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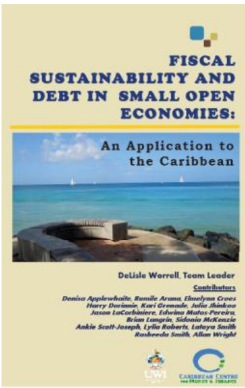

FISCAL SUSTAINABILITY AND DEBT IN SMALL OPEN ECONOMIES: AN APPLICATION TO THE CARIBBEAN

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For many years, the debt-to-GDP ratio has been used as the primary tool to assess a country's overall solvency and credibility in financial markets. Authors such as Geithner (2002), Belhocine and Dell'Erba (2013), and the international financial institutions (World Bank and the IMF) advocate its use and suggest various thresholds as a panacea to ensuring debt sustainability. However, the book *Fiscal Sustainability and Debt in Small Open Economies* deviates from this norm, by using a country's foreign reserves and fiscal stance as an objective measure of debt default that is more suited to small very open economies (SVOEs). The book has five chapters. Chapter 1 explains the factors that can lead to unsustainable fiscal policies. Chapter 2 reviews the most pertinent literature on debt and fiscal sustainability. Chapter 3 analyses the fiscal experience of countries prior to, within and after the 2008 economic recession. Chapter 4 discusses the methodology for determining unsustainable fiscal policies, and the final chapter recaps the preceding chapters and concludes.

The book begins with a detailed and coherent view of the limits in which fiscal policy in SVOEs becomes unsustainable compared to more developed countries. Central to this argument is that fiscal policy is unsustainable when it increases the demand for foreign exchange beyond the supply, thereby exacerbating the ability of the country to fully service its debt obligations. In the context of SVOEs, the authors argue that the impact of fiscal deficits and debt on growth is indirectly through the balance of payments. Essentially, a fiscal expansion increases the spending power of individuals and hence the demand for imports, which exhausts the wherewithal needed to service the country's debt. It is emphasised that expanding the money supply in an attempt to finance the fiscal deficit can also largely impact the balance of payments by increasing aggregate spending power, which also leads to a depletion of foreign reserves. This view provides the context for the aforementioned debt assessment framework, as an indicator of the risk of a crisis in SVOEs, rather than the conventional debt-to-GDP ratio.

The authors next highlight the theoretical and empirical literature underpinning the concept of debt and fiscal sustainability. In this chapter, the authors reinforce the inconsistent views of sustainable and unsustainable debt levels proffered by both authors and institutions. Most of the theoretical literature argues that fiscal policy is sustainable as long as it does not result in debt default or debt surpassing a certain threshold (see IMF 2002; Blanchard et al. 1990; Adams, Ferrarini and Pak, 2010; and Wypolsz, 2007). The empirical literature assesses various econometric approaches used to study fiscal sustainability, which includes time series models, multiple equation models, dynamic stochastic general equilibrium models, Debt Sustainability Analysis (DSA), and empirical studies undertaken within the Caribbean. The authors argue that the literature depends on a range of assumptions and none uses compatible approaches to sustainable debt and fiscal policies. Interestingly, the methodology used by the authors to determine fiscal sustainability was not theoretically nor empirically validated in the existing literature.

Despite the aforementioned limitation, Chapter 3 analyses the trajectory of fiscal policies and debt prior to, within, and after the 2008 global financial crisis in nine Caribbean countries, namely: Aruba, The Bahamas, Barbados, Belize, Antigua and Barbuda, Dominica and St. Vincent and the Grenadines, Jamaica and Suriname. The common thread among the countries under review was weak government revenues, prior to the 2008 economic crisis. This eventually worsened with the onset of the crisis due to continued increases in public expenditures (aimed at restoring economic stability), as well as the inability to attract foreign capital inflows through tourism and investments. Notwithstanding these challenges, the authors emphasised that Caribbean countries were able to avoid an external current account crisis, due to their ability to maintain adequate amounts of foreign reserves. The authors, therefore, stress that as long as the balance of payments constraint is not contravened, countries' fiscal, financial and economic policies could be considered sustainable.

The chapter continued to give a detailed account of countries that have and have not undertaken debt restructurings. Most countries, including those that were able to avert a debt restructuring, had a debt-to-GDP ratio below 80 percent between 2008 and 2013. Nevertheless, four countries (Jamaica, Belize, St Kitts and Nevis, and Grenada) opted to restructure their debt. It was emphasised that during the recession there has been no evidence that the restructurings were due to the countries' inability to service debt obligations. Additionally, each country – with the exception of Jamaica – had adequate levels of foreign reserves, which justified that the restructuring decision was merely undertaken to avoid the cost of additional adjustments. It is on this basis that the authors attempt to reinforce the argument that the Caribbean has sustainable fiscal policies.

Chapter 4 is the focal point of the book. The authors use a comprehensive model that builds on the concept of the monetary approach to the balance of payments, similar to that developed by Howard and Mamingi (2002). The test of fiscal sustainability was done over a 25-year period by analysing the relationship between money creation and the level of foreign reserves for the seven countries under review. It is purported that when the deficit has to be financed through Central Bank intervention, increases in the money supply can cause a hike in aggregate demand for imports. As a result, foreign exchange reserves will deteriorate, thereby hindering the ability of the country to fully service its external debt obligations. The chapter illustrates this concept by the use of graphs, which show that despite the Caribbean region's high propensity to import, it has been able to sustain the 12-week benchmark cover with foreign reserves averaging 10 percent of GDP.

The results also suggest that Aruba, Barbados, the noted ECCU islands and Suriname were characterised as low risk, owing to the adequacy of reserves and hence the ability to increase central bank credit by a minimum of 5 percent of GDP, before reaching the three-month target. Belize and the Bahamas were found to be moderately risky due to their history of money creation and semi-dollarisation within the economy. Jamaica was ranked as high risk, since the reserves holdings were below the threshold, even before any form of money creation was applied. Given the findings, the authors conclude that potential debt defaults are unlikely and overall fiscal policy has been sustainable in the countries under review.

This book provides a useful and unique approach for measuring sustainable fiscal policies in SVOEs. In this instance, it caters specifically to the peculiarities of each economy by taking into account factors that can significantly affect the ability to service debt obligations, that is, the balance of payments and the level of foreign exchange reserves. Moreover, due to its non-technical nature, it can be used by non-academics as the foundation for further research and a tool for policymakers and investors in their decision-making process.

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