A COMMON CURRENCY FOR THE CARIBBEAN

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The Caribbean needs a credible, convertible currency to replace the existing national currencies, most of which are devalued or under threat of severe depreciation. The introduction of a regional currency offers the chance to begin again the process of repatriating monetary authority, avoiding the costly errors of the first attempts, represented by several existing currencies. On the other hand, if the regional monetary authority is not constituted with the required independence, technical competence and commitment to stability, it will condemn the whole region to the fate of our worst currencies.

This paper advocates the establishment of a regional Caribbean dollar, fixed in terms of the US dollar, and backed with ample reserves of foreign exchange. The issuing authority would be constitutionally debarred from issuing money not backed by foreign exchange, above a modest limit. Such a proposal is tantamount to a recommendation that the Caribbean join the US currency area, and is justified by economic theory as fully as by popular intuition. Economists recommend that countries join a currency union - and use the same currency or link their individual currencies at unchanging parities - if the economies are very open, if capital and labour are highly mobile between them and if they tend to be happy with similar rates of inflation. (The seminal articles on this subject are Mundell (1961), McKinnon (1963) and Frenkel (1975); there is a useful summary of the arguments in Zaidi (1990).) Caribbean countries are open economies par excellence, with trade ratios for goods and services among the world's highest. In spite of exchange controls capital has proved extraordinarily mobile, even if the estimates of capital flight are somewhat exaggerated. There has been continuous migration of labour to North America, in spite of quite rigorous entry requirements. (It has been made possible largely because of the size of the Caribbean community in North America, whose members have made effective use of provisions to invite relatives to join them.) The Caribbean considers it acceptable if it achieves inflation rates no higher than for North America.

The currency union should stimulate faster growth in the Caribean by improving the allocation of investment, by increasing overall

investment and by improving the productivity of investment through reduced exchange rate uncertainty. Economies should become more stable when Caribbean governments forswear exchange rate adjustment as a tool of policy. The costs may be greater regional disparities in performance, but in fact these disparities may not be much greater than in the absence of currency union. The more nearly a region matches the criteria for an 'optimum' currency area, the lower the costs in relation to benefits, precisely because the major instrument surrendered by currency union - exchange rate adjustment - is of so little efficacy.

It has occasionally been suggested that the Caribbean adopt the US dollar as legal tender, and extinguish all local currencies. The establishment of US dollar accounts in Jamaica is a small step in this direction. That is not recommended because there is some seignorage to be earned by the issue of a regional currency, through the small fiduciary issue and interest earnings on foreign assets. The Panamanian experience shows that the lack of a local currency may give the US an enormous political lever over countries which are already so dependent that they should maximise whatever opportunity avails to increase their room for manoeuvre. A regional currency may be issued in denominations and sizes more convenient to the needs of the Caribbean than the US dollar might be. These are not overwhelming reasons. A good regional currency is to be preferred to the US dollar, but a poor regional currency is much worse.

The next section of this paper discusses the features of a Caribbean monetary authority which could ensure the convertibility of the Caribbean dollar. This is followed by an analysis of the operation of the currency union, to examine the extent of expected benefit, the implications for fiscal policy, the possibilities of regional disparity in performance and the implications for the mobility of labour. We then discuss two alternative ways of moving from the current situation to a singl currency, and conclude with our recommendations.

An Independent Regional Monetary Authority

The regional monetary authority must be so constituted that it cannot be forced to reduce its holdings of foreign exchange belo the level necessary to ensure the currency against devaluation i terms of US dollars. That implies a limit to its discretionary powers to create money. Recent interest in the stability of mone

in a variety of countries has produced several studies which offer insight about the circumstances which lead monetary authorities to excessive money creation.

The central bank must not create money to finance fiscal deficits. If the central bank is truly committed to a stable currency and is independent of political influence, it may be permitted limited money creation in order to accomodate fluctuations in the balances of government transactions. Advances would be made at times of the month when salaries are paid, for example, and they would be liquidated later when government revenues are received.

The central bank should avoid creating money to deal with government deficits of longer duration and with deficits that are a result of cycles in the pattern of economic activity. If some unforeseen circumstance or a slump in economic performance causes the government's deficit to increase, immediate steps should be taken to raise taxes, trim expenditure or raise loans from the public or from foreigners. Borrowing from the central bank should be avoided at all costs. It is a good rule to treat these 'adverse shocks' as permanent, requiring adjustment in government operations. Benign 'shocks', such as a windfall in government revenues should be treated as temporary, and surplus funds should be held on deposit with the central bank, rather than being used to boost spending (Williamson, 1990 p., attibutes this suggestion to).

The Caribbean offers telling examples of the soundness of this recommendation. In 1974 and 1975 record sugar prices brought windfall revenues to the government of Barbados, at the same time that the Jamaica government reaped a windfall from the imposition of a new levy on bauxite companies. The Barbados government set aside a large portion of the gain for later investment, while the Jamaica government spent the entire amount on an emergency employment programme. The windfall soon came to an end in both instances, leaving Jamaica with a large fiscal deficit and chronic unsatisfied demand for foreign exchange. Other foredoomed attempts to finance a way out of structural fiscal deficits have occurred in Barbados (since 1985), in Guyana, and in Trinidad and Tobago (from 1981 to 1985).

The central bank must avoid circumstances which might lead to money creation for advances to financial institutions. It should

make discounts only against marketable securities, and it should have full discretion over discounting policy, including the right to refuse discounts in circumstances when the demand for them is deemed excessive. The central bank should use open market operations in preference to other means of increasing or reducing the supply of money. These practices reduce the danger that the bank may be unable to realise on the value of its assets because of the insolvency or cash flow difficulties of institutions that borrow from it. In these circumstances the central bank is tempted to supply further advances to assist the defaulting institutions. The central bank should under no circumstances advance money to rescue failing institutions. Rescue operations can depreciate the currency as severely as the most serious fiscal excesses, as the Chilean experience illustrates. Financial rescues should be financed from government budgets, as in the case of the US savings and loans banks.

The central bank must not be under any obligation to finance government, statutory bodies, public corporations or government financial institutions. State firms and institutions must obtain funds on the same basis as private firms, through financial institutions, on the basis of marketable security and at a cost determined by market conditions and by monetary policy. Favourable treatment of government financial institutions contributed to the collapse in the value of the CFA franc, when the central bank created money to make good their losses from nonperforming credits (See Honahan, 1990). State owned financial institutions in the Caribbean - development banks and commercial banks - have accumulated a heavy burden of nonperforming credits, and many are technically insolvent. They must be recapitalised from government's budget or closed; they should not be kept going on central bank created finance.

The central monetary authority must have discretion to set interest rates on its discounts and on deposits it accepts from financial instutions. It must be able to raise interest rates to penalise borrowers when the economy overheats, and to induce them to seek funding from abroad.

Hetzel (1990) suggests that central banks ought to refrain from rationing of credit or from discriminating among creditors or classes of creditors with respect to interest rates. The experience of central banks in industrialised countries indicates that such policies involve the central bank in political

competition, and make it more difficult to maintain its credibility as an institution whose principal focus is the value of money. Similar arguments would apply to the rationing of foreign exchange.

In view of the unfortunate history of the larger central banks in the Caribbean with respect to the creation of money, any new monetary authority should be set up with statutory limitations on its ability to issue currency that is not backed by foreign exchange. This seems essential in order to secure credibility for the new currency. When the limit of the fiduciary issue is reached the monetary authority can issue no liabilities of any kind, except in exchange for foreign assets.

The central bank must be so structured that it is able to resist political pressure. The bank's chief decision makers should have security of tenure, and their terms of office should be statutorily independent of election cycles. Appointments should be on the basis of proven competence and technical ability. The central bank's board should be required to report to government - to the regional governments, in the case of the regional central bank - on an annual basis, and these reports should be published in timely fashion, so that they may inform the public on the rationale of the banks' policies.

The political pressure on the central bank will sometimes become very intense, no matter how carefully the institution is structured. The bank's authority will ultimately come to depend on its reputation for technical competence. It must be staffed by individuals of the highest calibre, and special emphasis should be placed on the quality and comprehensiveness of the information it provides on economic matters. Its information services must be such that the public comes to rely on the bank as the source of dependable, reliable information and dispassionate analysis.

Growth and Stability in a Caribbean Currency Union

It is not feasible to move immediately to a single currency for the Caribbean, but we need to know what the effects of such an arrangement might be, so as to decide whether this should be the ultimate goal. Let us suppose there were a single currency for the Caribbean, issued by a monetary authority with the powers described in the last section, with a value linked to the US dollar and with a guarantee of foreign reserve backing. National governments retain their disparate taxes, spending patterns and

borrowing habits, but they have no facility for money creation. There are no national monetary authorities and governments have no authority over interest rates, credit allocation or the regulation of financial institutions; the central monetary authority is responsible for all monetary policy. There are no exchange controls. National governments retain their immigration controls and the movement of persons is not entirely free. There is internal free trade, with no quatitative controls and no administrative barriers, and there is a common external tariff.

If we compare this scenario with the current regime in the Caribbean, can we expect faster growth for the region as a whole? Would all countries be better off and would there be less disparity in regional growth rates than there is at present? And would there be less instability in the growth rates of the region and its constituent members?

Investment in Tradables

A single currency stimulates growth if it increases the proportion of actual and potential saving that is invested in the production of tradable goods and services. Levels of investment in the Caribbean appear to be quite respectable, but far too large a proportion has been allocated to real estate, and very little indeed to increases in the capacity to produce, particularly those goods and services which serve to relieve foreign exchange shortages. There has been insufficient investment in upgrading of exports to increase productivity and retain international competitiveness. Moreover, some saving has fled the Caribbean, and in a few countries a great deal has been diverted to the informal sector, where it makes little contribution to the long term growth of productive capacity. The single currency may also speed up growth if it improves the climate for foreign investment and capital inflow.

In a single currency area the mobility of capital should optimise investment in the tradable sector by reducing the degree of oligopoly in the business sector. The profits in the nontradable sector of small economies are kept artificially high, relative to those in the tradable sector, by the power of small numbers of dominant companies to manipulate prices to their advantage. It is not possible to protect high profits in the same way in the tradable sector because there the local firm must compete with suppliers from all around the world. This disparity in market power may well account for a great deal of the bias towards

investment in nontradables. A Caribbean currency union might reduce the oligopoly power of firms in the nontradable sector, because there could be no exchange controls against firms investing across national borders to take advantage of attractive profits in that sector.

One may envisage a mature currency union where increased competitiveness in nontradables had reduced the level of profitability in that sector to levels comparable to the returns available in the tradable sector, restoring investment in tradables which is currently diverted to nontradables by artificially boosted returns. The ratio of investment allocated to the two sectors would then more nearly reflect their underlying dynamic efficiencies, determined by the rates of technical innovation in the tradable and nontradable sectors, the skill intensities of the sectors compared with the skills endowment of Caribbean countries, and the nature of external economies and diseconomies in the two sectors.

We may well be sceptical about the extent to which a single currency will increase the degree of competitiveness in the Caribbean, however. Even in the absence of exchange controls capital movements may be inhibited by legal and administrative hurdles, where there remain a variety of laws and practices on property transfers, income tax provisions and exemptions, licencing, registration and superintendence of various kinds of business and fees and duties for professional services. Moreover, the largest portion of capital is in the form of real estate and investment in people (their skills, experience and knowledge), and is not particularly mobile. (This has been found to be true of the US - see Eichengreen (1990) - and may therefore be confidently expected to be true - a fortiori - of the Caribbean.) What very limited experience we have with capital flows in the OECS region reinforces one's scepticism about the extent of capital mobility: one does not have the impression that intra-OECS capital flows are larger (in relation to total investment in the OECS) than capital movements between OECS countries and other Caribbean countries such as Trinidad and Tobago and Barbados. Also, capital flows among countries whose exchange rates have not changed in relation to each other for many years are not noticably larger than flows with countries where exchange rates have changed.

There may not, after all, be much of a reduction in oligoply. Capital flows will not speed up to anything like the extent that a model of free capital mobility would suggest. The firms that are likely to take advantage of the absence of exchange controls are those that are already large in terms of the regional market, and the diversification of the geographical range of their interests may well serve to reinforce their oligopolistic controls of the market, extending their market power from their national base to a regional one.

There are circumstances in which a single currency may lead to greater investment in tradables, even in the presence of oligopolies. If information needed for investment in tradables is concentrated in one country, or where the most attractive locations for investment do not have an adequate base of knowledge of relevant markets and techniques, the diffusion of capital may accelerate investment in tradables. If the economies of scale in the tradable sector are much greater than in the nontradable sector, the move from national to regional conglomorates may serve to attract a disproportionate interest in tradables. Where joint production in several locations improves the mix of technology and factor proportions or enhances the quality and or competitiveness of the product (perhaps in the tourism sector) there may also be significant improvement in tradable investment performance. These hypothetical gains are quite possibly of some importance. For example, joint ventures by the major trading companies of Barbados, Jamaica and Trinidad and Tobago might grow large enough on internationally traded markets to reap considerable economies of scale in export marketing and market research.

The convertibility of a Caribbean currency would increase the proportion of savings that are invested in tradables, and switch finance from foreign asset holdings to investment in tradables. The lack of convertibility of existing currencies - and threats to the convertibility of those that are not subject to foreign exchange rationing - causes people to expect high inflation. There is apprehension about the extent of wage reaction, the prospect of troublesome industrial relations and uncertainty about what the relative prices and comparative advantages might be if the exchange rate ever stabilises. The best ways to insure the real value of wealth and the returns on financial accumulation in these circumstances are to sequester funds in (invariably illegal) foreign accounts, to invest in real estate,

to buy gold, jewellery and consumer durables, and at all costs to avoid long term investment other than real estate.

In a world with perfect foresight and full information, investment in exports is an equally attractive way to preserve the value of assets. Earnings are insured against devaluation because they accrue in foreign exchange, and, unlike capital flight, this is a perfectly legal way to sustain the real purchasing power of one's future stream of income. In practice it is very expensive for firms to equip themselves to avoid losses from exchange rate depreciation, especially where direct and indirect foreign inputs to the production process are considerable. Even where firms develop sophisticated understanding of foreign exchange markets, unexpected changes in foreign exchange management (what economists refer to as 'regime changes') may expose them to incalculable risks. Investment in exports is therefore relatively low where currencies are not convertible and relatively high where they are, all other things being equal - that is, if they have comparable infrastructure, social stability and wage-productivity profiles.

The corollary of all this is that establishing convertibility will accelerate investment in tradables by eliminating the incentive for capital flight, removing the need for inflation hedges, reducing the information costs of exporting and eliminating the risks deriving from changes in government's strategy for managing the exchange rate.

Inequality

The factors which may cause some member states of the currency union to grow more rapidly than others include differences in the extent of wage rigidities and tolerance of inflation, the development of human resources and physical infrastructure and the extent of external economies in the production of tradables.

Countries where productivity of tradables increases more quickly than unit labour costs will attract greater investment than those where unit labour costs are driven up by resistance to new technology, inflexible and outmoded work rules and wage increases which are insensitive to implications for the competitiveness of tradables. Countries with well developed infrastructure and a relatively generous endowment of human resources will attract more investment than those less favourably positioned. Where

there are externalities to be reaped investment will be greatest in locations where there is already the largest concentration of production. These are tendencies inherent in any form of economic association; the removal of controls on capital flows as a result of a currency union removes a substantial barrier to their implementation. Fears of unequal growth suggest the establishment of a regional equalisation fund as a supplement to the currency union.

Fiscal Implications

The establishment of a single currency is a way - perhaps the only practical way - to reimpose fiscal discipline in the Caribbean. The limit to the fiduciary issue of the regional money reduces government's ability to function as a shock absorber and insures against the financing of government spending when adjustment is needed. We support the use of rules limiting the fiduciary issue because of the difficulty of measuring what might be considered an ideal amount of money creation to allow for absorbing shocks and giving some time for adjustment. The tendency is to keep on financing and avoiding adjustment. The limited fiduciary issue contains government borrowing according to the foreign reserve position and the demand for credit by the private sector. When foreign assets of the monetary authority decline the scope for financing the government deficit by money creation diminishes.

Although fiscal discipline has become highly valued in the Caribbean because of the incontrovertible evidence of long term structural disequilibrium resulting from fiscal excesses, it has been very difficult to achieve in times of economic difficulty, in all countries which have their own central banks. Fiscal conservatism in times of adversity requires a working consensus on the extent of adjustment required, the timing of that adjustment and how the burden of adjustment is to be shared. With the current central banking arrangements, Caribbean states - with the exception of the OECS - have proven incapable of arriving at the required consensus, within the bounds of a fiscal deficit that does not destabilise the external accounts. In the currency union envisaged in this paper, adjustment of government expenditure would be immediate, and to the full amount of the adverse 'revenue shock', except for any borrowings that could be obtained from the private sector or from abroad. Loans will have to be serviced out of future taxation. If government falls into arrears of payment these too will have to be cleared using

additional taxation. Because the regional central bank is to be forbidden to lend to state companies or to official financial institutions on government guarantee, there is no finance to be had from these sources. If government tries to compel lending by private institutions they can readily transfer funds within the region to escape national restrictions.

Within the currency union there is limited scope for less disciplined governments to finance excess deficits by using the savings of citizens of countries with more cautious administrations, if financial institutions raise funds in the latter to lend to the former. In well informed markets such institutions would be shunned by depositors in favour of banks whose balance sheets were free of the debts of overborrowed governments. However, the strong faith of ordinary people and bankers in governments, even relatively intemperate ones, suggests a real danger, especially where the borrowing government is large, and the financial institutions accumulate surpluses in smaller countries. The danger can be minimised by informed management of financial institutions, insistence by the regulatory authorities that all loans, including loans to government, be backed by marketable securities, and by full public information of the state of all government finances. (The regional bank has the advantage that full disclosure of the parlous state of government finances will not undermine investor confidence and provoke capital flight, because governments' difficulties cannot affect the value of the currency.) In the worst case some financial institutions may fail because of governments' delayed debt servicing. More typically, governments' borrowing requirements will drive up interest rates, attracting funds away from the private sector, and drawing in finance from abroad, if the rates rise sufficiently.

Different structures of the income tax in member countries of the currency union may influence intraregional flows of finance and investment because they create differentials in the rate of return for comparable investments. The countries offering the highest rates of return for various kinds of activity under the present tax regimes might be computed from information on tax rates, tax credits, allowances, incentive grants and other concessions, though so far only my own paper on Barbados attempts to do this (Worrell, 1989). Assuming that the tax structures remained unchanged under unified currency arrangements we could calculate differentials in the rates of return for various

activities. However, investment does not seem to be very responsive to differentials in the rates of return within countries - as evidenced by the persistence of large differentials - and we are not sure that we ought to expect greater responsiveness among countries.

It is possible that the differentials in rates of return in the nontradable sector will be higher than those for tradables because there are provisions for the harmonisation of fiscal incentives for tradables. (They are not sufficiently comprehensive to eliminate tax-induced differentials in the rate of return, however.) We may therefore expect rather larger investment flows in the nontradable sector. Expansion in the nontradable sector of countries with relatively attractive returns leads to increases in their demand for all goods, including tradable goods. To sustain the demand for tradables the country would have to secure additional financial inflows from elsewhere in the union, because of the rule linking the expansion of money to foreign exchange earnings. This excess demand for money will in time draw up interest rates in other member countries and reduce the attractiveness of investment in nontradables in the country which initiated the process. Although prices in the nontradable sector of this country might tend to be inflated for a while the process will eventually tend to correct itself.

Differences in tax structures probably will not widen disparities in economic performance to any noticable extent. The responses to rate of return differentials appear to be small, the differentials may be significant only in nontradables, and the investment flows that might result from differentials create tendencies for self-correction. Still, countries which have a strong bias against inflation may wish to ensure that their tax breaks for investment in nontradables are not especially attractive. In the case of tradables the harmonisation of incentives might be extended to services.

The proponents of European monetary union have placed great emphasis on the provision of an equalisation fund (For example, see Hetzel, 1990). Revenue equalisation is a major feature of the the stability of the union arrangements of the USA (Eichengreen, 1990). Revenue equalisation is less vital in the Caribbean than in currency unions where members have significant scope for independent monetary and exchange rate action. Precisely because

the exchange rate is so ineffective in the Caribbean, members of the currency union cannot claim to be surrendering a useful policy instrument, for which they ought to be compensated. On the contrary, the countries which have used the exchange rate tool actively have most to gain from the prospect of a stable currency. Nonetheless, an equalisation fund may play an important psychological role in making its smaller members comfortable with the currency union.

An equalisation fund might provide resources to build infrastructure, develop human resources and provide technical assistance to build up production capabilities in depressed regions to the point where it is possible to reap external economies. It would directly seek to remedy those disadvantages which might cause a migration of investment funds away from less well endowed regions. This is already within the mandate of the Caribbean Development Bank. The equalisation fund might be in the form of additional resources for CDB, contributed by member countries of the currency union, for allocation under stipulated conditions of eligibility related to the deficiencies in the investment climate. The fund would be a continuation and enhancement of policies entrenched in the Caricom treaty, policies which have helped to remove disparities which existed two decades ago in the infrastructure of the larger and smaller Caricom countries.

Unlike the EC, the US and other unions which may be said to constitute their own currency area, the Caribbean currency union should not use its equalisation fund as a shock absorber - for example in the case of countries exporting to the EC, the Caribbean dollar value of whose earnings might be adversely affected by a decline in the value of EC currencies with respect to the US dollar, to which the Caribbean currency would be fixed. Instead, the monetary authority might encourage the development of currency insurance (through forward contracts, swaps, options, etc.) to take care of short term fluctuations. The composition of exports and the direction of trade must be allowed to adjust to persistent trends in the movement of world exchange rates.

There are fears that large member states may overwhelm the smaller countries of the currency union, though we ought to recognise that the disparity of economic sizes is not so great as is the disparity of populations and land area (if the ECCB is considered as a single unit). (See Chart 1.) Large countries

may attract a disproportionate amount of investment because of economies of scale and external economies; oligopolies headquartered in large countries may extend their grip throughout the region; dissaving by governments or private sectors of large countries may absorb the savings of small countries; and large countries' willingness to tolerate high inflation or slow growth may impose these same choices on the rest of the union. If financial markets were quite competitive, and firms, individuals and governments were well informed, an independent, technically competent monetary authority and a modest equalisation fund might insure against these dangers.

The existence of the currency union makes little difference to the flows of investment, in our view, and the equalisation fund ought to provide adequate compensation. Government and private dissavers could not capture finance from smaller members involuntarily. The dissaving country would have to offer higher interest rates, which would draw up rates everywhere, and restore the distribution of finance. Rates could not rise much above foreign trends in any case because of the international mobility of capital, so dissavers have little leeway and must soon mend their ways.

No member country may push its rate of inflation beyond a structural rate determined by the costs of producing nontradables and the demand elasticites for nontradables. (The prices of tradables are given by world markets and the exchange rate.) Since the structural rate difference is confined to nontradables it cannot be exported to other members of the union directly. However, the high inflation country, if it is large, may attract finance which constitutes a considerable portion of the resources of a small member country. That country must be eligible to make compensatory drawings on the equalisation fund.

Unfortunately, markets for finance and investment are oligopolistic and not fully informed. Additional safeguards are needed and some danger of inequity remains. Interest rates will not necessarily be equalised across the region, and financial institutions may well continue to borrow at low rates in small countries to lend to dissavers in large countries. (A recent article drawing on the experience of Italy argues that regional disparities in interest rate structure are persistent; see Hester and Sdogati, 1989.) Large oligopolies are quite capable of overwhelming smaller firms to create regional oligopolies. Financial institutions may continue to show excessive faith in

governments, in a new regime where governments will not be able to create money and may therefore find themselves unable to meet their commitments. This could lead to the collapse of financial institutions that have overlent to profligate governments, with losses to depositors in small countries which had funds with those institutions. The monetary authority, we will recall, must be expressly forbidden to rescue failing institutions.

A very high calibre of financial regulation and vigorous efforts to improve the quality of economic and financial information are the best forms of additional insurance against these dangers of perverse financial flow. The public must have a regular supply of easily digestable information which allows it to discriminate against financial institutions that try to segment markets to their own advantage. For example, if interest rates are kept relatively low in small countries, depositors should be wise enough to shift their surpluses to accounts in countries where higher rates are offered. The demand for such services would no doubt encourage the development of instruments to make such transfers readily available. Regulators of the financial system must be skilled and given the authority to insist on remedial action where financial institutions have weak asset portfolios, whether the credits are outstanding for governments or for the private sector.

It is highly desirable that countries of the currency union share a common regulatory framework for financial institutions. Financial institutions should not be given incentives to manoeuvre between individual country regulations to their own advantage, with the danger that they may increase their overall exposure to dangerous levels. This might happen, for example, if some jurisdiction allowed unacceptably low capital requirements or did not take careful account of off-balance-sheet exposures. It would also immensely complicate the job of inspectors of banks, and increase the possibility that they will not detect unsound practices, if there are a variety of capital requirements, limits on the scope of licenced activity, accounting standards and reporting standards. There is a danger that the financial system's integrity might be eroded by the spread effects from one weak node in the regulatory framework. Financial institutions may set up where the regulatory framework is least adequate, do business throughout the region and then find themselves in difficulty.

The regulatory framework should include provisions for adequate capitalisation in relation to exposure, including off balance sheet items. Financial institutions should be required to have sufficient financial expertise on their boards and in top administrative positions, as a condition of retaining their licences to operate. Standards should be established for external audit. Inspections by the regulatory authorities, including physical inspections of books, systems and records, should ensure sufficient quality of assets, systems and controls, effective board supervision and should make provision for monitoring, follow up and sanctions where necessary. There should be standards for public disclosure, guidelines for the relationship between the managements of financial institutions, their external auditors and the financial regulators. The regulatory framework should be comprehensive, to cover all financial firms and the interrelationships between them. Registration and licensing requirements should include qualifications of directors and capital adequacy.

From time to time apprehensions are expressed about the lack of complementarity among Caribbean countries. Some feel that this reduces the chances of successful integration in every area, including the prospects for currency union. These apprehensions are misplaced. Complementarity among members makes for a different kind of union, one which, like the EC, may be thought of as constituting a currency area of itself. The complementarity of Caribbean countries is not among themselves, but with the US. This requires that the Caribbean currency union become part of the US currency area, rather than a currency area on its own, but it does not deny the logic of the currency union. The aim of Caribbean integration, in all its guises, is not so much to stimulate reciprocal economic flows between members as to combine economic resources to address the world market more effectively.

Free labour mobility is highly desirable in order to realise the investment gains that a convertible regional currency would make possible. It would help investors to take advantage of externalities, bringing the appropriate quantity and quality of labour to locales where the infrastructure is to be found. It would allow the concentration of pools of talent to achieve the minimum size needed for international competitiveness in areas such as research, marketing and quality control. It would increase the spread of unit labour costs in every country,

reversing the tendency for unskilled workers in more affluent societies to price themselves out of international markets.

However, the size disparity of country populations, and the fact that the largest populations now have among the lowest per capita incomes, means that smaller countries are at some risk from free labour movement. Even modest migration from the more populous territories might cause a deterioration in the living standards of small recipient countries. A special filter will be needed to limit the rate of migration of the unskilled.

Nevertheless, wholesale labour migrations are unlikely in the Caribbean area, except from Guyana. There are large emotional and psychological costs to migration, and US experience has shown that it requires very major catastrophe, or very great windfall in some area, to precipitate large migration. With the establishment of a stable currency a major incentive for migration disappears. Moreover, for those who decide to migrate, North America remains the preferred destination.

Paths to a Single Currency

There are two ways to proceed from the current situation to the establishment of a single convertible Caribbean currency. The first is to achieve convertibility of individual currencies and then link them rigidly. Then the individual currencies could be replaced at these fixed rates by the new currency. The region would need to begin by stating the minimum condition for accession to the fixed rate mechanism - a minimum condition which reflected the fact that each joining currency was backed by sufficient foreign exchange reserves that it could maintain its US dollar value without difficulty, and would be in a position to contribute foreign reserves to the unified monetary authority sufficient to meet the target requirements for backing the regional currency. A suitable minimum condition is as follows:

- the joining member must have foreign reserves equivalent to three months' imports or 80% of its central bank's liabilities, whichever is higher; this level must have been maintained for at least 12 consecutive months;

> the country's exchange rate must have remained unchanged in terms of US dollars for at least 36 consecutive months, during which time there must have been no arrears on external payments.

These conditions would be necessary to ensure that the common currrency were set up with sufficient credibility. Attempts to unify the currencies before their convertibility is established in the popular mind with no shadow of a doubt are to be avoided at all costs. They will taint the few stable currencies with the lack of confidence of the weakest, and will have the perverse effect of destabilising those countries that are currently stable.

It would constitute a wonderful incentive for the required degree of fiscal discipline if countries undergoing adjustment programmes were to set themselves these targets for accession to the regional currency mechanism. However, projections of current prospects indicate that Guyana has no chance of meeting these criteria in the foreseeable future, while Jamaica may achieve stability only if its debt burden is substantially reduced. (Projections of economic performance in some Caribbean nations, on which this conclusion is based, appear in my study Worrell, 1990.)

There is an alternative which would allow the setting up of a regional currency immediately. A Caribbean monetary authority would be set up to issue a new currency, fully backed by foreign reserves, which would circulate alongside existing currencies in all member countries. It would be legal tender everywhere, and there would be no exchange controls on transactions in this currency. Its rate in terms of existing currencies would be determined by their values in terms of the US dollar, to which the new currency would be tied. In fact, in order to obtain the regional currency financial institutions would need to deposit US dollars or some other convertible currency with the regional authority. Existing currencies could not be converted directly into the new Caribbean currency because the regional monetary authority would be expressly prohibited from accepting any existing currency, or any instrument or instruction denominated in any regional currency, for any purpose whatever, including clearing. Any bank which issued new Caribbean currency in exchange for national money, or which opened Caribbean dollar

accounts for customers who could not service them with convertible foreign currency, could not realise on the value of its assets by presenting them to the regional monetary authority.

The regional monetary authority might be set up immediately, and citizens from all member countries of the union would be free to hold accounts in the new currency, provided they had access to foreign exchange (in the first instance) or to earnings from Caribbean dollar accounts. There would be great pressure for the adoption of the new currency, especially where existing currencies have been heavily devalued, or are under threat of devaluation. This public pressure would constitute a useful incentive for the fiscal adjustment needed to stabilise Caribbean economies. Governments cannot create Caribbean dollars to help finance deficits; excess money creation, using national currencies, accelerates the depreciation of these currencies in terms of the Caribbean dollar, and intensifies calls to abandon the national currency in favour of the regional currency.

Countries could control the rate of penetration of Caribbean currency to some extent, particularly by rules for the repatriation of export proceeds into national currency. These controls will be less effective where export proceeeds are difficult to track, especially in the services sectors. The advantage of gradual transition to the regional currency is that it allows time for the painful adjustment to the required fiscal contraction. A quick switch to a convertible regional currency would be particularly traumatic for Guyana, Jamaica and Trinidad and Tobago. The swift reduction of the fiscal deficit would mean compulsory lay-offs, wage reductions, curtailment of government functions, and probable industrial unrest. These countries might therefore use revenues from their mineral and agricultural exports to ensure a more gradual transition.

Recommendations

A Caribbean Monetary Authority should be established to issue a new Caribbean dollar, fixed to the US dollar and backed with foreign exchange set at a proportion of liabilities sufficient to reassure the public of the currency's enduring convertibility. In view of Caribbean experience that proportion must be quite large, in the region of 80%. If the proportion is not set high enough to begin with, there will not be a second chance to revise it upwards; if there is any doubt the authorities should choose the highest figure. The capital of the CMA should be subscribed in US

dollars by the participating countries. Caribbean dollars would be issued only in return for convertible hard currencies until the CMA builds up the equivalent of three months' imports of the region covered by the currency. Thereafter the CMA may make advances to governments or to financial institutions, provided the ratio of domestic to foreign assets does not rise above 20%.

Lending to governments would be limited to 50% of their hard currency capital subscription, and would be carried out strictly by means of open market operations, through the purchase of treasury bills and short term government securities. Advances to financial institutions would be at the discretion of the CMA and at rates determined by the CMA's board of directors. State owned financial institutions would be treated no differently than private institutions. The CMA would carry out no direct transactions with the public, and would not hold accounts or perform banking services for governments.

The Caribbean dollar would be legal tender in all countries whose governments had subscribed to the capital of the CMA and it would circulate alongside existing national currencies for a transitional period. There would be no restrictions on the use of Caribbean dollar accounts, and they might be used for domestic and foreign transactions. Caribbean dollar accounts could be opened only by those who have foreign currency or Caribbean dollars. Existing national currencies could not be sold for Caribbean dollars because the CMA will not accept national currencies for repatriation, nor will it accept drafts in national currencies for clearing. There would be no restriction on financial institutions accepting national currencies for deposit in Caribbean currency accounts, but such institutions would have to make their own arrangements for realising the value of the national currency assets they acquired.

Governments might continue to require repatriation of export proceeds into domestic currency, and to apply exchange controls, but they would apply only to existing national currencies, not to Caribbean currency accounts. Such restrictions would slow down the adoption of Caribbean currency within the nation by limiting the amount of foreign exchange available to the public for conversion into Caribbean currency. It would allow an extended period of adjustment for the Caribbean currency to supplant national currencies, and cushion the shock of the transition to currency convertibility.

The CMA board of directors should consist of bankers, economists, financial professionals and businessmen of proven worth, serving for fixed terms of at least five years. Their terms should overlap, so that one director retires each year. Suitably qualified candidates might be nominated by each member country in rotation, subject to veto by a majority, or by some similar device. The chief executive of the CMA would be chairman of the board, which would be responsible for all appointments, administration, budgets and policy. The CMA would make a public annual report to the member governments, explaining economic circumstances and the CMA's policies.

The initial coverage of the CMA may be limited to the OECS, Bahamas, Barbados, Belize and Trinidad and Tobago. The shock of quick accession to a convertible standard may be too great for Jamaica and Guyana. They might join the arrangement once their balance of payments disequilibria were eliminated, their arrears paid off and the acute shortage of foreign currency relieved.

The West Indian Commission

October 21, 1990

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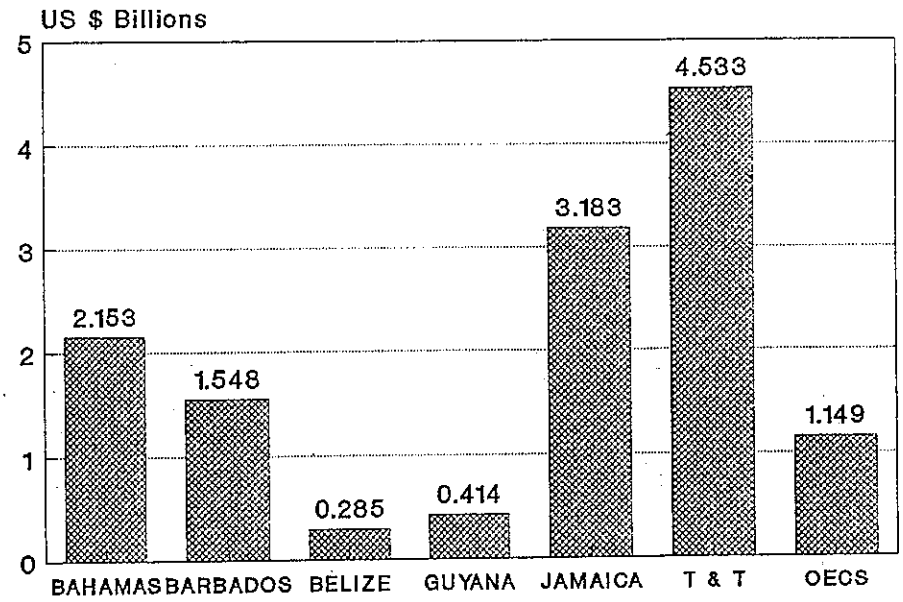
Chart 1

GROSS DOMESTIC PRODUCT
AT CURRENT MARKET PRICES FOR 1988



CARICOM AREA