

Seventh Adlith Brown Memorial Lecture

Liberalization of the Foreign  
Exchange System in Jamaica

Owen Jefferson



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ADLITH BROWN  
Memorial Lecture

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SYSTEM IN JAMAICA

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REGIONAL PROGRAMME OF MONETARY STUDIES  
INSTITUTE OF SOCIAL AND ECONOMIC RESEARCH  
UNIVERSITY OF THE WEST INDIES, JAMAICA

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Seventh ADLITH BROWN Memorial Lecture  
by Owen Jefferson  
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## *The late Dr. Adlith Brown*

*The Adlith Brown Memorial Lecture honours the memory of Dr. Adlith Brown, co-ordinator of the Regional Programme of Monetary Studies from 1980 to 1984.*

*Although born in Jamaica, she could truly have been described as a Caribbean woman. Her sense of regionalism was nurtured on the Mona campus of the University of the West Indies where she did her under graduate work in Economics and had the distinction to be in the first graduating class for the B.Sc. (Economics) offered by the University. She subsequently completed her Masters (with distinction) as well as her doctorate degrees from McGill University.*

*Adlith returned to teach at the University (St. Augustine campus) in 1969 and in 1971 was transferred to the Mona campus where she taught Monetary Economic Research in 1976 and was one of the main anchors of its research programmes. She co-ordinated first the Caribbean Public Enterprise Project and from 1980 the Regional Programme of Monetary Studies. In this period she was also promoted to Senior Research Fellow and in 1982 to the position of Acting Deputy Director, which she held up to her death. These latter years demonstrated most her capacity for intellectual leadership and for creative management.*

*Adlith revelled in the realm of ideas. It is therefore understandable that she was fast developing a reputation of being an outstanding economic theorist as her writings attest. Indeed, she was an ideal person to co-ordinate the Regional Programme of Monetary Studies, given her passion for regionalism, her intellectual standing and her understanding of the process and problems of policy-making with which her colleagues in the central banks had to cope.*

*Each year the Open Lecture at the conference of the Regional Programme of Monetary Studies is sponsored by Caribbean central banks and designated the Adlith Brown Memorial Lecture.*

*J. Edward Greene  
University Director,  
ISER*

# LIBERALIZATION OF THE FOREIGN EXCHANGE SYSTEM IN JAMAICA

*Owen Jefferson*

# INTRODUCTORY REMARKS

by  
Selwyn Ryan

I take pleasure, acting in my new capacity as University Director of the Institute of Social and Economic Research, to welcome you to this Open Lecture and to introduce our guest speaker, Dr. Owen Jefferson, Senior Deputy Governor of the Bank of Jamaica.

Exchange rate liberalization is one of the policies being proposed to bring order and stability to foreign exchange markets in these highly open economies of the Caribbean. Jamaica has had extensive experience in grappling with exchange rate management and I can think of no one better equipped to share with us the lessons of these experiments than Dr. Jefferson. He has now had over fifteen years of practice in this sphere and must certainly be at the point of drawing some firm conclusions.

We honour the memory and work of Dr. Adlith Brown this evening. Adlith has been, over the years, student, teacher, researcher and programme leader as the profession has sought to come to grips with the economic realities of the region. Her contribution both as academic and administrator has been profound. Her contribution to the literature on the phenomena of unemployment, public enterprises and economic adjustment under surveillance of multi-lateral financial institutions stands out. As Coordinator of the Regional Programme of Monetary Studies her leadership was of the highest calibre.

As Dr. Jefferson speaks to us on *Liberalization of the Foreign Exchange System in Jamaica*, we invite you to let your intellect and your imagination soar to new heights as together we grapple with the complexities of the socio-economic issues involved.

# LIBERALIZATION OF THE FOREIGN EXCHANGE SYSTEM IN JAMAICA

At the outset, I would like to thank the organizers of this lecture series for inviting me to make this presentation thus enabling me to play some small part in commemorating the very valuable services rendered by Dr. Adlith Brown in relation to the Regional Programme of Monetary Studies and to the economics profession in general. I consider myself fortunate to have been a friend and colleague of Adlith. We were colleagues in the Department of Economics at the University of the West Indies during the nineteen seventies. At a later date I joined the Bank of Jamaica and she became Director of the Regional Programme of Monetary Studies, with respect to which the Bank had a very strong interest. In carrying out our respective functions our paths continuously crossed. Not only did she perform superbly in co-ordinating the various aspects of the Monetary Studies Programme but her own research, which centred largely around issues relating to adjustment and development in Caribbean economies, provided many valuable insights for which we are all grateful.

I am sure that she would have had very great interest in my topic for tonight which centres around the issues relating to the Liberalization of the Foreign Exchange System in Jamaica. All of you will be aware that on September 25 of this year, approximately two months ago, the Government of Jamaica, in a bold policy initiative, abolished exchange controls which had been a constant element in the mix of economic policies pursued by successive governments since the 1970s. This move was not made in a vacuum but is consistent with the overall policy direction of the Government which, in line with what has become a worldwide trend, has been pursuing a policy of deregulation and liberalization. In keeping with this philosophy, tariffs have been reduced and standardized, financial markets have been deregulated, the monopoly position enjoyed by certain public sector entities have been removed and, in general, the productive sectors are exposed to the full blast of international competition. The aim is to achieve a market-based economy relying on price signals derived from the inter-action of supply and demand, thus improving the allocation of resources. Against this background, my modest aim is to locate the liberalization of the exchange system within a theoretical frame as well as the operational dynamics of the situation, to discuss briefly the conditions

which are necessary for its success, and to point towards the research and policy challenges which are indicated.

In most CARICOM countries, exchange controls arose as a war time measure in the colonial context. During war time, it is often necessary to commandeer various resources for the war effort. In such circumstances, foreign exchange is usually regarded as a very valuable resource, the allocation of which cannot be left to market forces. After the cessation of hostilities, the Exchange Control Act normally remains on the books and in typical cases is administered largely as a monitoring device. Ministers of Finance who believe that they have an economic war to fight inevitably see the tightening of exchange controls as an indispensable part of their policy mix. Against the background of deterioration in Jamaica's balance of payments position, exchange controls were tightened in Jamaica in the latter part of the nineteen seventies and administered in conjunction with all-pervasive import licensing arrangements. The import controls were largely dispensed with in the mid nineteen-eighties but the movement towards loosening of exchange controls which began at about the same time was slow and halting. A major step forward was taken in September 1990 with the introduction of the Inter-bank Foreign Exchange System involving a substantial freeing of current account payments which paved the way for the abolition of exchange controls in September 1991.

The background to the tightening of exchange controls in the latter part of the nineteen seventies was the deterioration in the balance of payments as reflected in the rapid depletion of the international reserves following the buoyant economic activity of the nineteen fifties and sixties, which was propelled by the significant investment inflows into the Bauxite/ Alumina and Tourism sectors. These capital inflows enabled the country to run a very large current account deficit for many years. The essential fragility of the economy was revealed when these capital inflows came to an end in the early nineteen seventies. Instead of immediate adjustment efforts, the response was a running down of the country's foreign reserves in an attempt to maintain imports at previously existing levels. Problems caused by the end of the investment boom were aggravated by the first oil shock of 1973. The substantial increase in the Bauxite Levy, which is payable in foreign currency, went some way towards mitigating this external shock but rapid expansion of government expenditure leading to massive escalation of the public sector deficit placed an intolerable strain on the reserves leading to their exhaustion. It was at this stage in 1976/77 that exchange



controls and import licensing were severely tightened within the context of the implementation of other macro-economic policies aimed at correcting the growing fiscal and external account imbalances being experienced by the economy.

Further shocks were to be experienced by the economy. The second oil shock of 1979 sent the economy into a tail-spin and this was followed in the early eighties by the virtual collapse of the bauxite/alumina industry, the country's largest earner of foreign exchange. Arising out of the international recession, the value of exports of this industry fell by some 40 per cent between 1980/81 and 1982/83. The response to the balance of payments disequilibrium was heavily weighted in favour of financing rather than adjustment. The foreign debt escalated rapidly, fed by loans predominantly from multilateral and bilateral sources resulting in a situation where in per capita terms Jamaica became one of the world's most heavily indebted countries. Despite repeated reschedulings of eligible portions of the debt, the actual debt service ratio is still of the order of 30 per cent and this contributes substantially to the intractability of the foreign exchange problem.

### *FOREIGN EXCHANGE REGIMES*

Against the background of the vicissitudes which I have touched upon, Jamaica has since 1977/78 been undergoing, on a continuous basis, stabilization programmes under the auspices of the International Monetary Fund. Since the early nineteen eighties stabilization programmes have been complemented by structural adjustment policies administered by the World Bank. This is not the time or place to recount or to assess the effects of those programmes. However, the foreign exchange regime (defined to include the administration of exchange control as well as the mechanism for exchange rate determination) has been central to all the programmes entered into by Jamaica with the multilateral institutions. With regard to the exchange rate mechanism, almost every permutation and combination of available systems have been utilized at some point during the past fifteen years. We have had at varying times:

- a) A single rate fixed by the Bank of Jamaica;
- b) Dual exchange rates with both rates fixed by the Bank of Jamaica;

- c) A crawling peg regime with pre-determined movements of the exchange rate at pre-announced intervals;
- d) A multiple exchange rate system including an official rate fixed by the Bank of Jamaica, a special CARICOM rate also fixed by the Bank of Jamaica and a parallel market rate determined by the forces of supply and demand;
- e) An auction system administered by commercial banks;
- f) An auction system administered by the Bank of Jamaica;
- g) A floating rate determined by supply and demand in an inter-bank foreign exchange market within a context of exchange controls on invisibles;
- h) The present system in force since September 25, 1991, under which exchange controls are no longer applicable and the exchange rate is freely determined by authorized dealers.

The frequent changes in policy have been due to the concern of the authorities with the stabilization of the exchange rate in a context where the openness of the economy and in particular its heavy dependence on basic imported consumer goods means that exchange rate changes provide a very significant impetus to inflationary pressures.

While some of these regimes had a measure of success over varying periods, they clearly did not and could not by themselves provide a sustainable solution to the underlying problem of excess demand for foreign exchange. While much attention was focussed on exchange rate systems, the demand management strategy was not pursued with the required degree of vigour and consistency.

#### *APPROACHES TO EXCHANGE RATE POLICY*

With regard to the question of exchange rate policy in developing countries, economists recognize two broad approaches, viz., the new orthodox real targets approach and the alternative nominal anchor approach. The real targets approach is based on the view that the nominal exchange rate can and should be used, together with other policy instruments, to attain real objectives such as an appropriate level of demand for domestically produced goods and services and a desired current account. This implies that a devaluation is perceived as having real effects that are sufficiently long lasting (say, two to four years) to be worth pursuing

provided that expenditure policy avoids excess demand at the same time. The real targets approach can be characterized as active exchange rate policy. Once the real objective is chosen, say, stabilization of domestic demand or an export boost through enhanced competitiveness, the exchange rate follows other domestic expenditure and pricing policies in realizing the objective.

The alternative nominal anchor approach is a version of monetarism. The exchange rate anchors the domestic inflation rate to that of trading partner countries. When periodic adjustments are made, they are meant to offset the inflation differential with trading partner countries if such a trend sets in. The fixed nominal exchange rate constrains domestic monetary policy to some rule of money growth related to that of the trading partners. With the extent of domestic public sector financing so determined, fiscal policy therefore becomes endogenous. Rather than a system in which the exchange rate follows other nominal variables such as domestic price and wage inflation, in order to attain real objectives, it leads them. The parameters imposed by the exchange rate policy restrain government's expenditure profile and send signals to private agents about the prospects for inflation. The implication is that if the signals are credible, the real economy will adjust appropriately to various shocks guided by anti-inflationary exchange rate policy.

Stabilization programmes in Jamaica have adopted both of these approaches since 1983, the year in which the first steps towards liberalization were taken with the virtual elimination of import licensing. Between 1983 and 1985, the Jamaican dollar was allowed to depreciate to alter the price signals in the tradable sector and, in conjunction with fiscal contraction and monetary tightening, to realign domestic absorption with supply. Thereafter, a low inflation model was thought appropriate in which the exchange rate was relatively stable (although a mechanism was retained to allow market-determined flexibility) and a complementary fiscal and monetary stance developed to support this anchor.

The evolution of exchange rate policy and performance has been complicated since 1988 by the supply shock of Hurricane Gilbert and, subsequently, political changes. However, conflicting views developed as to the credibility and feasibility of a fixed parity on the one hand and the assumed superiority of market-based adjustment to the exchange rate through the then existing auction mechanism. These conflicts led to two debilitating developments. In the context of the fixing of the exchange rate

at what was considered to be a desired nominal level, large payment arrears accumulated which increased the likelihood of an exchange rate adjustment and intensification of speculative demand in the official market. Secondly, foreign exchange earnings were increasingly diverted to the parallel market where there was a significant differential above the official rate.

### *STEPS TOWARDS LIBERALIZATION*

It was against this background that the Government which had assumed office in 1989 and had expressed a general commitment towards privatisation and liberalization began in 1990 to intensify the pace of liberalization of the foreign exchange regime. In June 1990, building on a dormant scheme first announced in 1983, the authorities gave approval for residents as well as non-residents to hold foreign currency accounts in local banks in respect of foreign exchange receipts not derived from exports of goods and services. Interest earned in these accounts would be tax free.

The next step took place in September 1990 when further substantial delegation of exchange control functions relating to current account invisible payments were delegated to the commercial banks which would henceforth be fully responsible for all private sector payments. The central bank retained responsibility for public sector payments (including external debt) and oil. Loan inflows and earnings from bauxite, sugar, bananas and a portion of tourism would flow to the Central Bank which would meet any shortfall by purchasing the required proportion of foreign exchange flows into the commercial banking system. At the same time, retained accounts for exporters were expanded. The exchange rate would be determined in the Inter-Bank Market run by the commercial banks.

One of the problems associated with partial liberalization, particularly as it relates to exchange control regimes, is that the initial instalments whet the appetite for more, lead to a clamour by some interests for speeding up of the process and sometimes leads to behaviour which ensures that acceleration actually takes place. This is even more likely when as in the present case the Government had repeatedly stated its commitment to the removal of exchange controls, albeit on a gradual basis. Leading private sector spokesmen continued to call for early abolition. The market drew its own conclusions as to the likely outcome and one indicator of the thinking was that in July 1991 for the first time the lodgments to foreign

currency accounts exceeded sales of foreign exchange to commercial banks. Wholesale flouting of the exchange control regulations had obviously become the order of the day. After reviewing the situation and heartened by the data which showed a significant improvement in the current account of the balance of payments for the first six months of 1991 compared with the same period in 1990, the authorities decided that the time had come to remove exchange controls and this was done in the latter part of September, 1991.

In a nutshell, the abolition of exchange controls means that:

- (1) There are no surrender requirements for earners of foreign exchange. They are free to hold their earnings in foreign currency accounts abroad or with local commercial banks and to utilize such funds for meeting their obligations abroad. If they wish to sell foreign currency to obtain domestic currency, they should do so through an authorized dealer.
- (2) Persons who wish to make payments to meet foreign obligations need not present documentation to be able to secure funds from an authorized dealer.
- (3) The Bank of Jamaica no longer has the power to force authorized dealers or foreign exchange earners to sell foreign exchange to it. Apart from foreign loans to the public sector and any other foreign exchange inflows to the Government, such as the Bauxite Levy, the Bank of Jamaica has to compete in the market to secure funds to meet obligations such as external debt and upkeep for embassies etc. Oil payments are being divested to the commercial banks on a phased basis.

Many issues arise from the bold and far reaching step which Jamaica has taken but we do not have time to go into all of these. I will touch briefly on four aspects as follows:

1. Do exchange controls work?
2. If they are to be removed, are there a set of pre-conditions which should be in place and what should be the timing?
3. What are the implications of their removal in Jamaica?
4. What are the indicated research and policy challenges?

I will comment briefly on each of these but I wish to note that the views given here are my own and should not be regarded as necessarily those of the institution to which I am attached.

### *Do Exchange Controls Work?*

It is my view, based on long experience in a central bank, that exchange controls by themselves achieve very little in the absence of a proper mix of macro-economic policies - monetary, fiscal and income policies. By the same token, if there is a proper mix of the abovementioned policies, the controls become largely redundant as a policy instrument but can be useful as a monitoring device.

If exchange controls are accompanied by lax monetary and/or fiscal policies, the excess demand for foreign exchange spills over into the parallel market and the premium in that market gives some indication (though not necessarily a conclusive one) of the extent of overvaluation of the currency in the official market.

The greater the premium in the illegal market the greater is the disincentive for the exporter to surrender his earnings to the official market while facing a cost structure which reflects to some degree the exchange rate in the parallel market.

Attempts to cushion certain producers and consumers from the effects of devaluation through devices such as multiple exchange rates mean that certain foreign exchange earners have to bear the burden. If explicit subsidization is to be avoided or kept at minimum levels, it follows that to the extent that some individual or firms purchase foreign exchange at less than the market rate some earners of foreign exchange have to surrender it at such a rate. This introduces many distortions into the system. Attempts to provide cushioning for particular groups in the context of exchange rate changes are better done in a transparent form through appropriate taxes and subsidies. It is inadvisable to levy an invisible tax on foreign exchange earners if the objective is to boost exports.

One of the major objectives of exchange control is to prevent capital flight. I do not believe that there are many persons who still believe in the efficacy of this method. It is now generally admitted, based on the experience of a number of countries including Jamaica, that exchange controls do not prevent capital flight since there are many techniques such as under-invoicing of exports, over-invoicing of imports, and compensation

deals which allow persons intent on evading the controls to do so with little risk of detection.

We can safely conclude that if a country is observed to have maintained a stable exchange rate and equilibrium in its balance of payments it is quite likely that even if that country has exchange controls, its success has been achieved despite rather than because of the existence of these controls. It is also almost a certainty that these controls are being applied so lightly as to be almost unnoticed by the population at large.

### *PRECONDITIONS FOR AND TIMING OF LIBERALIZATION*

It should be clearly apparent from the foregoing that the liberalization of the foreign exchange market needs to be supported by an appropriate monetary, fiscal, payments and pricing environment and by appropriate demand management policies. Different countries, as informed by their objective social and economic circumstances, have timed and phased supporting demand management and institutional reform in relation to foreign exchange market liberalization in different ways. At opposite extremes are the gradual sequential implementation of different elements of reform as against simultaneous and comprehensive introduction. This could be categorized as the gradual vs the big bang approach.

The gradual path to liberalization relies on the building of consensus and on the establishment of macro-economic reforms in order to make the transition to a new exchange rate regime relatively acceptable and sustainable over time. It requires ideally the removal of institutional distortions particularly in the fiscal and monetary spheres before actual implementation of exchange rate reform. The achievement of fiscal balance and the establishment of a market-determined interest rate structure and flexibility in mechanisms for the determination of domestic prices are regarded as basic unavoidable reforms which must precede or at least accompany exchange rate reform.

The merits of a gradual approach are considerable, not the least reason being the enhanced possibility for avoidance of costly overshooting in exchange rate adjustment which can create considerable damage and lack of confidence in the longer term. Despite the obvious advantages of orderly implementation through a gradual approach, however, it may not be feasible in given objective circumstances. In a context of acute foreign exchange crisis and growing loss of confidence in the official foreign

exchange system, the time phasing for implementation may have to be sharply compressed.

As indicated earlier, the authorities in Jamaica were committed to a gradual approach to the question of liberalization of the foreign exchange regime. We have seen that the timing of implementation of this move was partly determined by market developments. Partial liberalization resulting in growing anticipation of early removal of remaining controls led to a situation where many players began to behave as though exchange controls had already been fully removed. For example, the increase in the flow of funds into foreign currency accounts at the expense of sales to the banking system became problematic in a situation where the Central Bank was still substantially dependent on the commercial banking system for foreign exchange to meet foreign debt and other obligations.

One school of thought in Jamaica holds to the view that foreign exchange liberalization cannot be successful in the absence of a cushion of reserves which can enable the authorities to intervene so as to prevent the exchange rate from depreciating too sharply in the early stages of the process. While the availability of this cushion would be doubtless desirable and would make the process substantially less hazardous, the matter boils down to the practical possibilities of securing such a cushion in a meaningful time frame. Jamaica's efforts under stabilization and structural adjustment programmes have been directed at precisely such an objective over the past fifteen years. While adequate reserves would be helpful in the transition from exchange controls to a liberalized regime, the reliance on exchange controls acts as a deterrent to the kinds of economic behaviour which would result in the accumulation of such reserves. As it turned out, the conjuncture of events made those aspects of the debate largely academic.

### *SOME IMPLICATIONS OF JAMAICA'S MOVE*

As was indicated earlier, exchange controls are not a substitute for proper macro-economic policies and might achieve little without such policies. Exchange controls might, however, disguise the need for such policies, since the state has the power to issue directives as to how foreign exchange should be deployed.

With the removal of foreign exchange controls, a different situation emerges. The absence of surrender requirements enables the earner of



foreign exchange to deploy such resources in keeping with his own interest. The importance of demand management, therefore, comes to the fore. For example, if interest rate levels are inappropriate, the foreign exchange earner would have an incentive to hold his earnings in a foreign currency account and borrow domestic resources.

Against this background, demand management policies have had to be considerably tightened. The Government has moved to further reduce the overall public sector deficit to a level of less than 2 per cent of Gross Domestic Product and the Bank of Jamaica has moved aggressively to mop up liquidity in the system, resulting in a sharp increase in interest rates so as to contain the growth of banking system credit. Public sector enterprises are passing through in their prices the full impact of exchange rate changes. One of the problems in the past, which weakened the adjustment effort, was that when the exchange rate depreciated the prices of commodities such as basic foods and electricity which are heavily import-dependent were adjusted only after a considerable lag. This eased the pressure on prices but at the cost of delaying adjustment in the balance of payments which would have been brought about through the price effect. Present policy is seeking to correct the deficiencies of the past. It is a painful but necessary process.

The transition to a new exchange rate regime almost inevitably results in an initial depreciation of the currency. This depreciation arises because of the need to establish a new equilibrium in the foreign exchange market, which fully reflects the demand for and supply of foreign exchange compared with the previous disequilibrium which helped to trigger the move towards liberalization.

The magnitude of the depreciation is likely to reflect the differential which existed previously between the official and parallel market exchange rates. It often happens that there is overshooting of the parallel market rate because of a lag in the full effectiveness of macro-economic policy actions which accompany the liberalization.

In the case of Jamaica, the exchange rate has depreciated by some 30 per cent since liberalization was implemented but shows signs of settling down in the range of 19 to 20 Jamaica dollars to the United States dollar. Optimism is based on the fact that the last quarter of the year is a relatively lean period for foreign exchange inflows (the dead season for tourism) and is also characterized by heavy demand for foreign exchange arising from

stocking up for the Christmas season. The first quarter of the year usually reflects a more favourable balance between demand and supply.

When all things are considered, an objective analysis would suggest that the initial stages of the liberalization process have gone as well as could have been expected given the less than ideal conditions under which the programme was launched. As often happens in cases of this kind, there are persons who expect miracles overnight and complain when these are not forthcoming. But it is inevitable that the pain of adjustment (such as the inflationary pressure associated with significant exchange rate adjustment) comes immediately while the benefits such as capital inflows and the impetus to production for export, come only after a lag.

#### *SOME AREAS FOR FURTHER RESEARCH*

I close by mentioning a few areas which appear to be deserving of further research and which could possibly be undertaken under the auspices of the Regional Programme of Monetary Studies:

- (1) The efficacy of exchange controls: Do they really make economic sense. Under what conditions do they work well? If they exist but are being lightly administered, should they be tightened when the country begins to lose reserves or should there be more reliance on monetary and fiscal policy?
- (2) If exchange controls are abolished in a situation of foreign exchange imbalance, is so-called "dollarization" of the economy inevitable? We have already seen a trend developing in Jamaica where suppliers of goods and services to foreign exchange earners are expressing the view that they should be paid in foreign currency.
- (3) If dollarization becomes widespread and economic units increasingly hold their savings in foreign currency, what are the implications for monetary policy?
- (4) In a situation where persons in the private sector have responsibility for meeting their own obligations and are able to hold foreign currency accounts, should amounts held in such accounts be regarded as a part of the country's reserves or as a capital outflow?

## LIBERALIZATION OF THE FOREIGN EXCHANGE REGIME IN JAMAICA

I am sure that many more fertile areas of research will be thrown up as a result of the liberalization of the exchange regime in Jamaica and, of course, in Guyana which embarked on this path earlier. Unfortunately, I did not have time to be able to compare their experience with ours. This is another research project which I commend to the Monetary Studies Programme.

I thank you once again for having had the opportunity to address you and you have my best wishes for fruitful deliberations for the remainder of the Conference.