POINT COUNTER-POINT

MANAGING MONETARY POLICY

Fixed Rate or Managed Float?

The Exchange Rate: To Fix or not to Fix

The Jamaican Economy in a dollarised situation, using the US Dollar as the anchor currency, would adopt conditions conducive to economic stability and growth. However, fundamental change in the current arrangement may be premature at this stage.

Edward Seaga

The Bank of Jamaica (BOJ) grew out of the need for a dominant financial institution to be established at the time of independence. The institution would oversee the expected new thrust in the financial system to match the increased political authority which Independence would bring.

Prior to the advent of the BOJ, the monetary authority was a currency board which had a very limited role. It was the mechanism used to exchange Jamaican currency for hard currency, such as sterling and the dollar, and vice versa. It had no power of decision in monetary or foreign exchange policy.

The Jamaica Currency Board was part of a general system of currency management called the Colonial Exchange Standard. The system operated out of London and was available to all colonial countries. The currency board system provided automatic cover for exchange risks which, it was argued, contributed to monetary stability and development of the island, a view reported by the *Bank of Jamaica the first 40 years 1961-2000 pg.4*

But, as the BOJ recognized, this arrangement gave a currency board no discretion regarding the external value of the currency vis-a vis other currencies. It prevented the country from responding independently to external shocks. Monetary management was external and costly since the system required 100% backing of the currency with assets held in sterling, and moreso, at a fixed rate of exchange.

The establishment of the Bank of Jamaica created an institution which could control the financial system. With this centralized authority under Jamaican control after Independence the BOJ could decide the rate of exchange, regulate interest rates, determine the direction of investment and invest the reserve assets of the BOJ in whatever asset it considered to be in the best interest of the economy to stabilize the value of the currency and stimulate growth.

This dichotomy of systems of control has provided two poles for discussion as to whether full control by the Central Bank over the exchange rate is more advantageous to development than the restricted model of a currency board which is empowered to exchange currency.

The central bank model allows for various approaches to regulate the exchange rate to achieve stability. Broadly, the rate can be: Fixed or pegged, with a hard or soft peg; floated freely, responding only to market forces, or managed by manipulation of economic variables which can limit the movement of the rate.

The Bank of Jamaica operates on a managed float which allows it to intervene in the market to regulate the exchange rate. The powers of intervention offer various options in which control of money supply is the pivot. The strategy of the intervention is based on interaction with other variables in the economy which have an impact on the exchange rate. In the case of the Jamaican economy, the principal objective is to reduce liquidity in the banking system to a level which will remove excess pressure on available foreign currency and by extension, the exchange rate. In the event of excess liquidity, the BOJ intervenes by issuing debt instruments (bonds and certificates of deposit) which mop up the excess liquidity. These debt issues are liabilities to the Bank of Jamaica which have the effect of reducing the amount it can transfer to the revenue of central government at the end of the accounting year, if there is indeed a surplus in the BOJ financial accounts. BOJ interventions in 2009 totalled $19.8 billion.

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If there was no pressure on the rate of exchange, interventions by the BOJ would be unnecessary. This would, in 2009, enable a larger BOJ surplus of $19.8 billion for transfer to the revenue to reduce the fiscal gap, which is the ultimate objective of the current IMF programme with the Government of Jamaica. A fixed exchange rate should, therefore, be a beneficial operational objective of the BOJ ultimately providing more revenue.

Retrospectively, the fiscal deficits, cumulatively, could have been reduced by a potential $110 billion of intervention costs incurred over the five year period 2004-2008, based on the Bank's audited financial statements for those years. Significantly, the five year annual average cost of intervention, at $22 billion, ▸▸

represents approximately ninety percent (90%) of the Bank's total annual average operating expenses, at $25 billion. Consequently, a paradigm shift to fix the exchange rate rather than leave it to the vagaries of the present costly floats, free or managed, would generate significant fiscal benefits to the Consolidation Fund from the BOJ for example, to reduce the fiscal deficit, a prime concern at this time, or to reduce the indebtedness of central government, another prime consideration

In such cases, there are often benefits which are immediate:

- *Countries which have a fully fixed rate usually adopt a strong currency to which they anchor their own currency even to the extent of replacing the local currency with the anchor currency, as in dollarisation.*
- *The anchor currency to which the associated currency is to be attached must have macro-economic strength which would sustain a low and stable interest rate and low inflation. These features would pass on to the associated currency.*
- *The Jamaican economy in a dollarised situation using the US dollar as the anchor currency would adopt these positive conditions conducive to economic stability and growth, both of which have been absent from the Jamaican economy for the better part of the past 35 years.*

This scenario is both positive and negative. The rate of exchange of the US dollar has been sliding. Over the last two years, 2008 and 2009, during the recession, average annual exchange has slipped by J$19.40. Because the economic fundamentals on productivity and competitiveness between the US dollar and the Chinese yuan have not been realigned, the US dollar will continue to slide. The Jamaican dollar would not suffer nor benefit more or less than the US dollar in a dollarised connection and would perhaps be in a stronger position than it would be if it was floating on its own.

Another positive feature of dollarisation would be the open door it would provide for inflows of cheap US dollar financing for mortgage investments and other investments as a whole. This could provide for considerable inflows of foreign exchange and foreign investment because the alignment of the two currencies as one denomination would remove the exchange rate risk of depreciation which may occur. This would be a great boon to the economy without a doubt enabling long term infrastructure investments at previously unknown low rates of interest. Such cheap external flows would pressure local banks to lower interest rates to remain competitive.

THE DOWNSIDE OF DOLLARISATION

But despite these positive features there is a huge negative. Dollarisation would require the economy to operate entirely on domestic assets only to the extent of the foreign assets of the economy. This would mean that the domestic funds for operating the economy could only grow to the extent of the increase of the external earnings or receipts of the economy (tourism, mining, remittances etc).

The future development of the economy would therefore be dependent on the growth in exports and other external receipts. This would of course be a positive paradigm for a development platform, but in adverse situations, where the Jamaican economy faced uncontrollable shocks, whether from natural causes or other disasters, the ability to respond would be limited by the strength of the net foreign exchange reserves. The present recession has created an economic shock which exceeds US$1.0 billion. The challenge to deal with shocks of this nature from an international reserve of some US$1.7 billion would be precarious. The conclusion is inescapable that Jamaica, in its present condition, is too fragile to risk dollarisation of its economy at this time, despite the substantial benefits under a favourable economic climate. This does not mean an inevitable reliance on the costly managed rate of exchange currently in place which has stagnated the economy for decades as the only model of choice.

There is a fear that pegging the rate may cause a run on the Jamaican to the US dollar. But present circumstances do not warrant this fear.

The alternative is a variation of the fixed rate, the pegged rate. The peg is a fixed currency value accepted or legislated as non-variable. Pegged rates can last decades without change, as has been the case in the Organization of Eastern Caribbean States. The pegged exchange rate of EC$2.70: US$1 has enabled this ▸▸

group of small economies to survive huge economic challenges without depreciating the exchange rate over the past 20 years and more. This has enabled the economies of this group to produce significantly higher per capita real GDP per country compared to the Jamaican counterpart. The J$ slipped from J$5.51 to US$1.00 to J$89.60 to US$1.00 over the past two decades. Further, GDP of the OECS group of countries over the past 10 years has averaged 3.5 percent per year compared to 0.92 percent average for the Jamaican economy over the same period. There is a fear that pegging the rate may cause a run on the Jamaican to the US dollar. But present circumstances do not warrant this fear. The unstable condition of the Jamaican economy, facing further compression, the Jamaican dollar is most unlikely to flee to another economy where saving rates are even lower and the exchange rate is sliding.

A WINDOW OF OPPORTUNITY

For the next couple of years, conditions will remain inimical to robust growth in the western industrial world and those economies under their influence. While this condition prevails, a window of opportunity will exist to shift the Jamaican economy with minimal fear of a flight of foreign exchange. But this would not be entirely a positive position. The recently announced establishment of the Jamaican Debt Exchange (JDX) as a strategic component of debt reduction required by the IMF Agreement with the Government, has unsettled the commercial financial market. Banks now have to reset their commercial rates for saving and lending and this will set up different comparisons on costs and benefits in the domestic rate structure. In these circumstances, changing the exchange rate platform at this time would present unknown risks.

Under such conditions, while this paper favours a pegged exchange rate platform for the economic reasons set out above, it considers that any fundamental change in the current arrangement would be premature at this stage and the best option would be to await the development of new conditions arising from the JDX in order to then reach a considered conclusion. ■

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