

THE PARALLEL FOREIGN EXCHANGE MARKET .  
THE JAMAICAN EXPERIENCE

by

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1. BACKGROUND

During the period of the 1960's the Jamaican economy experienced positive growth. It grew consistently in real terms at an annual average rate of 6 per cent while the average annual rate of inflation was some 5 per cent. The balance of payments position was strong given the significant inflows in foreign exchange earned from bauxite, alumina, tourism and sugar sales. These inflows facilitated increased capital formation and the expansion of the local productive sectors. This comfortable level of foreign exchange reserve position covered in excess of three month's supply of imports.

Following this period of rapid growth, Jamaica experienced negative growth during every year from 1974-1980, by which time real G.D.P. declined by 18 per cent below the 1973 figure. The following wide range of economic, climatic and political factors contributed to the decline.

There was the unprecedented increase in oil prices, which caused Jamaica's oil import bill to more than double during the period. Grains and other imported commodity prices also increased, consequently there was a significant increase in the overall import bill. Additionally, the international recession reduced world demand for bauxite and alumina, the country's major earners of foreign exchange. World interest rates also increased during the period and had the effect of increasing the country's debt service payments.

A number of internal factors also contributed to this acute shortage of foreign exchange. There had been increasing demand for a wide range of consumer goods which is a result of the North American type consumption pattern that Jamaicans have developed over the years. Furthermore, most of the producers in the manufacturing sector are net users of foreign exchange, consequently any increase in production in this sector will result in increase demand for foreign exchange. In addition, the productive sector is not fully integrated; backward and forward linkages between the various sectors are limited and in some instances non-existent.

Rather, these local sectors are more integrated in the North American productive system which place them into a vulnerable situation. They are exposed to the ravages of international recession which usually have a devastating effect on their operations. The period was marked by the levels of production caused by unfavourable weather conditions such as severe droughts between 1976 and 1980 and the ravages of Hurricane Allen in 1980. Weak management policies both in the private and public sectors prevailed. There was a high degree of political uncertainty and during the period surrounding the 1980 General Elections a considerable increase in the flight of capital was experienced. Finally, although the tourism sector had been earning substantial amounts of foreign exchange, the degree of leakage was considerably high with reduced amounts of these funds entering the banking system.

Given the considerable increase in demand for foreign exchange and the acute shortage of this commodity, a number of measures were implemented by the authorities in an attempt to solve the problem.

There was substantial foreign borrowing during the period (see Table I). The country utilized all the available facilities of the International Monetary Fund, by borrowing US\$797.1mm. between 1976-1982. In addition US\$693.2mm. were borrowed from other international lending institutions. Export incentive schemes were implemented aimed at increasing export earnings while import substitutional industries were established to reduce import dependence. In an effort to manage the limited resources available, Foreign Exchange Budgeting was instituted by the Central Bank in 1977 while exchange controls were significantly intensified.

## 2. EXCHANGE RATE POLICY

In 1977 Jamaica adopted a dual exchange rate policy designed to:-

- (a) provide positive incentives for the expansion of the productive sector;
- (b) avoid the adverse effects of a unitary devaluation;
- (c) make exports continue to be competitive on the world market and
- (d) to reduce the burden on the Government's budget.

The then existing exchange rate (US\$1.00 = J\$0.9091) became the "basic" rate. However, all purchases and sales of foreign exchange by the Government and the bauxite and alumina companies were transacted at this rate. All other foreign exchange transactions took place at the "special" rate fixed at US\$1.00 = J\$1.25, representing a 27.5% devaluation of the special rate from the existing rate.

In May 1978 these rates were unified at US\$1.00 = J\$1.55 which resulted in a devaluation of 47.5 per cent of the basic rate while the special rate was devalued at 14.8 per cent. Along with this, monthly crawling peg devaluations of between 1.0-1.5 per cent and totalling 15.0 per cent were instituted over the twelve month period to May 1979 when the single rate of exchange of US\$1.00 = J\$1.781423 was established. (See Table II).

Over the years the increasing exchange control regulations and the uncertainty regarding the future value of the Jamaican dollar led to a thriving "street market" for foreign currency (mostly U.S. dollars) at rates over and above the official rate of exchange. The funds generated into this market are believed to be supplied by:-

- (a) The recycling of capital which left the country in previous periods;
- (b) Illegal exports;
- (c) Leakages from official inflows, particularly from the tourist sector;
- (d) Diversion of migrant remittances from the official system.

## 3. REGULATION OF THE "STREET MARKET"

The authorities realized that the "street market" for foreign exchange had become an integral part of the institutional framework and would continue to be so for a long time unless the foreign exchange situation improves considerably within the banking system. The pool of remittances in this market was estimated to be in the region of several hundred million United States Dollars.

The authorities therefore aimed at tapping this source of foreign exchange channels into the banking system where it would be utilized for the purchase of raw materials, capital and other urgently needed basic commodities needed for economic development. It was then decided to establish a type of mechanism that would tap this foreign exchange resource "informal" foreign exchange market free from Central Bank control but subjected to Government existing trade policies was established. The "no funds" licensing system was introduced and a source of financing imports. However, the system did not gain full acceptance by some members within the mercantile community since they felt that they would be exposing themselves to investigation and possible prosecution under the Exchange Control Act. Consequently, in November 1980 the Bank of Jamaica, under the Act granted "no funds" licences for high priority imports. Licences issued under this scheme for 1980 were valued at US\$140mn. or 6.4 per cent of total value of licences issued for that year.

In April 1981 the Act was further amended to allow "approved importers" to open "Special Retained Accounts" in foreign exchange at local commercial banks into which they could deposit foreign exchange secured from other than official sources on a "no-questions-asked" basis with the understanding that these funds would be free from Central Bank control. It was then understood that these accounts would be financed by offshore funds or by the street market dollars, not from export proceeds or loan funds. Once permission had been given by the Central Bank for an account to operate, the importer proceeded to make arrangements to bring in goods which were financed from this account without reference to the Central Bank. For these transactions, no licences were required only for items restricted under the Trade Act. In 1981 no-funds licences (including the bauxite and alumina sector) accounted for US\$353.1mn. or 16.3 per cent of total licences for the year, categorised accordingly; foods US\$36.2mn., other consumer goods US\$119.8mn. and capital goods US\$13mn. In 1982 it was increased to US\$750.3mn. of which foods accounted for US\$66.5mn., other consumer goods US\$63.1mn., capital goods US\$193.3mn. while raw materials accounted for US\$422.4mn.

This informal market had increased in significance in recent times, but the use of special retained accounts and the issuing of no-funds licences have proved inefficient for the following reasons:-

- (a) The multiple layers of intermediation operating in this market resulted in large spreads between the buying and selling rates thereby leading to artificially high selling rates;
- (b) The funds generated in the market have been used largely for purchases of consumer goods rather than imported inputs for the productive sectors;
- (c) Operators in the market have been unable to document their transactions for tax and audit purposes because of the informal nature of the market; and
- (d) The system has led to an increasing harassment of tourists which had a negative impact on the industry.

## 2. THE PARALLEL MARKET

Based on this assessment, the authorities introduced a new set of economic measures to correct this trend and reduce the leakage of foreign exchange from the tourism sector and to ensure that export proceeds are accounted for, and fully utilized. The measures were also designed against the background of unfavourable world economic conditions, declining earnings from bauxite and alumina and a general shortage of foreign exchange in the banking system. Consequently on January 10, 1983 the following measures became effective:

- (a) A two-tier foreign exchange market was established. The official market rate of exchange remained at J\$1.78 = US\$1.00 while in the formalised parallel foreign exchange market, rates were to be determined by commercial banks on the basis of supply and demand, unlike the "special rate" (established in April 1977) which had a fixed exchange rate. In the official market the banks operate as principals. Certain transactions such as debt payments, imports of basic foods, bauxite/alumina and hotel receipts were to be transacted at the official rate of exchange. Those commodities which were not specifically designated would be transacted at the formalized parallel rate.

- (b) Non-traditional exporters were allowed to retain 50 per cent of their export sales to countries outside the CARICOM region. These retained funds can be utilized for the importation of raw materials, spare parts and capital goods; if not, they could be sold to commercial banks at the going parallel market rate of exchange.
- (c) A quota system was introduced to bring about a more efficient allocation of foreign exchange resources among the broad categories of imports and to ensure that the overall import target was not exceeded. Purchases of foreign exchange from the parallel market would be in accordance with the import quota allocations and approvals by the Exchange Control Department of the Bank of Jamaica.

With respect to CARICOM imports, only those goods qualifying as official imports will be transacted at the official rate; all other imports would be transacted at the parallel rate of exchange. Export proceeds however, must be sold to the commercial banks at the official rate of exchange. Following this, the authorities of some member countries within CARICOM retaliated, consequently a special rate (US\$1.00 = J\$2.25) for all transactions with CARICOM countries was established in May 1983.

During January, the average monthly parallel (selling) rate was US\$1.00 = J\$2.00, this increased by 9.23 per cent to US\$1.00 = J\$2.84 during February, and was however reduced to US\$1.00 = J\$2.71 following a statement by the Minister of Finance during the latter part of February that these rates were artificially too high, and that if these rates were reduced (buying US\$1.00 = J\$2.84) they would have the effect of accelerating inflows of dollars especially from those speculators who were with-holding funds. In May the average selling rate was US\$1.00 = J\$2.75, and declined during June and July and stood at US\$1.00 = J\$2.71 at August, where the average buying rate was US\$1.00 = J\$2.60. (See Table III).

The differential between the buying and selling rates among the commercial banks was in many instances as high as 12 cents (J), moreover these rates fluctuated and so as to attain a measure of stability and predictability in the market which would be supportive of the operations of commerce and industry, the authorities decided on rate fixing effective August 30, which would operate as follows:-

- (a) The daily rate for the US dollar would be fixed jointly by commercial banks and would be available for transactions at the opening of business on each Monday morning;
- (b) The rate determined for the US dollars would remain in force for a period of five days and reviewed by commercial banks at the beginning of each week;
- (c) The rates for other foreign currencies would be determined in relation to the US dollar reference rate on a daily basis; and
- (d) The spread between buying and selling rates for the US dollar should not exceed 5 cents (J\$).

Jamaica did not meet the performance criteria under the second year Extended Fund Facility programme, which ended 31st March, 1983, due to shortfall in inflows of foreign exchange on the official market, following the failure of certain loan inflows to materialise. Inflows from the parallel market were, however, well on target. The Government requested, and got a waiver from the Fund which enabled Jamaica to draw down US\$40.4mn. during June 1983. (Since then, the performance criteria, at the end of June was successfully met). In order to meet the targets established for the final year of this programme, certain adjustments were made to the external accounts and to the fiscal budget as well.

Effective 16th June, the following economic measures designed to safeguard the economy

were taken.

- (a) The import level was reduced by approximately US\$159mn. to US\$1,220mn. and the value of cash transactions to be financed in the official market would be US\$1,076mn. while those to be financed in the parallel market would be some US\$523mn. The import of capital goods would be reduced by US\$101mn., US\$53mn. for consumer goods, while raw material imports would be reduced by US\$5mn.
- (b) With respect to the fiscal budget, the overall Government expenditure would be reduced by approximately J\$147mn., given the shortfall in external resources. This was necessary, because had it not been done there would have been increased public sector credit demand on the banking sector which would reduce credit availability to the productive sector. Moreover, given the state of the economy, increased taxation or running a larger deficit were both unacceptable.
- (c) There was to be increased utilization of available resources in the parallel market, consequently all other commodities, except the following would be imported at the parallel rate of exchange.
  - (i) public debt,
  - (ii) public capital payments (direct and guaranteed),
  - (iii) a portion of Government imports and service payments
  - (iv) basic foods and raw materials imported under special credit terms,
  - (v) food imported for the tourist sector, and,
  - (vi) fertilizer imported under special credit terms.

In effect, a significant portion of the foreign exchange transactions were passed to the parallel market in order to relieve the pressure of demand for the scarce official foreign exchange. Effective 1st June 1983, foreign currency balances resulting from purchases on the parallel market were classified as part of commercial banks' liquid assets. In addition, commercial banks, as a group, will endeavour to provide annually US\$240.0mn. (at an average of US\$20.0mn. per month) from all purchases of foreign exchange towards financing Jamaica's oil payments. This measure became effective during August 1983.

## Economic Effect of the Parallel Market

### 1. Allocation of Funds

The parallel market competes against the "black market" by attracting resources and placing them at the disposal of the productive system for the purchase of much needed raw materials, capital goods and other essential imports. Normally, these funds would be used to purchase non-essential imports. The market has augmented available foreign exchange resources during a period of decline in earnings in the official market. (Export earnings during the first six months of 1983 declined by US\$86.3mn.) Since its inception in January 1983, the parallel market has generated total resources of some US\$263mn. up to the end of September while a total of US\$226mn. was disturbed over the period.

Since the formalization, foreign exchange inflows have increased every month between January - August. (See Table 3). However, following the fixing of rates by the banks on a weekly basis at the end of August, there has been a 43.9 per cent. reduction in inflows between that period and the end of September. However, other causal factors such as seasonality in the tourism industry should also be examined as possible reasons for the reduced inflows.

### 2. Prices

Following the introduction of the formalized parallel market and the subsequent shift of some imports from the official market to this market, consumer prices have increased by 5.3 percentage points on a point-to-point basis during the first five months of 1983. Prices will, therefore, have to be monitored closely and if necessary some price controls imposed if the gains from the parallel market are to be maintained. In addition, to avoid the build-up of pressure on the parallel rate of exchange and also on the official rate, with the resulting effect of further depreciation of the currency, the authorities should, if necessary, institute measures to reduce consumer demand for non-essential imports and to reduce the import-oriented consumption pattern.

### 3. Exports

Non-traditional exports grew by US\$4.8mn. during the first half of 1983 (when compared with the corresponding period of 1982) which could have resulted from the availability of funds from the parallel market. If, however, these producers continue to be net users of foreign exchange and if these non-traditional exports continue to be producers of "samples" and cannot sustain their market then the effect could be negative. There is need for continued innovation and increase in agricultural exports and from mere raw material exports to greater concentration of manufactured exports. There is also need for increased utilization of local raw material inputs for local manufacture.

Although there was an upward movement in the exchange rate between Jamaica and other CARICOM countries, and the subsequent trade war which occurred, Jamaica's trade balance within the region moved from minus US\$9.8mn. to positive US\$7.1mn. during the first six months of 1983, when compared with the same period of 1982. Total imports moved from US\$44.4mn. to US\$24.9mn. while exports moved from US\$34.6mn. to US\$32.0mn.

Much effort and resources have been given to the smooth function of the parallel market however, to reduce any undue pressure on the existing rates of exchange the authorities need to implement price, wage and fiscal restraint and to increase export earnings in both the traditional and traditional export markets. These measures will also serve as instruments which improve the country's balance of payments situation.

### Evaluation and Conclusion

The parallel market could continue to be a part of the financial system as long as there is shortfall in official inflows, and as long as the "street market" continues to flourish.

If the aims and objectives of the parallel market are to be realized a number of steps will have to be taken. Some nine months have elapsed since its inception and therefore enough information is available to analyse the various factors influencing its activity. For example, it would appear that if market rates are left to the free forces of demand and supply, then more resources could be mobilized. A number of transactions relate to the tying of sales of foreign exchange to the banks against future needs. The problem here is that such transactions may have a low priority when funds are scarce to satisfy basic essentials such as oil, drugs, and food.

Due to the higher domestic cost of production some importers are able to buy foreign exchange at very high rates, import the goods, sell them and still make supernormal profits. Two problems can arise from this.

- (a) Importers will purchase foreign exchange (at the street market) irrespective of the rates charged and this can further cause massive depreciation of the local currency.
- (b) If the local cost of production continues to be high, importers will secure almost total market share (domestic). The consequences are that local producers will be unable to dispose of the products, with the effects of factory closures, increased unemployment and worst, a number of producers within the manufacturing sector could opt for the more profitable mercantile trade. As more producers move into the mercantile community there will be greater demand for the already limited foreign exchange.

There ought to be restraint on consumer demand for non-essential imports, perhaps through restriction in bank lending, and locals are to be encouraged to consume more locally produced goods. Local producers too will have to be encouraged to utilize more local raw materials in their production process.

Following the shifting of more imported commodities from the official market to the parallel market in June there has been an acute shortage of foreign exchange. The market will now have to be closely monitored to see that importers do not intercept funds that would normally flow

into the official market which could result in shortage in the official flow, and further cause further devaluation. Moreover, the country will continue to experience price increases as long as goods continue to shift from the official rate to the higher parallel rate. The authorities will need to continue monitoring prices as long as this continues. The authorities should endeavour to place more basic essential imports on the official market as the foreign exchange situation improves.

The private sector will have to be vibrant and willing to take risks and while it seeks to make profits it should not be at the expense of retarding development of the country. The authorities should not only provide the basic infrastructure but should provide stable political and economic climate for increased production to be realized. Export incentive schemes should be available to manufacturers so that they can produce, and increase export earnings.

Finally, since certain external factors affect the country's export earnings, these will have to be taken into account in terms of proper foreign exchange management. The international recession has considerably reduced the country's export earnings to the extent that merchandize trade (value) moved from minus US\$141.7mn. in 1971 to minus US\$441.5mn. in 1982. (See Table II). Two things will have to be done:-

- (a) The country will have to become more self-sufficient and less import dependent, and since, to some extent, the country's growth and development is influenced by economic factors within industrialized countries with which we trade, and so steps will have to be taken to get these countries to be less protectionist in their trade policies and to accept the need for a new International Economic Order.
- (b) Finally, the country will have to continue the monitoring of its scarce foreign exchange resources and allocate them in areas where they are most needed as the same time try to generate more foreign exchange through exports.

## STATISTICAL APPENDIX

Table I	Jamaica: External Debt Operations
Table II	Jamaica-US Exchange Rates
Table III	Parallel Market Operations - Monthly Performance
Table IV	Jamaica's External Account

Jamaica: External Debt Operations

Table I

	US\$ mns.					
	1977	1978	1979	1980	1981	1982
Principal Payments	93.1	143.6	142.5	135.7	148.7	160.0
Interest Payments	66.0	62.2	97.9	126.4	138.1	133.8
Disbursements (Private and Official Sources)	136.6	202.3	203.5	350.0	349.9	453.6
IMF Loans	25.0	75.6	190.1		250.1	185.6

Source: Bank of Jamaica

Table II

Date	Basic	Special	Notes
22/4/77	US\$1.10 = J\$1.00	US\$1.10 = J\$1.00 <sup>1</sup> or US\$1.00 = J\$0.909	Adoption of dual exchange rate system.
		US\$0.80 = J\$1.00 or US\$1.00 = J\$1.25	-27.3
24/10/77	US\$1.10 = J\$1.00 or US\$1.00 = J\$0.909		Minor adjustment in special rate.
	US\$0.80 = J\$1.00 or US\$1.00 = J\$1.25	US\$0.78 = J\$1.00 or US\$1.00 = J\$1.28	-2.5
13/1/78	US\$1.10 = J\$1.00 or US\$1.00 = J\$0.909	US\$0.95 = J\$1.00 or US\$1.00 = J\$1.05	Devaluation of both rates
	US\$0.78 = J\$1.00 or US\$1.00 = J\$1.28	US\$0.74 = J\$1.00 or US\$1.00 = J\$1.35	-5.1



Table III

Date	Previous Rate	Revised Rate	% Change	Comments	Parallel Market Operations - Monthly Performance, 1983 US\$000				
					Months	Purchases	Sales	Buying Rate	Selling Rate
9/5/78	<u>Basic</u> US\$0.95 = J\$1.00 or US\$1.00 = J\$1.05	<u>Basic</u> US\$0.65 = J\$1.00 or US\$1.00 = J\$1.55	-31.6	Devaluation of both rates bringing basic to level of special rates thus ending the dual exchange system.	January	11,786	2,005	2.50	2.60
	<u>Special</u> US\$0.74 = J\$1.00 or US\$1.00 = J\$1.35	<u>Special</u> US\$0.65 = J\$1.00 US\$1.00 = J\$1.55							
6/78	US\$0.65 = J\$1.00 or US\$1.00 = J\$1.55	US\$0.64 = J\$1.00 or US\$1.00 = J\$1.57	-1.5	Beginning of the monthly mini devaluations.	February	24,475	22,641	2.73	2.84
7/78	US\$0.64 = J\$1.00 or US\$1.00 = J\$1.57	US\$0.63 = J\$1.00 or US\$1.00 = J\$1.60	-1.5	Mini devaluation.	March	33,185	32,150	2.57	2.71
8/78	US\$0.63 = J\$1.00 or US\$1.00 = J\$1.60	US\$0.62 = J\$1.00 or US\$1.00 = J\$1.62	-1.5	"	April	34,131	33,253	2.63	2.75
9/78	US\$0.62 = J\$1.00 or US\$1.00 = J\$1.62	US\$0.61 = J\$1.00 or US\$1.00 = J\$1.65	-1.5	"	May	30,842	25,575	2.64	2.74
10/78	US\$0.61 = J\$1.00 or US\$1.00 = J\$1.65	US\$0.60 = J\$1.00 or US\$1.00 = J\$1.66	-1.0	"	June	31,277	26,404	2.60	2.70
11/78	US\$0.60 = J\$1.00 or US\$1.00 = J\$1.66	US\$0.60 = J\$1.00 or US\$1.00 = J\$1.67	-1.0	"	July	36,756	29,253	2.60	2.71
12/78	US\$0.60 = J\$1.00 or US\$1.00 = J\$1.67	US\$0.59 = J\$1.00 or US\$1.00 = J\$1.69	-1.0	"	August	33,968	34,094	2.60	2.71
1/79	US\$0.59 = J\$1.00 or US\$1.00 = J\$1.69	US\$0.58 = J\$1.00 or US\$1.00 = J\$1.71	-1.0	"	September	21,862	20,602	2.91	2.96
2/79	US\$0.58 = J\$1.00 or US\$1.00 = J\$1.71	US\$0.58 = J\$1.00 or US\$1.00 = J\$1.73	-1.0	"	TOTAL	283,282	211 328,183		
3/79	US\$0.58 = J\$1.00 or US\$1.00 = J\$1.73	US\$0.57 = J\$1.00 or US\$1.00 = J\$1.75	-1.0	"					
4/79	US\$0.57 = J\$1.00 or US\$1.00 = J\$1.75	US\$0.57 = J\$1.00 or US\$1.00 = J\$1.76	-1.0	"					
5/79	US\$0.57 = J\$1.00 or US\$1.00 = J\$1.76	US\$0.56 = J\$1.00 or US\$1.00 = J\$1.78	-1.0	End of mini devaluation.					

Table IV

## Jamaica's External Accounts

	US\$mn.											
	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Merchandise (net)	-141.7	-157.3	-177.3	-117.6	-159.3	-131.9	93.3	44.5	-67.9	-75.4	-322.7	-411.5
International Reserves (net) (US\$mn.)	171.9	121.8	83.7	144.3	62.4	-199.3	-154.6	-324.2	-476.9	-548.5	-636.0	-345.5
Capital Movements (net) (US\$mn.)	145.7	77.7	137.2	243.2	208.9	45.7	56.9	-78.5	-10.2	107.1	225.4	465.6
Current Account Balance (US\$mn.)	-123.5	-150.5	-166.4	-166.9	-202.7	-302.7	-34.5	-66.7	-142.6	-166.3	-336.8	-380.3

Source: Bank of Jamaica