

**STRUCTURAL ADJUSTMENT
AND ECONOMIC INTEGRATION**

by

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This paper begins with a discussion of the effects of economic performance on Caribbean integration. Many of Caricom's difficulties were caused, not by adjustment policies, but by the underlying malaise which those policies are designed to correct. The paper continues with an analysis of the national economic policies which inhibited economic integration in the 1970s and 1980s - trade restrictions, exchange rate policies and labour and capital market restrictions. These policies were adopted in a defensive, haphazard fashion and they cannot be considered a coherent programme of structural adjustment. Next comes an examination of elements common to current structural adjustment programmes in the Caribbean and their implications for regional integration. The last section considers whether economic integration may improve the chances of successful structural adjustment.

Caribbean Economic Performance & Integration

Thinkers who exercised the most decisive influence on the foundation of Caricom expected that regional integration would enhance Caribbean growth by strengthening the regional production base for exports as well as sales to the internal market. Progress was to have been marked by intra-regional factor movement, the evolution of firms with operations in several countries, the combination of resources from

different countries and intra-regional trade. Efforts were encouraged to engineer greater complementarity among members as their economies evolved so as to increase the potential gains from intra-regional trade, but regional integration was expected to improve export performance as well.

Major benefits were expected from the development of internationally competitive firms combining the mineral resources of Jamaica and Guyana with the energy resources of Trinidad & Tobago, the agricultural resources of Guyana and Belize with the labour resources of the rest of the Caribbean and the education and skills of the region as a whole. The internal market was important as an incubator for internationally competitive firms. Regional integration would also be a weapon against "beggar thy neighbour" policies such as competing regimes of fiscal incentives.

The trade provisions which have become the centrepiece of debate on structural adjustment were intended as the first phase in the development of the Caribbean Community. The coordination of domestic economic policy, joint international economic policy, free factor movement and many common firms and institutions were expected to follow. Economic circumstances and policy errors stymied the development of the Community. Most of its twenty years have been devoted to efforts to get the first stage right.

Intra-regional trade rose as a proportion of total Caricom trade in goods and services in the late 1970s principally because of rapid economic expansion in Trinidad and Tobago, Caricom's largest economy. Exports to Trinidad & Tobago from Barbados, Jamaica and OECS countries grew rapidly and visitors from Trinidad & Tobago accounted for one quarter of tourist arrivals in Barbados. Also there was a considerable capital flow from Trinidad & Tobago to Barbados for the purchase of real estate. Many Caricom countries switched to Trinidad as a supplier of a larger proportion of oil requirements to take advantage of liberal payments arrangements offered by the Government of Trinidad & Tobago.

The reversal of the trend towards greater intra-Caricom trade coincides with the oil price collapse of 1981 and the subsequent contraction of the Trinidad & Tobago economy. Barbados' manufacturing and tourism were especially affected. Trinidad & Tobago had become Barbados' principal market for furniture and other manufactured goods and for some tourist facilities on Barbados' south coast. A long period of economic contraction in Jamaica from the mid-1970s onward depressed actual and potential exports to that country. Guyana lost its potential as a market for Caricom exports as its economy declined from third position to last in the economic rankings.

The divergences of economic performance increased the difficulty of regional economic coordination. While the largest economies were in secular decline the economies of the OECS, Bahamas and Belize grew at an average of 3-5% per year. This raised fears that poor economic performance in the larger economies would depress income and living standards in the smaller countries. There was no enthusiasm for measures to facilitate intra-regional labour and capital movements.

Regional groupings require transfer mechanisms to compensate members for the effects of shocks imported from other countries in the region. Where countries are of disparate size there must be safeguards to limit outward transfers from smaller economies and special provisions to cushion imported shocks. In the case of one useful mechanism, the Caricom Multilateral Clearing Facility, these safeguards were not observed. Suspension of the CMCF served to heighten apprehension about integration.

Economic Policies and Regional Integration

The policies adopted by Guyana, Jamaica and Trinidad & Tobago to address their economic difficulties of the 1970s and 1980s were quite different from current structural adjustment policies. The main elements were government ownership of major economic enterprise, money financed fiscal deficits, import rationing, foreign exchange rationing, price control and dual exchange rates (usually with official and

unofficial exchange rates). These policies inhibited regional integration directly through trade restrictions and exchange rate uncertainty and indirectly by weakening the three economies concerned. Policy errors that weakened the Barbados economy in the late 1980s adversely affected regional trade even though the Barbados Government did not impose trade restrictions.

Guyana was the first country to impose quantitative restrictions on Caricom imports in pursuit of a misguided policy of self-sufficiency. Many Caricom goods deemed non-essential were prohibited. When these goods became unavailable on formal markets in Guyana demand was diverted to informal markets which were mainly supplied by non-Caricom sources. The draconian Guyana measures were not emulated elsewhere but Jamaica and Trinidad & Tobago maintained an extensive system of licencing for many years. Although the licencing in these countries attracted great public attention, casual empiricism suggests that its impact was not significant. The Trinidad & Tobago licencing system remained virtually unchanged from the mid-1970s to the mid-1980s. In the late 1970s Barbados' exports to Trinidad & Tobago rose dramatically. With no change in the licencing system they then declined very rapidly in the early 1980s. The first of these sub-periods was the height of the oil boom and the second came after the collapse of oil prices, suggesting that incomes in Trinidad & Tobago were the primary influence.

Erratic exchange rate movements depressed trade and were a severe deterrent to capital movements. Exchange rate uncertainty diverted producers from regional to national markets. Very few of those affected had the resources to divert to extra-regional markets. Many firms went under because the national market available to them was too small to support efficient production.

Devaluation was the inevitable consequence of the devaluing country's failure to stabilize its balance of payments. The devaluations were always large - in excess of 15% - and exporters were exposed to risks of crippling foreign currency losses. No exchange rate insurance is available for the low volumes of intra-regional transactions and the large potential devaluations that characterise the Caribbean.

Exchange rate uncertainty will remain a damper on intra-regional trade until the major Caricom countries achieve a stable balance of payments. Exchange rate uncertainty has effectively stymied efforts to establish a Caribbean Securities Exchange. Institutional arrangements are in place for investors in Barbados, Jamaica and Trinidad & Tobago to buy shares in any of these three countries. There have, however, been very few cross-border transactions. Barbadians and Trinidadians were well advised not to buy Jamaican shares during the spectacular escalation of values on the Jamaican Securities Exchange in 1992 and 1993. The subsequent bout of exchange

rate depreciation would have wiped out potential gains, and policies to stabilise the Jamaican exchange rate have led to a dramatic collapse of stock market values.

Policies with respect to migration, both inwards and outwards, had adverse consequences for integration. Guyana, Jamaica and Trinidad & Tobago imposed severe conditions designed to discourage emigration. All Caribbean countries screened potential immigrants whether from within Caricom or outside. Aspiring immigrants from poorly performing Caribbean countries were often discriminated against. These restrictive migration policies were harmful - most of all to the countries imposing them. The restrictions on emigration and migrants' allowances failed to stem the flood of emigrants from Jamaica, Guyana and Trinidad & Tobago. Restrictions on immigration deprived the rest of the Caribbean of many talented people whose contribution might have enriched the region.

Adjustment Policies and Regional Integration

Successful structural adjustment policies will facilitate regional integration by stabilizing external payments and restoring growth in the largest Caricom countries. If Guyana, Jamaica and Trinidad & Tobago overcome their chronic external payments deficits, their exchange rates will stabilize and the uncertainty which now inhibits regional factor movements and trade in services and goods will be eliminated. That paves the way for resource pooling, greater efficiency in resource use, economic

policy coordination and monetary union. Sustained growth in Trinidad & Tobago and Jamaica will remove fears of the smaller economies that integration will be to their detriment. The efficiency gains, reductions in transactions costs and reductions in uncertainty which come with deeper economic integration will significantly enhance Caricom's growth potential.

Unfortunately, this virtuous cycle of structural adjustment and economic integration has gone unrecognised in the current debate on Caricom's future. Recent thinking on integration (Cobham, 1991; Worrell, 1992; Robson, 1993) should caution economists and policy makers that exclusive concern with intra-Caricom trade and tariffs misses the great potential benefits of Caricom integration. The static welfare gains which are the concern of customs union theory are of little consequence in Caricom. The rationale for Caricom lies in the possibilities of economies of scale and scope which, on a regional scale, nurture firms that are large enough and knowledgeable enough to accept the challenge of international marketing. These possibilities depend on intra-regional movement of capital and skills. It is the intensification of regional movement of capital and skills which yields significant economic benefit to Caricom.

Recent literature on integration reveals other non-trade benefits which may significantly enhance growth potential. A monetary union eliminates the transactions

costs of regional currency conversions and encourages investment by reducing the volatility of exchange rates, prices and interest rates. A strong regional central bank lends credibility to national fiscal policy by eliminating avenues for money creation. Fiscal credibility is the most elusive element in the quest for economic stability. Pooling of foreign exchange reserves provides a greater degree of insurance for any level of reserve holding.

With this perspective we now review elements of the structural adjustment packages which have been put in place in Barbados, Guyana, Jamaica and Trinidad & Tobago.

Trade Reform

The main elements of trade reform are the replacement of non-tariff barriers with temporary surcharges and a reduction in the maximum tariff under the Caricom Common External Tariff (CET). These policies are expected to produce a small welfare gain through the reduction in consumer prices for protected items. The fall in production of import substitutes releases labour and capital employed in these activities. This creates a small potential efficiency gain which will be realised only when the unemployed resources are re-employed in more efficient production. The trade reform provides no incentive for the investment required to realise this gain.

The reduction in non-tariff barriers should encourage intra-regional trade while lower CET rates will permit extra-regional imports to displace some imports originating within the region. The net effect is very small even for the most seriously affected economies. The largest items in intra-regional trade are oil and tourism, neither of which is affected by trade reform.

Tax Reform

The objectives of tax reform are simplification, reduction in exemptions and special provisions to bias incentives towards exports of services and goods. (It has been taken for granted that the value added tax - VAT - improves the competitiveness of exports, but this is untrue if exports consist mainly of services.) Income tax bands were reduced and exemptions and deductions drastically curtailed. The coverage was extended horizontally, for example by eliminating provisions which persons above the minimum tax-paying threshold use to reduce their tax liability. A value added tax replaced a variety of taxes on expenditures (except for customs duties). It has an in-built bias towards exporters who may reclaim VAT included in the prices of inputs that they purchase, but it has a perverse effect on tourism, generally increasing the tax burden on the industry.

Tax reform is entirely compatible with regional integration. It is not necessary to have VAT at the same rate everywhere because of the high cost of travel in search

of the lowest VAT rate. It is not desirable to have the same rates of income tax or the same overall burden of taxation because the services provided by government are not of equivalent standard everywhere. It is not feasible to impose the same effective rate of corporation tax because different activities have different capital intensities, rates of technical change, etc. The same nominal corporate tax rate will have different effects in different sectors and different countries.

Deficit Reduction

Though painful, deficit reduction is essential for economic stabilization. Since balance of payments instability and the resulting exchange rate uncertainty remain the principal barriers to deeper regional integration successful deficit reduction paves the way for regional deepening.

Measures to contain the deficit in Jamaica and Guyana inhibit efforts to reduce regional disparities in the provision of social services and in the quality of infrastructure. However, the deterioration of security, health and education standards in Jamaica and Guyana predated the imposition of structural adjustment policies, and cannot be attributed to the effects of those policies (though the policies may have made matters worse). Furthermore, the quality of social services and infrastructure continued to improve in Barbados and Trinidad & Tobago during the period of structural adjustment.

Exchange Rate Policy

The instability of Caricom exchange rates is a major barrier to regional integration and a brake on the growth of individual countries. The most damaging effects have been on intra-regional movements of skills and capital, though exchange rate uncertainty has also inhibited intra-regional trade. Facilities for securities trading between Barbados, Jamaica and Trinidad and Tobago remain unused because of uncertainty of currency values. Skilled personnel will not migrate from areas with stable currencies to areas with floating currencies. From the national point of view, floating currencies encourage the holding of financial assets and US dollar denominated assets rather than investment in job creating activity.

The impetus for regional integration could not be maintained if some currencies within Caricom did float. Remarkably, the three currencies where exchange rates are no longer affected by central bank intervention refuse to float in response to the demand and supply of foreign exchange. Their behaviour under the liberalized exchange rate system mimics their behaviour under the fixed exchange rate system - periods of stability followed by precipitate devaluation.

That evidence and the remarkable rescue of the Barbados dollar in the second half of 1991 suggests a strong preference on the part of Caricom populations for a regime of stable exchange rates and low inflation. Inflation in the Caribbean has remained

in the neighbourhood of international inflation except for periods of currency devaluation. The population supports policies which result in a fixed exchange rate.

The current exchange rate strategies of Jamaica, Guyana and Trinidad and Tobago are temporary expedients designed to achieve a credible fixed value of their currencies. The authorities hope that market forces will drive the exchange rate to a level that produces sufficient net supply of foreign exchange for the central bank to build up adequate foreign exchange reserves. The central bank would then be able to sell foreign exchange to accommodate balance of payments contingencies which might otherwise provoke currency depreciation. Fiscal and monetary policies might be used to sustain the fixed exchange rate.

If the strategy succeeds the basis for further integration emerges once more. However, the strategy is seriously flawed. It makes no provision for an institution to lead the market, an essential feature of stable oligopolistic markets. (Licencing scores of small or occasional dealers as Guyana has done does not noticeably reduce the degree of market concentration.) Informal arrangements for market leadership have evolved in all three countries but they lack the credibility needed for a stable exchange rate regime. The potential demand for foreign exchange is infinitely large so long as the future value of domestic currency is uncertain and there remains a

preference for the use of foreign currency for all transactions, contracts and asset accumulation.

Although central banks in Guyana, Jamaica and Trinidad and Tobago have removed all administrative restrictions on the purchase of foreign exchange, the supply continues to be rationed by financial institutions. Foreign exchange is sold only to those deemed to have a legitimate need to pay for imports, foreign travel or other external obligations. This rationing system artificially limits the demand for foreign exchange; for example, firms that do not earn foreign exchange cannot write wage contracts in foreign currency because financial institutions will not sell foreign currency for their payroll. However, the system remains unstable with an inherent tendency towards the dollarization of a widening range of economic activity.

Guyana, Jamaica and Trinidad and Tobago might bring stability to their exchange rates by taking initial action towards the formation of a monetary union with an independent central bank legally bound to operate according to conservative rules. Such a model has been provided by the Report of the Central Bank Governors to the Caricom Heads of Government (1992). Once the "floating" exchange rates had settled at levels that reflected economic fundamentals the populations would be assured that the currency values would be maintained by appropriate fiscal and monetary policies and that they would be able to convert assets denominated in

local currencies into assets denominated in a new Caribbean currency with no loss of value.

The Liberalization of Exchange Controls

Exchange controls have had little effect on current account transactions in Caricom countries. Their removal in Belize, Guyana, Jamaica and Trinidad and Tobago may be seen as an admission of that fact. Elsewhere, exchange controls on current account transactions serve principally to provide statistical information on the balance of payments. The many ineffective and anachronistic procedures which remain have little effect other than to create a nuisance to the general public. The removal of exchange controls on the current account is to be encouraged throughout Caricom.

Exchange controls on the capital account transactions may be used to guard against exchange rate instability provided their limitations are recognised. Only large transfers and transfers through formal financial channels may be regulated. Moreover, some major transfers such as trade credits are not subject to control. It is impractical to regulate a trading firm's choices between domestic and foreign trade credit. It is counter-productive to attempt to cover all capital transactions. The administrative costs are prohibitive, the regulations are intrusive and small and medium firms resort to informal channels just as they would for current account transactions.

However, exchange controls on the capital account are a very effective counter to foreign currency speculation when they focus on large transactions. In any Caricom country the number of firms and institutions with the resources to engage in destabilizing foreign currency speculation is relatively few. In general, they value their relationship with the regulators and they employ formal financial institutions. The regulation of their foreign currency business is therefore not difficult and may be quite effective.

Moreover, these large firms and the financial institutions that serve them value the leadership which a central bank may give to the oligopolistic market in foreign exchange. The experiences of Guyana, Jamaica and Trinidad and Tobago indicate that the activities of tens of thousands of small sellers and buyers have no effect on an exchange rate that is tacitly agreed among major firms and financial institutions. The foreign exchange market oligopoly maintains a stable exchange rate only if there is a credible market leader. The central bank is the obvious market leader provided its policies are credible. The central bank maintains its credibility by regulating capital flows only in defence of an exchange rate which reflects economic fundamentals. Market participants will welcome that as a discipline on any one of their number who is tempted to break ranks and precipitate a price war.

Unfortunately, the authorities in Guyana, Jamaica and Trinidad and Tobago have not yet recognised this important feature of their foreign exchange markets. Their abolition of exchange controls on capital account transactions exposes them to exchange rate instability even where economic policies and performance would otherwise indicate an equilibrium demand and supply of foreign exchange. For the moment, this is a background issue because none of the three central banks has built a sufficient store of foreign exchange reserves. Their exchange rates remain at risk because there are insufficient foreign exchange reserves with which to defend them against market fluctuations or speculative attack. The stabilising value of capital account controls will emerge only when an adequately stocked central bank finds its foreign exchange reserves under speculative attack by a major financial institution playing the role of maverick in defiance of the rest of the market.

A common regime of exchange controls must be agreed for Caricom. Controls should be limited to large capital account transactions and should be designed to deter speculative transfers, not to prohibit outward investment. Prospects are that the soundness of the case for such controls and the feasibility of implementing them will emerge once the central banks of Guyana, Jamaica and Trinidad and Tobago have foreign exchange reserves sufficient to intervene to stabilise the exchange rate.

Financial Liberalization

Financial liberalization has brought greater uniformity across the Caribbean in the regulation of financial institutions. In the 1970s and 1980s the central banks of Jamaica and Guyana maintained tight controls on credit and interest rates while other central banks were more liberal to varying degrees. Financial controls were completely removed in Guyana, Jamaica and Trinidad and Tobago and credit and interest rate directives were relaxed elsewhere. In addition, collaborative efforts to achieve commonality in the regulatory framework (so far as is practicable) are underway. The current evolution of financial regulation aims to deepen the integration of regional financial markets.

In some respects financial liberalization in Jamaica may have gone too far. The Bank of Jamaica's refusal to intervene to direct interest rates in line with expected inflation has resulted in high real interest rates which may have significantly contributed to inflation. However, the most important source of expected inflation is exchange rate instability. Stabilisation of the exchange rate would remove the dilemma of interest rates and expected inflation.

Divestment

The divestment of state owned firms in Barbados, Guyana, Jamaica and Trinidad & Tobago offers many opportunities for intra-regional capital flows of a kind that might

strengthen the region's productive base. Some firms have seized the opportunity. There are, today, many more firms with a presence in several Caricom countries than there were a decade ago though only a few of the regional acquisitions have involved firms previously owned by the state. The divestment programme has the potential to accelerate intra-regional capital flows - an important source of potential gains for Caricom.

Integration as a Strategy for Structural Adjustment

A most unfortunate aspect of current policy-making is the failure to recognize that the deepening of Caricom integration is a very powerful instrument of structural adjustment. The crucial policies are monetary union, intra-regional mobility of capital and skills and a regional export development strategy.

A properly constituted, carefully implemented monetary union is the fastest way to eliminate economic instability in Barbados, Guyana, Jamaica and Trinidad and Tobago and to restore credibility to official policies in these countries. The report of the Caricom Governors to the Heads of Government shows how a Caribbean Monetary Authority set up on currency board lines with strict criteria for accession protects Caribbean populations against money financed fiscal deficits and economic instability. The experiences of a wide variety of countries undergoing adjustment, including Jamaica in the Caribbean, demonstrates that stable economic environment

is the first step to sustained economic growth (This point has been made in respect of other developing countries by Summers & Pritchett, 1993 and Greenaway & Morrissey, 1993).

The Caricom Governors' Report envisages that the Caribbean Monetary Authority's independence would be secured by its constitution and rules governing the appointments of the Chief Executive Officer and the Board of Directors. Directors could be overruled only by unanimous decision of participating countries. The Caribbean Monetary Authority would be forbidden to lend to Government or financial institutions above a small percentage of its foreign assets and its lending would always be on the basis of marketable securities. The Caribbean Monetary Authority would always have sufficient foreign exchange reserves to intervene to stabilize the exchange rate. This should reduce the expected inflation, result in low real and nominal interest rates and encourage fixed investment. The Report and studies which informed it explore the extent of economic convergence required for successful implementation of a monetary union. While quantitative work remains to be done the Report argues that achievement of the qualifications for accession to the monetary union ensures a sufficient degree of convergence to make for a durable unit.

Caricom firms need to operate on regional markets if they are to attain a size which enables them to compete on international markets. In an annual survey of public companies conducted by Caribbean Week (1993) only 20 firms in the whole Caribbean area (including some non-Caricom countries) had profits in 1992 significantly in excess of US\$5 million. The smallest of those 20 had sales of only US\$26 million and employed 385 people. Companies with operations in more than one country occupied all top 20 positions.

Only the largest Caribbean firms - and they are small by international standards - may afford the sophisticated skills of marketing, finance, organization and technology required for on-going competitiveness in international markets. Even so, typically they enter joint ventures for development of new products, services and markets so as to reduce the danger of over-exposure. If a company has made only US\$1 million of profits, the amount that it may safely allocate for venture capital is soon exhausted.

It is critical to a development strategy which emphasises the diversification of exports that companies be able to invest freely within Caricom and that they be allowed to move skilled personnel around. Firms which are now confined to national markets must be encouraged to form alliances and to broaden their operations across the region. The focus should be shifted from trade, where there is little potential, to

investment which results in larger, stronger firms operating at international standards of efficiency.

The experiences of all successful newly industrialising countries - with the exception of Hong Kong - suggest that strong institutional support for new exporters is vital. The costs and risks of export market development are considerable. In the long run returns make them well worth while but only firms with very deep pockets will survive to the long run. The failure of several attractive export prospects in the Caribbean in recent years serves to reinforce this lesson.

National export promotional efforts are so puny as to be irrelevant, to all intents and purposes. They suffer similar diseconomies of scale and scope as the firms they serve. None has resources sufficient to offer meaningful services to any of the firms in the Caribbean's top 20. The firms they service may develop niche markets abroad but even if they are successful beyond reasonable expectation their total contribution to Caribbean exports will not significantly change the index of export concentration.

A regional export promotion strategy of appropriate scope and scale is an urgent priority. Existing institutions such as the Caribbean Tourism Organization and the Caribbean Export Development Project are grossly underfunded and limited in scope.

The development of an export promotion capability which can service the needs of the Caribbean's largest firms is now an urgent matter.

Conclusion

The regional integration mechanisms - a monetary union, free mobility of capital and skills and regional export promotion - are the most effective policies for stabilising Caricom economies and stimulating growth based on diversification of exports of services and goods. Governments should therefore be encouraged to put these high on their list of structural adjustment measures. Other structural adjustment measures such as fiscal discipline, trade reform, tax reform and financial liberalization will not impede progress towards integration. Divestment offers an opportunity to encourage capital mobility. The monetary union will help countries with unstable exchange rates to solve the dilemma of "floating" exchange rates which do not in fact float. It may be the only way to resolve that dilemma. The only measure which threatens regional integration is the abolition of exchange controls on large capital transactions and that would seem to be a mistake which needs to be corrected.

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