FISCAL, POLICY AND THE FREE TRADE AGREEMENT:
MEXICO, THE CARIBBEAN AND CENTRAL AMERICA

by

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This paper is a contribution to the ongoing debate on the merits and implications of regional integration. Its thesis is that when countries of very unequal economic power are as closely linked as are the US, Canada, Mexico, the Caribbean and Central America free trade arrangements make little difference. With or without a formal free trade agreement Mexico, the Caribbean and Central America (the Caribbean Basin countries) are constrained to similar policies. The most effective policy, if Government has the required credibility, is the use of fiscal adjustment to anchor the exchange rate. The experiences of the Caribbean Basin suggest nothing else stabilizes the economy as effectively or creates the circumstances for sustained growth.

The first section of the paper is a brief round-up of the recent policy and performance in selected countries of the Caribbean Basin, including the December 1994/January1995 Mexican crisis which had unprecedented financial repercussions. The second section discusses policy options available to small open economies in the situation of the Caribbean and Central America. The

third section discusses the impact of free trade area agreements in these circumstances.

Economic Policy and Performance

After many years of economic turmoil Mexico in 1988 embarked on a new economic policy which, until December 1994, was judged to be well-thought out, guided by the best theory and experience of countries in comparable circumstances and successful. It included tight fiscal policies, the active use of indirect monetary instruments, trade and financial liberalization, a crawling peg with a band within which the exchange rate was allowed to fluctuate and "pactos", tri-partite wage agreements between unions, employers and government.

Between 1988 and 1993 investment was robust, rising to 22% of GDP. There were strong capital inflows, a good foreign exchange build-up and high levels of confidence. Even though the balance of payments current account deficit widened from 7% to 8% of GDP in 1994, capital inflows slowed (evidently as a result of increases in US interest rates) and the Mexican money supply rose, the US Government, the Washington international financial institutions and world financial markets were stunned by the dramatic collapse of the peso in December 1994. The floatation of the peso brought deep devaluation and no slowdown in foreign exchange reserve loss until the IMF and the US Treasury hastily contrived massive financial support for the peso. (There are numerous analyses of the Mexican crisis but good concise summaries are to be found in the UN World Economic and Social Survey 1995, the IMF World Economic Outlook, March 1995 and the IMF Staff Report on Mexico, June 1995).

None of the explanations advanced for the Mexican crisis is fully convincing. It has been argued that the crisis was precipitated by adverse shocks - external economic and domestic political. However, by December the effects of these shocks seemed to have worn off. Some have argued that the external payments position of Mexico had become unstable, but the current account deficit in 1994 was only slightly larger than in 1993, exports of manufactured goods continued to expand vigorously and investment remained strong. Others have argued that monetary policy was not sufficiently tight. Zarazaga (1995) points out that the ratio of the monetary base to foreign exchange reserves rose to 160%. However, tighter monetary policy might arguably have precipitated the crisis rather than averting it. Taken altogether, the major economic indicators gave no warning of imminent instability and the authorities would at no time have been justified in

adopting strong fiscal and monetary contraction on the basis of ambiguous monetary signals.

The Mexican crisis has been profoundly unsettling to the international community of scholars and policymakers working on the open economy. The Mexican economy was subjected to sudden intense destabilization and deep output contraction even though every element of the recommended economic strategy for countries in its circumstances seemed to be in place. After orthodox monetary and fiscal stabilizations were seen to fail in several countries the international community had inclined to the view that the addition of heteredox elements, particularly an exchange rate anchor and an understanding on wages, constituted the appropriate package for countries in Mexico's circumstances (see Kiguel and Liviatan, 1992). The Mexican crisis raises the prospect that there remains a missing element: a mechanism for defending the exchange rate against capricious speculation once the exchange rate strategy is firmly anchored by fiscal policy. Such a mechanism, in the form of a $53 billion financial package, arrested the peso's free fall - at a rate far below anything that might have been considered appropriate prior to the December collapse. Mexican policymakers must surely be apprehensive about their prospects once the current contingent financing expires.

Jamaica has pursued policies advised and supported by the international financial institutions since the late 1970s with only a few years of interruption when agreed policies were not sustained and programmes suspended. Yet the economy remains unstable, with output growth weak and erratic. Jamaica has suffered from being a laboratory for changing views on macroeconomic stabilization by the international financial institutions. The early programmes focussed entirely on demand management through fiscal contraction and the use of direct and indirect monetary instruments. These programmes proved ineffective and opinion in Washington shifted towards financial liberalization, the use of indirect instruments and the liberalization of trade and exchange controls. A fixed exchange rate, undermined by the emergence of an unofficial market, was abandoned in favour of an exchange rate auction at rates determined by licensed financial institutions.

Marston (1995) identifies two phases in which the Jamaican authorities pursued a strategy of full liberalization, interrupted by a brief period when they returned to the use of direct monetary instruments. The first period from 1985-1989 ended

in failure because the combined deficit of government and the Bank of Jamaica could not be contained. The government deficit was sufficiently low in spite of burdensome debt service but the Bank of Jamaica, in efforts to contain the growth of money supply, was forced to issue certificates of deposit at interest rates so high that interest payments largely defeated the purpose of the issue. In addition to this, the Jamaica economy was plunged into crisis by a devastating hurricane in 1989.

An even more comprehensive programme of liberalization was adopted in the 1990s. It included tight fiscal and quasi-fiscal policy, positive and very high market driven real interest rates and targets for the accumulation of foreign exchange reserves and the monetary base, but not for the exchange rate.

There has been continous policy failure in the 1990s. Growth remained sluggish, inflation was well above targets, and the real costs of finance were so high as to damage competitiveness and fuel inflation. The exchange rate has been very erratic. There were extended periods when the rate remained unchanged, stabilised by the use of informal rationing in the face of seasonal fluctuations in the supply and demand of foreign exchange. These were followed at unpredictable intervals by exchange rate collapse with each devaluation pushing the exchange rate past the level needed to make up for any difference between domestic and foreign inflation. The Jamaican economic strategy continues to fail despite a very tough fiscal stance because it lacks three vital elements, only one of which is acknowledged by the Jamaican authorities and the international financial institutions: an exchange rate anchor; a mechanism to defend the exchange rate against speculative attack; and a social compact.

It is not surprising that the Jamaican authorities are reluctant to commit to an exchange target in spite of the overwhelming evidence of its efficacy in small open economies. In the 1970s and 1980s the authorities repeatedly failed to sustain an announced rate in experiments with a variety of mechanisms including fixed rates, a crawling peg and managed auctions. They now fear that any new commitment will be met with scepticism. Nevertheless, it is clear that private economic agents desire a fixed exchange rate as an anchor for expectations. In a remarkable episode in 1993 a major tourism corporation led an initiative to arrest exchange rate depreciation during a period of rapid decline. With the support of banks and talkshow hosts the exchange rate was kept unchanged for 18 months with no official support. The often demonstrated willingness of the Jamaican private sector

to endure voluntary foreign exchange rationing rather than buy and sell at depreciated rates indicates the importance of providing an exchange rate anchor. However, Jamaica's experience suggests that a government with no reputation cannot sustain a fixed exchange rate even with the correct fiscal policy. Government needs additional levers by which it can demonstrate to a sceptical public its ability to defend the exchange rate. An adequate stock of foreign exchange reserves is the first line of defence but, in addition, the Bank of Jamaica needs guaranteed lines of credit and swop arrangements large enough to convince markets it can outlast foreign currency speculators.

The Government of Jamaica has recognized the need to buttress fiscal policy with a social compact and discussion is in progress as of this writing (March 1996). After policy failure and surprise inflation workers try to recover lost real income by wage increases that wipe out the cost advantages of devaluation. Firms resist weakly because they expect to recover levels of profitability by future devaluation and inflation. A social compact which interrupts this vicious cycle becomes possible with a credible exchange rate anchor.

Trinidad and Tobago which, like Mexico, is an oil-producer and exporter, underwent a period of wrenching adjustment in the 1980s following the halving of the price of oil in 1979-80. Output stagnated, real income contracted sharply and the government was forced to cut back drastically in line with much diminished oil royalties. By 1990 the output mix had been changed to reduce concentration of exports and the fiscal deficit reduced to sustainable levels, though output growth remained sluggish. In the 1990s the government of Trinidad & Tobago followed orthodox policies with a novel feature - an informal pact to maintain a fixed exchange rate. The policy mix included tight fiscal policies, a moderately positive real interest rate, foreign exchange reserve accumulation to defend the parity and the liberalization of trade and foreign exchange restrictions. As part of a liberalization in the second quarter of 1993 which included a modest currency devaluation, the Central Bank of Trinidad and Tobago formally abandoned the fixed parity of the Trinidad and Tobago dollar. However, since then the exchange rate has remained essentially unchanged, managed by an informal agreement between the Central Bank and leading financial institutions. Speculators are unwilling to bet against the major financial institutions and a government backed by oil resources.

Trinidad & Tobago has achieved stabilization in the absence of a social compact even though economic growth remains sluggish. As the country is an oil and natural resource exporter wages are set by profitability in the export sector. Government's wage bill, potentially the major domestic source of inflation, has been contained by the conservative fiscal stance. Trade liberalisation has eliminated inflation in the domestic production of importables at the expense of a loss of output and jobs in the manufacturing sector.

The Bahamas maintained a fixed exchange rate anchor backed by foreign exchange reserves of the Central Bank and co-circulation of the US and Bahamas dollars. The Bahamas dollar is fixed at par with the US dollar and both currencies circulate freely in the Bahamas. The exchange rate remains credible because there has never been a devaluation. Foreign exchange reserves are sustained by sufficiently tight fiscal policy. Adverse capital flows are avoided by a real interest rate close enough to US interest rates to cover the costs of foreign currency transactions (Worrell, 1995).

The Bahamas' macroeconomic policy was a qualified success, achieving stability with modest if intermittent growth. A social compact has not been necessary because the co-circulation of the US dollar contains monetary expansion; the domestic currency accounts for less than 50% of the money supply; excessive monetary expansion reduces the percentage of domestic money in the money supply rather than leading to an increase in aggregate demand; foreign exchange reserves decline, warning of the need for fiscal contraction. The strategy based on a fixed exchange rate appears to be the correct one for a country in the Bahamas' circumstances. Calvo and Vegh (1994) recommend a nominal exchange rate anchor with credible policies in the presence of currency substitution.

The countries of the OECS (the Organization of Eastern Caribbean States) maintained a monetary union with a single currency and a shared central bank. The currency is fixed in value to the US dollar. The Eastern Caribbean Central Bank maintains the value of the currency by passive intervention, buying and selling foreign currency on demand at the fixed parity. The Central Bank maintains adequate foreign exchange reserves by limiting increases in the monetary base so that they do not exceed increases in the foreign exchange reserves by a great deal.

The Bank limits its advances to member Governments and such advances are always by way of interest-bearing securities. It makes no advances to quasi-government institutions and is not expected to bail out failing financial institutions. For the most part, the fiscal policies of OECS members have been sufficiently tight. Governments have few options for sustaining fiscal deficits. Some governments have built up arrears or obtained high levels of foreign credit but in every case they have been forced to apply correction in subsequent years. The differentials between interest rates in the OECS countries and foreign interest rates are less than the cost of foreign currency transactions. The monetary union and the reputation of the Eastern Caribbean Central Bank have served to stabilize the exchange rate and provide an environment of low inflation with no need for a social compact and measures for defending the exchange rate other than the central bank's foreign exchange reserves.

Barbados has also maintained an unchanged exchange rate supported by passive foreign exchange intervention. Fiscal policy was used to maintain the level of foreign exchange reserves and in 1992/93 to restore seriously depleted reserves to an adequate level. Interest rate differentials were less than the cost of foreign currency transactions except for a brief episode in the early 1980s. Exchange rate and domestic policies gained credibility because the currency value has remained uchanged since 1975. Corden (1994) recommends a nominal exchange rate target when the exchange rate has been stable for a long time. A social compact was introduced in 1992 and renewed in 1994. It is intended to link wage increases to increases in productivity. The social compact achieved a temporary pause in wage inflation between 1992 and 1994 but its long-term impact on external competitiveness remains to be seen.

After 15 years of a failed experiment with a controlled economy the Government of Guyana changed course in 1988. In all the major sectors - agriculture, mining, manufacturing, wholesale and retail, finance and public utilities - nationalized companies were made available for private sector purchase. Trade restrictions were amended and foreign currency restrictions totally removed. By 1988 years of inappropriate policy and balance of payments disequilibrium had rendered the official exchange rate meaningless and virtually all private transactions were conducted at highly depreciated unofficial rates. The exchange rate was unified by licensing a large number of foreign exchange traders and abolishing a fixed exchange rate set by the Bank of Guyana. A large debt reduction package was negotiated at the same time, though debt service costs remain a very large

percentage of foreign exchange earnings and government revenues. These measures were supported by finance and technical assistance from international financial institutions.

Although the package contained all the orthodox measures the exchange rate entered a free fall. It fell rapidly past the unofficial market rate and continued to depreciate over the period 1988-91 until its value was only 8% of the initial amount in terms of the US dollar. The exchange rate continued to depreciate more slowly between 1992 and 1994. Since then it has remained virtually unchanged. The Bank of Guyana continues its policy of non-intervention but there is evidence that the largest financial institutions, weary of the depreciating currency, have encouraged and supported informal rationing to stabilize the exchange rate. The low level of real income in Guyana - the result of years of economic stagnation and deep devaluation - served to curb domestic demand for foreign exchange and to reduce the numbers of firms and individuals with resources and interest in foreign currency speculation. Low real wages have spurred a resurgence of agricultural production and new mineral exploitation is underway, leading in recent years to rapid growth and a relatively large injection of foreign exchange receipts - an important factor in stabilizing the currency.

Costa Rica enjoyed a decade of uninterrupted growth ranging between 2% and 8% per year in the decade to 1994. However, inflation was high, ranging from 16% to 28%, up to 1993, when it was cut to 9.8%. Inflation accelerated in 1994 to 13.5% and it continues to rise. The balance of payments current account deficit widened but a strong capital account surplus was recored, reflecting private capital inflows. Foreign exchange reserves increased up to 1992 but declined a little in excess of $50 million each year in 1993 and 1994. The fiscal deficit was low up to 1991 and there were overall surpluses in 1992 and 1993 but there was a sharp deterioration in 1994. The floating exchange rate depreciated at about 10% per year, except for 1992, when it was little changed. There were no significant monetary injections. M_1 remained in the range of 10% - 14% of GDP in the 1980s and was reduced to about 8% in the 1990s.

Signs of disequilibrium emerged in 1994. The government deficit rose from a small surplus in 1993 to 6.7% of GDP in 1994 as a result of tax relief, a 44% increase in government wages and a substantial increase in interest payments. (1994 was an election year which saw a change of government.) There was some monetary expansion as a result of the collapse of Banco Anglo Costarricense. The Central Bank financed its closure, increasing reserve requirements and issuing its

own bonds to counteract the resulting growth in money supply. Interest rates rose, and the cost of servicing the bonds contributed to Central Bank losses equivalent to 1.4% of GDP.

The Dominican Republic was able to stave off pressure for exchange rate depreciation arising from fiscal expansion in 1994 by intervening heavily in the foreign exchange market. Foreign exchange reserves declined from US$651 million to US$252 million during the course of that year. The exchange rate was kept at about 12 pesos per US dollar and the intervention bought time to correct the fiscal expansion. Although 1994 was an election year with a contested result there seems to have been little economic effect other than temporary fiscal expansion.

The Dominican Republic has enjoyed growth since 1986, except for 1990. Virulent inflation in the 1980s (to 1991) was abruptly corrected in 1992 and inflation has remained in single digits since then. The stability of the nominal exchange rate contributed greatly to ending high inflation. The exchange rate has changed little since 1991; it is determined by market demand and supply, but with active intervention by the Central Bank. The Dominican Republic is a major exporter of minerals, which provide the Central Bank with a war chest of foreign exchange reserves with which to deter hostile speculation. That war chest was seriously depleted by the 1994 intervention when the Central Bank had to counter short-term outflows thought to be almost $300 million. However, government seems not to have depended entirely on financing the balance of payments deficit with foreign exchange reserves. The growth of imports was held below the growth of exports through fiscal correction late in 1994. The ratio of base money to GDP was cut back in the 1990s and, although it was a little higher in 1993 and 1994 than in 1991 and 1992, it remained well below the level of the 1980s. A major anomaly is the very high real interest rate at about 26% for short-term loans in 1994. Apart from temporary fiscal expansion in 1994 fiscal policy was remarkably tight with low deficits between 1984 and 1988, surpluses ranging from one-half to 3.9% of GDP between 1989 and 1993 and a deficit in 1994 of only 0.1%. However, losses of public enterprises raised the overall official deficit in 1994 to 2.5% of GDP.

In Panama after political upheavals in 1988-1989 the economy grew quite rapidly in the 1990s, at between 5% and 10% per year. Low inflation and balance of payments stability was guaranteed by the co-circulation of the Balboa and the US

dollar, which exchange freely at par. The rate of inflation remained below 2% per year. There has been a balance of payments surplus reflected in the growth of of foreign exchange reserves every year since 1989. The reserves' expansion pushed up the money supply. The ratio of narrow money to GDP rose about one point per year to 10% in 1994. Fiscal policies have been prudent. Large deficits in 1988 and 1989 associated with loss of revenue through the disruption of the Canal service were eliminated with the restoration of revenues and the containment of current expenditures. Overall deficits were converted to surpluses in 1992 and the years following, rising to a surplus of 4% of GDP in 1994.

Suriname suffered recession and runaway inflation in 1993 and 1994 after five years of growth between 1988 and 1992. Exports continued to grow but domestic production declined significantly. The fiscal deficit went out of control. There has been dis-saving each year, much of it funded by grants from the Netherlands. The level of dis-saving has, however, increased from about 6% in 1990 into the teens in 1991 and 1992 to over 20% in 1993 and 1994. Despite this, the balance of payments current account was in surplus between 1992 and 1994 on recorded transactions; however, there was a large illegal import which remains unrecorded. Also, there was a large net outflow on capital account during those years. A multiple exchange rate system was introduced late in 1992. The official rate, unchanged at 1.8 Guilders per US dollar, became irrelevant as transactions switched to the market rate, which reached 113 Guilders per US dollar by January 1994. Also, government built up substantial balance of payments arrears.

A structural adjustment programme was agreed in January 1993. It was an orthodox programme featuring fiscal policies, monetary and exchange rate policies, structural reform and social policies. In July 1994 the exchange rates were unified and the rate was left to float. It plummeted rapidly to 410 Guilders to the dollar by December before stabilizing in 1995. Government imposed a ceiling on wage increases for the public sector but the budget deficit remained excessive. Payments to public enterprises were in arrears, the Central Bank was unable to contain the money supply and part of government's deficit was monetized. Purchases of gold by the Central Bank aggravated in the monetary expansion. The accumulation of foreign exchange reserves also added to the money supply. Inflation skyrocketed from 22% in 1990 to 369% in 1994.

Policy Options in Small Open Economies

Monetary policy is ineffective in Mexico, the Caribbean and Central America because of the near perfect mobility of finance. The prevalence of capital flight in these countries is testimony to the mobility of finance (see Williamson and Lessard, 1987; Charette, 1992 and Bennett, 1989). Monteil (1994) finds relatively high capital mobility in the Caribbean Basin countries that appear in his sample. Financial flows are inhibited only by the cost of foreign currency transactions and they are very sensitive to exchange rate uncertainty. Capital controls are ineffective except to deter pure speculation. An analysis of the limits to monetary policy in selected Caribbean countries appears in Worrell, 1995. There is no evidence among the countries mentioned in the previous section of this paper of attempts to use monetary policy to manage aggregate demand. In Jamaica and Mexico monetary policy was used to defend the exchange rate, with domestic interest rates set to offer highly remunerative real returns. The results were not encouraging. A high domestic interest rate increases finance costs, inhibits competitiveness and sustains inflationary expectations. This role for monetary policy proves unnecessary when domestic policies are credible and the exchange rate is stable.

Exchange rate policy is to be avoided in small open economies in favour of a stable exchange rate anchor. Unprogrammed changes in the nominal exchange rate destabilize the economy and depress investment and output in the long-term. There may be temporary increases in income through the use of spare capacity but real exchange rate gains are soon eroded (see Rouis, 1994 for evidence on sub-Sáharan Africa). Note also that growth of output and the real exchange rate may be inversely related when capital is imported (Serven, 1995). If there is no spare capacity in the tradable sector output is likely to fall with a devaluation even in the short run. The relative price advantage from a nominal devaluation is eroded more quickly the greater is the percentage of the wage good that is imported. If 100% of the wage good is imported devaluation yields relative price gains only if real income contracts. Direct and indirect important content of the consumption basket is very high for all countries of the Caribbean and Central America, approaching 100% in the Bahamas, the Caymans and many others. There is now growing theoretical literature to support observations that unanticipated changes in exchange rates depress investment (Pindyck, 1991). Unanticipated exchange rate fluctuation undermines fiscal policy. Government loses credibility because of a fear that it will resort to devaluation in the future so as to reap an inflation tax (Kiguel and Liviatan). Consequently, there may be exchange rate slippage in spite

of tight fiscal policy. "News", misinterpretation of seasonal fluctuations and other factors may cause devaluation which is unwarranted by the economic fundamentals.

There appears to be no unique market equilibrium for the nominal exchange rate. Whénever the exchange rate deviates from its expected path massive speculation is triggered. In every recent experience in the Caribbean and Central American region this drove the nominal exchange rate far below the minimum value anyone had predicted or recommended on the basis of economic circumstances. These large exchange rate adjustments may result in major misalignment, with the potential to inhibit growth because of hysteresis (Baldwin and Lyons, 1994). If firms plan investments on the basis of depreciated costs in the devaluing currency they find their profitability eroded and production untenable at the equilibrium real exchange rate. They may exert pressure to maintain a permanently undervalued real exchange rate. A further argument against the use of exchange rate policy in small open economies is growing evidence that exchange rate uncertainty inhibits trade (Eichengreen and Irwin, 1995).

Trade policy is entirely innocuous in Mexico, the Caribbean and Central America. It can provide no gain in efficiency or competitiveness and it plays no role in economic stabilization. The major determinants of trade between North America, the Caribbean and the Central America do not include relative prices and so are not affected by tariffs or non-tariff barriers. (Because the countries are geographically close travel is inexpensive and borders porous; non-tariff barriers affect relative prices, not the supply of imports.) The major determinants of trade are: geographic proximity, size, common borders, relative GDP growth, common language, and transport costs (see Braga, et al, 1994 and Krugman and Venables, 1995). Siggel (1995) finds that domestic prices in Mexico never varied much from international prices and protection has not been binding mainly because of the long border with the United States.

Small countries have very little potential for switching tradables from import substitution to exports. This argument may not apply to Mexico which has a large domestic market but it does to all Central America and Caribbean countries. The import substitution sector is tiny - less than 5%of total GDP in every case. Most domestic production is either exported or non-tradable. The potential for switching resources is therefore very limited to begin with. Such a switch is unlikely in any

event. Firms that produce exclusively for import substitution are too small to enjoy economies of scale necessary for exports. The typical situation is represented in Chart 1 which shows a small firm A producing only import substitutes and a firm B producing for export as well. Their supply schedules are S(A) and S(B). The small firm owes its existence to a tariff T which allows it to sell at home at a price P_a defined by the equilibrium of its supply and domestic demand (DD). The large firm also sells on the domestic market, probably at the price P_a so as to accommodate his smaller rivals in the interest of his public image, but he is competitive on the world market. The essential difference between Barbados and Brazil and between Montserrat and Mexico is that any Barbadian or Montserratian firm which is as large as B, that is, large enough to reap scale economies, must be an exporter. There is insufficient domestic demand for even a single firm of internationally competitive size in any internationally traded good or service. (This fact has been largely overlooked in discussions of trade policy but Aw and Hwang (1995) show that larger size is the main explanation for higher productivity in export firms in the electronics sector in Taiwan.)

Export concentration is essential to reap external economies and agglomeration economies needed for export competitiveness. Because of external and agglomeration economies significant new export activity is probable only with deliberate government finance and promotion, except for natural resource based production. Passive trade policy, that is, the removal of non-tariff barriers and the lowering of tariffs, has no effect on export diversification. The experiences of successful new exporters in East Asia illustrate the importance of agglomeration and external economies and the role of government in overcoming them (see Rodrick, 1995; Chan, 1995 and Amsden and Singh, 1994).

There is no convincing evidence that trade liberalization increases competitiveness or efficiency in small countries (see Jenkins, 1995, on Bolivia and Weiss and Jayanthakumaran, 1995, on Sri Lanka). In larger economies the evidence is mixed. Hanson (1994) finds that trade liberalization (pre-NAFTA) contributed to firms' agglomeration in Northern Mexico and that market access, transportation costs and within-firm economies of scale were strong incentives for relocation. However, Tybout and Westbrook (1995) doubt that trade liberalization led to any economies of scale in Mexico though there were efficiency gains from relative price changes due to other factors.

Fiscal policy remains as the only effective tool in the armoury of the small open economies of the Caribbean and Central America and it is most effective when the exchange rate is anchored to the US dollar. Mexico may have gained in competitiveness from trade liberalization in the past but has probably now exhausted these possibilities so it is also left to depend on fiscal policy. Fiscal policy should be used to stabilize the exchange rate by adjusting the fiscal balance to raise or lower aggregate expenditure depending on the flow of foreign exchange receipts and the propensity to import. Because of lags the fiscal adjustment should take place well in advance of the time of the targetted adjustment. The authorities must project a level of foreign exchange reserves sufficient to defend the exchange rate parity given expected foreign exchange receipts and key current fiscal policy to moderate future imports in order to secure that target.

Fiscal policy is an effective stabilizer if government has established a reputation for vigorous defense of the exchange rate parity. Where the currency has been subjected to unexpected devaluation an added circumstance is necessary to lend credibility to the fiscal stance. The possibilities include an export windfall leading to rapid accumulation of foreign exchange reserves, monetary union with a large neighbour which has a reputation for maintaining low inflation and/or a sufficiently large exchange rate stabilization fund which may be in the form of standby arrangements, swap arrangements or short-term lines.

A "Tobin tax" or other mild exchange controls on capital transactions - such as screening of large capital transactions by the central bank with no attempt at rationing - may help to protect the exchange rate against speculation. Such controls appear entirely feasible in small open economies. Obstfeld (1995) advocates the Tobin tax to counter speculation in developing countries with shallow financial markets. Park (1994) warns that the removal of exchange controls on the capital account may, by itself, undermine an equilibrium exchange rate even if there is no external shock and no problem on the current account. This is an inference that may be drawn also from Edwards (1989) who shows that exchange controls are one determinant of the equilibrium real exchange rate.

Fiscal policy may contribute to economic growth by altering the real exchange rate. Calvo et al (1994) show that a change in fiscal policy is necessary for a permanent change in the real exchange rate. Fiscal expansion in the small open economy appreciates the real exchange rate because its aggregate demand effects inflate the price of non-tradables whereas the price of tradables is not affected

because the economy is a price taker. Fiscal contraction depreciates the real exchange rate. A movement in either direction may be required depending on the relation of the current to the equilibrium real exchange rate required for long-term sustained growth. Fiscal policy may also affect the equilibrium real exchange rate through channels such as government investment to accelerate the growth of skills and human resource development, government expenditure on the development of new export markets and investment in modern telecommunications. These and other initiatives which lower costs, enhance domestic productive resources and create new opportunities to reap external economies will alter the long-term equilibrium allocation of resources and the relative prices at which internal and external imbalance is achieved.

Growth in most Caribbean Basin countries involves an increase in productivity. Only a few have unexploited natural resources. A wages compact is a useful mechanism to establish an institutional framework which focusses on productivity and competitiveness. Agreements on productivity linked pay are attainable in a climate of low inflation, stable exchange rates and credible fiscal policy.

Fiscal Policy and Free Trade

Trade liberalization has little effect on the economies of Mexico, the Caribbean and Central America except for its implications for financial and factor movements. There are low tariffs or no tariffs at all on commodities where these countries have a comparative advantage (see IDB, 1995). Few such commodities are subject to non-tariff barriers. On the contrary the elimination or reduction of non-tariff barriers has harmed or will harm some countries of the region; for example, quotas for exports of sugar from the Dominican Republic to the United States have been drastically cut and the exports of bananas from the Windward Islands to the European Community are endangered. Where the removal of non-tariff barriers has the potential to benefit the Caribbean and Central America that potential may not be realised. The cost of invoking the treaty provisions for redress against non-tariff barriers is prohibitive. Countervailing duties hurt domestic consumers without any benefit to domestic producers. Imported goods become more expensive but there is no import substitution because the small domestic market offers insufficient demand to satisfy the minimum scale of efficient production for exporters. Domestic exporters cannot usually afford the time and cost of appeal against non-tariff barriers. Not surprisingly all estimates show the expected benefits of the Free Trade Area of the Americas to be small

(see Erzan and Yeats, 1992). Most commentators acknowledge that Mexico's main motive for accession to NAFTA was to "lock in" economic reforms since the expected benefit from trade measures was not significant (Hufbauer and Schott, 1993).

It is doubtful that the free trade agreement goes far enough in enhancing policy credibility in Mexico or that a similar agreement would be sufficient to enhance policy credibility in the Caribbean and Central America. The December 1994 Mexican crisis is dramatic evidence for the sceptical view. Bayoumi and Eichengreen (1994), in a comparison of NAFTA and the European Union, argued that credibility gains for Mexico are limited in the absence of a monetary union. In assembling a rescue package to stabilize the Mexican peso the US Treasury may be said to have accepted the logic of monetary union even while the US Government refuses to contemplate any long-term formalization of arrangements for a monetary union. Rebello (1994) argues that nothing short of a monetary union will entrench fiscal discipline.

Economic relationships between the Caribbean and Central America and North America are not much affected by anything short of a full economic union. The Caribbean and Central America is already strongly linked to North America through trade, travel and migration (see Worrell, 1993). The Caribbean and Central America's degrees of freedom are limited to choices of strategy appropriate for their small size in relation to North America and the fact that many policy tools are immobilized by this close subordinate relationship.

All Caribbean and Central American countries appear to have accepted the need for exchange rate based stabilization - some explicitly and others implicitly. The evidence is that in all countries which have no formal exchange rate rule the actual rate fails to fluctuate according to seasonalities and other market peculiarities. Instead, the rate remains stable for extended periods before falling into repeated crises of deep devaluation. This pattern is observed in countries like Guyana, Jamaica and Trinidad and Tobago where there are no controls on foreign transactions of any kind and there are large numbers of registered foreign currency dealers licensed to buy and sell at whatever the rate the market requires. In effect, private markets recognize the limitation on monetary policy and exchange rate adjustment imposed by the close subordinate relationship. However, in the

absence of credible fiscal policy and a mechanism for defending the exchange rate against speculation through market intervention the exchange rate is subject to repeated crisis.

The free trade area therefore has no impact on the required strategy for stable growth in Mexico, the Caribbean or Central America. That strategy must be anchored on a stable exchange rate sustained by fiscal adjustment to maintain adequate foreign exchange reserves and achieve an equilibrium exchange rate. Domestic monetary policy remains passive with domestic interest rates determined by the US interest rate, transactions costs and expected interest rate depreciation. It is desirable to have a social compact which contains inflationary wage tendencies and targets productivity increases. The strategy can be engineered by governments with a good reputation for maintaining stability. Governments without such a reputation need an unlimited exchange rate guarantee from the US Federal Reserve and the IMF for any attack which all parties agree is purely speculative.

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