

FOREIGN RESERVES MANAGEMENT IN BELIZE
An Assessment Of The Liquidity Constraints
In 1979
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The Monetary Authority Of Belize
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FOREIGN RESERVES MANAGEMENT IN BELIZE:
An assessment of The Liquidity Constraints in 1979.

Throughout the Caribbean, emphasis is placed on the maintenance and promotion of confidence in the value of domestic currencies as a means of facilitating trade and capital inflows and, linked to this, the adequacy of internationally acceptable assets for settling Balance of Payments deficits. The excess supply of a currency is associated with a deficit on a country's current and long-term capital account, or a heavy outflow of short-term capital. The ability to safeguard the value of a currency in the face of an excess supply of it on the foreign exchange market hinges on the amount of internationally acceptable money that a country possesses or can acquire through borrowing. The need to hold foreign reserves is, therefore, closely related to the need to (a) settle an incipient Balance of Payments deficit and (b) the existence of alternative means of financing or adjusting to payments disequilibria. Governments tend to respond to Balance of Payments imbalances through a combination of policies involving financing through the use of owned reserves and credit facilities, through altering its domestic policies and the exchange rate, and through the imposition of controls on trade.

In Belize, the demand for and supply of foreign exchange reserves are closely linked to foreign trade. On account of the open nature of the Belizean economy, foreign exchange earnings are made possible largely through export sales (and to a lesser extent from capital inflows into private investment and the public sector). These earnings are, in turn used to finance domestic demands for foreign goods and

services and are, therefore, the major source for settlements abroad. Because of the significant role trade plays in determining money flows, monetary imbalances tend to be manifested immediately in foreign exchange losses.

Given the role foreign reserves are expected to play in cushioning disturbances in the Balance of Payments, the level of these reserves which a country needs to maintain should be based on a measure that adequately reflects changes in the Balance of Payments. In an attempt to capture this feature, the Monetary Authority's foreign assets are associated with its demand liabilities and this institution is required to maintain, at all times, external assets equal to not less than fifty percent of these liabilities.

The association between foreign assets and deposit liabilities dates back to the Currency Board period. The Belize Board of Commissioners of Currency (1894 - 1976) was charged with the responsibility of ensuring that each unit of local currency that was issued was backed by its equivalent value in sterling.¹ Essentially, therefore, the Board was operating under a system which provided cover for the complete issue of currency notes in Belize and which ensured that sterling was always in adequate supplies to allow for unrestricted conversion. Such an arrangement, it was argued, promoted confidence in the local currency (thereby facilitating trade) and minimised the problem of external management. Such an arrangement, however, did not allow the Board to take any discretionary action to safeguard the value of the currency vis-a-vis sterling or to introduce measures to affect trade and payments with the rest of the world, and thereby to regulate the level of its holdings of foreign reserves.²

In the transfer of the assets and liabilities of the Belize Board of Commissioners of Currency to the Monetary Authority of Belize, there was a change in the relationship between foreign reserves and demand liabilities. "Demand Liabilities" was widened to include deposits by financial institutions and public sector entities with the Monetary Authority. While it was recognised that the Authority must maintain some degree of liquidity in its asset holdings consonant with its liabilities structure, the maintenance of a reserve level equal to the volume of currency plus deposit liabilities did not allow for flexibility in influencing domestic banking policy. In the bid for greater domestic control, not only was the Monetary Authority required to maintain external assets at no less than fifty percent of its deposits liabilities, but the link between the United States and the Belize dollars was reinstated. The decision followed the renewed difficulties with sterling in the 1960's, its continued weakening against the United States dollar and the rising prices of Belize's imports. In addition, convertibility restrictions were effected against all currencies, including the one to which the Belize dollar was tied while the Monetary Authority began to diversify its portfolio of foreign assets in an effort to minimise the risk of currency depreciation on its foreign investments.

In the search for greater autonomy, more emphasis was placed on maintaining the absolute levels of reserves above the legal requirement than on the factors which could aggravate a reserve loss and, thereby, frustrate the achievement of this goal. It was the low level to which the external assets ratio had declined at the end of September, therefore, that first alerted

the Monetary Authority to the rapid deterioration in liquidity and foreign reserves, and which forced this institution to institute measures to stem the reserve drain and restore order to the system. While liquidity normally declines during the last quarter each year, the rate of decline in liquidity after August, 1979 was unanticipated. After peaking at \$26.8 million in August, the foreign reserves declined rapidly, dropping to as low as \$9.8 million by November, the lowest level since January 1977. Associated with the decline in foreign reserves of the banking system was the drop by \$15.5 million in the Monetary Authority's foreign assets over the same time period. The Monetary Authority's foreign holdings deteriorated as the banks increasingly sought accomodation from the Monetary Authority to fulfil their liquidity requirements.

TABLE I
MONETARY AUTHORITY OF BELIZE

	<u>Foreign Assets</u> <u>(Bze \$000)</u>	<u>Demand Liab.</u> <u>(Bze \$000)</u>	<u>Foreign Assets/</u> <u>Demand Liab. (%)</u>
Dec. 1976	11,951	13,694	87.3
Dec. 1977	15,231	18,576	82.0
Dec. 1978	25,899	25,941	99.8
Mar. 1979	27,668	25,184	109.8
Jun. 1979	23,535	23,406	100.6
Sep. 1979	25,697	26,726	96.1
Dec. 1979	20,250	22,919	88.3
Mar. 1980	20,732	24,523	84.5
Jun. 1980	19,002	24,184	78.6

Source:- The Monetary Authority Of Belize Statistical Digest,
June 1980.

The depletion of foreign reserves and subsequent liquidity shortage that became evident after September 1979 was precipitated by the rapid growth in domestic credit. The decline in foreign reserves was traced primarily to the rapid growth in commercial bank lending which rose strongly throughout 1979. The need for close surveillance of credit to prevent a rapid increase in lending activating an outflow of reserves was camouflaged by the relatively high ratio of foreign assets to demand liabilities maintained by the Monetary Authority during the first two years of its operation. This was also the case even in those periods when bank liquidity dropped to its lowest levels. Bank liquidity normally peaks in August when sugar export earnings (second payments) are distributed to farmers. Thereafter, liquidity normally declines as the system is required to finance heavy import demands as businessmen build-up inventories in preparation for the Christmas season and to provide sugar farmers with the funds they require for re-planting.

In the face of the Monetary Authority's ability to maintain its external assets ratio with relative ease was the rapid expansion in domestic credit. The initial increase in

TABLE II

DOMESTIC CREDIT

BZE \$000

	<u>To Government (Net)</u>	<u>To Other Public Sector Entities</u>	<u>To Private Sector</u>	<u>Total</u>
Dec. 1976	3,558	4,044	58,601	66,203
Dec. 1977	7,756	4,385	54,798	66,939
Dec. 1978	12,216	6,249	58,747	77,212
Mar. 1979	11,654	6,606	62,552	80,812
Jun. 1979	13,676	7,453	68,443	89,572
Sep. 1979	15,713	7,024	72,850	95,587
Dec. 1979	12,628	8,126	76,469	97,223
Mar. 1980	15,625	7,537	71,530	94,692
Jun. 1980	22,585	6,998	68,686	98,269

Source: Monetary Authority Of Belize Statistical Digest, June 1980.

domestic credit between 1976 and 1978 was largely the result of the increase short-term borrowings of Central Government.³ From the end of 1978 onwards, however, the growth in private sector credit quickly outpaced the expansion in Central Government short-term needs. Between December 1978 and December 1979, therefore credit to the private sector had risen from \$62.6 million to \$76.5 million, a growth rate of 22.2 percent.

(Credit to Government, over the same period had shown very little change). It was this expansion in credit, particularly commercial banks' direct lending that is linked to the reserve losses in 1979, given the association between the continued increase in Belize's imports bill and importers' need to finance this bill.

Table III shows the relationship between the net foreign assets of the banking system and the number of weeks imports such reserves could finance:

TABLE III

	BZE \$M		
	Foreign Reserves Monetary Authority & Banks	Imports Per Week	Fgn. Reserves /Imports
Dec. 1977	10.1	2.4	4.2
Mar. 1978	16.3	2.8	5.8
Jun. 1978	17.5	4.4	4.0
Sep. 1978	26.5	4.1	6.5
Dec. 1978	24.8	4.5	5.5
Mar. 1979	26.5	5.4	4.9
Jun. 1979	20.6	4.8	4.3
Sep. 1979	20.1	4.8	4.2
Dec. 1979	11.8	5.0	2.4
Mar. 1980	15.5	4.8	3.2

Source:- The Monetary Authority of Belize:- Statistical Digest, June 1980; Annual Report 1977, 1978, 1979; Quarterly Review, March 1980.

The data indicate that while external assets rose strongly up to March 1979, largely due to the rapid build-up in the Monetary Authority's foreign holdings, after September 1979, these reserves were sufficient to finance imports for a declining number of weeks. While, therefore, the External Assets ratio of the Monetary Authority was showing that this institution was better equipped to cushion any payments imbalance, the net foreign holdings of the banking system were becoming less able to finance the continued expansion in the value of imports.

The strong rise in commercial bank credit is associated with the growing cost of imports. In open economics, one expects a high proportion of loans and advances to be used to purchase goods purchase goods with high import content; in addition, the commercial banks throughout the Caribbean were originally set up primarily to provide finance for the export-

import trade between the colonies and the United Kingdom and this continues to be the banks' practice. One, therefore, expects a high correlation between the growth in loans and advances, the increase in imports and the subsequent decline in foreign reserves.⁴ This relationship becomes more evident when one examines the expansion in sectoral lending by the commercial banks. The \$21.6 million increase in loans and advances between December 1978 and December 1979 was largely concentrated on the Distributive and Personal Sector, two sectors which normally requires financing for the importation of consumption goods;⁵ these two sectors together accounted for 49.0 percent of the growth in the banks' direct credit during that year.

Commercial bank credit has risen strongly particularly since the early 1970's. The expansion in bank credit, however, was halted after 1976 when the Monetary Authority began to operate. The strong growth in bank credit between 1978 and 1979 was stimulated by the unanticipated and unseasonal boost in liquidity upon the receipt of insurance compensation for damages caused by Hurricane Greta in September 1978. A sizeable proportion of these funds were placed on deposit at the commercial banks. The commercial banks, thereupon, proceeded to readjust their asset portfolio by first acquiring large sums of Government securities and later expanding their direct lending. Private sector demand for loans rose rapidly during 1979 as importers borrowed increasingly to accommodate the continued rise in prices and costs (particularly fuel prices and costs⁶). The banks' decision to lend in response to these inflows of

TABLE IV

COMMERCIAL BANKS
BZE \$000

	<u>Net Foreign Assets</u>	<u>Deposits</u>	<u>Loans And Advances</u>
1950	+779	2,798	1,845
1955	+30	4,396	4,238
1960	-186	7,077	6,100
1965	+4,133	12,108	7,821
1970	-11,093	20,335	28,140
1975	+4,193	59,137	51,559
1976	-8,537	61,290	64,053
1977	-4,580	62,278	59,515
1978	+1,079	79,316	64,996
1979	+7,543	83,293	86,550
Mar. 1980	-4,182	81,588	80,962
Mar. 1980	-2,894	84,775	80,306

Source: The Monetary Authority Statistical Digest June, 1980
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(1894-1976), Journal of Belize Affairs, Vol. 8, April
1979.

insurance funds was made with little regards for the short-term nature of these funds; the banks also did not initiate any measures to reduce direct credit once these deposits were withdrawn and used by businessmen to replenish their stocks. The need to readjust their asset portfolio was further delayed as bank liquidity was boosted by foreign exchange inflows which began in early 1979 as sugar cane farmers began receiving their earnings for the year. Following the completion of the second payments to the cane farmers in mid-July the commercial banks continued to finance the high level of advances, this time by selling off their stock of Government of Belize Treasury Bills.

The decision by the Authority to introduce corrective measures was speeded up by the commercial banks' request for

accomodation from the Monetary Authority once they began to experience liquidity pressures after September 1979. It was also this request for financing by the banks that was reflected in the rapid decline in the Monetary Authority's foreign assets and its external assets ratio.

During the Currency Board era, and even after the Monetary Authority commenced its operations, the banks financed an expansion in credit through Head Office borrowing. Commercial banks operating in Belize have traditionally extended loans on the basis of their assessment of the "credit worthiness" of borrowers, a factor largely influenced by the profitability of the loan. The commercial banks, being branches of transnational banks, had access to their Head Office Funds and to major capital markets and, as a result, paid little attention to prevailing liquidity conditions; the only real constraint on their willingness to lend therefore was the extent to which their respective Head Office was prepared to facilitate them. As is evident from Table IV, the rapid expansion in bank credit began in the mid-1960's (from that time until the mid-1970's the level of bank credit outpaced deposit growth) and it was at this time, that the commercial banks became net borrowers from their Head Offices.

As credit expanded after 1976, the banks' remained net debtors.⁷ The decision to borrow from the Monetary Authority at the end of 1979 was therefore, contrary to the norm.⁸

The decision to borrow locally stemmed primarily from the fact that it was less costly to borrow in Belize. To a lesser extent, this decision was also influenced by the

legal requirement that foreign borrowings are not classified as liquid assets unless the debt has been incurred for more than ninety days.

Based on the policy to promote confidence in the domestic economy and the financial institutions, interest rates in the local economy remained fairly stable for the first three years of the Monetary Authority's operations. This practice explains the disparity that

COMMERCIAL BANK PRIME LENDING RATE (PERCENT)

	<u>United States</u>	<u>United Kingdom</u>	<u>Mexico</u>	<u>Belize</u>
Dec. 77	7.75	9.0	17.0	9.5
Dec. 78	11.75	11.0	17.5	9.5
Dec. 79	15.25	18.0	19.0	9.5
Mar. 80	19.50	19.0	21.39	15.0
Jun. 80	11.50	17.5	22.47	15.0

developed between local and foreign rates. Under the Currency Board system, domestic rates would have moved correspondingly with any alteration in international interest rates and irrespective of the prevailing credit conditions in the domestic economy. The movement in domestic interest rates was facilitated by the convertibility arrangements with sterling which enabled the free flow of capital within the sterling area.

In the first two years of the Monetary Authority's operations, local rates remained, for the most part, stable and above the rates prevailing internationally. By the end of 1979, however, this

pattern was reversed and foreign interest rates moved ahead of domestic rates. Thereafter, the disparity between local and foreign rates widened particularly as rates in the United States and the United Kingdom rose to unprecedented levels. In a renewed bid to cope with the impact of high oil prices and in an effort to halt inflationary growth, many countries favoured the upward movement in interest rates as a means of attracting inflows and restraining monetary growth. With guaranteed convertibility being replaced by exchange control against all currencies the local rates no longer moved sympathetically along with external rate changes. Nevertheless, Belize is not totally isolated from such changes abroad. Local interest rates are influenced by external rates to the extent that exchange controls do not eliminate completely flows resulting from the differential. Transnational companies, for example, have access to Head Office Funds and to the extent that firms, companies or individuals can borrow internationally, to this extent will rate differentials affect the decision about the source and placements of funds.

Given the inadequacy of Balance of Payments data, it can only be speculated that capital flows were influenced by the disparity between local and foreign interest rates; neither does data on recorded sales of foreign exchange indicate any acceleration of such flows after 1978.⁹ However, various occurrences since then point towards such an association. It was noticed that companies began altering, not only the timing of their payments, but also the location of

their borrowing. There was an acceleration of payments for imported products, and companies affiliated with transnational corporations and which previously received financing from such organisations, relocated their borrowing to take advantage of the cheaper rates obtainable locally.

In its efforts to halt the decline in the net foreign assets in the system, the Monetary Authority undertook measures to control the growth in bank credit. The ability of the Monetary Authority to extend credit enables this institution not only to underpin the confidence of the public but also to encourage the commercial banks to use their resources more efficiently and effectively. As a signal and as a deterrent, the Authority first allowed its lending rate to climb. The banks, however, continued to request loans from the Authority, the low cost of borrowing locally being enhanced by the fact that these loans were enabling them to fulfil their liquidity and cash requirements. Following the Authority's decision in December to lend to the banks only as temporary expedient, the banks were forced to resort to the more expensive credit obtainable from abroad (It was judged that the expansion in the banks' liquidity would commence early in the new year, however, it would be largely dependent on the slow build-up in deposits once the grinding of sugar commenced).

The adjustment in the Authority's lending policy, however, is only an indirect approach to controlling bank credit; the ability of the banks to extend credit is still largely determined by their access to external funds. More direct restrictions on credit were, therefore, implemented to prevent the banks responding to the anticipated boost in liquidity. A directive was issued requiring that by the end of March 1980, the banks reduce total loans and advances by 5.0 percent of their value as at December 22, 1980. Thirdly, to minimise any capital outflows that were resulting from the differential between

local and external rates, the prime lending rate rose to 11.5 percent.¹⁰ Less important, the Monetary Authority adjusted the maturity composition of its foreign investments. The adjustment, however, signals an attempt to capture the seasonal influences on liquidity and to predict more accurately the demand for foreign assets.

The immediate response to the curtailment in credit was the reduction in deposits. Transactors requiring additional sources financing for the external payments, reacted by reducing their deposits. While bank lending fell sharply in that initial period, therefore, liquidity experienced only modest increases with the seasonal impact of sugar sales abroad being negated. The recovery of the net foreign assets of the system, therefore, reflected the initial earnings from the 1980 crop. This modest increase in liquidity was largely manifested in a reduction in the banks' external liabilities and not in an expansion in the banks holdings of local securities.¹¹

Deposits, however, was restored to the December level by June 1980. While deposits rose partially in response to inflows of sugar funds, the increases in interest rates paid on deposits was also a determining factor given that the expansion over that period was concentrated on term deposits.

Foreign reserves made a remarkable recovery in the first half of 1980. While, this increase reflected, to a large extent, a seasonal build-up in liquidity, the restrictions imposed in late 1979 ensured that the commercial banks did not respond to the expansion in liquidity by increasing direct credit. The experience in 1979 highlights the need to exercise control and/or give direction to the expansion in domestic credit while the restriction imposed

on credit suggests a strong departure from the non-interventionist policy adopted by the Monetary Authority during the first two years of its operations.

FOOTNOTES

1. Unlike the currencies of the other countries which operated Currency Boards, the new currency that was issued when the Belize Board of Commissioners of Currency commenced its operations was based on the gold standard and the United States dollar. Notes were issued in return for the United States' "current gold coin" and had to be redeemed on demand, in either silver or gold. It was not until 1939 that the link with gold, and 1949 that the link with the United States dollar were severed. During this time, however, the Belize dollar was always convertible into sterling.
2. The only attempt by the Board to influence trade and payments was made following sterling devaluation in 1949. Being tied to the U.S. dollar, the Belize dollar automatically changed vis-a-vis sterling (unlike other currencies in the sterling area). As a result, Sterling in the Note Guaranteed Fund was not equal to the currency in circulation and the Board was required to take measures to restore the value in Belize dollars, of the sterling investments. The decision to devalue the Belize dollar and link it to sterling, was not, however, based only on the need to restore the reserve backing but also to stimulate trade in the area given the slump in the United States' demand for chicle and sugar after World War II.
3. Central Government gained access to an **additional** source of short-term financing with the first issue of \$2.4 million worth of Treasury Bills in August 1977. By December 1978, this figure had climbed to \$12.1 million.
4. While, admittedly, fluctuations in invisible transactions and capital movements can also generate reserve changes, disturbances of the visible trade account appears to be the major contributor to reserve depletion in Belize.

5. During October, 1979, the banks' direct advances rose by a record monthly rate of \$4.6 million which corresponds closely to the decline in foreign reserves during that month (between September and October 1979, net foreign assets dropped from \$20.1 million to \$16.1 million). Within this expansion in credit, loans to the Distributive sector rose by \$2.7 million whilst loans to the Personal sector increased by \$1.7 million.
6. The increase in fuel prices during 1979 resulted in Belize's fuel bill rising from \$22.0 million to \$49.1 million, more than doubling during the year.
7. The net creditor position in 1978 (TABLE IV) reflected the influence of insurance compensations made following Hurricane Greta.
8. The commercial banks had sought accommodation from the Monetary Authority on one other occasion. This occurred in early 1977 in the transition from the Currency Board to the Monetary Authority. Accommodation was provided to help the banks meet the new liquidity and cash requirements without and major reorganisation in their asset portfolio, given their practice of maintaining a high ratio of advances to deposits.
9. Capital outflows resulting from the disparity between domestic and international interest rates could also have been concealed by the receipt of insurance compensation for damages done by the hurricane in 1978.
10. Further rate increases followed in March 1980. Then, the commercial banks, after consultation with the Monetary Authority, allowed the prime rate to rise as high as 17.0 percent. The rate paid on all interest-paying deposits also rose. The increase in the deposit rates, apart from being in response to the Monetary Authority's expressed desire to maintain or

10. reduce the spread between lending and deposit rates was also done in a competitive bid to attract deposits.

APPENDIX

BALANCE OF PAYMENTS (CURRENT ACCOUNTS)

1976 - 1979

	<u>BZE \$000</u>			
<u>Merchandise Account</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>
Exports (f.o.b.)	94,041	124,400	159,565	203,376
Imports (c.i.f.)	161,510	180,151	211,988	266,328
Visible Trade Balance	-67,469	-55,751	52,423	-62,952
 <u>Invisibles</u>				
Factor Income (Net)	-3,000	-3,500	-3,700	-4,000
Travel (Net)	5,200	5,600	6,000	6,500
 <u>Transfers</u>				
Overseas Aid (U.K)	12,000	18,000	19,000	29,000
Other Aid (Canada, U.N., etc.)	3,000	3,200	3,600	4,200
Remittances (Net)	3,500	3,500	3,600	1,800
Other (Net)	1,200	1,400	1,500	1,600
TOTAL	<u>-45,569</u>	<u>-27,551</u>	<u>-26,023</u>	<u>-21,852</u>

Source: Central Planning Unit

ECONOMIC SURVEY

The figures for 1979 are provisional

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