Central Banking In The Caribbean In The Context of Globalization

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Abstract

The paper examines the role of the central bank in promoting economic development in the region in the context of globalization. A critical review is conducted of what appears to be a consensus that the principal contribution a central bank can make in promoting economic development is to pursue as a primary objective the goal of price stability and that any direct intervention by the central bank in the pricing and allocation of credit is likely to be counter productive. It is argued that such a view does not adequately take into consideration deficiencies in the underlying economic structure and determinants of growth in the economies of countries in the region. It is suggested that the pressures on the economies created by globalization calls for new forms of governance for the financial sector. Such a change is required in order to establish a consensus as to the role which the sector ought to play in contributing to goals of development, as well as a greater sense of responsibility on the part of the various institutions in the sector for the successful realization of such goals. The paper outlines an alternative form of governance for the sector and the role of the central bank in this new structure.

Introduction

The progressive reduction in barriers to trade in goods and services, the elimination of restrictions on capital movements and the emergence of knowledge intensive production technology, means that we have entered an era in which critical decisions are determined by global considerations. As a result, it is argued that there is now a necessity to rethink traditional approaches towards economic policy formulation and the role of institutions, such as central banks, in assisting in the realization of national economic objectives.

Central banks in the Caribbean have traditionally been viewed as having a central role to play in the promotion of economic development of countries in the region. It has been pointed out that the Acts establishing CARICOM central banks generally conveyed the following basic purposes. These were, the preservation of the internal and external value of the currency, the promotion of economic development, the promotion of a healthy financial system and the development of capital markets(Blackman,1992a). All but the last of these might be described as being concerned with outlining the role for monetary policy in the promotion of economic development. In carrying out their mandate to assist in the promotion of economic development, central banks in the region have resorted to such direct measures of intervention as the direction of credit to selected sectors, interest rate regulation and foreign exchange controls. The onset of globalization has led to the view that such methods of direct intervention in the market place by central banks will not be an effective means of promoting economic development and could indeed be counterproductive. As a result, the role of the central bank in contributing to economic development is seen as resting in creating a stable macro economic environment by ensuring price stability.

In this paper we will challenge the notion that globalization implies that it is no longer appropriate for central banks to play an activist developmental role. In the first section of the paper, there will be an outline of the issues raised in contemporary discussions on the appropriate role of the central bank. It will be pointed out that what seems to be emerging as a consensus on the role for central banks in the region appears to ignore certain deficiencies in the underlying economic structure and determinants of growth in the region. The second part of the paper, will be devoted to the outline of an alternative approach to central banking in the region which will enable the central bank to carry out its mandate in contributing to economic development in an era of globalization.

The Contemporary View of the Role of the Central Bank

The current thinking on the role of the central bank for Caribbean type economies in the context of globalization is very much dominated by the view that the principal problem with which these economies will have to cope is how to avoid becoming marginalised. As a result of advances in technology, as well as the move in most parts of the world to eliminate controls on capital movements, investors are faced with a wide array of choices when deciding where to place investments. Consequently, countries which seek to attract external investments will find themselves operating in a highly competitive environment. Small open economies, such as those in the Caribbean, need to attract foreign investment to supplement domestic investment if they are to realize the rates of growth necessary to bring about significant improvements in living standards. It is then argued that a country must be internationally competitive if it is to succeed in attracting external investment. International competitiveness is often equated with cost competitiveness. It is also emphasized that a country must be seen as being open or friendly to business by the international investment community. A country is deemed to score high in this area, when firms can function in an environment in which government regulations have a minimal impact on investment decisions and hence market forces are allowed a free play in allocation and pricing decisions. As a result, the role of the central bank in contributing to development is centred on its ability in contributing to an appropriate environment for investment. This will be achieved by adopting as its main objective the goal of price stability, while avoiding such things as regulating rates of interest on loans and deposits, the flow of credit to particular sectors and foreign exchange controls.

A central bank will be able to achieve its goal of achieving price stability to the extent that it can independently exercise control over growth of the monetary base. Its ability to manage the monetary base in a manner consistent with the realization of that objective will in large measure be determined by its degree of independence from the political directorate. Stanley Fischer has argued that the theory of modern central banking revolves around the inflationary tendencies inherent in the conflict between the short and long run effects of monetary expansion and in the temptations of monetary financing of government spending(Fischer, 1995,p.1). It is the latter point which is often seen as being of particular significance for Caribbean type economies. The pressure imposed on central banks to finance government expenditure is held to have been a major contributor to the relatively high inflation rate experienced in countries like Guyana and Jamaica, during the decades of the seventies and eighties. In addition, it was also held responsible for the general poor economic performance of economies in the region, with the exception of the OECS states(Blackman, 1988; Farrell,1990). At the same time, as Fischer has pointed out, in advocating autonomy for such a potentially important institution, the question arises as to how autonomy can be reconciled with accountability to the public.

Courtney Blackman, a former governor of the Central Bank of Barbados, who has been one of the strongest proponents for a greater degree of autonomy for central banks in the region, suggested that autonomy could be reconciled with accountability in the following way. First, in order to ensure autonomy, the tenure of the Governor and the Directors should be clearly defined and they should serve on good behaviour. There should be no ministerial veto on staff appointments below the level of deputy governor. In addition, the ability of the government of the day to resort to central bank financing should be rigorously circumscribed, with it possibly being entrenched in the constitution. Secondly, the issue of accountability could be resolved by making the Central Bank responsible to Parliament(Blackman, 1988).

If the achievement of price stability is seen as being essential if countries are to realize their growth potential, there are those who have argued that the adoption of a rules based system of monetary management would be the best way to realize such an outcome. It has been proposed that many small countries should restructure their central banks to function on currency board principles. Henke(1993), for example, suggested that Jamaica should return to a currency board system. Governments would be forced to exercise a greater degree of fiscal discipline in that the central bank would no longer be in a position to finance fiscal deficits on demand. This arises from the fact that the supply of money would be linked directly to the country's holdings of foreign exchange and the money supply would adjust to changes in the balance of payments.

There is, however, no assurance that governments would always be willing to operate within the constraints of a currency board arrangement. This would depend on their assessment of the short term political costs associated with operating within these constraints. If these were deemed to be too high, then one might expect that a country would experience the periodic exchange rate crises that one associates with an unsustainable fixed exchange rate regime.

There is also an alternative view that CARICOM type economies might be better off if they were to abandon the notion of administering an independent national currency and adopt the currency of a major country(Dornbusch, 2000, p 250). Such a move, it is held, would yield the following benefits. It would make it easier for countries to attract foreign direct and portfolio investment since exchange risk would be totally eliminated. In addition, it would eliminate the possibility of political involvement in the determination of the money supply. As with the currency board, the adoption of a major currency will not be a panacea. There continues exist economically depressed regions within the US dollar domain, as well as that of other major currencies. However, the adoption of a major currency is often seen as part of a process of closer economic association with a major economy through a free trade or customs union arrangement.

A Critique of the Contemporary View

Thirty years ago, Thomas argued that in considering the prospects for the role of central banks in the region it was necessary to have a clear understanding of the underlying economic structure and determinants of growth in the respective countries(Thomas, 1972, p.5). This warning continues to be of relevance in the contemporary period. Price stability is clearly a necessary requirement for economic growth. However, to suggest that the central bank should refrain from any form of intervention in the market and restrict itself to strict management of the money supply as the best way to make a positive contribution to development is not in keeping with Caribbean reality. This non interventionist approach is based on the implicit assumption that there exists an appropriate balance of human and natural resources and more importantly, levels of entrepreneurship which will result in decision makers responding in an optimal manner to market signals.

The emphasis placed on price stability and economic liberalization reflects a view, as stated above, that cost competitiveness determines international competitiveness and international competitiveness is seen as the key to a country achieving satisfactory rates of growth. It is now accepted that we are now in the era of the knowledge based economy. As a result, the principal determinant of a country's ability to compete will be its stock of human capital and that the real basis of international competitive advantage rests on productive adaptability, which depends on the quality of management and the labour force(Hirst and Thompson, 1999). It is innovativeness at the firm level, which is at the basis of competitive advantage. This, in turn, appears to be closely related to such institutional considerations as the constitutional nature of company governance systems, the institutional operation of the labour market and the form of social settlement between social partners and organised interest groups. For example, it has been argued that the sharp class divisions that have historically characterized Jamaican society contributed to an especially rancorous relationship between management and workers and had an important negative impact on the information technology sector. These factors all contributed to a demoralized labour force anxious to leave the industry at the earliest possible opportunity. The result was that the Jamaican industry came to be viewed as one that was cheap but inefficient(Mullings, 1998, pp. 147 - 150). In much the same vein, a report by the Economic Commission for Latin America and the Caribbean, concluded that the dominant role of the merchant capitalist class in the region and its limited interest in the professional and technical development of workers, as well as its failure to take concerted action to support measures designed to advance the technological learning process, constituted a major constraint to development in the contemporary environment(Watson, 1994,p.75).

In light of these deficiencies, it is then apparent that role of the central bank cannot be restricted to that of simply providing a stable framework within which the financial sector can function. Indeed, these institutional deficiencies suggest that the countries in the region are not yet at the stage where it makes sense to think in terms of institutions functioning within narrowly prescribed limits. More precisely, the popularity of the notion that the central bank should abstain from direct intervention in the mobilization and allocation of credit presupposes the existence of a diversified and sophisticated financial sector. The rapid expansion and subsequent collapse of the financial sector in Jamaica, the largest in the region, highlights the problems which arise from providing a free rein to a relatively immature sector. The problems experienced by the sector could in part be attributed to weaknesses in the supervisory framework. However, the tendency towards overinvestment in sectors such as real estate, points to a lack of dynamism in the sector.

The ability of the financial sector to make an effective contribution to development depends on its ability to mobilize the maximum level of savings from domestic and international sources and channel these savings into productive investment. The dominant institutions in the sector, the commercial banks, life insurance companies, building societies and credit unions, operate within a set of traditional guidelines, which on the basis of experience, enable them to meet their institutional objectives. Indeed, what they might deem to be sound management practices might result in a tendency towards risk avoidance. This results in an overwhelming share of funds directed in to areas such as consumer lending, mortgages and real estate, with which they have a greater degree of familiarity, with little attention paid to means of providing support for non traditional areas of productive activity. However, if countries in the region are to be successful in the new global economy the financial sector will have to be more aggressive in supporting a wider array of what might be considered non traditional productive activities. In the advanced industrial countries many of the traditional financial institutions are in a constant process of reinventing themselves and carving out new roles to reflect changes in the domestic and international economy. In the CARICOM context, these institutions, in the presence of limited dynamism in the internal economic structures, have a role to play in effecting change in economic structures. In other words their role must be as much catalytic as reactive in nature.

The major financial institutions, because of their existing staffing structures, are not in a position to take on such a role. The staff of the financial institutions in the region consist in the most part of individuals geared to carry out specific functions of the institution. Unlike institutions in the advanced countries, they have apparently not seen the value of including in their staff non specialists who would be involved with monitoring domestic and international socio - economic trends. For example, to my knowledge, there is no general research division in any of the financial institutions. This is where the central bank could play a role in helping the financial institutions become more pro active in contributing to development. Courtney Blackman has pointed out that a major portion of the staff of central banks consist of what might be considered knowledge workers, economists, accountants, and statisticians and has a vital function as an information system(Blackman, 1992a). The central bank, functioning as an information system could play an important role in helping institutions in the sector develop the in house capabilities to function more effectively in promoting development. By entering into a new form of working relationship with the various institutions in the sector, the central bank could play a major role in helping the institutions reinvent themselves. Central to this new relationship would be a learning component designed to impress on the institutions the benefits that they stand to realize from breaking out of their traditional operating practices, while at the same time contributing positively to the advancement of the economy.

The advocacy of a minimalist role for the central bank reflects the importance attached to countries in the region being integrated into the global economy. Integration, however, does embody certain costs. The recent developments in parts of Asia and Latin America highlight some of the potential costs of being integrated into global financial markets, given the volatility of international portfolio capital movements. Friedman(1999) has argued that small countries have very limited ability to alter the rules of international finance to protect themselves from arbitrary destabilizing speculation. Consequently, small countries should not dismiss out of hand the introduction of measures which might be seen as leading to a measure of disengagement from international capital markets. It is now accepted that controls on short term capital flow are justified. In the context of the Caribbean, it is now realized that there are no long term guaranteed benefits from providing unrestricted opportunities to foreign direct investors. The experience with the garment industry being a case in point.

An Alternative Role for CARICOM Central Banks

In the previous section, it was argued that there is a need for a new form of working relationship between the central bank and institutions in the financial sector. This new relationship would have to be centred on an agreement among all parties as to a set of common goals for the sector and a sense of shared responsibility for the realization of such goals. In essence, there will have to be a fundamental change in the traditional structure of governance for the sector. As it is currently structured, the principal players have virtually no input into the establishment of sectoral objectives and consequently feel no responsibility for the realization of objectives. Correcting this deficiency must be part of a comprehensive change in approach to policy formulation and decision making.

As a first step, an effort must be made to create community based organizations structured in such a way as to provide an avenue for direct involvement of as broad a cross section of the population as possible in setting development goals. These organizations must be established with a clear understanding that the role of participants is not simply that of promoting or defending particular local interest, but also that of providing an input into the creation of a national consensus on developmental objectives. This would help in the creation of a broader sense of ownership and responsibility for the realization of national objectives.

It is against this background that the following approach to defining a new role for central banks in the region is based. The first element in this new governance structure is directed towards effecting a change from what has historically placed the central bank in a potential adversarial relationship with the government, on the one hand, and financial institutions on the other. This would be brought about through the establishment of a new national body, called for example, the National Finance Committee. This committee would consist of representatives drawn from the central bank, the Ministry of Finance, as well as the commercial banks, life insurance companies, credit unions and other major institutions in the sector. This committee, chaired by the Minister of Finance or a person chosen by the Minister, would be responsible for establishing the basic principles for a stable financial sector as well as financing priorities which are in keeping with the broad development objectives. This body would resolve such issues as inflation targets, the limits on central bank financing in support of government expenditure, exchange rate targets in those instances where countries operate under flexible exchange rate regimes. In addition, it would have the responsibility for arriving at an agreement with respect to which productive sectors funding should be directed as a matter of priority.

A series of functional sub - committees operating under the general direction of the central bank would be responsible for pursuing the objectives assigned the financial sector by the National Finance Committee. These sub - committees would be responsible for overseeing financing priorities, for example, in such areas as agriculture, tourism, manufacturing and housing. Each of these sub - committees would be chaired by a staff member of the central bank and would have among its members individuals drawn from financial institutions which are actively involved in the sector. These sub - committees would meet on a regular basis, no less than once per month. This would allow the members to be kept abreast of developments in the domestic and international economy which might necessitate a rethinking as to the appropriate strategies for realizing particular objectives. It will also provide for a continuous feedback from the private institutions to the central banks on unanticipated difficulties the institutions might face in trying to pursue sectoral objectives.

In addition to these sub - committees, an important new element in this new governance structure would be a sub - committee which would have the responsibility for identifying ways in which financial support could be provided to encourage expansion in non - traditional areas of productive activity. The function of this sub - committee would be to generate ideas as to where efforts should be directed to support innovative activity and the adjustments which might be required in the financial sector in order to ensure that the necessary financial support will be provided. At the initial stage, the central bank would have to take the lead in getting the operations of this sub - committee off the ground. As indicated earlier, the current staffing practices in the institutions means that primary concern of employees has been with traditional institutional practices. As a result, the central bank, given its ability to tap directly and indirectly into a broad resource base, must take on the responsibility of educator and motivator. In performing this dual function it will be pointing to the potential benefits to the nation at large, as well as the institutions, which might be realized by not being restricted to traditional methods of operation.

The Regional Dimension

The countries in the region have committed themselves to a deepening of the integration process with the establishment of a single market with a common currency. The question arises as to how this alternative model for central banks outlined in the previous section would function in this context, where the existing central banks would function as operating arms of a regional monetary authority. The various proposals on the organizational structure of a CARICOM central bank have emphasized the need to have an independent institution which would be able to perform its functions without interference from the political directorate. It has been suggested, for example, that there should be incorporated in the charter of the institution, rules prohibiting the financing of fiscal deficits, or establishing strict limits on the financing of such deficits(Blackman,1992b; Worrell,1990). This is reflective of the view that the principal factor contributing to economic instability in countries in the region has been the use of central banks to support irresponsible government programmes. In the words of former governor Blackman there is a need to depoliticize the monetary process. Accordingly, what is envisaged is a highly centralized and independent regional central banking system.

The alternative approach to central banking proposed in the previous section when applied in the regional context would imply a decentralized central banking arrangement. The role of the central bank in contributing to economic development rests in its ability in mobilizing the institutions in the financial sector to identify with and assume responsibility for the realization of common goals. Given the differences in economic structures among countries in the region there must be sufficient flexibility to allow for innovativeness within the different countries. For example, there would be a need to reconcile at the regional level the financing priorities of the individual member countries. In addition, the regional branches of the monetary authority would have more authority in the administration of interest rates.

Conclusions

The contemporary view on the role of the central bank in contributing to development is reflective of the view that globalization imposes severe limits on the scope for independent monetary policy initiatives. Small countries, such as those in CARICOM, which are reliant on foreign investment, must concentrate on creating a business friendly investment climate. This is seen as the way to optimize the level of international and domestic investment activity. Consequently, central banks should refrain from such measures as direct intervention in the allocation and pricing of credit.

In imposing such limits on central bank activity there is the implicit assumption that the private institutions in the financial sector are well equipped to mobilize and allocate savings in a manner consistent with optimizing the economic growth potential of the country. It was pointed out that the major institutions in the sector, the commercial banks, life insurance companies, building societies and credit unions, operating within their traditional structures do not see themselves as having any particular role in development. Financial institutions in the major industrial countries are in a process of reinventing themselves in light of changes taking place in the domestic and international environment. If the financial sector in CARICOM is to be effective, then the institutions will have to break out of their traditional roles and become more innovative in identifying new types of activity worthy of support.

The institutions, given their staffing patterns, are not in a position to engage in such a process. The central banks, on the other hand, have a staffing complement which is more suited to address broader issues of development strategy. It is in this context that one must think of the role of the central bank in contributing to development. In order to perform this role there will be a need for a new form of governance structure for the sector. In this new approach the emphasis rests on formalizing new partnership relationships between the central bank and the institutions in the financial sector. All players must become directly involved in the establishment of goals and priorities for the sector. This will be an essential first step in the development of a sense of common purpose and a shared sense of responsibility for working towards the realization of common objectives. The role of the central bank in helping small developing countries meet the challenges of globalization is centred on helping in the transformation of the financial sector. Such a transformation is essential if the sector is to play a role in providing support for the kinds of innovative activity essential for economic success in the new environment.

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