

*“Exchange Rate Regimes and
International Competitiveness:
The Caricom Experience.”*

By

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Abstract

Two sets of issues are analysed in assessing the potential impact of the choice of exchange rate regimes on the international competitiveness of CARICOM economies. One concerns the issue of the choice of regime on cost competitiveness. The other involves the broader issue of the role of the regime in contributing to the creation of a climate appropriate for the making of optimal investment decisions. The analysis was based on the experience of Barbados, which operated under a fixed exchange rate regime and Jamaica and Trinidad and Tobago, operating under a flexible exchange rate regime. A series of indicators were used to assess developments in the international competitive position of the respective countries and the potential impact of the exchange rate regime on these indicators. No direct link could be established between the exchange rate regime and these indicators. It was also found that there was no unique relationship between the exchange rate regime and the investment climate in the countries.

Introduction

Given the trade dependence of economies in the CARICOM region, maintaining and enhancing international competitiveness would appear to be critical for assuring improvements in living standards. In this paper, attention will be directed to the role of the exchange rate regime in determining the competitiveness of export and import competing industries of economies of countries in the region.

In evaluating the role of the exchange rate regime in this context, there are two broad sets of issues which will be explored. The first, concerns the issue of international cost competitiveness. An attempt will be made to identify potential linkages between changes in cost competitiveness and trade patterns. Central to this investigation will be the question of the extent to which the chosen exchange rate regime might have led to the emergence of exchange rates which undermined international competitiveness. Associated with this issue would be the role of the regime in helping exporters and producers for the domestic market identify new market opportunities.

Beyond the narrow focus on the issue of cost competitiveness, there are what might be considered broader dynamic considerations. These include the following. How will the choice of the exchange rate regime contribute to efficient resource allocation by assuring that the exchange rate does not distort the pricing mechanism? To what extent is the role of the exchange rate regime relevant in the creation of a climate conducive to the promotion of investment? The focus of attention will be the potential influence of the choice of exchange rate regime on the willingness of a government to exercise discipline in its conduct of fiscal and monetary policy. The exercise of such discipline would contribute to the maintenance of a low inflationary environment which would make a positive contribution to competitiveness.

Most countries in CARICOM have adhered to rigidly fixed exchange rate regimes. The

notable exceptions are Guyana, Jamaica and Trinidad and Tobago. All three countries operate with some form of floating exchange rate regime. Jamaica and Guyana adopted these regimes in the eighties and Trinidad and Tobago in the nineties. For purposes of this exercise, the issue of the relevance of the exchange rate regime, with respect to competitiveness, will centre on the comparative experiences of Barbados, Jamaica and Trinidad and Tobago, three of the largest economies in the region. Barbados has adhered to a rigidly fixed exchange rate regime, while the latter two countries have, as indicated, operated with flexible exchange rate regimes.

The paper will be organized as follows. In the first section, an effort will be made to identify potential links between the exchange rate regime and competitiveness by examining the evolution of trade patterns for the respective countries, since the mid eighties. Of particular interest, on the export side, will be developments in trade of what might be considered non traditional products. In the second section, there will be an examination of a series of cost competitiveness indicators for the respective countries with a view to determining what role might have been played by the exchange rate in the evolution of these indicators. In the final section, attention will be directed to the broader issues related to the possible link between the impact of regime choice on resource allocation and the investment climate.

Evolution of the Commodity Composition and Direction of Trade

In considering the implications of the exchange rate and the exchange rate regime for competitiveness for the respective economies, the following factors will be taken into consideration. On the export side, the overall growth rate, as well as, changes in the composition of exports and evidence of successful entry into new markets, will all be used as indicators of competitiveness. A high overall export growth rate might be taken as an indicator of an ability to maintain and enhance price competitiveness in the sector. This might be deemed, among other things, to be a reflection of the fact that the country was able to avoid exchange rate overvaluation. Exchange rate overvaluation is often deemed to be a major contributor to the presence of a so called anti - export bias present in many developing economies (Krueger, 1978). However, in the case of countries where a major share of exports consist of products which are not sold under what might be considered competitive market conditions, caution must be exercised in linking export performance to price competitiveness based on the exchange rate. This would certainly be the case with respect to such major exports, as bauxite and alumina in Jamaica and petroleum, in Trinidad and Tobago. Similar considerations would also apply in the sugar exports for all three countries. In the case of manufactured products, a failure to retain and expand global market share, as well as establish new markets might more appropriately be linked to a weak competitive position associated with exchange rate misalignment. Consequently, in the subsequent analysis, particular attention will be paid to trends in exports of manufactured products.

On the import side, an increased share of imports consisting of intermediate and capital goods could be taken as a sign of a trend towards greater diversification of activity within the economy, with

Table 1
Exports: Barbados: Jamaica: Trinidad and Tobago
1983 - 2000
\$ Mn.

	Barbados B\$		Jamaica US\$		Trinidad & Tobago TT\$	
	Total	Mfg. Products	Total	Mfg. Products	Total	Mfg. Products
1983	510.2	411.7	685.7	62.3	5646.3	327.3
1984	583.7	464.5	702.3	73.0	5216.3	271.2
1985	502.1	396.2	568.6	88.6	5247.1	283.3
1986	425.0	321.0	590.8	93.3	4988.6	449.0
1987	223.7	108.5	710.0	150.5	5264.6	494.9
1988	248.0	121.2	883.0	172.2	5424.2	640.1
1989	251.6	133.6	1000.4	183.1	6706.9	892.0
1990	253.9	105.6	1157.5	150.5	8842.0	1114.1
1991	244.6	103.2	1150.7	216.3	8436.4	987.1
1992	269.1	107.2	1053.6	204.4	7943.0	1112.0
1993	282.3	127.2	1075.4	242.0	8800.9	1531.4
1994	270.3	122.5	1219.6	314.7	11055.2	1658.3
1995	338.8	148.3	1436.8	362.1	14129.3	2331.3
1996	428.5	165.0	1387.3	316.3	14355.1	2182.0
1997	421.0	161.4	1387.3	271.9	15887.6	3177.5
1998	390.8	164.5	1316.3	262.5	14220.5	3142.7
1999	395.1	156.0	1245.7	204.4	17661.2	3232.0
2000	379.3	143.2	1301.0	201.4	26923.5	3123.1

Sources: Barbados: Central Bank of Barbados, **Annual Statistical Digest**. Jamaica: Bank of Jamaica, **Statistical Digest**, Monthly. Trinidad and Tobago: Central Bank of Trinidad and Tobago, **Annual Economic Survey**.

a greater range of products being produced for home and international markets. On the other hand, a rate of growth of imports of consumer goods in excess of the rate of growth of income, might occur because import prices are artificially, low due to an overvalued domestic currency. As a result, the overvalued currency would inhibit, what under other circumstances might have been an expansion in the production of import substitutes.

Trinidad and Tobago was the only one of the three countries in which there was a significant increase in the overall value of exports over the past two decades. This growth was in large part due to increases sales of petroleum. However, as can be seen in Table 1, there was also a major expansion in exports of manufactured products. The decade of the nineties witnessed a tripling in the value of exports of manufactured products. The total value of Barbadian exports was actually lower in 2000, than in 1983. This was in large measure a reflection on developments in the manufacturing sector. Exports of manufactured products collapsed in the mid eighties. This came about as a result of a decision taken by one of the major firms, which had been involved in the production of electronic components for the export market, to discontinue operations. Prior to that decision, exports of electronic components accounted for more than 50 percent of total exports. One must presume that cost considerations played an important role in the decision to discontinue operations.

In Jamaica, there has been limited growth in the value of exports since 1992. There was a significant expansion in exports of manufactured exports in the first half of the decade of the nineties. However, by the end of the decade, the value of exports of manufactured products had fallen back to the levels reached in 1991. These developments reflected the country's initial success and subsequent loss of position as a manufacturer of garments for the US market. This was due, among other things, to the less favourable position the country found itself in after the incorporation of Mexico in to NAFTA and a deterioration in its overall cost competitiveness(see, for example, IMF Staff Country Report, NO 00/19, 2000, where a series of indicators to highlight a deterioration in the competitive position of the country).

In the case of Barbados and Trinidad and Tobago, there was evidence of change in the commodity composition of exports. In the case of the former, whereas electrical components accounted for more than one half of the value of total exports in the early eighties, during the nineties the growth of the sector was associated with a greater degree of product diversification. In Trinidad and Tobago, in addition to the aforementioned growth in exports of manufactured products, chemical products emerged as major exports. The growth in these exports reflects the success in employing the petroleum sector as a basis for economic diversification. There was, however, no major change in the composition of Jamaican exports in this period. Traditional exports, such as bauxite and alumina and primary agricultural and food products, accounted for the major share of exports.

Since the contraction in exports of electrical components to the United States, CARICOM has emerged as the major market for Barbadian exports. That market absorbed approximately 37 percent of the country's exports between 1990 and 2000. As indicated in Table 2, there was a modest increase in the share of exports destined for the United Kingdom and other countries, in that period. However, when one considers trends in the absolute values of exports, with the exception of the CARICOM market, there was no noticeable evidence of an upward trend in export sales. In all but

Table 2
Direction of Trade
Percent

	Average				
	1986	1990	2000	1986 - 1990	1990 - 2000
Barbados					
UK	8.3	18.3	13.0	14.4	16.5
US	45.5	13.0	15.3	29.7	15.3
CARICOM	18.5	30.6	42.0	25.4	36.7
Other	17.6	33.4	24.8	23.7	24.5
Jamaica					
UK	18.9	15.0	12.8	17.6	13.8
US	33.9	29.3	38.0	25.7	35.2
Canada	16.1	11.2	9.5	14.7	11.3
EEC	8.0	14.4	19.2	11.3	14.6
CARICOM	7.2	6.1	3.8	6.8	4.5
Other	12.6	10.9	7.6	12.8	11.4
Trinidad & Tobago					
UK	4.9	2.9	1.7	3.3	2.0
US	61.2	55.7	43.5	57.5	43.9
EEC	9.6	5.4	4.3	7.3	4.8
CARICOM	10.6	13.0	22.9	11.7	18.8
Other	12.1	21.6	26.3	18.2	32.5

Sources: Same as for Table 1.

four years, between 1990 and 2000, the annual value of sales to the United Kingdom never exceeded the level attained in the earlier year. In terms of export sales to other markets, a similar situation prevailed. In this instance, on only two occasions in the period, did export sales exceed 1990 values.

In the case of Jamaica, the dominant position of the United States as a market for the country's exports strengthened over the period. There was a modest increase in the share of exports destined for continental Europe during the nineties. There were absolute declines in the value of exports to the United Kingdom, the United States, CARICOM and other markets in that decade. Exports to continental Europe and Canada declined in the latter half of the decade.

The United States maintained its position as the major market for exports from Trinidad and Tobago. However, there was a significant decline in its market share, as during the nineties there were major increases in the share of exports destined for the CARICOM market, as well as other miscellaneous countries. Unlike the other two countries, there were increases in the absolute values of exports destined to CARICOM and new markets.

In summary, given overall export trends and developments in the direction of trade, Trinidad and Tobago, would appear to have been the only one of the three countries which was able to expand export sales, maintain its position in traditional markets and make some inroads into new markets. This, at a minimum, would indicate that there was no weakening in the country's competitive position over the past two decades. The increased reliance on the part of Barbados on sales to the CARICOM market, a preferential market and an absence of evidence of increased sales to other markets might be deemed indicative of a weakening in its competitive position. Finally, for Jamaica, all the trends in exports point to a weakening in its competitive position.

Turning now to developments in the composition of imports. There were no major changes in the structure of Barbadian imports over the period. During the nineties, as indicated in Table 3, there was a modest increase in the share of imports falling within the major functional categories. The annual rate of growth of imports of goods falling within these categories in that period, exceeded the overall rate of growth of GDP. This reflected a sharp reduction in the share of imports falling in the unclassified category. In Jamaica, there was a major increase in the share of imports consisting of consumer goods during the nineties. The average annual growth rate of imports of consumer goods exceeded by a substantial margin the GDP growth rate, in current values, for the comparable period. At the same time, the share of imports classified as consumer goods was more than 60 percent higher than that for imports falling in the category of capital and intermediate goods and raw materials.

Once again, the situation in Trinidad and Tobago was significantly different from that of the other two countries. During the nineties, the annual rate of growth of imports of consumer goods of 6.5 percent, was much less than that of overall GDP growth rate in current values, of 9.5 percent. Consumer goods accounted for a declining share of total imports in that period, with annual growth rates being less than half that for imports of capital and intermediate goods.

The relative stability of the share of imports across the major functional categories in Barbados might be taken as being indicative of the fact that the exchange rate had no discernable impact on competitiveness. At the same time, the fact that the growth rate of imports of consumer goods exceeded that of GDP in the nineties, might be indicative of the relative uncompetitiveness of the import substitution sector. The adherence to a fixed exchange rate might have worked to offset any positive changes in cost competitiveness of domestic producers. The growth in imports of

Table 3
Imports By Economic Function
Annual Average Percentage Share and Growth Rates
 Barbados Jamaica Trinidad & Tobago

	Barbados	Jamaica	Trinidad & Tobago
Consumer Goods			
1984 - 1990	37.1	18.0	38.7
1991 - 2000	42.8	24.5	21.8
Intermediate & Capital Goods			
1984 - 1990	50.6	82.0	53.9
1991 - 2000	57.0	75.5	68.1
Annual Growth Rates			
Consumer Goods			
1984 - 1990	4.5	25.3	- 5.1
1991 - 2000	6.1	32.2	6.5
Intermediate & Capital goods			
1984 - 1990	0.1	19.1	8.3
1991 - 2000	6.5	19.6	15.7
GDP Current Values			
1984 - 1990	6.6	21.9	2.3
1991 - 2000	4.5	22.3	9.5

Sources: Same as Table 1.

consumer goods in Jamaica, suggest that the nominal depreciation of the currency, over the decade, did not enhance the position of those engaged in the production of import substitutes. On the other hand, the relative decline in imports of consumer goods in Trinidad and Tobago, might be indicative of an improvement in the competitive position of those engaged in the production of import substitutes.

The evolution of trade patterns from the mid eighties point to a potential weakening in the overall competitive position of the Jamaican economy. The situation with respect to Barbados is somewhat ambiguous. There was evidence of the development of new export activity in the late nineties. However, the emergence of CARICOM, a preferential market, as the major export market, raises questions about the country's international competitiveness. The evolution of trade patterns for Trinidad and Tobago, since the mid eighties, does suggest some overall improvements in the competitiveness of its economy. This is reflected in the growth of exports of manufactured goods and the relative decline in imports of consumer goods.

Cost Competitiveness and the Exchange Rate Regime

The negative impact on a country's international competitive position, arising from such developments as a decline in productivity or an increase in the rate of inflation relative to that of its major trading partners, could be modified by the appropriate adjustments in the exchange rate. An alleged advantage of a flexible exchange rate regime is that under such a scenario there would be a greater likelihood of such an exchange rate adjustment. On the other hand, there is ample evidence to support the notion, that under a fixed exchange rate regime, governments tend to view devaluation as a last resort.

In analysing developments in international competitiveness for the respective countries, we will begin by examining trends in labour productivity in the decade of the nineties. In Barbados, there was an overall sectoral decline in labour productivity of 4 percent between 1991 and 1996. This was followed by a modest increase of 3 percent over the remaining years of the decade. The end result was that there was virtually no change in output per worker over the course of the decade. A review of development in individual sectors revealed some important differences. In the agricultural sector, as shown in Table 4, there were significant increases in labour productivity. Output per worker increased at an annual average rate of 5.6 percent from 1992 to 2000. In the manufacturing sector, there was a decline in labour productivity, between 1991 and 1993, but in the remaining years of the decade, there were annual increases in excess of 3 percent. As a result, output per worker was in 2000 almost 12 percent higher than in 1991. On the other hand, in tourism, there were decreases in output per worker in most years during this period. This resulted in output per worker being, approximately, 12 percent lower at the end of the decade.

Wages remained fairly constant between 1991 and 1994. This was true for all sectors, as well as the sectors discussed in the preceding paragraph. From 1995 to 1999 the nominal wage index rose by, approximately, 24 percent. This increase in wages combined with the changes in labour productivity point to an increase in labour costs across all sectors. The impact of the higher labour costs on competitiveness could have been moderated by a lowering of the exchange rate. Since Barbados operated under a rigidly fixed regime, any adjustment would be in the real effective exchange rate. In the post 1994 period, the appreciations in the rate exceeded the depreciations. The appreciations could be largely attributed to the unchanged US dollar rate in a period when the US dollar appreciated against other major currencies. The unchanged nominal rate and the appreciation in the real effective exchange rate meant that exchange rate adjustments did not work

Table 4
Barbados: Output Per Worker, Wages & Real Effective Exchange Rate
Percent Change

	All Sectors	Agriculture	Manufacturing	Tourism	Wages	Real Effective Exchange Rate ¹
1992	- 2.3	- 15.1	- 5.8	- 4.9	- 1.8	2.4
1993	2.1	8.7	- 4.6	8.4	1.6	4.8
1994	- 0.6	3.2	4.8	-7.3	- 1.6	11.6
1995	- 1.9	9.4	0.0	- 5.8	4.7	11.5
1996	- 1.4	- 7.7	15.9	- 1.6	3.0	5.5
1997	1.3	5.9	- 3.0	1.5	6.0	- 2.3
1998	1.2	1.7	2.5	- 5.3	4.0	9.4
1999	0.5	8.2	2.3	10.5	4.1	6.9
2000	0.1	16.9	0.5	- 6.7		- 15.7

1. Appreciation (+), depreciation(-)

Sources: Central Bank of Barbados, Annual Statistical Digest; International Monetary Fund, *Country Report, Statistical Appendix No. 00/161*, October, 2000.

to modify the decline in cost competitiveness during the period.

In Jamaica, overall sectoral labour productivity increase between 1990 and 1993. Since that time, as indicated in Table 5, there was a steady decline in productivity. In 2000, output per worker was 4.3 percent less than in 1993. These general labour productivity trends were not reflected in the performance of individual sectors. In the agricultural sector, output per worker increased at an annual average rate of 4.4 percent over the decade. In the mining sector, real output per worker increased in all but two years in the decade. In the manufacturing sector there was significant growth in labour productivity, especially in the period from 1997. However, these productivity gains were more than offset by wage increases. The resulting rise in unit labour costs across the major economic sectors would clearly be a major contributor to a weakening in international competitiveness.

Jamaica, operating under a flexible exchange rate regime, experienced a major currency depreciation. The nominal effective exchange rate index depreciated in all but two years over the course of the decade. In spite of this, the real effective exchange rate index appreciated by 71 percent from 1992 to 1998. Consequently, the adjustments in the rate, under the flexible exchange rate

Table 5
Jamaica: Output per Worker, Unit Labour Costs, Nominal & Real Effective Exchange Rates
Percent Change

	All Sectors		Agriculture		Mining		Manufacturing		Effective Exchange Rates ¹	
	O/W	ULC	O/W	ULC	O/W	ULC	O/W	ULC	Nominal	Real
1991	0.8	42.0	2.7	55.4	1.3	24.2	-7.8	57.0	-30.0	-9.7
1992	7.7	61.0	24.8	47.2	23.1	79.1	37.6	71.7	-47.3	-13.5
1993	1.8	47.0	24.1	24.6	-31.9	27.9	1.3	33.2	7.5	12.7
1994	-5.6	29.0	4.2	32.3	30.2	32.7	-3.1	17.4	-14.6	-2.2
1995	2.1	38.0	5.7	24.4	-4.0	55.7	-2.0	36.0	-5.9	6.4
1996	-1.7	26.0	4.1	9.1	14.3	8.3	-1.5	21.0	-3.4	19.0
1997	-0.4	13.0	-9.0	20.2	14.2	13.7	10.1	7.2	8.1	15.6
1998	-1.1	8.0	-0.3	7.1	5.1	13.1	1.0	3.1	-0.9	6.6
1999	0.6	8.0	3.2		0.6		5.5		-4.8	-0.9
2000	1.9	10.0	-10.1		15.2		9.7		-6.7	-1.8

1. Appreciation(+), depreciation(-).

Source: International Monetary Fund, *Staff Country Report No. 00/19*, February, 2000:

regime, did not help to moderate the decline in competitiveness arising from the higher production costs. In fact, it might be argued, that in this instance, the depreciation in the rate was a major contributor to the higher labour costs. This arises from the strong link between exchange rate depreciation and the rate of inflation and the impact of inflation on the wage bargaining process. At the same time, the link between the depreciation of the exchange rate and the inflation rate would have been weaker if the Bank of Jamaica had placed more emphasis on limiting the rate of growth of the money supply as a central feature in its strategy for combating inflation, prior to 1996 (Bennett, 2000).

In Trinidad and Tobago, there were significant increases in labour productivity in the manufacturing and petroleum sectors. In the manufacturing sector, as shown in Table 6, these increases occurred in all but one year, while in the petroleum sector, most of the major improvements occurred in the latter half of the decade. Unlike the other two countries the productivity increases were not offset by wage increases. There were significant decreases in unit

Table 6
Trinidad & Tobago: Output Per Man Hour, Unit Labour Costs, Real Effective Exchange Rate
Percent Change

	Manufacturing		Petroleum		REER
	O/Mh	ULC	O/Mh	ULC	
1991	10.1	- 7.0	- 17.8	9.8	0.5
1992	14.1	- 7.0	14.9	- 12.4	2.0
1993	- 3.1	8.7	- 6.1	6.1	- 9.7
1994	16.3	- 15.5	- 2.0	2.0	- 6.8
1995	12.1	- 5.6	- 47.6	35.2	- 2.3
1996	1.5	2.2	26.3	- 3.1	1.9
1997	21.6	- 11.4	13.4	- 6.7	0.4
1998	29.7	- 17.8	38.9	- 34.4	4.9
1999	4.2	- 12.6	37.4	- 48.4	2.7
2000	14.1	- 6.0	15.6	12.6	4.6

Source: Central Bank of Trinidad & Tobago, *Annual Economic Review*.

labour costs, especially in the latter part of the decade. The country moved to adopt a flexible exchange rate regime late in 1993. The real effective exchange rate index based on consumer prices has appreciated since that time. However, the index based on unit labour costs has depreciated (see IMF, Staff Report for 2001 Article IV Consultation No. 01/107). The apparent increases in international competitiveness reflected the major gains in productivity and was neither harmed or assisted by movements in the exchange rate.

In summary, the choice of exchange rate regime did not appear to have any particular impact on the competitive position of the respective economies. There appeared to be a loss in international competitiveness for Barbados, operating under a fixed exchange rate regime and Jamaica operating under a flexible exchange rate regime. In Trinidad and Tobago, the major improvements in productivity, the principal factor contributing to an enhancement of the country's cost competitiveness might be more a reflection on the quality of management investment decisions.

The Exchange Rate Regime and Resource Allocation

The exchange rate is what establishes the link between domestic and international prices. This relationship will have a direct influence on the decisions taken by consumers and investors. In this section, our primary concern is with the impact of the exchange rate on the investment decision. To

the extent that the relationship between domestic and international prices established by the exchange rate reflects the underlying differences in domestic and international costs, one might expect production decisions to be consistent with efficient resource allocation. For example, the generation of an appropriate price relationship over time provides a rational basis for the decision as to whether to invest in production for the home or international market. This leads to the question as to what type of exchange rate regime will result in the generation of exchange rates which establishes the appropriate relationship between domestic and international prices.

Let us first consider the implications of operating under a fixed exchange rate regime. Under such a regime the exchange rate will help maintain the appropriate relationship between domestic and international prices to the extent that there is no change in the relationship between the domestic rate of inflation and that of the country's major trading partners. This would be the case if the following conditions held. There was, over time, no weakening in productivity leading to relatively higher costs and prices in the home market. The authorities were able to exercise restraint in the conduct of monetary and fiscal policy and in this way help contain inflationary pressures. Finally, if the authorities were prepared to devalue the currency, without undue delay, when it became evident that the domestic/ international cost relationship had undergone fundamental change, the proper relationship might be restored between domestic and international prices.

In the case of the flexible exchange rate regime any development, such as a decline in productivity, or expansionary monetary and fiscal policy leading to higher domestic inflation rates, would through the impact of these developments on the trade balance, result in a depreciation of the exchange rate. The movement in the exchange rate would work to restore the appropriate relationship between domestic and international prices, reflecting the changes which had taken place in cost and prices. Given the reluctance of governments to resort to currency devaluation under a fixed exchange rate regime, a flexible exchange rate regime is often seen as one more likely to result in the establishment of the appropriate relation between domestic and international prices.

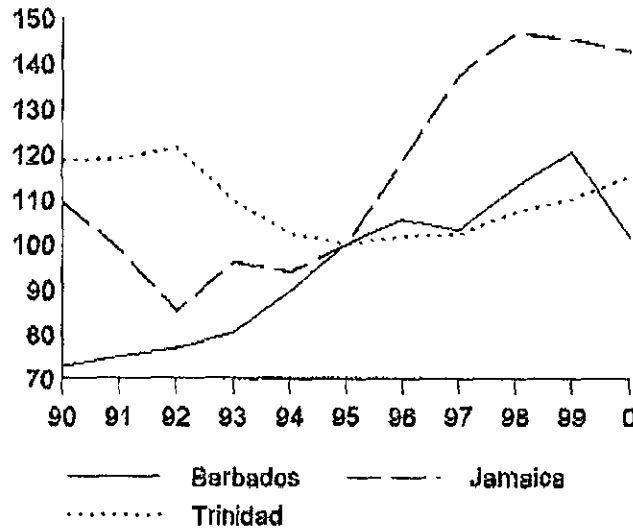
The preceding discussion was based on the premise that the prime determinant of movements in a country's exchange rate would be trends in commodity flows. However, it is well known that surges in portfolio flows are, in the main, responsible for short term volatility in the exchange rate, when countries operate under a flexible exchange rate regime. As a result, because of the impact of portfolio flows, the prevailing exchange rate might result in the establishment of a relationship between domestic and international prices which does not accurately mirror the relationship between domestic and international costs. Portfolio flows are influenced by factors such as, existing or expected differentials in earnings on financial assets, as well as by speculation. Earnings differential in financial assets might arise from a decision on the part of a central bank to aggressively pursue an anti inflationary strategy by significantly increasing interest rates. The portfolio inflows attracted by the higher earnings could result in a significant increase in the money supply in the absence of effective sterilization on the part of the central bank. These developments would lead to an appreciation in the real effective exchange rate, irrespective of the exchange rate regime. The real appreciation would likely be greater under a flexible exchange rate regime given the combination of inflation and a nominal appreciation in the exchange rate.

Large portfolio outflows might be triggered by the actions of speculators. The result of such activity would initially show up in the form of massive losses in international reserves as the central bank intervened in the foreign exchange market, if the country operated under a fixed exchange rate regime. This type of intervention in the foreign exchange market would also result in some contraction in the money supply. In the face of persistent speculative activity, the authorities would eventually be forced to abandon the fixed rate. The resulting devaluation is likely to be large, in light of the reluctance of the authorities to devalue. The large nominal devaluation would imply a corresponding devaluation in the real effective exchange rate as long as the authorities did nothing to counteract the impact on the money supply of the effort made to defend the parity. The deflationary impact on the economy of such a decision and the perception of the likely political costs are such that the authorities are unlikely to willingly pursue such a course of action. The direct impact on internal prices arising from the devaluation, combined with the attempt to offset the impact on the money supply would lead to inflationary trends resulting in a real appreciation of the exchange rate. Under a flexible exchange rate regime, the speculative outflows would result in a sharp depreciation in the exchange rate. Since by its very nature speculative activity is not based on objective criteria, the amount of the depreciation would likely be excessive. In highly open economies, such a depreciation would likely trigger an inflationary spiral leading to an appreciation of the real effective exchange rate.

How relevant are the types of considerations outlined above likely to be for our sample of CARICOM countries? Given the relatively underdeveloped state of the financial markets in the three countries under consideration, major surges in portfolio flows are not likely to be something with which the authorities will likely have to cope in the foreseeable future. There is, however, the matter of capital flight. Such capital flight has been seen as significant in the past (Bennett, 1995). However, the decision taken in the nineties to lift exchange controls and allow residents to maintain US dollar bank balances should reduce the incentive for such flight since there is now an alternative way to avoid exchange risk.

A potential indicator as to the degree of exchange rate misalignment could be trends in the real effective exchange rate. The greater the degree of stability in the rate, or alternatively, the absence of evidence of persistent appreciation, the less would be the likelihood of the rate providing misleading signals for investors. Figure 1, below, sets out annual movements in the real effective exchange rate for the three countries from 1990 through the year 2000. In all cases there was a trend towards appreciation in the rate over the latter part of the decade. The most significant rates of appreciation occurred in Jamaica and Barbados. The behaviour of the rates suggest the emergence of a degree of rate misalignment, particularly, with respect to Jamaica, and to a somewhat lesser extent, Barbados. However, in light of the differences in the experience of Trinidad and Tobago and Jamaica, both operating under flexible exchange rate regimes, it would be difficult to argue that choice of regime was a critical factor in the different outcomes.

Figure 1
Real Effective Exchange Rates :1995 = 100



Exchange Rate Regime and the Investment Climate.

It is generally argued that a stable environment, one involving low rates of inflation, a stable tax regime and no short term policy reversals on the part of government, is one which would be deemed desirable by most investors. This leads to the question as to what role might the exchange rate regime play in contributing to the emergence of such a climate. In other words, might there be a relationship between the exchange rate regime under which a country operates and the degree of discipline exercised on the part of government in its conduct of economic policy.

It has been argued that the economic policy decisions taken by a government in a democratic society will be conditioned by the desire to prolong its period in office (Collins, 1996; Edwards, 1996). Under a fixed exchange rate regime, a failure to exercise restraint in the conduct of fiscal and monetary policy would likely result in a weakening in the country's balance of payments position and a run on reserves. This would, likely, force the government to abandon the peg. It is argued that a government associated with a forced currency devaluation is unlikely to survive in office. Recognition of their limited ability to support the rate, along with a desire to avoid the political costs associated with a devaluation, would encourage governments to exercise restraint in their conduct of policy. The adoption of a fixed peg, by establishing a direct link between the domestic rate of inflation and that of the country to which the currency is linked, is seen as providing evidence of a commitment to a future rate of inflation. This will help to reinforce confidence in the government's

commitment to maintain price stability.. Alternatively, it is argued that since the government is not seen as bearing any direct responsibility for the for the external value of the currency under a flexible exchange rate regime, it would not have to bear the political costs associated with a depreciation in the value of the currency. As a result, the government might be less willing to adhere to limits on the size of fiscal deficits, as well as inflation targets and allow the currency to depreciate.

On the other hand, there are those who argue that a government's decision to adopt a fixed exchange rate regime, at a particular point in time, does not preclude the possibility of subsequent adjustments in the rate. This line of argument is based on a recognition of the contingent nature of a government's policy decisions(see, for example, Kenen, 1994). A policy decision will be taken after assessing the costs associated with various policy options. For example, a decision will be taken to devalue the currency if it is believed that it would be less costly than pursuing the policy alternatives necessary to support the fixed rate. Consequently, a fixed exchange rate regime, rather than promoting discipline in the conduct of policy, is as likely to be associated with a series of financial crises, followed by devaluations(Aghveli, Khan and Montiel, 1991).

In reviewing the fiscal performance of the respective countries over the decade, there did not appear to be any significant differences in so far as the exercise of fiscal discipline was concerned. In the case of Jamaica, the country which recorded the poorest economic performance, where one might have expected that there would have been a great deal of pressure on the government to expand spending programmes, total government expenditure as a percentage of GDP , as shown in Table 7, remained virtually unchanged over the first half of the decade. The sharp increase in spending in the latter half of the decade was due to the increased weight of interest payments in overall government spending. This arose from the obligations the government assumed in response to the crisis in the financial sector in 1997.

Total expenditure as a share of GDP declined in Trinidad and Tobago and rose slightly in Barbados in the latter part of the decade. The spending restraint exercised by the three governments also worked to keep the fiscal deficit under control. Trinidad and Tobago, with two exceptions, operated with balanced budgets in virtually every year. The Barbadian deficits, apart from one year was well within the three percent range normally viewed as being an acceptable upper limit. The large deficit ratios for Jamaica starting with the 1996/97 fiscal year, was due mainly to an upsurge in interest payments on the additional debt obligations assumed, rather than as a result of any significant new expenditure programmes. In fact, as indicated in the table, if one were to exclude interest payment on debt, the government would have operated with surpluses in each year of the decade. An earlier study comparing the fiscal behaviour of CARICOM governments operating under different exchange rate regime could find no evidence linking fiscal performance to the exchange rate regimes under which they operated(Seerattan,2000).

In summary, CARICOM governments are all committed to the pursuit of the kind of orthodox policy initiatives thought to be essential in establishing an environment conducive to the promotion of economic growth. Consequently, as the evidence of the last decade indicates, the regime under which the country operates will not likely have a decisive impact on the conduct of policy.

Table 7
Fiscal Indicators
Percent GDP

Fiscal Year	Total Expenditure			Deficit/Surplus		
	Barbados	Jamaica	Trinidad	Barbados	Jamaica	Trinidad
1991/92	36.7	23.1	30.4	- 1.9	3.7	- 0.2
1992/93	38.7	23.5	29.8	- 1.9	3.7	- 2.8
1993/94	37.9	25.4	27.5	- 2.4	3.1	- 0.1
1994/95	36.9	25.6	25.8	- 1.2	3.1	0.0
1995/96	37.1	28.6	26.7	- 0.9	2.0	0.2
1996/97	39.3	35.2	28.5	- 3.7	-6.7 5.5*	- 0.5
1997/98	40.8	36.0	27.4	- 1.4	-8.3 1.9*	0.1
1998/99	39.8	36.6	27.2	- 0.9	-7.5 6.1*	- 1.1
1999/00	40.0	37.3	25.6	- 1.7	-4.6 10.6*	- 2.1

* Excludes interest payments

Conclusions

The review of the evolution of the international competitive position of the selected CARICOM economies conducted in this study, suggests that there was no unique relationship between the exchange rate regime under which the countries operated and their competitive position. This arose from the finding that although exchange rate misalignment might have contributed to a loss of competitiveness, it was not possible to establish a direct link between the occurrence of exchange rate misalignment and the exchange rate regime under which the respective countries operated. The prime determinants of competitiveness are such factors as the quality and quantity of productive inputs, the level of entrepreneurship and the quality of fiscal and monetary management displayed by the authorities.

It was found that the decline in international cost competitiveness in Barbados and Jamaica was due in large measure to a decrease in labour productivity. In view of the openness of these economies, the impact of this decline in productivity on competitiveness could not have been modified in any meaningful way by an adjustment in the exchange rate.

Given that the fundamental determinants of competitiveness are based on public and private sector initiatives which are seen to have an impact on productivity, the role of the exchange rate regime may be seen to rest on the extent to which it might influence investment decisions and the conduct of government policy. It was shown that when one incorporates the impact of portfolio flows on exchange rate determination, there is the possibility of exchange rate misalignment regardless of the exchange rate regime. The distorted price signals generated would undermine the efficiency of investment decisions. Furthermore, partly as a result of the influence of external agencies, such as the International Monetary Fund, all governments in the region have committed themselves to the current economic orthodoxy, reflected in the belief that creation of a stable price environment is essential if the economy is to embark on a stable growth path. Exchange rate stability is seen as critical to the achievement of success in achieving and maintaining a non inflationary environment. Governments seem willing to accept the constraints on fiscal and monetary management necessary to ensure exchange rate stability. In essence, there will be self imposed discipline on governments regardless of the exchange rate regime.

In spite of the declared commitment by governments to exchange rate stability the decision of investors will be partially based on the credibility they attach to government policy declarations. The fact that a country operates under a flexible exchange rate regime may lead investors to believe, that in spite of the governments stated commitment to exchange rate stability, there is a greater probability of significant movements in the rate than would be the case under a fixed exchange rate regime. Since the authorities seem to accept the same constraints when operating under a flexible exchange rate regime than under a fixed exchange rate regime, the latter regime may then seem to provide a better climate for investors by removing an element of uncertainty, while imposing no additional costs on government. However, the flexible exchange rate regime, operating in the appropriate policy environment, does allow for smoother adjustments in the rate in the face of changing circumstances. Accordingly, there is no strong rationale for those countries currently operating under a flexible exchange rate regime to revert to a fixed rate regime.

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