Analytical Evidence to Support Guyana's Green State Development Strategy: Vision 2040

Fiscal and Monetary Policy

Table of Contents

Table of Contents ....
List of Figures ....
Box ....
1 Fiscal and Monetary Policy 1
1.1 Fiscal policy 1
1.2 Monetary policy (including exchange rate and capital account) 5
2 Conclusion 7

List of Figures

Figure 1: Guyana’s Central Government Debt
Figure 2: Guyana’s Fiscal Deficit
Figure 3: Guyana’s Debt Maturity Profile
Figure 4: Official Development Assistance as a % of GDP
Figure 5: Guyana’s Exchange Rate Profile
Figure 6: Guyana’s Inflation Level

Box

Box 1: Optimum and maximum levels of debt

A1. Fiscal and Monetary Policy

A1.1. Fiscal policy

Like much of Latin America, Guyana struggled with falling commodity prices, budget deficits and high external debt throughout the 1980s. Guyana suffered large public sector deficits and a ballooning debt-GDP ratio (over 700% in 1987). This culminated in an IMF-led austerity and restructuring package introduced in 1988, the Economic Recovery Program (ERP), which combined fiscal reforms with international support. The ERP stabilised the economy and external debt levels. It was not until the Inter-American Development Bank (IDB) cancelled USD 470 million of debt in 2007, however, that the net debt-to-GDP ratio fell significantly, from around 80% to under 50%, as shown in Figure 1.

Figure 1: Guyana's Central Government Debt

Note: Net debt is equal to gross debt minus central government deposits in the banking system. In 2016, central government was borrowing from the central bank, therefore, central government had no deposit and the net debt is equal to gross debt.

Source: IMF World Economic Outlook Database, April 2017

Box 1: Optimum and maximum levels of debt

There is little consensus about the 'optimum' level of public debt for a country. Public debt comes with the associated cost of interest payments, although these can be outweighed if the debt fuels productive investment with a higher social rate of return. Even where debt is used to support social expenditure, it may be desirable in a rapidly growing economy as a means of borrowing from future generations which are expected to be better off than current generations. Benchmarks of 40% - 60% are often used as ceilings on debt to ensure sustainability: for example, the Maastricht Criteria for economic convergence (the prerequisites for joining the euro) stipulate a limit of debt-to-GDP of 60% (although in practice many countries have breached this ceiling). The IMF often refers to a 40% threshold for developing countries, although notes that breaching this cap does not necessarily imply a crisis. The World Bank (2006) set thresholds for defining 'highly indebted' countries at '150 percent for the ratio of the net present value of debt (NPV) to exports of goods and services and 250 percent for the ratio of NPV to fiscal revenue,' implying a threshold of around 75% of GDP for Guyana (based on fiscal revenues of around 30%). Studies have suggested debt limits of around 150% - 260% of GDP for advanced countries before triggering a crisis.

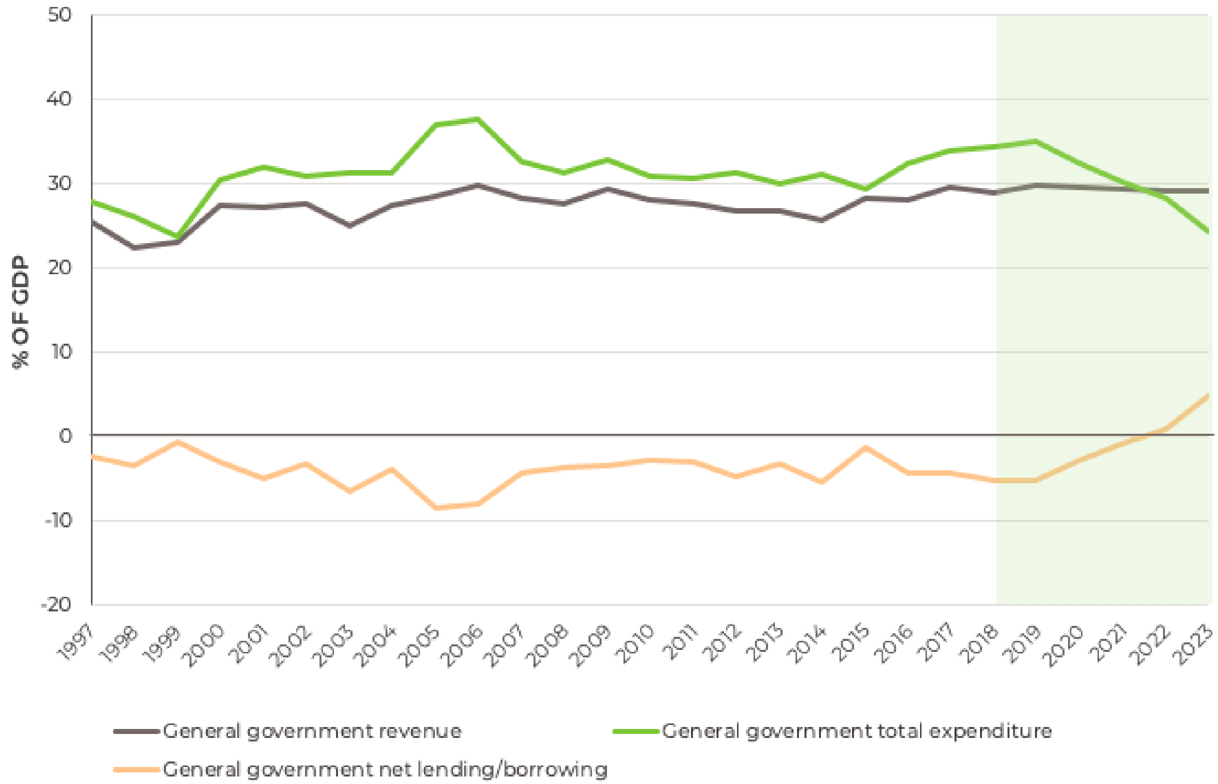
Direction of change is often considered more important than the absolute level of debt. If the budget deficit is greater than the rate of GDP growth, this implies that debt (and therefore interest payments) are growing faster than the overall economy, whilst that ratio will stay stable when the budget deficit is equal or less than the rate of growth. Thus, a country with a high but falling level of debt may be less at risk from a crisis in confidence than a country with lower total debt but high budget deficits.

Where high levels of debt exist, the impact of trying to run government surpluses (through high taxation and austerity) on growth may be costly, and the preferred strategy is often to 'grow away' the debt over the longer term

Continued growth in the economy since 2006 has allowed the Government to run a consistent budget deficit whilst maintaining a stable debt-to-GDP ratio. Figure 2 shows that from 2009-2014, revenues and expenditure both fell relative to a growing economy. Since 2016, public expenditure has accelerated.

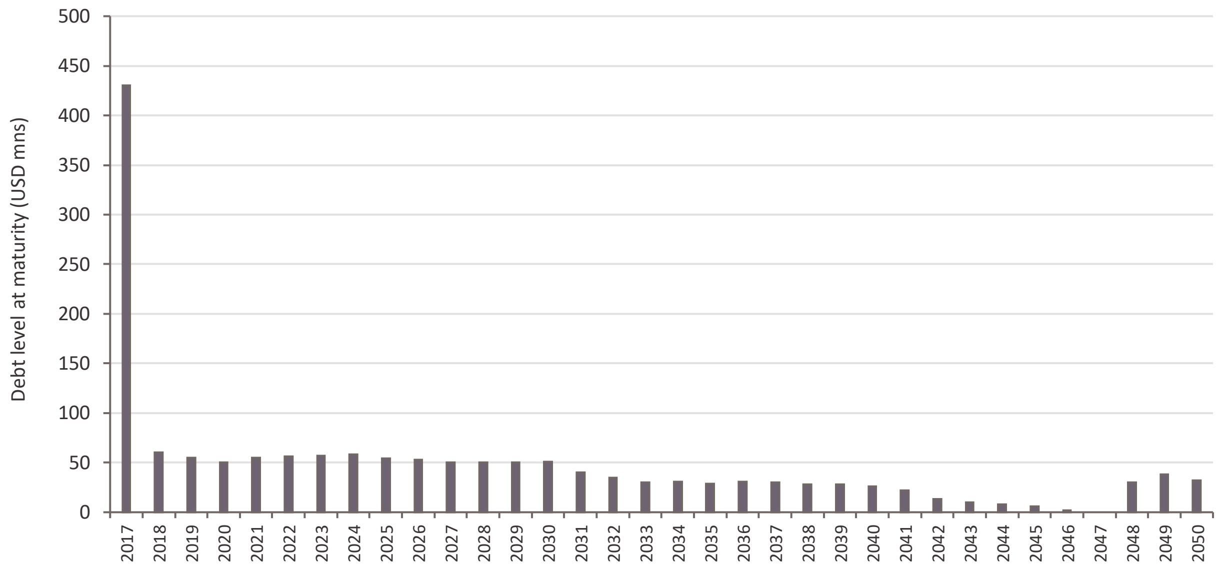
Guyana has limited options in raising public debt. It lacks a sovereign risk rating by major international credit ratings (not unusual for a country of its size and income level). The majority of its debt is short term treasury bills held by the domestic banking sector, as shown in Figure 3. This leaves it vulnerable to short term changes in interest rates and the IMF has recommended exploring longer term bonds as an alternative which would be more conducive to longer term infrastructure investments.

Figure 2: Guyana's Fiscal Deficit



Source: IMF World Economic Outlook, April 2018

Figure 3: Guyana's Debt Maturity Profile

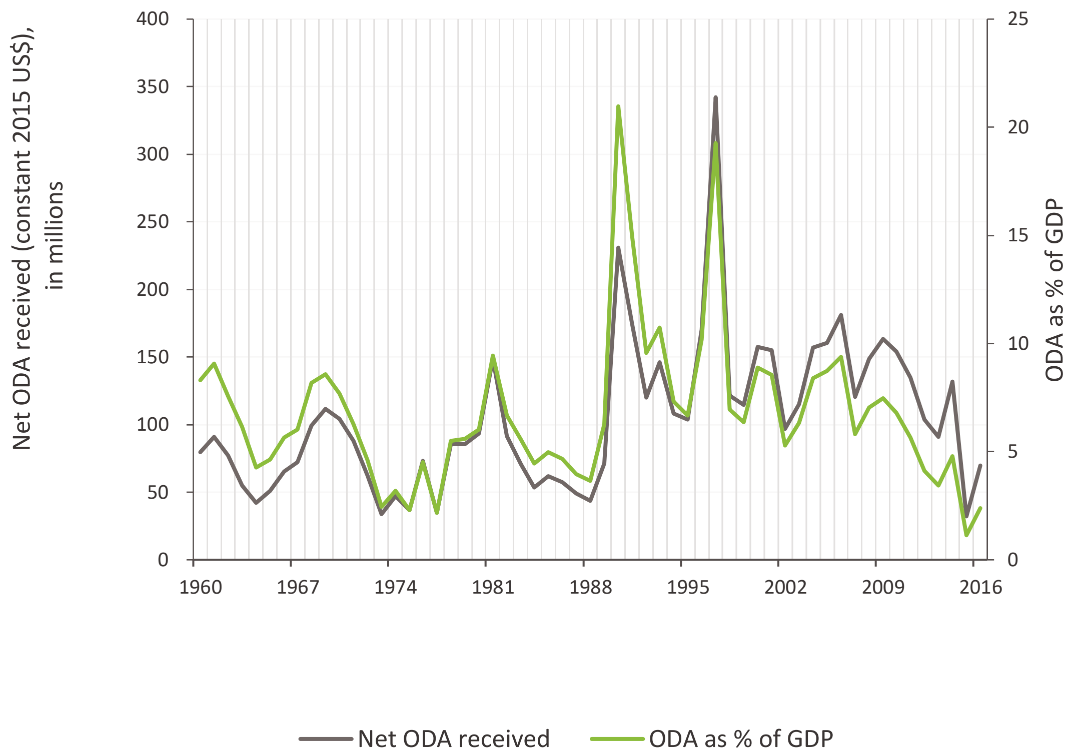


Source: IMF Country Report 17/175, June 2017

Guyana has hitherto demonstrated some restraint in public expenditure. Government spending has risen steadily since 2015, from 29% of GDP to a projected 35% in 2019. Capital expenditure is taking an increasing share of Government expenditure, up by 28% in the 2018 budget from the 2016 budget and accounting for around 22% of overall public spending. However, the latest Concluding Statement from IMF Staff recommended moderation in expenditure increases.

Official development assistance has made an important contribution to the economy over the past three decades but has declined in significance. ODA has supported the provision of public goods and services in Guyana, such as infrastructure, health and education, relieving pressure on government budgets. Figure 4 shows that for most of the period between 1990 and 2010 ODA has accounted for over 5% of GDP. However, as the economy grows, ODA has been declining in both absolute and relative terms, to less than 3% of GDP in recent years.

Figure 4: Official Development Assistance as a % of GDP



Source: The World Bank

Oil production will dramatically change the fiscal landscape and become the largest single source of public revenue. Estimates of oil reserves and expected daily production vary between different sources and the government has yet signed only one production sharing agreement. The IMF estimates that, by 2023, oil production could reach 250,000 barrels per day and public revenue from oil exports could exceed GYD 160 billion, roughly equal to total central government revenue in 2015. Other reports suggest production, oil prices and public revenue could be even higher.

This will ease pressure on the public budget and facilitate an expansive new program of expenditure, but also place significant demands on public institutions to manage new economic risks. International experience shows that natural resource wealth does not necessarily lead to broad-based improvements in development and, in some cases, can introduce damaging volatility to fiscal revenue and economic performance. Venezuela and Trinidad and Tobago

illustrate the risks of windfall resource wealth; expenditure closely tracks oil revenue which in turn closely tracks international oil prices. Efficient and stable public spending requires regulatory checks and balances upheld by strong and accountable institutions.

Guyana's current public sector does not have the capacity to effectively plan, procure and manage such a large expenditure program. The social programs and infrastructure investments needed to translate natural resource wealth into sustainable income growth are large and long term. Guyana's current annual budgeting framework makes this challenging to manage and align with its long-term development ambitions. With such high-value and complex projects, it can also be difficult to assess potential contractors' ability to deliver the work, monitor and manage progress, and ensure fiduciary responsibility and accountability.

A1.2. Monetary policy (including exchange rate and capital account)

Most economies face a macroeconomic trilemma, they can only have two of the following: an independent monetary policy, a fixed exchange rate and unrestricted capital flows. As part of the Economic Recovery Programme (ERP), Guyana liberalised financial markets and removed exchange rate controls. It now has a floating (but managed) exchange rate, unrestricted capital flows and a mostly independent monetary policy (although some direct intervention is continued to keep the exchange rate stable).

Initially, the easing of controls on foreign exchange and the realignment between official rates and market rates resulted in a significant devaluation, from GYD 10 per US dollar to GYD 33 in 1989 and GYD 45 in 1990. In 1991 Guyana adopted a floating exchange rate and the exchange rate stabilised at around GYD 125-140 per US dollar in the early and mid-90s, and then at around GYD 200 in the 2000s. Since then, it has been allowed to float within a narrow band against the dollar and has seen some appreciation, as shown in Figure 5.

The collapse in the value of the currency led to extraordinarily high inflation rates, of above 20% between 1987 and 1992, and peaking at over 100% in 1991. Since then, macroeconomic stability has returned and inflation has averaged 5%, reaching double digits just once in 2007 (12%), in a year of rapid economic growth (7%). Inflation in 2017 was 2.1% and is forecast at 2.6% for 2018, creating a stable price environment (Figure 6).

Monetary policy is overseen by the Bank of Guyana under the Bank of Guyana Act No.19 of 1998. The principal objective of the autonomous Bank is:

"Within the context of the economic policy of the Government, the Bank shall be guided in all its actions by the objective of fostering domestic price stability through the promotion of stable credit and exchange conditions, as well as sound financial intermediation conducive to the growth of the economy of Guyana."

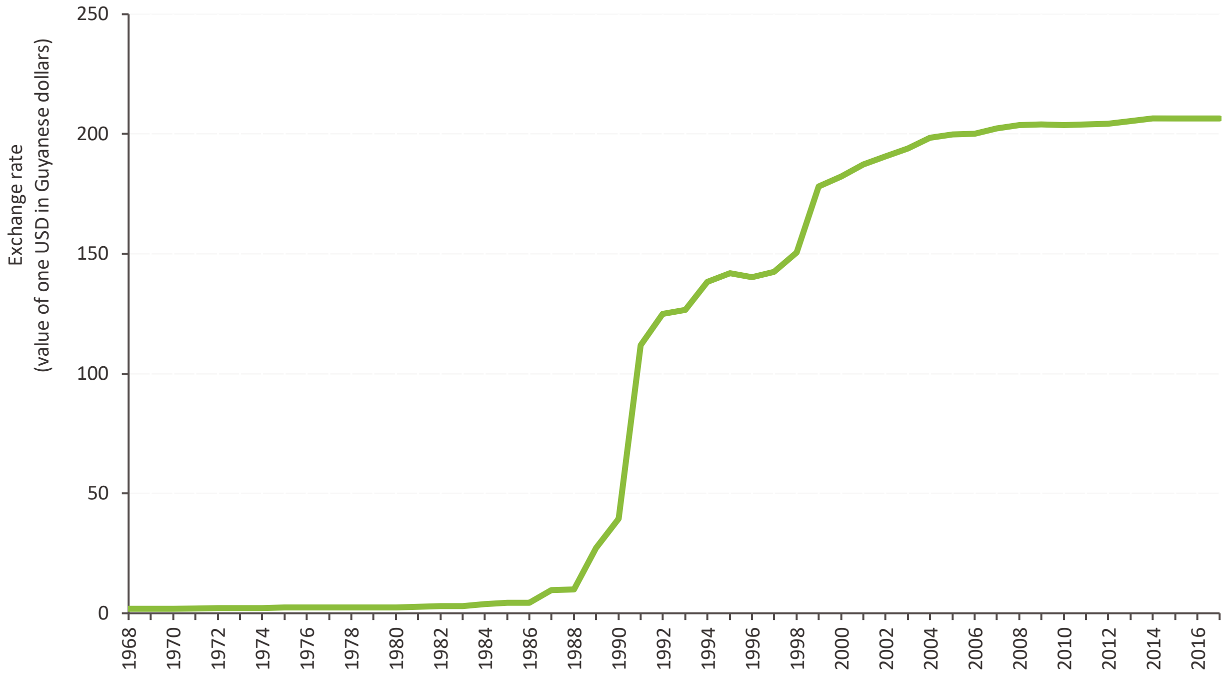
Bank of Guyana achieves these objectives using two instruments: setting reserve requirements for domestic banks; and open market operations (the buying and selling of short-term treasury bills to take excess money out of the system in inject more liquidity). Recent monetary policy has been accommodative.

Accelerated fiscal expenditure will raise domestic inflationary pressure, potentially harming the international competitiveness of export industries. If the revenues from oil exports are introduced to the Guyanese economy, there will be an unprecedented increase in demand for goods and services. If there is not sufficient productive capacity to meet this demand, domestic prices can rapidly increase. Moreover, without significant expansion in the money supply, this will also place upward pressure on the nominal exchange rate. Together, these impacts have the potential to significantly increase the price of Guyanese exports relative to the rest of the world's, lowering the competitiveness of Guyana's key economic industries.

This will present the Bank of Guyana with a clear choice: (i) allowing exchange rate flexibility, at the risk of a loss of competitiveness in other sectors, or (ii) attempting to directly manage exchange rate appreciation by increasing its

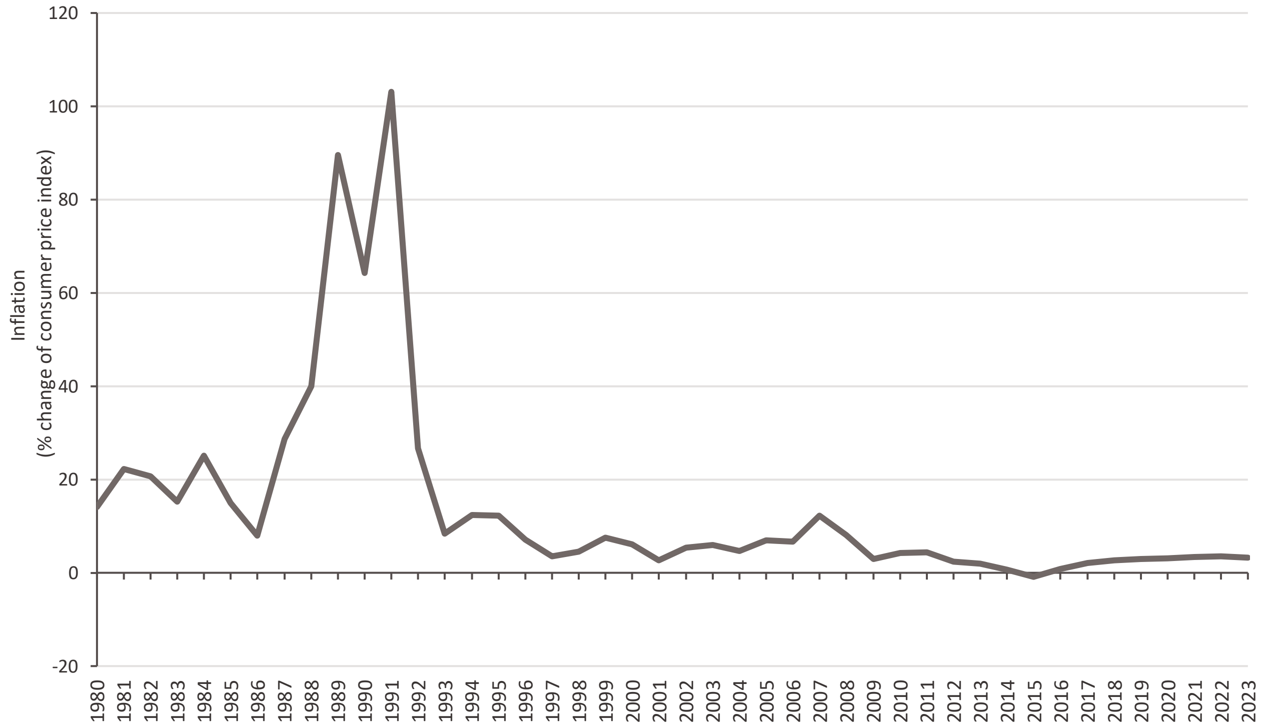
foreign reserves through increases in the money supply (risking excess liquidity and inflation) or issuance of bills and bonds (with an interest payment cost).

Figure 5: Guyana's Exchange Rate Profile



Source: Vivid Economics, calculated based on GDP figures in national currency and US Dollars from IMF World Economic Outlook, April 2018

Figure 6: Guyana's Inflation Level



Source:IMF World Economic Outlook, April 2018

A1.3. Conclusion

With the help of international creditors, Guyana has successfully reduced and stabilised national debt though public capital markets remain shallow. National debt exceeded 100% of GDP between 1990 and 2005, raising concerns over sovereign credit risk and the cost of public borrowing. In 2007, the IDB cancelled USD 470 million of debt reducing the total to roughly 60% of GDP. Sustained economic growth since has allowed the government to run a budget deficit without raising national debt levels. However, as almost all public debt has a maturity of 1 year or less, and Guyana lacks a sovereign credit rating, the government still has few options to raise money from capital markets.

Oil production will become the largest single source of public revenue and place significant demands on public institutions to manage new economic risks. The IMF estimates that, by 2023, public revenue from oil exports could exceed GYD 160 billion, roughly equal to total central government revenue in 2015. Other reports suggest production, oil prices and public revenue could be even higher. Venezuela and Trinidad and Tobago illustrate the risks of windfall resource wealth; expenditure closely tracks oil revenue which in turn closely tracks international oil prices. Efficient and stable public spending requires regulatory checks and balances upheld by strong and accountable institutions. In addition, expanded public expenditure will also place more pressure on institutions to assess potential contractors' ability to deliver the work, monitor and manage progress, and ensure fiduciary responsibility and accountability.

The Bank of Guyana must manage domestic inflationary pressure from accelerated fiscal expenditure. If the revenues from oil exports are introduced to the Guyanese economy, there will be an unprecedented increase in demand for goods and services. If there is not sufficient productive capacity to meet this demand, domestic prices

can rapidly increase. The Bank of Guyana has a clear challenge to proactively demand to this pressure and maintain broad macroeconomic stability.