

AN ASSESSMENT OF MONETARY AND CREDIT POLICIES

IN THE OECS REGION 1975-1985

Due to the uniqueness of the institutional features that circumscribe the conduct of monetary policy in the OECS countries, it is considered that an appropriate point of departure for this paper would be to highlight the main features of the monetary arrangements. Accordingly Section I gives a description of the monetary and institutional arrangements in the OECS region; this is followed in Section II by a review of developments in the real economy, while Section III surveys the money supply process, credit developments and policies. Section IV examines the use of monetary instruments and provides an appraisal of the efficacy of monetary and financial policies over the period of assessment.

I. INSTITUTIONAL ARRANGEMENTS

The OECS region is served by a common currency, the Eastern Caribbean dollar. During most of the period considered in this paper 1975 to (September) 1983, the monetary unit was issued and managed by the East Caribbean Currency Authority (ECCA) under the terms of the ECCA Agreement. The ECCA generally lacked the power to pursue an active monetary policy. It had no power to determine the level or structure of interest rates, the distribution of credit, minimum liquidity requirements, or statutory reserves for commercial banks. Within these limitations however, the ECCA performed a range of important functions. In addition to the note issuing function, it had the authority to offer rediscount facilities to commercial banks and grant credit to participating governments within certain statutory limits. It also served as a clearing house for the settlement of transactions, both within the ECCA and wider CARICOM region, and managed a large portion of the external reserves of the area.

Effective October 1, 1983 the Eastern Caribbean Central Bank (ECCB) replaced the ECCA as the Monetary Authority for the OECS region. The Agreement establishing the new institution incorporated provisions for the use of the monetary instruments which are normally associated with central banking and which were lacking under the terms of the Agreement establishing its predecessor. These include the authority to impose reserve requirement against deposit liabilities of financial institutions; to determine limits on domestic rates of interest; to regulate credit; as well as to carry out the function of bank supervision and administer schemes for the provision of export credit insurance and guarantee.

The additional powers were granted in order to better equip the Bank to perform its major purposes which are to regulate the availability of money and credit; promote and maintain monetary stability; promote credit and exchange conditions and a sound financial structure conducive to the balanced growth and development of the economies of the territories of participating governments.

II. ECONOMIC STRUCTURE AND PERFORMANCE

The OECS countries are broadly similar in terms of size, openness of economy, resource base and structure of production. They depend heavily on a narrow range of exports of goods and tourist services in order to be able to purchase the necessarily much wider range of imports needed for consumption, investment and production purposes. Agriculture is the mainstay of the area economy and accounts for more than half of export earnings. The major export commodities are bananas, sugar (both of which are exported primarily to the United Kingdom) cocoa and nutmegs. Agricultural output is sometimes affected by adverse weather conditions such as drought, and more seriously by hurricanes. Tourism, the second largest foreign exchange earner, is providing an increasing proportion of export earnings, while manufacturing remains relatively modest in terms of its contribution to GDP.

All OECS countries were seriously affected by the first oil shock and the subsequent world recession from 1973-1975. However, from 1976 through 1978, in virtually all countries real GDP growth rates were positive and fairly high (the exceptions were St. Kitts and Nevis, and Montserrat which recorded negative growth in 1976). Over this period weather conditions were favourable, agricultural production rose and light manufacturing and tourism expanded significantly.

After 1978, there was a significant deterioration in the economic environment. Several countries experienced natural disasters - two hurricanes in 1979 caused severe losses to productive capacity in Dominica, and the economy of St. Vincent and the Grenadines was seriously affected by volcanic eruption in the same year. In 1980 another hurricane hit the area causing substantial output losses in St. Lucia and Dominica. Moreover, a second oil price increase affected growth in the industrial countries in 1979 and 1980 and led to a fall in tourist arrivals in the OECS area; this was exacerbated by the decline in commodity prices in 1981 through to 1983. Real growth declined substantially in all countries and became negative in Dominica in 1979 and 1980, St. Lucia in 1980, Antigua in 1982 and Grenada, St. Kitts and Nevis, and Montserrat in 1983 (Table 1). The countries badly hit by the natural disasters turned to external grants and loans to finance large fiscal deficits occasioned partly by the rehabilitation efforts, and those that were IMF members utilised Fund resources.

Real GDP growth recovered in the period 1983-1985, as the upturn of economic activity in the United States resulted in increased tourist arrivals. At the same time better weather conditions as well as improved methods of production and packaging of bananas, particularly in St. Lucia, bolstered agricultural exports.

TABLE 1

OECS AREA - SELECTED ECONOMIC INDICATORS

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|----------------------------|-------|-------|-------|-------|-------|--------|-------|-------|--------|
| <u>ANTIGUA</u> | | | | | | | | | |
| Nominal GDP | 153.3 | 172.3 | 206.0 | 247.8 | 274.5 | 295.7 | 331.3 | 369.3 | 409.3 |
| Real GDP | 153.3 | 161.0 | 175.3 | 189.3 | 196.7 | 194.1 | 206.5 | 220.0 | 234.67 |
| % Change in Real GDP | n.a. | 5.02 | 8.88 | 7.99 | 3.91 | - 1.32 | 6.39 | 6.54 | 6.67 |
| Rate of Inflation (CPI) | 13.8 | 6.2 | 16.2 | 19.2 | 11.5 | 4.2 | 2.3 | 3.9 | n.a. |
| <u>DOMINICA</u> | | | | | | | | | |
| Nominal GDP | 84.8 | 105.9 | 105.8 | 143.7 | 152.9 | 163.6 | 178.4 | 197.9 | 213.9 |
| Real GDP | 84.8 | 95.4 | 79.2 | 92.2 | 98.1 | 100.5 | 102.6 | 108.9 | 110.2 |
| % Change in Real GDP | n.a. | 12.4 | -17.0 | 16.4 | 6.4 | 2.4 | 3.1 | 6.2 | 1.2 |
| Rate of Inflation (CPI) | 9.5 | 7.8 | 18.0 | 32.7 | 13.3 | 4.4 | 4.2 | 2.1 | 2.1 |
| <u>GRENADA</u> | | | | | | | | | |
| Nominal GDP | 108.2 | 132.5 | 152.9 | 169.7 | 200.5 | 216.2 | 223.2 | 242.3 | 259.5 |
| Real GDP | n.a. | n.a. | n.a. | n.a. | 183.2 | 184.2 | 179.0 | 182.5 | 188.0 |
| % Change in Real GDP | n.a. | n.a. | n.a. | n.a. | n.a. | 0.5 | - 2.8 | 2.0 | 3.0 |
| Rate of Inflation (CPI) | n.a. | n.a. | n.a. | 21.2 | 18.8 | 7.8 | 6.1 | 5.7 | 2.5 |
| <u>MONTserrat</u> | | | | | | | | | |
| Nominal GDP | 27.6 | 31.9 | 38.1 | 57.6 | 63.9 | 71.0 | 76.4 | 84.2 | 90.7 |
| Real GDP | 27.6 | 29.6 | 32.4 | 36.4 | 36.7 | 38.0 | 36.2 | 37.4 | 39.1 |
| % Change in Real GDP | - 2.2 | 7.3 | 9.3 | 12.4 | 0.9 | 3.7 | - 4.7 | 3.2 | 4.6 |
| Rate of Inflation (CPI) | 13.0 | 10.9 | 16.3 | 29.8 | 7.1 | 9.8 | 4.7 | 5.5 | 2.7 |
| <u>ST. KITTS AND NEVIS</u> | | | | | | | | | |
| Nominal GDP | 69.2 | 76.3 | 87.5 | 103.1 | 120.5 | 137.8 | 136.2 | 148.9 | 155.6 |
| Real GDP | 69.2 | 71.2 | 77.0 | 80.1 | 84.1 | 89.4 | 87.8 | 90.7 | 91.6 |
| % Change in Real GDP | - 0.1 | 2.9 | 8.1 | 4.0 | 5.0 | 6.3 | - 1.8 | 3.3 | 1.0 |
| Rate of Inflation (CPI) | 19.4 | 12.2 | 11.2 | 17.9 | 10.4 | 6.0 | 2.2 | 2.7 | 2.2 |
| <u>ST. LUCIA</u> | | | | | | | | | |
| Nominal GDP | 156.7 | 191.0 | 229.1 | 264.2 | 299.4 | 312.5 | 323.4 | 353.0 | 388.8 |
| Real GDP | 156.7 | 177.0 | 183.5 | 182.1 | 184.3 | 189.9 | 197.6 | 207.5 | 219.5 |
| % Change in Real GDP | | 13.0 | 3.7 | - 0.8 | 1.2 | 3.0 | 4.1 | 5.0 | 5.8 |
| Rate of Inflation (CPI) | 8.9 | 10.9 | 9.4 | 19.5 | 15.1 | 4.6 | 1.5 | 1.2 | 1.0 |
| <u>ST. VINCENT</u> | | | | | | | | | |
| Nominal GDP | 79.6 | 101.5 | 117.2 | 131.5 | 164.6 | 188.2 | 204.3 | 216.8 | 232.0 |
| Real GDP | 79.6 | 88.1 | 91.4 | 95.5 | 102.6 | 108.6 | 114.1 | 117.7 | 122.9 |
| % Change in Real GDP | 6.5 | 10.7 | 3.7 | 4.5 | 7.4 | 5.9 | 5.1 | 3.1 | 4.4 |
| Rate of Inflation (CPI) | | | 15.6 | 17.2 | 12.7 | 7.3 | 5.4 | 2.7 | 2.0 |

SOURCE: Statistical Departments and OECS Secretariat

Savings and Investment

As is to be expected, gross domestic savings mirrored developments in GDP. In the period 1979-1981 gross domestic savings declined in most countries (both in nominal terms and as a percentage of GDP) and became negative in the countries most severely affected by disasters, namely, Dominica and St. Lucia (Table 2). Gross domestic investment by contrast increased significantly in most countries during the period, which meant that an increasing proportion of investment was financed by foreign savings. Much of this increase was in the form of grants and other forms of aid to governments. In the period 1982-1985, the rate of domestic savings picked up in most countries but this was offset by a fall-off in the rate of capital inflows, leading to a reduction in the ratio of investment to GDP.

The principal problem in developing countries is one of raising per capita income over time. Given the role of domestic savings in this process, it follows that the efficacy of monetary policy may usefully be assessed in this regard. In developing countries generally, the financial components of domestic savings are of vital importance, as it is through financial assets that domestic savings are channelled to the most productive sectors of the economy. A review of policies in this regard would be taken up in Section IV.

Developments in the External Accounts

The external balance deteriorated considerably during the period 1979-1981 as imports rose substantially due to the rehabilitation requirements following the effects of natural disasters in that period. The external current account deficit rose from 22% of GDP in 1979 to 29% in 1981, while the overall external balance shifted from a surplus equivalent of 2.5% of GDP to a deficit of almost 3% (Table 3). This was followed by a significant improvement in the area's external balance in the 1982-1985 period; the current account deficit was reduced to 27% of GDP in 1982 and to less than 15% in 1985, while the overall balance shifted to a surplus equivalent of about 4.6% of GDP in 1985.

TABLE 2

ECCA REGION: SAVINGS AND INVESTMENT

(In Millions of EC dollars)

| | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|----------------------------|-------|-------|-------|-------|-------|-------|-------|-------|------|
| <u>ANTIGUA</u> | | | | | | | | | |
| Gross Domestic Savings | 29.8 | 36.2 | 15.2 | 20.7 | 32.4 | 31.0 | 59.8 | 57.0 | |
| As % of GDP | 19.4 | 21.0 | 7.4 | 8.4 | 11.8 | 10.5 | 18.1 | 15.4 | |
| Gross Domestic Investment | 36.9 | 39.0 | 88.5 | 93.5 | 145.9 | 146.9 | 84.6 | 116.7 | |
| As % of GDP | 24.1 | 22.6 | 43.0 | 37.7 | 53.2 | 49.7 | 25.5 | 31.6 | |
| <u>DOMINICA</u> | | | | | | | | | |
| Gross Domestic Savings | 2.1 | 0.5 | -34.3 | -32.9 | -21.9 | 1.0 | 18.5 | 17.4 | 27.4 |
| As % of GDP | 2.5 | 0.5 | -32.4 | -22.9 | -14.3 | 0.6 | 10.4 | 8.8 | 12.8 |
| Gross Domestic Investment | 21.5 | 27.5 | 41.0 | 79.7 | 57.1 | 54.9 | 57.6 | 88.9 | 84.6 |
| As % of GDP | 25.6 | 26.0 | 38.8 | 55.5 | 37.3 | 33.6 | 32.3 | 44.9 | 39.6 |
| <u>GRENADA</u> | | | | | | | | | |
| Gross Domestic Savings | n.a. | n.a. | n.a. | - 2.8 | 11.5 | 17.6 | 11.6 | 6.4 | |
| As % of GDP | n.a. | n.a. | n.a. | n.a. | 5.7 | 8.1 | 5.2 | 2.6 | |
| Gross Domestic Investment | n.a. | n.a. | n.a. | 53.9 | 94.2 | 124.1 | 107.2 | 88.5 | |
| As % of GDP | n.a. | n.a. | n.a. | n.a. | 47.0 | 57.4 | 48.0 | 36.5 | |
| <u>MONTSERAT</u> | | | | | | | | | |
| Gross Domestic Savings | - 8.6 | - 9.7 | -14.0 | -18.1 | -17.3 | -17.8 | -15.1 | - 9.7 | |
| As % of GDP | -31.2 | 30.4 | 36.7 | 31.4 | 27.1 | 25.1 | 19.8 | 11.5 | |
| Gross Domestic Investment | 9.9 | 14.3 | 19.6 | 26.9 | 33.7 | 32.1 | 25.6 | 26.9 | |
| As % of GDP | 35.9 | 44.8 | 51.4 | 46.7 | 52.7 | 45.2 | 33.5 | 21.9 | |
| <u>ST. KITTS AND NEVIS</u> | | | | | | | | | |
| Gross Domestic Savings | 17.5 | 14.6 | 11.4 | 10.2 | 1.7 | 5.4 | -21.7 | 0.1 | |
| As % of GDP | 25.3 | 19.1 | 13.0 | 9.9 | 1.4 | 3.9 | -15.9 | 0.1 | |
| Gross Domestic Investment | 38.8 | 25.1 | 37.3 | 49.9 | 46.1 | 55.1 | 49.9 | 53.3 | |
| As % of GDP | 56.1 | 32.9 | 42.6 | 48.4 | 38.3 | 40.0 | 36.6 | 29.4 | |
| <u>ST. LUCIA</u> | | | | | | | | | |
| Gross Domestic Savings | 3.96 | 8.57 | 15.74 | 20.1 | - 7.0 | - 1.2 | 33.7 | 43.8 | |
| As % of GDP | 2.5 | 4.5 | 6.9 | 7.6 | - 2.3 | - 0.4 | 10.4 | 12.4 | |
| Gross Domestic Investment | 62.5 | 101.2 | 128.6 | 159.1 | 164.8 | 145.3 | 113.8 | 126.0 | |
| As % of GDP | 39.9 | 53.0 | 56.1 | 60.2 | 55.0 | 46.5 | 35.2 | 35.7 | |
| <u>ST. VINCENT</u> | | | | | | | | | |
| Gross Domestic Savings | - 9.4 | 4.4 | -15.3 | -18.6 | 1.4 | - 0.4 | 17.8 | 37.5 | |
| As % of GDP | 11.8 | 4.3 | -13.1 | -14.1 | 0.8 | - 0.2 | 8.7 | 17.3 | |
| Gross Domestic Investment | 33.9 | 34.4 | 48.6 | 62.8 | 64.2 | 68.4 | 73.7 | 84.3 | |
| As % of GDP | 42.6 | 33.9 | 41.5 | 47.8 | 39.0 | 36.3 | 36.1 | 38.9 | |

SOURCE: Statistical Departments and OECS Secretariat

TABLE 3

OECS REGION: SUMMARY BALANCE OF PAYMENTS

(In millions of EC dollars)

| | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 |
|---|--------|---------|---------|---------|---------|---------|---------|
| <u>Current Account</u> | -209.8 | -324.0 | -373.4 | -372.6 | -209.9 | -241.3 | -262.0 |
| Trade Balance | -608.3 | -744.7 | -797.9 | -774.6 | -745.2 | -870.4 | -948.4 |
| Exports | 278.1 | 456.6 | 465.5 | 471.3 | 508.3 | 545.5 | 575.0 |
| Imports | -886.4 | -1201.2 | -1263.4 | -1245.9 | -1253.5 | -1415.9 | -1524.4 |
| Service Balance | 259.5 | 281.1 | 264.9 | 237.4 | 351.8 | 446.3 | 505.4 |
| Travel (net) | 251.4 | 294.3 | 295.1 | 301.9 | 340.0 | 432.5 | 495.8 |
| Other Services | 8.1 | -13.2 | -30.2 | -64.5 | 11.8 | 13.8 | 9.6 |
| Private Transfers | 139.2 | 139.6 | 159.6 | 164.8 | 183.6 | 182.8 | 180.8 |
| <u>Capital Account</u> | 230.3 | 289.7 | 328.6 | 356.1 | 206.5 | 318.1 | 343.2 |
| Official Grants | 73.7 | 114.8 | 102.3 | 95.0 | 88.2 | 147.4 | 153.6 |
| Net Public Borrowing | 58.0 | 43.0 | 128.8 | 88.3 | 73.7 | 47.5 | 31.3 |
| Changes in Arrears | 1.1 | 1.6 | 4.1 | 12.4 | - | - | - |
| Commercial Banks | -9.5 | 4.6 | -8.6 | 17.3 | -31.5 | 2.3 | -0.6 |
| Private Direct Investment and Errors & Omissions | 107.0 | 125.8 | 102.1 | 143.1 | 76.1 | 120.9 | 158.9 |
| <u>SDR Allocations</u> | 3.0 | 4.1 | 3.8 | - | - | - | - |
| <u>Overall Surplus/Deficit (-)</u> | 23.5 | -30.2 | -41.0 | -16.5 | -3.4 | 76.8 | 81.2 |
| <u>Financing</u> | -23.5 | 30.2 | 41.0 | 16.5 | 3.4 | -76.8 | -81.2 |
| Changes in ECCB Foreign Assets | -28.3 | 22.1 | -3.5 | 15.1 | -3.5 | -69.5 | -63.8 |
| Changes in Govt. Foreign Assets | - 3.0 | 0.5 | 0.8 | - 0.2 | -1.2 | - 0.6 | - 0.9 |
| IMF Borrowing (net) | 7.8 | 7.6 | 43.7 | 1.6 | 8.1 | - 6.7 | -16.5 |

SOURCE: IMF (1979-1982), ECCB (1983-1985)

The area's combined merchandise exports rose quite sharply in 1980. This reflected the recovery from the devastation of the previous year, but more so, a sharp rise in the unit value of exports due to a general rise in commodity prices as well as the appreciation of sterling. Subsequently, however, the growth in exports slowed considerably as commodity prices fell and sterling depreciated. In relation to GDP, exports declined from almost 41% in 1981 to 33% in 1985. Tourism recovered from the 1980-1982 slump, however, expanding moderately in 1983 and strongly in 1984 and 1985. Imports declined noticeably in 1982-1983 reflecting the weakness in tourism and investment spending, but rebounded in 1984, with the recovery in economic activity, tourism and private foreign investment. These balance of payments developments were the major factors affecting the money supply process which is the subject of the next section.

III. THE MONEY SUPPLY PROCESS

Due to the institutional constraints in the application of conventional monetary policy in the OECS region during most of the period covered in this paper, it is fair to say that no direct attempt was made to influence the availability of money. In any event, even in countries where the necessary instruments exist doubt has been cast as to the direction of any causal relation between changes in the money supply and changes in real variables. Eshag [6] notes that in most cases, changes in the supply of money are not only accompanied by, but are actually caused by movements in other economic variables. He observed that this is true, for example, of changes in the supply of money which results from the budgetary and balance of payments positions.

Data on money supply for the OECS countries between 1975 and 1985 show that narrow money grew at an annual average rate of 14.3% and broad money by a rate of 14.7%. As can be seen from Table 4, while the difference in the average rate of growth of the two aggregates during the period was small, there was much greater volatility in the growth of the narrow money aggregate.

Also during the period 1976-1980 the growth rate of narrow money was consistently higher than that of broad money, whereas, in the period 1981-1985 the converse situation obtained. The latter period was one of relatively high interest rates and the lower rate of growth of narrow money relative to that of broad money, may indicate some degree of interest rate sensitivity of narrow money.

TABLE 4

Money Supply and Components
(Quarterly Averages)

| | M1 \$M | M2 \$M | MB \$M | M ₁ K | M ₂ K |
|------|-----------|-----------|-----------|------------------|------------------|
| 1974 | 85.7 | 358.2 | 50.8 | 1.69 | 7.05 |
| 1975 | 93.7 | 429.8 | 90.9 | 1.03 | 4.73 |
| 1976 | 113.6 | 509.6 | 186.6 | 0.61 | 2.73 |
| 1977 | 133.9 | 553.8 | 168.2 | 0.80 | 3.29 |
| 1978 | 162.0 | 634.0 | 176.2 | 0.92 | 3.60 |
| 1979 | 206.5 | 775.3 | 177.8 | 1.16 | 4.36 |
| 1980 | 251.3 | 879.4 | 180.4 | 1.39 | 4.87 |
| 1981 | 278.1 | 1021.7 | 191.2 | 1.45 | 5.34 |
| 1982 | 286.3 | 1123.4 | 160.0 | 1.79 | 7.02 |
| 1983 | 308.6 | 1265.3 | 174.5 | 1.77 | 7.25 |
| 1984 | 336.1 | 1429.7 | 227.9 | 1.47 | 6.27 |
| 1985 | 365.9 | 1614.0 | 274.7 | 1.33 | 5.88 |

M1 = Narrow Money; M2 = Broad Money; MB = Monetary Base;
M₁K = Narrow Money Multiplier; M₂K = Broad Money Multiplier.

SOURCE: ECCA/ECCB Banking Statistics

The theory of the monetary base asserts that the money supply consists of a money multiplier and high powered money or the monetary base. The latter consists of 'till money' and bankers' balances, which are a subset of the liabilities of the Central Bank. Applying this theory as outlined by Cuthbertson [5], to the OECS countries, the monetary base B, may be held either by the non-bank sector R_p or the banks R_b . With the money supply M_s , defined as cash held by the non-bank sector C_p , and deposits D of the commercial banking system,

$$M_s = C_p + D \quad (1)$$

$$B = R_p + R_b \quad (2)$$

A rearrangement of these two identities gives a third identity

$$M_s = \frac{1 + C_p/D}{\frac{R_p}{D} + \frac{R_b}{D}} B = \left[\frac{1 + a}{b_p + b_b} \right] B \quad (3)$$

where $a = \frac{C_p}{D}$ etc. The term in brackets is referred to as the multiplier, denoted by k , so that,

$$M_s = kB \quad (4)$$

From the above identity the money supply may then be seen as reflecting both the behaviour of the Central Bank, through the monetary base and the behaviour of the bank and non-bank sectors via the money multiplier. The Central Bank influences the monetary base through its credit to governments, and changes in foreign and other assets. The influences of the banks and non-bank sector are fed through the changes in the factors affecting the multiplier.

Following Bhatia [2], this analytical framework can be used to decompose changes in the money supply, into changes attributable to variations in the money multiplier and those due to variations in the monetary base. Thus from (4) above

$$\Delta M_s = B \Delta k + k \Delta B \quad (5)$$

Of these two determinants of the money supply, cumulative yearly changes in the money multiplier accounted for only 5.4% of the increase over the period 1975-1985 (Table 5). Changes in the monetary base were the predominant trend and cyclical influence on the changes in the money supply of the OECS countries. While the trend influence of the changes in the money multiplier tended to reinforce the trend influence of the changes in the monetary base, their respective cyclical contribution was on occasion conflicting. A cyclical increase in the monetary base was accompanied by a dampening of the value of the money multiplier and vice versa. The increase in the monetary base and contraction in the money multiplier in the period 1975-1976 was associated with the hedging operations of the commercial banks at a time when speculation was rife concerning a revaluation of the EC dollar. These operations led to an abrupt rise in bank reserves with the Monetary Authority, which was only partially reflected in increased commercial bank deposits. In the period 1981-1983, natural disasters and economic recession culminated in a sharp decline in the monetary base, and a substantial rise in the money multiplier. With the revival of economic activity in 1984 and 1985, the direction of change in these components of the money supply was reversed.

Changes in the monetary base has its counterpart in the assets of the monetary accounts as represented by the changes in net foreign assets, net credit to governments, and as a residual, changes in other assets of the Monetary Authority. Movements in net foreign assets reflecting the area's balance of payments out-turn was the dominant influence on the monetary base over the period under consideration. The cumulative influence of credit to participating governments accounted for about 25%, and its impact was relatively steady over the period, due to the limitations imposed on this form of credit by the monetary arrangements of the area.

TABLE 5

Impact of Changes in Money Multiplier and Monetary
Base on Changes in Money Supply - 1975 to 1985
(EC\$M)

| | ΔM | $K(\Delta B)$ | $B(\Delta K)$ |
|------------------|---------------|---------------|---------------|
| 1975 | 71.6 | 236.2 | -164.4 |
| 1976 | 80.6 | 357.3 | -277.6 |
| 1977 | 44.2 | - 55.7 | 99.5 |
| 1978 | 80.2 | 27.9 | 53.4 |
| 1979 | 141.3 | 6.0 | 134.6 |
| 1980 | 104.1 | 12.0 | 91.3 |
| 1981 | 142.3 | 55.1 | 87.3 |
| 1982 | 101.7 | -192.8 | 295.0 |
| 1983 | 141.9 | 103.5 | 38.5 |
| 1984 | 172.2 | 362.0 | -189.1 |
| 1985 | <u>185.1</u> | <u>285.9</u> | <u>-100.5</u> |
| Cumulative Total | <u>1265.2</u> | <u>1197.4</u> | <u>68.0</u> |
| Percentage | 100.0 | 95.6 | 5.4 |

SOURCE: ECCA/ECCB Banking Statistics

In determining the limits of credit expansion, the Monetary Authority takes into account the existing levels of external assets and demand liabilities, and, bearing in mind its obligation to maintain a reserve of external assets of not less than 60% of its demand liabilities, establishes global credit limits for the ensuing twelve months. Credit allocation to each government is determined by the ratio of its recurrent revenues to total revenues for all members. Governments are free to draw on their allocations at any time in order to finance budget deficits, subject to the issuance by them of the appropriate mix of Treasury Bills and long-term securities (debentures) as advised by the Monetary Authority¹ (see Allen [1]). In practice, the global amount allocated in any one year has never been taken up in full, though on occasions individual governments utilised the full amount of their respective limits.

The differential effect on the money supply by budgetary deficits if financed by borrowing from a country's central bank or its commercial banking system has been noted by Coats and Khatkhate [3]. Central Bank credit to government causes money to expand directly by increasing the monetary base. However, if financed by commercial banks, the monetary effects depends upon the behaviour of the money multiplier. In very open economies like those of the OECS, this has direct implications for the balance of payments. Increases in the money supply occasioned by the expansion in Central Bank credit, in the absence of rigid and effective exchange controls, are apt to lead more to reductions in external reserves than to price inflation. This suggests that the employment of financial resources emanating from such credit expansion is crucial and ought to be directed more towards development orientated projects.

¹ With the establishment of the ECCB an additional facility to grant advances to participating Governments to meet seasonal needs was introduced.

Credit Policy and Developments

During the period of assessment no formal instruments were in force to influence either the level of credit or its sectoral allocation in the economies of the OECS. That is not to say however that the authorities have not been concerned with the composition of credit. Recognising that the availability of finance to certain specific sectors is a sine qua non for investment and hence economic growth, both the governments and the monetary authority have sought indirectly to influence the allocation of bank credit by moral suasion. This aside, credit policy was the prerogative of the lending institutions in the area. In this regard, two basic criticisms have consistently been directed at the commercial banks operating in the region. Firstly that the banks have exhibited a definite preference for self-liquidating short-term loans and secondly that their loan portfolios are biased in favour of loans to the distributive trades and those for personal use, while loans to the manufacturing and agricultural sectors are given a relatively low priority ranking.

In the ECCB area total bank credit increased at an average annual rate of 15% between December 1975 and December 1980. On a territorial basis the most rapid growth was recorded in St. Kitts with Dominica and St. Vincent and the Grenadines also recording rates above the average. All other territories recorded rates which were below average, the lowest being in Grenada. The pattern of growth in the individual territories during the period has not been uniform and has fluctuated in large measure with the varying economic developments in the territories. However on average there were notable increases in the years 1978 and 1980 when total bank credit expanded by 20.6% and 20.9% respectively. In 1981 and 1982 bank credit expanded at a fairly constant rate of 17% but was followed by a slow down in 1983 and 1984 to approximately 11%. In 1985 the growth of credit again showed signs of acceleration rising by 13%.

An analysis of the distribution of credit by sectors in each country and for the area as a whole (Table 6) appears to support the criticism referred to earlier regarding the apparent bias of commercial banks in favour of lending to the distributive trades sector and for personal uses. It must however be borne in mind that the statistics present only the supply side of credit disbursement and information regarding the demand for credit by these sectors is not known. These two sectors accounted for a combined share of 45% of total loans outstanding in the area at the end of 1985 compared with a share of 43% at the beginning of the period. Despite this apparent marginal increase in overall figures, there were substantial increases in St. Lucia and Antigua. In the former territory the proportion rose from 35.8% to 55.7% over the period, while in the latter the share rose from 38.9% to 46.2%. A particularly significant development over the period was the decline in the proportions in St. Kitts and Nevis from 50.9% to 29.7% and in St. Vincent and the Grenadines from 53.6% to 34.7%.

It should be noted however, that credit to the distributive trades may indirectly be financing imports for the productive sectors, building materials for example, and that about 50% of lending for personal use is for the purchase of house and land, which represents an addition to the physical wealth of the purchasers, and should strictly be regarded as investment rather than consumption. However, consumer durables (mainly car purchases) which do not contribute to the development of the area's productive capacity, have been rising, with direct implications for the balance of payments.

When consideration is given to commercial bank lending to the productive sectors, namely, agriculture, manufacturing and tourism the picture is quite different. For the area as a whole these sectors together absorbed credit over the period amounting to only 19.5% of total loans outstanding. Moreover the share of loans to these sectors has declined in all countries over the 1975-1985 period with the notable exception being St. Vincent where the proportion actually increased from 15.5% at the beginning of the period to 29% at the end of 1985. In Dominica the fall was particularly large from 34.9% in 1975 to 14.3% in 1985.

TABLE 6

DISTRIBUTION OF LOANS AND ADVANCES

Quarterly Averages in Per Cent

| | | Agriculture | Manufacturing | Distributive Trades | Tourism | Construction | Government & Statutory Bodies | Personal | Other |
|---|------|-------------|---------------|---------------------|---------|--------------|-------------------------------|----------|-------|
| <u>Antigua & Barbuda</u> | 1975 | 3.9 | 7.7 | 19.5 | 11.9 | 13.5 | 9.8 | 19.4 | 14.3 |
| | 1985 | 1.4 | 6.7 | 7.7 | 8.2 | 10.3 | 12.3 | 38.5 | 14.9 |
| Period Average | | 2.0 | 8.6 | 14.1 | 6.3 | 8.5 | 15.3 | 29.4 | 15.8 |
| <u>Dominica</u> | 1975 | 18.9 | 6.4 | 26.3 | 9.6 | 8.3 | 10.8 | 13.7 | 6.0 |
| | 1985 | 4.4 | 5.5 | 19.1 | 4.4 | 5.7 | 19.1 | 23.5 | 18.3 |
| Period Average | | 12.7 | 6.5 | 19.8 | 5.5 | 5.0 | 18.5 | 19.7 | 12.3 |
| <u>Grenada</u> | 1975 | 7.5 | 4.3 | 30.9 | 7.1 | 5.8 | 19.7 | 13.6 | 11.1 |
| | 1985 | 3.3 | 7.5 | 25.3 | 6.8 | 7.9 | 9.9 | 22.2 | 17.1 |
| Period Average | | 5.4 | 5.4 | 28.1 | 7.9 | 6.6 | 13.4 | 19.6 | 13.6 |
| <u>St. Kitts & Nevis</u> | 1975 | 6.7 | 2.1 | 20.7 | 4.5 | 4.6 | 11.1 | 30.2 | 20.1 |
| | 1985 | 0.5 | 3.5 | 8.1 | 5.7 | 7.7 | 43.5 | 21.6 | 9.4 |
| Period Average | | 2.5 | 4.8 | 14.4 | 6.3 | 7.4 | 24.1 | 24.2 | 16.3 |
| <u>Montserrat</u> | 1975 | 2.5 | 2.7 | 15.5 | 5.4 | 11.8 | 2.8 | 44.9 | 14.4 |
| | 1985 | 0.4 | 3.2 | 17.1 | 4.3 | 2.7 | 12.1 | 48.1 | 12.1 |
| Period Average | | 1.9 | 3.2 | 19.1 | 5.2 | 8.1 | 7.9 | 40.8 | 13.8 |
| <u>St. Lucia</u> | 1975 | 6.8 | 11.0 | 16.7 | 6.7 | 11.7 | 15.9 | 19.1 | 12.1 |
| | 1985 | 3.5 | 5.3 | 16.8 | 8.5 | 2.6 | 9.7 | 38.9 | 14.7 |
| Period Average | | 5.1 | 10.8 | 16.6 | 7.5 | 6.0 | 10.0 | 29.9 | 14.1 |
| <u>St. Vincent & The Grenadines</u> | 1975 | 7.4 | 2.7 | 29.7 | 5.4 | 9.1 | 11.0 | 23.9 | 10.8 |
| | 1985 | 7.7 | 19.9 | 12.3 | 1.4 | 5.3 | 6.7 | 22.4 | 24.3 |
| Period Average | | 6.3 | 12.8 | 18.6 | 2.6 | 7.0 | 11.7 | 24.6 | 16.4 |
| <u>ECCB Region</u> | 1975 | 7.2 | 6.5 | 22.6 | 7.9 | 9.8 | 13.1 | 20.3 | 12.6 |
| | 1985 | 3.1 | 7.6 | 13.7 | 6.1 | 6.4 | 15.9 | 30.8 | 16.4 |
| Period Average | | 4.9 | 8.5 | 17.8 | 6.1 | 7.0 | 14.7 | 26.1 | 14.9 |

Of the three productive sectors, agriculture received the smallest share of credit¹. On average over the period a mere 5% of total bank credit went to agriculture. When this is compared with the contribution of this sector to GDP, which amounted to approximately 17% over the period, the discrepancy between the importance of this sector to growth in the economy and its weighting in terms of the availability of credit becomes apparent. In all territories except for St. Vincent and the Grenadines where there was a small increase, agriculture's share in total credit has been declining. In Dominica the developments have been particularly significant. In 1975 the share of bank credit extended to this sector was as much as 18.9%. It fell to 9.5% in 1978 and then rose again to reach 17.7% in 1980 following the hurricanes in 1979. Thereafter the proportion has been declining steadily and in 1985 reached an all-time low of 4.4%.

Tourism over the period of analysis received on average 6% of total bank credit. Its share has exhibited a declining trend in most territories, the exceptions being St. Lucia and St. Kitts and Nevis where small increases were recorded. In Antigua which has grown increasingly dependent on tourism as the major foreign exchange earner, the proportion of bank loans extended to this sector fell from 11.9% to 8.2% over the period. In Dominica and St. Vincent and the Grenadines the fall in respective shares was also significant.

The manufacturing sector was the only productive sector which recorded an increased share in total credit and even then it was not dramatic. On average the area as a whole recorded an increased share from 6.5% in 1975 to 7.6% in 1985. The increase in share was however significant in St. Vincent and the Grenadines where the proportion rose from 2.7% at the beginning of the period to 19.9% at the end. At the other extreme St. Lucia recorded a decline in share from 11% to 5.3%. There were smaller decreases in Antigua and Barbuda and Dominica while the other territories all recorded marginal increases.

¹ Though some loans for agricultural purposes may have been classified as loans to statutory bodies.

An analysis of total domestic credit in the ECCB area for the period 1979-1985¹ show an average rate of expansion of 14.5%. Accelerated growth was experienced in 1980 and 1982 followed by a general slow-down. In 1985 however most countries witnessed increased rates of credit expansion.

Table 7 shows the distribution of total domestic credit by borrower in each country and for the area as a whole over the period 1979-1985. The data show the extent of the public sector's demand on the domestic resources of the area. Because of the substantial involvement of governments in many areas of economic activity, borrowing by this sector has been utilised for a myriad of purposes. These include the financing of current account deficits and long-term expenditures such as the construction of social infrastructure and in some instances the acquisition of hotels. To the extent that credit to this sector represents a bias towards the finance of public consumption, they may have diverted resources away from investment.

Over the period total public sector credit accounted for an average of 26% of total domestic credit. Of this central government absorbed an average of 18% while the rest was taken up by statutory bodies and government corporations. Whereas the proportion remained relatively stable for the area as a whole there were significant increases in Grenada, St. Kitts and Nevis, St. Vincent and the Grenadines and Montserrat. However the ratio declined substantially in Antigua and Barbuda and Dominica.

Of total private sector credit, borrowing by individuals accounted for the largest proportion. Overall this category of borrower accounted for 35.7% of domestic credit. Antigua and Barbuda and St. Lucia recorded particularly large increases over the period (from 34.2% to 51.5% and from 34.4% to 48.3% respectively). However there were notable reductions in Grenada and St. Vincent and the Grenadines.

¹ Data is not available for the period prior to 1979

TABLE 7

Distribution of Domestic Credit by Borrower

Quarterly Averages: In Percent

| | Central Govt. | Statutory Bodies & Govt. Corp. | Business Firms | Individuals | Other |
|---|------------------|--------------------------------------|-------------------|-------------|-------|
| ANTIGUA AND BARBUDA | | | | | |
| 1979 | 27.5 | 4.0 | 32.1 | 34.2 | 2.2 |
| 1985 | 20.1 | 0.8 | 26.5 | 51.5 | 1.1 |
| Period Average | 24.1 | 2.7 | 31.6 | 39.4 | 2.2 |
| DOMINICA | | | | | |
| 1979 | 28.7 | 4.2 | 28.2 | 37.5 | 1.4 |
| 1985 | 19.6 | 5.8 | 29.7 | 38.4 | 6.5 |
| Period Average | 24.7 | 5.8 | 34.8 | 31.4 | 3.3 |
| GRENADA | | | | | |
| 1979 | 21.8 | 1.5 | 38.0 | 36.3 | 2.4 |
| 1985 | 26.3 | 5.1 | 38.8 | 28.0 | 1.8 |
| Period Average | 24.7 | 4.4 | 38.1 | 30.6 | 2.2 |
| MONTserrat | | | | | |
| 1979 | 0.0 | 4.4 | 39.8 | 38.4 | 17.4 |
| 1985 | 9.5 | 5.1 | 35.8 | 38.7 | 10.9 |
| Period Average | 7.8 | 2.4 | 37.7 | 37.6 | 14.5 |
| ST. KITTS AND NEVIS | | | | | |
| 1979 | 16.4 | 9.6 | 27.2 | 29.0 | 17.8 |
| 1985 | 19.8 | 26.5 | 19.8 | 32.2 | 1.7 |
| Period Average | 15.1 | 23.3 | 25.9 | 29.2 | 6.5 |
| ST. LUCIA | | | | | |
| 1979 | 15.0 | 4.3 | 41.1 | 34.4 | 5.2 |
| 1985 | 14.1 | 1.0 | 34.7 | 48.3 | 1.9 |
| Period Average | 13.5 | 1.9 | 39.0 | 43.2 | 2.3 |
| ST. VINCENT AND THE GRENADINES | | | | | |
| 1979 | 17.0 | 7.8 | 34.4 | 35.3 | 5.5 |
| 1985 | 10.4 | 26.1 | 31.2 | 30.1 | 2.2 |
| Period Average | 12.6 | 16.5 | 37.9 | 30.6 | 2.5 |
| ECCB REGION | | | | | |
| 1979 | 20.2 | 5.0 | 34.8 | 34.4 | 5.6 |
| 1985 | 17.8 | 9.3 | 30.0 | 40.5 | 2.4 |
| Period Average | 18.4 | 7.9 | 34.8 | 35.7 | 3.2 |

The share of domestic credit allocated to business firms increased over the period 1979 to 1982 from 34.8% to 39.2% but subsequently declined to 30% in 1985. Most countries exhibited this declining trend during the three last years with significant reductions recorded in Dominica, and Antigua and Barbuda. In the other territories the decline actually started a year earlier, that is in 1981.

Over the period 1975-1979 commercial banks in the area exhibited a relatively high degree of liquidity, the loans to deposits ratio averaging 72%. Although this ratio has increased significantly since then, a number of banks are at present fairly liquid. Alternative investment opportunities need therefore to be identified so as to ensure that the banks excess funds are used for developmental purposes.

IV. MONETARY POLICY AND INSTRUMENTS

In the OECS, monetary policy and the use of instruments in the period under consideration reflected the limitations of the monetary arrangements referred to earlier, as well as the regional nature of the monetary institution. Policies to regulate or otherwise to affect the financial system were initiated both at the level of the Monetary Authority and by the respective Ministries of Finance.

(i) Reserve Requirements

Changes in minimum reserve requirements can be an important technique of monetary control in developing countries. In the absence of Authority by the ECCA to prescribe reserve requirements for commercial banks in the OECS region, governments in the 1970s with the exception of that of Montserrat required commercial banks to place a specified proportion of their deposits with the Treasury as statutory reserves. In some countries however, the locally owned banks were exempted from this requirement. Initially these statutory deposit requirements varied from 2.5% in St. Vincent to 5% in Antigua and St. Kitts and Nevis, to 7.5% in Dominica, to 10% in Grenada and St. Lucia. Subsequently, these rates were increased in St. Vincent to 7.5%,

in Antigua to 10% and in Grenada to 20%. While it was stated initially that the imposition of the statutory deposits were for prudential reasons, the resources were in practice used for fiscal purposes and therefore did not in fact serve any monetary objective.

With the establishment of the ECCB, agreement was reached with governments for the Bank to assume the special deposit liabilities to commercial banks. At the same time the Bank, with the approval of the Monetary Council, prescribed that commercial banks operating in the territories of the participating governments maintain minimum reserves with it at the level of 6% of their deposit liabilities. Where banks were required to hold special deposits with the Treasury of their respective territories, they were permitted to satisfy 5% of the reserve requirement by a transfer of resources from their Special Deposit Account. The remaining 1% was to be met by banks in the form of cash balances. Commercial banks that were not required by governments to maintain special deposits were required by the Central Bank to satisfy 1% of the requirement in cash balances, but were given a maximum period of three years to meet the overall reserve requirement of 6%. The Statutory Deposits held by banks with the Treasuries of the various governments and which were assumed by the Central Bank amounted to \$75.7m. These were reduced to \$21.1m by March 1986 as resources were transferred to meet the Central Bank's reserve requirement on increased deposit liabilities.

The Bank's policy on required reserves was intended to have no more than a minimal immediate impact on the operations of commercial banks. Indeed prior to the imposition, some banks held balances with the Central Bank in excess of the cash portion of the requirement. The more immediate objective was to develop uniformity in the ECCB area in the minimum level of reserves.

(ii) Interest Rate Policy

The power to regulate interest rates was only obtained since the establishment of the ECCB in October 1983. While both the ECCA and ECCB Agreements provided for the Monetary Authority to rediscount bills and make advances to meet the short-term liquidity needs of approved commercial banks, the banks have made only infrequent use of these facilities and consequently the bank rate has had little or no influence on the structure of interest rates in the area. Indeed the bank rate has functioned more as a penalty rate, with the objective of encouraging banks to bring in resources from abroad.

Commercial banks operating in the area are not required under the banking or exchange control laws of the respective territories, to surrender foreign exchange earnings to the Central Bank. To encourage the banks to surrender their foreign currency earnings, a policy was introduced in the mid 1970s whereby commercial banks were permitted to maintain interest bearing deposit accounts, in which the local currency proceeds of the sale of foreign currency may be held. In practice, the rates offered in these deposits reflected those on international markets, while the bank rate, applicable mainly for overdrafts and advances, is normally set at between one and two percentage points above the one month rate on fixed deposits. As noted above, these rates had little or no influence on the structure of interest rates in the area.

More direct action was taken in relation to interest rate, when effective January 1985, the Central Bank introduced regulations prescribing a minimum rate of interest of 4% to be paid on savings deposits by commercial banks. The intent of this policy measure, was to assist financial intermediation in the area and to reward and encourage savings by small deposit holders. Prior to the introduction of this measure interest rates on savings deposits had remained fairly stable for a number of years with most banks offering rates as low as 2.5%.

For much of the period under consideration therefore, commercial banks operated in an environment in which they were largely free to set their own interest rate. Although usury laws existed in Grenada and St. Vincent, those were easily circumvented by discounting procedures. In discussing interest rate policies therefore, focus must be placed on the commercial banking sector. An IMF study conducted by Grant-Suttie and Vaez-Zadeh [7], noted that the interest policy of the major commercial banks may be considered as one of seeking to achieve a target rate of return. In these circumstances the overall level of deposit rates was to ensure that bank resources grow at the desired rate; given these deposit rates and projections of the bank's asset and liability portfolios, lending rates are set to achieve the target rate of return. On those occasions when the growth in bank resources fell below requirements, leading to pressures on liquidity, it was usually the interest rate on time deposits that had been raised. If as a result the projected rate of return fell below the target rate, this provided an indication that lending rates should be raised.

An analysis of the structure of commercial bank interest rates in the period under consideration, reveals that up until 1976, interest rates in the region were directly influenced by those in the U.K. market, as the EC dollar link with sterling facilitated the freedom of capital movements. With the severance of the EC dollar/sterling peg in 1976 and the extension of exchange controls to all foreign currencies, the relationship lapsed. Since then, interest rates in the region have shifted generally in line with the liquidity position of banks, as measured by the loan/deposit ratio. This ratio declined from 76% in 1975 to 72% in 1979 but increased to an average of 83% in the period 1983-1985. Over this period interest rates offered by banks on savings deposits declined continuously from a range of 4%-5% in 1975 to one of 2.5%-5% in 1978, and remained essentially at that level until the end of 1984. Similarly, time deposit rates, as indicated by the three-month rate declined from a range of 6%-9% in 1975 to one of 2.5%-6% in 1980. Thereafter this rate rose sharply to a range of 4%-11% in 1983, reflecting the deterioration in bank liquidity. Interest rates on deposits were negative in real terms during the period 1975-1980, as the average inflation rate measured in terms of the retail price index remained in the range of 13%-16% in the OECS region.

With the abatement in the rate of inflation in 1981 and the rise in nominal rates due to a tightening of liquidity, some real rates became positive in the period 1982-1985, particularly those for time deposits.

The rise in nominal deposit rates began in 1982 when the liquidity position of the banks, came under severe pressure. The deterioration was due in part to the effects of the economic depression and partly to buoyant demand for consumer type loans. An outflow of funds and decline in remittance due to speculation concerning a devaluation of the EC dollar may also have been a contributory factor.

Lending rates in the area as indicated by prime rates declined from an average of 10% in 1975 to an average of 9% in 1981, but increased in the years 1982-1984 to an average of 11% reflecting the liquidity pressures in the banking system referred to earlier. In real terms, prime lending rates were mostly positive up until 1978, negative through 1978-1980, with the intensification of inflation and positive since then. Prime lending rates do not necessarily give an accurate indication of how the cost of loans to the customer has varied. Actual costs depend on the premium paid above prime (usually at least two percentage points for private customers) but more importantly the discounting procedure in calculating interest. Effective rates on so called "add-on loans" ranged between 17% and 24% in the respective countries in 1984.

The nominal spread between savings deposits rate and the prime rate has been ranging between 6 to 8 percentage points, but the effective spread has been much wider. The effective spread varies between individual banks depending on the structure, and therefore the weighting of their deposit base in relation to the structure and discounting procedure of their lending operations. Effective interest spread were calculated to range between 6% and 10% in the various territories in 1984.

Both the ECCB and the member governments are concerned about the current high level of lending rates in the area, especially in light of the relatively liquid position of the banking system, and have used moral suasion to encourage the banks to reduce these rates. While in some instances the banks have responded positively, much more needs to be done in this regard.

(iii) Exchange Rate Management

In the existing international arrangement, the exchange rates of the major currencies are determined through floating. For small countries like those of the OECS area, the circumstances are such that it is not possible to operate effectively with a floating exchange rate given the small size and under-developed nature of their capital and exchange markets. The options available to the OECS countries are either to peg to a major currency and float against all others with that currency, peg to the SDR basket, or to a basket of currencies which reflects the pattern of trade of all countries of the area taken together. The actual choice must, however, be based on criteria such as exchange rate stability and the maintenance of external competitiveness.

The Eastern Caribbean dollar has been pegged at a rate of EC\$2.70 = US\$1.00 since July 1976; prior to that time the currency was pegged to the pound sterling at a rate of EC\$4.80 = £1.00. The shift to a peg arrangement with the US dollar which was made at the cross-rate prevailing at the time, followed the changed international monetary arrangements in the early 1970s from a system of predominantly fixed exchange rates to one where floating became predominant among major countries.

The pound sterling depreciated substantially against most other major countries for much of the early and middle 1970s, and because of its link to sterling the EC dollar depreciated in tandem. The decision to peg to the US dollar, took into account the depreciation of sterling, the fact that the area's trade relationships had changed from a situation where sterling trade was dominant to one where trade was mainly in US dollars or US dollar linked currencies, as well as a judgement about the future exchange rate movement of sterling and the US dollar and their likely effect on the economies of the EC dollar countries.

The US dollar peg was considered advantageous in that it was simpler to administer, as it avoids periodical calculations and announcement of values that would be necessary if a currency basket was used. However, judging that a US dollar peg at a particular rate is the most appropriate of the available alternatives at some point in time, does not necessarily mean that that rate would also be appropriate in the future. In judging the adequacy of the parity, account must be taken of the competitive position of the area economies. In deciding on any adjustment, consideration should be given to the economic prospects, including the relative cost and price trends between the respective economies and their trading partners. This would involve an analysis of the likely impact of that policy measure on various sectors of the economies. If an adjustment is considered necessary, it would have to be accompanied by suitable macro-economic measures which should include the pursuit of policies consistent with the control of cost and prices, such as keeping fiscal deficits within prudent limits and not allowing the positive effect to be eroded by defensive wage increases.

The real effective exchange rate (REER) is commonly used as an indicator of movements in the underlying competitiveness of a country. Table 8 presents the REER index on a trade weighted basis. The data show that the REER in relation to the individual countries appreciated quite significantly in 1981, but less rapidly in subsequent years. Over the period 1980-1986 (June) rates of appreciation for individual countries ranged between 5% in St. Kitts and Nevis and 31% in Grenada. The relatively larger appreciation and hence loss of competitiveness for Grenada and Dominica, partly reflects a higher rate of increase in the CPI of those countries compared with the others, and partly to a proportionately greater trade relationship with the non-US dollar linked countries.

It is to be noted, however, that as the bulk of the competition facing OECS countries does not originate from domestic procedures in the importing countries¹, a better indicator of external competitiveness of exports might be a commodity weighted index, in which the countries selected are exporters of similar commodities and the weights reflect their share in the region's export markets.

¹ The competition facing bananas in the U.K. market, for instance, comes not from in the U.K. itself, but from Central America and other places.

TABLE 8

Comparative Indices of Real Effective Exchange Rates

(1980 = 100)

| | 1981 | 1982 | 1983 | 1984 | 1985 | Second Quarter | |
|--------------------------------|-------|-------|-------|-------|-------|----------------|-------|
| | | | | | | 1981 | 1986 |
| <u>I. End of Period</u> | | | | | | | |
| Antigua and Barbuda | 104.3 | 105.9 | 108.5 | 114.0 | 108.7 | 105.9 | 108.5 |
| Dominica | 108.8 | 115.1 | 125.2 | 133.9 | 122.6 | 108.9 | 119.9 |
| Grenada | 116.6 | 125.6 | 134.5 | 143.2 | 130.0 | 117.5 | 130.8 |
| St. Christopher and Nevis | 103.9 | 106.6 | 108.0 | 111.8 | 105.2 | 103.9 | 104.9 |
| St. Vincent and the Grenadines | 107.3 | 111.6 | 115.0 | 118.1 | 110.3 | 107.4 | 112.1 |
| St. Lucia | 111.1 | 112.4 | 116.0 | 121.1 | 110.6 | 112.0 | 109.9 |
| <u>II. Period Averages</u> | | | | | | | |
| Antigua and Barbuda | 104.6 | 106.1 | 107.0 | 110.8 | 112.2 | 104.9 | 108.6 |
| Dominica | 108.2 | 111.8 | 118.8 | 128.5 | 130.0 | 107.2 | 119.3 |
| Grenada | 115.6 | 122.7 | 129.1 | 137.1 | 137.8 | 115.2 | 130.9 |
| St. Christopher and Nevis | 103.3 | 106.1 | 107.1 | 109.1 | 108.8 | 103.1 | 104.9 |
| St. Vincent and the Grenadines | 105.9 | 109.5 | 113.2 | 115.1 | 114.0 | 106.1 | 112.5 |
| St. Lucia | 109.8 | 112.6 | 114.3 | 117.8 | 117.0 | 109.5 | 109.7 |

Sources: IMF

In the management of the exchange rate, these developments are kept under constant review.

CONCLUSION

For most of the period covered by this assessment, the Monetary Authority for the OECS region, generally lacked the power necessary to pursue an active monetary policy. Consequently, the vital areas of interest rates and credit allocation policies were largely the prerogative of the commercial banks. To the extent that their perceptions and objectives may not have always coincided with those of the authorities on these issues, this meant that sufficient consideration may not have been given to the developmental requirements of individual countries, or to the interests of the region as a whole.

Although the ECCB was established in October 1983, with power to employ the full complement of monetary tools normally at the disposal of central banks, monetary policy formulation is still at an embryonic stage. In the meantime however, the Bank has introduced certain policies and measures aimed at the redistribution of liquidity in the region, and the facilitation and provision of working and longer-term capital with a view to expand exports and so foster economic growth.

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