

Staying the Course

by Donald J. Harris

Current talk about a supposed need for revaluation of the Jamaican dollar should be a cause for alarm. At the same time, recurring expressions of self-congratulation over the net international reserve position (NIR) have not made the situation any better by contributing to a false sense of security over the state of the macroeconomy. I should hope the monetary authorities will be able to preserve a more balanced long-term view and not be stampeded into short-term measures and palliatives.

The fact is that revaluation of the Jamaican dollar would be exactly the wrong policy to pursue at this time. In effect, it would amount to wiping out the gains already achieved from the existing policy of "holding the line", following upon the previous phase of sharp devaluations and associated economic instability.

The Key Principle of Policy

In considering the appropriate policy towards the exchange rate, the key principle is: preserving the alignment of the exchange rate in relation to the **fundamentals** as reflected in the **real exchange rate (RER)**. The RER is, strictly speaking, a measure of the real value of the tradable goods and services that the economy produces. It is determined by the price of what those goods and services cost in Jamaica's trading partners relative to Jamaica's domestic costs and prices. A standard measure of RER is the **nominal exchange rate (NER)** multiplied by this price ratio. The NER is the market rate quoted in daily transactions at the commercial banks and reported in the newspapers.

The NER is one of the main policy instruments for managing adjustment to the fundamentals. (Others are: fiscal and



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monetary policy, income and price policy). It is also one of the economic indicators most closely watched by all economic agents in a foreign-exchange sensitive economy like ours. The action of those agents, in line with their expectations about likely movement in the exchange rate in a situation of perceived misalignment, can itself produce large movements in the rate and create turmoil in the foreign exchange market. The experience of our neighbor Mexico in the past few weeks should be a dramatic reminder to us of exactly how this process works.

That expectations do play a powerful role in the foreign exchange market is a matter that cannot be overemphasized. In the present day context of highly computerised global trading in currency markets, the effect of such expectations operates at the speed and volume of electronic signals sent from computer terminals all over the world. The effect is almost instantaneous. Any finance minister is in peril for ignoring this basic and simple point. Many have gone down the drain on account of it. Minister Jaime Serra Puche of Mexico is the latest casualty.

Increase in NER (devaluation) is warranted when domestic costs rise in relation to international costs. Decrease in NER (appreciation/revaluation) is war-

ranted in the reverse situation, i.e. when domestic costs fall in relation to international costs. The need for such adjustment, of one type or the other depending on the particular situation, arises precisely because of (a) movements in the current account brought about by response of exports and imports to a situation of overvaluation or undervaluation of the exchange rate in relation to the underlying structure of relative prices, or because of (b) movements in the capital account due to capital inflow/outflow in response to relative interest rates and risk factors.

Jamaica's Experience

As regards the adaptability of Jamaican exchange rate policy to the underlying fundamentals, my analysis of data for the last 30 years indicates a mixed record of performance. The results are shown in the accompanying Figure 1 in terms of the relation between the RER and NER. In general, it appears that there is an overall tendency of inertia in the NER. However, since 1987, sizeable adjustments have been made in the NER so as to bring about closer alignment with the fundamentals.

The Jamaican record of performance in this respect is certainly not as good as that of Costa Rica where the monetary authorities have been much more adept in biting the bullet from very early on, with a sharp devaluation of some 33% during the crisis of 1981-2 and a continuing devaluation (or crawling peg) every year since then up to the present. The record is, however, better than that of Barbados where the authorities have stuck to a policy of holding constant the NER for the past 25 years or so, attempting to use fiscal policy along with wage and price policy to defend this rate, while in the process the economy has lost international com-

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petitiveness in the major sectors of exports.

Furthermore, my analysis indicates that these very adjustments in the exchange rate have been an important determining factor in the growth of exports in Caribbean countries (IDB Working Paper, 1995). Specifically, in a sample of five countries (Barbados, Costa Rica, Dominican Republic, Jamaica, Trinidad & Tobago), considering their performance over the past 27 years, a six percent real depreciation added, on average, an estimated one percent to the growth rate of total exports of goods and services. In the particular case of Jamaica, the effect was even larger, more than twice the average. As one would expect, the effect also varies across different categories of exports. The most responsive sectors are tourism and non-traditional exports, in both manufacturing and agriculture. It is to be expected, and straightforwardly clear on economic grounds, that the response would be greater in sectors where domestic input costs are a high proportion of total costs and demand is relatively price-elastic.

Accumulated results from research on other developing countries confirm this picture. In general, effective management of the exchange rate is one of the key factors that determine export performance. The experience of the East Asian countries, in particular, has been shown to conform very much to this general rule.

Fragility of the Present Situation

The present situation of the Jamaican economy is based upon a rather fragile balance of macroeconomic forces (exchange rate, interest rate, inflation rate, fiscal balance) which has allowed for the recent improvement in the NIR position. The underlying fragility is due, in part, to the uneven situation among the main categories of exports and overall slowdown in export growth. In particular, the sectors of tourism and apparel have turned in

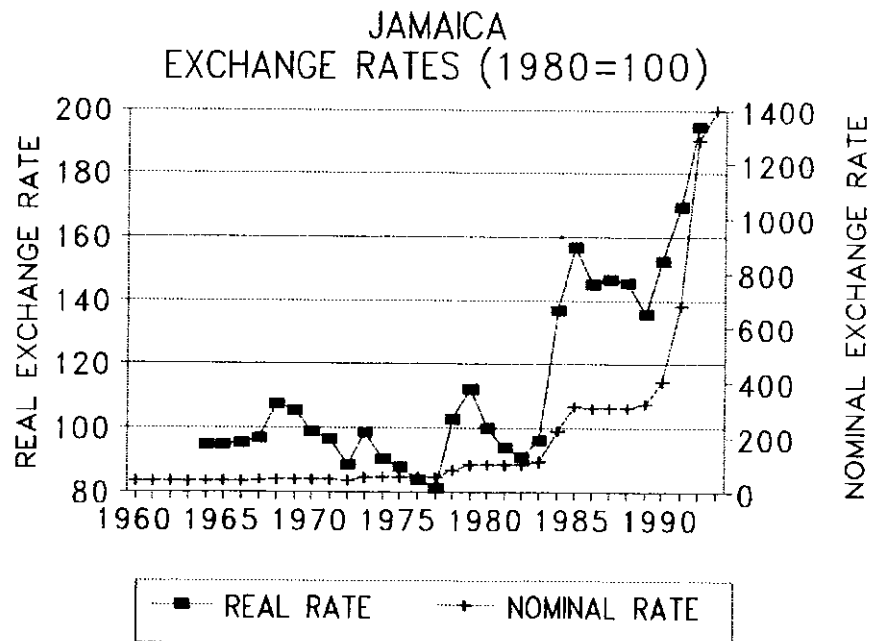
rather weak performance so far and the prospect of an early improvement are not too good. A revaluation of the currency at this time would have a disastrous effect on these sectors, especially because of the recent devaluation of some 40 percent in Mexico, Jamaica's greatest rival for the North American market.

The persistence of high inflation, at the estimated level of about 27 percent annual rate this past year, despite the success in bringing the rate down from the record high of 80 percent in 1991, is another major source of fragility. Continued inflation at this rate is having the effect of undermining a crucial element of the fundamentals, namely Jamaica's relative costs and prices vis-a-vis its trading partners and competitors. This is apparent from examining comparative annual inflation rates in the rest of the world. In the OECD countries, the inflation rate has been running at a low 2.2 percent on average in 1994 and is pre-

dicted to rise to a mere 2.8 percent on average in 1995. Inflation rates for selected individual countries are shown in the accompanying Table 1. It is evident that Jamaica's rate is far above that of all other countries in this sample, about seven and a half times the average for this group. There is no reason to suppose that Jamaica's productivity performance is any better than these countries; in fact, all indications are that the overall level of productivity has been stagnant or declining. It must be concluded therefore that Jamaica's relative cost position in the international economy is deteriorating.

A third source of fragility comes from the prospect of a reduction in capital inflows if interest rates continue to rise in the US and elsewhere and rates continue their recent downward trend in Jamaica. In this respect, ironically, success in reducing interest rates may have the short term effect of undermining macroeconomic balance. But in the long run, it is a necessary requirement for increased investment in exports which is the only

Figure 1



Source: Calculated from data-bases of IDB, IMF, and BOJ, by D. J. Harris.

EXCHANGE RATE POLICY: (CONTINUED)

solid basis for significant improvement in the chronic balance of payments deficit.

Because of this underlying fragility, it must seem doubtful to keen observers that the present economic situation is sustainable for long, in the absence of some significant turnaround in export earnings, in inflation, or in capital inflows. If there is indeed real cause for such doubt, a revaluation of the currency now would definitely compound the problem. Specifically, it would heighten the expectation of a bigger subsequent devaluation when it turned out that the revalued rate cannot be sustained. Here is where the expectation effect would begin to bite with a vengeance. The action of economic agents in keeping with that expectation would force a subsequent devaluation, making it into a self-fulfilling prophecy.

Thus, to pursue a policy of revaluation at this time seems terribly short-sighted at best. At worst, it would have the effect of throwing the economy back into a state of heightened uncertainty and risk and reduced international competitiveness, which is the very opposite of what is needed to build up a momentum of long-term growth through investment in export expansion.

The challenge to the policy-makers at this moment is to keep a sharp focus on the long-term goal. Let them not be distracted by quick fixes that undermine the possibility of

Comparative Inflation Rates, 1994

Countries	Rates
Britain	2.6
Canada	-0.1
Germany	2.7
Hong Kong	8.4
Jamaica	26.7
Japan	1.0
Malaysia	3.3
Mexico	6.7
Singapore	3.9
Taiwan	6.3
U.S.A.	2.7

Source: The Economist, Far Eastern Economic Review, Business Mexico Bank of Jamaica.

achieving that goal.

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