

*“Factors in the Choice of
Exchange Rate Regime with
Special Reference to the
Caribbean.”*

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**FACTORS IN THE CHOICE OF AN EXCHANGE RATE REGIME:
WITH SPECIAL REFERENCE TO THE CARIBBEAN**

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INTRODUCTION

The exchange rate is the most important price in any country; it determines the terms of trade with foreigners, as well as relative prices within the economy. "Establishment" economists are quick to point out the negative implications of an over-valued exchange rate; they are silent about the deleterious effects of an under-valued exchange rate. However, economists are unanimous about the benefits of exchange rate stability, i.e. an exchange rate to whose fluctuations or trends the domestic economy can adjust with relative ease.

In the 1950s and 1960s "Free Market" economists, led by Milton Friedman, argued that free-floating exchange rates would promote exchange rate stability world-wide; and so they welcomed the collapse of the Bretton-Woods fixed exchange rate system in 1971. Instead of the promised stability, there has been widespread and sharp exchange rate volatility. Exchange rate instability proves too uncomfortable even for West European industrialized nations, prompting them to establish a common currency. Emerging economies in Latin America and Asia have also been severely affected by exchange rate stability, spawned by the international financial crises of the 1990s, following pressure from the "Washington Consensus" to deregulate their financial markets, float their currencies and open up their financial markets to unfettered global

capital flows. Only those escaped who retained an element of capital control, or were prepared to intervene intelligently and pragmatically in their capital exchange markets.

CARICOM has been a veritable laboratory for the study of various exchange rate regimes. Member states have at various times employed the fixed exchange rate, the currency board, the peg to a basket of currencies, the foreign currency auction, the interbank market, the free float and the managed float. This Paper reviews the Caricom experience with various exchange rate regimes over the past three decades. It pays especial attention to foreign exchange markets in conditions of chronic disequilibrium, and to the role of the cambio system. A number of lessons are extracted from the experience of CARICOM that should be especially helpful to similar small LDCs in their choice of an appropriate exchange rate regime. The most important lesson is that fiscal discipline is the sine qua non of exchange rate stability.

In conclusion, the Paper develops a normative framework for the choice of a feasible exchange rate regime for a given country. The chief consideration is the quality of financial markets, i.e. their breadth, depth and competitiveness. Exchange rate regimes are seen to exist on a continuum with the "free float" at one end and the fixed rate (i.e. peg, currency board or dollarization), at the other. The US and EU would occupy one end, and Barbados, Panama and Cayman islands, the other. Countries like Argentina, Brazil or Trinidad and Tobago fall between the two "stools", and must employ customized and hybrid exchange rate regimes, i.e. some kind of managed system.

There three Charts and one Diagram appended.

LESSONS FROM THE ANGLOPHONE CARICOM EXPERIENCE

The Anglophone member states of CARICOM provide an excellent laboratory for the study of exchange rates. Four of them operate fixed exchange rate regimes – The Bahamas, Barbados, Belize, and the Organization of Eastern Caribbean States (OECS), comprised of Antigua & Barbuda, Dominica, Grenada, St. Kitts & Nevis, St. Lucia, St. Vincent & the Grenadines, and the two remaining British colonies of Anguilla and Montserrat. Guyana and Jamaica have operated floating exchange rate regimes, with the latter switching around 1994 to a managed float; Trinidad and Tobago (T&T) has conducted a managed float operation since 1993.

All Central Bank Acts include currency stability among their objectives, and all monetary authorities have at their disposal the traditional powers to set reserve requirements, interest rates, and to employ selective credit controls if deemed necessary. All Central Bank Acts also include limitations on central bank lending to Government but in some countries these regulations have been more honored in the breach than the observance. Exchange control regulations on capital accounts remain in force in The Bahamas and Barbados. Belize has recently modified their exchange control regime by the introduction of cambios.

Fixed Rate Regimes

The Bahamas

From its establishment in 1974, the Central Bank of Bahamas has operated a fixed exchange rate regime, with B\$1.00 = US\$1.00. The Bahamian economy is mainly service-based, with more than 40 per cent of the national income linked either directly or indirectly to tourism; another 15 per cent is derived from banking and financial services. The financial sector is two-tiered – a domestic sector and an off-shore sector. The domestic financial sector is subject to exchange regulations, while the off-shore sector is largely free of controls.

The fixed exchange rate regime has served The Bahamas well. The economy delivered average growth rates of over three per cent in the 1970s and 1980s, but fell flat in the 1990s. However, living standards have continued to rise, with The Bahamas enjoying the highest per capita GDP (US\$14,960) of independent countries in the Western Hemisphere, after the USA and Canada; inflation has mostly remained in the low single-digits, as successive Administrations have kept government debt/GDP ratio below two per cent in all but two of the last ten years.

The secret to Bahamian economic success is that both its main industries have been riding a secular economic upswing. Tourism is frequently described as a fickle industry. In fact, tourism is the fastest growing global industry, and its fortunes have been nothing so volatile as those of oil or bauxite. Oil prices, in particular, have moved from highs of US\$40 per barrel in 1981 to less than US\$10 a barrel in 1986! It has taken the events of September 11, 2001, the most horrific shock to the capitalist system since World War II, to stop the tourism industry in its tracks.

The Bahamian monetary authorities have therefore been able to treat the fall-off in tourist arrivals during global recessions as temporary, and defend the exchange rate by drawing down foreign exchange reserves or by borrowing abroad until the international economy recovered. The pursuit of conservative fiscal policies during the economic upswings has ensured the foreign exchange reserves and good credit ratings needed during recessionary times. However, the years immediately ahead will be testing times for The Bahamas because of the medium-term uncertainty of the tourism industry and the aggressive attempts of OECD countries to put tax-havens out of business.

There is one foreign exchange institution peculiar to The Bahamas. The Central Bank maintains a market in investment currency, prescribed for the purchase of foreign currency securities from non-residents and the making of direct investments outside The Bahamas. This market has its origins in the UK following World War II and was established in The Bahamas in 1972. The Central Bank began support for the currency pool from its own foreign reserves in 1986, and assumed responsibility for its administration from London dealers in 1989. In 1995 total purchases amounted to about US\$200,000 and sales to about US\$270,000, with an end of year balance of US\$1.3 million. Most sales were for portfolio and real estate investments overseas.

Barbados

The Barbadian economy is based primarily on tourism, which earns two-thirds of the island's foreign exchange earnings. The Barbadian monetary authorities also consider the fixed exchange rate to be the center piece of national economic policy.

The Barbados currency was pegged to the US dollar in 1975 at a rate of BDS\$2.00 = US\$1.00, and has remained unchanged since then. Except for a brief period (1991-92) the Central Bank has been able to supply adequate foreign exchange to the market so that a parallel market has never emerged.

Monetary policy in Barbados has mostly been conducted within the context of fiscal responsibility, with the fiscal deficit/GDP ratio usually at the three per cent level or below. However, on two occasions (1982 and 1991) Barbados, following two large election-related fiscal deficits, was forced to enter IMF Structural Adjustment programs, barely avoiding devaluation on the second occasion by legislating an eight per cent cut in civil service salaries.

For Barbados too, the fixed exchange rate has worked well, delivering a steady average real growth rate of between one and two per cent over the last three decades with inflation usually in the low single digits. In the 1990s, growth in GDP averaged three per cent. Meanwhile Barbados, with a per capita GDP of US\$8,600 has moved into the ranks of middle income countries, and ranks 31st in the world and first among nations of the Americas (after the USA and Canada) in the UNDP human development index.

With tourism as the main industry, Barbadian authorities, like the Bahamian, have opted to defend the exchange rate during recessionary times by drawing on foreign exchange reserves and borrowing abroad until good times return. They have also added the weapon of an incomes policy to their armory. Government, Business and Labor have formally instituted a "Social Contract" to establish appropriate parameters for wage increases. So far it has worked well.

Belize

Unlike The Bahamian and Barbadian, the Belizean economy is broad based, with a variety of industries – bananas, citrus, sugar cane, rice, fishing and shrimping, lumbering and tourism, especially eco-tourism. The economy, although less vulnerable to international recession, is from time to time devastated by hurricanes and floods. Belize also shares common borders with Guatemala and Mexico, and conducts significant trade with the latter. Belize's foreign exchange earnings are therefore most sensitive to devaluations of the Mexican peso.

The Belizean currency was already pegged to the US dollar at a rate of B\$2.00 = US\$1.00 when the Central Bank of Belize was established in 1981. The Bank is required by law to hold not less than 40% of currency in circulation and deposit liability. Belize, with a per capita GDP of US\$2,910, has enjoyed a more rapid growth rate than any other Caricom state, averaging more than five per cent per annum over the 1980s and 1990s. However, the trend of growth has been more uneven. For example, real GDP in the second half of the 1980s averaged a record 8.6 per cent per annum, but only 4.4% annual in the first half of the 1990s, and has weakened since then.

Belize has been more prone to periods of fiscal excess than either The Bahamas or Barbados. Fiscal deficits in 1992 and 1993 were 6.6 and 6.1 per cent of GDP, and fiscal policy has been especially loose in recent years with the fiscal deficit/GDP ratio registering 10.2%, 9.8% and 11.7% in 1999, 2000 and 2001, respectively. Not surprisingly, the Belizean economy is currently undergoing balance of payments stress, and the authorization of cambios in 2001, the only instance among countries with fixed-rate regimes, is not a good omen.

OECS

The Eastern Caribbean dollar has been pegged to the US dollar at US\$1.00 = EC\$2.70 ever since the Eastern Caribbean Currency Authority, predecessor of the ECCB, untied from sterling. Ironically, the OECS, entitled as LDCs to concessions under the Caricom agreement, has outperformed the MDCs in many areas. For most of the 1980s the economy grew in real terms at 6 per cent for the entire sub-region, with growth in Antigua & Barbuda and Montserrat exceeding 10 per cent per annum, but slowed to an average of three per cent during the 1990s, still strong in relation to the rest of CARICOM. The per capita incomes of independent OECS now range from US\$9,070. for Antigua & Barbuda to US\$2,690 for St. Vincent and the Grenadines, while the per capita incomes of three MDCs, T&T, Jamaica and Guyana, are US\$5,540, US\$2,270, and US\$840 respectively. It is true that the OECS has been a beneficiary of substantial grant and aid flows - mostly in response to the frequent hurricanes and occasional volcanoes that afflict the region.

The secret of OECS currency stability is the "unanimity rule" whereby major policy decisions require the approval of all eight Ministers of Finance. This means that no individual Minister of Finance has the power to transgress the rules establishing minimum foreign exchange backing for currency issues or limitations on central bank credit extended to governments. For this reason no member state government is empowered to finance fiscal deficits through central bank credit, the most traveled path to currency debauchment. Individual member states have been guilty of fiscal indiscipline, but they must make adjustment through fiscal measures and not

through money creation. Finally, an individual member state negotiating a structural adjustment program with the IMF cannot commit the ECCB to a currency devaluation.

Floating Rate Regimes

Guyana

Guyana is an extreme example of a foreign exchange market in chronic disequilibrium. In 1975 Guyana untied from sterling and fixed to the US dollar at the rate of US\$1.00 =G\$2.55. At that time Guyana was the best placed of Caricom non-oil exporters to withstand the first oil-shock. It possessed four strong foreign exchange earners in alumina/bauxite, sugar, rice and timber, and produced much of its food. Bumper sugar earnings in 1975 lifted foreign exchange reserves to a healthy US\$85 million. In that same year Guyana declared itself the Cooperative Republic of Guyana, and took the first fateful steps down the road to "cooperative socialism".

Government launched an over-ambitious program of social welfare expenditures, and initiated a series of nationalizations of strategic industries, including bauxite/alumina; in the process three major foreign commercial banks were indigenized. By 1976 Government was firmly in control of the "commanding heights" of the economy, and by 1986 the public sector accounted for almost 90 per cent of total claims on the banking sector, up from 40 per cent in 1970.

The vastly increased public expenditures were primarily financed by central bank lending, with Bank of Guyana claims on Government increasing from G\$45 million at year-end 1975 to G\$346 million at year-end 1977, wiping out Guyana's foreign

exchange reserves. The sharp fall-off in export earnings in 1976 and 1977 only compounded the problem and the Government relied increasingly on foreign borrowing and trade credit. As a result Guyana's foreign debt moved from US\$206 million to almost US\$700 million in 1985, while the Bank of Guyana's foreign exchange reserves declined to less than negative US\$500 million, and Guyana was on the way to becoming the most impoverished nation in the Western Hemisphere, with a per capita income of US\$840 in 2001, US\$360 more than Haiti's.

In spite of increasing payments pressures, no action was taken on the exchange rate until 1981 when, on entering an IMF arrangement, Guyana devalued to a rate of US\$1.00 = G\$3.00, and again in 1984 to US\$1.00 = G\$4.12. At this point the local currency was pegged to a basket of currencies. Between 1984 and January 1987 the modal rate of the fluctuating Guyanese dollar was about US\$1.00 = G\$43. The emergence of a thriving parallel market in 1986, with rates diverging sharply from the official rate, prompted a further devaluation to a rate of US\$1.00 = G\$10. With the parallel rate fluctuating between G\$14-20 per US dollar, the Bank of Guyana established a "Free Foreign Exchange Market", a second legal rate to compete with the parallel market. The "free" rate was set at US\$1.00 = G\$20, while the official rate remained at US\$1.00 = G\$10. When the parallel rate reached US\$1.00 = G\$50 in 1989, the Bank abolished the free foreign exchange window and returned to a single official rate of US\$1.00 = G\$33. Another devaluation quickly followed to US\$1.00 = G\$45, and the Government set up the "Cambio System" as a means of eliminating the black market for currencies. Even commercial banks were allowed to set up cambios as separate units of their organizations.

The cambio rate quickly jumped as high as US\$1.00 = G\$90, and in 1990 the floating exchange rate was formally introduced for the entire economy. The cambio system appeared at first to have stabilized the exchange rate, but by 1966 it had fallen to US\$1.00 = G\$145, and today it fluctuates around US\$1.00 = G\$200. Besides the Foreign Exchange Market Scheme and the Cambio System, the Guyanese authorities experimented, to no avail, with several mechanisms for restoring currency stability, most notably barter trade with other socialist states.

In default on a foreign debt of US\$1.5 billion, Government turned to the IMF and the World Bank in 1989, and a classic monetary and market program was attempted, including real positive and market-determined interest rates, and demand management measures. The program was assisted by Government's abandonment of the obviously failed socialist experiment, and its readiness to divest inefficient loss-making government enterprises and woo foreign investment. Some measure of economic growth was restored, but it is clear that repeated devaluations have not made the Guyanese economy more competitive. Nor has continual ethnic-based political and social unrest helped the situation.

Jamaica

Jamaica pegged its currency to the US dollar in 1971 at the rate of J\$1.00 = US\$1.20. In the light of increasing balance of payments pressures, a modest devaluation was made in 1973 to J\$1.00 = US\$1.10. But Jamaica's difficulties really began in 1975 when, in the name of "democratic socialism", Government embarked on

massive social expenditures, financed primarily by Central Bank credit – most reminiscent of the Guyanese experience. During 1977 and 1978 Government increased its loans outstanding from the Central Bank from J\$77 million to J\$346 million. The Bank of Jamaica's foreign exchange reserves were quickly exhausted and Government resorted to heavy foreign borrowing. Jamaica has since been forced into a series of painful foreign debt reschedulements, barely avoiding technical default. Like Guyana, Jamaica has never recovered from the toxic injection of new money in 1975.

At first, Jamaica experimented with multiple exchange rates, starting in April 1977. A "basic" rate of J\$1.00 = US\$1.00 and a special rate of J\$1.00 = US\$0.80. The basic rate applied to (a) payments for imports of basic foods, petroleum products, drugs, fertilizers and animal feeds; (b) receipts and payments on Government account, and (c) receipts and payments related to the mining sector. In October the same year new "basic" and "special" rates were established, but in 1978 the dual exchange system was discontinued when Jamaica entered an Extended IMF Facility. In 1983 Jamaica returned to the dual exchange system, with an official rate of US\$1.00 = J\$1.78, and a formal parallel market determined by commercial banks on the basis of demand and supply. A third rate of US\$1.00 = J\$2.25 was introduced in May. The exchange rate system was soon after unified, and an Auction System for foreign exchange established.

In 1990 Jamaica embarked on a program of financial liberalization with the introduction of an inter-bank foreign exchange system, under which responsibility for the purchase and sale of foreign currency, at market determined rates, was transferred to authorized dealers, who were required to sell a percentage of their purchases to the Central Bank. Pauline Bachelor et al, in "The Evolution of the Financial Sector in

Jamaica", a paper in The Financial Evolution of the Caribbean Community 1970-1996, op.cit, concludes:

It was anticipated that with the implementation of the inter-bank foreign exchange system there would have been a substantial increase in foreign exchange inflows into the banking system. This, however, did not materialize.

The Bank of Jamaica's efforts at liberalizing the foreign exchange market culminated in 1991 when exchange controls were removed, with the exception of the prohibition against trading in foreign currency by an authorized dealer. In 1994, a system of *cambios* was established in an effort to marginalize the black market. Since 1990, Jamaica has essentially operated a free floating exchange rate regime. At year end 1990 the exchange rate was J\$8 = US\$1.00; by the end of 2001, it had fallen to J\$45 = US\$1.00. In addition, high rates of inflation have prevailed: the average annual GDP deflator from 1990 – 2001 was 22 per cent. It appears that the Bank of Jamaica has intervened systematically in the foreign exchange market since the late 1990s to maintain a level of exchange rate stability.

To make matters worse, the program of financial liberalization, carried out in the context of a poorly supervised financial system, collapsed in the second half of the 1990s when all indigenous commercial banks, representing 60 per cent of liabilities in the banking system, and the two largest life insurance companies, failed and had to be rescued by Government. The Jamaican story is compelling proof of the ineffectiveness of orthodox financial policies when the foreign exchange market is in chronic disequilibrium. Nor have crime rates and divisive politics helped matters any.

Trinidad & Tobago

Trinidad & Tobago (T&T) has been a significant oil exporter for decades, and more recently a major producer of natural gas and its derivatives. Indeed, the energy sector represents 25% of GDP, and earns about 60 per cent of the country's foreign exchange. The oil shocks of 1974 and 1978, which created major problems for other CARICOM economies, led to boom conditions in T&T. Between 1974 and 1982, GDP grew at an average rate of 6.3 per cent, with correspondingly high levels of government revenues and a strong build up of foreign reserves, which rose from less than US\$50 million in 1973 to over US\$300 million in 1974, and peaked at US\$3.2 billion in 1981. Government expenditures also rose sharply, leading to a significant reduction in unemployment. As a result there was an unprecedented improvement in the general standard of living and vastly increased importation of consumer goods.

The adverse movement in the terms of trade brought about by falling oil prices from a peak of US\$40 a barrel in 1981 led to shrinking of government revenues and to rising fiscal deficits; as a percentage of GDP, the fiscal deficit grew from 1.4 per cent to 13.1 per cent in 1983.

The instinctive reaction of the authorities was to defend the existing exchange rate. With massive balance of payments deficits in prospect, they opted in 1983 for direct import controls in preference to currency devaluation. They introduced a system of *ex ante* Central Bank controls over visible imports and introduced a plethora of tariffs, taxes and subsidies, which created many opportunities for rent seekers. When these measures proved insufficient the T&T dollar was devalued, with a dual exchange

rate regime. The exchange rate moved from US\$1.00 = TT\$2.40 to US\$1.00 = TT\$3.60, except for imports of food, drugs and other "basic" items which traded at the old rate.

With the collapse of international oil prices to less than US\$10 in 1986, there was a precipitous decline in the level of foreign exchange reserves which fell to the equivalent of less than two months worth of imports. For two years more the authorities persisted with quantitative import restrictions, although of a less fierce variety. By 1988 Government realized that an approach to the IMF was inevitable and struck preemptively by further devaluing the currency to a unified rate of US\$1.00 = TT\$4.25. Under the IMF Stand-by Program which T&T entered in 1989, import controls began to be dismantled. In 1993 Government decided to abolish controls on current and capital transactions, and to have the value of the T&T dollar determined within the context of an inter-bank market whose major players would be the authorized foreign exchange dealers. The rate of the original "float" was US\$1.00 = TT\$5.35, but in recent years it has fluctuated within a band of US\$1.00 = TT\$6.00 – 6.30.

But the narrow range of currency fluctuation betrays the fact that the float is not really **free** but **managed**. The Central Bank, the Ministry of Finance, and the major commercial banks cooperate in a program for the maintenance of orderly market conditions, which includes rationing of foreign exchange sales and the sharing of foreign exchange purchases among authorized dealers. The Central Bank has also made several interventions to maintain stability. The IMF describes the T&T "floating" exchange rate regime as a *de facto* peg. It certainly is not floating freely, nor is it fixed! Maybe the IMF's description is merely a tribute to the success of the T&T authorities in maintaining currency stability.

The performance of the T&T economy since 1993 suggests that the series of devaluations and the adoption of the managed float have borne fruit. The export manufacturing sector, in particular, has flourished, benefiting from cheap electricity generated by abundant supplies of gas and reduced real wages resulting from successive currency devaluations. Whereas real GDP grew annually at a rate of negative three per cent from 1985-1992, the average rate of growth since then has been three per cent.

The Role of the Cambio

Whereas cambios in developed economies play the marginal role of money changing for the convenience of tourists, they have featured quite prominently in the financial systems of Caricom countries whose foreign exchange markets have slipped into chronic disequilibrium. Historically the cambio has not existed in Caricom countries with fixed exchange rate regimes. Its introduction in Belize is a very recent phenomenon.

Clearly, cambios have emerged because they provide a needed service. They serve individuals who wish to trade the relatively small amounts of foreign exchange that come into their possession, or who wish to obtain relatively small sums of foreign exchange to meet purchases and family obligations overseas, but find it intimidating or inconvenient to deal with commercial banks. On the macroeconomic level they consolidate numerous small quantities of foreign exchange which can then be utilized for more socially useful purposes. However, cambios have never brought in the quantities of foreign exchange anticipated, and have made little contribution to alleviating the foreign exchange constraint which mires their economies in a low-production mode.

At the same, neo-liberal economists are inclined to treat the price of foreign exchange prevailing in the cambio system as the true market rate for the aggregate economy. The fall in the cambio rate therefore leads to a disproportionate fall in asset values throughout the economy, triggering an upward spiral in prices, nominal wages and, as shown above, worsening conditions of disequilibrium. The rationalization is and, as shown above, worsening conditions of disequilibrium. The

rationalization is that the cambio price is the only market-determined price. As a result, the entire economy is held hostage to the cambio; put another way, the tail wags the dog.

It is a fallacy to equate markets of the cambio system with the orderly financial markets of developed countries, which process information across the entire economy and so appropriately determine the national exchange rate. The distinction between an orderly market and a disorderly market is critical. Professor Paul Davidson observes that "an orderly market means that changes in market prices can be expected to be small and appropriate given the news of the day." The cambio systems of CARICOM do not meet these requirements of orderliness, and so cannot form the basis of a sound national exchange rate policy.

This brings us to Professor Davidson's next point:

A *market maker* is defined as someone who publicly announces a willingness to act as a residual buyer or seller to assure orderliness if an abrupt disruptive change occurs on either the demand or supply side of the market. The market maker, following the preannounced rules of that market, guarantees that the next market price will not differ chaotically from the last transaction price despite the disruption.

The implications of the above analysis are:

- 1. that the cambio system should be integrated into a system of orderly national financial markets, and**
- 2. the Central Bank, as suggested above, is the only institution capable of fulfilling the responsibility of market maker. However, the market maker does not necessarily maintain a fixed price, only orderly conditions.**

Lessons from the Caricom Experience

1. Those countries which maintained currency stability achieved the highest rates of economic growth.
2. Fiscal discipline proved to be the most important factor in the maintenance of currency stability and sustained economic growth.
3. Timely and credible currency devaluation proved to be the best policy in the event of sharp declines in national income that were inevitable in the short-run.
4. Multiple exchange rates created more problems than they solved.
5. Elaborate bureaucratic mechanisms of import control always proved counter-productive and costly and had to be abandoned.
6. Once foreign exchange markets succumbed to chronic disequilibrium, even deep and repeated currency devaluations failed to shift resources from the domestic to the external sector.
7. In no country where the cambio system was introduced did they make a critical difference in the mobilization of foreign exchange and the restoration of currency stability. Frequently they made matters worse by promoting flight out of the domestic currency.
8. The problems of exchange rate management were exacerbated in Guyana and Jamaica by the absence of a minimum social and political consensus.

CONTINUUM OF EXCHANGE RATE REGIMES

The various types of exchange rate regimes may be viewed as existing on a continuum with the “free-float” at one end and the fixed rate, e.g. peg, currency board or dollarization, at the other. (Diagram I gives a graphical representation of this continuum.) The most important factor in the choice of an exchange rate regime is the quality of its financial sector.

Successful floaters are usually countries with large developed economies, like the USA, or groups of developed economies, like the European Union, or relatively small developed economies with highly sophisticated financial markets, like the UK, Switzerland or Sweden. Even large countries lacking deep and wide financial markets, like Argentina and Brazil, have failed to operate successful floating exchange rate regimes. China, with a large and rapidly growing economy, has hesitated to launch a floating exchange rate regime, and has only recently allowed its currency to be converted outside of China.

Successful “fixers” are usually mini-states with simple economies, mainly involved in the export of tourism and financial services, such as Cayman Islands and Bermuda, which both operate currency boards. Some small services exporting countries with central banks, such as Barbados, The Bahamas and the OECS, have operated successful fixed-rate regimes for over 25 years, but only in the context of highly disciplined fiscal policies and, in the case of Barbados, through resort to an incomes policy made possible by its ethnic and social homogeneity.

The current Argentinean crisis has demonstrated that relatively large countries with significant commodity and/or manufacturing exports are not well-served

by a pegged exchange rate. When the currencies of trading partners depreciated against the Argentinean peso, the “hard” peg to the US dollar prevented domestic cost adjustments through devaluation and the rigid exchange rate system broke down, leading to the collapse of the financial system. At the same time, the current Brazilian crisis demonstrates that even an economy as large and broad-based as Brazil’s may not successfully operate a freely floating exchange rate regime, since its financial markets lack the requisite breadth and depth to absorb shocks from the global economy. The financial markets of both Brazil and Argentina are puny when compared to those of the USA. Even some neo-liberal economists now accept that it was the fragility of their financial markets that contributed to the financial collapse of some of the “Asian Tigers” – Malaysia, Thailand and South Korea.

Floating is even more hazardous for small countries with embryonic financial markets. External shocks requiring downward exchange rate adjustments can easily lead to overshooting and to serious undervaluation of the currency. (It is surprising that neo-liberal economists, who are highly vocal about the evils of an overvalued currency, are silent on the even greater disasters of massive undervaluations.)

In fact, even the USA does not conduct a perfectly free float. The monetary authorities of countries with highly developed financial markets are able to use market-oriented policy instruments to moderate and smooth out currency fluctuations. For example, the Federal Reserve Board may raise interest rates to attract capital inflows and reverse an undesired depreciation of the dollar – as little as ½ per cent might do the job! In extreme cases the monetary authorities of the USA, EU and Japan may, through concerted open market operations, bring about the desired exchange rate outcome.

Such policies are not available to the monetary authorities of Argentina or Brazil, whose fragile financial markets do not qualify them to play in the “Big League”. Countries with poorly developed financial markets therefore have no choice but to use non-market measures of intervention to assist their financial markets in coping with shocks from the global economy. That is why Chile has instituted reserve requirements on short-term capital inflows to protect its financial markets. Professor Gerry Helleiner has strongly urged the IMF,

to recognize capital account controls, direct and indirect, as legitimate macroeconomic policy instruments in most developing countries to deal with volatile capital flows.

Even Professor Ronald McKinnon, the author of “financial repression”, now concedes that the full liberalization of financial markets should be phased. He adds:

Free foreign convertibility on capital account is usually the last stage in the optimal order of economic liberalization ...

It is also instructive that those “Asian Tigers” who best weathered the Asian Crisis of the 1990s were those which practiced some measure of exchange rate management – Taiwan, Hong Kong, and Singapore. Also noteworthy is that these countries maintain very high levels of foreign exchange to serve as a buffer against shocks from the global environment. In June 2002, Taiwan, Hong Kong and Singapore held foreign exchange reserves of US\$155 billion, 112 billion, and 80 billion respectively, compared to US\$10 billion, 42 billion, and 15 billion for Argentina, Brazil, and Chile respectively. The Caricom experience has also demonstrated the importance of holding adequate levels of foreign exchange.

Chronic Market Disequilibrium

Exchange rate overshooting becomes extreme when foreign exchange markets enter a stage of chronic disequilibrium. Chronic disequilibrium describes the situation, such as in Guyana, Jamaica, and indeed Suriname, where the demand for foreign exchange so far outstrips the supply that the foreign exchange market does not clear, and is unlikely to do so in the foreseeable future. In such situations, as the Consultant has demonstrated in Central Banking in Theory and Practice: A Small State Perspective, repeated currency devaluations not only fail to bring the market into equilibrium, but worsen the situation.

Chart 1 represents classical market conditions. Note that a currency devaluation, represented by an upward movement in the price of foreign currency from P_1 to P_2 , brings supply and demand into equilibrium, and the disequilibrium defined by Q_1, S_1, S_2, Q_2 , (shaded area) disappears.

Chart II represents a market in a state of chronic disequilibrium. The supply function is realistically shown as a perfectly inelastic supply curve, so that an upward movement in price from P_1 to P_2 (which represents a devaluation) does not elicit an increase in the supply of foreign exchange. Note that the area of disequilibrium actually increases as P_1 moves higher to P_2 (i.e. devaluation occurs) so that market equilibrium is not attained, and the disequilibrium defined by Q_2, S_2, D_2, Q_2 , (shaded area) is larger than the shaded area Q_1, S_1, D_1, Q_2 . In conditions of chronic disequilibrium then, the equilibrium exchange rate is indeterminate, so that the adoption of a free float will most likely lead to further currency depreciation, without any

significant economic benefit, and with strong inflationary pressures, as the cases of Jamaica, Guyana and, indeed, Suriname have demonstrated.

The inelasticity of the supply curve is indicative of the extreme scarcity of foreign exchange; and for developing countries, which must import the vast proportion of their capital and intermediate goods, chronic shortage of foreign exchange imposes a severe constraint on production, leading to economic stagnation.

For these reasons, then, devaluations worsen the situation: first, market dysfunction hinders a devaluation from shifting resources away from the domestic to the external sector; secondly, low levels of productivity minimize the availability of resources for transfer, so that the export earnings forthcoming in textbook economics do not materialize; and thirdly, a devaluation alters the terms of trade to the disadvantage of the local producers since they cannot increase output to exploit the advantage of lower export prices.

In the short run, therefore, policy makers must seek second-best solutions to maintain some semblance of exchange rate stability through direct market intervention and rationing, even as they pursue medium - long term strategies of structural change. The strategies employed will depend on the peculiar circumstances of the country, the technical skills available, and the extent of public understanding and support.

Structural economic change, as Chart III demonstrates, will require the parametric shift of the demand curve to the left, possibly through foreign debt reduction and more economic usage of foreign exchange, and the parametric shift of the supply curve to the right through improved productivity; at the same time, confidence building

measures might help rotate the supply curve to the right as supply responds positively once again to increased price.

Dollarization

Several Surinamese businessmen have expressed a preference for dollarization. The Argentinean experience has demonstrated that although a currency board system rules out central bank financed government deficits, it does not close other sources of fiscal disequilibrium, such as excessive foreign or domestic borrowing. Nor does it provide a satisfactory mechanism for adjustment when the currencies of trading partners and foreign competitors depreciate against the dollar. Dollarization would have been even worse for Argentina because of the cost of exit: a decision to de-dollarize would set off an unstoppable flight of capital, producing even more severe financial and economic turmoil.

The arithmetic of dollarization is also disadvantageous. To dollarize, a country would first have to draw down foreign exchange reserves for purchasing US currency to replace domestic currency in circulation, worsening its foreign debt position.

Finally, dollarization flies in the face of development theory, which suggests the transfer of capital from rich to poor nations; dollarization represents an indefinite and interest-free loan from poor countries to the world's richest country. No wonder dollarization is to be found either in countries with a long history of dependence on the USA, such as Liberia and Panama, or those who see it as the only way out of a desperate economic situation, such as Ecuador and El Salvador. At any rate, a currency

board regime offers the same protections against central bank financed deficits --and the same rigidity, but with foreign exchange earnings from foreign reserves backing the currency, and with the availability of a less traumatic exit. The Washington international - financial institutions, interestingly enough, have never expressly endorsed dollarization!

DIAGRAM ONE

CONTINUUM OF EXCHANGE RATE REGIMES

EXCHANGE RATE REGIME	FREE FLOAT		MANAGED FLOAT		FIXED RATE	
					PEG	CURRENCY BOARD
					DOLLARIZATION	
COUNTRY TYPE	LARGE	MEDIUM	LARGE / MEDIUM	MEDIUM / SMALL	SMALL	MINI-STATE
QUALITY OF FINANCIAL MARKET	HIGHLY DEVELOPED		EMERGING		EMBRYONIC	INSIGNIFICANT
COUNTRY EXAMPLES	USA EU	UK CANADA SWEDEN	ARGENTINA BRAZIL MEXICO INDIA CHINA	HONG KONG SINGAPORE TAIWAN TRINIDAD & TOBAGO	BARBADOS NETHERLANDS ANTILLES THE BAHAMAS	BERMUDA CAYMAN ISLANDS

CHART ONE

AUTOMATIC MARKET ADJUSTMENT FOR FOREIGN EXCHANGE

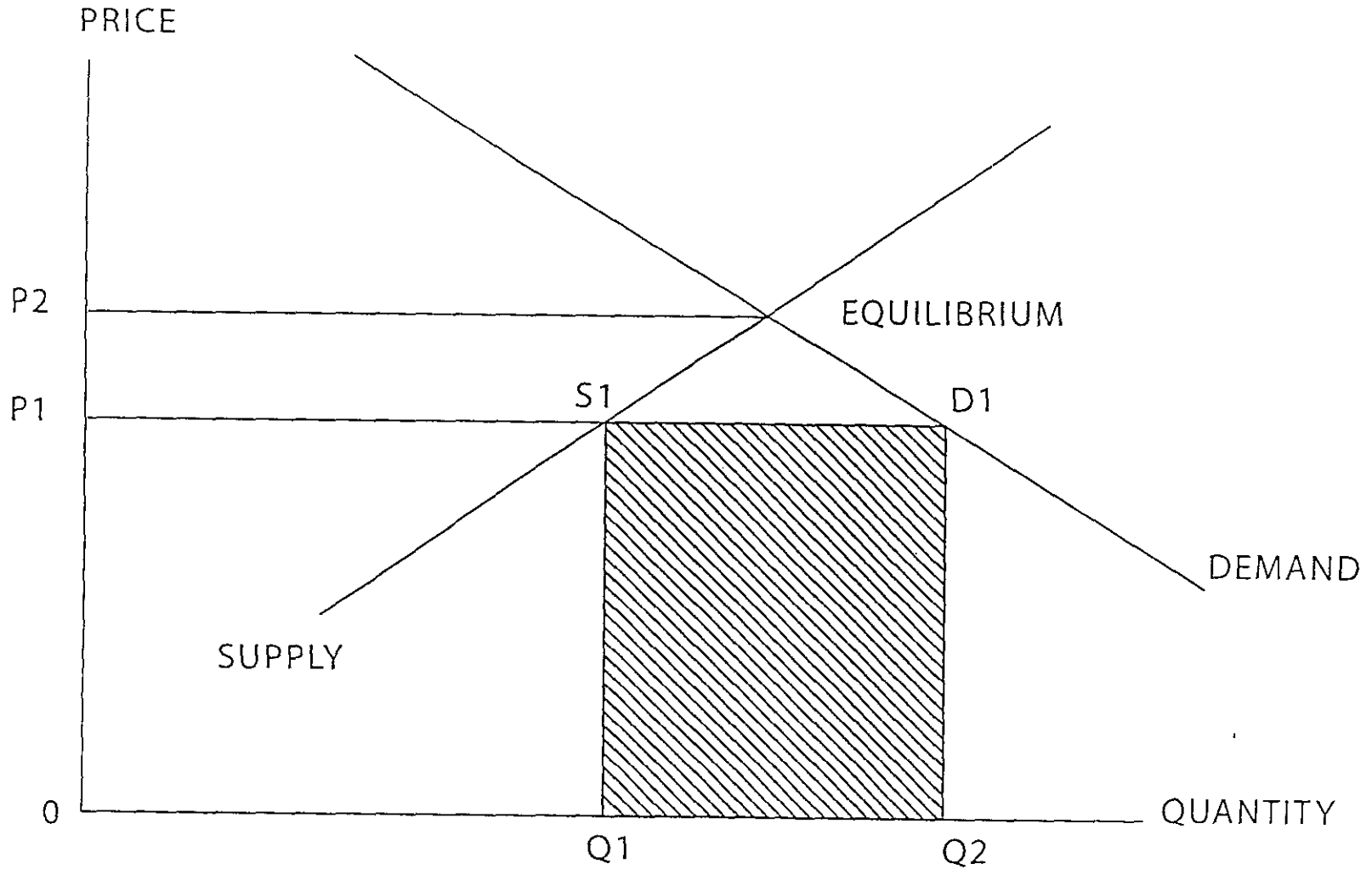


CHART TWO

CONDITIONS OF CHRONIC DISEQUILIBRIUM

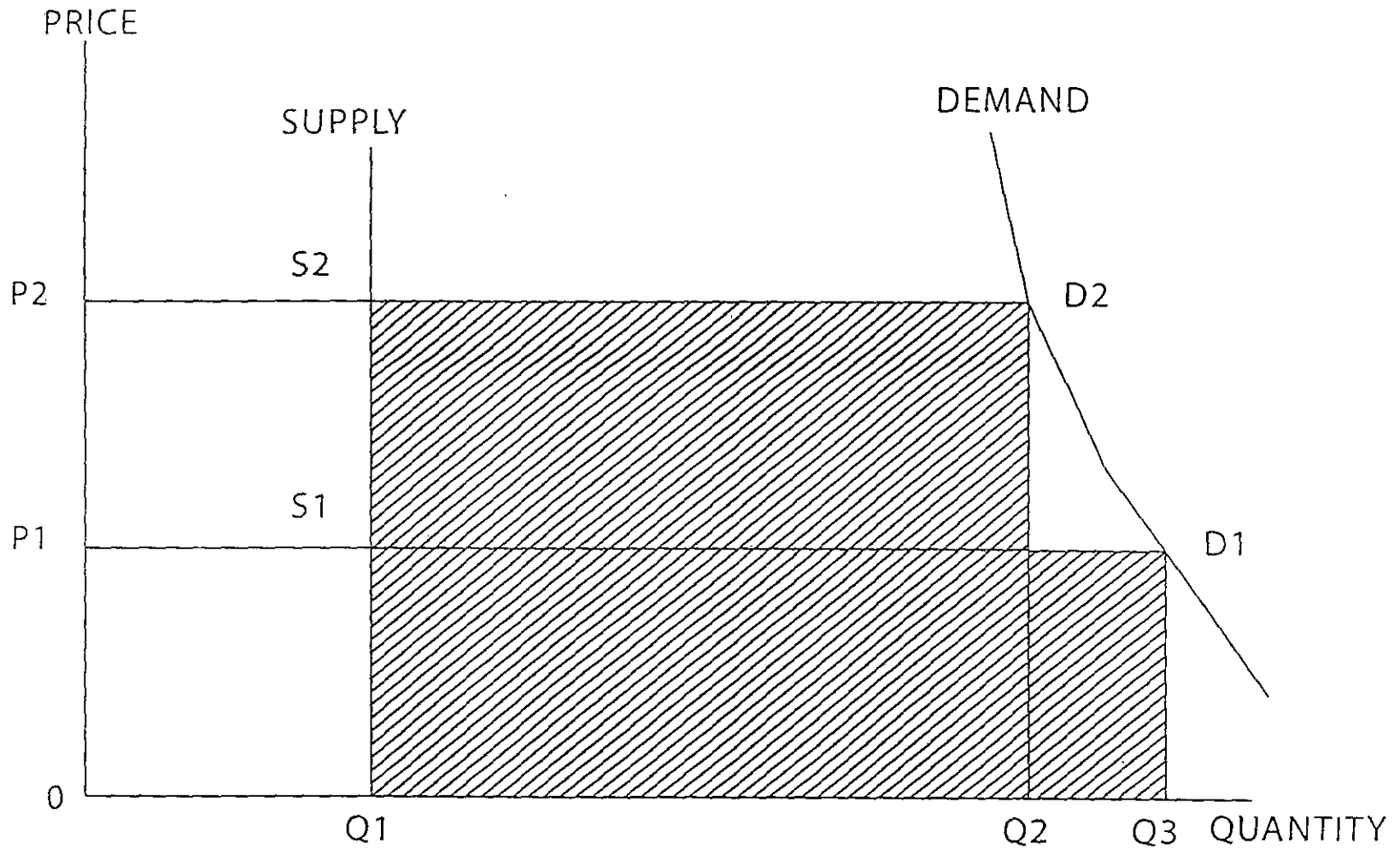


CHART THREE

POLICY REQUIREMENTS IN CONDITIONS OF CHRONIC DISEQUILIBRIUM

