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Role Models for Monetary Policy in the Caribbean: Comparing Caricom Central Banks

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Introduction

Financial reform has risen to prominence on the macroeconomic agendas of most developing countries in recent times. Reform packages are part of the stabilization programmes of all Caribbean economies with which the IMF and other multilateral financial institutions have been involved. Much attention focuses on the liberalization of financial markets in Guyana, Jamaica and Trinidad and Tobago and the development of new financial instruments and institutions in Jamaica and Trinidad and Tobago. A presumption is emerging that these financial developments are the beacon for the future of Caribbean financial systems.

That premise should be carefully examined. What have been the benefits of financial reforms in Jamaica and Trinidad and Tobago? Are the financial sectors of Guyana, Jamaica and Trinidad and Tobago more sound than those of the Bahamas, Barbados, Belize and the Organization of the Eastern Caribbean States? Do the central banks of the former countries have leverage on the real economy which those of other Caricom countries do not have?

The Central Bank of Barbados has maintained a market-friendly approach to policy from the start of its operations, relying on moral suasion and market instruments in the first instance, with controls resorted to only in cases where the Central Bank thought these market instruments could not deliver the results it intended. Direct interventions involved a consultative process where efforts were made to persuade the financial institutions of the merit of Central Bank policy and elicit their active cooperation. The Bank remained sensitive to the practical limits

on effective intervention.¹ This contrasts with the notion that informs the recommendations of the international financial institutions - a notion accepted by the more activist Caribbean central banks - that policy instruments should push financial institutions in directions they strongly resist. The means have changed, from direct intervention to interest rate and exchange rate fluctuation, but the intent remains the same.

This paper contrasts the *modus operandi* of the activist central banks (in Guyana, Jamaica and Trinidad and Tobago) with that of the remaining Caricom countries, whose monetary policies were less ambitious, even though they may have tried similar instruments. The essential difference is not between liberalized and interventionist policies. Rather it is between policies which are sensitive to signals not only from the financial markets, but from government and the economy on the whole, on one side, and, on the other, policies designed to manipulate credit, deposits and interest rates so as to force private agents to take decisions they would rather not.

1. Market Friendly Interventions

The more effective instruments used by the Central Bank of Barbados during all of its 25 years were exercised through the financial market. They include moral suasion, changes in the discount rate, interventions at treasury bill auctions, pricing of Government securities to market and purchase, sale and repurchase of treasury bills and other Government securities.

Moral suasion has always been the Central Bank of Barbados' first resort. Its effects are difficult to quantify but it has been unquestionably influential when backed by convincing analysis of economic circumstances. Moral suasion has become more effective as the Central Bank's reputation has grown over the years. From the outset, the Bank's moral suasion extended beyond the financial system to Government and the general public. The greatest contribution to the effectiveness of Central Bank initiatives has been the growth of an informed public opinion which has, at critical times, created an irresistible constituency for correct policy.

Changing the central bank's *discount rate* (the rate at which commercial banks borrow from the Central Bank, when they are short of liquidity) was a second frequently used tool. Effectively this was part of the information base

¹A former Governor of the Bank frequently reminded his staff, with respect to exchange controls, that there were scores of private sector agents willing to devise schemes to evade controls, if the controls were unreasonable enough to provoke them to.

which strengthened moral suasion. An increase in the discount rate is a signal of tighter credit conditions. It does not actually serve to tighten credit because banks never borrow from the central bank's general discount window to onlend to customers. Discounts are infrequent, required only when large unexpected transactions temporarily disrupt the bank's cash position, and they are quickly repaid.²

The treasury bill rate in Barbados has always been market determined - a fact which Barbadians take for granted. The central bank has often signalled an ease in credit conditions by entering the *treasury bill auction* and bidding for significant amounts at a reduced interest rate. That strategy does not work when credit conditions tighten but central bank intervention should not be necessary in that circumstance. The competition for funds should provoke banks to seek more attractive interest rates at the auction. The fact that this often fails to happen tells us something about how our financial system works.

The Central Bank of Barbados manages the issue of Government securities. Issues are timed to ensure an effect on the money supply that is consistent with policy and economic circumstances and *securities are priced in line with market conditions*. Potential buyers have often been canvassed to supplement the central bank's economic intelligence, which already boasts the most sophisticated market sensors available in Barbados. The price of Government securities offers an effective means of signalling tighter credit conditions.

The Central Bank of Barbados has attempted *open market operations* since the 1970s, altering margins on the purchase and sale of treasury bills from its own portfolio on several occasions, and engaging in repurchase agreements on government securities³ all in the effort to reduce the money supply and replace central bank funding to government. These attempts have met with limited success. Banks and other financial institutions buy only when they have excess cash, effectively switching one central bank asset for another with no effect on the money supply.

These market-friendly policy tools were the most actively used for all of the Central Bank of Barbados' history. Their effects are illustrated by movements in the treasury bill rate (Figure 4.1). In periods when liquidity was low (1977, 1981-83, 1989-91) the rate rose, falling when liquidity eased, just as might be expected

²Special discounts offered by the central bank are a different matter; their rates were not used as a monetary policy tool.

³In 1983 and 1984 the Central Bank of Barbados sold debentures to commercial banks with agreement to repurchase in 6 months, on several occasions.

Figure 4.1 **Excess Liquidity and The Treasury Bill Rate: Barbados**

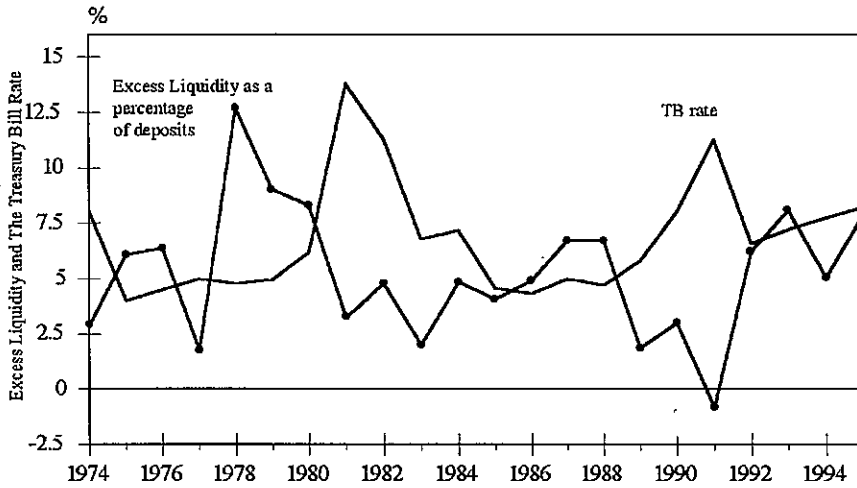


Figure 4.2a **Loan/Deposit Ratio and Treasury Bill Rates: Guyana**

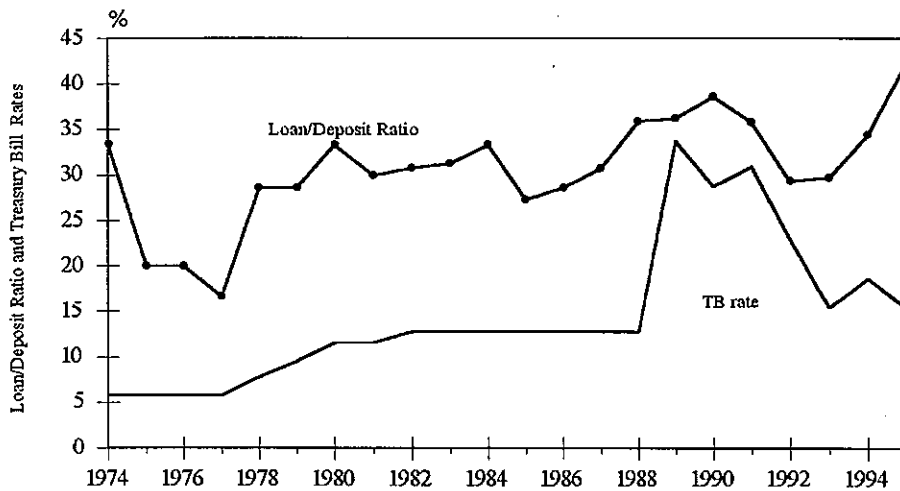


Figure 4.2b **Loan/Deposit Ratio and Treasury Bill Rates:**
Jamaica

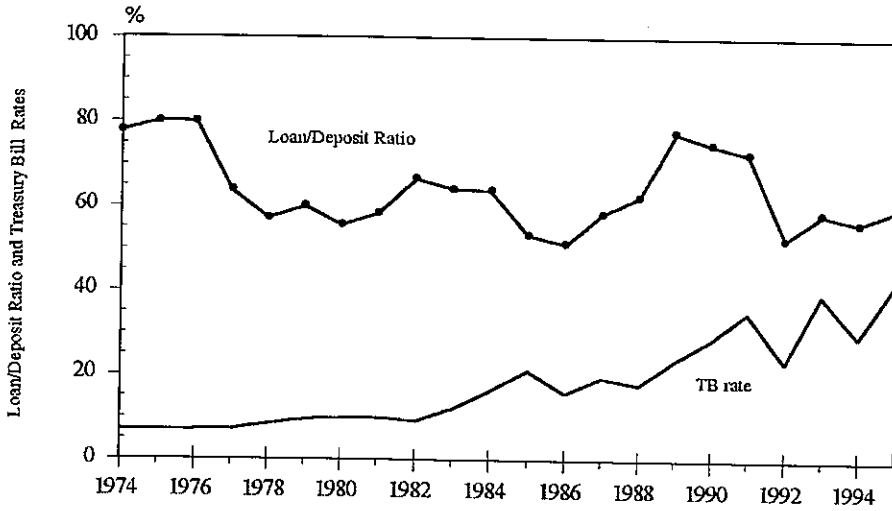
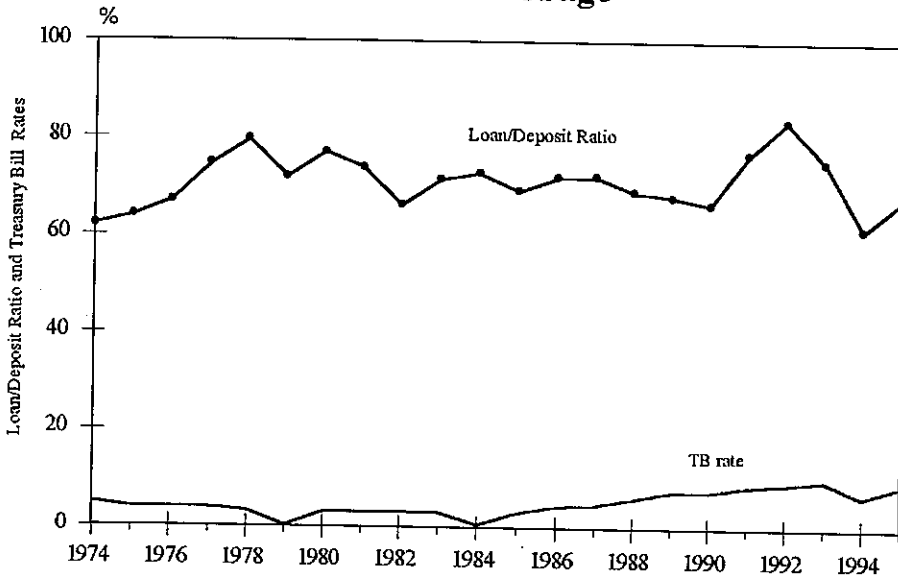


Figure 4.2c **Loan/Deposit Ratio and Treasury Bill Rates:**
Trinidad & Tobago



in a competitive market.⁴ Contrast the picture for Guyana, Trinidad and Tobago and Jamaica where, prior to liberalization in the mid-1980s, discount rates, the treasury bill rate and the rate on Government securities remained unchanged for many years, notwithstanding changes in liquidity (Figures 4.2).

2. Severity and Effectiveness of Regulation

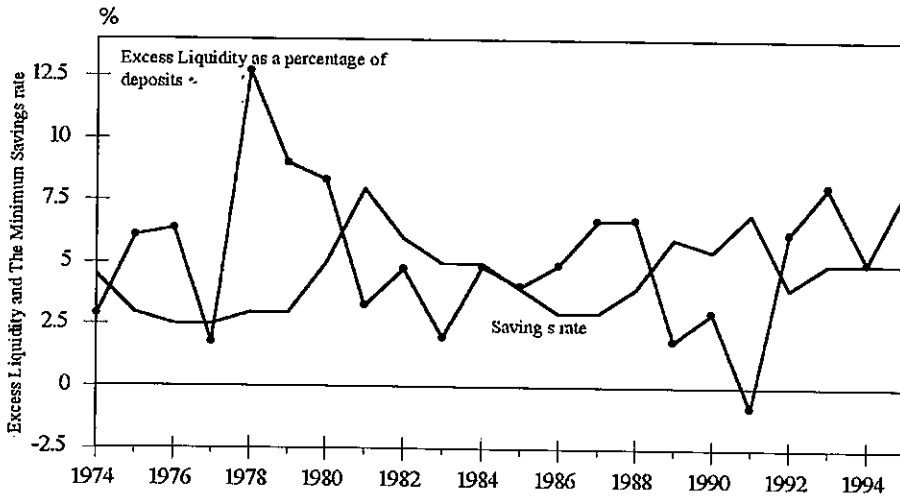
The Central Bank of Barbados' direct interventions with respect to interest rates reflected the underlying market conditions: the interest rates rose when credit conditions tightened and fell when credit eased. Complex notional regulation of the deposit interest rate structure proved ineffective and was abandoned in the 1970s. Spreads between deposit and loan rates were adjusted in line with the banks' requirements. The loan interest rate was controlled in name only; exemptions were pervasive and the actual was frequently above the "controlled" maximum. Selective credit limits were non-binding and often exceeded. Consumer instalment credit controls were avoided by borrowing from non-controlled institutions and by lease arrangements. Global credit limits were in effect for only six months during the twenty-five years of the Central Bank's history. There was never any foreign currency rationing for current account transactions and there were systematic though complicated guidelines on foreign currency transactions.

The Central Bank's *direct interest rate interventions* reflected market conditions. The principal interest rates - the minimum deposit rate and the prime lending rate - moved in tandem. The interest rate rose when credit conditions tightened and fell when credit eased (Figure 4.3). The trend in interest rates, guided by the Central Bank, did not create incentives which distorted market signals. On the contrary, Central Bank initiatives increased the visibility of market signals (such as the excess liquidity ratio, government financing needs and long term interest rate trends in international markets, all closely monitored by the Central Bank) and ensured orderly transitions when interest rates needed to be changed.

It is a standard tenet of economics that in markets with few agents a leading player will give price leadership. Since the financial systems of the Caribbean are dominated by a few large banks someone needs to lead on changes in interest rates (and other prices such as exchange rates). There are powerful

⁴The correspondence is not exact. The rate is influenced as well by the public sector borrowing requirements.

Figure 4.3 **Excess Liquidity and The Minimum Savings rate:
Barbados**



reasons why the Central Bank should be the leader. It is the most fully informed, being the repository of a wealth of data, producing the most comprehensive assessment of the economy and maintaining constant economic oversight.⁵ It is mandated to take a national view, one that is not excessively motivated by bank profit at the expense of consumers nor excessively influenced by credit and money demand at the expense of bank viability. It interacts directly with government and the private sector, advising Government on policy responses to changing economic circumstances and interpreting those policies for the private sector.

So long as the central bank is efficient, thoughtful bankers and the general public are happy to have it provide interest rate (and exchange rate) leadership. Unfortunately, inefficient interest rate manipulation in some Caricom countries may have made central bank policy less credible, where central banks mandated interest rates which remained out of line with liquidity conditions for extended

⁵The notion that the central bank is more fully informed than the private sector does not seem surprising. In a recent working paper of the US National Bureau of Economic Research, Christina and David Romer (1996) conclude that the US Federal Reserve has a 'significant information advantage' over commercial forecasts.

periods. These rates failed to signal changes in monetary conditions, and were ignored or circumvented.⁶

The Central Bank of Barbados has made many mistakes, though none was so pervasive as to cause financial system dysfunction or perverse economic reaction. For many years the Central Bank tried to dictate the structure of deposit rates, the spread between deposit and loan rates, and the structure of loan rates. There were, until 1981, official regulations stipulating the maximum interest rates that might be offered on deposits of different sizes. These were recognized to be impractical, and irrelevant. Deposits at banks and other financial institutions regulated by the Central Bank have always been exempt.⁷ The Central Bank does stipulate a minimum interest rate for fixed term and savings deposits (until 1993 for savings only), but banks and financial institutions have always been allowed to offer any rate or range of rates above that minimum.

Between 1976 and 1983 the Central Bank stipulated the prime interest rate to be offered by commercial banks;⁸ the average *lending rate* was mandated up to 1991. The Bank was motivated by the very large spreads between the deposit and loan interest rates which are characteristic of Caribbean banking systems. Economists in the Caribbean, Washington and elsewhere, complain repeatedly about high interest rate spreads and take them to be tokens of bank inefficiency.⁹ In fact, wide interest rate spreads, characteristic of small financial markets everywhere, far from being a sign of inefficiency, are the expected behaviour in markets with low transactions volume. It is a nostrum of market theory that where volumes are low, mark-ups will be relatively high. The Central Bank of Barbados thought it might narrow spreads by fiat after aggressive interest rate competition by incoming American banks failed to make any impact in the early and mid-1970s. In fact, if anything, the spread widened somewhat during the

⁶The failure to sustain leadership in setting credible exchange rates was even more devastating to the central banks' reputation and standing.

⁷The regulations, issued by Government under an ancient statute, predated the Central Bank by many decades. They applied only to mortgage loans by attorneys and deposits held at non-financial private firms, until their revocation in 1982.

⁸Administering this regulation proved a headache. Whenever a bank dissented from the Central Bank stipulation, fewer and fewer of its customers, even the most creditworthy enjoyed "prime" rates.

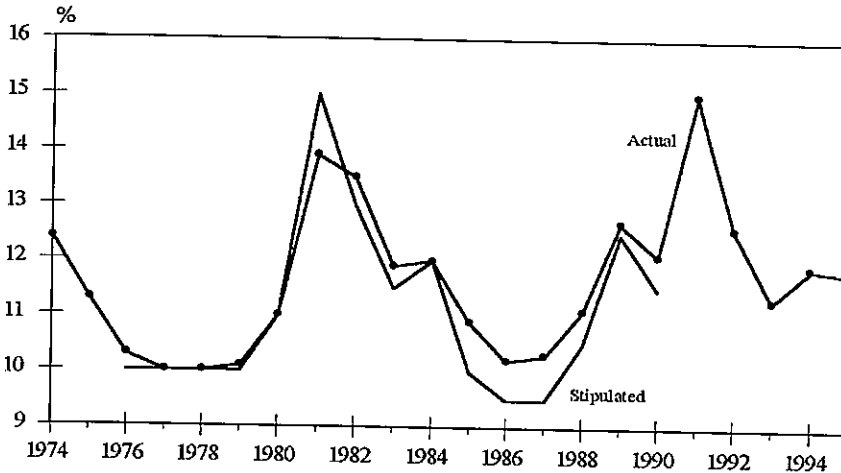
⁹This concern surfaces in virtually every analysis of commercial banking in the Caribbean, including, most recently, the article by Bennett (1995).

period of Central Bank regulation. In line with its market driven philosophy the Central Bank always consulted banks before changing rates. It was never able to persuade the banks to agree on narrower spreads and was wisely never willing to risk evasion by defying the banks' wishes. The Bank conceded to exclude "add-on" loans - upwards of one-quarter of the total - from the interest rate stipulations, leading to a situation where the actual loan rate was often in excess of the "maximum" fixed by the Central Bank for extended periods (Figure 4.4).

The Central Bank also stipulated a maximum interest rate for mortgages, until September 1992. This created no difficulty so long as the interest rate on mortgages was moved in step with the principal indicator rates - the deposit and loan rates - with a sufficient mark-up on the deposit rate that mortgage lending institutions could offer an adequate premium on long-term deposits and a sufficient discount to reflect the relatively low risk attached to mortgages compared with other lending. This policy was followed throughout, except for the period from November 1989 to August 1991 when failure to raise the interest rate on mortgages in line with the general interest rate structure dried up the supply of finance for mortgages.¹⁰

Figure 4.4

Loan Rates Actual & Stipulated Barbados



¹⁰This may have inadvertently reduced private sector credit (a policy objective at that time), provided the funds that might have been diverted from mortgages were not spent on consumer items.

Ceilings set for bank credit to households and firms in the distribution sector, instituted in August 1977, proved ineffective. Banks pointed out that they were obliged to honour existing commitments to offer overdrafts to long-standing customers. The Central Bank conceded, allowing scope for distribution credit to rise up to 25% over the apparent limit. These overdraft lines were routinely renewed and often raised. Actual credit always remained below the effective limit (the notional limit plus undrawn commitments), and the limit was never binding.

Limits on loans to households were invalidated by a series of exemptions beginning in 1978 with loans for home improvement. In subsequent years, exemptions were allowed for solar water heaters, locally manufactured stereo equipment, insurance on property, bridging loans for construction and house repairs. Households borrowed to the limit for allowable purchases and used incoming cash, drawdowns of deposits, loans from unregulated non-bank financial institutions and informal arrangements for the remainder of their consumption needs. Distribution limits were occasionally used by banks as cover for turning down high-risk applicants but most large and well-established customers had business connections in non-controlled sectors which gave them access to additional finance without limit.

Not only were the controls ineffective in restraining credit, to say nothing of consumption, they were the source of constant debate between the Central Bank and financial institutions about the definition of "distribution" and "households". Banks sought to maximize their room for manoeuvre by reclassifying anything that could arguably be removed from the controlled categories. It was a great relief to those charged with the responsibility of trying to enforce the regulations when the limits were first abolished in January 1987.

In contrast to interest rate spreads and selective credit controls - which distorted very little - detailed and well-policed *restrictions on consumer instalment credit* were the only instrument employed by the Central Bank which distorted the financial market. Furthermore, they did so without achieving the Central Bank's goal of restraining spending. Complicated guidelines were set down for hire purchase contracts in February 1977. They were kept in place until 1992, with adjustment only in 1986. Initially, the stipulations were not very restrictive but as time went by with no adjustment for inflation, the limits were comprehensively circumvented. The principal vehicle was the lease agreement, which differed little from a hire purchase contract but could not be captured under the consumer instalment regulations. The credit restrictions were responsible for the rapid growth of credit unions in the 1980s. By the end of the decade credit unions, which were exempt from consumer instalment regulations, were the principal source of funding for motor cars and consumer durables other than those sold

under lease purchase. Consumer instalment controls have left a legacy of strong credit union hostility to central bank intervention, even for prudential purposes.

The Central Bank imposed global controls on bank credit for a brief period only - the last six months of 1991. They appear to have been effective. They were introduced to support major fiscal contraction - including a reduction of the deficit from 8% to 1% of gross domestic product (GDP) in a single year - during a period when Government was in protracted negotiation with the International Monetary Fund (IMF) on a programme for economic stabilization. The fiscal measures were already in place when the credit limit was imposed. The limit was observed, imports were reduced and the foreign exchange reserves began to recover. The fact that the limit was known to be temporary may have been a key to its success. The limit was removed as soon as agreements for a standby were signed with the IMF.

The Central Bank of Barbados has never engaged in foreign currency rationing of current transactions. Current payments have always been freely allowed so long as banks obtained full documentation from their customers. There has never been a restriction on inward capital movements or the repatriation of capital gains and income. Outward capital movements are screened for evidence of speculation. The administration of exchange controls remains somewhat cumbersome and is being liberalized but the underlying principle of monitoring large outflows remains sound. It contributes to the stability and credibility of the currency and therefore to the favourable climate for investment.

Exchange control as exercised by the Central Bank of Barbados - and the Eastern Caribbean Central Bank (ECCB), and the Central Banks of Bahamas and Belize - is an altogether different instrument from the policy exercised by the Bank of Guyana, the Bank of Jamaica and the Central Bank of Trinidad and Tobago until the late 1980s. Banks in the latter group developed schemes for the programming and allocation of foreign exchange. The information requirements of these systems were vast, well beyond the capability of their exchange control departments. Their very existence created a strong incentive for powerful private institutions to set up systems of evasion. Also, unlike its counterparts in the more populous Caricom countries, the Central Bank of Barbados never used exchange controls to defend the exchange rate. The exchange rate has been kept stable by unlimited sales to banks at the fixed rate, on demand.

It is not at all pointless for central banks to maintain scrutiny of foreign currency transactions, if the exchange rate and macroeconomic conditions are stable, and fiscal policy is appropriate. Controls will almost certainly fail if they attempt to direct legitimate trade and investment decisions and if exchange controls are used to substitute for sound macroeconomic policies. But exchange

control, as it has been practised by Caricom's smaller Central Banks, is a highly effective deterrent to speculation and thereby contributes to exchange rate stability - a most attractive element of the investment climate in the Bahamas, Barbados, Belize, and the OECS.

3. The Illusion of Open Market Operations

The Central Bank of Barbados' diffidence about open market operations is based on experience over more than two decades. Reporting on the economy in 1974 the Bank stated: "In keeping with its policy of fostering the development of a money market, the Bank permitted the Treasury Bill rate to move in sympathy with general market rates" (Central Bank of Barbados, (1975, p.2)). Ever since then the Bank has tried to manage liquidity and the government's domestic borrowing through the securities market. However, experience reinforces the lessons of theory: open market operations fail unless they persuade consumers to switch from purchases of goods and services to hoarding financial assets. Liberalization does not make open market operations more effective because it does not provide motivation to switch from purchasing to hoarding. Full liberalization may increase the dangers of perverse reaction, through a switch from hoarding local financial instruments to assets held in the United States.

The Central Bank of Barbados was concerned from its inception with the need to avoid money creation through lending to Government. Instead, the public sector was directed towards borrowing from financial institutions and the public through the issue of government securities of varying maturities. For about two years after its establishment in 1972 the Central Bank of Barbados ensured that banks bought securities by increasing the required percentage of deposits to be invested in this way. From 1975 onwards and up to the present time, however, banks have held securities in excess of central bank requirements. To persuade them or the public to provide additional finance to government it has been necessary to use the interest rate incentive by way of the treasury bill auction, pricing government debentures and treasury notes to market demand and using open market operations by offering a sufficient discount on central bank held securities to encourage banks to purchase them. The Central Bank of Barbados has used all three mechanisms, as noted earlier.

However, open market operations do not work if the treasury bill auction or a successful securities issue has not already solved the problem. Central banks in the Caribbean have seldom needed to supply money to the private sector, so we may illustrate using the situation where the central bank wishes to tighten the money supply by a sale of additional government securities. If commercial banks

have excess cash there is no problem. They tender for the additional treasury bills offered at the auction. If government prefers longer term financing it may increase the offer of debentures or treasury notes, following the long-standing central bank practice of pricing them to guarantee interest by insurance companies or private sector firms and individuals. The payment cheques drawn on banks reduce the banks' excess cash, which goes to finance government. In these circumstances there is no need for open market operations. The additional government securities are fully disposed of so long as liquidity permits. Note however, that there is no tightening of the money supply. The public employs exactly the same amount of finance as it did before the transactions. All that has changed is that banks, insurance companies or the public now earn an interest return from government on funds which formerly sat idle at the Central Bank.

There is no problem of excessive money if banks are happy to leave excess cash with the Central Bank at no interest rate, as they have for extended periods in countries that have stable exchange rates. The excess cash holdings shave something off bank profits but not enough to induce them to put these funds in the hands of the many claimants who seek them out daily but fail to meet their criteria of creditworthiness.

The monetary authority has a problem only where there is no excess cash and an unsatisfied public sector borrowing requirement. In these circumstances, additional treasury bill auctions fail, new government securities are ignored and open market operations cannot be completed because no-one will offer to buy from the central bank's portfolio of government securities. The Central Bank of Barbados found itself in this situation from time to time. In the 1991 stabilization crisis the Bank aggressively discounted its treasury bill holdings to encourage banks to divert funds from the private sector to government. The Bank resorted to direct limits on private sector credit (previously alluded to) only when it became clear there was no interest in the open market offer.

The Central Bank of Barbados' failure with open market operations is not for want of trying. The Bank has a standing offer for sale and purchase of treasury bills from its portfolio whenever it holds bills. Several times since the late 1970s these margins have been adjusted in concert with other measures to tighten monetary conditions. The most recent and most aggressive was in response to import surges in 1993 and 1994. In circumstances where banks were not actively seeking to employ excess cash, the Central Bank has never been able to effect a sale of bills by offering a more attractive return on them.

The Bank of Jamaica has been more aggressive in buying and selling government securities since the liberalization of the financial system in the

1980s.¹¹ Because of its chronic losses the Bank of Jamaica is unable to intervene at the treasury bill auction in the way the Central Bank of Barbados does and the marketing of long-term government securities is problematic in an economy as volatile as Jamaica has been. The Bank of Jamaica has no option but to use what is arguably the least effective tool for influencing interest rates, that is, open market operations.

The Bank of Jamaica has been unable to secure contraction of the money supply through open market operations. Driving interest rate yields to great heights attracted treasury bill purchases, not via a contraction in the domestic money supply, but by sucking in short-term funds from abroad to capitalize on the widening foreign/domestic interest rate differential. Government's cash deficit was effectively financed by short-term capital inflows, at one remove.

Its monetary policy has locked the Bank of Jamaica into a regime of very high real interest rates from which it has been unable to escape. High rates are necessary to lock in the capital inflow which provides foreign exchange with which to defend the exchange rate. When, in September/October of 1995, the Bank of Jamaica used open market operations to bring the interest rate down, the exchange rate depreciated by 17% in two months and interest rates had to be pushed back up quickly.

Open market operations fail in Caribbean economies because changes in interest rates are insufficient incentive for consumers to change their behaviour, and banks know this. If the central bank's sale of securities is to tighten the money supply banks must cut credit to the private sector to purchase the securities. If the purchase is funded from banks' excess cash there is no effect on the money supply. If it is funded by capital inflow the money supply may actually rise instead of falling.

When banks raise loan rates the demand for loans does not usually fall, except temporarily. It is far more likely that firms try to pass on higher interest costs and that household demand remains unchanged, except for mortgages. In these circumstances, it is easy to explain the typical commercial bank response to attempted open market sales by the central bank. If the securities on offer are only moderately more lucrative than lending to the private sector - discounted for risk preference - the central bank's offer is ignored. Banks are not interested in creating hardship among their most dependable borrowers (including home owners) for a small improvement in their profits.

¹¹Despite the liberalization, the Jamaican financial system is obliged by the Bank of Jamaica to invest 50% of its deposit liabilities in financing government.

We have to speculate about banks' response to a very generous offer of returns on government securities in Barbados relative to rates on lending to the private sector because the margin has never been more than two points above the norm. However, an abrupt shift in interest rates is certain to damage the credibility of the central bank - reason enough for the Central Bank of Barbados to have avoided it.

Large shifts in interest margins for open market operations in Jamaica have induced banks to raise deposit and loan rates. In nominal terms the demand for credit remained robust, even for home mortgages. However, inflation, to which the high interest rate contributed directly (through the mortgage rate) and indirectly (through overhead costs), reduced both the real purchasing power of credit and the real capacity to service additional borrowing. The Bank of Jamaica failed to persuade consumers to switch to financing government; instead, open market operations contributed to inflation which reduced demand in constant prices (though not in current dollars) by reducing real income.

None of this would have been surprising to students of international monetary economics twenty-five years ago. It was an acceptable tenet that monetary policy was ineffective in small open economies with a high degree of capital mobility with fixed exchange rates, and that open market operations were unattainable in thin financial markets (see, for example, Thomas, (1972)). The conventional wisdom has departed from these nostrums in two particulars, both dubious.

The first is the belief that small open economies in circumstances such as those of the Caribbean have an option of flexible exchange rates. The experiences of small countries - even prosperous industrial countries - in the immediate neighbourhood of large dominant countries demonstrate that the best exchange rate strategy is to fix to the currency of one's neighbour. The experiences of the Netherlands, Austria, Denmark and the European principalities confirm this.¹² It is no accident that prosperous Caribbean countries all have exchange rates fixed to the US dollar.¹³

¹²I have been reminded that Canada, a relatively small country compared with the US, manages its currency flexibly with respect to the US dollar. It would be instructive to compare fluctuations in the Canadian/US dollar rate with fluctuations in say, the Sterling/US, Duetsche Mark (DM)/US or Yen/US rates.

¹³It is common practice to distinguish between countries which "link" their currencies to a major international currency, and those which "peg" their currencies. However, Caribbean currencies are "pegged" to the US dollar by exactly the same mechanism as smaller European countries "link" their currencies to the DM: that is, by central bank foreign exchange intervention.

The second is the belief that financial markets in small open economies may somehow be “deepened” and made “contestable” by a deliberate policy of central bank aloofness and that the ensuing increase in financial transactions will facilitate open market operations by making the market more competitive. In fact, exactly the opposite has happened. The degree of financial concentration in the liberalized markets of Guyana, Jamaica and Trinidad and Tobago has increased and threatens to increase further. The legion of small players admitted to the financial market have added to the burdens of regulators and raised apprehensions about the soundness of their financial operations without weakening the grip of the dominant institutions.

4. The Paradigm is Wrong

The IMF, those who support its recommendations, those who criticize its policies and most economists, all share an unrealistic view of the central bank's role. It assumes that when government and private sector agents are motivated to decisions which will destabilize the economy the central bank may take action to frustrate these intentions. The only difference between the old interventionist and new liberalizing views is about the action to be taken. Should it be to ration finance directly or to alter the price of money, that is, the interest rate?

Both logic and Barbadian experience suggest these approaches are equally unproductive. Market intervention is unlikely to provoke a sufficiently large interest rate to matter. If it does, the effects are likely to be perverse, sucking in foreign exchange to increase the money supply when the intention is to lower it. Mild direct credit rationing is innocuous and severe impositions encourage the growth of non-bank financial institutions and quasi-financial arrangements which carry high risks for the consumer because they fall outside the prudential umbrella of the central bank. The monetary authority may not, by any means available to it, frustrate the intentions of government and the private sector determined to follow an inappropriate course. Instead, the central bank must seek to influence the motivation for spending, especially in the public sector. There is probably not a great deal a central bank may do to affect private consumption and encourage saving other than its contribution to a climate of economic stability.¹⁴ The central bank should focus on improving economic information and understanding among

¹⁴Rapid currency depreciation and high inflation may wipe out saving (as in Jamaica and Guyana) and discourage the savings habit.

the general public in the hope that this encourages more careful budgeting and a long-term perspective that favours investment and savings.

In the short run, policies must be framed with private sector intentions as given, by and large. Government must tailor its own saving to fill the gap between desired investment and expected saving from the private sector and from abroad. The central bank's role is to provide projections of financial sector balances within which such a policy may be formulated. No macroeconomic problems arise so long as fiscal policy is managed so that government complements private spending. Monetary policy may then properly be used to accommodate seasonalities in spending patterns, to give guidance on medium term interest rate trends, to discourage destructive interest rate wars and to inhibit currency speculation.

The experiences of Caricom Central Banks all confirm that policies which give order and predictability to financial markets are successful while those which attempt to alter private decisions are frustrated. The fixed exchange rate strategy maintained through fiscal adjustment of aggregate demand - not via central bank foreign exchange controls - is the best example of a policy which is successful because it enjoys general popular endorsement. Where the exchange rate is fixed, foreign currency controls to discourage speculation are welcomed by the private sector.

5. A Role for Monetary Policy

Central banks in the Caribbean should accommodate to private sector expenditure plans in circumstances where macroeconomic stabilization and adjustment are achieved via fiscal policy. The central bank's role is to ensure orderly financial markets, avoiding interest rate wars, giving guidance on fundamentals, deterring speculative foreign currency movements and adjusting to seasonalities. The models to follow are those of the Central Banks of The Bahamas, Barbados, Belize and the Eastern Caribbean Central Bank.

The moral suggested by the Caribbean experience is that central banks should accommodate to private expenditure plans and that fiscal policy should be used to achieve macroeconomic stabilization and adjustment. Monetary actions which seek to influence private credit and spending are very likely to make matters worse, destabilizing financial markets, encouraging financial disintermediation and weakening prudential standards in the financial sector. It is generally accepted that monetary policy cannot make up for lack of fiscal adjustment. It must be stressed as well as that monetary policy cannot make up for insufficient fiscal adjustment. Fiscal adjustment must be appropriate and sufficient.

The central bank's role is to ensure orderly financial markets. It does so by offering guidance on interest rates, managing seasonalities in bank liquidity and government financing, creating difficulties in the path of foreign currency speculation and, from time to time, taking steps to allow time for fiscal adjustment to take effect. In Caribbean financial markets there are a mere handful of dominant players and they are becoming fewer, especially in liberalized economies. This raises the spectre of harmful interest rate wars and other predatory acts. The central bank may reduce the danger by giving signals of medium term trends in interest rates based on foreign interest trends (because of the high degree of capital mobility) and projected domestic liquidity.

The central bank has an important role in managing seasonalities in bank liquidity and government's cash flow through its intervention in the market for government short-term securities. For example, if liquidity is at a seasonal low and the public sector borrowing requirement rises, an increase in the interest rate on short-term government securities may induce corporate treasurers to postpone discretionary spending and take advantage of the windfall, provided they confidently expect interest rates to fall after the seasonal liquidity crunch has passed.¹⁵

The surest deterrent to foreign currency speculation is a credible exchange rate backed by fiscal policy to ensure a stable balance of payments and adequate foreign exchange reserves with the central bank. However, for a small economy it is very costly to hold foreign exchange reserves large enough to ensure a successful defence of the exchange rate against speculative attack by any one of a small number of large corporations and financial institutions. The regulation of large capital outflows is an effective means of reassuring the public that a few large players do not have *carte blanche* to destabilize the exchange rate for selfish gain. Such regulation, as practiced by the Central Banks of Barbados, the Bahamas and Belize and the Eastern Caribbean Central Bank, imposes no conditions on foreign direct or portfolio investment. It obliges domestic financial managers to take a medium term view of external investment and makes it difficult for them to engage in active portfolio management in foreign currencies, which is probably just as well, given the huge risks involved in such transactions.

From time to time the occasion arises for the central bank to take action in support of fiscal adjustment, as in 1991 when the Central Bank of Barbados imposed a global credit limit so that measures to tighten fiscal policy could take

¹⁵A colleague has expressed skepticism about this limited role, and his view may well be justified.

effect. Note that the credit limits were imposed after fiscal measures were already fully implemented, that they were introduced with the full cooperation of financial institutions and that they were understood as a minor and temporary part of an overall package of adjustment which satisfied the popular commitment to the fixed exchange rate. The limit would not have held in the absence of any one of these.

Financial liberalization offers no new possibilities for monetary policy. The evolution of new financial instruments and the proliferation of minuscule financial institutions in Jamaica and Trinidad and Tobago is a result, not of financial liberalization, but of the lack of credibility of the exchange rate. New financial institutions are an avenue of escape from domestic currency, and a means of circumventing monetary contraction and/or reaping high domestic currency returns from inflated interest rates. Open market operations are a complicated device to do what might be accomplished more straightforwardly by a simple directive to banks with respect to their minimum interest rate on deposits: that is, sucking short-term capital from abroad. No central bank in Caricom has managed to contain spending through monetary policy.

The Central Banks of Barbados, the Bahamas and Belize and the Eastern Caribbean Central Bank are the successes of Caricom and the role models for the implementation of monetary policy. For the most part they have been modest and light-handed in their interventions and have achieved their limited objectives when they have taken an active stand. They have never sought to spearhead economic adjustment, concentrating instead on guidance and advice on the best fiscal policy. That is what Caribbean Central Banks ought to do.

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