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THE ROLE OF THE CENTRAL BANK IN A LIBERALIZED ENVIRONMENT

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Introduction:

Before beginning any discussion on the role of the Central Bank in a liberalized environment, it is perhaps instructive to clearly identify our terms of reference. Firstly, I will try to define what constitutes a liberalized environment. By which we mean the end process of a financial liberalization movement or reform of the financial sector and the shift in the foreign exchange regime from a fixed or pegged rate system to a flexible or floating rate system, or even what is known as a managed float, and the predominant use of direct rather than indirect instruments of monetary policy. The final product of this effort should be an efficient allocation of domestic and foreign exchange resources, and the promotion of savings through competitive market forces which bring about greater transparency and accessibility.

The development of financial institutions and competitive markets that are designed to produce satisfactory levels of national economic growth and welfare and which are further enhanced by the development of an appropriate structure of interest rates which in turn would help reduce the savings investment gap, thereby freeing up investment funds for national development. Meanwhile, the enactment of an appropriate foreign exchange regime which combined with an exchange rate that clears the domestic market for foreign currency would promote external competitiveness while ensuring domestic price stability even in the presence of external shocks. In subsequent sections we will look more closely at what constitutes a liberalized environment and why its prominence at this time.

The topic of the paper makes the unstated assumption that the role of the central bank in this new environment is different from its present role in a presumably non-liberalized environment. The paper will explore briefly the principal functions of a classical central bank, before delving more deeply into individual roles and functions and how they should change, adapt or be eliminated in this new financial environment. To do this, we will broadly classify non-liberalized policy instruments of the central bank as "direct" instruments of monetary policy as opposed to "non-direct" instruments employed in a liberalized environment.

As the paper develops we will look at the experiences of the Jamaican and Guyanese economies which have ventured into this new environment, reviewing their journey and seeking to comprehend what lessons may be gleaned by other regional central banks as they consider the whole question of liberalization. Finally we will pose the question, whether, a liberalized financial environment, particularly for foreign exchange is necessarily the most appropriate regime for all regional economies.

WHAT CONSTITUTES A LIBERALIZED ENVIRONMENT

The short answer to what constitutes a liberalized environment is that it is the pre-dominance of market forces for the efficient allocation of resources including credit and foreign currency, and the reliance on market-based instruments for the conduct of monetary policy. A more exhaustive list of financial reforms which are at the heart of any liberalized environment cannot preclude: the development of long-term capital markets; the reform of selective credit regulations; recapitalization and restructuring of weak financial institutions; strengthening of competition among banks; reforms of bank supervision and regulation; the

development of a market-based interest rate regime; and, instituting an exchange rate system governed by market forces and responsive to the economic growth and development of the economy. The paper while exploring the overall role of the central bank will focused principally on its role in the application of the latter two reforms and in particular an appropriate exchange rate regime.

The Exchange Rate Regime

Exchange rate regimes, or the conduct of exchange rate policy in the developing countries has undergone a remarkable metamorphosis over the past decade an a half. Fluctuations in exchange rates of major currencies, as well as an upsurge in inflation within these countries themselves, has required more frequent adjustments in exchange rates in these countries. During the same period of time, a variety of external shocks have placed increasing pressure on the exchange rates of these countries moving them away from their equilibrium position. The combination of these factors have coalesced in the belief in the need for more flexible foreign exchange arrangements, featuring more frequent devaluations (a floating peg) or a freely floating exchange rate that would protect the domestic economy from external shocks.

In general, the exchange rate acts as a barometer of external competitiveness and with the balance of payments serving as a binding constraint for many developing countries, the exchange rate also provides a much needed bulwark to protect that domestic competitiveness. The belief that a flexible arrangement allows for a more independent monetary policy, including financing fiscal deficits to promote domestic development will be explore in subsequent sections. The question remains, does liberalization automatically means the instituting of an exchange completely free from bureaucratic manipulation either by the

government or by the monetary authorities. By this definition, few if any currencies can be described as fully liberalized. Even in the developed world, central banks can and do intervene in the currency markets to "protect" the domestic currency and to maintain certain comparative levels. This has most often been described as a "managed float". However, for the most part, market forces and the relative state of the domestic economy determines the level of exchange rate parity.

THE BROAD CONTEXT OF LIBERALIZATION

Liberalization or financial reform is often a part of a broader economic liberalization effort that involves a shift from allocating resources through directives towards the reliance on market processes. Seldom is this a voluntary process, but one that is imposed on individual countries. As a condition of IMF assistance in meeting balance of payments difficulties, these countries are urged to adopt policies directed towards debt servicing and the generation of foreign reserves. However, as many countries much to their chagrin have found out, financial sector and capital account liberalization along with liberalization of the exchange rate regime should occur relatively late in the overall reform effort if they are to prove successful.

Structural reforms are often necessary in order to support and strengthen the effectiveness of stabilization efforts. That is, reform of the principal monetary agency, the central bank must precede further financial sector reform if these reforms are to succeed. A shift by the central bank from direct to indirect instruments of monetary policy would in one example induce appropriate responses by lenders and borrowers to the market determined price for money (i.e. interest rates) thus producing a proper impact on resource allocations. This price is

in turn determined by the underlying conditions of supply and demand rather than by bureaucratic fiat. However, even prior to monetary reforms, there is a need for some measure of fiscal reform if financial reforms are to be effective.

LIBERALIZATION EXPERIENCE OF JAMAICA AND GUYANA

It would not be inaccurate to describe Jamaica as a small, open economy which has always been highly dependent on its mining sector (principally bauxite and alumina) for its merchandise exports, and tourism for its invisible receipts. The openness of the economy made it particularly vulnerable to the inflationary impact of the oil shocks of the early 1970s. The abrupt rise in interest rates in the late 1970's and early 1980's greatly exacerbated the cost of servicing the foreign debt obligations incurred over the previous decade. Battered by these external shocks and stymied by falling bauxite and alumina prices along with a steady erosion in tourism receipts, the economy was faced with a greater percentage of foreign reserves being allocated to meeting interest expenses on foreign debt. At the same time, foreign exchange receipts from tourism and commodities exports were declining precipitously, heralding a continuos balance of payment crisis.

In response to this situation, a series of "mini" devaluations were implemented in the late 1970's as short term corrective measures to address the external imbalance. This downward staircase of pegging and repegging terminated in 1979 with the rate at US$1.00 = J$1.78. Over the next four years, the rate was held relatively stable, however, there was an increasing diversion of foreign reserves to the black market, confirming the inadequacy of the formal rate in clearing the market.

For much of the early 1980s, the government searched for an appropriate mechanism for fixing the price of the currency and the manner in which foreign

exchange is allocated. By 1993, the system of multiple rates proved unworkable and was replaced by a single fixed rate with an auction system to distribute foreign currency. This also enjoyed a very short existence and fixed rate was scrapped in favor of a freely floating currency, although the auction itself was maintained. The persistent downward trend in the rate necessitated government intervention to prevent the depreciation of the currency and eventually, this intervention reached as much as US$10.0 million per week. However, from the end of 1985 to 1989, the currency was held relatively stable at J$5.1 = US$1 although in the same period of time, consumer prices rose by some 50%.

In 1989, the government suspended the auction and "liberalized" the rate. The absence of accompanying fiscal and monetary restraint led very quickly to a run up in the rate and in 1990 on the advice of the IMF and due to balance of payments considerations, the currency was devalued to J$7.0 = US$1. In September 1990 an interbank foreign exchange trading system was introduced and the exchange rate was in theory floated once more. Unofficially, this system evolved to the point whereby the licensed traders of foreign exchange, mostly commercial banks bought and sold only at a previously agreed rate thereby creating an unofficial fixed interbank rate. This eventually led to a majority of exporters and importers doing their foreign exchange transactions outside the interbank market. With the exchange rate unofficially fixed and the continuing presence of exchange controls, the rate was unable to clear the market demand continued to outpaced supply.

In September 1991 the government removed the last significant exchange control, suspended the interbank system and allowed the rate to float freely. Although firms and individuals could legally hold as much foreign exchange as they wanted; banks could open foreign exchange accounts; and a large dollar based financial market developed, the rate deteriorated quickly in large part

because fiscal and monetary reform did not accompany the exchange rate liberalization.

In that month, the government took the final steps to fully liberalize the domestic currency market. An unofficial interbank system had evolved whereby the licensed traders of foreign exchange bought and sold only at an agreed rate. The dealers had also been required to remand 25% of their receipts to the BOJ at the average selling price for the day. Now the interbank rate was no longer set by agreement and allowed to more closely reflect the rate that would best clear the market. The number of licensed dealers was enlarged and the BOJ was charged with developing its own trading room, thus entering the market directly in order to obtain the foreign exchange it needed. This obviated the surrender requirement and eliminated the main disincentive to the use of the official market. Although stabilization was tentatively achieved in 1992 with the tightening of monetary and fiscal policy and the intervention of the private sector in support of the Jamaican dollar, long-term stabilization became a real possibility only after institutional and policy reforms. Despite the fact that there would be further teething problems, involving monetary and fiscal policy, Jamaica had now fully entered the era of liberalization.

Guyana

Similar to Jamaica, Guyana has been plagued by high external debt obligations which along with declines in its export sector has resulted in a continuos balance of payments crisis. Also, similar to Jamaica, the medicine prescribed for Guyana's ills included liberalizing the local economy including the domestic currency market.

Between its independence in 1966 and prior to 1988, the government in Guyana followed a socialist model of economic development. Existing private investments were nationalized, particularly the all-important sugar and bauxite sectors and governmental control extended to most financial institutions. All major economic activities were state-dominated, either through direct ownership, or through price, credit and foreign exchange controls. The public sector dominance of the economy, price controls and the rationing of foreign exchange emasculated any incentive for the private sector and led to the growth of a parallel economy both in commodities and foreign exchange.

While economic performance showed positive growth during this boom period, the collapse of sugar prices (45.8% decline in 1976) threw the economy in reverse precipitating a fall-off in output, coupled with large fiscal deficits, accelerating inflation, a surging import bill and increasing reliance on external borrowings. Although the government made some attempt to address these issues in the mid-1980s, through a series of devaluations in 1984 and 1987 in addition to restructuring some public enterprises, reducing public sector employment, and establishing a multiple exchange rate system, the magnitude of the problems quickly overwhelmed their efforts. The nominal devaluations had little real impact as these were offset by a continued high rate of deficit induced inflation. Although total public sector employment fell after 1980, between 1984 and 1986 it rose dramatically. In the early 1980s, the government began to suspend payments on its external debts, and by the end of 1988, the public sector (including the Bank of Guyana) had accumulated external arrears of US$1.03 billion on its 1988 external debt of US$1.76 billion.

Finally, in consultation with the IMF, the government announced a major shift in policy in mid-1988. The public sector's role in the economy would be greatly reduced, a greater role mandated for the private sector and removal of the controls

that distorted commodity and factor prices. For our purposes, some of the most crucial steps taken under this Economic Recovery Program (ERP) were; a commitment to the reduction of fiscal deficits and money supply growth, with the resultant decline in the rate of inflation; and the establishment of a free market for foreign exchange trading among banks and registered dealers. This was to become the "cambio market" and represented a major step forward to liberalizing the market for foreign currency in Guyana.

The parallel market for foreign exchange which had existed for more than a decade was legalized as the cambio market in March 1991. This system represented an independent market for foreign exchange by allowing banks and non-bank dealers to trade foreign currency at rates free from official administrative oversight and direction in terms of demand and supply and the prevailing price level. Market forces should determine the price of foreign exchange and its direction of movement. Although in truth, the rate tended to be set by the larger commercial banks.

The cambio rate was applied to most trade, except sugar exports and imports of fuel, sugar and official debt service which attracted the official rate which was substantially more appreciated. This lasted until February 1991 when the official rate was "unified" with the cambio rate, moving from G$45.00 to G$102.00. By October 1991, the official rate was abolished. The exchange rate in the early weeks after unification depreciated to a peak of G$135.00 in March 1991. However, by the end of the year, the rate had rebounded to G$122 and three years later was trading at G$132.15. Although Guyana has a long way to go, the irrevocable step towards liberalization had been taken.

Transition to a Liberalized Environment

Institutional reform for Jamaica, Guyana and other regional central banks pursuing liberalization depends on redefining the role and responsibilities of the central bank. In a non-liberalized economy with a fixed or pegged exchange rate regime, monetary policy in its broadest sense is determined for all practical purposes by that prevailing internationally. In such an environment, the central bank's role is principally that of overseer and caretaker. In order to maintain exchange rate parity, domestic inflation cannot persistently exceed that of the country to which its currency is pegged. In addition, because the supply of money is externally determined, the Bank must hew to stable money and credit growth paths as significant deviations could result in a fall-off in foreign reserves making the export sector less competitive due to hikes in domestic prices. Likewise in order to maintain price stability, the Bank is constrained in its ability to "print" money in order to finance budget deficits or other local projects.

However, in a liberalized environment with flexible or floating exchange rates, this paradigm is turned on its head. In addition to greater flexibility to pursue an independent monetary policy, the Bank also has added responsibility to control domestic inflation and develop a sustainable reserve position. The need to maintain domestic price stability and a certain level of international reserves and thus protect exchange rate parity, no longer acts as a constraint on the monetary policy aspirations of the Bank. With money supply growth and in fact monetary policy no longer exogenously determined, what mechanisms if any are in place to ensure responsible monetary policy? The obvious one would be to allow the market to determine optimal resource allocation by the promotion of savings, efficient financial intermediation, efficient credit allocation and an appropriate exchange rate regime.

Direct vs. Indirect Monetary Instruments

In order to achieve these operational objectives in a market based environment, the Bank needs monetary instruments that are not only effective but which are also flexible and efficient. Flexibility ensures that the instrument can be adjusted frequently or infrequently and in small or large increments. Flexible instruments also mean that given broad guidelines or policy parameters, the Bank has the autonomy to make use of these instruments to administer monetary policy to carry out its principal functions.

The efficiency of a monetary instrument depends on its ability to perform effectively and flexibly with the least overall distortion to the market. Typical traditional monetary instruments including credit ceilings, bureaucratically determined interest rates and arbitrarily fixed exchange rates may prove very effective however, they bring along considerable inefficiencies and distortions.

These instruments collectively are called direct instruments of monetary policy and present the following problems, and distortions:

-they are often inflexible, hard to hard to apply discretely and typically only affect certain segments of the system;

-credit ceilings largely eliminate competition as borrowers have few options to switch banking relationships;

-the lack of freely determined interest rates allows for artificially high lending rate and equally low deposit rates;

-ceilings make monitoring of compliance increasingly difficult, as credit is extended in forms not covered by the ceiling or interest is paid or charged in forms other than interest;

-these instruments tend to hinder price competition and the development of a money market;

-they promote the organization and use of unofficial domestic markets for both lending (loan-sharking etc.) and foreign exchange.

-they require the central bank to become increasingly involved in micromanagement issues related to individual banks, often conflicting with its macroeconomics role.

-the most economically dangerous aspect of these controls may be that they make the determination of the levels of credit, interest rates and the availability of foreign exchange seem a political decision and, therefore prone to political rather than monetary considerations.

In a liberalized environment, there will be a movement away from these types of monetary instruments towards instruments that accomplish the same tasks but that do through market forces. Although there will probably always be a need for some direct policy instruments, the role of the central bank in a liberalized environment will be characterized by a transition from direct to indirect instruments of monetary policy.

Indirect or market based monetary policy instruments equilibrate demand and supply for money and credit in the money market and foreign exchange in the foreign currency market. Market determined interest and foreign exchange rates provide the following advantages:

-they ensure automatic and immediate adjustment, thereby reducing the risk of policy error;

-they transmit the policy signals and effects to all segments of the economy immediately;

-they make pressures on their individual markets immediately apparent;

-they assure an optimal allocation of money and credit and foreign currency based on price and relative risk and return;

-they reduce the political sensitivity to rate changes;

-they ensure consistency between monetary, fiscal, and exchange rate policies; and

-they allow the central bank to stand back from the market without losing control.

Transition to Indirect Policy Instruments

Liberalization of the exchange rate regime was not the panacea for Jamaica's problems as expected. In fact, true liberalization was not possible without a fundamental shift in the role of the government in general and the Bank of Jamaica in particular. The transition to direct instruments of monetary policy and a flexible exchange rate regime can not be an abrupt one. This transition would need to follow the pace of other developments and reforms. Both Jamaica and Guyana clearly illustrate that the sequencing of financial reform is as least as importance as the reforms themselves.

Different financial traditions, differing banking systems and financial markets at different levels of development mean that individual countries will start their transition from various points and will achieve success at different speeds. In addition, the pace of reforms in individual countries also affects the transition and complicates the process. However, before moving ahead with any reform efforts, it is important to have a clear and realistic idea of the result expected to be achieved at the end of the process. Individual economies may be more responsive to some instruments rather than others; greater reforms of both the fiscal process and the monetary and financial system depending on the country; and the central bank should not lose sight of the objective reality of their financial markets and be prepared to accommodate that reality.

IS A LIBERALIZED ENVIRONMENT OPTIMAL FOR ALL ECONOMIES

THE HUMAN RESOURCE QUESTION

The changing role of the central bank in a liberalized environment, and its added responsibilities, will have a significant impact on the resource personnel of the Bank. In particular, an independent monetary policy requires trained, skilled personnel with the education and the experience to craft credible national economic policy. As regional central banks tackle the issue of liberalization, it is imperative that consideration be given to the question of whether their skills and intellectual capacity within the bank to effectively manage the economy in this liberalized environment. The development of economists familiar with the eccentricities of the local economy is vitally important, but equally important is the training and theoretical knowledge to make the most efficient use of indirect monetary instruments as well as the skill to craft policies that will take the economy forward to the next milestone. Central banks may want to postpone this transition until some of these questions can be answered. The gradual development of the necessary skills will make the eventual shift to a liberalized economy a relatively painless one.

THE SMALL OPEN ECONOMY QUESTION

Although the benefits of liberalization to the domestic market may be clear, it can be argued that for many Caribbean nations the nature of their economies make liberalization, particularly a flexible exchange rate regime less than optimal. Because so many of the Caribbean states, the Bahamas especially is so open to international trade, the argument can be made that this presents a strong case for fixing the exchange rate because of potential costs to international transactions of

frequent exchange rate adjustments. Or in the case of the Bahamas, the uncertainty faced by its three million annual visitors, as relative prices are adjusted frequently. Furthermore, such openness makes a fixed exchange rate more effective in channeling abroad a domestic monetary shock, and stabilizing output by limiting the destabilizing movements of domestic interest rates.

THE FINANCIAL DISCIPLINE QUESTION

The way in which a fixed exchange rate regime can impose financial discipline has been extensively studied (see Krugman 1979) but to put it briefly; consider a small open economy like that prevalent throughout the Caribbean with a fixed exchange rate for both trade and financial transactions. In this circumstance, the world inflation rate determines the domestic inflation rate and if we assume a unitary income elasticity of money demand, the rate of growth of domestic money is determined by the rate of growth of real output plus the rate of world inflation.

If some measure of the domestic money supply is backed by foreign exchange to defend the fixed rate, then the rate of growth of domestic credit cannot permanently exceed the rate of growth of nominal demand for money. Although the central bank may resort to external borrowing to replenish reserves and sustain the exchange rate in the event this discipline is breached, this process cannot continue indefinitely as foreign creditors will be unwilling to finance central bank intervention to an unlimited degree. In short, a fixed exchange rate regime is a clear signal to both the local and the international financial community that the government and the central bank is committed to responsible monetary and fiscal policy.

CONCLUSION

Establishing the credibility of a government's commitment to prudent financial policies is difficult for countries with a long history of expansionary policies and high inflation. For countries for whom a liberalized economy is in fact the optimal circumstance, a practical solution, and one recommended by IMF and the IBRD, may be to grant considerable autonomy to a central bank with a reputation for financial conservatism. What is abundantly clear however, is that liberalization, including the establishment of flexible exchange rate regime and the use of indirect rather than direct instruments of monetary, does not free the authorities from the external constraint on their domestic policies, which will greatly influence movements in the exchange rate and the current account balance. And these movements in turn, constrain domestic policies thus completing the cycle.

Reforming any local economy and restoring the attractiveness of the domestic currency requires that the central government sustain its commitment to sound fiscal policy regardless of the exchange rate regime, as well as providing the central bank with the authority or autonomy to conduct monetary policy in the manner necessary to maintain the real value of the currency. The market must be confident of this commitment on the part of the authorities who must realize that this credibility will be constantly tested. To fail this test by allowing an excessively loose fiscal or monetary policy could seriously damage investor confidence and quickly lead to excess demand, higher inflation and higher real interest rates, thereby jeopardizing any prospects for real economic growth. The governments in both Jamaica and Guyana have taken significant steps to full liberalizing their economies and reforming their monetary and fiscal structures, yet still they face skeptical markets and will continue to do so until the markets are reassured that fiscal and monetary stability has been restored and economic reform achieved.

It is clear that whether one believes that a liberalized exchange rate regime is optimal or even advisable for small, open developing economies such as we have in the region, the need for monetary and fiscal discipline remains paramount. For economies facing balance of payments difficulties or not, market confidence in the fiscal and monetary authorities to maintain price stability as well as stable money growth path would determine whether the regime is the appropriate type. Floating exchange rates have always been heralded as a boon for those economies seeking protection against external shocks while fixed rates for those preferring price stability. The flexibility of the exchange rate allows for a certain amount of inflationary financing without jeopardizing external competitiveness. However, this flexibility should never become a substitute for undertaking as strong an effort as possible to implement prudent financial policies. Even in a liberalized environment, the role of the Central Bank will continue to be the preservation of health of the banking system and more generally the preservation of stable monetary conditions which would allow the monetary development of the country and ensure the availability of necessary funding for individual and families financial growth and development.

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