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

1. We thank the staff for a very informative set of papers and we broadly concur with their analysis and recommendations. After a few years of buoyant economic activity, growth in the Eastern Caribbean Currency Union (ECCU) is expected to return to its trend in 2008. However, as the staff point out, there are significant downside risks to this soft landing scenario, including a slowing world economy, high food and oil prices, and large debt levels and debt servicing costs. Preserving internal and external stability within the framework of the exchange rate peg, restoring debt sustainability, reducing external vulnerability, and strengthening medium-term growth prospects will require ambitious fiscal consolidation as well as determined structural reforms aimed at enhancing the fiscal and financial sector frameworks and boosting the region's competitiveness.

2. The authorities' strategy to foster economic integration and cooperation within the framework of the OECS Economic Union is timely and highly welcome. Creating a single market and harmonizing regulatory frameworks will help to enhance the efficiency of resource allocation within the region, which together with the measures aimed at improving the business environment will strengthen external competitiveness and medium-term growth prospects. Moreover, we welcome the authorities' strategy to develop and expand linkages between tourism and other sectors, as described in Mr. Fried and Ms. Morgan's helpful Buff statement. *Apart from agriculture and manufacturing, does the staff see any other sectors that have the potential to mitigate the heavy dependence on tourism?*

3. The very high public debt levels limit the fiscal space for priority and capital expenditure and could undermine the sustainability of the exchange-rate peg and the currency union. Hence, fiscal consolidation along the lines of the Eastern Caribbean Central Bank's (ECCB) revised fiscal benchmarks needs to become a top priority in all member countries. Expenditure restraint and better prioritization will be key and we look forward to the work of the newly established Public Expenditure Commission in this

regard. Budgetary repercussions from rising fuel and food prices, for example by protracted adjustments of gas prices to world market levels or new tax concessions and exemptions, should be avoided. Fiscal risks emanating from the social security system, even though they may not materialize in the short term, need to be addressed without delay. Enhancing the debt management capacity of ECCU countries becomes increasingly important as global liquidity conditions tighten. Hence, we support technical assistance by the Fund and other multilateral institutions in this area.

4. We welcome the ECCB's intention to examine inflationary pressures more closely. Moderate declines in fuel and food prices, while probable, cannot be taken for granted. Moreover, a continued depreciation of the U.S. dollar could further increase the cost of rising non-U.S. imports. Against this background, we encourage the monetary council to formulate a coherent set of policies at the union level in order to contain price pressures. Individual countries should contribute through fostering product and labor market flexibility rather than administrative controls. Inflation measures should reflect the true cost of living in all member countries.

5. The staff's assessment that large medium-term current account imbalances appear sustainable is surprising. While acknowledging that tourism-related foreign direct investment (FDI) and imports can be expected to lead to a current account deficit above equilibrium levels for some time to come, we wonder whether the estimation of the current account norm – with its time horizon ending in 2012 – needs further qualification, in particular given the unique demographic characteristics of ECCU countries. *Staff's comments would be welcome.* In any case, not only the level but also the financing and the driving forces behind the current account imbalances need close monitoring. Any shift in the financing of the current account deficit from FDI to debt-creating inflows would be very risky as this would further weaken debt sustainability and heighten external vulnerability.

6. We welcome the authorities' examination of various approaches aimed at insuring against natural disasters. In ECCU countries, the management of natural disaster risks is of key importance, and introducing insurance measures to achieve an efficient sharing of expected losses stemming from natural disasters should be considered.

7. Banking sector soundness has further improved, but rapid credit growth and the vulnerabilities of local banks, namely their high government exposures, need to be monitored closely. Furthermore, supervision should be extended to the non-bank financial sector and the prudential regimes for offshore and domestic banks need to be aligned. Given the ECCB's limited means to finance a lender-of-last-resort facility and possible moral hazard concerns the authorities are well-advised to design additional instruments to prevent and resolve potential banking sector distress. *Additional comments by staff on the options considered by the authorities would be appreciated.*