Budget Alert 3.2 Policy Options for Managing the Economy

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The policy options for managing the economy should become common knowledge to enable public participation in the process of economic development and transformation. The main policy options for managing the economy are monetary policy, fiscal policy, and structural policy. Monetary and fiscal policies are most commonly referred to as they have a direct impact on economic agents and the subsequent influence on national income. Structural policies are usually ongoing, but the impact is sometimes subtle and manifested over the medium-term.

The policy options are aimed at directing the level of economic activity and changing the structure of the economy. Monetary policy, which is generally conducted by the Monetary Authority, refers to the use of interest rates, commercial banks reserve requirement and open market operations to affect the availability of money in the economy, and influence the direction of economic activity. Fiscal policy is the authority of governments to raise revenue and use such funds to provide goods and services; impacting on the wellbeing of the population and the level of economic activity. Structural policies are aimed at improving the productivity of industries and sectors; and changing the structure of the economy. Among these policy options, monetary and fiscal policies have a more immediate and direct impact on national income.

There was active monetary policy globally and in the ECCU during the Covid-19 Pandemic and its aftermath. The common monetary policy instrument applied was the interest rate. With the onset of the Covid-19 Pandemic, the monetary authorities reduced the interest rates for lending to financial institutions and governments. The main objective was for financial institutions to reduce their lending rates, leading to cheaper cost of funds, expansion in credit and ultimately to growth of money in circulation and economic activity.

Active interest rate policy continued to be pursued in the aftermath of the Covid-19 Pandemic. The disruptions in supply and distribution chains which were further aggravated by the Russia/Ukraine war resulted in a period of unprecedented inflation. The monetary authorities in the advanced economies, which operate with targeted inflation rate, aggressively increased interest rates. The objective was to reduce credit and the money in circulation in order to align the money supply with the available goods and services.

Among the advanced economies, the Federal Reserves of the USA reduced the interest rate from 1.75 percent in 2019 to 0.25 percent in 2020, aimed at halting economic contraction. Thereafter, as inflation soared, interest rates increased steadily to 5.00 percent by March 2023. Also, the Bank of England reduced its official bank rate from 0.75 percent in 2019 to 0.10 percent in 2020, and similar to the other monetary authorities, it increased the official bank rate to 4.25 percent by

March 2023. During the Covid-19 Pandemic, the European Central Bank maintained a fixed rate of 0.0 percent, and to curb inflation, it increased its rate to 3.25 percent by2023.

This inflationary period was brought about by both supply and demand factors. On the supply side, the shortages brought about by the disruption in the supply and distribution chains were manifested in higher prices. This was combined with the availability of money due to the expansionary fiscal and monetary policies pursued during the Covid-19 Pandemic. These conditions created an ideal inflationary environment. Therefore, a combination of structural, fiscal and monetary policies, in a coordinated manner, is necessary to address the inflationary period.

In the ECCU, the Eastern Caribbean Central Bank (ECCB) pursued an expansionary monetary policy stance. It reduced the discount rate, the rate at which commercial banks and governments borrow from the ECCB, from 6.5 percent to 2.0 percent in April 2020. The objective was to make funds available to these entities at a cheaper rate, and to signal to financial institutions to reduce lending rates. This monetary policy stance had not occurred since the 2001 to 2003 period, when the discount rate was reduced from 8 percent to 7 percent in 2001, and then to 6.5 percent in 2003. In these periods of expansionary monetary policy stance, the policy decisions were undertaken in the context of slow economic growth.

The impact of monetary policy in the Eastern Caribbean Currency Union is generally limited. During the 2001 to 2003 period of monetary policy, the commercial banks had not traditionally resorted to the ECCB for financing, and hence the limited impact of the interest rate policy. During the Covid-19 Pandemic, the banking system was liquid resulting in low demand for liquidity from the ECCB. Therefore, interest rate developments in the commercial banks, as assessed by the average lending rates on loans and advances did not diverge significantly from the rates prior to the Covid-19 Pandemic. There was an increase in borrowing from the ECCB by the commercial banks in a few member countries in 2021, which subsided to the pre-Covid-19 level in 2022.

The other interest rate policy instrument available to the ECCB is the 2.0 percent administered Minimum Savings Rate. This rate was reduced from 4 percent to 3 percent in 2002 and then to 2 percent in 2015. In establishing the Minimum Savings Rate, it was intended to encourage savings by maintaining a positive real interest rate, that is, an interest rate that is above the inflation rate. Its reduction in 2015 deviated from this position, and it was anticipated that with the reduction, commercial banks would lower the interest rates on loans to stimulate investment and the economy.

If the administered Minimum Savings Rate is to maintain a positive real interest rate for depositors, an upward adjustment is warranted during this inflationary period. However, liquidity

in the banking system is high, and incentives are not needed to attract deposits. With the mix of products offered by the commercial banks, interest rates on deposits have been lower than the Minimum Savings Rate resulting in negative real interest rates. Additionally, commercial banks are profit oriented institutions, and with high liquidity, upward adjustment to the administered Minimum Savings Rate could increase cost to commercial banks for holding funds. This could ultimately lead to higher lending rates, constraining the growth in loans and advances and ultimately in economic activity.

The other major monetary policy instruments are reserve requirement and open market operations which are not applied in the ECCU. The structure of the financial sector does not allow for the pursuit of effective monetary policy. Therefore, in the ECCU, fiscal policy is the dominant policy used to influence economic activity and improve the well-being of the population.

Knowledge is power and experience is the greatest teacher.

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