COSTS AND CONSTRAINTS IN THE APPLICATION OF MONETARY POLICY

Jamaica in the 1970s and 1980s

by

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I INTRODUCTION

The subject of monetary policy has been the subject of a rich and lively debate in the Caribbean from as far back as the 1950s [see (1), (4) - (11)]. Much of the early literature was concerned about monetary arrangements under the Currency Board system and the implications for real aggregate demand and the balance of payments. Even though the early discussions focus on the Currency Board system and the perceived problems are different from the present ones, many insights emerge which bear continuing relevance. For example, Thomas (10) starting from an accounting perspective, traces the relationship between money supply changes and the balance of payments and underlines the role of the former in determining the state of the balance of payments. The analysis presented brings out the major underlying relationships affecting the

[1] I wish to acknowledge with gratitude the assistance of Messrs. D. Latibeaudiere and D. Marston, Deputy Governor and Senior Director respectively of the Bank of Jamaica, in giving me information and facilitating my access to the library resources of the Bank. All errors and omissions are my full responsibility.

balance of payments and in so doing, foreshadows many of the present-day concerns as efforts are made to stabilise our economies.

The analyses conducted in the past have tended to take for granted the mechanisms used in the implementation of monetary policy. These mechanisms inevitably bear costs for the economy and there is scope for a useful analysis of these considerations in order to be able to arrive at an optimal design for the application of monetary policy. This paper makes a preliminary exploration by looking at the main mechanisms of monetary policy used in Jamaica in the last two decades. Particular attention is paid to one instrument, the issuing of certificates of deposit, in describing the costs and constraints of monetary policy.

During the 1980s, monetary policy emerged as a major focus of economic policy aimed at achieving stabilisation objectives in Jamaica. Up to the early 1980s, monetary policy played an accommodating role as fiscal policy measures were emphasised. The attempt to evolve an independent and active role for monetary policy is underlined by the commencement of open market operations by the Bank of Jamaica in 1985 and the creation of Certificates of Deposit as the basis for these operations. In spite of these steps, it is evident that the underlying factors which determine the level of success achieved in stabilising the economy have not changed. They continue to be the issues on the real side of the economy reflected in the condition of the government budget balance and the balance of payments. Two other inter-related considerations are the policy objectives with respect to changes in the interest rate and the exchange rate.

II EVOLUTION OF POLICY OBJECTIVES

The background to stabilisation policies since the 1970s is dominated by a deteriorating performance with respect to output growth, employment and the balance of payments. However, among these areas, the condition of the balance of payments has emerged as the predominant preoccupation in the 1980s. The reason for this is that persistent balance-of-payments deficits have culminated in a severe debt problem which poses enormous problems with respect to the prospects for future development. Along with the concentration on the balance of payments, there has come a concern about the exchange rate and a determination to prevent the depreciation of the latter as far as possible. Attempts to stabilise the economy tend to have adverse consequences with respect to output and employment growth, highlighting the search for an optimal mix in order to maximise the competing objectives.

It is interesting to observe how the role of monetary policy in Jamaica has undergone considerable change within the last two decades in response to the vagaries of economic performance. At the beginning of the 1970s, the engine of growth was showing a secularly declining trend, when compared to the previous two decades, but was still advancing. The balance of payments had experienced only three deficits throughout the decade of the 1960s so that there was little worry on that account. The primary role of monetary policy was perceived as fine-tuning aggregate demand with a view to controlling inflation. At the same time, attention was paid to preventing interest rates from rising sharply with adverse consequences for the real growth performance.

Ironically, the low interest-rate policy had mixed results in the climate of free

international capital flows which was in operation at the time. Low interest rates reduced the competitiveness of savings institutions in Jamaica in the international market when interest rates abroad were rising. Consequently, a delicate balance had to be sought between interest rates too low for attracting savings and too high for satisfactory real growth performance. In a related development, a restriction was placed on local borrowing by non-resident and non-resident controlled companies in October 1969 in response to a marked increase in local borrowing by these companies. This increase was attributable to the relatively low interest rates prevailing in Jamaica at the time.

By the late 1970s, conditions had changed drastically with negative growth being experienced consistently from 1974 to 1977 and the balance-of-payments position being recognized to be in crisis. The net reserves position of the country went into the red in 1976, a condition that has prevailed ever since. Underlying the persistent balance-of-payments deficits experienced was a sharp decline in private capital inflows which had to be compensated for by official capital inflows leading ultimately to the emergence of a severe debt problem (see table 1). By 1978, official debt charges amounted to US$267 million making up some 28 percent of total foreign exchange receipts. In these circumstances, the preoccupation shifted to the balance of payments and to efforts to keep the exchange rate from depreciating.

The effort to achieve satisfactory growth while stabilising an economy in external deficit poses a typical policy dilemma for a developing country. The objectives of defending the prevailing exchange rate and fostering growth indicate conflicting responses with respect to interest rate policy. A central factor determining the efficacy of monetary policy is the size of the government budget deficit.

III POLICY INSTRUMENTS

Over the last two decades, the main instruments of monetary policy have been changes in the liquid assets and cash reserve ratios and manipulation of the interest rate. These have been supplemented by ceilings on lending to the public sector as well as selective credit controls and re-discount facilities aimed primarily at influencing the allocation of resources on a sectoral basis. It is evident too that 'moral suasion' has been used frequently. It may be argued that monetary policy as such was not vigorously applied until the external and internal imbalances reached crisis proportions. The most recent major addition to the monetary arsenal has been the certificates of deposit issued by the Bank of Jamaica.

Liquid Assets and Cash Reserve Ratios

Changes in the liquid assets ratio and cash reserve ratio were the centre-piece of monetary policy in Jamaica previous to the establishment of open market operations in 1985. Changes in these ratios were used, not only to control the growth of the money supply, but also to influence the allocation of lending between the public sector and the private sector by providing a ready market for treasury bills. An overview of the changes in the required liquid assets ratio over the last decade and half would reflect the changing policy positions with respect to public sector deficit and the role of the private sector in the economy.

In May, 1969, as part of a package of monetary policy changes, the liquid assets ratio was raised from 15½ to 17½ percent while the cash reserve ratio was set at 5 percent. As the need

for monetary restraint intensified in the 1970s, the required liquid assets ratio rose steadily reaching 29½ percent in August, 1978. The actual liquid assets ratio averaged 42 percent in 1978. Up to this time, the Bank Act permitted a maximum liquid assets ratio of 35 percent which was raised to 40 percent in May 1978. Not surprisingly, therefore, an element of moral suasion was an accompanying feature as commercial banks were encouraged to observe a voluntary liquid assets ratio of 40 percent until 1983. It was only in 1983 when private sector demand for credit expanded significantly giving rise to tightening credit conditions, that the voluntary liquid assets ratio of 40 percent was abandoned and the statutory maximum reduced to 36 percent.

The rising liquid assets ratio was integrally connected to the growing demands of the public sector for deficit financing. The increasing difference between the liquid assets ratio and the cash reserve ratio was largely taken up in treasury bills and other public sector debt instruments at relatively low rates of interest. In the meantime, the statutory limit on treasury bills outstanding rose continuously from J$30 million in 1969 to J$3.5 billion in October 1988.

After the brief reduction in the liquid assets ratio in 1983, it started to rise again. These new increases came about in the context of efforts to sharply reduce the public sector deficit and even achieve a surplus and also to promote the role of the private sector in economic activity. Accordingly, the cash reserve ratio was observed to rise in tandem with the liquid assets ratio, thereby restricting the amount of credit virtually set aside for public sector borrowing. Hence, as the liquid assets ratio was raised from 36 to 40 percent in early 1984, the cash reserve ratio also rose from 5 to 10 percent in three discrete movements.

The required liquid assets ratio rose steadily reaching a peak of 48 percent in April, 1985.

This was a time of high liquidity in the system with the actual liquid assets ratio reaching 55 percent. These increases were accompanied by increases in the required cash reserve ratio which reached 20 percent in July, 1985. It is worth noting that the increases in the required liquid assets ratio placed on the banking sector was accompanied by rises with respect to the near-banks (Trust Companies, Merchant Banks and Finance Houses) also.

The year 1985 marks a turning-point in the approach to monetary policy as certificates of deposit were launched and less reliance was to be placed on the liquid assets ratio to control the money supply. It was decided to do away with the non-cash part of the liquid assets requirement altogether and accordingly the liquid assets ratio was gradually reduced to 20 percent by 1988. Interest rates of up to 30 percent were paid on cash reserves. It is interesting to note, however, that the required liquid assets ratio has again been on the increase, reaching 27.5 in May, 1990. This underlines the relative effectiveness of this measure as an instrument for the control of the money supply.

The required liquid assets ratio is typically viewed as an instrument to be used at discrete intervals but it has been applied with some flexibility in the past. From time to time, variations have been made in the kinds of assets and the proportion of specified assets which may be included. Moreover, the penalty for deficiencies in cash and liquid assets reserves and the level of liquidity support offered by the Bank of Jamaica may also be varied in line with policy objectives. For example, the interest payable for such breaches was raised from 0.10 percent per day to 0.17 percent per day in January 1986.

Interest Rate Policy

On the whole, the interest rate has operated in a passive way, reflecting the degree of tightness or ease in the market for credit. The last two decades have witnessed a trend of steadily rising interest rates in Jamaica. Whereas there was some concern in 1970 that interest rates might be too low, given free international capital flows and the need to attract deposits, by the late 1980s, it was feared that they were too high in light of the need to encourage investment.

At the beginning of the 1970s, the bank rate and the prime lending rate stood at 6 and 8 percent respectively. Somewhat in response to the concern about the low level of interest rates, commercial banks were allowed compete for time deposits of more than six months and this led to interest rate increases. The general policy of allowing the interest rate to be determined competitively was furthered in the early 1980s when a mechanism was adopted so that interest rates could move in line with treasury bill rates. Interest rates rose steadily with the prime rate and the savings deposits rate reaching peaks of 23 and 20 percent respectively in mid-1985. Subsequently, interest rates were on the decline, reflecting generally easier credit conditions and monetary policy, but in 1990, they have resumed their upward trend. Rising interest rates as a reflection of tighter credit conditions are defended as part of the effort to curb aggregate demand and minimise the depreciation of the exchange rate in the prevailing circumstances of severe balance-of-payments imbalance.

Selective Credit Controls

The placing of ceilings on the growth of credit is an instrument which has frequently been used by the Bank of Jamaica to bolster other instruments being employed. This instrument has been applied in such a manner as not only to curb credit availability, but also to influence the pattern of credit availability in the context of wider objectives of economic development. Several types of ceilings have been imposed. Apart from global ceilings imposed at times when the money supply threatened to exceed tolerable levels, there has been specific concern with containing the growth of consumer credit. In addition, quantitative ceilings have been placed on private sector borrowing but these have been removed at other times during the 1980s in line with the emphasis on the adoption of a market-oriented system. Limits on lending to the public sector have also been a regular feature. A special type of credit restriction was the one placed on local borrowing by non-resident companies in 1969 to counteract a sharp increase in such borrowing.

Credit controls have been accompanied by special re-discounting facilities aimed at promoting economic activity in selected sectors such as building and construction, agriculture and other "productive" sectors. These facilities weaken the impact of credit controls but are evidently aimed at fostering real growth in critical sectors.

Deposit Schemes for Foreign Exchange Arrears

A major manifestation of external imbalance since the late 1970s is the occurrence of large arrears with respect to qualified requests for foreign exchange. Such arrears tend to frustrate the automatic mechanisms for restoring balance because they cause a back-up of liquidity in the financial system. To counteract this problem, schemes have been devised whereby the total local-currency deposits with respect to the arrears have to be backed by cash reserves. These schemes are not costless, given the fact that interest may be payable on cash reserves, and indeed partly reflect the immediate cost of holding on to an exchange rate that is not sustainable.

CERTIFICATES OF DEPOSIT

Certificates of deposit were established in 1985 in order to place monetary policy on an independent footing by having the Bank of Jamaica issue its own paper. The experience with C.D.s serves to dramatise the limitations and costs of monetary policy. Since the start of the C.D. auction in 1986, sales have expanded rapidly. Indeed, even though C.D.s were originally envisaged as being used for both purchases and sales, the condition of the money supply and the balance of payments has dictated that there have only been sales. The issue of C.D.s has expanded rapidly so that by August 13, 1990, the value of C.D.s outstanding had reached J$2.2 billion.

The high level of C.D.s traded imposes an enormous cost in terms of the interest which

has to be paid on them. At the present time, the interest charges stand at close to J$1 billion. The payment of these interest charges gives rise to the need for further sterilisation leading to an inexorable spiral of sales and costs. In addition, since the central bank is part of the public sector, C.D. sales are contributing to the expansion of the public sector deficit which is a major basis of the original problem of instability. Resources have to be channelled into paying interest that might have been devoted to education, health and other worthwhile areas. Given the severe effects of contracting resources being devoted to the latter areas, this is a serious adverse effect of the C.D. market.

C.D. sales also put upward pressure on the interest rate which, in turn, has an adverse effect on investment and real growth. High interest rates are leading to a spectacular growth in holdings of liquid assets as funds are diverted from risky but important investment ventures.[2] This is a noticeable symptom of economic stagnation. Furthermore, it is conceivable that the large-scale holding of C.D.s may be having significant wealth effects which, by promoting consumption, aggravate the balance-of-payments problems which are the root causes of instability.

What are the fundamental reasons why these instruments of monetary restraint are called for? Ultimately, monetary restraint is required because of the chronic state of crisis in the balance of payments. More specifically, however, monetary restraint is being used to defend the exchange rate against pressure for depreciation. In that light, it is important to be aware of the costs of keeping the exchange rate from depreciating in order to fully evaluate the success of the strategy. Were the exchange rate to be depreciated, the need for sterilisation would be reduced

[2] See Thomas (1990) for a description of this phenomenon as it applies to building societies.

as the meeting of foreign obligations would have a more contractionary impact on the money supply. In addition, this would be a move in the direction of an improved balance of payments. It is important to determine if the net benefits from a lower exchange rate would justify a depreciation.

A second factor at the basis for monetary restraint is the public sector deficit. For a given relationship between savings and investment, a reduction in the budget deficit would be associated with a decline in the disequilibrium of the balance of payments and thus alleviate the need for monetary restraint.

In the final analysis, it is the real factors such as the level of the balance-of-payments and budget deficits and the exchange rate which must be addressed if full stabilisation and recovery are to be achieved. In the Jamaican context, the national external debt represents an insurmountable burden, the removal of which will play a major role in the prospects of the country. A major element of debt relief is inescapable if Jamaica is to achieve recovery. With these steps being taken, monetary policy can play a supporting role in the maintenance of economic stability.

CONCLUSIONS

Among the battery of mechanisms which have been employed in Jamaica, the early reliance on variations in the required liquid assets ratio has given away somewhat to the use of open market operations based on the market for certificates of deposit. Indications are that the open market operations are particularly costly and the Authorities should perhaps look again at

a greater use of credit ceilings and the liquid assets ratio. These two mechanisms would tend to raise the rate of interest but the contribution to the internal debt would be less severe. Further study needs to be done to establish the relative costs of these mechanisms.

The second point worth emphasising is that monetary policy must play essentially a subordinate role in the search for economic recovery and stabilisation in Jamaica. The emphasis has to be placed on the central factors of debt relief, the reduction of the budget deficit and tolerable rates of interest and exchange.

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Table 1

THE BALANCE OF PAYMENTS OF JAMAICA
1973 - 1988
(US$M.)

YEAR	CURRENT ACCOUNT BALANCE	NET CAPITAL MOVEMENTS	OFFICIAL CAPITAL BALANCE	PRIVATE CAPITAL BALANCE	CHANGE IN RESERVES*
1973	-180.7	137.1	36.7	100.4	25.9
1974	-167.0	243.2	90.1	153.1	-59.5
1975	-282.7	208.9	124.2	84.7	80.8
1976	-302.6	126.7	79.2	47.5	180.9
1977	-34.6	34.3	2.9	31.4	30.5
1978	-86.7	-78.5	167.5	-246.0	165.8
1979	-142.6	-10.2	65.7	-75.9	137.4
1980	-166.3	107.1	187.4	-80.3	57.8
1981	-336.8	225.4	240.2	-14.8	95.6
1982	-387.9	465.6	446.0	19.6	-86.0
1983	-480.5	190.5	300.7	-110.2	289.1
1984	-291.1	482.7	362.9	119.8	-225.7
1985	-295.8	243.0	174.0	69.0	72.6
1986	-24.7	20.1	-27.7	47.8	24.0
1987	-150.4	360.1	215.6	144.5	-208.2
1988	-34.5	180.6	117.4	63.2	-178.1

SOURCE: Bank of Jamaica, Balance of Payments of Jamaica, 1985 and 1988.

Notes

* Net errors and omissions not included.

1988 figures are provisional.

Table 2

GOVERNMENT BUDGET BALANCE
(J$M.)

YEAR		OVERALL		TOTAL		NET		NET	NET
	SURPLUS/		FINANCING		FOREIGN		DOMESTIC		DOMESTIC
	DEFICIT				BORROWING			NON-BANK	BANK
1979	-451.5	473.7	28.0		73.2		372.5		
1980	-640.9	645.0	122.3	103.7	419.0				
1981	-569.1	578.7	291.4	88.1		199.2			
1982	-843.9	879.7	293.6	133.2	452.9				
1983	-778.7	778.7	378.2	-28.5	429.0				
1984	-622.5	622.5	828.3	145.3	-351.1				
1985	-760.3	760.3	296.2			464.1*			
1986	-790.6	790.6	-278.7			1069.3*			
1987	20.0	-20.0	-		-		-		
1988	-723.7	723.7	176.7			547.0*			

SOURCE: Bank of Jamaica, Annual Report and Statement of Accounts, several issues.

* Includes net domestic non-bank borrowing.

The figures in this table relate to April to December of the respective years.