IMF CONDITIONALITY AND JAMAICA'S ECONOMIC POLICY

IN THE 1980'S

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ERRATA

Pg. 1 - Para. 3	Should read "conclusions still remain important. . ."
Pg. 5 - Para. 1	Should read "The Absorption Approach sees the excess of domestic income over domestic absorption. . ."
Pg. 8 - Para. 1	Should read "Demand management policies may, in reducing inflationary pressures. . ."
Pg. 26 - End of Para. 1	Should read "Performance targets focused on restricting borrowing by the Central Governments. . ."
Pg. 27 - Para. 1	"Foreign Exchange Rate Policy and the Exchange Rate" is a subtitle
Pg. 31 -	Quotation at the bottom of the page should read "It is thus apparent that relative profitability between export and. . ."
Pg. 35 - Para 1	Should read "Capital expenditure fell in both nominal and real terms and was down to 4.8% of GDP. . ."
Pg. 37 -	Under Monetary Policy insert a subtitle "a) Liquidity Management" before the second paragraph.
Pg. 39 - Para 1	Should read "By any standards, with the liquidity ratio at 48% and the cash reserve ratio at 20%. . ."
Pg. 39 -	Subtitle should be "b) Selective Credit Controls"
Pg. 41 -	Subtitle should be "c) Interest Rate Policy"
Pg. 44 -	Last paragraph should read "Investment income had become less negative between 1980 and 1982, but recorded its greatest negative balance for the period (-US$304.8 mn) in 1984."
Pg. 49 -	Last paragraph should read ". . . in light of economic contraction with lay-offs in the public and bauxite/alumina subsectors."

INTRODUCTION

This paper represents a preliminary analysis of Jamaica's Economic Policy in the 1980's, under the influence of International Monetary Fund (IMF) Balance of Payments adjustment programmes.

In so far as Jamaica's economic policy since 1981 has been designed "in conjunction with" the IMF, this paper outlines first of all the Theory of IMF conditionality and the IMF's view of the balance of payments adjustment process. In so doing, there will be a review of some of the more common criticisms of the IMF's approach and typical responses to those criticisms by the Fund and its staff members.

The paper then examines the background to the situation as existed in 1980, looking in particular at Jamaica's "adventures" with foreign exchange crisis and the IMF in the 1970's. In looking at the 1980's, it is important to identify what "lessons" had been "learnt" from the 1970's and the extent to which those same conclusions still remain imprrtant in either vindicating or invalidating the IMF's approach to Economic Policy in a Jamaican context.

Two main IMF programmes have dominated Jamaica's economic policy in the 1980's. Firstly, there was an Extended Fund Facility extending from April 1981 to its premature termination at the end of September 1983. Secondly, there was a Stand-by Arrangement covering the period Fiscal Year 1984-85. These programmes included the main IMF performance targets as well as many of the typical pre-conditions and undertakings (not all of which appear to have been officially announced). Also, within the context of these agreements, there have been many policy adjustments (for example, of Cash and Liquid Assets Ratios). It is hoped that this paper will be able to give a systematic outline of the programmes, the performance targets and undertakings and specific policy measures without being overbearingly detailed.

Against the background of those policy measures, we will review the performance of the economy in the 1980's. The primary concern is not with the passing of periodic performance tests. (It is apparent that significant effort was made on the part of the Ministry of Finance and the Bank of Jamaica to pass those tests.) Technical waivers have been granted on the basis of uncontrollable delays in programmed foreign exchange inflows.) Our primary concern is with the ultimate impact of the Balance of Payments adjustment programme on the economy (for example, in terms of growth rates, unemployment, inflation, Balance of Payments performance, etc.).

The review of the economic impact of the policy measures will permit a re-examination of the role of IMF adjustment programmes in Jamaica. It is hoped that from this review, useful policy implications may be drawn for Jamaica, other under-developed economies with actual or latent balance of payments problems and for the role of the IMF and the international monetary system in the process of balance of payments adjustment.

SECTION ONE

IMF CONDITIONALITY AND BALANCE OF PAYMENTS ADJUSTMENT POLICIES

"Conditionality" from the perspective of the International Monetary Fund "refers to the policies the Fund expects a member to follow in order to be able to use the Fund's General Resources."[1]

While the term was not defined as such in the original articles of agreement, the practice evolved with the use of Stand-by Agreements throughout the 1950's. De facto conditionality led in turn to "definitions" of the principle appearing in Fund Annual Reports of 1964 and 1965. For example, the 1964 Report stated:

> Drawings beyond the Gold tranche . . . . are conditional in greater or lesser degree, on the adoption by the drawing countries of policies designed to ensure the temporary character of their payments problem and designed also to eliminate or reduce the member's reliance on exchange restrictions or certain other exchange practices.[2]

While some critics of the IMF have questioned the principle or legality of "conditionality" and some IMF functionaries have argued trivially that the IMF does not impose policies on debtor countries, the basis for conditionality may be seen as reflected in the original Articles of Agreement and emphasized in their Second Amendment. For example, Robichek's quotation of the Second Amendment, Article IV, Section 1, indicates the Fund's "responsibility" for orderly and stable exchange rate practices and other "economic and financial conditions conducive to stability and growth." Article IV, Section 3, emphasizes the Fund's

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[1] Joseph Gold, "Conditionality", IMF Pamphlet Series, NO. 31, p. 1.

[2] Joseph Gold, op. cit., p. 2.

powers of surveillance over the economic policies of member countries.[3] In any event, as di Tella, in response to Robichek's presentation, stated: " . . . conditionality, legal or not, does in fact exist . . . ".[4]

The availability of IMF financing to a country experiencing Balance of Payments problems especially under Stand-by and Extended Fund Facility agreements is therefore conditional upon the borrowing country undertaking certain policy adjustments. Such financing is seen as permitting a lengthening of, and reduction of, severity of the adjustment process.

In providing financing on the conditionality of adjustment, "the Fund seeks to help members to attain, over <u>the medium term</u>, a viable payments position, in a context of reasonable <u>price and exchange rate stability</u>, a sustainable level and growth rate of economic activity, and a <u>liberal system of multi-lateral</u> payments."[5] It must be emphasized that a "viable payments position" does not necessarily refer to an overall surplus but may mean a current account deficit which is financed by sustainable net capital inflows "that are compatible with the development and growth prospects of the country, and therefore, with its debt carrying capacity."[6]

IMF adjustment policies focus on both demand management and the attainment

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[3] E. Walter Robichek, "IMF's Conditionality Re-examined", in Joaquin Muns (ed.), <u>Adjustment, Conditionality and International Financing</u>, pp. 68-69.

[4] <u>Op. cit.</u>, p. 76.

[5] Manuel Guitian, "Fund Conditionality, Evolution, Principles and Practices", <u>IMF Pamphlet Series</u>, No. 38, p. 3.

[6] <u>Loc. cit.</u>

of "appropriate economy-wide prices." These two strands of policy must be seen as being inter-related and interdependent.

The focus on demand management has grown out of the Absorption and especially the Monetary Approaches to the Balance of Payments. The Absorption Approach sees domestic income over domestic absorption or alternatively an excess of domestic "Investment" over domestic "Savings". The Monetary Approach to the Balance of Payments, focusing on the "Overall Balance", sees Balance of Payments dis-equilibria as being a result of disequilibrium between the stock demand and stock supply of money. (The IMF's concept of a sustainable current account deficit indicates the Monetary Approach's emphasis on the overall balance.)

Analysis of Balance of Payments problems often focuses on the role of pressures generating increasing fiscal budget deficits which directly contribute to excessive Absorption. Given a tendency for such deficits to be increasingly financed by the Central Bank, there is excessive money creation, reflecting itself in either foreign reserve losses or pressure on a flexible exchange rate. Demand management policies therefore usually include control of the fiscal budget deficit (especially on current account), restrictions on Central Bank lending to the public sector and restrictions on credit expansion by the banking and financial system. These requirements are normally expressed in terms of quantified performance targets to be met periodically (usually quarterly) to facilitate continued access to IMF funding.

The focus on appropriate economy-wide prices has its roots in the emphasis of the neo-classical tradition on the superiority of markets in the efficient allocation of resources. The theoretical foundations of this emphasis have also been significantly strengthened by the well-known works of Shaw, McKinnon, Gablis and Fry (on Financial Repression and Deepening) and various staff studies by the

International Monetary Fund.

The prices with the most pervasive economy-wide effects are usually seen as being the exchange rate and interest rates. Attention is also paid to wages, subsidies, marketing boards or any other "intervention" which inhibits the "appropriate" (as in "market determined") adjustment of internal terms of trade (rural-urban) and the relative prices of traded and non-traded goods, and domestic relative to foreign costs of production.

The negative consequences of an overvalued domestic currency include: excess demand for foreign exchange with balance of payments problems and reserve losses; foreign exchange rationing with attendant problems, inefficient allocation and the costs of bureaucracy and corruption; speculation against the domestic currency resulting in capital flight; cost non-competitive exports and price non-attractive traded goods; diversion of foreign exchange from official to parallel markets.

Nominal interest rates have often been administered in underdeveloped countries where, in a context of inflation, real rates are sub-equilibrium (unable to equate the supply and demand for loanable funds), and often negative. The consequences of sub-equilibrium and negative real rates of interest include: excess demand for loanable funds or an excess of domestic investment over domestic savings, reflecting itself in balance of payments problems; inefficient credit-rationing; a disincentive to save in domestic currency with implications for capital flight; utilization of financial surpluses for socially inappropriate consumption and investment (for example, capital intensive technology in a labour surplus economy).

Wages that increase too rapidly relative to the rate of domestic currency depreciation and/or the rate of increase of labour productivity, undermine the

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international competitiveness of domestic production.

Subsidies and price controls are seen as having a negative impact on the allocation of productive resources. For example, a policy of keeping imported wage goods artificially cheap for social welfare purposes suppresses the prices of traded goods relative to those of non-traded goods, inhibiting efficient import substitution and replacement and improved balance of payments performance.

"Appropriate pricing" therefore usually includes:

1) Exchange rate devaluation. This may take the form either of an administered devaluation to a fixed exchange rate, or some allowance for fluctuations influenced by "market forces". Multiple exchange rate practices are not a favourite of the IMF.

2) Increases in real interest rates with allowance for greater influence by market forces. Beyond allowing for increases in nominal rates, anti-inflationary policy is also important in this context.

3) Controlling the rate of wage increase.

4) The removal of subsidies and price controls.

These pricing policy adjustments are expected to reverse the negative consequences of "inappropriate prices" as listed above. For example, the foreign exchange and savings-investment gaps should be closed and their attendant resource misallocation and balance of payments consequences eliminated.

It should be noted that the various pricing policies are inter-related in their effects. While an "appropriate exchange rate" is expected to increase the flows of domestic savings, an appropriate "real interest rate" is expected to inhibit the foreign exchange leakage. As stated by Claudio M. Loser,

". . . interest rate policies in a world of increasing financial dependence cannot be seen as separate from exchange rate management; they will have to be compatible with some other domestic financial policies."[7] Again, a trade-off between the rate of wage increase and the rate of currency devaluation is often a feature of IMF sponsored adjustment programmes.

While we have spoken of demand management and appropriate pricing as being two strands of adjustment policy, it must be emphasized that they are tightly interwoven. Demand management policies may, in redressing inflationary pressures, supplement the expenditure switching effects of devaluation. (In fact, more stringent demand management may reduce the necessary rate of currency devaluation.) On the other hand, devaluation, higher real interest rates, removal of price controls and subsidies and wage controls may all make a significant contribution to demand management.

Performance targets for demand management and the increase of net international reserves and the movement toward more appropriate prices, are normally supplemented by "undertakings" to deregulate imports and capital flows and eliminate foreign payments arrears consonant with the IMF's expressed purpose to free international movement of goods, services, capital and investment income.

IMF adjustment policies have been subjected to several criticisms (many of which are inter-related), some of which are briefly discussed hereunder with some of the responses presented by the IMF and its functionaries.

1) Firstly, it is argued that adjustment policies emphasize stabilization (demand management) rather than growth (supply expansion). They are therefore seen as leading to economic stagnation and unemployment. Manuel Guitian responds as follows:

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[7] Claudio M. Loser, "The Role of Economy-Wide Prices", in J. Muns (ed.), op. cit., p. 91.

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> While the achievement of a sustainable level of aggregate demand and the consequent achievement of financial stability may have been the <u>proximate</u> objectives of Fund policies, the attainment of supply potential has always been the ultimate aim.[8]

He borrows the metaphor of the Marshallian scissors to describe the dual (supply and demand) nature of Fund adjustment policies.

Robichek admits the importance of building supply oriented measures into adjustment programmes but argues that some of the necessary measures are beyond the IMF's competence (" . . . the IMF was designed to be a specialized doctor and not a general medical practitioner . . .") and more related to the role of the World Bank.[9]

Both Guitian and Robichek see the supply orientation of IMF adjustment policies as being inherent in the emphasis on appropriate economy-wide prices in generating a more efficient allocation of resources as a basis for economic growth. Increasing the stability of the economic environment and the cushion of IMF, and IMF-inspired financing, is also seen as a necessary basis for the expansion of economic activity. Appropriate pricing however may only be effective where markets are developed and competitive. Also foreign inflows which serve to build up resources and pay off other arrears will require additional financing to enhance growth.

2) The IMF has often been accused of not being sufficiently flexible in tailoring its adjustment policies to the specifics of the social, political and

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[8] Manuel Guitian, op. cit., p. 26.

[9] E. Walter Robichek, op. cit., p. 73.

economic realities and policy priorities of the recipient country.

Joseph Gold discusses in detail the Fund's Executive Board's Decision of March 2, 1979, paragraph 4, of which states:

> In helping members to devise adjustment programmes, the Fund will pay due regard to the domestic social and political objectives, the economic priorities, and the circumstances of members, including the causes of their payments imbalances.[10]

Paragraph 8 of that same decision refers to the non-discriminatory treatment of members.

> The Managing Director will ensure adequate co-ordination in the application of policies relating to the use of the Fund's general resources with a view to maintaining non-discriminatory treatment of members.[11]

Paragraphs 11 and 12 respectively require ongoing assessments of individual adjustment programmes and periodic reviews of the general experience of IMF adjustment policies.

Despite the apparent willingness of the IMF to be sensitive to domestic realities and reflective on its policies, many of its critics are not convinced that such decisions have effectively been translated into practice. In particular, there is insistence on "appropriate prices" regardless of the level of

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[10] Joseph Gold, op. cit., p. 22.

[11] Op. cit., p. 30.

development of markets. Also, the insistence on deregulation is opposed to central planning or "socialist regulation".

3). The IMF has been criticized for the stringency of its targets, the expected speed and associated costs of adjustment and the tightness of programmes repayment periods. The costs of adjustment, it is therefore argued, tend to be severe. The IMF counterposition argues that, in the context of ongoing Balance of Payments deficits, the use of financing instead of adjustment is not indefinitely possible in so far as international reserves are not infinite.

> Countries typically seek to enter into arrangements with the IMF when their own international reserves are close to exhaustion and when their access to other external sources of finance is severely curtailed.[12]

The conception therefore is that many Balance of Payments deficit countries only seek the medicine of the IMF when their "illness" is chronic or acute. In that context, it is argued (somewhat illogically) that the patient must, of necessity, be given larger doses of the antidote.

On a more sound logical foundation, it is argued that the provision of IMF financing is designed to smooth and facilitate the process of adjustment. The intensity and abrasiveness of the adjustment effort necessarily varies inversely with the amount of emergency financing available. Given that the deficit country's international reserves are usually exhausted, the intensity and speed of adjustment are dictated by the limits of IMF financing.

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12. Robichek, op. cit., p. 71.

Wanda Tseng, in supporting the case for adjustment, argues that "the costs of such adjustment must be measured against those of not adopting timely adjustment policies."[13] Because deficits cannot be sustained indefinitely, adjustment, in the absence of IMF policies, will be forced upon a country and the costs of such adjustment may be more significant and less socially and politically tolerable. These costs will include: depletion of international reserves; erosion of international credit worthiness and interruption of trade credits; capital and raw material shortages; capital flight.

It must be stressed however that IMF adjustment policies very often appear to be socially and politically intolerable in underdeveloped countries. di Tella puts the issue in perspective, as follows:

> . . . the limits to flexibility are not only determined by a limit to Fund resources, but also by the internal situation in a country which imposes a de facto limitation, one which I fear is becoming more significant. . . . Sometimes we speak as if in a dialogue of the deaf, about the limit on the fund and the limit on individual countries when in fact both exist.[14]

Thus, it may be necessary for the fund to acquire expanded resources to provide a more tolerable balance between adjustment and financing.

4) The IMF's medicine is undoubtedly strong but it is often argued that it is related to faulty diagnosis and is therefore inappropriate in treating the basic

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[13] Wanda Tseng, "The Effects of Adjustment", Finance and Development, Vol. 21, No. 4, December 1984, p. 5.

[14] Guido di Tella in J. Muns (ed.), op. cit., p. 77.

cause of Balance of Payments disequilibrium. For example, it is claimed that the IMF underplays the role of exogenous shocks (oil price increases) and other external factors (including protectionism in developed countries). As another example, the IMF is accused of ignoring structural features in underdeveloped countries which limit the flexibility of their supply response. In this sense, Fund policies tend to be global rather than selective.

The IMF, for its part, points to its development of special financing facilities (for example, Oil and Compensatory Financing Facilities) as evidence of its sensitivity to changing external circumstances. It is not clear however that such financing especially in the absence of extra-IMF flows have been adequate to the needs of oil-importing developing countries.

In relationship to protectionism in developed countries, underdeveloped countries complain that they have carried the main burden of adjustment while there is limited leverage on the policies of surplus economies, especially of the developed world.

The IMF argues that it focuses mainly on macro-economic targets, leaving the distribution of cutbacks to be informed by the priorities of the deficit country. In reality, however, the Fund has insisted on the cutting of specific categories of fiscal expenditure. "This arises when projects are of questionable productivity, imply exorbitant recurrent costs, or are at low priority relative to other claims on the budget."[15]

It may also be appreciated that extremely tight global fiscal targets may force a government to cut forms of expenditure which it sees as being essential

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[15] Peter S. Heller, "Controlling Fiscal Expenditure", Finance and Development, Vol. 22, No. 2, June 1985.

for the long-term development of its economy.

On the question of structural factors inhibiting development, it has already been pointed out that Fund policies are restricted to demand management and appropriate prices. While the World Bank is designated as the specialist for supply problems and there is to be increasing collaboration between the Fund and the Bank in their country programmes, the Bank's concept of "structural adjustment" is not synonymous with the Latin American/Caribbean concept of "structural transformation".

5) We have stressed the central role of "appropriate prices" in Fund sponsored adjustment programmes. According to di Tella:

> Obviously the Fund's philosophy holds to the belief that markets adjust speedily and well. This implies believing that markets are competitive, no oligopoly exists to hamper competitive adjustment, that markets are transparent, that only a single price exists in each of them, that there are no natural disequilibria and those that do exist are temporary aberrations, that the markets are stable and that no destabilizing trends exist or that these are temporary or of short duration. . . . In reality there is no automaticity, competitiveness, transparency or stability in the markets and the impact of the adjustment variables that need to be used is so great and spread over such a long period if time that they become impossible, if not to say utopian.[16]

[16] di Tella, in J. Muns (ed.), op. cit., p. 78.

While di Tella accepts the logical consistency of the IMF's policy model, he believes, because of market inflexibility in underdeveloped countries, that the required scale of the designated policy changes is unrealistic.

There has been much controversy on the flexibility of markets in underdeveloped countries, with the Fund from its empirical analyses remaining convinced of there being a sufficient degree of responsiveness to warrant its persistence with appropriate pricing policies. It nonetheless appears that price adjustments have been more effective in restricting aggregate demand than increasing aggregate supply. Furthermore, price changes which are too frequent, too large or too unpredictable may generate psychological reactions which tend to undermine the objectives of the policy. For example, a foreign exchange rate that makes wide and uneven swings (in both directions) may undermine confidence in the functioning of the foreign exchange market. Again, high nominal rates of interest (even when real rates are positive and stimulating real savings) may discourage the expansion of investment.

6) The Fund has been seen as a powerful international apostle of free market ideology and an agent of the international capitalist and banking system in the extraction of surpluses from underdeveloped economies.[17, 18]

While this paper is not prepared to deliver a judgement on the above characterization, it is a fact that the IMF emphasizes the role of the price mechanism in the allocation of resources where such an emphasis is not universally appropriate. An uncritical global deregulation of imports may not

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17 Richard Bernal, "Democratic Socialism Meets the IMF", in Jill Torrie (ed.), Banking on Poverty, p. 239.

18 Kari Levitt-Polyani, "Manley's Defeat, Whose Fault", in Jill Torrie (ed.), Banking on Poverty, p. 260.

be in the best interests of an underdeveloped country (especially where there is protectionism in developed countries).

The deregulation of capital flows and removal of foreign payments arrears, while protecting the interests of foreign lenders or investors, may also open the door to more foreign financing. Such inflows, however, if on non-concessionary terms or for "socially non-productive" purposes, may sink the recipient country deeper into the "vicious circle of international debt."

The IMF therefore needs to reconsider the flexibility in its diagnoses and prescriptions and the international monetary system needs to be redesigned to ensure greater flows of concessional liquidity in keeping with the needs and aspirations of underdeveloped economies.

SECTION TWO

THE BACKGROUND TO THE ECONOMIC CRISIS OF THE 1980'S

Caribbean economies have been characterized as open dependent and structurally underdeveloped. Historically, their process of integration into the world capitalist system has left them as specialists in production of primary products where most of their consumption and investment needs are imported from the rest of the world. This pattern of specialization makes Caribbean economies very vulnerable to economic fluctuations in their developed trading partner economies, and to extended periods of declining terms of trade.

Given the vulnerability of primary export specialization as demonstrated in the Great Depression, and inspired by the apparent success of Puerto Rico's Operation Bootstrap, Jamaica among other Caribbean economies embarked on a programme of import-substituting "Industrialization by Invitation" in the 1950's. While the programme has subsequently been seen as being deficient in several respects, it, with the expansion of Tourism and the Bauxite/Alumina sectors, contributed to "respectable" rates of growth through the 1950's and the 1960's. Between 1962 and 1971 GDP per capita in real terms grew at an average rate exceeding 2% per annum. The rate of fixed capital formation exceeded 18% every year and was nearly 30% between 1968 and 1970 (the last phase of major bauxite/alumina expansion). For the same decade (1962-1971), the rate of domestic savings averaged 21% per year.

Despite the surface manifestations of economic health, Jamaica in the 1960's ran current account (balance of payments) deficits which were financed by net capital inflows especially for expansion in tourism and bauxite/alumina. (Were these current account deficits sustainable?) It is also true that the rate of unemployment almost doubled between 1962 and 1972 and growing disaffection with the proliferation of symbols of socio-economic inequity contributed significantly to the change of government in 1972. The Democratic Socialism of the new government and its emphasis on social welfare redistribution were in part a reaction to that rising disaffection.

The 1972-80 period was one of constant economic decline. Real GDP per capita declined at an average annual rate of 4%, while manufacturing and mining contracted and agriculture stagnated, government services grew significantly. Savings and Investment rates fell almost every year. By April 1980 the unemployment rate had risen to 27.9%. Inflation was for the most part higher than in the 1960's and peaked at 47% in 1978-79. The current account (balance of payments) was mostly in deficit and net capital inflows declined with the result that net foreign reserves declined from J$188mn in 1972 to minus J$821mn in 1980.[19]

In looking at the 1970's, 1972-76 may be seen as the years in which the crisis was entrenched and 1977-80 as the years in which IMF-inspired attempts were made to grapple with that crisis. For the 1972-76 period, the economic down-turn is seen as being caused by a combination of internal and external factors but there is some disagreement on their relative importance.[20]

Girvan et al. see the crisis as being caused mainly by external factors including the oil price increase (1973), declining terms of trade, increasing debt service payments, declining net capital inflows and political hostility resulting in a decline in tourism (1974-76). They see the IMF's emphasis on the

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[19] Jennifer Sharpley, "Jamaica 1972-1980", in Tony Killick (ed.), The IMF and Stabilization, pp. 115-117.

[20] Norman Girvan, Richard Bernal and Wesley Hughes, "The IMF and the Third World: The Case of Jamaica, 1974-80", Development Dialogue, Reprint from 1980:2, p. 20.

rate of wage increase as being misguided.[21]

According to Jennifer Sharpley, "Jamaica's Balance of Payments crisis was not so much the result of external factors . . . as of domestic policies and structural factors affecting the demand for non-oil imports, the supply of exports and net inflow of foreign finance."[22]

While mentioning most of the external factors presented by Girvan et al., she believes that there were of a second order of importance. She argues that imported inflation explained less than half of domestic inflation which was more dependent (contrary to Girvan et al.) on large money wage increases increasing the real wage between 1973 and 1976. In fact, there was a redistribution from capital to labour with negative implications for Investment.

The policy mistakes of the government are seen by Sharpley as including:

1) Delaying devaluation and attempting to defend a fixed exchange rate with quantitative import restrictions (causing distortion of relative prices).

2) Expansionary fiscal and monetary policy fuelled by the Bauxite Levy.

3) Fiscal deficits inappropriately financed by external commercial credits and monetization.

4) Overemphasis on social welfare with a negative attitude towards economic stabilization.

5) Absence of an effective domestic productive strategy especially for agriculture.

Sharpley also discusses the role of a non-integrated economy (absence of linkages),

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[21] Girvan et al., op. cit., p.144.

[22] Sharpley in T. Killick (ed.), op. cit., p.129.

inefficient capital intensive import substitution and adverse private sector reactions to the government and its Democratic Socialism.

Kari Polanyi-Levitt also feels that beyond the external factors, the crisis was to a large extent generated by policy mistakes by the government including:

1) Emphasis on redistribution without growth.

2) Rhetoric against "the international capitalist system" while wasting the Bauxite Levy.

3) Vacillation in social and economic reorganization to increase the resilience of the economy (the Non-IMF Alternative?).

4) Fiscal mismanagement - lack of controls and accountability.

5) Absence of effective foreign exchange management (till there was no more foreign exchange to manage).

6) Naivety with respect to the local private sector.[23]

The crisis may therefore be seen as having been influenced by both internal and external factors. The internal factors included weak demand management, inappropriate policies and lagging production. It was in that context that a two-year Stand-by Agreement was signed between Jamaica and the Fund in July 1977.

Prior to the agreement, the government had in January 1977 outlined a programme including increases in import and exchange controls, foreign exchange rationing and demand restraint measures. Given the political fear of a unitary devaluation, a dual exchange rate system was adopted in May 1977. Demand restraint measures were included in the agreement but the IMF, against its standard preferences, accepted the existence of a dual exchange rate, exchange and import controls and a relatively liberal wage control policy. Given the

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[23] Kari Polanyi-Levitt in Jill Torrie (ed.), op. cit., pp. 257-259.

intensification of demand management and the requirement for accelerated elimination of foreign payment arrears, Dell and Lawrence found that the resources made available by the IMF were inadequate.[24] The IMF also failed in its role as a catalyst for additional foreign financing.

With the failure of the first (December 1977) test, an Extended Fund Facility agreement was negotiated, being finalized in May 1978. This agreement provided for drawings of SDR 200mn (270% of Jamaica's quota) over three years and repayment in eight years (the maximum time allowed). The funding appears to have been more generous and more in keeping with the "growth objectives" of the programme. Targets included those usually related directly to demand management but additionally there was to be devaluation to a unified excgange rate and a programmed crawling peg devaluation totalling 15% between May 1978 and May 1979. Given controls on nominal wages, real wages were to be cut by 25-30% over that year. Despite referring to growth objectives, the programme seemed to emphasize demand restraint more heavily than supply considerations. Despite the government's apparent commitment to the programme (including the devaluations and the cut in real wages), weak supply effects, debt servicings and foreign capital outflows contributed to Investment, growth and balance of payments stabilization objectives not being met. Given the disappointing results and hardships created by the first year of the programme, there was a renegotiation in 1979 allowing for additional funding and more generous performance target ceilings. Demand management, however, still appeared to be the central focus. The additional financing was made possible by increasing IMF flexibility and additional resource availability through the creation of the Supplementary Financing Facility in February 1979.

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[24] Dell and Lawrence, <u>The Balance of Payments Adjustment Process in Developing Countries</u>, p. 10.

In that year, despite the renegotiation, economic performance was again disappointing. Among the contributing factors were oil price increases, higher interest rates on external debt, weak extra-IMF capital flows and the effect of floods on the agricultural sector. In September 1979, negotiations on the refinancing of Jamaica's commercial bank external debts falling due in 1980 were suspended. In December 1980 Jamaica failed to meet three performance targets and the IMF agreement was terminated. While Girvan et al. have established that exogenous factors contributed 60% of the shortfall in net international reserves,[25] Sharpley suggests that the main reason for IMF withdrawal was the government's lack of fiscal restraint.[26]

Given the IMF's requirement for tighter wage controls and lay-offs in the public sector, the Jamaican government withdrew from negotiations for a new Stand-by Agreement in March 1980 and subsequently lost the "IMF elections" held in October of that year.

In discussing Jamaica's experience from 1977 to 1980, Girvan et al. refer to:

1) The failure of exchange rate and demand management policies to improve the merchandise trade balance.

2) The absence of supply effects in the face of supply rigidities and technological dependence.

3) The failure of the investment rate to recover and continual negative growth.

4) Negative socio-political consequences of adherence to IMF policies.[27]

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[25] Girvan et al., op. cit., p. 29.

[26] Sharpley in T. Killick (ed.), op. cit., p. 153.

[27] Girvan et al., op. cit., pp. 145-147.

Polanyi-Levitt's summary comment on the failure to reverse the economic slide is to the effect that the IMF is not essentially concerned with growth but rather to ensure that hard currency accruing to the international capitalist and banking system is not locked into underdeveloped countries.[28]

Sharpley's conclusions on Jamaica's 1977-80 policy experience may be summarized as follows:

1) There is a direct relationship between willingness and ability to accept IMF conditionality and the quantum of resources made available by the IMF.

2) Sunstantial foreign assistance was necessary to ease the costs of adjustment.

3) The Fund displayed "constrained flexibility" in response to social tensions and exogenous shocks.

4) The programmes had a pro-market bias but claims of an anti-socialist bias are questionable.

5) The IMF seal of approval does not always act as a catalyst for additional foreign financing.

6) Fund agreements could not easily dispel "uncertainty surrounding the domestic policies of the People's National Party (PNP). . .".[29]

Despite elements of disagreement on the relative importance of causative factors, and on the focus and influence of IMF adjustment policies, certain relatively uncontroversial conclusions may be drawn from the experience of the 1970's:

1) Balance of Payments problems may be caused by both internal and external factors.

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[28] Polanyi-Levitt in J. Torrie (ed.), op. cit., p. 260.

[29] Sharpley in T. Killick (ed.), op. cit., p. 160.

2) The internal factors may include a policy environment conducive to excess aggregate demand but may also relate to structural deficiencies and supply rigidities.

3) The IMF's policies appear to have been dominated by demand management and appropriate prices.

4) While the essential importance of growth was accepted, there seems to have been no consistent or comprehensive programme to generate that growth. Was it taken for granted that appropriate price signals would be sufficient?

5) While the IMF may have recognised the role of exogenous shocks and the need to provide additional financing, such additional financing, in the absence of extra-IMF flows, may be inadequate.

6) Emphasis on tighter demand restraint in the face of exogenous shocks may be less than helpful.

SECTION THREE

ECONOMIC POLICY IN THE 1980'S

The Programmes

In April 1981, the new government signed a three-year Extended Fund Facility with the International Monetary Fund. This agreement provided for drawings totalling US$698mn including US$48mn from the Compensatory Financing Facility. It was expected that IMF financing and the required policies for adjustment would serve as a catalyst for the inflow of additional financing.

This Extended Fund Facility was to be a cornerstone of the Economic Recovery Programme, the priority objectives of which "were identified as the promotion of economic activity in order to restore the economy to a sustained growth path and a reduction in the level of unemployment."[30] To attain these objectives, the strategy was

1) To employ excess capacity to earn foreign exchange, and

2) To increase productive capacity to reduce unemployment.

It was envisaged that there would be increased reliance on market forces with a greater reliance on the private sector as against the public sector.

The performance targets under the Extended Fund Facility included:

1) The Net International Reserves of the Central Bank

2) The Net Domestic Assets of the Central Bank

3) The Net Domestic Credit to the Public Sector

4) A ceiling on Foreign Debt Authorizations.

Ceilings on domestic monetary variables and international reserves were flexible, depending on the out-turn of programmed non-IMF capital inflows. Wages policy was based on ability to pay and there was no insistence on immediate devaluation

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[30] Bank of Jamaica, Annual Report 1981, p. 1.

but undertakings had to be made not to officially introduce multiple currency practices or intensify trade and foreign exchange controls. Sharpley sees in this agreement a greater degree of generosity and willingness to be flexible on the part of the IMF relative to their Jamaican programmes in the late 1970's.[31]

The Extended Fund Facility programme survived until September 1983, when the IMF disagreed with the Bank of Jamaica "on certain technical aspects relating to the computation of one of the performance criteria." The agreement was terminated and, after protracted negotiation, replaced by a Stand-by Agreement to run from April 1984 to March 1985. The focus of this Stand-by Agreement was to improve the Balance of Payments, enhance the accumulation of foreign exchange reserves and eliminate arrears on external payments. The agreement was to provide funding of US$180mn including support from the Compensatory Financing Facility. The main elements of policy were to be a flexible market determined exchange rate, tight demand management and "prudent debt policies". Performance targets focused on restructuring borrowing by the Central Government and Public entities (to free up credit for the private sector), increasing the net international reserves of the Bank of Jamaica and the elimination of external payments arrears.

The Jamaican government was granted a technical waiver for failure to meet a December 1984 performance target. In March 1985, however, it again failed to meet performance targets and the Stand-by Agreement had to be renegotiated. A new Stand-by Agreement was entered into in July 1985, again emphasizing strict monetary and fiscal targets (with more lay-offs in the public sector), maximizing the input of market forces in the determination of the exchange rate and other prices, and continued deregulation of the economy. The first quarterly

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31 Sharpley in T. Killick (ed.), _op. cit._, p. 156.

test at the end of September 1985 has however been failed and the government has applied for a technical waiver on the grounds that programmed inflows failed to arrive in time. (Do the tests become harder the more one fails?)

Foreign Exchange Rate Policy and the Exchange Rate

Jamaica's foreign exchange policy in the 1980's has been faced with two major issues (which are of course inter-related). These are:

1) What is the most "efficient" system for the mobilization and allocation of foreign exchange, and

2) What is the appropriate or equilibrium exchange rate and how ought it to be determined?

In the 1980's, Jamaica has experimented with several sets of arrangements in attempting to optimize foreign exchange flows. The present auction system has undergone at least two major modifications. The standard textbook listing of the "pros and cons" of fixed as against flexible exchange rates becomes much more complex in a situation where gross reserves are negligible, net reserves are highly negative, where there is a thriving parallel market in foreign currency and where entrenched expectations of ongoing devaluation have developed.

1981 dawned with Jamaica in a critical foreign exchange situation. Balance of Payments performance in preceding years had been disappointing, net international reserves had become highly negative and there was a pile-up of arrears on foreign payments. One consequence of all of the above was an inability to finance imports of raw materials and capital equipment to reverse the negative trends in growth performance. It is also worthy of note that in the late 1970's a significant "street market" in foreign exchange had sprung up, diverting funds from the "official market".

While there was no official devaluation at the outset of the Extended Fund Facility, an attempt was made in 1981-82 to divert the resources of the "street market" into the financing of required imports by the utilization of "no funds" licences. This device effectively constituted a de facto recognition (if not quite a "formalization") of a second market in foreign exchange.

Against the background of the international recession, the downturn in bauxite/alumina exports and consequent weakening foreign exchange flows, new foreign exchange arrangements were introduced on January 10, 1983. These new measures were also influenced by excesses in the administration of the "no funds" licence system and a perceived need to gain greater control over the direction of foreign exchange flows.

The two main policy measures introduced are as follows:

1) The "formalization of the parallel market" system with an official market at a fixed exchange rate of US\$1=J\$1.78 and a second market operated by commercial banks. These banks were initially permitted each to set its own buying and selling rate. In May, following protest from CARICOM trading partners, a special CARICOM rate of US\$1=J\$2.25 was introduced for CARICOM transactions.

2) Allowance for non-traditional exporters to retain 50% of their export receipts as an incentive to those exporters.

The Bank of Jamaica Report of 1982 also refers to a quota system to prioritize the allocation of foreign exchange and keep imports within targeted levels. Official market payments included public debt, basic food, petroleum products, tourism inputs, school books, drugs and infant feeds. Most other imports were to be financed by the formalized parallel market. Receipts from bauxite/alumina, traditional agricultural exporters and tourism were to be surrendered at the official rate. The system was aimed at giving incentives to non-traditional exporters, discouraging "non-essential" imports and holding down the prices of basic needs. It was also hoped to close down the street market by moving it into the banks, with greater potential for official monitoring.

Shortfalls in official foreign exchange flows saw a further shift of import items to the formalized parallel market in June. Furthermore, the street market itself was not effectively eliminated and it continued to compete for funds with both the official (for example, tourism flows) and the formalized parallel market. On the formalized parallel market the anticipated unification (equilibriation) of the exchange rate was not attained and there were "undercurrents" between banks and between the Ministry of Finance and banks on the matter of rate setting.

Despite the elimination of "tied purchases" in August, the parallel market continued with its appearance of distortion, fragmentation and of being subject to manipulation. Official flows continued to be weak and there appeared to be an acute shortage of foreign exchange for essential imports. Parallel market flows were also running below levels targeted for the Fiscal Year 1983-84.

Given the weaknesses in the system and also the need to negotiate a Stand-by Agreement (the Extended Fund Facility having ended as of September 1983), the "two tier foreign exchange market" was terminated on November 23, 1983.

It was replaced on November 24 by limited foreign exchange auction where the daily rate was set by commercial banks within a J$3 band, the midpoint of which would be received fortnightly by the Bank of Jamaica. The initial band was J$3.00 to J$3.30 per US$.

By early 1984, it was found that the system was vulnerable to collusion in exchange rate setting and therefore that the system did not "reflect the forces of Demand and Supply" (Bank of Jamaica Report, 1984, p. 10).

Commercial banks instead of being principals were to be commission agents of the Central Bank in the purchase of foreign exchange. The auction supply was to be the difference between total purchases and amounts subtracted for official payments (debt servicing, build-up of reserves, etc.). The minimum bid for direct access was to be for US$50,000 with smaller bids being channelled indirectly through the commercial banks. The J$0.30 band remained in force with the exchange rate being determined as the lowest bid clearing the auction supply and with allocations being made at that rate. The band was to be adjusted upwards (devaluation of the J$) "if unsatisfied demand in the auction was greater than a predetermined level over three consecutive auctions" (Bank of Jamaica Annual Report, 1984, p. 10).

It was subsequently realized that the March 1984 system had certain weaknesses. By bidding at the top of the band, transactors could ensure themselves an allocation at a lower clearing rate while effectively forcing an upward adjustment of the J$ range of the band. Effective November 29, 1984, therefore, the band was removed and the Jamaican dollar "allowed to freely reflect the forces of demand and supply." (At last?) Provision was made for the appreciation of the Jamaican dollar and successful bidders were to pay for foreign exchange at the rate at which they bid. The system with these modifications has remained in place to the present time (November 1985).

The auction system is generally accepted as being more successful than the parallel market system in enhancing the flows of foreign exchange through the banking system. Such flows, however, may yet be inadequate to meet the multiple demands of financing official payments and necessary imports, building up foreign exchange reserves and stabilizing the exchange rate.

The official price per US$ has moved from J$1.78 in 1981, through J$3.00 - J$3.30 at the establishment of the auction system, J$4.75 at its modification in

November 1984 to J$5.50 on November 14, 1985. In between, however, there have been some fluctuations, some of them spectacular. For example, with the modification of the auction in November 1984, the price per US$ plunged immediately from J$4.75 to J$4.00 but by December 20 was back to J$4.95. In October 1985, the price per US$ increased from approximately J$5.95 to J$6.40 on October 17 and subsequently fell (with sharply increased supply) to J$5.50 by November 14.

It is clear, however, that in the 1980's there has been significant devaluation of the Jamaican dollar. By early 1985, when the price per US$ had exceeded J$5.00, a senior Bank of Jamaica functionary declared that the extent of the devaluation had been sufficient to restore international competitiveness to Jamaican exports. This view is supported by the work of the Planning Institute of Jamaica in computing a real effective exchange rate index for Jamaica on a quarterly basis, between 1975 (1st quarter) and 1984 (4th quarter). This index almost doubled between 1975 and 1984 and increased by about 80% between 1980 and 1984. The Planning Institute of Jamaica therefore concluded in early 1985:

> It is thus apparent that relative probability between export and non-export activities has been shifted in a fundamental way, perhaps unprecedented in the history of the country. The non-traditional export sector is thus in a position to meet the challenges posed by the deterioration of the Bauxite-Alumina Sector.[32]

The above quotation places in relief the question of the appropriate exchange rate and emphasizes the absence of highly developed market forces on

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[32] Planning Institute of Jamaica, "An Assessment of Real External Competitiveness of the Jamaican External Sector", Quarterly Economic Report, Vol. 1, No. 3

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the foreign exchange markets, constraints on the domestic production and the international trade of underdeveloped economies. Despite "competitiveness" having been attained at approximately J$5=US$1, the exchange rate proceeded to J$6.40=US$1.00 by October 1985 and has only been brought back to J$5.50=US$1.00 (November 1985) by uncharacteristically generous intervention by the Bank of Jamaica. While non-traditional exports have been expanding, it is clear that supply has not responded fast enough or in suffieicnt volume to fill the gap left by the bauxite/alumina fall-out. The Caribbean Basin Initiative has so far been disappointing for Caribbean economies, and their efforts to diversify are still haunted by protectionism in developed market economies.

The auction system is not a free market. On the demand side, it is subject to what appears to be oligopsonistic demand. On the supply side, the Bank of Jamaica's interventions have been anything but refined. Furthermore, almost nobody "believes in" the current exchange rate (J$5.50=US$1.00). Given the state of the economy, one necessarily questions the ability of the auction system to maintain that exchange rate. Large swings in the exchange rate can only serve to undermine confidence in the auction system and confidence in the currency.

Fiscal Policy and External Debt

Fiscal policy in the 1980's, in keeping with the need to control the public sector borrowing requirement, sought to reduce the current account and overall budget deficits as percentages of the GDP. One initial projection of the aborted 1981-84 Extended Fund Facility was that (given estimates of real growth) in comparison to a current deficit of 7.5% of GDP in 1980-81, a current surplus of 1% of GDP would be generated by the third year of that programme.

Fiscal policy therefore concentrated to a large extent on significantly

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increasing current revenue and controlling current expenditure. In increasing current revenue much emphasis has been placed on the need to make the tax collection machinery more efficient. In 1981, a Revenue Board was set up, charged with the task of streamlining and co-ordinating the collection of public sector revenue. Also between 1981 and 1982, significant effort was made to collect tax revenue arrears dating back to the 1970's. (Businessmen were threatened with the "back tax axe".) These efforts were very successful as between April and December 1981, tax receipts were almost 42% higher than for the corresponding period in 1980. The improvement was maintained in 1982 and 1983. Increases in taxation were minimal in 1981 and 1982 and moderate in 1983.

While tax collection was improving, the Fiscal Budget suffered in 1982 and thereafter from the down-turn in the bauxite/alumina industry with contracting production, the bauxite levy as a percentage of GDP fell from 5.5% in 1981-82 through 4.9% in 1982-83 to 2.0% in 1983-84. Table 1 below sets out selected fiscal indicators for the period 1980-81 to 1984-85.

The effort to control recurrent expenditure was initially centred on the rate of increase of wages and salaries in the public sector. The cause of restricting public sector remuneration in 1981 and 1982 was supported by low rates of inflation in 1981 (4.6%) and 1982 (6.5%). Recurrent expenditure has also involved increasing interest payments on the public debt. In 1983 the rate of inflation increased to 16.7% and for the fiscal year 1983-84 current expenditure as a percentage of GDP increased to 33.9% from 30.8% in the previous fiscal year. There are indications that the effort to control current expenditure has resulted in extensive neglect in the maintenance of public property (schools, roads, gullies, courthouses, etc.).

Capital expenditure has also suffered from the need for fiscal restraint.

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TABLE 1

SELECTED FISCAL INDICATORS

PERCENTAGE OF GDP (OUT-TURN)

1980/81 TO 1984/85

	80/81	81/82	82/83	83/84	84/85
Tax Revenue		21.4	23.3	21.0	21.4
Bauxite Levy		5.5	4.9	2.0	4.2
Current Resources		27.9	29.3	23.9	26.6
Current Expenditure		31.6	30.8	33.9	30.3
Capital Expenditure		11.9	11.1	8.8	4.8
Total Expenditure		43.5	41.9	42.7	35.1
Current Balance	-7.5	-3.7	-1.5	-10.0	-3.7
Overall Balance	-17.0	-15.6	-12.6	-18.7	-7.2

Source: Economic and Social Survey (Jamaica) 1984, Table 6.2

Between 1981 and 1983, the most "buoyant" element of capital expenditure had been amortization of the public debt. Other elements of capital expenditure were severely curtailed with the result that capital expenditure as a percentage of GDP fell from 11.9% of GDP in 1981-82 to 8.8% of GDP in 1983-84.

Given the above trends in fiscal performance, the current balance as a percentage of GDP in 1983-84 was -10% (instead of the projected 1%) and the overall balance was -18% of GDP. It is in that context that the 1984-85 Stand-by Agreement focused heavily on the need for drastic and immediate fiscal improvement. The overall deficit was to be reduced to, or below, 8.3% of GDP in fiscal

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year 1984-85. A tax package totalling J$183mn was announced before the budget (J$138mn) and during the budget (J$45mn), 1984. Recurrent expenditure was to be controlled by limiting public sector wage increases (to the lower of 10% to 15% or $15 per week) and laying off 6,200 public servants during that fiscal year. The rate of inflation for 1984 was 31.3%.

Between April and December 1984, total revenue increased by 57.6% with tax revenue increasing by 30%. Total expenditure increased by 19% with recurrent expenditure increasing by 37.8% and capital expenditure falling by 20.8%. So effective was the government's effort at fiscal restraint that for fiscal year 1984-85, the overall deficit had been reduced to 7.2% of GDP (1.1% below the targeted ceiling). Current expenditure fell in real terms, and to 30.3% of GDP. GDP itself is estimated to have fallen during the fiscal year. Capital expenditure fell in both nominal and real terms and was down to 4.8% in GDP in 1984-85. This fall in capital expenditure was the result both of a rescheduling in debt payments and limited public sector investment. Tax revenue and bauxite-related earnings (counter-trade agreements and CDF transfers) increased as a percentage of GDP.

There appears to have been an acceleration in the accumulation of public debt in the 1980's. This is especially true of the external debt which increased by 26.2% in 1981, 32.57% in 1982, 62.82% in 1983 and 74.60% in 1984. Gross external debt as a percentage of GDP increased from 36.7% in 1981 to 83.77% of GDP in 1984. In the 1980's also external debt has replaced internal debt as the dominant component.

Debt service ratios have also been heavy and increasing. While the Bank of Jamaica Annual Reports give the ratios of total debt service to gross exports of goods and services as follows:

TABLE 2

CENTRAL GOVERNMENT DEBT INDICATORS (AT DECEMBER)

1980 - 1984

	1981	1982	1983	1984
Annual Increase in Gross Net Debt %	28.9	18.76	40.42	55.08
Annual Increase in Gross Internal Debt %	30.6	10.39	24.14	36.48
Annual Increase in Gross External Debt %	26.2	32.57	62.82	74.80
Gross National Debt as % of GDP	97.2	143.26	127.27	152.48
Gross External Debt as % of GDP	36.7	44.34	62.11	83.77
Gross External Debt as % of Gross Nat. Debt	37.7	42.09	48.80	54.94
Gross Internal Debt as % of Gross Nat. Debt	62.3	57.91	51.20	45.06

Source: Economic and Social Survey (Jamaica) 1981-1984.

	1980	1981	1982	1983	1984
%	18.5	29.1	31.7	27.9	27.5

these figures, especially for 1983 and 1984, may be somewhat misleading. The debt servicing figure used is net of refinancing or rescheduling and if these are taken into consideration the ratios for 1983 and 1984 may be of the order of 36% and 40%. It is apparent therefore that the debt servicing burden, given the heavy accumulation of foreign debt in the 1980's, is increasing. Successful debt servicing especially in view of refinancing arrangements requires economic growth and export expansion.

While the fiscal targets have been attained, there has been considerable dissatisfaction among public sector employees, notably teachers, nurses and those who have lost employment. Inadequate salaries and lack of maintenance and expansion are seriously threatening the quality of the educational system. While maintenance and capital expansion have been minimized, effort has been made to catch up with external payments arrears. External payments have also been rescheduled, reducing current pressure on the budget, but what are the implications for the future debt servicing burden if tighter and tighter demand restraint means continued economic stagnation? Fiscal balance is enhanced, but at what cost to social stability and long-term economic potential?

Monetary Policy

Monetary policy in the 1980's has been influenced mainly by the need to restrain financial system liquidity and to generate positive market determined real rates of interest in keeping with the various economic performance targets.

Liquidity restraint has been an essential element of demand management, designed to restrict inflation, enhance balance of payments performance and subsequently to control demand on the foreign exchange auction. During 1981 and 1982 the voluntary liquid assets ratios of commercial banks were maintained at 40% (the maximum ratio statutorily permissible remaining at 29.5%). In 1983, in the context of a continuation of weak official foreign exchange flows, the 40% voluntary liquid assets ratio was abolished and the statutory ratio was increased in two steps to 36% by April of that year. In June 1983, the liquidity situation of commercial banks was eased somewhat by their being allowed to count their parallel market float as a part of their liquid assets.

The continuing need, at the end of 1983, to stabilize the balance of payments and to increase foreign exchange reserves led to the introduction in January 1984 of Ministry Paper 5/84. The liquidity related measures included in that paper

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are as follows:

1) The statutory liquid assets ratio of commercial banks to be increased from 36% to 40%.

2) The cash reserve ratio of commercial banks to be increased from 5% to 10%.

3) The permission granted in June 1983 for the inclusion of "foreign currency float" as liquid assets was withdrawn.

4) The liquid assets ratio of merchant banks and trust companies to be increased from 10% to 15%.

After the unification of the exchange rate in November 1983 and the establishment of the auction system, it came to be an "article of faith" of Jamaica's monetary authorities that high levels of demand at the auction and consequent slippage of the exchange rate were primarily caused by excess liquidity in the commercial banking system. Therefore, subsequent to the introduction of Ministry Paper 5, there were further attempts to tighten liquidity. In May 1984, a deposit scheme for the elimination of payments arrears was introduced resulting in a sharp depletion in commercial bank liquidity between May and June. After September 1, the cash reserve ratio was increased from 10% to 14% and a voluntary liquid assets ratio of 44% was introduced. In November, the maximum statutory liquid assets ratio was increased to all of 50%.

While the deposit scheme for the clearing of arrears was discontinued after July, commercial banks, after October 22, were required to maintain a special clearing account at the Central Bank as a separate entity from their statutory liquid assets. Attempts were made to mitigate the effects of tightening liquidity on strategic productive sectors by the expansion of Bank of Jamaica's rediscounting facility in the latter half of the year.

In the first six months of 1985, the required liquid assets ratio was increased from 44% to 48%. The cash reserve ratio was increased in steps from 14% at the beginning of the year to 20% in July.

By any standards, with the liquidity ratio of 20% and the cash reserve ratio at 20%, liquidity requirements were extremely tight. These measures, contrary to the expectations of the Bank of Jamaica, proved inadequate to stabilize the exchange rate.

Selective Credit Controls

Throughout the 1980's, occasional attempts have been made to mitigate potentially harmful effects on private sector production of tightening liquidity. In the context of liquidity management, it was hoped that the strict management of the public sector borrowing requirement would free sufficient credit for the private sector.

To influence the allocation of private sector credit, ceilings on consumer oriented credit and selective rediscount facilities were used. Consumer credit guidelines which had been in operation since the 1970's were tightened in March 1982 and May 1983. Three special rediscounting facilities operated by the Jamaica Export Credit Insurance Corporation were integrated in 1984 to form a Bankers' Rediscounting Facility. The sectors facilitated were exports, construction, manufacturing, tourism and agriculture. The JECIC also operated an Export Development Fund and a Rehabilitation Fund (for construction and manufacturing).

From Table 3 below, it would appear that there has been an improvement in the sectoral allocation of commercial bank credit in the 1980's. The share of manufacturing increased and the share of consumer credit declined throughout the period. While "agriculture's" share fell between 1981 and 1983, it increased markedly in 1984. The steadily increasing share of construction and land development ought not to be taken as a necessary manifestation of socially productive credit allocation. The larger share of that sector's allocation is for "land development" and may suggest heightened speculation. This latter point indicates the need for a more extensive and sensitive analysis of credit flows.

Some attempt has been made, therefore, to mitigate the effects on production of tight liquidity. It is likely, however, that the liquidity constraints and selective credit controls will affect large businesses differently from relatively small businesses.

TABLE 3

SECTORAL ALLOCATION OF COMMERCIAL BANK CREDIT (1980-1984)

SELECTED SECTORS - PERCENTAGE OF TOTAL

	1980	1981	1982	1983	1984
Consumer credit*	32.5	29.7	26.5	21.2	15.0
Manufacturing	19.7	21.2	20.2	21.3	24.8
Construction and land development	11.7	12.1	16.6	21.0	22.5
Agriculture	10.8	12.9	11.8	10.8	14.6

*Includes distribution, personal and professional services

Source: Bank of Jamaica Annual Reports, 1980-1984

Interest Rate Policy

Throughout the 1980's, interest rate policy has been concerned with the need to allow market forces to generate higher and positive real rates of interest as a means of stimulating savings and improving efficiency in the allocation of financial resources. It was expected that tightening liquidity (as discussed above) would exert upward pressure on nominal rates and help to attain the desired results.

In 1981, it was determined that the Bank rate should be tied to the Treasury Bill rate which would fluctuate with the state of liquidity. While nominal interest rates increased gradually between 1981 and 1983, in the latter 5 months of 1984 there was sharp upward adjustment under the influence of tightening liquidity. The bank rate moved from 13% in August to 16% in November with a concomitant movement in commercial bank lending and deposit rates. The Treasury Bill rate increased from 11.3% in June to 15.40% in December with the result that some short-term deposit rates reached 20% and some lending rates reached 26% in the latter month.

The upward movement of nominal interest rates has continued into the first two quarters of 1985.

The upward movement in nominal interest rates has, however, not been sufficient to generate positive real rates of interest throughout the 1980's.

A crude comparison of interest rates and changes in the consumer price index would indicate that while real rates may have been positive in 1981 and 1982, real deposit rates were negative in 1983 and all real rates negative in 1984. The work of the Planning Institute of Jamaica has indicated that real deposit rates of interest have continued to be negative in 1985. In the second quarter of 1985 (April-June), the bank rate was increased to 21% and the prime

TABLE 4

SELECTED COMMERCIAL BANK INTEREST RATE INDICATORS (%)

A WEIGHTED AVERAGE

DECEMBER 1980 - DECEMBER 1984

	DEC 1980	DEC 1981	DEC 1982	DEC 1983	DEC 1984
Deposit 3 - 6 months	9.59	12.24	12.30	12.65	18.47
Deposit 12 - 24 months	8.21	10.49	10.83	12.47	14.55
Treasury bill - discount rate	9.91	9.97	9.26	12.11	16.40
Credit - instalment	20.57	21.64	21.89	22.59	23.68
Credit - commercial	16.64	15.61	15.70	16.35	19.61

Source: Bank of Jamaica Annual Reports, 1980-1984.

TABLE 5

CHANGE IN ALL ITEMS CONSUMER PRICE INDEX

DECEMBER 1980 - DECEMBER 1984

	1980	1981	1982	1983	1984
Percentage (point to point)	28.7	4.7	6.5	16.7	31.3

Source: Economic and Social Survey (Jamaica), 1984 lending rate to 23%.[33]

Despite tight demand management, the slide of the exchange rate has continued to generate inflation resulting in negative real rates of interest.

33 Planning Institute of Jamaica, Quarterly Economic Report, Vol. 2, No. 1, pp. 22-23.

SECTION FOUR

BALANCE OF PAYMENTS AND MACRO-ECONOMIC PERFORMANCE, 1980 - 1984

The summary of economic policy initiatives in the previous section is not exhaustive. For example, there has been movement towards dismantling controls, deregulation of imports and in conjunction with the World Bank's structural adjustment programme an attempt to change the nature of protectionism from quotas to tariffs. Also, in addition to selective credit controls, attempts have been made to stimulate production and exports by means of fiscal incentives. Agro-21 and the Caribbean Basin Initiative have been focal points of the government's drive for economic growth.

We have, however, focused on the central elements of IMF inspired policy for demand management and appropriate pricing. This section gives a brief summary of the Balance of Payments and Macro-economic out-turn in the 1980's.

The Balance of Payments

The merchandise trade balance became more negative between 1980 and 1982, but improved between 1983 and 1984. The initial worsening was due both to a freeing up of imports and the decline in bauxite/alumina production in the early 1980's. (Import liberalization had a negative effect on domestic agriculture.) The improvement between 1983 and 1984 was due to marginal increase in exports (non-traditional) and a significant curtailment in imports. There does not appear to be much more scope for import contraction.

The "Services" balance became less negative between 1980 and 1983 but deteriorated in 1984. Foreign travel has been positive and increasingly so since 1980. Investment income had become less negative between 1980 and 1982, but recorded its greatest negative balance for the period (-US$304.8mn). Total net investment income outflow for 1981-84 is US$944.9mn.

TABLE 6

JAMAICA'S BALANCE OF PAYMENTS, 1980 - 1984

(US$MN)

	1980	1981	1982	1983	1984 (PROV)
A. MERCHANDISE	-75.4	-322.7	-441.5	-438.5	-295.7
Exports (fob)	962.7	974.0	767.4	685.7	738.7
Imports (fob)	1038.1	1296.7	1208.9	1124.2	1034.4
B. SERVICES (NET)	-181.7	-138.4	-96.8	-18.0	-122.3
Foreign travel	228.9	270.6	306.1	374.3	403.3
Investment income	-251.2	-201.5	-183.5	-185.1	-304.8
Other	-158.9	-207.5	-219.4	-207.2	-220.8
GOODS & SERVICES (NET)	-257.1	-461.1	-538.3	-456.5	-418.0
C. UNREQUITED TRANSFERS (NET)	90.8	124.3	150.4	101.5	127.0
Private	81.8	123.3	134.5	94.7	118.0
Official	9.0	1.0	15.9	6.8	9.0
CURRENT ACCOUNT BALANCE	-166.3	-336.8	-387.9	-355.0	-291.0
D. NET CAPITAL MOVEMENTS	105.1	225.4	465.6	76.4	515.3
Official	226.6	240.2	446.0	321.0	358.2
Private	-121.5	-14.8	19.6	-244.6	157.1*
E. TOTAL A TO D	-61.2	-111.4	77.7	-278.6	224.3
F. ALLOCATION OF SDRs	10.0	10.0	-	-	-
G. TOTAL E PLUS F	-51.2	-101.4	77.7	-278.6	224.3
H. CHANGES IN RESERVES (Increase = Minus)	50.2	90.5	-86.0	289.1	-224.3
Holdings of SDRs	0.5	-1.3	1.2	0.1	-
Reserve position of IMF	-	-2.8	-1.3	4.1	-
Government	-12.7	14.0	-1.0	17.4	-3.8
Capital Development Fund	-0.1	-4.0	4.1	0.2	-
Bank of Jamaica & other banks	71.0	86.5	-90.3	257.6	-183.8
Export Development Fund	-8.5	-1.9	1.3	9.7	-36.7
NET ERRORS & OMISSIONS	1.0	10.9	8.3	-10.5	-

* Includes Net Errors and Omissions

Source: Bank of Jamaica Annual Reports

"Unrequited transfers (net)" has been positive throughout the period. It increased from 1980 to 1982, declined in 1983 and increased again in 1984. Private transfers have dominated official transfers.

The current account balance has been negative throughout the 1980's. It worsened between 1980 and 1982 and improved thereafter. Net capital movements, with the exception of 1982 and 1984, have been inadequate to finance these current account deficits.

Net capital movements have been positive in the 1980's. They increased between 1980 and 1982, declined sharply in 1983 and exceeded the 1982 level in 1984. It is clear that positive official capital movements have dominated mostly negative private capital flows. For 1981-84, official capital movements total US$1365.4mn, while private capital movements total _US$82.7mn. Private capital movements, therefore, like net investment income, has been a foreign exchange drain in the 1980's.

Reserves have mostly fallen with the exceptions (1982 and 1984) being largely due to official capital inflows and in the case of 1984 to private capital inflows. It is not clear that these private capital inflows will be maintained. If they are maintained, they, with official capital inflows, will necessarily have implications for investment income outflows and external debt servicing.

The Balance of Payments situation, therefore, has not been stabilized. Imports can hardly be cut further without affecting the prospects for economic growth. Investment income outflows have continued to be a drain on the economy, while private capital inflows have been disappointing. There is some potential for the expansion of non-traditional exports, services (especially foreign travel) and a resurgence of the bauxite/alumina industry is still hoped for. These latter improvements (especially tourism) are crucially dependent on the maintenance of socio-political stability.

Inflation

After initial successes in controlling inflation in 1981 and 1982, there was a resurgence in 1983 and 1984.

TABLE 7

PERCENTAGE CHANGE IN THE ALL ITEMS CONSUMER PRICE INDEX, 1981 - 1984

	1980	1981	1982	1983	1984
Percentage (point to point)	28.7	4.6	6.5	16.7	31.3
Percentage (average)	28.2	11.9	6.5	11.3	27.8

Source: Economic and Social Survey (Jamaica), 1984, Tables 4.1 and 4.2.

Given relatively strict wage controls (especially in the public sector) with a consequent decline in real wages, it would appear that domestic inflation in the 1980's has been dominated by movements in the exchange rate.

In 1981 and 1982, there was no official devaluation (despite the existence of a thriving street market in foreign exchange). Also, in those years, the local market was flooded with imported means of consumption. In 1983, there was the formalization of the parallel market with cumulative shifting of transactions from the official to the parallel market. In late 1983, there was official devaluation with the unification of the exchange rate. Under the auction system between 1983 and 1985, there has been significant devaluation of the Jamaican dollar. The IMF's preference for decontrolling prices and eliminating subsidies has also contributed to the inflationary experience.

The inflationary resurgence has been maintained in 1985 with prices in the first quarter increasing by 5.9% and in the second quarter by 8.4% (on a point to point basis). The link between the exchange rate and inflation creates a vicious spiral wherein inflation makes balance of payments and exchange rate stabilization more difficult, makes real interest rates negative and threatens social stability in the face of demand restraint.

Economic Growth

1981 represented a reversal of the economic contraction as experienced throughout most of the 1970's. The growth performance in the 1980's has, however, been uneven.

TABLE 8

PERCENTAGE CHANGE IN GDP IN CONSTANT PRICES, 1980 - 1984

	1980	1981	1982	1983	1984
Percentage change	-7.33	2.49	0.96	2.04	-1.4

Source: Economic and Social Survey (Jamaica), 1984, Table 1.1.

Note: These figures represent Planning Institute of Jamaica revisions of earlier estimates.

In 1982, influenced by the contraction in the bauxite/alumina industry, growth was initially estimated as 0.0% and subsequently as 0.96%. After a resurgence in 1983, the economy again contracted in 1984. This contraction has continued in 1985, with the Planning Institute of Jamaica, by the middle of

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the year, estimating a decline of 4-6% for the entire year. Beyond the continued slump in bauxite/alumina, the Institute sees the tightening of fiscal and monetary policy as contributors to economic decline.[34]

The analysis could be deepened by more sectoral detail. It appears, however, that economic performance is influenced by economic shocks in a situation where the contractionary effects of policy dominate any stimulative or expansionary effects.

Unemployment

The rate of unemployment appears to have been relatively constant throughout the 1980's.

TABLE 9

UNEMPLOYMENT PERCENTAGE, 1980 - 1984

	1980	1981	1982	1983	1984 (OCT.)
Percentage unemployment	27.9	25.9	27.4	26.4	25.4

Source: Economic and Social Survey (Jamaica), 1980 - 1984.

It declined in 1981, improved in 1982 and declined slightly in 1983 and 1984. The 1983 and 1984 improvements are especially surprising in light of economic contraction with lay-offs in the bauxite/alumina subsectors. Those reductions in the rate of unemployment are ascribed to increased female employ-

[34] Planning Institute of Jamaica, Quarterly Economic Report, Vol. 2, No. 1, September 1985.

ment in the service sector. (It is not clear exactly what this means.)

Domestic Savings and Investment

Domestic savings and investment are important as foundations of the economic growth process. The fractions of GDP saved and invested may be taken as an indication of the ability of an economy to sustain its growth process.

TABLE 10

DOMESTIC SAVINGS, GROSS AND NET INVESTMENT AS A PERCENTAGE OF GDP

1980 - 1984

	1980	1981	1982	1983	1984 (PROV)
Domestic savings*	10.16	8.6	7.7	10.6	10.2
Gross investment	15.9	20.5	20.8	21.6	22.5
Net investment	7.0	11.2	11.4	13.4	9.1

*Includes depreciation

Source: Computed from Economic and Social Survey (Jamaica), 1984, Tables 1.1 and 1.6

Domestic savings as a percentage of GDP fell from 10.16% in 1980 to 7.7% in 1982, increased to 10.6% in 1983 but by 1984 was back to the percentage of 1980. It must be noted that within Gross Domestic Saving, capital consumption allowances are dominant with other saving (private plus public) being negligible or negative.

Gross Investment has increased steadily from 15.9% of GDP in 1980 to 22.5% of GDP in 1984. This investment is financed mainly from external sources. Since 1981, foreign financing has dominated domestic financing.

Net Investment as a percentage of GDP increased from 7.0% in 1980 to 12.4% in 1984. In 1984, however, it fell to 9.1% of GDP.

It appears, therefore, that while Gross Investment performance has been positive, the improvement in net investment has not been sustained. Gross Domestic Saving has been weak generating an increasing reliance on foreign financing for domestic investment. A more detailed analysis of public and private sector saving behaviour is necessary. In particular, one must examine the relationship between the real rate of interest and real private sector savings.

This paper has indicated, however, that economic policy in the 1980's has not always been able to control inflation and guarantee positive real rates of interest. One may also conclude that the economy has become increasingly dependent on foreign financing.

CONCLUSION

A theory may be logically consistent and mathematically elegant but it must be remembered that theory is only a guide to reality and in part an abstraction from reality. An economist must not only be a "good technician" in being able to construct and manipulate models, but must also be sensitive to the social and political reality in which one is operating. So, while it is argued that the Monetary Approach to the balance of payments is "a universally valid analytical framework arising as it does from the balance sheet identity",[35] it must be realized that peculiarities of individual countries may make them prone to excessive money creation and limit the rate of feasible monetary adjustment.

There are, however, important lessons for underdeveloped countries in that Monetary Approach to the Balance of Payments. For countries which have not yet had to take large doses of IMF medicine, it is important to exercise fiscal restraint and sound financial management. The eventual alternative may be IMF influenced restraint where the priorities of the IMF are likely to differ from those of the country receiving IMF assistance. (For example, inflation as against unemployment and the rate of wage increase as against socio-economic welfare.) This need for sound economic management is vividly illustrated by Jamaica's fiscal and monetary over-expansion in 1974-76 creating a need for the IMF's financial support and "seal of approval".

Several weaknesses in IMF inspired economic policies in Jamaica in the 1970's have been identified. While the IMF has displayed signs of increasing generosity and flexibility, it is not clear that the fundamental weaknesses of the programmes and policies have been corrected. There is continued emphasis on demand restraint

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35 Robichek in J. Muns (ed.), op. cit., p. 72.

and appropriate prices, while measures to stimulate supply, especially in the face of exogenous shocks, have been inadequate. It is also clear that the IMF's "seal of approval", especially where international banking is worried about international debt, may be impotent as a catalyst for additional financing.

Jamaica's economy has not been stabilized and it has contracted in 1984 and 1985. Socio-economic welfare has deteriorated, social resistance has already been displayed as in the January 1985 protest over the gas price increase. Those demonstrations are seen as having had a negative impact on the tourist industry. Ironically, Jamaica, having borrowed so much and grown so little, may now be approaching the limits of its debt carrying capacity.

The international financial system is still in crisis with its survival still being threatened by the overhang of international debt. There are signs of increasing resistance to debt servicing requirements and the nature of IMF conditionality. In that context, a recent suggestion for additional financing for the world's largest debtors (with an increased role for the World Bank) at the cost of more austerity may be inadequate to solve the problem.

Therefore, while one accepts the need for more prudent economic management in underdeveloped countries, there is also a need for more emphasis on the stimulation of economic growth. Where markets are not highly developed, reliance purely on market forces may be misguided. International demand management, with protectionism in developed countries, will have negative consequences not only for individual underdeveloped economies, but for the international economic system. There is also a need for increased international financing, on more concessional terms, and a more realistic approach to the debt problems of underdeveloped economies.

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