

REPORT ON THE SYMPOSIUM ON THE MANAGEMENT OF EXCHANGE RATES

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The Commonwealth Secretariat led off the discussion with a framework for exchange rate management. It was necessary to manage exchange rates:

- (a) because floating among major currencies might impose misalignments;
- (b) so that exchange rates can be used to compensate for inflation differentials, though a devaluation may cause inflation and discourage investment;
- (c) to compensate for exchange rate shocks arising from terms of trade changes, capital outflows or dramatic changes in output.

What sort of regime for the change of exchange rate should be adopted and in what circumstances should we choose devaluation over other means of adjustment?

Choosing the Exchange Rate

Most participants thought that Caribbean countries had little real alternative to a US dollar peg. Their populations want a local currency which has a dependable, predictable value in terms of US dollars; failure to provide this results in a flight from domestic

currency. Policy should be designed to arrive at a rate for the US dollar which may be sustained in the long term.

It was suggested that disequilibrium in the labour market might be taken as an indicator of the appropriate exchange rate, in preference to the usual exchange rate indices. High and growing unemployment, together with unacceptably high money cost of employment creation, would indicate an overvaluation. There was some sentiment that the exchange rate should be set with an eye to the future, at a level which might be deemed appropriate five or ten years hence, taking account of new markets and the costs of producing new products. This is the strategy said to have been followed by some East Asian countries. However, it seems rather impractical, involving considerable guesswork about what will succeed and how the future will look. The exchange rate that might be indicated would vary tremendously depending on the assumptions chosen. It would almost certainly be possible to justify a continuation of the existing exchange rate under some plausible assumption.

The "real exchange rate" should be regarded as the relative cost of providing the same quality of a given factor service (for example, labour services) between two countries. This relative cost is only one factor in determining investment, along with the political and social climate, the choice of technology and the choice of activity in which to invest. An adjustment in the real exchange rate will promote investment and growth only if the climate is favourable. Moreover, the relative cost of labour seems to bear a strong relationship to relative

income per head in the various countries, rather than to countries' nominal exchange rates. Relative labour cost might appropriately be considered a result of relative standards of living including availability of health, housing, education and recreation. It was pointed out that the Guyanese real wage was among the lowest in the region at about US\$70 a day but because of systematic disorder there has been no investment response.

The literature is inconclusive on the choice of exchange rate strategy. There are several possible objectives that might be served by the exchange rate and many constraints on what is possible. The data required for a choice of what the exchange rate ought to be is never available in advance. One may only make a determination in hindsight. The requirements for floating the exchange rate are beyond the capability of Caribbean countries. The adjustment costs of a fixed rate may not be as high as many people think because they can be moderated by the reaction of the authorities to shocks of one kind or another. The authorities have discretion that if a shock is deemed to be temporary they can bear the adjustment through running down foreign exchange reserves. A choice of a change in exchange rates or alternative policies can be made for permanent shocks. There was strong sentiment for infrequent discreet changes in the exchange rate. Most favoured a peg to the US dollar, with one or two votes for a basket of currencies.

Qualifications on the Outcome

Several peculiarities of Caribbean economies bear on the outcome of exchange rate change. The inputs for all kinds of production have to

be imported, including the things which sustain the life of the worker. There is no coherent policy on income distribution and therefore there is always a squabble over the allocation of income shares whenever there is a devaluation. The population is internationally mobile and has close ties with relatives and friends overseas. It is impossible to make any stringent exchange control rules stick. Cultural penetration of the region has raised expectations and the countries are often saddled with incompetent information systems which limit the capability to implement certain kinds of programmes.

The Jamaican auction

Horace Barber offered a novel interpretation of the Jamaica foreign exchange auction. The Bank of Jamaica would have preferred to move immediately to a fixed rate but there were insufficient foreign exchange reserves and the balance of payments deficits were too large. It would have been difficult to convince the private sector that any new rate could have been sustained. The auction was an attempt to get the private sector themselves to arrive at some formal rate to replace the informal rate then being used in private transactions. He argued that it took Jamaica two to three years of the exchange auction to eliminate the informal market. Even at that stage, reserves were not enough to move to a fixed rate. Instead, the auction has been managed so as to keep the rate from moving significantly. When appropriate policies have secured comfortable reserves target, he envisages that the rate will once more be fixed.

Complementary Policies

The exchange rate complements other policies. Exchange rate changes might increase the profitability of tradables relative to non-

tradables, but the capital market may not be so segmented that any discrepancy in the rates of profit between tradables and non-tradables can continue for any length of time. There is probably a tendency for the equalization of profit rates throughout our small economies.

Many discussants felt that fiscal, monetary and exchange rates should be put in place together. These might be followed up later by incomes policies and still later by industrial policies. However, a distinction might be made between countries which have some foreign exchange reserves (but foresee a coming deficit which might threaten reserve levels) and countries which already have a foreign exchange deficit, no reserves and a build up of arrears. The prescription for a full range of policies applies to the latter group but might have to be modified with respect to the former. Exchange rate policy is the least discriminatory of those available and the one that has the least predictable effects.

It was argued that countries should act early to adjust the exchange rate, putting together a policy package sufficiently stringent to secure adjustment while remaining within the compass of what is politically acceptable. No-one seems to have asked why it is that this frequently repeated and eminently sensible advice has never been followed in practice. The real problem is that only with hindsight does it become clear that an exchange rate change was inevitable. In fact, even with hindsight, counter-factual situations might be suggested where exchange rate changes could have been avoided.

Devaluation might best be seen as one of a group of policies designed to stimulate an increase in export supply. If we look sufficiently to the future, it is possible to argue that the exchange rate change will contribute to increased supplies. Complementary policies include demand management, export promotion and direct action on production cost via wage guidelines, taxes and subsidies and where possible fuel prices.

Labour Intensity and Wage Rate

The Caribbean should not go for very labour intensive industry but rather should insist on activities which demand higher quality labour so as to recoup their considerable investment in human capital. While this may reduce the labour absorption per unit of output it should not prejudice chances of eliminating unemployment if countries penetrate the North American market on a sufficiently large scale.

Devaluation is designed to redistribute income from wages to profits. In Caribbean societies the wage good is imported and its price increases with devaluation. The only way to reduce the real cost of labour relative to our competition is to reduce the demand of imported goods and services. This will mean reduced access to food, clothing, housing, health services, travel and recreation. In short, a reduction in real living standards. The population will resist this to the extent they can by refusing to accept jobs at real wages which are below what they think their talent warrant. The reduction in the real wage brought about by a major devaluation may lead to increased voluntary unemployment rather than greater labour absorption. It was suggested that fiscal measures might be put in place to offset the income distribution consequences of devaluation to some extent. This

would require a shift in fiscal resources towards education, health, housing and essential social services.

Multiple Exchange Rate Systems

Arguments were put forward in favour of multiple exchange rate systems because of the need to offer different incentives for different kinds of foreign exchange transactions. However, there was considerable skepticism among those who have to administer multiple rates as to the practicality of a multiple exchange rate system. For one thing, the longer it persists the more complicated it gets and naturally everyone makes a case that he is entitled to the most favourable exchange rate on offer. If he does not succeed in convincing the authorities of the merit of his case, he may resort to unofficial arbitrage - offering to buy foreign exchange which someone else with a legitimate claim has gotten at the more favourable rate.

Reserve Management

It was generally agreed that healthy levels of foreign exchange reserves were desirable. Whatever the regime, some reserves were needed to enable the authorities to manage the exchange rate. Reserves are also a visible sign of effective economic management. Central Banks may need to hold reserves just as ample as any currency board, on average. The benefit of a central bank is that the reserves may be run down from time to time to finance temporary foreign exchange shortages as economic circumstances warrant. This degree of flexibility in the response to economic disturbance is the main advantage which central banks have over currency boards.

In addition to reserves needed for cover on normal transactions, the central bank needs a defensive stock - a "war chest". The size of the "war chest" will depend on the cost of accumulating reserves and on the cost of involuntary exchange rate adjustment if speculators succeed in exhausting the central bank's stock. There is a case for allowing the private sector a share in the responsibility of managing foreign assets, if the level of reserves will permit. It will be seen as a vote of confidence in domestic economic management if the authorities are confident that funds will not be diverted from domestic investment into foreign asset holdings.

A Regional Payments Mechanism

Marion Williams suggested that the criteria for a revived payments arrangements should be adequate capitalisation, strict limits on debtors, sanctions for those who do not meet settlement requirements, endowment of the fund with a legal personality, and a monitoring system with a good information base.

The Experience of the East Caribbean Central Bank

The East Caribbean Central Bank has succeeded in imposing fiscal discipline on its members by virtue of the fact that they cannot borrow above given limits. It has been able to maintain adequate reserves which at the end of 1986 were equivalent to five months of imports. However, the fixed exchange rate has not always been comfortable for all members. The rise of the US dollar curbed banana exports to the UK. When the dollar fell, Dominica's exports showed strong response to the resulting increase in local currency prices, however, St. Lucia did not show a similar response even though the circumstances were quite

similar. In any case, there is no exchange rate strategy that may adequately shield countries from dramatic changes in the US/ Sterling exchange rates.

The Unofficial Market for Foreign Exchange in Guyana

The unofficial market is not well-policed and there is no accountability. However, there have been few frauds because dealers realise that they need to maintain confidence if the market is to survive. The unofficial market is very inflationary: in addition to the upward price displacement that occurred when the market first came into prominence, the social costs of operating unofficial exchange rate markets are considerably higher than the private costs.

The lessons from the market are that successful policy needs to increase the access by the public to foreign exchange. There must be a strong political and social motivation to move out of the parallel market if it is to be defeated. Penalising foreign travel on the official exchange market is particularly harmful and is a major stimulus to the development of unofficial markets.

The lesson for all countries is that the population determines the real value of the domestic currency, based on the economic circumstances and their assessment of the credibility of official policies. The central bank decides to ignore the market view of the exchange rate at the risk of making itself increasingly irrelevant. If the central bank allows its stock of foreign exchange to be exhausted real activity will inevitably be diverted to a parallel market.

Some General Observations

The meeting seemed generally of the opinion that exchange rates in the Caribbean should be fixed, preferably to the US dollar, and that changes should be made only infrequently, even if that meant the changes had to be large. Floating rates, frequent adjustments and crawling rates are useful only as means of ascertaining what a new rate should be when the existing rate proves not to be feasible. There was no clear agreement as to how one might determine the target exchange rates. The choices include indices of relative prices, relative wages, indicators based on investment, growth or other indices of economic performance, and parallel market rates. Perhaps the best strategy is to develop as many indicators as seem relevant and compare them to arrive at a judgement as to the exchange rate target. There was no consensus on the objectives of exchange rate policy. Some people thought that rather than stabilise the balance of payments one might aim for a target rate of economic growth or to increase the supply of exports. My own view is that the exchange rate itself should be a target and that policies should be directed to sustaining whatever exchange rate the public seems prepared to go along with.

It was agreed that there should be "a policy cluster" including fiscal and monetary measures to accompany any exchange rate change. The content of the policy cluster would have to be decided on an individual country basis but it should include specific export promotion policies, direct action on wages, taxes and subsidies and, where appropriate, fuel prices. It was suggested that fiscal measures might be put in place to cushion the adverse effects of devaluation on income distribution.

We all felt that the framework for exchange rate analysis is too narrow. It does not include an adequate treatment of the income distribution consequences of exchange rates. There is insufficient attention to the fact that the wage good is imported and that devaluation therefore leads to a decline in real living standards. That makes sense in the short run only if it provides some assurance of recovery in the longer term. The analysis also pays insufficient attention to the practicalities of exchange rate management, the limits to exchange control, the fact that an equal burden of adjustment cannot be imposed in a democratic society and that there are a large number of opportunities for circumventing regulations.

A distinction must be drawn between exchange rate management in circumstances where foreign exchange reserves are available and situations of acute foreign exchange shortage. In the latter circumstances, some multiple exchange rate arrangement may be necessary, via an official parallel market or the use of more than one official rate. These systems are inherently unstable; people will want to buy the foreign exchange at the most favourable rate whether their activity qualifies them for it or not. An unofficial market is, inevitably, going to arise where people try to buy the foreign exchange which those eligible for favourable treatment are allotted. The objectives should be to so adjust the official rate that one eventually minimizes the foreign exchange shortage. This is the only way that a degree of deliberate exchange rate management can be reinstated.

We should put on the research agenda the development of models of adjustment which explicitly incorporate income distribution, specific export promotional targets and specific changes in the institutions by which we manage our exports and imports. Unless our models incorporate these details, we cannot use them in a useful way to indicate the feasibility of alternative exchange rate strategies.

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