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EXCESS LIQUIDITY, FINANCIAL POLICY

AND

ECONOMIC GROWTH IN GUYANA

(A Preliminary Examination)

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1. INTRODUCTION

The relationship between finance and growth has been expounded by many economists, notably, Goldsmith, Gurley, Shaw, Richards, and McKinnon among others. There is the general consensus that financial deepening influences economic growth primarily through its effects on the level and efficiency of savings and investment. One economist aptly summarises the relationship between the financial system and growth by stating:-

> "The financial system can influence the capital intensity and output by achieving the allocation of capital resources that places productive resources with the most efficient producers and thus alters the aggregate production function of the economy. An efficient financial system will produce financial services at low unit financial costs and will tend to raise the capital intensity ....and output in the economy"[1].

The financial structures in developing countries are generally rudimentary and the transmission effect is not always effectively realised. The experiences of the Guyanese economy with its repressed financial system may be an extreme case in the Caribbean. The persistent balance of payments difficulties, dramatic loss of foreign reserves, high inflationary pressures, growing parallel market activities, excessive money creation augmented by high levels of capital flight do present serious distortions and difficulties in efforts aimed at financial reform.

This preliminary paper examines the relationship between the financial policy pursued, the excess liquidity problem and economic growth during the period 1980-1987. The extent to which financial savings have contributed toward the financing of real investment was the main indicator used to show the relation between finance and growth. The excess liquidity problem is linked to the contraction of private sector activities, lack of investible financial instruments and the money supply process. Financial policy was constrained by the rapid deterioration of foreign reserves and also by the fact that the government sector is the major borrower in the financial system. These developments have influenced the development of the financial system and economic performance in the country.

The paper is organised in several sections. Section 2 briefly examines shallow finance in developing countries. Section 3 outlines Guyana's economic and financial structure. Section 4 concisely relates the money supply process in Guyana. Section 5 describes the liquidity position in the economy. Section 6 examines financial policy and economic growth in Guyana. The final section gives the conclusion.

2. SHALLOW FINANCE IN DEVELOPING COUNTRIES

The financial sector development is a desired objective of developing countries since it is perceived that through financial deepening, economic growth and development can be enhanced. However, in many instances, shallow financing is more evident. Shaw identifies a set of features of shallow financing[2] which pertain generally to developing countries. These include:-

(a) The demand for financial assets is repressed by low real interest rates and the supply of primary securities on these terms is repressed by credit rationing.

(b) Organised finance is dominated by the banking system which behaves as a high-cost, high-profit oligopoly.

(c) The economy depends relatively heavily on its government fiscal budget and on its international capital accounts for the flow of savings to finance capital growth. Capital flight is also evident in the economy.

(d) Shallow finance is commonly associated with overvaluation of the official exchange rate. This discourages exporting and savings but encourages instead importing and consumption.

3. GUYANA'S ECONOMIC AND FINANCIAL STRUCTURE

The Guyanese economy is relatively small and open with a gross domestic product of US$344 million in 1987. The annual growth rate of real gross domestic product over the last decade averaged minus 2.0 percent. The production structure is very narrow with exclusive reliance on the three main export commodities - sugar, rice and bauxite, which account for about one-fourth of gross domestic product. The four largest sectors (Agriculture, Mining and Quarrying, Distribution and Government) account for 70 percent of gross domestic product. There has been some changes in the relative shares in recent years mainly from productive to more service oriented areas with greater contributions from the distribution and transport and communication sectors.

The financial structure in Guyana is comprised of the Central Bank, six commercial banks (of which two are foreign owned), two development banks, and a number of private non-bank financial institutions (a building society, two trust companies and a few insurance companies and pension schemes). The financial system has a small range of financial instruments. Bank loans and deposits are the main financial instruments with government securities becoming increasing significant over the last three years. The banking system has supplied 85 percent of total credit extended by the financial system and about 90 percent of credit to the public sector.

The financial system in Guyana is unsophisticated and is characterised by a number of features which deter efforts aimed at financial reforms. These features include:-

(a) The limited size and simplicity of financial system. The only interest earning financial assets other than time and savings deposits with commercial banks are government treasury bills and debentures and the New Building Society deposits. This lack of financial investment opportunities is one factor which promotes capital flight and currency substitution in the Guyanese economy.

(b) A high ratio of public sector borrowing from the banking system. This high ratio of public sector borrowing is linked to the financing of persistent deficits of the central government. The percentage of total domestic credit extended to the government rose continuously from 35.5% in 1974 to 83.8% in 1987. Conversely, private sector borrowing declined from 41.4% to 14.1% over the same period.

(c) Central Bank lending to the Government, which takes the form of compulsory purchases of central government securities or direct advances to government. Credit from the Central Bank to the government has increased from 8.5 percent in 1974 to 60.1 percent in 1987. It has therefore become difficult for the Central Bank to pursue an independent monetary policy since it has to accommodate the fiscal deficit.

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5. LIQUIDITY IN THE ECONOMY

The Guyanese economy has witnessed an upsurge in the liquidity position which was due mainly to the increasing public sector deficit and the manner in which it was financed and partly to the shortage of foreign exchange. The significant deterioration in the fiscal accounts and the monetary accommodation in financing the deficit gave rise to the excessive liquidity in the economy. The liquidity ratio i.e. total nominal money supply to gross domestic product rose from 56.4 percent in 1980 to 87.8 percent in 1982. This ratio increased significantly thereafter to reach 114.4 percent in 1987. The excess liquidity in the economy has had consequential implications for inflationary and balance of payment pressures as experienced during the period.

Liquidity in the Financial System

(a) The Non-bank Financial System

The non-bank financial institutions have over the years become increasingly liquid with greater investment shares in government treasury bills than debenture issues. During the period 1980-1982, the non-bank financial intermediaries held on average G$18.4 million in treasury bills compared with G$90.4 million in debentures. There was a shift towards shorter term investment and at the end of 1987 treasury bills investment had amounted to G$185.4 million compared with G$268.2 million in debentures.

A breakdown reveals that the largest holders of government treasury bills in 1987 were the New Building Society (88%), the

Insurance Companies (11%) and Pension Funds (1%). The lack of a wide variety of investment opportunities have caused the non-bank financial institutions to increase investments in the shorter term government securities.

(b) The Commercial Banking System

The total commercial banking system is also faced with the serious problem of excess liquidity. The commercial banks' liquid assets[3] have far exceeded the legal requirements during the period (1980-1987) (Table 2). The surplus as a ratio of the required liquid assets[4] has shown significant increases, rising from 145.7 percent in 1980 to 263.0 percent in 1987. The liquid assets in the commercial banks as a percentage of total deposits has also shown an upward trend, from 49.7 percent in 1980 to 69.7 percent in 1987.

Private sector deposits have grown significantly during the period from G$606.5 million in 1980 to G$2,336.8 million in 1987. The propensity to deposit i.e. the ratio of deposit increments to gross domestic product averaged 11 percent during the period 1980-1987 compared with 5 percent in the period 1974-1980. The two factors which seemed to have had the strongest influence on deposits were the sluggishness in investment and the rise in parallel market activities. Noteworthy is the fact that yields on deposits have declined in real terms during the period 1980-1987, following the significant rise in inflation.

The high liquidity in the banking system has reflected the absence of a developed money and capital market, which considerably narrows down the range of alternative forms of assets available to private savers. The banking system continued to have excess liquidity because of the contraction of private sector economic activities. To the extent that commercial banks were not able to significantly increase lending to the private sector because of the contraction of economic activities in this sector, they were forced to purchase treasury bills to invest their surplus funds.

6. FINANCIAL POLICY AND ECONOMIC GROWTH

The financial system must be viewed in the broad context of the interaction between monetary policies pursued and the overall economic performance. The varying economic policies and the resulting changes in the real economy have, in turn, influenced the financial structure. The broad financial policy objectives for economic growth must be (a) to enourage savers to hold their savings in the form of financial assets, (b) to ensure that investment (capital stock) is allocated efficiently to the most productive users and (c) to provide incentives to induce greater savings, investment and production. The achievement of these objectives rely heavily on the expansion of financial market and the confidence and stability of strong monetary management. The Central Bank has therefore the important functions of mobilising greater levels of savings and allocating resources consistent with development objectives.

The worsening economic crisis in the early 1980's witnessed the tightening of restrictions on external payments and the growing financial burden of the government. The financial strains of the government were reflected in the sharp increase in Central Bank credit to the government as a ratio to the gross domestic product. The general monetary policies pursued were very accommodative to the fiscal imbalance. In particular, credit policies especially to the public sector became lax and interest rate policies ineffective (despite interest rate increases in 1980 and 1982). The overall resulting effects were strong inflationary pressures, negative real growth and low capital formation in the economy.

The real gross investment in the economy has declined significantly from 28 percent of GDP (G$280.6 million) in 1980 to 19 percent of GDP (G$158.3 million) in 1986 (Table 4). The major reasons for the decline were the acute shortage of foreign exchange and reduced capital inflows. A serious consideration for investment during this period is related to the government's policy on investment, which, it has been claimed, deterred foreign investment. The financing of the gross investment has witnessed two important changes, from earlier years, namely, the decline in gross national savings despite increases in private sector's contribution and greater reliance on the use of net foreign savings.

One important indicator to judge the importance of financial development is to examine the extent to which financial savings contributed to the financing of investment. In Guyana, the gross domestic savings have declined steadily, becoming negative in 1982 and remaining so until 1986. Although the private sector financial savings have improved the deficit position of the non-financial public sector has far outstripped these increases thereby resulting in negative domestic savings. It therefore became necessary that greater reliance was placed on net foreign savings to finance the domestic investment. In these circumstances, foreign financing rose from 16 percent of GDP in 1980 to 21 percent of GDP in 1986. This development is linked to the serious debt problem the country is experiencing.

The intensification of the economic decline in the early 1980's made financial policy increasingly limited. The performance of real money balances (i.e. M_2/GDP) was due primarily to the rapid expansion of the nominal money stock which created inflationary pressures and the deterioration of the foreign reserve position. Money creation was no substitute for the mobilisation of savings as a source of finance for new investment or for sustaining current production. In fact, this meant that the real lendable resources from the banks increased slowly thereby making a marginal contribution to the capital accumulation process.

Real money balances can be considered a vehicle through which excess savings of the private sector, are transmitted to the more productive sectors. This therefore provides a direct link between growth in real money balances, capital accumulation and output. Growth in the real money stock is therefore essential and the monetary authorities can do so by increasing the attractiveness of money. This can be achieved by (a) lowering the rate of inflation by restraining the expansion of the nominal stock of money by fiscal discipline and/or (b) by raising nominal interest rates paid to deposits. In this regard, there is a link between the monetary authorities' action with interest rates policy and the development of the financial structure; and between the financial structure, capital accumulation and growth in the economy.

The excess liquidity position of the financial system in Guyana is essentially illusory mainly because the measurement is in nominal values. The large extension of the Central Bank's credit to finance the fiscal imbalance generated further rounds of deposit growth at the present low rate of interest. The ballooning of the banks' assets and liabilities in this manner created an illusion of the financial system development. While nominal financing was made available, real resources needed were not.

The real assets of the financial sector expanded from G$779.9 million in 1980 to G$1,073.9 million in 1984 and to G$881.9 million in 1986. The ratio of real financial assets to gross domestic product rose from 79 percent in 1980 to 106 percent in 1986. Likewise, the total money supply as a percentage of gross domestic product also indicated an increase during the period. These figures reflected some form of financial deepening in the economy. However, the financial developments in the Guyanese economy have amounted to the repression of the financial system and "shallow financing". The following features highlight this fact.

(a) Real interest rates were negative for the entire period except for 1986 when the inflation rate was reduced considerably.

(b) The ratio of real financial system credit to gross domestic product increased substantially during the period (1980-1986), whereas real economic growth was negative in the earlier years and exceedingly low in the latter years. Credit during this period was directed mainly for consumption since the government sector was the predominant borrower.

(c) The financing of investment has relied heavily on external sources since domestic financing was grossly inadequate. Capital flight was evidently widespread in the economy.

(d) The exchange rate was very much overvalued as indicated by the wide divergence with the parallel market exchange rate. The approximate parallel market rate for foreign exchange was three/four times the the official exchange rate. This distorted relative prices and thus encouraged importing and consumption and penalized exporting and saving.

In the present context of the Guyanese financial environment the authorities must pursue policies to arrest the spiralling inflation, mobilise greater levels of domestic savings and direct the allocation of resources to more productive use so that there will be greater improvement in the development of the financial system and the economy as a whole.

7. CONCLUSION

This paper has examined financial sector development in the Guyanese economy in the period of serious economic recession. Although no econometric analysis was carried out, it was clear that the financial sector development was severely repressed and this in turn affected the capital accumulation process and economic growth.

While it was evident that the liquidity base of the financial system strengthened nominally through the financing of the fiscal deficit the acute foreign exchange problem with its consequential distortions hindered investment opportunities.

The deteriorating financial operations of the non-financial public sector (and notably the government sector) resulted in domestic savings becoming negative. The accommodating monetary policy in large measure contributed to inflationary pressures. The real negative interest rates during the period did not seriously deter private sector savings. In fact, private sector's savings continued to increase but at a slower rate. The financing of gross investment depended heavily on foreign financing.

The economic crisis with its attendant strict restrictions on imports has limited investment prospects and with it the development of the financial sector. The balance sheets of these financial institutions have become distorted with emphasis on short term securities as the main assets. The excess liquidity problem is linked to the limited size of the financial system. The choice of portfolio of savers is limited since there are only the commercial banks and a limited number of non-bank financial institutions as access for savings.

In the situation of balance of payments difficulties and negative growth, financial policy became increasingly ineffective. The drastic deterioration of foreign reserves and strong inflationary pressures made interest rate policies non-applicable. Likewise, the monetary accommodation of the excessively large fiscal deficit allowed credit policy to become lax. The overvalued exchange rate created serious distortions in prices and resource allocation. In this scenario the authorities need to put in place policies to reduce the inflationary pressures, increase domestic savings, pursue an appropriate exchange rate policy, and invigorate investment opportunities in the economy.

FOOTNOTES

1. Spellman, Lewis, "Economic Growth and Financial Intermediation" in R. McKinnon (ed) Money and Finance in Economic Growth and Development. Marcel Dekker Inc. New York, 1976. pp.18.

2. Shaw, Edward, Financial Deepening in Economic Development, Oxford University Press, London, 1973, pp.9-11.

3. Liquid assets are defined as cash on hand, balances with local and foreign banks net of liabilities (to local banks), deposits with the Central Bank, balances with head offices and branches, treasury bills and commercial bills.

4. The liquid assets ratio has remained 20 percent of demand liabilities and 15 percent of time liabilities from December 1966. The minimum reserve requirements have also remained at 6 percent of demand liabilities and 4 percent of time liabilities from March 1966. The liquid assets ratio in fact influences the amount of funds at the disposal of banks for credit extensions.

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Table 1

SUMMARY ACCOUNTS OF THE FINANCIAL SYSTEM

G$Mn.	1980	1981	1982	1983	1984	1985	1986
Net Foreign Assets	-394.9	-466.4	-688.3	-908.2	-1700.8	-2177.7	-2599.8
Net Domestic Credit	1603.8	1957.1	2704.5	3374.8	4234.0	5174.8	6206.8
Pub. Sec. Credit (net)	1312.9	1591.9	2243.3	2873.5	4069.6	5031.9	5814.6
Central Govt. (net)	(1119.6)	(1258.5)	(2004.7)	(2351.1)	(3642.1)	(4323.9)	(5744.8)
Pub. Ents. (net)	(204.3)	(351.6)	(259.0)	(546.4)	(457.0)	(747.1)	(208.0)
Unconsolidated Pub. Sec	(-11.0)	(-18.2)	(-20.4)	(-24.0)	(-29.5)	(-39.2)	(-138.2)
Private Sector Credit	402.5	502.5	609.3	694.3	796.0	920.3	1085.0
Other Credit (net)	-111.6	-137.3	-148.1	-192.9	-631.7	-777.3	-692.7
Counterpart Unrequited foreign exchange	39.0	50.7	50.1	43.9	-376.5	-400.0	-468.5
Long-term Foreign Liabilities	24.6	23.4	40.1	46.7	39.0	102.8	94.3
Deposits on External Payment Arrears	74.8	137.1	271.6	396.2	464.9	513.0	583.4
Liabilities to Private Sector	1070.5	1279.5	1654.4	1980.0	2323.0	2703.4	3294.4
Currency in Circulation	(166.9)	(186.1)	(231.0)	(268.9)	(335.8)	(421.7)	(508.7)

SOURCE: I.M.F.

Table 2

LIQUID ASSETS OF COMMERCIAL BANKS

G$Mn.	1980	1981	1982	1983	1984	1985	1986	1987
Total Liquid Assets	334.7	344.3	522.0	688.5	810.3	963.6	1303.7	2218.2
Cash	13.9	15.2	16.5	17.8	23.5	20.2	24.4	40.0
Deposits With Central Bank	43.8	41.2	67.2	72.2	130.7	99.2	187.0	1726.8
Treasury Bills	210.9	238.0	402.1	563.0	615.0	791.6	1041.3	214.0
Other Liquid Assets	66.1	49.9	36.2	35.5	41.1	52.6	51.0	237.4
Required Liquid Assets	136.2	146.6	199.6	234.3	292.2	350.5	417.6	611.1
Surpluses	195.8	197.7	322.4	454.2	518.1	613.0	886.1	1607.1
Surplus/Required Liquid Assets (%)	145.7	134.9	161.5	193.9	177.3	174.9	212.2	263.0
Liquid Assets/ Total Deposits (%)	49.7	43.2	51.8	55.8	56.4	56.1	63.4	69.7

SOURCE: Bank of Guyana Statistical Bulletin, December 1987.

Table 3

MONEY SUPPLY, INFLATION AND REAL ECONOMIC GROWTH

(Annual Percentage Changes)

Years	Money Supply	Inflation	Real G.D.P.
1976	9.4	9.0	4.5
1977	21.7	8.3	-6.2
1978	10.1	15.1	-1.0
1979	7.3	17.8	-1.4
1980	19.2	14.1	1.6
1981	17.3	22.2	-0.3
1982	27.3	20.6	-10.4
1983	20.8	15.2	-9.6
1984	18.3	25.2	2.1
1985	19.5	15.0	1.0
1986	20.5	7.9	0.2
1987	46.9	28.5	0.4

SOURCE: Bank of Guyana

Table 4

FINANCING OF INVESTMENT

G$Mn.	1980	1981	1982	1983	1984	1985	1986
Gross Domestic Investment (Real)	280.6	273.2	157.0	120.8	138.2	153.2	158.3
Gross Domestic Savings (Real)	120.6	8.9	-44.8	-68.8	-3.3	-40.8	-17.1
(a) Public Sector	10.0	-151.6	-127.0	-187.3	-148.2	-212.9	-170.5
(b) Private Sector	110.6	160.5	82.2	118.5	144.8	172.1	153.4
Gross Foreign Savings (Real)	160.0	264.2	201.7	189.6	141.5	193.9	175.4
Real Gross Domestic Product	992.0	989.0	886.0	804.0	821.0	829.0	832.0
As a percent of G.D.P.							
Gross Domestic Investment	0.28	0.28	0.18	0.15	0.17	0.18	0.19
Gross Domestic Savings	.12	0.01	n.a	n.a	n.a	n.a	n.a

SOURCE: I.M.F.