

THE EXCHANGE RATE AND ECONOMIC DEVELOPMENT : A CARICOM  
PERSPECTIVE

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THE EXCHANGE RATE:  
AN IMPORTANT POLICY TOOL FOR THE CARIBBEAN

INTRODUCTION

In response to both immediate and predictable long-term balance-of-payments problems, the Caribbean countries with independent central banks have relied by and large on expenditure-switching devices. With their severe unemployment problems, the reluctance to deploy expenditure-reducing policies is understandable. However, while switching devices such as tariffs, import restrictions and exchange controls have been used as a matter of course, the exchange rate as a policy tool has been resorted to only sparingly and under exceptional circumstances. Furthermore, article 43 of the treaty creating the Caribbean Common Market, by accepting the goal of exchange rate stability between member currencies, suggests that in future exchange rate changes with respect to extra-regional currencies may be less frequent than in the past, while an agreed-upon set of regional parities is maintained indefinitely.<sup>1</sup>

A number of explanations can be advanced for the unwillingness of the Caribbean states to utilise the exchange rate to complement or substitute for the other, seemingly more acceptable, switching devices. The first of these explanations is concerned with the severity of the balance-of-payments problems facing Guyana, Jamaica and Trinidad and Tobago. Each country has increased its reserves while financing larger and larger current account deficits. If this is considered a healthy state of affairs then each country is likely to see little need for using the exchange rate, a tool which has come to be associated with severe balance-of-payments problems. Instead, trade restrictions and tariffs are used mainly as protective rather than adjustment devices while exchange controls, intended for balance-of-payments reasons, provide a check on capital outflows.

The second set of explanations is concerned with the belief that alternative switching devices are superior to exchange rate changes. The tariff, besides producing revenue, has the merit

of being specific which makes it possible to exempt such items as food, capital goods, raw materials and at the same time allows the imposition of high and variable rates of tax on commodities considered less essential. In effect, tariffs permit a country to have a different exchange rate for each commodity. Bans, quotas and controls are often preferred to both tariffs and exchange rate changes because they have an immediate impact on the economy and, like tariffs, they are specific. Furthermore, with quantitative restrictions on major items the effect on the balance-of-payments, at least on the import side, is planned and known with a fair degree of certainty. On the other hand, with price changes induced by tariffs or the exchange rate, estimates of the effects are often difficult to prepare and are, in any case, subject to significant errors. Perhaps a further advantage offered by changes in tariffs and quantitative restrictions is their greater acceptability by the public, partly because such policies do not represent departures from existing practices.

Thirdly, the reluctance to use the exchange rate may be due to a fear of its adverse effects on wages, prices, and capital movements as well as of its lack of effectiveness in promoting the sale of the kind of goods that less developed countries produce. Devaluation is supposed to make domestically produced goods relatively cheaper but if the import content of domestic goods is high and/or if wages respond quickly to the devaluation then the relative price advantage will be reduced, thus wiping out some of the gains from the devaluation while unleashing inflationary forces in the economy. In the Caribbean, where the import content of the domestic market basket as well as of domestically produced manufactured goods is high and where the labour unions are strong, a country which devalues is likely to fear its susceptibility to such inflationary erosion. On the export side, the supposed beneficial effects of a devaluation will depend upon (a) the price-elasticity of the supply of exports, (b) the extent to which domestic demand for the export goods rises and (c) the

extent to which the costs of production rise. It may be argued that due to the likelihood of one or all of these factors being unfavourable in less developed countries, the export promotion advantages to be derived from exchange rate changes will not be large. Finally, a devaluation may generate expectations of a further devaluation which, in turn, may have adverse effects on capital flows as both foreigners and residents perceive an exchange risk in holding the currency of the devaluing country.

The fourth set of explanations is concerned with the benefits of unified exchange rates between members of a common market, benefits which may be lost if each country were allowed to change its exchange rate at will. A fixed and unchanging rate of exchange between two countries will simplify all transactions involving foreign exchange, thus facilitating trade between member countries. Exchange rate unification is thought to be particularly important in reducing the risk involved in investment in common-market-based industries. The argument here is that if a member country is allowed to devalue, this is tantamount to a subsidy on its exports and a tariff on its imports which would create disruption in the competing industries in partner states.<sup>2</sup> It is further argued that a consequence of exchange rate unification will be a greater mobility of money capital and by implication physical and human capital, permitting the union as a whole to move closer to the frontier of its production possibility curve. It is possible to also argue that the stability of a currency is in part a function of the magnitude of hard foreign exchange holdings (gold included) that the country issuing the currency holds. In a situation where the reserves are pooled, these stability gains may accrue if the currencies of the states are freely convertible with each other and if their policies with respect to other foreign currencies are jointly formulated to be uniform. In this case, the rest of the world may use the sum of their foreign exchange assets in appraising the stability of their currencies, making each currency more stable than it would otherwise be.

The primary purpose of this paper is to argue that despite these considerations policy-makers have underestimated the usefulness of unilateral exchange rate changes in restoring balance and also in promoting integration.

#### THE DEFICIT

The question of where to draw the line to determine a surplus or deficit in the balance-of-payments has been widely discussed. Although no consensus exists, the view seems to be that the line should be drawn somewhere between current account plus long-term private capital and current account plus all capital transactions. It is our contention, however, that in a small developing country a deficit should "consist in an excess of real expenditure over real income".<sup>3</sup> Thus the correction of a deficit requires real national income (output) and real national expenditure to be brought into equality. Viewed in this fashion a balance-of-payments surplus or deficit must be primarily a current account appraisal, especially when the appraisal is to run over accounts for several years. This is not to argue that capital transactions are unimportant. On the contrary, it is obvious that without the borrowing of capital, both private and official, deficits on current account cannot be sustained. However, for a small country to expect capital inflows to continue to bridge the gap between output and expenditures for a long period of time is unrealistic.

Table 1 below reveals the current account deficits for Jamaica, Trinidad and Guyana. Jamaica has shown a current account deficit for every year since 1966. Except for the year 1968 Trinidad has also shown current account deficits throughout the period. The size of the deficit in 1972 for both Jamaica and Trinidad was five times as large as in 1966, indicating the rapid rate at which the situation was worsening. Although Guyana also showed a current account deficit for each year, the size of the deficit was smaller in 1972 than in 1966.

In deciding whether or not exchange rate variation should be a part of the regular box of tools used to foster expenditure

Table 1

Deficit on Current Account

	JAMAICA Million C.\$	TRINIDAD Millions TT \$	GUYANA Millions Guy.\$
1966	\$ 30.1	\$ 62.4	\$ 41.0
67	50.6	25.0	40.5
68	86.2	-32.6	23.0
69	103.0	38.4	21.0
70	127.2	141.1	38.6
71	143.1	256.1	11.4
72	157.6	309.7	18.0

Sources: Statistical Abstract--Jamaica  
Statistical Digest--Trinidad  
Bank of Guyana Annual Reports

switching it is important first of all to identify the nature of the deficit or surplus. A "stock" deficit derives from decisions to alter the composition of the community's assets by substituting foreign securities or goods for domestic securities or assets. A "flow" deficit arises from spending in excess of receipts. A "stock" deficit is normally not continuous and strong specific controls are generally used to stop the substitution while society tries to change the conditions that led to the stock deficit.<sup>4</sup> A closer examination of the details behind Table 1 reveals that categories like food imports and non-durables account for significant portions of the imports. This would indicate that the spending in excess of receipts is part of the "normal" flow of trade and does not represent decisions to alter the composition of the community's assets. Each deficit, in other words, is a "flow" deficit. A primarily "flow" deficit is not corrected by, for example, the kind of restrictive measures on capital movements recently imposed in Jamaica but requires significant expenditure switching. As we argue below, this expenditure switching should, in the first instance, be across the board and secondly, be supported where necessary by specific measures to restrict the inflow and encourage the exports of particular commodities.

That the successive current account deficits shown in Table 1 were "flow" deficits and pointed to the need to introduce

deficit combating policies cannot, we think, be denied. It is instructive, however, to note that the formal identification of a surplus or a deficit in the Caribbean Community countries appears to follow the official settlements balance position. The Bank of Jamaica, for example, despite steady increases in Current Account Deficits, could state that "the Balance of Payments for 1970 indicate(d) an overall surplus of J \$20.9m."<sup>5</sup> because Jamaica's cash reserves increased in 1970. Furthermore, the implications of the following Bank of Jamaica statement-- "1971 was a good year for Jamaica's overall balance of Payments"--<sup>6</sup> and the timing of policy decisions designed to effect changes in the Balance of Payments suggest that the official settlements Balance view is used as the policy guide. We suspect that the reluctance to use exchange rate variation with any degree of regularity to combat deficits in the Balance of Payments rests in part on this official settlements view which suggests that Jamaica, Trinidad and Guyana have been experiencing periodic surpluses and deficits rather than on-going deficits.

The concept of an increase in foreign exchange reserves as indicative of a balance of payments surplus derives from a purely cash flow approach where such increases, whether obtained through asset or liability transactions, are termed a surplus, signifying that a country's holdings of "international cash" have increased. The misleading implications of this view are highlighted when it is realised that a surplus may be obtained by government borrowing to stave off a balance-of-payments crisis if the borrowing in a particular year exceeds the deficit sum of current account plus private capital.

For Trinidad, the oil bonanza has for the time being made irrelevant much of this discussion on methods of dealing with balance-of-payments problems. The increased oil revenues should produce a dramatic turn around in Trinidad's balance on current account. But for countries like Jamaica, the increases in the price of oil have caught them in balance-of-payments situations which were already deteriorating. Table 1 pointed to Jamaica's

on-going "flow" deficit with the gap between imports and exports growing wider each year. Further evidence of this already increasing deficit dependency is provided by the ratio of net goods and services to G.D.P.

Table 2

Millions of J \$

Year	GDP	Net Goods & Services	NGS/GDP%
1969	868.6	114.9	13.2
70	974.8	145.4	14.9
71	1061.2	159.6	15.0
72	1157.6	160.2	16.1

Source: Adapted from Statistical Abstract, 1972.

This ratio is a rough measure of Jamaica's relative dependency on foreign goods and services. Its growth indicated that the imbalance in her payments position was increasing. The implication of Tables 1 and 2 is that for Jamaica the deficit was both on-going and growing in magnitude relative to the growth of the economy even before the advent of the oil crisis. The oil crisis has greatly exacerbated the rate of deterioration and forced the government to undertake rationing devices as well as measures to recall privately owned foreign assets in order to protect or enhance the Central Bank's liquidity position.

#### THE EXCHANGE RATE

The case for the exchange rate over other switching devices is based primarily on its effects on the export-producing sector and secondarily on both the costs associated with long-term quantitative measures. The case is stronger for a non-planned economy with skill shortages than for an economy with detailed planning and an abundant supply of skilled manpower. This does not mean, however, that the exchange rate is the correct tool for every type of balance-of-payments problem; nor does its use preclude the deployment of other devices.

A view that is currently popular in the Caribbean is that foreign exchange is a national resource to be carefully husbanded. If, however, one's currency is generally overvalued the effect of the overvaluation is similar to a tax on exports. In the local



currency the exporter receives less dollars than he would have received had the currency been appropriately devalued. Taxing exports that earn foreign exchange hardly seems a rational policy for countries that perennially run deficits on current account. The implication of this reluctance to use exchange rate variation as a policy tool is highlighted by the current inability of countries like Jamaica to produce agricultural products so, as to obtain the gains from the present increase in world prices for primary products. The long period of low prices discouraged production and inhibited the desire to increase export sales. In the period 1964-1970 for example, the average price of Jamaica's main agricultural exports increased only minimally.

Table 3

Average Price of Jamaica's Exports

	Sugar (per ton)	Rum (per ton)	Molasses (per ton)	Bananas (per ton)	Pimento (per ton)
1964	\$ 94.00	\$ 1.64	\$ 17.24	\$ 65.32	\$ .52
65	73.66	2.20	9.20	61.16	.58
66	81.44	1.35	11.20	63.30	.62
67	85.62	1.08	21.18	68.98	.62
68	88.82	1.82	20.52	90.08	.66
69	94.92	1.12	18.17	82.60	.58
70	97.02	1.13	17.08	88.12	.64
71	100.41	1.35	16.39	93.15	.71
72	122.58	1.82	16.90	97.37	.71

Source: Bank of Jamaica, Balance of Payments of Jamaica, 1971 & 1972.

Without in anyway bypassing the argument that steps should have been taken to obtain better overseas prices for these commodities it should have been obvious that an increase in foreign exchange earnings was necessary and that if the currency was overvalued the exporter was being encouraged not to produce. The disincentive to export is further demonstrated by the fall in the volume of exports over the period which resulted in Jamaica on occasion not being able to fulfill her "quota" let alone try to expand the volume of her exports. The disincentive effects of the implicit tax on exports is even more serious when it is realised that the high rates of unemployment in the Caribbean mean that it

Table 4

Volume of Selected Exports: Jamaica

	Sugar tons (000)	Rum gals(000)	Molasses tons (000)	Bananas tons (000)	Pimento lbs (000)
1966	408	2363	143	200	5291
67	535	2942	120	190	4267
68	383	975	145	153	5030
69	294	1926	133	151	7225
70	303	1584	126	134	4926
71	299	1791	106	126	4203
72	276	1577	68	127	4551

Source: Balance of Payments of Jamaica, Bank of Jamaica, 1970 & 1972.

is highly desirable that the export industries that are developed have a high labour content in the value of their output. Jamaica's agricultural exports clearly satisfy this criterion.

The above discussion on exports has focused on the agricultural sector but if the goal of industrial diversification is to be achieved then manufactured exports must also increase. The supposed lower wage rates in Jamaica and other Caricom countries should permit them to compete with the developed countries even when faced with lower productivity and transportation costs for certain inputs. However, wage rates have been growing rapidly as Table 5 below shows in the case of Jamaica.

Table 5

Average Wage Increases in Percentages: Jamaica

	1968	1969	1970	1971	1972
Manufacturing	12.7	13.1	18.1	18.4	17.6
Commerce	9.9	13.4	19.8	14.8	15.9

Source: Bank of Jamaica, Annual Reports.

These wage increases reflect a number of underlying forces in the economy. For our purposes, however, it is sufficient to note that the pressure on wages in the Caribbean due in part to the existence of powerful unions and the gross inequities in income distribution will continue and, if anything, is likely to escalate. These wage increases in the face of a reluctance to vary the exchange rates have eroded and will continue to erode our ability to export our labour surplus embodied in our export products.

Before discussing the question of general versus specific expenditure switching it is perhaps important to dismiss the oft-repeated argument that devaluation cannot help the Caribbean. The argument on the export side is as follows. Exports are determined largely by agreement and the price to the foreigner is fixed in its foreign currency value. A devaluation will therefore affect neither the agreement nor the price the foreigner pays. On the import side it is argued that the imports are necessities and therefore a devaluation will serve merely to increase prices. In other words, the argument as stated would leave receipts and expenditures in foreign exchange unchanged because the quantities bought from and sold to foreigners are not expected to change. It is, however, more accurate to think of the demand for Caribbean exports as being infinitely elastic over the relevant range; that is, at the prevailing price small countries like Jamaica can increase their sales overseas with no decline in the price of exports. The fact that they cannot fill their quotas demonstrates that it is safe to assume that at the prevailing price they can increase sales. It is clear, therefore, that if the quantity available for export responds to a devaluation then the balance of payments must improve as long as import and export prices in foreign currency are independent of the devaluation and even if the demand for imports does not fall.

The crucial empirical question is whether the supply of exports will respond to price increases. The evidence in Tables 3 and 4 suggests that when export prices remain stable while other prices are rising, quantity supplied falls which in effect means that the supply curve is positively sloped in the range of relative prices obtaining over the past several years. If the supply curve does have some elasticity then the use of price devices to encourage exports cannot be denied given that the demand curve for these exports is infinitely elastic. Obviously the supply curve is likely to become completely unelastic at some stage as all available manpower and land is used up but in the lower ranges the implication

for balance-of-payments purposes of an elastic supply curve is that there must be an exchange rate which provides sufficient foreign exchange receipts to meet a given import bill. One objection that can be raised against the argument made above is that a devaluation affects all domestic prices so there is no guarantee that it will raise the relative price available to the exporter. However, our argument is valid so long as the increase in the price paid to the exporter is greater than the increase in the general level of prices. Turning this argument around, however, points to the superiority of the exchange rate over the generally accepted switching devices. To the extent that tariffs, quotas and bans raise domestic prices they lower the relative price paid to the exporter while with an exchange rate change the worst that can happen is that the relative price paid to the exporter remains the same.

In addition to their effect on exports, devices that work primarily on the import side have a number of other disadvantages, the major one of which is their possible employment-reducing effect. The Caribbean countries have successfully encouraged the establishment of a number of import-substituting industries. Most of these industries have a high import content in that in order to operate they must obtain raw materials, capital goods and spare parts from abroad. Regardless of whether such industries are exempted, the initial impact of large-scale quantitative restrictions on imports is likely to be uncertainty on the part of all importers. If, as a result of this, inventories of productive materials are run down and orders for future needs are not placed, the measures would have an employment-reducing effect. If the measures cause delays and shortages of necessary items on a continuing basis the employment in import-substituting industries is almost certain to fall. The major benefit to be derived from a long-term strategy based on the use of tariffs to promote import substitutes is unlikely to be a large reduction in future foreign exchange expenditures because of the high import content of such industries. Clearly, such industries have important employment effects but from the balance-of-payments point of view create problems. If it is necessary to impose high tariffs on a

number of intermediate goods, then one must hope that the new rates will not be effective in reducing quantities bought because this would tend to signify a fall in employment if domestic substitutes are not available.

We have stressed that the expenditure switching policy of exchange rate variation cannot be ruled out. It should also be stressed that at the broad macro level it matters not whether expenditure switching is obtained by exchange rate variation or by specific tariffs, quotas and bans. This point is better appreciated by formally defining the balance as  $B = Y - E$  where  $Y$  is real incomes and  $E$  real expenditure. If  $E > Y$  a deficit exists and the impact on the deficit from changing  $E$  is independent at the macro level of the measures used to change  $E$ . This is not of course to say that there are not significant differences stemming from the particular measures used to affect  $E$ .

The first and most obvious difference is at the income distribution level. We recognise that the more general impact of exchange rate devaluation makes it inevitable that one of its immediate first round effects is to cause price increases on imported items important to the low income earners of the society. Similarly a devaluation will benefit both workers and owners in export industries. That tariffs, bans, exchange control and quotas have income distribution effects is, however, also obvious but if one wishes to insulate a particular product from these effects, one need not impose the control on that product. With devaluation, however, it is also possible to insulate the product by granting a subsidy. In any event, the need to move toward a more equitable distribution is of such importance and so difficult that specific policies designed to narrow the income differences are necessary.

The belief that general price increases naturally stem from a devaluation in open economies like Jamaica is widespread and largely true. What is not readily appreciated, however, is that all other expenditure switching policies also either generate

inflation or spawn long queues and black markets.

The evidence above suggests the need for an on-going realignment of the rates of exchange. Both Guyana and Jamaica have in the recent past used the exchange rate tool. However, the forces generating the need for exchange rate realignments--wage rate increases, sluggish export prices, etc.--are of a structural nature, making an on-going realignment necessary. The generality of the exchange rate tool should be viewed as an advantage especially in the Caribbean because it does not require difficult rationing devices necessary for quantitative restrictions or detailed commodity-by-commodity calculations necessary for the imposition of tariffs.

#### EXCHANGE RATE VARIATION AND THE CARIBBEAN COMMUNITY<sup>7</sup>

The arguments thus far have been primarily with reference to the need for adopting a positive exchange rate strategy with respect to the rest of the world. As discussed in the introduction, however, there is also the question of exchange rate strategy within the Caribbean Community.

This question is probably being avoided currently as while Article 43 speaks of the goal of maintaining fixed or relatively fixed parity between regional currencies the reality is that with the Jamaican dollar tied to the U.S. dollar and the other currencies to sterling the goal of a fixed parity is daily, if not hourly, being violated. Exchange rate strategy for a Common Market is a difficult problem, however, and as outlined in the introduction many benefits are supposed to flow from exchange rate unification.

As we appraise the advantages which flow from the adoption of exchange rate unification, it is important to distinguish between advantages that accrue from convertibility and advantages that accrue from a fixed and unchanging rate of exchange between the currencies.

The increase in the flow of trade, the greater mobility of factors of production and the added stability of each of the currencies are made possible by a significant degree of convertibility. A decline in convertibility or the introduction of exchange

control invariably means an increase in bureaucratic red tape coupled with a limitation or an outright ban on certain transactions. In the event then of exchange limitations being imposed, the flow of trade and the mobility of factors arguments are no longer strong. The supposed stability gains are also wiped out since without convertibility the separate currencies of the region will of necessity be viewed as independent units. Finally, if exchange rate unification introduces the possibility of exchange and quantitative restrictions affecting member countries, the risks involved in investment in industries designed to serve the Caricom market may well be increased, thus negating any advantages that are derived from maintaining a fixed relationship between the exchange rates.

Proponents of stable or unified exchange rates recognise the dangers of quantitative restrictions on goods produced within the union and of exchange controls but they argue that the likelihood of such measures being introduced is very low because a common market treaty usually ensures current account convertibility, bans quantitative restrictions on regional trade and permits capital account convertibility under all but the most abnormal circumstances. In other words, in the face of a balance-of-payments disequilibrium a member country would resort to alternative measures in order to restore external balance. It is worth noting that the treaty establishing the Caribbean Common Market guarantees current account convertibility and freedom of payments on capital transactions "necessary to further the objectives of the common market". Furthermore, it bans quantitative restrictions on the import of goods of common market origin unless such restrictions are necessary for balance of payments reasons.<sup>8</sup>

The legalistic argument presented in the last paragraph needs to be considered in an economic setting. Maintaining a significant degree of convertibility at unchanged exchange rates requires that the overall price levels in the member countries do not diverge significantly from each other. This is unlikely,

however, as both internal and external forces operate differently in the respective CariCom countries. If the differences persist and grow, CariCom countries will be in serious imbalance with respect to each other.

Table 6

	Consumer Prices ( 1964 = 100)		
	Jamaica	Trinidad & Tobago	Guyana
1965	104.8	102.6	103.0
66	106.8	106.8	105.1
67	110.0	109.1	108.3
68	116.5	118.0	111.6
69	123.8	121.0	113.1
70	135.9	124.1	116.9
71	144.9	128.4	119.3
72	150.3 <sup>(a)</sup>	140.7 <sup>(a)</sup>	122.3 <sup>(a)</sup>

(a) second quarter

Source: International Financial Statistics, I.M.F., Nov.1972

The table above points to significant differences in the rates of change of consumer prices among Guyana, Trinidad and Jamaica. If these differences continue to grow and no exchange rate adjustments were permitted a serious imbalance could develop. This problem is further complicated within CariCom by the overall importance to some countries of trade with partner countries. In Barbados, for example, exports to CariCom countries in 1970 constituted over 20% of the total exports of Barbados. Trinidad on the other hand, as revealed in the table below, has a growing surplus with respect to all other CariCom countries.

Table 7

Balance of Trade with Respect to all CariCom Countries

	Trade Surplus Millions of \$ TT
1965	\$ 2.48
66	1.23
67	2.89
68	5.70
69	6.93
70	9.72

Source: Overseas Trade Report of Trinidad and Tobago

In the absence of medium term financing and exchange rate variation the policy options open to a country facing a serious



imbalance are exchange control, trade restrictions and monetary and fiscal policy changes. If the terms of the treaty are to be preserved, however, only monetary and fiscal policy changes--expenditure reducing policies--will be permitted. However, Caricom governments, as argued above, are unlikely to undertake deflationary monetary and fiscal policy changes given the high rate of unemployment in the region.

Under these circumstances, the situation of a serious imbalance will lead to the imposition of exchange and trade restrictions if the exchange rate is to be maintained. These restrictions need not be imposed on transactions with partner states. If, however, a country unilaterally changes the levels and types of restrictions it imposes against the rest of the world, the common market is reduced to a free trade area. It would be necessary to reimpose customs barriers within the union to avoid imports from the rest of the world evading the restrictions or special tariffs by entering the deficit country through the doors of the partner states.

Even though the rules prohibit actions to reduce imports from the region, under certain circumstances a member country may be left with no option but to do so. If countries are prevented from breaking the rules openly, they may do so discretely through such measures as administrative delays in granting approval for licences to import and setting up of state import monopolies which refuse to place import orders for non-essential commodities regardless of their place of origin.

If such measures are to be avoided while keeping the exchange rates stable, other types of policing measures may be necessary. For example, if a country wishes to pursue its own brand of socialism or promote development through inflation the rest of the union will be quick to bring pressure to bear upon the individualistic country if its policies threaten either the exchange rate or the economic union. If the country succumbs, national sovereignty is sacrificed at the altar of unified exchange rates. If it does

not succumb, the relationships will become strained, threatening the existence of regional cooperation and integration. The Caribbean union, still in its formative stages, may be unable to withstand these kinds of pressures. As there are differences in the domestic attitudes and policies of Caribbean governments, the danger is by no means hypothetical.

Another argument against a unified exchange rate system is that it tends to intensify regional inequalities because member countries are unable to realign their currencies relative to the currencies of their fellow members.<sup>9</sup> A realignment becomes necessary in the absence of accommodating labour flows and of acceptable fiscal measures to aid the less developed regions within the union.

Clearly, if the more developed members provide adequate subsidies or transfers to the less developed countries in the region, the problem of inequalities can be solved. However, in the absence of such measures the less developed countries, tied by a system of unified exchange rates and common protection, are likely to demand the right to impose trade restrictions or internal tariffs so as to maintain or increase their share of the gains from integration. In other words, in order to increase its exports to the region and to attract new investors, a less developed country would need to devalue with respect to member currencies regardless of whether it has a balance-of-payments problem, but if this avenue is not open and other options are closed, the less developed country is likely to withdraw from the union unless it can institute a system of non-tariff barriers and subsidies against member countries without their knowledge.

In the context of the European union it has been argued that exchange rate unification, by encouraging the mobility of capital, may provide a solution for the problem of regional inequalities. Capital would flow into depressed areas where wages are usually low, thus reducing the need for transfers on a government-to-government basis. However, in unions of less developed countries

profits are usually higher in the richer countries where wages are high. This latter situation already exists in CariCom and a group of regional less developed countries have been formally recognised. Apparently, however, no attempt has been made to determine the appropriate rate of exchange between these countries and the developed countries of the region and one gets the impression that the rates determined by traditional links to sterling are somehow deemed optimal.

Another reason for "perverse" capital flows may be the precautionary motive. If one currency is known to be "stronger", individuals and firms in the common market will tend to store up wealth in the "stronger" currency regardless of whether exchange rates are fixed and capital mobility is assured. The effect is that the stronger currency grows stronger. These two considerations suggest that on balance there would be an outflow of funds from the less developed to the more developed countries in the region if capital mobility were to be permitted.

Given a common protective policy, possibly a common set of fiscal incentives, free trade within the region and unified exchange rates, the less developed countries, in view of their economic size and economic backwardness, will strongly resent their inability to be competitive with their partners in establishing new industries even if the more developed countries provide some kind of aid. In order to encourage investment in local industries, they may resort to quantitative and other restrictions on trade whether or not such restrictions are permitted by the agreement. For example, in the Caribbean we may see a frequent use of quantitative restrictions (which are permitted only for balance-of-payments reasons) to provide extra protection for domestic industries.

In our view, a restriction-free region with the possibility of exchange rate changes provides a greater scope for development than a region characterised by exchange rate stability and restrictions on regional trade. Under fixed exchange rates,

both balance-of-payments and distribution considerations may prompt countries into introducing such restrictions while the ability to vary the exchange rate is likely to obviate the need for these measures. A positive aspect of regulated exchange rate variation on an individual basis is that it may allow the less developed countries to obtain their fair share of the gains from integration, reducing the need for aid or compensation from the more developed countries.

#### CONCLUSION

The central thrust of our arguments is that exchange rate variation is an important policy tool. We further argue that the conditions under which the exchange rate should be varied should not be limited to situations of critical shortages of foreign reserves. On the contrary it is the state of the Current Account that should be used as the basis for determining exchange rate variations. Continuous current account deficits--continuous for as little as two or three years--are signals that the existing rate requires examination.

The argument that exchange rate variation cannot be helpful to the Caribbean is shown to be deficient and in the light of available evidence the elasticity conditions for an improvement in the balance of payments are clearly satisfied.

If exchange rate variation is accepted as a "normal" tool then the massive "once and for all" devaluation approach should be discarded in favour of smaller, more prompt and more frequent changes in exchange rates. This would allow for a more gradual adjustment by the producers of exports and import substitutes and at the same time serve to inform them that their returns in local currency will be protected from international financial conditions.

Exchange rate parity based simply on traditional links with sterling should be discarded. This is particularly true for the defined less developed countries of the region as they become fully independent and introduce their own currencies.

In addition the growing importance of intra CariCom trade, particularly for some countries, means that continued differences in the rates of change in prices will begin to affect the direction of trade and the location of new industries as firms respond to the relative price differences. Exchange rate changes can be used to neutralise such developments if necessary.

Thus far we have argued the case for a more positive exchange rate variation strategy. Exchange rate variation as noted, however, is not costless and there are many occasions when it will be impolitic or impractical to vary the rates. In that event the appropriate exchange rate should be calculated and like a shadow price used as a planning tool.

The principle of a shadow exchange rate is no different from a shadow transfer price within a firm since the misallocation from a failure to plan, using meaningful relative prices, now resounds throughout the entire economy. Shadow exchange rates, for example, would serve to dramatise the real value of total imports as well as identify to planners and others the height of tariffs or subsidies that may be introduced in lieu of exchange rate variation. In the case of agricultural exports discussed above, for example, the availability and use of shadow exchange rates would have dramatised the need to earn foreign exchange even from the sale of agricultural exports at what some regarded as depressed prices.

Shadow exchange rates are difficult to determine and their development for CariCom countries forms a part of the larger exercise of which this study is a preliminary statement.

FOOTNOTES

1. Treaty establishing the Caribbean Community, Caribbean Community Secretariat, 1973, p.68.
2. This point is made in From Carifta to Caribbean Community, Commonwealth Regional Secretariat, 1972.
3. Johnson, H.G. "Towards a General Theory of Balance of Payments" in R.N.Cooper (ed.), International Finance, Penguin Books, 1969.
4. Ibid., pp. 2 and 3
5. Bank of Jamaica, Balance of Payments of Jamaica, 1964 - 1970, p. 1.
6. Bank of Jamaica, Balance of Payments of Jamaica, 1971, p. 2.
7. Copies of an earlier discussion paper on this subject are available.
8. Op. cit., Treaty, pp. 46, 52 and 68.
9. For a more detailed discussion of this issue see Hall, Marshall and Dhiru Tanna, "Exchange Rate Unification: A Comment," Economic Journal, Dec. 1972.