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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 08/69-3

3:55 p.m., July 25, 2008

3. Barbados—2008 Article IV Consultation

Documents: BUFF/08/109; SM/08/230 and Correction 1 and Supplement 1; SM/08/239

Staff: Daseking, WHD; Espinosa, MCM; Fetherston, PDR

Length: 25 minutes

Executive Board Attendance

M. Portugal, Acting Chair

Executive Directors	Alternate Executive Directors
	S. Itam (AE)
L. Rutayisire (AF)	
	D. Vogel (AG), Temporary
	Y. Ha (AU), Temporary
	M. Jakoby (BE), Temporary
	A. Joseph (BR), Temporary
	J. He (CC)
	R. Lin (CC), Temporary
J. Rojas (CE)	
J. Fried (CO)	
	M. Jakubowicz (FF), Temporary
	F. Haupt (GR), Temporary
	P. Ray (IN), Temporary
	V. Crispolti (IT), Temporary
	N. Imamura (JA), Temporary
	A. Mohammed (MD), Temporary
	H. Caracalla (MI), Temporary
	T. Galac (NE), Temporary
	B. Ólafsson (NO), Temporary
	A. Shabunina (RU), Temporary
	S. Alnefaee (SA), Temporary
	C. Sucharitakul (ST)
	N. Raman (ST), Temporary
	P. Gasiorowski (SZ), Temporary
	M. Kaplan (UA), Temporary
	H. Robinson (UK), Temporary

P. Bradley, Acting Secretary
J. Young, Assistant

Also Present
IBRD: M. Arena Buffoo. Monetary and Capital Markets: M. Espinosa, G. Gasha, C. Medeiros. Policy Development and Review Department: E. Cerutti, M. Fetherston. Secretary's Department: P. Cirillo, P. Martin. Western Hemisphere Department: T. Alleyne, P. Cashin, C. Daseking, G. El-Masry, A. Guerson, M. Kandil, S. Panth, C. Pattillo, N. Wagner. Senior Advisors to Executive Directors: P.Musinguzi (AE), J. Perrault (CO). Advisors to Executive Directors: Y. Alvarez (CO), A. Matoto (ST), E. Ndong Ondo Bilee (AF).

3. BARBADOS—2008 ARTICLE IV CONSULTATION

The staff representative from the Western Hemisphere Department (Ms. Daseking) submitted the following statement:

> This statement updates the Board on developments in Barbados since the issuance of the staff report (SM/08/230), including the main policy initiatives announced in the Prime Minister's budget presentation on July 7, which do not change the thrust of the staff appraisal.
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> Recent data are consistent with the staff's projections for 2008. The latest national accounts estimates confirm the staff's projections of a significant slowdown in economic activity in 2008. Following a buoyant first quarter, preliminary data for the second quarter suggest a marked weakening in growth, led in particular by the construction and tourism sectors. Accordingly, the authorities now expect the economy as a whole to grow by 2–2½ percent during 2008, consistent with staff projections of 2.3 percent. The authorities also expect an acceleration in inflation to about 8 percent (compared with 9 percent projected by staff).
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> The revised budget proposals are also broadly consistent with the fiscal stance for FY 2008/09, as presented in the staff report. The new proposals include increases in taxes on alcohol, tobacco, and gambling, and a wide range of nontax revenues, such as fees on vehicles, professional services, and mobile telephones. These measures are estimated by the authorities to provide additional revenue of about 1.3 percent of GDP on an annual basis. The government proposes to use this fiscal space to finance additional expenditures and tax rebates to targeted groups, estimated to cost 1.1 percent of GDP. These expenditures include: raising the old-age pensions and welfare payments to low-income recipients; providing free bus transportation for school children; zero-rating of VAT for building materials for low-income housing; and supporting agriculture, energy conservation, and alternative energy production. Incorporating these measures into the revised projections for the central government balance implies a deficit of 2 percent of GDP in FY 2008/09, slightly lower than the deficit projected in the staff report of 2.2 percent of GDP.
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> The government has also decided to adopt an automatic adjustments for fuel prices. Effective August 2008, prices on

petroleum products and natural gas will be regularly adjusted on the basis of a predetermined formula, and without any political involvement. Accordingly, fuel prices are expected to be increased in August, and such regular adjustments are likely to prevent a deterioration in the overall public sector balance that would have otherwise occurred as a result of losses by the National Oil Company.

Mr. Fried and Mr. Perrault submitted the following statement:

Barbados' authorities thank the staff for the high quality dialogue in both the Article IV consultation and the FSSA – Update. I am pleased to report that there has been a fair amount of consensus between the authorities and the staff, and the authorities have already launched an aggressive effort to safeguard Barbados' short and long-term prospects.

Barbados' new government has identified the four major issues that will affect economic outcomes in the near-future: a slowdown in the tradables sector (notably tourism), vulnerabilities arising from elevated food and energy prices, a high national debt and fiscal deficit, and an insufficient supply of housing for low and lower middle income families. Addressing these issues is at the heart of the government's policy program, which considers both aggressive and innovative responses to these challenges. Most importantly, the government's plan rests on extensive national consultations. This will ensure a high degree of ownership of the reforms.

Barbados has been affected significantly by the global economic turmoil. Growth has slowed to an estimated 1.8 percent in the first half of the year from an average rate of expansion of 4.2 percent in the corresponding periods between 2004 and 2007. Some of this slowdown reflects a reduction in construction and tourism activity following Cricket World Cup (CWC) 2007, but the downturn has affected sectors of the economy that benefited marginally from the CWC. In tandem, rising commodity prices have led to a surge in inflation, with year-over-year inflation rising to 5.0 percent in March 2008 from 2.9 percent in September 2007.

The authorities' fiscal plans are based on the March WEO forecasts for the world economy. They thus consider the staff's estimate for growth in 2008 of 2.3 percent roughly balanced. Based on the updated WEO forecasts, however, there is increasing optimism that the economic deterioration in the United States and other important trading partners will not be as harmful as assumed in the budget. Indeed, while tourist arrivals are well below the CWC-inflated numbers registered a year ago, tourist arrivals have shown a surprising degree of strength thus far in 2008. Accordingly, there is reason to believe that the economic scenario used for fiscal planning purposes is conservative, and that the authorities will meet their fiscal objectives.

There is a consensus in Barbados that the fiscal situation is untenable over the medium term. While constrained by the need to support families at the lower end of the income scale, the government has nevertheless identified a number of measures to boost revenues, while at the same time increasing its support for the poor. On the revenue side, the government has increased fees and excise taxes on a range of activities, and has also modified the refined petroleum and LPG pricing regimes to make them more responsive to market developments. Equally importantly, the government has increased various outlays aimed at supporting less well-off Barbadians. This includes, inter alia, substantial cuts to the VAT on housing for lower income housing. On balance, these changes to revenues and expenditures will lead to a significant improvement in government finances in the near term. Given the importance they attach to medium-term fiscal sustainability, they are committed to ensuring that fiscal policy is appropriately geared to this objective in future budgets.

Inflation has accelerated quickly in Barbados, owing to both the rise of commodity prices and an acceleration of inflation in Barbados' major trading partners. A substantial portion of the rise also reflects the authorities' decision to remove the subsidies on petroleum products as of April. My authorities expect a further acceleration of inflation by year-end, with the moving average rate of inflation predicted to be 7.9 percent. Despite the rise in food and energy prices, core inflation remains well-contained, and there are no indications that second round-effects are at play. Nevertheless the authorities agree with staff that it is important to take account of these potentially damaging second-round effects in the ongoing national wage negotiations.

The Central Bank of Barbados has limited tools at its disposal to counter the inflationary surge, but is has managed to maintain a comparatively tight monetary policy relative to the United States, the currency against which it is fixed. As indicated in the staff report, the

Central Bank does have the scope to reduce interest rates if economic conditions warrant, but will not do so at the expense of accelerating inflation. In this light, the Central Bank is keeping a watchful eye on inflation expectations and stands ready to move aggressively if there is evidence that these are becoming unhinged.

Moving beyond these immediate policy challenges, the government has launched an ambitious program aimed at diversifying the economy with minimal public funds. Among the many reforms being implemented are: opening the distributive sector to international competition, which is expected, among other effects, to increase competition in the food sector; increase the use of technology in the agricultural sector; improving irrigation and increasing the amount of arable land; encouraging the development of fish farming by eliminating the duties on inputs to this sector; increasing the availability of student loans, and focusing on measures to encourage overseas Barbadians to increase their investments in Barbados.

As a matter of urgency, the government is committed to improving the accuracy of its national statistics. With the generous technical assistance of the Inter-American Development Bank, the authorities will improve the accuracy of unemployment statistics. A beneficial result will be an improved retail price index that will better capture the price of services and allow its composition to change through time to reflect changing consumption patterns. Perhaps most critically, the traditional measure of the public debt makes no allowance for the guarantees the government gives to government-owned corporations. The statistical modernization program will address this deficiency.

Barbados' authorities welcome the findings of the FSSA update, and agree with its conclusions that the banking system is sound, profitable, and able to weather moderate shocks. The staff report identifies some room for improvement in the areas of financial sector regulation and supervision. Given that the government has been elected recently, these conclusions will be carefully examined by them. Since the authorities' aim is to maintain Barbados' standing as a world-class financial centre, they are committed to improving financial sector regulation and supervision as necessary. As noted in the staff report, Barbados has implemented a number of the recommendations made in the 2002 FSAP, and they will take the Update equally seriously.

My Barbados' authorities value the staff's constructive engagement in this Article IV consultation, and they look forward to continued meaningful dialogue with the staff as they proceed with their ambitious reform agenda.

Mr. Yamaoka submitted the following statement:

We thank the staff for their informative report. We also thank Mr. Fried and Mr. Perrault for their helpful statement, which informed us that, so far in 2008, tourist arrivals have shown strength. We agree with the thrust of the staff appraisals.

Inflation

As in many countries, the co-existence of upward pressures on prices and downward pressures on real economic activities imposes a heavy burden on the authorities' macroeconomic policies. The pegged exchange rate regime, which has been the only feasible option for the authorities, due to the nation's economic size and geographic location, increases the difficulties in policy conduct.

The Staff Report states that monetary policy should aim at containing inflation expectations, and we also concur with the importance of stabilizing inflation expectations. Having said that, the key challenge, not only to Barbados but also to many countries, is how to stabilize inflation expectations. Moreover, the following factors may also constrain monetary policy conduct.

Although the authorities maintain a comparatively tight monetary policy following U.S. rate cuts only partially, Barbados' subsequent decline in nominal interest rates and increase in inflation have inevitably led to a substantial decline in real interest rates. (According to Taylor's principle, simply "resisting" interest-rate reductions would not be effective enough to contain inflation expectations.)

Since food and fuel occupy a substantial share of the household expenditures basket, increases in food and fuel prices might affect inflation expectations, unless regarded as only temporary.

Due to the limited availability of reliable data on inflation expectations, it is not always easy for central banks to examine whether inflation expectations are really contained or not.

In light of the above, we would welcome if the staff could make some practical recommendations to overcome these constraints in order to contain inflation expectations.

Fiscal Policy

Taking into account the limited maneuvers of the nation's monetary policy, fiscal policy should bear the burden of stabilizing both inflation and the real economy. Thus, we would like to encourage the authorities to execute fiscal tightening, while making well-targeted expenditures so as to enhance productivity, broaden the country's industrial base and support the poor. It would also be critical to contain wage growth in line with productivity growth. We welcome the government's efforts to make the refined petroleum pricing regimes more responsive to market developments.

Financial Sector

We welcome the soundness and profitability of the banking sector. Having said that, the profitability of the banking sector may partly be supported by a large margin between loan rates (10.5 percent) and deposit rates (4.75 percent), which reflects the institutional framework of the nation's financial system. Such a large margin, as well as multiple reserve requirements, may bring about some counter-effects, such as inefficiency in fund intermediation, we would like to encourage the authorities to further improve supervisory and regulatory frameworks.

With these remarks, we wish the authorities every success in their future endeavors.

Ms. Agudelo and Mrs. Joseph submitted the following statement:

We thank staff for a detailed set of papers and Mr. Fried and Mr. Perrault for their helpful buff statement.

The Barbadian economy gave a solid performance in 2007, fueled in the main by activity in the non-traded sectors, and accompanied by modest inflation, a decline in the current account deficit and an increase in the fiscal deficit. During the first half of 2008, economic activity slowed to less than half of that recorded for the first six months of 2007, with lower rates of growth in both the tradable and non-tradable sectors. Modest growth is expected for the rest of 2008 and in 2009, as the global economic slowdown, particularly in the US and UK, is expected to lead to a moderation in tourist receipts and FDI inflows to the luxury housing market. It is also anticipated that inflationary pressures will heighten, as a result of the impact of higher energy and food prices (the new government reduced the level of subsidies on petroleum products in April).

In the current international environment, the authorities should initiate the right combination of policies to damp inflationary pressures without stalling the growth momentum and to limit any increases in the fiscal deficit in the face of a high debt-to-GDP ratio. Although Mr. Fried and Mr. Perrault reported that tourists' arrivals have shown some resilience, the current account deficit is projected to remain at the current levels against the background of high food and energy prices. Wisely, the new government has already adjusted the fiscal position so that the original budget deficit of 4 percent of GDP should be reduced to 2.2 percent of GDP in 2008/09. In addition, the authorities have made good on their promise to include further measures to realize fiscal savings in the revised budget presented in early July. These included hikes in fees with respect to the use of the highways, the licensing of financial institutions and use of mobile phones. This, together with a monthly adjustment to domestic energy prices to reflect the price paid by importers based on a formula, should prevent a widening of the fiscal deficit.

Given the uncertainties in international financial markets, it is sensible for the authorities to delay the planned liberalization of the capital account until the situation stabilizes and improves. As recommended by staff, the central bank should continue their preparations to move toward more market-based instruments to conduct monetary policy in light of the expected removal of exchange controls for regional transactions later this year. We advise the authorities to keep an open mind with respect to the use of direct instruments as often, a more effective monetary policy stance utilizes a combination of both sets of instruments in developing economies like Barbados. The lowering of interest rates appeared not to have impacted significantly on demand as private sector credit growth is moderate. In this regard, we endorse the authorities' current policy, unless economic activity slows more than expected.

With regard to the latter, we welcome the moves by the government to pursue aggressively measures to diversify the economy, as stated by Mr. Fried and Mr. Perrault. There is some concern that the upcoming wage negotiations may fuel inflationary pressures. However, the government's consultations with business and trade unions in the past have been successful with respect to wage moderation. It is anticipated that there will be a similar outcome following consultations held with these stakeholders in June. Can staff provide an update? Moreover, the government has taken steps to mitigate the impact of the decline in real incomes of the more vulnerable groups in the society through the introduction of certain social assistance programs in the revised budget.

6.The authorities have actively taken on board the recommendations made in the 2002 FSAP and significant progress has been made. The regulator is moving toward a risk-based supervisory framework, training of staff has intensified and a deposit insurance scheme has been introduced. In addition, the authorities have wisely insulated the domestic financial system from the offshore financial sector with strict legal provisions, which should continue to protect the onshore sector from contagion risks. The soundness and stability of the financial system is critical to the future of the Barbadian economy and we are certain that the authorities have taken note of the recommendations of the 2008 FSAP Update and will continue to strengthen the supervisory and regulatory framework based on the expert advice given.

With these remarks, we wish the authorities all success in overcoming the challenges that lie ahead.

Mrs. Sucharitakul and Ms. Matoto submitted the following statement:

We thank the staff for the well-written set of papers and Messrs Fried and Perrault for their helpful buff statement.

We commend the Barbados' authorities for the fairly robust economic performance despite the heightened global uncertainties. Like many in the Fund's membership, the economy faces near-term challenges from exogenous price shocks and weakening global environment. Looking ahead, we agree that growth is likely to slow in 2008 as a result of spillovers from the economic slowdown in advanced economies, and there could be attendant consequences on prices, the fiscal position and external balances.

In our statement last year, we characterized the fiscal position in Barbados as perhaps not as strong as it could be, putting the country at some risk if benign conditions did not persist. We regret that the benign period appears to have come to an end, which would imply fiscal consolidation at a time of cyclical weakness. The actions taken so far, including the aim to reduce the deficit and the removal of universal subsidies for fuel and petroleum products, in favour of targeted assistance, will certainly help build medium-term resilience. However, we agree with staff that more ambitious plans are called for. In that regard, we found staff's suggestions on where there may be scope for expenditure reductions and revenue improvements very useful. Those that could command significant public support, most notably removing the cap on property taxes, would not likely hit Barbadians, could be implemented quickly. We invite staff to elaborate on areas that might be prioritized by the authorities in their efforts to build consensus. Generally, while we welcome the authorities' intentions to raise revenues through the implementation of new fiscal measures, we are less convinced that non-tax measures will deliver the improvements the authorities will need. On the expenditure side, the authorities need to enforce tighter fiscal discipline to ensure that spending is within allocations. To mitigate second-round effects of oil and food price shocks, there may need to be some restraint on the public sector wage bill. We would be interested to hear from the staff about the outcome of wage negotiations.

The other key issue in Barbados is in dealing with the large external debt burden. While the authorities have moved forward in fiscal consolidation, the debt burden has not fallen appreciably. The arithmetic is irrefutable; a stronger fiscal consolidation effort is needed if the debt is to be placed on a downward path. In addition, we welcome the authorities' intention to revisit off-budget projects and deficits in public enterprises, seeing as how this has impacted the debt. We would be interested in understanding what the staff's assumptions on the financial positions of these public enterprises are over the medium term.

We commend the authorities for appropriately being more circumspect in the face of the aggressive easing of US monetary policy. We note from the staff report that the authorities stand ready to reduce interest rates further, if required, should there be a slowdown in economic activity. Growth concerns appear to have eased and the authorities are now appropriately focused on inflation, as noted by Messrs Fried and Perrault. We welcome their reassurances that the authorities are closely monitoring the inflation developments and stand ready to move aggressively if the situation deteriorates. In this context, the moderate growth in private sector credit is a hopeful sign of the efficacy of the higher lending rates. We also take note of the CBB's influence over its monetary policy through exchange controls and multiple reserve requirements, which have helped the central bank deal with the current uncertainties.

We are pleased that the financial system has shown resilience notwithstanding the global turmoil, and the banking sector appears to be sound and profitable. The FSSA Update comes at a useful time, allowing the authorities to not only take stock of their action plans identified under the initial assessment, but also to better prepare themselves for potential future challenges. While we note that there has been considerable progress made since the 2002 assessment, a considerable portion of the recommendations remain unimplemented. Taken together with the new recommendations in the FSSA Update, the authorities will have quite a work program ahead of them. In particular, we would prioritize bringing the insurance sector and credit unions fully into the formal regulatory umbrella; and strengthening cross-border supervisory cooperation. We would also urge the authorities to improve asset classification and provisioning requirements. While welcoming the deposit insurance scheme, we noted that the fund has assets amounting to 0.2 percent of total deposits. We would be interested to understand better how this initial level of funds compares to deposit insurance schemes in other countries in a similar situation, and to what size the authorities intend to build up funds in the scheme. Staff further elaboration would be welcome.

With these remarks, we wish the authorities success in their future endeavours.

Mr. Murray and Mr. Ha submitted the following statement:

We thank staff for the excellent reports and Messrs. Fried and Perrault for their succinct statement. We agree with the thrust of the staff's appraisal, which we view as striking an appropriate balance in managing the conflicting risks to inflation, growth and fiscal sustainability. We add the following brief remarks.

We welcome the authorities' recognition that the fiscal situation is untenable and commend them for their recent actions to improve revenues and to limit the drain on budget resources by removing subsidies on petroleum products, while increasing targeted assistance to the vulnerable sectors and households. Looking ahead, we agree that the phasing-in of additional fiscal savings is necessary and note that staff have provided the authorities with a menu of options to achieve this. We urge the authorities to examine these measures and to identify a fiscal consolidation strategy early on, given that savings may take time to build.

As in all countries, monetary policy's objective at the current juncture should be to contain the second-round effects on inflation and inflation expectations of rising food and fuel prices. In this regard, we welcome the authorities' actions to limit reductions in interest rates. The comparatively tighter monetary stance vis-à-vis the United States, together with the decision to delay capital account liberalisation, affords the authorities greater flexibility in the short term to address the upside risks to inflation and downside risks to economic activity. Like staff, we agree that wage moderation will be important to contain second round effects, and take comfort in the previous success in the early 1990s of the tripartite consultation framework in generating a consensus on wage moderation in the face of economic shocks. An update on the mid-June national consultations would be appreciated.

Lastly, we welcome the findings of the FSAP update that the banking sector remains sound and profitable. We note the authorities' commitment to improving its supervision and regulation of the financial system and encourage them to address the weaknesses identified in the FSSA, particularly in the prudential oversight of the non-bank sector.

We wish the authorities success.

Mr. Silva-Ruete and Mr. Vogel submitted the following statement:

Barbados' key economic, social, and political indicators shown in the first page of the staff report once again give us the very positive effects that, beyond their intrinsic value, sound institutions and good social policies, among others, have on the economic side. Meanwhile, the new authorities will have to face important challenges, namely the global economic turmoil, which has already significantly affected the country, the need to ensure fiscal sustainability over the medium term, and to keep inflation well-contained. We are encouraged by the authorities' awareness of the challenges and their willingness to decisively face them, and particularly the government's efforts to "ensure a high degree of ownership of the reforms", as noted in Mr. Fried and Mr. Perrault's helpful buff statement.

The fiscal analysis and the exercises on public debt under different scenarios presented in the staff report clearly exhibit the need to undertake a substantial improvement in government finances over the medium term. In this regard, we welcome the authorities' objectives of ensuring fiscal sustainability, while taking care of increasing its support for the most vulnerable sectors of the population. The mission made some suggestions on the revenue side, including raising tax rates on offshore activities, lifting the cap on the property tax, and reducing tax incentives for foreign investments, all measures that should obviously take into account the effect that these changes could have on the involved activities.

We believe that the monetary policy stance is appropriate and welcome the authorities' decision to be ready in order to continue containing inflation expectations and mitigate second-round effects.

With these remarks, we wish the authorities every success in their future endeavors.

Mr. Prader and Mr. Jakoby submitted the following statement:

We thank staff for the interesting and well-written Report and welcome the Financial Sector Stability Assessment (FSSA) update. We are also thankful to Messrs. Fried and Perrault for the useful additional information in their buff statement.

We agree with the staff's analysis and appreciate the alignment of views with the authorities on key policy challenges, despite some differences on the proposed corrective actions. The short-term priority is to contain inflationary expectations stemming mainly from imported inflation. The long-term priority is to alleviate the vulnerability of the economy to exogenous shocks, particularly by reducing the high public debt and to protect the competitiveness and improve the incentives for output diversification.

With a limited portfolio of monetary policy tools relating to the dollar peg, the keystone of short- and medium-term policy response will be to undertake fiscal consolidation and liberalization measures so as to improve the supply side of the economy. In the area of fiscal policy, besides savings in central government spending, the authorities are well-advised to address the relatively large negative balance of public enterprises. On the revenue side, we support the staff's recommendation that the future focus should be on systemic tax system modifications rather than relying on non-tax revenue such as fees and charges. With regard to the supply side issues, we welcome the measures that will enhance competition and productivity in the agriculture sector as mentioned by Messrs. Fried and Perrault.

The central bank's vigilance to inflationary pressures and readiness to promptly react is commendable. While we understand the motivation behind the delayed capital account liberalization in the context of the global financial turmoil and the corresponding risks relating to short-term capital volatility, we encourage the monetary authorities to expedite their efforts in preparing for the shift of the monetary policy toolkit towards market-based instruments.

The analysis in the FSSA update confirms that the onshore banking sector in Barbados is in good shape as reflected by the soundness of major financial indicators. However, we note that the capital adequacy of this sector will fall below prudent levels if sizeable declines occur in the principal drivers of the Barbadian economy – tourism and industry sectors. In addition, the dynamic growth of the nonbanking sector with assets corresponding to 65 percent of GDP calls for an improvement in its regulation and supervision practices as recommended by staff. The current deficiencies in information about the soundness of the insurance sector are of particular concern and should be addressed.

Mr. Fayolle submitted the following statement:

At the outset, we would like to thank staff for their informative report and for the FSSA update. We are also grateful to Mr. Fried and Mr. Perrault for their helpful buff statement.

We broadly agree with the Staff's assessment on Barbados's economic situation and we support their recommendations for facing the current deteriorating environment. The following points are thus mainly for emphasis.

On fiscal policy, we agree with Staff on the need to create fiscal space for targeted support to vulnerable groups and to identify measures to lower public debt, whose high level limits the room for maneuver in dealing with gloomier outlooks. We thus urge the authorities to pay due attention to the measures suggested by Staff on both the expenditure and revenue sides to generate fiscal savings.

Given the peg regime and the limited tools of the Central Bank, the monetary policy is constrained and we take note of its comparatively tight stance relative to theUS. With regard to the ongoing national wage negotiations, we were reassured to read in Mr. Fried's and Mr. Perrault's statement that the authorities are well aware of the potentially damaging second-round effects of the oil and food price shocks on inflation. In the same line, we welcome the authorities' decision to adjust prices for fuel products and reduce distortions on controlled prices.

On the financial sector, we were pleased to read that a number of the recommendations made in the 2002 FSAP have been implemented and that the system has proved to be resilient in the face of the global turmoil so far. However, the FSSA update also points to the remaining weaknesses that promptly need to be addressed, especially with regard to the banking sector regulations and the non-banking sector's prudential oversight. We were encouraged by Mr. Fried's and Mr. Perrault's statement that the authorities will give serious consideration to the update.

Staff mentions that the anti-money laundering and combating the financing of terrorism (AML/CFT) regime of Barbados has been assessed by the Caribbean Financial Action Task Force (CFATF) and its findings were presented for approval by its Plenary in May 2008.

We regret not to find any update on the implementation of AML/CFT in the FSSA Update, contrary to what was announced by Staff during last year's discussions. Could Staff elaborate on the content of this assessment?

Mr. Rojas submitted the following statement:

We thank staff and Mr. Fried and Mr. Perrault for their comprehensive buff statement.

The world economy turmoil makes the Barbados economy vulnerable for their high openness and reduced diversification. We welcome the high understanding, the agreement and clear position between the staff and the Barbadian authorities in order to identify the vulnerabilities, control the risk and preserve the stability of the economy.

The Barbadian economy is a solid economy. Barbados has grown in a sustainable way and their economic indicators have shown that it is a well performing economy. Even though fiscal vulnerabilities and the risk of inflation remain in Barbados and, some policy adjustments have to be done in banking system and in the wage structure.

We agree and support the staff recommendation in fiscal policy to safeguard sustainability and the level of public debt. It is very important to reduce the debt ratio to GDP and to preserve the sustainability of growth and the stability of the economy. We encourage the Barbadian authorities to move forward surplus in the public sector balance, first by a very clear and aggressive prioritization of the expenditure, adjusting prices of utilities and public services and second containing the public sector wage bill besides by improving the tax structure and looking for a more efficient tax collection.

We commend the CBB to continue the conservative and cautious monetary policy and to follow and adjust the rates in response US variations. We support the staff recommendation to the regional exchange controls and commend the Barbadian authorities to deepen the financial markets.

We believe that a resilient and sound financial system is a key factor to maintain the stability and support strongly the staff recommendation to enhance the banking system regulation, to improve the regulation and the supervision of the nonblank financial sector. The creation of a Financial Service Commission is a priority in order to guarantee supervision and soundness of the financial sector.

We encourage the Barbadian authorities to implement these recommendations and strongly wish all success.

Mr. Rutayisire submitted the following statement:

We thank staff for a comprehensive report, and Mr. Fried and Mr. Perrault for their informative buff statement.

Economic performance over recent years in Barbados was strong, due not only to the increasing activities in the service sector, but also the rebound in consumer goods, construction and tourism. Also, the political stability has been a contributing factor to this favorable development. Due to the current high food and oil prices, compounded by International financial turmoil, the growth rate is expected to slow down and the inflation rate to increase in 2008. The decline in the external current account deficit is welcome. We commend the authorities for their commitment to macroeconomic stability and encourage them to continue their adjustment efforts in the fiscal, financial, and structural areas, with the view to further containing inflation expectations, reducing public debt, and securing adequate financing for priority spending.

This being said, we note that Barbados still faces daunting challenges, including external shocks, capital account liberalization and open market pressures, in addition to the sizeable public debt and fiscal deficit. In light of these challenges, the authorities may need to implement sound macroeconomic policies aimed at containing external imbalances and vulnerability to shocks. Moreover, strong financial regulation and supervision are critical to cushion the volatility and risk of currency mismatches and cross border spillover of the global financial market turmoil and open market pressures. We welcome the authorities’ actions aimed at diversifying the economy as reported by Mr. Fried and Mr. Perrault.

On the fiscal front, we commend the authorities for the country’s improved fiscal position over the past several years, and welcome their commitment to fiscal consolidation and to increase support for the most vulnerable segments of the population. We take note of the steps taken by the authorities in response to the deteriorating global environment, including the joint agreement with CARICOM partners aimed at reducing common external tariff on selected food items, the adjustment in controlled prices for fuel products, and the more sequenced approach to capital account liberalization. On the revenue side, while noting the authorities' preference of nontax measures to increase revenues, we see merit in giving due consideration to other measures such as improving tax administration, adjusting some specific direct and indirect taxes, and streamlining tax exemptions.

As regards monetary and financial policy, we value the critical role the Central Bank of Barbados (CBB) has played and continues to play in providing foundation for a sustainable growth and macroeconomic stability containing inflation expectations, and minimizing second-round effects of the oil and food price shocks. We welcome the ongoing efforts to shift from interest rate controls and reserve requirements to market-based policy instruments, to strengthen the framework for monitoring interest rate differentials, and to adopt a sequenced approach to capital account liberalization. We concur that financial sector policy may usefully focus on strengthen banking regulation, oversight on nonbanking sector, and cross-country cooperation among regulators and supervisors. We urge the authorities to work closely with all involved stakeholders to strengthen prudential oversight.

With these remarks, we wish the authorities every success in their ongoing endeavors.

Mr. Heath and Mr. Kaplan submitted the following statement:

We thank the staff for their well targeted Report, and Messrs. Fried and Perrault for their informative statement. We are in line with the staff's recommendations, and make the following comments for emphasis.

First, we appreciate the staff's attention to exchange rate matters, especially given the centrality of the peg to economic policy. We were gratified to note that the analysis suggests the actual real exchange rate is moving roughly in line with its equilibrium, as compared to tourism-dependent countries in the Caribbean and across the world.

On the other hand, the external sustainability approach demonstrates the need for medium-term adjustment, which could take the form of a real depreciation, or by additional fiscal consolidation. This assessment would appear to strongly reinforce the staff's helpful analysis of the dangerous trajectory for public debt, in the absence of significant additional fiscal measures over the medium term.

Indeed, the need for additional fiscal tightening given the projections for public debt dynamics has been a concern of this chair for some time. We welcome the report from Messrs. Fried and Perrault that there is a consensus that the fiscal situation is untenable over the medium term. We welcome the Staff Statement that the government has decided to adopt an automatic adjustment to fuel prices in August 2008, but note that this is just the beginning of a series of challenges that the new government must confront, made all the more difficult by the less favorable international environment and the understandable need to adjust policy to protect the less fortunate. We support the staff's recommendation to adopt automatic price adjustment mechanisms for all utilities, in order to address price distortions, expensive subsidies, and the political difficulties associated with continual price adjustment.

The previous consultation with Barbados spent some time on the issues of capital account liberalization. Given recent volatility, the staff appear to take a sanguine view of the authorities' decision to postpone action. We wonder, given that elections this year broke the previous government's fourteen year tenure, whether the current authorities maintain the same broad assessment of the benefits of medium-term capital account liberalization as did their predecessors. Staff comment is welcomed. For the current consultation, we highlight the staff's recommendation that Barbados' authorities should maintain the pace of fiscal tightening and financial sector reform so that liberalization can take place smoothly as soon as possible.

Finally, as Mr. Fayolle, we would have appreciated an update on the implementation of AML/CFT in the FSSA Update, noting that Barbados' AML/CFT regime was assessed by the Caribbean Financial Action Task Force (CFATF) and presented for approval by its Plenary in May 2008. We look forward to staff comment.

Mr. Itam made the following statement:

We would like to thank the staff for the factual report and Mr. Fried for the informative statement. We note with satisfaction the recent economic developments in Barbados, in particular the good performance and further growth in employment. We commend the authorities for the continued improvement in social, political, and competitiveness indicators which remain among the highest in the region. We support the authorities' objective of greater regional and global integration and the decision to liberalize the capital account within CARICOM.

As pointed out by other Directors, capital account liberalization will help the authorities reap the benefits of globalization and develop Barbados as a major tourist destination and regional center for financial services. However, liberalization of the capital account comes also with its own risks, and requires strong supporting policies. In this regard, we are somewhat concerned that such an important decision is being considered while the views of the authorities and the staff differ with regard to important policy areas like the projected level of the current account deficit, and the extent of the fiscal adjustment.

On the other hand, we are comforted by the staff's assessment that the immediate impact of the liberalization of capital movement is not large, because the current approval requirement is liberal.

We note also the staff's positive assessment of the credibility of the peg and of the level of the effective exchange rate given that they believe that it is not far from its estimated equilibrium.

The staff rightly indicates that over the medium term, liberalization may expose the country to sudden capital account reversals. In this regard, we encourage the authorities to consider the staff's suggestions for additional fiscal measures as detailed in paragraph 8 of the report, to reduce public debt, and to improve the country's reserve position. On this latter point, we tend to sympathize with the authorities' position regarding reserve adequacy. While conventional financial indicators are helpful for cross-country comparisons, when they are used to trigger policy recommendations, they should take into consideration the country particular circumstances. We note in the case of Barbados that bank foreign liabilities are fully matched by liquid foreign assets. With these comments, we wish the authorities all the success.

The staff representative from the Western Hemisphere Department (Ms. Daseking), in response to comments and questions from Executive Directors, made the following statement:

> There was one question related to inflation expectations, and whether we had any practical recommendations to contain these expectations. We did discuss that at some length with the Central Bank of Barbados, and we agreed that a convincing strategy would probably have to have three elements. The first element would be to build awareness that the spike in inflation is actually temporary, provided that there is an appropriate policy response. The second element would be to explain what this response entails for fiscal policy, monetary policy, as well as wage setting. And the third element would be to make a credible and convincing case that the government will play its part, and that it also stands ready to tighten policies further should there be signs of second-round inflation effects. This is indeed broadly what the Barbadian authorities have been doing through their national consultations as well as their public announcements. As pointed out in Mr. Fried and Mr. Perrault's buff, the CBB has stressed its readiness to move aggressively should there be any evidence of inflation expectations becoming unhinged.
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> There was a request for an update on the outcome of national consultations. The consultations focused on the high cost of living, and they provided a chance for the different stakeholders to participate in the discussions and to provide an input into the government's policy response. As such, the measures that are included in the budget are partly the outcome of the national consultations. At the same time, the consultations also gave an opportunity to the government to explain the need for a coordinated policy response and also the risks of harmful second round effects on inflation. The hoped for outcome is wage restraint, but it is too early to tell right now because the negotiations in the key sectors are still ongoing. That said, following the public pronouncements of union leaders, there seems to be a broad understanding that to preserve the competitiveness of the economy and jobs, wage increases will need to remain moderate and below the currently high rate of inflation.

There was a question of whether the new government has a different view about the benefits of capital account liberalization than the previous one. In its public pronouncements, the new government has expressed its commitment to the process of liberalization. It has, however, chosen a more cautious approach than the previous government, and it has not yet committed to a firm timeline for the first step, which is the liberalization within CARICOM. Finally, there was a question about the staff assumptions about the position of the public enterprises. In our medium-term projections we assume that the deficit of public enterprises remains broadly unchanged at about 3 1/4 percent of GDP. Underlying this are two offsetting effects: prospective infrastructure investments, on the one hand, and some envisaged improvement in the cost recovery of the public enterprises, on the other.

The staff representative from the Monetary and Capital Markets Department (Mr. Espinosa), in response to comments and questions from Executive Directors, made the following statement:

Directors noted that the deposit insurance fund is close to 0.2 percent of total deposits and asked how this initial level of funds compared to the deposit insurance schemes in our other countries.

The choice of startup reserve funds choice varies across countries, either the government capitalizes the reserve fund to its target level from the outset, and then gets repaid on a pay-as-you go basis with the premiums of the deposit insurance members or the start-up capitalization is modest and the ultimate size of the fund evolves with the collection of premiums as in the case of Barbados. The decision on the reserve fund target is not straightforward, because there is no firm rule about the optimal level. The optimal level should be a function of the country's specific characteristics, including the degree of concentration in the system, the quality of the regulatory infrastructure, and so on.

Currently, Barbados does not have a set target. Most reserve funds around the world stand at between 1 and 5 percent of the system's deposits. For example, Jamaica's target is 1 percent of the system's deposits.

Directors want to know why the FSSA update does not contain an update on the implementation of AML/CFT standards. As we report

> in the FSSA update, the CFATF recently carried out an AML/CFT assessment, although the preliminary assessment has been approved by CFATF. The mutual evaluation report and the ROSC, which contained the main findings, have yet to be issued. The Board will be notified of these findings by the Legal Department as soon as they become available.

Mr. Mohammed noted that the growth of net domestic assets in 2008 was close to zero and broad money growth dropped from 13 percent in 2007 to 2.8 percent in 2008. He asked how those trends were consistent with the rise in nominal GDP growth from 6.8 percent in 2007 to 11.2 percent in 2008.

The staff representative from the Western Hemisphere Department (Ms. Daseking) replied that money growth was driven by changes in net foreign, as opposed to domestic, assets. The inflows into the capital account had been strong in 2008, which was revealed in the reserve position of the central bank. She noted that the 2008 figures were projections and could be revised through the year.

Mr. Fried made the following concluding statement:

> I thank my colleagues who have contributed their thoughts both orally and in writing. Barbados has been a model and a leader for the region for some years. Firstly, it is a thriving democracy, and they have pursued what they like to consider as a social compact. The authorities, in successive governments, have expended great energy and effort in bringing together business and organized labor, and the public sector, to reach better and continuing national understanding of both the circumstances of the country and the country's prospects. It has shown to have provided tremendous benefits in economic terms and the staff has highlighted that in the immediate circumstances. The new government, which comes to power after 15 years in opposition, is facing head-on what are increasingly challenging global circumstances, including inflation. The authorities took a very tough decision to pass-through petrol prices, for example, and getting the message across as well that wages have to be constrained below the level of inflation. All the signals point toward the population as accepting these measures as necessary because they have an understanding of their purpose. We talk often in this Board about country ownership and engaging stakeholders. What you have here is a record of success, and one that can carry forward from one government to the next in nonpartisan terms. I am satisfied, after having met separately and extensively with the new authorities, that

this is a government committed to a sustainable path and bringing its debt down, which brings me to the second point. If I were to take another collective concern from other chairs, it is whether or not the authorities are truly facing up to the revenue side. Our buff, and the staff report, highlight some of the tough measures taken very early in the mandate of this government—in addition to the petroleum pass-through. I can reassure everyone that they are fully aware of the other options presented by the staff, in fact they were the subject of very good dialogue in exchange of views. The signal from the authorities was they are pretty confident that the measures they have taken, together with the fairly robust signs on tourism revenue and financial services, will help them meet their targets. However, they do stand ready to consider other measures as may be necessary should the situation deteriorate.

Finally, on liberalization, just to underscore the word caution, we are witnessing global volatility. This is a country that wants to make sure it is not going to make mistakes in moving to more liberalization. As was reported by staff, the authorities are taking a methodical approach to assessing their own capacity without necessarily a change in direction.

Finally, I want to reaffirm on the issue of AML/CFT, that the guidance of the Fund staff should be incorporated and cross referenced with other work underway in other for a, including the regional FATF process which is underway. Not everything has to be overloaded into the Article IV consultation.

Rest assured, all of the views will be reported back to the authorities. Historically, Barbados has always been willing to publish its Fund documentation, subject to the appropriate deletions policy. We will review that with them expeditiously.

As always, the invitation is open for everyone to visit.

The Acting Chair (Mr. Portugal) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that Barbados has benefited from strong institutions and social and political stability. Directors observed that the Barbadian authorities are faced with a significant challenge of balancing conflicting risks to inflation, growth, and medium-term sustainability. While direct spillovers from the financial turmoil have been contained, Directors cautioned that weaker global demand could affect the Barbadian economy primarily through its important tourism sector, at a time when inflation has been pushed up by rising food and fuel prices. With the exchange rate pegged to the U.S. dollar and fiscal space constrained by high public debt, Directors stressed the importance of addressing these challenges through a coordinated policy response.

Directors saw the main task for fiscal policy in identifying savings to finance targeted support to the most vulnerable groups, while containing risks to medium-term sustainability. They welcomed the recently revised budget, which combines a reduction in the central government deficit with well-identified revenue measures to finance additional social and other priority spending. Directors encouraged the government to make additional efforts to generate a modest overall public sector surplus over the medium term, to reverse unfavorable debt dynamics and put public debt on a firmly declining trajectory. As fiscal savings could take time to materialize, Directors advised the authorities to identify specific revenue and expenditure measures early on. They welcomed the recent adoption of an automatic fuel price adjustment mechanism as an important step in this direction.

Directors saw the main role for monetary policy in containing the risk of entrenching inflation expectations, and deemed the current policy stance as appropriately tight. However, a reduction in interest rates may become necessary should a more severe slowdown in economic activity be accompanied by easing of inflationary pressures. Directors also encouraged the authorities to advance preparations for introducing indirect monetary policy instruments, to be ready for their implementation once global financial markets have calmed.

Directors viewed the outcome of wage negotiations as critical in determining the effectiveness of the overall policy response to the current challenges. Wage moderation was needed to minimize second-round effects of the oil and food price shocks and thereby help the economy adjust in the least harmful way. Directors warned specifically about the risks of wage indexation to currently high headline inflation rates.

Directors agreed that the 33-year peg of the exchange rate to the U.S. dollar enjoys strong support and credibility and has served the economy well. The real effective exchange rate is currently not far from its estimated equilibrium, and there are no apparent signs of competitiveness problems in the dominant tourism sector. Directors stressed, however, that adjustments in domestic policies will be important in the medium term to contain external imbalances.

Directors welcomed the FSAP update finding that the financial system remains resilient in the face of the global turmoil. To ensure that Barbados' financial sector continues to thrive, they encouraged the authorities to address the identified weaknesses in its prudential oversight and to implement the key recommendations of the FSAP update mission. In addition to a number of important provisions to strengthen banking regulation and cross-border cooperation, Directors recommended that priority be given to removing the gaps in the supervision of the nonbank sector.

It is expected that the next Article IV consultation with Barbados will be held on the standard 12-month cycle.

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SHAILENDRA J. ANJARIA
Secretary