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Statement by Mr. Warjiyo and Mr. Sabtu 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 staff for the candid report and an informative set of Selected Issues Papers. We also thank Mr. Fried and Ms. Morgan for their helpful buff statement. We are pleased to note the encouraging overall economic performance of members of the Eastern Caribbean Currency Union (ECCU) in recent years despite domestic constraints and difficult external environment. On the whole, there has been a significant pick-up in growth, improvement in inflation management, stronger public financial management on the back of fiscal reform, and progress in diversifying the economy away from agricultural exports as preferential EU trade access has lapsed. Nevertheless, it is clear that these economies face substantial challenges in completing their reform agenda, which will be further complicated by vulnerability to external shocks and frequent recurrence of natural disaster. Like Mr. Larsen and Ms. Farrant, we are also gratified by this chance to discuss the overall regional context of issues and policies in the ECCU before turning to the individual members later in the day.

Sustaining Macroeconomic Stability

2. ECCU members have no scope for independent monetary policy – either individually as members of a currency union, or collectively given the peg to the US dollar. We agree that the dollar peg has delivered stability, and certainly conditions do not warrant a change in the immediate term. Nonetheless, we are particularly concerned with the sizable current account deficits in these countries which may put risks on the sustainability of the system over the longer-term. We note that significant of these deficits can be explained, to a large extent, by fundamental factors, not the least of which is the investment in tourism facilities, and are more than amply financed by FDI. Still, the sheer size of these deficits, in some cases amounting to nearly a third of the individual economies, does mean that ECCU members are vulnerable to shifts in investor sentiments. Certainly, one policy mix to sustain macroeconomic stability and growth would be domestic demand restraining,

mainly through bold fiscal consolidation, coupled with economic diversification. Another option would be thinking ahead as to how the peg will evolve going forward. We could, for instance, imagine a policy mix over the medium term that envisages a more rapid fiscal consolidation coupled with a nominal depreciation of the exchange rate to alleviate competitive pressures. To be clear, we do not advocate moving in that direction at the present time, but as an option, we could see a change in the mix as being useful in informing discussions between staff and the authorities. *We invite staff to elaborate on any discussions on the various possible options they had with the authorities.*

3. This brings us to fiscal policy. Fiscal sustainability is still the major concern for most of the countries in the region. Public sector debt remains high at around 102 percent of regional GDP and debt servicing constitutes a significant portion of the revenues in most countries, thereby limiting fiscal space for much needed social and poverty reduction spending. Revenue measures are being undertaken, but expenditures are also rising, limiting progress with fiscal consolidation. While we support the ECCB's Monetary Council decision to a revised system of fiscal benchmarks, we are concerned that these benchmarks have not been made operational. Like staff we would like to encourage the authorities to place greater weight on achieving incremental improvements to the fiscal position so that the benchmarks remain credible and useful. We welcome the recent decision to establish a Public Expenditure Review Commission which would help to forge a regional consensus on expenditure priorities and the role of government. We also share authorities' concern on the need to have in place adequate capacities to manage and ensure debt sustainability in the region to complement fiscal consolidation measures of the authorities. *We welcome staff comments on the role the Fund can offer in this aspect.*

4. As we noted, we are gratified that the authorities have addressed revenue issues in recent years. We commend the move to levying indirect taxes such as value added taxes and the use of market valuations of land to levy property taxes. On the latter, we note that most members have not fully instituted such measures and *invite staff to elaborate on the timetable for their full adoption*. Clearly, property is going to be key to medium-term fiscal sustainability, whether as a source of tax revenues or non-tax receipts arising from land sales. We see two risks in this context. First, that the policy of sales will, to some extent, target sales to foreigners in order to maximize revenues. The current global economic slowdown could impair the capacity of authorities to raise funds in this manner. Second, the potential domestic political backlash could prematurely halt the sales program, depress prices and perhaps even actual sales, thereby impairing tax revenues going forward. For instance, we note that at least in St. Kitts and Nevis, resistance to land sales to non-nationals has been an issue and we imagine there would be similar concerns on the other islands. *Staff comments would be welcome*.

5. Clearly, fiscal space across the ECCU is constrained by high public debt (at 102% of GDP for the group), about half of it is external debt. We appreciate that this situation is a legacy of a series of exogenous shocks, starting with the loss of the agriculture sector,

followed by a number of natural disasters to strike the islands. Nevertheless, we are glad to note that many members of the ECCU have moved forward in restructuring their civil services and urge them to be steadfast in implementing reforms. We also note that a number of ECCU members face potential fiscal liabilities from their pension systems. In that regard, we especially appreciated Chapter VII of the SIP, which clearly lays out the options open to the authorities. Fiscal space is also constrained by the slow disbursement of committed aid flows from EU. Could staff elaborate on the impact on ECCU's debt burden if all the commitment is realized. We welcome the progress made so far in raising retirement ages but obviously, much more needs to be done.

Medium-term Growth Prospects and Economic Diversification

6. As we have noted, most ECCU members have been enjoying significant growth as the efforts to diversify their economic base has started to show results. Clearly, domestic investment expenditure on tourism has played a key role, spurred in part by activity related to the Cricket World Cup in 2006. To some extent, we would expect to see growth settle down to a more sustainable path. Nevertheless, it is clear that if most ECCU members are to be able to reach the living standards comparable to regional leaders, growth performance will need to be enhanced. We recall that staff have raised concerns on the business climate in many of these islands and continue to do so. In that respect, we welcome Mr. Fried and Ms. Morgan's statement that the various authorities aim to build on the positive findings of the 2006 *Doing Business Report*.

7. Given the central role tourism is envisaged to play in this process, we note staff's concern on the impact of the new supply of rooms on existing facilities, unless arrivals increase commensurately. It is clear that a number of factors will need to be in place: sufficient investment in infrastructure (including transport) will need to be made; conditions that ensure tourism-related businesses can thrive will need to achieved; and the general welfare of tourists must be ensured.

8. With respect to the strategy the authorities have pursued, we see potential risks in that there is a near-universal concentration on a particular segment, namely high-end tourists from the United States, United Kingdom and Canada. In that context, we particularly welcome Chapter V of the SIP that discusses determinants of tourism demand in the ECCU. Unlike staff, however, we are not completely convinced that arrivals will remain relatively unaffected by global conditions, even if the segment these islands attract tend to be relatively affluent. One would imagine that sustained depreciation of the dollar and real appreciation of the EC dollar due to higher inflation will have some impact on arrivals from the US. Slower growth in the UK and Canada is also bound to have an impact, especially given that staff's projections are based on data from a relatively new industry that, in many places, has not experienced a global slowdown. In the event staff's more optimistic assessments do not come to pass, the authorities would be well advised to consider alternative approaches in marketing the islands, including targeting other price

points and other markets.

9. On the issue of adequate transport infrastructure, we note from Mr. Fried and Mr.Charelton's statement on St. Vincent and the Grenadines that without airports, tourists will simply not be able to access some of these islands. We have great sympathy for the authorities, given the fiscal constraints they face. As our Chair noted in our statement on that country, this is a problem of scale; the small size of these countries means even modest investments have outside effects on their economies. There are no easy solutions to these dilemmas, though we would only say that the authorities need to exercise the greatest care when considering the projects they would like to proceed with and the options for funding them. Given the importance of ensuring the safety and welfare of tourists, it is with some concern we noted both staff's findings and news reports that violent crime on a number of islands. We appreciate that tourists are rarely subject to violence, but given that tourism is an industry where perceptions, especially negative ones, can rapidly spread, the authorities would be well advised to act expeditiously.

Financial Sector

10. We welcome the measures taken by the authorities to strengthen prudential regulation and supervisory framework of the banking sector as per the FSAP recommendations. In view of the rapid expansion of the non-bank financial sector, we also welcome the authorities' commitment to give priority to the establishment of single regulatory unit to supervise this sector. We view that faster expansion of credit and increased dollarization of deposits asks for further strengthening of supervision, and welcome the adoption of amended uniform Banking Act by all member countries.

11. In that connection, we found Chapter IV of the SIP extremely interesting. We commend staff on the innovative use of the binary classification tree methodology, though we would treat some of the estimated thresholds with some caution. For instance, we are quite curious as to why an indicator of external sustainability, such as the current account balance, was not included among the indicators of macroeconomic fundamentals. One would have thought it would be an important factor to consider in that banking crises have, quite often, coincided with currency crises in emerging markets. We wonder if the exclusion of such an indicator leads to the quite unexpected finding that having a relatively low inflation rate, low interest rate margins and relatively slow export growth puts the risk of crisis at about 21 percent. We have some difficulty in taking such thresholds seriously. The inflation threshold is 19 percent, which most countries manage to achieve quite routinely. Interest rate spreads have also declined in many countries due to financial deepening, which one would attribute to greater financial sector efficiency. Finally, the export growth threshold is relatively high at about 12 percent. Again, most emerging markets have fallen below that threshold fairly often, given how high it is. Nevertheless, the study is a useful first step and we look forward to seeing further

refinements in the method.

Natural Disasters

12. Following the discussion on Dominica earlier today, and recalling discussions on other Caribbean members that have experienced various natural disasters in recent years, we remain concerned that the impact of these catastrophes remain sizable and significant. As we noted in our statement on Dominica, it appears that the World Bank's Caribbean Catastrophe Risk Insurance Initiative has had problems. We recall in discussions last autumn that the CCRI was being reviewed and we invite *staff to elaborate on the progress of the review.* Nevertheless, it is clear that fiscal space will need to be created to deal with these events, especially since it appears that some of the assumptions on hurricane frequency may have been over-optimistic, estimated as they were during an unusually tranquil period in the second half of the 20^{th} Century.

13. With these comments, we wish the ECCB and authorities of the member countries of the ECCU well on their policy endeavours.