REALIZING A CARIBBEAN MONETARY UNION

ANDRÉ BALADI[1]

ABSTRACT

This paper discusses the implications a Caribbean monetary union will have on regional monetary policy, fiscal policy, and trade and growth before suggesting a number of policy options that will facilitate the required convergence amongst CARICOM members in creating a successful monetary union. It emphasizes the need for adjusting and enhancing the convergence criteria, establishing ex ante a set of fiscal rules with credible sanctions against non-conformers, and giving greater independence to central banks. Ultimately it recognizes that a monetary union will never be realized until there exists the requisite political commitment that binds members not only monetarily, but fiscally also.

JEL Classification Numbers: E52, E58, E61, E62, F36, H87

Keywords: Monetary Union, CARICOM, Convergence Criteria, Fiscal Policy, Monetary Policy, Central Bank Independence.

---

1 Senior Economist in the Research Department of the Bank of Guyana, and Overseas Development Institute (ODI) Fellow. The author is thankful for the comments received from participants at the Caribbean Centre for Monetary Studies 38th Annual Conference (at which a draft of this paper was presented) and staff at the Bank of Guyana. The views are the author's alone and should not be interpreted as those of the Bank of Guyana or ODI.

1.0 Introduction

The initial move towards monetary union within the Caribbean Community (CARICOM) began in 1990 when the Governors of CARICOM central banks were mandated by heads of state to undertake a study into the feasibility of such a union. A flurry of research by leading economists, drawn from the region and beyond, culminated in a report by the Governors in 1992 proposing how the region should move towards Caribbean monetary union (CMU). The report envisaged that CMU would include all members of CARICOM[2] and recommended that a fully operational common currency be in place by the year 2000.

With 2000 long gone, this paper assesses how far the region has to go in realizing this goal. More importantly, from a region-wide perspective, it seeks to establish what actions need to be taken for CARICOM to realistically establish a viable and sustainable monetary union. This presentation will, however, *not* cover the theoretical advantages and disadvantages of forming a currency union,[3] nor the issue of whether CARICOM should move in this direction. To the extent that the region is serious about establishing CMU, efforts should instead focus on investigating *how* this can be achieved.

The establishment of a monetary union is not without controversy. By compatible member countries adopting a single currency between them they anticipate a level of fiscal and monetary performance that is superior to one in which each country functions individually. In theory, this will enhance the economic performance of member countries and, therefore, that of the union as a whole. As countries within the union establish greater economic credibility so too does their common currency, which in turn facilitates a stronger position on international trade and capital markets. However, in order to achieve this, potential member countries must first meet a set of often stringent criteria designed to

---

2 This included the Bahamas, Barbados, Belize, the ECCU (Antigua and Barbuda, Dominica, Grenada, Montserrat, St.Kitts and Nevis, St.Lucia, and St.Vincent and the Grenadines), Guyana, Jamaica, and Trinidad and Tobago. Suriname and Haiti joined in 1995 and 1999, respectively, but today only Suriname is being considered for CMU.

3 For a discussion of these see Farrell (1994) and Worrell (2003).

ensure they all converge towards common macroeconomic positions. For many this will require the equivalent of putting on a fiscal and monetary straightjacket which may do little to enhance the socio-economic status of their citizens and is likely to be politically unpopular. Furthermore, a stronger currency *vis a vis* those of their trade partners may reduce the competitiveness of member countries exported goods.

In light of this, the paper is organized as follows: Section II provides a background to CMU by discussing its implications for the monetary and fiscal policies of member countries, as well as the trade and growth prospects of the region. Section III focuses on what actions need to be taken by Caribbean policymakers to achieve a viable and sustainable monetary union. Section IV concludes by summarizing the main findings of the paper and provides suggestions for further research.

2.0 Background

2.1 Implications of Forming a Monetary Union

To put the convergence criteria in context, an appreciation of the implications, once such a union has been formed, is required. There are, of course, a myriad of implications, but this study will focus on three of the larger issues: monetary policy; fiscal policy; and trade and growth.

2.2 Implications for Monetary Policy

CMU will require each member to replace its domestic currency with a regional one – the Caribbean Dollar – and forfeit the seigniorage revenues generated from printing its own money.[4] Furthermore, monetary policy must be surrendered to a regional central bank - the Caribbean Monetary Authority (CMA), and foreign exchange reserves will be pooled, as will decision-making on their utilisation. Individual countries

4 Though this would be partly offset by the sharing of seigniorage revenues by the CMA.

will be confronted with a monetary policy that no longer serves purely their own needs but those of the region as a whole. This could be potentially debilitating for some members, as has been the case for Germany and France under the European Monetary Union (EMU). However, Williams *et. al.,* (2001) have shown that countries in an already established monetary union within CARICOM – the Eastern Caribbean Currency Union (ECCU) – have achieved greater balance of payments protection from the pooling of reserves than the West African CFA Franc zone[5] countries.[6]

The transmission mechanisms of monetary policy in member states vary because of different financial depths, maturity structures of debt, legal structures, and alternative financing on capital markets. This is an important consideration since the response to monetary policy steps taken by the CMA will also vary. Furthermore, the uncertainty that the economic environment would have changed once the monetary mechanisms have impacted on their target variables is compounded by the fact that economic agents in the Caribbean do not respond to changes in interest rates as much as they do in more advanced economies. For example, Worrell (2000) found that investment expenditure in the Caribbean is more elastic to interest rate changes than consumption expenditure. This will have implications for the sustainable expansionary path of CARICOM economies.[7]

---

5 The "Communauté Financière Africaine" monetary union between members of the Central African Economic and Monetary Union (Cameroon, Chad, Congo, Central African Republic, Equatorial Guinea, and Gabon) and some members of the Economic Community of West African States (ECOWAS – Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, and Togo). The other members (The Gambia, Ghana, Guinea, Liberia, Nigeria, and Sierra Leone) have declared their intention to join the CFA Franc zone, except for euro-pegged Cape Verde.

6 Unanticipated changes in the terms of trade lowered reserves in the CFA relative to the ECCU, which may reflect a greater reliance on primary commodities in the CFA compared with services in the ECCU.

7 Since a significant increase in the interest rate will result in a larger proportional fall in investment.

2.3 Implications for Fiscal Policy

A well functioning monetary union requires all members to be aware of the spillover effects of their national policies, especially budgetary ones. The fiscal position of most CARICOM members has deteriorated in recent years due to sharp increases in expenditure rather than a fall in revenues (Sahay, 2005). Expansionary fiscal policies put pressure on inflation and require an adjustment in monetary policy. Kufa *et. al.,* (2003) also suggest that being part of a monetary union may have attenuated the deterioration of the ECCU's fiscal position. Since the deterioration was not followed by exchange rate depreciation, higher interest rates or inflation, members had little incentive for fiscal discipline.

Governments must make a commitment to avoid excessive public sector deficits and ensure that their fiscal policies do not contradict an effective, externally executed, monetary policy. This will bring about a harmonization of fiscal policy within the union, requiring structural changes in the composition of expenditure and the coordination of taxes. For example, Guyana's spending on education is 3% of GDP per capita per student, compared to Jamaica's 116% (Mishra, 2006). Tax harmonization has gathered significant attention in recent years, in particular to overcome tax competition and fiscal erosion (especially with the advent of the Caribbean Single Market and Economy (CSME) and its subsequent liberalization of human and capital resources). Some success has been achieved in areas such as double taxation and a harmonized corporate tax structure, and a common Investment Code and a Financial Services Act have been drafted by the CARICOM Secretariat.

2.4 Implications for Trade and Growth

The Common External Tariff (CET) has encouraged growth in intra-regional trade, and it is hoped that a single currency will further enhance this (as transaction costs and exchange rate uncertainties are eliminated between members) and, consequently, growth also.[8] However, intra-regional trade within CARICOM is estimated at only 8-10% of total trade,[9] compared with 60% in the EU. This limits the intra-regional trade benefits of forming CMU since the largest potential gains will be realised in their trade with *extra-regional* trading partners, acting to divert trade *away* from intra-regional partners.

Rose and van Wincoop (2001) estimated that the reduction in transaction costs due to EMU offset the losses from surrendering monetary independence to an external authority. The boost in trade from monetary union ranges from Baldwin's (2006) best estimate of 9% (with regard to the euro-area) to Rose's (2000) extravagant estimate of 235% (with reference to a much wider survey of mostly developing countries). Baldwin (2006) also acknowledges that EMU's control group[10] provides a unique opportunity to analyze the impact of currency unions. He found no evidence of trade diversion away from the three non-member; indeed their trade with the euro-area had increased by almost as much as that of the euro-founding members. Regarding the Caribbean, Egoume-Bossogo and Chandima (2002) found CARICOM membership had a positive impact on bilateral intra-regional trade, suggesting that further integration would allow the region to realize its full intra-trade, and therefore its growth, potential.[11] However, they also found that while the ECCU has not constrained trade among the larger member countries in CARICOM, the ECCU is not internally trade creating.

---

8 Unlike in the EMU, the primary motive of CMU is to impose monetary and fiscal credibility on its members. Enhancing trade is only a secondary consideration.

9 Williams (2006) suggests that this would be more in the region of 3-5% if intra-regional oil exports are excluded.

10 The three countries that did not join in 1999 – Denmark, Sweden and the UK.

11 However, it should also be noted that CARICOM's trade with the rest of the world has also risen, fuelled notably by the trade-diverting impact of reductions in the CET, arrangements and despite the negative impact of the declining preferential access to EU markets for some commodities.

Worrell (2003) observes that CARICOM countries have been able to maintain stable, low inflation with sustained growth only when exchange rates are pegged to the US dollar.[12] Furthermore, multiple studies have shown that exchange rate flexibility is inappropriate for small open economies and that a pegged exchange rate might be advantageous (IMF (1997); Eichengreen *et. al.,* (1998); and Dornbusch (2001). Straughn (2003), for example, found that exchange rate variability is prohibitive to trade between some CARICOM countries. It should, however, also be recognized that a fixed exchange rate regime can encourage fiscal profligacy. Tornell and Velasco (2000) argue that a fixed exchange rate may provide less discipline for policy makers than a flexible one because countries can run expansionary policies for a longer period before macroeconomic variables indicate an exchange rate adjustment is necessary, and being in a monetary union can exacerbate this as foreign exchange reserves are pooled. In this regard, Duttagupta and Tolosa (2006) found that Caribbean countries with fixed pegs and in currency unions demonstrate greater "free-riding" behaviour than those with flexible regimes.

As a result, the Caribbean dollar will be pegged to the US dollar[13] at a rate of 1:1 for a transitional period, after which it will float freely. Initially, pegging to the US dollar will provide credibility to the new monetary regime as CARICOM countries will essentially be forced to import the monetary and fiscal stability of the US. In the longer run, a flexible regime will overcome temptations by members to "free-ride"

12 This is because changes in the exchange rates of small, very open economies do not result in switches in expenditure towards the production for export and the consumption of import substitutes, rendering the nominal exchange rate ineffective as a shock absorber or adjustment policy.

13 While Rose's (2000) research tying trade growth to colonial relationships suggests CARICOM might consider pegging its currency to sterling or the euro, Caribbean foreign transactions are overwhelmingly denominated in US$, its tourism industry is priced in US$, 50% or more of non-tourism based extra-regional export income is in US$, and about 60% of the region's trade is with the US. Furthermore, changes in the US$ value of sterling and the euro have relatively little impact, and no other currency is of significant importance to the region (Worrell, 2003).

via fiscal profligacy. Members with flexible regimes[14] will have to make long-term commitments to the fiscal and structural adjustments required in switching to a fixed regime. Some appear reluctant, even when the alternatives are severe penalties in terms of high interest rates, an uncertain investment climate and low growth potential (Worrell, 2003). An asymmetric incentive problem may also develop whereby countries without relative fiscal and monetary credibility will be keen to join the CMU, but those with such credibility will not. This dilemma is presently faced by the relatively fiscally prudent and pegged economies of the Bahamas, Barbados, Belize and the ECCU.

2.4.1 Convergence Criteria

Considering these implications, a set of criteria was established which member countries must satisfy before joining CMU. These state that member countries must adhere to the following:

1. Hold external reserves equal to at least 3 months of imports for at least 1 year.

2. Maintain a stable exchange rate for at least 3 years (i.e. the exchange rate is not to fluctuate by more than 1.5% during the 3 years prior to monetary union).

3. Have external debt service obligations of no more than 15% of exports.

4. Contain fiscal deficits below 3% of GDP.

5. In the year prior to monetary union, have an inflation rate within 1.5% of the median of the 3 countries with the lowest (but positive) rates.

14 Guyana, Jamaica, Suriname, and Trinidad and Tobago.

However, to date none of the CARICOM countries satisfy all the criteria. Trinidad and Tobago comes closest, having satisfied four out of the five. The Bahamas and the ECCU area presently meet three of the five, but the Bahamas has no interest in CMU since its currency is already pegged 1:1 to the US dollar. Barbados and Guyana lag behind, meeting only two of the five criteria, and Belize and Jamaica are furthest behind, satisfying just one. This suggests that, to the extent the convergence criteria reflect CARICOM's readiness to form a monetary union, it is still a long way from realizing its goal.

3.0 Policy Recommendations

Before addressing the question of what needs to be done to reach the goal of CMU, it may be informative to consider whether CARICOM members should in fact wait for convergence on the criteria before establishing a single currency *or* establish a single currency to leverage the attainment of macroeconomic convergence between members. After all, CMU entry per se may provide substantial impetus for trade expansion, which may in turn result in countries satisfying the convergence criteria ex post rather than ex ante (Frankel and Rose, 1997).

In attempting to answer this question, it may be constructive to consider some of the research conducted into Optimum Currency Areas (OCA).[15] Anthony and Hallett (2000) have argued that while CARICOM countries do not satisfy the traditional OCA criteria, the establishment of the monetary union itself might create those convergent OCA conditions in the future. This is because CMU will encourage more trade among members as they take advantage of lower transaction costs and the

15 As advocated by the pioneering research into monetary integration by Mundell (1961). He recognized that the formation of a currency union would generate a positive outcome if the countries concerned displayed the following characteristics, or OCA properties: 1. Economic openness and strong trade between members; 2. Similar economic structures and susceptibility towards similar shocks and preferences; 3. A good degree of factor mobility and wage and price flexibility; 4. The existence of a system of fiscal transfers between members as a substitute.

elimination of exchange rate uncertainties, and as trade increases the structural divergences between members will reduce. Consequently, it could be presumed that CMU members would experience convergence in their monetary and fiscal positions.

However, empirical evidence suggests that this is unlikely to occur. Frankel and Rose (1997) found that OCA conditions could be experienced only if members of a currency union engage in *intra-industry* trade, which usually only occurs in manufactured goods in large (broad-based) economies. If CARICOM countries do take advantage of economies of scale that result from the CSME, it is likely to increase *inter-industry* trade between members as they are too small and un-diversified to create any other pattern of trade. Evidence from the CFA Franc zone found that forming a currency union did bring about price, monetary and fiscal stability, but this only served to give CFA countries access to cheaper capital and development assistance, and did not lead to greater regional trade and growth (Frankel and Rose, 1997). Moreover, Anthony and Hallett (2000) assert that more inter-industry trade will encourage specialization, which will lead to less economic convergence, not more, and make CARICOM countries more vulnerable to asymmetric shocks, not less.

Nevertheless, the introduction of the CSME in January 2006 is testimony to the desire of the region to more fully integrate. As in Europe, the establishment of an economic union was considered a prerequisite for forming a monetary union. Likewise, CARICOM must first exhibit a sustained period of economic integration before moving too quickly towards CMU, and in this regard it may be prudent to give this process more time so that a clear assessment can be made of the CSME's impact. Moreover, while the CSME promotes economic *cooperation,* the region must demonstrate more economic *harmonization* between members if it is to achieve a strong and sustainable monetary union.

To do this, and in light of the evidence pointing to the need for CARICOM members to convergence on the criteria before establishing a single currency, the remainder of this section will discuss a number of options open to policymakers. The objective here is not simply to provide a menu of budgetary adjustments that will ensure member countries merely meet the convergence criteria, but to propose a number of actions that will facilitate the creation of the necessary economic and political environment conducive to the transition towards sustainable convergence among members.

3.1 Changes to Existing Convergence Criteria and Additions to them

While most of the convergence criteria are appropriate in facilitating the move towards CMU, some enhancements could be made to ensure the criteria are met and maintained. Firstly, the requirements on foreign reserves and exchange rate stability will ensure some monetary and fiscal convergence, but the proviso that these reserves be held for just one year may not be sufficient to keep exchange rates stable for three years. Countries should demonstrate a good track record of ensuring that their foreign reserves adequately meet the import demands of their population otherwise they will face a deteriorating debt situation. It is recommended that the time period on this criterion be extended to holding sufficient reserves for 3 years prior to entry into the currency union.

Secondly, many of the convergence criteria follow those established under EMU.[16] The extent to which the small, open and essentially still developing countries of CARICOM can emulate the conditions placed on more developed countries is questionable and may ultimately prevent any member ever achieving all the criteria. For example, Appendix 1 shows that the average fiscal deficit across the region over the period 1991-2005 was 3.1%, suggesting that the criterion set for this is representative of the region's experience. However, this figure is offset by the fiscal surplus that oil-rich Trinidad and Tobago enjoys. Taking this country out of the equation gives an average fiscal deficit of 3.6%, and when looking at 2000-2005 the average deficit is 5%. It may therefore be appropriate to re-set this criterion to a more realistic interim target of 4%, with a binding agreement that commits members to reduce it to 3% within two to three years after having formed CMU.

Appendix 1 also highlights that the convergence criteria could be tightened up with respect to the criterion on import ratios (increasing it

16 Such as the criteria on fiscal deficits, price stability and exchange rate stability.

to 4 months) and the debt service ratios (reducing it to 13%). Moreover, given the region's exposure to varied shocks which have asymmetric impacts, there may be a need to base the convergence criteria on target bands instead of specific values.

Further to the aforesaid adjustments, the following additional criteria should be introduced to better prepare members for CMU and to enhance the stability and sustainability of the union once formed:

3.2 Limits to Public Sector (Gross) Debt

This is crucial to the establishment and sustainability of CMU. As public debts rise, countries increasingly borrow on capital markets, causing interest rates to rise. This raises the debt burden for other members and also adversely affects investment and economic activity. An unsustainable debt ratio also poses the threat of default. If bonds of a defaulting country are widely distributed among members in the union[17] then these countries face pressure to bail out the defaulter to avoid disruption and contagion in the financial system. Therefore, focusing purely on external debt ratios does not necessarily give an indication of the underlying fiscal difficulties faced by a member since external debt may be unsustainably high even if debt service ratios remain within 15% of exports. Furthermore, domestic debt levels may also be significant and stabilizing a country's debt ratio is not sufficient to achieve a sustainable debt level. It will only become sustainable when future primary balances are sufficient to meet the service obligations on existing *and* future debt (Kufa *et. al.*, 2003).

In 2003, fourteen of the fifteen Caribbean countries ranked in the world's top thirty indebted emerging markets (Sahay, 2005). Reducing their stock of debt is crucial to the region's development. Ironically, the ECCU area fails to meet the debt service ratio criterion because it has done just this – from 2004 to 2005 its debt service ratio rose from 33.1% to 42.7%, but as a result its debt stock fell by 8.2%. Since debt levels

---

17 Or, as in the case of the Caribbean, where a high percentage of commercial banks' assets are held in the form of government liabilities, as will be addressed later in the paper.

vary widely across the region, introducing this criterion would certainly be controversial,[18] but Pattillo *et. al.,* (2002) found that external public debt may begin to have an adverse impact on economic growth when it reaches about 40% of GDP,[19] and most CARICOM members exceed this.

While EMU adopted this criterion (no more than 60% of GDP, or a declining trend if greater), several members have since exceeded the limit (for example, Greece's ratio exceeds 100%). Debt ratios within CARICOM in 2005 ran between 8.9% (Trinidad and Tobago) and 139.6% (Guyana) of GDP. Some countries have been successful in bringing their ratios down (such as Trinidad and Tobago), while others, such as Belize, have had the opposite experience. Appendix 1 shows that the average debt-to-GDP ratio for the region over the period 1991-2005 was 63%, and over the period 2000-2005 it averaged 55%. This suggests that setting a limit similar to that adopted by EMU (with commitments to lower the ratio over a period of time for those unable to meet this criterion) would be appropriate.

3.3 Interest Rate Convergence

The lack of financial depth in CARICOM suggests that members are not as sensitive to interest rate changes as more developed economies, making this a highly controversial recommendation. This criterion is likely to be unpopular because interest rate variance between members reflects structural differences, a variety of monetary regimes and lack of capital mobility. However, it will be harder for members to converge when interest rates vary widely within the region.[20] Furthermore,

18 And some members may resent the special treatment Guyana receives, having qualified for HIPC debt relief.

19 This is because high debt will either crowd-out private investment or create expectations that future debt-service obligations will be met by increases in taxes and a reduction of public investment.

20 Since high interest rates attract capital away from members with lower rates, and discourage investment in member countries with high interest rates in favour of those with low rates.

the interest rate would be the same among all members once CMU is implemented and members need to give themselves sufficient time to adjust to this. In this regard, harmonizing monetary regimes (see central bank coordination below) may assist in making this a viable additional convergence criterion.

In 2005 interest rates within CARICOM ran between 2.6% (Guyana) and 8.6% (Suriname). Appendix 1 shows that over the period 1991-2005 the ECCU area, Barbados and Bahamas have consistently had the lowest rates in the region, and Jamaica and Suriname have had the highest. The much higher interest rates in the latter two countries pulls the period average up to 8.2%, which is likely to be prohibitive to encouraging investment.[21] However, there has been a downward trend in interest rates across the region in recent years (with the average over the 2000-2005 period being 5.9%) which suggests that the rate could be comparable to those in developed markets. As such, establishing a criterion that encourages the attainment of an interest rate that more closely matches the average of the three members with the lowest rate (as is the case for joining the euro) should be introduced.

3.3.1 Establishing Sanctions to Discourage Profligacy

With the surrender of monetary policy to the CMA, the only instrument national governments will have at their disposal for influencing macroeconomic stability and growth is fiscal policy. ‘Fiscal smoothing’ may therefore be a temptation (indeed, even a necessity) for national governments to pursue. However, it is vital to ensure that fiscal policy instruments are consistent with a stable monetary environment and potential member countries must make the necessary adjustments to meet the convergence criteria by harmonizing fiscal policies. As mentioned above, there has been some success in achieving this in areas such as double taxation.

Fiscal profligacy not only affects public debt levels and the consequent problems mentioned above, but in CARICOM it also has implications for the stability of the financial system since commercial

---

21 Although it would certainly attract “hot” money.

banks' domestic claims on the government typically represent a significant percentage of their total domestic assets (Jahjah, 2001). Moreover, under CMU a fiscal crisis in one country will force an easing of monetary policy, therefore endangering price stability in the whole union. In sum, fiscal negligence on the part of even one member erodes the stability such a union is supposed to bring, as other members become vulnerable to the quick spread of crises. Furthermore, not only can running high fiscal deficits cause macroeconomic instability, but they it also represents an opportunity cost in terms of growth potential. Gupta *et. al.,* (2002) provide empirical evidence showing the benefit to economic growth when fiscal deficits are reduced. They found that a 1% reduction in the fiscal deficit to GDP ratio can lead to an average increase in per capita growth of 0.25-0.5% as the overall composition of public expenditure shifts towards more productive uses.

Crucially important for the transition towards CMU is to prevent a "weighing-in" effect whereby countries impose excessively restrictive and artificial measures to meet the convergence criteria only to loosen them afterwards, thus causing a 'boom-bust' cycle. Therefore, potential CMU members must not only be encouraged to reach but, more importantly, *maintain* the fiscal rules set in the convergence criteria. The EU has had problems preventing some member countries exceeding the 3% of GDP rule for fiscal deficits (for example, Portugal's is currently above 4%), and the 60% of GDP rule for total debt (for example, Italy's is more than 100%). Since it is not viable for member countries to pull out of a monetary union (although public opinion in Germany supports this), solutions need to be provided to get member countries 'back on track.'

The likes of Bredenkamp and Deppler (1990), Begg *et. al.,* (1991) and Dornbusch (1997) argue that fiscal constraints are not necessary or even desirable since private financial markets will impose the necessary discipline, as reflected in the differences in the cost of borrowing to states on the basis of their fiscal positions. However, the discipline that financial markets might impose is less relevant to the developing countries of the Caribbean because member states are small, financial markets are not well developed or integrated, an active secondary market in government debt does not exist, and there is limited availability of external finance for (some) members. Creating a regional securities market (as has recently been proposed) could contribute to improving efficiency in the market for debt, resulting in different interest rates based on fiscal performance. But it could also lead to excessive government debt issuance throughout the region and ultimately intensify fiscal deterioration and enhance negative externalities among members.

Collier (1991) argues that the regional monetary authority provides an "agency of restraint" over macroeconomic policies generally. This is likely to be more effective if there is some external link, for example, an external currency peg. However, there is debate over the effectiveness (and willingness) of this external agency of restraint, as Guillaume and Stasavage (2000) argue has been the case in the CFA Franc zone.[22] They found the monetary union was not enough to provide fiscal discipline, and that it could only do so if the hands of the fiscal authorities were also tied by strong fiscal restraints.

Consequently, the CARICOM Secretariat must impose common discipline on national fiscal policies, especially given the prevalence of relatively weak institutions in the region. However, policymakers must ensure that fiscal targets do not lead to creative accounting rather than real fiscal adjustment. Easterly (1999) found that fiscal adjustments in many countries with IMF and World Bank programmes resulted in the decumulation of government assets through privatization, cuts in private investment, accumulation of hidden liabilities, or expenditure postponement. Therefore, further to the convergence criteria being made *permanent* once CMU has been launched, a set of fiscal rules must be established, ex ante that compel members to pursue sound, sustainable and transparent policies which enforce penalties for non-conformers. In this regard, an EMU-like 'Stability and Growth Pact' is advocated.

A number of initiatives to establish fiscal rules could be pursued. Masson and Pattillo (2001) argue that it is not clear whether fines are a credible way to deter violations of fiscal restraint since there is little likelihood that they will be paid. It may be more effective to consider a system where a country's membership to the union is temporarily suspended or sanctions imposed (such as denial of access to regional funds). Jahjah (2001) asserts that redistributing seigniorage revenues

---

22 Where there is a fixed peg to euro and a guarantee of convertibility of their currency from the French Treasury.

conditional on the fiscal stance of a government gives more incentive to implement a sound fiscal policy. Furthermore, agreements within a monetary union should be made to prohibit direct central bank financing and access to favourable financing. Given the high exposure of banks to government default mentioned above, the central bank could be forced to intervene by directly buying government securities or by providing liquidity to troubled banks when they are faced with a financial crisis. But bailing out a government with an unsustainable fiscal policy would have implications for the viability of the exchange rate and value of the currency, not to mention the moral hazard it creates (Masson and Pattillo, 2001).

Unfortunately, even the iron-clad and credible ban on central banks financing government deficits is not enough to ensure fiscal discipline since such formal rules against bailouts are rarely observed, especially in countries with weak fiscal and monetary institutions and a lack of strong public support for low inflation (Masson and Pattillo, 2001). Indirect bailouts (by lowering interest rates), in particular, would be especially difficult to rule out since there could be other plausible reasons for loosening monetary policy. Moreover, laying down binding rules that stipulate no bail-out will be undertaken by the central bank or other member states is unlikely to occur in the Caribbean, given its susceptibility to external shocks. Indeed, a Regional Catastrophic Fund has been proposed where fiscal deficits will receive financing (up to a limit) under exceptional circumstances.

In addition to establishing fiscal rules, national central banks must work with their respective Treasuries in coordinating monetary and fiscal policies. Conflict between the central bank and the Treasury increases uncertainty in financial markets and the probability of price and output instability, and reduces the credibility of macroeconomic policies (Worrell, 2000). Laurens and de la Piedra (1998) suggest that a clear delineation of responsibilities between the central bank and the Treasury will suffice where they both coordinate their objectives and responsibilities. Worrell (2000), however, argues that consistent policies are assured only when the fiscal and monetary authorities share the preferences of the general public – a dynamic process involving the interaction of such authorities with financial markets and the public. He states that it is crucial to maintain an ongoing dialogue between the central bank, Treasury and financial markets on economic performance, policy and prospects as this will provide for fiscal and monetary discipline through the sanction of informed public opinion.

3.3.2 Greater Independence for National Central Banks

Another implication of forming a monetary union not previously discussed, is the effect it will have on the national central banks (NCBs), which must ultimately relinquish control of their monetary policies. Establishing the CMA will effectively mean that operational activities become centralized in the region. It is envisaged that the CMA will be independent (but accountable to the council of finance ministers), responsible for price and exchange rate stability, will have tight limits to which it can finance members' fiscal deficits, and have surveillance authority over members' external borrowing.

However, there will be a certain degree of decentralization since NCBs will still be left with the responsibility for managing their reserves (and those of the various governments), providing liquidity, running the payment systems and supervising the domestic banking system. They will also have a duty to insist on a sound fiscal performance from their respective governments – for example, the German Bundesbank President set a good precedent in 2005 by resisting calls from the Finance Minister to sell gold reserves to fund public expenditure. This may present significant challenges to NCBs under their present arrangements since they are generally regarded as not being independent enough of their respective governments nor do they have a strong track-record of pursuing anti-inflationary policies. Mahadeva and Sterne (2000) have shown that CARICOM countries rank among the lowest in the world in terms of overall central bank independence. However, perhaps a system will evolve where NCB's specialize in certain areas, as is the case in the USA under the Federal Reserve System.

The prevailing opinion, not without its critics, is that an autonomous central bank is the most hopeful mechanism for achieving low inflation (Worrell, 2000). In this regard, the seminal work of Cukierman *et. al.,* (1992) found a negative relationship between the degree of central bank independence and the rate of inflation in industrial countries[23] but that

---

23 That is, on average, more independence correlates with lower inflation.

this relationship did not hold for developing countries. Worrell and Belgrave (1997) extended this analysis to the Caribbean and found that, while the they appear to be closer to the industrial country average, many of the variables that define central bank independence have no significant impact on inflationary performance. Other studies have shown the political muscle of interest groups, political vulnerability and instability, and central bank turnover in politically volatile periods provide better explanations for why developing countries have, on average, higher and more variable inflation than industrial ones.[24]

While this evidence may not strengthen the case for central bank independence in the small, open Caribbean economies, the importance of this issue is establishing a successful CMU cannot be underestimated. The newly established CMA must convince markets that it complies with its core mandate of maintaining price stability and that it is genuinely independent from government interference. To do this it must, in case of doubt, always lean in favour of a tight monetary policy stance. However, this has not always been the case among CARICOM NCBs. If monetary authorities do not assert their credibility *before* a monetary union is formed then it is unlikely that the CMA will be able to effectively do this. Anthony and Hallett (2000) go further by suggesting that if the CMA's policies are run by the present crop of central bankers in the region, then there is little reason to expect they will apply new discipline. Moreover, national governments, which have become accustomed to influencing monetary policies in CARICOM countries, must make the necessary adjustments to the realities of the system they will face once the CMA is created. Hence, for the CMA to function as intended NCBs must gain greater independence prior to monetary union. Not only will this enable national governments to 'test the waters', but, more importantly, it will facilitate a smoother transition to an external authority affirming its mandate and independence.

Following this argument, therefore, NCBs should be granted *full* operational independence and mandated to maintain low inflation. Worrell asserts that NCBs "should be empowered by law and precedent to apply the tools of monetary policy without prior approval of the Treasury, prohibited by law and custom from lending to the government

---

24 See Possen (1993), Cukierman and Webb, 1995.

on non-market terms, and accountable to parliament" (2000:3). NCBs must first gain credibility by consistently achieving low inflation before (political, economic and social) credibility will be given to the CMA. Moreover, if the CMA cannot build a reputation for price stability and impose fiscal austerity, the probability of devaluation will increase. Worrell (2000) also recognizes that an expansionary fiscal policy trivializes the notion of central bank independence since no matter what instrument the central bank uses, low inflation will be unattainable.

This is why the issue of central bank independence *along with* imposing fiscal discipline must first be addressed before a CMA can realistically be sustained. However, this is not to say that the central bank and government cannot cooperate with respect to monetary and fiscal policy. Indeed, a review of the literature affirms that effective monetary-fiscal cooperation is the only framework within which policy can be successfully conducted in small open economies like the Caribbean.[25] If the Central Bank and the Government do not cooperate, fiscally imprudent governments with high public sector borrowing requirements will face increased expectations of higher inflation, a depreciation of the exchange rate, and a rise in taxes. NCBs will then be forced to react by raising interest rates to avoid capital flight. In addition, fiscal indiscipline is compounded by governments borrowing more than the legal limit from their central bank,[26] which will cause monetary targets to be exceeded. Alternatively, the government could turn to international financial markets to finance their deficit, further adding to their excessive debts. Ultimately, this will harm their credit ratings and punish them through higher interest rates.

Since governments typically favour a more relaxed monetary stance, NCBs may have to demonstrate their independence in their attempt to achieve low inflation. This has been the case in the euro area over the past few years with the European Central Bank (ECB) rejecting calls from Germany and France to lower interest rates. The CMA must

25 See for example, Eijffinger and de Haan (1996); Fry (1997); Demertzis *et. al.,* (1999); Valila (1999).

26 Who must honour cheques written by the government so as not to lose public confidence in fiscal policy.

also enforce tight limits on financing member countries' fiscal deficits, ideally not financing them at all. To prevent national governments circumventing these restrictions by financing their deficits through increased external borrowing,[27] the CMA must implement binding rules that impose restrictions on members' borrowing from domestic *and* external markets.

There is also no reason to expect that NCBs monetary policies cannot be coordinated between potential CMU members prior to its launch. Indeed, this should be encouraged since it will better prepare NCBs for the transition to the CMA and strengthen commitments to monetary union. Recently, many central banks (the ECB included) have moved towards adopting an explicit inflation target (or range), and CARICOM NCBs could adopt this approach in an effort to coordinate monetary policy. Other forms of targets could also be coordinated, such as money and exchange rate targets with each assigned various levels of priority. As mentioned above, given the region's susceptibility to external shocks (which impact members unevenly) a single target may be less appropriate.

3.3.4. Increasing Public Awareness and Giving CMU Higher Priority in the CSME Framework.

It goes almost without saying that monetary union, regardless of its perceived economic advantages, will never be realized if the political support for it is non-existent. While the political leaders of CARICOM countries have signalled their intention to move towards monetary union, the initiative has not been embraced with the requisite commitment by them. This lack of political will was also evident in the build up to EMU as many EU members expressed apprehension. Potential members of CMU also seem anxious to allow an external authority (in this case the CARICOM Secretariat) to impinge upon the sovereignty of their fiscal policy.

Cohen (2003) argues that commitment is the key ingredient in forming a sustainable monetary union since it requires an upward shift in the delegation of formal authority and entails a loss of sovereignty.

27 As has been the case in the CFA Franc zone.

This requires an 'alliance of allies' – other states with similar preferences and disposition to act cooperatively. In practice, such allies are not that plentiful. A major barrier to establishing a monetary union is the collective action it requires, and overcoming this obstacle has proved very difficult, as evidenced by the fact that EMU is the *only* monetary union to be formed in the post-war period, and this has only been a recent development.

For the sustainability of a monetary union, Cohen further states that economic linkages appear to be of secondary importance to political ones. Either a powerful hegemony or a community of equally committed members is required to ensure sovereign governments receive the necessary incentives to stick to bargains, and that the reason why monetary unions are so uncommon is that there are few places where either exists. EMU benefitted from a sufficiently powerful hegemony (Germany), but CARICOM lacks one or the local sense of solidarity sufficient to sustain the requisite degree of commitment. Indeed, the close trade links it has with an external large hegemony (the USA) may inhibit the success of CMU since there is less incentive for a mutual commitment between members. Conversely, Masson and Pattillo (2001) point out that if the political determination to join a monetary union is strong, as is Nigeria's and Ghana's desire for one throughout the Economic Community of West Africa States, then this could suggest that the convergence criteria will not be applied rigorously (enough). This increases the prospects of creating an unsustainable monetary union.

Nevertheless, it is widely recognized that the political will for CMU is a necessary prerequisite. Prime Minister Arthur of Barbados, who has lead responsibility for the implementation of the CSME, commented in 2005 that "the convergence project will go nowhere unless there is substantial political engagement on the matter of monetary convergence" (Williams, 2006). His sentiments were supported by Governor Williams of the Central Bank of Trinidad and Tobago when he stated in 2006 that "we (the Caribbean region) need to summon up the political will and achieve public buy-in to make this initiative a success." As such, member countries must recognize the convergence criteria in their economic targets, and the criteria must form an integral part of the planning and budgeting cycle if they are to be achieved and sustained.

While central banks are notoriously cautious with respect to communicating opinions and policy stances for fear of upsetting markets, in an effort to overcome public uncertainties surrounding CMU, NCBs have a responsibility to disseminate accurate and timely information to enhance greater understanding for the mechanics of the process. This should be part of a wider initiative by them to improve their communication with the public and private sector so that policy actions are better aligned with expectations. Indeed, according to Worrell (2000): "through the information it gives to the public, the authority with which the governor speaks and the plausibility of its analysis, the bank has the opportunity to make a major impact on public perceptions of economic performance and policy, and therefore on the targets that society, through its representatives, seeks for itself" (2000:15).

4.0 Conclusion

This paper has sought to identify what needs to be done to realize monetary union amongst CARICOM members. In doing so, it has considered the implications of CMU for monetary and fiscal policy, and trade and growth. Adopting a single currency will require member countries to relinquish control of their monetary policy to an external authority, which will bring difficult adjustments to a monetary policy that serves the region as a whole instead of its individual units. Member countries must also be aware of the spillover effect of excessive fiscal deficits since they will create inflationary pressures and require an adjustment in monetary policy. To overcome these problems, potential members must harmonize fiscal policies. Adopting a single currency that is initially pegged to the US dollar will eliminate transactions costs and exchange rate uncertainties, in theory allowing the region to realize its full intra-trade, and therefore its growth, potential. However, the very low level of intra-regional trade within the Caribbean may prove to be a stumbling block in this regard as exchange rate stability with the region's largest trading partner (the USA) may only serve to increase extra-regional trade.

Criteria for potential members to satisfy before forming CMU have been established, but to date no country has managed to satisfy all of them. Clearly, action needs to be taken to create the necessary economic and political environment conducive to transitioning the region towards

CMU. In this regard, the main findings of this paper are that the criteria need to be enhanced to include limits on public sector debt and convergence on interest rates; a set of fiscal rules with credible sanctions against non-conformers need to be established ex ante; and central banks should be given greater independence, in part, to compel national governments to make the necessary adjustments towards an externally executed monetary policy by an independent authority. Ultimately, however, it also recognizes that the initiative will never actually be realized unless leaders of CARICOM nations make the requisite political commitment to a union that binds them not only monetarily, but fiscally too.

Needless to say, once members have met the convergence criteria the implementation of CMU will not happen overnight. In addition to establishing the necessary legal structure, operating framework and logistics of monetary integration, there are a number of other issues that will require considerable attention. In this regard, policymakers will require further research on structural reforms within the region since countries differ in their dependence on certain industries and there is an acute awareness of the need for diversification. Furthermore, since CMU is likely to follow a path similar to EMU,[28] continuous reform will be required to 'finely tune' the system and operations of the CMA, and to ensure that there is sufficient flexibility to allow smooth adjustments in the economic system, especially with respect to labour market flexibility.[29] In this regard, brain-drain induced intra and (especially) extra regional migration in the Caribbean will put pressures on the fiscal positions of countries. Further research into how policymakers can overcome these by enhancing private sector growth, retaining highly-skilled workers, and re-orientating their education systems towards providing skills in demand within the region will also be crucial to the success of a Caribbean monetary union.

---

28 Where a core of countries initially formed the euro area and others joined later.

29 Which has been a problem in Germany, for example, since it joined the euro area.

BIBLIOGRAPHY

Anthony, M.L. and A.H. Hallett. 2000. *Is the Case for Economic and Monetary Union in the Caribbean Realistic?* Glasgow: University of Strathclyde.

Arthur, O. 2005. Speech to the Trinidad and Tobago Chamber of Commerce. (Port of Spain, June 2005).

Baldwin, R. 2006. 'In or Out: Does it Matter'? An Evidence-based Analysis of the Trade Effects of the Euro, CEPR, June 2006. London: Centre for Economic Policy Research.

Beetsma, R. and A. Bovenberg, 2001. 'The Optimality of a Monetary Union without a Fiscal Union,' *Journal of Money, Credit and Banking*, Vol.33, No.2.

Begg, D., F. Giavazzi, L. Spaventa, and C. Wyplosz. 1991, 'European Monetary Union – The Macro Issues,' in *Monitoring European Integration: The Making of Monetary Union*. London: Centre for Economic Policy Research.

Bredenkamp, H. and M. Deppler. 1990. 'Fiscal Constraints of a Fixed Exchange Rate Regime,' in *Choosing an Exchange Rate Regime: The Challenge for Smaller Industrial Countries*, edited by Argy, V. and De Grauwe, P., Washington: IMF.

Cohen, B.J. 2003. 'Are Monetary Unions Inevitable?' *International Studies Perspectives*, No.4, 275-292.

Collier, P. 1991. 'Africa's External Economic Relations, 1960-90,' *African Affairs*, Vol.90, 339-356.

Committee of Central Bank Governors. 2005. 'Monetary Cooperation in the Caribbean,' Executive Summary Submitted to the Caricom Central Bank Governors, (Belize, 2 December 2005).

Cukierman, A., S. B. Webb, and B. Neyapti. 1992. 'Measuring the Independence of Central Banks and its Effects on Policy Outcomes,' *The World Bank Economic Review*, Vol.6, No.3, 353-398.

Cukierman, A. and S.B. Webb. 1995. 'Political Influence on the Central Bank: International Evidence.' *The World Bank Economic Review*, Vol.9, No.3, 397-423.

Demertzis, M., A.H. Hallett, and N. Viegi. 1999. *An Independent Central Bank Faced with Elected Governments*, Glasgow: University of Strathclyde.

Dornbusch, R. 1997. 'Fiscal Aspects of Monetary Integration,' *American Economic Review*, Vol.87, No.2, 221-223.

Dornbusch, R. 2001. 'Fewer Monies, Better Monies,' *NBER Working Paper*, No. 8324.

Duttagupta, R. and G. Tolosa. 2006. 'Fiscal Discipline and Exchange Rate Regimes: Evidence from the Caribbean,' *IMF Working Paper*, No. 06/119.

Easterly, W. 1999. 'When is Fiscal Adjustment an Illusion?' *Economic Policy*, Vol.14, No.28, 55-86.

Economics Focus. 2006. 'The Euro and Trade,' *The Economist*, June 24th-30th, 90.

Egoume-Bossogo, P. and M. Chandima. 2002. 'Trade and Integration in the Caribbean,' *IMF Working Paper*, No. 02/148.

Eichengreen, B. *et. al.,* 1998. 'Exit Strategies: Policy Options for Countries Seeking Greater Exchange Rate Flexibility,' *IMF Occasional Paper*, No. 168.

Eijffinger, S. and J. de Haan. 1996. 'The Political Economy of Central Bank Independence,' *Princeton Special Papers in International Finance*, No.19.

Farrell, T.W. 1994. 'Monetary Union: A Guide for the Perplexed,' in *Caribbean Monetary Integration*, edited by Farrell, T.W. and Worrell, D., Port of Spain: Caribbean Information Systems & Services Ltd.

Frankel, J.A. 1999. 'No Single Currency Regime is Right for all Countries or at all Times,' *NBER Working Paper*, No. 7338.

Frankel, J.A. and A.K. Rose. 1997. *The Endogeneity of the Optimum Currency Area Criteria*, Berkeley, CA: University of California.

Fry, M. 1997. 'Assessing Central Bank Independence in Developing Countries: Do Actions Speak Louder than Words?' *Oxford Economic Papers*, Vol.50, No.3, 512-529.

Guillaume, D. and D. Stasavage. 2000. 'Improving Policy Credibility: Is There a Case for African Monetary Unions?' *World Development*, Vol.28, No.8, 1391-1407.

Gupta, S., B. Clements, E. Balducci, and C. Mulas-Granados. 2002. 'Expenditure Composition, Fiscal Adjustment, and Growth in Low-Income Countries,' *IMF Working Paper*, No. 02/77.

International Monetary Fund. 1997. *World Economic Outlook*, October 1997.

Jahjah, S. 2001. 'Financial Stability and Fiscal Crises in a Monetary Union,' *IMF Working Paper*, No. 01/201.

Kufa, P., A. Pellechio, and S. Rizavi. 2003. 'Fiscal Sustainability and Policy Issues in the ECCU,' *IMF Working Paper*, No. 03/162.

Laurens, B. and E. de la Piedra. 1998. 'Coordination of Monetary and Fiscal Policies,' *IMF Working Paper*, No. 98/25.

Mahadeva, L. and G. Sterne, (eds.) 2000. *Monetary Policy Frameworks in a Global Context*, London: Routledge.

Masson, P. and C. Pattillo. 2001. 'Monetary Union in West Africa: An Agency of Restraint for Fiscal Policies?' *IMF Working Paper*, No. 01/34.

Mishra, P. 2006. 'Emigration and Brain Drain: Evidence from the Caribbean,' *IMF Working Paper*, No. 06/25.

Mundell, R. 1961. 'A Theory of Optimum Currency Areas', *American Economic Review*, Vol. 51, No.4, 657-665.

Pattillo, C., H. Poirson, and L. Ricci. 2002. 'External Debt and Growth,' *IMF Working Paper*, No. 02/69.

Posen, A. 1993. 'Why Central Bank Independence Does Not Cause Low Inflation,' *Central Banking*, Vol. 4, No. 2.

Rose, A.K. 2000. *One Money, One Market: Estimating the Effects of Common Currencies on Trade*. Berkeley, CA: University of California.

Rose, A. and E. van Wincoop. 2001. 'National Money as a Barrier to International Trade: The Real Case for Currency Union,' *American Economic Review*, Vol.91, No.2, 386-390.

Sahay, R. 2005. 'Stabilization, Debt and Fiscal Policy in the Caribbean,' *IMF Working Paper*, No. 05/26.

Straughn, R. 2003. *Does Exchange Rate Variability Affect Bilateral Export Volume in Caricom?* Bridgetown: Central Bank of Barbados.

Tornell, A. and A. Velasco. 2000. 'Fixed or Flexible Exchange Rates: Which Provides More Fiscal Discipline?' *Journal of Monetary Economics*, Vol.45, 399-436.

Valila, T. 1999. 'Credibility of Central Bank Independence Revisited,' *IMF Working Paper*, No. 99/2.

Williams, E.S. 2006. 'From Single Market to Single Economy (Benefits and Challenges),' address at the Second Biennial International Conference on Business, Banking and Finance. (Port of Spain, 2 May 2006), BIS Review 37/2006.

Williams, O., T. Polius, and S. Hazel. 2001. 'Reserve Pooling in the ECCU and the CFA Franc Zone: A Comparative Analysis,' *IMF Working Paper*, No. 01/04.

Worrell, D. and A. Belgrave. 1997. *The Treasury and the Central Bank: Independence or Consensus*. Bridgetown: Central Bank of Barbados.

Worrell, D. 2000. 'Monetary and Fiscal Coordination in Small Open Economies,' *IMF Working Paper*, No. 00/56.

Worrell, D. 2003. 'A Currency Union for the Caribbean,' *IMF Working Paper*, No. 03/35.

APPENDIX 1
CRITERION AVERAGES, 1991-2005

Country	Import Ratio Criteria	Exchange Rate Criteria[a]	Debt Service Ratio Criteria	Fiscal Rate Criteria	Inflation Rate Criteria	Total Public Debt Criteria*	Interest Rate Criteria
Bahamas	2.8	0.0	5.5	(2.3)	2.4	8.6	4.7
Barbados	4.6	0.0	11.0	(2.4)	2.7	22.7	4.3
Belize	2.2	0.0	11.7	(4.5)	2.2	48.7	5.7
EC Currency Union	6.5	0.0	15.6	(3.1)	2.7	48.8	4.2
Guyana	4.8	3.7	16.0	(4.4)	11.4	257.5	9.8
Jamaica	3.4	9.3	21.6	(2.8)	21.2	61.5	18.9
Suriname	2.6	26.5	6.9	(5.2)	73.8	23.5	12.0
Trinidad & Tobago	5.0	3.2	12.7	0.4	5.2	33.0	5.7
Region-wide Average	4.0	5.3	12.6	(3.1)	15.2	63.0	8.2

Source: Caribbean Centre for Monetary Studies, Meeting of the Committee of Central Bank Governors, June 2nd, 2006.

± 1993-2005
* Suggested Criterion