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CHARTING A MONETARY POLICY FOR THE 1990'S

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Introduction

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It is with pleasure that I participate in this Development Summit as it seeks to examine the Development Plan 1990 - 1994, which has been in preparation for some time. It is my wish that today's exercises benefit from the active participation of all who are here today: that the deliberations are fruitful in the provision of constructive criticisms of the draft of this plan which is intended to guide the direction of the economy in the medium term; and that the drafters of the plan find it possible to incorporate, in the final document, the positive ideas which may arise in discussion today.

I have been mandated to address you on Charting a Monetary Policy for the 1990's. That mandate has been interpreted as inviting the presentation and analysis of a monetary policy which is appropriate to the draft development plan before us and which therefore promotes the stated objectives of sustainable economic growth and social development. In this presentation, I will attempt to raise issues which I believe are important in the context of today's proceedings. Time constraints preclude detailed

treatment of these issues, but I hope that in the discussion which will follow issues can be clarified.

During the next 15 minutes, I will attempt to do several things. I will, first of all, outline a framework for monetary policy. This will be followed by brief discussions of the interrelationship of fiscal and monetary policy, the objectives of monetary policy, and the important considerations which determine the efficacy of monetary policy. The final portion of this presentation will focus on important elements of a monetary policy aimed at supporting the general aims of the development plan before us today. Particular emphasis will be placed on the need for policies to promote stability in the general level of prices, the value of the Belize dollar and the financial system in general, since these variables are critical to the export-led growth strategy defined in the draft development plan.

Framework for Monetary Policy

The framework for monetary policy may be seen as being comprised of two sets of variables. The first is the set of institutions, organizations and persons who have a role to play in the formulation and implementation of monetary policy and/or who react in response to policy decisions. The second is the set of monetary and financial variables - both instruments and targets - through which the makers of

monetary policy attempt to influence the level of economic activity.

Players in the Monetary Sector

There are a number of institutions, organizations and persons who play a role in the evolving developments of the monetary sector. These include financial institutions such as the commercial banks, credit unions and insurance companies which receive, as deposits or premiums, a major portion of the financial savings of the economy and are therefore in a position to determine the areas of investment into which these savings are channeled. In addition, there are certain public sector financial institutions, such as the DFC and Recondev, which also onlend public sector savings as well as resources from abroad.

Central Government and other public sector agencies such as the Social Security Board, also play a role in the monetary sector. Both these institutions have over the past few years been accumulating substantial surpluses - a development of significant importance to the monetary sector and the economy as a whole. Public sector deposits in the commercial banks, which are dominated by the deposits of Central Government and the Social Security Board, accounted for 23% of total deposits at the end of April. These public sector deposits have, therefore, become an increasingly

important source of financing of commercial bank credit to the private sector.

The general public - as savers and investors - also play an important role in the monetary sector. When taken together, individual decisions to save or invest determine the extent of new domestic resources which become available for investment as well as the dynamism of investment behaviour. Decisions to save or invest are influenced by the current state of the economy and by expectations of improvement or deterioration in the economy.

The final player in the monetary sphere which I would like to highlight today is the Central Bank. In its roles as banker to the commercial banks and to government, issuer of currency and guardian of the foreign reserves; with direct responsibility for the supervision of banks; with general responsibility for the provision of economic policy advice to Central Government; and with a clear mandate to implement appropriate monetary policy, the Central Bank is central to the process of formulating, implementing and monitoring the performance of monetary policy.

Monetary Variables

The variables which are key to the monetary policy process may be divided into instruments and targets. The instruments of monetary policy are those variables which can be adjusted in order to obtain a desired change in the

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targets of monetary policy. Among the generally accepted instruments of monetary policy are: reserve ratio requirements, interest rate floors or ceilings, Central Bank lending rate to commercial banks, open market operations and selective credit controls. The effectiveness of these instruments in obtaining the desired results varies as the monetary sector develops in response to changes in the economy.

The targets of monetary policy vary with the particular economic perspective which is brought to bear on the analysis of the monetary sector. In general, however, certain variables tend to be targeted. These are: money supply, outstanding credit, the exchange rate and the level of foreign reserves. These targets may be stated as particular magnitudes, in terms of growth rates or in specific relation to certain other macro-economic variables such as gross domestic product, export earnings, import requirements etc.

Interrelationship of Fiscal and Monetary Policy

Although the implementation and monitoring of monetary policy is within the purview of the Central Bank, it is important to recognize the interrelationship of fiscal and monetary policy. For, although fiscal policy and monetary policy are sourced in different agencies, the implementation of one has implications for the other. Whether Central

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Government achieves a surplus or a deficit on its operations is particularly important if this surplus or deficit is sustained over a number of fiscal years.

A sustained deficit, for example, is expansionary and can place pressure on the balance of payments and foreign reserves. This is because, by spending more than it takes in, Government fuels consumption which has a high import content. Moreover, the way in which the deficit is financed has additional implications. Financing a deficit by borrowing from the commercial banks may siphon off funds that would otherwise be available for lending to the private sector. This "crowding out" of the private sector is particularly worrisome if it goes into current rather than capital expenditure since it will increase the debt burden without increasing the capacity to service the debt.

Where the deficit is financed by borrowing from the Central Bank or by additional issue of government bonds or treasury bills, the effect is a direct upward push on money supply with negative implications for the balance of payments, foreign reserves and price levels. In addition, borrowing from the Central Bank tacitly subordinates monetary policy to fiscal policy and has implications for confidence in the sustainability of the exchange rate, not only because of the impact on the foreign reserves, but also because the Central Bank's important role as protector of the value of the domestic currency is negated.

A sustained surplus on Central Government's operations, such as has been experienced recently in Belize, also has important implications for the monetary policy process. This surplus, although it promotes positive balance of payments performance and strong growth in foreign reserves, can have a contractionary impact on the economy. The extent of the contractionary impact depends on how much of the accumulating surplus is "sterilized" by placing it where it is not recycled into consumption or investment expenditure, such as on deposit with the Central Bank or with financial institutions abroad. Where the surplus is placed with domestic commercial banks or other financial institutions, the funds can be used as a basis for expansion in lending. In such a case, the issue becomes whether the sectors into which this expansion in commercial bank credit will be channeled are those that are defined as the priority sectors for growth.

Objectives of Monetary Policy

I would now like to turn my attention to the objectives of monetary policy as suggested by the Draft Development Plan 1990 - 1994. The general macro-economic objective of the Plan is the promotion of sustainable economic growth and development. This growth and development is to be led by a dynamic export sector with some support from producers for the domestic market. In this context, the primary objective of monetary policy, the

final target, so to speak, is stability - of prices, the exchange rate and the financial system in general.

This stability is vital to sustained dynamism in investment in the export sector for two important and interrelated reasons. The first is that investor confidence is very sensitive to price and exchange rate stability. Price increases and exchange rate fluctuations raise uncertainties about the future prospects of the economy and therefore are important indicators to potential investors.

The second is that sustained increases in the level of prices increase the cost of living and the cost of production and, as a result, lower the international competitiveness of export commodities. This is a primary consideration behind the strategy of currency devaluation being pursued by a number of countries in the Caribbean region and elsewhere. Because international competitiveness is central to export-led growth strategies, price and exchange rate stability become central to the practice of monetary policy.

Stability in the financial system is also important to sustained economic growth and development and is an important indicator of several things. These include the capacity of the financial institutions to perform the role of financial intermediaries, the strength and solidity of

the institutions in the system and the need for, or performance of, monetary policy adjustments.

In the first place, system stability is a barometer of the capacity of financial institutions to improve efficiency in performing the role of intermediating between savers and investors as the economy develops. This intermediation is not only between domestic savers and investors, but in economies like ours, is also between foreign savers and domestic investors since the financial institutions are conduits for international financial flows.

Where financial institutions cannot efficiently carry out the role of financial intermediation, the implications are far reaching. In the first place, it may be that the expectations placed on existing institutions go beyond their experience and capacity. If this is so, it may provide the impetus for promoting alternative methods of financial intermediation - through the formation of new kinds of financial institutions, through the development of capital markets, through expanding the scope of existing public sector financial institutions ... etc.

It must be clearly understood, however, that an aggressive policy to reform and/or develop the financial system can itself lead to the kind of instability which undermines the investor confidence which is so critical to export-led growth. The objectives of financial reform and

development must be informed by broad and deep analysis, be clearly articulated and be firmly committed. If the objectives are not clear, if the analysis is inadequate and if commitment to reform appears to waver midstream, it is almost inevitable that the end result will be added instability.

System stability may also be an indication of the strength of the institutions which comprise the financial system. If we examine the experience of the US financial system over the past several years, for example, we find a major source of instability and crisis to be the high degree of insolvency of savings and loans institutions and commercial banks as a result of imprudent practices. The safety net of Federal Deposit Insurance has been stretched to the limit and there are fears that its viability has been severely and permanently undermined.

In Belize we do not have a system of deposit insurance. But this is not necessarily a negative since there is a strong argument that a system of deposit insurance does not encourage financial institutions to engage in prudent financial practices.

What the crisis in the financial system of the US has taught that country, and other countries whose financial systems are closely linked into the US financial system, is that deposit insurance, while it is important in protecting

the small depositor, does not necessarily promote sound financial institutions. There also needs to be firm guidelines for the activities of financial institutions.

As a result, there are strong moves in the US, in Europe and in the Caribbean, to strengthen the supervision of financial institutions to, as far as is possible, protect depositors funds, ensure viability of the institutions and thereby promote stability in the financial system. In the US and the UK, for example, there are moves to regulate the practices of bank holding companies in order to preclude the possibility of these companies engaging in non-banking activities which would jeopardize the viability of their banking activities. In Jamaica, the banking act is being updated to chart clear steps to be taken in cases where financial institutions have been found to be insolvent so as to protect the essential stability of the financial system.

As the Central Bank seeks to promote the final target of price, exchange rate and financial system stability, it has at its disposal a range of potential indirect or intermediate targets. The choice of targets which are used to monitor or influence developments in the monetary sector depends on the perspectives which inform the formulation of policy as well as the specific outcome which is sought. Money supply growth, credit expansion, fluctuations in the real exchange rate and level of foreign exchange reserves are the primary variables targeted by monetary policy.

There are a number of instruments which can be used to influence these targets. These include interest rate adjustments, open market operations in treasury bills and other government paper which may be issued, variations in reserve and liquid asset requirements, exchange control and selective credit controls.

Efficacy of Monetary Policy

The efficacy of monetary policy is determined not only by the appropriateness of the policy instrument and the quality of the analyses which inform the policy decision, but also by the structure of the economy and the financial system. The openness of the economy, for example, allows financial institutions to circumvent the intentions of policy decisions by bringing funds from head offices and/or affiliates abroad. This is particularly true of such policy instruments as reserve and liquidity requirements.

Where financial institutions collude rather than compete, the efficacy of monetary policy is also undermined. In an environment of collusion, it is unrealistic to attempt to let the free market set interest rates. At the same time, financial institutions have a range of practices which bypass the intentions of interest rate ceiling and floors. These include redefining the prime lending rate and placing restricting conditions on time deposits.

The quality of the information base for the formulation of monetary is also key to its efficacy. Where variables are incorrectly specified or where the information returned from the financial institutions is inaccurate, the possibility of inappropriate policy action is increased. Because of this, the Central Bank spends a significant portion of its human resources in determining the accuracy of information and integrity of variable specification.

In other instances, the efficacy of monetary policy is determined by the approach of policymakers. In the case of direct controls and intervention in the process of financial intermediation by Central Banks, for example, there is an undeniable history of failure to achieve desired results in those economies which have tried them. Here in Belize, our experience with direct controls and intervention has been very limited.

In the case of credit, selective controls can be qualitative or quantitative. Qualitative controls direct financial institutions to channel specific percentages of lending into particular sectors whereas quantitative controls prohibit them from lending to particular sectors. In their implementation, the former can be inflationary as financial institutions seek to meet the requirements while continuing to lend in their areas of preference. The latter can be deflationary as financial institutions refrain from lending to those sectors to which they are not prohibited

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from lending. With these possibilities in mind, it is reasonably safe to say that the era of direct credit controls is passed.

With respect to controls on foreign exchange transactions, it is now generally believed that the imposition of restrictions on the purchase of foreign exchange has the effect, not of reducing the net outflow of foreign exchange, but of encouraging the development of informal and/or illegal markets for foreign exchange and capital flight. These responses may be clear indicators of policy distortions.

In the 1970's and early 1980's a number of Caribbean Central Banks, notably Jamaica and Guyana, tightened the administration of exchange control in an attempt to halt the deterioration in the balance of payments and conserve foreign exchange. These policies failed to have the desired effect because they addressed the symptoms of the problem rather than the cause - which was stagnant or declining production and export earnings. In addition, these policies compounded the production problem by undermining investor confidence in the ability to access foreign exchange to purchase inputs for the production process.

Belize's experience with the imposition of strict exchange control is limited to the early 1980's when the economy was faced with dwindling foreign reserves. It is

not clear that the policy was successful. What is clear, however, is that a strong foreign currency reserve position is tied much more closely to a strong economy with a vibrant export sector than to the strictness of exchange control.

This is not to say, categorically, that exchange control is unwarranted. Rather, it is to say that exchange control functions more efficiently as an aspect of the management of foreign currency reserves rather than as an immovable constraint on the outflow of foreign currency. In its role as an aspect of reserve management, exchange control provides essential information on changes in the patterns of outflows and inflows and is therefore vital to the process of formulating monetary policy.

Another approach to monetary policy which has not had generally positive results is direct intervention in financial intermediation by central monetary authorities. In the Caribbean, for example, following the attainment of political independence, policymakers were faced with a need to channel funds into those sectors which were deemed to be the priority sectors for development. The financial systems were dominated by institutions whose lending portfolios leaned heavily towards the financing of trading activity. These institutions were not willing to engage in the financing of productive activity in such high risk sectors as agriculture and small manufacturing.

As a result, the newly established central banks in these territories, such as Jamaica and Guyana, were given a mandate to facilitate, directly and indirectly, the flow of development financing to these sectors. The experience has not been positive and there are important lessons to be learned.

In the first place, development financing and central banking are not necessarily compatible. This is because the risks and high degree of financial losses associated with the former have negative implications which can impugn the credibility of the latter. This credibility is essential to the perception of stability of the domestic currency. The central bank, as custodian of the value of the currency has an obligation not to engage in activities which can undermine the discharge of its responsibility.

Secondly, questions of compatibility aside, central bankers do not necessarily have expertise in development financing and where they engage in this activity may in fact contribute to its failures. What experience has shown, is that, where there is a need for financial intermediation of a specific nature, the optimal choice tends to be the establishment of specialized institutions or special credit windows at appropriate institutions. While the experience of national development banks in the Caribbean has been mixed, there are sufficient examples of well-run institutions to indicate that it is possible for such

institutions to succeed, once they are allowed to operate with a clear mandate to finance, with no exceptions, projects that are found to be viable.

Thirdly, central banks, in their role as bankers to and inspectors of financial institutions have a supervisory role over the process of prudent financial intermediation in the economy. This becomes difficult when central banks also themselves become involved in financial intermediation.

The experience of central banks engaging in financial intermediation has led to a generally accepted view that the business of central banking is that of guarding the stability and integrity of the financial sector as a vital aspect of the creation of an environment of economic growth and development. Financial intermediation is better accomplished by institutions designed with that specific purpose in mind.

Charting a Monetary Policy for the 1990's

Current thinking on monetary policy is informed by several considerations. Firstly, given the interdependence of fiscal and monetary policy, there needs to be some analysis of the monetary implications of the accumulating public sector surpluses. Whereas deficit financing is expansionary, surplus accumulation can be contractionary; that is, it can contribute to a slowing of the rate of economic growth. If this is the objective, there is no

problem. If however, the aim is to attain self sustaining economic growth, the efficient management of these surpluses is key.

Furthermore, in promoting an atmosphere of financial stability, the independence of monetary policy is important. As custodian of the external reserves and as controller of currency, the Central Bank must be in a position to intervene when necessary to protect the value of these important variables. It must be clear to all that the Central Bank is willing and able to engage in those activities which are important to the discharge of its responsibilities.

In the Caribbean, there is a history of central bank financing of unsustainable fiscal deficits. (In Belize in the early 1980's this was the case.) This practice compounds economic instability and erodes investor confidence by fueling the perception that there is no agency or institution operating to offset the effect of fiscal imbalance on the economy. In these times of fiscal plenty, it is good for the practice of independent monetary policy to be clearly visible so that, if and when fiscal constraints becomes a factor in the economy again, the policy response of the Central Bank can have the stabilizing impact which is intended.

In conclusion, let me reiterate that the important element of the approach to monetary policy for the 1990's is a commitment to stability of the general level of prices, the exchange rate and the financial system. This stability is seen as vital to the attainment of the macro-economic objectives outlined in the draft development plan before us today.

The success of monetary and macro-economic policies will be influenced by the realism of the expectations which underlie them; the depth of analysis and the quality of information which are going into their formulation; and by the ability of the public and private sector institutions and agencies in the financial system to exercise genuine good faith in their dealings with each other, with the full realization that this may in fact be the decisive factor in the success or failure of public policy in the 1990's.