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Credit, Excess Liquidity and Monetary Policy Issues in Guyana

by

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1.0 Introduction

There is a consensus that private investment plays a critical role in generating economic growth in developing countries (Greene and Villanueva, 1991). Consequently, one of the major objectives of structural adjustment programmes implemented in developing countries is an expansion of the private sector in economic activities i.e. in production and trade. To facilitate this, the private sector requires an increased supply of financial resources to stimulate private investment. Given the relatively small net flow of foreign capital to most developing countries and shallow state of their financial system, the private sector in most developing countries relies mainly on domestic savings to cover the financing of investment.

In the context of stabilisation and adjustment programmes, liberalisation of the financial system may stimulate domestic savings through higher real interest rates (Fry, 1988). Theoretical and empirical evidence of positive interest rate effects on savings, however, tend to be small and ambiguous (Nissanke, 1991). Notwithstanding, the banking system may experience difficulties in channeling financial resources mobilised to prospective borrowers because of counter inflationary monetary policy to restore and maintain macroeconomic stability; default risk of lending at higher interest rates (Jaffee and Stiglitz, 1990); the small and underdeveloped state of the financial system; and by financial and operational weaknesses of domestic banks (World Bank, 1989). Limited absorption capacity of the economy where there is limited investment opportunities may also be a constraint to commercial bank lending. Consequently, there is excess liquidity in the financial system which has major implications for monetary policy and macroeconomic stability if left unmanaged.

Guyana, since 1988, has undertaken a program of economic and financial sector reform. Economic policy has been reoriented with excessive intervention by the state being replaced by market mechanism. Financial reform has been a key component of the overall scheme of macroeconomic and structural reform program, consisting of the removal of restrictions on interest rates, credit and foreign exchange transactions; use of indirect instruments of monetary policy; improving the stability and soundness of the financial institutions; and strengthening the institutional capacity in the financial sector to boost financial savings and to reduce public sector

crowding out of the private sector in the credit market (Das and Ganga, 1997). These policies have been having favourable outturns in the form of domestic savings, reduced public sector borrowing from the domestic banking system and monetary management. But, there remained a persistent problem of excess liquidity in Guyana. This paper seeks to study the credit market, incidence of excess liquidity and policies to reduce it in Guyana.

The organisation of the paper is as follows: section 2 provides an overview of developments in domestic credit markets in Guyana in the decade prior to the adoption of structural adjustment program in 1988. Section 3 outlines the main policies of financial reform. Section 4 discusses the impact of financial liberalisation on savings mobilisation, credit and excess liquidity. Section 5 discusses the monetary policy implications arising from excess liquidity. Section 6 provides some concluding remarks.

2.0 Overview of credit markets in Guyana 1970 – 1988

The financial system in Guyana has been dominated by commercial banks. Prior to 1970, private ownership has played a major role in the banking system with four foreign-owned banks established in Guyana. However, this was reversed with the establishment of the government-owned Guyana National Co-operative Bank (GNCB) and the process of localisation (nationalisation) of foreign-owned commercial banks in the 1980s. By 1988, all of the major financial institutions, except for two commercial banks, were either wholly or partly publicly owned. Overall, the state owned about 62 percent of the assets of the banking sector and had majority control in banks that had 73 percent of the total banking sector assets. The non-bank financial institutions in the financial sector were very limited with the major players being the insurance companies, Guyana Co-operative Agricultural and Industrial Development Bank (Gaibank), The New Building Society, and the Guyana Co-operative Mortgage Finance Bank (GCMFB). The share of the non-bank financial institutions to total financial intermediaries averaged 20 percent during the review period. The main source of funds comprised deposits, insurance premiums and development credit from donors and international agencies.

Table I
Financial & Monetary Indicators
G$Million

Year	Broad Money/GDP	Total Deposits / GDP	Private Sector Credit / GDP	Inflation Rate	Real Average Lending Rate	Real 3Mths. Time Deposit Rate
1970	31.07	23.91	15.13			
1971	34.33	26.99	14.94	1.00	7.90	3.75
1972	38.74	30.54	13.94	5.00	3.10	(1.00)
1973	42.53	33.80	15.56	7.50	1.40	(3.50)
1974	33.69	26.70	10.79	17.50	(8.60)	(13.50)
1975	38.11	29.86	9.11	7.90	1.00	(3.90)
1976	44.00	33.77	9.84	9.00	(0.10)	(5.00)
1977	53.63	39.65	9.55	8.30	0.60	(4.30)
1978	52.40	39.21	8.93	15.20	(4.70)	(8.20)
1979	53.88	43.18	11.45	17.80	(5.05)	(8.80)
1980	56.39	46.69	12.44	14.10	(0.22)	(3.10)
1981	62.44	52.15	15.38	22.20	(8.26)	(11.20)
1982	87.16	72.91	21.39	20.90	(4.69)	(8.90)
1983	104.48	87.30	25.63	14.90	1.31	(2.90)
1984	106.76	87.93	26.03	25.20	(8.99)	(13.20)
1985	110.47	90.64	25.84	15.00	1.21	(3.00)
1986	117.81	96.35	29.86	7.90	8.31	4.10
1987	115.46	98.85	28.50	28.70	(12.49)	(16.70)
1988	134.27	110.52	37.71	39.90	(23.69)	(27.90)

Source: Bank of Guyana Annual Reports
1970 is the base year used to calculate inflation in this table.

Table I shows that during the 1970s and 1980s, the banking system expanded in terms of financial assets/liabilities. Broad money as a percentage of GDP also increased from 31 percent in 1970 to 56 percent in 1980 and to 134 percent in 1988. Similarly, deposits as a percentage of GDP increased from 24 percent in 1970 to 47 percent in 1980 and to a peak of 111 percent in 1988. In contrast, borrowing by the private sector fell during the 1970s. The stock of outstanding credit to the private sector as a percentage of GDP declined from 15 percent in 1970 to 9 percent in 1975 and to 12 percent in 1980. In 1985 and 1988, private sector credit increased to 26 and 38 percent of GDP respectively.

Table II
Guyana – Summary Accounts of the Public Sector, 1977-1990

	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Current Account Surplus/Deficit	**(9.8)**	**74.0**	**54.6**	**32.5**	**(288.1)**	**(309.3)**	**(542.6)**	**(499.9)**	**(865.7)**	**(701.3)**	**(890.0)**	**(796.1)**	**519.0**	**513.1**
Central Government	(62.6)	(60.2)	(102.4)	(162.6)	(245.8)	(248.3)	(452.6)	(582.0)	(875.8)	(870.8)	(1439.6)	(1236.7)	(536.1)	(2247.7)
Other Public Sector	52.8	134.2	157.0	195.1	(42.3)	(61.0)	(90.0)	82.1	10.1	169.5	549.6	440.6	1055.1	2760.8
Central Government Capital Reserves	**2.7**	**2.2**	**17.3**	**3.8**	**20.7**	**3.3**	**2.0**	**51.2**	**34.6**	**27.1**	**102.2**	**60.9**	**252.1**	**849.8**
Capital Expenditure	**257.6**	**187.7**	**279.0**	**356.8**	**422.1**	**323.3**	**274.8**	**400.8**	**376.9**	**1272.0**	**1057.8**	**1188.0**	**2035.9**	**4373.8**
Central Government	115.9	105.8	176.9	300.2	359.5	758.1	239.2	638.6	416.8	1222.0	660.0	952.0	1249.7	3320.4
Other Public Sector	151.6	102.2	114.0	117.6	115.8	89.1	86.6	176.0	141.0	259.0	461.0	458.0	978.0	2318.0
Transfers to Corporations	(9.9)	(20.3)	(11.9)	(61.0)	(53.2)	(523.9)	(51.0)	(413.8)	(180.9)	(209.0)	(63.2)	(222.0)	(191.8)	(1264.6)
Overall Surplus/Deficit	**(264.7)**	**(111.5)**	**(207.1)**	**(320.5)**	**(689.5)**	**(629.3)**	**(815.4)**	**(849.5)**	**(1208.0)**	**(1946.2)**	**(1845.6)**	**(1923.2)**	**(1264.8)**	**(3010.9)**
Financing (net)	**264.7**	**111.5**	**207.1**	**320.5**	**689.5**	**629.3**	**815.4**	**849.5**	**1208.0**	**1946.2**	**1845.6**	**1923.2**	**1264.8**	**3010.9**
Net External Borrowing	89.0	121.0	106.0	130.0	383.0	258.9	168.0	102.7	370.0	298.7	141.0	234.2	322.0	308.8
Net Domestic Borrowing	175.7	(9.5)	101.1	190.5	306.5	370.4	648.2	746.8	838.0	1647.5	1704.6	1689.0	942.8	2702.1
GDP at Market Prices	**1124.6**	**1267.6**	**1326.0**	**1508.0**	**1597.0**	**1446.0**	**1468.0**	**1700.0**	**1964.0**	**2220.0**	**3357.0**	**4137.0**	**10330.0**	**15665.0**
Overall Deficit/GDP	(0.24)	(0.09)	(0.16)	(0.21)	(0.43)	(0.44)	(0.56)	(0.50)	(0.62)	(0.88)	(0.55)	(0.46)	(0.12)	(0.19)
Net Domestic Borrowing/GDP	0.16	(0.01)	0.08	0.13	0.19	0.26	0.44	0.44	0.43	0.74	0.51	0.41	0.09	0.17

The increase in money stock and deposit as a percentage of GDP was due largely to domestic credit creation to finance large fiscal deficits and an underestimation of GDP due to a growing parallel economy during the 1970s and 1980s. Table II shows that the non-financial public sector performance deteriorated sharply after 1980. The overall public sector deficit increased almost three-fold from 21 percent of GDP in 1980 to 62 percent in 1985. In 1986, it peaked to 90 percent of GDP and then declined to 46 percent in 1988. The deficit was financed largely from domestic borrowing. Domestic borrowing as a percent of GDP increased from 13 percent in 1980 to 43 percent in 1985 and peaked to 76 percent in 1986, then declined to 41 percent in 1988. Domestic borrowing as a percent of the overall fiscal deficit averaged 74 percent during the 1980-1988 period. With regards to GDP, conservative estimates suggest that the GDP was underestimated by almost 50 percent during the period under review. This is a consequence of foreign exchange control and quantitative restrictions which are distortionary. There was diversion of resources and unrecorded economic activities. Specifically, prohibitive tariff in Guyana led to an evasion of trade barrier invariant to smuggling which resulted in more people being employed in distribution-cum-rent seeking.

The decline in private sector borrowing was due to a number of factors which included the crowding out of the private sector from the domestic credit markets by public sector borrowing as illustrated in Table II. Another major factor was the decline in loan demand attributed to the set of policies followed by the government which was characterised as "cooperative socialism." These policies led to domination of the public sector in the economy and severely distorted incentives for the private sector. Specifically, existing private investments were nationalised, particularly the sugar and bauxite sectors. Government controls on prices, and the rationing of foreign exchange also limited private sector activity and discouraged domestic agricultural production.

As a result of low private sector investment most banks did relatively little lending, but simply collected deposits and funnelled them into the Treasury bill markets and special deposit accounts[1] at the Central Bank which were safe and as liquid as Treasury bills. All banks were

[1] The special deposits account of commercial banks with the central bank started in 1987 and attracted an interest rate of 2.5 percentage points below the Guyana Bank rate.

highly leverage in liquid assets as evidenced in Table III which shows a large amount of excess liquidity i.e. the portion of commercial bank funds that is not on-lent. Between 1970 and 1988, actual liquid assets greatly exceeded the required levels at an annual average of 151 percent of the required liquid assets and consisted mainly of Government of Guyana Treasury bills and deposits at the Bank of Guyana.

Table III
Commercial Banks: Liquid Assets
(Actual and Required)
G$Million

Year	Required Liquid Assets (RLA)	Actual Liquid Assets (ALA)	Surplus/ Deficit	Surplus/Deficit as a percent of RLA	Surplus/Deficit as a percent of ALA	Total Loans as a percent of Total Deposits
1970	24.0	30.2	6.1	25.5	20.35	74.0
1971	28.6	51.2	22.6	78.8	44.07	64.7
1972	33.2	79.9	46.6	140.3	58.38	53.0
1973	40.6	92.5	51.9	127.8	56.10	56.3
1974	48.5	92.0	43.6	89.9	47.34	63.8
1975	71.9	207.8	135.9	189.1	65.41	47.5
1976	73.6	180.0	106.4	144.5	59.10	51.0
1977	88.0	228.3	140.3	159.3	61.44	51.7
1978	101.4	290.6	189.2	186.6	65.11	48.4
1979	114.6	305.6	191.0	166.7	62.50	57.5
1980	136.2	334.7	198.5	145.7	59.31	60.1
1981	146.6	344.3	197.7	134.9	57.42	76.0
1982	199.6	522.0	322.4	161.5	61.76	59.2
1983	234.3	688.5	454.2	193.9	65.97	77.8
1984	292.2	810.3	518.1	177.3	63.94	67.2
1985	350.5	888.9	538.4	153.6	60.57	79.3
1986	417.6	1,183.1	765.5	183.3	64.70	47.2
1987	611.1	2,097.6	1,486.5	243.2	70.87	40.8
1988	846.0	2,390.3	1,544.3	182.5	64.61	46.9
1989	2,553.2	3,847.5	1,294.3	50.7	33.64	45.3
1990	3,643.2	6,592.4	2,949.2	81.0	44.74	45.6
1991	4,386.1	8,559.0	4,172.9	95.1	48.75	37.2
1992	6,512.6	18,446.1	11,933.5	183.2	64.69	32.2
1993	7,897.1	19,947.0	12,049.9	152.6	60.41	30.0
1994	8,033.6	13,482.6	5,449.0	67.8	40.42	37.5
1995	10,675.0	13,405.2	2,730.2	25.6	20.37	46.7
1996	13,193.0	16,960.2	3,767.2	28.6	22.21	61.9
1997	15,012.0	19,414.2	4,402.2	29.3	22.68	63.9
1998	15,620.5	17,649.4	2,028.9	13.0	11.50	65.4

Source: Bank of Guyana Annual Reports

3.0 Financial Sector Reforms: 1988-1997

Guyana has been undertaking reforms of its financial sector as part of a broader macroeconomic adjustment program and structural reform since 1988. Key elements of the reform were aimed at improving the efficiency of the financial system and enhancing competition among institutions; strengthening the prudential framework; and developing and deepening financial markets.

3.1 Policies to improve efficiency and competition in the financial sector

The central features of these reform measures comprised the removal of restrictions on interest rates, credit and foreign exchange transactions and the use of indirect instruments of monetary policy. In mid-1991, the Central Bank introduced a competitive bidding process for treasury bill auctions. The bank rate and the rediscount rate were determined in relation to the market determined treasury bill rate for 91 day bills. The frequency of treasury bill auctions increased to bi-weekly auctions in 1995 and then to weekly auctions in February 1996.

While the above measures helped to strengthen monetary control and increase the role of market forces in the financial system, monetary policy continued to rely on direct instruments of monetary control in the form of reserve requirements on commercial banks because of excess liquidity in the financial system. In mid-1991, reserve requirements on demand deposits were increased from 6.0 to 11.0 per cent and on savings and time deposits from 4.0 to 9.0 per cent. In April 1994, the reserve requirements went up further from 11.0 per cent of demand deposits and 9.0 per cent of savings and time deposits to 16.0 and 14.0 per cent respectively. In February, 1999, the requirement has been reduced to 12 percent of both demand and saving deposits and time deposits respectively. In addition, the scope of reserve requirements has been extended to include licensed non-bank depository institutions as well as the definition of reserves to include foreign currency deposits to provide a level playing field for all licensed depository financial institutions. The liquid asset ratio has remained at 25.0 per cent of the banks demand deposits and 20.0 per cent of time deposits since May 1991. The scope and reporting period have been changed to reduce administrative cost.

In the external sector, measures included the abolition of exchange control and the establishment of a market determined exchange rate system. In 1990, both bank and non-bank foreign exchange markets (cambios) were allowed to operate. Partial convertibility of the Guyana dollar was introduced during the same year. Under the new system, two markets - the official and the cambio market co-existed. In February 1991, the exchange rate in the two markets was unified whereby the official rate was determined weekly based on the average free-market rates for the preceding week. In 1993, the Central Bank began inter-bank cambio market operations to achieve a closer integration of the official and cambio markets. In 1995, the Exchange Control Act was abolished.

A critical element of financial development is the payment system which has been a neglected area. However, steps have recently been taken to improve the payment system. At the retail payments level, cheque clearing is projected to be fully automated by the end of 1999.

Reducing the role of the state in the financial sector is seen as critical to improving competitiveness and efficiency. At the end of 1997, government ownership of financial entities was reduced to 25 per cent of the end-1993 asset value of the group of banks the government owned at that time. This was achieved through the sale of all government shares in the Guyana Bank for Trade and Industry and the National Bank of Industry and Commerce.

3.2 Policies to strengthen the prudential framework and bank supervision

Concomitant with the relaxation of structural regulations was a step up of prudential regulations. This was brought about through the enactment of the Financial Institutions Act (FIA) in March 1995. The legislation requires all institutions carrying on banking and financial business to be licensed by the Bank of Guyana and centralises the surveillance responsibility over all licensed financial institutions on the Central Bank.

The improvement of supervision of financial institutions is primarily to promote the transparency of the status of financial institutions, to increase consumer protection and to ensure the safety and soundness of the system. The prudential requirements emphasise capital adequacy and asset quality. Capital adequacy requirement in line with internationally accepted standards

has been implemented. In addition, commercial banks are required to follow the guidelines on the calculation of risk assets that the Bank of Guyana adopted from the Bank for International Settlements (BIS) guidelines.

The FIA also addresses issues of large exposures, limits on investment in non-bank companies, liquidity ratio, minimum capital for the setting up of a bank, licensing of new banks, insider lending, prohibited operations, loan classification, provisioning and other regulations that would limit risk and concentration of ownership of financial institutions. The off-site surveillance and on-site inspection of banks were strengthened. In addition to the FIA, a revised Central Bank Act, designed to increase the independence of the Central Bank in the formulation and operation of monetary policy was passed in parliament.

3.3 Policies to develop and deepen financial markets

Money market and long term debt securities are thin and secondary markets are almost nonexistent. To encourage the latter development, the interbank market has been supported by the provision of the enabling framework (i.e. interbank transfer system) recently announced by the Central Bank. Similarly, the government encouraged capital formation and the growth of an efficient securities market, while protecting purchasers of securities and promoting ethical behaviour in the industry through the Securities Act 1998. This provides for the registration of securities brokers and dealers, certain self-regulatory organisations and certain issuers of securities. Notwithstanding, there are virtually no capital account restrictions.

4.0 Impact of Financial Reform on Private Sector Credit

Economic and financial policy reforms implemented under the structural adjustment programme favourably affected financial markets in Guyana. There was a progressive reduction in public sector borrowing from the banking system. Net flows of domestic borrowing by the public sector as a percent of GDP increased from 45 percent of GDP in 1983 to 90 percent in 1985 and fell to 17 percent in 1990. During the 1991-1998 period, net flows were generally negative, as the public sector was a net depositor to the banking system. This outturn is attributed to the narrowing of the fiscal deficits, greater availability of external capital and development assistance and the achievement of targets by the Bank of Guyana agreed under the

IMF structural adjustment programme for the expansion of various credit and monetary aggregates in order to control inflation.

Reforms have caused the range of financial services to expand considerably, especially in the form of deposits and credit instruments with the liberalisation and maintenance of positive real interest rates. Time and savings deposits increased sharply from G$3.8 billion in 1989 to G$18.4 billion in 1992 and to G$46.9 billion in 1997. As a per cent of broad money, quasi-money increased from 62 per cent in 1989 to 70 per cent in 1992 and to 73 per cent in 1997. This indicator suggests that reasonable interest rates, more branches, better service and more diversified savings instruments have contributed to a deepening of the financial system which raised aggregate savings.

Table IV
Selected Monetary Indicators (1989-1998)

Year	Broad Money M2 % GDP	Deposit % GDP	Finan-cial Assets % GDP	Credit to Private Sector % GDP	Quasi Money (G$ Million)	Quasi Money % M2	Real Deposit Rate[1]	Real Lend-ing Rate2	Infla-tion Rate	Interest Rate Spread3	Aver-age Money Multiplier
1989	68.2	78.3	96.2	27.8	3809.3	61.5	-87.8	-84.0	120.0	6.6	
1990	68.1	77.9	97.0	29.7	5982.9	63.6	-56.9	-54.0	85.0	4.9	
1991	48.4	56.7	71.4	19.8	10256.9	63.1	-41.1	-36.8	70.3	9.0	3.2
1992	64.6	76.1	87.9	21.5	18355.0	70.3	4.0	11.7	14.2	13.1	2.5
1993	67.4	75.9	89.7	20.7	23991.8	71.9	2.2	8.8	8.7	8.7	3.1
1994	61.9	63.7	86.0	27.8	26849.3	68.6	-3.3	3.8	16.1	9.8	3.2
1995	67.3	66.5	90.8	28.2	35332.7	71.6	4.7	11.0	8.1	9.9	3.2
1996	70.0	73.0	86.0	44.1	41543.1	72.1	4.5	12.5	4.5	10.73	2.7
1997	72.3	78.4	84.0	50.5	46930.5	73.0	4.2	12.8	4.2	10.93	2.8
1998	71.7	82.7	90.0	54.0	50874.9	74.1	3.22	12.2	4.8	11.26	2.8

Source: Bank of Guyana's:

Statistical Abstract (Dec 1994, Mar 1998)

Annual Report (1991, 1998)

1/ Commercial Banks' three month time deposit rate

2/ Average prime lending rate

3/ Weighted average lending rate less average savings rate

In contrast to the quasi liquid assets to M2 ratio (see Table IV), the standard financial depth indicator of the ratio of money stock to GDP declined substantially after 1989. It fell from 114.5 per cent in 1988 to 68.1 per cent in 1990 but increased to 72.3 per cent in 1997. In the 1990-1997 period, the ratio has remained relatively stable except for a sharp decline in 1991. Similarly, the ratio of financial assets to GDP, which declined from 162.0 per cent in 1988 to

96.0 per cent in 1989 to 84.0 per cent in 1997, remained relatively stable over the 1989-1995 period with the exception of 1991. The decline in these ratios is attributed to the large devaluations of the Guyana dollar between 1989 and 1991 which resulted in considerable expansion of nominal GDP. Specifically in 1989, the Guyana dollar was devalued by 70 per cent to G$33 per US$1. In 1990, the Guyana dollar was further devalued from G$33 per US$1 to G$45 per US$1. In 1991, the Guyana dollar was again devalued from G$45 to G$101.75 per US$1. The use of intermediate monetary targets during the period of macroeconomic *stabilisation, has helped to create* a consistent framework within which the financial sector can grow further.

The quantity of bank credit extended to the private sector is shown in Table IV. The data indicate that since 1988, the credit markets displayed greater buoyancy in extending credit to the private sector. Specifically, the quantity of bank credit extended to the private sector increased from G$943 million in 1987 to G$4.1 billion in 1990 to G$51.8 billion in 1998. Not only has credit growth been significant in absolute terms, but the ratio too has improved. The share of credit to the private sector rose from 39.0 percent in 1985 to 88 percent in 1992 to over 94 percent between 1993 and 1998. This is attributed to the reversal in economic policies through the adoption of the International Monetary Fund/World Bank programmes, which focused at eliminating distortions in commodity and factor markets and reducing the size of the public sector in the economy. However, the volume of credit extended by banks to the private sector remained relatively unchanged in relation to the size of the economy. Private sector credit as a percentage of GDP increased marginally from an annual average of 34.3 percent during the 1985-1989 period to 36.4 during the 1990-1998 period. This reflected largely the relatively small contribution of the domestic private sector to GDP. Growth in gross domestic product during the 1990s is attributed largely to the contributions from the public sector enterprises (sugar and bauxite) and foreign-owned enterprises (gold and forestry). Non-residents enterprises are *allowed to borrow no more than G$1 million from* the domestic banking system without approval from the Bank of Guyana.

In sectoral terms, the distribution of the stock of private sector credit has changed significantly between 1988 and 1992. The share of credit to the business enterprises, including

griculture, manufacturing, mining and services, has increased from an annual average of 75 ercent during the 1985-1987 period to an annual average of 84 percent during the 1988-1992 period. This was due in part, to the restoration of confidence in the economy through the adoption of IMF/WB programme and availability of foreign exchange as well as from expectation of political stability from democratic elections. The significantly high negative real lending rate (except for 1992) due to high levels of inflation also explained the increase in credit to business enterprises. Between 1993 and 1998, there has been a decline in business enterprises' share of total credit and an increase in households' share. Business enterprises' share declined to an average of 78 percent while households' share increased to an annual average of 22 percent. This decline in business enterprises' share is attributed to lower inflation and the associated decline in inflation expectations and high real interest rates. The increase in loans to households to a large extent represents borrowing essentially for consumption purchases. This is attributed to the growth in real earnings from sharp improvement in real output growth (GDP) during the 1993-1998 period, except for 1998 when GDP contracted by 1.3 percent. The increase in household's borrowing is also due to the availability of semi durable and durable consumer goods from the removal of import restrictions and liberalisation of the foreign exchange market.

Although there was an increase in credit to the private sector, commercial banks continued to hold substantial levels of excess liquidity, which grew during the 1990s on account of the accumulation of net international foreign reserves from negative US$27 million in 1991 to US$154 million in 1996 to US$122 million in 1998. Table III shows that in volume terms excess liquid assets averaged G$5.5 billion during the 1990-1998 period. However, as a percentage of the required liquid assets, excess liquid assets average declined sharply from 185 percent prior to 1990 to 75 percent during the 1990-1998 period. In 1992 and 1993, however, the ratios were higher at 183.2 and 152.6 percent respectively. After 1994, there has been a significant decline in excess liquid assets both in volume and ratio terms. Specifically, average yearly excess liquid assets for the 1995-1998 period was G$3.2 billion while as a ratio of required liquid assets, it averaged 24 percent. The decline in excess liquid assets is explained in part by increased commercial banks investment in long-term treasury bills which averaged G$15

billion between 1995-1998[2]. In addition, during the period under review, the ratio of loans to deposits averaged only 43.7 percent out of a maximum of 85 percent due to an average reserve requirement of 15 percent. The decline in liquid assets during the 1995-1998 period, however, reflected in part the growth in private sector credit and its share of total credit during the period. Credit growth to the private sector was strong during the 1995-1998 period averaging 40 percent while its share of total credit expanded to average 96 percent. The increase in credit to the private sector was facilitated by an increase time and savings deposits which grew at an annual average rate of 17.5 percent during the 1995-1998 period. This is attributed to, among other factors, the increase in real deposit rates, higher income and more bank branches.

After a decade of adoption of adjustment programmes supported by the IMF and World Bank, the economy has fundamentally shifted towards a market-oriented system. Increased confidence boosted investment and growth, notwithstanding the contraction in GDP in 1998, national and private savings relative to GDP increased as inflation declined, exchange rates have been relatively stable and real interest rates turned positive. Despite these favourable outturns, the banks continued to be in a highly liquid position with limited investment outlets as 28-35 percent of commercial banks net domestic assets is invested in Government of Guyana Treasury bills[3] issued by the Central Bank to absorb excess liquidity and 44 percent is lent to the private sector.

5.0 Monetary Policy Implications Arising From Excess Liquidity

Excess liquidity in the banking system in the presence of exchange liberalisation would lead to high rates of inflation, dollarisation, deterioration of the balance of payment and exchange rate depreciation. Therefore, this required the Bank of Guyana to manage the domestic currency supply and hence the level of interest rates. The Bank used a combination of two systems i.e. Liquidity Forecast Framework and Reserve Money Programming to forecast liquidity problems weekly. It allows the Bank to know on a weekly basis what factors are driving excess liquidity in the system and to be able to address the sources.

[2] The outstanding stock of Treasury bills have been shifting from short-term to medium and long term-term bills. Treasury bills of 182 days and 364 days are not considered liquid assets, only 91 day bills.

[3] Government of Guyana Treasury Bills is used instead of Bank of Guyana securities because the latter requires an increase in high power money to pay the interest cost of the securities.

The Liquidity Forecast Framework projects excess liquidity based on various variables affecting liquidity level including changes in cash flow of the public sector, currency in circulation, change in holding of government securities and target change in free reserves in the banking system (see Table VI). The Reserve Money Programming sets the weekly target reserve money based on the net foreign assets and net domestic credit, including the net credit to the public sector and the Government that are compatible with pre-set macroeconomic targets i.e. economic growth and inflation rate and private sector credit (see Table V). The deviations established by the comparison of the outturn to the target indicate the level of open market operation necessary. This, however, is not always sufficient and other factors such as the state of the foreign exchange market, the interbank market, commercial banks' behaviour relative to Central Bank policy, the structure and relation between domestic interest rates and foreign interest rates and the liquidity position of the non-bank financial institutions, are taken into consideration.

The regular auction of treasury bills to absorb excess liquidity and hence, the transition to indirect instruments of monetary policy, has resulted in an improvement in the capabilities of the Bank of Guyana to regulate more effectively the growth in money and credit, through a market mechanism. The absorption of excess liquidity through the issue of treasury bills, has brought about better control and management of the money supply, as evidenced by the relative stability of the money multiplier during the 1992-1998 period. The auction mechanism is helping to create competitive market conditions, by compelling banks to critically examine their funds management practices and the manner of pricing their deposits and loans. It is important to note that the auctioning of treasury bills for sterilisation purposes, which has improved the management of liquidity, has resulted in a high interest expenditure to the government of approximately G$28.0 billion during 1991-1998. This has constrained Government's capacity to deliver social and economic infrastructure.

Absorbing excess liquidity through open market operation is not only costly from the perspective of the domestic interest cost on the Treasury bills sold but also from liquidity subsequently added to the system. In view of this, open-market operations could not be

continuously relied on particularly where there is sustained excess liquidity of the quantity that exists in Guyana from the limited absorptive capacity of the economy, persistent fiscal deficit and major capital inflows to build up international reserves. In these situations, it would be desirable for authorities to consider alternatives or supplementary techniques and instruments that would provide the scope for more efficient monetary management.

Resource preemptions, through reserve requirements on commercial banks have become a relatively less important instrument to mop up excess liquidity available in the financial system in Guyana. In February, 1999, reserve requirements were reduced from 14 percent of time liabilities and 16 percent of demand liabilities to 12 percent for all liabilities. This change in policy is seen as necessary to lower the reserve requirement tax which reduces profitability, distorts interest rates, expands interest rate spreads and crowds out private sector borrowers. To the extent that banks liquidity needs to be contracted or expanded rapidly or financial markets still remain relatively thin and unable to absorb substantial liquidity through open market operations, reserve requirements may be useful (Balino and Zamalloa, 1997:183).

Excess liquidity in the banking system can be sterilised by having the central bank play a more active role in the financial markets by directing credit to generate development and diverting huge deposits away from commercial banks. Specifically, the Central Bank can rechannel some of the sterilised funds into the long end of the market by transforming the maturity structure of the pool of savings from short term to long term. Non-bank financial institutions such as mortgage and agricultural banks that will encourage investment can access these funds at preferential rates. Also, contractual saving institutions, as well as central government and agencies can be induced to deposit funds directly with the Central Bank as a supplementary sterilisation measure.

Table V
Comparative Cash Flow for Treasury Bill Auction
G$Million

	October 1998	September 1999	October 1999
	Auct # 3	Auct # 3	Auct #3
	16/10/98	17/09/99	15/10/99
1. Net non-interest current receipts (-) or payments (+) of Central Government	-661	-708	-432
2. Capital Receipts (Divestment) :- G$ only (-)	-19	-	-
3. Capital expenditures-- local component (+)	128	121	148
4. Counterpart funds to BOG (-)	-	-	-174
5. Disbursements to Gold Board by MOF (+)	75	101	111
6. Currency in circulation (Increase (-)	1	-6	2
7. Central Government long term debt outside BOG		-	-
Redemption	/-/	/-/	/-/
Interest Payments	/-/	/-/	/-/
8. Treasury Bills held outside BOG	316	500	-
91-day Treasury bills	/-/	/-/	/-/
182-day Treasury bills	/316/	/500/	/-/
364-day Treasury bills	/-/	/-/	/-/
9. Net change in foreign exchange transactions	-16	-141	-276
10. Change in Required Reserves [increase (-)]	-1	0	4
11. Purchase of 3 year Debenture	-	-	-
12. Change in other items, net	1	0	0
13. Targeted Change in Free Reserve[increase (-)]	484	200	700
14. Discount factor	7	-	0
15. Adjustment factor	4	3	-3
16. Net Change in Banking System Liquidity	**319**	**70**	**80**

TableVI
Detailed Weekly Reserve Money Programme
Open Market Operation (G$Million)

Bank of Guyana	Target	Projection	Deviation
Net Foreign Assets	(2,968)	(2,968)	0
Gross Reserves	39,188	39,188	0
Foreign Liabilities	(42,156)	(42,156)	0
Net Domestic Assets	25,060	26,138	(1,078)
Credit Public Sector	(21,491)	(20,413)	(1,078)
Central Government	(19,872)	(18,794)	(1,078)
Treasury Bills	0	0	0
Debentures	0	0	0
Advances	0	0	0
Deposits	(19,872)	(18,794)	(1,078)
Other Deposits	(1,619)	(1,619)	0
Special funds	7	7	0
Funds,Other Public Sector (net)	(1,626)	(1,626)	0
Valuation adjustment	39,699	39,699	0
Other(exc. margin)	6,852	6,852	0
Reserve Money	22,092	23,170	(1,078)
Currency in Circulation	10,598	10,417	181
Liab. Comm Banks	11,494	12,753	(1,259)
Required Reserves	9,317	9,311	6
Free Reserves	1,382	2,658	(1,276)
Vault Cash	795	784	11

Open Market Operation: Withdrawal of liquidity: ($1,078)

6.0 Conclusion

Open market operation is perceived as a useful tool to manage internal liquidity in Guyana. The amount of surplus funds is specified relative to a particular level of interest rate (opportunity cost of funds) as reflected in the price bidding behaviour. Generally, this ensures that the attractiveness of deposits is maintained and funds are channelled to the most efficient investors. However, the level of excess liquidity of approximately G$35 billion and the annual

estimated sterilisation cost of G$3.5 billion suggest that Guyana cannot continuously rely on monetary policy for liquidity management. It is imperative that policies are implemented to enhance the absorptive capacity of the economy since excess liquidity can only be reduced when loans and advances as a proportion of banks' assets increased.

The demand for/supply of loanable funds will only be increased when there are lucrative investment opportunities in the economy. Therefore, it is necessary that there are policies to foster an environment for viable investment in productive activities. In this regard, macroeconomic stability in the form of low inflation, sustained real economic growth, stable exchange rate, declining fiscal and external deficits and adequate levels of foreign exchange reserves is necessary. Political stability and avoidance of civil unrest are essential for maintaining confidence, and providing for an enabling macroeconomic environment and hence incentive to invest. Political strife and civil unrest in 1998 had a debilitating effect on the economy and resulted in unfavourable macroeconomic outturns despite the authorities' persistence with prudent fiscal and monetary policies.

Fiscal policies need to be oriented toward supporting economic activity and encourage investment. This is usually done through the provision of tax incentives in both developed and developing countries. Many tax incentives, however, affect different types of investment decisions in different ways. It may encourage investment selectively and cause inefficiencies from distortion in the way in which capital is allocated. In view of this, there is need for designing investment incentives that are effective and based on cooperative arrangements on a regional basis among Caricom countries so as to avoid tax competition.

Institutional reform such as agricultural land policy is also an important factor in the decision to invest and demand for credit. The land leasing practices within a National Land Use Plan, need to be reformed with respect to selection criteria, approval time of application, leasing time, transferability and land rental rates. This will provide the necessary conditions for production financing with land being accepted as collateral by commercial banks.

With limited opportunities to invest the excess liquidity locally by resident Guyanese, it might be useful to explore the possibility of making the excess liquidity available to foreign investors in productive ventures. Currently, loans to non-residents are small and need to be approved by the Bank of Guyana. This requirement was to maximise the inflow of foreign direct investment. In view of the level of excess liquidity in the financial system, this requirement can be less rigid through some form of selective credit control. Such policies should, however, avoid any distortionary effect on resident domestic borrowing from the banking system and on the foreign exchange market.

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