



The Caribbean: In Search of Lost Competitiveness

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International Monetary Fund

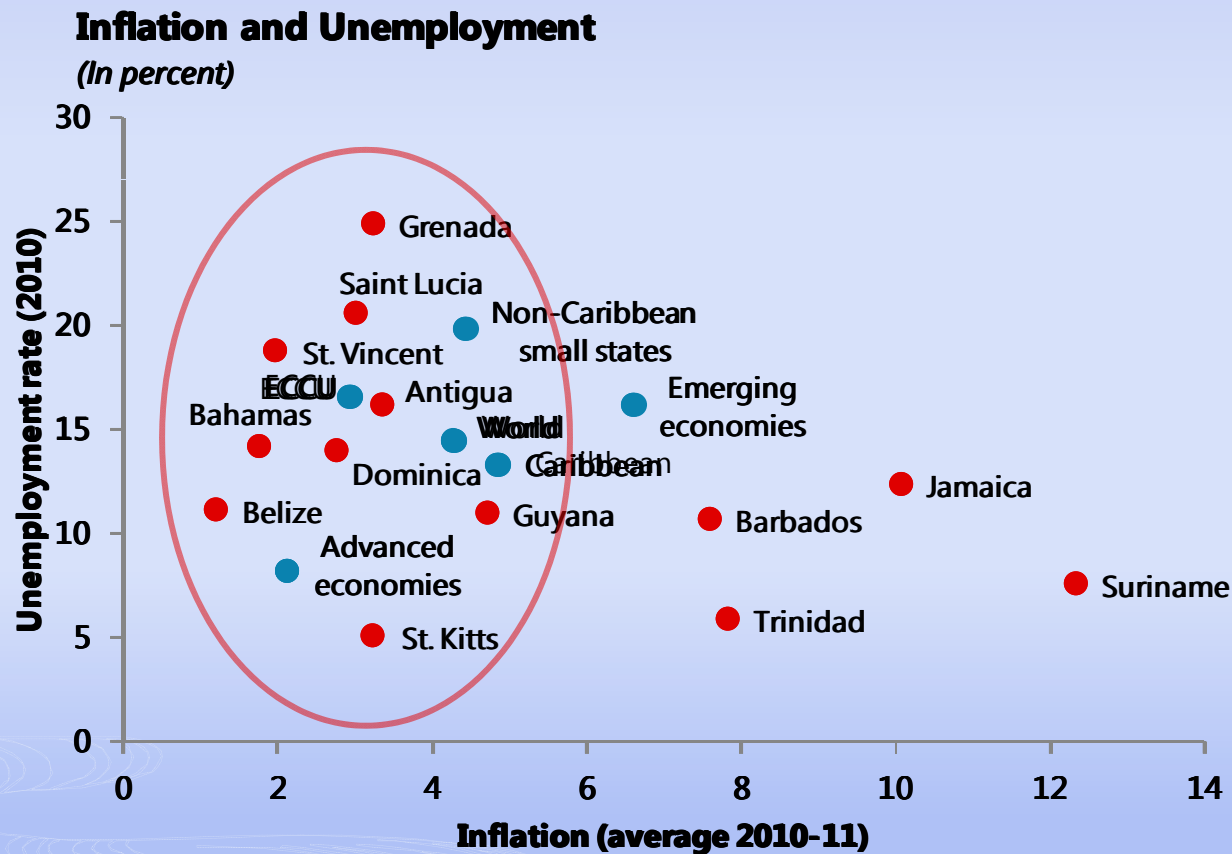
OUTLINE

- What is competitiveness?
- Is competitiveness an issue in the region?
- What are the policy options?
- IMF staff research on the pros and cons of policy options

CHALLENGES TO COMPETITIVENESS AND GROWTH

- Many definitions of competitiveness; we take the broadest: economy's ability to achieve both
 - full employment or potential level of activity (internal balance)
 - sustainable external position (external balance)

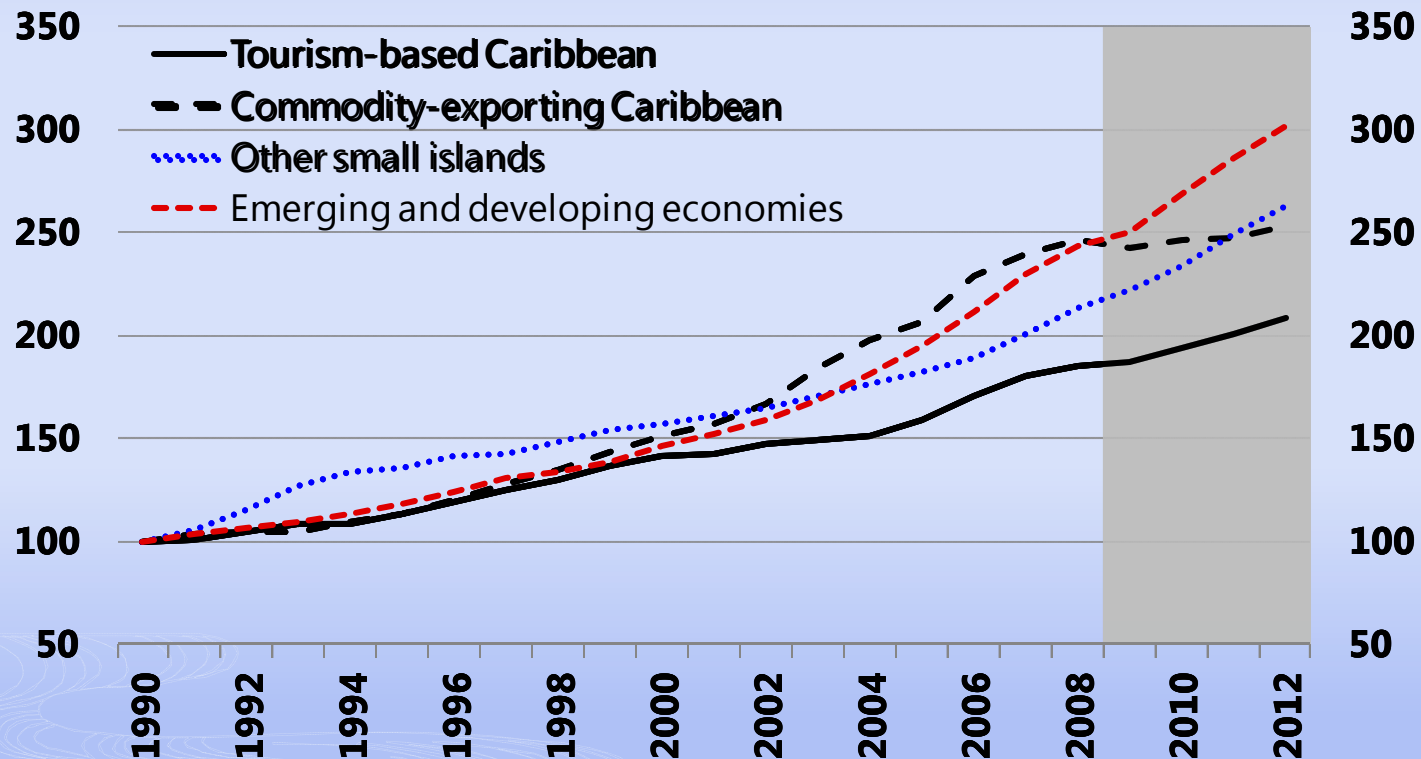
Most Caribbean countries are in a high unemployment -low inflation environment...



*...reflecting both the recent downturn
and generally weak long-term growth*

Real GDP

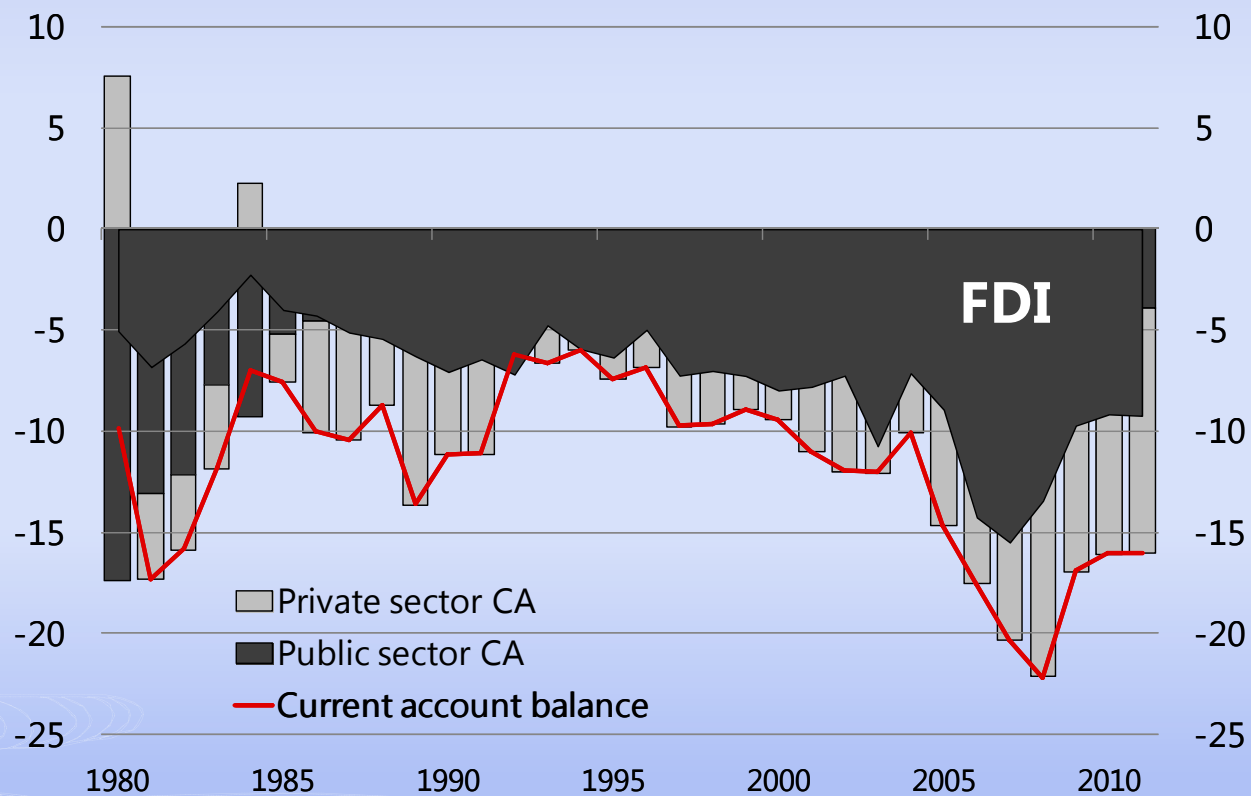
(indexes, 1990 = 100)



Current account deficits are high, both in the public and private sector, ...

Caribbean: Current Account Balances

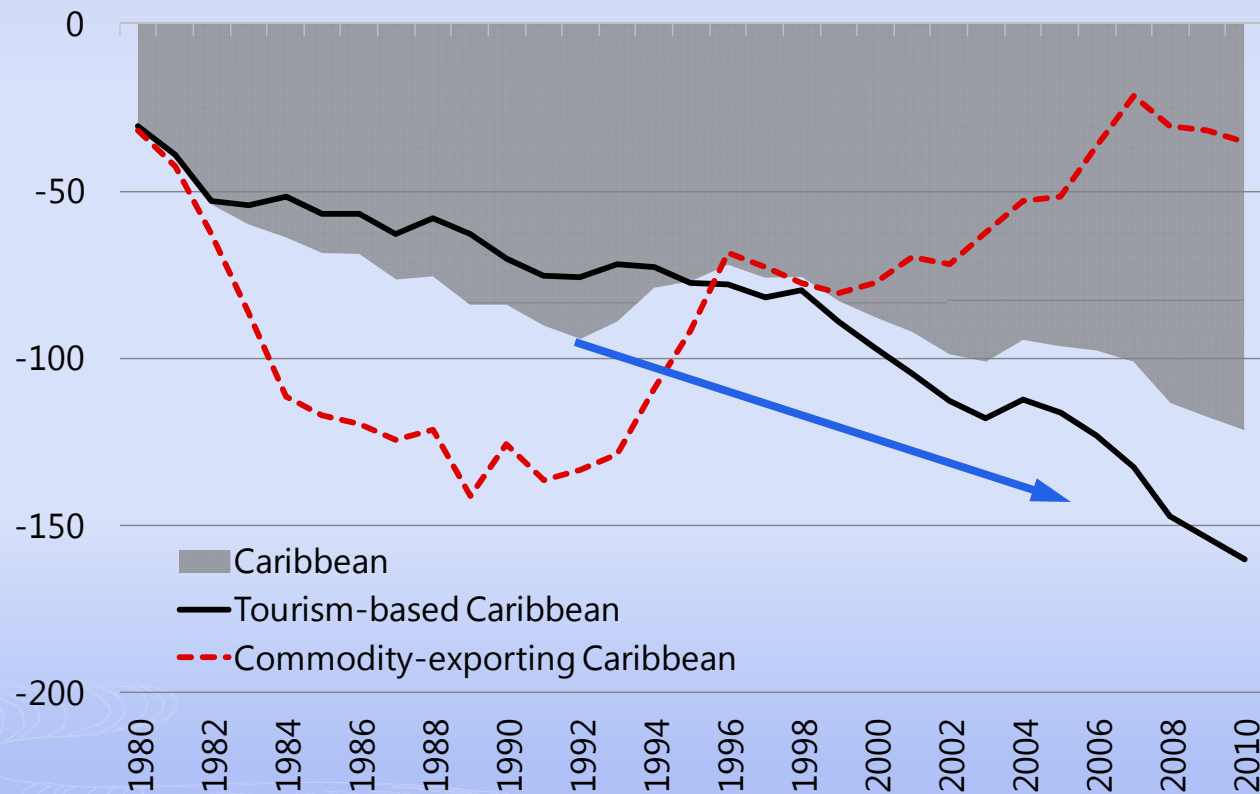
(Percent of GDP)



... and net external asset positions are deteriorating in most countries.

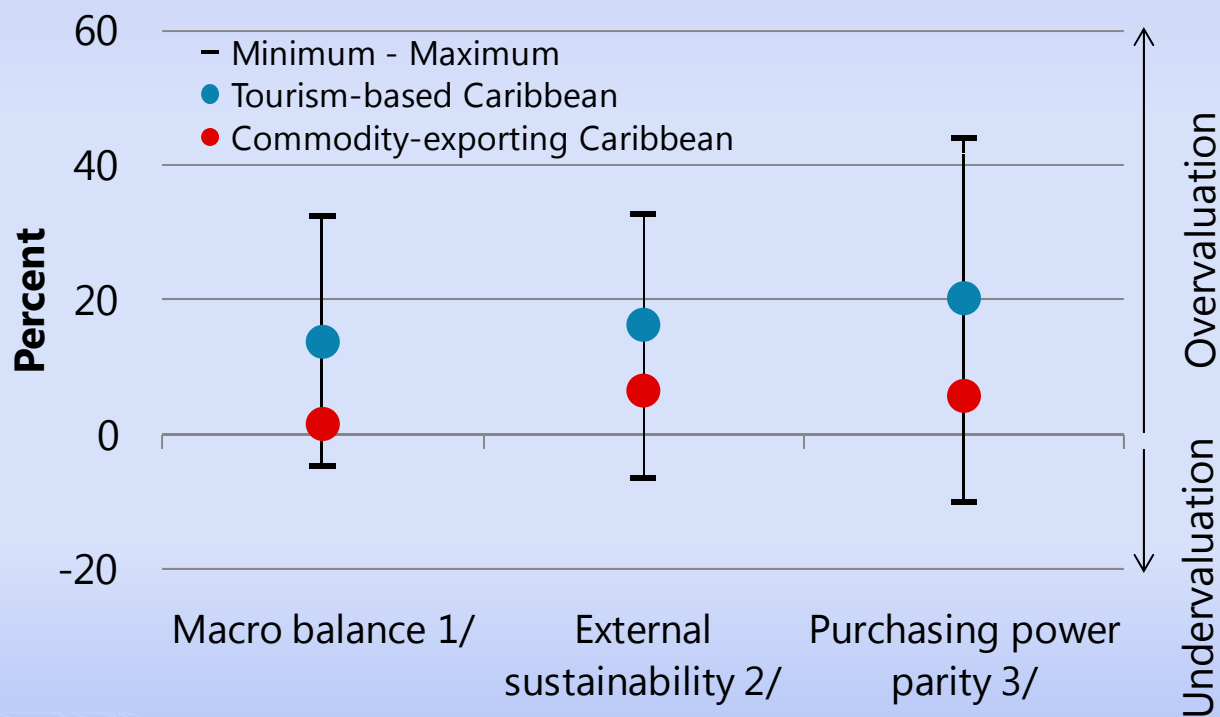
Caribbean: International Investment Positions (IIP)

(Percent of GDP)



Formal assessments confirm external positions may not be sustainable

Real Effective Exchange Rate (REER) Relative to Norm



1/ REER adjustment required to bring current account balance in line with fundamentals.

2/ REER adjustment required to bring current account balance to sustainable level.

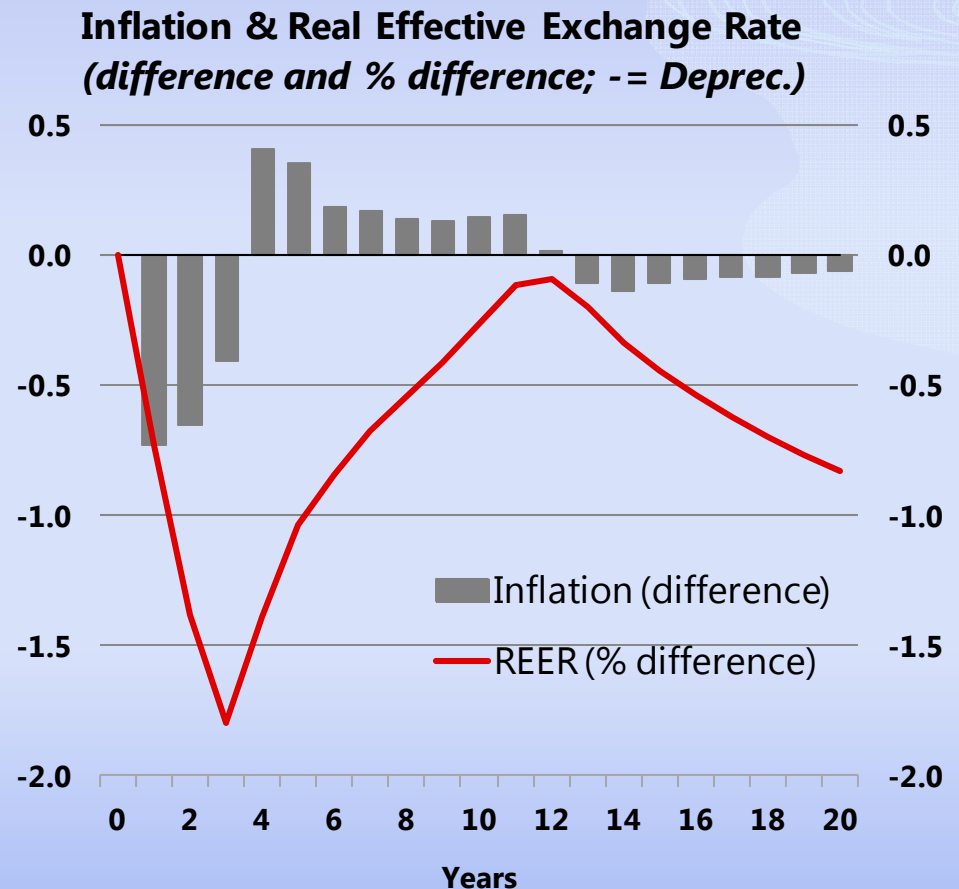
3/ Relative to Balassa-Samuelson prediction; average of 2007-09.

WHAT ARE THE OPTIONS?

- Reduce relative costs through:
 - I. Internal (fiscal) adjustment
 - II. Fiscal devaluation (change in tax composition to reduce labor costs)
 - III. External devaluation
 - IV. Structural reforms
- Staff research on first three options (DSGE model; event study; empirical analysis)

INTERNAL ADJUSTMENT?

- Fiscal spending cuts (e.g. wage bill): lower demand and prices for non-tradables, hence REER depreciation
- Barbados in 1991, Baltics recently
- Simulation results: what happens when small countries adjust?

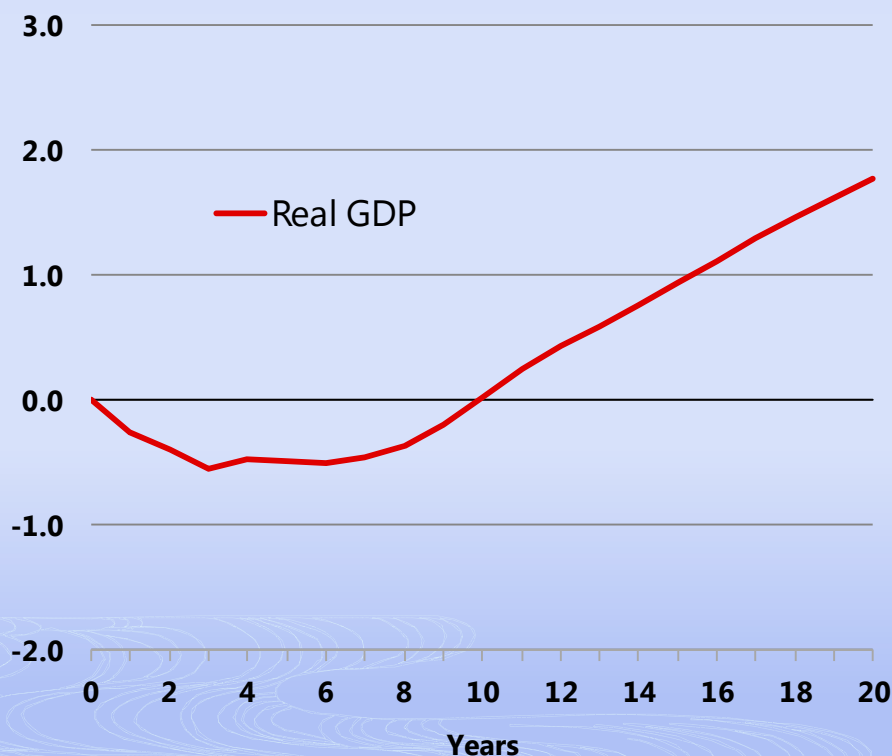


INTERNAL ADJUSTMENT?

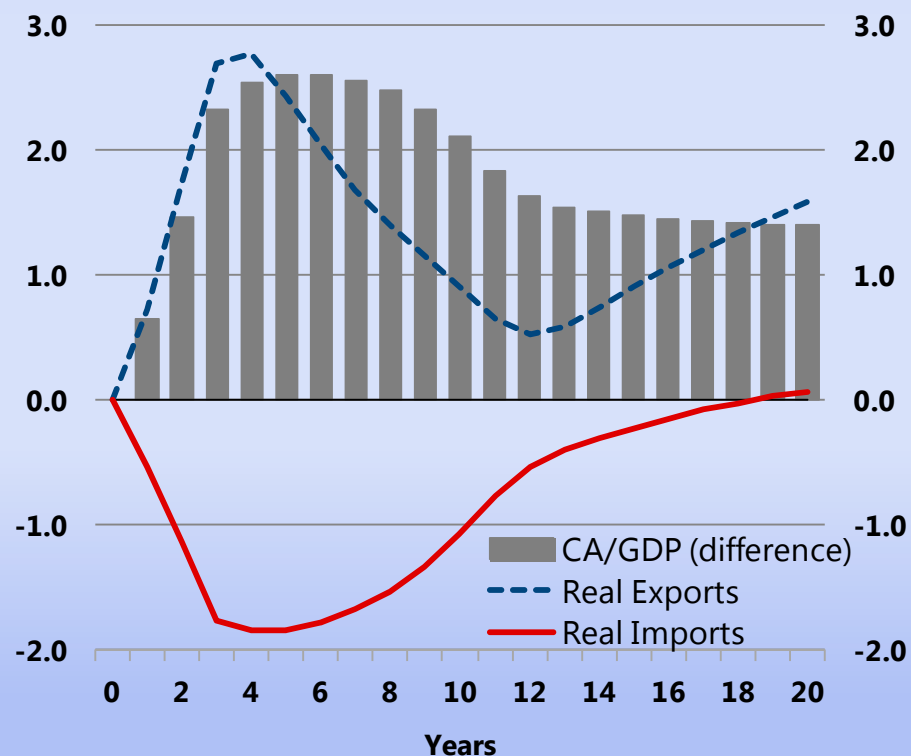
Moderate short-term output losses but long-term gains

Strong correction in external imbalances

Real GDP
(% difference)



Real Exports and Imports and CA/GDP
(% difference)

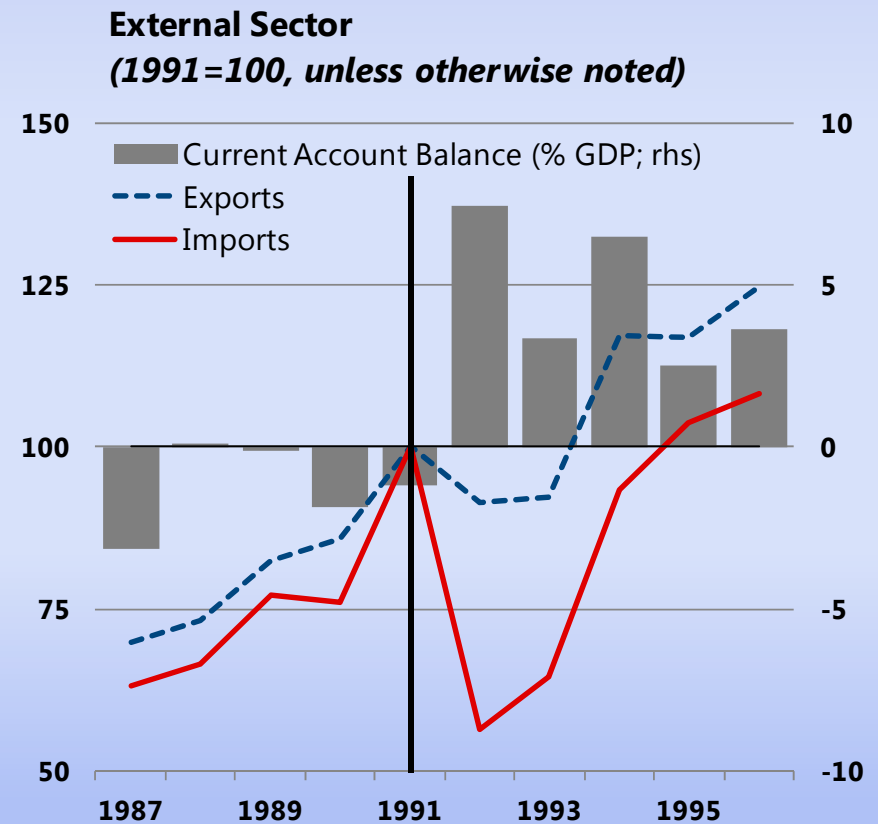


INTERNAL ADJUSTMENT: BARBADOS 1991

Short-term output losses
quickly reversed



External position improved
notably



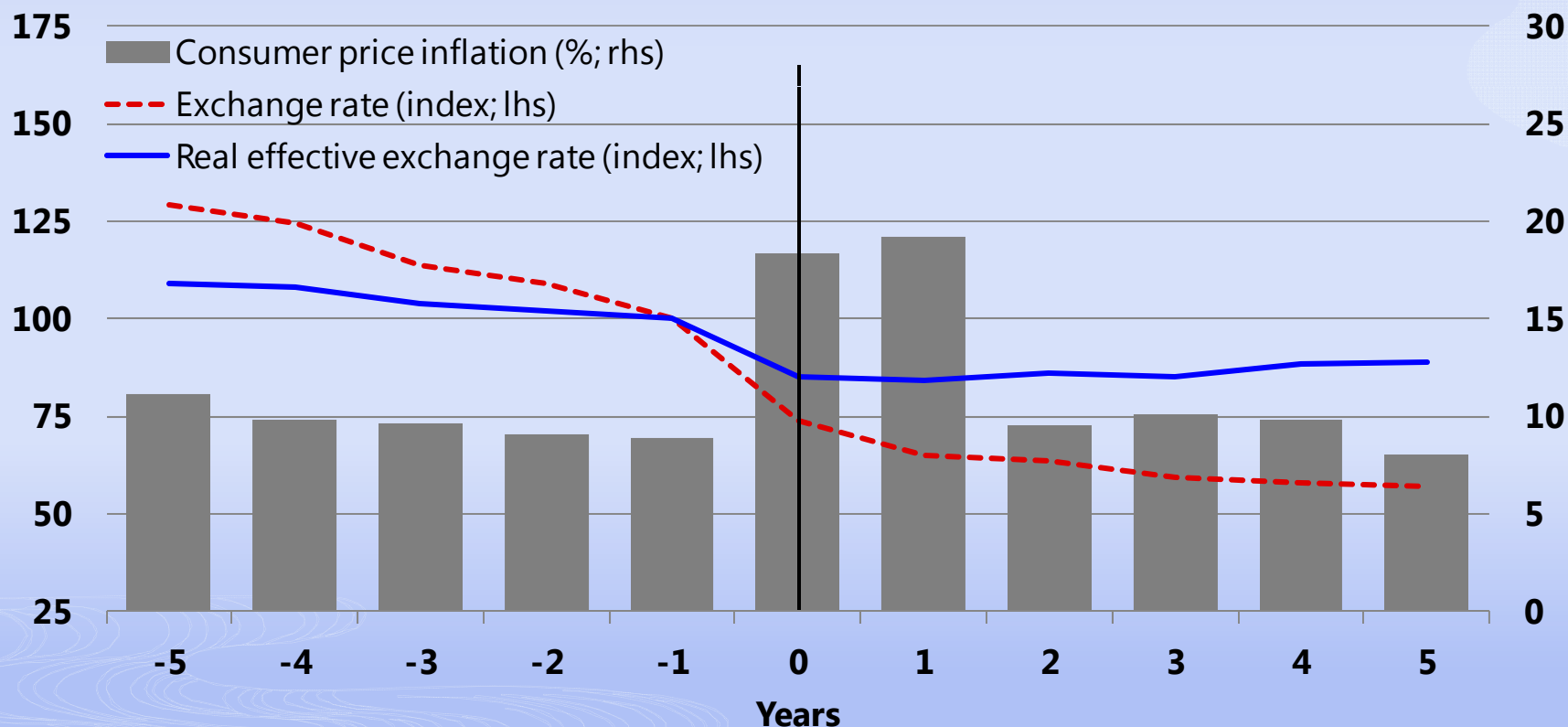
FISCAL DEVALUATION?

- ❑ Revenue-neutral switch from employment taxes to consumption taxes:
 - Reduces unit labor costs, increases cost of imports: mimics real depreciation
 - External position improves
 - Higher exports boost growth
- ❑ Portugal, France, discussed for EU
- ❑ Requires: fixed exchange rate and wage rigidities
- ❑ How much room for it in the Caribbean?

EXTERNAL DEVALUATION?

What happens when small countries devalue their currency?
(event study: 24 small-country episodes)

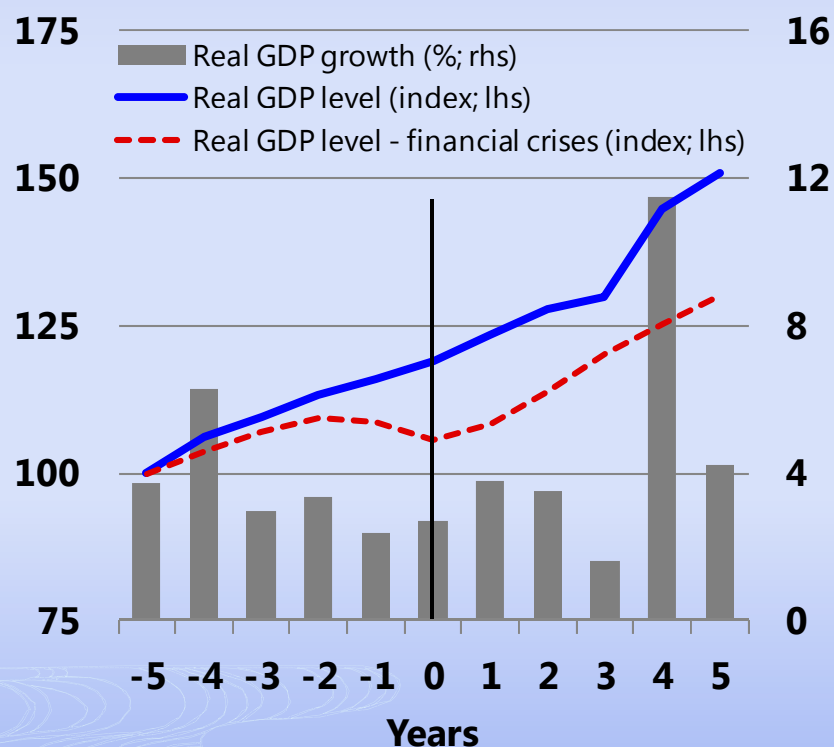
Exchange Rates & Inflation



EXTERNAL DEVALUATION?

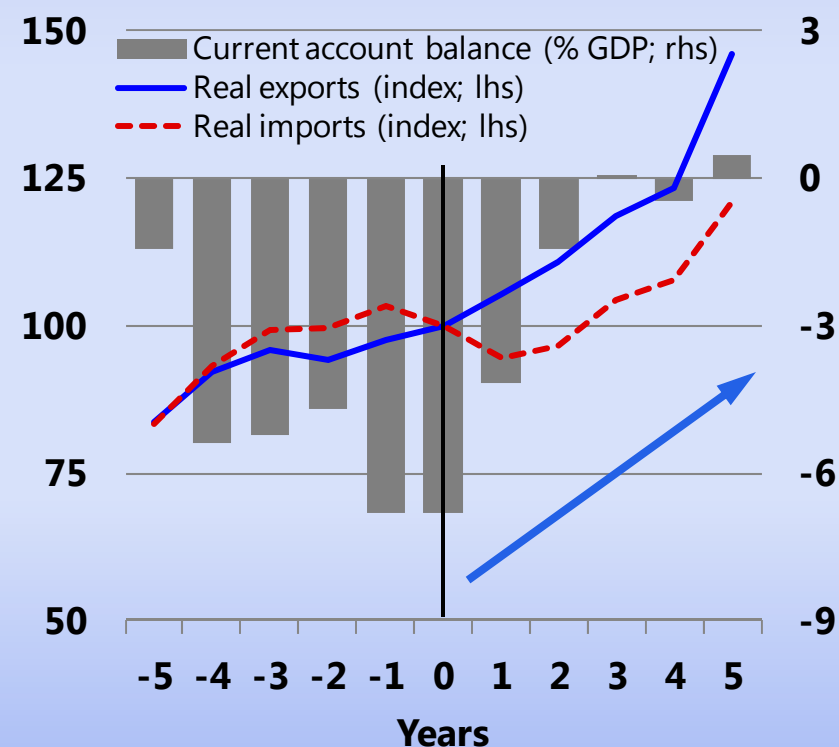
Growth strengthens, especially in controlled devaluations

Real GDP



External position improves

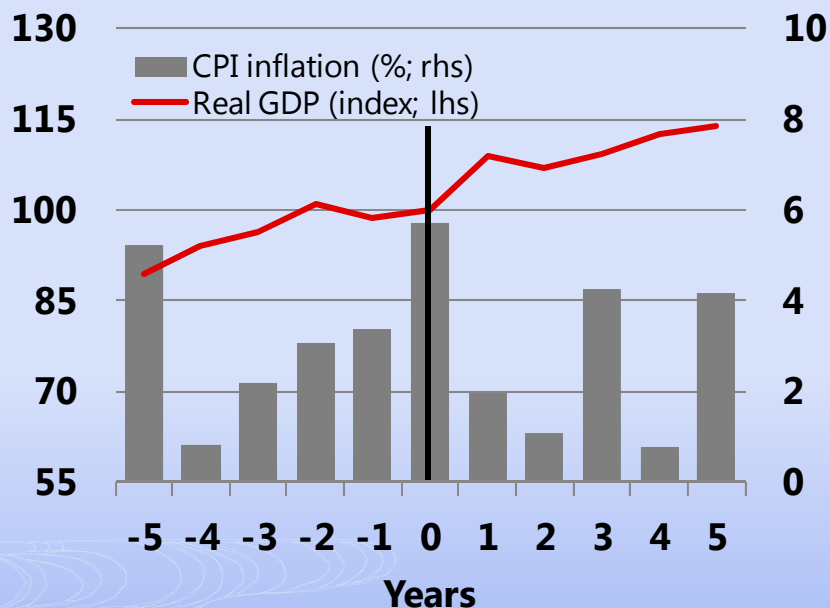
Current Account Developments



EXTERNAL DEVALUATION: Fiji, 1998

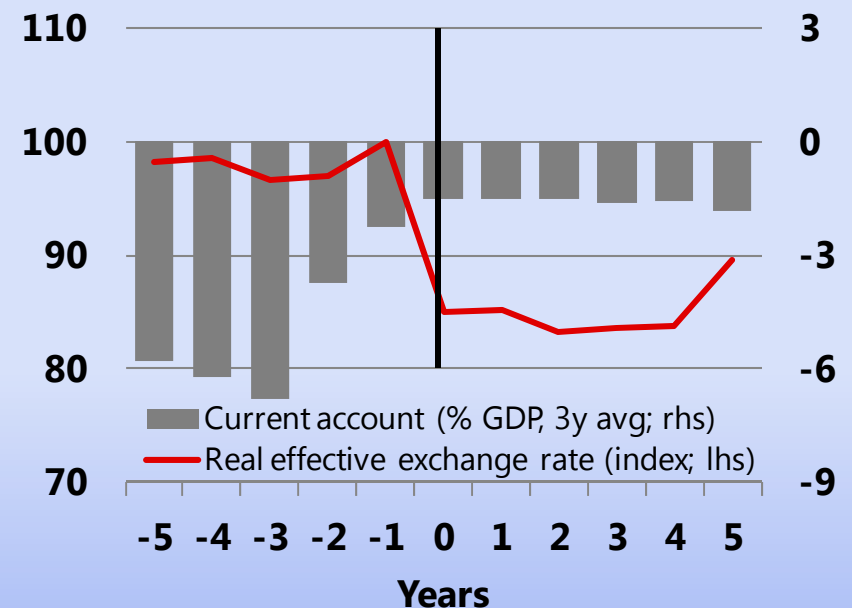
Growth picked up and inflation controlled

Fiji: Output and Inflation



External imbalances sustainably corrected

Fiji: Current Account and Exchange Rate

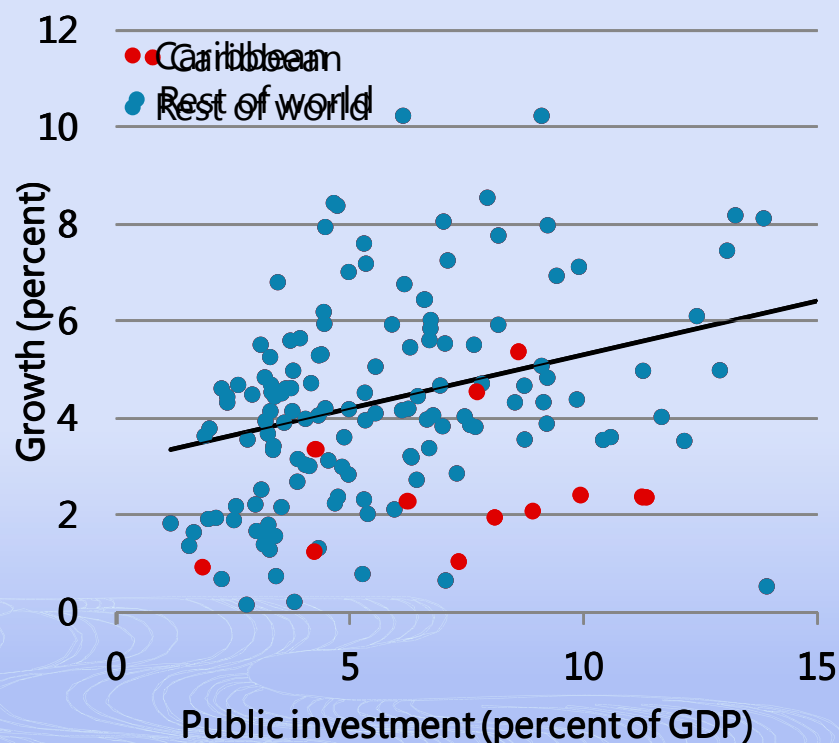


STRUCTURAL REFORMS?

Targeting public investment in productive infrastructure

Public Investment and Growth

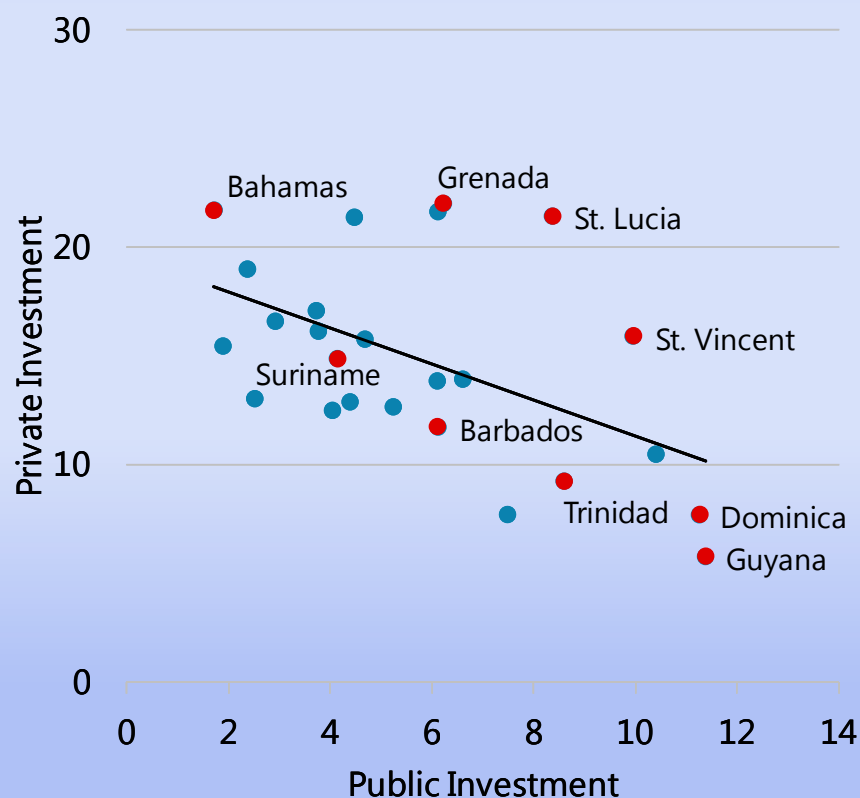
(average 2000-11)



Crowding in private investment through improved business climate

Public and Private Investment in the Region

(average 2000-11; percent of GDP)

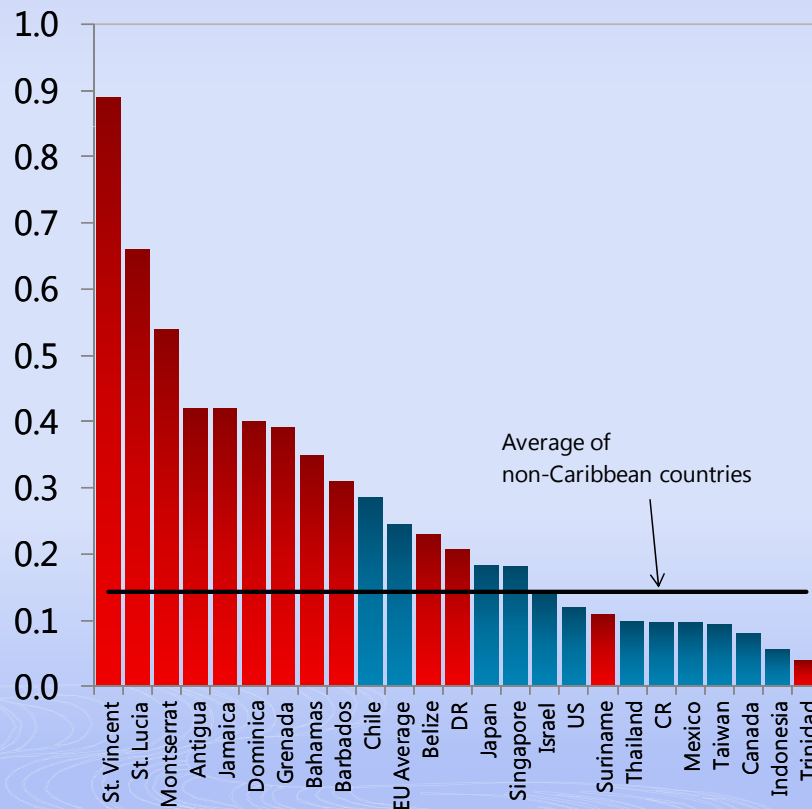


STRUCTURAL REFORMS?

Reducing costs of doing business

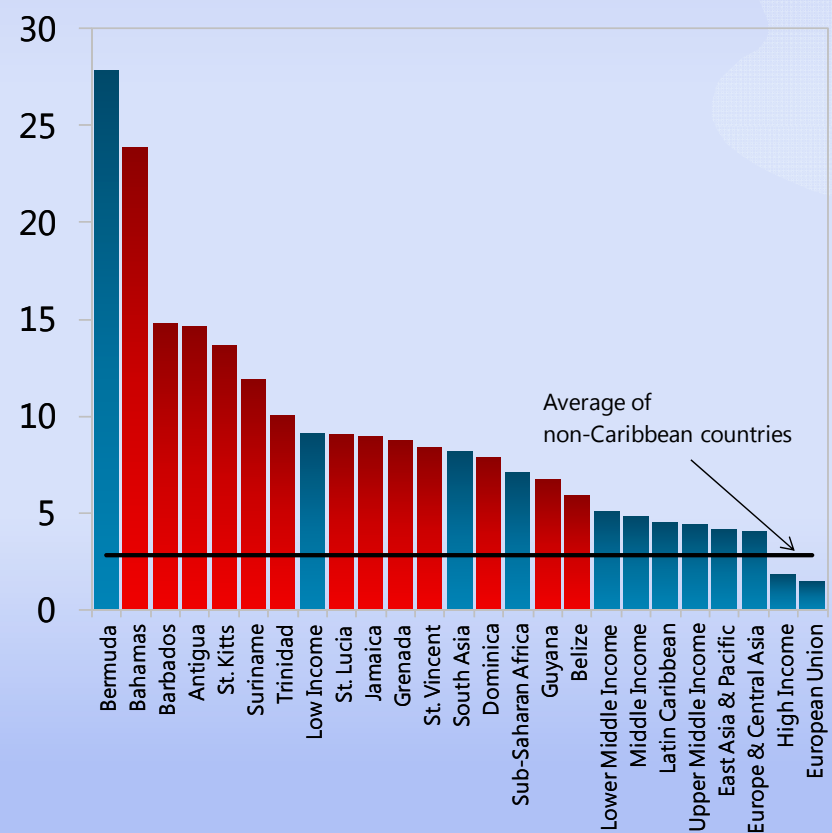
Electricity Tariffs

(US dollars per KWH, June 2011)



Effective Import Tariff Rates

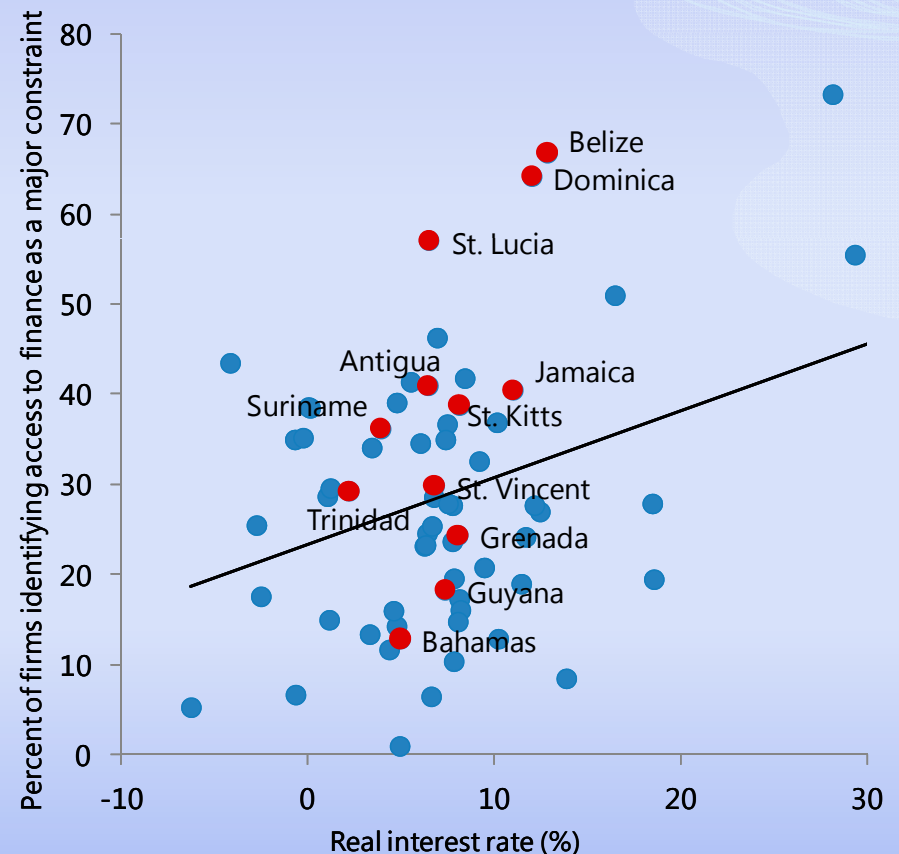
(Average of all products, latest available)



STRUCTURAL REFORMS?

- Improving labor market flexibility to keep real wage costs down and growing in line with productivity
- Increasing access to credit (credit bureaus, recovery of collateral, floor on saving deposit rate)

Access to Finance and the Real Interest Rate
(Emerging and developing economies, 2010)



WHAT OPTION THEN?

- ❑ Structural reforms have no downside (although difficult) and should be pursued
- ❑ Where fiscal adjustments are needed, these will also help boost competitiveness
- ❑ External devaluations can work, especially if:
 - tight incomes and fiscal policies limit passthrough;
 - supported by fiscal adjustment and structural reforms to ensure credibility; and
 - controlled (not forced by crises)