

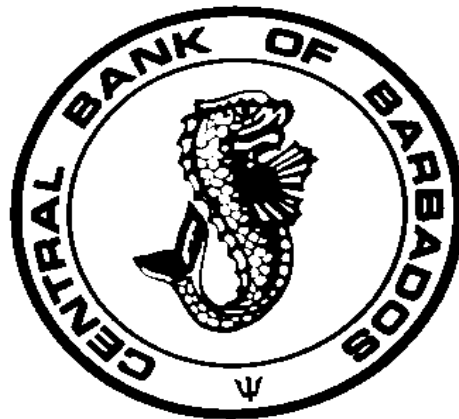
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**THE ECONOMIC PROSPECTS FOR THE CARIBBEAN**

BY

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## The Economic Prospects for the Caribbean

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The economic prospects for the Caribbean depend on creative private sector responses to the challenges of the countries' markets for exports of goods and services, principally in North America and Europe. Governments' role is to stabilise exchange rates, thereby minimising inflation and ensuring domestic policy credibility, to support the private sector export thrust in selected, strategic areas, and to secure the social safety net for vulnerable groups in society. These countries have all achieved a relatively good quality of life for their citizens, reflected in Human Development Indices that range from the medium to the highest category; simply by avoiding economic contraction they may preserve a comparatively good lifestyle, in the interval that will be required while new investments in exports, tourism and other export services germinate.

Caribbean economies may grow in a sustainable fashion only when their foreign exchange earnings increase, because they have very high import propensities, and there is almost no overlap between the things they produce at internationally competitive prices, and the things they need to import to sustain production and an acceptable quality of life. There are import substitutes for only a handful of food items, and they are typically more expensive than the imported items. In most Caribbean countries, everything else is imported.

The Caribbean's share of the markets for its exports, tourism and other services is so small that the Caribbean contribution has no effect on the ruling prices. For whatever is the comparable product or service quality, the Caribbean is able to sell everything it is able to produce at the ruling price, and nothing whatever at a higher price. It follows that the Caribbean does not engage in price competition, in the international market for any commodity. Instead, growth strategies involve investment in increased production capacity, increased quality and productivity to gain access to higher quality market segments, and investment in product differentiation. These strategies are all being pursued with success to varying degrees throughout the Caribbean, in tourism, international business services, export agriculture, food and beverage manufacturing, and in the energy sector in Trinidad-Tobago. Government support is offered in various forms and with varying commitment of time and resources.

Efforts are being made to diversify the markets for Caribbean exports and services, to Latin America and Asia, the world's fastest growing economies. In the case of Latin America this would seem to be a natural and welcome development, in view of the location of the Caribbean on the fulcrum between north and south. In the case of Asia the geographic argument is not compelling, but there may well be some scope for selling into the high end of that market. However, in neither case should resources be diverted from North America and Europe, because that is where the Caribbean's existing marketing strength lies, and from where the bulk of foreign exchange comes. The greatest effort should be devoted to solidifying the foundations of Caribbean access to traditional markets, and to securing growth on the basis of those foundations. The fact that the economies of North America and Europe are growing slowly, if at all, need not limit the potential growth of Caribbean exports of goods and services to them. Because Caribbean production is so little, the region may target those counties, states, provinces and municipalities that are most prosperous, and where incomes are growing faster than the national average.

Investment in alternative sources of energy is the new sector that has the potential to make a significant contribution to the growth potential of Caribbean economies. The region has abundant resources of thermal, solar and wind energy, and the technologies for implementing these systems are now within an accessible price range. The remaining barrier to takeoff of these technologies in the Caribbean is the unavailability of suitable financing and arrangements for distributed energy production. Waste disposal is a perennial problem, especially in the island economies, and one may expect to see increasing interest in the construction of waste to energy plants. Once alternative energy production is ramped up, it will enhance overall growth potential through the saving of foreign exchange for oil imports.

Investment, with a bias towards the foreign exchange earning and saving sectors, and the physical and social infrastructure that supports them, is the strategy that maximises growth potential. That investment should include substantial commitment to marketing, in order to build loyalty to Caribbean brands. Initiatives are needed to substantially increase service quality in tourism, international business services and government services in particular, so that excellence of service becomes a source of competitive advantage for the Caribbean, and a basis for differentiating the Caribbean brand. The growth of exports, tourism and other services provides the foreign exchange surpluses (over their own requirements) that supply the resources for consumer imports and imported inputs to the nontraded sectors.

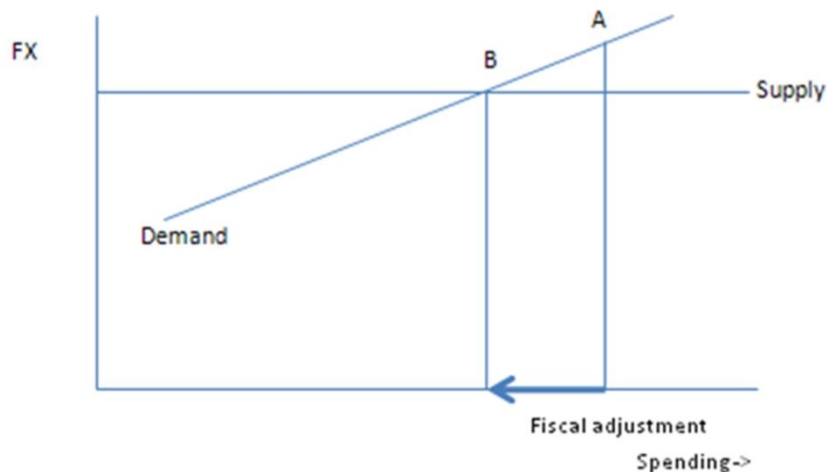
*Stabilisation of the balance of external payments provides the necessary foundation for growth*

Because all consumption is imported or uses imported inputs, any depreciation of the exchange rate causes a reduction in the real purchasing power of income. In the Caribbean, as in all economies of our size, devaluation always depresses living standards: imports are more expensive, there are no local import substitutes to switch to, and exports, tourism and other services will not expand because market share cannot be captured by reducing prices, since Caribbean countries are price takers. It is for this reason that no Caribbean country has ever devalued its currency as a deliberate policy. Devaluations have always been forced upon the authorities by the fact that excessive demand for foreign exchange went uncorrected for too long, allowing the central bank's foreign reserves to become exhausted. Faced with excess demand for foreign exchange, several governments have attempted to ration foreign exchange for imports of goods and services, as well as capital and financial outflows. However, Caribbean economies are so intimately linked to the international economy, both in trade and finance, that these rationing devices prove ineffective, both on the current and on the capital accounts.

There is a durable myth that financial flows may be rationed through capital controls, a myth accepted even by those who acknowledge that rationing of current transactions cannot be made to work. However, the mechanisms available to the private sector for cross border financial flows are if anything even more powerful than for the current account. They include transfer pricing (which is impossible to detect in tourism and services exports), intra-company transfers by multinational companies or groups, changes in the patterns and use of trade credits vs funding imported inventory with domestic financing, exchange of goods and services in kind, and, most recently, central treasury management of several currencies by multinational firms, not to speak of informal or other arrangements. As a result, capital controls cannot be used as a rationing device, though they may sometimes permit authorities to buy time to make fundamental adjustments to expenditure, in order to secure external balance.

The conundrum Caribbean economies face is how to manage aggregate demand so that spending on imports does not exceed available foreign exchange inflows. For this purpose Caribbean economies have only one effective tool: the fiscal. Figure 1 illustrates how fiscal policy may be used to achieve external balance.

Figure 1. Adjustment Policy for External Balance



In the short run the supply of foreign exchange may be forecast with acceptable precision, based on the capacity in the foreign exchange sectors and the prevailing prices in those sectors. The demand for imports will be larger the greater is aggregate spending; therefore, should spending be at a level which implies imports amounting to a level represented by Point A, measures must be taken to bring expenditure down to Point B, where imports will exhaust all the available foreign exchange.

The needed adjustment cannot be secured using monetary policy. That would require an increase in interest rates, but expenditures in the Caribbean are quite insensitive to interest rate changes, so a very large increase would be required. However, any increase in interest rates, all other things being equal, is more likely to attract capital inflows than to put pressure on spending. Except that this is a situation where all other things are not equal: in particular, the motivation for the policy is a deficiency of foreign exchange. Once that fact becomes known, the likelihood is that there will be capital flight, rather than an inflow, on the expectation that the interest rate defense of the currency will fail, and a subsequent devaluation will more than wipe out any interest premium on foreign lending to the country.

In the circumstances of Figure 1, if projected foreign exchange demand is at Point A, the only option available to Caribbean policy makers is fiscal contraction, in an amount sufficient to reduce imports by the desired amount. Institutional mechanisms must be put in place to make this policy effective. Fiscal policy is made in advance, because the measures do not have instantaneous effects, and they may require legislative and other time consuming changes. An effective macroforecasting system is therefore essential. Forecasts provide a benchmark against which to judge the future as it arrives, and it is also essential to have a close monitoring and feedback mechanism, which allows timely adjustments to be made along the way.

Using these tools, the authorities may maintain the balance between the supply and demand of foreign exchange, and sustain an adequate reserve of foreign exchange. Drawing on the foreign reserves as needed from time to time, the central bank meets the ins and outs of the foreign currency market at an

exchange rate which does not change, because the market equilibrium is achieved by adjusting the quantity demanded, rather than the price.

This framework of policy minimizes the potential for inflation and output loss, protects the real value of domestic financial savings, lends credibility to official policy, and provides the least uncertain – and therefore most favourable – climate for investment. Inflation is minimized because the effect of imported inflation, which predominates, is not compounded by exchange rate depreciation. Real income losses as a result of devaluation are avoided, as are the corrosive effects of devaluation on the real value of domestic financial assets. Because of the known ill effects of devaluation, and the fact that it has never been voluntary, exchange rate depreciation is seen as evidence of policy failure; conversely, the ability to sustain the exchange rate lends credibility to official policy. Furthermore, it is by now well known that uncertainty about exchange rates is a disincentive to fixed investment.

#### *A critique of the World Bank/IMF approach to growth, debt and stabilisation*

The preferred strategy for stabilisation and growth in the Caribbean and other small open economies is:

- Balance the external accounts by managing aggregate demand using fiscal policy to stabilise expectations and create a positive investment climate in the short run; and
- Support initiatives for investment (including marketing), productivity and product quality with a view to increasing foreign exchange earnings in the longer term, to release the potential for growth.

This contrasts with the views of the international financial institutions, articulated most recently at the IMF-CDB-Government of Trinidad-Tobago sponsored conference in September 2012. They advocate:

- A growth strategy based on a reduction in supply prices (by way of devaluation or draconian fiscal adjustment, involving wage cuts), and a search for new products and new markets, along with productivity increases;
- A limit of 100% maximum for the gross debt to GDP ratio (some authors recommend 60%); and
- The use of a combination of monetary policy and exchange rate flexibility to achieve short run stability.

The reasons why these recommendations cannot be expected to renew growth in the Caribbean are implicit in the features of Caribbean economies set down above. Exchange rate depreciation causes contraction, not growth. If the country is small, it sells all it can produce at the ruling international price; selling at a lower price simply reduces the return to the producer on the amount sold. These results hold whether the devaluation is external (via the exchange rate) or internal (via wage cuts). The search for new markets and products will be most effective if it builds on current strengths, and is therefore best centred on market niches, with relatively less emphasis on entirely new products and markets. The need for productivity increases is a point well taken, however.

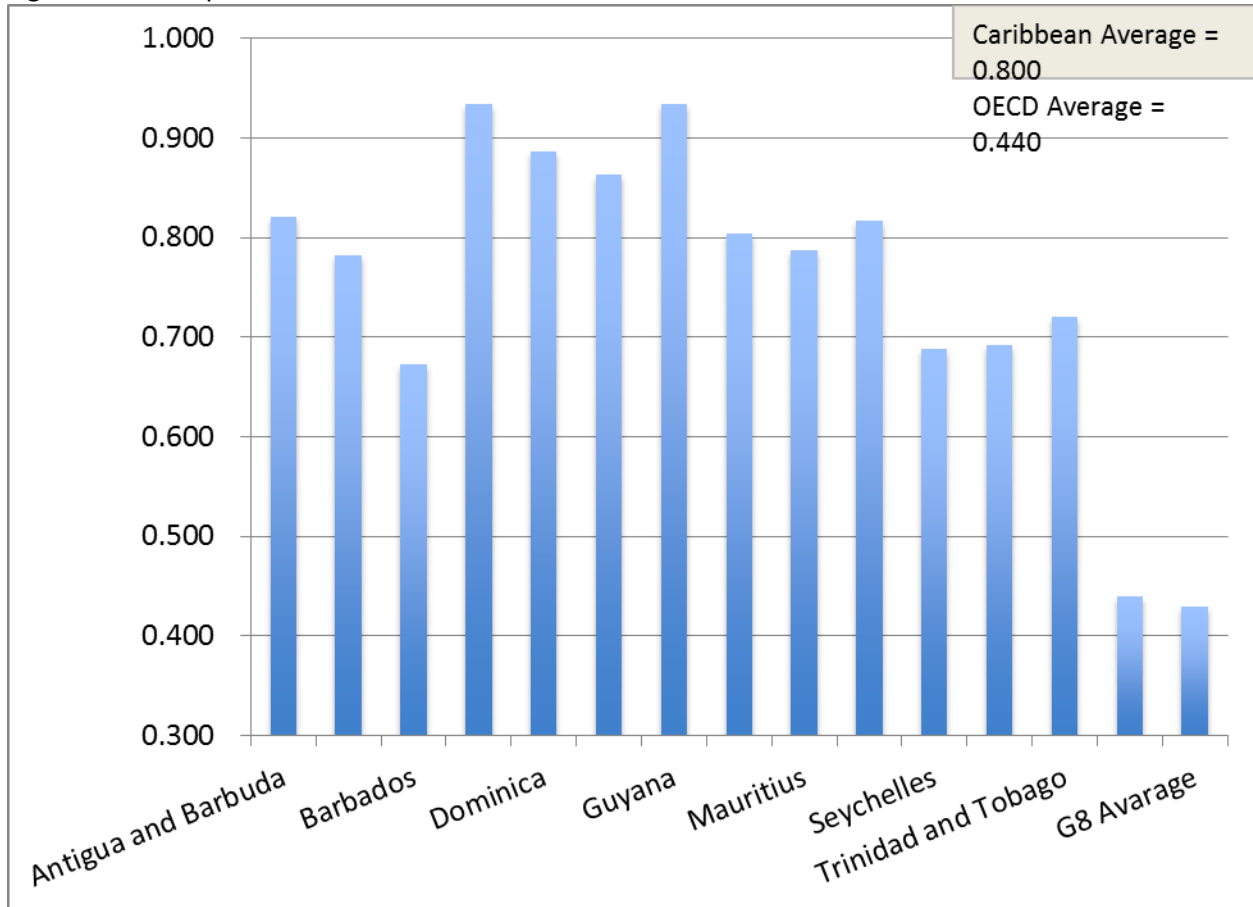
Growth strategies that may have been successful in large countries cannot always be applied in economies as small as those of the Caribbean. Small countries inevitably specialize in the production of a limited number of tradable commodities, because a few lines of internationally competitive production are enough to exhaust their stock of human and material resources.<sup>1</sup> Trade specialization indices for Caribbean countries are almost twice the OECD average (Figure 2). As a result, there is little overlap between exports and domestic production, and trivial possibilities for import substitution. Strategies

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<sup>1</sup> For a correlation of size and export specialization, see Carter, Adrian, "Economic size, openness and export diversification: a statistical analysis," Central Bank of Barbados *Economic Review*, December 1997.

based on switching production and consumption from exports of goods and services to domestic production, or on diversifying to a wide range of exports and services, will have no meaningful impact on growth. A depreciation of the real exchange rate is one such strategy. It has no effect on production, and it reduces real income via terms of trade effects, as the income earned in production domestically buys fewer foreign goods.

Figure 2. Trade Specialisation Index

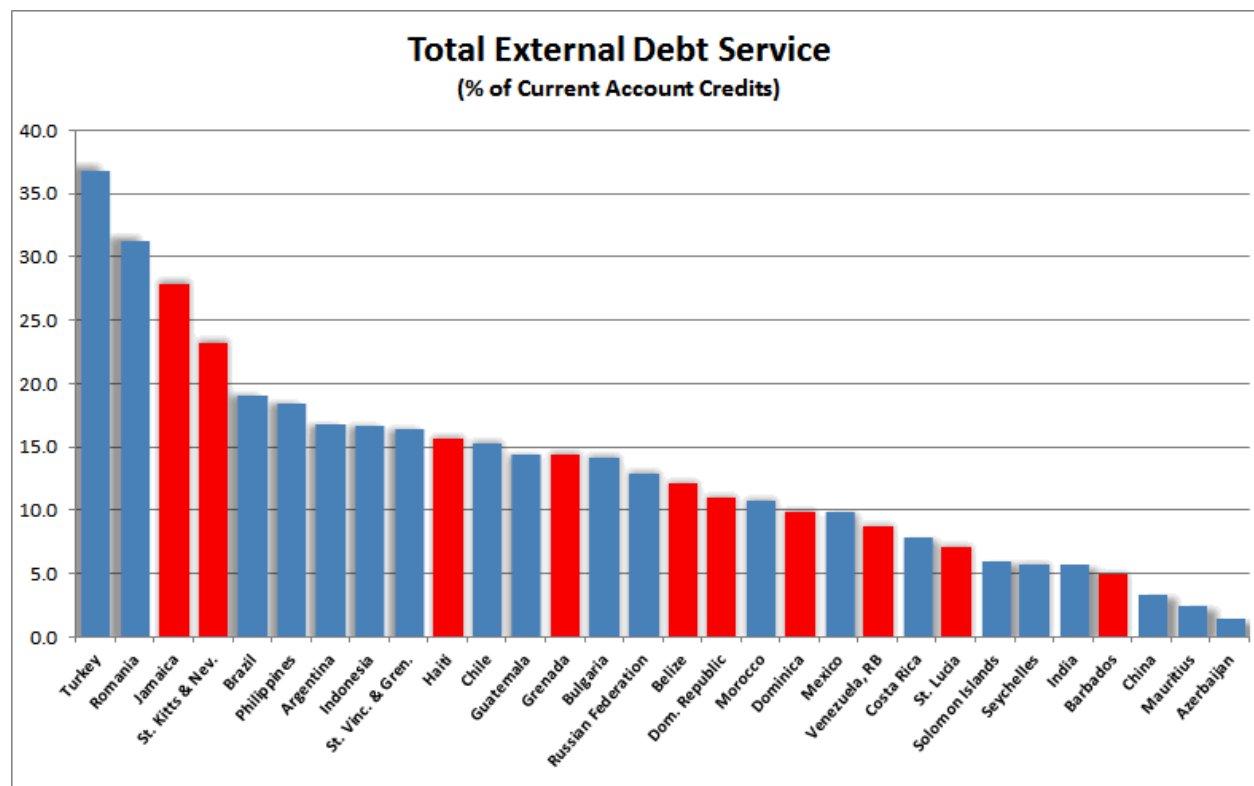


Note: The trade specialization index is the weighted sum of the absolute value of  $(Exports - Imports)/(Exports + Imports)$  for each commodity group where the weights are defined as the share of foreign trade in total foreign trade for that commodity group. The index ranges between 0 and 1, where the value of 1 implies perfect specialization in foreign trade.

Source: Dr. Winston Moore, University of the West Indies

The most important limit on debt sustainability in the Caribbean is the proportion of foreign exchange earnings that must be devoted to foreign debt service. If this ratio is too high, the country may be in danger of a default on foreign loans, which will precipitate capital flight and a full blown economic crisis, not just with respect to external payments. (This was the experience of Barbados in 1991. In this case, the overall debt/GDP ratio is immaterial; in Barbados in 1991 that ratio was comparatively low.) Figure 3 shows how the Caribbean compares internationally, with respect to external debt service obligations. Jamaica and St Kitts-Nevis are the only Caribbean countries where external debt service requires a substantial commitment of available foreign exchange inflows.

Figure 3.



Sources: ECCB, WB, IMF, CBB  
Data as at end-2010

A second ratio of some importance is the ratio of interest payments to government revenue. However, if the external debt service ratio is low, a high ratio of interest to revenue will not provoke a crisis, and may be sustained at that high level for years if not decades, as in the case of Jamaica. So long as the debt is mainly domestic, its servicing is a matter of internal income redistribution within the country, from taxpayers to the holders of debt securities. While those distributional effects may be problematic from a social point of view, there is no mechanism through which they might provoke a crisis.

Several recent studies have found a correlation between high debt/GDP ratios and rates of economic growth in countries around the world, including some Caribbean countries. However, this correlation most probably reflects the impact of other factors affecting both debt and growth, such as financial and balance of payments crises, rescue packages for financial institutions, countercyclical policies fuelled by money creation which precipitated balance of payments crises, etc.

Monetary targeting frameworks are unworkable in the Caribbean because no country can be indifferent to movements in the exchange rate. With a de facto fixed or semi-fixed exchange rate and a financial account that cannot be effectively closed, there is little scope for domestic monetary policy. If the domestic policy stance is credible, an interest rate increase sucks in portfolio capital, instead of tightening expenditure; if the policy stance lacks credibility, an interest rate increase has the perverse effect of motivating capital flight, on the assumption that the attempt at an interest rate defence of the exchange rate will fail.