1995

# Inflation, Money Supply (M2), and Stability in the Jamaican Economy

Instability has been and continues to be an underlying feature of the Jamaican economy since the 1970's. The performance of the Jamaican economy as measured by its GDP growth has been poor by any established standards. While growth has shown a sort of five year cyclical fluctuation, this has ranged between growth of 12.2% in 1970 to declines of -8.2% (1976) has averaged only 0.8% growth annually over the last twenty years. Per capita incomes have declined by 18.6% over the same period, and this has resulted from the population growth rate being significantly greater than that of GDP. This performance has been the result of the interaction of an array of factors, historical, cultural and political. Of greatest significance has been the effects of economic policies, which over the years, do not appear to have been producing economic growth and development, but rather have helped to foster instability and economic decline.

## Inflation, Money Supply and Growth

Theoretically, there is a standard relationship between the growth of money supply, the growth of economic output (GDP) and inflation. This can be expressed as follows:

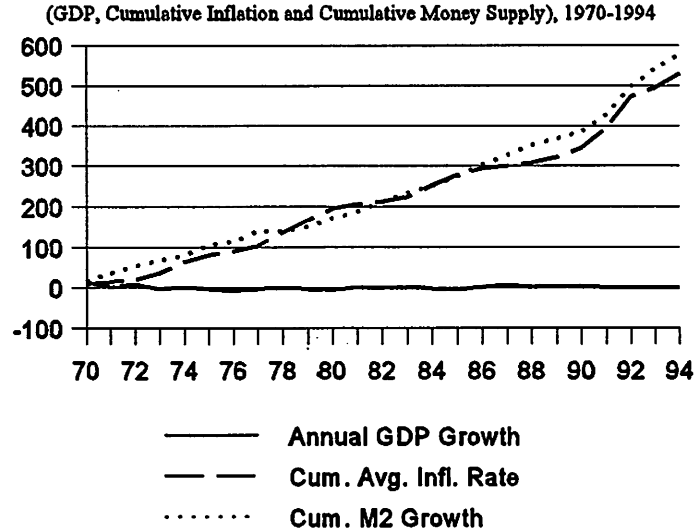
**Growth in Money Supply = Growth in Output (GDP) + Inflation**

Between 1970 and 1994, inflation has averaged 22.2% per annum and has ranged annually between 5.3% (1971) to 77.3% (1992). The high levels of inflation experienced in Jamaica are related in a direct way to the significant growth in Money Supply (M2). Since 1970 the average annual rate of growth in money supply (M2) was 22.5%. This implied a significant annual rise in the quantity of money circulating in the economy, which concurrently was exhibiting only a 0.87% increase in average annual output. It therefore only served to fuel inflation, increase the demand for imports, aggravate the Balance of Payments deficit and depress the exchange rate. In addition, over the period, the Jamaican currency depreciated by 16% (compounded annually) against the US dollar -

Figure 1

**Trends in Selected Indicators**

(GDP, Cumulative Inflation and Cumulative Money Supply), 1970-1994

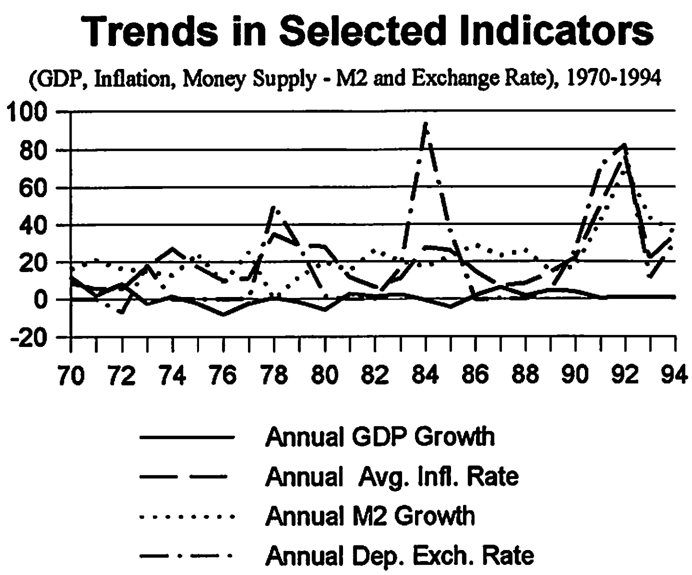


this being prompted by the high liquidity, high foreign exchange earnings, which characterised our economy.

The diagram (figure 1) shows that over the period 1970-94 the cumulative growth of M2 and Inflation followed the same trend and differed only slightly in magnitude.

Figure 2 which shows the trends in the annual average growth of both inflation, M2 and annual GDP growth, illustrates that the periods of lower inflation and lower M2 growth coincide with the periods of higher GDP growth (1970-76) and (1986-90), while

Figure 2




periods of high inflation and high M2 growth coincide with lower levels of economic growth eg. (1983-86) and (1990-94). While other factors could also be at play it is clear that high inflation and high M2 growth are not conducive to the development process. High inflation impacts negatively on investments since it fuels instability of prices/costs, and, if combined as it is in the Jamaican economy, with high interest rates, provides the ideal climate to deter meaningful levels of investment, the main catalyst for growth and development.

**Fiscal Performance**

Over the years, Government has been utilizing larger shares of the economic pie. Its expenditure as a percentage of GDP has more than tripled, moving from 15.8% in 1960/61 to 14.3% 1970/71 to 51.6% in 1994/95. This implies that a larger share of resources are being transferred to the public sector from the private sector who are overall, more efficient at resource utilization. However, Government's fiscal imprudence has led to the creation of huge budget deficits which stood at 8% of GDP in 1984/85 but grew to exceed 18% in 1994.

This has been brought about by the use of inappropriate fiscal and monetary policies. In its efforts to create stability in the economy, lower inflation and stabilize the exchange rate, Open Market Operation were used to mop up liquidity. Its issues of Treasury Bills (TB's) and Certificates of Deposit (CD's) at varying interest rates resulted in an almost doubling of the internal debt and the servicing of these securities puts more liquidity into the system. TB and CD interest rates set the rates for loans and deposits in the financial system. So as government raises interest rates to draw in funds from the system, not only does this increase capital and other costs thereby deterring investments but government also becomes trapped in an increasing level of debt. The servicing of this debt results in a decrease in the level of budgetary funds it has for capital expenditure as well as for social and development projects such as infrastructure to facilitate growth.

Government's control over the operations of the Central Bank and its access to cheap and unlimited credit facilitates the ease of implementing its fiscal and monetary activities which combined, have served to destabilize the economy. When the Government via Bank of Jamaica, purchases foreign exchange to pay its debts or boost the NIR level, it actually increases M2 when cash is pumped into the economy but has no actual increase in goods and services occurring, this activity is inflationary. Similarly, when Bank of Jamaica provides the interest payment cheques to service the TB and CD issues - the resulting increase in M2 helps to fuel inflation.

Trends in Government's revenue collection have shown interquartile fluctuations - yet, no successful efforts have been made to synchronize expenditure and revenue levels, so interquartile deficits continue to be a feature of governments operations. These deficits are usually financed by low or interest free credit from Bank of Jamaica - ultimately negatively impacting on the money supply and inflation. While government's fiscal and monetary policies are undertaken to achieve some basic economic objective, there are inherent weaknesses which serve to counter the intended good and create the instability in the macro-economic environment which does not foster growth.

The persistence of instability in the Jamaican economy is evidenced by the inability of the economy to achieve especially over the past four (4) years its targeted levels of inflation and money supply growth. It has not achieved its targeted budgetary surplus, nor achieved stability in its exchange rate. The fact that the country is unable to attract and retain reasonable levels of even short term international capital/investment is also evidence of some level of instability in the economy. Strong banking and financial institutions are one of the drawing cards a country needs to gain and retain investors interest to mobilize the resources it requires. Strong linkages between the financial system and overall macro-economic policies are pivotal.

<u>Corrective Measures</u>

1. At the center of the problem of instability in the Jamaican economy lies fiscal mis-management, which is facilitated by the systems and cultural and institutional arrangements by which it is supported. Therefore corrective measures should include changes in these arrangements. The BOJ/GOJ relationship which has been increasingly abused over the years and which has substantially contributed to the country's current economic dilemma needs to be changed - and either a totally independent Central Bank with constitutionally entrenched provisions, instituted, or alternative monetary regimes such as dollarization of the economy or the institution of a Currency Board effected.

    a. An independent Central Bank free of political interference or the dictates of government officials, would create a more credible institution capable of instituting more prudent credit and monetary practices. A truly independent Central Bank can play an important role in achieving and maintaining a low rate of inflation, and foster growth under reasonable fiscal behaviour. It can stand up to the executive branch about the need to adhere to prudent monetary policies. Essential to supporting the Central Bank's credibility and guaranteeing the soundness of a financial system would be the establishment proper and independent regulatory authorities for overseeing banks financial intermediaries and capital markets.

b. Alternate monetary arrangements to a truly independent and constitutionally entrenched Central Bank would be the institution of a Currency Board - which because it operates on the premise of full convertibility of local to reserve currency, does not provide scope for money creation by way of credit creation/extension or the printing of money which in Jamaica has been the main vehicle for fueling inflation. This system does not lend itself to government manipulation and should therefore encourage more prudent fiscal management, with low inflation and exchange rate stability.

c. Another alternative to instituting either the independent Central Bank or a Currency Board system would be to dollarize the economy. Dollarization necessitates the total use of another currency other than the local currency as the country's legal tender. To the extent that this currency is imported it therefore eliminates the ability of the Central Bank to print same, it eliminates the money creation which Central Banks can indulge in, thereby increasing the money supply which is inflationary.

d. Emanating from the institution of these alternate monetary regimes should be a government - exercising more prudent fiscal responsibilities. Resulting from this should be the elimination of large fiscal deficits - and the associated high inflation environment it creates. The accumulation of a large domestic debt burden should also be slowed and the attendant, high debt - servicing lessened. This strengthening of fiscal policy would therefore mean less reliance on monetary policy to achieve stability.

e. The supporting role of monetary policy would be dictated by the Bank of Jamaica which would be free to focus on the achievement of low inflation. With low inflation would come low but real interest rates, exchange rate stability and an economic climate that would foster confidence and growth rather than uncertainty and stagnation.

2. Increased production is the answer to economic growth which is essential to the improvement of our standard of living and thus provision of a better life for all. This must be the ultimate goal of our economic policy. However, it is difficult to foster increased production in an atmosphere of high inflation and economic instability. So inflation has to be controlled to stabilize prices and the exchange rate and to do this money supply has to be controlled.

To effect this, there needs to be the implementation of a mix of policies fine tuned, well thought out, consistent and effective in bringing about the desired results in the economy, and, solving problems while not creating others. They should address the following issues:

a. Achieving overall fiscal restraint to prevent budget over-runs as well as more efficient resource allocation.

b. Increased efficiency in revenue collection.

c. Getting government expenditure to run in tandem with its receipts.

d. Use of Treasury function in the Ministry of Finance and not Bank of Jamaica credit for short term over-runs.

e. Prioritizing expenditure so that the infrastructural requirements which foster, development get priority attention eg. training and human resource development, roads, utilities, bridges and ports, transport and health care.

f. The reduction or removal of bureaucratic red tape which are barriers to increased production, export and trade.

3. The Government's recently announced policy to operate on a cash-budget basis is an attempt towards achieving prudent fiscal management. However, if this and other supporting policies were constitutionally entrenched, there would be some assurance of conformity which would help to foster more confidence and credibility in Government's operations.