Central Banking in the Context of a Highly Indebted Caribbean Economy

XXVII Adlith Brown Memorial Lecture

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ACKNOWLEDGEMENT

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Remembering Adlith Brown

- Described as being of Jamaican birth but a Caribbean woman.
- Educated at UWIMONA AND Mc Gill University; taught International and Monetary Economics at UWISTA and UWIMONA; Senior Research Fellow at ISER; significant body of Caribbean Policy Research; ED of RPMS.
- Personal recollections of teaching, mentorship, scholarship and joie de vivre.
- Deeply honoured to be asked to follow the pantheon of Caribbean scholars in honouring her memory.

Outline of Presentation

- Current trends in delineating the “appropriate” roles and functioning of central banks.
- Economic reality and the challenges for central banking in the Caribbean.
- Are central banks acting “appropriately” within their contextual reality?
- Are there any other considerations to inform the functioning of central banks?

The Unique Character of Central Banking

- The mystique of central banking; often best understood by people who work in central banks but then often so imperfectly.
- The most difficult concept: “What exactly do you mean by Central banks can create money out of thin air?”
- Seigniorage, quasi-fiscal operations and reattachment to public understanding through “inflation tax”.
- So central banks are powerful institutions but “who voted for them anyway?” and should they be more independent or less independent with all that power?

The Theoretical Impact of Money in Short and Long Run

- It is generally conceded that prices increase proportionately with the money stock in the long run; therefore managing money supply growth manages inflation and preserves the value (purchasing power) of currency.
- In the short run, monetary fluctuations may influence interest rates, exchange the level of aggregate demand and economic activity.
- Central banking is not a "zero sum game."

Expectations and Nominal Targets

- The short run impact of money on economic activity is significantly exacerbated by the role of expectations; e.g. re prices, interest rates and the exchange rate.
- To manage expectations, monetary policy seeks to attach itself to the achievement and maintenance of a single easily understood objective; a “nominal anchor” for expectations.
- Nominal anchors have included monetary, exchange rate and inflation targeting.

Monetary and Exchange Rate Targeting

- Monetary targeting was "legitimized" by the monetarist tradition of the long run neutrality of money and Milton Friedman's commendation of rules over discretion.
- Monetary targeting was undermined by fluctuations in and uncertainty regarding the money multiplier and the demand for money.
- An exchange rate anchor: promoted by "Bretton Woods" and attractive option for small open ex-colonial economies with conservative monetary arrangements.
- The exchange rate peg vs. real competitiveness and speculative attack.

Inflation Targeting (IT)

- Monetary “misbehaviour” in OECD countries and speculative threat to foreign exchange rate pegs in 1970s -80s .
- Inflation Targeting pioneered by the New Zealand “Policy Targets Agreement” contractual model (with an independent central bank).
- Really “Inflation Forecast Targeting” recognizing lags in effect of monetary policy and on the basis of a (e.g. Taylor) rule.

“Pure” Central Banking and Strict Institutional Specialization.

- Central banking exclusive focus on inflation in a context of deliverables from other specialized institutions.
- An absence of “fiscal dominance”.
- Relative to post “great recession”, OECD economies were not heavily debt burdened.
- Taking debt management and financial supervision out of central banking.
- Inflation targeting and the meaning of central bank independence (instrument vs target and independent oversight)

An Obituary for Inflation Targeting

Jeffrey Frankel (Kennedy School, Harvard University):

- ***"It is with regret that we announce the death of inflation targeting. The monetary-policy regime, known as IT to friends, evidently passed away in September 2008. The lack of an official announcement until now attests to the esteem in which it was held, its usefulness as an ornament of credibility for central banks, and fears that there might be no good candidates to succeed it as the preferred anchor for monetary policy."***

Circumstantial Suspension of Inflation Targeting

- Did inflation targeting and “market fundamentalism” miss the threat of asset price bubbles?
- Inflation targeting and the tightening of monetary policy in face of adverse terms of trade shocks.
- Inflation targeting vs. quantitative easing (QE).
- New debt in OECD economies.
- Targeting “nominal GDP”?
- Caution from Carney : Monetary vs fiscal stimulus; timing and lags; threat to policy credibility.
- Inflation targeting and “pure central banking” in the short to medium term.

Blinder: Central Banking in Crisis

- Financial sector crisis change central banks’ time horizon from 2-3 years to immediate and shifts focus from inflation to financial stability.
- Collaboration with treasury accentuated: rapid deployment vs. political legitimacy.
- Central bank’s imperative to preserve balance sheet integrity in a context of quasi-fiscal ops.
- Political legitimacy required for decisions of which financial institutions shall live and which shall die.

Stylized Characteristics of Caribbean Economies.

- Small (island) developing states with small domestic markets and limited natural endowment.
- Highly open economies dependent on a narrow range of primary based exports and susceptible to terms of trade shocks.
- Highly vulnerable to natural disaster and economic shocks.
- Many Caribbean economies are highly indebted resulting in economic growth retardation.
- Incidences of poverty, unemployment and social underdevelopment.

Economic Impact of Hydro –Meteorological Events in Jamaica (2001-2010)

EVENT	Year	Category	US ($M)	Impact (% GDP)
Hurricane Michelle	**2001**	**4**	**54.7**	**0.8**
May/June Flood Rains	**2002**	**-**	**50.9**	**0.7**
Hurricane Charley	**2004**	**4**	**7.2**	**0.02**
Hurricane Ivan	**2004**	**3**	**601.6**	**8.0**
Hurricanes Dennis & Emily	**2005**	**4**	**95.7**	**1.2**
Hurricane Wilma	**2005**	**5**	**57.6**	**0.7**
Hurricane Dean	**2007**	**4**	**344.6**	**3.4**
Tropical Storm Gustav	**2008**		**212.6**	**2.0**
Tropical Storm Nicole	**2010**		**235.7**	**1.9**
Total				**2.0**

An Unholy Triumvirate

- It is established and generally accepted that in small open economies, only two of the following three may coexist:

a) Independent monetary policy.
b) An exchange rate peg.
c) An open capital account (no capital controls).

- Countries with peg cannot pursue independent monetary policy without exchange control.
- Countries pursuing independent monetary policy cannot fix the exchange rate (in a context of an open capital account).

Monetary Arrangements in Caribbean Economies

- Exchange rate pegs vs. managed floats
- Objective to promote and maintain monetary stability
- Objective to promote and maintain financial system stability – regulation of deposit taking.
- Economic development, primarily through the management/influencing of credit allocation.

The Implications of “Stylized Characteristics” for Deficit/Debt

- Small domestic markets and narrow resource base limits taxable capacity (border tax dependence)
- Fixed costs of public administration in small populations.
- Extreme economic vulnerability from narrow base export dependence, natural disaster and global warming.
- Economic growth capacity constrained by elevated public indebtedness.

The Costs of Financial Regulatory Failure

- Jamaica’s mid-90s financial crisis cost 40% of GDP and drove Debt/GDP from 80 to 140%.
- The pan Caribbean impact of the CL Financial/BAICO failure.
- The social and potential public financial costs of UFOs.
- Potential financial costs of potential failure of indigenous banks.

Cash Accounting and Quasi-Fiscal Losses

- Cash accounting records expenditure when undertaken and ignores accounts payable.
- Cash accounting therefore encourages improperly recorded debt accumulation through “deferred financing” and payment arrears accumulation.
- Quasi-fiscal expenditure through the central bank and public enterprises disguises debt accumulation.
- New PPP initiatives have to be constrained by medium to long term debt sustainability considerations.

The Impact of the "Great Recession"

- Decline in economic growth rates after 2008.
- An increase in Caribbean sovereign spreads and threat of financial system instability.
- Reduced foreign exchange inflows from exports of goods and services, foreign direct investment and remittances.
- Heightened inflation and threats to exchange rate stability.

Trends in Public Debt/GDP% in the Caribbean

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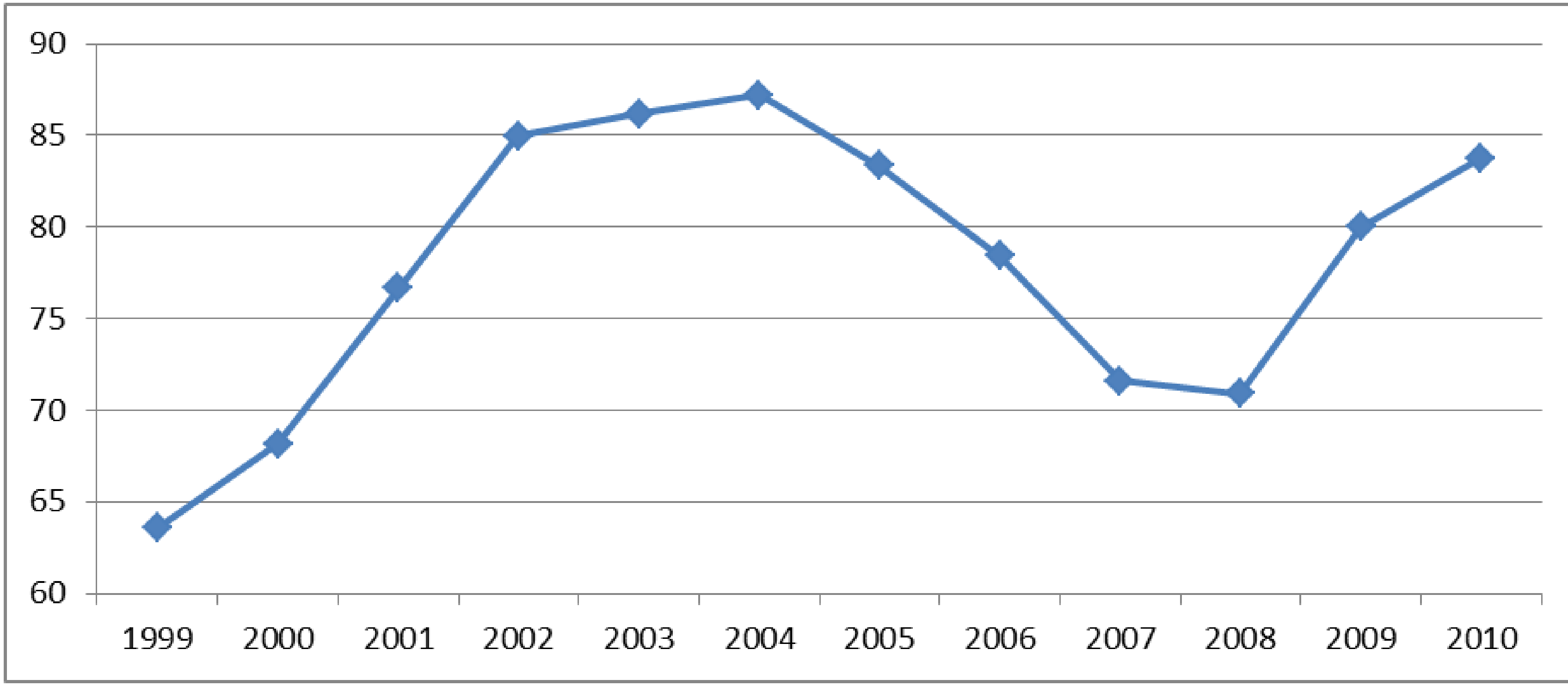

Impact of “Great Recession” on Public Indebtedness

General Government Gross Debt (% of GDP)			
Country	**2007**	**2009**	**2010**
Antigua and Barbuda	79.2	102.5	90.8
Barbados	53.2	63.9	72.6
Belize	85.7	84.4	84.4
Dominica	73.0	64.2	69.9
Grenada	89.5	97.7	104.3
Guyana	59.9	64.8	65.3
Jamaica	114.6	139.4	140.8
St. Kitts and Nevis	134.0	148.5	163.9
International Monetary Fund, World Economic Outlook Database, April 2013			

GDP (%) of Selected Caribbean Economies, 2007-2012						
Country	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Antigua and Barbuda	7.1	1.5	-10.7	-8.5	-3.0	1.6
Barbados	1.7	0.3	-4.1	0.2	0.6	0.0
Belize	1.2	3.8	0.0	2.7	1.9	5.3
Dominica	3.9	7.8	-0.8	0.7	1.9	0.4
Grenada	6.1	0.9	-6.7	-0.4	1.0	-0.8
Guyana	7.0	2.0	3.3	4.4	5.4	3.3
Jamaica	1.4	-0.8	-3.1	-1.4	1.4	-0.5
St. Kitts and Nevis	4.8	3.9	-4.2	0.0	-1.9	-0.9

International Monetary Fund, World Economic Outlook Database, April 2013

Regulatory Challenges in the Caribbean

- Traditional central bank focus on “deposit taking” misses emergent problems elsewhere.
- Temptation to see central banks and indigenous banks as development financial institutions (monetary vs fiscal resources).
- Question of appropriate financial regulatory architecture (all-in, all-out or some in-some out)
- Central bank “forward looking” responsibility for systemic financial stability.
- Systemic risk avoidance vs. financial market development.

Institutional Architecture for Debt Management

- Barbados and Jamaica, debt Management is the responsibility of the Ministry of Finance.
- In Barbados, medium term fiscal strategy was crafted in consultation with central bank and the debt advisory committee includes the central bank.
- In Jamaica the public debt management committee includes membership of the Governor.
- In the ECCU, Debt Management is the responsibility of the individual governments.
- ECCB eight point stabilization plan incorporates a debt management programme and EC Debt Management Strategy 2013-2015 references close technical collaboration with ECCB

Contextual Challenges to “Pure” Central Banking.

- Diseconomies of small size re adequacy of human resources for strict institutional specialization (exacerbated by migration).
- Disproportionate remunerative capacity of central banks in attracting and retaining high quality human resources.
- The reality of “fiscal dominance” and “unsustainable” public debt.
- The need for political “legitimacy” in making tough calls in the financial system (Blinder)
- The availability of qualified, independent, disinterested non-central bank monetary policy committee oversight in small societies.

The Monetary Union Option

- Theoretically (but not practically) attractive as means of incentivizing fiscal discipline.
- Relative success in the ECCB has not eliminated systemic threat from sectional fiscal looseness and financial system weaknesses.
- Diverse monetary arrangements have evolved and may each be appropriate to national circumstance.
- The end of fiscal dominance and establishing debt sustainability remain as essential pre-conditions.
- In the face of exogenous shocks, fiscal federalism remains an essential condition for sustainability.

Additional Recommendations

- In the short to medium term, during a period of fiscal dominance, the central bank should rank immediate priorities and pursue policy coordination. Priorities may involve:
  - Fiscal consolidation/ debt management
  - Financial system stability
  - Financial market development
  - growth
- Central Bank should sequentially work through the priorities

Summary Observations on Central Banking in the Caribbean

- Individual Caribbean central banks are pursuing operational models largely appropriate to their circumstances.
- Differences of circumstances are for the most part influenced by differences in natural characteristics (including population size) and of historical fiscal responsibility.
- Despite these differences and the formal differentiation between peg and managed float, all have considered relative exchange rate stability to be a desirable objective.