

How to Avoid a Darkening Debt Storm in the Caribbean: Lessons From the Banking Union Framework in the Euro Area*

Andrew Hughes Hallett
School of Public Policy, George Mason University
3351 N. Fairfax Drive Arlington, VA 22201, USA
ahughesh@gmu.edu

and

Svend E. Hougaard Jensen
Department of Economics, Copenhagen Business School
Porcelaenshaven 16A, 2000 Frederiksberg C, Denmark
shj.eco@cbs.dk

Abstract: Using the euro area and the Eastern Caribbean Currency Union as case studies, this chapter argues that a comprehensive policy framework should comprise not only a rule for fiscal policy but also, and equally important, a broader set of strategies designed to improve competitiveness and economic growth. Specifically, we stress the need to prevent a build-up of debt, public *and* private, by introducing a mechanism to ensure that public and private borrowing is consistent with an overall macroeconomic strategy. This introduces elements of a banking union framework, tied into Europe's notion of a fiscal and competitiveness compact. We use this framework to show how different policy institutions can retain different priorities in their own economies, and hence individual policies that are internally consistent, while also maintaining a degree of flexibility that allows them to deal with problems as they arise.

Keywords: The euro area, The Eastern Caribbean Currency Union, public debt, private debt, fiscal rules, banking union, structural reforms

JEL codes: E62, E63, F33, F34, F36, H63, N14, N16

August 2014

* This paper has been prepared for the 46th Annual Monetary Studies Conference, to be held at the Central Bank of Trinidad and Tobago in Port of Spain, Trinidad, 18 - 20 November, 2014.

1. Introduction

Before the outbreak of the financial crisis in 2008, public finances in the euro area and most of the other OECD economies seemed to be in relatively good shape. Soon after, however, fiscal positions deteriorated rapidly. This has shaken investor confidence and led to dramatic increases in risk premia attached to government debt issued by most troubled countries, especially those in the southern part of the euro area (EA). However, despite these reactions by financial markets, governments have failed to keep their public finances on a sustainable path, even though the economies themselves have started to improve.

Recent developments in public debt and deficits have also shown that the fiscal rules embodied in Europe's Stability and Growth Pact, now Fiscal Compact, have proved impossible to enforce in practice. In fact, the deterioration of public finances happened regardless of how well designed the fiscal rules - with deficit limits, sanctions, balanced budget amendments etc. - appear to be. Thus, despite the dismal prospects of austerity, fiscal pain, bailouts, default, debt restructuring or monetization, the lack of an effective enforcement mechanism remains the key element in any fiscal crisis.

The bottom line is that neither financial markets nor supranational fiscal rules in Europe have a strong track record as providers of sound public finances. Also, recent experience shows that when fiscal austerity programmes have been applied, they have in many cases worsened rather than improved the fiscal positions. So, fiscal sustainability is not easily delivered; and the task becomes even more complicated if we allow for the fact that if the net present value of future public sector liabilities for social security and health care need to be included. If that is done, the fiscal stance of most of the EA countries is a lot worse than the recorded figures imply.

This paper attempts to draw out lessons from the EA that are important and transferable to the fiscal situation in the Eastern Caribbean Currency Union (ECCU). In fact, the fiscal imbalances among ECCU member countries have resulted in part from a long tradition under currency union arrangements, where fiscal imbalances are even more threatening than in the European currency union. We choose the Euro zone as comparator because the EA is the nearest equivalent currency union between several small open economies with varying degrees of diversification, but with full fiscal sovereignty. The experience of EA and its operating procedures therefore provides an instructive model of the alternative fiscal, monetary, and financial regulation frameworks that the

ECCU could adopt. In the same way, we use the ECCU as a model for what might be done in the wider Caribbean: the Caribbean Economic Forum or in the CARICOM economies.

Based on observations from both the EA and the ECCU, and paying due attention to differences and similarities between the two regions, we present a new macroeconomic framework capable of imposing fiscal discipline in the ECCU. It is designed to avoid the unsustainable fiscal policies of the past reappearing and to prevent union policies from being undermined by undisciplined national governments.

Key to the positions taken in this paper is that the appropriate policy response should allow for the circumstances underlying the fiscal problem. Clearly, if irresponsible government spending has compounded the problem facing uncompetitive Caribbean states, as argued by Wigglesworth and Mander (2013), the fiscal problems have to be dealt with through tough austerity measures. But an upsurge in public debt can happen just as easily from poor macroeconomic fundamentals, or major external disturbances, as it can from fiscal irresponsibility *per se*. Therefore, policies directed at obtaining fiscal discipline may be too narrow, and the policy framework needs to be designed to handle the more general problem: to cure the disease, not just the symptoms.

In particular, a comprehensive policy framework should comprise not only rules for fiscal policy but, equally important, policies to cover risk sharing, public and private financing, liquidity, competitiveness and growth. Specifically, we stress the need to prevent a build-up of debt, public and private, by introducing a mechanism that ensures private and public borrowing is consistent with the overall macroeconomic strategy. This should be augmented by a resolution mechanism in case sustainable debt limits are breached, as well as policies directed at structural reforms to stimulate growth and employment in the private sector.

Throughout the paper we are concerned with the policymaking framework, rather than with how specific policies might be constructed to deal with particular circumstances. We use this framework to show how different policy institutions can retain different priorities, and hence individual policies that fit together (are internally consistent), while also maintaining a degree of flexibility that allows them to deal with problems as they arise.

The structure of the paper is as follows. Section 2 reviews the scope and structure of macroeconomic imbalances in the ECCU, including a discussion of whether the large fiscal imbalances in fact are attributable to fiscal irresponsibility, or rest with more fundamental imbalances within the private sector. Section 3 outlines a simple framework for bank resolutions, liquidity provision and financial regulation. Section 4 discusses fiscal balances and financial regulation, based on support from a banking union, and Section 5 shows how a model of risk sharing, based on fiscal transfers and monetary federalism, can be applied. Finally, Section 6 concludes and offers suggestions for future policies and research in the area.

2. Scope and Structure of the Macroeconomic Imbalances in the ECCU

2.1. The ECCU macroeconomic framework

The Eastern Caribbean Currency Union (ECCU) consists of eight member countries or territories that share a common currency, monetary policy, and exchange rate system. The common central bank, the Eastern Caribbean Central Bank (ECCB), issues a common currency known as the Eastern Caribbean dollar (XCD) and it implements the region's monetary policy which has price stability as the primary objective.¹ The ECCB has pursued this objective by maintaining a fixed exchange rate link with the US dollar since 1976. The ECCU members pool their foreign reserves and the fixed exchange rate system is unilateral, as opposed to multilateral in the EA, because the fixed link is to an external currency (the US dollar). That converts a potentially multilateral system to a unilateral one with respect to the US dollar as far as monetary policy is concerned.

Monetary policy in the ECCU is thus potentially more constrained than it would be in an EA type framework where the common monetary policy remains subject to choice and can, if correctly used, be set to offset a part of each country's stabilisation problem. The consequence, however, is that fiscal policy will be relied on to a greater extent, and used more vigorously, in the ECCU than in either the EA or a free-standing economy with equal monetary discipline. For that reason, there is greater need to introduce effective fiscal restraints, or safety measures, in the ECCU than elsewhere.

¹ A standard analysis of a common currency area in the Caribbean is in Anthony and Hughes Hallett (2000).

The ECCB is committed to maintaining a level of pooled reserves at not less than 60% of its demand liabilities. Therefore, the exchange rate system is referred to as a quasi-currency-board arrangement. In practice, however, the ECCB holds significantly higher levels of foreign exchange reserves than that. This is a consequence of weak fiscal discipline among ECCU members. The central bank's excess of foreign exchange reserves over the statutory requirement gives the ECCB room to act as a domestic lender of last resort for banks under financial stress and to lend to governments during natural disasters.

The ECCB's ability to operate is also constrained by the underdeveloped nature of its domestic financial markets. This inhibits the ability of the Bank to influence the interest rates and thereby the availability of money and credit through the markets. In principle, market rates in the currency union are set at the discretion of the commercial banks, except that the ECCB regulates the minimum rate payable on savings deposits.

The ECCU member economies are individually small and undiversified: basically agricultural economies specialized in exporting bananas and sugar, though tourism has also become a major sector. They are also very open economies, trading mainly with the US and the EU. They are exposed to a variety of shocks, whether economic or from natural disasters, which affect them differently from the countries to which they are fixed. However, the ECCU economies have no formal risk sharing arrangements, such as through fiscal transfers (fiscal federalism), inter-island lending, or cross-border ownership of stocks, bonds or firms (essential compliments for a financially sustainable formal, *de jure* or *de facto* currency union according to Asdrubaldi et al., 1996). Nor do they have an equalization system like the German *Finanzausgleich*. This, in addition to their small size and lack of diversification, has left them very vulnerable not only to shocks and internal disruption caused by sudden stops or reversals in financing, but also to financial disruptions transmitted by persistent macro-imbalances over which they have little control – for example, trade shocks, foreign remittances, net investment income, or sudden changes in competitiveness – not to mention natural disasters, hurricanes etc.

Nevertheless, there are still several mechanisms that serve to impose fiscal discipline within the ECCU. In particular, the currency board structure of the ECCB has provided a measure of fiscal discipline over several years. Since the ECCB is allowed to hold domestic assets, lending to member governments is restricted to specified ratios of tax revenues. As a result of such

constraints, the public deficits have come to be financed by borrowing from external sources at market prices, a point to be elaborated on below.

More recently, the ECCU has created a Regional Government Securities Market, and an inter-bank market, to enhance liquidity and facilitate the issuing of Treasury securities. They are a diversification measure to allow the emergence of a secondary market where existing securities can be traded, separately from newly issued ones. The creation of such a facility could lead to problems of moral hazard, which would induce members to issue even more debt if the ECCB were to become the buyer of last resort. However, this has been addressed, by having the ECCB adopt the practice of only purchasing treasury bills to replace bills that are maturing at the time of purchase. This effectively means that the ECCB maintains its stock of government securities at existing levels and safeguards the operations of the currency board.

In addition, the ECCU has tried to create a single financial space, to gain greater economies of scale in the area's financial markets and to enhance the efficiency of capital mobilization. To that end, the ECCB has promoted and encouraged the development of an interbank market, and the regional securities exchange (ECCB, 2012). These markets have begun to increase liquidity and improve the efficiency with which interest rate changes are transmitted within the union.

2.2. Fiscal trends

Table 1 shows recent fiscal developments in six independent members of the ECCU (Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines). The selected public finance indicators, all stated as ratios to GDP, comprise the primary balance, the overall balance and public debt.

The public debt-to-GDP ratio is very high in all the ECCU countries. It has exceeded 60% in all countries since 1990, and has increased to over 100% since the global financial crisis took off in 2008 (IMF 2011a). There are marked differences across the six countries in the region, with St. Kitts and Nevis being especially badly hit [a debt-to-GDP ratio close to 150]. This upward trend in ECCU debt is not at all in line with what is observed in emerging and developing economies, where debt ratios declined from 50% in 2000 to 37% in 2009 (IMF 2010).

Yet, the ECCU pattern does not deviate that much from that found in advanced economies. For example, the gross general government debt in the advanced economies is estimated to have

topped 100% of GDP in 2012, which is a rise nearly 30 percentage points of GDP above their pre-crisis levels (IMF, 2011b). But, compared to the EA economies where public debt has risen from 66% of GDP in 2007 to 92.7% in 2013 (European Commission, 2014), the situation in the ECCU is therefore worse than the EA average. However, it is not worse than the EA's so-called GIIPS-countries (Greece, Italy, Ireland, Portugal and Spain), where debt ratios have risen to levels of between 120% and 180%.

Table 1: ECCU Selected Central Government Fiscal Indicators (% of GDP)

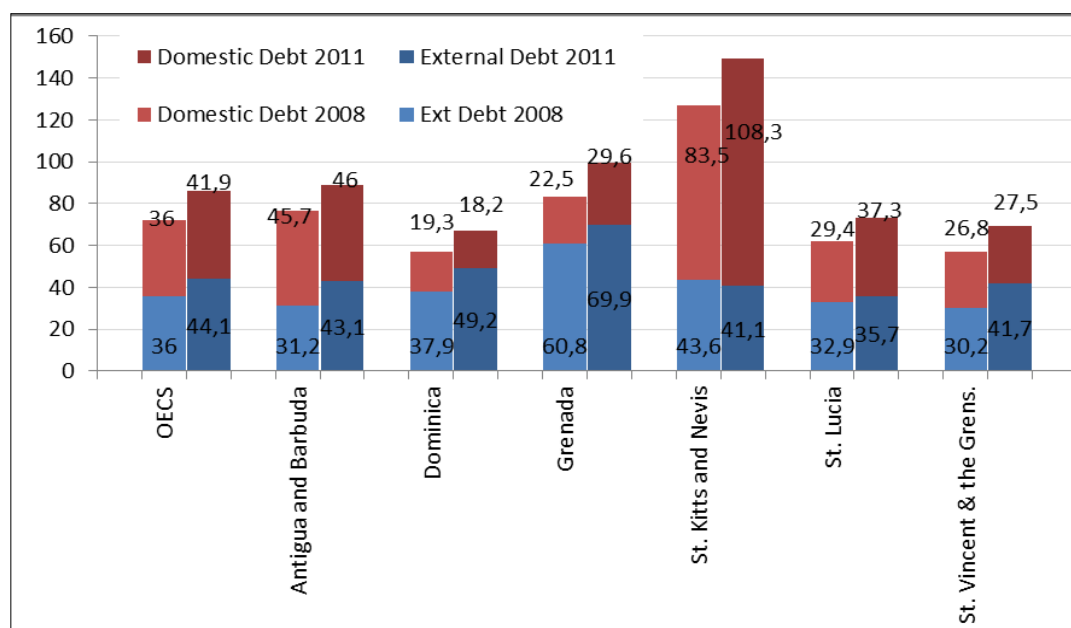
	2006	2007	2008	2009	2010	2011	2012	2013
Primary balance								
Antigua and Barbuda	-3,8	-2,5	-2,6	-10,9	1,7	1,4	2,3	2,5
Dominica	4,8	3,7	2,4	1,2	-1,2	-0,3	0,0	0,6
Grenada	-3,4	-4,6	-2,4	-3,0	-1,0	-2,9	-1,8	-0,6
St. Kitts and Nevis	3,7	2,7	2,6	3,7	-0,4	3,9	4,2	5,0
St. Lucia	-2,6	2,3	2,0	-1,0	-2,7	-4,7	-1,9	-0,5
St. Vincent & Grens.	-0,5	-0,8	1,1	-0,4	-2,9	-0,3	-0,8	0
Overall balance								
Antigua and Barbuda	-7,6	-5,7	-5,4	-18	-0,3	-1,7	-0,5	0,1
Dominica	2,9	1,8	0,7	-0,2	-2,6	-1,8	-1,4	-0,8
Grenada	-4,9	-6,3	-4,1	-5,2	-3,1	-5,2	-4,8	-3,5
St. Kitts and Nevis	-3,9	-3,5	-3,9	-2,9	-7,4	-3,1	-5,2	-1,9
St. Lucia	-5,7	-0,6	-0,9	-3,9	-5,8	-8,1	-5,5	-4,3
St. Vincent & Grens.	-3,2	-3,2	-1,4	-3,2	-5,8	-3,2	-3,7	-2,6
Public debt								
Antigua and Barbuda	90,4	78,8	76,9	101,8	89,4	89,1	86,5	82,9
Dominica	77,9	71,7	57,1	64,2	67,3	67,3	67,3	66,7
Grenada	92,8	88,7	83,3	96,4	99,3	99,5	99,5	99,5
St. Kitts and Nevis	145,3	132,6	127,1	144,6	156,4	149,4	156,4	149,4
St. Lucia	61,4	56,7	58,8	63,2	65,3	71,8	65,3	71,8
St. Vincent & Grens.	65,1	55,5	57,0	64,3	67,2	69,2	67,2	69,2

Source: IMF, World Economic Outlook Database, April 2012

Table 2 shows public debt broken down on a domestic and a foreign component, respectively. As can be seen, for the region as whole, total public debt is divided more or less equally between domestic and foreign creditors. But behind this average number, large differences emerge. For example, in St. Kitts and Nevis, the public sector debt-to-GDP ratio was 149% in 2011, of which the domestic component was 108% of GDP, i.e. around 70% of the total public debt. This indicates that the country had rather limited access to external funding. It may also reflect an

inappropriate financial market structure, characterized by strong incentives for private banks to favour lending to the public sector over lending to the private sector. The remaining economies had an easier time borrowing abroad, the external share of public debt being more than half in most and up to nearly three-quarters in Dominica.

Table 2: Composition of Public Debt on Domestic and Foreign Creditors



Source: IMF, World Economic Outlook Database, April 2012

Moreover, debt ratios were stable or decreased over the crisis period between 2008 and 2011, so some fiscal consolidation has been initiated. In addition, the debt-to-GDP ratios are expected to fall in four of the six countries in 2013. Only in St. Lucia and St. Vincent and the Grenadines is the debt ratio expected to worsen. Similarly, while budget balances showed fairly large deficits in all ECCU countries in 2012, the 2013 forecasts indicate that significant progress is expected. In fact the primary balances for 2011, and forecasts for 2012 and 2013, show that the region as a whole is on course towards primary surplus. But large differences between countries still remain.

Some countries in the region are pursuing explicit primary surplus targets of 2-4% of GDP in order to consolidate their fiscal positions. Estimates of fiscal adjustments required to put public debt on a sustainable path show that, depending on the existing debt ratios, the fiscal tightening required ranges from 2 to almost 10% of GDP relative to a status quo scenario (IMF, 2011a). So

it will not be an easy or short process to get the debt ratios down to manageable and safe levels. In addition, the demographic trends are such that the future will be marked by the higher costs of ageing and lower potential growth as fewer working age people shoulder the burden of an increasing proportion of older individuals. This can only make the consolidations more difficult, and could threaten the sustainability of public finances in the coming decades.

Finally, in view of the currency union and the policy of a fixed rate against the US dollar, it is important that national austerity programmes are coordinated to avoid free-riding by member governments and to avoid creating of adverse spill-overs for the weaker members.

2.3. Non-fiscal imbalances

If the current level of public debt is unsustainable, it may reflect macroeconomic imbalances elsewhere in an economy, and may not necessarily be the result of fiscal irresponsibility. This is a much neglected point which, in what follows, we try to demonstrate through a comparison of macroeconomic imbalances between the EA and the ECCU.

The starting point is the fundamental accounting identity for any open economy, stating that the current account balance of a country must be equal to the sum of the general government net borrowing and the private sector's savings-investment gap: $S-I = G-T + X-M$, where S = private saving, I = investment, $G-T$ = budget deficit (public spending less revenues) and $X-M$ = current account balance (earnings less outflows). This identity links external imbalances ($X-M$) and private financing imbalances ($S-I$) to the government's fiscal imbalance ($G-T$). It shows how excess public plus private spending on the right hand side can lead to a banking crisis in the private sector; *or* how external imbalances, even in the absence of fiscal irresponsibility, can lead to accumulations of public debt, or capital outflows, and a financial sector liquidity crisis in which private debt is replaced by public debt.

For example, if a current account deficit appears for any reason ($X-M < 0$), then either the government has to run a budget deficit ($G-T > 0$), or private savings must fall relative to investment ($S-I < 0$) to restore equilibrium. But private savings tend to rise, and investment to fall, in a recession: $S-I > 0$. So the more likely outcome is that the government budget deficit will rise. Indeed, if the private sector has been carrying too much debt, it will be the first to deleverage in a downturn, creating a balance sheet recession and banking crisis because savings have to rise to

pay down that debt. This causes a loss of liquidity in the banking system, and a potential banking crisis, which leads to even larger fiscal deficits to provide liquidity, rebalance economic activity, and to smooth consumption or tax revenues and replace the savings in banks.

At that point, excess private debt becomes excess public debt. Demand for assets in countries in difficulties will collapse, especially in a currency union like the EA or ECCU where asset sales can be sent to low-risk countries (e.g., Germany or Finland in the EA case; or to the US in the ECCU case) without any material transactions costs or exchange rate risk. Government bonds in the problem countries are then no longer capital risk free, especially if any prospective bailout looks unlikely or too small. In such cases, the expected value of a euro held in one place is not the same as its expected value in another – leading in turn to a run on the deposit base in the problem economies and increased borrowing costs (a capital reversal).

Thus, imbalances in the form of “twin deficits” (a deficit on both the current account and the government budget) can lead to a funding crisis in the private sector. But it can go the other way too, from financial/funding crisis to fiscal crisis without any irresponsible fiscal decisions.

One can extend this example by asking: how did the private sector get indebted in the first place? If an economy enters an era of historically low interest rates (a global savings glut, or on joining a more disciplined currency zone), then savings will fall with the start of an asset bubble or domestic credit boom (US, Ireland) which turns the savings-investment gap negative. This is not a fiscal problem if, and as long as, the credit bubble produces a matching trade or current account deficit and financing inflow. Portugal and Spain (until 2008) are cases in point. But if it fails to produce that inflow, or if the credit/asset bubble bursts, or trade financing dries up (so investment falls too), or if there is a deposit run as mooted above, then there will be a financing stop and fiscal deficits have to increase to provide liquidity to the banks. Hence the distribution of debt matters. This needs to be recognized in our analysis and policy recommendations.

Sequences of events like these provide the links by which poor macroeconomic fundamentals and persistent imbalances elsewhere in the economy can easily translate into fiscal deficits and a crisis in the banking sector, even if there has been no fiscal irresponsibility at all (Ireland, Spain). Fiscal irresponsibility (Greece, say) simply adds to the fiscal deficits implied. It is sufficient for us to note these links in a given fiscal environment, responsible or otherwise, and then examine

how they have contributed to unsustainable financing requirements (and accumulating private or sovereign debt) at that level of fiscal responsibility.

The implication is that financial regulation and policy oversight has to cover the consequences of *all* these imbalances; *and* to prevent one kind of imbalance morphing into another, *as well as* to remove any excess imbalances. The implication is that the ECCU will need better institutions rather than specific policies to achieve that in a world where countries have different objectives, different priorities and different time frames.

2.4. The Caribbean (ECCU) experience in comparison

How does the story unfold for the ECCU economies, compared to the EA experience? Are the fiscal imbalances the main risk to those economies, and cause of a poor economic performance? Or do the risks and need for restructuring lie elsewhere?

In order to answer these questions, we report the recent developments in general government net borrowing (Table 3), current account imbalances (Table 4) and the private sector savings investment gaps (Table 5), with the details being provided in the top panel for a select of EA economies and in the bottom panel for the ECCU. Note that the figures in Table 3 are defined as government revenues minus expenditures, so that a positive sign means “net lending”.

Table 3: General Government Net Lending (% GDP)

	2006	2007	2008	2009	2010	2011	2012	2013
	(a) EA							
Finland	4.1	5.3	4.3	-2.7	-2.8	-0.9	-1.7*	-2.0*
Germany	-1.6	0.2	-0.1	-3.1	-4.1	-0.8	0.2	-0.3*
France	-2.4	-2.7	-3.3	-7.6	-7.1	-5.2	-4.6*	-3.7*
Greece	-6.0	-6.8	-9.9	-15.6	-10.7	-9.4	-6.4	-4.6*
Ireland	2.9	0.1	-7.4	-13.9	-30.9	-13.4	-7.7	-7.5*
Italy	-3.4	-1.6	-2.7	-5.4	-4.3	-3.7	-3.0	-2.6*
Portugal	-3.7	-3.2	-3.7	-10.2	-9.8	-4.4	-4.9*	-5.5*
Spain	2.4	1.9	-4.5	-11.2	-9.7	-9.4	-10.3	-6.6*
EA	-1.3	-0.7	-2.1	-6.3	-6.2	-4.1	-3.6	-2.9
	(b) ECCU							
Antigua/ Barbuda	-8.8	-5.0	-5.7	-18.2	-0.2	-3.6	-1.2	-6.6*
Dominica	3.0	1.8	0.7	-0.3	-3.5	-4.5	-3.8*	-3.4*
Grenada	-5.6	-6.3	-4.1	-5.2	-3.1	-4.4	-4.7	-6.1*
St. Kitts/ Nevis	-3.9	-3.5	-3.9	-2.9	-7.8	1.8	5.2	2.2*
St. Lucia	-5.9	-1.9	-0.9	-3.1	-4.8	-6.9	-11.9	-9.4*
St. Vincent/ Grenadines	-3.1	-3.1	-1.4	-3.2	-5.4	-3.6	-2.7*	-2.8*

* Estimates. Source: IMF, World Economic Outlook Database, April 2013

A first look at ECCU data suggests that by far the biggest imbalances are in the current account, and then the savings-investment financing gap. Private financing therefore covers the larger part of the external deficits; but not by enough, so that fiscal deficits have had to make up the difference. This leads to cumulating public debt, not least in St Kitts, Grenada and Antigua in recent years. The ECCU countries are therefore open to a big risk from sudden financing stops, disasters or capital reversals, a risk that varies country by country as some have larger financing gaps than others (Table 5). This has obviously happened in St Kitts, Antigua, St Lucia and even St Vincent on occasion. Note that we are concerned with sudden deteriorations in the savings-investment gap itself here, and with sudden improvements which reflect a drop in investment.

Table 4: Current Account Balance (% GDP)

	2006	2007	2008	2009	2010	2011	2012	2013
	(a) EA							
Finland	4.2	4.3	2.6	1.7	1.5	-1.6	-1.7	-1.7*
Germany	6.2	7.4	6.2	6.0	6.2	6.2	7.0	6.0*
France	-0.6	-1.0	-1.7	-1.3	-1.6	-1.9	-2.4	-1.3*
Greece	-11.4	-14.6	-14.9	-11.2	-10.1	-9.9	-2.9	-0.3*
Ireland	-3.5	-5.4	-5.7	-2.3	1.1	1.1	4.9*	3.4*
Italy	-1.5	-1.3	-2.8	-2.0	-3.5	-3.1	-0.5	0.3*
Portugal	-10.7	-10.1	-12.6	-10.9	-10.6	-7.0	-1.5	0.1*
Spain	-9.0	-1.0	-9.6	-4.8	-4.5	-3.7	-1.1	1.1*
EA	0.5	0.4	-0.7	0.2	0.5	0.6	1.8	2.3
	(b) ECCU							
Antigua/ Barbuda	-26.3	-30.0	-25.9	-19.4	-14.7	-10.8	-12.8*	-13.1*
Dominica	-13.0	-21.1	-27.5	-21.2	-16.2	-12.8	-13.4*	-13.8*
Grenada	-29.6	-27.7	-25.3	-23.6	-24.1	-23.3*	-22.9*	-23.4*
St. Kitts/ Nevis	-14.1	-18.2	-27.6	-27.4	-22.4	-15.6	-13.5*	-15.9*
St. Lucia	-30.6	-30.6	-29.2	-11.7	-16.9	-20.1	-19.1*	-18.2*
St. Vincent/ Grenadines	-19.5	-28.0	-33.1	-29.3	-30.6	-28.8	-27.8*	-26.8*

* Estimates

Source: IMF, World Economic Outlook Database, April 2013

In the euro area there are some obvious jumps in government net borrowing where there are government bail-outs. But this is not the case in the ECCU (St Kitts apart). In fact, the patterns in the ECCU are all fairly stable, except for the private investment-savings gap in 2008-09; the current account balance in 2008-10; and government net lending in 2009-11. This lagged effect with respect to the fiscal gap tells us a lot about the flow of causality in the ECCU. Imbalances start with private sector external payments which are not fully financed by capital inflows from

abroad. In fact those inflows tend to dry up before the external deficits fall, which then throws the problem onto support from fiscal deficits and public debt.

Table 5: Private Savings-Investment Gap (% GDP)

	2006	2007	2008	2009	2010	2011	2012	2013
	(c) EA							
Finland	0.1	-1.1	-1.7	4.5	4.3	-0.7	0.7*	0.3*
Germany	7.9	7.2	6.3	9.0	10.4	7.0	6.8	6.4*
France	1.8	1.7	1.6	6.2	5.5	3.2	2.3*	2.4*
Greece	-5.3	-7.8	-5.0	4.4	0.6	-0.5	3.5	4.3*
Ireland	-6.4	-5.4	1.7	11.6	32.0	14.5	12.7	10.9*
Italy	1.9	0.3	-0.2	3.4	0.8	0.6	2.5	2.9*
Portugal	-7.0	-6.9	-8.9	-0.6	-0.5	-2.8	2.8*	5.6*
Spain	-11.3	-11.9	-5.1	6.4	5.2	5.7	9.2	7.7*
EA	1.9	1.1	1.5	6.7	6.7	4.7	5.5	5.4
	(d) ECCU							
Antigua/ Barbuda	-17.5	-24.9	-20.1	-1.1	-14.5	-7.2	-11.5*	-6.5*
Dominica	-16.0	-22.9	-28.2	-20.9	-12.7	-8.4	-9.6*	-10.4*
Grenada	-23.9	-21.4	-21.2	-18.4	-20.9	-18.9*	-18.3*	-17.3*
St. Kitts/ Nevis	-10.2	-14.6	-23.7	-24.5	-14.6	-17.4	-18.7*	-18.2*
St. Lucia	-24.6	-28.7	-28.3	-8.6	-12.1	-13.2	-7.2*	-8.8*
St. Vincent/ Grenadines	-16.5	-24.9	-31.8	-26.0	-25.2	-25.1	-25.1*	-24.0*

* Estimates

Source: IMF, World Economic Outlook Database, April 2012

A more detailed look at these tables shows that the private sector-public sector distinction is where similarities with the EA come to an end. The ECCU's biggest problem is current account deficits (particularly Grenada, St Lucia, St Vincent and St Kitts), whereas the biggest problem in the EA is clearly the fiscal deficits, augmented by external imbalances of either sign in Greece, Germany and Portugal before 2012. In addition, the European budget imbalances have been worse, at 4-5% of GDP, than those in the ECCU (at 3-4% of GDP). But the current account imbalances in the ECCU are four to five times larger (about 15% to 30% of GDP) than those in the EA (less than 2% of GDP, now mostly in surplus). Current account deficits in Europe have been falling therefore, whereas those in the ECCU have been larger and static since 2010.

The upshot is that the ECCU's main problem is a private sector one, and not in the first instance a public sector one as typically argued. Official policy therefore needs to be adapted to deal with that situation. That is not to say that fiscal deficit and debt reductions would not be an important complement to policies directed at easier financial mediation/stability and structural reform. The ECCU private imbalances are considerably larger and evidently feed through to induce increased

fiscal deficits and public debt. So policies directed at increasing savings, growth or employment, and improving the balance of trade and net investment would have the biggest impact on improving economic performance and reducing the risk of periodic financial crises, *as well as* reducing the pressures on fiscal budgets and escalating public debt.

Tables 3-5 make the differences between what might otherwise appear to be a common excess debt problem in the ECCU and EA clear. As a consequence, the policy prescriptions need to be different. In that regard, it is important to note that the savings-investment gaps have all turned positive since 2008 in the EA which, with improving trade balances, means the Europeans have shifted their private sector deficits onto the public budget, in which case consolidation is now the correct strategy. In the ECCU, there are no changes in the sign of the private savings-investment gaps or the size of external deficits. Their imbalances remain in the private sector.

Europe is therefore at a point where consolidation policies can probably be used successfully in the public sector. This means a clear distinction needs to be made between fiscal consolidation and restructuring (now that growth and private sector balances are returning to normal), and that restrictions should be placed on the premature use of the austerity policies which seem to have delayed the return to a “business as usual” scenario in the EA (Alessandrini et al., 2014).

In the ECCU, by contrast, the need is for policies directed explicitly at restructuring the private sector, both physically in real terms, and financially. However, without co-ordinated financial policies, financial stability is much more difficult to achieve.

3. Bank Resolutions, Liquidity Provision, and Financial Regulation

A concern in Europe has been the realization that macro imbalances in general (i.e., not just fiscal imbalances and fiscal irresponsibility) can play a major role in inducing fiscal deficits. This implies that the macro imbalances need to be controlled as well. At one level this is obvious: it is a matter of recognizing that fiscal deficits and debt are endogenous, and only partly subject to choice if the other macro imbalances are not controlled. But that is usually presented as a short run stabilisation issue.

However, recent experience in the EA has shown that these imbalances, if not held in check or reduced, can also pose serious structural problems. This has important implications for the design of financial policies and regulation procedures:

- a possible loss of financial control and uncertainty in the currency union;
- the difficulty of imposing sufficient discipline on the borrowers;
- the need to prevent a build-up of debt (public or private) in any participating economy, and what to do about it if it happens (the resolution mechanism);
- recognition that escalations in public debt can happen just as easily from excess private debt and asset bubbles, as it can from fiscal irresponsibility; and
- that a coordinating mechanism is needed to ensure that the borrowing done by either party is consistent with the overall macroeconomic strategy of the currency union.

3.1. Regulation and common or mutualized bonds

Participation in a currency union presumes that independent governments are able and willing to cooperate over matters of mutual interest. There is no issue of financial regulation or conduct for those involved in the issuance or management of national debt in the ECCU since 100% of financial sector activities already fall under common ECCU legislation and regulatory practice. From this point of view, mutual C-bonds would just be one more player in the market, much like the municipal or corporate bonds that already exist. The issue is how to manage the debt, and prevent an excessive build up of debt that disrupts the ECCU economy or the thrust of ECCU policies. We return to elaborate on this point below.

3.2. Jointly administered rescue funds

Based on the European experience, there are two points here: it is already illegal under the European Systemic Risk Board legislation for one country not to participate in a private sector bail-out on the basis of proportional activity levels if to do so would damage financial services in another jurisdiction (a violation of the single market). We recommend the ECCU adopt the same position; on the argument that it will be in the interest of any participant to proportionately bail out an institution not headquartered in its own jurisdiction since not to do so would precipitate the financial collapse of an institution, and possibly others, operating in that jurisdiction.

This may appear irrelevant to outsiders. But it is not, for two reasons: i) establishing a *feasible* public debt management and resolution scheme requires a separation private risk from public risk (we may wish to bail out the former as a liquidity problem, but not the latter as a solvency problem); and ii) because the governance arrangements need to recognise that sovereign debt

problems are often caused by financing stops and trade imbalances that arise in the private sector, rather than fiscal irresponsibility per se.

This section therefore makes the case for a jointly run bailout vehicle; that is, one which is mutually owned and operated, but run independently of governments and does not involve the mutualisation of debt since the decision to bail out will depend on factors that differ in different jurisdictions and may vary on a case-by-case basis. Moreover, the mutualisation of debt is to be avoided in order to preserve market discipline on the *individual* issuers of debt. That is necessary to limit the impact of moral hazard as far as possible on the issuers in the market for debt.

A second concern is that the Central Bank should not stand ready to bail out a national government with an unsustainable fiscal debt. The analogue here is the rules of the EA where 18 countries share the same currency, but none has legal or political authority over the central bank issuing that currency. Nevertheless, the ECB has found it necessary to bail out illiquid and possibly insolvent institutions within its member states repeatedly since 2007; and stands ready to continue. Since those institutions have traditionally been the largest purchasers of domestic sovereign debt, this bailout facility is a way of bailing out an illiquid or insolvent sovereign by the backdoor. Examples are the €500bn bank loans in the ECB's short term lending programme, buying the debt of distressed sovereigns on the secondary markets, loans made against collateral to lower borrowing costs, or forms of quantitative easing like the (as yet) unused OMT/outright monetary transactions program. The ECCB could easily find itself in the same position.

But, what the ECB has not agreed to do is intervene directly in the *primary* debt markets for distressed sovereigns, including the all-important refinancing operations of those sovereigns, to lower borrowing costs or avert default. Nor has the ECB embraced the idea that fiscal deficits and debt are often the result of "sudden stops" or capital reversals or private sector deleveraging. Or that deficits arise when of a lack of competitiveness turns the current account into a deficit that is difficult to finance. So it becomes important to create a system that separates fiscal irresponsibility from excess private sector debt, recognising that causality may flow either way.

3.3. The separation principle

The point being made here is that we need to create a regime that separates private sector risk from public risk, while providing a lender of last resort mechanism to underpin stability in the private markets but imposing fiscal constraints to rule out the chances of a sovereign default. The

former requires a rigorous system of financial regulation (as now proposed in Europe, and with greater clarity and coherence in the US and UK); but the latter requires a system of debt limits or targets with effective sanctions (a debt protocol operated by an independent fiscal policy watchdog – a Fiscal Policy Council). Then, having separated the two components into separate institutions, problems in the financial sector can be treated on merit with targeted lending of last resort where needed. By contrast, unsustainable fiscal policies will eventually be ruled out by the fiscal council through a technocratic device, in effect suspending the policy process until sustainability can be restored. In normal times, the markets and financial sector firms may pursue their own interests without constraint – unless their decisions would predictably lead to insolvency.

3.4. A fund for private sector bail-outs

On the private sector side, this argument requires a fund for private sector bailouts be set up and operated by a financial stability board run by the ECCB. It suggests a fund of guarantees, public ownership, or contributions supplied by member institutions, paid out as deemed necessary by the Financial Stability Board on an institution by institution basis. The funds in question should be lent/paid direct to the financial institutions themselves (not via either government) and should be regarded as being conditionally available to any institution in the union. If public ownership proves necessary, then that institution will become jointly owned (on a shareholder basis) by the participating fiscal and lending authorities. The size of fund and its ability to borrow have been controversial issues in Europe. This needs further thought in the Caribbean context; but since the ECCB's ability to expand its balance sheet and accept collateral for liquidity financing would lie behind any guarantees, those concerns may be less controversial than in Europe.

3.5. Why a mutually owned rescue vehicle is superior to mutually guaranteed public debt

To deal with public risk, a popular suggestion is to offer a joint guarantee on the national bonds (in effect creating C-bonds) to reduce borrowing costs. This is taken from the proposal to mutualise national debt in the EA under the control of a common Debt Agency, with the ability to issue Euro-bonds up to some limit, say 60% of GDP.

In this proposal, the ECCU's debt agency would be allowed to act in the primary market for sovereign bonds by placing a proportion of all new sovereign bond issues of ECCU members. The debt agency would also intervene in the secondary markets, by allowing it to switch between

existing national bonds and C-bonds.² Ordinarily, if a bond is issued by a country with high deficits, the spread should be larger compared to a country with stronger public finances. This would imply an incentive to bring deficits down. However, this has not happened in the euro zone. The spreads were minimal until 2009 and are again now. We suggest a similar limit, of say 60% of GDP, on the issuance of C-bonds by any member government in order to bring market pressures to bear on the individual borrowers (as opposed to the union as a whole) who exceed the safe limit. In effect, this is recognition that the presence of a resolution mechanism or rescue vehicle, with the implication that a bail out will almost certainly take place when the financial or economic costs of a default or break up by one party would be too large for the others, means that the markets will ordinarily price the risk to the currency zone as a whole and not price the risk posed by individual participants. Only when the markets realise that the rescue vehicle might not be large enough, or that a bail out may not be forthcoming, or that austerity measures may be imposed on the individual, will risk premia (and hence market discipline) be applied.

This is clearly demonstrated in Figure 2 below. The yield spreads of 10-year government bonds in the EA were minimal until 2010, apart from a mild increase from mid-2008 that had largely vanished by the end of 2009. That is at least 30 months after the start of the financial crisis. But once the defects of the Greek fiscal data were revealed in January 2010, and the markets realized that the situation was more serious than they had thought, and that the EA rescue vehicle might not be strong enough to save both Greece *and* the other problem countries, the spreads widened for all 5 countries and then continued to widen inexorably until late 2012.

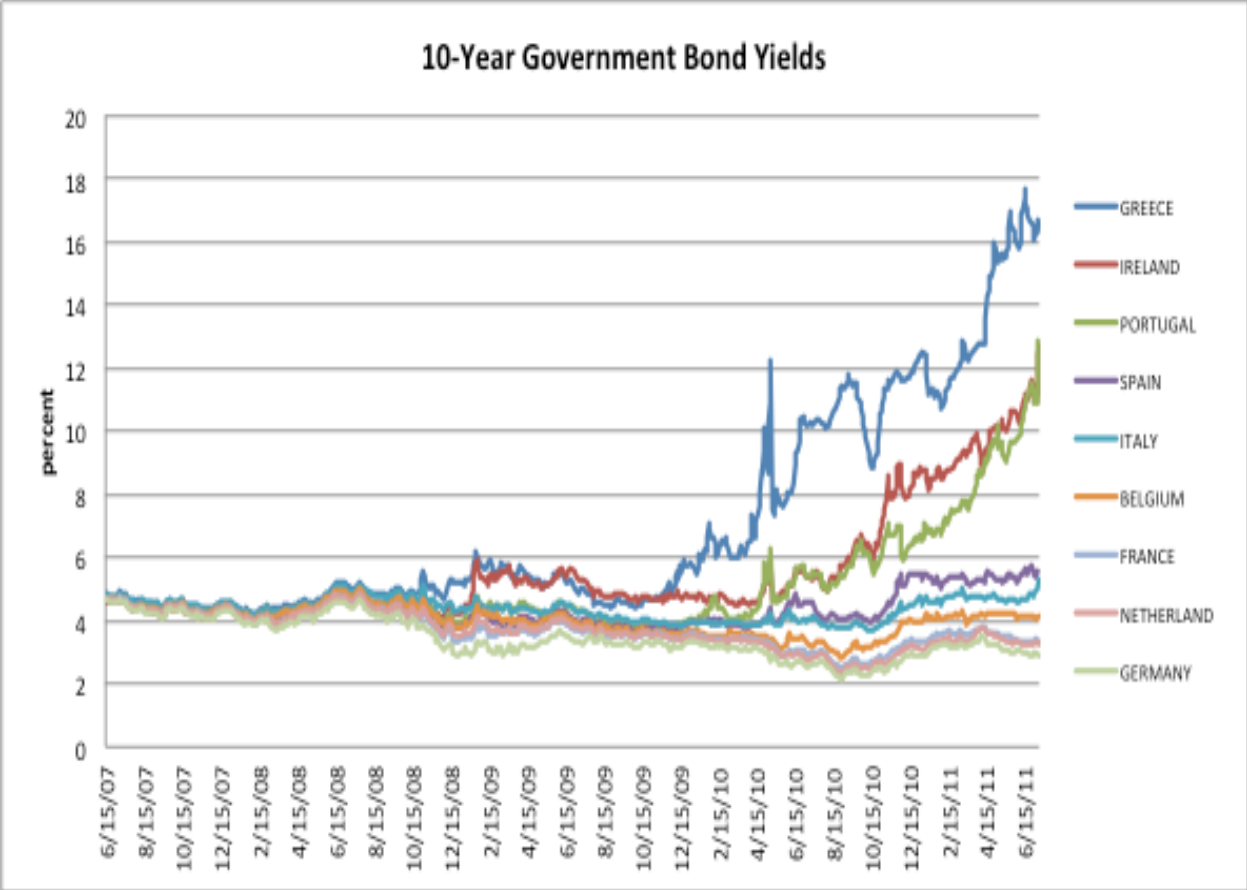
But by then it was too late; the deflationary impact of austerity and higher borrowing costs made debt and deficit ratios rise, further increasing borrowing costs and the need for austerity. In short, the worst feature of debt mutualisation is that it prevents market discipline being imposed early on, exactly when it is needed.

It is also difficult to see how common bonds could operate without problems of moral hazard in the financially weak economies. By lowering borrowing costs in the weakest economies, mutual bonds would in fact encourage more fiscal borrowing and institutionalise the over-expansion bias in those economies. Stronger members would be unaffected. They would continue to issue their

² By allowing investors to switch from national to C-bonds, this system should boost confidence in the markets. C-bonds would likely have a higher status as collateral for the ECB, which must be counted as a stabilising effect.

own bonds at interest rates lower than the rates charged for collectively guaranteed bonds. The weaker economies would borrow as far as they can in common bonds, and then issue their own bonds, for a total larger than if they had to borrow exclusively in higher interest domestic bonds.

Figure 2: Yields on 10-year government bonds, daily observations Jan 2007-March 2012



This arrangement will therefore lower borrowing costs for the weaker economies in the union. That is helpful in a downturn, but encourages more borrowing. It also raises borrowing costs for the stronger economies unless they use their own bonds – which they will. Common bonds therefore redistribute activity from strong to weak, reducing the locomotive effect of the stronger economies. The question arises: who pays if a country cannot refinance its debt? If collectively guaranteed, then C-bonds would be a way of loading default risk onto tax payers in the stronger economies, damaging performance of the zone as a whole. Hence, the chief disadvantage is the absence of market discipline when it is needed most. That is early on, and in ordinary times.

Nevertheless, the C-bond proposal could be expected to create a more liquid market for sovereign bonds in ECCU. Not only would this offer some protection against speculative attacks on the debt of individual countries and lower borrowing costs, but it would also serve to develop existing capital markets and attract new flows into the Caribbean area and ECCU in particular.

3.6. Market Discipline and Excess Debt Insurance

The remaining difficulties for the ECCB are: a) there is no rescue or resolution mechanism for island governments in liquidity/solvency problems; and b) there is no mechanism to impose market discipline on policymakers or governments in the early stages of a fiscal expansion.

A simple way to deal with both problems is to use the idea of “insurance bonds”. Governments issuing bonds would be required to pay an “insurance premium” on all bonds outstanding at that point. Knowing that they would have to pay a premium to issue more bonds, and that any discipline lapses in the future would increase not only the current premium, and hence current borrowing costs, but also the cost of all past and future borrowing, this should exert significant market discipline on current borrowing. Moreover, that discipline would not only affect current borrowing; but, unlike the present system where the costs of past debt are fixed, also through costs that are related to the size of the existing debt. It would make the policymakers look to future costs as reflected in the likely future premia on all debt, as well as the likely escalation of the debt burden itself. In short a kind of pre-emptive buttress against moral hazard.

The success of this mechanism obviously depends on how the premium payments are priced. They would be paid into a jointly owned (shareholder basis) rescue fund, not to the bond holders per se. They would not be directly market determined, for the very reason that the markets are typically pricing a different risk and not providing the market discipline we need. In that case, we need to simulate market discipline instead.

How to calculate the premium payments? Ideally they should be computed on an actuarial basis to reflect the probability of a default or restructuring becoming necessary – low for the safe economies (low debt, high growth, no macroeconomic imbalances), but higher for those with a large and/or increasing debt burdens, low growth, or long standing macro-imbalances. One could also relate the premia to the market rates for CDOs. But given that independent agencies such as the ECCB or its Financial Stability Board would probably have better information and longer horizons than market participants, transparency and simplicity suggest relating those premia to

competitiveness (unit labour costs), current account imbalances, liquidity premia in the financial markets (bid-ask spreads), an index of tax capacity, or to changes in the debt ratios, all relative to some agreed benchmark (which might include a debt target or debt limit). That allows numerical premia to be derived from agreed and published formulae.

4. Fiscal Balances and Financial Regulation Based on Support from a Banking Union

Most of the recent developments affecting economic governance in EA that have actually been agreed (as opposed to merely proposed) have been on the fiscal side: the Enhanced Stability Pact of 2011; the intergovernmental summit in December 2011; the Treaty on Stability, Coordination and Governance in Economic and Monetary Union (comprising the fiscal compact and budgetary monitoring by the European Commission); and the European Council declaration of June 2012.³

However, a number of unfinished issues in the fiscal area remain: the status of the competitiveness pact; the detail of how to set debt targets; what fiscal rules should support them; what enforcement and sanctions mechanisms are needed, etc. Agreement on these topics seems some way off; and as a result, agreement on a full fiscal union yet further off. Nevertheless, if fiscal policies are to be kept compatible and responsible, in the absence of automatic inter-economy fiscal transfers (“fiscal federalism”) there will have to be a more coordinated approach to fiscal and monetary policy.

Both aspects, inter-regional fiscal transfers and formal fiscal-monetary coordination mechanisms, are often controversial because they conflict with national interests and lower the pressure for reform and efficiency; and because they diminish national sovereignty. As a result, the EA has introduced a number of financial and monetary policy measures which are relevant here because they support and substitute for the coordination necessary in a fiscal union. Among these measures, we include long term refinancing operations by the ECB (official financing or the Target2 payments system, for banks), Outright Monetary Transactions (for distressed

³ References for the fiscal governance measures adopted. Overview of the 6-pack, 2-pack, and Fiscal Compact:

http://ec.europa.eu/economy_finance/articles/governance/2012-03-14_six_pack_en.htm

Regulation from the 6-pack containing the 1/20th debt rule (Article 2):

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:306:0033:0040:EN:PDF>

Fiscal Compact Treaty and the European Council decision:

http://www.consilium.europa.eu/media/1478399/07_-_tscg.en12.pdf (debt rule is in Article 4). See also van

Rompuy H. (2012) ‘Towards a Genuine Economic and Monetary Union - Report by the President of the European Council’, European Commission, 26 June 2012, Brussels

governments), increased commitment by the ECB to growth, Basel III rules on banks, a banking union and an EU-wide system of financial regulation.

Of these, the last two are the most important for the long term; while the first two (and the bailout vehicle, ESM, inside the banking union) will be more important in specific episodes. One can also see the beginnings of a separation between mechanisms for dealing with public and private risk, although the implementation is not as clean as one would like. For example, the long term loans made to distressed banks at cheap rates were largely used to buy bonds of distressed governments, relieving their refinancing difficulties and providing them with a bailout by the backdoor. Similarly, governments are now required to provide matching finance to the ESM to bailout a bank.

Both have therefore been compromised in practice although the intention was sound. That said, outright monetary transactions, in which the ECB undertakes (under certain strict conditions) to intervene *without limit* in the markets for national debt in order to reduce domestic borrowing costs, differ from the loans scheme which depends on unconditional but limited interventions. This marks the difference: by keeping interest rates lower than market rates, OMT activities can help to reduce the distance and transition between the actual real exchange rate and debt in the problem cases and the levels necessary to reach a temporary equilibrium – especially if the prospect of unlimited transactions leads expected future interest rates to remain low. Loans, by contrast, put no pressure on the real exchange rate and need to be increased continually to keep interest rates down. That cannot be done in a limited scheme, unless expectations shift to help.⁴

For Basel III, the major economies have agreed an outline framework. But detailed definitions for capital ratios, what counts as reserve (Tier 1) assets, whether investment and retail banking should be separated, and whether regulation and supervision should be extended to financial services generally, remain to be settled.

Nevertheless, part of the Basel discussion has been about financial regulation and this does affect the EA or ECCU in particular. Inevitably that debate has become part of the attempt to set up a Banking Union for the EU. In that context, it is agreed that a Banking Union should contain three elements: a) a common rule book for prudential banking practice; b) a common deposit insurance scheme; and c) a common resolution process for banks in trouble. These components

⁴ The only formal analysis of these two options known to us is in Hughes Hallett and Martinez Oliva (2012).

are not in themselves controversial. However, as of 2014, the introduction of a Banking Union remains incomplete because we have no agreement on how far the regulation and oversight process should go. The accepted structure is that the overall regulation and supervision functions should be carried out at the federal (European) level by the ECB for the systemically important banks. But the detailed monitoring and supervision of smaller institutions, and of the non-bank institutions, should be discharged by national regulators acting on behalf of the ECB.

Although a definition of what should constitute a large bank (assets exceeding 30bn Euros) is agreed, as so often in federal systems major disagreements remain over the responsibilities, rights and resources of the national regulators; i.e. their individual mandates vs. responsibilities to the ECB regulator. It is agreed, however, that all countries have to participate in a bank rescue in proportion to the bank's business in that economy irrespective of the home of its headquarters. But there are still differences over whether limits should be imposed on the amount of sovereign debt a bank may hold; over how much capital must be held against that debt; whether the ECB's supervision board should work on a one-member-one-vote basis, or votes distributed to reflect the size of the banking sectors; whether these rules should be extended to the financial services generally; and whether members should have the right to vary banking/financial services rules, within limits, from the ECB's own rules to deal with variations in local conditions. So, although working arrangements for deposit insurance and the ESM's bailout facility may be easy to agree, a fully functional banking union is more difficult.

5. Risk Sharing: Fiscal Transfers and Monetary Federalism

A crucial question for any currency union is how far the fiscal sovereignty (autonomy) of the national governments should be allowed to go. National governments have a natural agenda to provide stability for their economies, yet provide the levers that lead to economic growth and job creation. To satisfy these goals, the fiscal instruments with more variable revenues will inevitably have to be allocated to the national governments to provide growth and development; and that in itself automatically makes borrowing necessary to provide stability.

5.1. The allocation of policies to different authorities

This argument points to a natural allocation of policy instruments between central and national policy makers. The power to tax *immobile* factors, property and natural resources should be

allocated to national governments. They should also be free to set user fees, benefit contributions and spending; and have the power to raise income, sales, corporate or business taxes, and the social security taxes that affect mobile factors, production costs and competitiveness; and also spending on health, education, infrastructure, innovation, and development. The latter are instruments that affect productivity in the short and long run, and hence unit labour costs and employment.

Taxes on *mobile* factors are included here because the ability to set taxes equal to the marginal cost of providing services at the regional level is necessary if households and firms are to choose locations that provide the most efficient level of services. More importantly, they are the policy levers that allow island governments to promote growth and better economic performance in the member economies.

By contrast, “framework policies” that affect monetary conditions, price stability, financial stability, (inter-economy) income redistribution, competition and regulation policy, internal and external co-ordination, and trade policy are better left with the central authorities. This allocation of policy instruments follows comparative advantage for the goals of member governments and the currency union, respectively.

5.2. Fiscal federalism

But with borrowing and more variable revenues among member governments, institutional measures to support risk management, risk sharing, and fiscal oversight are needed to bring credibility and stability to the system.

Risk sharing with automatic transfers is the obvious way to reduce any member government’s dependence on borrowing and debt. Given an allocation of policy instruments by comparative advantage, regional governments might pay an agreed portion of their revenues to the central authority (in this case the central authority of the ECCU) for certain pooled services: defence, security, central administration, debt service. To this we add a certain percentage of GDP in solidarity funds to allow the ECCU Economic Commission to make its own redistribution and stabilisation payments. Power over the remaining taxes and expenditures could then be allocated to national governments; that is, excluding sales taxes (a common sales tax is necessary for a common competition policy), but including power over taxes that affect the rate of return on labour – unemployment insurance, payroll taxes paid by employers, and corporate taxes.

Notice that automatic transfers (that is, risk sharing elements) are built into this arrangement specifically to provide automatic stabilisers via the central budget. This is designed to reduce a government's need to borrow in bad times. For example, suppose two economies are at different points in their cycle because their cycles are out of phase. If they have delegated taxes and expenditures, both regions will finance their expenditures from taxes collected locally. But the region enjoying a relative boom will have a stronger budget, because tax revenues will be above trend and cyclical expenditures (unemployment or business support, social projects) below trend. Meanwhile, the region in relative recession will have below average revenues, above average expenditures, and a potential deficit.

However, there is compensation for the recession region from the central budget. Taxes from the boom region to the central budget will be higher, and central expenditures in that region lower, so that region will be transferring some of its surplus to the centre. The recession area will be transferring lower taxes but draw above average expenditures from the centre. It will be receiving a net transfer from the centre. If the centre balances its budget, that implies an indirect transfer from surplus to deficit region. Moreover, these transfers are automatic and reversible: there are no monitoring or decision lags, no need for parliamentary consent, and no biases. There will also be risk sharing via integrated capital or financial markets, and via loans/credit channels, in the usual way. Indeed, studies have shown that these last-mentioned channels supply the larger part of risk sharing within existing currency unions (80% in the US or Canada; half that in the UK), but less outside.⁵

5.3. Monetary federalism

An obvious extension of the fiscal federalist framework, with a common currency and common monetary institutions underpinned by a banking union as described above, is to use monetary policy to absorb regional shocks and thus narrow differentials in performance or activity levels. To show how this might be done, we assume a market for debt that consists of mutual C-bonds guaranteed by the ECCU plus national bonds from the member states.

Since investors will always have the choice between domestic and C-bonds, the interest rate on the latter will typically be an average of the "risk free" rates payable on the domestic bonds of

⁵ See Asdrubaldi et al. (1996), Kalemli et al. (2003) and Melitz (2004).

the weaker economies who issue C-bonds. The stronger economies would never need to use C-bonds since they can benefit by issuing their own national bonds at interest rates lower than that average. The weaker can issue their own bonds too, above the cap on C-bonds, but at higher interest rates and with weaker guarantees/collateral.

Now, in addition to investors, the ECCU debt agency may intervene in the market for debt – allowing it to “switch” between holding national bonds and C-bonds, or indeed between national bonds of different types. This raises the question about the conversion rate between national and C-bonds, or between national bonds. One might expect to start at par, but that a discount or spread would soon be attached depending on market stress. Thus, if the bond in question is issued by a country with high deficits, the spread should be larger than for a country with stronger public finances. With this spread structure being known in advance, there would be some incentive to bring the larger deficits down. At the same time, the spreads will imply variations in the relative prices: the strong economies having higher prices and lower yields for their bonds, the C-bonds with common prices and yields in the middle, and weaker economies having lower prices and higher yields and higher interest rates.

In this set up, the debt agency might buy the national bonds of a weak economy to redistribute activity toward that economy by lowering its bond yields and interest rates relative to the ECCU and C-bond average. If those purchases are funded by sales of C-bonds, it will have the effect of lowering prices and raising interest rates for the other weak economies. So that will not usually be the best plan. But they could be funded by selling national bonds from the strong economies, raising their interest rates relative to the C-bond and ECCU average.

Thus, operations of this kind (“monetary federalism”) can be used to stabilise weak economies by redistributing activity, growth, employment or investment (or restrain inflation in the strong economies) through changes in relative interest rates in national markets. In short, if this is done without impact on the overall money supply, it represents a kind of relative quantitative easing.

But if it is done by net sales out of, or creating net purchases into the debt markets as a whole – using the C-bond segment for example – then the money supply will change, and ECCU interest rates as a result. That is a form of open market operations in the traditional sense, to determine the ECCU-wide monetary policy using C-bonds. The national bonds offer the opportunity for regional stabilisation in the same way that fiscal federalist transfers do via a central budget.

6. Concluding Remarks

In this paper we have attempted to draw out lessons from the recent fiscal policy experience in the euro area. Specifically, by focussing on the Eastern Caribbean Currency Union, the paper has looked into what new institutional arrangements could be usefully introduced: (a) to increase fiscal-monetary as well as fiscal-fiscal coordination within the ECCU, (b) to separate private and public risks; (c) to create a greater degree of risk sharing; (d) to introduce common bonds to deepen the market for, and lower the cost of, borrowing; and (e) to increase the degree of competitiveness, both inter-island and with respect to the outside world.

While a credible and enforceable fiscal rule is key to any macroeconomic policy package, in this paper we have argued in favour of a comprehensive policy framework, comprising not only rules for fiscal policy, but also a set of policies capable of underpinning competitiveness and growth. As excessive public debt may result from not only fiscal irresponsibility, but also from macroeconomic imbalances in general, policies focusing on fiscal discipline may simply be too narrow.

Recent developments in the structure of macroeconomic imbalances in the EA and ECCU serve to illustrate the point well. In fact, the EAs largest problem is fiscal deficits, augmented by external imbalances in Greece, Portugal (and Germany!) before 2012. The EA deficits have been worse (4-5% of GDP) than those in the ECCU (3-4% of GDP). However, current account imbalances in the ECCU are four to five times larger (about 15 to 30 % of GDP) than those in the EA (less than 2% of GDP, and mostly in surplus).

These figures make the differences between what might otherwise appear to be a common excess debt problem in the ECCU and EA clear. It is important to note that the savings-investment gaps have all turned positive since 2008 in the EA which, with improving trade balances, means the EA has shifted private sector deficits onto the public budget. In the ECCU, there are no such changes in the sign of the private savings-investment gaps or the size of the external deficits. Their imbalances remain in the private sector.

To address those differences, the policy prescriptions need to be different. Specifically, Europe is now at a point where consolidation policies could operate on the public sector. This calls for a distinction between fiscal consolidations and restructuring, now that growth and private sector balances are returning to normal. The premature use of austerity policies which had probably

delayed the return to a “business as usual” equilibrium in the EA. In the ECCU, by contrast, the need is for policies explicitly directed at restructuring the private sector.

The upshot is that ECCUs main problem is a private sector one in the first instance, and official policy should be adapted to deal with that. This is not to say that fiscal deficit and debt reductions would not be important. But the private sector imbalances are considerably larger and evidently feed through to induce increased fiscal deficits and public debt. Policies should therefore be directed at increasing savings, growth or employment. Improving the balance of trade and net investment incomes or remittances would have the biggest impact on improving economic performance, on reducing the risk of periodic financial crises, as well as reducing the pressures on fiscal budgets and escalating public debt.

Finally, the findings of the paper may suggest a potential topic for future research. While the patterns in the ECCU appear fairly stable, there are exceptions: the private investment-savings gap in 2008-09, the current account balance in 2008-10, and government net lending in 2009-11. This lagged effect with respect to fiscal gap tells us something about causality – that imbalances start with private sector external payments which are not fully financed by capital inflows from abroad. In fact, those inflows tend to dry up before the external deficits fall, hence showing up as increases in fiscal deficits and public debt. It would be interesting to carry out a more formal investigation of whether such causality can be identified statistically.

References

1. Alessandrini, P., M. Fratianni, A. Hughes Hallett and A. Presbitero (2014) “External Imbalances and Financial Fragility in the Euro Area”, *Open Economies Review*, 25, 3-34.
2. Anthony, M. L. and A. Hughes Hallett (2000), “Is the Case for Economic and Monetary Union in the Caribbean Realistic?” *The World Economy*, 23, 119-144.
3. Bergman, U. M., M. M. Hutchison and S. H. Jensen (2014), “Shaping the Fiscal Policy Framework: Lessons from Fiscal Consolidations in Denmark and Sweden”, to appear in Andersen, T., M. Bergman and S. H. Jensen, “Reform Capacity and Macroeconomic Performance in the Nordic Countries”, Oxford University Press.
4. Bokan, N., A. Hughes Hallett and S. H. Jensen (2013), “A Note on Growth-Maximising Public Debt under Changing Demographics”, mimeo.
5. Calmfors, L. and S. Wren-Lewis (2011), “What Should Fiscal Councils Do?”, *Economic Policy*, 26, 649-95.

6. Checherita C., A. Hughes Hallett and P. Rother (2013), "Fiscal Sustainability Using Growth Maximising Debt Targets", *Applied Economics*, 46, 638-647.
7. ECCB (2012), "Monetary Policy", <http://www.eccb-centralbank.org/about/mon-policy.asp>, Basseterre, St.Kitts.
8. European Commission (2011) "Public Finances in EMU-2011", *European Economy-3*, Brussels.
9. Hughes Hallett, A. (2008), "Debt Targets and Fiscal Sustainability in an Era of Monetary Independence", *International Economics and Economic Policy*, 5, 165-187.
10. Hughes Hallett, A. and D. Weymark (2007), "Fiscal Leadership and Central Bank Design", *Canadian Journal of Economics*, 40, 607-27.
11. Hughes Hallett, A. and S.E.H. Jensen (2012), "Fiscal Governance in the Euro Area: Institutions vs. Rules" *Journal of European Public Policy*, 19, 646-64.
12. International Monetary Fund (2010), "Eastern Caribbean Currency Union: Staff Report for the Discussion on Common Policies of Member Countries", IMF, Washington DC, 17 September.
13. International Monetary Fund (2011a), "Eastern Caribbean Currency Union: Selected Issues", IMF Country Report No. 11/32, January, Washington DC.
14. International Monetary Fund (2011b), "Fiscal Monitor: Addressing Fiscal Challenges to Reduce Economic Risks", September, Washington DC.
15. Jordà, Ò., M. Schularick, and A. M. Taylor (2013), "Sovereigns versus Banks: Crises, Causes and Consequences", CEPR Discussion Paper 9678, CEPR, London.
16. Wigglesworth, R. and B. Mander (2013), "The Caribbean: A Darkening Debt Storm", *Financial Times*, April 28.