Central Banking in Theory and Practice

A Small State Perspective

by Courtney N. Blackman

Caribbean Centre for Monetary Studies

Written from the perspectives of scholar, administrator and national policy maker, Dr. Courtney Blackman's collection of fifteen essays are erudite, thoughtful and penetrating. Together they constitute the authoritative work on central banking in small developing states. Dr. Blackman marries theoretical concepts with practical insights drawn from his rare experience as a founding central bank governor. Moreover, his readiness to challenge the conventional wisdom, whatever its source, makes for an exciting and refreshing book - indeed a *tour de force*. These essays are required reading for central bankers and ministers of finance everywhere - not only in small states, but especially for international economists who prescribe for the monetary ills of small developing countries.

About the Author

Dr. Courtney N. Blackman has since January 1995 served as Barbados' Ambassador to the United States and Permanent representative to the Organisation of American States. He graduated with an honours degree in Modern History in 1956 from the University of the West Indies, and gained his Ph.D. in 1969 from the Graduate School of Business, Columbia University, N.Y., where he majored in Money and Banking, with a Minor in International Business. He later worked as an Economist between 1968-1971 at the now defunct Irving Trust Company, going on to become Associate Professor of Management at Hofstra University on Long Island, New York.

Dr. Blackman served three terms as founding governor of the Central Bank of Barbados, between June 1972 and March 1987, and as Barbados' Alternate Governor to the IMF. He was awarded his country's Gold Crown of Merit and an Honorary doctorate by Hofstra University for services to the Central Bank of Barbados. An authority on central banking in developing countries, Dr. Blackman has lectured at major universities in Britain, Canada and the USA, and has published in several learned journals. A collection of his speeches, **The Practice of Persuasion,** was published in 1982.

From 1987 to 1994 Dr. Blackman worked as an international business consultant to several governments, central banks, multilateral institutions and international corporations and he also served as Director of several corporations and financial institutions. Dr. Blackman is married to the former Gloria McKoy; they have three adult sons.

Caribbean Centre for Monetary Studies

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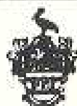

CENTRAL BANKING IN THEORY AND PRACTICE: A SMALL STATE PERSPECTIVE 1998

Courtney N. Blackman

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A Bankers' Banker

The subject of this book is central banking in theory and practice. Its point is that practical banking has little chance of success, if it is not anchored in theory. The author draws a simple but seminal distinction between a theory of the foreign exchanges and a foreign exchange handbook. While the latter is arithmetic, the former is algebra; it makes all the difference.

This is the work of a bankers' banker, offered from a strategic position, by a wise and distinguished practitioner. Dr. Blackman presents it in the form of a selection of 15 papers he had delivered over the years, a distillation of what has been a rare experience, perhaps unique.

When he assumed the governorship of the Central Bank of Barbados, this now retired professional started at the top. Neither as economist nor commercial banker, had he had any exposure in the Caribbean. Nor had he worked in a Central Bank at all, let alone as Chief Executive. Moreover, the Bank was itself a completely new institution, the first of its kind in the CARICOM region bold enough to embark without having at the helm an experienced expatriate.

Dr. Blackman assumed office on June 11, 1972. The Bank started business on June 11, 1972. On December 18, 1971, the Smithsonian Agreement had been concluded thereby making permanent the suspension by the US Treasury, the previous August, of Bretton Woods convertibility and ushering in a new regime of flexible exchanges. By the time floating rates were formally adopted by the international financial community, significantly in Kingston in January 1976, the Bank and its Governor can be said to have had a true baptism of fire. Dollar/gold based, the system had been brought to crisis by the complete collapse of the US balance of payments and a liquidity shortage corrected neither by the resort of the SDR nor through the mere issue by the US of its IOUs to finance its own deficit.

It was OPEC's quadrupling of the price of oil in October 1973 which, in its own way, resolved the international liquidity crisis. For being the medium of settlement of bills in the oil trade, the dollar was now suddenly secure as the world's reserve currency. The newer role had come to anchor the older. It was an odd solution, outweighed by new problems. Neither could the oil exporters absorb their immense new surpluses, nor the importers compress consumption or fund their deficits. There emerged the classic "transfer problem", postponed by the breezy recycling of the 1970s, only to surface lugubriously once more in the 1980s, in the shape of "the debt crisis." Led by Mexico, the debtor community was so near insolvent, no conceivable "adjustment" seemed sufficiently "structural."

A whole new burden had fallen on the mechanism of adjustment. Sovereign central bankers would be absorbed by nothing less than an increasingly "globalised" order, one needing urgently to reinvent itself with a single collective policy centre, ecumenical, multilateral, sensitive. Would it be compatible with the still growing number of parochial jurisdictions? Question for the governors: "Could a new central bank in the Caribbean accomplish anything useful?"

The 20th century had already created many nations, not least in this region. The last hundred years will probably be remembered more for the collapse of empire than for the leaps in technological progress which have facilitated, perhaps even promoted, an unprecedented and possible irreversible integration of markets, for goods as well as services and capital. The passing of the sterling hegemony and the rise of the dollar seemed at first to promise a dispensation marked by many sovereignties, frankly parochial. Had the closing rites to World War II not foreshadowed more central banks, their governors and their centres of decision, in a macroeconomic scenario unabashedly keynesian?

In some ways a concert of nation states was the essential premise of the United Nations System and to Bretton Woods too, even if the latter's 1944 Charter failed to reflect Keynes' remarkably democratic proposals. The latter included a world currency based on 30 primary commodities embracing both oil and gold; penalties for surplus as well as deficit countries; development responsibility to a special UN Fund; a mandate to an international trade organization to stabilize primary commodity prices as well as the promotion of multilateral trade.

Many observers think that, by ignoring such proposals, the actual arrangements sowed the seeds of the latter instability. And yet the dispensation also admitted high levels of employment in the industrial countries, witnessed favourable terms of trade for the primary exporters and triggered a start towards manufactures among not a few of the latter. The more than two decades of expansion served effectively to vindicate the vision of a global system predicated on a multitude of viable local jurisdictions. It also created an environment in the end as vulnerable as ever to external shocks, market and policy.

It is therefore hard to say if the outcome of the more than a quarter of a century since the demise of the Bretton Woods regime has been truly surprising. The legacy of the better days has been combined with a mix of mostly expedients, adopted to keep the system afloat, and with sundry developments in the technology and the politics. Perhaps the still evolving multilateral arrangements have turned out a little too lopsided while a whole unprogrammed trend towards regional integration has been summarily accelerated. Equally, the experience has thrown up a variety of models of local response to stimuli emanating in the wider environment. Some such as Hong Kong and Singapore variants are the more highly sung.

One great virtue of these reflections on nearly thirty years of experience is that, for the first time, they afford the world a glimpse of the workings of the Barbados model. From the admittedly narrower angle of vision of the monetary authorities, Dr. Blackman furnishes elements of appraisal. He documents ways in which perhaps the most successfully managed of the Caribbean countries has been coping.

The key insight of these essays is this: theory can scarcely be escaped in the quest for sound practice; but that is not all. If we are to arrive at a theory specific to the Caribbean, or any part of it, even less can we dispense with a general theory of central banking, applicable to all contexts. Dr. Blackman is clear sighted. In character, the general view cannot but be normative. It needs to state what should be achieved by central banking, in all conditions and above everything else. Which is to say, the regulation and the management of liquidity, as needed for stable values.

The way effectively to achieve this varies from place to place and from time to time. It depends on the historical, cultural and institutional context, on the current conjuncture, and more. The trick of the effective theorist is to differentiate "concepts by postulation", which do not, for their validity, depend on situation, from "concepts by intuition", which only capture the particulars, and which therefore, as practice differs, invariably undergo changes in meaning.

Proceeding in this manner, Dr. Blackman begins with the idea that, in "small, developing countries", such concepts as "stock markets' and "reserve requirements" have specific local reference. By the time he comes to look back at what he has elected to offer in this volume one finds, first, that he is ready to abandon such notions as "small" and "developing' in exchange for "different contexts to policy and management." Second, that he comes close to seeing the ultimate challenge to theory, monetary and other, as one of accepting that options are altered not so much by the efficiency of markets as by their presence or absence. Third, that the existence or not of markets is not simply "the most conspicuous difference" between "developed" and "developing" countries; it constitutes the decisive argument for seeing what we call "underdevelopment" as our consistent failure to recognise the necessity and the validity of "extra-market" measures.

The latter is only one concept emphasised in what is an enormously fertile and erudite rendering. Dr. Blackman warns us against insisting on the rate of interest as the index, even where supply and demand scarcely intersect. He reminds us that market incentives are often incapable of producing the required resource transfers; and that changes in the exchange rate may effect zero adjustment. He underscores the difference between financial and real saving as a source of much prestigious confusion. Referring to the experience of chronic disequilibrium conditions in Guyana and Jamaica, he points out that there are quite normal conditions under which the equilibrium exchange rate is simply indeterminate.

In theoretical terms, we are compelled to revise many of our postures and return to the drawing board. In practical terms, it may mean "resisting the exhortation of the international financial institutions to remove exchange controls entirely." The implication is that "Exchange rates should be managed, not left

completely to market forces..." I find such conclusions to be a model of educated common sense, all the more remarkable, given the ideological texture of the period. "The true path to Jamaican economic development is neither a Socialist path nor a Free-market path but the Jamaican path... the most important thing is for policy to eschew dogma, to be prepared to make adjustment in the light of clear mistakes and new information, and to remember that Rome was not built in a day."

I have enjoyed much opportunity over the years to trade ideas with Dr. Blackman. I could not help noticing to what extent his opus, including these essays, betrays his early training, first in the classics (Latin and Greek) and then in history. There are absolutely none of the professional blinkers. If anything, the preference is for the management discipline. The approach is emphatic: intelligent reference to whatever is relevant. Even in what looks so specialist a domain as financial accounting for central banks, there is a catholicity I find totally refreshing.

The observer's view here is a wide as it is long. Though his centre of active interpretation is the Central Bank of Barbados over fifteen years, there is copious drawing on the whole of the experience of the Caribbean Community. Dr. Blackman knows that his baptism of fire in that period, into the late 1980s, in some ways, took place in a privileged context. Structural adjustment, upward to improving terms of trade as well as downward to the inevitable deterioration, had been familiar to the whole region for more than three hundred years of almost complete export specialisation and susceptibility to external shocks. The Barbados sugar economy had been the limiting case, uncluttered, paradigmatic. Or so it seemed, save that a latent capacity for autonomous and responsible self-adjustment existed waiting to be activated. It reached back, we can guess now to the founding matrix and the initial conditions under which a unique island civilization had been established. A colony of permanent settler proprietors had briefly predated the flood of largely absentee investors. Much like the algebra, that too is the difference.

In the CARICOM countries, the advent of the Central Bank offered monetary policy as one more new instrument but for an extremely old problem, one made intractable by the nature of an economy which, precisely, had been invented by the absentee

investment and was still very much its creature as well as its creation. In some ways, the region is defined by the extent to which its constituent parts are the outcome of that long standing process of migration of capital, on a global scale, and predicated on the single ecumenical centre of policy decision, fitfully in correspondence with the parochial jurisdictions. From Sterling as an international system, the English-speaking West Indies had inherited a fund of wisdom about ways and means of adjustment, automatic more than managed, employing private agents and actors more than resorting to community measures, collective and concerted.

Did the region emerge with any sense of itself and its past, fountain of history, basis of theory? Did it acquire the habit of learning, especially from itself? That is the issue. It is this harvest of the fruits of experience, as guide to action, that Dr. Blackman's effort now splendidly supplies us, for and on behalf of the community of CARICOM central bankers, under the chosen rubric. He agrees that economic integration is required for our collective salvation. To that end, monetary integration needs to be approached not with some project, feasible only if everybody behaves, but with plan and programme, possessed of "strategic intent." The last four essays are devoted to economic and monetary union, each to a facet. They make a fitting crescendo.

Lloyd Best,
Trinidad and Tobago Institute of the West Indies

Preface

Central banking is both art and science. For one thing, the political, economic, social and international environment of central banks is in constant flux; at the same time central banks are quite dissimilar in their constitutions and **modus operandi,** sharing only the potential of money creation. No two Banks are exactly alike. Practitioners of central banking must therefore move continually between the worlds of monetary theory and practical experience, adjusting their policy measures as developments in either sphere demand. Central banks are also organizations, and as such have to be managed; here too evolving management theory must be adapted to local circumstance.

As founding Governor of the Central Bank of Barbados, I was called upon to apply theories of money and of management I had learned in the classroom and from ongoing experience. The fifteen essays following reflect my efforts to reconcile the worlds of theory and practice. They were all heterodox at the time of writing; some still are! Experience teaches that theories have long become obsolete by the time they are generally accepted. I have therefore always assumed that the consensus, even the "Washington Consensus", must be wrong.

Literally scores of people have assisted me over more than three decades to make this publication possible; only a few can be mentioned. Robert Shay taught my first class in Money and Banking at the Columbia Business School, and later supervised my doctoral dissertation; George W. McKinney introduced me to the real world of Money and Banking when he recruited me as an Economist at the Irving Trust Company, No. 1 Wall Street; Lloyd Best and Clive Thomas helped clear up several theoretical difficulties with my dissertation; the late G. Arthur Brown and Victor Bruce, Governors of the Bank of Jamaica and the Central Bank of Trinidad and Tobago, respectively, held my hand in my early days of practical central banking; both as colleagues and former colleagues, Winston Cox, currently Governor, DeLisle Worrell and Marion Williams (Both Deputy Governors), and a host of Bank economists helped me in one way or another in the preparation of various essays; several Bank secretaries typed drafts of the early essays; and over twenty-years, scholars in the Caribbean

Monetary Studies Programme, like Dwight Venner (Governor of the ECCB), Compton Bourne and Terrence Farrell, have through their vigorous argumentation sharpened my understanding of central banking issues.

For the final execution of the project, I owe much to Laurence Clarke, Executive Director of the Caribbean Centre for Monetary Studies, who manoeuvred adroitly to bring the publication to Press. However, without the financial assistance of the Caribbean Development Bank, authorized by its President Sir Neville Nicholls, the monograph might still not have seen the light of day. Lloyd Best kindly agreed to write the Foreword. I am also grateful to those institutions and persons who have permitted me to reprint published articles. A list of acknowledgements is shown below.

But by far the greatest credit belongs to my wife, Gloria. She supported me throughout every phase of my academic preparation and banking career, spanning more than three decades. She typed all the papers written since I left the Central Bank, and checked and retyped all the copy going to Press. More critically, in the familiar style of caring wives, she has alternately coaxed and goaded me into completing this project. For this reason I have dedicated this monograph to her.

In spite of such generous assistance, errors no doubt remain in this work; they are mine and mine alone.

Courtney N. Blackman, Ph.D.

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2. "Structural Adjustment in Conditions of Disequilibrium" *Money Affairs,* January-June, 1992.

3. "Towards a Theory of Central Bank Management - With Special Reference to the Caribbean." *Money Affairs,* Vol. 6, No. 2, July-December, 1993.

Central Bank of Barbados:

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2. "The Practice of Central Banking in Barbados: An Interpretation of the First Fifteen Years" *Central Banking in Barbados: Reflections and Challenges,* 1997.

Caribbean Affairs:

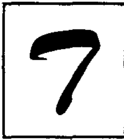
"Towards a Caribbean Monetary Union." *Caribbean Affairs,* Vol. I, No. 2, 1988.

Drs. Terrence Farrell & DeLisle Worrell:

"Institutional framework for a Caribbean Monetary Authority." *Caribbean Monetary Integration,* Port of Spain, 1992.

To my wife Gloria,
without whom this book would
never have been written.

Introduction



he era of central banking in the anglophone Caribbean, inaugurated with the founding of Bank of Jamaica in 1961, has been with us for a generation. Central banks were later set up in Trinidad and Tobago, Guyana, Barbados, Belize, The Bahamas and eventually in the Organization of Eastern Caribbean States (OECS), when the Eastern Caribbean Currency Authority graduated into the Eastern Caribbean Central Bank (ECCB) in 1983. Previously the monetary needs of the region were served by currency boards, passive mechanisms for the exchange of domestic currency into sterling and vice versa. Currency boards lack the power of money creation so that the limit of the domestic money expansion is determined by the volume of foreign exchange inflows. The defining attribute of central banks is the power of money creation within its jurisdiction. The establishment of central banks therefore gave monetary authorities the power to vary the volume of money and credit in the economic system.

Shortly after my appointment as Governor of the Central Bank of Barbados in 1972, I warned that the central bank was a "two-edged sword". A well-managed central bank can provide new credit to stimulate a depressed economy and restrain the expansion of money and credit during a boom. In particular, it can assist a prudent government in meeting its short-term liquidity needs more economically than by borrowing from commercial banks as in the old currency board days. On the other hand, excessive money creation in open economies, especially for the financing of fiscal deficits, will not only lead swiftly to inflation but also to balance of payments collapse, wreaking considerable economic and social havoc.

As it turns out, many of the economic and associated social ills in the region can be traced to the abuse of the money creating powers of central banks or the misapplication of central banking theory and techniques. This hypothesis is confirmed by the superior economic performance of the so-called less developed OECS, whose Ministers of Finance are denied the facility of deficit financing through central bank credit.

In the predictable international economic environment of their early existence, the new central banks behaved very much like the currency boards which preceded them. The relative tranquility of the 1960s was broken by the gathering turbulence in the international financial system, brought on by the collapse of the Bretton Woods System in 1971, the demise of the Sterling Area in 1974, and the Oil Shocks of 1974 and 1978 that precipitated the LDC Debt Crisis.

No degree of central banking skill could have shielded Caribbean societies from the negative effects of these external pressures. Unfortunately, attempts to deal with this situation through central bank credit proved disastrous, especially for Guyana and Jamaica, and there was a close call for Barbados in 1991-92. At the same time both Caribbean officials and academics badly underestimated how narrow was the margin for error in monetary policy, and how difficult it would be to recover from the consequences of such miscalculation.

In Guyana and Jamaica the descent into chronic internal and external monetary disequilibrium had been provoked by well-meaning neo-Marxian and socialist attempts in the mid-1970s to accelerate economic growth and to redistribute incomes. This approach focused on the real economy to the neglect of monetary and financial considerations. As the deepening balance of payments crisis forced these countries to seek assistance of the Washington international financial institutions (IFIs) . They were subjected to structural adjustment programmes rooted in general equilibrium theory, which stressed monetary and financial variables to the neglect of the real economy. In fact, both real and financial issues must be addressed simultaneously. After more than twenty years of adherence to IFI programmes,

the Jamaican population is worse off than in 1975, and the economy is no closer to equilibrium.

The premise of the following collection of papers is that the roots of much of the economic disaster described above are intellectual. Monetary authorities, sometimes out of genuine ignorance but more often driven by left-wing ideology, either rejected pragmatic policy formulations quite accessible to them, or were forced by the desperate need for foreign exchange inflows to accept structural adjustment programmes driven by "free-market" ideology which failed to take the specifics of regional economies into consideration.

The following exercises in applied economics are informed by over thirty years of reflection on central banking as a scholar, practitioner and consultant. Except for minor corrections, they are reproduced as they were originally written. The exception is "Liquidity Management in Liberalizing Environments", which was based on a verbal presentation. These essays were written mostly as critiques of the conventional wisdom on monetary issues, and of ideologically driven programmes. Their intention was to influence policy, and since few policy makers are, or need to be, professional economists, technical language and graphical illustrations are kept to a minimum. They should be readily intelligible to the interested layman.

Unfortunately, these essays were not as influential at the time of writing as I had hoped. It is no great consolation that many of their recommendations have since passed into the conventional wisdom - too late to avoid considerable damage. Incomes policies are now a standard element of adjustment programmes and are accepted even by some regional trade unions; **The Economist** now questions the efficacy of devaluation; and the IFIs have begun to shift their emphasis away from "getting prices right" to institutional issues like governance. Better late than never!

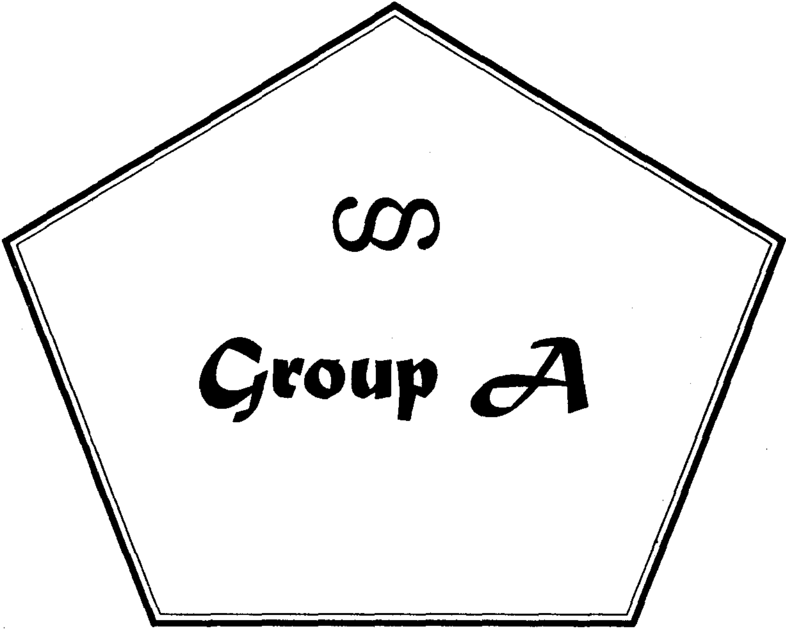
Three themes are sustained throughout this monograph:

1. Ideologically driven prescriptions should be resisted, whether from the left or from the right.

2. Economic policy making is contextual; economic programmes developed in advanced economies are most unlikely to fit the circumstances of less developed countries.

3. The most important consideration in economic policy making is the role of markets. It is not true that all markets are efficient, and we must not pretend that efficient markets exist when they do not. If market outcomes are unacceptable, we must intervene to achieve more desirable results.

The fifteen essays are arranged in four groups. Those in **Group A** deal with the rationale and practice of central banking; **Group B** examines various practical aspects of this subject. The papers in **Group C** address issues of structural adjustment and problems arising from the recent trend towards financial liberalization. **Group D** explores the possibilities of Caribbean Monetary Union. As is unavoidable in stand alone essays written over an extended period, some degree of repetition is unavoidable; hopefully this will serve to reinforce the common themes of this monograph.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Group A

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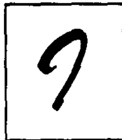
The Practice of Central Banking in Barbados: An Interpretation of the First Fifteen Years*

Introduction



am grateful to Governor Calvin Springer for inviting me to set down my personal reflections on the first fifteen years of the existence of the Central Bank of Barbados (June 11, 1972 to March 31, 1987), during which I served as its Governor. Contemporary students of institutional building will want to judge the extent to which the goals and aspirations of the founders were achieved; future scholars of Caribbean money and banking will certainly be curious about the thinking that informed the establishment of central banks in the region, and of the Central Bank of Barbados in particular. This is the audience whom I will be addressing in the following pages. Following this introduction, I discuss principles of central banking which governed my tenure at the Bank. In **Sections 2 & 3,** I review approaches to national economic policy making and financial development, respectively, during this period. In **Section 4,** regional issues, particularly the experience with the Caricom Multilateral Clearing Facility,

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* Published in *Central Banking in Barbados: Reflections and Challenges,* on the occasion of the 25th Anniversary of the Central Bank of Barbados.

are discussed. **Section 5** examines my relationship with the politicians whom I served, and the prerequisite for greater independence of Central Banks in the Caribbean. I reflect on my interaction with fellow central bankers before summarizing in **Section 7** the major principles of central banking and economic management which informed my tenure.

This exercise is essentially autobiographical and involves the frequent use of the first person. However, I am deeply conscious that little would have been achieved had Prime Ministers not given me room to operate and to grow, had the Directors not shared their experience and wisdom, and if managers and staff had not given their unstinting support.

SECTION I

RATIONALE OF CENTRAL BANKING

My first foray into central banking theory was quite conventional. In a graduate term paper circa 1966 I accepted the examples of the Bank of England and the Federal Reserve System as "true" central banks, and perceived the art of central banking in developing countries as essentially one of "working up to" the state of "true" central banks - mimicking is a harsher but probably more appropriate terminology. This is not far from the position of today's financial liberalisers, who want central banks in LDCs to focus on open market operations and generally to use the same tools as the Federal Reserve System.

My term paper approach informed my Ph.D. draft proposal. Fortunately I was able to discuss the problem with Clive Y. Thomas and Lloyd Best. They showed me the error of my ways, and indicated the need for me to develop a "normative " theory of central banking as a basis for assessing the performance of the Bank of Jamaica. A normative model would incorporate the generic elements of central banking and would apply to central banks everywhere, whereas my "true" model was really a special theory applicable only to central banks in developed conditions.

I therefore sought to develop a general theory of central banks, whose operation would be modified by the circumstances of the particular country.

Liquidity, the ease with which assets can be transformed into cash, was identified as the primary concept in the theory of central banking. We may speak of the liquidity of an individual asset, and by extension, the liquidity of the portfolios of particular economic units, of the economy as a whole, or of a particular sector, including its external sector. In the latter instance, liquidity is indicated by the convertibility of domestic currency into foreign exchange, the level of foreign exchange reserves and the availability of foreign credit. It is the level of liquidity of his portfolio which enables its holder to purchase goods and services.

The economic role of the Central Bank is to regulate, in an optimal fashion, the overall level of liquidity in the economy, and its distribution among various sectors and between domestic and external sectors. Because of the Central Bank's ability to create money, its portfolio may be described as infinitely liquid. Through calculated purchases and/or sales of financial assets it can significantly enhance or diminish the liquidity of individual economic units, economic sectors or of the economy as a whole.[1]

The challenge then in 1972 was one of devising central banking policies appropriate to Barbadian circumstances rather than those that merely mimicked the practices of the Bank of England and the Federal Reserve System. Such policies would take into account two main factors: first, Barbados' main goal of economic development; and secondly, the underdeveloped and oligopolistic financial market environment in which the Central Bank would have to operate. The goal of economic development required monetary policies which favoured savings and investment, necessarily at the expense of consumption; the

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[1] For a more elaborate discussion see **Chapter 4** of this work.

imperfection of financial markets meant that the Central Bank could not rely solely, or even primarily, on the "free market" to allocate credit among the major economic players.

Whereas the central bank in a developed country can make small adjustments in interest rates or money supply growth and confidently expect the financial markets to bring about the desired allocation, central banks in developing countries may need to intervene directly to slow economic expansion. For example, the Bank on occasion raised legal down payments on durable good purchases and lowered the maturity on consumer loans in order to curb consumer imports. At the same time the small number of financial institutions also allows the Governor to use "moral suasion" in Barbados whereas U.S. Chairman Greenspan, with his 12,000 banks, cannot. Empirical research on the local situation also led us to focus on commercial bank credit, rather than the traditional money supply, as the critical monetary control variable, and made us skeptical of the direct relationship between real savings and positive real interest rates.

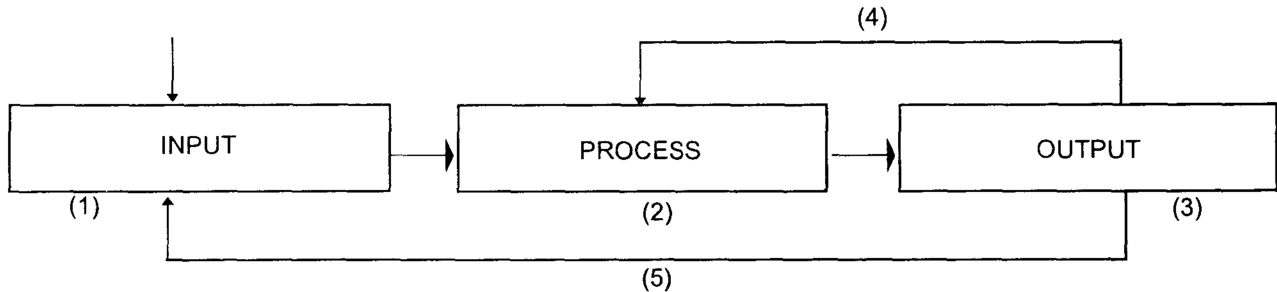
We also needed to develop the appropriate organizational model of a central bank for implementing our normative theory of central banking. The objective was to establish a modern organization which performed at international operational and professional standards - including the quality of office accommodation! The institutional parameters of the new organization were set by the Central Bank Act, which closely followed the Bank of England model, and which provides for operational autonomy within the framework of overall government policy. We were therefore able to prevent politicization of the Bank's operations, especially in the key areas of staffing and publications. Except where required by law, appointments were not discussed with the Minister, nor were press releases, speeches and statistical publications submitted for ministerial vetting. This represented a major departure from the tradition of statutory corporations in Barbados. Although working closely with the Ministry of Finance, the Central Bank would develop a personality of its own and a ***modus operandi*** quite different from that of the Civil Service.

The functional aspects of the new organization were determined by the perception of the Central Bank as an information system. At my very first meeting with the Board of the Central Bank, and at numerous other meetings with my managers, I described a management model of the Bank - three horizontal rectangles joined by two lines. **Figure 1** presents a more elaborate version of this model. The Bank, I explained, was an information system in which inputs of information from several sources were processed by the technical, professional and management skills of the staff into outputs of monetary policies and decisions, advice to Government, and the information and education of the general public. The managerial implications of this model are that the quality of the Bank's outputs depended on the Bank's research and analytical capabilities which, in turn, required continuous staff training and development. I stressed that the central bank was foremost an intellectual institution.

The public relations function also incorporates the economic education of the public. Through the Bank's annual and quarterly reports, regular Press briefings, speeches by the Governor and Senior Economists, etc., the Barbadian public has been transformed into the Caribbean's most literate society in terms of economic affairs. It was undoubtedly the public understanding of the relationship between wages and the exchange rate which helped the Sandiford Administration to avert the devaluation of the Barbados dollar in the economic crisis of 1991-92. On leaving the Bank, I listed a well-trained staff as my proudest achievement; perhaps I could also have cited an electorate sophisticated in economics.

Four factors aided the task of building the new institution. First, we were starting from scratch, with a ***tabula rasa*** on which we could inscribe our new patterns. Secondly, we had a young staff open to new ideas - at 39 I was one of the oldest; thirdly, we were able to operate for over 13 years in a Union-free environment, thus escaping the rigidities of trade union constraints. We tried hard to prevent the Bank from degenerating into a bureaucracy, i.e. an organization more committed to the preservation of existing processes than with the achievement

FIGURE 1
INFORMATION MODEL OF A MODERN CENTRAL BANK



Legend:			
	(1)	Input:	Information from Environment
	(2)	Process:	Intelligent People/Intelligent Machines: Memory, Analysis, Judgement
	(3)	Output:	Knowledge-based Services: Policy Decisions, Advice to Government, Services to Economic Units, Education of Policy.
	(4)	Feed-back:	To permit monitoring and, if necessary, correction of results.
	(5)	Feed-back:	Information genderated by Output.

References: Adapted from David W. Miller & Martin K. Starr, **Executive Decisions and Operations Research,** Englewood Cliffs, New Jersey, Prentice Hall, 1969.

of the novel goals assigned to it. Finally, and most important, the political directorate was generally permissive.

The information model described in **Figure 1** required maximum staff participation in the conduct of the Bank's operations. This was attempted through the medium of a Staff Association, which negotiated salaries and other conditions of employment with the Management. With salaries and benefits superior to those in the Public Sector, industrial relations at the Bank were good to excellent for the first thirteen years. The Bank was especially generous in its training policies, and numerous staff members were assisted in obtaining Diplomas, Bachelor's and Master's degrees, and even Ph.Ds, without the conditionality of remaining in the Bank's service.

These relations were undermined by the economic conditions of the 1980s. First, job opportunities were not available for trained staff whose promotion was blocked in a no longer expanding Bank staff. Secondly, economic stagnation led inevitably to a clash between the Bank's policy stance on "wage restraint" and the salary demands of junior staff. They successfully sought representation by the Barbados Workers Union who had tried unsuccessfully to represent the staff in 1974. Supervisory Staff, who had accepted the Bank's offer, joined in an act of solidarity. Negotiations with the BWU, especially on the issue of categories to be represented, were less than cordial.

SECTION II

NATIONAL ECONOMIC POLICY MAKING

A World Bank Report 1991[2] conceded that "during the first 20 years of its independence (1966-86) Barbados' economy was managed with great skill and acumen." This, in spite of the fact that Barbadian economic policy seldom obeyed the orthodoxy of Washington's international financial institutions. We never devalued; we never pursued a high-interest rate policy for any extended period; and we did not hesitate to intervene directly in the financial markets when the situation demanded.

The Bank's participation in national economic policy-making formally began with the establishment of the Research Department in January 1973, but its full range of policy instruments did not become available until the issue of the new currency in December that year. It was, indeed, a baptism of fire. The year 1973 had seen a sharp rise in world commodity prices, and in January 1974 the OPEC countries tripled the price of oil, precipitating a world recession in 1975. The already high inflation rate of 23% for 1973 rose to 40% in 1974, while unemployment reached 22.5% at year-end 1975. Government and Central Bank officials reacted pragmatically to these disruptive and unprecedented events, and by the mid-1970s the outline of a national macroeconomic policy began to appear.

The main thrust of macroeconomic policy was to maximize our surplus on current account and to finance capital expenditures whenever possible from soft institutional loans. Second, devaluation was ruled out as a proactive policy instrument; third, the imperative of high and positive real interest rates was rejected; fourth, the practice of wage indexation was resisted. It was from this time that I began my insistent calls for wage restraint - but more about this later!

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2 World Bank, Barbados: **The Requirement for Sustained Development,** Washington D.C., 1991.

Record foreign exchange earnings of US$55 million for the 1975 sugar crop eventually saved the day, and with the recovery of the international economy in 1976, the Barbadian economy experienced its five most prosperous years since the 17th century.

By the mid-1970s a distinctive methodology of economic policy-making had also emerged. The assembly and analysis of economic data was the accepted responsibility of the Research Department of the Central Bank. Macroeconomic policy recommendations emerged from deliberations of the Bank's Board of Directors, on which the Director of Finance and Planning sat, and were sent up to the Prime Minister/Minister of Finance.

Although the Central Bank operated at some distance from the Ministry of Finance, I can recall no bureaucratic turf battles between us, as technicians from both institutions cooperated in a routine fashion. In the Tom Adams Administration, meetings of the Prime Minister, the Director of Finance and Planning, Mr. Steve Emtage, and the Governor developed into a kind of Finance Executive Committee, with senior technicians in attendance as the situation demanded. The term "cordial but frank" accurately describes the relationship between the three of us. Prime Minister Owen Arthur, in a recent conversation, referred to that period as the "Augustan Era" of our national economic management.

By the end of the 1970s international financial officials had coined the term "The Barbados Model", which was held up to other LDCs as an example to be emulated. The incoming DLP Administration effectively modified the methodology described above with the introduction of the 1986 Alternative Budget, which was developed outside that framework and in the face of serious reservations on the part of senior finance officials.

Barbados' commendable performance during this period was marred by three serious policy errors. The first was the excessive taxation of windfall sugar earnings by Prime Minister Barrow in 1975. Because taxes were imposed on gross rather than on net incomes, some plantations made losses in a year when real

sugar prices were at their highest in living memory. The industry was therefore unable to make good the deficits of the previous five years or so, and has struggled ever since.

The second serious policy error was the excessive spending on the eve of the 1981 elections, leading to a record deficit of BDS$155 million. In its weakened fiscal condition, the economy was hardly well braced for the short but sharp recession of 1981-82, and struggled for the next four years. However, it can be said for Mr. Adams that once the problem was recognized, he made an early approach to the IMF, before his options were exhausted. In this way he avoided the surrender of economic sovereignty to the Fund.

The third and most serious policy error was the 1986 Alternative Budget, which copied the Reagan "Supply Side" initiative. The real damage came in 1987 when a massive fiscal deficit of BDS$219 million, second only to the 1990-91 pre-election deficit of BDS$248 million, threatened to destroy the balance of payments and to derail the economy. It required sharp policy reversals in 1988 to restore the situation.

The policy measure for which I am probably best remembered and was most criticized was that of "wage restraint". Early in my tenure of office, the pay-off between exchange rate stability and wage increases became quite obvious to me.[3] If we opted for a fixed parity with the US dollar, we would have to limit overall wage hikes to increases in national economic output. Failure to do so would lead inevitably to inflation, reduced employment, balance of payments collapse, and eventually to an IMF imposed currency devaluation when our foreign exchange reserves and international credit dried up. Indeed, devaluation was only narrowly avoided in 1992 by Prime Minister Sandiford's deal with the IMF to cut public service salaries by 8%. The

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[3] Blackman, Courtney N., "Wage/Price Policies for Increasing International Competitiveness in the Caribbean", Increasing the International Competitiveness of Exports from Caribbean Countries, Economic Development Institute of the World Bank, Washington, D.C. 1991.

Contract drawn up in 1993 between the Social Partners - Government, Business and Labour - to restrain wage increases, was for me a bitter-sweet vindication of policy recommendations I had made 20 years earlier, and which one trade unionist had described as "untimely, unwarranted and malicious."

SECTION III

FINANCIAL MARKETS

The first challenge of the new Central Bank was to establish its primacy in the area of money and banking without inviting confrontation with the financial community, which was initially quite skeptical of the new institution. However, it could hardly be expected that the foreign banks, which had ruled the economic roost for so long, would surrender without demur. They balked at the Bank's regulation of commissions on the sale of foreign exchange, and they were reluctant at first to open the "confidential affairs" of their clients to the Bank's Supervisors; but they soon fell into line. The Bank seldom invoked the provisions of the Central Bank Act but depended primarily on "moral suasion" to secure the cooperation of commercial banks.

In contrast to the trend in the rest of CARICOM towards nationalization or indiginization of banks (Mr. Forbes Burnham, late President of Guyana, called it "miniaturization of the foreign financial sector"), neither the Barrow nor the Adams Administration put any pressure on foreign commercial banks to change their status. The four American banks[4] which pulled up stakes did so for their own corporate reasons. I heartily supported this policy of the Government, viewing the relationship between the Bank and the foreign commercial banks as a positive-sum (win-win) game rather than a zero-sum game. They were to be regarded as constituents of the Central Bank, which

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[4] Bank of America, Chase Manhattan, Citibank and First National Bank of Chicago.

had a duty to safeguard their interests when these were not in conflict with the national welfare. In particular, I valued their ready access to outside sources of precious foreign exchange. This policy was vindicated in December 1983 when the foreign commercial banks agreed to introduce US$14 million from their head offices to avert failure of one notorious IMF "Test". The continued presence of foreign commercial banks has been an important asset in Barbados' drive to establish itself as a world-class off-shore financial centre.

This benign policy towards foreign commercial banks did not imply hostility towards indigenous banks. Two local initiatives to set up local banks came to my attention and obtained my support; neither came to fruition. Eventually, the Barbados National Bank (BNB) would become the first indigenous commercial bank. The financial success of the BNB was greatly compromised by its unfortunate yoking with the former Sugar Industry Agricultural Bank. I opposed the marriage of a commercial bank with a not-for-profit development institution - without success. Nevertheless, the Central Bank placed its technical and training facilities at the full disposal of the new institution. Besides, as both former IMF Director, Paul-Pierre Schweitzer and the late G. Arthur Brown, former Governor of the Bank of Jamaica, had warned me, indigenous banks would prove more difficult to regulate than foreign banks. This warning proved to be prophetic.

The administration of Exchange Control was another area of challenge for the Central Bank. Here again, our policies ran counter to the draconian measures invoked by Guyana, Jamaica and later, though to a lesser extent, by Trinidad and Tobago. Our strategy was to administer exchange control regulations with the lightest hand possible. There were to be no time-consuming declarations of foreign exchange holdings and no humiliating body searches of passengers at the airport, unless firm grounds for suspicion of crime existed. I strongly advised against prosecutions for foreign exchange infractions. Whenever the balance of payments permitted we increased travel allowances and, above all, we processed exchange control applications with maximum sympathy and despatch.

The purpose of exchange control was to monitor payment flows and gather qualitative information about such flows. Outflows of foreign exchange were to be restricted, not at the water's edge, but at the fountainhead - through the tightening of monetary and fiscal policy. The public can only buy foreign exchange if they possess domestic cash or credit. The intent of this relaxed approach was to reassure the general public that their legitimate requirements of foreign exchange would be met. I warned the Exchange Control Department against challenging the public to a game of foreign exchange hide-and-seek: there were 250,000 of them working day and night and only 20 exchange control officers working forty hours per week! We simply could not win. This policy worked well.

The development of capital markets is the "in" thing these days among international financial institutions. As early as 1973 the Central Bank of Barbados commissioned an OAS Study on Capital Markets. Our first steps were to resuscitate the treasury bill market so as to provide reliable and economical funding of Government operations; we then promoted the government bond market by customizing maturities to the needs of Life Insurance Companies; we underwrote Barbados Development Bank Issues; we designed special National Savings Bonds for the general public; and we gave our fullest support to the establishment of the Securities Exchange of Barbados, our local stock exchange.

However, the Bank's most important contribution in the field of financial development was the establishment of Barbados as an Off-Shore Financial Centre, an innovative plank in the 1976 BLP Manifesto. I felt that it was important for the Bank to get in on the ground floor and guide the process along the right path. The Bank took the initiative in researching and selling the project to the public. The Adams Administration and the Central Bank agreed on two basic principles: (1) the Offshore Financial Centre would not be host to nefarious activities; (2) it would not be simply a domicile of brassplate companies, but would offer substantial services to international clients. In time the Central Bank was able to persuade the banking, legal and accounting professions that they could benefit financially, and since then they have virtually carried the ball. Today the offshore

financial business earns more foreign exchange for Barbados than does sugar.

SECTION IV

REGIONAL ISSUES

The Central Bank of Barbados was the fourth to be established in the region, following the Bank of Jamaica in 1961, the Bank of Guyana in 1962, and the Central Bank of Trinidad and Tobago in 1963. Early in 1974 we joined the system of bilateral clearing agreements which already existed for the settlement of trade balances among regional authorities, including the Eastern Caribbean Currency Authority[5] from which we had seceded in 1973. The bilateral arrangements would later develop into the Caricom Multilateral Clearing Facility (CMCF). The collapse of the CMCF in 1983, when the Bank of Guyana defaulted, was a bitter blow for Caricom central bankers and the occasion for much criticism of Governors and uninformed academic analysis. The missing piece in the mosaic was an understanding of the strategic thinking of the Governors who shaped and administered the CMCF. Only two of us survive; it is time to tell the story before it is too late.

The purpose of bilateral clearing systems is to economize on the use of scarce foreign exchange in the settlement of intra-regional payments. Instead of settling each transaction immediately in cash, debit and credit payments are offset against each other over a period of time and settled on a monthly, quarterly or half-yearly basis. This reduces the level of "float" which participants in the agreement hold and thus minimizes the opportunity cost of trading. Multilateral payments agreements can produce even greater savings. This meant that Caricom trading partners could finance larger volumes of trade with reduced outlays of foreign exchange. Indeed, CMCF operations led to the highest levels of intra-regional trade on record.

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[5] The ECCA has now been transformed into a Central Bank called the Eastern Caribbean Central Bank (ECCB).

The CMCF began at a time of high promise for the future of CARICOM and the regional integration movement, to which the regional central bank Governors fully subscribed. Indeed, the late Victor Bruce, who chaired the CMCF throughout its active operation, was the region's leading exponent of regionalism, in practice if not in rhetoric. Accordingly, when Guyana and Jamaica began in the late 1970s to experience balance of payments problems, the Governors did all they could to alleviate their difficulties. First, they lengthened the period of settlement from monthly to quarterly; secondly, they introduced an element of credit so as to give some leeway to Central Banks which were short of foreign exchange. Debtors would pay interest on outstanding balances, at a rate below LIBOR (London inter-bank offer rate), but did not have to settle in full.

The truly innovative feature of the CMCF was the differential interest rates for debtors and creditors. If the former paid a rate of 6%, say 2% below LIBOR, the creditors received only 4%. The 2% differential was invested in a No. 2 Account with the Federal Reserve Bank of New York and allowed to accumulate. It was expected that these funds would eventually become the capital for a kind of regional IMF, which could then be levered through market loans to provide medium-term support for participants in balance of payments difficulties. Indeed, a similar "safety net" proposal had been earlier put forward by the Caricom Secretariat, but proved abortive.

Early models of the CMCF included limits on the extent of credit that participants would be called upon to bear. CBTT, with its massive foreign holdings (a peak of US$3 billion in 1983), accepted the highest credit limit, while the ECCA was granted the lowest. However, the expansion of exports from Trinidad and Tobago and Barbados soon exceeded the debt limits placed on Jamaica and Guyana. The Governors, in their eagerness to promote intra-regional trade and its concomitant job expansion, and anxious too to ease the corresponding pressure on the dwindling foreign exchange reserves of Guyana and Jamaica, raised the general limits of the Facility to US$100 million, and removed the country credit limits altogether.

It was confidently expected that Trinidad's exports of manufactures, based as they were on cheap oil, would swamp the regional markets and that CBTT would very soon become the chronic creditor to all other participants. To make this rule politically palatable for Trinidad and Tobago, the other participants agreed to the lifting of all country credit limits. Theoretically then, Barbados or Jamaica, as much as Trinidad and Tobago, could end up with US$100 million credit to the Facility, but no one believed that this would happen, and US$100 million was seen as a negligible percentage of the foreign reserve holdings of the Central Bank of Trinidad & Tobago.

As it turned out Barbadian exporters, especially of furniture and garments, overwhelmed the Trinidad and Tobago producers and began to build up heavy credits with the Facility. On the other hand, exports virtually dried up from Guyana, which had been a frequent creditor in the earlier bilateral agreements. But the mortal blow to the CMCF was struck when, in an attempt to shore up a tottering Guyanese balance of payments, it was agreed that oil payments from Guyana to Trinidad and Tobago might pass through the CMCF. These payments were so large as to put CBTT in credit with the CMCF, so that Barbados effectively shared with CBTT the burden of financing Guyana's oil imports. Meanwhile the Jamaicans employed numerous devices to avoid imports from the rest of CARICOM; ECCB was a modest creditor. The profile of CMCF credits and debits in the early 1980s came to look roughly like that depicted in **Table 1.**

Table 1. Profile of Later CMCF Debits and Credits

	CREDITS	DEBITS
Barbados	60	0
Trinidad and Tobago	35	0
Guyana	0	95
ECCB	5	0
Jamaica	0	5
	100	100

With Guyana both weak and unwilling to pay, CBTT able to pay but not in debt, and Barbados with reserves too limited to comfortably shoulder such a heavy credit burden, the CMCF participants reached an impasse.

One solution was to allow Barbadian oil imports from Trinidad to pass through the Facility, thus reducing the drain of Central Bank of Barbados reserves to pay for oil imports. At this point fate intervened with the death of Dr. Eric Williams. However inscrutable the great Trinidadian statesman, his commitment to Caribbean peoples was unquestioned. In spite of his open hostility to President Forbes Burnham's ideology and policies, he continued to extend substantial loans and grants to Guyana. Indeed, it was upon the rock of Dr. Williams' magnanimity that Victor Bruce's own commitment to CARICOM ultimately rested. The incoming Chambers Administration reversed gears, and severely limited Bruce's degrees of freedom. He simply could not get the National Oil Company to accept payment of Barbados' oil imports through the Facility. In Dr. Williams' day it would have taken a five minute phone call! Nor could he continue his policy of allowing Barbados to repay an earlier TT$48 million foreign bond through the CMCF. The Barbadians were stuck.

We had considered US$30 million a realistic ceiling for Barbados' credit to the Facility, and as that figure was reached and exceeded, secession from the CMCF seemed the obvious tactic. On the eve of a crucial meeting of the Board of the CMCF I informed Prime Minister Adams that I intended to threaten secession in order to extract concessions from my colleagues and that, were my bluff called, I would have to take that step. "You do not have that card in your hand, Courtney", he replied. Obviously he considered the political cost of breaking up the CMCF to be unacceptable. In fact, the following day, Governor Bruce offered Barbados a "buy out" from the CMCF, but I had to let it pass. Some weeks later, when the Facility reached its legal US$100 million limit, Barbados called for its suspension. In spite of numerous false starts, the CMCF operations were never resumed.

Various reasons were put forward for the demise of the CMCF. We should have insisted on prompt settlement. There should have been no element of credit. Prime Minister Adams was annoyed that the Governors had, in their administrative experiment, not sought political direction, and had thus "acted as if they were politicians." In fact, the extension of credits over time is a norm of international trade - all the more so among nations professedly moving towards a common market. And, as Lloyd Best recently consoled, "If you had sought political direction you would have done nothing!"

For me, the culprit was the remarkable indifference of the Guyanese Administration of the day. It did not have to settle the entire outstanding debt to the Facility. Payment of the interest, at well below commercial rates, would have been enough. All kinds of arrangements for debt deferral were offered following the suspension of the Facility at meetings where Guyanese officials showed not the slightest interest. Public trustees are expected to pass the test of reasonable prudence. The Central Bank Governors of CARICOM might be forgiven for expecting member governments to act in a reasonable manner. The Guyanese government of the day did not! The CMCF failed but I like to think of it as a "gallant failure."

SECTION V

THE POLITICS OF CENTRAL BANKING

The defining attribute of the Central Bank is its power of money creation. This is also a potential, almost inevitable, source of conflict between the Minister of Finance and the central bank Governor. Excessive money creation is anathema to a responsible central bank Governor, while Ministers of Finance can always do with more money. This endemic conflict recedes in time of buoyant government revenues and re-emerges in times of deficit spending, especially on the eve of general elections. A further ambiguity derives from the fact that Government is usually both the major borrower from the Central Bank and also its sole or dominant shareholder.

Manifestations of this endemic conflict run the gamut of total government domination of the Central Bank, as practiced for so long in Africa and Latin America, and the independence of the Bundesbank, protected by both law and the memory of the horrific hyperinflation of 1923 and post World War II. Caribbean central banking practice is rooted in the British model, in which the Bank of England is operationally independent within the framework of Government policy, and differences worked out away from the public gaze; impeccable decorum is observed at all times in the interest of public confidence. Because of its famous unanimity rule, the Eastern Caribbean Central Bank enjoys the greatest independence within CARICOM; the Bank of Guyana has at times operated in almost total submission to the Ministry of Finance.

In the absence of clear-cut laws governing the relationship between Governor and Minister, personalities play an important part. As can be imagined, the Governor must walk a careful path. He serves at the will of the Minister, but is required to give him advice that is frequently unpalatable; and he must certainly resist resolutely if the Minister encroaches on the legal prerogatives of the Bank. My relationship with Mr. Barrow the first time around (1971-76) was the most comfortable of all. He had appointed me and had a stake in my success. Thirteen years my elder, he exhibited an avuncular air, attributing my shortcomings to youth and inexperience.

The incoming Adams Administration must have been convinced of my disinterested politics, and the transition in 1976 from the Barrow to the Adams Administration was virtually seamless as far as the Central Bank was concerned. With Mr. Adams a mere 18 months older, I lost my alibi of youth but we quickly developed a cordial and effective working relationship which was never threatened by occasional differences of opinion. This spilled over into the St. John Administration. At all times I eschewed both the substance and the appearance of political partisanship. Mr. Adams once described the Bank as not only "apolitical" but "above politics". But the greatest tribute to the Bank's non-partisanship were the repeated references of Opposition members to the Bank's Annual Report as the "Economic Bible".

The public hostility of the incoming Barrow Administration in 1986 was unfortunate in that it created the impression that the position of Governor was political, rather than technical. It was also unnecessary since the Central Bank Act allows for the removal of the Governor. The boycott of the Opening of the new Central Bank Headquarters by Government Ministers was inexplicable. I have been greatly relieved by the civility displayed during the 1994 transition from the DLP to new BLP Administration. It augurs well for future relations between the Central Bank and the Government.

In fact, the duties of Central Bank Governor are technical, not political. If he is a true professional he will seek to gather the most able staff around him, without any reference to their political association. (No one was ever appointed to or dismissed from the Bank staff during my tenure out of political consideration). Like all top positions, the post of Governor requires considerable diplomatic and personal skills, both to lubricate dealings with the Minister and to conduct the Bank's public relations. He is a "politician" with a little "p". Himself an expert in politics, the Minister of Finance on his part has no need for political support from his Governor. However, he will almost certainly be lacking in central banking expertise. To the degree that a Governor is involved in politics, he will correspondingly be deficient in the practice of central banking!

Since my departure from the Bank, I have made fervent pleas for greater central bank independence, a movement which has gathered much momentum over the past two decades. Indeed, I discussed this issue with Mr. Steven Emtage, then Director of Finance and Planning, during the Constitutional Commission hearings of the 1970s. We agreed that we had better leave well enough alone. Furthermore, as the incumbent I was hardly the appropriate person to champion the cause of greater independence for myself. However, the excessive money creations of 1990-91, and 1986-87 suggest that the Directorate of Central Banks in the Caribbean should be strengthened in its dealings with the Government of the day. The following minimum measures should be undertaken to place some distance between the Minister and the Governor:

1. The Bank should be made responsible to Parliament and not to the Minister.

2. The terms of both the Governor and the Directors should be extended by two years and they should serve on good behaviour.

3. The power of money creation should be vested solely in the Central Bank Directorate.

4. The Minister might, after public debate in which the Bank's position was openly aired, over-rule a decision of the Bank.

SECTION VI

THE BROTHERHOOD OF CENTRAL BANKERS

On leaving my first dinner at the Bank of England, held in honour of visiting Central Bankers in June 1973, the Governor of the Central Bank of Mauritius took me aside and in a paternal fashion whispered, "You have joined a good club". In fact, I had been admitted into a brotherhood. The ideology which knits central bankers everywhere - not only Governors - is a fervent commitment to sound money. We all agree with John Maynard Keynes that the most certain method of destroying a society is the debasement of its currency. As we have witnessed so starkly in the region, once people lose their confidence in their currency the descent into political, social and economic morass is steep and difficult to reverse. Hence my astonishment at the exuberant partiality of the "Washington Consensus" for frequent and sharp currency devaluations, a prescription so certain in its deleterious effects upon the general well-being of a society.

The "Brotherhood" provided a rich and reliable source of technical support for the Bank, especially in the early years. The Bank of England and the Federal Reserve Bank of New York provided numerous training opportunities for senior and middle-

level staff, as did the IMF, the central bankers' Central Bank. Bank staff also gained considerable experience through assignments at the Bank of Canada, the Federal Reserve Banks of Boston, St. Louis and Atlanta, the Federal Reserve Board in Washington, D.C., and as far afield as the Bank of Pakistan.

Naturally the connection was closest with the Caricom cell of the "Brotherhood". The experiences of the recently established Central Banks of Jamaica, Trinidad and Tobago and Guyana were obviously more relevant to a Caribbean start-up operation than those of the "Old Lady of Threadneedle Street" or other long-established Central Banks. They all willingly shared their experience with their young brother from Barbados. In particular, their distinguished Governors, G. Arthur Brown of Jamaica, Victor Bruce of Trinidad and Tobago, and Willie D'Andrade of Guyana proved superb role models. Already legendary figures in Caricom financial circles, they could have been forgiven had they patronized me; they never did. From the very first they treated me as a colleague and friend, for which I am extremely grateful. May they all rest in peace!

I was most consciously influenced by the first two. Brown was a world-class technocrat, who held his own easily with the world's brightest and best. Bruce was the ultimate administrator; blessed with a remarkable physique and presence, he projected his influence throughout the Third World and, indeed, throughout the international banking community. In particular, he taught me that in central banking "style is also substance". At the numerous conferences we attended in the Caribbean and throughout the world, I seldom left the shadow of these two great men during my early years in office.

I have also been the beneficiary of much brotherly attention from my former colleagues at the Central Bank of Barbados. Senior Bank officials shielded me in large degree from the fiercest blasts of incivility surrounding my departure, and assisted me in numerous ways in the pursuit of my private consultancy from 1987-1994. In particular, librarians Maxine Williams and Aldine Payne responded swiftly to frequent requests for information. My wife and I were touched by Governor Kurleigh

King's gracious invitation to participate in the 20th Anniversary celebrations, as we are by Governor Springer's invitation to be present at the 25th.

SECTION VII

LESSONS OF EXPERIENCE

Listed below are not so much the lessons learned from the first fifteen years of the Bank's operation as the confirmation of propositions which could have been initially suggested by commonsense or deduced logically from realistic assumptions about the Barbadian economy, namely, that it is small and highly open, with imperfect financial markets. There are nine major principles of central banking and national policy-making confirmed by the experience of the Central Bank's operations during its first fifteen years:

1. Operational autonomy is the sine qua non of effective corporate organization - especially in the case of central banks.

2. Central banking is an intellectual, not a political, exercise.

3. The primary concern of national economic managers should be to preserve control over domestic policymaking. They will succeed only when implementing policies which they themselves have formulated, and in which they are confident. Conditionalities imposed by International Financial Institutions (IFIs) have seldom succeeded since their economic models are based on assumptions which are unrelated to the realities of developing countries.

4. The maintenance of a viable balance of payments position is the foundation of economic policymaking in small, open developing countries. Balance of

payments collapse will result in unsustainable foreign debts, and even worse, submission to the conditionalities of IFIs.

5. Fiscal discipline is the bedrock of balance of payments stability. Unsustainable fiscal deficits in highly open economies lead swiftly to balance of payments collapse.

6. The operation of monetary policy in the narrow and shallow financial markets of developing countries involves sharp movements in interest rates, with devastating side effects on the real economy. The brunt of economic adjustment must therefore be borne by fiscal policy, and monetary policy resorted to only ***in extremis.***

7. Exchange rate instability is hazardous to sustainable economic growth, while the narrowness and shallowness of foreign currency markets in developing countries rules out a regime of floating exchange rates. Some technique of exchange rate stabilization must be utilized, such as the fixed rate regime adopted by the Barbadian authorities.

8. The decision to maintain a fixed exchange rate regime creates the imperative of an incomes policy to restrain aggregate demand, promote external competitiveness and maintain employment levels.

9. Economic policy-makers in developing countries should pay less attention to equilibrium interest and exchange rates and focus instead on the basic factors which directly affect output - education, law and order, infrastructure and governance.

10. High quality political leadership is the critical factor in economic development.

SECTION VIII

CONCLUSION

One way to judge the quality of the foundation laid during the Bank's first fifteen years is to examine the integrity of its superstructure in the 25th year. The findings are pleasing on several grounds:

1. The Bank has palpably performed its prime function of promoting the island's macroeconomic stability. The value of the Barbados dollar, pegged to the US dollar in July 1975 at a parity of BDS$2.00 = US$1.00, remains unchanged. Throughout this period the inflation rate has seldom moved beyond the single digit range: and, except for a few months in 1991-92, the Bank has been in a position to meet legitimate public demands for foreign exchange. Indeed, the Bank's foreign exchange position throughout 1996 was at its strongest ever.

2. The Bank's operations have been a model of efficiency and customer satisfaction. Its quarterly and annual reports have been produced in a timely manner, and its finances conducted without any suspicion of malfeasance.

3. The Bank has been a leader in monetary and economic research in the region, with its economists frequently outperforming their academic counterparts in the publication of papers in learned journals. Its economic analyses continue to provide the basis of decision-making for both DLP and BLP Administrations, and its senior economists and technical staff are regularly called upon to carry out consulting assignments for regional and multilateral institutions.

4. The acid test of any organization, however apparently successful, is how its employees fare. Too many organizations, both public and private, throughout the

> region and even in Barbados, have become graveyards for the careers of promising men and women. In stark contrast, the Bank has served as a platform for the launching of distinguished careers both within and without the Bank.

To sum up, the Central Bank of Barbados has taken its place, by reason of its record, among the world's leading central banks. It enjoys and deserves the confidence of the Barbadian public, as it continues to operate "above politics."

2

The Role of the Central Bank in the Formulation and Implementation of Economic Policy in Small Developing Countries*

Introduction

o determine the role of the Central Bank in the formulation and implementation of economic policy in developing countries, we must first settle the issue of what central banking itself is about. This is more urgent than it appears. Professor Milton Friedman has won many converts to the proposition that central banks should be stripped of discretionary power and their role in economic management restricted to maintaining a constant growth rate in the money supply, however you choose to define it. Central bankers, he argues, have more often than not taken the wrong decisions and made matters worse than they otherwise might

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* Paper presented at a Seminar in Jerusalem marking the 25th Anniversary of the Central Bank of Israel, November 1979.

have been. In a rare instance of agreement with Friedman, Professor Galbraith also noted this marked propensity to err on the part of central bankers, but conceded: "The central bank still remains important for useful tasks - the clearing of cheques, the replacement of worn and dirty bank notes, as a loan source of last resort. These tasks it performs well."[1]

If Professors Friedman and Galbraith are right, then our symposium here in this biblical city of Jerusalem would be, in the words of St. Paul, "... as sounding brass and tinkling cymbals". Fortunately, we need not disagree with their conclusions about the past performance of central bankers in order to reject their judgements about the proper role of central banks. Indeed, it is not at all difficult to concede that central bankers are just as fallible as academic economists! This paper advances the proposition that central bankers failed, not out of perverseness or even obtuseness, but because they were unclear about what policies to adopt in the face of the changing problems which confronted them over time. All policy formulation must derive from norms, and norms can derive only from normative theory.

The theme of my paper is that both past and current normative theory of central banking has been most deficient. Our first task will be to expose the traditional theory of central banking as merely descriptive theory - what I shall call in this text a "factual social theory", or "factual theory" for short. Secondly, we shall suggest an approach to a general theory of central banking. Thirdly, from this general theory we will develop a normative theory of central banking for developing countries. Fourthly, we will discuss the problems of policy formulation and then of policy implementation in the context of our special theory of central banking in developing countries. We will conclude with some speculation about the future of central banking.

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[1] Galbraith, John K., **Money: Whence it Came, Where it Went,** Boston, Houghton Mifflin Company, 1979, p. 306.

The Traditional Theory as Factual Social Theory

Nowhere in the literature have I been able to discern the outlines of a normative theory of central banking, that is, a theory that tells central bankers what they **ought** to do. We still have only a descriptive theory of traditional central banking, or what Professor Northrop would call "factual social theory".[2] The most comprehensive study of central banking to date remains the South African DeKock's **Central Banking**.[3] In it he presents a descriptive analysis of the evolved functions of a well established central bank and provides a catalogue of the techniques which have developed over time. But he apparently thought that his was a normative work: he wrote, "It is now... legitimate to speak of the 'science of central banking",[4] and he went on to talk about a "real" or "true" central bank.[5]

Called upon to advise newly-independent nations in the post World War II period on the establishment of central banks, British and American experts unthinkingly used the traditional theory as if it were a normative theory. Observing, and quite rightly so, that the circumstances and problems of the developing countries were quite different, they concluded that the establishment of central banks was unwarranted in these countries. But in spite of these warnings, the developing countries proceeded to set up their own central banks. Ironically enough, they sought their operational expertise from the same sources which had advised against the establishment of central banks in the first place. With only the traditional descriptive theory of the DeKock variety to work with, most expert advisers and some (not all) early central bank Governors from the developed coun-

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[2] Northrop, F.C.S., **The Logic of the Sciences and Humanities,** New York, The World Publishing Company, 1965, p.70.

[3] DeKock, M.D., **Central Banking,** London, Staples Press, 1946, p.17.

[4] Ibid. p. 21.

[5] Ibid. p. 21-22.

tries, adopted a teleological approach. That is, they tended to view their task as that of "working up to" the pattern of the traditional central bank, which was the "true" central bank.

By using the traditional theory of central banking normatively in developing countries, these central bank experts fell into the error which Professor Northrop describes as the "culturalistic fallacy", that is, the identification of the "ought" of normative theory with the "is" of factual theory.[6] Of all the scholars of that period I have read, only Edward Nevin clearly appreciated the historical context of traditional central banking practice: "Historically, the functions performed by these banks have been those which fell to them by reason of the circumstances and conditions in which they evolved."[7]

Towards a Normative Theory of Central Banking

Let us see if we can move towards a more general theory of central banking. Professor Northrop, in a most difficult and remarkably abstruse work **The Logic of the Sciences and Humanities,** spelled out the distinction between "factual theory" and "normative theory"! He describes factual theory as essentially descriptive. In epistemological terms it remains in the natural history stage of enquiry. Facts have been apprehended, described and classified.

However - and this is very important - factual theory has validity only with respect to the phenomena from which it was induced. This is because it utilises concepts which he calls "concepts by intuition" or "concepts by induction", if you want. He describes these as "concepts abstracted from a wider historical context, not realising their full concrete meaning apart from this context". He warns that if we make use of such concepts, we should keep in mind always the empirical and social context from which they were derived.[8]

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6 Northrop, F.C.S., op. cit., p. 70

7 Nevin, Edward, **Capital Funds in Underdeveloped Countries,** London, St. Martin's Press Inc., 1961, pp. 23-24.

8 Northrop, F.C.S., op. cit., p. 69-70.

The function of normative theory is to provide us with guidance over the entire range of phenomena we are likely to encounter, and not only the empirical circumstances from which the theory was induced. In other words, it must be a generalised theory; it must be deductive rather than inductive; it must resort not to "concepts by intuition" but to "concepts by postulation", concepts whose validity transcends the context which inspired them. However, the traditional theory has been induced from the examination of existing traditional banks and, since it does not utilize generalized "concepts by postulation", it cannot be appropriately applied in a normative fashion to the problem of central banking in developing countries.

Our most important task in the formulation of a general theory of central banking is to identify the quintessential and fundamental attribute of central banks. "What is central banking really about, no matter where in the world we happen to be?" This is a matter of judgement, but most will agree that the most universal and important characteristic of a central bank is that its liabilities are accepted as final payment within the political entity which it serves. We might say that its balance sheet position is infinitely liquid.

We define "liquidity" as that quality of a balance sheet which makes it possible for the economic unit to pay for required assets. We define an "asset" as something which has worth. Our final relevant concept is that of a "liability", defined as that which is owed by one economic unit to another. Note that these three concepts of liquidity, asset and liability are concepts by postulation and do not depend for their validity on any particular cultural, political, geographical or historical circumstance. Whereas concepts like stock markets, reserve requirements, and so on, are concepts by intuition which derive from our immediate inspection of specific institutions, and which change their meaning as financial practices differ from time to time and from country to country. It is for this reason that we have chosen such fundamental concepts to proceed towards a more general theory.

The concept of liquidity which we utilise in our theory refers to the liquidity of a firm's balance sheet, its liquidity position. This does reflect the liquidity of its assets; it also reflects the maturity of its liabilities. Above all, it reflects the judgement of current and prospective debtors of the firm's viability and prospects. Changes in market or institutional arrangements may cause a drastic re-evaluation of the firm's liquidity.

The purchasing power of a given economic unit will depend on the liquidity of its balance sheet, its liquidity position. If its liquidity position is strong, it will be able to purchase the additional goods it needs to carry out its economic objectives. If it is weak, it will be forced to liquidate some of its assets or curtail its economic activity, or both.

The liquidity position of an economic unit also determines its ability to borrow, since it is the potential creditor's perception of the firm's liquidity position which determines his readiness to lend. Once we focus on the liquidity position of economic units, the potentially important role of the central bank becomes quite obvious. The central bank is infinitely liquid. Theoretically, the central bank could purchase all the assets in a society and, looking at the balance sheets of some Third World central banks, one might come to believe that this proposition is not only theoretical but also practical.

Through its buying and selling operations, the Central Bank can therefore exert a powerful influence over the liquidity position of all economic units, and thus over the entire economy. It is this attribute of infinite liquidity which leads even the cynical Galbraith to concede the important role of lender of last resort to central banks. Professor Edward Simmons goes even further:

> There are no liquid assets apart from money unless there is a central bank... the liquidity of things which may not be absorbed by the central bank is a fair weather phenomenon.[9]

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[9] Simmons, Edward C., "The Relative Liquidity of Money and Other Things", **Readings in Monetary Theory,** eds. American Economic Association, Homewood, 111; Richard D. Irwin, 1951. p. 36.

A Central Bank, however, does not need to deal in a large variety of goods and services. In a perfectly competitive economy, it could theoretically deal in any liquid or relatively liquid asset, or any asset for that matter, since changes in the supply or price of one asset would, in a perfectly competitive situation, affect the supply and prices of all other assets through the process that Walras calls "tatonnement". In this way the central bank would affect the liquidity position of the various economic units in the society. But obviously it is most convenient in a perfectly competitive situation to concentrate on supply and price of the most liquid asset, money. A rise in the price of money or a reduction in its availability, would damage the liquidity of economic units throughout the economy. A fall in its price, or an increase in its availability would enhance general liquidity. In the other limiting case, the pure barter economy, the central bank would have to hold vast quantities of a suitable real commodity. However, commodity reserve holdings are inconvenient to store and transport, and are finite in quantity. Money and financial assets are easy to store and transport, and, as central bankers have too frequently demonstrated, can be produced in infinite quantities.

The liquidity of firms stems not only from market conditions, but from institutional arrangements as well. Societies, even at low levels of development, have developed laws and conventions protecting private property and enforcing the repayment of debts. Such legal arrangements protect the liquidity of firms by insuring the safety of their assets and by increasing the likelihood of the settlement of debts owed to them. Various commercial activities, such as insurance against loss, also serve to enhance the liquidity of firms. The Central Bank can also affect the liquidity of economic units through its regulatory authority. For example, a change in reserve requirements or in the terms of hire purchase arrangements can have a significant effect upon the liquidity position of commercial banks and consumers, respectively.

We may now describe the central bank in general terms as an institution whose balance sheet is infinitely liquid, thereby endowing it with the potential for influencing the liquidity positions of economic units throughout the community.

The specific normative theory of central banking to be applied in any given country will depend on the "values" implicit in the national objectives. On the occasion of the establishment of the Bank of England in 1694, the preoccupation of William of Orange (who determined the national objectives) was the pursuit of war against France. The Bank of England therefore undertook to enhance the liquidity position of the British Government by purchasing King William's securities, which were, to all intents and purposes, the same as the securities of the British Government.

In the nineteenth century, the national concern of industrialized countries was the recurrent banking crisis. It was during this time that the role of the central bank as a lender of last resort evolved, or was discovered. By purchasing the assets of commercial banks, the Central Bank bolstered the liquidity position of commercial banks and, by extension, the liquidity position of all those economic units in the community which might otherwise have suffered the loss of their most liquid assets - savings and demand deposits.

Since Keynes, the goals of steady economic growth, full employment, and price stability have determined the objectives of central banking policy. Essentially, Central Banks have taken steps generally to enhance the liquidity of economic units in times of economic recession by purchasing Government paper to facilitate deficit spending and by providing reserves generously to the commercial banking system. In times of inflation the process is reversed. We may observe here that the conflict among the goals of full employment, price stability and economic growth have sometimes made it politically difficult for Governments to permit central banks to conduct a truly contra-cyclical policy.

It is most important to note that money and capital markets had already been highly developed in the industrial nations by the time that Keynes arrived on the scene. And so Central Banks in countries like the U.K., the U.S.A. and other European countries were able to employ sophisticated techniques, such as changes in reserve requirements and open market operations, in the conduct of Keynesian contra-cyclical policies. In other words, it was the sophistication of their financial markets which made it possible for them to utilize the Keynesian economic tools.

Central banking practice in Socialist states is also easily encompassed within our general theory. In such countries the Central Bank also enjoys infinite liquidity. The norms which determine its role are dictated by the ideology of central planning. The implementation of policy is constrained by the total absence of money and capital markets. And since the Gosbank, the prototype of the Socialist Central Bank, performs functions not only of central bank but also constitutes the commercial banking system as well, it is able to exert direct control over the liquidity position of all state-owned enterprises. It does not operate through financial intermediaries since there are no money and capital markets.

The Theory of Central Banking in Developing Countries

Let me sum up very quickly and say that central banking in any country, developed or not, has to do with the regulation of liquidity, and this power to regulate derives from the infinite liquidity of the central bank. The objectives of central banking policy are determined by the society through various institutional processes, and the techniques to be used are dictated by the state of development of the real and financial markets, the latter in particular.

Now we can proceed to a normative theory of central banking which would have validity for developing countries. Since liquidity is the central concept of our general theory, then a special normative theory of central banking for developing countries must be stated in terms of the importance of liquidity

in the process of economic development. We do not know for sure why some countries develop rapidly while others do not. About one thing we are fairly certain, namely, that investment must increase in relation to consumption if economic development is to take place. Clearly, then, successful central banking policy in developing countries must favour investment activities at the expense of consumption.

Let us for the purposes of this analysis divide the economy into three economic groups: investors, consumers and Government. We must contrive that investors have access to an increasing proportion of national output so as to expand aggregate productive capacity; the same for Government, which will be required to undertake expensive infrastructural projects; consumers will have to be restrained. As we have seen, the ability of each sector to obtain additional goods and services depends on its liquidity position. The Central Bank should therefore take measures which enhance the liquidity position of investors and of Government, to the degree that Government participates in capital formation. (It is important to remember that Government is also a consumer). It should also pursue policies which restrain the liquidity position of consumers - and of Government in the areas where it is a consumer. In short, the art of central banking in developing countries is the art of discrimination in favour of investment activities. For, as Keynes once said, investment is the engine of growth.

If investment is the engine of growth, then credit must be the fuel that makes the engine go; and credit, as we have seen, depends on the liquidity position of the would-be borrower. The enhancement of the liquidity position of investors therefore facilitates an increased flow of credit into the productive sectors of the economy. Central banking policy should therefore ensure that the lack of credit does not constitute a bottleneck in the production process.

In Barbados we have identified agriculture, manufacturing and tourism as the critical productive sectors. Accordingly, the Central Bank has established schemes to finance the cultivation, production and marketing of our main product, sugar,

and here we subsidize credit through lower than market interest rates as well. In addition, the agricultural, manufacturing and tourist sectors have been exempted from the quantitative restrictions on commercial banking credit which we impose from time to time in the interest of economic stability. On the other hand, severe curbs have been placed on the financing of high priced imported consumer durables by increasing the down-payment and by shortening the maturity of instalment credit agreements. A Small Business Guarantee Loan Scheme has also been launched to assist small businessmen.

But it is not enough that short term credit is channelled to the productive sectors. It is also important that the liquidity position of investing firms be sustained over time because, as the process of economic development proceeds, the gestation period of investment projects will lengthen. In these circumstances long-term credit, rather than short term credit, will become increasingly essential. As Professors Albert Hart and Peter Kenen acutely observed,[10] the growth of debt is the counterpart of economic growth. This is another way of saying that if the residue of debt occasioned by investment leads to a significant deterioration in the investors liquidity position, he will be unable to sustain a satisfactory rate of investment spending in the future. This situation can only be avoided if the retention of long-term assets does not impair the desired liquidity position of creditors, in other words, if creditors are prepared to hold long-term debts. If they are not, they will decline to hold the long-term debt of investors, and so imperil the development process. An important challenge to the Central Bank, therefore, is the enactment of measures calculated to sustain the liquidity of creditors who are holding long-term debt. This is another way of saying that the Central Bank in a developing country should take an active part in the development of money and capital markets.

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[10] Hart, A.G. and Kenen, P.B., **Money, Debt and Economic Activity,** Englewood Cliffs, N.J., Prentice Hall, 1961, p. 122.

So far the Central Bank of Barbados has tried to create a market for treasury bills involving commercial banks. It has on occasion offered repurchase facilities to commercial banks for long-term government debentures. It has also cooperated with the local Chamber of Commerce in the establishment of a Securities Exchange intended to improve arrangements for the trading of equities and other securities in the island. The Bank is also considering proposals that it act as lender of last resort in order to establish a secondary mortgage market.

The fact that developing countries depend so heavily upon imports from developed countries, especially of capital and durable goods, gives rise to special balance of payments problems for Central Banks in the Third World. Central Bank policies must therefore discriminate as well in favour of those who export and against those who import. Fortunately, in a highly open economy the same measures used to restrain consumer spending are also effective in restricting imports. Most consumers must resort to instalment credit for the purchase of high priced durable goods, such as motor cars, washing machines, etc., which are usually imported into small developing countries. The tightening of instalment credit conditions by the Central Bank is therefore the most effective weapon in controlling the importation of high priced luxury items. More positively, the Central Bank may offer various incentives to exporters.

In Barbados the technique of shortening the maturity of instalment credit loans and increasing the proportion of the loan which must be paid down, has been most effective in restraining the importation of high priced consumer goods. The Central Bank has also opened a special rediscounting window at a subsidized rate of interest to exporters, and has established export credit insurance and guarantee schemes to assist them.

But the Government sector poses the most difficult problems of all. This stems from the fact that Government is the largest consumer in the economy and, as such, must be restrained. Even as an investor, the preponderance of its expenditure can so enhance the liquidity of its employees and suppliers as to

frustrate attempts by the Central Bank to erode the liquidity positions of these two groups. Moreover, in the vast majority of cases in both developing and developed countries, Government is the sole controlling shareholder of the Bank's stock. In very few cases can Central Banks pursue an independent monetary policy. In these circumstances, the regulation of the liquidity position of Government is a delicate matter of art and not of science. The Central Bank can and must place the issues forcibly before the Administration; all too frequently a Government reluctant to impose heavy taxes, or unable to withstand trade union pressures for higher wages, will resort to deficit spending financed by the central bank, thus nullifying the discriminatory effects of central banking policy.

The Formulation of Economic Policy

Now that we know what we ought to do, there remains the problem of policy formulation. Policy formulation is a process involving inputs from several sources - departments of Government, various organisations in the community, and indeed some international financial institutions, such as the World Bank and the I.M.F.We must now shift our attention from the normative to the functional aspects of central banking.

It is useful to regard the central bank as an information system with three basic elements - inputs, process and outputs. The input element receives, screens and classifies data, and generally prepares it for processing. These inputs undergo analysis in the "process". The results of the "process" emerge as "outputs", and these "outputs" are policy decisions, advice to government, and information and exposition to the public at large.

These inputs comprise data both from within and from without the Bank. Because of its role as banker to the commercial banks, the Central Bank's own accounts are an excellent source of information about the liquidity of the banking system. Through its commercial bank supervision activities, the Bank can also learn much about the condition of the corporate sector, whose debt represents a significant proportion of the

assets of commercial banks. Reports on commercial bank operations also provide a basis for the bank's regulatory policy.

As banker to Government, the Central Bank has an on-going picture of Government's financial position. Exchange control and foreign exchange operations provide a steady flow of information on the balance of payments. As fiscal agent of Government, the Bank has an intimate knowledge of the national debt position, both foreign and domestic. The Bank's network of relationships with international institutions provides the Bank with wide knowledge of international financial markets, while its membership in the international central banking fraternity makes it privy to much sensitive and invaluable information.

We view the Bank's knowledge workers as comprising the "hardware" of the "process" – the economists, the statisticians, and so on. The "software" of the process is represented by the theories about the economics of central banking, the analytical methods employed by the accountants, statisticians, and other technicians, and above all their attitudes, integrity and dedication. This information model, therefore, views central banking essentially as an intellectual process in which the quality of the outputs depends on the intellectual quality of the Bank's personnel and the relevance and effectiveness of their theoretical models and techniques. For a variety of historical reasons, Central Banks through the world have been able to attract, develop and hold high quality staff at all levels.

The achievement of central banking goals also requires the collaboration of several government departments, and in this respect Governments have found it very useful to involve the Central Bank on various standing policy committees, especially the Government budget committee, and these committees provide an excellent opportunity for the Central Bank to influence economic policy. In small developing countries with scarce intellectual and technical resources, the Central Bank would do well to develop its capability as "a mini-think-tank". An effective technique for influencing economic policy is to anticipate developments, and develop expertise in critical areas,

long before their need is recognised. Information and expertise are the most important sources of influence in modern society.

The Implementation of Economic Policy

We may identify three aspects of economic policy implementation by the Central Bank: first, the administration of monetary and credit policy; second, the execution of various tasks and programmes, either as agent of Government or in pursuit of some longer-term Bank policy, and third, the promotion of desirable changes in the orientation and economic intelligence of the community - adult education, if you wish.

The administration of monetary and credit policy in most small developing countries is constrained by the low level of development of financial markets and the structure of these economies. This means, of course, that many of the techniques of traditional central banks are not effective. In Barbados, for example, there is hardly any secondary trading of Government debentures and only the Central Bank makes a market in treasury bills. Open market operations, therefore, are out of the question. Again, because of the openness of the Barbados economy (Imports represent 70 percent of Gross National Expenditure) and the heavy seasonality of export earnings (sugar and tourism), commercial bank deposits are liable to steep increases over the first five months of the year. In these circumstances, a change in reserve requirements is an inadequate tool for the control of the money supply, since its effective use would require sharp and frequent movements of the ratio. The manipulation of the bank rate is similarly quite ineffective in these circumstances.

Central banks in small developing countries must therefore find other techniques for regulating the financial sector. In these circumstances, small size is a distinct advantage. The managers of all seven commercial banks in Barbados fit comfortably into the Central Bank's Board Room, making moral suasion a quite effective technique. The commercial banks can be told quite precisely what is to be done. During our balance of payments difficulties in 1977, specific targets were set for overall

commercial bank credit as well as for credit to particular sectors. The policing of commercial bank operations by the Bank Supervision department is also greatly simplified by the small number of bank branches to be inspected.

The reputation of traditional Central Banks for superior performance has proved a most valuable heritage for newly established central banks. It has ensured them the operational autonomy not permitted other statutory corporations in developing countries, but so essential to the success of the modern corporation. This operational autonomy imparts a tremendous administrative flexibility to Central Banks.

Central banking is a most varied activity involving the combination of numerous skills. This factor, combined with the administrative flexibility characteristic of Central Banks, may well produce beneficial synergistic effects. In other words, because we do some things so well, we are able to make a job of some other things as well. As a result, the new Central Banks have been able to carry out many tasks as agents for Government, or to launch programmes which Government could only carry out at a much greater cost in administrative resources and money. Indeed, there is a danger in the English-speaking Caribbean that Central Banks may be called upon to do more than they can!

In Barbados the Central Bank, nearly seven years old, has established an Export Credit and Guarantee Division which also administers a Small Business Finance Guarantee Scheme. It is also cooperating with the Chamber of Commerce and contributing much of the finance for the establishment of Securities Exchange of Barbados Ltd., an embryonic stock market. The Bank was also responsible for the technical preparation of the Off Shore Banking Act of 1979, whose object is to promote the island as an international financial centre.

The illumination of economic issues is an important aspect of policy implementation – a task which central banks could do better than Governments if they have established a reputation for being above politics. Frequently the Central Bank finds itself

having to advocate tough credit and fiscal policies. Indeed, the mere mention of "wage restraint" is enough to bring down the wrath of the trade unions. In a democratic and pluralistic society like Barbados or Israel, it is important that the public understand, in an intuitive fashion at least, what issues are at stake.

There are also numerous, varied and subtle techniques of economic policy implementation. Through its public relations programme, the Bank could provide support for numerous worthy causes which promote economic development, but which would otherwise be neglected. Our most ambitious effort has been the foundation of the Sir Winston Scott Memorial Lectures. These lectures invite the Barbadian intelligentsia and, through television and media, the general public, to take a peep into the world of the future, e.g. the world of computers and the exploitation of ocean resources. But even the architecture of the Bank's buildings might reflect its policies. In the brief for the construction of our New Headquarters Building, the architect was specially enjoined against designing a "fortress". The requirements of security are not incompatible with community-orientation. The Barbadian public will be encouraged to view numismatic and art exhibitions during office hours and to use the Bank's auditorium for cultural activities in the evening. The architecture is meant to suggest that the Central Bank stands not against the community but in it - admittedly an elaborate and convoluted technique of policy implementation.

The Prospects for Central Banking

According to Galbraith, "There is nothing about money that cannot be understood by the person of reasonable curiosity, diligence and intelligence".[11] He is resoundingly mistaken. The Central Bank, which far outstrips gold, silver and copper mines as a source of liquidity, is an extraordinarily ingenious and flexible social device. It must, as one wag has suggested, rank close to fire and the wheel in the history of human

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[11] Galbraith, John K., op.cit., p.5.

invention. But the environment in which it operates is continuously changing - an environment of cultural attitudes, political beliefs and economic doctrines. For this reason its appropriate role, deriving from its infinite liquidity, has proven most elusive not only for central bankers but, obviously, for academic economists as well. There is a continuing need for central banks to redefine their role in the light of new theoretical insights, new technologies and new problems.

The Central Bank of Israel is to be complimented on this Symposium which seeks to refocus attention on the fundamental role of central banks. I have also noted your institution of the Horowitz Prize for the best essay on central banking. Dr. Horowitz, I understand, was a most innovative and distinguished central bank Governor. It is only by continual review of this fascinating institution that we will improve upon the errors of our predecessors, which, with the benefit of 20/20 hindsight, we now perceive so clearly. The paper has suggested that we search most diligently for a more generalized theory of central banking.

A General Theory of central banking is more urgent than ever as we enter the electronic age. With essentially twenty-four hour banking services, with direct payments by consumers through the computer, with the arrival of the cheque-less and currency-less society, the traditional tasks for which Galbraith concedes our usefulness, will diminish in importance. It will also become increasingly difficult to measure, or even to define, the money supply - that pot of gold at the end of the monetarist rainbow. What will we do then? I recently observed to an American friend that many of the cheque-clearing and funds-transfer operations of the Federal Reserve District Banks could well become obsolete. That is why it is so important for us to go back to first principles and re-examine the quintessential quality of Central Banks.

The trend towards increased cooperation among central banks throughout the world gathers momentum. Prior to the Second World War, cooperation was essentially limited to those European Central Banks which were members of the Bank for

International Settlements. In time of severe crisis the Governors of the Bank of England, the Bank of France and the President of the Federal Reserve Bank of New York might hold a summit. With the establishment of the International Monetary Fund, the association among Central Banks has become much wider, and the increasing ease of travel has made it possible for central bankers to meet much more frequently than in the past. More importantly, the increasing inter-dependence of our economies and the vulnerability of even major economies like the U.S.A. to international financial instability, has rendered cooperation among central banks even more urgent. Indeed, central bankers in the major financial markets of the world are agreed about the need to bring the rapidly expanding Euro-dollar market under control; central bankers from developing countries are especially concerned that the International Monetary Fund should expand its role as a source of international liquidity for Third World countries hard hit by the energy crisis. Indeed, the presence of so many Governors of central banks at this symposium is indicative of the growing sense of common interests among us.

It is very possible that the usefulness of the Central Bank in the future will derive more and more from its tradition of excellence, its administrative flexibility and its developing "think tank" role. Standing somewhat above the fury of political battles, Central Banks could make very useful contributions to the study and solution of practical social and economic problems. I notice that the Central Bank of Israel has appointed someone to co-ordinate its scientific activities. I find the use of the term "scientific" to be most significant. I constantly urge my senior staff to rise above their operational routines and become "students" of their area of responsibility. Hopefully, one day soon we at the Central Bank of Barbados will be justified in replacing the term "students" with "scientists".

Finally, I believe that Central Banks will have to become much more open and community-oriented, especially in highly democratic societies like Israel and Barbados. I am convinced that an industrialized country cannot achieve the triad goals of economic growth, price stability and full employment without

recourse to an incomes policy. And yet the success of an incomes policy in a democracy is virtually impossible without a consensus on the part of Government, Business and Trade Unions. Here the Central Bank can play an important role. By maintaining its credibility with the general public, it could develop its potential as honest broker among competing economic interests.

I was confirmed in this view over drinks with the distinguished President of the Bundesbank, Dr. Emminger, under a tropical Barbadian sky close by the blue Caribbean Sea. Incidentally, of all European central bankers, men of otherwise sound judgement, only Dr. Emminger and Governor Richardson of the Bank of England have so far discovered that Barbados lies on the air routes to North America and, to generalize the case, to all other places in the world. You are all welcome there.

3 New Directions for Central Banking in the CARICOM Caribbean*

Introduction

It is now something of a Caribbean tradition that the institution of central banking be reviewed from time to time. Central banking is both science and art, so that improvements in its practice must draw on both systematic academic analysis as well as upon the experience of practitioners. The first critique of Caribbean central banking was "A First Appraisal of Monetary Management in Jamaica" by Lloyd Best and Alister McIntyre in 1961.[1] This brief and tentative study commented on the Bank of Jamaica's reaction to an upward movement in the Bank of England's discount rate and concluded that the existing powers of the Bank were inadequate to cope with the problems of capital flight. It also recommended a devaluation of the Jamaican currency. The second critique came in 1969 in the form of my own Ph.D. dissertation "Central Banking in a Dependent Economy: The

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* Paper presented at the Twentieth Annual Conference of the Regional Programme of Monetary Studies Port-of-Spain, Trinidad November 16-18, 1988.

1 Best, Lloyd and McIntyre, Alister, "A First Appraisal of Monetary Management in Jamaica", ***Social and Economic Studies,*** Vol. 3, September, 1961.

Jamaican Experience 1961-67."[2] I complimented the Bank on the financial integrity of its operations. However, I was critical of its traditional concern with the money supply and its narrow focus on commercial bank credit to the neglect of non-bank intermediaries. I also regretted its neutral stance towards developmental problems. Its preoccupation with the "soundness of the currency" irked me then. It would not today!

Professor C. Y. Thomas, our most distinguished authority on monetary economics, published **The Structure, Performance and Prospects of Central Banking in the Caribbean in 1972**.[3] Thomas' immediate concern was with the inappropriateness and, indeed, the inequity of the Sterling Area Arrangements. He also recommended two reforms - the imposition of exchange controls against sterling and the regulation of borrowing by non-resident controlled multinational corporations - practices now observed throughout the region. Fortunately, his more radical recommendations, involving nationalization of financial institutions and the direction of all lending by the central bank, were not generally heeded. I doubt whether Professor Thomas would still stand by the arguments he used then:

> The recent history of nationalizations in India, Libya, South Yemen and Tanzania, show that the complications are overstated and that nationalization, although not a guarantee of adequate banking, is certainly necessary for the development of adequate banking in poor countries.[4]

We might add the example of Burma to the above list to hammer home the disutility of a monolithic financial regime of the type recommended by Professor Thomas.

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2 Blackman, Courtney N., "Central Banking in a Dependent Economy: The Jamaican Experience, 1961-1967", Ph.D. Dissertation, Columbia University, 1969.

3 Thomas, Clive Y., **The Structure, Performance and Prospects of Central Banking in the Caribbean,** I.S.E.R., University of the West Indies, Jamaica, 1972.

4 Ibid, p.58.

Reviews of central banking performance as organizations in the 'seventies and early eighties' were generally favourable. Speaking at the 10th Anniversary of the Central Bank of Trinidad and Tobago, Alister McIntyre, then Secretary General of Caricom, praised the initiatives of Caribbean Central Banks in the development of the Caricom Multilateral Clearing Facility. G. Arthur Brown, the first native governor of a Caribbean central bank, also gave high marks to regional central banks on the occasion of the Central Bank of Barbados Tenth Anniversary in 1982.

However, Caribbean central banks lost much of their mystique in the 1980s. There have been no rave reviews for them in this decade. In June 1984 the late Prime Minister Adams publicly criticized Caribbean governors for the collapse of the Caricom Multilateral Clearing Facility. Speaking in the House of Representatives in July 1986, the late Prime Minister Errol Barrow savagely attacked the incumbent Governor, blaming him, strangely enough, for the high level of the national foreign debt. We also witnessed the bizarre spectacle of a Minister of Finance boycotting the opening of the Headquarters of the Central Bank of Barbados, an institution for which he was responsible to Parliament. In Port-of-Spain the incoming Prime Minister publicly criticised the incumbent Governor. About the same time in Jamaica the Opposition was threatening the incumbent Governor with dismissal in the event of a P.N.P. victory at the polls.

Most serious of all has been the recent critique by Mr. Frank Rampersad, the retired Permanent Secretary of Finance of Trinidad and Tobago. In assigning responsibility for the current debt problems of the region, Mr. Rampersad had this to say:

> The Ministry of Finance has to bear major responsibility for it; but vigilant Central Banks could also have been expected to have highlighted the consequences of failure of the Governments to exercise due procedure in their external financial transactions;

> and there is no empirical evidence to indicate that these Banks did that.[5]

It may very well be that the recent uneasiness of politicians with central bank governors reflects an unfortunate but episodic clash of personalities and that things will return to normal very soon. I think not! In any case, we cannot dismiss critics like Rampersad when they ask: Where were the central banks when the fiscal deficits were widening; when the currencies were depreciating; when the foreign debts were piling up? If the answers to the above questions are unsatisfactory, we must pursue a further line of inquiry: What institutional changes must we put in train to ensure that central banks are more effective in the future?

The first section of this paper recapitulates our experience with central banking in the Caribbean. Secondly, we develop a comparative model of central banking. In so doing we shall identify three basic types of central banks. These types will be defined in respect of their location at the centre and at the two extremes of a continuum registering the extent of the central bank's independence of the Administration in power. We shall then use this model as a reference for identifying the various Caribbean central bank types. Fourth, we shall assess the appropriateness of the existing central banks to our political, economic, social and cultural circumstances. Finally, we shall make suggestions on future directions for central banking in the Caribbean.

The Caribbean Experience with Central Banking

The term "experience" in the heading of this section is used most advisedly. This section does not seek to appraise the monetary policies of regional central banks - that is a task for scholars in the Monetary Studies Programme. Nor does it attempt to evaluate their performance as organizations - although the

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[5] Rampersad, Frank, "Economic Policy Formulation and Implementation in the Caribbean", Lecture delivered to Central Bank Trainees at Central Bank of Trinidad and Tobago, May 31, 1988, Unpublished Mimeograph.

heavy reliance of Governments on their technical and administrative expertise, if not always on their policy advice, suggests that central banks have generally out-performed other government units in respect of organizational efficiency; if anything, Governments have tended to overload them with responsibilities. Rather we seek in this section to identify the respects in which central banking has made a significant difference, for better or for worse, to economic outcomes in the Caribbean. What has been our experience with this alien institution introduced into our region less than thirty years ago?

Central banking came first to the Caricom Caribbean in 1961 when the Bank of Jamaica opened its doors to business. By the end of the decade the Central Bank of Trinidad and Tobago (1964) and the Bank of Guyana (1965) had been established. The Central Bank of Barbados (1972) and the Central Bank of the Bahamas (1974) followed in the 1970s. It was not until the 1980s that the Central Bank of Belize (1982) and the East Caribbean Central Bank (1983) were set up.

Central banks are much more elaborate institutions than the passive currency boards they replaced. They act as banker to Government and to the banking system; they manage the country's foreign exchange reserves and the national debt; they administer the Exchange Control regulations and advise Government on economic and financial matters. However, the crucial respect in which central banks differ from their predecessors is in their discretionary powers of money creation. The balance sheet of a central bank is infinitely liquid within its national boundaries. It can theoretically purchase all the assets in the national economy. However, and this is too frequently forgotten by the political directorate, they cannot create a single unit of foreign currency.

This peculiar attribute of a central bank - the infinite liquidity of its balance sheet - makes it a fearsome two-edged sword, to be wielded with both skill and restraint. If properly used, it enables the monetary authorities to lubricate the financial wheels of the economy. The constant danger is that the Administration in power, either in the mistaken view of the

developmental advantages of deficit financing or in pursuit of short-term political advantage, will pressure the central bank into financing its fiscal deficits. Excessive money creation, in turn, will quickly lead to domestic inflation and eventually to the erosion of the external value of the currency. As John Maynard Keynes observed, there is no more certain means of destroying a society than "the debauchment of the currency." More recently Professor Walter Eltis would conclude that "the ultimate effect of the ... deficit-financed expansion is to destroy the balance of payments."[6]

The Acts establishing Caricom central banks vary in their language but they generally convey five basic purposes:

1. the preservation of the internal value of the currency;
2. the preservation of the external value of the currency;
3. the promotion of economic development;
4. the promotion of a healthy financial system;
5. the development of capital markets.

We may determine the impact of central banks on societies by the extent to which these purposes have been achieved. It will be much easier to identify the negative bank activity than the positive contributions. The important consideration is whether the outcomes, positive or negative are different from what they would have been under the old currency board system.

The central bank's regulation of money creation is most critical to the preservation of the internal value of the currency. Other things being equal, an increase in money (credit) in excess of productivity gains will result in inflation, thus eroding the internal value of the currency. In small open economies, like those in the region, inflationary pressures will spill over into

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[6] Eltis, Walter, "The Failure of Keynesian Conventional Wisdom", ***Lloyds Bank Review,*** October 1976, No. 122, p.5.

imports and, if not brought under control, result in a balance of payments disequilibrium which will be corrected either by a formal devaluation or a de facto devaluation manifested by shortages of goods and by widespread black market operations in foreign exchange. For our open Caribbean economies the internal and the external value of the currency are really sides of the same coin.

Up to the mid-1970s the operations of Caribbean central banks produced outcomes very much like those which would have resulted from currency board operations. Indeed, central banking operations in some countries have changed little since then. The East Caribbean Central Bank, for reasons mentioned below, operates very much as if it were a currency hoard. The Bahamian authorities, too, have identified one-to-one parity of the Bahamian dollar with the U.S. dollar as a parameter of their economic system, and have quite sensibly designed their economic policies around this motif. This strategy calls for tight control over fiscal deficits and the restraint of consumer credit in their remarkably open economy. The healthy foreign assets ratio of these two central banks, as well as the quite low rates of inflation recorded in the respective countries, reflect the limited use of the money creating powers of their central banks.

The Central Bank of Belize increased its lending to Government during 1984 to such an extent that its external assets ratio fell below the legal requirement. However, with the assistance of an IMF Stand-by Agreement, this unsatisfactory situation was corrected in the following year.

The Barbadian authorities exhibited considerable restraint throughout the 1970s with respect to the money creation powers of their central bank. Indeed, there were times in 1978 and 1979 when the amount of government debt held by the central bank was negligible. There was a fall from grace in 1981 when credit outstanding to Government rose by more than half in order to finance a record fiscal deficit of BDS$180 million. The sharp rise in the fiscal deficit was mirrored in a more than fifty per cent rise in the foreign debt - to US$123 million. This situation was corrected by adherence to the conditionalities of the 1982-

84 eighteen month Stand-by-Agreement with the International Monetary Fund. The fiscal deficits for 1982, 1983 and 1984 came in at under BDS$100 million each year; central bank credit remained flat, while the foreign debt grew at only US$20 million per annum.

For the remainder of the 'eighties substantially higher fiscal deficits, reaching a new record of BDS$190 million in 1987, were sustained primarily by heavy foreign borrowing. Barbados' foreign debt has more than doubled - from US$193 million at year end 1984 to US$391 million at mid-1988. On the other hand, central bank claims on Government have stabilized at well below their 1984 levels.

Dr. Richard Haynes' 1986 supply-side "Alternative Budget" actually utilized a portion of a Japanese Yen loan to finance the "give-backs" promised during the election campaign. This readiness to finance fiscal deficits through foreign borrowing reflected a strange notion, current among some economists on the U.W.I. Cave Hill campus, that only fiscal deficits financed by the central bank are harmful to the economy. In fact, fiscal deficits financed through foreign borrowing deliver what Americans call a "double whammy". Foreign debt rises first when the loan is drawn down and changed into local currency, and again when it is spent in the domestic economy on imported goods. With the dramatic decline in visible exports since 1984, and only a moderate expansion in tourist arrivals, the preservation of the external value of the Barbadian currency now rests squarely on the nation's international credit worthiness. So far so good!

The Trinidad and Tobago Authorities cannot be accused of abusing the money creation powers of its central bank. During the oil-boom years, there was no need to. In fact, Government ran tremendous fiscal surpluses and massive foreign exchange reserves accumulated in the central bank. The recent balance of payments problem, resulting in two successive devaluations of the Trinidad and Tobago dollar, rather reflects the collapse of oil prices in the mid-1980s which has led to a sharp decline in government revenues. Failure to effect a proportionate reduction

in government expenditures caused a swift erosion of an apparently impregnable foreign exchange position as Government was forced to draw down its foreign exchange surpluses to meet its domestic commitments.

The cases of Guyana and Jamaica are quite different. In 1975 both Governments, motivated by socialist ideology, embarked on massive programmes of fiscal expansion which were financed primarily by central bank credit. Government borrowing from the Bank of Jamaica rose from J$76.8 million at December 31, 1975 to J$435.8 million by the end of 1977. Bank of Guyana claims on the Government on the comparable dates were G$44.5 million and G$346 million. In both cases the extravagant government spending spilled over into the balance of payments. By the end of 1976 both countries had exhausted their foreign exchange reserves and were forced to borrow heavily abroad. Guyana, with an external debt of over US$1.2 billion, has defaulted on all her foreign loans. Jamaica has rescheduled an average of US$230 million each year since 1981 and now has foreign liabilities of US$3.5 billion. Neither economy has yet recovered from that initial toxic injection of new money in 1975.

As a result, both the internal and the external value of the two currencies have been severely eroded. The World Bank gives an annual average rate of inflation of 10.2% for Guyana and 19.8% for Jamaica over the period 1980-86. (The Guyanese rate obviously reflects only prices of public sector goods and not those in the informal economy, estimated by some economists to be almost equal in size to the formal economy). The erosion of the external value of their currencies is even more dramatic. The Jamaican currency, valued at J$1.00 = US$1.10 in 1975, now trades at J$5.50 = US$1.00. The Guyanese dollar, valued at 40 US cents in 1975, is now worth ten US cents officially, five US cents at the "open window" of commercial banks, and between two and three US cents on the black market. It was the availability of central bank financing which seduced these governments down such alluring but disastrous policy paths.

It is empirically observable that those countries which made excessive use of central bank credit grew more slowly than those

which did not. The Jamaican GDP declined at an annual average rate of 2.5% over the period 1973-1985, while Guyana's GDP recorded an annual average rate of negative 1.2%. All other countries in the region experienced positive growth rates ranging from 1% - 3% per annum over the same period. Of the countries which did experience growth, only in Barbados did the Central Bank consciously attempt the allocation of credit to the productive sectors of the economy. It is impossible to determine whether such policies contributed significantly to economic development. However, we can state with considerable confidence that an environment of relative price and currency stability is more conducive to economic growth than is inflation, repeated devaluations and crushing debt service obligations.

The inflationary pressures and currency devaluations deriving from excessive money creation certainly militated against orderly financial operations and the development of capital markets, stimulating a massive flight of both human and financial capital. In Guyana and Jamaica, the foreign exchange markets virtually collapsed. In Guyana, tremendous liquidity built up in the commercial banking system for which few investment opportunities could be found, and the nation has actually been dissaving. In Jamaica, the indigenous financial structures so patiently nurtured during the early life of the Bank of Jamaica have just about survived, although there were some financial failures. In Trinidad and Tobago, the sharp fall-off in national expenditures since 1985 precipitated a number of liquidations in the non-banking sector. In both Jamaica and Trinidad and Tobago, the Bank Supervision Departments of the Central Bank were welcome agents of stability.

The older central banks, i.e. those more than ten years old, have all taken extensive measures to develop capital markets in their economies. The lone exception is Guyana, where the miniaturization or nationalization of foreign financial institutions became the declared government policy. In Jamaica, Barbados, and Trinidad and Tobago, the central banks stimulated the treasury bill market, were prominent in the establishment of stock markets, and promoted various specialized financial activities. The three youngest central

banks have all now set up programmes for the extension of capital markets. An export credit insurance scheme is already operating under the aegis of the East Caribbean Central Bank.

A Comparative Model of Central Banking

We can identify three basic types of central banks. These may be seen in terms of their location on a continuum ranging from virtual independence of the Administration in power to supine accommodation to government policy.

The Bank of England, the archetype of central banks, would occupy the centre-point on the continuum registering independence from the Administration in power. The Old Lady of Threadneedle Street was once a law unto herself. Since its nationalization in 1948 the Bank of England is now viewed as "independent within the framework of government policy". That is, although required to treat government policy as a parameter within which it must operate, it is expected to arrive independently at its conclusions on financial and economic matters and so provide the Administration with a **second opinion.**

The present Governor, Mr. Robin Leigh-Pemberton, describes the Bank's relationship with Government in the following terms:

> If you have a Treasury that is hellbent on an inflationary programme, I think a central bank has to do its best to reduce the implementation of that policy, to limit as far as possible the damage it does, to advise, to dissuade if possible, to do almost anything except obstruct. I don't think one can obstruct a democratically elected government. If the government decides to go ahead, you have the alternative of executing its policy or resigning.[7]

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[7] As quoted by Fay, Stephen, **Portrait of an Old Lady,** New York, Viking-Penguin, Inc., 1987, p.177.

This concept of the central bank thus contemplates the possibility of disagreement between the Bank and the Government and, indeed, the possibility that the existence of disagreement may become transparent to the public. But it is expected that the "fighting" will take place in private between the Governor and the Minister. In this context the political views of the Governor or the Minister are quite irrelevant; what is important is the cogency of the Governor's arguments and his skill in putting them across. The Bank of England, then, is viewed as "not only apolitical, but above politics", to borrow an expression once publicly used by the late Tom Adams to describe the Central Bank of Barbados.

In the more mature societies, debate deriving from a difference of opinion is regarded as essential to the development of sound policy. Mr. Duisenburg, Governor of the Bank of the Netherlands and himself a former Minister of Finance, once described to me his relationship with Dr. Zilstra a former Governor of the Bank of the Netherlands. As Minister of Finance, he met and fought with Zilstra over policy issues once a week for the last two years of Zilstra's first term of office. He reappointed Zilstra to a second term and resumed his weekly battles until he himself was voted out of office some years later.

West Germany's central bank probably occupies the position farthest to the right on the continuum of independence. The Bundesbank not only offers Government a second opinion, but may actively seek to obstruct an Administration apparently bent on a path of financial and economic disaster. Although no doubt preferring consensus reached after discreet discussion, the President of the Bundesbank would not hesitate to ventilate in public an opinion contrary to that of the Administration. This remarkable independence of the Bundesbank stems from the fear of inflation, so deeply etched in the German psyche by their experience of the bizarre hyperinflations of the 1920s and 1940s. So rapid were price increases in 1923 that workers were sometimes paid twice a day. Their wives took the morning's wages straight to the market in the certain knowledge that goods would cost much more by nightfall. Farmers paid off their mortgages with a bag of potatoes; life insurance policies matured and could hardly buy a handkerchief!

So determined are the Germans that this nightmare should never recur that they have entrenched the independence of the Bundesbank in law. It is the Bundesbank, independently of the Minister of Finance, which is charged under the constitution of the Federal Republic of Germany with the preservation of the internal and external value of the currency. Appointed for eight years, the President cannot be removed by the Chancellor. The majority of the Directors represent Federal units and are independent of the Administration. It is not surprising then that the rate of inflation commonly remains much lower in West Germany than in any other industrialised country.

During one of his two visits to Barbados the late Dr. Emminger, a former President of the Bundesbank, recalled once telling the German Trade Unions that they were free to demand any rate of wage increase they wished. However, should their demands be excessive, the Bundesbank would certainly not expand the money supply at the rate required to validate those increases, and so they might confidently expect large numbers of their members to become unemployed. The unions took him at his word! Right now Dr. Poehl, Dr. Emminger's successor, is at loggerheads with the Chancellor over the proposed European Central Bank. He is concerned that the proposed institution might lack the independence of the Bundesbank and could become a tool of profligate governments.

The U.S. Federal Reserve System stands somewhere between the Bank of England and the Bundesbank on the independence continuum. Federal Reserve Governors are appointed by the President for 14 years certain and the Chairman four years certain. The operational autonomy of the institution is not challenged, but its independence is in the gift of the Congress and is not enshrined in the constitution. The President and the Congress, acting together, could clip the wings of a Federal Reserve Board which threatened to become an independent republic.

Dr. Arthur Burns, Chairman of the Federal Reserve System during the Nixon years, apologised for the Fed's inability to halt inflation during his term of office:

> My conclusion is that it is illusory to expect central banks to put an end to the inflation that now afflicts the industrial democracies does not mean that central banks are incapable of stabilizing actions; it simply means that their practical capacity for curbing an inflation that is continually driven by political forces is very limited.[8]

Mr. Paul Volcker certainly did not accept this view of the Fed's limitations. He instituted such a tight monetary policy that inflation was squeezed out of the American economy in a few short years, and he made no apology for the recession of 1981-82, the deepest since the great depression of the 1930s. Indeed, Mr. Volcker frequently found himself at odds with the Reagan Administration, complaining all the while about that Administration's widening fiscal and trade deficits. This did not stop Mr. Reagan from reappointing him to a second term, and offering him a third. (Volcker declined, allegedly because the President didn't beg him hard enough to stay!)

The Bank of Italy would occupy a position on the continuum quite close to the U.S. Federal Reserve System. Its President is appointed for life - like Supreme Court Justices in the U.S.A. **The Economist** has this to say of that institution:

> .....however ineffective governments may be in Italy, the Bank of Italy remains staunchly independent and highly respected. The Central Bank has thereby helped to maintain investors' confidence. Governors are appointed for life and so are free from political retribution. There have been 47 governments since the war, but only five governors. Mr. Carlo Ciampi, the present governor, is certainly not afraid of publicly criticising the government's budgetary policy.

The Bank's autonomy from the Treasury was strengthened in the early 1980s. In the 1970s the Bank of Italy was obliged to buy up any debt that remained unsold in the public auctions,

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8 Burns, Arthur, "The Anguish of Central Banking", International Monetary Fund Per Jacobsson Lecture, 1981.

thus inflating the money supply. In 1981 the Bank was freed from this obligation, breaking the link between the deficit and monetary creation.[9]

At the opposite end of the continuum we find those central banks which serve as the passive instruments of irresponsible government fiscal policy. They are geographically located mostly in Africa and Latin America. They serve as mechanisms for the monetization of huge deficits which have fuelled chronic and spiraling inflations, precipitated massive and frequent devaluations, and have plunged their societies into economic, social and political chaos. Such central banks are totally politicized and bereft of professional integrity. Governors who venture a second, or any opinion at all, are dismissed and, in one or two tragic instances, assassinated. That is why I warned the Barbadian public on my departure from office that "a politicized central bank is worse than no central bank at all".

Ironically enough, it is central banks in the highly socialist countries which have pursued the most conservative monetary policies. Since their banking systems are monolithic, with the central bank at the apex, the expansion of commercial bank credit can be rigorously controlled from the centre. Furthermore, communist governments have traditionally balanced their budgets so that the central bank was seldom called upon to monetize runaway fiscal deficits. On a visit to Moscow in 1979, I complained to the Vice President of the Gosbank, the Russian central bank, about my Government's propensity to incur deficits. "You can't have that," he replied sternly. I am afraid, however, that bad capitalist habits are beginning to rub off on the Communists. Both China and the Soviet Union now report central bank financed deficits and accelerating inflation.

The Caribbean Model of Central Banking

The Bank of Jamaica, the first Caribbean Central Bank, was cast faithfully in the Bank of England mould. Indeed, its

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[9] **The Economist,** February 27 - March 4 1988, "A Survey of the Italian Economy", p.10.

first two governors were both seconded from the Bank of England and served for a combined period of seven years. The model which they established was accepted both by their successors and the political directorate. In his address to the seminar marking the 10th Anniversary of the Central Bank of Barbados, Mr. G. Arthur Brown, articulated a theory of central banking in terms to which Mr. Leigh-Pemberton could take no exception:

> The first principle to state is that the Central Bank, its Governor and staff exist within the context of a social structure which, in the case of the Caribbean has indicated the broad areas of government policy and economic organization through the electoral system. No central bank can arrogate to itself the direction nor the elaboration of policies out of harmony with the mandate of the government in power... Many critics of central banking policy in the Caribbean appear at times to assume that these banks should have their own economic and foreign policy. A word which is pejorative but aptly describes what these critics advocated, is sabotage.

Brown then went on to spell out his understanding of the Governor's relationship with the Administration in power:

> By his training, knowledge and experience, he must show the consequences of various courses of action. He must be freè to propose alternatives and spell out the consequences. In operating in this area, the highest standards of discretion and secrecy must obviously be observed. The Governor cannot resort to writing letters to the press or making speeches against some government policies. His obligation is to tender advice forcefully but objectively. Like the auctioneer, he will advise once, twice and thrice. But if having done this, the Prime Minister says, "I have heard you and understand you, but the Government does not agree," he must then see how best the government's decision can be carried out.[10]

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[10] Brown, G. Arthur, "Central Banking in the Caribbean", **The First Decade,** Central Bank of Barbados, Bridgetown, 1983.

The vagaries of Caribbean politics have exerted continuous pressures which have shifted central banks down stream from their central position on the continuum. Indeed, the central banks in Guyana and Jamaica have drifted dangerously near the wrong extreme of the continuum. Hopefully, these trends will soon be reversed. In Barbados, the Barrow Administration, returning to power in 1986, fired what appeared to be opening salvoes against the autonomy of the central bank. In Port-of-Spain the incoming Prime Minister made similar moves, inducing the early departure of the Governor.

Rampersad's contention that within the Caribbean context the central bank "is, and is expected to be, independent of the Government" and that both "the laws and the conventions require it to be so" must be rejected. In my judgement, Brown's model accurately represents the convention observed both by Governors and politicians in the region. Certainly neither Dr. Eric Williams, Mr. Forbes Burnham nor Mr. Errol Barrow, nor any other West Indian Prime Minister has ever regarded the central bank as independent of the Government.

The legislation, as well as the practice, also supports the principle that the central bank is subordinate to the administration in power. In Barbados the Governor and Directors serve at the discretion of the Minister of Finance and not, as in other Caribbean States, on good behaviour. In Belize, Jamaica and The Bahamas, appointments of officers earning more than a certain annual salary must be approved by the Minister of Finance. In Barbados interest rate and credit policy decisions require, by law, the concurrence of the Minister of Finance. Changes in exchange rate parities are certainly outside the legal powers of any regional central bank. In Jamaica, the access of Government to unlimited central bank credit is assured. Section 37, Part VI of the Bank of Jamaica Act (as amended 10/1977 5.8) states:

> The Bank shall not in any financial year purchase or otherwise acquire securities issued or guaranteed by the Government of a nominal value exceeding 40 per centum, or such percentage as the House of

> Representatives may from time to time by resolution approve.

Section 49, Part IX of the Central Bank of Barbados Act, 1972, makes specific provisions for the Government to assume responsibility for monetary policy.

Nor is Rampersad justified in assuming that central banks failed to advise vigorously against the detrimental policy measures of the political directorate. The conventions which they observed did not permit public opposition and certainly not obstructionism. To my certain knowledge every Caribbean central bank has pointed out the pitfalls of excessive deficit financing to their Ministers. Most conspicuous was **The Report of the Committee to Review Government Expenditure,** chaired by Dr. Euric Bobb, then Deputy Governor of the Central Bank, which was submitted in October 1978 to the Trinidad and Tobago Government. The Report strongly recommended a sharp reduction in government expenditures but was not taken as seriously as was warranted.

Even if we reject Rampersad's charges against the directorate of central banks, we can still share his concern about institutional arrangements which have created such havoc in some Caribbean economies through excessive monetary expansion. Indeed, Shadow Minister of Finance Dr. Richard Haynes, in quite justified criticism of the 1981 Adams election budget, suggested that constitutional changes be made to entrench the independence of the Central Bank of Barbados:

> I believe strongly that we need to look at the Constitution again, that we need to look at the Central Bank Act and we need to make it a criminal offense for that kind of monetary expansion to take place in Barbados in response to political needs.[11]

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[11] Parliamentary Debates, ***Official Gazette,*** Bridgetown, Barbados, March 14, 1983.

The fact is that, unlike cricket but like most other British cultural exports, the institution of central banking did not travel well to the Caribbean. The Bank of England model of "independence within the Government" is riddled with contradictions which are resolvable only through the observance of subtle conventions evolved over centuries, and for which the British have a special genius. Mrs. Margaret Thatcher's disenchantment with Gordon Richardson during the last four years of his tenure as Governor was no secret to those in the know, but on no occasion did she express her feelings in public. He was made a Life Peer on his retirement from the Bank. In the Caribbean, personal attacks by politicians on Governors are now quite commonplace. Indeed, the paradoxical relationship between Governor and Minister, embedded in our prevailing central bank model, is beautifully captured in the late Prime Minister Barrow's contention that either the Governor advised the former Administration rightly and his advice was ignored, in which case he should resign; or he advised then wrongly, in which case he should resign.

Another difficulty stems from the small size and unsophistication of our communities. In the Bank of England model the Governor depends on his experience, technical experience and skill, to persuade the Minister of Finance. To do so, he must develop a personal relationship with him. The public in the small Caribbean states does not, and some politicians pretend not to, understand how a professional public servant can serve an Administration for several years without becoming a political ally. The Governor and the Directors of the Central Bank are now confidently expected by the public to be removed on every change of Administration. It is feared that they will sabotage the incoming Government! For this the society pays a heavy price in the loss of continuity and the erosion of the morale of the Bank. Worse of all there is a growing public perception of the central bank as a political rather than a technocratic institution.

Some years ago in Vienna, Dr. Koren revealed to me that he was actually Leader of the Opposition when he was invited to become Governor of the Bank of Austria. The Administration

never considered for one moment that Dr. Koren would sabotage their policies while in office. His party affiliation is viewed as irrelevant to the execution of his gubernatorial duties. This is an example which we in the Caribbean should mark, heed and inwardly digest.

Perhaps the most important difference between the central bank environments of the U.K. and the Caribbean is one of institutional and economic vulnerability. There are in the U.K. and other mature societies, many more institutional constraints on the adventurism of governments. As Rampersad observes in another context,

> ...we in the Caribbean have not had adequate time to entrench certain conventions which operate as surrogates for formal machinery.[12]

Where excessive money creation in the U.K. might lead to an inconvenient fall in the value of sterling on the foreign exchange market, it may produce, as we have seen, disaster in a Caribbean state. Prevention is the only cure for a balance of payments crisis in small open economies. It is a paradox that the restraining powers of central banks on governments need to be stronger in the small Caribbean states than in mature and wealthy societies.

Whither Caribbean Central Banking?

If we agree that the existing central banking arrangements have not served us well, what kind of a central bank do we need in our current economic, social and cultural circumstances? We should certainly take steps to reverse the drift of our central banks towards that region of the continuum populated by central banks of countries with double - and sometimes triple digit monthly inflation rates. Yet it would be asking too much of our political directorate to create central banks with the independence of the Bundesbank! However, with a few amend-

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[12] Op. Cit.

ments to the existing legislation, the efficacy of our existing central banks could be greatly enhanced and the probability of monetary excesses considerably reduced. Nevertheless, we should be mindful, as **The Economist** warns, that "no central bank can be sure that it will not be outflanked by politicians."[13]

Four minimal reforms are required if we are to suppress the intrinsic tendency of our central banks to drift towards the wrong end of the independence continuum. First, the tenure of the Central Bank directorate must be rendered more secure. The Governor and Directors should serve on good behaviour, the Governor for at least seven years certain, and the Directors for five years certain, with one Director retiring each year. The Governor's tenure would routinely bridge Administrations and so promote the public perception of the office as professional-technical rather than political.

Secondly, the operations of the Central Bank should be made truly autonomous. The Ministerial veto of staff appointments below the level of deputy governor should be discontinued. Since political considerations are irrelevant in the selection of central bank personnel, the involvement of the Minister is inappropriate.

Third, the Central Bank, as in the U.S.A., should be made responsible to Parliament rather than to the Minister of Finance, thus ensuring that the viewpoint of the Central Bank is at all times known to the public. As in the United States and Canada, the Governor would periodically appear before the relevant Parliamentary Committee to report on the national finances. This would promote the education of the electorate in economic matters and greatly enrich the democratic process. In this way, too, the relationship between the Central Bank and the Government would be institutionalised and the Governor could conduct his business with the Minister in a more formal manner. He would thus feel free to disagree with the Minister publicly.

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[13] **The Economist,** June 11-17, 1988. p. 18.

Fourth, the powers of the Administration to resort to central bank financing should be more rigorously circumscribed-ideally by entrenchment in the constitution. The limits on advances to the treasury, and on treasury bills and other public sector bonds held by the central bank should be precisely specified.

Let me anticipate one predictable objection - that democratic principles require the representatives of the sovereign people to exercise ultimate control over economic affairs. But as Karl Popper has reminded us, "...Nowhere do the people actually rule. It is governments that rule."[14] He replaces the question "Who should rule?" with "How best can we avoid situations in which a bad ruler causes too much harm?" There are few more harmful things a government can do in a developing country than to precipitate a collapse of the balance of payments, and there are few processes more difficult to arrest and reverse. "Hell", I have always maintained, "is when a country has exhausted its foreign exchange reserves."[15] Indeed, the Constitution of the U.S.A. is based on the premise that democratic election does not confer infallibility on Administrations, and that well designed checks and balances are required to minimize their excesses.

In fact, there is a strident school of economists, headed by Nobel Laureate Milton Friedman, which argues for rules that would limit, through constitutional amendment, the discretionary powers both of Ministers and central banks to create new money.[16] **The Economist** agrees:

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[14] Popper, Sir Karl, "The Open Society and its Enemies Revisited", **The Economist,** April 23, 1988. p.20.

[15] For a more elaborate exposition on the slide into balance of payments crisis, see Blackman, Courtney N., **The Balance of Payments Crisis in the Caribbean: Which Way Out?** Central Bank of Barbados, 1979.

[16] **The Search for Stable Money,** eds. Dorn, James A. and Schwartz, Anna J., University of Chicago Press, 1987.

> Depriving governments of the use of the printing press to finance their budget deficits would indeed remove an element of national economic autonomy; but since finance ministries almost always abuse the power to create money, that is entirely desirable. In any case, ample economic sovereignty would remain, and in a somewhat less risky form.[17]

But there is a neater solution - if we could discover an arrangement which removes from Caribbean governments both the temptation and the option of runaway fiscal deficits, loose monetary policies, and unwarranted wage settlements. Actually the model is right before our very eyes in the example of the East Caribbean Central Bank. The distribution of political control over the East Caribbean Central Bank among seven governments produces a system of automatic checks and balances within the Organization of East Caribbean States. No individual member state possesses the licence to monetize its deficits through the East Caribbean Central Bank, and all are forced to conduct their financial, fiscal and incomes policies within the iron constraints of their national income and any available foreign loans and grants. At the same time they may exert discretionary powers through unanimous agreement. It is not accidental that the peoples of the Organization of East Caribbean States have been shielded from the devastating reductions in their living standards experienced in the more richly endowed Jamaica and Guyana, and that their performance in the area of economic growth, price and currency stability has matched that of other more developed Caricom states.

In short, we need a Caribbean Federal Reserve System. The reserves of existing central banks would be pooled; a common currency would be used, and a common monetary policy would be pursued. Regional Governors would come together as a Board and the chairmanship rotated among them every year or two. As I have argued elsewhere, the establishment of a

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[17] **The Economist,** June 25 - July 1 1988, p.12.

Caribbean Federal Reserve System could be the centre-piece of any movement towards regional economic integration - the only viable solution for states as small as ours.[18]

In closing, let me say how fitting it is that I should have delivered this paper in Port-of-Spain, the arena of my closest friend in financial circles, the late Victor Bruce, former Governor of the Central Bank of Trinidad and Tobago, himself a most distinguished central banker and a champion of the independence of Caribbean central banks.

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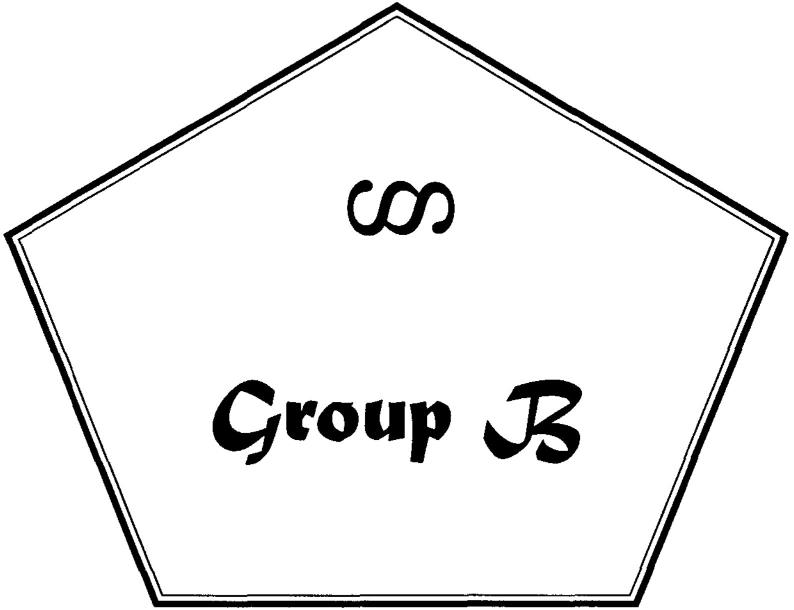
18 Blackman, Courtney N., "Towards a Monetary Union", ***Caribbean Affairs,*** Vol.1, No.2, Second Quarter, 1988. pp. 56-66.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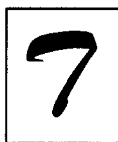
The Exchange Rate in the Balance of Payments Adjustment Process of CARICOM States*

Introduction



he English speaking Caribbean provides an excellent laboratory for the study of the exchange rate variable in the balance of payments adjustment process. We have witnessed almost every type of exchange rate regime. All of our currencies were once tied to the sterling before pegging to the US dollar. The Guyanese dollar is in theory pegged to a basket of goods, but is quoted in US dollars. The Jamaican dollar was once subjected to a crawling peg and its value is now determined through periodic auctions. (These might appropriately be described as "dirty" auctions since by the rules of the game the amount of currency on the block is manipulated by the Bank of Jamaica). Trinidad and Tobago has had a dual exchange rate, while Jamaica on one occasion had as many as three tiers in its exchange rate regime. No currency has ever been allowed to float freely, although for a brief period the Barbados dollar floated solely against the Jamaican dollar, with the Central Bank of Barbados refusing to intervene in the

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* Paper commissioned by the Commonweath Secretariat, October 31, 1987.

Barbados/Jamaica currency market. This situation came to an end when the Jamaicans fixed a Caricom rate in May 1983. Jamaica has carried out numerous devaluations since her currency was tied to the US dollar in 1975. Guyana has experienced fewer but even more massive devaluations than Jamaica. Trinidad and Tobago has devalued once. Barbados actually revalued its currencies when it fixed to the US dollar. Neither Barbados, The Bahamas, Belize nor the Organizationof Eastern Caribbean States have moved their exchange rates since tying to the US dollar.

Three territories in the region, Barbados once, Guyana and Jamaica on several occasions, have undertaken IMF adjustment programmes. The two latter have also carried out devaluations under the tutelage of the IMF. Both governments have had bitter disagreements with the IMF, usually revolving around the appropriate exchange rate level.

In recent years, exchange rate adjustments in the region have posed serious problems for intra-regional trade. The massive devaluations by Jamaica in the early eighties appeared to give that country's manufactured exports an unfair advantage over those of Barbados and Trinidad and Tobago, the other leading manufacturing states in CARICOM. Moreover, the import liberalization policies dictated by the IMF to Jamaica, seemed to give non-Caricom countries easier access to Jamaican markets than Caricom members enjoyed. These perceptions led to retaliation by Barbados and Trinidad and Tobago in 1983; Barbados floated its currency solely against Jamaica, while Trinidad and Tobago took the opportunity to impose fierce protectionist measures, not only against Jamaica, but against all other Caricom states. Except for transactions between Barbados and the OECS, intra-regional trade is now conducted largely on the basis of bilateral deals, and amid strident accusation and counter-accusation of unfair practice. The free-trade clauses of CARICOM are more honoured in the breach than in the observance.

This paper represents yet another attempt to arrive at a regime which will accommodate differences in regional exchange rates and promote the regional integration process.

In their paper, "Exchange Rate Policy within the Caribbean Community", Bourne, Cox, Solis and Worrell approached the problem from the point of view of technicians.[1] One of their particular concerns was "whether exchange rate policy can be so managed as to ameliorate the impact of any one country's exchange rate adjustment policies on other countries' trade balance." Their recommendations were inconclusive and amounted to a plea to Caricom members to be as sensitive as possible to their partner's circumstances while continuing to do their own thing.

This paper is more comprehensive. First it seeks to establish the role of exchange rate policy in the management of the balance of payments. Secondly, it asks the question, "What set of institutional arrangements can we devise to ensure that our exchange rate regime advances rather than impedes our progress towards an integrated regional economy." This paper is policy -oriented and will draw on the author's direct experience as an economic policy maker and participant in Caricom negotiations over the last fifteen years.

First of all we will set out the problem of balance of payments adjustment with a special focus on the role of the exchange rate in the economic policy mix. Secondly, we will develop a theory of balance of payments adjustment in small developing countries like the member states of CARICOM. Thirdly, we will conduct case studies of five Caricom member states which have manipulated the exchange rate variable over the past fifteen years. Barbados, Trinidad and Tobago, Jamaica, Guyana and the OEC states have been selected. The findings from these case studies should permit us to reach certain conclusions about the role of exchange rate in the management of the balance of payments. Finally, we will put forward some general proposals for institutional changes to mitigate the problems of divergent

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[1] Compton Bourne, Winston Cox, Felix Solis and DeLisle Worrell, "Exchange Rate Policy within the Caribbean Community", mimeo June 1985. (Commissioned by the Inter American Bank and the Caribbean Community Secretariat).

exchange rates in the region. These would greatly enhance the prospects for the successful economic integration of Caricom states.

Statement of the Problem

The exchange rate is an index of the price of a country's exports in relation to its imports from other countries. In the case of relatively self-sufficient economies, like Russia or China, the exchange rate is relatively unimportant. For small and highly open economies, as Caricom states are, it is a factor of the highest importance. This is because exchange rate variations are an important mechanism by which the effects of disturbances in the international economy are transmitted to the national economy.

The international environment has become most turbulent in recent years. First, the stability which free market economists like Milton Friedman predicted would follow the introduction of freely floating exchange rates did not materialize. Secondly, revolutionary advances in telecommunications and the globalization of financial markets have facilitated the electronic transfer of vast sums across national boundaries, introducing further unpredictability in currency and capital markets. Thirdly, there has been a sharp fall in the demand for and the prices of commodity exports from developing countries, including the Caricom states.

Changes in exchange rates can significantly affect the prices of a country's exports and the costs of its imports. For developing countries, exchange rate levels will determine the availability of critical inputs into the development process - raw materials and intermediate goods, capital equipment and foreign credit. Violent fluctuations in exchange rates also heighten uncertainty and create problems for decision-makers both in the private and the public sectors. These facts of life give rise to two important policy considerations: (1) how to minimize the damaging effects of disturbances in the international economy on the domestic economy, and (2) what policies are required to enable the domestic economy to adjust to external disturbances

with minimal cost and lapse of time. We are especially interested in the role of the exchange rate in the solution of this problem.

Highly developed countries, even those as open as Sweden or Switzerland, are better placed to cope with exchange rate instability. Possessing deeper and more developed foreign exchange markets, they can better absorb the continual fluctuations of a floating exchange rate regime. Furthermore, sophisticated forward markets permit international traders to hedge against most exchange risks. Even so, the developed countries have found floating rates to be most uncomfortable. The members of the European Monetary System have huddled around the strong deutchemark in an attempt to minimize exchange rate fluctuations among themselves. More recently the major trading nations, the Group of Seven, U.S.A., U.K., France, West Germany, Canada, Italy and Japan, have recognized the need for collaboration on exchange rate policy so as to reduce the wide swings in international exchange rates.

Lacking sophisticated currency and forward exchange markets, small open developing countries would find wild exchange rate gyrations quite unmanageable. It is now the conventional wisdom that such states should peg to the currency in which the major proportion of their trade is transacted. This limits their exposure to exchange rate variations. This system has served the Caricom states quite well. The instability of the US dollar has motivated consideration of the "basket of goods" regime. Indeed, Guyana has adopted it in a rather half-hearted manner. Simulations carried out at the Central Bank of Barbados have shown that a basket of goods, which faithfully reflects the dominance of the US dollar in Barbadian trade, would not have significantly diminished the effects of exchange rate instability.

Policy measures to bring about internal adjustment to external disturbances excite far greater controversy. The IMF has placed great importance on overvalued exchange rates as a source of balance of payments disequilibrium, and has made devaluation the centre-piece of the vast majority of its adjust-

ment programmes. The World Bank Development Report for 1983 attributed the balance of payments difficulties of many Sub-Saharan African states to overvaluation of their exchange rates and argued: "Changing the real exchange rate can be a powerful tool for balancing trade without burdening the administrative system and without distorting domestic incentives." [2] In several countries the World Bank also reported overvalued exchange rates as harmful to economic growth.

Devaluation is regarded by these international institutions as a crucial policy instrument for restoring the competitiveness of a country's exports since it reduces the volume of imports by making them more expensive. It therefore shifts resources from the domestic or non-tradable goods sector into the export or tradable goods sector, and counteracts capital flight. Devaluation, whose effects are presumed to take place through the market mechanism, is considered much more desirable than extra-market techniques such as qualitative restrictions and subsidies, since it minimizes distortions from intervention into the market place.

Although not ruling out the possible benefits of a devaluation, some scholars have begun to question its efficacy. Tony Killick, for example, argues:

> There appears to be serious doubts about our understanding of the connections between the policy instruments employed in adjustment and the variables they are intended to influence ...
>
> Our present uncertain knowledge indicates a need both for more theoretical and empirical research (in which the differentiation of economy types may prove a useful way forward), and for a richer mix of experimentation

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[2] **World Development Report,** 1983. World Bank, Washington, D.C., U.S.A. p. 58.

> in the adjustment programs that must meanwhile be implemented.[3]

This paper takes up the challenge laid down by Tony Killick by carrying out both a theoretical and an empirical study of the Caricom experience in balance of payments adjustment.

The Theory of Balance of Payments Adjustment

As Secretary James Baker discovered to his amazement just over a year ago, less developed countries need to grow even as they adjust. Policy makers in small open developing countries therefore require a bifocal model that addresses both the problem of short-run external and internal stability, as well as that of long-term economic growth. Both segments of the model will, of course, interact. On the one hand, a collapse of the balance of payments or a runaway inflation would compromise the objective of growth; on the other hand, without the continuous restructuring involved in the growth process, the economy could hardly make the adjustments required to maintain a dynamic stability over the long run.

The bifocal model presented below is predicated on two basic assumptions. The first is that both financial and real markets in the Caribbean are characterized by significant imperfections, and that the assumption of perfect markets so common in academic literature will produce misleading conclusions. **In other words, we must not proceed on the grounds that markets are perfectly competitive when we know quite well that that is far from being the case.**

This approach runs contrary to that of the Monetarists and especially of the New Classical or Rational Expectations School, who regard markets as generally efficient, and who presently exert a tremendous influence on international financial

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[3] Tony Killick, "Balance of Payments Adjustment and Developing Countries: Some Outstanding Issues", **Problems of International Money, 1972-85,** IMF, Washington, D.C., and Overseas Development Institute, London, 1986, ed. Michael Posner, pp. 82-3, passim.

institutions. This paper prefers to err with Neo-Keynesians like James Tobin, Hyman Minsky and recent Nobel Laureate Robert Solow in insisting that some markets are less efficient than others, and that efficiency is a positive function of market competitiveness. The most conspicuous difference between developed and underdeveloped countries lies in the extent of market development: the difference, say, between Switzerland and Guyana. Indeed, most Caribbean territories are so small that, even with regional integration, monopoly and oligopoly will be the most prevalent type of market organization in the foreseeable future.

The second assumption is really a corollary of the first. It is that the effects of market-oriented policy instruments, e.g. interest rates and currency devaluations, will not be transmitted as efficiently through imperfect markets as through highly developed markets. Joan Robinson and Edward Chamberlin have developed models which deal with certain types of market imperfection. In extreme cases of market failure, we will have to apply extra-market policy measures to achieve a more rapid reallocation of resources.

Even in highly developed economies, situations may arise which require resort to extra-market policy measures. Professor John Kenneth Galbraith, who directed Price Control policy for the U.S.A. in World War II, argues: "Market incentives are incapable of producing the comprehensive transfers in resource employment that any considerable mobilization requires".[4] He therefore recognizes that in such circumstances we will have to operate a disequilibrium system. I would posit that the disequilibrium which existed in the Jamaican economy during its recent balance of payments adjustment travails, far exceeded that experienced by the U.S. economy during World War II.

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[4] John Kenneth Galbraith, **A Theory of Price Control,** Cambridge, Mass., Harvard Univ. Press, 1980. p.30.

The Polak Model

The economic model developed by J. J. Polak, and used by the International Monetary Fund in its country financial programming exercises, provides an excellent point of departure in our search for a theory of balance of payments adjustment in small open and developing countries. Polak adopts an essentially monetary approach which assumes a poor state of market development:

> In most of the less developed countries, the transition from money to other assets is rather abrupt. On the one hand there is money; on the other hand there are real assets... There is little in between....assets that form the transition between money and real assets in countries with fully developed financial systems play a minor role in the asset structure of most of the less developed countries... In fact, in such countries there usually is no true market nor a capital market - in which a rate of interest is formed by the interplay of demand and supply forces.[5]

Polak's model has the virtue of simplicity:

> Its central relationship is that circular flow, with additions and subtractions as specified: income of this period = income of the previous period + new income resulting from internal credit creation + new income arising from exports - income lost through imports. Of the four variables in this equation, two - credit creation and exports - are considered exogenous in character. Only one more equation is needed (and possible) therefore, to tie the whole system into a complete package. That equation is the one explaining imports. The money value of imports is explained here in terms of the money value of income. The form of

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[5] J. J. Polak, "Monetary Analysis of Income Formation and Payments Problems", **The Monetary Approach to the Balance of Payments,** IMF, Washington, D.C., 1977, p. 53.

> the import equation assumes the assumption of a unit of elasticity of demand for imports.[6]

The Polak model is unsatisfactory in two respects. First, it regards imports as induced rather than autonomous:

> The effects of an autonomous reduction in imports can be considered.....as equivalent to an increase in exports. This is true independently of the character of the measures that produce the reduction in imports: increased tariffs, quantitative restrictions, or exchange depreciation.[7]

Polak treats imports as deriving from income and hence as being tantamount to negative exports. This approach is certainly valid in respect of raw materials, intermediate goods and even certain consumer items which are inputs into products manufactured for exports. However, there is a wide range of imports, especially big ticket consumer durables, which are not immediately essential to the national productive effort. Such items, like motor cars, electrical home appliances and other electronic goods, should be disaggregated from "negative" exports and treated as an autonomous variable.

A second limitation is the absence of a variable representing the wage rate. (With a fixed exchange rate and a readily convertible currency, it does not matter whether one uses the real wage rate or the nominal wage rate). Theoretically, it requires a corresponding increase in money to validate a wage increase which is not warranted by an increase in real output. In such a situation, the refusal of the Central Bank to create new money would lead to an increase in unemployment. Even so, the new wage rate becomes a reference price for new investors, who do not have the flexibility of well established producers in adjusting to higher wage rates. In Caribbean economies, which depend so heavily on foreign inputs, an

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[6] Ibid, p. 31.

[7] Ibid, p. 38.

uncompetitive wage rate could be a distinct disincentive to new investment and hence would impact negatively on exports. In the highly unionized Caribbean, the wage rate is an administratively determined price and, as such, must be treated as a decision variable. It is not therefore surprising that the IMF in recent times has included restrictions on wage increases among its conditionalities.

The most insightful aspect of the Polak model is its focus on credit creation rather than the money supply as an autonomous variable. The treatment of the money supply as an endogenous variable corresponds to the experience of small developing countries where the variability of export receipts puts the money supply beyond the continuous control of the monetary authorities. At the same time, as Polak rightly contends:

> ..... credit expansion is subject to the responsibility of the banking system. It may be difficult, perhaps in some circumstances humanly impossible to withstand demands for credit from Government or other insistent borrowers... But for the purpose of monetary analysis and monetary policy there is a clear gain in clarity if the responsibility is pinpointed on the credit expansion.[8]

The identification of exports as an autonomous variable is unavoidable, but more problematic. Whereas the authorities have it in their power to expand or contract credit or directly restrict imports, or even refuse to pay increased wages, they cannot directly increase exports. (They would hardly want to restrict exports). They might use fiscal or financial incentives to encourage producers to push their exports of goods and services but there is no certainty of success.

Nor is devaluation of the currency, the favoured IMF policy measure, certain to lead to the expansion of exports. The purpose of a devaluation is to increase the price of foreign exchange relative to that of the domestic currency. This has the effect of

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[8] Ibid, p. 27.

making imports dearer and exports cheaper. But whereas dearer imports are almost certain to lead to a reduction in their demand, cheaper exports need not lead to increased foreign exchange earnings. In the first place, the demand for most agricultural commodities, sugar, bananas, coffee, etc., is quite inelastic in the short run. Indeed, so is their supply. In the case of minerals, a small developing country is usually a price taker, so that a cheaper unit price will not result in an increase in aggregate export earnings. It is only in the manufacturing sector that the small developing country faces a reasonably elastic demand curve and can expect to increase its export earnings. But here again imperfections in the financial and real markets will lead to supply inelasticities, and a significantly increased output of goods may not be forthcoming. Moreover, a high proportion of the raw materials, capital equipment, and intermediate goods which are used by small countries in manufacture must be imported. The increased costs of these inputs, resulting from the currency depreciation, will before long feed into the production process and erode the original price benefits of the devaluation. The increased earnings from manufactured exports which the devaluation exercise was calculated to elicit may never be realized.

Most serious of all are the potential effects of a devaluation on public expectations. Devaluation will immediately add to inflationary pressures and unless it is deep enough to be credible, and unless an adequate cushion of foreign exchange is available, it could lead to a general loss of confidence in the system, with a consequent expansion of the black market and capital flight.

Devaluation, then, does not qualify as the standard prescription for balance of payments adjustment. Its use is rather analagous to that of surgery in medicine. However, once it becomes clear that a country's major exports are irretrievably uncompetitive, devaluation becomes mandatory - and the sooner and the deeper, the better.

The Problem of Long Run Economic Growth

The Polak model is essentially a model of short term adjustment. To increase its usefulness, we must incorporate features which address the ongoing problem of economic development. If there is one thing we know about economic development, it is that investment must grow relative to consumption as a proportion of GDP. In the developed countries, savings were historically squeezed out of the system at the expense of the weaker classes of society, e.g. the working classes in Britain and the Kulaks in Russia. Small open developing countries cannot rely on domestic savings. Since crucial capital, raw material and intermediate inputs have to be imported, such countries must have access to foreign exchange, either through export earnings, foreign investment or foreign loans. For small open developing countries therefore, foreign exchange must be treated as a resource.

As economic growth proceeds, increasing amounts of foreign capital will be required to sustain economic development. What is more, the scarce resources of foreign exchange must be allocated in such a manner as to generate export earnings adequate for covering an increasing proportion of foreign exchange needs, for meeting debt charges on accumulated debt, and for the repatriation of dividends and profits.

Economic policy, therefore, must impart a distinct bias in favour of investment versus consumption expenditures, especially in those sectors which earn foreign exchange. Applying our modified Polak model, the authorities would make sure that an adequate supply of credit flowed into investment, especially to the foreign exchange earning sectors, at the expense if necessary of the consuming sectors. This could be achieved by a system of selective credit controls, including credit ceilings and hire purchase regulations. In dire circumstances, tariffs on imports and, over short periods, even quantitative restrictions on "non-essential" big ticket items, might be employed. Some form of incomes policy should also be followed and, if necessary, currency devaluation should be employed if the country's exports threaten to become uncompetitive. In the interest of continued

stability, - fiscal and monetary policy should be conducted in a manner as to avoid currency depreciations. In particular, wage restraint is the price of exchange rate stability.

If everything goes well, a small developing country, after many years, may reach a dynamic equilibrium where rising productivity, generated by accumulated capital investments, enables it to earn adequate foreign exchange or to attract it readily from international sources. Switzerland could certainly be said to have reached that happy situation. Most frequently, not least in the Caribbean, the majority of developing countries founder some distance off the shores of the promised land. Deteriorating terms of trade, oil shocks, acts of God, and plain bad policies lead to a situation where both reserves and creditworthiness run out, and the balance of payments go drastically into deficit. Just as increasing foreign exchange inputs promote positive economic growth, correspondingly decreasing availability produces a downward spiral of economic decline which may be described as an implosion. The longer this downward process continues, the more disproportionally large will be the supply of foreign exchange needed to arrest it.

Killick rightly observes that a government's capacity to carry out an adjustment programme will depend heavily on the stage of development of the country's real and financial markets:

> In a mixed economy, this capacity will be determined by the efficiency of the market mechanism, by the structure and technical characteristics of production, and by the quality of decision-making and execution in the organs of the state ....the efficiency of the market system....is likely to be lowest in the least developed countries. Poor communications and transport, low levels of education and literacy, social and other obstacles to the mobility of labour, dualistic capital markets, heavy concentrations of monopoly and power, as well as the often maligned influence of the state interventions all conspire to make it so.[9]

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[9] Tony Killick, op.cit., p. 80.

As foreign exchange ceases to be a flexible resource and becomes an inexorable constraint, and with markets riddled with the rigidities and imperfections which Killick so starkly enumerates above, the employment of conventional policy instruments taking their effect through the workings of the market mechanism becomes futile. The use of the devaluation technique to shift resources from the non-taxable to the tradable sector is hardly likely to succeed.

A disequilibrium system exists when some indispensable resource becomes so scarce that a rise in its price does not evoke an increase in its supply. Such a system may be graphically depicted as a series of individual markets with perfectly inelastic supply curves, and downward sloping demand curves located so far to the right that no intersection between two curves is possible within the feasible region. An excellent example of a disequilibrium system arises when there is a prolonged drought. In such circumstances, normal market transactions are suspended and extra-market policy measures are used to allocate scarce supplies of water. In a balance of payments crisis it is the inelastic supply of foreign exchange which precipitates the disequilibrium system.[10]

The beauty of the market system is that it removes the necessity of tracking the inner workings of an economy. Using the changes in relative prices as a monitoring device, we can manipulate certain decision variables to achieve desired economic results through a series of automatic responses to market forces. In a disequilibrium system, the ordinary communication linkages become discontinuous as market after market fails to clear and signals that a price is high do not evoke a corresponding increase in supply. The market model must therefore be severely modified and resort taken to an approach

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10 See John Kenneth Galbraith, op.cit., especially Chap.4, "The Disequilibrium System".

which focuses more on the unique qualities of the economic system - The Systems Approach.[11]

The Systems Approach involves tracing through, step by step, the actual workings of the system. It means going to the roots of problems, which we may frequently find to be cultural, sociological, political or ideological, and not economic at all. In the case of complex systems, as small open economies are, we will not be able to develop deterministic models; we must have resort instead to heuristic models, in which experience, skill, patience and insight will count for more than will mastery of the most sophisticated market models.

Five Case Studies

The exchange rate strategies since 1970 of five Caribbean monetary authorities, provide us with variegated empirical data to test our hypothesis about the role of the exchange rate in the management of the balance of payments. The cases of Barbados, Trinidad and Tobago, Guyana, Jamaica and the East Caribbean States will be examined briefly below:

Barbados

Barbados operated on the exchange rate variable on one occasion. On untying from sterling on July 5, 1975, the Barbadian authorities revalued the Barbadian dollar by 9.5% against other currencies and pegged to the US dollar at a rate of US$1.00 - BDS$2.00. In making this decision, the authorities considered that they could be indifferent to the precise exchange rate over a considerable range. The convenient rate of two to one fell comfortably within this range and was selected. The rate has never been changed since then. In the negotiations leading up to the 1982-84 IMF standby arrangements, an exchange rate devaluation was discussed but not seriously contemplated. Instead the programme focused on fiscal and credit policies.

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[11] See C. West Churchman, **The Systems Approach,** New York, Dell Publishing Company, Inc., 1986.

Barbados passed all the performance criteria during the 18 month programme.

The conventional wisdom ever since 1975 has tended to view the Barbadian rate as overvalued. However, since then Barbados has negotiated the 1975 recession, the 1978 oil shock and the 1981-82 mini-depression with considerable elegance. Real growth between 1973 and 1985 has averaged 1.5% with per capita GNP of US$4,680.00 in 1985, placing Barbados in the World Bank category of Upper Middle Income Countries. Inflation has been kept under reasonable control, liberal exchange control regulations have remained in place, living standards have risen more or less continuously, and foreign debt liabilities have been discharged on their contractual terms.

However, unsustainable wage increases are the Achilles heel of Barbados. Barbadian administrations, except during the 18 month IMF standby, have pursued aggressive fiscal policies since 1980, and trade unions have consistently won wage increases far in excess of productivity gains. Whereas real output between 1980 and 1986 grew by less than five per cent, the wage index for the manufacturing sector has risen by more than 60 per cent. These gains have been obtained at the expense of chronic high unemployment (around 18 per cent), and heavy foreign borrowing. The official foreign debt has increased from US$82 million in December 1980 to US$277 million at the end of 1986. There are signs that Barbados' exports of goods and services are losing their competitive edge. If this situation is not reversed, it could very well make a currency devaluation necessary.

Trinidad and Tobago

Trinidad and Tobago presents the most fascinating case of all. It demonstrates clearly that the possession of large foreign exchange reserves does not necessarily mean that a currency rate is "in equilibrium". The first active use of the exchange rate policy by the authorities was the untying of the TT dollar from sterling and its pegging to the US dollar at the rate of US$1.00 = TT$2.40. This actually involved a devaluation of 12.7%.

Trinidad and Tobago at this time was enjoying the fruits (not all of them sweet) of an oil boom. Foreign exchange reserves moved from less than US$50 million in 1973 to over US$300 million in 1974, peaking at US$3.2 billion in 1981.

At the height of this foreign exchange affluence, acute observers, notably Sir Arthur Lewis in a conversation with me, perceived the TT dollar as being overvalued. The basis of his observation must have been the growing uncompetitiveness of the Trinidad and Tobago manufacturing sector. This was occasioned by massive wage increases, sometimes by as much as 100 per cent, and inflation rates in the middle or upper teens. By the end of 1983, the authorities had to resort to fierce import licensing and exchange control restrictions to shield domestic producers from the influx of cheaper and higher quality Caricom goods.

During the early 1980s the price of oil as well as its demand began to fall, and Trinidad and Tobago's foreign exchange reserves fell correspondingly from their 1981 peak of US$3.2 billion to US$1.2 billion at the end of 1984. The authorities devalued the TT dollar from US$1.00 = TT$2.40 to US$1.00 = TT$3.60. No doubt the authorities realized that with the collapse of oil revenues, the restoration of the competitiveness of Trinidad and Tobago exports and the reduction of imports was mandatory. In spite of this massive devaluation, the authorities have not yet dared to remove their non-tariff protectionist measures, and the nation's reserves continue their dramatic fall-by over US$0.5 billion during 1986. As long as manufactured exports from Trinidad and Tobago remain uncompetitive, a further devaluation cannot be ruled out.

Jamaica

Jamaica has been the greatest exponent of exchange rate devaluation in the Caribbean. Starting in December 1971 with a rate of US$1.00 = J$0.77, the Jamaican currency was devalued once in 1973, twice in 1977, twice again in 1978, and by monthly mini-devaluations through May 1979. A two-tier system was begun in January 1983 and unified at year end. An Auction system was then inaugurated with the J$ moving within

a predetermined band. A year later the band was removed so that the J$ could move freely. By April 1985 the J$ was trading at US$1.00 = J$5.50. Within 15 years the J$ had depreciated by a factor of almost six.

In spite of all these devaluations, and in spite of massive foreign borrowings from commercial and official sources and considerable grant funds from several friendly nations, the Jamaican economy has performed miserably. Real GDP declined at an average annual rate of 2.1% over the period 1973-1985. Government depended heavily on the Bank of Jamaica to finance its massive deficits, and the foreign debt rose from just over US$200 million in 1973 to over US$1.8 billion in 1985.

None of the beneficial effects claimed for devaluation seem to have been realized in Jamaica. The 1973 devaluation was probably influenced by a school of Caribbean economists promoting structural devaluation. A currency devaluation sufficiently deep, it was argued, would create such bottlenecks from the scarcity of foreign exchange as to elicit increased domestic output, and achieve a structural shift away from dependence on the metropolitan economies. The Caricom Secretariat published a tract in 1972, "Economics of Devaluation under West Indian Conditions", which supported this position. In fact, the oil shock of 1974 mimicked to a large extent the intent of the structural devaluation school, but with sombre consequences. The structural devaluationists have not been heard from in many years.

The best review so far of the Jamaican experience is by Derrick Boyd.[12] His study shows that sharp devaluations failed to halt the decline in exports or to arrest the merchandise trade deficit. Attractive rates in the parallel free market failed to staunch the hemorrhage of private capital outflows. At the same time, devaluations increased the domestic cost of external debt

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12 Derrick Boyd, "Macro-economic Stabilisation in Jamaica: The Lessons of Recent Experience", Working Paper No.19, Overseas Development Institute, London, July 1986.

service, swelling the government deficits and creating even further instability.

The only area of improvement was in production for the domestic market. The general reduction in imports forced the population to shift from imported to local produce. There was some improvement in the non-traditional export sector, but this was slight in comparison to the decline in traditional exports of bauxite/alumina, sugar and bananas, which could not buck adverse conditions prevailing in international commodity markets. The tourism sector, which benefited from numerous government incentives, also performed disappointingly.

The lesson of the Jamaican experience is that even the deepest devaluations cannot compensate for inappropriate policies of credit creation, populist import policies, the absence of wage restraint, a cyclical downturn in international commodity prices, and social and political instability. Only those commentators with an axe to grind now deny Boyd's assessment, that in the first Manley Administration "insufficient regard was taken of the internal and external constraints within which the economy had to perform." [13]

Government's nominal expenditures averaged a 32% rate of growth over the 1972/73 - 1976/77 fiscal years, with the overall budget deficit increasing from 5 % to 24% of GDP over the period 1972-76. Moreover, according to Adlith Brown,[14] "government expenditure reflected consumption rather than investment." Policies of import control followed a feast or famine cycle. In 1982 consumer goods rose by a massive 44% over 1981. The Manley Administration deliberately permitted real wages to rise - by 50% and 60% respectively, in 1974 and 1975, while the Seaga government could never persuade the Trade Unions to accept an incomes policy. Finally, social and political unrest led

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[13] Ibid, p. 14.

[14] Adlith Brown, "Issues of Adjustment and Liberalisation in Jamaica: Some Comments", ***Social and Economic Studies,*** Vol.31, No.4, December 1982, p. 199.

to the mass emigration of professionals, skilled workers and entrepreneurs. No devaluation, no matter how deep, could have deterred them from taking all the foreign exchange they could in search of physical safety. Unavoidably they took their precious human capital as well, contributing to the downward spiral of economic decline which our model explained above.

Guyana

The Guyanese case is the saddest of all. Guyana's first devaluation actually took place in 1971 when the currency was pegged to the US dollar at US$1.00 = G$2.55, a devaluation of 8.5%. That rate was held until June 2, 1981, when it was announced that the G$ exchange would be determined by movements in the composite rate of a basket of goods comprising US$, LStg, DM, TT$ and the Yen. The Guyanese dollar was then fixed at US$0.333. On January 11, 1984, the basket of currencies was changed to LStg, DM, French Franc, Neth. guilder and the Yen, and the currency fixed at US$1.00 = G$3.75. The rationale and workings of the new regime are quite mysterious. According to Bourne et al, "The Guyanese authorities continued to operate the exchange rage system without reference to the basket for a long time after it was introduced." [15] In 1986 the Guyana dollar was once again devalued to US$1.00 G$10.00. In addition, there is an open window at commercial banks where US dollars are traded at rates in excess of US$1.00 = G$20.00. Effectively, the Guyanese dollar has been devalued since 1971 by a factor of almost forty.

In 1974 Guyana was the best placed of Caricom non-oil exporters to withstand the oil shock. It possessed four strong foreign exchange earners - alumina/bauxite, sugar, rice and timber. It also produced much of its own food. For reasons grounded in ideology, the Guyanese Government embarked on a policy of public spending supported by central bank credit creation. Respectable foreign reserves of US$85 million (1975 was a bumper year for sugar) were completely wiped out during

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[15] Op. cit.

1976. The Guyanese foreign debt moved from US$208 million in 1975 to almost US$700 million in 1985, while total foreign reserves slumped to more than a negative US$500 million. In the meantime, Guyana, formerly considered a more developed Caricom country (MDC), has become the most impoverished Caribbean state after Haiti.

As in the case of Jamaica, devaluation could not offset the effects of fantastic money creation and other inappropriate economic policies; nor could it halt financial or human capital flight as thousands of skilled Guyanese fled what they considered to be intolerable social, economic and political conditions; nor could it shift resources into tradable goods in the face of falling commodity prices and production bottlenecks brought about by the severe shortage of foreign exchange, and this, in spite of the fact that Government was able to hold real wages at extremely low levels.

The efficacy of the devaluation technique was also reduced by socialization policies which minimized market operations. With more than 75% of organized industry and commerce nationalized, there was little scope for market-oriented policies to take effect. The Guyanese economy became the dis-equilibrium system ***par excellence,*** and as domestic capital resources evaporated and foreign sources of foreign exchange dried up, the system imploded as our model predicts.

The Organization of Eastern Caribbean States

I have left the happiest story for the last. The OEC states used the devaluation tool only once - on July 7 1976, when they untied from sterling and pegged to the US dollar at the rate of US$1.00 EC$2.70. This involved only a slight devaluation on that day, but established the EC$ at US$0.13 and US$0.05 weaker, respectively, than the currencies of Barbados and Trinidad and Tobago, their main trade competitors. The EC dollar has never been moved since then.

In spite of natural disasters in the region, especially the eruption of Mt. Soufriere in St. Vincent and a hurricane in

Dominica, and the man-made catastrophe in Grenada, all seven OEC states - Antigua and Barbuda, Dominica, Grenada, St. Lucia, St. Kitts and Nevis, and St. Vincent, together with Montserrat, have all put in respectable performances. Over the period 1973-85, the OEC states all recorded positive growth rates ranging from 1.2% for Antigua and Barbuda to 5.0% for St. Lucia, and 5.1% for Montserrat. Their 1985 per capita incomes range from US$970.00 for Grenada to US$2,030.00 for Antigua. Montserrat's per capita income in 1984 was an impressive US$2,780.00. The comparable statistics for Guyana and Jamaica respectively, are -1.2% and -2.5% growth from 1973-85, and GDP per capita of US$570.00 and US$940.00 in 1985. In addition, the OEC states have controlled their inflation far better than either Guyana or Jamaica, or for that matter than Barbados or Trinidad and Tobago.

The moral of this story is clear. The constitution of the East Caribbean Authority (later the East Caribbean Central Bank) severely limited the credit creation powers of the monetary authorities. Government expenditures were restricted to tax revenues, foreign aid and foreign loans. Their adherence to a currency board type of operation limited credit creation by the monetary authorities, and their unsophisticated financial systems inhibited autonomous credit creation by the banking system. By force of circumstances, the governments in these states pursued "appropriate" fiscal and monetary policies. Wage rates were also constrained by the inability of the monetary authorities to validate excessive wage demands through credit creation. Also significant is the unanimity rule in important policy decisions. Agreement on a change in currency value is a long and involved political process. There is no other choice than to pursue a passive exchange rate policy and to force the other decision variables - fiscal, credit, and incomes policies - to bear the brunt of adjustment. This approach has worked very well for the OEC States.

Findings and Conclusions

Our findings from the five Caricom case studies support the hypotheses of our model. Following is a summary:

1. There was no evidence that an active exchange rate policy, whether involving revaluation or devaluation, improved the balance of payments performance of the countries studied.

2. The period under review was one of extreme international exchange rate instability. We must assume then that the currencies of those countries whose rates remained fixed must have been 'overvalued' at some time. Yet those countries which maintained stable exchange rates, performed better than those which devalued frequently. It must either be that the non-devaluers found appropriate compensating policies, or that small open economies possess considerable tolerance to exchange rate misalignment. It also suggests that the internal instability created by repeated devaluation was more damaging than external instability with currency misalignment.

3. Excessive credit creation appeared to contribute more than any other factor to the deterioration of the balance of payments.

4. Excessive wage rates became critical when they rendered a country's exports uncompetitive and made devaluation mandatory.

5. In the case of Caricom states, falling commodity prices and international recession dominate the exchange rate factor in the balance of payments adjustment process.

6. Even deep devaluations were unable to effect a significant shift in resources from the domestic to the export sector. The increased cost of imports occasioned by devaluation did result in some import-substitution.

7. Once public confidence in the economy had collapsed, even deep devaluations were unable to halt the flight of financial capital, especially when in coincidence with the flight of human capital.

8. Finally, the reliance placed by the IMF and the World Bank on the currency devaluation as a policy instrument for the restoration of balance of payments stability appears to be excessive. This is not surprising. Lord Kaldor, a strong advocate of the 1967 devaluation in the U.K., admitted more than a decade later: "I greatly overstated the effectiveness of the price mechanism in changing the relationship of exports to imports at any given level of income."[16] More recently, we have seen the value of the US dollar fall by almost 40% against the DM and the Yen in less than two years, with very little effect upon the U.S. foreign payments deficit. Both of these examples involved economies with much more efficient markets than those of Caricom states.

It is ironical that the International Monetary Fund, which was established to promote international exchange rate stability, has made currency devaluation the centre piece of its adjustment programmes. Its emphasis on the equilibrium exchange rate has reminded me of Jay Forrester's brilliant paper, "The Counterintuitive Nature of Complex Systems".[17] In it he posits two interesting theorems. The first is that there are points of entry into any complex system which, with a slight effort, will produce disproportionately rich results. The second is that the point of entry which first occurs to the observer is the wrong one. This is because complex systems, whose main purpose is to preserve the ***status quo,*** will send out decoys to attract interlopers to the point of entry which will least disturb their equilibrium.

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[16] Nicholas Kaldor, **Further Essays on Applied Economics,** London, Duckworth, 1978, as quoted by ***The Economist,*** January 20, 1979, p. 111.

[17] Jay Forrester, "The Counterintuitive Nature of Complex Systems", **Systems Behaviour**, eds. John Beisham and Geoff Peters, London, Harper and Row, 1972.

The validity of Forrester's theorems have been confirmed by the Caribbean experience. In spite of every variety and depth of devaluation, the subject economies have remained mired in a condition of low productivity, high inflation, and rising debt. Only those states have flourished which, through sensible economic policies, have preserved exchange rate stability. In the management of the balance of payments adjustment process, the equilibrium exchange rate has proven to be a decoy!

Some Recommendations for Institutional Reform

In their study, Compton Bourne et al found that exchange rate differentials among Caricom partners did not for very long confer competitive advantage upon the devaluing member, since costs resulting from the devaluation itself quickly fed into the production system.[18] However, the perception of member countries that devaluations by other members place them at a grave disadvantage is difficult to suppress and has, on occasion, caused bitter disagreement and vigorous retaliation. It is therefore in the interest of the CARICOM integration movement that institutional arrangements are developed which promote exchange rate stability among member countries, and provide for orderly exchange rate adjustments.

One obvious approach is to identify the factor most likely, indeed most certain, to precipitate the need for an exchange rate adjustment, and devise a system which makes its development most unlikely. We have identified that factor as excessive credit creation. The system which would guard against the abuse of credit creation is right before our very eyes - the East Caribbean Central Bank.

As we have noted above, since the constitution of that Central Bank limits its money creation powers, and since no single government can force the Bank to create new credit for its account, the shareholders collectively have been compelled

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[18] Op. cit.

to pursue conservative policies of credit creation. This situation has also stiffened the backbone of governments negotiating with trade unions: unlike the governments of Guyana, Jamaica, Barbados, and Trinidad and Tobago, they cannot order the Central Bank to print money to satisfy extravagant union demands.

The establishment of a CARICOM Federal Reserve System would achieve the same result for the entire community. All central banks would be associated under a constitution which provided for a common currency, or currencies with a fixed relationship and full convertibility within the region. Reserves would be pooled and free movement of capital would be permitted as was the case within the old Sterling Area. It is amazing that up to the early 1970s millions of pounds could move freely between Barbados and Australia or even between Barbados and Iceland, whereas today not even $100.00 can be transferred within CARICOM without some form of exchange control approval.

A Federal Reserve System of the Caribbean would also provide structured and ongoing arrangements for joint discussion of regional policies, and would promote the coordination of national economic policies along the lines now being pursued by the Group of Seven nations - U.S.A., U.K., West Germany, France, Japan, Canada and Italy. IMF programmes might be jointly negotiated - an excellent idea once put forward by Maurice Bishop, the late Prime Minister of Grenada. Such an organization could well serve as the catalyst for a more effective regional economic system. Above all, it would save both the electorate and the politicians from themselves.

5 The Rationale of Interest Rate Policy in Barbados 1972-1987*

Introduction

s a central bank governor I found myself frequently in the paradoxical situation of justifying to IMF and World Bank officials our intervention in the financial markets while continually arguing with my Barbadian colleagues, and even with my own staff, about the importance of restricting such intervention to the absolute minimum.

Actually, the older I grow, the more comfortable I am with paradox. I am convinced that truth is usually embedded in paradox and I have become most skeptical of uncomplicated theories and situations. For example, I find myself most sympathetic with the Pope's position that abortion is morally wrong; I also approve of legalized abortion. Just as unwanted pregnancies do occur in the real world, central banks also find it necessary to intervene in the market place from time to time to regulate interest rates.

* Paper presented at the seminar on Interest Rate Management St. Kitts, March 28 and 29, 1988.

The orthodox position on interest rate management is based on the work of Professors Ronald McKinnon and Edward Shaw. They analyze the developing economy as "financially repressed" and argue that financial repression, i.e. distortions of financial prices, including interest rates, reduces the real rate of growth of the financial system relative to non-financial magnitudes and invariably halts or severely retards the development process. According to Maxwell Fry, "A common feature of all models in the McKinnon-Shaw framework is that the growth-maximizing deposit rate of interest is the competitive free-market equilibrium rate."[1]

The McKinnon-Shaw thesis has exerted a tremendous influence on IMF and World Bank policy prescription, which stresses the removal of interest rate ceilings, the allocation of credit through the free market mechanism, the maintenance of positive rates of interest, and general financial liberalization.

I confess to serious heresies in the conduct of interest rate policy in Barbados over the period 1972-1987. I trust that the justifications which I set out in this paper will reduce the period of purgatory in the place below reserved for delinquent central bankers. The interest rate policy pursued by Barbadian authorities in the period 1972-1987 was predicated on:- (1) the recognition that financial markets were highly imperfect; (2) the imperative of economic development; (3) a concern to insulate the economy against the extreme volatility of the international financial system, and (4) the development of financial markets.

Market Imperfection

That markets in developing countries are imperfect is a truism; if their markets were perfect they would not be developing countries. Small size itself is an important source of market imperfection. As Professor Boulding observes,

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1 Fry, Maxwell J., **Money, Interest and Banking in Economic Development,** Baltimore and London, The Johns Hopkins Press, 1988, p. 420.

> ... In the mass human behaviour is fairly regular - which explains, incidentally, why so much of economics assumes the mass-interactions of perfect competition and why indeterminacy appears in the theory of oligopoly - i.e. in the interaction of few exchanges.[2]

The commercial banking market in Barbados represents a classic oligopoly. For most of the period under review four foreign banks accounted for more than three quarters of all commercial bank deposits. In the absence of antitrust legislation, collusion has traditionally been accepted. Indeed, I was once invited by a commercial bank manager to have "consultations" with him prior to the treasury bill auction. Oligopoly theory accurately predicts that in these market conditions prices will be higher than in a purely competitive situation and that excess profits will usually be realized.

The Barbadian experience confirms the hypotheses of oligopoly theory. Commercial bank loan rates, which rose readily in times of tight liquidity, were extremely sticky downwards. On the other hand, deposit rates which fell rapidly in periods of excess liquidity, proved most sticky upwards. The Central Bank Annual Report for 1975 notes:

> In spite of a sensational build-up in liquidity and a weak demand for loans, commercial banks lowered their lending rates only slightly and by year end the prime rate had fallen by no more than 1½ percentage points from the 11% prevailing in January ....Meanwhile, interest rates for 12-month deposits had been lowered from a maximum of 10% to 7%, with one bank offering as low as 5%. Commercial bank lending rates which had moved up in sympathy with rates in Euromoney markets showed a disturbing stickiness downwards.[3]

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2 Boulding, Kenneth E., **Beyond Economics,** Ann Arbor Paperbacks, University of Michigan Press, 1970, p.193.

3 Central Bank of Barbados, ***Annual Report*** 1975, p.3.

It is not surprising that commercial bank staff are the most highly paid workers in the society!

Another feature of the commercial banking market in Barbados was the confrontation of oligopoly and oligopsony. Three or four major commercial enterprises (still anachronistically referred to as the "Big Six") account for a disproportionately large share of commercial bank loans. They exert amazing market power vis à vis even the largest commercial banks. In our efforts to regulate commercial bank credit to the distributive sector, we discovered that the leading commercial houses were able to maintain large contingent lines of credit without any compensation to commercial banks.

In these circumstances the Central Bank exerted in the financial markets what Professor John Kenneth Galbraith describes as a "countervailing power". Our object was to bring about market conditions which simulated, as closely as possible, those which would prevail in a theoretically perfect market.

The Central Report for 1976 reports:

> When moral suasion proved inadequate, the Central Bank, for the first time in its history, directed that commercial banks should lower their prime and average lending rates to levels not exceeding 8.5% and 10%, respectively.[4]

The Central Bank also made it clear that variable mortgage rates were flexible in either direction. At a time in 1978 when the prime rate stood at 8½%, the Central Bank placed a floor of 3% under the rate for savings deposits. Twice in 1980 Central Bank directed commercial banks to increase the savings deposit rate - from 3% to 5% and from 5% to 7%, in tandem with increase in the minimum lending rate.

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[4] Central Bank of Barbados, ***Annual Report*** 1976.

In regulating loan rates the Central Bank was also concerned to blunt the consequences of the oligopoly-oligopsony connection. The establishment of a simple rate ceiling would permit the oligopolists to extract extremely low loan rates from the oligopolists who, in turn, would recoup their losses at the expense of weaker borrowers. The Central Bank therefore stipulated a weighted average lending rate and a minimum lending rate, thus forcing the major borrowers to carry their fair share of the burden. Loan rates were deliberately left without a ceiling, permitting borrowers access to loans for potentially profitable but high-risk ventures.

This Barbadian strategy has recently received recognition in the literature. Maxwell Fry writes:

> At the same time, bank cartels must be destroyed and financial intermediaries made to behave competitively. The optimal competitive solution might have to be forced upon some of the sample countries' cartelised and/or oligopolistical financial systems by fixing **minimum** deposit rates of interest and obliging depository institutions to satisfy all deposit demand at these rates. This would be the only control needed to produce the competitive result, provided loan demand were elastic at rates above the competitive loan rates of interest (Fry, 1980b). Minimum deposit rates are clearly preferred to licence fees as a means of tapping monopoly profit. **Barbados** is the only economy in the sample in which minimum deposit rates are set.[5]

The rationale of the Bank's position was that it could not pretend that the financial markets were competitive and efficient when both intuitive and empirically observed data suggested the opposite. In this respect, the example of the airline industry in the U.S.A. is most instructive. President Carter was persuaded

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[5] Fry, Maxwell J., Financial Sectors in Some Small Island Developing Economies", in Problems and Policies in Small Economies, ed. B. Jalaw, London, Croom Helm, 1982, p. 193.

to apply the competitive free market model to the naturally oligopolistic airline industry. Under the inevitable cut-throat price competition which ensued, the small airlines went to the wall and a number of good-sized companies were forced to merge. The travelling public have paid for their lower airfares with a sharp deterioration in service and reduced safety standards. Meanwhile, there are fewer airlines in operation than ever before and there is the distinct likelihood that an even more powerful oligopoly will emerge, able to extract even higher excess profits than before deregulation.

Economic Development

Interest rate policy was used by the Central Bank to ensure that an adequate supply of credit flowed to the productive sectors of the economy, especially the foreign exchange earning sectors. This was to be achieved at the expense of the consuming sectors. Whereas the Central Bank sometimes depressed interest rates on loans to tourism, manufacturing and agriculture, the rates on hire-purchase loans, which financed the importation of high-priced consumer durables, were left entirely to the market. However, the Central Bank did promote a truth-in-lending Bill to inform borrowers of their true interest costs.

In "normal" times the Central Bank merely tried, as explained above, to simulate the credit conditions of a theoretically perfect market. In times of abnormally tight credit, interest rate policy was designed to contain the financing costs of the productive sectors (within "safe" limits). Basically, selective credit controls were used to supplement the price mechanism in the allocation of credit. This is not unlike the policy of rationing scarce supplies taken by the U.S.A. and the U.K. in time of war. For Third World countries the struggle for development is almost tantamount to war.

Sometimes the Central Bank subsidized the interest rate costs of the agricultural sector, the fledgling manufacturing sector, and the small business sector. (Assistance to the two latter was insignificant). This was achieved by means of rediscounts at preferential rates and amounted to a disguised

grant from Government whose profits from Central Bank operations were correspondingly reduced. Compared to the largesse which American and West European farmers enjoy, these subsidies were quite modest. On another occasion the Central Bank depressed the mortgage interest rate deliberately to inhibit investment in private housing at a time when Government development projects had exhausted the man power resources in the construction sector.

The Central Bank was extremely sensitive to the importance of the commercial bank overdraft in the financing of medium-sized and small enterprises. The annual Report of 1981 explains:

> The Directors were deeply conscious of the heavy dependence of local enterprise, especially mall business, on commercial bank loans, and even for long term capital, and were therefore reluctant to let interest rates follow the U.S. trends.[6]

In fact, in the absence of a developed stock exchange, the commercial bank overdraft serves as a substitute for equity. The advantage of equity is that dividends can be skipped, whereas interest charges must be met whether the enterprise is profitable or not.

The interest rate policies of the Central Bank did at times transgress the most sacred tenet of the McKinnon-Shaw thesis - the maintenance of positive real interest rates in economic development. Savings are assumed to be a function of real interest rates; investment is seen as a function of savings, and economic growth as a function of investment.

At the Central Bank we treated the relationship between savings and the real rate of interest as an empirical question. Our studies suggested that aggregate savings were primarily determined the national income and by custom, whereas the

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6 Central Bank of Barbados, ***Annual Report*** 1981, p. 5.

relative rates of interest among various financial assets determined the portfolio mix of investors. Maxwell Fry, who is not unsympathetic to the McKinnon-Shaw School, admits:

> The evidence presented ... suggests that financial conditions exert modest impact on the overall level of savings and a considerable effect on the efficiency with which both national savings and foreign savings are allocated among alternative investment projects.[7]

In its treatment of economic development the McKinnon-Shaw School also assume that financial savings will be automatically transformed into real growth. They take for granted effective operations of the real sector. In fact, the development of the financial sector depends on expansion in the real sector. If enterprises in the main sector are decimated by extraordinarily high interest rates, the development of the financial markets will not matter. For example, interest rate policy is hardly relevant in countries where the productive system has collapsed.

Insulation from the External Environment

All recent Barbadian Administrations have deliberately pursued "openness" as an integral part of their economic strategy. They decided early against restrictive exchange control measures and extensive import licensing. They also judged that it would have been both costly and futile to police a black market in a foreign exchange in a tourism-oriented economy. The corollary of this strategy was the pursuit of policies, including interest rate policy, which would maintain a realistic relationship between internal and external prices.

The Central Bank was extremely apprehensive about the possibility of capital flight should a wide enough differential open up between domestic and international interest rates. The first threat to the system came in 1973 while rate funds still moved

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7 Fry, Manwell, **Money Interest and Banking,** op. int. p.153.

freely within the Sterling Area. Recognizing that capital was more likely to move in large rather than in small blocks, the Central Bank permitted higher interest rates on deposits over $10,000.00 and $25,000.00. The 1981 ***Annual Report*** states:

> ... the growing differential between US and domestic rates became increasingly uncomfortable. Many foreign businesses which had retained their profits in Barbados for many years began to find the opportunity cost of keeping their funds here unacceptable. In addition, Barbadian importers either had to pay promptly for their foreign supplies or endure harsh credit terms, while it suited the foreign importers of Barbadian goods to delay payments as long as possible. The local branches of foreign commercial banks, who have traditionally maintained a debit position with their head offices, were also motivated to keep their foreign borrowings to a minimum and to meet their liquidity needs by short-term borrowings from the Central Bank.[8]

With international interest rates reaching unprecedented levels, the Monetary Authorities permitted interest rates to rise as high as the survival of industry and commerce seemed to permit. In 1981 the minimum savings rate reached 8% and the average lending rate a peak of 15% while selective credit restrictions were used to ration credit - always to the benefit of producers and at the expense of consumers. At the same time, interest rate subsidies were stepped up to the Sugar industry and to the Barbados Development Bank for onlending to the hardest hit elements of the productive sectors. To discourage foreign commercial banks from substituting short-term borrowings from the Central Bank for head-office accommodation, the Central Bank raised its discount rate to a record 22%. A similar concern was voiced again in the Annual Report of 1983. The concern of interest rate policy was always the survival of the productive sectors until the days of low rates returned. They always did!

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[8] Central Bank of Barbados, ***Annual Report*** 1981, p. 5.

Developments of Financial Markets

The position of the Central Bank on the importance of financial markets in economic development is not seriously divergent from that of the McKinnon-Shaw School. Although pragmatic considerations sometimes dictated market intervention and financial repression, the Central Bank regarded these occasions as exceptional. Basically the Bank accepted the price mechanism as the most satisfactory allocator of scarce financial resources. We would not have contested the judgement of Tun Wai and Patrick:

> An essential condition for an effective capital market is that prices be determined freely by interaction of forces determining demand and supply. Yet the low interest rate policy pursued by governments in many LDCs conflicts with the principle and practice of freely determined market prices for securities, notably for bonds.
>
> The moral is that the development of capital markets requires freedom from government attempts to control interest rates in that market.[9]

In particular, the Central Bank was able to persuade Government that its borrowing costs should reflect demand/ supply conditions in the credit markets. The Central Bank 1974 Annual Report records:

> In keeping with its policy of fostering the development of a money market, the Bank permitted the Treasury Bill rate to move in sympathy with general market rates. During the year, the rate of ninety-one day Treasury Bills fluctuated between 10.3% and 8%, moving consistently downward after April as market conditions eased. It is hoped that a realistic rate will induce private institutions to regard the Treasury Bill

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[9] Tun Wai, V and Patrick, Hugh H., "Stock and Bond Issues and Capital Markets in Less Developed Countries", International Fund Staff Papers, 20(2) July 1973, p. 283.

> as logical investment for temporary liquid funds. At the same time, a market rate for Treasury Bills reflects more accurately the economic cost of short-term borrowing by Government.[10]

By encouraging Government to incorporate tax-free features in its issues of medium and long-term debentures, the Central Bank was able to market an increasing volume of Government debt to voluntary holders. In only one or two years did the Bank take significant positions in Government long-term debt. At times during 1979, it held no Government paper at all. The Central Bank also used the interest rate tool in the promotion of the National Savings Bond which was sold in denominations of from $50 to $1,000 and directed at small savers. Discount rates were significantly higher than savings rates and yields rose as Bonds were held to their full five year maturity. Yields on these bonds were also tax-free. They usually sold like hot cakes and were not frequently cashed in.

Concluding Remarks

I conclude by returning to the two paradoxes I introduced earlier - my position on market intervention and on the abortion issue. In both cases the dialectical clash of apparently contradictory positions have produced useful and good outcomes - if you believe, like Plato, that the good is the useful.

In one case the Pope's uncompromising position inhibits the faithful from actions which give rise to unwanted pregnancies, while legalized abortion protects the weak and the unlucky from the dangers of back-room surgery. In the other instance the Central Bank's bias in favour of resource allocation through the market mechanism ensured that resort to interest rate ceilings and subsidies would be determined by the pragmatics of the situation; financial repression was thus kept to a minimum.

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[10] Ibid., ***Annual Report*** 1974, p 2.

One final caveat! Meaningful interest rate policy can only be formulated in the context of sound fiscal policy. None of the above considerations could realistically have been pursued in the face of a loose and irresponsible fiscal policy which produced unsustainable fiscal and foreign deficits, and which promoted inflation. In those circumstances interest rate policies are at best ineffectual, at worst irrelevant.

6

Structural Adjustment in Conditions of Disequilibrium*

Introduction

his Paper takes off from the First Adlith Brown Memorial Lecture, 1985, **A Heterodox Approach to the Adjustment Problem.**[1] In that Paper I developed Leijonhufvud's hypothesis of the "corridor", to which Nobel Prize Laureate Robert Solow refers:

> .... there is an equilibrium path that is surrounded by what he calls a corridor, a range above and below the equilibrium path. If the economy is disturbed off the equilibrium path and remains within the corridor, normal market forces can bring the economy back; if the disturbance moves the economy outside the range, then inflationary and contractionary expectations and assumptions may become so strong that the normal market forces are unable to push the economy back to a satisfactory state. Physically, it would be like the

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* Paper presented at CEMLA Policy Seminar, Central Bank of Barbados July 8 - 9, 1991.

1 Blackman, Courtney N., **A Heterodox Approach to the Adjustment Problem,** Institute of Social and Economic Research, January 1986.

> cup on the desk. If you tilt it a little bit, it will go back to upright. But if you tilt it too much, it will fall.[2]

I suggested some additional hypotheses to accommodate the situation of developing countries: **(Cf. Figures 1a and 1b)**

1. Because of more highly developed markets the "corridor" within which normal market forces can bring the economy back to the equilibrium growth path is wider for developed countries than for LDCs.

2. There is a "lane" on each side of the corridor within which market-oriented policies, i.e. fiscal, monetary and exchange rate policies will restore the economy back to its equilibrium path. Again because of differences in market perfection, the lanes for LDCs will be narrower than for developed countries. We may describe an economy operating in either of these lanes as being in a situation of "partial disequilibrium".

3. As an economy moves outside the lane, it enters a situation of chronic disequilibrium. In this situation market-oriented policies lose much of their efficacy, and resort must be made to non-market techniques to restore the economy first to partial disequilibrium and then to its long-run equilibrium growth path.

I contended then that for economies in chronic disequilibrium, market oriented policies, particularly the standard prescriptions, lose much of their efficacy and relevancy, and may actually make the situation worse than before. This position challenges the validity of the structural adjustment programmes of the World Bank and IMF, which place great store by currency devaluations and high positive real interest rates.

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[2] Solow, Robert M., as quoted by Arjo Klamer in **Conversations with Economists,** Rowman and Allanheld, Totowa, N.J., p. 133.

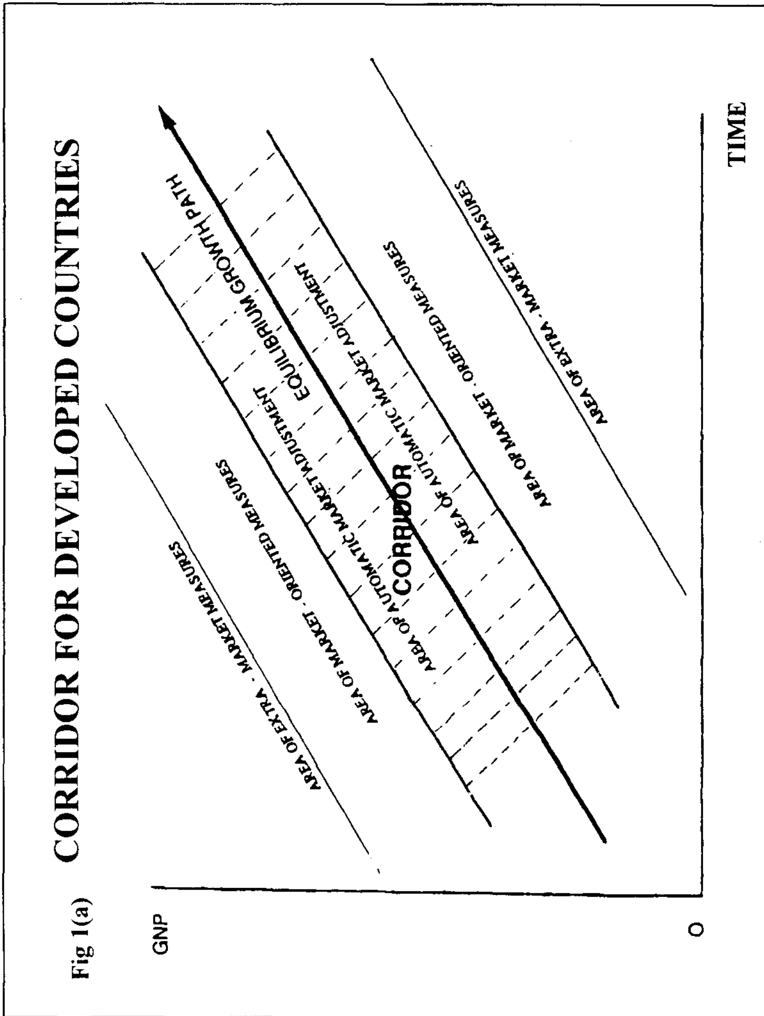
Fig 1(a)
CORRIDOR FOR DEVELOPED COUNTRIES
GNP
O
TIME
EQUILIBRIUM GROWTH PATH
CORRIDOR
AREA OF EXTRA - MARKET MEASURES
AREA OF MARKET - ORIENTED MEASURES
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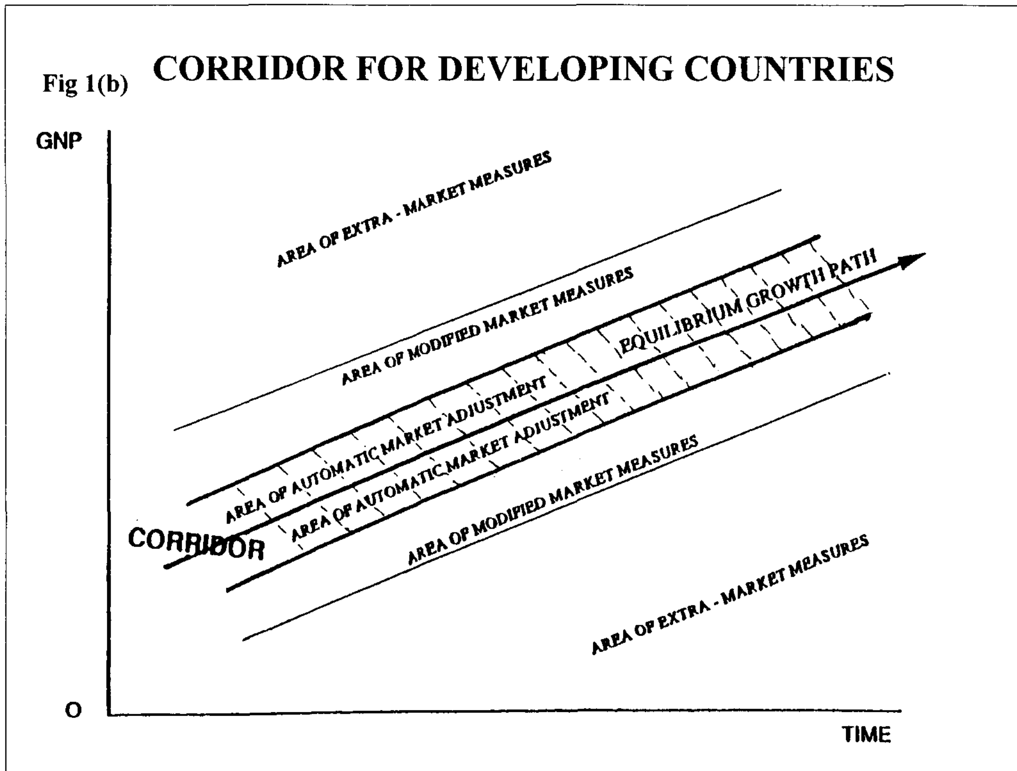
Fig 1(b)
CORRIDOR FOR DEVELOPING COUNTRIES
GNP
AREA OF EXTRA - MARKET MEASURES
AREA OF MODIFIED MARKET MEASURES
EQUILIBRIUM GROWTH PATH
AREA OF AUTOMATIC MARKET ADJUSTMENT
AREA OF AUTOMATIC MARKET ADJUSTMENT
CORRIDOR
AREA OF MODIFIED MARKET MEASURES
AREA OF EXTRA - MARKET MEASURES
O
TIME

In this Paper I develop this thesis further in the search for appropriate policy measures for dealing with economies in chronic disequilibrium. The theoretical discussion will be illustrated by the experiences of Jamaica and Guyana since the late 1970s, which I have identified as economies in chronic disequilibrium. The Trinidad and Tobago economy strayed into partial disequilibrium but recovered before it slipped into chronic disequilibrium. Market oriented measures, such as devaluation plus macroeconomic demand management measures, were sufficient to rescue that economy.

This Paper is organized as follows. First we define conditions of chronic disequilibrium with special reference to the Caribbean. Secondly, through graphical analysis we explore the effects of disequilibrium on foreign exchange markets. Thirdly, we explore the impact of high positive real interest rates on the financial markets of economies characterized by chronic disequilibrium. In closing we outline an alternative approach to structural adjustment in conditions of chronic disequilibrium.

The Disequilibrium System

The term "disequilibrium" has been adapted from Professor John Kenneth Galbraith's description of the US War economy: "Because it was a distinctive and pervasive feature of the system, I have used this disequilibrium of demand and supply to name the system as a whole." In such a system Galbraith observed,

> For regulating the use of resources, the available choice is between the incentives and compulsions of the market, and authority. Market incentives are incapable of producing the comprehensive transfers in resource deployment that any considerable mobilization requires.[3]

A disequilibrium system exists when a critical factor or factors of production for which no substitutes exist, are in

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[3] Galbraith, John Kenneth, **A Theory of Price Control,** Cambridge, Harvard University Press, 1980, p.30.

extremely scarce supply; or when, in the jargon of economists, their supply is perfectly inelastic at least in the medium term. At the outbreak of World War 11, the supply of steel and leather (for army boots) in the USA became highly inelastic overnight. In such circumstances, a rise of factor price could not elicit an increase in supply; it would merely have added to inflationary pressures. For this reason, non-market measures, such as rationing and official directives, were employed to allocate scarce resources among alternative uses.

In the struggle for the development of small, open developing countries, foreign exchange is the non-substitutable factor of production. Without foreign exchange or foreign credits, capital equipment, raw materials and intermediate goods, as well as food and other staples, would be unavailable. Adverse external factors, but especially inappropriate public policies, have conspired to create a situation of chronic disequilibrium in the foreign exchange markets of Guyana and Jamaica. This is characterised by a highly inelastic supply of foreign exchange. We may also observe a high inelasticity of demand for foreign exchange in Jamaica, and especially in Guyana, where citizens, in their eagerness to obtain essential goods or to emigrate, are willing to purchase any US dollars available at the price asked.

Disequilibrium in Foreign Exchange Markets

The situation existing in a normally functioning foreign exchange market is shown in **Figure 2a.** Note that a movement up the *y* axis from P1 to P2 - i.e. a currency devaluation - results in the restoration of equilibrium. **Figure 2b** describes a situation in which disequilibrium between demand and supply is only partial and both supply and demand curves are more inelastic. Since it would require a severe devaluation to restore equilibrium, the authorities might resort to extensive foreign borrowing to shift the supply curve for foreign exchange parametrically to the right, and simultaneously implement fiscal and monetary policies to restrain demand and so shift the demand curve parametrically to the left. Note that this policy choice becomes more and more difficult as the extent of disequilibrium increases and as supply and demand becomes more inelastic.

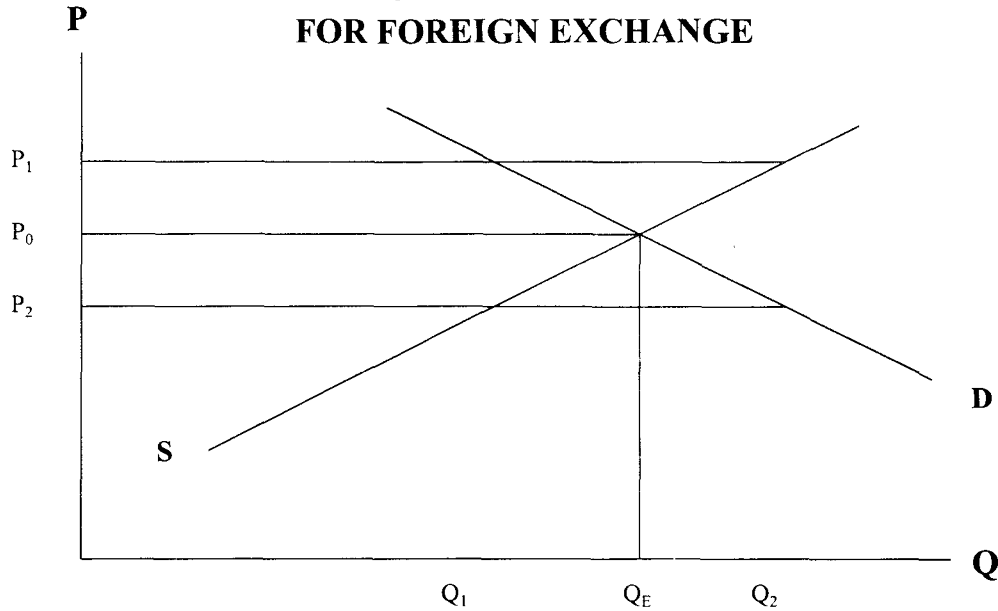

Fig. 2(a)

AUTOMATIC MARKET ADJUSTMENT FOR FOREIGN EXCHANGE

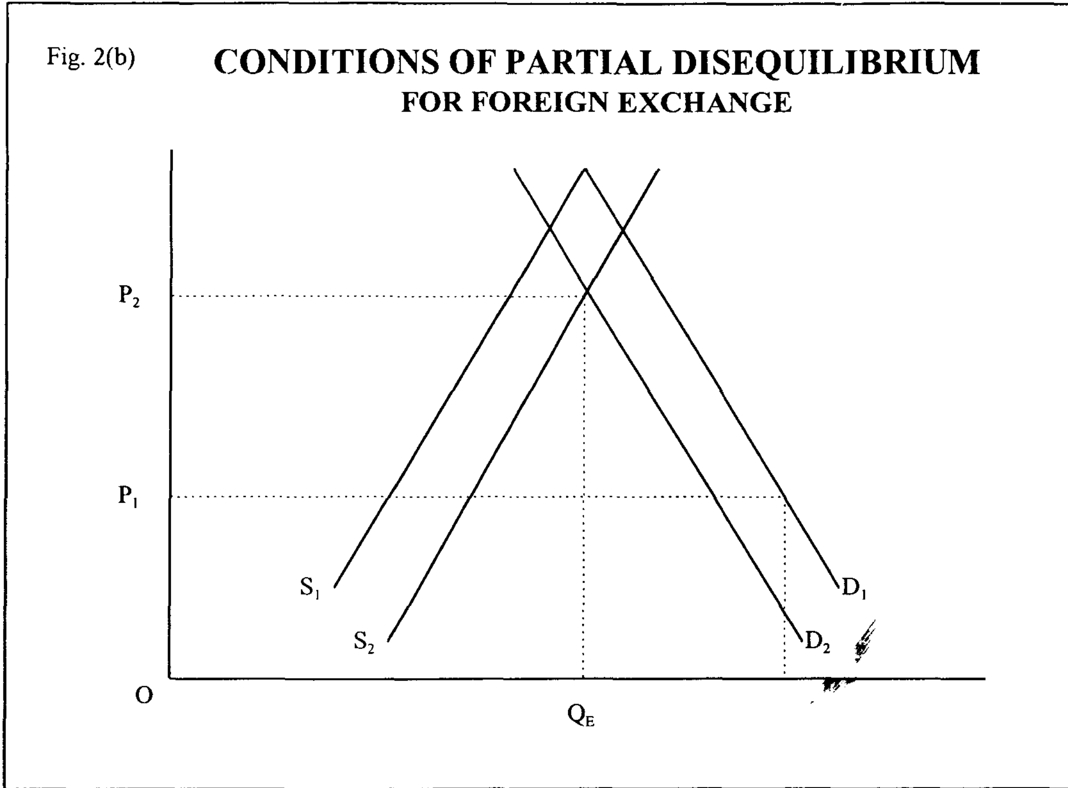

Fig. 2(b) **CONDITIONS OF PARTIAL DISEQUILIBRIUM FOR FOREIGN EXCHANGE**

Figure 2c describes a system in chronic disequilibrium. The supply of foreign exchange is realistically portrayed as inelastic; demand for foreign exchange is drawn far over to the right. Given the inelasticity of demand as well, the supply and demand curves do not intersect, reflecting the absence of equilibrium in the region of feasible transactions. In this situation an increase in price elicits neither an increase in supply nor a reduction in demand; nor does it move the system to an equilibrium position within the area of feasible transactions. Meanwhile, the extent of disequilibrium increases with devaluation. Note that the area defined by the points Ql, S2, D2, Q2, is greater than the area defined by the points Ql, Sl, Dl, Q3!

The inelastic supply curve in **Figure 2c** reflects not simply a shortage of foreign exchange, but a situation in which foreign exchange is not readily available through foreign borrowing. At the same time the scarcity of foreign exchange limits the capacity of the economy to produce the tradeable goods and services needed to earn additional foreign exchange. This presents the policy makers with a classic "Catch 22" situation. The disequilibrium exists because the supply of foreign exchange has dried up; at the same time foreign exchange is required to earn additional foreign exchange so as to relieve its shortage.

The absence of an intersection of the demand and supply curves reflects the overhang of unpaid foreign liabilities. Default on foreign debt, in turn, precludes new foreign borrowing that would make possible the production of foreign tradeables to earn additional foreign exchange. Meanwhile, the build-up of foreign debt pushes the demand curve for foreign exchange further and further to the right. At the same time, the worsening disequilibrium renders the demand curve even more inelastic.

The experiences of Guyana and Jamaica confirm the indeterminacy of an equilibrium exchange rate in conditions of chronic disequilibrium. Whenever the official rate has been unified with the black market rate, the latter has moved upward to maintain a differential between the two rates. In those cases where the officials have left the official rate to be determined

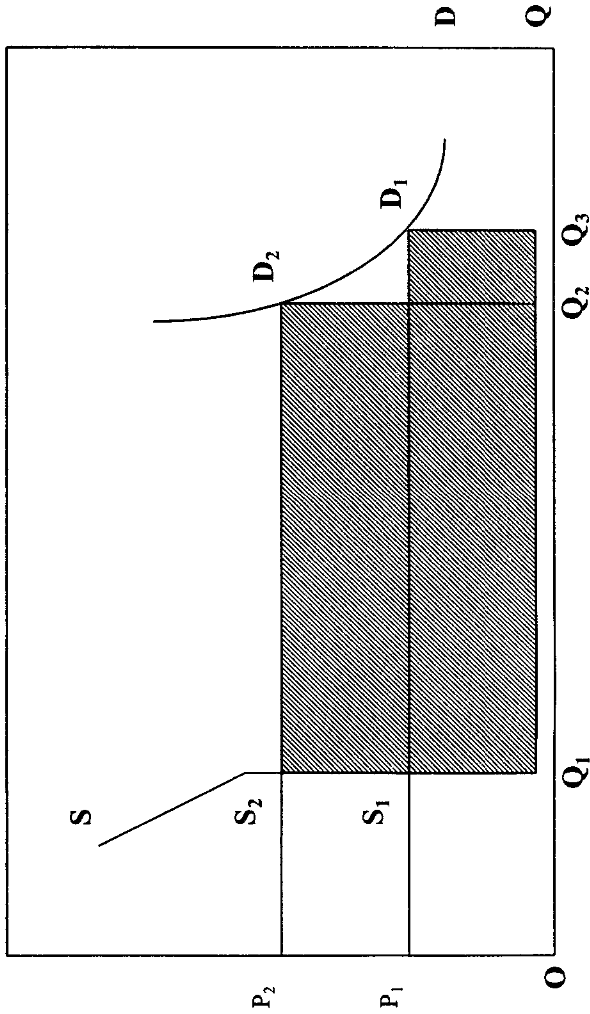

Fig. 2(c)

CONDITIONS OF CHRONIC DISEQUILIBRIUM

by the market, the price of foreign exchange has moved steadily upward without reaching a stable equilibrium.

As recently as June 1981, the G$ exchange rate was US$1.00 = G$3.00. The rate was maintained in the range of G$4.15 - G$4.40 = US$1.00 from October 1984 until January 1987 when it was devalued to G$10.00 = US$1.00. In April 1989 the central rate was established at G$33 = US$1.00, and G$60 = US$1.00 in June 1990. Later in the year restrictions on dealings in foreign exchange were lifted and the Guyanese dollar allowed to float. It reached G$125 = US$1.00 before settling at around G$120 = US$1.00. However, this stabilization probably reflects the about face policies of the Hoyte Administration which have attracted considerable aid inflows as well as renewed foreign investment in Guyana's natural resources. Similarly in Jamaica, periodic devaluations have never closed the gap between the official and black market rates nor achieved any lasting equilibrium exchange rate. The recent abandonment of the fixed exchange rate to market forces has set off an upward spiral in the cost of foreign exchange, with the black market and the futures rates racing far ahead of the "official" market rate.

It is not unreasonable to postulate a backward sloping supply curve for foreign exchange in the case of frequent devaluations. **(Cf. Figure 2c)** The expectation of future devaluations could encourage citizens to hoard their foreign exchange in anticipation of still further devaluation. Citizens who plan to emigrate in search of better economic conditions have an increased incentive to hoard foreign exchange. In this way repeated devaluations could actually contribute to a reduced rather than an increased supply of foreign exchange.

Financial Markets in the Disequilibrium System

High and positive real interest rates constitute the second most popular prescription in the conventional structural adjustment programme. This reflects the influence of the Shaw-

McKinnon Thesis.[4] The logic of that thesis goes like this: Economic growth is a function of investment; investment is a function of savings; savings is a function of real interest rates, which should be both high and positive so as to optimize economic growth.

Empirical studies leave much doubt as to whether aggregate savings depends more on interest rates, real or nominal, than on income and custom - even in developed countries. Nor has it been satisfactorily explained why high positive real interest rates are supposed to have such a beneficial effect upon the economic growth of LDCs, but are regarded as deflationary in developed economies. Shaw and McKinnon are quite right that the long-term development of financial markets require that interest rates be allowed to respond to supply and demand fluctuations. However, in a system labouring under chronic disequilibrium, a policy of high real positive interest rates can be shown to worsen, not improve the situation.

The flaw of the Shaw-McKinnon thesis is that the "savings" which fuel investment is **real** savings, not financial savings.[5] Indeed, the phenomenon is not rare in distressed economies that a high level of financial savings is associated with low output and dissaving. In Guyana commercial banks have frequently declined savings deposits since there was no productive outlet for their use. Real savings in a closed economy depends on the excess of production over consumption. In an open economy, of course, savings of foreigners can be borrowed. In conditions of chronic disequilibrium not only is foreign savings scarce, but its absence severely limits the capacity of the economy to generate real domestic savings since, as we have established, foreign exchange is an essential input of domestic production. Indeed, in both Jamaica and Guyana, the latter especially, we have observed considerable dissaving to maintain minimal levels

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4 Shaw, Edward S., **Financial Deepening in Economic Development,** New York, O.U.P., 1973.

5 McKinnon, Ronald I., **Money and Capital in Economic Development,** Washington, D.C., The Brookings Institute, 1973.

of domestic consumption. This is especially noticeable in the deterioration of infrastructural institutions. If there is inadequate production, there can be little real savings, and no level of interest rate, real or positive, can elicit a greater supply.

The negative effects of high interest rates are manifested in several ways. First, high loan rates drive marginal producers into bankruptcy, especially in LDCs where bank overdraft loans serve as a substitute for equity. Secondly, high interest rates increase margins on financial assets and stimulate activity in the financial sector. However, since financial assets do not in these circumstances represent real savings, the increased financial activity is largely sterile, and does not result in an expansion of exportables. Fourth, it requires unusually high profit margins to cover interest costs; such margins are achievable only in highly inflationary conditions. A protracted period of high real positive interest rates could very well tip the disequilibrium economy into a hyper-inflationary mode - as in the case of Germany after the two World Wars, and as has occurred so many times in Latin America in the past decade.

Policy Implications

The above analysis suggests that policy makers should focus more on parameters than on variables in trying to bring about improvements in the chronic disequilibrium system. This will involve considerations of politics, public relations and diplomacy, and will certainly involve some tough decisions.

The first concern must be to achieve a parametric shift of the supply curve over to the right (cf. **Figure 2c**). In short, the authorities must get hold of additional foreign exchange, by hook or by crook, so as to bring about an increase in output, especially of tradeables. This implies some kind of resource allocation in favour of exporting enterprises. In short, the authorities must behave as nations do in time of war; they must ration foreign exchange. The exhortation of international financial institutions to remove exchange controls entirely must be firmly resisted. However, exchange controls should be administered in a liberal and humane manner.

The second concern must be to affect a rotation in the supply curve to the right so as to increase its elasticity. Everything must be done to encourage the public to sell their foreign exchange to authorized dealers. The one thing which must not be done is to establish a regime of snooping, airport searches and prosecutions for foreign exchange violations. The more vigorous and successful such a programme, the higher the black market price will rise, and the scarcer foreign exchange will become. At any rate, no open developing country has the administrative capacity to enforce an effective program of foreign surveillance. Indeed, benign neglect is probably the most effective policy in such circumstances. Meanwhile, everything should be done to restore confidence in the currency, in the quality of economic management and, where applicable, in the political legitimacy of the Administration. In short, the restoration of confidence requires effective political leadership combined with bureaucratic and technical competence.

Above all, the inevitable hardships endemic to the chronic disequilibrium system must appear to be evenly shared. In this regard, the insistence of international organizations on the removal of subsidies for the poor seems to make no sense. (I have always marvelled as to why subsidies are so healthy for rich recipients in developed countries and so harmful to the poor in LDCs.). This approach is in marked contrast to that taken to by John Maynard Keynes in "How to Pay for the War".[6] In it Keynes sets out a wartime economic strategy which emphasized that sacrifices should not be borne predominantly by the poor. Indeed, many British working class people enjoyed higher living standards during the war than before. Recent talk at the World Bank about "adjustment with a human face" is a most welcome development.

The next concern must be to shift the demand curve parametrically to the left. This is achieved by obtaining forgiveness or rescheduling of foreign debts. At the same time

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[6] Keynes, John M., **How to Pay for the War: A Radical Plan for the Chancellor of the Exchequer,** New York, Harcourt Brace, 1940.

every attempt should be made to economize in the use of existing foreign exchange so as to minimize the build-up of foreign debt. The success of such policies will depend heavily on the quality of political leadership and of supporting technicians. They must be able to persuade foreign creditors and foreign nations that their overall strategy has a chance of success, and that they enjoy national support for its implementation.

The time to worry about the equilibrium exchange rate is when the supply and demand curves come within hailing distance of each other and some elasticity is restored to them. Until then the exchange rate should be kept at as high a level as permits the country's exports to be competitive. The true purpose of devaluation is to reduce real wage rates and to bring consumption into equilibrium with available foreign exchange. Neither of these is of concern by the time disequilibrium becomes chronic. Imports would have been at rock bottom for some time, and wages would have fallen so low as to stifle incentive and adversely affect productivity.

The most futile and counterproductive exercise is the search for the equilibrium exchange rate through repeated devaluations. This frequently reflects the mistaken belief that the black market rate is the equilibrium rate. As we have seen, the black market rate merely moves to maintain a satisfactory premium over the official rate. Meanwhile repeated devaluations not only fuel inflation, but create an atmosphere of uncertainty, and discourage the long term investment needed for the production of high value exportables. It also encourages financial speculation at the expense of real activity. In time, the continually depreciating currency and the associated shortages promote a sense of hopelessness and despair, and with it the flight of both human and financial capital.

Little has been said about fiscal and monetary policy since in conditions of chronic disequilibrium their efficacy is swamped by other effects. In particular, frequent devaluations create havoc with the money supply and with the distribution of the incomes to be taxed. The same is true for an incomes policy. These policy instruments are best used to prevent the economy from falling

into disequilibrium, and resume their importance once the economy escapes from chronic back to partial disequilibrium.

Obviously, theoretical explorations will not help us very much in our search for non-market policy instruments. Here, history is a more likely source of insights. In my Adlith Brown lecture, mentioned above, I expressed amazement that "politicians and economists had not perceived the current international debt crisis as analogous to the German War Reparations issue or the Marshall Plan."[7] After several years of pretending that the LDCs could be net exporters of capital and achieve growth at the same time, First World leaders and economists are now beginning to accept the need for debt relief and to take the first steps towards debt forgiveness. Better late than never!

A reading of German financial history after both World Wars is most instructive.[8] In neither post war period did the German economy emerge from chronic disequilibrium until a strong currency was re-established. After the disastrous hyper-inflation of 1923, a new currency, the rentenmark, replaced the reichsmark at the rate of 1 billion reichsmarks for a rentenmark, and the new Central Bank, the Deutche Rentenbank, was made independent of Government. Shortly afterwards, the old Reichsbank was reorganized to replace the Rentenbank, and mandatory limits were imposed on the new currency issue. This reform was made possible by the Dawes Plan of 1924 which greatly alleviated the payment of German war reparations and advanced new loans to Germany. The miraculous German economic recovery after World War II was also rooted in the 1948 Monetary Reform in which 10 reichsmarks were exchanged for one new deutchemark. Again the success of the Reform depended on the benevolence of the US and other allies.

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7 Blackman, Courtney N., Op. Cit., p.14.

8 Kindleberger, Charles P., **A Financial History of Western Europe**, London, George Allen & Unwin, 1984.

A reading of the German experience suggests that the re-establishment of a stable currency is a necessary condition for escape from conditions of chronic disequilibrium. The experience of CARICOM is most persuasive - only those countries with stable currencies have enjoyed sustained economic growth. Instead of aiding and abetting Guyana and Jamaica in a futile and demoralizing search for an equilibrium exchange rate, the international financial institutions should persuade international creditors to grant a five-year moratorium on the repayment of loan capital, and use all available foreign aid and soft loans to re-capitalize independent central banks. The most elaborate safeguards possible should then be put in place to protect those societies from money creating Ministers of Finance.

7

Exchange Rate Policy in the Context of Economic Liberalization in Jamaica*

Introduction

amaica has served as a veritable laboratory for the study of exchange rate regimes over the last three decades. Starting with the old Currency Board system, Jamaica established its Central Bank in 1961, retaining the sterling peg. With the phasing out of the Sterling Area, Jamaica pegged to the US$ in 1971. There have been frequent devaluations since then and a variety of exchange rate regimes. There were mini-devaluations (crawling peg) in 1978-79; a two-tier system inaugurated in 1983 became a three-tier system later that year when a special Caricom rate was added. An Auction system was inaugurated at year-end 1983, with the rate moving within a narrow band; the band was later removed. A more or less fixed peg was resumed in November 1989.

In September 1990 a flexible exchange rate interbank system was instituted. Under this system authorized dealers have been free to buy and sell foreign exchange on their own

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* Paper presented at the Seminar, "The 1992/93 Budget and Near-Term Prospects for the Jamaican Economy" Pegasus Hotel, Kingston, Jamaica, July 1, 1992

account and set their buying and selling rates. In September 1991, Exchange Control regulations, with minor exceptions, were abolished. All repatriation and surrender requirements for earners of foreign exchange were discontinued and residents were allowed to hold foreign currency accounts abroad. Both current and capital transactions, with the exception of portfolio outflows by deposit-taking institutions, were freed of controls, and residents and non-residents were allowed to settle internal obligations in any currency mutually acceptable to both parties of a transaction. This deregulation of the foreign exchange system is regarded as "the visible centre-piece" of the programme of economic liberalization to which the Jamaican Government has committed itself.

The Jamaican authorities launched this programme of exchange rate deregulation in an almost self-congratulatory fashion. The 1991 Bank of Jamaica Annual Report describes the elimination of exchange controls as "a bold initiative" and some senior technocrats have proclaimed these steps as inevitable for the rest of CARICOM. Yet we cannot but get the feeling that the Jamaican Monetary Authorities may be whistling in the dark.

The Bank's 1991 Report described the challenge for economic policy as "to moderate tendencies towards an inflation-devaluation spiral while ensuring that the process remains growth oriented." Indeed, it described the "primary challenge" as "the credible and defensible securing of relative exchange rate stability through operation on market demand and market supply." In fact, the introduction of a floating exchange rate has led to an even sharper rate of currency depreciation and to price rises which threaten to become hyper-inflationary. A pertinent question is whether the Jamaican Authorities have launched their exchange rate deregulation programme with adequate ground preparation. One wonders whether they have calculated with adequate care the risks of their latest experiment.

This Paper explores the issues surrounding the introduction of Jamaica's programme of exchange rate deregulation. **Section II** reviews the role of the exchange rate in macroeconomic

management. **Section III** discusses the issue of economic liberalization. **Section IV** presents a model for the analysis of the Jamaican foreign exchange market. In **Section V** we offer a broad critique of exchange rate policy in Jamaica. We conclude with some general suggestions.

SECTION II

THE ROLE OF THE EXCHANGE RATE

The exchange rate is an index of the value of a country's exports in relation to its imports. It is to the nation what product price is to the corporation. It used to be the case in relatively self-sufficient economies, like the former USSR and the USA, that the exchange rate was quite unimportant. As globalization determines that "all ships are small in the ocean", even the Russians and the Americans must worry about the exchange rate.

As the international economic environment has grown more turbulent, the stability deriving from freely floating exchange rates, which Nobel Laureate Milton Friedman promised, proves more and more elusive. Revolutionary advances in telecommunications and the globalization of financial markets have facilitated the electronic transfer of vast sums of capital across national borders. These capital movements are many times the volume of transfers related to the trade in goods and services which inspired conventional international trade theory.

Even the advanced industrial countries, with their deeper and more developed capital markets, have found currency fluctuations most uncomfortable. Within the European Monetary System they have huddled around the strong deutchemark in order to minimize the instability of their own currency values, while the very powerful industrial nations, the Group of Seven, have recognized the need for collaboration on exchange rate policy so as to moderate swings in international exchange rates. The proposed establishment of a European Central Bank is designed to eliminate exchange rate disparities throughout the Common Market and to provide for individual countries,

especially weaker states like Ireland and Greece, a measure of exchange rate stability which they could not achieve on their own.

For small open developing countries, such as ours in the Caribbean, the exchange rate takes on even further importance; it is the conduit for the transmission of disturbances from the international to the domestic economy. Such disturbances are all the more severe because of the volatility of the prices of commodities which dominate the export earnings of several LDCs. To make matters worse, LDCs lack foreign exchange markets with the depth and sophistication to absorb the shocks from the international environment.

Moreover, severe currency devaluations in small open economies lead swiftly to a rise in prices, with adverse effects upon economic growth. The experience within CARICOM suggests that currency stability is positively related to price stability and economic growth. In the period 1980-1990, the three devaluing countries, Guyana, Jamaica, and Trinidad and Tobago all recorded negative real economic growth, whereas the non-devaluers, Barbados, the OECS, Belize and The Bahamas all recorded positive growth; the former also recorded rates of inflation far higher than the latter over the same period.

For this reason small open economies have usually pegged their currencies to a hard currency, usually that of their major trading partner. A few have pegged to a basket of currencies, like the SDR. This strategy requires either the matching of domestic currency issues with foreign asset holdings, or the maintenance of an adequate level of foreign exchange reserves which the Monetary Authorities may use to support the pre-determined peg in the foreign exchange market.

Only a few high income small states, such as Switzerland, Singapore and Taiwan, maintain a floating exchange rate regime, and in every case the Monetary Authorities intervene, either through market operations or macroeconomic policies, to support the appropriate exchange rate. Even industrialized countries with hard currencies still maintain reserves of gold

and foreign assets to support their currencies in the foreign exchange market.

SECTION III

ECONOMIC FINANCIAL LIBERALIZATION

The basic premise of economic liberalization is that economic growth and development are most efficiently pursued in the context of free markets. With the collapse of Communism in the former Soviet Union and its erstwhile satellites, this doctrine, which gained considerable credence during the Reagan-Thatcher era, has been exalted into dogma. Economic liberalization, in some degree or other, is now a required element in any Fund/World Bank set of conditionalities. (It is unclear the extent to which Jamaica's programme of economic liberalization is IMF-inspired or the product of official conviction!)

The five basic elements of economic liberalization are:

1. removal of import and export restrictions;

2. removal of subsidies and price controls;

3. removal of ceilings on interest rates and selective credit controls;

4. deregulation of the exchange rate regime and the abolition of exchange controls;

5. privatization of state-owned enterprises.

It is true that the advanced industrialized market economies are more market driven than are LDCs. Granted too that the LDCs, including Jamaica, have stymied their economic progress over the last two decades by the adoption of statist policies and overcentralized economic management. (For over a decade now I have railed against overcentralized bureaucracy in the region, and over the past five years have

stridently recommended privatization, and the independence of central banks). However, the proponents of economic liberalization sometimes forget that the advanced countries of today did not always pursue liberal market-oriented policies. In fact, most of them at various times in their development pursued downright mercantilist strategies, opening up their economies only as they became stronger and more competent to face the cold blasts of international competition - this is true for the UK, France, Germany, USA and Japan.

Nor is the transition to the free market economy in these countries complete even today. Japan still incurs the wrath of its trading partners because of its blatantly protectionist policies. Government subsidies extended to farmers in North America and Europe are notorious, and a plethora of tariff and non-tariff barriers against LDC imports exist in the relatively open US marketplace.

Furthermore, none of the "Asian Tigers" have pursued purely market-oriented policies to achieve their brilliant economic successes. Singapore, Taiwan and South Korea have all practiced a nice mix of central direction and market-oriented measures. Even in laissez-faire Hong Kong, Government has assumed the responsibility for mass housing, which would never have been built through the "free market".

The true path to Jamaican economic development is neither a Socialist path nor a Free-market path, but the Jamaican path, involving pragmatic policy measures and superior technocratic skills. In some cases subsidies may be the best solution, and price controls may sometimes be necessary; natural monopolists must certainly be subjected to social control. But the most important thing is for policy makers to eschew dogma, to be prepared to make adjustment in the light of clear mistakes and new information, and to remember that Rome was not built in a day.

The areas of financial liberalization and exchange rate deregulation specifically concern us here. Speaking to the Jamaican Agricultural Development Foundation last year, I took

issue with the McKinnon-Shaw basis which underpins the financial element of economic liberalization programmes:[1]

> The trouble with structural adjustment programmes based on the McKinnon-Shaw thesis is that they work best under conditions of perfect competition, i.e. in markets with numerous buyers and sellers, homogeneous products, perfect information, etc. However, the markets of LDCs are, by definition, generally imperfect. If they were perfectly competitive, the countries would not be underdeveloped.

I went on:

> But the most serious flaw in the McKinnon-Shaw thesis is the identification of financial savings with real savings. Real savings derive from the excess of output of goods and services over the consumption of goods and services. For this reason monetary authorities must be concerned first with what is happening in the real sector and do all it can to maintain the economic health of important industries. If there is no surplus production in the real sector, there can be no real financial savings.

I concluded:

> It is just a matter of time before a Study is written showing that structural adjustment programmes based on the McKinnon-Shaw thesis may have done more harm than good.

The Study which I anticipated then has now come from none other than McKinnon himself - although he might not concede as much. In his most recent book, **The Order of Economic Liberalization,** subtitled "Financial Control in the

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1 McKinnon, Ronald I., **Money and Capital in Economic Development,** Washington D.C., The Brookings Institution, 1973. Shaw, Edward S., **Financial Dependency in Economic Development,** New York, Oxford University Press, 1973.

Transition to a Market Economy, (1991) McKinnon now warns against the headlong rush to financial liberalization which his earlier work inspired:

> In securing this non-inflationary financial equilibrium, however, there are definite limits on the relative speeds of liberalization in commodity and capital markets and on how fast interventionist policies or planning controls over domestic and foreign trade can be withdrawn (McKinnon 1973, 1982; Edwards 1984). How fiscal, monetary, and foreign exchange policies are **sequenced** is of critical importance. Governments cannot, and perhaps should not, undertake all liberalization measures simultaneously. Instead, there is an "optimal" order of economic liberalization, which may vary for different liberalizing economies depending on their initial conditions ...[2]

In particular, he found that fiscal control should precede financial liberalization:

> Before price inflation can feasibly or safely be phased out, and before the capital market is opened for free borrowing and lending, the first and most obvious need is to balance the central government's finances. **Fiscal control should precede financial liberalization.** [3]

In reviewing the experience of Mexico, Argentina and Brazil, McKinnon noted:

> Because of the cumulative effect of very high interest rates (over 30 percent real was not unusual) on their existing domestic liabilities, government debt-to-GNP ratios have been building up in an unsustainable fashion even though most of these countries are not paying much on their debts to the international banks.

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2 McKinnon, Ronald I., **The Order of Economic Liberalization,** Baltimore, The Johns Hopkins University Press, 1991, p.4.

3 Ibid. p. 4.

> In many LDCs, people now anticipate that the government will default on its own domestic bonds - as in March 1990 with the Brazilian government's freeze of 80 percent of its own outstanding liabilities in the hands of Brazilian firms and households.[4]

On the issue of free capital mobility, his research suggested that:

> To minimize the probability of bank panics and financial breakdowns, where risk premiums in real interest rates rise to exorbitant levels that impair the credit worthiness of virtually any borrower, the pace of deregulation of banks and other financial institutions in liberalizing economies must be carefully geared to the government's success in achieving overall macroeconomic stability ... Without price-level stability, unpredictable volatility in real interest rates or exchange rates makes unrestricted domestic borrowing and lending by deposit-taking banks... simply too risky.[5]

SECTION IV

THE JAMAICAN FOREIGN EXCHANGE MARKET

Analysis of the Jamaican foreign exchange markets requires the use of a model that reflects the critical features of the real-life situation. The realities of that market certainly do not conform to the text-book model of intersecting demand and supply curves **(*see* Figure 1)**. If this were so, econometric estimation of these equations could within a reasonable margin of error predict an equilibrium rate.

In fact, the Jamaican foreign exchange market is extremely thin and shallow, with relatively few buyers and sellers. Some of

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[4] Ibid. p. 6.

[5] Ibid. p.6.

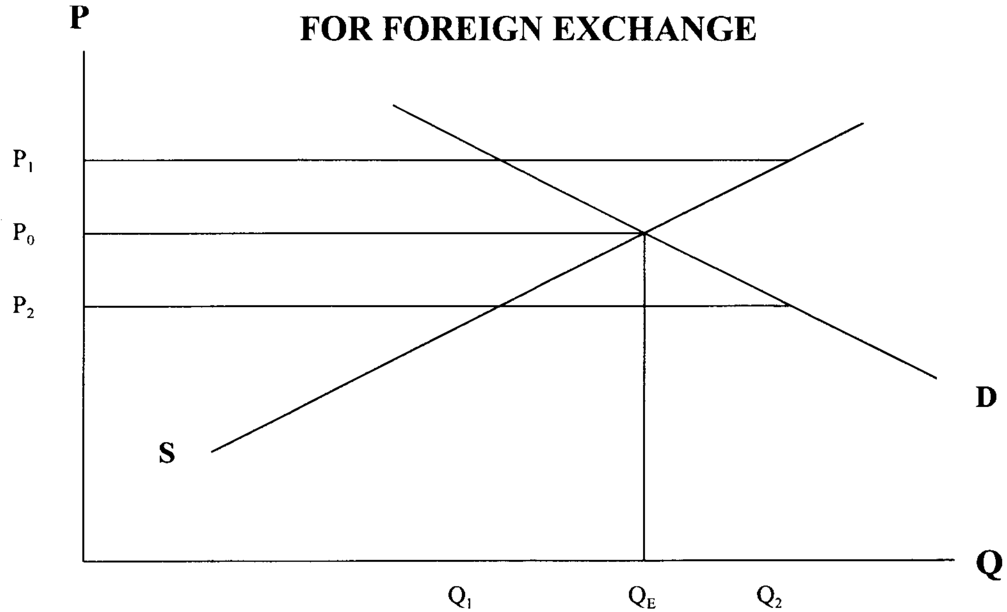

Fig. 1 AUTOMATIC MARKET ADJUSTMENT FOR FOREIGN EXCHANGE

the participants, like the commercial banks and the major hoteliers, exercise disproportionate market power - that is why a single market player like "Butch" Stewart, could make such a stir in the market.

Moreover, the supply of foreign exchange is limited in absolute terms, showing negligible increases from year to year. However, the appreciation in the value of foreign exchange does not elicit a significant increase in its supply. At the same time, there is a huge unsatisfied demand for foreign exchange to meet both official and private foreign liabilities.

To make matters worse, the domestic money supply keeps expanding at a rate which far outstrips the output of domestic goods and services. The increase in narrow money (Ml) was J$3,351 million or 95.3% as compared with J$776.0 million or 28% recorded in 1990, fuelling the supply of domestic dollars available for chasing the rather stable inflows of foreign exchange.

I read with considerable interest the article entitled "The Conundrum of the Dollar" by Cedric Wilson in **The Money Index**[6] His novel approach towards an explanation of the shenanigans of the Jamaican dollar is most refreshing. Mr.Wilson has a promising future as an economist, but I would have to describe his theorizing as a gallant failure. Mr. Wilson's hypothesis violates a well established scientific convention that we should favour a simple explanation of natural phenomena over one as farfetched as an upward sloping demand curve.

In the First Adlith Brown Memorial Lecture, I postulated an inelastic supply curve to explain exchange rate instability in the "collapsed" foreign exchange markets of Guyana and Jamaica. The model has demonstrated considerable predictive powers.[7]

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6 Wilson, Cedric, "The Conundrum of the Dollar", **The Money Index,** Jamaica, May 19, 1992.

7 Blackman, Courtney N., "A Heterodox Approach to the Adjustment Problem", The First Adlith Brown Memorial Lecture, ISER, University of the West Indies, Mona, Jamaica, 1985.

Figure 1 portrays a classical demand/supply situation with an upward sloping supply curve and a downward sloping demand curve intersecting at an equilibrium point. **Figure 2** describes a foreign exchange market in chronic disequilibrium. The supply curve is inelastic and the demand curve downward sloping but located far to the right. The inelastic supply curve reflects the reality of the chronic shortage of foreign exchange in Jamaica; the location of the demand curve far over to the right indicates that the legitimate demand for foreign exchange in Jamaica is far in excess of supply. The shaded areas are a measure of disequilibrium reflecting, in particular, the overhang of unpaid foreign liabilities. In this situation, the demand and supply curves do not intersect, signifying that the foreign exchange market is not clearing, so that the equilibrium exchange rate is indeterminate within the feasible region. An equilibrium exchange rate would exist if every Jamaican tendering Jamaican dollars for the purchase of foreign exchange could obtain it at that rate **on demand.** I am assured that situation does not presently obtain.

Using this model, I forecast that a policy of devaluation would not achieve an equilibrium exchange rate in either Jamaica or Guyana. Indeed, each time the Guyanese Monetary Authorities, on IMF advice, tried to close the gap between the official rate and the parallel market rate, the latter moved to a higher level. (Initially, IMF economists used to regard the parallel market as the equilibrium rate in the total market. In fact, the parallel market rate is the equilibrium rate only in a segment of the market, and shifts as the official rate is changed). When the rate was eventually freed up, the cost of a US dollar moved to the astronomical rate of G$125.00 = US$1.00.

In these circumstances it is best for the Monetary Authorities to peg at a rate where exports are competitive, and learn to live with the parallel market. I suggested that they concentrate instead on strategies calculated to shift the demand curve parametrically to the left and the supply curve to the right. Foreign debt reduction would be most efficacious in shifting the demand curve over to the left. Monetary and fiscal policies which

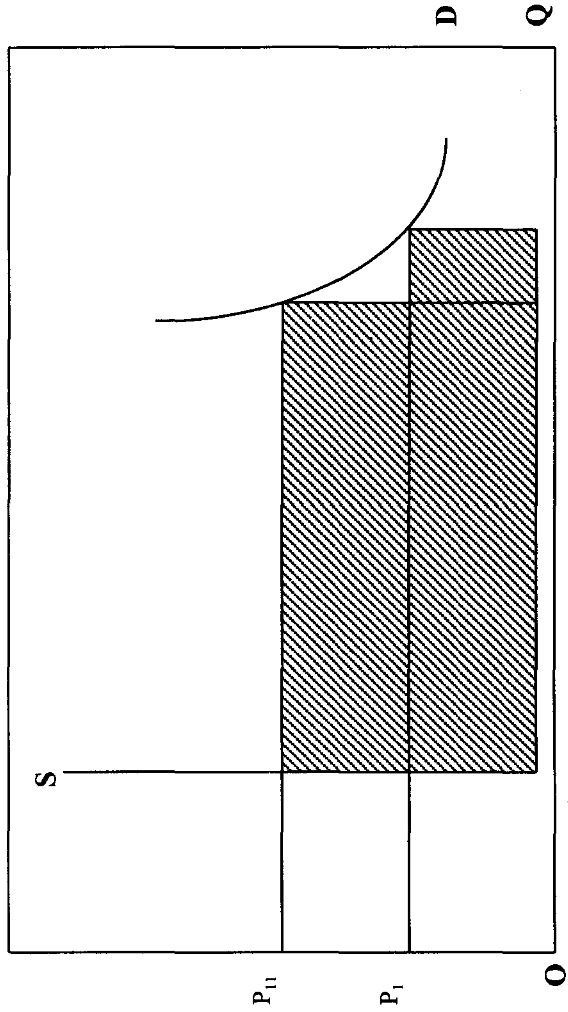
Fig. 2
CONDITIONS OF CHRONIC DISEQUILIBRIUM
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curb domestic demand, and various measures to increase foreign exchange earnings, would also help. If some measure of confidence could be restored, the supply curve would rotate to the right, thus making it more elastic and closing the gap between supply and demand **(*see* Figure 3)**. The continued success of such strategies would eventually bring about the intersection of the demand and supply curves and thus restore equilibrium in the foreign exchange market.

My model also explains the apparent achievement of equilibrium in Guyanese foreign exchange markets, albeit at the horrifically high rate of G$120.00 = US$1.00. First, Guyana's ***de facto*** repudiation of its foreign debt effectively shifted its demand curve parametrically to the left; the passing of President Forbes Burnham, the 180 degree sea change carried out by President Desmond Hoyte, and the prospect of a free election have restored a degree of confidence, thus imparting a considerable degree of elasticity to the supply curve. The simultaneous influx of foreign capital to exploit Guyana's natural resources has resuscitated production for export and increased foreign exchange earnings, thus effecting a parametric shift of the supply curve even further to the right. Should the Guyanese achieve a transparently fair election (a tremendous challenge for a country which has gone almost three decades without one), foreign aid and investment would accelerate, imparting even further elasticity to the supply curve and simultaneously shifting it parametrically to the right. The prospect is then for a revaluation of the Guyanese dollar in the year ahead.

What about the Jamaican dollar? The "Butch Stewart initiative" did enhance confidence and probably effected some rotation in the supply curve; the injection of new funds also shifted the supply curve to the right. However, the additional funds are so small relative to Jamaica's need for foreign exchange that the supply and demand curves are still far from intersection.

But just as the "Butch Stewart initiative" effected an appreciation of the Jamaican dollar, a counter-initiative by "Joe Bad" selling large amounts of readily available Jamaican dollars into the market, could just as easily effect a dramatic

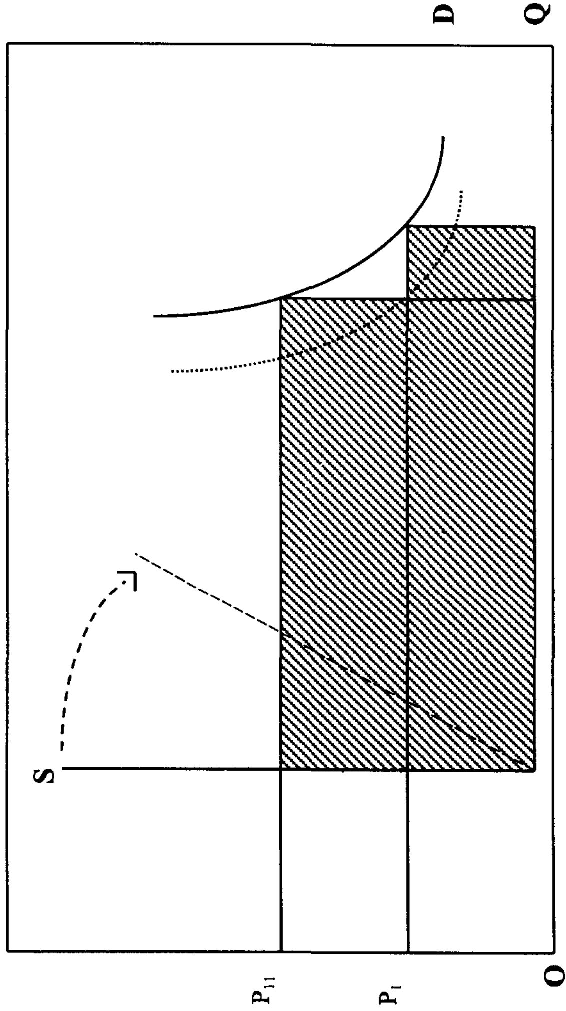

Fig. 3

depreciation of the domestic currency. As long as the huge overhang of foreign debt remains, and as long as Government's fiscal operations, via Central Bank credit, creates millions of new Jamaican dollars, the value of the Jamaican dollar will remain indeterminate.

SECTION V

CRITIQUE OF EXCHANGE RATE POLICY IN JAMAICA

The Jamaican economic liberalization programme, involving a floating exchange rate, appears overly ambitious in the context of such a thin and shallow foreign exchange market. Other contra-indications are the negative foreign asset position of the Bank of Jamaica and the still substantial overhang of foreign debt (nearly US$4 billion). As noted above, even nations with higher incomes and more robust balance of payments shrink from floating their currencies and seek arrangements which shelter them from the hazards of currency instability.

Given the decision to embark on a programme of liberalization, the authorities seem to have moved with undue haste. For one thing they have ignored the strictures of McKinnon that the restoration of fiscal stability should precede financial liberalization. It is true that Government has improved its fiscal position considerably, to the point where the overall government deficit has been reduced to 2% of GDP - a considerable achievement. However, this does not take into account the accumulated losses of the Bank of Jamaica for 1989, 1990 and 1991 of nearly J$4 billion, legally required to be repaid to the Bank out of the Consolidated Fund, and the chronically high level of central bank credit needed to support Government operations. Total Government payments due to the Bank of Jamaica at December 31, 1991 were close to J$25 billion. Besides, frequent currency depreciations and high domestic interest rates (up to 35% on treasury bills) continually threaten the integrity of the Government's fiscal position through their frightening compounding effect on the volume of Government's foreign and domestic liabilities.

The general macroeconomic situation is seemingly threatened by high interest rates against which I warned last year. I feared very much then that the high interest rate regime, characterized by Central Bank CDs with a coupon of up to 50%, might tip the economy into a hyper-inflationary mode, since it would be extremely difficult for producers to obtain high enough margins to meet interest costs except in a hyper-inflationary environment. Inflation rates, sometimes exceeding 100% per annum during some months, have justified my fears.

One of the characteristics of a hyper-inflationary environment is that asset holders are prone to switch from the production of real goods and services to financial speculation. The rapid expansion of the Jamaican financial sector vis a vis the productive sectors, and the bloated earnings of financial institutions celebrated each week in the **Money Index,** are not entirely a healthy sign.

The Monetary Authorities were ill-advised to abandon the peg in 1990 and to move to a floating rate. In so doing, as illustrated above, they surrendered any control over the exchange rate variable, which then became and remains indeterminate. They would have been better advised to have maintained the peg by fiat at a rate where Jamaican goods and services were competitive in foreign markets and learned to live with the parallel market. The fact is that the Jamaican foreign exchange market constitutes "a disequilibrium system", in Galbrathian terms,[8] in which case free market operations cannot be expected to achieve optimal allocation of resources.

Finally, the removal of restrictions on capital flows, which McKinnon contends is the last stage in the liberalization process, must be considered premature. It made quite good sense to remove a number of nuisance exchange control regulations which made criminals of reasonable citizens; and since so many

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[8] Galbraith, John Kenneth, **A Theory of Price Control,** Cambridge, Harvard University Press, 1980.

Jamaicans already held foreign accounts, the removal of the restrictions against holding such assets merely validated a ***de facto*** situation. However, the harsh truth is that foreign exchange represents the non-substitutable factor in the Jamaican production system; since its supply is highly inelastic, some way must be found to ration it no matter how crude the system may be, though with minimum red tape. During World War II the American authorities did not leave the allocation of steel to the market; they curtailed the production of automobiles and other consumer durables! The implementation of an economic liberalization programme is, at best, fraught with peril. In the context of an economy under stress for so many years, the Jamaican authorities can look forward to many anxious moments over many years and her citizens to a really rough ride.

SECTION VI

SOME CONCLUDING REMARKS

Any recommendations we make must reflect the fact that what's done is done. In many cases the repeal of the measures so far taken is neither possible nor desirable. However, there are two areas in which damage control is required.

First, interest rates must be ratcheted downwards to relieve the stress on the productive sectors. In particular, the Bank of Jamaica should abandon its open market issue of high interest rate CDs and revert pragmatically to more direct methods of liquidity suppression, e.g. cash reserve requirements. At any rate, the payment of interest in such a large volume of "high-powered" money is itself a source of increased liquidity.

Secondly, some measure of exchange rate stability must be restored, at least through "dirty" floating. Indeed, the stabilization of the Jamaica dollar at the rate of US$1.00 = J$22.50 following the "Butch" Stewart initiative was itself an example of "dirty" floating. The recent inauguration of consultations between the Bank of Jamaica and the commercial banks is

pregnant with the possibilities of "dirty" floating - the dirtier the better!

The agreement between the Bank of Jamaica and the Authorized Dealers to establish a Stabilization Fund for possible intervention into the foreign exchange markets is also a step in the right direction. In fact, this used to be the natural role of the Bank of Jamaica - when it had foreign reserves. Although limited by the disproportionate amount of foreign debt owed to multilateral institutions which neither reschedule nor forgive, the Jamaican authorities should direct their best efforts toward foreign debt reduction. Also, the relatively shallow discount of 20% on Jamaican debt in the secondary markets suggests that the Jamaican Authorities may be excessively virtuous in meeting their payments on commercial debt. A large part of the progress of Chile's liberalization programme stemmed from her success in obtaining relief on up to half of her foreign debt of over US$17 billion. It is the overhang of foreign debt which hangs like an albatross around the neck of the Jamaican economy.

The formation of a Committee to look into the establishment of an independent Central Bank is a most welcome development. Ministers of Finance, both in Jamaica and elsewhere in the Caribbean, have shown a distinct tendency to abuse the money creating powers of central banks, sometimes in ignorance, at other times for short-term political gain. Finance Minister Hugh Small should move heaven and earth to raise the foreign exchange needed to recapitalize the Bank of Jamaica and then cut it loose from his apron-strings. The Bank should then be constitutionally interdicted from financing his deficits. The Jamaican political directorate is to be applauded for having the courage to face up to this fundamental issue. Its Caricom counterparts should go and do likewise.

Finally, the history of monetary crises in Europe after both World Wars, as well as experience elsewhere - not least in the Caribbean - teaches that the restoration of a stable currency is a ***sine qua non*** for the recovery of collapsed economies. Currency stability in Germany was achieved both in 1932 and 1948 through the establishment of a new and stable currency, issued by a

new and independent central bank and financed on both occasions by American grants and soft loans. It was not achieved through repeated devaluations in search of the "equilibrium exchange rate" on which IMF/World Bank orthodoxy insists. It is of more than passing interest that the centre piece of the Russian Stabilization Plan is the issue of a hard rouble, underpinned by western loans and guarantees!

8 Liquidity Management in a Liberalizing Environment*

Introduction

et me first say how delighted I am to be here as leadoff presenter at this Workshop on Liquidity Management in Liberalizing Economies. This is also the occasion of the formal launching later to day of the Caribbean Centre for Monetary Studies, successor to the Regional Programme for Monetary Studies (RPMS) a highly successful cooperative programme of the University and the Central Banks since 1968. Since 1972 I have attended all but three of the annual conferences of RPMS, and on those occasions have very much enjoyed the intellectual sparring, especially with the younger economists.

My task is not so much to offer specific solutions - I am now some distance away from the front line - but to provide a conceptual framework for our discussion of liquidity management, and develop some broad principles of liquidity management. In recent times we have seen tremendous forces

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This paper developed out of a verbal presentation at a Workshop on "Liquidity Management in Liberalizing Economies", held at the Institute for Social and Economic Research, UWI, St. Augustine, Trinidad. August 1, 1996.

of liberalization let loose on our economies. These impulses emanate from two sources: the first is ideological; the second is managerial, an approach which I embrace.

The ideological impulse reflects the "free-market" approach to economic policy-making, epitomized by the works of Milton Friedman, and which, even at the height of the Keynesian era, clung to the view that a government was best which governed least, and that optimal economic outcomes were achievable only through the workings of the "free-market". This view was considerably strengthened when the pure Keynesian model failed to solve the economic problems of the 1970s and 1980s: when the industrialized economies struggled unsuccessfully with "stagflation", the LDCs stumbled, the Communist system collapsed and, with it, much of the Marxian paradigm.

The most mischievous element of the "free-market" approach was the McKinnon-Shaw thesis of "financial repression":[1] economic underdevelopment was attributed to government regulations, especially interest rate ceilings and restrictions on capital flows, which hindered the transfer of resources from savers to investors and thus suppressed economic growth. Financial liberalization, through the operations of the "free market", would optimize the rates of saving, investment and hence of growth in LDCs.

McKinnon and Shaw were most successful in selling this prescription to the international financial institutions (IFIs), who in turn imposed it on LDCs seeking funding for structural adjustment programmes. The financial liberalization element of structural adjustment programmes involved the removal of ceilings on interest rates, promotion of high and real positive interest rates, removal of exchange controls on capital movements, and the floating of exchange rates.

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[1] McKinnon, Ronald, **Money and Capital in Economic Development,** Washington, D.C., The Brookings Institution, 1973, and **Financial Liberalization and Economic Development,** International Center for Economic Growth, Occasional Paper 6, 1988.

The Managerial school agrees with the "free marketeers" that past development models have run out of steam, and acknowledges the need for decentralization, but they approach the problem from a different perspective. The Managerial school does not believe that markets will always produce optimal results - that they are divine, nor that government intervention is bad ***per se.*** Because markets are inexpensive allocators of resources, "Managers" will make use of them wherever possible; however, if market outcomes are unacceptable, they see intervention as not only necessary, but also capable of outperforming the "free market".

The Managerial school also discriminates among markets in respect of their degree of competitiveness. Nor is competitiveness achieved by the simple lifting of government regulations. As Nobel Laureate James Buchanan observes:

> A market is not competitive by assumption or by construction. A market becomes competitive, and competitive rules come to be established as institutions emerge to place limits on individual behaviour patterns.[2]

It does not surprise the "Managers" that the New York Stock Exchange, the most "perfect" market in existence, is also the more highly regulated. This has led me to the aphorism: **"If it is free, it's not a market; and if it's a market, it's not free!"** We also have the paradoxical situation that the more we liberalize financial markets, the more we have to regulate them.

This paper accepts the need for financial liberalization in LDCs, not least of all CARICOM, a process which is long overdue. However, it argues that any programme of liberalization must be formulated and executed with due consideration of regional goals and the specific circumstances of the countries involved, especially the underdevelopment of their financial markets.

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2 Buchanan, James, **What Should Economists Do?** Indianapolis, Liberty Press, 1990, p.3.

We begin with an examination of various aspects of liquidity. This paves the way for an analysis of the problems faced by monetary authorities in the management of both domestic and international liquidity. Special attention is paid to the role and limitations of financial markets in LDCs. From this exercise we distil ten principles of liquidity management in a liberalizing environment liberalizing environment. We conclude with some musings on the predicament of LDCs in the era of financial liberalization.

Aspects of Liquidity

Liquidity in this paper is considered from the perspective of a Caricom central banker. The economic function of the central bank is the regulation of liquidity in the economy. Indeed., the concept of liquidity is central to the theory of central banking central banking. We can identify four aspects of liquidity: (1) liquidity of an asset; (2) liquidity of a portfolio; (3) overall liquidity in the economy, and (4) international liquidity.

1. *Liquidity of an Asset*

The liquidity of an asset is that attribute which makes it readily exchangeable into cash (or other assets). Clearly, the concept of liquidity has no relevance outside the context of markets, since there is nothing intrinsic in an asset which makes it liquid in an economic sense. The liquidity of assets, then, depends on the width and depth of the markets in which they are traded.

2. *Liquidity of Portfolios*

The liquidity of a portfolio, i.e. a collection of assets, certainly reflects the liquidity of the assets contained in it, but it also depends on who owns the portfolio. Whereas a creditor might not be prepared to lend Mr. A an amount of X dollars against the collateral of a given portfolio, he might be willing to advance Mr. B the sum of X + Y dollars against the collateral of an identical portfolio. We may explain this anomaly by attributing a superior value to the human capital of Mr. B - arising from his reputation,

his technical skill or his management ability. Similarly, Mr. C might lend Z dollars against the collateral of a given portfolio in January,, and be prepared to lend Z - Y in February against the identical collateral. This demonstrates that the liquidity of a portfolio does not merely reflect "objective" market conditions, but also the psychology of potential creditors, which is highly variable over time. The most significant implication of a liquid portfolio is that it enables its owner to undertake expenditures with relative facility, either by exchanging liquid assets to do so, or by obtaining credit against the collateral of his portfolio.

3. *Overall Liquidity*

The level of overall liquidity in the economy is the aggregate of the liquidity of the portfolios held by economic units, and includes both the nominal sum of liquid assets as well as credit available to those economic units. Needless to say, this is not an easily quantifiable entity. An economy characterized by a large proportion of economic units with relatively liquid portfolios is in a better position to incur expenditures than one which is characterized by economic units holding illiquid portfolios. It is also possible to have a situation of high overall liquidity in which economic units are reluctant to spend, usually because of pessimistic expectations about future economic conditions.

4. *International Liquidity*

The overall liquidity discussed above refers to the domestic economy. International liquidity is determined by the proportion of the assets in the collective national portfolio that is readily exchangeable into real or financial foreign assets, and the availability of credit from international sources. International liquidity enables a society to make ongoing payments for its imports of goods and services in the event of an adverse balance in its foreign payments, both current and capital. International liquidity is the most important of the four types of liquidity for highly open LDCs, who must import almost all the capital goods needed to execute investment activities, as well as raw materials, intermediate and consumer goods. For them savings/ investment is tantamount to foreign exchange. For this reason

financial assets which are not convertible into foreign exchange are really not savings, since they are not available for true investment purposes. That is why a deficiency of external liquidity leads so swiftly to a downward spiral of economic activity in LDCs. **The identification of domestic financial assets with real savings has been the most egregious error of financial liberalizers.**

Managing Domestic Liquidity

The economic function of a central bank, we reiterate, is to maintain the overall domestic and external liquidity of the economy at optimal levels. The attribute of a central bank which endows it with this capacity is the infinite liquidity of its own portfolio. Since its liabilities are legal tender within its national boundaries, it can in theory purchase all the assets in a country. Indeed, central banks in some countries have tried to do just that!

We may represent an economy as comprising four tiers of institutions of ascending degrees of liquidity. At the bottom are households, which typically possess the least liquid portfolios with a high proportion of slow moving assets, such as homes, or rapidly depreciating assets like automobiles and clothing. In the tier above them are commercial and industrial enterprises, with high levels of working capital and relatively liquid inventories. In the third tier are financial institutions, while the sole occupant of the top tier is the central bank, with its infinitely liquid portfolio.

The first two tiers (in ascending order of liquidity) enhance the liquidity of their portfolios by selling financial assets to one or more of the more liquid tiers above. Households sell financial assets (i.e. obtain credit from) to industrial and commercial enterprises, and sometimes to financial institutions; enterprises, in turn, improve their liquidity positions by selling debt to financial institutions, i.e. by obtaining loans from commercial banks, mortgage banks, etc.; and financial institutions adjust their liquidity positions by selling securities to the central bank. The central bank, with its infinitely liquid

portfolio, has no difficulty, if it so wishes, in accommodating the liquidity needs of financial institutions.

In the example immediately above, the purpose of the central bank's purchase of securities from the financial sector was to increase overall liquidity in the economy. Using the cash from the sale of securities, the financial sector was in a position to increase credit to enterprises which, in turn, were able to increase credit to households, permitting them to consume more thus leading to an expansion of economic activity.

To achieve the contraction in economic activity, the central bank could simply reverse the process. It could sell securities in the financial markets, thus driving down the price of financial assets and causing a reduction in the net worth of financial institutions. Financial institutions would therefore be forced to tighten credit to enterprises which, in turn, would tighten credit to households and reduce expenditures on production inputs, especially labour. With fewer of them at work and with less credit available, households would have to reduce their consumption of goods and services, leading ultimately to a contraction in economic activity.

Since financial markets constitute the medium through which the central bank seeks to influence overall liquidity in the economy, the efficacy of its policies will depend crucially on the quality of those markets. If financial markets are characterized by serious imperfections, e.g. oligopoly, collusion, and a paucity of buyers and sellers, the impulses emitted by central bank transactions will be distorted during transmission, and monetary policy will not have the desired effect.

The defining feature of underdeveloped economies, such as ours in the Caribbean, is pervasive imperfection of both real and financial markets. Regional central banks cannot therefore rely heavily on monetary policy as an instrument of liquidity control. Whereas the U.S. Federal Reserve System can achieve the desired effect by moving interest rates up or down by one quarter of a percentage point, and seldom into double digits, the Bank of Jamaica has had to offer yields of up to 50% per annum

or so "to mop up liquidity", with horrendous side effects on the real economy. Indeed, the state of the market is the primary consideration when policy instruments are being devised towards any economic objective. The insistence of the Washington financial liberalizers that the Bank of Jamaica adopt the open market operations techniques of central banks in highly developed financial markets has been little short of disastrous. Jamaican markets are far too narrow to deal with a massive build up of liquidity in the financial system. The problem would best have been attacked at its source - the runaway fiscal deficits and the crushing burden of foreign debt.

Because growth is the primary goal of LDCs, central banks must be concerned that the liquidity of investors' portfolios be maintained, necessarily at the expense of consumers. Once again market forces may not automatically bring about the desired result, and the central bank may need to allocate credit to the productive sectors through selective policy instruments - as the South Koreans did with such success during "The East Asian Miracle." On the other hand, the removal of constraints on consumer spending can lead to an upsurge in consumer spending and to a collapse of the balance of payments.

Management of International Liquidity

The objective of international liquidity management is to maintain foreign exchange reserves and access to foreign loans at levels which allow orderly financing of imports and the timely servicing of both private sector and public sector foreign debt. This task is much more difficult than the management of domestic liquidity. For one thing, the national central bank cannot create international liquidity at will, as in the case of domestic liquidity. International liquidity has to be earned through the export of goods and services, and by building the confidence of foreign creditors as insurance against unpredictable contingencies, such as the oil shocks of 1974 and 1978 or recession in a major market. Excessive liquidity in the domestic economy can also lead to excessive imports of consumer goods and the erosion of international liquidity. Sound management of domestic liquidity is therefore a prerequisite for the effective management of international liquidity.

Foreign debt management is a critical aspect of international liquidity management. As long as their debt payments exceed capital imports, economic activity in LDCs will remain stagnant. For this reason the struggle for debt relief must continue. For the more fortunate, the major policy concern is for the extension of debt maturities and the avoidance of default on payments. As part of their exchange control liberalization programmes, central banks should also promote foreign portfolio investments by National Insurance Boards, insurance corporations, pension funds and even individuals, especially in times of excess domestic liquidity. These overseas investments will in time come to constitute a second line of foreign exchange defence against the rainy day which is never long in coming for LDCs. A case in point was the 1992 Eurodollar loan to the Barbados Government against the collateral of private corporate foreign assets which enabled the settlement of a Japanese bullet loan.

Exchange Rates

The exchange rate must be a key consideration in the management of international liquidity, especially in highly open economies, since it determines the price at which local product is exchanged for foreign exchange. The experience of Caricom States suggest that there is great virtue in the maintenance of exchange rate stability. Over the past quarter of a century, the non-devaluers have consistently out-performed the devaluers. Exchange rate stability provides the atmosphere in which both Government and the Private Sector can plan for the future: citizens are encouraged to hold domestic assets as a store of value, while foreign creditors regard it as an indicator of sound economic management.

Sir Arthur Lewis, the Caribbean's sole Nobel Laureate in Economics, has warned that "devaluation is a dangerous medicine for an economy whose imports are large relative to national income", a characteristic typical of Caricom countries.[3]

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[3] Lewis, Arthur W., **The Evolution of the Economic Order,** Princeton, N.J., Princeton University Press, 1978, p.54.

Devaluation will certainly lead to increased money costs of consumer goods, raw materials and capital goods, with an inevitable rise of inflation, while the rigidities of supply in developing countries seldom result in a compensatory expansion of export earnings.

(The reverse is true in the case of Japan, at once a major exporter and the world's largest importer of foodstuffs and raw material. These inputs into Japanese production are priced in US dollars, and so tend to depress the cost of Japanese exports when the Yen appreciates against the dollar. Japanese exports therefore benefit as much from the lower dollar as American exports do, hence the chronic Japanese trade surplus with the USA).[4]

The experience of Guyana and Jamaica, whose currencies are, respectively, 1/70th and 1/40th of their value in 1970, suggest that devaluations are not very efficacious in expanding exports.[5] Moreover, the loss of confidence in these unstable currencies has led to massive capital flight and to the loss of confidence of foreign creditors.

The moral of the Caricom experience is that economic policy makers should use policy instruments other than devaluation, especially fiscal policy, to correct early signs of balance of payments disequilibrium. However, devaluation will become necessary if the economy suffers a significant and sectoral, as opposed to cyclical, loss of export earnings, such as Trinidad and Tobago experienced with the halving of oil prices in the 1980s. Then the currency depreciation should be swift and deep enough to be credible, and wage indexation firmly resisted. Most to be avoided are serial devaluations, which lead to the progressive impoverishment and demoralization of society, with very little to show for the sacrifice.

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4 Drucker, Peter F., "The Global Economy and the Nation State", **Foreign Affairs,** September/October 1997, p.165.

5 Bynoe-Mayers, Nola, "Measuring the Real Exchange Rate Using GDP Deflators"., **Economic Review.,** Central Bank of Barbados.. Vol. XXLV, No. 1, June 1997.

Pegged or Floating Exchange Rates?

The other favourite prescription of the financial liberalizers is that of floating exchange rates. Lewis also has something to say on this matter:

> Free floating is an obvious nuisance for countries with no organized forward markets. This is an important difference in the economic order between the rich and the poor.[6]

In today's globalized and turbulent financial markets, free floating is contra-indicated for even more developed countries than those of CARICOM. To understand why, we must examine the fundamentals of international money.

Currencies cover a continuum ranging from commodity money at one extreme to pure fiat money at the other. In the case of commodity money, intrinsic value is equal to face value. Pure fiat money possesses no intrinsic value and has no backing of commodities; it has simply been declared legal tender by the sovereign. Several commodities have historically served as money, e.g. salt, tobacco, sugar, iron, etc., but gold and silver finally emerged as the commodity of choice for circulating coins. Under the gold standard of the 19th and early 20th century, it was paper money which actually circulated, but it was understood that gold would be paid on demand for paper currency tendered.

Under the Gold and Dollar standard, all governments subscribing to the Bretton Woods Agreement pegged their currencies to gold, which was priced in US dollars. The "hardness" of a currency was determined by the level of its reserves of gold, US dollars and other reserve currencies. Since President Nixon discontinued American sales of gold in 1971, the relative value of currencies has been determined by demand and supply on the international currency markets, and gold has

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6 **New York Times,** September 27, 1997, p.A4.

become simply another commodity. As a matter of prudence central banks have maintained reserves of gold, US dollars and other "hard" currencies for last ditch intervention in the international currency markets, should the value of their currency stray from the desired value or band of values. Increasingly, however, central banks have been reducing the proportion of gold in their reserves, and the US dollar has become the ***de facto*** international currency. This reflects the world's choice of the US dollar as the medium of international exchange and store of value, as well as unit of account.

Since the US settles its foreign debts almost entirely with US dollars, that is with fiat money, the US dollar is simultaneously fiat and commodity money. Several "hard" currencies, e.g. sterling, yen, D-mark, French franc, etc., are also traded on the international currency markets and are, in some degree, treated as commodities. However, they must still maintain reserves of US dollars to settle their net deficits with other countries. Such currencies are partly commodity and partly fiat money. I have described them as "hybrid" currencies. The more traded a currency, the less is the need for precautionary foreign exchange reserves. That is why Singapore maintains higher reserves than the UK or France. However, the USA alone settles its international debts by the issue of its national currency.

Since the currencies of LDCs, including Caricom states, are held by foreigners neither for transactions purposes nor as a store of value, they are not traded on established international currency markets; on informal markets they are held only for speculative purposes - hence their potential volatility. For this reason, the Bank of Jamaica could hardly have met its primary challenge of "relative exchange rate stability through operation of market demand and supply," as it promised in its 1991 Annual Report. Even Western European nations with "hard" currencies have flinched from that challenge, and now seek refuge under the umbrella of a Eurocurrency. In fact, the floating of the Jamaican dollar led to sharp devaluations and most uncomfortable exchange rate instability.

Capital Flows

The pursuit of the equilibrium exchange rate may be an exciting exercise for theoretical economists; the more modest objective of international liquidity management should be currency convertibility. This means that citizens should have reliable access to foreign exchange for legitimate purposes, while foreign investors should have confidence that their investments and dividends can be repatriated without significant capital loss. Convertibility is the bedrock of successful international liquidity management.

Convertibility is most simply achieved by pegging one's currency, either to the US dollar or that of the dominant trading partner, while pursuing policies which promote balance of payments equilibrium. A corollary of pegging is the maintenance of high levels of foreign exchange reserves to cover occasional imbalances in the domestic demand and supply of foreign exchange. In this respect the current benchmark of an appropriate level of international reserves - three months equivalent of import costs - is quite irrelevant in an era when the value of daily international capital movements vastly outstrips the value of international trade. The most serious threat to convertibility derives from unpredicted and massive outflows of capital. Although the exchange control restrictions of yesterday must be progressively relaxed, monetary authorities should retain the ultimate authority to regulate abnormal capital flows. Even McKinnon has concluded that the removal of restrictions on capital flows is the last stage in the liberalization process - not yet completed in Japan!

Since pegging takes the exchange rate option out of play, international liquidity managers will have to rely on the three other available policy instruments - monetary policy, fiscal policy and incomes policy. Because of the underdeveloped state of markets in LDCs, monetary policy will involve limited use of the interest rate tool, and greater reliance on variations in reserve requirements of central banks and, if necessary, direct intervention into financial markets. Fiscal policy is the key; and an incomes policy, however difficult to implement, will have to play its part.

The return to currency board arrangements has been strongly recommended to the Government of Jamaica by Professor S. Hanke as a means of ensuring convertibility. Indeed, Argentina has adopted this strategy with some success. The original arguments of policy rigidity and sacrifice of seignorage, which prompted the graduation from currency board to central bank remain valid. The optimal monetary regime is a well managed central bank operating within a framework of a stable macroeconomic framework. However, if Governments doubt the national capacity for responsible fiscal operations, they should not hesitate to return to currency board arrangements.

Principles of Liquidity Management

The globalization of financial markets requires a corresponding adjustment in LDCs, including CARICOM. The issue is whether we shall swallow the prescriptions of the financial liberalizers hook, line and sinker, or if we will pursue our programmes of deregulation in a studied and deliberate manner. The following ten principles of liquidity management are suggested by the preceding analysis:

1. Policy making is contextual, requiring the adaptation of generalized principles to the specific circumstances of the case.

2. The state of financial markets determines the manner in which liquidity management is conducted.

3. The widespread imperfections of financial markets in LDCs, such as Caricom States, limits the efficacy of interest rate policy and open market operations in the management of domestic liquidity. Frequently non-market measures, e.g. moral suasion and the selective allocation of credit will have to be utilized.

4. In the management of domestic liquidity the greater reliance must be on fiscal policy; resort should also be made to an incomes policy to the degree that it is politically feasible.

5. Effective management of domestic liquidity is the prerequisite for successful management of international liquidity.

6. Since currency stability is so vital to economic progress, devaluation should be a policy instrument of last resort. External borrowing is appropriate to cover cyclical fluctuations in foreign earnings.

7. Devaluation is the indicated policy instrument when a secular decline in export earnings is judged to be permanent; then devaluation should be deep enough to be credible so as to avoid repeated currency depreciations.

8. "Floating" is contra-indicated for highly open LDCs such as Caricom states.

9. Currency convertibility is best achieved through pegging to a "hard" currency, along with the maintenance of high levels of foreign exchange reserves.

10. The liberalization of capital flows is the final stage of financial liberalization.

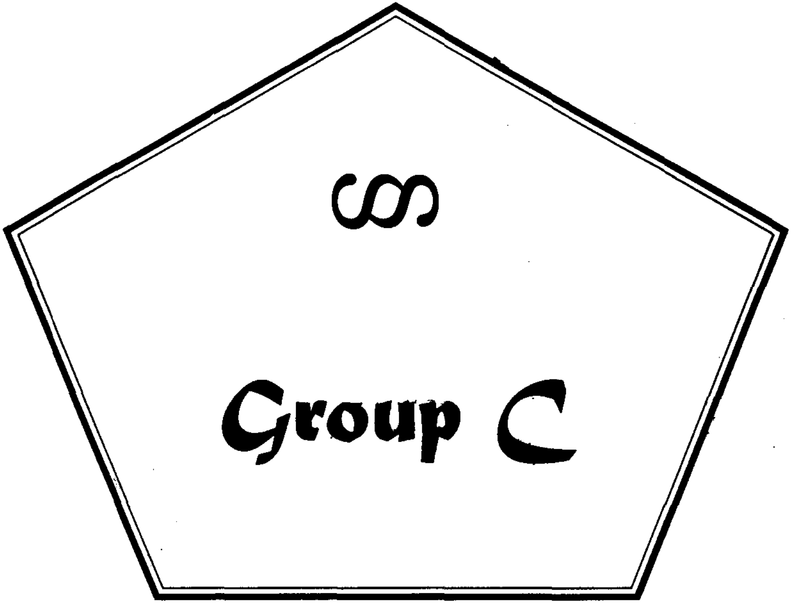
Concluding Remarks

Sometime in the Spring of 1996, I had the honour to represent Prime Minister Arthur at the meeting of Western Hemisphere Finance Ministers in New Orleans. Several of the Latin American Ministers present complained of the economic dislocation and the civil unrest which had accompanied their financial liberalization programmes. The most spectacular was the collapse of the Mexican peso, when only an American orchestrated IMF/OECD bale-out averted economic catastrophe.

I observed that I could sense the ghost of Karl Marx hovering above the meeting place. Marx's most important insight was the inherent instability of the capitalist system which generated deeper income inequality and led to class alienation. John

Maynard Keynes, although fiercely anti-Marxist, also acknowledged the inherent instability of capitalist production, and so prescribed government spending as a means of generating contra-cyclical demand and restoring full employment. The American economist Hyman Minsky would later identify the increasing complexity of the financial sector as a major source of instability in capitalist economies.

The lesson for LDCs is that financial liberalization will certainly render our economies more unstable and difficult to manage. This is why we must proceed with such caution and, hopefully, with even greater wisdom. President Jiang Zemin got it right when he insisted that, although the process of economic reform was irreversible, China would make major moves to open its markets only "as economic conditions improve and at a pace that China feels it can handle".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Group C

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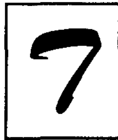
Towards a Theory of Central Bank Management - With Special Reference to the Caribbean*

Introduction



here was considerable consensus among Caribbean economists in the 1960s and 1970s that new public sector institutions were required to serve as catalysts of economic development. In particular, the New World Group encouraged elaborate programmes of public sector investment, including the nationalization of both foreign and domestic enterprises. However, inadequate attention was paid to the problem of managing these new institutions. My own insistence in the late seventies on the critical importance of management in economic development was regarded as eccentric. The disastrous financial losses of public enterprises during the 1980s in Trinidad and Tobago, Jamaica, Guyana, and most recently Barbados, have focussed attention on the poor quality of management at all levels of the Caricom economy,

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and management institutes have been established on all three University of the West Indies campuses to address the problem. More recently CARICAD has published a monograph, **Report on Management of Public Enterprises in the Caribbean,** which includes my Study, "The Management of Caribbean Public Enterprises".

Central Banks were the most important of the new Caribbean public sector institutions. However, whereas there are numerous studies on the managerial problems of State-owned commercial, industrial and financial enterprises – most notably "Management in Development", appearing in the World Bank's **World Development Report 1983** – there have been few studies on the managerial problems of central banks. Indeed, my research has unearthed only one article on central bank management – "Management Strategy of a Central Bank in a Developing Country,"[1] by the late Rudolph Kroc, who advised on the establishment of the Central Bank of Barbados and served as its first General Manager. Kroc's remarkably concise piece touches several aspects of central bank operations and still deserves the attention of central bankers everywhere. However, Kroc's treatment remains firmly fixed within what Stanley Davis describes as the "mechanistic/industrial" management tradition.[2]

The rarity of studies on the management of central banks reflects the mystique in which the directorates of these institutions have traditionally clothed their organizations. Indeed, the general public is far more likely to assess the performance of a central bank on the basis of the Governor's personality than from the consequences of its policies. For one thing, there are less than 200 central banks throughout the

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1 Kroc, Rudolph, "Management Strategy of a Central Bank in a Developing Country", **Finance and Development,** Washington, D.C., World Bank, June 1972.

2 Davis, Stanley M., **Future Perfect,** Reading, Mass., Addison-Wesley Publishing Company, Inc., 1987, p. 200.

world, and only one in each country! Although central banks (including the Bank of England in the 1970s and the Bundesbank most recently), have sometimes invited international business consulting firms to review and update their operations, and although the IMF's Central Bank Advisory Department routinely dispatches consultants to advise on central bank management, the literature on central banking has been concerned primarily with policy issues, and with the relationship between the Central Bank and Government rather than with the problems of institutional management.

This situation will probably soon change. First, like public sector institutions everywhere, central banks are increasingly subject to public scrutiny. The Bank of England is currently under severe criticism for failing to act in a more timely manner against BCCI. With excessive money creation the major source of economic discontent in Jamaica, it is not surprising that the Patterson Administration has set up a committee to examine the establishment of an independent central bank. Guyana, Barbados, and Trinidad and Tobago would do well to follow suit. On a more positive note, the collapse of the Eastern Bloc has led to the creation of over a dozen new central banks, and led to the reorientation of the socialist-style national banks. The Bank of England has set up an Institute of Central Banking especially to train the new central bankers and to re-tool the old ones. A new periodical, "Central Banking", focusing exclusively on central bank issues, commenced publication a year ago in London.

In the opening remarks of his above-mentioned article, Kroc acutely observed:

> Most managers of central banks, especially in developing countries, think of their institutions as being well-managed. In arriving at this judgement, they apply the simple criterion that so far, it has been able to carry out the functions for which it was created. From this narrow point of view, it is difficult to fault their judgement. However, if the performance of these managers is viewed from the vantage point of optimal efficiency in attaining the aims of the central bank in the long run, and in accomplishing its various functions

> continuously and effectively, the judgement may be quite different.[3]

His observations still make sense over twenty years later. In view of the dramatic changes in management practice following the arrival of the New Information Age, central bank managers would do well to reexamine the premises on which the management of their organizations are founded. This Paper outlines an analytical framework within which such a managerial review might usefully be conducted.

We begin with a parody of Peter Drucker's classic question, "What is the business of central banks?" In answering this question we cannot escape discussion of the relationship between the Central Bank and Government. The answer to this question leads us to model the central bank as an information system utilizing knowledge workers to process inputs of data into outputs of decisions, advice, and education. Third, we explore the managerial implications of employing knowledge workers. The next obvious question is, "How do we measure the performance of a central bank?" We conclude with a summary of our findings.

The Business of Central Banks

Different Caribbean Central Bank Acts define their purposes in different ways. These purposes may be generalized as follows:

1. preservation of the internal value of the currency;

2. preservation of the external value of the currency;

3. promotion of a healthy financial system;

4. promotion of economic development;

5. development of capital markets.

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[3] Kroc, Rudolph, op. cit.

In most cases the Acts do not establish a clear hierarchy of purposes. The Barbadian Act appears to give equal weight to them; the Jamaican and Guyanese Acts seem to give priority to economic development over other purposes, while the Bahamas and ECCB Acts suggest the priority of monetary stability over economic development. However, none of them are as specific as the Act establishing the Bundesbank, which allows support of the Government economic policies "without prejudice to the performance of its functions." "This means", says Hans Tietmeyer, "that in case of conflict ... the commitment to price stability would carry the day."

Similarly, Central Bank Acts broadly describe their functions as follows:

1. issue and redemption of the currency;
2. management of foreign exchange reserves;
3. banker to the government;
4. banker to the financial institutions;
5. Bank Supervision;
6. Exchange Control.

Several central banks, including the banks of Jamaica and Guyana in CARICOM, do not operate exchange controls. In some developing countries, notably Canada and Germany, bank supervision is conducted by other institutions. The US Federal Reserve System shares the responsibility for bank supervision with the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the State bank supervisory authorities.

The distinctive characteristic of a central bank is that its liabilities must be accepted as final payment within the political entity it serves. We might say that its balance sheet position is infinitely liquid. Because of this attribute the Central Bank can exert a powerful influence over the liquidity positions of

economic units, collectively or individually. It does this by altering the price of money through changes of the discount rate, or by affecting the aggregate supply of money through changes in reserve requirements, open market operations, or by extension of credit to Government and commercial banks. It is this attribute of the infinite liquidity of its balance sheet which enables the Central Bank to act as lender of last resort. In developing countries with highly imperfect money and capital markets, central banks may resort to direct methods, such as interest rate and credit ceilings, and through direct quantitative restrictions that limit or allocate credit.

The extent of the Central Bank's responsibility for the achievement of its objectives is a function of its independence of the Government. The Central Bank/Government relationship is especially problematic. Government is at once the owner and the main customer of the Central Bank; it is also the major investor and the major consumer in the society. This makes Government a most unruly client. Caribbean central banks have therefore little defence against irresponsible fiscal policy.

Legislation establishing central banks in some developed countries, notably Germany, have deliberately shielded them from Government directives, and have endowed their management with considerable independence from political direction. New Zealand, South Africa and Chile (the "wise men from the South") have recently taken steps to free their central banks from the authority of the Ministry of Finance and charged them with the single objectives of price stability. Alone among Caricom States, Jamaica is considering the establishment of an independent central bank.

The ECCB, although formally subject to the Council of Ministers, does in fact enjoy considerable independence by virtue of the rule which requires ministerial unanimity on all major decisions. This has effectively prevented any individual Minister of Finance from abusing the money creation powers of the ECCB, and undoubtedly accounts for the superior performance of the OECS relative to its "more developed" Caricom partners. Not surprisingly, the recommendations of Caricom Central Bank

Governors on the institutional structure of the proposed Caribbean Monetary Authority insist upon the independence of the institution, and that its primary objective should be the preservation of the internal and external value of the currency.[4]

A second constraint on the performance of central banks is the extent of their operational autonomy. In some cases salary scales must be approved by the Minister of Finance, and senior staff appointments, and some not so senior, must be approved by him. The first practice severely limits the ability of central banks to attract and retain high-class personnel; the second serves too frequently as the thin end of the wedge, opening up opportunities for the politicization and consequent corruption of the organization. As Professor Galbraith so forcefully argues, operational autonomy is the only administrative arrangement consistent with effective corporate operations.[5]

The third constraint on central bank performance is the unfamiliarity of the public at large with the Bank's purposes and operations. Macroeconomic management in the modern economy is most difficult, if not impossible, in the absence of widespread public understanding and cooperation. A successful central bank must allocate considerable resources to the ongoing education of the public at large.

The Central Bank as an Information System

The quality of a central bank's performance depends critically on the appropriateness of its policies and of its advice to Government. It is therefore useful to conceive of the Central Bank as an information system embedded within the environment of the domestic and international economy. The basic elements of the information system are "output", "process",

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[4] The author has dealt extensively with this topic in "New Directions for Central Banking in the Caribbean", *Social and Economic Studies,* Vol.38, No.4, 1989.

[5] Galbraith, John K., **Economic Development,** Boston, Houghton Mifflin, 1964, p.89.

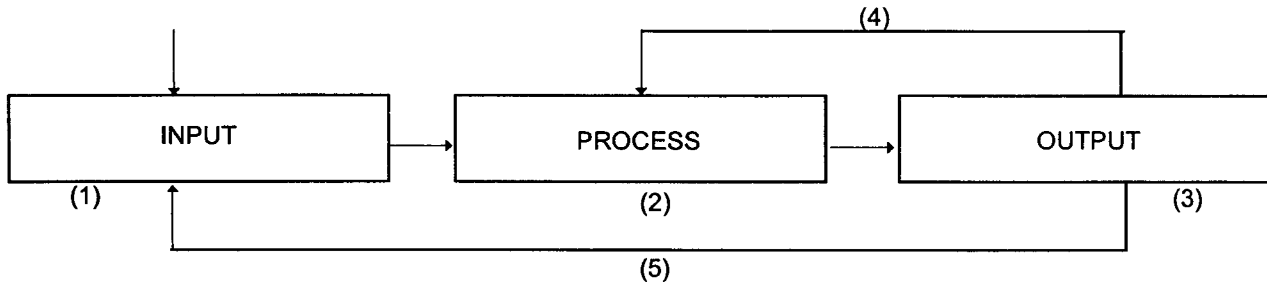
and "output". The more complicated model, presented in **Figure 1,** includes "feed-back" from "output" to "process" in order to allow for monitoring and correction of performance, and "feed-back" of results back to "input".

Because of its role as banker to the commercial banks, the Central Bank's own accounts are an excellent source of information about the liquidity of the financial system. Through its bank supervision activities, the Central Bank also learns much about the condition of the corporate sector, whose debt represents a significant proportion of the assets of commercial banks. As banker to Government, the Central Bank has an on-going picture of Government's fiscal and financial operations. Exchange control and foreign exchange operations provide a steady flow of information on the balance of payments. As fiscal agent of Government, the Central Bank has an intimate knowledge of the national debt position, both foreign and domestic. Finally, the Central Bank's network of relationships with international institutions engenders a wide knowledge of international financial markets, while its membership in the international central banking fraternity makes it privy to much sensitive and invaluable information.

Information from the environment is screened, classified, stored, retrieved and analyzed by Central Bank statisticians, economists, accountants, lawyers, managers and other technical and professional staff, subsumed under the category of "knowledge workers." Knowledge workers now constitute an increasing proportion of the staff of a central bank - a knowledge institution ***par excellence***. The tools of knowledge workers are theories, analytical techniques, and other professional, technical and intellectual skills.

Knowledge workers have traditionally used libraries as their most important data bases and data processors. Today, they increasingly use computers to store, retrieve and analyze information. We may therefore think of the "process" as comprising both the brains of the Central Bank' s knowledge workers and the high-technology equipment which they employ in their data collection, analytical and decision-making exercises - intelligent people and intelligent machines.

FIGURE 1
INFORMATION MODEL OF A MODERN CENTRAL BANK



Legend:	(1)	Input:	Information from Environment
	(2)	Process:	Intelligent People/Intelligent Machines: Memory, Analysis, Judgement
	(3)	Output:	Knowledge-based Services: Policy Decisions, Advice to Government, Services to Economic Units, Education of Policy.
	(4)	Feed-back:	To permit monitoring and, if necessary, correction of results.
	(5)	Feed-back:	Information genderated by Output.

References: Adapted from David W. Miller & Martin K. Starr, **Executive Decisions and Operations Research,** Englewood Cliffs, New Jersey, Prentice Hall, 1969.

The output of the information system comprises the policies, decisions, advice to Government and the Central Bank's communications to the public at large. The quality of these outputs can have a decisive influence on economic outcomes. Unfortunately the impact of central bank operations on the regional economy has been generally deleterious, and too often devastating.

Managing Knowledge Workers

Increasingly staff employed by central banks in the Caribbean are not manual and clerical workers, but university trained statisticians, economists, computer analysts, lawyers and management specialists - what we now call knowledge workers. Indeed, many clerical and secretarial officers at the Central Banks of Barbados and Trinidad and Tobago hold university degrees, and a growing number of Ph.D.'s now inhabit these institutions. Moreover, today's clerical and stenographic staff work with increasingly sophisticated computerized equipment which has considerably enhanced their productivity and potential contribution. Indeed, the arrival of the computer is leading rapidly to the demise of yesterday's clerk, stenographer and statistical assistant. For example, economists no longer hand out their manuscripts to typists, but compose their papers on word-processors; and they conduct their statistical analyses and design their graphs on computers.

To accommodate and, indeed, to realize the potential of knowledge workers requires a radical change in our management approach. Yet central banks in the region continue to employ the mechanistic/industrial model of management, with its top-down hierarchical structures, and bureaucratic procedures that assign a specific job to each worker and indicate specifically to whom he reports and who reports to him. Where union contracts exist, there are also standardized incremental salary scales, rewarding seniority rather than performance, and defining precise disciplinary procedures.

The closer the centre of gravity of central banks shifts towards "knowledge" work, the more obsolete the mechanistic/

industrial management model becomes. In the first place, as Drucker points out, "the knowledge worker is not productive under the spur of fear; only self-motivation and self-direction can make him productive. He has to be achieving in order to produce at all."[6] This is because the productivity of the knowledge worker derives, not from the number of hours worked or physical effort expended, but from the quality of his intellectual contribution. You cannot force quality out of a knowledge worker; he has to give it to you! In short, he needs leadership more than he needs direction and supervision. An organization staffed by knowledge workers is by definition a thinking organization. The rapid developments in science, technology and management practices dictate that the knowledge organization must be a learning organization as well. For knowledge workers education is an on-going activity. Knowledge workers need not so much training and re-training, as did yesterday's workers; they need opportunities to learn and room to grow.

Organizational Structure

Organizational structures are means to ends, not ends in themselves. Their appropriateness is determined by the nature of the tasks to be executed and the capacities of individual staff members. Institutions whose success depends on knowledge and knowledge workers require a different organizational structure from that prescribed by the mechanistic/ industrial model. Here we focus on the four most important considerations in the organizational design of the modern Central Bank.

1. *Lateral Communication*

The organizational structure must accommodate lateral communication between knowledge workers. This is because the tasks of central banks require a mix of several different skills, and knowledge workers must be in continuous communication with each other across the formal boundaries of their

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[6] Drucker, Peter F., **Management: Tasks, Responsibilities, Practices,** New York, Harper & Row, 1974, p.176.

departments. Indeed, the "task force" is just becoming the classic organizational technique of knowledge institutions.

2. *"Flat" Organizational Structure*

Organizational structures will be flatter than in the past. The proliferation of computers provides for the instantaneous flow of operating results from the front line to top management, thus eliminating the need for several layers of middle management who previously served as conduits of information flows - and too frequently as obstacles. Moreover, as noted above, self-directed knowledge workers do not require the detailed and continuous supervision as did the old-fashioned workers. Corporations in developed countries have been shedding middle managers by the tens of thousands.

3. *Multiple Rather than Specific Tasks*

The increasingly better educated front line staff, freed by the computer from boring and repetitive tasks, can be trained to carry out multiple rather than specific tasks. They also will routinely communicate across previously impenetrable functional barriers. Moreover, as Tom Peters argues, "The key to unlocking extraordinary productivity and quality improvements lies within the heads of the persons who live closest to the task, those on the firing line."[7]

4. *Less Rigidity and Formality*

Since the task of top management in the knowledge institution is shifting from command to leadership, the organizational structure of the Central Bank will become less rigid and formal. The relationships among managers will reflect shared values, rather than hierarchical status. The primary role of the Governor in this scenario will be the shaping and the sharing of the vision of the organization, the definition and articulation of its mission, and the determination and nurture

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7 Peters, Tom **Thriving on Chaos,** New York, Harper & Row, 1988, p. 663.

of the core values of the organization which, James Handy suggests, should be built around information, ideas and intelligence.[8] The days of the super-star Governor with a large supporting cast are certainly numbered. Communication, rendered easier by lateral linkages between departments and the flatter organizational structure, will be an increasingly essential skill of Top Management. **Figure 2** presents an extreme representation of the organization of tomorrow.

The arguments expounded above are concisely expressed by Drucker:

> Business organization as we know it has developed fundamentally in the shape of a pyramid, with a "command" function, mitigated by the emergence of "staffs" who were "advisory" rather than "command"... Increasingly, we will see organizations as concentric, overlapping, coordinated rings, rather than as pyramids. There is need for "top management" and there is need for an ultimate "command" - just as there is need for a skeleton in the animal body. There is need for a clear locus of decisions, for a clear voice and for unity of command in the event of common danger and emergencies. But there is also need for accepting that within given fields the professionals should set the standards and determine what their contribution should be.[9]

The ultimate implication of the emergence of the knowledge-based Central Bank is the inclusion of all staff in the purposes of the organization and in the responsibility for the achievement of its objectives. Stanley Davis has suggested a beautiful paradigm of this imperative.[10] Just as the genetic

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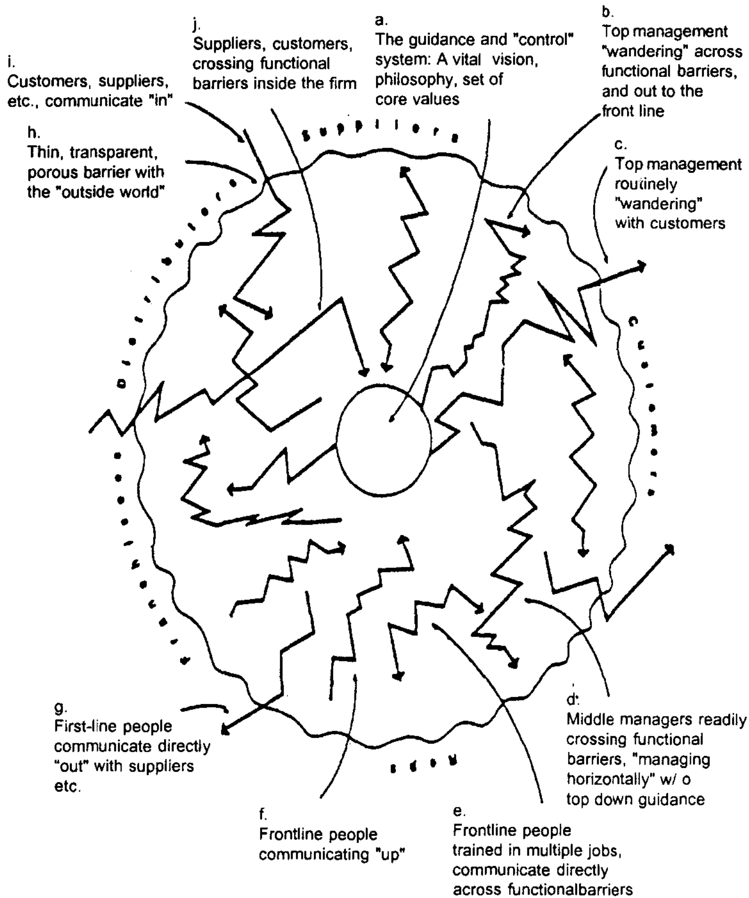
8 Handy, James, **The Age of Unreason,** Boston, Mass., The Harvard Business School Press, 1989, p.141ff.

9 Drucker, Peter F., **Managing in Turbulent Times,** London, Pan Books Ltd., 1980, pp.129-130.

10 Davis, Stanley M., op. cit., p.201.

FIGURE 2

THE FLEXIBLE, POROUS, ADAPTIVE, FLEET-OF-FOOT ORGANIZATION OF THE FUTURE: EVERY PERSON IS "PAID' TO BE OBSTREPEROUS, A DISRESPECTER OF FORMAL BOUNDARIES, TO HUSTLE AND TO BE FULLY ENGAGED WITH ENGENDERING SWIFT ACTION AND CONSTANTLY IMPROVING EVERYTHING



Source: Tom Peters, **Thriving On Chaos: Handbook for a Management Revolution,** New York, Harper & Row, 1988, p. 661.

code of our entire biology resides in every cell, so must the image of the desired central bank exist in the consciousness of every staff member.

Measurement of Performance

Performance measurement presumes the prior establishment of goals and objectives, and the determination of standards and measures by which we may assess the extent to which goals have been achieved. Assessing the performance of a central bank is especially difficult. Many of the results of its performance are observable only after a long time period - sometimes long after the Management which set the policies in motion has retired. However, incumbent managers have no choice but to design procedures for assessing institutional performance on an on-going basis.

Profits, that is the excess of the value of outputs over the cost of inputs, are the conventional measure of performance of enterprises in capitalist economies. (Even that measure must be interpreted with great caution, since enterprises frequently earn short-run profits at the expense of their medium or long-term extinction). In the case of central banks, "profit" is virtually useless as a measure of performance. Indeed, it can frequently be a perverse index of performance. Interest earned from the extension of credit to finance run-away fiscal deficits may produce enormous central bank profits in the midst of general economic collapse!

The performance measurement problem derives from the fact that whereas the inputs into the central bank operations are purchased in the market place - labour, supplies, equipment - its outputs are generally not saleable. This reflects the uniqueness of the Central Bank. The problem of measurement is further complicated by the variety of a central bank's clients and services.

It is possible to identify and measure earnings from some central banking operations. The most obvious is the return on the investment of foreign exchange reserves. Even here absolute

money earnings are not conclusive. More useful are comparisons with the performance of international portfolio managers. I have elsewhere suggested that "pace-maker" portfolios be farmed out to established international portfolio managers, operating under identical criteria of performance, so as to serve as a standard of performance for the Central Bank's in-house portfolio managers.[11]

In some cases it may be possible to impute values through reference to similar services provided by private sector enterprises. Some central banks actually bill commercial banks for bank supervision services, while others charge Government for debt management services at cost plus the prevailing profit margin. However, we must be careful that these measurement exercises are not so costly as to negate the value of knowing how well the organization is performing.

A Practical Approach to Performance Measurement

Overall cardinal, or even ordinal, measures of a central bank's performance are clearly futile. This does not absolve central bank managers from establishing standards of performance for each operation or department, using quantitative measures where possible, as in the case of portfolio management, and judgmental standards where necessary. This approach must begin with Drucker's stricture that all results are realized outside the organization, i.e. in the value of services to clients. Within the organization, he contends, there are only costs. Applied to central banking operations, this means that the value of a central bank's services are appropriately assessed by the extent to which they add value to the outputs of clients.

The first step in this approach is to identify the various clients, to determine what services the Central Bank can and should deliver, and to identify the departments responsible for

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[11] Blackman, Courtney N., "Managing Foreign Exchange Reserves in Small Developing Countries", New York, Group of Thirty, ***Occasional Papers*** No. 11, 1982.

the delivery of particular services. The second step is to devise quality standards and measures of performance for the production of these services. For example, one measure of performance in the Exchange Control Department might be a minimum time period for the processing of applications. Step three is the determination of the costs of resources required to meet the standard of performance desired. This is the critical step: the Department Head must be put under great pressure by the Budget Committee to come up with the most cost-effective means of achieving the desired departmental objectives. Once the overall budget is finalized, there should be no pressure on him to cut costs further, since there is no way of knowing the true relationship between the costs saved and the value of the product lost from the cost-saving exercise. In short, the concepts of cost-minimization or profit-maximization are of limited value in the management of a central bank. We must practice the art of "satisficing". Finally, the top Central Bank Management, through its Public Relations Department, must be in continuous receipt of feed-back from its various clients as to effectiveness of its services, so that on-going efforts might be made to improve and extend such services.[12]

However, the most important aspects of central banking operations cannot be captured by either judgmental or qualitative measures of performance. They have to do with professionalism and disinterest in party politics. Perhaps the word which captures it best is "credibility". The general public, and especially the Opposition Parties, must come to trust the authenticity of the Central Bank's statistical reports and press releases. It must have confidence that the interpretation of statistical data and the timing of their releases are not calculated to serve the political interests of the political party in power, or any other party for that matter. And credibility once lost is most difficult to recover!

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[12] The author has spelled out the role of Public Relations in Central Banking in "The Concept of the Image", **The Practice of Persuasion,** Bridgetown, The Cedar Press, 1982, pp. 170-177.

Summary and Conclusions

1. The independence of the Central Bank from the policy directives of Government, except in unusual circumstances, is absolutely necessary if this institution is to make a meaningful and rèliable contribution to national economic prosperity. The simultaneous status of sole proprietor and chief client of the Central Bank represents a clear conflict of interest on the part of Government, and has caused several regional central banks to become dysfunctional.

2. The maintenance of the internal and external value of the currency should be established as the primary goal of central banking. No other activity should be allowed to prejudice this purpose.

3. The remaining governmental constraints on the operational autonomy of central banks in the Caribbean should be speedily removed. Operational autonomy is a ***sine qua non*** for the effective functioning of any corporate enterprise - not least of all central banks.

4. The progressive shift towards the employment of knowledge workers requires a paradigmatic shift in the theory of central bank management. This will involve: (a) provision for more extensive lateral communications; (b) a flatter organizational structure; (c) the job enrichment of front line staff through training for multiple rather than specific tasks; (d) a shift in managerial style from command to leadership.

5. The role of the Governor will progressively become one of (a) shaping and sharing the vision, (b) defining and articulating the mission, and (c) establishing and nurturing the core values of the organization.

6. The modern Central Bank must not only be a thinking organization, but a continuously learning one as well.

7. The quality of the Central Bank's performance increasingly depends on the commitment of all staff to the goals of the institution.

8. The establishment of appropriate standards and measures of performance requires the precise identification of the Central Bank's several clients, and the clear definition of the services offered to each client.

9. The view of the Central Bank as a provider of services to the public requires the development of the public relations function, both to market the Central Bank's products and to provide feed-back on the quality of its performance.

10. The most important measure of a central bank performance is its credibility with the public at large. In this respect, a politicized central bank is worse than no central bank at all!

10 Financial Policy and Institutional Reforms: The Central Bank*

Introduction

Some wines do not travel well and have to be drunk **in situ.** Similarly, the institution of central banking, unlike the game of cricket, did not travel well across the Atlantic, and has not flourished in its Caribbean environment. Established to maintain internal and external monetary stability and to promote economic development, the money-creating powers of Caricom central banks have frequently been abused by political directorates, thus promoting inflation, currency depreciation and economic decline. In Guyana and Jamaica in the second half of the 1970s, and most recently in Barbados (1990-91), the financing of massive government fiscal deficits through central bank credit has been the proximate cause of balance of payments collapse and consequent economic malaise. Dr. Terrence Farrell has also remarked on the inability of the Central Bank of Trinidad and Tobago to pursue policies which might have compensated for extravagant government

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* Paper presented at the Seminar: "The Jamaican Economy in a Changing World: The Way Forward: 1993/94 and Beyond". The Jamaica Pegasus Hotel, February 25, 1993.

spending of windfall petro-dollars in the seventies and early eighties.[1]

Since other central banks, with the notable exception of the Eastern Caribbean Central Bank (ECCB), operate under the same institutional arrangements as those in the MDCs, there is a high probability that those institutions too could similarly become subject to political abuse in times of economic stress, with the inevitable consequence of balance of payments collapse and other economic disasters. In short, the central bank as an institution has become dysfunctional in the conditions of CARICOM.

The purpose of this Paper is to review the institutional record of the Bank of Jamaica, to diagnose its institutional defects, and make recommendations for its institutional reform. I have been well positioned over the years to carry out this exercise. I first visited the Bank in 1966. I returned in 1967 to carry out research on my dissertation for a Ph.D. at Columbia University, New York, entitled "Central Banking in a Dependent Economy: The Jamaican Experience 1961-67." (The dissertation was completed in 1969). In my capacity as Governor of the Central Bank of Barbados from 1972 -1987, I enjoyed close and continuous relations with the Management and Staff of the Bank of Jamaica. Since 1987 consulting assignments have kept me in regular contact with the institution.

I should like to emphasize at this point that this Paper deals with the institutional aspects of Bank of Jamaica and is in no way a critique of its Management and Staff. In fact, they are more appropriately cast as the victims of ideology and partisan politics, as sacrifices to the false gods of "equilibrium exchange rates", "high positive real interest rates", and "financial liberalization". Indeed, no cadre of public servants in the

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1 Farrell, Terrence W., **Central Banking in a Developing Economy: A Study of Trinidad and Tobago 1964-1989,** Institute of Social and Economic Research, Mona, Jamaica, 1990, p. 129.

Caribbean has served with greater dedication and tenacity in the face of seemingly insuperable odds.

Institutional Review

Any assessment of the performance of an institution must begin with an examination of its purposes. The critical purpose of the Bank of Jamaica, as set out in the relevant statute, is "... to influence the volume and condition of supply of credit so as to promote the fullest expansion in production, trade and employment consistent with the maintenance of monetary stability in Jamaica and the external value of the currency ... " The Bank of Jamaica, as an institution, is to be judged by the extent to which these goals have been achieved.

The attribute which enables the Central Bank to regulate the volume of credit, and hence the level of liquidity in the financial system, is its legal power of money creation. By purchasing the financial assets of commercial banks or of the Government (i.e. by financing fiscal deficits), the Central Bank can increase overall liquidity in the economy. By raising reserve requirements, interest rates, and through various other monetary techniques, it can tighten liquidity conditions in the financial system. Excessively tight liquidity conditions depress economic activity, leading to a reduction of employment, imports and, most likely, of prices. Excessively liquid conditions, usually brought about by the financing of Government deficits, can lead to an over-expansion of economic activity, accompanied by inflation and balance of payments disequilibrium. In highly open economies like Jamaica, Professor Walter Eltis reminds us, "The ultimate effect of the ... deficit financed expansion is to destroy the balance of payments."[2]

During the first decade of its existence, 1961-1971, the Bank of Jamaica did an excellent job of maintaining price and exchange rate stability, and national economic growth proceeded

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[2] Eltis, Walter, "The Failure of Keynesian Conventional Wisdom", **Lloyds Bank Review,** No. 122, October 1976.

at a steady, if not dizzying, rate. The judgement of my dissertation was that up to 1967, at least, "the Bank never degenerated into being an agent for Government deficit financing."

The 1974 Oil Shock presented the first serious challenge to the institutional integrity of the Bank. Jamaica is highly dependent on imported energy, and the three-fold increase in the price of oil struck a serious blow at an economy already subsiding from the rapid growth rates of the 1960s. As I recall, the Management of the Bank of Jamaica demonstrated great skill and resourcefulness in maintaining adequate supplies of foreign exchange to support national economic activity. With the unilateral increase in the levies on bauxite exports, Jamaica's foreign exchange reserves stood at the historically high level of US$318 million at year-end 1974.

It was at this juncture that the Manley Administration, imbued with the ideology of democratic socialism, embarked on a massive programme of fiscal expansion which was financed primarily by central bank credit. Government borrowing from the Bank of Jamaica increased from J$76.8 million at December 31, 1975 to J$435.8 million by the end of 1977, and the nation's foreign exchange reserves were exhausted by the end of 1976. The Second Oil Shock of 1978 struck an economy already operating in the zone of negative foreign exchange reserves and threw it into chronic disequilibrium. The insistence of international financial institutions on treating a case of chronic disequilibrium with "equilibrium" medicine, has greatly hindered the recovery of the patient.[3]

Clearly, the goals of economic growth, and internal and external monetary stability, with which the Bank is charged by statute, have not been achieved. According to World Bank statistics, Jamaica's economic growth rate was negative 1.3% during 1965-90, and the average rate of inflation 12.8%, moving up to about 18% during the decades of the 1970s and 1980s. In

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[3] For a more extensive treatment of "chronic disequilibrium", *see* Blackman, Courtney N., "A Heterodox Approach to the Adjustment Problem", (The First Adlith Brown Memorial Lecture), ISER, Mona, Jamaica, 1985.

recent times the Jamaican economy has flirted with hyper-inflation, with monthly rates sometimes approaching 100%. Meanwhile, the external value of the Jamaican dollar has slipped from US$1.00 = J$0.77 in 1972 to US$1.00 = J$22.50 today. Jamaica's external debt outstanding, a mere US$154 million in 1970, reached US$1.4 billion in 1981 and, in spite of significant foreign aid and debt forgiveness, stood at nearly US$4 billion in 1990. Equally as troubling, the financing of run-away fiscal deficits has resulted in a humongous overhang of government liabilities to the Bank of Jamaica of over J$20 billion at year-end 1991. Not surprisingly, as Dr. Headley Brown points out, the financial system remains awash with liquidity.[4]

It is empirically observable that those Caricom countries which did not, or could not, finance their fiscal deficits with central bank credit, have outperformed Jamaica and other offenders in respect of economic growth, and internal and external monetary stability. Guyana, which embarked on a similar deficit spending binge at the same time as Jamaica, fared even worse! Barbados was doing quite well until its 1990 pre-election central bank financed deficit spending extravaganza, which precipitated that island's balance of payments collapse and plunged the economy into chronic decline. On the other hand, OECS member states have maintained a steady and positive growth rate, averaging about 4% over the decades of the eighties and the nineties, and have held their inflation rates mostly in the single digit zone. Moreover, the ECCB has maintained the US dollar value of its currency throughout the period.

We may draw two important inferences from this data. The first is that long-term sustainable economic growth is incompatible with high rates of inflation and repeated currency devaluations. The second is that measures which seek to accelerate economic growth through deficit spending, financed by central bank credit, will set off a downward spiral of economic decline.

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4 Brown, Headley A., "Serious Misunderstandings about Bank of Jamaica Losses", Press Release, Kingston, January 26, 1993.

The superior performance of the OECS, as compared with their ironically titled "more developed" Caricom partners, is especially instructive. The reason is not hard to find. The constitution of the ECCA, as well as that of its successor ECCB, severely limited the money creation powers of the monetary authorities by requiring unanimous agreement among Ministers of Finance on all issues. The unanimity rule means that although the ECCB Governor cannot say "no" to the Council of Ministers speaking with one voice, neither can he say "yes" to an individual Minister seeking to finance his fiscal deficits with central bank credit. The fiscal expenditures of OECS members have been restricted to tax revenues, local commercial bank loans, foreign aid and limited foreign borrowing. By force of circumstance the OECS member states have pursued the "appropriate" fiscal policies. The major lesson to be drawn from the OECS experience is that the "depoliticization of the money supply" is a necessary condition for economic growth and stability under Caricom conditions.

The Trajectory of Institutional Decline

Some time ago Mr. Frank Rampersaud, retired Permanent Secretary of Finance in Trinidad and Tobago, posed the question: "Where were the central banks when the fiscal deficits were widening; when the currencies were depreciating; when the foreign debts were piling?" He went on:

> The Ministry of Finance has to bear major responsibility for it; but vigilant Central Banks could also have been expected to have highlighted the consequences of failure of the Governments to exercise due procedure in their external financial transactions; and there is no empirical evidence to indicate that these Banks did that.[5]

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[5] Rampersaud, Frank, "Economic Policy Formulation and Implementation in the Caribbean", Lecture delivered to central bank trainees at the Central Bank of Trinidad & Tobago, May 31, 1988. (Unpublished mimeograph)

Mr. Rampersaud's stricture ignores the institutional realities of central banking within CARICOM. The Bank of Jamaica, the first Caribbean Central Bank, was cast faithfully in the Bank of England mould. Indeed, its first two governors were both seconded from the Bank of England and served for a combined period of seven years. The model which they established was accepted both by their successors and by Caricom political directorates. In his address on the occasion of the 10th Anniversary of the Central Bank of Barbados, Mr. G. Arthur Brown articulated his theory of central banking in terms to which Mr. Leigh Pemberton, the current Bank of England Governor, could not take exception:

> The first principle to state is that the Central Bank, its Governor and staff exist within the context of a social structure which, in the case of the Caribbean has indicated the broad areas of government policy and economic organization through the electoral system. No central bank can arrogate to itself the direction nor the elaboration of policies out of harmony with the mandate of the government in power ... Many critics of central banking policy in the Caribbean appear at times to assume that these banks should have their own economic and foreign policy. A word which is pejorative but aptly describes what these critics advocated, is sabotage.

Brown then went on to spell out his understanding of the Governor's relationship with the Administration in power:

> By his training, knowledge and experience, he must show the consequences of various courses of action. He must be free to propose alternatives and spell out the consequences. In operating in this area, the highest standards of discretion and secrecy must obviously be observed. The Governor cannot resort to writing letters to the press or making speeches against government policies. His obligation is to tender advice forcefully but objectively. Like the auctioneer, he will advise once, twice and thrice. But if having done this, the Prime Minister says, "I have heard you and understand you, but the Government does not agree",

> he must then see how best the government's decision can be carried out.[6]

Brown's model accurately represents the convention observed by both governors and politicians in the region. Indeed, Barbados' Prime Minister and Minister of Finance Sandiford recently reaffirmed to a gathering of central bankers that there was no question about "his" Central Bank being independent. Central bank legislation throughout the region leaves no doubt that central banks are subordinate to the Ministers of Finance. We must therefore reject Rampersaud's contention that in the Caricom context the Central Bank "is, and is expected to be, independent of the Government", and that both "the laws and the conventions require it to be so."

The Bank of England model of "subordination" to Government policy is gradually being replaced within CARICOM by the model of "political subservience" to the Administration in power. Central bank governors are deemed incapable of professional and politically disinterested service, and not infrequently are summarily dismissed or hounded from office by incoming Administrations. Increasingly the general public regards central bank governors as political appointees rather than professional technocrats. This sinister trend should be reversed with all deliberate speed.

With the amendment of Section 37, Part VI of the Bank of Jamaica Act in 1977 the Jamaican Government virtually transformed the Bank of Jamaica into a giant printing press for the creation of money to finance its runaway deficits. The amendment reads:

> The Bank shall not in any financial year purchase or otherwise acquire securities issued or guaranteed by the Government of a nominal value exceeding 40 per centum, or **such percentage as the House of**

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[6] Brown, G. Arthur, "Central Banking in the Caribbean", The First Decade, Central Bank of Barbados, 1983.

Representatives may from time to time by resolution approve. [7]

The Opposition Jamaica Labour Party opposed the amendment at the time, but took no steps to repeal it on its accession to power. Meanwhile, the Bank has lost much of its original identity, and functions more and more as adjunct of the Ministry of Finance.

To my certain knowledge, central bank governors throughout CARICOM warned governments of the consequences of excessive deficit spending financed by central bank credit. In the face of Ministerial intransigence, the Governors' only weapon has been the heroic gesture of resignation - a weapon that can only be used once.

Ironically, Government's failure to heed the warnings of their central banks has led inevitably to the further down-grading of these institutions. Since beggars are not choosers, Governments seeking IMF/World Bank assistance must accept the conditionalities of these institutions. Senior Bank officials are displaced by IMF technicians, many years their junior, from their statutory roles as chief monetary advisors to Government. Instead they are cast in the role of functionaries in the implementation of structural adjustment and other programmes - frequently against their better judgement.

The final blow to the Bank of Jamaica's status came with the wholesale acceptance by Government of the financial liberalization package. With interest rates freed up and the installation of a floating exchange rate regime, the original purpose of the Bank of Jamaica - the maintenance of internal and external stability - has effectively disappeared. Those responsibilities have been transferred to the "free market", whatever that may be.

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7 For a fuller discussion of this issue, *see* Blackman, Courtney N., "New Directions for Central Banking in the Caribbean", ***Social & Economic Studies,*** Vol. 38, No. 4, 1989.

The condition of the Bank of Jamaica recalls a story which Peter Drucker tells about the ship building industry in old New England. From time to time, a ship would be launched which soon became notorious for the number of fatal accidents occurring on it. In time it would acquire the soubriquet of "widow-maker", whereupon it would be returned to the shipyard, broken up and a new ship constructed. The Bank of Jamaica has become a "widow-maker". Its crew are increasingly prone to political accidents and loss of reputation, while the institutional loss of status and purpose must promote among its staff a deep sense of frustration and failure.

Drucker's lesson from the parable of the "widow-maker" is that when men and women of superior quality suffer repeated defeats over nearly two decades in the pursuit of institutional goals, then it is time for their jobs to be abolished. It is time to wind-up the affairs of the Bank of Jamaica. The Jamaican authorities should then beg, borrow or steal the foreign exchange needed to re-capitalize a new central bank, this time with its independence and ***modus operandi*** entrenched in the Constitution.

The Independence of Central Banks

The independence of the central bank is an idea whose time has come! In recent years Ministers of Finance in South Africa, Chile and New Zealand, the "wise men from the South", as **The Economist** describes them, have cut loose their central banks from their respective Ministries. The banks are now responsible for maintaining price stability, with no obligation whatever to finance fiscal deficits. Since then the Spanish Cabinet has approved **new** statutes that would empower the Bank of Spain to determine monetary policy and prohibit it from financing the Treasury and other public bodies. In France there is cross-party agreement to give the Bank of France monetary autonomy, and in Italy legislation was passed in February 1992 to give effect to the independence of the Bank of Italy. The former Chancellor of Exchequer, Nigel Lawson, had similar ideas for the Bank of England at the time he resigned from the Thatcher Cabinet. In their recent Report to the Heads of Government, the

Caricom central bank governors made independence from political direction the centre-piece of the proposed Caricom Monetary Authority. Minister of Finance Hugh Small is to be congratulated on his recent establishment of a Committee to examine the establishment of an independent Central Bank of Jamaica.

The standard objection to the independence of central banks is that democratic principles require that the elected representatives of the people be responsible for policy, and that non-elected central bankers should carry out such policy under the direction of those representatives. Former Bank of Jamaica Governor, G. Arthur Brown, is a strong defender of this position. In this respect he may very well be an unconscious prisoner of British political theory.

In Britain, Parliament is sovereign and so, in theory, the Bank of England cannot be independent. But in Caricom democracies the Constitution is sovereign and, indeed, the purpose of a written constitution is to impose restrictions on the people's representatives, especially in cases where concern for partisan interest, or sheer human weakness, could do irreparable damage to the body politic. The American political system of checks and balances is based on that principle. Certainly countries like Austria and Germany, with independent central banks of long standing, are no less democratic than Barbados or Jamaica.

After their horrific experience of hyper-inflation in the 1920s and 1940s, the West Germans decided that they would never again entrust the power of money creation to elected representatives, and have entrenched the powers of the Bundesbank in their laws. It is not therefore surprising that West Germany has enjoyed price and currency stability, with economic growth, far superior to that of countries like Britain and France, whose central banks remain subservient to their Treasuries. Jamaicans, whose constitution already shelters the judiciary from the elected representatives, should need little convincing that the abuse of the Central Bank's money creating powers for political advantage represents an unacceptable risk.

Indeed, sophisticated Ministers of Finance might even welcome protection from the temptation of the soft option of central bank financed fiscal deficits. If educated in the classics, they might recall the advice of Circe to Odysseus as he approached the land of the Sirens:

> If any man draws near in his innocence and listens to their voice, he never sees home again ... but the Sirens will bewitch him with their melodious song ... Go on past that place, and do not let the men hear; you must knead a good lump of wax and plug up their ears with pellets; if you wish to hear yourself, make the men tie up your hands and feet and fasten your body tight to the mast ... Tell them that if you command them to let you loose, they must tie you tighter with a few more ropes.[8]

By analogy, the role of an independent Central Bank is to protect the Minister of Finance from the seductive but fatal attraction of fiscal deficits financed by central bank credit.

Institutional Features of a Reformed Central Bank

Five minimal reforms are required for the establishment of a new, independent and effective Jamaican central bank. First, the tenure of its directorate should be made secure from the vagaries of partisan politics. The Governor and directors would serve on good behaviour, the former for eight years and the latter for five, with at least one director retiring each year. In this way, the tenure of the Bank's directorate would straddle political administrations and so promote the public image of the Bank as a technical-professional rather than a political institution.

Secondly, the operations of the Central Bank should be made truly autonomous. Ministerial approval of staff appointments other than those of the Governor, Senior Deputy Governor and Directors, should be discontinued, as should ministerial approval of salary scales except for the said top officials.

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8 Hcmer, **The Odyssey,** as translated by W.H.D. Rouse, New York, Penguin Books, 1960, Book X11, pp. 138-9.

Thirdly, the Bank should be made accountable to Parliament rather than to the Minister of Finance, thus ensuring that the view point of the Governor is at all times known to Parliament and to the public at large. In this way, distance would be placed between the Minister and the Governor, who would be quite free to disagree with the Minister publicly. As in the United States, the Governor would appear periodically before the relevant parliamentary Committee to present his viewpoint on the state of the national economy. This practice could only enhance democracy in the nation.

Fourth, the Bank should be charged with the primary goal of maintaining internal and external monetary stability, and would support the economic policies of the incumbent Administration only after the achievement of that primary goal was assured. Bank policies which conflicted with those of the incumbent Administration would not then be regarded as acts of sabotage, but as fulfilling the legal responsibilities of the Bank.

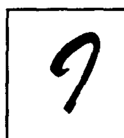
Finally, access by Government to central bank financing should be severely circumscribed and, at any rate, would be in the discretion of the Bank.

If we have learned anything in the Caribbean over the past two decades, it is that the achievement of economic growth, with price and exchange rate stability, is most improbable in the absence of a sound currency. This also was the lesson of the reformed Reichsbank of the 1920s and of the new Bundesbank in the 1940s. In both cases, the foreign exchange reserve backing for the new currency was provided by Germany's former enemies, especially the USA.

The Jamaican Government should do everything in its power to divert the assistance of creditors, donor countries and international financial institutions from sterile structural adjustment programmes towards the capitalization of a reformed Bank of Jamaica, or of a new Caricom Monetary Authority, whichever comes first. The economic recovery of Jamaica is not in prospect until it can be relieved of its burdensome foreign debt, and until its massive liabilities to Bank of Jamaica can be cleared away.

11 Financial Accounting for Central Banks: With Special Reference to CARICOM*

Introduction



n an earlier Paper, "Towards a Theory of Central Bank Management - With Special Reference to the Caribbean",[1] I grappled with the problem faced by Central Bank Management in measuring the performance of the institution. I attributed this to the basic fact that, whereas the inputs into the Central Bank's operations (i.e. wages, supplies, services, etc.) were costed by the market, its outputs of advice to Government and information and other services to the public, for which it received no fees, were for the most part not costed by the market. This situation derives from the unique function of a central bank in the economy.

The managerial approach which I suggested was to disaggregate the activities of the Central Bank according to

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* Paper presented at the 25th Annual Conference of the Regional Programme of Monetary Studies, Port-of-Spain, Trinidad November 17-19, 1993.

Blackman, Courtney N., "Towards a Theory of Central Bank Management - With Special Reference to the Caribbean", **Money Affairs,** CEMLA, Vol.VI, No.2, 1993, pp 89-100.

classes of clientele, e.g. Government and commercial banks, etc., and according to functions, e.g. exchange control, bank supervision, etc., and then develop appropriate measures of performance for each activity. I acknowledged the difficulty of designing any measure of central bank performance, but I insisted that Management would have to do its best to obtain some indication of how well or badly it was doing.

I observed along the way that "profits" represented a most unsatisfactory overall measure of performance for central banks. For example, there is no reason to believe that the $30 million profit of the Central Bank of Barbados in 1992 represented a superior performance than the $4 million loss in 1989.

Profit is not only a misleading measure of performance in the case of central banks, but frequently a perverse one as well. A central bank might very well record splendid profits during a period when its operations actually contributed to dysfunction in the economy, but report a loss when it contributed to superior economic results. For example, by financing two/thirds of the record Government deficit in 1990, the Central Bank of Barbados contributed much more to the malfunctioning of the national economy than it did in the year before; yet it earned $4 million in profit in 1990, $8 million more than in 1989. By the same token, the J$3.7 billion of Bank of Jamaica "losses" accumulated up to year end 1992 reflect not so much the performance of its Management as its forced financing of Government and public sector operations.[2]

The difficulty of measuring the performance of central banks is twin-rooted. First, their function of monetary management is, by its very nature, shared with Ministers of Finance, and usually in a manner which makes it difficult to allocate the responsibility for various monetary outcomes. Secondly, there is the unsatisfactory state of financial

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[2] **Report of the Committee Appointed by the Government of Jamaica to Examine The Role of the Bank of Jamaica,** Bank of Jamaica Review Committee, January 1994.

accounting for central bank operations. This reflects both the uniqueness of the central bank in any economy (making comparison with other financial institutions difficult), as well as professional accountants' imperfect understanding of the nature of central banking. The latter is hardly the fault of accountants, since in the entire economic literature there exists not even one authoritative exposition on the theory of central banking.

Even if, for various reasons, the central bank's financial reports provide an imperfect measure of managerial performance, they should certainly provide the public with some meaningful index of the central bank's relative contribution to real economic progress, whether positive or negative. At least, the more egregious distortions produced by current accounting conventions might be mitigated, even if not eliminated. This Paper represents a first attempt to do so.

Section II clears away the confusion surrounding the issues of the measurement of central bank performance. **Section III** explores the phenomenon of seignorage, a concept which lies at the heart of central bank financial operations. **Section IV** develops the case for distinguishing between "real" and "nominal" values in financial accounting for central banks. **Section V** offers a critique of the monetary arrangements of central banks within CARICOM, especially in regard to their financial operations. We conclude with suggested changes in financial reporting so as to provide a more accurate picture of the central bank's contribution to the real economy.

SECTION II

ISSUES OF THE MEASUREMENT OF CENTRAL BANK PERFORMANCE

This Paper makes the point that the financial reports of central banks should provide a more realistic idea of their contribution to real economic output/decline. Such an index might or might not measure the performance of Management,

depending on the degree of independence from Government which the Central Bank enjoys. This is an issue which Professor Compton Bourne thoroughly obfuscates in his Paper, "Performance Evaluation and Accountability of Central Banks".[3] He writes, "Performance accountability of central banks is closely related to but not identical to the question of central bank independence from the political system."

In fact, an individual or institution can only be held accountable for its performance if it has the legal authority and the means to carry out the functions assigned to it. In the case of the Federal Republic of Germany, we may conclude with considerable justification that the low level of inflation prevailing in that country since World War II is a positive index of the Bundesbank's performance. The Act establishing the Bundesbank unequivocally charges it with the responsibility of price stability and empowers it to implement monetary policies independently of the Administration and, on occasion, policies opposed to those of the Administration, if that is necessary to fulfill its statutory mandate.[4] New Zealand's Minister of Finance recently settled the issue of the Central Bank's accountability by specifying monetary stability as its sole performance criterion. Maximum inflation targets are agreed on between the Governor of the Central Bank and the Minister of Finance, who has surrendered his authority to give directions to the Central Bank except under specified circumstances.[5]

After his introductory remark that Caricom central banks "are subject only to the authority of the political directorate to whom they are legally answerable and from whom they may receive directives", Professor Bourne continues: "The reality, as distinct from the constitutional formality, of political control

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[3] Bourne, Compton, "Performance Evaluation and Accountability of Central Banks", (unpublished mimeo), 1992.

[4] Tietmeyer, Hans, "The Role of the Independent Bank in Europe", **The Evolving Role of Central Banks,** eds. Downes, Patrick and Vaez-Zadek, Reza, Washington, D.C., International Monetary Fund, 1991, p. 181.

[5] The Economist, "Wise Men from the South", February 2, 1991, p.77.

and accountability is the subject of this paper." But operatives are, by definition, accountable to those who have the power to appoint and remove them. If Caricom central banks do not behave as if they are accountable, this reflects poorly on the political directorate. In fact, the frequency with which Caricom central bank governors and directors are removed or hounded from office when Administrations change, does not suggest the absence of political control. It does suggest, alas, that Caricom central banks are held accountable for political rather than institutional ends.

In opposing central bank "independence" Professor Bourne shows how captive he is to the British concept of parliamentary democracy which fosters the tyranny of the Executive. In the absence of a written constitution, the British Parliament is sovereign, so that an Administration enjoying even a simple majority in Parliament is also sovereign. Not surprisingly then a British Cabinet finds it difficult to entertain the concept of central bank independence. However, in republican and especially federal regimes, such as exist in Germany and the U.S.A., it is the Constitution which is sovereign, and checks and balances among the executive, legislative and judicial branches are deliberately built into the political system. "Government" and the Executive are not synonymous, and it is not unusual for different elements of "Government" to pursue fundamentally different objectives. In spite of their written constitutions, Caricom Administrations behave very much as if they were sovereign, and continue to observe British parliamentary precedents.

That the Bundesbank has sometimes found itself in conflict with the Chancellor, and the Chairman of the Federal Reserve with the President, does not make Germany and the USA any less democratic than Guyana or Jamaica, where the Central Bank has operated primarily as a money printing machine for the Minister of Finance. My own preference is for central bank independence within a democratically determined political system that limits the power of the Administration to destroy the economy through central bank financed fiscal deficits.[6]

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[6] Blackman, Courtney N., "New Directions for Central Banking in the Caribbean", ***Social and Economic Studies,*** Vol. 38, No. 4, 1989.

Increasingly, enlightened Administrations in countries as varied as Chile, South Africa, New Zealand and France have taken steps to free their central banks from the political direction of the Ministry of Finance, and to make price stability the unequivocal criterion of their performance. In the absence of similar developments within CARICOM, we must at least develop financial reporting conventions which indicate whether central banks are contributing positively or negatively to real economic output.

SECTION III

THE PHENOMENON OF SEIGNORAGE

The distinguishing feature of a central bank is its monopoly of money creation, and hence its unlimited access to seignorage. Seignorage may be defined as the rent earned from the right to issue currency. The means of realization of such rent depends on the monetary regime in operation. There are two basic types of monetary regimes, (1) commodity money and, (2) symbolic money. In the first case the intrinsic value of the circulated currency is equal to its face value; in the second instance the intrinsic value of the circulated currency bears no relation to its exchange value.[7]

It was notorious in the era of gold and silver coinage that the King would clip the coinage and reissue the clipped coins at their original face value. The proceeds from clippage would be melted down to mint new coins. (It was only after 1660 that the edges of English coins were embossed so that any filing down was plainly visible). Seignorage was reflected in the profits from such clippage, along with the service charge to those who brought new silver and gold for minting.

The move to symbolic money began when it was realized that the public was quite indifferent to the state of the coinage

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[7] Vilar, Pierre, **A History of Gold and Money,** 1450-1920, London, Verso, 1991.

as long as there was price stability. However, if the King overdid the clippage, growth of the money supply would exceed the increase in national output, thus leading to inflation. This would cause the public to lose confidence in the domestic currency.

Excessive clippage would also lead to currency devaluation. Whereas the locals might be tolerant of the circulation of clipped coinage, foreign merchants always insisted on "true" coinage. With moderate clippage, the local merchants could always hoard enough "true" coinage to meet their external liabilities. When they were forced to pay with clipped coins, the sophisticated foreigners would demand coinage of an increased face value to compensate for the reduced intrinsic value of the clipped coins.

A Currency Board's issue is analogous to commodity money in that it is convertible for hard currency on demand. The Currency Board obtains its seignorage from the interest earned on the foreign securities which "back" the issue - after operational expenses are covered. The Currency Board usually maintains foreign investments in excess of its domestic liabilities to serve as a cushion against the vagaries of the international capital market.

With the currency board system the money supply is a direct function of the trade balance and foreign capital flows, and the foreign payments problem is eliminated. There is still limited scope for domestic inflation via the increase of money velocity, or through the credit creation process of the commercial bank system. However, the balance of payments effects are self-limiting, as the draw down of foreign exchange reserves to purchase imports leads automatically to a contraction of the money supply and a consequent reduction in the demand for imports.

Most modern economies use symbolic money. One advantage of symbolic money is that it does not involve the sacrifice of real commodities or foreign assets for its "backing". Another advantage is its flexibility: its supply can easily be expanded or contracted to the desired level through the operations of the Central Bank. The inflexibility of commodity

money was a serious drawback, so that the expansion of the money supply, and hence the growth of the economy, depended heavily on imports of bullion and ultimately on the discovery of new lodes of gold and silver. The integrity of symbolic money depends on the appropriate balancing of its supply and demand. Its over-supply leads to inflation with its consequent economic pathologies. Its undersupply could lead to falling prices, recession and even depression, as happened in the depression of the 1930s.

Countries with hard currencies settle their foreign deficits through the purchase of other foreign currencies on the international foreign exchange markets. Equilibrium in the collective foreign exchange markets is brought about by changes in the relative external values of various traded currencies. Countries with "soft" currencies, like those in CARICOM, have no choice but to adopt a mixture of symbolic and commodity currency, and maintain stocks of commodity money (gold or foreign exchange assets) to settle their external debt. This is because their own foreign exchange markets are too thin and shallow to "play" in the international "big league". It is not surprising then that attempts to float Caricom currencies have usually led to rapid and disruptive currency depreciation.

The Gold Standard and its successor, the Gold and Dollar Standard, were hybrids of the commodity and symbolic monetary systems. Under the pure Gold Standard, the national currency was theoretically redeemable in gold. However, this did not necessitate a 100 per cent backing of gold bullion, since all the currency notes and coins in circulation could hardly be tendered simultaneously at the Central Bank. Indeed, in times of crisis, the commitment to redeem currency for gold might be temporarily suspended. Under the Gold and Dollar Standard (The Bretton Woods Agreement) the national currency became entirely symbolic, in that nationals could not redeem their local currency for gold, while net foreign deficits were settled between central banks in gold or acceptable "hard" currency. The need to settle in gold or hard currency imposed a discipline on monetary authorities and motivated them to keep a tight rein on the growth of their money supply, since the consequence of delinquency was a "shameful" devaluation of the national currency.

In a monetary regime using symbolic currency, seignorage is earned by the Central Bank when it lends new money to Government or the commercial banking system or, indeed, when it purchases goods and services for its own use. Typically the operating expenses of a central bank are so small that they constitute a negligible portion of the available seignorage. The same cannot be said for fiscal deficits which, if financed by the central bank, could threaten the integrity of the national currency. There is a point at which seignorage ceases to be a harmless source of income, and becomes an agent of inflation and currency depreciation, setting off a downward spiral of economic decline.

SECTION IV

"REAL" AND "NOMINAL" VALUES IN CENTRAL BANK OPERATIONS

One of Sir Arthur Lewis' most important insights was the distinction he drew between developed and underdeveloped countries:- developed countries possess unlimited supplies of capital; underdeveloped countries have unlimited supplies of labour.[8] In the current intellectual climate where the same free market model fits all countries, this distinction is frequently disregarded by policy makers with baleful consequences for their clientele. Another egregious error of policymakers in developing countries is the application of the Keynesian closed model to their typically highly open economies. These two distinctions have important implications for policies of money creation in these respective types of economies.

In the Keynesian-type closed economy with unlimited supplies of capital, recessionary conditions reflect the idleness of already installed capital accompanied by high unemploy-

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[8] Lewis, Arthur, "Economic Development with Unlimited Supplies of Labour", **The Economics of Underdevelopment,** eds. Agarwala, A.N., and Singh, S.P., New York, O.U.P., 1963, pp. 400-449.

ment.[9] This unemployment reflects the deficiency of aggregate demand in the economy, so that the creation of new money to fund government expenditures serves to expand aggregate demand and so bring idle resources of capital and labour back into use. In these circumstances money creation by the central bank contributes to the expansion of real output. However, since supplies of capital are unlimited, it is the full employment of labour which is first achieved; continued expansion of aggregate demand creates inflationary pressures and, in time, balance of payments disequilibrium, as both consumers and capitalists are forced to import goods and services which the fully employed labour force can no longer produce. This explains the propensity of industrial countries to import labour during the upswing of the business cycle.

In the case of developing countries, the creation of new money by the Central Bank to fund government expenditures quickly brings all idle capital into use long before a dent is made in the unlimited supplies of labour. This is why Sir Arthur Lewis recommended the importation of foreign capital and technology to exploit idle or underemployed labour in the traditional sector. The alternative model, employed by the Soviets and Japanese during their early development, required the ruthless extraction of savings from the peasant class to finance imports of physical capital and technology.

Real savings is the source of capital, and failure to appreciate the inelasticity of real savings in LDCs has led international financial institutions to impose Professor Ronald McKinnon's high real interest rate policies on some Caricom States in a futile attempt to bring non-existent real savings into play.[10] Such policies have led to the bankruptcy of several small businesses, but have brought about only negligible increases in real savings. We should note that financial savings are not the same thing as real savings!

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9 Keynes, J. M., **The General Theory of Employment, Interest and Money,** New York, Harcourt, Brace & World, Inc., 1964.

10 McKinnon, Ronald I., **Money and Capital in Economic Development,** Washington, D.C., The Brookings Institution, 1973.

Once the limits of production imposed by the sparse supply of capital are reached in developing countries, excess purchasing power generated by money creation can only be satisfied through imports. This process is halted only by the exhaustion of the nation's foreign exchange reserves and the drying up of its credit and foreign aid sources. The chronic shortage of foreign exchange precipitates economic collapse, as the cases of Guyana and Jamaica so vividly demonstrate.

If a central bank's operations lead to economic decline and dysfunction, its operations can in no useful sense be termed "profitable". Indeed, except for buildings, equipment and meager holdings of foreign exchange, the assets currently listed in the balance sheets of the Banks of Guyana and Jamaica are comprised primarily of a vast volume of non-marketable securities and may properly be described as fictitious or, more politely, "nominal". The auditors may confirm the arithmetic of their financial reports as correct; they should not represent their accounts as being a "true and fair" record of their operations.

The balance sheets of the Banks of Jamaica and Guyana are to be contrasted with that of the Eastern Caribbean Central Bank (ECCB), whose assets are primarily comprised of foreign balances and securities, all realizable in the international market place. The Bank's holdings of domestic treasury bills are relatively small and liquid, and its holdings of long-term government securities limited. Seignorage is earned primarily through returns on the foreign assets which "back" the currency and so ensure that the Bank's liabilities are readily exchangeable for foreign exchange. Utilizing the well-founded accounting principle of conservatism, we may distinguish between the "real" and "nominal" transactions of central banks. The criterion is whether or not the financial operations represent values realizable in the capital or money markets. According to this criterion, the accounts of the ECCB would overwhelmingly represent realizable values, while those of the Banks of Jamaica and Guyana would not. In the case of the Central Bank of Barbados the auditors would have to sort the "chaff" from the "wheat".

SECTION V

CRITIQUE OF MONETARY ARRANGEMENTS IN CARICOM

At the root of the current monetary disarray within CARICOM is the failure of monetary authorities to recognize the limits of seignorage; or, put another way, to recognize that you can only clip the coinage so many times before public confidence in the currency is lost. Jamaican and Guyanese Ministers of Finance have regarded the seignorage deriving from the currency issue as infinite. The consequent debasement of the Guyanese and Jamaican dollar has extinguished the usefulness of those currencies as "units of account" and "stores of value". They remain "media of transaction" only through the force of law.

Secondly, most Caricom governments overlook the critical importance of adequate foreign exchange reserves in the context of small and open underdeveloped economies. It is the level of foreign exchange holdings which determines the extent to which seignorage can be "safely" extracted. Once the banking system and, ultimately, the Central Bank are unable to meet the public demand for foreign exchange, public confidence in the domestic currency is lost, and once lost is very hard to restore. Both the Guyanese and Jamaican currencies have suffered this fate.

Thirdly, misguided by the free market ideologies of the World Bank, IMF and IDB, some Caricom States have set off in search of the holy grail of the "equilibrium exchange rate", plunging their currencies into free-fall devaluations. The monetary instability created by exchange rate volatility makes measurement of the financial operations of central banks even more difficult. In fact, no Caricom country possesses foreign exchange markets with the depth and breadth to sustain a floating exchange rate regime. Furthermore, as I have explained in the First Adlith Brown Memorial Lecture, once foreign exchange markets have collapsed, as they did in Guyana and Jamaica, the equilibrium value of the exchange rate becomes

indeterminate.[11] Commenting on the case of the industrialized nations, Professor Peter Kenen has this to say:

> Exchange rates should be managed, not left completely to market forces, but informal arrangements such as those exemplified by the Plaza and Louvre agreements may not suffice. To manage exchange rates effectively over the long term, it may be necessary to manage them systematically, not periodically, and thus to devise a pegged rate system resembling the EMS.[12]

What makes the governments of tiny countries like Trinidad and Tobago, Guyana or Jamaica believe that they can go it alone?

Fourth, central banks themselves have failed to distinguish in their financial reporting between "real" and "nominal" transactions, and have thus contributed to further economic dysfunction. Indeed, the balance sheets of some Caricom central banks read like a fairy tale. This is especially so in respect of the valuation of assets, the recognition of income and the reporting and the pay out of "profits". For example, the assets of the Bank of Guyana are comprised predominantly of government securities which have negligible market value. Again, the "foreign reserves" of the Central Bank of Barbados include a high proportion of balances of the defunct Caricom Multilateral Clearing Facility (CMCF). Since the debtor, the Government of Guyana, is potentially immortal, these balances need not be written off. However, only the proportion of CMCF assets earning income at the prevailing rate of interest should be treated as "real" assets; the remainder should be considered "nominal" assets and shifted to suspense accounts. At any rate,

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11 Blackman, Courtney N., "A Heteredox Approach to the Adjustment Problem", First Adlith Brown Memorial Lecture, Institute of Social and Economic Research, Mona, Jamaica, 1985.

12 Kenen, Peter P., **Managing Exchange Rates,** New York, Council on Foreign Affairs Press, 1988, p. 4.

illiquid foreign assets are, by definition, not foreign exchange reserves!

In some cases, Caricom central banks purchase vast quantities of government paper to fund runaway fiscal deficits which, far from expanding real output, sets off inflation, currency devaluation and economic decline. Although such loans to Government actually contribute to economic dysfunction, central banks yet treat interest on these loans as income, and take them into the profit and loss account. In contrast to a commercial bank, which treats bad loans as losses, Caricom central banks report "profits" in spite of the real economic losses resulting from their credit extension.

What is worse, the Central Bank pays out these "profits" to Government and other domestic institutions, thus injecting more highpowered money into the economy, and setting off a further round of price increases and currency depreciations. It was the interest income from credit to Government which contributed so substantially in 1992 to the record "profits" of the Central Bank of Barbados. These "profits", in turn, were paid out to the Government, allowing it to further increase its inflationary expenditures. Indeed, some Ministers of Finance perceive central banks more as convenient sources of credit and income than as regulatory institutions.

The Bank of Jamaica has its own version of this charade. Supposedly for the purpose of mopping up excess liquidity in the banking system, the Bank issues short-term certificates of deposit (CDs) at rates of up to 50% per annum. This means that a purchaser of a J$8 million CD (worth approximately US$300,000 today) would receive J$9 million at the end of three months, leading to an overall net increase of liquidity of 12.5% in three months, a dramatic rise in the money supply in a country experiencing chronic inflation. To prevent such an expansion in liquidity, the Bank would have to issue another CD to the value of J$9 million, and so on, and so on. In theory, the interest costs of these issues are borne by the Jamaican Government. But what Government can afford to pay 50% on its loans? Not surprising then, a government debt to the Central Bank of over

J$20 billion had built up by the end of 1991, representing a horrendous overhang of liquid assets in the economy. Certainly it would be better for the Bank of Jamaica to sell long term government paper from its portfolio in the capital markets at an appropriate discount so as to sterilize the funds over the long term. Or why not raise the cash reserve asset, or the proportion of Government securities to be held by the banking system? And why such high interest rates? Is it because these perfectly sensible measures are forbidden by the international "gods" of financial liberalization?

It should by now be clear even to blind men that sustainable economic development is unlikely in the absence of a sound and stable currency. Within CARICOM, the OECS, Belize, The Bahamas and Barbados, whose economic policies have maintained monetary stability, have far outperformed those countries whose policies led to currency depreciation -Guyana, Jamaica and Trinidad and Tobago. There have been a number of proposals for restoring public confidence in the Caricom currencies. In this respect it is surprising that the strategy of currency reform has not occurred to the monetary authorities in Georgetown and Kingston. It is an historical fact that neither in the 1920s nor the 1940s did economic growth resume in Germany until comprehensive currency reforms had been put in place.

We have discussed above the issue of independence for regional central banks. Professor Stephen Hanke, in a Paper, "From Monetary Mischief to Sound Money", has proposed that Jamaica should return to a currency board system.[13] I have frequently put forward the ECCB as a model for a regional Caricom Central Bank.[14] In the meantime, we should seek the assistance of the Accounting Profession in developing financial

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[13] Hanke, Steve H., "From Monetary Mischief to Sound Money: Why Jamaica Should Return to the Currency Board System", (unpublished mimeo). 1993.

[14] Blackman, Courtney N., "New Directions for Central Banking in the Caribbean", op. cit.

reporting conventions which provide a fair financial picture of the impact of central bank operations on the real economy.

SECTION V

PROPOSALS FOR NEW ACCOUNTING RULES

In proposing new accounting rules for Caricom central banks, we invoke the rapidly evolving accounting principle that financial assets should be marked to market and, secondly, the long established principle of conservatism. The first principle implies that central bank assets should be valued at what they would fetch in active foreign and domestic financial markets. The convention of conservatism suggests that proceeds from seignorage, and the income derived therefrom, should not be regarded as "real". This is because of the uncertainly as to whether the ***ex ante*** proceeds from seignorage will represent ***ex post*** market values.

These principles yield the following proposals:

1. All assets should be marked to market.

2. Only assets tradeable on the external or domestic markets should be regarded as "real". These would include securities traded on the international money and capital markets, and assets readily saleable on domestic goods and financial markets.

3. Advances from the Central Bank to Government should attract no interest charges. Similarly, securities purchased directly from Government by the Central Bank should bear no coupon.

4. Only income from "real" assets should be taken into the Profit and Loss accounts. Income from nominal assets or from seignorage should be segregated in suspense accounts.

5. Profits should not be paid to Government unless the Auditors certify that the external assets of the Central Bank are at a prudent level, given the Bank's external liabilities.

6. The accounts of the Central Bank should be recorded in terms of an accepted "hard" currency or a basket of "hard" currencies. This would ensure comparability from year to year.

7. Central Bank advances to Government should be limited to a fixed proportion of the external assets of the Central Bank, rather than related to the current expenditure of Government. The above rules would help to ensure that the profile of the Central Bank's balance sheet reflects its "true" financial state, and would limit the possibilities for compounding the effects of excessive credit creation.

12 Managing Foreign Exchange Reserves in Small Developing Countries*

Introduction

or the major developed nations of the world, the management of foreign exchange reserves is mainly an aspect of exchange rate policy. Under the Bretton Woods Agreement, adequate holdings of gold or foreign currency were needed for intervention in the foreign exchange markets so as to maintain the national currency within the range determined by the IMF rules. If market pressures against a currency became too strong, adjustment was brought about through a devaluation.

Under the present regime of general floating there is, theoretically, no need for reserves at all except for maintaining orderly markets. In fact, however, few nations permit their currencies to float freely. Most of them indulge in "dirty" floating; that is, they intervene in the currency markets to counteract exchange rate movements which they believe to be transitory and superficial influences, rather than a reflection of fundamental changes. This requires moderate holdings of foreign exchange reserves, which can often be supplemented by currency swaps among the central banks of friendly countries.

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* Paper published in the ***Occasional Papers 11***, Group of Thirty, New York, 1982.

In developed countries, exchange rate targets can sometimes be more effectively and economically achieved through interest rate policy than intervention in the currency markets. During 1981, the dollar rose sharply against gold and other currencies as extraordinarily high interest rates sucked funds into the U.S. money markets. The Federal Reserve System would have had to sell several billion dollars of foreign exchange reserves to achieve a comparable appreciation of the dollar.

With the less developed countries (LDCs), however, foreign reserve management is not so much a means of achieving an optimal exchange rate or maintaining orderly trading conditions on the exchanges: it is, in fact, a critical element of any strategy of economic development.[1] The rationale of reserve management for economic development can be summarized as follows:

(1) The structural dependence of most LDCs on foreign trade;

(2) Wide fluctuations in the export earnings of LDCs on the one hand, and a steady demand for imported necessities on the other;

(3) Technological and financial dependence on the modern industrial economies;

(4) The need to concentrate scarce foreign exchange on strategic development.

Five broad reserve management policies for monetary authorities in LDCs within a strategy for economic development can be articulated:[1]

(1) The need to manage foreign exchange reserves;

(2) The provision of export incentives and disincentives for non-essential consumer imports;

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[1] Courtney N. Blackman, "Managing Reserves for Development", Columbia Journal of World Business, Fall, 1975.

(3) The restriction of the right to borrow foreign exchange to sectors which promote economic development, especially those promising to generate foreign exchange earnings;

(4) The desirability for most developing countries to err on the side of an "overvalued" rather than an "undervalued" currency;

(5) The careful yet flexible administration of exchange control regulations.

This present paper addresses the problems of foreign exchange reserve management faced by central banks in small developing countries, given the critical role of foreign exchange in the development process, and in light of the special circumstances in which such central banks function.

The active management of foreign exchange reserves is relatively new in small developing countries, especially the newly independent. The tradition was for external assets to be invested in the imperial capital without reference to, or review by, the colonial governments. The Crown Agents in London managed the foreign assets of British colonies with complete discretionary powers. In view of slow communications and the complete ignorance of international finance on the part of colonial civil servants, this situation was probably unavoidable. However, decolonialization transferred responsibility for foreign asset management to the new central banks, and the vast improvements in telecommunications have made the effective exercise of that responsibility increasingly feasible; but the evolution of a relevant theory of foreign exchange management for small developing countries has not kept pace with these developments.

This paper does not pretend to provide a detailed foreign reserve investment handbook; rather it seeks to establish a systematic approach to the problem of reserve management and to bring into focus the relevant theoretical and philosophical issues. The section following describes the several objectives of

reserve management in small developing countries. Next we attempt to develop an appropriate philosophy of reserve management. The implications of such a philosophy are set out in Section Three and broad operational guidelines suggested for the management of the reserve portfolio. Section Four discusses the problems of measuring the performance of reserve portfolio managers. We end with a brief summary and conclusions.

1. Objectives of Foreign Reserve Management

The management of a nation's foreign exchange reserves is commonly the responsibility of its central bank. The objectives of central bank management are substantially different from those of a private sector institution whose goal is essentially that of profit maximization. A central bank is an institution charged with the public interest, and so its objectives must reflect the current concerns of government, no matter how independent legislation may declare it to be. At any rate, profit is hardly the appropriate measure of central bank performance, even though central banks usually generate a healthy surplus on their operations. For example, a high proportion of central bank income often derives from credit extension to government; certainly, it behooves a central bank to minimize its income from that source at times of inflation.

Since governments have multiple objectives, so we may expect the objectives of the central bank's reserve policy to be multiple as well. Five distinct objectives of reserve management may be identified:

1. Liquidity
2. Income
3. Precaution against a "rainy day"
4. Maintenance of value
5. Political considerations

Liquidity

Assuming that the small developing country operates exchange controls and maintains a fixed currency relationship to a key currency, the monetary authorities require commercial banks to surrender to the central bank foreign exchange in excess of prescribed limits. In turn, the central bank is prepared to sell foreign exchange to commercial banks when public demand exceeds their foreign exchange receipts.

Because of the extreme openness of most small developing economies, and because of the seasonality and lumpiness of receipts from sales of primary commodities which such economies typically export, foreign exchange inflows and outflows will not necessarily move in sympathy. As a consequence, the central bank will have to maintain considerable sums of foreign exchange in the form of liquid assets. Holdings of liquid assets must accommodate both seasonal and cyclical variations in foreign exchange inflows. A major objective of reserve management, then, must be the reliable availability of foreign exchange to meet the essential national needs.

Essential payments include not only purchases of food, basic consumer items, and intermediate and capital goods, but also the servicing of foreign liabilities. The latter takes on extra significance when the national development strategy emphasizes external borrowing or direct foreign investment. Unless interest, amortization and dividend payments are promptly remitted, the sources of foreign capital wilt rapidly dry up.

In times of balance of payments crisis, liquidity becomes the sole relevant objective of foreign exchange management. In the direst circumstances central banks may resort to a system of detailed foreign exchange budgeting.[2] Foreign exchange management will then involve day to day, and even hour to hour, monitoring of foreign exchange receipts and

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[2] Winston Carr, "Jamaica: Balance of Payments and Foreign Exchange Budget, 1977-1980", unpublished mimeo. Bank of Jamaica, 1981.

payments. Foreign exchange budgeting is the central banker's version of hell. The best cure for a balance of payments crisis is prevention through early and determined fiscal, monetary and incomes policies to restore economic equilibrium in the shortest possible time.

Income

It is arguable that the main reason for a developing country to hold reserves is to be free to concentrate on a positive program of economic development without the distraction of balance of payments crises. The holding of foreign exchange reserves involves an opportunity cost with respect to the goods and services which might otherwise be imported if the reserves were immediately spent. Reserve assets should therefore yield a rate of return at least equal to the opportunity gain of their immediate expenditure. In other words, foreign reserves over and above those needed for liquidity or other legitimate purposes should be deployed in such a way as to maximize the rate of return on investment. Funds held purely for liquidity purposes should also be placed in the highest yielding assets consistent with the schedule of likely payments. Here the techniques of cash management come into play. The idea is to minimize the amount of funds lying idle in current accounts, by making use of overnight, call and other short-term opportunities.

Third World economists have long recognized the opportunity cost involved in holding reserve assets. Indeed, some of them argued not very long ago, and with great emotion, that the holding of foreign exchange reserves constituted a loan to those developed countries whose liabilities were being held and should be reduced to a minimum. This attitude may very well have led countries like Ghana, which held considerable sterling assets when it obtained independence, to exhaust them in an orgy of "development" spending on unproductive prestige projects.

That was before economists became fully conscious of the concept of "absorptive capacity". From the experience of surplus OPEC countries it is now recognized that there is a limit to the quantity of imports a country can take in without economic,

social and cultural disruption. Once the limit of its absorptive capacity is reached, it makes good sense for a developing country to invest surplus foreign assets in the international money and capital markets at maximum yields. Any positive return on such investments would constitute an opportunity gain.

Precaution Against a "Rainy Day"

One objective of maintaining reserves is to guard against total ruin. Somewhere there should be a "nest egg" to be utilized when the "wolf' is actually clawing at the door. The gold tranche of a reserve portfolio probably fills this role better than any other. It is an asset which, even in the most unsettled of times, is likely to find a willing buyer. At the start of the Second World War, it was Britain's extensive gold holdings which bought her the time that President Roosevelt needed to whip up support in the United States for the Allied cause. On the occasion of the first oil shock, the Bank of Italy was able to pledge its gold holdings to the German Bundesbank in return for foreign exchange to pay for Italy's vital imports of oil.

The great drawback of gold is that it is not an earning asset, and so the security of holding significant quantities of gold involves an opportunity cost of the return of alternative investments which, in times of high interest rates, could be considerable. In recent years, there also has existed the distinct possibility of a capital loss on gold holdings. However, although the price of gold may fluctuate widely in the short run, it will probably keep pace with inflation over the long run. Furthermore, the price of gold is likely to rise in times of calamity when the nest egg will presumably be most useful. A distinct advantage of small countries is that the quantity of gold which they could offer on the market would be insufficient to depress the price. Had the Italians attempted to sell, rather than pledge their gold, they would have knocked the bottom out of the market.

Another means of preparing against the "rainy day" is to promote the accumulation of foreign assets outside the central bank's portfolio but subject to its permission and regulations. Such foreign assets should be held to the account of domestic

financial institutions subject to the legal control of the central bank. In a time of national crisis, such assets could be acquired on demand by the central bank and placed at the national disposal. In both world wars, the Bank of England purchased foreign securities from its nationals for use in the war effort.

The main investors in foreign securities would be pension funds and insurance corporations, including National Insurance Systems. Small developing countries do not ordinarily possess capital markets deep and varied enough to accommodate a rapid build-up of pension fund contributions and insurance premiums. To restrict pension fund and insurance portfolios to investments within a small and dependent economy would severely restrict their possibilities for risk management through portfolio diversification.

Political Considerations

To fulfill some national or institutional goal, the central bank may be called upon to make investments which do not fall into the "prudent man" category. A friendly nation may suffer a natural disaster, such as a hurricane or an earthquake; in such circumstances the central bank may be invited to buy that country's treasury bills or debentures to shore up its faltering external liquidity. Those securities may be low-yielding and unmarketable. In such cases political approval should be obtained and the responsibility for the possible loss of such investments placed squarely on the government. Even so, the central bank should have a clear view of acceptable limits of loss and should so advise the government.

Sometimes the bank, either with government encouragement or in pursuit of its own institutional goals, may purchase the securities of certain international financial institutions, such as the World Bank, the Inter-American Development Bank, or its regional development bank. Such investments, although quite safe and sometimes quite marketable, might not constitute an optimal investment in terms of maturities, earnings, and liquidity. Such investments are appropriate as long as their nature is clearly recognized.

Maintenance of Value

Sometimes a developing country finds itself with exceptionally large holdings of foreign exchange as a result of windfall earnings from commodity sales or, more recently, from sharp increases in oil export earnings. Trinidad and Tobago, with reserves now in excess of US$2½ billion and a population of only one million, is an excellent case in point. In such cases, the country may be quite unable to absorb imports on the scale required to run down those reserves without wasteful expenditure and severe social and cultural disruption. It would make sense for the country to store those reserve assets until they can be usefully spent. In the case of the rich oil-exporting countries, reserve assets may have to be stored for decades. In those circumstances the problem of maintaining the value of such assets becomes critical. Unless the value of the reserves can be maintained, it might be better to withhold the country's main export commodity from the market.

The operational implication of the above analysis is the segregation of the reserve portfolio into tranches corresponding with the several management objectives. Such segregation might be conceptual, or separate accounts might be established and managed as distinct portfolios. If size warranted, they might even be placed under the responsibility of different managers. Schematically, the structure of the reserve portfolio would be as follows:

5. Maintenance of Value (Capital Fund)
4. Income
3. Political
2. Liquidity
1. Gold

2. Selecting a Philosophy of Investment

Basic Types of Decisions

Modern decision theory identifies four basic types of decisions:[3]

1. Decision-making under certainty - when we know for certain which state of nature will occur. In those circumstances the selection of a strategy is straightforward;

2. Decision-making under risk - when we are in a position to assign probabilities to the prospective states of nature. In such cases we select the course of action which brings us the highest expected value, i.e. the rewards of an outcome multiplied by the probability of success;

3. Decision-making under conflict - when we are pitted against a rational opponent intent on minimizing our gains to his advantage. In such cases, the Theory of Games is properly brought into play;

4. Decision-making under uncertainty - when we are unable to assign probabilities to the prospective states of nature, and when no reliable pattern (as in the case of a rational opponent) can be attributed to the prospective states of nature, in other words, when we are totally ignorant of the prospective states of nature.

Foreign reserve management generally exemplifies decision-making under uncertainty, especially over the past two decades. Who could have predicted a nominal prime rate of over

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[3] For a discussion of decision making *see* David Millar and Kenneth Starr, **Executive Decisions and Operations Research,** Englewood Cliffs, N.J., Prentice-Hall, 1960, Parts 1 & 11.

20% in the capital rich United States? Who could have predicted gold at $800 per ounce? Who could have predicted the quadruple rise in the price of oil? Who could have predicted the fall of the Shah? Yet these events have largely shaped the states of nature in which the foreign reserve manager currently operates.

Decision theory provides no single best criterion for decision-making under uncertainty. The best advice available is that we should honestly examine our hearts and determine our own attitude to life or else, on some other basis, establish some clear-cut organizational policy; we should then faithfully stick to it. At the extremes we may discover that we are either pessimistic or optimistic. The worst results will be obtained if we switch willy-nilly from one criterion to another; by so doing we could very well end up with the worse of both worlds.

"Maximin" and "Maximax" Criteria

The pessimistic reserve manager will be attracted by Abraham Wald's "maximin" criterion. Under this criterion the decision-maker assumes that the breaks will always go against him, that nature is malevolent; he therefore selects a strategy which maximizes the minimum gains possible no matter what state of nature occurs; he thus avoids maximum loss. The optimistic reserve manager, on the other hand, selects the maximax criterion, i.e. he always selects the course of action which promises the maximum gains, thus accepting the possibility of maximum loss should the actual state of nature turn out to be the most unfavorable of all. Central bankers traditionally exhibit an extreme aversion to risk; in the jargon of management science they opt for the "maximin" criterion. This seems most appropriate in a small developing country. The reserves which they manage constitute one of the nation's last defenses against economic ruin, so that a major investment loss would constitute an unacceptable disaster. A reserve manager who uses the "maximax" strategy is prepared to sustain severe losses occasionally with the expectation of making exceptionally large gains from time to time. He is confident that his superior skill will enable him to out-perform the market over time. However, the assumption of superior investment

skills is not often warranted by investment managers in small developing countries operating far from the major financial centers of the world. As long as major losses are unacceptable, the manager should logically adopt a "maximin" strategy.

3. Operational Guidelines for Foreign Reserve Management: Implications of "Maximin" Criterion

The adoption of the "maximin" criterion has important implications for reserve management. Most Central Bank Acts impose restrictions on reserve investments. Investment in foreign securities is usually restricted to government debentures and treasury bills or government guaranteed securities issued by quasi-governmental or international institutions. But such legislative restrictions cannot be exhaustive and additional guidelines should be specifically established.

Another obvious guideline is the limitation of business relationships to enterprises of unquestioned integrity and financial soundness. For example, investments in the U.K might be limited to the clearing banks, or in the U.S. to the city banks of the Federal Reserve System. The respective monetary authorities in these countries are unlikely to permit the financial collapse of one of their major financial institutions. Even so, a limit should be placed, depending on the size of the reserve portfolio, on the sums which might be invested with a single institution. Secondly, investment should be restricted to those countries which have historically demonstrated a high degree of political stability, which possess well-developed economic and financial institutions, and which have demonstrated a high level of responsibility in the fulfillment of their international obligations. This would obviously eliminate countries with a propensity to civil disorder and coups d'etat.

There might be some modification in the application of the "maximin" criterion in the management of the tranche dedicated to income maximization, as long as the basic precautions spelled out in the previous paragraph are met. In the first place, the "income" tranche will represent a relatively small proportion of the total portfolio, so that even a substantial

investment loss would not constitute total ruin, or even unacceptable loss, when we consider the reserve portfolio as a whole. Furthermore, there is the distinct possibility of significant gains. Given such protection, investment of the income tranche might reasonably be regarded as an exercise in decision-making under partial, rather than complete, uncertainty. Since the reserve manager would be involved in careful study of economic trends of technical conditions in the financial markets, he would not be absolutely ignorant of the prospective states of nature. He might justifiably adopt the subjectivist approach, by which subjective probabilities are assigned to the various states of nature and the investment exercise is treated as decision-making under risk.

The objective of maintenance of value will also necessitate the adoption of more aggressive investment policies than the use of a cautious "maximin" criterion would permit. The reserve manager might once again adopt the subjectivist approach and regard himself as making decisions under risk. Since the very existence of a "maintenance of value" tranche implies that the risk of national ruin or unacceptable loss is extremely remote, some of the "maximin" safety precautions may also be relaxed. Certainly, investments in equity and real estate might reasonably be made as a hedge against inflation.

A Safe Reserve Level

There is no set formula for deciding how a central bank should allocate funds among the various tranches of its foreign reserve portfolio. At any rate, any exercise in allocation requires the determination of a "safe" level of overall reserve holdings. A "safe" level of reserve holdings is itself an elusive quantity. It depends heavily on the structure of the economy, the point in the international business cycle, the prevailing seasonalities, and the openness of the economy. All of these factors are constantly changing. For this reason, a reserve level which may be "safe" in one year, or even one quarter, could be "unsafe" in the next. The extent of penetration by foreign capital is also a difficult variable to handle. Sometimes investors may allow retained earnings to build up for years and then repatriate

dividends and profits en masse. This is especially likely if interest rates rise rapidly in the country of source. The safe level of reserves then must be a matter of judgment and experience.

Whatever benchmark we decide upon, it should reflect movement in the variables underlying the balance of payments. The most popular rule of thumb for determining a safe level of reserves is the value of three months imports used by the IMF and World Bank, However, that measure does not take cognizance of potential non-trade outflows from debt charges and dividend payments. The formula for a safe reserve level might include some number of months value of imports plus some consideration for charges on official and unofficial debt, including repatriation of private dividend payments. In addition, some lower reserve level should be established which would trigger corrective policy actions by government to replenish reserve holdings.

Allocation Among Tranches

The first tranche to be determined is the liquidity tranche. Again the size of this tranche will depend on the trading patterns and volatility of inflows and outflows of foreign exchange. A careful study will have to be made of historical patterns of receipts and payments. The level of reserves held should accommodate the most likely divergences between receipts and payments. In this respect, it is better to err on the side of excess liquidity, since funds not immediately required can usually be invested quite profitably in the money markets. Indeed, increasingly powerful techniques of cash management are being developed for maximizing returns on short term funds. Again, a minimum liquidity level would be established, below which replenishment would be made either from the income tranche or from established credit lines.

Any funds in excess of those required for liquidity purposes will be allocated to the income tranche until the upper "safe" reserve level is reached. The allocation of reserves in excess of the overall "safe" reserve level will depend on whether this excess

is viewed as temporary or likely to persist over a medium term (2-5 years). If it is viewed as short term, it should be added to the liquidity tranche, even though that tranche may be at its "optimal" level. If it is seen as a medium term holding, it will be assigned to the income tranche. In some cases the maturity of security held may be tailored to the anticipated holding time of the additional reserves. If the funds in excess of "safe" upper level promise to be long term, in excess of five years, they should be placed in the capital fund. The size of the capital fund is indeterminate.

The political tranche would ideally be fed from the capital fund, but might have to be taken from the income tranche. The growth of the political tranche reduces the earnings of the income tranche. Its size, of course, reflects purely political considerations and cannot be rationally determined. It could very well be that the survival of some countries may be co-determined, so that a country might be prepared to make considerable sacrifices to assist others.

The gold tranche will be fed at times when reserve levels are buoyant. Generally speaking, some target level should be determined, keeping in mind that gold is not an earning asset and that its price fluctuates. Many central banks use ten percent of the "safe" level as a target.

Use of Credit Lines

With the best planning in the world, a country's liquidity holdings may prove inadequate to meet a run on the country's foreign reserves. Such a run may occur overnight; a revolution, a crop failure, an earthquake, or a flood could change a country's liquidity position quite dramatically. In such cases it is useful for the central bank to have access to adequate credit lines with international financial institutions. Of course, such credit lines must have been put in place in good times. It might be costly and difficult, indeed even impossible, to obtain credit lines once the crisis has set in.

The advantages of short-term credit lines may be both strategic and tactical. Sometimes the loss of reserves may be so

serious that the availability of credit lines of 180 days or so may buy the time to develop a long-term strategy for correcting the country's external position. Such a strategy would include government long-term loans, tighter fiscal and monetary policies and possibly resort to an incomes policy, or drawings on the facilities of the International Monetary Fund. Tactically, the drawing down of credit lines could make it unnecessary to sell from the central bank's income tranche at capital loss. Sometimes, savings can be effected by drawing on a credit line to avoid breaking a fixed deposit.

4. Measurement of Reserve Management Performance

We come next to the problem of measuring our progress towards the achievement of our objectives. The nature of the objective will determine our criteria of measurement. We will therefore have to examine each case separately and tailor our accounting system to each objective. It is notorious that accounting measures influence the behavior of managers who tend to maximize the indices which are being formally measured. An important aspect of the measurement problem will be the time period over which performance is to be measured. It makes a tremendous difference whether we use a monthly, quarterly or annual time measure, since the rate of return usually varies with the maturity of the security selected. Finally, valuations of performance will also vary with the unit of account selected, since units of account themselves are not absolute, but vary over time and in their relation to other units of account.

Gold Tranche

The purpose of gold tranche is to provide security against the possibility of national economic ruin. Truthfully, we shall not know whether we have achieved our objective until we have sustained at least one national disaster. If the liquidation or pledging of our gold reserves protected us from total ruin, we would regard the holding of gold as useful. If our gold holding in no way alleviated our economic discomfort, we might view the gold tranche a failure. But then again the fact that one has never had his house burn down is not an argument against taking out fire insurance.

The accounting system for the gold tranche portfolio must take into account the long term and, indeed, the indefinite time period of our objective. It should not therefore concern itself with day to day, or even year to year, fluctuations in the price of gold. The obvious convention would be to measure gold holdings at cost in the central banks official reporting currency and to take profits or losses only on liquidation. Such liquidation would occur only if a disaster did occur or there were a strategic change in the decision to hold gold. This presumably would not happen often.

This convention to hold gold at cost rather than at market is an important policy issue. Conceivably, gold might be held in both the "income" tranche and the "maintenance of value" tranche, in which case holdings would be valued at market and profits or losses recognized at the end of the relevant time period. But to value the gold tranche holdings at market would motivate the portfolio manager to speculate in gold. In his anxiety to avoid losses, he would be behaving then as a profit maximizer, or at least, as a cost minimizer when, in fact, he should be maximizing security or minimizing the possibility of national ruin.

Another approach to the management of the gold tranche would be to determine in advance what proportion of the "safe level" the gold holding should be and through market operations maintain it at that level. In that case the manager would sell gold in a rising market and buy in a falling market. Assuming that the long-run trend in gold prices was upward, the Bank would tend to gain rather than lose but, again, the manager would take no view of the price of gold.[4]

It would still be useful, however, to establish a review period, say every ten years, to examine how gold is performing against other commodities. Such reviews may suggest either an increase in gold tranche holdings or a decrease. The review

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[4] I am grateful to Stefan Mendelsohn for suggesting this approach.

might even suggest a move from gold into silver, platinum or some other commodity, though it is most unlikely.

Political Tranche

Since the purpose of the political tranche is to maximize goodwill rather than earnings, the measurement of performance in pure terms of money values would be inappropriate. The measurement of the value of the goodwill achieved by coming to the assistance of friends in need, or in investing in the securities of international financial institutions, is a purely subjective exercise.

Nevertheless, it may be politically useful for us to know the opportunity cost of our gestures of goodwill. This is easily ascertainable by using the average rate of return on the "income" tranche and applying it to the political tranche. The differential earnings would constitute the opportunity cost of our goodwill. We could then decide whether we are in fact prepared to extend assistance on such a scale or whether we are prepared to do even more for those less fortunate than ourselves.

Liquidity Tranche

The main objective of the "liquidity" tranche is to ensure that liquid funds are readily available at all times to meet the day to day demands upon the central bank for foreign exchange. The measurement of the reserve manager's performance poses severe difficulties since the "adequate" level of liquidity is a moving target in that it changes from day to day and from month to month over the business cycle, with the changes in the country's balance of payments. At the same time, the manager should try to employ funds not immediately required as profitably as possible. However, the investment options of the "liquidity" manager will be constrained by the timing of demands on the portfolio, which are largely outside his control. He may face heavy demands when interest rates are low; this would minimize his earnings on available balances.

It would be virtually impossible to come up with a single index which measured the success of the manager in attaining his objective of an "adequate level of liquidity". We could more easily measure the nonaccomplishment of his objective. It would be a black mark against him if he incurred serious losses on currency speculation in search of higher income, since income maximization is not his objective! He would also have failed were he forced to break term deposits at high penalty costs to meet unforeseen demands, or if he forced the central bank to dip into its "income" tranche to sell long term securities at high capital loss! Such failures would be distressing unless brought on by the most unusual circumstances, like an oil shock or by eccentric economic policy on the part of government.

However, it is possible to measure the cost of maintaining adequate liquidity over a given time period. We could calculate the weighted average daily balance of funds held in the liquidity portfolio and the average weighted daily rate of interest on investment in similar securities over the same time period. Of course, such a rate of interest would be obtainable only if the manager had perfect knowledge of the timing of his inflows and outflows of foreign exchange. This ideal rate of return could be approached only asymptotically. Nevertheless, the difference between the ideal rate of return and the actual rate of return would indicate the maximum opportunity cost of having to maintain liquid balances.

Of course, it would be impossible to determine the maximum opportunity cost the manager could have achieved; nor could we usefully match his performance with that of a manager in similar circumstances since no two countries have the same balance of payments profile. However we might expect the manager over the years to improve his performance through experience and increased skill in liquidity management. We would be disappointed if the rate of return on liquid balances moved progressively away from the ideal rate.

Income Tranche

The appropriate measures of performance for the management of the "income" tranche are almost identical with

those for the management of private money market funds. As indicated above, the "maximin" criterion would be relaxed and the manager would be deciding under risk. However, central bank aversion to risk would still impose constraints in respect to the integrity of financial institutions with whom he dealt and the reliability of those political entities whose securities he purchased. The purchase of equities might also be excluded. The manager of the "income" tranche would therefore operate as a profit maximizer subject to the constraints of safety imposed by the central bank's overall "maximin" criterion. In fact, many fund managers in the major financial centers manage clients' accounts under similar conditions. Once the relevant constraints were observed, the manager would be free to select the maturity and currency denomination of securities for the "income" portfolio, taking into consideration current and prospective conditions in the money and capital markets.

As in the case of a private fund manager, the "income" manager's performance would be measured on the basis of the rate of return on the funds entrusted to him. Two parameters would have to be determined in advance: the unit of account for measuring the rate of return, and the time period over which performance is to be measured. The most important criteria for selecting a unit of account are consistency and convenience. (There is, of course, no perfect monetary unit of account). The national currency would, naturally, be the most convenient from an accounting viewpoint since that is the unit of account in which the central bank's financial statements are published. However, if the national currency is volatile, it might make sense to use either the U.S. dollar or the SDR in measuring the performance of the "income" manager, even if the accounts were translated into national currency units for official reporting. The U.S. dollar is attractive and it is the currency most used in international transactions, but there may be a case for some central banks to use the French franc, the Deutschemark, the pound sterling, the Japanese yen, or even some other currency. The minimum accounting period for the measurement of performance would be one year. However, it is difficult to arrive at a valid assessment of a manager's performance until he has managed through a full interest rate cycle - probably five years or more.

The benchmark of the "income" manager's performance would be the rate of return achieved by fund managers operating under similar constraints. One technique of establishing a comparable measure of performance is to farm out a portion of the "income" tranche to portfolio managers in a major money center financial institution and use their results as a benchmark for judging the domestic manager. Some allowance would have to be made for the fact that the manager in a developing country usually operates at some distance from the major international financial centers. In spite of the tremendous advances in telecommunications, he would still be at a serious disadvantage in respect of the timeliness of information vis a vis the foreign fund manager, against whom he is competing. His handicap allowance might be the equivalent of the fees charged by the foreign managers for their services.

Except in the most unusual circumstances, the "income" tranche should be managed by nationals. Fund management can be learned only through rigorous application and long experience. The opportunity costs of not farming out the entire income portfolio to professional foreign fund managers may be viewed as the cost of training national fund managers.

Maintenance of Value Tranche (Capital Fund)

The objective of the "maintenance of value" tranche is the preservation of capital values over the long run. There are two major threats to the achievement of this objective, currency depreciation and inflation. To counter these effects, the manager must achieve a rate of return on investment which equals or exceeds the combined rates of inflation and currency depreciation. The measure of the manager's performance must be designed so as to establish unequivocally whether this goal has been achieved.

As usual, the first requirement for performance measurement is the determination of a suitable unit of account. This will be particularly important since the relevant time period would probably be in excess of ten years. The unit of account should therefore exhibit a high degree of stability relative to other units of account. The ideal accounting unit would also

exhibit stability in purchasing power over time, but in times like these that might be asking too much. We would settle for the unit of account least likely to depreciate dramatically over time. Actually, our choice is quite limited; we would rather choose the currency which we think will best fit these requirements, which boils down to the Swiss franc, the U.S. dollar, the Deutschemark, sterling or the yen, or a composite currency. The weight of argument would probably come down on the side of the SDR which includes the major currencies and therefore depreciates less than the weakest currencies in its "basket".

The choice of a unit of account does not deal with the problems of inflation, although the tendency would be for the weights of the least inflated currencies to increase in the SDR basket over time. However, even the strongest currencies will suffer erosion in their values from inflation and so the manager will have no option but to generate earnings which exceed the general rate of inflation. The general rate of inflation might be taken to be the composite inflation rate of those countries represented in the SDR currency basket weighted according to their respective weights in the SDR basket.

Summary & Conclusions

As in any other activity, the first requirement for success is the clear establishment of objectives. As with most governmental activities, there will be multiple objectives in foreign reserve management. The nature of these objectives are to a large extent a function of portfolio size. If the nation's reserve position is desperate, the only relevant objective will be liquidity; if it is comfortable, some funds may be stashed away in gold for the rainy day and segments of the portfolio dedicated to income maximization and assistance to friendly countries. If there are windfall earnings, then the issue of maintenance of value comes into play. To deal with these multiple objectives, it is practical to segment the portfolio into tranches reflecting the several objectives.

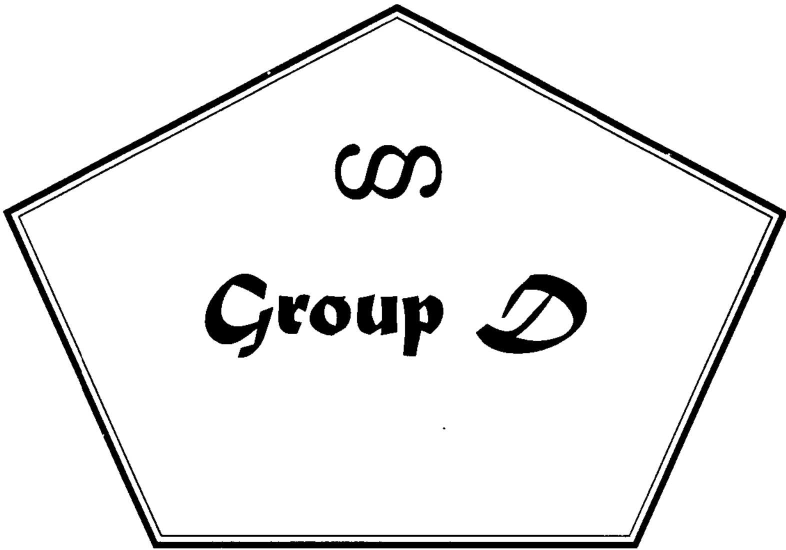
Because of the critical importance of reserve management to the economic health of the nation, and because of the uncertain international environment for investment, the basic

approach of foreign reserve management will be one of risk aversion. The basic criterion of decision-making will be the "maximin". As reserves reach levels where the prospect of total national ruin recedes, the "maximin" criterion may be relaxed with respect to the "income" and "maintenance of value" tranches; the reserve manager, using his experience and knowledge, will then be prepared to pit his skill against nature, behaving as a decision-maker under risk. In the management of the "maintenance of value" tranche, he will increasingly take calculated risks in his attempts to maintain the value of his capital over time.

It is important that appropriate measures of performance be established in order to motivate managers to achieve their goals. In this respect, the selection of a suitable unit of account and relevant accounting procedures are of critical importance. Some ingenuity is also required in the establishment of measures of performance for non-monetary objectives.

Reserve managers in small developing countries will have to monitor closely conditions in the major financial markets, familiarize themselves with modem investment theory and techniques, and keep up to date with the most recent technological developments. This will enable them to squeeze additional income from their portfolio; where large sums are involved, a marginal increase in earnings can be quite substantial.

Finally, movements in foreign reserves reflect more fundamental developments in the national economy. They provide feed-back to the national decision-makers about the consequences of their economic policies. Rapid increases in reserves may signal new opportunities; a rapid decline may be a warning that fundamental changes in policy are required. To use the vernacular, the foreign exchange reserve portfolio is the "wash" where it all comes out.


Group D

13 Towards a Caribbean Monetary Union*

Introduction

wo years ago down under in Melbourne, Australia, I found myself discussing with Clive Lloyd the prospects for Caribbean unity, a goal which the West Indian Captain had pursued with such spectacular success on the cricket field. Lloyd argued with great passion for the establishment of a common currency which might be used throughout the region. I explained to the great man, with patience and possibly in a patronising manner, that a common currency implied a coincidence of monetary, fiscal and welfare policies which currently did not exist among CARICOM States. I pointed out that though the European Common Market countries had achieved significant convergence in their economic policies, they were still far away from their eventual goal of monetary union.

The position I put forward represents what is still the conventional wisdom in the Caribbean. As William Demas articulates it:

> ... A single independent currency entails a single set of economic, monetary, financial and fiscal policies designed to influence the balance of payments. Such a single set of policies is possible only with a high

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> degree of economic union tantamount to a political union.

In fact, a Caribbean monetary union did exist in colonial times. Under the old Currency Board system, colonial governments were authorized to issue new currency only against the equivalent holdings of sterling securities. This currency regime, which Demas describes as "primitive and antiquated", prevented colonial governments from pursuing an independent and possibly inflationary monetary policy. Barbados, Guyana, Trinidad and Tobago and the present OEC States shared the same currency under the British Caribbean Currency Board. Even after Guyana, Trinidad and Tobago, Barbados and the Bahamas had established their own Central Banks, their currencies remained linked to the East Caribbean dollar under the Sterling Area Agreement. Under this agreement, and as late as 1974, the currencies of all Commonwealth members, with the exception of Canada, as well as those of Iceland, Jordan and Ireland, were freely convertible among each other and capital moved freely throughout the Sterling Area. The only drawback was that when Sterling devalued all its satellites followed suit.

In the pre-independence Caribbean, not only was there freedom of movement of capital but, with colonials holding British passports, labour moved with relative ease as well within the region. Colonial civil servants and private sector personnel relocated from colony to colony as circumstances demanded. Movement of enterprise was certainly total with several companies, especially commercial banks, operating branch offices throughout the region. Trade among the territories was extensive, especially in the East Caribbean, with schooners and motor vessels ploughing the sea-lanes with cargoes of fruit, charcoal and timber. Trade restrictions were minimal.

With the coming of independence these patterns of regional intercourse were drastically altered. Nationalist sentiment operated not only against former colonial powers, but often with even greater intensity against other West Indians, who became subject to entry and work permits. With the winding down of the Sterling Area in 1974, CARICOM governments raised exchange control barriers against each other and adopted increasingly

mercantilist trade policies. Whereas in 1972 a Jamaican could send a million pounds to Iceland or Jordan without exchange control, today he cannot send even one hundred dollars to Barbados without exchange control approval, often requiring Ministerial concurrence. Indeed, the ongoing Caribbean integration movement may be viewed largely as an attempt to put Humpty-Dumpty together again.

Since my conversation with Clive Lloyd, developments both in the Caribbean and the wider world have led me to place a high premium on monetary union. I no longer, like Demas, view a common Caribbean currency as the ultimate consequence of a "single set of economic, fiscal, financial, monetary and exchange rate policies for the region," but as a powerful tool for moving the region towards the set of economic, fiscal, financial, monetary and exchange rate policies needed to achieve the regional integration and consequent economic development.

The European Monetary System (EMS) is an obvious point of departure in our exploration of the possibilities or a Caribbean Monetary Union. The insights from that experiment will be applied to our own experience in monetary cooperation here in the region. In this respect, the contrasting experience of the OEC States and the so-called More Developed Countries with their own Central Banks should be most instructive. This will lead us naturally to consideration of a unified monetary system for CARICOM and the optimal institutional arrangements for such a system in our Caribbean situation.

The European Search for Monetary Union

Although the Western Europeans are still a long way off from their declared goal, their quest for monetary union provides useful lessons for us here in the Caribbean. The Treaty of Rome (1957) establishing the Common Market, envisaged three stages to be completed over 12 years. Stage one was the establishment of a Free Trade Area, involving the removal of customs duties and other trade barriers among members. The second move was towards a Customs Union with the establishment of a common external tariff. The Common Market would finally come into being

with the provision for the free movement of the factors of production - labour, capital and enterprise. The three phases proceeded according to plan and in 1969 the six members of the community decided to transform their organization into an Economic and Monetary Union (EMU). Essentially the new EMU would be a Common Market with the complete unification of monetary and fiscal policy.

In the "great debate" on monetary and economic union, two distinct schools of thought emerged - the "economists," mostly the Germans and the Dutch, and the "monetarists," comprising the French, the Luxembourgers, the Belgians and the technocrats of the European Economic Commission. Both schools agreed on the ultimate objective but differed over the appropriate path to be followed. The "monetarists" emphasized early action on locking exchange rate parities into place so as to impose the requisite monetary discipline upon member states. By contrast the "economists" saw the need for the prior convergence of economic policy and performance before proceeding to immutable parities.

The final proposal for the EMU represented a compromise between the two schools. Rather than the locking of exchange rates into place from the outset, it provided for a margin of exchange rate fluctuation around the central parities within the EEC which would be much narrower than the margin between the US dollar and the collective community currencies - the famous snake within the tunnel device. Before the EMU could be introduced, the Bretton-Woods System of fixed exchange rates collapsed and the current regime of floating exchange rates commenced. The EMU was finally shelved in 1974.

The early attraction of floating exchange rates was that it allowed each government to pursue an independent, and usually expansionary, monetary policy in the knowledge that currency markets would maintain exchange rate equilibrium with other currencies. Moreover, the consequent fall in personal incomes would be less explicit than in the case of a currency devaluation in a fixed rate regime! In short, it is easier to fool the public under a floating than under a fixed rate regime. Moreover, the

proponents of market determined exchange rates, like Nobel Laureate Milton Friedman, promised that floating exchange rates would he much less destabilizing than the faltering Bretton-Woods regime.

However, it soon became evident that the freedom to pursue an independent monetary policy also militated against convergence of overall economic policy which, according to the "economists", monetary union required. In addition, exchange rate instability proved more problematic than ever before. In 1977 Roy Jenkins, President of the EC Commission, decided that a common monetary policy was in fact required to impose discipline on the wayward economic policies of Common Market members. West German Chancellor Helmut Schmidt was able to obtain the support of the French and the European Monetary System (EMS) was established in 1979.

The EMS is much less ambitious than the EMU. There is no provision for immutable exchange rates or a common currency. The emphasis is rather on the creation of a zone of stability. For each national currency a central rate is fixed in terms of the European Currency Unit (ECU) and exchange-rate fluctuations within a narrow band are permitted. Divergence from the central rate triggers corrective measures of market intervention and, only if necessary, currency realignment. In practice the D-mark, the strongest European currency, plays the role of anchor of the EMS, pressuring the other member governments to shadow the traditionally tight West German monetary policies. This minimizes the occasions for currency realignment.

The Economist describes the EMS as "one of the few "Eurocontraptions" which is not yet broken" and warns EEC Finance Ministers against tinkering with the institution:

> The previous rules meant that West Germany chose the Group's monetary policy and left the others to like or lump it. Exactly. That is why they worked. The D-mark's grip on the system is the main reason why the EMS, instead of collapsing in a heap, has forced

its members to accept the blessings of low inflation and stable exchange rates.

Writing in 1985, retired Chancellor Schmidt urged a strengthening of the EMS in order "to harmonize the economic behaviour of participating governments in the fiscal and monetary fields, and to create a really common market in respect of the money, or currency, being used."

Caribbean Economic and Monetary Cooperation

The failure of the West Indies Federation in 1962 suggested to Caribbean leaders that regional integration might better be accomplished via the economic rather than the political route. The first definitive move was the signing of the Caribbean Free Trade Association, CARIFTA, by Antigua, Barbados and British Guiana at Dickenson Bay, Antigua, in 1965. A new CARIFTA came into effect on May 1, 1968, with the participation of Antigua, Barbados, Guyana and Trinidad and Tobago. By year end they had been joined by Dominica, Grenada, St. Kitts/Nevis/Anguilla, St. Lucia, St. Vincent, Jamaica and Montserrat. Belize would become a member in May 1971.

It was also agreed that CARIFTA would eventually become the Caribbean Common Market which would be established through a number of stages for the achievement of "a viable community of Caribbean territories." Special concessions were made to the present OEC States, Montserrat and Belize. This group would become known as the Less Developed Countries LDCs) and Barbados, Guyana, Jamaica, and Trinidad and Tobago as the More Developed Countries (MDCs). The Caribbean Community and Common Market (CARICOM) was established by the Treaty of Chaguaramas in July 1973 and came into effect the next month. The LDCs joined shortly afterwards, while the Bahamas became the 13th member state of the Community - but not of the Common Market - exactly 10 years later.

A group of Caribbean experts reported commendable progress in certain areas of functional cooperation among Caricom States. However, they considered the degree of

economic policy coordination to have been less conspicuous. Little progress, they thought, had been made in the joint development of industrial and natural resource development, e.g., the proposed regional aluminum complex and the promotion of extra-regional exports. Nor had States been consulting with third countries as envisaged under the Treaty. They did note that significant technical and financial resources had been transferred to the LDCs, and that the West Indies Shipping Corporation (WISCO) and LIAT (1974) had been providing valuable services to the region.

The CARIFTA agreement led to an encouraging expansion of regional trade. At the same time the CARICOM Central Banks embarked on a programme of almost frenzied cooperation. In 1969 bilateral clearing arrangements were established between the Central Banks of Guyana, Jamaica and Trinidad and Tobago. This Intra-Regional Payments Scheme (IRP) economized on the use of foreign exchange through an offsetting payments system with periodic net settlements. The IRP was transformed into the even more sophisticated Caricom Multilateral Clearing Facility (CMCF) in 1976.

An important innovation of the CMCF was its enhanced credit feature. The settlement period was extended from quarterly to semi-annual settlements and debtors permitted a minimum settlement of 50 per cent of their outstanding debts. Interest costs to debtors were significantly lower than the LIBOR rate and the LDC's benefited from concessionary rates. At the same time, the total credit available within the CMCF was increased from US$40 million to US$80 million. Further liberalization of the CMCF took place in 1980 with the increase in eligible transactions to include air travel and payments for oil and fertilizer. The credit limit was also increased to US$100 million.

An Interim Balance-of-Payments Mutual Support Facility was also agreed upon in 1976 to be managed by a council of Central Bank Governors. It was envisaged that the Facility would be capitalized by contributions from each member state and that borrowings from the facility would be subject to conditionalities.

It soon became apparent that the balance of payments needs of Jamaica alone far exceeded the proposed capital of the Mutual Support Facility and the project never got off the ground.

Two other developments are worth mentioning. First, a Caricom Travellers Cheque was introduced in 1980 by the Central Banks operating the CMCF. Being negotiable only within CARICOM, the cheque narrowed the scope for capital flight from the region. Secondly, the CMCF directors commenced the retention of interest payments due to creditors with a view to building up a capital fund and eventually transforming the Facility into a Corporate Financial Institution capable of providing medium term credit to members in balance of payments difficulties.

Monetary cooperation among CARICOM States turned out to be a fair-weather phenomenon which evaporated with the onset of balance of payments difficulties in the mid 1970s. Gradually the patterns of monetary cooperation so painfully developed over the years began to unravel. In 1975 the Central Banks of Guyana and Jamaica ceased the redemption of their currency notes and coins repatriated by other CARICOM monetary authorities. In the following year both countries imposed restrictions on CARICOM imports as their balance of payments situation grew worse and worse, and their intra-regional trade slowed to a trickle.

Exchange rate instability has also posed serious problems for intra-regional trade. The frequent devaluations and the import liberalization policies imposed by the International Monetary Fund on Jamaica, without reference to the CARICOM context, appeared to give that country's exports an unfair advantage over those of Barbados and Trinidad and Tobago and to provide easier access to Jamaican markets for non-CARICOM than for CARICOM exports. These perceptions led to retaliation by Barbados and Trinidad and Tobago in 1983: Barbados floated its currency solely against Jamaica while Trinidad and Tobago used the occasion to impose fierce protectionist measures, not only against Jamaica, but against all other CARICOM States. Except for transactions between Barbados and the OECS, intra-regional

trade is now conducted largely on the basis of bilateral deals amid strident accusation and counter-accusation of unfair practice. Indeed, the free trade clauses of the Caricom Treaty are more honoured in the breach than in the observance.

The death of Dr. Eric Williams in 1981 proved a serious blow to economic and monetary cooperation in the region. Whatever his eccentricities, he was deeply committed to the concept of regional unity, and backed that commitment with generous support by way of aid and loans to CARICOM member states well in excess of US$200 million - the vast proportion to Guyana. With his passing, the Chambers Administration reversed his policies. The Grenada incident of 1983 was the straw which finally broke the camel's back, severely straining intra-CARICOM relationships. Meanwhile, the Guyanese default on her obligations led to the collapse of the CMCF in 1983 and to the cessation of regular meetings of Central Bank Governors. Today meaningful collaboration on monetary and economic matters hardly exists among CARICOM States.

Contrasting Approaches to Economic Integration

The Caribbean situation provided an excellent laboratory for testing the relative merits of the "economist" and the "monetarist" approaches to economic union. The Caricom Agreement sought the convergence of economic policies among member states with a view to eventual economic integration. The harmonization of exchange rate movements and the liberalization of capital flows within the region are especially encouraged. In fact, there were two integration movements proceeding simultaneously within CARICOM. On the one hand, there was the larger Caricom grouping dominated by the four MDCs, each possessing its own Central Bank and pursuing separate monetary policies. On the other hand, a single currency locked the OEC States into common monetary and exchange rate policies. Let us examine the relative merits of these two approaches.

As we have seen above, cooperation in both economic and monetary areas progressed satisfactorily within the wider

Caricom grouping until the mid-seventies when the balance of payments difficulties of Guyana and Jamaica strained and eventually led to the collapse of cooperative monetary arrangements. The economic difficulties of these two states stemmed from an ideologically motivated fiscal expansion which ignored the constraints of the balance of payments. Guyana's socialist programme involved massive outlays for the purchase of foreign enterprises while the People's National Party in Jamaica embarked on a policy of extensive income redistribution in pursuit of its new found democratic socialist principles.

Both countries had exhausted their foreign exchange reserves by the end of 1976 and, as their earnings from commodity exports collapsed, resorted to money creation to finance their mounting fiscal deficits. But fiscal deficits in these small open economies were swiftly transformed into balance of payments deficits which, with the exhaustion of foreign exchange reserves, could only be financed by foreign loans! As their foreign credit ran out, Guyana and Jamaica had recourse to IMF stand-by agreements involving devaluation, inflation, a crushing foreign debt and the progressive impoverishment of their people. Neither government would have been able to carry through these disastrous experiments in the absence of Central Banks which they could require to finance their fiscal deficits.

Ironically enough, the OEC States, so-called LDCs, turned in a far more impressive performance than their more developed CARICOM partners. In spite of natural disasters, like the eruption of Mt.Soufriere in St. Vincent, and the man-made catastrophe in Grenada, the OEC States all achieved positive growth rates over the period 1973-85, ranging from 1.2 per cent per annum for Antigua and 5 per cent per annum for Saint Lucia. The comparative for MDCs were 3.6 per cent for Trinidad and Tobago, 1.5 per cent for Barbados, negative 1.2 per cent for Guyana and negative 2.5 per cent for Jamaica. By 1985 the per capita income of the poorest OEC State Grenada (US$970) exceeded that of both Guyana (US$570) and Jamaica (US$940); that of the wealthiest, Antigua (US$2,030) was more than twice Jamaica's and more than three times that of Guyana. Besides, the OEC States have controlled their inflation much better than

the MDCs, and the East Caribbean Central Bank (ECCB) currently boasts a healthier foreign exchange position than either Barbados or Trinidad and Tobago.

The verdict is clear. The constitution of the East Caribbean Currency Authority (later the ECCB) severely limited the credit creation powers of the monetary authorities. The fiscal expenditures of OEC States were restricted to tax revenues, local commercial bank loans, foreign aid and limited foreign borrowing. No individual state could force the monetary authorities to create new money to finance deficit spending. By force of circumstances the OEC States pursued "appropriate" fiscal policies. Moreover, wage increases unaccompanied by productivity gains could not be validated by money creation.

Also of great importance was the unanimity rule which made changes in the exchange rate a long and involved political process, thus shielding individual states from the imposition of unwarranted devaluation by the IMF. In this way, they have enjoyed the tremendous advantages of exchange rate stability which even hardened Free Marketeers like **The Economist** have come to recognize. They had no other choice than to pursue passive exchange rate and monetary policies and to force fiscal policy and incomes policy to bear the brunt of balance of payments adjustment. The "monetarist" approach has thus preserved both the OECS politicians and their electorate from themselves. Meanwhile, the sharing of a common currency has provided the catalyst for even deeper integration of the OEC States, stimulating the taste for political union among some national leaders.

Institutional Arrangements for Caribbean Monetary Union

Both the EMS experiment and our own CARICOM experience recommend the "monetarist" approach to regional economic integration. The insulation of Central Banks from government pressure to finance deficits and the promotion of exchange rate stability are critical features of an effective CARICOM. Clearly it will take forever for Caribbean political leaders to agree on the common economic, fiscal and financial policies which might

eventually lead to full economic union, including a common currency. Time is not on our side! We must therefore make a quantum leap to the establishment of a monetary union. We do not have to go far to find the appropriate model. It is before our very eyes in the form of the East Caribbean Central Bank. Intrinsic to its format is the curtailment of political control over money creation and a bias in favour of exchange rate stability.

A Caribbean Federal Reserve System (CFRS) would be set up embodying the following basic features:

1. There would be a pooling of reserves so as to economize on scarce foreign exchange.

2. A common currency, pegged either to the US dollar, the SDR or some other basket of currencies, would circulate throughout the region.

3. Exchange controls within CARICOM would be abolished, allowing for freedom of movement of goods, capital and enterprise.

4. The CFRS would be managed by a Council comprising the governors of existing Central Banks with the Chairman appointed either by the Caricom Heads of Government or through rotation among the Governors.

5. Important policy decisions would be reached unanimously or by overwhelming majority, say 75 per cent of the membership.

The imposition of a common monetary policy would also promote convergence in fiscal, trade and welfare policies and regular meetings of the CFRS Council would stimulate the research and understanding of regional economic issues.

The Economist recently predicted an international currency by the year 2018:

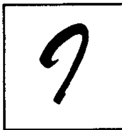
> Prices will be quoted not in dollars, Yen or D-marks but in, let's say, the phoenix. The phoenix will be favoured

> by companies and shoppers because it will be more convenient than today's national currencies, which by then will seem a quaint cause of much disruption to economic life in the late twentieth century.

It is also time for us to remove at one fell swoop the counterproductive network of exchange controls, licensing restrictions, entry and work permits, etc., which make the Caribbean such an expensive place in which to do business and which condemn us to persistent poverty. I recommend August 31, 1994 as the target date for full regional economic union. Why? It would be a nice 50th birthday present for Clive Lloyd, the most brilliant exponent to date of Caribbean unity in action.

14 Economic and Monetary Union in the CARICOM Caribbean*

Introduction



am deeply honoured by Governor Venner's invitation to deliver the feature address at this Third Annual Commercial Banks Meeting on the island so appropriately called the "pearl of the Antilles". I should like to congratulate the Governor for conceiving of this forum for the frank but friendly exchange of ideas between the Central Bank and the commercial banks under its supervision. Governor Venner understands well that commercial banks are the constituents of the Central bank, not its adversaries. Indeed, the relationship between the two may be described as symbiotic, since the commercial banking system represents the medium through which the Central Bank conducts its monetary policies. Such policies are most effective when the system as a whole is competitive and vibrant, and its units profitable and sound.

Governor Venner has asked me to speak on the topic "Economic and Monetary Union". No doubt, this is because he recalls that I was the first Caribbean economist to put forward the theoretical case for a Caribbean monetary union, with the

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* Feature Address presented at Third Annual Commercial Banks Meeting St. Lucia, September 3, 1992.

ECCB as the model for its organization. I did so first in 1988 in a popular article "Towards a Monetary Union",[1] and more formally later in a Paper entitled, "New Directions for Caribbean Central Banking".[2] I have described the latter elsewhere as a "much unquoted Paper", since the ideas first presented there have been frequently repeated by others without ascription.

"Economic and Monetary Union" is an issue much to the fore these days. A monetary union may exist in the absence of an economic union. In colonial times, and up to the demise of the Sterling Area in 1974, a monetary union did exist in the British Caribbean. The currencies of the British Currency Board, which served Barbados, Guyana, Trinidad and Tobago, and the islands which now constitute the OECS, were pegged to sterling, as were the Currency Boards of The Bahamas, Belize and Jamaica, and therefore fixed in relation to each other. They were freely convertible one into the other so that capital moved freely throughout the region. Monetary union was shattered throughout much of CARICOM with the establishment of central banks in the 1960s and 1970s. However, the ECCA, the forerunner of the ECCB, preserved a common currency for the states which now constitute the OECS. The statement in the Governors' Report, "Caribbean Monetary Integration" (hereafter the Report), page 23, that "true monetary integration does not exist in the OECS since there is no formal mechanism for fiscal coordination" is certainly mistaken. Neither is there a formal mechanism for the coordination of the fiscal policies of the US Federal Government, the 51 States and the hundreds of municipalities, but no one denies that the USA is a monetary union!

We should note that monetary union does not require a common currency, nor a common central bank, only a fixed and

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1 Blackman, Courtney N., "Towards a Monetary Union", **Caribbean Affairs,** April-June, 1988.

2 Blackman, Courtney N., "New Directions for Caribbean Central Banking", *Social and Economic Studies,* Vol. 38, No. 4, 1989.

permanent relationship between the exchange rate parities of the parties involved. The obsession of the recent West Indian Commission Report[3] with a common Caribbean currency is populist in its origin. This has led it to support Dr. DeLisle Worrell's proposal for the early issue of a "hard" Caribbean dollar circulating alongside national currencies, in the expectation that the "strong" Caribbean dollar would eventually drive out the "weak" national currencies.[4] This proposal flies in the face of Gresham's Law. Gresham's Law, the most frequently confirmed law in Economics, dictates that whenever two currencies of unequal "hardness" circulate as legal tender alongside each other, the "softer" currency will drive out the "harder". We might confidently expect that softer national currencies will drive out the harder Caribbean dollar. Parallel currencies are not a very good idea.

Economic union, the equivalence of the proposed Caricom Single Market, could not flourish in the absence of a monetary union. A single market implies the free movement of goods, services, capital, labour and enterprise within a given geographical region. This, in turn, requires a mutually acceptable monetary unit of account to measure the value of transactions, a monetary medium of exchange through which settlements might be made, and a monetary store of value to facilitate savings for investment and growth. In the absence of full convertibility among currencies used by the economic units involved or, a common currency, it is not surprising that intra-regional trade fell off so dramatically with the collapse in 1983 of the Caricom Multilateral Clearing Facility (CMCF). This is also why the OECS, with its single currency has made more progress towards economic union than CARICOM as a whole. In 1989 Caricom Heads of Government stated their intention to work towards the creation of a Single Market for CARICOM by 1993,

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3 The West Indian Commission, **Time for Action,** Barbados, 1992, p.109ff.

4 Worrell, DeLisle, "A Common Currency for the Caribbean", The West Indian Commission, *Occasional Paper 4,* 1991.

later put forward to 1994. In 1990, they went further, specifically mandating Governors of Central Banks to commence a Study towards the transformation of the Common Market into a Monetary Union. Last month the Governors presented their Report to the Caricom Heads, who noted it, endorsed its approach towards the achievement of monetary union, and complimented the Governors on its quality. This is a good time to critique this Report and review the movement towards Caribbean economic and monetary union.

Recommendations of the Governors' Report

The Report recommends a Two-Tiered, Three-Stage approach to the establishment of a Caribbean Monetary Authority and a common currency. Caricom States are divided into categories A and B. In Category A fall OECS, The Bahamas and Belize, which maintain a fixed exchange rate regime and meet certain foreign exchange reserves and debt service ratio criteria, viz. the maintenance of 3 months' import cover in foreign exchange reserves for at least 12 months and a stable exchange rate for 36 months, with a sustainable debt service ratio, not exceeding 15 per cent - the "13-12-36-15" criteria. Category B comprises Barbados, Trinidad and Tobago, Guyana and Jamaica, States which do not meet Category A qualifications. Strictly speaking Jamaica and Guyana form a separate category since, unlike the case of Barbados and Trinidad and Tobago, comprehensive balance of payments collapse has forced them to move from a fixed to a floating exchange rate regime - a "dirty" float, most recently in the Jamaican case. I shall refer to Barbados and Trinidad and Tobago as B-1 countries, and Jamaica and Guyana as B-2 countries.

The Report proposes that the goal of a common Caricom currency in the year 2000 be approached in three stages. Stage 1 would commence in January 1993. During this state no specific actions would be required of Category A countries beyond "the maintenance of sound macroeconomic management." B-1 countries would be required to "accelerate their stabilization and adjustment programmes", and B-2 countries would continue their structural adjustment programmes and undertake to maintain their exchange rate parities within broad bands.

Two institutional steps would be taken at the beginning of Stage One:

(a) A Council of Central Bank Governors of CARICOM would be set up by the Heads of Government to coordinate exchange rate policy in the region, to consult on the conduct of monetary and fiscal policies, and to initiate relevant Studies on the problems of monetary integration. Prior consultation with the Council would be mandatory before an exchange rate change or alteration in the exchange rate regime.

(b) The second institutional step would be "to equip the Caricom Secretariat to continue the work of developing uniform companies' legislation and of harmonizing foreign policy and diplomatic representation ... and the standardization of social, security, labour laws, etc."

Stage Two would begin in January 1997 with the establishment of a Caribbean Monetary Authority with the power to issue currency, working alongside the various national central banks. At some time during Stage Two, a common currency would be circulated within the OECS, Barbados and Trinidad and Tobago, issued by the Caribbean Monetary Authority, and replacing the national currencies over some period. Stage Two would be concerned mainly with securing the establishment of new institutions and laws appropriate to a monetary union. When this process is completed, the CMA would take full responsibility for the conduct of monetary policy. It is expected that waivers would have to be granted to Trinidad & Tobago in respect of its debt service and to Barbados in respect of its net reserves position.

Meanwhile, at some point during Stage Two, Jamaica and Guyana would cease adjustment of their parities, and Stage Three would commence when either accedes to the common currency arrangement - hopefully in the year 2000.

The Council of Central Bank Governors would be transformed into the CMA when Category A countries are ready to

issue the common currency. The CMA would be (i) independent, (ii) accountable to a Council of Ministers of Finance, (iii) mandated to achieve and maintain price and exchange rate stability, and (iv) responsible for prudential supervision and regulation within the region. Various safeguards would protect the Governor and the Directors from political pressures and give the Authority operational autonomy; its decisions could be overridden only by unanimous vote of the Council of Ministers of Finance.

Mechanics of Integration

There are two basic approaches to integration. In one case, we may promote the convergence of economies to the point where they virtually "slip into" monetary union by locking their currencies at the prevailing exchange rates, with or without a common currency. Presumably the range within which their currencies fluctuated would have been narrowing over time, or public acceptance of their relative values achieved. In this case the gains and losses from monetary union would be quite negligible.

In the other case, monetary assets are pooled and existing currencies exchanged for a common currency in proportion to the value of the monetary assets surrendered. This is the reverse of the process by which Barbados withdrew from ECCA. In that instance monetary assets were given back by ECCA to underpin the Barbadian dollar in proportion to the currency returned. Monetary union promotes economic integration; it certainly inhibits economic divergence. However, there are several other forces at work, e.g. geography, or nationalism, which may get in the way. After two hundred years of monetary union there are still considerable economic differences among American States; after seventy years with a common currency, the Russian economy disintegrated.

Today's problems of economic and monetary integration reflect the fact that whereas these processes were historically imposed by force, we now seek to effect them through negotiation. When Bismarck imposed economic and monetary

union on the numerous German States and principalities, he did so through "blood and iron". He did not concern himself with losses and gains in this exercise. Incidentally, he capitalized the first German Central Bank with the gold seized from France as war reparations.[5]

Until recently the West Europeans adopted the convergence approach to economic and monetary integration, using generous resource transfers to accelerate the growth of the laggard economies. Frustrated by the slow pace of this approach, they have decided to "fast-track" monetary integration as well so as hasten the integration process - the tunnel, the snake in the tunnel, zone of stability, and now the European Central Bank, are some of the techniques used in the process.

In the Caribbean case, monetary union offers the most promising method of offsetting the centripetal forces which drive our economies further and further apart on their several paths of destruction. Hopefully too, it would create centrifugal forces to push them towards the economic integration which all of us agree is required for our collective salvation.

Because of the considerable economic divergence and the absence of effective foreign currency markets to establish the relative values of our currencies, we have no choice but to use the approach involving the pooling of monetary assets. This approach minimizes the need for massive real resource transfers from the stronger to the weaker. However, the extreme openness of our economies does require a substantial pool of assets to capitalize the proposed Caribbean Monetary Authority. Unlike the East Germans, we have no "Big Daddy" to support the weaker members. Briefly in the early 1980s, Trinidad and Tobago might have filled that role. Ironically it is our LDCs, OECS and Belize, who bring the most monetary assets to the table!

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[5] Kindleberger, Charles P., **A Financial History of Western Europe,** London, George Allen and Unwin, 1987.

Critique of Report

The Report is a model of clarity and conciseness. Highly supportive of the goal of monetary integration, the Governors present in less than 50 pages an intelligent and comprehensive treatment of the issues involved in the establishment of a CMA, and an exhaustive enumeration of the obstacles along the way. However, in its preoccupation with the current European integration exercise, the Report misreads important aspects of the ECCB experience, and misses important insights from earlier European economic history. But the most serious shortcoming of the Report is its lack of strategic intent. It fails to outline an effective strategy for solving the technical difficulties and for overcoming the most serious obstacles to monetary integration. Rather it is the description of a feasible programme for achieving monetary integration if everybody behaved themselves and everything went well.

A strategic plan is a set of mutually consistent policies for the achievement of a specified goal. Strategic planning is necessary because of future uncertainty. The question which therefore faces the strategic decision-maker, writes Drucker, the Dean of management experts, is "What do we have to do today to be ready for an uncertain tomorrow?" The question, he reiterates, is not what will happen in the future, but "What will not get done unless we commit resources to it today?" He continues:

> There are plans that lead to **action today** - and these are true plans, true, strategic decisions. And there are plans that talk about action tomorrow - these are dreams, if not pretexts for non-thinking, non-planning, non-doing.[6]

The stipulation that the Caribbean currency should be held fixed for the first several years is an excellent example of a plan that talks about action tomorrow.

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6 Drucker, Peter F., **Management: Tasks, Responsibilities, Practices,** New York, Harper & Row, 1974, p.127.

It is not surprising then that the Ministers of Finance and Heads of Government are so pleased with the Report. They have been passing resolutions and making declarations concerning their intentions about economic and monetary integration for over a decade now. This Report requires them to make no hard decision nor commit any scarce resources **today.** The demands made upon them are costless, e.g. the establishment of a Council of Central Bank Governors; the provision of resources to the Caricom Secretariat. The requirements of "maintenance of sound macroeconomic management" and "accelerated stabilization and adjustment" are so vague as to be meaningless. The first hard decision is scheduled for 1997, when they give up authority for money creation to the Governors of the CMA. Interestingly the Report avoids the issue as to whether Belize or The Bahamas would benefit from Caribbean monetary integration. If, as the former British Prime Minister Harold Wilson observed, "a week is a long time in politics", four years gives Caribbean politicians plenty of time to escape from uncomfortable commitments - as they have done so adroitly over the last two decades.

Alternative Strategy

"The first stage of strategic thinking", writes Kenichi Omae, the brilliant Japanese management consultant, "is to pinpoint the critical issue in the situation."[7] In the matter of Caribbean monetary integration, the critical issue is the depoliticization of money. Every Category B country owes its current predicament to the vulnerability of its Central Bank to political expediency. In the mid-seventies, ideologically inspired public spending programmes soon exhausted the foreign reserves of the Banks of Jamaica and Guyana; what I have elsewhere called the "mother of pre-election budgets" destroyed the foreign reserve position of the Central Bank of Barbados;[8] in the Trinidad and

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[7] Ohmae, Kenichi, **The Mind of the Strategist,** New York, Penguin Books Ltd., 1983, p. 15.

[8] Blackman, Courtney N., "The Descent into Debacle: How We Got There", **The New Bajan,** April 1992.

Tobago of the late 1970s, the Central Bank was in no position to lean against the winds of loose fiscal policy. In his splendid book, **Central Banking in a Developing Economy: A Study of Trinidad and Tobago, 1964-1989,** Dr. Terrence Farrell makes the courageous observation:

> In the period 1974-79 ... the Central Bank adopted an accommodating posture to the government's economic management, which became increasingly incoherent. While technical weaknesses may have contributed to this accommodation, it appears that the political risks in adopting an independent posture were made extremely high.[9]

The fact that the foreign exchange reserve holdings of the Central Banks of Guyana and Jamaica are negative and those of Barbados and Trinidad and Tobago negligible, constitutes the major obstacle to monetary union. Moreover, their exchange rate parities are far too unstable for us to think of irrevocable fixed parities with Category A countries; and they either come empty-handed or make inadequate contributions of foreign exchange to the capital of the proposed CMA. The last time that Caricom Member States were in a position to establish a CMA was early in 1975, the year of wind-fall sugar profits and bloated alumina-bauxite earnings.

Since the establishment of a CMA in 1997 depends on the adequate capitalization of at least the Central Banks of Barbados and Trinidad and Tobago, and the accession of Jamaica and Guyana on a return to positive foreign exchange holdings by then, a valid strategic plan must include provisions for the recovery and maintenance of central bank integrity in Category B countries. It must also guard against the deterioration of the monetary condition of Category A countries - The Bahamas and Belize. We need not worry about the ECCB!

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9 Farrell, Terrence W., **Central Banking in a Developing Economy: A Study of Trinidad and Tobago, 1964-1989,** Institute of Social and Economic Research, 1990, pp.129-130.

The only way to maximize the probability of strong central banks is to cut them loose from their subservience to Ministers of Finance. In short, we must provide the other Caricom central banks with the insulation from abuse of their money creation powers which the ECCB now enjoys by virtue of its unanimity rule. Governor Venner cannot say "No" to all OECS Ministers collectively, but neither can he say "Yes" to any one of them individually who wished to finance his national fiscal deficit with central bank credit.

The proposed constitution provides for a CMA independent of CARICOM Ministers of Finance in keeping with the proposals of my Paper, "Institutional Framework for a Caribbean Monetary Authority".[10] However, it is not tomorrow that we need to decide on the independence of central banks, but **today.** There is a distinct possibility that the integrity of Category A banks could be compromised in the absence of such independence.

An inadequate understanding of the ECCB model leads the Report to overestimate the adjustment costs of monetary union and the impact of debt service requirements of heavy debtors on their partners. It is difficult to see why the Governors regard the inability to use the exchange rate as a cost to Jamaica, Guyana or Barbados, rather than as a benefit. In fact, the inability to use the exchange rate tool has forced member countries of OECS to make their adjustment through fiscal policy, and has thus spared them the horrors of the downward spiral of currency values which has destroyed the balance of payments of Jamaica and Guyana, and threatens the Barbadian. The inability to use the exchange rate tool is not a cost, but a welcome discipline.

The loss of political control over the money supply also limits the capacity of heavy debtors both to contract and to service debt. The fiscal extravagance of Antigua, for example, imposes negligible cost on its partners in OECS. The Antiguan

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[10] Blackman, Courtney N., "Institutional Framework for a Caribbean Monetary Authority", prepared for the Central Bank of Trinidad and Tobago, (unpublished), 1992.

Government can only finance its expenditure out of real resources taxed away from its citizens or borrowed from domestic and foreign creditors. At first, lenders in search of higher interest rates may move funds from other territories to purchase Antiguan debt. Sooner or later, however, they will perceive that the limitations of Antigua's ability to repay its debts to foreigners or domestic borrowers depends on its real earnings. Its command over foreign exchange resources of the ECCB depends on its holdings of real assets rather than issues of financial liabilities.

The European experience with convergence is not very relevant to CARICOM. The decision to establish the CMA is in fact a decision to use a common monetary policy to enforce fiscal discipline on member states, thus promoting economic integration. The strategic problem facing CARICOM at this time is how to restore the foreign exchange position of Category B-1 central banks to an acceptable level, how to re-capitalize Category B-2 central banks, and how to sustain the integrity of Category A central banks. Success in the achievement of these three goals would set up the conditions for the establishment of a CMA by the year 2000.

The Report also missed important insights from the experience of Germany after the two World Wars. In both instances a stable currency was restored only after German foreign debts were forgiven and a new central bank set up with capital grants and guarantees from the allied powers - notably the USA. In like manner a six billion dollar guarantee is now being considered to underpin a new Russian rouble. In a Paper delivered at the Central Bank of Barbados in July last year, I suggested that Guyana and Jamaica should abandon "the futile and demoralizing search for an equilibrium exchange rate" and try to persuade the IMF, World Bank and other international financial institutions to grant a five year moratorium on the repayment of loans.[11] They should then use all available foreign

[11] Blackman, Courtney N., "Structural Adjustment in Conditions of Dis-equilibrium", **Money Affairs,** Centre for Latin American Monetary Studies, Vol. V., No.1, Jan.- June, 1992.

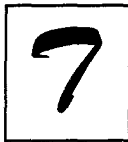
aid and soft loans to recapitalize their central banks, with elaborate safeguards to protect the new institutions from money creating Ministers of Finance. With that accomplished we could then go about establishing a CMA.

Final Remarks

The famous American writer Mark Twain once observed, "A person should be allowed to have a few redeeming vices, but never bad manners." It may be that the Governors have been too well mannered to cause their political masters any pain. Such reservations do not apply to former Governors, especially to one in exile. But, as the saying goes, "No pain, no gain".

15 Institutional Framework for a Caribbean Monetary Authority*

Introduction


here is more than a little irony in current proposals for the establishment of a Caribbean Monetary Authority/Central Bank. For all intents and purposes a Caribbean Monetary Authority did exist in colonial times. The British Caribbean Currency Board, serving Barbados, Guyana, Trinidad and Tobago and the islands which now constitute the OECS, along with the Currency Boards of The Bahamas, Belize and Jamaica, operated very much as branches of a Federal Reserve System with its headquarters in London. Regional currencies were freely convertible into sterling and hence into each other, and capital moved freely throughout the region as did, for the most part, goods and services, labour and enterprise. Monetary and exchange rate policies were determined in London, and the colonies followed suit.

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Right up to the mid-1970s the newly-established regional central banks operated very much like earlier currency boards, maintaining high proportions of their monetary liabilities in sterling. With the demise of the Sterling Area in 1974, the apron strings of the "Old Lady of Threadneedle" were cut and Caribbean central banks went their several ways, spawning numerous impediments to the regional integration process. As the abuse of central bank credit destroyed the balance of payments of one Caricom member state after another, the locus of monetary policy formulation for the region has shifted to Washington D.C. A Caribbean Monetary Authority (CMA) would represent the first truly independent regional monetary authority.

This Study focuses on the institutional aspects of a CMA. As such, it calls more on the discipline of Management than on that of Economics - the allocation of scarce resources among competing ends. According to Peter Drucker, the world's leading authority on the subject, Management is not only a discipline; it is also "culture": "Management is a social function and embedded in a culture - a society - a tradition of values, customs, and beliefs, and in governmental and political systems."[1] This observation is especially pertinent to the task at hand, for the architects of a Caribbean Monetary Authority (CMA) must accommodate the rich political, economic, social, national and cultural diversity that characterizes CARICOM.

The Study draws heavily on the experiences of two of the world's oldest and most respected federal central banking systems -the US Federal Reserve System and the Bundesbank. But there are even richer insights to be gleaned from the example of one of the world's few multinational central banking systems, the Eastern Caribbean Central Bank (ECCB), whose unique constitution and ***modus operandi*** have sheltered its constituents from the woes that have befallen some of its "more developed" partners in CARICOM.

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1 Drucker, Peter F., **Management: Tasks, Responsibilities, Practices,** New York, Harper & Row, 1974, Chapter 41, pp. 518-528.

The brief for this Study is as follows:

> The study anticipates some form of monetary union and in that context, addresses the question of how a Monetary Authority/ Central Bank should be institutionalized. The study should first point to the functions of such an institution, that is, those things which it must do, those things which it may do, and those things which it should not do. It should examine how such an institution would need to carry out these functions within a monetary union inclusive of all of the existing Caricom member countries. The structure of the institution at Board, Executive, Management and departmental level should be outlined with some discussion of the major possible alternative structures in which instant, the study should also examine the conduct of policy by Caribbean Monetary Authority/Central Bank and the management of the relationship between the institution and the possible forms that fiscal authority may take in the context of monetary integration.

The brief breaks down into five arguments: (1) functions of the proposed institution, (2) its constitution, (3) its organizational structure, (4) its ***modus operandi*** and (5) its politics. Following Drucker's dictum that "structure follows strategy", **Section I** develops the strategic considerations which lead us to contemplate a CMA. **Section II** then specifies the functions of such an institution, "that is, those things which it must do, those things which it may do, and those things which it should not do." **Section III** examines "how such an institution would need to carry out those functions within a monetary union inclusive of all of the existing Caricom member countries." Following Drucker's admonition that organizational design "is not the first step; it is the last", specification of organizational structure is deferred. **Section IV** combines the "conduct of policy" by the CMA, and "the management of the relationship between the institution and the possible forms that fiscal authority may take in the context of monetary integration." The outline of a proposed organizational structure, along with a suggested Organizational

Chart, is given in **Section V.** The Study concludes with some musings on the implications of an effective Monetary Authority.

SECTION I

STRATEGIC CONSIDERATIONS

There are two strategic considerations attaching to the establishment of a CMA. First, a CMA would promote convergence of economic policies and finesse several of the impediments to a Single Market. Secondly, a CMA would provide a framework of regional monetary and exchange rate stability, a precondition of economic growth and development - as we have learned from bitter experience. These strategic considerations weigh heavily in the design of a CMA.

Economic Policy Convergence

The decision of the Caricom Heads of government to go for a Caribbean Monetary Authority/Central Bank and a common currency represents a shift from the conventional view of a common currency as the ultimate consequence of a convergence of the overall economic policies of member states. As William Demas articulated it some time ago:

> ...A single independent currency entails a single set of economic, monetary, financial and fiscal policies designed to influence the balance of payments. Such a single set of policies is possible only with a high degree of economic union tantamount to a political union.[2]

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[2] Demas, William, **West Indian Nationhood and Caribbean Integration,** CCC Publishing House, Barbados, 1974, p.54.

Writing in 1988, I saw the common Caribbean currency as "a powerful tool to moving the region towards the set of economic, fiscal, financial, monetary and exchange rate policies needed to achieve regional integration and consequent economic development."[3]

Two analogous schools of thought - the "economists" and the "monetarists" - also emerged in the "great debate" on European monetary and economic union.[4] The "economists" saw the need for the prior convergence of economic policy and performance before proceeding to fixed exchange rate parities; the "monetarists" emphasized early action on locking exchange rate parities into place so as to impose monetary discipline upon member states and herd them towards convergence of their economic policies. The European Monetary System, anchored by the tight monetary policies of the Bundesbank, falls short of fixed parities or a common currency, but it has, in the words of **The Economist,** "forced its members to accept the blessings of low inflation and stable exchange rates."[5]

With the demise of the Sterling Area, regional central banks could fix their own exchange rate parities, pursue their own monetary policies and enforce exchange rate controls against each other. In the early 1970s the relations among Caribbean monetary authorities was characterized by cooperation, frequent consultation and generous balance of payments support by the Central Bank of Trinidad and Tobago to its weaker Caricom partners. However, as the balance of payments and external debt pressures built up, relations between the central banks were increasingly marked by beggar-thy-neighbour restrictions. When the Caricom Multilateral Clearing Facility collapsed in 1983 as a result of the Bank of Guyana's default, intra-regional

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3 Blackman, Courtney N., "Towards a Monetary Union", ***Caribbean Affairs,*** April-June 1988, Vol.1, No.2, p. 57.

4 Swann, Dennis, **The Economics of the Common Market,** Penguin Books Ltd., Middlesex, England,1985, pp. 175-205.

5 **The Economist,** September 19-25, 1987, p. 14.

settlements of goods and services became increasingly unreliable and intra-regional capital flows virtually dried up.[6]

These impediments to intra-regional commerce and investment reversed the trends of the 1960s and 1970s towards expanded Caricom trade. Fierce exchange controls have staunched intra-regional capital flows. Moreover, frequent and un-coordinated exchange rate adjustments have made corporate planning extremely difficult. In particular, Caricom producers have been unable to develop significant home markets, exploit resources on a regional basis, or through mergers achieve the critical mass required to penetrate the global market place.

Although suffering as a result of the disruptive practices of their more powerful Caricom trading partners, the OECS have at least been spared such discomforts within their own sub-region. Up to 1983 their Eastern Caribbean Monetary Authority provided monetary stability, and their common currency ensured prompt settlement of sub-regional trade and the free flow of capital among the member states. In the ECCB, the OECS has stumbled on a most felicitous formula for the maintenance of price and exchange rate stability. It is not surprising that the OECS has made such enormous progress towards economic and political integration.

Similarly, a CMA administering a common currency would promote the conditions for free trade, the free flow of capital and exchange rate stability - the three pillars of a meaningful Common Market. Moreover, as the European experience has shown, the discipline of a common and rigorous monetary policy would promote the convergence of fiscal and other economic policies, and quicken the tempo of the Caricom integration process.

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6 Blackman, Courtney N., "The Balance of Payments Crisis in the Caribbean: Which Way Out?", Central Bank of Barbados, 1979.

Price and Balance of Payments Stability

The establishment of central banks also opened up the way for Caricom governments to finance their fiscal deficits through money creation. Jamaica and Guyana led the way. In 1975 both Governments embarked on massive programmes of fiscal expansion heavily financed by central bank credit. Both had exhausted their reserves by the end of 1976 and sank into a morass of foreign debt obligations, spiraling inflation and frequent currency depreciations. Barbados set out down a similar road with a record deficit in fiscal 1990/91, sixty per cent of which was financed by central bank credit. This precipitated the current balance of payments crisis which has already led to a Barbados' first postponement of a foreign payment, and threatens the exchange rate parity which has held since 1975.[7]

The Caribbean experience has proved conclusively that sustained economic growth is incompatible with high rates of inflation and chronic currency depreciations. Those countries, e.g. the OECS, Belize, The Bahamas and Barbados, which have enjoyed relative price and exchange rate stability, grew far more rapidly in the 1980s than Guyana, Jamaica and Trinidad and Tobago, which all experienced negative growth during this period. The lesson to be drawn is that measures which seek to accelerate economic growth through deficit spending, financed by central bank credit, will condemn our societies to a downward spiral of economic decline. Dr. Terrence Farrell makes the point very well:

> ... Monetary and financial policy are only a necessary condition for growth and transformation ... To appreciate this is to appreciate the limitations of a central bank in the promotion of growth and development ... A central bank must design monetary

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[7] Blackman, Courtney N., "The Time for Action on the Balance of Payments is Now", **New Bajan,** Nov. 1989.

> and financial policy in such a way that growth and development is facilitated and not hindered. The best way a central bank can help in this regard is to ensure monetary stability ... Deviation from these policies with a view to encouraging development would be dangerous and in the long run inimical to the very development which it is seeking to promote.[8]

The "long run" for delinquent Caribbean Governments has turned out to be very short indeed.

The superior performance of the OECS in relation to their ironically titled "more developed" Caricom partners is especially instructive. The reason is not difficult to find. The constitution of the ECCA, as well as that of its successor the ECCB, severely limited the credit creation powers of the monetary authorities by requiring unanimous agreement among Ministers of Finance on all issues before them. The unanimity rule means that although the ECCB Governor cannot say "no" to the Council of Ministers speaking with one voice, neither can he say "yes" to an individual Minister seeking to finance his fiscal deficits with central bank credit. The fiscal expenditures of OECS members were restricted to tax revenues, local commercial bank loans, foreign aid and limited foreign borrowing. No individual state could force the monetary authorities to create new money to finance deficit spending. By force of circumstance the OECS pursued the "appropriate" fiscal policy. The lesson to be drawn from the OECS is that the "depoliticization of the money supply" is a necessary condition for economic growth and stability under Caribbean conditions. The Germans, Austrians and Swiss learned this lesson decades ago. We in the Caribbean have insisted on repeating the mistakes of others.

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8 Farrell, Terrence W., **Central Banking in a Developing Economy: A Study of Trinidad and Tobago, 1964-89,** Institute of Social & Economic Studies, Mona, Jamaica, 1990, p.132.

SECTION II

FUNCTIONS OF A CARIBBEAN MONETARY AUTHORITY

Statement of Mission

Before we can specify "those things which it (CMA) must do, those things which it may do, and those things which it should not do," we should first ask Drucker's classic question, "What is our business, what should it be, what will it be?"

Caribbean Central Bank Acts typically set out a number of purposes for the institution. The Central Bank of Barbados Act states in Part 11 para. 5:

> The purposes of the Bank shall be:
>
> a) to regulate the issue, supply, availability and international exchange of money;
>
> b) to promote monetary stability;
>
> c) to promote a sound financial structure;
>
> d) to foster the development of money and capital markets in Barbados; and
>
> e) to foster credit and exchange conditions conducive to the orderly and sustained economic development of Barbados.

What the Act does not do is specify the order of importance of these various objectives.

The Act establishing the Bank of Jamaica is more specific:

> ... The principal objects of the Bank shall be to issue and redeem notes and coins, to keep and administer the external reserves of Jamaica, to influence the volume

> and conditions of supply of credit so as to promote the fullest expansion in production, trade and employment, consistent with the maintenance of monetary stability in Jamaica and the external value of the currency, to foster the development of money and capital markets in Jamaica and to act as banker to the Government.

The clear mission to the Bank's Management is "the promotion of the fullest expansion in production, trade and employment," and the "maintenance of monetary stability ... and the external value of the currency" are treated as constraints on economic growth.

The Bank of Guyana Ordinance (1965) makes it clear that the economic policy of the Government supersedes the objective of monetary stability:

> Within the context of the economic policy of the Government the Bank shall be guided in all its actions by the objectives of fostering monetary stability and promoting credit and exchange conditions conducive to the growth of the economy ...

The Agreement establishing the Eastern Caribbean Central Bank comes closest to elevating the objective of monetary stability above that of economic development:

> The purposes of the Bank are:
>
> 1. to regulate the availability of money and credit;
> 2. to promote and maintain monetary stability;
> 3. to promote credit and exchange conditions and a sound financial structure conducive to the balanced growth and development of the economies of the territories of the Participating Governments;
> 4. to actively promote through means consistent with its other objectives the economic development of the territories of the Participating Governments.

It is not surprising that in their pursuit of growth, Caribbean Monetary Authorities in Guyana, Jamaica, Trinidad and Tobago, and more recently in Barbados, have miscalculated the minimal requirements of price and exchange rate stability. Unfortunately, the downward slope thereafter has been extremely slippery.

Modern management theorists especially emphasize the importance of a clear mission. Central bankers in recent years have become increasingly convinced that the pursuit of more than a single objective blunts the effectiveness of the organization. They are increasingly attracted to the constitution of the Bundesbank. The Bundesbank is committed by law to the task "of safeguarding the currency." The Bundesbank Act also stipulates that "without prejudice to the performance of its functions, the Deutche Bundesbank is required to support the general economic policy of the Federal Government. This means that in case of conflict ... the commitment to price stability would carry the day."[9]

A few governments, notably South Africa, New Zealand and Chile (dubbed "the wise men from the South" by **The Economist**), have divorced their central banks from the Ministry of Finance and have charged them with a single objective - price stability. The Government of New Zealand has negotiated a performance criterion of 0-2% price increase within a given time period, and has linked the compensation of the Governor and that of his senior management to the achievement of that objective.

The current condition of the Caricom economy strongly suggests that the mission of a CMA should be defined as "the maintenance of the internal and external value of the currency", and that all other objectives, especially that of economic growth, be subordinated to that mission. In highly open economies such as ours in CARICOM, internal and external monetary stability are but different sides of the same coin. What is more, success in the achievement of the goal of internal and external monetary

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[9] Tietmeyer, Hans, "The Role of an Independent Central Bank in Europe", **The Evolving Role of Central Banks,** Washington, D.C., International Monetary Fund, 1991, p. 181.

stability for the region would, in a synergistic fashion, remove the major impediments to regional economic and political integration and foster the conditions for sustained economic growth.

Functions of the CMA

To accomplish its mission successfully, there are five minimal things which the CMA must do:

1. Issue a common Caricom currency;
2. Conduct common monetary policy for the region;
3. Manage the pooled foreign reserves of the region;
4. Manage the exchange rate;
5. Supervise the banking system.

1. Issue of Currency

The Caribbean Monetary Authority would be granted a monopoly of legal tender issue, replacing the national currencies now in circulation. A common currency would considerably reduce the transactions cost for those trading and doing business within CARICOM and would dissipate balance of payments problems among Caricom member states.

2. Unified Monetary Policy

The monopoly of note issue would create the conditions for the conduct of a unified and independent monetary policy for the region. This in turn would pressure member states towards convergence of their economic policies. Under Dr. Worrell's suggestion of a Caribbean dollar which would circulate in competition with national currencies,[10] a unified and

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[10] Worrell, DeLisle, "A Common Currency for the Caribbean", unpublished mimeo, 1990.

independent monetary policy would not be feasible until the "strong" Caribbean dollar finally drove out the "weak" national currencies - an unlikely eventuality in view of Gresham's Law.

3. *Management of Foreign Exchange Reserves*

The foreign exchange reserves of the existing central banks would be pooled and used as cover for the new currency. In open developing countries like the Caricom member states, foreign exchange does not merely figure as cover for the domestic currency. It constitutes as well the non-substitutable input in the production process. Our experience in the Caribbean and elsewhere suggests that an inadequate level of reserves condemns an economy to chronic economic decline. The management of foreign exchange reserves would be the responsibility of the CMA. This would not prevent the branch banks from holding foreign balances for transaction purposes, or for such purposes as the Board of Governors might authorize.

4. *Exchange Rate Management*

The management of the relationship between the Caribbean dollar and other currencies would be the responsibility of the CMA. Should a floating regime be adopted, the CMA would determine the timing and means of intervention. Large discrete movements of the exchange rate would involve the Caricom political directorate whose decisions should be subject to a unanimity rule or at least a 75 per cent majority vote. The responsibility for exchange rate management might, and probably should, include exchange control operations. The total liberalization of exchange controls by Guyana and Jamaica is an admission of the impotence of monetary authorities to influence the exchange rate. It represents the ultimate failure of macroeconomic policy, not its triumph.

5. *Bank Supervision*

The regional financial system would be the vehicle of the intra-regional payments system and the medium through which the CMA will conduct its unified monetary policy. On both these

counts its health and efficiency should be of concern to the CMA. It is important that responsibility for surveillance of the regional financial system be vested in the CMA, especially in view of the expected and, indeed, desired regionalization of financial institutions in tandem with the progressive integration of CARICOM. (Professor Goodhart reminds us that the prudential role of central banks predates their role as macroeconomic managers; it may very well survive it).[11] The Agreement establishing the CMA should include the power to intervene into and, if necessary, assume management control over problem or failing financial institutions.

Things The CMA May Do

We can expect a number of secondary activities to flow from pursuit of the declared mission of the CMA, of its secondary objectives, and in areas where the benefits of synergy are inexpensively realized. For example, the CMA might well undertake financial deposit insurance as an aspect of bank supervision. Its expertise in this area would give it a considerable comparative advantage in surveillance of Caribbean Stock Exchange Operations. Similarly, its role as manager of the regional foreign exchange reserves would generate the skills needed for managing the debt of member states, which branch banks might carry out very much as they do today - this time at cost. This list is not all-inclusive.

Things The CMA Should Not Do

Even more important are the things the CMA should not do. Clearly it should not engage in commercial activities in competition with other financial institutions. (The sale of traveller's cheques to the general public by one regional central bank has always struck me as inappropriate). It should also refrain from any promotional activities which require it to

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[11] Goodhart, Charles, **The Evolution of Central Banks,** Cambridge, Mass., MIT press, 1988.

operate under the policy umbrella of a national government, or for that matter, of the Caricom authorities. This would rule out Export Promotion, though not Export Credit Insurance (an aspect of Deposit Insurance), Student Loan Fund Administration, Offshore Business promotion, and most other developmental promotion activities. The ultimate criterion of what the CMA should not do, is anything which distracted it from, or reduced its capacity to accomplish its mission of maintaining price and exchange rate stability, or anything which gave the appearance that its operations were subject to the supervision or control of the political directorate.

SECTION III

CONSTITUTIONAL ISSUES

There are four main issues to be resolved by the designers of a constitution for the CMA. The first is the degree of independence from the political directorate; the second and related issue is the accountability of the Management of a CMA; the third issue derives from the necessity in all cooperative arrangements to divide up authority between the centre and the constituent parts, and the fourth issue relates to the decision-making scope of the CMA.

Central Bank Independence

The record of central banks around the world, as well as our own experience here in the Caribbean convey two clear lessons: The first is that economic growth is most unlikely to proceed in the absence of price stability. It is instructive that the German economy did not resume growth after either World War I or World War II until monetary stability had been restored.[12] The second is that price and exchange rate stability is a positive

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[12] Kindleberger, Charles, **A Financial History of Western Europe,** London, George Allen and Unwin, 1984.

and increasing function of the independence of the monetary authority. In a comparative study of industrialized nations, Alberto Alesina demonstrated a positive correlation between price stability and central bank independence.[13] The problem facing us is how to insert this novel principle of central bank independence into the framework of our democratic traditions.

I have, in another place, put forward four minimum reforms for strengthening the independence of existing central banks. They will apply with equal force to any CMA:

> Firstly, the tenure of the central bank directorate must be rendered more secure. The Governor and Directors should serve on good behaviour, the Governor for at least seven years certain, and the Directors for five years certain, with one Director retiring each year.
>
> Secondly, the operations of the central bank should be made truly autonomous. The ministerial veto of appointments other than those of Directors, Governor and Deputy Governors should be discontinued.
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> Thirdly, the central bank, as in the USA, should be made responsible to parliament rather than to the Minister of Finance, thus ensuring that the viewpoint of the central bank is at all times known to the public. In this way the relationship between the bank and the government would be institutionalized and the Governor could conduct his business with the Minister in a more formal manner. He would thus feel free to disagree with the Minister publicly. As in the United States, the Governor would periodically appear before the relevant parliamentary committee to report on the national finances.
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> Fourthly, the powers of the administration to resort to central bank financing should be more rigorously

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[13] Alesina, Alberto, "Politics and Business Cycles in Industrial Democracies", **Economic Policy**, April 1989.

circumscribed - ideally by entrenchment in the constitution. The limits on advances to the treasury, and on treasury bills and other public sector bonds held by the central bank should be precisely specified.[14]

Accountability of Central Banks

The issue of the accountability of the CMA is more complicated. The problem is usually raised that democratic principles require that the representatives of the sovereign people exercise ultimate control over economic affairs. The treatment of this issue by more sophisticated and equally or more democratic societies than ours is instructive. Unfortunately, we have slavishly followed the Bank of England model - and even perverted it.

Security of tenure is taken for granted in Austria and Germany as well as in several other countries. Governors serve on good behaviour. They can only be removed for cause. Tenure is for 5 years in Austria, 8 years in Germany and 14 years in Australia. The Bundesbank derives its mandate from its enabling legislation and is not subject to any higher authority. The President of the Austrian National Bank is appointed by the President of the Republic, but is responsible to the "Public". The functional independence of the Bundesbank is limited by the right of the Federal Government to determine exchange rate parities; members of Government may attend and even propose motions at meetings of the Central Bank Council. The Government also has the right to delay Council decisions for up to two weeks. In Austria the Governing Board as a whole, (or any individual member) may, "if it feels impeded by Government's supervision" or if there is an infringement of any of the prohibitions for the Federal Republic "Lander", appeal to an Arbitration Tribunal." The Tribunal, comprising the President of the Supreme Court, as Chairman, and four members, two

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[14] Blackman, Courtney N., "New Directions for Central Banking in the Caribbean", *Social and Economic Studies,* Vol.38 No.4, Dec. 1989, pp. 219-240.

appointed by the Government and two by the National Bank, must send down its decision within three days.[15]

In fact, we in the Caribbean should not find it so difficult to accept the independence of the CMA. Already we accept the independence of the Judiciary. In making his case for "some insulation and some recourse in the relationship between the Central Bank and the Executive in respect of monetary policy, and probably in respect of bank supervision and regulation as well", Terrence Farrell suggests that the Central Bank

> ... should be seen as an integrative institution, having a quasi-judicial function in the economic sphere and specifically as the guardians of the public interest against the dangers of monetary profligacy, but being not elected, they must ultimately bow to the will of the elected government.[16]

Farrell's position is about as far as we can go at this tender stage of our political development. If the principle of "the depoliticization of money" is accepted, and if the reforms recommended above are accepted, I would settle for the ECCB model with its unanimity rule. Caribbean governments are no more likely to reach unanimous decisions on important monetary matters than they have on the numerous trivial issues which have blocked our progress to regional economic integration. The unanimity rule, therefore, while making the CMA accountable to the political directorate, would provide it with considerable insulation from political pressures.

Centralization versus Decentralization

In any federal experiment the issue of the distribution of decision-making authority between the centre and the parts is always problematic. Indeed, this is what the differences between Britain and the Europeans over the proposed European Central

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[15] Schumayer, Maria, "Central Bank Independence in Austria", **The Evolving Role of Central Banks,** op. cit., p.169.

[16] Farrell, Terrence W., op. cit., pp. 132-3.

Bank are all about. To what extent should the original Caribbean central banks retain the authority to address special situations in their home territories?

It is instructive to read Arthur Bloomfield's report of the debate on this issue over thirty years ago:

> ...the governments of Jamaica and Trinidad held divergent views regarding the nature of the central banking arrangements for the area as a whole. Jamaica favoured a system of essentially autonomous central banks that would consult with each other and cooperate on matters of common interest through a federal central banking board on which they and the Federal Government would be represented. The view of Trinidad, however, was that the regional central banks should be little more than operating arms of a unified federal central banking system.[17]

In fact, the U.S. Federal Reserve Act did envisage a high degree of regional autonomy vested in the individual Reserve Banks to take care of local conditions. Things did not work out that way, and policy making decisions became increasingly centralized. Similarly, the German central banking system established in 1948 was predicated on a high degree of regional autonomy. There was a two-tier system of central banks, involving a Bank of the German States designed to serve as banker for, and coordinator of regional state central banks. Again, the system soon operated as a single central bank with policy decisions originating with the Bank of the German States and executed by the state central banks. This ***de facto*** situation was legalized in 1957 with the creation of the Bundesbank, a strong central bank with regional branches. Switzerland is another illuminating case. It is a federation characterized by extreme decentralization of political decision-making; yet it has opted for a highly centralized and independent central banking system.

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[17] Bloomfield, Arthur I., **Central Banking Arrangements for the West Indian Federation,** Institute of Social and Economic Research, 1958, p. 14.

Besides the above examples from three of the world's most successful federal experiments, the experience of autonomous Caricom central banks should push us in the direction of a CMA with highly centralized policy-making. According to the Caricom Treaty, member states are obligated to consult among themselves before significant movements in the exchange rate. After the first two or three devaluations in the early 1970s, deeper exchange rate variations and other changes in monetary policy were made on a unilateral basis, usually under pressure from the IMF, and without consideration for their impact on other member states. Today the monetary policies of Caricom States have no relationship with each other. It is this failure of policy corvergence which has made the path to Caricom integration so painful and frustrating. There should be no doubt that the conduct of a common monetary policy for the region should be the sole responsibility of the Board of Governors of the CMA.

Rules versus Discretion

The final issue to be settled is the degree of discretion to be permitted the CMA itself in the formulation and implementation of monetary policy. Monetarists, like Milton Friedman, would rigidly restrict the money creating powers of the central bank by requiring it to operate under a fixed rule. However, central banking practice in recent years has demonstrated that problems of definition and measurement of the money supply make it very difficult to prescribe sensible monetary targets, whereas the turbulence of the international monetary system renders it almost impossible to specify monetary rules which maintain their validity for any length of time.

Dr. DeLisle Worrell would tie the currency of the CMA firmly to the US dollar by insisting on 100 per cent foreign reserve currency backing and free convertibility into the US dollar. In his attempt to insulate the CMA from political interference, he would also impose rigid limits on CMA financing of Government deficits, and severely restrict the CMA's ability to make advances

to financial institutions and to rescue failing financial institutions.[18]

Dr. Worrell's heart is in the right place. It makes good sense to stipulate minimum foreign reserve cover for monetary liabilities (at least 50 per cent), and ceilings on central bank advances to national governments (not more than 10% of the previous year's current revenue). However, in these uncertain times, the peg to the US dollar may not long remain the optimal exchange rate regime for the region, and there may be occasion, such as a deep recession accompanied by abundant foreign exchange reserves, when circumstances dictate an expansionary monetary policy. Nor should the CMA stand idly by in a financial crisis. Even as harsh a detractor as Professor John Kenneth Galbraith concedes the critical importance of central banks as lenders of last resort.[19]

Moreover, we should be careful to leave some discretionary room for the CMA to make a creative contribution, through differential interest rates in favour of investment or through variable reserve requirements, to the economic development of the region in so far as the primary goal of price and exchange rate stability is not compromised in any way. In such judgements the political directorate should not participate.

Finally, a system which totally eliminates political input is unrealistic. The virtue of central bankers ***vis à vis*** politicians is their longer term perspective; but central bankers too are capable of error in their long term perspectives. In such cases it would be left to the political directorate to take corrective action, but only when their case is air-tight - that is, after a full public airing of the issue, and when it has arrived at a unanimous position.

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[18] Worrell, DeLisle, op. cit., and Blackman, Courtney N., "A Common Currency for the Caribbean: A Critique", unpublished mimeo, 1991.

[19] Galbraith, John Kenneth, **Money: Whence It Came, Where It Went,** Boston, Houghton Mifflin Company, 1975, p.306.

SECTION IV

MODUS OPERANDI

Conduct of Monetary Policy

The Board of Governors of the CMA would have sole responsibility for the formulation and implementation of a unified monetary policy for the entire CARICOM. The members of the Board would act in their personal capacity and would represent no national interests. The Board would not be subject to directives from any other authority in this area.

The Board would meet periodically with the Council of Finance Ministers so as to ascertain their regional economic policy positions. The individual governors (governors of the branch banks) would be responsible to the Board for the implementation of monetary policy in their respective territories. They would meet periodically with Ministers of Finance of Caricom member states so as to ascertain their national policies, but they would not be subject in any way to the authority of national ministers.

The CMA would assist Caricom authorities, mainly through technical assistance and advice, in the achievement of development and other objectives to the extent that the original goal of monetary stability was not compromised. All such assistance would be at the discretion of the Board of Governors.

CMA policy formulation and implementation would be conducted by a small core of experts in each of the four functional areas monetary policy, exchange rate management, foreign reserve management, and bank supervision. The CMA would maintain a lean staff, and would not try to duplicate the research and operational capacities of the branch banks, but would exploit their resources through the use of committees. (The Board might very well utilize the Library facilities of the branch bank in whose territory its headquarters is located).

Generally speaking the branch banks would act as the agents of the CMA in the implementation of policy or the conduct of operations, e.g. issue and redemption of currency, trading in securities, bank supervision, and publication of documents. Branch banks would all operate within the framework of policies laid down by the Board of Governors. The accounts department of the CMA would be responsible for the continuous audit of the federal branches and would itself be audited at least once per year, or as necessary, by auditors appointed by the Council of Ministers.

The CMA would not be limited in any respect by the Council of Ministers or the Governments of member states in the employment or compensation of staff. However, the salaries and allowances of the chairman would be fixed by the Heads of Government, and those of the federal governors by their respective governments.

Relationship with Fiscal Authorities

The "depoliticization of money" and the imposition of a unified monetary policy would fundamentally alter the relation between the Fiscal and Monetary authorities. The political leverage over central banks enjoyed by fiscal authorities in the past made monetary policy a residual of the budgetary outcome. Moreover, with the need for political concurrence with changes in interest rate, and other monetary variables, the scope for Caribbean central banks "to lean against the wind" was quite limited. (For Caribbean governors the instrument of "moral suasion is usually more needed in dealings with Ministers of Finance than with managers of commercial banks). In the circumstances of an independent and consistent monetary policy, fiscal policy becomes a residual of monetary policy, which thus imposes a discipline on the fiscal authorities. History teaches us that this is exactly what is needed.

An extreme view, advanced by Dr. DeLisle Worrell, is that a Caribbean Monetary Authority should, like the Bundesbank, be

debarred from making any loans to governments.[20] The Delors Report forbids direct loans to individual governments and would allow a European Central Bank to purchase government paper only in the course of open market operations. The current heavy dependence of Caribbean governments on central bank financing and the underdeveloped state of regional capital markets suggest a quite extended period of weaning. Caribbean governments could not fund even modest fiscal operations in existing capital markets with any reliability. Besides, the promotion of money and capital market development, an activity quite consistent with the goal of price and exchange rate stability, frequently requires that central banks make a market for government paper. Even mature central banks, like the Federal Reserve System and the Bank of England sometimes find this necessary.

However, under the proposed monetary regime the limits on central bank accommodation would be established by the Board of Governors and would have to be scrupulously observed by branch banks. The current practice whereby statutory limits of central bank overdrafts to governments are regularly breached and retroactively ratified, would hardly be countenanced by a conscientious Board of Governors. Purchases of government paper would also be made within limits specified by the Board of Governors. It would be quite permissible for branch banks to provide services, such as debt management, negotiation of foreign loans and other banking services to individual governments. But these transactions should always be conducted at arms length and at cost.

The Economist has warned that even the most independent central bankers can be outflanked by politicians. A case in point was the recent "victory" by President Kohl of West Germany over President Pohl of the Bundesbank in the determination of the rate of exchange at which East German marks would be converted into West German marks upon reunification. The chink in the armour of an independent CMA would be the

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20 Worrell, DeLisle, op. cit.

retention by the individual governments of the right to finance deficits with foreign loans. Unless foreign loans are used for productive purposes, they have the same economic effect as money creation by the Monetary Authority, and create a foreign liability on the total system. The inefficient expenditure of windfall foreign earnings would have a similar effect.[21]

It is probably asking too much, as the West Indian Commission does, to expect that Caricom member states "would undertake to abide by the CMA advice on external borrowings."[22] However, Caricom member states should be required by law to seek the advice of the CMA on all foreign credit operations. (Some existing central bank Acts require such consultation - a practice more honoured in the breach than in the observation). The CMA should certainly be involved in all IMF and similar consultations, and as the West Indian Commission also suggests, "Such advice would be in the public domain and available to potential foreign lenders."

SECTION V

ORGANIZATIONAL STRUCTURE

The organizational structure of a CMA, which would effectively be a Caribbean Federal Reserve System is charted below. The following features may be noted:

1. The Council of Finance Ministers would be the point of contact between the CFRS and the Caricom political directorate. The Council would not give directives on monetary policy or operational matters to the Board of Directors. However, if the Council of Finance Ministers

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[21] Blackman, Courtney N., "Debt, Development and Decline in the Caricom Caribbean", ***Caribbean Affairs***, July - Sept. 1988, Vol.1 No. 3.

[22] The West Indian Commission, "Towards a Vision of the Future", Barbados, Cole's Printery, 1991, p. 48.

were dissatisfied with the tenor of the Board's monetary policies, they might, after a unanimous vote, assume direction of monetary policy for a period of not more than 12 months, as is the case in New Zealand.

2. The Board of Governors would be comprised of the Governors of the branch banks of the CFRS, e.g. Federal Reserve Bank of Barbados, Federal Reserve Bank of Guyana, etc., plus a Chairman appointed by the Caricom Heads of Government. The Chairman of the Board would serve as CEO of the CFRS and would hold office for a period of seven years on good behaviour.

3. The federal nature of the organization would be reflected in the composition of the Board, in that the Governors of the branch banks would be appointed, as is presently the case, by the national authorities. However, they would serve in their personal capacities on the Board. Like the Chairman, branch bank Governors would serve on good behaviour for seven years, and would have no responsibility to the national Ministers of Finance. As CEOs of the branch banks, these Governors would be responsible to the Board in the area of policy, but to the local Board of Directors for the day-to-day administration of the branch bank. The Board of Directors of the branch banks could make representations to the Board of the CFRS on matters of policy and would seek to exert their influence through their Chairman.

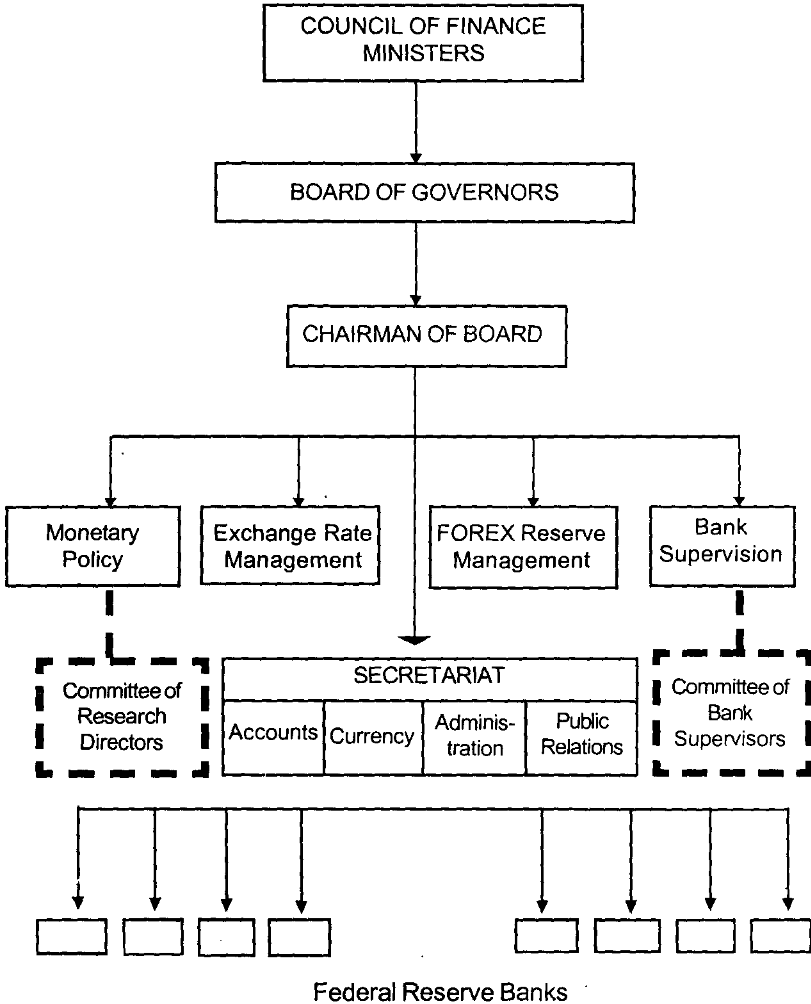
4. Four of the five load-bearing elements of the organizational structure would be located in separate departments - Monetary Policy, Foreign Exchange Rate Management, Foreign Exchange Management and Bank Supervision. The fifth key element, the Currency Issue, involves responsibility rather than substantive operations, which would be carried out by the branch banks as agents of the CFRS. Administration of the currency issue is therefore located in the Secretariat, along with Accounting, Administration (including Personnel), and Public Relations. A General Manager

would be responsible to the Chairman for the overall administration of the Federal Reserve Board.

5. Standing Committees of Heads of Research and Bank Supervision would advise on Monetary Policy and Bank supervision respectively.

ORGANIZATION CHART

CARIBBEAN FEDERAL RESERVE SYSTEM



SECTION VI

MUSINGS ON A CFRS

The sands of time are running out for the governments and peoples of CARICOM. Unless we move swiftly towards the Single Market which we have been postponing on an annual basis for some years now, we shall be absorbed piecemeal into one or more of the regional trade groupings now being formed around us. Such an eventuality would considerably reduce our collective clout in the global marketplace.

It is also high time to arrest the serial debauchments of our national currencies - the most certain path to the destruction of our societies and the disintegration of our civilization. An independent Monetary Authority would give us a fighting chance of averting the descent into chaos.

To complement a Single Market, we will need to establish a common currency as a vehicle for a unified monetary policy so as to impose fiscal discipline on member states. This, in turn will require some surrender of national sovereignty by the Caricom member states to a CFRS charged with the primary goal of price and exchange rate stability. Hopefully, this sacrifice of sovereignty will initiate a trend away from the "primacy of politics to an era in Caribbean public affairs where politics and "technics" are assigned their proper roles.

Finally, it is not too much to say that the very economic survival of CARICOM depends on the establishment of an independent and well capitalized Monetary Authority, manned by highly skilled professionals. Caricom governments should try to divert IMF/World Bank policies away from structural adjustment programmes towards the provision of capital funds for the recapitalization and reform of our national central banks. The way would then be clear for the establishment of a Caribbean Federal Reserve System. Caricom's needs for this purpose would be far less than the US$5-6 billion which Georges de Menil has proposed for the stabilization of the Russian rouble.[23]

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[23] New York Times, Saturday, February 15, 1992.