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REPERCUSSIONS OF FINANCIAL IMBALANCES IN AN ENCLAVE ECONOMY:
Part I

PAPER BY

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1. Introduction

This paper deals with money and monetary policy in countries with less than 1 million inhabitants. According to the World Development Report 1992 more than 40 percent of all countries have such a small population, many of these are islands lying in the Third World. Although the economic characteristics of the countries are quite diverse, a number of fundamental similarities can be detected, all associated with the smallness of the population and the limited macroeconomic purchasing power. In general, these countries are confronted with serious shortages of local skills as well as financial savings, and are hardly able to benefit from the well-known advantages originating from large scale production and distribution. Small economies often have only one major service sector, i.e. tourism, or export industry based on the exploitation of available natural resources with the mobilization of foreign capital and labor, on privileged terms.

In these so-called enclave economies, the export sector usually generates a relatively high per capita income and has a dominant *influence on the various other economic variables, but this sector* has only limited commercial links with the rest of the economy, the potential of which cannot be sufficiently exploited. Therefore, the production base is narrow, dualistic and disharmonious -leading to substantial differences in productivity between regions and sectors. At the same time, developments in the export sector, in combination with high aspirations under the population, induce wage increases in the other sectors in excess of real productivity gains. Thus, the average wage level is relatively high, also due to a shortage of skilled labor - in a number of cases brought about by a restrictive immigration policy. As a result, the competitive position of these countries is, generally, weak.

Given the characteristics of enclave economies it is very difficult, to transform them into more diversified structures. Endeavors to accelerate the process of economic development are hampered by a complicated system of internal bottlenecks, of which the most severe one, ultimately, determines at what speed progress can be achieved: every chain is as strong as its weakest link. In addition, enclave economies have a fragile position on

international markets, on which they are usually merely price takers. Due to the one-sided production often more than 75 percent of total spending consists of foreign goods and services, making these economies particularly vulnerable to external shocks and cyclical movements in the world economy, also because their exports are sectorally and geographically concentrated. Thus, even with relatively high per capita incomes, enclave economies are characterized by economic instability. In brief, in many respects it is not beautiful to be small.

Generally, it is unlikely that development will spontaneously emerge in enclave economies. One should not overrate the effectiveness of the price mechanism. Progress can only be achieved if the government and private sectors form a realistic bond for economic development. In this framework, it is essential to formulate a realistic development program, aimed at promoting structural transformation along two lines. On the one hand, one should endeavor to create a few additional export-oriented growth nuclei based on a more intensive exploitation of the available natural resources. On the other hand, small-scale activities should be stimulated in order to increase employment opportunities for low skilled persons and to meet the basic needs of the population.

In order to promote structural transformation a comprehensive package of integrated policy measures should be employed. In this framework an outward-looking strategy is indispensable. Despite the problems associated with participating on the world economic front, international trade can ease a number of constraints resulting from smallness. Enhancing integration is the only way in which more production factors can be mobilized effectively to realize the objectives of the development program. However, an outward-looking policy entails that the competitive position of small countries may not compare unfavorably with those of their main trading partners. Cost and price developments must be kept in line with external trends.

It is widely recognized, that external viability can be stimulated most effectively through a system of stable exchange rates, because this system eliminates a dimension of uncertainty in a wide variety of decisions. The question now arises what contribution monetary

policy -which essentially aims at regulating domestic demand by influencing the level of money supply -can make to promote the objective of exchange rate stability, and, consequently, structural transformation. Furthermore, attention will be given to the effectiveness of the direct and indirect instruments of monetary policy.

2. Exchange rate stability: an intermediate goal

The collapse of the Bretton Woods system of fixed exchange rates in the early 1970s, placed small developing countries for serious problems, and hampered their endeavors to integrate more fully in the world economy. In order to limit the damage induced by fluctuating exchange rates many of them linked their currency to that of their main trading partner. The US dollar mostly performs the function of anchor currency. However, quite a number of countries were not able to sustain this link. Devaluations were of the order of the day. Some countries even introduced systems of foreign exchange auctions, while in others black markets in foreign exchange emerged- creating considerable unrest and leading to a sharp acceleration in inflation. On the basis of practical experience the departure of the linkage system should be considered unfortunate -a statement that can easily also be theoretically based. After all, in general, at least three major advantages can be derived from the link. Firstly, it facilitates international trade and flows of services and capital between the countries concerned, because one may assume that exchange rate risks are limited for a longer period of time. Secondly, the linkage imposes a stringent discipline on macroeconomic policy, because it requires that in the long-run the price and cost trends are in line with inflation in the anchor country. Thirdly, if more countries in the region are linked to the same currency, regional integration can be stimulated -resulting in closer financial cooperation, and, eventually, possibly even in establishing a monetary union.

Although the indicated advantages are distinct, problems may arise from the linkage from time to time, and, therefore, it should be considered to be only a second best solution as compared to complete exchange rate stability. Firstly, the link implies that cyclical movements in the anchor country will be imported. If inflation in the anchor country is increasing and undue emphasis is

placed on monetary policy in order to curb inflationary pressures in that country, higher inflation and higher interest rates may be induced than is desirable on the basis of purely domestic considerations. Furthermore, in the case of a depreciation of the anchor currency vis-á-vis other major currencies, the value of import payments and repayments on loans from the latter countries will increase, expressed in the national currency. Therefore, the anchor country should pursue prudent economic policies -a condition that is not always fulfilled. This problem is, at present, highly topical, given the renewed drastic depreciation of the US dollar against the European currencies and the Japanese yen. It should be noted, however, that the depreciation of the dollar also has distinct advantages: it makes, inter alia, tourists' centra more attractive for Europeans, and creates new, albeit probably temporary, opportunities for the export industry, especially in countries with favorable trade agreements with the European Community. In addition, rate the relatively low US dollar makes imports from that country attractive.

Delinking is not the appropriate way to reconcile the indicated conflicting interests. In most cases even a substitution of the anchor currency for a basket of relevant currencies will not be advantageous. Although in that case the amplitude of the fluctuations between individual currencies will be reduced, linking to a basket would imply that the advantages of fixed exchange rates are completely lost. Moreover, a simple calculation, using the receipts of and payments in the various currencies as a basis, will in most cases indicate that such a substitution will have a negative net effect on the balance of payments measured in terms of the national currency, because the bulk of the transactions is, usually, settled by using the anchor currency. It is by far preferable to attempt to reconcile the conflicting interest by, among other things, gradually strengthen the supply side of the economy, inter alia, via limiting wage rises to productivity gains, shifting the geographical distribution of exports into a more balanced direction, importing goods and services from relatively cheap areas, synchronizing incoming and outgoing financial flows in the various currencies, and diversifying the country's international reserves to cope with temporary payments disequilibria in relevant currencies. Problems related to the loan

repayment of official debt originating from development aid received in the past could, if possible, also be solved in negotiations with the donor countries. In the case of short-term transactions, such as supplier's credit, exchange rate risks might be reduced via transactions on the forward markets in the anchor currency.

3. Domestic monetary financing

Given the acceptance of the linkage to an anchor currency as a crucial intermediate goal, the question now arises what role monetary policy can play to promote exchange rate stability as defined here. It can easily be seen that a certain relationship exists between the amount of money in circulation and the exchange rate level. In the longer run, the exchange rate is determined by the supply of and the demand for foreign exchange -in turn depending on the level of domestic spending, and, consequently, on the amount and velocity of money in circulation. Under the conditions prevailing in small developing countries, one should not expect that domestic money creation and the ensuing increase in effective demand will result in an appreciable increase in domestic production. The domestically generated supply of goods is insufficiently diversified, and barely has any short-term elasticity due to physical and organizational bottlenecks. Owing to this and the extremely high propensity to import, the additional demand will focus mainly on foreign supply. The so-called monetary approach of the balance of payments, which seeks the causes of disequilibria on external payments in the monetary sphere, is, therefore, highly topical in enclave economies, also due to the adverse influences of inflationary and exchange rate expectations on capital movements and on the process of saving and investment.

Furthermore, it is important to realize that the effect of domestic money creation on the balance-of-payments cannot be adequately cushioned by reducing the openness of the economy through protectionist measures. If this is done, an excessive money creation will, in all probability, result in accumulation by the public of involuntarily held cash balances and induce the emergence of black markets in commodities and services, pushing up actual prices. Sharp price increases will also originate from a forced

import substitution, with normally only modest positive effects on *production and employment.If finally, in an attempt to keep the official cost of living artificially low, fixed maximum prices for certain foodstuffs are announced, business profitability will be eroded, and government subsidies will become necessary.*

Therefore, domestic money creation may generate effects contrary to the goals initially strived at. It may create an atmosphere of social unrest, broad strata of the population feeling aggrieved and attempting to shift the effects of the price increases onto others by demanding income increases in excess of real productivity gains. In this way a self-reinforcing income-price spiral may be set in motion, severely impairing the country's competitive position, also via the formal overvaluation of the currency. Ultimately, contact with the world economy may be increasingly lost and the viability of the country jeopardized. Under such conditions, existing physical bottlenecks are only aggravated by disequilibria in the financial sphere. On basis of these arguments, one should conclude that the supply of money originating from domestic sources must be limited and, grosso modo, brought into line with the demand for money on account of the real increase in economic activity, while to increase the supply of goods and trying services. Merely, creating money does not produce additional welfare.

The government's financing behavior has a decisive influence on the realization of balanced monetary relationships. Governments will be confronted with many, commendable aspirations and they will be pressurized to give priority to alleviate social needs, even at the expense of financial stability. However, it will soon become obvious that such a policy is counter-productive and that a high price will have to be paid for sacrificing financial stability. Despite the plea to increase public spending, the level of expenditure should remain in line with the available real supply of goods and services. Current expenditure should be covered by effective taxation, without putting excessive burdens on the private sector. Unavoidable structural budget deficits due to *capital expenditure should be financed on the domestic capital* market and from development aid or other forms of capital imports, *matched to reasonable repayment terms.* Also, *as much as possible* money should be used effectively for productive projects. One

should strictly adhere to the golden rules of financing. The government simply is not a cow that grazes in heaven and is milked on earth.

The country's central bank can play a crucial role to ensure sound financial management. Because this institution is established with the specific purpose of safeguarding stability in the internal and external value of the currency, and, therefore, is, contrary to the government, not responsible for realizing other policy goals, which might conflict with its specific function, the central bank is in a unique position to advise the government on financial matters, and to warn against the dangers of excessive monetary financing. In order to be able to perform this function the central bank should be granted far-reaching and inviolable autonomy, and should not be subject to day-to-day political manipulations. Society should have the self-discipline to delegate fundamental decisions on the volume of money creation to a competent central bank. At any rate, the bank must never degenerate into a factory of "cheap" money creation. If such an unfortunate situation would occur, one will be tempted to think back with nostalgia to the colonial times where there was no central bank the government could abuse to finance its fiscal deficits, and where currency boards arrangements required the full backing of local money in circulation by gold and foreign exchange.

4. Inflow of foreign funds

If exchange rate stability is to be ensured, it is necessary, but not sufficient, to impose limits upon the domestic money creation. It is also essential that there is an adequate and steady inflow of foreign funds in order to finance the induced increase in imports of goods and services. In the case of money creation from domestic sources, the loss of foreign exchange is not covered by an initial inflow of foreign funds. This means that in the latter case the ratio of the international reserves to the money supply will decrease immediately, whereas in the case of money creation from external sources this ratio need not decline in the short-term. As a result of the extremely high import propensity in small countries, a process of monetary expansion must be accompanied by gross inflows of foreign funds if balance-of-payments disequilibria are to be avoided and exchange rate stability preserved. In this

way, harmonious monetary conditions can be created at the highest feasible level of general economic activity, a situation labelled here as capacity equilibrium.

One should even endeavor to realize a certain surplus on the overall balance of payments, in order to realize an adequate growth of the monetary reserves, in order to be able to cushion temporary and autonomous external disturbance as well as to sustain confidence in the national currency. Unavoidable price rises, for instance due to imported inflation, should also be financed out of external sources, because if this inflow is not sufficient, a shortage of money might occur and have a deflationary effect on the economy -leading to a downward pressure on domestic prices and stimulation of exports. A structural current account deficit should be financed by imports of private and official capital. If it is impossible to attract sufficient foreign capital, the balance-of-payments deficit must necessarily be reduced, even when capacity equilibrium has not yet been achieved. Thus, the permissible size of the current account deficit is limited by a country's potential to attract external capital or to run down monetary reserves without creating unrest on the financial markets. If it would be attempted, to push up expenditure further than is warranted on the basis of the available foreign funds, the negative effects of domestic monetary financing outlined earlier will make themselves felt increasingly.

On the other hand, it should be prevented that excessive capital imports exert too great a pressure on domestic production, because this would equally generate an unwelcome inflation. In the countries considered here, this could easily happen due to the limited capacity to productively absorb large flows of capital. Overheating of the economy may occur due to relatively massive inflows of development aid and/or private capital in conjunction with the realization of one or more large projects, because the absorption capacity of the economy is limited by the most scarce means of production or -complementary facilities- a role that might be played, for instance, by a shortage of skilled labor, a lack of dwellings or an inadequate technical, economic and social infrastructure. Enclave economies are often caught in a vicious circle: owing to, inter alia, an initial shortage of capital their

absorptive capacity is small, while the small absorptive capacity hampers the effective use of capital. Under these circumstances the capital imported should be used as much as possible to eliminate physical bottlenecks and enhance the supply side of the economy. If these attempts are not successful, one should try to raise the propensity to import or, to spread the capital imports harmoniously over time to avoid a domestic cost push inflation. Under the circumstances described here, revaluation of the external value of the currency will not solve the problems, simply because the inflation is not a sign of real strength, but purely the result of too large capital imports and structural impediments.

The utilization should be subject to objective criteria. In the case of loans allowance will have to be made for future interest payments and debt repayments. In essence, the same criteria should apply to official grants received, because one should, normally, not consider this aid to be a permanent phenomenon. Therefore, external capital should be used to directly or indirectly, attain an acceptable and lasting increase in both production and exports. The national economic return on investment should, on average, exceed the cost of capital imports or at least equal them. Capital imports should, sufficiently, result in extra domestic savings and generate foreign exchange to repay external debt. Furthermore, the average pay-back period of the investment should correspond with the repayment terms of the loans. The other side of the coin is, of course, that the recipient country should critically evaluate the conditions of attracting capital and should not be too generous in granting privileges and guarantees to private investors. To avoid exchange rate risks, loans should be denominated, preferably, in the anchor currency. Development aid should be contracted as much as possible in the form of grants, especially if this aid is used to finance infrastructure projects with long maturing periods. In short, capital imports should, structurally, enhance the viability of the economy.

If, in determining the direction of use of foreign capital, insufficient account is taken of the indicated criteria, the financing problems will only be put off, making themselves felt in the future. Sooner or later external debt and guarantee obligations will have to be met, threatening the liquidity and solvency. The

possibility to finance investment from capital imports is, consequently, restricted by the necessity to pursue a well-thought-out financing policy. External indebtedness may never exceed the strength of the economy. Therefore, it is essential to closely coordinate monetary policy and the policy with respect to foreign payments and receipts, and to, preferably, concentrate the legal authority to implement such policies in the central bank. This institutional set-up would also enhance the central bank's effectiveness to control the money supply and the exchange rate, simultaneously.

The above implies, that, although the regime with respect to current international payments should be grosso modo of a liberal nature, a certain guidance by the central bank of incoming and outgoing capital can certainly be useful. Thus, if the central bank is also responsible for the foreign payments policy, it should examine if capital imports are utilized roughly in line with the indicated principles and if these imports can effectively be absorbed in the economy. Furthermore, speculative capital movements should be discouraged by an adequate interest rate policy. For instance, a too low interest rate might from time to time, prompt large investors to borrow domestically instead of abroad, while large savings with the local banking system might be discouraged. In contrast, small investors and savers lack such external opportunities, simply because they do not have timely and sufficient information on developments abroad and there is no institutional framework to enable them to react swiftly on the rapid changing conditions on international financial markets.

5. Instruments of monetary policy

In view of the major problems which might arise from domestic money creation, the monetary authorities i.e. the Minister of Finance and the central bank should primarily aim at controlling the domestic causes of money creation. Unambiguous guidelines should be formulated to determine the room for domestic liquidity creation, and to divide this room between the public and the private sector. In support of such a policy, annual monetary budgets could be compiled based on projections of bank balance sheets, the balance of payments, public finance statistics and a few main national accounts variables. The forecasts should provide an overall insight

into the means of financing of the intended expenditure of the various sectors. Subsequently, the question should be asked to what extent this financing is in accordance with the guidelines for attaining capacity and balance-of-payments equilibrium. If such accordance does not spontaneously result from the original intentions, policy measures could be prepared timely.

Formulating broad guidelines for monetary policy does, of course, not imply that the monetary authorities, are under all circumstances able to control the total amount of money in circulation, nor that such is, at any point of time, necessary for exchange rate stabilization. Short-run deviations from these guidelines may occur, especially due to foreign transactions and changes in the liquidity preference of the public. These deviations can mostly be absorbed by an active management of the country's international reserves. There need not be a constant relationship between the growth of national income and the total demand for money because this demand is not only determined by transaction motives, but also by precaution and speculative motives, which mainly refer to the financial sphere of the economy. However, in contrast to the situation in industrial countries, where a well-developed financial infrastructure and a high degree of actual international capital mobility exists, purely financial transactions are only of minor importance due to a variety of market imperfections. Therefore, in enclave economies, a relatively close relationship exists between the increase in economic activity in the real sphere and the changes in money supply. If monetary, fiscal and foreign payment policies are effectively coordinated, it should, generally, be feasible to grosso modo control the growth in money supply and the exchange rate simultaneously. This is, of course, not possible if monetary policy is applied in isolation, because in that case conflicts might arise between the various policy goals. In theory, it is then not possible to achieve the twin goals with respect to money supply and exchange rate stability: one instrument cannot realize two goals.

In principle, preference should be given to market-oriented approaches to contain domestic money creation. However, in most countries the attainment of this ideal is far from possible, simply because there are no well developed and orderly functioning

financial markets. A complicating factor is also that the financial system is dominated by one or two, mostly foreign owned, banks merely specialized in the financing of the international trade in the form of the granting of self-liquidating commercial credit and related short-term business. Under such circumstances it is difficult to successfully apply indirect instruments of credit control, such as cash reserve requirements. The individual banks often have a very different initial liquidity, partly because the general public often has more confidence in the financial solidity of certain well established banks. Consequently, uniform liquidity requirements would be advantageous for those banks. Also the final outcome of using indirect instruments is rather uncertain, especially if the economy is highly liquid due to large capital imports. Under such circumstances it is also difficult to pursue a more active interest rate policy, because the banks are too liquid and need not take recourse to central bank credit. Also higher interest rates could discourage investment and housing construction, without having a similar effect on consumption due to the low price elasticity of consumers' demand. Given the problems associated with the use of indirect instruments of credit control, a credit expansion, anticipated by massive capital inflows, can best be limited by allowing commercial banks to invest a larger part of their excess liquidity abroad, to pay interest on time deposits with the central bank, as well as by creaming off excess liquidity through issuing government or central bank paper and sterilizing the proceeds of such issues.

Given the institutional framework in enclave economies, the central bank in many cases will have no other realistic option than to resort to direct intervention in the credit mechanism, which is, of course, merely a second best solution. Only prevention is better than cure. However, the shortcomings of direct control might be limited, because the number of financial institutions is limited- giving the central bank a unique opportunity to realize the goals of monetary policy via personal contacts. In small countries, effective moral suasion, supported by an adequate legislation, can be most effective, making it possible to achieve tailor-made solutions for existing problems. This requires that the central bank has a high prestige and is conceive to act fairly. Under such circumstances the negative side-effects of the introduced of a

credit ceiling system can be reduced. For instance, the freezing of existing market shares of the individual banks can be prevented by dividing the macroeconomic room for credit expansion among the individual banks in a flexible and creative manner, taking into account their specific microeconomic position and growth potential, as well as special circumstances. Also, newly established or young institutions can be exempted from the arrangement for a certain period of time.

It is also possible to incorporate various market-oriented devices in the credit ceiling system in order to minimize its side-effects, inter alia, by putting a penalty on exceeding the credit ceiling and allow the banks to transfer unutilized expansion facilities among themselves. The attracting of savings by the commercial banks can be promoted and disintermediation avoided by granting banks additional credit expansion facilities to the extent that they are successful in attracting real savings. Flexibility can also be achieved by exempting or having more liberal restrictions on certain types of loans from the ceiling, e.g. housing mortgages in order to alleviate housing shortages. Finally, disintermediation could be avoided by including certain non-monetary financial institutions in the credit control regime. Although, these institutions do not directly create money, they might contribute to financial disturbances by attracting savings not formed out the current real production but purely out of excessive monetary financing elsewhere in the economy. By mobilizing these nominal savings the velocity of money is pushed up. Therefore, one cannot say that these institutions are always irrelevant from a viewpoint of monetary policy.

6. Conclusion

The philosophy set out in this paper warrants the conclusion that the real significance of monetary policy in enclave economies lies in its ability to create favorable financial conditions to more fully integrate these countries in the world economy, enabling them to realize structural transformation. A balanced monetary policy creates a climate of confidence and stability, indispensable for sustainable economic growth. In contrast, an inapt monetary policy hampers domestic and external financial stability, inducing serious problems for real economic development, which may, eventually,

undermine the country's viability. Thus, money and monetary policy are of vital importance for attaining a well-balanced economic growth. However, monetary medicines cannot remedy non-monetary ailments. Solving problems in the real sector requires, primarily, the strengthening of the supply side of the economy. Of course monetary policy can easily be frustrated by an inadequate management of public finance and international payments. In short, monetary policy simply cannot do the whole job all by itself.

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