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

We thank staff for a well-focused report and an interesting set of selected issues. We also thank Mr. Fried and Ms. Morgan for their informative statement. Since we agree with the staff's appraisal, our comments are for emphasis.

1. Economic performance of the Eastern Caribbean Currency Union (ECCU) has been favorable, notwithstanding the erosion of EU trade preferences and disappointing tourism activity in 2007. Growth has been relatively strong, even after taking account of the temporary impetus provided by the World Cricket Cup in 2007; foreign direct investment inflows remain significant and cover a large share of the current account deficit; and international reserves have increased significantly. These are major achievements for small economies facing longstanding vulnerabilities and challenges. We commend the country authorities for the good economic performance and encourage them to sustain their efforts to address the challenges ahead within their regional integration setting.

2. Staff are right in focusing the discussion on the need for policies to ensure sustainable growth and reduce vulnerabilities, and we agree with the related analysis and policy recommendations. With most of the ECCU's economic activities shifting away from agriculture toward the service industry, it is important to address structural impediments to growth and competitiveness, including improving inter-islands transportation, eliminating labor market rigidities, reforming tax and customs administration, and simplifying and harmonizing the legislative and regulatory framework to reduce transaction costs. In this regard, we welcome the steps being taken to address the issues highlighted in the World Bank's *Doing Business* report, as indicated by Mr. Fried and Ms. Morgan,

3. Reducing inflation is a major challenge against the odds of high energy and food prices, the depreciation of the U.S. dollar against major currencies, and the hurricane damage to local crops. With the pegged exchange rate arrangement precluding independent use of monetary policy instruments, the authorities have moved to cushion the inflationary effects, including by eliminating or reducing import duties and taxes on selected food and basic items and controlling profit margins on selected items, as indicated by Mr. Fried and Ms. Morgan. The recently established Inflation Working Group will further explore these issues in the period ahead; however, controls on profit margins are ineffective at best and might distort the price setting mechanism. The authorities may wish to consider these measures as temporary and review them in light of price developments in the domestic market and abroad while maintaining a competitive environment.

4. The quasi-currency board arrangement has served the ECCU well by anchoring inflation expectations and enhancing credibility. The real exchange rates appear close to their equilibrium levels and are in line with fundamentals. While the authorities are committed to the exchange rate regime, supporting the arrangement would require maintenance of strong fiscal positions to deal with exogenous shocks and acceleration of structural reforms to improve competitiveness.

5. Well-coordinated efforts at fiscal consolidation are needed to bring the debt to sustainable levels and provide room for added policy flexibility. We share the staff recommendation to achieve the ECCB's revised fiscal benchmarks and we see merit in linking the benchmarks to medium-term fiscal targets and enhancing the credibility of peer review by the Monetary Council. The tasks ahead to achieve fiscal consolidation will be challenging, given the need to provide for social and poverty reduction expenditure. Nonetheless, there is room for revenue mobilization by broadening the VAT system, eliminating tax exemptions, and further strengthening the tax and customs administration. In this regard, we agree with the suggestion made by Mr. Bakker and Mr. Tanasescu for the ECCU to consider a regional treaty on tax incentives, which would end the race to the bottom in the tax-based competition to attract foreign direct investment. Lowering the debt burden is also a key component of fiscal consolidation, and we support the authorities' request for Fund technical assistance to enhance debt management capacity. Moreover, we welcome the debt write-off granted by Italy in favor of St. Vincent and Grenadines and encourage other donors to provide debt relief to the ECCU countries.

6. It is gratifying to note that the ECCU banking system is resilient and its vulnerability to various exogenous shocks is low. Financial sector supervision has been improved, with a number of countries working toward establishing a single regulatory unit for non-banks. The ECCU's relative isolation from international financial markets has shielded their financial sectors from the recent market turbulences, as indicated by

staff. While this should not be an incentive for further isolation, it should reinforce the need for improved supervision of the off-shore financial centers and aligning their prudential regimes with domestic banks, as recommended by the 2004 FSAP.

7. We fully share the view that a deepening of the integration process will help the ECCU members deal with the vulnerabilities associated with their small size and the challenge of competing in the global economy. In this regard, the decision taken in October 2007 to create a single economic and financial space within the OECS is a step in the right direction.

With these remarks, we wish the authorities every success.