GENERAL LC/CAR/G.715 3 March 2003 ORIGINAL: ENGLISH

Exchange Rate Regimes in the Caribbean

Table of Contents

Executi	ive Sum	mary	i		
Introdu	ction		1		
1.	The debate on exchange rate regimes				
2.	Perspectives on exchange rate regimes in the Caribbean				
3.	Exchange rate regimes in the Caribbean: the legal framework				
	3.1.	Members of the Organization of Eastern Caribbean States	15		
	3.2	Pegged exchange rate regimes in the Caribbean. The cases of Barbados and Belize	20		
	3.3.	Dual and multiple exchange rate regimes: Bahamas and Suriname			
	3.4.	Soft pegs exchange rate regimes: Guyana, Jamaica and Trinidad and Tobago			
4.	Nominal and real exchange rate trends				
5.	Exchange rate regimes and macroeconomic performance				
6.	A model to examine exchange rate policy in the Caribbean				

Executive Summary

This document analyses exchange rate regimes in the Caribbean subregion. Caribbean exchange rate regimes are typified into hard and soft pegs. Hard pegs refer to those arrangements that maintain a constant value of the domestic currency in terms of the currency of a major trading partner. The Organisation of Eastern Caribbean States (OECS) economies established a monetary union in 1983. The Bahamas, Belize and Barbados also fixed the value of their domestic currency in relation to the United States dollar in the middle of the 1970s. Soft pegs are monetary arrangements characterized by a forcefully managed exchange rate. Three countries are included in this category, Guyana, Jamaica and Trinidad and Tobago.

In the Caribbean, the choice of exchange rate regime responded, initially, to a development model based on foreign direct investment flows, fiscal subsidies and an import policy destined to encourage domestic production of final goods. In the soft peg cases, the choice of exchange rate regime was also a consequence of the adoption of stabilization-cum-structural adjustment policies at the beginning of the 1990s, following deep macroeconomic disequilibria in the previous decade. Currently, there is no consensus in explanations of the choice of exchange rate regime in the Caribbean. Nevertheless, a rationale can be provided both in terms of size of the economies and also in terms of their production structure.

The choice between a hard and a soft peg determines the degree and applicability of exchange rate controls. Hard peg countries have stricter controls especially on capital and visible and invisible transactions than soft peg countries. Over time, however, Caribbean countries have been gradually suppressing exchange rate controls.

A descriptive analysis of exchange rate trends shows that variations in nominal exchange rates for the soft peg regimes have subsided over time and that there is a clear sense on convergence, at least in terms of standard deviations. The decline in variability has not contributed to dampen the appreciation of real effective exchange rates, which remain at significant levels for some economies and which affect, their external competitiveness, especially in the case of resource-based economies.

A comparison of macroeconomic indicators for three decades (the 1970s, 1980s and 1990s) classifying Caribbean economies into three groups (small economies with a hard peg, large economies with a hard peg, and economies a with soft peg) shows that performance is heterogeneous among categories and time periods chosen. Nonetheless, the comparison indicates that hard peg countries have a greater tendency to accumulate debt and are prone to fiscal disequilibria.

Determining the conditions under which exchange rate regimes can be conducive to stability and growth complements this comparative analysis. Building on previous literature on the subject, this document addresses this fundamental issue and tries to provide a tentative answer using a model suited for small open economies.

Introduction

This document analyses exchange rate regimes in the Caribbean subregion. The traditional approach found in the literature on the subject classifies Caribbean exchange rate regimes into two opposing poles, namely fixed and floating. This document confirms that all Caribbean exchange rate regimes are, in fact, closer to the former than to the latter regime. They are, in essence, pegged regimes.

Following the recent debates on this issue, Caribbean exchange rate regimes have been typified into hard and soft pegs. Hard pegs refer to those arrangements that explicitly acknowledge the existence of a currency union or that maintain a constant value of the domestic currency in terms of the currency of a major trading partner. The OECS economies established a monetary union in 1983. The Bahamas, Belize and Barbados also fixed the value of their domestic currency in relation to the United States dollar in the middle of the 1970s.

Soft pegs are monetary arrangements characterized by a forcefully managed exchange rate. Three countries are included in this category, Guyana, Jamaica and Trinidad and Tobago. The exchange rate regime of these countries is labeled in the literature and in official publications and statements as a float. However, frequent Central Bank interventions, through direct monetary policy instruments such as variations in required reserve ratios or variations in international net reserves and via indirect means such as open market operations, prevent the exchange rate from floating. In fact this managed regime has implicitly created an intra-band, within which the exchange rate 'floats,' that has markedly narrowed in the last decade.

In the Caribbean, the choice of exchange rate regime responded, initially, to a development model termed "industrialization by invitation." The model was based on foreign direct investment flows, fiscal subsidies and an import policy destined to encourage domestic production of final goods. In the soft peg cases, the choice of exchange rate regime was also a consequence of the adoption of stabilization-cum-structural adjustment policies at the beginning of the 1990s following deep macroeconomic disequilibria in the previous decade. Currently, there is no consensus to explain the choice of exchange rate regime in the Caribbean. Nevertheless, a rationale can be provided both in terms of size of the economies and also in terms of their production structure.

In smaller economies there are sound arguments that favor a hard over a soft peg. In these economies the exchange rate is the nominal anchor and thus the vehicle to control costs and prices. In addition, smaller economies have a negligible non-tradable sector, their non-traditional exports are situated in enclave zones and the development of their traditional exports is hampered by internal obstacles rather than by external constraints. Moreover, export supply is not elastic to price changes. In the case of smaller economies that specialize in services, and in particular tourism, the marked seasonality of economic activity is an additional argument in favor of hard peg.

In the case of larger economies and, in particular, larger resource-oriented economies, the case for soft peg is stronger. Greater diversification in production and the positive response of the non-tradable sector to changes in the terms of trade provide a basis to justify switching expenditure policies through exchange rate adjustment.

The choice between a hard and a soft peg determines the degree and applicability of exchange rate controls. Hard peg countries have stricter controls especially on capital and visible and invisible transactions than soft peg countries. Over time, however, Caribbean countries have been gradually suppressing exchange rate controls.

A descriptive analysis of exchange rate trends shows that variations in nominal exchange rates for the soft peg regimes have subsided over time and that there is a clear sense of convergence at least in terms of standard deviations. The decline in variability has not lessened the appreciation of real effective exchange rates, which remain at significant levels, for some economies, and which affect their external competitiveness -especially in the case of resourcebased economies.

A comparison of macroeconomic indicators for three decades (the 1970s, 1980s and 1990s) for a typification of economies into three groups (small economies with a hard peg, large economies with a hard peg, and economies with soft pegs) shows that performance is heterogeneous among categories and time periods chosen. Nonetheless, the comparison indicates that hard peg countries have a greater tendency to accumulate debt and are prone to fiscal disequilibria.

Identifying the conditions under which exchange rate regimes can be conducive to stability and growth can complement this comparative analysis. Sir Arthur Lewis first addressed this issue in the context of Caribbean economies. Lewis centered on the 'adequate' external conditions. Building on Lewis, this document returns to this fundamental issue and tries to provide a tentative answer using a model suited for small open economies.

The document is divided into six sections. The first section presents the current debate on exchange rate regimes. The second centers on the choice of exchange rate regime for Caribbean economies. Drawing on International Monetary Fund (IMF) documentation, the third section describes the exchange rate restrictions of Caribbean economies. While some restrictions may have been modified or suppressed, the rationale underlying the section is to provide an overview of exchange rate restrictions according to different regimes. The fourth section looks at nominal and real exchange rate trends in the Caribbean. The fifth section analyzes macroeconomic performance and volatility of Caribbean economies classifying economies according to size and exchange rate regime. The final section specifies a model comprising 20 equations for smaller economies. The aim is to delineate the conditions under which an exchange rate regime is conducive to macroeconomic stability.

1. The debate on exchange rate regimes

Exchange rate regimes fall into two categories, fixed and floating exchange rate regimes. In fixed exchange rate regimes, governments set the value for the national currency in terms of a foreign currency. Maintaining a fixed value of one currency in terms of another requires intervention by the central bank and capital controls. Ultimately, the sustainability of a given fixed exchange rate will be governed by the market's perception of the state of the economy and by the orientation of economic policy. In the case of smaller economies with an underdeveloped capital market, the availability of international reserves plays a crucial role in maintaining a fixed exchange rate regime.

At the opposite end, in floating exchange regimes market forces determine the exchange rate. In turn, the exchange rate may be determined as any other 'normal' good. That is, it may be seen as the outcome of the interaction of flow supplies and demands. Alternatively, it may be determined like an asset in the sense that "its present value depends on expected future returns to holding assets valued in home or foreign money" (Eatwell and Taylor, 2000, p. 62).

In the first case, the focus of analysis is the trade account of the balance of payments. Capital flows are treated as 'exogenous shocks' (Hallwood and McDonald, 1994). This is easily illustrated through a theory known as the Purchasing Power Parity Theory, which in its absolute form states that a good must have the same price in different countries when corrected for the exchange rate. Letting P and P* denote the domestic and foreign price of a good or a composite good and e the spot exchange rate,

(1) $P = eP^*$

If $P > eP^*$, the price for the good in the domestic market exceeds that of the foreign market opening the possibility of making capital gains by buying in the foreign market and selling in the domestic market. This process will bring about the required equality by changes in e or in P and P.

Two other early approaches that viewed exchange rates as determined by 'normal' good supply and demand flow curves are the elasticities and the absorption approaches.

According to the first approach, a situation of excess supply over demand of foreign exchange leads to an appreciation of the exchange rate. This lowers the price of imports for the home country increasing the demand for foreign exchange. At the same time, an appreciation of the exchange rate increases the price of the home country exports in the foreign country. As a result the supply of foreign exchange declines. Provided stability conditions are satisfied, the balancing of supply and demand will ensure a tendency towards equilibrium in the foreign exchange market. Within this framework, capital inflows or outflows are viewed as external shocks without altering the mechanism by which the demand and supply for foreign exchange are brought into equilibrium. An argument put forward to establish the conditions under which the foreign exchange market is stable (i.e., a change in the exchange rate is not cumulative) is the Marshall-Lerner condition. It states that the foreign exchange market will be stable if the sum of the export and import elasticities of national and foreign demand is greater than one. Another argument put forward in favor of stabilization is the 'stabilizing speculator' argument put forward by Milton Friedman (1953). According to Friedman (1953, p.175), speculation could be a destabilizing activity if speculators sold domestic currency when the price of the currency is low and bought domestic currency when its price is high. But this would be equivalent to saying that speculators do not maximize profits and in fact lose money.

The other approach dealing with the trade account is the absorption approach The starting point of the absorption approach is a simple national account identity stating that income (Y) equals consumption (C), investment (I), government expenditure (G), and exports (X) minus imports (M). That is,

(3)
$$Y = C + I + G + (X-M)$$

Substracting consumption (C), investment (I) and government expenditure (G) from both sides of the identity, it obtains that the difference between income (Y) and expenditure (C+I+G) equals the trade balance result,

(4) Y-(C+I+G) = X-M

An excess of expenditure over income ($Y \le (C+I+G)$) implies that the trade balance is in deficit (X-M ≤ 0). The recommended policies to correct the trade balance deficit include expenditure switching and expenditure reduction policies.

Neither the elasticities nor the absorption approach pay particular attention to capital flows. The adoption of market oriented policies, liberalization and technological innovation, changed the focus of the debate on exchange rate determination from the trade account to the capital account leading to the view of the exchange rate as an asset price.

An early exposition, by no means outdated, is that of Keynes (1923). According to Keynes, the premium on the exchange rate (i.e., the difference between the forward and the spot exchange rate) is equal to the difference in the rates of interest,

(5) $i - i^* = (f-s)/s$

Where,

i = home interest rate
i* = foreign interest rate
f = forward interest rate
s = spot interest rate

Other complementary and alternative approaches to asset exchange rate determination include the portfolio approach and the efficient market hypothesis. A main issue that the asset approach must tackle is to define the determinants of the exchange rate premium. In particular relevant aspects of the issue in the literature concern the role, if any, of 'fundamentals', the degree of efficiency of the foreign exchange rate market, the transmission mechanisms of an asset determined exchange rate to the trade account and to real variables.

In practice the divide between fixed and floating exchange rate regimes has been nebulous in part due to the announced intentions of the authorities ('de jure' exchange rate regimes) and the actual course of events ('de facto' exchange rate regimes).¹ Despite all the arguments defending the virtues of free exchange rate regimes countries have tended, with a few exceptions, to adhere to a variant of fixed exchange rate regimes (See Table 1).

Country	Period	Probability the monthly per cent change	
		in nominal exchange rate falls within	
		+/-1 % band	+/-2.5% per cent band
United States \$DM	Feb. 1973 - April 1999	26.8	58.7
Japan	Feb. 1973 - April 1999	33.8	61.2
Australia	Jan. 1984 - April 1999	28	70.3
Bolivia	Sept. 1985 – Dec. 1997	72.8	93.9
Canada	June 1970 - April 1999	68.2	93.6
India	March 1993 - April 1999	82.2	93.4
Kenya	Oct. 1993 - Dec. 1997	50	72.2
Mexico	Dec. 1994 - April 1999	34.6	63.5
New Zealand	March 1985 - April 1999	39.1	72.2
Nigeria	Oct. 1986 - March 1993	36.4	74.5
Norway	Dec. 1992 - Dec. 1994	79.2	95.8
Peru	Aug. 1990 - April 1999	45.2	71.4
Philippines	Jan. 1988 - April 1999	60.7	74.9
South Africa	Jan. 1983 - April 1999	32.8	66.2
Spain	Jan. 1984 - May 1989	57.8	93.8
Sweden	Nov. 1992 - April 1999	35.1	75.5

Table 1The fear of floating

预览已结束,完整报告链接和二维码如下:



