REGIONAL EXCHANGE RATE STRATEGIES

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Exchange rate arrangements in CARICOM have their origins in the colonial monetary system under which currencies were fixed in terms of the pound sterling. The existing arrangements, in their operational aspects, have not moved very far away from their origins, except that sterling has been replaced by the US dollar; however, consciousness of the exchange rate in the array of economic policy instruments is now very high. The first regional discussions of the exchange rate as a policy instrument took place in 1968 [U.W.I./ISER 1968] in response to the 1967 devaluation of the pound sterling. By that time one of the formal aspects of the colonial monetary system - the currency board - had disappeared in Jamaica, Trinidad and Tobago, and Guyana where central banks were in operation. Consciousness of the exchange rate was also sharpened by membership of the CARICOM countries in the International Monetary Fund and exchange rate changes moved from what can be described as the 'passive phase' to the 'active phase'.

This paper examines the changes in exchange rate strategies in the region, and assesses the case for overvaluation of regional currencies which is seen as a result of the existing exchange rate practices. The paper also discusses the case for a basket type arrangement as a possible solution to the perceived problems of exchange rate arrangements in the region; a note on methods of calculating effective exchange rates, which is attached, also forms part of the paper.

I Exchange Rate Arrangements

Taking 1967 as our starting point all currencies of the CARICOM countries were fixed to the pound sterling. In Trinidad and Tobago, Guyana and the East Caribbean countries[1] the dollar was the unit of account valued at the rate of one pound sterling to 4.80 dollars. At that time it did not matter that both Guyana and Trinidad and Tobago had their own dollar, the TT$ and the G$, respectively, and that the EC$ had recently replaced the BCCB dollar in circulation in the East Caribbean. In Jamaica the Jamaican pound, equal to the pound sterling, was the unit of domestic currency until 1969 when it was replaced by the Jamaican dollar at the rate of two dollars to the pound [Central Bank of Barbados 1982]. These were administrative changes of little economic significance. All regional currencies bore a fixed relationship to each other through the pound sterling and a country could secure a competitive price advantage over its neighbours only by keeping its own costs below theirs (Table I). This situation remained unchanged apart from an 8.5% devaluation of the Guyana dollar against the pound sterling and against all regional currencies in 1971 (Table II).

[1] Antigua, Barbados, Dominica, Grenada, Montserrat, St. Kitts-Nevis, St. Lucia and St.Vincent.

The first change of any significance in regional exchange rate arrangements came in January 1973 when the Jamaican authorities severed the link between the Jamaican dollar and the pound sterling and tied the domestic currency to the US dollar. At the same time, following the Guyanese lead, the currency was devalued by 6.7% independently of the currency to which it was pegged[2]. A second devaluation of 10% (in terms of sterling and other regional currencies) followed in February 1973 but this was a 'passive' devaluation following that of the US dollar. This move by the Jamaican authorities was operationally of major significance. The rate for the Jamaica dollar vis-a-vis the other regional currencies was determined by the exchange rate between the US dollar and sterling. This process continued until all the regional currencies had severed the link with sterling and were tied to the US dollar.

Two years were to elapse before the next country, Barbados, severed the link with sterling and tied its currency to the US dollar (July 5, 1975). In fixing the rate at one US dollar to two Barbados dollars the Barbadian authorities revalued the domestic currency by 9.5%. The Guyanese authorities tied their currency to the US dollar in the same year (October 9, 1975)

[2] In any event, by 1973 the system of par values was abandoned (August 15, 1971) and the system of floating exchange rates was in place. This was of little operational significance to those countries whose currencies were pegged to a major currency.

but at the rate of one US dollar to G$2.55, the rate prevailing at the close of business on the previous day. The Trinidad and Tobago dollar was tied to the US dollar on May 28, 1976 at the rate of US$1 to TT$2.40, which involved a revaluation of 12.7%; two months later (July 7) the EC dollar was also tied to the US dollar at the rate of US$1 to EC$2.70, which involved a slight devaluation of 1.4%.

The link to a single currency restored the fixed relationship of regional currencies to each other even though the values ranged from J$1.10 to the US dollar to EC$0.3703 to the US dollar.

The next movement in the 'active phase' of exchange rate policy came in 1977 (April 22) when Jamaica adopted a dual exchange rate system which included a basic and a special exchange rate. The basic exchange rate was the existing rate of J$1.10 to the US dollar and was applied to:

a) payments for imports of basic food, petroleum and petroleum products, essential drugs, fertilisers and animal feeds;
b) receipts and payments on Government account; and
c) receipts and payments relating to the mining sector.

All other transactions were at the special rate of J$0.80 to US$1.00, a 37.5% devaluation on the basic rate. These rates remained in force until October (21st) when a new basic rate

of J$1 to US$0.9524 and a special rate of J$1 to US$0.78125 were adopted.

Jamaica again led the way in exchange rate innovations in the region. A crawling peg exchange rate was introduced from May 1978 to May 1979. First, the dual exchange rate system was abolished and a new central rate of J$1 to US$0.64515 was introduced in May 1978, by May a year later the rate was J$1 to US$0.56135. A period of stability in the official Jamaica dollar/US dollar rate followed until November 1983 but in the meantime Jamaica re-introduced a dual exchange rate system in January 1983. Unlike the earlier dual rate system the authorities only fixed the official rate which remained at J$1 to US$0.56135; the second rate was left to be determined by market forces. A dispute ensued about the rate to be used for settlement of regional balances and after a series of meetings the Jamaican authorities introduced a special rate of J$1 to US$0.4444 for transactions with CARICOM countries. This rate was abolished in November when the exchange rates were unified at an official rate of J$1 to US$0.32.

Guyana, in the meantime, introduced a new system for determining the value of the currency. From June (2nd) 1981 the value of the Guyanese dollar was determined by a composite basket made up of the US dollar, the pound sterling, the Deutschemark, the Japanese yen, and the Trinidad and Tobago dollar. The US dollar, however, remained the reference currency for determining the exchange rate of the Guyanese dollar which was also fixed at that time at

G$1 to US$0.3333, a devalation of 17.6% on the previous rate. This move by the Guyanese authorities made little difference to the actual management of the exchange rate. Although the value of the Guyanese dollar in terms of the basket fluctuated, the official rate was held constant in terms of US dollars.

Pegging to a basket gives the authorities the opportunity to make incremental changes in the exchange rate without appearing to devalue or revalue since technically the local currency unit is floating against the currencies in the basket. However, the Guyanese authorities continued to operate the exchange rate system without reference to the basket. The value of the Guyana dollar remained fixed at US$0.3333 long after market forces on the currencies in the basket indicated that a change was necessary to reduce the appreciation of both the real and the nominal exchange rate for the Guyana dollar. Perhaps the authorities never established a threshold beyond which they would act, or if they did it was not reached, or more likely it was ignored. In any event, an opportunity for a truly innovative exchange rate strategy was missed.

Evidence of decisions on the exchange rate after 1976 was confined to Jamaica and Guyana. However, in the other CARICOM countries the exchange rate was no doubt a subject for discussion with the IMF consultation or programming missions. But except the countries were negotiating with the IMF no action was likely

to follow such discussion. Even when Fund programmes were being discussed institutional arrangements and the use of more powerful tools of economic policy precluded the use of the exchange rate in the adjustment strategies. This was certainly the case in the OECS countries where an exchange rate change required the approval of all the member states of the East Caribbean Central Bank (ECCB) and where fiscal policies in each individual country are likely to be more effective than an exchange rate change for all the countries. It was also the case in Barbados where adjustment under the Stand-by Arrangement negotiated in 1982 depended on fiscal and credit policies. Nevertheless, membership of the IMF has resulted in much greater consciousness of exchange rates and in the need to adopt policies that avoid erosion of confidence through frequent exchange rate adjustments.

There has been some concern that exchange rate changes have given some countries an advantage over others in regional trade. To analyse this requires information on the way in which exchange rates affect factor costs in the currency of each importing country. In the absence of this information relative consumer price movements are often used as a rough and ready indicator. This index can be modified by an index of changes in the exchange rate, to indicate how prices of goods made in one country are affected by the exchange rate when they are sold in a neighbouring country.

From 1978 to 1983 the value of the price adjusted trade weighted exchange rate (PTE) for the Barbados dollar rose by 27.6%; for the OECS countries the appreciation was 12.4%, for Guyana 61.1%, for Jamaica 6.2%, and for Trinidad and Tobago 48.2%. The difference in the appreciation of the PTE between Barbados, the OECS and Trinidad and Tobago reflect changes in relative rates of inflation; changes in nominal exchange rates since 1978 are also reflected in the case of Guyana and Jamaica whose currencies have been devalued by 40.3% and 84.4% since 1978.

The movement in the exchange rates adjusted by the relative CPI's (the purchasing power parity - PPP) have been used to measure the competitiveness of countries in intra-regional trade. The PPP of Jamaica against Barbados and Trinidad and Tobago has declined, especially since 1974 in the case of Barbados and since 1976 in the case of Trinidad and Tobago. Trinidad and Tobago's PPP against Barbados declined from between 1969 and 1974 but remained relatively stable thereafter, a reflection of the fairly close rates of inflation in the two countries. In the case of Guyana the PPP fell against the other currencies. If exchange rates remain unchanged a fall in the PPP indicates that domestic consumer prices are rising faster than foreign consumer prices. Under such conditions importing becomes more attractive and exporting may be made more difficult. Exchange rate adjustments however, can be used to compensate for this but in highly open economies a devaluation soon feeds into the price of both tradable and non-tradable goods. The advantage of a devaluation

tends therefore to be short-lived.

II <u>A Unit of Account</u>

One idea which has been mooted to address the current payments impasse in CARICOM is the creation of a CARICOM unit of account. The notion seems to be that the value of regional currencies would be fixed in terms of the unit of account, which would be used to value regional transactions, and to make settlements. Some means would have to be found to ensure the convertibility of the unit of account. This section of the paper clarifies issues surrounding that proposition.

Two of the better known examples of units of account are the ECU used in the EEC and the transferable rouble used for trade between the countries making up the Council for Mutual Economic Aid (COMECON). The transferable rouble is actually used for settlement of intra-COMECON trade, but it is not convertible into foreign currencies. In effect therefore it is a unit of account for barter operations between COMECON countries [Garvy 1977, IBEC 1977]. The ECU on the other hand, is not a settlement unit for intra-EEC trade or for trade with non-EEC member countries. Settlements both within and outside the EEC take place in the currencies of member countries; these currencies are freely convertible into third currencies.

A Caricom unit of account, like any other unit of account, is convertible only if the currencies supporting the unit are convertible. Creating the unit will require a supporting pool of foreign exchange - essentially United States dollars, otherwise it will only serve at best to denominate barter arrangements. The Barbados dollar, the East Caribbean dollar and the Trinidad and Tobago dollar are convertible because their respective central banks stand ready to make legitimate sales at the official price for US dollars. The Jamaica and Guyana dollars are not convertible because their central banks can offer no such assurance. If a Caricom unit of account is to be convertible, the account manager will need an adequate reserve of United States dollars - and Trinidad and Tobago will have to provide most of it. Outsiders can hardly be expected to capitalise a Caricom fund if members of Caricom are not willing to make the major contributions themselves.

Already the US dollar functions both as a unit of account and as a means of settlement and this is not by accident. The United States is perhaps the only country willing and able to allow its currency to be used as a reserve currency, and its central bank to be used as a clearing house by the rest of the world. Any other currency, including the SDR, could also serve as a unit of account but at the point of settlement would certainly involve the pointless calculation of converting regional currencies to the new unit and then to the US dollar. The Trinidad dollar is to some extent used as a unit of account for regional travel

since the Caricom travellers cheques are not convertible into non-regional currencies. Eventually however, these travel credits and debits have to be settled in US dollars.

Although total intra-Caricom exports must equal total intra-Caricom imports, this is unlikely to be true for any individual country. In fact, if some countries are net importers, others must be net exporters. Moreover, although a country is a net exporter to Caricom it may be a net importer from the rest of the world. The country in that situation must be able to use the foreign exchange earned by selling to Caricom to buy goods from the rest of the world. That is to say, the country must earn convertible money from its Caricom sales. If the country does not earn convertible currency in Caricom, it will have to limit its sales to Caricom to its purchases from Caricom, and the existence or non-existence of a Caricom unit is immaterial to that situation.

Another presumed advantage of the proposed regional unit of account is that it would introduce exchange rate stability in the region. This is based on the mistaken notion that the ECU prevents the exchange rate fluctuations of the European currencies against each other. In fact, the limits to ECU variation depend on the complex system of rules determining the points at which the authorities intervene in the market to prevent divergences away from some desired relationship. This is one of the last vestiges of the parity system when margins were fixed within which currencies could legitimately trade against each other.

The European earlier variations included the 'snake' which set even narrower margins for EEC currencies against each other, and the 'worm' which set even stricter limits on the fluctuations of the Benelux currencies. The upshot of these arrangements is that very often action is taken by the strongest and the weakest currency in the parity grid.

Caricom countries could not sustain such a system at present precisely because they do not have convertible currencies to support intervention necessary to maintain an agreed relationship to the unit of account. But if they were able to do so a parity grid similar to that in use in the EEC could in fact be constructed around the US dollar, thus obviating the need for a unit of account. For the same reasons that Jamaica and Guyana are unable to maintain current parities with the US dollar, they would be unable to sustain their currencies' value in terms of any other unit of account. Under these circumstances a given set of regional currency parities could be preserved only by depreciating the strong Caricom currencies in line with the weakest. That option has always been open to Trinidad and Tobago, ECCA, Belize, the Bahamas and Barbados. Not surprisingly, they have chosen not to exercise it.

The Caricom problem revolves around foreign exchange management in those countries which have unmanageable foreign exchange deficits. They cannot shoulder their share of the burden of maintaining the convertibility of the regional settlements. The system can only be re-activated if someone is prepared to bail

them out. When the sums involved were small and when Trinidad and Tobago's reserves were on the increase, that appeared feasible. Now it seems we must wait for Jamaica and Trinidad and Tobago to put their economies to rights; Guyana will remain outside the system for sometime.

TABLE I

CARICOM SELECTIVE COUNTRIES: PURCHASING POWER PARITY POSITION*

	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Barbados Dollar														
Jamaica	0.55	0.55	0.60	0.61	0.67	0.70	0.73	0.70	0.68	0.87	0.98	0.89	0.91	0.94
Trinidad/Tobago	0.83	0.87	0.94	0.92	0.94	1.07	1.18	1.28	1.22	1.20	1.22	1.19	1.19	1.18
Guyana	0.65	0.67	0.75	0.83	0.89	1.06	1.28	1.34	1.34	1.27	1.26	1.27	1.29	1.27
Jamaica Dollar														
Barbados	1.78	1.78	1.67	1.64	1.48	1.43	1.37	1.42	1.47	1.15	1.03	1.13	1.11	1.07
Trinidad/Tobago	1.47	1.55	1.57	1.52	1.39	1.53	1.62	1.81	1.78	1.38	1.26	1.35	1.33	1.27
Guyana	1.15	1.20	1.25	1.36	1.33	1.52	1.75	1.90	1.96	1.46	1.29	1.43	1.42	1.36
Trinidad/Tobago Dollar														
Barbados	1.21	1.15	1.06	1.08	1.06	0.94	0.84	0.78	0.83	0.83	0.82	0.84	0.84	0.85
Jamaica	0.69	0.65	0.64	0.66	0.71	0.65	0.62	0.55	0.56	0.73	0.80	0.74	0.75	0.79
Guyana	0.78	0.78	0.79	0.90	0.95	0.99	1.09	1.06	1.10	1.06	1.03	1.06	1.07	1.08
Guyana Dollar														
Barbados	1.54	1.49	1.33	1.20	1.12	0.94	0.78	0.75	0.75	0.79	0.79	0.79	0.77	0.78
Jamaica	0.87	0.84	0.79	0.73	0.75	0.66	0.58	0.53	0.51	0.68	0.77	0.74	0.70	0.73
Trinidad/Tobago	1.27	1.29	1.26	1.11	1.05	1.00	0.92	0.95	0.90	0.94	0.97	0.94	0.93	0.93

*Parity Position was calculated by the following formula: (Cross exchange rate) (Foreign Price Consumer Index)/ (Domestic Price Consumer Index).

Source: International Financial Statistics - IMF 1983

Note: Decrease means overvaluation. Increase means undervaluation.

TABLE II

NOMINAL EXCHANGE RATES OF REGIONAL CURRENCIES AGAINST THE BARBADOS DOLLAR 1967-1983

(END OF PERIOD)

Year	Guyana	Jamaica a)	OECS b)	Trinidad & Tobago	BDS$/US$
1967	1.0000	2.4000	1.0000	1.0000	0.5149
1968	1.0000	2.4000	1.0000	1.0000	0.4967
1969	1.0000	2.4000	1.0000	1.0000	0.5001
1970	1.0000	2.4000	1.0000	1.0000	0.5000
1971	0.9210	2.4000	1.0000	1.0000	0.5318
1972	0.9210	2.4000	1.0000	1.0000	0.4892
1973	0.9210	2.2727	1.0000	1.0000	0.4840
1974	0.9210	2.2483	1.0000	1.0000	0.4893
1975	0.7843	2.2000	0.8430	0.8430	0.5000
1976	0.7843	2.2000	0.8333	0.7407	0.5000
1977	0.7843	1.5625	0.8333	0.7407	0.5000
1978	0.7843	1.1800	0.8333	0.7407	0.5000
1979	0.7843	1.1227	0.8333	0.7407	0.5000
1980	0.7483	1.1227	0.8333	0.7407	0.5000
1981	0.6667	1.1227	0.8333	0.7407	0.5000
1982	0.6667	1.1227	0.8333	0.7407	0.5000
1983	0.5333	0.6400	0.8333	0.7407	0.5000

Source: Economic and Financial Statistics, Central Bank of Barbados, March 1984

Notes: a) The rate for the Jamaica dollar is used throughout;

b) Organisation of East Caribbean States.