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Seventeenth ADLITH BROWN Memorial Lecture

Professor Clive Y. Thomas

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**SEVENTEENTH ADLITH BROWN MEMORIAL
LECTURE**

**MACROECONOMIC ADJUSTMENT,
GROWTH AND DEVELOPMENT**

IN

SMALL, POOR, OPEN ECONOMIES

Professor Clive Y. Thomas

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17th Adlith Brown Memorial Lecture,
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The Late Dr. Adlith Brown

The Annual Adlith Brown Memorial Lecture honours the **memory** of Dr. Adlith Brown, Co-ordinator of the then Regional Programme of Monetary Studies from 1980 to 1984.

Although born in Jamaica, Dr. Brown could truly have been described as a Caribbean woman. Her sense of regionalism was nurtured on the Mona Campus of The University of the West Indies where she did her undergraduate work for the B.Sc. (Economics). She subsequently completed her Master's (with distinction) as well as her Doctorate from McGill University.

Adlith returned to teach at the University (St. Augustine Campus) in 1969 and in 1971 was transferred to the Mona Campus where she taught Monetary Economics in 1976 and was one of the main anchors of its Research programmes. She co-ordinated, firstly, the Caribbean Public Enterprise Project and secondly, in 1980, the Regional Programme of Monetary Studies. In this period, she was also promoted to the position of Senior Research Fellow and in 1982 to the position of Acting Deputy Director - a position which she held until her death. These latter years demonstrated most her capacity for intellectual leadership and for creative management.

Adlith revelled in the realm of ideas. It is therefore understandable that she was fast developing a reputation for being an outstanding economic theorist as her writings attest. Indeed, she was an ideal person to co-ordinate the Regional Programme of Monetary Studies, given her passion for regionalism, her intellectual standing and her understanding of the process and problems of policy-making with which her colleagues in the Regional central banks had to cope.

Each year an eminent Caribbean scholar is invited to deliver the Memorial Lecture, during the Annual Monetary Studies Conference of the Caribbean Centre for Monetary Studies (CCMS), in tribute to the life and work of Adlith Brown.

*MACROECONOMIC ADJUSTMENT, GROWTH
AND DEVELOPMENT IN
SMALL, POOR, OPEN ECONOMIES*

by

Prof. Clive Y. Thomas

Introduction

It is an honour and privilege to have been asked to give this Adlith Brown Memorial Lecture. My presentation tonight will touch on several issues captured in the Conference Theme: Money, Economic Growth and Development. Its more precise aim, however, is to use my previous work to de-construct the mode of short-run macroeconomic management as it is practised by the Authorities in the Caribbean region (referred to hereafter as the Region) from the perspective of growth and development. Some pointers towards an alternative approach will also be provided.

Adjustment and stabilization concerns have been at the forefront of regional discussion of economic growth and development since the 1970s, and this has continued into the New Millennium. In the mid-1990s, I had argued that adjustment and stabilization did not just appear in the 1970s, but that Regional economies have always had to adjust, even as colonies (Thomas 1994). At present, the prevailing view in the Region appears to be that there is no alternative to the neo-classical/neo-liberal monetarism which is now deeply embedded in the analysis and policies of the Monetary Authorities. The intellectual basis of this view is that a country in disequilibrium is living beyond its means, is either purchasing more from overseas than it is selling or receiving as unrequited gifts and investment flows, or government is spending more than it is receiving in revenue and capital sales, or some combination of both. In this circumstance, whether adjustment takes place through contraction of consumption, or the expansion of output, or some combination of both, is not as impartial as the fact that adjustment must take place. How, therefore, adjustment takes place seems to be relegated to a secondary concern. Unsurprisingly, this embeddedness has been accompanied by a retreat from economic (monetary) theorizing, producing what I can only term as “menu approaches” to economic modelling.

A stylised menu approach goes as follows: first, a problem is identified; then a brief description of it follows; next, the equations necessary to solve the model are identified; after the information available is found to be deficient; these equations are modified and data proxies introduced; thereafter the equations are estimated; and finally, the results are presented. The limitation of this “menu approach” is that it loses sight of the central role which ideas and theories should play in informing an economic (monetary) model. Without being informed by ideas and theories, models become pre-occupied with a display of the mastery of the techniques or technical details of modelling, as it were an end in itself. The tragedy is that such an approach fails to appreciate that all the great model builders of the various schools of economic thought have developed their models to *aid* the explication of their central theories and ideas about economic behaviour. This situation holds true for the neo-classical/neo-liberal school, which is the focus of the critique offered in this lecture.

To illustrate, the following are some key ideas and theories of economic behaviour that are central to the neo-classical model, and it is these ideas and theories which represent the true foundation of the model. These key ideas, in my opinion, are:

- That people think about the future when making economic decisions;
- That their expectations can be “modelled” because in so doing: (a) they have a comprehension of economic fluctuations/variability/uncertainty and (b) they use their information to make unbiased (but not error-free) forecasts;
- That macroeconomic policy can be expressed as policy rules, rather than the “one-time” or “exogenous” use of policy instruments, because of the way governments function in terms of –
 - (i) commitment;
 - (ii) time consistency; and
 - (iii) credibility.
- That following shocks, economic agents will respond in a manner that returns the economy to the “normal path” – recognizing that rigidities may slow this process down.

At a deeper level, it can be argued that the menu approach has led to a retreat from exploring the linkages between adjustment, growth and development, in the context of the institutional, social and political realities of the Region. Indeed, at present, such concerns are

ordinarily matters of second-order priority, as macroeconomic adjustment is considered as an end in itself.

The first section (Section 1) of this presentation introduces the ABC of macroeconomic management in a small, poor, open developing economy and identifies certain “follies” of macroeconomic policy in the Region. Section 2 highlights the economic rationale behind the pursuit of these “follies”. Section 3 identifies key aspects of the global economy as it affects monetary and financial policy in the Region. Section 4 concludes the discussion.

Section 1: The ABC of Macroeconomic Management

Beginning with my doctoral thesis (Thomas (1964)), I have consistently argued that in Caribbean economies, the relationship between the financial and real sectors is a sub-text of the broader linkage which exists between the promotion, on the one hand, of short-run macroeconomic balance and, on the other, of economic growth and development. The purported classical dichotomy of the real and financial sectors is unrealistic. And so too, for that matter, is the purported neo-classical identity of economic growth (increases in real per capita GNP/GDP) and

development. These are, at best, heuristic devices, invoked largely for instructional purposes. In the Caribbean, neither this classical dichotomy nor identity is a practical basis for economic theorizing, as the real and financial sectors are inseparably inter-twined and economic growth is substantially less than development.

If allowance is made for individual country gradations, variations and nuances, policies of adjustment as proclaimed in the Region since the 1980s have been based on the “Washington Consensus” and directed at (1) enhancing the role of markets and price incentives in resource allocation; (2) downsizing the state and restructuring its ownership and/or control of economic resources in favour of the private sector; (3) raising the management and institutional capacity of the downsized state through such programmes as public service reform, fiscal reform, and improved project management; (4) creating windows of opportunity for FDI, while promoting the local private sector as a joint-venture partner; (5) liberalizing external trade; and (6) “adding-on” social sector adjustment programmes and policies in order to minimize the social/political fall-out of the deflationary consequences of macroeconomic adjustment. As a rule, these policies have impacted, firstly, on the **articulation** of the state and the role of private markets in contemporary

Caribbean society. Secondly, they have encouraged the **re-construction** of civil society and its forms and modes of organization. And, thirdly, they have re-directed the **pattern of insertion** of the Region into the rapidly evolving global system.

Strategically, therefore, we may conclude that the objectives of adjustment in the 1980s and 1990s are not difficult to determine. These were aimed at (1) clearing the then external indebtedness of countries (this originated with the debt crisis and was linked to the oil and commodity crises of 1973 and 1979); (2) securing a retreat from the “inward-oriented growth path” in vogue at the time and promoting an “open” economic system, the liberalization of all major markets and closely integrating regional economies into the world economy (this secured the abandonment of the goal of the South to promote a New International Economic Order and contain the powers of the TNCs); (3) de-legitimizing the expectations of the “Golden Age” of economic growth (the mid-1960s to mid-1970s) particularly in regard to the welfare state and the pattern of income distribution it supported (this saw the abandonment of the “social contract” where workers had a ‘right’ to share in technical progress and productivity gains); and (4) promoting the private sector as the engine

of growth (as these were “efficient” and government “failure” pervasive).

Up to Independence and shortly after, the myth persisted in the Region that dynamic adjustments of growth to development and of real to monetary sector accounts were not necessary, mainly because of the institutional arrangements of the currency board-system, which were in operation. That system, it was claimed, precluded either internal or external macroeconomic imbalances from emerging. In effect, it minimized the costs of stabilisation. While we shall return to these issues in a while, the point needs to be made early that, contrary to this view, adjustment of short-run macroeconomic imbalances, and for that matter, as well as, long-run economic growth, to development are inevitable consequences of a world comprised of independent states or different National Authorities. Once these exist, economic adjustments take place continuously, and these adjustments invariably involve social sector adjustment. Practice has also revealed that the timing, sequencing and mode of implementation of various adjustment policies exercise an independent influence on the outcomes, particularly in regard to the distribution of the costs and benefits of adjustment. Whether or not the authorities admit it therefore, adjustment is a fact of life. Its particular

configuration, however, and hence outcomes, depend on governments and the way they manage the process (or let it unfold).

With regard to the problem of adjusting increases in real per capita GDP/GNP (growth) to development, I have pointed out elsewhere (Thomas 2000) that there is broad agreement within the Region on several key development priorities. These include:

- Alleviation of poverty;
- Reduction of unemployment and underemployment, and the expansion of productive jobs and self-employment activities;
- Sustained improvements in human capital (health, education and skills) and the standard-of-living of the broad mass of the population;
- Economic diversification;
- Attenuation of economic fluctuations, vulnerability, and insecurity;
- A more equitable distribution of income, wealth, productive assets, and access to opportunities;
- Removal of political, racial, gender, and other forms of discrimination;
- Good governance and the development of mass-based democratic politics.

Two points should be noted about these items of consensus. The first is that most, if not all of them, would find wide acceptance as global priorities. In this sense, therefore, they are not particularly distinctive as regional priorities. Second, the empirical record across countries shows that, while economic growth and development are not the same, the single largest contributor towards the achievement of the development priorities identified above has, in fact, been economic growth. Further, the record also shows that economic growth has depended principally on improvements in factor productivity generated by increased knowledge, innovation and technical progress. Indeed, there is overwhelming evidence that attempts to achieve growth by relying primarily on capital accumulation per worker puts inordinate pressure on the domestic living standards of the broad mass of the population and, unless financed out of foreign savings, is unsustainable in the long run. In the Region, there has been a preoccupation with capital investment, particularly FDI, and a neglect of productivity enhancing solutions in providing self-sustaining growth. This represents the first “folly” of macroeconomic management, which I shall identify this evening. It is foolish for us not to benefit from the economic mistakes of the various socialist accumulation models. These models failed because,

ultimately, they led to unacceptable burdens being placed on consumers and their living standards, through their emphasis on generating domestic savings to finance high rates of growth driven by capital accumulation and an extensive growth path.

In relation to the problem of adjusting the real to the financial sectors, I have argued in a recent study (Thomas 2000) that CARICOM Authorities (CA), in the face of unprecedented changes in the global economy, either deliberately or by default, independently or in “consultation” with the IFIs and major bilateral donors, pursue a model of macroeconomic adjustment and stabilisation that impacts adversely on the region’s trajectory of growth; the contribution of technical progress to that growth; the development priorities as outlined above; and the development of mass-based participatory democratic politics.

The starting point for the elucidation of these ideas is what I have elsewhere termed as the ABC of macroeconomic management in a small, poor, open economy and the so-called “policy trilemma” which this necessarily entails. Simply put, my argument is that in a small, poor, open economy, it is not possible to sustain as independent targets both *internal balance* [briefly defined as potential full employment non-inflationary growth, with

the smallest possible deviations in the long run in the size and duration of economic fluctuations as a consequence of shocks, taking into account the national preferred trade-off between price stability and output and employment stability] and **external balance** [briefly defined as a zero balance on the current account]. Further, in regard to **external balance**, typically, we find that in these economies the Authorities (and indeed the wider public) react with distress at signs of current account imbalances in the balance of payments. This attitude leads to a second folly of short-run macroeconomic management in the Region. As I pointed out years ago (Thomas 1965), a small, poor, open economy must **sustain a current account deficit if it is to effect a real, as distinct from a nominal, transfer of resources from abroad into the Region**. There is no other way that a national resource deficit can be effectively financed from overseas.

Today, I go further and state that unless the Authorities are in a position to pursue some combination or all of the following policies, short-run macroeconomic balance cannot be promoted by them in a small, poor, open economy. These policies are:

- An independent, as distinct from an automatic, monetary and fiscal adjustment to shocks (particularly the former);

- Some degree of flexibility in the exchange rate (“dirty float” as the minimum);
- Some regulation of international transactions (in particular short-term inward and outward flows such as bank debt, bonds and portfolio equity).

In regard to this proposition, there are four pertinent observations:

- (1) An independent monetary/fiscal mix is a necessary inclusion for all workable combinations of these policy instruments, as it is the only one that independently targets internal balance;
- (2) All three instruments can affect both the magnitude and the composition of aggregate expenditure and output flows in the economy;
- (3) While the Authorities have a monopoly in the supply of base money (currency and bank deposits with the Central Bank), in the absence of administrative/direct controls, they cannot control both the supply and price of money;
- (4) Since the price of money has two aspects to it, namely, the interest rate and the exchange rate, the Authorities can therefore set either the interest rate, the exchange rate, or the supply of base money, but not all three. As a result of this, monetary policy and

exchange rate management are intrinsically integrated. It would be pure “folly” for the Authorities to work from any other premise.

If this ABC of macroeconomic management is applied to a small, poor, open economy with the characteristics of those in CARICOM, the textbook case of this “policy trilemma” becomes literally a “***policy straightjacket***”. It may be asked at this stage: What are these characteristics of CARICOM economies to which I refer? These can be listed as follows:

- The Region's small size, and the integration of its financial and capital markets into world markets;
- The rapid process of global trade liberalization and its impact on the Region, which is still very dependent on preferential market access;
- The high cost and uncompetitive nature of its exports, which, without the economic rents obtained from their preferential marketing, cannot survive;
- The high frequency of external and internal shocks;
- The significant debt overhang in several countries;
- The high dependence on concessional flows, especially for infrastructural projects;
- Given domestic needs, the high opportunity costs of holding international reserves;

- The considerably restricted scope for direct intervention/moral suasion in domestic markets as a result of recent divestments;
- The high outward levels of migration, a large diaspora, and heavy dependence on remittances, repatriated skills, etc.;
- The frequency of systematic asymmetric information flows and serious principal-agent dilemmas—for example, borrowers know, by a large margin, more about a financial transaction than lenders; managers know more about the state of an enterprise than its owners; significant persistent gaps exist between budgets and actuals; and government statistics are irregular, secretive, and prone to manipulation).

Here, experience with the pre-independence currency board mechanism in which there was no attempt to resolve the “policy trilemma” is very useful and there could be no greater folly of contemporary macroeconomic management than failure to grasp the lessons of that experience - as seems to be the case with current flirtations in the Region with dollarization. Under the currency board mechanism, fixed exchange rates, free capital flows, and a domestic currency fully-backed by convertible currency holdings ruled out an independent or discretionary

monetary/fiscal policy mix. External balance was consistently achieved at the expense of internal balance, without regard to either its economic or social costs. In effect, therefore, we had a situation where:

- For reserves to run out, the domestic money supply had virtually to be reduced to zero – an improbable outcome;
- Balance of payments surpluses/deficits automatically induced monetary expansion/ contraction;
- The money supply was endogenous and the government could not monetize the public debt;
- There was no lender-of-last-resort.

We may go further and posit that in such a situation there was really no point in having a currency of one's own. Such a mechanism forms the basic appeal of contemporary proposals for dollarization, which are being discussed within the Region. Dollarization, it is claimed, will:

- Eliminate the risks of devaluation;
 - Reduce the costs of international borrowing;
 - Prevent the emergence of parallel markets and reduce demand/supply imbalances;
- (4) Remove the transaction costs of currency conversion.

Proponents recognize that there will be a loss of seignorage and reduced control over money laundering, but the benefits outweigh these.

On close examination it will be seen that dollarization, as proposed, understates **two** critical considerations. The first of these is that the working of its adjustment mechanism is faster and more surgical in its effect only if three conditions obtain: weak trade unionism; limited wage indexation; and considerable upwards **and** downwards flexibility of all prices. The truth is that none of these “favourable” conditions are to be found in the Region. And, in my view, at this stage of the Region’s development, it would require unacceptably large political and social costs to put them in place. Such conditions would require major reversals in the social and political gains of working people in the age of mass politics in the Caribbean.

The second consideration is that dollarization assumes that society is not only largely indifferent to the trade-off between employment and inflation, but that it **remains so even in a situation where an uncompromising “one or the other” approach would require a huge amount of trade-off loss.** Failure to recognize that uncompromising policies (like dollarization) are intrinsically unattractive as they would involve huge trade-off losses for the options (items) which are not preferred, in order to

minimize the loss of the preferred options (items) in the trade-off, could lead to disastrous macroeconomic management. Uncompromising policies ignore the consideration that the mathematical specification of the trade-off frontier would show a large pay-off for a small sacrifice of any one of the trade-off items (options) after a certain point. In concluding this section, let me give my assessment of the observed behaviour of CARICOM Authorities and their revealed preferences for the macroeconomic policies identified in the “policy trilemma”:

- First, a fixed exchange rate which is the centrepiece of macroeconomic management [ten countries practise this, while five others formally proclaim some form of floating. However, in reality, the latter five aspire to fixed rates and envy their other more “successful” counterparts];
- Second, open capital accounts [that is, the progressive removal of all forms of control on inward and outward capital flows, long-term and short-term] and the liberalization of trade in goods and services (Thomas, 2001);
- Third, a preference for monetary over fiscal policy in the policy mix.

In the context of a rapidly globalising world economy and strong pressures in favour of continued liberalization, the combined effect of these policy preferences is that the system of macroeconomic adjustment in the Region has been progressively reverting towards the currency board-type mechanism, whether intended or not.

Section 2: The Rationale

2.1 Why is there a revealed preference for a fixed exchange rate?

Before responding to this question, let me first point out some important practical aspects of the way fixed exchange rate management operates in the Region. These are:

- Fixed parities are maintained with the US dollar, which therefore permits depreciation/appreciation against third countries.
- The Authorities actively use their foreign exchange reserves to guard against currency speculation and to “sterilize” undesired effects on the domestic economy arising from outflows and inflows of foreign funds.

- The Authorities implicitly accept responsibility for the financing of the balance of payments. This is not left to private agents.
- Although regional foreign exchange reserves are increasing in absolute terms, they are becoming smaller relative to the size of the total value of foreign funds with the potential for rapid movement in and out of the area, even as domestic capital markets are becoming increasingly integrated into global financial markets. This situation not only limits the capacity of the Authorities to secure effective “sterilization”, but increases the exposure of regional economies to both current and capital account shocks in the balance of payments.

Given this background, the arguments advanced in support of a fixed exchange rate are grounded in some variation of the six claims listed below. Fixed rates provide:

- (1) An “auto-pilot” to guide the macroeconomy; [however, this means, given the integration of monetary management and exchange rate policy referred to earlier, the “auto-pilot” subordinates internal to external balance];
- (2) Through confidence, discipline, and fear of the political costs of abandoning fixed rates, the

Authorities are able to obtain better inflation control than would otherwise be the case. [We should note, however, (a) there is the question of the direction of causality: Could it be that countries with better inflation control are better able to maintain stable exchange rates? (b) When speculation does take place, for example in Jamaica, it is usually a destabilizing one-way option];

- (3) Given the effects on confidence and discipline referred to above, fixed exchange rates are better able to promote investment and economic growth. [Empirical evidence, however, indicates (a) that an incorrectly chosen fixed rate can slow productivity and growth and cause severe resource misallocation, (b) inability to use the exchange rate as an instrument of adjustment to shocks causes larger fluctuations in growth and employment levels than would otherwise be the case];
- (4) By fixing parities with the US dollar the Region directly benefits from the US commitment to a low domestic inflation policy. [If true, this admits the deflationary bias of fixed exchange rates in the Region];
- (5) Because of the growing tendency to denominate assets and liabilities in US dollars, exchange rate

stability (a) reduces the risk in the financial system, (b) lengthens the investment horizon, (c) reduces transactions costs, and (d) minimizes the risk of, or divergence between, market expectations about the exchange rate and economic fundamentals. [The experience of Jamaica, however, seems to contradict all this: financial collapse, short-term bias in assets, significant risks remaining, and masking of the foreign exchange risks to which corporate borrowers and domestic banks are exposed];

- (6) A fixed exchange rate makes fiscal policy extremely effective. [While true in theory, in practice the region does not rely on the routine use of fiscal policy as an adjustment instrument].

2.2 Why has the Region exhibited a revealed preference for an open capital account?

First, let me begin by pointing out some practical aspects of capital controls as they are practised. These include the fact that these controls:

- Represent the most common form of insulating the domestic economy from adverse consequences emanating in the global financial system;
- Have been placed on all types of capital flows (FDI, real estate, domestic banks, foreign exchange debt,

corporate and individual foreign exchange liabilities positions and assets, forward market transactions, and derivatives);

- Are permitted under current IMF Articles, and indeed the Fund can itself recommend their implementation;
- Have been rapidly liberalized within the Region.

The World Bank Development Report 1999/2000 cites the cases of Jamaica and Trinidad & Tobago:

“The speed and depth of capital account liberalization have varied across countries, however. Most countries have moved toward capital account convertibility as part of a wide-ranging, gradual economic reform program that includes measures to strengthen the financial sector. But Argentina, the Baltic countries, Costa Rica, El Salvador, Jamaica, the Kyrgyz Republic, Mauritius, Singapore, Trinidad and Tobago, and Venezuela have opened important parts of their capital accounts in one stroke.”

Separate research by Bennett (1999) and Doyle (1997) confirm the high level of capital mobility in the four large regional economies, including Barbados.

The argument in favour of an open capital account is that, like free trade in goods, it maximizes global welfare.

This, however, is a false parallel to draw because of well known systemic features of financial markets, which distinguish them from goods markets and those of other services.

2.3 Observations on The Existing Monetary/ Fiscal Mix

With regard to the third policy option, practice in the region has shown that fiscal policy, even when it includes an incomes and prices component, is administratively and legislatively far too inflexible for use as a macroeconomic stabilization instrument. This therefore rules out its practical usefulness. In addition, there are other major concerns with fiscal policy: recognition, implementation and impact lags in effecting fiscal changes; the fear some Authorities have of sending “wrong signals” to the rest of the economy; the possibility of anticipatory compensating private behaviour; fears of both “crowding-out” and “crowding-in” the private sector; and the complicated politics of frequent government spending/tax changes. However, in times of grave emergency, these drawbacks have been overlooked and contractionary fiscal policy (e.g. SAPs) has been resorted to as a draconian response. Because of its inflexibility, fiscal policy would seem more important for long-term structural adjustment than short-

period macro-economic adjustment. As a consequence, of this, there is, in the Region, a far greater reliance on the use of monetary rather than fiscal policy.

Section 3: The Global Economy

With this synopsis of the Region's revealed preference for policy options and their rationale, let us turn to the third issue we need to address, that is, how has globalisation impacted on these policy concerns? Over the past three decades, partly due to policy changes, fragmented national economic and financial systems have given way to a considerably more integrated global one. As a consequence, national economies and policies are increasingly being subordinated to the dictates of the global economy. In general, this subordination has been translated into the pursuit of certain "rules of the game" over wide economic areas of trade, finance and investment. Of immediate concern to us is the fact that in the area of finance, it is being claimed that the "rules of the game" will produce a situation where, with uncovered interest parity, domestic interest rates in the Region will more or less follow world rates or that of the country to which the local currency is fixed. This circumstance clearly anchors the exchange rate in the balance of payments and domestic price levels. It expects

that with capital and financial mobility, there will be a tendency towards convergence of local inflation and interest rates to the global interest and inflation rates, or that of the lead currency. In the case of the Caribbean, the lead currency is obviously the US dollar. Such an outcome, when it occurs, would signify the promotion of an optimal global allocation of savings, and thereby produce, in the real sector, a tendency towards the global convergence of levels of real income and its growth.

These outcomes, however, pre-suppose many improbable occurrences, including: (1) perfect information flows [no asymmetric flows]; (2) competitive markets and (3) stabilizing financial speculation based on managing future risks, as distinct from “gambling” based on minute-to-minute, day-to-day changes in asset prices. If, regrettably, market imperfection occurs, the aim should be to ensure that global policies are directed at the removal of these market imperfections. And if unsuccessful, it is advanced that global cooperation should aim at establishing a financial facility to act as “global lender-of-last resort” which would provide the liquidity needed to “oil the wheels” of this system and still encourage the Authorities to support “the rules of the game”. The implicit and explicit movement towards a fixed exchange policy, open capital

account and trade liberalization, which I have identified above, is driven in large measure by this global perspective.

Unfortunately, however, the observed behaviour of financial agents across global markets complicates this scenario. Thus we find that there have been:

- Surges in volatile hot-money flows of huge amounts of funds with marked indications of herding behaviour;
- Regular two-yearly episodes of sharp swings and reverse flows with strong “contagion” effects in the 1990s. [This is in contrast to the stabilizing speculation predicted by theory, and required to justify the rapid financial liberalisation, which has occurred];
- Intrinsically asymmetric information flows, as borrowers in general know more about their financial transactions than lenders. [This has given rise to moral hazard, adverse selection, herding, and “gambling” for redemption through desperately risky loans];
- A pattern of FDI flows which seem to reward countries for “pro-market liberalization” measures and punish others.

As regards the governance of the global financial system, we also find that:

- The burden of adjustment is asymmetric, favouring lenders over borrowers;
- There is a high degree of centralized control over decision-making;
- The issue of bailouts and the concern over moral hazard of providing these have arisen, leading to questions in some quarters (the US) about the very usefulness of the IMF and World Bank.

Important as these considerations are, the fundamental problems posed by globalisation go well beyond them. Over the past two decades the world has experienced a qualitative transformation of some of the fundamental economic categories with which we deal. Consider two examples: Is global trade today the same as yesterday? If we examine this paper closely, we would find that the rate of growth of global trade now exceeds that of global GDP and all regions are becoming more open, including those with traditionally large self-sustained economies such as the USA and China. In this expansion of trade, the rate of growth of trade in services has exceeded the rate of growth of trade in goods; the rate of growth of intra-industry trade has exceeded the rate of growth of inter-industry or

traditional trade; the linkage of trade to trade-related concerns in trade regulations—technology, environment, social/labour, intellectual property and competition, is phenomenal; and, the rate of growth of non-arms length trade has exceeded that of arms length or traditional trade.

The second example is the case of foreign investment. To what extent is this typical of previous periods? Now we find that most foreign investment occurs through Mergers and Acquisitions (M&As), with the latter far exceeding the former. Much of the growth is policy-driven, mainly through privatization and the relaxation of limitations against foreign ownership worldwide. Also, the overwhelming share of investment flows is among the OECD countries as compared to the traditional North-South flows of the past. Further, within the South, the bulk of investments is concentrated in a few countries which have comparatively higher rates of growth and expected returns, and where, therefore, there may be a lesser “need” for external inflows due to higher domestic savings.

Given such profound transformations, the cycle of promoting “market confidence” and the integration of domestic markets for finance, capital, goods and services into world markets, through trade liberalization, the removal of all capital controls and capital mobility, and fixed exchange rates narrow the economic (and

consequently the political) space for national control of the economy by the Authorities. In this situation, the opportunities for domestic change and reform lie more and more with vicissitudes in the operations of the global financial and trade architecture than with the domestic situation. At the same time, the Caribbean, being such a tiny Region, finds that the scope for its influencing global outcomes is severely limited.

As I have remarked elsewhere:

“This political situation contrasts sharply with the strong alternative mass-based politics Caribbean electorates have known for most of this century until the 1980s. Some portray this outcome as a mark of the growing sophistication of politics. To my mind, it is the opposite. Politics without mass involvement, and in which there are neither clear alternative options nor a strong national consensus in favour of one, represents a weakening of the democratic political culture. This the region can ill afford, in light of the massive problems that it presently faces. If this persists, politics will become shallow, symbolic, ritualized, and routinized. Formal democracy may widen to cover excluded minorities. It will not, however, deepen to embrace mobilization for development and economic and social equality.”
(Thomas, 2000)

Section 4: Conclusion

I have often asked the question at the end of a searching analysis: Is there a way forward? I do so once more and therefore ask: Is there scope for creating national space and autonomy in macroeconomic management? What I have said clearly suggests the need to re-think the policies of fixed exchange rates and open capital accounts, if we are to give some ease to the macroeconomic constraints that regional economies face. It is tempting to presume from this that a case for freely floating/flexible exchange rates has been made. It has not. Indeed, I think that freely floating exchange rates would be highly impractical in the Region today. What I believe, however, is feasible is for the Authorities to sustain what has been termed a "dirty float" or some approximation to it. As the term implies, a "dirty float" is a combination of intervention by the Authorities and reliance on private markets. What is sought is a rate flexible enough to respond to underlying economic conditions and so give some measure of autonomy for domestic monetary policy, but not so stable as to constitute a permanent deflationary bias. Such a policy places a high premium on the skill and judgment of the Authorities. There are, therefore, risks attached to it. In particular, there is the risk of "falling between two stools" and ending up

with the worst, and not the best, of both worlds, as is my intention in advocating this policy option.

As I have stressed in this lecture, there is a trade-off in the roles of the exchange rate as an instrument of macroeconomic adjustment and an indicator of international competitiveness, as well as a trade-off between monetary contraction/expansion and the nominal exchange rate depreciation/appreciation that occurs in response to changes in capital flows. Since the majority of the macroeconomic shocks in the Region have either been external or can be sourced to real changes in the domestic economy, some flexibility in exchange rates is to be preferred. This permits relative price changes to reallocate resources in response to shocks. A flexible rate has the advantage also of revealing the costs of unsustainable domestic policies more readily than a fixed rate does. This is because of the link of the exchange rate to domestic price movements. As such, this policy instrument expands not only the scope for autonomous monetary policy but gives the Authorities greater control over the real exchange rate than its fixed rate counterpart.

Although many of you here have argued for years that several products exported from the region are price takers, and prices of these will remain fixed in foreign currencies after exchange rate changes, variations in the domestic

currency equivalent will nevertheless occur, boosting or reducing domestic income. While it is true that this may eventually evaporate because of domestic price level changes, there are techniques that the Authorities can use to slow the process. Although inappropriate in the short-run, it is my belief that in the long-run it is plausible for some form of the “purchasing power parity” theory to hold; in which case, simply stated, the money supply can be held proportionately to the level determined by the world price (P_w) or that of the lead currency to which the exchange rate (E) is fixed, i.e (P_w/E). A fixed rate binds monetary policy to the price level of the world or the lead currency. With a floating rate, the exchange rate is determined more or less by the ratio of the lead currency/world price to the domestic price level. Monetary policy is more “free” to fix the money supply and therefore “set” the domestic price level. As the domestic price level changes relative to the world/lead currency price level, so does the exchange rate. Monetary policy cannot be used for domestic stabilisation if the exchange rate is fixed and capital is mobile.

In a recent study on this issue, I cited none other than the First Deputy Managing Director of the IMF, in relation to the Asian crisis:

"The crises in Thailand, Indonesia, Korea, Russia and Brazil, were all associated with exchange

rates that had become more or less fixed. Other hard-hit countries, among them South Africa, Mexico, and Turkey, used their exchange rates to absorb part of the adjustment burden, and suffered less." (Fischer, 1999, p2).

I pointed out there that an open capital account, combined with financial liberalization, tends to propel investments into riskier assets, because barriers to the entry of new firms are reduced and the increased competition lowers operating margins. In Jamaica, this helped to produce a severe banking crisis, weakened the entire financial infrastructure, hampered financial deepening, and has created much uncertainty. In Jamaica, also, the policy of fixed exchange rates has been tied to high interest rates for a long period. This circumstance presents speculators with a one-way option, as serious exchange rate changes can move in only one direction. This is a destabilizing situation, made worse by the already large sustained losses of growth and investment following the high interest rate policy pursued now for several years.

Capital controls designed to restrain short-term inflows to the carrying capacity of the financial infrastructure and to prevent their use as fuel for a consumption boom are, therefore, essential. Again, I do not seek to present here a call to revert to the capital control regimes of

the 1970s. These have proven to be administratively and politically unworkable. I am also not appealing for "sands in the wheel" of capital flows, as advocated by Tobin and others. The call here basically is for the Authorities to be selective and in fact "market-friendly" in their choice of controls.

"Market-friendly" capital controls seek to alter price incentives. These could include many elements. One set could be based on prudential and protective regulations for investors, e.g., the provision of adequate insurance and lender-of-last-resort facilities. Another set could be based on regulations governing open positions in foreign exchange-based transactions between residents and non-residents; the holding of external bond and equity issues; the liabilities of commercial banks in foreign currency and their short-term obligations to non-residents; and the status of non-performing loans in the banking system. A third set could be based on regulations governing transparency, corporate governance, the provision of adequate information for private markets to function efficiently, and for government to be informed so that preventative action can be taken when necessary. These regulations would also facilitate IMF surveillance, which is an international obligation.

Experience elsewhere suggests that it would be unwise to take a single menu approach towards the specific forms of capital controls. That experience also suggests that the best sequencing of these controls is to begin with the strengthening of the domestic financial system, through implementation of the necessary prudential, regulatory, accounting and data-dissemination standards. The next vital step would then be to establish good macroeconomic fundamentals. The third step would be to liberalize FDI flows. It is only after these steps have been taken that a policy of retention of capital controls on the short-term flows should be adumbrated. It would also be better for this sequencing to be pursued in periods of boom rather than in periods of downturn and crisis.

The mix of policies proposed in this presentation is linked to three related concerns. One is the area of “uncertainty” and “timing” which we all face in understanding and forecasting the workings of the economy and the “risks”, therefore, that are attached to the policies themselves. Diversification of policy instruments, following the “Tinbergen rule”, reduces risks based on the aphorism: *“We should not put all our eggs in one basket”*. The timing and sequencing of policy changes, to which we have already made some brief references, are also key.

The second concern is the social dimension of macroeconomic policy. This can be seen in a number of areas, but here I make reference to two: We must ask the questions, in terms of **priority-setting**: Do macroeconomic priorities reflect social objectives? And, in terms of **practice**: To what extent do the Authorities incorporate **social goals in a policy coherent manner**?

The third concern is that while stabilisation could contribute to growth, pursuing it in an uncompromising way could also impose its own costs in terms of growth. The evidence of excess liquidity locked up in the Central Bank of several Caribbean countries suggests that these costs could be significant – reflected in the suppression of demand, including import demand and investment. As I said before, uncompromising policies at this juncture of the Region's development are both theoretically and practically unattractive. It would be folly to behave as if they were otherwise.

The capacity of small, poor, open economies to pursue an alternative adjustment path that is more oriented towards growth and development depends less on the force or clarity of the reasoning behind it, than it does on the social, economic, and political forces that can be mobilized in its support. In this regard, it is worth bearing in mind

that structures of inequality, while demanding in themselves, can, through human intervention and policies, become structures of opportunity. The subordinated, weak, and exploited condition of these economies in today's world should not be interpreted as the end of the story, but the position from which they must now start.

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