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Caribbean Outlook 3

Economic recovery and repositioning in the era of COVID-19

Introduction

The economies of the subregion were hard hit by the COVID-19 pandemic, particularly those dependent on tourism. As a result, the Caribbean has seen a reversal of the hard-won gains achieved in growing their economies and reducing unemployment and inequality. The inflation stemming from pandemic supply chain disruption, which has been exacerbated by the war in Ukraine, has made the sustained uptick in economic performance beyond pre-pandemic levels unlikely, notwithstanding strong growth estimates for 2021 and 2022.

The last two years have taught the region that continued ‘business as usual’ is no longer an option for advancing sustainable development. As such, recovery and repositioning of the economies must take place in all sectors for the subregion to thrive.

The pandemic exposed many areas requiring thoughtful consideration throughout the region, including fragile health systems, a pressing need for national and regional interconnection, and the need to diversify the economic base and to invest in capital services that promote self-reliance and decent work.

Despite currently prevailing efforts, significant and substantial issues remain. The subregion faces converging multidimensional vulnerabilities that create a perfect storm of cumulative challenges.

Key recommendations:

- **Develop innovative financial instruments to provide long term funding for green and blue industry projects, for disaster-proofing its economy and for economic restructuring**
- **Caribbean governments should support the launch of the Caribbean Resilience Fund (CRF)**
- **Improve efficiency with which limited funds are used**
- **Invest in technology accumulation and human capital development**

This convergence has occurred precisely as debt accumulation and servicing costs have narrowed the fiscal space. The narrowing of the fiscal space was exacerbated by COVID-19 and unavoidable climate event-related expenditures to support the economy, such as the 2021 eruption of the La Soufrière volcano which caused significant damage and losses in Saint Vincent and the Grenadines, Saint Lucia and Barbados.

As the region continues to experience the residual effects of the pandemic and pursues efforts to adjust to the new normal, governments must focus on building resilience in the face of increasing economic,

social, and environmental shocks. Thus, economic restructuring is necessary to create an environment conducive to dynamic economic expansion in the near and medium term. Within this context, successful economic restructuring, requires an industrial policy designed to increase international competitiveness and foster increased productivity. It should also leverage improved technology, knowledge, and workforce skills, and facilitate greater intersectoral linkages and attendant improved access to decent jobs.

There must be a system of innovation, with input from both private and public sectors, that is linked to the productive system. This should cover a range of areas including competitiveness policies, trade and inward foreign direct investment (FDI) policies, policies to foster innovation, human resource training, upgrading the tourism sector, and small and medium enterprises (SME) development. In addition, industrial policy should aim to reduce constraints facing business expansion through several strategies, including trade facilitation and logistics improvement.

Background

COVID-19 restrictions stalled normal economic activity in the subregion, especially those driven by tourism services. Indeed, the decline in economic activity in 2020 excluding Guyana was -13.1% (see table 1). Further, many individual countries saw declines greater than ever experienced in modern times. While average economic growth has been positive in the two years since the start of the COVID-19 pandemic, incomes still lag below 2019 values. During 2021, most of the subregion economies expanded, with average growth rising to 5.1% (3.5%, if Guyana is excluded). For 2022, growth is projected at 10.4% and 4.6% respectively, with and without Guyana. These growth rates, the highest achieved in more than a decade, are actually due to normalization of economic activity and a low comparison base rather than true growth dynamics.

Table 1: Real GDP growth rates, 2020–2022 (Percentages)

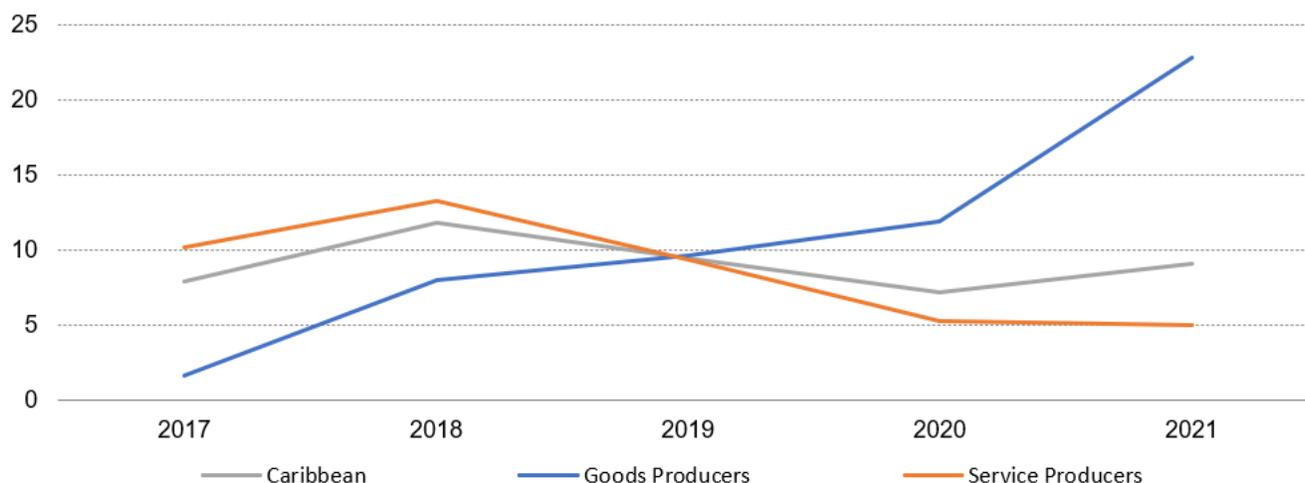
	2020	2021	2022
Caribbean	-9.2	5.1	10.4
Goods producers	-1.6	3.8	15.5
Service producers	-15.9	6.5	5.4
Caribbean excluding Guyana	-13.1	3.5	4.6
Goods producers ex. Guyana	-9.4	-0.3	3.5
Latin America and the Caribbean	-6.9	6.5	2.7

Source: Economic Commission for Latin America and the Caribbean on the basis of official figures.

Most of the individual economies are still smaller than they were pre-pandemic and are not expected to surpass 2019 levels until 2023 or 2024 —assuming the global situation becomes more favourable. Compared to the wider Latin America and the Caribbean, the subregion experienced a deeper contraction in 2020 and a slower rebound in 2021. In 2022 however, the growth of the Caribbean (excluding Guyana) of 4.6% will surpass the 2.7% growth projected for Latin America and the Caribbean.

Despite these numbers, there exists some downside risks to the subregion. These include high inflation caused by pandemic supply chain issues, made worse by increased energy and food costs resulting from the Russia-Ukraine war; higher borrowing costs as the Federal Reserve System of the United States of America increases interest rates; and reduced tourism demand. There is also, the potential for the return of restrictions if a more virulent variant of the COVID-19 virus emerges to become dominant. Inescapably, in the absence of repositioning and diversification of the subregion’s economies, there is likely to be a return to the pre-pandemic trend of low growth rates. Thus, economic restructuring is necessary to create an environment conducive to dynamic economic expansion in the near and medium-term.

Figure 1: Foreign direct investment inflows for the Caribbean (Percentage of GDP)



Source: Economic Commission for Latin America and the Caribbean on the basis of official figures.

Note: Data excludes Barbados and Suriname for 2021.

Though economic restructuring in the subregion can revitalize economic activity, bringing it closer to the path of sustainable long-term growth, sourcing adequate and affordable development financing remains a two-pronged challenge for the region—quantity and quality. First, with respect to quantity, access to finance is inadequate to the challenge of creating a dynamic, competitive, and sustainable economy. Secondly, the quality of finance, measured by cost, term structure, scale, and efficiency of use are inadequate.

Domestic finance is often an important vehicle for funding development, particularly the Sustainable Development Goals (SDGs). Additionally, even before the pandemic, the region confronted a deficit of long-term, affordable, sustainable financing for high-impact economic, social and environmental projects. This included insufficient finance for the restructuring of key segments of tourism, agriculture and light manufacturing. These conditions hinder productive efforts, especially in the critical export sector, starved of finance for successful enterprise upscale. Consequently, as the region develops a post-COVID-19 financing strategy, both factors—quantity and quality—should be tackled simultaneously, to ensure financial arrangements work for development.

Access to finance for economic restructuring

Foreign direct investment (FDI) is a vital source of development finance in the subregion. FDI not only provides funding, often for long-term projects in key sectors such as tourism, mining, agriculture, telecommunications and power generation, but is also a critical source of technology transfer, management, organizational know how and marketing that enables access to foreign markets. The varied benefits of FDI have led to countries competing for inflows with a range of fiscal and non-fiscal incentives. In the last five years, FDI to CARICOM States averaged only US\$ 263.7 million per year.

Moreover, excluding Guyana, a major recent recipient due to the exploration for and production of oil, FDI inflows for the subregion averaged a mere US\$ 129.8 million. Indeed, without Guyana, inflows of FDI declined by 13.7% in the last five years. Also, FDI accounted for only 9.1% of GDP in 2021 (figure 1). This suggests the region may be losing its attractiveness, in favour of other regions, to direct investors in tourism, industry and other sectors.

Innovative financing mechanisms and vulnerability measures

With most of the subregion unable to access concessional financing, innovative financing mechanisms are necessary for advancing the region's development initiatives. ECLAC has made progress advancing a Caribbean Resilience Fund to provide long-term, affordable financing for climate and economic resilience building, debt relief and liquidity enhancement to achieve sustainable debt levels in the subregion. The resilience building pillar aims to raise substantial funding to finance high impact climate adaptation and mitigation projects, including resilient infrastructure, green energy, and transportation. The debt restructuring and liquidity enhancement facility will assist countries with debt restructuring and reprofiling, as well as liquidity management operations. The aim is to extend maturity structures to up to 20 years and reduce servicing costs by 50% in selected countries, while providing for new debt to be guaranteed by the Development Financing Institutions (DFIs) as a means of crowding in private creditors to scale up development finance to the subregion. ECLAC envisages that the CRF could be established over the period 2023–2024.

A complementary mechanism to cope with economic shocks, is the state-contingent debt instruments (SCDIs). These instruments, particularly the natural disaster clause or hurricane clause includes in the contractual terms of a sovereign's debt, the ability of the creditor to defer payments of interest and principal in the event of a disaster that meets minimum levels of intensity, and impact on the socioeconomy of the affected debtor country (Cleary Gottlieb, 2021). Both Barbados and Grenada have already introduced natural disaster clauses, providing an example for others in the subregion to follow. In addition, blended financing arrangements which combine concessional with commercial loans may be used to de-risk key projects of higher economic and social benefit, such as in renewable energy and improved waste management.

Mechanism for economic recovery

Normalization of economic activity will likely see economies of the subregion rebound from the COVID-19 shock. Yet, improving upon sluggish long-term growth trends requires industrial restructuring. Industrial or economic restructuring refers to a shift in an economy's production structure increasing the share of domestic value in existing products and activities, and the number of activities contributing to total output. This also develops and strengthens intersectoral linkages and increases production of high value-added, customized products and services capable of commanding higher returns in export markets. Production in the subregion's economies is typically concentrated in a narrow range of activities geared towards a small number of partners. The narrow range of products and export partners creates greater vulnerability to terms of trade and other economic shocks.

For successful economic restructuring, an industrial policy designed to increase international competitiveness through increased productivity, usually requires the use of improved technology, knowledge, and workforce skills, greater intersectoral linkages and attendant improved access to decent jobs. There must be a system of innovation, with input from both private and public sectors, that is linked to productive systems. Modern industrial policy should focus on those activities that have positive spill overs to additional sectors and activities (Stiglitz 1999). This should cover a range of areas including competitiveness policies, trade and inward FDI policies, policies to foster innovation, human resource training, upgrading the tourism sector and SME development. In addition, industrial policy should aim to reduce the constraints facing business expansion through a number of strategies, including trade facilitation and logistics improvement.

The continuous emergence of regional and international value chains have changed modern systems of production and allowed small developing economies to engage in the global economy. The importance of knowledge, information and innovation has been elevated in all processes.

To capitalize on these trends there must be a shift toward becoming knowledge economies while increasing export capacity (Alleyne 2019). This involves investment in the domestic capital making sector and use of capital services for exports. The domestic capital cluster includes sectors such as education, healthcare, information and communications technology (ICT), finance, engineering, architecture, design and the creative industries, as well as industries such as tourism, travel services, wholesale and retail (James, August 2018). The quality of the labour force must be enhanced through the development of real skills via the formal and informal education system. In addition to the traditional academic school system, there must be development in the vocational school system, providing students a menu of high-quality offerings. Much can be done to improve opportunities for youth. This would in turn, reduce unemployment and concomitant high levels of emigration.

Policy recommendations

Develop innovative financial instruments : Caribbean governments, with the support of the private sector, should build a careful strategy based on incentives and promotion to attract innovative, long-term financing to facilitate the development of green energy and blue industry projects, and for investment in disaster risk reduction and restructuring tourism, agriculture and other traditional sectors.

Caribbean governments should support the launch of the CRF: ECLAC's Caribbean Resilience Fund (CRF), which aims at leveraging long term affordable finance for sustainable development, along with state-contingent debt instruments are key pillars of innovative financing mechanisms but need to be supported by debt for nature swaps, blended financing arrangements that are properly structured to reduce contingent risks for the state and climate resilience bonds, among others. Additionally, there should be the removal of barriers to financial innovation. Caribbean governments, along with relevant international financing institutions (IFIs) should be encouraged to support the accelerated

development of the CRF and state-contingent debt instruments as two signature innovative financing mechanisms that could expand the financing on the one hand and fiscal space on the other to catalyse transformative growth with equity in the subregion. The IFIs should support the use of state-contingent debt instruments to help cushion the impact of shocks faced by Caribbean SIDS. This should be supported by targeted strategy, including proven incentives and a modernized business environment to attract more high-impact FDI.

Improve efficiency with which limited funds are used: Alongside increasing the quantum of finance, it is vital that the subregion places a strong focus on improving the efficiency with which limited funds are used. This should be based on a careful assessment of priority projects, effective procurement procedures and the monitoring and evaluation of project delivery to prevent or reduce cost-overruns that are a burden to the treasury. This will improve the impact/cost ratios for scarce funding in the subregion.

Invest in technology accumulation and human capital development: Investment in promoting technical capacity in human capital development will help support economic diversification and allow countries to ascend the value chain.

Conclusion

Given the current global uncertainty, there is a need to build economic resilience and engage in economic restructuring of our economies. There is also need for greater investment to improve infrastructure and optimizing exports. Further, unless the subregion expands its population to the extent that it can have a lot of domestic consumption of the goods that it produces, the growth path of the subregion doesn't necessarily lie in the production of goods in the short term.

Therefore, the subregion's growth poles heading into the future must be focused on engaging in the production and export of capital services, such as education, creative services, and health care, as they are seen as rising stars in CARICOM's trade competitiveness matrix for goods export.

More importantly, if we are to use these capital services as key drivers of economic growth, the region needs to:

- Develop innovative financial instruments.
- Support the launch of the CRF.
- Improve the efficiency with which limited funds are used.
- Ensure investment and financing for technology accumulation, human capital development, and research and development, as drivers of productivity, competitiveness, and structural change.

In order to achieve these goals, the subregion needs to improve access to development finance and engage in structural transformation and diversification of our economies. ECLAC's Caribbean Resilience Fund is seen as a key initiative in providing the necessary resources for fostering and financing the structural change that the region requires.

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