

STABILIZATION ISSUE'S IN THE O.E.C.S.

by

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INTRODUCTION

In recent years the question of economic stabilization has been receiving increasing attention by both scholars and policymakers. Recessionary conditions among other things has forced many Third World countries to adopt austere measures to stabilize their economies. Many countries have had to seek balance of payments support from the IMF and this has quite often meant adopting stabilization mechanism proposed by the Fund.

This paper looks at the development of the stabilization debate from the monetariat structuralist debate of the 1950's and 1960's attempting to identify some of the major issues.

The main purpose of the paper is to identify some of the critical macro relationships that exist in the extremely small, open economies of the Organization of Eastern Caribbean States (O.E.C.S.) It is hoped that this will throw light on

some of the issues that must be confronted in attempting to design a stabilization package for these micro states. More importantly, one hopes to identify some of the important variables that must be manipulated in order to manage these economies. Hence, one can make no attempt at proposing firm policy prescriptions at this juncture.

EARLY STABILIZATION DEBATE

(i) MONETARIST/STRUCTURALIST DEBATE

Economic stabilization can be defined as an improvement in the balance between supply and demand in our economy designed to moderate inflationary pressures and strengthening the balance of payments.

The conflict that existed in metropolitan economies about the need for stabilization policies or not, has manifested itself in the Third World particularly (Latin America) in the monetarist/structuralist debate of the 1950's and 1960's.

Structuralism is usually associated with gradualist stabilization policies. This approach argues that the roots of inflation are imbedded in the economic structures. In the case of developing countries this is characterized by resource immobility, market segmentation and disequilibrium between sectoral demands and supplies.

It is argued that as growth proceeds the economy is likely to develop extended bottlenecks as the changes in demand created by higher income levels are not met by an adequate supply response. Some examples of the main bottlenecks would be the supply of food products; the availability of foreign exchange; the rigidity in the tax and expenditure structure of the government; the inability

to generate sufficient internal saving.

The structuralist argue that any stabilization programme that does not recognize the existence of such bottlenecks is doomed to failure. It may erase one disequilibrium (the rate of inflation) but do so at the expense of creating others: excess capacity, unemployment and concentration of income and wealth. Therefore, the core of a structuralist stabilization policy would be doing away with the bottlenecks that force the economy to go through inflationary cycles. This implies that this would be a long-run policy since structural disequilibrium can only be eliminated by a re-allocation of investment. Hence, the controlling of inflation has to be a gradual process.

The monetarist view in contrast is seen to be short term and favouring a rapid control of inflation. They argued that inflation adversely affects growth and it also produces negative income distribution effects through the regressive "inflation tax." Therefore, the monetarists show a strong preference for zero inflation. They suggest that the shorter the period the goal is achieved the better. In this case a shock treatment approach to stabilization is suggested rather than a gradual adjustment to equilibrium.

In an effort to achieve this goal, the monetarists focus on the use of a few policy instrument: the control of

money supply, reduction of the fiscal deficit, exchange rate devaluation, freeing of prices and the doing away with subsidies.

In short, these were the views prevalent on stabilization in Latin America in the 1950's and 1960's. The late 1950's saw the application of numerous monetarist programmes including (Chile (1955-58), Argentina (1959-62), Bolivia (1956), Peru (1959), and Uruguay (1959-62). The policies pursued followed closely the orthodox monetarist package of stabilization policies: monetary and credit contraction, reduction in public expenditure, decreases in real wages, exchange rate devaluation and the elimination of subsidies and price control.

The short run results of the policies were generally considered to be successful. While in general inflation rates decreased they did so at the expense of falling production, rising unemployment and a deterioration of the income share of wage earners.

The structuralists got their turn to apply their policies in the 1960's and early 1970's. A good example is the stabilization programme during the Frei administration in Chile. The main aim of the programme was to stabilize the economy gradually and at the same time introduce the required long-term reforms to remove the basic bottlenecks in the agricultural, external and

fiscal sectors. After six years the economy showed a 30 per cent inflation rate, moderate growth and some improvement in the distribution of income. Alejandro Foxley argues that the high inflation rate at the end of the period is indicative of a problem inherent in the structuralist type stabilization programme. He suggests that for it to be successful it must be advanced consistently on three fronts: price stability, structural reforms and income redistribution. The balance between them is precarious and can be easily disrupted by dissatisfied interest groups. For example, Trade Union's substantial wage increase initiated by Trade Unions will produce a higher rate of inflation than was originally programmed.

THE ORTHODOX MODEL OF STABILIZATION

Despite the controversy that exists in the literature there has been fairly widespread acceptance of what can be described as the Orthodox Model of Stabilization. The model defines stabilization broadly as correcting inflation and balance of payments deficit.

Orthodox stabilization theory primarily focuses on excessive money - creation and over-valuation of the exchange rate as the sources of inflation and balance of payments deficits. The main policy measures for attaining economic stabilization are reduction in the rate of growth of domestic credit and devaluation of the exchange rate. A well recognized formulation of the orthodox theory is that by Jacques Polak. In his model, income equals money supply times velocity (by the quantity theory); money supply equals domestic credit plus international reserves. Under equilibrium conditions this year income equals last year's income. Hence, this year's money supply must equal last year's. Under these circumstances, any increase in domestic credit must be offset by a reduction in reserves to hold money supply constant. The depletion of reserves leads to a balance of payments deficit. Therefore, there is a monetary theory of the balance of payments. Generally, it argues that any growth of domestic credit leads abroad through balance of payment deficit and reserves depletion. The balance of payments can be

corrected by reducing credit. The model can accommodate economic growth in its analysis. The argument will be that if domestic credit is growing too fast for consistency with real output growth (and velocity trend, there will be a depletion of reserves and stabilization can be achieved by a decline in the growth rate of domestic credit. This basic monetary approach to the balance of payments has been at the core of the IMF stabilization programme for many years. It is interesting to note that these programmes usually contain clauses specifying limits for the expansion of domestic credit.

The control of the rate of monetary expansion has formed the centre-piece of demand management policies advocated by the fund. But stabilization programmes proposed by the IMF also include measures which are supply related. Supply side policies of the Fund assign a primary role to the workings of the 'free market' implying the removal of price controls, subsidies etc.

The IMF's support of such measures rests on the argument that, in some instance, imbalances between aggregate demand and the supply are caused by distortions in the structures of prices of both factor services and commodities particularly exports. Such distortions are held to be the factor responsible for the suppression of real output, to the extent that

they encourage a pattern of resource allocation which is in conflict with efficiency criteria.

A lot of IMF literature deals with two broad types of cost/price distortion. The first pertains to distortions in exchange rates, interest rates and wages which if they prove to be out of line with their real market values, can reduce the country's international competitiveness, and misdirect resources away from their most productive use. The second kind of cost/price distortion is said to be caused by State intervention in the allocation and pricing of resources. This type of intervention includes the widespread practice of price controls and the use of subsidies or anti-inflationary devices and the charging of less than market prices for public sector output and services. These measures are said to be destructive insofar as they prevent resources from being allocated in accordance with their relative scarcity.

The type of trade regime employed by a country is also said to affect the efficiency with which resources are employed. It is argued that a country's export performance will improve if domestic industries are exposed to increased competition viz a reduction in import controls, and if the access of these industries to foreign investment goods is not interfered with the licensing or credit rationing systems. It is for these reasons that the IMF proposes an open trade regime as part of its stabilization package.

STABILIZATION ISSUE(ii) THE RELATIONSHIP BETWEEN FISCAL MONETARY AND BALANCE OF PAYMENTS VARIABLES

There are many reasons why a discussion of the issues relating to economic stabilization in a small, open economy is important. I would suggest that perhaps the most compelling of these from a practical point of view, is the very large fiscal deficits that exist in many developing countries, and the adverse effects they have on the balance of payments in these economies. Therefore, it is useful before embarking upon a discussion of economic stabilization that some understanding of the relationship between the fiscal, monetary and balance of payments variables is shown.

SOME DEFINITIONS

The national income accounts identity is as follows:

$$Y = C + I + G + (X - M)$$

Where:

Y = total income

C = consumption

I = investment

G = government expenditure

X = exports

M = imports

We can define aggregate expenditure as:

$$E \equiv C + I + G \quad (1a)$$

Therefore,

$$Y \equiv E + (X - M) \quad (1b)$$

Rearranging, equation 1b we determine aggregate excess demand

$$Y - E \equiv X - M \quad (1c)$$

If we subtract net taxes, i.e., taxes minus domestic transfers from the righthand side and lefthand side of equation 1 and add international transfer. We get a definition of the disposable income of residents.

$$Y = R = T \equiv C + T + (G - T) + (X + R - M) \quad (2)$$

Where:

R = international transfers

T = net taxes.

We can also define private savings as

$$S \equiv Y + R - T - C \quad (3)$$

Where:

S = savings

substituting equations (3) in equation (2) and rearranging we obtain the current account surplus/deficit.

$$X + R - M \equiv S - T + (T - G) \quad (4)$$

Equation (4) implies both internal and external balance. It shows that a current account surplus on the balance of payments requires that you have excess saving over investment or a

public budgetary surplus (i.e., $T > G$). Alternatively, a sizeable fiscal deficit will have an adverse impact on the balance of payments causing a current account deficit.

Now, if there is a current account surplus/deficit then there must be some change in net foreign assets. Therefore

$$X + R - M = \Delta NFA \quad (5)$$

Where:

NFA = net foreign assets.

Substituting equation (5) into (4) we obtain:

$$S - I + T - G = \Delta NFA \quad (6)$$

One of the important implications of equation (6) is that a fiscal surplus/deficit will have an impact on the NFA and hence the balance of payments.

We can define the money stock in a small, open economy as the sum of the NFA of the banking system and the stock of domestic credit.

$$M_s = NFA + Dc \quad (7)$$

Where:

M_s = money supply

Dc = domestic credit

You will get a change in domestic credit either because of an increase in public or private borrowing. Hence:

$$DC = \Delta Dc^P + \Delta Dc^G \quad (8)$$

Where:

Dc^P = change in domestic credit (private)

Dc^G = change in domestic credit (public)

A fiscal deficit can be financed by the government by either borrowing locally or overseas; hence;

$$G - T \equiv \Delta Dc^G - \Delta NFA^G \quad (9)$$

Now, by rearranging equation (7) we can determine that a change in real NFA is equal to a change in the money supply minus the change in domestic credit.

$$\Delta NFA \equiv \Delta M_s - \Delta Dc \quad (10)$$

Substituting equation's (8) and (9) into (10) we obtain

$$\Delta NFA \equiv (T - G - \Delta NFA^G) + (\Delta M_s - \Delta Dc^P). \quad (12)$$

Equation (12) points out that a change in NFA implies a change in government's fiscal position and a change in the stock of money relative to private sector credit.

In the context of many Third World countries with large fiscal deficits it can be seen from equation (12) how these deficits contribute to the balance of payments problems that alot of these economies face. It would seem that the domestically financed government deficit is the key macroeconomic fiscal target in examining policies that influence the overall balance of payments.

A SIMPLE MODEL

We can construct a simple macroeconomic model which is relevant for small, open economies. The model is essentially Keynesian in orientation and makes three major assumptions. First, it describes a small country which meets the "small-country conditions" as far as prices paid for imports and received on exports are concerned. These countries are 'price takers' in the world market and are unable to influence prices. Second, in relation to this is the assumption that the world demand for the country's products is exogeneously determined. Third, there is 'underemployment' which implies that changes in demand do not affect the domestic price level. Therefore we assume price level to be constant.

The model postulates that the demand for domestic output is the sum of private spending, government and world demand for domestic output; hence:

$$Y \equiv D(Y,P) + G + X (Y^*) \quad (1)$$

Where:

Y = domestic output

Y* = rest of world income

G = government spending

X = exports

Total expenditure in the economy is:

$$E = C + I + G + M = D + G + M \quad (2)$$

Where:

$$D = C + T$$

$$M = \text{imports}$$

If we add and subtract M in equation (1) we obtain:

$$Y = D(y, P) + M(y, P) + G + X(y^*, P) - M(y, P) \quad (3)$$

$$= E(y, P, G) + T(y, y^*, P) \quad (3a)$$

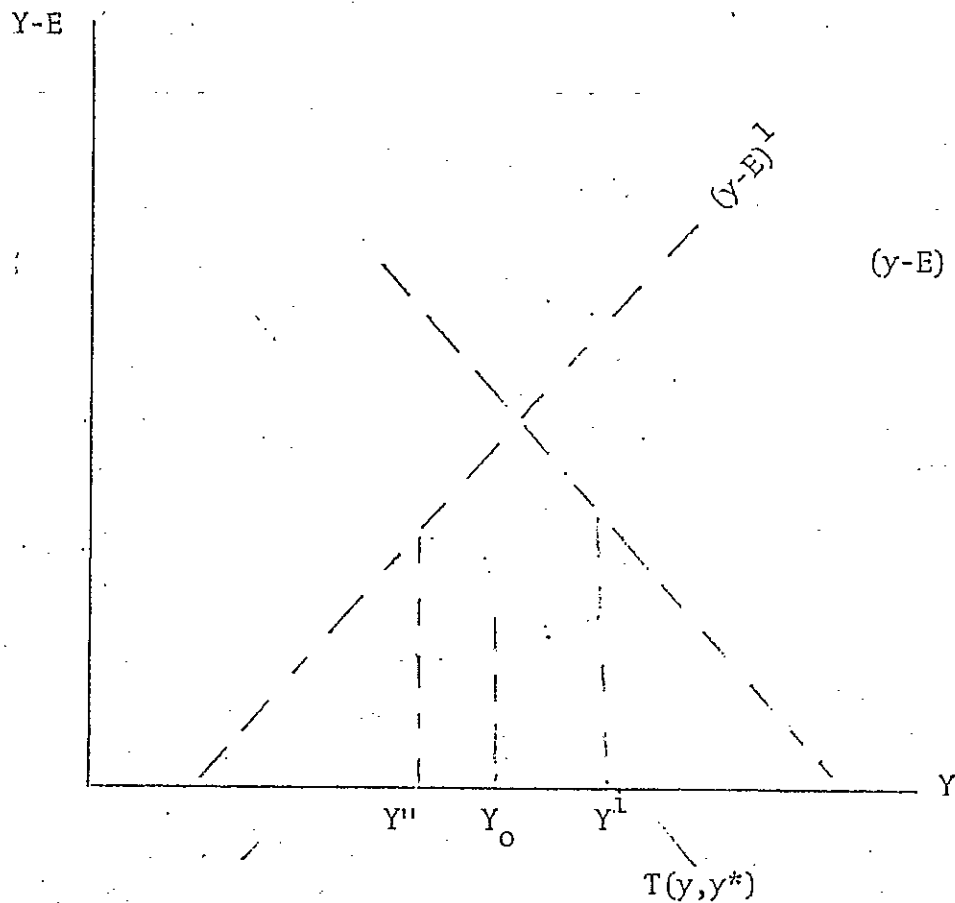
Where:

$$T = X - m + T(y, y^*, P) \quad (4)$$

In equation (3a) we are saying that total expenditure is composed of expenditure on domestic output by residents i.e., D and G and expenditure on imports. Our second term in equation 3a (T(Y, y*, P)) is the trade balance which is determined by domestic and world income levels and relative prices (i.e., local to foreign price level).

Equation (3) and (4) comprise a system which can be used to analyse the effects of the trade balance on the domestic level of incomes and this ^{has} important implications for stabilization policy as will be seen later in the discussion.

We can trace these effects by looking at the following diagram:



In our diagram the slope of Y-E is given by the marginal propensity to save and the trade balance has a negative slope with respect to Y given by the marginal propensity to import;

hence:

$$\frac{\partial E}{\partial y} = 1-s; \quad \frac{\partial (y-E)}{\partial y} = s$$

$$\frac{\partial T}{\partial y} = -m.$$

In the diagram point A defines an equilibrium level of income because the trade surplus is equal to net savings.

We can now ask the question: What will happen if there is an increase in world demand? By looking at equation 3a we can explore this question by differentiating totally and rearranging. By so doing we argue that an increase in world demand is the same as a change in exports. A change in X will produce a change in Y which will induce further changes through its impact E and T. Hence, when we differentiate equation (3) totally and rearrange we get:

$$\frac{dy}{dx} = \frac{1}{m+s} \quad (5)$$

Therefore, the income response to a change in X will depend on the marginal propensity to save (MPs) and the marginal propensity to import (MPM).

Now, we can ask what will happen to the trade balance? To find out this we differentiate equation (4) and rearrange:

$$dT = dx - mdy \quad (6)$$

Or, by substituting for dy in equation (6) we get:

$$\frac{dT}{dx} = 1 - \frac{m}{m+s} = \frac{s}{m+s} \quad (6a)$$

This implies that the larger is s rather than m the greater will be the trade balance improvement. Conversely, the larger is m the smaller will be the improvement. With a larger s the expenditure gap would be closed. In our diagram a larger s shifts

$T(y, y^*)$ to the right reflecting an improve trade balance and in consequence an increased level of income. By looking at equation (5) we see that a left word shift of $(y-E)$ in our diagram will produce a larger m than s . Hence, the increase in y due to an increase in X will result in rise in M which will widen the expenditure gap and ultimately lead to a fall in Y .

The model is purely an expenditure model and it does not discuss relative prices which is obviously a limitation. We could therefore construct a model which does account for relative prices but that will be a major derivation from the objective of this paper.¹

A central feature of our model is that it points to the 'openness' of these small economies and the importance of import expenditure. Small economies with low levels of domestic production will find that a substantial amount of an increase in income will be used by residents to purchase imports which proves to be a major source of foreign exchange leakage. In these economies the Keynesian multiplier process does not operate as suggested by Keynes if the MPM is larger than the MP's which is the case in many small economies

An important implication of this is that small economies can only really allow generous wage increases in periods of increasing foreign exchange earnings. To allow sizeable wage increases in periods of declining earnings is to encourage balance of payments problems. In many small economies the government is the largest employer. For the government to offer generous wage increases which puts a strain on the fiscal budget looking to a fiscal deficit which has to be financed through accommodation with the Central Bank which itself leads to a depletion of reserves. The increase in wages also leads to an increase in imports as spending increases by residents and this also has a negative effect on the balance of payments. So from a stabilization point of view it is critical that small economies closely monitor their domestically financed fiscal deficits and levels of imports.

It can be argued that these economies will always have to import as they are unable to produce the variety of goods and services they demand. The critical factor therefore is to produce viable exports which will enable them to finance the imports they need. In many of these economies this means moving into new areas of production which in itself necessitates a process of structural transformation which is obviously a

long-run objective. As this requires a whole host of changes by these countries, e.g. achieving a technological capability, development of human resources, good management and information system etc.² This would suggest stabilization is really a short term objective which must be carried on with the longer run process of structural transformation.

At this juncture most of the Caribbean countries are experiencing economic difficulties. In many cases the traditional exports (sugar, bauxite, oil etc.) are not generating their foreign exchange earnings that they used to so there is a continuous widening of the visible trade deficit. Many of these same countries are desperately trying to reduce sizeable fiscal deficits which are domestically financed and are therefore reserve depleting. This is true of Guyana, Jamaica and more recently Barbados and Trinidad. These countries have had to adopt austered measures in an attempt to stabilize their economies. This can be seen as only a short-run objective as the critical issue facing these countries is what new exports are they to produce? In a world of rapid technological change and these societies possessing a dearth of technical know-how the challenge is formidable but not necessarily insurmountable. However, the critical point is that a reasonable forecast would suggest that these countries would continue to have to adopt 'crisis' measures to manage their economies unless a

process of structural transformation of their economies is set in motion which would allow them to produce a new range of competitive exports.

The rest of this paper will be devoted to looking at the movements in the visible trade balances, the money supply and the fiscal balance in the O.E.C.S. Against the background of our theoretical discussion the paper will attempt to determine if there is any correlation in the movements of these variables and what are the implications for economic stabilization in these countries. In particular, I hope to determine what are some of the critical variables that must be manipulated to stabilize these economies during the present recessionary conditions.

STABILIZATION IN THE O.E.C.S.

A distinguishing feature of the O.E.C.S.'s economies is their high level of 'openness'. This is most clearly reflected in their pattern of production and trade. A large proportion of total production is for export on the world market and being small producers they have no influence on export prices and as such are 'price-takers.' A large proportion of domestic spending is comprised of imports of wage and investment goods. Consequently, increases in domestic demand followed by rising income largely do not result in an increase in production but rather finance imports. The data in Table 7 indicates that in all of the islands at least 70 per cent of domestic spending is on imports and in the case of St. Lucia 100 per cent and more. This would seem to suggest a very high marginal propensity to import (MPM) in these economies. This would imply as suggested by our model that an increase in income induced by a rise in exports will widen the expenditure-gap and ultimately reduce income. A further implication from a policy point of view is that these economies must increase their MPMs and existing production capacity/general ⁱⁿ towards the local market. Some economists dismiss this as being a simplistic and partial solution. They argue that small economies must import large quantities of goods and services as it is not feasible or viable for them to produce the range of goods and

services they need. Hence, the critical factor is that they must export vibrantly to finance the imports they need.

During the 1970's the O.E.C.Ss economies experienced a sharpe widening of the visible trade deficit. Despite the increasing return from exports these were insufficient to finance the imports demanded by these economies. In fact the situation became increasingly worse as the decade grew older. In 1972 the balance of visible trade was -\$189 .8 million E.C. and deteriorated to -\$407.1 million E.C. in 1978. The data in Table 2 shows a similar pattern for the individual islands as to be expected. This obviously was a source of substantial foreign exchange leakage and would have an adverse impact on the balance of payments. In many of these societies substantial foreign exchange inflows come from tourist expenditures and remittances and this cushions the impact of the negative visible trade balance. However, a critical issue still facing these economies is the identification and production of viable exports so that they could finance the imports they need. This is the long-run policy objective but in the short-run stabilization policy would aim at controlling the level of import rise via quotas, import controls etc.

In the decade of the 1970's a number of Caribbean governments decided that the public sector should provide the impetus for economic growth and development. This major policy

decision ascribed a much larger role for the public sector in the national economy those previously existed. This gives rise to substantial increases in public expenditure both in terms of current and capital spending. This increased spending was not accompanied by increases in government revenues, giving rise to fiscal deficits in many O.E.C.S. economies. The O.E.C.S. economies have been increasingly suffering from fiscal deficits. The data in Table 3 shows the emergency of fiscal deficits in these islands particularly after 1974 and notably all of them ended the decade with relatively large deficits with Antigua having a high deficit of \$36.3 million E.C.

The fiscal deficits in the O.E.C.S. economies are financed either through: First, foreign currency financing. Second, domestic financing i.e., ECCA credit, Bank credit and Non-bank credit. In the islands the ECCA does not accommodate the fiscal deficits as in the case with the Central Bank's in the Caribbean where the deficit is fully monetized. Under the present monetary arrangements the East Caribbean Currency Authority (ECCA) perform a limited number of central banking functions for the group. It issues the common currency provides services to the commercial banks and manages most of the foreign reserves of the areas but it lack the power to pursue an activist monetary policy.³

TABLE 3 : ST. LUCIA CENTRAL GOVERNMENT OPERATIONS
1970 - 1980 (\$'000)

	1970	1972	1974	1976	1978	1980
CURRENT REVENUE	16,249	22,907	28,395	44,830	57,669	98,500
TOTAL REVENUE & EXPENDITURE	19,222	29,998	32,162	45,133	63,396	107,372
CURRENT EXPENDITURE	14,628	17,597	25,919	40,268	44,793	92,602
TOTAL EXPENDITURE	18,949	26,886	34,167	48,507	63,408	109,544
AND NET LENDING						
DEFICIT/SURPLUS ()	(873)	(3,112)	2,005	3,374	12	2,172

GRENADA CENTRAL GOVERNMENT OPERATIONS
1970-1980 (\$'000)

	1970	1972	1974	1976	1978	1980
CURRENT REVENUE	17,609	N.A.	14,701	27,895	45,434	
TOTAL REVENUE & GRANTS	19,383	N.A.	17,721	31,485	47,138	87,315
CURRENT EXPENDITURE	18,345	N.A.	19,338	32,230	51,580	59,564
TOTAL EXPENDITURE	21,172	N.A.	23,977	35,189	57,924	93,564
AND NET LENDING						
DEFICIT/SURPLUS ()	(1,789)	N.A.	(6,256)	(3,704)	(10,786)	(6,249)

Source: C.D.B. estimates

ANTIGUA CENTRAL GOVERNMENT OPERATIONS
1970-1980 (\$'000)

	1970	1972	1974	1976	1978	1980
CURRENT REVENUE	16,299	18,788	26,457	33,883	42,394	60,874
TOTAL REVENUE & GRANTS	18,076	22,460	30,197	50,876	46,380	70,723
CURRENT EXPENDITURE	17,074	17,563	24,817	31,470	40,911	73,327
TOTAL EXPENDITURE AND NET LENDING	20,120	22,122	30,870	47,050	51,362	107,049
DEFICIT/SURPLUS ()	(2,044)	288	(673)	(3,174)	(4,982)	(36,326)

DOMINICA CENTRAL GOVERNMENT OPERATIONS
1970 - 1980 (\$'000)

	1970	1972	1974	1978	1978	1980
CURRENT REVENUE	9,756	12,612	17,628	22,256	25,288	47,186
TOTAL REVENUE & GRANTS	15,120	18,229	23,382	27,679	36,197	66,167
CURRENT EXPENDITURE	10,892	13,494	22,155	23,568	32,234	60,141
TOTAL EXPENDITURE AND NET LENDING	16,878	17,964	27,344	27,949	36,666	72,888
DEFICIT/SURPLUS	(1,758)	265	(3,962)	(269)	(469)	(6,721)

Source: C.D.B. estimates

This means that the linkage between governments fiscal operations and the money supply and the balance of payments is not as well defined as it is in the larger states. It also implies that attempts at stabilization will have to be carried out largely via fiscal policy. File data in Table 4 indicates that capital grants are the most widely employed tool of deficit financing. Net domestic financing is of some significance but not of the same order of magnitude. Hence, the indirect linkage between fiscal deficits and the balance of payments is not well established. However, the correction of the fiscal deficits should still be an objective of stabilization policy.

In attempting to correct the fiscal deficits fiscal policy should aim at reducing current expenditure in particular wherever possible. As its going to be very difficult indeed to increase revenues in economies with shrinking or stagnating tax bases. Priority should be given to capital - expenditure. The argument cannot be said to be water tight. The distinction between productive and unproductive expenditure does not usually coincide with the national accounts distinction between consumption and investment or what is classified in government's budget as current and capital expenditure. In addition, alot of public sector expenditure on capital goods are relatively unproductive in that they do not really add to medium-term growth potential. Wherever, some items of current expenditure improve the productive capacity of workers and therefore complement physical capital

formation in the growth process by improving the productivity of the existing capital stock.

The above discussion seems to imply quite strongly that in designing the fiscal content of stabilization programme, it is more appropriate to use disaggregated approaches in evaluating the profile of total expenditure, the efficiency of government's involvement and the effects of the tax system on work incentives and private sector savings.

In the O.E.C.S. countries the money supply (M) increased throughout the 1970's and this seems to have coincided with increase in the net foreign assets during the decade. If we look at the data in Tables 5 and 6 we would observe that there was some slowing down in the growth of the money supply and the net foreign assets between 1973-1976 the period of serious international recession. Following this, there was a fairly substantial increase in both the money supply and the net foreign assets.

The expansion of domestic credit in the 1970's was largely fuelled by increases in commercial banks credit to the private sector. However, an important feature of the period has been the increase in credit from the commercial banks to the public sector particularly after 1975. This has been largely due to

the decline in multilateral lending with the onset of the international recession. This precipitated serious competition for concessionary finance so O.E.C.S. countries began to look at foreign and local commercial banks for finance to support their capital expenditure programme. This of course would put the state in competition with the private sector for the purchasing of investible funds and the possibility of the 'crowding out' effect occurring became real. Available information suggests that this occurred in Grenada creating a severe liquidity squeeze. In 1982 the use of non-concessional financing rose to about 13 per cent of GDP principally through borrowing from the local commercial banks through a doubling of the special deposit requirement to 20 per cent of deposits. Public sector borrowing from the local banking system increased by EC \$30 million and created a severe liquidity squeeze. This caused the ratio of the bank's net foreign assets to total deposits to fall from 26 per cent at the end of 1981 to 4.6 per cent at the end of 1982. In the case of the government-owned national commercial banks, this ratio fell from 39 per cent to 2 per cent during the same year.⁴ Thus, in the case of Grenada public sector borrowing placed severe constraints on the private sector's access to credit and at the same time created a severe liquidity squeeze.

The increasing use of domestic credit by the public sector must be monitored closely by the authorities. In a situation where there is a limited pool of credit, funds have to be allocated efficiently giving priority to investment that contributes to GDP, foreign exchange earnings and employment. It is a waste of scarce resources to deny the private sector access to credit for consumption loan financing by the state. So, it should be ^{the} priority of the authorities to monitor commercial banks loan policies and minimize loan financing of consumption rather than investment.

The data in Table 4 and 5 would seem to suggest that a lot of the expansion of the money supply in the 1970's was as a result of increases in the net foreign assets. Using the balance of visible trade as a proxy of the current account of the balance of payments we plotted a logarithmic graph (Table 6) of the money supply and visible trade balance for the period 1972-78. It would seem to suggest that percentage changes in the money supply were matched by almost proportional percentage changes in the visible trade balance. One can infer with some certainty from this that there is some correlation between the money supply and the balance of payments. This implies that controlling money supply expansion necessitates the efficient management of reserves. As an increase in the money supply finances increases in spending

which increase the demand for imports leading to a further leakage of foreign exchange and an unfavourable effect on the balance of payments. Hence, stabilization policy requires the efficient management of reserves, the controlling of domestic spending on imports. The authorities must bleed the economy of the excess money and in the O.E.C.S. this could be done either by taxation or selling government bonds to the commercial banks and the public.

CONCLUSION

Economic stabilization has become of increasing importance with the recession of the 1970's that has persisted into the 1980's. The structure of small, open economies has serious implications for the use of orthodox stabilization measures in these economies. Probably the most critical factor is the degree of openness of these economies and the effect high levels of import expenditure have on income and the trade balance and ultimately the balance of payments.

The O.E.C.S. economies are very open with very high levels of expenditure on imports. Despite moderate increases in foreign exchange earnings from exports they have not been sufficient to finance the imports these countries demand. As such there has been a continuous widening of the visible trade balance in the 1970's and this has resulted in a leakage of foreign exchange. A target of stabilization policy must be to control the growth of this deficit.

The 1970's saw the emergence of fiscal deficits in these countries and policy must be aimed at correcting this. The most sensible solution would be to reduce expenditure wherever possible. By using a disaggregated approach one would be able to cut expenditure that is consumption rather than investment oriented and as such not growth promoting.

Finally, the expansion of the money supply in the decade has been largely due to increases in net foreign assets. Stabilization policy should aim at the efficient management of reserves and bleeding the economy of the excess money.

The lower-run objective of these economies has to be the identification and production of more viable exports which necessitate a whole range of things - human resource development, good management and information, proper marketing etc. These small economies must import and will find it increasingly difficult to finance the imports they need from their present group of exports (bananas, sugar, arrowroot, spices etc). Hence, stabilization policy can only help ease the prices in the short-run but the much larger challenges in changing their patterns of production to meet the demands of a changing international market. If this is not attempted the O.E.C.S. may find itself for years having to keep in place stern stabilization measures with untold hardships besetting the populace.

TABLE 1. ECCA: Measure of Exposure to Foreign Trade

	Exports as Per cent of GDP 1/					Imports as Per cent of Domestic Spending						
	1976	1977	1978	1979	1980 2/	Period Average	1976	1977	1978	1979	1980	Period Average
Antigua	17.1	10.9	17.8	13.4	21.1	16.1	66.8	56.8	57.0	74.7	79.1	66.9
Dominica	40.1	33.4	37.0	20.7	17.1	29.7	74.8	61.8	64.5	42.3	63.3	61.3
Grenada 3/	29.4	28.7	27.4	30.5	-	29.0	59.5	65.4	55.0	58.5	-	59.6
Montserrat	4.6	6.3	14.5	7.2	7.0	7.9	83.9	77.5	107.2	115.7	76.1	92.1
St. Kitts- Nevis	-	51.8	49.6	42.8	34.6	44.7	-	92.6	82.7	87.0	57.9	80.1
St. Lucia	31.4	32.3	30.9	32.2	40.9	33.5	87.8	100.0	126.2	112.8	116.6	108.7
St. Vincent	28.7	27.0	34.8	28.8	26.2	29.1	62.6	71.7	75.7	73.9	68.7	70.5

Sources: World Bank Economic Memorandum; E.C.C.M. Trade Digest 1979.

1/ Percentages would be much higher if tourism and remittances were included.

2/ Estimates.

3/ No data for 1980.

TABLE 2. TOTAL IMPORTS, TOTAL EXPORTS AND BALANCE OF VISIBLE TRADE: 1970-1979
E.C. (\$'000)

Year	CATEGORY	TOTAL ECCM	ANTIGUA	DOMINICA	GRENADA	MONTserrat	ST. KITTS	ST. LUCIA	ST. VINCENT
1970	Total M	- -	72,649	31,258	44,632	8,801	23,427	54,585	30,517
	Total X	- -	21,846	11,810	12,075	2777	8,294	8,078	6,529
	(X-M)	- -	-50,803	-19,448	-32,557	-8,524	-15,133	-46,507	-23,998
1971	Total M	- -	86,767	33,019	46,051	8,558	30,505	68,998	36,016
	Total X	- -	32,230	12,279	10,193	125	8,059	9,207	5,391
	(X-M)	- -	-54,537	-20,740	-35,858	-8,433	-22,446	-59,791	-30,625
1972	Total M	272,241	90,967	34,693	- -	12,080	30,563	68,690	35,239
	Total X	82,407	34,639	13,459	- -	370	12,117	15,118	6,704
	(X-M)	-189,834 (2.76)	-56,337	-21,234	- -	-11,710	-18,446	-53,572	-28,535
1973	Total M	329,300	94,504	32,293	42,487	12,148	35,595	74,170	38,103
	Total X	137,515	59,445	16,738	14,512	686	16,576	19,234	10,124
	(X-M)	-191,985 (2.281)	-35,059	-15,555	-27,975	-11,462	-19,019	-54,936	-27,979
1974	Total M	418,497	143,750	38,908	37,080	15,968	39,366	91,115	52,300
	Total X	179,401	66,468	20,949	19,266	1,048	24,134	32,909	14,627
	(X-M)	-239,096 (2.378)	-77,282	-17,969	-17,814	-17,814	-15,232	-58,206	-37,673

(cont'd)

TABLE 2. TOTAL IMPORTS, TOTAL EXPORTS AND BALANCE OF VISIBLE TRADE: 1970-1979
E.C. (\$'000)

Year	CATEGORY	TOTAL ECCM	ANTIGUA	DOMINICA	GRENADA	MONTSERRAT	ST.KITTS	ST.LUCIA	ST.VINCENT
1975	Total M	465,045	145,141	45,036	42,487	16,544	51,361	100,425	53,913
	Total X	210,293	59,920	24,646	26,915	1,019	46,841	34,453	16,396
	(X-M)	-254,752 (2.405)	085,221	-20,390	-24,710	-15,525	- 4,520	-65,972	-37,414
1976	Total M	474,154	91,836	49,248	66,248	20,803	57,711	125,708	62,016
	Total X	208,213	23,164	29,055	34,121	1,122	46,402	49,912	24,445
	(X-M)	-265,941 (2.425)	-68,672	-20,777	32,127	-19,681	-11,309	-75,796	-37,579
1977	Total M	556,204	92,094	59,081	84,763	18,933	59,178	160,232	81,923
	Total X	218,349	17,686	32,295	38,451	1,643	40,535	60,983	26,756
	(X-M)	-337,855	-74,408	-26,786	-46,312	-17,290	-18,643	-99,249	-55,167
1978	Total M	694,911	108,420	76,770	96,269	65,336	233,469	97,690	
	Total X	287,815	33,775	42,890	45,775	3,775	45,282	72,390	43,992
	(x-M)	-407,096 (2.530)	-74,645	-33,880	-50,494	-23,216	-20,084	-151,079	-53,698
1979	Total M	- -	- -	59,970	117,660	- -	86,659	272,738	125,202
	Total X	- -	- -	25,391	58,479	2,054	45,474	85,973	39,826
	(X-M)	- -	- -	-34,579	-9,181	- -	-41,185	-186,764	-85,376

Source: 1970-72 - The Commonwealth Caribbean - Sidney E. Chernick

1973-79 - Trade Digest 1979 (.E.C.C.M. Secretariat)

TABLE 4. Financing of Public Sector Deficits
(In millions of EC dollars)

	1975					1980 1/				
	Capital Grants	Net Foreign Borrowing	Net ECCA Borrowing	Change in International Reserves	Net Domestic Financing	Capital Grants	Net Foreign Borrowing	Net ECCA Borrowing	Change in International Reserves	Domestic Financing
Antigua	4.0	0.5	0.4	1.8	-2.2	226.6	2/	2.7	-0.5	-10.0
Dominica	-	-1.7	0.1	2.1	0.4	-	0.1	0.6	-0.1	- 2.0
Grenada	-	-	-	-	-	21.0	2/	1.0	-1.9	12.0
Montserrat	3.7	0.3	-	0.2	0.4	6.1	1.0	-	-1.1	-
St. Kitts- Nevis	1.1	-0.3	-	-1.6	1.1	8.9	10.8	-	0.2	- 4.0
St. Lucia	10.3	2.7	1.5	-0.3	3.9	29.1	2/	1.8	-0.1	6.1
St. Vincent	<u>2.6</u>	<u>0.6</u>	<u>0.6</u>	<u>-0.3</u>	<u>2.7</u>	<u>5.0</u>	<u>12.6</u>	<u>-</u>	<u>-</u>	<u>1-</u>
Area total										

Source: World Bank Economic Memorandum.

1/ 1980 estimates except for St. Vincent, 1979/80 actual.

2/ Loans and grants grouped together.

TABLE 5. E.C.C.A. Money Supply Statistics (1970-80)
(EC\$million)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Money (M ₁):	4.814	4.223	4.882	4,900	5.003	5.00	5.01	5.25	5.251	5.361
(i) Currency with public	65.2	66.5	76.3	79.4	100.8	99.9	125.8	160.3	178.3	229.5
(ii) Demand deposits	33.1	33.2	36.8	32.6	37.4	40.6	47.0	59.6	63.1	78.1
Quasi-Money	192.6	202.4	233.7	257.1	310.9	394.0	418.2	444.3	517.4	598.0

Source: E.C.C.A.¹ Annual Statement of Accounts 1975; 1980

¹E.C.C.A. is the Eastern Caribbean Currency Authority

TABLE 22. Percentage Change in Demand Deposits and Quasi-Money
1972-80

	1972	1973	1974	1975	1976	1977	1978	1979	1980
Demand Deposits	2	13	4	21	-2	21	22	10	22
Quasi-Money	5	13	9	17	21	6	6	14	13

TABLE 6. Factors Affecting The Money Supply
(EC\$ million)

Assets	1971	1972	1973	1974	1975	1967	1977	1978	1979	1980
FOREIGN ASSETS (NET)	76.1	86.5	78.5	54.8	81.0	146.7	157.4	145.3	189.0	231.6
(i) Monetary Authority	60.8	71.5	75.9	54.1	151.6	165.8	147.5	157.2	154.8	
(ii) Commercial Banks	15.3	115.0	2.6	0.7	19.7	-4.9	-8.4	-2.2	31.8	46.8
DOMESTIC CREDIT	184.9	193.0	239.0	275.0	371.1	325.9	408.5	499.3	539.1	634.3
(i) Commercial Banks	181.6	189.7	234.1	266.1	296.3	308.1	383.6	473.2	509.7	598.9
ii. (a) Public Sector	4.6	5.1	4.7	6.2	3.7	38.8	92.6	110.5	88.3	126.7
(b) Private Sector	177.0	184.6	229.4	259.9	292.6	269.3	291.0	362.7	421.4	472.2
(ii) Monetary Authority	3.2	4.2	4.9	8.9	14.7	17.8	24.9	26.1	29.4	35.4
(a) Participating Governments	3.3	4.2	4.9	8.9	14.7	17.8	24.9	26.1	29.4	35.4
TOTAL ASSETS	261.0	280.4	317.5	329.8	392.0	472.6	565.9	644.6	728.1	865.9

Source: E.C.C.A. Annual Statement of Accounts 1972; 1975; 1980.

M₅
(X-A)

6

5

4

3

2

1

(X-A)

(M₅)

0

1972

1973

1974

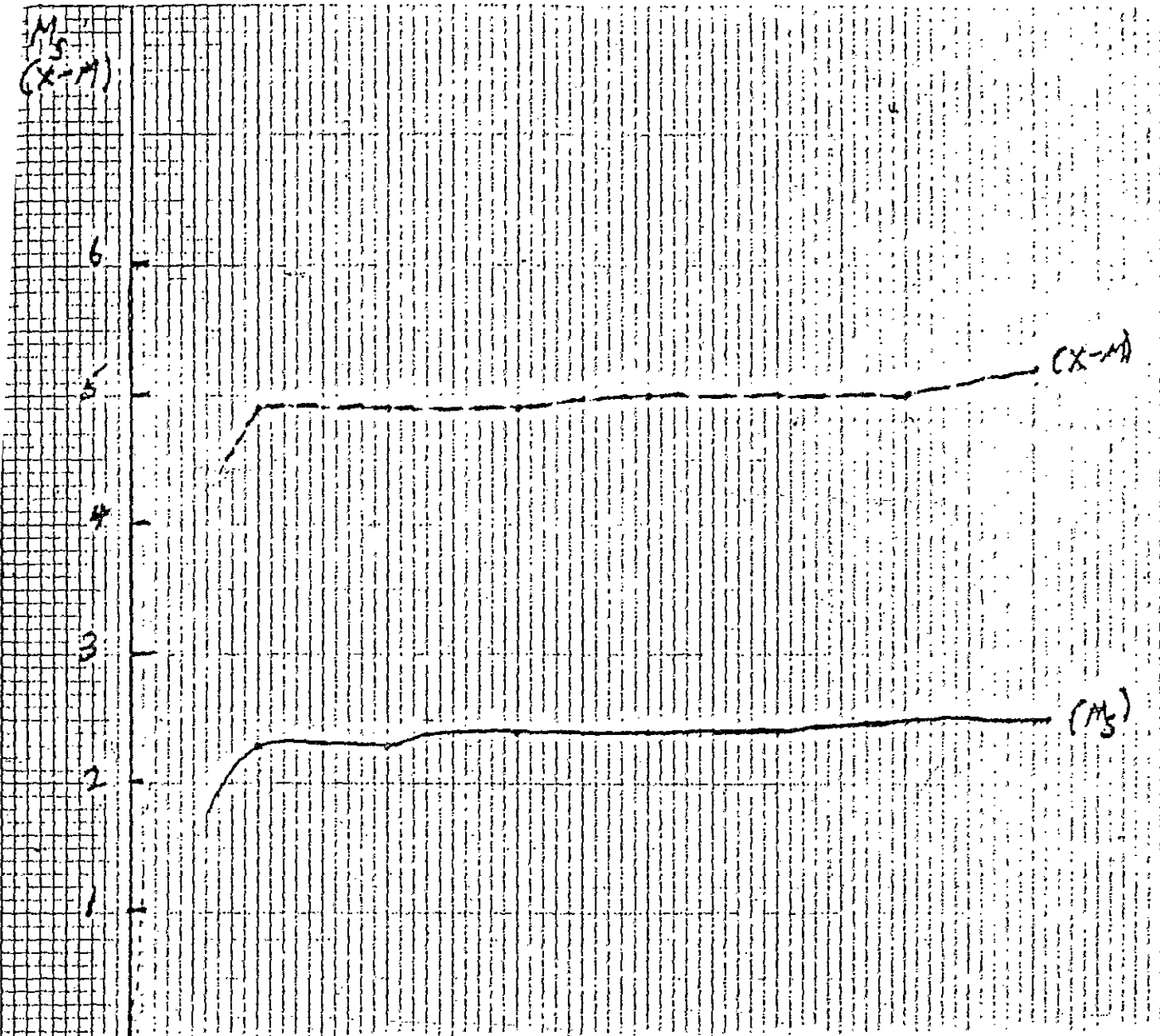
1975

1976

1977

1978

YEARS



Year	(X-A)	(M ₅)
1972	4.2	1.8
1973	4.8	2.2
1974	4.8	2.3
1975	4.9	2.4
1976	5.0	2.4
1977	5.1	2.5
1978	5.2	2.5

FOOTNOTES

¹It should be noted that fiscal policy does affect relative prices p.9. Changes in the tax rates on foreign trade items. Also it affects the general price level.

²A good discussion of some of the critical features of a transformation strategy in the present international content can be found in Farrell, T.M. "Some notes on Economic Transformation" (Mimeo, Department of Economics, St. Augustine.

³The O.E.C.S. have now established the Eastern Caribbean Central Bank. The agreement was signed by the Heads of Government on July 5, 1983. The Agreement states that the purpose of the banks are:-

1. to regulate the availability of money and credit;
2. to promote and maintain monetary stability;
3. to promote credit and exchange conditions and a sound financial structure conducive to the balance growth and development of the economies of the territories of the Anticipating Governments;
4. to actively promote through means consistent with its other objection the economic development of the territories of the Participating Governments.

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