

THE BANKING SYSTEM AND
BALANCE OF PAYMENTS ADJUSTMENT

THE CASE OF GUYANA

BY

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INTRODUCTION

It has more or less been firmly established that developments in the balance of payments accounts of an economy can be traced to the accounts of the domestic banking system. As a result, Monetarists argue that the domestic banking system, with the use of the tools of monetary policy at its disposal, must play a pivotal role in the elimination of balance of payments disequilibria. This should not, however, be interpreted to mean that there is no place for the use of fiscal policies in the adjustment process. In fact, given their interdependence and the need for both internal and external balance, there must be a mix in the use of fiscal and monetary policies. Moreover, policymakers are required to ensure that the two sets of policies do not conflict.

This study analyses the role of the domestic banking system and of monetary policy in the adjustment process in Guyana. The analysis spans the period 1977-1982 not only because it is the most recent but also because it was the period during which Guyana experienced severe balance of payments disequilibria.

The paper is divided into three sections. Section I discusses the monetary model with special reference to its use in the balance of payments adjustment process. The second section analyses the economic and financial developments in the Guyanese economy during 1977-1982. Section III comprises the conclusion.

SECTION I

THE MONETARY APPROACH TO BALANCE OF PAYMENTS

The monetary approach to balance of payments has its foundation in the absorption approach to balance of payments theory. This latter approach view the phenomenon as the relationship between aggregate receipts and aggregate payments by residents of a given economy. Algebraically,

$$B = R - P$$

where B represents the balance of payments;

R " total receipts by residents; and
P " total payments by (or aggregate demand of) residents.

In a closed economy framework, total payments by residents would be equal to total receipts by residents. In other words, aggregate demand would be equivalent to the value of total output in the economy. In an open economy, however, this may not necessarily be the case. Injections into the economy, such as imports, may exceed the outflows from the system. An excess of receipts over payments denotes a balance of payments surplus while an excess of payments over receipts is a deficit.¹⁾ Thus, the absorption approach exposes the monetary nature of the balance of payments as well as its relation to the aggregate activity of the economy.

A fundamental balance of payments problem is said to arise when a country experiences a recurring substantial deficit on current account.²⁾ In this case, the basic "flow" balance of payments equation becomes

$$\Delta B = \Delta Y - \Delta E$$

- 1) From here onwards this analysis will be mainly concerned with the problem of balance of payments deficits as countries with surpluses are rarely forced to adjust their economies.
- 2) In the case of developing countries this may not necessarily be so. A current account deficit in this case may imply that resources needed for development are being mobilised.

where ΔY is the change in current incomes; and
 ΔE is the change in expenditure.

The approach argues that balance of payments deficits could only persist if residents are dissaving or if credit is being created to feed the excess demand. As deficits which result from dissavings would, in most instances, disappear once savings have been exhausted, monetarists argue that credit creation is the important factor which must be controlled. In this light, monetary policies are more effective in eliminating excess demand.

Using this approach, the resolution of a balance of payments deficit implies either measures to increase income (output), measures to reduce demand, or some combination of the two. As measures to increase output must necessarily be of a long-term nature, and since it is hardly likely that there will be long-term growth without medium term stability, policymakers are more or less constrained to use demand management policies in their attempts to achieve balance of payments equilibrium.

An early exposition of the monetary approach to the solution of balance of payments disequilibrium is contained in a simple, highly aggregate model formulated by J.J. Polak.³⁾

The Model⁴⁾

The model focuses on the relationship between credit expansion and change in foreign assets. There are four interdependent endogenous variables - namely, the stock of money (MO), nominal income (Y), imports (M), and change in net foreign assets (ΔNFA) - whose

- 3) A recent version of the model is contained in J.J. Polak and Victor Argy, "Credit Policy and the Balance of Payments," in The Monetary Approach to the Balance of Payments. International Monetary Fund. Washington. 1977.
- 4) This exposition of the model draws heavily from the description of the Polak model in I.M.F. Institute: Financial Policy Workshops - The Case of Kenya. I.M.F. Washington D.C. 1981. pp 157-163.

GUYANA: STATISTICAL DATA ON VARIABLES, 1974-82

G\$Mn.	1974	1975	1976	1977	1978	1979	1980	1981	1982
INCOME (Y)	943	1,179	1,117	1,120	1,268	1,326	1,508	1,597	1,666
IMPORTS ¹⁾ (M)	619	892	1,032	885	800	930	1,213	1,375	1,400
EXPORTS ¹⁾ (X)	607	869	697	644	744	721	958	899	876
MONEY STOCK (MO)	318	449	492	603	664	713	850	997	1,262
NET FOREIGN ASSETS (NFA)	94	185	-52	-130	-141	-276	-497	-645	-870
NET DOMESTIC CREDIT (NDC)	224	264	544	733	805	989	1,347	1,642	2,200
CAPITAL MOVEMENTS (CM)	88	123	114	173	62	73	36	227	107
ANFA	71	91	-237	-78	-11	-135	-221	-148	-104
ANDC	-	40	280	189	72	184	358	295	277

SOURCES: Bank of Guyana Annual Reports, Appendices I and II

1) On national accounts basis

APPENDIX IV

GUYANA: RATIOS OF IMPORTS TO INCOME ($m = M/Y$) AND MONEY TO INCOME ($k = MO/Y$), 1974-1982

	$m = M/Y$	$k = MO/Y$
1974	0.656	0.337
1975	0.757	0.381
1976	0.924	0.440
1977	0.790	0.538
1978	0.631	0.524
1979	0.701	0.538
1980	0.804	0.564
1981	0.861	0.624
1982	0.721	0.878
	6.845	4.824

values change if there is a change in value of at least one of the following exogenous variables: exports (X), capital movements (CM), and change in net domestic credit (ΔNDC).

The relationships of the model are as follows:

$$M_t = mY_t, \quad 0 < m < 1 \quad (1)$$

$$Y_t = 1/k MO_t, \quad 0 < k < 1 \quad (2)$$

$$MO_t = \Delta NFA_t + \Delta NDC_t + MO_{t-1} \quad (3)$$

$$\Delta NFA_t = X_t + CM_t - M_t \quad (4)$$

The first relation is a behavioral equation which shows that nominal imports in period t are a constant fraction, m, of nominal income for the same period. Thus, m is the marginal propensity to import. Equation (2) describes a constant proportional relationship between nominal income and money stock; 1/k is the income velocity of money (Y_t / MO_t). Equations (3) and (4) are definitional identities.

After combining equations (3) and (4) to yield

$$\Delta MO_t = X_t + CM_t - M_t + \Delta NDC_t$$

and defining

$$A_t = X_t + CM_t + \Delta NDC_t$$

the model becomes

$$M_t = mY_t, \quad 0 < m < 1 \quad (1)'$$

$$Y_t = 1/k MO_t, \quad 0 < k < 1 \quad (2)'$$

$$MO_t = A_t - M_t + MO_{t-1} \quad (3)'$$

This shows that, given the constancy of m and k, a change in A (i.e. any of the exogenous variables) will, in the first round, affect M through changes in MO and Y. The net effects can be computed by obtaining the reduced form of the model. That is,

$$M_t = \alpha A_t + \alpha \beta M_{t-1} \quad (5)$$

where $\alpha = \frac{m}{m+k}$, $\beta = \frac{k}{m}$

Uses of The Model

The model may be used for various purposes if there were numerical values for m and k and if the value of the exogenous variables were known or could be estimated. For example, (i) the level of imports may be projected or (ii) the impact of any endogenous variable of a given increase in net domestic credit could be determined. Thirdly, a target for income or foreign assets could be set and the change in net domestic credit, as compatible with the preassigned target, could be determined. In other words, the model could be used for forecasting as well as for policy purposes.

For analyzing policy problems, equation (5) may be written as:

$$M_t = \alpha(X_t + CM_t + \Delta NDC_t) + \alpha \beta M_{t-1} \quad (6)$$

This shows that the authorities, through credit policy, can influence directly the value of imports. Thus, a policy of balance of payments equilibrium equivalent to

$$M_t - X_t - CM_t = 0 \quad (7)$$

will be achieved if credit is set at

$$\Delta NDC_t = \frac{(1-\alpha)}{\alpha} (X_t + CM_t) - \beta M_{t-1} \quad (8)$$

The budgetary performance of the Central Government improved considerably during 1977 as a result of cuts in expenditure. Current revenue, at a level of G\$355 million was 8% lower than that earned during 1976. However, as a result of cuts in subsidies and in the capital programme, the Government was able to contain spending to a level of G\$586 million or 69% of the 1976 level. The overall budget deficit decreased by 45%, and amounted to 20% of G.D.P. compared with a deficit which represented 36% of G.D.P. in 1976.

In spite of the decrease in domestic supply, inflation did not become a major problem as it remained at 8% when measured by the C.P.I. In terms of the G.D.P. deflator it was estimated at a mere 2%.

The balance of payments results improved somewhat during the year. Export of goods and non factor services fell by 6%, mainly as a result of lower output levels. However, the marginal propensity to import fell from 92% to 79% causing import of goods and non-factor services to decrease by 14%. These developments, coupled with the relatively high level of capital inflows contributed significantly to the slowdown in the depletion of international reserves. The balance of payments recorded an overall deficit of G\$78 million.

Growth in money and quasi money accelerated sharply from 10% in 1976 to 23% in 1977 largely because of a 35% increase in domestic credit. Credit to the Public Corporations expanded by 50% during 1977 compared with an increase of 34% during 1976. The improvement in the budgetary performance of the Central Government, discussed above, resulted in net credit to the Central Government expanding by 37%, compared with an increase of 16% during 1976. Credit to the private sector declined by 6%.

1978-1981¹⁾

During the period 1978-81 the performance of the economy deteriorated markedly. With the exception of 1980 when it grew by 2%, real G.D.P. (constant 1977 prices) declined at an average annual rate of 1.5% - reducing from a level of G\$1,019 million during 1977 to G\$989 million in 1981. On the other hand, aggregate domestic demand increased steadily at an average annual rate of 15% in nominal terms. Gross fixed investment as a proportion of G.D.P. fell to 19% during 1978 but increased to 25%, 27% and 31% during 1979, 1980 and 1981 respectively. Similarly, consumption expenditure changed marginally during the period, accounting for 87% of G.D.P. during 1981.

Gross domestic savings amounted to 21% of G.D.P. in 1978 and 1979 respectively but decreased rapidly thereafter. It amounted to 18% of G.D.P. in 1980 and 13% of G.D.P. in 1981. In large measure the reduction in savings was a result of lower levels of savings by the public sector as private savings remained fairly stable over the period.

While there was some improvement in the budgetary performance of the Central Government during 1978 this was not maintained. Inability to increase recurrent revenue as well as the need to maintain certain levels of activity resulted in the overall budget deficit increasing sharply from 21% of G.D.P. in 1979 to 36% of G.D.P. in 1981. These deficits were financed largely through borrowing from the banking system.

1) The performance of the economy during this and the previous period forced Guyana to enter into a three year stabilization programme with the International Monetary Fund during the latter part of 1980. In essence the programme was deflationary. Some of the performance criteria entailed, limits on the Net Domestic Assets of the banking system, Credit extended by the banking system and the central government and public corporations budget deficit. By the end of 1981 the programme was suspended as a result of failure to meet the agreed performance levels. The authorities requested a cancellation of the arrangement during the first half of 1982.

The rate of inflation as measured by the C.P.I. increased rapidly at an average annual rate of 20%. By the end of 1981, Guyana was experiencing rates of inflation which were in the vicinity of 25% per annum. In large measure this was a direct result of the lower levels of output and increases in domestic demand as well as world-wide inflation.

After recording an overall deficit of G\$78 million during 1977, the balance of payments showed some improvement during 1978. Export of goods and non factor services increased by 13% in nominal terms. As a proportion of G.D.P., however, it remained the same as in 1977. In part, this was a result of the relatively higher prices received for sugar. In nominal terms, import of goods and non-factor services was 10% lower than in 1977 primarily as a result of lower import volumes as the import price index increased by 13%. With net capital inflows of G\$82 million, the balance of payments recorded an overall deficit of G\$11 million. However, for the remainder of the period the balance of payments deteriorated sharply. Export volumes decreased continually, leading to fluctuations in export earnings. Nevertheless the value of imports increased at an average annual rate of 24% during 1979-1981. As a proportion of G.D.P., import of goods and non-factor services increased from 63% in 1978 to 70%, 80% and 86% in 1979, 1980 and 1981 respectively. Relatively low levels of capital inflows during 1979 and 1980 put severe pressure on the domestic banking system as, it was forced to run down its net international reserves by G\$135 million and G\$221 million during those years. Moreover, even with capital inflows of G\$327 million during 1981 the net international reserves of the banking system was depleted by a further G\$148 million.

The rate of growth of money and quasi money decreased from 23% in 1977 to 10% in 1978 and 7% in 1979 in line with the improved balance of payments performance in 1978 and the decrease in reserves during 1979. However, even with higher levels of reserves use during 1980 and 1981 the rate of monetary expansion accelerated, primarily as a result of increased rates of domestic credit creation. On

average, the stock of money and quasi money expanded at an annual rate of 16%. The ratio of domestic credit to G.D.P. increased rapidly from 69% in 1977 to 114% at the end of 1981.

A sectoral analysis of domestic credit reveal that most of the credit expansion resulted from increased credit to the Central Government and Public Corporations. This was primarily a result of the overall budget deficits recorded by these two sectors.

1982

Provisional estimates indicate that the performance of the economy deteriorated further during 1982. Real G.D.P. is estimated to have fallen by a further 10%. While aggregate expenditure fell by an estimated 12%, it amounted to 17% more than G.D.P. Moreover, most of the expenditure reduction resulted from lower levels of investment. Gross fixed investment as a proportion of G.D.P. declined from 31% in 1981 to 26% during 1982 while consumption expenditures increased to 91% of G.D.P.

Indications are that gross domestic savings during the year amounted to G\$135 million or 9% of G.D.P. compared with the level of 13% of G.D.P. during 1981. Once again, this performance has been traced to dis-savings by the public sector.

The operations of the Central Government is estimated to have recorded an overall budget deficit of G\$977 million, equivalent to 68% of G.D.P.; while the Public Corporations recorded a deficit of G\$158 million, equivalent to 11% of G.D.P.

As the rate of inflation was almost the same as the average for the previous period, it remained one of the major problems of the economy.

The balance of payments recorded an overall deficit of G\$325 million despite the 24% reduction in the nominal value of imports. Lower output levels, international recession and relatively low prices resulted in the value of export of goods and non-factor services amounting to G\$792 million during 1982 compared with G\$1,050 million in 1981. Moreover, a reduction in the creditworthiness of the economy, coupled with a depletion in the amounts available to the international financial institutions resulted in a low level of net capital inflows. Net capital inflows amounted to G\$107 million compared with G\$327 million during 1981.

Banking system statistics show that the rate of monetary expansion accelerated to 27% during the year. Again, this was a direct result of credit expansion. Domestic credit increased to 173% of G.D.P. While credit to the Public Corporations decreased by 19% and credit to the private sector increased by 20%, credit to the Central Government amounted to 75% of total domestic credit and 129% of G.D.P.

Policy Measures Employed By The Monetary Authorities

The rates of growth of domestic credit and of the money supply suggest that the monetary authorities were playing a passive role or that the measures employed to regulate the movement of the monetary aggregates were ineffective.

During 1977-1982 emphasis was placed on interest rate and exchange rate changes, direct control of imports, and ceilings on credit to the Public Corporations. Interest rates were increased by two (2) percent during 1978, 2% during 1979 and 2% during 1980. However, as Raghubar Singh has shown these have had very little effect on the rate and level of savings.²⁾ Similarly, Leslie Glen has shown that

2) R. Singh: "The Level And Structure of Interest Rates in Guyana. - A Preliminary Paper". Bank of Guyana. 1982.

the exchange rate change, which was one of the measures in the stabilization programme with the International Monetary Fund during 1980, had very little impact on the economy.³⁾ Meanwhile, the bureaucratic nature of direct import controls has rendered this more or less inefficient.

Even though the monetary authorities placed limits on the amount of credit which was to be extended to the Public Corporations, they did not ensure that these limits were adhered to. As a matter of fact, while the Corporations were advised as to the amount of credit which they should have, the commercial banks were rarely advised as to these limits. The Corporations, which were experiencing persistent overall deficits, continued to make heavy demands on the resources of the banking system.

The Public Corporations faced a serious dilemma. In the first instance, output levels were comparatively low while, as a result of recession in the industrial countries, demand for their output was also low. Secondly, the price for sugar and bauxite (the two largest Corporations) reached their all-time low during the period. Thirdly, the Central Government, in their attempt to control the rate of inflation in the economy, was asking the Corporations to subsidize their sales to the domestic market. These had undesirable effects on the revenue of the Corporations. Moreover, because of their policy of not increasing the rate of unemployment, the Central Government more or less forced the Public Corporations to operate inefficiently. So that, in allowing the banking system to extend credit to the Corporations, the monetary authorities were merely playing a passive role in the face of government policy.

A survey reveals that the reserve requirements of the commercial banks have not been changed since they were established in 1966. This would have been one sure way of controlling the amount of resources available to the commercial banks for on-lending. In spite of the fact

3) L. Glen: "Devaluation: Is It Effective - The case of Guyana". Paper to be presented to the 20th Meeting of CEMLA Technicians. Bolivia. 1983.

that reserve requirements were not increased, we found that the Central Bank was actually lending to a particular commercial bank, partly to finance the reserve requirements of that Bank. The monetary expansion to which this contributed has been discussed above.

SUMMARY

We have seen that over the period 1977-1982 real output in the economy declined considerably. On the other hand, the levels of aggregate demand increased rapidly primarily as a result of increases in consumption expenditures. Low levels of output, higher levels of aggregate demand and international inflation put the consumer price index under severe pressure; so that, the rate of inflation passed the 20% mark.

Gross domestic savings as a proportion of G.D.P. declined considerably over the period. To a large extent this was a result of dissaving by the public sector.

Further, the budgetary performance of the Central Government deteriorated rapidly primarily as a result of lower income levels and the need to maintain a minimum of social and other current expenditure. Cuts in the capital programme had little impact. Similarly, the operations of the public sector corporations started to record overall deficits sometime in 1979.

Moreover, these developments contributed in no small measure to the poor performance of the balance of payments. We have seen that net international reserves were rapidly depleted during this period. Notwithstanding, this result was understandable as the rate of monetary expansion accelerated mainly as a result of significant increases in credit by the domestic banking system. Increases in credit to the Central Government and to the Public Corporations were the main sources of the increases in total domestic credit.

CONCLUSION

The monetary approach to balance of payments suggests that balance of payments disequilibria (deficits) results from excess domestic demand. It further suggests that, given a constant propensity to import, the monetary authorities may control the level of imports (and thus, the balance of payments outturn) by controlling the rate of monetary expansion or credit creation. Basically then, the monetary approach to balance of payments argues that to eliminate balance of payments deficits, an economy must employ deflationary monetary policies.

In the case of Guyana, the analysis has shown that on average persistent balance of payments deficits over the period 1977-1982 were accompanied by relatively low levels of income, large budget deficits, rapid increases in aggregate domestic demand, reductions in the rate of growth of domestic savings and rapid growth of money and quasi money. A look at the statistics reveal that the ratio of international reserves to the domestic money supply, at a negative 22% in 1977 was very low. Thus, the authorities could not rely on the natural self-correcting process. The elimination of the deficit required active policy on the part of the monetary authorities.

For a small developing country like Guyana, the primary tools of monetary policy which are available to the authorities consist of selective credit controls and credit ceilings, reserve requirements, interest rates, open market operations, and exchange rate policies. Interest rate policies and open market operations are of doubtful effectiveness - probably because of the under-

developed nature of the financial market. Similarly, exchange rate changes tend to be of little use to an economy which is importing mainly essential commodities and exporting primary goods.

A survey shows that since 1966 neither the Liquid Assets Ratio nor the Minimum Reserve Requirements of Commercial Banks have been changed. As international reserves have deteriorated sharply it was obviously the increase in domestic credit which caused the rapid acceleration in the growth of the money supply.

Persistent Central Government budget deficits imply that the monetary authorities were forced to feed the balance of payments deficit by credit creation in the pursuit of governmental policies - a classic case of monetary policy being consistent with fiscal policies. In fact, even though the level of international reserves deteriorated, the supply of money increased. By the end of 1982 the ratio of international reserves to the money supply had reached a negative 76% - an indication of the rate of creation of domestic money.

We may therefore conclude that the monetary authorities played a passive role in the balance of payments adjustment process during the period 1977-1982. If there is to be any improvement in the economy over the next five years the banking system in general, and the monetary authorities in particular, must reevaluate its role in the adjustment process. Given that the banking system must finance the Central Government budget deficit it is imperative that the banking system evaluate the performance of the public corporations with a view to establishing their efficiency. In this way the banking system may be able to reallocate credit to the private sector so that credit creation in period one may lead to increases in output, income and savings in subsequent periods.

This should not be taken to mean that there is no place for the use of fiscal policies. In fact, as we are agreed that monetary policy was passive in the face of fiscal developments, the major emphasis must be placed on fiscal developments. A reduction in the Central Government budget deficit as well as in the deficits of the Public Corporations is of major importance. Fiscal objectives must be re-evaluated so as to ensure their consistency.

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Statistical Data were obtained from the Following Sources:-
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GUYANA: STATISTICAL DATA ON VARIABLES, 1974-82

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SOURCES: Bank of Guyana Annual Reports, Appendices I and II

1) On national accounts basis

APPENDIX IV

GUYANA: RATIOS OF IMPORTS TO INCOME ($m = M/Y$) AND MONEY TO INCOME ($k = MO/Y$), 1974-1982

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1979	0.701	0.538
1980	0.804	0.564
1981	0.861	0.624
1982	0.721	0.878
	6.845	4.824

GUYANA: MONETARY SURVEY, 1974-1982

GSMn.	1974	1975	1976	1977	1978	1979	1980	1981	1982
NET FOREIGN ASSETS	94	185	- 52	-130	-141	-276	-497	-645	-973
Foreign Assets	148	299	103	82	182	101	91	59	61
Foreign Liabilities	54	114	155	212	323	377	588	704	1,034
DOMESTIC CREDIT	259	327	594	771	853	1,085	1,461	1,812	2,493
Government (net)	92	148	391	534	603	743	1,029	1,163	1,867
Public Corporations	60	61	82	123	127	177	236	386	312
Private Sector	107	118	121	114	123	165	196	263	316
OTHER ITEMS (NET)	35	63	50	38	48	96	114	170	256
MONEY PLUS QUASI-MONEY	318	449	492	603	664	713	850	997	1,269
Money	130	202	219	281	294	283	323	352	436
Currency	64	92	105	143	156	148	167	186	231
Demand Deposits	56	96	94	106	107	112	132	139	164
Uncleared Effects	10	14	20	32	31	23	24	27	41
Quasi-money	188	247	273	322	370	430	527	645	833

SOURCE: Bank of Guyana Statistical Bulletins

GUYANA: BALANCE OF PAYMENTS, 1974-1982

GSMn.	1974	1975	1976	1977	1978	1979	1980	1981	1982
EXPORT OF GOODS & NON FACTOR SERVICES	645	909	756	710	800	794	1,042	1,050	782
IMPORT OF GOODS & NON FACTOR SERVICES	619	892	1,032	885	800	930	1,213	1,375	1,043
NET FACTOR INCOME PAYMENTS ABROAD	38	40	59	66	56	73	84	151	156
NET TRANSFERS	- 5	- 9	-16	-10	-17	1	- 2	1	-25
CURRENCY ACCOUNT BALANCE	-17	-32	-351	-251	-73	-208	-257	-475	-432
NET CAPITAL MOVEMENTS¹⁾	+88	+123	+114	+173	+62	+ 73	+ 36	+327	+107
CHANGE IN NET FOREIGN ASSETS (Increase -)	-71	- 91	+237	+ 78	+11	+135	+221	+148	-306

SOURCES: Bank of Guyana Annual Reports and Appendix I

(p) - Preliminary Estimates

1) - Residual