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

We would like to thank the staff for the set of interesting papers and Mr. Fried and Ms. Morgan for their Buff statement.

We share the staff's assessment on the macroeconomic situation in the ECCU. Overall, the ECCU's macroeconomic performance was mixed in the past year. While economic growth was strong, inflationary pressures are building up.

We appreciate the authorities' commitment to protect and strengthen credibility of the current exchange rate regime. In an environment of picking up inflation the quasi-currency board arrangement plays a crucial role anchoring inflation expectations. The current administrative measures like profit margin control and reducing sales taxes on first need products are instruments that temporarily contain inflation. However, over the long term, the authorities should focus on fiscal policy. Fiscal consolidation is needed not only as an instrument mitigating domestic demand, but as a necessary step to build a fiscal space for better targeted social expenditures.

We support the staff's recommendation to bring the fiscal and public debt position to more sustainable levels. The medium-term fiscal benchmark supported by a well tailored national fiscal policy should build momentum to invert the current trend of members of the ECCU repeatedly recording primary deficits despite strong economic growth. As a consequence, the high fiscal deficits and the increasing burden of debt servicing have barely allowed the countries to achieve a reduction in the region's high public debt stock, which leaves them vulnerable to a worsening of economic conditions or to shocks.

The high debt burden will require a sustained effort in restraining expenditure.

Interest payments have grown more than any other area of expenditure over the last few years. Against this background, the recent decision to set up a Public Expenditure Commission is a welcome step. It should help to better prioritize expenditures, in particular capital spending. We agree with staff on the areas where action is needed most. In particular, a move toward more flexible fuel price mechanisms in all countries and a stronger effort to contain the public wage bill would further help to alleviate fiscal cost.

On the revenue side, we welcome the recent introduction of the VAT. The new tax should strengthen tax revenues in times of robust growth boosted by domestic demand. On the other hand, a slow down of the economic growth will immediately lower indirect tax revenues. Hence, the built-in tax revenue vulnerability should be compensated by a suitable system of tax revenue stabilizers. From this perspective, the direct tax system seems to be important.

A current policy of generous tax concessions for foreign investors is an important obstacle for a transparent and stable tax system. Moreover, the uncoordinated tax exemption policy between the members creates undesirable tax competition. In our opinion the union should promote coordination of the tax policy. Staff's comment in this respect will be very welcome.

We are worried about the projected depletion of the pension funds, which create the risk of enormous social hardship. While staff provides some general recipes to consolidate the pension funds, we would like to know how entrenching the corrections need to be and whether we should expect fiscal costs to arise in addressing the underfunding of the pension funds.

On the financial sector, we note that efforts have been made to strengthen supervision, in particular of the banking sector. Nonetheless, we share the staff's concerns that vulnerabilities remain. In particular, it seems that domestic banks have higher levels of government exposures, higher nonperforming loans and are less profitable than foreign banks. Moreover, increasing foreign currency exposures will require closer monitoring. While supervision has improved in the banking sector, the non-bank financial sector remains largely unsupervised. In this context, we welcome the plans to establish single regulatory units for the non-bank financial sector.

We agree with staff that lowering the cost of doing business is a central point when it comes to reviving entrepreneurship in the tourist sector. Given that in a global environment of low air tariffs the near-monopoly could raise them to operate profitably, we wonder why there are no competitors entering the market. We would like to ask staff whether the incumbent company enjoys certain privileges. Also, it would be interesting to analyze the reason why the ECCU's growth rates in travel receipts have dramatically slowed.