CENTRAL BANKING TODAY IN THE EASTERN CARIBBEAN

by

Lucilla Lewis

Economist, Eastern Caribbean Central Bank

PAPER PRESENTED TO THE 22ND ANNUAL CONFERENCE OF THE OF THE REGIONAL PROGRAM OF MONETARY STUDIES (RPMS) IN GEORGETOWN, GUYANA, OCTOBER 14-18, 1990

INTRODUCTION

A Central Bank is expected to participate with the fiscal authorities to achieve the policy goals of price stability, growth consistent with full employment, equilibrium in the balance of payments, and stability of the financial system and is equipped with the following instruments to achieve those goals:

Market Instruments

Central Bank Lending Rate

Open Market Operations

Direct Instruments

Control of Interest Rates

Exchange Rate Policy

Reserve Requirements

Other

Banker to Governments

Moral Suasion

The choice and effectiveness of instrument used to achieve the goals will depend on the structure of the economy, on the financial institutions and on the behavior and expectations of households and firms. In addition, the international economic relations of the country, and lags in the adjustment process which sometimes require reliance on intermediate targets such as monetary aggregates. Accordingly, also are critical the choice of effective instruments of monetary policy for a unique institution like the Eastern Caribbean Central Bank (ECCB)[1] seems a uniquely difficult task.

Monetarists often question the ability of monetary policy to achieve more than determining the rate of inflation in the long run. The fact that price stability is the major policy objective of the German Bundesbank bears this out. This paper discusses some of the reasons for more ambivalence on the use and effectiveness of monetary policy in the ECCB area, and suggests innovative means by which the ECCB can achieve its goals.

To put the analysis in perspective, section I gives a brief overview of the economic and financial structure of the area. In section II the experiences and limited success of the ECCB with monetary policy are recounted. Section III expresses some thoughts on the direction for monetary policy in the area. While emphasizing the important role for a more market driven financial sector, this section also proposes quantitative and qualitative credit controls as a requisite for averting possible balance of payments crises and for facilitating the development of entrepreneurial activity. In the circumstances of the OECS Countries, this seems to be necessary to sustain the growth process from within and simultaneously deepen the market for a wider range

---

[1]Members of the ECCB comprise Grenada, St Vincent, St Lucia, Dominica, Antigua, Montserrat, St Kitts and Nevis, Anguilla. These countries also make up the sub-regional grouping known as the Organization of Eastern Caribbean States (OECS). Anguilla has observer status in the OECS.

of financial assets in the public and private sector. The need for consistent monetary and fiscal policies and for convergence of economic growth within the ECCB area is also emphasized. In a concluding note the need for initiative on the part of the ECCB and the crucial role that can be played by complete economic and political integration in the OECS area and ultimately of the wider Caricom region are underscored.

SECTION I

ECONOMIC AND FINANCIAL STRUCTURE OF THE ECCB MEMBER STATES

The economies of the ECCB member countries are small and dependent. Their small size and small population pose a constraint to their ability to diversify production and benefit from economies of scale. Their small domestic markets make it imperative for them to pursue a policy of export led-growth. As a result, international transactions are large in relation to economic activities. Much production is for export and consumption has a high import content. This high degree of external orientation of the economies make the balance of payments a crucial variable in the growth process of the area.

The economies all exhibit an overall high level of reliance on commercial bank credit. An examination of loan distribution by sector reveals that the personal sector (consumer durables) receives the biggest share of loans followed by the distribution sector, and then the public sector. (See table 1). This may be seen as a manifestation of the effect of colonialism on the economic and financial structure of the area, and the contingent excessive

caution exercised by commercial banks in financing investment long-term projects. It is by no means implied that commercial banks should operate as development banks. It does indicate that there is a problem: the OECS is at a stage of its development where a big share of the demand for investment credit is largely in the public sector, while the supply of credit is available from commercial banks oriented to private sector lending.

Table I

Sectoral Ratio of Loans by Commercial Banks in 1989

Selected Sectors	Antigua	Dominica	Grenada	Montserrat	St Kitts	St Lucia	St Vincent
Personal	38.1	47.3	33.8	68.8	34.2	47.6	34.4
Distribution	12.8	13.9	22.2	11.3	12.7	15.1	12.1
Tourism	10.7	3.6	7.8	3.6	8.9	10.5	3.0
Manufacturing	3.5	6.7	7.4	1.0	5.0	3.8	15.1
Agriculture	0.4	3.0	2.3	0.2	7.1	2.7	6.7
Other	34.5	25.5	26.5	15.1	32.1	20.3	28.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total Loans	565.22	190.14	310.04	52.43	295.63	567.76	245.02

This contention is borne out by the fact that when from 1985 to 1988 the commercial banks were experiencing a high level of liquidity, they began, for the first time, to lend for mortgage financing and this dramatic increase in long-term debt on their asset portfolio provided the outlet for this liquidity. It should be pointed out that this development resulted in decreased liquidity ratios for commercial banks through-out the sub-region by 1989 and resulted in some form of credit rationing by the commercial banks by the beginning of 1990.

The financial sector in the area is in general not sophisticated in respect of the types of financial assets available. There is no equity market while the money market is dominated by government securities. The non-existence of a capital market was largely responsible for the ironic situation in 1987 when the commercial banks complained of excess liquidity levels in an area which so badly needs capital investment. The commercial banks are by far the most important financial institutions in the area comprising in order of importance, (i) branches of foreign banks, (ii) indigenous banks, and (iii) foreign owned locally incorporated banks. At the end of 1989 the dominant branch banks held 57% of the total assets of commercial banks in the area. The banks also have access to resources of sister branches and head offices outside the area, a condition that reduced the control of the Central Bank on the supply of money.

The economic and financial structure in the OECS dictated that the Eastern Caribbean dollar (EC$) be tied to that of its major trading partner the United States of America. A corollary of this pegging of the EC$ is that the ECCB loses control over price stability. Based on Purchasing Power Parity (PPP), $P = eP^*$ where P is domestic price, P^* foreign price and e is the exchange rate EC$/US$; if e is fixed, to maintain PPP, domestic prices must move in line with foreign prices, leaving the OECS vulnerable to the vicissitudes of price changes in trading partner countries. Allowing for transportation costs and mark-ups, this "law of one price" (loop) seems to hold in the OECS where the tradeable sector is big relative to the non-tradeable sector. Further, since e cannot adjust freely to equilibrate the external sector, a non-zero overall balance on the balance of payments leads to a change in reserves.

The following conclusions can, therefore, be drawn from this section:

1. The ECCB cannot control to any significant extent the rate of imported inflation in the area, given the high importation of goods and services.

2. Control of the money supply by the ECCB is limited not only by the unknown behavior of the public and of banks, which is the multiplier effect in the short run, but also by the institutional arrangements dictated by the economic and financial structure of the area.

Stating the change in the money supply:

$Ms = (CCG + DACB + OR) * M(.)$ where

CCG is change in credit to Central Government by the Central Bank,

DACG is change in discounts and advances to commercial banks,

OR is change in official reserves M(.) is the money multiplier.

Control of the domestic credit base of the commercial banks can be made less effective by relations of branch commercial banks with other branches and head offices outside the system. Further, because of the fixed parity of the EC$ the ECCB has no control over the level of official reserves through exchange rate policy, an overall deficit has to be financed out of reserves since the exchange rate cannot be used to ensure equilibrium in the external sector. Only ΔCCG can be controlled by the ECCB.

SECTION II

EXPERIENCES IN THE USE OF MONETARY INSTRUMENTS

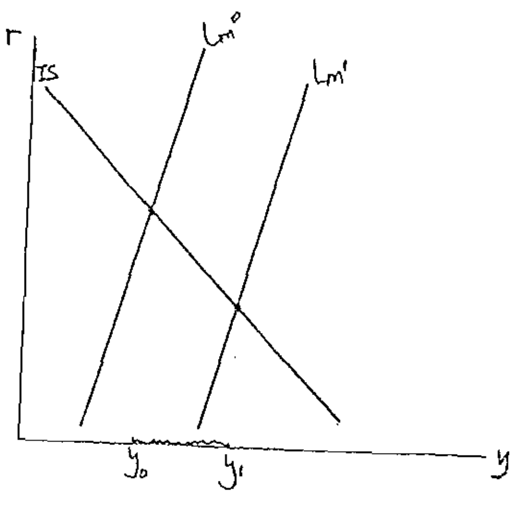
By the Agreement signed by member governments, the ECCB is equipped with many of the instruments of a Central Bank. However, during its first five years of operation it encountered only limited success with the use of those instruments in influencing the supply of money.

Central Bank Lending Rate. The ECCB is authorized to fix differential discount and rediscount rates and ceilings for various classes of transactions or maturities so as to influence the availability and cost of funds, however, the usefulness of this instrument cannot be fully realized because of the leakages discussed above which may pre-empt commercial banks' borrowing from the ECCB. This policy resulted in inertia by the Monetary Authority during the period of high liquidity levels from 1985 to 1989. The lending rate has therefore merely had occasional effect in encouraging banks to bring in resources from abroad. (The foreign assets of the commercial banks are not controlled by the ECCB). The inter-bank market established in 1987 had been very inactive and is now virtually dormant, while there has however been some activity in the Treasury Bill market.

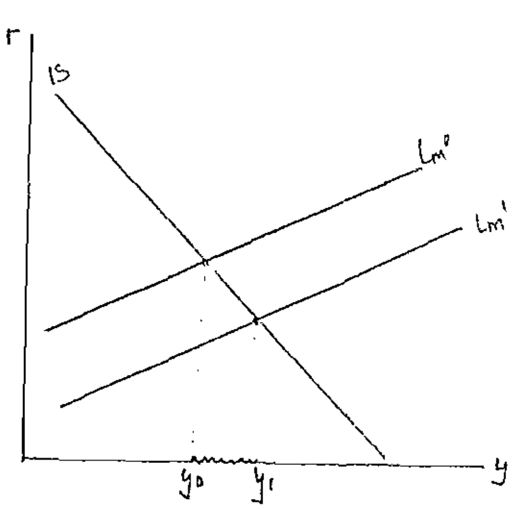
Open Market Operations. As is the case in other small developing economies, the market for government securities in the OECS is very narrow both on the supply side and the demand side. The supply side is limited by inadequately articulated development strategies while the demand side is kept low by economic and socio-political factors which lead to a situation where the national banks and national insurance companies are the biggest holders of government bonds. As a consequence of the above, the market for open market operations is limited, and the scope for monetary policy inadequate.

Control of Interest Rates and Credit Limits. Despite its power to prescribe minimum and maximum rates on deposits, to set the permissible purposes, aggregate ceilings and maximum maturities on all categories of advances whether by loans or overdrafts, the ECCB has been very circumspect in using these powers mainly because attempts at econometric analysis of a money demand function by staff of the ECCB and the IMF have been plagued with problems of data weaknesses and as such there is some uncertainty as to the interest elasticity of demand for money in the area. Statistics reported by the banks reveal that there is some elasticity on the deposit side while the demand for consumer loans seems relatively interest inelastic. This observation is based on a simple analysis of changes in deposits and loans respectively in comparison to changes in interest rates. Data limitations and inefficiencies have not allowed serious empirical work on this subject and the ECCB needs to be informed by further research in this area. It is well known however, that macro-economic theory interprets low interest elasticity of money demand as the case where monetary policy works and therefore raison d'etre for the Central Bank to 'interfere'. This can be illustrated using simple IS-LM graphs. Setting income on the horizontal axis and interest rates on the vertical axis it can be seen that an increase in money supply will have a more expansionary effect on income the steeper the LM curve (a steep LM curve denotes low interest elasticity of the demand for money). It cannot be doubted that lack of financial deepening as exists in the OECS will leave consumers with no choice but to hold deposits at commercial banks.

Inelastic LM-Curve



Elastic LM-Curve



<u>Exchange Rates</u>. According to the ECCB Agreement, only by unanimous recommendation and decision by all members of the Board can the Bank change the external value of the EC dollar. Suffice it to say that given the multistate nature of the ECCB, the diverging nature, and the structure of the OECS economies - low import elasticities and high import to GDP ratios - this instrument will and should remain one of the very last resort.

<u>Reserve Requirements</u>. Following the establishment of the ECCB, a reserve requirement of 6% of deposit liabilities was imposed on the commercial banks. This ended up being essentially a taking over of governments' liabilities with the commercial banks. In the 1970s, for fiscal reasons, the OECS governments had required commercial banks to hold Special Deposits with their respective treasuries; in most cases these Special Deposits were used to meet the reserve requirement. In that case the reserve requirement did not have a significant impact on the operations of the commercial banks. With the tightening of liquidity throughout the commercial banking system in recent months, this requirement may now begin to have effect.

<u>Banker To Governments</u>. As banker to governments of the OECS, the ECCB may provide deposit and borrowing facilities to governments, administer the public debt, act as fiscal agent and render technical advice on matters of monetary and financial policy.

Provisions for lending by the ECCB to governments are legally controlled by annual limits and are generally based on the revenue capacity of governments e.g. the Agreement states: "subject to terms and conditions as the Board may prescribe, the bank may make temporary advances to each participating government to meet its seasonal needs in an amount not to exceed during a given financial year five percent of its average annual recurrent revenue as determined by the Bank over the three preceding financial years".

The ECCB's ability to lend to member governments is further limited by a clause related to its role as custodian of the common reserve pool for member countries which states that the foreign assets of the ECCB should be equal to at least 60% of its demand liabilities. The ECCB therefore cannot indiscriminately monetize government debt, a practice which has led to instability in some Caricom countries.

The multistate nature of the ECCB makes these controls necessary to avoid internal tensions, and this imposition of the geographic and historical circumstances of the sub-region is the prime contributor to the stability of the ECCB and the EC dollar, by establishing the philosophy of the need for a balanced budget in the public finances. See Table 2.

Table 2

Current Account Balance on Operations of Central Government as a Percent of GDP

	1986	1987	1988	1989
Antigua	2.3	0.1	-1.5	0.4
Dominica	1.2	2.9	4.3	6.5
Grenada	-10.2	-4.8	2.9	-10.9
Montserrat	0.6	0.4	NA	NA
St Kitts-Nevis	1.6	1.8	1.4	3.0
St Lucia	6.3	8.5	15.2	14.7
St Vincent	3.9	4.8	3.7	3.4

SOURCE: Statistics Departments and Ministries of Finance

Moral Suasion. In attempting to curb the rate of growth in consumer loans, the ECCB along with member governments have relied on moral suasion, with some response from the commercial banks. However this moral suasion attempt has not restrained the insatiable demand for consumer loans in the area.

The foregoing sections suggest that the leakages from the commercial banking sector are relatively large, that imports are high relative to exports and that consumer spending absorbs the largest share of the expansion in commercial banks' lending. These factors make it difficult to ensure improvement in the current account of the balance of payments without demand management policies. On the fiscal side, policies aimed at demand management are being pursued in most member countries, however, there is a need for monetary policy to complement this effort by the respective governments, if maximum returns are to be derived.

SECTION III

SOME THOUGHTS ON THE DIRECTION FOR MONETARY POLICY IN THE AREA

The analysis in this section will be made easier by focussing on the common thread in the first two sections, namely: the economic and financial structure of the region as it severely impairs the ability of the ECCB to control the money supply, and makes it difficult to influence price stability and ultimately the development of the sub-region. All of these issues point to the urgent need for the structural transformation of the economies and the financial sector of the area. To some extent the ECCB is on track but much more initiative will be required in the future. The following measures/instruments are proposed if the ECCB is to play a more significant role in achieving this goal:

1. A higher profile of the ECCB in each off-shore territory.
2. Measures aimed at increasing equal competition in the commercial banking sector.
3. Quantitative and qualitative credit controls.
4. A fostering the co-ordination of monetary and fiscal policy at the area level.
5. A more direct developmental role.

<u>A Higher Profile for the ECCB in Off-Shore Territories</u>. Given the circumstances described above, the ECCB has to rely on moral suasion as a key instrument of monetary policy and therefore needs to have a strong presence in each member country. The ECCB attempts to achieve this by setting up agency offices outside the headquarter territory. The Resident Representatives at these offices assist not only with data gathering and maintaining country profiles, but are expected to give insights into the data reported to Head Office on a monthly basis. In effect the Resident Representatives (RR) are expected to function as localized country economists. However, co-operation from the commercial banks is likely to benefit most from the effective functioning of the Resident Representatives.

<u>Measures Aimed at Increasing Even Competition in the Commercial Banking Sector</u>. This has to be the first step towards increasing the response of the commercial banks to domestic market influences and permitting more confident assessments of interest elasticity and substitution effects in the monetary sector. Freeing the national banks of the fiscal burden i.e. the virtual compulsion to buy government securities to finance fiscal deficits when they exist would help in that respect. The national banks increased their share of total assets from 18.8% at the end of 1980 to 35.1% at the end of 1984, while their share of private sector deposit liabilities increased by 26% per annum over this period. This growth performance by the national banks is particularly impressive considering that their ability to compete for deposits at higher

interest rates has been limited by their reduced access to larger scale private sector lending operations partly because of their late arrival on the market[2]. This market disadvantage is compounded by the fiscal burden. On average at least 60% of gross earnings of commercial banks in the area come from interest on loans to private businesses and individuals. A spillover of this is the marginal involvement of the national banks in foreign exchange transactions the second most lucrative part of the market. There is no doubt that if relieved of the fiscal burden the national banks will make further inroads into the market thereby increasing competition and sensitivity to domestic market indicators in the commercial banking sector.

<u>Credit Controls</u>. The importance of the balance of payments (B.O.P) to the development of the area and the openness of the economies make credit controls a crucial tool of monetary policy. The OECS economies though similar are at varying stages of the development process and hence record mixed b.o.p performances; but, they all depend on official inflows of aid and loan financing to close the gap on the current account of the balance of payments. As world economic developments indicate substantial reductions in aid flows from developed countries to Third World Countries can be expected in the future. This means that if this main source of capital inflows to the OECS is going to be cut off, this may take its toll on the common reserve pool now managed by the ECCB. This development may even lead to increased unemployment. Measures to

[2] The first National Bank in the ECCB area was opened in the 1970s.

reduce the chronic current account deficit in the OECS, as shown in Table (3), through increased production must be pursued. In both the Keynesian and monetarist framework, control of domestic credit would have a positive effect on official reserves, and in the OECS

Table 3

Current Account Balance of Payments as a Percent of GDP

	1986	1987	1988	1989
Antigua	-65.3	-31.5	-25.9	-27.4
Dominica	4.3	1.7	-6.3	-20.8
Grenada	-3.4	-21.0	-15.6	-17.6
Montserrat	-0.6	-5.4	-	-
St Kitts-Nevis	-8.6	-11.7	-18.8	-16.7
St Lucia	1.3	-3.7	-2.1	-7.6
St Vincent	5.6	-13.1	-2.1	-7.6

SOURCE: ECCB and Statistical Departments

would have the desired effect of keeping down excessive imports of consumer goods and also of increasing the productive capacity of the economies by channeling a larger share of credit to the productive sectors. Based on the Monetary approach:

$Ms = Md.$

$Md = P.\ f(y\ i)$

$R = Md - D$

$g_R = Md/Rg_{md} - D/Rg_D$

Letting r, the international reserve ratio, be R/Ms = R/md then $g_R = 1/rg_{md} - (1-r/r)gd$, and substituting for g_{md} gives:

$$g_R = 1/r\ (gp + ny.gy + ni.gi) - (1-r/r)g$$

where Ms is money supply, Md demand for money, R reserves, D domestic credit, P prices, y income, i interest rate, g represents growth in the subscripted variable, and n elasticity.

Given P, y and i, this model predicts an inverse relationship between reserves and domestic credit: $g_R = -(1-r/r)gd$. This means that as the public gets more money in the form of loans, this excess supply is disposed of by purchasing more overseas thus worsening the balance of payments.

The model also predicts that increasing income will lead to an improvement in the B.O.P given gD. Again the rationale here is that as the demand for money increases with income, this excess demand has to be met by an improvement in the current account. While quantitative controls may run into problems, qualitative controls would be quite feasible and effective in the ECCB area. Ceilings may have to be imposed on consumer loans or the ECCB should seek to influence the sectoral distribution of credits. Of course this will have to be complemented by a hire-purchase policy to be effective. The objective of such measures would be to channel an increasingly larger share of total credit by commercial banks to the productive sector. This action would impact positively on official reserves both in the short and the long run. In the shorter term import volumes should fall, in the longer run, because of increased local output which would result, imports should fall further while export volumes may increase. All of this would be working simultaneously to improve the balance of payments and increase employment.

Co-ordination of Monetary and Fiscal Policy at the Area Level. When a area has a multi-state Central Bank managing a common reserve pool for its members, it requires factor mobility and convergence of economic growth. If this does not happen, the imminent drying of foreign official capital inflows would force its occurrence or challenge the continuation of the reserve pooling arrangement. Sharing a common reserve pool means that different stances of fiscal policy could result in a flow of real resources from one member country to another. This can be seen by stating the current account CA = (S+T)-(I+G). Where CA is the current account of the BOP, S is savings, T taxes, I investment and G government expenditure. A member country exercising fiscal restraint will improve its current account balance and the overall reserve holdings at the ECCB. An expansionary fiscal policy will have the opposite effect of worsening the BOP. Up to now countries pursuing the latter policy have been able to attract foreign bank financing and private direct investments. However, international developments indicate that these sources of external financing will dwindle in the years ahead, so that the capacity to meet the external debt burden by such countries in the future can become a challenge to the reserve pooling arrangement. We are contending that labor mobility within the OECS, will be necessary to pre-empt the serious intra-regional tension which can result if countries share a common reserve pool but do not all pursue monetary and fiscal policies dictated by reserve developments. If a conceivable situation arises in which the ECCB will have to assist a member country faced with an external debt repayment crisis which in effect requires all member countries to share the repayment effort, tension will only be avoided if labor is allowed to move from the country striving for external balance to the one aiming for internal balance. This development can be quickened through the realization of political and economic integration, which would also facilitate the use of regional specific monetary policy within the integrated unit, and improve the capacity of the ECCB to have a more developmental role in the area.

A More Direct Developmental Role. From the above analysis it can be surmised that the stability of the EC dollar has been achieved at the cost of increased unemployment in periods of recession, or increased foreign borrowing by individual governments. However, by taking a more direct role in the development process the ECCB can minimize the negative impact on employment of this noble achievement. Two major avenues for achieving this role are discussed below. First we consider Foreign Exchange Earnings and second we consider financial deepening.

Foreign Exchange Earnings. The ECCB Agreement vested the Authority for foreign exchange controls with the respective Ministries of Finance. This led to diverse regimes in the area from very liberal to strict controls. In a common currency area with free movement of funds, and a pegged exchange rate, such an arrangement can provide a window for capital flight outside the region and from one country in the OECS to another where interest rate differentials exist and can be another potential source of intra-regional tensions. Harmonization of exchange control laws in the OECS is therefore necessary and legislation is now being tabled in respective member countries to this effect.

To support the foreign exchange earning sector in the area, the ECCB established the Export Credit Department in 1984. The department operates a Pre-Shipment Finance Guarantee Scheme and a Post-Shipment Discounting Guarantee Scheme, and through guarantees by the ECCB, ensures that exporters of manufacturing goods obtain commercial bank financing when necessary. However, the ECCB can make more significant contributions to expanding the foreign exchange earning capacity in the sub-region. Concessionary loans to the major export producing enterprises and more industrial financing are needed. This can be done either through a discount window or through the development banks in respective member countries.

<u>Financial Deepening</u>. While achievement of the above four objectives will have the spill over effect of financial deepening, the ECCB must also take a leading role in this regard. New financial instruments have to be developed and the Central Bank has to be in the forefront. For example, while some feel that there is a dearth of venture capital in the subregion, a recent study undertaken by the Crown Agents, reveal that the shortage is in entrepreneurial skills. The ECCB in its endeavor to develop the financial sector in the area should therefore set the training process in motion either directly by recruiting suitably qualified

staff for this purpose or indirectly by obtaining technical assistance on behalf of member countries.

The achievement of each of the measures are inter-related and will all lead to widening and deepening the financial sector. An economically and politically integrated OECS would however quicken the achievement of those goals. A single OECS market by its larger size should also help to increase entrepreneurial activity, which can serve as a catalyst for deepening the financial sector. Only in such a scenario will the ECCB have greater control on the development of the OECS economies through its influence on monetary aggregates.

CONCLUSION

The success of a multi-state Central Bank in an area characterized by underdeveloped, open disequilibrium economies will depend on the extent to which the challenge is accepted. Neo-Classical economics will not lay most of the ground rules necessary for this task. The measures and instruments suggested in section III are by no means exhaustive but, if achieved, should set in motion the transformation of the financial sector, without which the ability of the ECCB to have even minimal impact will continue to be questioned. Exchange rate policy for example can hardly be a variable without political and economic integration and consequent convergence of economic development in respective regions of the OECS. The success of the ECCB will depend importantly on its innovative spirit and on the political factor. With the increased awareness which will result from serious research and analysis of relevant issues, and assuming a commitment to regional development by all parties involved, the necessary political support should be forthcoming. In any event the entire Caricom region may be forced into closer economic and monetary union by similar developments in Europe, in the far East and in North America.

The OECS economies have in place some necessary conditions for their transformation. They are, however, not sufficient. We have suggested some necessary and sufficient conditions and have articulated the role that the ECCB can play.

BIBLIOGRAPHY

Eastern Caribbean Central Bank Agreement 1983

Mc Clean W A — Money and Banking in the Eastern Caribbean, ISER : Jamaica

Ellis, C F — High Liquidity levels of Commercial Banks in the OECS ECCB, 1986

Ellis, Lewis, Fernando — Balance of Payments in the OECS ECCB, 1987

Research Dept. ECCB — Exchange Rate Developments in the ECCB Area ECCB 1986

Mc Kinnon R — Optimum Currency Areas AER September 1963

R Mundell — A Theory of Optimum Currency Areas AER September 1961

ECCB — Annual Reports