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Statement by Mr. Shaalan and Ms. El-Ganainy on Eastern Caribbean Currency Union--2007 Discussion on Common Policies of Member Countries (Preliminary)
Executive Board Meeting 08/11
February 4, 2008

1. Economic performance in the Eastern Caribbean Currency Union (ECCU) region has been, in a number of aspects, satisfactory in 2006. This performance continued well in 2007, as reflected in robust GDP growth, subdued inflation, improved fiscal position, and strong foreign direct investment (FDI). However, the current account deficit remained large and public debt levels continued to be high. These latter developments, together with the erosion of trade preferences and donor assistance, and the region's exposure to natural disasters, render the economies of the ECCU susceptible to exogenous shocks. Against this background, the main challenge in the period ahead is to enhance the region's resilience and growth potential, while reducing vulnerabilities. This would require accelerating fiscal consolidation efforts to reduce underlying debt-related vulnerabilities, while decisively advancing with the implementation of the region's reform agenda—with the aim of enhancing the competitiveness of the ECCU economies, and creating an enabling environment for private sector-led growth.

2. We welcome the projected improvement in the fiscal position, as reflected in the narrowing of the overall and primary balances—largely on account of expenditure restraint. Recent strong growth rates should provide an opportunity to advance with stronger fiscal adjustment if sizable improvements in the debt ratios are to be achieved. This is all the more important in view of the need to reconcile much-needed social and poverty-reduction spending with fiscal and debt sustainability considerations. We also welcome the Eastern Caribbean Central Bank's (ECCB's) revised system of fiscal benchmarks, which places a greater emphasis on integrating annual national budget objectives with the regional medium-term goal of reducing public debt to 60 percent of GDP by 2020. We note the divergence of views between staff and the authorities regarding the use of an enforcement mechanism based on economic sanctions to assist in the achievement of the fiscal benchmarks. In view of the authorities' reluctance to adopt such an enforcement mechanism, *could staff comment on the effectiveness of peer review and enhanced transparency in achieving the revised benchmarks?*

3. Ensuring consistency of national fiscal policies would be crucial in supporting the stability of the quasi currency board arrangement (quasi-CBA). Therefore, we consider the recent decision by the ECCB's monetary council to establish a Public Expenditure Review Commission a step in the right direction. This would help build regional consensus on expenditure priorities and the role and size of government. On the revenue side, staff analysis in the highly-relevant selected issues paper (SIP), shows that tax concessions have eroded the corporate income tax (CIT) base across the Caribbean, leading to revenue losses. At the same time, the benefits in terms of increased FDI appear to have been limited. Accordingly, we encourage the ECCU authorities to limit the use of tax concessions, and rather address investment-related issues through efforts aimed at enhancing the business climate. We are encouraged to note from Mr. Fried and Ms. Morgan's helpful Buff statement that members of the ECCU are taking steps to reduce distortions related to tax incentives, and agree on the merits of pursuing a regional approach to deal with this matter. In this connection, *we would welcome staff's views on the possibility of achieving tax harmonization in the region, given that it would require convergence in both CIT rate and the tax base among member states, as indicated in the SIP.* Finally, we commend the authorities for the implementation of far-reaching tax reforms—including through the introduction of the value-added tax (VAT) in some member countries. It should be noted, however, that maintaining the integrity of the VAT is crucial to ensure its success in generating sizable revenues, going forward.

4. With a ratio of public debt-to-GDP above 100 percent, the ECCU countries are among the most indebted in the world. Despite strong growth, limited progress was made in reducing debt during 2007. Accordingly, we agree that there is a need to address debt management capacity constraints in the region. In this regard, we note that some countries have benefited from Fund's technical assistance to enhance debt management capacity, and encourage others to follow suit. We also note the authorities' concern that fiscal consolidation alone would not be adequate to ensure debt sustainability in the region, and that attaining such a sustainability would require, among other measures, tapping debt relief wherever possible. In this connection, and while we see merit in the authorities view, we wish to emphasize that debt relief should not be a substitute for fiscal consolidation.

5. The ECCB-operated quasi-CBA has served the region well, as it continued to deliver price and exchange rate stability even in the presence of adverse shocks. We agree with the staff's assessment that the real exchange rate is closely aligned with fundamentals. The authorities are encouraged to capitalize on the wide respect and credibility of the quasi-CBA to garner public support for pursuing stronger fiscal consolidation, going forward.

6. We appreciate staff's cautious approach in assessing the region's competitiveness by recognizing the rapid structural changes in the ECCU economies, as they transform from agricultural to tourism-based economies. Staff indicate that, despite their apparent high levels, medium-term current account imbalances in the ECCU countries appear sustainable. This is mainly due to the expectation that current account deficits will taper off to more sustainable levels after 2012 as tourism-based investment opportunities decline over the medium term. While we could see merit in staff's argument, *it would have been useful to include a discussion of less optimistic scenarios regarding the sustainability of the current account deficits. For instance, could these imbalances be sustained should the performance*

of the tourism sector weaken, oil prices increase, or FDI inflows decline?

7. Finally, and despite sharing a common currency for some time, economic integration is far from complete. Indeed, and given the small size of the economies of the ECCU, and their similar economic structure, we believe that effective coordination among member states would facilitate the achievement of higher growth, while allowing them to exploit economies of scale through the collective provision of selected government services. In this vein, the approval of a draft Treaty on Organization of Eastern Caribbean States (OECS) Economic Union is a welcome step, and we encourage the authorities to expedite their efforts towards greater integration, going forward.

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