TENTH ANNUAL CONFERENCE
REGIONAL PROGRAMME OF MONETARY STUDIES
BANK OF JAMAICA
OCTOBER 23-25, 1978

THEMES: (a) CENTRAL BANKING UNDER DIFFERENT ECONOMIC SYSTEMS
(b) WAGES, PRICES AND THE BALANCE OF PAYMENTS

CENTRAL BANKING IN THE ECCA TERRITORIES - FUNCTIONS, STRUCTURE AND PROSPECTS

by

George Theophilus

Deputy Managing Director

EAST CARIBBEAN CURRENCY AUTHORITY

This paper was prepared for presentation at the 10th Annual Conference of the Regional Programme of Monetary Studies. Responsibility for the views expressed therein rests solely with the author.

INTRODUCTION

Financial institutional development is a necessary concomitant, if not a precondition for, sustained economic growth. Recognition of this fact partly underlies the current effort to transform the East Caribbean Currency Authority into a Central Bank to enable it to play a more positive role in the struggle to develop the tender economies of Grenada, the Associated States and Montserra

In fashioning a central bank for the area cognizance must be taken of three structural features which by themselves may determine the prospects for effective central banking in the ECCA territories:

(a) that there are seven separate political entities to be served, each functioning independently in the area of fiscal and budgetary policy;

(b) that there exists among these States an economic union i.e. an association of states with a common currency and a common market and

(c) that there is in existence a regional institutional forum in the West Indies Associated States Council of Ministers (WISA) for the coordination and harmonization of policy in several fields of activity - diplomatic, economic, political etc.

According to one's predilections, there can be found in the present arrangements of the ECCA territories both the ministrations of hope and the counsels of despair for the future of the proposed East Caribbean Central Bank. Given the apparent ascendancy of pragmatism and eclectism in the political outlook of the sub-region, it should not be assumed that the ultimate boundaries of cooperation have been penetrated. In fact central banking should be looked at as a framework for consolidating the extant areas of economic cooperation and as a device for bolstering and strengthening the management of the common currency, which is essential for the continuing health of the brittle economies of the 'Little Seven'.

In examining alternative functional and structural regimes which may serve as a basis for modelling the proposed central bank, the Draft East Caribbean Central Bank, which was prepared by the IMF, will be used merely as a convenient point of reference.

OBJECTIVES OF THE CENTRAL BANK

As envisaged in the IMF document, the purposes of the proposed central bank are three-fold:

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

(2) to promote monetary stability and

(3) to promote credit and exchange conditions and a sound financial structure conducive to the balanced growth of the economy of the territories of the participating Governments.

Within this framework two macroeconomic objectives are assigned to the central bank - promotion of monetary stability and balanced economic growth. In the pre-Keynesian era central banks were seen as instruments of aggregative economic policy with price stability as their primary objective. Keynesian liberal economics brought with it a novel emphasis on employment, and the maintenance of full employment was seen as one of the primary aims of aggregative economic policy which central banks should help governments to achieve. Since the last war, with the emergence of the Third World, greater fiscal activism on the part of governments and recurrent visitations of the Western industrial world by adverse balance of payments conditions, central banks have been seen as instrumentalities for the pursuit of congruent debt management policies, sustained economic growth and international balance.

The proponents of the Phillips Curve hypothesis have advanced that central banks should not be assigned the dual and conflicting objectives of promoting at one and the same time full employment and price stability since there is, in their view, an inverse relationship between the rate of growth of unemployment and the rate of inflation. The pursuit of full employment would have its price or trade-off in the accentuation of inflation. The recent and continuing bout of international stagflation or slumpflation has led to the repudiation of the Phillips Curve by many economists and the emergence of the protagonists of the natural rate of unemployment hypothesis, who contend that there is a 'natural' level of unemployment determined by the institutions of the labour market towards which the economy will tend to gravitate.

Whatever the outcome of the debate, it should be emphasized that the pursuit of price stability in the open economies of the ECCA territories may be a desirable object of policy but a difficult objective to realize given the dominance of exogenous cost-push influences on the price level. In addition high rates of unemployment may be regarded as a chronic feature of these economies and it would seem preferable to require the central bank to pursue policies which will help to reduce the level of unemployment or augment opportunities for employment.

International balance as an object of policy presupposes a degree of control over certain economic variables, which will remain illusive as far as the ECCA territories are concerned. Apart from the fact that these territories are price takers in their foreign trade dealings, the exchange rate vis-a-vis currencies other than the US dollar and dollar pegged currencies is externally determined by the fortunes of the reserve currency to which the East Caribbean dollar is linked, irrespective of prevailing internal economic conditions. Since the terms of trade and the exchange rate in relation to non-dollar based currencies are exogenously determined and since these have a major influence on the capacity to achieve external balance the measures which are within the powers of the central bank to take, e.g. exchange rate adjustments, may easily be frustrated by adverse movements in external financial variables, which the central bank is powerless to obviate and which may have a decisive impact on the balance of payments.

Moreover the power of favourable interest arbitrage to counter or reverse adverse capital flows and to attract foreign funds in small distant States as the 'Little Seven' is questionable in view particularly of the absence of a reasonably developed and internationally recognized money and capital market and the known wide interest rate differentials required to effect such movements across developed money markets. Particularly important is the potential negative effect on local investment of attempts to manipulate interest rate levels to achieve external balance.

The role of the central bank in efforts to attain balance of payments equilibrium should be pursued through measures to facilitate and augment export production and to ensure that the foreign exchange proceeds of such exports (visible or invisible) are reflected in the foreign exchange holdings of the area.

Based on the foregoing observations the objectives of central banking in the ECCA territories could be summarized as follows:

the promotion of financial and economic conditions conducive to

(a) rising levels of employment
(b) constraining domestically generated inflationary pressures on the economy
(c) sustaining real economic growth and
(d) strengthening the economies balance with the rest of the world.

FUNCTIONS OF THE CENTRAL BANK

The functions normally assigned to central banks may be classified as follows:

(i) Monetary policy functions
(ii) Credit policy functions
(iii) Regulatory and supervisory functions
(iv) Service functions
(v) Development functions

MONETARY POLICY

Monetary policy involves a deliberate and tendentious employment of the discretionary powers of the central bank to influence the supply of money in a direction consistent with the general aims of government economic policy. Its use is based on the premise that the central bank can fine tune the economy by contracting or expanding the money supply in inflationary or recessionary conditions thereby stemming adverse trends in the economy.

To assess the role which monetary policy should play in the ECCA territories it appears necessary to examine briefly the four theoretical explanations of the monetary mechanism which have gained prominence in the last four decades:

(a) the credit conditions or Keynesian approach
(b) the quantity of money or Fisher/Friedman approach
(c) the liquidity or Radcliffe Committee approach
(d) the availability of money or Roosa approach

Keynesian approach

The basic closed economy equation of the Keynesian model is $C + I_n + G$ (aggregate demand) = NNP (aggregate supply). The transmission mechanism of monetary policy in this model begins with the effect of monetary policy on the size of commercial bank reserves, which influences the supply of money, which in turn affects interest rate levels (i.e. the cost of credit) with consequential impact on investment spending, output, employment and the price level. A more sophisticated version of this approach sees the effect of interest rate on investment as the primary nexus of the transmission mechanism. If a given NNP can be associated with high levels of unemployment, the central bank would be expected to pursue an easy money policy to increase the money supply thereby lowering the interest rate, which would augment investment by making a larger volume of spending profitable with the ultimate effect of expanding the equilibrium net national product (NNP). In these circumstances planned investment has fallen short of saving and the object of easy money is to bring back planned investment to the level where it equates saving.

According to this approach, investment spending is more responsive to changes in interest rates than consumer spending because of the size of investment projects and the longer gestation period involved. In addition changes in investment spending are influenced by interest rates by their effect on the relative attractiveness of capital equipment and bond purchases.

It should be stated parenthetically that Commissions in the U.S., U.K. and Canada have discovered empirically that business decisions are relatively insensitive to changes in credit conditions. The Porter Commission in Canada as well as the Radcliffe Committee in the U.K. found that businesses, faced with tight credit conditions, were capable of responses the result of which was to minimize the effect of these conditions on their financial arrangements and investment activities. Available were such options as borrowing abroad, sale and leaseback arrangements, trade credit, issue of commercial paper, dividend attrition, issue of debt and equity, etc.

Fisher/Friedman Approach

Instead of interest rates and business expenditures, the quantity theorists concentrate on the direct relationship between the quantity of money and spending. The current equation of exchange is MV (aggregate demand) = PQ (aggregate supply) i.e. Money Supply x Income Velocity of Money = Price Level x Physical Volume of goods and services. The transmission mechanism in the quantity theory is less circuitous and more direct than that of the credit approach i.e. a change in the money supply engenders a change in net national product. Historically the quantity theorists or the monetarists (as now popularly called) perceive a close positive correlation between the money supply and the money national product and consequently draw the inference that the money supply is the critical causal factor in the determination of the net national product (PQ).

While Keynesians maintain that the channel of influence of a change in money supply is through the rate of interest, monetarists contend that the immediate effect is on portfolio balances of individuals and business whose relative preferences for money, financial assets and goods are affected. An increase in the quantity of money leads individuals to feel that their holdings of money are excessive thus instigating switches to financial assets (i.e. lending) and goods and services (i.e.spending).

Whereas the crucial financial variable in the credit approach is the rate of interest, the monetarists emphasise the money supply. In their view even if interest rates were to remain unchanged, a change in the money supply will be accompanied by a change in the amount of wealth to be allocated between money and other assets.

Radcliffe Committee Approach

This school of thought views the money supply as part of a wider whole, the general level of liquidity. Spending decisions in the community are influenced not merely by the part, the money supply, but by the whole, the structure of liquidity in the economy. The ability and willingness of the community to borrow and its holdings of saleable financial and physical assets are as important to spending decisions as its holding of cash or money.

The liquidity approach accepts the Keynesian emphasis on interest rates in the transmission mechanism and advances the view that changes in interest rates in altering the level of total demand have two aims:

(a) inducing a change in the incentive to purchase capital goods (i.e. the interest incentive which Radcliffe proved to have minimal effect), and

(b) altering the general liquidity of the entire economy.

A change in the rate of interest (say bank rate) tends to affect the level and structure of interest rates, which impacts on the liquidity condition of individuals, financial and business institutions, thereby affecting the liquidity position of the economic system. It is this effect which makes the rate of interest an important tool of economic management.

The Porter Commission in Canada also saw interest rates as a component of credit conditions and explained the influence of monetary policy on spending in terms of changes in credit conditions i.e. the cost (interest), terms and general availability of credit to borrowers and consequently the terms and yields on which savers can invest their funds.

Changes in credit conditions forced spending units to weigh the relative attractions and advantages of an increase in spending against the risks, difficulties and disadvantages involved in financing it. The link between financial markets and real expenditures is the whole gamut of credit conditions prevailing in the economy.

The liquidity approach sees the money supply as one of several determinants of credit conditions:

(a) significant changes in the volume of financial assets

(b) profitability of physical investments

(c) changing propensity to save or spend

(d) changing preferences and expectations of the investing public.

The transmission mechanism of the liquidity approach is from interest rates through liquidity to expenditures. The Porter Commission saw a direct route from interest rates to expenditure as the interest rate in its view also reflectsthe impact of changed liquidity.

This monetarist conclusion is based on the premise that "V" in the equation of exchange is relatively stable though not constant as Fisher originally assumed. Because "V" is relatively stable a change in M automatically generates a comparable effect on PQ. Keynesians challenge the premise and contend that "V" is variable both cyclically and secularly. The monetarist prescription of a fixed monetary rule rather than contribute to stability would be a source of major fluctuations in aggregate demand, which will be manifested in unstable economic conditions. In their view even a small change in "V" will have a significant effect on PQ or NNP or could negate the effect of a large change in M.

The monetarists support their position on the relative short-run stability of "V" by pointing out that "V" is influenced by the demand for money, a transactions demand, which in the short run remains unchanged because the factors that affect the amount of money the public wants to hold, such as spending habits, length of pay periods, availability of credit instruments etc., change intermittently and gradually over an extended time frame.

The Keynesian reply is that money is not only a medium of exchange but also a store of value. There is in addition to the transaction demand for money (money as a medium of exchange) a speculative demand for money (money as a store of value) which varies inversely and significantly with the rate of interest, thus causing it to be unstable. With doubt and uncertainty about future changes in the rate of interest, wealth-holders will tend to hold securities instead of money if interest rates are expected to fall and conversely. A decision to hold money for speculative reasons will depend on the degree of certainty associated with the prospective interest rate change by the wealth-holder, the time frame of the expected change, the current rate of interest compared with the anticipated rate of interest.

Since velocity = $\frac{\text{Annual Income}}{\text{Average Money Balance}}$ or $\frac{PQ}{M}$, an increase in the speculative demand for money, Keynesians contend, will increase the denominator in the equation and thereby decrease "V" and conversely. In so far as the speculative demand for money is inversely related to the rate of interest, the velocity of money, which varies inversely with the speculative demand for money, therefore varies directly with the rate of interest.

The relevance of the debate to central bankers is reflected not only in the alternative choices or indicators offered for the pursuit of monetary policy but also in the political/economic options postulated i.e. the visible hand of governmental or quasi-governmental discretionary monetary control or the invisible hand of the competitive market system. The symbols of the debate should not be allowed to overshadow the substance.

The contribution of this school to economic thought is in focussing on the impact of monetary policy on aggregate demand by its effect on both lenders and borrowers.

The Relevance of the Keynesian/Monetarist Debate

The Keynesian/Monetarist debate is couched mainly in economic terms but it essentially represents a philosophical and ideological contretemps between the forces of liberalism and conservatism in public life, and also between the advocates of the relative efficiency of governmental intervention as an allocative and distributive device and the merchants of the free market mechanism. Keynesians contend that the inequities engendered by the market mechanism are a notorious fact and that the powers of government must be invoked to correct the inequitable effects reflected in both maldistribution and misallocation of resources and income disparities. The free market has systematically failed to provide public goods and has been a constant source of business fluctuations and economic instability resulting from imbalances between planned investment and saving. In their view the record of recurrent episodes of inflation and unemployment suggests the absence within the free market of a mechanism for the achievement of macroeconomic stability.

The monetarists with their philosophical and ideological commitment to laissez-faire and conservatism believe that the free market mechanism or competitive market system is an effective instrument for efficient resource allocation and macroeconomic stability i.e. stability in the level of output, employment and prices. Governmental interference in the economy in the form of minimum wage laws, pro-union legislation, farm price supports, and pro-business monopoly legislation has made downward wage/price movements intractable and inflexible. In this vein, economic instability is attributed to the use of discretionary fiscal and monetary policies to fine tune the economy.

It is for this reason as well as the uncertain length and variability of countercyclical lags of monetary policy that monetarists advocate the replacement of discretionary monetary policy by a fixed-throttle monetary rule, notwithstanding their faith in the potency of the influence of the money supply in the economy.

By increasing money supply by a pre-determined annual rate equivalent to the potential growth of GNP, which is assumed to be in the region of 3% to 5%, the major cause of economic instability, the unpredictable and idiosyncratic features of discretionary monetary policy, would be eliminated. Such a role would provide an automatic corrective to deflationary trends as well as ensure that any developing inflationary pressures are quickly defused because of lack of monetary fuel.

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Problems and Limitations of Monetary Policy

The functional efficacy and reliability of monetary policy as an ongoing instrument of monetary management has been called into question as a result of a number of practical problems and apparent limitations which have been observed over time.

One of the crucial limitations is the incomplete counter-cyclical effectiveness of monetary policy. Whereas tight money can have a dramatic impact on commercial bank reserves with consequential effect on bank lending and the money supply, the converse, an easy money policy, while providing the capacity in the form of augmented bank reserves, depends entirely on the willingness of the commercial banks to lend and the public to borrow. As long as pessimistic expectations of entrepreneurs outweigh the incentive effect of low interest rates so long will investment activity be resisted. The central bank can raise the level of bank excess reserves through its monetary operations but it cannot guarantee that loans will be contracted and the supply of money increased.

Perverse shifts in velocity may also frustrate policy instigated changes in the money supply. Velocity tends to vary inversely with the quantity of money over the business cycle, rising when the money supply is reduced to fight inflationary pressures and falling in a recession when money supply is boosted to inflate the economy. This happens because spenders are influenced by actual and expected changes in the price level. Since inflation reduces the purchasing power of money, householders and businessmen reduce their holdings of money in an inflationary or expected inflationary situation by spending thereby raising the level of velocity. In addition financial intermediaries which are not subject to central monetary control can have an offsetting effect on policy by making funds available to spenders, which, when used, help to increase the velocity of money.

Monetary policy is designed to fight demand-pull inflation; it is relatively ineffective in the face of cost-push or profit-push inflation, the causes of which are to be found on the supply or cost side of the market. It may help to dampen a wage/price based inflation but it cannot eliminate it.

Through its influence on the rate of interest, monetary policy is intended to have an ultimate effect on the level of investment. Theoretically, the investment demand curve tends to be insensitive to the rate of interest. A shift in the investment demand curve may also affect the impact of monetary policy. If tight money in an inflationary setting is accompanied by business optimism reinforced possibly by improved technology, the investment demand curve would shift to the right thus increasing investment spending despite the higher interest rate or bank

credit restrictions. As the Porter Commission and the Radcliffe Committee have shown corporations have discovered a number of strategies for continuing their activities during periods of tight money including improved cash management facilities, shifts from short-term financial investments to intended physical investment, resort to foreign borrowing, trade credit, etc.

While one school of thought perceives the growth of the public debt as a facility for the effective pursuit of monetary policy through open market operations, it is also claimed that significant holdings of public debt by commercial banks, institutional investors, business and individuals have provided an ample source of liquidity which facilitates transfer of funds among various economic units and the mobilization of funds for business activity in situations where a credit squeeze obtains. Commercial banks are known to borrow from one another through this medium, to accumulate government securities during periods of monetary ease and to offload these fractionally in periods of tight money to maintain levels of lending activity. There is a comparable phenomenon evidenced in corporate behaviour and strategy calculated to secure protection against the effect of restrictive monetary policy on their capacity to invest.

The differential and selective sectoral incidence of monetary policy has also been identified as a major limitation as it tends to be negatively discriminatory in its impact on businesses which

(a) are dependent on borrowed funds for working and fixed capital
(b) are relatively small
(c) are incapable of raising funds abroad
(d) produce goods and services for sectors susceptible to changes in credit conditions
(e) have marginal growth and profit records
(f) require a high capital-output ratio or are subject to long gestation periods.

The countercyclical lags associated with monetary policy, it is contended, make its effect on the economy slow, imprecise and variable. The uneven length and variability of these lags - inside, intermediate and outside lags - burden monetary policy with a problem of timing and forecasting. A policy initiated on the strength of existing economic conditions may well impact on the economy at a time when the state of the economy has been transformed.

Important developments which have the potential for underminir monetary policy are to be observed in public attitudes to the maintenance of idle cash balances reflected in the substitution of deposits for currency for transaction purposes. The institution of NOW (negotiable order of withdrawal) to facilitate automatic transfers between interest to non-interest bearing demand accounts will have an impact on the different measures of the money supply.

In open economies shifts in the balance of payments could lead to massive flows of funds into or out of the economic system. Excess liquidity fed into the system by balance of payments surplus cannot easily be siphoned off with the traditional instruments of monetary control. The action of the central bank may counteract secondary deposit expansion by the commercial banks, which will nonetheless have sufficient liquid funds to support primary deposit expansion based on their purchases of foreign exchange from the public.

An indicator problem also besets the pursuit of monetary policy. The central bank is faced with the stark problem of identifying and selecting the most appropriate measure or index on which to operate to achieve its policy objectives.

These problems and limitations do not totally discredit monetary policy as an instrument of economic management. What they do indicate is that it is, like every other instrument of policy, an imperfect tool and its professional users should continuously review its operational effects so as to be in a position to take alternative measures to counteract its unintended consequences.

Guidelines for Monetary Policy in the ECCA Territories

Given the minefield of booby-traps and trip-wires that monetary policy appears to be, the ECCB will nonetheless have to choose a path of greatest safety or least danger in its pursuit of its monetary objectives. In its choice of guidelines, the central bank should be guided by the following criteria:

(1) the indicator should be a financial variable on which it has a reasonable measure of control;

(2) the variable must be one from whose movement and direction the public, particularly financial institutions, can unambiguously discern the intent of central bank policy, and

(3) the magnitude selected must be one the manipulation of which will have a significant influence on economic activity in the direction intended.

With these criteria in mind the following alternatives may be examined:

(a) money supply
(b) price level
(c) interest rates
(d) credit conditions
(e) excess reserves of commercial banks
(f) liquidity of economic system

Money Supply

The money supply in the open economy of the ECCA territories is not a variable which can be controlled with any degree of precision. The influence of the balance of payments on the money supply as well as the potential effects of independent fiscal and debt management activities of governments could limit the impact of the monetary activities of the central bank. There is moreover no clear indication of the appropriate measure of money supply, whether M1, M2 or M3, which should be preferred for purposes of control.

The monetarists have advocated the adoption of a monetary rule to replace the fallible judgment and discretion of the central bank. Apart from the likely unintended consequence of accelerated obsolescence of central bank governors, the fixed throttle rule harbours the germ of economic instability since the rule cannot conceivably be an adequate curative measure for both recession and inflation.

Experiments in the use of annual targets or adjustable rolling targets for the money supply are doomed to failure in the ECCA territories where the openness of the economy makes precise control of the money supply impossible. This is not to suggest that efforts to influence the course of the money supply should be wholly abandoned.

Price Level

The general level of prices is influenced by both endogenous and exogenous influences. Endogenous demand influences may be amenable to a measure of monetary influence but the exogenous (cost of imported inputs) as well as endogenous (wages/profits) cost factors are not equally responsive to monetary actions inspired by the central bank. The factors which determine the price level (including expectations) are so wide and varied that it does not appear to be a suitable variable through which to indicate the direction of policy.

The Rate of Interest

Movements in the rate of interest have traditionally been recognized as a measure of the direction of monetary policy, rising rates, especially rising bank rate in the U.K., having been associated with the authorities' intention to dampen economic activity and conversely. Evidence in the 1960s seems to suggest that financial and corporate institutions have found means to circumvent the effects of interest rate pressure on their activities.

Interest rates in the ECCA territories are invariably administered rather than market rates. The limited stock of government securities does not provide immediate hope of the possibility of influencing the level of interest rates by open

market operation. The central bank will therefore have to rely on or resort to direct controls in order to influence this variable. The Commercial Banks will for some time be immune to the effects of discount rate changes as long as their Head Offices continue to be their lender of last resort.

In effect, the rate of interest by itself is not an ideal control variable.

Credit Conditions

The cost, terms and availability of credit (credit conditions) lend itself to a broader area of influence than interest rate. The availability of credit must be complemented by willingness on the part of lenders to lend and borrowers to borrow and spend. There may not be a coincidence of availability and willingness at certain stages in the business cycle and the operations of the central bank may fail to elicit the desired result.

While credit conditions may not be a perfect guide to monetary policy, it offers the prospect of influencing business activity as well as restricting a few undesirable lending operations (e.g. financing of imported consumer durables) which have characterized the activities of financial institutions in the open economies of the ECCA area.

Excess Reserves of Commercial Banks

Operations by the central bank to influence the level of excess reserves of commercial banks affect one class of financial institution. Since the activities of other financial intermediaries can also have a comparable impact on economic activity as bank lending, the level of excess reserves will not affect economic activity to the extent intended.

Liquidity Levels

If the Central Banks were able to operate on the whole liquidity structure of the economic system, this would be the ideal control variable. In practice, this would be administratively complex and operationally easy to evade. The ECCB in the foreseeable future will not be in any position to undertake such a monumental exercise.

ECCB's Option

The ECCB will for some time have no other option but to be eclectic. Through a transitional learning period it may entertain the hope, however idealistic, of arriving at the ideal variable or combination of variables on which to operate.

Instruments of Monetary Policy

The instruments of monetary policy refer to those powers the use of which enables the central bank to increase or decrease the reserves of banking and other financial institutions subject to its control and in so doing influence the money supply in a direction consistent with its economic objectives. In the Draft

ECCB Agreement four (4) monetary instruments may be identified.

(1) rediscounting and the rediscount or discount rate

(2) open market operations

(3) reserve requirements

(4) marginal reserve requirements

Discounting

Discounting (or rediscounting as originally termed) is a means by which the central bank can augment the cash reserves of eligible financial institutions and serves as

(a) a source of temporary or emergency accommodation for banks faced with large unexpected deficit or portfolio adjustments

(b) a safety factor for commercial banks during periods of monetary restraint

(c) a facility to help meet seasonal need for additional cash reserves, and

(d) a means of minimising cash effects of imbalances of balance of payments.

Traditionally discounting took the form of rediscounting of eligible government or commercial instruments but it is currently pursued principally in the form of temporary secured or unsecured advances to commercial banks. In this respect it is to commercial banks an alternative to inter-bank borrowing, the sale of securities or other assets from its portfolio and the issuing of certificates of deposit.

Since the central bank normally imposes a charge for the granting of credit, both the resultant financial flow and the charge have monetary effects. Borrowing from the central bank has the effect of increasing the total reserves of commercial banks and serves as a basis for expansion of money and credit in the economy. Where reserves made available in this way are exempted from required reserve requirements, the excess reserves of the system are increased by the full extent of such advances thereby enhancing the capacity of commercial banks to extend credit compared to resources raised by other means.

The discount rate or bank rate is the rate of interest charged for loans or advances granted to the commercial banks. The interest on such advances is normally discounted at the time the loan is negotiated rather than collected when the advance is repaid. In the United Kingdom and Canada, the discount or bank rate is a penal rate as borrowing in these countries is regarded as a right rather than the privilege which it is in the United States. Because of the privileged nature of the activity the United States Federal Reserve not only insists on collateral specifications but also scrutinizes the reason and purpose for which it is asked to perform the function of lender of last resort.

In Canada the discretionary bank rate has been superseded by a floating bank rate which varies automatically and at a predetermined rate with the Treasury Bill rate. A similar experiment was attempted in the United Kingdom in 1972 in the form of a Minimum Lending Rate but this was recently abandoned. The floating bank rate was considered to be the simplest method of keeping bank rate at a penal level and avoiding frequent adjustments to keep the fixed rate at a penal level. Bank rate was abandoned in the U.K. because of its dramatic announcement effects, which at the higher levels of the rate often had undesirable political repercussions and macroeconomic effects. The fixed Treasury Bill nexus converted bank rate from an active market-leading to a passive market-following rate. After six years, the experiment was abandoned as it was discovered that the Treasury Bill link led to undesirable erratic interest rate movements and to confusion and uncertainty about the intentions of the monetary authorities.

Historically bank rate or the discount rate has had a signalling effect, indicating the intention of the central bank and its perception of the economic climate. Commercial bank and public response has largely been influenced by their economic expectations.

A marked feature of the discount mechanism is that it is a client-initiated facility. The initiative emanates from the commercial banks, which, in essence, determine the amount of money injected into the system through the discount window. While the central bank retains the discretionary power to determine which commercial banks will be accommodated, the limits of trading through the discount window and the rate of discount, yet the cost, terms and convenience of borrowing from alternative sources, the state of demand for bank loans etc. will be among the main factors influencing the demand for discount accommodation. The effects of discount policy adjustments on the volume of discounting are therefore unpredictable and uncertain.

The efficiency of discounting as an instrument of policy rests upon the premise that commercial banks will avail themselves of the facility. In the ECCA territories where the lender of last resort function continues to be performed by the Head Office of banking institutions the potential level and frequency of discounting remains dubious. The experience of the central banks of the Commonwealth Caribbean does not offer much hope for an early reversal of institutional attitudes.

Milton Friedman contends that the discontinuity of discount rate adjustments in the United States has been a source of instability, which is reinforced by uncertainty associated with negative "announcement effects" of such changes.

While there is not much hope that discounting will be an active tool of monetary control in the ECCA territories in the

immediate future, the East Caribbean Central Bank should devise persuasive strategies to encourage the use of the discount window not only for its psychological effect, but also for the tone and nuance it is likely to impart to the relationship between the central bank and the commercial banks.

Open Market Operations

As an instrument of monetary policy open market operations involves the purchase and sale of government short-term, medium-term and long-term securities with a view to influencing

(a) the level and structure of interest rates

(b) the reserve position of the commercial banks and through this the stock of money in the economy.

Purchases replenish and sales contract the reserve base of the banking system thereby influencing the lending capacity of commercial banks. These operations, particularly large sales and purchases, tend to affect the price of the specific securities and "osmotically" other market instruments. As a corollary, the level and structure of interest rates in the money market is affected.

Open market operations have evolved in the developed market economies as the primary tool of monetary policy because it has the advantage of flexibility, and the impact on bank reserves is prompt. It has no announcement effects as its implementation is usually subtle and unobtrusive.

Because changes in monetary and economic conditions occur daily, monetary management through open market operations must be subject to an equal measure of frequency. Impersonal and widespread in its effects, open market operations can be pursued on a continuous basis. The amounts involved can be relatively large or small. Since it has no announcement effects policy can be reversed quickly and easily. It lends itself for use as a defensive mechanism in smoothing disruptive and disorderly market conditions as well as a dynamic force for the maintenance of stable economic conditions.

The efficacy of open market operations hinges on the existence of a broad and active securities market and the dominance of government securities in the composition of the commercial banks investment portfolio.

In the ECCA territories the volume of government Treasury Bills and Bonds is sparse, their issue frequency spasmodic, the amount limited and the maturity spread uneven and devoid of regional method. Even if the ECCB were to succeed in augmenting significantly commercial bank holdings of government securities that would not by itself lead to a vibrant market in government paper, which is a sine qua non for the effective pursuit of open market policy.

Credit expansion through open market purchases of government securities may be less costly to governments in its asymetrical effect on the price of and interest on government debt, but it is less profitable for the commercial banks. The profit motivations of these banks as well as their liquidity preoccupations will inevitably serve to restrain ready sale of government paper in their portfolio.

The state of liquidity of the banking system is a crucial determinant of the efficacy of open market operations. If the level of commercial bank excess reserves is very high, open market sales may have a negligible impact on their lending capacity.

The ECCB should nonetheless actively encourage the habit of dealing in government securities. The effectiveness of open market policy does not depend exclusively on the absolute volume of security availabilities but also on the relative level of holdings in the investment portfolio and the existence of the will, inclination and confidence to deal regularly in instruments of public debt.

An examination of the stringent limits on the holdings of government debt envisaged in the ECCB proposals would suggest that open market operation as an instrument of monetary policy is in any case a forlorn hope. The maximum holding of Treasury Bills is not to exceed 10% of estimated recurrent government revenue in the current financial year and maximum holding of bonds/ debentures is not to exceed 15% of currency in circulation and other demand liabilities of the ECCB. The central bank is not expected to play a more active role in the government paper market than the ECCA which it is to replace, for these are the very limits enshrined in the East Caribbean Currency Agreement.

If the ECCB is to assist in the development, however tentatively, of a money market to facilitate and infuse a greater measure of liquidity to idle local bank balances, to encourage financial institutions to use the discount window and ultimately to try to influence the reserve holdings of the commercial banks, it will need an element of operational flexibility which fixed-and-fast ultra-conservative ratios are designed to deny and diminish.

Reserve Requirements

The Draft Central Bank Agreement permits the central bank to prescribe the maintenance of required reserves including differential and marginal required reserves. It specifies:

(a) 15% as the maximum level of the required reserve

(b) deposit and other similar liabilities as the base for the requirement

(c) vault cash, demand deposits with the Central Bank and, permissibly, government issued or guaranteed securities up to 10% of deposit and other similar liabilities as the assets which qualify for consideration as required reserve

(d) uniformity of r.serve ratio for financial institutions in same class but leaves it mercifully to the discretion of the central bank to determine the degree of leverage which may be permitted through the compliance period.

The employment of reserve requirements by a central bank impounds a proportion of the liabilities of the financial institutions to which it is extended thereby limiting the base for the expansion of credit. While often intended to ensure sound management and to protect the public, reserve requirements may be looked at as a complement or alternative to open market operations. In economies such as the ECCA territories where an extensive securities market is yet to emerge, reserve requirements will mainly serve as an alternative to open market operations.

By varying the reserve ratio the central bank can affect the money creating capacity of the banking system by the impact of the requirement on the level of excess reserves, the base for credit creation, as well as its effects on the multiple by which the banking system can lend. The higher the reserve ratio the lower will be the credit expansion multiplier and conversely. When the central bank raises the reserve ratio it transforms all or part of the excess reserves of the banking system into required reserves thereby reducing the money creating potential of the system and in the case of "loaned up" banks leads to a deficiency of reserve holdings, which forces them to borrow or liquidate investments to meet the required reserve level.

Apart from the liquidity of the banking system and the money supply, reserve requirements can be used as an allocative mechanism for the channelling of credit for particular uses. In this respect it qualifies as an instrument of credit policy. One problem the ECCB will have to contend with is that the operational and structural characteristics of reserve requirements that may be suited for one purpose may in fact negate another purpose. Liquidity, for instance, favours a long averaging period for meeting the requirement but monetary control is enhanced as the average accounting period shortens.

Money supply control, though of doubtful efficacy in open economies plagued with the autonomous effects of balance of payments vicissitudes, can, however, be influenced by the level of the reserve requirement. High reserve requirements reduce the money multiplier and consequently tend to check the rate of growth of the money supply. The 15% maximum envisaged in ECCB Agreement may not be as conservative as it appears given the experience of

the central banks in the Commonwealth Caribbean in the use of this instrument.

Variable reserve requirements could be complemented by differential and marginal reserve features, which facilitate discriminati between different classes of deposits and which permit marginally higher reserve requirements when deposits exceed a previous or other indicated level. The latter is comparable with the British monetary instrument nicknamed the corset which allows the Bank of England to freeze a higher level of bank deposits beyond a specified total or percentage growth rate. Marginal reserve requirements tend to concentrate its impact on the growth of bank deposits or other reserve base thus limiting multiple credit expansion beyond an existing or intended level. Differential requirements on time, savings and demand deposits take cognizance of differences in turnover of these deposits as well as their volatility. The requirements tend to be highest on demand deposits and lowest on savings deposits. High rates are sometimes required on time deposits often to make it less profitable for large commercial banks to siphon time funds from other savings institutions by offering much higher rates.

The ECCB will through a learning process arrive at working required reserve variations to suit changing economic conditions and circumstances. The embargo on reserve requirements beyond 15%, the limiting of the base to deposit and similar liabilities, the stipulation against discriminatory reserve ratios for institutions in the same class but of different sizes may serve to limit the options open to the central bank. If local indigenous institutions are to be encouraged, it is a moot point whether uniform reserve requirements will not severely affect their initial competitiveness and profitability, and whether the blinkered approach required will not prove inimical to the initiation of new financial institutions in the area.

Opponents of reserve requirements perceive disturbing announcement effects in its use giving rise to strong resistance to reverse course expeditiously if the central bank were to misread the economic indicators. Apart from the fact that it is discontinuous in time and amount, it tends to proceed in large doses which make piecemeal financial adjustment to unanticipated consequences impossible and which affect the viability of the financial operations of the commercial banks. Frequent fluctuation of the requirement may also be a source of instability and uncertainty.

The ECCB Agreement in making it permissible to use investments in government issued and guaranteed securities among the assets that qualify for inclusion among reserve assets has probably introduced a feature which could severely limit the efficacy of

reserve requirements. Even if the ECCB were to be assigned a debt management function it will not be able to exercise adequate leverage on the volume of government securities in the investment portfolio of the commercial banks. Thus a reserve asset (the requirement) which should serve to restrict bank lending capability would become itself a base for credit expansion, thus defeating the monetary control function of the required reserve.

It has been indicated that both discount and open market policies are unlikely to be effective instruments of monetary policy in the ECCA area. Reserve requirements offer prospects of serving as a meaningful monetary tool provided that it is not loaded with built-in deficiencies.

CREDIT POLICY

Credit policy involves the use of the powers of the central bank to achieve the most efficient allocation of loans and to ensure that the mix of deposits accompanied with its rate structure is not inconsistent with the general aims of macroeconomic policy. It employs a number of qualitative controls to regulate the availability and distribution of credit and these may be categorized as follows:

(a) Speculative credit control
(b) Mortgage credit control
(c) Consumer instalment credit control
(d) Interest rate control
(e) Eligibility control
(f) Liquidity control
(g) Informal control

Speculative Credit

Under the rubric of margin requirements, monetary authorities attempt to regulate and control the use of credit for the purchase of securities. It involves the setting of minimum percentage downpayments for purchases of securities or stock as well as the fixing of limits or ceilings on the level of such loans. Margin requirements are usually extended to all institutional lenders.

Historically, it is a device designed to limit speculative purchases of corporate stock and other securities with borrowed funds. Shifts in the level of the requirement could dampen or stimulate activity in the stock market. Prudent enforcement of the requirement may help to minimize the risk of pyramiding stock in a rising market and of forced sales of securities in a falling market.

While such requirements may help to exercise a degree of restraint on stock market speculation by marginal borrowers, the ease of evasion by misrepresentation of the purpose of loans leads one to question their over-all efficacy. It is unlikely that the

ECCB will have to address itself to that type of problem in the foreseeable future.

Mortgage Credit

The thrust of mortgage credit control is on the regulation of the downpayment and maturity terms of real estate loans. Its underlying intent is to influence the level of economic activity in the construction industry and real estate generally.

Real estate credit is usually sensitive to changes in general credit conditions because marginal interest rate adjustments usually have a major impact on monthly mortgage payments and the over-all cost of real estate development projects. Fixed interest rate ceilings are usually used to avoid crowding out house buyers from the credit market. It is thought that such rate ceilings lead to the diversion of funds from the mortgage market when other unregulated rates exceed the ceiling.

This aspect of credit control is particularly important at this time throughout the ECCA territories. The ECCB Agreement in permitting the central bank to prescribe the purposes, aggregate ceilings, maximum amounts, maximum maturities, maximum interest chargeable and minimum cost, margin or security required for advances whether by way of loans or overdrafts has equipped the bank with adequate powers to act in this area of credit activity.

Consumer Instalment Credit

The rationale for consumer instalment credit is to regulate consumer expenditure, which may add to inflationary pressures in the economy. Consumer stalment credit involves the fixing of minimum downpayments and maximum maturities for borrowing to finance the purchase of consumer durables. By employing the technique of direct controls it is expected that the volume of sales of such goods will be affected.

Expenditure on durable consumer goods is generally considered somewhat insensitive to general credit controls, hence the preference for direct controls which can be adjusted to meet the needs of the particular stage of the business cycle.

In practice this tool of credit policy tends to have a discriminatory impact on specific industries and groups in the community and it is sometimes condemned as a threat to economic freedom. A few central banks, such as the Federal Reserve of the U.S., have avoided controls on consumer credit because of problems of administration and enforcement.

Given the traditional emphasis of locally based financial institutions on the financing of imports of consumer durables and the significant leakage of scarce foreign exchange through this medium, the ECCB will be expected to activate this instrument to safeguard the economy from the abuse of consumer instalment credit.

Interest Rate Control

Interest rate control is attempted by the establishment of ceilings on the rate of interest which commercial banks may pay on savings and time deposits. The ceiling is often pegged at a relatively low level as a form of protection for savings institutions and the mortgage market against price competition from the commercial banks. Since the ceiling applies to the interest-bearing liabilities of one segment of the credit market, it is a discriminatory device to encourage the flow of funds to the uncontrolled sectors.

Nonbank thrift institutions because of the structure of their assets tend to be at a disadvantage in competing for funds particularly during periods of credit restraint. Compared to commercial banks whose assets are varied and mainly of a short-term liquid nature, the portfolio of mortgage corporations, for instance, is tied in mortgage loans which are long-term and illiquid assets. The turnover of such loans is very slow and yield adjustments tend to lag behind market interest rates. While the assets of these institutions are at the long-end of the maturity spectrum, their deposits are usually of a short-term variety responsive to the pressures of competing rate alternatives especially in periods of rising interest rates. Without the safety valve of a rate ceiling, these nonbank financial institutions may be forced to adjust their rates upward to safeguard their deposits with consequential erosion of their profitability and impairment of their solvency.

The use of deposit rate ceilings in the ECCA area will need to be balanced by comparable restraint on lending rates. In the oligopolistic banking situation that prevails in the area, it could serve as an unsolicited subsidy to commercial banks whose lending rates tend to be very sticky downwards.

Eligibility Control

Eligibility requirements grant the central bank the option to determine which bills are eligible for rediscounting and acceptable as collateral for advances. Where discounting is an established medium of financing, eligibility privileges could influence movement of resources to eligible instruments and the issuers of these instruments. To that extent it fulfils an allocative function.

It has been indicated that the absence of an active securities market and the continued reliance by commercial banks on Head Office to sustain their liquidity levels make it unlikely that discounting policy will be effective in the ECCA area. Without discounting, eligibility requirements are largely meaningless.

It should be noted that the instruments which qualify as collateral for advances by the ECCB are already specified in the ECCB Agreement.

Liquidity Control

Liquidity control is pursued by the institution of liquidity requirements in the form of minimum and variable liquid asset ratio. The essence of the requirement is that it allows the central bank the discretion to determine which assets are liquid. It is as such not so much an instrument of restraint as it is an instrument of public debt management. The allocation of credit to the public sector is often fostered through liquidity requirements. The cost of public debt is restrained without overtly pegging the rate on government securities.

To the banking system liquidity requirements are preferable to reserve requirements since interest is earned on eligible securities unlike required reserves on which interest is not payable. The enforcement of a liquidity asset ratio may be said to protect the profitability and solvency of the commercial banking system while it helps in the development of a money market.

The ECCB Agreement does not provide for the imposition of liquidity requirements and in this respect denies the central bank a vital instrument for exercising leverage on the investment portfolio of the commercial banks.

Informal Control

Informal control is sought through moral suasion, a kind of "friendly persuasion" which is often reflected in policy statements, public pronouncements, appeals, etc. It is really an effort to achieve a given objective by the "voluntary" cooperation of financial institutions. Moral suasion is sometimes supported by the threat of sanctions, and warnings about the potential deleterious effects on the economy of non-compliance. Informal agreements are not an unusual result of the use of moral suasion.

How successful moral suasion is likely to be is often dependent on the number of institutions involved, the degree of competitiveness, existing profit levels, the effect on the profitability of the operations of the institutions affected as well as the nature, frequency and duration of the request for cooperation. There are, however, the usual evasions, which ultimately lead to a breakdown of the understanding.

In the ECCA area where the number of financial institutions is relatively limited and where the operations of the banking system can be subjected to a great measure of surveillance, the potential efficacy of the informal approach should not be automatically dismissed. The risks inherent in breaches of informal agreements are much greater in small states and could serve as a disincentive to evasion.

REGULATION AND SUPERVISION

The function of regulating and supervising the financial system, particularly the banking system, has been delegated in most countries to the central bank.

The regulatory aspect of the function is designed to achieve compliance with the requirements of law pertaining to the function, structure and operations of financial institutions. These regulations are often enshrined in general banking and central banking legislation. In such legislation financial institutions may be required to maintain

(a) minimum levels of liquidity
(b) specified local asset ratio
(c) minimum capital base and required relationship between capital and deposit liabilities
(d) given level of reserves with the central bank and
(e) specified records for submission to the authorities, etc.

The regulatory mechanism in essence seeks to ensure propriety and prevent improper institutional behaviour calculated to circumvent the intent of law. It is therefore mainly a police function.

The supervisory role applies to those activities designed to promote the health and sanctity of the financial system. Safety, soundness and solvency are its prime concern and the maintenance of confidence in the financial system its ultimate objective. In this capacity the supervisory authority can advise, caution, warn and report and in so doing minimize the possibility of institutional insolvency, which could undermine public confidence in the safety of their financial investments.

The ascendancy of foreign owned financial institutions in the monetary system of the ECCA territories emphasizes the need for effective regulation and the emergence of indigenous institutions makes a proper system of supervision a vital safety mechanism for the future development of these institutions.

In these territories the multiplication of supervisory agencies would be the surest road to mediocrity of performance and achievement. The management base cannot at present sustain it. It is for this reason that financial intermediaries and the fledgling development agencies should be brought under the surveillance of a central institution equipped with staff of the calibre required to supervise their operations. The future may well be saddled with the cost and relics of colossal financial fiascoes unless urgent steps are taken to ensure that our indigenous institutions fulfil the purpose and promise of their creation.

The ECCB has a part to play in this effort. The limited nature of the supervisory role envisaged in the provision of the ECCB Agreement is unlikely to assist the central bank to supervise the financial institutions fully and effectively.

SERVICE FUNCTIONS

There are a number of services which the ECCB like every other central bank will be required to provide the governments and financial institutions of the area.

Government

Fiscal Agent and Banker

As contemplated in the ECCB Agreement the central bank could serve the function of fiscal agent and banker of the government. Because of its control function within the monetary system the central bank must have a close working relationship with government, whose financial operations have a major influence on the direction of the economy.

How this function is performed by the ECCB should be examined in the light of the emergence of a number of indigenous banks in the area. It may require a distinction between the internal fiscal operations and the external fiscal activities of governments, the former assigned to indigenous commercial banks and the latter reserved for the central bank. There are other permutations which may be considered to suit the varying needs of the different territories.

In these small territories fluctuations in the receipts and payments of governments affect the reserve of the banking system in a manner comparable with open market operations. A government surplus would be the equivalent of a sale of securities to the commercial banks, which has the effect of contracting commercial bank reserves and their capacity to expand credit.

The fiscal and banking functions of the central bank facilitate the development of healthy institutional ties with the financial departments of government and place the central bank in a position to advise government on fiscal and monetary matters.

Debt Management

The debt operations of governments are often undertaken by central banks. In the ECCA territories the need for this will be more than a matter of mere administrative convenience. Confidence of financial institutions that investments in government instruments are not lifetime obligations but liquid investments which may be sold should it become necessary to augment reserves to cope with the demand for credit by their customers will be an important contribution which the central bank nexus will make to debt management. Moreover the logistics of issue and redemption could be more effectively planned to encourage the development of a short-term money market.

Foreign Exchange Management

Central Banks have come to be recognized as the main custodian of the foreign exchange reserves of a country. As such foreign exchange management is one of the government assignments to its central bank. The crucial role of foreign exchange in the development process makes it necessary to conserve foreign exchange earned and to protect as far as possible its external value by prudent investment and deployment.

The administration of exchange control regulations is therefore an important service function of a central bank. A necessary precondition for the exercise of this function by the ECCB is the enactment of uniform legislation for the territories. Complementary to this will be the establishment of a regional ministerial forum to determine general policy guidelines, a matter which will be discussed further in considering the structural arrangements for the ECCB.

While policy and operational directions should emanate from the centre, the actual exchange control operations will be decentralized. Administrative convenience and efficiency ordains this.

Currency Management

The currency function has long been regarded as one of the principal tasks which a central bank should perform on behalf of governments. It involves the printing of notes and the minting of coins as well as the administrative arrangements for the issue and redemption of the currency. Apart from the inventory and supply function, there is a major security undertaking associated with this exercise.

The problems which the ECCB will encounter in this field will not be new, since it will be taking over an existing function of the ECCA.

International Financial Relations

A sensitive and challenging role undertaken by central banks is in the area of international financial relations. With the movement towards independence in these territories, membership of various international financial organizations will inevitably follow. The advice and guidance of the central bank on complex international financial and monetary issues will be necessary.

The advisory role of the central bank will loom large in negotiations with the IMF particularly for balance of payments support. Undertakings to and understandings with the IMF must not be allowed to prejudice the interest of other members in the common currency area. Unilateral undertakings on the exchange rate must be explicitly excluded as a basis for negotiations by individual governments with the Fund. This is one reason why the central bank should be very visible around the negotiating table

lest overzealous IMF officers wrench invidious commitments from individual governments whose financial condition may predispose them to accept unpalatable preconditions, which may directly affect the economic interests of other members of the currency union.

The survival of the regional monetary arrangements probably hinges on the role the ECCB is required to play in international financial relations.

The negotiation of foreign loans and the issuing of bonds in the international money market are areas where the central bank can be of maximum assistance to governments. The regular contact and affinity which the central bank develops with foreign financial institutions, both public and private, enables it to assess the money market and advise governments on the timing of bond issues, the selection of lead managers, the maturity structure of foreign debt, market conditions, the interest coupon etc. In fact, the central bank can serve as a cost-saving source of financial intelligence.

Commercial Banks

The bankers bank is invariably the central bank. The benefits from the service are mutual. Commercial banks are provided through this medium a facility for ready settlement of inter-bank indebtedness while the central bank is afforded daily information on the reserve position of the banking system. Complementary to this is the cheque clearing facility which is provided the banking system, a facility which helps to minimize the extent and duration of float in the system and to effect expeditious settlement of outstanding inter-bank balances.

The central bank affords the commercial banks ready access to currency to meet their customers' demands as well as the facility for redemption of excess cash in their vaults. The discount window of the central bank is usually open for use by commercial banks, a service which often entails a hidden subsidy to the banking system.

Services of this nature will not be a novelty to the ECCB since the ECCA, which it is to replace, is already fulfilling these ancillary obligations.

DEVELOPMENT FUNCTIONS

Central banks in the developed world were conceived as economic regulators - institutions to help to keep the economy on an even keel and to maintain the value of the currency, primarily the external value. In the Third World central banks are perceived not as mere instruments of regulation but as indispensable catalysts in the development process.

If the ECCB were to be conceived in the traditional image it might as well remain unborn. It could conceivably avoid creating the conditions which lead to economic instability but it will not be in a position to prevent the incursion of those external forces which are the primary sources of instability in open dependent economies. External prices and demand for the primary products of the area, the extent of foreign aid, the number of foreign tourists and the level of their expenditure, the extent of inward remittances, etc., and the net balance of payments effects of these variables are "acts of God" and therefore totally outside the purview and control of a mortal central bank.

But a central bank has within its grasp the miracle of money, which has the unique capacity of appearing locally and disappearing externally. It holds foreign exchange reserves, which we now know is capable of depletion (our colleagues in the central banks of Guyana and Jamaica know all about these slippery US dollars). The upshot of this play on words is that the central bank has the means for the promotion of development but the foreign exchange base is never infinitely elastic.

The ECCB must be expected and required to use its resources within reasonable limits to bolster and boost development. In doing so, it cannot afford wasteful duplication of the activities and services which development banks and development finance corporations are designed to provide.

Just as it has the power to lend to foreign financial institutions with all this entails in the way of subsidy so must it be given the flexibility and option to lend to indigenous institutions involved in the development process. It is sometimes overlooked that development institutions must first be provided with financial resources if they are to finance industrial development.

The ECCB Agreement envisages this role for the central bank. Whether the limits and conditions attached in the relevant provisions are ideally suited to balance flexibility with prudence is a moot point.

Central banks must have the option to invest in securities of their choice according to circumstances and prevailing conditions. Legislative prescriptions in these matters in delimiting the means often defeat the end.

Prudence without development is certainly not a realistic alternative to development without prudence. The proper alternative is development with prudence, development pursued in the knowledge that the central bank cannot print foreign exchange.

STRUCTURE OF THE CENTRAL BANK

The assignment of functions to any institution may be a necessary preliminary requirement for it to perform; it is by no means a sufficient condition for effective performance. An indispensable concomitant is a congruent structure. The functions assigned to the ECCB will have to be performed within an institutional setting the structure of which will determine how policy is formulated, approved, implemented and evaluated.

Central banks in unitary and federal states are usually endowed with a three-tier structure:

The Minister of Finance	-	policy (general)
Board of Directors	-	policy (institutional)
Management and Staff	-	execution

As the structure suggests the ultimate source of authority in the system is the Minister as representative of the government. In this respect there are specified areas of policy of major political and economic significance which require the prior approval of the Minister before action can be taken by the Board. One of these involves measures to control the cost and terms of credit. Another is the exchange rate.

There are however a number of areas of policy considered to be internal to the central bank ultimate authority for which resides in the Board of Directors, e.g. staff matters, charges for its various services, etc. The Board of Directors is in effect assigned responsibility for the policy and general administration of the central bank subject always to the Minister's authority to issue directives to the Board.

Management and staff are expected to run the organization and to implement faithfully the decisions of the Board and the directives of government. A major function of the executive arm of the central bank is also to assist the Board in the formulation of policy.

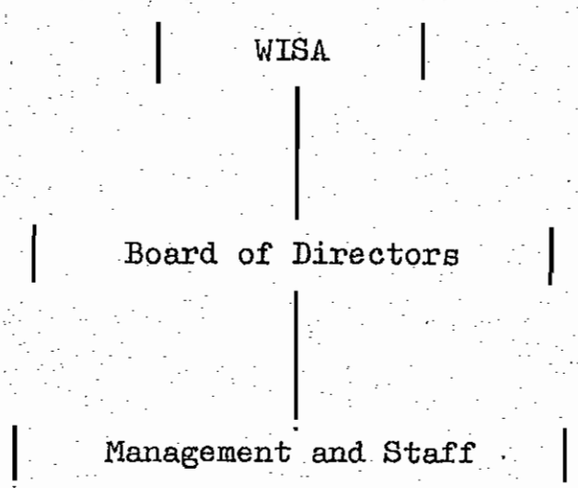
The evaluation of the activities of the central bank is normally carried out through reporting, auditing and parliamentary discussion. Coordination is achieved through periodical discussions between the Minister and his senior staff with the Governor and Deputy Governor of the central bank as well as joint economic committees where the state of the economy is assessed and policy alternatives are examined. From such informal arrangements a consensus tends to emerge. Government is made aware of the views of the central bank and the directors and senior staff of the bank are kept informed of the thinking of the government on general and specific economic issues.

The question that arises is whether this tripartite structural model is suited to a multinational central bank such as the ECCB. There is nothing in the three-level hierarchy per se which appears potentially inconsistent with the efficient administration of the central bank and expeditious decision-making at the policy level.

The problem is not in the number of levels but in the composition and character of the first level of the hierarchy. The ECCB will be serving seven separate States with seven Ministers of Finance. The central bank cannot be expected to report and be responsible to seven ministers individually. That would tantamount in effect to seven central banks operating under the guise of a common designation. The inconsistencies, contradictions and conflicts of policy which would emerge would ineluctably lead to the dismantling of the central bank.

The immediate solution which comes to mind is the formation of a coordinating body of Ministers of Finance to which the Board of the central bank would be responsible. The current institutional arrangements of the ECCA territories entrust ultimate decision-making powers to the West Indies Associated States Council of Ministers, which in theory consists of the Prime Minister of Grenada, five Premiers and one Chief Minister but in practice Ministers representative of all the portfolios of government attend in a representative capacity at one time or another depending on the matters on the WISA Agenda.

There are two implications which are of immense moment to the future and potential effectiveness of central banking in these territories. Unless a revised model is accepted to meet the special needs of the ECCB the structure is likely to be either



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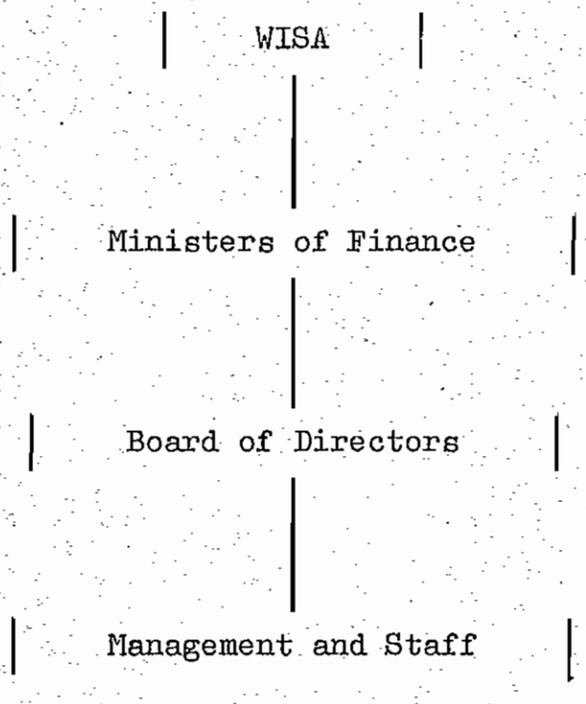
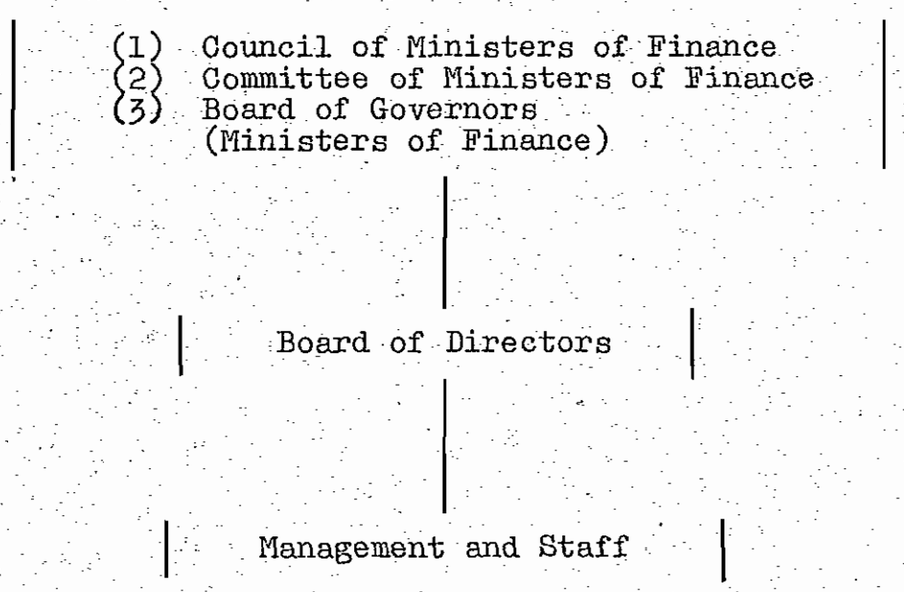


Under the first alternative the WISA Council which for practical purposes is an unstructured body of Ministers meeting from time to time to discuss an amorphous assortment of matters will be the decision-making power for ECCB policy issues. There is the grave risk that those States that are represented by Ministers other than Ministers of Finance may merely note the finance matters for reference on return to their territories to the relevant Minister. This bodes ill for expeditious policy-making, an important requirement in the monetary policy field where quick decisions are often called for to forestall the possibility of premature leaks which could stimulate speculative activity inimical to the public interest.

The second alternative compounds the problem by lengthening the decision-making hierarchy. The decisions of the Ministers of Finance would have to be ratified by the WISA Council. If it is often difficult to get one group of Ministers to meet, it does not require much imagination to appreciate the nature of the task of securing the attendance at meetings of two different groups of Ministers.

Each of these alternatives appears unsuited to the needs of the central bank. It is for this reason that proposals have been mooted to make the primary policy making body a homogeneous group of Ministers with full decision-making powers. The titles given to the group have not always been identical but the underlying intent is the same. The proposed structure would be as follows:-



Whatever the designation the intent is to establish a forum with authority to decide. The proposal is not only feasible but appears likely to gain acceptance in view of the 1976 precedent when Ministers of Finance took the final decision which led to the termination of the EC dollar link to sterling.

The division of functions between the body of Ministers of Finance and the Board of Directors need not present much of a problem. Within the existing ECCA arrangements there is a division of powers which should merely be extended to incorporate the additional functions assigned to the central bank. Exchange control policy, debt management policy, credit policy, exchange rate policy and monetary policy should be pursued within the limits of policy guidelines emanating from the Finance Ministers. These are areas of activity which have significant implications for general economic management and which may impinge heavily on the economic policies of individual States. In effect, these are policy pursuits which must be coordinated if the common currency and reserve pool are not to be buffeted by the contradictory pulls and pushes of inconsistent actions at national level.

The functional operating structure of the central bank also appears to be a cause of concern. The structure of the central bank must be congruent with the geographical structure and the political realities of the area. A wholly centralized central bank to serve seven separate independent political entities is neither desirable nor prudent. The ECCB must have a regional image as well as a national identity. It needs to centralize those services amenable to performance at the central level most efficiently and at least cost and to decentralize those operational activities which lend themselves to localization and effective implementation within the separate units. To illustrate:

Service	Centralized Activities	Decentralized Activities
Currency	Arrangements for printing of notes and minting of coin. Maintenance of central stock. Supplies to territories. Central currency records. Security arrangements. Matters such as denominations, designs, sizes, etc. would require prior Ministerial approval.	Issue of currency to commercial banks and redemption. Destruction and cancellation of mutilated notes. Maintenance of local currency stocks and records. Local security arrangements. Purchase of foreign exchange from authorized dealers. Repatriation of foreign currency to centre. Scanning of currency for forgery.
Exchange Control	Directives and instructions to authorized dealers. Design and content of exchange control forms. Limits on exchange approvals for different types of requests e.g. gifts, foreign travel, etc. Guidelines for local officers. Consolidated exchange control statistics. Approval of applications for authorized dealer status. Interpretation of Exchange Control Regulations etc.	Processing of application and approvals. Record keeping. Exchange Control statistics. Local dealings with authorized dealers. Reports. Consultation with centre on problem issues. Printing of forms, etc.

The thrust of the foregoing is that in addition to headquarters there would be an agency of the central bank in each of the other six territories. Even in unitary states central banks have found it administratively convenient and economically expedient to establish agencies in the main cities. The United States with its federal structure has imbued its central bank, the Federal Reserve System, with a federal structure comprising twelve Federal Reserve Banks. What is relevant in the US arrangement is the recognition of the need to give their central bank a federal as well as a state identity. There are policy decisions which can only be taken at the centre, e.g. target growth rate of money supply, and those that are delegated to Federal Reserve Districts, e.g. discounting though the discount rate is subject to central approval.

The multinational composition of the ECCB posits the need for structural features consistent with this character. The survival of the ECCB will probably rest on the nature of the policy-making and operational model adopted.

PROSPECTS FOR CENTRAL BANKING

The prospects for central banking in the ECCA territories are not clear. There are numerous imponderables which would make it foolhardy to attempt to divine the future course of events. Political history offers only guarded pessimism; present day economic realities encourage a residual hope. The fissiparous propensities that mark our history are balanced by a recognition of the serious deficiencies in the monetary arrangements of these States and a realization more or less that a common approach offers the best prospect for economic salvation.

The central bank, if it should be given the breath of life, will be faced with such problems as the coordination of fiscal and monetary policy, achievement of consensus on credit policy, balancing monetary and credit policy with uneven economic conditions prevailing in the unit territories. Such problems are not peculiar to the character of the ECCB. They are problems which central banks in unitary and federal states continually face.

Given an appropriate policy-making structure, the means for coordination and attainment of consensus will be available. There are possibilities for differential discounting practices, which the central bank can implement subtly and without fanfare to assuage the discriminatory territorial effects of uniform monetary or credit policies.

Central banks have yet to find the perfect instrument of monetary policy. All the known permutations have identifiable strengths and weaknesses. The impact of these instruments remains a matter of vehement debate among economists.

The ECCB like other central banks will have to live with the imperfect tools at its command and hope over time to arrive at a combination of policies and practices that best meet the needs of the area.

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