

CHAPTER 1. THE GROWTH CHALLENGE

1.1 This chapter examines the growth performance of the OECS countries over the past three decades, taking a cross-country approach. It analyzes the trends, sources (sectoral contribution as well as the relative importance of factor accumulation and productivity) and determinants of growth, taking into consideration the impact of volatility. The chapter then reviews the OECS countries' recent macroeconomic performance and current social, fiscal and external challenges.

1.2 Growth has been relatively strong in the OECS at an average of 4.1 percent per year during 1980-2003—higher than the average for the world, micro states and Caribbean countries. However, this growth performance is clouded by several factors. First, growth in the OECS has been slowing down since the early 1990s and this slowdown is associated with a decline in productivity growth and a contraction in private investment. Second, while growth in the 1980s was in part supported by large public investment financed primarily by aid flows, OECS governments' efforts in the late 1990s and early 2000s to offset exogenous shocks and the contraction in private investment through increased public investment have not translated into a revival of growth. Rather, because these investments have been financed by expensive commercial borrowing, the result has been a significant build-up of debt in the OECS countries, to levels that test the limits of sustainability. Third, past growth does not appear to have been driven by a strategic agenda for competitiveness. Rather, it has been driven by special and preferential treatment on export trade and the sectoral reallocation of resources from agriculture to tourism, led by inflows of foreign direct investment.

1.3 The implication is that, if current policies were to continue, prospects for growth in the OECS would be uncertain, given the decline in productivity, the increased macro-economic vulnerability and the lack of a strategy for achieving global competitiveness. In addition, trade preferences are eroding and aid flows to the OECS are expected to continue to decline, while the traditional *sun, sea and sand*-based tourism product is experiencing a slowdown in growth and market share. Three main policy conclusions arise from the growth analysis. The first is a need to improve the sub-region's economic productivity if the declining growth trend is to be reversed and sustained at a relatively high level. Business as usual would no longer be able to sustain growth in the OECS countries in the next decade. Second, new areas for efficient and profitable investment are needed and would require, *inter alia*, improvement in the investment climate. Third, the OECS countries need to attach higher priority to sustainable fiscal policy and debt management, if economic growth is to be sustained.

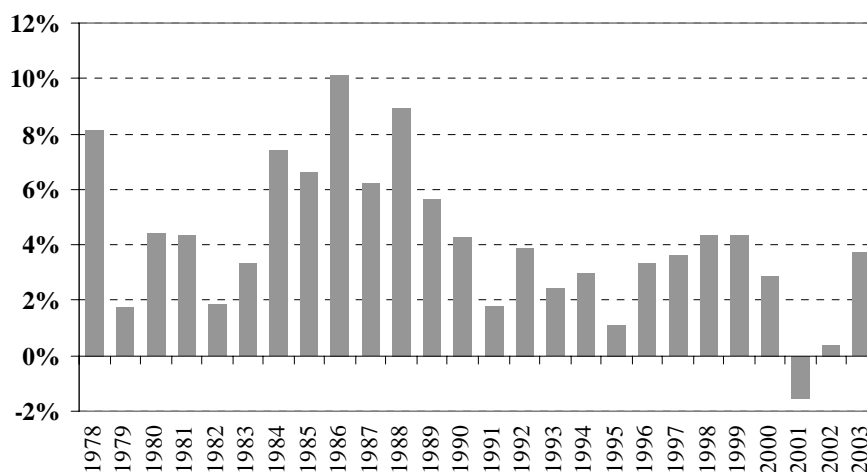
A. Growth trends

1.4 **Growth in the OECS has been relatively strong at an average of 4.1 percent per year during 1980-2003** compared with a world¹ average of 2.9 percent, a micro states² average of 3.8 percent, upper middle income countries average of 1.0 percent, and the Caribbean average of 3.1 percent (see Table 1 in Introduction). All the OECS countries are in the top two quintiles of the world in terms of average growth rates during 1980-2003.

¹ 195 countries.

² For the purposes of this report, micro states are identified as independent countries with populations of less than 500,000 persons.

FIGURE 1.1: REAL GDP GROWTH IN THE OECS, 1978-2003
(% change)



Note: Real GDP at market prices.

Source: Eastern Caribbean Central Bank (ECCB).

1.5 The sub-region has experienced a secular slowdown in growth since the early 1990s. Real GDP growth in the OECS averaged 5.9 percent per year in the 1980s, 3.3 percent in the 1990s and 1.4 percent in the new millennium (see Figure 1.1). Decomposing these growth rates into trend and cyclical components using the two most common techniques³ shows similar patterns of slowdown from the 1980s to the 1990s for all member states. In Antigua and Barbuda, St. Kitts and Nevis and St. Vincent and the Grenadines, the slowdown was evident from the 1970s, whereas in Dominica and Grenada⁴ growth was on average stronger in the 1980s compared to the 1970s. The slowdown in the OECS was the sharpest felt in the broader Caribbean⁵ during this period.

A. Sources of growth

1.6 Growth in the 1980s was driven largely by services, public investment and a positive resource balance supported by strong growth in tourism and banana exports. The slowdown in growth is associated initially with sharp declines in productivity growth and in public investment between the 1980s and 1990s, followed by a contraction in private domestic investment and a retrenchment in exports between the 1990s and the new millennium. OECS governments' efforts in the late 1990s and early 2000s to offset exogenous shocks and the contraction in private investment through increased public investment have not translated into a revival of growth—rather they led to a further contraction in private investment due to crowding out. The growing fiscal imbalances associated with the increased public investment have been financed by expensive commercial borrowing – both domestic and external – and resulted in an unsustainably large debt burden. Simultaneously, a deterioration in the external environment causing a contraction in exports and in the resource balance exacerbated the situation.

(i) Sectoral composition of growth

³ The Hodrick-Prescott, and Baxter and King filters. See Kida (2004).

⁴ St. Lucia has insufficient data for this exercise.

⁵ IMF (2005).

1.7 The services sector has been the major impetus for overall growth in the OECS during the last two decades (see Table 1.1), accounting for around three quarters of the growth in value added during 1980-2003. Key drivers were construction, communications, banking and insurance, distribution (wholesale and retail trade), transport and, notably, government services which were the leading driver of growth in the 1980s and 2000s. Although the industrial sector has been growing at faster rates than services, this growth is concentrated in non-tradables such as utilities and construction that is likely to have been driven by expansion in the tourism and public investments.

TABLE 1.1: SECTORAL COMPOSITION OF GDP* AND GDP GROWTH, 1980-2003

	Shares of GDP (%)			Average growth rates (%)			Contribution to GDP growth (%)		
	1980s	1990s	2000s	1980s	1990s	2000s	1980s	1990s	2000s
Agriculture	14.3	10.3	7.4	3.0	-1.3	-1.6	0.4	-0.1	-0.1
Industry	19.3	21.0	23.2	8.1	3.7	2.0	1.6	0.8	0.5
Mining & Quarrying	0.7	0.9	0.9	14.6	3.0	0.3	0.1	0.0	0.0
Manufacturing	7.4	6.6	6.3	6.9	1.5	0.9	0.5	0.1	0.1
Electricity & Water	2.9	3.8	4.8	7.4	7.0	3.7	0.2	0.3	0.2
Construction	8.3	9.8	11.1	9.0	4.2	2.1	0.8	0.4	0.2
Services	71.5	76.1	78.8	6.0	3.8	1.5	4.0	2.6	1.0
Services excl. Gov. Serv.	52.8	60.6	63.5	6.6	4.8	1.3	3.6	3.0	0.9
Wholesale & Retail Trade	11.7	12.6	12.0	5.4	3.8	0.2	0.6	0.5	0.0
Hotels & Restaurants	8.2	9.2	8.6	6.9	4.6	1.7	0.6	0.4	0.1
Transport	10.9	11.4	11.1	7.5	3.2	0.9	0.8	0.4	0.1
Communications	4.2	8.6	10.9	14.4	9.8	1.0	0.6	0.8	0.1
Banks & Insurance	6.9	9.3	11.1	8.0	6.5	2.5	0.6	0.6	0.3
Real Estate & Housing	6.7	5.5	5.5	3.0	2.2	2.8	0.2	0.1	0.2
Government Services	18.7	15.5	15.3	4.6	1.9	2.7	0.9	0.3	0.4
Other Services	4.2	4.1	4.2	4.9	4.2	1.8	0.2	0.2	0.1
GDP at factor costs				5.9	3.3	1.4	5.9	3.3	1.4

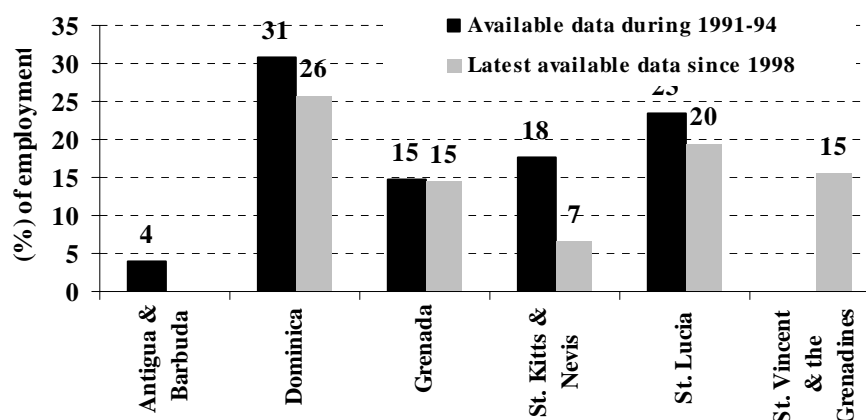
Shaded boxes represent the sub-sectors accounting for the 3 largest individual shares of GDP, the 3 fastest growing sub-sectors, and the 3 sub-sectors that have the largest contributions to growth, in each decade.

* at factor costs

Source: ECCB.

1.8 Throughout the last two decades, production in the OECS has shifted from agriculture to industry and services, but this has been accompanied by much more modest shifts in employment, resulting in rising unemployment. The contribution of agriculture to GDP declined from 14 percent in the 1980s to 7 percent in the 2000s (see Table 1.1). However, agriculture still accounts for a significant 16 percent of employment in the sub-region – over a quarter of the labor force in Dominica in 1999, and one fifth in St. Lucia in 2000. The concentration of the workforce in this rapidly declining sector has resulted in rising unemployment (see Table 5.8).

FIGURE 1.2: EMPLOYMENT IN AGRICULTURE



Sources: Available labor force surveys and censuses. Data for Antigua and Barbuda is from 1991; for Dominica: 1991 and 1999; Grenada: 1991 and 1998; St. Kitts and Nevis: 1994 and 2001; St. Lucia: 1993 and 2000; and St. Vincent and the Grenadines: 2001.

(ii) Productivity growth

1.9 **Basic estimates of total factor productivity (TFP) growth in the OECS countries show a dramatic decline in the 1990s compared with the 1980s**, with the exception of St. Kitts and Nevis (see Table 1.2). However, the interpretation of these estimates must be conditioned by the data limitations faced in computing them. Box 1.1 reviews some of these data constraints and how they may affect these estimates and their interpretation. The basic conclusion that can be drawn is that the TFP estimates measure general productivity of the economy (including productivity improvements coming from a host of economic changes such as improvements in human capital, capacity utilization and shifts into more productive sectors) and not simply disembodied technical change.

1.10 Taking these assumptions at face value, **the OECS countries recorded an average 2.7 percent productivity growth during the 1980s, but only 1.3 percent productivity growth during the 1990s**. In comparison to the relatively stable growth rates of capital and labor over the period, the change in productivity growth is clearly associated with the slowdown from the high growth rates in the 1980s to more moderate growth rates in the 1990s. St. Lucia and St. Vincent and the Grenadines experienced the sharpest reduction in productivity growth from 4-5 percent per year in the 1980s to around near zero growth in the 1990s. Antigua and Barbuda, Dominica and Grenada saw declines from around 4 percent productivity growth in the 1980s to around 1.5 percent in the 1990s. St. Kitts and Nevis stands out as recording an increase in productivity growth between the two periods, but also the least acute overall growth slowdown driven instead by a halving of the growth rate of capital.

TABLE 1.2: TOTAL FACTOR PRODUCTIVITY GROWTH (SOLOW RESIDUALS),⁶ 1980-2000

		1981-2000	1981-1990	1991-2000
Antigua and Barbuda	GDP	4.73	6.14	3.32
	Labor	0.42	0.32	0.51
	Capital	1.20	1.23	1.18
	TFP	3.11	4.59	1.63
Dominica	GDP	3.53	5.38	1.68

⁶ We report Solow residuals as a measure of TFP growth – regression estimates and cyclically-adjusted regressions estimates were computed with the same results.

	Labor	-0.11	-0.10	-0.12
	Capital	0.84	0.98	0.70
	TFP	2.80	4.50	1.10
Grenada	GDP	4.62	5.57	3.68
	Labor	0.32	0.26	0.38
	Capital	1.23	1.13	1.34
	TFP	3.07	4.18	1.96
St. Kitts and Nevis	GDP	4.86	5.47	4.24
	Labor	-0.02	-0.33	0.29
	Capital	1.38	2.04	1.31
	TFP	2.45	0.43	2.65
St. Lucia	GDP	5.12	7.62	2.61
	Labor	1.84	1.82	1.86
	Capital	0.90	0.79	1.01
	TFP	2.37	5.01	-0.26
St. Vincent and the Grenadines	GDP	4.13	6.07	2.19
	Labor	0.56	0.64	0.49
	Capital	1.12	1.02	1.22
	TFP	2.44	4.41	0.47

Source: Kida (2004).

BOX 1.1: MEASURING AND INTERPRETING TOTAL FACTOR PRODUCTIVITY (TFP) IN THE OECS

Gains in total factor productivity (TFP), reflecting more efficient use of inputs, have long been recognized as an important source of improvements in income and welfare. However, measuring TFP is difficult for two reasons. Different assumptions about the national production function, including returns to scale and elasticity of factor substitution, and different estimates of the stocks and growth rates of labor and capital, can lead to very different estimates of TFP growth. Consequently, the interpretation of the TFP itself and its role in output growth should reflect clearly the assumptions and data estimation methods used. These issues are very relevant for interpreting estimates of TFP growth in the OECS where there continue to be serious data constraints.

Capital stock growth will be overestimated (and productivity growth underestimated) in the event of natural disasters. It is common practice to measure capital growth by the perpetual inventory method: adjusting annual investment (Gross Fixed Capital Formation) for depreciation, usually assumed to be constant over time. However, natural disasters in the OECS sub-region periodically destroy a larger share of capital stock than would be accounted for by routine depreciation. Without precise estimates of the share of capital stock destroyed in each disaster, it is not possible to construct a more accurate measure of capital growth. However, we can assume that, for countries impacted by such events, capital growth will be overestimated using the standard methodology since much of the investment in the year following the disaster will be replaced rather than capital added. On the basis of the limited data available, the incidence of natural disasters in the OECS was approximately the same in the 1980s and 1990s – 18 and 19 events, respectively. Without comprehensive measures of the damages from each event, it is not possible to quantify any biases on the TFP estimates provided above.

In the OECS, only Antigua and Barbuda stands out as suffering a significantly higher incidence and intensity of natural disasters in the 1990s than in the 1980s – two incidents in the 1980s compared with five in the 1990s. However, without estimates of the damages incurred in these disasters (data is only available for two out of the seven events), it is not possible to correct the estimates of the productivity slowdown. St. Lucia and St. Vincent and the Grenadines experienced fewer incidents in the 1990s over the 1980s, indicating that capital growth is overstated, and productivity growth understated in the earlier period. Correcting for this would reduce the magnitudes of the declines in productivity growth across both periods for both countries.

Exaggerated public investment figures overstate growth in capital stock and understate productivity growth. A second issue relates to the measurement of public investment at the national level – which often coincides with domestically financed capital investment and all donor-financed projects, including those that finance recurrent spending like technical assistance. In those years where public expenditure accounts for a larger share of domestic investment, capital growth is probably overestimated, and TFP underestimated. For the current purposes, public investment accounted for a larger share of domestic investment in the OECS in the 1980s. This implies that TFP growth is underestimated during that period, and the magnitude of the slowdown in productivity growth is also underestimated.

Measurement of human capital is hampered by inadequate labor market data. Ideally, labor should be measured by the growth of the human-capital adjusted labor force, and physical capital should be adjusted for capacity utilization and depreciation. In the OECS, there is almost no data on wages as a share of value added to confirm assumptions about the production function, labor force participation is not measured on a systematic basis and educational attainment is measured once per decade in the national census. As such, for these computations, labor is measured simply as the size of the working age population. In this case, estimates of TFP growth will include, among other things, part of the accumulation of human capital that is embodied in individual worker skill levels.

1.11 **Data limitations prevent further specification on the reasons for the slowdown in productivity growth in the OECS over the 1990s.** However, there are a number of possible explanations that can be explored.

1. 12 **One hypothesis is that productivity growth in the OECS may be partly based on the transition shifts to more productive sectors.** Kida (2004) and World Bank (2005b) show that for the broader Caribbean a similar slowdown in productivity growth in the 1990s can be associated with a slowdown in the sectoral shifts. Most of the transition to services in the rest of the Caribbean took place in the 1980s, while this movement slowed significantly in the 1990s. However, in the OECS it appears to have continued at largely the same pace over the two decades. Services accounted for 72 percent of GDP in 1980, 76 percent in 1990 and 79 percent in 2000.

1. 13 **A second hypothesis is that the shift in the composition and financing of investment over the decades resulted in lower productivity of capital.**⁷ The larger share of public investment in the 1980s concentrated in social and transport infrastructure supporting the booming tourism and banana sectors may have yielded higher productivity growth than in the 1990s when private domestic investment was leading but catering mainly to protected domestic markets and declining terms of trade. Some have posited that the contraction of donor financing and subsequent rise in commercial financing of public investment in the OECS during the 1990s (see Figure 1.5) has been associated with less rigorous analysis of individual projects and an increased number of white elephants that lower overall productivity (discussed further in Chapter 4). Nonetheless, these remain hypothesis until additional data can be brought to bear on the analysis.

1. 14 **A third hypothesis relates to increasing volatility of growth or income that can lower productivity of capital** because it shortens planning horizons for investors and results in sub-optimal decision-making by both the public and private sectors. However, in the OECS both real GDP levels and growth rates were less volatile in the 1990s compared with the 1980s as measured by the coefficient of variation.

1. 15 **A fourth and associated hypothesis is that an increased incidence of natural disasters reduced productivity growth.**⁸ On the one hand, natural disasters disrupt the normal process of learning by doing, as an economy takes “time out” for recovery, while on the other, the periodic reconstruction of capital stock that follows a disaster can provide an earlier opportunity for introducing new innovations than would otherwise have been affordable or efficient. For example, in Grenada, Hurricane Ivan has provided a window of opportunity for investing in more productive variety of nutmeg trees. In the OECS, the incidence of natural disasters was similar in the 1980s and 1990s but, as noted above without additional data it is impossible to ascertain whether the intensity of these events or the duration of the recovery periods was greater.

(iii) Factor decomposition of growth

1. 16 **The slowdown in the 1990s also reflects a major deceleration in investment growth, whereas the decline in the early 2000s reflects a contraction in the resource balance led**

⁷ In general, it is felt that labor productivity should have been improving over the 1990s as educational attainments continue their rapid expansion, albeit not at the same pace as wages (see further discussion in Chapter 5).

⁸ Since 1970, on average a natural disaster occurred once every four and a half year in each of the six OECS countries. Not all these events were very large, however. Considering only incidents that affected at least 2 percent of a country’s population or inflicted damage of at least 2 percent of GDP, such events occurred in the individual countries once every nine years or somewhere in the OECS once every two and a half years. Among these large disasters, the median number of affected amounted to 9 percent of the country’s population and the median value of damage was equivalent to 14 percent of the country’s annual GDP (see IMF, 2004c).

predominantly by a sharp reduction in export growth. Table 1.3 examines the factor decomposition of growth in the OECS during 1980-2003.

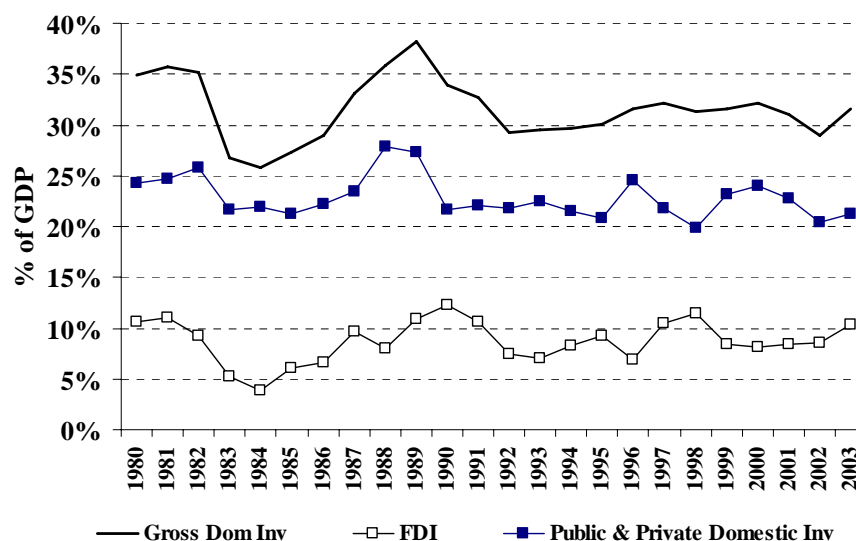
TABLE 1.3: FACTOR DECOMPOSITION OF GROWTH

	Contribution to GDP growth (%)		
	1980s	1990s	2000s
Resource balance	0.7	0.3	-0.9
Exports	4.7	1.5	-1.4
Imports	4.1	1.2	-0.5
Consumption	3.1	2.6	1.8
Investment	2.1	0.4	0.4
GDP	5.9	3.3	1.4

Source: World Bank (2004i).

1.17 **Throughout the last two decades, investment rates in the OECS have been persistently high.** Gross domestic investment averaged 31 percent of GDP (see Figure 1.3). This is comparable with a Caribbean average of 28 percent and that of other micro states at 29 percent, but is significantly higher than the average for upper middle income countries of 25 percent over the same period.⁹ On average, during 1990-2003, FDI accounted for 29 percent of gross domestic investment in the OECS, public investment for 33 percent and private domestic investment for 39 percent.

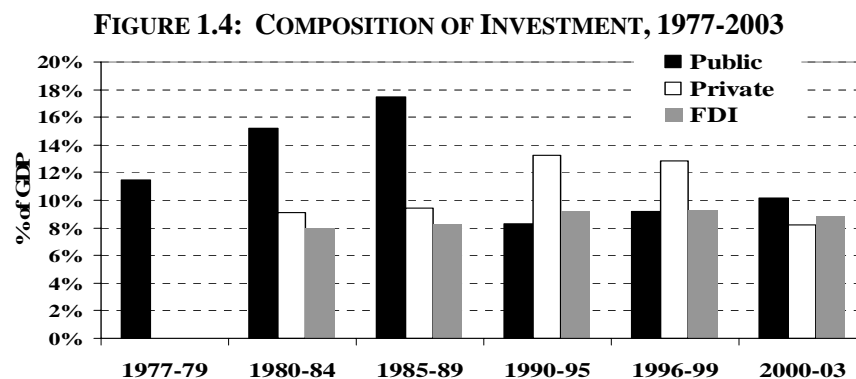
FIGURE 1.3: TOTAL, FOREIGN AND DOMESTIC INVESTMENT, 1980-2003



Source: World Bank (2004i).

1.18 **The persistently high investment rates in the OECS mask radical shifts in the composition of that investment over the last two decades.** During the early 1990s, the region saw a large contraction in public investment (Figure 1.4) due primarily to reductions in aid flows, as donors refocused their assistance on low income countries. In the early 1980s, public investment accounted for about half of total investment or 16 percent of GDP during 1980-90, whereas in the 1990s the private sector drove overall investment.

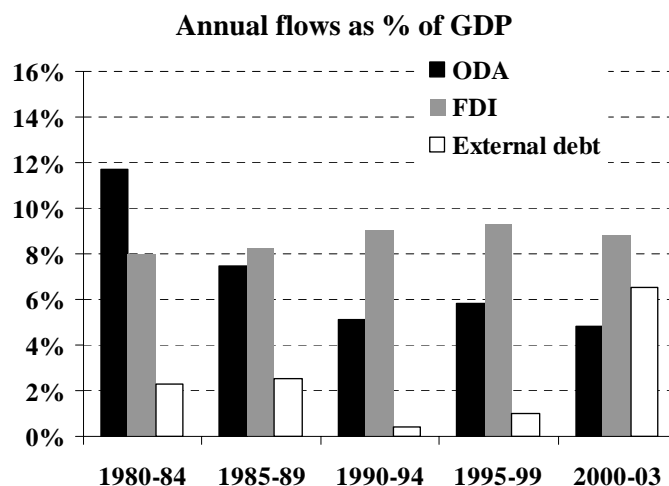
⁹ Investment rates worldwide averaged 23 percent and those for all developing countries' averaged of 24.5 percent over the same period.



Sources: World Bank (1990, 2004i).

1. 19 **Public investment in the 1980s was financed mainly by large flows of development assistance**, around 12 percent of GDP during 1980-85 (see Figure 1.5). Shortly thereafter, aid flows began a rapid decline reaching about 5 percent of GDP in the first half of the 1990s. Initially, public investment remained high during the second half of the 1980s, but eventually declined to around 8 percent of GDP during the first half of the 1990s.

FIGURE 1.5: SOURCES OF FINANCE FOR INVESTMENT, 1980-2003



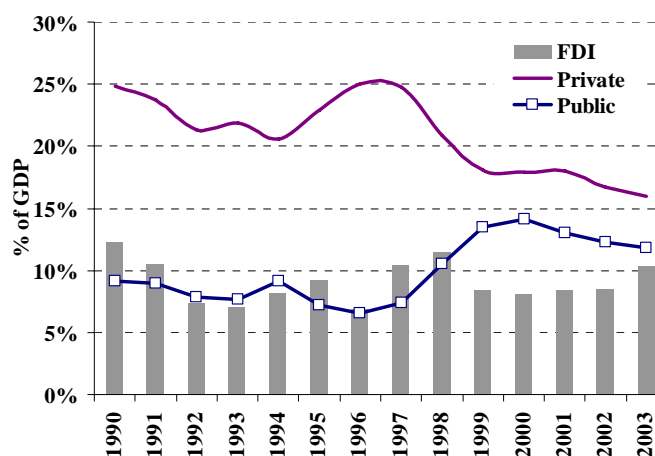
Note: External debt measures average annual increase in stock.

Sources: IMF International Financial Statistics (IFS), and OECD.

1. 20 **During the late 1990s, the sub-region then experienced a rapid decline in private investment accompanied by a rapid recovery in public investment, as the sub-region pursued an expansionary fiscal policy aimed at resuscitating growth.** The decline in private investment was predominantly a severe contraction in private domestic investment, as FDI flows remained relatively stable (see Figure 1.6). Despite the reduced availability of aid, there appears to have been an implicit policy to offset the decline in private investment with public investment (see Figure 1.6) resulting in a noticeable decline in the volatility of overall investment from the 1980s to the 1990s (see Figure 1.3). During 1980-1991, the coefficient of variation of investment was 12.2 percent, compared with 3.6 percent during 1992-2003. Over the same periods, the correlation coefficient between FDI and domestic (including public) investment shifted from 0.44

to -0.55 , and the correlation between public and private investment in the 1990s became sharply negative with a correlation coefficient of -0.45 .

FIGURE 1.6: COMPOSITION OF INVESTMENT, 1990-2003



Source: World Bank (2004i).

1. 21 **The expansion in public investment in the late 1990s and early 2000s was financed primarily by expensive commercial borrowing – a policy that became increasingly unsustainable.** In the face of sharply reduced aid flows, the increases in public investment in the late 1990s and early 2000s were not financed by raising revenues, but through expensive commercial borrowing (both domestic and external) and growing fiscal deficits (see Figure 1.7). IMF (2005) notes that interest payments increased for the more indebted OECS countries during 1998-2003, even when global interest rates were declining. The impact of the growing fiscal deficits and debt led to a further crowding out of private investment. Eventually, public investment too contracted as the fiscal situation became unsustainable (see Figure 1.7).

1. 22 **The slowdown in growth across the decades is mirrored in the performance of the sub-region's major exports – tourism and bananas.** After growing by 16 percent in the 1980s and 5 percent in the 1990s, overall exports contracted by 4 percent during the new millennium. Specifically, during the 1980s tourism experienced strong growth in arrivals, receipts and room stock (see Table 1.4) and banana exports accounted for around 10 percent of GDP and 14 percent of exports of goods and services. Tourism growth slowed down in the 1990s and came to a halt in the early 2000s, while banana exports contracted in the 1990s and experienced a significant decline in the early 2000s.

TABLE 1.4: PERFORMANCE OF MAJOR EXPORTS, 1980-2003

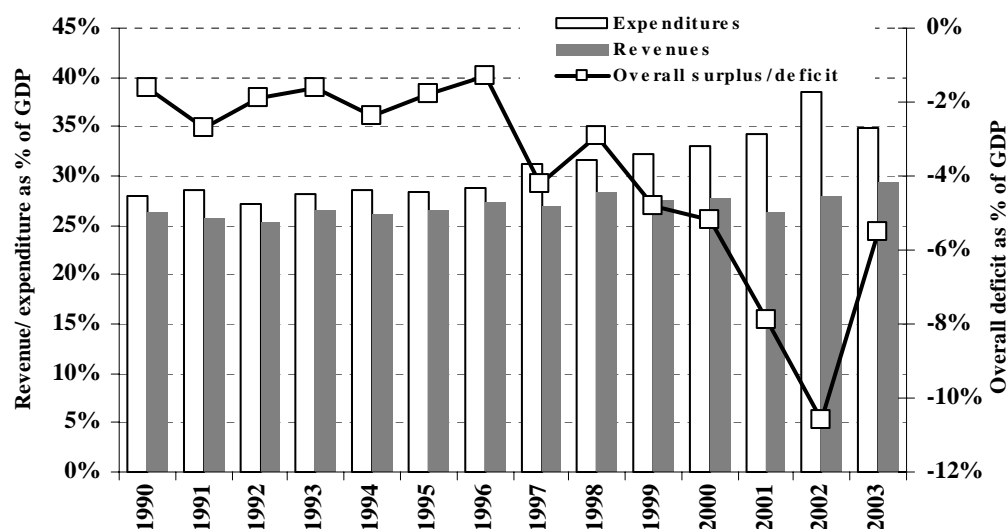
	Tourism			Bananas		
	1980s	1990s	2000s	1980s	1990s	2000s
	average annual growth rates (%)					
Rooms	8.3	4.3	-1.3	Volumes	12.8	-4.8
Arrivals	8.5	4.0	0.4	Values	20.7	-3.9
Receipts	17.6	4.1	0.4	% of GDP	9.7	5.1
% of GDP	40.0	36.5	29.8	% of exports	14.4	7.9
% of exports	60.7	57.9	54.1			3.0

Sources: Caribbean Tourism Organization (2003), West Indies Banana Development and Export Company, and World Bank (2004i)

B. Macroeconomic outcomes and impact

1.23 **The impact of the declining growth rates combined with the response of expansionary fiscal policies in the OECS has yielded significantly worse macroeconomic outcomes in the new millennium compared with a decade earlier.** Public debt-to-GDP levels are critically high in all the countries. The six countries now rank among the top sixteen most indebted economies in the world and none of the countries have achieved the ECCB fiscal benchmark for public sector debt of 60 percent of GDP. Although most of the OECS governments have recently been making efforts at fiscal adjustment and consolidation, these efforts have been piecemeal and a number have conceded periodic public sector wage increases despite declining productivity. The overall fiscal deficit for the sub-region increased from an average of 2.9 percent of regional GDP during 1990-97 to 6.4 percent in 1998-2003 and has been slightly reduced to an estimated 6.0 percent in 2004. Private investment continues to be weak at 16 percent of GDP in 2003.

FIGURE 1.7: FISCAL ACCOUNTS, 1990-2003



Source: World Bank (2004i)

1.24 Despite the deteriorating macroeconomic situation, the current account balance has remained relatively stable at 12 percent of GDP during 1996-2003 and continues to be financed by sufficient capital inflows to allow steady increases in international reserves. More recently, however, the capital account is demonstrating signs of growing vulnerability as evidenced by an increasing share of portfolio inflows (from 5 percent of total capital inflows in 1996-99 to 23 percent in 2000-03), declining official grants (from 23 to 16 percent across the same periods), and increasing net outflows by commercial banks (from 0 to 22 percent of the capital account).

C. Current challenges

1.25 As noted above, the growth performance of the OECS has been relatively strong over the past 25 years, but there has been a major slowdown over the past decade associated with weakening external performance and unsustainable fiscal policies. The current challenge facing the sub-region is how to reinvigorate growth in order to address the following imperatives – reducing high unemployment and poverty rates, restoring fiscal and debt sustainability, and securing a position for the sub-region in a more competitive global environment. We examine each of these imperatives below.

1.26 ***The social imperative.*** The most recent Poverty Assessment in the sub-region (Dominica, 2002) paints a picture of poverty that is predominantly income- and employment-based, as opposed to rooted in lack of access to broad social services. The latter reflects the sub-region's history of investment in social and human capital. As such, reducing poverty will require an expansion of job-generating growth, as well as continuous efforts to increase human capital so that the poor can take advantage of these opportunities. The sub-region has targeted 6 percent unemployment as its medium term goal. With a current average unemployment rate of 16 percent (and a population of approximately 570,000 persons), the OECS needs to create 57,000 new jobs over the medium term to achieve its target of 6 percent unemployment – assuming that the population growth rates remain near zero. However, given the need for fiscal adjustment, which may involve some reductions in public employment, and the continued decline in agriculture (still accounting for a significant share of the labor force), this number could be larger.¹⁰ One of the key challenges in this regard will be to raise the skill levels of the poor and unemployed, as well as the population in general. This will be discussed in more detail in Chapter 5. Given that this will take time, there is an urgent need to improve social protection and safety net programs during the transition period. This report will not address the details of such efforts which have been reviewed in recent and ongoing work by the World Bank.¹¹

1.27 ***The fiscal imperative.*** Regaining fiscal and debt sustainability across the OECS is critical not only to resuming growth, but also to safeguard the Eastern Caribbean Currency Union currency board arrangement which has provided one element of macroeconomic stability since independence. As such, the ECCB has established fiscal benchmarks for the individual countries, including minimum budget current balance of 4-6 percent of GDP, budget deficit of 3 percent, and maximum central government debt of 60 percent, to be achieved by 2007. In 2003, none of the countries had achieved the debt targets.

1.28 Table 1.5 shows the estimated required fiscal adjustment needed to achieve the debt-to-GDP benchmark over the next five years.¹² Clearly, there is a relationship between the magnitude of debt reduction needed, growth, and the required fiscal adjustment. For a given level of debt, faster growth will reduce the needed fiscal adjustment. OECS public debt stood at 113 percent of GDP in 2003. Assuming real interest rates of 4 percent and growth rates of 2.6 percent, the sub-region would need to achieve an average primary surplus of 12 percent of GDP in order to achieve the ECCB debt benchmark by 2008. This, in turn, would imply an OECS average fiscal adjustment of 14 percent of GDP. If, however, the sub-region achieves its target growth rate of 6 percent, the required primary surplus would fall to 8 percent and the fiscal adjustment to 11 percent of GDP.

¹⁰ At a first glance, it would seem that these jobs are needed predominantly in the Windward Islands, but one should note carefully intra-regional migration flows. For example, Antigua and Barbuda's low unemployment rates have been due to a policy of employer-of-the-last resort pursued by the recent government which has shown itself to be clearly unsustainable. Yet, given the large share of other OECS nationals in the Antiguan and Barbudian labor force, any rationalization of the public sector will have implications for unemployment and therefore the need for job growth in the rest of the region.

¹¹ World Bank (2003c, 2003e, 2004f, 2004g, 2004h, forthcoming) and ongoing work on a Caribbean Social Protection Strategy.

¹² The benchmark of 60 percent of GDP may be too high for the medium term sustainability. Experience has shown that the median public debt-to-GDP ratios the year before in countries which have defaulted were about 50 percent. Moreover, high variability in revenues, typical for a small, highly open and vulnerable island economies, generally indicate a lower sustainable public debt ratio.

TABLE 1.5: DEBT SUSTAINABILITY

% of GDP	Public debt 2003	Average growth 1998-2003	Real interest rates	Primary surplus required to achieve 60% debt-to-GDP by 2008	Avg primary surplus/deficit 1998-2003	Implied fiscal adjustment
Antigua and Barbuda	142	3.0	1.8	14.7	-3.3	18
Dominica	122	-0.4	2.1	15.5	-2.2	18
Grenada	113	4.1	6.6	13.4	-4.0	17
St. Kitts and Nevis	171	2.3	3.8	24.7	-6.5	31
St. Lucia	69	1.0	5.0	4.6	0.4	4
St. Vincent and the Grenadines	73	4.7	4.5	2.5	0.4	2
OECS	113	2.6	4.0	12.2	-2.3	14

Source: IMF and World Bank staff estimates.

1. 29 **It is important to note that the growth assumptions/targets and required fiscal balances are not independent.** Jamaica provides an important lesson from within the region. Jamaica has been running a primary surplus in the order of 8.5 percent of GDP over the last decade (1991-2003) in order to reduce its public debt that stands at 142 percent of GDP. Such a sustained tight fiscal policy has in turn contributed to a contraction in growth that averaged only 1 percent during 1998 to 2003. With respect to the OECS, the assignment and quality of fiscal adjustment will be important for determining its impact on growth.

1. 30 **A closer analysis of fiscal accounts presented in the recent World Bank Analyses of Fiscal Issues for most of the OECS countries¹³ suggests that the adjustment should be focused on the expenditure side,** in part because tax rates in the OECS are already high – corporate tax rates average 34 percent across the sub-region – and because unfettered increases in both current and capital expenditures across the sub-region has been at the root of the current imbalances. Expenditure levels are relatively high averaging 34 percent of GDP (see Table 2 in Introduction). Recent work by the World Bank has shown that there is scope to reduce expenditures while maintaining or even improving the quality of public services. However, a significant portion of the savings is likely to come from civil services’ reform which may aggravate the already difficult unemployment situation and thus needs to be undertaken together with efforts to encourage private sector activity. Public investment would also need to be selectively prioritized toward growth supporting interventions, its efficiency improved and its financing coming mainly from grants and concessional loans.

1. 31 **At the same time, there is scope for increasing the efficiency of revenue mobilization that in turn can positively affect growth.** Widespread use of concessions has narrowed the tax base and created distortions in the economy, while reducing revenue intake. Attention to tax policy is also warranted on the ground that OECS countries are expected to lose tariff revenues as a result of regional free trade arrangements. There also remains significant scope for improvement in tax administration. Recent work by the IMF and a sub-regional Tax Reform and Administration Commission (2004) presents a program of reform measures, including the introduction of a value added tax that would broaden the tax base.

1. 32 **The external imperative** for accelerating growth stems from the rapidly increasing globalization that is shaping the external climate for the OECS, and issues of external

¹³ World Bank (2003e, 2004f, 2004g, 2004h, forthcoming).

sustainability. The former is discussed in more detail in Chapter 3. As a very open economy, the OECS sub-region is dependent on imports for both domestic consumption and investment. In the past, these have been adequately financed by exports (primarily a positive services balance) and steady flows of aid and FDI. Large foreign investment projects have often driven up the current account deficit in individual countries as they temporarily expand the imports of materials and machinery. On average, the sub-regional current account balance has remained relatively stable at 12 percent of GDP during 1996-2003 and continues to be financed by sufficient capital inflows to allow steady increases in international reserves. However, in recent years, several factors have combined to bring the issue of external sustainability to the forefront, notably the rapid increase in external indebtedness, the slowdown in export growth and the changing composition of capital flows. The capital account is now demonstrating signs of growing vulnerability as evidenced by an increasing share of portfolio inflows and growing net outflows by commercial banks as they offshore excess liquidity.

1.33 The sub-region now faces several risks to its external sustainability, including the possibility of rising interest charges on the external debt, reduced access to external finance or capital outflows in the event that creditors downgrade their OECS paper, and continued weakness in export earnings. Any deterioration in these accounts would severely impact the OECS economies. As such, accelerating growth through improving export performance is thus critical to maintaining and increasing consumption levels. Externally, the OECS is already facing steeper competition for its exports and the advent of more liberal trade agreements that would expand and deepen globalization will increase these challenges. Thus, the sub-region needs to rapidly find and develop new sources of competitiveness, or it will be at risk of being left behind and outside of the world economy on which it depends so heavily.