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**ISSUES OF MONETARY POLICY
IN THE CONTEXT OF A MULTI-STATE CENTRAL BANK:
THE CASE OF THE ECCB**

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ISSUES OF MONETARY POLICY IN THE CONTEXT OF A MULTI-STATE

CENTRAL BANK: THE CASE OF THE ECCB

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A number of regional scholars and organizations have recently shown renewed interest in the benefits that might accrue from monetary integration of the caribbean Community countries (CARICOM). The desirability of such monetary integration was recently discussed at the highest regional level; the Heads of Government Conference. This renewed interest stems in part from the experience of the Eastern Caribbean Central bank (ECCB) member countries. They have been able to achieve relative price and exchange-rate stability and good rates of economic growth, which many observers attribute in part to the monetary arrangements followed by these countries.

The ECCB, established October 1983, represents a monetary union of a group of eight island micro-economies, as characterized by (i) the issuance of a single common currency, the flow of which is unrestricted among its members; (ii) a common pool of foreign exchange reserves, and (iii) the existence of a central monetary authority which decides on the union's monetary policy¹. This

¹The members of the monetary union are the islands of Anguilla, Antigua and Barbuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines.

paper analyses the factors relevant to the monetary integration of the ECCB area and the scope for monetary policy and adjustment in such a context.

Institutional Structure, Powers and Responsibilities

The governing bodies of the ECCB are the Monetary Council and the Board of Directors. The Monetary Council is the highest decision making authority in the ECCB. It is comprised of one minister appointed by each government of the participating countries. The function of the Council is to provide directives and guidelines on matters of monetary and credit policy to the Bank. The Board is comprised of ten directors; the governor and deputy governor, and one director appointed by each government of the eight participating countries. The Board of Directors is responsible for policy and general administration of the Bank, while the Governor, the chief executive, is responsible for the day-to-day management and operations.

Although a monetary union, the responsibilities and powers of the ECCB are similar to those of any other central bank. The ECCB has statutory responsibility to regulate the availability of money and credit; to promote and maintain monetary stability; to promote credit and exchange conditions and a sound financial structure conducive to balanced growth and development.

The main central banking provisions which are summarised below relate to the foreign exchange cover, limits to the amount of credit the Bank can extend to governments, and the regulation of banking business.

The ECCB is required to maintain a minimum foreign exchange cover equivalent to 60 percent of currency in circulation and other demand liabilities. In addition to the foreign exchange cover requirement, the ECCB is constrained in its power to grant credit to its member governments. Temporary advances to meet seasonal needs, and holdings of treasury bills issued by member governments are limited to 5 percent and 10 percent of each government's recurrent revenue, while the holdings of securities other than treasury bills in respect of all governments, may not exceed 15 percent of currency in circulation and other demand liabilities.

The ECCB is empowered to regulate banking business on behalf of and in collaboration with member governments. In particular it has the power:

- (i) to impose reserve requirements against deposits and similar liabilities specified for this purpose. Such reserves to be held either in cash or as non-interest bearing deposits.

- (ii) to require financial institutions to hold securities issued by the member governments, up to 10 percent of such institutions' deposits and similar liabilities.
- (iii) to prescribe minimum and maximum interest rates payable by financial institutions on deposits and similar liabilities, the maximum interest rates chargeable on loans, and to prescribe the method of computation and the manner of disclosure to the public of interest rates on deposits and loans.
- (iv) to prescribe permissible purposes, aggregate ceiling, maximum maturities, and minimum cash, or security required, in respect of loans and other credits.

Features of the ECCB Monetary Union

✓ In a monetary union decisions on monetary policy need to be harmonised, while those relating to exchange rate changes must necessarily be made at the union level. Flexibility in respect of these instruments will therefore be constrained even in the context of differences in the adjustment requirements of the different countries. If the member countries exhibit differences in fundamental disequilibria, it is possible that policies which would bring about adjustment at the group level may not produce equally

favourable results in each member country. Exchange rate adjustments for instance, may have differential country impacts resulting primarily from differences in export products and market concentration.

Similarly, from a policy point of view, it would be desirable that interest rates within a monetary union be harmonised to avoid distortions in capital flows within the union. Such a policy however could encounter the difficulty of country variations in the rates of return on investments. In that case, the interest rate level appropriate in one country may be inappropriate for another. Indeed, in the environment of an unregulated market for funds, the levels of interest rates in the different ECCB member countries have on occasions shown some variations, reflecting differences in liquidity within different countries. With the expansion of the money and capital market region-wise, these interest rate differentials would in time disappear.

The participation in a union puts constraints on the flexibility and independence of fiscal policy, since the flexibility to monetize budgetary deficits would be limited through collective decision making. As was noted above, the Agreement establishing the Central Bank requires the pursuit of credit policies consistent with the maintenance of a foreign exchange cover, equivalent to no less than 60% of currency in circulation and other demand liabilities. This constraint limits the power of

the central bank to grant credit, and the ability of its members to pursue excessively expansionary budgetary policies. This limitation, however, has been shown to have favourable effects on both external and internal financial stability.

While these features may imply some costs to membership of the union, there are undoubtedly benefits. Compared with a single-country currency, a common one, in which no single country could take unilateral steps to affect its value, could enjoy greater stability and confidence, and thus provide a more favourable climate for greater domestic savings and investments. Such a common currency would be an added incentive for holding savings in a financial form, thus contributing to the funds available for capital formation.

The existence of a monetary union also provides a basis for the development of regional money and capital markets. Commercial banks have more opportunities for financial intermediation between countries, and those with excess funds could seek to channel these funds to other banks in the region with excess demand. Thus, the elements of an inter-bank regional market would develop. Similarly, investors with excess capital in one country could transfer this capital to other countries in the region, where there are opportunities for investment and a shortage of capital. The potential for the development of a regional stock market, therefore, is also facilitated.

✓ The sharing of a common currency has resulted in a more stable exchange rate for the group than would be the case if each country managed its own currency, since external and internal shocks would tend to be spread across countries. The region is susceptible to natural disasters. When this occurs in any one country, the immediate effects of the shock is cushioned by the reserves and the larger productive and export base of the region. Similarly, since the member countries engage in different export activities (some are largely agricultural commodity exporters, while others depend extensively on tourism), the impact of fluctuations in the price of any single export on the exchange rate tends to be mitigated by offsetting fluctuations of other activities.

✓ A further benefit is the possible savings on external reserves; which given the high premium placed on foreign exchange in the region, such savings are of particular importance. These savings could derive, firstly, from the elimination of the need to hold reserves for intra-regional transactions. Secondly, the sum of the collective foreign reserve holdings that would be required of the group would be smaller, as compared with what would be required if held individually by countries. Thirdly, the aggregate balance of payments of the region would be less affected by external and internal shocks, than would be the case if fluctuations in the external flows of each country were not offset by those of another.

✓ The existence of a monetary union and common currency serves also to promote intra-regional trade, through the elimination of risks of exchange rate variations among member countries. While in the case of the ECCB members the volume of intra-regional trade is still small, the existence of a common currency has played an important role in the development of manufacturing in the sub-region. Trade in these commodities in the sub-region has not encountered the difficulties caused by the shortage of foreign exchange experienced in the wider CARICOM community during most of the 1980s.

The exchange rate stability and financial discipline that the union provides have had important dynamic effects. The confidence that this engenders provides the important dimension of a favourable climate for savings and investment in the region. In time, it would be possible to improve the environment further with the provision of better infrastructure and higher worker productivity. These will lead to improved resource allocation, further increases in domestic savings and enhanced financial intermediation, all of which would serve to promote growth in the region.

Monetary Policy and Adjustment in the ECCB

We now turn to assess scope for monetary policy as a tool for demand management and the experience of the ECCB in the context of the monetary union. We accept the theory, as outlined by Sharpley (1984), that money and monetary policies influence aggregate

incomes, the level of real output, prices, and the balance of payments in a number of ways. Consumer spending and demand for investment are impacted by the volume of money in circulation. Money received from exports or created by the banking system have a multiplier effect on incomes and aggregate demand. Domestic supply or real output is also influenced by the availability of loans and credit to production and investment.

In the framework of the money multiplier theory, the supply of money represents the product of the money multiplier m and the monetary base or high-powered money B , i.e. $M = mB$. The money multiplier represent the extent of cumulative credit creation by the banking system, and highlights the role of the Central Bank by linking money supply to the monetary base. The monetary base has a foreign and a domestic component. The foreign component, net foreign assets, changes as a result of the Central Bank's foreign exchange trading, and in situations of a fixed exchange rate regime, reflects changing conditions in export and imports markets and international capital flows; i.e, the balance of payments out-turn. The domestic component of the monetary base reflects the central bank credit to government and to the commercial banks.

To the extent that the components of the monetary base and money multiplier are controllable and predictable, the monetary authorities could employ monetary instruments (reserve requirements, the bank rate, open market operations, ceilings on bank credit, etc) to manipulate the money supply to achieve

desirable policy objectives. This however presumes that these monetary instruments are available to the authorities, and that it is practicable to use them at any given time. In practice, in small developing countries like those of the ECCB area, there are technical limitations imposed on the effectiveness of traditional monetary instruments.

In the first place, the menu of money market assets available to private units in the ECCB area are limited, both in terms of volume and variety, and an organized market in which the central bank can conduct open market operations is yet to be developed. Secondly, while changes in reserve requirements can be used to manipulate the monetary base, its effect is considered too dramatic, and as a result reserve requirements have not been varied since they were first introduced in 1984. Thirdly, the central bank's ability to use the bank rate as a regulatory tool is limited by the dominance of the international branch banks, whose reliance on the central bank for liquidity is minimal, and by the absence of controls on the inflows of banking funds, which leads to the holding of large net foreign assets by banks from which their credit needs are met.

In any event, the effectiveness of most of these instruments requires the central bank to accurately predict the money multiplier and to be in control of the monetary base. It requires a stable multiplier and the ability to dominate those base components that it does not control with those that it does.

(Coats and Khatkhate 1980). A study conducted by Liburd and Tempio (1986) found that the money multiplier for the ECCB member countries was relatively stable. Cumulative yearly changes in the money multiplier accounted for only about 5% of the increase in the money supply over the period 1975 to 1985.

Fluctuations in the net foreign asset component of the monetary base are reflections of the overall balance of payments, and given the existence of a fixed exchange rate regime in the ECCB region, it precludes its effective control and an independent monetary policy in that regard. A payments surplus increases net foreign assets held by the central bank and expands the money supply, while a deficit will have the opposite effect.

The component of the monetary base most susceptible to central bank control therefore is its domestic credit, and this has been the instrument of focus for monetary adjustment in the ECCB. In essence, domestic credit expansion is the increase in the money supply less the increase in the net foreign assets of the banking system, while domestic credit expansion by the central bank is simply the increase in the monetary base less the increase in the net foreign assets of the central bank. While in many less developed countries, central bank credit is often treated passively to accommodate the deficit financing requirement of government, (Sharpley, 1984), the statutory credit limits imposed by the ECCB Agreement provides the monetary authorities with some control over the extent to which the budgetary deficit is monetized.

In determining the annual limits for credit expansion, the central bank takes into account, the existing level of net foreign assets and demand liabilities and, bearing in mind its obligations to maintain a reserve of net external assets of not less than 60 per cent of its demand liabilities, establishes global credit limits for the ensuing twelve months. Credit allocations to each government are determined by the ratio of that government's recurrent revenues to total revenues for all members. Governments are free to draw on their allocations at any time to finance budget deficits, and the central bank advises them on the appropriate mix of treasury bills and long-term securities (debentures). In practice, the global amount allocated in any one year has never been taken up in full, though on occasions individual governments utilized the full amount of their respective limits.

As an alternative to money creation by the central bank, governments may borrow from the commercial banks. The different monetary impact of financing the governments deficits by borrowing from the central bank and by borrowing from commercial banks is well documented in the literature (see Coats and Khatkhate, 1980, for instance). Government borrowing from the central bank directly expands the monetary base, with a potential multiplier effect on the growth of the money supply. The effect on the money supply of government borrowing from the commercial banks will depend on whether the banks are holding excess reserves and the behaviour of the money multiplier. If the banks lend to governments by drawing down excess reserves, the value of the money multiplier will

increase and the money supply will rise. If there are no excess reserves, there will be no increase in the money supply, as commercial banks can only lend to governments at the expense of their lending to the private sector.

In the context of the very open economies of the ECCB area, these alternative methods of financing governments' budgetary deficits have direct implications for the balance of payments. Increases in the money supply occasioned by the expansion in central bank credit, in a situation of fixed exchange rate and in the absence of rigid and effective exchange controls, are apt to lead, at least in the first instance, to reductions in external reserves rather than price inflation.

The judicious use of central bank credit, as the main instrument of monetary policy in the ECCB area, has permitted the region to withstand a series of external and internal shocks during the 1980s. The fiscal discipline this imposes, coupled with favourable developments in the balance of payments, permitted the exchange rate to remain stable in relation to the United States dollar, since its peg in 1976.

Concluding Remarks

The principal theme emerging from this paper is that the Eastern Caribbean monetary union has yielded substantial net benefits to the economic development of the region. Monetary integration has resulted in price and exchange rate stability.

This in turn promoted growth, through expanded investment, increased domestic savings, enhanced financial intermediation, and expanded intra-regional trade. Its success, and the fact that the countries have been able, for the most part, to maintain satisfactory degrees of internal and external balance, has been due in large measure to the fiscal discipline imposed by membership in the union.

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