

INTERNATIONAL MONETARY FUND



Staff Country Reports

Eastern Caribbean Currency Union: 2004 Regional Surveillance—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director on the Eastern Caribbean Currency Union

This staff report on discussions with regional institutions for the Eastern Caribbean Currency Union (ECCU) was prepared by a staff team of the International Monetary Fund in the context of the periodic regional surveillance on the ECCU. The regional perspective of such discussions is intended to strengthen the bilateral discussions that the IMF holds with members in the region under Article IV of the IMF's Articles of Agreement. The following documents have been released and are included in this package:

- the staff report for the 2004 Regional Surveillance, prepared by a staff team of the IMF, following discussions that ended on **February 28, 2004**, with the officials of the ECCU regional institutions on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on April 14, 2004.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its May 5, 2004 discussion** of the staff report that concluded the discussion of regional surveillance.
- a statement by the Executive Director representing the countries of the ECCU.

The document listed below will be separately released.

Selected Issues Paper

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INTERNATIONAL MONETARY FUND
EASTERN CARIBBEAN CURRENCY UNION

Staff Report for the 2004 Regional Surveillance

Prepared by the Western Hemisphere Department

(In consultation with other departments)

Approved by José Fajgenbaum and Matthew Fisher

April 14, 2004

- **Eastern Caribbean Currency Union (ECCU).** Comprises six Fund members: Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines; and two British territories, Anguilla and Montserrat. ECCU countries formed the Eastern Caribbean Central Bank (ECCB), with a common currency, the Eastern Caribbean dollar, which has been pegged to the U.S. dollar at EC\$2.70=US\$1.00 since 1976. All six Fund members have accepted the obligations of Article VIII, Sections 2, 3, and 4. ECCU members participate in the Fund's General Data Dissemination System (GDDS), but there is a need for improvement in some key areas to enable more effective surveillance. Dominica is the only ECCU country that currently has a Fund-supported program.
- **Previous Board Discussion.** Regional surveillance papers on the ECCU have been discussed by the Executive Board on January 27, 2003 (along with the Article IV consultations on Grenada, St. Lucia, and St. Vincent and the Grenadines) and on October 24, 2003 (with the Article IV consultations on Antigua and Barbuda, and St. Kitts and Nevis). During the previous Board discussions, Directors stressed the need to reduce fiscal imbalances to safeguard the currency board arrangement and the financial system. They noted that fiscal consolidation and stabilizing public debt ratios would involve wage restraint, improved public expenditure management, early reduction in tax concessions, a broadening of the tax base, and strengthened public debt management. They also urged an acceleration of structural reforms to strengthen the region's competitiveness and growth potential. To this end, they encouraged the authorities to increase the flexibility of labor markets and accelerate regional integration plans.
- **Key Surveillance Issues.** The main policy challenge facing the region is to reinvigorate growth, while restoring public debt sustainability in an orderly fashion. Key components include removing impediments to growth, enhancing institutional capacity, strengthening the underlying fiscal stance, addressing the debt stock, and reducing vulnerabilities to near-term contagion risks and to the natural disasters, particularly hurricanes, that are common in the region.
- **Discussions:** A staff team comprising, at various stages, R. Sahay (Head), D. Robinson, P. Cashin, J. Chai, P. Njoroge, T. Rasmussen, and P. Rodriguez (all WHD), held discussions during February 8-28, 2004, with senior government officials in each of the six ECCU Fund member countries, as well as the ECCB, the Caribbean Development Bank, the Organization of Eastern Caribbean States, prominent regional donors based in Barbados, representatives of the private sector and members of civil society. The staff team also gave presentations of analytical papers to the authorities in all six member countries and to the ECCB. I. Bennett and R. Campbell (OED) participated in the final discussions at the ECCB, including with the Monetary Council.

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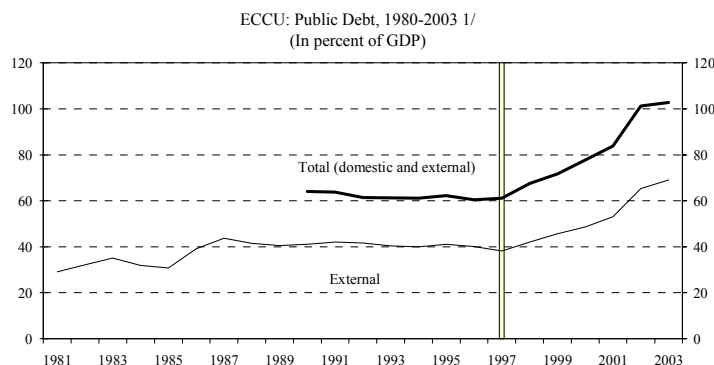
EXECUTIVE SUMMARY

- **The ECCU region has, since the mid-1990s, faced slow growth and mounting debt.** Growth decelerated from nearly 5 percent during 1980–95 to 2¼ percent since 1996, reflecting competitive pressures from lower-priced tourist destinations, weaknesses in the global economy, the 9/11 terrorist attacks on the United States, and a reduction in preferential trade agreements. Fiscal stances were relaxed in an attempt to sustain employment and growth as well as to meet natural disaster-related costs. As a result, public debt levels rose rapidly, reaching 103 percent of GDP at end-2003 from 61 percent of GDP at end-1997.
- **The region's economies strengthened in 2003 but, despite an improvement in fiscal balances, debt continued to rise.** Driven by a revival in tourism and the absence of natural disasters, growth recovered to 2½ percent in 2003. Overall fiscal balances strengthened significantly, largely on account of one-off reductions in expenditures—the current balance improved by 1½ percent of GDP on average, but remains in deficit.
- **Reinvigorating growth is a high priority.** Traditional agricultural crops—bananas and sugar—are facing continuing declines as trade preferences are eroded and new crops have been slow to emerge. Increasing value added from tourism by strengthening linkages to the rest of the economy, reducing labor market rigidities, improving competitiveness, and public enterprise reform, are key areas to facilitate a strengthening of growth. Greater regional cooperation could also help, by overcoming the fundamental constraint on growth stemming from the small size of markets.
- **Restoring debt sustainability in the most highly indebted countries will require comprehensive adjustment strategies.** In four countries—Antigua and Barbuda, Dominica, Grenada, and St. Kitts and Nevis—existing debt levels are in excess of 100 percent of GDP and it is unlikely that debt can be brought down purely through fiscal adjustment. Thus a comprehensive strategy—incorporating fiscal adjustment, growth-enhancing structural reforms, asset sales, and a debt strategy—needs to be designed. In Dominica, the authorities are already at an advanced stage of implementing such a strategy. The authorities in the other countries in the region are seeking to implement a gradual approach, targeting debt sustainability over the medium term.
- **The coverage ratio of the currency board is well above legal requirements, but there is a need to reduce vulnerabilities.** Gross international reserves at the ECCB continue to rise and the coverage ratio is in excess of 95 percent—well above the legal requirement of 60 percent. While foreign banks hold more than half of banking system assets, strengthening the effectiveness of banking supervision would reduce risks emanating from locally incorporated banks several of which have large exposures to the public sector and relatively high ratios of nonperforming loans. Given the region's vulnerability to natural disasters, there is also a need to increase preparedness and develop timely response mechanisms.
- **Further progress in institution building and improving governance is needed in the region.** Basic institutions should be strengthened to enhance fiscal management—including expenditure control, tax administration, and budgeting practices—and more binding fiscal rules should be introduced to ensure greater consistency of national fiscal policies with regional obligations. Statistics are weak, particularly in the areas of international trade, labor markets, debt, and quasi-fiscal liabilities.

I. BACKGROUND

Economic perspective

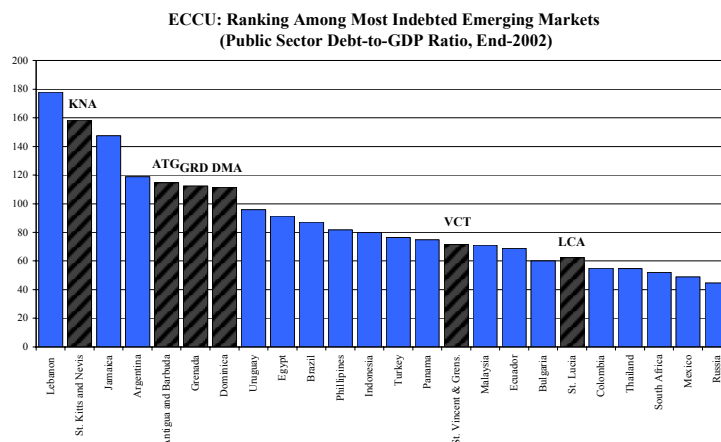
1. **Macroeconomic conditions in the ECCU countries have weakened considerably since the mid-1990s.** GDP growth slowed sharply from nearly 5 percent a year during 1980–95 to about 2¼ percent a year since then.¹ The slowdown in economic activity stemmed from increased competition from lower-priced tourist destinations, weaknesses in the global economy, the gradual reduction in preferential trade agreements, and closures of offshore banks. In an attempt to create employment opportunities, public expenditures as a share of GDP were raised sharply in the last few years. As a result, some countries are now facing high public debt and severe fiscal pressures. In this environment, preserving the currency board arrangement (CBA) and addressing several sources of vulnerabilities are key challenges.²



Sources: ECCU country authorities; and Fund staff estimates.

1/ ECCU countries that are members of the IMF are: Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

2. **Public debt levels have risen rapidly since 1998, reaching 103 percent of GDP at end-2003.** External current account deficits have been high—in the range of 10–20 percent of GDP—throughout the 1990–2003 period. During 1990–97, external current account deficits largely reflected private sector investment and were financed by foreign direct investments, helping to contain public debt to 60 percent of GDP. Since 1998, external current account deficits have been largely driven by increasing fiscal imbalances, resulting in the rapid



Source: WEO.

¹ ECCU aggregates are calculated by summing the individual country data; ratios to GDP are then calculated by dividing this sum by GDP of the region.

² The CBA functions as a quasi-currency board, with the legal backing of the currency set at 60 percent of demand liabilities. De facto, it has operated with a significantly higher coverage ratio, at 95 percent at end-2003.

accumulation of public sector debt. This pattern is noticeable across all six countries, although the public debt to GDP ratio ranges from 66 percent of GDP (St. Lucia) to 162 percent (St. Kitts and Nevis), placing them among the most indebted countries in the world.³ While external debt servicing costs—with interest rates averaging between 4 and 5 percent—are low by international standards, for the more indebted countries they have edged up to 7-8 percent, or even higher, on new debt in the last two years.

3. Fiscal slippages account for the bulk of the rapid accumulation of public debt during 1998–2003.⁴ Public debt rose by an average of 7½ percent of GDP a year in 1998–2003, after falling by one half of one percent of GDP per year in 1990–97. While the refinancing of interest payments has been the largest contributor to the increase in debt (over 50 percent), the clear turnaround in the 1998–2003 period occurred in the deterioration of the primary fiscal balance—contrasting sharply with the 1990–97 period when primary fiscal surpluses helped reduce public debt. Other factors, which in the latter period were dominated by public sector assumption of private sector debt, have been important contributors to the turnaround. The positive contribution of growth to tempering the debt build-up was small, and declined in the second sub-period.

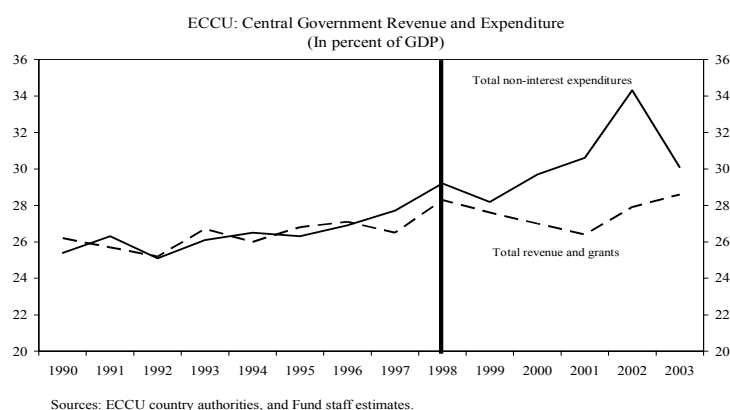
4. The deterioration in fiscal balances in 1998–2003 was triggered by policy slippages and the costs associated with adverse exogenous shocks. The overall balance weakened from an average deficit of about 2 percent of GDP in 1990–97 to a deficit of more than 6 percent in 1998–2003. Despite a halving of concessional financing as a share of GDP, current and capital expenditures rose sharply—by nearly 3½ and 1½ percentage points of GDP, respectively, in the second sub-period. While part of the increase in expenditure could be attributed to

ECCU: Contributions to Debt Accumulation
(Averages, percent GDP, per year)

	Period 1990–97	Period 1998–2003
Public debt accumulation	-0.4	7.6
Contribution of:		
Primary balance (net of grants)	-0.4	2.7
Accumulation of foreign assets	0.8	1.2
Debt service	3.0	3.8
Output growth	-1.7	-1.3
Real exchange rate growth	-0.3	0.2
Others 1/	-1.8	1.0

Source: Fund staff estimates.

1/ Others includes: valuation changes, debt relief, and the assumptions of private sector debt by the public sector.



³ Existing data do not permit the calculation of debt ratios on a NPV basis for the ECCU countries.

⁴ A detailed accounting of the sources of the debt build-up is contained in Chapter V of *Eastern Caribbean Currency Union—Selected Issues*: “Public Debt Accumulation in the ECCU.”

unanticipated reconstruction and disaster management-related costs in some countries, they also reflected an attempt to create employment and preserve wages as growth slowed.

Social and political context

5. **While the economies are dominated by the service sector, agriculture remains very important politically and socially, despite its small and declining contribution to GDP.** The share of services (including tourism) to ECCU output rose from 78 percent in 1990 to 86 percent in 2003, while that of agriculture fell from 12 percent to 7 percent during the same period (Figure 1). The agricultural sector remains very important politically, because of its social significance—it continues to employ about one-fifth of the labor force, and over half the ECCU population lives in rural areas.

6. **Health and education levels are a source of considerable pride in the region, although the skill mix produced by local educational institutions does not seem to correspond to the region's current needs.**⁵ Infant mortality rates are moderate (about 18 per 1,000 live births) and life expectancy at birth is high (over 70 years). Primary and secondary education enrollment rates are at levels comparable to OECD countries. The region also boasts several professional schools of medicine and veterinary colleges, which attract students from the United States and Europe. However, based on the limited data available, local unemployment rates appear to be high, ranging between 10–25 percent. There is a constant brain drain from the region. The spread of HIV/AIDS is also a concern, as the Caribbean region has the world's second highest rate of infection after Africa.⁶

7. **The ECCU countries have democratically-elected governments, with elections held generally every 4-5 years.** Governments tend to be fairly stable in the region, with infrequent changes of the ruling party. However, as election cycles are not synchronized—since 1979, elections have taken place in at least one country in 18 of the last 26 years—it would have been

ECCU: Political Cycles—Winners in the National Elections
(1979-2004 1/)

	Antigua and Barbuda	Dominica	Grenada	St. Kitts and Nevis	St. Lucia	St. Vincent and the Grenadines	Number of elections each year
1979					SLP	SYLP	2
1980	ALP	DFP		PAM			3
1981							0
1982					UWP		1
1983							0
1984	ALP		NNP	PAM		NDP	4
1985		DFP					1
1986							0
1987					UWP		1
1988							0
1989	ALP			PAM		NDP	3
1990		DFP	NDC				2
1991							0
1992					UWP		1
1993							0
1994	ALP					NDP	2
1995		UWP	NNP	SKLP			3
1996							0
1997					SLP		1
1998						NDP	1
1999	ALP		NNP				2
2000		DLP		SKLP			2
2001					SLP	ULP	2
2002							0
2003			NNP				1
2004	UPP						1
Number of elections per country	6	5	5	5	6	6	

Source: Internet.

1/ Updated until April 2004. Acronyms for political parties are described in Appendix IV.

⁵ Data on progress towards achieving the MDGs are scarce, but the starting level for most indicators is very high.

⁶ Data on HIV/AIDS are not available for the ECCU countries.

Figure 1. ECCU: Sectoral Share of GDP 1/
(In percent)



Sources: ECCU country authorities; Eastern Caribbean Central Bank; and Fund staff estimates.
1/ Percentage contribution of gross domestic product by economic activity, at current prices.

difficult for governments to take a regional approach and coordinate the implementation of bold economic reforms. The major political parties in the region emerged from the pre-independence labor movements. Consequently, the political agenda and mandate, irrespective of which party comes to power, is heavily tilted towards meeting social goals—reducing unemployment and raising living standards—and the size of the governments tends to be large.

II. RECENT ECONOMIC DEVELOPMENTS AND NEAR-TERM PROSPECTS

8. **Following weak growth in 2001-02, the region's economies picked up strength in 2003, and are likely to grow moderately faster in 2004.** A favorable external environment—revival of tourism as the global economy continues to recover, the depreciation of the U.S. dollar against major currencies, and the absence of natural disasters—contributed to the strengthened outcomes in 2003 and improved prospects for 2004. Reserve coverage of the currency board has continued to increase well beyond the statutory level of 60 percent and inflation remains very low (Table 1).

ECCU: Selected Economic Indicators, 2000–04

	2000	2001	2002	Proj. 2003	Proj. 2004
(In percent)					
Real GDP	2.8	-1.3	0.2	2.4	2.5-3.5
Real effective exchange rate, (depreciation -)	4.3	1.8	-5.7	-9.6	...
CPI, end-of-year	3.1	2.0	0.8	1.5	1.5
(In percent of GDP)					
Overall central government balance	-6.4	-7.8	-10.5	-5.9	-5.4
Revenue and grants	27.0	26.4	27.9	28.6	28.4
Expenditure and net lending	33.4	34.2	38.4	34.5	33.8
External current account	-15.5	-16.7	-19.6	-19.5	-19.1
Travel receipts	28.2	26.2	24.7	27.3	27.8
Total public debt	78	84	101	103	103
Of which					
External	49	53	65	69	68
Gross international reserves of ECCB (US\$m)	384	446	505	540	560
Currency backing ratio, in percent	88	93	97	95	95

9. **Despite the recent pick up, output remains well below potential.** In 2003, output is estimated to be below potential in all the countries except St. Vincent and the Grenadines (Figure 2), with large output gaps—in excess of 4 percent of potential output—in Dominica, Grenada, St. Kitts and Nevis, and St. Lucia.⁷ Growth has largely stemmed from a rebound in tourism, as new facilities have opened and security concerns that reduced global tourism in the aftermath of September 11, 2001 have diminished. Growth in 2004 is anticipated to continue to be driven by tourism and tourism-related services.

10. **Fiscal balances for the region as a whole strengthened significantly in 2003, in part due to one-off factors, but structural balances remain in large deficit** (Table 2). The overall deficit for the ECCU region is estimated at 6 percent of GDP in 2003, an improvement of close to 5 percentage points over the previous year. The greatest adjustments occurred in Grenada, due to a one-off payment in 2002 of 11½ percent of GDP to terminate a number of leasing arrangements, and in St. Kitts and Nevis, largely due to the completion of projects to repair hurricane damage to key tourism infrastructure. Focusing on the current balance (which is not affected by these one-off factors), the adjustment is more modest—by 1½ percent of GDP to a current deficit of ¾ percent of GDP—reflecting significant

⁷ Expansions and contractions in economic activity in ECCU countries are analyzed in greater detail in Chapter I of *Eastern Caribbean Currency Union—Selected Issues: “Key Features of Caribbean Business Cycles.”*

improvements in all countries except St. Lucia; in Antigua and Barbuda, the improvement stemmed from ad hoc expenditure compression in response to the lack of available financing. However, structural deficits remain large throughout the region, with the exception of St. Vincent and the Grenadines (Figure 2).

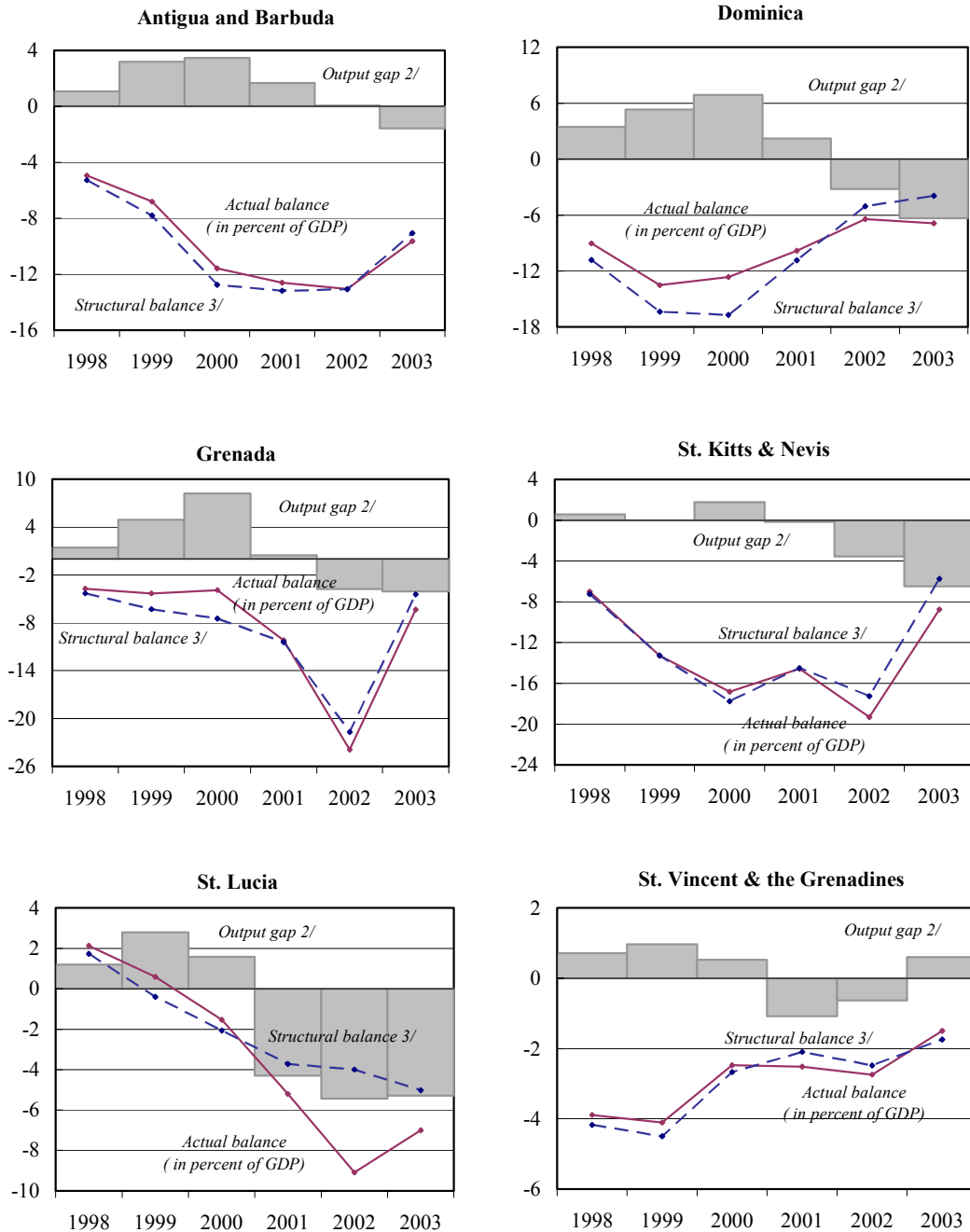
11. Fiscal revenues have been mostly flat, despite the pick up in activity and efforts to improve tax policy and administration. Average revenues (including grants) have remained almost constant at 26–28 percent of GDP over the last few years, though there is significant variation amongst countries—ranging from an average of about 20 percent of GDP in Antigua and Barbuda to 26 percent of GDP in St. Lucia, and more than 30 percent of GDP in the other four countries. In 2003, total revenues and grants rose markedly only in Dominica and Grenada. The lack of buoyancy in the region's tax systems reflects, in large part, the concentration of the recent economic rebound in the tourism sector, which is fairly lightly taxed as many of the large operators in the sector enjoy extensive tax concessions. A review of tax policy and administration in each of the countries was conducted by FAD and the Caribbean Regional Technical Assistance Center (CARTAC) in October–December 2002. Subsequently, a Tax Reform and Administration Commission comprising representatives of the member countries produced a draft report laying out a strategy for tax reform in the region that incorporated the key recommendations from the earlier report. The Commission is developing an implementation schedule for each country. Most countries in the region have accepted the objective of moving to a VAT or similar broad-based sales tax, though timeframes and implementation schedules are still being developed with assistance from CARTAC.⁸

12. Despite the fiscal strengthening and renewed growth, the debt to GDP ratio of the region increased to 103 percent in 2003 and is likely to remain at that level in 2004. The overall fiscal balance for the region is projected to improve only modestly in 2004—by less than ½ percent of GDP—driven by a reduction in noninterest expenditures. A significant strengthening of the fiscal position is foreseen in the approved 2004 budget in St. Kitts and Nevis, based on expenditure reduction and increased revenues due to administrative improvements implemented in 2003 and the ending of some tax breaks provided to a major new hotel. In other countries, particularly Antigua and Barbuda where the March 23 elections resulted in a change in government, the projected fiscal stance is highly uncertain. Even with the above-mentioned adjustments, the overall deficit for the region would remain at around 5½ percent of GDP in 2004, and debt to GDP ratios would not decline.

13. Commercial creditors, principally private domestic and foreign-owned banks, were the largest holders of total public debt at end-2002, the latest year for which data are available (Table 3). Commercial creditors held around 40 percent of external debt, with the remaining amount split equally between bilateral and multilateral lenders. Private domestic banks held half of domestic debt at end-2002, with the rest held by various creditor groups, depending on the country. With the launching of the Regional Government Securities

⁸ The introduction of a VAT has been announced in Dominica (July 2005) and in Grenada (January 2006).

Figure 2. ECCU: Central Government Actual and Structural Budget Balances 1/
(In percent of potential GDP)



Sources: ECCU country authorities; Eastern Caribbean Central Bank; and IMF staff estimates.

1/ Actual balance is the overall balance (revenue and grants less expenditure), and is expressed as a percentage of actual output. Actual output is measured as gross domestic product (GDP) at factor cost.

2/ The output gap is actual output less potential output, as a percent of potential output.

3/ Structural balance is expressed as a percent of potential output. The structural balance is the budgetary position (overall balance) that would be observed if the level of actual output coincided with potential output. Structural balances also incorporate one-time expenditure adjustments.

Market (RGSM) in November 2002, countries placed local currency debt with ECCU region banks on better terms than those available in their local markets. Grenada, St. Kitts and Nevis, and St. Vincent and the Grenadines have made the most active use of this market. Given its relatively better economic indicators, St. Vincent and the Grenadines has been able to access this market at steadily declining interest rates.⁹

14. **The external current account deficit is estimated to have remained at 19½ percent of GDP in 2003, despite the fiscal adjustment and the large real depreciation of the Eastern Caribbean dollar** (Table 4). Following a period of sustained appreciation over the last decade, the Eastern Caribbean dollar depreciated (in real effective terms) by over 15 percent during 2002 and 2003—owing in large part to the sharp depreciation of the U.S. dollar against major currencies since the second half of 2002. An increase in export receipts (including tourism) was offset by a rise in imports, in part due to a sharp increase in capital imports related to direct foreign investment inflows (mainly in construction, hotels, and telecommunications—following the liberalization of the sector in several countries in the region) to about 13 percent of GDP, still somewhat below the levels of the late 1990s. Despite the large current account deficits, the overall balance of payments position of the ECCU has remained in surplus, reflecting both the large direct foreign investment inflows and portfolio investment inflows as governments placed debt instruments on international markets. As a result, gross international reserves of the ECCB increased by US\$35 million, reaching US\$540 million (4½ months of imports) at end-2003.

15. **Monetary aggregates have continued to expand rapidly, relative to the region's output growth rates, despite increasing pressures on the health of the banking system** (Tables 5 and 6). Broad money (M2) grew in real terms by 5½ percent in 2002 and by 8 percent in 2003, as deposits with the banking sector rose despite a reduction in the minimum savings deposit rate from 4 percent to 3 percent in September 2002. Net lending to the public sector contracted sharply, as governments made increasing recourse to external borrowing and government social security funds built up deposits with the banking system. Private sector credit growth—principally loans to individuals, mostly for housing—declined to 2 percent in 2002 and to 1 percent in 2003, as interest rates did not adjust to the excess liquidity in the banking system and banks accumulated foreign assets. Despite the high interest rate spread, the rate of return on bank assets is low.¹⁰

⁹ The two issues of three-month treasury bills in the second half of 2003 were placed at interest rates of 4.8 and 4.9 percent, and that in February 2004 at 3.9 percent, compared with 6.6 percent prior to the establishment of the RGSM.

¹⁰ Domestic lending rates are about 13 percent in the ECCU region, while deposit rates are about 4¾ percent.

III. POLICY DISCUSSIONS

A. Overview and Strategic Considerations

16. **Policy discussions focused on bringing a regional perspective to the current economic difficulties, and identifying the main sources of vulnerability and risks.** Two broad themes emerged:

- *Addressing fundamental economic problems in the region:* ensuring long-run debt and fiscal sustainability, and regional coherence in economic policies to support growth and preserve the currency board arrangement.
- *Facing near-term risks:* taking immediate measures to reduce vulnerabilities and increasing preparedness to respond to a negative event, if it cannot be prevented.

17. **While acknowledging the deterioration of their economic conditions since the mid-1990s, the authorities maintained that key causes were unfair global trading practices and the series of negative shocks that had hit their economies.** The dismantling of preferential trade arrangements starting in the 1990s had triggered a decline of traditional agricultural crops (bananas and sugar), despite efforts to sustain them via domestic subsidies and European Union compensation projects (Box 1).¹¹ The authorities pointed to the labor-intensive nature of the production of agricultural crops, and the strong linkages of this industry to other sectors of the economy. They expressed frustration with the double standards they considered were imposed by industrial countries in agriculture—transferring large subsidies to their own agricultural sectors while preventing developing countries from providing subsidies to their domestic agricultural sectors, and removing preferential arrangements—that had undermined

ECCU: Total Official Development Assistance Flows
(In percent of GDP)

	Avg. 1977-97	Avg. 1998-2002
Antigua and Barbuda	3.0	1.8
Dominica	17.0	8.6
Grenada	10.2	3.4
St. Kitts and Nevis	6.8	3.8
St. Lucia	5.7	3.3
St. Vincent and the Grenadines	10.3	4.1
ECCU average	8.8	4.2

Sources: OECD; Eastern Caribbean Central Bank; and Fund staff estimates.

¹¹ Estimates of the magnitude of the shock to the region from the loss of trade preferences are contained in “Fund Support for Trade-Related Balance of Payments Adjustments,” (www.imf.org). Assuming that the new trade agreements would imply a 40 percent loss of preference margins, then the shock would be equivalent to a reduction in export unit values of 9.8 percent in St. Lucia, 8.9 percent in St. Kitts and Nevis, 5.5 percent in Dominica, and 3.4 percent in St. Vincent and the Grenadines.

Box 1. Caribbean Preferential Trade Arrangements: Bananas and Sugar

The Windward Islands (Dominica, Grenada, St. Lucia, and St. Vincent and the Grenadines) have a preferential trade arrangement in bananas with the European Union (EU), while St. Kitts and Nevis, together with other Caribbean countries, have a preferential agreement with the EU in sugar.

The EU Banana Regime

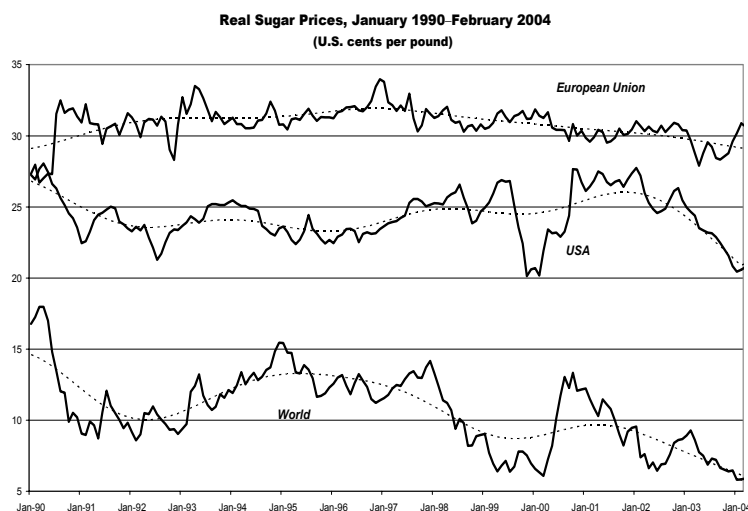
Prior to the establishment of a Single European Market in 1993, EU countries had bilateral arrangements with their ex-colonies in the Caribbean, Africa and the Pacific ("ACP" bananas). Between 1993–98, the unified European Union (EU) banana regime operated on the basis of an annual ACP banana quota for duty-free export to the EU by 12 traditional producers, and an annual quota for bananas from Latin America ("dollar" bananas), subject to a tariff. Given the quantity restrictions and subsidies paid to EU banana producers, the price of bananas in the EU averaged about 80 percent more than the world price.

From the start, the EU banana regime was controversial. Following several legal challenges at the GATT and WTO, reforms to the system were introduced in various stages from January 1, 1999. The reforms introduced regional (rather than country-specific) quotas, progressively reallocated quotas to Latin American producers and simplified licensing procedures. A key modification, to be introduced on January 1, 2006, is the move to a tariff-only regime (no quotas or licenses) for dollar bananas as of January 1, 2006, but allows the tariff preference, at a level yet to be determined, for ACP bananas to remain until 2008.

The EU Sugar Regime

Since 1975, the ACP countries, under the Lome Convention, have supplied raw sugar to the EU at guaranteed prices subject to a quota that could be increased in the event of a shortfall in the supply of sugar to EU refiners. The average price currently paid by the EU to ACP sugar producers is about twice the international price of sugar. Australia and Brazil filed a complaint at the WTO in February 2003, which concerned the fact that the EU imports raw sugar from the ACP countries at above-market prices, then refines the sugar and re-exports it at below-market price, resulting in unfair competition.

This preferential scheme is being dismantled and by 2007, the Caribbean sugar industries will have to compete in the international market. Given that production costs in the ECCU region are significantly above international prices, the dismantling of the regime could result in large losses in employment.



Source: International Monetary Fund, Commodity Price System.
Notes: Sugar (USA) is the U.S. import price, CSCE nearest futures, c.i.f. New York; sugar (EU) is the European Union negotiated import price for raw unpackaged sugar from ACP countries, c.i.f. European ports; sugar (world) is the free market price, CSCE nearest futures, c.i.f. New York. Dashed lines are measures of the long-run trend (smoothed versions) of the respective real price series. All nominal price series were deflated using the Fund's manufacturers' unit value index.

the region's ability to compete on world commodity markets.¹² They also noted that the new global rules imposed by industrial countries (who, they noted, did not necessarily comply with them themselves) via the Financial Action Task Force (FATF), had abruptly shut down the offshore financial centers, severely retarding the emergence of a new growth sector for the region (Box 2). The authorities also pointed to much diminished levels of external concessional assistance flows from developed countries, which had hampered their efforts to undertake growth-enhancing investment in human and physical capital. In addition, the economies had been subject to adverse weather conditions (including several hurricanes), crop diseases, and the 2001 terrorist attack on the United States which had been a severe setback for the tourism sector, the mainstay of the economies of the ECCU.¹³ In sum, they argued that the forces of globalization presented difficult challenges to small open economies, disrupting traditional cultures and lifestyles.

18. **Staff noted the authorities' concerns on the adverse impacts of globalization, but pointed to the opportunities for raising growth rates that it afforded.** Staff suggested a two-pronged approach: first, to continue to confront inequities in trade practices, in coordination with other developing countries in the context of the WTO, by pushing for freer and fairer trade, rather than continuing protectionism. Second, to pursue regional and national strategies that would take advantage of the new global environment. In particular, opportunities clearly existed in tourism, where the ECCU countries have only just begun to exploit the sector's vast potential. Education and health levels, that are well ahead of other developing nations and comparable to OECD levels, could be adapted to correspond to the current needs of the region. Finally, the richness of the soil and favorable climate in the region lends itself to developing new agricultural products for export to both regional and world markets, as well as for local consumption, including by the tourism sector.

¹² The authorities complained that multinational supermarket stores like Asda-Wal Mart (the third-largest supermarket chain in the U.K.) were dumping bananas in the U.K. market, in order to capture the market. Since the price cutting, which was initiated by Asda-Wal Mart in August 2002 (and followed by other supermarket chains in the U.K.), the retail price of bananas in the U.K. (the ECCU's dominant export market) has fallen by about 30 percent.

¹³ The authorities also noted that while some ECCU countries had drawn upon the Fund's Emergency Disaster Assistance Facility in the wake of recent natural disasters (Grenada in 2003 and St. Kitts and Nevis in 1998), the facility's non-concessional rate of charge, tardiness in transferring funds, and the small amounts available, combined to make this facility of limited attractiveness to disaster-affected countries.

Box 2: The Re-emergence of Offshore Financial Centers in ECCU Economies

By end-2000, several offshore financial centers (OFCs) were operating in the ECCU region. Available data indicate that at end-2000, OFC employment ranged from about 8 percent of the labor force in Antigua and Barbuda to only one-half of one percent of the labor force in Dominica. Income from fees accounted for, on average, 5.8 percent of central government current revenues, ranging from about 7 percent in Antigua and Barbuda to 0.7 percent in Dominica. A majority of the fee income was generated from international business companies (IBCs) and, in Antigua and Barbuda, from internet gaming companies. However, the net revenue contribution from the sector averaged only 2.3 percent, after taking into account the business and supervisory cost of maintaining an OFC.

Annual Fee Income to Governments from OFCs, 2000 (as percent of central government revenue)		
	Gross income	Net income
ECCU Area		
Antigua and Barbuda	7.2	6.0
Dominica	0.7	0.4
Grenada	4.5	3.0
St. Kitts and Nevis	2.8	2.0
St. Vincent and the Grenadines	1.4	-0.1
Rest of the Caribbean		
Barbados	2.1	1.9
British Virgin Islands	54.6	53.2
Cayman Islands	14.6	13.8

Source: Suss, Williams, and Mendis, "Caribbean Offshore Financial Centers: Past, Present, and Possibilities for the Future," IMF Working Paper 02/88, May 2002.

The listing of four ECCU countries by the Financial Action Task Force (FATF) as "noncooperative" starting in mid-2000, generated an overhaul in the regulatory framework, which resulted in a sharp contraction in the level of offshore activities. Dominica, Grenada, St. Kitts and Nevis, and St. Vincent and the Grenadines were identified by the FATF as noncooperative territories, but all countries in the region took steps to strengthen their regulatory frameworks. The number of offshore banks fell drastically, with many folding voluntarily as supervision tightened. The adverse publicity associated with the listing has also negatively affected other offshore institutions such as IBCs and trust companies. Data on IBCs are only available for St. Vincent and the Grenadines, but indicate that the total number of IBCs fell by about 13 percent in 2002 and a further 23 percent during 2003.

Number of Active Offshore Banks, 2000 and 2003		
	2000	2003
Antigua and Barbuda	22	15
Dominica	8	1
Grenada 1/	31	1
St. Kitts and Nevis	1	1
St. Lucia	1	2
St. Vincent and the Grenadines	36	11

Source: ECCB

1/ There are 7 licensed banks, only one of which is authorized to conduct banking business.

By June 2003, all four countries had been de-listed by the FATF and the strengthened and more reputable environment has enabled the re-emergence of OFCs. On the basis of the partial data that are available, the remaining offshore banks expanded their assets between 2001 and 2003. In St. Lucia, a new offshore bank will begin operation in 2004. In St. Vincent and the Grenadines—the only country for which recent revenue data on the OFC are available, the fee income from insurance companies tripled in 2003, and that from offshore banks increased marginally—as the authorities charged offshore banks new fees to cover strengthened due diligence and on-site inspection. Fee income generated from the IBCs declined by 35 percent in 2003, but the number of IBCs has begun to increase in 2004.

19. **The authorities did not consider that the weaker economic outcomes of the last few years had significantly elevated risks in the region.**¹⁴ They noted that the region had withstood a series of large adverse shocks and that many events—such as large public sector wage arrears, defaults to certain classes of creditors, deposit runs, sharp decline in export receipts—that had triggered crises in other parts of the world, had occurred somewhere within the region in the last few years without resulting in a crisis. Both Dominica, due to its small size within the ECCU (representing about 8½ percent of ECCU GDP), and Antigua and Barbuda, due to its long history of fiscal difficulties and arrears to creditors, were regarded in the region as outliers whose actions did not reflect on the other members of the ECCU.

20. **The mission noted that implementation of ambitious front-loaded macroeconomic adjustments in all countries, as in Dominica, would reduce the risk of disorderly adjustments later.** Staff cautioned that the ECCU region needed to begin adjusting now so that it can be done in an orderly way and avoid prolonged economic stagnation. Gradual adjustments—the preferred approach in most countries in the region—raised concern because the already large macroeconomic imbalances could become even larger, given the vulnerability to negative shocks. At the same time, the authorities of the region expressed favorable views on the progress of the Fund-supported program with Dominica, stating that the successful completion of the program was necessary to correct for past fiscal profligacy and ensure growth (Box 3).

21. **The mission welcomed the work being undertaken by the authorities to design home-grown stabilization programs, yet urged the authorities to make greater use of this work in their policymaking deliberations.**¹⁵ Each country, with technical support from CARTAC (the main regional technical assistance center) is developing a framework to implement stabilization program under the Structural Adjustment and Technical Assistance Project (SATAP) initiative. This initiative could prove to be a powerful tool for ensuring macroeconomic stability, dealing with debt problems, and implementing reforms to embrace new opportunities for growth. Staff pointed out that the success of these programs, however, would depend critically on the ambitiousness of the programs and the determination with which they were implemented, the integration of SATAP programs with policy making and monitoring, and the quality and technical expertise of their staff.

¹⁴ Early Warning System (EWS) models of the ECCU as a whole suggest that the probability of a balance of payments crisis occurring within the next two years, assuming unchanged policies, is low at about 10 percent. For individual ECCU countries, risks in Grenada and St. Kitts and Nevis are higher than in other countries—details of the EWS model employed are contained in Chapter V of *Eastern Caribbean Currency Union—Selected Issues*: “Public Debt Accumulation in the ECCU.”

¹⁵ See Appendix I for more information on CARTAC’s activities in the region.

Box 3. Dominica—Progress in Stabilization and Regaining Sustainability

Dominica has faced similar economic problems to those confronting the rest of the ECCU. A combination of external shocks—which affected tourism and included the dismantling of preferential trade agreements and the closure of most of the offshore banks—and inappropriate policy responses led to a rapid deterioration in fiscal performance and accumulation of public debt. An attempt to stabilize the economy in August 2002, supported by a Stand-By Arrangement (SBA), fell short of expectations due to difficult conditions and weak political support. The economy continued on a downward trend, reaching a budgetary crisis, as arrears accumulated rapidly. By mid-2003, the economy was in a deep recession, with output falling by about 10 percent in the previous two years. In 2002/03, the structural primary fiscal balance deteriorated to a deficit of 5 percent of GDP and public debt reached 112 percent of GDP, more than double its level in 1998.¹

A two-stage strategy of stabilization and structural reforms introduced in mid-2003 is proving effective in paving the way for an economic recovery and averting a budgetary crisis.

The first stage consisted of a short-term stabilization program for the second half of 2003, supported by an extended and modified SBA. Political

commitment was strengthened and a tight budget for 2003/04 was adopted, including a 5 percent cut in nominal wages. All performance criteria and structural benchmarks under the SBA were observed, helping mitigate a budgetary crisis and arresting a further contraction in output.

In the second stage, measures to revive growth and regain sustainability have been adopted at end-2003 in the context of a PRGF arrangement. The key elements of the program include an ambitious fiscal consolidation effort, a comprehensive debt restructuring, and an ambitious structural reform agenda, including fiscal and financial sector reform and the deregulation of the economy to improve competitiveness. As a consequence, the structural primary fiscal position is expected to swing from a deficit of almost 5 percent of GDP in 2002/03 to a surplus of 3 percent of GDP by 2006/07. The authorities have embarked on a consensual and comprehensive debt restructuring, and have adopted best practices in their negotiations with creditors, including the principles of transparency and inter-creditor equity. The debt restructuring process is progressing as envisaged; the debt exchange offer was announced on April 6. The authorities are targeting the completion of the debt restructuring in May 2004.

¹The structural primary balance is calculated as the actual primary balance with capital expenditures and grants set equal to their historic averages of 7 and 3½ percent of GDP respectively (see IMF Country Report No. 04/6).

Dominica: Macroeconomic Framework, 2002-2006						
	SBA			PRGF		
	2002	2003	2003	2004	2005	2006
	(In percent)					
GDP growth	-4.7	-1.0	0.0	1.0	2.0	2.0
Inflation	0.5	2.5	2.9	1.5	1.5	1.5
Current account / GDP	-15.0	-16.7	-16.9	-15.0	-12.2	-9.2
	(In percent of GDP, fiscal year)					
Structural primary balance 1/	-4.5	-2.0	-1.7	0.5	2.0	3.0
Overall fiscal balance 1/	-7.1	-5.6	-5.5	-5.5	-4.2	-3.3
Public debt	111.5	114.7	114.6	...	...	...

Sources: Dominican authorities; and Fund staff estimates.

1/ Fiscal years beginning July 1.

22. **In addition to implementing individual country economic programs, staff urged the authorities to take a regional perspective in designing their programs.** This perspective, in the staff's view, had two aspects.

- *Building on the achievements of the past*—in particular, the currency board arrangement (CBA). Staff stressed that the currency and inflation stability provided by the CBA could not be taken for granted, and that the authorities had to be mindful of the negative regional externalities that could be generated by large fiscal slippages and high levels of public debt in any one country, as these could threaten the stability long enjoyed by all.
- *Meeting the challenges of globalization and the opportunities it created by breathing new life into institution building and regional cooperation.* National labor, capital, and goods markets are small and prevent the individual countries from realizing their full potential (Box 4). Pursuing greater outward orientation of the economies—including through deepening regional markets—would assist in overcoming this hindrance to growth.

23. **Discussions with civil society revealed limited acceptance of the implications of the changes in the global environment and a lack of awareness of the gravity of the economic difficulties.** Staff considered there was a need to improve public awareness of two issues:

- *The implications of a changing world environment.* Specifically, that the loss of preferential trading access for traditional crops meant that, in the period ahead, they would inevitably play a smaller role in the economy, and that rural livelihoods would need to adjust and quickly adapt to the new opportunities.
- *The government cannot continue to serve as the employer of last resort in bad times.* The public needed to be made aware that it is an equal partner of the government in sharing the largesse of good times as well as the pain of adjustment in bad times.

The authorities in some countries (for example, St. Vincent and the Grenadines) pointed out that greater efforts were being made in the region at broadening public awareness through the creation of tripartite commissions, including representatives from all elements of society, and through town hall meetings with the population at large.

24. **Deepening the consensus for reform will require a strengthening in social safety nets, especially for labor released from the agricultural sector.** Staff identified a need to provide a safety net in the form of unemployment benefits to those who lose jobs because certain sectors are closed down and to those who give up their job in declining sectors and take risks to start a new business or look for employment in another sector. Staff indicated that there were no standard ways to strengthen safety nets—transfers could either be by direct income support or input subsidies—however, it was important that these support systems be temporary in nature.

Box 4. Institution Building to Support Macroeconomic Stability and Growth

The institutional framework inherited at independence in the late 1970s and early 1980s was reasonably strong. However, emerging macroeconomic weaknesses in the region have revealed shortcomings in the current framework and point to a need to strengthen economic institutions to preserve macroeconomic stability and support growth, as discussed below.

1. Strengthening macroeconomic stability: Key reforms needed for securing macroeconomic stability and reducing economic vulnerabilities are:

- *Promote financial sector stability*, by strengthening the ECCB's regulation and supervision of the banking system, transferring the power to close banks from national authorities to the ECCB, and streamlining the regulatory and supervisory framework of the nonbank financial sector. It is expected that this work will be guided by the recommendations of the recent FSAP mission.
- *Ensure fiscal discipline and sustainability*, by providing credence to established ECCB benchmarks or introducing national fiscal rules, strengthening public debt management, integrating annual national budgets with medium-term plans, and improving the quality of the public sector investment programs to increase the efficiency of capital spending.
- *Improve the wage setting mechanisms*, by ensuring that wage increases are linked to productivity increases, including by strengthening dialogue via tripartite committees.
- *Introduce a comprehensive pension reform* to ensure the long-term viability of the schemes in the region and to provide appropriate compensation to pensioners.

2. Effecting the functioning of market mechanisms to raise economic growth: Reforms needed to ensure a more efficient allocation of resources to stimulate high-quality growth and create employment are:

- *Streamline the investment approval process*, simplify entry/exit procedures and reduce the reliance on tax and other concessions to attract investments.
- *Establish strong regulatory mechanisms for utility companies* and other natural monopolies.
- *Liberalize trade further* to facilitate greater integration of the ECCU markets with the global economy, by removing the remaining price controls and import monopolies, and complying with WTO commitments, including updating legislation on intellectual property rights.
- *Further integrate regional financial markets* and consolidate existing institutions.
- *Improve accounting and business reporting standards*, in line with best world practices to allow for greater market discipline.
- *Reduce the cost and delay in transferring private property*, especially those held as collateral.

3. Redefining the role of the public sector: In view of weak fiscal performance in recent years and pressures on the public sector to create employment, the improvement needed to ensure high quality of public services and performance are:

- *Strengthen the composition and management of public expenditures and procurement procedures.* Ongoing work by the World Bank, including the review of public expenditures and public sector reform, can be expected to guide these initiatives (see also Appendix III).
- *Divest public services that are unconnected to core functions.*
- *Improve accountability and financial management* of public enterprises and statutory bodies.
- *Enhance transparency in reporting* to the general public on the operations of the public sector.
- *Streamline the functions of the public sector and consolidate common services* within the region to exploit economies of scale.

4. Strengthening disaster mitigation and management: There is a need for a coordinated approach for disaster mitigation and response planning to lower the fiscal and economic costs of the frequent natural disasters. Ongoing work by the CDB and the World Bank could be expected to provide critical inputs in this area.

B. Long-Term Sustainability of Policies and Economic Performance

25. **There was broad agreement that the high levels of public debt needed to be reduced, particularly in the four countries—St. Kitts and Nevis, Grenada, Antigua and Barbuda, and Dominica—with debt to GDP ratios in excess of 100 percent of GDP.** The mission noted that maintaining such high levels of debt severely constrained policy options and left the economies vulnerable to events outside the control of the authorities. Bringing debt down to more sustainable levels, for example, a public sector debt to GDP ratio of 60 percent by 2007, would require a comprehensive adjustment strategy.¹⁶ On the assumption of current (2002) policies and that real interest rates and growth rates will be at historical averages (last five years), in St. Vincent and the Grenadines and St. Lucia, it could be possible to reach the public debt to GDP ratio target simply through fiscal consolidation—it would require achieving primary surpluses of 3 percent of GDP each year until 2007 in both countries, a difficult, but plausible task (Figure 3). In the remaining four countries, public debt would rise to an average of 155 percent of GDP by 2007 at current policies, and the level of primary balances needed (ranging from 9 percent to 30 percent) to reach the target public sector debt to GDP ratio appear unrealistic. Even if the four highly indebted countries were to target the less ambitious objective of stabilizing their stock of public debt at current levels, they will need to improve their primary balances considerably—by 2 to 4 percent of GDP (Figure 4).

26. **Discussions on strategies for achieving debt sustainability highlighted four key elements, which were also key to enabling the region to achieve its growth potential.** These were a combination of fiscal consolidation, debt strategy, asset sales/privatization, and growth-enhancing structural reforms.

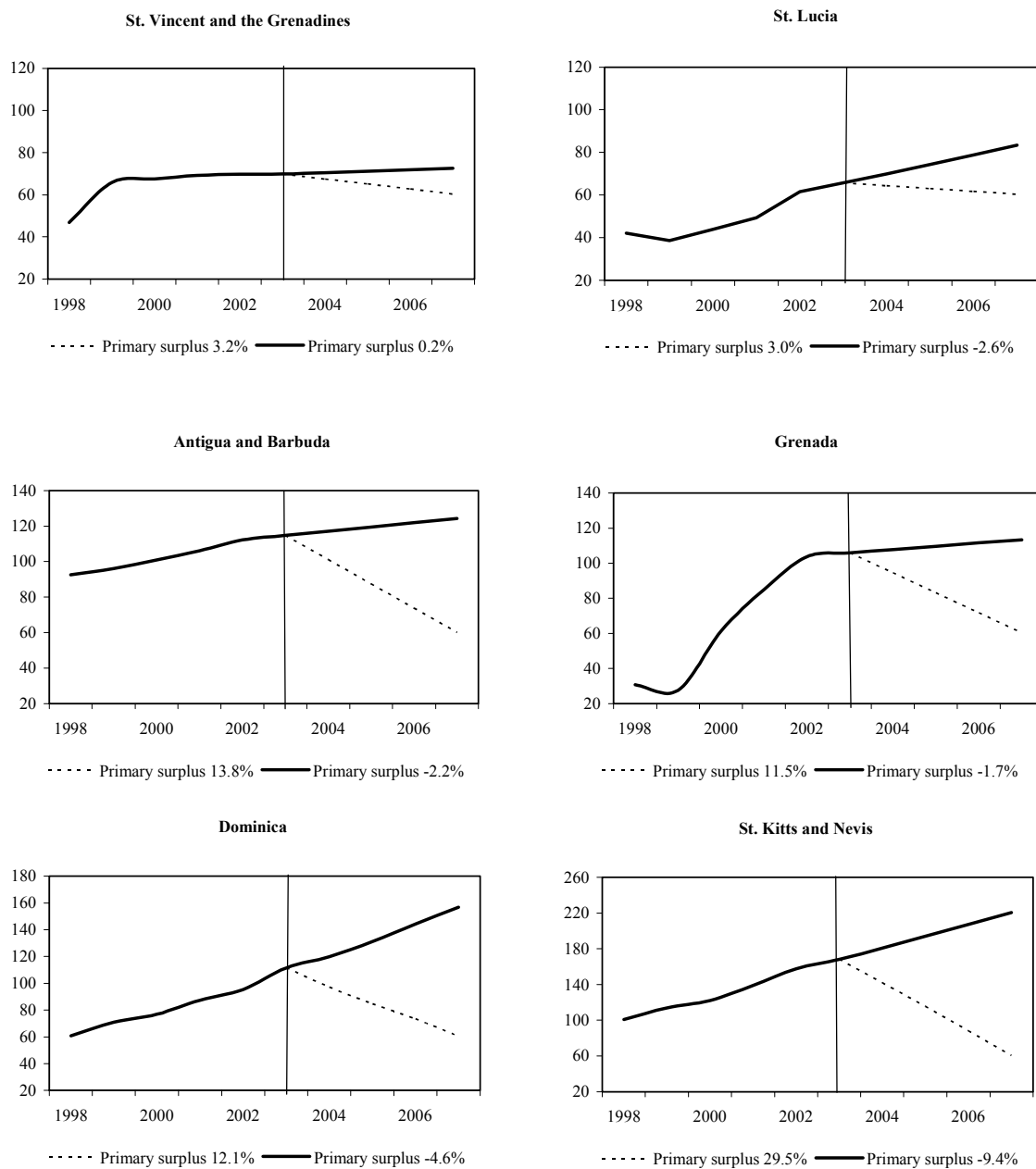
Fiscal adjustment

27. **Sustained fiscal adjustment is needed in all countries under any scenario.** The rebound in economic activity, particularly tourism, provides an opportune time to address the underlying fiscal imbalances. Staff recommended that, for the fiscal adjustment to be sustained, measures need to be based on the following general principles:

- *Revenue measures.* Legislated rates on the major taxes are already at fairly high levels by international standards. However, through a combination of extensive tax concessions and low levels of compliance, the tax burden falls heavily on a fairly narrow base of taxpayers. Raising revenues—essential to offset the anticipated loss of revenues as the import tariff reductions scheduled under existing agreements with

¹⁶ The fiscal benchmarks adopted by the ECCB's Monetary Council include a debt ceiling of 60 percent of GDP on central government debt. In light of the fairly small amount of public sector debt that is not central government or guaranteed by the central government, calculations are based relative to overall public sector debt. The fiscal benchmarks are to be achieved "over the medium term," which has generally been interpreted as a 2007 target date.

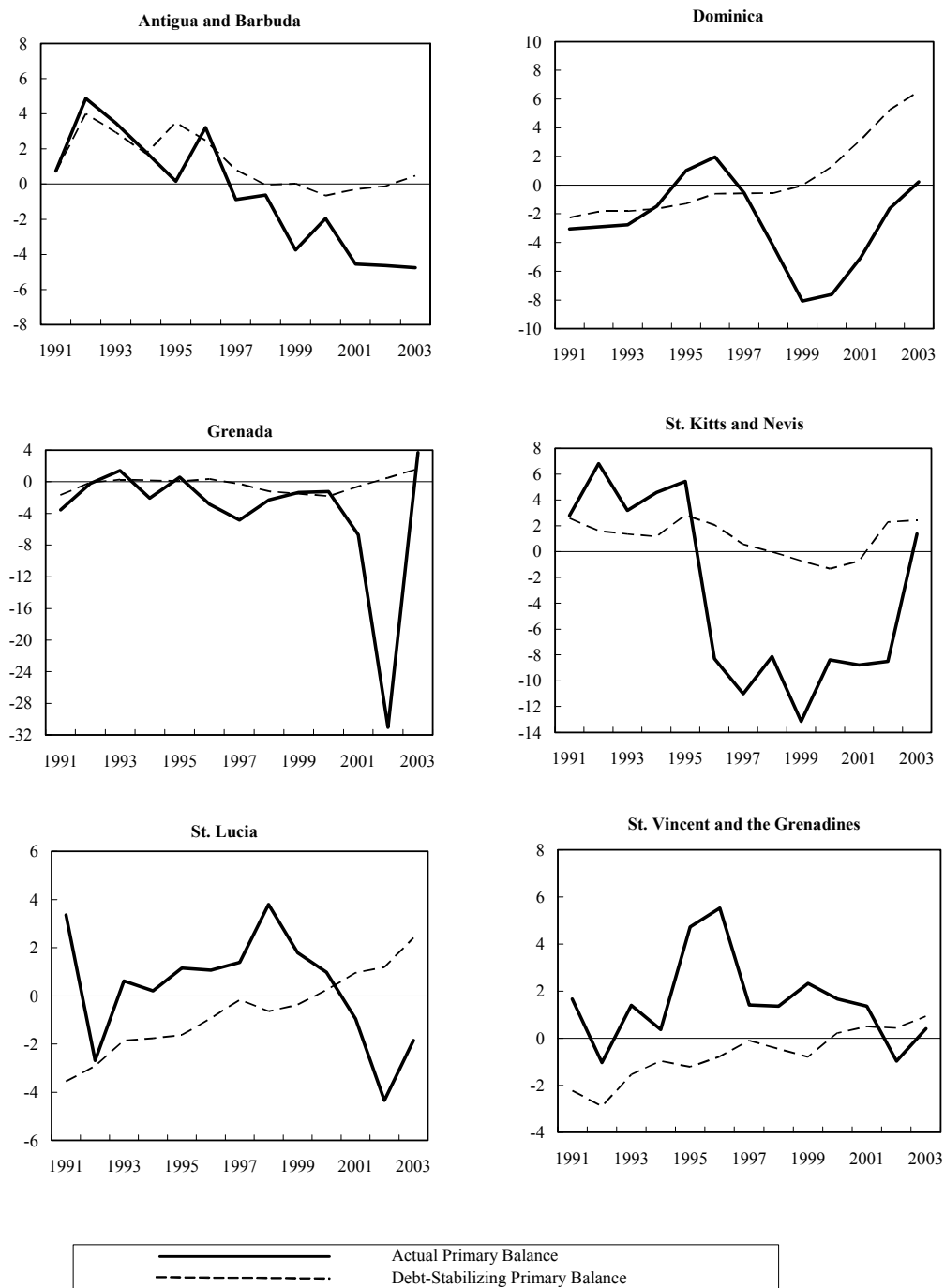
Figure 3. ECCU: Debt-to-GDP (Primary Surplus Scenarios)



Sources: ECCU member country authorities; and IMF staff estimates.

Note: All scenarios assume growth and interest rates at historical averages.

Figure 4. ECCU: Primary Balance: Actual Versus Debt Stabilizing, 1991–2003
(In percent of GDP) 1/



Sources: ECCU member country authorities; and IMF staff estimates.

1/ The debt-stabilizing primary balance is calculated using the five-year moving averages for the interest rate and the nominal GDP growth rates. Data on public enterprises may be incomplete.

CARICOM are implemented—should therefore focus on broadening the tax base and raising collection rates. As the structure of the economies and, therefore the tax base, shifts increasingly to the services sector, it is particularly important to ensure that the tax system is designed to capture this base. As the VAT, or similar broad based consumption tax, could assist in this regard, staff encouraged the authorities to continue their efforts to prepare for the introduction of such a tax.

- *Expenditure control.* Strong cash and commitment management systems were essential to ensure that budgets were executed as intended. Staff congratulated the authorities on the significant improvements introduced in St. Kitts and Nevis, Dominica, and St. Vincent and the Grenadines in this area in recent years, and urged ECCU countries to continue to strengthen existing systems to ensure that there was adequate control over spending commitments by line ministries.
- *Expenditure reform.* Government expenditures are high in all six ECCU countries. Acknowledging that this is a common feature of small states throughout the world, staff strongly encouraged the authorities to systematically review their expenditure policies in order to enhance the efficiency of service provision and eliminate duplication of services. Given the large size of the wage bill relative to total expenditures, civil service reform—to permit a planned rationalization of services rather than ad hoc cuts—should be a key element of the expenditure reform package.¹⁷ In addition, subsidies to inefficient public enterprises, such as the sugar industry in St. Kitts and Nevis, are a significant drain on fiscal balances and need to be curtailed.

28. **The authorities noted that reforms consistent with these objectives were already underway in most countries, but curtailing tax concessions was a difficult issue.** While agreeing that the granting of concessions had significantly eroded the tax base—by some estimates, tax revenues lost due to concessions range from 5–9 percent of GDP—several country authorities argued that granting such concessions was essential to attract FDI and therefore create employment.¹⁸ Staff made the case, and some authorities agreed, that the returns from the concessions had not always been very large and it would be useful to undertake a careful cost-benefit analysis of existing concessions. In the meantime, should new concessions be granted, staff strongly encouraged the authorities to grant them in a transparent manner, to halt the granting of discretionary concessions, and that any new incentives be strictly limited in both magnitude and duration.

¹⁷ As an example, Dominica's planned public sector reform envisages a 10 percent reduction in the wage bill (5 percent in each of fiscal years 2004/05 and 2005/06), through the retrenchment of civil servants.

¹⁸ Revenues lost from tax concessions are discussed in Chapter VII of *Eastern Caribbean Currency Union—Selected Issues*: "Regional Integration and Trade Regimes."

29. **There is also a need to strengthen institutional arrangements to ensure the consistency of national fiscal policies with the preservation of the CBA.** Countries have moved progressively further from the ECCU's own fiscal and debt benchmarks, introduced in 1998 to be met by 2007. The number of guidelines observed by the countries has declined from 11 in 1998 (out of a maximum possible of 24) to just 3 in 2003. Only one country—St. Vincent and the Grenadines—is currently meeting any of the fiscal benchmarks recommended by the ECCB. Staff stressed that fiscal discipline and debt sustainability are essential to preserve the CBA.

30. **While the authorities agreed that institutions should be strengthened to ensure greater fiscal prudence, there was limited support for introducing more binding fiscal rules, such as Fiscal Responsibility Laws.** The mission was of the view that introducing more binding fiscal rules could depoliticize the budgetary process and reduce the leeway for incumbent governments to undertake ad hoc discretionary spending to satisfy voter constituencies. Some national authorities believed that legislation would not necessarily constrain irresponsible governments, while others felt that such laws might tie the hands of democratically-elected governments in undesirable and restrictive ways. In view of the increasing divergence over time between the existing fiscal benchmarks and performance, staff urged the authorities, at a minimum, to enhance the effectiveness of the benchmarks by introducing incentives for meeting the targets and identifying realistic but ambitious time paths for convergence.

ECCU: Progress Toward Central Government Fiscal Guidelines 1/

(In percent of GDP, unless otherwise indicated)

Convergence Criteria	Status of Implementation of Guidelines in 2003 by Country						Number of Countries Meeting the Guidelines					
	Antigua and Barbuda	Dominica	Grenada	St. Kitts and Nevis	St. Lucia	St. Vincent and the Grenadines	2003	2002	2001	2000	1999	1998
Current balance (saving) (guideline: 4 - 6 percent of GDP)	-5.4	-3.2	3.4	-0.3	0.0	4.1	1	0	0	2	1	1
Overall balance (guideline: > or = -3 percent of GDP)	-8.0	-5.5	-5.0	-7.3	-5.9	-1.3	1	1	1	2	2	2
Government and government guaranteed debt outstanding 2/ (guideline: < or = 60 percent of GDP)	112.8	121.9	108.9	162.1	66.3	71.1	0	0	1	2	2	3
Debt service payments 3/ (guideline: < or = 15 percent of current revenue)	28.3	38.6	27.2	33.5	17.1	12.0	1	1	2	2	3	5
							Total					
Number of guidelines met in 2003	0	0	0	0	0	3	3					
Number of guidelines met in 2002	0	0	0	0	0	2	2					
Number of guidelines met in 2001	0	0	0	0	2	2	4					
Number of guidelines met in 2000	0	0	2	0	4	2	8					
Number of guidelines met in 1999	0	1	2	0	3	2	8					
Number of guidelines met in 1998	0	1	3	1	3	3	11					

Sources: ECCU member country authorities; and Fund staff estimates.

1/ Excludes Anguilla and Montserrat.

2/ Includes external arrears.

3/ Excludes domestic debt amortization.

Debt strategy

31. **The authorities stressed their desire to preserve their good payments history and avoid recourse to debt restructuring.** While Dominica has already approached its creditors and Antigua and Barbuda has a history of arrears to certain creditors, other country authorities emphasized their intent to preserve their strong payment record. In St. Kitts and Nevis, the country with the highest debt to GDP ratio, the authorities emphasized their commitment to bringing down the debt burden gradually over the medium term, arguing that near-term risks had been reduced through a significant strengthening in the fiscal stance and in the economy's infrastructure, and an active debt management strategy that has significantly extended the maturity of debt, reducing roll-over risk as well as debt service costs. Indeed, Grenada, St. Kitts and Nevis, and St. Lucia have sought to take advantage of the current low interest rates in the global economy to refinance more expensive debts into lower interest longer maturity instruments. However, in several cases, this has involved the conversion of local currency debt into foreign exchange denominated instruments, thereby increasing balance sheet mismatches.

Asset sales/privatization

32. **Options for raising resources through sale of government assets differ markedly across countries.** In St. Kitts and Nevis, projected proceeds from land sales are viewed as a significant element in the strategy to reduce debt. Staff cautioned that international experience with large-scale privatization was not very encouraging—net privatization receipts (except in the unique case of transition economies) had rarely exceeded 5 percentage points of GDP in any given year. Moreover, distress sales had often led to low returns or corrupt insider deals.

Growth

33. **The authorities were unanimous that the key economic objective going forward is to raise economic growth.** This would strengthen fiscal balances, reduce debt ratios and help create employment opportunities for labor released from traditional agricultural sectors and public sector retrenchment. While there was agreement that significant growth potential existed in tourism and new areas in agriculture, opinions differed as to the role of the government in untapping that potential and the degree to which competitiveness was an issue.

34. **Most countries in the region are still facing the prospect of further significant declines in traditional agriculture crops, with new crops being slow to emerge.** The authorities noted that the steady erosion of preferential trading arrangements and the unequal global trading practices had resulted in continued decline in the production of traditional crops. While a small minority of producers account for the bulk of national output of traditional crops, the authorities argued that these crops were still the main livelihoods of many small-scale farmers and vital to rural livelihoods. In St. Vincent and the Grenadines the government is attempting to facilitate the creation of a more efficient traditional sector and greater diversification of the economy, through the retirement of unproductive growers (by offering pension-like arrangements) and agricultural input subsidies. While staff agreed that

input subsidies had an important advantage over output subsidies, by not requiring farmers to continue to produce the output of traditional, yet declining, industries (banana and sugar), it urged the authorities to ensure that such input subsidies be temporary, so as not to engender a permanent misallocation of resources across industries and sectors and to contain the fiscal impact. As long as producers were efficient in the new global environment, the mission supported a continuing role for traditional industries in ECCU countries. The government could also facilitate a move into new agricultural products by training farmers and through agricultural extension services. Moreover, for several ECCU countries a decline in production of traditional agricultural commodities would also permit the release of scarce land for alternate purposes, particularly new agricultural products, tourism, agro-tourism, and housing.

35. **While tourism has enormous potential, there is significant scope for increasing the contribution from this sector to the rest of the economy.**¹⁹ The mission noted that tourism functioned as a niche market, with its contribution to other sectors limited by a combination of low linkages to the rest of the domestic economy and by the granting of large tax concessions that resulted in modest budgetary revenues from the sector. Strengthening linkages with agriculture would help reduce imports and at the same time provide a source of livelihood for a rural population, which is currently dependent on traditional exports.

36. **Indicators of competitiveness are mixed, but there is evidence of a loss of competitiveness in the tourism sector in the region over time.** Traditional real effective exchange rate measures do not point to a significant loss of competitiveness—indeed, in light of the recent depreciation of the U.S. dollar against major currencies, the E.C. dollar appeared now to be close to its equilibrium value (Box 5). Alternative measures of the real exchange rate—customer-based and competitor-based measures of real effective exchange, as defined in Box 6—also do not fully explain the loss of competitiveness in tourism in the region. The observed loss of tourism shares to other Caribbean markets could be explained by the stickiness of tourism products in U.S. dollars and by nonprice factors, including a low quality of service.

37. **The authorities did not see clear-cut evidence that the E.C. dollar was overvalued, and stressed their commitment to maintaining the currency board arrangement and the current exchange rate parity.** They argued that the potential benefits from changing the parity were unlikely to be significant and the costs were potentially substantial. Staff agrees with this assessment, noting that the principal potential benefit of a devaluation undertaken as part of a comprehensive adjustment package would be to enhance competitiveness, by generating a reduction in real wages that may be difficult to achieve through nominal wage cuts. However, pass-through of foreign to domestic prices can be expected to be substantial, due to the open nature of the economies, as witnessed by the high import ratio (about 50 percent of GDP), and the political pressures for wage

¹⁹ The tourism sector is covered in more detail in Chapter IV of *Eastern Caribbean Currency Union—Selected Issues*: “Eastern Caribbean Tourism: Developments and Outlook.”

Box 5. The ECCU's Long-Run (Equilibrium) Real Exchange Rate ¹

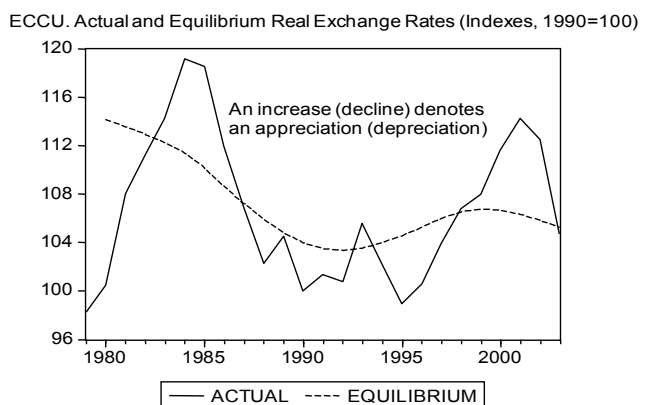
The ECCU real exchange rate has undergone a sustained period of depreciation since February 2002. Is this more depreciated rate consistent with the fundamentals of the region? Johansen's method can be used to investigate the existence of a long-run, cointegrating, relationship between the real exchange rate and a set of fundamentals—terms of trade, net foreign liabilities (proxied by public sector external debt), and size of the government (measured as the ratio of government expenditure to GDP). Economic theory suggests that these fundamentals affect the real exchange rate by raising the price of nontradable (NT) goods relative to tradable (T) goods, with increases (declines) in the NT to T ratio producing a real appreciation (depreciation) of the currency. More specifically, an increase (decline) in the terms of trade or a decline (increase) in net foreign liabilities increases (reduces) an economy's wealth, and puts upward (downward) pressure on the price of NT relative to T due to the more limited supply of NT goods. Higher (lower) government spending usually increases (reduces) the price of NT goods, as government spending tends to be biased toward NT goods.

Given that the E.C. dollar is a regional currency, regional aggregates—weighted by GDP—are used in estimating the equilibrium real exchange rate. Data are annual and cover the period 1979–2003. The analysis suggests that a cointegrating (long-run) relationship exists between the real exchange rate and its fundamental determinants, and the signs of the coefficients are consistent with economic theory. The estimated coefficients and the trend component of the fundamentals (derived using the Hodrick-Prescott filter to smooth the underlying series) are then used to generate an estimate of the equilibrium real exchange rate.

The cointegrating equation that summarizes the long-run relation between the ECCU's real effective exchange rate ($reer_t$) and its fundamentals is presented below (LN denotes natural log). The estimated coefficients in the equation below are semi-elasticities for government size and net foreign liabilities (both are measured in percent of GDP) and an elasticity for the terms of trade:

$$\text{LN}(reer_t) = 2.40 + 1.39 \cdot \text{LN}(tot_t) + 0.07 \cdot (\text{government size}_t) - 0.015 \cdot (\text{net foreign liabilities}_t).$$

The estimation suggests (see figure) that the E.C. dollar went through a period of overvaluation that started in 1998. The recent depreciation of the U.S. dollar against major currencies, and its impact on the real value of the E.C. dollar (through the E.C. dollar's peg to the U.S. dollar) seems to have corrected the previous overvaluation—as of 2003, the actual real exchange rate is very close to its equilibrium level. A caveat to the analysis is that the long-run determinants of the equilibrium real exchange rate vary from country to country, and for some ECCU countries no long-run relationship was found. However, the results presented serve as an indication of the situation in the region as a whole.

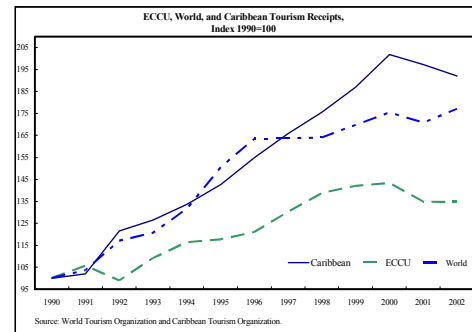


¹ See also Chapter III of *Eastern Caribbean Currency Union—Selected Issues*: “Competitiveness in the ECCU: Measures of the Real Exchange Rate.”

Box 6. Competitiveness in the ECCU Region: Tourism Developments

Tourism is the most important source of income in the ECCU countries. Over 1990–2002, the comovement (measured by correlation coefficient) between real economic growth and the growth in stayover tourist arrivals was nearly 80 percent and between real economic growth and tourism receipts was 75 percent.

During the 1990s, there was uninterrupted growth in both the wider Caribbean region and world tourism. On average, the growth in Caribbean stayover arrivals (4.7 percent) and tourism receipts (7.8 percent) *outpaced* the growth in world stayover arrivals and tourism receipts (4.3 percent and 7.7 percent, respectively).

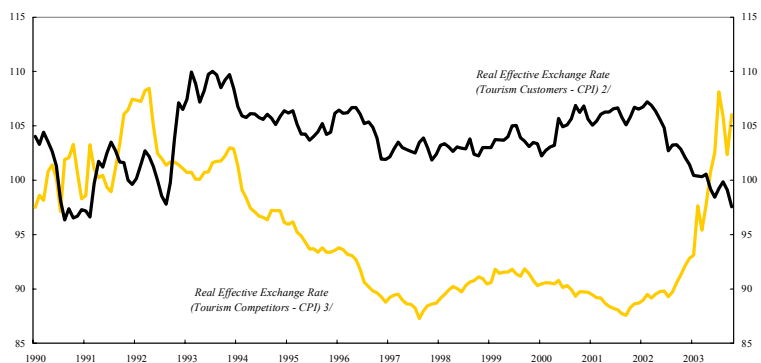


However, during this period, ECCU began losing market share relative to the rest of the Caribbean, particularly since the mid-1990s. ECCU's market share of Caribbean tourist arrivals declined from 5.4 percent in 1990 to 4.6 percent in 2002, while its share of Caribbean tourism receipts declined from 6.8 percent to 4.8 percent over the same period. ECCU's world tourism market shares also declined during this period.

The September 11, 2001 terrorist attacks on the United States caused a contraction in world and Caribbean tourism for the first time since 1990, which was even more pronounced for the ECCU region. ECCU tourist arrivals declined by 4.9 percent in 2001, while world and Caribbean tourist arrivals contracted by 0.5 percent and 3.3 percent, respectively. The decline in tourism receipts in the ECCU was even more pronounced.

Real effective exchange rate measures cannot fully explain the loss of competitiveness since the mid-1990s. The competitor-based REER index (weighted by the share of tourist arrivals to competitor Caribbean countries), shows a sharp improvement in ECCU's competitive position vis-à-vis other Caribbean competitors through much of 1997; followed by a period of stable REER until the second half of 2002, when there was a pronounced appreciation. The customer-based REER (weighted by the share of tourists arriving from each country) was more or less stable from 1993–2002, and also does not explain the declining share of the ECCU during the 1990s.

ECCU Real Effective Exchange Rates (1990 = 100) 1/



1/ For real effective exchange rate indices. An increase (decrease) indicates an appreciation (depreciation). Excludes Anguilla and Montserrat in calculation of the ECCU average.
2/ Weighted average of CPI in a common currency. Customers: Antigua - (Canada, UK, USA); Dominica - (France, UK, USA); Grenada - (Trinidad and Tobago, UK, USA); St. Kitts - (Canada, UK, USA); St. Lucia - (Canada, UK, USA); St. Vincent - (Trinidad and Tobago, UK, USA). Weights are based on proportion of tourists arriving from each country in 2001.
3/ Weighted average of CPI in a common currency. Competitors: Bahamas (23.4%); Barbados (8.0%); Dominican Republic (43.5%); Jamaica (19.4%); Trinidad and Tobago (5.7%). Weights are based on the share of tourism arrivals to the Caribbean in 2000.

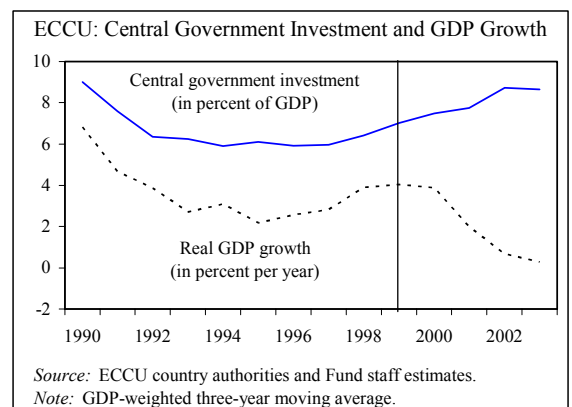
The under-performance of the ECCU during 1995–2002 is not explained by movements in real effective exchange rates, suggesting the possible dominance of nonprice factors or the rigidity of tourism-specific price factors measured in U.S. dollars. In fact, the depreciation of the E.C. dollar vis-à-vis its competitors did not translate to a decline in several key factors such as cost of vacation packages, car rental prices, and long-distance telecommunication charges.

increases. The impact on tourism, the principal growth engine, would likely be modest, as tourism receipts appear relatively inelastic to price developments. Also, given that the majority of public liabilities are denominated in foreign currency, a devaluation would cause debt to surge—by almost 20 percent of GDP for a 50 percent devaluation, on average. While an increase in tax revenue from faster economic growth and a reduction of real wages in the public sector could help improve fiscal balances, the increase in debt would take years to unwind even in the most optimistic scenario. Moreover, any exchange rate adjustment would need to be accompanied by measures to ensure the continued soundness of the banking system. At the same time, the currency board arrangement could, in time, become severely strained if decisive actions to strengthen public finances and bring public debt to sustainable levels are not pursued aggressively.

38. **High labor costs and labor market inflexibility are important obstacles to growth and, given the CBA, have prevented adjustment to shocks** (Box 7). Private sector wages are estimated to have increased by more than 25 percent in the 1998–2003 period as compared to the average for 1990–97. The public sector wage bill as a share of GDP also rose sharply during this period (rising by almost 1 percent of GDP to 13 percent). The absence of sustained high growth since the mid-1990s indicates that wage costs have risen in relation to productivity. Moreover, persistently high levels of unemployment suggest rigidities in labor markets. Given the large real shocks that regularly hit the region and the rigidity of the CBA, flexibility of wages and labor mobility are needed to reduce unemployment and allow adjustment in the economy. Staff urged the authorities to develop productivity measures and to adopt wage policies that were linked to labor productivity.

39. **The price and quality of utilities is a potential constraint on investment, pointing to a need for public enterprise reform to enhance the efficiency of service provision.** Recent reforms in the telecommunications sector of several countries had already produced beneficial effects across a wide spectrum of economic activities. However, reforms in the water and power supply are needed in several countries.²⁰

40. **Direct government intervention, including high levels of public investment, is viewed by the authorities as essential to generate growth, although there is little evidence that this policy has been successful in the recent past.** Since the second half of the 1990s, the authorities have responded to both permanent and temporary negative shocks by pursuing expansionary fiscal policies, including creating public sector employment. Even though fiscal imbalances narrowed significantly in 2003,



²⁰ For example, hotel operators in St. Lucia reported that inadequate water and sewerage infrastructure and the high cost of electricity were severe constraints on their operations.

Box 7. Labor Market Institutions and Developments

Formal labor market institutions in the ECCU region have traditionally provided the framework for setting the norms for employer-worker relations and their respective rights and duties. Although national trade unions are a common feature, wages are typically set at the enterprise level. In light of existing concerns regarding high levels of unemployment, governments have also attempted to facilitate the flow of information between potential employers and workers on job vacancies and the skills of available workers. The main institutions in the labor market and their recent developments are summarized below.

Labor code: All countries have labor laws that protect workers' rights and set standards on leave, health-related issues, pensions, hiring, and firing procedures. Several countries are planning to update their labor laws to establish a modern comprehensive Labor Code. All six countries are members of the ILO.

Labor unions: The extent of unionization of the labor force varies widely, from about 10 percent of labor force in St. Vincent and the Grenadines to about 50 percent in Grenada.

Minimum wages: Minimum wages are legislated in all six countries for certain sectors and occupations, but have been revised infrequently. The latest revisions were: Antigua and Barbuda in 1981; Dominica in 1989; Grenada in 2002; St. Kitts and Nevis in 1996; St. Lucia in 1985; and St. Vincent and the Grenadines in 2003. The importance of the minimum wage law varies widely—in Antigua and Barbuda, it is largely irrelevant (wages at the low-end are substantially higher than legislated minimum wages), while in St. Vincent and the Grenadines many workers in the retail and hotel sectors are paid at or just above the minimum wage. Typically, workers in agriculture are paid above the minimum to attract labor to that sector.

Wage negotiations: Wages are generally set through negotiations between employers and labor unions at the enterprise level. The agreed wage package will typically cover three to four years and cover all workers in that enterprise. Labor departments are involved only when negotiations breakdown, and despite the differences in wages between the public and private sectors, most negotiations settle around the wage increments in the government sector. Recent agreements include a four-year agreement in September 2003 in Grenada awarding government workers a 14 percent wage increase by end-2005, and a two-year agreement in December 2003 in St. Vincent and the Grenadines awarding government workers a 7 percent increase by end-2005.

Recent experiences on wage restraint include:

- **St. Vincent and the Grenadines:** Following the sharp deceleration in economic activity in 2001, the government met with trade union leaders to negotiate a freeze in public sector wages and request wage restraint in the wider labor market. Following this appeal, trade unions in the government sector delayed negotiations on the next three-year agreement, while those in the private sector agreed to a wage restraint. In 2003, the government ended the wage freeze and a two-year wage agreement was concluded in December.
- **St. Kitts and Nevis:** Except for one year since 1995, the government has either paid its workers an end-year bonus equivalent to one month's income or granted a generalized wage increase of about 10 percent. However, this practice was interrupted in the aftermath of the September 11, 2001 terrorist attack, and no wage bonuses or increases were granted through 2003.
- **Dominica:** Against the backdrop of a worsening fiscal situation in 2002 and a wage bill to GDP ratio that far exceeds the averages in the wider region, the government sought to cut the wages of its workers in the context of its Fund-supported adjustment programs. Initially, a 4 percent payroll tax for all workers was introduced in August 2002 *in lieu* of a wage cut. Subsequently, the tax was reduced to 3 percent in July 2003, when a 5 percent across-the-board cut in wages of government workers was introduced. There was some opposition from the trade unions and other stakeholders at the outset of the program, and a legal challenge from the public sector union is still in the courts.

Tripartite bodies: Four of the six countries (Antigua and Barbuda, Dominica, Grenada, and St. Kitts and Nevis) have ratified the ILO's convention on tripartite consultation. Discussions on wage increases based on productivity have only begun in St. Vincent and the Grenadines and St. Lucia.

Social security: All countries have public social insurance schemes financed by payroll taxes. There is concern about the long-term viability of these schemes, in light of the anticipated impact of aging of the population and the fiscal crisis in many countries.

fiscal stances in 2004—in most cases already approved in the context of the budget—remain expansionary despite the improvement in economic activity. Indeed, only in Antigua and Barbuda (where the financing constraint is likely to force additional adjustment) and St. Kitts and Nevis are fiscal balances projected to improve significantly in 2004. Staff argued that the high level of public investment cannot be relied upon to generate high quality growth; in fact, the relationship between public investment and growth turned negative after about 1998, confirming the limits of public sector initiatives to sustain growth.

41. **The mission argued that the role of the government should be limited to providing an enabling environment for the private sector to develop.** Given the small size of the economies, harmonizing business procedures and regulations, and ensuring that they are fair and transparent, is likely to improve investor perceptions of the region, and attract investment. Withdrawing government support for loss-making sectors—such as traditional agricultural crops—is vital to free up scarce land resources for more productive uses. Also, measures aimed at creating a more efficient financial sector are needed to lower the cost of capital for private sector investment—presently, nearly half of ECCU banking system loans are for personal consumption (real estate and consumer loans).²¹ While this reflects weak economic conditions, the floor on the savings deposit rate and sticky high lending rates are likely to have driven away potentially viable private sector projects. Staff encouraged the authorities to assess whether the failure of interest rates to decline, despite continued high levels of excess liquidity, was due to the existence of monopoly rents in the financial system or the result of the 3 percent floor on the savings deposit rate. The removal of existing legal impediments to the foreclosure and liquidation of collateral would also enhance the lending environment and reduce the incidence of delinquency.

42. **The process of building high-quality regional institutions is well underway, but deeper regional cooperation in the economic spheres could help to overcome the fundamental constraint on growth stemming from the small size of the economies.** The authorities noted that key success areas at the OECS level included the financial sector (Eastern Caribbean Central Bank and Eastern Caribbean Securities Exchange), the judiciary (Eastern Caribbean Supreme Court), telecommunications (Eastern Caribbean Telecommunications Authority) and transportation (Directorate of Civil Aviation). Progress in implementing CARICOM initiatives had, though, been slow.²² Some authorities expressed concern that regional integration, if taken too far, could impinge on the uniqueness of the islands and on their sovereignty. While acknowledging the achievements, staff identified several areas of regional cooperation which could bring economic benefits to all countries:

²¹ See also Chapter VI of *Eastern Caribbean Currency Union—Selected Issues*: “The Role of the Banking Sector in the ECCU.”

²² Chapter VII of *Eastern Caribbean Currency Union—Selected Issues*: “Regional Integration and Trade Regimes” provides additional information on the status of key regional initiatives.

- *Freeing labor and goods markets.* While trade in goods amongst OECS countries was formally free, subject to meeting rules of origin requirements, various non-tariff barriers, including customs charges and transportation costs, have prevented a significant impact on intra-ECCU trade. Regarding the labor market, some groups of workers with special skills formally had free mobility throughout the region, though this had not yet been fully implemented. Free movement of workers would not only increase the efficiency of labor markets but also facilitate adjustment to shocks, given the CBA.
- *Education reform.* The OECS Education Reform Unit provides an institutional framework for increased regional cooperation in the standardization of curricula, but progress has so far been limited. Greater efforts could also be made to reorient the skills produced to fit with the new growth sectors, particularly tourism.
- *Coordination of tax incentives and holidays.* Tax revenues lost to concessions were a severe drain on fiscal balances in the region. A coordinated regional approach needed to be taken to reduce tax competition amongst individual countries.
- *Coordination in the provision of government services.* Given the fixed costs associated with maintaining the basic institutions of the state apparatus, the small size of the countries constrains institutional capacity, particularly at a time of significant pressures to limit public expenditures. Staff noted several areas where cost savings were being achieved, but encouraged the identification of additional areas where government services could be provided on a regional basis.
- *Financial market supervision.* The recent FSAP for the ECCU region identified a number of areas in which the effectiveness of the ECCB's supervision over locally incorporated banks could be strengthened, including by the national authorities transferring additional powers to the ECCB (Box 8). In addition, given the increasing role of financial conglomerates operating in the region, cross-border regulatory cooperation should be enhanced.

C. Facing Near-Term Risks: Prevention and Management

Prevention

43. **The ECCU economies are subject to several sources of vulnerabilities.** In addition to unexpected and untoward developments in the world economy and the risks inherent in the existing high debt levels, key risks stem from weaknesses in the financial system and the incidence of natural disasters.

Box 8. FSAP: Main Findings and Recommendations

An FSAP for the ECCU region was conducted during September and October 2003.

The main findings were:

Despite recent macroeconomic pressures, the FSAP found continuing confidence in the financial system. The historical presence of strong foreign banks and relatively developed financial institutions, which provide access to financial services for a very high share of the population, are contributing factors.

The financial sector showed signs of stress. Stress factors included high levels of nonperforming loans (NPLs) and uncertain quality of capital in a few indigenous banks, the practice of taking accrued interest on government debt arrears into income in some banks, and zero risk-weights applied to public sector debt in arrears. Stress tests indicated that indigenous banks were more at risk of insolvency or severe capital impairment if their governments default, and the knock-on effects on the private sector's ability to service debt could put the broader financial sector at risk. Additional weaknesses included the ECCB's lack of necessary enforcement powers reflected in incidents of regulatory forbearance, and deficiencies in the quality, timeliness and availability of key data. Supervision of the nonbank financial sector is generally weak or negligible.

Recommendations focused on:

- *Enhancing the effectiveness of supervision.* The ECCB should focus on its core mandate to promote monetary and financial stability by focusing on systemically important areas and be provided with adequate powers to achieve that end. In particular, the ECCB should: (i) reprioritize its resources and work program to focus on the regulation and supervision of domestic banks; (ii) develop a program of supervision according to the risks inherent in each institution; (iii) strengthen prudential regulations including setting minimum capital commensurate with the risks of each institution; revise guidance on accruals of interest; and providing regulations on market (e.g., foreign exchange) risk; (iv) be provided with adequate powers to achieve effective regulation of domestic banks; and (v) give greater attention to financial sector governance, including the composition of Boards of Directors and internal audit and control.
- *Building crisis management capacity.* Monitoring capacity should be enhanced and integrated with a contingency plan that acknowledges the limited resources of the ECCB for lender of last resort operations as well as the constraints on fiscal authorities to provide credible guarantees, and that the ECCB's emergency powers make specific reference to the administrative tools to ensure effective implementation.
- *Strengthening the supervision of offshore banks.* Effectiveness of supervision would be enhanced by issuing and enforcing a comprehensive set of prudential guidelines; establishing uniform reporting requirements; and ensuring that legislation and guidelines are enforced in a consistent and timely manner.
- *Strengthening the supervision of other nonbank financial institutions.* Key steps would include: transferring lead supervision responsibility for systemically important near-banks to the ECCB; increasing cross-border regulatory cooperation (for example, with Barbados and Trinidad insurance supervisors); strengthening supervision of the smaller credit unions and other near banks at the national level; and independent supervision for development banks to enhance their financial performance.

The findings of the FSAP were presented to the ECCB's Monetary Council in February. While agreeing with many of the recommendations, the urgency of enhancing crisis management capacity was downplayed and some of the authorities questioned the need to transfer additional powers to the ECCB.

44. **Despite the large presence of foreign banks and the low level of cross-border linkages, vulnerabilities in the financial sector remain.** Foreign banks account for 58 percent of banking sector assets, but the locally incorporated banks maintain a high level of nonperforming loans (over 20 percent) and large exposures to the local housing market and the public sector. Risks are compounded by weaknesses in banking supervision. Cross-border financial and trade linkages are currently very low, but likely to increase with the increasing integration of capital markets, so that the transmission of financial shocks will most likely be felt faster and to a greater extent than before. A general confidence effect, resulting in either a bank run, a disruption in financing flows to the region, or large capital outflows, could though pose a significant challenge to the region. Partial data on gross financing needs suggest that most countries appear to have sufficient flexibility in budget execution to be able to withstand a temporary disruption in access to financing, but problems could mount beyond that.

ECCU: Cross Border Linkages

	Financial 1/		Trade 2/
	Gross Claims	Net Claims	Exports
	on other ECCU Public Sectors	on Other ECCU Banks	of goods to ECCU
	(in percent of bank assets)		(percent of GDP)
Antigua & Barbuda	0.5	-2.1	0.3
Dominica	0.7	1.2	3.2
Grenada	1.1	2.6	3.2
St Kitts & Nevis	0.9	-9.2	0.4
St Lucia	1.4	4.1	0.9
St. Vincent & the Grenadir	3.2	0.8	4.0

1/ July, 2003.

2/ Average, 1998-2002.

45. **Reducing vulnerabilities in the financial system requires strengthening the effectiveness of banking supervision.** The mission noted that while the ECCB identifies “weak banks” and requires corrective measures to be taken by these banks through the signing of a Memorandum of Understanding, it rarely sets out a timetable for a restructuring action plan to be carried out, nor can it impose penalties.

46. **Given the region’s continuing vulnerability to natural disasters, staff encouraged the authorities to take further steps to mitigate the impact of any future shocks.**²³ While private insurance against natural disasters (‘all-peril’ insurance) is usually required of ECCU mortgage borrowers, a large proportion of low-income households does not have a mortgage, and hence does not have such coverage. In addition, the take-up of insurance by ECCU governments is limited, and crop insurance is not always available. The region has received

²³ The ECCU countries are among the most vulnerable in the world to natural disasters. Forty-four natural disasters have been recorded in the region since 1970, of which 34 were the result of hurricanes. While cost estimates are highly uncertain and only available for less than half of the recorded events, available data suggest that a typical event affected 1,800 people, caused damage equivalent to 10 percent of the country’s annual GDP, and induced a sharp drop in GDP growth in the year of the event, a collapse of agricultural production, a rapid surge in current account and fiscal imbalances, and a jump in public debt stocks. Chapter II of *Eastern Caribbean Currency Union—Selected Issues*: “Natural Disasters and their Macroeconomic Implications” provides additional information on the incidence and economic costs of disasters in the Caribbean.

significant help from the World Bank, the Caribbean Development Bank (CDB), and bilateral donors to strengthen preventative structures and mitigate the effects of disasters. However, these initiatives have been insufficient, and further enhancement of efforts is required. Staff urged the authorities to further increase preparedness in strengthening zoning and building code legislation and enforcement to reduce the vulnerability of infrastructure and housing, and improving insurance legislation and regulatory oversight to increase insurance penetration. Staff also encouraged ECCU countries to build up contingency funds to facilitate an effective and speedy response in the event of a natural disaster.

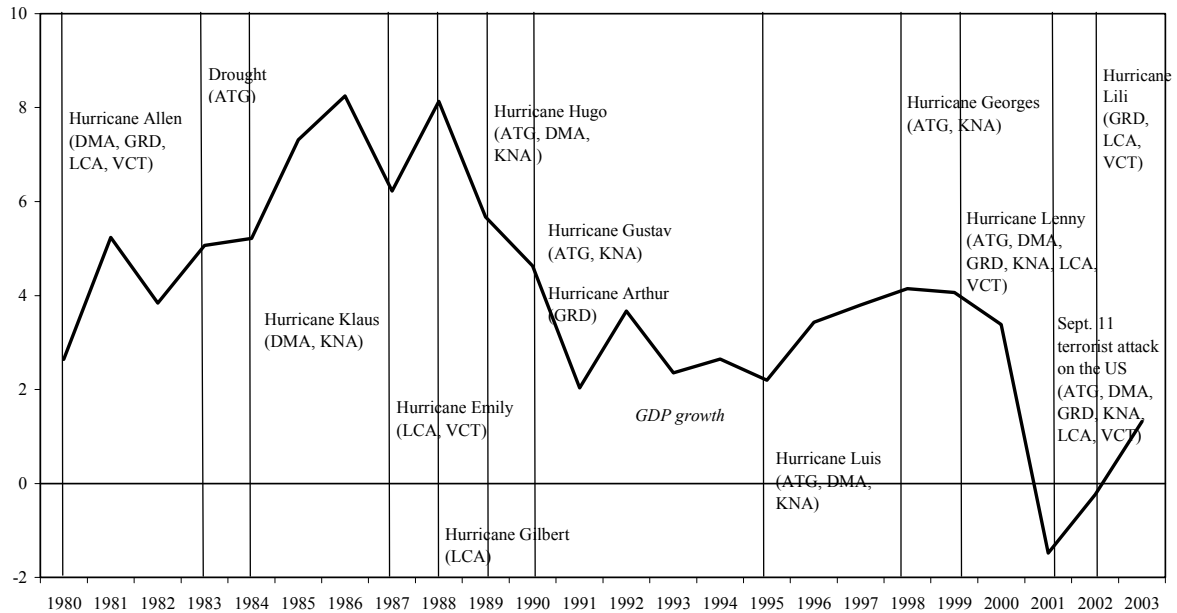
Management

47. **Every possible attempt should be made to prevent a crisis.** While the coverage ratio of the CBA (the ratio of international reserves to base money) is well in excess of the legal norms (and close to 100 percent), one consequence of the depth and breadth of the financial sector in the region is that the ratio of international reserves to broad money is only 20 percent. Thus, pressures in the region that trigger a run on deposits and capital flight could quickly result in the rapid depletion of the reserves of the ECCB (if liquidity support is provided to local banks) and ultimately force a country to impose either restrictions on deposit withdrawals or on convertibility.

48. **Country authorities fully endorsed the mission's recommendation to draw up contingency plans for a crisis event, even though they considered the probability of a crisis to be fairly low.** To preserve the CBA, staff advised that the role of the ECCB be limited to providing technical support and moral suasion, but stop short of extending liquidity support since the amount that could be provided was modest and could have a very damaging impact on confidence in the CBA.²⁴ Thus, the burden of responding to a crisis rested with governments through emergency fiscal and other measures. Possible fiscal policy responses could likely include a combination of expenditure reductions and postponements, and emergency revenue measures.

²⁴ The ECCB is legally required to maintain international reserves equal to 60 percent of demand liabilities. At end-December 2003, reserve coverage was 95.3 percent implying that the ECCB could extend a maximum of US\$333 million (13 percent of private sector deposits in the banking system) in liquidity support to banks.

ECCU: Exogenous Shocks and GDP Growth, (1980-2003)



Source: Country authorities.

Note: Since 1979, the IMF has approved emergency assistance related to natural disasters for the following ECCU countries: Grenada (2003); St Kitts and Nevis (1998); St Lucia (1980); St Vincent and the Grenadines (1980); and Dominica (1979). Only natural disasters affecting multiple ECCU countries displayed in the Figure.

The Incidence of Natural Disasters in the ECCU Compared to the Rest of the World, 1970-2002

	All Recorded Natural Disasters			With Estimates of Number Affected		With Estimates of Damage	
	Number	Number Divided by Land Size (Index)	Number Divided by Population (Index)	Number	Cumulative Affect in (In percent of Population)	Number	Cumulative Damage (In Percent of Annual GDP)
All countries	6,480	100	100	4,511	62	2,036	21
Advanced economies	1,511	23	39	742	7	742	3
Caribbean	162	599	387	114	65	58	37
ECCU	44	1,212	770	31	85	18	66
Antigua and Barbuda	7	1,198	883	6	248	2	22
Dominica	8	803	890	6	125	4	118
Grenada	4	886	348	2	1	3	23
St. Kitts and Nevis	7	1,465	1,295	4	33	4	132
St. Lucia	8	988	451	5	64	2	67
St. Vincent and the Grenadines	10	1,931	755	8	41	3	35
Other Caribbean	118	190	131	83	52	40	17
Other	4,807	49	75	3,655	74	1,236	23

Sources: EM-DAT for data on natural disasters, including estimates of damage and number of people affected; World Development Indicators for data on land size; World Economic Outlook for data on GDP and population.

Note: The sample contains 150 countries after omitting countries without at least one natural disaster associated with a cost estimate and/or missing information on GDP. Simple unweighted averages are used for country groupings.

D. Statistical Issues

49. **The mission discussed with the authorities their plans to bolster statistical practices in the region.** In particular, serious inadequacies were noted with respect to data on labor markets, domestic and external debt and debt servicing and the national accounts, while weaknesses persist regarding the coverage, timeliness and quality of data on consumer prices, fiscal outcomes, the balance of payments and the balance of trade. The mission urged the national authorities to make greater efforts to improve the quality, timeliness and coverage of their statistical data and database management. The staff also encouraged the ECCB to continue its efforts to address data quality issues, especially of coverage and timeliness, in those statistical areas over which it has responsibility. The mission noted the strong support given by the authorities for the constructive role played by CARTAC in the provision of technical assistance in the construction and maintenance of national accounts data, price statistics, and balance of payments statistics (see also Appendix I).

IV. STAFF APPRAISAL

50. **Economic conditions in the ECCU countries remain difficult, with average public debt at nearly 103 percent of GDP at end-2003.** Following a period of relatively high growth in the 1980s, GDP growth decelerated sharply in the 1990s. The economies were subject to several shocks in the 1990s: the dismantling of preferential agreements in banana and sugar; the closing of offshore financial centers; and the September 11, 2001 terrorist attack that affected tourism. Despite the slowdown in growth, budgets were kept in balance until the mid-1990s. Since then, however, in an effort to generate growth, create employment, and maintain living standards, fiscal deficits have emerged, widening very sharply since 1998 and leading to sharp increases in public debt. While growth began to pick up in 2003 and fiscal deficits narrowed significantly, public debt stocks in all six member countries continued to rise—a trend that, on current policies, appears difficult to reverse in four countries.

51. **The high levels of public debt have added to existing sources of vulnerability that are typical of small open economies.** Vulnerabilities emanate from a number of exogenous factors: unanticipated deterioration in the global economic environment; new terrorism threats that hamper international tourism travel; spillovers from adverse fiscal and financial developments in neighboring countries; crop diseases; and the constant threat of natural disasters—hurricanes and floods—and their devastating effects. At the same time, the inflexibility of the currency board arrangement, labor market rigidities, and weaknesses in the domestic financial system constrain policy options.

52. **Enhancing the public's understanding of the issues and policy options will be critical to ensuring the successful implementation of regional and individual country reform programs.** The permanent negative shock emanating from the dismantling of the preferential trade arrangements has caused significant hardships to the traditional agricultural sector. However relying on the government to create employment opportunities and generate growth is not a sustainable strategy. Private sector initiatives from the local population would be a welcome step to complement government measures to create an enabling investment environment.

53. **Achieving an orderly adjustment in the region is hindered by the lack of consensus at the highest political levels on the imminent need for concerted action to reduce vulnerabilities.** Between early 2004 and early 2005, elections are due in three countries, and country authorities are not likely to be receptive to undertaking the fundamental adjustments in the fiscal stance that are needed in the run-up to elections. Further, the ability of the Dominican authorities to maintain their fiscal adjustment ahead of the January 2005 elections, and the results of those elections, will provide a key test of the strategy for resolving debt problems in the region.

54. **Given the high public debt and other large sources of vulnerability, ambitious front-loaded macroeconomic adjustments are needed now.** While authorities should be commended for establishing a framework for home-grown structural adjustment programs in each country with technical assistance from CARTAC, there is an urgent need to integrate them in domestic policy making processes at the highest levels.

55. **Addressing the region's fundamental economic problems requires key steps in the fiscal and debt areas.** To improve fiscal positions, it is necessary to ensure effective expenditure controls, broaden the tax base, raise collection rates, strengthen transparency and ensure timely and comprehensive fiscal data. Debt would also have to be reduced to sustainable levels through fiscal savings, privatization, deeper structural reforms to stimulate growth, and an active debt strategy.

56. **There is a clear need for a coordinated regional approach to ensure the consistency of national fiscal policies with the CBA.** The lack of progress in meeting the existing fiscal benchmarks established in 1998 reflects, in part, the negative shocks that hit the region in the last several years and the desire to pursue counter-cyclical policies. Fundamental changes to the existing set up are needed to give credence to the benchmarks. One possible solution is to introduce more binding fiscal rules at the national level.

57. **Reinvigorating growth will be essential, both because of its direct impact on debt ratios as well as to generate the political will to implement difficult measures.** Private sector growth can be facilitated by providing an enabling environment and reducing reliance on public sector investment. While large-scale diversification is not a viable option, given the small size of the economies, greater regional cooperation within the OECS and CARICOM will help achieve economies of scale and give scope for specialization. In particular, there is a clear need for greater flexibility and integration of the labor and goods markets within the region. A coordinated regional approach could also reduce revenue losses in tax concessions and enable greater efficiencies in the provision of government services.

58. **The large real depreciation of the Eastern Caribbean dollar since 2002 has allayed concerns about the competitiveness of the exchange rate.** Enhancing competitiveness is best achieved through wage restraint and deepening structural reforms to raise productivity in both traded and non-traded goods sectors.

59. **To smooth the transition away from traditional agriculture to non-traditional agriculture and services, social safety nets need to be strengthened and better targeted.** The traditional agricultural sectors are a major drain on the fiscal resources of ECCU

countries. To build consensus for reforms, temporary benefits should be given to those who lose jobs or give them up to start a new business or search for employment in an emerging sector.

60. **Priority should be given to reducing the sources of vulnerability in the region.** Vulnerabilities can be reduced by encouraging economic diversification, strengthening underlying fiscal positions, and enhancing the effectiveness of banking supervision. The authorities are also encouraged to strengthen their institutional capacity to deal with natural disasters, in order to mitigate their impacts. A key element—given that revenues are likely to fall at the same time that expenditure needs rise—is to increase self-insurance, in the form of contingency funds, perhaps at the regional level, by generating fiscal surpluses in good times.

61. **In the short run, authorities are urged to develop contingency plans to respond to an unanticipated adverse event, given the large and varied sources of risks in the region.** Policy responses would likely include a combination of expenditure reductions and postponements, and emergency revenue measures. To mitigate hardship on the poor in the event of a crisis, the adequacy of social safety nets needs to be ensured.

62. **The coverage and quality of the region's statistical data and data-management practices remains weak, and urgent improvements are needed.** In particular, the Fund's surveillance activities and the policy deliberations of the authorities themselves would benefit from improvements in data on the national accounts (especially the development of expenditure-based measures of economic activity), labor markets, and debt stocks.

63. **It is proposed that the next discussions with ECCU regional institutions take place in 12 months, with an update of regional developments in six months time.**

Table 1. ECCU: Selected Economic and Financial Indicators 1/

	1998	1999	2000	2001	2002	Prel. 2003	Proj. 2004
(Annual percentage change)							
National income and prices							
Real GDP	4.0	4.1	2.8	-1.3	0.2	2.4	2.5 - 3.5
GDP deflator	2.5	1.8	1.3	1.8	1.0	1.0	1.5
Consumer prices, end-of-year	0.9	2.1	3.1	2.0	0.8	1.5	1.5
Monetary sector							
Liabilities to private sector (M2)	12.9	10.6	10.6	5.9	6.6	9.7	6.5
Net foreign assets	52.9	-11.0	-7.2	40.8	25.8	33.6	8.5
Net domestic assets	5.7	10.6	15.2	-1.3	0.9	0.9	5.5
<i>Of which</i>							
Private sector credit	8.0	10.3	10.4	2.3	1.9	1.1	4.8
Credit to central government	1.1	14.4	35.6	1.4	-1.5	-9.7	3.1
(In percent of GDP)							
Central government 2/							
Overall central government balance	-2.9	-4.8	-6.4	-7.8	-10.5	-5.9	-5.4
Total revenue and grants	28.3	27.6	27.0	26.4	27.9	28.6	28.4
Total expenditure and net lending	31.3	32.3	33.4	34.2	38.4	34.5	33.8
Foreign financing	3.1	2.7	1.5	5.6	9.6	5.6	2.9
Domestic financing including arrears	-0.2	2.1	4.9	2.1	0.9	0.3	2.5
Central government current account balance	1.7	1.1	-0.6	-1.9	-2.3	-0.7	-0.1
Total public sector debt, end-of-period	67.5	71.7	77.7	84.0	101.2	102.8	103.1
(Annual percentage change)							
External sector							
Exports, f.o.b.	6.0	3.6	9.7	-15.6	2.4	-5.6	11.0
Imports, c.i.f.	4.2	6.5	3.1	-8.1	0.4	8.2	4.5
Stayover visitors	1.5	-0.7	0.2	-5.1	2.1	7.5	5.3
Nominal effective exchange rate; (1990=100) end-of-period (depreciation -) 2/	-2.2	4.0	6.0	1.9	-4.8	-8.8	...
Real effective exchange rate; (1990=100) end-of-period (depreciation -) 2/	-1.0	3.4	4.3	1.8	-5.7	-9.6	...
(In percent of GDP; unless otherwise specified)							
External current account balance	-14.1	-16.4	-15.5	-16.7	-19.6	-19.5	-19.1
Trade balance	-37.7	-38.5	-37.6	-35.4	-34.5	-37.3	-36.6
Services and transfers	23.7	22.1	22.2	18.7	14.9	17.8	17.5
<i>Of which</i>							
Travel	31.1	29.1	28.2	26.2	24.7	27.3	27.8
Capital and financial accounts 3/	16.1	17.5	16.1	19.0	21.6	21.0	19.7
External public debt (end-of-period) 2/	42.1	45.7	48.6	53.1	65.4	69.1	68.4
External debt service, in percentage of GNFS	5.2	5.3	7.7	9.3	11.4	9.1	9.1
<i>Of which</i>							
Interest	2.7	2.4	3.6	3.3	4.2	4.0	3.9
End-year gross reserves of the ECCB (US\$ millions)	357.6	364.6	383.7	446.0	504.8	539.9	559.9
In months of imports	3.3	3.2	3.2	4.1	4.6	4.6	4.5
In percent of broad money	19.8	18.2	17.4	19.1	20.2	19.7	19.2
Currency backing ratio, in percent 4/	90.9	88.0	88.3	92.9	97.1	95.3	95.3

Sources: Eastern Caribbean Central Bank; and Fund staff estimates and projections.

1/ The ratios and growth rates for the ECCU region are constructed from the consolidated data of the territories in the region, and treat intra-ECCU transactions as transactions between residents for the monetary and external sector data.

2/ Excludes Anguilla and Montserrat.

3/ Includes errors and omissions.

4/ ECCB's foreign assets as a ratio of its demand liabilities.

Table 2. ECCU: Selected Central Government Indicators by Country 1/

(In percentage of GDP)

	1998	1999	2000	2001	2002	Proj. 2003	Proj. 2004
Total revenues and grants	28.3	27.6	27.0	26.4	27.9	28.6	28.4
Antigua and Barbuda	21.9	20.2	18.6	19.5	21.9	21.2	19.9
Dominica	34.1	32.3	37.1	29.4	32.7	34.0	32.9
Grenada	29.1	28.1	29.9	30.9	29.4	33.6	35.6
St. Kitts and Nevis	31.6	31.7	30.0	29.2	33.7	33.4	35.5
St. Lucia	29.2	29.4	26.9	26.1	26.3	26.8	26.0
St. Vincent and the Grenadines	30.5	30.2	29.4	30.7	32.1	32.7	31.8
Current expenditure	23.7	24.5	25.6	26.6	27.9	27.1	26.7
Antigua and Barbuda	23.3	23.9	26.5	25.5	27.9	26.1	24.7
Dominica	28.3	30.3	31.4	32.1	33.0	31.5	30.4
Grenada	23.2	21.4	20.9	24.1	26.3	25.0	28.9
St. Kitts and Nevis	30.4	33.2	34.1	33.2	33.2	33.0	30.2
St. Lucia	19.5	19.6	20.9	22.8	24.0	24.7	24.2
St. Vincent and the Grenadines	23.9	26.2	26.5	27.8	28.3	27.5	27.1
<i>Of which</i>							
Interest payments	2.1	2.5	3.7	3.6	4.3	4.4	4.4
Antigua and Barbuda	2.9	2.6	6.2	3.9	4.6	4.0	3.8
Dominica	2.5	3.9	4.9	5.2	5.5	5.7	6.1
Grenada	1.6	2.3	2.2	2.6	4.8	5.5	6.1
St. Kitts and Nevis	3.2	3.9	5.0	5.7	7.0	7.2	6.7
St. Lucia	1.3	1.3	1.6	2.4	2.5	3.3	3.6
St. Vincent and the Grenadines	1.9	2.5	2.9	2.8	2.7	2.6	2.0
Saving (current revenue less current expenditure)	1.7	1.1	-0.6	-1.9	-2.3	-0.7	-0.1
Antigua and Barbuda	-2.8	-4.2	-8.4	-6.5	-7.5	-5.4	-4.8
Dominica	0.9	-1.0	-4.0	-4.6	-5.0	-3.2	-2.3
Grenada	1.3	4.8	6.0	2.5	0.7	3.4	2.5
St. Kitts and Nevis	0.2	-2.6	-5.3	-4.9	-3.2	-0.3	4.9
St. Lucia	6.1	6.1	5.4	1.6	0.3	0.0	-0.2
St. Vincent and the Grenadines	4.1	2.1	1.7	0.9	2.6	4.1	3.6
Primary balance	-0.8	-2.3	-2.7	-4.2	-6.2	-1.4	-1.0
Antigua and Barbuda	-1.3	-3.2	-3.8	-6.9	-6.5	-4.0	-2.9
Dominica	-5.0	-7.5	-5.8	-3.2	0.1	0.2	0.5
Grenada	-1.5	-1.3	-1.0	-5.8	-14.7	0.4	-2.5
St. Kitts and Nevis	-2.7	-7.3	-9.5	-6.8	-9.3	0.0	5.8
St. Lucia	3.0	1.8	0.3	-2.0	-5.1	-2.6	-2.6
St. Vincent and the Grenadines	-1.4	-0.9	0.8	0.7	0.4	1.3	0.1
Overall balance	-2.9	-4.8	-6.4	-7.8	-10.5	-5.9	-5.4
Antigua and Barbuda	-4.2	-5.8	-10.0	-10.8	-11.1	-8.0	-6.8
Dominica	-7.6	-11.4	-10.7	-8.3	-5.4	-5.5	-5.6
Grenada	-3.0	-3.5	-3.2	-8.4	-19.5	-5.0	-8.5
St. Kitts and Nevis	-5.9	-11.2	-14.5	-12.5	-16.4	-7.3	-0.9
St. Lucia	1.8	0.5	-1.3	-4.4	-7.6	-5.9	-6.2
St. Vincent and the Grenadines	-3.3	-3.5	-2.1	-2.1	-2.3	-1.3	-2.0
Government and government guaranteed debt stock							
Total public sector debt	67.5	71.7	77.7	84.0	101.2	102.8	103.1
Antigua and Barbuda	92.6	96.1	105.4	106.1	114.7	112.8	114.8
Dominica	72.1	77.3	86.2	92.7	111.4	121.9	125.3
Grenada	55.3	55.2	57.0	64.7	112.3	108.9	110.2
St. Kitts and Nevis	100.7	113.8	120.7	133.7	158.5	162.1	155.8
St. Lucia	42.0	38.9	43.6	50.1	62.3	66.3	68.2
St. Vincent and the Grenadines	49.1	65.8	67.6	69.3	71.5	71.1	67.2
External debt 2/	42.1	45.7	48.6	53.1	65.4	69.1	68.4
Domestic debt	25.4	26.0	29.1	30.8	35.9	33.7	34.7

Sources: ECCU country authorities; Eastern Caribbean Central Bank; and Fund staff estimates.

1/ Excludes Anguilla and Montserrat. Budget data for Dominica and St. Lucia are for fiscal years.

2/ Includes external arrears.

Table 3. ECCU: Creditor Composition of Public Debt at End-2002 1/

(Share of total)

	Antigua and Barbuda	Dominica	Grenada	St. Kitts and Nevis	St. Lucia	St. Vincent and the Grenadines	Total
External debt	100	100	100	100	100	100	100
Central government	93	89	87	69	80	93	87
Multilateral, total	1	28	23	20	38	40	20
Official bilateral, total	30	18	24	9	11	18	21
Commercial, total	41	41	40	40	32	35	39
Arrears, total	21	3	0	0	...	0	...
Other nonfinancial public sector	7	11	13	31	20	7	13
Domestic debt	100	100	100	100	100	100	100
Central government	92	96	99	76	86	81	87
ECCB	4	8	...	1	...	1	...
Private domestic banks	...	35	68	57	...	32	...
Nonbank financial institutions	...	27	...	...	...	...	...
Insurance funds	...	0	...	...	...	...	...
Other	...	26	...	18	...	48	...
Arrears, total	26	0	0	0	0	0	6
Other nonfinancial public sector	8	4	1	24	14	19	13
Memorandum items:							
Public debt (end-2002, percent of GDP)	113.8	103.4	107.1	157.5	59.3	74.0	99.1
<i>Of which</i>							
External debt	74.6	75.5	64.5	72.3	38.0	48.8	60.6
Public debt (end-2002, U.S. dollars)	820.4	262.4	430.0	560.9	398.8	267.3	2,739.9
<i>Of which</i>							
External debt	537.5	191.6	259.0	257.5	255.4	176.2	1,675.4

Sources: Eastern Caribbean Central Bank; and Fund staff estimates.

1/ Excludes Anguilla and Montserrat.

Table 4. ECCU: Summary Balance of Payments

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
(In millions of U.S. dollars)						
Current account	-450.4	-438.3	-475.6	-570.6	-592.2	-606.5
Trade balance	-1,055.8	-1,066.3	-1,006.8	-1,004.8	-1,130.8	-1,162.4
Exports	327.4	359.2	303.1	310.4	292.9	325.2
Imports	-1,383.2	-1,425.5	-1,309.9	-1,315.2	-1,423.7	-1,487.5
Services and income	472.4	463.9	417.8	325.0	420.9	435.9
Services	642.4	671.3	594.9	526.8	641.1	664.2
Transportation	-129.1	-116.0	-91.5	-93.5	-98.6	-101.9
Travel	798.1	799.6	743.0	718.6	828.1	884.1
Other services	-26.5	-12.3	-56.7	-98.3	-88.4	-118.0
Income	-170.0	-207.4	-177.1	-201.8	-220.2	-228.3
Current transfers	133.0	164.0	113.4	109.2	117.6	120.0
Capital and financial account	475.7	453.9	539.7	630.1	635.6	626.5
Capital transfers (net)	108.6	122.3	134.2	132.2	114.7	122.9
Financial account	367.0	331.6	405.5	497.9	520.9	503.6
Direct investment	335.2	306.8	281.0	316.3	392.6	410.2
Portfolio investment	48.4	68.0	48.7	167.7	123.0	50.0
Public sector long term	48.9	23.3	77.3	30.3	71.6	70.0
Other public sector capital	0.4	0.0	2.3	0.6	0.2	0.0
Commercial banks	-34.1	45.5	-90.5	-77.3	-191.2	-56.8
Other capital 1/	-31.7	-112.0	86.7	60.2	124.7	30.2
Overall balance	25.3	15.6	64.2	59.5	43.4	20.0
Financing	-25.3	-15.6	-64.2	-59.5	-43.4	-20.0
(in percentage of GDP)						
Current account	-16.4	-15.5	-16.7	-19.6	-19.5	-19.1
Exports	12.0	12.7	10.7	10.7	9.7	10.2
Imports	-50.5	-50.3	-46.1	-45.2	-46.9	-46.8
Services, incomes and transfers	22.1	22.2	18.7	14.9	17.8	17.5
Of which						
Travel	29.1	28.2	26.2	24.7	27.3	27.8
Current transfers	4.9	5.8	4.0	3.8	3.9	3.8
Capital and financial account	17.4	16.0	19.0	21.6	21.0	19.7
Of which						
Direct investment	12.2	10.8	9.9	10.9	12.9	12.9
Overall balance	0.9	0.5	2.3	2.0	1.4	0.6
(Annual percentage change)						
Exports	3.6	9.7	-15.6	2.4	-5.6	11.0
Imports	6.5	3.1	-8.1	0.4	8.2	4.5
Travel, net	-1.4	0.2	-7.1	-3.3	15.2	6.8
Memorandum items:						
End year gross reserves of the ECCB, US\$ millions	364.6	383.7	446.0	504.8	539.9	559.9
In months of current year imports (months)	3.2	3.2	4.1	4.6	4.6	4.5
ECCU GDP at market prices, EC\$ millions	7,396.2	7,647.1	7,671.5	7,863.4	8,187.8	8,584.7

Source: Eastern Caribbean Central Bank

1/ Includes errors and omissions.

Table 5. ECCU: Summary Accounts of the Banking System

(In millions of Eastern Caribbean dollars)

	1999	2000	2001	2002	2003	Proj. 2004
I. Monetary Survey (Consolidated Banking System)						
Net foreign assets	1,104.7	1,024.8	1,442.6	1,814.1	2,424.3	2,631.6
Net domestic assets	4,292.1	4,943.8	4,877.1	4,920.4	4,964.4	5,236.3
Net credit to the public sector	-249.4	-97.7	-69.1	-87.2	-169.0	-172.2
Central government	475.9	645.2	654.5	644.7	582.1	600.4
Nonfinancial public enterprises 1/	-725.4	-742.9	-723.6	-731.9	-751.2	-772.6
Credit to private sector	5,293.4	5,842.8	5,979.1	6,090.8	6,160.2	6,458.8
Other	-751.9	-801.3	-1,032.9	-1,083.2	-1,026.8	-1,050.3
Liabilities to private sector (M2)	5,396.8	5,968.6	6,319.6	6,734.5	7,388.8	7,867.9
Money (M1)	1,191.0	1,211.7	1,246.0	1,319.2	1,507.9	1,576.1
Quasi-money	4,205.8	4,757.0	5,073.6	5,415.3	5,880.8	6,291.7
II. Eastern Caribbean Central Bank						
Net foreign assets	975.9	1,018.8	1,192.2	1,355.1	1,449.1	1,503.1
Net domestic assets	-586.9	-631.9	-818.7	-961.9	-1,022.0	-1,060.2
Net position with banks and other institutions	-627.4	-646.9	-830.6	-910.9	-1005.8	-1041.9
Credit to government	24.1	29.5	32.7	1.9	31.5	30.5
Other	16.4	-14.5	-20.9	-53.0	-47.7	-48.7
Liabilities to private sector	388.9	386.9	373.4	393.2	427.1	443.0
Currency issued	572.7	536.0	537.5	558.7	605.7	647.9
Currency held by banks	-183.8	-149.1	-164.1	-165.4	-178.6	-204.9
III. Commercial Banks						
Net foreign assets	128.8	6.0	250.4	459.0	975.2	1,128.4
Net claims on ECCB	628.7	632.2	833.2	902.5	955.8	992.0
Net domestic credit	4,250.3	4,943.5	4,862.7	4,979.8	5,030.6	5,304.5
Net credit to the public sector	-273.5	-127.3	-101.9	-89.1	-200.5	-202.7
Central government	451.9	615.7	621.8	642.8	550.6	569.9
Rest of the public sector	-725.4	-742.9	-723.6	-731.9	-751.2	-772.6
Credit to private sector	5,293.4	5,842.8	5,979.1	6,090.8	6,160.2	6,458.8
Other	-769.6	-772.1	-1,014.6	-1,021.9	-929.1	-951.6
Liabilities to the private sector	5,007.9	5,581.7	5,946.2	6,341.3	6,961.6	7,424.9
Memorandum items of the consolidated banking system:						
(Percentage growth compared to M2 at the beginning of the year)						
Net foreign assets	2.2	-1.5	7.0	5.9	9.1	2.8
Central bank	0.3	0.8	2.9	2.6	1.4	0.7
Commercial banks	1.9	-2.3	4.1	3.3	7.7	2.1
Net domestic assets	8.4	12.1	-1.1	0.7	0.7	3.7
Of which						
Net credit to the public sector	-1.9	2.8	0.5	-0.3	-1.2	0.0
Credit to the private sector	10.1	10.2	2.3	1.8	1.0	4.0
(Annual percentage change)						
Liabilities to private sector (M2)	10.6	10.6	5.9	6.6	9.7	6.5
Private sector credit	10.3	10.4	2.3	1.9	1.1	4.8
Income velocity of broad money	1.4	1.3	1.2	1.2	1.1	1.1
Private sector credit/GDP (percent)	71.6	76.4	77.9	77.5	75.2	75.2
Broad money/GDP (percent)	73.0	78.1	82.4	85.6	90.2	91.7
Foreign currency deposits/M2 (percent)	7.5	10.0	10.4	11.7	11.9	12.2

Sources: Eastern Caribbean Central Bank; and Fund staff estimates.

1/ Includes the national insurance schemes.

Table 6. ECCU: Selected Vulnerability Indicators

	2000	2001	2002	Prel. 2003
Key economic and market indicators				
Real GDP growth (in percent)	2.8	-1.3	0.2	2.4
CPI inflation (12-month cumulative, in percent)	3.1	2.0	0.8	1.5
Interbank interest rate	...	6.8	6.2	5.3
Exchange rate NC/US\$ (end of period)	2.7	2.7	2.7	2.7
External sector				
Current account balance (percent of GDP)	-15.5	-16.7	-19.6	-19.5
Net FDI inflows (percent of GDP)	10.8	9.9	10.9	12.9
Export growth (f.o.b.)	9.7	-15.6	2.4	-5.6
Terms of trade (12-month percentage change)	-2.8	1.9	0.5	-1.8
Real effective exchange rate (1990 = 100)	112.0	114.5	112.6	103.4
Gross international reserves (GIR) in US\$ billion 1/	0.384	0.446	0.505	0.540
Net international reserves (NIR) in US\$ billion 1/	0.377	0.442	0.502	0.537
Total gross external public debt in percent of GDP	48.6	53.1	65.4	69.1
Total gross external public debt in percent of exports of GNFS	79.4	94.8	122.0	124.5
Gross external financing requirement (in US\$ billion) 2/	0.651	0.665	0.779	0.820
(In percent of GDP)				
Consolidated public sector				
Overall central government balance	-6.4	-7.8	-10.5	-5.9
Primary central government balance	-2.7	-4.2	-6.2	-1.4
Central government current account balance	-0.6	-1.9	-2.3	-0.7
Public sector gross debt	77.7	84.0	101.2	102.8
(In percent)				
Public and private financial sector 3/				
Capital adequacy ratio (Indigenous banks)	16.6	17.7	18.9	19.1
NPLs/total loans	11.7	13.5	13.7	12.0
Indigenous banks	16.7	17.4	17.4	16.8
Foreign banks	6.3	9.1	9.3	6.5
Loan loss provision/NPLs	28.0	28.1	29.7	34.0
Indigenous banks	25.6	27.1	27.9	27.7
Foreign banks	35.0	30.3	33.6	52.5
Loans to agricultural sector/total loans	3.2	3.6	3.9	4.0
Loans to tourism sector/total loans	7.9	7.5	7.9	7.9
Loans to household sector/total loans	45.9	46.6	46.4	47.4
Gross government claims/total assets	15.2	15.0	15.1	15.2
Government deposits/total deposits	18.6	18.1	17.8	18.2
FX deposits/total deposits	15.7	15.0	15.7	15.3
FX deposits/gross international reserves	129.1	113.3	112.9	107.2
Net foreign currency assets/total capital (indigenous banks)	1.2	29.0	40.0	84.8
Contingent liabilities/capital (indigenous banks)	74.6	62.1	59.3	68.9
(Pre-tax) return on average assets	2.2	2.1	1.6	0.4
Memorandum items :				
ECCB reserve cover 4/	88.3	92.9	97.1	95.3
ECCB gross reserves/M2	17.4	19.1	20.2	19.7

Sources: Eastern Caribbean Central Bank; and Fund staff estimates.

1/ Gross reserves defined as foreign assets of ECCB. Net reserves defined as net foreign assets of ECCB.

2/ Defined as external current account deficit plus external amortization.

3/ End-September for 2003.

4/ Foreign assets as a percentage of demand liabilities.

CARTAC: Capacity Building in the ECCU

The Caribbean Regional Technical Assistance Center (CARTAC) was established in November 2001 as a regional resource, based in Barbados, to provide technical assistance and training to 20 Caribbean countries in core areas of economic and financial management. It is a multi-donor project with the IMF as executing agency.²⁵ An active Steering Committee consisting of representatives from the participating countries, the donor agencies, CARICOM, and the CDB provides strategic guidance and ensures ownership and commitment.

The ECCU countries have been among the most active participating countries in requesting technical assistance and training in all of CARTAC's core areas. In the little more than two years since it began, CARTAC has fielded more than 200 missions to the ECCU countries, in addition to the many regional seminars and workshops in which they have participated. This level of technical assistance support has represented a significant additionality to the Fund's technical assistance to the ECCU region. Some examples and highlights of CARTAC's technical assistance to the ECCU countries in the various core areas are provided below.

In the area of tax policy and administration, CARTAC and FAD conducted a comprehensive review of the OECS tax systems and administrations. Some countries have started to implement the recommendations of the review. Grenada and Dominica have begun work to introduce a VAT, and others are expected to follow. Training has been provided in customs valuation to three OECS countries in coordination with CCLEC and support from the Canadian and US Customs agencies. CARTAC has assisted the ECCB in the estimation of VAT and excise tax revenue yields for Anguilla, Antigua and Barbuda, Grenada, St. Kitts and Nevis, and St. Lucia. CARTAC has also been helping to establish an Inland Revenue Department in Anguilla, has provided training in audit techniques to Antigua and Barbuda, in streamlining the collection of arrears procedures in Dominica, in training of customs officers in UNIX and ASYCUDA in Dominica, Grenada, St. Kitts and Nevis, and St. Vincent and the Grenadines, and in training and other assistance to prepare for the establishment of a revenue authority in St. Lucia.

In public finance management, CARTAC and the ECCB assisted all ECCU countries in diagnostic exercises as part of the Fiscal Machinery Project to draw up action plans to address public expenditure management weaknesses. Following up on these diagnostic assessments, CARTAC has focused on improving cash management and budgeting procedures in the ECCU countries with both seminars and short-term missions. In order to support a coordinated regional approach to public finance reform, CARTAC has supported the establishment of the Caribbean Public Finance Management Association (CaPFA), in which the ECCU countries have been active.

²⁵ CIDA provides over 50 percent of CARTAC's total funding, with DFID, EU, IDB, Ireland, IMF, UNDP, US, and the World Bank contributing the remainder.

A good example of CARTAC's ability to respond and adjust in a timely way to the needs of the region was the establishment of the Stabilization and Adjustment Technical Assistance Program (SATAP). Not foreseen when CARTAC first began, SATAP was set up in response to a request from the ECCU, following a meeting of their Monetary Council, in which they agreed that all member countries would seek to implement "home grown" adjustment programs to achieve a set of common targets by 2007. CARTAC consultants have worked with small teams set up in the six independent ECCU countries to prepare macroeconomic projections under a baseline scenario, identify imbalances and measures to address these imbalances, prepare projections for an active scenario, and finally to develop a monitoring framework for the financial program based on quarterly targets for key indicators. Work is at various stages of progress in the six countries, with active scenarios completed for all countries except Antigua and Barbuda. CARTAC is currently supporting (with special assistance from DFID) the setting up of a Coordinating and Monitoring Unit within the ECCB to work with the country teams in tracking and monitoring the adjustment programs.

In financial sector supervision, CARTAC has provided technical assistance to the ECCU in two main areas—the strengthening of the supervisory infrastructure and capacity building of supervisory staff. In order to improve the efficiency and effectiveness of financial sector supervision in the ECCU, CARTAC has assisted in the preparatory work to establish single supervisory units (covering the banking and non-banking financial sectors), preparing feasibility studies in four countries and draft legislation in two of these countries. Strengthening the legislative framework has been addressed in the individual countries and at the ECCB. International banking acts, capital adequacy regulation, guidelines on the management of risk, money transmitters legislation, and other prudential guidelines are being developed with CARTAC assistance in the ECCU. Assistance has also been provided in the development of standardized on-site inspection procedures and off-site monitoring and supervision. Regarding training of supervisory staff, CARTAC has provided seminars, workshops, conferences, and regional and international attachments. For example, corporate governance seminars have been held for industry representatives in four ECCU countries.

The CARTAC program to improve economic and financial statistics in the ECCU has focused on four projects. To improve national accounts, CARTAC has assisted ECCU countries in the development of supply and use tables to identify data gaps and also to help rebase the national accounts. In balance of payments statistics, CARTAC is working with the ECCU countries particularly to address gaps in financial flows and the coverage of services, and more generally to bring the data collection systems up to international standards. Assistance in price statistics has assisted ECCU countries to incorporate the results of a household budget survey completed in 1999. The development of import/export price indices has begun with a pilot project in St. Lucia, with expansion to other countries expected.

Caribbean Development Bank: Overview of Activities in the OECS

The Caribbean Development Bank (CDB) has as one of its core mandates, the mobilisation of resources to finance projects and programmes that contribute to the development of its 17 borrowing member countries. In this regard, the CDB has played an important role in the development of the eight countries in the OECS sub-region. Over the period 1970–2003, CDB has approved US\$2.4 billion to its borrowing member countries, with the OECS as a whole accounting for approximately 37 percent, or US\$869.5 million. To date, most of CDB's interventions in the OECS have been directed towards infrastructural development, and is in part directly related to the incidence of natural disasters in the region, and the need to ensure adequate infrastructural support for investments in tourism and other productive sector activity. Resources approved for physical and social infrastructure have, on average, accounted for 56.2 percent of overall lending to the sub-region, and focussed mainly on upgrading transportation and communication, educational services, power and energy and housing. Interventions in those directly productive sectors account for 25.9 percent of total activity, and have focussed largely on manufacturing and agriculture—the two sectors most severely impacted by developments in the external environment. Multi-sectoral interventions, which may take the form of *inter alia* institutional strengthening of government departments, feasibility studies, and the assessment and implementation of transactions-based taxes, have also been an important element of the CDB's activities in the OECS, representing 17.9 percent of total interventions to the sub-group.

Over the period 1970–2003, St. Lucia has been the largest recipient of CDB activity in the OECS sub-region. Over this period the CDB approved assistance to St. Lucia of US\$225.6 million, which accounted for 27.5 percent of approvals to the OECS. Of total approvals, US\$158.0 million was disbursed. Most of the projects currently on-going in St. Lucia are in the areas of physical and social infrastructure development, with interventions to improve the water supply, road rehabilitation, natural disaster mitigation and solid waste management, which forms part of a wider OECS solid waste management programme. Within the productive sectors, CDB has been involved mainly in tourism and stimulating the recovery of banana production.

The CDB has also played an extremely critical role in assisting Dominica to pursue its development objectives. During the period 1970–2003, US\$149.2 million was approved, which represented 17.1 percent of its resources to the sub-region, with disbursements totalling US\$112.1 million. Projects underway in Dominica are in the areas of education sector enhancement, natural disaster management, waste management and the upgrading of eco-tourism sites. In addition to the CDB's usual capital project-related interventions, the Bank has actively assisted Dominica in its economic reconstruction effort through the provision of stabilisation/structural adjustment loans.

St. Kitts and Nevis has been another significant beneficiary of CDB's activities since 1970, with US\$94.7 million disbursed from US\$140.5 million approved (16.2 percent of OECS resources). Ongoing activities in St. Kitts and Nevis are mainly in the areas of disaster rehabilitation and natural disaster management, with some emphasis on improving the provision of education services and enhancing the waste management function.

Resources approved to Grenada account for 15.4 percent or US\$133.5 million of all approvals to the sub-region with disbursements to date amounting to US\$93.2 million. The development of physical infrastructure has been the main focus of ongoing activities in this island, with significant emphasis being placed on bridge and road improvement, the rehabilitation of schools, waste management improvement and natural disaster management.

Approvals to St. Vincent and the Grenadines amounted to US\$127.6 million over the period 1970 to 2003, accounting for approximately 14.7 percent of CDB's approvals to the OECS, while disbursements totalled US\$92.3 million. The main areas of CDB ongoing involvement are in road rehabilitation, basic education, solid waste management and natural disaster management.

Activity in Antigua and Barbuda has been small by comparison, with approvals to this island accounting for only 4.6 percent or US\$40 million of total approvals over 1970–2003, with US\$24.1 million disbursed. Education sector enhancement has been the main focus of the recent interventions along with security improvements to the air and sea ports.

Activity in Anguilla is also relatively small, representing 2.6 percent or US\$23.1 million of total approvals since 1970, while US\$20.2 million was disbursed. Ongoing projects in Anguilla are predominantly in natural disaster management.

Approvals to Montserrat have also been minimal amounting to US\$16.3 million or 1.9 percent of total approvals to the sub-region over 1970–2003, of which US\$10.6 million was disbursed. Education sector enhancement is the main intervention on-going in Montserrat.

CDB Operations in the OECS

(In millions of U.S. dollars)

	Approvals 1970-2003	Disbursements 1970-2003	Approvals 2003	Disbursements 2003
Anguilla	23.1	20.2	0.0	2.5
Antigua and Barbuda	40.0	24.1	1.5	4.2
Dominica	149.2	112.1	8.4	9.3
Grenada	133.5	93.2	7.0	7.9
Montserrat	16.3	10.6	0.0	nil
St. Kitts and Nevis	140.5	94.7	13.3	6.0
St. Lucia	239.4	158.0	8.6	20.1
St. Vincent and the Grenadines	127.6	92.3	5.3	2.4
OECS Sub-region	869.5	119.0	44.1	52.4

OECS: Relations with the World Bank Group (As of March 16, 2004)

World Bank Group Strategy

The World Bank's program focuses on structural reforms aimed at raising international competitiveness and helping to manage volatility at the macroeconomic and household levels. The Bank will also take the lead on public sector reforms with a particular focus on the efficiency of public spending, social expenditures (including safety nets), disaster mitigation and environmental management. The Bank and Fund will work jointly on issues concerning the financial sector, both domestic and offshore.

The World Bank's management presented to its Board an Eastern Caribbean Sub-Region Country Assistance Strategy (CAS), on June 28, 2001. The CAS, which covers FY 2002–06, proposed new commitments of around US\$110 million for the five borrowing member states of the OECS—Dominica, Grenada, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines. Of this amount, US\$59 million has already been committed. The main goals of the strategy are to build human and institutional capacity to meet the challenging economic and social environment facing these small states. Most new projects are being provided under a sub-regional umbrella mechanism, and in close collaboration with sub-regional organizations and external partners. A new CAS is to be prepared during FY05.

Increasing international competitiveness. In addition to stabilizing macroeconomic conditions and redressing high fiscal deficits and public debt levels, the OECS countries are focusing on (i) improving the investment climate by broadening the tax base, streamlining the investment incentive regime and making it more transparent; (ii) improving public sector performance, by raising the efficiency of public investment and improving service delivery; (iii) reducing transaction costs, by strengthening regulation and efficiency of public utilities, and sea/air transport; and (iv) promoting appropriate education and skills development to take advantage of new opportunities in the global environment. The OECS authorities also are targeting to expand their positive experiences with sub-regional functional cooperation (e.g. common central bank, telecommunications regulation, pharmaceutical procurement) to other areas as a way of better allocating the region's scarce human and financial resources.

The Bank is supporting these efforts through ongoing analytical work on **Growth and Competitiveness in the OECS** and a series of **Public Expenditure Reviews**, and a number of ongoing projects. The **OECS Telecom Reform** project, a pilot **St. Lucia Water Sector Reform Project**, and technical assistance in the power and energy sectors, which are expected to serve as a basis for future work on **Regulatory Reform** for other utilities. A new **Education Development** program is addressing secondary education outcomes and a proposed **Caribbean Knowledge and Learning Network**, which aims to strengthen the provision of tertiary education, in part through improvements in sub-regional collaboration and connectivity which will be followed by Bank support for a **Public Sector Reform program** in FY05.

Managing volatility. Recent analytical work on macroeconomic vulnerabilities has shown that the frequent natural disasters in the OECS are a major cause of income insecurity and

high poverty rates in the sub-region, as households cycle in and out of poverty in tandem with these events.

Disaster Management. Despite the regularity of natural disasters, the authorities in the OECS have generally pursued reactive policy responses rather than mitigation measures. Given declining aid flows and limited institutional capacity, the countries need to move to proactive responses with greater cooperation between governments, donors and civil society at both the national and the sub-regional levels. The Bank is working to strengthen mitigation and response planning through the **OECS Disaster Management Programs I and II**.

Safety Nets. Despite relatively high per capita incomes, unemployment (estimated between 5-20 percent) and poverty levels (ranging 12-38 percent) are quite high in the OECS. However, current safety nets suffer from a plethora of uncoordinated programs, which lack appropriate targeting mechanisms and adequate coverage. These will need to be improved to address the impact of eroding trade preferences on the rural sector, emerging problems with youth-at-risk, an aging population, continued vulnerability to external shocks and new vulnerabilities arising from the HIV/AIDS epidemic. Improvements to the efficiency and targeting of social safety nets are being examined under the public expenditure reviews. The Bank has provided financial support for a **Poverty Reduction Fund** in St. Lucia, which has piloted community procurement, a **Social Protection Review** for Dominica and an **IDF grant** to strengthen poverty measurement in the OECS. A **Caribbean Regional HIV/AIDS** program, including Barbados, was approved in June 2001, which will include projects for Grenada and St. Kitts and Nevis (ongoing), St. Lucia and St. Vincent and the Grenadines in FY04, and Dominica in FY05. A **review of Health Financing** is programmed for FY05.

Bank-Fund Collaboration in Specific Areas

Fiscal management. The Bank is helping to improve the management of public spending in the OECS, including ongoing **Public Expenditure Reviews** for individual member states; a **Financial Accountability Assessment** and **Procurement Assessment Report**; and additional country specific work on the Dominica Public Sector Investment Program. The regional products will be critical inputs into the upcoming **Public Sector Reform** program scheduled for FY05.

Dominica. The Bank has recently disbursed an US\$3.1 million IDA adjustment credit in support of Dominica's program of economic recovery. The main focus of this operation was improvements in public expenditure and financial management, financial sector reforms, and actions aimed at improving the climate for private investment.

Financial sector reforms. The Bank plans to support implementation of the recommendations of recent FSAP, conducted jointly the IMF and World Bank, with a **Financial Sector** operation in FY 2005.

Main Political Parties in ECCU Countries

Antigua and Barbuda

ALP Antigua Labour Party
UPP United Progressive Party

Dominica

DFP Dominica Freedom Party
DLP Dominica Labour Party
PLM People Labour Movement
UWL United Workers Party

Grenada

GULP Grenada United Labour Party
NDC National Democratic Congress
NNP New National Party

St. Kitts and Nevis

PAM People's Action Movement
SKLP St. Kitts-Nevis Labour Party

St. Lucia

NA National Alliance
SLP St. Lucia Labour Party
UWP United Workers Party

St. Vincent and the Grenadines

NDP New Democratic Party
PPM People's Progressive Movement
ULP Unity Labour Party
SYLP St. Vincent Labour Party



INTERNATIONAL MONETARY FUND

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700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Discussion on the Eastern Caribbean Currency Union

On May 5, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the discussion of regional surveillance on the Eastern Caribbean Currency Union.¹

Background

Macroeconomic conditions in the region weakened considerably since the mid 1990s, with the growth of real GDP slowing from an average annual rate of nearly 5 percent during 1980–95 to about 2¼ percent since then. The slowdown in economic activity has reflected increased competition from lower-priced tourist destinations, the global economic slowdown, and the gradual reduction in preferential trade arrangements. Inflation has remained subdued, with consumer prices rising on average by less than 2 percent per year. Economic activity picked up in 2003, as a result of the favorable external environment as tourism and the global economy strengthened, and benefits accrued from the recent depreciation of the U.S. dollar.

The fiscal position of the governments in the region has deteriorated sharply in recent years—due to a combination of adverse exogenous shocks and policy slippages—and resulted in a marked increase in public sector debt. The overall balance of the central government for the ECCU as a whole widened from a deficit of 3 percent of GDP in 1998 to 10½ percent of GDP in 2002. The overall deficit narrowed sharply in 2003 to about 6 percent of GDP, primarily as a result of a reduction in capital spending due to one-off factors such as the completion of some large projects. The current balance improved by 1½ percent of GDP in 2003, but remained in deficit. Consequently, public sector debt grew rapidly to 103 percent of GDP in 2003, and the debt stocks of the countries in the region ranged between 66–163 percent of GDP in 2003.

¹ The regional perspective of such discussions is intended to strengthen the bilateral discussions that the IMF holds with the members in the region under Article IV of the IMF's Articles of Agreement. A staff team visits the region, collects economic and financial information, and discusses with officials in the region the region's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country authorities in the region and this PIN summarizes the views of the Executive Board.

The external current account deficit remained at 19½ percent of GDP in 2002 and 2003, having increased moderately from 2001 as a result of the weaker economy. Tourism receipts strengthened in 2002 and 2003 but were offset by a rise in imports, in part due to a sharp increase in imports for construction, hotels and communication. In turn, foreign direct investment grew sharply in 2003 and, as in recent years, a positive overall external balance was recorded as overall capital inflows remained robust. Gross international reserves of the Eastern Caribbean Central Bank (ECCB) have continued to rise, to US\$540 million at end-2003, and have remained at comfortable levels in recent years.

Monetary aggregates have continued to expand rapidly, relative to the region's output growth rates, despite increasing pressures on the health of the banking system. Broad money grew by 6½ percent in 2002 and by 9½ percent in 2003, as deposits with the banking sector rose despite a reduction in the minimum savings deposit rate from 4 percent to 3 percent in September 2002. Net lending to the public sector contracted sharply, as governments made increasing recourse to external borrowing and government social security funds built up deposits with the banking system. Private sector credit growth—principally loans to individuals, mostly for housing—declined to 2 percent in 2002 and to 1 percent in 2003, as interest rates did not adjust to the excess liquidity in the banking system. Despite the high interest rate spread, the rate of return on bank assets is low. Efforts in the region have focused on strengthening the supervisory and regulatory regimes in both the domestic banking sector and the offshore financial sector. As a result, none of the countries are now included on the Financial Action Task Force's (FATF) listing of noncooperative areas for inadequate anti-money laundering policies in the offshore financial sector.

Executive Board Assessment

Directors noted that since the mid-1990s the region had faced lackluster economic growth associated with a series of adverse shocks, including natural disasters, the dismantling of preferential trade agreements in bananas and sugar, the decline in activity in the offshore financial centers, weaknesses in the global economy, and the effects of September 11. In response to these shocks, the ECCU countries pursued expansionary fiscal policies in an effort to generate growth, create employment, and maintain living standards. However, these policies had also led to a rapid increase in debt levels and a weak fiscal position in many countries.

Directors welcomed the pick up in economic activity in 2003, and urged the authorities to adopt upfront comprehensive measures to strengthen the fiscal position and bring down the debt rapidly, while at the same time undertaking reforms aimed at reinvigorating growth. These reforms should focus on improving the business environment and competitiveness, including through lowering labor costs, providing for greater flexibility and integration of the labor and goods markets, and reducing the role of the public sector. Enhanced regional cooperation could also help broaden markets and provide opportunities to achieve economies of scale. Directors emphasized the need to build consensus and public support for this strategy across the region.

Directors underscored the importance of steps to reduce the sources of vulnerability in the region. They suggested that emphasis be placed on decreasing reliance on traditional agriculture, strengthening underlying fiscal positions, and enhancing the effectiveness of financial sector supervision. It would also be important to strengthen the region's institutional

capacity to mitigate the effects of natural disasters, and to develop contingency plans to respond to a sudden deterioration in the global or regional environment.

Directors took note of the efforts being made in some countries to strengthen the fiscal situation. They recommended that prompt and significant fiscal consolidation, together with improved debt management, will be needed to reduce the risks to the currency union. Further progress toward fiscal consolidation will require expenditure restraint and effective spending control—in particular over wages and capital projects. On the revenue side, they called for a broadening of the tax base, particularly by a concerted, regional approach to reducing the wide range of tax concessions, and improved tax administration. Directors suggested that consideration should be given to introducing a value-added tax. More effective fiscal management would also be furthered by enhancing transparency and the quality and timeliness of fiscal data. In the most highly-indebted countries additional measures will likely be required—including asset sales and growth-enhancing structural reforms.

Directors encouraged the authorities to ensure the consistency of national fiscal policies with the region's currency board arrangement. In this regard, they expressed concern about the lack of adherence by most countries to the ECCB's fiscal benchmarks and recommended that governments make credible commitments to align their fiscal policies and targets with the requirements of the currency board arrangement. In this connection, Directors welcomed efforts to develop home-grown stabilization programs under the Structural Adjustment and Technical Assistance Project (SATAP), which benefits from technical assistance from the Caribbean Technical Assistance Center (CARTAC).

Directors stressed that preserving the currency board arrangements operated by the ECCB depends on the sustainability of the region's fiscal and debt situation and a sound financial sector which is effectively regulated. Directors supported the conclusions of the Financial System Stability Assessment, which found continued confidence in the financial system, however, they agreed that there is scope for strengthening financial sector supervision. In this regard, Directors encouraged the authorities to implement the Financial Sector Assessment Program recommendations, and suggested that the role of the ECCB in this area should be strengthened, particularly with respect to the domestic banks. Directors looked forward to continued full implementation of AML/CFT measures by all ECCU member countries.

Directors urged the national and regional authorities to strengthen the coverage, timeliness, and quality of the region's statistical data and data-management practices, particularly in the fiscal and debt areas, the national accounts, external sector, and labor markets. They emphasized that data improvements would go a long way toward helping the authorities assess economic and financial conditions, and implement appropriate and timely policies, including the home-grown adjustment programs.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Eastern Caribbean Currency Union: Selected Economic Indicators

	2000	2001	2002	Prel. 2003	Proj. 2004
(Annual percentage change)					
Real sector					
Real GDP	2.8	-1.3	0.2	2.4	2.5 – 3.5
GDP deflator	1.3	1.8	1.0	1.0	1.5
Consumer prices, end of year	3.1	2.0	0.8	1.5	1.5
(In percent of GDP) 1/					
Public finances					
Central government overall balance	-6.4	-7.8	-10.5	-5.9	-5.4
Revenues and grants	27.0	26.4	27.9	28.6	28.4
Expenditure and net lending	33.4	34.2	38.4	34.5	33.8
Total public sector debt	77.7	84.0	101.2	102.8	103.1
(In percent of GDP, unless otherwise indicated)					
External sector					
Current account balance	-15.5	-16.7	-19.6	-19.5	-19.1
Trade balance	-37.6	-35.4	-34.5	-37.3	-36.6
Travel	28.2	26.2	24.7	27.3	27.8
Exports, f.o.b. 2/	9.7	-15.6	2.4	-5.6	11.0
Imports, c.i.f. 2/	3.1	-8.1	0.4	8.2	4.5
Stayover visitors 2/	0.2	-5.1	2.1	7.5	5.3
(Percentage change)					
Money and credit					
Net foreign assets 3/	-1.5	7.0	5.9	9.1	2.8
Net domestic assets 3/	12.1	-1.1	0.7	0.7	3.7
Broad money	10.6	5.9	6.6	9.7	6.5

Sources: Data provided by the authorities, and IMF staff estimates.

1/ Excludes Anguilla and Montserrat.

2/ Annual percentage change.

3/ In relation to broad money at the beginning of the period.

**Statement by Charles X. O’Loughlin, Alternate Executive Director
and Richard Campbell, Senior Advisor to Executive Director on the
Eastern Caribbean Currency Union
May 5, 2004**

A valuable, forward-looking Report...

1. **This Staff Report marks a watershed. It does not lack criticisms. But a focus on the region’s opportunities and strengths, and on identifying how to exploit these for the region’s betterment, is at its core.** My ECCU-region authorities deeply appreciate this focus. They thank the staff for their hard work and analytical insights. They offer their fullest cooperation in building upon this positive effort going forward. They hope – and expect – that a broadening and deepening of the kinds of analyses undertaken for this Report will prove as rewarding to the staff and to the Fund as it should prove beneficial to the region.

The region’s economies strengthened in 2003...

2. **A recovery in growth to 2½ percent was underpinned by a revival in tourism – travel receipts rose by 15 percent in 2003.** The very open ECCU regional economy had contracted in 2001-2002, reflecting the joint effects of global economic weakness, the 9/11 terrorist attacks, competitive losses attending a rising US dollar parity, and the ongoing unwinding of former trade preferences. This recovery, accompanied by a tightening of fiscal stances as need for counter-cyclical budget support in the face of recession eased, has virtually halted the previous upward spiral in public debt ratios. Inflation continued to be low, mirroring developments in the US. International reserves rose again – keeping pace with rising imports. FDI inflows, together with capital transfers, almost fully financed the region’s balance of payments deficit on current account.
3. **Future prospects have also brightened.** One key factor is the ongoing strength of US demand, and even if less critical to the progress of the region’s extremely open economies, the continued global recovery. A second is the very substantial increase in net FDI inflows through 2003, part-laying the basis for future growth in addition to signaling confidence in the region’s future. These considerations give my authorities confidence that economic growth in 2004 may be closer to the upper end of the range suggested by the staff – which would lay the basis for a third positive factor to kick in going forward. A further tranche of fiscal consolidation could unleash a virtuous – growth supportive – cycle of stronger budget balances leading to an easement of debt which in turn reinforces capacity for further improvement in fiscal positions. Such a virtuous cycle, which would assure full consistency of fiscal policy with the currency board arrangement, is the goal of the region’s Ministers of Finance.

But a “sustainable growth” strategy is needed, nonetheless...

4. **My authorities agree with the staff that “reinvigorating growth is a high priority”.** They warmly welcome the focus of the staff on this priority, throughout the consultations and in their Report. They concur with the (implicit) view of the staff that the region has a potential to aspire to more than the stronger growth which an improving external environment may support. They view the essential ingredients for a better, sustainable performance as (a) restoring the region’s former growth-supportive fiscal position, (b) maintaining the long-standing EC\$/US\$ parity and the soundness of the region’s financial system, and (c) focusing structural policy towards exploiting the region’s strengths.

The first essential, fiscal policy, was reoriented in the right direction through 2003...

5. **Fiscal policy was kept in counter-cyclical mode as recovery set in.** The Staff Report rightly recalls that “fiscal stances were relaxed in an attempt to sustain employment and growth, as well as to meet natural disaster-related costs” in the recent period of low growth or recession. The ECCU area has responded to the recovery now well underway with appropriate adjustment of fiscal stances. As Table 2 of the Staff Report indicates, on average across the ECCU:
- central government current balances improved by 1.6 percent of GDP,
 - helped by a 1 percent of GDP decline in the non-interest current spending/GDP ratio
 - which, in conjunction with a considerable reduction in net capital spending (as public investment, aimed at countering the effects of faltering growth, was eased back),
 - prompted a very major improvement – of 4.6 percent of GDP¹ - in overall fiscal balances across the ECCU area.
6. **More importantly, the reorientation – from fiscal support in the face of recession to consolidation as the recovery became established – was region-wide.** Of the six countries concerned, five cut their current spending-to-GDP ratios last year. Four reduced net public investment. And four cut their overall fiscal deficits substantially – bringing the regional average down from more than 10 percent of GDP in 2002 to a little below 6 percent in 2003.

¹ Discounting a once-off impact which *raised* Grenada’s 2002 fiscal deficit (to remove an element of deficit reduction in 2003 which is apparent rather than real) net fiscal tightening across the ECCU area was slightly below 3 percent of GDP.

Almost wholly arresting the hitherto-steep rise in the ECCU area debt ratio...

7. **The previous steep increases in ECCU-member debt/GDP ratios were not repeated.** Over the period 1998-2002 the average ECCU-member's debt/GDP ratio rose, annually, by more than 8 percentage points of GDP. However, last year, as growth picked up and fiscal consolidation drove public deficits down, the increase in the stock of ECCU-wide government and government-guaranteed debt was held to 1½ percentage points. While the region's indebtedness may remain virtually static this year, my authorities recognize that stronger economic growth will have to be accompanied – in several member-states – by further fiscal consolidation, to set debt-ratios across the region on a downward path. The staff recommendation to enhance public understanding of the issues and policy options is particularly well-made in this context.

The basis to build on these improvements is being put in place...

8. **The ECCB/CARTAC-assisted SATAP initiative, designed to help ECCU members develop sound, sustainable adjustment strategies, is continuing** – as noted in the Staff Report. In particular, Policy Units in the Ministry of Finance in each of the countries are now engaged in developing “home grown” adjustment programs focusing on fiscal consolidation. Further, as part of a strategy to address weaknesses in tax policy and administration developed by the region's Tax Reform and Administration Commission, preparatory work on the introduction of a VAT has already commenced in three member-countries. The SATAP initiative also embraces evaluation and recommendations on the expenditure side. Some first fruits in this respect are reflected in the easing of expenditure/GDP ratios through 2003. The analysis of tariffs in Chapter VII of the Selected Issues paper represents a useful input to the SATAP process.

The second essential, a sound financial sector, is being maintained...

9. **“Financial institutions in the ECCU are relatively well developed” and the ECCU area “has experienced a sustained period of monetary and financial stability at least since 1976”** according to the Financial System Stability Assessment (FSSA) before the Board. My ECCB authorities agree. They also agree that “A solvent and liquid domestic banking system is fundamental to the maintenance of the ECCB's quasi-currency board arrangement, as well as for sustaining economic growth and development”. They welcome the recognition in the FSSA [summary Box, 1st page] that “there is continuing confidence in the financial system”. The ECCB, however, accepts that theirs, as any other financial system, harbors some weaknesses and faces some risks – and are in general agreement with the recommendations of the FSSA [Box 1, page 8], which are summarized in Box 8 of the Staff Report.
10. However, they have fundamental differences with some interpretations of “Threats to Financial Stability” as presented in the Executive Summary of the FSSA, and difficulties with their tone which, precedent to publication, require amendment to accord with the

findings in the FSAP background documents. The following examples indicate the basis for some of those differences and difficulties:

- *“The financial sector showed signs of stress ... including ... uncertain quality of capital in **many** indigenous banks”* [Staff Report: Box 8, page 33] draws on the accompanying FSSA paper which says [Paragraph 6, page 6] that *“the quality of capital of **a few** indigenous banks is uncertain”*. The underlying fact is that the capital of two of the region’s 18 locally-incorporated banks is impaired by virtue of holding non-performing government debt. These two banks represent **5.8 percent** of the ECCU banking system’s assets – with the issue, for the larger of the two, in course of resolution through Dominica’s ongoing debt-restructuring. The inference of a threat to financial stability via “uncertain quality of capital” does not seem justified.
- *“The financial system, especially the indigenous banks, is under stress ... [because of] unacceptably high levels of nonperforming loans”* [FSSA: Paragraph 6, page 6]. It is true that NPLs “on the books” are high. They are high because administrative and legal difficulties associated with foreclosure in the ECCU area delay the resolution of collateralized NPLs more than elsewhere. Potential losses on such NPLs *are already* provided for, in accordance with internationally-accepted provisioning guidelines. The inference of a threat to financial stability via “unacceptably high” NPLs does not seem justified.
- The FSSA [Page 6] refers to *“Lack of contingencies to deal with deposit withdrawals and capital flight”* as a risk to the area’s financial system. Appropriate powers to deal with systemic problems *are* provided in the Agreement establishing the ECCB under the “Special Emergency Powers of the Bank”. Under the Agreement, where the ECCB *“is of the opinion that inter alia the interests of depositors or creditors of a financial institution are threatened, the Bank (ECCB) shall, in addition to any other powers conferred on it, have power to inter alia*
 - i. *take all steps it considers necessary to protect the interests, and to preserve the rights of depositors and creditors of the financial institution.*
 - ii. *provide such financial assistance to the financial institution as it considers necessary to prevent the collapse of the financial institution”*The inference of a threat to financial stability via risk associated with lack of powers to respond to systemic problems does not seem justified.

And the staff has pointed the way towards realizing the third essential ...

11. My authorities note the range of opportunities that the staff advocates pursuing. They appreciate the comprehensive (and candid) statements of the strategies which are appropriate to harness the identified opportunities. They particularly note the calls for:

- Private sector initiatives to complement public measures in creating an enabling investment environment;

- Concerted regional action to reduce (fiscally-based) vulnerabilities, including the possibility of more binding fiscal rules;
- Deeper structural reforms to stimulate growth;
- Greater regional cooperation within the OECS and CARICOM, both to harness the potential of specialization and scale economies, and to roll back unproductive competition between the region's individual members;
- Enhanced competitiveness and increased economic diversification;
- Social safety nets adequate to facilitate economic restructuring; and
- Strengthened institutional capacity to deal with – unfortunately recurrent – natural disasters.

12. The economic situation in the ECCU region remains challenging, although the return to growth and recent fiscal improvement have been encouraging. Much still needs to be done and efforts to intensify economic reforms, increase international competitiveness and sustain growth will continue. In this context, my authorities undertake to give the foregoing strategies their fullest consideration. They also anticipate that the conclusions of a study on growth and competitiveness in the Caribbean by the World Bank, expected to be completed later this year, will point to further opportunities and strategies for progress.