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Executive Summary

The global economy is experiencing a recession, which originated in the United States and is affecting developed and developing economies alike. Between the second and third quarter of 2001, the United States GDP growth rate decreased from 2.6 per cent to 1.2 per cent. For the same period, the European Union's GDP growth rate declined from 2.4 per cent to 1.7 per cent. For Latin America and the Caribbean the growth will fall from 4 per cent in 2000 to 1 per cent in 2001.

A central issue regarding the current recession is whether it will be short lived or rather a protracted one. Identifying the nature of the recession will determine the type of macroeconomic policy to deal with this phenomenon. The type of macroeconomic policy advocated to deal with the current recession is mainly countercyclical. This involves the reduction in tax cuts and interest rates to stimulate spending and investment.

Exchange rate movements have been stable and have responded, so far, to leading macroeconomic indicators. For its part, the terms of trade variations are registering the decline in non-oil and oil commodity prices. For the majority of developing economies the decline in non-oil commodity prices adds a further constraint to their potential economic performance. In the same vein, a decline in oil prices for non producer countries provides a respite in the efforts required to maintain the current account balance and, in some cases, a true 'buffer stock' mechanism for the government budget.

The recession is taking place as important institutional arrangements are being negotiated or implemented. The extension of the market access preferences of the Caribbean Basin Initiative (CBI) to garments under the Law of Commerce and Development may serve to develop textile industry and exports to the United States. At the same time the granting of the trade promotion authority to the executive branch of the United States government will erode part of the positive effects of the Law of Commerce and Development. The fourth World Trade Organization (WTO) Ministerial Conference (Doha, Qatar, 9-14 November 2001) addressed several pressing issues for developing economies. Among the most relevant for Caribbean countries are the implementation of special and differential treatment, the small economies issue, the extension of export subsidies for developing economies, and the extension of a waiver to the European Union to maintain a preferential and discriminatory trading regime with African, Caribbean, Pacific (ACP) countries.

The impact of the recession on the Caribbean will depend on a number of factors. These include the length and depth of the economic slump in these major markets and other markets; the impact of the slowdown on capital and trade flows, particularly tourism receipts. The effect on commodity prices, the extent of countries' scope for adjustment based on reserves and other variables and the dexterity in economic policy-making and management will also be crucial determinants of performance. Most likely, by hardening the balance of payments restrictions, the recession will force a tightening of the fiscal stance for Caribbean economies. This, in turn, may mean an increase in unemployment rates and decreases in output growth.

GLOBAL ECONOMIC DEVELOPMENTS 2000-2001

Introduction

During 2000-2001, the global economy experienced a slowdown in growth. The decline in growth originated in the United States in the high technology industries and is affecting developed and developing nations alike. Between the second quarter of 2000 and 2001, the United States and the European Union GDP growth rates decreased from 2.6 per cent to 1.2 per cent and from 2.4 per cent to 1.7 per cent, respectively. For its part, between 2001-2000 Latin America and the Caribbean experienced a decrease of three percentage points in its growth rate (4 per cent to 0.9 per cent).

A key question that underlies the debate about the causes of the current recession is that of its duration. Does it correspond to the downward phase of the business cycle with a turning point expected within the near future or is it perhaps the reflection of structural imbalances and is likely to be long lived? The precise identification of the nature of the recession will determine the type of policies that should be followed in order to confront this economic phenomenon. As it currently stands, the policy actions and recommendations to revamp stagnant economies include expansionary monetary and countercyclical fiscal policies. Industrialised economies have opted for implementing tax cuts and engineering interest rate reductions. The tax cuts are aimed at increasing disposable income and providing a stimulus to spending. The interest rate reductions are geared towards increasing loans and investment which, through a multiplier process, would enhance economic activity. Paraphrasing John Maynard Keynes (1883-1946), the objective is “to start the ball rolling”.

The current situation, the uncertainty that surrounds these issues and the rapidity and depth with which the recession is spreading have resulted in periodic downward revisions of the growth forecasts. For the year 2002, the United States, the European Union and Latin American and the Caribbean economies are expected to grow by 0.7 per cent, 1.4 per cent and 1.9 per cent, respectively.

The current recession is taking place at the same time that significant institutional arrangements are being negotiated or implemented. The Law of Commerce and Development extends to garments part of the preferential market access granted by the CBI to other export products from Central American and Caribbean countries. The adoption of the Trade Promotion Authority by the United States Congress gives a broader authority and mandate to the executive branch of the United States to change trade agreements. This could be a stumbling block for the regional development of the export sector. The Doha Ministerial Conference (Qatar, 9-14 November 2001) launched a new round of trade negotiations. The new trade agenda incorporates a series of issues of relevance to Caribbean economies. Among these are the implementation of special and differential treatment, the issue of small economies, the extension of export subsidies and the waiver allowing the European Union greater time limits to extend its preferential trading regime with ACP countries.

The precise impact of the recession especially in the wake of 11 September, and the slowdown in economic growth on the Caribbean will depend on a number of factors. These include the length and depth of the economic slump in these major markets and other markets; the impact of the slowdown on capital and trade flows, particularly tourism receipts. The effect on commodity prices, the extent of countries' scope for adjustment based on reserves and other variables and the dexterity in economic policy-making and management will also be crucial determinants of performance.

This document analyzes the most significant global developments that have taken place in 2000-2001 with a view to provide an overall picture of the international context facing Caribbean economies in the short run.

The document comprises seven sections. The first one examines the weakening of global growth prospects. The second section focuses on the debate surrounding the nature of the United States recession. The third section describes the type of policy responses that industrialised countries have and plan to undertake to confront the current recession. The fourth section deals with exchange rate and terms of trade developments. Exchange rates have responded to 'news' about leading economic indicators, which could provide some clues regarding the nature and significance of the recession. For its part, the terms of trade (the ratio of the prices of exports to that of imports) are affected by two opposing tendencies. On the one hand, commodity prices are declining meaning a lower unit value for exports. On the other hand, the decline in oil prices will also cause a downward movement in the import unit values. The fifth section examines the behaviour of capital flows. The sixth section deals with institutional developments. In particular, this section focuses on the Law of Commerce and Development, which is an extension of the CBI Act, the Doha Ministerial Conference and the regulations for the offshore banking sector. The final section outlines the possible channels of transmission from the global economy developments to the Caribbean economies.

1. The weakening of world economic growth

During 2000-2001, world economic growth registered a slowdown. The slowdown in growth originated in the United States and is also affecting, with differing degrees of intensity, other industrialised countries. Since the second quarter of 2000, without exception, all major industrialised economies have decreased their rates of growth. Between the second quarter of 2000 and the second quarter of 2001, the rates of growth of the United States, Europe and the United Kingdom have decreased by 4 per cent 2.8 per cent and 1 per cent respectively (see, Table 1).

The downturn has not yet translated into greater overall unemployment rates (see Table 2). It has impacted mostly telecommunications, computer services and airline industries. That is, industries that are likely to employ a more highly educated section of the workforce. In this sense the current recession will perhaps be “a recession for the educated”.¹

Preliminary studies carried out for the United States suggest that the unemployment rate for those with a college education is higher than for those with a high school diploma. If the 1994 unemployment rate (6 per cent) is taken as a reference rate, its distribution among college graduates, those with high school diplomas, but no college and those without high school diplomas, was 2.6 per cent, 5.3 per cent, 9.8 per cent, respectively. By comparison, in September 2000 those rates were 1.9 per cent, 3.4 per cent, and 6.2 per cent. Between July and November 2001, the unemployed rate for college graduates had returned to its 1994 level. In contrast, the unemployment rate for those without a high school diploma had only increased to 7.5 per cent and was still below its 1994 level.

The decreasing growth trend has resulted in a downward revision of growth projections for all economic regions. The global growth forecast has been cut from 2.6 per cent for the current year to 2.4 per cent while that of the United States has been decreased from 1.3 per cent to 1.1 and for Europe the growth rate has been revised downwards from 1.8 per cent to 1.7 per cent. In the case of developing countries the forecasted growth rate has decreased by 0.3 per cent percentage points. For Latin America and the Caribbean the growth rate estimated initially at 1.7 per cent, is now thought to be within the 1 per cent growth range (see Table 3).

¹ See, “A recession for the educated?.” *National Economic Trends*, December 2001. The Federal Reserve Bank of St. Louis.

TABLE 1
Quarterly growth in major industrialised economies
First quarter 1999 to second quarter 2001

Country and country grouping	1999.1	1999.2	1999.3	1999.4	2000.1	2000.2	2000.3	2000.4	2000.1	2000.2
Canada	4.73	5.05	5.38	5.09	5.03	4.78	4.42	3.51	2.63	2.13
Euro Area	2.00	2.16	2.76	3.59	3.60	3.87	3.21	2.85	2.43	1.67
France	2.80	2.50	2.96	3.73	3.60	3.51	3.37	3.10	2.77	2.31
Germany	0.72	0.97	2.04	3.04	2.95	4.34	3.18	2.48	1.84	0.65
Italy	0.96	1.34	1.39	2.75	3.31	3.02	2.71	2.63	2.54	2.09
Japan	-0.38	1.02	2.07	0.44	2.38	0.96	0.34	2.50	0.20	-0.72
United Kingdom	1.81	1.64	2.30	2.75	3.04	3.31	2.74	2.44	2.70	2.31
United States	4.02	3.89	4.02	4.41	4.23	5.22	4.38	2.81	2.55	1.22

Source: Federal Reserve of St. Louis (2001)

TABLE 2
Unemployment rate in major industrialised economies
First quarter 1999 to second quarter 2001

Country and country grouping	1999.1	1999.2	1999.3	1999.4	2000.1	2000.2	2000.3	2000.4	2000.1	2000.2
Canada	7.90	7.86	7.52	6.97	6.80	6.68	6.92	6.87	6.96	7.00
Euro Area	10.30	10.10	9.80	9.60	9.30	9.00	8.80	8.60	8.40	8.40
France	11.65	11.44	11.02	10.58	10.12	9.65	9.29	8.94	8.64	8.54
Germany	8.75	8.68	8.57	8.39	8.12	7.96	7.84	7.72	7.75	7.83
Italy	11.58	11.46	11.24	11.12	10.96	10.62	10.31	9.99	9.67	9.49
Japan	4.62	4.72	4.72	4.67	4.80	4.68	4.65	4.80	4.75	4.86
United Kingdom	6.27	6.10	5.97	5.97	5.84	5.56	5.44	5.33	5.14	5.04
United States	4.28	4.27	4.22	4.10	4.05	4.00	4.02	3.98	4.23	4.48

Source: Federal Reserve of St. Louis (2001)

TABLE 3
Growth forecasts
2001-2002

Regions and countries	Years			
	Forecast November 2001		Forecast October 2001	
	2001	2002	2001	2002
World output	2.4	2.4	2.6	3.5
United States	1.1	0.7	1.3	2.2
<i>European Union</i>	1.7	1.4	1.8	2.2
Japan	-0.9	-1.3	-0.5	0.2
Developing countries	4.0	4.4	4.3	5.3
Latin America and the Caribbean	0.87	1.9	1.7	3.6
CARICOM	1.5	2.0	2.0	2.2
Asia	5.6	5.6	5.8	6.2
SEMAE	1.2	2.3	1.7	4.2

Source: IMF (2001); ECLAC (2001).
Note: SEMAE denotes South Asian Emerging Asian Economies.

The United States which had registered an unprecedented expansion lasting 107 months since the last business trough (March 1991) eclipsing the economic growth of the 1960s, has entered into a recession. A recession is understood as “a period during which output growth is significantly below that of productive potential, so that unemployment rises” (Godley, 2001). According to the National Bureau of Economic Research Business Cycle Dating Committee that keeps the record of business cycle, the recession started in March 2001. The 11 September attacks have most likely deepened the recession as consumers have reduced their spending following the attacks and businesses reduced their employed workforce.

According to the latest figures, the United States GDP declined by –1.1 per cent in the third quarter of 2001. According to the report issued by the United States Department of Commerce, the downturn reflected a deceleration in personal consumption expenditures (1.1 per cent in the third quarter of 2001 versus 2.5 per cent in the second quarter), a decrease in government expenditure (0.1 per cent for State and local government expenditure in the third quarter compared with an increase in 6.6 per cent in the second quarter), a lower than expected export growth rate (decrease of 17.7 per cent in the third quarter compared with a decrease of 11.9 per cent in the second quarter) and a decrease in non-residential fixed investment (decrease of 9.3 per cent in the third quarter).

In the Euro Area, the GDP growth figures reflect the slowdown in the world economy, and its effects on European exports, investment and inventory accumulation (see Table 4). Notwithstanding these effects, private consumption will remain the most important and stable contributor to real GDP growth mirroring the growth of domestic income, which has been enhanced by fiscal stimulus measures in a number of countries. The contribution of net exports

(i.e., exports minus imports) will remain positive, as lower export growth is expected to be offset by reduced import growth. Export growth is expected to decrease from 12 per cent in 2000 to a range of 2.4 per cent-5.2 per cent in 2001 and 0.3 per cent-3.5 per cent in 2002. For its part, import growth will be reduced from 11 per cent in 2000 to a range between 1.1 per cent-3.7 per cent in 2001.

TABLE 4
Projections of selected macroeconomic variables for the Euro area
2000 – 2003

	2000	2001	2002	2003
Private consumption	2.6	1.7-2.1	1.2-2.2	1.5-3.1
Government consumption	1.8	1.1-2.3	0.8-1.8	0.8-1.8
Gross fixed capital formation	4.5	-0.6-0.4	-1.0-2.0	1.2-4.4
Exports of goods and services	12.4	2.4-5.2	0.3-3.5	4.0-7.2
Imports of goods and services	10.9	1.1-3.7	0.6-4.0	3.7-7.1

Source: European Central Bank. Monthly Bulletin, December, 2001.

In particular, the economic perspectives of the United Kingdom are of special concern to Caribbean countries since it is their second and, in some cases, their first trading partner. For the United Kingdom, GDP growth has not experienced a similar decline akin to that of the United States. Between the second and third quarter of 2001, output growth declined from 2.3 per cent to 2.1 per cent. This performance, due to the decline investment and exports which fell in the third quarter of 2001 by 2.7 per cent and 2.3 per cent, will nonetheless affect import growth. A weakening of consumer confidence and falling financial wealth will compound these effects.

Following the general trend, Latin American economies will also experience deterioration in their overall macroeconomic performance. Latin American GDP will decrease from 4 per cent in 2000 to 1 per cent during the current year (see Table 5, below). This performance reflects not only the effects of the external environment but also the current economic conditions affecting some of the major economies in the region and, in particular, that affecting the Argentine economy.

TABLE 5
Latin America GDP growth rates
1995-2002

	1995	1996	1997	1998	1999	2000	2001a/	2002a/
Argentina	-2.9	5.5	8.0	3.8	-3.4	-0.5	-2.0	-1.0
Bolivia	4.7	4.5	4.9	5.2	0.5	1.8	0.5	1.5
Brazil	4.2	2.5	3.1	0.1	0.7	4.5	1.8	2.5
Chile	9.0	6.9	6.8	3.6	-0.1	4.9	3.0	3.5
Colombia	4.9	1.9	3.3	0.8	-3.8	2.3	1.8	2.5
Costa Rica	3.7	0.6	5.6	8.2	8.0	1.7	0.5	2.0
Ecuador	3.0	2.3	3.9	1.0	-9.5	2.8	5.5	2.5
El Salvador	6.2	1.8	4.2	3.5	3.4	1.9	1.0	2.0
Guatemala	5.0	3.0	4.4	5.1	3.6	3.1	1.5	2.5
Honduras	3.7	3.7	4.9	3.3	-1.5	4.8	2.3	2.5
Mexico	-6.1	5.4	6.8	5.1	3.7	7.0	0.1	1.5
Nicaragua	4.4	5.1	5.4	4.1	7.4	4.7	1.5	2.0
Panama	1.9	2.7	4.7	4.6	3.2	2.8	1.8	1.5
Paraguay	4.5	1.1	2.4	-0.6	-0.1	0.7	1.0	1.5
Peru	8.6	2.5	6.8	-0.5	0.9	3.0	-0.5	3.5
Dominican Republic	4.7	7.2	8.3	7.3	8.0	7.8	1.5	3.0
Uruguay	-2.3	5.0	5.4	4.3	-3.3	-1.7	-1.0	1.0
Venezuela	5.9	-0.4	7.4	0.7	-5.8	4.0	3.2	3.2
Total	1.1	3.6	5.2	2.3	0.2	4.1	0.87	1.85

Source: ECLAC (2001).

Note: a/= projections.

In 1991 Argentina adopted a currency board to stop a hyperinflationary process. However, the Argentinian economy has accumulated an important external debt, which it is unable to service due to low export and output growth. Argentina's external debt equals 50 per cent of GDP and its total debt (internal and external) is estimated at \$155 billion which is more than five times its annual exports.

The current spread between the interest rate earned on United States treasury bonds and that obtained on Argentine sovereign bonds measures the risk of holding a bond for which the government will be unable to pay its debt. The spread between Argentine sovereign bonds and United States treasury bonds has reached 30 per cent which, according to financial analysts, may signal a probable default by Argentine authorities.

So far, the Argentine Government has avoided debt default by implementing strict financial and fiscal measures. These include the temporary freeze of current account deposits, cuts in pension funds, government expenditure and the rolling over of debt obligations. The latest restrictive measures consist of the reduction of expenditure costs by \$9 billion as part of a

plan to balance the budget. To a large extent, the current problem is the combination of fiscal profligacy with a stringent monetary rule. The monetary rule consists of the backing of most of the currency issued with dollar reserve or dollar denominated assets. In the face of foul weather external factors, the currency board arrangement imposes a pro-cyclical fiscal policy, which can aggravate economic fluctuations. The authorities have resisted the temptation to devalue due to its effects on the value of assets and the growing debt of the population and businesses in foreign currency.

Argentina's woes have contributed to the deceleration of another Latin American major economy, namely Brazil. The Brazilian Central Bank has tightened its monetary stance increasing interest rates to avoid further currency depreciation. This, in turn, will negatively affect investment and consumption. In addition, Brazil is suffering from a drought-triggered energy crisis thus starving one of its main engines of economic growth in the past year. Between 2000 and 2001, Brazil's GDP growth is expected to decrease from 4.5 per cent to 1.8 per cent.

For its part Mexico is also expected to worsen its economic outlook as the growth in exports, the most dynamic variable in recent years, registers the effects of the decline in the United States demand. Mexican exports to the United States represent 85 per cent of its global exports.

2. A transitory phase of the business cycle or a protracted recession?

As pointed out, the effects following the 11 September attacks have magnified the current recession. However, the nature of the recession still remains to be identified. The expectation is that world growth in the years 2001 and 2002 will remain weak but that the recovery should be underway by the year 2003. However, as in the recent past, these projections are subject to a high degree of uncertainty.

Determining whether the recession is part of a business cycle and will be short lived, or whether it reflects structural imbalances in the United States economy (which have spread to the rest of the world) and is likely to be a long protracted one, is of crucial importance to developing economies and the Caribbean region. This will determine the policy mix chosen to deal with the possible effects of the current recession.

A short-term economic slump may only require temporary countercyclical measures and buffer stock mechanisms to deal with the macroeconomic disequilibria. The short run recession hypothesis identifies the decline in demand for the information and communication technologies and the lagged impact of the decline in oil prices as major causes of the recession. The terrorist attacks of 11 September deepened the economic downturn by adding more uncertainty to the current situation.

A long-term recession is a more delicate and complex issue. It will mean a reorientation of policy and outlining strategies for more in-depth types of reforms. According to the proponents of this hypothesis (Godley and Izurieta – 2001), the United States experienced an unprecedented expansion in the 1990s that was aided by supply side factors. However, the

corresponding structure of aggregate demand was based on the accumulation of debt and provided a weak foundation for the economic expansion of the 1990s.

During the 1990s GDP growth (3.0 per cent during the 1990s) was on average similar to that of the 1980s but with the lowest fluctuation since the 1950s. The unemployment rate followed a similar pattern. The stable behaviour was permitted, in part, by the absence of supply side shocks. The rate of technological advance, proxied by productivity growth, showed a smooth advance as shown by the low volatility of productivity growth. In turn, productivity growth reflected the advances made in information technology. As well, energy and food price shocks, prominent during earlier decades, were simply absent or unimportant during the 1990s. The worst supply side shock of the 1990s, due to the effects of the Gulf War, was less than one-fourth as large as the effect of the oil price shock that took place in the 1970s (see Table 6 below).

Significant energy and food price shocks raise costs and these are translated, in turn, into higher prices. The monetary authority has then the choice of contracting aggregate demand to fight inflation at the risk of provoking higher unemployment rates or expanding aggregate demand to avoid raising unemployment but at the risk of producing a higher actual and expected inflation outcome.

In other words, supply side shocks imply a trade-off between employment and growth for the monetary authority. When supply side shocks are not a relevant issue for the design and implementation of economic policy, the authorities do not face such a trade off and can achieve simultaneously price and output stability and growth.

TABLE 6					
Selected macroeconomic indicators, 1950-1990					
Averages and standard deviation					
	1950s	1960s	1970s	1980s	1990s
GDP growth average	4.2	4.4	3.3	3.0	3.0
Standard deviation	3.9	2.1	2.8	2.7	1.6
Unemployment rate average	4.5	4.8	6.2	7.3	5.8
Standard deviation	1.3	1.1	1.1	1.5	1.1
Productivity growth average	2.8	2.8	2.1	1.5	2.1
Standard deviation	4.3	4.2	4.3	2.9	2.6
Food and energy price shocks	.....	-0.12	0.61	-0.51	-0.22
Average Standard deviation	.....	0.45	1.41	0.97	0.50
Source: Mankiw (2001).					
Note: The food and energy shock is measured as the Consumer Price Index inflation rate over 12 months minus the core (that is excluding food and energy) Consumer Price Index inflation rate over the same period.					
..... denotes not available.					

While supply side factors were a significant contributing factor to the United States economic performance during the 1990s, the demand side exhibited important structural imbalances.

The expansion of aggregate demand that took place during the 1990s was deemed to be unsustainable because it relied mainly on the accumulation of internal private and foreign debt. The expansion of aggregate demand was made possible by a process of the continuing growth of private spending over disposable income, which meant an increasing accumulation of debt by the private sector and by an external deficit financed by a growing negative net foreign asset position of the United States. According to this view the private sector excess of spending over income reached 6.7 per cent of GDP during 2000 and as a result the ratio of private sector debt over income has increased steadily reaching more than 1.5 in 2000.

3. Interest rates and fiscal policies

The policy recommendations to engineer a recovery include: (i) policies to raise foreign demand; (ii) policies to change the relative prices of imported and exported goods; and (iii) countercyclical policies. The most desirable combination is a set of policies to raise internal and external demand simultaneously. An increase in internal demand without a concomitant increase in exports would further widen the external gap. Also an increase in net exports would preclude the need to foster substantial government expenditures. An alternative and, perhaps, complementary measure to the increase in export demand is to apply article 12 of the World Trade Organization (WTO) which allows for the use of non-discriminatory import controls. The idea behind these measures is to allow the financial balances of the private sector, the government and the external balance of payments position to reach equilibrium over time.

As a reaction to the economic slowdown, to date, most countries have resorted to the third type of policy option mentioned above, that is, fiscal stimuli packages and monetary flexibility in order to restore a sustainable growth path. The central banks of major industrialised economies have reduced short-term interest rates in order to provide a short-run stimulus to aggregate demand (see Table 7, below). The short-term rates of interest have decreased in the Euro Area from 5.02 per cent in the fourth quarter of 2001 to 4.12 in the third quarter of 2001.

In the United States, between the end of the year 2000 until 6 November 2001, the Federal Reserve has lowered the federal funds rate from 6.5 per cent to 2 per cent.² According to a recent statement the Federal Reserve open market committee has referred to the increasing uncertainty and concerns about a deterioration in business conditions and abroad as the main factors which have dampened economic activity.

In addition, some countries have decided to reinforce the effect that automatic fiscal stabilizers can have on output by engineering tax cuts to boost demand. In the United States, as a response to the recession, the authorities have put in place a tax rebate, effective July 2001 and the Federal Reserve has consistently lowered interest rates. The budget proposal for the fiscal year 2002 includes changes in the tax law that would reduce tax revenues over the next decade.

² The federal funds rate is the rate charged by commercial banks on overnight loans. Through the manipulation of the federal reserve funds rate, the Federal Reserve is said to control bank reserve and thus indirectly the money supply.

The proposed package includes substantive reduction in the personal income tax, estate and gift taxes and the corporate income tax. These tax cut proposals would start in 2002 and be fully effective in 2006. As a share of GDP, the tax cut proposals would average 1.2 per cent over a 10-year period.³

³ An Analysis of the President's Budgetary Proposals for Fiscal Year 2002. May 2001. The Congressional Budget Office.

TABLE 7
Short-term interest rates in major industrialised economies
First quarter 1999 to second quarter 2001

Country and country grouping	1999.1	1999.2	1999.3	1999.4	2000.1	2000.2	2000.3	2000.4	2001.1	2000.2	2000.3
Canada	5.0	4.7	4.82	5.04	5.28	6.12	5.90	5.81	5.10	4.48	3.95
Euro Area	3.09	2.64	2.70	3.43	3.54	4.26	4.74	5.02	4.75	4.59	4.27
Japan	0.49	0.11	0.09	0.29	0.11	0.08	0.27	0.54	0.36	0.04	0.04
United Kingdom	5.50	5.20	5.19	5.89	6.12	6.19	6.12	5.99	5.63	5.23	.....
United States	4.90	4.98	5.38	6.06	6.03	6.57	6.63	6.59	5.26	4.10	3.4

Source: Federal Reserve of St. Louis

TABLE 8
Long-term interest rates in major industrialised economies
First quarter 1999 to second quarter 2001

Country and country grouping	1999.1	1999.2	1999.3	1999.4	2000.1	2000.2	2000.3	2000.4	2001.1	2001.2	2001.3
Canada	5.24	5.49	5.78	6.21	6.20	5.96	5.81	5.72	5.67	5.95	5.90
Euro Area	3.99	4.26	5.05	5.32	5.62	5.43	5.44	5.28	4.99	5.19	5.12
Japan	1.83	1.39	1.79	1.78	1.79	1.71	1.79	1.74	1.39	1.28	1.36
United Kingdom	4.47	4.89	5.45	5.50	5.60	5.30	5.28	5.05	4.81	5.09	.....
United States	5.60	6.04	6.34	6.55	6.54	6.29	6.06	5.85	5.56	5.81	5.59

Source: Federal Reserve of St. Louis

4. Exchange rates and commodity prices

The behaviour of exchange rates has in, general, been stable as have most non-oil commodity prices. Foreign exchange markets have been driven by expectations regarding the performance of the United States economy.

Periods of a strong dollar followed by a renewed confidence for economic recovery in the United States alternated with periods of a weak dollar amid data releases in the United States indicating that the country was entering a recession and that the recession might last longer than expected. As a result, with a few exceptions, the bilateral exchange rate between the dollar and the currencies of the United States major trading partners has remained broadly stable.

TABLE 9			
Main trading partners of the United States and bilateral dollar exchange rates variations			
Country	Market share of US imports	May 2001-May 2001 (rates of change in bilateral exchange rates)	November 2001-November 2000 (rates of change in bilateral exchange rates)
Canada	19	3.0	3.2
Japan	13	12.4	12.3
Mexico	11	-3.4	-3.0
European Union	10	-3.4	3.9
China	8	0.0	0.0
Taiwan	3	7.9	6.4
South Korea	3	16.0	10.9
United Kingdom	4	-5.5	0.7

Source: Federal Reserve Bank of St. Louis (2001); MAGIC (2001).
Note: a - sign indicates an appreciation of the dollar and a + sign a depreciation of the dollar.

As shown in Table 9 above, the only trading partners that have experienced significant exchange rate variations in their currency with respect to the dollar have been Japan and South Korea. Japan accounts for 13 per cent of all United States imports and South Korea accounts for 3 per cent. The exchange rate fluctuations in the yen/dollar exchange rate respond mainly to the deflationary trends in the Japanese economy. Japan has now been in recession for 10 years and the successive fiscal and monetary measures to revamp the stagnant Japanese economy have so far been unsuccessful. During the second quarter of 2001, Japan registered negative growth rates and is expected to achieve a zero growth rate by the year 2002.

For its part the movements of the terms of trade are influenced by two contradicting tendencies. On the one hand, the prices of non-oil commodities which are of concern to

Caribbean countries have exhibited, for the most part, a downward trend reflecting a deterioration in the unit value for primary commodity exports (see Table 10 below).

TABLE 10								
Evolution of selected commodity prices								
1999-2001								
Commodity	Unit	Jan.- Dec. 1999	Jul.- Sept. 2000	Oct.- Dec. 2000	Jan- Mar. 2001	Apr.- Jun. 2001	July- Sept. 2001	Nov. 2001
Cocoa	Cents/ kg	113.5	91.2	88.3	100.4	104.5	100.8	123.2
Coffee	Cents/ kg	229.1	176.4	157.5	146.7	146.4	129.7	129.7
Rice	\$/mt	248.4	184.8	185.6	181.3	165.4	170.2	173.5
Bananas EU	\$/mt	850.4	611.0	628.2	910.2	834.9	686.0	650.8
Bananas USA	\$/mt	373.8	354.1	399.4	587.4	599.2	650.9	496.0
Sugar EU	Cents/ kg	59.17	54.22	52.89	53.0	53.12	52.57	52.61
Sugar USA	Cents/ kg	46.60	42.09	47.56	47.44	46.96	46.78	47.02
Tin	Cents/ kg	540.4	537.4	526.2	511.3	490.8	398	404.2
Zinc	Cents/ kg	107.6	117.7	107.2	102.0	93.4	82.6	77.3
<p>Source: World Bank (2001)</p> <p>Note: Coffee prices are price quotations for Arabica coffee. Sugar EU refers to the European Union negotiated import price for raw unpacked sugar from African, Caribbean and Pacific (ACP) under the Lomé Convention. Sugar (US) refers to the CIF import price quoted in the futures market in New York. Bananas (EU) refers to the European CIF price quotation for major brands.</p> <p>mt= metric tonnes.</p>								

On the other hand, the expected decrease in oil prices will lower the unit value of imports. Depending on whether the decline in commodities' export prices are offset or not by the decline in oil import prices, the evolution of the terms of trade may be favourable or unfavourable to non-oil producing developing countries.

The behaviour of oil prices depends on its demand and supply. Demand has and is likely to weaken as a result of the current recession and the 11 September attacks. The downturn of the United States economy, which accounted for one third of global consumption in 2000, will have an important immediate impact on oil prices. The Organization of Petroleum Exporting Countries (OPEC) members control the supply side of oil prices. During the year, OPEC agreed on several production cuts to boost the price of oil but following the 11 September attacks, OPEC decided not to modify its quota system (see Table 11, below).

TABLE 11				
Oil prices, demand and production				
	1999	2000	2001	2002
	Oil price			
First quarter	11.26	26.94	25.79	23.45
Second quarter	15.46	26.89	27.38	20.53
Third quarter	20.64	30.34	25.39	20.18
Fourth quarter	24.06	29.67	23.10	21.89
Year	17.86	28.48	25.42	21.51
	Oil consumption (percentage of world total)			
North America	31.6	31.7	31.5	31.5
Europe	20.2	19.9	19.8	19.7
Latin America	6.4	6.4	6.4	6.4
	Oil demand and supply balance (million of barrels)			
Oil production	74.12	76.74	76.81	77.46
Oil consumption	75.12	75.88	76.22	76.82
Balance	-1.09	0.86	0.59	0.64
Source: Economist Intelligence Unit (2001)				

5. Capital flows

Capital flows are now the main driver of economic globalisation. Foreign direct investment is now particularly important as a factor in integrating markets and enhancing the international production and trade in the world economy. World Foreign Direct Investment (FDI) grew by 18 per cent in 2000, surpassing growth in world production, capital formation and trade. FDI inflows jumped to a record \$1.3 billion during the year, but are expected to decline with the slowdown in the United States, the European Union and Japan - the Triad.

Capital flows to developing countries as a proportion of GDP has declined since the Asian financial crisis of 1997. This trend has been induced by a decline in demand for these flows in some countries and weak supply to others as a result of high sovereign risk ratings and general economic uncertainty. With the contraction in capital flows as a percentage of developing countries' GDP and exports, their debt/GDP and debt/exports have declined. Capital flows to developing countries continue to be influenced by strong push and pull factors. A major push factor is the increasing financial integration at the global level, catapulted by the information and communications revolution. Two important pull factors are economic reform and structural changes that attract investors to countries with strengthened business environments, offering a cluster of services; and psychological factors, including perceptions of risk and uncertainty.

Aggregate external resources to developing countries declined on average by 2.8 per cent per annum between 1997 and 2000. The average contraction in flows reflected the lingering effects of the Asian crisis and continued caution on the part of investors in re-entering emerging markets. In 2000, however, investor confidence seems to have returned, as inflows increased by 21.6 per cent over the amount for 1999, to total \$ 299.3 billion.

Latin America and the Caribbean continue to be the most heavily dependent on external financing of all the major regions. Net resource flows to Latin America and the Caribbean posted strong growth over the 1990s, growing from \$21.8 billion in 1990 to \$ 116.5 billion in 1999. In 2000, resource flows declined by 12 per cent to \$102.4 billion compared with 1999. Of these flows, net FDI, which accounted for 74 per cent of total net resource flows in 2000, declined during the year. Consequently, net transfers⁴ to the region contracted by a substantial 40 per cent in 2000, amounting to \$33.2 billion.

FDI is overwhelmingly the most important component of capital flows to Latin America and the Caribbean, far surpassing portfolio flows, both in terms of size and contribution to the development process. After a three-fold increase in the second half of the 1990s FDI inflows to Latin America and the Caribbean declined in 2000. Inflows fell sharply by 22 per cent to \$86 billion in 2000. Fortunately, this does not represent a negative turning point, but an adjustment after the major acquisition of three Latin American firms in 1999.

The pattern and direction of FDI inflows to individual countries is varied depending on the levels of development, resource endowment and market incentives, including degrees of macroeconomic and financial stability. Brazil remains the largest recipient of FDI inflows in the region with inflows going predominantly to the services sector. Although the pace of privatisation in Brazil has slowed, it continues to provide impetus for inflows and accounted for roughly 22 per cent of total inflows, compared with 28 per cent in 1999. The largest privatisation deal in 2000 was the sale of the dominant stake of the bank Banespa to the Spanish Banco Santander Central Hispano (BSCH) for \$3.6 billion. Underscoring the importance of size and economic reforms, Mexico, with \$13 billion, was the second most important host country for FDI in the region. Importantly, unlike most other major players in the region, Mexico's inflows increased by 10 per cent in 2000. Half of the inflows went to the manufacturing sector, but a substantial 31 per cent share was directed to financial services. This resulted from the takeover of domestic banks by Spanish banks in the wake of the lifting of the remaining restrictions on foreign ownership of banks in 1999.

Argentina and Chile, however, were faced with substantial reductions in FDI inflows in 2000, reflecting a tapering-off of mergers and acquisitions. The countries had experienced three major mergers and acquisitions in 1999 (Repsol's purchase of YPF in Argentina and Endesa España's acquisition of Endesa and Enersis in Chile). FDI inflows to Colombia and Peru were adversely affected by political and economic instability, while inflows increased in Venezuela on account of acquisitions in the services sector.

⁴ Net transfers refer to disbursements or drawings on loan commitments minus debt service payments.

Some Latin American firms, more so than their Caribbean counterparts, have improved their competitiveness and have become more market savvy, enabling them to penetrate extraregional markets. In 2000, Chile was the leading outward investor for the region, with outflows of \$5 billion that exceeded inflows. Most of the investment, however, was undertaken by foreign affiliates in Chile. The second largest overseas investment by a Latin American company was the acquisition of Cemex from Mexico of Southdown in the United States for \$2.8 billion. This acquisition makes Cemex the third largest company in the world and one of the largest transnational corporations (TNCs) in the world.

6. Institutional developments

6.1 The Caribbean Basin Initiative and the Trade Promotion Authority

The CBI (1983) gave a preferential access to a gamut of export products from Caribbean and Central American countries to enhance the development and growth of these economies. Initially the CBI was set for a period of 12 years ending in September 1995. The law excluded textiles and garments, leather products, canned tuna, petroleum and its derivatives.

Due to the disadvantage in the competitive positioning of Caribbean and Latin American countries after the entry into force of the North American Free Trade Agreement (NAFTA) (1994) and the adverse consequences of Hurricane Mitch for Central American countries, the CBI was expanded in May 2000 to include the products that had been excluded in the previous legislation. The new legislation titled the Law of Commerce and Development that entered in force on October 2000 provides an equal tariff treatment to canned tuna and leather footwear to that received by Mexico. In the case of textiles the situation is more complex.

The law allows free of tariff market access and quotas to garments which are elaborated in the region with United States fabric and string. It also permits the free market access for garments which are cut in the countries that benefit from the CBI but that have United States fabric and strings. Furthermore, it allows free market access to the United States of 250 million square meters of knitted garments made with fabric from the region and but with United States strings. Finally, it allows the free market access of 4.2 million square meters of knitted shirts elaborated with regional fabric and United States strings. The quotas of 250 and 4.2 million square meters were distributed among Central American and Caribbean economies as shown in Table 12 below.

TABLE 12		
Market share of quota distribution of 250 million knitted garments and 4.2 square meters of knitted shirts among CBI beneficiary countries		
Country or regional	Market share of 250 million	Market share of 4.2 million square

block	knitted garments	meters of knitted shirts
CARICOM	4.9	5
Costa Rica	7.5	1.5
El Salvador	21.3	20.8
Guatemala	19.4	11.2
Honduras	25.2	42
Nicaragua	2.0	4
Panama	1.5	1
Dominican Republic	18.1	10
Total	100	100
Note: On the basis of official data.		

The Law of Commerce and Development extends the categories of garments that have preferential access to the United States import market. The other categories are “807 plus”, guaranteed access level and specific limit. The category “807 plus” includes products elaborated with United States fabric and strings and which have to pay tariff upon entry into the United States territory on only the value added but with no quota restrictions. The guaranteed access level category includes those textile products that elaborate with fabric made and cut in the United States. Exports that fall under the category of guaranteed access levels are subject to quota restrictions and tariffs on their value added. Finally, specific limit export products are those textile products elaborated with fabric from any country. This category also includes products that are imported by the United States from a third country and which may be re-exported after undergoing a transformation process. The precise impact of the extended CBI initiative on the export and the performance of the beneficiary countries remain uncertain and will depend on the unit price of garments, on their export capacity and their potential to fully use the assigned quotas to enter the United States market.

However, most recently the CBI trade concessions granted to Caribbean and Central American countries have been partly withdrawn by the United States through the approval of the trade promotion authority.⁵ Under the trade promotion authority the United States Congress can approve or reject trade treaties but is unable to amend them. Under this authority, granted by the United States Congress to the President, the executive branch decided to allow duty-free and quota-free entry to the United States market, to apparel sewn in the area only if it is made from fabric dyed, printed or finished in United States territory. This withdrawal of export preferences to the export of the apparel industry in Caribbean and Central American countries will have an important impact on overall export performance. The trade promotion authority also provides special treatment for other United States import sensitive products, such as citrus fruits, sugar and steel.

6.2 The Doha Ministerial Conference

The fourth WTO Ministerial Conference (Doha, Qatar, 9-14 November 2001) signaled the continuation of another round of multilateral trade negotiations. The ministerial conference

⁵ The trade promotion authority was approved on 6 December 2001.

gave the WTO a broad negotiation mandate including, among others, negotiations on agriculture, services, trade-related aspects of intellectual property rights, dispute settlement, trade and environment and electronic commerce. Among the issues in the work programme that will affect in particular small developing economies are: (i) the implementation and design of differential and special treatment; (ii) the need to examine issues related to the trade of small economies; (iii) the recognition to take into account the specific problems confronted by least developed countries; (iv) the possible extension of export subsidies; and (v) the waivers granted to the European Union to extend the regime of preferential tariff treatment for products which originate in ACP countries.

Following a proposal made by several developing economies to change the implementation and design of special and differential treatment (WT/GC/W/442), the ministers reaffirmed that the provisions for special and differential treatment are an integral part of the WTO agreements and agreed to review these provisions with a view to make them more precise, effective and operational. The Framework Agreement on Special and Differential Treatment proposes an outline of some of the initial issues that should be contemplated in a special and differential framework agreement. These are:

- (i) The mandatory and binding nature of Special and Differential treatment shall be mandatory;
- (ii) The inclusion of the development dimension in trade agreements and the extent to which they facilitate the attainment of development targets;
- (iii) The undertaking of the evaluation of the implications of any future agreement, with respect to implementation costs in terms of financial, capacity building and technical assistance;
- (iv) The provision of a link between the transition periods and the economic objectives (debt level, level of industrial development, human development index, etc.) and social (literacy and life expectancy) criteria; and
- (v) Allowing the undertaking of policies which promote growth and development in developing countries.

The Doha declaration only makes reference to the cited document and only addresses special and differential treatment in a very broad manner.

Regarding the need to examine the issues of trade in small economies, the Doha declaration deprives the 'smallness' of an economy of any meaningful sense since it does not qualify or quantify the characteristics of a small economy. Perhaps this approach to small economies trade issues is justified by the fact that the WTO does not want to create an additional subcategory of country members. This would imply changing the trade negotiation process as well as amending most multilateral trade negotiation agreements. Also it would imply partitioning special and differential treatment into that afforded to developing economies, least

developed countries and small economies adding a further degree of complexity to the trade negotiation process.

The Doha ministerial declaration recognises the need to eliminate tariff and non-tariff barriers to expand the trade and market access possibilities of least developed countries. As well it makes reference to the Integrated Framework for Trade Related Technical Assistance (WT/LDC/HL/Rev.1, 23 October, 1997) as a viable model for development. The integrated framework seeks to provide assistance in areas that are key for developing economies. These include: institution building to handle trade policy areas, the strengthening of export supplies capabilities, trade support services, and trade facilitation capabilities, training and human resource development and the assistance in the creation of a supportive trade-related regulatory and policy framework to encourage trade and investment. The question remains of the precise commitments that countries are willing to take to ensure the necessary aid and the conditionality involved in this aid. In fact, the issue of the conditions attached to the delivering of the aid could mean a return to the discussions of the General Agreement on Tariffs and Trade (GATT) during the 1960s and the appended part IV that created a normative framework for developing countries' needs.

The WTO agreement on Export Subsidies and Countervailing Measures granted an extension of eight years (1994-2003) to developing countries to dismantle export subsidies. It also allowed countries with a GNP below US\$1,000 to continue the use of export subsidies until their GNP per capita was greater than that amount. Export subsidies are considered to include any financial contribution of a government or public body. This implies that financial transfers as well as the absence of tax collection by the government is considered to be a subsidy. Latin American and Caribbean countries can use the time extension granted by the agreement to foster the development of export enclaves, including especially the development of the garment industry. Between the entry of force of the agreement and the Doha Ministerial Conference, Latin America did not provide any transitional agreement or restructure their enclave industries to eliminate and withdraw export subsidies. Following the Doha Ministerial Conference, extensions will be granted to export subsidy programmes in the form of full or partial import duties and external taxes. As a result, developing countries will continue to enjoy special privileges to develop free trade zones exports. The question remains whether countries will take advantage of the new time extension to develop subsidies, which are WTO compatible, or whether the time extension will only prolong the present state of affairs.

Finally, the Doha Ministerial Conference decided to allow the European Community to provide preferential tariff treatment for products originating in ACP States without being required to extend the same treatment to like products of any other member. In this sense, the Ministerial gives the European Community a waiver to comply with Article I of the GATT regarding the principle of non-discrimination. The waiver applies to the Cotonou Agreement and the case of bananas until 31 December 2007. As well, from 1 January 2002 and until 31 December 2005, paragraphs 1 and 2 of article XIII of the GATT 1994 are waived regarding the European Community separate tariff quota of 750 000 tonnes for bananas of ACP origin. These last two provisions throw some doubt on the resolutions of the Ecuador Panel which was formed to examine the compatibility of the multilateral trade agreements with the European Union-ACP export regime. The Ecuador panel ruled that the European Union-ACP regime was in fact

incompatible with article XIII of GATT and forced the European Union to look for an eventual alternate export regime. The granting of the waiver still means the eventual and gradual erosion of trade preferences which will mean for Caribbean countries a process of reforming and restructuring their traditional exports and perhaps their industrial potential.

6.3 Offshore banking regulations

Money laundering and other illegal practices have become rather problematic for the world economy. The Financial Action Task Force (FATF) estimates that the scale of money laundering transactions was between 2 to 5 per cent of GDP in 1998. Further, it is believed that Gresham's law clearly operates with bad money driving out the good leading to lasting damage to financial systems.

Individual Caribbean countries continue to face mixed perceptions with respect to their efforts to combat money laundering and being used as clandestine tax havens. Currently, four countries in the region are still on the FATF's blacklist, all of which are Organisation of Eastern Caribbean States (OECS) countries -Dominica, Grenada, St. Kitts and Nevis and Saint Vincent and the Grenadines. Meanwhile, the Bahamas, Cayman Islands and Panama have been delisted after undertaking required reforms. In spite of the fact that some of its members are listed, the Caribbean Financial Action Task Force (CFATF) continues to work to upgrade supervision, regulation and disclosure requirements in the regional jurisdictions.

Most of the countries are in various stages of implementing the 25 criteria of the international FATF. Measures that have been implemented include self-assessment of the implementation of recommendations for reform, ongoing mutual evaluation of members and coordination of training and technical assistance programmes. The CFATF has also undertaken a series of typology exercises to examine the types of money laundering, for example, casino gambling and cyber-money and to design countermeasures suited to each type. Legislation has also been upgraded in most countries to deal with money laundering. For example, variations of the Proceeds of Criminal Conduct and Regulation Acts have been implemented in most countries to criminalise dealing and benefiting from money laundering activity. Further, there is now a team of legal, financial and law enforcement persons tracking the performance of individual countries in respect of compliance.

In the OECS, the role of the Eastern Caribbean Central Bank (ECCB) has been enhanced to deal with some aspects of regulation of offshore centres. Efforts are also being made to adopt a variant of the Basle Committee Standards on banking regulation to the offshore sector which balances the need for secrecy with the public interest in disclosure. This is not expected to be an easy task, however.

In the aftermath of the terrorist attack in the United States, the CFATF has listed the fight against terrorism as a major objective. This would be done, largely by preventing terrorists from funneling resources through regional centres. Measures to strengthen cross-border cooperation in information sharing enhanced supervisory powers and customer due diligence, including know-your-customer systems have been stepped up.

With reference to international cooperation, however, it is vital to note that capacity constraints in terms of expertise, finance and legal skills are major impediments to progress in implementing reform in the region. International agencies need to assist where they can to bring the region on board

7. Global developments and the implications for Caribbean economies

What do these problems in the major trading partners and the forecasted recession in the United States and probably the world economy portend for the Caribbean? For one thing, there is no clear sense of how these events are likely to play out with any precision. Nonetheless, the current and projected global slowdown will have significant implications for the performance of Caribbean economies and the conduct of macroeconomic policy and a first approximation assessment can be made based on the past experiences with recessions in major trading partners.

The decline in external demand will directly affect the growth of Caribbean exports of goods. The extent of the impact will be determined partly by institutional developments described in Section 6 and the sensitivity of Caribbean exports to variations in external demand.

The effects of the slow export growth coupled with their high propensity to import will, other things being equal, widen the trade gap. Table 13 shows the average propensity to import of Caribbean countries (measured by the ratio of the rate of change in imports relative to the rate of change in income) and their export performance (measured by the ratio of exports to the average import propensity). Depending on whether or not the expected decline in the price of oil compensates the decrease in the export prices of basic commodities, the variation in the terms of trade may soften or exacerbate this effect.

	1990	1993	1996	1999	2000
Barbados					
Import propensity	42.3	36.9	44.0	47.8	41.5
Export performance ratio	1.0	1.0	1.1	1.1	2.8
Belize					
Import propensity	52.1	52.9	42.2	55.0	.....
Export performance ratio	3.7	3.7	3.9	3.8	
Dominica					
Import propensity	86.2	61.9	60.8	65.1	.....
Export performance ratio	0.2	0.3	0.4	0.4	
Grenada					
Import propensity	54.1	53.3	59.7	57.9	62.4
Export performance ratio	0.1	0.1	0.1	0.5	.....
St. Kitts and Nevis					
Import propensity	69.7	54.4	53.5	44.4	63.9
Export performance ratio	0.0	0.2	0.3	0.4	0.3
Saint Lucia					
Import propensity	65.3	53.0	46.8	46.0	51.6
Export performance ratio	0.7	0.8	0.7	0.6	0.5
Trinidad and Tobago					
Import propensity	24.9	30.6	37.2	49.1	41.5
Export performance ratio	2.6	2.5	2.6	2.5	2.8
St. Vincent & the Grenadines					
Import propensity	64.3	49.5	46.0	54.0	42.0
Export performance ratio	0.6	0.5	0.5	0.4	0.5
Source: On the basis of official data					
Note: "...." Denotes not available.					

The services balance is also likely to be reduced although the final outcome will depend on a series of factors. First, there is the risk factor. Tourism receipts originating in the United States will decrease due to the lower number of tourists visiting the region as their perception of risk of travelling increases. However, the decrease in American tourism may be partly offset by more dynamic tourism flows emanating from Europe. Europeans may, in fact, view Caribbean destinations as a lesser risk than travelling to other destinations, such as the Middle East. Second, airlines have been trimming down their airline flights to the region. Third, the increase in insurance and other costs for commercial airlines following the 11 September attacks will place an additional restriction on tourist flows as airlines fares are increased or the number of flights reduced.

As it now stands, hotel occupancy rates in a number of countries have fallen to about 15 per cent, relative to average rates of 60 per cent in September-October (International Monetary Fund - IMF). Indeed, the significant fall in visitor arrivals and weak commodity prices for

bananas, sugar and apparel have exacerbated the current account deficit of the balance of payments in 2000. Preliminary estimates indicate that the external financing gap of the region could widen to between \$1-2 billion -2 to 4 per cent of GDP in 2002 (see IMF).

Regarding the service balance account of the balance of payments, it is important to note that the offshore financial services sector, which was already under pressure from the Organization for Economic Cooperation and Development (OECD) is likely to face even more pressure in the wake of the terrorist attacks, reducing activity and income.

A widening of the trade gap and a narrowing services balance surplus are likely to create a current account constraint.

Within the Caribbean Community (CARICOM) subregion, the external current account recorded an average deficit of \$170.4 million in 2000, the equivalent of 9.7 per cent of GDP. The performance of individual countries was quite mixed, reflecting the variability of macroeconomic performance, exports and imports and income flows and transfers. The current account deficit expanded in most countries in 2000 compared with 1999 (see Table 14, below). The Bahamas swung from a substantial current account surplus of \$406.1 million to an even larger deficit of \$560.3 million in 2000. Barbados also displayed a similar pattern moving from a surplus of \$147 million to a deficit of \$111.9 million. Growth in the deficit was also significant in Belize, Guyana and Suriname. Incidentally, the OECS member countries and Jamaica posted the smallest growth in their deficits.

In the first half of 2001, the current account position of most countries worsened, with improvements in only the Bahamas, Barbados and Trinidad and Tobago. Barbados' current account surplus increased from \$27 million in the first half of 2000 to over \$60 million in the corresponding period of 2001. This improvement reflected the collapse in all categories of imports on account of a decline in growth. In Trinidad and Tobago, the current account strengthened from a deficit of \$59 million in the first quarter of 2000 to a surplus of \$377 million in the first quarter of 2001. The robust position of Trinidad and Tobago reflected the turnaround in merchandise account that was bolstered by strong petroleum receipts due to vibrant exports and prices. The Bahamas' current account improved on the basis of a 7 per cent growth in export receipts and an over 20 per cent decline in imports. As for other countries, this points to the importance of import compression as a mechanism for adjusting to the weakening output performance in most countries of the region.

Guyana's current account deficit widened in the first semester of 2001, relative to the similar period of 2000 on account of weakening prices of its major commodity exports. High oil prices and declining commodity receipts resulting in worsening current account deficits also buffeted Suriname and Jamaica.

TABLE 14
CARICOM: External Current Account (US\$ million)

Countries	1991	1992	1993	1994	1995	1996	1997	1998	1999	Projections			
										2000	2001	2002	2003
Bahamas	-179.4	37.5	49.7	-41.6	-148.2	-269.3	-665.1	-995.7	406.1	-560.3	-235.3	n.a.	n.a.
Barbados	-23.4	143.4	70.2	134.7	90.2	104.5	-49.4	-55.9	147.5	-111.9	-108.9	-83.1	-88.6
Belize	26.6	29.1	-49	-20.3	7.3	2.3	-14.4	-41.8	-67.2	-128.3	n.a.	n.a.	n.a.
Guyana	-118	-146.7	-136.4	-100.8	-94.9	-20.2	-105.1	-98.5	-75.2	-117.5	n.a.	n.a.	n.a.
Jamaica	-225.8	10.9	-194.2	135.8	-192.3	-237.8	-310.6	-255.8	-252.1	-285.5	n.a.	n.a.	n.a.
EC Currency Union	-291.5	-203.2	-565.5	-237.4	-210.9	-336.5	-404.1	-388.7	-454.4	-465.3	n.a.	n.a.	n.a.
Suriname	-94.9	-25	21	-237.4	-62.7	-63	-48	-154.8	-52.6	-73	-81	-73	-61
Trinidad and Tobago	-20.7	56.6	-107.8	221.4	269.9	68.2	-578.9	-645.3	30.6	378.5	311.2	192.2	366.1
Total	-927.1	-97.4	-912	144.5	-341.6	-751.8	-2175.6	-2636.5	-1424.5	-1363.3	-114	36.1	216.5

Source: Caribbean Centre for Monetary Studies, 2001

The current account can be balanced by an increase in capital flows (private and/or official) or by a decrease in aggregate demand. This can be seen from a simple national income accounting identity whereby the balance of payments is seen to be equal to the excess of private spending over private disposable income and the budget deficit.

(1) Exports – Imports + Net property income from abroad = [national income – taxes – private expenditure] + [taxes – public expenditure]

The Caribbean's experience with net capital inflows has not been as favourable as fast-growing Asian economies and Latin America. Nevertheless, the resurgence of capital flows at the global level in the 1990s led to growth in inflows to Caribbean countries. The composition of aggregate external inflows to the Caribbean has changed in important respects relative to the 1980s. The region has not been immune from the decline in official development assistance (ODA). In fact, the Caribbean was one of the regions hardest hit by the sharp contraction in aid flows over the 1990s. Caribbean countries are not important recipients of portfolio capital flows due to their underdeveloped capital markets and lack of adequate risk ratings. FDI is by far the most important source of capital inflows. This is indeed a welcome feature, since FDI provides strategic benefits in terms of production for export and the transfer of technology⁶, skills and management expertise, which are important for the competitiveness of the region.

In recent years, Caribbean countries have been able to finance their current deficits with capital inflows, particularly FDI, on relatively good terms. The global slowdown could lead to a significant decline in capital inflows and also more discriminating investors. This would raise the stakes for Caribbean countries with their relatively poor risk-ratings the result of them being little-known in international capital markets. There were already significant downside risks in international capital markets before the terrorist attack on the United States. These risks stemmed from sluggish output and corporate earnings, weakening equity markets and widening yields and spreads in emerging markets. The attack simply amplified these risks, thereby making markets even more uncertain. As in the Asian crisis, the major response was a flight to quality that raised borrowing costs for the more risky emerging markets. What this means is that Caribbean countries might have to borrow on onerous commercial terms to finance worsening fiscal and external current account deficits. This has serious implications for the accumulation of debt and debt servicing commitments in the future.

A number of Caribbean countries were already enticed to substitute international debt for domestic debt with the fall in interest rates in major markets, especially the United States. Jamaica, for instance, issued a \$200 million bond in 2000 and Trinidad and Tobago also undertook external borrowing. Although this debt might have been contracted on soft terms, future increases in interest rates in creditor countries could lead to a sharp increase in debt service obligations.

Net FDI inflows of \$16.3 billion flowed to the Caribbean, including Cuba and the Dominican Republic, between 1991 and 2000. FDI inflows averaged around \$91 million per

⁶ See The World Investment Report 2001: "Promoting Linkages", UNCTAD

year during the same period. In 2000, however, total FDI inflows declined sharply by over 41 per cent to \$2033 million, relative to the previous year. FDI declined in 13 of the selected countries and was up in only six of them. The larger Caribbean countries generally fared better than their smaller counterparts in terms of the slowdown in FDI inflows. Inflows to the Dominican Republic contracted by over 29 per cent. This probably reflected a decline in investment in the free zones. Inflows to Jamaica were down by over 27 per cent in 2000, reflecting the continued sluggish sectoral performance, especially the manufacturing sector. Inflows fell in Barbados, the OECS countries and Suriname as investor sentiment towards these countries weakened. Inflows to Guyana and Trinidad and Tobago increased in 2000. Trinidad and Tobago was particularly favoured by continued flows for the LNG plant project in the petrochemical sector.

Indications point to an average decline in FDI inflows to the region in 2001. The slowdown in growth in the United States and the European Union has increased investor caution in these countries and dampened overseas investment. FDI inflows into the tourism sector in the Bahamas contracted and the situation was similar for commodities and manufacturing in Jamaica and Guyana. Meanwhile, in Barbados the completion of some tourism projects led to a reduction in inflows.

In the absence or reduction of foreign capital flows and given the commitment of Caribbean countries to foreign exchange rate stability, the balance of payments restriction will have to be balanced by a decrease in demand coming from the private or the public sector. Ideally, greater export growth or investment would replace the decline in private and public expenditure. The former alternative implies a higher export demand or an exchange rate depreciation. A higher export demand is unlikely due to the current slump, while an exchange rate depreciation is protracted by the exchange rate regime of Caribbean countries aimed at maintaining stable if not fixed nominal exchange rates. The latter outcome would imply lower rates of interest, which would also put pressure on the exchange rates.

The restriction in aggregate demand will imply a tight fiscal stance. The fiscal stance is measured by the ratio of government spending to average rate of taxation (taxes divided by GDP). The ratio will equal GDP when the budget is in balance and will be greater (lower) than GDP when the budget is in deficit (surplus). The fiscal stance allows making inferences regarding the nature of fiscal policy. Table 15 shows the actual GDP and the fiscal stance ratio for Caribbean economies. In all cases the excess of the fiscal stance ratio over GDP signals the fact that during the 1990s fiscal policy maintained an expansionary nature.⁷ The present situation may force the authorities to take stringent fiscal measures. These in turn may soften the balance of payments restrictions but at the cost of higher unemployment and output losses.

To alleviate the onslaught of a global recession, Caribbean countries may need to adjust macroeconomic and structural policies. On the macroeconomic front, countries should explore the possibility of containing fiscal outlays and manage contingency funds, such as revenue

⁷ The linkages of the tourism sector with the rest of the economic sectors can also aggravate the fiscal stringency. A decrease in tourism activity has a fiscal revenue impact through the reduction in tax revenue of the activities connected with tourism.

stabilisation funds, prudently. Complementary options include the swapping of international debt with domestic debt if this is less expensive in order to obtain the needed financing.

TABLE 15
Fiscal stance of selected Caribbean economies
1990 – 2000

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Barbados											
GDP	2965.3	2893.4	2708.5	2791.2	2920.7	3147.5	3377.4	3610.4	3852.5	4137.9	.....
Fiscal stance	3740.7	3023.4	2819.3	2949.9	2993.5	3223.4	3715.7	3735.4	3963.9	4307.9	
Belize											
GDP	810.8	865.2	969.3	1060.9	1104.5	1174.4	1211.4	1235	1259.2	1375.6	1509.9
Fiscal stance	1185.6	1527.3	1762.0	1337.3	1475.3	1408.2	1311.5	1413.9	1084.6	1259.9	1980.9
Dominica											
GDP	369.4	407.4	435.9	456.4	494.1	500.7	537.5	554.7	585.1	609.7	613.9
Fiscal stance	618.1	595.5	635.9	611.6	720.8	688.9	688.6	778.2	810.9	1035.2	952.9
Grenada											
GDP	.....	.....	.....	675.1	708.1	745.9	795.6	850.2	946.7	1021.1	1108.5
Fiscal stance				711.5	749.4	819.4	800.3	1025.3	1059.2	1006.4	965.1
Guyana											
GDP	3319.0	3519.0	3792	4104	4453.0	4676.0	5048	5360	5270.0	5426.0	5590.0
Fiscal stance	7597.1	7260.8	6106.2	5358.6	6861.1	5102.7	6383.8	7600.8	7353.5	7215.5	8811.6
Jamaica											
GDP	.....	44158	72539	95785	142572	197451	233989	254275	268423	287903	320495
Fiscal stance		50488	77642	99261	149055	214952	330910	370902	373824	390168	401243
St. Kitts and Nevis											
GDP	360.1	379.3	418.3	451.0	505.6	524.8	555.8	625.0	652.0	693.3	763.0
Fiscal stance	544.9	612.5	629.6	685.4	775.7	888.8	897.1	1065.1	1065.1	408.8	1592.6
Saint Lucia											
GDP	1122.5	1208.9	1343.0	1343.7	1400.2	1495.8	1542.9	1551.2	1672.6	1823.5	1889.3
Fiscal stance	1189.8	1308.2	1548.4	1792.7	1675.9	1842.8	1949.6	1885.7	1835.6	2143.6	2258.8
St. Vincent & the Gren.											
GDP	534.22	573.7	629.6	644.7	656.8	712.6	751.8	793.1	856.6	890.4	923.4
Fiscal stance	668.4	843.3	948.4	925.7	836.6	947.8	922.1	1179.7	1279.1	1195.5	1225.9

Source: On the basis of official data.

Note: GDP is expressed in millions of national currency units.

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