SOME ISSUES OF ADJUSTMENT AND LIBERALISATION IN JAMAICA

by

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This paper raises some issues which emerged in our ongoing investigation of stabilisation and liberalisation policies in Jamaica. The set of measures which have been effected so far include devaluation, restructuring of the government budget, restructuring of the external debt, reduction of the number of items subject to price controls and to subsidies, as well as the removal of some restrictions on imports and changes in the tariff schedules. These are typical measures which are now generally aimed at adjusting the demand for and supply of foreign exchange. The mechanisms through which external and internal balance are expected to be restored are well known; so too are the mechanisms through which the reallocative shifts which will support these new relationships will occur. A basic assumption is that greater reliance on price mechanisms will enhance balance of payments management and internal price stability. It is also assumed that the measures which are aimed at export promotion will yield additional foreign exchange earnings, and that the growth of exports will be associated with a higher level of capital inflows. In addition, there is also the aim of a reduction of the size of the public sector. This is not necessarily a different aim from that of increased competition through a greater reliance on price mechanisms, in so far as it is assumed, and may well be the case, that public sector activity is to be associated with price intervention. Further, since domestic inflation could be associated with the growth of the government deficit, a reduction in the deficit was a necessary aspect of the aim of reducing the rate of inflation.

The issues which we raise concern the prospects for an export promotion strategy; the role of the government sector; the implications of the structure of the capital account of the balance of payments, and the role of the informal sector and the dual foreign exchange market. Our basic propositions are that the basis for a switch to an export promotion strategy, as this is commonly understood does not exist, given the continuing shortage of foreign exchange, and the fact that imports cannot be liberalised; that the current official perception of the role of government is not in the short to medium term at least, compatible with the aim of a higher level of capital inflows; that while the illegal market in foreign exchange helps to maintain economic activity, ease import shortages and maintains earnings and employment especially in the formal sector, that system has produced a bias towards distribution and against production. We discuss each of these in turn.

Some results of our investigation into relative price changes and wage changes under adjustment, were presented last year at the meeting in Trinidad. Those results indicated that there was on balance a shift in profitability towards the export sectors, and that that shift was associated with relative price changes and real wage reductions. We found however that the shifts were concentrated in the traditional export sectors, of mining and export agriculture, and also in distribution. We concluded on that basis, that export prospects in the short and medium term were poor. In fact, export sector recovery and expansion have been weak. Further, the response of induced capital inflows and induced domestic investment have also been weak. This could be partly explained by underutilization of capacity, and also by differing rates of contraction and expansion in the various industries which have different capital-labour ratios. Nevertheless, those results also indicated that the policy bias towards import substitution has not in fact been replaced by a policy bias towards export promotion in the manufacturing industries. It is likely that the possible effects of the exchange rate change have been counteracted by the structure of incentives to import-substituting industries which have been maintained in spite of the aim to switch to an export promotion strategy.

Import-substitution policies which were initiated in Jamaica in the 1950s, and which were consolidated and extended in the 1960s derive from a variety of incentives. These reduce the domestic prices of imported capital goods and raw materials to domestic producers, increase profits through generous tax holidays and depreciation allowances. In addition, for some commodities, the domestic market was secured through the granting of monopoly status or the restriction of competing imports. There was nevertheless a greater reliance on tax and other incentives. Only recently, in the 1970s, was there widespread use of quantitative restrictions in response to the deteriorating external position.

It is worth noting that when the incentive structure was established, the stated aim of policy was to encourage exports of manufactured goods. Import-substitution based on imported inputs developed bacause the set of incentives taken as a whole supported that development

So far, liberalisation and export promotion measures involve the removal of some recent restrictions on imports; the easing of licencing requirements and the removal of some commodities from the licencing requirements. There remain, however, restricted or banned commodities of all classes, which cover a wide range of manufacturing activity. Additional incentives to exports include special facilities which are offered through the Export Development Fund and the Jamaica Export Insurance Corporation, as well as the facilities for some exporters to hold external accounts.

In effect, the removal of some elements of restriction, and the simplification of the system of licencing have not had a noticeable effect on the bias towards import-substitution. The bias is maintained by the complex system of incentives to production for the domestic market and the continuing need to ration the use of foreign exchange. The maintenance of the system of incentives is not consistent with the aim to stimulate exports through changes in the exchange rate. However, even if the system of incentives is dismantled, the continued shortage of foreign exchange would limit import liberalisation, and the switch to export promotion. The switch of an import dependent manufacturing sector to an export promotion strategy is not possible under conditions of foreign exchange scarcity.

Having said that, I would nevertheless argue that the distinction between export promotion and import substitution strategies in manufacturing may be overdrawn in the case of Jamaica. It is not at all clear that for an export dominated economy, the gains from earning additional foreign exchange from manufac turing sector exports outweigh the gains from saving foreign exchange through production for the domestic market. One argument for export promotion in manufacturing derives from the observation that countries with rapidly growing export manufacturing sectors, withstood the external pressures of the 1970s, better than those without. However, there is the possibility that the resilience was in part related to a relatively higher degree of domestic sector integration, and with that, a lower degree of dependence of the manufacturing industries on imports, than is currently the case in Jamaica. Another argument for export promotion concerns scale effects. Here, the question is whether the incentive system supports a commodity output structure and production techniques including capital-labour ratios which require minimum plant sizes which would not otherwise be optimal in these small labour surplus economies.

The difficulty arises not so much from whether or not to export, but because the institutional structures which now supports the manufacturing sector, promote inefficiencies in the use of foreign exchange, and in the allocation of resources. In particular, the subsidies on imported raw materials and capital goods, which are allowed to the organised manufacturing sector, are an aspect of resource mis-allocation, not between exports and domestic output, but between the organised manufacturing sector, and others such as agriculture and the informal small scale producing sector. The argument put forward in this connection is that the subsidies to capital in organised manufacturing promotes capital market segmentation and reduces the capital available to other sectors. In effect, there is a case for a detailed examination of the effects of the structure and extent of manufacturing sector protection on output, and employment in other sectors.

Another observation which we raise for discussion concerns investment and the structure of the capital account of the balance of payments. Unless long term capital inflows can be re-activated, the disequilibria which mark transition to recovery and growth will continue.

Until the late 1960s, private long term inflows were maintained at a level which allowed external balance. The slowing down in these flows is associated with the course of events in the traditional export sectors, especially mining, but also in tourism and in the new manufacturing sector. Those changes in the capital account and the effect on domestic investment were among the factors which influenced the nature of increasing government participation in economic activity. The reversal on the external capital account which is associated with the crisis of the 1970s occurred in the context of a general slowing down in the traditional long term private inflows. Undoubtedly, that reversal reflected a loss of confidence in the government's policies at the time. However, one aspect of that was the acceleration of the rate of those outflows which would have occurred in any event, although over a longer time period. It is not to be expected that such flows will return. Unless new sources are initiated, a return to the previous structure and level of private inflows is unlikely. Further, what is required is not a return to the trends of the late 1960s, but to the trends of the period between the early 1950s and the mid 1960s. However, in the current domestic and international climate, private autonomous inflows have not been substantial. It is usual in such a situation for official flows and public sector activity to fill the gap. The public sector joint ventures of the 1960s offer an example. These were a means of maintaining the necessary capital inflows, and the level of economic activity.

The issue now is whether, and to what extent a reliance on official inflows, whether these take the form of direct or guaranteed debt, is compatible with the reduced role of government.

Much attention has been given to the need to reduce government's expenditures, the government deficit, and the total scope of government economic activity. There is little doubt that the government was itself a contributor to the crisis of the 1970s. Yet it can be argued that the difficulty resulted in part from the structure of expenditures, and the imbalance between the structure of the sources of revenue and the structure of expenditures. First, government expenditures reflected consumption rather than investment. Transfers through the government budget raised consumption levels, and contributed to domestic price increases, but did not induce private investment. Second, these increases in consumption were financed in part through government short term borrowing abroad. Third, a substantial proportion of government's expenditure on capital account represented asset transfer.

Nevertheless, the sharp reductions in government activity and in debt inflows to government which are envisaged, are likely to have untoward consequences for economic activity. Inflows through the public sector financed not only consumption, but imported inputs, which are necessary to maintain capacity utilisation and production. In addition, when debt is reduced the import demands which were stimulated during the period of rising debt are not similarly reduced, so that there is excess demand which can contribute to inflationary pressures.

It would seem therefore that the need is for a greater emphasis on the appropriate changes in the structure of the government budget, rather than an emphasis on the size of the budget and the scope of government activity. Government induced inflows and government investment activity, even if this is direct, should not be automatically excluded in the current economic situation, where private inflows and private investment continue to be sluggish. The granting of that traditional role to government has implications for the rate at which the government deficit is reduced. In the transition and until the capital account of the balance of payments shows greater stability and somewhat higher levels of net inflows, a slower rate of reduction of the government's expenditures can help to maintain domestic activity. The assumptions are that the government can in fact induce medium to long term inflows, and that these can be directed towards raising the level of investment and output.

The existing economic structure as well as the historical and present trends in the capital account of the balance of payments suggest that limitations on government's role and on the over-all function of the government budget may hinder adjustment in the short to medium term.

Another set of issues which we wish to raise concern the informal sector. This covers a wide range of activities including agriculture and non-agricultural goods, personal services, repair, distribution, transportation and other services, as well as the sale and purchase of foreign exchange. Because there is still so little information on these activities, the observations are only tentative. What is known about the sector, however, suggests that the issues which arise from the nature of the growth of the sector are pertinent to the current attempts to stabilise the economy. The paradox presented by the informal sector is that while its characteristics are often said to limit the applicability of orthodoxy, its inherent flexibility may well enhance the positive effects of the orthodox adjustment measures.

The informal sector has traditionally served as a means of maintaining incomes in one part of the economy, especially during periods of recession. The activities fluctuate in size and composition in response to events in other areas of the economy. These compensatory fluctuations were however regarded as having only a limited effect on the rest of the economy. Until recently, these activities had little access to official sources of foreign exchange, and no access to the import allowances available to the organised manufacturing sector. Unincorporated enterprises are in any event not eligible for many of the benefits of the various incentive schemes. Informal sector activities were domestic based activities, with little import content and no export markets.

These activities have recently gained access to foreign exchange, although not to allowances on raw material and capital goods imports, through the official sanction of the illegal market in foreign exchange. The sector appears to be showing a degree of flexibility in finding external markets and supply sources. Up to now these activities have helped to reduce excess demand and have cushioned the effects of a decline in activity in wage earning sectors. The recent growth of the sector is nevertheless associated with a marked bias towards distribution and especially the distribution of imported goods.

One question is what is the nature of the relation between the supply of foreign exchange on the illegal market and the supply on the official market? Does the use of the illegal market and the growth and profitability of these distributive activities which use this market reduce the potential supply available on the legal market. This would occur if foreign exchange which would otherwise be available through the legal market is diverted to the illegal market. This is likely in a situation of foreign exchange and trade controls in the legal market and greater profitability in the illegal market.

One difficulty here is that the size structure and functioning of the informal sector activities have not so far been the subject of detailed analysis. It is not clear what is the impact of this sector on production, foreign exchange availability and use, as well as on the ability of the authorities to manage the money supply. Do activities on the illegal market which functions outside of the control of the monetary authorities affect exchange rate expectations on the official market? Does the market invalidate the purpose of continuing exchange and trade controls?

These issues which we raise here suggest that there are inconsistencies in the stabilisation and liberalisation programme. They also suggest that foreign exchange uncertainty and a slow recovery of capital inflows and therefore of domestic investment, are likely to continue. In effect, in the absence of a windfall which raises the available flow of foreign exchange, the basic strains are ever present. These are continuing high levels of unemployment and slow investment and output growth.