THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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Caribbean Integration Finds Its Rhythm

BY GARY N. KLEIMAN

After years of discussion on forging a unified trade zone among the fifteen members of the Caribbean Community (Caricom), a smaller version was launched in February between core countries, Barbados, Jamaica, and Trinidad and Tobago. Their Caribbean Single Market and Economy (CSME) envisions free cross-border goods and services flows, and aligned banking and securities regulation to promote financial sector integration. A similar effort is underway on financial services harmonization in the neighboring Organization of Eastern Caribbean States (OECS) bloc, which shares a common currency tied to the U.S. dollar.

Emerging market debt and equity investors have begun to take notice of this evolution. Jamaica was one of the best performing frontier stock markets on the S&P/IFC index in 2004, up 108 percent. Trinidad and Tobago won coveted investment grade status, which allows conservative U.S. mutual and pension funds to allocate a portion of their multi-trillion dollar portfolios. Attraction to the area has increased despite over-reliance on basic commodities and tourism, weak fiscal policy, and hurricanes and natural disasters that regularly pressure domestic and external accounts.

JAMAICA

For Jamaica, the situation has dramatically reversed since 2003 when debt default or rescheduling was widely predicted. A debt/GDP ratio of 150 percent, double-digit inflation, a sliding currency, and 35 percent interest rates coincided with a severe visitor downturn. The country was ready to turn to the International Monetary Fund for funding to meet international bond payments. Instead, an emergency program was adopted—the so-called Partnership for Progress whose

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chief element is a public-sector wage freeze—which bought time as a broad-based recovery replaced recession with 2 percent GDP growth.

In the past year, tourism, bauxite, and alumina have all boomed on record world prices and heavy cruise ship and facility outlays. Agriculture, however, has suffered from the effects of Hurricane Ivan in summer 2004, and the imminent removal of EU duty-free preferences for banana and sugar exports. Inflation, despite a steep oil import bill, has receded to near single digits, aided by halving the annual fiscal deficit to 3.5 percent of GDP on a combination of better tax collection and cuts in government capital and personnel expenditure.

Nonetheless, servicing the debt, most of it the legacy of a system-wide banking rescue in the late 1990s, continues to absorb 60 percent of revenue. A fall in interest rates to the 15 percent range has provided relief, but the domestic burden alone is crushing at 100 percent of GDP. The gap is financed by local bonds bought by Jamaican banks and institutional investors. External obligations are less of a weight, and equally split between official and commercial creditors. With a “B” sovereign rating and no representation in the benchmark JP Morgan Index, bonds are not held abroad by mainstream investors, although reserves have recently swelled above U.S. $1.5 billion on good remittance and foreign direct investment numbers providing a needed cushion.

Reduced returns on government debt and single market launch have spurred a prolonged equity upswing on the forty-company, U.S. $14 billion bourse. Blue chips such as conglomerate Grace Kennedy and Bank of Nova Scotia are cross-listed on neighboring exchanges and have rapidly expanded their regional presence in consumer products and lending, respectively. Another favorite is Jamaica Money Market Brokers, which dominates the important securities repo business and has initiated joint ventures throughout the Caribbean, including an attempt to start a local ratings agency.

TRINIDAD AND TOBAGO

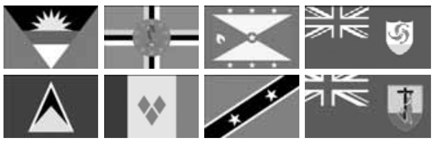
Trinidad and Tobago is the biggest economy and growth leader at over 6 percent in 2004. Its hydrocarbon riches make it the leading supplier of liquefied natural gas to the United States. Inflation is subdued at 4.5 percent. U.S. $3 billion in oil proceeds have been devoted to a stabilization fund to protect against eventual price correction, and the government aims for developed country income status by 2020. A multibillion-dollar renovation scheme around the capital, Port of Spain, seeks to compete for the headquarters of the Free Trade of the Americas secretariat. In the financial sector, life insurance companies are among the most aggressive cross-border investors and participants, with many holding government and corporate paper from a half dozen islands.

With consecutive fiscal surpluses, the government has obtained cheaper refinancing of domestic debt, with prime lending rates dipping below 10 percent. On these results, it injected additional capital into 50 percent-owned ailing airline BWIA. Proceeds will also be used for prevention and treatment of AIDS which has spread rapidly in recent years. Prime Minister Patrick Manning has been under fire for receiving free airplane flights from gas multinationals, and for his plan to enter preferential energy agreements with Venezuela which risks alienating the United States. New elections are scheduled for 2007 with the legislature almost evenly split, and the rival UNC party may put a former central bank governor at the top of the ticket to emphasize a sober anti-graft image.

BARBADOS

Barbados registered 3 percent GDP growth last year, although widening trade and current account deficits brought foreign reserves to their lowest levels in decades. Tourism and services were firm, the latter reflecting rising popularity as an outsourcing center for data processing and automated calling. Offshore banking, in contrast, has been struggling to rebound from the confrontation between Prime Minister Owen Arthur and the Paris-based Financial Action Task Force over alleged discrimination against developing countries in meeting anti-tax evasion and money laundering standards. Politics has also been deadlocked in a dispute over becoming a full republic and renouncing the Queen of England as sovereign, which could curb the flow of Commonwealth aid.

Privatization has occurred with the unloading of shares in Barbados National Bank, but debt/GDP still surpasses 80 percent. Unemployment and value added tax are high at 12 percent and 22 percent, respectively. A clash lingers with Trinidad and Tobago over fishing rights with the issue referred the United Nations for interpretation under the Law of the Sea Convention. A bright spot has been telecoms activity which saw half a dozen companies open cellular networks with the termination of Cable and Wireless's monopoly. To bolster incentives for travel agents and operators, the Barbados Tourism Authority itself has floated a local bond which was well-subscribed.



ECCU

In the Eastern Caribbean Currency Union (ECCU)—grouping the six independent states of Antigua and Barbuda, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia, and Saint Vincent and the Grenadines, and the British territories of Anguilla and Montserrat—agriculture was devastated by 2004 hurricanes, most notably in Grenada where the entire nutmeg crop was destroyed. It and Dominica have been forced to pursue commercial and official debt restructuring, and debt/GDP levels are also above 125 percent in St. Kitts and Nevis and Antigua and Barbuda. For the two, their top bilateral donor has been Taiwan, which has hesitated over extending further assistance prompting them to approach mainland China for help in exchange for recognition. Trinidadian banks are major creditors, and have resisted proposed haircuts estimated at 60 percent of net present value in Dominica's case. For the zone, state-owned sugar and banana companies have been a chronic treasury drain and drag on growth with privatization needed to improve fiscal and output performance, according to the IMF.

Notwithstanding these stresses, the currency board arrangement—with a U.S. dollar peg to the EC dollar at 2.70 since 1983—has kept inflation negligible. Under the Eastern Caribbean Central Bank charter, money in circulation must be backed by a minimum 60 percent of foreign reserves and that sum now stands at 90 percent. In 2001 the Eastern Caribbean Stock Exchange, supported by USAID and the Inter-American Development Bank, was inaugurated and billed as the Western Hemisphere's first fully computerized regional market. Seven stocks with capitalization of U.S. $200 million are listed, mainly banks, utilities, and trading companies. The exchange plans to become a Caricom-wide one, with Grace Kennedy and Company and other prominent regional groups expected to receive cross-listing approval in the coming months. A public government securities market operates in parallel, with maturities from ninety days to ten years. Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines have issued Treasury bills and bonds. Several UK-based specialist funds have bought the paper at current yields above 7 percent. The introduction of EU-style convergence criteria for fiscal policy to be phased in over the next few years is designed to boost overall creditworthiness and appetite in the segment from Caribbean and international buyers.

HAITI

Movement among the English-speaking nations has overcome dashed outreach attempts toward Haiti and the Dominican Republic. Caricom had cultivated relations with former Haitian President Aristide and was divided over his forced ouster in February 2004 amid violent chaos. The successor interim administration, headed by technocrat Gerard Latortue, has not received its diplomatic embrace, and the U.S. $1 billion aid package pledged by the international community was criticized for its lack of coherence and lavishness. Only U.S. $200 million has been absorbed over the past year with the limited administrative capacity in Port au Prince, even with a restoration of GDP growth at 3 percent. Most of the money was for short-term public service job creation, infrastructure rehabilitation, and police protection.

Broader macro-economic stability is a distant goal, although the so-called Cooperation Framework signed with aid providers projects inflation tumbling to 15 percent and foreign reserves rising above U.S. $20 million. Budget discipline, clearance of external debt arrears, and a private sector development strategy focused on small- and medium-sized enterprises are other components which mirror general Caribbean trends. However, not just language but extreme poverty poses an enormous divide. Haiti is the poorest country in the hemisphere and ranks near the bottom of the UN's Human Development Index. Seventy percent of the population is destitute, less than one-third have access to adequate sanitation, and life expectancy is 53 years. The government hopes to establish special industrial zones that can link with Caricom markets, but interaction beyond this mechanism faces persistent low income and political legitimacy barriers.

DOMINICAN REPUBLIC

On the other side of Hispaniola, the Dominican Republic was courted by Caricom as its biggest banks collapsed in 2003, spurring massive intervention by authorities that doubled public debt to 55 percent of GDP. In early 2004, an IMF standby arrangement was agreed and subsequently suspended for failure to meet budget cutback and structural reform conditions. At the same time, the Paris Club of bilateral creditors granted U.S. $200 million in relief. The write-off contained a standard clause stipulating comparability of treatment with private counterparts, mainly bond holders owed U.S. $1 billion in global issues due in 2006 and 2013. The cash-strapped government was forced to forgo gas and electricity purchases, producing widespread shortages which contributed to the defeat of the incumbent in May elections and the return to power of New York-raised Lionel Fernandez who was president in the mid-1990s.

Confidence revived as he surrounded himself with experienced economic managers whose first priority was passage of adjustment measures to satisfy IMF criteria and regain credit access. A hike in VAT and other levies, and civil service and subsidy reductions, target a 2 percent primary surplus. Re-privatization of electricity distribution and generation is slated, along with application of a 10 percent minimum bank capital standard. Amid these moves, the exchange rate appreciated 30 percent and inflation and interest rates dropped 15 percent. Growth, buoyed by a large current account surplus on strong tourism, free zone, and remittance earnings, came in at 2 percent in 2004. A new U.S. $670 million two-year facility was inked with the IMF in February 2005. However, even with fresh support, a U.S. $200 million financing shortfall is projected for this year, and by its own admission the country has fallen behind on payments to commercial suppliers. This announcement triggered an immediate downgrade by Standard and Poor's to "selective default" as a formal offer to bondholders had yet to be unveiled.

A market-friendly deal stressing maturity extension, especially on a U.S. $500 million amortization due next year, has now been indicated, but cash flow scenarios prepared by New York and London investment houses show that the squeeze may compel an outright interest or principal reduction in the future. In the meantime, coupon payments continue to be made at the very end of thirty-day grace periods as the finance ministry juggles its books. An informal foreign creditors committee has been organized, and many analysts argue that further capital repatriation and not debt reprofiling is the answer to the current liquidity constraint. According to official calculations, while capital flight has fallen by half since the height of the crisis, it is still running at U.S. $1.5 billion annually, exceeding foreign exchange reserves.

Fernandez's party meanwhile only controls a minority in parliament, and the opposition is reluctant to provide any overseas negotiating leeway, especially when several members have received arrest warrants for alleged corruption in the previous administration. The bickering was also pronounced when a tax on corn sweetener imports was introduced and later revoked which would have jeopardized the IMF plan. Equally, it would have violated the proposed bilateral Central American Free Trade Agreement with the United States, which the Dominican Republic joined in its final phase. That decision was a blow to the rival Caribbean pact and new overtures have been suspended as the latter concentrates on solidifying its base.

Despite this initial single market progress in the English-speaking areas, future momentum will require a deeper mix of macro-economic austerity, industry liberalization, and prudential uniformity which have proven elusive especially when faced with perennial natural catastrophes and pressing social concerns. Worsening crime and unemployment weigh against spending restraint and a crack-down on problem enterprises and financial institutions, especially when physical security concerns spill over into the vital tourism industry. Both business executives and government officials working on the process agree that to reach the next phase of commercial union, job and law-and-order gains must be demonstrated alongside enhanced corporate competitiveness and investment return.

For the moment, the CSME has gone from acronym to action and positioned the jurisdiction for wider hemispheric trade and financial confluence. Fuller implementation over the medium-term, although an optimistic scenario given the track record to date, could propel the area into the ranks of conventional emerging markets. Already greater scope exists for pan-Caribbean exposure that can offset the relatively tiny size of individual island businesses and economies. ◆