
CHAPTER 1

A Summary of the Argument

Only a few of the smallest Caribbean countries have survived the 1970s and 1980s with healthy economies. The majority of the Caribbean populations are no better off in 1991 than they were in 1970. Earlier, I explored the roots of economic decline in the English-speaking Caribbean (Worrell, 1987). This study discusses strategies and prospects, and the possibilities for economic growth and stability.

The content of economic adjustment policies in less developed countries has been at the centre of economic discussion for most of the last two decades. The Caribbean has received some attention, with studies of single countries (for example Boyd, 1988, Brown, 1981, Ceara-Hatton, 1989) and surveys that cover the region (such as Beckford and Girvan, 1989, and Worrell and Bourne, 1989) but there is little confidence that the strategies currently in place will serve to restore external balance and raise economic output. Our aim is to search for alternatives and improvements.

Although each country's economic situation is singular in many respects, it should be possible to find guidelines for policy within groups of rather similar countries. Caribbean nations share economic characteristics (see Table 1.1) which affect the outcomes of various policies and determine the range of policies available. The characteristics of Caribbean-type economies, discussed in Chapter 2, centre on the distinctively different markets for tradable and non-tradable goods, the mobility of finance and skills, the characteristics of the monetary sector and the organisation of labour markets. Because of shared features we may expect Caribbean economies to react in similar ways to exchange rate devaluations, interest rate policy and tariff protection, although magnitudes will vary from place to place. These responses in many respects are quite different from those of large LDCs such as Brazil or countries where factors and goods cannot move across borders so freely.

We examine the way the Caribbean economy adjusts to fiscal policy, exchange rate changes, monetary policy and administrative controls. A strategy combining elements of these policies may be designed so as to address each economy's needs and circumstances. We place Caribbean economies in four categories, according to their economic circumstances. Category 1 countries have no adjustment problem; their economies grow steadily, their external balance is sustainable and they have a sound infrastructure. Category 2 countries are subject to intermittent disequilibrium; economic growth is too low, output may be contracting when the balance of payments is in equilibrium or the balance of

Table 1.1 Caribbean Structure and Performance

	Area (sq kms)	Pop. ('000)	GDP/Cap US\$ 1987	Growth, 1985-7	Inflation, 1980-7	Reserves, cum. 1983-7 (\$million)	Arrears, cum. 1983-7 (\$million)	Imports, % GDP	Infant mortality /000	Life expectancy	Literacy rate
OECS Countries											
Antigua & Barbuda	0.44	83	2788	0.6	6.1	39	37	167.5	-	73.0	-
Dominica	0.75	78	1314	0.1	5.7	14	-	38.6	-	74.0	-
Grenada	0.35	99	1128	-	4.9	15	9	63.6	-	69.0	-
Montserrat	0.10	12	3833	-	-	-	-	-	-	-	-
St Kitts & Nevis	0.27	48	1974	3.3	5.2	-	-	-	-	68.0	-
St Lucia	0.62	131	1260	2.3	3.9	26	7	78.4	-	70.0	-
St Vincent & the Grenadines	0.29	106	1293	1.2	4.6	19	-	69.2	-	69.0	-
Other Caricom											
Bahamas	13.94	249	11767	0.9	6.3	57	-	81.2	28.5	68.0	93.0
Barbados	0.43	256	5535	2.4	6.1	27	-	49.5	10.8	72.7	99.0
Belize	22.96	170	1269	1.9	1.1	20	1	56.6	-	-	-
Guyana	214.97	989	348	-4.4	13.6	20	536	46.7	45.0	68.2	91.30
Jamaica	11.42	2409	1188	-1.5	19.4	-6	266	42.1	13.2	73.0	73.10
Trinidad & Tobago	5.13	1224	3856	1.3	6.2	-2941	-	25.6	15.6	68.7	97.20
Non-Caricom											
Haiti	28.00	6100	360	0.5	7.9	-25	-	19.2	108.2	52.7	37.00
Dominican Republic	49.00	6700	730	2.3	16.3	-180	285	31.5	37.6	64.1	69.40
Suriname	163.27	420	2328	1.8	4.1	-219	-	27.3	27.6	68.0	80.20

Sources: ECLAC, *Economic Survey of English-speaking Caribbean Countries*, mimeo, August 1989;
The World Bank, *World Development Report*, 1989
IMF, *IFS Yearbook*, 1989

IDB, *Economic & Social Progress in Latin America*, 1989 Report

Notes: Guyana, arrears and reserves, 1983-85

payments deficit may be unsustainable at reasonable growth rates. Category 3 countries have a persistent adjustment problem; they will have suffered several years of economic decline accompanied by foreign exchange reserve losses; usually there are arrears on external payments. Category 4 countries are afflicted by a prolonged crisis: output is contracting, external payments are in arrears and infrastructure has begun to deteriorate or is inadequate.

The new orthodox policy enshrined in the conditions required for credit from the World Bank and IMF includes the following: adjustment of nominal exchange rates, interest rates greater than inflation, low values for the ratio of fiscal deficits to GDP, low uniform customs tariffs and non-intervention in the prices of goods and factors. The international financial institutions attempt to negotiate a politically acceptable compromise around this core. Heterodox policies include some elements of the above but they also include intervention to control the prices of goods and factors, tariff discrimination, special incentive regimes, differential pricing and fiscal subsidies. We hope to arrive at a view as to whether orthodox policies are suitable for Caribbean economies and in what circumstances. Where they might not be suitable we try to suggest the content of heterodox policy.

An implication of the economic structure of small open economies, as set out in Chapter 2, is that the tradable sector sets a limit on the overall economic growth rate, except in the short run. Non-tradables are import-using, and their expansion must be supported by growth in the tradable sector, if foreign exchange reserves are to be maintained at levels sufficient to support the exchange rate. If tradables grow too slowly the exchange rate depreciates, causing inflation and a decline in real income, unless the depreciation stimulates the output of tradables sufficiently. The exchange rate relieves the tradable constraint on growth if the supply of tradables is very elastic with respect to the exchange rate in the medium as well as in the short run. If the supply is inelastic the exchange rate will eventually depress income by enough to reduce demand for foreign exchange to the supply, imposing the tradables constraint at a lower level of income.

Domestic price inflation in the small economy deviates from the international trend only to the extent of exchange rate depreciation, either on official or unofficial markets. Excess of aggregate demand or domestic cost push appears as a balance of payments deficit which sooner or later drives the exchange rate downwards, inflating domestic prices. An increase in local factor costs depresses the supply of exports, and, by increasing the price of non-tradables while reducing their supply, eventually produces a reallocation of the consumption basket in favour of imports. An increase in aggregate demand also drives up non-tradable prices and diverts expenditure to imports. In both cases reserves decline and the exchange rate depreciates. If the shocks are not sufficient to produce an exchange rate change the domestic inflation rate reverts to correspondence with the international rate. Balance of payments adjustment is therefore the pivot of adjustment in the small open economy, both for growth and stabilisation.

We are rather more confident about policies for stabilisation than about policies for growth. A reduction in aggregate demand through a contraction of the

fiscal deficit seems to be a reasonably predictable way of stabilising external payments, though the extent of the contraction necessary in particular circumstances may be beyond the country's capacity to undertake within the horizons of politicians and international financial institutions. Growth may be possible for some time without any new investment, if there is excess capacity in the tradable sector, though it is not always easy to identify excess capacity. The fact that capital equipment is not fully utilised does not necessarily imply that additional output of the same quality may be supplied at the same price (or more cheaply). Eventually excess capacity is exhausted and new investment in tradables is required. The factors which determine that investment are the weakest segment of adjustment theory (and practice), and the least amenable to quantitative policy influence. The strongest macroeconomic lever seems to be tax policy – not exchange rate adjustment, because of the importance of imports in the wage good and in producers' goods – but it is by no means decisive. We recommend countries individually tailor export promotion strategies which stress institutional development.

The record of Caribbean countries which have undertaken orthodox adjustment programmes under the auspices of the IMF and World Bank is no more encouraging than for the majority of developing countries. Economic growth has been slow and intermittent, and countries have been unable to recover ground lost during the seventies. They remained in danger of a renewed slump, even in the years when output increased. Investment rates have not been strong enough or sufficiently persistent to reduce the unemployment rate in any country. Investment has typically been concentrated in one or two lines of activity – mainly tourism and assembly plants in free trade zones – rather than in a wide cross-section of economic activity. There has been severe contraction in the living standards of the poorest in society, and standards of health, education, housing and nutrition have declined in most adjusting countries. The distribution of income seems to have become more uneven in most cases.

Exchange rates in adjusting countries have been unstable, depreciating in erratic and unexpected fashion. Experiments with a variety of ways of managing the rate have not produced any system of changing nominal rates that has predictable results, and that moves in accordance with the underlying trade elasticities. Fixed rates backed by ample foreign reserves seem to be the only system that produces stable expectations; once reserves are no longer adequate and the rate has to be moved, no country has avoided exchange rate instability. Countries have experienced intermittent inflation, usually associated with sharp exchange rate depreciation, as might be expected. On the other hand the adjustment policies have usually arrested the excess demand for foreign exchange and reduced the amount of foreign payments arrears, with the help of a succession of belt-tightening policies.

Unorthodox policies have been an unrelieved failure in the Caribbean. They have resulted in high inflation and chronic balance of payments deficits, in addition to difficulties similar to those experienced by countries which opted for

orthodox policies. Inflation has appeared on unofficial markets in countries where attempts were made at rationing and price control. Investment and output contracted, and maintenance and infrastructure were neglected because of foreign exchange shortages. Countries have eventually fallen back on orthodox strategies as foreign arrears of payment accumulated and vital trade relationships were eroded. Caribbean experience suggests a choice of orthodox policies that produce little growth, and unorthodox policies that result in instability and contraction.

Adjustment policies may be improved upon by better articulation of fiscal policy. Fiscal policy must bear a much greater burden of responsibility for export promotion, economic stabilisation and ensuring the provision of essential social and economic services. The stabilisation function has always been recognised, and the importance of essential services and the protection of the poor is on the agenda for most adjustment programmes in the late 1980s, but there remains scepticism about the government's role in investment promotion.

The management of the exchange rate is a second area for review. Adjustment programmes have failed to admit the delicacy of exchange rate management. Artificially high values of local currency will not hold in the face of emerging parallel markets, but attempts to alter relative prices at home and abroad by means of the nominal exchange rate have no better chance of success. Getting the official exchange rate "right" is a delicate confidence act, depending mainly on the use of fiscal policy to establish the credibility of the rate. Where the official rate must be set (in order to equate to the endogenous nominal rate as defined in Chapter 4) depends on current and expected fiscal policy.

In implementing policies countries must adapt to the circumstances of the markets through which the policy levers work. One may not act as though exchange rates and interest rates will adjust to eliminate inefficiencies and excess demand in the presence of banking oligopolies and of unlicensed unofficial money and exchange dealers, often operating illegally. A surprising mythology has built up of entrepreneurship in informal markets, but in fact they are poorly informed, lacking in financial and organisational skills, deficient of any of the usual kinds of transaction insurance and highly risky for the providers of services and their clientele.

The obvious failures of tightly regulated regimes seem to have led to an over-reaction in favour of hands-off and market-led price formation, though in practice even orthodox stabilisation programmes have never gone as far in that direction as the protagonists of deregulation have advocated. Programmes have allowed for some form of exchange rate guidance, even when the rate was market-led, in contrast to interest rates, which have often been completely deregulated. In fact all financial and exchange markets need economic guidance and strong prudential regulation if prices are to be free of excessive fluctuation and prolonged periods of waywardness. It is government's responsibility to provide that guidance, together with comprehensive public information which allows the public at large to participate in the assessment of the market and the appropriateness of policy.

Adjustment programmes have suffered from our inadequate understanding

of the determinants of investment. The assumption that changes in relative prices would be sufficient to spur additional investment has proved unreliable; in some activities and in some countries investment has increased as the relative price of tradables rose, but there are other activities and other countries where there was no response to incentives of the same magnitude. Moreover, in many countries where investment was most vigorous there was no improvement in the relative price of tradables. There has, in general, not been sufficient attention paid to the qualitative aspects of investment.

Chapters 3-5 deal with these arguments in some depth, as they discuss the probable effects of various policies in the circumstances of small open economies. There have been changes over time in the content of orthodox adjustment policies. Responding to criticisms that stabilisation programmes in the seventies were exclusively demand-oriented, international institutions introduced a strong emphasis on supply in the eighties. Unfortunately they focussed almost exclusively on nominal exchange rate adjustment, high interest rates and an attack on import substitution, none of which is an appropriate instrument for adjustment in small open economies. (The nominal exchange rate is a target to be set in light of actual and intended fiscal policy, the interest rate should not be higher than the international rate and import substitution is a trivial issue.) Only recently has there come recognition that government investment may be highly productive for private investment, and much greater insight is needed with respect to investment in the medium and long term.

While basic needs and the welfare of the poor have long been a dominant concern of the community of development scholars and of the international development institutions, these concerns have only recently been incorporated as integral to the adjustment process. It is now accepted that programmes which fail to incorporate the effects on income distribution and basic needs may stand little chance of stabilising the balance of payments even in the short run, because of the decline in productive effort. Moreover, such programmes have virtually no chance of reviving output because of the deterioration of human resources. The implications of human resource development for the content of economic adjustment programmes are not yet fully worked out.

Orthodox stabilisation policies need to be amended and strengthened if they are to form the basis of a strategy for adjustment with growth in small open economies. This study makes the case for a fuller articulation of fiscal measures, linking them to their effects on the several targets – rates of return on investment, aggregate demand, relative prices, income distribution – that fiscal policy may address simultaneously. We argue for a more nuanced linkage of fiscal and exchange rate targets, to secure an exchange rate that may be held unchanged over the medium term, using fiscal measures to adjust relative prices and aggregate demand, and building foreign reserve stocks to enable the authorities to ride out periods of exchange rate nervousness. The central bank should give sensible guidance on local interest rates, anchoring them on the trend of international rates. If the exchange rate policy is successful domestic inflation will be in line with

international inflation, so there will be no need to anticipate the “real” rate of interest.

Small countries need individually tailored export promotion strategies, with emphasis on institutional development, management enhancement and organisational skills. A sophisticated regulatory framework is called for, with clear ground rules, systems for public information, and rules which make for transparency of the activities of financial agents. For many countries none of the above amounts to a feasible strategy unless there is a programme for relief of external debt servicing which goes much beyond anything that is currently on the cards.