

CHAPTER 2 : MACROECONOMIC COMPETITIVENESS

2.1 As discussed in Chapter 1, accelerating growth in the OECS will largely depend on the sub-region's ability to strengthen its performance in the global economy, which in turn will require improving its competitiveness. At the macro level, competitiveness can be defined as an economy's ability to attract the demand for its exports and the investment to supply that demand, all within social norms that result in an improved standard of living for its citizens. This, in turn, depends on the macro- and micro-economic policies, regulations and institutions that affect the productivity of the economy's factors of production and the costs of doing business. This chapter examines the sub-region's recent performance on three measures of macroeconomic competitiveness: the real exchange rate as a general indicator of price competitiveness, the exports of goods and services, and trends in FDI inflows to the sub-region.

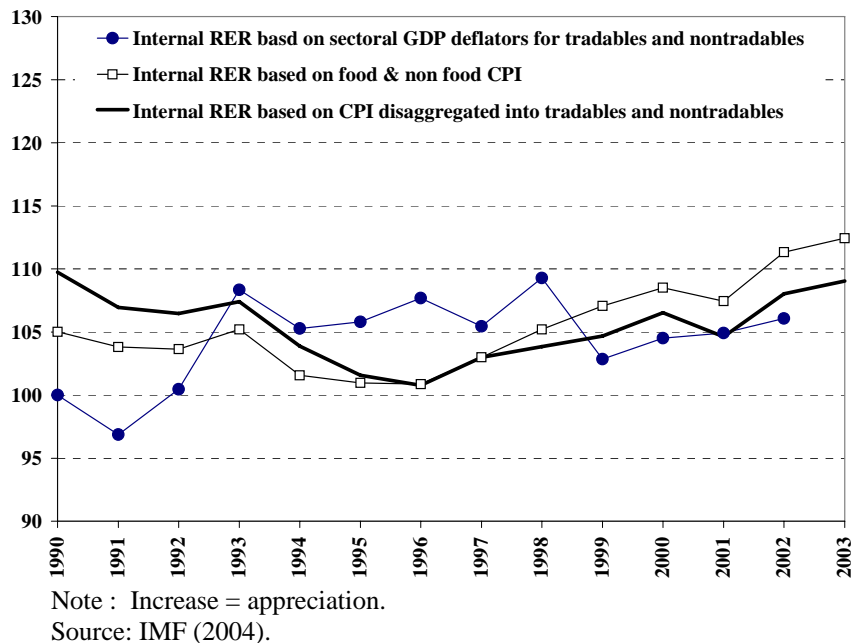
2.2 The analysis of real exchange rate trends shows evidence that, in the latter half of the 1990s, the OECS economies demonstrated a growing inward, rather than outward, orientation, and a general loss of price competitiveness. However, owing to a recent realignment driven mainly by external developments (notably the weakening of the US dollar), the real exchange rate as of mid 2003 did not appear to be either over- or under-valued with respect to key fundamentals. The analysis of export trends shows that after strong growth during the 1980s, exports of both goods and services experienced relatively weak performance during the 1990s, and contractions in the 2000s. Since the 1990s, OECS tourism and offshore financial services have lost market share in the Caribbean and worldwide, while key merchandise exports, including but not limited to the traditional agricultural products, have contracted or seen only marginal growth. However, there are some indications that the sub-region is in the process of identifying new exports – both of goods and services, but these are still too small to impact macroeconomic performance. In contrast to exports, the OECS has been extremely competitive in attracting foreign investment, with relatively stable flows as a share of GDP through the last two decades. However, in comparison to the Caribbean and the rest of the world the sub-region has been losing ground. This analysis suggests that the focus going forward should be on the trade and investment climates as well as on the direct factors of production rather than on the exchange rate.

A. The real exchange rate

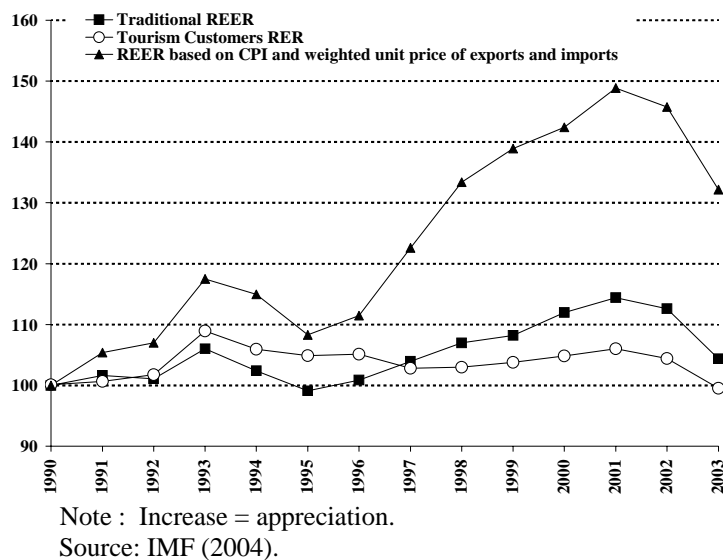
2.3 **After suffering a general loss of price competitiveness and a growing inward orientation over the latter half of the 1990s, the OECS experienced a relatively sharp correction in the real exchange rate, driven by external factors, so that by mid 2003, it did not appear to be either over- or under-valued.** The real exchange rate (RER) index measures how a country's international price competitiveness evolves over time with respect to its trading partners and competitors. Real exchange rates are computed by adjusting nominal exchange rates by the relative movements in costs of production. The latter is proxied by a variety of indicators each having their own interpretation, but which can be grouped into two categories: (i) RERs which are adjusted by disaggregating domestic price indices into the relative movements of the prices of tradables versus non-tradables and can be interpreted as a measure of the internal versus external orientation of the economy; and (ii) RERs which are computed using relative movements of domestic and international price indices – the latter usually specified as a weighted average of prices from the host country's trading partners or competitors – and are generally interpreted as a measure of international competitiveness.

2. 4 The IMF (2004c) constructs several alternative measures of the RER illustrated in Figure 2.1 and Figure 2.2. **Two of the three measures that use domestic price indices – the CPI or the GDP deflator – disaggregated into tradables and nontradables appreciated from around 1995 through late 2002 indicating a growing inward orientation of the regional economy** (see Figure 2.1).

FIGURE 2.1: RER BASED ON DOMESTIC PRICE INDICES ONLY, 1990-2003



2. 5 The traditional RER fluctuated around its early 1990 level through mid 1997, then appreciated by 10 percent through late 2001. Since then, however, it experienced a depreciation that entirely offset the earlier appreciation. The RER based on the unit prices of export and imports shows a similar pattern but with a much stronger appreciation during the late 1990s and weaker correction through 2003. With respect to the OECS tourism customers – its trading partners – the RER fluctuated steadily around its early 1990 level until late 2001, after which it depreciated sharply. The post-2001 depreciation is associated with the sharp depreciation of the US dollar (to which the EC dollar is pegged) against major currencies. This illustrates that **the OECS maintained its international price competitiveness through most of the 1990s, became increasingly uncompetitive in its non-tourism trade in the later part of the decade, but has since broadly regained price competitiveness as in the start of the decade.**

FIGURE 2.2: RER BASED ON DOMESTIC AND EXTERNAL PRICE INDICES, 1990-2003

2.6 In addition, the IMF (2004) estimates a co-integrating relationship between the real exchange rate and a set of fundamentals specified as the terms of trade, public sector external debt as a proxy for net foreign liabilities, and government expenditure to GDP. It extracts the trend component using the Hodrick-Prescott filter to generate an estimate of the equilibrium exchange rate. Its work illustrates that a significant part of the real exchange rate appreciation since 1995 and more recent depreciation could be accounted for by realignment to this equilibrium rate. In addition, given these recent corrections, the REER in mid 2003 appeared to be neither over- nor under-valued with respect to key fundamentals.

B. Export performance

2.7 After strong growth during the 1980s, the OECS experienced relatively weak performance in its exports of both goods and services during the 1990s, and contractions in the 2000s. Since the 1990s, OECS tourism and offshore financial services have lost market share in the Caribbean and worldwide, while key merchandise exports, including but not limited to the traditional agricultural products, have contracted or seen only marginal growth. There has been some diversification in merchandise exports, but the large majority of the new products is as dependent on preferential access to its main markets as traditional exports. Emerging exports of services such as offshore medical education are not yet well measured by national statisticians, but offer potential for future growth as discussed in Chapter 7. Although the volatility of total export growth has decreased over time, merchandise exports have remained much more volatile than service exports (as currently measured).

TABLE 2.1: EXPORT PERFORMANCE, 1980-2003

	1980-2003	1980s	1990s	2000s
Growth rate (average annual % change)				
Total	7.1	13.1	5.7	-4.0
Services	9.8	19.1	7.6	-5.2
Goods	2.9	6.2	0.7	-7.5
Volatility (coefficient of variation)				
Total	1.3	0.8	1.2	-0.8
Services	1.2	0.7	0.8	-0.5
Goods	3.4	1.8	26.5	4.8

Source: World Bank (2004i).

2.8 During 1980-2003, the OECS experienced a 7 percent average annual growth in exports of goods and services. However, this has deteriorated over time. Growth rates declined from an average of 13 percent in the 1980s to 6 percent in the 1990s, and exports contracted by 4 percent during the new millennium (see Table 2.1). Service exports, which accounted for, on average, 70 percent of export earnings over the period, grew by 10 percent per year, while merchandise exports grew by 3 percent. Notably, merchandise exports have been far more volatile throughout the period than service exports, despite the fact that tourism – considered a very volatile sector – dominates the service earnings. The higher volatility is due mainly to the concentration of the merchandise exports in traditional agricultural commodities.

2.9 **OECS service exports are dominated by tourism and tourism-related transport receipts which account for 82 percent of earnings. During 1990-2003, the OECS has been losing market share in tourism both worldwide and in the broader Caribbean.** OECS tourism receipts grew slower at 4.2 percent per year than worldwide tourism receipts, which grew by 5.0 percent per year, indicating a loss in market share. The OECS share of Caribbean tourism earnings also declined from 7 percent in the early 1990s to just under 5 percent in 2002. Tourist arrivals to the OECS have also experienced a moderate but continuing decline in Caribbean market share from 5.6 percent in 1992 to 3.9 percent in 2002. In 2003, however, the sub-region saw its market share rebound to 4.6 percent. Further details are presented in the case study on tourism in Chapter 7.

2.10 “Other service exports”, for which data is only available since 1996, were growing through 1999, after which they have experienced a sharp reduction. In part, this reflects the decline in the offshore financial services sector following the downturn in the global equity markets, and the increased scrutiny under the OECD’s Financial Action Task Force (FATF) in 2000 and after the terrorist attacks in the U.S. on September 11, 2001. However, offshore financial service exports account for at most 17 percent of OECS “other service exports”. The largest share (43 percent of other services, 12 percent of services and 10 percent of total exports of goods and services) is in “Other Business Services”, a category which is not well defined, and does not appear to be dominated by any single activity.

2.11 **One issue going forward is the need to strengthen the measurement of service exports both in the balance of payments as well as in the national accounts.** Currently, the balance of payments accounts for the OECS do not capture data on educational service exports as the data is not forthcoming from operators, with the exception of one island in which expenditure by offshore medical students is captured as a separate line item in Travel Credit. Receipts from offshore financial entities to government are captured in the balance of payments, but there has been less success in recording payments from offshore financial entities to lawyers and other professional agents for the use of their services (e.g. annual legal fees and retainer fees). With

respect to offshore gaming, the balance of payments only captures wages paid to local workers. Also, the national accounts statistics only capture data on domestic investments of offshore entities. Since these entities are not mandated to keep records on island, acquiring data on their financial operations has been difficult.

2.12 Merchandise exports which have accounted, on average, for 30 percent of exports of goods and services from the OECS have also seen major deterioration in performance during the 1990s followed by a contraction during 2000-03. However, despite the recent collapse in banana and sugar exports which together account for one third of export earnings – during 1998-2003 these exports contracted by 13 percent per year – merchandise exports as a whole only declined by 0.2 percent per year during the same period. This reflects the growing diversification of the sub-region's export base in the 1990s (see para. 2.14). However, the important question is whether this diversification has been in sustainable directions, and therefore provides evidence of improving competitiveness.

TABLE 2.2: TOP TEN* MERCHANDISE EXPORTS

	Total US\$m	Share %	Growth % §	Direction of trade		
				OECS	Caribbean % share	Rest of the world
Total	172.2	100.0		19.8	22.2	58.0
Bananas	39.6	23.0	-13.4	6.9	7.2	85.9
Electrical apparatus	27.8	16.1	9.7	0.5	0.1	99.5
Soap & soap products	12.6	7.3	-6.6	11.5	80.1	8.5
Nutmeg & others spices	10.8	6.3	1.3	0.3	1.3	98.4
Beer	10.6	6.2	14.3	34.4	61.2	4.3
Essential oils	7.0	4.0	6.8	7.5	78.7	13.9
Sugars & sugar confection.	7.3	4.2	-3.1	0.0	0.0	100.0
Paper products	5.6	3.3	-2.3	41.1	54.8	4.1
Arrowroot & other tubers	4.0	2.3	-3.0	18.5	48.2	33.3
Fish, frozen & fresh	3.9	2.3	-2.7	5.4	6.1	88.5
Other products	43.1	25.0		52.0	18.2	29.8

* Outside the OECS sub-region.

§ Annual average growth rate for the period, 1998-2003.

Source: World Integrated Trade Solution (available at wits.worldbank.org) and FTAA Tariff databases.

2.13 Table 2.2 lists the top 10 merchandise exports from the OECS to CARICOM and the rest of the world in 2003.¹ Of the just over half of the exports which go to the rest of the world, some 70 percent are directed to markets for which the OECS have preferential access. Within CARICOM, almost half of these exports are protected by CET rates of over 10 percent. Of these top ten exports, only four – beer, electrical apparatus, nutmeg and essential oils – demonstrated positive growth during 1998-2003.

2.14 The Herfindhal-Hirschmann Index² (HHI) for OECS merchandise exports as a whole is 0.16 which indicates a reasonable level of diversification for the sub-region. However, the HHI for individual countries ranges from 0.50 for St. Kitts to 0.22 for Antigua and Barbuda and Dominica, indicating much less diversification on a country-by-country basis. Seven of the top 10 exports originate predominantly from one or two countries in the sub-region: electrical

¹ Data from Antigua and Barbuda is from 1999, but this accounts for a very small share of exports, none of which comprise the top ten products for the sub-region.

² Based on shares of the top 10 products only.

apparatus and sugar comprising 92 percent of merchandise exports from St. Kitts and Nevis, soap products and essential oils which represent 51 percent share of merchandise exports from Dominica, fish and nutmeg which are 56 percent of exports from Grenada, beer which comprises 20 percent of St. Lucia's exports, tubers from St. Vincent and the Grenadines and Dominica, and paper products from St. Lucia and Grenada.

2. 15 **The predominance of these products derives from a combination of history** (sugar and nutmeg³), **efforts to capitalize on sources of comparative advantage** (fish, soap products⁴ and essential oils⁵) **and preferential access** (electrical apparatus from the US-Caribbean Basin Initiative, beer and wheat within CARICOM). **The major issue is how replicable these experiences will be in the future.** Clearly those based on preferential access will face major risks in the evolving global environment. For sugar, the earlier source of comparative advantage – cheap labor – has disappeared, and St. Kitts and Nevis' small geographic size precludes it from the new source of competitive advantage in this product which stems from economies of scale. The comparative advantage of nutmeg and essential oils continues to persist – for both products the countries are in a very limited group of producers worldwide. The survival of the other products will depend on how they are able to create competitive advantage in the new global economy. Box 2.1 shows the uncertain prospects of electronics assembly in St. Kitts and Nevis.

BOX 2.1: ELECTRONICS ASSEMBLY IN ST. KITTS AND NEVIS

The largest merchandise export in St. Kitts and Nevis is electronic parts – cable network filters and light dimmer switches exported by two firms. These companies are positioned in a relatively small market segment in the US in which most production has not yet been outsourced by North American manufacturers. Network filters enable cable companies facing increased competition in the US to differentiate their promotions across market segments. This requires just-in-time delivery to facilitate the rapid roll-out of new offerings. Thus, this firm competes on its lead time of three weeks between order and delivery versus the 6-8 weeks that would be possible from Asia where competitors offer cheaper wages. The second company is positioned to serve the growing construction market in the U.S. Its comparative advantage is being able to purchase inputs from around the world, cheaper than they would be available in the US. Both operations are fairly labor intensive – combined, they employ approximately 620 persons – and require a significant amount of training for the production line staff. Proximity to the US allows the firms to source scarce specialized technical skills at short notice rather than install permanent technical staff, as would be required in Asia. The firms report that the investment in training is a large fixed cost for these small operations, and the fact that the home companies are first-time outsourcers who are reluctant to venture very far from the US in terms of both language, culture and distance has made these types of investments less footloose. They contend that the OECS still has a comparative advantage to offer smaller outsourcing operations of around \$50-100m turnover and requiring a small labor base of around one thousand employees. However, a third firm in a different market segment has already relocated because of cheaper labor elsewhere. Also, the two firms noted that, as the Latino community in the US grows, the comparative advantages vis-à-vis Central America will decline.

C. Foreign direct investment

2. 16 **In contrast to exports, the OECS appears to be competitive in attracting foreign investment. The sub-region has historically attracted very high levels of FDI relative to its size and income levels.** FDI accounted for around 9 percent of GDP during 1998-2003,

³ Nutmeg was introduced to Grenada in the 18th century because of the island's ideal soil conditions and to create a closer source to Europe than the Dutch East Indies.

⁴ Dominica's soap products started on the basis of earlier coconut plantations that have since been abandoned. Oils for soap production are now imported.

⁵ Bay oil derives from the leaves of a non-cultivable tree found solely in Dominica.

compared with 7.9 percent for other micro states and 3.8 for upper middle income states (see Table 2 in Introduction). On average, FDI represents about 27 percent of gross fixed capital formation in the OECS compared with 15 percent for Latin America. On the UNCTAD index of FDI performance, the OECS countries had an average rank of 20 in 2002, with St. Kitts and Nevis ranking 3rd after Luxembourg and Chad (see Table 2.3).

TABLE 2.3: FDI PERFORMANCE

	1980s	1990s	2000s	Rank in UNCTAD FDI Performance Index	
				1990	2002
	(% share of GDP)				
Antigua and Barbuda	11.0	6.4	7.3	2	25
Dominica	4.1	9.3	5.8	7	32
Grenada	3.5	8.6	14.1	11	16
St. Kitts and Nevis	11.3	12.5	22.8	1	3
St. Lucia	11.5	7.9	1.1	4	62
St. Vincent and the Grenadines	3.0	15.0	9.0	20	36
OECS	8.1	9.2	8.8	5	20
Caribbean * (simple avg.)	3.0	4.7	5.2		
Caribbean * (weighted avg.)	0.7	2.6	8.0		
OECS share of Caribbean FDI	20.3	12.3	3.7		

* not including the OECS

Source: UNCTAD, IMF International Financial Statistics, World Bank (2004i)

2.17 **Figure 1.3 illustrates that, while cyclical, FDI inflows to the OECS have been relatively stable averaging 8 percent of GDP annually and the volatility for the sub-region as a whole has decreased over time.** This stable average however masks significant changes in the FDI inflows across the OECS countries. Antigua and Barbuda and St. Lucia have seen a steady decline in FDI as a share of GDP since the 1980s, while Grenada and St. Kitts and Nevis have seen steady growth. Dominica and St. Vincent and the Grenadines experienced a boom in the 1990s which has since moderated (see Table 2.3).

2.18 **While FDI inflows to the OECS remain large and their share of GDP stable, the OECS has lost some ground over time, including to the rest of the Caribbean and the rest of the world.** FDI inflows to the rest of the Caribbean have increased from around 0.7 percent of GDP in the 1980s to almost equal the OECS ratio in the new millennium (8.0 percent). In addition, the OECS share of inflows of FDI to the Caribbean has fallen from just over 20 percent in the 1980s to around 4 percent in the new millennium. In terms of the rest of the world, the OECS average ranking on the UNCTAD FDI Performance Index has fallen from 5 in 1990 to 20 in 2002, as the sub-region has been overtaken by other countries, which have succeeded in attracting large volumes of FDI relative to their GDP.