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

We thank the staff for the high-quality report and comprehensive Selected Issues papers. While growth in 2008 is expected to remain above potential, ECCU members face significant downside risks that may dampen consumption and tourism demand. ECCU members are particularly vulnerable to these risks because of their very high public debt levels. The continued credibility of the regional quasi-currency board arrangement depends, in particular, upon members' determined efforts to bring fiscal and debt positions to more sustainable levels.

Exchange Rate Policy

We welcome the staff's excellent analysis of competitiveness in the ECCU. We particularly appreciate the staff's efforts to adapt existing econometric methodology to the idiosyncrasies of the ECCU economies.

While the exchange rate is broadly aligned with fundamentals, the equilibrium real exchange rate has fallen by roughly 5 percentage points since 2001. That is, ECCU members had to sustain a 5 percent real exchange rate depreciation to maintain external equilibrium. The decline in the equilibrium real exchange rate is, in large part, the result of a reduction in tourism-sector productivity, vis-à-vis the Bahamas, and a deterioration of the terms of trade. In our view, this highlights the need for structural reforms to improve the region's competitiveness.

Large amounts of foreign direct investment in the tourism sector largely explain the high current account deficits in the ECCU. Furthermore, the macroeconomic balance approach suggests that the high projected current account deficits are sustainable over the medium term. ECCU policy makers should be focused, however, on the fact that foreign direct investment in the tourism sector is expected to decline over the long run. Commitment now to fiscal discipline will allow for a gradual transition from FDI and help avoid increasing dependence on debt-creating sources of external finance.

Fiscal Policy

We strongly recommend the elimination of oil subsidies to allow greater flexibility in retail oil prices. Like the staff, we underscore the importance of sustained progress toward meeting the revised ECCB fiscal benchmarks, since public debt levels remain among the very highest in the world.

Fiscal deterioration is, in part, a likely result of relying heavily on tax concessions to boost competitiveness. Tax concessions should be nondiscretionary, equitable, transparent, and limited in size, duration, and scope. In this respect, we welcome measures taken by ECCU members, outlined by Mr. Fried and Ms. Morgan, to reduce distortions in the tax systems. Country authorities should pursue additional measures to improve the overall business environment, including the quality of public services and infrastructure, education level of the work force, and the ease of doing business.

Financial Sector

The acceleration of credit growth underscores the importance of sound banking supervision. Supervision of the non-bank financial sector should be enhanced, especially given the deepening of regional capital markets and the growth of non-bank financial institutions.