INTERNATIONAL MONETARY FUND

Staff Country Reports

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Eastern Caribbean Currency Union: 2005 Article IV Consultation—Staff Report and Public Information Notice on the Executive Board Discussion 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 2005 Regional Surveillance, prepared by a staff team of the IMF, following discussions that ended on April 28, 2005, 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 June 27, 2005. 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 July 13, 2005 discussion of the staff report that concluded the discussion of regional surveillance.

The document listed below will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

EASTERN CARIBBEAN CURRENCY UNION

Staff Report for the 2005 Regional Discussions

Prepared by the Western Hemisphere Department

(In consultation with other departments)

Approved by Ratna Sahay and Matthew Fisher

June 27, 2005

- **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 territories of the United Kingdom, Anguilla and Montserrat. They share a common central bank, the Eastern Caribbean Central Bank (ECCB) and a common currency, the Eastern Caribbean (EC) dollar, which has been pegged to the U.S. dollar at the rate of EC$2.70 per U.S. dollar since July 1976. All six Fund members of the ECCU 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 considerable need for improvement in several key areas to facilitate more effective surveillance.
- **Previous Board Discussions**: Executive Board discussions on the ECCU were held on May 5, 2004 (together with the Article IV consultations on St. Vincent and the Grenadines and St. Lucia) and in an informal seminar on November 15, 2004 (together with the Article IV consultations on Antigua and Barbuda and St. Kitts and Nevis, and an ENDA request for Grenada).
- **Key Issues**:
    - The region is facing a number of key challenges: raising growth potential, adapting to a changing world environment including the erosion of trade preferences, strengthening fiscal positions and lowering public debt levels, and reducing vulnerabilities by improving financial sector supervision and developing contingency plans for unanticipated exogenous shocks.
    - Progress is being made in several countries—fiscal consolidation is being sustained in Dominica under a PRGF-supported program, Antigua and Barbuda has announced an ambitious fiscal reform agenda including civil service retrenchments and the reintroduction of a personal income tax, and St. Kitts and Nevis has announced the closure of the sugar industry which will ease fiscal pressures and release valuable resources to enable more rapid private sector growth.
    - The pace of fiscal consolidation remains slow, development strategies need to place more emphasis on private sector growth by strengthening the investment climate, implementing regional initiatives, raising the effectiveness of financial sector supervision, and enhancing the relevance of the fiscal benchmarks.
- **Discussions**: A staff team comprising at various stages R. Sahay (Head), D. O. Robinson, P. Cashin, J. Chai, P. Mishra, P. Njoroge (all WHD), and G. Fernandez (MFD) held discussions with the prime ministers, other senior government officials, private sector participants, and members of civil society and the media in each of the six ECCU Fund member countries, as well as the ECCB, the Caribbean Development Bank (CDB), the Organization of Eastern Caribbean States (OECS), and regional donors based in Barbados. Discussions were held during a number of missions during February–April, with the concluding meeting and an ECCU-wide press conference held at the ECCB on April 28. K. Lynch and C. O'Loghlin (OED) participated in key discussions.

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ACRONYMS

ASYCUDA—Automated System for Customs Data
CaPFA—Caribbean Public Finance Management Association
CARICOM—Caribbean Common Market
CAR—Capital Adequacy Ratio
CARTAC—Caribbean Regional Technical Assistance Center
CAS—Country Assistance Strategy
CBA—Currency Board Arrangement
CCLEC—Caribbean Customs Law Enforcement Council
CDB—Caribbean Development Bank
CET—Common External Tariff
CIDA—Canadian International Development Agency
CIT—Corporate Income Tax
CPI—Consumer Price Index
CSME—Caribbean Single Market and Economy
DFID—Department for International Development, United Kingdom
EC—Eastern Caribbean
ECCB—Eastern Caribbean Central Bank
ECCU—Eastern Caribbean Currency Union
ENDA—Emergency Assistance for Natural Disasters facility
EU – European Union
FAD—Fiscal Affairs Department
FATF—Financial Action Task Force on Money Laundering
FDI—Foreign Direct Investment
FSAP—Financial Sector Assessment Program
FSSA—Financial System Stability Assessment
FTAA—Free Trade Area of the Americas
FX—Foreign Exchange
GDDS—General Data Dissemination System
GDP – Gross Domestic Product
GNDI—Gross National Disposable Income
GNFS—Goods and Non-Factor Services
GNP—Gross National Product
GNI—Gross National Income
HDI—Human Development Index
ICT—Information and Communications Technology
IDA—International Development Association
IDB—Inter-American Development Bank
IFI—International Financial Institution
NC—National Currency
NIS—National Insurance Scheme
NPL—Nonperforming Loan
ODA—Official Development Assistance
OECD—Organization for Economic Co-operation and Development

OECS – Organization of Eastern Caribbean States. Includes the British Virgin Islands in addition to the eight members of the ECCU.
PRGF—Poverty Reduction and Growth Facility
REER—Real Effective Exchange Rate
RGSM—Regional Government Securities Market
SATAP—Structural Adjustment and Technical Assistance Project
SDR—Special Drawing Rights
STABEX—A system of export earnings stabilization set up by the European Union (EU) for the African, Caribbean, and Pacific (ACP) states.
UNDP—United Nations Development Programme
VAT—Value Added Tax
WDI—World Development Indicators
WIBDECO—Windward Islands Banana Development and Exporting Company
WTO—World Trade Organization

EXECUTIVE SUMMARY

Background

- **Living standards are high, reflecting a strong political emphasis on social outcomes**—adult literacy rates average more than 90 percent and average life expectancy is more than 70 years. The region has a strong democratic tradition and, with all political parties having their roots in the pre-independence labor movements, political mandates are tilted heavily toward achieving social objectives.

- **Economic growth has declined since the start of the 1990s as the region struggled to cope with a series of shocks**. Growth declined from nearly 6 percent per annum in 1980–89 to less than 3 percent per annum in 1990–2004. Growth slowed with the erosion of trade preferences for traditional agricultural products (bananas and sugar), a sharp reduction in official development assistance, and the September 11 attack in 2001.

- **Fiscal stances were relaxed in the second half of the 1990s in an attempt to raise growth rates, resulting in very high public debt levels in the region**. As the economies slowed down, public investments rose and the government was used as the employer of last resort. Public sector debt stocks averaged over 100 percent of GDP at end-2004.

- **While fiscal and growth outcomes began to strengthen in 2003, they have not been sufficient to steer public debt on a downward path**. Particularly worrisome are the widening of fiscal deficits in St. Lucia and St. Vincent and the Grenadines in anticipation of the World Cricket Cup in 2007 and ahead of elections. Debt levels can be expected to decline in 2005–06 if ongoing debt restructurings in three countries—Antigua and Barbuda, Dominica, and Grenada—are successfully completed.

- **Confidence in the regional quasi-currency board arrangement (CBA) remains high**. Foreign exchange reserve coverage is substantially above the legal requirement and there have been no obvious periods of pressure on the exchange rate or the banking system.

- **Absent an enforceable fiscal discipline mechanism, the regional CBA has induced a free-rider problem that is exacerbated by spending spikes associated with electoral cycles**. A system of fiscal benchmarks was introduced in 1998 (to be observed by 2007) but fiscal outcomes have steadily deteriorated relative to these benchmarks—in 2004, it is estimated that two countries met one of the four benchmarks, and the other four countries met none.

- **The region is among the most vulnerable in the world to natural disasters**. Measured in terms of natural disasters per square mile, all the ECCU member countries rank in the top ten in the world. During 2004, the region was hit by Hurricane Ivan—causing damage estimated at 200 percent of GDP in Grenada—as well as an earthquake in Dominica.

Policy discussions

- **There has been increasing recognition and public debate of the difficult economic challenges facing the region in the past year**. Economic issues have featured prominently in recent elections—fiscal mismanagement in Antigua and Barbuda, the Fund-supported program in Dominica, and the very high public debt in St. Kitts and Nevis. Authorities are stepping up outreach efforts to build consensus for reforms.

- **Key steps are underway in the most indebted countries to address the economic imbalances, but the pace of fiscal consolidation should be accelerated**. The positive near-term growth outlook provides an opportunity for tightening the fiscal stance. Fiscal consolidation is underway in Dominica, Grenada, and Antigua and Barbuda. In St. Kitts and Nevis the closure of the loss-making sugar industry has been announced. However, these measures are not sufficient to reduce high debt stocks.

- **Ensuring the consistency of fiscal policies with the CBA is key to preserving macroeconomic stability**. Incentive compatible mechanisms at the regional or country level need to be introduced to contain fiscal imbalances. At the very least, the effectiveness of the fiscal benchmarks should be enhanced through greater public dissemination and the setting of interim annual or quarterly targets.

- **The announced further erosion of preferential trade arrangements and declining ODA flows increase the transition cost of declining traditional sectors**. While bananas and sugar no longer contribute substantially to GDP, they remain important sources of rural employment and incomes. Following the closure of the sugar industry in St. Kitts and Nevis, planning and funding of a transition strategy is needed. The banana-growing economies (Dominica, St. Lucia, and St. Vincent and the Grenadines) are looking to sustain production, but interventions are needed to provide a safety net to displaced workers and encourage diversification.

- **The investment climate should be strengthened and regional co-operation enhanced to stimulate growth and competitiveness**. Significant growth potential exists, but its realization will depend upon efforts to remove distortions created by the tax concession regime, increase the flexibility of labor markets, and improve the efficiency of public utilities. Greater integration of product and labor markets and the collective provision of government services could yield large-scale economies.

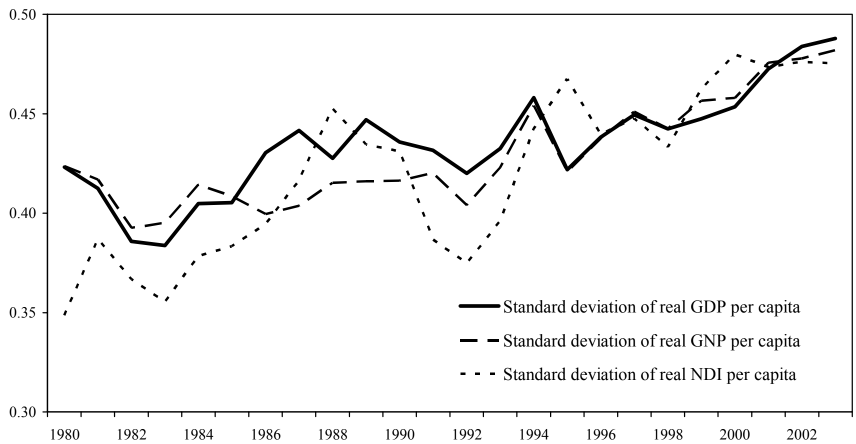
- **Given the region's vulnerabilities, increased efforts to mitigate the potential impact of adverse shocks are warranted**. This should include strengthened disaster mitigation and preparedness efforts, and the development of contingency plans.

- **Financial supervision should also be strengthened to contain potential risks**. The approval of legal amendments to the Uniform Banking Act would enhance prudential supervision, and increased recourse to on-site inspections would enhance the effectiveness of banking supervision.

I. A Brief Perspective

1. **The ECCU economies are small middle-income countries with strong social indicators, but living standards differ across the islands**. Despite the close ties from sharing a common currency, there is considerable divergence in per capita incomes. Moreover, reflecting limited regional integration, the cross-country dispersion of per capita GDP, GNP, and GNDI (gross national disposable income, which includes net current transfers from abroad) has increased through time.[1] Recorded poverty levels are relatively high, but this may reflect in part the use of nationally-defined poverty lines that are high by international standards, as well as weaknesses in available data.

ECCU: Standard Deviations of Real GDP, Real GNP and Real NDI Per Capita, 1980-2003



Sources: Eastern Caribbean Central Bank; World Bank, WDI; and Fund staff estimates.
Note: Real GDP, Real GNP, and Real NDI per capita are in logarithmic form.

ECCU Countries: Social and Demographic Indicators

	Antigua & Barbuda	Dominica	Grenada	St. Kitts & Nevis	St. Lucia	St. Vincent & the Grens.	ECCU
Population (thousands) in 2003, estimate	79	71	104	47	161	106	567
Poverty headcount index, 2000 1/	12	33	32	31	25	38	29
HDI rank (2004), rank out of 177 countries	55	95	93	39	71	87	...
Life expectancy (years), 2003	75	77	73	72	74	73	74
Adult illiteracy rate (percent), 2001	13	4	6	2	10	11	8
Mortality rate, infant (per 1000 live births), 2003	11	12	18	19	16	23	17
GDP at market prices, 2004 (in US$ million)	815	282	437	404	762	404	3,105
Share in nominal GDP, 2004	26.3	9.1	14.1	13.0	24.6	13.0	100
GDP per capita (US$) in 2004, estimate	10,375	3,962	4,205	8,647	4,748	3,801	5,473

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

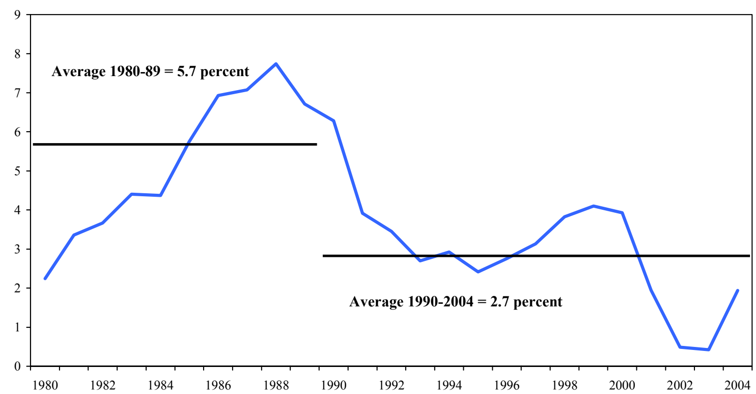
1/ Percentage of population living below each country's locally-defined poverty line in 2000.

[1] See "Macroeconomic Fluctuations in the Eastern Caribbean Currency Union" by P. Cashin and P. Wang, Chapter I in *Eastern Caribbean Currency Union—Selected Issues*.

2. **A strong emphasis on social outcomes is a reflection of the political landscape, where most parties have their roots in the pre-independence labor movements**. Democracy is deep-rooted in the region, with elections typically held every 4–5 years and active opposition parties in most countries. Political mandates, irrespective of the party in power, are heavily tilted towards achieving social goals—reducing unemployment and raising living standards.

3. **Economic growth has declined since the start of the 1990s as the region struggled to cope with a series of shocks**. Shocks of a more permanent nature included the erosion of trade preferences for traditional exports (bananas and sugar) and the decline of offshore financial sectors in 2000, after the inclusion of most ECCU countries in FATF's list of "noncooperative jurisdictions." In addition, the region suffered a steep decline in world tourism following the events of September 11, 2001. Longstanding structural rigidities, notably in the labor market, and continued disruptions in the aftermath of hurricanes and other natural disasters also served to constrain growth.

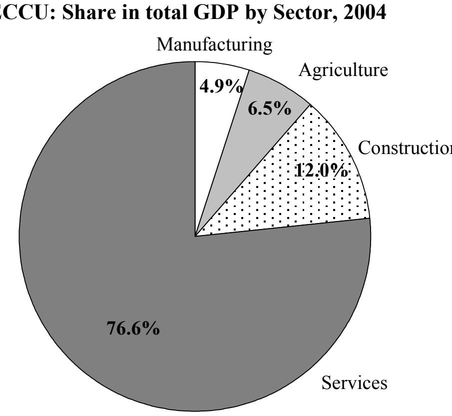
ECCU: Real GDP Growth, 1980-2004
(Annual percentage change, 3-year moving average)



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

4. **The economies of ECCU countries are now dominated by services—particularly government, tourism and financial**. The share of agriculture in GDP declined from 15 percent of GDP in the mid-1980s to about 6½ percent at end-2004, reflecting the effects of the erosion of trade preferences. Tourism and financial services have grown, but so has the government sector, which has often served as the employer of last resort during economic downturns.

ECCU: Share in total GDP by Sector, 2004

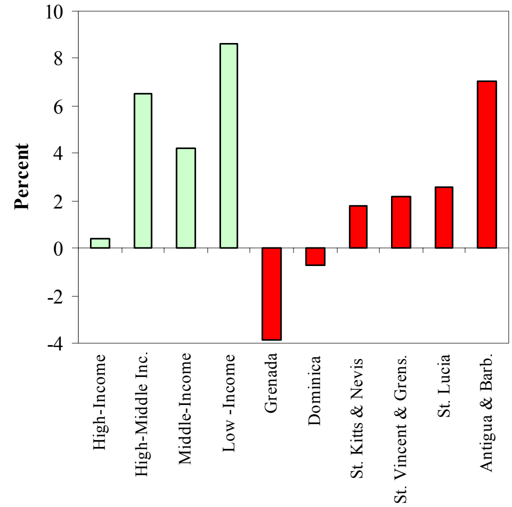


Sources: Eastern Caribbean Central Bank; and Fund staff estimates.

5. **The ECCB operates a quasi-currency board arrangement (CBA) that has preserved exchange rate and price stability and fostered financial development, despite external shocks and domestic policy slippages.** The ECCB has operated with a high degree of independence in managing the CBA: lending to member jurisdictions has been kept well

within statutory limits and external reserve coverage is substantially in excess of the legal floor of 60 percent of demand liabilities. There have been no obvious periods of pressure on the EC dollar, and inflation remains in the low single digits, reflecting the very high import content of the consumption basket. The financial sector is deep relative to other countries at similar levels of economic development. Reflecting the confidence in the CBA, foreign currency deposits are very low.

ECCU: Fiscal Policy Procyclicality 1/



Source: ECCU--Selected Issues, Chapter II.
1/ Calculated as the difference between average annual growth of central government real expenditure in good times (real GDP growth above median) and bad times (growth below median). Higher values are thus associated with greater procyclicality.

6. **The confidence engendered by the regional CBA and the development of domestic financial markets have enabled the region to increase their access to capital markets and use fiscal policy to temper economic downturns**. With the exception of Antigua and Barbuda, where access to capital markets has been restricted for many years, the countries in the region have been able to borrow during economic downturns and thereby limit the procyclical nature of fiscal policy that is common in most developing and emerging market economies.[2]

7. **Absent an enforceable fiscal discipline mechanism, the regional CBA has induced a free-rider problem that is exacerbated by spending associated with election cycles**.[3] In effect, the costs of fiscal slippages—in the form of anticipated future inflation, higher interest costs or pressures on the currency board—are being deferred to the future or shared with member governments. Indeed, fiscal outcomes have steadily deteriorated relative to the benchmarks approved by the ECCB's Monetary Council in 1998 (to be achieved by 2007),

ECCU Countries: Election Calendar

	Last election	Scheduled date of next election	Correlation between primary balance and closeness to election 1/
Antigua and Barbuda	March-04	2009	-0.15
Dominica	May-05	2010	-0.40
Grenada	November-03	2008	-0.13
St. Kitts and Nevis	October-04	2009	-0.08
St. Lucia	December-01	2006	-0.17
St. Vincent and the Grenadines	March-01	2006	-0.39
Other Caribbean countries:			
Fixed exchange rate regimes 2/			0.00
Flexible exchange rate regimes 2/			0.12

Sources: Eastern Caribbean Currency Union -- Selected Issues, Chapter IV.
1/ Based on elections since 1990.
2/ The number of Caribbean countries with fixed and flexible exchange rate regimes are three and nine, respectively.

[2] See "Islands of Stability? Determinants of Macroeconomic Volatility in the ECCU" by T. Rasmussen and G. Tolosa, Chapter II in *Eastern Caribbean Currency Union—Selected Issues.*

[3] The free rider problem is discussed in "Fiscal Policy in a Regional Currency Union" by R. Duttagupta and G. Tolosa, Chapter IV in *Eastern Caribbean Currency Union—Selected Issues.*

with just two countries meeting only one of the four benchmarks in 2004. Governments have granted wage increases, expanded civil service employment, and extended more concessions to both the public and the private sector in the run up to elections.

8. **Public debt to GDP ratios throughout the region are amongst the highest in the world**. Four of the six countries feature in the ten most indebted emerging market countries, with public debt in the region averaging more than 100 percent of GDP since end-2002.

9. **While many of the challenges faced by the ECCU countries are similar to those of other Caribbean countries, they face additional constraints because of their small size.** The erosion of trade preferences has impacted traditional producers of sugar and bananas throughout the region. Natural disasters—hurricanes, earthquakes, tropical storms, floods, and crop diseases afflict many countries in the region. With the slowing down of growth in recent years, several countries have attempted to stimulate their economies through large public sector investments that have resulted in very high public debt to GDP ratios. However, the extremely small size of the ECCU economies limit the scope of economic diversification, raise the cost of providing government services, and magnify the effect of natural disasters more than in other Caribbean countries.

10. **The Fund has stepped up its work on the ECCU in response to the challenges facing the region**. There are three key elements to this approach. First, the analytical basis of staff's advice has been deepened, as reflected in the *Selected Issues* papers accompanying the regional discussions for 2004 and 2005. Second, to increase policy coordination, common regional themes are developed and discussed with senior policymakers in each of the countries, as well as with key regional institutions. This approach is strengthened by staff visits to individual countries during budget preparations and the annual Article IV consultation discussions. Finally, several types of outreach activities are ongoing to help build ownership of reforms—a conference on the Caribbean region co-organized last year by the Central Bank of Trinidad and Tobago and the Fund received wide attention.[4]

[4] The paper "Stabilization, Debt, and Fiscal Policy in the Caribbean," presented by staff at the conference was widely covered by the media and its key messages cited in budget speeches and parliamentary debates. This paper was subsequently issued as an IMF Working Paper (WP/05/26).

ECCU: Compliance With Proposed Central Government Fiscal Guidelines 1/

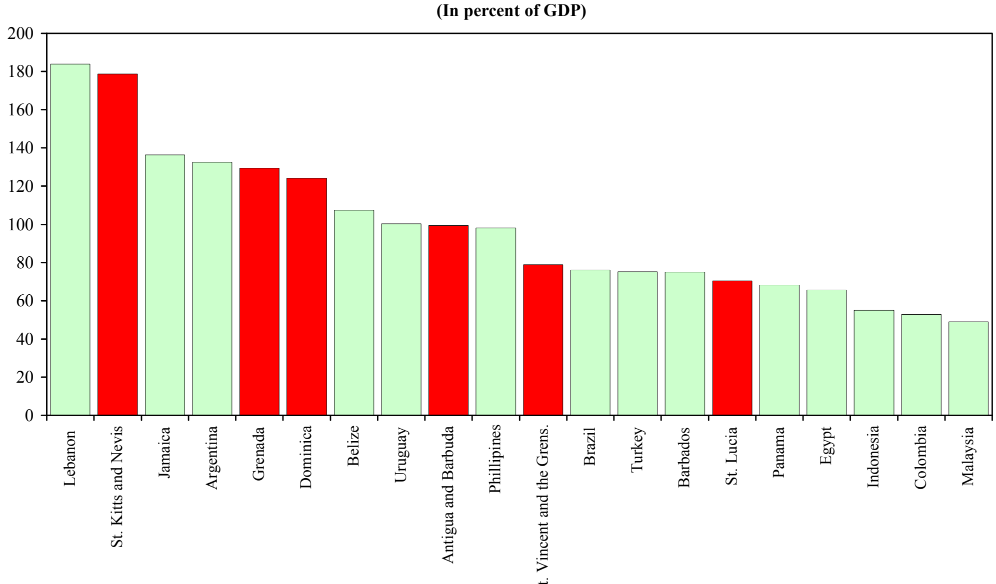
(In percent of GDP, unless otherwise indicated)

Convergence Criteria	Antigua and Barbuda	Dominica	Grenada	St. Kitts and Nevis	St. Lucia	St. Vincent and the Grenadines	
	Status of Implementation of Guidelines in 2004 by Country						
Current balance (saving) (guideline: 4 to 6 percent of GDP)	**-3.1**	**0.4**	**-2.4**	**-1.2**	**3.3**	**3.1**	
Overall balance (guideline: greater than or equal to -3 percent of GDP)	**-4.6**	**-2.5**	**-2.8**	**-11.5**	**-4.7**	**-3.4**	
Government and government guaranteed debt outstanding 2/ (guideline: less than or equal to 60 percent of GDP)	**99.4**	**115.0**	**129.4**	**178.7**	**70.5**	**78.9**	
Debt service payments 3/ (guideline: less than or equal to 15 percent of current revenue)	**126.4**	**38.0**	**40.4**	**34.0**	**18.6**	**19.3**	
							Total
Number of guidelines met in 2004	0	1	1	0	0	0	2
Number of guidelines met in 2003	0	1	0	0	0	2	3
Number of guidelines met in 2002	0	0	0	0	0	1	1
Number of guidelines met in 2001	0	0	0	0	2	2	4
Number of guidelines met in 2000	0	0	3	0	3	2	8
Number of guidelines met in 1999	0	1	3	0	3	1	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.

Public Sector Debt in Highly-Indebted Emerging Market Countries, end-2004
(In percent of GDP)



Sources: IMF, World Economic Outlook; and Fund staff estimates.

II. Recent Economic Developments and Near Term Prospects

11. **Economic activity has accelerated since mid-2003—despite an active hurricane season in 2004—and, given the positive world economic outlook, near-term growth prospects appear strong.** Growth has been driven by construction and a rapid expansion in tourism, with most economies in the region now running at or close to potential (Figure 1). The impact of Hurricane Ivan on Grenada was severe (Box 1), but because damage to other ECCU countries was limited, growth in the region was just above 3 percent compared to a pre-Ivan projection of 4 percent. Given the positive outlook in the region's major tourism markets (the United States and the United Kingdom) and ongoing construction projects ahead of the 2007 Cricket World Cup, growth is likely to remain strong, at 3–3½ percent in 2005.

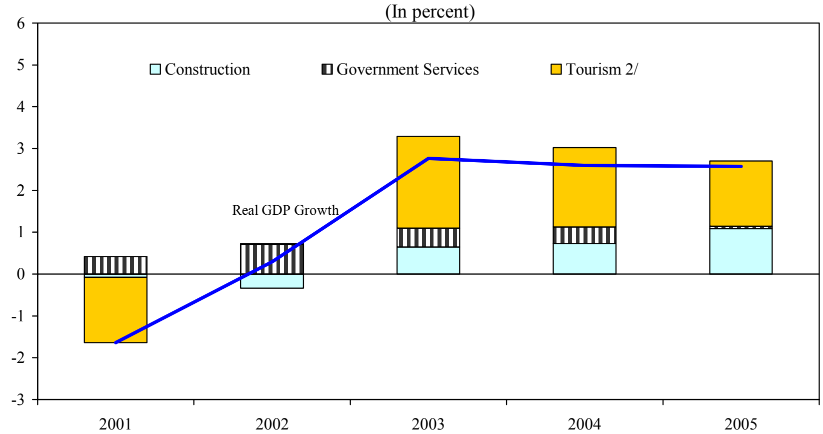
ECCU: Selected Economic Indicators, 2001-2005

	2001	2002	2003	Prel. 2004	Proj. 2005
National income and prices 1/	(Annual percentage change)				
Real GDP	-1.5	0.7	3.4	3.2	3.2
Consumer prices, end period	1.5	1.0	2.1	2.2	2.1
Real effective exchange rate 1/, 2/	1.5	-5.5	-8.8	-3.6	....
Public sector 1/	(In percent of GDP)				
Overall central government balance	-7.8	-10.9	-5.6	-4.9	-7.1
Primary central government balance	-4.2	-6.7	-1.0	-0.4	-2.5
Total public debt (end-of-period)	89	109	109	106	108
	(In percent of GDP)				
External current account balance	-18.1	-20.4	-21.4	-17.3	-19.4
Stayover tourist visitors (annual percentage change)	-5.0	1.3	9.9	10.1	8.8
Gross international reserves of the ECCB (In U.S. dollar, millions)	446	505	540	632	679
External reserve coverage (in percent of monetary demand liabilities)	92.9	97.1	95.3	96.2	....

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

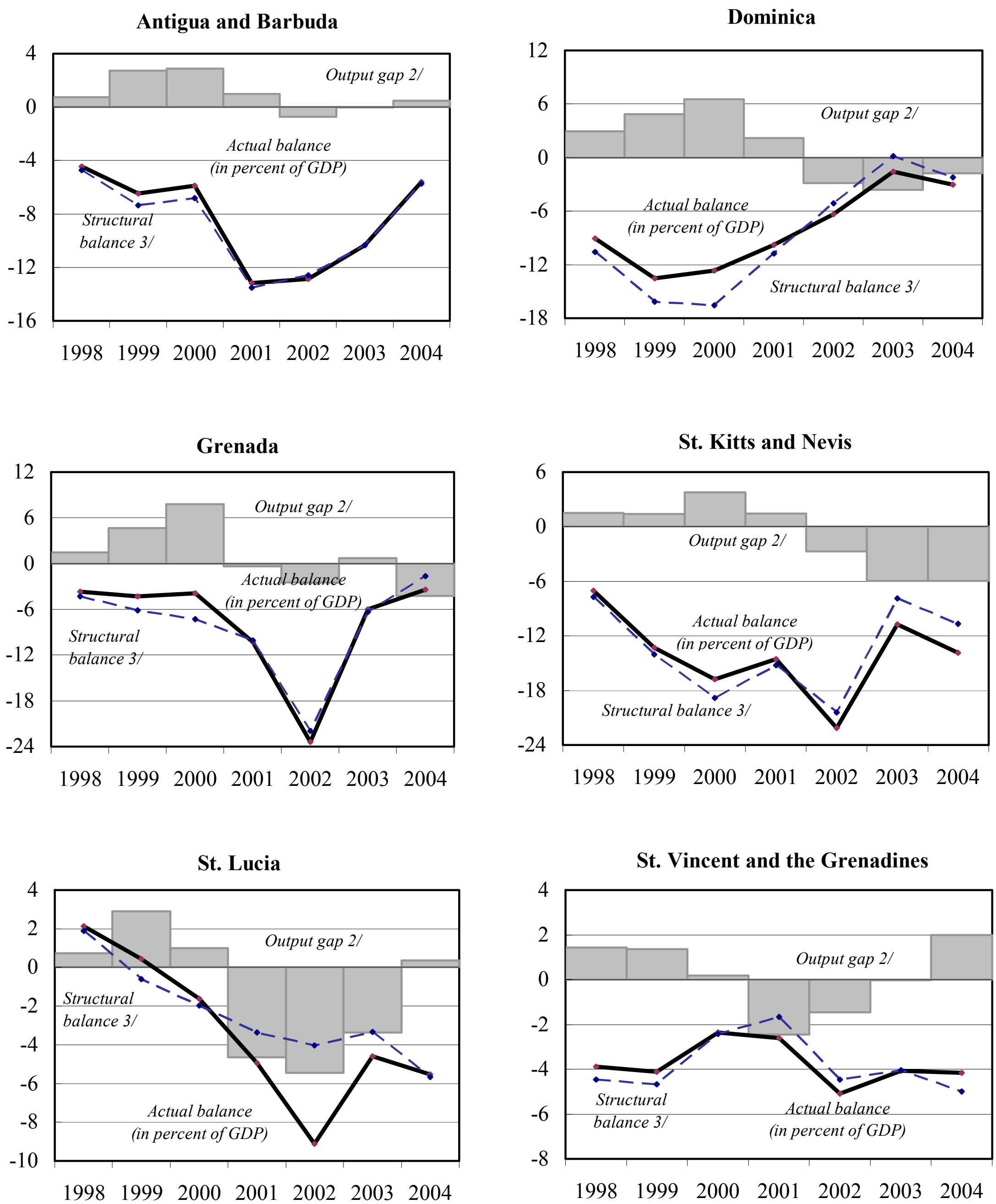
1/ Excludes Anguilla and Montserrat.
2/ End-of-period (depreciation -), 1990=100.

ECCU: Contribution to Real GDP Growth by Sector 1/
(In percent)



Sources: Eastern Caribbean Central Bank; and Fund staff projections.
1/ Excludes Anguilla and Montserrat.
2/ Includes wholesale and retail trade, hotel and restaurant, air transport, and half of local transport.

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



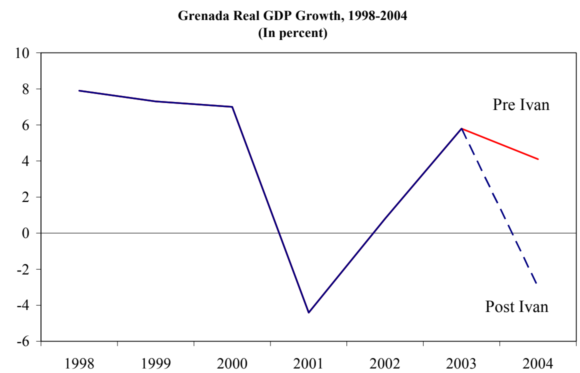
Sources: ECCU country authorities; Eastern Caribbean Central Bank; and Fund staff estimates.

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.

Box 1. Grenada: Impact of Hurricane Ivan



On September 7, 2004, Hurricane Ivan—one of the strongest storms ever in the Caribbean—passed directly over Grenada causing extensive destruction. Damage was estimated at US$900 million, or more than 200 percent of GDP. Nearly 90 percent of the housing stock was damaged or destroyed, all education facilities had to be closed, and the electricity supply was significantly disrupted. The economy was also hit hard as most tourism facilities suffered considerable damage, and nutmeg plantations, which produce the principal export commodity, were largely destroyed. GDP growth which had been projected to reach over 4 percent in 2004 is now estimated at −3 percent, while the unemployment rate increased by at least 8 percentage points to more than 20 percent in the immediate aftermath of the hurricane. The banking system has proven to be resilient—deposits have risen as households received insurance payments and transfers from abroad—but profitability has declined significantly as loan loss provisioning rose sharply.

With external help, the government quickly stabilized the economic and social situation. Security and utilities were restored early and schools reopened gradually. Emergency relief supplies and reconstruction support were provided by the regional and international community and bilateral donors, as well as by nongovernment organizations.

The reconstruction effort is underway, but the arduous task of recovering fully from the shock will persist over the medium term. An Agency for Reconstruction and Development has been established to help in the recovery and reconstruction. At two donors' conferences last year in Washington, D.C. and Grenada respectively, pledges of US$150 million (one-third of GDP), including over US$25 million in budgetary support, were marshaled. Grenada also purchased SDR 2.93 million (25 percent of quota) in November 2004 under the Fund's emergency assistance policy for natural disasters (IMF Country Report 04/405: http://www.imf.org/external/pubs/ft/scr/2004/cr04405.pdf). Reconstruction of schools and the housing stock, and revitalizing agriculture, are ongoing. However, continued fiscal adjustment and further support from donors and creditors will be needed over the medium term to reconstruct the economy and close the large projected financing gaps.

12. **The rebound in tourism helped to narrow the external current account deficit in 2004, but it remained large—at 17 percent of GDP—financed mostly by foreign direct investment (FDI)**. In the past two years, tourist arrivals have increased sharply with the easing of the global security concerns, the rebound in growth in the world economy, and the depreciation of the U.S. dollar against major currencies that has improved competitiveness in European markets. Imports continued to increase in relation to GDP, partly reflecting an increase in current transfers (largely to Grenada), which more than offset a modest decline in FDI flows. The external current account deficit is likely to widen marginally to 19 percent of GDP in 2005, mostly financed by capital inflows to finance investment, particularly construction activity.

13. **Fiscal outcomes strengthened modestly in 2004**. After a sharp adjustment in 2003, central government primary balances in the region improved modestly by ½ percent of GDP, but remained marginally in deficit. This reflected significant increases in primary balances in both Antigua and Barbuda—as the new administration attempted to contain fiscal imbalances—and in Grenada—where public sector investment was curtailed sharply. Fiscal positions were eased in the rest of the region, notably in St. Kitts and Nevis ahead of the elections. The pace of fiscal consolidation has been relatively slow and structural deficits have widened in four countries (see Figure 1).

14. **Significant fiscal reforms are underway in several countries, but fiscal positions are likely to weaken in 2005, particularly if approved budgets are fully implemented**. Approved budgets—even assuming that the implementation rate for capital expenditures will be at historical levels—would imply a deterioration of about 2 percent of GDP in fiscal outcomes for the region as a whole. However, important measures are being introduced in a number of countries that will strengthen fiscal positions over the medium term—civil service retrenchments and the overhaul of the tax system in Antigua and Barbuda, the ongoing fiscal consolidation in Dominica, efforts to strengthen revenues in Grenada, and the announced closure of the sugar industry in St. Kitts and Nevis. Both St. Lucia and St. Vincent and the Grenadines are due to hold elections no later than 2006, and the approved budgets suggest easing of fiscal stances, particularly in St. Lucia.[5] The deterioration in the primary balance could be contained to ½ percent of GDP if additional measures, recommended during bilateral discussions with country authorities, are adopted.

15. **Public debt remains at a very high level—at an average of 106 percent of GDP at end-2004—although progress has been made in reaching agreements with creditors on debt restructuring in three countries** (Box 2). The strengthened fiscal outcomes and the revival of growth in 2003–04 have not been sufficient to steer public debt to GDP ratios on a downward path. Going forward, the public debt to GDP ratio in St. Lucia and St. Vincent and the Grenadines—countries with relatively lower debt levels—can be expected to rise in 2005, as fiscal policies are relaxed in anticipation of the elections. On the other hand, successful implementation of the ongoing debt restructuring in Antigua and Barbuda, Dominica, and Grenada will help bring down the regional debt burden. In St. Kitts and Nevis, the authorities anticipate substantial privatization proceeds over the next few years from the disposition of large holdings of government assets, including sugar lands which cover a wide area of St. Kitts.

[5] The approved 2005/06 budget in St. Lucia foresees a primary deficit of 8.8 percent of GDP, a deterioration of 7.5 percent of GDP relative to the projected outcome for 2004/05. The loosening in the fiscal position is driven by a doubling of public sector investment to 16 percent of GDP as well as an across-the-board reduction in tax receipts and increases in current expenditures.

Box 2. Public Debt Restructuring in ECCU Countries

Antigua and Barbuda. After taking office in March 2004, the newly elected government initiated a dialogue with creditors with a view to regularizing relations—most loans have been in arrears for many years. A major step included an agreement with the Italian Government to clear US$196 million debt (one-third of external debt) through a bullet payment of US$18.5 million. A Debt Coordinating Committee was formed in mid-2005, with representatives from the public and private sectors, to facilitate this process.

Dominica. The authorities embarked on a cooperative restructuring strategy in late-2003. A debt exchange was launched in April 2004 and, as of end-May 2005, creditors—official and private—holding over 70 percent of eligible debt have agreed to the restructuring. The authorities continue to make good faith efforts to reach understandings with creditors who have not yet agreed to participate in the restructuring, and have committed to making payments into escrow accounts on restructured terms for such creditors.

Grenada. Following Hurricane Ivan, the authorities announced in early October 2004 their difficulty in servicing their debt in full and their intention to seek a cooperative solution with creditors. Following missed interest payments on external bonds in December 2004, Grenada was downgraded to "selective default" by Standard and Poor's. The government is maintaining a dialogue with creditors. Financial and legal advisors are assisting the government in designing its strategy and a creditor committee has been formed. The official creditors are also being contacted but the process has become complicated with the severance of diplomatic relationship between Grenada and its largest official creditor, Taiwan Province of China.

16. **Inflation has been stable and monetary aggregates have been expanding rapidly, reflecting continued growth in the demand for money and confidence in the banking system and the CBA**. Broad money grew 9½ percent in 2003 and 13½ percent in 2004, but inflation remained at around 2 percent. The modest uptick in inflation from the early 2000s (when inflation was about 1½ percent) can be largely traced to the direct and indirect effects of rising global energy prices. External reserve coverage of monetary demand liabilities at the ECCB has risen to over 96 percent.

17. **The brisk growth of deposits and weak credit growth, particularly to the private sector, has left the banking system highly liquid**. Deposit growth has been driven by the strengthening economy, continued large social security surpluses, the floor established by the ECCB on the savings deposit rate (set at 3 percent since September 2002), and a lack of alternative savings instruments. Liquidity has been increasingly channeled into government securities, with typically substantial oversubscription for issues floated in the Regional Government Securities Market (RGSM). Private sector credit growth has been slow, with the bulk of new loans related to real estate.

18. **Progress continues to be made in strengthening the institutional framework for financial sector supervision and in developing broader capital markets**. The ECCB has prepared revised prudential guidelines on capital adequacy, risk-based supervision, and corporate governance standards in line with some of the recommendations of the ECCU regional FSAP completed in 2004, though needed amendments to the Uniform Banking Act

have not been enacted in any country.[6] Capital markets have continued to develop, particularly the RGSM which has become a key regional market—only Antigua and Barbuda and Dominica have yet to place issues.[7] The number of equities listed on the Eastern Caribbean Securities Exchange has continued to increase, but trading activity remains low. The ECCB has also supported the development of the Eastern Caribbean Home Mortgage Bank, the Eastern Caribbean Unit Trust, and the Eastern Caribbean Enterprise Fund.

III. Policy Discussions

A. Overview

19. **In the past year, regional and country authorities have increasingly recognized the difficulty of their economic situation, which has weakened further by new shocks**. As underscored in previous regional and Article IV consultation discussions with individual countries, the region is facing many external and domestic challenges. In addition, the region was hard hit by natural disasters during 2004: in September, Hurricane Ivan inflicted widespread destruction in Grenada and, to a lesser extent, St. Vincent and the Grenadines; and Dominica experienced an earthquake in November that registered 6.0 on the Richter scale. For Grenada and St. Vincent and the Grenadines, damage inflicted by Hurricane Ivan amounted to over 200 and about 5 percent of 2003 GDP, respectively; for Dominica, the estimated damage caused by the 2004 earthquake was about 7 percent of 2004 GDP. Moreover, oil prices have risen sharply and are expected to rise further.

20. **The dialogue between Fund staff and the regional and national authorities has deepened, with the most indebted countries taking distinct steps to confront their challenges**. The authorities agreed that reducing debt levels was a top priority for the region: progress is being made in Dominica under the ongoing PRGF arrangement; in Grenada in designing the reconstruction and macroeconomic stabilization strategy; in Antigua and Barbuda in addressing the deep fiscal and macroeconomic imbalances; and in St. Kitts and Nevis with the announcement of the closure of the sugar industry.[8] However, the

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[6] Progress on approving the draft amendments to the Uniform Banking Act has varied: they have been gazetted in St. Kitts and Nevis and the first reading has taken place in the Parliament in Antigua and Barbuda. In Grenada and Dominica, the first reading is expected to take place soon. Little progress has been made in the remaining two countries. The FSSA for the ECCU region is available at: http://www.imf.org/external/pubs/ft/scr/2004/cr04293.pdf .

[7] At end-May 2005, debt securities valued at US$134 million (4 percent of 2004 regional GDP) were listed on the RGSM, of which half were issued by St. Lucia.

[8] A few months prior to the announcement of the closure of the sugar industry, the authorities had organized a conference, widely attended by the private sector, trade unions, and the media, on the future of the industry. Fund staff presented a macroeconomic analysis of the industry, quantifying the losses, examining the impact on the fiscal and debt positions, and highlighting the opportunities foregone of sustaining the sector.

longstanding macroeconomic stability under the CBA has made it difficult to instill a sense of urgency in the public of the need for substantial policy adjustments, and there is a clear sense of complacency that such stability will continue going forward.

21. **The Fund is increasingly viewed as a valued advisor and a catalyst for donor support in the region, but the appetite for formal Fund-supported programs remains limited**. The authorities throughout the region appreciated the increased emphasis given to regional issues as well as the focus on growth and vulnerabilities—particularly high public debt levels, natural disasters, and repercussions of declining official assistance. They indicated that the long-term Fund engagements in Guyana and Jamaica were seen in a negative light by their populations, making it politically difficult for countries to request formal Fund arrangements. Staff noted that implementing and sustaining good policies with public support would be key to success, with or without a Fund-supported program.[9]

22. **Ensuring the sustainability of ongoing reforms and initiating new ones will require further strengthening of outreach efforts with civil society.** Staff noted the active discussions on political and social topics in the media, but expressed concern about the relative paucity of informed debates on economic issues. Many countries in the region are stepping up their outreach efforts through town hall meetings, public policy debates, regional conferences, and press conferences, including by the ECCB and at the conclusion of Fund missions.[10] Indeed, recent elections in the region have focused on economic issues—fiscal management in Antigua and Barbuda, the IMF program in Dominica, and debt in St. Kitts and Nevis. Regarding the staff's outreach efforts, the authorities took note of the recent initiatives, but pointed out that the Fund was still behind the World Bank in terms of the resources devoted to such activity.

23. **Discussions focused on a wide range of policy challenges, embracing three broad themes**:

- *Adjusting to a changing world environment and reinvigorating growth:* in particular, confronting continued erosion of trade preferences and declining official development assistance flows, raising competitiveness, changing the role of the public sector, removing labor market rigidities, adapting the investment climate and maximizing the

[9] The staff has been collaborating closely with the World Bank in elaborating the reform agenda, as well as with CARTAC, which continues to provide extensive technical assistance in implementing key reforms.

[10] For the first time, a joint press conference at the conclusion of the ECCU regional discussions was held at the ECCB and was livecast simultaneously to the press in all eight ECCU member jurisdictions (including Anguilla and Montserrat, the two non-Fund member territories of the United Kingdom). In addition, drafts of *Selected Issues* papers prepared in the context of the ECCU regional discussions were presented in every country and were actively discussed by the authorities and the wider public in some countries.

benefits of migration flows to support new growth opportunities, and regional cooperation and integration;

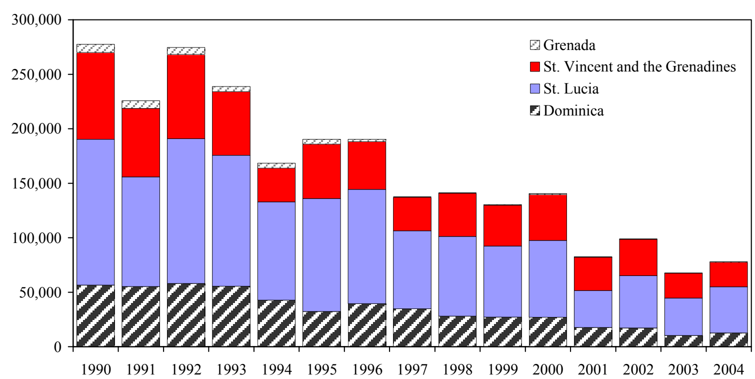
- *Addressing fiscal imbalances and the large stock of public debt*, through fiscal consolidation, active debt management, and divestment of public assets; and
- *Managing the region's high vulnerability to shocks*, in particular: natural disasters, a narrow export base, and potential contagion through the financial system.

B. Adjusting to a Changing World Environment and Reinvigorating Growth

The changing world environment

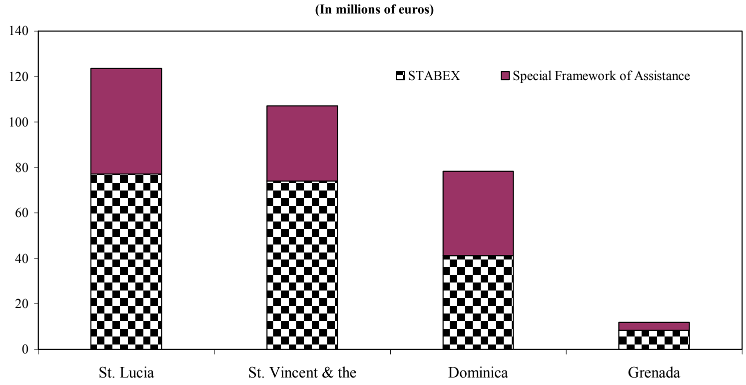
24. **Preferential trading arrangements that support traditional sectors—bananas and sugar—have been steadily eroding since the 1990s**. While these sectors have long since ceased to be a key contributor to value added or export earnings, they continue to be a vital source of rural employment in the banana-producing countries—Dominica, St. Lucia, and St. Vincent and the Grenadines—and in St. Kitts and Nevis, which has traditionally produced sugar. The staff noted that the countries face substantial costs of maintaining the sectors going forward, while the annual income transfers derived from quota rents (stemming from the sale of bananas and sugar at above world market prices) will continue to decline. Staff supported the temporary use of measures to facilitate the transition away from these sectors—such as income transfers to farmers, and retraining programs. Following the closure of the loss-making sugar industry, the Government of St. Kitts and Nevis has established a committee, with donor support, to design a transition strategy including a land use management plan, land sales, and retraining programs for labor shed from the industry. The authorities in the banana-growing countries, however, saw

Windward Islands Banana Exports, 1990-2004
(In Tonnes)



Source: Windward Islands Banana Development and Export Company.

Banana-Producing Windward Islands:
Assistance from the European Union, 1993-2004
(In millions of euros)



Source: European Union, Delegation of the European Commission in Barbados and the Eastern Caribbean.

opportunities for a continuation of the sector, although they acknowledged that continued support would be needed to enhance the efficiency of producers. They also expressed concern about the uncertainty created by the announcement of impending changes in the banana regime by the European Union.

25. **Foreign aid flows to ECCU countries have fallen sharply in recent years**. While aid from OECD countries has waxed and waned with the timing of natural disasters in the region, overall official assistance has remained roughly constant in U.S. dollar terms since the mid-1970s, implying a significant decline in real terms and relative to GDP. The authorities noted that the reduced availability of grants—as well as, in some cases, the loss of access to concessional financing sources—had significantly impacted the economies and contributed directly to the rising public debt burdens seen throughout the region.

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

	Average 1977-1997	Average 1998-2003
Antigua and Barbuda	3.0	1.7
Dominica	17.0	8.0
Grenada	10.2	3.4
St. Kitts and Nevis	6.8	3.2
St. Lucia	5.7	3.2
St. Vincent and the Grenadines	10.3	3.7
ECCU	8.8	3.8

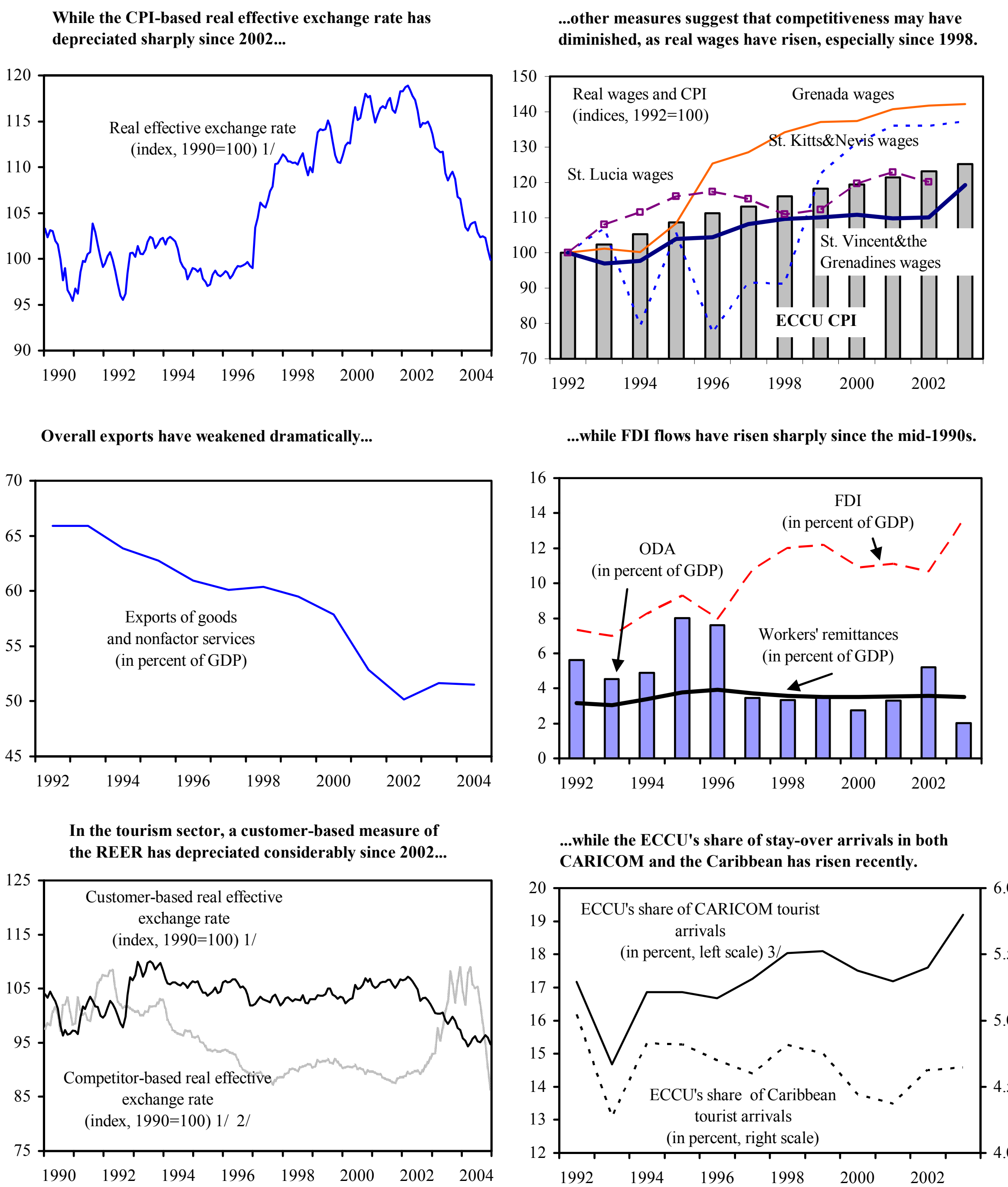
Sources: Organization for Economic Cooperation and Development; Eastern Caribbean Central Bank; and Fund staff estimates.

26. **Indicators of competitiveness present a mixed picture, but with the depreciation of the U.S. dollar since 2002, the economies have become more competitive** (Figure 2). While real wages in some countries have grown rapidly, traditional measures of the real effective exchange rate (REER) have fallen sharply since end-2001, and are currently below the level of the early 1990s. Both customer-based (reflecting demand-side influences) and competitor-based (reflecting supply-side factors) measures of the REER have declined recently.[11] Indeed, tourist arrivals—both in absolute terms and as a share of the Caribbean Common Market (CARICOM)—have increased sharply since 2002.

27. **The authorities agreed that competitiveness needed strengthening, but stressed that this should be achieved through fiscal and structural reforms.** The authorities noted

[11] The customer-based real effective exchange rate index is a weighted average of CPI in a common currency, with the weights being the country-specific share of tourists arriving from each ECCU country's three largest country sources (in most cases, the United States, the United Kingdom, and Canada). The competitor-based real effective exchange rate index is a weighted average of CPI in a common currency, with the weights being the share of tourist arrivals to the specific competitor country (for example, the Dominican Republic). The derivation of these series is described in P. Cashin, P. Njoroge and P. Rodriguez (2004), "Competitiveness in the ECCU: Measures of the Real Exchange Rate," *Eastern Caribbean Currency Union—Selected Issues*, IMF Country Report No. 04/335.

Figure 2. ECCU: External Competitiveness, 1990–2004



Sources: Eastern Caribbean Central Bank; Caribbean Tourism Organization; ECCU country authorities; ECCU National Insurance Schemes; and Fund staff estimates.

1/ An increase (decrease) indicates an appreciation (depreciation).

2/ The sharp movements in the competitor-based real exchange rate in 2002-04 were largely driven by the Dominican Republic's peso.

3/ Total tourist arrivals of CARICOM in 2003 does not include those of Haiti and Suriname.

that there was full confidence in the exchange rate peg, which had contributed substantially to macroeconomic stability. They observed that the peg had withstood natural disasters, the erosion of trade preferences, the September 11 shock to tourism, political cycles, the fiscal deterioration and debt build-up, and the slowing down of growth. The underlying challenge was viewed as one of raising productivity levels, and that this should not be addressed through a change in the exchange rate peg. The staff broadly concurred with this assessment. An adjustment to the peg would be unlikely to yield significant benefits, due to the high level of pass-through of imported prices to domestic ones, the significant foreign currency component of public debt, the potential weakening of the financial sector, and the low price elasticity of demand for tourism services. However, staff pointed out that maintaining the peg would require determined efforts to bring fiscal and debt positions to more sustainable levels, and to increase the flexibility of labor and product markets.

Constraints to growth

28. **Growth rates in the region in the past decade have been disappointingly low, relative to the high spending on physical and human capital** (Box 3). Robust growth in the 1980s was driven by high public investment financed by official assistance, preferential access for traditional exports, and the emerging tourism sector. In the 1990s, official assistance began to dry up, preferential access to markets started to erode, and the high initial growth spurt in tourism abated. With the slowdown of growth, ECCU governments responded by increasing public investments—financed by accessing external capital markets and tapping the fast-growing domestic financial sector—yet with disappointing growth outcomes.

29. **Higher public investment in recent years has not succeeded in raising growth rates**. Indeed, public investments rose at the same time that growth rates declined—this pattern was particularly visible in the 2000s. Moreover, since the mid-1990s, public expenditure has been reoriented away from economic infrastructure towards social sectors and general public services.[12] Country authorities indicated that much of the public investment had been either to replace capital or protect the population following the series of natural disasters that hit the region in the second half of the 1990s, or to put in place needed infrastructure—such as international airports—without which tourism could not have expanded.

30. **Public projects in recent years have been adopted with little oversight by governments, donors, or financing agencies**. Staff recommended that large public investment programs be cutback or reprioritized towards those that are complementary to private sector development. In addition, an overhaul of the legislation and systems governing the contracting, management, and disclosure of public investment and debt, including contingent liabilities, should be undertaken. The process of strengthening public sector

[12] See World Bank (2005), *Towards A New Agenda for Growth: Organization of the Eastern Caribbean States*.

Box 3. Are Growth Rates in the ECCU Too Low?

Simulation analyses show that the per capita real GDP growth rates in the ECCU have been lower than expected based on cross country comparisons. Barro (1991) uses variations in initial per capita income, human capital and government consumption to explain growth rates across a wide number of countries. Levine and Renelt (1992) use, in addition to Barro's variables, investment and population growth as additional determinants of growth. Table 1 presents predicted per capita growth rates for the ECCU countries using these models and compares them to the actual experience. The results are striking—with one exception; realized growth rates are lower than predicted by either model for any of the ECCU countries. Overall, the ECCU growth rates forecast by the Levine-Renelt equation are much higher (and consequently the difference with the realized rates larger) than those predicted by Barro's equation—highlighting the fact that investment, which is very high in the ECCU, has not been productive.1/

Table 1. Actual and Predicted Annual Per Capita Growth Rates (1990-2003)

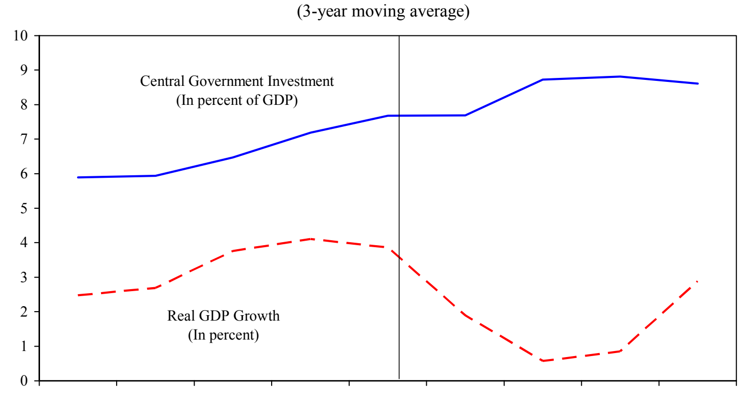
	Realized	Predicted	
		Barro	Levine-Renelt
Antigua	2.8	3.8	5.8
Dominica	1.4	2.7	5.9
Grenada	2.1	2.2	6.4
St. Kitts and Nevis	2.7	4.6	9.5
St. Lucia	0.9	3.5	4.2
St. Vincent and the Grenadines	3.1	2.0	5.8
ECCU	2.2	3.1	6.3

1/ Barro, R. J., 1991, "Economic Growth in a Cross-Section of Countries," *Quarterly Journal of Economics*, Vol. 106, pp. 407–443. Levine, R. and D. Renelt., 1992, "A Sensitivity Analysis of Cross-Country Growth Regressions," *American Economic Review*, Vol. 82, pp. 942–963.

investment programs has begun with the help of CARTAC and, at the initiative of the ECCB, debt management workshops have been held at the Fund and in St. Kitts and Nevis.

31. **Realizing the region's growth potential will require a paradigm shift away from the public sector as the main engine of growth toward strengthening the investment climate.** While the authorities agreed that the private sector should take the lead in stimulating growth, they expressed disappointment at the lack of initiative by local entrepreneurs. Staff pointed out that the private sector faced several hindrances, in particular labor market rigidities, skill shortages, a distortionary tax

ECCU: Central Government Investment and GDP Growth
(3-year moving average)



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

regime, a weak regulatory environment in several areas, and limited regional integration, and stressed the role of the public sector in addressing these hindrances.

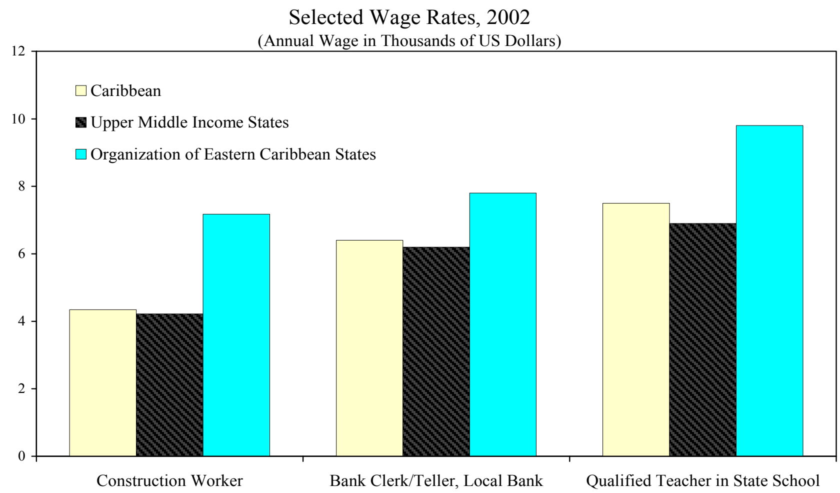
32. **Labor market rigidities in the ECCU are high and are reflected in relatively high wages in the face of high unemployment**. Wage rates across different categories of skills in the ECCU are significantly higher than in other Caribbean countries and upper middle income countries. While data are scanty, available evidence points to skill mismatches relative to the needs of the region, low access to tertiary education and job training, high unemployment, predominance of public sector, strong labor unions, significant cost in hiring and firing workers, and relatively low intra-regional mobility.

Indices of Labor Market Flexibility 1/

	Rigidity of Employment	Difficulty of Hiring	Difficulty of Firing	Firing Costs
Organization of Eastern Caribbean States	22	23	40	59
Other Micro States	7	8	5	15
Upper Middle Incomes States	28	27	22	38

Source: *Towards a New Agenda for Growth: Organization of Eastern Caribbean States,* World Bank, (2005).

1/ Index range is from 0 to 100, higher values indicate greater rigidity.



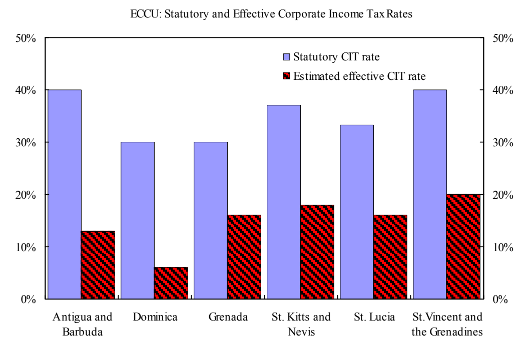
Source: *Towards a New Agenda for Growth: Organization of Eastern Caribbean States*, World Bank, (2005).

33. **Shortages in skilled labor are reported by both public and private sectors as the key constraint to enhancing efficiency and competitiveness throughout the region**. Staff recommended raising the quality of education, reorienting education and training programs to better suit the needs of the region, undertaking civil service reform, introducing performance and productivity based wage increases, and allowing freer movement of labor among islands. While the authorities generally agreed with these recommendations, some pointed out that labor codes precluded introducing procedures to link wages to performance, and productivity could not be measured accurately owing to data constraints. Several countries are setting up new training centers in hospitality services to better serve the tourism sector.

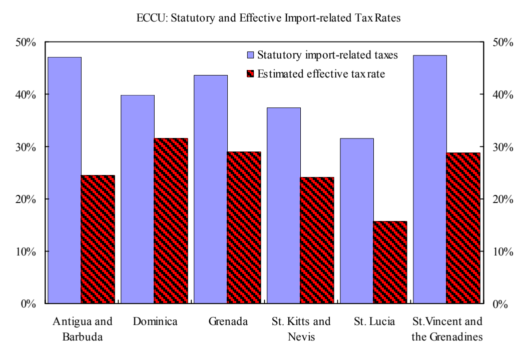
34. **To attract FDI, the ECCU region has relied primarily on costly fiscal incentives (or tax concessions)**. In the authorities' view, tax concessions had contributed strongly to growth. Staff noted that while FDI had remained significant, it had come at the expense of large fiscal losses (forgone customs revenue alone equivalent to 4–12 percent of GDP) and a distorted, nontransparent, and administratively burdensome investment regime (Box 4). Moreover, a World Bank survey of firms operating in the region indicated that fiscal

Box 4. Tax Concessions in the ECCU[1/]

Tax concessions have been used extensively by ECCU member countries in an attempt to promote private investment and support social objectives. Concessions for investment in sectors such as tourism and light manufacturing, have generally been provided through tax holidays and import duty exemptions. Agriculture and fisheries have often been exempted from taxes on investment and inputs. Also benefiting from concessions have been the government, statutory bodies, utilities, and nongovernmental organizations, such as churches.



Considerable discretion has been applied in the granting of concessions. Available data from Dominica and St. Vincent and the Grenadines show that investment-related concessions account for nearly 50 percent of total customs duty concessions, whereas concessions granted by discretionary Cabinet decisions account for about 20 percent.



Revenue losses from concessions are large, and have increased significantly in two countries. Estimated effective corporate income tax rates are about 40 percent of the statutory rates, and account for revenue losses of 3–6 percent of GDP per year. Effective import-related tax rates are about 60 percent of the statutory rates, and account for revenue losses of 4–12 percent of GDP per year. In Antigua and Barbuda and in St. Kitts and Nevis, concessions rose sharply over the past decade.

Table. ECCU: FDI Performance Index 1/

	1979–83	1984–88	1989–93	1994–98	1999–2003
Antigua and Barbuda	24.1	12.3	11.4	3.5	2.6
Dominica	2.5	8.0	10.9	8.8	2.3
Grenada	1.8	7.1	8.5	6.2	5.3
St. Kitts and Nevis	12.3	16.4	19.2	7.0	8.4
St. Lucia	37.4	10.8	12.1	4.9	2.3
St. Vincent and the Grenadines	3.0	5.0	7.7	14.5	4.0
ECCU	16.0	11.7	11.7	8.1	4.3
Small island economies	7.0	8.9	7.6	6.7	8.2
Latin America and the Caribbean	1.8	1.5	1.4	2.0	1.6
Developing countries	1.4	1.2	1.4	1.8	1.2

Sources: World Investment Report 2004 and IMF staff estimates.

1/ Performance index is the share of a country's FDI inflow in the world's FDI inflow, divided by the share of the country's GDP in the world's GDP.

The benefits in terms of increased foreign direct investment (FDI) appear to have been limited. While FDI as a share of GDP remained significant or even rose in some countries, the FDI performance of the ECCU countries *relative to the rest of the world*, declined sharply in the mid- to late-1990s. A preliminary empirical analysis suggests that tax concessions played a very limited role in attracting FDI. Instead, the key factors attracting FDI are good governance, a generally low and broad-based corporate tax regime, and the absence of FDI restrictions.

[1/]This box is based on "Tax Concessions and Foreign Direct Investment in the ECCU" by J. Chai and R. Goyal, Chapter V in *Eastern Caribbean Currency Union—Selected Issues*.

incentives were given a low weight in attracting FDI, ranking 16th of the 40 identified determinants of the investment climate.

35. **While all country authorities voiced their concerns regarding the pressures they faced from neighboring countries in granting concessions, opinions differed on where to draw the line**. Some considered that the investment climate should be strengthened in other ways and tax concessions reined in to protect tax bases and reduce distortions facing domestic investors. Others considered the existing system of tax incentives to be broadly appropriate, arguing that in their absence investment—and, therefore, employment and tax revenues—would be significantly lower. Staff noted that regardless of where the line was drawn, there was room for improving transparency (by eliminating the granting of discretionary concessions and publishing the cost of all concessions granted in a tax expenditure annex to the budget), and limiting the size, duration, and scope of statutory concessions.[13] To encourage investment, tax credits for investment, accelerated depreciation, and loss carrying forward provisions could be considered.

36. **Staff recommended additional steps to strengthen the investment climate:**

- *Revamping the regulatory framework*. Complex and cumbersome laws and amendments in tax and custom administration preclude the effective monitoring and collecting of taxes. Greater efficiency can be achieved by stepping up e-government, reducing trade barriers, and allowing greater competition in domestic markets, including by eliminating remaining state monopolies for distribution of imported goods. The regulatory framework for utilities, energy, and transport services need to be strengthened to attract private investment and promote competition and efficiency.

- *Improving infrastructure*. While access to basic infrastructure to the general population is high, the reliability, quality, and costs to the productive sector need to be improved further. Maritime transportation is irregular, vessels are in poor condition, and freight and port costs are high.

[13] In Dominica, the Cabinet has decided to publish tax concesssions granted from July 2005 onwards.

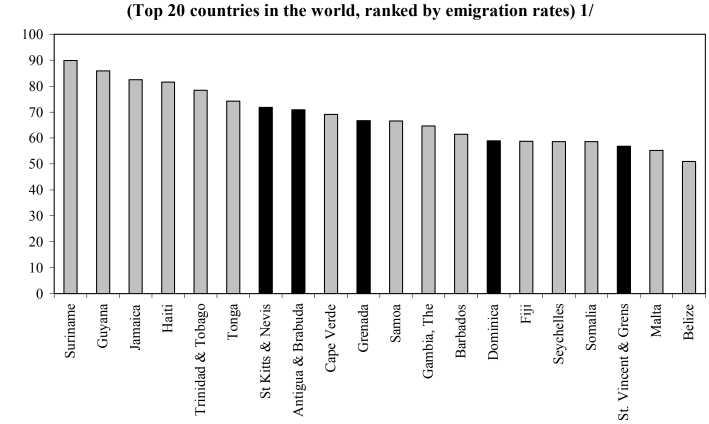
- *Building private sector capacity*. Private sector activity can be encouraged by donor financing of feasibility studies, providing information on best practices, supporting business incubators, and creating the right incentives for firms to train and innovate. In addition, governments could pool resources for seminars and roundtable discussions with foreign and local businesses for exchanging ideas, information, hearing concerns and attracting investments.

Growth opportunities

37. **Notwithstanding the lackluster growth performance in the past decade, considerable growth potential exists in the ECCU region**. A recent World Bank study identifies significant growth potential in niche products based on the geographical location, natural beauty, the rich culture, and the English-speaking population.[14] These areas include diversification of tourism activities, increasing interlinkages between tourism and the agriculture and other sectors of the economy, offshore education, information and communications technology (ICT) enabled products and services, health and wellness activities, and offshore financial services.

38. **High migration from the region has created a large diaspora that represents a potential source for investment and entrepreneurial skills**.[15] Staff noted that emigration rates were among the highest in the world—during 1970–2000, between 40 and 70 percent of the skilled labor force had emigrated.[16] This large-scale emigration has produced a steady flow of remittances, but it is unclear if emigration has been a net benefit as it has drastically lowered domestic stocks of human capital and entrepreneurial skills. The authorities agreed that high emigration rates had contributed to the shortage of skills, but noted that it was inevitable given the limited range of opportunities available on small

Percent of Skilled Labor Force that has Migrated to the OECD, 1970-2000
(Top 20 countries in the world, ranked by emigration rates) 1/



Source: Eastern Caribbean Currency Union—Selected Issues, Chapter VI.
1/ Skilled are defined as having more than 12 years of completed schooling.

[14] *Towards A New Agenda for Growth: Organization of the Eastern Caribbean States*, The World Bank (2005).

[15] See "Emigration and Brain-Drain: Evidence from the Caribbean" by P. Mishra, Chapter VI in *Eastern Caribbean Currency Union—Selected Issues*.

[16] Some authorities noted that emigration in certain categories (teachers and nurses) was particularly high because of active recruitment efforts by some industrial country agencies.

islands. Staff recommended that contacts with the diaspora be enhanced in order to build networks for trade, investment promotion, and tourism. Some countries are already tapping the diaspora—Dominica, for example, is trying to formulate an explicit diaspora strategy based on input from Dominicans living abroad.

39. **While several initiatives in regional cooperation have met with success, there remains substantial scope for furthering this process** (Table 7).[17] Successes and ongoing initiatives include the stability provided by the common CBA, the broadening and deepening of regional capital markets, the common judiciary, centralized procurement of pharmaceuticals, the common diplomatic missions at the World Trade Organization (WTO), greater competition and cost reduction in telecommunications under the auspices of the Eastern Caribbean Telecommunications Authority, and addressing security issues under the Directorate of Civil Aviation. At the same time, staff pointed out that there remained considerable room for expanding collective provision of government services—for example in tax administration, debt management, evaluation of public investment projects, procurement, security, and regulatory environment for transport, energy and infrastructure.

40. **Regional integration initiatives in the ECCU have had limited impact in promoting trade and growth**. Many regional initiatives, such as free movement of labor and a free trade regime in services, are yet to be implemented, and a number of important exceptions to free trade in goods remain.[18] In addition, while the average tariff rate of CARICOM's Common External Tariff (CET) is fairly low at around 10 percent, effective protection for certain products is much higher due to the presence of exemptions in the regime as well as nontariff barriers—given the virtual absence of a manufacturing sector in the ECCU, the CET serves to support the larger CARICOM economies at the expense of consumers in the ECCU region. While intra-regional travel is permitted for limited duration or by those with specified skills, considerable barriers exist in most occupations, serving to reduce the aggregate pool of labor supply and magnify skill mismatches.

41. **The staff urged the speedy implementation of initiatives to foster closer economic integration both within the OECS and CARICOM**. The Caribbean Single Market and Economy (CSME), Free Trade Area of the Americas (FTAA), and the WTO offer opportunities for ECCU countries to integrate with the regional and global economy, and the staff encouraged the authorities to pursue regional integration vigorously as a stepping stone to greater integration at the global level. The authorities' views on the prospects for deeper regional integration of labor markets were mixed—some considered this a key mechanism for obtaining needed skills and, in many cases, formalizing the unofficial labor flows that already occur. Others expressed concern about higher local unemployment

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[17] The current status of regional integration initiatives, and labor and product market rigidities, are discussed in "Integration and Growth in the Eastern Caribbean" by M. Mlachila and W. Samuel, Chapter VII in *Eastern Caribbean Currency Union—Selected Issues.*

[18] For example, the so-called less developed countries in CARICOM, including those of the OECS, are allowed to impose licensing requirements and/or tariffs on products such as beer and flour.

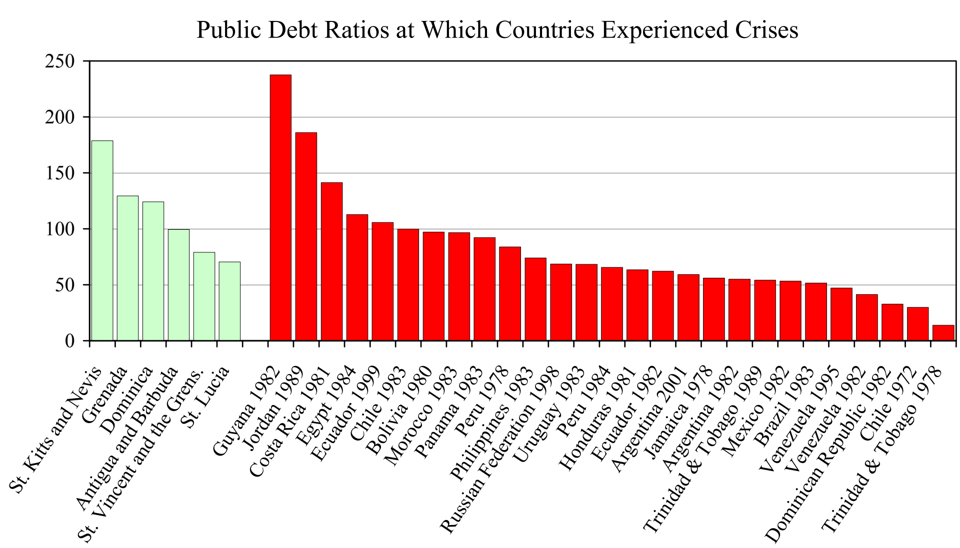
and the increased fiscal burden of providing social services to non-nationals—education, health, and social security.

42. **Increased regional cooperation could reduce tax competition and strengthen the region's negotiating position in dealings with large multinationals, but would be difficult to enforce**. In the area of concessions, a regional cooperative approach could prevent a "race to the bottom" as potential investors played off the islands against each other. Some regional agreements are already in place for statutory concessions—for example, the Harmonization of Fiscal Incentives to Industry Act which establishes similar statutory concessions in each island. However, the authorities noted that this is used as the starting point in negotiations by multinationals, with large investors insisting on more generous packages. The authorities also stressed that even if the ECCU countries coordinated their approach, they would face stiff competition from other neighboring islands. More generally, the authorities noted that their small size placed them at a significant disadvantage in negotiations with large multinational companies, which also had the support of strong lobbying groups in their home countries—a case in point is cruise ship tourism, where the cruise ship owners have been able to get the islands to compete against each other resulting in the bulk of the proceeds from this trade accruing to the cruise ship companies.

43. **To give regional integration renewed vigor, at the initiative of senior policymakers, a new treaty on economic union of the OECS countries was being considered**. The regional authorities noted that in view of the changing global environment and their desire to integrate within the OECS before integrating within the CARICOM, the current treaty needed to be revamped. This treaty would allow for a common approach to policymaking and institution building. Common legislative framework would be drafted for consideration by individual parliaments. So far, all national constitutions had been reviewed and needed amendments identified.

C. Fiscal Consolidation and Reduction of Public Debt

44. **Public debt levels in the region are very high, and in two countries, there still appears to be a lack of urgency in addressing the debt situations.** In St. Lucia and St. Vincent and the Grenadines, the two countries with lower public debts but with elections due during 2006, the



Note: Figures for the ECCU countries are public debt ratios as a percent of GDP in 2004. The remaining bars list middle income countries that underwent an adverse credit event during 1970-2001, as identified by Reinhart, Rogoff, and Savastano (2003), "Debt Intolerance," NBER Working Paper No. 9908, with the figures referring to public debt as a percentage of GNI in the year of the event.

approved budgets target a significant expansion in public sector investment. The authorities in St. Lucia and St. Vincent and the Grenadines view such investment as necessary to support growth, and they maintain that their fiscal imbalances are not worrisome given their relatively low levels of debt. The staff argued that there was no room for complacency as debt levels throughout the region—even in the lower debt countries—are significantly above the levels at which other countries had experienced either financial or exchange rate crises. The authorities noted that levels of debt tolerance in small economies appeared to be different from larger emerging market economies. They pointed to their excellent record (with the long-time exception of Antigua and Barbuda) of servicing their debt and continued access to capital markets as evidence of the markets' confidence. They also contended that unlike other highly indebted countries, large public debts had not discouraged FDI flows.

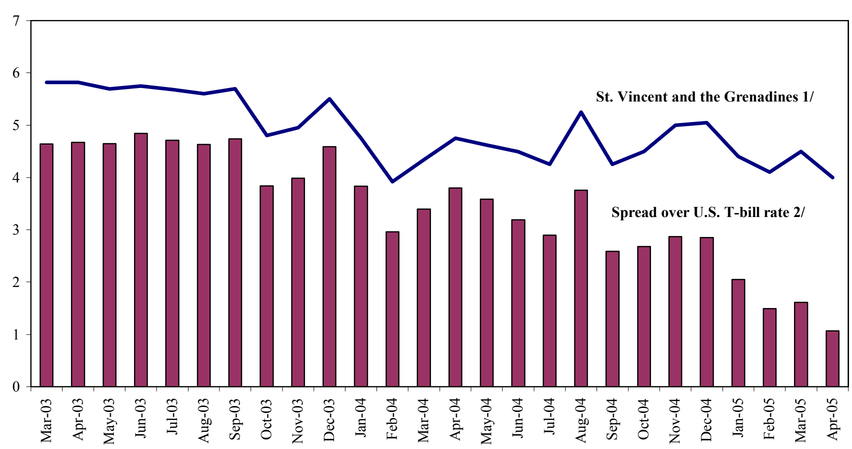
RGSM Auction Results, 2003-2005 1/
by type of instrument

	Average yield (in percent)	Oversubscription (in millions of EC)
2003		
91 day treasury bill	5.2	104
365 days treasury bill	6.0	4
2004		
91 day treasury bill	5.2	167
365 days treasury bill	5.3	23
5 year bond	5.8	26
6 year bond	6.0	5
10 year bond	7.0	62
2005		
91 day treasury bill	4.2	165
365 days treasury bill	4.5	24

Source: ECCB.
1/ Data for 2005 are through end-April.

45. **Staff noted that the continued access to capital markets enjoyed by most countries in the region, despite high and rising debt levels, reflected in part financial market distortions**. Demand for EC dollar assets—both bank deposits and government paper—appears to have been buttressed by the ECCB mandated floor on savings deposit rates and implicit restrictions on the asset portfolios of social security schemes. While this has resulted in lower debt service costs for some governments—in St. Vincent and the Grenadines, the interest spread has declined to only 100 basis points over U.S. treasury bills—this has been achieved at the expense of higher borrowing costs for the private sector. The artificially high levels of liquidity have also served to mitigate the potential role of the RGSM as a fiscal disciplining device. While interest rates do vary by creditor, with those countries with lower debt levels generally securing lower interest rates, the overall level of interest rates may not fully reflect the underlying riskiness of the securities.[19]

St. Vincent and the Grenadines: Interest Rate, 91-Day Treasury Bills, 2003-05
(In percent)



Sources: Eastern Caribbean Regional Government Securities Market; and U. S. Federal Reserve.
1/ March and May 2004 rates for St. Vincent and the Grenadines are interpolated.
2/ U. S. rate is interest rate on 13-week Treasury bills.

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[19] The infrequent issuance of securities by most countries and the lack of secondary market trading prevents the analysis of individual country risk premia.

- *Floor on savings deposit rates*. While initially introduced to protect depositors from a perceived lack of competition amongst deposit-taking institutions, the legislated floor on savings deposit rates may no longer be needed. Indeed, staff noted that the floor has limited the responsiveness of lending rates to changing liquidity conditions, thereby slowing the growth of private sector credit and discouraging locally-funded private sector investment. Staff encouraged the authorities to gradually remove the floor on deposits to reflect the true cost of funds and thereby eliminate the distortionary effect it has on the financial system. The authorities agreed that the floor could be withdrawn once financial markets were sufficiently well-developed, hence the question was just one of timing.

- *Concentration of the investment portfolios of the social security schemes in government securities*. Staff noted that large exposures to national and regional government securities imply a concentration of risk that should be reduced by greater diversification of the asset portfolios of social security schemes into instruments held outside the region. The authorities commented that in some countries there were no formal restrictions on the asset portfolios of the national social security schemes, and viewed the development of the RGSM as providing significant opportunities for risk diversification, particularly given the high rates of return available.

46. **The fiscal benchmarks approved by the ECCB's Monetary Council have not, to date, been sufficient to ensure the consistency of national fiscal policies with the CBA**. While the benchmarks are only to be achieved by 2007, staff noted that they appear to have had little impact on fiscal policies as fiscal outcomes have increasingly diverged from the targets since their introduction in 1998. The authorities argued that the deviations from the benchmarks had been deliberate policy decisions in response to shocks. Thus, the targets had not been ignored, but rather overtaken by other priorities. However, the authorities acknowledged that most benchmarks would not be achieved by the target date.

47. **Despite the large deviations, the authorities were unanimous that the fiscal benchmarks should not be eliminated**. However, opinions differed as to whether the targets needed to be modified: some country authorities saw moral hazard in changing the targets at this stage, while others saw benefit in revisiting the specification of the targets to ensure that they were realistic and corresponded to the needs and risks faced by the region. Several authorities believed that setting annual benchmarks that could differ across countries, depending on their starting conditions, could facilitate the achievement of targets, albeit at different points in time. In this context, staff recommended that the definition of debt should be clarified to include all public and publicly-guaranteed debt, rather than solely central government and government-guaranteed debt, as it would provide a more meaningful indicator of the magnitude of liabilities that the budget may have to sustain. In addition, the national authorities were encouraged to publish and widely disseminate performance relative to the established benchmarks on a quarterly or annual basis.

48. **There is little appetite for creating a supra-national authority to enforce the fiscal benchmarks**. The country authorities were uniformly opposed to any loss of sovereignty over national fiscal policies that would be implied by the creation of a supra-

national body. They also pointed to the experience in the Euro Area, where ensuring compliance with the fiscal targets remained a challenge despite the existence of such a supra-national body. Going forward, they considered that the most effective means for ensuring compliance would be peer pressure at the level of meetings of the prime ministers. At the technical level, they pointed out, mechanisms have recently been established with assistance from CARTAC—the SATAP (Structural Adjustment and Technical Assistance Project) program—to enable policymakers to set, monitor, and achieve the benchmarks. However, effective feedback from the SATAP units to the policymakers needs to be substantially strengthened.

49. **In light of the large public debt positions, staff urged that substantial fiscal consolidations be pursued on the basis of broadening the tax base, streamlining expenditures, and strengthening fiscal institutions**. Notwithstanding the authorities' efforts at restructuring their debt in an orderly manner, staff stressed that debt restructuring should not be viewed as a substitute for fiscal consolidation. Regarding specific measures, as statutory tax rates are already fairly high in the region, measures to broaden the tax base should be implemented, including reducing tax concessions, enhancing tax compliance, strengthening tax and customs administration, assessing property at market value for tax purposes, and introducing a broad-based consumption tax (or VAT). Consideration could be given to lowering the high marginal tax rate in the medium term, concurrent with the phasing out of tax concessions. On the expenditure side, staff emphasized civil service reforms to reduce the wage bill and over-employment in the public sector, but at the same time, allowing for greater wage differentiation to reflect skills and performance. In addition, there is a need to strengthen expenditure management systems, improve debt management, and reprioritize and monitor overly ambitious public sector investment programs. While many of these measures are already underway, civil service and tax concession reforms are not yet on the priority list—with the notable exceptions of Antigua and Barbuda and Dominica.

D. Living with the Region's High Vulnerability to Shocks

50. **The ECCU region faces significant vulnerabilities—many beyond the control of regional policymakers—posing challenges to economic management**. There are three principal sources of vulnerabilities:

- *Natural disasters.* Measured in terms of natural disasters per square mile, all the ECCU countries rank in the top ten in the world. The region is located in the Atlantic Basin hurricane belt that experienced 9 hurricanes and 14 tropical storms during 2004, with a similar number expected this year.[20] The region is also located on a geological fault line, producing occasional earthquakes—most recently in Dominica in November 2004.

- *Global economy*. The significance of tourism in the economies makes the region particularly vulnerable to the world business cycle and shocks to global security. The

[20] Professor William Gray, Colorado State University, USA. http://hurricane.atmos.colostate.edu/forecasts/.

region also imports all its oil and, given the very high debt levels, is susceptible to global capital market conditions.

- *Domestic or regional shocks*. Financial sectors have proven resilient to a broad range of shocks. However, the sources and nature of possible shocks are constantly evolving as financial sectors develop and cross-border linkages deepen, raising the risk of contagion.

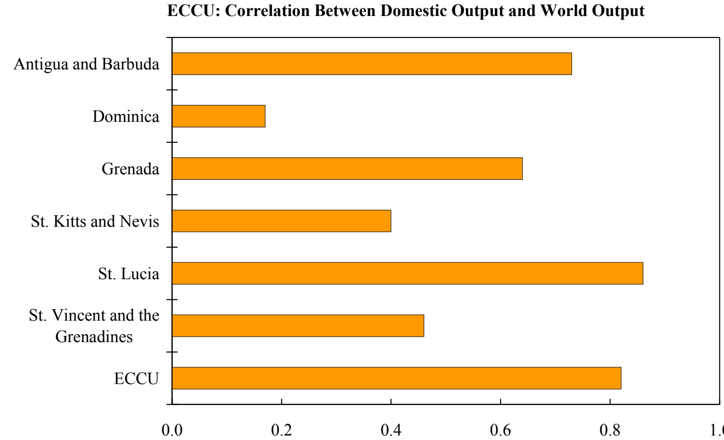
Natural disasters

51. **Natural disasters are a fact of life in the region, and efforts to both mitigate the impact of disasters and facilitate recovery should be stepped up**. While ECCU countries have invested in disaster risk mitigation activities (such as strengthening building codes) and in national and regional disaster response agencies, staff recommended that these efforts, and their enforcement, should be enhanced. Existing national and regional disaster contingency funds are inadequate, and traditional insurance markets in the Caribbean are characterized by relatively concentrated coverage, high prices and low-risk transfer (see the Annex).[21] Staff encouraged the authorities to work with multilateral agencies—particularly the World Bank and the Commonwealth Secretariat—in developing new schemes, such as regional insurance pools. The authorities noted that the devastation caused by Hurricane Ivan in Grenada had refocused their attention on these issues. In some cases, the coverage of publicly-insured infrastructure was being increased, but full coverage was not possible given the fiscal challenges facing the region. Several countries urged the international donor community to take a more proactive role by providing an ex ante pool of disaster relief funds to be used in an emergency, as well as grant financing for insurance of public infrastructure.

Global economy

52. **The emergence of tourism as the dominant sector in the region has created a significant dependency on the world business cycle and global security developments.** Growth in each of the countries is highly correlated with world output and, as seen in the aftermath of the September 11, 2001 attacks, a downturn in world output or world security

ECCU: Correlation Between Domestic Output and World Output



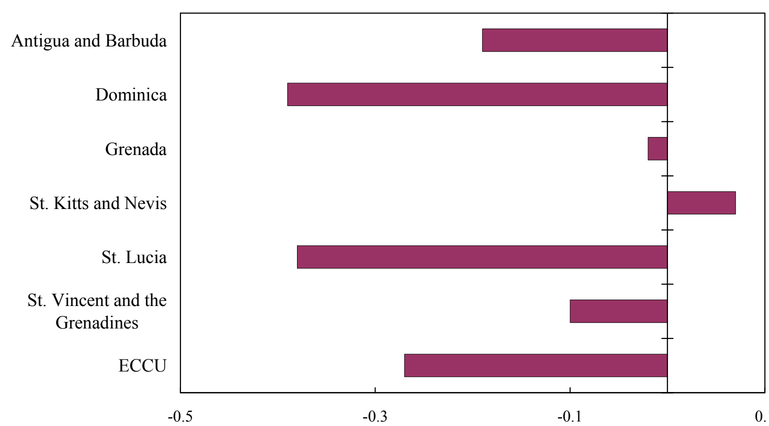
Source: Eastern Caribbean Currency Union—Selected Issues, Chapter I.

[21] The annex is based on "Government Responses to Natural Disasters in the Caribbean" by P. Cashin and P. Dyczewski, Chapter III in *Eastern Caribbean Currency Union—Selected Issues*.

could induce a recession throughout the region. The authorities were well aware of the risks stemming from the tourism sector, noting that the dependence is much greater now than when the economies were based on traditional agricultural sectors. Staff cautioned that options for diversification away from tourism and related linkages are limited, but ensuring diversity in the source country of tourists—through, for example marketing campaigns in various regions of the world as well as regionally—could reduce risks.

53. **The ECCU countries are heavily dependent on oil and energy imports, with some countries now exploring alternative energy sources**. The small size of the economies prevents the emergence of a competitive market in oil products, so that oil prices are tightly regulated throughout the region. In most countries, there is an explicit formula linking the retail price of oil to the imported price, but the retail price is adjusted only infrequently and in the past few years has been used to shield consumers from the full increase in oil prices. The infrequent price adjustments have served to limit the impact of oil price fluctuations on domestic output, but the cost is born by the budget in the form of reduced tax revenues as well as through a loss of efficiency in production, consumption, and distribution services. The staff urged increased flexibility in oil pricing—as in Dominica where oil price fluctuations are fully passed through to domestic prices. The authorities agreed that the fiscal burden of maintaining artificially low oil prices was substantial, but expressed concern about the social and growth consequences of permitting full pass-through. Several countries are examining options to harness alternative energy sources, such as geothermal energy.

ECCU: Correlation Between Domestic Output and Crude Oil Price



Source: Eastern Caribbean Currency Union—Selected Issues, Chapter I.

54. **The high debt ratios of ECCU countries make them particularly vulnerable to capital market conditions**. During the last year there has been a shift away from external financing towards increased reliance on domestic sources, in part reflecting the low interest rates available on the RGSM. Many of these placements have been at fairly short maturities, raising concerns as to rollover risk. Given that global interest rates appear likely to rise over the medium term, staff urged the authorities to prepare in advance for these adverse prospects

through improved debt management as well as the implementation of fiscal reforms to reduce debt levels.[22]

Domestic or regional shocks

55. **Financial markets have shown remarkable resilience to the many large shocks that have hit the region, but this resilience cannot be taken for granted going forward**. While banking systems in each country remain highly liquid and with reported capital positions above prudential norms, exposures to the government are high and NPLs are rising, pointing to the existence of significant vulnerabilities as confirmed by stress tests on the banking system (Box 5).

56. **Cross-border linkages are low but rising as regional capital markets develop**. As the volume of activity on the RGSM and other regional markets increases, the linkages among financial systems in the region will strengthen, potentially raising contagion risks. These linkages are currently small: holdings of other ECCU government securities are no more than 3½ percent of bank assets in any country; claims on other ECCU banks are higher as a share of assets but appear to be dominated by cross-border deposits between banks operating in different countries but sharing the same parent bank. Trade linkages are also very low.

ECCU: Cross Border Linkages

	Financial 1/		Trade/2
	Gross Claims on other ECCU Public Sectors	Net Claims on other ECCU Banks	Exports of goods to ECCU
	(in percent of bank assets)		(percent of GDP)
Antigua and Barbuda	0.6	-0.7	0.4
Dominica	2.8	14.8	3.5
Grenada	1.5	5.8	2.3
St. Kitts and Nevis	1.9	-5.9	0.4
St. Lucia	1.4	1.1	1.1
St. Vincent and the Grenadines	3.4	8.5	3.8

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

1/ December 2004
2/ Average, 1998-2004

57. **Enhancing the effectiveness of financial sector supervision will be key to containing potential risks**. While acknowledging the progress made in revising the ECCB's prudential regulations and in strengthening supervision over offshore financial centers, staff expressed concern that the enhanced prudential regulations were not fully effective, and that the number of on-site banking inspections conducted each year—an average of four institutions per year during 2000–04—should be raised. The authorities noted that the needed legislation to strengthen prudential regulations was proceeding through national parliaments but that this was a time-consuming process. In terms of the frequency of on-site inspections, the authorities argued that they conduct off-site inspections frequently and had sufficiently detailed information on banks and substantial contacts with those banks to be able to identify at an early stage any emerging problems. Regarding the regional FSAP's recommendation to transfer the power to revoke bank licenses from the national authorities to the ECCB, several

[22] The ECCB organized at end-April 2005 a seminar on debt management including both public and private sector participants from throughout the region that produced draft guidelines for debt management. A follow-up seminar on technical aspects of debt management is to be hosted by CARTAC later this year.

Box 5. Banking System Vulnerabilities

Financial soundness indicators provide a mixed picture of the health of the banking system. While measures of capital adequacy appear strong, nonperforming loans (NPLs) and exposure to the government are very high in some countries. Moreover, weaknesses in the legal frameworks in some countries for property disposal and lengthy court procedures contribute to persistently high NPL levels, for instance in Dominica and St. Lucia**.**

ECCU Banking System: Financial Soundness Indicators, December 2004 1/
(In percent)

	ATG	DMA	GRD	KNA	LCA	VCT
Capital adequacy 2/	13.0	23.0	14.9	36.5	18.0	8.9
NPLs/Total loans 2/	24.6	41.6	7.1	11.2	22.2	14.3
Gross government exposure/Total assets	12.0	11.4	11.3	27.6	13.0	20.7
Loans to households/Total loans	41.8	52.1	59.4	38.1	47.8	55.1
(Pre-tax) return on average assets	1.6	1.2	0.5	2.8	2.4	1.2
Liquid assets/Total assets	32.5	45.5	38.4	38.9	22.7	36.0
Total loans/Total deposits	75.0	57.5	57.6	75.6	80.7	71.2

Source: Eastern Caribbean Central Bank.

1/ ATG (Antigua and Barbuda), DMA (Dominica), GRD (Grenada), KNA (St. Kitts and Nevis), LCA (St. Lucia), and VCT (St. Vincent and the Grenadines).
2/ Indigenous banks.

Banking system vulnerabilities appear to be concentrated in locally incorporated banks. The exposure of local banks to the government amounted to 21 percent of total assets in 2004, about three times the level at foreign banks. While the capital adequacy ratio of locally incorporated banks was more than double the 8 percent prudential requirement, potential underprovisioning and sovereign risks could reduce that amount.

ECCU: Financial Soundness Indicators, end-2004
(In percent)

	Capital Adequacy 1/	NPLs/ Total Loans 2/	Provisioning/ NPLs 2/	Provisioning/ Total Loans	Return on Assets	Return on Equity
Aggregated banking system	…	12.0	34.3	4.1	1.8	…
Foreign branches	…	7.9	41.2	3.2	2.1	…
Locally incorporated	17.3	15.6	31.3	4.9	1.5	13.9

Sources: Eastern Caribbean Central Bank and Fund staff estimates.

1/ The foreign branches have consolidated capital positions with their parent banks in Canada and Barbados.
2/ Non-performing loans.

The financial sector has been remarkably stable, despite the buildup in banking sector exposure to the government, high public debt levels, and the regular occurrence of natural disasters. The stability appears to reflect the continued confidence in the currency peg, the credibility of the ECCB in the region, and the lack of any major banking crises in the past.

However, adverse shocks such as a major hurricane or a sudden stop of tourism arrivals, could lead to insolvency of some systemically important banks in the region. The banks in the region appear particularly vulnerable to shocks that disrupt tourism and/or trigger government sector defaults. For example, an adverse shock that results in an additional 5 percent of total loans in loan losses and a 10 percent nonrepayment on government obligations could lead to the undercapitalization of about half of the local banks. While the impact would be more severe in some countries than others, the undercapitalized banks account for on average one-third of total deposits, and could trigger a more general confidence effect in the region. The stability of the banking sector in Grenada (which had among the strongest prudential indicators in the region prior to the hurricane) in the face of an even larger shock suggests that additional factors—such as the possibility of capital injections for foreign banks—also need to be considered.

country authorities vehemently opposed it, arguing that it would impinge on national sovereignty.

Crisis management

58. **Contingency planning for a crisis scenario should form a key part of prudent macroeconomic management.** While every possible attempt should be made to prevent a crisis, the possibility of a crisis cannot be ruled out. Consequently, the staff encouraged the ECCB and country authorities to develop a contingency plan to deal with that possibility, including a clear delineation of the responsibilities of the ECCB and of the national governments.

E. Statistics

59. **Efforts are underway to improve the quality, timeliness, and dissemination of statistical series in the region to permit more effective policy monitoring**. Staff welcomed the emphasis placed by the ECCB on urging national authorities to strengthen the availability and quality of statistics throughout the region. In view of the need for more comprehensive data on the household sector, it was disappointing that more use had not been made of the data from the census conducted in 2001. The authorities indicated that there had been technological problems with the processing of census returns, so that the results were not yet available in all countries.

IV. Staff Appraisal

60. **The ECCU countries are facing several challenges**. With the erosion of preferential access to markets in bananas and sugar and the decline in official development assistance, the external environment worsened considerably in the last decade. Natural disasters have been frequent, often inflicting substantial damage to the economies, and the September 11 attacks on the United States clearly demonstrated the vulnerability of the economies to shocks to tourism. In the past few years, the ECCU countries have also faced a sharp increase in petroleum import prices. The resultant deceleration of growth since the early 1990s, combined with the relaxation in fiscal stances, has considerably weakened domestic economic conditions and produced a rapid accumulation of public debt.

61. **There is increasing recognition of the difficulty of the current economic position and bold steps are being taken in several countries to address these challenges**. The importance of responding to the economic challenges has been highlighted by the prominence given to economic issues in recent electoral campaigns in Antigua and Barbuda, Dominica, and St. Kitts and Nevis. Staff welcomes the key measures now underway in the more highly indebted countries to tackle the economic difficulties: in Antigua and Barbuda, Dominica, and Grenada, determined actions to strengthen fiscal positions and reduce debt levels are being undertaken; and in St. Kitts and Nevis, the authorities have announced the closure of the long-time loss-making sugar industry which should significantly enhance fiscal and growth prospects in the coming years.

62. **While progress towards fiscal consolidation was made in 2003–04, a more rapid adjustment is needed to place debt on a clearly downward path**. In view of the positive global growth outlook in the near and medium term, and strong prospects for tourism-dominated economies, the present time is opportune for a more forceful fiscal adjustment. Other means of addressing the fiscal imbalances—such as reducing debt by seeking a cooperative solution with creditors and privatization—will not be sufficient to achieve debt sustainability. Fiscal institutions, tax systems, budget processes, expenditure management, public debt management, and public sector investment programs need to be strengthened in tandem to preclude fiscal slippages in the future.

63. **Ensuring the consistency of fiscal policies with the CBA needs to be assured if macroeconomic stability is to be maintained**. The CBA has delivered a long period of exchange rate and price stability even in the presence of frequent large adverse shocks, fiscal indiscipline, and rigid labor markets. However, this stability has been maintained by the governments' ability to borrow by remaining current on debt obligations and tapping the captive social security surpluses. Moreover, liquidity in the banking system has been sustained at a high level by attracting deposits through the imposition of a floor on savings rates. This situation cannot continue indefinitely. Preserving the exchange rate peg—which is uniformly supported by the wider population in the region—will require individual governments to make good on their commitments to policy coordination by achieving the fiscal benchmarks approved by the ECCB's Monetary Council. Staff urge the setting of interim annual targets and a broader dissemination of performance relative to the benchmarks as a means of generating discipline and building ownership of fiscal positions.

64. **Raising productivity is key for maintaining competitiveness and supporting the exchange rate peg**. Growth rates since the 1990s have been much lower compared to countries with similar levels of spending on human and physical capital, pointing to a low level of efficiency in investment. Enhancing labor market flexibility will be important for unlocking the economy's growth potential, and ensuring that the economy adjusts to shocks. The depreciation of the U.S. dollar in the last few years has provided some breathing room, but going forward competitiveness can only be sustained if wages are kept in line with productivity growth.

65. **Several key steps can be taken to provide a supportive investment climate for the private sector to flourish**. The distortionary, nontransparent, and costly tax concessions regime should be reformed. The regulatory environment in utilities, energy, and transportation should be improved. Importantly, the skill level in the region needs to be raised, and education and training programs reoriented to better serve the needs of the region. In view of the high migration rates of skilled labor, the Caribbean diaspora should be tapped more aggressively to support private investment in home countries.

66. **Realizing the growth potential will require redefining the role of the public sector**. The public sector should focus on creating a conducive investment climate, rather than attempting to create employment and generate growth by further expansions. Public sector investment programs that are critical for private sector development should be implemented only after careful project evaluation and prioritization, with continuous

oversight and monitoring during the implementation phase. More generally, the institutional capacity of the public sector should be enhanced in order to facilitate the needed fiscal reforms and assure higher quality of public services.

67. **The potential benefits from regional integration and cooperation are extremely high and should be exploited**. Given the small size of the economies, and the high fixed costs of providing government services, there is tremendous scope to increase the collective provision of select government services both to cut costs and achieve efficiencies. Steps need to be taken towards further integration of markets, particularly goods and labor, to benefit from economies of scale and to lower product and labor costs.

68. **High public debt levels limit the ability of the ECCU governments to use fiscal policy to respond to external shocks, underscoring the need for measures to reduce the region's vulnerabilities**. Natural disasters occur regularly, so that disaster mitigation and preparedness efforts need to be stepped up, even as better insurance mechanisms are sought. Given the increasing dependence of the countries on tourism and tourism-related products, diversification can be achieved by attracting tourists from a larger group of customer countries and increasing interlinkages between tourism and other sectors, particularly agriculture.

69. **Further action to enhance the effectiveness of financial sector supervision is needed to contain potential risks**. As regional capital markets deepen, financial sector linkages are likely to rise and any adverse event in one country will likely affect neighboring ones, underscoring the need to constantly strengthen financial sector supervision. An increase in the frequency of banks' on-site inspections was needed, as recommended by the FSAP. Amendments to the Uniform Banking Act, the ECCB Act, and the prudential guidelines, should be enacted soon.

70. **Contingency planning for an untoward event should be undertaken by both country and regional authorities**. While every possible attempt should be made to prevent a crisis, the possibility of a crisis cannot be ruled out. Preparing in advance, irrespective of the likelihood of the event, could significantly reduce the financial and output costs associated with such events.

71. **While the quality and depth of the dialogue between Fund staff and the authorities has intensified in the past year, a further strengthening of statistics and outreach activities are warranted**. Staff welcomes the stepped up efforts in most countries to increase transparency and generate public consensus on reforms. However, in view of the far-reaching reforms that need to be implemented, greater debate on economic issues and outreach activities is recommended. To facilitate better policymaking and permit regular monitoring of the impact of reforms on living standards, it is imperative that statistics in all areas be improved, but particularly on labor markets, poverty, and other social indicators.

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

Table 1. ECCU: Selected Economic and Financial Indicators, 2000–2005

	2000	2001	2002	2003	Prel. 2004	Proj. 2005
	(Annual percentage change)					
National income and prices 1/						
Real GDP	2.9	-1.5	0.7	3.4	3.2	3.2
GDP deflator	1.2	2.0	1.3	1.6	2.2	1.9
Consumer prices, end of year	1.5	1.5	1.0	2.1	2.2	2.1
Monetary sector						
Liabilities to the private sector (M2)	10.6	5.9	6.6	9.5	13.3	9.1
Net foreign assets	-7.2	40.8	25.8	32.4	20.0	16.5
Net domestic assets	15.2	-1.3	0.9	1.1	10.1	5.3
Of which						
Private sector credit	10.4	2.3	1.9	2.2	6.3	6.3
Credit to central government	35.6	1.4	-1.5	-13.9	-15.3	-11.9
	(In percent of GDP)					
Public sector 1/						
Primary central government balance	-1.8	-4.2	-6.7	-1.0	-0.4	-2.5
Overall central government balance	-5.2	-7.8	-10.9	-5.6	-4.9	-7.1
Total revenue and grants	27.7	26.2	28.1	29.3	28.8	31.0
Total expenditure and net lending	32.9	34.0	39.0	34.9	33.7	38.1
Foreign financing	2.8	5.7	8.1	4.3	-6.0	0.4
Domestic financing including arrears	2.4	2.1	2.8	1.3	10.9	6.6
Central government current account balance	-0.3	-2.0	-2.2	-0.2	-0.1	-1.9
Total public debt (end-of-period)	83.2	89.4	108.7	108.7	105.5	107.5
	(Annual percentage change)					
External sector						
Exports, f.o.b	8.6	-14.2	-1.1	1.7	4.4	4.0
Imports, f.o.b	3.1	-8.1	0.4	12.7	8.4	5.0
Stayover visitors	-0.6	-5.0	1.3	9.9	10.1	8.8
Nominal effective exchange rate 1/						
(1990 =100) end-of-period (depreciation -)	5.9	1.9	-4.8	-8.1	-4.7	...
Real effective exchange rate 1/						
(1990 =100) end-of-period (depreciation -)	4.3	1.5	-5.5	-8.8	-3.6	...
	(In percent of GDP)					
External current account balance	-16.1	-18.1	-20.4	-21.4	-17.3	-19.4
Trade balance	-37.7	-35.3	-34.8	-38.4	-39.2	-39.0
Services, incomes and transfers	21.6	17.2	14.4	17.0	21.9	19.5
Of which						
Travel	28.4	26.3	24.8	27.9	29.5	30.9
Capital and financial accounts 2/	16.6	20.3	22.5	22.7	20.1	20.7
Of which						
Foreign direct investment	10.9	11.1	10.7	16.9	14.6	15.1
External public debt (end-of period) 1/	46.8	52.9	65.2	68.2	61.6	63.1
External debt service, in percentage of goods and non-factor services	5.7	5.7	9.4	9.4	20.3	10.3
Of which						
Interest	2.5	2.9	4.1	4.7	4.9	4.6
End-year gross foreign reserves of the ECCB						
In U.S. dollar million	383.7	446.0	504.8	539.9	632.4	678.7
In months of imports	3.2	4.1	4.6	4.4	4.7	4.8
In percent of broad money	17.4	19.1	20.2	19.8	20.4	20.1
Currency backing ratio, in percent 3/	88.3	92.9	97.1	95.3	96.2	...

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

1/ Excludes Anguilla and Montserrat. ECCU aggregates are calculated as weighted averages of individual country data; ratios to GDP are then calculated by dividing this sum by the aggregated GDP of the region.

2/ Includes errors and omissions.

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

Table 2. ECCU: Selected Central Government Indicators by Country, 2000–2005 1/

(In percent of GDP)

	2000	2001	2002	2003	Prel. 2004	Proj. 2005
Total revenues and grants	**27.7**	**26.2**	**28.1**	**29.3**	**28.8**	**31.0**
Antigua and Barbuda	21.7	19.2	21.7	20.9	21.4	21.9
Dominica	37.6	30.2	32.7	40.0	37.2	36.5
Grenada	29.8	31.0	29.0	34.5	33.1	41.7
St. Kitts and Nevis	29.9	29.0	34.8	33.1	34.9	38.2
St. Lucia	26.8	25.4	27.0	28.0	27.4	28.5
St. Vincent and the Grenadines	29.4	30.7	31.7	31.6	30.3	31.8
Current expenditure	**25.2**	**26.5**	**27.8**	**26.9**	**26.8**	**28.4**
Antigua and Barbuda	24.6	25.6	27.5	25.7	23.8	25.0
Dominica	31.8	33.1	33.1	31.2	30.3	29.5
Grenada	20.8	24.2	25.9	24.3	27.9	31.0
St. Kitts and Nevis	34.0	32.9	34.0	33.7	35.3	36.1
St. Lucia	20.8	22.2	23.9	24.7	24.0	25.7
St. Vincent and the Grenadines	26.6	27.7	28.0	26.9	26.4	29.3
Of which						
Interest payments	**3.4**	**3.6**	**4.2**	**4.6**	**4.5**	**4.6**
Antigua and Barbuda	4.7	4.4	4.2	4.6	3.8	3.2
Dominica	5.0	5.3	5.5	5.8	5.9	5.5
Grenada	2.2	2.6	4.7	5.2	6.4	6.1
St. Kitts and Nevis	5.0	5.7	7.3	7.7	7.3	7.6
St. Lucia	1.6	2.3	2.5	2.9	3.3	4.0
St. Vincent and the Grenadines	2.8	2.6	2.6	2.7	2.5	3.9
Saving (current revenue less current expenditure)	**-0.3**	**-2.0**	**-2.2**	**-0.2**	**-0.1**	**-1.9**
Antigua and Barbuda	-6.8	-6.9	-7.1	-5.0	-3.1	-4.5
Dominica	-4.1	-4.7	-5.0	-0.2	0.4	-0.1
Grenada	6.0	2.5	0.6	3.2	-2.4	-3.2
St. Kitts and Nevis	-5.2	-4.9	-2.9	-1.4	-1.2	-1.1
St. Lucia	5.3	1.6	0.1	1.1	3.3	-0.7
St. Vincent and the Grenadines	1.6	0.9	2.6	4.1	3.1	0.7
Primary balance	**-1.8**	**-4.2**	**-6.7**	**-1.0**	**-0.4**	**-2.5**
Antigua and Barbuda	-0.3	-6.8	-6.8	-4.1	-0.8	-3.6
Dominica	-5.9	-3.2	0.1	4.5	3.4	3.0
Grenada	-1.0	-5.8	-14.5	0.4	3.7	-2.5
St. Kitts and Nevis	-9.5	-6.7	-11.2	-1.1	-4.1	-0.2
St. Lucia	0.2	-1.8	-5.0	-0.9	-1.3	-4.1
St. Vincent and the Grenadines	0.8	0.5	-1.6	-0.6	-0.9	-2.7
Overall balance	**-5.2**	**-7.8**	**-10.9**	**-5.6**	**-4.9**	**-7.1**
Antigua and Barbuda	-5.0	-11.1	-11.0	-8.8	-4.6	-6.8
Dominica	-10.9	-8.5	-5.4	-1.3	-2.5	-2.5
Grenada	-3.2	-8.5	-19.2	-4.8	-2.8	-8.5
St. Kitts and Nevis	-14.4	-12.4	-18.5	-8.9	-11.5	-7.8
St. Lucia	-1.4	-4.1	-7.6	-3.8	-4.7	-8.1
St. Vincent and the Grenadines	-2.0	-2.1	-4.2	-3.4	-3.4	-6.5
Government and government guaranteed debt stock						
Total public sector debt	**83.2**	**89.4**	**108.7**	**108.7**	**105.5**	**107.5**
Antigua and Barbuda	125.4	123.6	139.2	132.0	99.4	100.0
Dominica	87.4	95.4	121.8	122.0	115.0	113.8
Grenada	56.2	63.7	109.6	110.0	129.4	133.1
St. Kitts and Nevis	122.2	138.8	161.0	172.6	178.7	178.1
St. Lucia	44.7	51.1	64.3	64.1	70.5	73.4
St. Vincent and the Grenadines	67.5	68.2	70.5	72.8	78.9	83.9
External debt 2/	**46.8**	**52.9**	**65.2**	**68.2**	**61.6**	**63.1**
Domestic debt	**36.5**	**36.4**	**43.5**	**40.5**	**43.9**	**44.4**

Sources: Country authorities; and Fund staff estimates.

1/ Excludes Anguilla and Montserrat. Fiscal years for Dominica and St. Lucia.

2/ Includes external arrears.

Table 3. ECCU: Summary Balance of Payments, 2000–2005

	2000	2001	2002	2003	Prel. 2004	Proj. 2005
(In millions of U.S. dollars)						
Current account	**-455.6**	**-514.2**	**-594.8**	**-655.1**	**-567.6**	**-674.9**
Trade balance	-1069.9	-1004.7	-1013.9	-1176.0	-1286.4	-1354.3
Exports	355.6	305.2	301.8	307.0	320.6	333.5
Imports	-1425.5	-1309.9	-1315.6	-1483.0	-1607.0	-1687.8
Services and income	449.0	377.3	308.9	393.5	486.7	539.6
Services	665.1	568.4	515.8	613.3	736.8	818.5
Transportation	-124.4	-112.1	-105.4	-132.7	-147.2	-161.8
Travel	806.6	747.4	723.0	854.6	968.8	1075.2
Other services	-17.1	-66.9	-101.7	-108.6	-84.8	-94.9
Income	-221.5	-202.9	-209.1	-221.7	-250.4	-280.2
Current transfers	165.3	113.1	110.2	127.5	232.0	139.8
Capital and financial account	**471.2**	**578.4**	**655.4**	**696.0**	**660.2**	**721.1**
Capital transfers (net)	122.3	133.9	132.9	131.3	104.2	189.4
Financial account	348.9	444.5	522.5	564.7	556.0	531.7
Direct investment	309.2	316.3	311.2	518.3	477.4	525.8
Portfolio investment	68.0	55.5	153.0	162.5	48.8	51.7
Public sector long term	33.3	82.3	48.0	18.2	35.9	57.7
Other public sector capital	0.0	2.3	1.2	0.0	0.0	0.0
Commercial banks	26.3	-89.8	-86.2	-168.2	-101.8	-50.8
Other capital 1/	-88.0	77.9	95.3	33.9	95.7	-52.7
Overall balance	**15.6**	**64.2**	**60.6**	**40.9**	**92.5**	**46.3**
Financing	**-15.6**	**-64.2**	**-60.6**	**-40.9**	**-92.5**	**-46.3**
(In percent of GDP)						
Current account	**-16.1**	**-18.1**	**-20.4**	**-21.4**	**-17.3**	**-19.4**
Exports	12.5	10.7	10.4	10.0	9.8	9.6
Imports	-50.2	-46.0	-45.1	-48.4	-49.0	-48.6
Services, incomes and transfers	21.6	17.2	14.4	17.0	21.9	19.5
Of which						
Travel	28.4	26.3	24.8	27.9	29.5	30.9
Current transfers	5.8	4.0	3.8	4.2	7.1	4.0
Capital and financial account	**16.6**	**20.3**	**22.5**	**22.7**	**20.1**	**20.7**
Of which						
Direct investment	10.9	11.1	10.7	16.9	14.6	15.1
Overall balance	**0.5**	**2.3**	**2.1**	**1.3**	**2.8**	**1.3**
(Annual percentage change)						
Exports	8.6	-14.2	-1.1	1.7	4.4	4.0
Imports	3.1	-8.1	0.4	12.7	8.4	5.0
Travel, net	1.1	-7.3	-3.3	18.2	13.4	11.0
Memorandum items:						
End-year gross reserves of the ECCB, US$ millions	383.7	446.0	504.8	539.9	632.4	678.7
In months of current year imports	3.2	4.1	4.6	4.4	4.7	4.8
ECCU GDP at market prices, EC$ millions	7,662.1	7,687.7	7,868.2	8,273.1	8,858.1	9,384.8

Source: Eastern Caribbean Central Bank.

1/ Includes errors and omissions.

Table 4. ECCU: Summary Accounts of the Banking System, 2000–2005

(In millions of Eastern Caribbean dollars)

	2000	2001	2002	2003	Prel. 2004	Proj. 2005
I. Monetary Survey (Consolidated Banking System)						
Net foreign assets	**1,024.8**	**1,442.6**	**1,814.1**	**2,401.8**	**2,882.0**	**3,357.0**
Net domestic assets	**4,943.8**	**4,877.1**	**4,920.4**	**4,975.4**	**5,479.0**	**5,766.9**
Net credit to the public sector	-97.7	-69.1	-87.2	-217.4	-230.5	-327.8
Central government	645.2	654.5	644.7	554.8	470.1	414.4
Nonfinancial public enterprises 1/	-742.9	-723.6	-731.9	-772.3	-700.6	-742.2
Credit to private sector	5,842.8	5,979.1	6,090.8	6,222.3	6,615.8	7,034.2
Other	-801.3	-1,032.9	-1,083.2	-1,029.5	-906.3	-939.5
Liabilities to private sector (M2)	**5,968.6**	**6,319.6**	**6,734.5**	**7,377.1**	**8,361.2**	**9,123.8**
Money (M1)	1,211.7	1,246.0	1,319.2	1,505.7	1,884.4	2,026.1
Quasi-money	4,757.0	5,073.6	5,415.3	5,871.5	6,476.8	7,097.7
II. Eastern Caribbean Central Bank						
Net foreign assets	**1,018.8**	**1,192.2**	**1,355.1**	**1,449.1**	**1,702.9**	**1,828.0**
Net domestic assets	**-631.9**	**-818.7**	**-961.9**	**-1,022.0**	**-1,219.4**	**-1,285.9**
Net position with banks and other institutions	-646.9	-830.6	-910.9	-1,005.9	-1,161.7	-1,140.1
Credit to government	29.5	32.7	1.9	31.5	-39.0	-120.2
Other	-14.5	-20.9	-53.0	-47.6	-18.7	-25.6
Liabilities to private sector	**386.9**	**373.4**	**393.2**	**427.1**	**483.5**	**542.0**
Currency issued	536.0	537.5	558.7	605.7	660.3	734.6
Currency held by banks	-149.1	-164.1	-165.4	-178.6	-176.8	-192.6
III. Commercial Banks						
Net foreign assets	**6.0**	**250.4**	**459.0**	**952.6**	**1179.1**	**1,529.0**
Net claims on ECCB	632.2	833.2	902.5	948.9	1158.1	1,136.6
Net domestic credit	**4,943.5**	**4,862.7**	**4,979.8**	**5,048.6**	**5,540.3**	**5,916.2**
Net credit to the public sector	-127.3	-101.9	-89.1	-248.9	-191.4	-207.6
Central government	615.7	621.8	642.8	523.3	509.2	534.6
Rest of the public sector	-742.9	-723.6	-731.9	-772.3	-700.6	-742.2
Credit to private sector	5,842.8	5,979.1	6,090.8	6,222.3	6,615.8	7,034.2
Other	-772.1	-1,014.6	-1,021.9	-924.8	-884.1	-910.4
Liabilities to the private sector	**5,581.7**	**5,946.2**	**6,341.3**	**6,950.0**	**7,877.6**	**8,581.8**
Memorandum items of the consolidated banking system:						
(Percentage growth compared to M2 at the beginning of the year)						
Net foreign assets	-1.5	7.0	5.9	8.7	6.5	5.7
Central bank	0.8	2.9	2.6	1.4	3.4	1.5
Commercial banks	-2.3	4.1	3.3	7.3	3.1	4.2
Net domestic assets	12.1	-1.1	0.7	0.8	6.8	3.4
Of which						
Net credit to the public sector	2.8	0.5	-0.3	-1.9	-0.2	-1.2
Credit to the private sector	10.2	2.3	1.8	2.0	5.3	5.0
(Annual percentage change)						
Liabilities to the private sector (M2)	10.6	5.9	6.6	9.5	13.3	9.1
Private sector credit	10.4	2.3	1.9	2.2	6.3	6.3
Income velocity of broad money	1.3	1.2	1.2	1.1	1.1	1.0
Private sector credit/GDP (percent)	76.3	77.8	77.4	75.2	74.7	75.0
Broad money/GDP (percent)	77.9	82.2	85.6	89.1	94.4	97.2
Foreign currency deposits/GDP (percent)	10.0	10.4	11.7	11.8	13.3	13.7

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

1/ Includes the national insurance schemes.

Table 5. ECCU: Creditor Composition of Public Debt at end-2004 1/

(Share of total)

	Antigua and Barbuda 2/	Dominica 3/	Grenada	St. Kitts and Nevis	St. Lucia	St. Vincent and the Grenadines
External debt	**100**	**100**	**100**	**100**	**100**	**100**
Central government	87	78	79	75	83	94
Multilateral	3	36	24	21	38	32
Official bilateral	24	17	12	7	6	13
Commercial	60	23	41	29	38	49
Other	...	...	0	18	0	...
Arrears, total	...	2	2	0	0	0
Other public sector	13	21	21	25	17	6
Domestic debt	**100**	**100**	**100**	**100**	**100**	**100**
Central government	94	88	81	59	87	87
ECCB	...	9	...	1	5	1
Private domestic banks	...	21	...	30	40	36
Nonbank financial institutions	...	...	...	0	0	0
Insurance funds	...	44	...	0	9	8
Other	...	11	...	28	33	41
Arrears, total	...	3	...	0	0	0
Other public sector	6	12	19	41	13	13
Memorandum items:						
Public debt (end-2004, percent of GDP)	99.4	124.1	129.4	178.7	70.4	78.9
Of which						
External debt	46.6	88.3	95.0	78.1	46.4	54.7
Public debt (end-2004, U.S. dollars)	822.2	333.4	565.8	709.2	520.7	318.7
Of which						
External debt	385.2	237.3	415.6	310.1	343.3	220.9

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

1/ Excludes Anguilla and Montserrat.
2/ Public debt data for Antigua and Barbuda includes principal and interest arrears, which account for 36.4 percent of total public debt
3/ Dominica data are for the consolidated public sector.

Table 6. ECCU: Selected Vulnerability Indicators, 2000–2005

	2000	2001	2002	2003	Prel. 2004	Proj. 2005
Key economic and market indicators						
Real GDP growth 1/	2.9	-1.5	0.7	3.4	3.2	3.2
CPI inflation, end of year in percent	1.5	1.5	1.0	2.1	2.2	2.1
Interbank interest rate	...	6.8	6.3	6.0	...	...
Exchange rate, NC/US$ (end of period)	2.7	2.7	2.7	2.7	2.7	...
External sector						
Current account balance (percent of GDP)	-16.1	-18.1	-20.4	-21.4	-17.3	-19.4
Net FDI inflows (percent of GDP)	10.9	11.1	10.7	16.9	14.6	15.1
Export growth (f.o.b)	8.6	-14.2	-1.1	1.7	4.4	4.0
Terms of trade (12-month percentage change) 2/	-7.4	2.5	0.3	-1.6	-2.4	-2.1
Real effective exchange rate (1990=100) 1/	112.5	115.0	113.1	104.2	99.8	...
Gross international reserves in US$ billion 3/	0.384	0.446	0.505	0.540	0.632	0.679
Net international reserves in US$ billion 3/	0.377	0.442	0.502	0.537	0.631	0.677
Total gross external public debt in percent of GDP	46.8	52.9	65.2	68.2	61.6	63.1
Gross external financing requirement (in US$ billion) 4/	0.509	0.556	0.672	0.730	0.828	0.774
		(In percent of GDP)				
Consolidated public sector 1/						
Overall central government balance	-5.2	-7.8	-10.9	-5.6	-4.9	-7.1
Primary central government balance	-1.8	-4.2	-6.7	-1.0	-0.4	-2.5
Central government current account balance	-0.3	-2.0	-2.2	-0.2	-0.1	-1.9
Public sector gross debt (end-of-period)	83.2	89.4	108.7	108.7	105.5	107.5
		(In percent)				
Public and private financial sector						
Capital adequacy ratio (indigenous banks, Tier I capital over risk weighted assets)	14.7	15.8	17.5	16.4	16.4	...
NPLs/total loans	11.5	13.1	13.7	13.9	12.0	...
Indigenous banks	16.7	17.4	17.4	18.2	15.6	...
Foreign banks	5.8	8.2	9.3	8.9	7.9	...
Loan loss provision/NPLs	28.6	28.9	29.7	30.0	34.3	...
Indigenous banks	25.6	27.0	27.9	26.1	31.3	...
Foreign banks	38.0	33.4	33.6	39.1	41.2	...
Loans to agricultural sector/ total loans	3.2	3.6	3.9	4.0	3.8	...
Loans to tourism sector/total loans	7.9	7.5	7.9	7.5	7.7	...
Loans to household sector/ total loans	45.9	46.6	46.4	48.4	47.4	...
Gross government claims/total assets	15.2	15.0	15.3	14.4	15.3	...
Government deposits/total deposits	18.5	18.0	17.6	17.2	17.0	...
FX deposits/total deposits	15.7	15.0	15.7	15.4	15.4	...
Contingent liabilities/capital (indigenous banks)	74.8	62.3	59.7	65.7	77.3	...
(Pre-tax) return on average assets	2.2	2.1	1.6	1.7	1.8	...
Memorandum items						
ECCB reserve cover 5/	88.3	92.9	97.1	95.3	96.2	...
ECCB gross reserves/broad money	17.4	19.1	20.2	19.8	20.4	20.1

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

1/ Excludes Anguilla and Montserrat.
2/ Excludes Anguilla, Antigua and Barbuda, and Montserrat.
3/ Gross reserves defined as the foreign assets of ECCB. Net reserves defined as net foreign assets of ECCB.
4/ Defined as external current account deficit plus external amortization.
5/ Foreign assets as a percentage of demand liabilities.

Table 7: Status of Implementation of Key Elements of the CARICOM Single Market and Economy 1/

Key Elements	Original Deadline	New Deadline	Status	Action Required
Treaty establishing the Single Market: To encourage competition	**2000**	**2005**	All 12 countries to which it applies have signed and ratified the revised Treaty	All countries except Barbados, Belize, St. Lucia and Suriname to enact Treaty
Free movement of goods: Removal of unauthorized import and export duties on goods of regional origin and removal discriminatory internal fiscal charges	**1996**	**2005**	Belize, St. Kitts Nevis and Nevis, and St. Vincent and the Grenadines apply duties on a limited range of imported goods; Suriname on export of lumber; environmental taxes apply in some countries	Countries to remove duties and discriminatory charges
Free movement of services: Removal of restrictions on the provision of services	**2002**	**2005**	List of existing restrictions ratified in 2000; none of the countries have removed all restrictions	Legislative and administrative actions to remove remaining restrictions
Free movement of persons: Provides for free movement of university graduates, media workers, musicians, sports persons, and self-employed service providers.	**2002**	**2005**	10 countries have enacted legislation and put administrative arrangements in place for first three categories; Jamaica and St. Vincent and the Grenadines for the last category	Antigua and Barbuda and St. Kitts and Nevis to amend legislation, Other countries to take necessary action for the last category
Free movement of capital: Removal of restriction on the movement of capital within CARICOM and cross- and trading listing on stock exchanges	**2002**	**2005**	10 countries have liberalized capital account; List of restrictions notified by all members in 2000 and schedule of commitments for removal approved in February 2002	Legislative and administrative action to be taken by all countries.
Intra-regional double taxation agreement	**1998**	**2005**	11 countries have signed and ratified the agreement and 9 have enacted the legislation	Montserrat and Suriname to sign and ratify and enact laws; Grenada and St. Kitts and Nevis to enact laws
Rights of establishment: The removal of restrictions on CARICOM individuals and firms to set up business in other CARICOM countries	**2002**	**2005**	List of restrictions notified in 2002; schedule of commitments for removal approved in February 2002. Jamaica has taken action toward meeting requirement	Legislative and administrative action to be taken by all member states
Common external tariff (CET): Implementation of four phases of the CET, and implementation of revised structure based on 2002 HS	**1998**	**2005**	10 countries have implemented the 4th phase of CET, and Jamaica and Trinidad and Tobago have implemented the revised structure	Antigua and Barbuda and St. Kitts and Nevis to implement CET; countries except Jamaica and Trinidad to implement revised structure
Competition Law: To provide a level playing field for doing business	**2005**		Draft Law approved; Barbados, Jamaica, and St. Vincent and the Grenadines have taken action	Other countries to enact legislation
Implementation of harmonized customs legislation, regulation and forms	**2005**	**2005**	The draft law is being finalized	Enactment of the law

Memorandum item:

OECS economic union: Initiatives under the CSME plus free movement of labor	**2006**	**2006**	Most countries have passed legislation for movement of persons under the CSME	Action under the CSME; permit free movement of labor

Source: CARICOM Secretariat website - www.caricom.org

1/ CARICOM consist of 15 member countries, Antigua and Barbuda, Barbados, Belize, The Bahamas, Dominica, Grenada, Guyana, Haiti, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname and Trinidad and Tobago, but the revised Treaty does not apply to The Bahamas, Haiti, and Montserrat. Montserrat is awaiting entrustment from the U.K. and has been granted a two- year derogation on implementation

GOVERNMENT RESPONSES TO NATURAL DISASTERS[1]

At the government level, there are three main responses to the economic volatility induced by natural disasters, and in obtaining needed post-reconstruction funds:

▪ ***Risk identification and risk reduction* focus on reducing the effects of a disaster should one occur**. Proper risk identification occurs through hazard data collection and vulnerability assessments. Similarly, risk reduction activities can reduce vulnerabilities through disaster mitigation and preparedness, such as by strengthening and relocating structures, retrofitting, and enforcing land use codes and building standards. Such activities are important as they reduce disaster risk exposure, and assist in lowering insurance costs by reducing the underlying structural risk of physical assets.

▪ ***Self-insurance* involves the attainment of economy-wide insurance through the intertemporal transfer of national resources**. A typical example might involve creating a precautionary saving fund (based on actuarial probabilities) to draw down upon in the event of a disaster. For many developing countries, the first response involves the diversion of development expenditure to disaster relief and reconstruction; other forms of self-insurance involve borrowing and tapping remittance flows.

▪ ***Risk transfer* involves the transfer of resources across states of nature**. There are several types of risk transfer mechanisms: *external assistance*, through sovereign debt relief and official development assistance; *market insurance and reinsurance*, which can provide coverage for public and private assets beyond the capacity of self-insurance; *insurance risk pooling*, whereby geographical or cross-industry pooling lowers the high cost of disaster risk insurance; capital-market based *risk transfer instruments*, such as catastrophe bonds or options, or weather-related derivatives; *contingent lines of credit*, which typically are available to insurers and banks on the basis of an annual commitment fee; and *changes in the structure of public borrowing* to promote risk-sharing between debtors and creditors.

The mix of financing options for post-disaster expenditure can usefully be arrayed as a graduated response to increasing levels of natural disaster risk.

First, proper vulnerability assessments and actions to mitigate disaster risk and enhance post-disaster response are key to reducing immediate catastrophe risk.

Second, lower level risk layers could be covered by the establishment of ex ante funding approaches, including the creation of taxpayer-funded national disaster contingency funds, emigration and remittance flows, and traditional insurance mechanisms for key public assets. While self-insurance will not provide the full cost of disaster reconstruction, it is important that sufficient funds be available to meet the immediate costs of a disaster.

[1] This annex is based on “Government Responses to Natural Disasters in the Caribbean” by P. Cashin and P. Dyczewski, Chapter III in *Eastern Caribbean Currency Union—Selected Issues*.

Third, for higher risk layers, greater recourse could be made to risk transfer mechanisms such as regional insurance pools for catastrophe insurance of public and private assets. Where insurance markets are underdeveloped (as in the Caribbean), this may involve spreading risk through the establishment of a regional catastrophe insurance pool, potentially supported by reinsurance and catastrophe bonds, and require mandatory insurance policies and stringent risk mitigation initiatives.

Fourth, for extremely high risk layers, provision could be made for access to contingent lines of credit.

Fifth, funding of post-disaster expenditures would remain important. Funding would include the continuing provision by IFIs and bilateral donors of concessional loans and grants designed to finance post-disaster mitigation and reconstruction costs, focusing on disaster relief and the rehabilitation of low-income households. Such funds should be made at least partly contingent on the undertaking of ex ante risk mitigation activities, so as not to encourage excessive moral hazard.

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.[1] An active Steering Committee consisting of representatives from participating countries, 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 three years since it began, CARTAC has fielded more than 200 missions to the ECCU countries, in addition to numerous regional seminars and workshops. 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.

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. Antigua and Barbuda, Dominica, and Grenada have begun work to introduce a VAT, St. Vincent and the Grenadines will begin soon, 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 U.S. 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: helped establish an Inland Revenue Department in Anguilla; provided training in audit techniques to Antigua and Barbuda, Dominica, and St. Kitts and Nevis; aided the streamlining of procedures for collection of arrears in Dominica; trained customs officers in UNIX and ASYCUDA in Dominica, Grenada, St. Kitts and Nevis, and St. Vincent and the Grenadines; and provided training and other assistance to prepare for the establishment of a revenue authority in St. Lucia. More recently, CARTAC has assisted Antigua and Barbuda with the reintroduction of a personal income tax.

Public finance management. CARTAC and the ECCB assisted all ECCU countries in diagnostic exercises as part of the Fiscal Machinery Project to develop 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 assisted with the establishment of the Caribbean Public Finance Management Association (CaPFA), in which the ECCU countries have been active. At the individual country level, CARTAC

[1] CIDA and DFID provide over 50 percent of CARTAC's total funding, with EU, IDB, Ireland, IMF, UNDP, U.S., the World Bank, and the CARTAC member countries contributing the remainder.

has provided, or is in the process of providing assistance with cash management (Antigua and Barbuda, Dominica, St. Kitts and Nevis, and St. Lucia), budget development (Dominica and St. Lucia), public sector investment (Antigua and Barbuda and St. Kitts and Nevis) and accounting systems (Dominica and St. Lucia).

Stabilization and Adjustment Technical Assistance Program (SATAP). Not foreseen when CARTAC first began, SATAP was set up in response to a request from the ECCB, 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.

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. 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 nonbanking financial sectors), sponsored feasibility studies in four countries and drafted legislation in two of these countries. Strengthening the legislative framework has been addressed in the individual countries and at the ECCB. International Banking Acts, an Insurance Act, 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 Financial Sector Advisors have provided on-the-job training and guidance during the conduct of on-site inspections at offshore banks in St. Vincent and the Grenadines and at credit unions in Dominica. On-site assistance to insurance inspectors in St. Lucia is planned.

Economic and financial statistics. The project has focused on four areas. To improve national accounts, CARTAC has assisted ECCU countries in the development of supply and use tables to identify data gaps and 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 was provided 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, and expansion to Dominica and St. Vincent and the Grenadines has already begun.

CARIBBEAN DEVELOPMENT BANK: OVERVIEW OF ACTIVITIES IN THE OECS

The Caribbean Development Bank (CDB) has as one of its core mandates the mobilization of resources to finance projects and programs 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 approved US$2.4 billion to its borrowing member countries, with the OECS as a whole accounting for approximately 37 percent. 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 sectors. Resources approved for physical and social infrastructure have, on average, accounted for 56 percent of overall lending to the sub-region, and focused mainly on upgrading transportation and communication, educational services, power and energy, and housing. Interventions in directly productive sectors account for 26 percent of total activity, and have focused 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 18 percent of total interventions to the OECS.

Over the period 1970–2004, St. Lucia has been the largest recipient of CDB activity in the OECS, accounting for 25½ percent of approvals to the OECS. Of total approvals, US$195 million has been disbursed. Most of the projects currently ongoing 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 1970–2004, US$163 million has been approved, representing 17 percent of resources to the sub-region. Disbursements totalled US$141 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 stabilization/structural adjustment loans.

Approvals to St. Vincent and the Grenadines amounted to US$167 million over the period 1970 to 2003, accounting for 17½ percent of CDB's approvals to the OECS, while disbursements totalled US$106 million. The main areas of CDB ongoing involvement are in road rehabilitation, basic education, solid waste management, and natural disaster management.

St. Kitts and Nevis has been another significant beneficiary of CDB's activities since 1970, with US$109 million disbursed from US$149 million approved (15½ 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 15½ percent or US$146 million of all approvals to the sub-region with disbursements to date amounting to US$111 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.

Activity in Antigua and Barbuda has been small by comparison, with approvals to this island accounting for only 4½ percent or US$41 million of total approvals, with US$30 million disbursed. Education sector enhancement has been the main focus of recent interventions, along with security improvements to the air and sea ports.

Activity in Anguilla is also relatively small, representing 2½ percent or US$23 million of total approvals since 1970, while US$22½ million was disbursed. Ongoing projects in Anguilla are predominantly in natural disaster management.

Approvals to Montserrat have also been minimal amounting to US$16 million or 1½ percent of total approvals to the sub-region over 1970–2004, of which US$13½ million was disbursed. Education sector enhancement is the main intervention ongoing in Montserrat.

CDB Operations in the OECS

(In millions of U.S. dollars)

	Approvals 1970–2004	**Disbursements 1970–2004**	**Approvals 2004**	**Disbursements 2004**
Anguilla	23.2	22.5	0.0	1.5
Antigua and Barbuda	40.7	30.0	0.0	5.6
Dominica	163.1	141.4	14.9	20.6
Grenada	146.3	110.9	9.6	10.3
Montserrat	16.0	13.5	0.0	0.1
St. Kitts and Nevis	148.9	108.8	6.4	7.0
St. Lucia	242.4	194.9	5.5	29.4
St. Vincent and the Grenadines	166.7	105.5	36.2	4.6
OECS Sub-region	947.3	727.5	72.6	79.1

OECS: Relations With the World Bank Group
(As of May 31, 2005)

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 the Fund 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$107 million for the five borrowing member states of the OECS—Dominica, Grenada, St. Kitts and Nevis, St. Lucia and St. Vincent and the Grenadines. 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. During the first four years of the CAS, a total of US$113.3 million was committed. The nonprogrammed projects include five post-September 11 emergency projects. The World Bank is currently preparing a new Country Assistance Strategy (CAS) for the Eastern Caribbean (OECS) sub-region including Dominica. This CAS will cover FY 2006–09.

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 a comprehensive series of analytical studies related to **fiscal and debt sustainability**, **growth and competitiveness, the financial sector, public sector management and social protection** 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 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 will be followed by Bank support for a **Public Sector Reform program**.

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**. In addition, the Bank is undertaking a feasibility study of catastrophe risk insurance for the Caribbean.

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 were 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 includes projects for Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

Bank-Fund Collaboration in Specific Areas

Fiscal management. The Bank is helping to improve the management of public spending in the OECS, through the dissemination of the recently completed **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 ongoing **Public Sector Reform**.

Dominica. The Bank has recently disbursed a 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.

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IMF Executive Board Concludes Discussion on the Eastern Caribbean Currency Union Region

On July 13, 2005, the Executive Board of the International Monetary Fund (IMF) concluded its discussion on the Eastern Caribbean Currency Union.[1]

Background

Economic growth has declined since the start of the 1990s as the region struggled to cope with a series of shocks. Growth declined from nearly 6 percent per annum in 1980–89 to less than 3 percent per annum in 1990–2004. Growth slowed with the erosion of trade preferences for traditional agricultural products (bananas and sugar), a sharp reduction in official development assistance, and the September 11 attack in 2001. Economic activity has accelerated since mid-2003—despite an active hurricane season in 2004—due to an acceleration of activity in the tourism and construction sectors. The impact of Hurricane Ivan on Grenada was severe, but because damage to other ECCU countries was limited, growth in the region was just above 3 percent compared to a pre-Ivan projection of 4 percent. Similar growth is expected in 2005.

Fiscal stances were relaxed in the second half of the 1990s in an attempt to raise growth rates, resulting in very high public debt levels in the region. As the economies slowed, public investments rose and the government was used as the employer of last resort. After a sharp adjustment in 2003, central government primary balances in the region improved modestly in 2004, but remained marginally in deficit for the region as a whole. This reflected

[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, the IMF holds bilateral discussions with members, usually every year. 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's authorities in the region.

significant strengthening in primary balances in both Antigua and Barbuda—as the new administration attempted to contain fiscal imbalances—and in Grenada—where public sector investment was curtailed sharply. Fiscal positions were eased in the rest of the region, notably in St. Kitts and Nevis. Public sector debt stocks have averaged more than 100 percent of GDP since end-2002.

The rebound in tourism helped to narrow the external current account deficit in 2004, but it remained large—at 17 percent of GDP— and financed mostly by foreign direct investment (FDI). In the past two years, tourist arrivals have increased sharply with the easing of the global security concerns, the rebound in growth in the world economy and the depreciation of the U.S. dollar against major currencies that has improved competitiveness in European markets. Imports continued to increase in relation to GDP, partly reflecting an increase in current transfers (largely to Grenada), which more than offset a modest decline in FDI flows. Gross international reserves of the Eastern Caribbean Central Bank (ECCB) have continued to rise, reaching US$632 million at end-2004, implying that the coverage of monetary demand liabilities has increased to 96 percent, well above the legally mandated floor of 60 percent.

Inflation has been stable and monetary aggregates have been expanding rapidly, reflecting continued growth in the demand for money and confidence in the banking system and the quasi-currency board arrangement (CBA). Broad money grew 9½ percent in 2003 and 13½ percent in 2004, but inflation remained at around 2 percent. The brisk growth of deposits and weak credit growth, particularly to the private sector, has left the banking system highly liquid. Capital markets have continued to develop, particularly the Regional Government Securities Market which has become a key regional market—only Antigua and Barbuda and Dominica have yet to place issues. The number of equities listed on the Eastern Caribbean Securities Exchange has continued to increase.

Executive Board Assessment

Directors observed that the ECCU region has been confronted with several challenges in the last decade, including the erosion of trade preferences in traditional agricultural exports, a decline in official development assistance, recurring natural disasters, and the September 11, 2001, shock to tourism, all of which contributed to a sharp decline in economic growth. The growth slowdown, combined with a relaxation in fiscal stances, has considerably weakened economic conditions and led to a rapid buildup of public debt. Directors noted that, while recent growth and fiscal outcomes have improved, economic policies have not strengthened sufficiently to place debt on a clearly downward path and ensure sustainable growth, and many structural rigidities and vulnerabilities remain.

Against this background, Directors called for strengthening fiscal consolidation, lowering the debt ratios, and ensuring the consistency of fiscal policies with the currency board arrangement, while undertaking reforms aimed at improving private-sector-led growth. These reforms should focus on improving the investment climate and competitiveness through lowering labor costs, providing for greater flexibility and integration of the labor and product markets, and reducing the role of the public sector. More generally, Directors called for intensified economic and financial integration, which would help provide the full benefits of a common currency area.

Directors noted the increasing determination among the authorities to tackle the region's difficult economic situation, including in recent electoral campaigns. They welcomed the step-up in outreach efforts by governments through town hall meetings, public policy debates, and press conferences. Directors recognized that the improved quality and depth of dialogue between staff and the authorities has helped instill greater public awareness of economic problems and attain public consensus on the need for fiscal and structural reforms, and they encouraged further efforts in this direction.

Directors noted the steps being taken by most countries to address their underlying macroeconomic imbalances. However, the recent easing of fiscal policies in some countries in anticipation of the elections and the 2007 World Cricket Cup was a setback, and Directors stressed that the authorities should take advantage of the favorable global growth outlook and step up the pace of fiscal reform. In this context, and expressing concern about the seriously high debt levels, Directors urged the authorities to strengthen fiscal institutions in order to facilitate fiscal consolidation. This should be achieved through expanded tax bases, better expenditure and public debt management, and well prioritized and effective public sector investment programs.

Directors underscored the importance of ensuring consistency between national fiscal policies and the regional quasi-currency board arrangement in order to preserve the exchange rate arrangement. They noted that protracted fiscal weaknesses could adversely affect confidence in the CBA and macroeconomic stability. In this regard, Directors urged that efforts be made by regional governments to achieve the fiscal benchmarks approved by the ECCB's Monetary Council. Directors considered that greater fiscal responsibility could be encouraged by the setting of interim annual fiscal targets, in association with broader dissemination of fiscal performance relative to the benchmarks in order to generate heightened discipline and public ownership of fiscal performance.

Directors noted that financial contagion risks are likely to rise as regional financial markets deepen, pointing to a need for continued efforts to strengthen financial sector supervision. In this regard, Directors urged the implementation of key measures identified by the regional Financial Sector Assessment Program, including an increase in the frequency of on-site bank inspections and the approval of amendments to the Uniform Banking Act at the national level. The regulatory and supervisory frameworks for the nonbank and insurance sectors should also be strengthened. Further, Directors underscored the importance of developing contingency plans by country authorities, in coordination with the ECCB, to prepare for unanticipated shocks and crises.

Directors noted that the region's high public debt levels limit the ability of ECCU governments to use fiscal policy to respond to external shocks, underscoring the need for measures to reduce the region's vulnerabilities. Directors urged the authorities to further enhance disaster mitigation and preparedness activities, and undertake greater investment in insurance of public assets and infrastructure, possibly through participation in regional insurance pooling arrangements.

Directors stressed the importance of boosting the competitiveness and growth potential of the region. They urged a fundamental change in the role of the public sector in the region, away from serving as employer of last resort and main engine of growth, to that of providing a supportive business environment to permit the private sector to flourish. Directors recommended that the investment climate be improved by deepening regional integration, removing labor market rigidities, revamping the regulatory framework, and attaining greater efficiencies through consolidation and provision of collective government services. Directors also emphasized that the region's distortionary, nontransparent, and costly tax concessions be reformed, and that a coordinated regional approach be adopted to avoid costly tax competition between islands. Also, in light of the high emigration rates of skilled labor from the region, Directors saw scope for tapping the Caribbean diaspora to support domestic private investment. Directors also recommended that distortions in financial markets, including the floor on the rate for savings deposits, should be gradually phased out to stimulate private sector credit and investment.

Directors welcomed the continued emphasis placed by the ECCB on strengthening the availability and quality of statistics in the region. They stressed that improvements in the coverage, quality, and timeliness of statistical data in all areas would facilitate better assessment of economic, social, and financial conditions, and enhance the quality of policymaking and public debate at all levels.

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

	2001	2002	2003	Prel. 2004	Proj. 2005
(Annual percentage change)					
Real sector 1/					
Real GDP	-1.5	0.7	3.4	3.2	3.2
GDP deflator	2.0	1.3	1.6	2.2	1.9
Consumer prices, end of year	1.5	1.0	2.1	2.2	2.1
(In percent of GDP)					
Public finances 1/					
Central government overall balance	-7.8	-10.9	-5.6	-4.9	-7.1
Revenue and grants	26.2	28.1	29.3	28.8	31.0
Expenditure and net lending	34.0	39.0	34.9	33.7	38.1
Total public sector debt	89.4	108.7	108.7	105.5	107.5
(In percent of GDP, unless otherwise indicated)					
External sector					
Current account balance	-18.1	-20.4	-21.4	-17.3	-19.4
Trade balance	-35.3	-34.8	-38.4	-39.2	-39.0
Travel	26.3	24.8	27.9	29.5	30.9
Exports, f.o.b. (annual percentage change)	-14.2	-1.1	1.7	4.4	4.0
Imports, f.o.b. (annual percentage change)	-8.1	0.4	12.7	8.4	5.0
Stayover visitors (annual percentage change)	-5.0	1.3	9.9	10.1	8.8
Terms of trade (12-month percentage change) 2/	2.5	0.3	-1.6	-2.4	-2.1
Real effective exchange rate (annual percentage change) 1/, 3/	1.5	-5.5	-8.8	-3.6	...
End-year gross foreign reserves of the ECCB					
In U.S. dollar million	446.0	504.8	539.9	632.4	678.7
In months of imports	4.1	4.6	4.4	4.7	4.8
In percent of broad money	19.1	20.2	19.8	20.4	20.1
External public debt (end-of-period)	52.9	65.2	68.2	61.6	63.1
(Percentage change)					
Money and credit					
Net foreign assets 4/	7.0	5.9	8.7	6.5	5.7
Net domestic assets 4/	-1.1	0.7	0.8	6.8	3.4
Broad money	5.9	6.6	9.5	13.3	9.1

Sources: ECCU country authorities; and IMF staff estimates.

1/ Excludes Anguilla and Montserrat. ECCU aggregates are calculated as weighted averages of individual country data; ratios to GDP are then calculated by dividing this sum by the aggregated GDP of the region.
2/ Excludes Anguilla, Antigua and Barbuda, and Montserrat.
3/ End-of-period (depreciation -), 1990=100.
4/ In relation to broad money at the beginning of the period.