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Is the Whole Greater than the Sum of its Parts? Strengthening Caribbean Regional Integration

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I N T E R N A T I O N A L M O N E T A R Y F U N D

IMF Working Paper

Western Hemisphere Department

Is the Whole Greater than the Sum of its Parts? Strengthening Caribbean Regional Integration

Prepared by Abdullah Al Hassan, Mary Burfisher, Julian Chow, Ding Ding, Fabio Di Vittorio, Dmitriy Kovtun, Arnold McIntyre, İnci Ötker, Marika Santoro, Lulu Shui, and Karim Youssef¹

Authorized for distribution by Krishna Srinivasan

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Abstract

Deeper economic integration within the Caribbean has been a regional policy priority since the establishment of the Caribbean Community (CARICOM) and the decision to create the Caribbean Single Market and Economy (CSME). Implementation of integration initiatives has, however, been slow, despite the stated commitment of political leaders. The “implementation deficit” has led to skepticism about completing the CSME and controversy regarding its benefits. This paper analyzes how Caribbean integration has evolved, discusses the obstacles to progress, and explores the potential benefits from greater integration. It argues that further economic integration through liberalization of trade and labor mobility can generate significant macroeconomic benefits, but slow progress in completing the institutional arrangements has hindered implementation of the essential components of the CSME and progress in economic integration. Advancing institutional integration through harmonization and rationalization of key institutions and processes can reduce the fixed costs of institutions, providing the needed scale and boost to regional integration. Greater cooperation in several functional policy areas where the region is facing common challenges can also provide low-hanging fruit, creating momentum toward full integration as the Community continues to address the obstacles to full economic integration.

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EXECUTIVE SUMMARY

Deeper regional integration has been a long-standing objective for the Caribbean. The persistent interest in this quest led to the Treaty of Chaguaramas in 1973, which established the Caribbean Community (CARICOM) to address the constraints of small size on development, share the cost of common services, and pool bargaining power in international fora. Changing global conditions and the rise of globalization prompted the political leadership to seek a deeper form of integration by establishing the Single Market and Economy (CSME), with the Revised Treaty of 2001 setting up a roadmap. The goal was to create a common economic space and transform CARICOM into an economic union through policy coordination, harmonization of functional areas, and an eventual move to a currency union. CSME provisions focused on forming a free trade area, a customs union, a common market with free movement of capital, skilled labor, goods, and services, and an economic union with coordinated sectoral and macroeconomic policies.

While significant progress has been made, institutional integration within CARICOM has advanced slowly. Implementing the CSME provisions has been a gradual and incomplete process, with around 57 percent of the actions required to establish the CSME completed since the Revised Treaty. Most progress has been in the Free Trade Area stage of integration, with intra-CARICOM goods trade essentially free of tariffs, and some progress also made in promoting a common market in services and skilled labor. However, the customs union and common market stages remain incomplete with significant nontariff barriers (NTBs) to trade, divergent tariff rates applied to extra-CARICOM trade, and lack of harmonized regulations and duplication of processes affecting intraregional labor movement. Limited progress has been made in harmonizing/coordinating policies to support a single economic space, with continued restrictions on capital mobility, and lacking harmonization and coordination of investment codes, tax incentives, and macroeconomic policies. Integration within the Organization of Eastern Caribbean States (OECS) advanced faster, with free movement of labor and services within the OECS and some supranational institutions for policy harmonization.

The degree of economic integration also lags behind other well-integrated regions. Divergence of key macroeconomic variables across the region has fallen over time, but the fall has slowed down or even reversed recently, partly reflecting the different impact of external shocks on tourism-dependent CARICOM countries vis-à-vis commodity exporting members. While increasing, the share of intraregional trade in total trade remains at low levels compared to other integrated regions. The low degree of synchronization of business and credit cycles suggests a higher cost of pursuing common economic policies. Slower convergence of incomes and a widening gap between the lowest and highest income brackets across the region highlight the need to ensure the region benefits from integration as a group. While financial integration seems to have proceeded faster with tightly-interconnected financial systems, capital markets remain underdeveloped and fragmented. No Caribbean-wide capital market exists, with most activity concentrated in a few countries through cross-listing of securities.

The slow pace of regional integration reflects a combination of economic, institutional, and political economy factors, and resource and capacity constraints. The lack of a regional body with powers and accountability to effect decision making and of tools to transform community decisions to binding laws are key impediments. A decision-making process based on unanimity principle under which each member retains its sovereign authority also hinders progress, especially when combined with inadequate resources and technical expertise, and lacking prioritization needed to draft and ratify laws and secure public support for the decisions made. Misaligned incentives for integration add to these institutional constraints, with large up-front costs of implementing the necessary measures and the potential benefits for trade, growth, or employment perceived as uncertain, potentially uneven, or materializing over a longer horizon. Lack of diversification of export and production structures, diverging economic fortunes across commodity- and tourism-based economies, and diverse income and development levels add to diverging national interests, making the

harmonization of economic and structural policies a challenge. The slow progress with institutional integration and harmonization of legal and administrative frameworks, in turn, hinders implementation of the essential components of the CSME and undermines economic integration.

The paper's findings suggest that greater regional integration through further liberalization of trade and greater labor mobility across the Caribbean can generate significant economic benefits. In particular, reducing the high NTBs and trade costs within the region and vis-à-vis non-CARICOM trading partners will not only generate trade expansion and welfare gain for all members, but will also help restructure economies from contracting to expanding sectors, resulting in a net employment gain across the region. Further integration could also allow free movement of people and better allocation of skills and factors of production. Improved factors and skills allocation could increase labor productivity and create long-term growth benefits for the entire region, including by helping to limit the pervasive brain-drain through migration to other regions and rebalancing factor and product markets following external shocks.

The region therefore needs to focus its utmost attention to addressing the key impediments to progress in institutional integration. Accelerating efforts to harmonize and rationalize the key institutions and processes across the region can provide significant dividends for economic integration. Caribbean authorities remain committed to establishing a common economic space and acknowledge that greater collaboration is needed to tackle common challenges. Efforts in this direction are still seen by the regional authorities as worthwhile a goal to pursue today as at the inception of CARICOM. It is important to capitalize on this momentum.

Integration through functional policy cooperation can offer an effective way to create momentum toward full integration. As the Caribbean Community continues to resolve the impediments to full integration, advancing functional policy cooperation in areas where the region faces significant common challenges could provide low-hanging fruit, while building momentum toward full integration and helping realign incentives. These areas could include, for example: safeguarding regional financial stability in a tightly interconnected financial system; building resilience to more frequent and costly climate-related risks; fighting violent crime; and preventing a race to the bottom in granting incentives to foreign investors. As in furthering the CSME, deepening cooperation in these areas calls for accelerated efforts to harmonize/streamline the institutional frameworks given the significant fiscal and capacity constraints, improve their efficiency and transparency, and reduce disparities across countries, with a view to reducing costs and increasing the scale and resources.

- **Advancing policy coordination in the financial sector:** While bringing benefits, integrated financial systems can also generate systemic risk and propagate shocks across national borders. A coordinated approach with effective information sharing and home-host supervisory arrangements and harmonized resolution frameworks is essential to limit regulatory arbitrage, respond to financial stress, and safeguard financial stability. The region has made progress in aligning regulatory and supervisory frameworks toward best practice, but more is needed to establish regional regulatory/resolution frameworks for cross-border institutions. Progress in these areas and effective AML/CFT regimes will also help with the loss of correspondent banking relationships and persistent weakness in asset quality—both regional challenges. A regional distressed-asset market and reduced data gaps are also key in this regard.
- **Building resilience to natural disaster and climate risks:** In a region highly vulnerable to frequent and costly natural disasters with severe macroeconomic consequences, building resilience is a key policy priority. But the region underinvests in ex-ante resilience, reflecting in part resource and capacity constraints. With a shared goal of attaining a climate-resilient Caribbean, collaborative solutions should aim at pooling resources and capacity, building on the positive experience with facilitating speedy recovery and reconstruction after disasters and with mitigating financial costs of disasters through the Caribbean Catastrophe Risk Insurance

Facility (CCRIF). An integrated Caribbean has also a better chance of acquiring necessary, low-cost financing from development partners, accessing more affordable insurance, raising its voice on climate mitigation policies, and building resilience to climate change risks.

- **Fighting crime:** The high rates of crime impose a serious social and economic burden on the region. It impedes economic growth by discouraging tourism and business investment, reducing labor productivity, and diverting government spending away from growth-enhancing investments. Regional efforts could accompany national efforts to address the common challenge of crime, with its drivers and effects crossing national boundaries. CARICOM has taken significant steps to deal with crime (the fourth pillar of the regional integration movement), but limited national budgets continue to favor ex-post response through law enforcement, as opposed to ex-ante management of crime risk. Collaboration could focus on both preventive and response efforts, pooling regional resources and information, standardizing legal and institutional frameworks, enhancing intraregional labor mobility to create jobs and disincentivize crime, and safeguarding border security.
- **Avoiding a race to the bottom:** Regional cooperation can be particularly fruitful in areas where it can facilitate solutions to collective action problems that encourage harmful competition and result in prisoners' dilemma situations.
 - **Tax incentives** often entail large fiscal and social costs and can create negative externalities for other countries, yet empirical analyses do not find them benefiting the wider economy. Close cooperation on, and harmonization of, tax incentives can help safeguard fiscal revenues and limit potential adverse effects on fiscal sustainability, growth, and development. While streamlining tax incentives, efforts could focus on harmonizing systems for tax administration, sharing taxpayer information and transfer pricing methods, and improving the business environment. A regional institution can be helpful for monitoring implementation of policies on harmonizing tax incentives.
 - **CBI programs** have become an important source of public revenues, helped improve fiscal growth, and external outcomes, and facilitated debt repayments. Developing a regional approach to manage CBI programs can improve their long-term viability and prevent a race to the bottom by relaxing rules to attract inflows and undermining, in turn, fiscal sustainability and integrity of the programs. A regional approach can also provide economies of scale and reduce costs, improve their long-term viability through best practices, and more rigorous due-diligence processes with a broadened information base. Close cooperation could also focus on regionalizing the CBI programs and best practices with management of inflows to limit potential macroeconomic risks from large inflows.

The CARICOM leadership has been taking recent decisions aimed at reinvigorating the efforts to complete the CSME agenda. These include the decision to move forward with liberalizing free movement of labor by select CARICOM states; a move by the OECS to harmonize CBI programs; the recent calls to establish a Caribbean-wide securities market and a multi-country implementation committee to prioritize progress on functional cooperation, and to form "a coalition of the willing," rather than waiting for unanimity; and calls for well-defined roadmaps and timelines to harmonize markets and institutions to avoid duplication. Actions along these lines can help demonstrate benefits from coordinated action and serve as a building block to the ultimate goal of full integration. IFIs, global and regional development partners, the private sector, labor unions, and civil society could join these efforts, to coordinate, advocate, and support the actions, including through funding and technical assistance (e.g., by leveraging on institutions such as the CARICOM Development Fund and benefiting from TA by IFIs in areas of common challenges) to make sure that benefits of integration are shared across the region. Importantly, regional integration should be seen as a means to the end of a globally better-integrated Caribbean that could take advantage of global value chains.

I. INTRODUCTION AND MOTIVATION

1. Deeper economic integration within the Caribbean has been a regional policy priority since the establishment of the Caribbean Community (CARICOM) in 1973.

Comprising 12 island states or territories and three larger coastal states, CARICOM represents a diverse group, given the large differences in population, land sizes, levels of economic development and incomes, and exposure to diverse external shocks, notwithstanding the cultural and historical similarities and some common shocks and challenges in building and maintaining institutions with limited financial, technical, and human resources.² A key objective of establishing CARICOM at the Treaty of Chaguaramas was to pursue regional integration, with a view to addressing the constraints of small size on development, sharing the cost of common services, and pooling bargaining power in international fora (Lewis 1950; Demas 1976 and 1997; Nicholls, Birchwood, Colthrust, and Boodoo 2000; Warner and Anatol 2015; and West Indian Commission 1992).

2. Nearly 30 years after CARICOM's establishment, member countries signed the Revised Treaty of Chaguaramas to create an economic union,

by initiating the CARICOM Single Market and Economy (CSME). Members felt that the Original Treaty fell short of addressing its stated objectives—of free movement of goods, services, capital and people, strengthening the region's external position through coordination of foreign policies, and pooling limited resources through functional cooperation. The Revised Treaty in 2001 aimed to create a common economic space and transform CARICOM into a borderless community, with deeper economic policy coordination, increased harmonization of functional areas, and an eventual move to a currency union. The new architecture was hoped to permit the region pool resources and exploit opportunities that individual states would not be able to achieve separately (Review Commission Secretariat 2017).

3. The implementation of regional integration initiatives and the CSME has been slow, despite the stated commitments of the CARICOM members.

As of end-2017, 18 years after the Revised Treaty, 57 percent of the actions required to establish the CSME had been completed. This implementation deficit has created increasing skepticism about completing the CSME and its benefits and may have taken a toll on the region's commitment to the integration movement. The March 2017 Jamaican Commission Report on CARICOM and CARIFORUM frameworks stressed that regional integration remains as valuable and relevant today as at its inception, but called for specific, time-bound, measurable, and verifiable program of action to complete all the requirements for the CSME and make it operational within the next 5 years. Special Meeting of Heads of Government on the CSME (November 2018) and the 13th Intersessional of Heads of Government Meeting (February 2019) took decisions in several areas aimed at reinvigorating regional integration.

² CARICOM countries include the Organization of Eastern Caribbean States (OECS) (including Antigua and Barbuda, Dominica, Grenada, Monserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines), and non-OECS states (Bahamas, Barbados, Guyana, Haiti, Jamaica, Suriname, and Trinidad and Tobago). CARICOM states with lacking data (Haiti and Monserrat) are not included in the analyses of this paper.

4. **This paper documents the evolution of regional integration within CARICOM and discusses possible ways to move forward.** It uses three main concepts of regional integration: *institutional integration* (defined as the outcome of joint policy decisions taken by regional inter-governmental fora designed to affect the depth and breadth of regional integration); *economic integration* (captured by the convergence of various indicators of monetary, real, and financial integration);³ and *functional cooperation* (in areas including, stability, security, environment, or disaster response). To track progress with integration, it constructs indices of institutional integration (Section II) and economic integration (Section III), compares them with other regions, and analyzes the interplay between institutional and economic integration and possible factors undermining their progress (Sections II, III, and IV). The paper then analyses potential economic benefits from further integration through further trade liberalization and labor mobility (Section V) and explores the scope for deeper functional cooperation as a way to build momentum for full integration (Section VI). Section VII concludes.

II. TRACKING INSTITUTIONAL INTEGRATION IN THE CARIBBEAN

The evolution of institutional integration within the Caribbean, based on the progress made in completing the five stages of institutional integration underlying the CSME—free trade area, customs union, common market, economic union, and economic policy integration—suggests that the region has advanced toward implementing the CSME, but the progress has been slow, and the integration movement has a long way to go. While progress has been made in liberalizing the movement of goods, services and skilled people within the region, establishing the single market and coordination or harmonization of policies to support a single economic space are well behind schedule.

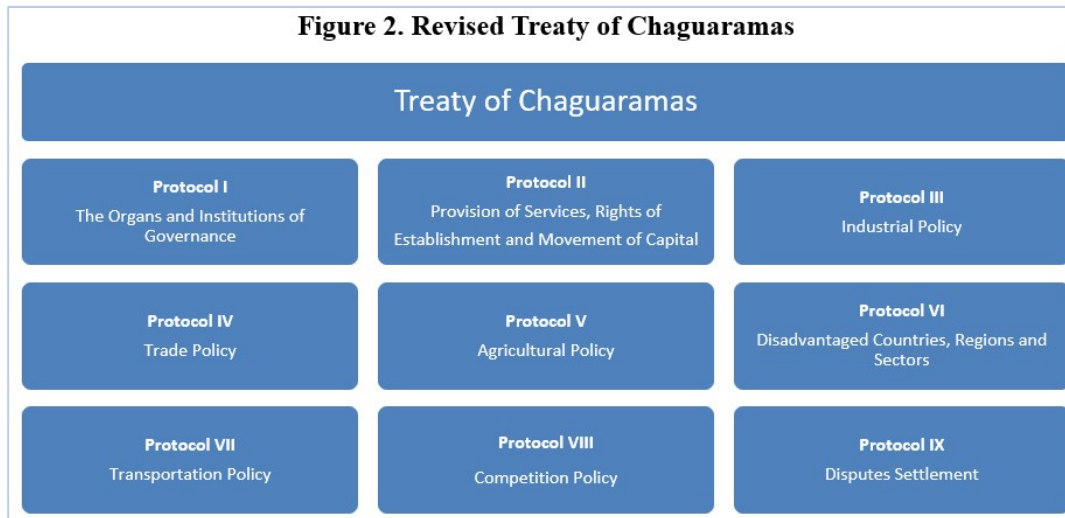
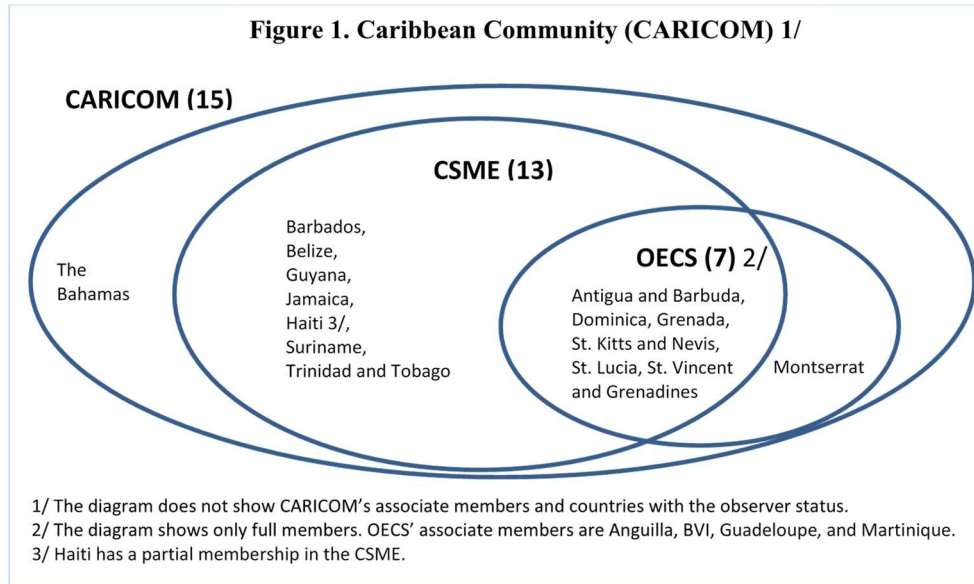
A. The Context

5. **Regional integration has been a long-standing goal in the Caribbean, dating back to the pre-independence period.** The Treaty of Chaguaramas established the Caribbean Community (CARICOM) in 1973, with the objectives of deepening economic integration through free movement of goods, services, capital, and people, coordination of members' foreign policies, and pooling their resources through functional cooperation in the areas of education, health, environment, science and technology, communications, and response to natural disasters—Warner and Anatole (2015). In a span of 46 years, CARICOM membership grew from 4 founding states (Barbados, Guyana, Jamaica, and Trinidad and Tobago) to 15 members, including now the members of the OECS, The Bahamas, Belize, Haiti, and Suriname (Figure 1). The Bahamas is outside the customs union, hence the CSME.

6. **One of the key milestones in the CARICOM integration process was the decision to create an economic union with a much deeper form of integration.** The Revised Treaty of Chaguaramas in 2001 set out a roadmap for building the CSME to create a common economic space, through implementation of nine Protocols of Amendment to the original Treaty (Figure 2). Recognizing the importance of policy coordination for a single economic space, the provisions focus on facilitating a free movement of goods, services, capital and

³ The approaches follow closely the novel approach of Dorrucchi and others (2005).

skilled labor in the region, and include additionally coordination of fiscal, monetary, and sectoral policies of the member states, along with increased harmonization of laws governing the treatment of labor and business, and eventually a currency union. In this context, the CSME agenda includes macroeconomic convergence, with the coordination pillars including an agreed Fiscal Responsibility Framework and Debt Management Strategy with prescribed fiscal and debt reduction targets achieved in the medium term, alignment of monetary policies, abolition of exchange controls, and full convertibility of currencies within the region.

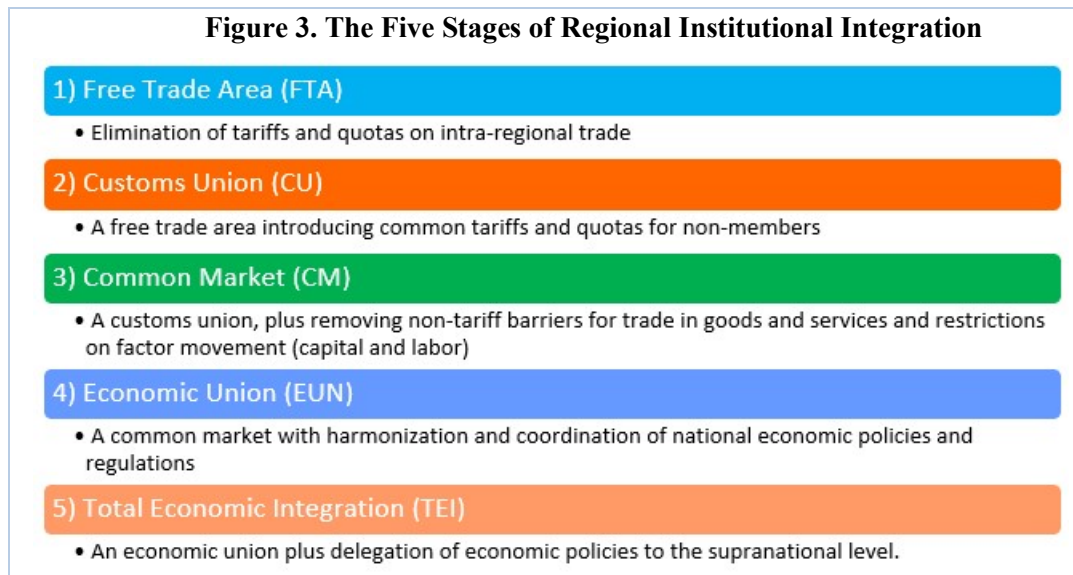


7. **Despite considerable progress, the integration objectives spelled out in the CSME agenda are not complete.** The analysis below takes an in-depth look at the institutional integration process and its evolution for CARICOM, as well as separately for OECS and non-OECS members, with the former having taken much deeper steps toward integration through a common currency and a central bank that conducts a uniform monetary policy and oversees financial and banking integrity for the independent OECS states. The region's progress in completing institutional integration is assessed by constructing an index

of institutional integration following the Balassa (1961) framework applied by Dorucci and others (2002, 2015) to institutional integration within the European Union (EU).

B. The Evolution of Institutional Integration in the Caribbean

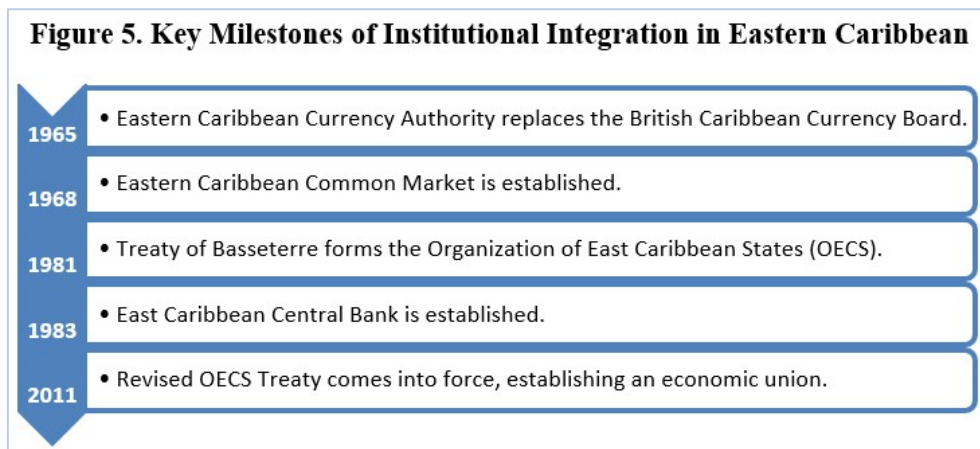
8. **Institutional integration to assess implementation of the CSME focuses on the policy and regulatory aspects of integration**, based on the outcome of joint policy decisions taken by regional inter-governmental fora toward deepening integration. With the CSME aiming for a much deeper form of integration with a free movement of goods and services, capital, and skilled labor, coordination or alignment of macroeconomic policies, and harmonization of laws, the seminal work of Balassa provides a useful framework to assess the region's progress toward institutional integration. Balassa (1961) identifies 5 stages of regional institutional integration that broadly corresponds to the goals of the CSME: A Free Trade Area (FTA); a Customs Union (CU); a Common Market (CM); Economic Union (EUN); and Total Economic Policy Integration (TEI) (Figure 3). Progress in completing these five stages helps assess the progress with institutional integration within CARICOM.



9. **More specifically, an Index of Institutional Integration is constructed following the approach of Dorucci and others (2002).** In computing the index, a maximum score of 25 points is assigned to each of the four stages (FTA and CU are assessed jointly), with the overall index ranging from 0 (no integration) to 100 (full integration) depending on the progress with the implementation of integration initiatives. To track actual institutional integration, points are assigned based on *implementation*, rather than *announcement* of a decision to implement specific measures in the future. Importantly, implementation of stages could be non-sequential; that is, some elements from each stage can be implemented simultaneously. Relaxing restrictions on factor movements could, for instance, occur alongside the establishment of supranational institutions.

10. **The institutional integration indices are constructed over 1965-2017 for the OECS members, as part of a currency union, and non-OECS members of CARICOM.** Compiling the indices involves detailed examination of the key CARICOM institutions and

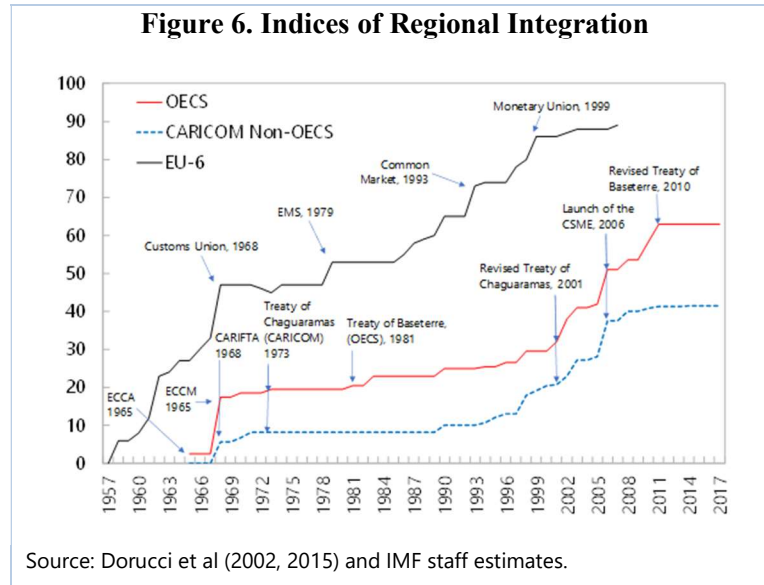
implementation of the agreements associated with the establishment of the Caribbean Free Trade Association (CARIFTA), CARICOM, the Eastern Caribbean Currency Union (ECCU), and the CSME (Figures 4 and 5), and requires, in several cases, judgement about the timing and relative importance of certain steps in the integration process. The speed of institutional integration in the Caribbean is compared with that in other regions, by comparing the Caribbean institutional index with similar indices constructed for the EU and MERCOSUR (Southern Common Market) blocks—the latter indices are taken from Dorucci and others (2002).



11. **The indices suggest that progress with institutional integration within CARICOM has been slow and incomplete.** Integration has proceeded in several waves, with periods of integration followed by slowdowns in progress, much of which seems to have been driven by the first two stages of institutional integration (i.e., free trade area and customs union, Figure 6). The process began when eleven countries joined CARIFTA in the late 1960s, starting the process of trade liberalization.⁴ In 1973, CARIFTA was superseded by CARICOM to facilitate economic integration of member states, at a time of the UK's entry to European Economic Community and highlighting that integration efforts were in response to the need to adapt to the changing external environment. However, progress during much of the 1970s-1980s was limited, with the integration index among non-OECS

⁴ Belize joined CARIFTA in 1971 and Suriname in 1973 as an observer. The Bahamas does not participate in the free trade area and did not sign up to the CSME.

CARICOM members rising only to 25 by 1990. Trade regimes were characterized by high and widely dispersed tariffs and considerable use of non-tariff barriers (NTBs), including quantitative restrictions such as discretionary licensing requirements. Protectionist policies also included high import duties on imports from within the region, which severely impeded intraregional trade growth.



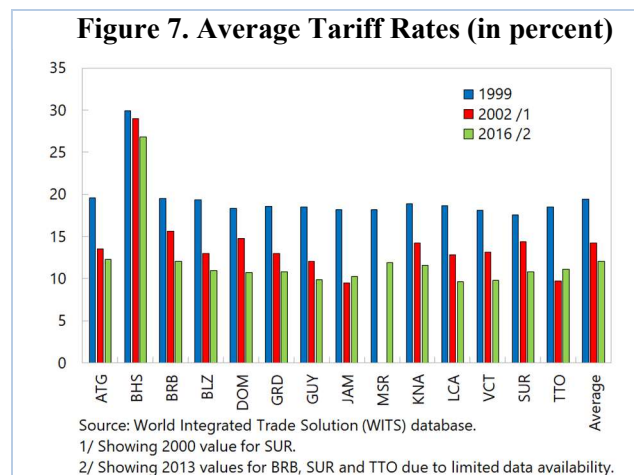
12. **Integration started to accelerate in the 1990s, driven in part by external factors.** In 1989, the Grand Anse Declaration issued by CARICOM Heads of State announced a goal to establish the CSME by 1993 with the rapid changes in the external environment. EU integration, the loss of trade preferences, and the emergence of a global market with new sources of competition led to a realization that the development model needed to shift from import substitution toward export-driven growth.⁵ This realization resulted in a marked shift in the development policy paradigm in some Caribbean countries, from a focus on protecting domestic markets and significant state involvement toward an outward-oriented strategy that emphasized export competitiveness, adoption of liberal policies to facilitate a more efficient functioning of markets, and reduced state role and intervention in the economy. Trade was liberalized, with quantitative restrictions phased out and replaced by temporarily higher import duties that were lowered over time. The effect of NTBs on imports was reduced from an estimated 40 percent of imports in the mid-1980s to 11 percent by 1997 (Baumann 2008).

13. **As part of this process, membership in CARICOM brought more commonality to trade policy, with progress along the second stage of institutional integration.** All countries subscribed to the common external tariff (CET) on extra-regional imports, and between the late 1990s and early 2000s, every country, except for The Bahamas, had a nearly 5½ percentage point reduction in average import tariff rates, from average levels of 19½ percent (Figure 7). Tariffs continued to fall but showed more modest declines since then. The CET and rules of origin are in operation in all CARICOM states except The Bahamas and

⁵ See West Indian Commission (1992).

Haiti, though differences across CET have remained (see below).⁶ The Bahamas maintained a relatively high average tariff, at 27 percent in 2016.

14. **The CSME was formally launched in 2006, but the second stage of integration following its launch has been slow and important gaps remained**—in particular in completing the common market and economic union stages of integration. The CARICOM has made significant progress in establishing the common market, in that with some notable exceptions, intra-CARICOM trade in goods is essentially free of tariff barriers, the customs union has been advanced, and there has been progress with promoting the common market in the areas of trade in services and free movement of skilled labor. However, issues with full implementation of the facilitation of travel regime and harmonization of processes for movement of skilled nationals and NTBs remain. There has also been limited progress in integrating capital markets (Section III) and in the last two integration phases in the Balassa taxonomy (economic union and total economic integration). At the time of the CSME launch, the index of institutional integration for non-OECS CARICOM members was close to 38, less than half of the EU level when the EU Common Market was established.



15. **The OECS countries advanced integration faster than the rest of the Caribbean.** Eastern Caribbean islands were a part of the British Caribbean Currency Board in 1935 and unified their currency system based on the West Indian dollar in 1949. Since the collapse of the West Indies Federation in 1962, members created some supranational institutions necessary for coordination and harmonization of policies, including the Eastern Caribbean Currency Authority, ECCA (1965), the Eastern Caribbean Common Market (1968) as a precondition for entry into CARIFTA, the OECS (1981), and the Eastern Caribbean Central Bank, ECCB (1983) to replace the ECCA with an additional mandate to conduct regional monetary policy. The revised Treaty of Basseterre (2011) provided the foundations for an economic union among OECS members, most notably with the free movement of people within the OECS. To advance capital market and financial sector integration, the Eastern Caribbean Securities Market and the Regional Government Securities Market were set up in 2002, facilitating issuance/trading of equities, corporate bonds, and government securities.

⁶ The CET maintains lists of exemptions, which permit differentiated tariffs, including higher tariffs for some items in member states.

16. **These advances helped the OECS sub-region to become more institutionally integrated than the rest of CARICOM.** The institutional integration index for the OECS stood above 60 in 2017, compared to just above 40 for non-OECS CARICOM. In particular, the OECS is more advanced in establishing the common market, with the free labor mobility policy applying to non-skilled, as well as skilled, labor, the presence of a regional securities market, and capital flows free of restrictions within the OECS. Nonetheless, gaps remain in total economic integration, owing to the limited coordination of policies (particularly fiscal policy) and the limited setup of supranational institutions and policies in these areas.

17. **The pace of integration has also been slow compared with the EU for the region as a whole.** The CSME's formal launch took much longer than expected, with the slow implementation of a comprehensive revision of the Treaty of Chaguaramas. To be fair, the gap with the EU partly reflects the very high bar set by the EU for institutional integration at the outset, as well as its greater resources and capacity for implementation. Strong political support for integration in the aftermath of World War II allowed European countries to pursue ambitious objectives, such as elimination of borders for trade in goods and factors of production, and delegation of many policies to supranational levels. The demise of the Bretton Woods System in 1971 and the realization that full benefits of a common market cannot be achieved with exchange rate uncertainty provided impetus to the European Monetary System and the common currency. For CARICOM, the objective of a common currency was seen overly ambitious and has been indefinitely deferred (Girvan 2005).

C. Current Gaps in the Implementation Status

18. **As suggested by the institutional integration index, a detailed assessment of the implementation status of CSME actions also implies that the integration project has a long way to go** (Table 1). Based on the CARICOM Secretariat CSME Status Reports, only 56.5 percent of the actions required to establish the CSME has been completed as of 2017, suggesting some limited progress since the last assessment in the early 2000s (Girvan 2005). Actions related to the Single Economy continue to be the areas where very limited progress has been made, but significant gaps also remain in implementing the Single Market provisions.

- **Goods and services:** Continued progress has been made in liberalizing the movement of goods and some services. However, an *unfinished trade agenda* remains, particularly in removing all NTBs, as well as in full implementation of the CET by all member countries (Section V). Potential trade disputes can result from nonapplication of the CET to extra-regional goods imports, application of Sanitary and Phyto-Sanitary (SPS) measures and Technical Barriers to Trade (TBT) that limit the entry of CSME-originating goods, and maintenance of unauthorized taxes and other charges on specified CARICOM goods (Warner and Anatole 2015).⁷

⁷ The absence of an Agreed Protocol on SPS procedures and certification impede intraregional trade in agricultural goods. Other key areas that need to be completed on the trade agenda include: (i) Agreement of the application of Rules of Origin to goods produced within the Free Zones in Member States; and (ii) Harmonization of Customs laws, regulations and procedures including, especially, perishable goods.

Table 1. Actions Taken Toward Implementation of the CSME

Summary of Implementation Status of CSME Actions (as of end-2016)				
Category	No. of Action Elements	Total Required Actions 1/	No. Completed	Percent Completed
A. Legal and Institutional Infrastructure	19	261	192	73.6
1. Treaty Revision	3	39	39	100
2. Consultative Mechanism	4	60	32	53.3
3. Enforcement, Regulation and Supporting Institutions	12	162	121	74.7
3.1 Caribbean Court of Justice	3	39	36	92.3
3.2 CROSQ (Standards and Quality)	2	30	30	100
3.3 CARICOM Competition Commission	1	13	13	100
3.4 National Competition Regime and Agency	2	26	4	15.4
3.5 CARICOM Development Fund	2	28	12	42.8
3.6 CARICOM Implementation Agency for Crime and Security	2	26	26	100
B. Single Market	18	228	145	63.6
4. Free Movement of Goods 2/	3	39	22	56.4
5. Movement of Temporary Service Providers 3/	2	26	8	30.8
6. Free Movement of Persons	13	163	115	70.6
6.1 Free Movement of Skills 4/	2	26	13	50
6.2 Facilitation of Travel	6	72	63	87.5
6.3 Mechanism for Accreditation and Equivalency 5/	3	39	18	46.2
6.4 Agreement on Social Security	1	13	13	100
6.5 Protocol Amending Agreement on Social Security	1	13	8	61.5
C. Single Economy	10	130	13	10.0
7. Macroeconomic Policy Harmonization and Coordination	10	130	13	10.0
7.1 Financial Services Agreement 6/	1	13	0	13
7.2 Capital Market Integration 7/	2	26	0	0
7.3 Investment Policy and Code 8/	2	26	0	0
7.4 Protocol To Intra-CARICOM Double Taxation Agreement on Exchange of Information 9/	2	26	0	0
7.5 Public Procurement Protocol 10/	2	26	13	50
7.6 Consumer Protection 11/	1	13	0	0
Total	47	619	350	56.5

Note: Haiti has not been able to participate in a large number of CSME actions.

1/ Number of identified action elements multiplied by the number of countries required to take each element. CSME involves 13 countries.

2/ Key actions: Common External Tariff and Rules of Origin; Implementation of the Harmonized Scheme 2012 (classification); and Harmonized Customs Bill and Regulations.

3/ Key actions: Passage of Movement of Factors Act and administrative measures to facilitate entry of service providers.

4/ Key actions: Passage of CARICOM Skilled Nationals Act; removal of work permit requirement, amendment of immigration laws of member states to provide for definite entry for the period of time needed by the CARICOM National Service provider (minimum 6 months) and indefinite stay for spouses of approved categories of skilled workers;

5/ Key actions: Establishment of National Accreditation Bureau and Regional Accreditation Bureau together with National Vocational Qualifications Infrastructure

6/ Financial Services Agreement approved by the Council on Finance and Planning in August 2013. Still to be finalized and Member States indicating need for further consultations.

7/ Draft Securities Model Law and regulations to be reviewed by a working session of securities regulators.

8/ Draft CARICOM Investment Code considered in 2017 and a Proposals for a Harmonized Regime of Investment Incentives has been prepared for further consultation with Member States.

9/ Protocol seeks to amend the Intra-CARICOM Double Taxation Agreement that was adopted by Member States in 1994 to more explicitly provide for the global standard on exchange of information upon request. Draft Protocol is still under review by the Legal Affairs Committee.

10/ Framework Regional Integrated Policy for Public Procurement (FRIP) has been adopted as the policy framework. The Draft Public Procurement Protocol has been adopted by Member States and sent to the Legal Affairs Committee for finalization and submission to the Conference of Heads of Government for signature.

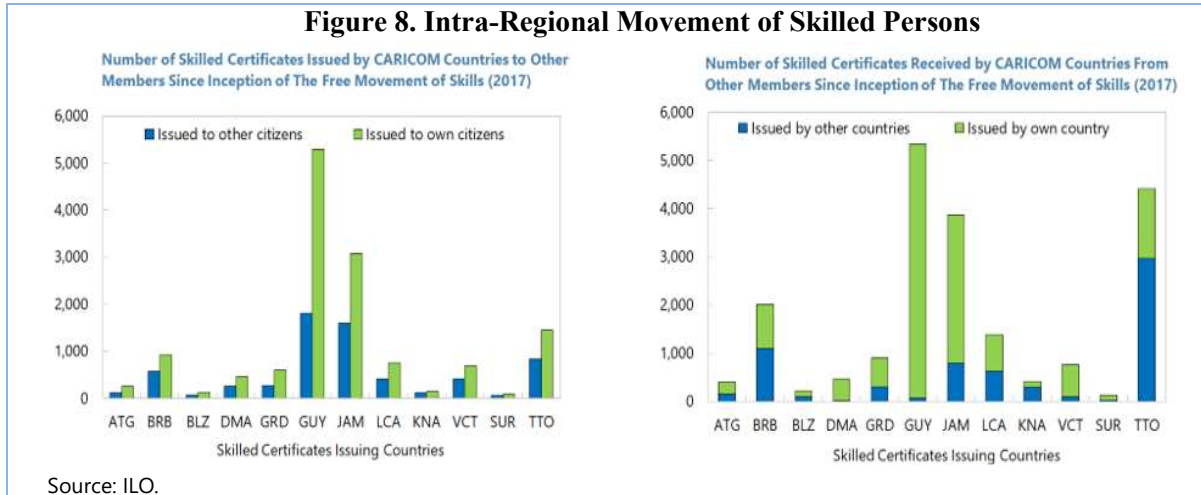
11/ Model Consumer Protection Bill was approved in September 2016 and now to be implemented by member States.

Source: COTED; Reports presented to Meetings of the Council of Trade and Economic Development, 2017.

- Movement of people:** While some progress has been made in *the movement of skilled persons*, issues of noncompliance, lack of harmonized processes, and duplication of processes among and within member states continue (COTED 2017).⁸ Some progress has been made in putting in place the legislation to provide for the *movement of service*

⁸ Only 10 categories of workers are currently entitled to work throughout the region without work permits. Other CARICOM nationals are entitled to up to six months stay but not to seek employment. Only Jamaica, Guyana and Grenada currently recognize all ten agreed categories of workers. Data from ILO suggest that the number of skilled certificates issued by CARICOM countries to other members has been limited since the inception of free movement of skills, reflecting the difficult macro conditions in the region, as well as long delays in granting certificates and other administrative hurdles that discourage skilled persons to use the program (Figure 8).

providers, with some member states having enacted the omnibus model, Movement of Factors Act, or some variant of it.⁹ However, policy action to facilitate such movement has been limited; only two countries have procedures for certifying service providers. Several member states retain legal restrictions on *the right to establish business*, which also limit intraregional movement of labor.



- Institutions:** Progress has also been limited in other institutional areas. The CARICOM *Competition Commission* to ensure fair competition has been established, but the legal and institutional framework for enforcing the rules of competition at the national level remains to be initiated in several states. The Model *Consumer Protection Bill* approved in 2016 is with members for implementation. *Intellectual Property* legislation needs modernization, harmonization, and institutional arrangements need to be put in place at the regional level. The *Caribbean Court of Justice*, with prime responsibility for interpreting and applying the Revised Treaty of Chaguaramas, is vital to the functioning of the CSME, but while it is established as a court of original jurisdiction in all CARICOM countries, as an appeals court, it has been established only in a few member states (Barbados, Belize, Dominica, and Guyana).
- Policy coordination and harmonization.** The program for macroeconomic policy coordination and harmonization in support of the CSME has been endorsed in 2012, but implementation to establish a single economic space is well behind schedule. Technical work on the design of legal and regulatory frameworks for credit reporting and deposit protection has been completed and draft policies developed, but the work on coordination and harmonization of fiscal policy and exchange of information is ongoing, as well as the work of the CARICOM Commission on the Economy to advise on coordinating and promoting a growth agenda for member states. Little progress has been made in developing common/coordinated sectoral policies. Further work on financial services agreement, capital market integration and harmonization, currency convertibility, double taxation, and regional investment and tax incentives

⁹ Belize, Guyana, St. Lucia, Jamaica, Trinidad and Tobago, and Barbados. Antigua and Barbuda, Grenada and St. Vincent Grenadines have passed but not enacted the Movement of Factors Act.

policy needs to be completed for effective functioning of a single market and to limit wasteful competition.

19. **With long delays in implementing the CSME agenda, the CARICOM leadership recently took decisions to reinvigorate momentum to establish the CSME.** At the November 2018 Special Eighteenth Meeting of Heads of Government on the CSME and the Thirtieth Intersessional Meeting of Heads of Government in February 2019, key decisions were taken to decisively move forward with implementation of the CSME agenda in critical areas such as free movement of labor: (i) agreement that those member states so willing would move towards full free movement of labor within the next three years; (ii) reiteration that a skills-certificate issued by one member state would be recognized by all member states; (iii) additional categories of skilled nationals entitled to move freely and seek employment within the Community; and (iv) agreement to complete legislative arrangements for free movement of all categories of skilled persons by all member states. All members signed the Protocol on Contingent Rights, a step forward for free movement of people. CARICOM also agreed in 2018 that Member States that wanted to proceed on a faster track to implementation of CSME decisions could do so. Actual implementation of these steps should boost the institutional integration index.

III. TRACKING ECONOMIC INTEGRATION

Notwithstanding the significant progress made, the degree of Caribbean economic integration, as measured by comovement and evolution of a range of real, monetary, trade, and financial indicators, is low compared to other well-integrated regions. While increasing, the share of intraregional trade in total trade remains at lower levels compared to other integrated regions, the degree of synchronization of business and credit cycles is limited, and convergence of incomes between the lowest and highest income brackets has been slow. While financial integration seems to have proceeded faster with tightly-interconnected financial systems, financial markets remain underdeveloped and fragmented, with no region-wide capital market.

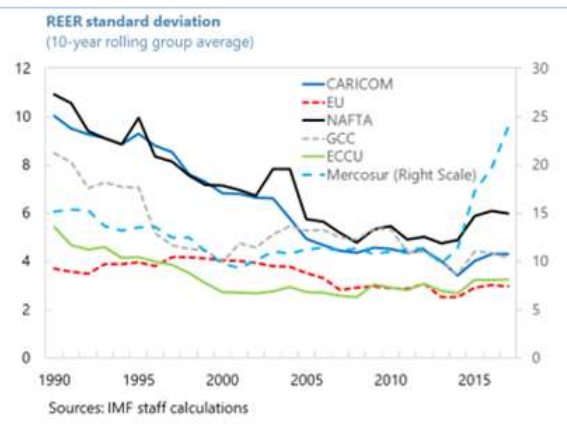
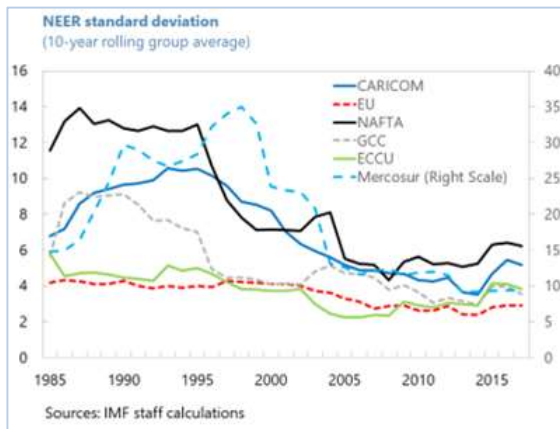
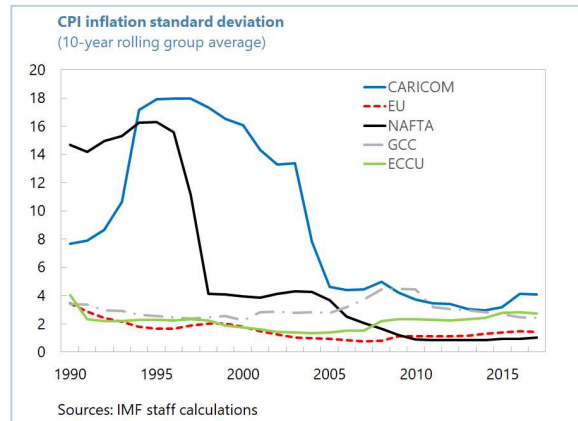
20. **An economically-integrated region displays a high level of convergence of key economic indicators across its member countries.** This section assesses the degree of Caribbean economic integration by analyzing the variability across countries of various indicators of real, financial, and monetary integration, including synchronization of business and financial cycles, convergence of inflation, interest rates, and incomes, exchange rate variability, and depth of trade and financial integration. Economic integration is measured here by the synchronization or comovement of these economic indicators over time, and is summarized in an overall index of economic integration. The index computed for CARICOM is compared with those for other regional blocks, such as the EU, MERCOSUR, and NAFTA, as well as with the evolution of the institutional integration index.

A. Inflation and Exchange Rate Convergence

21. **Inflation convergence and falling exchange rate variability within the region can signal policymakers' commitment toward the single economy component of economic integration.** Countries can extract higher benefits from increased economic and institutional integration if inflation rates are converging over time, while inflation divergence can complicate implementation and harmonization of macroeconomic policies. Convergence of

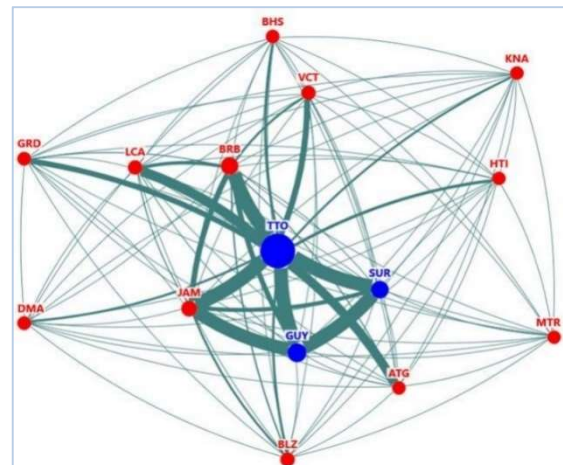
inflation can also help reduce variability in exchange rates across countries and diminish the likelihood of exchange rate misalignments. If real exchange rate variability is small and currencies are stable against each other, the cost of adopting a common currency or a common monetary policy framework will be lower (Dorucci 2005).

22. **Inflation rates and effective exchange rates have been converging within CARICOM, though variation remains relatively high.** While deviations among inflation rates across CARICOM countries have fallen drastically since mid-1990s, convergence has slowed down, or even reversed since mid-2000s, and inflation variation remains high relative to other regional groups, such as the EU, NAFTA, and the ECCU. Exchange rate variation in the region, which started increasing in the mid-2010s, after falling significantly from the mid-1990s, is also higher than the variation within the EU and the ECCU.



B. Trade Integration

23. **Trade integration within the region has been ongoing, but not at the levels of more integrated regional blocks.** Intraregional goods trade has grown from about 2 percent of GDP in the mid-1980s to about 4 percent in recent years but has plateaued for more than a decade. Most of the increase in intraregional trade represents trade between commodity and non-commodity exporting CARICOM economies, while trade within each group has been no more than one percent of GDP, reflecting in part the specialization of production (or lack of



Source: Direction of Trade Statistics; authors' computations.

diversification) and export structures, with insufficiently high variety of goods to form a basis for trade. Intra-Caribbean trade is well below that of some regional blocs, such as the EU where intraregional trade reached 13-20 percent of GDP. A large part of the CARICOM trade is with the rest of the world; the share of other CARICOM members is less than 20 percent of total trade, compared to above 50 percent for the EU and NAFTA. Close to 90 percent of CARICOM goods exports go to non-CARICOM states (the US, Europe, and Canada—Table 2), with intraregional trade dominated by a few countries (mainly Trinidad and Tobago—see above¹⁰). Similarly, intra-Caribbean tourism represents less than 10 percent of total tourism arrivals, and about 5 percent of total tourism receipts.

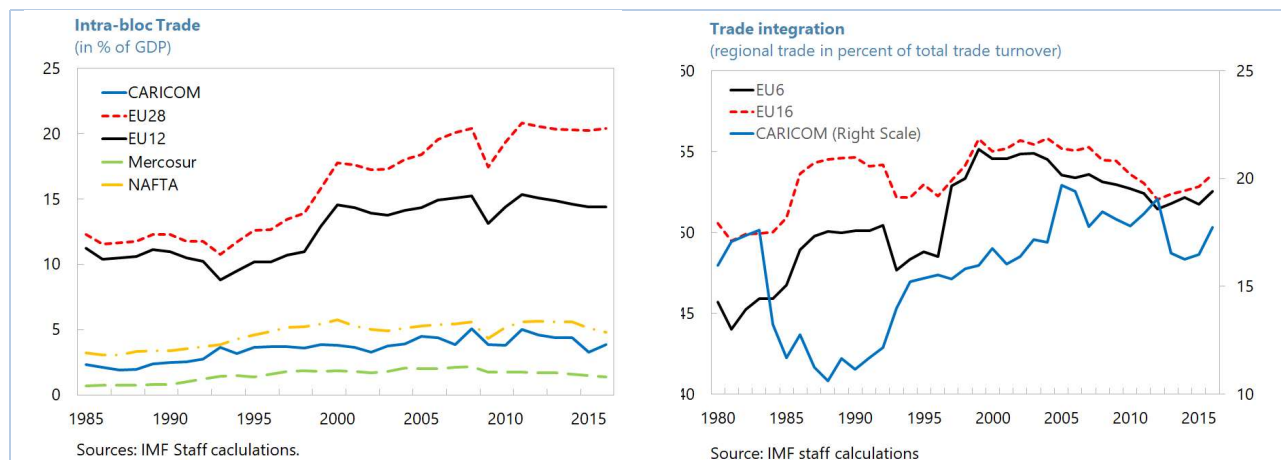


Table 2. The Caribbean: Intra-Regional and Extra-Regional Goods Trade (in percent)

CARICOM Exports 2017	Total	CARICOM	EU	USA	Canada	R.O.W
Antigua and Barbuda	100.0	3.5	58.8	3.8	0.1	33.8
Bahamas, The	100.0	1.6	9.9	67.0	0.5	21.1
Barbados	100.0	42.0	9.0	31.7	2.2	15.1
Belize	100.0	14.5	46.3	18.5	0.1	20.6
Dominica	100.0	47.3	1.8	3.0	0.1	47.9
Grenada	100.0	36.8	10.1	23.9	1.4	27.9
Guyana	100.0	12.5	16.7	15.0	22.6	33.2
Haiti	100.0	0.2	4.5	78.3	2.9	14.0
Jamaica	100.0	6.0	14.4	36.9	8.0	34.8
Montserrat	100.0	8.7	10.0	8.7	0.3	72.4
St. Kitts and Nevis	100.0	21.9	5.5	60.9	0.2	11.5
St. Lucia	100.0	20.3	8.1	64.0	0.2	7.3
St. Vincent and the Grenadines	100.0	44.8	3.1	2.5	0.1	49.5
Suriname	100.0	10.0	11.9	2.0	0.2	75.9
Trinidad and Tobago	100.0	12.4	10.5	32.2	0.6	44.3

Source: Direction of Trade Statistics; authors' computations.

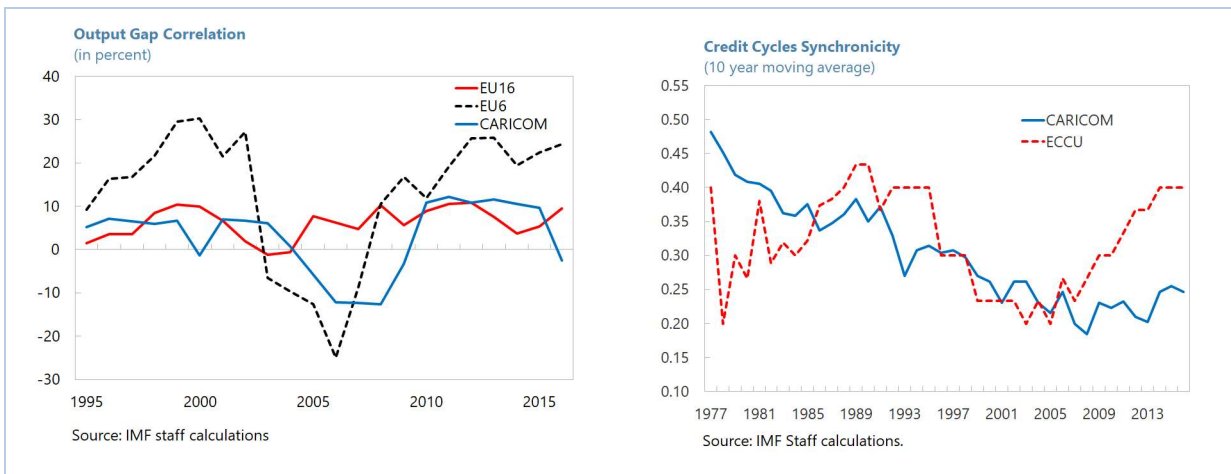
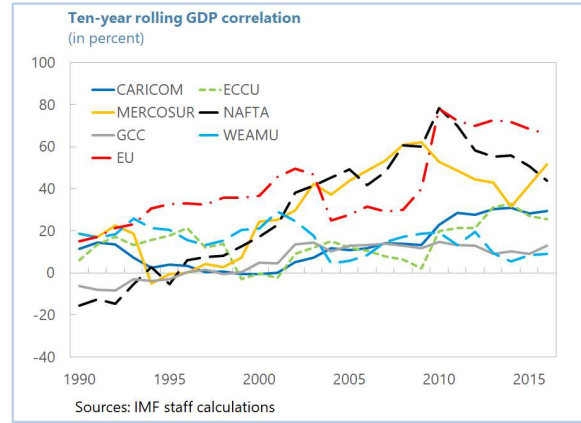
¹⁰ Node sizes in the network chart represents the importance of the country in regional trade. The width of the lines represents the strength of the trading relationship, with commodity exporters in blue and tourism dependent economies in red.

C. Synchronization of Economic Activity

24. **Highly synchronized business cycles may suggest that economic activity is exposed to common external shocks or that the economies are highly interconnected.**

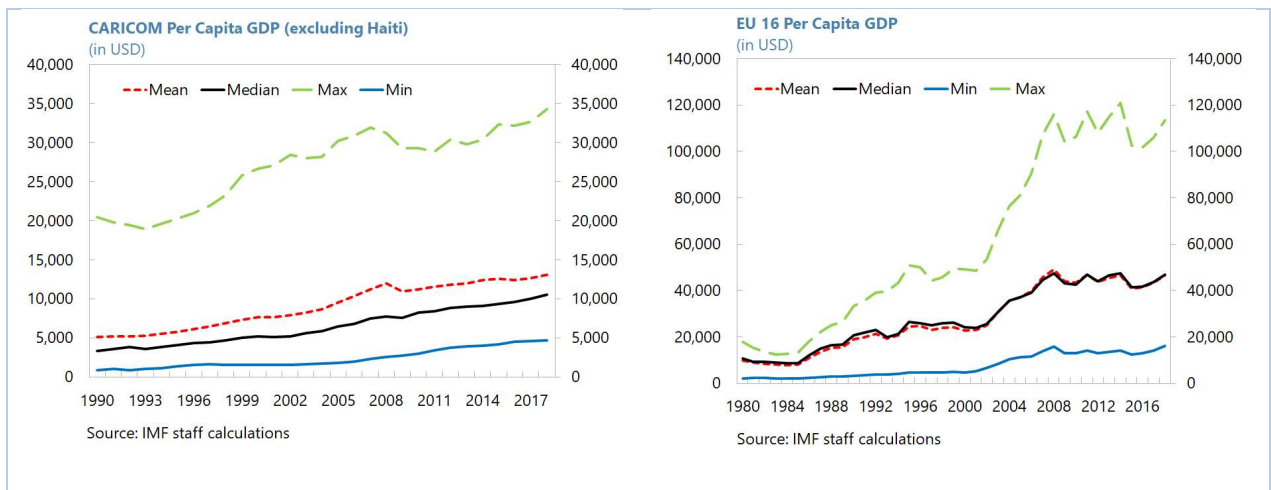
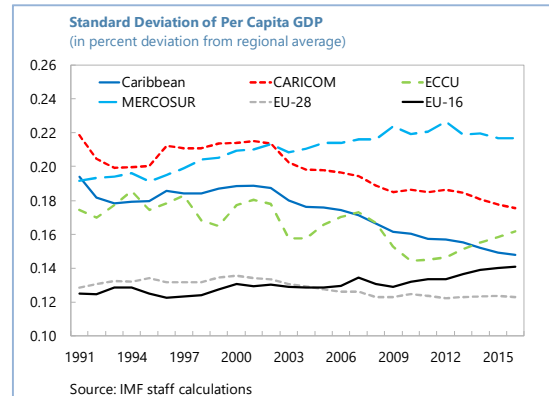
Highly-correlated real GDP growth and comovement of output and credit gaps across countries point to greater homogeneity in business cycle positions. The higher the synchronization, the lower would be the cost of pursuing common economic policies and of deepening integration. The rolling correlations of real GDP among countries in the CARICOM and ECCU have been increasing over time, but they are considerably below those of other regional groups. The correlations among CARICOM members' output gaps have been broadly

lower than those of the more-integrated EU6-group and the gaps have started to diverge recently—possibly owing to the varying economic performance between tourism-based and commodity-based economies in recent years and different external factors that affect their economies. Credit-cycle synchronicity across CARICOM has also been falling over time. With the significant presence of the same foreign banking groups in the region, the divergence may suggest changing portfolio choices by the banking groups (as suggested by the recent move of Scotia Bank out of nine Caribbean small states). Credit cycles of the ECCU countries seem more synchronized compared to the overall CARICOM.



D. Income Convergence

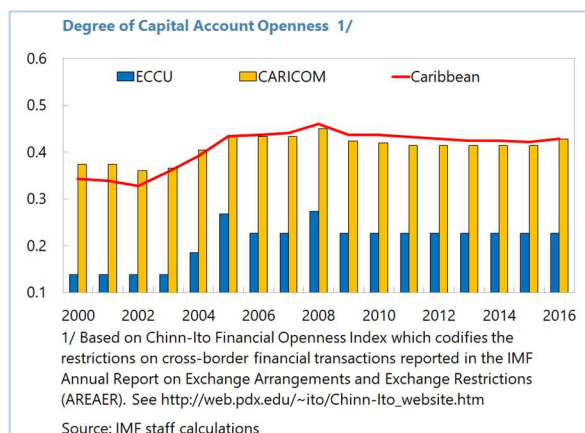
25. **Greater economic integration should be associated with converging incomes across countries in a region.** In particular, by facilitating greater mobility of factors of production (capital and labor), increased regional integration should result in converging income levels and greater, more equitable, standards of living, provided that countries are converging as a group to a higher income bracket. This can be observed in the low per capita GDP variation across the EU region and in the gradual pick up of the mean and median incomes with the higher income brackets. Within CARICOM, while variability of GDP per capita has been declining, it remains high, and average and median incomes do not seem to be catching up with the best-performing countries and the gap between the lowest and highest income brackets is widening. Together with weak business cycle synchronization, low income convergence highlights the need to ensure that the region benefits from integration as a group.



26. **The limited convergence of incomes within CARICOM may be driven by a number of factors, including the limited factor movement within the Caribbean.** The Revised Treaty of Chaguaramas provides provisions for the abolition of exchange controls and full currency convertibility within the region, removal of restrictions on the provision of banking, insurance and financial services, and on the movement of capital across national boundaries. Recent reviews by the CARICOM Secretariat of the progress with CSME suggest that two member states maintain exchange controls and liberalization of capital movement is incomplete (also see below from IMF, AREAER, which suggests that many CARICOM countries maintain controls on most capital account transactions). Capital accounts seem more open in the ECCU compared to the rest of the region.

27. Limited intraregional labor mobility may also affect income convergence.

CARICOM Free Movement Protocol in 1989 and the CSME envisage free movement of skilled labor and provide a framework for intraregional mobility of people. However, only five of ten categories of skilled labor have been granted the right to work in all member states without a work permit, and for the five newer categories, compliance varies across the membership. In addition to the possible difficulties at the national level that may discourage applications for skill certificates, lack of harmonization and duplication of processes also hinder mobility (CARICOM Secretariat 2018). At the same time, the region is characterized by net out-migration (mainly to the US, Canada, and Europe) with the limited growth and job prospects and environmental shocks reinforcing the pervasive brain drain (International Organization for Migration 2017, and Alleyne and others 2017). The intraregional migration is significant only for a small part of the region, although official statistics may not accurately measure movement of unskilled labor that may enter as visitors up to 6 months and stay.¹¹ The island geography, limited and expensive sea and intraregional air connectivity likely also affect the intraregional mobility of people, as well as intraregional trade and tourism flows,¹² and undermine the ability to tap into regional and global value chains (ECLAC 2014).¹³



environmental shocks reinforcing the pervasive brain drain (International Organization for Migration 2017, and Alleyne and others 2017). The intraregional migration is significant only for a small part of the region, although official statistics may not accurately measure movement of unskilled labor that may enter as visitors up to 6 months and stay.¹¹ The island geography, limited and expensive sea and intraregional air connectivity likely also affect the intraregional mobility of people, as well as intraregional trade and tourism flows,¹² and undermine the ability to tap into regional and global value chains (ECLAC 2014).¹³

E. Financial Integration

28. Financial integration is a key component of economic integration and has been an explicit objective of the CSME in creating a common economic space (Box 1).

Regionally-integrated financial systems enhance the availability of capital, support efficient allocation of resources at reduced transaction costs, lead to convergence of interest rates and asset prices, and improve financial standards, all of which can support economic growth. Integrated financial systems also promote competition, efficiency, and risk sharing, but in the absence of adequate regulatory and supervisory frameworks within and across borders, they can facilitate transmission of adverse shocks and destabilize economic and financial systems.

¹¹ Most intraregional migration is limited to a few CARICOM countries, with Antigua and Barbuda, St. Vincent and the Grenadines, Trinidad and Tobago, and Barbados receiving most inflows; The Bahamas and St. Maarten also receive significant migrant flows but are outside the CSME (World Bank Bilateral Migration Matrix 2017).

¹² The International Air Transport Association Connectivity Index shows that intraregional traffic accounts for only 9 percent of the region's passenger traffic in 2017, with high travel costs associated with taxes, fees, and charges in air transportation, regulatory barriers, institutional factors as key factors. The costs—higher for intraregional flights—added an estimated 54 percent to the cost of an average one-way ticket in 2016 (Ram, Reeves, James 2018). Air connectivity is also hindered by limited direct services and routes between member countries.

¹³ Recent regional cooperation initiatives should help facilitate intraregional mobility of people. The signing by CARICOM Heads of Government of the Multilateral Air Services Agreement in early 2019, for example, expands the scope for the CARICOM-owned airlines to provide air services across the region.

29. **Evidence suggests continued progress in financial sector integration within the Caribbean, but not all parts of the region and sectors of the financial system have proceeded at a similar pace.** The Caribbean financial systems seem well-integrated, while the integration of financial markets is still ongoing, with markets remaining relatively underdeveloped and fragmented, likely reflecting the lack of harmonization of the regulatory frameworks across national securities markets and the paucity of cross-listings. Three major stock exchanges—in Jamaica, Trinidad and Tobago, and Barbados—lead the region’s equity markets, while bond markets are dominated by government securities. Interest rate and asset price convergence has been uneven across different segments.

Box 1. Provisions for Financial Integration in Caribbean Community (CARICOM)

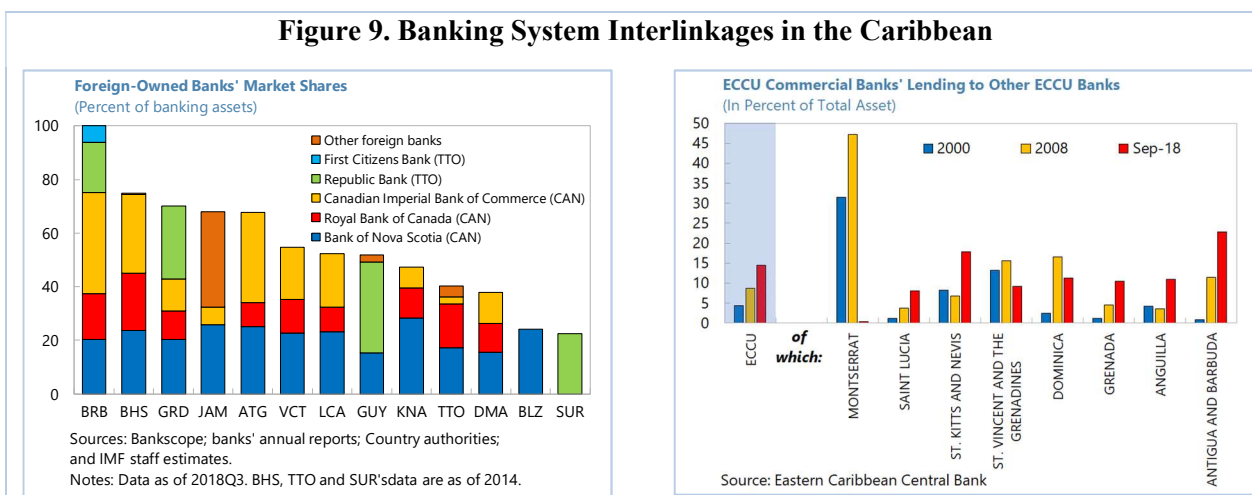
The [Revised Treaty of Chaguaramas](#) include several provisions and envisions to support financial integration:

- Removal of discriminatory restrictions on banking, insurance and other financial services.
- Removal of restrictions on movement of capital and current transactions, including equity/portfolio investments, short-term bank and credit transactions, payment of interest on loans and amortization, dividends and other investment income after taxes, repatriation of proceeds from the sale of assets, and other transfers/payments relating to investment flows.
- Harmonized legal/administrative arrangements for the operation of partnerships, companies or other entities.
- Abolition of exchange controls in the CARICOM and free convertibility of the currencies of member states.
- Convergence of macroeconomic performance and policies through coordination or harmonization of monetary and fiscal policies, including, policies relating to interest rates, exchange rates, tax structures and national budget deficits.

Financial System Integration

30. **The financial sector is highly-interconnected, within the region as well as with global institutions and markets** (Canetti and others 2017). Evidence supports increasing integration in the banking sector, with active presence of domestically and foreign-owned common lenders that are structured as financial conglomerates with significant cross-border operations and complex, opaque ownership linkages.¹⁴ Cross-border lending and borrowing of commercial banks has been increasing particularly in the ECCU, where banks’ outstanding claims on other banks in the ECCU increased significantly since 2000 (Figure 9).

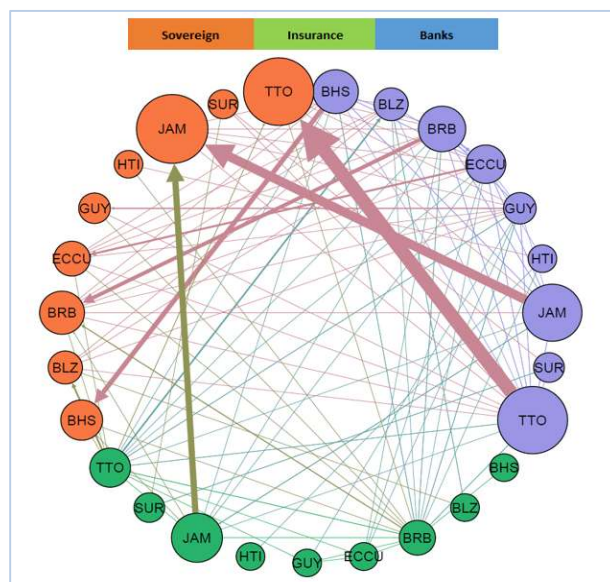
Figure 9. Banking System Interlinkages in the Caribbean



¹⁴ Canadian banking groups hold about 45 percent of the region’s banking system assets. The Trinidad-based Republic Bank has also significant share of the banking system in a number of countries, with the share to rise further upon approval of the sale of Scotiabank operations in the ECCU, Guyana, and Sint Maarten.

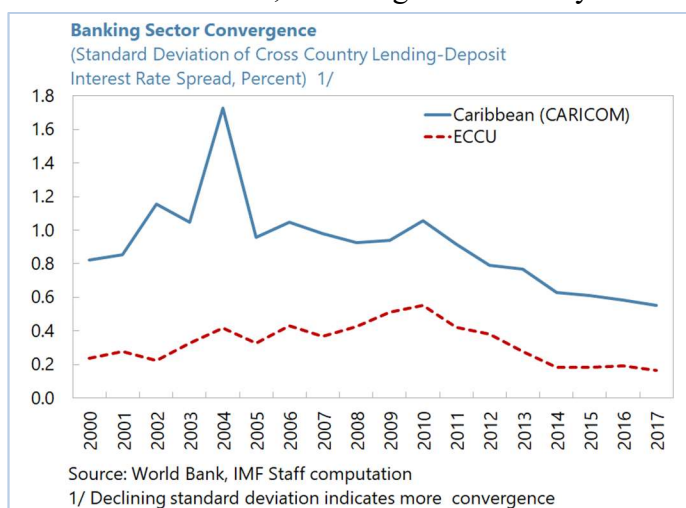
31. Regional financial conglomerates also dominate the insurance sector, and their ownership links with other financial and nonfinancial institutions add to the connectivity in the financial system.

Findings from a recent [IMF study](#) (Canetti and others, 2017) suggest significant interlinkages across insurance companies, banks, and sovereigns, based on reported balance sheet information. A network representation of the cross-border and cross-sectoral linkages shows that cross-border operations of the Caribbean insurers are large as a share of their total assets and span many countries in the region. Banking systems of several countries are also highly interconnected (Barbados, Guyana and Trinidad and Tobago). In the insurance sector, Barbados and Trinidad and Tobago appear at the center of the regional financial system; the Barbados and Trinidad-based insurance companies—Sagicor and Guardian—carry out operations in 8 and 9 Caribbean countries, respectively.



32. Increased financial system integration has, in turn, resulted in converging interest rates in the region. In a financially-integrated region, where banks compete across borders, the margins they charge above the costs of funds (including the risk premium) will converge even if the latter may vary across markets. As such, declining cross-country

standard deviation of lending-deposit rate spreads (sigma convergence) signals a more integrated banking sector ([Sy 2006](#)). In the Caribbean, although it remains relatively high, cross-country standard deviation of lending-deposit rate spreads have been falling since mid-2000s. The ECCU has greater convergence, likely reflecting the currency union that reduces cross-border transaction costs and the fixed exchange rate regime that facilitates more financial flows. A similar conclusion emerges



from pairwise correlations of short-term interest rates across CARICOM: Interest rates are highly correlated across the ECCU block, as well as among Bahamas, Belize, and Guyana, and between Barbados and Trinidad and Tobago (Figure 10). At the same time, greater convergence could also be driven by the dominance of foreign banking groups, which can affect the lending spreads, and funds flowing from low rate countries to high rate countries.

Figure 10. Interest rate Correlations in the Caribbean, 2007-2016

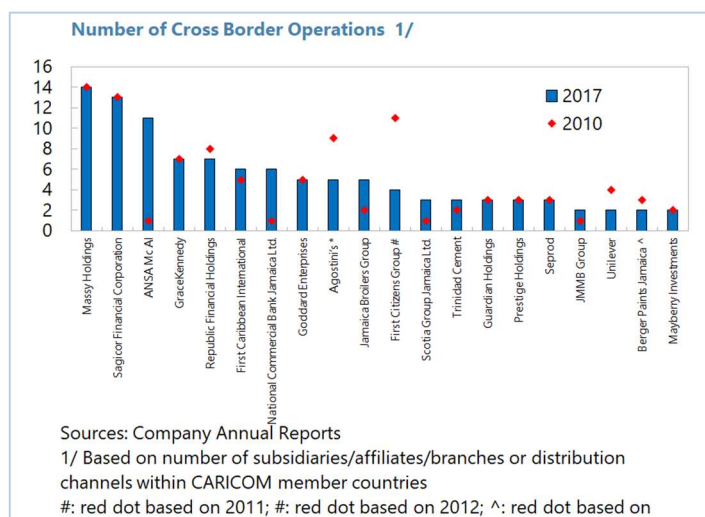
	AIA	ATG	BHS	BRB	BLZ	DOM	GUY	HTI	JAM	MSR	SUR	KNA	LCA	VCT	TTO	
AIA	1.00															
ATG	0.51	1.00														
BHS	0.31	0.66	1.00													
BRB	0.37	0.52	0.59	1.00												
BLZ	0.32	0.60	0.93	0.59	1.00											
DOM	0.45	0.94	0.73	0.45	0.68	1.00										
GUY	0.33	0.61	0.95	0.70	0.97	0.67	1.00									
HTI	0.28	0.37	0.39	0.49	0.41	0.36	0.45	1.00								
JAM	0.00	0.29	0.56	0.57	0.64	0.28	0.68	0.19	1.00							
MSR	0.48	0.93	0.76	0.51	0.74	0.96	0.74	0.36	0.41	1.00						
SUR	-0.29	-0.68	-0.69	-0.20	-0.70	-0.74	-0.63	-0.18	-0.21	-0.69	1.00					
KNA	0.46	0.92	0.74	0.51	0.70	0.96	0.71	0.38	0.35	0.98	-0.70	1.00				
LCA	0.50	0.96	0.67	0.43	0.64	0.97	0.62	0.32	0.26	0.97	-0.72	0.96	1.00			
VCT	0.50	0.91	0.63	0.33	0.58	0.95	0.56	0.32	0.19	0.95	-0.69	0.95	0.97	1.00		
TTO	0.25	0.41	0.69	0.85	0.70	0.41	0.79	0.49	0.74	0.50	-0.15	0.46	0.36	0.28	1.00	
CAR	0.40	0.75	0.90	0.78	0.91	0.77	0.95	0.48	0.74	0.84	-0.58	0.81	0.74	0.68	0.83	1.00

Source: Monetary and Financial Statistics (IMF); Correlations are computed across bank deposit rates.

Financial market integration

33. **Capital markets remain relatively underdeveloped and fragmented, with a slow record of implementation of the formal integration arrangements.** Progress has been made in liberalizing the movement of finance across borders, but very limited progress in harmonizing legal and administrative arrangements across the region. Formal capital market integration has been limited to facilities for cross-listing securities on the securities exchanges of Barbados, Eastern Caribbean, Jamaica, and Trinidad and Tobago, while the remaining CARICOM members remain outside this arrangement (Worrell and Jhinkoo 2009). High costs of regulatory compliance under lacking harmonization of the regulatory regimes could undermine cross-listings. No Caribbean-wide capital market exists to date, but CARICOM leaders announced plans to establish one at the 2018 CARICOM Conference of Heads of Government meeting, putting

greater focus on advancing measures for a competitive Single Market.¹⁵



34. **Notwithstanding the delays in implementing the formal commitments under the CSME, integration of the region's financial markets seems to have progressed**

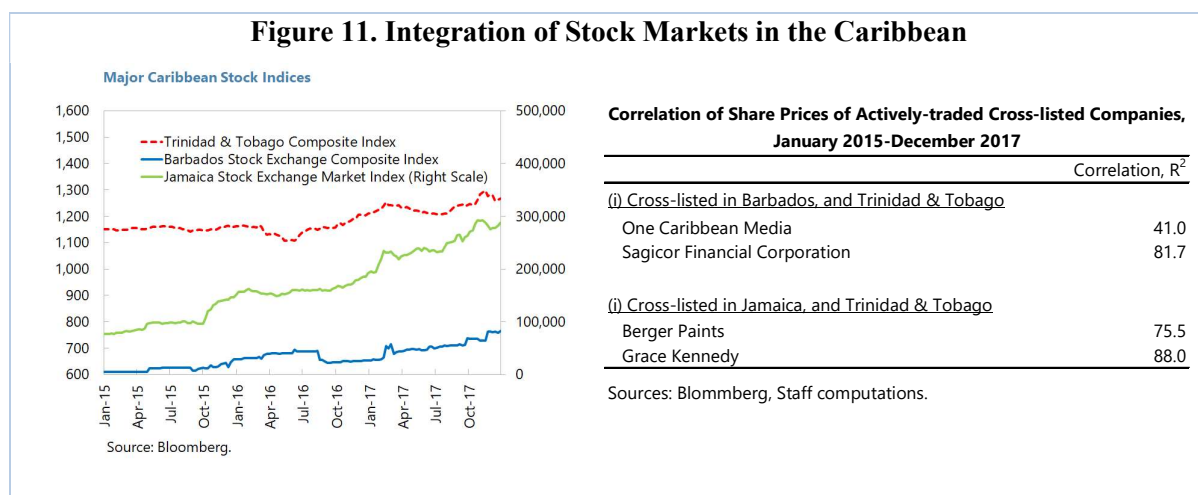
¹⁵ Including an Investment Policy and Investment Code, Incentives Regime, Integrated Capital Market, and model Securities Legislation. The Council for Finance and Planning is mandated to finalize these instruments by July 2019; <https://caricom.org/cochog/view/communique-issued-at-the-conclusion-of-the-thirty-ninth-regular-meeting-of-the-conference-of-heads-of-government-of-the-caribbean-community>.

informally. Mergers, acquisitions, lending, and investments have accelerated across the region (Worrell and Jhinkoo 2009). Several large corporations have cross-border operations and regional linkages through distribution channels, branches, or joint ventures.¹⁶ The conglomerate with the widest network, for instance, has operations in 14 countries. One third of these firms have expanded cross-border operations during 2010-17 and engage in a wide range of activities (e.g., financial services, telecommunications, construction, manufacturing, hotel management, trading, and wholesale/retail operations). Several large companies have multiple listings across major stock exchanges. The Trinidad and Tobago, Barbados, and Jamaica exchanges have an arrangement for cross-listing and trading of shares and bonds in 1991 and feature more than one fifth of the companies listed in multiple regional exchanges. The exchanges have low liquidity and market capitalization, due in part to small size.

Cross-Listed Companies in 2018				
Stock Exchange	Number of Listed Firms	Cross-Listed Firms	Share of Cross-Listed Firms	Share of Cross-Listed Firms in 2012 1/
Trinidad and Tobago Stock Exchange	33	12	36.4	32.4
Barbados Stock Exchange	26	8	30.8	27.3
Jamaica Stock Exchange	40	8	20.0	20.5

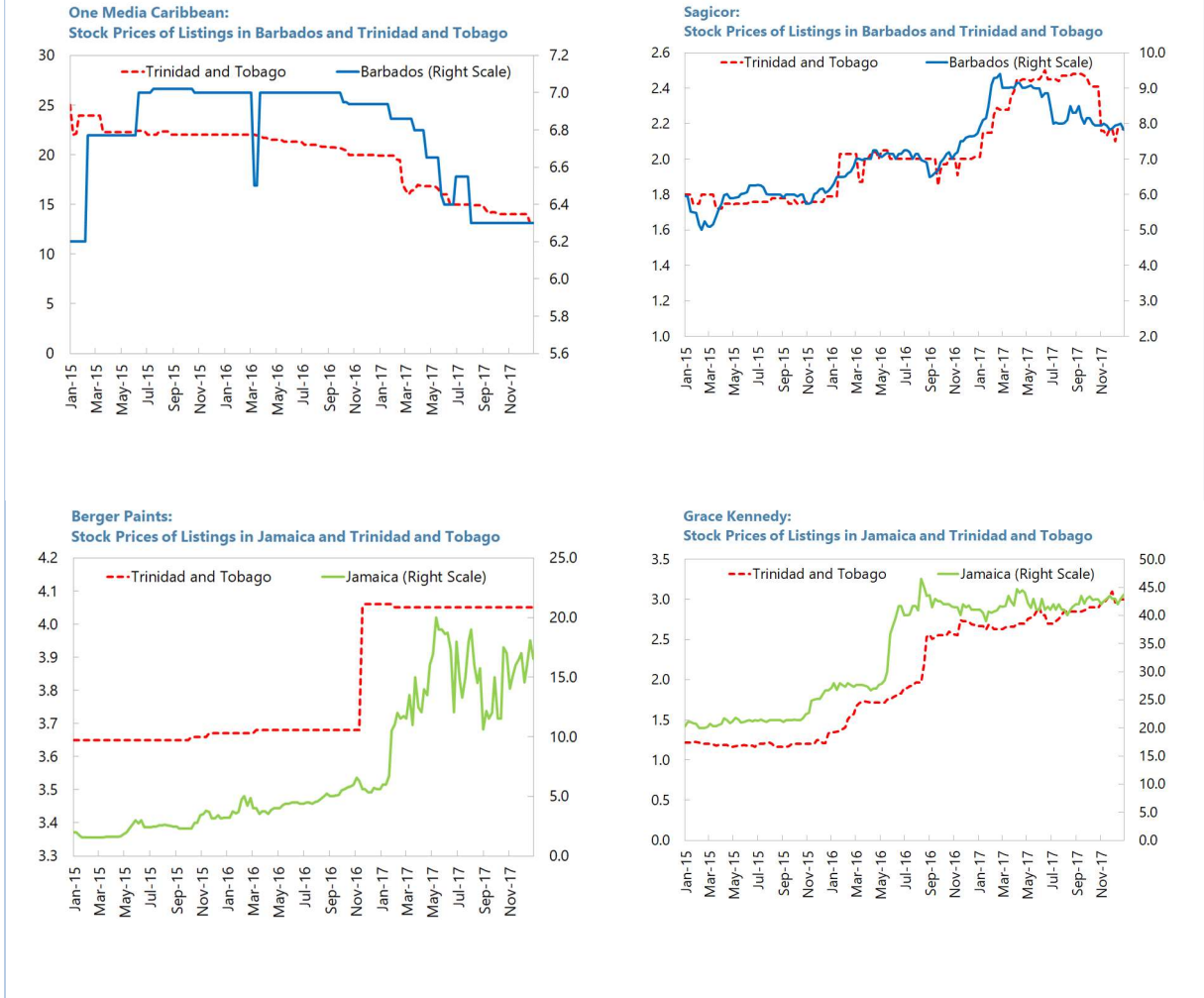
Source: Country Stock Exchanges.
1/ Based on findings in Ogawa, Park, Singh, and Thacker (2013)

35. **Available data suggest converging share prices of actively-traded firms cross-listed in the three major Caribbean stock exchanges, helping to align the broader stock market indices.** Some convergence of share prices of actively-traded cross-listed firms, albeit with a small time lag, is evidenced by pairwise correlations across the main exchanges and has influenced, to a certain extent, the co-movement in stock market indices in Barbados, Jamaica, and Trinidad and Tobago (Figures 11, 12), likely reflecting cross-border trading in the listed securities. At the same time, country specific macroeconomic risk factors remain important determinants of stock market volatility.



¹⁶ Based on [Businessuite](#) 2017 Top 50 Caribbean Companies By US\$ Revenue and companies' annual reports.

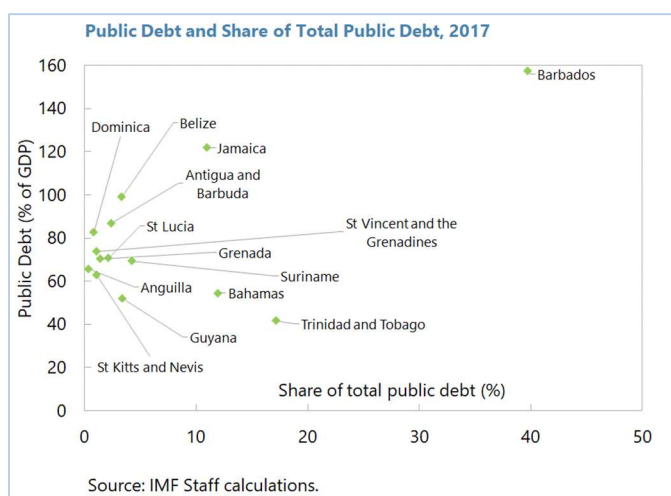
Figure 12. Stock Prices of Actively-traded Companies Listed in Barbados, Jamaica, and Trinidad and Tobago



Source: Bloomberg.

36. The region's bond markets continue to be dominated by government debt securities, reflecting high public sector debt in most CARICOM countries. The Eastern Caribbean Regional Governments Securities Market (RGSM) is the only existing

(sub)regional market, established in 2002 for trading ECCU debt instruments to support government financing needs at low borrowing costs, assist in debt management, deepen the region's financial markets by integrating the eight fragmented markets of the ECCU, and create a single regional financial space. The RGSM has been successful in creating a regional market for government debt but is believed to be performing below its full potential.¹⁷ Beyond the RGSM, Barbados, The Bahamas, Jamaica, and Trinidad have the most developed markets in CARICOM, where short/long-term fixed income securities, equities, and collective investment funds are traded. Small markets in Belize, Haiti, Guyana, and Suriname largely trade government securities. Available data suggest low level of integration across the region's bond markets, with short-term treasury bill rates, other than for the ECCU, largely uncorrelated (Figure 13).



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Figure 13. Correlation Matrix of Treasury Bill Rates, 2015-2017

	Antigua & Barbuda	Bahamas	Barbados	Belize	Dominica	Grenada	Guyana	Jamaica	St. Lucia	St. Vincent & the Grenadines	Trinidad & Tobago
Antigua & Barbuda	1.00										
Bahamas	-0.55	1.00									
Barbados	-0.02	0.41	1.00								
Belize	-0.82	0.35	0.00	1.00							
Dominica	0.28	-0.38	-0.16	-0.38	1.00						
Grenada	0.80	-0.77	-0.20	-0.66	0.51	1.00					
Guyana	0.67	-0.51	-0.24	-0.72	0.55	0.84	1.00				
Jamaica	0.64	-0.58	-0.26	-0.61	-0.06	0.43	0.21	1.00			
St. Lucia	0.65	-0.68	-0.04	-0.54	0.74	0.83	0.67	0.30	1.00		
St. Vincent & the Grenadines	0.04	0.01	-0.01	-0.11	0.39	0.01	-0.01	-0.10	0.35	1.00	
Trinidad & Tobago	-0.63	0.67	0.33	0.50	-0.03	-0.49	-0.28	-0.75	-0.39	0.08	1.00

Source: International Financial Statistics, IMF

F. Economic Integration: Putting it all Together

37. While progress has been made, economic integration in the region, as measured by the comovement of its key indicators of nominal and real convergence, remained relatively low. Indicators of real economic convergence (Table 3) suggest that trade

¹⁷ The primary market consists of only short-term securities, banks as the main investor, with limited participation from retail and foreign investors. The secondary market is small and illiquid, with limited number of long-term securities to trade, "buy and hold" investors, order-driven transactions; lack of pricing of risk and market conditions, and lack of timely, reliable information on members' macroeconomic situation.

integration within CARICOM increased over the past two decades but remains at a much lower level compared to other regions, in particular Europe; real business cycles have been converging but their correlation within the region remains at a very low level; and while the variability of real per capita incomes have been falling for the region, the gap between the highest and lowest incomes have been widening, with high-income countries remaining as outliers. Nominal convergence indicators also suggest that inflation, interest, and exchange rates are converging but are not highly correlated compared to those in Europe.¹⁸

Table 3. Selected Indicators of Economic Integration

		Business cycle correlation	Real Per Capita GDP percent difference	Inflation rate correlation	Real interest rate correlation	Nominal interest rate correlation	REER volatility	NEER volatility	Nominal Bilateral ER (US\$) volatility	Loan/Deposit Spread Standard Deviation /1	Capital Account Oppeness 2/	Credit Cycle Synchronization
EU 16	1997-2001	0.25	41.50	0.19	0.16	0.39	54.16	2.73	0.40	0.8083	0.86	
	2002-2006	0.18	40.66	0.11	0.13	0.31	60.41	17.82	0.15	0.7068	0.95	
	2007-2011	0.03	38.72	0.10	0.28	0.32	29.29	13.04	0.22	0.7456	1.00	
	2012-2016	0.19	32.84	0.29	0.29	0.32	15.97	8.76	0.23	1.0530	0.98	
	2017	0.54	30.27	0.30	0.29	0.44	19.28	6.69	0.16			
EU6	1997-2001	0.44	77.01	0.45	0.41	0.57	8.17	0.06	0.00		0.97	
	2002-2006	0.41	70.56	0.10	0.20	0.56	2.42	0.17	0.00		0.99	
	2007-2011	0.16	69.95	0.22	0.64	0.44	2.66	0.63	0.00		1.00	
	2012-2016	0.53	67.65	0.50	0.41	0.53	3.84	0.13	0.00		1.00	
	2017	0.58	60.26	0.56	0.49	0.51	1.01	0.17	0.00			
CARICOM	1997-2001	-0.09	32.68	-0.11	-0.04	0.02	67.46	101.04	46.97	0.8161	0.40	0.23
	2002-2006	-0.07	41.64	0.02	0.01	0.06	43.28	84.76	40.98	0.7952	0.42	0.26
	2007-2011	-0.06	31.31	0.01	0.07	-0.02	22.38	82.63	67.42	0.8987	0.44	0.20
	2012-2016	0.06	21.39	0.05	0.07	0.10	15.72	74.68	68.47	0.6983	0.42	0.29
	2017	0.03	24.91	0.06	0.02	0.01	16.20	69.03	70.68			
ECCU	1997-2001	0.13	32.33	0.14	0.20	0.75	6.26	0.18	0.00	0.2109	0.28	
	2002-2006	0.02	37.50	0.11	0.10	0.37	6.30	0.51	0.00	0.3448	0.31	
	2007-2011	-0.01	27.05	-0.07	0.03	0.04	11.63	9.31	0.00	0.4553	0.33	
	2012-2016	0.61	16.23	0.20	0.00	0.24	8.96	5.20	0.00	0.2425	0.27	
	2017	0.43	30.11	0.00	-0.02	0.07	8.43	5.56	0.00			
MERCOSUR	1997-2001	0.30	25.10	0.27	0.05	0.12	40.17	87.50	94.46	14.7069	0.51	
	2002-2006	0.36	8.54	0.00	0.06	0.14	99.79	117.41	103.46	8.4580	0.63	
	2007-2011	0.06	14.96	-0.05	-0.05	0.05	90.71	130.76	104.16	6.7076	0.61	
	2012-2016	0.13	19.86	0.10	0.03	0.13	87.42	142.60	101.30	5.4053	0.48	
	2017	0.17	20.23	0.09	0.10	0.07	132.73	161.73	94.91			

1/ Includes on 12 of the EU16 countries due to data limitations

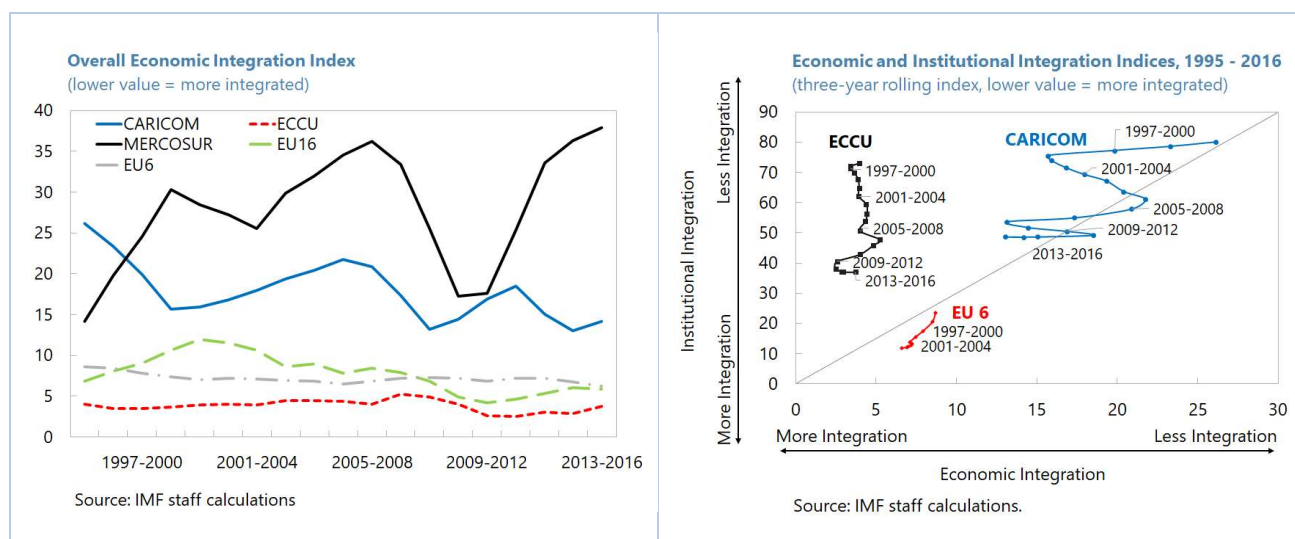
2/ Chinn-Ito Index Regional Average

38. **An overall index of economic integration summarizes this evolution.** The index measures the extent to which the region has highly correlated business cycles, inflation rates, and real and nominal interest rates, while also having high trade integration and small differences in per capita incomes, real and nominal exchange rate volatility, and smaller deviations in interest rate spreads. The indices suggest that the EU countries have become more integrated over time (marked in the low level of and gradual decline in the index for broader EU, though diverging somewhat more recently). MERCOSUR countries seem to be in a period of divergence, reflecting large differences in inflation rates, variability of interest and exchange rates and more asynchronous business cycles. In CARICOM, the overall trend is toward economic integration as suggested by the gradual decline in the index, but the region overall seems much less integrated, including in relation to the ECCU subregion. The

¹⁸ For a long while, the Caribbean Centre for Monetary Studies (later the CCMF) provided (unpublished) reports to the Committee of Central Bank Governors on the progress of the convergence criteria (monitored twice per year by CCMF from 1992 to facilitate monetary and financial integration).

convergence seems to have gone back and forth—with occasional reversals breaking the momentum achieved. It is worth noting that economic integration within Europe was already high even at the inception of the Single Market in 1993, reflecting continuous integration efforts among sovereign countries, including through the various sub-regional agreements ever since the end of World War II (Annex III)—with the caveat of the more recent tensions in the context of Brexit talks. In contrast, CARICOM was established in the 1970s against the background of the collapse of a short-lived West Indies Federation and strong political concerns of “loss of sovereignty” across the region.

39. **The evolution of economic integration along with institutional integration also suggests that CARICOM is moving in the right direction in both dimensions but still has considerable room to deepen integration.** While there is a clear trend toward integration, as suggested by the trajectory of economic and institutional integration indices toward the axis origin, the region has a long way to go in both dimensions (see also Craigwell and Maurin, 2011).



40. **Weak economic integration may, in part, be the result of the prominent influence of external factors, given the small size of the Caribbean economies.** The Caribbean economies are subject to a range of shocks (including commodity, external demand, or natural disaster shocks) at different frequencies and intensities. To the extent these external factors are not perfectly correlated, they can pull CARICOM economies away from the common growth trends in the region. The cointegration analyses conducted for the region suggest a long-run relationship between the growth rates of tourism-dependent CARICOM economies and the United States, the top tourism-source country for the region, as well as a long-run relationship between the small commodity exporters and global commodity cycles. For the region’s largest two economies, Jamaica and Trinidad and Tobago, no long-run relationship has been found with respect to partner country growth or commodity prices, suggesting that economic trends in these countries may be driven less by external factors compared to smaller Caribbean states. The overall results suggest, however, that beside regional integration, integration with the global economy is also important for the Caribbean countries (see below and McLean, Pantin, and Skerrette, 2014).

41. **The interplay between the economic and institutional integration indices also suggest that economic integration has been affected by the slow and incremental progress in institutional integration.** Trade integration, in particular, has been undermined by the slow progress in lowering high NTBs and trade costs in the absence of harmonized customs laws, regulations, and institutional processes and frameworks. The lack of harmonized processes and infrastructure to facilitate intraregional connectivity and other legal restrictions have constrained the free movement of people and capital within the region, undermining the essential components of the single market and economy. In the ECCU subregion, economic integration seems to have gained steam with the steady and significant advances in institutional integration. Accelerating institutional integration, including by harmonizing and rationalizing the key institutions and processes, can therefore provide significant dividends toward economic integration.

IV. UNDERSTANDING THE IMPLEMENTATION CHALLENGES

The key observation that institutional and economic integration go hand in hand suggest that the region should focus its utmost attention to identifying and addressing the key impediments to progress in institutional integration. A combination of institutional, economic, structural, and political economy factors, as well as resource and capacity constraints, underlie the implementation challenges. Addressing these challenges swiftly should help reduce the fixed costs of institutions and doing business in the region and provide the necessary scale and boost to the regional integration move.

42. **A combination of institutional, economic, structural, and political economy factors, and resource and capacity constraints have been undermining cooperation and challenging the Caribbean integration process.** In a regional context, forging effective cooperation requires, first and foremost, appropriate institutional and governance mechanisms and tools, such as a regional authority with accountability and powers to effect, and ensure implementation of the outcomes of, decision making. In the absence of such authority, cooperation must rely on voluntary action, which works only if national interests are well-aligned around common or shared goals (see, e.g., Otker 2014). Cooperation (hence integration) would work best when incentives to cooperate are well-aligned to address common practical challenges. When perceived benefits from integration are limited, or are not widely shared, while requiring large costs, full regional cooperation would not occur. All of these obstacles are relevant in the case of the CSME.

43. **First, the institutional and governance structures of CARICOM raise important challenges for furthering the CSME agenda.** Except for the Caribbean Court of Justice, none of the bodies created to support the integration process (Annex II) has been given supranational powers for decision making and no instruments exist to transform Community decisions to binding laws across jurisdictions (Warner and Anatole 2015). Moreover, as a “Community of States,” decisions are taken by consensus, with the principle of discretionary intergovernmental cooperation, under which each member state retains its sovereign authority and regional policies and decisions can only be reached through unanimity, not by qualified majority. With the Revised Treaty providing no commitment to a form of Caribbean union, member states retain their frontiers, and the CSME agenda focuses on harmonizing selective legislation to facilitate economic transactions and creating a level-

playing field. The difficulty in achieving the CSME through such cooperation is noted clearly by the political leadership:¹⁹

Our Caribbean Community has been conceived to be a Community of Sovereign States. Each sovereign state in such an arrangement retains exclusive powers in relation to the implementation of community decisions. There is also no provision for the transfer of sovereignty to any supranational regional institution and there is no body of community law that takes precedence over domestic legislation or is automatically applied in domestic jurisdictions. The Caribbean has therefore chosen the most difficult political form of integration by which to implement something that is as complex as a single market and economy. (Prime Minister Owen Arthur 2004)

44. **In contrast, certain features of the institutional structure within the EU supports integration.** The Single European Act was incorporated into the Treaty of Rome to “provide for an area without frontiers, in which free movement of goods, persons, services, and capital is ensured” (Brewster 2002). The EU, in general, does not require unanimity for decisions to be approved and relies on qualified majority voting.²⁰ The Council of the European Union (with one representative from each member state) and the European Parliament (directly elected by voters in each member State) together exercise authority in specified areas that binds member states. All decisions are defined as European Directives and automatically have the force of EU law, and member states are required to incorporate them into national law.²¹ In addition to Directives, the EU legislature also adopts Regulations that are directly applicable and legally binding in all member states. Both Directives and Regulations are EU legal instruments. This process and the institutional capacity in the EU provide a stronger basis for deeper regional integration. These features of EU integration, as well as the closer integration within the ECCU region, where the creation of some supranational institutions has helped better coordination and harmonization of policies and institutions, could provide some food for thought to resolving the implementation challenges in the CARICOM context.

45. **The incentives problem provides another key obstacle.** Policymakers tend to assess the case for integration through the lens of costs vs. benefits from closer integration. Many of the CSME measures (e.g., reducing or eliminating tariffs, NTBs, or specific taxes) are likely to result in a loss of already small revenue base, at least in the short run, or displaced high-cost local production, and most measures will require some surrender of sovereignty (Bourne 2003; Girvan 2005). Most actions require significant resources, to draft laws and regulations, ratify them nationally, and secure support from the public. Against the large upfront costs, benefits for growth, employment, or trade may seem uncertain and

¹⁹ Report of the Commission to Review Jamaica’s Relations within the CARICOM and CARIFORUM Frameworks (March 2017, page 35).

²⁰ The EU also had originally adopted the principle of decision-making by consensus. Unanimity remains the norm for the EU Council of Ministers in certain areas (e.g., common foreign and security policies, citizenship, EU membership, harmonization of national legislation on indirect taxation, social security/social protection).

²¹ The European Court of Justice has developed a doctrine according to which EU law is a new, autonomous legal order that confers rights and obligations for the citizens in member states. Certain provisions of EU law are directly effective in that they create individual rights, which national courts must protect without any need for implementing legislation in the members states. Directly effective provisions of EU law have primacy over conflicting provisions of national law.

uneven (given different production structures and development levels and dominance of trade with non-CARICOM states), or hard to quantify, or occur beyond the life-span of prevailing governments.²² Different development levels and structures also make it challenging to coordinate and harmonize policies across the broader Caribbean.

46. **Efforts are hence needed to align incentives across the region**—including by providing evidence on the potential benefits from further integration and by leveraging on the existing mechanisms and institutions, such as the CARICOM Development Fund (CDF). The CDF was established in 2008 as an institution of the Caribbean Community to provide safety nets and financial and technical assistance to less developed states, regions and sectors in the Community disadvantaged by further integration. It aims at addressing disparities among CARICOM states that may result from implementation of the CSME and provide financing for projects that could strengthen economic development and boost capacity, but has limited resources. In the absence of well-structured, adequately resourced, and accepted mechanisms for distribution of the benefits from integration and compensation for its costs, and absent a duly-constituted supranational authority, there will be little incentive for individual states to cooperate across the board and reduce disparities.²³

47. **Resource and capacity constraints to implement a complex integration process in the absence of adequate prioritization or sequencing of actions add to the implementation deficit.** The small economic size and limited institutional and technical capacity at national levels imply limited resources devoted to implementing the integration agenda. The initial deadlines to complete the CSME agenda do not seem to have taken into consideration the region's capacity gaps and the complex undertaking required to draft protocols, negotiate texts, secure agreement by Heads of Government, ratify by individual parliaments, and implement the required changes in legislation and procedures at the national level.²⁴ The 619 actions that need to be taken by 13 member states to establish the CSME underscore the complexity of the task. Most decisions have high resource costs and place demands on a limited pool of technical expertise and resources and require significant capacity building support, adequate fiscal space and access to low-cost financing in a highly-indebted region, and political will and prioritization at the national levels (Stoneman, Pollard and Inniss 2012). Recent calls by regional leaders that the CDF provide vital support to

²² A survey of private sector participants and regional institutions identified loss of sovereignty and political factors among the key obstacles to integration. The survey was sent to senior government officials and private sector executives in CARICOM member states. 104 respondents were invited to participate and only 14 were completed, including 4 private sector entities. Of survey respondents, 86 percent and 79 percent, respectively, identified loss of sovereignty and political factors as a key obstacle, followed by institutional capacity in member states (36 percent).

²³ In dealing with heterogeneity of its membership, the EU had used structural/cohesion funds to facilitate income convergence, managed through common institutions and budget, to complete the single European market goal. Merler (2016), who investigated the role played by the cohesion funds provided to the more disadvantaged regions, found that convergence continued for the EU as a whole, and convergence funds played an important role in limiting crisis effects, at least within the group of disadvantaged regions that were entitled to receive them, especially compared to equally disadvantaged regions that were not.

²⁴ The CSME deliberations in 1989 set the target for full implementation as 1993. The drafting and negotiation of the Protocols occupied the period 1992-98, with a new deadline set for 1999. The revised target encountered setbacks as well as national-level implementation faced significant capacity constraints especially in the OECS.

member states through technical and financial assistance and address social and economic disparities that may be caused by CSME implementation are positive steps in this direction.

48. **Against this background, can CARICOM move towards firmly establishing the CSME and deeper integration without embracing a closer union?** The current reliance on intergovernmental cooperation, a key factor affecting the implementation of CSME actions, means that unless governments are prepared to accept a level of supranationalism, effective functioning of key regional institutions will be impeded (Brewster 2002). Failing to bring in supranationalism to the integration process means that full cooperation will not occur unless member states are convinced of the benefits of integration, ensure an equitable distribution of these benefits, and in so doing focus their efforts on aligning national incentives with the interests of the region.

49. **The CSME, if fully implemented, should be viewed as having a positive impact on the region, strengthening its competitiveness and addressing key impediments to growth.** While the small size and scale of the Caribbean economies, and the associated supply-side constraints, may potentially limit how much benefit can be extracted from economic integration in the form of regional value chains, acting as a group will enhance their scale, and benefits will likely exceed what can be gained by acting individually; that is, the whole could be greater than the sum of its parts. Recent discussions of the region's policymakers stress that regional integration remains as valuable and relevant today as at the inception of CARICOM. The lack of free movement of labor and capital are also seen as key obstacles to conducting business within CARICOM and high production costs and limited access to finance as constraints for expanding exports—challenges that could be addressed by increased scale and reduced skills and funding gaps through labor and capital mobility. The following sections analyze the potential benefits from greater integration through further liberalization of goods and factor markets and greater functional cooperation.

V. ECONOMIC BENEFITS FROM REGIONAL INTEGRATION

Greater regional integration through further trade liberalization and increased labor mobility among the Caribbean economies can generate significant macroeconomic benefits, providing incentives for further integration within the region. Granular trade and tariff data indicate that intra-CARICOM tariff barriers are low but NTBs and trade costs are still relatively high, both within the region and vis-à-vis non-CARICOM trading partners. Reducing such barriers and costs will not only generate trade expansion and welfare gains for all CARICOM members, but will also stimulate a restructuring of economies from contracting to expanding sectors, leading to a net employment gain across the region. Further integration could also allow free movement of people and better allocation of skills and factors of production, which could, in turn, increase labor productivity and create long-term growth benefits for the entire region.

50. **Earlier sections stressed that national and regional efforts will need to focus on aligning national incentives with the interests of the region, absent binding regional enforcement mechanisms to ensure implementation of actions toward regional integration.** This section explores two areas where further regional integration can bring potential economic benefits—liberalization of trade within and outside the region and increased intraregional labor mobility—using two general equilibrium model approaches to explore potential benefits: (1) a global, multisector, computable-general-equilibrium (CGE)

model that offers a tool for controlled experiments in which the sectoral and macroeconomic effects of a change in trade policy can be identified, while holding all other effects constant; and (2) a dynamic general equilibrium model to illustrate the main channels through which labor market integration could affect macroeconomic outcomes.

A. Potential Benefits from Trade Liberalization—A CGE Model Analysis

51. **A standard, static CGE framework (the Global Trade Analysis Project, GTAP) provides a useful tool to analyze potential economic effects of further liberalization of trade.** The model solves for a new, market-clearing equilibrium solution after all prices and quantities adjust following an economic policy shock. In a medium-term timeframe of 5-7 years, skilled workers, capital stock and land resources are assumed to be fixed in national supply, fully employed and mobile across sectors, while unemployment is considered in the unskilled labor market, allowing the unskilled labor supply to accommodate changes in labor demand at a fixed real wage. The analysis aggregates 141 regions of the database into 13 regions (5 in CARICOM—Jamaica, Trinidad and Tobago, Belize, Suriname and Guyana, and “Other Caribbean”—and 8 major CARICOM trading partners),²⁵ 16 industries (with 6 in agriculture and resource sectors, 6 in manufacturing sectors, and 4 in services sectors). Eight factors of production are aggregated into capital, land, unskilled labor and skilled labor.

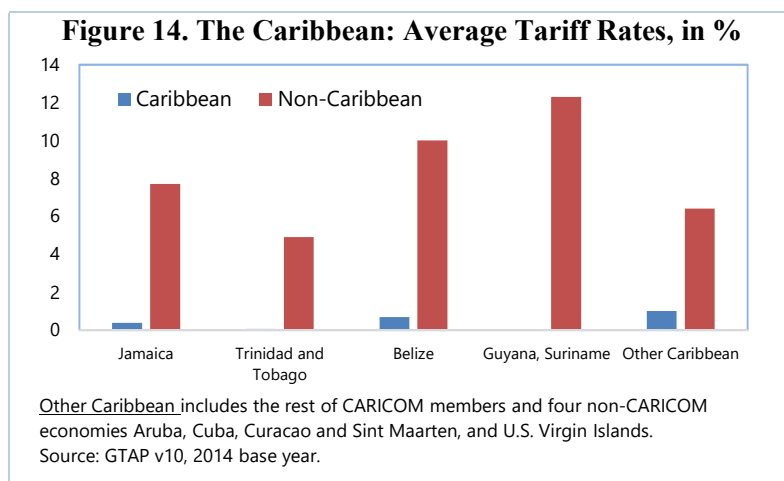
52. **Data indicate that intra-CARICOM tariff barriers are low.** The trade-weighted average tariffs on trade within CARICOM are mostly zero, except for trade with the Other Caribbean region, which includes some non-CARICOM countries (Figure 14; Table 4). The mostly zero tariffs on intra-CARICOM trade contrast with the much higher tariffs CARICOM countries impose on imports from their major non-CARICOM trade partners. The trade-weighted average tariffs on imports from non-CARICOM regions range from 5 percent for Trinidad and Tobago to 12 percent for Suriname/Guyana.

53. **Intraregional nontariff barriers are relatively high.** The availability of data on the NTBs of the Caribbean countries is limited and does not provide a fully satisfactory basis for describing nontariff measures (NTMs) on a country and commodity basis. This analysis uses multiple sources of information that, taken as a whole, indicate that the NTMs imposed by at least some CARICOM economies affect their trade volumes and trade costs, and should be accounted for in a trade policy analysis.²⁶ It incorporates the ad valorem equivalents (AVEs) of import tariffs of sanitary and phytosanitary measures (SPS—used to protect plant, animal, human health) and technical barriers to trade (TBTs) used by Belize, Jamaica, Suriname, and

²⁵ A limitation of the GTAP database for this analysis is that two of its pre-defined regional aggregations include both CARICOM members and non-CARICOM countries. GTAP’s “Other Caribbean” region includes 18 countries, of which 10 are CARICOM members (Antigua and Barbuda, The Bahamas, Barbados, Dominica, Grenada, Haiti, Montserrat, Saint Kitts and Nevis, Saint Lucia, and Saint Vincent and Grenadines) and 4 are associate members (Anguilla, British Virgin Islands, Cayman Islands, and Turks and Caicos Islands). Four, including Aruba, Cuba, Curaçao and Sint Maarten, and the U.S. Virgin Islands, are non-CARICOM members. An analysis of trade flows within this GTAP region, using the TASTE and WITS databases, indicates that most trade within this aggregate, and between the aggregate and the rest of CARICOM, is among CARICOM members. Unless noted, GTAP’s “Other Caribbean” region is assumed to be a CARICOM member.

²⁶ This analysis tries to capture those trade restrictive effects without exceeding the empirical foundation of the estimated effects of NTMs that are available in the literature.

Trinidad and Tobago, as estimated by Ghodsi, et al (2016).²⁷ The AVEs of NTMs in services are drawn from Fontagne et al (2016). The estimations of Fontagne et al (2016) for Jamaica and Trinidad/Tobago are extrapolated across CARICOM by imposing the average of the two countries' services AVEs on the imports of trade/transport, business and other services of other CARICOM members (Table 5). The CGE model is recalibrated to represent the AVEs of goods and services NTMs as surcharges to import tariffs.



54. **Trade costs are also high in the Caribbean.** They include time expenditures, fees, and other burdens entailed in transporting goods across borders. The OECD defines a trade facilitation index (TFI) that describes 11 dimensions of trade costs, including, formalities, procedures, fees, and adjudication processes. Trade costs in CARICOM are relatively high, with an average index value as low as 0.23 (related to customs fees and charges), compared to an index value of 2 when customs performance is optimal. Moise and Sorescu (2013) estimate the AVEs of trade costs, concluding that they add 16.2 percent to the price of imports by the aggregated Latin American and Caribbean region. In the model used in this analysis, the AVE of trade costs is applied uniformly across all CARICOM countries and represented as iceberg-type trade costs.

55. **With these estimations of AVEs of NTMs and trade costs, three trade liberalization scenarios are explored.** First, *tariffs* among CARICOM countries are eliminated.²⁸ Second, the AVEs of *SPS, TBT and services-trade NTMs* are reduced by 25 percent. This partial reduction reflects that only some NTMs are likely to be actionable or without some desirable protective benefit. The partial reduction rate is similar in magnitude to the degree of liberalization often assumed in other trade policy studies, following Francois et al (2013). Third, *trade costs* are also reduced by 25 percent, to describe possible gains in customs efficiency such as electronically posted fee schedules. SPS and TBT measures and efficiency gains in trade and customs procedures are likely to affect all trade partners of a country. Therefore, reductions of NTMs and trade costs by CARICOM are introduced in the

²⁷ The estimated AVEs of NTMs for Barbados and St. Vincent and Grenadines are applied to Other Caribbean.

²⁸ This scenario excludes Other Caribbean because their tariffs are assumed to be imposed between CARICOM and non-CARICOM countries within the same group and by the group's non-CARICOM members on imports from the rest of CARICOM.

model experiment on a multilateral basis, rather than the bilateral treatment given tariff reforms. The reporting of model results decomposes the effects of NTM and trade cost reductions within CARICOM and external to the region.

56. **Key findings from the trade liberalization simulations are as follows.**

- **All CARICOM countries achieve welfare gains from the trade liberalization**, with a \$6.2 billion gain for the region as a whole (Table 6), equivalent to 7.6 percent of the region's GDP in 2018. Welfare gains describe the monetary income equivalent of the gain in purchasing power made possible by trade liberalization. Most of the welfare gains are generated by reducing NTMs and facilitating trade with non-CARICOM countries, reflecting their market share in CARICOM imports. NTM reductions among CARICOM countries can generate welfare gains for all members. With tariffs within CARICOM already at or near zero, further tariff reductions are of negligible benefit. All CARICOM countries achieve real GDP growth as a result of trade liberalization, with gains ranging up to 7 percent for Belize (Table 7, Figure 15).
- **Gains from trade liberalization in terms of trade balance can be uneven.** Trade balances for Jamaica, Belize, and the Other Caribbean region deteriorate, as their imports grow more than exports with the fall in their trade barriers (Table 8). For Trinidad and Tobago and Suriname/Guyana, import growth is more than fully offset by export growth, resulting in an increase in their initial trade surpluses.
- **Trade expansion leads to increased demand for the region's workers.** Unskilled labor employment increases in all CARICOM regions, reaching over 8 percent increase in Belize (Table 9). Higher demand for skilled labor causes their wage to increase in all CARICOM countries. Most of the benefits of trade reform for factor markets stems from liberalizing trade with the non-CARICOM market, but trade facilitation and liberalization of both intra- and non-CARICOM trade will be beneficial.

	Importers:				
Exporters:	Jamaica	Trinidad and Tobago	Belize	Suriname/Guyana	Other Caribbean
Jamaica	0.0	0.0	0.0	0.0	3.2
Trinidad/Tobago	0.0	0.0	0.0	0.0	0.5
Belize	0.0	0.0	0.0	0.0	0.0
Suriname/Guyana	0.0	0.0	0.0	0.0	0.6
Other Caribbean	1.9	0.3	3.4	0.2	0.7
SC America	3.4	4.2	9.1	12.3	2.8
USA	9.1	7.1	10.9	7.7	12.6
Canada	8.5	2.9	9.9	5.2	5.9
Mexico	5.9	8.6	12.9	11.8	7.9
China	10.3	7.1	15.5	8.7	5.7
UK	4.3	6.9	5.8	4.4	6.6
EU-27	5.0	4.4	8.1	6.3	5.8
ROW	10.0	3.4	6.4	6.0	7.4
Total Non-CARICOM	7.7	4.9	10.0	12.3	6.4

Note: Tariff rates exclude NTMs.

Sources: GTAP v10, 2014 base year, TASTE, WITS.

Country	Sector	NTMs			Services NTMs
		SPS	TBT	SPS + TBT Total	
Barbados					
	Fruits/vegetables	0.0	1.2	1.2	-
	Other crops	0.0	8.4	8.4	-
Belize					
	Fruits/vegetables	0.0	2.8	2.8	-
	Other crops	0.0	12.4	12.4	-
	Livestock/meat	0.0	3.8	3.8	-
	Other food prods.	0.0	1.2	1.2	-
	Petro-chemical	0.3	0.3	0.5	-
	Motor vehicles	10.3	0.0	10.3	-
Jamaica					
	Grains/oilseeds	0.5	0.0	0.5	-
	Livestock/meat	0.5	0.0	0.5	-
	Petro-chemical	0.4	0.0	0.4	-
	Elec/equipment	0.1	0.0	0.1	-
	Business services	0.0	0.0	0.0	23.2
	Other services	0.0	0.0	0.0	54.1
St. Vincent and Grenadines					
	Food products	0.8	0.0	0.8	-
Trinidad and Tobago					
	Textiles/apparel	0.4	0.0	0.4	-
	Petro-chemical	0.1	0.0	0.1	-
	Mfg. nec.	0.2	0.0	0.2	-
	Trade/transport	0.0	0.0	0.0	53.2
	Business services	0.0	0.0	0.0	133.9
	Other services	0.0	0.0	0.0	136.7

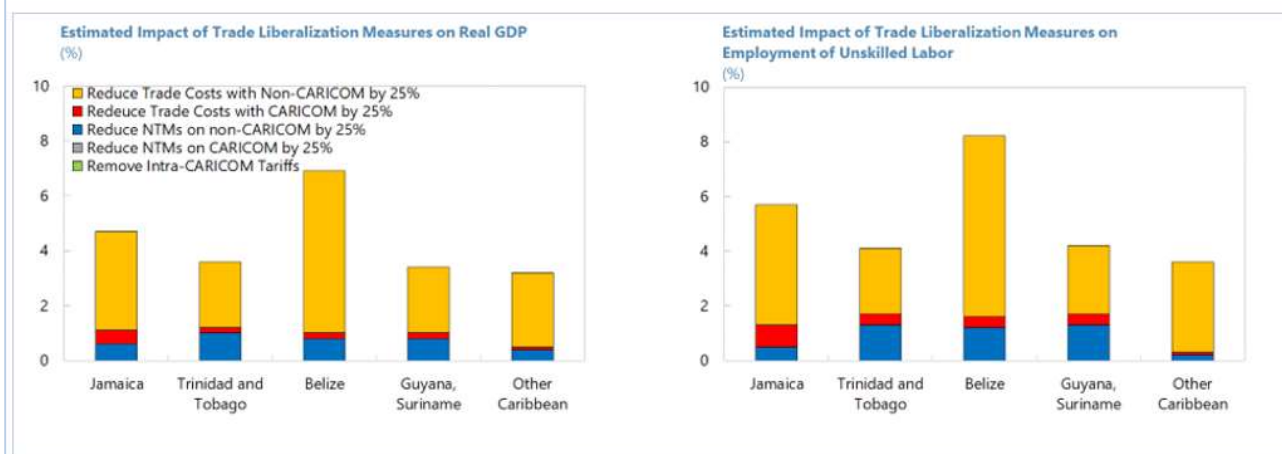
Notes: SPS and TBT data are trade-weighted aggregations of AVEs of NTMs estimated at HS 6 level to the sectors in the model.
Sources: Ghodsi, Greubler and Stehrer (2016) and Fontagne et al. (2016).

- **Trade reforms stimulate a restructuring of economies** as sectoral output and trade respond to trade policy changes that differ by industry, as well as the general-equilibrium effects of sectoral competition for labor and capital resources as some sectors expand. Sectoral gains and losses in production will require workers to shift their employment from contracting to expanding sectors.
- **Due to data limitations on AVEs of NTMs and trade costs, there is uncertainty** regarding the trade-restrictive effects of the estimated NTMs, particularly in services trade, suggesting interpreting the results with caution.

57. **The GTAP model results overall indicate that the Caribbean economies stand to benefit the most from reducing NTMs and trade costs for trade within and outside the region.** We introduce the reductions of NTMs and trade costs on a multilateral basis. However, there may be some potential to reduce NTMs on a bilateral basis among the Caribbean countries to further facilitate intraregional trade. To that end, the region would benefit from coordinating efforts to strengthen, streamline, and harmonize trade processes and procedures, modernize regulations and legislation, and facilitate conflict and dispute resolution in the CARICOM market.

Table 6. Impacts of CARICOM Trade Liberalization

	Intra-CARICOM Tariffs	NTMs on CARICOM	NTMS on non-CARICOM	Trade facilitation with CARICOM	Trade facilitation with non-CARICOM	Total
Impact on Welfare (\$US million)						
Jamaica	-0.1	2.4	-1.5	88.6	610.3	699.6
Trinidad and Tobago	0.1	3.2	299.5	73.1	804.4	1,180.2
Belize	0.0	0.2	4.5	4.4	77.6	86.7
Suriname/Guyana	0.0	0.9	94.5	39.6	322.7	457.8
Other Caribbean	0.0	8.7	-60.3	136.5	3,696.9	3,781.8
Impact on Real GDP (percent change)						
Jamaica	0.0	0.0	0.6	0.5	3.6	4.7
Trinidad and Tobago	0.0	0.0	1.0	0.2	2.4	3.6
Belize	0.0	0.0	0.8	0.2	5.9	7.0
Suriname/Guyana	0.0	0.0	0.8	0.2	2.4	3.4
Other Caribbean	0.0	0.0	0.4	0.1	2.7	3.2
Impact on Trade Balance (E-M) (\$US million)						
Jamaica	0.1	-0.5	70.0	-16.0	-82.2	-28.6
Trinidad and Tobago	0.0	0.9	-62.3	35.2	92.7	66.5
Belize	0.0	0.0	3.1	-0.8	-3.8	-1.5
Suriname/Guyana	0.0	0.2	10.8	10.6	94.9	116.5
Other Caribbean	0.0	-2.6	463.9	-39.7	-613.9	-192.3

Figure 15. The Caribbean: Impacts of Further Trade Liberalization

Source: GTAP Database and authors' computations.

Table 7. Effects of CARICOM Trade Liberalization on Real Factor Prices and Unskilled Employment (percent change)					
	Jamaica	Trinidad and Tobago	Belize	Suriname /Guyana	Other Caribbean
Intra-CARICOM tariffs					
Land	0.0	0.0	0.0	0.0	0.0
Skilled labor	0.0	0.0	0.0	0.0	0.0
Capital	0.0	0.0	0.0	0.0	0.0
Unskilled employment	0.0	0.0	0.0	0.0	0.0
NTMs on CARICOM					
Land	0.0	0.2	0.0	0.0	0.0
Skilled labor	0.0	0.0	0.0	0.0	0.0
Capital	0.0	0.0	0.0	0.0	0.0
Unskilled employment	0.0	0.0	0.0	0.0	0.0
NTMs on non-CARICOM					
Land	5.3	5.2	2.8	3.1	2.3
Skilled labor	0.2	1.0	0.7	1.0	0.0
Capital	0.3	2.0	0.9	1.1	0.2
Unskilled employment	0.5	1.3	1.2	1.3	0.2
Trade facilitation with CARICOM					
Land	0.5	3.9	1.4	0.9	0.1
Skilled labor	0.6	0.2	0.3	0.3	0.1
Capital	0.6	0.1	0.3	0.3	0.1
Unskilled employment	0.8	0.4	0.4	0.4	0.1
Trade facilitation with non-CARICOM					
Land	-2.3	-2.1	4.9	0.7	-1.6
Skilled labor	3.5	1.8	5.8	2.0	2.8
Capital	3.3	2.0	5.2	1.8	2.2
Unskilled employment	4.4	2.4	6.6	2.5	3.3
Total					
Land	3.6	7.2	9.1	4.8	0.7
Skilled labor	4.3	3.1	6.9	3.3	2.9
Capital	4.1	4.2	6.4	3.2	2.5
Unskilled employment	5.7	4.1	8.3	4.2	3.7

B. Benefits of Labor Market Integration—A GIMF Model Analysis

58. **Free movement of people can generate better matching of skills and improve labor productivity.** Previous studies find that with labor market liberalization and trade unions, there would be a migration of workers from countries with low productivity and wages to countries with high productivity and higher wages (Kahanec and Zimmermann 2016; IMF 2018). For example, in Europe, the enlargement of the EU common market and removal of frictions to allocation of resources in 2014 led to increased migration flows from the 8 new EU accession countries to the former core EU15, with the share of those migrants in EU15 doubling in size. Migration also created some temporary small compression in wage growth/markups in the destination countries, and a mild acceleration in wage growth in the countries of origin (Blanchflower and Shadforth, 2009).

59. **To estimate the economic effects of migration and productivity arising from improved labor market integration, this section uses a dynamic general equilibrium model, GIMF—the IMF Global Integrated Monetary and Fiscal model.**²⁹ The model allows to quantify gains for firms and households while modeling explicit trade relationships with the main partner countries. It features agents who behave according to a life-cycle framework (overlapping generations (OLG) agents a la Blanchard, 1985) and liquidity-constrained households, who have no access to financial markets. Firms produce tradable and non-tradable intermediate and final goods. A series of nominal and real rigidities prevent sudden changes in investment and consumption.³⁰ The model also features a monetary authority and government that respond to shocks to stabilize the economy as rigidities amplify their impact. It captures regional migration by applying changes to the labor force, where inflows of workers could lead to increased labor supply, a contemporaneous fall of reservation wage and inflation, and increased investment; the opposite could materialize in countries experiencing an outflow of labor. The model's general-equilibrium feature allows endogenous adjustments of the labor and product markets to mimic these developments.

60. **The GIMF model is applied to analyze the effects of increased labor mobility in the Caribbean, by specifying the model to include six regions:** Caribbean 1 (C1), Caribbean 2 (C2), Caribbean 3 (C3), North America (the US and Canada, UC), Latin America (LA) and the Rest of the World (RW). Bilateral migration flows from a World Bank database show that the more developed islands of the three Caribbean regions have attracted larger immigrant flows. Between 2013 and 2017, there was an increase in net inflow of migrants from less developed countries in the Caribbean (St. Vincent and the Grenadines, Grenada, St. Lucia from C1 and Guyana from C3 and to some extent from Jamaica from C2)

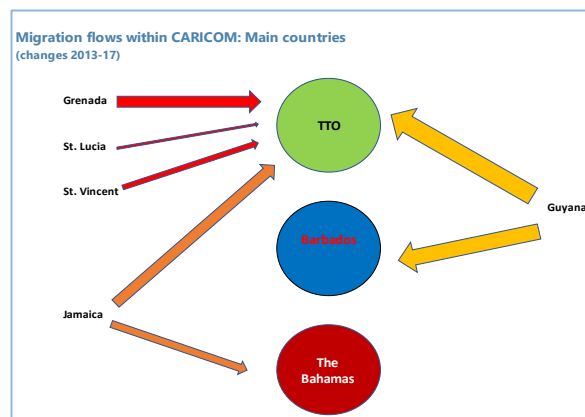
Caribbean 1	Antigua	Latin America	Brazil
	Dominica		Chile
	Grenada		Mexico
	St. Lucia		Peru
	St. Kitts and Nevis		Colombia
	St. Vincent		Costa Rica
Caribbean 2	The Bahamas	Dominican Republic	El Salvador
	Barbados		Honduras
	Belize		Mexico
	Jamaica		
Caribbean 3	Trinidad and Tobago		
	Guyana		
	Suriname		

²⁹ For details on the GIMF model see Komhof et al. (2010).

³⁰ Blanchard (1985), Kumhof, Laxton, Muir, and Mursula (2010).

to more developed ones (The Bahamas, Barbados from C2, Trinidad and Tobago from C3). These bilateral migration patterns between 2013-2017 are used to identify the countries more likely to be the recipients of future migration flows if labor mobility in the region improves.³¹

61. **Shocks to migration flows to simulate greater intraregional labor mobility are calibrated based on the recent developments.**³² Since 2011, The Bahamas and Trinidad and Tobago experienced an increase of about 1 percent of the total labor force in the number of migrants coming mostly from other CARICOM countries. In the case of a further liberalization of labor mobility, the same countries are assumed to experience a similar influx of population/workers from the other Caribbean regions. Based on the previous observations, most migrants are assumed to come from C1 countries, and some migration is assumed to take place from C3 to C2 countries. Accounting for the relative size of each of the countries involved in the migration, the shock could lead to a (net) increase in labor supply in C2 (by 0.2 ppt) and C3 (by 0.5 ppt) and a decrease in C1 (3 ppt), with the shocks assumed to be permanent.



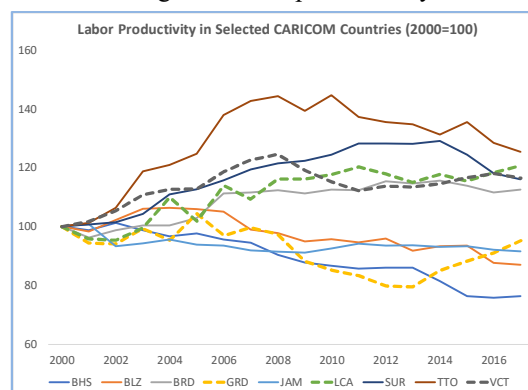
62. **In addition to resulting in greater intraregional labor mobility, the improved factor and skill allocation could boost labor productivity, with associated growth benefits in all countries participating in the labor market.** In the EU experience, labor productivity in the new-admitted countries grew by about 2 percentage points faster than in the original more advanced members (EU15) in 2004. The exercise for CARICOM assumes that labor productivity improves by 6 percent across the region (with improvement assumed to be gradual and accrue in 10 years), based on the evidence from the OECS countries following the Revised Treaty of Basseterre to form an economic union and allow free movement of labor within the OECS (Box 2). Such gains in productivity are conceivable, including through positive effects of a temporary/permanent migration of skilled labor on the less endowed countries' human capital (including through transfer of technology and know-how), the impact on production capacity, competitiveness, and production bottlenecks associated with unavailability of local labor at affordable wage rates (Bourne 2003). Greater intraregional labor mobility can also boost productivity by keeping high-skilled labor in the region and limiting the pervasive brain drain through out-migration.

³¹ The current stock of intra-CARICOM immigrants (2017 data) in the net-recipient countries include: (i) Barbados, where the immigrants from the CARICOM region represent 13.4 percent of the labor force (mostly from St. Lucia and St. Vincent and the Grenadines (C1) but also from Guyana and Trinidad and Tobago (C3)); (ii) Bahamas (C2) at 5.7 percent of the labor force (mainly from Jamaica (C2)), and (iii) Trinidad and Tobago (C3), where immigrants represent 4.2 percent of the labor force (mostly from Grenada and St. Vincent and the Grenadines (C1)). For Bahamas, we disregarded a large share of immigrants coming from Haiti as asylum.

³² Data on migration after EU enlargement in 2004 show that after 4 years (from 2004 to end 2007), the share of migrants residing in the original more advanced 15 member economies (EU15) more than doubled with migrants from newer members (EU8) (an increase of 112 percent—Kahanec and Zimmermann, 2010).

Box 2 . The Divergence of Labor Productivity Growth in the Caribbean

Labor productivity, measured as output per worker, seems to have grown at a faster pace in the OECS countries in recent years than in the rest of the Caribbean. According to the data published by the Penn World Table (PWT), the three OECS countries covered by PWT (Grenada, St. Lucia and St. Vincent and the Grenadines) saw a steady increase in their labor productivity since the early 2010s, while in the rest of the region labor productivity remains stagnant, if not decreasing, over the same period. In tourism-based countries such as the Bahamas, Belize and Jamaica, labor productivity has been trending down since 2000.¹



What may explain the divergence between the OECS countries and the non-OECS ones? It is well documented in the literature that a variety of country-level structural factors, such as macroeconomic stability, competitiveness and FDI, can be associated with the performance of labor productivity. At the regional level, an important development for the OECS countries was the establishment of the OECS Economic Union in 2011 (the Revised Treaty of Basseterre was signed in June 2010 and ratified by most member economies in the following year). The Revised Treaty granted OECS citizens the full freedom of movement within the region for an indefinite period to work, establish businesses, provide services or reside. Although the OECS countries are still in the process of enacting all domestic legislation required to give effect to the Revised Treaty, the OECS authorities have also agreed in principle to the free circulation of goods and services within the Economic Union.

As shown by the experience of the European Union, free movement of labor could provide a boost labor productivity, through improved skill matching and job placement, positive externalities of innovation, reduced costs for cross-border services and various other channels.

To examine whether this is also the case for the OECS countries following the establishment of the OECS Economic Union, we perform a difference-in-difference analysis using the non-OECS countries as the control group. Given the high homogeneity of the Caribbean economies, especially those dependent on tourism and susceptible to the same types of external shocks, the non-OECS countries serve as an ideal control group. To isolate the causal effect of the regime change (treatment) for the OECS countries after 2011, we also control for country-level factors including inflation, FDI (as percent of GDP), income level (PPP-GDP per capita), and the real effective exchange rate. Our analysis indeed points to a positive impact of the treatment on labor productivity growth for the OECS countries by 6-7 percentage points. The results are robust if we exclude the commodity exporting countries from the control group.

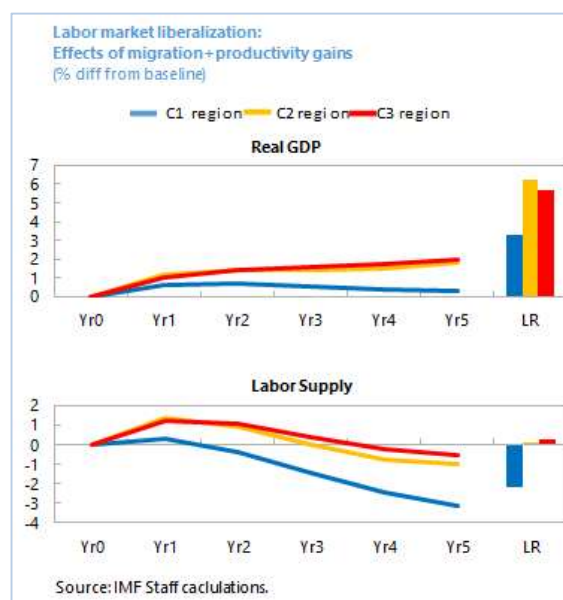
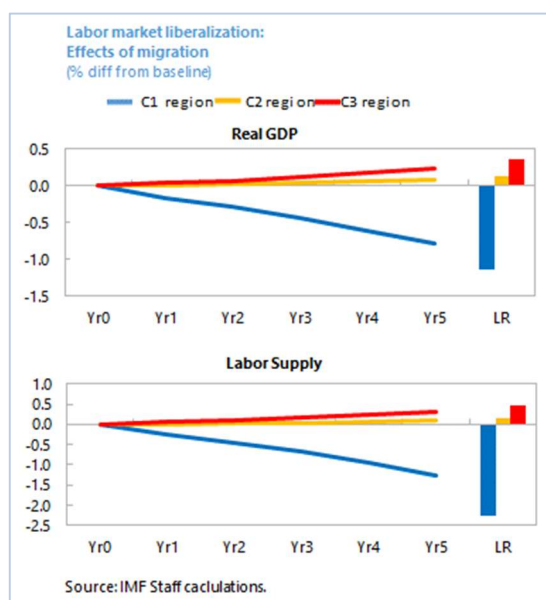
Dependent variable: Log of labor productivity		
	(1)	(2)
Log of income (lagged)	0.176*** (5.56)	0.105** (2.07)
Inflation	0.00 (-0.57)	0.00 (0.34)
FDI (as percent of GDP)	0.004*** (3.32)	0.006*** (3.68)
Real effective exchange rate	0.004*** (5.89)	0.005*** (4.21)
Treatment (1 if OECS countries)	-0.060 (-0.23)	-0.058 (-0.34)
Post (1 if year>2011)	-0.099*** (-5.98)	-0.074*** (-3.19)
Treatment x Post	0.069*** (2.97)	0.074*** (2.86)
Observations	153	119
Number of countries	9	7
R-squared:		
within	0.3752	0.3007
between	0.2949	0.0767
overall	0.2969	0.0834
***p<0.01, **p<0.05, *p<0.1 z-scores in parentheses (1) includes the full sample of 9 countries for 2000-2017. (2) excludes the two commodity exporting countries Suriname and Trinidad and Tobago.		

¹ <https://www.rug.nl/ggdc/productivity/pwt/>.

63. **The simulation results suggest that the benefit from labor movement alone is limited.** Positive shocks to labor supply in C3 and C2 countries generate gains in terms of GDP in the order of 0.1-0.3 percent after 5 years. The model highlights how the increase in

labor supply could induce lower wage pressure (lower reservation wage) and improve firms' costs. This is the main channel that leads to a real GDP increase. On the other hand, the outmigration of workforce from C1 generate a negative shock on labor supply and a loss in terms of GDP of about 1 percent after 5 years.

64. **Simulations also suggest that growth gains could be sizable if enhanced factor market integration generates some further improvement in labor productivity.** Adding a 6 percent shock in productivity to all Caribbean regions (C1, C2, C3) suggests a cumulative increase in real output by 3-6 percentage points. For regions that may lose labor in a more integrated regional market, the growth benefit from labor productivity gains is more than enough to offset the output loss from reduced labor force. In light of the increase in productivity observed in the OECS after the integration initiative in 2011, we interpret these improvements as arising from more than just a better allocation of labor, but also as gains from free flow of factors overall and services.



VI. WAY FORWARD: POLICY HARMONIZATION AND COOPERATION INITIATIVES A LOW HANGING FRUIT?

The preliminary analyses of the previous section suggest that the CSME is still a worthwhile goal to pursue and provide some support to focusing regional efforts toward full regional integration. As the Caribbean Community continues to address the impediments to progress, advancing functional policy cooperation in areas where the region faces significant common challenges could provide low-hanging fruit, while building momentum toward full integration. These areas could include, for instance: safeguarding regional financial stability in a tightly interconnected financial system; building resilience to natural disasters and climate change risks; avoiding a “race to the bottom” in granting incentives to foreign investors; and fighting violent crime. Deepening cooperation in these areas, as well as implementing the CSME, calls for accelerated efforts to harmonize the institutional frameworks as a way to reduce the fixed costs of institutions and facilitating greater integration within the region.

71. **Some of the key challenges facing the Caribbean region transcend national boundaries, calling for regional solutions.** Addressing such challenges as safeguarding financial stability in increasingly more interconnected financial systems, building resilience to more frequent and intense natural disasters, or containing violent crime, can be viewed as regional public goods that require collective action and cooperation by individual nations. The absence of such action, where individual solutions will not have the scale to generate desirable outcomes or possibly result in ‘prisoners’ dilemma’ situations, poses significant challenges to the stated goals of CARICOM. At a time when the momentum for integration seems to have stalled with skepticism about benefits of CSME, there may be a case for close cooperation in these or other areas, as the region continues to address the barriers to full regional integration. As noted by Girvan (2005), a Caribbean community with 15 million people would likely be in a stronger position to cope with the common challenges and act with one voice than a collection of 15 jurisdictions with an average population of 1 million.

A. Advancing Policy Coordination in the Financial Sector

72. **Integrating national capital markets has been an explicit goal of CARICOM, to create a common economic space, and some progress has been made toward this objective.** As discussed in Section III, progress has been limited in integrating capital markets and liberalizing the movement of capital, but the national financial systems have become increasingly more interconnected and complex, with large conglomerates and mixed groups organized increasingly less along jurisdictional lines and more along functional lines. Operating across the region through extensive networks of subsidiaries and branches, the conglomerates have complex ownership structures, with many nonbank financial institutions operating as subsidiaries/affiliates of commercial banks.

73. **While an integrated financial system brings many benefits to the region, it can also make the system harder to manage.** The extensive and opaque cross-holding structures, rapid growth of novel products, interconnected indigenous banks and ownership linkages across institutions, and active presence of common lenders can create regulatory blind spots for regulators and supervisors. Sovereign-bank linkages add to the complexity (Ogawa and others 2013; Canetti and others 2017). Absent sound financial stability regimes, a highly-interconnected financial system can propagate shocks across sectoral and national boundaries. The failure of the Trinidad-based regional insurance company, the CL Financial Group, in 2009 is a clear example of how a group’s failure can have spillover effects in other countries (group assets represented 30 percent of the region’s GDP) in the absence of sound risk management, governance, consolidated oversight of conglomerates, and safety nets.

74. **A coordinated approach to regulation and supervision and harmonized and well-coordinated crisis management and resolution frameworks are needed to narrow existing institutional gaps and safeguard financial stability.** These include, in particular: appropriate domestic and regional regulatory frameworks; effective mechanisms for information sharing among supervisory authorities and home-host supervisory arrangements to limit blind spots and regulatory arbitrage; and mutually-agreed crisis management and resolution frameworks to prevent financial stress from spreading and facilitate speedy resolution of failing cross-border institutions. Such cooperation can also help save scarce supervisory resources in the region’s resource-constrained economies.

75. CARICOM states have been making progress in aligning regulatory and supervisory frameworks toward best practice, but further work is needed.

Harmonization of supervisory architecture and practices has been a key task of the Caribbean Group of Banking Supervisors (CGBS), and a technical working group has been assigned the mandate to harmonize across the region the laws, supervisory standards, and approaches to restructuring financial groups, develop a standardized accounting and reporting framework, and improve information-sharing between regional regulatory agencies. Advancing the CSME goals requires finalizing the work on harmonization and establishing a regional framework for supervision/regulation of financial entities operating in the regional economic space (CARICOM 2013).³³ Implementation has been progressing, but gaps remain (Box 3).³⁴

76. Integration of financial markets is work in progress. Underdevelopment and fragmentation of financial markets undermine the ability to manage risk and boost the region's growth potential.³⁵ The current state of the markets reflects, in part, weak market infrastructure and lack of harmonization of regulations. Concerted efforts to harmonize listing and reporting requirements and establish common mechanisms/frameworks for cross-border transactions would help integrate stock exchanges and facilitate cross-border trading. A common legal framework to enforce cross-border collateral, a regional securities depository, a mechanism for linking the existing national depositories, cross-border sharing of credit information, a regional credit rating agency in 2014, as well as the recent plans to establish a pan-Caribbean securities market, are important steps in this regard.

77. Progress in these areas would also help the region cope with a number of current challenges faced, in addition to supporting the stability of the regional financial system. These include persistent weaknesses in asset quality with high levels of nonperforming loans (NPLs) in the banking system and the loss of correspondent banking relationships (CBRs).

78. Building a Regional NPL Market for the Caribbean. The quality of bank assets in the Caribbean gradually deteriorated after the recession that followed the global financial crisis. The NPL ratio rose from low levels to more than 10 percent across several Caribbean countries and remained high with continued weakness in the region's economic growth and structural impediments to their resolution. A survey of banks and regulatory authorities suggested that deficiencies in the legal process, difficulties in valuing and realizing collateral, protracted insolvency procedures, information gaps that hinder risk and collateral valuation, weaknesses in prudential/supervisory frameworks, and the absence of a market for distressed assets were among the key impediments to NPL resolution (Beaton and others 2017). Persistent weaknesses in asset quality pose macro-financial stability challenges to the region, clogging bank credit, which, in turn, undermines economic growth. Staff analyses suggest that a 2.5 percent increase shock to NPLs would reduce GDP growth by nearly 0.6 percent.

³³ CARICOM Press Release, August 2013, available from <https://caricom.org/communications/view/caricom-finance-ministers-tackle-growth-and-development>.

³⁴ The discussion is based on Canetti and others (2017), Ogawa and others (2014), Narain, Otker-Robe, and Pazarbasioglu (2012), and CARTAC reviews and assessments.

³⁵ Bauer and others (2008) estimates that growth in CARICOM could increase by 0.6 percentage points per year if financial integration allowed the region's economies have access to financial markets similar to those of Barbados.

Box 3. Regional Cooperation to Strengthen Regulatory and Supervisory Frameworks

Microprudential oversight: For banks, regional efforts are underway to strengthen microprudential supervision, move to risk-based supervision, and develop supervisory guidelines under the Basel II framework. Risk-based supervision is work in progress, and limited headway has been made in implementing Basel II.¹ For insurers, the critical gaps in the overall legal, regulatory, and supervisory structure to oversee cross-market/cross-border activities and information exchange remain largely unaddressed, with some legislative work ongoing in Trinidad and Tobago to strengthen insurance and cross-border supervision. Very few Caribbean states have introduced risk-based capital for insurance companies. The region is not yet ready for IFRS-9 implementation, which can create challenges for financial conglomerates operating in multiple jurisdictions.

Macroprudential oversight: Strong microprudential supervision needs to be complemented by macroprudential, or systemic, oversight in a tightly interconnected financial system. Most countries in the region integrate systemic risk evaluations into their regulatory and supervisory frameworks, monitor system-wide contagion matrix of bilateral exposures, and have in place SIFI identification and monitoring frameworks, but progress has been limited in establishing macroprudential policy (MaPP) frameworks and tools to manage systemic risk, or in setting up an MaPP body tasked for implementing it (except in Guyana and Jamaica). Progress is needed to identify regional SIFIs and agree to an enhanced supervisory approach to limit the failure risk.

Cross-sectoral supervisory coordination: Cooperation across sectoral supervision authorities is at a nascent stage. Financial stability committees to assess risk and coordinate policy responses are in place in only a few countries, and their mandates are largely restricted to information exchange. Coordination is particularly important, with the oversight responsibility of different financial institutions separated across multiple agencies in most states. Coordination should be expanded to assess/respond to systemic risk and ensure a well-coordinated, timely response to stress, particularly those from regional financial conglomerates.

Cross-border cooperation: Embedding cross-border dimension in financial stability frameworks is crucial to limiting regulatory arbitrage across jurisdictions. While this is increasingly recognized by policymakers, cross-border coordination is still at a nascent stage. Supervisory standards are largely country specific and cooperation arrangements through MOUs mostly lay out a framework for information exchange. The CGBS finalized a consolidated supervision framework, but a regional framework is pending formalization of national frameworks. There is no financial oversight committee to assess regional financial stability risks and, in the event of systemic stress, facilitate a coordinated response. Cooperation takes place under the Regional Financial Stability Coordination Council, RFSCC, whose mandate is limited to information exchange. The existing MOUs can be amended to formally establish a supervisory coordination role for the RFSCC.²

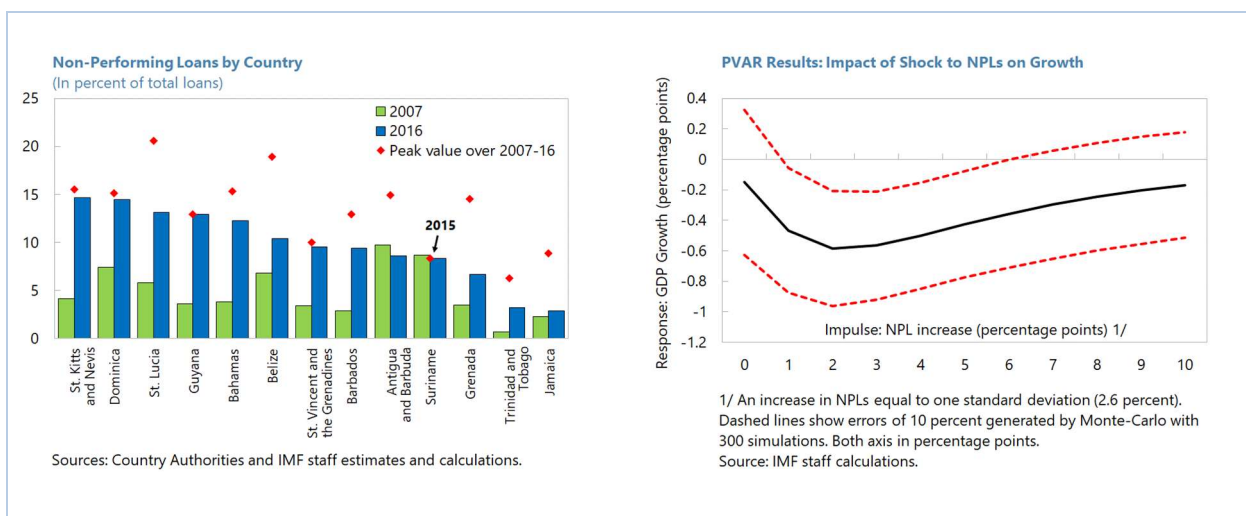
Home-Host supervisory coordination: With the prevalence of foreign financial institutions in the region, home-host cooperation and information exchange are essential to get a full picture of the risks and soundness of institutions. Caribbean supervisors have made increasing efforts to strengthen cooperation with their home counterparts and are represented in the supervisory colleges for large foreign banks operating locally. Multilateral MOUs for information sharing have been put in place by regional regulators and several countries signed MOUs with the Canadian regulator, but obstacles to information sharing remains and the MOUs do not take account of cross-border resolution matters.³ A regional credit bureau does not exist, though there are ongoing efforts to establish one in the ECCU. For insurance, the Colleges of Insurance and Banking Supervisors meet periodically and share information. For securities, members of the Caribbean Group of Securities Regulators share information on market conditions and investor protection and coordinate supervisory/enforcement actions.

Resolution frameworks and tools: Currently, there is no regional resolution or crisis management framework. The existing framework is based on national resolution regimes and associated funding modalities, rather than on an integrated national or regional approach. The CGBS developed a draft outline of a resolution strategy for regional banks following the CL collapse, but the final plan is pending consensus. Emergency liquidity facilities to contain regional spillovers remain to be developed, requiring agreement between CARICOM member states on burden sharing. Only four countries have deposit insurance. Regional SIFIs do not have systemic risk management plans or “living wills” (recovery and resolution plans that require firms and regulators to develop systematic and holistic plans for recovery/orderly winddown in the event of failure. Implementation of such plans for cross-border firms need MOUs that specify respective responsibilities of home-host resolution authorities to avoid a prolonged and disruptive resolution process.

¹ Only two Caribbean countries (The Bahamas and Bermuda) fully implemented Basel II; some countries have not started implementation. While they refined their Basel II/III implementation plans, the earliest date for full implementation in ECCU, Belize, Guyana, Jamaica is 2020, with slow progress reflecting staffing constraints and diversion of resources to other supervisory priorities.

² The MOUs were signed in 2011 by Aruba, The Bahamas, Barbados, Haiti, Jamaica, Guyana, Trinidad and Tobago, and Turks and Caicos.

³ CARTAC (2019), “Developing a Harmonized Framework for SIFI Monitoring and Macroprudential Regulation in the Caribbean.



79. **Cooperation among the regional authorities to strengthen the regulatory and supervisory frameworks, close information gaps, and develop a regional market for distressed assets can help address the NPL problem.** The small size of the Caribbean economies, information gaps on distressed borrowers and collateral valuations, limited institutional capacity, and cultural and social factors, hinder the development of a well-functioning domestic market for distressed assets. Collaborative efforts could focus on building a market based on a common pan-Caribbean platform open to external investors to create economies of scale and address some of the cultural and social obstacles. Ongoing regional initiatives, such as establishing a regional Asset Management Company and credit bureau, modernizing the foreclosure/insolvency regimes, and setting guidelines for collateral valuation in the ECCU region are positive steps in this regard (Beaton and others 2017).

80. **Correspondent Banking Relationships.** CBRs, a key component of a well-functioning international financial system, experienced significant disruptions during 2015-16 (Alleyne et al. 2017). Banks across the Caribbean lost CBRs as correspondent banks reassessed their business models in response to changes in macroeconomic and tightened regulatory environment. Compliance-related AML/CFT issues have been the most widely referenced reason for the withdrawal of CBRs. While the overall macroeconomic impact of CBR losses has been broadly contained and losses stabilized since 2017, the region continues to experience adverse consequences in the form of higher CBR fees, transaction times, and customer due-diligence costs, and loss of access to CBRs by some services and sectors perceived as risky. Moreover, the replacement of lost-CBRs with few smaller correspondent banks and nonbank payment service providers likely increased counterparty and concentration risks in the financial system, making it vulnerable to a broad-based withdrawal.

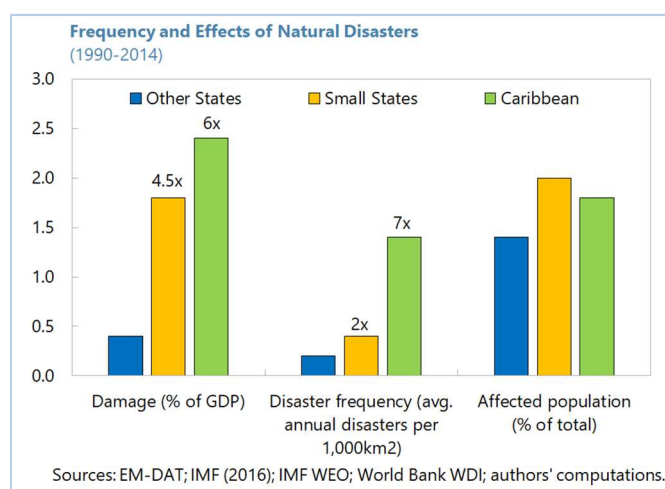
81. **Regional cooperation could play a pivotal role in this context.** At the regional level, through CARICOM, Caribbean policymakers have established a task force to study the de-risking phenomenon underlying the CBR losses and have made it a key aspect of their engagement and dialog with international partners (Alleyne and others 2017). As part of the efforts, countries need to prioritize action to meet international AML/CFT and tax transparency standards and facilitate exchange of information. One notable example has been the ECCU's move to consolidate national AML/CFT supervision into one regional operation

at the ECCB to maintain consistent standards of supervision across the region and mitigate concerns about AML/CFT risks. Further efforts to enhance coordination can help mitigate the risk of financial exclusion and instability, and place greater attention to financial integrity issues, such as corruption, transparency, and sanctions as possible drivers of CBR pressures. The use of a regional information repository to share information on suspicious transaction flows among regional financial intelligence units could enhance effectiveness of AML/CFT frameworks. Regional CBR roundtables could facilitate international dialogue, bringing together and correspondent and respondent banks and other stakeholders for concrete actions.

B. Building Resilience to Natural Disasters and Climate Change

82. **The Caribbean is highly vulnerable to climate-related disaster risks, which have significant macroeconomic implications.** Many of the Caribbean islands are among the top-25 vulnerable nations in terms of disasters per-capita or land area, with damages well

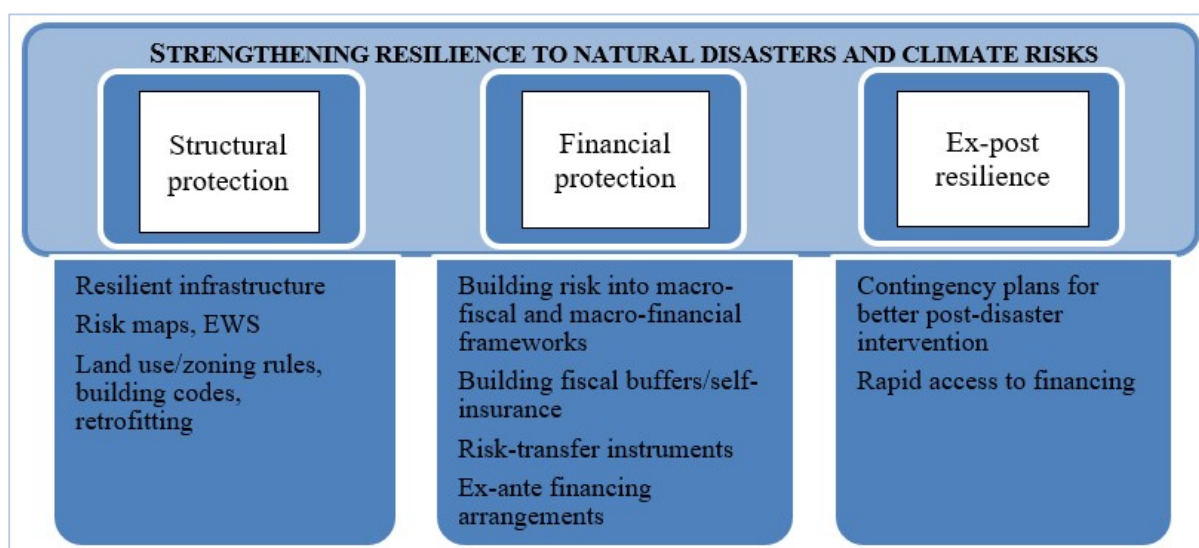
exceeding the size of the economy for some disasters.³⁶ Climate change is expected to intensify these vulnerabilities by making disasters more frequent and intense and affecting large shares of the population through rising sea levels and temperatures. High exposure to climate risks, in turn, amplifies the structural impediments to the region's long-term economic prospects, such as limited fiscal space, brain drain, violent crime, financial sector weaknesses, and high cost of doing business (Alleyne and others 2017), as disasters take a deep toll on growth, erode governments' fiscal buffers, worsen public-debt dynamics, and take resources away from development toward post-disaster recovery and reconstruction.



83. **Building resilience to disasters and climate risks is therefore a key policy priority for the region.** Resting on three complementary pillars—structural protection (to reduce the risk and impact of disasters), financial protection (to mitigate the economic cost of disasters), and ex-post resilience (to facilitate speedy recovery from disasters), resilience building can provide significant benefits. Studies show, for example, that cutting disaster damage by one-half can lead to annual growth gains of about one percent for some of the most disaster-prone countries (e.g., Dominica, Grenada, and St. Kitts and Nevis—see Chamon and others 2017). Moreover, resilient public investment can raise potential output by 3–11 percent in the ECCU, with an annual contribution of 0.1–0.4 percent during the transition to a resilient state. Growth gains, in turn, can help break the high debt-low growth cycle prevalent in the region by improving countries' debt dynamics.

³⁶ See Muñoz and Otker (2018); Otker (2019); Otker and Loyola (2017); and Otker and Srinivasan (2018).

84. **Despite well-established evidence on its benefits, countries invest little in building resilience ex-ante, reflecting in part resource and capacity constraints.** The Climate Change Policy Assessments conducted for Belize, Grenada, and St. Lucia suggest estimated resilience investment gaps of 2-3 percent of GDP a year over a decade or more (IMF 2019). High upfront costs of resilient infrastructure (estimated to be 25 percent higher than regular infrastructure) and limited national fiscal buffers and global funds present challenges to investing in physical resilience (UNEP 2016). Investing in financial resilience is also limited, reflecting cost considerations, weak fiscal positions, and under-developed financial markets to hedge disaster risk. Innovative risk-sharing tools, such as catastrophe bonds, have not been issued by Caribbean sovereigns given their high setup costs, complexity, and capacity/regulatory constraints. Capacity/resource gaps also limit the ability to design a comprehensive resilience strategy that builds in the upfront costs and long-term benefits of resilience investments into macro-frameworks, restores and maintains fiscal sustainability, and identifies and implements resilience projects financed by climate funds.



85. **Closing the large resource and capacity gaps call for a collaborative approach and intraregional cooperation is a crucial dimension of such collaboration.** In countries highly exposed to large-scale disasters, country efforts to implement fiscal adjustment will likely fall short of the scale needed to undertake resilience-building investments. Full implementation of resilience strategies will require new aid flows, capacity building support, and collaborative efforts to assess disaster risks, financing gaps, and benefits/costs of risk-management tools, and to deepen markets for risk-sharing tools (IMF 2019). At a 2018 [high-level conference](#) organized by the IMF, World Bank, and Inter-American Development Bank, participants expressed strong support for investing in ex-ante resilience and “building alliances” among key stakeholders, with greater collaboration across the Caribbean states and with the international community. Such collaboration should generate synergies and expand the resource and knowledge pool to confront the key obstacles to resilience-building.

86. **Caribbean states have been taking steps in this direction.** Collaboration has generally focused on building capacity to facilitate speedy recovery and reconstruction after disasters: A regional inter-governmental agency to coordinate emergency response (the

Caribbean Disaster Emergency Management Agency) has been created by 18 states to generate economies of scale and facilitate logistics more systematically. The agency has a comprehensive disaster management strategy that supports all phases of a disaster management cycle and is developing a regional risk information system for greater risk awareness and preparedness and evidence-based decision making. Notwithstanding the progress in this area, more needs to be done to ensure a coherent timely response and recovery, including through peer learning, resource sharing, improved physical connectivity, and labor mobility to facilitate relocation of disaster-affected populations across the region.

87. The region has also made some progress in on mitigating financial costs of disasters, including through a regional catastrophe risk insurance facility, CCRIF.³⁷ CCRIF is the first of its kind³⁸ to provide 20 Caribbean islands with parametric insurance against natural disasters. Risk pooling through CCRIF is estimated to have reduced the financial cost of insurance for its members by up to 50 percent, compared to what they would have to pay in the market individually (World Bank 2014b). Caribbean states remain under-insured, however, owing to resource and capacity constraints and relatively high insurance premia. Regional cooperation can enhance the scale needed to lower insurance costs, including by expanding CCRIF membership to non-member Caribbean states and combining efforts to sway donors to subsidize insurance premia, directly or indirectly (by augmenting CCRIF capital or rewarding resilience efforts). Access to risk-transfer tools can be enhanced by joining efforts to develop a regional capital market with adequate oversight frameworks. While involving potentially complex issues, regional disaster funds are also being discussed.

88. Regional collaboration could also be helpful in raising the region’s voice in climate negotiations and building resilience to climate change. Collaboration could help, for instance, in attaining contingent lines of credit with bilateral, multilateral and commercial creditors to reduce ex-ante disaster financing uncertainty. As a group that contributes a tiny share of global emissions while being disproportionately exposed to its consequences through coastal erosion, sea level rise, or pollution of water, and the vulnerability of their climate-sensitive sectors and weak infrastructure, a united Caribbean can also have a better chance of raising the region’s voice in negotiating global policies for climate mitigation or adaptation. A more integrated Caribbean with free movement of people can also better deal with disaster-induced migration pressures following disasters, for both the recipient and affected countries. Their small size and the minimum efficient scales needed for effective solutions—waste/fisheries management, marine conservation, biodiversity protection, and shared ecosystems, make concerted action essential to ensure resilience and sustainability (ECLAC).

C. Fighting Crime in the Caribbean

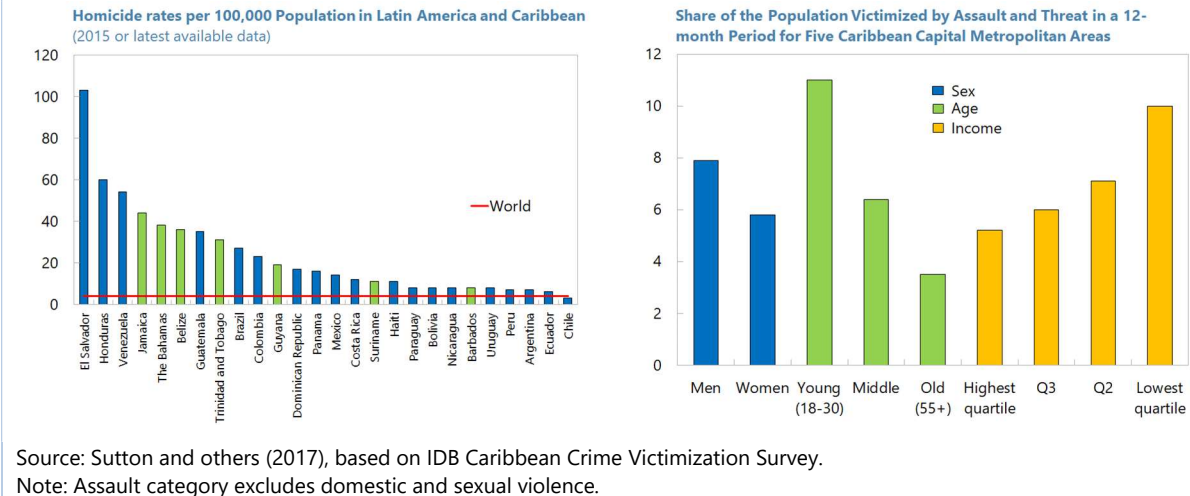
89. Violent crime is pervasive in the Caribbean, and a common challenge facing the region, with homicide rates now among the highest in the world. In several Caribbean countries, crime has risen sharply since 2007 and homicide rates more than doubled (Sutton

³⁷ Created in 2007, CCRIF provides quick payouts to meet immediate cash-flow needs and is not designed to provide full insurance against natural disasters. Insurance coverage is low for both public and private sectors in the Caribbean, with average insurance gap at 66 percent (Munich Re 2018).

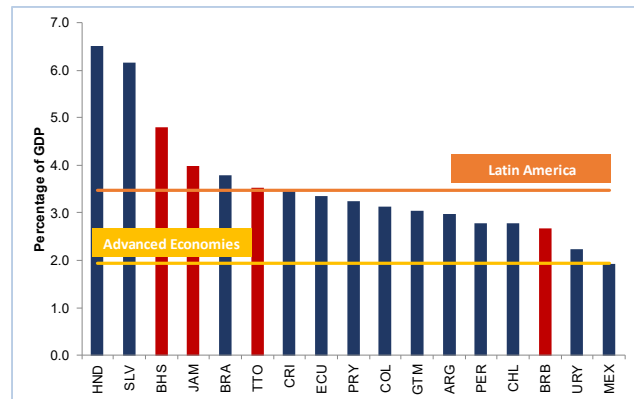
³⁸ Similar sovereign insurance pools were created in Pacific (PCRAFI) and African (ARC) small states in 2013.

and others 2017). Some Caribbean economies have some of the highest homicide rates globally, at an average rate of 24 per population of 100,000—more than three times the rate in non-Caribbean small states (Alleyne and others 2017). The victims of violent crime are predominantly young and in the lowest income groups, suggesting significant adverse economic and social implications in the short and long term.

Prevalence of Violent Crime in the Caribbean



90. **High rates of violent crime impose a serious social and economic burden for the region.** Crime-related costs are estimated at 3.7 percent of GDP (see chart), including direct costs (from loss, injury, damage, and costs related to forgone income, private and public spending on security, and costs of the criminal justice system), as well as indirect costs associated with changes in behavior caused by crime or cost to victims' families (Sutton and others 2017). Violent crime impedes economic growth by discouraging tourism and business investment, reducing labor force and its productivity, and diverting government spending toward fighting crime from growth-enhancing investment in health, education, and productive infrastructure (Sutton and others 2017). About 40 percent of the Caribbean population identify crime and security-related issues as the principal problem facing their countries.³⁹ Overall, 24 percent of Caribbean capital city metropolitan area residents report intentions to immigrate on security concerns, which can contribute to the brain drain already prevalent in the region (Alleyne and others 2017). With businesses being frequent targets, high crime affects the business climate, with an average 84 percent of Caribbean businesses reporting crime as an obstacle to doing business—Sutton and others (2017). The study also



³⁹ Latin American Public Opinion Project 2014/2015 Caribbean data sets.

finds 3.26 percentage points reduction in tourism arrivals growth associated with one homicide per 100,000 rise.

91. **High cost and macro-social consequences of crime suggest that there are significant economic and social welfare gains from reducing crime in the Caribbean.**

Based on panel estimations of the effects of crime on growth over 1995-2011, IDB (2017) shows that GDP growth for the region would have been 1.14 percent higher annually and annual tourism arrivals growth would be 2.14 percent higher if homicide rates were reduced to the global average. Alleyne and others (2017) also show significant scope for raising growth in the Caribbean, including by reducing homicide rates. The significant growth gains call for accelerated efforts to reduce crime, including through greater emphasis on understanding its drivers and a shift in focus to prevention, to reduce the drain on fiscal budgets and to address the issue at the source.

92. **With eradicating crime being a common goal, national efforts to address crime could be accompanied with regional efforts.** Drivers of crime and violence in the Caribbean are similar—including, drugs and gun trafficking, given the geographical location of the Caribbean islands, and money laundering. As such, efforts for dealing with crime call for regional solutions, since violent crime can transcend national boundaries in the absence of close cooperation among jurisdictions through information sharing, application of standard legal and institutional frameworks, and safeguarding border security.

93. **CARICOM members have been undertaking steps in this direction, but further efforts are needed.** Investment has been made in prevention (Box 4), with Crime and Security being the fourth pillar of the regional integration movement, but limited budget allocations continue to favor ex-post response through law enforcement, as opposed to ex-ante management of crime risk. Efforts on youth vocational training (to enhance formal job opportunities and keep the youth off streets, community-based initiatives that involve partnership with civil society, private sector, hospitals, and teachers, information sharing across law-enforcement agencies in the region, including through greater collaboration on regional border security and developing indicators to accurately monitor efficacy of anti-crime programs would be helpful in this regard (Sutton and others 2017).

D. Avoiding Race to the Bottom

94. **Regional cooperation can be particularly fruitful in areas where it can facilitate solutions to collective action problems.** Collective action failures can occur when national policies to safeguard countries' own interests generate negative externalities and pressure other countries to follow suit, possibly engaging in harmful competition (e.g., to attract foreign direct investment (FDI) to promote tourism through tax incentives or to attract funds to support domestic economies through Citizenship-by-Investment (CBI) programs). Countries acting in their own interest may obtain immediate gain from these actions, while losses from the impact of adverse consequences may collectively cause damage to all involved.⁴⁰ Close cooperation and harmonization of policies in these areas can be particularly

⁴⁰ Similar to the “the tragedy of the commons problem” (see e.g., Otker 2014).

fruitful by protecting fiscal revenues and maintaining the integrity of domestic policies, while limiting potential side effects on macroeconomic sustainability, development, and growth.

Box 4. Various Regional Initiatives to Tackle Crime in the Caribbean

- The Caribbean Financial Action Task Force (CFATF) was created in 1992 to address money laundering.
- For drug trafficking, CARICOM established the Secretariat Regional Coordinating Mechanism for Drug Control in 1997 and members signed several international conventions and multilateral plans of action.
- In 2001, as part of a regional initiative, the Regional Task Force on Crime and Security (RTFCS) was tasked with identifying the major causes of crime in the region and recommend approaches to deal with drug and weapon trafficking.
- In 2005, Caribbean Heads of Government endorsed a new Management Framework for Crime and Security, which establishes a Council of Ministers responsible for security and law enforcement, a Policy Advisory Committee, and an Implementation Agency for CARICOM initiatives in this area.
- Steps were taken to create mechanisms for regional coordination and cooperation in regional intelligence sharing and the accompanying CARICOM Treaty on Mutual Cooperation on Fighting Crime is being passed into law in various countries.
- In 2013, CARICOM launched a Crime and Security Strategy that stipulates, among other objectives, the harmonization and standardization of criminal legislation in the region (IDB 2017).
- In January 2018, regional cooperation aimed at fighting crime and violence advanced further with the launch of the 10th European Development Fund CARIFORUM Crime and Security Cooperation Programme that focus on the thematic areas of reducing the demand for and dependence on illicit drugs, advancing trust toward drug-supply control initiatives with enhanced coordination and dialog with Latin America, and addressing crime and violence prevention and social development.
- In June 2018, Barbados called for more collaboration on regional border security, by working together to strengthen inter-agency collaboration for good border management, with immigration, police, and customs authorities working together, and national cooperation with neighbor countries through exchange of information/experiences on border-control issues, training security officials and conducting joint operations.

Tax Incentives

95. **Regional cooperation can help overcome an important collective action problem in the Caribbean associated with the pervasive use of tax incentives.** Many Caribbean countries grant tax incentives to attract FDI in tourism, manufacturing, agro-industries, and offshore banking and insurance, in an attempt to diversify their economies and boost competitiveness. Such incentives entail large fiscal and social costs, yet empirical analyses have not found them to be particularly effective in attracting FDI and benefiting the wider economy, while pointing to the relevance of other factors, such as the business climate, the quality of infrastructure, institutional, and legal systems, availability of skilled labor, political and macroeconomic stability, the regulatory environment, and predictable, transparent, and efficient codes of conduct by public agencies (Box 5).

96. **Tax incentives can also create negative externalities for other countries in the region, resulting in a harmful race-to-the-bottom.** In particular, the provision of attractive incentives by one country can result in an intense tax competition by other jurisdictions in an attempt to protect their competitiveness, hurting, in turn, everyone (Munongo, Akanbi, and Robinson 2017). Corporate income tax competition has, for instance, been estimated to have eroded the tax base in 15 Caribbean countries (Nassar 2008). Regional collaboration to harmonize and streamline tax incentive regimes could provide mutual benefits while

reducing their adverse implications for macroeconomic and fiscal sustainability in a region where most countries face a vicious cycle of high debt and low economic growth.

97. **Notwithstanding their limited benefits and significant costs, tax incentives are unlikely to be abandoned as a policy instrument, suggesting a more pragmatic approach.** Efforts need to focus on minimizing the harmful effects of tax incentives so that potential benefits outweigh the cost associated with their implementation, including for the neighboring countries, streamlining the incentives, enhancing their transparency, harmonizing tax administration, sharing taxpayer information, and implementing the necessary structural reforms that would make the business climate conducive for investment, thereby making tax incentives redundant over time.

98. **This would require countries to streamline tax incentives based on clear principles consistent with international best practices.** These principles include (i) providing an explicit rationale or market failures that incentives aim to address, with well-defined targets, costs in terms of forgone revenue, and sunset clauses; (ii) broadening the tax base, while reducing tax rates to enhance attractiveness of investments; (iii) reducing the scope for discretion toward a rules-based system; (iv) designing tax incentives as part of a sustainable fiscal framework and incorporating them in the budget; and (v) strengthening tax administration and enforcement, with periodic assessments to reduce leakage and distortions.

99. **Moreover, a coordinated regional approach is necessary to overcome the collective action problem that creates tax competition and undermines national reform efforts.** While streamlining national tax incentives will help lower their cost, it is essential to avoid a race-to-the-bottom. Very similar products (such as tourism) that many Caribbean economies offer and the discretionary nature of most incentives have created a cycle of larger and larger incentives and reluctance to reduce/eliminate them to remain competitive vis-à-vis others (McIntyre 2017). Such competition has resulted in tax rates that are too low and tax bases too narrow, worsening the already limited fiscal rooms in the region.

100. **A coordinated approach involving a regional agreement on best practices can address these collective action problems and help avoid prisoners' dilemma situations.** Building a regional code of conduct supported by a stronger business environment can bring substantial benefits. The code could be based on key principles such as: (i) protecting the tax base and strengthening national tax systems, (ii) maintaining an investment-friendly tax environment through moderate and predictable taxes, (iii) avoiding tax discrimination and competition, and (iv) respecting national sovereignty. Such an approach can help reduce erosion of tax bases in the Caribbean, supporting fiscal sustainability and creating resources to build high-quality infrastructure that attracts FDI.

Box 5. Tax Incentives in the Caribbean

Tax incentives have been an integral part of the tax systems in the Caribbean since the 1970s. Incentives have been granted to attract FDI in tourism, manufacturing, agro-industries, and offshore banking and insurance, in an attempt to diversify the economies. The tourism sector has been a particular target, with a proliferation of bilateral agreements granting exemptions to the hotel industry to boost tourism competitiveness and compensate for distortions or deficiencies in the investment climate by boosting the profitability of projects with positive spillover effects on the economy. Corporate income tax (CIT) holidays and exemptions from indirect taxes, such as customs duty and VAT on imports, have been common, as well as employment tax credits, property tax exemptions, and cost recovery incentives.

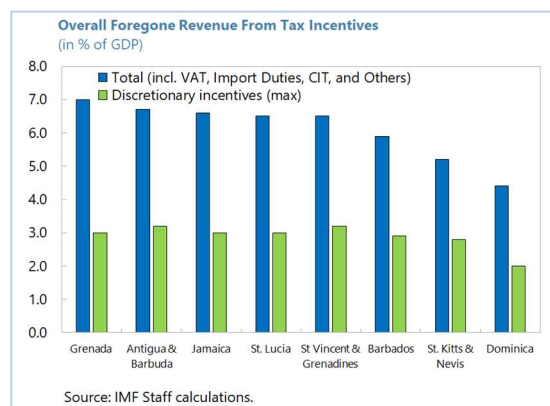
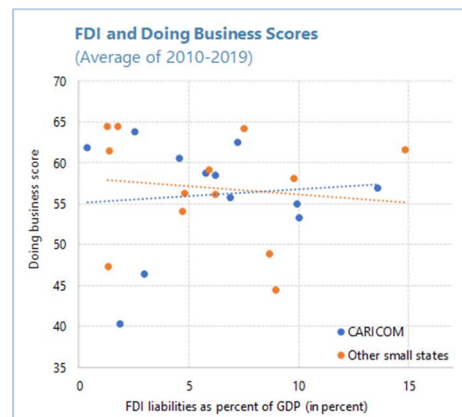
A key feature of the incentives is that they are typically not rules-based (or clearly specified in the tax code) or transparent. Cabinets or ministers exercise discretion in granting concessions, including in determining the duration of the incentive and eligibility. Incentives are often granted on the basis of individual negotiations between investors and policymakers and concessions granted are typically not publicized, and beneficiaries are either not required to submit financial information to tax authorities or the requirements are not effectively monitored or enforced. Some efforts for scaling back generous tax incentives, or at least shifting from discretionary to rules-based and more transparent incentives system, seem to have started in a few countries (e.g., Grenada and Jamaica).

Experience in the Caribbean indicate that tax incentives have a positive, though limited, impact on investment flows to the region, with uncertain benefits for the overall economy. Empirical analyses¹ suggest that incentives can be effective in attracting FDI, but may not result in increased gross capital formation, hence economic growth. Instead, business climate, quality of infrastructure, legal, and institutional systems, availability of skilled labor, political and macro-economic stability, regulatory environment, and predictable, transparent, and efficient code of conduct by public agencies play a more important role in attracting FDI, compared to taxes and tax incentives.

At the same time, tax incentives have been costly for the Caribbean states. Costs are associated with efficiency losses from preferential treatment of certain sectors and activities over others, erosion of the tax base and associated loss of tax revenue, administrative cost of implementing an increasingly complex tax system, and social cost of corruption and rent-seeking activities associated with potential abuse of incentive provisions. Redundancy rates for tax incentives can be very significant (as high as 50-98 percent) by providing tax relief to economic activities that would have received investment even without the incentives. In the absence of data to quantify most of these costs, analytical work has typically focused on estimating total revenue from the provision of tax incentives losses ('tax expenditures') given by the gap between potential and actual tax collection based on statutory rates and bases.

Estimates of tax expenditures suggest that incentives have imposed significant fiscal costs on the Caribbean economies. In a sample of 15 Caribbean countries, the average revenue loss from CIT and import-related tax incentives amounted to 10.8 percent of GDP over 1995-2004. Revenue losses were higher for the ECCU countries, at about 10-16 percent of GDP. Later studies put the estimated tax expenditures typically in the range of 4-7 percent of GDP. While these estimates can be seen as an upper limit for fiscal costs of incentives, since they also include revenue losses from investments that would not have taken place without the incentives and the impact of other factors, such as tax evasion, inefficient tax administration, or position over the business cycle, on actual tax revenue, efficiency cost or rent-seeking activities not captured in the estimates could add to the total cost of tax incentives.

Sources: Chai and Goyal (2006; 2008); ECLAC (2007; 2018); Bauer and others (2008); James (2009); Johnson and Toledano 2013; Klemm and Parys (2012); Krelove and others (2014); Krelove, Crivelli, and Gendron (2014); Kusek and Silva (2018); McIntyre (2017); Munongo, Akanbi, and Robinson (2017); Norregaard and others (2015); Ross (2018); Schlotterbeck (2017); Stausholm (2017); Taitt (2013); Vale Colombia Center (2013); and World Bank (2006; 2013).



101. **Coordination and harmonization of tax and incentive systems among the ECCU and CARICOM countries are still at an earlier stage** (Bauer and others 2008; Parys and James 2010; McIntyre 2017). Progress has been limited notwithstanding the decision by CARICOM states to harmonize their fiscal incentives by signing the Agreement on the Harmonized Scheme of Fiscal Incentives in the 1970s to avoid race to the bottom.⁴¹ Despite multiple consultations and revisions, the agreement on the Investment Code to establish a common regime for the protection, promotion and facilitation of investments in CARICOM has not been reached. Preliminary staff analyses suggest that harmonizing corporate income taxes in the region and using the savings for efficient, resilience building public investment can have cumulative growth benefits (of 3-8 percent) in the medium term.

102. **The efforts are believed to have failed for a number of political economy factors.** Individual countries continue to perceive benefit associated with deviating from an agreed framework, given their focus on attracting common investors for similar products. The lack of political backing and commitment to cooperating likely add to the challenges, in the absence of a regional institution with a clear political mandate to supervise and enforce the agreement. In contrast, the success of tax coordination in other regions (e.g., in the EU), reflects each country's political commitment to participate and support enforcement.

103. **Experience suggests that developing a regional code takes time and needs careful preparation and sequencing.** Regional authorities could start from some basic steps that aim mainly at streamlining tax incentives, enhancing their transparency, and harmonizing the associated tax administration systems as a way provide low hanging fruit:

- It may be best to begin by **taking stock of existing incentives and examining their cost** to individual economies. The transparent reporting of tax expenditures could provide the needed impetus for reform and regional cooperation as policymakers and key actors see the impact of tax incentives on their fiscal frameworks, the high-debt-low growth vicious cycles, and their efforts to achieve fiscal sustainability.
- Smaller countries could consider a **regional tax incentive scheme** administered by a regional body of member states, to alleviate political pressure and better resist the bargaining power investors can place on governments (World Bank 2013). In the ECCU, for example, where countries offer similar tourism products, authorities could coordinate and harmonize tourism tax incentives to a level that is lower and more optimal for all, to avoid attracting investment at the expense of each other (Parys and James 2010). Tax incentives could also focus on encouraging regional tourism brands that aim to attract (stayover and cruise-ship) tourists to multiple destinations.⁴²
- As regional authorities work on building an effective code of conduct, parallel efforts could focus on **harmonizing institutions and systems** to develop more standardized

⁴¹ The revised Treaty of Chaguaramas to establish the CSME had envisaged development of a region-wide investment policy, including a harmonized system of investment incentives (Articles 68, 69).

⁴² In the 2019 High-Level Caribbean Forum in Barbados, Caribbean authorities broadly supported regional coordination of tax incentives. Some suggested agreement at the CARICOM level to avoid a race to the bottom, others proposed a regional tax policy unit, or to agree on a level below which no state would lower their taxes.

approaches in tax administration, taxpayer information sharing, tax audits or transfer pricing methodologies, including to deal with impacts of different tax systems on compliance and avoid transfer-pricing and double taxation problems (IMF 2008).

- Drawing synergies from the EU experience in **enforcing tax coordination**, an important step could be to establish in a regional institution an organizational home for developing and monitoring implementation of harmonized tax incentives. This could involve a regional body with the legal power to monitor and enforce the tax code. Penalty and dispute mechanisms could facilitate enforcement and implementation, though this is likely to raise sovereignty issues.
- Structural reforms to **improve the business environment** are crucial to strengthen competitiveness and promote investment. Empirical evidence suggests that investors respond more positively to a favorable business climate, supported by infra-structure and institutional quality, efficient and friendly regulatory environment, availability of skilled labor, and predictable, transparent, and efficient public code of conduct. Pursuing structural reforms to achieve greater labor market flexibility, narrow skill gaps, lower energy costs, increase efficiency in public service delivery, and eliminate cumbersome bureaucratic procedures would help keep FDI in the region.

Citizenship by Investment Programs

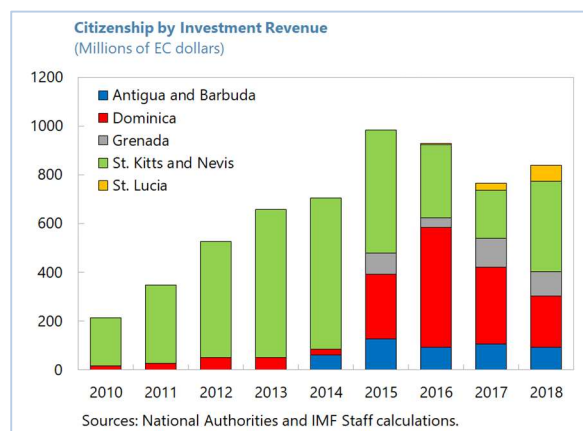
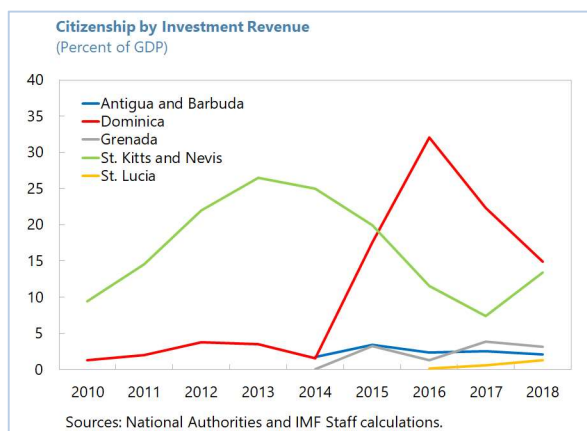
104. **Economic citizenship programs (ECPs) have gained prominence in the Caribbean, particularly in the Eastern Caribbean Currency Union (ECCU) countries.** Following large inflows to St. Kitts and Nevis and Dominica under these programs, three other ECCU countries—Antigua and Barbuda, Grenada and St. Lucia—launched their own programs during 2013-15 (Alleyne and others 2017). These programs are attractive to small states for they often lead to large inflows that can have a significant economic and fiscal impact. However, in the absence of commitment to a regional framework for ECPs, there are risks of a “race to the bottom” (or harmful competition) going forward. As in the case of fiscal incentives, collective action is needed through a coordinated regional approach to make the best of these programs and avoid undesirable outcomes for both the individual countries and the region as a whole.

105. **Five countries in the OECS offer citizenship in exchange for contributions to their budgets or private investment.** Inflows from the programs have become an important component of budgetary revenues in these countries (at about 3.5 percent of their combined GDP in 2016), improved fiscal outcomes, facilitated repayment of debt, and supported growth and external performance. Notwithstanding these benefits, poor management of large and persistent inflows from ECPs can exacerbate macroeconomic and financial sector vulnerabilities. They can create inflationary pressures and asset price bubbles, particularly when investment inflows concentrate in the real estate sector, hurt competitiveness, crowd out of private sector activity, and complicate macroeconomic management. Heavy inflows (and their potential reversal) can create financial stability risks, if the bulk of budgetary receipts from the programs are kept in the banking system.

106. **If not carefully managed, the programs can also have important spillover effects and downside risks for the region.** Inadequate due diligence processes in vetting citizenship

applications can result in security breaches and facilitate illicit activities, such as tax evasion and money laundering, and expose the host jurisdictions to reputational risks. Such risks can easily spillover to other countries since advanced economies are less likely to differentiate between citizenship programs. Increased competition from other programs within and outside the region can result in efforts to relax the requirements and undermine the integrity and credibility of the programs, as countries compete to attract inflows from potential investors.

107. There have been some emerging signs of regional competition among the CBI programs. Several countries reduced the price and requirements for investment to increase demand for applications (Box 6). For example, Dominica amended its ECP requirements in end-2016, lowering the fee for the real estate investment option to expand hotel construction. St. Lucia substantially eased the conditions for access by reducing the cost to generate more revenue and enhance the program’s competitiveness. Antigua and Barbuda reduced the overall price nearly by half in late 2017. St. Kitts and Nevis rolled out a Hurricane Relief Fund (HRF) in early 2018, lowering the price for donations to the development fund and allowing family members to come for free, to make the program more competitive and support real estate developers. While the HRF has expired, the donation now starts at the lower price. While the impact of these moves on the share in total inflows seems mixed, inflows to the region has been falling.



108. Integrity concerns have been raised with some programs, which need to be carefully managed, including by avoiding a race to the bottom and further strengthening due diligence processes. Such concerns jeopardized some programs and caused others to discontinue in the past. For instance, international security and financial integrity risks have reportedly contributed to the discontinuation of citizenship programs in Belize, Grenada, and Nauru after the September 11 attacks in 2001. Rapid emergence and growth of the programs may exacerbate risks of abuse and corruption and raise the possibility of curtailed visa-free access to advanced economies. While the programs require clean criminal record and have established due-diligence procedures, there are lingering reputational and financial integrity risks due to limited resources for vetting. These risks can undercut one of the main benefits of these programs, that is, visa-free entry to many countries, as illustrated by Canada’s revocation of visa-free entry to St. Kitts and Nevis

citizens (November 2014) and Antigua and Barbuda citizens (June 2016), citing concerns about the management of the programs.⁴³

109. **To address reputational challenges, Caribbean authorities have taken steps towards regional cooperation.** To establish a stronger regulatory framework and promote collaboration on due diligence, the CBI Programs Association was formed under the auspices of the OECS, to which the ECCU authorities have recently granted the mandate to coordinate regional cooperation on CBI Programs. A special meeting of the OECS in mid-March 2019 endorsed an ECCB initiative that called for a consolidation of arrangements with respect to the CBI programs, noting the need for harmonization of the due diligence arrangements, agreement to common standards and common application protocols, and information sharing across countries and with the Joint Regional Communications Centre (JRCC).

110. **Developing a regional approach to the ECP programs would improve their long-term viability and help reduce the programs' reputational and financial integrity risks.** Joint management of ECP applications would help achieve economies of scale and reduce costs, while preventing a race to the bottom and pressure on fiscal sustainability. A regional approach can also safeguard the integrity of the programs through increased transparency and international best practices on exchange of tax information, improved information-sharing on applicant backgrounds, and rigorous due-diligence processes that benefit from a broadened information base. The latter can help prevent applicants who do not pass due diligence in one country from applying elsewhere. Pooling resources can also help reduce the cost of due diligence to each member, while reducing reputational, security, and financial integrity risks. Close cooperation could also focus on extracting best practices with management of the inflows to limit macro-fiscal/macro-financial risks while maximizing benefits for fiscal sustainability and sustainable growth (e.g., by setting up saving funds for windfall revenues, along with appropriate fiscal rules and strong financial supervision to reduce financial risks).

VII. SUMMARY AND CONCLUDING REMARKS

111. **Addressing the common challenges facing the Caribbean requires a regional approach that rests on greater integration and policy coordination.** Despite their different economic sizes and development stages, the Caribbean economies face common external shocks and structural impediments to growth. CARICOM policymakers have long recognized the imperative of regional integration as a way to build greater resilience and scale and join forces to enhance bargaining power in international fora. They have made strides in implementing the regional integration initiatives and, despite significant institutional gaps and political-economy difficulties, have remained committed to establishing a single market and economy in the region, with key decisions taken at the December 2018 Heads of Government meeting aiming at reinvigorating momentum to complete establishment of the CSME. It is important to capitalize on this momentum.

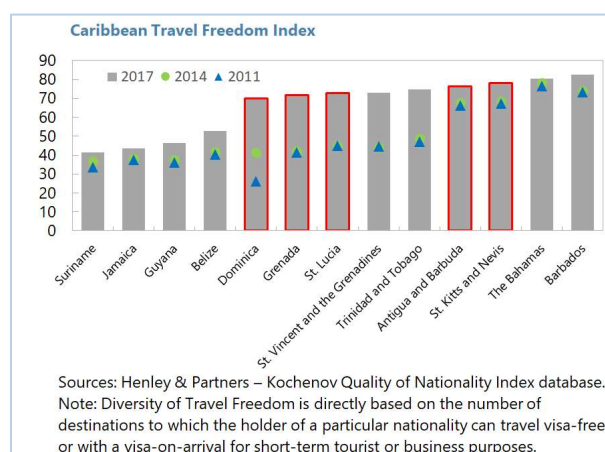
⁴³ <http://citizenlane.ch/canadas-new-visa-requirements-mean-caribbean-citizens/>

Box 6. Competition Across CBI Programs

Antigua and Barbuda, Grenada, and St. Kitts and Nevis lowered the minimum investment requirements of their respective CBI programs in 2017-18. However, it is difficult to assess whether the decline in the region's total CBI revenue was driven by the lower average price in the absence of information on the number of applicants for each program.

Recent Changes to CBI Minimum Investment Requirements				
Country	Inception Year	Previous Minimum Investment	New minimum investment	Date of change
Antigua and Barbuda	2013	US\$250,000 for a family of five or over	Reduce the NDF investment amount by 50%. From \$200,000 to \$100,000 for a Family of Four. From \$250,000 to \$125,000 for a Family of Five or over	November 2017
Dominica	1993	US\$100,000		
Grenada	2014	US\$250,000 for individual applicants	Reduce to USD 150,000	January 2018
St. Kitts and Nevis	1984	US\$250,000	\$150,000 to the Sustainable Growth Fund (SGF) or the minimum real estate investment required by law is US\$200,000 (resalable after 7 years) or US\$400,000 (resalable after 5 years) for each main applicant.	September of 2017
St. Lucia	2016	US\$100,000		

The travel freedom index has improved for the countries with CBI programs, a trend also shared by many other Caribbean countries. This could mean greater competition for CBI revenue down the road. At the same time, as of November 2018, all five ECCU countries with CBI programs were identified by the OECS as potentially posing a high-risk to the integrity of the OECD/G20 Common Reporting Standard (CRS). This could carry reputational cost and adversely affect CBI inflows to the region.



112. **Economic integration in the CARICOM has taken place on a number of levels but lags behind other well-integrated regions.** Intraregional trade linkages have grown over the last two decades, largely thanks to growing imports and exports of commodities within the region, but the overall volume has remained at a much lower level compared to other closely-integrated regional blocks such as NAFTA and the EU. Business cycle synchronization and income convergence have been weak, likely reflecting limited intraregional movement of factors of production and suboptimal allocation of regional resources. Overall, economic integration has been undermined by the slow and incremental

progress in institutional integration, with remaining legal restrictions, lacking harmonization of processes and infrastructure to facilitate intraregional connectivity, and occasional reversals breaking the momentum.

113. **The limited level of economic integration in the Caribbean suggests that significant dividends can be gained by fully implementing the CSME agenda.** Both international and regional experience points to the substantial benefits from free trade, free movement of factors of production, and coordinating macro and structural policies in response to common shocks. The paper's simulation analyses suggest that reducing NTBs and trade costs could lead to trade expansion and welfare gains for all CARICOM members and stimulate a restructuring of economies toward tradable sectors, with a net employment gain across the region. Removing existing restrictions on labor market access for CARICOM residents could also encourage free movement of people and better allocation of skills and factors of production. This, in turn, could increase labor productivity and create long-run growth benefits for the entire region by reducing skill mismatches and brain drain from the region. Free movement of people could also facilitate dealing with disaster-induced migration.

114. **The priority for the region should hence be to focus its efforts on understanding and addressing the key impediments to progress in institutional integration.** A combination of institutional, economic, structural, and political economy factors, as well as resource and capacity constraints, appear to be the key impediments to progress. Addressing these impediments swiftly and rapid progress in harmonizing and coordinating institutional frameworks should help reduce the fixed costs of institutions and doing business in the region and provide the necessary scale and boost to economic integration.

- **Appropriate institutional and governance mechanisms:** The absence of a regional authority empowered with decision-making powers and accountability to ensure implementation of decisions, lacking tools to transform Community decisions to binding laws across jurisdictions, and a decision-making rule based on unanimity, rather than qualified majority, are among the key drivers of the implementation gap. In the absence of broader support for supranationality, efforts could focus on areas that are less costly, economically and politically, such as reevaluating the decision-making rules in the Community or improving efficiency of mechanisms to transform decisions to binding laws across jurisdictions. In so doing, the focus should be more on streamlining institutions, improving efficiency and transparency, and reducing disparities across countries than complicating the existing processes.
- **Alignment of incentives:** Absent an appropriately-constituted supranational authority and necessary mechanisms for effective decision making, individual member states have little incentive to cooperate, unless national interests are aligned around common or shared goals, and greater integration helps address common practical challenges. When perceived net benefits from integration are seen limited or are not widely shared, there will be limited incentive for full cooperation. The large upfront costs associated with implementing CSME measures (with some loss of income and sovereignty), perceptions of uncertain or uneven benefits from further integration, and different economic structures and development levels across members may reduce the drive for further coordination or harmonization of policies across the broader Caribbean. National and regional efforts should focus on aligning national interests with those of the region, supporting these efforts with convincing evidence on the

potential benefits from further integration and with well-structured and adequately resourced mechanisms to reduce adverse distributional effects. Appropriate safety nets and financial and capacity support to states disadvantaged by further integration could ensure that benefits from integration are equitable and widely shared.

- **Addressing resource and capacity constraints:** CSME implementation is a highly complex undertaking at both national and regional levels. The small economic size and limited technical and financial capacity of Caribbean states limit their ability to implement the necessary measures, even where agreement is reached. Most decisions have high resource costs and place demands on a limited pool of technical expertise and resources. Rationalizing institutions and processes is essential, given the significant fiscal and capacity constraints, as well as adequate technical support, access to low-cost financing, and political will and prioritization at the national level. Leveraging existing institutions (e.g., a strengthened CDF, capacity support from regional and international development partners and IFIs) can help address unintended social and economic disparities that may be caused by CSME actions.

115. **Could integration through functional cooperation provide a “low-hanging fruit”?** Some of the key intertwined macroeconomic and structural challenges facing the Caribbean region transcend national boundaries, calling for regional solutions. Addressing challenges such as ensuring national and regional financial stability, building resilience to climate risks, or containing violent crime, can produce benefits across the board, provide the needed scale and resources, and would likely face fewer legislative hurdles. Cooperation can also be particularly fruitful where it can resolve collective action failures that encourage harmful competition and result in “prisoners’ dilemma” situations. At a time when momentum for economic integration seems to have stalled, close cooperation in high priority areas for the region can help demonstrate benefits of coordinated action and serve as a building block to the ultimate goal of full integration. As in furthering the CSME, deeper cooperation in these areas also call for accelerated efforts to harmonize and streamline institutional frameworks to provide the needed scale and resources.

116. **The whole can be greater than the sum of its parts.** While the small size and scale of the Caribbean economies, and the associated supply-side constraints, may potentially limit how much benefit can be extracted from economic integration in the form of regional value chains, acting as a group, through functional cooperation or full integration, can enhance the scale, with benefits likely exceeding what can be gained by acting individually and providing impetus to sustained growth and employment. Regional and global development partners, IFIs, the private sector, and civil society should join these efforts, to coordinate, advocate, and support the actions, including through funding, safety nets, and technical assistance to make sure that those hurt by the resulting shifts are supported and benefits of integration are shared across the region. A regionally integrated Caribbean should have a better chance to advance toward a globally-integrated Caribbean to take advantage of global value chains. That is, regional integration should not be the end-goal, but a means to an end of deepening global integration and its associated benefits.

Annex I. Indices of Institutional Integration in the Caribbean

This annex describes the construction of the indices of institutional integration for the OECS and other CARICOM countries. The methodology is adapted from that of Dorucci et al (2002). It explains how, in several cases, including when data are limited, judgment is required to assess the degree of integration. The analysis assigns a maximum of 25 points for each of the four following broad stages of integration: free trade area/customs union (FTA/CU); Common Market (CM); Economic Union (EUN); and Total Economic Integration (TEI).

A. Part I. Free Trade Area and Customs Union (FTA/CU)

The first part of the index tracks progress towards establishing a full-fledged FTA/CU. This includes full removal of tariffs and quotas on merchandise trade and the establishment of the common external tariff (CET).

Table A.1 FTA/CU Indicators: Methodology by Dorucci et al (2002)

Free trade area and customs union	Scores for each intermediate step
FTA	15
(i) each reduction of tariffs by at least 20 percent implies one additional point. However, the final step towards a FTA is weighted differently (see (iii)).	4=1*4
(ii) quota abolition.	4
(iii) the completion of the FTA (brings as many points as in the difference between 15 and the score achieved prior to completion).	6
(iv) the start of the Common Agricultural Policy (CAP) in 1962.	1
Customs Union	10
(i) each additional reduction by (at least) 20 percent in the difference between average external tariff in individual countries and the Common External Tariff (CETs) implies one additional point. However, the final step towards a CU is weighted differently.	4=1*4
(ii) the completion of the CU (brings as many points as is the difference between 10 and the score achieved prior to completion).	6

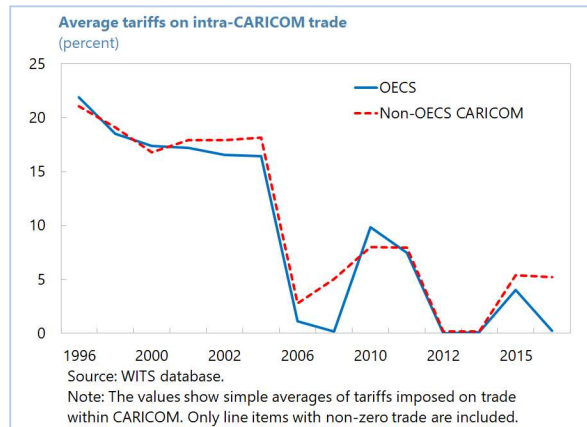
Source: Dorucci et al (2002).

The application of this methodology to the Caribbean is complicated by data gaps. For example, comprehensive tariff data are available only from the mid-90s. The scores related to trade barriers are assigned based on the broad narrative of trade integration reported in historical documents (Table A.2). The following considerations were used as a basis for assigning scores for the FTA:

- In 1968, 11 countries implemented the Caribbean Free Trade Association Agreement (CARIFTA), which freed approximately 90 percent of intra-regional trade in manufactured goods and instituted managed intra-regional trade in some agricultural products (Girvan 2005). Given the incomplete nature of FTA (exemptions, especially in the agricultural trade), only 10 out of 15 points are assigned for this event. This assessment is comparable to that of Dorucci and others (2002) in assigning scores to the establishment of Mercosur—an “imperfect” FTA in 1995). In addition, points given to non-OECS group were scaled down by a ratio reflecting the number of countries participating in the FTA —4/7 in 1968 (as FTA included only Barbados,

Guyana, Jamaica, Trinidad out of 7 non-OECS countries), 5/7 in 1971 accounting for Belize joining CARICOM, and 6/7 in 1995 as Suriname joined CARICOM. As the Bahamas does not intend to join, the factor of 6/7 is applied to non-OECS group through the rest of the index.

- In 2006, the Caribbean Single Market and Economy (CSME) was launched. That meant eliminating many of the remaining tariffs and moving the FTA much closer to completion. Thus, 3 points were added in 2006. One point was withheld for the remaining exceptions.



- Regarding the customs union, points assigned to the OECS reflect the introduction of the Eastern Caribbean Common Market in 1968, which committed to implementing a CET until 1981 (5 points). In CARICOM, the CET was implemented later: a four-phase implementation schedule was established in 1992, and countries reached Phase IV between 1998 and 2010 (Table A2). One point was withheld for not implementing Harmonized Schedule (2012) by several countries, and the final score for non-OECS group in 2016 reflects the fact that The Bahamas does not participate in the CET.

Table A.2 Indicators of Free Trade and Customs Union in the Caribbean

Year	Developments/Events	Free Trade Area			Customs Union		
		(maximum 15 points)			(maximum 10 points)		
		OECS	Other	CARICOM	OECS	Other	CARICOM
1968	CARIFTA Agreement is implemented in 11 countries. The agreement establishes immediate free trade between all signatories in respect of both quantitative import restrictions and import duties, subject to certain exceptions and a reserve list for which duties will be gradually removed. Also, East Caribbean Common Market (ECCM) is established, where countries committed themselves to CET (to be agreed/implemented within 3 years from the ECCM agreement). It is a pre-condition for entry into CARIFTA. The envisaged aim of the ECCM was a very high level of economic integration.	10	5.7	7.7	5.0	0.0	2.3
1971	Belize joins CARIFTA in May 1971	10.0	7.1	8.5	5.0	0.0	2.3
1973	CARIFTA becomes CARICOM when Barbados, Guyana, Jamaica and Trinidad and Tobago sign the Treaty of Chaguaramas.	10.0	7.1	8.5	5.0	0.0	2.3
1974	The other former CARIFTA members accede to the Treaty	10.0	7.1	8.5	5.0	0.0	2.3
1975		10.0	7.1	8.5	5.0	0.0	2.3
1976	Suriname joins CET agreement	10.0	7.1	8.5	5.0	0.0	2.3
1992	CARICOM governments establish a four-phase implementation program for the CET.	10.0	7.1	8.5	5.0	0.0	2.3
1995	Suriname joins CARICOM	10.0	8.6	9.2	5.0	0.0	2.3
1998	Deadline for Phase IV CET implementation is met by Trinidad and Tobago, St. Vincent and Grenadines, Guyana, Barbados.	10.0	8.6	9.2	5.0	3.9	4.4
1999	Jamaica implements Phase IV of CET	10.0	8.6	9.2	5.0	5.1	5.1
2000	Belize implements Phase IV of CET	10.0	8.6	9.2	5.0	6.4	5.8
2001	Antigua and Barbuda, Dominica, Grenada, St. Lucia, St. Vincent and Grenadines meet Phase IV of CET	10.0	8.6	9.2	7.5	6.4	6.9
2003	Suriname implements Phase IV of CET.	10.0	8.6	9.2	7.5	7.7	7.6
2006	Launch of the Caribbean Single Market and Economy. This event eliminates many remaining tariffs.	14.0	12.0	12.9	7.5	7.7	7.6
2010	St. Kitts implements Phase IV of CET	14.0	12.0	12.9	9.0	7.7	8.3
2017		14.0	12.0	12.9	9.0	7.7	8.3

Source: Fund staff estimates

B. Part II. Common Market (CM)

Besides removing tariffs and quotas, a common market includes the removal of non-tariff barriers (NTBs), including liberalization of trade in services, as well as liberalizing factors of production, most notably capital and labor. Thus, the points are assigned based on progress with removing NTBs in goods and services (9 points maximum) and liberalizing capital and labor markets (a maximum of 8 points each). The specific points assigned to OECS and non-OECS CARICOM countries are elaborated in Table A.3.

- **Removal of non-tariff barriers (NTBs) in goods and services markets.** Two points were allocated in 1990 for progress with reducing NTBs in early 1990s (IDB, 2005). One point was allocated in 2002 for the approval of the schedule of commitments for removal of restrictions, which included commitments in services. Finally, 4 points were allocated for the launch of the CSME in 2006, although a few points were “withheld” as the schedule of commitments has not been fully implemented.
- **Removing restrictions on movement of capital.** One point was allocated in 2002, as the schedule of commitments for removal of restrictions contained commitments to remove barriers to capital movement. In addition, the OECS has established the regional securities market (ECSM) in 2002 (4 points).

- Removing restrictions on labor mobility.** The liberalization began in 1996 when CARICOM committed to free movement of university graduates (1 point). In 2003, 3 points were assigned as most of CARICOM members implemented arrangements for free movement of skilled labor (Girvan 2005). In 2011, OECS implemented a policy of free movement of persons, reaching the maximum of 8 points. The rest of the CARICOM continue to limit labor mobility to skilled labor, justifying “withholding” of 4 points.

Table A.3 Indicators of Common Market

Year	Developments/events	Non-tariff barriers (including services) (9 points)		Capital (8 points)		Labor (8 points)		Total (25 points)		
		OECS	non-OECS	OECS	non-OECS	OECS	non-OECS	OECS	non-OECS	CARICOM
1990	Many NTBs are removed since the early 90s (IDB, 2005)	2	2	0	0	0	0	2	2	2
1996	CARICOM agrees to the free movement of university graduates	2	2	0	0	1	1	3	3	3.0
2001	Revised Treaty of Chaguaramas is signed	2	2	0	0	1	1	3	3	3.0
2002	The 13th Inter-Sessional Meeting of the Conference in February 2002 formally approves the schedules of Commitments for removal of Restrictions by member states, which takes effect from March 1, 2002. In addition, OECS establishes a Regional Securities Market (ECSM).	3	3	5	1	1	1	9	5	6.8
2003	Eleven of twelve member states have implemented arrangements for free movement as per July 2003 decision (Girvan, 2005).	3	3	5	1	4	4	12	8	9.8
2006	Launch of the CARICOM Single Market	7	7	5	1	4	4	16	12	13.8
2007	CARICOM launches the Caribbean Vocational Qualification	7	7	5	1	4	4	16	12	13.8
2011	OECS countries implement free movement of persons as a part of the revised treaty	7	7	5	1	8	4	20	12	15.7
2017		7	7	5	1	8	4	20	12	15.7

Source: Fund staff estimates.

C. Part III. Economic Union (EU)

The third part of the index tracks the coordination of national macroeconomic policies and harmonization of relevant microeconomic policies. The set of macroeconomic policies includes fiscal, monetary and exchange rate policies. According to the methodology by Dorucci et al (2002), microeconomic policies include competition policy (i.e., measures forbidding subsidies and regulations favoring domestic producers), transport policy, harmonization of VAT, harmonization of labor market and other policies to increase price flexibility within the region. In the Caribbean, progress with policy coordination has so far been limited (Table A.4) despite rather ambitious goals set by the Revised Treaty of Chaguaramas.

- Coordination of macroeconomic policies.** Article 44 of the Revised Treaty of Chaguaramas provides for the adoption of appropriate measures for macroeconomic coordination, the harmonization of monetary and fiscal policies and Article 70 contains provisions for promoting a sound macroeconomic environment in the member states. However, the coordination has so far been limited to regular meetings of the finance ministers (COFAP) and central bank governors, informed by semi-annual macroeconomic reports prepared by the Caribbean Centre for Money and

Finance (CCMF). In the OECS, macroeconomic coordination also includes fiscal benchmarks since 1998, although there are no enforcement mechanisms.

- **Coordination of microeconomic policies.** The Revised Treaty of Chaguaramas provided for harmonization of (i) competition policy, (ii) tax policy frameworks, (iii) investment policies, (iv), sectoral policies such as agriculture, industrial and transport policies. There has been some progress in harmonizing the competition policy as model competition bill has been approved, the CARICOM Competition Commission has been established in 2008, and 4-member states have put in place necessary legislation, institutional arrangements and enforcement capabilities. In tax policy framework, an intra-CARICOM double-taxation agreement was put in place in 1994, although it currently requires an upgrade. Progress in harmonizing other policies has been limited.

Table A.4 Indicators of Economic Policy Coordination

Developments/events	Macro policies (13 points)		Micro policies (12 points)		Total (25 points)			
	OECS	non-OECS	OECS	non-OECS	OECS	non-OECS	CARICOM	
	1994	Intra-CARICOM Double Taxation Agreement is put in place (COTED 2017)	0	0	0.5	0.5	0.5	0.5
1998	The first COFAP meeting, which is a forum for macroeconomic coordination, is held in June. Also, the ECCU introduces fiscal benchmarks.	3	1	0.5	0.5	3.5	1.5	2.4
2001	Competition law is amended in Jamaica (COTED 2017)	3	1	0.5	0.7	3.5	1.7	2.5
2002	Competition law is enacted in Barbados (COTED 2017)	3	1	0.5	0.9	3.5	1.9	2.6
2008	CARICOM Competition Commission is established	3	1	1.0	1.4	4	2.4	3.1
2010	Competition law is enacted in Guyana. The Caribbean Agricultural Health and Food Safety Agency (CAHFSA) is inaugurated.	3	1	1.5	2.1	4.5	3.1	3.7
2011	The Caribbean Public Health Agency (CARPHA) is established	3	1	2	2.6	5	3.6	4.2
2014	Trinidad establishes a national competition commission	3	1	2	2.8	5	3.8	4.4
2017		3	1	2	2.8	5	3.8	4.4

Source: Fund staff estimates

D. Total Economic Integration (TEI)

The final part of the index tracks development of the institutions and policies at the supra-national level. This part includes three distinct elements: (i) supranational institutions and decision-making processes, as well as the structuring of the process of regional integration through laws issued and enforced at the supranational level; (ii) the concrete steps towards, and the conduct of, macroeconomic policies at the supranational level, and (iii) microeconomic policies which are conducted only or mostly at a supranational level and are most likely to affect the need for regional exchange rate stability.

The integration scores assigned to OECS and non-OECS parts reflected the following main elements:

- **Supranational institutions.** These include mainly the major multilateral agreements providing framework for the integration process. This includes establishment of CARICOM by the Treaty of Chaguaramas in 1973, the establishment of the Organization of East Caribbean States (OECS) in 1981 and launching the Caribbean

Single Market and Economy (CSME) in 2006 as the revised Treaty of Chaguaramas went into force. The Caribbean Development Fund (inaugurated in 1970) and the Caribbean Court of Justice (inaugurated in 2005), were important additions to the regional institutions.

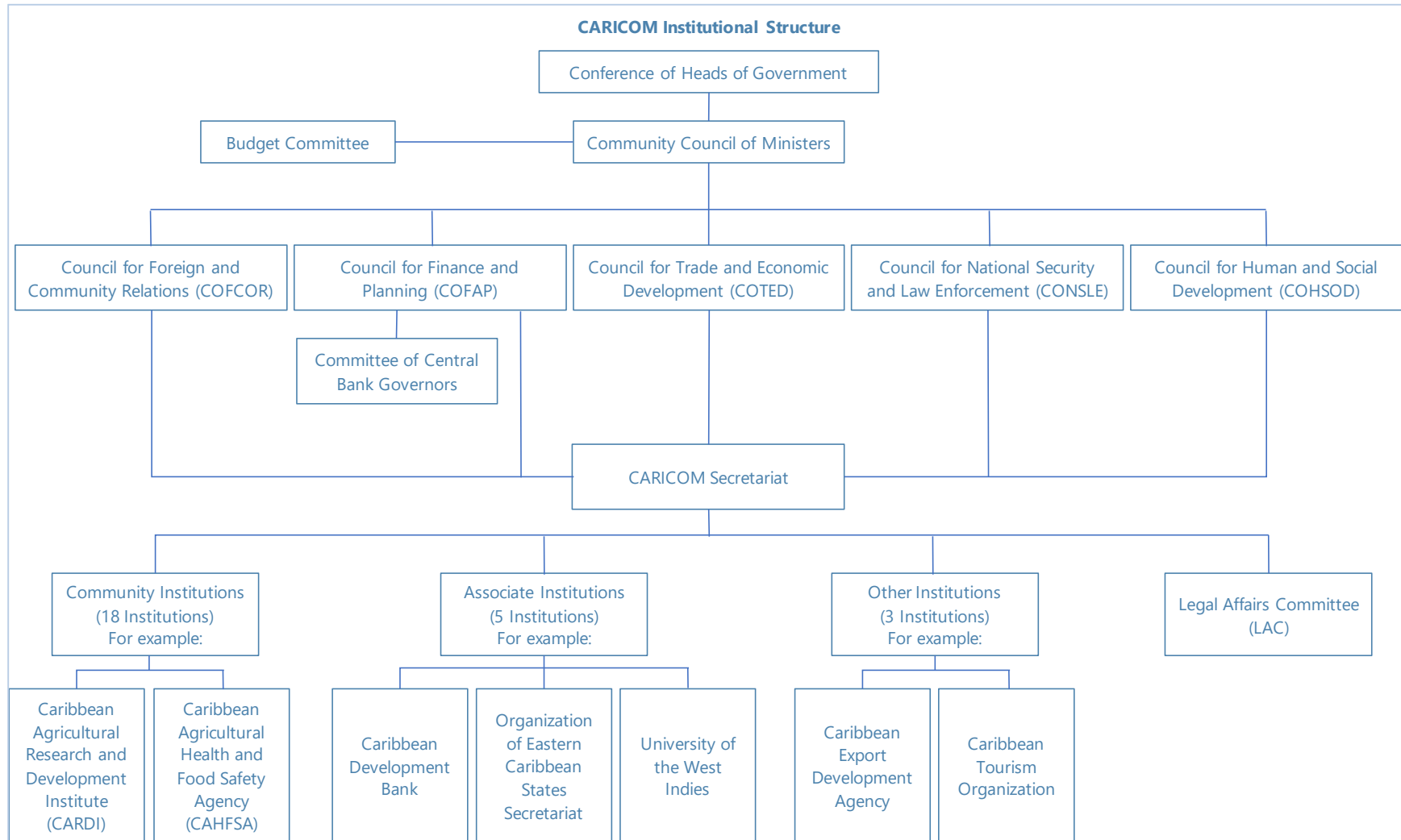
- **Macroeconomic policies on the supranational level.** The establishment of the Eastern Caribbean Currency Authority in 1965, followed by the establishment of the Eastern Caribbean Central Bank in 1983, achieved the goal of single monetary and exchange rate policy in the OECS (5 points total in line with Dorucci's methodology).
- **Microeconomic policies on the supranational level.** The Caribbean Development Fund (launched in 2008) provides country assistance programs (CAPs), which help reduce over time the disparities between the less developed and more developed countries in the CSME and accelerate recoveries after temporary adverse shocks.

Table A.5 Indicators of Total Economic Integration

	Developments/Events	Supra-national institutions and decision-making processes (9 points)		Macro policies at supra-national level (9 points)		Micro policies conducted at supra national level (7 points)		Total (25 points)		
		OECS	non-OECS	OECS	non-OECS	OECS	non-OECS	OECS	non-OECS	CARICOM
1965	The Eastern Caribbean Currency Authority (ECCA) is established. Unlike, BCCB, the ECCA is not required to back local currency 100% in sterling (but, the operational target is 80% and the minimum is 60%). It has no ability to conduct monetary policy.	0	0	2.5	0	0	0	2.5	0	1.2
1967	West Indies Association of States (WISA) is established, where countries status changed from being British colonies to states in free association with the UK.	0	0	2.5	0	0	0	2.5	0	1.2
1970	Inauguration of the Caribbean Development Bank.	1	1	2.5	0	0	0	3.5	1	2.2
1973	The CARICOM Agreement is signed	2	1	2.5	0	0	0	4.5	1	2.6
1981	Organization of East Caribbean States (OECS) is established to replace WISA and ECCM.	3	1	2.5	0	0	0	5.5	1	3.1
1983	East Caribbean Currency Bank (ECCB) replaces ECCA, adding to its mandate the authority to conduct monetary policy at the regional level.	3	1	5	0	0	0	8	1	4.2
1989	Grand Anse Declaration: the Heads of Government of CARICOM declare the goal of establishing a CARICOM CSME by 1993. (this was subsequently revised to 2006). The West Indian Commission is created with the objective to recommend a way forward to move regional integration in the Caribbean.	3	1	5	0	0	0	8	1	4.2
2001	Revised Treaty of Chaguaramas is signed	3	1	5	0	0	0	8	1	4.2
2005	Inauguration of the Caribbean Court of Justice. The inauguration took place in April 2005, with some controversy continuing to surround the Court's appellate jurisdiction (WB, 2009, p 33).	4	2	5	0	0	0	9	2	5.2
2006	Revised Treaty of Chaguaramas enters into force	5	4	5	0	0	0	10	4	6.8
2008	Launch of the Regional Development Fund.	5	4	5	0	2	2	12	6	8.8
2010	The OECS Treaty is revised, creating an economic union.	8	4	5	0	2	2	15	6	10.2
2017		8	4	5	0	2	2	15	6	10.2

Source: Fund staff estimates.

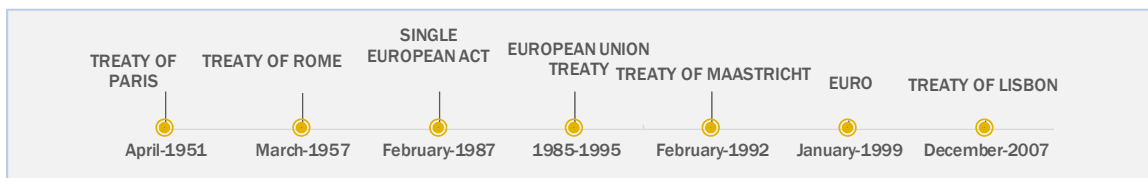
Annex II. CARICOM Institutional Structure



Annex III. The European Union Integration

The process of European integration was launched in the aftermath of the WWII with the scope to guarantee peace and prosperity to the European continent. The agreement started under the assumption that an efficient European economic space could help reduce conflict among European nations by strengthening economic linkages and protecting human rights and democratic values. The post-war European integration process began with rebuilding sustainable growth and by reconstructing the destroyed Western European infrastructure. Several organizations and cooperative agreements were established at the end of the 1940s, including Benelux Customs Union, the Treaty of Economic, Social and Cultural Collaboration and Collective Self-defense and the Organization for European Economic Co-operation.

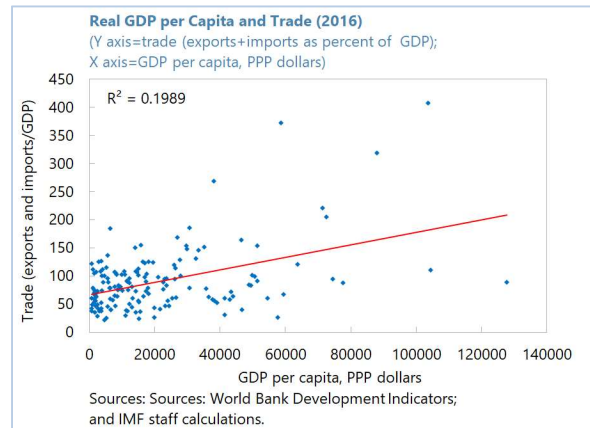
The process of European integration took place through a gradual process. The integration process started in April 1951 when six countries (Belgium, France, Italy, Luxemburg, The Federal Republic of Germany and the Netherlands) signed the Treaty of Paris. The Treaty established the European Coal and Steel Community (TECSC) with the objective to regulate markets of strategic importance for the reconstruction of Europe such as coal, steel and iron. It was followed by the Treaty of Rome (1957) which established the European Economic Community. The founding countries adopted a gradual approach which aimed to increase economic integration and establish supranational institutions with growing political responsibilities (European commission, The European Parliament, the Court of Justice and the Economic and social Committee). On July 1, 1987 The Single European Act (SEA) extended cooperation of the Communities to economic and social policy, environment protection, science development and technological progress. The second half of the eighties till the beginning of the 1990s was a time of integration slowdown.



The process of the European integration accelerated in the 1990s with the adoption of the growth and stability pact and the introduction of the euro. New impetus to the European integration process was given by the adoption of the Treaty of Maastricht (1992), which introduced the European Communities and new areas of cooperation among Member states such as Common Foreign and Security Policy (the Second Pillar) and Justice and Home Matters (the Third Pillar). On January 1, 1999 the euro is introduced as a non-cash monetary unit for 11 out of the 15 EU member countries. In the 2000s Europe expanded to 10 Eastern European countries reaching a total of 27 members and a population of about 500 million people. In 2007 the Treaty of Lisbon amended the Maastricht Treaty and the Treaty of Rome by moving from unanimity to qualified majority, enhancing the power of the European Parliament and creating the President of the European Council and a Ministry of EU Foreign Affairs (the High Representative of the Union for Foreign Affairs and Security Policy).

Deeper integration yielded positive productivity and growth effects for the European Union member countries. The European Integration has generated substantial growth and productivity payoffs. Some studies stress the exceptionality of Europe, as it is the only region with unconditional beta and sigma convergences (Eichengreen, 2007). However, there is considerable heterogeneity across countries. While Greece was the only country that experienced smaller GDP or productivity growth rates after joining the EU, estimates in the literature range from a minimum of 5 percent (Boltho and Eichengreen, 2008) gains in per capita income from EU accession to a maximum of 20 percent gains (Badinger, 2005). More recently, Campos et al. (2014) estimated per capita European incomes in the absence of the economic and political integration process would have been on average 12 percent lower with substantial variations across countries, enlargements as well as over time. These estimates are robust to various measures of GDP and productivity growth, to whether one focuses on the dynamic or on average effects of EU membership, to changes in the donor pool of countries (ranging from the whole world to a small set of countries), and to substantial changes in the covariates used in the estimation.

The creation of a single market space boosted trade. The economic literature shows that the European economic integration helped to boost regional growth through the effects of integration on trade. Baldwin and Seghezza (1996) find that intra-European trade liberalization following the European integration boosted investment in physical capital among European countries. The European Commission estimated that between 1995 and 2011, the jobs created in the EU supported by exports to the rest of the world increased by 67 percent to reach 31.1 million. This added to 12.5 million jobs supported by exports since 1995. Exporting activity of EU-based firms has become an increasingly important source of employment for European citizens.



The single market space has increased production sharing among the EU economies. The complementarity of the EU economies deepened due to the economic integration that characterizes the European Single Market (ESM). Intra-EU production chains supplying inputs to European exporters became more important over time. According to a report of the European Commission on EU exports in the world, 84 percent of the employment supported by extra-EU exports was in the Member State that ultimately exported to the rest of the world (down from 87 percent in 1995), while the remaining 16 percent (13 percent in 1995) of the jobs were in other Member States from where inputs to produce the exports were imported. In Slovakia, the Czech Republic, Estonia, Belgium and Poland more than 25 percent of the employment supported by extra-EU exports was driven by the exports of other Member States. In contrast, in Greece, Cyprus, Ireland and Lithuania it was less than 10 percent.

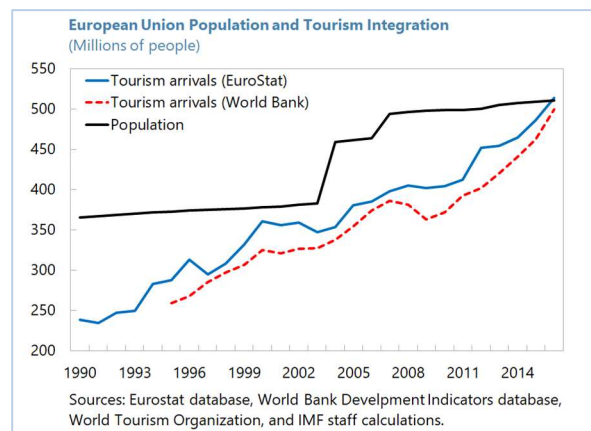
The German economy plays a crucial role in the intra-EU production sharing of the EU exports. According to the EU commission, the exports of Germany to the rest of the world

supported around 6.2 million jobs in Germany and 1.3 million jobs in other member states. Germany also hosted the largest number of jobs that were dependent on the exports by other member States to the rest of world (almost 900,000 jobs in 2011). These are jobs in firms based in Germany that supply inputs to exporters located elsewhere across the EU. Other major EU economies also play an important role in the export-led intra-EU value chains. The sales of goods and services from France to the rest of the world were the second most important driver of export-supported employment in other EU member states (around 500,000 jobs), followed by Italy (370,000 jobs) and the United Kingdom (340,000 jobs).

Trade integration is the most important economic benefit for the EU member countries. The benefits of the euro are many, including exchange rate stability, monetary stability, and low inflation. However, the main benefit of the euro for small and open economies within the euro area is the expansion of countries' potential trade. Several studies (Baldwin, 2006) show that trade integration increased substantially for countries that adopted the euro, through the expansion of the intra-euro trade and foreign direct investment (FDI). At the same time, further fiscal integration and strengthening the banking union could help improve the functioning of the union and support monetary integration.

The Schengen Agreement abolished the control of persons at internal borders of country members, but also strengthened their cooperation on security and asylum policies. The introduction of the Schengen area has contributed to boost intra-European country travel since its adoption in 2001 and help improve the competitiveness of the European tourism industry. About 3.5

million persons cross internal Schengen borders every day and intra-EU goods trade amounts to €2,8 trillion each year. Reestablishment of border controls within Schengen could create significant costs for road freight transport, cross-border passenger mobility, tourism, and border control administration. The European Commission estimates that such controls would generate direct costs between €5 and €18 billion annually (0.03-0.12 percent of GDP). The think-tank France Stratégie predicts that border controls would reduce trade between Schengen countries by 10-20 percent, lowering the GDP of EU Schengen countries by 0.9 percent by 2025. A study by the Bertelsmann Foundation assumes a 1–3 percentage points increase in import prices, reducing GDP for the EU by 0.4–1.2 percent by 2025.⁴⁴



⁴⁴ Euro Area Policies 2016 Article IV Consultation Staff Report, N0. 16/219

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