External Shocks and Macroeconomic Fluctuations in the Eastern Caribbean

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Abstract

This paper develops country-specific VAR models with block exogeneity restrictions for the Eastern Caribbean countries, in order to analyze the dynamic responses of the domestic business cycle to different external shocks and to determine the relative importance of these shocks as sources of business fluctuations in the region. The external variables of the model are completely exogenous to the domestic economy block, capturing the small open economy assumption and the high vulnerability of these economies to changes in climatic conditions. Main results are the key role of external shocks as a source of macroeconomic fluctuations in the Eastern Caribbean, accounting for more than half of real output fluctuations. Especially relevant are oil price shocks—the dominant source of output variations, external demand and climate shocks. A positive innovation to oil prices leads to a fall in real output which persists for two or three years after the shock. Domestic real output expands on impact with a lasting effect of about two additional years as a response to a positive external demand shock. Finally, a natural catastrophe leads to an immediate and significant fall in output, but the negative effects do not appear to be persistent, disappearing the year following the shock.

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