Chapter 10

Issues in Monetary Management in Countries with Common Currency: The Case of East Caribbean Central Bank

1. Introduction

Recent developments world over have revealed unprecedented dissatisfaction with the existing economic and political order. More of autonomy, democratic values, openness and less of centralization, controls and restrictions are generally preferred. On the other hand, trends of unification and integration of different economies have become stronger in some parts giving rise to sizeable regional blocks. Some communities are, however, caught in the dilemma and confusion over several questions, e.g. what are the costs of autonomy? Whether economic integration implies loss of autonomy and sovereignty? What are the political, economic and socio-cultural implications of economic integration of different economies? In order to have clues to such profound questions, it is desirable to examine the available experience in different spheres. In the field of monetary management, the East Caribbean Countries represent a unique case of monetary integration achieved over years through establishment of specific institutions like a common central bank with common currency. In the present paper, the case of The Eastern Caribbean Central Bank (ECCB) is discussed with emphasis on its role in the macroeconomic management of the economies of the Organisation of Eastern Caribbean States (OECS).

In the next section, we briefly outline the history of ECCB. The third section discusses the basic objectives and functioning of the Bank. The fourth section highlights some important provisions in the ECCB Agreement reached in 1983 which have implications on ECCB's control of the financial aspects of the economy. The fifth section is then devoted to the discussion of the important features of the financial institutional structure existing in the region which have some bearing on the effectiveness of the ECCB's control and conduct of monetary policy. The issues in monetary policy are discussed in the sixth section highlighting some features of the economies in the region. In the seventh and the final section, some alternatives before the region are discussed for meeting the challenge arising out of EC 1992 which is likely to result in a severe shock to the economies of the region.

2. Historical Perspective

ECCB is the apex body of the region's monetary system. It was established only recently on October 1, 1983 which marked a new phase in the development of the area's monetary system. Prior to any formal institutional set up existed in the area, i.e. before 1950, the foreign commercial banks issued their own notes which served as medium of exchange and store of value along with coins issued by the British government. In 1950, the need was felt to set up the British Caribbean Currency Board (BCCB) to facilitate the issue of currency of the colonial power to the commercial banks in the area. The BCCB was set up in Trinidad to cover the area of 10 member states viz. Trinidad & Tobago, Guyana, Barbados, Antigua & Barbuda, Dominica, Grenada, Montserrat, St.Kitts & Nevis, St.Lucia and St.Vincent & Grenadines. In 1965, the BCCB had to be dissolved because Trinidad & Tobago and Guyana withdrew to establish their own central banks. The move on their part was primarily guided by the desire to have

financial and fiscal autonomy. In 1965, therefore, East Caribbean Currency Authority (ECCA) was established in Barbados to serve the remaining members of the former BCCB. In 1974, Barbados also withdrew in order to have its own central bank. The headquarters of ECCA were shifted to St.Kitts in 1975. In 1976, the East Caribbean Currency Agreement was amended to provide choice in terms of the exchange rate regime to be followed. The choice was exercised and as a result, the EC dollar was delinked with the British pound and was linked to the U.S.dollar.

Since 1950, the BCCB operations were carried out on the principle of 100% back up of the currency put in circulation by the foreign reserves. These reserves had to be invested in the British government securities and treasury bills. The commercial banks in the BCCB area were required to deposit the British pounds to get equivalent British Caribbean Currency. The ECCA Agreement in 1965, on the other hand, revised such a stringent requirement of 100% backing to only 70% backing in terms of the foreign reserves. There was also a provision for reducing this ratio to 60% if required. This was the major move towards autonomy because it gave the much needed power to the ECCA to finance the deficits of the member governments by investing in their securities and treasury bills rather than investing solely in the British govenrment securities. This shift, therefore, implied a major change in the role of the monetary system to cater to the needs of the area as reflected in their governments' budget allocations. The ECCA, however, was not meant to provide advice to governments. It also lacked any authority to exercise influence on factors affecting the stability of the EC dollar. The ECCA had no powers to supervise the banking system or impose any reserve requirements. In short, it had no role to play in the credit policies in the area of its operation.

With the passage of time, as the Wind of Independence blew and pressure for greater autonomy increased, the role of ECCA steadily increased. The monetary authority started playing more pro-active role by acting as intermediary for receiving overseas aid funds on behalf of member governments and for dealing with the IMF and the World Bank as the fiscal agent for its members. It was becoming more and more clear that in order to facilitate economic growth with stability, sound and efficient management of the monetary sector is imperative. The financial structure of the area had also undergone substantial changes since 1973 when only 5.1% of the area's deposits were held by indigenous banks. By October 1983, around 35% of the area's deposits were held by indigenous banks who did not enjoy the advantage of having a head office to look after their liquidity problems under crisis. These local institutions had to be provided with the lender of the last resort. It was, moreover, clearly recognised that money and credit have to be consciously managed through policies which direct them to the desired ends. Since the participating government authorities decided in favour of the discretionary control of monetary system, creation of a Central Bank was the natural outcome. With a view to creating and maintaining a sound monetary, credit and banking system within the territories of the member countries, in 1983, an agreement was, therefore, reached to convert the existing ECCA into a common central bank - ECCB.

3. Objectives and Organisation of ECCB

Like all other central banks, ECCB also has well defined objectives to be achieved. Depending on the time of reference, the list of objectives would be modified or more sharply focussed as required, but within the frame clearly spelt out in Section 4 of the ECCB Agreement of 1983. The section 4 is reproduced as under:

"The purposes of the Bank are:-

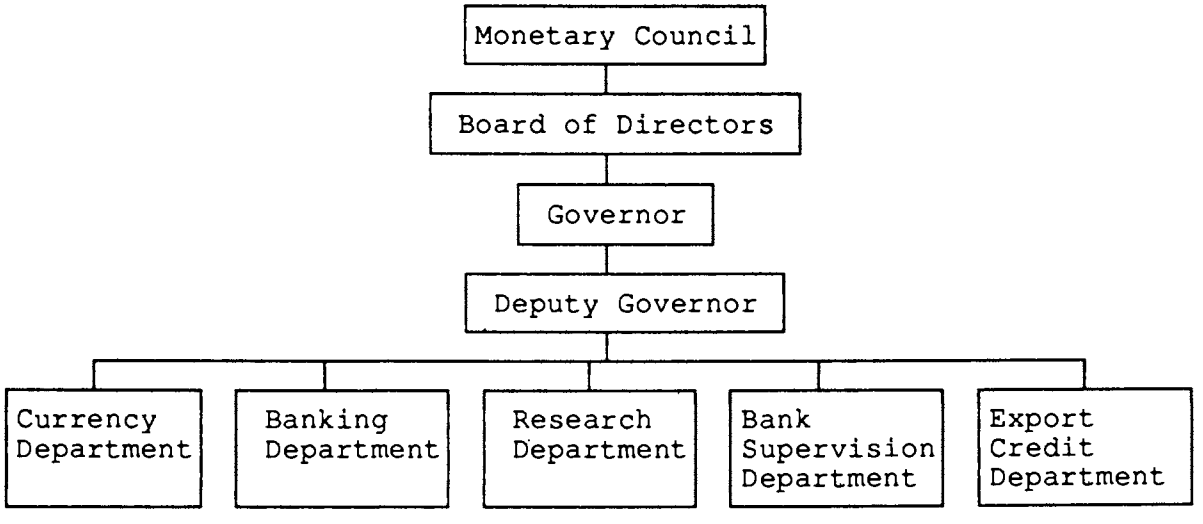
(1) to regulate the availability of money and credit;

(2) to promote and maintain monetary stability;
(3) to promote credit and exchange conditions and a sound financial structure conducive to the balanced growth and development of the economies of the territories of the Participating Governments;
(4) to actively promote through means consistent with its other objectives of the economic development of the territories of the Participating Governments." (P.2)

In short, the basic objectives of the ECCB are to maintain stability in the external and internal value of EC dollar; to ensure availability of credit at reasonable cost to the priority sectors; and monitor the domestic as well as foreign saving flows. Since ECCB is a central bank to 8 different countries including Anguilla, it has to work in close collaboration with governments of each country to fulfill its objectives regarding allocation of credit and saving flows. In this context, the organization of ECCB plays important role.

Chart 1 outlines the organisation of ECCB. The Monetary Council is the highest decision making authority and hence consists of one Minister (usually looking after Ministry of Finance or Economic Development) appointed by each participating government. The Minister may appoint an alternate to participate in his absence. This council meets at least twice a year and provides directives and guidelines for the monetary and credit policy to be pursued by ECCB. The powers of the Bank are vested in the Board of Directors which consists of 10 Directors including the Governor and the Deputy Governor. The other 8 Directors are appointed by the participating governments - one from each country. Generally, the Permanent Secretary of Finance or Fiscal Advisor is appointed as the Director by the participating governments to ensure proper linkages and coordination between the monetary policy and their individual fiscal policies. The Board of Directors is responsible for the policy and general administration of the Bank. The Governor who is the chief executive of the Bank looks after the day-to-day management and operations of ECCB with the assistance of the Deputy Govenor. The Governor and Deputy Governor are appointed for a term of 5 years by the Monetary Council and are eligible for reappointment. The Governor provides direct link between the Monetary Council and the Board of Directors. The Governor is the ex-officio chairman of the Board of Directors and has a casting vote in case of a tie. The Governor and Deputy Governor do not have the right to vote in the Board's meetings. The Board would meet as often as the business of the Bank requires but not less than once every three months. The term of the Directors is 3 years but they are eligible for reappointment. The quorum requirement for both the Monetary Council and Board of Directors is the presence of 5 appointed members from among the participating governments.

Chart 1: Organization Chart



It is important to note that every member has only one vote and the decisions are taken by simple majority except a few cases where unanimous decisions are required. Thus, participating governments get equal weight in the decision making irrespective of their size, problems or levels of development. Such a democratic organisational set up has worked effectively now for over 8 years without any significant problems encountered so far. The environment in the meetings is generally very friendly. No serious conflicts arise in the meetings though differences of opinions do exist. However, the decisions are generally arrived at by concensus through persuading arguments and discussions.

For carrying out various activities, the ECCB has 5 major departments like most other central banks. These are: (1) Currency Department whose responsibility includes, among other, to make accurate forecasts of territorial demands of coins and currency; (2) Banking Department which performs the banking function, accounting function and the investment function; (3) Research Department which is the economic intelligence unit of the Bank in charge of the dissemination of information and analysis to all quarters; (4) Bank Supervision Department whose main function is to safeguard the interest of depositors, borrowers and customers who obtain financial services from the Bank; and (5) Export Credit Guarantee Department whose main function is to encourage, facilitate and promote the export trade of the Eastern Caribbean Region.

4. The ECCB Agreement

The 1983 Agreement among the participating governments has several important provisions which define the nature and scope of ECCB's activities and its relationship with the financial institutions in the region and with the participating governments and hence their fiscal policies. The following are some of the important provisions in the Agreement.

The external value of the Eastern Caribbean Dollar can be decided by the Monetary Council on recommendation of the Board of Directors only when both the recommendation and the decision are adopted unanimously by all their members. Probably it is this provision which explains constant nominal exchange rate of the EC dollar with U.S. dollar over the period 1976 till today. This provision makes the alternatives of free float of the EC dollar or pegging of it with a basket of currencies a non-workable solution. Unanimity rule is a very strong condition for making changes in the status quo. If the external value of the EC dollar does not change with respect to the U.S. dollar, it has significant implications on the internal balance of the economy through the balance of payments and internal value of the currency. There is however, a provision that the Monetary Council would arrange for reasonable compensation to a participating government adversely affected by the change in the external value of the EC dollar. The compensation arrangement to cover losses due to changes in external value of the EC dollar provides for conducting an impact study, establishing a special compensatory financing fund, mobilizing resources from outside the Bank, etc.

Another set of important provisions in the Agreement is about the external reserves. As per the provision, the Bank should maintain External Reserves of at least 60% of the value of the currency and coins in circulation. This percentage can be changed by the Bank only by unanimous agreement of all of the members of the Monetary Council. Moreover, the Bank would be the depository of the external

assets of the participating governments, boards, agencies and other statutory bodies of these governments. The Bank can also designate agents and correspondents to hold these assets. The Bank would deal in gold coins, bullion or other precious metals and foreign exchange. It can buy, sell or deal in all these at rates fixed by it from time to time.

Provisions with regard to the relations of the Bank with financial institutions are as usual concerning the control of the latter by the former and providing basic services and facilities in return. In this context, 'financial institution' is defined as any person[6] doing banking business. All offices and branches of financial institution in the territories of the participating governments are treated as one financial institution. Provisions pertaining to the control and regulation of financial institutions include the ones on rates of discounts and rediscounts; differential rates and ceilings for various classes of transactions or maturities; reserve and marginal reserve requirements; different reserve ratios for different classes of deposit and other liabilities; supervision through accounts and other information; etc. A worth-noting provision in this regard is that the ECCB can grant a financial institution advances against treasury bills and securities issued or guaranteed by any of the participating governments or its agencies subject to some maximum of all such bills and securities accumulated with ECCB. This calls forth strict fiscal discipline on the part of the participating governments as well as the financial institutions dealing with them. The Bank may also require the financial institutions to hold securities issued by the participating governments upto 10% of the institution's deposits and similar liabilities. This is primarily required because well developed capital market does not exist. The Bank can also prescribe from time to time the method of computation as well as minimum and maximum rates of interest payable in respect of deposits and other similar liabilities. However, these decisions can be taken by the Monetary Council only by two-thirds majority of all its members on the recommendation of the Board of Directors with minimum two-thirds of the majority of all its appointed members. This makes such changes less frequent. The information provided by all financial institutions can be shared with the concerned participating government at the latter's request on the condition that it would be treated as secret.

The relation of ECCB with the participating government is defined by a set of provisions most of which are routine ones, e.g. the Bank would be the banker, fiscal agent and advisor to the participating governments on monetary and financial matters and would be the depository of funds of those governments. However, the participating governments are expected to maintain working balances with other financial institutions and generally use their services. But when the governments are facing temporary problems, the Bank can make temporary advances to them for meeting their seasonal needs subject to the limit of 5% of their average annual recurrent revenue during the given financial year. The average is taken over the three preceding financial years. Moreover, holding of treasury bills of any one government at any one point of time by ECCB should not exceed 10% of the estimated recurrent revenue of that government as determined by the Bank for the current year. Similarly, the other constraint imposed by the Agreement on the participating governments borrowings from ECCB is that the ECCB can purchase or sell publicly issued securities payable in EC dollars and maturing in 15 years or less, provided that all such securities at any one point of time do not exceed 15% of currency issued by the Bank. The only exception to this are the bonds of any corporation established under the authority of the participating government/s for the express purpose of financing development within their territories. In such cases the amount of bonds should not exceed 2.5% of the average annual recurrent revenue of the government. The Bank is also expected to monitor the operations of the licensed offshore

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[6] "Person includes any corporation, either aggregate or sole, and any undertaking, club, society, association or other body of one or more persons" (p.2 of the 1983 Agreement).

financial institutions. It is also explicitly stated in the Agreement of 1983 that "in carrying out its functions the Bank shall be guided solely by technical criteria and considerations and shall not discriminate in any aspect of its operations on political or other non-economic grounds." (p.21).

5. Financial Structure

The financial system in the OECS region is not well developed. The range of financial institutions is limited to commercial banks and a few non-commercial institutions. The banking sector is still dominated by foreign banks having branches and subsidiaries in the OECS region. The indigenous banks are still struggling to acquire a larger market share. The indigenous banks are those which have at least 51% of local ownership. These banks vary considerably in terms of the government involvement in their ownership from negligible to cent percent. The foreign banks in the OECS region are again mainly confined to four major banks which operate in more than one territories. These branches which are not locally incorporated in the region represent a tiny proportion of the total business of their respective parent banks. They have the basic advantage of falling back on their headquarters for any short term liquidity-crunch. Since they have the advantage of early entry into the market in the colonial days, they still enjoy greater confidence and a psyche of better service from the public. The market share in terms of assets is approximately in the proportion of 65:35 between the foreign banks and the indigenous banks.

The financial performance of the foreign banks in OECS has been significantly better than the local banks in terms of profitability which is generally measured as return (after tax) on assets employed. In the North America, a return on assets in excess of 1.0% is regarded as an excellent performance. Although all the commercial banks taken together in OECS region as well as in every individual country have the ratio well in excess of 1.0%, in 1983 when the separate data were available, Liburd and Ferracho (1985) have found that the ratio is only 0.90% for the local banks against 1.49% for the foreign banks in the OECS region. The explanation for this according to Liburd and Ferracho (1985) is in terms of the net interest margin and non- interest income of the banks. The composition of their assets and liabilities differed considerably. The public sector loans at concessional rates accounted for 36% of the total loans in the local banks as against only 12% in the foreign banks. In absolute terms too, the local banks' credit to the public sector was 89% more than the foreign banks. On the other hand, the loan-asset ratio in the two types of banks was very similar. The composition of deposits in the two types of banks was also unfavourable to the local banks. They had 43% of time deposits, 12% of demand deposits and 21% of savings deposits as against the foreign banks where these proportions out of total liability were 25% (TD), 14% (DD) and 36% (SD). Similarly the share of private sector deposits in total deposits was 64% in the local banks as against 95% in the foreign banks. The deposit structure has obvious implications on the cost of funds. Moreover, as already mentioned, local banks have to offer a higher interest rate for deposits to maintain their market share. If the local banks want to increase their profitability, they have to increase the margin further. How far this is possible is a difficult question particularly now when ECCB sets the minimum and maximum interest rates on deposits and loans. The interest rates are set by the commercial banks to achieve a target rate of return on capital. They, therefore, set overall level of the deposit rates so as to allow the deposits to grow at the desired rate. The lending rates are then set to achieve the target rate of return based on the projection of assets and liabilities.

The other actors in the financial system in the OECS include development banks which exist almost in all countries. These banks mainly cater to the medium and long term financial needs of the business sector. They also pay special attention to the financing problems of small enterprises. Other development oriented activities like home building and education are also financed by these development banks.

Together with the National Commercial Banks established in most countries with substantial government involvement and which cater to the short term financial needs of the priority sectors, the development banks represent the government effort to develop financial institutions to encourage savings and channelize them in priority or vital sectors in each country.

Other financial institutions include mortgage and finance houses which are locally incorporated (with a couple of exceptions) and hence operate within their home territories; life insurance companies which are predominantly foreign; and the national insurance schemes. These institutions together mobilize a significant portion of financial savings in OECS region. In order to recycle liquidity with profit in the banking system, in 1986 an Inter-Bank Market was introduced. This institution enlarged the options of the commercial banks and reduced their dependence on ECCB. Similarly, in January 1988, Treasury Bill Market is introduced to widen the range of options available to the commercial banks for management of their liquidity. Thus, in the OECS region, although the money market exists, there is a serious gap in terms of institution trading in equities and other long term securities.

The informal credit market in the OECS countries is practically non-existent except in the form of credit unions which are a force to reckon with in Dominica. They are not directly or even indirectly controlled by ECCB. These credit unions are becoming stronger and stronger controlling larger amount of assets than commercial banks. These unions enjoy a high degree of confidence of the people. They are primarily meant to serve the credit needs of the informal sector where the policy does not reach. These credit unions are not banks but their mobilization of savings is significant. They provide much more and better service to their clients who have to be their members. For instance, they provide built-in life insurance, accident insurance, etc. to the depositors or members. Similarly, as a share holder, one participates in their profits through dividends. For the borrowers, the procedures to secure a loan are less complicated and less time-consuming than those in commercial banks. The credit unions require even less collateral. Moreover, their net-work is very extensive and are deeply community based. They are genuinely village and people's institutions. In spite of all these advantages, there is no nominal interest rate differential between credit unions and banks. When imputed value of all these advantages are considered, deposits and loans with credit unions become more attractive in real terms. Currently, the ECCB is negotiating with these unions to incorporate them into its net so that their activities can be monitored and supervised. ECCB is aware that totally different set of norms and criteria would be required for the purpose.

6. ECCB and Monetary Control

Monetary policy is an important instrument for aggregate demand management in any country. In the monetary union crystalized in ECCB, the eastern caribbean countries agree to share the same monetary policy for all member countries. In order to monitor liquidity in the economy by controlling and regulating the cost and availability of credit to various sectors, the policy instruments available to any central bank are bank rate, open market operations, reserve requirements, ceilings on bank credit, etc. on quantitative side and moral suation on qualitative side. The provisions in the Agreement of 1983 as discussed earlier give all these powers to the ECCB. The prevalent financial structure in the OECS region, however, imposes certain constraints on ECCB which reduce the effectiveness of the traditional instruments of monetary control. As we have already discussed in the previous section, the financial structure of the ECCB area is underdeveloped. Capital market is not developed and money market assets are limited in quantum and diversity. Any organised market for conducting open market operations by ECCB does not exist for all practical purposes. Thus, the environmental constraint makes the open market operations ineffective instruments for ECCB. They are otherwise the most popular tool used

effectively by central banks in the developed countries.

Again, the financial structure in the OECS area wherein foreign banks dominate the banking system, imposes a limitation on bank rate to be an effective regulatory tool of policy. The major foreign banks in the area are only small branches in the international network of their parent banks. Traditionally, these branches were dependent on their respective head-quarters for liquidity crunch. Their reliance on ECCB as the lender of the last resort is minimal. The bank rate policy of ECCB functioned more as a penalty rate encouraging banks to bring in funds from abroad rather than borrow from it. However, with the creation of inter-bank market in the area, the bank-rate policy is likely to assume more importance. But so long as there are no controls on the inflows of banking funds, the bank-rate policy is less likely to be effective because large holding of net foreign assets from which the credit needs can be met are possible with banks under the present system. The bank rate policy has, therefore, little or no influence on the structure of interest rates.

The reserve requirements are generally considered to be very strong instrument of monetary control. The effects of changes in this measure are likely to be dramatic on small country open economies of the islands because it cuts the profitability of the banks. Frequent changes in the reserve requirements are, therefore, not desirable for stability of the banking business in the economy. Such considerations have dictated the choice of ECCB of not changing the reserve requirements of only 6% of the deposit liabilities ever since they were introduced in 1984.[7]

Thus, the traditional instruments of monetary control are not effectively available to ECCB. As a central bank for the countries in the OECS region, ECCB exercises control on the monetary resources or broadly defined money supply in the economy without the help of these three most commonly used instruments. The basic framework is provided by the money-multiplier theory at the root of which lies the identity that money supply (M) is the product of money multiplier (m) and high powered money (H); i.e.

$$M = m.H \qquad \ldots (1)$$

Liburd and Tempro (1986) have tried to argue that money multiplier (m) was relatively stable for the ECCB member countries over the period 1975-85 as a whole. However, their data show wide annual fluctuations in money multiplier. Table 1 presents the time-series data on M,m,H and its components for the ECCB member countries for the period 1980 to 1990. From the table, it can be seen that not only that m changes considerably from year to year but it shows cyclical behaviour. Such a cyclical behaviour of m in the face of almost continuously declining trend in the proportion of currency and coins (cash) in circulation in the money supply (M1) implies that other elements in the money multiplier are also not stable in the ECCB area. However, the monetary management by ECCB is based on the assumption of stable m which implies exclusive focus on the monetary base for monetary control in the region.

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[7] Even in 1984, the policy was intended only to ensure uniformity in the minimum level of reserves in the ECCB area. Prior to this policy also, several banks held balances with the Central Bank in excess of the requirement. Prior to 1984, respective governments held the statutory reserves of commercial banks. The rates varied from country to country and the resources were used for financing budget deficits.

Table 1: Money Supply, Monetary Base and Money Multiplier in ECCB Region, 1980-90							
Year	Money supply		Monetary base (H)	Assets with ECCB		Money multiplier with M2	Proportion of cash in M1 (in %)
	M1	M2		NFA	DC		
1	2	3	4	5	6	7	8
1980	259	909	255	209	46	3.56	36.48
1981	287	1056	236	184	52	4.47	36.78
1982	294	1165	205	132	73	5.68	36.80
1983	315	1321	209	135	74	6.32	35.76
1984	362	1489	364	208	156	4.09	34.47
1985	378	1664	428	270	158	3.89	36.31
1986	513	2004	550	382	168	3.64	32.14
1987	602	2280	589	415	174	3.87	30.61
1988	804	2719	582	412	170	4.67	26.68
1989	946	3114	641	473	168	4.86	26.01
1990	939	3353	651	466	185	5.15	24.56

Note: (1) Figures for all years except 1990 are for period ended December; For 1990 the figures are for period ended September.
(2) Columns (2) to (6) are in EC$ millions.
(3) From 1984, Statutory Required Reserves were introduced.
Source: *ECCB* Quarterly Reports.

Monetary base or the high powered money consists of the Net Foreign Assets (NFA) with ECCB which accounts for 60 to 70 percents of H (See Table 1) and Domestic Credit (DC) to the government sector and commercial banks. i.e.

$$H = NFA + DC \qquad \ldots (2)$$

NFA changes according to the overall balance of payments position. In other words, it is affected by ECCB's foreign exchange trading which essentially reflects changing conditions in the exports and imports markets as well as net flows of capital between the ECCB region and the rest of the world. In the presence of the fixed exchange rate regime in the ECCB region, control over NFA or an independent deliberate monetary policy to regulate it, is not possible. A direct relationship between the NFA and M is at the root of the fixed exchange rate regime.

The main focus of ECCB for monetary control, therefore, is the component of Domestic Credit (DC) in the monetary base. Since there are statutory limits imposed on the ECCB's credit to governments of the participating countries in the Agreement of 1983, ECCB can exercise sufficient control over this component unlike many other central banks of LDCs. It is precisely this component of DC which is manipulated through political pressures ultimately frustrating all serious efforts at monetary control in

other LDCs. The ECCB is an exception in this regard thanks to the strict provisions in the Agreement. The link between the fiscal policy and monetary policy is critically dependent on the ability and willingness of the central bank to monetize the budgetary deficits by extending credit to the government. In ECCB this aspect is very well regulated.

The monetary management of the system is done by deciding annual limits for domestic credit expansion. ECCB considers the existing level of NFA as well as the demand liabilities. It has an obligation to maintain a reserve of NFA of at least 60% of the currency liabilities with it. ECCB also generates some tentative forecasts of the magnitude of NFA during the year which represents more of judgement and informed guesses rather than any sophisticated forecasts based on a model. Considering the expected growth of incomes in the regional economy and the expected inflation rate in the economy which is adopted from the expectations about the U.S. inflation, the growth of nominal money supply is estimated. Based on the assumption of the stability of the money multiplier, the targetted growth of high powered money is obtained. Then, using equation (2) above, the target for domestic credit expansion in the region as a whole is derived as the residual. Once such a global target for DC is derived, it is decomposed and allocated to different member governments according to the share of a government in the total recurrent revenues in the region. The governments can use these quotas to finance their budget deficits as and when required but they cannot exceed them. ECCB may advise the goverments on the composition of trasury bills and long-term securities. If any government wants to exceed its quota, it can do so only after modifying the provisions in the ECCB Agreement which requires unanimity of all participating government on the issue. So far, however, such a need has never arisen. Actually, the monetary arrangement through ECCB has been able to impose such fiscal discipline on the participating governments that "the global amount allocated in any one year has never been taken up in full, though on occasions individual governments utilized the full amount of their respective limits." (Liburd, 1990).

One of the reasons for such a disciplined performance by the participating governments is that they could borrow from the commercial banks. However, the impact on the economy would be very different in such a case as compared to the situation when the central bank extends credit to the government. In the latter case, there is a direct expansion in the monetary base resulting in a multiple increase in money supply. In the former case, there are greater chances of the phenomenon of crowding out of private sector credit occurring rather than the money supply increasing. This is because the money supply would be affected only when the government borrowing is financed out of excess reserves with the banking system if they exist. In such a case the money multiplier increases and the money supply is increased. Experience of the past decade (Table 1) suggests existence of such a phenomenon. Moreover, competition among commercial banks in the region is also limited and imperfect as discussed earlier. Some flexibility in interest rate structure exists but it is insufficient to eliminate excess reserves from the system. As a result, the effect of government borrowing from commercial banks is likely to be in terms of both crowding out as well as increased liquidity in the system. The existence of foreign banks only aggravate the situation. The excess reserves with the foreign banks are likely to be relatively less. When the governments borrow heavy amounts from the foreign banks, they may depend on their head quarters to lend the sum increasing the liquidity in the process. This can happen if the interest rates prevalent here are favourable as compared to aborad. However, as we have already seen, the government is borrowing largely from the local banks in this region with only small amount borrowed from the foreign banks. Secondly, the foreign banks in this region are not known to be very heavily and frequently dependent on their head quarters. The interest rates prevalent here are also by and large in line with those prevalent in USA. All these together reduces the significance of the government borrowing from the foreign banks in the ECCB region.

It is important to note that how the governments' borrowing is financed has direct implications on the balance of payments of the region. If it is financed by the ECCB credit, it is likely to lead to a reduction in NFA because it would increase the supply of liquidity relative to its demand in the system depressing the nominal interest rates. With fixed exchange rate regime (at least vis-a-vis U.S.A.) and lack of effective exchange controls, increased supply of liquidity and hence lower interest rates would give rise to increased net outflow of capital, domestic prices remaining the same. If exchange controls were effective, increased supply of liquidity would trigger off inflation in the domestic economy again depressing the real interest rates but, this time, affecting adversely the current account of the balance of payments through decreased competitiveness of the system. On the other hand, if the government borrowing is financed by commercial banks, normally the supply of liquidity remains more or less unchanged in the system. Increased demand for credit may, therefore, lead to increased interest rates giving rise to the phenomenon of crowding out. In the absence of effective exchange controls, increased interest rates prices remaining the same may lead to increased net inflow of capital thereby affecting the balance of payments. If exchange controls exist, change in the composition of output implied by the crowding out, may pull costs of domestic output downward making returns on investment and exports more attractive. This is likely to affect both the current and capital accounts of balance of payments favourably. A judicious mix of the two ways of financing the government borrowing and some basic fiscal discipline implicit in the monetary arrangements in the ECCB area are the critical elements in the monetary management by ECCB. The major problems in its way are the relative instability of money multiplier and the existence of excess reserves in the banking system in the region.

The interest rate policy of ECCB is expected to take care of these two problems. The minimum interest rate on the savings deposit was raised to 4% by ECCB in January 1985. With the objective of promoting financial intermediation by encouraging savings of small deposit holders. This was a major change because prior to 1985, the interest rates on savings deposits were as low as 2.5% or less. As the IMF study by Grant-Suttie and Vaez-Zadeh (1982) found, the time deposit rates were changed whenever there were deviations from the targetted liquidity with banks. In order to maintain the desired (target) rate of return, the lending rates were then adjusted. Fixing minimum interest rate on saving deposits at 4% is expected to affect this process and rationalize the interest rate structure. The interest rates as well as movements therein varied from country to country within the ECCB region as can be seen from Table 2. Even within a country, the effective interest rates vary between the foreign banks and local banks as already discussed. The interest rate structure in different OECS countries showsthat the nominal spread between the saving deposit rate and the prime lending rate ranges between 6 to 8 percentage points, but as Liburd and Ferracho (1985) have argued, the effective spread has been much wider.It depends on the structure of the deposit base and the discounting procedure used for lending operation. Moral Suation is actively pursued by ECCB to encourage the banks to reduce lending rates particularly when their liquidity position is not tight. All these point to the existing imperfections in the competition among commercial banks in the area. However, interest sensitivity of bank deposits in the area also cannot be ignored. The proportion of cash in money supply has been falling since 1985 implying increased proportion of bank deposits in the money supply. If the money supply is interest elastic in the region, the volatility of the money multiplier can be controlled with proper interest rate policy. It is for this reason that ECCB monitors both the interest rate and the monetary base as targets for achieving the desired money supply.

The monetary control in the ECCB member countries requires monitoring the most important element of NFA. It is already argued that NFA is largely governed by conditions in the export and import markets and flows of capital to and from abroad. While the capital flows are determined to some extent by the interest rates and expectations of exchange rate fluctuations, the export-import markets are largely

determined by the degree of competitiveness of the economy which is measured by the real effective exchange rate (REER). The latter is determined by the domestic inflation rate in relation to the inflation abroad besides the nominal exchange rate. In order to maintain exchange rate stability, the EC dollar has been pegged to the U.S. dollar since July 1976 at the rate of $1 U.S. = EC $2.70. This arrangement makes EC$ move in the same way as the U.S.$ in the international market. Since different member countries have different trading partners and since their trade composition and pattern are significantly different, they are affected differently by the movement of US $ against major currencies in the world market. Such effects include the ones on the competitiveness of the economies, their foreign exchange earnings through exports and imports, and the cost of living as reflected in the consumer price inflation index. The countries like Dominica and Grenada are more directly hit by the fluctuations of the U.S. dollar because of the pre-dominance of their trade with non-U.S.$ linked countries.

Table 2: Interest Rates in Commercial Banks in ECCB Member Countries, 1984-90 (in %)

End of Year	Deposit Rates		Lending Rates		Deposit Rates		Lending Rates	
	Savings	Time	Prime	Others	Savings	Time	Prime	Others
1	2	3	4	5	6	7	8	9
	Country: Anguilla				Country: Antigua & Barbuda			
1984	3.5-4.0	7.5-8.0	10.0-11.5	10.0-16.0	2.5-6.0	7.0-13.0	12.5-13.0	12.5-18.0
1985	3.5-4.0	6.0-7.0	9.0-12.0	9.0-16.0	3.5-6.0	4.8-08.5	9.0-13.0	9.0-24.0
1986	3.5-4.0	5.0-6.3	10.0-12.0	10.0-16.0	3.5-5.0	4.0-08.3	11.0-13.0	11.0-23.2
1987	4.0	4.5-6.3	10.0-12.0	10.0-18.1	3.5-5.0	4.0-07.5	10.0-12.0	10.0-23.2
1988	4.0	4.0-6.3	10.0-12.0	10.0-20.0	4.0-5.0	4.0-07.5	10.0-11.5	10.0-23.2
1989	4.0	4.0-6.3	10.0-12.0	10.0-18.1	4.0-5.5	4.0-10.0	10.0-12.0	10.0-23.2
1990	4.0-7.8	4.0-9.0	10.0-12.0	10.0-18.1	4.0-7.5	4.0-10.0	10.5-12.0	10.5-23.2
	Country: Dominica				Country: Grenada			
1984	2.5-3.0	5.5-6.0	9.0-10.0	9.0-14.0	4.0	4.0-8.0	9.0-10.5	9.0-12.5
1985	4.0	5.5-6.0	9.0-10.5	9.0-15.0	4.0-5.0	4.0-8.0	10.5-11.5	10.5-15.0
1986	4.0	4.0-6.0	9.0-10.5	9.0-19.7	4.0-5.0	4.0-7.5	10.5-11.5	10.5-14.0
1987	4.0	3.5-6.0	9.0-10.5	9.0-19.7	4.0-5.0	4.0-6.5	10.5-11.5	10.5-14.0
1988	4.0	3.5-6.0	9.0-10.5	9.0-18.2	4.0-5.0	4.0-6.0	10.5	10.5-15.0
1989	4.0-5.0	3.5-6.0	9.0-10.5	9.0-18.2	4.0-5.0	4.0-7.0	10.5	10.5-15.0
1990	4.0-6.5	3.5-8.0	9.0-10.5	9.0-18.2	4.0-5.0	4.0-8.0	10.5	10.5-15.0
	Country: Montserrat				Country: St.Kitts & Nevis			
1984	2.5-6.3	3.5-5.5	8.5	8.5-14.0	2.5-5.0	5.5-7.0	8.0-10.0	8.0-17.5
1985	4.0	4.0-5.5	9.5-10.0	9.5-18.0	4.0-5.0	5.0-8.0	8.0-12.0	8.0-17.3
1986	4.0-5.0	4.0-5.5	9.5-10.0	9.5-18.0	4.0-5.0	4.0-7.0	8.0-12.0	8.0-18.2
1987	4.0	4.0-6.0	9.5-10.0	9.5-18.0	4.0-5.0	4.0-6.5	9.5-12.5	9.5-18.2
1988	4.0	4.0-6.0	9.5-15.0	9.5-18.0	4.0-6.5	4.0-8.0	9.0-12.0	9.0-23.3
1989	4.0-6.0	4.0-7.5	9.5-12.0	9.5-18.0	4.0-6.5	4.5-9.0	9.0-12.0	9.0-23.3
1990	4.0-5.3	4.0-7.0	9.5-11.0	9.5-17.3	4.0-6.5	4.5-9.0	9.0-12.0	9.0-23.3

	Country: St.Lucia				Country: St.Vincent & Grenadines			
1984	3.0-6.3	7.5-10.0	13.0-14.0	13.0-22.0	2.5-5.0	4.5-7.5	9.0-12.0	9.0-14.5
1985	4.0-8.5	3.3-10.0	12.0-14.0	12.5-19.5	3.0-5.0	4.5-7.5	11.0-12.5	11.0-15.5
1986	4.0-6.0	2.8-10.0	10.5-14.0	10.5-22.9	4.0-6.0	4.3-7.5	12.0	12.0-15.5
1987	4.0-5.3	4.0-6.0	9.0-11.0	9.0-23.9	4.0-5.0	4.5-6.5	11.0-12.5	11.0-15.5
1988	4.0-5.3	4.0-6.5	9.0-10.0	9.0-23.1	4.0-5.0	3.8-6.3	11.0-12.0	11.0-15.5
1989	4.0-5.3	4.0-6.5	9.0-10.0	9.0-23.0	4.0-5.0	3.8-5.8	11.0-12.5	11.0-15.5
1990	4.0-6.0	4.0-7.0	9.0-10.5	9.0-21.3	4.0-5.0	3.8-5.5	11.0-12.5	11.0-15.5
Source: ECCB: Commercial Banking Statistics (Monthly Publication).								

It is found that the consumer price inflation is highly associated with the prices of food articles in the Caribbean region (See Caribbean Community Secretariate, 1988, p. 169). For the small open economies of OECS region heavily reliant on imports of food and other necessities, domestic inflation is largely imported. However, it determines their competitiveness through the real effective exchange rates. Table 3 provides information on the rates of growth of real GDP and inflation for the member countries for the five years 1985-89. It can be seen from the table that the ECCB member countries have experienced a very high growth and relatively low inflation rates in recent years. However, the performance has been considerably different across the countries. Considering the fact that all these countries have the same currency and monetary policy, differences in the inflation rates although of small magnitude, may appear to be surprising. However, when we consider that (i) interest rates prevalent in these economics are different (Table 2); (ii) the growth of real GDP differs substantially during the given years (Table 3) and (iii) that composition of exports and imports are different giving rise to different trade weighted nominal exchange rates, it is possible to reconcile differing inflation rates among the ECCB member countries. In order to appreciate the magnitude of the effect of fluctuations of US $ on effective exchange rates for the ECCB member countries, Table 4 provides information on REER for these countries over the period 1977-87. It can be seen from the table that the differences in the movements of REER are confined only to the rates of change rather than direction of change among the member countries. However, the differences in REER existing over a given period of time are very crucial for the individual economies and their relative as well as asbolute performances over the period.

Table 3: Annual Rates of Real GDP Growth and Inflation in ECCB Member Countries, 1985-89 (in %)

Countries	Annual Rate of Growth in Real GDP					Annual Rate of Inflation (CPI)				
	1985	1986	1987	1988	1989	1985	1986	1987	1988	1989
1	2	3	4	5	6	7	8	9	10	11
1. Anguilla	8.2	11.1	12.3	9.3	9.0	N.A.	2.3	2.6	4.5	4.9
2. Antigua & Barbuda	7.8	8.4	8.8	7.6	6.2	-2.0	0.5	3.6	3.4	5.3
3. Dominica	1.7	6.8	6.8	7.9	-1.6	3.5	3.0	2.9	5.2	4.2
4. Grenada	4.9	5.5	6.0	5.3	5.6	1.8	-0.8	0.6	6.5	3.7

5. Montserrat	4.6	5.8	10.8	12.4	N.A.	3.2	0.2	2.7	3.6	1.8
6. St.Kitts & Nevis	5.6	6.3	7.5	6.7	5.1	1.8	-0.8	2.6	0.2	6.6
7. St.Lucia	6.0	5.8	2.1	6.8	4.0	1.0	4.5	5.1	1.6	3.8
8. St.Vincent & Grenadines	5.9	7.2	6.4	8.6	5.9	1.3	0.5	3.4	2.1	3.5
Source: ECCB Annual Reports.										

The World Bank study (1989) has tried to provide an explanation for the variations in REER by identifying the major causes as: (i) the resource gap as defined in terms of excess of real aggregate expenditure over real output (aggregate supply) which is measured as excess of imports over exports of goods and non-factor services as a proportion of real GDP; (ii) the relative price of bananas with four out of the eight member countries having preferential market for their bananas in U.K. such that they get a much higher price for their bananas than the Central American producers which exert both the expenditure and substitution effects on domestic price levels; and (iii) changes in REER between the U.S.$ and other major currencies affecting domestic prices in the ECCB member countries through their impact on prices of the traded goods. The study found that on an average one percentage point (i) increase in the resource gap causes a real appreciation of EC $ by 0.4%; (ii) appreciation of U.S.$ vis-a-vis other major currencies results in real appreciation of EC $ by 0.7%; and (iii) increase in the real price of banana causes the real appreciation of EC$ in Dominica, St.Lucia and Grenada by about 0.4% to 0.5%. These results assume no changes in other factors. They clearly point to the three fundamental issues in the exchange rate management in the ECCB area. These issues are so vital that the future of ECCB as a monetary arrangement depends on them.

Table 4: OECS - The Behaviour of Real Exchange Rates 1977-87 (1980 = 100)

Year	St.Kitts & Nevis	Antigua & Barbuda	Dominica	Grenada	St.Lucia	St.Vincent & Grenadines
1	2	3	4	5	6	7
1977	98.95	90.15	114.86	118.33	98.61	99.91
1978	100.62	95.39	121.56	114.31	101.48	105.19
1979	103.01	97.51	114.89	106.67	105.10	103.13
1980	100.00	100.00	100.00	100.00	100.00	100.00
1981	89.43	92.76	87.75	83.69	86.38	88.22
1982	82.40	82.96	81.98	75.80	80.62	80.29
1983	79.68	78.04	77.89	70.62	78.53	75.26

1984	76.82	73.32	75.49	66.23	76.83	72.61
1985	74.77	68.24	73.60	64.31	75.48	70.79
1986	82.85	72.78	79.54	71.19	82.15	77.83
1987	90.34	74.52	83.49	78.94	84.46	83.25

Note:The real exchange rate is measured using a weighted average of the wholesale price index in 6 major countries.
Source: World Bank (1989).

7. Future Challenges For ECCB

Liburd and Bain (1989) have shown that domestic saving rate in the OECS region is not affected by the real interest rate but is negatively influenced by the magnitude of foreign saving rate. The latter is, however, directly determined by the resource gap which is found to influence the REER. The resource gap could be financed either by foreign aid or by foreign private investments. Table 5 provides some estimates of the domestic and foreign savings over the period 1981-88 and Table 6 provides information on the summary of balance of payments for the five years 1985-89 for the ECCB member countries. From these tables, it is very clear that the OECS countries are heavily relying on foreign savings to sustain their growth. As long as they get preferential treatments for their exports, such trends may not pose serious threats, but if such preferential access to the markets of their major exports stops, heavy reliance on foreign investment would start becoming a burden to the economy raising problems of debt servicing and repartriation of factor incomes. The long term solution is, therefore, to encourage domestic savings and reduce reliance on foreign savings. Since this is well recognised by the governments in the area, the variations in the level and rates of REER across the countries are not desirable.

Table 5: Savings and Investment Rates in OECS Region, 1981-88 (in %)

Country	Rates	1981	1982	1983	1984	1985	1986	1987	1988
1	2	3	4	5	6	7	8	9	10
1. Antigua	s_d	11.8	10.5	18.1	15.4	10.2	11.0	13.0	N.A.
	s	53.2	49.7	25.5	31.6	28.0	36.0	42.0	N.A.
	s_f	41.4	39.2	7.4	16.2	17.8	25.0	29.0	N.A.
2. Dominica	s_d	-4.0	9.4	16.5	19.7	5.0	15.0	13.0	N.A.
	s	37.3	33.6	32.3	44.9	28.0	22.0	23.0	N.A.
	s_f	41.3	24.2	15.8	25.2	23.0	7.0	10.0	N.A.
3. Grenada	s_d	13.0	17.2	14.2	14.4	1.0	2.0	8.0	10.0
	s	47.0	62.8	52.2	39.4	31.0	33.0	35.0	36.0
	s_f	34.0	45.6	38.0	25.0	30.0	31.0	27.0	26.0
4. Montserrat	s_d	-27.1	-25.1	-19.8	-11.5	-17.0	-10.0	-8.0	-1.0
	s	52.7	45.2	33.5	21.9	27.0	34.0	39.0	47.0
	s_f	79.8	70.3	53.3	33.4	44.0	44.0	47.0	48.0

5. St.Kitts	s_d	28.0	22.4	-0.4	19.4	8.0	7.0	-1.0	-7.0
	s	38.3	40.0	36.6	29.4	32.0	28.0	29.0	31.0
	s_f	10.3	17.6	37.0	10.0	24.0	21.0	30.0	38.0
6. St.Lucia	s_d	-2.3	14.4	23.3	16.2	18.0	29.0	24.0	N.A.
	s	55.0	46.5	35.2	35.7	35.0	38.0	44.0	N.A.
	s_f	57.3	32.1	11.9	19.5	17.0	11.0	20.0	N.A.
7. St.Vincent	s_d	0.8	14.4	27.3	32.3	22.0	18.0	7.0	13.0
	s	39.0	36.3	36.1	38.9	28.0	20.0	33.0	31.0
	s_f	38.2	21.9	8.8	6.6	6.0	2.0	26.0	18.0

Note: s_d is Gross Domestic Saving as % of GDP; s is Gross Domestic Investment as % of GDP; and s_f is Foreign Savings as % of GDP.
Source: Statistical Department, OECS Secretariat and ECCB Estimates.

Closely connected with the above is the threat of EC 1992 developments which are likely to give a severe external shock to the OECS countries - particularly those dependent on banana exports. Currently under the Lome Agreement Protocol between the EEC and ACP states, bananas are sold in the protected UK market at a much higher price than the world price. The estimated implicit subsidy received by the OECS banana exporting countries through the protected UK market was of the order of US $ 149 million or 6% of GDP between 1980 and 1986 (World Bank, 1989, p.29). In 1986 alone, the subsidy came to about 37% of the value of banana exports. If the proposed single integrated market in Europe results in elimination or significant reduction of this subsidy, its effects on REER can be estimated by the results of the World Bank study (1989) reported in the previous section. Only by itself, a fall in the real price of banana to such an extent would lead to a substantial real depreciation of EC$. If we add to it the effects on resource gap of such a fall in banana price, the REER would depreciate still further. With fixed nominal exchange rates, such huge depreciation in real terms could be achieved only with strong deflation on prices, output and employment in the domestic economy. Unemployment would rise, real wages would decline, output and incomes would fall drammatically. If, however, the prices of the non-traded goods were downward rigid, such a drastic depreciation in real terms could be achieved by devaluing EC $ with respect to the U.S.$. Such a situation would be further aggravated by expectations for depreciation leading to capital flight from OECS countries. At this stage, it is important to note that devaluation requires unanimity among ECCB member governments and that only 4 out of the 8 member countries would be severely hit by the banana price crash. The devaluation to such an extent may not, therefore, be agreed upon.

Table 6: Nominal GDP and Balance of Payments for ECCB Member Countries, 1985-89
(EC $ million)

Year/Items	Antigua	Dominica	Grenada	Montserrat	St.Kitts	St. Lucia	St. Vincent
1	2	3	4	5	6	7	8
1985: GDP	464.8	223.3	246.2	86.0	171.8	388.8	250.2
Resource Gap	98.1	62.3	93.3	27.6	43.6	79.6	14.5
Current A/c	-67.0	-9.2	11.2	1.0	-10.8	-25.4	23.9

Capital A/c	78.5	11.7	15.5	5.9	15.4	40.0	2.0
1986: GDP	537.2	253.3	279.2	97.9	213.2	426.6	282.0
Resource Gap	375.6	20.7	95.9	29.6	46.9	43.7	32.6
Current A/c	-342.9	11.3	-1.1	-0.6	-18.3	4.5	16.0
Capital A/c	370.0	4.0	6.9	8.2	26.7	26.3	15.1
1987: GDP	614.2	281.8	320.5	113.5	239.8	453.2	318.0
Resource Gap	212.1	38.1	114.8	38.5	59.6	60.9	70.1
Current A/c	-189.9	4.8	-66.7	-6.1	-28.1	-14.2	-41.7
Capital A/c	183.2	19.5	77.1	9.5	29.9	29.4	26.6
1988: GDP	722.7	324.3	350.2	146.3*	278.3	504.4	358.5
Resource Gap	215.1	64.2	107.2	41.7	87.1	34.1	37.4
Current A/c	-189.0	-20.3	-54.5	-5.3	-52.3	-3.9	-7.4
Capital A/c	196.0	18.2	39.6	6.1	52.1	9.7	12.6
1989: GDP	773.1	339.5	376.4	N.A.	302.3	545.5	393.2
Resource Gap	254.4	142.1	135.8	38.6	85.8	161.0	76.3
Current A/c	-220.9	-87.4	-86.5	21.4	-50.5	-128.5	-30.0
Capital A/c	221.0	89.4	82.9	-20.7	67.6	143.6	32.7

* at current market prices
Note: (i) GDP is at current factor cost.
(ii) Resource Gap is measured as excess of imports over exports of goods and non-factor services.
(iii) Figures for 1989 are Provisional estimates.
Source: ECCB Annual Reports.

The deflationary pressure on the banana exporting countries would lead the whole region into a severe balance of payment crisis because reduction in income and prices in those countries would lead to excess supply of liquidity resulting in lower interest rates inducing capital flights and severe pressure on the foreign exchange reserves not only of the affected countries but also of all ECCB member countries. Since these will be deficits, they are hard to handle. In the past favourable external shocks through banana boom was experienced. It was easy to handle because surpluses can be invested off-shore but deficits cannot be met likewise so easily.

The hard options before the ECCB member countries are to search some solutions within, e.g. try to diversify the economic base of their economies; develop sound alternative exports or foreign exchange earning activities like tourism; promote greater freedom of movement of capital and labour across member countries; increase flexiblity in resource use by reducing restrictions on land-use, introducing flexibility in money wages, company laws, etc. In other words it calls forth a greater integration and liberalization of the economies of member countries. It puts further constraints on the political and economic choices of the member countries.

The other option is to reconsider the pegging of EC$ with the US$. Instead, it could be pegged to a basket of currencies or a freely floating exchange rate system. In both these latter alternatives, continuous political and administrative attention is needed. Moreover, the level of sophistication, skills and competence required to manage such a system effectively is not readily available in the region. The current fixed exchange rate system on the other hand is simple to administer. The current system has served the member countries reasonably well so far. It has withstood external shocks as well. However, the imminent shock is different in its magnitude and differential impacts on member economies. It will really test the soundness of the monetary integration model of the ECCB.

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