BALANCE OF PAYMENTS POLICIES AND CARIBBEAN INTEGRATION

by

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1. INTRODUCTION

The case for Caribbean economic integration has in large part rested on an acceptance of the fact that it provided the best opportunity for countries in the region to cope with the constraints to development created by their small size and the extreme openess of their respective economies. The balance of payments crisis experienced by several countries in the region in recent years has been associated with a set of policy initiatives by individual countries which have imposed severe strains on the process of Caribbean integration. The need for an immediate response to a payments crisis creates an environment in which policy makers are frequently forced to sacrifice long term policy objectives. In the context of the CARICOM system, this was revealed in the fact that when particular policy initiatives were undertaken consideration as to the potential impact of these measures on CARICOM partners and the process of Caribbean integration were not matters of primary importance.

It is the purpose of this paper to explore a set of approaches to the administration of external payments by CARICOM countries, which while addressing the short run payments problems likely to be experienced by all, would at the same time help to promote the process of integration. It is recognized that the whole range of macro economic policies will directly or indirectly influence their external payments position. However, the analysis in this paper will be restricted to an examination of issues related to exchange rate policy, nontariff barriers to trade and initiatives in the area of regional payments arrangements. In the next section we turn to a consideration of the issue of objectives of payments policy.

2. OBJECTIVES OF BALANCE OF PAYMENTS POLICY

The traditional theoretical literature on the balance of payments has long recognized that the appropriate state for a country's balance of payments is determined by how far it is consistent with the long term economic goals of the country. The actual administration of instruments of policy frequently involves short term responses to unexpected external and internal occurrences which influence the balance of payments. Accordingly, a great deal of attention was directed towards an identification of the appropriate mix of policy responses in the short run, which would be consistent with the ultimate objective of internal and external balance.

The major long term economic objectives of the CARICOM countries could be summarized as being growth in the levels of employment and income, a greater measure of equity in the distribution of income and increased diversification of their respective economies. Regional integration is seen as being vital to the realization of these objectives. There are, however, a number of unique characteristics of the CARICOM arrangement which complicates the process of identification of the appropriate short term policy responses to payments problems which would be consistent with the long term objectives.

In all of the member countries there is a high degree of concentration in their export sectors, both in terms of products and markets.

There is a very high import content in most major production activities. The common market arrangement has provided an impetus to the import substitution industrialization process in the region. This is reflected in the fact that regional trade consists mainly of finished consumer goods. At the same time, individual country imports from non members has increasingly been concentrated in the areas of raw materials and capital goods. Despite the growth in regional trade, the regional market still absorbs a relatively small portion of total exports of each of the member countries. As a result, extra regional developments remain the primary determinants of the extent to which any of the countries will be successful in working consistently towards their long term development objectives. A recession in a country which is a major market for its exports, unrealized expectations with respect to inflows of investment capital, foreign loans or assistance, would generate such a payments crisis that the restoration of balance in international payments would take precedence over all other objectives of policy. This would result in special efforts to curb imports, which, given the economic structures described would result in lower output and higher levels of unemployment. The common market arrangement would seemingly provide policy makers with the option of dealing with the payments problem generated by the extra regional development at a smaller short run cost in terms of sacrifice of domestic objectives. Given the link between imports and production, the policy thrust would be towards reducing non essential imports, which would mean curving imports from regional partners of consumer goods, while at the same time trying to shore up domestic income and employment by increasing exports to the unrestricted regional market. In effect, this represents a partial shift of the burden of adjustments to regional trading partners.

In a regional economic association, such as CARICOM, consisting of small developing countries all trying to cope with a similar set of development problems, an attempt by any member country to shift part of the burden of adjustment to a trading partner will seriously undermine the viability of the association. Furthermore, the kind of external shock which would provoke the policy responses described, would likely be experienced simultaneously by all countries in the area. Efforts on the part of all countries to expand sales to regional partners and restrict imports would be clearly self defeating.

Individual member countries of CARICOM will periodically be called upon to apply instruments of payments policy to deal with shocks to their international payment position originating from extra regional sources. Given that the deepening of the integration process is accepted as being vital to a realization of the long term development objectives of all CARICOM countries, there is a clear need to avoid application of these instruments in a manner which would be disruptive to the integration process.

3. EXCHANGE RATE POLICY

CARICOM countries have traditionally been reluctant to employ exchange rate adjustment as an instrument of balance of payments policy. The reasons for this reluctance are well documented in the Caribbean literature. In essence, the argument against exchange rate adjustment is that the structures of the economies are such that exchange rate changes cannot result in any permanent realignment of domestic and international prices. Specifically, employing devaluation as an instrument to correct a payments deficit would simply result in an increase in domestic prices. The experience of countries which have devalued would seem to support this position.

The question which must be explored with respect to the role of exchange rate policy concerns whether adopting exchange rate adjustment as an active tool of payments policy is consistent with the long term objectives of payments policy. Associated with this question is the issue of whether what might be called an active exchange rate policy by individual CARICOM countries could be pursued without severely disrupting the process of regional integration.

All CARICOM countries are committed to an outward looking development strategy. Success in this policy direction will be determined by the degree of international price competitiveness of commodities produced in the region. There is a body of opinion, what might be considered the IMF position, that the best way to establish and maintain price competitiveness is to eliminate all those institutional rigidities in the system which weaken the role of the price mechanism in contributing to an efficient allocation of resources. To this extent, it is argued that exchange rate adjustment, or alternatively, greater exchange rate flexibility, has to be incorporated in an outward looking development strategy.

The question as to whether a more market oriented approach to development is appropriate raises a range of issues concerning trade offs between growth and equity. Should short term concerns about equity be put aside in the interest of the overall alleged long term benefits? In the context of the CARICOM countries and indeed for most developing countries, concerns about the short run impact of policy measures on income distribution cannot be ignored. Nevertheless, given an environment in which major countries function on the basis of managed floating exchange rate standards, with developing countries in the main pegging their currencies to one of the major currencies, far more attention will have to be paid to the role which could be played by exchange rate adjustment in securing and maintaining market positions.

If it is the case that individual CARICOM countries will be forced to resort to exchange rate adjustment more frequently as a policy tool, will this introduce a constant element of strain to the process of regional integration. Unilateral exchange rate adjustments, although they might be justified in the particular circumstance, could nevertheless prove disruptive to the integration process, as was the case with the Jamaican action of 1983.

A potential solution to this problem might be found in the establishment of a dual exchange rate system. This would involve a system of fixed rates for intra regional trade while individual countries would be free to adjust exchange rates for trade with non CARICOM countries. It is, however, unlikely that the kinds of developments which would cause a country to consider an adjustment in the exchange rate as being appropriate would be related to factors which influence extra regional trade exclusively. An alternative approach, which would more effectively combine the necessary requirements for flexibility and stability, would be to establish a special unit of account, an artificial corrency unit, as the basis for intra regional settlements.

The system could operate as follows. Inter country claims and payments would be measured in units, which we will call Caribbean Units of Account, CUAs. The CUA would have a value expressed in U.S. dollars, the common intervention currency in the region. The value of the CUA would be a weighted average of the exchange rates of the six monetary units in CARICOM. The weight assigned a particular currency unit could be based on the shares of the individual country, or group, in the case of the ECCM, in regional trade. The advantage of such a system is that it would leave each monetary authority with a great deal of freedom in its management of exchange rates, while at the same time moderating any potentially disruptive effects of its action on its regional trading partners.

The example below will illustrate how this result could be realized. Let us assume that the following weights were assigned in establishing the CUA. The Trinidad and Tobago dollar a weight of 25 percent, the Barbadian, Guyanese and Jamaican dollar would each be assigned a weight of 20 percent, the Eastern Caribbean dollar, 10 percent the Belize dollar 5 persent. The value of the CUA, given the proposed weights would then be determined by the U.S. dollar value of the respective currencies as follows:

$$\begin{aligned} CUA = {} & .25(US\ \$/TT\ \$) + .20(US\ \$/B\ \$) + .20(US\ \$/G\ \$) \\ & + .20(US\ \$/J\ \$) + .10(US\ \$/EC\ \$) + .05(US\ \$/Bel\ \$) \end{aligned} \tag{1}$$

Using 1983 exchange rates[1]

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[1] The rates were Trinidad 41.7 cents, Barbados 50 cents, Guyana 33.3 cents, Jamaica 33.3 cents, East Caribbean 37 cents and Belize 50 cents.

$$CUA = .25(.417) + .20(.50) + .20(.333) + .20(.333)$$
$$+ .10(.370) + .50(.50)$$
$$= 39.92 \text{ cents U.S.} \tag{2}$$

In terms of regional currencies a CUA would have the national currency equivalents set out in Table 1, column 1.

Table 1

Value of the CUA in Regional Currencies

$	(1) Initial Value	(2) After Jamaican Devaluation	% Change
Trinidad/Tobago	.957	.918	- 4.1
Barbados	.798	.765	- 4.1
Belize	.798	.765	- 4.1
Guyana	1.20	1.15	- 4.2
ECCM	1.08	1.03	- 4.6
Jamaica	1.20	1.53	+27.5

Let us now assume that Jamaica devalued its currency by one third leading to a rate of 25 cents US per dollar. Given the weights, the value of the CUA would decline to 38.26 cents US and the value of the CUA in regional currencies would be as indicated in column 2 of Table 1. The Jamaican dollar would have depreciated by 27.5 percent against the CUA while the five other currencies would have appreciated between 4.0 and 4.6 percent. Since all regional claims would be in CUAs the impact of the Jamaican devaluation would have had a rather mild impact on the other monetary authorities in making regional settlements.

Apart from the issue of the potential disruptive effects of a devaluation on regional settlements there is the further question of whether the country which devalues will gain on unfair competitive advantage in the regional trading system. This is particularly important in light of the similarity in the range of products produced in the various member countries. Given that the Jamaican dollar had depreciated by 27.5 percent against the CUA, this would mean that on average the Jamaican dollar price of imports from her regional trading partners would rise by 27.5 percent. This might lead to the conclusion that there would be a significant reduction in the share of the Jamaican market held by regional producers, as Jamaican produced goods would increasingly replace their products in that country's market. The change in the value of the Jamaican dollar relative to the CUA, overstates the extent to which regional producers would be at a disadvantage. Reference was made earlier to the high import content in products produced by all the member countries. In Jamaica, imports of raw materials and capital goods have amounted to a minimum of one third of the value of Gross Domestic Product for several years. The 33 percent devaluation would then raise the cost of production by a minimum of 11 percent. The differential between the prices of imported products and those of Jamaican substitutes after the devaluation would be a maximum of 16.5 percent.

In Table 2, below, we have set out what would be the impact on prices of Jamaican exports in the currencies of the five currency areas. We have assumed that the Jamaican dollar prices would be adjusted to reflect the increased cost of production arising from the impact of the devaluation on inputs imported from third countries. Given our assumption concerning the share of imported inputs in production, the post devaluation Jamaican dollar price of Jamaican exports would rise by at least 11 percent. As is indicated in the table, the devaluation would cause a maximum average decline in the regional currency price of Jamaican exports of approximately 13 percent.

A similar devaluation, in the absence of an artificial unit of account, would have raised the Jamaican dollar price of imports from the region by 22 percent and the regional currency prices of Jamaican exports would decline by approximately 17 percent. The post devaluation relative price differentials would be, approximately, 25 percent less with the use of an artificial unit of account.

Table 2

Impact of a Devaluation on Prices of Jamaican Exports in Regional Currencies[1]

$	Pre Devaluation[2] Price	Post Devaluation[3] Price	% Change
Trinidad/Tobago	95.7	83.4	-12.9
Barbados	79.8	69.5	-12.9
Belize	79.8	69.5	-12.9
Guyana	120.0	104.5	-12.9
ECCM	108.0	94.1	-12.9

[1] Based on a pre and post devaluation values of 1 CUA in J $.

[2] Pre devaluation export unit price J $120.

[3] Post devaluation export unit price J $133.2.

There is also the important consideration for a regional grouping with respect to how such a policy initiative would influence the relative position of the country's trading partners in its home market, as opposed to non member countries. The use of an artificial currency unit for regional trade would in this instance enhance the competitive position of the country's trading partners. In our example the price of Jamaican imports from extra CARICOM sources would rise by one third. The price of imports from CARICOM would rise by 16.5 percent.

In summary, the use of an artificial unit of account for intra regional settlements would establish a framework within which exchange rate adjustment by any individual country would be less disruptive. At the same time any such changes by a country would leave its regional partners in a preferred position.

4. NON TARIFF TRADE BARRIERS

The payments crisis experienced by many of the member countries in recent years have placed policy makers in a position where they have been forced to place emphasis on ensuring that scarce foreign exchange is used in the most productive way. Consequently, there has been an intensification in the use of non tariff barriers to limit the use of foreign exchange for what might be deemed non essential purposes. This has caused a slow down in growth of regional trade. The reason for this is that regional products, given the stage of industrial development in the area consists of many items, which would fall in the non essential category. There also exists a considerable degree of duplication in production. Consequently, although the regional market has been important in contributing to the growth in production of a wider range of manufactured products, in a period of economic crisis governments will feel obligated to restrict trade in these items, as in the short run, they will be viewed as least likely to damage the development effort.

The long term solution to the problem has been correctly identified as being found in the promotion of regional industrial programming.

This would result in a greater range of products produced in the region which would fall into the basic or essential category and which would also be highly cost competitive. This would then mean that in a period in which action had to be taken to adjust the balance of payments, the adjustment costs would fall less heavily on regional trading partners.

There still remains the question of whether there are any short term initiatives which might be taken to reduce the incidence of such restructions on regional trade. One approach, which was recommended by the committee which recently reviewed the workings of CARICOM, would involve classifying regional products into two groups. In one group would be products which were produced using raw materials entirely of regional origin. In addition specific items could be designated as being high priority. It was then proposed that individual countries should surrender the right to impose restrictions on trade in these items to the Common Market Council. In the case of all other products, it was suggested that countries in imposing restrictions should provide more favourable treatment to CARICOM as against third countries.

Although this approach appears to be basically sound, the identification of products as being basic or essential and the application of restrictions on certain items is frequently influenced by the availability of credit. The resolution to the problem will have to be found in changes in the system of regional settlements which would result in the establishment of a workable credit system in support of regional trade.

5. REGIONAL PAYMENTS ARRANGEMENTS

The high import content in products produced in the region and the fact that the major portion of intra regional trade is in end products has resulted in regional trade expansion creating a range of payments problem similar to that which would be associated with a deepening of the import substitution process. As long as member countries earnings of foreign exchange from extra regional sources grows, there will be no problems associated with regional settlements. However, when there is a decline in foreign exchange earnings from extra regional sources an attempt to expand trade within the region, even on a balanced basis, will create problems similar to those which would be encountered in an attempt to deepen the process of import substitution in the same circumstances.

In 1983, Jamaica, one of the CARICOM countries experiencing very severe payments problems, exported products to its regional trading partners with a value of US $74.1 million and imported products from the region with a value of US $57.3 million. In conventional balance of payments analysis the surplus of US $16.9 million on regional trade would be thought of as making a positive contribution to the country's global payments position. However, if one were to make the not unreasonable assumption that one third of the unit price of exports repreented foreign exchange outlays to non CARICOM countries for material inputs, then a more accurate representation of the countrys regional balance would be net export earnings, US $49.4 million, import purchases US $57.3 million resulting in a deficit of US $7.9 million.

Prior to the breakdown of the Caribbean Multilateral Clearance Facility, regional payments were settled multilaterally on a semi annual basis. In a period when sales to extra CARICOM markets are declining that system of settlements creates additional foreign exchange cash flow problems for the regional Central Banks. The nature of this problem can be explained using the information provided above on Jamaican regional trade. Let us assume, for simplicity, that Jamaican regional exports and imports were evenly distributed over the course of the year. Furthermore, we will assume that Jamaican exporters would have operated with suppliers credits covering imported raw materials and equipment and would normally be required to make payments at the time of sales. Given our assumption concerning export flows and the import content in production, the Bank of Jamaica would be faced with monthly requests by exporters for US $2 million, approximately, based on sales of US $6 million, to satisfy supplier credits. However, the CARICOM Multilateral Clearance Facility provided for semi annual settlements so that the Bank would then be faced with the problem of securing bridging finances. If, on the other hand, payments were settled on a bilateral cash basis, there would be, in terms of this example, gross monthly inflow of US $6 millions and outflows of US $5 million, approximately, to pay for imports from regional partners. The US $1 million balance would then offset approximately 50 percent of required payments to extra regional suppliers of inputs used in products sold on the regional market. There would then be a proportionate reduction in required bridging finance and the costs associated with that financing.

The basic underlying cause of the payments problems in CARICOM rests in the underlying structural features of production in the various number countries. At the same time, there is no doubt but that a regional payments arrangement, which facilitates settlements on a multilateral basis and the use of local currencies in regional trade, is essential to the orderly development of the regional integration process. It is then necessary to consider the sort of initiatives which might be taken which will address more directly the kinds of payments problems likely to be faced by the member countries and will help restore an orderly system of multilateral settlements.

In 1976 it was agreed that an interim mutual balance of payments support facility should be established as a first step in the direction of a permanent institutional arrangement. The facility never functioned on a multilateral basis and the goal of a permanent balance of payments support facility was considered by the experts who recently reviewed the operations of the community as not being feasible in the short term. The conventional approach to such an arrangement in a regional economic association involves the extension of credit to partners and some pooling of reserves. In light of the crisis situation of the past few years it is easy to understand the position taken by the review group.

The current crisis calls for some regional initiative. As a first priority consideration should be given to what could be done to create an environment for unrestricted regional trade. It is argued here that the appropriate approach would be to work towards the establishment of an independently funded facility, which would be able to provide countries who are in debtor positions with their regional trading partners with intermediate term credit. This facility would be structured to function in such a fashion that credit balances with the facility would always be liquid. This agency would be able to function on the basis of a combination of subscriptions from the major donor countries to the regions, as well as, guarantees, of its liabilities. The management by the agency of a pool of funds provided externally, would avoid the shortcomings of the traditionally structured support arrangements, where individual members are expected to support each other.

Support provided by this Agency could not be unconditional. One of the major functions of the Agency would be to further the process of consultation and co-ordination of policies within the region. This would involve a close monitoring of the administration of policies and the economic performance of the various member status. Although, in its initial phase, this Agency would be geared towards providing the kind of support, which would discourage member countries from imposing restrictions on regional trading partners, it is recognized that the real base of the problem is the difficulty experienced by many in making the structural adjustments necessary to copy with the global situation. Accordingly, the conditions attached to providing support would be associated with recommendations for policy changes geared toward easing the structural adjustment.

It is recognized that the level of funding likely to be available to such an Agency would still leave those members countries with the most severe payments problems in a position where they would be obliged to seek support from institutions, such as the IMF. Nevertheless, the establishment of this Agency with its major concerns with the identification for policy initiatives to ease the process of structural adjustment, could help countries in their dealings with such external agencies.

The following is a suggested framework for the operations of the Agency. The Agency would administer regional settlements on a multilateral basis. Reference was made earlier to the special foreign exchange cash flow management problems associated with regional trade. Consequently, given the likely continuation for some time of a relatively sluggish overall export performance by these countries, it might be appropriate to establish relatively short settlement periods. A system of quarterly settlements should be established initially. Given that this Agency would be independently funded, countries with credit balances would normally receive payments in full. At the same time, given the assured liquidity of their credit balances, countries could be encouraged to maintain a part of their credit balances with the Agency. Interest would be paid on these balances.

Countries in a deficit position at the time of settlement would normally be required to make a minimum payment of 25 percent of their debit balances. In a situation where a country was in a deficit position over two or more settlement periods, the 25 percent payment would apply to the cumulative balance.

The position taken here is that if such an Agency is to perform its functions properly in what is clearly a highly unstable global environment, it should be able to be highly flexible in its dealings with individual debtor countries. This requires that there should not be specified credit limits for the six monetary authorities in the area. The governing board of the Agency would at its discretion determine the level of indebtedness permitted any of the monetary authorities and would establish terms for repayment on the basis of an assessment of the particular circumstances.

The long term objective should be to have the Agency established to play a major role in providing financial support and policy advice in helping countries cope with global balance of payments problems. Member countries would eventually be expected to contribute to its resources. The realization of this objective would place member countries in a position where they would have to place less reliance on the IMF, when experiencing payments problems. This would mean that, increasingly, countries requiring payments support would have to satisfy CARICOM, as opposed to IMF, conditionalities, which would more likely be consistent with their development goals.

6. CONCLUSIONS

The severity of the payments crisis in CARICOM underscores the need for a co-ordinated regional approach to the administration of payments policies, if the long run benefits expected from regional integration are to be realized. In this paper, initiatives in the area of exchange rate policy, the use of non tariff barriers, and payments arrangements were explored. In the final analysis, the state of the balance of payments and the degree of success achieved in overcoming the payments constraint will, ultimately, be determined by the overall effectiveness of economic management.

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