

There is presently great interest in a common currency for the Caribbean as a means - perhaps the only means - of providing the region with sound, widely acceptable money. The Caribbean has been plagued with unsound monies from earliest colonial times to the present day, except for the rather brief historical period of the currency boards. The currency boards provided sound domestic currencies by linking them rigidly to a major convertible currency, guaranteeing convertibility by holding foreign exchange reserves of the same amount as the currency issue. It did not matter how many currencies were issued in the Caribbean region; they were all sterling by different names.

The cost of the currency board system was the lack of an independent monetary policy. At the time of their independence Caribbean countries considered this a major sacrifice. Instead of holding foreign exchange reserves to back the currency and borrowing abroad to finance investment, it seemed that countries might economize by reducing the foreign exchange reserve cover and using some of those resources to finance investment. It turns out that the potential financing gains from this strategy were insignificant (estimates were made by Worrell, 1976) largely because Caribbean countries are so open: the foreign exchange reserves needed purely for balance of payments insurance is not much less than is required for 100% backing of the domestic currency. This fact was not perceived at the time and an insistent case was

made for the establishment of central banks to detach monetary policy from the balance of payments constraint (Thomas, 1972).

Unfortunately, the quest for independent monetary policy has returned the English-speaking Caribbean to its historical condition of unsound money. It was not simply the failure to realise gains in the efficiency of foreign exchange use; in the absence of limits on money creation imposed by the foreign exchange rule, profligate governments subverted central banks to inflate economies in fruitless efforts to raise consumption. One by one the strongest currencies of the region were felled by their governments' fiscal excesses, financed by money created by the central bank over the latter's hapless protests. Those currencies that have not been depreciated have been the subject of rumour, speculation and apprehension, leaving the East Caribbean dollar (for the time being) the only bastion of confidence in the Caribbean.

What is to be done about this unsatisfactory situation? The present publication chronicles current efforts to find a practical solution to the problems of unsound currencies in the Caribbean.

The issues are not simple; in order to introduce them gently to newcomers Terrence Farrell's "Guide for the Perplexed" deliberately neglects some of the nuances. [Summary of Terry's paper].

DeLisle Worrell's "A Common Currency for the Caribbean" makes the case for a Caribbean dollar to be managed by an independent central bank serving the region. The central bank would be debarred from creating money to finance fiscal deficits, or to bail out failing financial institutions; it would have full discretion with respect to monetary policy. The currency would be backed with adequate foreign exchange reserves and the central bank would have statutory limitations on the fiduciary currency issue. (Currency issued to banks and governments by way of a loan, instead of payment of hard currency by banks or governments). The central bank's decision-makers should be of proven competence and they should have security of tenure. The bank would be a source of economic information and advice to governments and to the general public.

A currency structured along these lines would accelerate investment in exportable goods, tourism and other international services. It would eliminate the incentive for capital flight, remove the need to invest in real estate to protect oneself against inflation, reduce the costs of doing business across the region and eliminate the risk deriving from changes in governments' strategies for managing the exchange rate.

The common currency should be supported by some arrangement for a limited amount of lending among members. There must be rules to ensure that government budgets are not too expansionary, but it is neither necessary nor desirable to harmonize all tax and expenditure policy. Labour mobility is desirable but not essential.

Complementarity of production between the members of a Caribbean currency union is not a necessary condition for its success. The benefits result from of efficiency in transactions between the region as a whole and North America and the rest of world. The gains from greater efficiency of intra-regional transactions are small in comparison. The Caribbean dollar should be pegged to the US dollar, to institutionalize the reality that the Caribbean is part of the US currency area, rather than a currency area in its own right.

To ensure the credibility and convertibility of the currency there would be strict criteria for accession to the currency union: "the joining member must have foreign reserves equivalent to three months' imports or 80% of its Central Bank's liabilities which is higher. This level must have been maintained for at least twelve consecutive months. The country's exchange rate must have remained unchanged in terms of dollars for at least thirty-six consecutive months during which time there must have been no arrears on external payments."

Alexander Italianer draws lessons for the Caribbean from the European experience. Similar benefits accrue to the Caribbean and Europe from price and exchange stability, public sector efficiency and international economic policy cooperation. An independent central bank is required and there should be a common regime of capital controls. Italianer thinks that mutual lending arrangements among members

essential and he suggests that international institutions be approached to help fund such arrangements. Taxes on capital income are recommended as a prime candidate for harmonization within the region. Labour mobility can act as an important adjustment instrument. The regional central bank could be made accountable to a council of ministers with authority to override the central bank only if their vote is unanimous. Conditions for access to the monetary union should include a minimum period during which a fixed peg is maintained, fiscal discipline, low inflation and balance of payments stability. During a transition period when preparations are being made for the regional currency a council of Caricom Central Banks should coordinate policy.

Alvin Hilarie et al, assess the options for monetary integration in Caricom. They review the economic structure and performance of the proposed members of the Caribbean monetary union, the regional payments systems, countries' economic policies and the medium-term prospects. They discuss the rationale for the monetary union and review the experiences of the European Community, the CFA Franc Zone and the Eastern Caribbean Central Bank. They conclude that the process of monetary union is likely to be a protracted one and that the most feasible approach is to implement the union in stages, with a definite timetable for each stage. Relatively strict limits must be imposed on Government's foreign borrowing and a high level of foreign exchange reserves must be maintained. They also recommend redistributive mechanisms.

Hilaire et al review issues of timing, eligibility, the value of the exchange rate, exchange rate flexibility, factor mobility, external debt, the infringement of the sovereignty of national governments and the transition mechanisms to the common currency. They evaluate options for the introduction of the common currency: the replacement of national currencies; a Caribbean currency that circulates in parallel with national currencies; the use of a Caribbean unit of account and the retention of national currencies; and an arrangement which retains national currencies but limits the extent to which they may be devalued in relation to each other. The replacement of national currencies with a single Caribbean currency is the only option that improves on the present unsatisfactory arrangements. To achieve it, Hilaire et al recommended introduction in stages, with countries divided into two groups. The first group, which would move ahead more quickly at each stage, would comprise those countries which had ample foreign exchange reserves, a sufficiently long unbroken record of exchange rate stability, and an external debt service profile below the threshold set by the regional central bank.

Karl Theodore's chapter on fiscal issues consults previous studies for guidance on the limits that must be put on fiscal policy in order to achieve monetary union. His survey indicates a need to manage national fiscal policies in a flexible manner, to allow countries within the union to make different fiscal adjustments to compensate for the fact that the same circumstance may have diverse effects on individual members.

(For Caricom, the most obvious example is an oil price increase, which improves the balance of payments of oil-exporting Trinidad and Tobago, but worsens the balance of payments of all other members.) Flexible fiscal policy also allows adjustment to countries' differing debt profiles. However, too much fiscal divergence may exacerbate tensions within the monetary union.

Theodore then checks whether previous studies arrive at a consensus about the necessity of a supra-national fiscal authority. No arguments are advanced explicitly for a central fiscal authority. Instead, the case is made for agreed coordination and specific rules of the game such as those suggested for Europe by the Delors Committee. The rules are designed to ensure that one country's fiscal policies do not create problems for its partners. Moreover, if there is a strong obligation to observe fiscal norms, commitments by national governments to sustain fiscal reforms become more credible in the eyes of the private sector and the international community. Some argue that market forces can supply enough control to prevent fiscal excesses but the evidence on this is "inconclusive". There is a complex interaction (in theory) between the exchange rate regime, the source of shocks to the economy and the degree of centralization of fiscal policy.

Theodore argues that the current mix of fixed and flexible exchange rates without a monetary union causes too much uncertainty. If all exchange rates were flexible within a monetary union, a powerful transfer mechanism would be needed and it

would have to be managed by the dominant member or members of the union; otherwise the arrangement would be unstable. Such an arrangement is not acceptable to Caricom members. A monetary union with fixed exchange rates must take account of asymmetries within the region. For example, demand management in the OECS countries has little effect on the larger partners in Caricom. However, demand management by Trinidad & Tobago or Barbados has a significant effect on the OECS countries. Policy coordination and a stabilization fund are needed to provide transfer mechanisms to counter these asymmetries. It suits the smaller partners to contribute to a stabilization fund from which larger partners may draw in order to cushion spillover effects from demand management in larger partner countries to the economies of smaller partner countries.

Ralph Henry and Andrew Downes find that the monetary union has little direct impact on the labour market. However, there will be indirect labour market effects to the extent that monetary union rationalizes product markets. The creation of a common market introduces pressures for the equalisation of wages among member countries because people may migrate from countries with relatively low wages. However, migration is costly, and it is inhibited by the financial and psychological costs of pulling up roots in the home country. Other barriers to migration include collusion between firms and unions and social ostracism of immigrants. Experience suggests some tendency for wage equalization among countries with a common market but the evidence is not conclusive.

Migration between countries may ease unemployment in some countries and provide remittances but it will have reverse effects elsewhere within the region. The outcome depends partly on the complementarities between labour and other factors of production in different sectors and the distribution of production among countries.

Although population growth rates are quite low, the percentage of unemployment in the English-speaking Caribbean has remained generally high. There is much variation among countries in the proportion of skilled workers in the labour force but unions are strong everywhere in the region.

Any exchange rate adjustment which accompanies monetary union cause inflation by increasing import prices, which have a severe impact on domestic prices in all Caribbean countries. Inflation generates wage increases for the countries affected, and there may, in theory, be a reaction by wage earners in competing industries in regional partner countries. Whether such spillovers are significant depends on comparable levels of unemployment, wage levels, the distribution of skills in each country's labour force, the degree of labour mobility and the nature of the collective bargaining process. The fact that migrants typically lose social security entitlements they have accumulated at home is a further inhibition to labour mobility.

All in all, monetary union is unlikely to lead to labour market disruption or to significantly intensify pressure for a free labour market within the region even if intra-regional trades in goods and services increases significantly. In any case, the greatest benefits of monetary union are in enhancing the Caribbean's capacity for extra-regional exports and not from the expansion of regional trade. Greater labour mobility will enhance the returns to unification by increasing Caribbean productive efficiencies but it is not a requirement for monetary union.

Courtney Blackman opens his chapter on "The Institutional Framework for a Caribbean Monetary Authority" with the suggestion that the regional central bank's mission should be the maintenance of internal and external value of the currency; other objectives, especially that of economic growth, should be subordinated to that mission. The Caribbean Central Bank would issue a common currency, conduct a common monetary policy, manage pooled foreign exchange reserves, manage the exchange rate and supervise the banking system.

The governor and directors of the Caribbean central bank would serve on good behaviour, the governor for at least seven years and the Directors for five years with one director retiring each year. Ministerial veto of appointments other than those of directors, the governor and deputy governors, should be discontinued. The central bank should be responsible to Parliament rather than to Ministries of Finance. Powers

of the administration to resort to central bank financing should be more rigorously circumscribed, ideally by entrenchment in countries' Constitutions.

The board of governors of the central bank would have sole responsibility for monetary policy, with each governor acting in his or her personal capacity, not as a national representative. The board would meet periodically with the Minister of Finance of each Caricom member state to ascertain national policies but they would not be subject in any way to the authority of national ministers. Policy formulation and implementation would be conducted by a small core of experts and branch banks of the central bank in each territory would act as agents for the central banks in the implementation of policy. Limits on central bank accommodation for governments would be established by the board of governors and would be scrupulously observed by branch banks. Caricom member states should be required by law to seek the advice of the regional central bank on all foreign credit operations. The board of governors would comprise the governors of the branch banks plus a chairman appointed by the Caricom Heads of Government.

In reviewing regional debt and reserves, Terrence Farrell notes that Guyana and Jamaica are heavily indebted, Trinidad & Tobago might be characterised as moderately indebted while most of the other countries have low to moderate indebtedness. In most cases where data are available the rate of growth of the debt stock has

exceeded the rate of growth of real GDP. Trinidad & Tobago, Jamaica and Guyana have all had to reschedule their official and commercial debt in the recent past.

The high levels of external debt and debt service of some Caribbean countries are a major obstacle to monetary integration. The pooling of debt would impose significant costs on the less heavily indebted countries. These costs are mitigated to the extent that reserves are pooled. However, the more heavily indebted countries have little foreign exchange to contribute to the pool cannot therefore even partially compensate less heavily indebted countries. At an early stage of the transition towards monetary union the community would have to agree limits to external debt accumulation by most heavily indebted countries. A stabilization fund to which less heavily indebted countries would enjoy preferential access would have to be established. The pooling of reserves may have to be delayed until the debt situation of the community reaches sustainable levels.

The report by the Caricom Central Bank Governors to the Heads of Government suggests a two-tiered stages approach to monetary union. Countries would be divided into two groups: Category A countries are those able to maintain three months' im- cover in foreign exchange reserves for at least twelve months and a stable exchange rate for thirty-six months with a sustainable debt service ratio not exceeding 1. All other countries would be in Category B. Category B countries would be required to undertake accelerated stabilization and adjustment. In Stage 1, Jamaica

Guyana would sustain policies to stabilize their parities. A Council of Caricom Central Bank Governors would be set up as the first stage in the movement towards monetary union, to coordinate these stabilisation policies. The Council would have a charter given by the Heads of Government to coordinate exchange rate, monetary and fiscal policies; to initiate the collection and collation of monetary, trade and fiscal data from member countries; and to undertake studies required for the formulation of monetary and exchange policies at the regional level. Prior consultation with the Council before an exchange rate change or alteration in the exchange rate regime would be mandatory. The Council would also begin the coordination of prudential supervision and regulation.

The second stage would see the establishment of a Caribbean Monetary Authority with power to issue currency. At some point during this second stage, a common currency would be introduced to replace the currencies of the OECS, Barbados and Trinidad & Tobago. At some point during Stage 2 Jamaica and Guyana would cease adjustment of their parities and Stage 3 would be initiated when either accedes to the common currency arrangement. The Governors recommended that Caricom work towards completing Stage 3 by the year 2000.

DeLisle Worrell
Central Bank of Barbados
January 22, 1993

References

Thomas, C.Y., 1972. The Structure, Performance and Prospects of Central Banking in the Caribbean, Mona, Jamaica: University of the West Indies.

Worrell, DeLisle, 1976. "The Theory of Optimal Foreign Exchange Reserves in a Developing Country", Social and Economic Studies, 25:3, pp. 259-279.

