BUFF/ED/11/167

November 21, 2011

Statement by Mr. Hockin and Mr. Rolle on Eastern Caribbean Currency Union
Executive Board Meeting
November 28, 2011

The OECS/ECCU economies have been under severe stress since the onset of the global crisis in 2008. The crisis exposed significant vulnerabilities in the financial sector with a corresponding buildup in fiscal risks, even as direct budgetary strains overturned the trend of debt consolidation that had been set in motion. The ensuing challenges have galvanized leaders into a more vigorous pursuit of common regional initiatives to bolster financial stability, improve medium-term growth prospects, and restore credible paths of fiscal consolidation. In this regard, the Monetary Council of the Eastern Caribbean Central Bank (ECCB) has been a critical sponsor of policy initiatives, with the ECCB's Eight Point Stabilisation and Growth Programme (the Eight Point Plan), adopted in 2009, providing a strategic framework through which to strengthen the base of the currency union. In complementary fashion, there has also been renewed commitment to accelerate the economic integration process, marked by ratification of the Treaty of Basseterre, establishing the OECS Economic Union on 21 January 2011.

As the staff report underlines, the most urgent priority is to stabilize the financial sector, resolving weak institutions and enhancing regulation and oversight. This is happening in parallel with efforts to strengthen member governments' fiscal frameworks, both as precursors to sustaining more vibrant real sectors. In this environment, the engagement with the Fund has taken on heightened importance, with our authorities valuing both the technical assistance and IMF financial support.

The Economic and Institutional Setting

As the staff report mentions, signs of a modest although broadly uneven recovery has emerged in the OECS/ECCU region, with fiscal pressures consequently still elevated. After two years of decline, the region is expected to experience marginal growth of less than 1 percent in 2011, firming to the mid 2 percent range during 2012 and 2013. Improved tourism performance is contributing to this outcome, although the underlying external environment remains unfavorable for more robust gains. In the meantime, remittance inflows are still soft, while the external climate and competiveness challenges are constraining FDI flows.

With government revenue performance also hampered, a tight rein on spending has helped to narrow fiscal deficits since 2009, but partly at the expense of public sector investments, which, on the contrary, need to occur on an expanded scale to boost private sector growth potential. Otherwise, strong pressures persist on social spending, the current account balance and inflation, owing to elevated fuel and commodity prices.

The economic environment partly explains the difficulties that the financial sector is encountering. Other factors include gaps in non-bank regulation that contributed to the CLICO and BAICO failures in the insurance sector and governance and structural weaknesses which exposed some indigenous banks. A more telling measure of the gravity of the crisis is that all of the IMF members of the currency union have resorted to Fund financed balance of payments support, either utilizing their 2009 SDR allocations, taking on negotiated programs, or resorting to emergency facilities following a series of natural disasters. These combined circumstances underscore the vulnerabilities of the OECS/ECCU on multiple fronts.

The authorities are taking regional approaches to confronting these challenges, even though the pace of policy responses is balanced against political constraints at the national levels. Under the ECCB's Eight Point Plan, and the new economic union treaty, a single economic and financial space with a rationalized number of operations will contribute to greater scope for efficient operations, with firm-level risks better distributed across the OECS, and with operations subject to harmonized and more effective consolidated regulations. At the apex of the economic union, the OECS Authority, comprised of the heads of governments of each country will have legislative authority in critical areas which require greater policy harmonization, including the financial sector. The intention for regional convergence on fiscal policies is also present and will be pursued thorough enhanced coordination efforts.

Financial Sector Policies

ECCU authorities fully agree on the need for swift resolution of the financial sector weakness, to avert costlier and destabilizing outcomes. An orderly process is vital to maintain long-term confidence and safeguard domestic wealth that is concentrated to a large extent within banks. Indeed, the experience with the two troubled banks in Antigua and Barbuda underscore that interventions can be effectively carried out without inciting panic; even though the authorities hope to avoid such drastic steps as resolutions continue. As efforts are advanced, the banking sector therefore remains under intensified supervision by the ECCB, while more regional collaboration and moves towards single regulatory units at the national levels are supporting increased attention to the non-bank sector.

As to the rigor of banking supervision, the ECCB continues to follow a robust approach, modeled closely on the Canadian risk-based framework. Offsite monitoring and stress tests provide the triggers for more focused onsite examinations, with the frequency of onsite visits calibrated to the severity of the assessed risks. This complements a regular, but more metered cycle of comprehensive examinations. Watch-listed banks are subjected to more in depth and high frequency oversight. Depending on the issues, these occur on a weekly and in some cases daily basis, extending to the monitoring of liquidity and to internal governance systems which impact credit risk exposures.

To advance the financial sector resolution, the Monetary Council agreed in October 2011 to establish an ECCB-led Task Force on the ECCU Financial System to develop concrete recommendations on a resolution strategy, addressing among other issues potential approaches to balance sheet repair, amalgamation of operations, and strengthening of the legal and regulatory framework. The Task Force, which has representation from member governments, the IMF, Work Bank and the Caribbean Development Bank (CDB), is mandated to take a comprehensive look at all segments of the financial sector. The overall timeline for completion of the work is the first half of 2012, with the estimates of indigenous banks' recapitalization and liquidity needs identified as the first deliverable. This will better inform the financing needs of the Resolution Trust Corporation (RTC), which was incorporated under the legal framework of the ECCB in July 2011.

The RTC will be deployed to restructure and recapitalize weak banks and manage troubled assets. In addition to capital of US$18.5 million that member governments have already committed to the corporation, an extensive effort is being made to mobilize external support. The assistance of the IMF and other IFIs in lending credibility and support to this effort will be critical to its success. Meanwhile, our authorities hope to sustain significant regional private ownership in a restructured banking sector. Indigenous institutions play a vital role in driving product innovations that are important to broadening the services platform of the banking sector.

Even as the authorities are committed to consolidated non-bank supervision, in a harmonized approach at the national levels, the Task Force will also explore whether currency union wide institutions are merited. That said, such options would require some political support.

In the insurance sector, there has been further progress towards resolving the BAICO and CLCIO matters. Since February 2011, ECCU governments have been preparing to sell off the life and health business of BAICO. While more actuarial work is being done to identify recapitalization needs, the sale of the portfolio should be concluded in the first half of 2012. However, efforts to address the non-traditional investment products to which both individuals and important financial institutions are exposed is moving slower, with some funding still being sought from the government of Trinidad and Tobago. In the meantime, the judicial management process for CLICO was recently set in motion across the region, in coordination with Barbados. CLICO's restructured operations are also expected to be preserved in some form as a going concern, with plans in this respect to be presented soon to the courts in all of the respective jurisdictions. Our authorities concur that contingent fiscal costs from the insurance sector resolutions have to be kept in full view even as the work continues on a more compressed timeline for banking sector priorities.

It is also important to qualify some of the perceptions on monetary and financial sector policies conveyed in the staff report. On the ECCB's interest rate policies, it must be noted that these are also framed in the wider content of the demand side impact on the currency union's balance of payments. In its latest decision, the Monetary Council determined that reductions in either the minimum deposit rate or the discount rate at this juncture would not stimulate export activities. As captured in the staff report, our authorities believe that achieving enhanced operating efficiencies is also critical to strengthening the commercial banks' profitability. Finally, the view that misaligned regulatory incentives, has led to the banking system's "over-exposure" to the public sector is exaggerated. The staff report itself acknowledges that this is more a feature of underdeveloped non-bank intermediation channels. This is being tackled by placing more emphasis on the use of the regional government securities market.

Fiscal Policies

Regional efforts have continued to strengthen fiscal frameworks in OECS/ECCU countries, to support budgetary consolidation to reduce debt-to-GDP ratios to 60 percent by 2020. This target remains sufficiently ambitious for the medium-term, given the critical role that public sector investments play in supporting growth. As the staff report underscores, the required consolidation effort varies across countries. Further, important gains are envisioned from strengthened public financial management frameworks and expenditure rationalization.

The recent decision to begin to publish member governments' annual targets for the debt and primary balance to GDP ratios helps to operationalise this process, bringing peer pressure to bear on medium-term policy frameworks.[1] Governments are already benefiting from additional TA to develop and strengthen these frameworks. The contribution of the Fund through CARTAC and other channels has been highly valued, as has the involvement of the World Bank, CDB and development partners such as Canada (CIDA). Even though the analysis underpinning this process could benefit from more harmonized fiscal year ends, the exercise is highly valued as it is, since it brings governments' medium-term fiscal strategies into focus.

On expenditure reform and rationalization, the Public Expenditure Review Commission, appointed by the ECCB's Monetary Council in 2010, is expected to present its final report by February 2012. Preliminary work has already been completed, following extensive public consultations to identify cost savings and reductions for member governments. Our

[1] Staff's advice to incentivize stronger discipline, by limiting governments' access to the Fiscal Trance II retained profits of the ECCB, is a policy already enforced. The Monetary Council has agreed that these resources can only be drawn on when members take on IMF supported programs.

authorities acknowledge that firm control over the wage bill has to feature prominently in any strategy, along with strengthened debt management practices, some rationalization of public services and, where feasible, more regional pooling of capacity. Additional efficiencies are expected from more targeted systems of social assistance.

Separately, the Commission on Pension and Pension Administration Reform, appointed by the Monetary Council in 2009, has continued its regional public consultations. This work is geared towards securing the long-term solvency of plans throughout the OECS and minimizing contingent fiscal risks. Governments will receive recommendations on how to harmonize plan features, standardize the retirement age and make benefits portable--particularly in keeping with the free movement of labor within the economic space.

Enhancing Growth

The redress of fiscal frameworks and the financial sector are ultimately to secure more robust and stable private sector led growth within OECS/ECCU countries. As the staff highlight, a few of these countries are still in critical need of expanded airlift to take better advantages of opportunities in tourism. This is a targeted example of where infrastructural investments are required. Aside from supportive public sector investments and efficiencies in government services that will lead to improvements in the business environment, our authorities concur that external competiveness also has to be raised through increased workforce productivity. They acknowledge that public sector wage policies will continue to play a role in influencing private sector expectations and therefore discipline in this area has to be strengthened. That said, the single economic and financial space will serve as a strong catalyst for growth.

Engagement with the IMF and other IFIs

The ECCU authorities appreciate the Fund's heightened engagement during this period. In addition to direct TA and BOP support, they rely on the IMF to play a central role in galvanizing broader external support for their adjustment efforts. In this regard, more efforts to restructure and reduce debt burdens also merit closer consideration. This year the Fund carried out Article IV consultation discussions with Anguilla and Montserrat, two non-IMF members of the ECCU. Our authorities see these inputs as providing a valuable deepening of the currency union surveillance. As this is also vital to capacity building within these countries, it is important that this contact be sustained.

Access to and the cost of multilateral financing is a pressing concern for ECCU governments. At the Fund, four of the currency union members are eligible for the PRGF, even as middle income states, in view of their assessed vulnerabilities. Such vulnerabilities exist at a heightened state among each of the currency union members. There is therefore merit in preserving and expanding the ECCU's access to lower cost financing. Such an approach, particularly among other development partners is fully compatible with strategies to lower the cost of debt and to increase the space for productive investments.

Conclusion

With the support of external partners, our ECCU authorities expect to make significant inroads to strengthen the base of the currency union, enhance growth and employment prospects, and sustain poverty reduction efforts. Bolstering the stability of the financial sector is of course an immediate priority, in tandem with credible measures to strengthen the fiscal frameworks and secure improved medium-term debt sustainability. They concur that fiscal objectives are best served by minimizing the cost of financial sector resolutions, and stress that the outcome must also sustain longer-term confidence in the sector's ability to contribute meaningfully to economic development. The regional initiatives to achieve more harmonized policy and regulatory frameworks are therefore important and consistent with these objectives. Our authorities are fully committed to these undertakings and strongly appreciate the IMF's multifaceted engagement.