



**REVIEW OF DEVELOPMENTS IN THE
EASTERN CARIBBEAN CURRENCY UNION
IN 2008 AND OUTLOOK FOR 2009**

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1. ***Following a period of robust growth, the ECCU countries have entered a more difficult period characterised by a sharp deceleration in economic growth, driven by the unfolding global economic and financial crisis, which is considered to be the most serious, particularly in the advanced countries, in the period after World War II.*** The crisis has so far had a limited impact on the ECCU banking sector, as banks were not exposed to the toxic instruments or institutions that spawned the crisis and bore the brunt of its first round effects. The second round effects of the crisis, however, are expected to negatively impact the ECCU. Already the pace of economic expansion in the ECCU slowed in 2008, and 2009 is forecast to be a difficult year, on account of the knock on effects of the global financial meltdown. There has been a fall off in inflows of foreign direct investment (FDI), as evidenced by a slow down of work on some major projects in a number of the member countries and the downsizing or postponement of some others. A fall in visitor arrivals and tighter financial conditions are also projected to adversely impact the region's economic performance, and hence produce serious setback to efforts aimed at poverty reduction. These challenges pose significant downside risks to the continued expansion of the ECCU economy, as the US enters what is believed to be a long and deep recession. The only bright spot is that inflationary pressures are expected to abate, as international oil prices decline following the sharp fall off in global aggregate demand.

2. ***The existing international policy responses thus far have all focused on the short-term – pumping liquidity into the international financial system, but to no avail.*** The policy authorities are only now coming to the realisation that this is a crisis of historic proportions which requires a globally coordinated policy response. In the current economic environment there is much danger, but a host of opportunities exist. The dangers are quite clear to all; this crisis offers the peoples of the ECCU tremendous opportunities for moving our integration agenda forward. The path we take would determine the extent to which we grasp the available opportunities. In respect of the ECCU countries, the recommendation is for policy responses which are short term in nature - contingent (defensive), and long term -structural (offensive). In respect of the contingent strategies, the focus ought to be stabilisation, primarily of the financial

system with the aim of mitigating the potential for regional financial contagion. On the structural side, the policy authorities must use this global financial crisis as the mechanism for accelerating the structural reforms that would enhance growth and macroeconomic resilience. Other critical structural measures include the implementation of the single regulatory units (SRUs) to strengthen regulation and supervision of the non-banks, and the design, implementation and adherence to a sustainable fiscal and debt policy path. In this regard, the recently initiated OECS Economic Union Treaty would form an important corner stone of the region's responses. The economic union provides more options and opportunities for all citizens of the OECS.

3. *Assessment of recent economic developments in the Eastern Caribbean Currency Union (ECCU).* Economic activity in the ECCU expanded in 2008, albeit at a slower pace relative to 2007, amidst challenges posed by sustained increases in international oil and food prices, continued depreciation of the US dollar, and the onset of a full blown international credit crisis in the last quarter of 2008. Growth in 2008 was provisionally estimated at 2.7 per cent, below the 5.2 per cent rate recorded in 2007. The deceleration in the rate of growth was a result of a combination of factors, including the emergent uncertainties in the international credit markets in the summer of 2007; sharp increases in the international prices of crude oil and food; a decline in the number of tourist arrivals influenced largely by developments in the latter part of the year; and a slow down in the pace of construction activity.

Construction activity, which accounted for 13.4 per cent of real GDP, increased by an estimated 4.1 per cent, well below the 6.0 per cent growth recorded in 2007. The deceleration in the rate of expansion reflected the initial effects, on private sector activity, of the global credit market turmoil which started in the summer of 2007. Public sector activity focussed on road development, airport improvement, and low-income housing development.

Performance in the tourism industry weakened in 2008. Stay-over arrivals are estimated to have declined in 2008 compared with the total in 2007. The decrease was on account of a sharp fall in arrivals in the fourth quarter of 2008 relative to the corresponding period in 2007, as the second round effects of the global credit crunch – rising business uncertainty, announced job cuts, and stock market losses – begun to bite.

Value added in the agricultural sector, which contributed 5.1 per cent of real GDP, is estimated to have increased by 1.9 per cent, down from growth of 4.9 per cent and 2.8 per cent in 2006 and 2007 respectively. Production of bananas, the main export crop, declined sharply, primarily due to developments in Dominica and St Vincent and the Grenadines.

4. *On an individual country basis, all countries in the ECCU experienced growth during 2008.* Four countries - Dominica, Montserrat, St Kitts and Nevis and Saint Lucia - experienced accelerations in growth during 2008 relative to 2007. The other four countries, all recorded decelerations in economic growth; in Anguilla, Grenada and St. Vincent and the Grenadines growth was less than half the rates recorded in 2007. These growth decelerations, while expected, were made worst by the unfolding global crisis.

5. *Inflationary pressures across the ECCU rose during 2008 from already elevated levels in 2007, as a result of a surge in international commodity prices during most of 2008.* As a result, the prices of most imported goods rose in tandem. Also contributing to elevated price pressures in the ECCU were the depreciation of the nominal exchange rate in tandem with the US dollar, shortages of local agricultural produce in some countries, and general tightness in the labour market for skilled construction workers associated with robust construction activity in some countries.

6. *The public sector debt to GDP ratio fell to 89.7 per cent at the end of December 2008 from a ratio of 93.5 per cent at the end of December 2007, as the region continued to be among the most highly indebted emerging market economies.* The public debt to GDP ratio, however, remained over 100.0 per cent for Grenada (103.8 per cent) and St Kitts and Nevis (163.2 per cent). High public debt continues to be a major policy challenge for the ECCU countries, even with the implementation of ambitious revenue reforms – administrative efforts and tax policy reforms- in a number of the countries. Future efforts at debt reduction would have to focus on improving the productivity of public expenditure and the management and accountability of state enterprises.
7. *The external position of the currency union deteriorated in 2008 relative to the outturn in 2007, largely on account of the fall off in foreign direct investment inflows, tourist arrivals and a surge in commodity prices.* The current account deteriorated largely due to increased debt-service obligations of the central governments, the weak performance of the export crops, and higher import payments for petroleum-based products on account of the sustained rise in international oil prices. The ratio of reserves to imports of goods and services, however, continues to exceed the IMF's three months benchmark; at the end of December 2008 the ratio stood at 4.6 months of imports.
8. *On balance, monetary and credit conditions tightened in 2008, as a result of slower economic growth, deterioration in the terms of trade, a depreciated REER and tightened lending terms and conditions.* Together these factors resulted in a deceleration in the pace of growth of monetary liabilities.
- Total monetary liabilities (M2) increased by 2.9 per cent to over EC\$11.4b, at a considerably reduced rate compared with growth of 8.1 per cent in the corresponding period of 2007.

- *The REER remained depreciated, broadly in tandem with the US dollar and the equilibrium REER.* This was consistent with movements in the trade-weighted US dollar index.
- *Meanwhile, domestic credit expansion remained robust, even as credit terms and conditions tightened.* The tightening of credit terms and conditions was primarily on account of the general slowdown in economic activity, head office directives and expected deterioration in liquidity and capital positions.
- *In line with these developments, the liquidity position of the commercial banking system tightened during 2008.* There were deteriorations in some of the key ratios including total loans to total deposits and the liquid assets to total deposits plus liquid liabilities, as well as a decline in the net liquid asset position of the banking system.

9. *The economic outlook for 2009.* We anticipate that in the ECCU economic growth would continue to decelerate in 2009, at a pace greater than that observed in 2008 on account of the global economic and financial crisis. The impact is expected to originate from the second round effects of the global crisis - largely contractions in tourist arrivals, private sector remittances and financing for foreign direct investment projects as growth slows appreciably in the OECD countries. Together, these factors are expected to result in a rapid fall off in domestic liquidity in the domestic banking system, thereby constraining credit growth.

10. *Headline inflation is projected to decline slowly, as the adverse global demand shock and price developments eventually feed through to the domestic economy.* International crude oil prices have come down sharply from the heights achieved in July 2008 (USD147 per barrel). These price developments have already impacted the ECCU economies, the extent depending on the structure of domestic price formation in

the energy sector. Food prices, however, remain elevated and it would take some time before any easing in prices is observed. As food prices remain elevated, the issue of food security intensifies. Our farmers must therefore be encouraged to produce food efficiently. More importantly, however, the region, must remove those impediments to efficient price formation in the domestic economy generally, but particularly in the product markets - greater competition is required.

11. ***Higher public sector deficits and public debt are expected in 2009, and are likely to reverse recent gains in fiscal consolidation.*** This result would be primarily on account of three factors. Firstly, *lower tax revenues*: slower GDP growth leads to slower import growth and thereby lower tax revenues. Secondly, *higher public expenditure*: a fall off in tourist arrivals and remittances is likely to increase unemployment and poverty. A rise in unemployment and poverty increases the pressure on governments to expand existing social safety net expenditures. In addition, the rigidities in government expenditures, along with recent announced wages and salary increases would keep public expenditures elevated. Thirdly, *higher cost of public sector borrowing*: larger fiscal deficits mean that the public sector would be issuing new debt, or rolling over existing debt, when credit market conditions tighten. This would result in higher public debt charges on the budget, further reducing resources available for productive investment.

12. ***On the external sector, the current account deficit is projected to narrow, as economic growth slows sharply, on account of a decrease in foreign direct investment, and a fall in international commodity prices.*** However, the overall balance of payments is expected to deteriorate as liquidity drains from the system.

13. There are six specific emerging challenges and risks to the ECCU's economic outlook. These are:
 - Meltdown in Global Financial Markets;
 - Continued fiscal and debt overhang;

- A surge in social deviance;
- Global warming;
- Demographics, aging and migration;
- Growth volatility and rising income inequality

- i. ***Meltdown in Global Financial Markets¹***: Credit markets in the US and Europe have become frozen as banks, uncertain as to each others status, have hoarded liquidity. This has led to a credit crunch with significant implications for the global real economy. The recent efforts to bail out major OECD financial institutions are useful, but would not prevent a recession and a significant repricing of risks. There, however, remains much to be done in respect of a co-ordinated global response to a truly global problem. This is important in both the pre and post crisis phases as governments must not only try to prevent financial disruption and collapse, but also guide the work out, once problems arise. As it stands now, a global recession over much of 2009 is almost assured. Failure to coordinate responses to this unfolding global financial meltdown would result in much lower global economic growth for a very long-time. This would have implications for international capital flows and, by implication, commercial bank liquidity.
- ii. **Continued fiscal and debt overhang**: The continued high levels of public sector debt and fiscal imbalances make the region vulnerable to the global financial turmoil. In particular, governments that need to refinance existing debt or raise new funding are likely to face very unfavourable financing terms and conditions. They also have implications for the credibility of the fixed exchange rate peg and, by extension, the long-run sustainability of economic growth in the ECCU.

¹ In September of 2008, the US financial market witnessed the collapse of Lehman Brothers, the acquisition of Merrill Lynch by Bank of America and the rescue of the world's biggest insurer, American International Group (AIG), by the Federal Reserve.

- iii. A Surge in Social Deviance:** In recent times there has been a surge in deviant behaviour, primarily among the youthful population within the ECCU. Most countries are now setting new national records in respect of murders and other unlawful violent acts among the general population. In some instances this has impacted tourism activity, yielding undesired negative international publicity. Criminal activity raises the cost of doing business and is therefore a very negative impulse on economic development and the indicators of human well-being. The member governments and peoples of the ECCU must move resolutely to address this problem at the regional level. Failure in this endeavour, is not an option, our lives and livelihoods depend on it.
- iv. *Global warming and climate change:*** The potential effects of global warming and climate change must not be forgotten in this period of financial and economic turbulence, as it has much more profound effects on the small island economies of the ECCU. These countries depend on their natural environment for much of their economic activity, and their very physical existence would be threatened. Sea level rise and increased hurricane activity would effectively destroy the tourism industry, and in its wake create severe unemployment and poverty for the vast majority of the region's people. Regional governments, already burdened by high debt levels are not able to deal with these issues on their own. They must continue to work with the international community to devise more robust international risk sharing arrangements.
- vi. *Adverse demographic trends:*** The region is currently faced with adverse demographic trends originating from two sources: population aging and high rates of emigration of skilled labour. These trends and our policy responses would help to determine the potential output of these countries over the long-term. In effect, what we plant today determines what we harvest tomorrow. In particular, the aging labour force currently makes it imperative that the social security arrangements undergo some type of reforms to ensure their long-term

solvency. Failure to do so would bring significant pressure on the public finances in years to come. Finally, failure to create the right incentives and opportunities for the region's youth would doom our region to the class of underperforming economies for many decades to come.

- vii. ***Growth volatility and rising income inequality:*** As the regional economy enters a period of slower or no growth, it is important that measures are put in place to help and protect the most vulnerable groups in the society. The slow down in growth would result in higher levels of unemployment and it is likely that the proportion of the population in poverty would also rise, further aggravating a bad situation. As the economy restructures and adjust to the unfolding economic trends, labour would require retraining to remain employable. The expected surge in unemployment and poverty can potentially result in the development of a large disillusioned underclass in the ECCU, adding fuel to existing social deviant behaviours that would eventually undermine economic progress and the well-being of all citizens.
14. In setting the stance of policies, policy makers will need to consider not, just baseline projections, but the balance of these risks and the costs associated with each.
15. Against this background, the main **policy priorities** for the region would appear to be the following.
- ***Urgent and coordinated response to the global financial market turmoil: The ECCB, the OECS Secretariat and the member governments should continue to collaborate on and closely coordinate their responses to the global financial market turmoil.*** The key characteristics of the unfolding global financial crisis are its breath and depth. As a result of this, contagion is a key driver of the crisis, even in countries that are not directly connected to the epic centre of the financial crisis. Drawing from the lessons of the European response to the crisis, it is imperative that the ECCU member countries work

together and respond in a coordinated and coherent manner. The member countries of the currency union need to establish, before a crisis, the fiscal response to a financial sector crisis. This is a key ingredient to successfully mitigating any negative impact of the unfolding global financial crisis on the ECCU economies.

- ***The priority of the regional policy authorities at this time is to prevent financial contagion from crippling the domestic banking system adversely impacting the entire currency union.*** Even if this contagion does not materialise, it is important that regional policy authorities still coordinate their policy actions, with a clear plan developed before it is required. A key strategy to mitigate the contagion potential is the early identification and resolution of problems at weak institutions. In this regard it is proposed that an ECCU financial/fiscal sector emergency/contingency stabilisation framework be established. A key part of this stabilisation strategy would be the articulation of a sustainable path for orderly reduction of fiscal and debt overhang.
- ***The ECCU member countries should adopt a macroeconomic transformation programme consistent with the objectives of the OECS economic union.*** The ECCU member countries have an opportunity to implement their regional transformation plan, inclusive of a reduction in the fiscal and debt overhang required to sustain growth and increase economic resilience, in a coordinated and planned manner. With the macroeconomic programme in place, international technical assistance can be sought in the implementation of structural policies which can be evaluated to determine progress overtime, with a consistent framework. In this way, progress in the implementation of the provisions of the single economic and financial space within the ECCU can be realised within a finite time.

- *Specific policies, such as increasing labour productivity, are required to raise the region's rate of potential GDP growth.* Attention is required on a number of issues, particularly the foreign exchange earning capacity; investment climate; private sector development; adequacy of education and skills for the new and emerging sectors; infrastructural constraints that hamper the new economy; and the perceptively high labour costs through labour market reform. These structural reforms are required, in conjunction with the fiscal policy initiatives, to address the medium-term sustainability of the fiscal stance (expenditure control, institutional strengthening) in order to boost the true growth potential of the ECCU.
- *More focus on developing a dynamic private sector to raise the growth potential of the region.* The growth process depends on the creation of the right incentives for investment in both physical and human capital. Policies that enhance total factor productivity need to form part of this nexus. Public sector expenditure has to re-focus on more growth-enhancing activities which support the emergence of a robust and dynamic private sector. Appropriately designed and monitored tax incentives, aimed at promoting private sector investment, ought to be part of the package. The public sector may also be required to engage in strategic investments (creating virtuous circles of growth) to propel the economy.
- *Implementation of a series of supply side policies aimed at making the ECCU economy more flexible.* Some of the key elements of this strategy would be labour market reform across the ECCU, in particular the removal of barriers to the free movement of labour across the single economic and financial space; implementing the full pass through in respect of international crude oil prices, along with the introduction of an information system on domestic and international prices. To complete this liberalisation of the regional economy the authorities would need to devise and implement an

innovative competition and regulatory authority that promotes the optimal conditions for private sector operation. This strategy would be central to the region's ability to effectively weather the recent spike in inflation.

- ***Formulation of a social and environmental strategy that focuses on creating sustainable job growth, social protection, crime reduction and environmental protection - paramount for sustainable growth.*** In this regard, an expanded and enhanced social protection framework would be necessary to lubricate the economic reform process. The existing social protection framework in some countries is inadequate to the task that economic reform has thrust upon it. It is, therefore, important that the available social protection mechanisms be refocused to ensure that the economy functions efficiently and effectively. A key component of this strategy would involve measures to reduce social deviant behaviours and crime fighting methods.
- ***A strategic approach to social security and pension reforms across the ECCU is required to respond to the aging labour force and unfunded mandates.*** Part of the strategic approach must involve the pooling of investment resources and associated technical and governance arrangements. It is envisaged that such a pooling arrangement would be for investments both internationally and within the region, giving regard to the region's social and economic objectives.
- ***Economic and financial integration.*** Progress towards the establishment of the single financial space is constrained by two major constraints - fractionalisation and fragmentation. Intra-territory *fractionalisation* stems from the proliferation of small-size, inefficient financial institutions characterised by scale diseconomies that, in the case of commercial banks, contribute to high interest rate spreads. Financial *fragmentation* prevents the

best allocation of resources, producing poorly diversified, small-scale institutions that are characterised both by high costs and a limited capacity to diversify risk. In order to realise the gains from a single financial space, policy interventions would be required to remove some critical impediments. These interventions include the following:

- *The establishment of a harmonised legal framework* that accomplishes regulatory control over affiliates of licensed financial institutions as well as non-bank financial institutions.
- *The establishment of an efficient ECCU regional payments system to fully support* the full range of transactions within and between the market economies of the area.
- ***Deepening of Money and Capital Markets:*** The Central Bank has established an information bulletin board of key interest rates for various short and long term financial products across the ECCU. It provides much needed information to the market participants and helps to improve market efficiency. Regional governments should seek to maximise the full benefits of the RGSM by issuing a wider variety of instruments on the market, permitting the construction of a yield curve. At present, the instruments are concentrated on the shorter end of the market spectrum, that is, 91-day T-bills. The enhancement of the RGSM, provides a mechanism for appropriate price discovery in respect of government securities. Indeed, the RGSM has proven to be a cheaper source of funds relative to other sources for member governments.
- ***Export Diversification:*** The Economic Partnership Agreement (EPA) will provide the region with greater access to European markets, which presents a significant opportunity for the region to expand and diversify its exports of goods and services. Services such as cultural tourism, which includes music,

theatre and arts and craft, could become important niches for driving future growth within the sector. Two of the key initiatives which can help the region to exploit these opportunities are the development of the *Eastern Caribbean Enterprise Fund (ECEF)* and the *OECS Distribution and Transportation Company (ODTC)*, pursuant to Article 4(4) of the Eastern Caribbean Central Bank (ECCB) Agreement. This is critical in addressing some of the regional challenges such as high transportation costs, rising food prices and issues related to food security.

16. *The OECS Economic Union, on which discussions are currently being held across the region, is the appropriate framework for formulating a response to the aforementioned challenges.* The Chinese proverb for crisis is, danger and opportunity. There are many dangers in the current policy environment and to continue as we have always done is an invitation to disaster. On the other hand, the current crisis also offers us in the region a golden opportunity to rapidly implement the structural reforms long required to transform the economies of the OECS, by enhancing the international competitiveness of OECS enterprises and laying the ground work for sustained increases in the indicators of human well-being. The key question for us, therefore, is whether we are going to grasp this opportunity and move on to a new stage of development. In the current environment, it is advisable for us to grasp this opportunity so that we can emerge as a stronger OECS.