Bze
U/F
1062

THE BELIZE EXPERIENCE IN THE MANAGEMENT OF MONETARY POLICY

1980 - JUNE 1986

BY

Yvette Alvarez

Paper presented at the XXIII Meeting of Technicians of Central Banks of the American Continent, Lima, Peru, November 17 - 21, 1986.

The views expressed here
are not necessarily those of
the Central Bank of Belize

Research Department
Central Bank of Belize

THE BELIZEAN EXPERIENCE IN THE MANAGEMENT OF MONETARY POLICY: 1980 - JUNE 1986

This paper discusses the effectiveness of monetary policy during the period 1980 to June 1986. It represents the sequel to a previous, less-detailed, paper by the same author and as such makes extensive use of the material therein.

The paper is arranged as follows:

SECTION I sets the scene by briefly reviewing the economic situation of this period;

SECTION II divides the review period into three sub-sections and reviews and discusses the implementation of monetary policy and its effectiveness;

SECTION III attempts to discuss the future role of monetary policy in Belize.

SECTION I

Belize, like many other developing economies, was adversely affected by the impact of worldwide recession, high interest rates and high levels of inflation. Characterising the economy at various points in time during the review period were inflationary pressures, a relatively low rate of growth due to poor performance of its main industry, the widening of the trade gap, increased deficits on the government's budget and falling foreign exchange reserves.

The deteriorating fiscal performance in Belize (which was a manifestation of the sluggish economy) was reflected in the increasing overall deficit of the nonfinancial public sector which doubled from 4 percent of GDP in FY 1980/81 to 8 percent of GDP in FY 1983/84. The balance of public sector current operations reversed from a surplus of $4\frac{1}{2}$ percent of GDP in FY 1980/81 to a deficit of 2 percent of GDP in FY 1983/84. The above situation therefore led to increased financing requirements on the part of the public sector. This was met largely through domestic sources (Central Bank and commercial banks). During the review period, this financing alternated between the two bodies.

The increasing rate of credit to the public sector coupled with the poor performance of the economy led to a widening of the trade gap and severe losses in foreign exchange and subsequently, a worsening of the balance of payments during this period. The current account deficit of the balance of payments increased from 2 percent of GDP in 1980 to an estimated high of 11 percent of GDP in 1982. There were no serious financing problems though since official and private capital inflows prevented an overall balance of payments deficit. The current account deficit registered a rise of 5 percent of GDP in 1984 after falling to 4 percent of GDP in 1983. This increased deficit in 1984 resulted in a net reserve loss of US$7.3 million.

During the entire review period Belize suffered from deteriorating terms of trade. Large contractions in the major sectors like manufacturing, construction and commerce were recorded. The sluggishness of the economy particularly in the early part of the review period was as a result of falling sugar prices and rising oil prices.

The depreciation of the Mexican peso and the pound sterling in 1982 were also key variables in this scenario. The depreciation of the peso brought to a virtual stand-still the previously flourishing re-export trade which was one of the mainstays of the small Belizean economy. The weakness of sterling meant reduced export earnings, especially for the Belizean banana producer and increased external debt payments for the Government of Belize.

The monetary approach to the balance of payments hinges on the basic assumption of a stable demand for money function. Also, that it is possible for the monetary authorities to influence the economic climate in an economy by controlling the money supply. The theory stresses the fact that the two functions (the demand for and supply of money) are not inter-related. Based on these basic assumptions, it is postulated that positive correlation exists between the supply of money and credit extended by financial institutions in the economy. If this relationship is in fact true, then movements in money supply should be mirrored by movements in domestic credit. An initial indication of the existence of this relationship in Belize is supplied by Table A which compares percentage changes in narrow money supply (M1), broad money supply (M2), total credit from the banking system and total credit from the commercial banks and the Central Bank. It is clear from this table that declining trends in M1 were observed between 1980 Q3 and 1980 Q4; 1981 Q1 and 1981 Q2; 1981 Q3 and 1982 Q1; 1983 Q1 and 1983 Q4 and 1984 Q4 and 1985 Q3. Also, that these trends were reflected in M2 and total credit, for the most part. An interesting feature of this table is the fact that increases/decreases in credit from the Central Bank alternated with reverse movements in credit from commercial banks.

Table A

PERCENTAGE CHANGES IN MONEY SUPPLIES (M1 and M2), AND TOTAL CREDIT FROM THE BANKING SYSTEM: 1980 - JUNE 1986

Year	M1	M2	Total Credit from the Banking system	Total Credit from the Commercial Banks	Total Credit from the Central Bank of Belize
1980					
1	-	-	-	-	-
2	4.7	4.0	4.2	2.1	17.8
3	8.2	10.5	7.6	10.9	-10.5
4	-1.2	-1.3	3.9	7.5	-20.6
1981					
1	4.4	9.7	6.7	7.0	3.7
2	-5.4	-	6.4	2.6	42.0
3	6.8	3.6	6.8	-0.6	57.9
4	-7.1	-1.6	0.2	2.6	-10.0
1982					
1	-4.3	1.3	2.5	1.3	8.8
2	4.7	5.2	5.1	6.5	-1.2
3	-8.1	-2.7	18.7	18.7	18.9
4	8.0	5.0	10.9	-5.8	93.1
1983					
1	11.7	9.4	-9.6	9.6	-55.7
2	1.9	6.5	1.3	5.2	21.5
3	-1.1	1.5	3.6	1.0	24.7
4	-0.7	0.6	3.0	0.6	19.0
1984					
1	10.0	2.3	3.0	1.8	9.4
2	1.8	-0.2	4.1	-0.7	28.6
3	4.6	1.9	-4.4	3.0	-33.3
4	8.1	1.4	8.2	-3.3	78.1
1985					
1	3.9	3.1	-4.5	-3.7	-6.9
2	1.3	0.7	-	0.3	-1.1
3	-4.3	0.2	-0.1	2.9	-10.4
4	7.8	4.2	-0.9	-0.7	-1.5
1986					
1	13.7	8.5	-3.1	4.7	-34.0
2	5.0	4.1	-2.4	2.9	-35.7

Source: Central Bank of Belize Quarterly Reports

SECTION II

The latter part of the previous section provided an early indication of the effectiveness of monetary policy implemented during the review period. As a matter of convenience, the review period will be divided into three sub-sections which in the author's view share certain common characteristics. The first period, covering the period 1980 to 1982 was characterised by the recognised need to dampen credit demand and improve the balance of payments. It also represents the first attempt by the Monetary Authority to influence monetary aggregates in the economy. The second period, 1982 to 1984 represents an era when the Authorities felt the need to stimulate economic activity. Lastly, the period 1984 to the present (June 1986) is unique in the sense that the Authorities for the first time introduced financial programming, backed by an IMF Standby Facility, to influence the path of development in the economy. Tables and charts highlighting the trends to be discussed below can be found in the appendix.

1980 to 1982 - first attempt by the Authorities to influence monetary aggregates.

Hurricane Greta in 1978 heralded increased insurance funds from abroad which swelled deposits at the banks. The commercial banks, ignoring the short-term nature of this flow, expanded credit in 1979. By the end of 1979 bank liquidity was heavily depleted following this sustained growth in lending and the concomitant pressure on reserves. The Monetary Authorities recognised the need to remedy this situation by dampening credit demand. A directive was issued by the Authorities on December 22, 1979 requesting all banks to reduce outstanding loans and advances by 5 percent from the level obtaining on the date of the direction. The commercial banks were required to achieve this by March 31, 1980. As a result of this directive by the Authorities, the commercial banks increased interest rates during the year in an effort to buttress the imposed credit restrictions. Lending rates were increased several times during the year from a low of 9.5 percent to a high of 17 percent. The rate paid on deposits was also raised a few times to reach an all time high of 15 percent by the end of 1980. The weighted average loan rate during this period was recorded at 19.5 percent, while the weighted average rate paid on deposits registered at 9.5 percent largely reflecting the high interest rates existing abroad.

By March 1980, the request for the 5 percent reduction in outstanding loans and advances was honoured - outstanding loans and advances fell by 6.5 percent and each bank had achieved the specified objective. Additionally, this contraction in credit was largely confined to the private sector. The liquidity crunch witnessed in 1979 was improved somewhat by the end of 1980 - excess liquid asset holdings by the banks rose by $3.5 million to $8.0 million.

The effectiveness of the credit restraint, however, can only be fully appreciated by an analysis of the effect of these policies on relevant monetary variables.

Real deposit growth of 8.5 percent was recorded between 1980 and 1981 and 6.8 percent the following year. The sluggishness of the economy, particularly the depressed sugar sector, 1/ was the main contributing factor to the declining rate of growth in 1982, especially since a positive real deposit rate was recorded (3.8 percent).

The initial drop in outstanding loans and advances recorded in the first quarter of 1980 was not long-lasting. By the end of 1980, net domestic credit had increased by $14.5 million or 15.4 percent to $108.6 million. The bulk of this increased credit (in 1980) was to the private sector. However, as the fortunes of the economy continued to decline into 1982, both the public and private sectors resorted to borrrowing despite a real estimated cost at 1982 of 10.9 percent. The steady expansion in credit and reduced export earnings resulted in falling foreign reserves - between 1980 and 1982 this was estimated at $22.1 million. As a result, the Monetary Authorities suspended dealings in Treasury bills. The commercial banks who were apprehensive about the duration of the suspension reduced their holdings of Treasury bills by $5.6 million or 75.7 percent to $1.8 million by December 1982.

Perhaps, the only target achieved by the end of 1982 was the improvement in the liquidity position. At December 1982, commercial banks were holding $10.8 million in excess liquid assets against a required minimum of $22.7 million. The cash reserve performance was, however, a bit tighter - $1.9 million in excess cash reserves.

1982 to 1984 - an attempt at stimulating a depressed economy.

The Monetary Authorities after interpreting the signals emanating from the developed world announced new monetary measures in December 1982 that would be effective January 1, 1983. The prime lending rate was reduced by 2 percentage points to 16 percent, and the rate paid on deposits to 12 percent. During the year rates were reduced further - the lending rate to 14 percent and the deposit rate to 9 percent.

A remarkable expansion in deposits was recorded in 1983. Real deposits grew by 17.8 percent only to fall by 6.2 percent in 1984. A large part of this growth in 1983 represented the temporary placing of funds with the banks by the Development Finance Corporation (DFC). The contraction in 1984 reflected the return to normalcy after reaching the high level in 1983, as well as the impact of deteriorating foreign reserves. The contraction in the net foreign assets of the banking system between 1983 and 1984 ($6.2 million or 29.8%) occurred despite the observed signs of recovery in the developed world.

Increased credit activity was most obvious during this period especially between 1983 and 1984. Total incremental credit between 1982 and 1983 grew by 15.3 percent with most of this credit being channelled to the public sector - 33 percent to the public sector and 8 percent to the private sector. Between 1983 and 1984 credit expanded by 11.6 percent with both sectors of the economy claiming a share. The real cost of borrowing for 1983 and 1984 were estimated at 9.5 percent and 9.6 percent, respectively.

Significant capital inflows occurred during this period. In

May 1983, SDR 3.6 million was received under a Compensatory Financing Facility due to export shortfalls in 1982. In addition, loan receipts by the Development Finance Corporation (DFC) from the Commonwealth Development Corporation (CDC) helped to strengthen the financial system. The Treasury bill market was, therefore, reactivated and between 1982 and 1983 commercial banks holdings of Treasury bills grew by $14.9 million or 827.8 percent. The following year, this was reversed when the banks reduced their holdings by 68.3 percent. The declining revenues being experienced by the public authorities at this time made it imperative for the Central Bank to take up the slack. As a result, the Central Bank's holdings of Treasury bills fell by 5.3 percent between 1982 and 1983 and expanded by 116 percent the following year. With the observed expansion in Treasury bill holdings in 1983, the banks' excess liquidity swelled some 69 percent to $18.3 million. Additionally, with the reduction in Treasury bill holdings in 1984, excess liquidity fell by 25.1 percent to $13.7 million.

1984 to June 1986 - financial programming for the first time.

Against the background of deteriorating international re-reserves and continuing high public sector deficits, the Government of Belize adopted a financial adjustment program in support of which it entered into (in December 1984) a Stand-by Arrangement with the International Monetary Fund for the amount of SDR 7.125 million. This programme aimed at strengthening the finances of the public sector and restoring the balance of payments to a sustainable position and to this end government initiated a major financial adjustment programme in June 1984. Specifically, government planned to achieve a surplus in the current operations of the nonfinancial public sector equivalent to 2½ percent of GDP in FY 1984/85 and 3½ percent of GDP in 1985/86. With respect to the balance of payments target, the authorities planned to contain the loss of international reserves of the Central Bank to US$6.5 million in 1984 and obtain an increase in such reserves in 1985 equivalant to US$5.0 million. The Government of Belize savings effort consisted both of measures to increase revenue yields and curtail current expenditures.

The policy measures introduced recognised the need for action to improve the public sector's fiscal performance, but at this stage in the programme the main emphasis was placed on monetary adjustment to curb excess credit creation and improve the balance of payments and official reserves. It was with these considerations uppermost that the government introduced the following package of monetary meaasures.

On November 1, 1984 the cash reserve ratio was increased by 2 percentage points from 5 percent to 7 percent. Effective January 28, 1985 the following changes were made:-

1) an increase by 2 percentage points on the minimum lending rate from 12 percent to 14 percent;
2) an increase by 3 percentage points on commercial banks savings and time deposits interest rates on the existing minimum deposits rates; and
3) an increase by 3 percentage points on Treasury bill sales from 9.76 percent to 12.76 percent - subject to bank bids.

A further increase in the cash reserve ratio from 7 percent to 9 percent was effected March 1, 1985. Two increases of the liquid assets ratio of the commercial banks were also introduced. The first increase of 5 percentage points was effective March 1, 1985 and moved the ratio from 20 percent to 25 percent. The second increase was effected April 1, 1985 and increased the ratio another 5 percentage points from 25 percent to 30 percent.

The commercial banks were also informed that the Central Bank would consider loans to them only where it was the view of the Board that failure to approve the loans would seriously harm the banking system.

Deposit growth during 1984 and June 1986 was very healthy. Real domestic savings grew by 4.9 percent in 1985 and 9.3 percent at June 1986. Real positive deposit rates were also recorded during this period. The expansion in deposits observed in 1985 is explained by the impact of the improvement in foreign reserves following substantial inflows of capital from IMF under the Standby ($9.6 million); and USAID under an Economic Stabilization Facility for US$13 million ($15.0 million). The improvement in the net foreign assets position of the banking system was of some 49 percent to negative $13.8 million at December 1985. This was accomplished even as external payments arrears were eliminated in September 1985. The 9.3 percent expansion in real deposits at June 1986 is largely explained by substantial sugar receipts given improved sugar prices, the filming of a movie in the early part of 1986 which implied an expenditure of US$5.0 million in Belize and the impact of $10.4 million in drawings under the IMF and USAID facilities mentioned earlier. The net foreign assets of the banking system, for the first time in four years was recorded at $16.4 million representing a 218.8 percent improvement in foreign reserves over the 1985 position.

The increased real cost of borrowing (by the end of 1985 this had increased by some 20 percent) accompanied by the low rate of growth in the economy partly explains the contraction in credit from the banking sector observed during this period. Outstanding loans and advances in 1985 and at June 1986 fell by 12.4 percent and 7.1 percent, respectively. The greatest part of this fall was felt in the first quarter of 1985 and was concentrated in the private sector – all economic sectors were affected. The commercial banks were now in a position to take up more Treasury bills and this they did by increasing their holdings in 1985 and at June 1986 by 177.4 percent and 164.6 percent, respectively.

The increased liquidity requirements resulted in a reduction in excess liquidity of some 40 percent to $8.2 million in 1985. The required holdings had grown by $16.1 million or 57.1 percent to $44.3 million between 1984 and 1985. By June 1986, however, the banks had excess liquidity of $27.8 million which represented an increase in liquidity of 239.0 percent over the 1985 position.

SECTION III

The successful use of traditional monetary tools was indicated in section II. Real deposits grew some 46 percent during the review period with the increases in the nominal interest rate restoring positive real rates by 1982 (negative rates of 10.2 and 1.3 percent were recorded for 1980 and 1981, respectively). The increasing rate of net domestic credit observed throughout the period was halted after 1984 when domestic credit reached an all-time-high of $206.4 million. Between 1984 and June 1986 net domestic credit contracted by 10.5 percent. The commercial banks were now better placed to invest in Treasury bills (the rate being paid at June 1986 averaged 12 percent) and their holdings of this short-term asset expanded by $31.5 million to $38.9 million during the review period. As a result excess liquidity at June 1986 was estimated at $27.8 million – an increase of $19.8 million from 1980. The net foreign reserves of the banking system improved tremendously during this period. Between 1982 and 1985, the banking system was perpetually in a net foreign liability position. At June 1986, the net foreign assets of the banking system stood at $16.4 million. This represented an improvement of $30.2 million over the previous year's position. This favourable position compares with a low of negative $27.0 million recorded in 1984. The financial programme thus came to a successful end in May 1986 when both the IMF and Belizean authorities were satisfied that the goals of the programme had been met.

With the recovery in the developed countries now well under way, it would now seem prudent to suggest that monetary policy should accomodate the resumption of the economy. This should be done without risking increasing prices. The external sector is now supported by declines in oil prices and interest rates as well as favourable demand conditions for most of our exports (world sugar prices are now relatively more attractive). This sector should be supported by efforts to reduce any market distortions that could discourage exports.

It is important to note, however, that small open economies like Belize need desperately to improve their productive base. Existing structural problems suggest that supply constraints on the economy must be dealt with if monetary policy is to successfully direct the path of development. Poor infrastructual development, insufficient domestic savings and lower than desired levels of foreign investment are a few instances of these constraints.

The experience acquired especially since 1984 illustrates the need to maintain an internationally competitive interest rate if the banks are not to divest themselves of Treasury bills. Additionally, the virtual nonexistence of a viable capital market makes investing in Belize difficult. This, of course, reflects itself in low levels of saving and, therefore, the inability of the economy to fuel local investment. Informal financial institutions abound in small economies like Belize and the extent of their activities can only be estimated. Control of these institutions is quite difficult.

Lastly, successful direction by monetary policy is impossible without appropriate and supporting fiscal policies. Both policies should work in harmony. The greatest constraint to the Government of Belize is the existing weak revenue base and the concomittant inability by the public sector to increase savings to finance much needed infrastructural development. The low levels of available external financing exacerbates an already impossible situation.

Perhaps, there is the recognised need to increase export earnings and to generate adequate domestic public sector savings to meet (among other things) external debt service payments. Also, there is a growing need to reduce dependence on external financing for developing the infrastructure for sustained growth. Our growth and development, however, is contingent on that of the industrialized countries. That the present trend towards protectionism will make such development impossible goes without saying. In fact monetary policy, working closely with fiscal and other policies aimed at redressing the supply constraints inherent in the economy, can together effectively influence the path of growth in the economy given the appropriate external environment.

APPENDIX

Table 1

FACTORS RESPONSIBLE FOR MONEY SUPPLY MOVEMENTS

1980 - JUNE 1986

BZ$M

	1980	1981	1982	1983	1984	1985	June 1986
MONEY OF EXTERNAL ORIGIN	8.2	0.5	-13.9	-20.8	-27.0	-13.8	16.4
Gross Foreign Exchange Assets of the							
Central Bank	24.8	20.7	19.7	18.6	12.1	29.6	62.7
Commercial Banks	23.7	23.1	14.9	18.5	18.9	19.3	17.9
Less: Foreign Exchange Liabilities of the							
Central Bank	0.9	0.4	0.4	8.5	17.1	22.1	23.8
Commercial Banks	39.4	42.9	48.1	49.4	40.9	40.6	34.7
MONEY OF INTERNAL ORIGIN	108.6	134.9	160.5	185.0	206.4	195.3	184.8
Net Domestic credit to:							
Public Sector	25.7	38.6	45.2	60.3	70.6	68.3	62.6
Central Government	21.7	34.6	45.5	68.3	79.6	90.4	92.5
Other Public Sector	4.0	4.0	(0.3)	(8.0)	(9.0)	(22.1)	(29.9)
Private Sector	82.9	96.3	115.3	124.7	135.8	127.0	122.2
OTHER ITEMS (NET)	-4.0	-5.6	-11.1	-3.0	-9.1	2.9	7.0
MONEY SUPPLY (M2)	112.8	129.8	135.5	161.2	170.3	184.4	208.2
Less: Savings deposits	31.6	27.8	26.6	30.9	32.4	31.8	37.4
Time deposits	36.8	54.5	67.0	85.2	80.8	90.6	96.8
MONEY SUPPLY (M1)	44.4	47.5	41.9	45.1	57.1	62.0	74.0
Currency with the public	17.5	19.0	20.6	21.4	22.8	22.6	27.5
Demand deposits	26.9	28.5	21.3	23.7	34.3	39.4	46.4

Source: Central Bank of Belize

Table 2

SECTORAL DISTRIBUTION OF LOANS AND ADVANCES

1980 - JUNE 1986

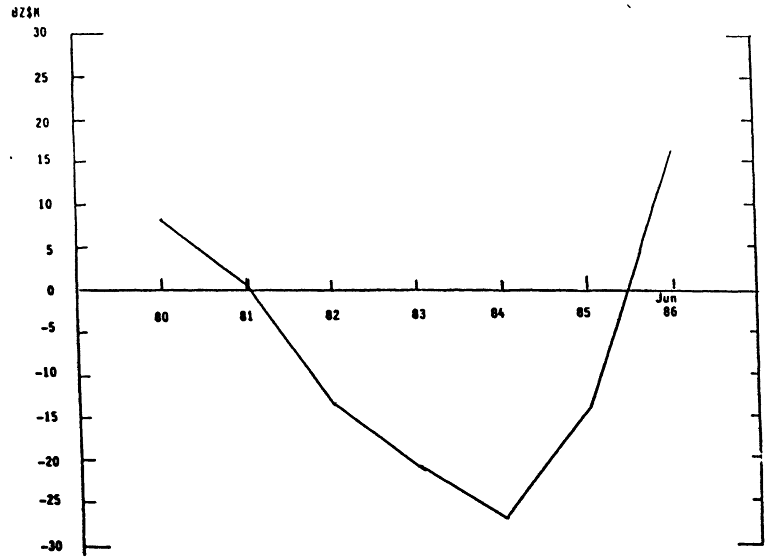
	1980	1981	1982	1983	1984	1985	June 1986
Agriculture	24.1	24.1	22.7	17.2	16.7	14.3	10.9
Sugar	12.6	13.3	10.7	8.0	6.6	3.9	2.2
Citrus	2.5	2.1	3.2	4.4	5.2	7.1	4.8
Bananas	3.6	3.8	4.2	1.4	1.7	0.2	0.7
Other	5.4	5.7	4.6	3.4	3.2	3.1	3.3
Manufacturing	12.5	11.9	18.1	18.6	19.9	21.1	15.6
Construction	9.2	11.9	12.6	13.1	15.4	15.4	16.1
Public Sector 1/	2.7	5.0	15.0	17.3	20.5	17.8	15.6
Pesonal	9.6	10.9	10.7	14.9	16.1	10.8	12.0
Distribution	25.2	36.3	41.3	42.7	45.9	45.9	44.8
Other 2/	8.6	8.8	11.9	17.6	24.5	16.1	16.3
Total	91.9	108.7	132.2	141.4	159.0	141.4	131.4

1/ Government Services and Public Utilities
2/ Commercial fishing, forestry, tourism, real estate, financial institutions, professional services, transport, entertainment, mining and exploration and sundries

Source: Central Bank of Belize

Chart A

NET INTERNATIONAL RESERVES OF THE BANKING SYSTEM 1980 - JUNE 1986

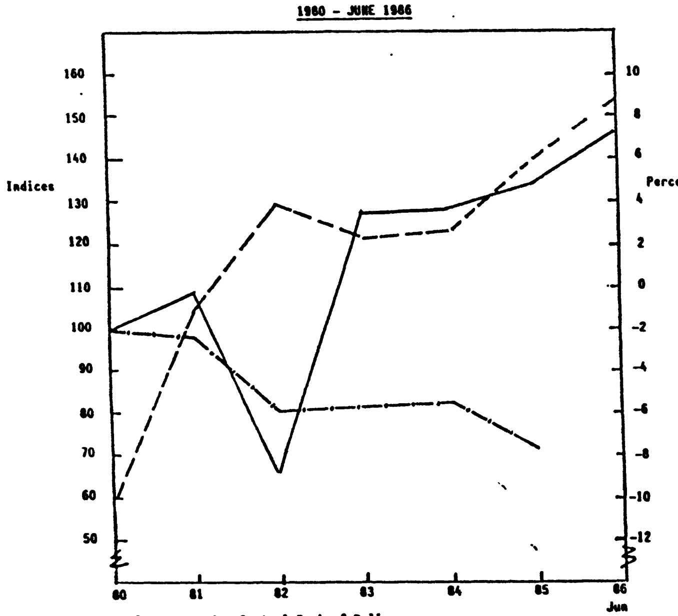


Source: Central Bank of Belize

Chart B

REAL DEPOSIT GROWTH, REAL DEPOSIT RATE AND EXPORT VALUE INDICES

1980 - JUNE 1986



Sources: 1. Central Bank of Belize
2. Central Statistical Office

Chart C

COMMERCIAL BANKS OUTSTANDING LOANS AND ADVANCES

1980 - JUNE 1986

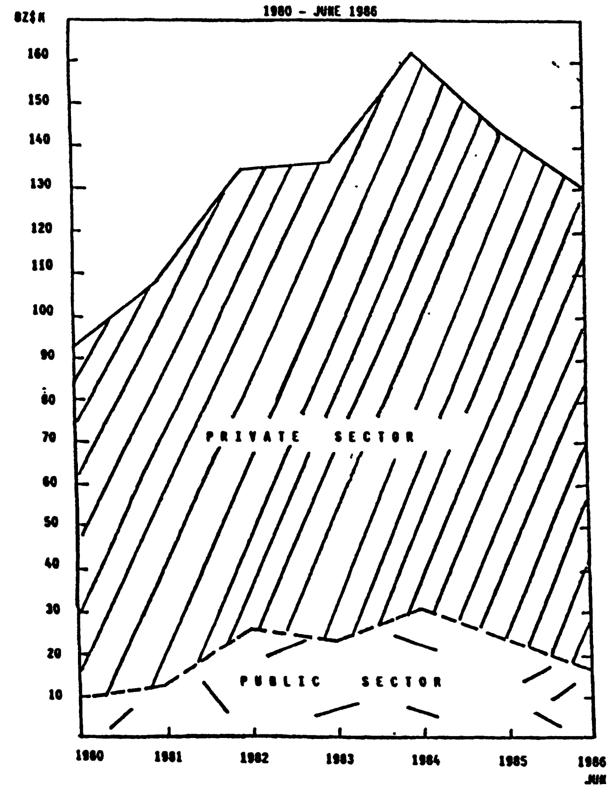
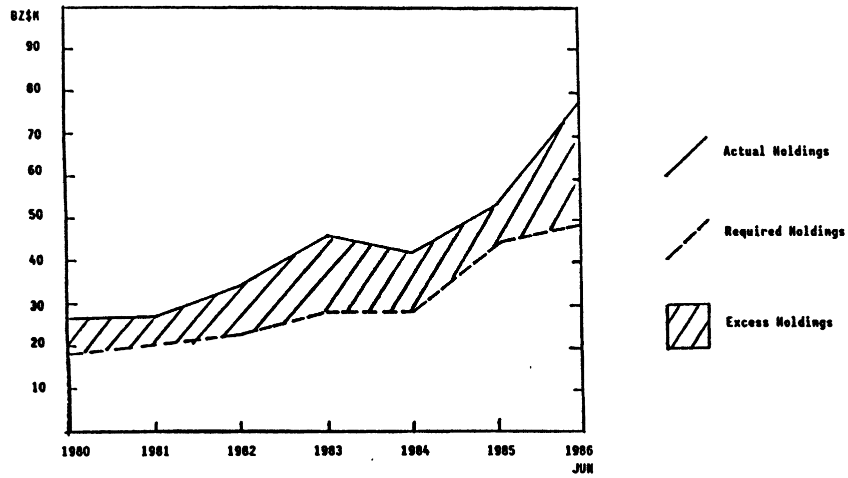


Chart D

COMMERCIAL BANKS LIQUIDITY

1980 - JUNE 1986

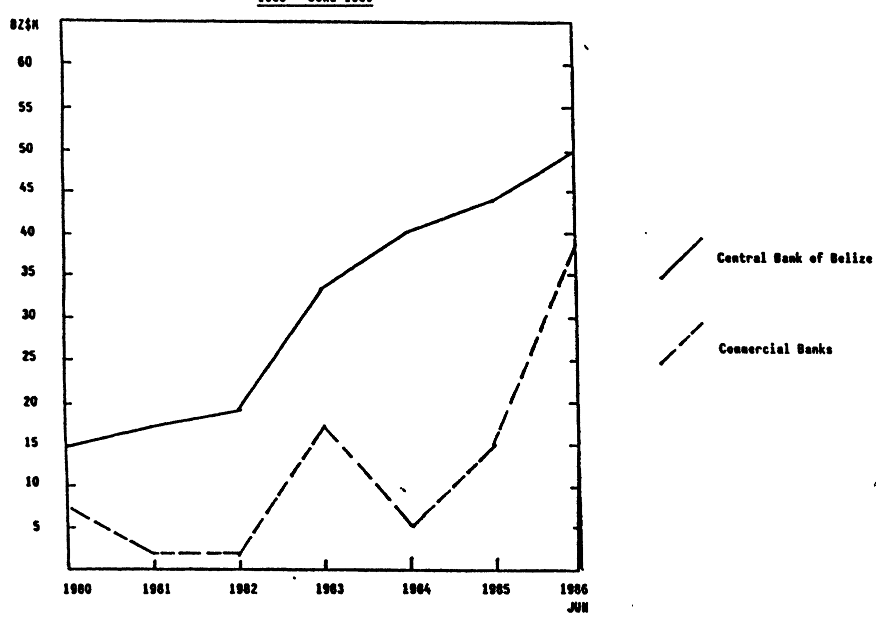


Source: Central Bank of Belize

CHART E

CENTRAL BANK OF BELIZE AND COMMERCIAL BANKS HOLDINGS OF TREASURY BILLS

1980 - JUNE 1986



Source: Central Bank of Belize

B I B L I O G R A P H Y

1. Alvarez, Y. — The Use of Liquidity Requirements. Paper presented at the XXII Meeting of Technicians of Central Bank of the American Continent, Guatemala City, Guatemala, November 1985

2. Humes, D. — The Efficacy of Monetary Policy in Belize. Paper presented at the XIX Meeting of Technicians of Central Banks of the Ameircan Continent, Chile, November 1982.

3. International Monetary Fund (IMF) — The Monetary Approach to the Balance of Payments. Washington, D.C., (IMF) 1977.

4. Joefield-Napier, W. — Instalment Credit and Monetary Policy in Trinidad and Tobago: 1970 - 1979. U.W.I., I.S.E.R., October 1980.

5. Justice, G. and Alvarez, Y. — Foreign Exchange Reserve Cover and Statutory Limits on Central Bank Credit to Central Government: The Need for a Consistent Approach. Paper presented at the Seventeenth Annual Regional Monetary Studies Conference, Nassau, Bahamas, November, 1985.

6. Monetary Authority of Belize/ Central Bank of Belize — Annual Reports, Quarterly Reports and Statistical Digest. 1980 - June 1986.