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Central Banking and Macro-Economic Management:
Reflections on the Jamaican Experience

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CENTRAL BANKING AND MACRO-ECONOMIC MANAGEMENT: REFLECTIONS ON THE JAMAICAN EXPERIENCE[1]

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I am very pleased to be afforded the opportunity to share some thoughts on central banking with you at this the Thirtieth Anniversary Conference of the Regional Programme of Monetary Studies (RPMS). As is well known this programme, under whose auspices the annual meetings are organized, had its genesis in a crisis arising out of the sterling devaluation of 1967. The then existing central banks in the English-speaking Caribbean, viz., the Bank of Jamaica, the Central Bank of Trinidad and Tobago and the Bank of Guyana were in a quandary because of the close link of their currencies to sterling. If they failed to devalue along with sterling, they would prejudice the viability of their sugar industries (and bananas in the case of Jamaica) since the prices of these products were denominated in sterling. However, if they devalued in line with sterling, they would preserve the viability of sugar and bananas at the risk of the creation of inflationary pressure since, increasingly, consumer imports were being obtained from non-sterling sources.

In view of the severity of the economic problems which have faced some Caricom countries in more recent times, the troubles of 1967 pale into insignificance. However, at that time, the situation was seen as potentially

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catastrophic and the central bankers in their quest for workable solutions appealed to the University for analysis which would shed some light on the consequences of the alternatives facing them. As a consequence, a conference on devaluation was convened and was so successful that the central banks agreed to fund a research programme at the Institute of Social and Economic Research (at the University of the West Indies) and subsequently involving the Institute of Development Studies at the University of Guyana. Annual conferences have been held every year from 1969 and an important research programme has been sustained culminating in the establishment of the Caribbean Centre for Monetary Studies (CCMS) at the St. Augustine Campus of the UWI.

As far as the practice of central banking is concerned, a lot of water has flowed under the bridge since the crisis of 1967. As additional countries gained their political independence from Britain, the establishment of a central bank was as inevitable as the possession of a flag and a national anthem. In addition to the institutions already existing at the time of the crisis of 1967, and referred to above, two central banks were established during the 1970s (Central Bank of Barbados 1972 and Central Bank of Bahamas 1974) and two more during the 1980s (Central Bank of Belize 1982 and the East Caribbean Central Bank 1983). Whereas six of the existing central banks in the English-speaking Caribbean serve a single country, the East Caribbean Central Bank is a multinational central bank serving eight countries some of which are independent while two are dependent territories of the United Kingdom.

As Blackman (5) has pointed out, the Acts establishing the Caricom central

banks vary in their language but they generally convey five basic purposes:

1) the preservation of the internal value of the currency;
2) the preservation of the external value of the currency;
3) the promotion of economic development;
4) the promotion of a healthy financial system.
5) the development of capital markets.

The outcomes in relation to items 1) and 2) above are inextricably linked and are in turn related in large measure to the relationship between money creation and gains in productivity. If the former runs ahead of the latter, the inevitable result will be inflationary pressure which is another way of saying that the internal value of the currency is being eroded. If inflation runs ahead of one's trading partners on a consistent basis, it becomes very difficult to maintain the exchange rate parity. In economies which are heavily import dependent, devaluation is likely to lead to further inflationary pressure which in the absence of drastic corrective measures can develop into an inflation/devaluation spiral with deleterious effects on the performance of the real sectors of the economy.

If we use the external value of the currency as an index of the performance of the Caricom central banks, we find that the performance has been very good in four cases, moderately good in one and poor in the remaining two. To be specific, in the case of Barbados, Bahamas, Belize and East Caribbean Central Bank, they have managed to maintain the par values of their currencies relative to their intervention currency, the US dollar, since the inception of the respective central banks. In the case of Trinidad and Tobago, the currency has moved from TT$1.71

= US$1.00 to TT$6.26 = US$1 over 34 years. Jamaica and Guyana have suffered frequent and sharp devaluations since the 1970s. In the case of Jamaica, the currency has slumped from J$0.71= US$1.00 to J$36.80= US$1.00 over a 38-year period and the Guyana dollar has moved from G$1.71 =US$1.00 to G$151.50 = US$1.00 over 33 years.

Even a cursory examination of the data suggests that there has been a close link between the extent of money creation and the fortunes of the currency. Furthermore, excessive money creation appears to have been strongly driven by excessive government expenditure with deficits being largely financed by the central banks.. In other words, by and large, in countries where the government pursued prudent fiscal policies and did not resort to excessive borrowing from the central bank, the par value of the currency remained largely intact. Correspondingly, substantial deficits financed by central bank credit led to large-scale money creation which inevitably eroded the value of the currency both internally and externally.

The remainder of this paper will be concerned with an evaluation of the role of the central bank in macro-economic management in Jamaica and in particular the circumstances which led to the tendency towards a sustained decline in the par value of the currency from the latter part of the 70s onwards. In this context, the interplay between monetary, fiscal and exchange rate policies will be examined.

Before getting into the details of the Jamaican situation, some general comments will be made by way of background. A survey of the literature on central banking suggests that although the activities of central banks worldwide are marked by great diversity, it is through the conduct of monetary policy that a central bank

has its most pervasive impact on the economy. Monetary policy allows central banks to have a significant impact on a broad range of macro-economic developments including growth, employment, inflation, interest rates, exchange rates and the balance of payments.

It would appear that for a central bank, the establishment of monetary conditions conducive to price stability over time should be seen as its primary responsibility and as the most effective way of promoting good economic performance in the medium and long term.

One of the most important lessons drawn from the experiences of a wide cross-section of countries is that fiscal policy plays a central role in the ability of a monetary authority to pursue its objectives. The data show that in a large number of countries, increases in the fiscal deficit have put great pressure on the monetary authorities to finance their deficits with consequent effects on money supply, exchange markets and inflation. Furthermore , decisions by the fiscal authorities on expenditures and the structure of taxation also affect the level of private sector savings and, in turn, the general economic environment in which monetary policy decisions are made.

The management of monetary policy in the pursuit of longer term price stability also depends critically on the conditions of domestic financial institutions. Monetary policy-making becomes much more complex when the authorities are faced with widespread risk and insolvency among financial institutions. Often the existence of such risk necessitates, in the short term, special liquidity support by the central bank for these ailing institutions. This liquidity support arising from the

central banks' role of lender of last resort tends to expand the money supply and thus complicates the task of monetary management.

The First Phase of Central Banking in Jamaica

As Farrell has indicated (7) the dominant paradigm in mainstream economics in the early 1960s when the Bank of Jamaica was being established was the neo-Keynsian model which prescribed an active role for the monetary authorities in macro-economic management and put great store on low interest rates as a means of stimulating investment and economic growth. A concomitant of the need to stimulate investment was the perceived need to curb consumption and this was to be accompanied by credit ceilings or selective credit controls directed at consumption spending.

The Bank of Jamaica was therefore not particularly preoccupied with the issue of price stability. The actual experience of inflation in the English-speaking Caribbean was quite favourable. In Jamaica, inflation averaged 4.1 per cent between 1961 and 1972. This inflation performance was due to the low rates of inflation prevailing in the industrial countries which were the main trading partners of the Caribbean countries, and to the fixed parity with sterling together with free and full convertibility of the local currency into sterling. As Thomas pointed out (16), these conditions made the money supply dependent on the balance of payments, in that excess domestic money creation would result in an outflow of foreign exchange and a subsequent correction of the money supply along the lines of the classical price -specie -flow mechanism.

As indicated earlier, the Sterling devaluation of 1967 caused turmoil at the Bank of Jamaica as well as at the other regional central banks. The Jamaican currency was devalued to the same extent as the Pound Sterling and with a significant increase of the United Kingdom Bank rate, the task of monetary management became much more complex than it had been hitherto. During the succeeding years, the Bank of Jamaica introduced a wide range of monetary policy measures to deal with the new problems. In 1968, with the emergence of surplus liquidity in the banking system, the Bank of Jamaica introduced a new instrument of policy to deal with the problem, viz. the special deposit scheme. In connection with this policy, several deposit facilities were set up, including the Banks' Deposit and Loan Fund which remained in operation until it was abolished in 1979. These deposit facilities had the same effect on bank liquidity as an increase in the reserve requirement ratio but were operated voluntarily.

During 1969, the continued expansion of credit and the deterioration of the external reserves led to the introduction of selective credit controls aimed at restricting consumer-oriented credit as well as credit to non-resident controlled companies. In addition, the Bank of Jamaica increased, for the first time, the minimum liquid assets ratio for commercial banks from 15 per cent to 17 ½ per cent in order to regulate the overall volume of credit to the private sector. By early 1970, liquidity had tightened in the banking system and in order to provide financing for exports and the channellng of funds into productive activity, rediscounting facilities for these activities were established.

During the period 1971-75, there were significant changes in the international

financial system which continued to influence monetary policy developments in Jamaica in succeeding years. In 1971, the suspension of automatic US dollar convertibility signalled the impending collapse of the BrettonWoods system of fixed exchange rates. By March 1973, the system had collapsed with the generalized floating of exchange rates. During the year, the first OPEC oil price shock was also experienced which, together with the system of floating exchange rates, created much instability in world financial conditions and put severe pressure on the country's external reserves. The problems arising from these pressures on the country's external reserves were to become intractable and persistent over the next two decades.

There was an overall devaluation of the Jamaica dollar by about 16.5 per cent in 1973 following the momentous decision to align the currency to the United States dollar instead of the Pound Sterling. This decision was influenced mainly by the shift in Jamaica's trading patterns which had taken place since establishment of the Bank in 1960. This meant that monetary policy would henceforth be more closely linked to prevailing conditions in the USA rather than the UK. During 1973-1974, several monetary measures were introduced to ease pressure on the balance of payments. For example, the Banking Law was amended to extend the control of the Bank of Jamaica over the operations of non-bank institutions in the financial sector, interest rates were increased and exchange controls were tightened significantly with a view to controlling the outflow of capital.

Response to New Economic Environment

As it turned out, the period covering more than two decades from about 1973 to the middle of the 1990s was marked by macroeconomic instability. The key instruments which the authorities had at their disposal for coping with this situation were monetary, fiscal and exchange rate policies. During the greater part of this period, Jamaica was in the throes of stabilization policies administered by the International Monetary Fund (IMF) and structural adjustment policies under the aegis of the World Bank (IBRD). How can we account for the elusiveness of a stable macroeconomic environment in Jamaica over such a relatively long period? A careful evaluation of the relevant evidence suggests that for most of the period, there has not been sufficient recognition of the key role of fiscal policy in the overall policy mix.

From the middle of the 1970s up to about 1990, successive Governments displayed almost a fixation concerning the nominal rate of exchange. This concern can be understood given the openness of the Jamaican economy and the obvious link between the exchange rate and the consumer price index. However, what was not so obvious and which tended to undermine any attempt at exchange rate stability was the constant tendency during the same period to run fiscal deficits funded to a considerable extent by borrowing from the central bank or by having the central bank engage in quasi-fiscal activities. These practices tended to lead to rapid increases in money supply which in the absence of other sufficiently strong demand management policies subjected the economy to repeated bouts of inflation and/or balance of payments crises which were inimical to the maintenance of a stable

nominal exchange rate.

In attempting to cope with this problem, the initial response was to impose or intensify trade and foreign exchange restrictions, domestic price controls, credit ceilings in the financial system and other quantitative controls. These measures, however, tended to exacerbate supply shortfalls, as resource misallocation and shortages of imported inputs limited domestic capacity utilization and expansion of exports. The continuing fiscal expansion led to further deterioration in the underlying balance of payments and/or inflationary pressure. Loss of confidence contributed to reduced capital inflows and/or capital flight thus increasing the resource constraints. At the same time, increasing debt service payments arising from the borrowing to fund the deficit complicated the task of containing further increases in the deficit. Low or negative growth also eroded the tax base thus worsening the problem.

To appreciate how this problem has been played out in Jamaica, one has to go back to earlier developments. The period of the 1960s and the early 70s in Jamaica has been described as the "golden age" indicating that they were relatively prosperous years, with strong growth in real output, led by the main export industries, mining and tourism, and newly established import substitution industries. During the period 1965 to 1970, real growth of Gross Domestic Product (GDP) exceeded 5 per cent per annum on average, supported by domestic financial stability, and direct foreign investment - the latter covering in large part the prevailing external current account deficits. However, towards the end of this period, the impetus towards continuation of the growth process appeared to be weakening.

The new Government, elected in 1972, wanted to give Jamaica a new economic vision, directed at reducing the economy's traditional dependence on foreign investment, redistributing income, boosting real wages and providing employment through an expanded role for the public sector. Growth turned out to be elusive and the economy quickly became characterized by macroeconomic instability which, while having its origins in external circumstances, was perpetuated by inappropriate policy responses as indicated below.

The year 1973 ushered in the first oil crisis which saw the price of the commodity rise fourfold causing tremendous turmoil in the country's balance of payments. This led to the introduction of the bauxite levy in 1974 which just about corrected for the oil-related problems. Another significant event occurred in 1976 with the amendment of the Bank of Jamaica Act which permitted the Government to increase its borrowing from that institution from 15 per cent to 30 per cent of expected revenues in any given fiscal year. This increased access to central bank resources was to play an important part in facilitating the growth of the fiscal deficit. This deficit increased from 5 per cent of GDP in 1972 to 24 per cent in 1976. Up until 1975, much of this deficit was financed by external public borrowing but at the same time, domestic credit to the public sector expanded fivefold during the period 1971-76 with the result that the share of credit going to the public sector more than doubled from 14 per cent to 35 per cent of total domestic credit over the same period.

This massive expansion of credit caused aggregate demand to far outstrip the supply of real resources from domestic production and available imports. Against

this background it is not surprising that the reserves of the Bank of Jamaica which began to decline during the first quarter of 1975 were completely exhausted by March 1976. The response to this development was a further tightening of import restrictions and exchange controls which had been stepped up in 1972. It is well known that the best time to tackle a balance of payments problem is before it becomes chronic thus reducing the options available. However, despite the obvious signs including the depletion of foreign exchange reserves, no approach was made to the IMF, the only possible source of balance of payments support available in the given circumstances, until well into 1977. It is commonly believed that the delay resulted from the unwillingness of the Government to subject itself to the obvious medicine which the Fund would prescribe - a devaluation and a reduction in Government spending so as to curb the deficit - in the period leading up to an election due to be held in the latter part of 1976.

It is clear that the macroeconomic policies pursued between 1972 and 1977 were not conducive to economic growth. The situation was aggravated by a growing tendency towards ideological confrontation in the context of the Cold War leading to a massive flight of capital and skilled persons and a reduction in the number of tourists entering the country. Nor was there much improvement after an agreement was signed with the Fund in 1977. There was still excessive reliance on trade restrictions and exchange controls which did not work well. There was experimentation with dual exchange rates to cushion the cost of living effect, followed by a crawling peg in 1978 leading ultimately to a unified exchange rate at a significantly devalued level. Inflation reached a level of 49.4 per cent in 1978, a

record up to that time. The second oil price shock struck in 1979 leading to a situation which would have required even further adjustment measures but the country was not prepared for this. Frequent bickering with the IMF concerning the need for, and the extent of the adjustment measures required, led to a termination of the agreement with the Fund in 1980.

With the change of Government following the election of 1980, a new programme was established with the IMF which provided access to borrowing from the multilateral agencies and bilateral sources. The second oil shock of 1979 had sent the economy into a tailspin and this was followed in the early 80s by the virtual collapse of the bauxite/alumina industry, the country's largest foreign exchange earner. Arising out of the international recession, the value of exports of the industry fell by some 40 per cent between 1980/81 and 1982/83 bringing in its wake both fiscal and balance of payments problems. The response to these disequilibria was heavily weighted in favour of financing rather than adjustment. The foreign debt increased from US$1.73 billion to US$4.15 billion over the course of the decade , and Jamaica became one of the world's most heavily indebted countries with the total foreign debt reaching a level of 167 per cent of GDP in 1985 and actual debt payments absorbing in excess of 47 per cent of exports of goods and services in 1987, after taking into account the benefits of rescheduling through the Paris Club. In addition, there was also relatively heavy recourse to central bank financing which resulted in a fiscal deficit which remained above 13 per cent of GDP throughout the first half of the decade.

During the first half of the 1980s, the Government's monetary policy

consisted primarily of direct controls such as the cash reserve and liquid assets ratio, the minimum savings deposit rate and selective and quantitative controls on credit expansion. While the cash reserve ratio directly affects credit expansion by controlling base money, the liquid assets ratio by forcing banks to hold Government securities increases lending to the public sector at the expense of private sector investments. Credit ceilings have a similar effect. When a ceiling is imposed on outstanding credit to the private sector, banks are encouraged to invest in Government securities which have a relatively low risk in relation to yield. It is clear that these measures distort the flow of credit with deleterious effects on productive investment, growth and employment.

Because of the extreme shortage of foreign exchange in the early 1980s, the primary goal of Jamaica's monetary policy was to support the exchange rate policy which was dedicated to maintenance of the fixed parity with the United States dollar. By 1983, however, the authorities were obliged to devalue the currency the currency by 84 per cent and introduce an auction system to determine the exchange rate. Because the Jamaican economy was inflating at a faster rate than the US economy, due to the expansionary fiscal policies, the exchange rate began to depreciate in the auction. In order to dampen domestic demand and maintain the rate, monetary policies were tightened both in regard to direct controls and open market operations.

At that time, Jamaica's traditional pattern of exchange rate adjustment was to use monetary austerity to keep the par value stable for as long as possible. When the rate could no longer be defended, there would be an adjustment and a

continuation of tight monetary policies. The recurring result would be depletion of foreign reserves, subsidization of imports and penalization of foreign exchange earners. Furthermore, since typically imports which were cleared through customs prior to the exchange rate adjustment, but had not yet been paid for, were given a guarantee at the preexisting rate, the private economy was not forced to fully adjust to the change and the central bank had to bear a substantial cost which affected the size of the overall fiscal deficit.

During 1985/86, arising out of World Bank recommendations, an attempt was made to restructure Jamaica's monetary policies so as to rely more heavily on a new market-oriented instrument called the Bank of Jamaica Certificate of Deposit than on the direct controls used in the past. This change was envisaged as part of a total package of monetary and fiscal reforms, which would include budgetary discipline, a sharp reduction in the Government's overdraft facility with the Bank of Jamaica and the marketing of Government debt instruments through the Stock Exchange rather than the central bank. The World Bank team recommended that the Government's overdraft facility be reduced from 30 per cent of estimated revenue to not more than 5 per cent and be used only for the Government's seasonal cash flow requirements. The total amount overdrawn including interest, was to be repaid in cash within the first quarter of the following fiscal year as required by law.

Another development caused a major shift of the Government's deficit from the Central Government to the central bank. In 1987, the major expenditure of the Bank was interest on the rapidly growing stock of Certificates of Deposit issued by the Bank and the servicing of certain national debt obligations including the IMF

borrowings as well as other balance of payments support such as loans from Venezuela and Mexico under the San Jose Accord. It was agreed that the Ministry of Finance would be responsible for these expenses and would reimburse the Bank on a timely basis. This did not occur with the result that the Bank incurred large losses during the second half of the decade consistently exceeding 5 per cent of GDP. The Certificate of Deposit Scheme was intended to improve the central bank's control of base money but because of only partial implementation of the proposed financial reform package, the new instrument became yet another source of monetary expansion . This injection into the monetary system of high powered money contributed to substantial overvaluation of the exchange rate which was kept fixed during the second half of the decade. By definition, an auction scheme would have required exchange rate flexibility so as to equate supply and demand but, with the exchange rate remaining fixed, payment arrears developed which, as they grew, weakened confidence in the system.

Although as previously mentioned, the Bank of Jamaica deficit (caused largely, as mentioned earlier, by the carrying out of quasi-fiscal operations on behalf of the Government) remained high up to 1992/93, improvement in the Central Government's fiscal outturn led to a sustained decline in the overall balance from a deficit of 19.6 per cent of GDP in 1983/84 to one of 8.4 per cent of GDP in 1987/88. A bulge in expenditure in the hurricane year 1988/89 led to an increase in the deficit to 12.8 per cent of GDP in that year but thereafter the downward trend in the ratio was resumed.

Following a change of Government in 1989 and some slippage of the

exchange rate, the auction system which was not functioning well was abolished and the par value of the exchange rate set at J$6.50 to US$1.00 in November 1989. Arrears which had begun to accumulate under the auction continued to increase. The country had increasingly begun to show signs of adjustment fatigue and, in particular, disenchantment with exchange control and associated measures. The Government had previously expressed a general commitment towards further privatization and liberalization. A substantial portion of the private sector was wholeheartedly in support and one of the slogans of the umbrella Private Sector Organization of Jamaica was "free enterprise and watch Jamaica grow". Against this background, the Government in 1990 began to dismantle the exchange control regime.

One of the problems associated with partial liberalization, particularly as it relates to exchange control regimes, is that the initial instalments tend to whet the appetite for more, leading to a clamour by some interest groups for speeding up the process and also encourages behaviour which ensures that acceleration actually takes place. This is even more likely when as in the case of Jamaica, 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 and wholesale flouting of the exchange control regulations became the order of the day. There was no turning back and the rest is history. Exchange controls were abolished in September 1991.

There was generally strong support for exchange control liberalization since it was increasingly apparent that controls were proving counter-productive. It is my

view, based on long experience in central banking, that exchange controls by themselves achieve very little in the absence of a proper mix of macroeconomic policies - monetary, fiscal and income policies. By the same token, if there is a proper mix of the above-mentioned 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 this market gives some indication (though not necessarily a conclusive one) of the extent of overvaluation of the currency in the official market. Attempts to cushion certain producers and consumers from the effects of devaluation through devices such as multiple exchange rates (which were tried in the 70s and again in the 80s) mean that certain foreign exchange earners have to bear the burden which translates into a disincentive to production in those sectors. In some cases it also results in an additional financial burden for the central bank which adversely affects the overall fiscal deficit.

One of the major objectives of exchange control is to prevent large-scale flight of capital. However, 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 negotiation of compensation deals which allow persons intent in evading the controls to do so with little risk of detection.

We can safely conclude that if a country is observed to have maintained macroeconomic stability, it is quite likely that even if the 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 have been applied so lightly as to be almost unnoticed by the population at large.

Draconian exchange controls and associated importing licensing distort the economic environment and deflect activity away from production into speculative activities. It also leads to the building up of a large bureaucracy, with highly discretionary powers, to administer these controls. I have been told by many CEOs of important corporations that during the period of exchange control and import licensing in Jamaica, they spent a disproportionate amount of their time dealing with the bureaucracy but that, given the importance of foreign exchange and import licenses to these businesses, it could not be otherwise as this function was much too important to be delegated to subordinates.

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. It requires ideally the removal of institutional distortions particularly in the fiscal and monetary spheres before the 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 record will show that the macroeconomic policy mix which accompanied the liberalization did not deliver a strong enough demand management effort to be

able to contain the exchange rate within reasonable bounds. Substantial increases in money supply translated into an almost free fall in the exchange rate which, given the openness of the economy, resulted in a dramatic surge in the inflation rate. After being pegged at J$7.00 to US$1.00 from January to August 1990, the rate moved to J$12.00 = US$1.00 during the first phase of the liberalization process which preceded the actual abolition of exchange controls and depreciated further to J$22.20 = US$1.00 by July 1992 at which level it remained for almost a year up to June 1993. During this latter period, a free foreign exchange market had ceased to exist and the country had effectively returned to a fixed exchange rate, albeit an unofficial one.

By mid-1993, it was clear that the exchange system was in a serious state of disequilibrium and that the seriously overvalued exchange rate had to be allowed to depreciate. The return to a floating rate in June 1993 saw the exchange rate depreciate to J$33.00 to US$1.00 by June 1994. Thereafter, it remained at between J$33.00 and J$34.00 until July 1995, when another bout of depreciation started leading to a rate of J$40.00 to US$1.00 by March 1996. Thereafter, a combination of factors, including heavy inflows of foreign exchange attracted by the relatively high interest rate regime which was being implemented , resulted in an appreciation of the currency to a range of J$35-36 per US dollar. After a slight depreciation during a brief period of uncertainty preceding the General Elections of December 1997, the rate has settled down at a level of about $36.50 since February 1998.

The exchange rate changes which began in 1990 were accompanied by a serious bout of inflation as shown by the following data :

Year	Change in Consumer Price Index
1989	17.2%
1990	29.8%
1991	80.2%
1992	40.2%
1993	30.1%
1994	26.7%
1995	25.6%
1996	15.8%
1997	9.2%

Inflation, after peaking at 80 per cent in 1991, has been gradually reduced to a level of 9.2 per cent in 1997. The major instrument for inflation fighting has been the interest rate which has been maintained at relatively high positive levels since mid-1993. While the fiscal situation had moved from deficit to surplus in 1992/93, liquidity was being created largely through the aggressive stance of the central bank in building up its net international reserves from a negative position of US$85.64 million in December 1992, to a positive level of US$692.61 million in December 1996. The domestic currency created by these purchases of foreign exchange from the market had to be "mopped up" from the system thus contributing to a build up of the domestic public debt and the maintenance of relatively high interest rates.

The relatively good fiscal performance which resulted in surpluses from 1992/93 to 1995/96 was reversed in 1996/97 when a deficit of the order of 7 per cent of GDP was experienced resulting partly from the need to provide support to

the ailing financial sector. This deficit increased to 9 per cent of GDP during 1997/98.

An examination of the internal debt of the Central Government shows that it has risen from J$59.6 billion at the end of 1995 to J$110.4 billion as at August 31, 1998, representing some 47 per cent of GDP. If one includes the obligations of the Financial Sector Adjustment Company (FINSAC) arising out of the rescue package for financial institutions[2], and which are guaranteed by the Government, the domestic debt is of the order of J$180 billion or 77 per cent of GDP. While FINSAC is holding assets which will in due course be divested to liquidate a portion of their indebtedness to financial institutions, this exercise will take some time and in the short run, the bulk of the debt service will have to be met from the Government's Budget.

Another matter which is worthy of attention is the apparent conflict between the existence of a surplus in the public sector between 1992/93 and 1995/96 while, at the same time, the public debt was increasing substantially. As indicated earlier, a significant portion of the incremental debt would have been accounted for by transactions related to reserve accumulation by the Bank of Jamaica which is not reflected in the deficit calculations. When the Bank of Jamaica makes net purchases of foreign exchange from the public, it is in effect creating Jamaica

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[2] Starting in 1996, the country experienced severe difficulties in the financial sector reflected in the insolvency of a significant portion of the insurance and banking industry. The Government established a new agency, the Financial Sector Adjustment Company (FINSAC) to provide assistance to the ailing institutions. FINSAC has recapitalized institutions and purchased non-performing loans together estimated at between J$70 billion and J$80 billion representing some 35 per cent of Gross Domestic product.

dollars to effect the purchase. This high-powered money has to be reabsorbed from the system if inflation is to be avoided. This reabsorption is carried out either through issues of new Government instruments which add to the public debt or by using instruments already held by the Bank of Jamaica which reduce the income of the Bank. The Bank of Jamaica invests and earns income on the foreign currency acquired but, given the disparity between domestic and foreign interest rates, there is a net loss on the overall operations. This cost can be avoided only if the Government simultaneously runs a surplus on its operations by increasing revenue and/or cutting some expenditure and transferring this surplus to the Central Bank so as to keep money supply from expanding as a result of reserve accumulation by the Bank.

Another factor contributing to the increase in the public debt which intensified from 1996 onwards, was the advances made by the Central Bank to banking entities arising from liquidity problems faced by a number of these institutions. These funds would also have had to be reabsorbed by the Central Bank. The debt obligations of the institutions to the Central Bank have either been or are to be taken over by FINSAC through the issue to the Central Bank of Government guaranteed paper.

Relatively high public sector deficits financed by domestic borrowing has tended to result in an interest rate structure which has remained substantially positive. The yield on Treasury Bills declined from 43.7 per cent in April 1996 to 17.7 per cent in August 1997. However, a number of factors including the worsening of the financial sector problems and the need for large-scale Government

support led to a reversal of this trend. As at August 1998, the Treasury Bill yield was approximately 24 per cent while the inflation rate was of the order of 10 per cent per annum. The situation is even more problematic if attention is focussed on average lending rates in the banking system which are still of the order of 42 per cent - that is 32 percentage points above the inflation rate and 18 percentage points above the Treasury Bill rate.

The substantial premium between the yield on Government paper and the inflation rate is accounted for by -

i) the pressure of Government borrowing on the market to fund the relatively large deficit;

ii) uncertainty regarding the ability of the authorities to maintain the exchange rate which is perceived, in some quarters, to be overvalued.

With regard to the large differential between rates on Government paper and lending rates in commercial banks, the following contributory factors can be noted:

a) The relatively high cash reserves ratio (presently 23 per cent of prescribed liabilities)[3] which deprives the institution of any earnings on a significant portion of their deposits.

b) The high level of non-performing loans in the financial system estimated at between 25 and 30 per cent. These have been purchased by FINSAC with Government-guaranteed paper yielding rates linked to Treasury Bill

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[3]The Minister of Finance announced in July 1998 that the cash reserve ratio for commercial banks which was then 25 per cent would be reduced by 2 percentage points effective August 1, 1998, and that there would be further reductions of 1 percentage point at quarterly intervals until the ratios for commercial banks and merchant banks were equalized at 17 per cent.

yields.

c) The relatively high cost-structure of the financial system which was built up during the inflationary years and is now being tackled through mergers being arranged by FINSAC which now controls a significant portion of the financial sector.

Real Sector Performance

As was indicated earlier, Jamaica's overall economic performance has been disappointing both in relation to its potential as well as to the performance of most other CARICOM countries. During the 25-year period from 1972-97, total GDP grew on average by only 0.3 per cent per annum, and on a per capita basis, GDP fell by 0.7 per cent per annum. During the more recent 10-year period from 1987-97, total GDP rose by 1.9 per cent per annum while on a per capita basis, it rose by only 0.9 per cent. For the years 1996 and 1997, overall GDP growth has been negative at rates of -1.8 and -2.4 per cent respectively .

The business of sustaining economic growth and development is a multi-faceted one and many factors will be at work at any given point in time. However, an analysis of the available evidence regarding the performance of the Jamaican economy over the past quarter of a century suggests that one of the major obstacles to sustained economic growth has been the failure to achieve and sustain over time a mix of macroeconomic policies which would produce a climate conducive to high levels of domestic savings, the investment of those savings in productive activities and the attraction of substantial amounts of direct foreign investment. Such policies

would aim at achieving simultaneously a relatively low level of inflation (in line with the trading partners), interest rates roughly in line with the level of inflation, and suitably adjusted for risk, and sustainable balance of payments and fiscal accounts.

For the greater part of the last 25 years, Jamaica has failed to simultaneously achieve these objectives and has paid a very high price in terms of lost output and employment. This is not to say that macroeconomic stability by itself would have guaranteed economic growth. The point being made is that the absence of macroeconomic stability almost certainly precludes such growth. In other words, macroeconomic stability is a necessary though not a sufficient condition for sustained growth.

We saw earlier that one of the primary functions of the central bank is to preserve the internal and external value of the currency, i.e., to maintain a low inflation environment. The Bank of Jamaica has, not been able to achieve this because of the entanglement of monetary and fiscal policy. During the greater part of the period under review, the Bank of Jamaica was seen by the Government as a means of financing the fiscal budget whether directly or indirectly. This approach was signalled in 1976 when the Bank of Jamaica Act was amended to increase the permissible level of advances from the Bank to the Government from 15 to 30 per cent of expected Government revenue. Thereafter, budgetary deficits financed by substantial credit creation became the order of the day and the advances from the central bank were not repaid as required under the Bank of Jamaica Act.

Additionally, the Bank was required to carry out substantial quasi-fiscal

operations which led to relatively large losses which were not reimbursed as provided for under the Bank of Jamaica Act. This was another source of credit creation which would have fuelled the excess demand which led to successive bouts of exchange rate depreciation. The consequential bouts of inflation would be inevitably followed by attempts on the part of trade unions to restore real wage levels which would be validated by further rounds of monetary expansion. To put this matter in proper perspective, it is worth pointing out that it has been estimated that during the period 1963-93, the Net Credit to the Public Sector provided by the Bank of Jamaica represented some 68 per cent of the growth of money supply (9).

Central Bank Reform

While the Government has continued to run fiscal deficits, the period since about 1993 has been characterized by a relative shift away from the central bank as a source of financing for the deficit with more reliance placed on market borrowing. Additionally, the Government has gone some way towards cleaning up the balance sheet of the Bank of Jamaica and the rebuilding of the Net International Reserves of the Bank. The latter has been achieved at the cost of expanding the Government's domestic debt and putting pressure on interest rates but has restored the profitability of the central bank.

However, arising out of bad memories of the past, there is a strong body of opinion which is of the view that steps should be taken to ensure that the Government does not return to funding its operations either by resort to advances from the Bank of Jamaica or by having the Bank engage in quasi-fiscal operations which is another way of achieving the same objective.

A number of interest groups have called for the Bank of Jamaica to be replaced by a Currency Board or for the monetary system to be "dollarized" meaning that the Jamaica dollar would be replaced by its American counterpart as legal tender in Jamaica. While one understands the desperation which lies behind these calls, a dispassionate analysis of the situation suggests that the authorities need not go to those lengths to achieve the desired objective which is to separate monetary and fiscal policy and so prevent the creation of money for fiscal purposes. Both "dollarization" and reversion to a Currency Board would put the economy in a straight jacket, deprive it of a monetary policy and render it helpless in coping with difficulties arising from unavoidable external shocks

This point of view is aptly summarized by Derick Latibeaudiere, Governor of the Bank of Jamaica, as follows: "Unless a country has been so devastated by successive monetary and fiscal failures, that its population has totally lost confidence in the capacity of the authorities to follow sound macroeconomic policy, the adoption of a Currency Board regime or dollarization is not a preferred option. While there are short-term gains from operating a Currency Board or having a dollarized economy, the potential costs of such regimes are considerable because the adjustment process has to be fully borne by the real side of the economy" (11).

The alternative to "dollarization" or a Currency Board is to seek to insulate the central bank from the political process as far as its day-to-day operations are concerned. Some persons speak of securing the independence of the central bank. The term "independence" is something of a misnomer. Even the Bundesbank which is acknowledged as possessing the most freedom of action of all central banks has

to operate within the overall policy context of the Government. The most that can be hoped for is autonomy within the overall Government structure.

There has been much discussion of this subject in Jamaica and a number of reports have been presented to the Government. What is now required, in order to instil confidence in the market, is the creation through amendment of the existing legislation, and the putting in place of adequate safeguards, of an autonomous central bank with full control of monetary policy. As Davis-Panton has pointed out (6), this means that the Bank must have the sole and unrestricted authority to use the traditional instruments of monetary policy such as reserve ratio manipulation, and open market operations in pursuit of its objectives.

Other necessary reforms would require more secure tenure for the Governor and Board of Directors and very limited ability for the Board to provide advances to the Government and only in very special and defined circumstances. Such advances would also have to be approved by Parliament and be rigidly subject to repayment within a relatively short time.

The Government has in recent years been very restrained in its attitude towards credit creation through the central bank and has, through various public statements, indicated its intention to increase the autonomy of the Bank. But its intentions need to be entrenched in law if the market players are to be convinced that there will be no reversion to the abuse of the central bank which was in evidence for almost 20 years and which contributed so much to macroeconomic instability and the resultant loss of output and employment.

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