Reducing Government's Interest Costs

By Dr. DeLisle Worrell
Governor
Central Bank of Barbados

Government's interest costs have been rising continuously in recent years, from $396 million in Fiscal Year 2008/9 to $673 million in FY 2015/16. In the first nine months of the current FY, the total interest paid on the Government debt was $593 million. The main reason for the increasing interest cost is the size of the deficit that has been financed by Government borrowing in each of these years. The debt raised to fund each year's deficit incurs additional interest costs, which are added to the already heavy burden of servicing.

A reduction in these interest costs will make a contribution to reducing the overall fiscal deficit, and will in that way be a vital link in a virtuous cycle, in which smaller deficits lead to lower borrowing requirements and smaller increases in interest costs.

There is only one assured way of reducing interest costs, and that is through the use of monetary policy, combined with a reduction in spending by Government sufficient to balance Government's ongoing expenditure with taxes and other revenues, month by month. Government must also make a plan to reduce and eliminate all arrears in a systematic fashion. These measures will eliminate Government's current, chronic shortage of cash. The Central Bank will then no longer be asked to make financing available to Government to meet its day to day needs, and frees the Bank to use monetary policy to adjust the level of interest rates, which is the orthodox approach used by central banks the world over.

Once the current account deficit is eliminated and Government cash flow is under control, potential investors will be reassured, and will be happy to lend to Government once more. The Government's borrowing requirements for capital projects are small, in comparison to the amount of excess liquidity in the banking system. Once the overall financing need is reduced to that level, banks will have to compete for the available Treasury bills on offer, and rates would begin to fall. The Central bank would nudge the system in this direction.

This process works as follows. Every other week Government issues about $300 million in Treasury bills, a Government security which is repaid in three months' time, for the most part. If the Government is able to pay all its commitments for the ensuing fortnight from tax receipts (and arrears are being taken care of separately), the amount of new Treasury bills issued is just sufficient to repay the holders of Treasury bills that were issued three months previously, and which are now due for repayment.

In a joint meeting with Treasury officials before each issue, the Central Bank makes a decision on what amount of the issue it will buy. The Bank canvasses the holders of maturing bills about their intentions and makes an assessment of the total demand for the new bills. In recent times demand for Treasury bills has been weak, even though commercial banks have a great deal of excess cash, because there is concern about the size of the fiscal deficit and Government's borrowing requirements.

In order to give an appropriate signal about T-bill rates through monetary policy, the Central Bank needs to buy enough bills at a suitably low interest rate to drive out the highest bidders. Let us suppose that there are bidders for all $300 million of an issue of average size, and that they bid at interest rates ranging from 3 percent to 3 1/2 percent. The Central Bank might decide to bid for $100 million at, say, one percent. The Treasury accepts bids, starting with the lowest, until it reaches its $300 million target.

Let us compare the interest rate outcome with and without Central Bank action. If the Bank does not bid, the resulting interest rate will average somewhere between 3 percent and 3.5 percent. With Central Bank intervention, the rate might be as low as 2.3 percent.

Note that the policy only works if the Government's current account is in balance, and the Treasury does not have to address an accumulation of arrears of payment. Satisfying both these conditions is essential for the successful conduct of monetary policy.

As soon as the T-bill rate falls, Government will be able to lower rates for all new issues of Treasury notes and Debentures, all along the yield curve. In this way, interest costs to Government are reduced in a market-friendly way, which preserves the Barbados' Government's unblemished record of meeting its debt obligations in full and on time, every time.

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