The Caribbean

From Vulnerability to Sustained Growth

Edited by Ratna Sahay, David O. Robinson, and Paul Cashin

INTERNATIONAL MONETARY FUND

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Foreword

After gaining their political independence from the United Kingdom in the 1960s and 1970s, the open island economies of the Caribbean prospered initially because of the preferential access given their traditional agricultural products to European markets, and later due to the growing importance of tourism. The national authorities, rightfully, put a strong emphasis on improving social conditions, and today living standards have reached levels that match upper-middle-income countries. In addition, many economies such as those that are members of the Eastern Caribbean Currency Union (ECCU), and which are the focus of several chapters in this book, have enjoyed a sustained period of price and exchange rate stability. However, during the last decade the island economies have been buffeted by a series of adverse shocks, including the erosion of trade preferences, decline in official foreign assistance, and frequent natural disasters. The relaxation of fiscal stances, in many instances reflecting accommodation to these shocks, has led to a rapid build-up of public debt in the region.

In response to the large macroeconomic challenges facing the Caribbean, the International Monetary Fund has stepped up its engagement in the region with the commencement of regional analysis and surveillance of the ECCU, intensified surveillance in Jamaica, more comprehensive Article IV consultations with individual countries, deeper technical assistance programs to help build local capacity, new IMF-supported programs in several countries (including Guyana, Grenada, and Dominica), and greater public outreach. The recent IMF-supported programs are developed by the authorities and embody a clear recognition of capacity constraints faced by many countries in implementing policies and undertaking reforms. In discussions with regional and national authorities, the IMF has emphasized that acceleration of the Caribbean's growth performance will require a multifaceted strategy designed to integrate the island economies with the global economy, facilitate the transformation of their economies from agriculture into tourism and related services, promote greater regional cooperation, particularly in the provision of collective government services, and implement fiscal policies that preserve macroeconomic stability.

The papers in this book arose from the IMF's regional and bilateral surveillance work in the Caribbean and have benefited from discussions with key national and regional policymakers and feedback from regional conferences, seminars, and workshops. The papers set out many of the economic challenges facing the island economies of the Caribbean and present policy options designed to ameliorate external shocks and embark firmly on a sustained growth path. I hope that the contributions to this book will form the basis for deepening our policy dialogue in the region and help achieve the economic aspirations of the Caribbean people.

Anoop Singh
Director, Western Hemisphere Department
International Monetary Fund

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The views expressed in this book, as well as any errors of commission or omission, are the sole responsibility of the authors, and do not necessarily reflect the opinions of the Caribbean authorities, the Executive Directors of the IMF, or other members of IMF staff.

About the Authors

Paul Cashin, a national of Australia, is Deputy Division Chief in the Caribbean I Division of the IMF's Western Hemisphere Department. Mr. Cashin holds a Bachelor of Commerce in Economics and a Master of Agricultural Science in Economics from the University of Melbourne in Australia, and a Ph.D. in Economics from Yale University. Prior to joining the Western Hemisphere Department, Mr. Cashin worked for several years in the Fund's Research Department on issues related to developing countries; prior to joining the Fund he was Principal Research Economist at the Ministry of Agriculture in Victoria, Australia.

Jingqing Chai, a national of People's Republic of China, is an Economist in the Caribbean I Division of the IMF's Western Hemisphere Department. Ms. Chai holds a B.A. in International Finance from the East China Normal University in Shanghai, a M.A. in Economics from the University of Massachusetts, and a Ph.D. in Economics from Stanford University. Prior to joining the Western Hemisphere Department, Ms. Chai worked for several years in the Fund's Monetary and Financial Systems Department on financial sector issues.

Rupa Duttagupta, an Indian national, is an Economist in the Caribbean I Division of the IMF's Western Hemisphere Department. Ms. Duttagupta holds a Masters in Economics from the Delhi School of Economics, India, and a Ph.D. in Economics from the University of Maryland. Prior to joining the Western Hemisphere Department, she worked for three years in the Monetary and Financial Systems Department, and a year in the Fund's Asia and Pacific Department. Her research interests include broad macroeconomic, trade and international finance issues related to developing countries.

Pawel Dyczewski, an Economist in the Caribbean I Division of the IMF's Western Hemisphere Department, is a national of Poland. He holds a B.A. in Economics from the University of Chicago and a Ph.D. in Economics from the University of California, Berkeley. He joined the International Monetary Fund in 2002. Prior to joining the Western Hemisphere Department, Mr. Dyczewski worked in the European Department on the transition economies of Eastern Europe.

Rishi Goyal, a national of India, is an Economist in the Caribbean I Division of the IMF's Western Hemisphere Department. Mr. Goyal holds a B.A. in Economics and Mathematics from Swarthmore College, and an M.A. and a Ph.D. in Economics from Stanford University. Prior to joining the Western Hemisphere Department, Mr. Goyal was in the Fund's Economist Program working in the Middle East and Central Asia Department and the Monetary and Financial Systems Department.

Prachi Mishra, a national of India, is an Economist in the Macroeconomic Studies Division of the IMF's Research Department. Ms. Mishra holds a Masters in Economics from the Delhi School of Economics in India, and a Ph.D. in Economics from Columbia University. Ms. Mishra has worked on issues relating to international migration and trade; she also spent a year at the Fund as an intern in the Office of the then First Deputy Managing Director, Mr. Stanley Fischer.

Montfort Mlachila, a national of Malawi, is an Economist in the Caribbean I Division of the IMF's Western Hemisphere Department. Mr. Mlachila graduated from the University of Grenoble in Econometrics and the Graduate School of the University of Auvergne Clermont-Ferrand, France, in Economics. Prior to joining the Western Hemisphere Department, he worked for several years in the Policy Development and Review Department; prior to joining the Fund, he worked at the Reserve Bank of Malawi.

Patrick Njoroge, a Kenyan national, is a Senior Economist in the Caribbean I Division of the IMF's Western Hemisphere Department. Mr. Njoroge holds B.A. and M.A. degrees in Economics from the University of Nairobi, Kenya, and a Ph.D. in Economics from Yale University. He has also worked in the Fund's European II Department on the transition economies of Eastern Europe, and in the Policy Development and Review Department. Prior to joining the Fund, Mr. Njoroge worked for several years in the Ministries of Finance and Planning in Kenya.

Ruby Randall, a national of Sierra Leone, is Senior Economist in the Office of Internal Audit and Inspection of the IMF's Office of the Managing Director. Mrs. Randall holds a B.A. in Economics and Political Science from McGill University, a Master of Philosophy in Economic Development from Cambridge University, a Master of Science in Economics from the London School of Economics, and a Ph.D. in Economics from the University of Maryland. Prior to joining the Fund, Mrs. Randall worked at the McKinsey Global Institute. Mrs. Randall has previously worked in the Fund's Western Hemisphere and African Departments.

Tobias Rasmussen, a national of Denmark, is the IMF's Resident Representative in Timor-Leste. Prior to this posting, he was an Economist in the Caribbean I Division of the Western Hemisphere Department, and he has also worked in the IMF's European and Finance Departments. Mr. Rasmussen holds Bachelor, Master, and Ph.D. degrees in Economics from Aarhus University in Denmark, and a Master of International Affairs degree from Columbia University.

David O. Robinson, a national of the United Kingdom, is Division Chief of the Caribbean I Division of the IMF's Western Hemisphere Department, which covers the Eastern Caribbean Currency Union (ECCU). He currently leads the regional surveillance mission to the six Fund-member ECCU countries, and has also headed missions to Antigua and Barbuda, and St. Kitts and Nevis. Mr. Robinson holds a Ph.D. in Economics from Stanford University, a Master of Science in Economics and Econometrics from the University of Southampton, and a B.A. in Economics from the University of Cambridge. Prior to working on the Caribbean, Mr. Robinson worked for several years on the transition economies of the former Soviet Union.

Ratna Sahay, an Indian national, is Senior Advisor in the IMF's Finance Department. Previously Assistant Director in the IMF's Western Hemisphere Department, she headed the regional surveillance mission to the six ECCU countries that are members of the IMF, and was responsible for regional initiatives in the wider Caribbean. Ms. Sahay holds a B.A. in Economics and an M.A. in Business Economics from Delhi University in India, and a Ph.D. in Economics from New York University. Ms. Sahay has written and published widely on international trade and finance and economic development, and has served as co-editor of *IMF Staff Papers* and Chair of the Working Group on Fund Research at the IMF.

Wendell Samuel, a national of St. Vincent and the Grenadines, is Senior Economist in the Central American Division of the IMF's Western Hemisphere Department. Mr. Samuel holds Bachelor and Master in Economics degrees from the University of the West Indies, and a Ph.D. in Economics from New York University. Prior to joining the Western Hemisphere Department, Mr. Samuel was Director of Research and Information at the Eastern Caribbean Central Bank, and a lecturer in the Department of Economics at the University of the West Indies.

Guillermo Tolosa, an Uruguayan national, is an Economist in the Central American Division of the IMF's Western Hemisphere Department. Mr. Tolosa holds a Bachelor in Economics degree from the University of the Republic of Uruguay, and an M.A and Ph.D. in Economics from the University of California, Los Angeles. Prior to joining the Fund, Mr. Tolosa was a researcher at CINVE, a Uruguayan think tank, and an Assistant Professor at the University of the Republic of Uruguay.

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Overview

Ratna Sahay, David O. Robinson, and Paul Cashin

The Caribbean islands have a distinct place in world history and culture that belies their small physical size. During the conquest of the Americas starting in the 17th century, the islands took center stage in the numerous naval campaigns between the European nations attempting to establish bases that would provide access to untold wealth in distant lands to the west. With the development of sugar and other tropical crops on the islands in the 18th and 19th centuries, the plantations themselves were treasured for the vast profits they generated.

Through time and driven by labor movements, the islands attained an increasing measure of autonomy, culminating in full independence for the larger islands by the 1970s. With the notable exception of Haiti, democratic traditions took strong root over time, and public policies today are actively debated and strongly influenced by the socioeconomic conditions of the populations. Unique local cultures have developed and flourish, as evidenced by Nobel prizewinners in economics and literature, as well as by the international success of pop music artists. The region has produced the West Indies cricket team, which dominated international competition for many years.

The last few decades have seen fundamental and lasting changes in the islands. Attaining independence, of course, is the key political change, which brought with it a need to define and implement national priorities. Economic structures have also changed—sugar and bananas, which were the backbones of the economies for centuries, have now been replaced as the dominant sector by tourism. Unfortunately, some things have not changed—the islands remain among the most disaster-prone region in the world, hit regularly by major hurricanes, landslides, earthquakes, and even volcanic eruptions.

So how have the economies fared since independence? To answer this question, this book provides a broad perspective on the Caribbean islands, while focusing on the smallest ones—those in the Eastern Caribbean Currency Union (ECCU). The good news is that most countries have enjoyed a sustained period of price and exchange rate stability, while maintaining and improving living standards. The bad news is that, in more recent years, negative shocks have exacerbated the remaining problems of adjustment from declining sectors, growth has slowed, and a substantial public debt burden has been accumulated.

The Caribbean countries have been able to deliver on promises of strong social and economic outcomes. Most political parties in the region have their roots in organized labor and place great emphasis on sustaining high levels of employment, safe working conditions, and a strong social safety net with free access to health and education services. The region has among the strongest social indicators in the world; for example, life expectancy in the ECCU countries averages 74 years, well in excess of the average of 70 for middle-income countries, while literacy rates in the ECCU countries average 92 percent. Per capita incomes have also risen since independence; for example, the ECCU countries are now among the upper middle-income countries of the world (Table 1.1).

Traditional agriculture has fared poorly in recent decades. Both banana and sugar producers have been supported for many years by preferential access to markets in Europe that have enabled Caribbean producers to receive prices substantially above those on the free market—in the case of sugar, the price in Europe has often been two or even three times higher than the free market price. In response to increasing international pressure on restrictive European trade regimes, the erosion of preferential trade access by Europe's former colonies is now accelerating. Banana production in the Windward Islands has fallen sharply, and is now about one-third of the 1990 level (Figure 1.1). The fate of sugar is even more dramatic—St. Kitts and Nevis, the last remaining producer in the ECCU region, announced the closure of its industry in 2005.[1]

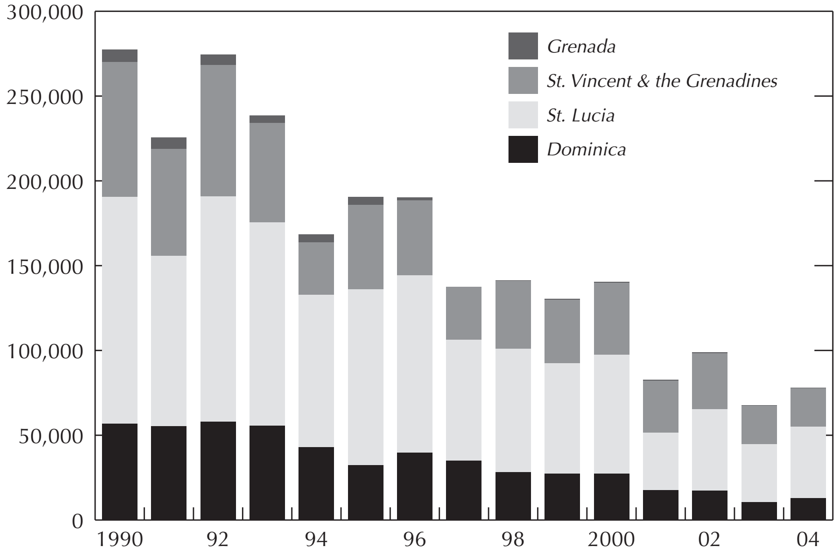
[1]The difficulties in the sugar industry are by no means new. As early as 1896, a Royal Commission headed by General Sir Henry Norman examined conditions in the sugar industry in the islands and concluded that the industry was in danger of extinction due to its inability to compete with more capital-intensive producers such as Brazil.

Table 1.1. Eastern Caribbean Currency Union (ECCU): Social and Demographic Indicators

	Antigua & Barbuda	Dominica	Grenada	St. Kitts & Nevis	St. Lucia	St. Vincent & the Grenadines	ECCU
Population (thousands), 2003 (estimate)	79	71	104	47	161	106	567
Poverty headcount index, 2000[1]	12	33	32	31	25	38	29
Human Development Index rank (2004) among 177 countries	55	95	93	39	71	87	. . .
Life expectancy (years), 2003	75	77	73	72	74	73	74
Adult illiteracy rate (percent), 2001	13	4	6	2	10	11	8
Mortality rate, infant (per 1,000 live births), 2003	11	12	18	19	16	23	17
GDP at market prices, 2004 (millions of U.S. dollars)	815	282	437	404	762	404	3,105
Share in nominal GDP, 2004	26.3	9.1	14.1	13.0	24.6	13.0	100
GDP per capita (U.S. dollars), 2004 (estimate)	10,375	3,962	4,205	8,647	4,748	3,801	5,473

Sources: World Bank, World Development Indicators database; Eastern Caribbean Central Bank; and IMF staff estimates.
[1]Percentage of population living below each country's locally-defined poverty line in 2000.

Figure 1.1. Windward Islands Banana Exports
(In tons)

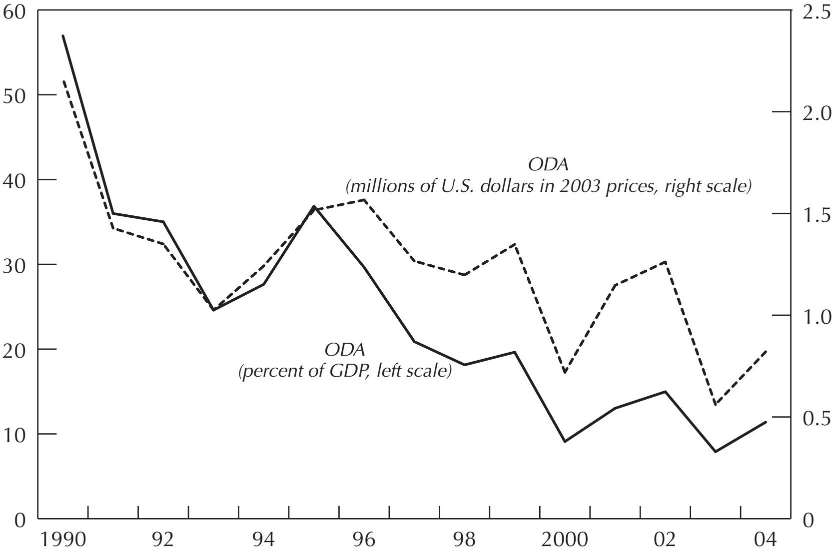


Source: Windward Islands Banana Development and Export Company.

How important are these traditional industries today? Measured in terms of value added or as a share of exports, the industries have long since ceased to constitute the dominant sector in the economy. Indeed, agriculture as a whole now accounts for just 6½ percent of GDP in the ECCU region, although there are notable exceptions in other Caribbean countries (in sugar-exporting Guyana, agriculture comprises about 30 percent of GDP). However, its social—and political—importance is much greater. These crops have been grown for centuries and form the foundation for rural livelihoods and the associated social support mechanisms. Closure of such industries—the sugar industry in St. Kitts and Nevis employed around 10 percent of the labor force when it was closed—creates significant social disruptions and economic challenges.

With independence and the rise in per capita incomes has also come a reduction in aid flows. Aid from member countries of the Organization for Economic Cooperation and Development (OECD)—largely to support the transition away from traditional crops and in response to natural disasters—has waxed and waned (Figure 1.2). While such flows have remained roughly constant in U.S. dollar terms since the mid-1970s, they

Figure 1.2. The Caribbean: Official Development Assistance (ODA)



Source: Organization for Economic Cooperation and Development.
Notes: The Caribbean includes the countries of the Eastern Caribbean Currency Union and The Bahamas, Barbados, Belize, Dominican Republic, Jamaica, Suriname, and Trinidad and Tobago.

have declined significantly in real terms and relative to GDP. For the ECCU countries as a whole, the reduction in aid flows is of the order of 5 percent of GDP a year, creating a substantial shortfall in government budgets and forcing either a scaling back in intended expenditure plans or the accumulation of debt. Going forward, the outlook is certainly no brighter in this regard for the Caribbean, as donor countries increase their relative aid flows to reducing poverty in the lowest-income countries, particularly in Africa.

Natural disasters have continued to hit the region with regularity (Table 1.2). The geographical location of the islands is a mixed blessing—beaches and climate that provide a natural basis for a tourism industry but also exposure to hurricanes. This is a critical area where the small size of the islands significantly constrains policy options. It is one thing for a state or a small corner of a large federation to be hit by a hurricane, and quite another matter when it devastates an entire country, as happened in Grenada in September 2004. St. Kitts and Nevis had to build and rebuild three cruise ship ports—vital infrastructure for a tourism dependent economy—in a three-year period in the late 1990s due to extensive damage

Table 1.2. Worldwide Incidence of Natural Disasters, 1970–2004

	All Recorded Disasters				
		Number of events divided by land area		Number of events divided by population	
	Number of events	Index	Rank	Index	Rank
All countries	7,116	100	75	100	75
Advanced economies	1,572	18	74	35	96
Caribbean	190	587	23	378	22
Eastern Caribbean Currency Union	48	1,173	5	747	5
Other Caribbean	142	196	35	133	34

Sources: EM-DAT Emergency Disasters Data Base (EM-DAT) (CRED, 2004) for natural disasters; World Bank, World Development Indicators database for land area; IMF, World Economic Outlook database for population.

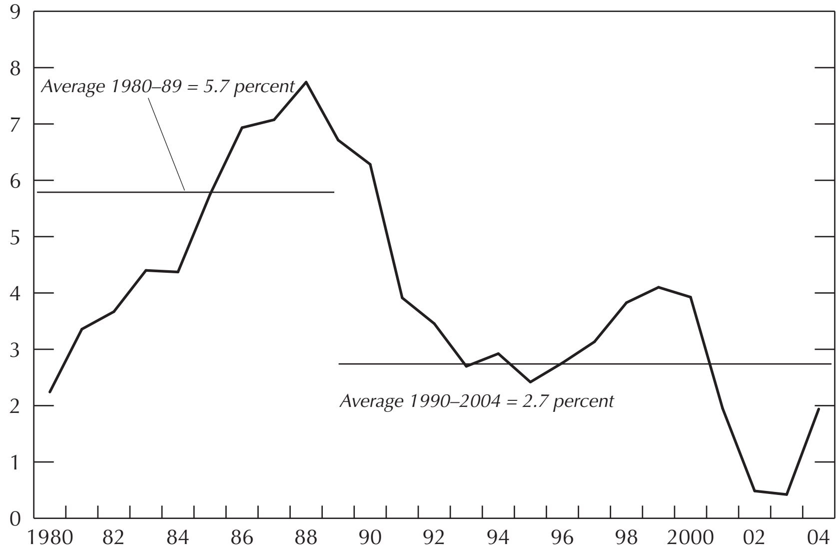
Notes: The sample contains 148 countries after omitting countries without at least one natural disaster associated with a cost estimate and/or missing information on GDP (24 advanced economies, 15 Caribbean countries, and 109 other developing countries). Simple unweighted averages are used for country groupings. Rankings are in descending order, with "1" indicating the most exposed to natural disaster.

from hurricanes. In the years to come, the rise in global warming augurs natural disasters with even greater frequency and severity.

The net effect of an erosion of trade preferences, declining aid flows, and a high frequency of natural disasters is that economic growth in the ECCU has been volatile and has slowed dramatically over the last decade (Figure 1.3). While the first two decades following independence saw strong growth reflecting the initial spurt to developing tourism, growth has halved since then as the contribution of tourism stabilized and the decline in traditional agriculture took its toll. Even countries such as Grenada that attempt to diversify away from traditional agriculture into new products are shortchanged by the long-lasting shocks caused by hurricanes that destroy crops such as nutmeg, which has a five- to seven-year gestation period.

The emergence of tourism as the dominant sector in the economies in the region has also created new vulnerabilities to global shocks, such as a sharp increase in petroleum-related products, which can disrupt international travel and intensely affect any number of tourism and tourism-related services and events. Indeed, the terrorist attacks of September 11, 2001 on the United States caused a sharp decline in Caribbean tourism and led to a dramatic contraction of output and employment in the region. The region's small economies are completely dependent on imports for their supply of petroleum products, and even a small shock to these

Figure 1.3. Eastern Caribbean Currency Union: Real GDP Growth
(Annual percent change, 3-year moving average)



Sources: Eastern Caribbean Central Bank; and IMF staff estimates.

prices can make a large difference to government finances and domestic production.

How should policymakers in these small and vulnerable economies respond to large, and sometimes sudden, shocks? The answer depends on the circumstances. To some extent, it is inevitable that public spending will rise following a natural disaster. When key infrastructure that is absolutely essential for a country to function is severely damaged by a hurricane, then it simply has to be rebuilt. This calls for greater savings during good times and access to well-functioning insurance mechanisms—both market as well as official (such as higher aid flows)—following disasters. Another way of looking at shocks is to ask if they are permanent or temporary. If shocks are temporary—as was the case of the September 11th attacks—then governments should attempt to smooth national consumption by borrowing in bad times and saving in good times. If shocks are permanent, however, there is a need to adjust to them steadily but surely, particularly if they are anticipated.

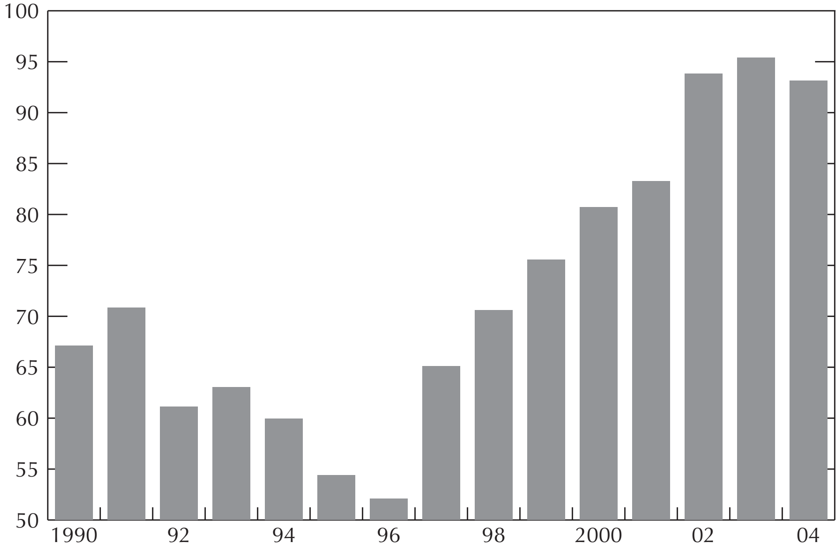
How have policymakers in the ECCU countries responded to these adverse developments in the external environment? The answer is that they have almost uniformly relaxed fiscal stances when the going became difficult. In the 1970s and 1980s, the small Caribbean economies grew rapidly, boosted by tourism. This growth helped generate fiscal savings that came in handy when natural disasters took their toll. However, since the slowdown in growth in the 1990s and the decline in trade preferences and aid flows, governments have begun to borrow heavily at home and abroad. The growth of domestic financial markets and cross-border capital flows, both natural consequences of economic development and globalization, facilitated this process. Hence, during a period when fiscal prudence was required to adjust to permanent negative shocks, government spending was increased to maintain and upgrade infrastructure and even create public employment. This last aspect is, perhaps, best illustrated in Antigua and Barbuda, where at end-2004, the central government alone employed 40 percent of the labor force, up from 30 percent a decade earlier. In addition, to spur private-sector-led growth, the Caribbean countries used all possible means available to attract new investment, including granting substantial tax exemptions or concessions that have served to erode the tax base and further widen fiscal deficits. As a result, since the mid-1990s public debt has grown rapidly to reach over 90 percent of GDP, and the economies in the region are now among the most heavily-indebted, emerging market countries in the world (Figure 1.4). One mitigating factor for the Caribbean people has been the substantial inflow of remittances resulting from the large-scale migration of skilled labor to industrial countries.

So what will the future hold for the region? Its economic challenges are formidable and complex, particularly for small sovereign states. The focus of this book is to document the many challenges facing the region and to explore policy options to address them. The book includes papers that were originally prepared to facilitate the IMF's regional and bilateral surveillance work in the Caribbean. They have benefited from discussions with prime ministers, central bank governors, senior government officials, and representatives from civil society and the private sector, as well as from presentations at many seminars and conferences in the region.

Part I of the book, "Fiscal Policy Challenges," examines the prime policy area of the growing fiscal imbalances in the Caribbean. It explores the reasons for larger fiscal imbalances in the ECCU countries—which share a common currency and a common central bank—compared to their neighbors.

Ratna Sahay reviews the economic performance of Caribbean countries since the 1990s, paying particular attention to their proclivity for growing fiscal imbalances. The rapid build-up of public debt is accounted for by a deterioration in fiscal balances, caused not by declining revenues but

Figure 1.4. The Caribbean: Total Public Debt
(In percent of GDP)



Source: IMF staff estimates.
Notes: The Caribbean includes the countries of the Eastern Caribbean Currency Union and The Bahamas, Barbados, Belize, Dominican Republic, Guyana, Haiti, Jamaica, Suriname, and Trinidad and Tobago. Simple average is used as the Caribbean average.

by a rise in expenditures, with the latter emanating from both domestic policy slippages (largely the deterioration in primary fiscal balances) and exogenous shocks (chiefly natural disasters and the erosion of trade preferences). Sahay concludes that the high public debt of Caribbean countries has heightened their vulnerability to economic shocks, and that a reduction in such debt stocks should be a priority macroeconomic goal. To be successful, debt reduction will need to be underpinned by a combination of fiscal consolidation, active debt management, asset sales, a lowering of domestic (financial sector) vulnerabilities to exogenous shocks, and the implementation of growth-enhancing reforms.

Rupa Duttagupta and Guillermo Tolosa examine the relationship between national fiscal policies and the ECCU's exchange rate arrangement. They draw on recent theoretical literature to assess the combined effect on national fiscal policies of a currency union with a fixed exchange rate arrangement. They find that fiscal stances under a currency union with a fixed peg tend to be associated with exacerbated free-riding opportunities that allow member countries to transfer the cost of fiscal slippages (the inflation tax) across time (given the exchange rate peg) and across member countries (given the currency union). The chapter highlights the experience of 15 Caribbean countries since the early 1980s, finding evidence of greater fiscal free-riding in the ECCU countries compared with countries possessing other exchange rate regimes. The findings underscore the necessity to have appropriate mechanisms to ensure that the fiscal policies of members of a currency union are consistent with the maintenance of a regional fixed exchange rate arrangement.

Part II, "Macroeconomic Cycles and Volatility," documents the extent to which the Caribbean countries are similar in their economic characteristics and proclivity to shocks, the degree of comovement in their national economic activity, and the major determinants of volatility in the region. These factors are important to determining whether policy responses should be similar across countries.

In studying the pattern of economic fluctuations in Caribbean economic activity over the past four decades, Paul Cashin finds that periods of expansion in activity (real GDP) typically last much longer than periods of contraction. However, in keeping with the findings from previous analyses of developed countries, the length of periods of above-average and below-average rates of Caribbean economic growth is found to be much more symmetrical. There is also little support found for the notion that expansions and contractions in trend-adjusted Caribbean output have a fixed duration. However, comovement of output is common in the eastern Caribbean. Importantly, Cashin finds a strong association between movements in real GDP of ECCU countries, and a very strong association between movements in developed-country output and the output of individual ECCU countries.

Tobias Rasmussen and Guillermo Tolosa study the determinants of macroeconomic volatility in the countries of the eastern Caribbean. Given the Caribbean region's vulnerability to real external shocks—its openness to trade, dependence on tourism, and proclivity to natural disasters—it might be expected that the volatility of economic activity would be higher than that of other middle-income countries. Counterintuitively, the volatility of output in the ECCU is found to be markedly lower than that of countries at similar levels of development. Drawing on cross-country analyses, the authors find that this relative stability of incomes can be attributed to the region's above-average ability to borrow externally, and thereby smooth the path of national income. However, they caution that the ECCU's ability to borrow externally and engage in countercyclical fiscal policies may be weakening, given the region's rapid accumulation of high levels of public indebtedness.

Part III, "Financial Sector Issues," examines the health and role of the region's banking system in the face of expanding fiscal imbalances. Drawing on a comparison of the performance of the ECCU banking system with that of other Caribbean Community and Common Market (CARICOM) countries, Jingqing Chai finds the ECCU banking system to be well capitalized, reasonably profitable and liquid, yet with high levels of nonperforming loans, low provisioning for loan losses, and large exposure to the household (mortgage) sector. The author points out that there are growing vulnerabilities in the ECCU banking system. As public debt in the ECCU has accumulated since the 1990s, the banking system's exposure to the public sector has also increased, with the performance of state-owned local banks clearly inferior to that of foreign bank branches. Consequently, Chai sets out measures to ensure continued financial stability, including reforms to the system's institutional framework.

Part IV, "Economic Implications of Natural Disasters," outlines the effects of and national policy responses to economic losses caused by the region's proneness to natural disasters. Tobias Rasmussen points out the rising incidence of natural disasters in the eastern Caribbean during three decades since 1970, noting that a natural disaster occurred once every 4½ years in each of the six ECCU countries that are members of the IMF. In cataloging the macroeconomic effects of major natural disasters in the ECCU region, the author finds that there typically is a contemporaneous contraction of output and a deterioration of fiscal and external balances, ameliorated by an up tick in transfers from abroad (including development assistance), with a rise in public indebtedness over the medium term. Rasmussen suggests several means by which countries can mitigate the cost of natural disasters, including through recourse to insurance and capital markets, and outlines the role of international assistance in promoting disaster mitigation actions by national governments.

Paul Cashin and Pawel Dyczewski examine the role of public policy in the mitigation of the risk of natural disasters. An important policy question is how small island economies can respond to the economic vulnerability induced by natural disasters. Three main responses include risk identification and risk reduction, self-insurance, and utilization of risk transfer mechanisms. The chapter sets out the weaknesses of traditional insurance markets and capital-market-based risk transfer instruments in the Caribbean, as well as the difficulty of measuring the government risk from natural hazards in developing countries. The authors also highlight the moral hazard induced by postdisaster flows of external assistance from donors and international financial institutions, which dampen the incentive for disaster-prone countries to undertake predisaster mitigation activities. The policy implications of these findings are that there needs to be a mix of financing options for postdisaster expenditure, arrayed as a graduated response to increasing levels of natural disaster risk in the Caribbean.

As the economies of the Caribbean are among the most open in the world, Part V, "Managing External Flows," takes up issues related to the influence of external flows—labor emigration and remittances, as well as the relationship between domestic tax incentives and foreign direct investment. Prachi Mishra quantifies the magnitude and nature of migration flows from the Caribbean, and estimates the costs and benefits to source countries of emigration. Mishra points out that Caribbean countries have lost 10 to 40 percent of their labor force due to emigration (largely to OECD countries) since 1970, with strikingly larger emigration rates among the highly educated. As a consequence, the Caribbean is the world's largest recipient of remittances (defined as the sum of worker remittances, compensation of employees, and migrant transfers), which in 2002 constituted about 13 percent of the region's GDP. However, the author cautions that the results of welfare calculations indicate that official remittance flows to the region are outweighed by the economic losses associated with high-skilled emigration, so that there does appear to be evidence of "brain drain" in the Caribbean.

Jingqing Chai and Rishi Goyal analyze the effectiveness of preferential tax treatment in promoting investment in the Caribbean. Tax concessions have been a longstanding and key component of the investment and development strategy of ECCU countries. The chapter outlines the major forms of tax concessions offered in the region—corporate income tax holidays, exemptions from import duties and taxes—and compares the cost of concessions (in terms of forgone revenue) against the benefits (attracting foreign direct investment). The authors find that reliance on tax concessions in ECCU countries has increased significantly over the past decade, resulting in forgone revenues ranging between 9½ and 16 percent of GDP annually, with only a modest effect in attracting additional investment. Consequently, the authors discuss several measures to reduce revenue losses and prevent excessive tax competition, including the adoption of a regional approach to harmonizing concessions.

Part VI, "Trade Integration and Tourism Developments," outlines developments in the tourism sector and the growth effects of the region's expanding integration with its trading partners. In recent decades the tourism sector has come to be the dominant driver of economic activity in Caribbean countries, and also exerts a strong influence on the evolution of both public finances and the balance of payments. Ruby Randall looks at recent trends and the competitiveness of Caribbean tourism, with an emphasis on the experience of ECCU countries. The chapter highlights the sharp contraction in world and Caribbean tourism following the September 11, 2001 terrorist attacks, and the Caribbean's gradual recovery of its tourism market share. It then presents both price and nonprice measures of the competitiveness of Caribbean tourism, with the former partly gauged using indexes of tourism-customer-based and tourism-competitor-based real effective exchange rates. The author finds evidence that Caribbean countries have experienced an erosion of their price and nonprice competitiveness, and sets out a range of measures that could enhance the efficiency and cost-competitiveness of Caribbean tourism enterprises.

In the book's final chapter, Montfort Mlachila, Wendell Samuel, and Patrick Njoroge explore developments in, and the effects of, greater regional and multilateral integration of the trade (goods and services), labor and capital markets of ECCU countries. The chapter charts the historical experience of ECCU and CARICOM countries in achieving greater regional integration, and points out the incongruity that while Caribbean economies are among the most open in the world, these economies fall a long way short of being fully integrated with the global economy. The authors then model the contribution of greater integration to economic growth in the ECCU and the wider Caribbean, controlling for exogenous shocks and domestic policy changes. The estimation results indicate that while greater integration can positively affect the pace of growth in the Caribbean, such growth is strongly dependent on economic growth in industrial countries.

The chapters in this book provide an assessment of economic developments in the Caribbean and a perspective on the key issues facing the region's policymakers. A common theme is the openness of the region's island economies, and the important influence of external shocks on their economic performance. Major shocks to these economies—the steady erosion of trade preferences and the decline in aid flows—are more permanent in nature and, to a large extent, anticipated. This calls for strategic planning by policymakers to adjust to the new global economic environment, while seeking new opportunities to ensure a steady increase in the living standards of the peoples of the Caribbean.