Overview

Taming Volatility:
Fiscal Policy and Financial Development for Growth in the Eastern Caribbean

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Overview

Understanding the sources of macroeconomic volatility and how to deal with them is important for the Eastern Caribbean region. Economic growth rates in the OECS are currently higher than in the recent past—and this represents an opportunity for the region to strengthen its ability to manage the impacts of unexpected shocks. Output growth rates over the last three years are at a higher level than the average for the period 2009-13 period, and there is hope that this growth momentum can be sustained. However, history suggests that the small, open economies of the OECS will remain vulnerable to considerable volatility stemming from terms of trade shocks. In the past, the region has been affected by a series of adverse events, including: the erosion of trade preferences; the decline in official foreign assistance; turbulence in the business cycles of the countries that matter the most for the region in terms of tourism revenues and foreign direct investments; and, recurrent natural disasters. With the incipient recovery, the OECS economies have an opportunity to build resilience to exogenous shocks.

The report “Taming Volatility: Fiscal Policy and Financial Development for Growth in the Eastern Caribbean” assesses the sources of macroeconomic volatility in the Eastern Caribbean, and discusses policy to improve long-term growth prospects. In doing so, it contrasts the performance of the member countries of the Organization of Eastern Caribbean States (OECS) with that of other developing economies in the Caribbean and other regions of the world. More specifically, the analysis focuses on the interplay between terms of trade volatility, fiscal policy, and financial development on growth in the OECS region. By considering the interaction between these factors, the report determines that an increase in volatility results in lower GDP growth. Moreover, the negative impact of volatility on growth is more pronounced in less financially developed countries, and in countries where fiscal policy is more pro-cyclical.

Growth in the Eastern Caribbean: Strong, but Volatile

While economic growth in the Latin America region (LAC) has plummeted over the last five years, the economies of the Eastern Caribbean are showing signs of a growth rebound. After enjoying several years of high commodity prices and strong growth across much of the region—often referred to as the “commodity super-cycle”—the Latin America region has been experiencing a significant growth deceleration for the last five years or so. Since the beginning of the “great deceleration” in 2011, the commodity-dependent south has followed closely the business cycle observed in China. The countries in the north, on the other hand, have followed more closely the business cycle of the U.S., which has started to show signs of some recovery. The synchronizations of growth between the economies of the Caribbean and those of China and Brazil were found to be weak.

The close ties with the U.S. economy and its business cycle means that the OECS remains particularly vulnerable to the fluctuations of output in the U.S.. The economic performances of the small islands of the OECS are much more closely associated with developments in its main trade partners, especially the United States
and the European Union, than with their neighbors in the Caribbean. In recent years, the economies of the Caribbean have outperformed most of the economies in both the north and south of the LAC region, with growth rates now much higher than immediately after the global financial crisis—reflecting, in part at least, a strengthening tourism market. Tourism is the single-most important industry for the OECS countries, ranging from 26 percent of GDP in St Vincent and the Grenadines to 74 percent of GDP in Antigua and Barbuda. Most of the tourists who visit the Caribbean with frequency come from the North America and Europe, and the tourism sector is particularly sensitive to changes in economic conditions in the (potential) tourists’ home countries. The pro-cyclicality of tourism is also mimicked by foreign direct investment (FDI) inflows, which have also been found to follow closely the business cycle observed in the U.S. economy.

The small size, degree of trade openness, and other intrinsic characteristics of the OECS economies have contributed to the volatility of economic growth in the region. The report finds that the volatilities in the rates of economic growth for countries in the OECS are higher than the average for the world. Although output volatility was more pronounced in the early half of the 1990s, and more recently during the global financial crisis than it is now, several factors make the region prone to exogenous shocks. These include the small size of the OECS economies, their openness to trade—with a notable sensitivity to economic conditions in the U.S. and EU—as well as the region’s exposure to natural hazards (such as hurricanes and flooding).

**How to Lean Against the Wind**

Most of the OECS economies continue to adopt fiscal policy stances which exacerbate output volatility. That is, they tend to behave in a pro-cyclical way during booms and downturns. Within the OECS, the only exception seems to be St. Kitts and Nevis, which adopts a counter-cyclical fiscal stance in times of economic boom—which is a good indication that they are saving for rainy days. However, St. Kitts and Nevis still displays a pro-cyclical behavior in downturns. In doing so, they tend to amplify upswings and worsen recessions. This behavior is in stark contrast with that of the large majority of industrialized countries, which have largely adopted a counter-cyclical or even an a-cyclical fiscal policy stance.

The large majority of developing countries, including the ones in the Eastern Caribbean, have yet to graduate from pro-cyclical fiscal policies. In the Caribbean, and the OECS in particular, the majority of the countries tend to follow pro-cyclical fiscal policies. The reasons for

**Figure 1** The OECS countries face higher volatility compared to regions with similar economies

![Real GDP Standard Deviation by Region](chart)

**Source:** IMF; WEO and World Bank staff calculations.

**Note:** 1/ 5 year moving standard deviation; 2/ Antigua and Barbuda, Dominica, Grenada, St. Lucia, St. Kitts and Nevis, and St. Vincent and the Grenadines; 3/ Comoros, Djibouti, Fiji, Guinea-Bissau, Kiribati, Maldives, Marshall Islands, Mauritius, Micronesia, Fed. Sts, Palau, Papua New Guinea, Samoa, Sao Tome and Principe, Seychelles, Singapore, Solomon Islands, Timor-Leste, Tonga, and Vanuatu; 4/ The Bahamas, Barbados, Belize, Guyana, Suriname, Jamaica, and Trinidad and Tobago; 5/ Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and Panama.
such behavior are various. This could be due to frictions in international credit markets that might prevent countries from borrowing in bad times and forcing them to lower spending during recessions. It could also be seen as a signal of weak and underdeveloped institutions in governments where there is limited technical capacity to develop the means to save in good times to spend in bad times.

**Governments should avoid reinforcing the business cycle because this behavior jeopardizes their ability to ‘lean against the wind’ in periods of hardship.** A pro-cyclical fiscal policy can hamper government efforts to reduce the effects of volatility on growth. In general, government spending can mitigate the negative effect that volatility has on growth—if government spending is counter-cyclical, and its impact on output is positive. From a risk management point of view, a counter-cyclical fiscal policy can be useful for at least three compelling reasons. First, by ‘leaning against the wind’, governments can continue to provide goods and services and to maintain public investment even in the event of a drop in public revenues. Second, in a downturn, a counter-cyclical fiscal policy can help governments increase social assistance. Third, as witnessed during the global financial crisis of 2008-09, a counter-cyclical fiscal policy can help countries stimulate the economy and cope better with the effects of a prolonged recession.

The volatility of output observed in the OECS region is also present in many of its relevant macroeconomic aggregates. An assessment of the volatility of major macroeconomic aggregates, including interest rates, trade balance, terms of trade, investments, government spending, and net foreign assets, shows that all of them are volatile. The observed volatility in the OECS is quite high compared to developed economies and even compared to a few other developing countries. The highest GDP volatility is observed in Antigua and Barbuda and in Grenada. Interest rates are also quite volatile in these countries but the magnitudes are similar across them, with the exception of St. Lucia. The volatility of trade balance and terms of trade shows much more dispersion across the OECS countries. In this context, the report finds that the OECS countries exhibit very volatile business cycles, even compared to developing economies.

**Financial Development for Lower Volatility and Higher Growth**

Financial development is an important driver of growth and can increase a country’s resilience to external shocks and volatility. Financially developed economies find it easier to mobilize savings, share information, improve resource allocation, and implement more effective diversification and risk management strategies. This then leads to a more efficient resource allocation.

**Figure 2** Caribbean Countries: Fiscal Cyclicality in Booms and Downturns (1990-2011)

Source: Carneiro and Garrido (2015) based on IMF’s World Economic Outlook (WEO).

Note: Proxy for fiscal cyclicality based on correlation coefficients for time series of real government expenditures and real GDP smoothed by the Baxter-King filter.
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allocation and, thus, may foster long-term growth. Financial development also leads to financial stability to the extent that deep and liquid financial systems with more diverse instruments can help alleviate the impact of shocks. Financial development also helps countries to manage better the impact of terms of trade volatility, especially in the case of small, open economies such as in the OECS.

The OECS should continue to pursue ways to strengthen its financial sector as this will help reduce volatility and create appropriate conditions for sustainable growth. The financial sector of the OECD is dominated by the banking sector; in 2015, banking sector assets represented 166 percent of the region’s aggregate GDP. Indigenous banks represent about half of the sector as measured by assets, deposits and loans. Credit Unions are increasingly gaining importance, with just under half of the region’s population belonging to one—although total assets of credit unions represent less than a tenth of those of the banks. The OECS has a regional capital market that remains underdeveloped.

To reorient financial development in the region to be more comprehensive, a number of challenges need to be addressed. Over the last decade, the OECS countries have made progress to further develop their financial systems. However, there is scope to reorient financial development in the region so that it is less prone to high collateral-low productivity projects, less likely to create asset price bubbles and is able to contribute to enhancing economic growth and reducing volatility.

There are feasible policy options that could help reorient financial development in what that would contribute to lower volatility, higher growth, and a more effective fiscal policy. Improving savings instruments, strengthening the regional supervision of insurance, and establishing deposit insurance could all help economic agents better manage volatility. Restoring banking stability can reduce the systemic volatility that has emanated from the heightened stress that the banking sector has experienced over the past five years. The new Banking Act, which has been passed in eight of the OECS countries, provides the foundation for improved banking supervision and future consolidation. Developing long term finance for infrastructure and more housing in addition to developing tools for more effective finance for small and medium sized enterprises against the backdrop of improvements to the enabling environment and credit infrastructure are critical for enhancing economic growth. The efficacy of fiscal policy in the OECS could be improved by reversing the short-termism in sovereign debt markets and striving for a more active secondary debt market.

What is the connection between financial development, volatility, and growth? Using an econometric model, the report confirms that terms of trade volatility has a significant negative effect on economic growth.

![Figure 3 Growth & Financial Development](image1)

![Figure 4 Volatility & Financial Development](image2)

Source: Authors’ own calculations using the financial deepening index developed by the IMF in Sahay and others (2015a).

Note: The curve in Figure 3 shows the predicted effect of financial deepening on growth for each level of the index, holding fixed other controls. The curve in Figure 4 shows the predicted effect of financial deepening on growth volatility, holding fixed other controls. Growth volatility is measured as the standard deviation of GDP growth rates over a five-year moving average.
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The analysis also indicated that macroeconomic aggregates in the OECS are quite volatile, with consumption exhibiting higher volatility than GDP. In addition, real interest rates are very volatile and reflect a counter-cyclical pattern relative to GDP and other macroeconomic variables. On the other hand, fiscal policies, while also volatile, exhibit pro-cyclical trends relative to GDP. Terms of trade volatility has a particularly large negative effect on economic growth in countries where fiscal policy is pro-cyclical.

Econometric estimates show that the negative effect of terms of trade volatility on growth is mediated by cross-country differences in fiscal policies and financial development. A key conclusion from the analysis is that counter-cyclical fiscal policies, particularly when accompanied by stable and well developed financial markets and institutions, will have high payoffs in terms of reducing the adverse growth effects of terms of trade volatility in the OECS region. Econometric simulations suggest that eliminating fiscal policy shocks could reduce the volatilities of consumption and trade balances, but would have a much more muted impact on GDP volatility. The adoption of greater fiscal discipline (e.g.: fiscal responsibility laws) could—in addition to reducing the negative impact of pro-cyclical policies—also assist countries in the region to make significant progress in the reigning in of fiscal expenditures and the implementation of fiscal consolidation programs. Financial market developments can play an important role in buffering the effects of interest rate shocks on the economy, which in turn would dampen volatility in both consumption and GDP.

Right Choices for a Bright Future

Moving toward a more counter-cyclical fiscal policy should be a priority for all the countries in the OECS. This will have particularly high payoffs in terms of reducing the adverse growth effects of terms of trade volatility in the region. One way of strengthening the region’s ability to shift toward a more counter-cyclical fiscal policy stance would be through the adoption of fiscal responsibility laws and fiscal rules. These are widely recognized as effective mechanisms that can increase the discipline and credibility of the fiscal authorities. Not only would these policy tools help in making fiscal policy less pro-cyclical in the OECS, but they would also help the countries in the region to make significant progress in reigning in fiscal expenditures and implementing effective fiscal consolidation programs. The introduction of fiscal rules would need to be supported by expenditure reforms in the context of a medium term fiscal framework to signal the authorities’ commitment to fiscal sustainability. Given that natural disasters are common across the region, OECS countries would do well to integrate the likelihood of a disaster in their fiscal programming exercises. Many countries in similar situations have benefitted from the parallel creation of an independent fiscal council that monitors macroeconomic projections underlying the budgeting process and the compliance with the fiscal rule.

“Taming Volatility” argues that OECS countries can also draw on existing good practices on how to strengthen their fiscal positions and be better equipped to adopt counter-cyclical fiscal policies.
Adopting fiscal responsibility laws—with or without a formal fiscal rule—requires some preparation and the need to build technical capacity in order to design, implement, and monitor the new policy tool. There are some well-established good practices in that regard that could help the fiscal policies of the Eastern Caribbean states to become less pro-cyclical. In addition to internalizing the likelihood of a natural disaster in their financial programming exercises, countries in the region should consider establishing savings funds with a strong institutional framework, a solid governance structure and clear operational rules for the allocation of the fund’s resources. The proceeds accumulated in such a fund could be used for emergency situations—following a disaster or a protracted economic shock, for example. The OECS countries should also strive to ensure that fiscal policy guides the budgetary process, and not the other way around; this could be done through the adoption of medium-term fiscal frameworks and medium-term debt management strategies. Other policy options that could help Eastern Caribbean countries respond in a more symmetric way to the business cycle include, for example, expenditure ceilings, cyclical deficit targets, and rules-based stabilization funds.

**Reducing volatility and sustaining growth will require more stable financial markets and stronger financial sector institutions.** The report discusses a few options for designing policies to help the OECS economies to achieve that objective. First, greater openness to international financial markets is important, as it could help the OECS economies to hedge fluctuations in fundamental shocks, such as shocks to technology, terms of trade, and shocks associated to natural hazzards. Second, greater openness must be accompanied by improvements in domestic financial markets and government’s efforts to stabilise domestic risk-premium. By reducing the frictions in the domestic financial markets, these economies can cushion the negative effects of interest rate shocks on domestic economic activity, and achieve lower volatility. Third, if pro-cyclical fiscal policies induce higher country risk-premium in the international markets, governments of the OECS countries can stabilise their country’s risk-premium by switching to counter-cyclical policies. Fourth, if government consumption is strongly complementary with private consumption, switching to an independent or counter-cyclical fiscal policy stance can reduce the volatility of consumption in the economy. All of these should have a positive effect on long-term growth.

**To strengthen financial development in the region, a number of challenges need to be addressed.** Over the last decade, the OECS countries have made progress to further develop their financial systems. However, there is scope for further financial development in the region. The report identified specific measures that can be adopted to further enhance financial sector development. A new Banking Act has been passed which provides the foundation for improved banking supervision and future consolidation, and the insurance sector would benefit from similar harmonization. Financial access can be improved through better credit information tools and institutions that help to reduce the elevated levels of SME credit risk, such as a guarantee scheme. Finally, there are legal and regulatory improvements in the secured transactions framework and in the foreclosure legislation that would greatly help the sector. Careful coordination across all of the above will ensure that a strengthened and more nimble financial sector is better able to provide for the needs of the economy of the OECS. Once the financial sector is strengthened in the region, a deposit insurance scheme can be developed to provide a formal financial sector safety net.