THE NEW ROLE OF THE STATE IN THE JAMAICAN ECONOMY: DEREGULATION OF THE FINANCIAL SECTOR

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I. INTRODUCTION

The dichotomy between the state and the private sector evolved as a result of the principles and practices of economic liberalism. The role of the state expands and contracts in relation to the functioning of private producers and markets. While it may be difficult to determine the direction of causality between expanding/contracting state and undeveloped/developed market, the more important task would seem to be to determine at what point the role of the state should be adjusted not only to reflect and further promote changes in production and market relations, but also to address social and political issues.

In developed market economies, the state's economic role expanded on account of the monopolistic and oligopolistic practices resulting from concentration of economic power and the inequities that resulted from the functioning of free markets. The state's role was therefore to mediate the tension between capital accumulation and distributive justice and between competitive and monopolistic forms of production. In less developed countries, markets have been largely undeveloped and regulated. The state's role extended beyond regulation to actual involvement in production and distribution. This to a large extent inhibited the development of competitive forms of production and the functioning of free markets.

The Jamaican economy became heavily regulated during the 1970s. But prior to that period 'free' markets did not really

exist. Domestic production was aimed at satisfying external demand and domestic demand was largely satisfied by external supply. Export marketing was regulated by state-controlled export marketing organisations; and import trade was controlled by tariffs. The labour market was regulated by labour legislation and trade unions. Production and trade were regulated by price controls and other bureaucratic practices, and financial sector activities were subject to legislative and other policy controls.

During the 1970s, government extended its regulation of external trade by imposing quantitative restrictions, requirements of import licences for several items and stamp duties to augment tariff charges. It also established an import organisation with monopoly for importing specific goods, notably those resulting from barter and other bilateral arrangements which the government negotiated. The foreign exchange rate remained fixed until 1977 and new exhange control measures were imposed. Travel allowances were significantly reduced and permits for remittances had to be obtained prior to foreign currency sales. All of these measures were imposed by government with a view to protect the balance of payments which deteriorated and the exchange rate which came under pressure due to increased demand and fall in supply.

At the same time the government expanded its economic role by acquiring private sector assets in various industries, especially the hotel industry which experienced a decline during that period. State intervention and participation in economic activity were dictated by the need to provide employment for a growing labour

force and to maintain the social infrastructure which underpinned production and growth. However, its extensive role could not be financed from the fiscal operations of the government. Structural budget deficits became a feature of the deteriorating economic situation facing the government at the end of the seventies. The combination of balance of payments and fiscal budget deficits led the government to rely increasingly on local and foreign borrowing resulting in a foreign debt which became difficult to service in the face of declining foreign exchange earnings. Reliance on the international financial institutions, in particular the IMF and the World Bank for financial support, meant adherence to a programme of economic reform based on the policy prescriptions of these institutions. Liberalisation and privatisation became the lynchpins of such a programme to reset the parameters defining state and private sector actions respectively.

II. ECONOMIC ADJUSTMENT

1. Views of International Financial Institutions

IMF and World Bank prescriptions for the Jamaican economy were based on the view that disequilibria in the economy were caused mainly by expansionary policies and the inward-oriented development strategy of the government. To correct the situation the government has to reduce state involvement in the economy and cut

budget deficits which tend to have an adverse effect on the balance of payments. Divestment of state-owned enterprises is the mechanism which would allow the government to achieve some of these objectives. At the same time, government has to control demand while putting in place measures to increase supply until equilibrium is restored. To facilitate the latter, it has to reduce the size of the state sector as well as its role in the economy. In other words, the balance of power must shift from the state to private producers.

To shift from an inward to an outward-oriented strategy, government has to liberalise the economy to allow for market, and presumably more efficient allocation of resources. And to encourage a liberal trade regime and foster competition, protection of local firms and farmers through quantitative import restrictions have to be eliminated and reliance placed instead on minimum tariff rates. Duty free concessions on imports should be given mainly to exporting firms. Distortions such as price controls and subsidies also have to be abolished.

Financial sector adjustment has to be pursued to allow the market to determine the exchange rate, to restrict the flow of savings into the public sector, to prevent money creation and to foster the growth of the capital market in Jamaica. And the measures that the government is expected to adopt are liberalisation of the foreign exchange market, abolition of exchange controls, reduction of borrowing from the Central Bank and the use of alternative monetary policy instruments.

2. Trends in Liberalisation

The trend in liberalisation of the Jamaican economy began from 1983 with exchange rate changes and the subsequent change in the system for determining the rate. The travel allowance was increased and a significant number of government shares in the National Commercial Bank were sold to the public. The trade liberalisation measures that were pursued since 1983 were in the main, removal of licensing requirements for several items of import, reduction of maximum tariff and stamp duty rates and the removal altogether of stamp duties from some imported items.

The liberalisation process accelerated from the late 1980s. Most of the non-tariff barriers to imports were removed and tariff rates were reduced to a maximum of 30 percent. At the same time privatisation of public enterprises was occurring at a relatively fast pace. In the financial sector, government owned non-voting shares in a major commercial bank many of which were sold in the 1980s. The rest of these shares are to be put on the market in the near future. Government ownership would now extend only to a number of development banks but even these are being considered for divestment during the 1990s.

III. FINANCIAL SECTOR REFORM

1. Trends in Deregulation

The foreign exchange rate was administratively determined

prior to 1984. In that year a new system was introduced based on a bi-weekly managed auction which was later modified to allow the dollar to float freely. In late 1989 the bi-weekly auction was changed to a weekly auction and then suspended. A review of the foreign exchange system was made in late 1990. The result was the introduction of an interbank foreign exchange system under which each commercial bank set its own exchange rate. A weighted average of the rates was used for daily transactions. The rationale for the change was to have a system that allocates foreign exchange on the basis of demand and supply, thereby reducing 'overall demand pressures' and inducing a steady inflow of foreign exchange into the official banking system [BOJ 1990]. However, excluded from the available supply were receipts from the main export earners, namely sugar, bananas, bauxite/alumina and tourism, which had to be surrendered to the Bank of Jamaica. Also excluded was a portion of the foreign exchange purchases of the commercial banks which the Central Bank required to pay for oil imports and service the official debt.

Exchange controls were further liberalised with an increase in vacation travel allowance. Commercial banks were allowed to make these and all other commercial payments. Investments abroad and real estate transactions by non-residents remained under Central Bank control. Foreign currency accounts were also introduced in 1990 as part of the new deregulated system of foreign exchange. Residents and non-residents could operate an 'A' account on which interest was paid in foreign exchange; a ceiling of US$10,000 was

placed on cash deposits in each account. They could also operate a 'B' account in which foreign currency deposits were converted to local dollars and thus earned interest at prevailing interest rates. Withdrawals could be made in foreign currency but are subject to existing exchange rates. These accounts were exempt from the income tax levied on savings accounts. However, they were not intended for deposits of proceeds from exports. But before the end of the year exporters were allowed to deposit a portion of their export earnings in these accounts. By May 1991, the ceiling on cash deposits in the 'A' account was removed.

The complete removal of exchange controls was undertaken in September 1991. The foreign exchange market became the mechanism for determining the exchange rate and for allocating foreign exchange; and the commercial banks were given the task of managing transactions within that market. Existing foreign currency accounts became essentially inoperable as new deposits could only be made to new accounts which for residents would now be subject to local income tax on interest earned.

Now, foreign exchange liberalisation was premised on a number of requirements: 1) existence of competitive financial markets, 2) removal of distortions in the financial and economic environments and 3) correction of imbalances in the public sector accounts [BOJ 1991]. The first would seem to be more a consequence of than a prerequisite for liberalisation. The second relates to existing elements of regulation of the economy such as subdidies, price controls, trade restrictions and some tools of monetary policy.

And the third focuses on keeping government expenditure in line with revenue.

To facilitate budgetary balance the goverment adopted a number of measures in 1990 in accordance with IMF/World Bank conditionality. These were in the main, increases in consumption taxes, increases in the prices of public goods and services as well as basic foods imported by the public sector and reduction of subsidies[ESSJ 1991]. Most of the controls on trade were removed and financial regulation shifted from reliance on reserve requirements to open market operations. The liquid asset ratio which was 48 percent in 1985 was reduced to 20 percent in 1988, that is, the non-cash portion was eliminated. The Central Bank also started paying interest on the reserves but at an administratively determined rate of interest. A non cash reserve requirement of 12.5 percent was reinstituted in September 1990 with interest paid at market rates. The aim was to contain liquidity as the foreign exchange system was being changed.

The problem with some of the deregulation measures is that they were elements of regulation under the previous economic regime that are now being viewed as distortions in the economy. This is because they are seen as constraining the development of a market economy. However, given the structural weaknesses of the Jamaican economy and present budgetary constraints, the reserve requirements functioned effectively to contain excess liquidity in the banking system during the mid 1980s. With the elimination of the non cash reserve requirement in 1988 banks had excess liquidy of 16 percent

or J$1625 million. To contain the growth of the money supply, the Central Bank had to intensify open market operations via Treasury Bills and Certificates of Deposit. The interest paid on these are borne by taxpayers but funds from the latter are sterilised.

At the time of the announcement of foreign exchange liberalisation in September 1991, it was revealed that the plan to implement liberalisation was based on certain figures for the period January to May 1991,such as the net foreign exchange position of the economy and the debt service ratio. The latter was significantly reduced and the former had increased by US$100 million over the corresponding period in 1990 [Sunday Gleaner 1991]. The data on net international reserves show that these improved from US$-432.8 to US$-391.2 over the period January to May 1991. Reserves at May 1991 were at the same level as at May 1989. They had however declined to US$-547.8 at May 1990 [BOJ 1991]. Other variables that should be taken into account in assessing the situation prior to liberalisation of the foreign exchange market are inflation rate, money supply, interest rate and supply of and demand for foreign exchange.

Inflation increased significantly between 1989 and 1991; the rate was 17.2 percent in 1989 and 29.8 in 1990 compared to a rate of 8.5 in 1988. By June 1991 the rate was estimated at 20 percent. The factors influencing the growth of inflation were depreciation of the Jamaican dollar and the measures adopted to deregulate the economy such as the removal of subsidies and price controls. The non cash portion of the liquid reserve ratio was again removed in

early 1991 as part of IMF/World Bank conditionality; and government advocated reduction in interest rates in May 1991 to stimulate investment and growth. The data show that the money supply M1 (narrowly defined) grew by 15 percent between January and May 1991 compared to a growth of 7 percent between January and May 1990. Broad money M2 grew by 13 percent over the five month period in 1991 compared to 5 percent over the same period in 1990. In 1989 M1 declined and M2 grew by 2 percent due to contractionary monetary policies. In 1991 government policies facilitated the growth in commercial bank liquidity and the money supply and the consequent increase in inflation; reserve requirements were adjusted and interest rates on open market instruments were reduced leading to a reduction in commercial bank lending and deposit rates.

These developments do not suggest that the criteria for liberalisation of the foreign exchange market and removal of exchange controls as set by the government were met prior to implementation of the policy. The improvement in net international reserves which facilitated money supply growth and provided an optimistic outlook for policy changes may not have been justified on account of the inclusion of commercial arrears as trade credits in the balance of payments [Financial Gleaner 18/10/91]. Because of the inadequate supply of foreign exchange in the system the Jamaican dollar equivalent of the arrears contribute to excess liquidity which increases demand and hence the price of foreign currency. In fact stringent monetary measures had to be adopted from October 1991 to contain the rapid slide of the dollar which

the government attributed to speculation. Interest rates on open market instruments doubled between June and October 1991. The high cost of monetary policy for stabilising the system has been shifted from the banking sector to the taxpaying public through the change in instruments used.

2. The New Role of The State

The new role of the state under IMF/World Bank adjustment programmes is to remove controls on economic activity and rely instead on the market mechanism and instruments of regulation. Relatively low tariffs would regulate trade and markets would regulate prices and international payments. The Jamaican state got involved in the economy to correct for undeveloped markets, to promote economic growth and to address issues of employment and distributive equity among others. However, monetarist objectives assumed dominance over the last decade. Markets must be allowed to function freely and allocate resources rationally. Redistribution takes place from labour and domestic consumption to capital and exports. Deregulation and privatisation of public enterprises are some of the measures to achieve this. Growth and employment are byproducts of this process. But while stabilisation measures contain inflation they also contain growth. Income policies have therefore been used in Latin America to restrain inflation [UN 1990]. However, the Jamaican government is committed to removing price controls under its adjustment programme. The combination of

deregulation and the liberalisation of trade and payments hamstring the government in addressing both inflation and change in the production and trade structures of the economy.

Deregulation is defining the new role of the state even as it widens the operations of the market. A method would have to be formulated for setting the parameters of state and market. Public consultation would seem to be necessary given the democratic premise of government. However, a number of questions can be posed. What has given rise to the particular type of state and its role in the Jamaican economy? Was it mainly economic factors or was it a mixture of economic, political and socio-cultural factors? To what extent can the government limit the freedom it has facilitated by deregulation in order to meet other social objectives? What form should intervention take? Or can the state transfer its functions and objectives to the market? Would the public choose to have the market determine the priorities of the country? And would the interest of private enterprise coincide with the interests of the public?

Shifting from direct intervention through controls to new forms of regulation does not entail a weaker role for the state in the economy. The government would have to enhance the institutional capacity of the state for monitoring and enforcing regulations and it would have to devise creative measures for influencing economic activity. The latter is of particular importance given the general nature of adjustment policies and the specificity of the Jamaican situation. For example, liberalisation

to induce domestic competition may be antithetical to creating international competitiveness because of the small size of the market. Government would also have to offer incentives to encourage production and export of items that would increase the country's competitiveness since the market is indifferent to targeting specific goods for export promotion. The examples of South Korea and Taiwan show that the state actively intervened to develop export competitiveness in specific products.

IV. TOWARDS A REGULATORY FRAMEWORK FOR THE FINANCIAL SECTOR

In studying regulatory frameworks one has to look at the economic, legal and institutional frameworks. The economic framework for deregulation of the financial sector in Jamaica is based on the following:

1) a shift to base money management;
2) the same cash reserve requirement for banks and near banks;
3) abolition of credit controls;
4) reduction of subsidies on interest rates.

The main question to be considered is the efficacy and feasibility of relying on the above measures of regulation given the nature and operation of the Jamaican economy.

The legal framework is based on amended versions of the:

1) Banking Act;
2) Bank of Jamaica Act; and
3) Financial Institutions Act.

These would be examined for adequacy in terms of capital requirements especially for near banks, lending limits and the extent to which they facilitate enforcement of rules.

The institutional framework is based on the capability of the Bank of Jamaica in effectively monitoring the banking system. It would have to be ascertained how the Central Bank acquires information on financial institutions in order to monitor their operations and practices. One would also have to examine the procedures used for regulation.

A comparative study of the regulatory framework of Caribbean countries would need to focus on a number of issues falling within the purview of monetary policy. These are in the main, the type of monetary management with reference to the strengths and weaknesses of various target and instrument variables used; reserve requirements and the advantages/disadvantages associated with the (non cash) liquid asset ratio; open market operations in terms of the benefits and costs to government (and taxpayers); credit controls, their relation to other aspects of monetary management and their effects on the nature and direction of investment; and interest rate subsidies in terms of their effects on the fiscal accounts (as well as transparency) and their utility in addressing specific development needs.

A comparative study of the legal framework would look firstly at the growth of financial institutions especially the non banks and the presence or absence of legislation to regulate their operations and influence their growth and expansion. In Trinidad

and Tobago, the number of financial institutions expanded significantly during the 1970s before adequate legislation had been put in place. Many of these institutions ran into financial difficulties but the Central Bank was constrained in its intervention by the inadequacy of existing legislation [Farrell 1990].

The comparative study of the institutional framework would need to examine, not only the structure and capability of central banks but also the structure and capability of Ministries of Finance and the nature of the relationship between these institutions. Areas of focus should include the goals and policies of the institutions and the relation between these and the economic strategies and policies of the government. Another important area of study should be the relationship between each of these institutions and the international financial agencies, the IMF and the World Bank.

Last but not least, studies of the regulatory framework would have to be done within the context of the state's role vis-a-vis the financial sector and the economy as a whole. In the case of Jamaica, the government participates in the financial sector through ownership of shares in commercial banks and ownership of a number of development and credit institutions. Government has been privatising the commercial banks and is now considering the divestment of other financial enterprises. In the meantime, under its adjustment programme the government has to reduce and make transparent interest rate subsidies provided through the

development banks. The relevant question for research and policy is whether government can and should remain an active participant in the financial sector via the development and credit banks or whether government should withdraw and rely exclusively on regulatory measures [Tyndall 1990]. Related to this is the nature of the regulation required to attain desired objectives, and other policy measures that can be used to attenuate the negative effects on economic development of deregulation measures such as removal of interest rate subsidies.

V. CONCLUSION

The role of the state in less developed countries has changes and is still changing due to changes in the domestic economy, changes in the world economy and the economic models that have assumed dominance over the last decade. That role needs to be defined as well as the timing of its adjustment. Contrary to perceptions, that role would be increased rather than reduced as data gathering and extensive monitoring of the economy would have to be undertaken. In addition, market-oriented growth and development has its shortcomings especially in relation to income distribution, provision of essential services and the protection of rights. The state's role would therefore increase as the need to mediate conflicts and address welfare issues increases. The state's role vis-a-vis that of the market should be defined on the basis of interaction between the main actors in the economy.

International financial agencies have been influencing the movement towards liberalisation and privatisation in Jamaica through their adjustment programmes. It is no longer a question of whether the role of the state in the economy should change but rather one of how quickly this change should take place. The change envisaged is mainly in relation to divestment of state-owned enterprises, removal of trade and payments restrictions and the enhancement of institutional and legal capabilities to monitor and regulate economic activities. This means devising and adopting an adequate regulatory framework and appropriate procedures. This is already being done in Jamaica with foreign assistance being provided to improve monitoring by by agencies such as Customs Department and the Central Bank.

Trends in deregulation of the financial sector show that the conditions may not have been propitious for liberalisation of controls on the operation of the foreign exchange system. Inflation and depreciation of the dollar have been increasing significantly. On the other hand, foreign exchange earnings and other capital inflows have not been increasing significantly and have declined in some instances while the demand for foreign currency has been out of sync with the supply. Reduction in reserve requirements as part of deregulation measures, means that government has to pay market rates of interest to secure funds to finance budget deficits. This is one way of containing these deficits but the shift to open market operations places a high cost on government and hence taxpayers.

The proposal for studying the regulatory frameworks of Jamaica and other Caribbean countries identifies studies of the economic, legal and institutional frameworks within the context of what the new role of the state should be. Retrospective and prospective analyses of the regulatory frameworks and the role of the state would have to used to help in delineating policy options while bearing in mind that historically the pendulum has swung between state and market.

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