
CHAPTER 6

Market Structure and Regulation

The size of the domestic market and the mobility of finance are factors which influence the degree and type of regulation desirable in Caribbean economies. Because of small size oligopolies are prevalent, and it is desirable to set some prices in order to inhibit monopolistic practices. There are practical limits to price setting because of the heterogeneity of most markets. The mobility of finance determines the range within which domestic discretion may be exercised, with respect to exchange rates, interest rates and credit.

Price Fixing and Wage Guidelines

Prices in most markets for goods and services are set by oligopolies. Few of these firms systematically collect and analyse market and macroeconomic data to inform their pricing decisions. There is, in some countries, an embryonic business information industry but it does not cover the full spectrum of domestic and international information pertinent to local decision taking, and its output is not widely used in ongoing management decisions. Official intervention in selected markets may reduce the excess profits garnered by oligopolies provided the regulatory institutions are staffed with professionals trained to observe and interpret local and international markets. These institutions are the source of much of the data used by the private information industry and they are well placed to make decisions which reflect the economic fundamentals.

Price regulation is effective if it is confined to markets for undifferentiated products such as finance and foreign exchange, and provided the authorities ensure that the regulated price does not create a considerable excess of demand or supply. There are insuperable administrative problems for differentiated products and for retail markets. Prices cannot be fixed in perpetuity; the authorities must have guidelines for adjustment which reflect underlying economic conditions in the relevant market. They should have a good information system which provides timely data on the market situation, and that information should be put into the public domain. The public should also be made aware of the guidelines for managing prices, though individual circumstances will govern the level of detail to be provided. The objective is to manage prices so as to create stable expectations. Regulation must be carefully handled and subject to public scrutiny if it is to improve efficiency; but failure to regulate leads to price fixing, occasional price wars, poorly informed markets, and erratic and perverse price movements.

The international financial institutions have failed to appreciate the importance of oligopolies in financial and foreign exchange markets. The case for market interest rates, for example, presumes efficient markets that, left on their own, will put domestic real interest rates equal to an international rate plus country and exchange risk premiums. Uncertainties and the cost of information are ignored (see Zephirin, 1990). The actual experience is that free market interest rates may remain below international rates for a long time so long as the economy remains stable. When the economy falters, interest rates jump suddenly and they may thereafter remain at levels very much higher than economic circumstances warrant. Moreover, the spread between borrowing and lending rates is larger at higher rates than at lower, contrary to what competitive markets should produce. Attempts to establish market driven exchange rates in Caribbean economies have been even more sobering. Unregulated auctions lead to excessive depreciation and high domestic inflation.

In both foreign exchange and financial markets there is a strong case for price setting by a well-informed authority. Interest rates and exchange rates must be set in accordance with economic circumstances; otherwise transactions will be diverted to parallel markets and the actual interest and exchange rates will diverge from the official. Rates should be set according to flexible guidelines which allow discretionary variations within an established norm. Ongoing data and analysis should feed back into the decision process so that rate changes may be implemented in timely fashion. There is a case for setting a floor on the cost of funds to financial institutions and a ceiling on their rate of return so that these oligopolies do not tax their clientele. A managed foreign exchange auction may be a useful device for achieving a durable exchange rate in some circumstances, but the most credible regime for small economies is a fixed rate set at a level which ensures a small excess supply of foreign exchange.

In order to prevent public utilities and natural monopolies from taxing their customers their prices should be regulated to equate to their marginal costs. However, the calculation of marginal costs involves a large element of judgement. In many economies there is no stock market to indicate what a competitive rate of return on investment might be; where stock markets do exist the volume of trading is so small that prices give very poor signals of the expected rate of return. Judgements may differ about the appropriate technology and factor proportions for the industry, as well as the expected rate of technical improvement. The valuation of assets may also be in contention, because of exchange rate variation or inflation. Judgements are needed about the projected growth of demand and possible gains in internal efficiency.

Prices of public utilities and natural monopolies may be set directly by government, by an independent body including public and private representatives, by an auction of the rights to production, or by some combination. Government may establish a final price by determining how large a subsidy (or how much taxation) it wishes to allocate, and adding that subsidy (calculated per unit) to the price at which the private sector supplies the required amount. Price changes,

however determined, may be referred to an independent commission which conducts public hearings and authorises the changes. Whatever the system, prices should be subject to regular update and review. Indiscriminate state subsidies to support fixed prices and complete price deregulation are both to be avoided.

Government's objective is to ensure adequate consumption of essential items by every household, irrespective of income. Price fixing for these items is one of several options, which may be used in combination. Government may provide the services free of cost or at a subsidised price, either generally or to households which are shown to have insufficient purchasing power, by predetermined criteria. Alternatively, a cash grant or special coupons entitling the bearer to free goods or services might be provided to the needy. The most useful combination of regulated, targeted prices and other measures will have to be approached in an incremental way, by considering the least costly way of adding an extra unit of any particular commodity to household consumption. This requires information on the cost of government versus the cost of private provision; whether a subsidy to the private sector would provide the same level of product more cheaply; the cost of administering means tests versus the demand from those who would not qualify for benefits if the test were applied; and the amount of income that would have to be transferred to poor households to enable them to achieve the extra consumption sought. This information, together with the fiscal deficit, should allow decisions about how best to achieve modest shifts towards the desired basic consumption goals, by means of a combination of the measures discussed.

A general price limit cannot be made effective because of changing relative prices among the numerous items that make up national expenditure. Theoretically the overall price might be set at a level which equates supply and demand (which might be manipulated by fiscal policy), but that price would persist only if it involved a structure of relative prices among the constituent commodities which provided for the equation of supply and demand of each item. That is an impossible condition, and the continuing movements of individual prices may well drive aggregate prices beyond the target. In that case there is no corrective mechanism available.

For all practical purposes the rate of inflation of import prices sets the floor on domestic price inflation in small economies. Because of the import content of wage goods and producers' goods even a freeze in the costs of domestic inputs will make for a very slight deflation of price increases, compared to those for imports. Oil exporting countries are an exception; they may hold down the price of fuels, which are a sufficiently important input to bring down the rate of inflation significantly, if this policy is carried far enough. However, adverse effects on the allocation of investment may result. Non-oil exporters may not hold down domestic prices by containing oil price increases because they must make up the difference between the market and the controlled price by means of a subsidy, which increases the money-financed fiscal deficit and eventually depreciates the currency and raises prices.

Labour is the principal domestic factor of production, so there is an attraction

in the notion of wage freezes and wage guidelines as a means of containing inflation and increasing external competitiveness. Unfortunately, these attempts are almost certain to fail. It is impossible to control the relative prices of different qualities of labour, and in a dynamic economy that would be undesirable. The aim for many open economies is to accelerate the growth of exports, relative to the growth of non-tradables. Workers whose skills are used more intensively in the export sector may expect their relative pay to rise. These changes in individual rates may violate the wage guideline. The heterogeneity of the workforce makes for an impossible task of administering wage guidelines, requiring the policing of re-gradings, merit awards and skills differentials. In the small economy a wage guideline that calls for increases lower than the increase in tradable prices implies a reduction in real living standards, and will be resisted. The agencies which promulgate the wage guidelines have no authority to enforce them when the inevitable challenge occurs. Nothing short of the force of macroeconomic circumstances – typically a rising rate of unemployment which increases competition for jobs and weakens the bargaining strength of labour – will contain the rate of nominal wage increase much below the international rate of inflation. (It is a mistake for LDCs to make inferences from the experience of industrial countries which use economy-wide wage norms. They are useful precisely because they bear little of the burden of economic adjustment. Output and prices are manipulated through macroeconomic policies, and the annual wage rounds merely provide an orderly means of ratifying the wage outcome.)

Price guidelines are bound to fail in small open economies, except perhaps for selected items which government may subsidise without strain on the budget. Wage guidelines are useful only as an information mechanism, to help the market to adjust to wage rates that are determined by economic circumstances and macroeconomic policies. They should be targeted flexibly, and understood to be norms. Even then, wage guidelines may be unhelpful; if one or two agreements exceed the norm this may be taken as a sign of incipient inflation and lead to defensive action that may in fact destabilise the exchange rate and trigger inflation.

Financial Liberalisation

For many years Caribbean central banks have engaged in foredoomed efforts to direct the allocation of credit by economic sector and to determine the aggregate amount of credit. Sectoral allocation can have no lasting effect on consumption and investment because of the fungibility of finance. Global credit limits have led to the emergence and expansion of parallel market finance.

In any event, credit control is unnecessary. It is not a shortage of bank finance which inhibits investment but low returns on export production due to poor selection of products and techniques. With respect to consumer durables the unavailability of credit does not inhibit consumption, though it may cause a temporary slowdown. Credit controls are ineffective and unnecessary and should be abandoned.

As we have argued above, interest rate guidance by the authorities is desirable. Also, arguments for interest rate subsidies to non-traditional export sectors should not be dismissed. The exploitation of new markets, the introduction of unfamiliar products, the improvement of quality, the reorganisation of production and the establishment of a new clientele are all very costly, with long pay-off periods. Pioneering firms in these areas may not be able to capture the full extent of returns. There is a case for soft loans and grants for development expenditure and credit insurance for exporters, as part of a package of export incentives.

A modern regulatory framework with prudential controls and efficient monitoring is now recognised as vital for economic growth (see World Bank, 1989, Chapter 6). All institutions which provide financial services should be required to hold licences, which would be granted on condition that they met stipulations with respect to capital and reserves, maximum exposure limits, public disclosure of operations, rules to preclude conflicts of interest and minimum qualifications for managers. The supervisory body must be competently staffed, with powers of inspection, authority to issue directives to individual financial institutions, and the right to replace management and to withdraw licences. Procedures should be set up for public audit. There should be arrangements for the exchange of information between managers, auditors and regulators, and a well-developed system of public information on the performance of individual financial institutions.

Trade Protection

In countries where import substitution will always be a minor activity tariffs are, in effect, a general consumption tax. Ideally, we might have a general consumption tax and no customs tariff; but a tariff with exemptions for raw materials and capital goods will be more or less equivalent. The incidental protection it offers to import substitutes is no significant drain on financial or human resources and it may provide useful psychological support for small businesses.

Quantitative restrictions encourage inefficient monopolies which save little foreign exchange and inflate the cost of the final product. Fortunately, the limited scope for import substitution means that their high costs will not carry much weight in total consumption. Quantitative restrictions encourage rent seekers and divert trade in the restricted items to the parallel market. Instead of import substitution the country suffers inflation, shortages and smuggling. International financial institutions are quite correct to insist on the removal of quantitative restrictions.

Exchange Controls and Foreign Exchange Rationing

The administrative rationing of foreign exchange is extraordinarily difficult. It leaves an excess demand for foreign exchange which is certain to frustrate the objective of rationing. Exchange controls imposed in order to avoid depreciation of the nominal exchange rate merely shift transactions at the depreciated rate to a parallel market, supplied by foreign earnings diverted from licensed institutions and perhaps also by foreign currency sold by the central bank for high priority transactions, since there are irresistible profits to be made by selling foreign exchange allocations to the highest bidder. A global foreign exchange ration is impractical; the central bank cannot sell foreign currency on a first come, first serve basis, if it is to avoid exhausting its stock before essentials such as fuels have been paid for. Even sectoral allocations are too aggregated: luxuries crowd out essentials. The only defensible system requires allocation by item, but that involves a truly massive information system, and demands an administrative system that even wealthy countries have been unable to manage in such a way as to ensure timely payments. Furthermore, it is virtually impossible to fully monitor the final use of foreign exchange sold, where parallel markets exist alongside the formal system.

Controls on foreign exchange for imports are counterproductive. Importers' efforts to obtain foreign exchange on informal markets, which are often risky and poorly informed, result in highly inflated prices for the goods they sell. Import rationing may be more inflationary than the exchange rate depreciation it is meant to avert.

A requirement for the repatriation of export proceeds may help with the official management of foreign liquidity, but it will not add to the available reserves. The regulation depends largely on voluntary compliance, and on the moral sanction it carries. If there is confidence in the trend of economic management high levels of compliance may be expected, but not otherwise. Attempts to penalise exporters are more likely to result in capital flight than in any addition to foreign exchange receipts by the central bank.

Rationing of non-trade current account payments is a disincentive for foreign investors and may lead to disinvestment. It may reduce the prospects of obtaining scarce skills from abroad. And the control may be circumvented by the use of transfer prices and similar devices. Rationing of capital outflows may be useful if applied gently. A slight squeeze on intended investment abroad by locals, by phasing the investment over a longer period, or by allowing smaller tranches in any period, may ease problems of liquidity management, but it will not enhance the total holdings. Prohibiting capital outflows, and subjecting them to stringent limits, are almost certain to worsen the central bank's foreign exchange position, by triggering a flight of capital.

Regulations which require certain procedures and certification for foreign transactions, which are usually included in the definition of exchange controls, are helpful in ensuring the probity of foreign transactions and in providing up-to-the-

minute information. The public should be provided with clearly stated guidelines on the documentation required for each category of transaction, with the assurance that all qualified transactions will be permitted. Such regulations may serve to bolster public confidence in the financial system, provided they are used as a source of regular public information. They may be the only comprehensive source of data on capital flows and debt service, on a current basis.

Exchange controls are not to be regarded as a major tool of macroeconomic adjustment. Rationing of foreign exchange for imports is counterproductive, generating more inflation than would a devaluation. A requirement for the repatriation of export proceeds, and mild rationing of investment outflows, may help with the central bank's liquidity management, but attempts at vigorous enforcement accelerate foreign exchange losses. The regulation of non-trade transactions is desirable, to protect the integrity of the foreign exchange institutions and to provide prompt reliable information.