Brian Wynter: What's in your wallet?

Address by Mr Brian Wynter, Governor of the Bank of Jamaica, at the opening of the 12th Annual Sir Arthur Lewis Institute of Social and Economic Studies Conference, Kingston, 23 March 2011.

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Ladies and Gentlemen:

Thank you for inviting me to this gathering of minds meeting here to consider what we have done with our political and economic freedom since Independence, what we should learn from the experience and where we want to go.

Coming to a shared vision of the future is one thing that has always eluded us and it might be expecting too much for that to be the outcome of the conference. I believe we can agree, however, on some aspects of our experience that we would like to keep re-living and others that we would not wish upon the next generation.

In contributing to this process, I am going to focus on an important aspect of the Caribbean experience not explicitly addressed elsewhere in the agenda – the role of monetary arrangements in shaping our development. They form a defining component of the policy choices that we made after Independence and, to my mind, have accounted for more of the outcome than we have generally acknowledged.

There is another reason that makes this occasion an opportune time for introspection and reflection on these issues. The year 2011 marks the 50th anniversary of the start of operations at the Bank of Jamaica. The establishment of the institution in 1960 preceded Independence as it was seen as part of the institutional machinery that should be in place when the time came to manage our own affairs. So, we at the Bank are very much in tune with your theme of celebration and welcome the opportunity to appraise the Central Bank's role in our collective affairs and to contemplate the form that this role might take in the future. In this context, most of my remarks will be focused on Jamaica, with references to our Caribbean neighbours for background and contrast.

The path taken – post independence, post Bretton Woods

I will begin with a sketch of the path that was taken after independence and during the post-Bretton Woods era. Among the group of former British colonies in the Caribbean, Jamaica was the first to establish a central bank, followed by Trinidad & Tobago in 1964 and Guyana in 1965. By the end of the 1960s these central banks had taken over the note issuing function of the currency boards that they replaced but would have done little else in the way of exercising discretion over monetary and exchange rate policies. So, while national currencies appeared, they maintained the look and the parities of the old money except that they were now issued by institutions of the newly christened nation states.

After the break-up of the Bretton Woods system in 1971 and the adoption of generalised floating by the major industrial countries, Caribbean nations, like other developing countries, were faced with the issue of what type of monetary arrangements they should adopt. Typically, the considerations included a desire for policy independence, "balanced growth" and price stability at home, all in the context of continued traditional trade links with the industrial countries. The options they faced ranged from the creation of currency enclaves as in Panama or Puerto Rico, a wide variety of pegging arrangements and institutional structures, to the formation of currency unions such as the one eventually adopted in the Eastern Caribbean. The most liberal extreme, joining the system of independently floating currencies, was not immediately feasible. For the most part, these developing countries responded to the changes in the international monetary system by pegging to the currency of their major trading partner.

However, pegging arrangements came under unprecedented pressure following the oil shocks of the 1970s and the subsequent swings in demand for commodity exports from developing countries. The alternative to the economic compression and restructuring demanded by these sharp changes was international borrowing; indeed, this proved to be the road most travelled. But, as it became clearer in the 1980s that further large-scale borrowing was unaffordable and that economic restructuring was inevitable, the question of suitable monetary and exchange arrangements once again arose.

The smallest states of the Caribbean – member countries of the Eastern Caribbean Central Bank – as well as Barbados, Belize and The Bahamas chose to make adjustments to their economies without changing the exchange rate and, in the process, experienced some loss in competitiveness but not obviously more than elsewhere. In these territories, wage awards and monetary conditions needed to be consistent with low inflation and a stable exchange rate, leaving the brunt of the adjustment process on government finances, employment and output.

The larger states of the Caribbean – Jamaica, Guyana and Trinidad & Tobago – all adopted flexible exchange rates as part of their structural adjustment programs. The prevailing consensus on development thinking, led by the Washington-based institutions, pointed to the likelihood of greater export diversity, sustainable balance of payments and improved economic efficiency if the adoption of flexible exchange rate regimes was accompanied by other economy-wide reforms. In Jamaica, many of these changes in the areas of trade liberalisation, tax reform and fiscal adjustment were implemented. A period of economic growth, spearheaded by nontraditional exports, occurred towards the end of the 1980s but the multilaterals themselves agree that the results of the process were relatively modest and short-lived when compared with the fast and sustained growth that was promised at the start.

One outcome of this process that was particularly sharp in Jamaica was its impact on inflation. Even after the initial adjustments to the domestic price level that accompanied these changes tapered off, they had set in motion a wave of negative expectations about exchange rate depreciation accompanied by inflation which, in turn, pushed organized labour into making wage demands to protect living standards. Government expenditure expanded to meet these and other needs which were funded, in large measure, by borrowing. Fiscal dominance, an open capital account and the absence of reserves defined a heavy role for monetary policy in reining in domestic expenditure. A large part of the book "Bank of Jamaica – The First Forty Years' is devoted to narrating the range of policy responses undertaken by the Central Bank and the uphill fight to maintain macroeconomic stability.

The inflation experience

The average inflation, growth in GDP and change in per capita income experienced by Jamaica in each of the last five decades is interesting:

	Inflation %	GDP %	Per cap income %
1961-70	4.6	5.2	3.7
1971-80	19.6	-0.9	-2.2
1981-90	23.2	2.4	1.5
1991-00	18.0	1.0	0.1
2001-10	12.0	0.7	0.3
Period Average	15.6	1.7	0.7

Alarming as they are, the average inflation rates for each decade in fact mask episodes of even more alarming instability. In one seven-year period – 1990–1996 – inflation amounted to 248 per cent and an annual average of 35.5 per cent.

We need to pause to consider what inflation rates at this level do to fixed contracts like pensions, savings and the salaries of persons with low bargaining power. Inflation at these levels virtually destroys the value of the income that they rely on to meet normal expenses and erodes the provisions they had put aside for retirement. It is a grim but silent reaper that leaves behind a mass of working poor and indigent pensioners while transferring windfalls to owners of property and assets denominated in other currencies.

Many of you who lived through this period would have had the experience of purchasing an insurance policy to help fund a child's education or to provide a source of income in retirement. You would have found, for example, that a princely $100,000 policy purchased in 1971 redeemed today would be worth less than $200 in 1971 dollars. While the face value was seen as the equivalent of US$110,000 then, it could purchase just over US$1,200 today.

People whose lives are shaped by such experiences adapt their responses to survive in that environment. Workers negotiate shorter contracts and demand adjustments that compensate for past losses and insist on provisions that anticipate further erosion of purchasing power. They demand higher interest rates on their savings to sustain the purchasing power of their deposits and are attracted to instruments such as insurance policies with a heavy investment component and periodic adjustment which are inherently better able to keep pace with inflation. And, for many, diversification has been the solution where despite the interest rates available on domestic instruments the quantum of foreign currency deposits in domestic financial institutions exceeds US$2.0 billion and keeps rising each year.

The inflation experience spawns other behaviour. It makes otherwise sane and conservative people condone, "invest in" and even promote wild financial schemes. It sends economic activity underground – to avoid taxation and to seek higher returns. Can this type of behaviour be described as a rational reaction to recurring bouts of instability? That is an open question. But nothing in my reading of events over the last 50 years better explains the perennial uncertainty, constant hedging, relentless rent-seeking and absence of commitment to any project with a delayed pay-off that typifies economic behaviour in Jamaica.

You would have noted from the figures that I read out that in the last decade, things have been improving. You would not know it from the usual media channels but, over a week ago, STATIN released, on the usual date, its inflation report for the month of February. The outcome was a reduction in prices by 0.4 per cent bringing inflation for the 11 months of the fiscal year to date to 6.7 per cent. The Treasury Bill auction today delivered a yield of 6.46 per cent on the three-month instrument and 6.63 per cent on the six-month instrument. So, annual inflation has fallen, financial markets have been more stable and, more recently, market-determined interest rates have fallen to their lowest levels in decades. A number of factors would have contributed to this including fiscal consolidation, external support and the cooperation of many local wealth holders and decision makers.

The analysis of that on-going transformation is something that will no doubt form part of your discussions later in the Conference. The key point that I wish to make in this context is that this juncture provides an ideal time for us to consider the institutional safeguards that could preserve price and macroeconomic stability for the next 50 years and leave the next generation with a different and better experience.

Policy and institutional options for a different future

We have on the menu essentially the same set of options that policymakers had post-Bretton Woods: pegging (or fixing) the exchange rate, monetary union, dollarisation and independent central banks. The difference now is that we have had 40years of experience since then and have spent a lot of time and energy in discussing some of them as regional issues.

The first three – a fixed peg, a monetary union and dollarisation – all imply relinquishing discretion over monetary policy. They differ in the degree of commitment or reversibility inherent in each regime and, in a sense, what the actual currency units would look like. The answer to the question "what's in your wallet?" would tell the world what your choice was.

A fixed exchange rate

A fixed peg has the appeal of establishing a known and predictable parity for the Jamaica Dollar against, most likely, the US Dollar. It would thus keep the Jamaica Dollar in your pocket and preserve its nominal external value by fiat. Other things being equal, policy would limit the permissible rate of domestic monetary expansion and would thus, in the absence of local supply shocks, tie domestic inflation to that of the United States. Given the current strength of the Net International Reserves and the growing record of exchange rate stability, this might seem to many to be the perfect time to establish an official fixed exchange rate.

Going back to where we were is not, however, a straightforward move. Somewhat akin to the idea of original sin, there is a reputational issue that has been burned into people's psyche – that of perennial uncertainty and the option that the Government would continue to have to adjust the parity whenever it deems it necessary. The issue of credibility is stacked against years of experience with expedient adjustments when pressures have arisen and the absence of any statutory or institutional commitment to maintaining the parity.

There are other realities. Supply shocks are a feature of life in the Caribbean, some of which, if they are long-lasting, may require an adjustment to economy-wide prices like the exchange rate. Further, exchange controls, which have traditionally been the institutional safeguard to ensure reserve adequacy, would be an anachronism in these times of open borders and financial integration. Thus, while the reserves may be sufficient at this time to support exchange rate stability, a change in investor sentiment and a consequent outflow of capital could only be managed by restrictions on credit expansion, reserve requirements and interest rate hikes. This would all be geared towards sustaining a rate which may well be unsuitable to the economic circumstances of the country and would thus provide a safe target for those who would wish to bet against the parity being maintained.

In light of these realities, I would rule out fixing the exchange rate. Determining a parity that would be suitable in all states of economic nature is nearly impossible. Defending an inappropriate parity is a very expensive losing proposition which is almost guaranteed to occur as circumstances are bound to arise that will test the resolve of the authorities. Finally, exchange control, which is the companion measure that is necessary in order to support a peg, is ruled out by law, by international agreement, by *de facto* integration and by progress.

Monetary union

The next candidate is joining the rest of the Caribbean Community ("CARICOM") in a monetary union and using a single Caribbean currency. Partly to enhance the credibility of monetary policy commitments but mainly to facilitate regional integration, the Heads of Government of CARICOM took a decision in July 1992 to establish a Caribbean Monetary Authority by 1997 and to move towards a full monetary union of all CARICOM members by the year 2000. Suriname and Haiti subsequently joined the group and membership by the Dominican Republic is being considered. A CARICOM-based monetary union would thus embrace virtually the whole Caribbean area.

The development of monetary cooperation is seen as an important and symbiotic adjunct to the tendency towards hemispheric cooperation in trade since it would reduce uncertainties about payments. It would also seek to deflect the issue of each individual member contending with pressures on their balance of payments by pooling their foreign reserves and conducting monetary policy through a regional monetary authority that would aim at maintaining the integrity of the regional currency.

Whatever its original merits and clear advantage in facilitating regional trade, the initiative has clearly lost steam over the 20 years of discussion. Part of the reason is that even in its absence there is no difficulty in making payments across borders using the *de facto* Caribbean currency – the US dollar. The other main drawback is that signing on to a single currency implies ceding control over some parts of national governance to a regional authority. While there would always be representation from each member, a regional monetary policy stance would necessarily affect members differently given the wide differences to be found in the economic characteristics of members in several important areas. This would not be the first union to face that issue but others, like the United States with different conditions among its member states, like the European Union and others, have mechanisms for effecting fiscal transfers to compensate for the adverse effects of a common policy on some members. In this regard, we can note as an example that the so-called “less developed countries” of CARICOM have always been extremely sensitive to the need to protect their populations via “special and differential treatment”.

In similar vein, Jamaica has always been and continues to be focused on North America and Europe in its external economic relations in a way that relegates a mechanism to promote commerce with CARICOM to a secondary role. Replacing the Jamaica Dollar with a Caribbean Dollar would be likely to enhance the predictability of its external and internal value and would offer a stronger level of commitment than an announced peg. By the same token, it would prove to be a stronger handicap where fundamental economic adjustment is required locally and where any change in parity requires unanimity among equal partners in the union.

Dollarisation

Dollarisation has returned to the discussion table periodically and has been touted as an even stronger commitment to monetary stability as it would abolish the currency entirely and replace domestic money with the US Dollar – both for circulation and for accounting purposes.

As in the case of the Caribbean Dollar, the adoption of the US Dollar would offer the benefit of tying our inflation experience to that of the United States and monetary policy would flow from the Federal Reserve in Washington. Of course, there are key differences between US dollarisation and Caribbean dollarisation. There would be no domestic input into policy making. There would be no right to the sharing of seigniorage – the income that accrues to the issuer of national currencies. There would be no means of supporting the financial system if liquidity shortages arose. Dependence on the United States for currency for circulation could raise issues of security and sovereignty (as is reported to have occurred in Panama).

Therefore, dollarisation could offer the kind of assurance that we are seeking to establish for ourselves but it would not be our doing and would say to the world “we are just not capable”. More important, it would present no guarantees as to reversibility especially when questions of security, sovereignty and independent national development issues assume centre stage in a nation’s political life. I would argue that there is a better alternative.

A strong and autonomous central bank

The starting point for offering succeeding generations a much more pleasing environment for price stability, growth and development is to define for ourselves what is a tolerable rate of inflation and what is not. Currently, our medium-term forecasts are built around getting inflation down to the 4%–5% range which is, approximately, the collective experience of our trading partners. There needs to be a public consensus, involving the highest levels of leadership, academia, commerce and an informed public, about the level of inflation that the authorities should be held to. This is the first step.

The second step is to deal with the perennial imbalances in public finances that are the counterpart to the imbalance in our current account. These have led to a huge overhang of debt the servicing of which consumes virtually all of the Government's tax revenue and crowds out public investment in infrastructure and social development. This is part of the story behind the slow growth and sluggish change in per capita income. It also retards growth in productivity which is the one sure way of achieving growth in GDP without inflation.

The third step is to put in place the institutional arrangements that ensure that low and stable inflation becomes the key responsibility of the central bank and that measures to ensure accountability are in place. This is not as difficult as it sounds and requires only a modification to the legal and operational framework that we already have.

The emerging literature on the redesign of central banks follows two strands: on the one hand, the delegation of monetary policy to a conservative central bank that then determines policy consistent with its low-inflation preferences (the "reputational" option); and, on the other hand, the formulation of strict principal-agent contracts where inflation targets are still set by elected officials but their achievement is contracted to a central bank empowered with the instruments to implement this (the "contractual" option). The Federal Reserve Board of the United States is an example of the first option while New Zealand's Reserve Bank is often cited as an example of the second type. Their relative merits are still unfolding but, given the dependence of the reputational solution on the personality of a single institution, the contractual option holds out greater promise of a credible, long-term, apolitical solution.

An autonomous central bank would be one that is insulated from short-term political priorities both by its terms of reference and by its governance provisions. Its focus on low and stable inflation would be monitored by its reporting to Parliament and by its implementation of an inflation targeting regime which has proven to be an effective anchor for inflation expectations in a growing number of industrial and developing countries. It would retain responsibility for financial stability and would thus have the mandate and the wherewithal to respond to potential threats to stability before they arise and to support systemically significant entities where the need arises. Such an institution would be of our making, could achieve all of the goals that we think are important to our collective well-being and would see us through the next 50 years proudly holding Jamaican dollars in our wallets.

Thank you.