

Recent developments in St Lucia, Seychelles and Vanuatu

Introduction

The global financial crisis of 2008 and 2009 and resulting global recession have impacted most economies, including those of small states, which are characterised by a high degree of economic openness. All three small island states that were profiled in the previous chapters were adversely affected but not with the same intensity, with Vanuatu still registering positive growth in 2009, whereas St Lucia and Seychelles are estimated to have experienced negative growth rates (IMF, 2010e).

Recent evidence would seem to suggest that the major effects on these small states were not mostly felt on the financial sector, due to the fact that the banking industry in these states did not indulge in excessively risky business, but on aggregate demand, especially on exports of goods and services.

This chapter will briefly describe recent changes in the economies of these three small island states, with information derived mostly from IMF surveys.

St Lucia

St Lucia, like many other small states, was impacted by the global economic turmoil, and this was manifested in 2009 through, amongst other things, a contraction of economic activity of 5.2 per cent, mostly due to fewer tourist arrivals as well as a slowdown in construction activity, which over the past few years had contributed towards the economic development of the country.

The drop in visitors has been accompanied by marked reductions in tourist expenditure which in turn led to losses in employment in the sector. Despite attempts at maintaining employment, the rate of unemployment in St Lucia as at 2009 increased to 20.5 per cent compared to 16.8 per cent in 2008.

The number of stay-over tourists in St Lucia started to recover in the fourth quarter of 2009 and continued into the first two months of 2010, albeit at a slow pace. This notwithstanding, the increase in tourist arrivals has not been matched by an increase in tourist expenditure as hotels have significantly reduced prices in a bid to increase tourist arrivals.

In addition, the global economic downturn has also had an impact on government revenue and foreign exchange reserves as well as foreign remittances.

In response to the economic crisis, the Government of St Lucia increased tax incentives to the hotel industry, deferred the remittance of Hotel Accommodation Tax to the tax authorities, lowered personal income tax and increased expenditure on short-term employment programmes aimed at creating jobs. Increased provisions were made in the budget for subsidies on basic food items and cash transfers to the poor were increased.

While the fiscal stimulus had the impact of mitigating the effects of external shocks and limiting the impact on unemployment, the limited fiscal space was a major constraining factor in this regard and the government budget deficit is expected to reach 6.5 per cent of GDP over the period 2009 to 2010 (IMF, 2010a).

Given these manifestations of economic vulnerability, authorities requested a disbursement under the Fund's Rapid Access Component of Exogenous Shocks Facility (RAC-ESF) to help mitigate the impact of the crisis on the economy. The request was met by the IMF, alleviating some of the immediate foreign exchange needs stemming from the spillover effects of the global economic downturn and financial turmoil (IMF, 2009a).

Enhancing resilience

In order to enhance economic resilience, authorities need to focus on fiscal sustainability as a means to allow for the better absorption of external shocks. This in turn should be conducive to macro-economic stability. According to the IMF (2010a), given current policies, the public debt of St Lucia is on an unsustainable path. As a result, there is the need for renewed emphasis on a credible commitment to medium-term fiscal consolidation. However, it is important to stress that the timing of fiscal withdrawal needs to be planned in a cautious manner so as to ensure that the exit strategy minimises the impact in the short run while adequately aiming for flexibility and growth enhancing activity in the long run. In addition, economic resilience also calls for efficiency in government spending such that spending is earmarked towards activities which render a rate of return to the economy.

Micro-economic market efficiency, another pillar of economic resilience, focuses on flexibility in the labour market particularly in terms of matching income to productivity gains as a means to enhance the competitiveness of St Lucia. Efforts have also been directed towards eliminating price controls (Gwartney et al, 2010).

In addition, given the recent financial sector difficulties in the Caribbean, resilience also calls for appropriate financial sector regulation and supervision. In particular, there is the need for strengthening the supervision of the domestic non-bank and offshore sectors. While abiding by enhanced national and international regulation and supervision may be costly, especially for a small state already severely constrained in terms of administrative capacity, this requirement is considered an important source of economic resilience.

Seychelles

On the basis of its performance in the wake of the recent global economic crisis, the economy of Seychelles may be cited as a prime example of how a vulnerable economy may rapidly and effectively recover from a deep adverse shock thanks to adequate resilience-

building policies. This is also attested by the results of an assessment of recent economic performance conducted by the International Monetary Fund (IMF, 2010b, 2010c).

As a small, open and vulnerable economy, Seychelles came practically to a standstill in 2009 as a result of the global economic and financial crisis. This was the result of a significant downturn in external demand which mirrored the unprecedented decline in global trade. For 2010, however, the economy is projected to be recovering from this recession. The IMF expects real GDP to grow by 4 percent in 2010, reflecting in good part a significant recovery in tourism activity. Inflation, which was negative during 2009 on account of the decline in domestic demand and in global prices, as well as a prudent monetary stance in spite of the economic debacle, is expected at around 1 per cent for 2010.

The IMF views this recovery towards positive performance to be the result of strong progress which is being made by the Seychelles authorities in their reform program, which is aimed at stabilising the economy in terms of its macro-economic performance and contains an ambitious array of structural reforms.

Macro-economic policies are building resilience mainly by improving fiscal and debt sustainability. The primary fiscal surplus reached 13.4 per cent of GDP over the first nine months of 2009, on account of strong revenue performance and effective expenditure control, in spite of the decline in economic activity. Many countries all over the world have attempted to counter the decline in economic activity through a strong fiscal expansion, which is now leaving them with the problem of planning a retreat strategy for fiscal policy that would not cause another recession. Seychelles is largely free of this problem, as it actually persisted with fiscal consolidation in spite of the decline in aggregate demand. This policy is now paying off, facilitating the implementation of key projects, notably in the area of public infrastructure.

Other important contributors to macro-economic stability included the liberalisation of the exchange regime and prudent monetary policies. As a sign of the ongoing economic improvement, the exchange rate has appreciated steadily since early 2009. Short-term interest rates on government securities declined sharply from about 30 per cent in January to below 5 per cent, reflecting the strong deflation and fiscal tightening.

A number of structural reforms are also being implemented, including important steps toward the introduction of a simple, fair and equitable tax system; the strengthening of public financial management; and the modernisation of central bank operations. The ongoing efforts to modernise the financial sector and improve the governance and performance of public enterprises will be crucial to sustain private sector growth.

In particular, the three targets for structural reform set for 2009 were met. These included better public financial management, the development and adoption of foreign reserve management guidelines; and the implementation of effective management and control systems of public enterprise through the introduction of a specific legislative act. In terms of the latter, external financial audits of the seven largest public enterprises were completed and management audits of major public entities have also been carried forward. Based on the results of these audits, the management of the public utilities company was replaced

by foreign expertise. The authorities have also adopted a public sector action plan for expenditure reforms in health and education.

The country's success at resilience-building is also conducive to facilitate the disbursement of assistance on the part of the Fund (IMF, 2010b, 2010c).

There remains further progress to be achieved in the building of economic resilience in Seychelles. According to the Gwartney et al (2010), Seychelles needs to further improve its entrepreneurial environment and particularly its regulatory framework and access to financing. As already argued with regard to St Lucia, abiding by enhanced national and international regulation and supervision is costly especially for a small state with limited administrative capacity, but this requirement is of major importance for economic resilience building. Efficiency levels in the public sector, as well as its relatively large size in the economy, deserve further attention. Recent reforms aimed at enhancing market flexibility in trade and monetary activities need to be intensified.

Vanuatu

Vanuatu remains one of the best economically-governed small states in the Pacific region. Since 2003, it has adopted a policy of fiscal prudence and a regulated monetary environment and these have paid dividends in terms of economic growth and inflationary tendencies.

Economic growth in terms of real GDP, which averaged around 6 per cent per annum between 2005 and 2008, slowed down to 3.3 per cent in 2009 but is likely to recover and, according to International Monetary Fund (IMF, 2010d), is expected reach 4.2 per cent by 2011. The main contributor to such growth was and remains the services industry, particularly tourism, transportation and communication. The services sector has continued to improve as a result of enhanced competition and progress in the regulatory frameworks. Privatisation, such as that of Air Vanuatu, has helped to reduce inefficiency in the sector.

Government finances have continued to be managed well, with VAT making an important contribution to government revenues. Fiscal surpluses were registered at 2.2 per cent of GDP in 2008, with an estimated balanced budget in 2009. As import taxes will continue to fall as a result of trade liberalisation, the government will have consider additional sources to make up for the tax-revenue shortfall.

Inflation, measured by changes in the consumer price index, was just under 5 per cent in 2008, showing a tendency to increase over the previous four years, but it is likely to go back to 3 per cent by 2011.

The current account deficit was 2.2 per cent of GDP in 2009, down from 5.9 in 2008, but it is likely to widen again in 2010 and 2011.

Like other small states, Vanuatu was adversely affected by the international financial turmoil, not directly in its financial sector, given that its banks did not indulge in overly risky business, and the ensuing global recession could have had a large negative impact on demand had it not been for the successes registered in tourism.

There is, of course, room for improvement in the economic governance of Vanuatu. According to Gwartney et al (2010), there is still too much state interference in the economy, and the incidence of inefficient state-owned enterprises tend to crowd out private-sector investment. In addition, starting a business is still a rather lengthy process. There is also room for improvement in the workings of product and labour markets, due to the excessive government intervention in agricultural prices.

Overall, however, Vanuatu may be considered as a small state that is assigning due importance to economic resilience building, but stability in future years will depend on what happens in the global economy, given the high degree of openness of this small island state.

Conclusion

The three small states that were profiled have one important characteristic in common, namely that the three of them are very open economies, and rely heavily on a narrow range of exports. They are, therefore, very economically vulnerable due to their high exposure to economic forces outside their control. It is important to note that the fact that Vanuatu still registered positive growth rates in 2009 and Seychelles and St Lucia are likely to return to positive growth rates in 2011, does not negate their economic vulnerability. They will remain very open to external shocks. For this reason, economic resilience building remains of major importance for these states, much more so than in larger states. Resilience-building policies in these small states should be aimed mainly at promoting economic stability and competitiveness, principally by improving the functioning of the product and labour markets, encouraging private sector development and adopting prudent approaches in public finances.