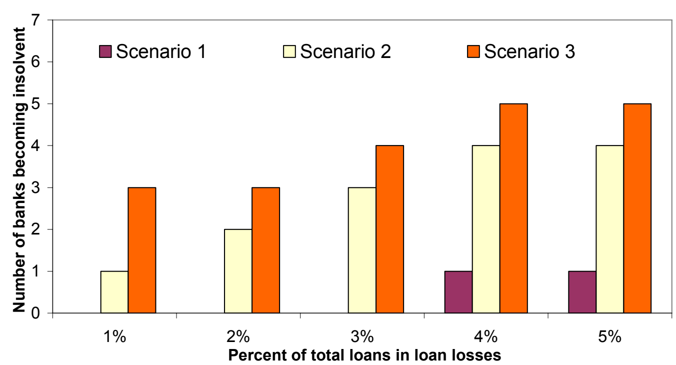
Sources: ECCB; and Fund staff calculations.

1/ The foreign branches have consolidated capital positions with their parent banks in Canada and Barbados.
2/ Non-performing loans.

The high levels of government exposures and NPLs have so far not translated into financial sector instability. The resilience of the ECCU banking system has been due in part to inflows of insurance payments and external assistance in the aftermath of natural disasters, which have helped to maintain liquidity. Sovereign debt restructurings in Dominica and Grenada have been designed to minimize the impact on the domestic banking system. Public confidence in the banking system has also been supported by the strong presence of foreign banks, as well as the credibility of the ECCB.

Stress tests confirm the vulnerability of indigenous banks to high levels of government exposures and credit risk. Banks in the region could be vulnerable to government sector defaults and/or disruptions in the tourism sector, in the context of sovereign debt restructurings, hurricanes, or a security event (such as September 11). Although the impact would be more severe in some countries than in others, an adverse shock that results in an additional 5 percent of total loans in loan losses and a 10 percent nonrepayment in government obligations (scenario 2), could lead to the insolvency of 4 of the ECCU's 17 indigenous banks. Region-wide, affected banks would account for over 9 percent of total deposits. The impact of possible under-provisioning is simulated by assuming that recovery rates would also be lower than provisioning by a modest 10 percent of NPLs (scenario 3). This raises to 5 the number of banks that would become insolvent.

Sensitivity Analyses, Indigenous Banks, end-2006



Note: Scenario 1 models the impact of increased loan losses (in percent of total loans); scenario 2 adds the non-repayment of 10 percent of government exposure to scenario 1; scenario 3 incorporates the impact of underprovisioning of 10 percent of NPLs to scenario 2.

Box 4. How Vulnerable is the ECCU to a Banking Crisis?

The ECCU banking system has been extremely resilient, despite being subject to many shocks. Vulnerabilities include: economic downturns triggered by natural disasters, shocks to tourism, sharp declines in the terms of trade, as well as significant exposures to their highly-indebted governments. A natural question is: what underpins the stability of the ECCU banking system?

To shed light on this question, staff analyzed a sample of 50 emerging market countries including the ECCU during 1990–2005, using a binary classification tree technique. This technique is able to identify the key predictors of banking crises, as well as the thresholds beyond which the predictors increase the probability of a banking crisis.[1/] The results identify the following conditions which increase the crisis-proneness of banks: (i) very high inflation; (ii) highly dollarized bank deposits combined with nominal depreciation or low bank liquidity; and (iii) low bank profitability, in particular, from interest income.

Applying these results to the ECCU confirms that financial stability in these countries is underpinned by the exchange rate and price stability offered by the quasi-currency board regime.[2/] Other factors that have also helped preserve the ECCU banking system include: relatively high interest income profitability (proxied by the interest rate spread), relatively low dollarization of deposit liabilities (proxied by the ratio of foreign currency deposits to official foreign currency (imputed) reserves), and relatively high liquidity (proxied by the share of private credit to deposits, where a higher ratio implies lower liquidity).

However, some ECCU countries have occasionally experienced bank stress (see below), but this did not trigger crises because the vulnerabilities did not occur in combination with other weaknesses or shocks such as nominal depreciation. The analysis corroborates the importance of the quasi-currency board arrangement in upholding the stability of the ECCU banking system. It also stresses that banking system weakness can be reduced further by lowering the risks related to excessive exposure to foreign currency liabilities or excessive credit growth.

Key Vulnerabilities Underlying Banking Crises	ECCU Episodes Since 2000
Macroeconomic instability: Inflation > 18.7%	None
Low profitability: Interest rate spread ≤ 3.1%	None
Foreign currency risk (1): Nominal depreciation > 9.1%	None
Foreign currency risk (2): foreign currency deposits/official FX (imputed) reserves > 140%	St. Kitts and Nevis (2001–05)
Low liquidity: private credit/deposits > 150%	None, but St. Lucia close in 2000–03 (ratio > 100%)

1/ See Duttagupta, R. and P. Cashin, "Anatomy of Banking Crises: A Binary Classification Tree Approach," IMF Working Paper (2008, forthcoming).

2/ The ECCU countries in the sample include: Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

Box 5. ECCU: Technical Assistance from the Fund in 2007 and 2008

The ECCU will continue being an intensive user of CARTAC (backstopped by the Fund) and Fund technical assistance (TA). The following support has been provided or is envisioned:

Tax and customs reform: Assistance with post value-added tax (VAT) implementation in Antigua and Barbuda, Dominica, and St. Vincent and the Grenadines. Assistance with near-term implementation of VAT in St. Lucia, St. Kitts and Nevis, and Grenada (CARTAC, FAD, LEG). Assistance with custom reforms in Grenada and St. Vincent and the Grenadines in early 2008 (CARTAC); as well as a full revenue administration assessment in the latter country. Similar assessments have just been completed in St. Kitts and Nevis and St. Lucia.

Pension reform: A study has been completed examining policy changes to strengthen the social security scheme and civil service pensions in St. Vincent and the Grenadines (FAD).

Debt management: Assistance for strengthening the quality and operations of national debt management, and the scope of debt data, in St. Kitts and Nevis and St. Lucia (MCM).

Public finance management: At the request of the ECCB, CARTAC provided TA to ECCU member countries in developing and implementing their own home-grown programs aimed at achieving a set of fiscal/debt targets by 2007. A review of the budget system was conducted in Antigua and Barbuda and St. Lucia in Fall 2007 (CARTAC); advanced internal audit training is scheduled for St. Lucia, Dominica, St. Vincent and the Grenadines, and Grenada (CARTAC).

Other capacity building: Regional training courses on the IT accounting system and the CARICOM Tax Treaty; a regional workshop on tax administration IT applications and systems to address the Caribbean region's medium-term needs (CARTAC, ECCB, and CARICOM); continued work in the establishment of a regional customs (ASYCUDA IT-based) service center in St. Lucia (CARTAC, and CARICOM).

Development of regional financial markets: Assistance to facilitate the establishment of an overnight repo facility and the functioning of the interbank market (MCM).

Monetary statistics: Assistance in the implementation of the *Manual on Monetary and Financial Statistics* and, in particular, in the compilation and reporting of monetary data based on the standardized report forms (STA).

Preference erosion: PSIA in early 2008, to identify the most vulnerable groups and assist in the design of a transition strategy (FAD).

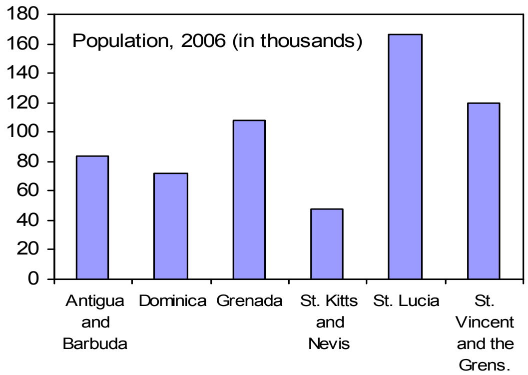
Economic and financial statistics: Ongoing assistance in compiling supply and use tables in all ECCU countries; the launch of a project for the compilation of tourism statistics in the last quarter of 2007 (both CARTAC); assistance in the development of tourism satellite accounts (CARTAC; CARICOM Secretariat; CDB and OECS Secretariat); and assistance in the development of a regional statistics network (STA).

AML/CFT: Workshop for OECS insurance supervisors on risk-based supervisory approaches for AML/CFT (LEG).

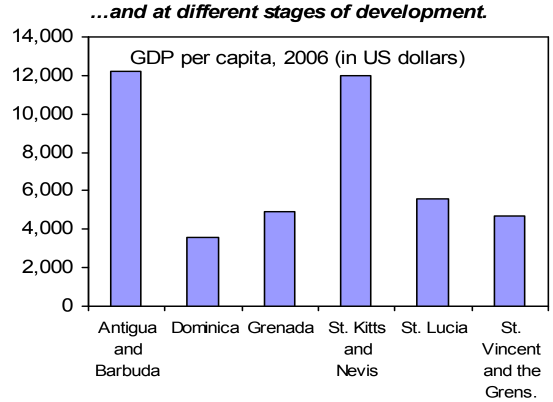
Figure 1. ECCU: Key Characteristics

ECCU countries are small, open economies, with many vulnerabilities.

The economies are small...



...and at different stages of development.

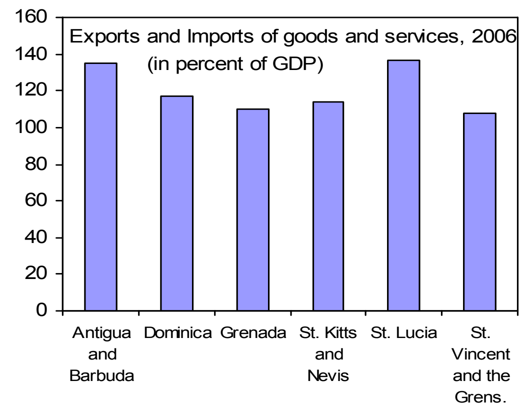


They are all vulnerable to natural disasters. . .

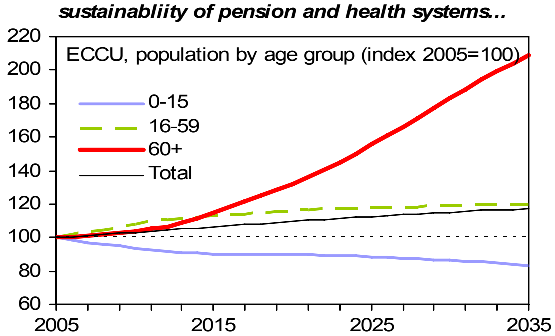
Worldwide Incidence of Natural Disasters, 1970–2006 1/

		All Recorded Disasters			
		Number of Events Divided by Land Area		Number of Events Divided by Population	
	Number of Events	Index	Rank	Index	Rank
All countries	8,069	100	92	100	92
Advanced economies	1,630	10	104	37	113
Caribbean	279	634	23	402	29
ECCU	50	778	7	780	7
Antigua and Barbuda	7	673	7	711	6
Dominica	9	508	12	1,028	3
Grenada	6	747	6	464	11
St. Kitts and Nevis	7	823	4	1,200	2
St. Lucia	9	614	10	447	12
St. Vincent and the Grenadines	12	1,302	2	829	5
Other Caribbean	229	547	33	176	43
Other	6,160	55	98	77	96

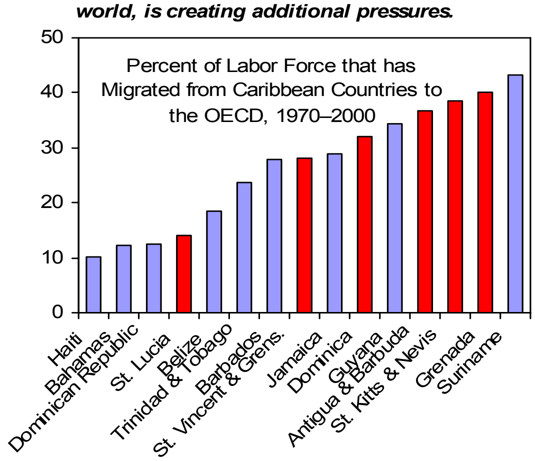
...and external shocks given the high degree of openness.



Rapid population aging is a challenge for the sustainabliity of pension and health systems...



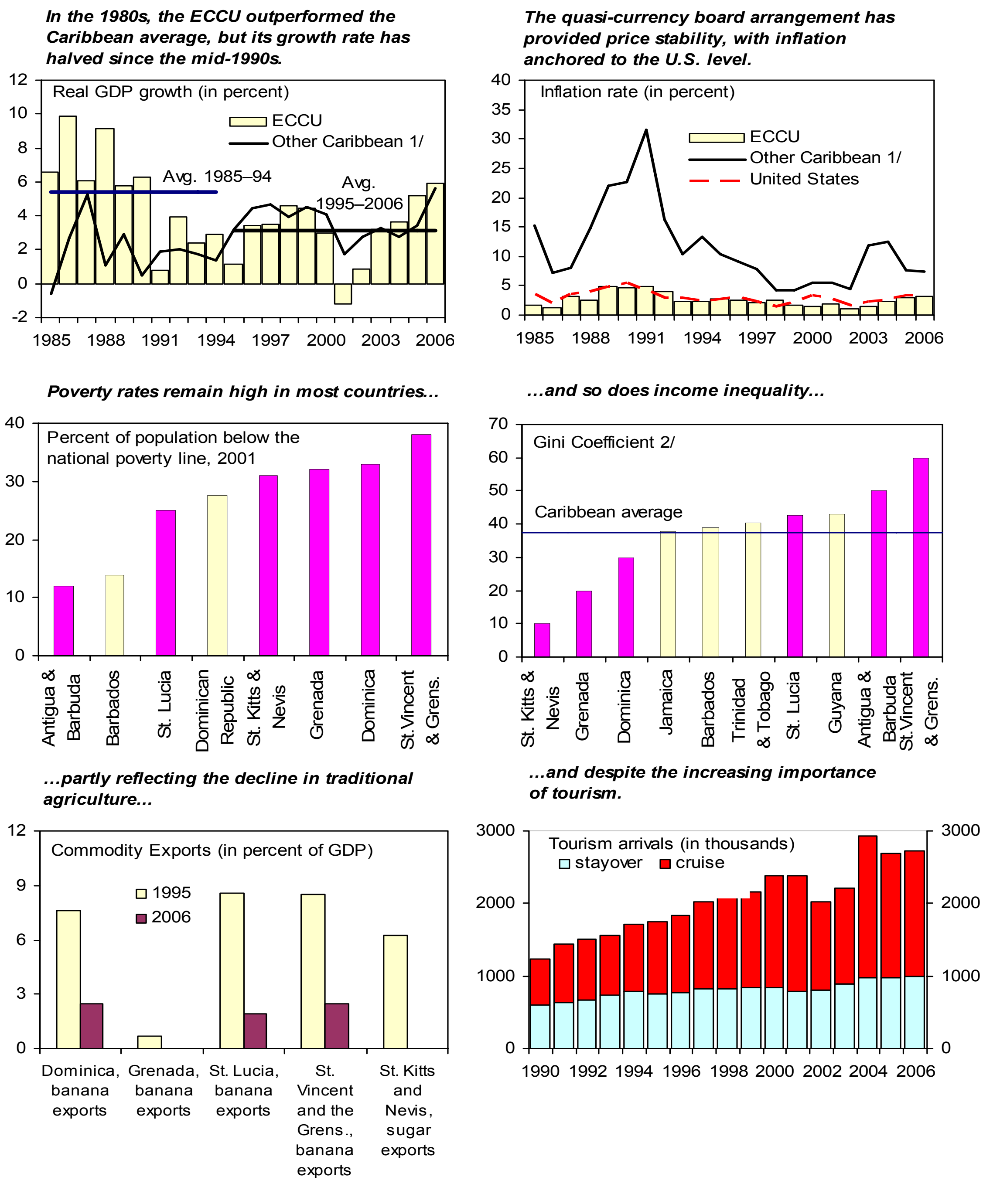
...and emigration, among the highest in the world, is creating additional pressures.



Sources: IMF, WEO; World Bank, WDI; EM-Dat; ECCB; and Fund staff calculations.

1/ The sample contains 184 countries. Simple unweighted averages are used for country groupings.Rankings are in descending order, with "1" indicating the most exposed to natural disasters.

Figure 2. ECCU: Overview

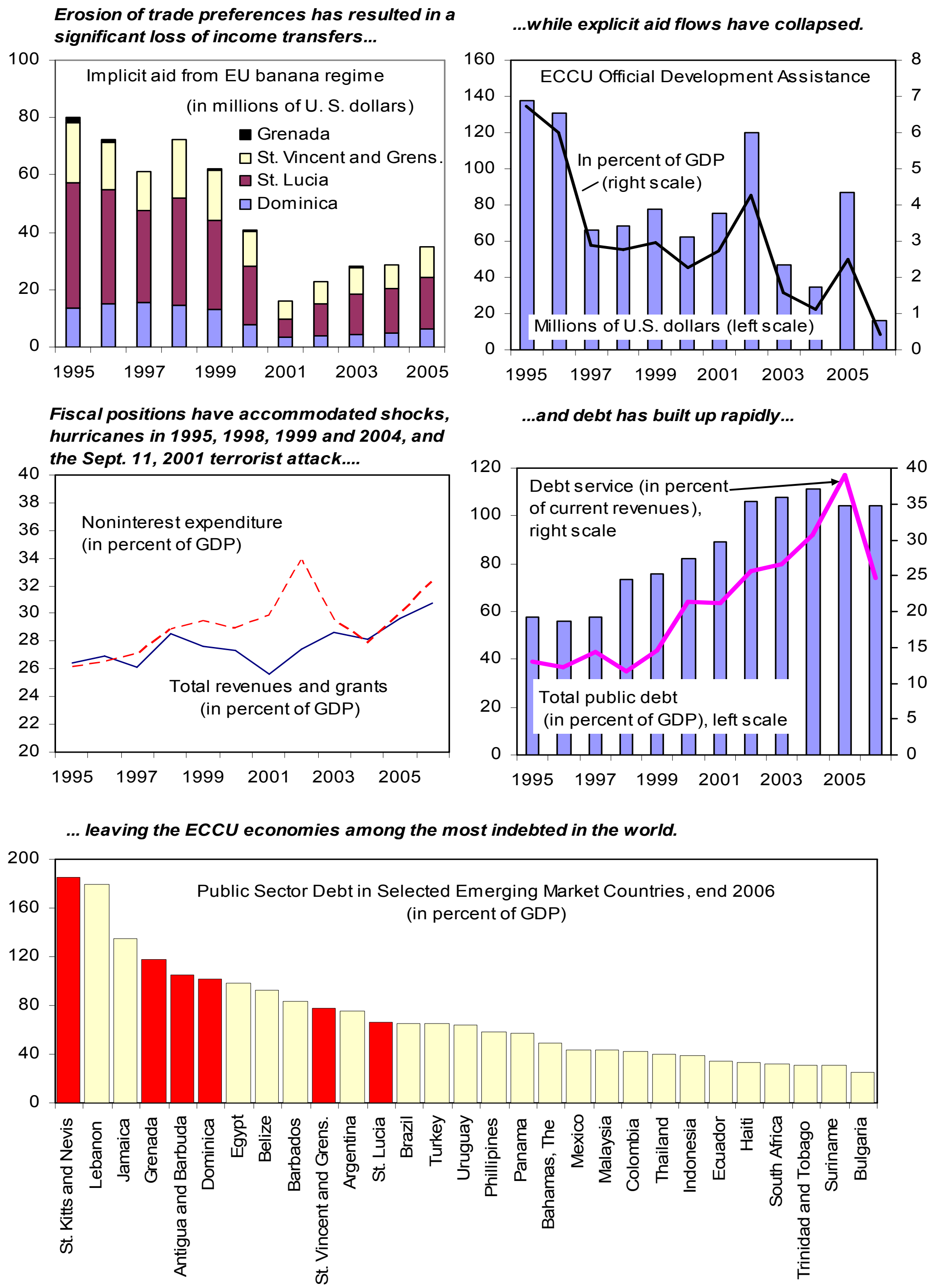


Sources: ECCB; World Bank; and Fund staff estimates.

1/ Simple average of The Bahamas, Barbados, Belize, Dominican Republic, Guyana, Haiti, Jamaica, and Trinidad and Tobago.

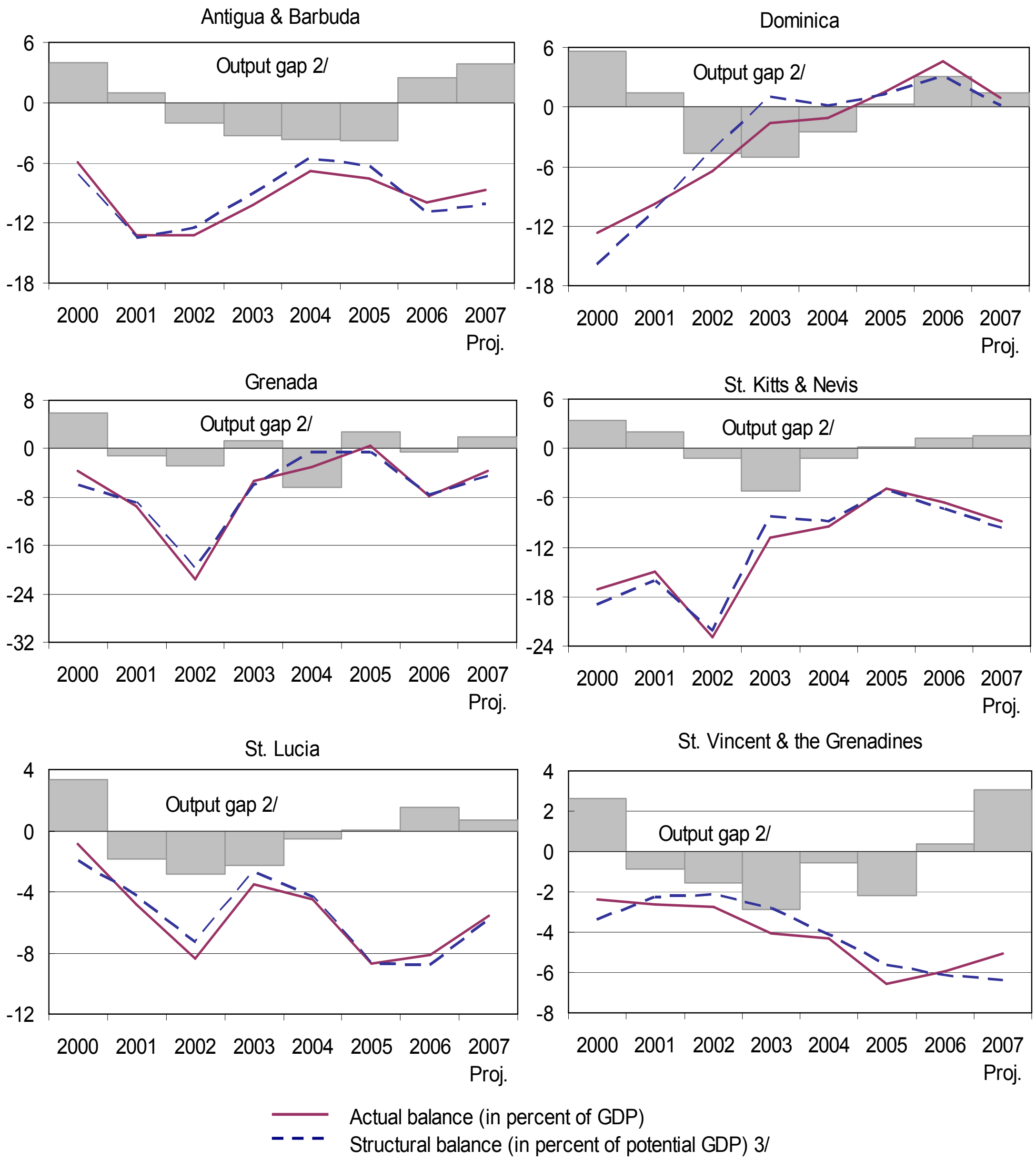
2/ A larger value indicates greater income inequality.

Figure 3. ECCU: External Environment, 1995–2006



Sources: World Bank, World Development Indicators; IMF, International Financial Statistics; IMF, World Economic Outlook; OECD, International Development Statistics; ECCB; and Fund staff calculations.

Figure 4. ECCU: Central Government Actual and Structural Budget Balances, 2000–07 1/
(In percent of potential GDP)



Sources: Country authorities; ECCB; and Fund staff estimates.

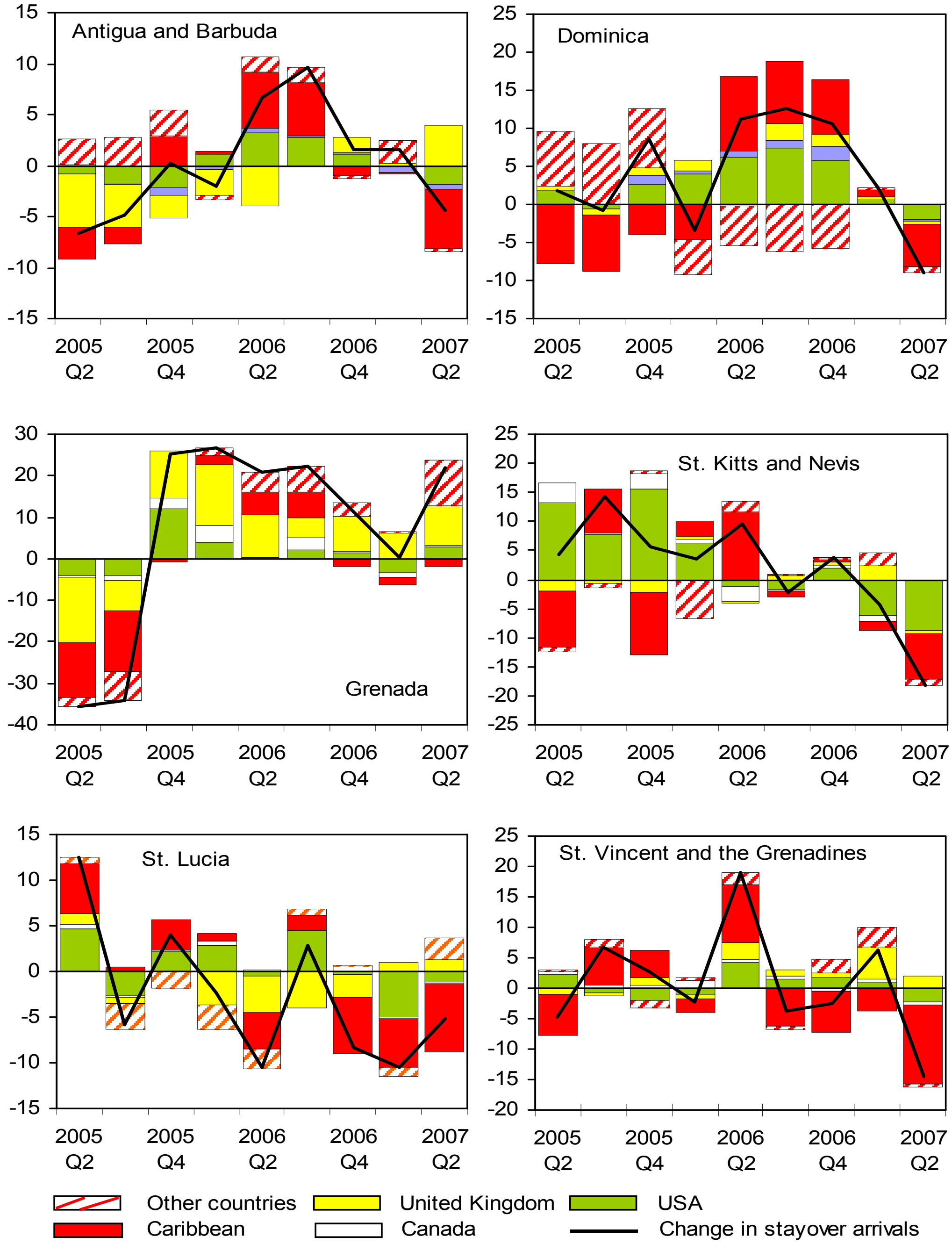
1/ Actual balance is the overall balance (revenue and grants less expenditure), and is expressed as a percentage of actual output. Actual output is measured as gross domestic product (GDP) at factor cost.

2/ The output gap is actual output less potential output, as a percent of potential output.

3/ Structural balance is expressed as a percent of potential output. The structural balance is the budgetary position (overall balance) that would be observed if the level of actual output coincided with potential output.

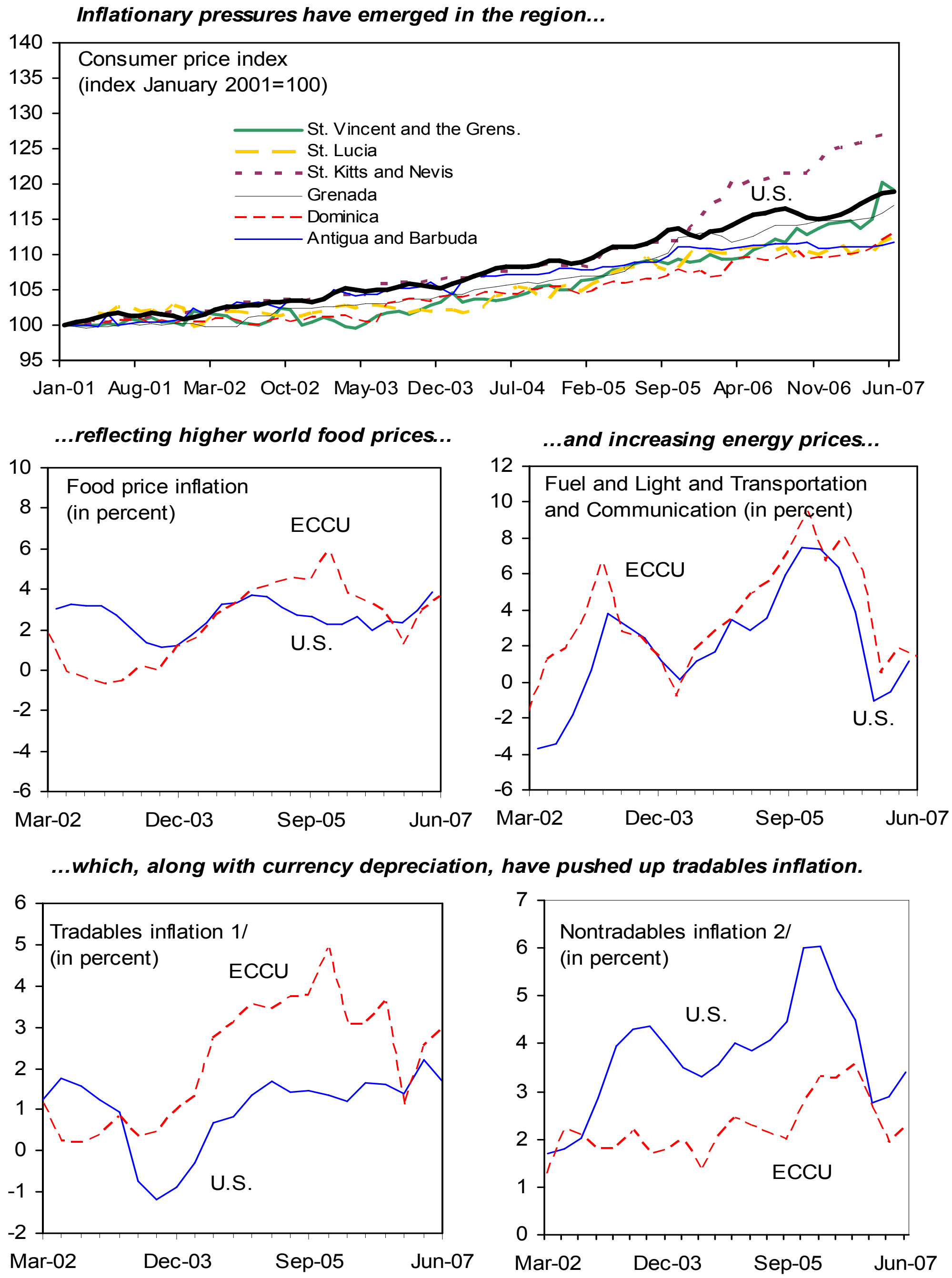
Figure 5. ECCU: Stayover Arrivals, 2005–07
(Annual percentage change)

Stayover arrivals have generally fallen in 2007. This decline reflects airlift problems in intra-regional travel and new passport requirements for U.S. visitors.



Sources: ECCB; and Fund staff calculations.

Figure 6. ECCU: Inflation Developments, 2001–07

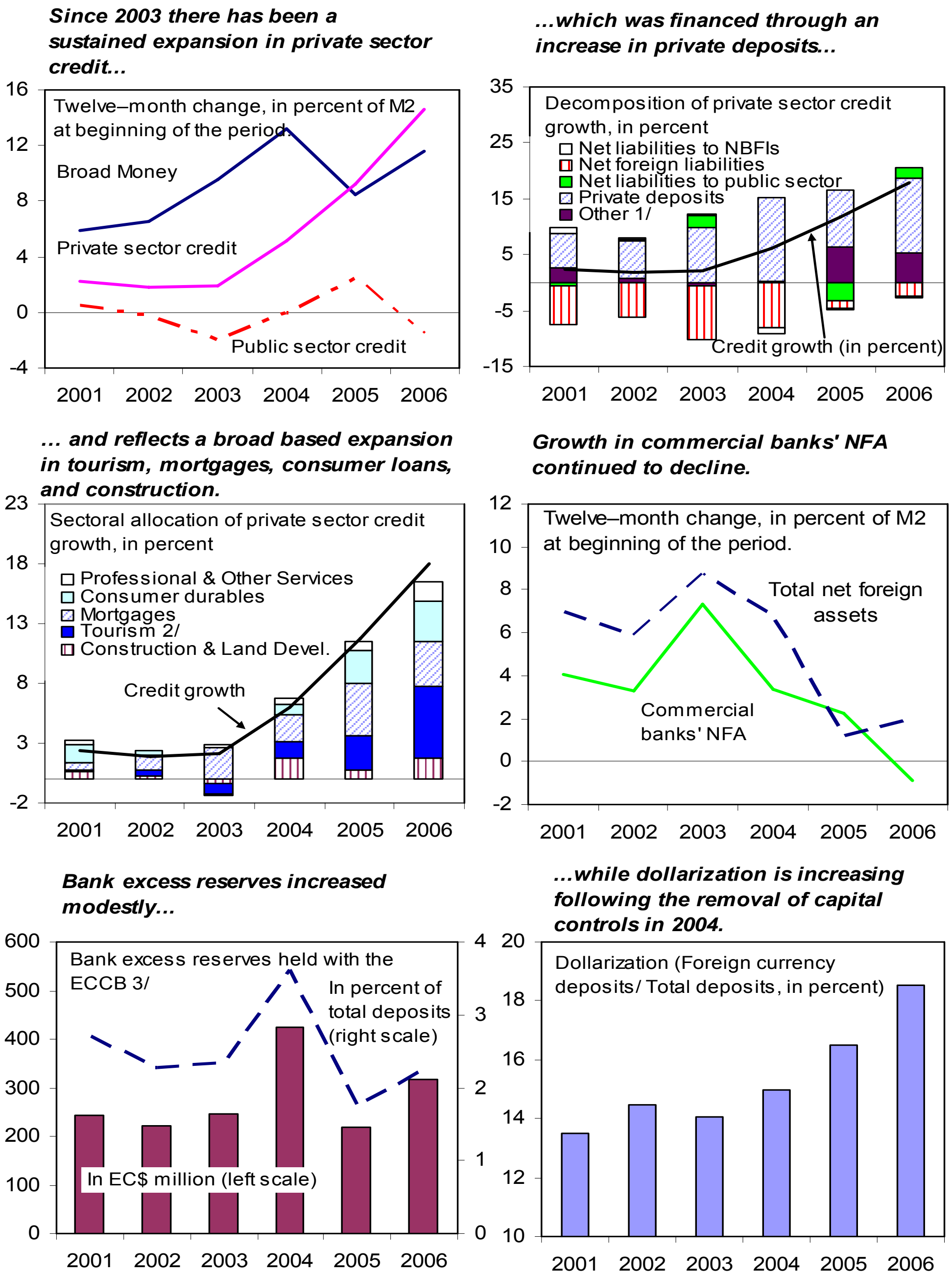


Sources: IMF, Direction of Trade Statistics; Haver; ECCB; and Fund staff calculations.

1/ Tradables are defined to include food, alcoholic beverages and tobacco, fuel and light, clothing and footwear, and household and furniture equipment.

2/ Nontradables are defined to include housing and utilities, transportation and communication, medical care and expenses, education, personal services, and miscellaneous.

Figure 7. ECCU: Monetary Developments, 2001–06



Sources: ECCB; and Fund staff calculations.

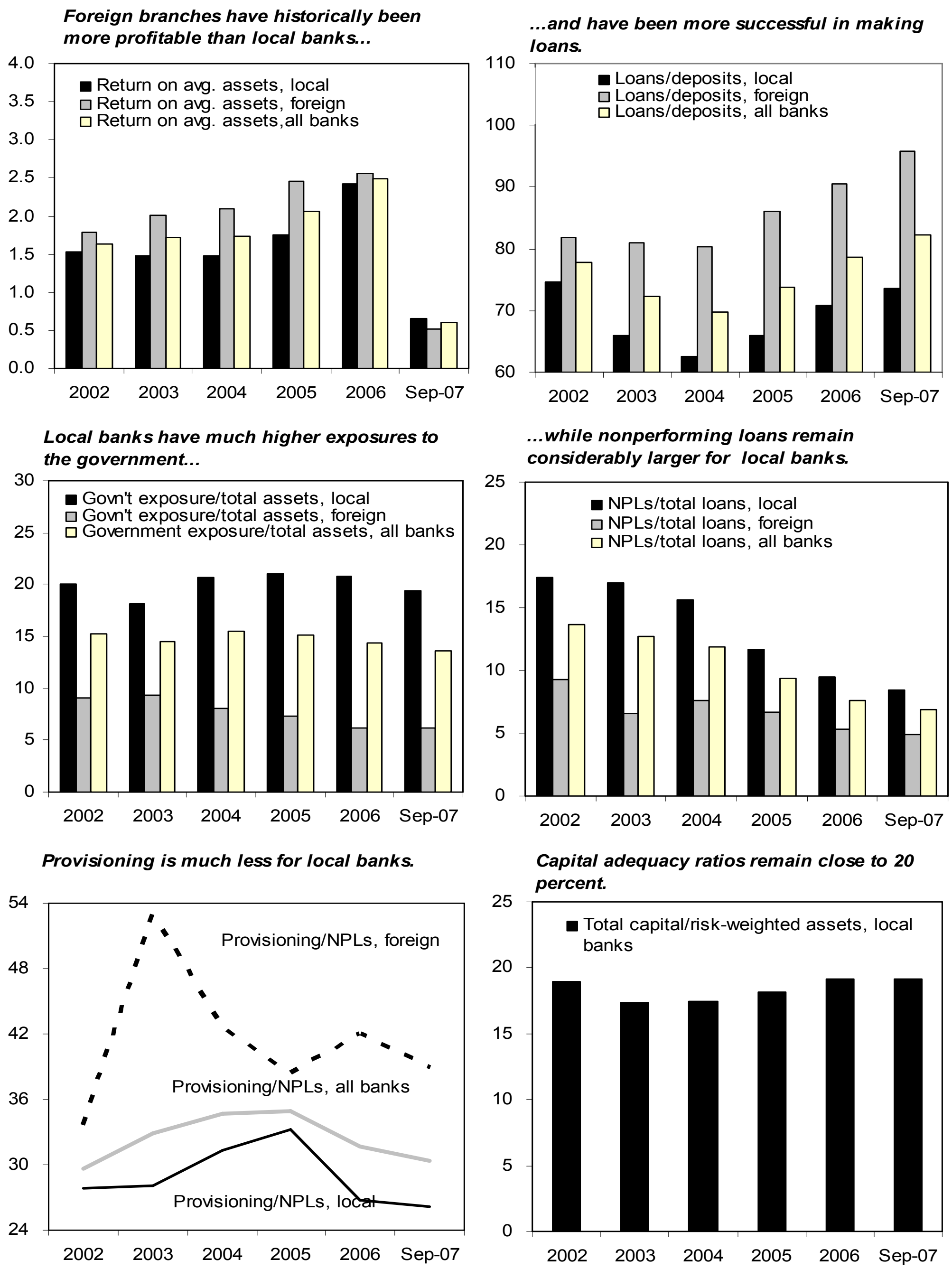
1/ Includes interbank float, reserves held with the ECCB, and other unclassified assets.

2/ Includes tourism, entertainment, and half of transport, distributive trade and professional services.

3/ Excess reserves is defined as the excess of bank reserves (cash holdings and deposits of commercial banks with the ECCB) over required reserves. The current reserve requirement is 6 percent of deposits.

Figure 8. ECCU: Banking System Vulnerabilities, 2002–07 1/

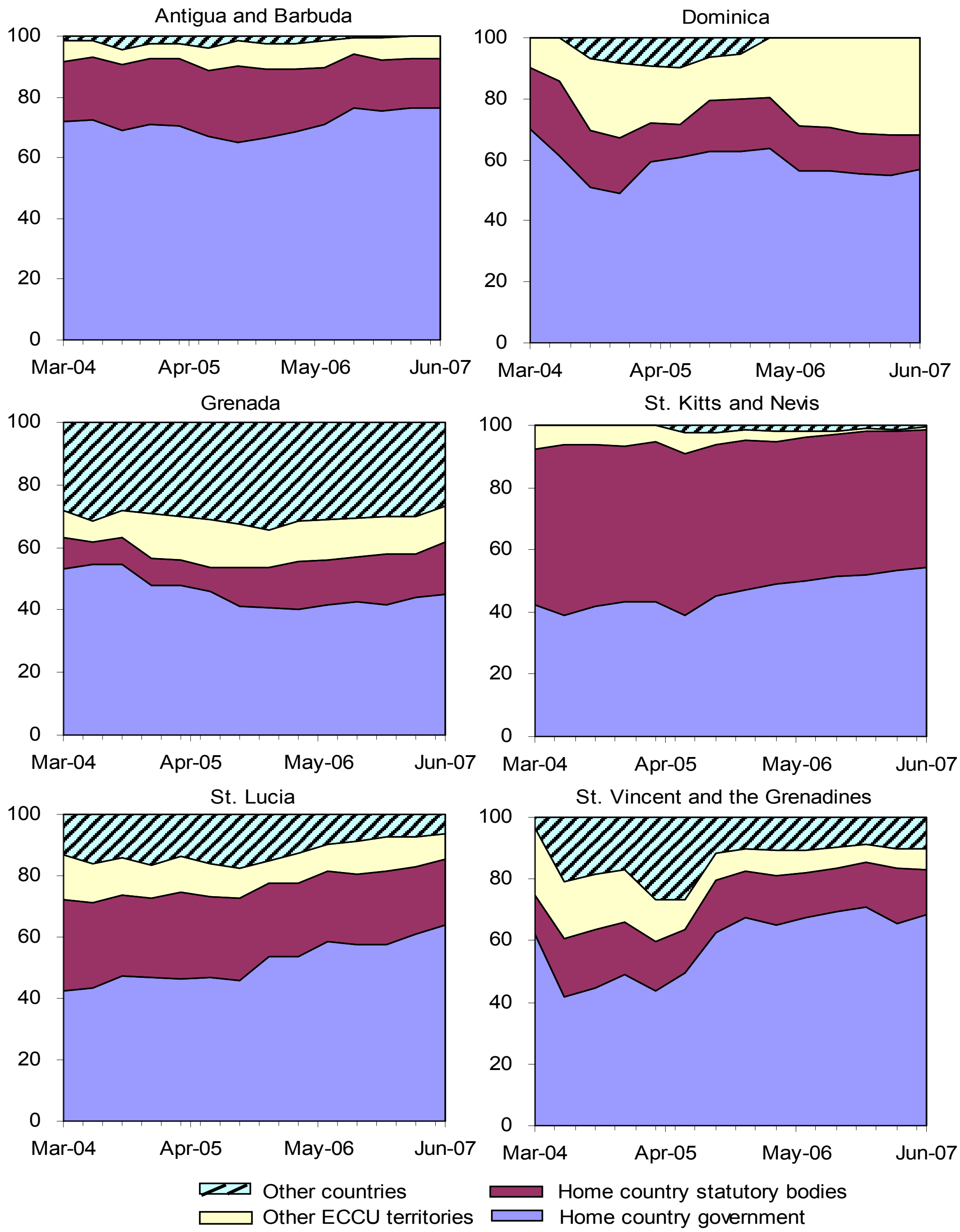
Local banks are weaker than foreign-owned banks, and have lower asset quality.



Sources: ECCB; and Fund staff calculations.
1/ Prudential indicators are reported by commercial banks, with infrequent onsite verification by the ECCB.

Figure 9. ECCU: Decomposition of Commercial Banks' Exposure to the Public Sector, 2004–07
(In percent of public sector exposure)

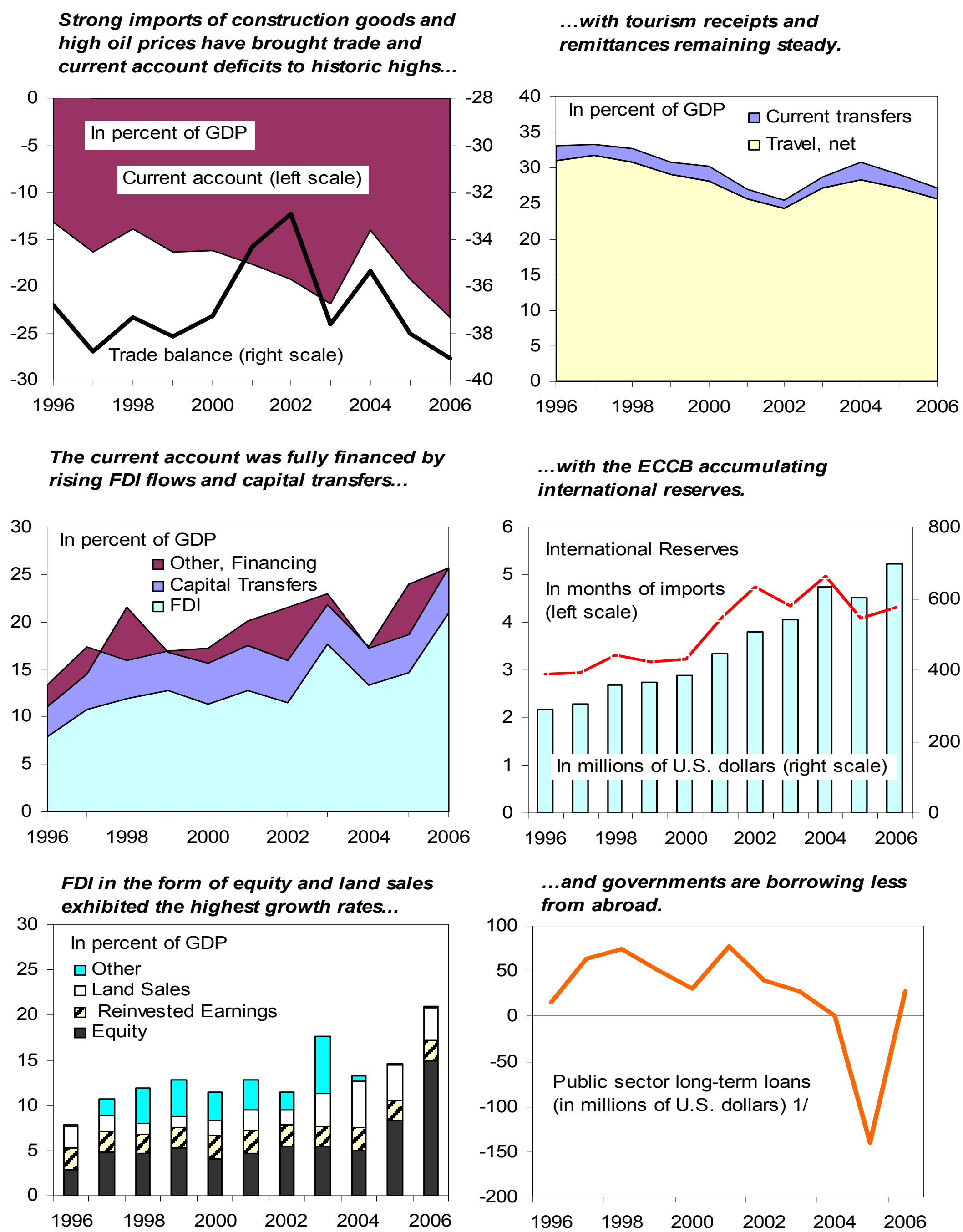
Commercial banks have large exposures to their home country public sector.



Sources: ECCB; and Fund staff calculations.

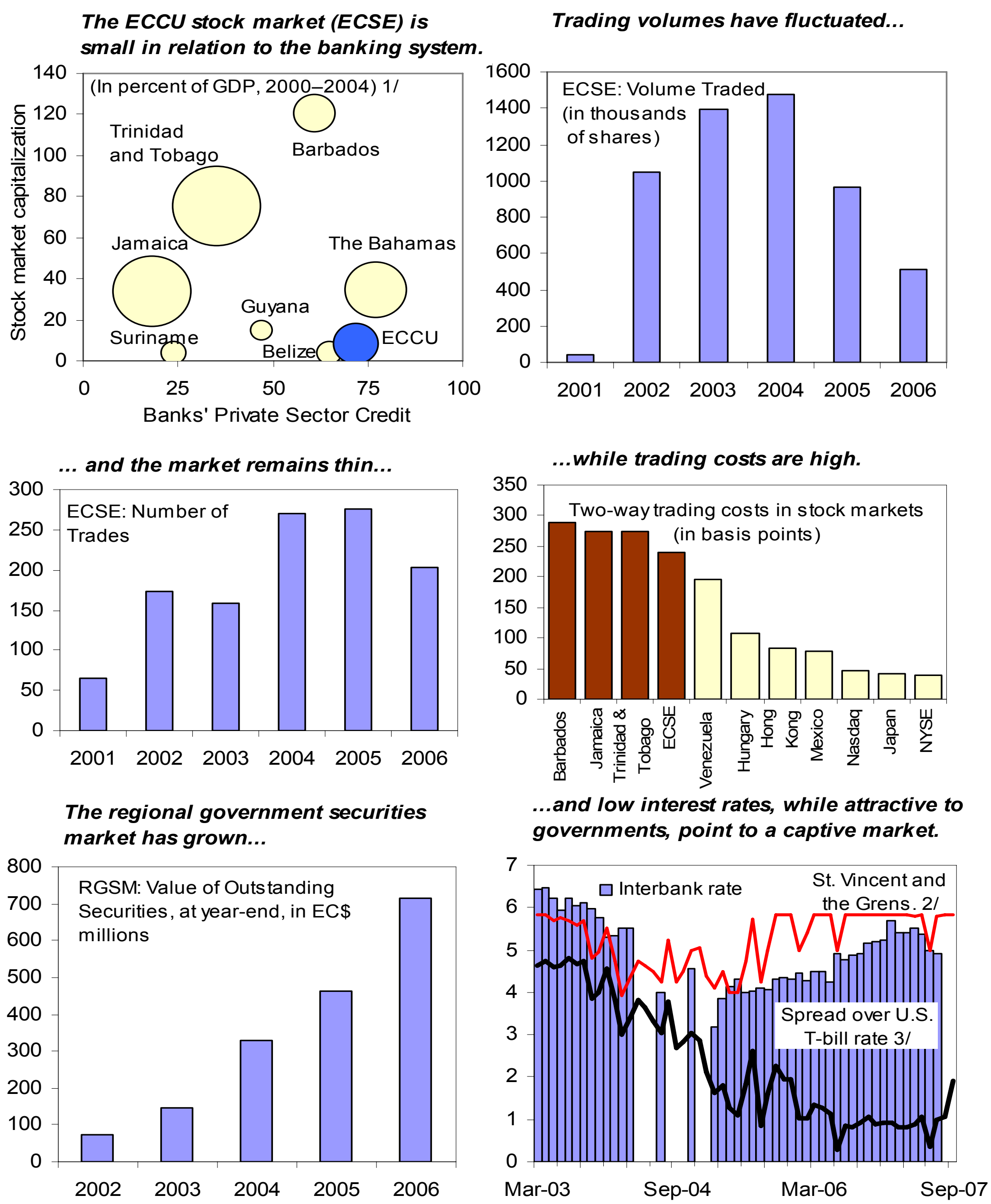
Figure 10. ECCU: Trade and Capital Account, 1996–2006

Large and worsening current account deficits are financed by surging FDI flows and transfers.



Sources: Country authorities; ECCB; and Fund staff estimates.
1/ A positive (negative) number indicates borrowing from (lending to) foreigners.

Figure 11. ECCU: Markets for Equity and Government Securities



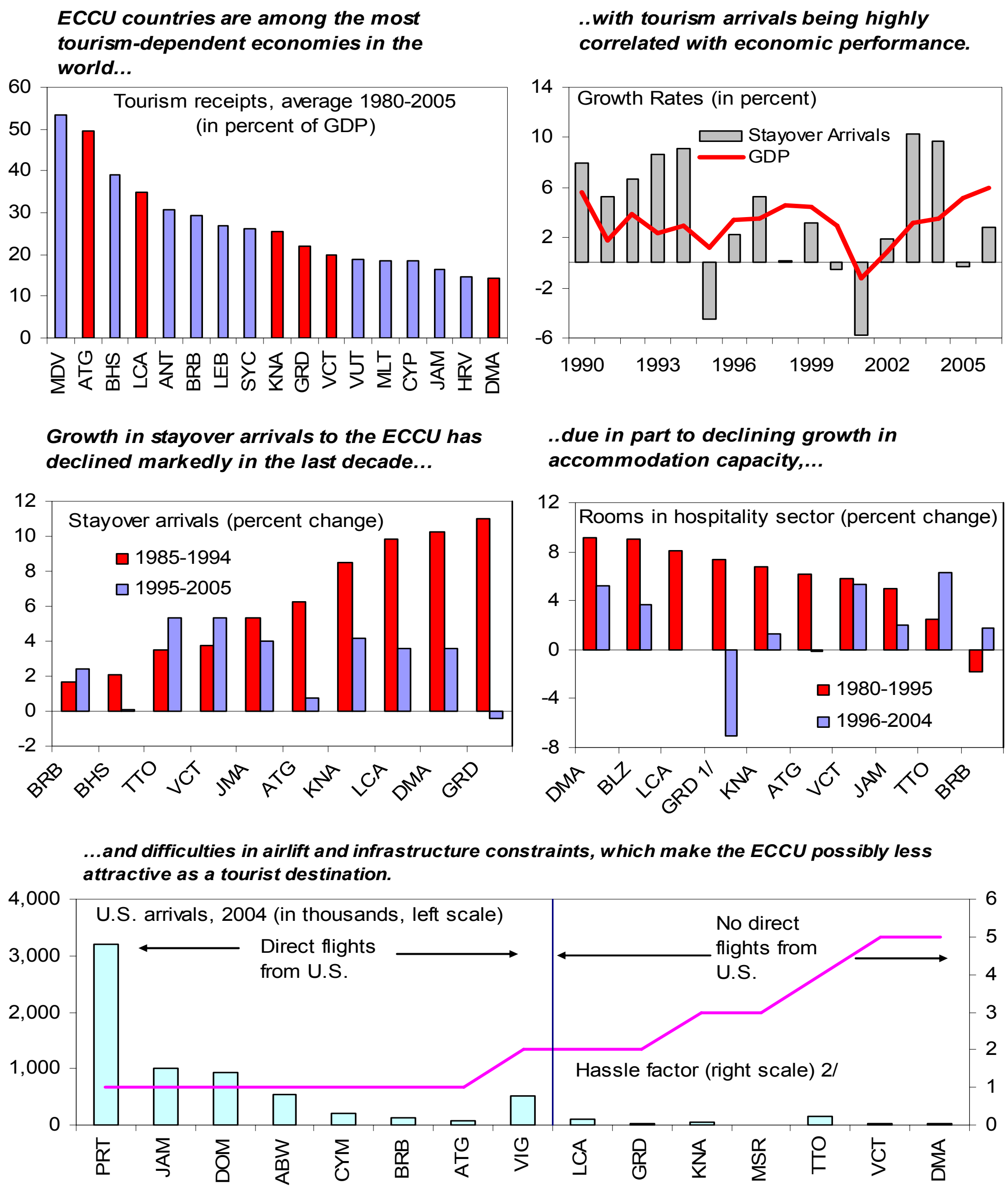
Sources: Eastern Caribbean Securities Exchange (ECSE); Regional Government Securities Market (RGSM); Caribbean Trade & Investment Report 2005; U. S. Federal Reserve; and Fund staff estimates.

1/ Size of bubble indicates country GDP in millions of U.S. dollars.

2/ Interest rates from RGSM auctions of St. Vincent and the Grenadines 91 day treasury bills. March-03, May-03, and Feb-06 rates are interpolated.

3/ U. S. rate is the interest rate on 13-week treasury bills.

Figure 12. Tourism Performance



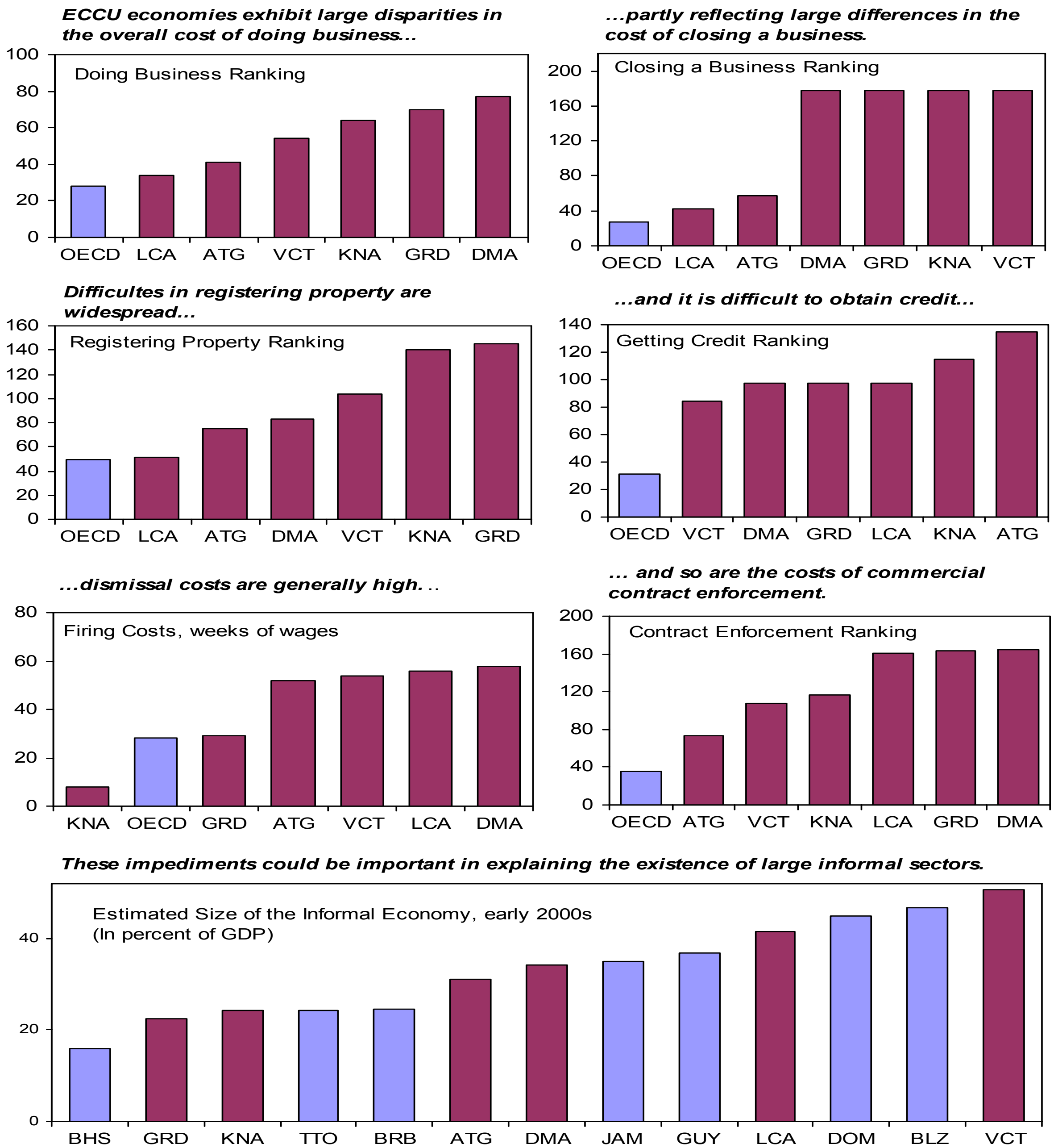
Sources: Country authorities; ECCB; and Fund staff estimates.

Note: Antigua and Barbuda (ATG), Aruba (ABW), Bahamas (BHS), Barbados (BRB), Cayman Islands (CYM), Croatia (HRV), Cyprus (CYP), Dominica (DMA), Dominican Republic (DOM), Grenada (GRD), Jamaica (JAM), Lebanon (LEB), Maldives (MDV), Malta (MLT), Montserrat (MSR), Netherlands Antilles (ANT), Puerto Rico (PRT), St. Kitts and Nevis (KNA), St. Lucia (LCA), St. Vincent and the Grenadines (VCT), Seychelles (SYC), Trinidad and Tobago (TTO), U.S. Virgin Islands (VIG), Vanuatu (VUT).

1/ Grenada's infrastructure was damaged in 2004 due to Hurricane Ivan.

2/ The hassle factor captures cost, distance and time to arrive at destination (including to the actual resort/hotel). It is based on Fodor's *Caribbean 2007*, with higher number indicating greater hassle factor.

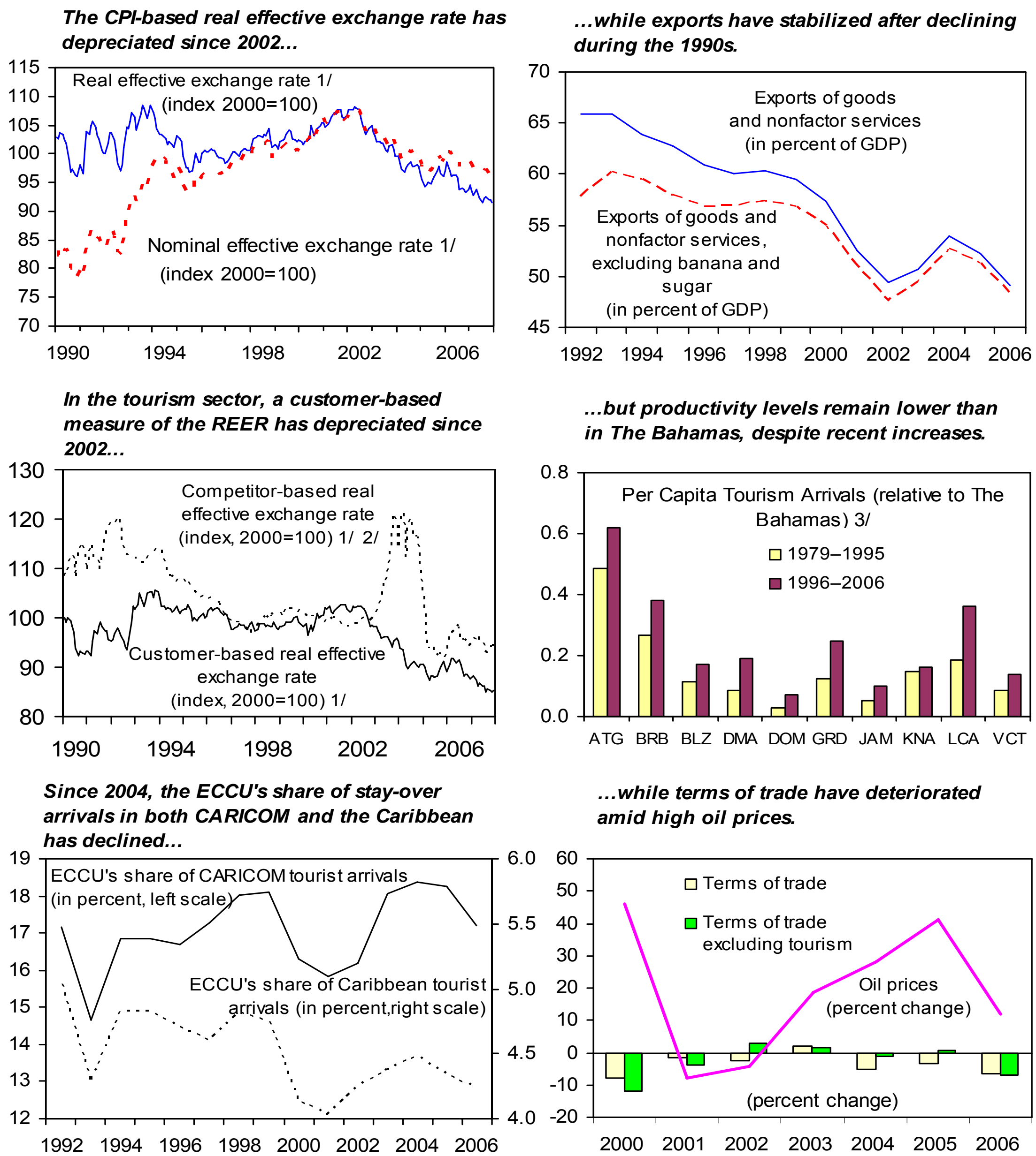
Figure 13. ECCU: Doing Business Indicators, 2007 1/



Sources: World Bank, *2008 Doing Business Indicators* (2007); and Fund staff calculations.
Note: Antigua and Barbuda (ATG), Bahamas (BHS), Barbados (BRB), Belize (BLZ), Dominica (DMA), Dominican Republic (DOM), Grenada (GRD), Guyana (GUY), Jamaica (JAM), St. Kitts and Nevis (KNA), St. Lucia (LCA), St. Vincent and the Grenadines (VCT), and Trinidad and Tobago (TTO).

1/ Smaller numbers represent greater ease in doing business. The rankings are across 178 countries.

Figure 14. ECCU: External Competitiveness, 1990–2007



Sources: ECCB; Caribbean Tourism Organization; Country authorities; World Travel and Tourism Council; and Fund staff estimates.

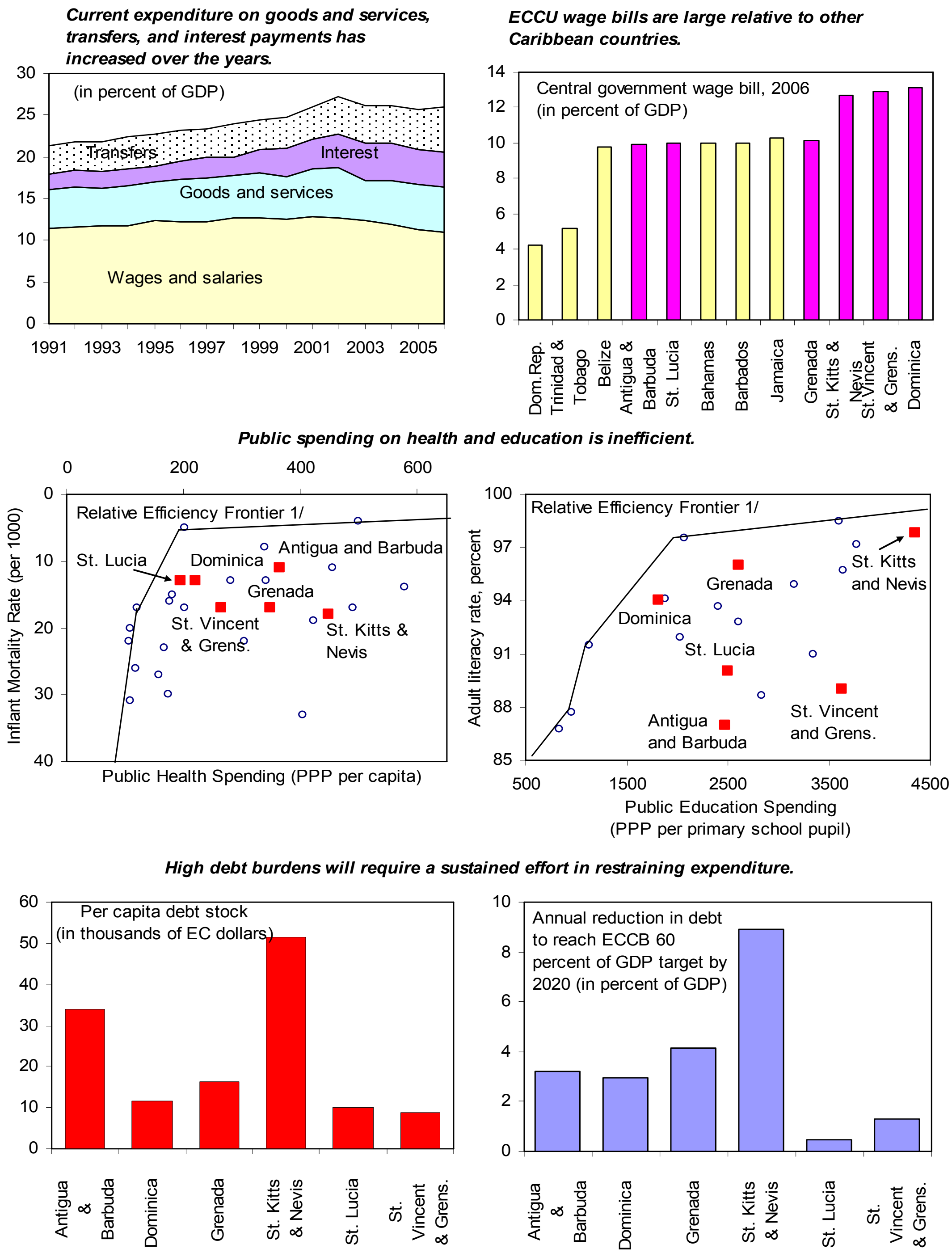
Note: Antigua and Barbuda (ATG), Barbados (BRB), Belize (BLZ), Dominica (DMA), Dominican Republic (DOM), Grenada (GRD), Jamaica (JAM), St. Kitts and Nevis (KNA), St. Lucia (LCA), and St. Vincent and the Grenadines (VCT).

1/ An increase (decrease) indicates an appreciation (depreciation).

2/ The sharp movements in the competitor-based real exchange rate in 2002–04 were largely driven by the Dominican Republic's peso.

3/ A value below 1 indicates that the country's tourism sector is less productive than that of The Bahamas.

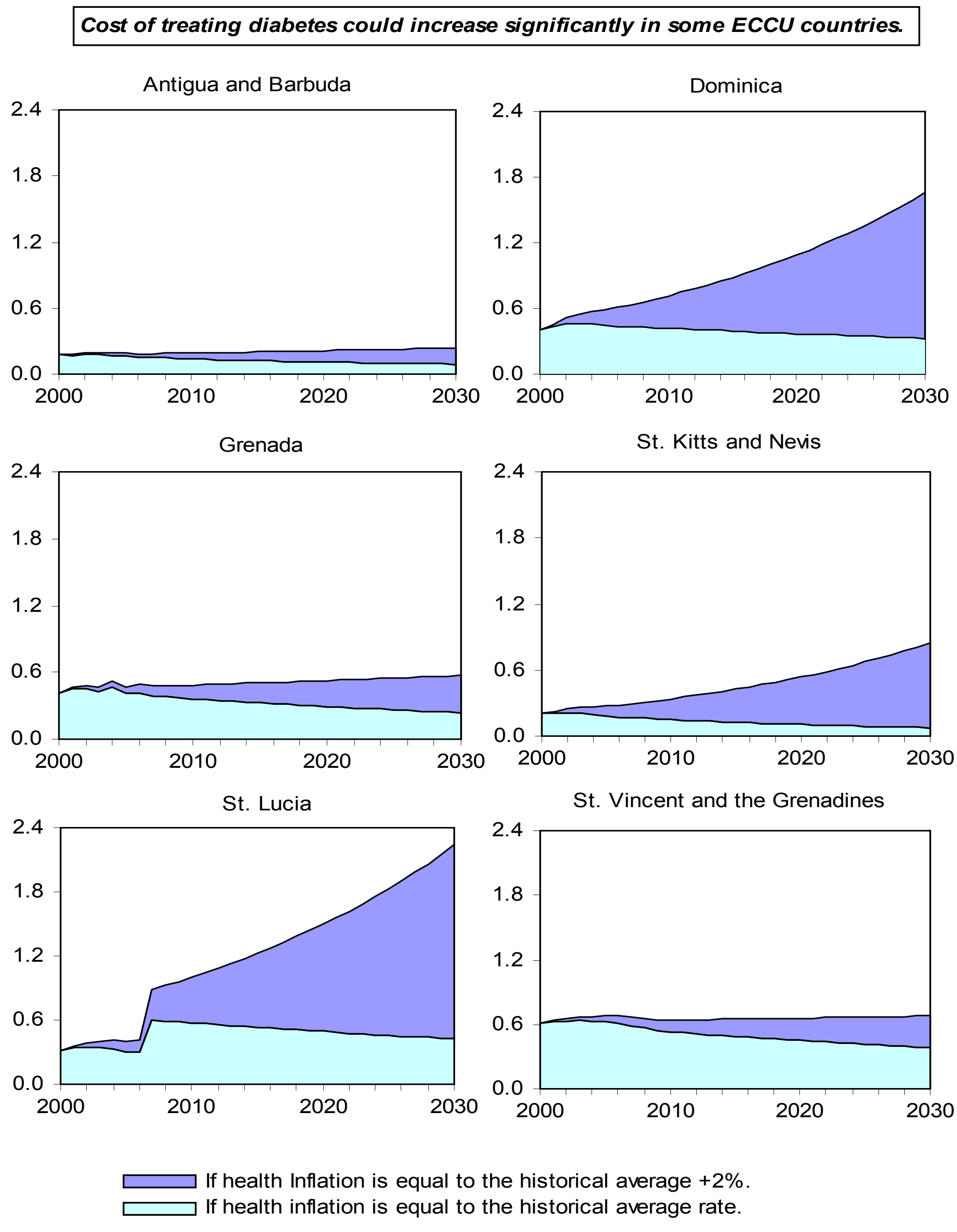
Figure 15. ECCU: Fiscal Expenditure



Sources: World Economic Outlook; World Health Organization; World Development Indicators; and Fund staff calculations.

1/ The straight line indicates the relative efficiency frontier. The distance from the frontier indicates the degree of inefficiency of that country's spending. The sample consists of mostly Caribbean and Latin American countries and some small island economies in the Mediterranean.

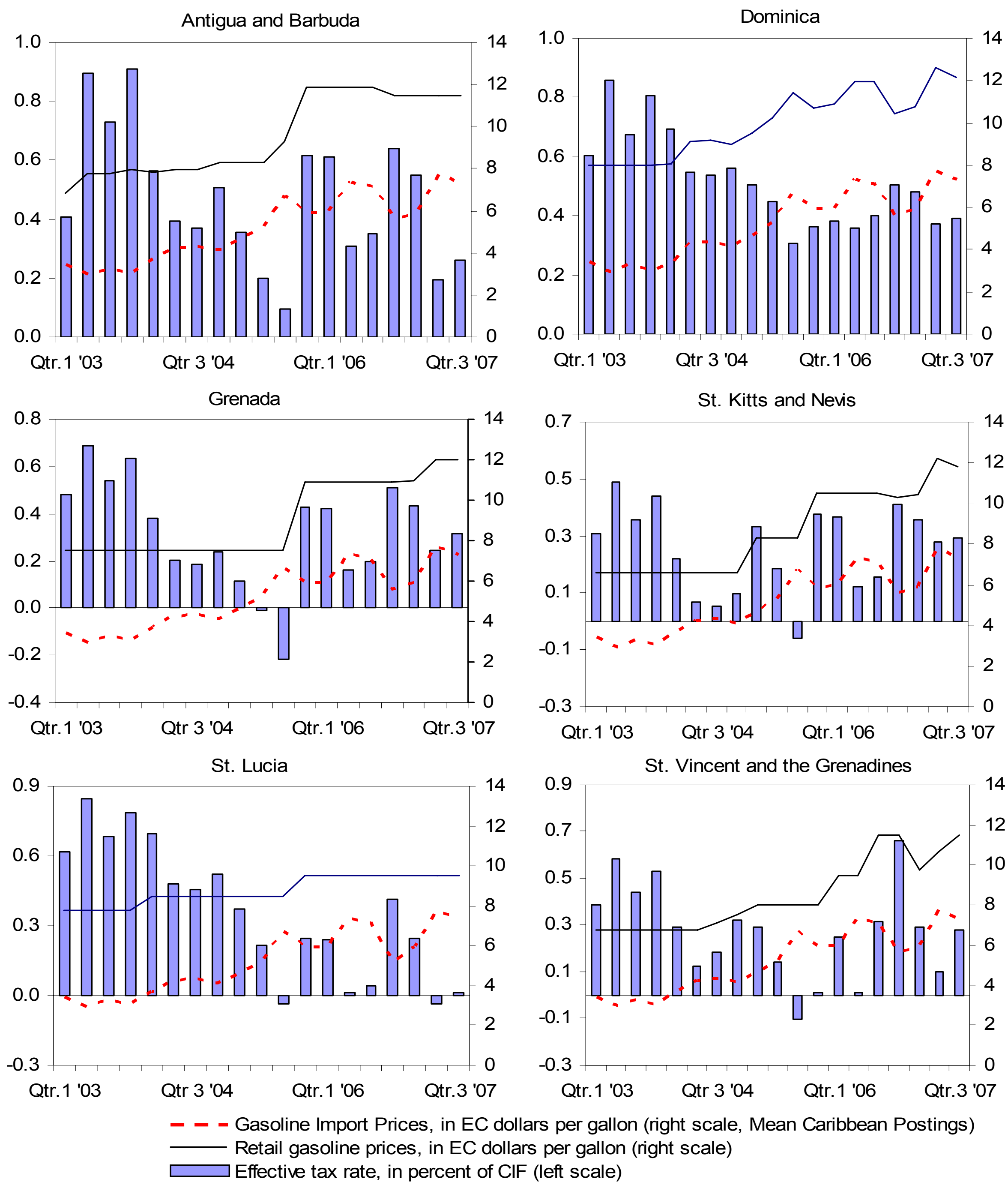
Figure 16. ECCU: Cost of Treating Diabetes, 2000–30 1/
(In Percent of GDP)



Sources: Caribbean Commision on Health and Development (2005); and Fund staff calculations.

Figure 17. ECCU: Effective Gasoline Tax Rate, Gasoline Import and Retail Prices, 2003–07

Failure to adjust retail prices to world oil price developments implies large fiscal costs.



Sources: ECCB; and Fund staff estimates.

Table 1. ECCU: Selected Economic and Financial Indicators, 2003–08

	2003	2004	2005	Prel. 2006	Proj. 2007	Proj. 2008
(Annual percentage change)						
National income and prices 1/						
Real GDP	3.2	3.6	5.2	5.9	4.1	3.3
GDP deflator	1.2	2.2	3.3	2.6	2.7	2.8
Consumer prices, average	1.6	2.1	3.1	3.4	3.6	2.6
Monetary sector						
Liabilities to the private sector (M2)	9.5	13.2	8.4	11.6	11.0	6.4
(Annual change, in percent of M2 at the beginning of the year)						
Net foreign assets	8.7	6.8	1.2	2.0	-1.2	0.9
Net domestic assets	0.8	6.4	7.2	9.6	12.2	5.5
Of which						
Private sector credit	2.0	5.1	9.2	14.6	12.0	5.7
Credit to central government	-1.3	-1.0	2.0	-0.2	1.3	-0.2
(In percent of GDP)						
Public sector 1/						
Primary central government balance	-0.8	0.1	-0.3	-1.6	-0.5	-0.3
Overall central government balance	-5.2	-4.3	-4.4	-5.8	-4.9	-5.3
Total revenue and grants	28.6	28.1	29.6	30.7	30.2	29.1
Total expenditure and net lending	33.9	32.4	34.0	36.5	35.2	34.4
Foreign financing	5.8	3.4	-3.3	1.6	1.2	1.6
Domestic financing including arrears	1.1	1.6	3.7	5.4	3.7	3.2
Central government current account balance	0.1	0.1	0.9	1.5	1.4	1.1
Total public debt (end-of-period)	107.7	111.2	104.5	104.2	101.8	102.9
(Annual percentage change)						
External sector						
Exports, f.o.b.	3.8	10.2	8.4	-2.9	-2.6	4.9
Imports, f.o.b.	16.7	2.8	15.2	10.0	4.3	4.6
Stayover visitors	9.9	10.0	0.4	3.4	...	...
Nominal effective exchange rate 1/						
(1990 =100) end-of-period (depreciation -)	-3.2	-2.7	-0.4	0.1	...	...
Real effective exchange rate 1/						
(1990 =100) end-of-period (depreciation -)	-4.1	-3.3	-0.7	-0.1	...	...
Terms of trade	2.2	-5.3	-3.4	-6.4	...	...
(In percent of GDP)						
External current account balance	-21.9	-14.1	-19.2	-23.4	-23.1	-21.6
Trade balance	-37.6	-35.3	-38.0	-39.1	-38.7	-38.0
Services, incomes and transfers	15.8	21.3	18.8	15.7	15.6	16.5
Of which						
Travel	27.2	28.3	27.3	25.7	25.0	25.4
Capital and financial accounts 2/	23.0	17.2	18.6	25.7	24.8	22.6
Of which						
Foreign direct investment	17.7	13.3	14.6	21.0	16.9	16.9
External public debt (end-of period) 1/	65.6	65.7	57.1	54.3	51.9	53.4
External debt service, in percent of goods and nonfactor services	9.5	11.1	15.5	9.1	10.8	10.1
Of which						
Interest	4.7	4.8	4.1	4.1	4.4	4.6
End-year gross foreign reserves of the ECCB						
In millions of U.S. dollars	539.9	632.4	600.8	696.0	770.5	816.8
In months of imports	4.4	5.0	4.1	4.3	4.6	4.6
In percent of broad money	19.8	20.5	17.9	18.6	18.6	18.5
Currency backing ratio, in percent 3/	95.3	96.2	96.5	98.7	...	…

Sources: Eastern Caribbean Central Bank; and Fund staff estimates and projections.

1/ Excludes Anguilla and Montserrat. ECCU aggregates are calculated as weighted averages of individual country data; ratios to GDP are then calculated by dividing this sum by the aggregated GDP of the region.

2/ Includes errors and omissions.

3/ ECCB's foreign assets as a ratio of its demand liabilities.

Table 2. ECCU: Selected Central Government Indicators by Country, 2003–08 1/

(In percent of GDP)

	2003	2004	2005	Prel. 2006	Proj. 2007	2008
Total revenues and grants	**28.6**	**28.1**	**29.6**	**30.7**	**30.2**	**29.1**
Antigua and Barbuda	21.1	21.6	21.9	25.2	24.2	23.6
Dominica	40.0	38.8	41.1	43.2	44.0	40.6
Grenada	32.0	30.8	34.5	33.9	29.2	28.9
St. Kitts and Nevis	33.5	34.3	39.5	38.9	37.4	36.3
St. Lucia	26.3	25.6	25.3	26.2	29.0	26.5
St. Vincent and the Grenadines	31.3	29.5	30.0	30.8	31.0	31.6
Current expenditure	**26.1**	**26.2**	**25.6**	**25.9**	**26.0**	**26.3**
Antigua and Barbuda	25.8	24.8	24.3	25.6	24.9	25.6
Dominica	31.2	31.0	30.4	28.8	30.1	28.8
Grenada	22.6	26.0	20.3	21.4	22.2	22.0
St. Kitts and Nevis	34.1	34.9	36.9	36.0	35.3	35.5
St. Lucia	22.5	21.8	22.2	22.1	23.3	23.7
St. Vincent and the Grenadines	26.7	26.0	27.3	26.8	26.3	27.1
Of which						
Interest payments	**4.4**	**4.5**	**4.1**	**4.2**	**4.4**	**5.0**
Antigua and Barbuda	4.5	4.5	4.1	4.3	4.7	6.6
Dominica	5.8	5.8	5.4	2.4	2.3	2.1
Grenada	4.8	6.0	2.0	2.1	2.4	2.4
St. Kitts and Nevis	7.6	7.1	8.1	9.6	9.5	9.5
St. Lucia	2.8	3.0	3.5	3.5	3.6	3.8
St. Vincent and the Grenadines	2.7	2.5	3.0	3.2	3.5	4.1
Saving (current revenue less current expenditure)	**0.1**	**0.1**	**0.9**	**1.5**	**1.4**	**1.1**
Antigua and Barbuda	-4.9	-3.4	-3.3	-3.4	-1.2	-1.9
Dominica	-0.2	1.7	2.9	6.2	2.2	3.1
Grenada	3.0	-2.2	3.8	3.7	4.4	4.7
St. Kitts and Nevis	-1.2	-1.0	-0.1	0.3	0.5	-0.3
St. Lucia	1.8	3.8	2.8	3.7	1.7	1.3
St. Vincent and the Grenadines	4.1	2.8	1.2	3.2	3.0	3.1
Primary balance	**-0.8**	**0.1**	**-0.3**	**-1.6**	**-0.5**	**-0.3**
Antigua and Barbuda	-4.2	-1.2	-2.3	-4.0	-2.6	0.7
Dominica 2/	5.4	3.5	7.3	6.6	3.0	3.0
Grenada	0.4	3.4	2.4	-4.3	-0.7	1.8
St. Kitts and Nevis	-1.4	-0.8	4.0	4.3	2.4	-0.2
St. Lucia	-0.1	-0.6	-3.4	-3.0	-0.8	-4.2
St. Vincent and the Grenadines	-0.6	-1.1	-2.5	-1.7	-0.7	0.7
Overall balance	**-5.2**	**-4.3**	**-4.4**	**-5.8**	**-4.9**	**-5.3**
Antigua and Barbuda	-8.7	-5.7	-6.4	-8.3	-7.3	-5.9
Dominica	-1.3	-0.9	1.2	3.8	0.8	0.9
Grenada	-4.5	-2.6	0.4	-6.4	-3.0	-0.6
St. Kitts and Nevis	-9.0	-7.9	-4.1	-5.3	-7.1	-9.8
St. Lucia	-2.8	-3.6	-6.9	-6.6	-4.4	-7.9
St. Vincent and the Grenadines	-3.3	-3.6	-5.5	-4.9	-4.2	-3.4
Government and government guaranteed debt stock						
Total public sector debt	**107.7**	**111.2**	**104.5**	**104.2**	**101.8**	**102.9**
Antigua and Barbuda	135.1	128.0	106.2	105.3	108.4	113.6
Dominica	130.8	116.0	108.1	102.5	97.6	92.3
Grenada	102.2	120.6	110.3	117.8	107.7	100.7
St. Kitts and Nevis	181.5	195.0	194.8	184.6	180.4	181.9
St. Lucia	59.5	64.7	66.1	66.8	68.4	73.3
St. Vincent and the Grenadines	72.3	77.0	80.7	78.0	67.6	68.0
External debt 3/	**65.6**	**65.7**	**57.1**	**54.3**	**51.9**	**53.4**
Domestic debt	**42.0**	**45.5**	**47.4**	**49.9**	**49.8**	**49.4**

Sources: Country authorities; and Fund staff estimates.

1/ Excludes Anguilla and Montserrat. Fiscal years for Dominica and St. Lucia.

2/ Dominica's primary balance is measured by below-the-line financing and may not equal the above-the-line definition.

3/ Includes external arrears.

Table 3. ECCU: Monetary Survey, 2003–08

(In millions of Eastern Caribbean dollars)

				Prel.	Proj.	
	2003	2004	2005	2006	2007	2008
I. Monetary Survey (Consolidated Banking System)						
Net foreign assets	**2,401.8**	**2,902.0**	**3,000.6**	**3,177.9**	**3,053.0**	**3,152.3**
Net domestic assets	**4,975.4**	**5,447.2**	**6,052.4**	**6,924.7**	**8,156.5**	**8,772.8**
Net credit to the public sector	-217.4	-219.2	-10.7	-148.3	-122.4	-149.3
Central government	554.8	482.9	652.3	638.7	766.3	739.4
Nonfinancial public enterprises 1/	-772.3	-702.1	-663.0	-787.0	-888.7	-888.7
Credit to private sector	6,222.3	6,599.4	7,371.1	8,697.0	9,910.9	10,554.1
Other	-1,029.5	-933.0	-1,308.0	-1,624.0	-1,632.0	-1,632.0
Liabilities to private sector (M2)	**7,377.1**	**8,349.1**	**9,053.1**	**10,102.6**	**11,209.6**	**11,925.1**
Money (M1)	1,505.7	1,884.2	2,084.1	2,256.3	2,503.6	2,663.4
Quasi-money	5,871.5	6,464.9	6,968.9	7,846.2	8,706.0	9,261.7
II. Eastern Caribbean Central Bank						
Net foreign assets	**1,449.1**	**1,702.9**	**1,611.7**	**1,871.9**	**2,073.2**	**2,198.1**
Net domestic assets	**-1,022.0**	**-1,219.4**	**-1,092.9**	**-1,288.5**	**-1,425.8**	**-1,509.4**
Net position with banks and other institutions	-1,005.9	-1,161.7	-1,043.7	-1,172.2	-1,309.5	-1,393.1
Credit to government	31.5	-39.0	-14.8	-52.8	-52.8	-52.8
Other	-47.6	-18.7	-34.3	-63.5	-63.5	-63.5
Liabilities to private sector	**427.1**	**483.6**	**518.8**	**583.4**	**647.4**	**688.7**
Currency issued	605.7	660.3	730.3	780.7	866.3	921.6
Currency held by banks	-178.6	-176.8	-211.4	-197.3	-218.9	-232.9
III. Commercial Banks						
Net foreign assets	**952.6**	**1,199.0**	**1,388.9**	**1,306.0**	**979.9**	**954.3**
Net claims on ECCB	948.9	1,170.4	1,029.2	1,180.2	1,309.5	1,393.1
Net domestic credit	**5,048.6**	**5,496.1**	**6,116.1**	**7,033.0**	**8,272.9**	**8,889.1**
Net credit to the public sector	-248.9	-180.2	4.1	-95.6	-69.6	-96.5
Central government	523.3	522.0	667.1	691.5	819.1	792.2
Rest of the public sector	-772.3	-702.1	-663.0	-787.0	-888.7	-888.7
Credit to private sector	6,222.3	6,599.4	7,371.1	8,697.0	9,910.9	10,554.1
Other	-924.8	-1,069.6	-1,259.1	-1,568.5	-1,568.5	-1,568.5
Liabilities to the private sector	**6,950.0**	**7,865.6**	**8,534.2**	**9,519.1**	**10,562.2**	**11,236.4**
(Percentage growth compared to M2 at the beginning of the year)						
Memorandum items of the consolidated banking system:						
Net foreign assets	8.7	6.8	1.2	2.0	-1.2	0.9
Central bank	1.4	3.4	-1.1	2.9	2.0	1.1
Commercial banks	7.3	3.3	2.3	-0.9	-3.2	-0.2
Net domestic assets	0.8	6.4	7.2	9.6	12.2	5.5
Of which						
Net credit to the public sector	-1.9	0.0	2.5	-1.5	0.3	-0.2
Credit to the private sector	2.0	5.1	9.2	14.6	12.0	5.7
(Annual percentage change)						
Liabilities to the private sector (M2)	9.5	13.2	8.4	11.6	11.0	6.4
Private sector credit	2.2	6.1	11.7	18.0	14.0	6.5
Income velocity of broad money	1.1	1.1	1.1	1.1	1.0	1.0
Private sector credit/GDP (percent)	73.4	72.4	74.3	79.5	84.7	84.8
Broad money/GDP (percent)	87.0	91.6	91.3	92.3	95.8	95.8
Foreign currency deposits/GDP (percent)	11.5	12.9	14.2	16.1	16.7	16.7

Sources: ECCB; and Fund staff estimates.

1/ Includes the national insurance schemes.

Table 4. ECCU: Summary Balance of Payments, 2003–12

				Prel.	Proj.					
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
	(In millions of U.S. dollars)									
Current account	**-686.5**	**-475.2**	**-705.3**	**-948.3**	**-1,001.3**	**-994.2**	**-1,014.2**	**-1,047.0**	**-1,094.6**	**-1,145.1**
Trade balance	-1,181.4	-1,192.3	-1,397.3	-1,583.5	-1,677.2	-1,753.4	-1,863.4	-2,005.4	-2,149.6	-2,302.2
Exports	306.5	337.7	365.9	355.1	345.7	362.8	379.7	394.1	408.9	424.1
Imports	-1,487.8	-1,530.0	-1,763.2	-1,938.7	-2,022.9	-2,116.3	-2,243.1	-2,399.6	-2,558.5	-2,726.3
Services and income	365.7	497.1	511.2	482.6	509.8	588.4	667.4	761.7	845.8	934.6
Services	606.9	764.5	745.2	736.1	772.1	855.9	940.4	1,039.3	1,131.5	1,229.2
Transportation	-138.6	-138.9	-163.3	-178.2	-190.6	-202.8	-216.9	-232.2	-247.8	-264.3
Travel	852.7	956.3	1,000.9	1,041.7	1,081.8	1,170.7	1,262.0	1,369.3	1,470.9	1,579.4
Other services	-107.2	-53.0	-92.4	-127.4	-119.1	-112.0	-104.7	-97.8	-91.6	-85.9
Income	-241.2	-267.4	-234.0	-253.5	-262.3	-267.5	-273.0	-277.6	-285.7	-294.6
Current transfers	129.1	220.1	180.7	152.7	166.1	170.8	181.8	196.7	209.3	222.6
Capital and financial account	**720.9**	**581.5**	**683.7**	**1,042.7**	**1,075.8**	**1,040.5**	**1,068.1**	**1,104.9**	**1,163.4**	**1,220.4**
Capital transfers (net)	131.2	135.8	343.1	191.4	150.0	155.0	155.0	155.0	155.0	155.0
Financial account	589.7	445.8	340.6	851.3	925.8	885.5	913.1	949.9	1,008.4	1,065.4
Direct investment	555.6	449.0	536.8	849.9	731.4	777.5	793.2	804.8	819.8	865.5
Portfolio investment	150.9	72.5	29.2	16.6	25.0	30.0	33.0	36.3	39.9	43.9
Public sector long term	27.4	0.0	-140.1	28.1	48.7	68.5	58.2	81.1	100.4	108.2
Other public sector capital	0.0	0.0	5.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Commercial banks	-168.2	-98.8	-77.4	-24.5	120.8	9.5	28.8	27.9	48.3	47.9
Other capital 1/	23.9	23.1	-13.1	-18.8	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Overall balance	**34.4**	**106.3**	**-21.6**	**94.4**	**74.5**	**46.3**	**53.8**	**57.9**	**68.8**	**75.4**
Financing	**-34.4**	**-106.3**	**21.6**	**-94.4**	**-74.5**	**-46.3**	**-53.8**	**-57.9**	**-68.8**	**-75.4**
	(In percent of GDP)									
Current account	**-21.9**	**-14.1**	**-19.2**	**-23.4**	**-23.1**	**-21.6**	**-20.6**	**-19.8**	**-19.4**	**-19.1**
Exports	9.8	10.0	10.0	8.8	8.0	7.9	7.7	7.5	7.3	7.1
Imports	-47.4	-45.3	-48.0	-47.8	-46.7	-45.9	-45.5	-45.4	-45.4	-45.4
Services, incomes and transfers	15.8	21.3	18.8	15.7	15.6	16.5	17.2	18.1	18.7	19.3
Of which										
Travel	27.2	28.3	27.3	25.7	25.0	25.4	25.6	25.9	26.1	26.3
Current transfers	4.1	6.5	4.9	3.8	3.8	3.7	3.7	3.7	3.7	3.7
Capital and financial account	**23.0**	**17.2**	**18.6**	**25.7**	**24.8**	**22.6**	**21.6**	**20.9**	**20.6**	**20.3**
Of which										
Direct investment	17.7	13.3	14.6	21.0	16.9	16.9	16.1	15.2	14.5	14.4
Overall balance	**1.1**	**3.2**	**-0.6**	**2.3**	**1.7**	**1.0**	**1.1**	**1.1**	**1.2**	**1.3**
	(Annual percentage change)									
Exports	3.8	10.2	8.4	-2.9	-2.6	4.9	4.7	3.8	3.8	3.7
Imports	16.7	2.8	15.2	10.0	4.3	4.6	6.0	7.0	6.6	6.6
Travel (net)	18.0	12.2	4.7	4.1	3.9	8.2	7.8	8.5	7.4	7.4
Memorandum items:										
End-year gross reserves of the ECCB, US$ millions	539.9	632.4	600.8	696.0	770.5	816.8	870.6	928.5	997.3	1072.7
In months of current year imports	4.4	5.0	4.1	4.3	4.6	4.6	4.7	4.6	4.7	4.7
ECCU GDP at market prices, US$ millions	3140	3374	3672	4054	4336	4612	4934	5281	5636	6010

Source: ECCB; and Fund staff estimates and projections.

1/ Includes errors and omissions.

Table 5. ECCU: Selected Vulnerability Indicators, 2003–08

				Prel.	Proj.	
	2003	2004	2005	2006	2007	2008
Key economic and market indicators						
Real GDP growth 1/	3.2	3.6	5.2	5.9	4.1	3.3
CPI inflation, end of year (in percent) 1/	1.8	2.5	4.4	1.9	3.7	2.4
Interbank interest rate (in percent)	6.1	4.7	4.0	4.8	...	...
Exchange rate, EC$/US$ (end of period)	2.7	2.7	2.7	2.7	...	...
External sector						
Current account balance (percent of GDP)	-21.9	-14.1	-19.2	-23.4	-23.1	-21.6
FDI inflows (percent of GDP)	17.7	13.3	14.6	21.0	16.9	16.9
Export growth (f.o.b)	3.8	10.2	8.4	-2.9	-2.6	4.9
Travel (percent of GDP)	27.2	28.3	27.3	25.7	25.0	25.4
Terms of trade (12-month percentage change)	2.2	-5.3	-3.4	-6.4	...	...
Real effective exchange rate (1990=100) 1/	97.4	94.2	93.5	93.4	...	...
Gross international reserves (in US$ billion)	0.540	0.632	0.601	0.696	0.770	0.817
Net international reserves (in US$ billion)	0.537	0.631	0.597	0.693	0.768	0.814
Total gross external public debt (percent of GDP) 1/	65.6	65.7	57.1	54.3	51.9	53.4
Gross external financing requirement (in US$ billion) 2/	0.763	0.589	0.921	1.045	1.131	1.115
Consolidated public sector (percent of GDP) 1/						
Overall central government balance	-5.2	-4.3	-4.4	-5.8	-4.9	-5.3
Primary central government balance	-0.8	0.1	-0.3	-1.6	-0.5	-0.3
Central government current account balance	0.1	0.1	0.9	1.5	1.4	1.1
Public sector gross debt (end-of-period)	107.7	111.2	104.5	104.2	101.8	102.9
Public and private financial sector (in percent) 3/						
Capital adequacy ratio (indigenous banks, Tier I capital over risk weighted assets)	16.4	16.2	16.9	17.3	17.0	…
NPLs/total loans	12.7	11.9	9.4	7.6	6.8	…
Indigenous banks	16.9	15.6	11.7	9.5	8.4	…
Foreign banks	6.6	7.6	6.7	5.3	4.9	…
Loan loss provision/NPLs	32.8	34.7	34.9	31.6	30.4	…
Indigenous banks	28.0	31.3	33.2	26.8	26.2	…
Foreign banks	52.9	42.6	38.4	42.0	38.9	…
Loans to agricultural sector/total loans	4.0	4.0	3.6	3.0	2.8	…
Loans to tourism sector/total loans	7.5	7.7	8.0	9.6	10.3	…
Loans to household sector/total loans	48.4	47.5	47.5	45.3	43.7	…
Gross government claims/total assets	14.5	15.5	15.1	14.4	13.6	…
Government deposits/total deposits	17.2	16.8	17.1	17.8	17.8	…
FX deposits/total deposits	15.3	15.4	16.0	18.0	17.9	…
Liquid assets/total assets	34.1	36.6	37.0	27.0	26.2	…
Large loans and advances/total loans	28.4	28.7	28.2	29.5	31.0	…
Large deposits/total deposits	23.5	22.6	22.2	23.0	23.4	…
Risk-weighted assets/total assets	58.7	53.4	55.2	58.0	61.3	…
Contingent liabilities/capital (indigenous banks)	68.0	77.5	86.6	89.4	71.4	…
(Pre-tax) return on average assets	1.7	1.7	2.1	2.5	2.4	…
(Pre-tax) return on average equity	12.9	13.6	16.2	20.8	20.2	...
Memorandum items:						
ECCB reserve cover (in percent) 4/	95.3	96.2	96.5	98.7	...	...
ECCB gross reserves/broad money (in percent)	19.8	20.5	17.9	18.6	18.6	18.5

Sources: ECCB; and Fund staff estimates and projections.

1/ Excludes Anguilla and Montserrat.
2/ Defined as external current account deficit plus external amortization.
3/ Figures for 2007, as at end-September.
4/ Foreign assets as a percentage of demand liabilities.

Table 6. ECCU: Creditor Composition of Public Debt at End-2006 1/

(Share of total)

	Antigua and Barbuda	Dominica	Grenada	St. Kitts and Nevis	St. Lucia	St. Vincent and the Grenadines
External debt	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Central government	88.3	75.5	90.4	67.2	97.0	97.8
Multilateral	1.5	38.6	29.7	18.7	41.2	41.1
Official bilateral	17.8	18.3	17.0	8.1	7.1	12.8
Commercial	29.6	17.1	43.6	21.8	33.9	44.0
Other	0.0	0.0	0.0	18.7	14.9	0.0
Arrears, total	39.3	1.5	0.0	0.0	0.0	0.0
Other public sector	11.7	24.5	9.6	32.8	3.0	2.2
Domestic debt	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Central government	95.1	84.7	81.3	57.5	96.5	76.2
ECCB	0.3	5.7	1.0	0.9	0.6	0.0
Private domestic banks	17.3	23.7	60.0	36.4	60.7	34.9
Nonbank financial institutions	…	3.9	0.0	1.2	12.3	3.6
Insurance funds	…	39.4	0.0	1.1	8.3	3.6
Other	14.6	6.7	12.9	17.9	14.6	34.1
Arrears, total	63.0	5.4	7.4	0.0	0.0	0.0
Other public sector	4.9	15.3	18.7	42.5	3.5	23.8
Memorandum items:						
Public debt (percent of GDP)	105.3	102.5	117.8	184.6	66.8	78.0
Of which						
External debt	40.7	70.9	81.8	66.9	44.0	48.0
Public debt (millions of U.S. dollars)	1057.5	313.7	658.4	913.8	616.4	384.3
Of which						
External debt	408.8	222.4	457.2	331.0	406.4	236.5

Sources: ECCB; and Fund staff estimates.

1/ Excludes Anguilla and Montserrat.

Table 7. ECCU: Change In Net Investment Position, 2000–06
(In percent of GDP)

	2000	2001	2002	2003	2004	2005	Prel. 2006
Assets	8.41	10.06	11.02	12.12	11.44	23.29	8.06
Direct investment abroad	1.35	1.05	0.97	0.88	1.03	1.24	0.73
Portfolio investment abroad	0.20	0.41	1.38	0.53	0.98	1.17	1.16
Other Investment	6.86	8.59	8.67	10.71	9.42	20.88	6.17
Liabilities	22.82	23.95	26.92	33.01	24.10	30.73	31.01
Direct investment in the ECCU	12.74	13.88	12.40	18.57	14.34	15.86	21.70
Portfolio investment in the ECCU	2.66	2.32	6.95	5.34	3.13	1.97	1.57
Other investment	7.42	7.75	7.57	9.10	6.63	12.90	7.74
Net investment position	-14.40	-13.89	-15.90	-20.89	-12.66	-7.43	-22.95
Direct investment abroad	-11.38	-12.83	-11.43	-17.69	-13.31	-14.62	-20.97
Portfolio investment abroad	-2.46	-1.91	-5.57	-4.81	-2.15	-0.79	-0.41
Other Investment	-0.56	0.85	1.10	1.61	2.79	7.98	-1.57

Source: ECCB.

Appendix Table 1. ECCU: Public Sector Debt Sustainability Framework, 2002–12
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-Stabilizing Primary Balance 1/
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	
							I. Baseline Projections					
1 **Public sector debt 2/**	**106.3**	**107.7**	**111.2**	**104.5**	**104.2**	**101.8**	**102.9**	**102.9**	**102.7**	**102.8**	**103.4**	**-0.8**
Of which : Foreign-currency denominated	64.5	65.6	65.7	57.1	54.3	51.9	53.4	53.1	52.1	51.8	51.7	
2 Change in public sector debt	17.2	1.4	3.6	-6.7	-0.3	-2.5	1.1	0.1	-0.3	0.1	0.6	
3 Identified debt-creating flows (4+7+12)	9.5	0.7	-1.7	-4.4	-2.5	-1.9	-0.7	-0.9	-0.7	-0.2	0.2	
4 Primary deficit	6.4	0.9	-0.2	0.3	1.6	0.5	0.3	0.6	0.8	0.8	1.0	
5 Revenue and grants	27.4	28.6	28.1	29.6	30.7	30.2	29.1	28.4	28.1	28.1	28.0	
6 Primary (noninterest) expenditure	33.8	29.5	27.9	29.9	32.3	30.8	29.4	29.0	28.8	28.9	29.0	
7 Automatic debt dynamics 3/	3.1	-0.1	-1.4	-4.7	-4.1	-2.4	-0.9	-1.5	-1.5	-1.1	-0.8	
8 Contribution from interest rate/growth differential 4/	3.1	-0.1	-1.4	-4.7	-4.1	-2.4	-0.9	-1.5	-1.5	-1.1	-0.8	
9 *Of which* : contribution from real interest rate	3.9	3.1	2.3	0.6	1.6	1.6	2.2	2.2	2.4	2.8	3.0	
10 *Of which* : contribution from real GDP growth	-0.8	-3.2	-3.7	-5.3	-5.7	-4.0	-3.2	-3.7	-3.9	-3.8	-3.8	
11 Contribution from exchange rate depreciation 5/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
12 Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2–3) 6/	7.7	0.7	5.2	-2.3	2.2	-0.6	1.8	1.0	0.5	0.3	0.4	
Public sector debt-to-revenue ratio 2/	387.5	375.8	395.9	353.0	339.4	336.6	353.4	362.8	365.9	366.1	369.1	
Gross financing need 7/	**14.3**	**10.0**	**10.2**	**13.9**	**14.1**	**10.5**	**11.1**	**10.9**	**10.8**	**10.7**	**10.7**	
In billions of U.S. dollars	0.4	0.3	0.3	0.5	0.5	0.4	0.5	0.5	0.5	0.6	0.6	
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.9	3.2	3.6	5.2	5.9	4.1	3.3	3.9	4.1	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	4.7	4.4	4.5	4.0	4.4	4.5	5.2	5.3	5.4	5.6	5.8	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.4	3.1	2.3	0.7	1.8	1.8	2.4	2.4	2.7	3.0	3.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	0.3	1.2	2.2	3.3	2.6	2.7	2.8	2.9	2.8	2.6	2.6	
Growth of real primary spending (deflated by GDP deflator, in percent)	15.8	-9.0	-1.5	13.1	14.5	-0.5	-1.2	2.7	3.5	4.3	4.4	
Primary deficit	6.4	0.9	-0.2	0.3	1.6	0.5	0.3	0.6	0.8	0.8	1.0	
							II. Stress Tests for Public Sector Debt					
A. Alternative Scenarios												
A1. Scenario with key variables at their historical average in 2007–12 9/						101.8	104.3	105.9	107.0	108.0	109.0	-1.2
A2. No policy change (constant primary balance) in 2007–12						101.8	103.2	103.2	102.7	102.5	102.6	-0.8
A3. Scenario with natural disaster 10/						101.8	104.8	107.4	109.9	110.0	110.6	-0.9
B. Bound Tests												
B1. Real interest rate is at baseline plus one standard deviations						101.8	103.6	104.3	104.8	105.5	106.8	-0.3
B2. Real GDP growth is at baseline minus one-half standard deviation						101.8	104.5	106.4	108.2	110.8	114.2	0.2
B3. Primary balance is at baseline minus one-half standard deviation						101.8	104.0	105.1	105.8	106.9	108.5	-0.9
B4. Combination of B1-B3 using one-quarter standard deviation shocks						101.8	104.2	105.6	106.6	108.0	109.9	-0.1
B5. One time 30 percent real depreciation in 2006 11/						101.8	128.2	128.0	127.6	127.6	128.2	-1.0
B6. 10 percent of GDP increase in other debt-creating flows in 2006						101.8	113.0	112.9	112.5	112.5	113.0	-0.9

1/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.
2/ Defined as nonfinancial public sector debt.
3/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
4/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.
5/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
6/ For projections, this line includes exchange rate changes.
7/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
10/ Assumes that a hurricane hits half of ECCU countries increasing their primary deficit by three percent of GDP for 2008, 2009 and 2010, and reducing growth to zero.
11/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix Table 2. ECCU: External Debt Sustainability Framework, 2002–12
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						Debt-Stabilizing Noninterest Current Account 1/
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	
						I. Baseline Projections						
1 **External debt 2/**	**64.8**	**66.1**	**66.2**	**57.4**	**54.5**	**52.3**	**54.0**	**53.7**	**52.7**	**52.5**	**52.4**	**-19.1**
2 Change in external debt	12.3	1.3	0.1	-8.8	-2.9	-2.2	1.7	-0.3	-1.0	-0.3	-0.1	
3 Identified external debt-creating flows (4+8+9)	3.0	-2.8	-7.1	-10.3	-7.0	0.8	-0.4	-0.7	-0.4	0.2	0.1	
4 Current account deficit, excluding interest payments	18.2	20.6	12.3	18.2	23.0	22.6	21.0	19.9	19.1	18.6	18.1	
5 Deficit in balance of goods and services	16.0	19.3	13.5	18.9	22.5	22.5	21.0	20.2	19.8	19.6	19.3	
6 Exports	51.6	52.9	56.8	54.8	51.9	50.5	50.5	50.3	50.1	50.0	49.9	
7 Imports	67.6	72.2	70.3	73.7	74.4	73.0	71.6	70.6	69.9	69.5	69.2	
8 Net nondebt creating capital inflows (negative)	-16.7	-23.1	-18.4	-25.5	-27.6	-21.9	-21.8	-20.8	-19.7	-18.7	-18.4	
9 Automatic debt dynamics 3/	1.5	-0.3	-1.0	-3.0	-2.4	0.1	0.5	0.3	0.2	0.3	0.4	
10 Contribution from nominal interest rate	2.2	2.5	2.7	2.3	2.2	2.2	2.1	2.2	2.3	2.3	2.4	
11 Contribution from real GDP growth	-0.5	-2.0	-2.3	-3.1	-3.1	-2.1	-1.6	-2.0	-2.0	-2.0	-2.0	
12 Contribution from price and exchange rate changes 4/	-0.2	-0.8	-1.4	-2.1	-1.4	...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 5/	9.3	4.0	7.3	1.5	4.1	-3.1	2.1	0.4	-0.6	-0.5	-0.2	
External debt-to-exports ratio (in percent)	125.7	124.9	116.7	104.8	105.1	103.5	106.8	106.7	105.3	105.0	105.0	
Gross external financing need (in billions of U.S. dollars) 6/	**0.7**	**0.8**	**0.7**	**1.1**	**1.1**	**1.3**	**1.2**	**1.2**	**1.3**	**1.3**	**1.4**	
In percent of GDP	25.0	28.2	22.2	32.9	30.3	31.3	28.9	27.4	26.4	25.7	25.0	
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	0.9	3.2	3.6	5.2	5.9	4.1	3.3	3.9	4.1	4.0	4.0	
GDP deflator in US dollars (change in percent)	0.3	1.2	2.2	3.3	2.6	2.7	2.7	2.9	2.7	2.6	2.5	
Nominal external interest rate (in percent)	4.2	4.0	4.4	3.7	4.1	4.4	4.7	4.7	4.7	4.9	5.1	
Growth of exports (US dollar terms, in percent)	-3.5	8.1	14.2	5.2	3.2	4.1	6.1	6.4	6.4	6.4	6.4	
Growth of imports (US dollar terms, in percent)	-1.3	12.5	3.6	14.3	10.1	4.9	4.0	5.4	5.9	6.1	6.1	
Current account balance, excluding interest payments	-18.2	-20.6	-12.3	-18.2	-23.0	-22.6	-21.0	-19.9	-19.1	-18.6	-18.1	
Net nondebt creating capital inflows	16.7	23.1	18.4	25.5	27.6	21.9	21.8	20.8	19.7	18.7	18.4	
						II. Stress Tests for External Debt Ratio						
A. Alternative Scenarios												
A1. Scenario with key variables at their historical averages in 2007–12 7/						52.3	55.4	54.2	51.9	49.8	47.8	-21.2
A2. Natural disaster scenario 8/						52.3	56.7	59.2	62.8	63.5	63.5	-19.3
A3. FDI is at historical average minus one standard deviation						52.3	57.5	59.2	59.0	58.5	57.9	-16.4
B. Bound Tests												
B1. Nominal interest rate is at baseline plus 400 basis points						52.3	56.3	58.3	59.6	61.4	63.5	-17.1
B2. Real GDP growth is at historical average minus one-half standard deviations						52.3	55.6	56.6	57.7	59.3	60.9	-17.6
B3. Non-interest current account is at historical average minus one-half standard deviations						52.3	55.8	57.2	57.8	59.1	60.6	-19.2
B4. Combination of B1–B3 using 1/4 standard deviation shocks						52.3	55.7	57.1	58.2	60.0	62.0	-18.0
B5. One time 30 percent real depreciation in 2008						52.3	74.1	71.0	68.6	67.1	66.0	-28.2

1/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

2/ Defined as nonfinancial public sector debt. Information on private sector external borrowing is not available.

3/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in U.S. dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

4/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

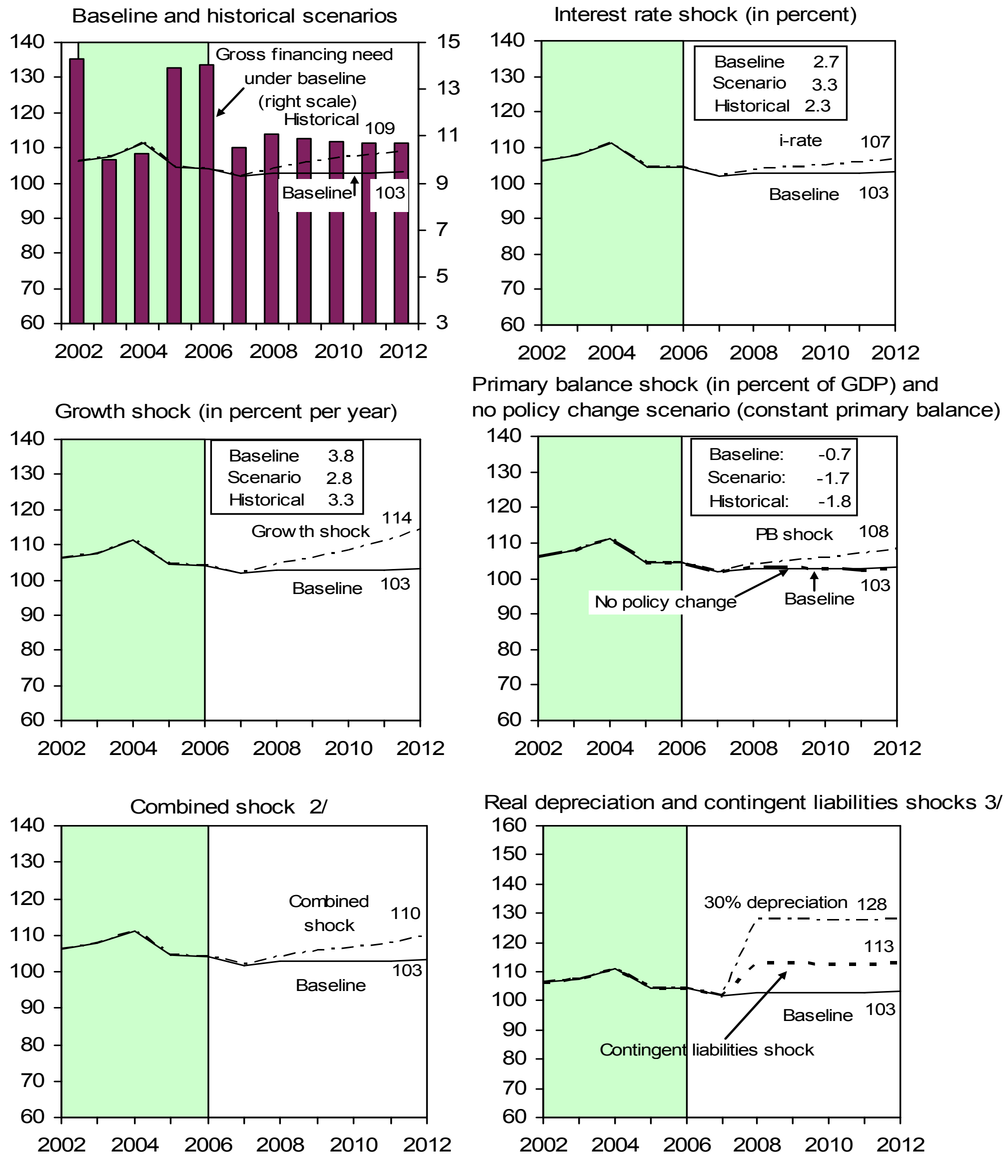
5/ For projection, line includes the impact of price and exchange rate changes.

6/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both noninterest current account and nondebt inflows in percent of GDP.

8/ Natural disaster impacting half the countries in the region, increasing the regional CA deficit by 4 percent of GDP in 2008, 2009 and 2010, and reducing growth by an average of 1.6 percentage points for the same period. These parameters are taken from the median impact of 12 large natural disasters in the ECCU (Rasmussen, WP/04/224).

Appendix Figure 1. ECCU: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



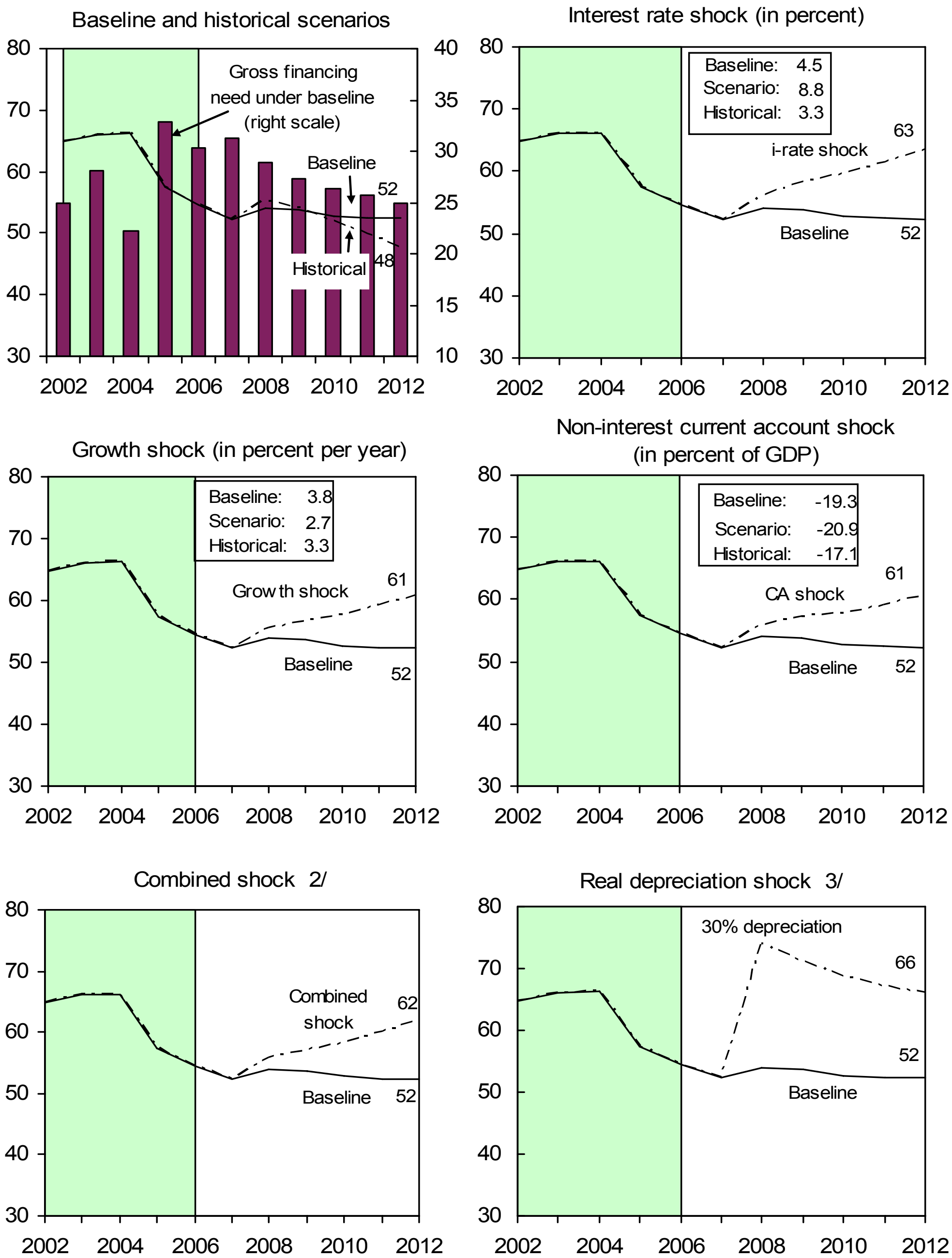
Sources: International Monetary Fund, country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2008, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Appendix Figure 2. ECCU: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and Fund staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2008.

ANNEX I. SUMMARY OF APPENDICES

The full appendices to this report are issued as a supplement.

Fund relations. The Eastern Caribbean Currency Union, consists of eight members that have a common currency, monetary policy, and exchange system. The common currency, the EC dollar, has been pegged to the U.S. dollar at the rate of EC$2.70 since July 1976. The region has a common central bank, the Eastern Caribbean Central Bank (ECCB), which has operated like a quasi-currency board, maintaining foreign exchange backing of its currency and demand liabilities close to 100 percent. The exchange system is free of restrictions on the making of payments and transfers for current international transactions. A safeguards assessment was completed recently, and concluded that the ECCB continues to have appropriate control mechanisms in place.

Relations with the World Bank Group. The country assistance strategy (CAS) for FY06−09 supports the region's development through: (1) stimulating growth and improving competitiveness; and (2) reducing vulnerability. Efforts in the area of growth are focused on a series of analytical and advisory activities. On reducing vulnerability, the Bank has facilitated the establishment and participation of OECS countries in the regional Caribbean Catastrophic Risk Insurance Facility. The CAS proposes a total lending envelope of US$103.4 million.

Relations with the Caribbean Development Bank. Between 1970-2005, the CDB approved loans of US$1027 million to the ECCU, of which US$793.1 million has been disbursed as of end-November 2007. Most of the CDB's interventions in the OECS have been directed toward infrastructural development, related to the incidence of natural disasters in the region as well as the need to ensure infrastructure improvements for productive investments. In 2006, the CDB expanded its range of instruments to include policy-based lending, to support policy reforms and/or institutional changes. St. Kitts and Nevis has received approval for the facility, but is yet to receive any funds.

CARTAC Capacity Building in the ECCU. CARTAC's core areas of TA include financial management, which includes tax policy and administration, public finance management, macroeconomic management and financial programming, financial sector supervision (including the non-bank financial sector and capital markets) and economic and financial statistics. ECCU countries have been among the most active countries in requesting TA and training in all of CARTAC's core areas. As in previous years, the largest areas of CARTAC involvement in the ECCU countries have been in VAT implementation and in building capacity to undertake improved macroeconomic management. This TA support has represented a significant addition to the Fund's TA to the ECCU region.

ANNEX II. ECCU: ANALYTICAL WORK

Analytical work by Fund staff has contributed to strengthening public dialogue on key issues in the ECCU.[34] Recent ECCB Monetary Council and national policy discussions have drawn heavily on input from Fund staff, including on the pricing of petroleum products, design of fiscal benchmarks, tax reforms, response to preference erosion, monetary policy initiatives, and social security reform.[35] The authorities have appreciated the increased emphasis given to regional issues as well as the focus on growth and vulnerabilities—particularly high public debt levels, natural disasters, and the repercussions of declining official assistance and trade preferences.

Ongoing Analytical Work (to be published as 2007 *ECCU Selected Issues* chapters and IMF Working Papers in 2008):

- Assessing Exchange Rate Competitiveness in the Eastern Caribbean Currency Union
- Price Dynamics in the Eastern Caribbean Currency Union
- The ECCB: Challenges to an Effective Lender of Last Resort
- How Vulnerable is the Eastern Caribbean Currency Union to a Banking Crisis?
- Tourism Demand in Small-Island Economies
- Corporate Income Tax Competition in the Caribbean
- Can the ECCU Afford to Grow Old?
- Financing Universal Health Care: Lessons for the Eastern Caribbean and Beyond.

Past Analytical Work (2006 *ECCU Selected Issues* chapters, unless otherwise denoted):

- *The Caribbean: From Vulnerability to Sustained Growth* (2006 IMF book)
- Income Dispersion and Co-Movements in the Eastern Caribbean Currency Union
- The Macroeconomic Impact of Trade Preference Erosion on the Windward Islands
- The Size of the Informal Economy in the Caribbean
- Social Security in the Eastern Caribbean Currency Union
- Domestic Investment and the Cost of Capital.

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[34] Outreach activities traditionally include the presentation of staff's preliminary analytical work to the authorities, civil society, academics and the general public in each of the six Fund-member ECCU countries, the Eastern Caribbean Central Bank (ECCB), and at academic conferences and workshops held in the region.

[35] All Fund papers (published since 2004) on each of the six Fund-member ECCU countries are available on the ECCB website. The link is http://www.eccb-centralbank.org/Publications/imfpapers1.asp .

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FOR IMMEDIATE RELEASE
February xx, 2008

IMF Executive Board Concludes 2007 Discussion on Common Policies of Member Countries of the Eastern Caribbean Currency Union

On February 4, 2008, the Executive Board of the International Monetary Fund (IMF) concluded the 2007 Discussion on Common Policies of Member Countries of the Eastern Caribbean Currency Union (ECCU).[36]

Background

Economic activity in the ECCU remains robust, despite high oil prices and the ongoing erosion of European Union trade preferences. Real GDP growth was close to 6 percent in 2006, its strongest rate in more than 15 years, driven by tourism and construction ahead of the 2007 Cricket World Cup. Private construction activity remains the main driver of economic growth, which is expected to reach around 4 percent in 2007, despite disappointing tourism arrivals and the damage caused by Hurricane Dean in August 2007. With most economies operating close to their potential, rising food and energy import prices, and ongoing depreciation of the U.S. dollar, inflation has picked up and is likely to reach about 3¾ percent by end-2007, nearly twice the level of 2006.

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[36] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. 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.

Despite the implementation of ambitious revenue reforms, limited progress has been made towards fiscal consolidation. While stronger growth, administrative efforts, and tax policy reforms (particularly the introduction of VATs) have improved tax revenues, a surge in capital spending associated with the Cricket World Cup led to a deterioration of fiscal balances in 2006. Revenues are likely to remain strong in 2007 yet expenditure pressures remain, and overall fiscal deficits are expected to average about 5 percent of GDP in 2007. Despite debt restructurings in several countries, public sector debt is projected at 102 percent of GDP at end-2007.

The financial system remains resilient, despite the recent global financial turbulence. Significant progress has been made in strengthening banking sector supervision, highlighted by the passage of the uniform Banking Act in all ECCU jurisdictions, strengthened off-site reporting by banks, and the issuance of new prudential guidelines. However, the rapidly-growing nonbank financial sector remains largely unsupervised, with a functioning single regulatory unit (SRU) established only in Grenada, and SRU-enabling legislation remains to be passed in other ECCU jurisdictions.

Prudential indicators suggest a modest strengthening of the financial sector, but vulnerabilities remain. Monetary aggregates continue to expand rapidly, with strong growth in credit to the private sector. Nonperforming loans (NPLs) of local banks continue their declining trend, and are close to the ECCB’s prudential target of 5 percent (of total loans). However, provisioning has continued to fall, and exposures to government remain high, largely concentrated in some state-owned local banks.

The external current account deficit widened in 2006 to over 23 percent of GDP—financed mostly by foreign direct investment. In 2007 the current account deficit is expected to narrow, due to the slowing of Cricket World Cup-related imports. Gross international reserves continue to grow, with the reserve coverage of monetary demand liabilities now close to 100 percent—well above the central bank’s legally-mandated floor of 60 percent. Since end-2001, the Eastern Caribbean dollar’s real effective exchange rate has depreciated by almost 14 percent (up to September 2007), and is currently at its most depreciated level in almost 20 years.

Executive Board Assessment

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Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Eastern Caribbean Currency Union: Selected Economic Indicators, 2004–08

	2004	2005	2006	Proj. 2007	Proj. 2008
	(Annual percentage change)				
National Income and Prices 1/					
Real GDP	3.6	5.2	5.9	4.1	3.3
GDP deflator	2.2	3.3	2.6	2.7	2.8
Consumer prices, average	2.1	3.1	3.4	3.6	2.6
	(In percent of GDP)				
Public finances 1/					
Overall central government balance	-4.3	-4.4	-5.8	-4.9	-5.3
Total revenue and grants	28.1	29.6	30.7	30.2	29.1
Total expenditure and net lending	32.4	34.0	36.5	35.2	34.4
Total public sector debt (end-of-period)	111.2	104.5	104.2	101.8	102.9
	(In percent of GDP, unless otherwise indicated)				
External sector					
Current account balance	-14.1	-19.2	-23.4	-23.1	-21.6
Trade balance	-35.3	-38.0	-39.1	-38.7	-38.0
Travel	28.3	27.3	25.7	25.0	25.4
Exports, f.o.b. (annual percentage change)	10.2	8.4	-2.9	-2.6	4.9
Imports, f.o.b. (annual percentage change)	2.8	15.2	10.0	4.3	4.6
Stayover visitors (annual percentage change)	10.0	0.4	3.4	…	…
Terms of trade (12-month percentage change) 2/	-5.3	-3.4	-6.4	…	...
Real effective exchange rate (annual percentage change) 1/ 3/	-3.3	-0.7	-0.1	…	…
End-year gross foreign reserves of the ECCB					
In U.S. dollars million	632.4	600.8	696.0	770.5	816.8
In months of imports	5.0	4.1	4.3	4.6	4.6
In percent of broad money	20.5	17.9	18.6	18.6	18.5
External public debt (end-of-period)	65.7	57.1	54.3	51.9	53.4
	(Percentage change)				
Money and credit					
Net foreign assets 4/	6.8	1.2	2.0	-1.2	0.9
Net domestic assets 4/	6.4	7.2	9.6	12.2	5.5
Broad money	13.2	8.4	11.6	11.0	6.4

Sources: ECCU country authorities; ECCB; and Fund staff estimates and projections.

1/ Excludes Anguilla and Montserrat. ECCU aggregates are calculated as weighted averages of individual country data; rations to GDP are then calculated by dividing this sum by the aggregated GDP of the region.

2/ Excludes Anguilla and Montserrat.

3/ End-of-period (depreciation -), 1990=100.

4/ In relation to broad money at the beginning of the period.