I Overview

With few exceptions, countries in the Caribbean region have performed reasonably well in recent years. They will, however, need to accelerate policy actions in a number of areas to address the challenges they are likely to face in the near future.

This occasional paper focuses on the independent states that are full members of the Caribbean Community (CARICOM), namely Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, and Trinidad and Tobago.[1] It provides background information on recent developments in the Caribbean region and lays out the principal policy issues that countries will need to address in the period ahead. The Caribbean countries[2] face a number of common problems and must deal with similar economic policy issues. Consequently, concentrating on the regional perspective permits a comparison of the individual responses to similar problems. The regional view would also throw light on the countries' movement toward convergence.

Background

Countries in the Caribbean region are small in size, but heterogeneous in structure. Their growth performance was mixed in the 1990s: Belize, Trinidad and Tobago, and member countries of the Organization of Eastern Caribbean States (OECS)[3] enjoyed relatively strong growth, but performance in the others has been uneven. Jamaica has experienced negative growth since 1995.

Caribbean countries have made some progress in diversifying their economies, but production and exports are still relatively concentrated in a few activities. Agriculture and mining remain important in many countries, but the structure of production has begun to shift more heavily toward services. While the number of tourists to the Caribbean has grown in the latter part of the 1990s, growth in tourist receipts has not kept pace with nominal GDP. Growth in the sector has been adversely affected, in part, by natural disasters in the last few years. The market share of the English-speaking countries within the broader Caribbean region has been falling in the 1990s.

Countries in the region are highly open. The principal destinations for the region's exports include the United States, Europe, and other CARICOM countries. Exports are concentrated in a few products, namely raw materials—particularly minerals—and agricultural crops. Imports consist mainly of manufactures, especially consumer goods.

The region's agricultural exports are characterized by high production costs and are sold in protected markets. Caribbean countries have traditionally relied heavily on a system of preferential access to markets for commodities such as bananas and sugar. Most of the countries have large and persistent trade and current account deficits, despite significant current transfers and remittances in some cases, but these deficits have been financed by private capital inflows (including foreign direct investment and commercial borrowing) and, to some extent, official grants.

The commitment to a fixed exchange rate by many of the small island economies in the region has been a key factor in creating a stable macroeconomic framework and in keeping inflation close to international levels. In recent years, all countries (except Suriname) have successfully reduced inflation to single-digit rates. There has been a general trend toward appreciation in the value of the U.S. dollar vis-à-vis other major currencies.

[1]The Bahamas is a member of CARICOM but not the Common Market. Haiti is in the formal process of becoming a full member of CARICOM. CARICOM also includes four U.K. territories: Montserrat and Anguilla are members, and the British Virgin Islands and the Turks and Caicos Islands are associate members. Negotiations for a free trade agreement are ongoing between CARICOM and the Dominican Republic, which is, among other Western Hemisphere countries and territories, a CARICOM observer.

[2]In this paper, "Caribbean countries" refer to the group of independent states that are full members of CARICOM.

[3]OECS membership includes six independent countries—Antigua and Barbuda, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines—and two U.K. territories—Anguilla and Montserrat.

The banking sector in the region is relatively well developed, compared with other developing countries, but real interest rates remain high because of high reserve and liquidity requirements, generally conservative monetary policies, and—in some cases—large fiscal imbalances. The cost of banking services is relatively high because of the lack of economies of scale, relatively undiversified loan portfolios, and the oligopolistic nature of banking in the region.

In the 1990s, fiscal deficits in the region tended to widen. The average central government deficit rose to 4½ percent of GDP in 1998 from 2 percent of GDP in 1994, mainly as a result of increases in expenditure. Increases in public sector wage bills contributed importantly to the overall increases in expenditure.

Caribbean countries have embarked on a process of economic integration toward the formation of a common market. The area where perhaps the most progress has been made is in trade liberalization. Progress toward fiscal harmonization, adoption of a common currency, and creation of a monetary union have been slower. Since most Caribbean countries trade with countries outside the region, the gains from forming a common market are likely to be small until intraregional trade expands. Furthermore, complex issues regarding convergence to common targets (e.g., on the size of fiscal deficits and the debt-to-GDP ratio) are likely to arise, given the differences that exist across countries in the region.

Challenges Facing the Region

Despite the successes in the 1980s and 1990s in reforming their economies and broadly satisfactory economic performance, Caribbean countries remain vulnerable in a number of ways. Because of their relative openness and concentration on a small range of products, exogenous changes in the terms of trade can have significant effects on their fiscal and external positions. Also, many countries that rely on preferential trading arrangements for their exports are likely to be facing a progressive erosion of these preferences. In addition, occasional natural disasters, such as hurricanes, have the potential to cause serious setbacks for these countries.

In light of their vulnerabilities and the risks to the economic outlook, Caribbean countries will need to take stronger measures to preserve the economic gains made in the past two decades and to provide some measure of insurance against future external shocks. They will need to accelerate policy actions in a number of areas to address the challenges they are likely to face in the period ahead. Specifically, these countries would need to:

- Deepen financial markets and improve banking sector efficiency, thus reducing the costs of financial intermediation in the region. For this purpose, governments should accelerate privatization of state-owned financial institutions, reduce barriers to entry for new banks that meet prudential standards, and strengthen banking supervision, and privatization of public enterprises.
- Expand trade liberalization to increase the net benefits for the region by further reducing the cost of imports and improving the allocation of resources. Countries will also need to address the likely loss of revenue from liberalization through reforms to their tax systems that broaden and deepen domestic consumption taxation, including introducing a VAT where feasible.
- Improve external competitiveness so as to accelerate growth and reduce unemployment. This can be achieved by restraining production costs, particularly by keeping wage increases in line with growth in productivity.
- Dampen the impact of external shocks by diversifying the structure of exports. Diversification can be encouraged by removing mechanisms that impede markets from working efficiently, such as wage and price controls and restrictive labor laws. Governments should refrain from using subsidies or other incentives that encourage activities for which the country does not have a comparative advantage.

Economic Outlook for the Region

Economic prospects for the region are generally favorable, as growth will likely accelerate somewhat and inflation will remain low over the medium term. Faster growth is likely to come from a number of factors, including higher investment in the energy and tourism sectors and stronger agricultural performance.

The inflation differential with the United States is expected to narrow, resulting in some gains in competitiveness for the region. The combined external current account deficit is likely to improve over the medium term, based on fairly robust growth in the region's export markets and higher prices for the region's major exports. Fiscal balances also are expected to improve, based on strong economic growth and the containment of public sector employment.

This outlook, however, is subject to a number of risks, including slower growth in major export markets, the effects of unpredictable natural disasters, and possible adverse terms of trade shocks.

Section II of this occasional paper discusses the structure of the Caribbean economies in broad terms. Section III presents selected issues facing these countries in greater depth and provides some cross-country analysis. Section IV outlines the economic outlook for the region, focusing on broad economic aggregates and potential risks. Section V contains the main conclusions.