

DRAFT

CONFERENCE ON MONETARY RESEARCH

held at

THE UNIVERSITY OF THE WEST INDIES

MARCH 29-30, 1969

SUMMARY OF DISCUSSIONS

AGENDA ITEMS 1 and 2

1. Paper on The New Sterling Agreements by Bank of Jamaica.

2. Paper on New Sterling Area Agreements: Some Implications for Monetary Management by the Central Bank of Trinidad and Tobago.

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1969 Regional Monetary Studies Conference

SUMMARY on Paper on the New Sterling Agreements by
Bank of Jamaica.

The Central Bank of Jamaica's paper gave a general description of the new sterling agreements and the developments leading up to their establishment. The paper shows how the U.K. authorities sought, by stabilizing their sterling balances at existing levels, to cordon off an area of potential danger to sterling while the overseas sterling area countries were able to obtain a guarantee of some 90% of their "official" sterling reserves against a future devaluation of sterling.

The first part of the paper examines the composition of sterling balances which falls into three main categories: (1) Balances held by residents of non-sterling area countries; (2) Privately held sterling area balances, and (3) Official balances of the overseas sterling area (O.S.A.) countries.

Since the 1960's the structural and institutional changes in sterling area countries have led to a diversification of reserves. The short-run fluctuations inherent in this diversification were recognised as a potential source of instability for sterling and the international monetary system as a whole.

It was these considerations which led to the Basle Facility of 1966 and other swap arrangements available to the Bank of England on a short-term basis, on which drawings could be made when the sterling balances fell below a fixed starting level.

The second part of the paper dealt with sterling after devaluation. A particular feature noted here was the continued instability of sterling after devaluation. This resulted in a good deal of uncertainty about the viability of sterling as a reserve currency and some O.S.A. countries, warned of another sterling devaluation, began diversifying their resources at an accelerated pace.

In this respect, Jamaica reduced her proportion of sterling in her reserves from 75% in November 1967 to 54% in July 1968. Continued diversification on the whole could have precipitated another crisis and perhaps another devaluation of sterling.

As a first response, it was pointed out that the Hong Kong arrangement was concluded. This provided the basis of the subsequent sterling agreements and its main features are:

- (a) Up to 50 per cent of Hong Kong's official external reserves to a limit of £150 million could be held in U.K. Government bonds denominated in Hong Kong dollars.
- (b) Bonds would be issued with a seven-year maturity.
- (c) Bonds would be encashable by the Government of Hong Kong in case of liquidity need or balance of payments purposes or by agreement with H.M.G.
- (d) The arrangement is subject to review by either side, or in any case in December 1969 if the Government of Hong Kong so requests.

However, it should be noted that the Hong Kong arrangement did not check the policy of diversification by other O.S.A. countries. In response to this problem, the Basle Facility of 1968 was formulated. (1) Under the facility, the United Kingdom is able to draw United States dollars or other foreign currencies from the BIS as and to the extent that the sterling balances of the OSA countries fall below an agreed starting level. (2) The facility will be usable to meet falls in both official and private balances held by residents of the sterling area countries. (3) It will not however, be available to finance any deficit in the U.K. balance of payments. (4) The facility has a 10-year life, but drawings may be made during the first three years. (5) Amounts drawn under it will have to be repaid between the 6th and

10th years. (6) The U.K. made a drawing on the facility towards the end of 1968.

The paper then discusses the sterling guarantee within the framework of the Basle Facility. The arrangement as finally agreed, involved an undertaking by the OSA countries to keep an agreed minimum proportion of their official reserves in sterling during the life of the agreements. The OSA countries were also urged to place some of their non-sterling holdings on deposit with the Bank for International Settlements in Basle. The U.K. on her part undertook to maintain the U.S. dollar value of eligible official sterling reserves of the OSA countries should there be a further devaluation of sterling.

Finally, the paper ^{assessed} ~~assured~~ the future implications of this agreement for Jamaica. In this respect it was noted that its acceptance resulted in the slowing down of the process of diversification. But in this connection he noted that there was no real choice in that it was implied in the negotiations that the proposals were not accepted in principle, that Jamaica would not be able to continue enjoying the benefits of sterling area membership. Furthermore, there was no well thought out alternative to membership in the sterling area. However, the paper concludes that at the expiration of the agreement, policy will have to be formulated as to whether or not Jamaica should remain in the sterling area.

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SUMMARY OF DISCUSSIONS

Agenda Items (1) and (2)

CONTINUATION

Second Session on the Bank of Jamaica and Bank of Trinidad
and Tobago's Papers.

Mr. McLean raised the point that in a conceivable winding-up of the present system, e.g. if the time came when the International Monetary System would move out of the holding of national currencies, e.g. sterling and U.S. dollars, to some form of international currency, the U.K. will be responsible for purchasing this new currency to be transferred to holders of her liabilities. Since the U.K. claims on the rest of the world are equal to one quarter ($\frac{1}{4}$) of her liabilities the U.K. would not be in a position to redeem her debts. The Caribbean Governments would obtain about one fifth (about £25 million of their assets) in convertible form.

Professor Cumper expressed concern over what would happen at the expiration of the agreement. He saw the need for projections to be made over a period of twenty years, in terms of patterns of trade, distribution of currencies, liabilities and debts, assuming no radical changes in policy making. Then an assessment of the consequences of alternatives to holding sterling should be undertaken. In other words there was need to minimise the risk and this could best be done by some quantitative exploration.

Mr Best noted that this was done in the Trinidad and Tobago Draft Third Five-Year Plan and what was now needed was to project the transactions demand for foreign balances.

Mr. McIntyre then suggested an examination of the instruments of monetary policy that could be used to take advantage of the favourable situation where the commercial banks have been increasing their local liquid position. He wished to explore the possibility of retaining this liquidity in the domestic system.

Mr. Muschette raised the legal implications of "locking-in" funds, that is, the refusal to redeem the commercial banks holdings of the national currency which he saw implied in Mr. McIntyre's comment.

Mr. McIntyre explained that what he had in mind was an appropriate variation of the local assets ratio and activation of similar instruments and he suggested by example that if the commercial banks brought in about ten million dollars and the local assets ratio was set at 90%, then the economy would gain nine million dollars.

The Chairman intervened with the thought that the holding of a local assets ratio of 90% would contribute to the undermining of the national currency.

Mr. D'Andrade emphasized that a distinction must be made between the holding of local assets against local liabilities and

the bringing in of assets against foreign liabilities. Whereas the former can be "locked-in", the latter poses problems of exchange control and repatriation of profits. He felt that to the extent that utilisation of the new liquidity was achieved the more effective would be the "locking-in". For example he pointed out that one way of using this excess liquidity was to run a budget deficit.

Mr. Muschette agreed that there was a need for using the surplus liquidity.

Mr. Asgar Ali pointed out that in this respect a co-ordination of monetary and fiscal policy was needed.

Mr. L. Best suggested the establishment of different types of Banks - development banks for different types of financing.

Mr. McIntyre noted that the Draft Third Five-Year Plan of Trinidad and Tobago does not take account of this source of capital, even though it proposed to embark on a wide range of economic projects.

Mr. McLean pointed out that a proper conception of a Central Bank is important. It was possible to choose between investment in equities or the establishment of other financial institutions, for example, the Central Bank can have a more direct relationship with mortgage society and rediscount mortgages. In the circumstances, serious research must be done on the type of Central Bank needed to operate in

the region.

Mr. Codrington pointed out that as institutions the commercial banks were only involved in short-term investment.

Dr. McLeod argued that making use of the available resources revolved not only around the government running a budget deficit or borrowing from the banking system. Private savers must be persuaded to put their money into government long-term issues. If the reserves are left in the banking system, there are limitations on what can be done. It was not enough to run a budget deficit. It was necessary to induce the public to buy government bonds in order to finance the long-term programme of government. As an alternative the funds could be transferred into development corporations. He went on to suggest that a budget deficit meant running down exchange reserves. This would imply a certain amount of pressure on the Central Bank in the operation of its exchange policy, since there is a difference between the exchange reserves of the commercial banks and those of the Central Bank, and in the circumstances the government cannot rely on using the foreign reserves of the commercial banks.

Mr. D'Andrade noted that in this system where foreign reserves were dissipated throughout the banking system, the Central Bank feels compelled to hold a higher level of reserves that would be normal in the same situation if these reserves

were centralised.

Mr. McLean pointed out that Dr. McLeod assumed that the liquidity structure of portfolio holdings was optimal but that was not so. He noted that commercial banks were given to holding short-term paper. Rather, they should concentrate on holding longer term paper. He acknowledged, however, that this attitude was probably based on the behaviour patterns in the private sector.

Dr. McLeod replied that he did not assume that the portfolio of commercial banks were optimal. He said that if the government or the private sector choose to do deficit financing each must take into consideration the willingness of the public to hold "paper". In terms of the optimal distribution of resources it was possible to hold all reserves in domestic issues at home, but he emphasized that the decision did not rest only with the Central Bank or with the commercial banks. He pointed out that it should be clear as to the reasons for holding reserves; for example, is it for possible fluctuations in export earnings. It is an exercise of judgement to determine a reasonable level.

Mr. Best said that what was important was a change in the location of reserves. Considerations must be given to the options open to government on the expenditure side, that is, government must spend in such a way as to reduce the import coefficient. He noted that luxury consumption items

become more important than, for example, home ownership. He felt that expenditure patterns of the public in the Caribbean depicted a revealed preference rather than a real preference. It was so because it is easier for example to obtain credit for imported goods.

Discussions then turned to the question of the adequacy of reserves.

Mr. David wanted to know under what conditions could reserves be considered adequate.

Mr. McLean thought that this question could not be considered in a vacuum and a research study was necessary for its adequate measurement.

Professor Cumper then pointed out that computer studies have been conducted on the reserve problems of corporations relative to their working balances and he found that such studies could be applied to the reserve adequacy problem.

After discussing the quantity aspect of reserves the Conference turned on the question of the quality in terms of reserve currency utilised or the holding of reserves.

Mr. Donalson suggested that studies should be undertaken both at the regional and territorial level to assess the advantages of Sterling Area membership.

Mr. McIntyre then emphasized that imperial preferences were not conditional on Sterling Area membership.

Mr. Best then pointed out that there were two principal arguments in favour of Sterling Area membership (a) Access to the London Capital Market and (b) the availability of financial intermediaries in deploring capital in the area more efficiently. He found that these two arguments were no longer relevant in that Sterling Area membership has never led to a net transfer of capital into the Caribbean region and the value of the London Capital Market has been considerably reduced.

Mr. McLean then said that a third argument was the pooling arrangements involved in the free convertibility of sterling. However in this era of free convertibility there was no need for arrangements.

Mr. Muschette wanted to know the alternatives to abandoning the Sterling Area; that is, whether a territory would stay on its own or become a member of another currency area.

Mr. McIntyre suggested that there might be three options available to the territories (a) remaining a member of the Sterling Area or (b) becoming a member of the dollar area, or (c) strengthening the IMF position, It was his view that the IMF position should be strengthened.

Dr. McLeos saw four aspects of the problem. First, there was the question of holding reserves in sterling or other currencies. At the time of devaluation some countries concluded that the possible gain or loss if they devalued

would have been negligible. Secondly, he noted the access to trade and conversion mechanisms. In this connection, although the dollar is technically more convertible, sterling has provided the OSA countries with convertibility in the past. Thirdly, there was the question of other trading relationships. He noted that there were no necessary relationship between Sterling Area membership and sterling trading relationships. Fourth, there was the question of access to the London Capital Market. He noted that this capital market has not been a successful source of capital.

The Chairman then concluded the discussions by pointing out that the territories must begin to examine their positions as the Agreement has given them a breathing space of three years. They should take stock and examine the position at the end of the Agreement and the likely direction of progress. Research work should be undertaken to determine trade patterns and reserves in order that they should be in a better position to negotiate with the U.K. government at the expiration of the Agreement.

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