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MACROECONOMIC POLICY AND FINANCIAL SECTOR STABILITY IN ST. KITTS AND NEVIS

S.B. Jones-Hendrickson, Ph.D.
Professor of Economics
University of the Virgin Islands
St. Croix

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S. B. Jones-Hendrickson, Ph.D.
Professor of Economics
University of the Virgin Islands
St. Croix, VI 00850
sjonesh@hotmail.com
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INTRODUCTION

In this paper our main focus will be on the macroeconomic policy and the financial sector stability of the State of St. Kitts and Nevis over the last five years, 1995-1999. The objective is to assess the public sector macroeconomic policy in light of the financial sector and the stability deriving from the macroeconomic policy on the financial sector.

The Theme for this year's Regional Program of Monetary studies is *"Central Banking in the Caribbean in the 21st Century."* It is appropriate that this topic, macroeconomic policy and financial sector stability, be considered under the purview of the theme because of the intimate nature of monetary policy and fiscal policy in the region. This is a theme that we first raised in 1975 in Georgetown, Guyana, and it has been our regional chant over the years. (Jones-Hendrickson, 1985).

The paper will broadly consider the traditional macroeconomic arguments of the State within the ambit of **a cursory look** at the role of the ECCB in its directional thrust in the State's policy. We will then look at some of the government's fiscal and budgetary issues, and finally we will assess the nature of the stability in the financial sector as that stability derives from the macroeconomic policies.

The salient principle of macroeconomics in the State of St. Kitts and Nevis, like other Caribbean countries, derives from the macroeconomic model ***a la Keynesian economics***, and the many variations on the theme thereof. In the narrow context, few persons would say that they are Keynesians today. In the broader context, many persons may say that regional policy makers have all incorporated some types of Keynesianism, some "refined Keynesianism", or have absorbed some "tangential Keynesianism" in terms of macroeconomic policies in the regional economies. The academic discourse has gone pass the post as far as monetarism and fiscalism are concerned. If fiscalism or Keynesianism is the song of liberals, then monetarism is the swan song of conservatives.

In the Caribbean this ***song versus swan song*** idea has had its ups and downs. Those who subscribe to pure monetarism tend to be conservatives. Those who subscribe to an active fiscal role of government, a la Keynesianism, tend to be liberals. This view, however, is the rhetoric of economics, not the reality.

The arbitrary dichotomy between monetarism and Keynesian or fiscalism has never been adhered to in the Caribbean, in the strict sense of the terms. In the State of St. Kitts and Nevis, if we look at the expenditures of government of the years, it does not matter what government is in power, government expenditures always tend to be on an upward spiral. This upward spiral has much to do with infrastructure development and the proximity of elections. In recent times the spiral has had much to do with the aftermath of natural disasters, such as hurricanes, floods, and the like. Policy makers in the Caribbean use, in a direct and indirect manner, both fiscal and monetary policies. A great deal of benefits is obtained from a sustained, coordinated and cooperative set of monetary and fiscal policies. It does not make sense to always have a monetary policy in vogue when a so-called Conservative Party is in power. And it certainly does not make sense to only use a set of fiscal policies when a so-called Liberal Party is in power. It makes economic and political sense to have both monetary and fiscal policies work as integrated policies, irrespective of party orientation.

The State of St. Kitts and Nevis is a member of the Eastern Caribbean Central Bank currency area. This fact is an essential point to note when one considers the macroeconomic policies of the State in line with the state's planning parameters and also how those planning parameters implicitly fall under the aegis of the ECCB. Even though the ECCB does not use a big stick of coercion, its subtle powers of moral suasion has had some impact on all of the economic planning in the ECCB region. The presence of the ECCB in St. Kitts, and the strength of the ECCB in the region, means that most of the macroeconomic policies in the Organization of Eastern Caribbean States (OECS) are circumscribed into a tightly detailed ECCB policy architecture. That policy architecture **has a positive long-term impact on the macroeconomic thrust of the State.**

In the traditional sense of macroeconomics, macroeconomic policy focuses on the economic orientation that dwells on Consumption, Investment, and Government Spending and International Trade. In St. Kitts and Nevis, and indeed in the OECS, issues such as wages, prices, monetary and fiscal policies, the money stock, the national budget, interest rates and external debt, are of central moment. The manageable essentialities of macroeconomic policy in St. Kitts and Nevis, like the rest of the region, center on three issues: **unemployment, inflation, and economic growth**. The questions of moment are:

How to reduce high and persistent unemployment?
How to reduce high and sustained inflation?
How to reduce persistent poverty?

The parallels of these three questions are:

How to increase employment?
How to improve the level and standard of living?
How to develop and sustain economic growth?

Fundamentally, in St. Kitts and Nevis, like other countries in the region, the questions are: What can government do, and what should government do about each of the above issues, and what is the appropriate mix of policies given parametric shifts internal to the economy and external to the economy? There are serious professional differences of opinion on how to go about resolving the above issues. The policy question in the open economy of St. Kitts and Nevis will differ from that of the so-called closed economy. In open economy St. Kitts and Nevis the question that would be upper most in the minds of decision-makers is the role of government in fixing the exchange rate, that is the EC$ to the US$. The other notion would be whether the exchange rate should be floating or market determined. In the ECCB region, the dollar is fixed; it is not market determined like in Jamaica, Guyana and Trinidad. The debate will continue on which type of approach is better. Those who subscribe to fixed exchange rates believe that a fixed exchange rate is a powerful anti-inflation check. Adherents of flexible or market-determined rates believe that the market is a more appropriate arbiter than the government.

One strong intellectual traditional in St. Kitts and Nevis is that the government has a significant role to play in the economy. Government intervention can significantly improve the working of the economy. Although, philosophically, the Labour Government Administration is different from the People's Action Movement type of Government, the role of government has always been an active one. Admittedly, there may be more degrees of government activity under a Labour Government than under a PAM Government, but each type of government has had an activist bent in the Keynesian or reformed Keynesian mode. Citations from the two types of governments' budgets and or party manifestoes serve to illustrate our point.

For example, if we consider a citation from the government ***Budget Address*** of (1993, 5:11-12), we note the following. (We have added the bold words for emphasis):

> *We will also continue to invest heavily in our social and economic infrastructure to provide our people with modern conveniences, enhance our tourism product and facilitate trade, commerce and industrial development. Over the coming year, we will therefore expand our already impressive programme of infrastructure development. It is our aim that this programme should reach every citizen of our Federation and (should) provide them with easy access to the basic amenities of a modern and progressive society.*
>
> *At the same time, we will continue to exert every effort* ***to keep the rate of inflation in check through fiscal restraint and to sustain our economic growth*** *by instituting appropriate safeguards to protect the environment. We also intend* ***to take whatever reasonable action is necessary to avoid the chronic fiscal and external imbalances*** *which have destabilized the economies of so many countries, and have thrust them in the throes of IMF supervised structural adjustment programmes.*

The above citation is couched in a Keynesian economic line and is very much in sync with a citation from the Labour Party's orientation as noted in the ***Manifesto of the St. Kitts and Nevis Labour Party*** (1993:6 and 9):

> *The St. Kitts-Nevis Labour Party is committed to a mixed economy in which the Private and Public Sectors exercise economic power.* ***The State will play a role primarily as a pump-primer for new businesses and in pioneering new venture capital in areas where the Private Sector is reluctant to do so.***
>
> *The New Labour Government will* ***work to reduce the high external debt*** *incurred by the present administration and* ***future borrowing will be used primarily for sustainable economic development and to increase output in our productive sectors.***
>
> ***Our fiscal strategy will be based on implementing programmes and policies aimed at providing full employment and reducing extremes in income levels between various groups in the society.***

In 1995, the PAM Administration repeated a similar government thrust when it noted in the ***Budget Address*** (1995: 6-7):

> *We have targeted a growth rate of at least 5% per annum over the next five years and we* ***intend to accelerate the process of diversifying our economy*** *and forging greater linkages between the various sectors of our economy.*
>
> *At the same time,* ***we will continue to exert every effort to keep inflation in check,*** *raise the level of domestic savings as a source of private and public sector investments,* ***provide increased employment and entrepreneurial opportunities,*** *pursue human resources development in the widest sense, protect our fragile environmental resources* ***and pay special attention to the needs of the aged, unemployed and vulnerable groups in society.***

The above 1995 citation from the PAM Administration which claims to be a non-activist government is substantively the same as that of the Labour Government as is observed in the Labour Government ***Budget Address*** of 1999 (7: 14-15):

> *...We must exercise prudence and make appropriate adjustments to economic policy.*
>
> *Such adjustments must be consistent with our goal of* ***creating a society in which all of our people are provided opportunities to improve their standard of living.*** *Hence, we* ***aim to enhance our level of economic growth over the medium term, reduce the level of unemployment, keep the rate of inflation in check, exercise prudence in fiscal management, accelerate the pace of economic diversification*** *and pursue human resource development by catering even more effectively to the education, health and other social needs of our people.*

When all is said and done, it is safe to say that the issue of note in this discussion of macroeconomic policy and financial sector stability in St. Kitts and Nevis revolves

around the same three issues of traditional macroeconomic policies: **inflation, unemployment and economic growth.** These issues are articulated around fiscal policy, the national budget and the external debt, since the role of the ECCB in the OECS has sanitized the impact of monetary policy, the monetary stock and interest rates. From the broad-based assessment of the macroeconomic arguments above, our focus will take a narrow look at **fiscal policy and the domestic debt** as they impact on the government approach to financial sector stability. We will conclude with some philosophical discussions on the issue of financial sector stability under in a microstate economy, such as St. Kitts and Nevis.

Even though we have narrowed the discussion, this narrow configuration of macroeconomic policy is still of signal importance in a state such as St. Kitts and Nevis. The financial sector imperatives deriving from this narrow macroeconomic perspective are critical in terms of how the government sees its role vis-à-vis the role of the private sector. Before we engage the debate along the lines of the narrow thrust, however, we will take **a cursory look** at the role of the ECCB and its impact on the macroeconomic policy and hence financial sector stability in the State of St. Kitts and Nevis.

A Cursory Look at the Role of the ECCB and Its Impact on the Macroeconomic Policy of the State of St. Kitts and Nevis.

The Mission Statement of the Eastern Caribbean Central Bank, the Central Bank for the countries of the Organization of Eastern Caribbean States as well as Anguilla, is very clear:

> ***To maintain the stability of the Eastern Caribbean (EC) dollar and the integrity of the banking system in order to facilitate the balanced growth and development of the member states.***

In the ***Foreword*** to the Eastern Caribbean Central Bank ***Report and Statement of Accounts, for the Financial Year Ended March, 1999***, K. Dwight Venner, Governor of the ECCB, amplifies some of the critical issues that the Central Bank is confronting as those issues develop a specificity in terms of macroeconomic policies in the member states of the ECC B region. Venner gives substance to the mission statement when he notes:

> *The governments of the sub-region have given high priority status to the need for a comprehensive policy framework in the ECCB member countries.*
>
> *The Treaty of Basseterre (*the enabling Treaty that ushered in the OECS*) addresses a fundamental approach to dealing with the incapacities of very small states which are faced with severe diseconomies of scale in providing for the domestic needs of their citizens as well as meeting obligations to the international community. Article 3, Section 2 of the Treaty lists 18 functions in which member countries stated an intention to 'coordinate, harmonise and pursue joint policies. These functions covered External Relations (a-e), creation of common Market (f),*

> *Development of Marine Resources (g), Law and Order, that is the Judiciary and Mutual Defense and Security (h and q), Central Banking and Public Finance (i-m), and Human Resource Development (h-p).*

By its very nature and charter, the role of the ECCB is concerned with monetary policy. Again, we quote Venner (1999:2):

> *Monetary policy (*in the ECCB area*) is conceived and implemented by the ECCB under a regime of joint sovereignty, The Monetary Council, which is the main decision-making body, comprises a minister (*government*) appointed by each participating government. This body...represents the currency union as a whole and not individual countries. To ensure that this principle holds the fundamental article in the Agreement, for example, the setting of the exchange rate and the backing of the currency,* ***require unanimous decisions to be changed.*** (This principle could be called a **unanimity principle**).

The ECCB sets targets for it perceives these targets as fundamental to monetary stability. The targets of the ECCB are delineated in **Article 4 of the ECCB Agreement.** The purposes of the ECCB are ***to establish monetary stability, money and capital development and Real Sector Development.*** This last point is of central moment, given that this is a classic case where the ECCB has greater degrees of freedom than traditional Central Banks. How does the ECCB ensure that the regional states and governments adhere to the rules and regulations laid down by the Bank? The founding fathers of the ECCB were particularly wise in terms of the conditionalities that they imposed. Apart from the **unanimity principle** above, the ECCB Agreement permits the directorate of the Bank to establish consistency. This is achieved via the Agreement whereby **real sector development is constrained by monetary sector stability.** Put another way, the implication is "*that the development of money and capital markets is a vital prerequisite and facilitator of monetary stability.*" (Venner, 1999:2).

The ECCB has maintained a "strong EC dollar policy". This policy can only be changed if the Monetary Council and the Board of Directors invoke the unanimity principle. Since this is virtually impossible, the EC dollar has being able to keep its exchange rate over the last twenty-seven years. The stability of the dollar in the ECCB area has, no doubt, benefited the individual member countries and the region as a whole. As a result of this stability and strength of the EC dollar, we can look at the monetary and credit policy in St. Kitts and Nevis.

Money and Credit

Over the years under review, it could be safely said that there has been a great deal of stability in the banking system in St. Kitts and Nevis. If we look at the ECCB standard chart of the St. Kitts and Nevis "Monetary Survey" (Percentage changes) of Net Foreign Assets, Domestic Credit and broad Money (M2), the stability will be very evident. Examples of these are to be found in Charts 27 ECCB's ***Economic and Financial Review*** (***EFR***, 1999, March, 31; and June, 1999:35ssshow graphs). This stability has much to do with the impact of the ECCB policy, the strength of the EC

dollar and the moral suasion of the ECCB. This moral suasion on the political directorate of the ECCB area is important in getting them, through the Monetary Council, to recognize and uphold the strong EC dollar policy as an effective counter weight to inflation, and a safe harbor for effective monetary policy.

The broad money base has been a relatively stable proportion of the GDP during the period under discussion. In 1999 the increase of broad money, the total monetary liabilities (M2), was faster than GDP growth. This was unusual but was reflective of a large build up in demand deposits, savings and foreign currency. Despite this stress in the system, the ECCB has amply managed bank credit to the public sector. In fact, this bank credit to the public sector has been kept acceptably well below the possible legal limits of what the ECCB could give to the state. Indeed, given the very strenuous fiscal position of the state during this time, a weak ECCB could have been lenient, or could have bent the rule. Fortunately the ECCB was not too lenient, and it did not bend or break the rule to benefit the state. The state still had to show real sector development and capacity to draw down funds from the ECCB.

From the ECCB's ***EFR*** (volume 18, no. 2, June 1999:35), the picture that emerges is generally typical of monetary polices of the late 1990's:

> *Interest rates remained unchanged during the period under review. Interest rates on savings deposits ranged from 4.0 per cent to 6.0 percent, while those on time deposits ranged from 1.5 per cent to 7.0 per cent. Prime lending rates ranged from 9.5 per cent to 13.0 per cent, while other lending rates ranged from 12.0 per cent to 19.9 percent.* (We present a full picture in Table One).

TABLE ONE

MONEY AND VELOCITY IN ST. KITTS AND NEVIS, 1995-1999

	1995	1996	1997	1998	1999
Income Velocity of Money	8.3	7.9	9.0	8.5	7.7
Income Velocity, broad money	1.4	1.4	1.4	1.4	1.3
Private Sector credit/GDP	70.8	70.2	70.2	71.7	75.2
Foreign currency deposits/GDP	12.5	12.7	16.3	13.4	14.7
Broad money/GDP	70.4	69.7	70.7	70.4	74.8
Lending interest rate (av.)	11.3	10.9	11.2	11.4	11.2
Deposit interest rate (av.)	4.5	4.0	4.1	4.2	4.3

Source: Eastern Caribbean Central Bank

Within recent times there has been high public sector borrowing, but an increase in the foreign liabilities of the commercial banks has cushioned the credit to the private sector. There was some liquidity squeeze in the banking system, but it was marginal in its impact on the system. "The total liquid assets to the deposits ratio declined by approximately 1.0 percentage to 40.6 percent" (***EFR***, 1999: 35). The public sector was involved in some overdrafts to facilitate the critical sugar industry, the infrastructure program of the Federal Government and the Nevis Island Administration. This upped the ante of the risks on loans, but except for some philosophical questions of "crowding out effect" the economy was not severely impacted. This does not man that there was not cause for concern.

Now that we have provided this cursory look at the ECCB and its impact on the monetary policy of the State of St. Kitts and Nevis (**and we would be the first to note that our discussion here does not do justice to the role of the ECCB in St. Kitts**), let us now turn to the two issues of moment in the macro-space. Let us see how they impact on the architecture of the stability in the financial sector. The two issues are fiscal policy, and domestic debt. First we will look at a theoretical background to the fiscal issue, given our discussions above. Then we will look at the fiscal policy under an actual dispensation of the fiscal policy.

Fiscal Policy: The Theoretical Background

The fiscal policy of the State of St. Kitts and Nevis is circumscribed in the dictates and philosophical underpinnings of the parties in power. We have seen, earlier, that there is no fundamental difference between a Labour Administration and a PAM administration; or so we can conclude from their respective Manifestoes and Budget Addresses. The central issue in our paper, therefore, is the age-old question: ***Can the government and should the government intervene in the economy to run aspects of the economy and to improve the economy?*** One school of reaction contends that the government cannot run anything and that anything the government puts its hands one will fail. They, by extension, argue that the private sector should run the show. In St. Kitts and Nevis the Labour Government is of the view that government has a central role to play in the economy. PAM Administrations, on the other hand, profess not to subscribe to this view, but their public sector activities come close to being as government driven as any Labour Administration.

The prevailing fiscal policy philosophy of the Government of St. Kitts and Nevis, under a Labour Administration, is one that seeks to apply macroeconomic theory to policy. No one, to my knowledge, is engaged in the debates of who is right from who is wrong, or who is monetarist, like Milton Friedman, formerly of the University of Chicago, or who is Keynesian, like Franco Modigliani of the Massachusetts Institute of Technology (MIT) or James Tobin of Yale University.

Macroeconomics and fiscal policy have gone through some permutations in the new classical macroeconomics as is epitomized in the works of Martin Feldstein of Harvard University, Robert Lucas of the University of Chicago and Neil Wallace of the University of Minnesota. These "classical macroeconomists" are really 1980's version of Milton Friedman. The new group sought to give substance to their views by dwelling on three basic assumptions: **Economic agents maximize; Expectations are rational; Markets clear.**

One bold and stark implication of these three assumptions is that involuntary unemployment is not possibility. Markets are presumed to be in continuous equilibrium. Macroeconomic of this nature continuously filters into policy making in Caribbean countries because the international overlords who evaluate the economies or who give financial assistance are sometimes wedded to these views in an uncritical position. We dealt with the issue of rational expectations in a paper entitled, "*Rational Expectations, Causality and Integrative Fiscal-Monetary Policy in the Caribbean*"(***SES**, vol. 34, no 4, 1985*).

The fiscal policy of the state of St. Kitts and Nevis has threads of all types of macroeconomic policies but over the last five years the policy seemed to be in line with the thrust of those who could be called the ***New Keynesians.*** The New Keynesians are those who are trained in the Keynesian tradition but have moved ***beyond Keynes***. Persons such as Janet Yellen and David Romer of the University of California-Berkeley, Oliver Blanchard of MIT and Laurence Summers formerly of Harvard, now of President Clinton's Cabinet, are of the view that markets do not clear all of the times. This has led them to try to understand and to explain why there are market failures. This issue of market failures is of principal importance in an open economy like St. Kitts and Nevis. The tractability of this ***beyond Keynesian concept***, and the essentiality of recognizing market failure and trying to understand market failure, forced me in 1985, six years before Mankiw and Romer (***New Keynesian Economics***, 1991) to argue that:

> *...Keynesian economic prescriptions were not intended to operate in economic and social systems such as those (*vulnerable, mini-and- microstates*) that obtain in the Caribbean* (Jones-Hendrickson, 1985:150).

Keynes recognized some of the problems we now argue are market failures or imperfections: He noted that "*the outstanding faults of the economic society in which we live are its failures to provide for full employment and its arbitrary and inequitable distribution of wealth and income.*" (Keynes, 1936:372). Keynes sought to give some guidance to correct this problem when he said that the "*State will have to give guiding influences on the propensity to consume partly through taxation, partly by fixing the rate of interest and partly by monetary policy.*" (Keynes, 1936:377). This was Keynes at his best. But his best was not good enough for us. And that is why we said in 1985 that:

> *When all the factors are given adequate weighting, the practice of Keynesian economics (*in the Caribbean*) was not more than an aggregative, macroeconomic approach to development. Keynes' prescriptions were not geared to alleviating the structural rigidities, which obtained at the* **micro** *level of operations. Fiscal and monetary policy under this regime was passive, as there was no conscious manipulation of fiscal and monetary policies geared to specific strata of the societies.*
>
> *It is our contention that in economic systems, circumstanced as the* Caribbean *systems,* ***the public sector has to play a dominant role*** (Jones-Hendrickson, 1985:152).

We suggested an integrative role of fiscal and monetary policy. "*Our system of integrative and monetary policy...goes beyond the Keynesian prescriptions*"(p. 153)...It is an integrative policy whereby "***Fiscal policy is fully political in that it permits conscious manipulation of decisions by the political directorate***" (p. 153) to benefit the citizenry. This calls for fiscal policies that will be oriented to the people.

For us, the centrality of this role of fiscal policy is steeped in the notion that markets do not clear always. The imperfections in the markets could be linked to

information problems, asymmetric information, costs of price changes, price and wage rigidities. Firms may be reluctant to cut wages because they may attract poor workers and it may be too costly to make the changes, in the long run. On the other hand, if they do not change wages, they may be negatively impacting the productivity of the workforce. Unemployment chaos could be a problem in this case. That is why wages, prices and incomes, as they relate to productivity, are so important in a system such as our systems in the Caribbean.

Venner (1999:3) puts it succinctly when he noted:

> *The governments (*in the ECCB region*) must put in place sound fiscal policies which obviate the need for central bank accommodation. The ECCB has outlined a Fiscal Reform Programme which has been endorse by the Monetary Council. If implemented, the targets identified in this programme will support the strong EC dollar policy.*

Furthermore, notes Venner (1999:3):

> *A critical element to preserving the strong EC dollar is maintaining its competitiveness.* ***This will require an incomes policy in wages, prices, employment and productivity remain in a certain relationship to each other with the emphasis being on productivity.*** (Emphasis, added).

So we are back to square one. The New Keynesian Economics is an integrative fiscal and monetary policy. But we dare say it is one geared to having an active role of the public sector rather a passive role. Fiscal policy in its macroeconomic scope is seductively linked to the political and economic issues of the moment. This means that there is a dire need to disentangle theoretical imperatives from policy implementations. When one spends for a practical reason, the political imperatives may be supreme to the theoretical parameters. Provided manageability and fiscal responsibility are accorded salience in the political imperatives, there should not be any problem in the long run. There may be short-run perturbations, however, as a result of the fiscal imperatives.

Fiscal Policy: The Actual Dispensation

Over the last five years, the State of St. Kitts and Nevis has experienced actual hurricanes, psychological impacts from the threats of hurricanes, and a devastating mudslide. As a result of these natural disasters, the fiscal health of the economy was under severe pressures. Revenues declined, precipitously, and expenditures expanded exponentially. The gap between revenues and expenditures brought about a level of instability in the system that could be viewed as unstable, given the definition of financial instability. From Table Two we note the revenues and expenditures for the period 1995 to 1999. We also look at the revenue-expenditure gap or deficit and the revenue to expenditure ratio. This ratio gives some insights into the fiscal capacity and effort of the State.

TABLE TWO

REVENUE, EXPENDITUTRE: ST. KITTS AND NEVIS, 1995-2000(*EC$M*)

	1995	1996	1997	1998	1999
Revenue	187.1	203.1	223.9	237.7	251.7
Expenditure	205.0	230.6	252.8	288.6	298.8
(R-E) Gap	-17.9	-27.5	-28.9	-50.9	-47.1
R/E RATIO	**0.91**	**0.88**	**0.89**	**0.82**	**0.84**

Source: *World Bank, Ministry of Finance, and Our Estimates*

* *This Estimate is our estimate; it differs from the World Bank's estimate of 250.4*

** *These numbers are ratios, they are not in EC millions.*

The data in Table Two are revenues and expenditures absent Grants. Given the current shift in grants to other parts of the world, the state has to depend more on its own resources as opposed to anticipating that it is going to benefit from the largesse of the overseas friends and benefactors. When we consider the Revenue/Expenditure ratio, we note that for every dollar the state raised in revenue, it spent, on average, 12.6 cents more than it raised. From a strict fiscalist point of view, this may seem problematic and destabilizing, given that Revenues are not at least equal to Expenditures, or given that that rare of fiscal harvest, "the surplus" is not waiting to be dispensed. Pragmatically, however, there is some stability in the R/E ratio. It is true that the R/E ratio has declined from .91 to an estimated .84 in 1999. But to the extent that it is not a wide swing, it is could be argued that there is no a major problem. If there were wide fluctuations in the R/E ratio, one could have seen cause for alarm.

Should the state policy makers worry about this issue? Yes, they should. But given the nature of what caused the state to have the kind of expenditure, namely the infrastructure, the hurricanes, the mudslides and the other natural disasters, one may be inclined to say that this was **functional finance**. In other words, it was functional in the sense that ***the finance was critical to the survival of the body economics and the body politics.***

We ought to remember that fiscal policy is best expressed as the *"deliberate exercise of the government's powers to tax and spend in order to achieve price stability, help dampen the swings of business cycles, and bring the nation's output and employment to desirable levels"* (Spencer, 1983: D-15). We have looked at the expenditure part. Let us now first look at the Tax, and the Tax on International Trade and Transactions (TITT) and GDP over the period. After that we will look at the ratios of the Tax and the TITT to GDP. In Table Three we present the data.

TABLE THREE
TAXES, NON-TAX REVENUE, AND RATIOS TO GDP, 1995-1999 (*EC$M*)

	1995	1996	1997	1998	1999
Tax Revenue	133.9	143.6	164.8	175.2	183.5
TITT	79.0	78.0	89.0	86.0	93.0
GDP fc	405.82	462.41	496.29	501.37	515.38*
Tax/GDP	0.33	0.31	0.33	0.35	0.36
TITT/GDP	0.19	0.17	0.18	0.17	0.18

Source: St. *Kitts and Nevis Statistics Division; the World Bank and our estimates.*
2000 Estimates
** These are derived ratios.
GDPfc: GDP at Factor cost

The data indicate that the Tax Revenue to GDP ratio averaged about ***34 percent*** of GDP over the period. The ratio for the Tax on International Trade and Transactions (TITT) to GDP averaged about ***17.5 percent*** of GDP. These trends have been constant for several years. The last five years were no exception to the rule. Given the trying circumstances of the State over the last five years, this performance was remarkable. But this is not to say that there are no problems in the tax/fiscal situation.

Indeed, when we look at the buoyancy picture, that is the Tax Revenue and the TITT regressed on the GDP, we note that the Tax Revenue buoyancy is .45 and the TITT buoyancy is . 13. (See Howard, 1992: 123 for some buoyancies for Barbados, Jamaica and Trinidad and Tobago). The relevant equations for the buoyancy in our case are:

$$TR = -54.06 + 0.45GDP$$
$$TITT = 23.10 + 0.13GDP$$

The obvious conclusion is that the tax system is suffering from a lack of buoyancy. This is problematic from a strict policy point of view. Spending pressures, arising from the effects of natural disasters, among other political dictates, may have all combined to put stress on the fiscal system. On a political level, governments try not to impose taxes, especially when it is perceived that the people will oppose the taxes and or when the government makes commitments that it will not impose any taxes. Situations of this nature force the government into a catch 22 situation.

Coupled with the lack of buoyancy in the tax system is the question of debt. We now turn to this issue and in the same vein discussed the question of **crowding effects.**

External Debt

We now turn to the issue of debt, both internal and external in the State over the period 1995-1999. This has been a very ticklish issue. From Table Four we note the

TABLE FOUR
DEBT, DEFICIT AND DEBT RATIOS IN ST. KITTS AND NEVIS, 1995-1999

	1995	1996	1997	1998	1999
Domestic Debt (DD)	216.0	255.0	233.8	271.4	316.9
External Debt (ED)	139.4	196.4	321.4	369.0	377.5
Deficit (Rev.-Exp.)	-17.9	-27.6	- 29.0	-50.8	-47.1
GDPmp	622.49	663.49	742.28	775.23	811.81^{p}
DD/GDP	34.7	38.4	31.5	35.0	39.0
ED/GDP	22.4	29.6	43.3	47.6	46.5
Deficit/GDP	-2.9	-4.2	-3.9	-6.6	-5.8

Source: St. Kitts and Nevis Statistics Division and IMF Estimates.

When the data in Table Four are considered, we note that in addition to the lack of buoyancy as illustrated in Table Three for the two components of Taxes, that there is an upward drift in the deficit as well as the internal and external debt. The Domestic Debt to GDP has been averaging about 34.5 percent of GDP. The External Debt has been averaging about 33.8 percent of GDP. Of note, beginning in 1997 there is now a shift of the debt from the internal system to the external market.

We wish to begin our conclusion by noting some pivotal points. First there is clear evidence that the State of St. Kitts and Nevis is managing its debt as it relates to its capacity. The debt may be considered high, according to some measures, but there was no great volatility.

Second among some persons in St. Kitts, there is a prevailing view that that Government's debt has caused some crowding out effect in the economy. We need to take a serious look at this notion. In a comparative static world, it is assumed that an increase in government spending raises equilibrium income and interest rate. Higher interest rates, it is contended, crowd out some investment spending. Crowding out occurs, so the argument goes, when expansionary fiscal policy or government policy causes interest rates to rise, thereby reducing private spending, especially investment. Now, in the context of St. Kitts and Nevis, the Labour Government's philosophy is that it has to play a special role because in many instances the private sector may not want to play an investment role in some sectors of the economy.

Furthermore, in an economy with unemployed resources, it has been fully established that there will not be crowding because the liquidity of money LM curve is in fact not vertical, as classical economics presupposes.

A fiscal expansion will raise interest rates, but income will also increase. Crowding out is a matter of degree. Indeed many observers have said that instead of crowding out, debt may have a "***crowding-in***" impact. When aggregate demand raises as a result of the fiscal expansion, the level of savings rises. As we note from the Money

section above, the monetary system is well sanitized in St. Kitts and Nevis. There are few degrees for errors. So, as savings rise, this leads to the possibility of financing a larger budget deficit, without private sector development being displaced or crowded out.

A final point is worthy of note. Given the level of unemployment in St. Kitts and Nevis and given the need for government to actively respond to the impact of the natural disasters, interest rates did not rise significantly when the government spending increased. See the Monetary section above. Hence, there may be only low level crowding out, if any. We say low level crowding out, if any, because crowding out in a situation like the case in St. Kitts and Nevis presupposes that the ECCB would accommodate the State's fiscal expansion by an increase in the money supply. But as we note in Table One, no such expansion took place.

In other words, there was no monetary policy accommodation form the ECCB. Monetary policy is accommodationist when the Central Bank increases the money supply so that the interest does not increase, and so that government expenditure is accommodated. This monetizing of the government debt was not evident in St. Kitts and Nevis. In fact, given the binding condition that the State can only borrow its revenue capacity, the ECCB was well far away from monetizing the fiscal deficits of the State.

This brings us to our final point. In the Laurence Kotlikoff tradition, "the standard neoclassical definition of crowding out is the reduction in national wealth that arises from government policies." This was not the case in St. Kitts and Nevis over the period 1995-1999. So in the spirit of the work of Bourne (1981), Fischer and Easterly (1990), Bernstein and Heilbroner (1989), public debt has some positive impact on development. Instead of crowding out, there may be crowding in. This leads us to consider the points of Barro (1989) and Buchanan (1976) in the context of the Ricardian Equivalence: namely, public debt has no discernable macroeconomic instability on savings and investment. It is perhaps this very vital point that brings us to the last note on a lemma that we can attribute to Lewis (1977). The ***Lewis lemma*** is a take-off from the argument developed in his monograph "The Evolution of the International Order" whereby he makes the following point.

Loans appropriately made are vital to development. Debt appropriately marshaled is crucial to development. The size of the debt is not really material to the country provided the money is invested wisely, that is, economically. Three caveats are of salience here:

(a) the debt must have additionality; that is, it must add to the national income more than it cost to borrow it;
(b) revenues derivable from the debt must be able to be converted to foreign exchange;
(c) additionality in incomes that are derivable from the debt must be earned within the life cycle of the debt.

In a brief, it the debt is managed in a propitious manner where it can generate benefits, there is nothing to worry about.

CONCLUSION

Over the last five years, six hurricanes and one mudslide have blasted the State of St. Kitts and Nevis. Hurricanes Luis, Marilyn, Georges, Jose and Lennie

and the mudslide seriously disrupted economic activity in the state and forced the government to engage in additional public sector spending that would not normally have been the case.

The issue of macroeconomic policy and financial sector stability in the State of St. Kitts and Nevis over the period 1995-1999, therefore, was to a large extent linked the natural disasters. However, the modal philosophical views of the government in power were the green light to determine the spending philosophy. This philosophy is well articulated in the ***Throne Speech*** of His Excellency, Sir Cuthbert Montraville Sebastian, a speech delivered by His Excellency Mr. Eustace John, Deputy Governor General on May 5, 2000. The opening paragraph of the speech clearly sums up the philosophy of the Labour Government:

> **In the recent General Elections (March, 2000) held here in our Federation, the people of St. Kitts and Nevis overwhelmingly endorsed the programme of development implemented by the Labour Government over the past five years (1995-1999), and gave the St. Kitts-Nevis Labour Party a massive mandate to continue along the path of progress that it had charted. (The Labour Party won a landslide of all eight seats in the parliament in St. Kitts). That path is characterized by a strong focus on people development and empowerment, and expansive programme of social development and poverty eradication, economic growth in all sectors of the economy, employment creation, unprecedented levels of infrastructure development, macroeconomic stability, the maintenance of law and order, and the pursuit of peace, harmony and unity among our people.**

In an unplanned and unregulated economy where there is a weak Central Bank, or where there is a highly accommodationist Central Bank, spending policies such as those entered into by the State may have caused serious disruptive financial sector instabilities. However, in the State of St. Kitts and Nevis, it is safe to argue that while there is some instability in the system, the core of the economy can stand the instability. The Central Bank policy has buttressed the fiscal policy not by an activist Central Bank but by a monetary policy that serves to "rudimentize" the essential features of planning from a monetary perspective while mindful of fiscal aspects. The stability of the monetary system and likely ***crowding-in*** of the government expenditure, instead of crowding-out, means that financial sector stability may only be one of degree. As the State completes the year 2000, more severe pressures will be on the state given its level of spending, and given the aftermath of the severe natural disasters. There should always be cause for concern in the fiscal space. Concern yes, but alarm no.

If fiscal responsibility is permitted to run the course, the economy will get on the trajectory that it wants. If the policy directorate institute a preemptive strike in terms of containerizing an excessive spending, then the macroeconomic stability and financial stability that it seeks will come on stream. But having said that, it is not the philosophy of the Labour government to be passive. The Labour Government is an activist government. Hence, by its very nature it would be more concerned about ensuring that all and sundry benefit from fiscal policy expansion rather than attempting to hue to the dictates of a financial overlord whose perennial mantra is financial stability. In any economy there

must be some instability. Indeed instability is desirable. However, too much instability could be problematic. We view financial instability like risk in the equity market. Risk is to be managed. So should financial stability. Financial stability is necessary but not desirable. Policy makers should manage the stability to ensue that the macro and micro actors in the economy benefit from the largesse of the public sector investment. The architecture of investment both from the private sector and the public sector are linked to debt, debt management and functional finance. To the extent that the fiscal stimulus is productive in the short and long run, a la the ***Lewis lemma***, financial instability may only be one of degree.

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