Monetary development within the context of Liberalisation
(The Case of Jamaica)

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The views expressed in this paper are not necessarily those of the Bank of Jamaica

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Monetary Development within the Context of Liberalisation

I. Context

The economic constraints which face less developed countries (LDCs) in their attempt to improve their socio-economic circumstance are numerous and open to debate. However, few would disagree that one of the most critical limiting factors in the Jamaican case is the chronic shortage of hard currency. The persistent deficiency of foreign exchange reserves is far different from that which derives from a temporary imbalance in the external account. On this basis therefore, the Jamaican situation is not amenable to short term corrective measures such as mini-devaluations. Rather what is required is a re-thinking of the existing monetary framework in line with the plight of limited reserves.

The dilemma which faces Jamaica is symptomatic of the wider developmental problems which confront an open and dependent economy. This arises from the fact that, despite efforts to develop a vibrant manufacturing sector, official foreign exchange earnings are largely dependent on primary exports, and more recently tourism receipts. Characteristic of both these activities is their vulnerability to exogenous shocks and, in the case of primary exports, the tendency for them to attract adverse terms of trade. These unsavory circumstances invariably translate into a deficit position in the external accounts.

The severity of the foreign exchange constraint suggests that measures are needed to ensure that optimum use is made of the limited reserves. However, if this optimal resource allocation is to be achieved the economy is constrained to operating at a rate of exchange which equates with the equilibrium rate. Any deviation from this equilibrium rate has varying consequences dependent on the direction of divergence. A rate of exchange which is lower than the equilibrium rate requires the maintenance of strict exchange control regulations as a means of rationing scarce resources. This may have the unfavourable effect of promoting the growth of a black market to cater to the unfulfilled demand. On the other hand, an exchange rate in excess of the equilibrium rate may have the adverse effect of ousting those firms which have the potential to contribute to the development process.

Within this context therefore, monetary and fiscal policy assumes a critical role in defining an environment which is consistent with the scarcity of hard currency reserves. It must however, guard against the propagation of excessive measures which prove to be a deterent to productive activity. This mandate suggests the need for an equilibrium real interest rate which not only attracts excess liquidity into the banking system, thereby limiting the potential for foreign exchange speculation, but which also fosters the growth of savings for increased investment in viable foreign exchange earning activities.

Financial policy in Jamaica since the mid 1980s was predicated on issues which arose solely in connection to the

II. Theoretical Justification for Liberalisation

The liberalisation of the domestic money market was seen as a necessary step towards reorienting the pattern and pace of domestic investment. It was anticipated that under liberalised conditions real equilibrium interest rates would be achieved and this would facilitate increased savings and increased investment. The potential for real equilibrium interest rates to increase savings and stimulate investment activity was justified through the theoretical discourse of McKinnon and Shaw.

Shaw (1973) and McKinnon (1973) argued that to the extent that interest rates are below the real equilibrium rate they are financially repressive,in that they discourage real savings and and productive investment. On this basis therefore, if the monetary authorities are genuinely committed to economic growth the real rate of interest must increase towards equilibrium so as to induce real savings and investment. Such an increase in savings derives from the greater financial incentive offered. Not only will increased real saving facilitate increased real investment but there should also be a more efficient allocation of resources as investors in activities which have relatively low rates of return will be forced out of the market.

The process of financial broadening, whereby the number of financial intermediaries increases to facilitate the growth in demand, plays an important role in economic growth. To the extent that financial intermediaries represent the half-way house between

domestic money market as distinct from its direct implications for the foreign exchange market. Arising from this policy direction the focus was on the removal of financial constraints as a means of increasing savings and investment. As history has proven however, this use of partial liberalisation has the tendency to produce partial results and certainly does not deliver joint equilibrium in the domestic money and foreign exchange markets.

This paper attempts to reinforce the view that the liberalisation of the domestic money market without the programmed liberalisation of the foreign exchange market in effect served to limit the potential economic benefits. Additionally, it seeks to highlight the need for consistent macroeconomic policy measures as an important factor which will contribute to the success of total liberalisation.

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The process of financial broadening, whereby the number of financial intermediaries increases to facilitate the growth in demand, plays an important role in economic growth. To the extent that financial intermediaries represent the half-way house between

savers and investors, they undermine the tendency for hoarding and increase the financial flows available for investment. Integral to the success of financial intermediary operations is the sense of security conferred to both savers and borrowers which is vital for promoting economic growth through converting saving into investment.

Galbis (1977) also adopted a similar viewpoint to McKinnon and Shaw in postulating the existence of financial constraints, and not the lack of investment opportunities, as the impediment to financial intermediation. This position remained relevant even in the context of interest insensitive real savings. On this basis therefore, Galbis suggested that efforts to improve development within LDCs would yield more concrete results if targeted at the active removal of financial constraints.

Integral to Galbis' analysis was a typology of LDCs identifying them as characterized by economic dualism. This dualism fostered the divergent growth of the modern and traditional sectors. The indivisibility of large lump sum investments in the modern production process in conjunction with the relative importance of self-financing for investment activities becomes a constraint to economic growth. The significant role of government in regulating domestic interest rates then inhibits the role of financial intermediation in contributing to economic growth.

Patrick (1966) suggests two possible approaches to the process of financial deepening - a demand following or a supply leading approach. From the demand following perspective the stimulus for additional financial intermediaries is derived from new demands for those services. Therefore one would anticipate that the growth of real national income stimulates the growth of financial intermediaries. On the other hand, in the "supply leading approach" the establishment of financial intermediaries precedes and encourages the demonstrated demand for them. The advantage of this approach rests on its ability to galvanize demand at an aggregate level. In the context of scarce foreign exchange however, this latter approach may be a wasteful diversion of resources already the subject of excess demand.

The theoretical vindication for foreign exchange market liberalisation can be developed along similar lines to that of domestic money market liberalisation. In keeping with standard supply and demand analysis - the equilibrium exchange rate is located at the point where the demand for foreign exchange is equal to its supply.

This equilibrium rate is however, not immutable, rather it adjusts in keeping with the economic environment. This is especially true for the case of an open and dependent economy, such as Jamaica, which is subject to exogenous shocks. The potential danger of designating a fixed rate as being permanently indicative of the market clearing rate is that over time the equilibrium rate may diverge from this fixed rate of exchange.

In the case where such divergence means that the fixed exchange rate is below the equilibrium rate it represents a repressive exchange rate. Under these conditions excess demand develops and monetary authorities will have to resort to exchange control measures as a means of rationing the availability of hard currency. In this context there develops a tendency for smuggling, corruption and capital flight.

A more practical option may therefore be the adoption of a flexible exchange rate regime. Under these conditions the exchange rate automatically adjusts to changes caused by the external environment. It is therefore possible to envisage a situation characterised by a permanent market clearing rate.

The benefits of operating a flexible exchange rate regime assumes that domestic money market liberalisation has rid the economy of all financial constraints. On this basis therefore, in order to have a balanced or optimum situation the ideal scenario would for simultaneous liberalisation of both of these financial markets - the domestic money market and the foreign exchange market.

One can identify two less than optimum scenarios. In the first, the domestic money market is liberalised but foreign exchange controls remain. The existence of foreign exchange controls suggest that the foreign exchange rate is repressive in that it is less than the equilibrium rate. Under these conditions there is the greater impetus for economic agents to indulge in

capital flight. This suggests that real interest rates will have to be high in order to compensate for perceptions of exchange rate risk. A subsidised rate lends itself to the inefficient allocation of resources, whereby firms benefit from an exchange rate differential which allows them to stay in the market when they otherwise would be forced to leave. A case may be made however, for strategic sectors which have developmental implications but can only exist given some form of subsidy.

Alternatively, scenario two relates to the liberalisation of the foreign exchange market without similar treatment of the domestic money market. Under these circumstances the economy is characterised by financial repression in the domestic money market whereby the domestic interest rate is less than equilibrium interest rate. Rational economic agents are therefore able to substitute foreign currency for domestic currency at a subsidised interest rate. This process of currency substitution, as foreign currency denominated assets compete with domestic monetary assets has been empirically proven to effectively erode the potency of the traditional monetary and fiscal policy measures. This arises from the fact that currency substitution dilutes the Central Bank's control over the aggregate stock of medium of circulation which increasingly involves foreign currency. There is also the additional factors of net capital outflows as capital responds rationally and moves to a market which offer a relatively higher real rate of return, adjusted for exchange rate risk.

Based on the preceding scenario detailed, of the potentially harmful effect of partial liberalisation, it is possible to theorise on the ideal situation, of the simultaneous liberalisation of both the domestic money market and the foreign exchange market. Total liberalisation is optimal in the absence of repression in both the foreign exchange and domestic money markets. Real effective exchange rate correction which should follow from foreign exchange market liberalisation should create incentives for shifting productive resources from non-tradeables to tradeables. On this basis therefore resource allocation will favour those areas which prove to be externally viable.

Towards this ideal situation domestic money market liberalisation seeks to deliver an equilibrium exchange risk adjusted real interest rate. This should ensure the indifference between domestic and foreign exchange denominated assets as both yield the same expected exchange rate discounted real rate of return.

Implicit in this positive outlook is the assumption that fiscal demands on domestic financing are kept within programmed margins, hence should programmed foreign financing not be forthcoming, domestic financing should not be substituted for the foreign fall-out. If this code of conduct is not followed the inflationary consequences are dire. Moreover, high inflation implies high nominal interest rates which have never been a politically desirable option.

The co-existence of the modern and traditional sectors presents specific problems which lend themselves to no easy solutions. The potential for the operations within the informal economy to frustrate monetary policy has long been realised. However, of equal importance is the benefits which can be derived from their operations insofar as they provide employment and creative approaches to industry which have far reaching implications. The benefits which can be derived from the informal economy suggest that policy should be directed at integrating their activities into the formal network. However this action may initially require some form of subsidised credit as a means of improving their operations and upgrading their technology. The existence of subsidised credit however, runs counter to the principle of liberalisation and may in fact perpetuate the continued inefficiency of the sector (efficiency here is defined in terms of the ability to earn foreign exchange).

The vulnerability of the economy to exogenous shock has implications for the rate of exchange, whereby unfavourable developments in the external environment may impact negatively on the Balance of Payments (BOP) and lead to the decline in foreign exchange earnings. Unless there is a proportional decline in demand then it is reasonable to anticipate a depreciation in the exchange rate - as persons compete for limited resources. In this respect therefore, macroeconomic policy needs to be cognizant of the need to accept a real interest rate which is slightly higher than that on developed capital markets so as to account for likely

perceptions of exchange rate risk. By so doing the domestic interest rate would have the potential not only to attract foreign exchange from external sources into the capital market, but would also provide the means through which residents would opt for domestic balances rather than convert into foreign currency.

Arising from these issues, it becomes evident that both fiscal and monetary policy assume key roles in contributing to a consistent policy environment. In relation to fiscal policy, public expenditure will have to become more sensitive to the global objective. Therefore Government expenditure will have to be contained within some prescribed narrow margin in order to minimise the inflationary potential. Alternatively, monetary policy should seek to reinforce the fiscal initiative by limiting the availability of credit through relatively higher interest rates. Additionally, economic policy will need to address the issue of unmanaged Central Bank financing of the Public Sector through an overdraft facility.

In the domestic money market one would anticipate that liberalisation would be facilitated by monetary policy assuming a more independent role vis-a-vis fiscal policy. On the fiscal side there should be concerted action towards a phased reduction in the fiscal deficit aided by a decline in overdraft facilities at the Central Bank. Greater reliance would need to be placed on the use of market instruments (eg. open Market operations) vis-a-vis non-market instruments (eg. credit ceilings and reserve ratios). Further, those factors which were considered to be the antithesis

of liberalisation, such as subsidised credit and interest rate floors/ceilings should be removed. Within a more competitive environment interest rate spreads between deposit and loan rates should contract and equilibrium rates should include a margin to compensate for any perceptions of exchange rate risk.

In relation to developments in the foreign exchange market, one anticipates a reversal of private capital outflows in response to market determined interest rates offered in the banking system. Financial resource allocation should also reflect the relatively greater importance of foreign exchange earning activity through a relatively greater concentration in favour of the more lucrative areas i.e. tradeables vs non-tradeables.

Given the existence of these indicators as measures of the success of liberalisation the question then arises as to how the actual performance of the domestic money market and foreign exchange market conforms to this standard. In order to gain some insight into this issue, the performance of the domestic money market under liberalised conditions will be addressed and thereafter the more recent liberalisation of the foreign exchange market will be assessed.

were low and sometimes negative. At the same time, increased domestic financing of a growing public sector deficit facilitated large spreads to relatively high lending rates with the consequent crowding out of the private sector.

Also characteristic of this period was the existence of subsidised credit to the prioritised sectors of the economy, (agriculture, manufacturing and tourism). Insofar as subsidised credit was provided in an environment characterised by limited and relatively expensive credit to the remainder of the private sector it represented a contradiction. This contradiction was symptomatic of the financially repressed environment.

Prior to 1986 the interest rate structure was characterized by the relatively free determination of interest rates - with a few exceptions. These exceptions may be denoted as; a floor at the savings rate which stood at 20.0 percent at the end of 1985; quantitative credit allocations targets; and preferential rediscounting facilities operated by Bank of Jamaica to facilitate growth in prioritised sectors.

A further financial constraint witnessed during this period was the growing deficit incurred by the public sector which contributed to rising inflation. The public sector was financed through the Bank of Jamaica's overdraft facility in conjunction with a relatively high liquid assets ratio which provided 'captive financing' (through treasury bills) at the expense of private sector investment. The dominant role played by the public sector

111. Financial Sector Reform Program and its Performance

The impetus to liberalise the domestic money market preceded the liberalisation of the foreign exchange market by some four years. This desire to transform the operations of the financial sector was instigated through a general review of money and credit policy in 1985, and was done isolation of the possible repercussions for the foreign exchange market.

Financial reform was facilitated through an improved macroeconomic environment whereby the domestic economy benefited from the windfall effect of a fall in oil prices in 1986. This favourable development ensured a stable exchange rate, dampened inflation and facilitated a downwards trend in interest rates. In light of this favourable domestic environment, the financial aspect of the Trade and Financial Sector Reform Program (TFSRP) was initiated with the specific aim of removing those factors which impeded the efficient performance of the financial sector. It was anticipated that the intermediation process would accelerate economic growth. Within this context the existing financial distortions were identified as being related to: an excessive credit creation (to accommodate the fiscal deficit); over reliance on non-market instruments (credit ceilings and asset ratio manipulation) to effect monetary policy; a floor to the saving deposit rate; and subsidised credit.

The financial sector of the early to mid 1980s was characterised by financial repression whereby real interest rates

was evident through the fact that in 1981 public sector credit accounted for some 70.0 percent of domestic credit. The 'crowding out' of private sector credit limited the ability of the Private Sector to facilitate productive activity, hence constrained the growth of G.D.P.

There is the additional feature of market distortions reflected in the private sector's preference for loan financing as against equity financing. This serves to inhibit the growth of the capital market as family owned enterprises prefer to operate a 'closed shop'.

The TFSRP sought to address these anomalies through providing an environment which was investment conducive. Within this framework their objectives included the following:

1. Separation of monetary and fiscal policies.

2. Elimination of distortions in financial markets in allowing for the free interplay of market forces in determining interest rates and allocating financial resources.

3. Reduction of bias against equity investments.

4. Creation of a fiscal and institutional environment which would strengthen the capital markets.

With these objectives in mind, reforms were concentrated on four areas: interest rate structure, monetary policy, housing

finance and money and capital markets. It was anticipated that liberalising the interest rate structure would attract savings into the system and increase investment activity. Within this ambit fiscal policy played a critical role in reversing the trend of Public Sector dominance of domestic credit. This was revealed through the decline in the overall fiscal deficit from J$659.6 million in 1985/86 to J$203.5 million and J$14.7 million in 1986/87 and 1987/88 respectively. This represented an improvement in the fiscal deficit/GDP ratio from 5.6% to 1.4% and 0.1% with respect to the stated time periods.

In spite of these favourable medium term trend, the intra-year fiscal performance does not display this smooth adjustment. This questions the capabilities of fiscal management to adopt prudential management. There may further be an element of inflexibility whereby programmed expenditure is undertaken even in the face of late or absent foreign financing, through the use of domestic financing.

The increasing (and changed role) for monetary policy sought to bring about greater reliance on Open Market Operations to effect liquidity changes. In this light the emphasis was on the phased elimination of the non-cash portion of the liquid asset ratio (which at the beginning of 1986 was 28.0 percent). By so doing it was anticipated that the extent of 'captive financing' enjoyed by the public sector at the expense of private sector credit would be curtailed. The public sector's ability to finance

the fiscal deficit was also to be affected by the reduction in available overdraft facilities at the BOJ.

The need for reforms in the operations of housing finance and money and capital markets arose chiefly from the extent to which they were seen by the IBRD as manifesting financially repressive conditions. With specific reference to housing finance, compulsory salary deductions through the National Housing Trust have been used to give mortgages at sub-market rates of interest. The effective subsidy on interest rates was deemed incompatible with market based resource allocation and it was thought that the resources could be more efficiently allocated. With respect to the operations of the capital market the TFSRP aimed to enhance its use in enhancing financing through tax and regulatory reform.

The success of the first phase of the reform may be gauged through the extent to which the targeted objectives were achieved. The policy objectives were largely attained despite the later need to reactivate the liquid assets ratio and credit controls in the wake of excess liquidity following hurricane Gilbert in 1988. (These credit ceilings and the non-cash liquid assets ratio were subsequently eliminated by the end of the fiscal year March 1991).

With respect to policy commitment to eliminate the non-cash portion of the liquid asset ratio this was achieved by the end of March 1988 when the cash reserve ratio was identical to the liquid assets ratio at 20.0 percent. This initiative limited

the extent to which the commercial banks were obliged to finance the Public Sector deficit at distorted interest rates. It also had the consequence of facilitating the disentanglement of monetary and fiscal policy as the Central Bank came to rely more heavily on Open Market Operations (OMOs) for the management of liquidity.

Interest rate behaviour during the 1986-88 period revealed the decline in savings rate from 20% - 13%, while the weighted average loan rate moved from 29.52% - 24.94%. A general benchmark rediscount rate, 21.0% in 1986, was effectively abandoned in that year. Thereafter, there was preferential discounting at 10.51 % for agriculture and construction and 14.85% for manufacture and tourism. A concern that it was inappropriate and distortionary for the Central Bank to be involved in preferential discounting, led to a discontinuation of this facility by March 1988.

The decline in interest rates from 1986-88, occurred in a context of a shift from interest rate targeting to quantum targeting in the conduct of Open Market Operations. For the most part, since 1986, Treasury Bills and Central Bank Certificates of Deposit have been marketed in flexible rate auctions of a fixed pre-announced quantum.

The final restraint to market determination of interest rates was eliminated on October 1990 following the removal of the floor on the savings rate. Ostensibly, the interest rate structure is now free to operate competitively following the removal of all

financial constraints. However, political and administrative concerns may imbue the unrestrained interplay of market forces. These concerns arise from the potential for outlier bids for Certificates of Deposits to generate high nominal rates of interest. The contention is that such bids contribute to market distortions since they arise chiefly from oligopolistic elements within essentially thin financial markets.

With reference to the real interest rate, there must, of necessity be some attention to the inflationary underpinnings. In this respect the inflation rate trend has become increasingly relevant (See Tables 4a and 4b). The possible causes for the accelerating rate of inflation may relate to the liberalisation of the foreign exchange market, but more fundamental is the extent of Public Sector use of domestic financing which drives the depreciation of the exchange rate.

The liberalisation of the interest rate structure in October 1990, provides the new freedom for commercial banks to offer competitive rates. The trend however has been towards the widening divergence between saving and loan rates. Since June 1991 there has been a downward trend in the savings rate to levels below the previously established ceiling of 18.0 percent to as low as 15.0 percent. There has also been a downward trend in the loans rate, but by a much smaller proportion than that in the savings rate (See Table 1). One can therefore identify a tendency towards the upward stickiness of savings rates while lending rates display the converse. This development attests to the oligopolistic

nature of the commercial banking system and the loyalty of savers to historically dominant institutions.

Unfortunately the intended reformation of the capital markets has not yielded any significant improvements. This is due to the delay in introducing appropriate legislation which has facilitated the growth of non-bank financial institutions as they took advantage of relatively low capital requirements. Their operations have effectively ensured the further narrowed relationship between depositor, intermediary and borrower.

IV. Foreign Exchange Liberalisation

Since the late 1970s, the foreign exchange regime has been the focus of reforms which seek to increase the extent of inflows into the formal system and stabilise the exchange rate. In response to sharply declining foreign exchange reserves a series of devaluations devaluations were implemented in the late 1970's. Despite supposedly short term corrective measures to address the external imbalance - the reality of the foreign exchange crisis still remains a limiting factor almost fifteen years later.

The end of the crawling peg system in 1979 preceded a period of relative exchange rate stability during which time the US$ vis a vis J$ exchange at US$1.00 = J$1.78. However, the growing ability of the black market to divert foreign exchange from the formal network attested to the non-market clearing rate offered in the official system. In an attempt to attract greater foreign exchange inflows into the formal network, special retained accounts and 'no funds' licenses were issued during the 1981-82 period. This proved unequal to the task of halting the diversion of foreign currency and lay the basis for a formalised Parallel market.

The Parallel market was introduced in January 1983. This entailed the co-existence of two rates: an official rate and a parallel rate. The official rate was used for all official transactions, "essential" imports and traditional exports. All

remaining transactions attracted a parallel rate of exchange which in fact diverged between commercial banks. The effectiveness of the system was impeded by the fact that over time the parallel placed increasing pressure on flows still subject to an "official rate". There also continued to be a wide disparity between rates on the official parallel.

Between late 1983 and March 1984, following the failure of the parallel system an Auction regime was implemented. It remained in effect until October 1989 during which time the rate varied between US$1.00 = J$3.20 and US$1.00 = J$6.40. There was however, a period of relative stability between November 1985 and April 1989 when the rate was approximately US$1.00 = J$5.50. This system ultimately suffered from the undesirable effect of responding to global excess demand through the build-up of significant external payment arrears.

A situation therefore developed whereby increasing pressure was placed on the market as excess demand and the obvious reluctance on the part of Governments to adjust the exchange rate. This policy stance fostered the continued existence of an unrealistic exchange rate and encouraged the growth of a foreign exchange black market as the public lost confidence in the government's ability to operate a foreign exchange market.

In an attempt to slow down the rate of depreciation the Auction was suspended and the rate was discretely adjusted from US$1.00 = J$6.19 to a peg at US$1.00 = J$6.50 in November 1989.

The continuing excess demand led, on February 1 1990 to the rate being further depreciated to US$1.00 = J$7.00. The Auction System though initially yielding favourable results, ultimately failed to avoid global excess demand.

The liberalisation of the foreign exchange regime was approached on a phased basis. Phase one was initiated in July 1990 through the removal of the exchange control Act which restricted the operations of foreign currency accounts by residents and non-residents. Under these conditions commercial banks were now able to accept credit to foreign currency 'A' and 'B' accounts in keeping with some stipulated guidelines. 'A' accounts were denominated in foreign currency while 'B' accounts were converted to a domestic currency equivalent but attracted a local currency interest rate ostensibly to compensate for exchange rate risk.

The more popular account was the A account and indications are that the operations of this account facilitated legalised capital flight, whereby foreign currency was passed through the Jamaican account en route to the rest of the world (See Table 3). This was facilitated through the eventual acceptance of essentially unlimited cash deposits on a cumulative basis.

In keeping with the commitment to liberalisation further exchange decontrol occurred as commercial banks assumed the central responsibility to process import documents relating to CARICOM. There was also the delegation of service payments, both commercial and non-commercial to the commercial banks in January

1991. Further, inward capital movements required limited documentation and real estate transactions by non-resident Jamaicans were unrestricted.

A necessary corollary of foreign exchange liberalisation was the deregulation of the public enterprises' pricing system. This meant that prices would automatically adjust to changes in import prices and the exchange rate, particularly for petroleum products and the utilities.

The policy initiative to liberalise the foreign exchange market resulted in September 1990 in an Interbank trading system. This new regime sought to encourage foreign exchange inflows in a free market competitive situation not tinged by government involvement. The potential benefits of a flexible exchange rate regime included rate flexibility, automatic clearing and the avoidance of payment arrears. In this light it was argued that a fixed regime had catered to the excess demand for foreign exchange, facilitated market segmentation and had led to a decline in the relative attractiveness of the J$ vis a vis the US$.

To the extent that a flexible exchange rate regime offered the potential to reverse this trend - it was an attractive option. Further, the prospect of a market determined exchange rate suggested that the market would clear and leave no residual of arrears (as was the case with the fixed exchange rate).

The Inter-bank Trading system operated on the basis of two exchange rates. The spot market rate related to all transactions

which were completed within two working days, while the forward market related to transactions taking in excess of five working days. The commercial banks were also required to surrender a specified percentage of their purchases to the Central bank. Throughout its year long existence the requirements of the system have been amended dependent on how best it was perceived that inflows could be improved.

The public's perception of what represented the equilibrium rate of exchange was indicated through the performance of the spot and forward markets (See Table 3). During the October to December period, activity was centered chiefly on the spot market and the weighted average selling rate was US$1.00 = J$8.12, at the end of December 1990. However, following amendments which allowed greater rate flexibility for the forward market, a noticeable shift in market emphasis occurred. Between January and June, forward market purchases then accounted for a larger share of the market. Far more important however, was the rapid rate of depreciation in the forward rate while the spot rate lagged behind.

This situation fostered the view that the spot rate was not indicative of true market conditions and lay the basis for gradual disillusionment with the spot market and hence the increased activity on the forward market. Initially, the policy stance was one which supported the spot rate as being a true indication of market forces, but with the widening divergence

between the spot rate and the forward rate this stance proved to be untenable.

Under public pressure to alleviate the extent of depreciation in the exchange rate and 'ensure a more orderly operation of the foreign exchange market' - the Jamaica Bankers' Association introduced new operating guidelines on June 1, 1991.

Within this new framework commercial banks set their own rates within a predetermined range on a daily basis which initially led to a sharp appreciation of the exchange rate. The greater transparency of their operations made them unwilling to be seen as the cause of rapid exchange rate depreciation. On this basis, therefore the rate remained relatively stable in the spot market, a situation which ran counter to the abject reality of continuing global excess demand, facilitating the resurgence of the "black" market.

Contrary to a theoretical perspective that fiscal and monetary policy are freed for developmental objectives under a flexible exchange rate regime (as against a fixed exchange rate regime), the socio-political viability of liberalisation is dependent on fiscal constraint to avoid a devaluation - inflation spiral.

Aggressive monetary policy measures were indicated chiefly through the use of Open Market Operations to mop up excess liquidity and limit the outgrowth of speculative activity. Arising from this policy stance it was envisaged that the

resulting increase in interest rates would also encourage Private Sector savings. The Public Sector was also accorded a major role in compressing the extent of aggregate demand as indicated through a gradual phasing out of the fiscal deficit. Divestment was seen as an additional means through which savings could be effected and excess liquidity absorbed.

Prior to September 25, 1991 the extent of remaining exchange control can be identified as being inherent in the need for BOJ approval for portfolio investment inflows by non-residents; the requirements that non-residents gain exchange control approval before purchasing real estate; limits on current account transactions such as vacation travel and business travel; requirements for surrender of export proceeds; BOJ's claim to foreign exchange proceeds from identified exports; a requirement for commercial banks to sell a specified percentage of their hard currency purchases to the BOJ; restriction of foreign exchange trading to authorised dealers chiefly commercial banks.

This partially liberalised system remained in effect until September 25, 1991, when the decision was taken to remove all existing exchange controls. This policy initiative arose from the fact that policy makers eventually became aware of the possible contradiction between exchange controls and sustained improvement of the foreign exchange accounts.

As was the case with domestic money market liberalisation, the success of foreign exchange market liberalisation hinges on

the ability of demand management measures to contain aggregate demand, and on the free interplay of relative price signals. With respect to the former this implies the ongoing efforts to control the outgrowth of aggregate demand. Further, under a competitive situation the economy cannot function effectively under subsidised conditions, hence the need to allow relative price signals to prevail. Governments must rid themselves of the temptation to interfere in the free interplay of market forces. It may therefore be possible to see some long run improvement as the inflationary impulses are gradually reduced.

The suspension of the Exchange Control Act as of September 25, 1991 paved the way for a totally liberalised regime. Under these conditions foreign currency can now be used interchangeably with domestic currency as the accepted medium of exchange.

Total liberalisation has varying implication for the various economic units dependent on which 'hat' is worn. On the part of residents, this initiative means that they are now free to hold foreign currency accounts overseas and like non-residents, transact business in the currency of choice; exporters are no longer required to repatriate their foreign currency earnings; and banks no longer have to sell a pre-determined portion of their foreign currency purchases to the Central Bank. Within this liberalised framework the BOJ will initially retain the prime responsibility for debt payments and Central Government expenditure, until alternative arrangements have been made.

V. Critical Evaluation

The picture emerging therefore, is that the success of liberalisation requires tight fiscal management, whereby the Public Sector conforms to programmed domestic financing. Within this ambit the public sector is prohibited from substituting domestic financing for a shortfall in foreign financing. Conversely the overall Public Sector demand for financing should be reduced to reflect this fall-out.

The issue then surrounds the capability of fiscal management to operate prudently. Prudent fiscal management is not reflected solely through the ability to meet programmed targets, but must be revealed through expenditure behaviour in between target dates. It is frequently the case that in developing economies while fiscal targets are met, the intra-year and intra-quarter performance is characterised by extreme fluctuations. In order to accomplish smooth adjustment, more effective fiscal management requires that programmed domestic financing be strictly adhered to. Further given the adverse consequence of excessive use of domestic financing in increasing inflation the impetus should be towards tight fiscal management.

In tandem with tight fiscal policy, monetary policy also requires tight measures. This may be achieved through aggressive open market operations and the unrestricted auction of Certificates of Deposit (CDs), the aim being to attract as much excess liquidity as they could garner into the bank's coffers. Resulting from this central imperative the BOJ had an open ended

offer of CDs in September. In spite of this aggressive stance not only was the response poor but it was indicative of the second lowest value of applications to be received for the calendar year. Successive auctions have revealed an equally unfavourable response.

The obvious shortfall in applications from the projected level is not out of line with an economy characterised by accelerating inflation, whereby twelve month inflation to August stood at 56.26%. For the fiscal year 1991/92 average inflation is now projected to be about 60.0 percent. Although there was some marginal gain in the average weighted rate on CDs from 27.08 percent for September (open-ended auction) to 38.04 percent for November (J$1.billion offer) this was below the public's requirements of a rate which would yield a positive rate of return in keeping with the rapidly increasing inflation rate.

In this light therefore the ongoing, exchange rate depreciation suggests that the general perception will be that the near future will contain an element of exchange risk. Hence in order for bid open market security sales to be forthcoming nominal interest rates must be consistent with the perceived exchange rate risk.

This state of affairs, whereby the interest rate structure remains repressive and saving rates remain sticky upwards even in the face of the widening divergence between savings and loan rates, is clearly at odds with the recommendation that domestic

interest rates should be sufficiently flexible to attract capital inflows. One would anticipate a real interest rate which is in line with that present in the United States (our major trading partner) plus a margin as a means of compensating for exchange rate risk. Under these conditions the rate indicated would approximate 60.0 percent given the U.S prime real interest rate of 2.0 percent and estimated domestic inflation rate of almost 60.0 percent.

Of course there is always the view that relatively high interest rates may adversely affect investment as credit becomes prohibitively expensive. One may however, provide the counter argument that this environment ensures that only the most efficient firms will operate, and further that creativity is at a premium in times of severe economic pressures. Providing that productive operations are concentrated on tradeables then nominal exchange rate adjustment may compensate for high nominal interest rates. Also the short run benefit of increased net capital inflows in response to higher rates of return may compensate for the decline in investment activity. Moreover this may yield the long run advantage of a stable exchange rate and a decline in the inflation rate towards a more investment conducive climate.

In this policy environment characterised by limited demand management underpinnings it was not a surprise that the rate of exchange of the J$ vis a vis the US$ has undergone significant depreciation. The existence of a negative real interest rate made J$ deposits relatively unattractive as against US$ and on this

basis the rational consumer opted for US$ deposits all of which helped to fuel demand for foreign exchange. Against this background, the spot market weighted average selling rate has depreciated from US$1.00 = J$13.98 on September 20, 1991 to US$1.00 = J$16.87 at the end of September and US$1.00 = J$18.78 at the end of October.

Under this new arrangement the BOJ is no longer guaranteed a percentage of total foreign exchange purchases from the commercial banks. This therefore means that they now have to compete as would any other member of the public for foreign exchange. In light of less than adequate demand management and given negative real interest rates, the aggregate foreign exchange demand of Public and Private Sectors could have been expected to put some pressure on the exchange rate. (See Table 3).

Despite the shortcomings in the performance of monetary and fiscal policy which facilitated the rapid depreciation of the exchange rate, indications are that the rate of depreciation in the exchange rate has declined. The rate of divergence between the average spot rate and the black market appears to be narrowing, as the inflationary impact is being felt by more persons. However, in the wake of some firms now making hardship allowances available to staff - this may facilitate increased aggregate demand given the regeneration of Jamaica dollar purchasing power.

There has been no noticeable switch in resource allocation as indicated through sectoral credit allocation though one may argue that it is premature to expect to see any radical change. There is also the difficulty of properly interpreting increased credit, whereby rather than it signalling increased investment it may be representative of cost inflation and speculation.

It seems evident from this initial analysis of total liberalisation that stricter adherence to,relatively strong measures is required if it is to be successful. Failure to institute these necessary initiatives promises to derail the economy from the programmed route of recovery.

Of equal consequence is the extent to which continued financial constraints in the domestic money market adversely affect the ability of the economy to operate under totally liberalised conditions. One example coming to mind is that of the limited growth of capital markets which have meant that Open Market Operations carry undue pressure as the main means of liquidity control.

An equally important concern centres on the previously mentioned oligopolistic nature of banking, whereby two historically entrenched banks control some 70.0% of the banking sector. Therefore whether they offer low or high rates their share of the saving deposit market is assured. The rational bank will of course be inclined to operate deposit rates as low as possible and loan rates equally high so as to maximise profit.

Policy makers also assume a key role in this environment by being committed to role of free market competition even if this means high nominal interest rates. Traditionally, governments have shied away from implementing high interest rates given the potential adverse implications for investment activity and social welfare. Given the Jamaican reality of high inflation however, there is no way to dodge the issue - providing that there is this genuine commitment to market forces.

In the same vein, policy makers must guard against the temptation of fixing the exchange rate. Pressure groups will no doubt develop to lobby a change in the exchange rate determination mechanism dependent on their potential for benefit - not understanding the macroeconomic underpinnings.

In conclusion therefore, one might say that the future of liberalisation is defined through the degree to which tight demand management measures are put in place and the commitment to market forces is sustained.