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Studies in Central Banking

and

Monetary Analysis in Dependent Economies

by

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INTRODUCTION

In this paper[1] an attempt is made to appraise the structure of the Central Banking Institutions in the Caribbean,[2] to review their experiences up to the end of 1968, and to indicate the directions of future development which seems to be necessary if these institutions are to be more relevant in the processes of structural transformation and development of the Caribbean. Since the publication of Best and McIntyre,[3] there have been no published attempts to make a general and serious review of the performance of these institutions - although there have been a considerable number of "internal" publications and private communications on monetary issues. This paper attempts to fill this void. However, as Best and McIntyre found the experiences gained so far may be too limited to make for confident prognostications. Nevertheless the paper argues in the following two sections that the institutional and legal scope of these institutions are too limited, as indeed the review of experience supports. In the final section an attempt is made to outline a program for major and structural reforms.

(1) This paper was originally read at a Monetary Conference sponsored by the University of Guyana, the University of the West Indies and the Central Banks of Guyana, Trinidad-Tobago and Jamaica.

(2) This refers to the constitutionally independent English speaking territories (Guyana, Jamaica, Trinidad-Tobago).

The monetary unit used is the Guyana dollar ($1 is equal to $1 - Trinidad and Tobago which is equal to approximately 42 cents Jamaica.

(3) A First Appraisal of Monetary Management in Jamaica - Social and Economic Studies Vol 10 No.3.

Section I

The Structure of Central Banking Laws and Policy Instruments

It is a widely recognised truism that banking laws and institutional structures no matter how carefully thought out and ideally constructed cannot by themselves guarantee efficient management and effective policy formation. The reverse proposition also holds true. Nevertheless an analytical study of the main aspects of the banking laws and institutional structures in the Central Banking territories of the Caribbean will serve not only to indicate similarities and contrasts in the various territories, but may also indicate some inconsistencies and redundancies that might not have been generally appreciated.

The usual starting point in this type of analysis is a study of the stated "objectives" of the Central Bank in order to determine whether these Central Banks do bring, or can foreseeably bring, social benefits to compensate for the fact that they are "expensive luxuries". Indeed the idea that Central Banks are "expensive luxuries" has often been used to resist their establishment in many small, poor economies, which it is believed cannot afford these "luxuries". In the narrowest sense of this term, i.e. in so far as the Central Banks are capable of being self-financing entities, it is not generally recognized how profitable Central Banking is. In the region the Central Banks of Jamaica, Trinidad and Tobago and Guyana have been established with subscribed capital of $4.8 million

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dollars ($2 million Jamaican), $2 million and $4.5 million respectively. Profits earned by the Central Bank of Trinidad and Tobago totalled $12 million in the four years 1965-68, which is equivalent to a return of 600% on paid-up capital. Indeed in the very first year of its operations the profits obtained by the Central Bank of Trinidad and Tobago was equal to its paid-up capital. At the end of 1968, expenses incurred in the administration of the Bank averaged 41% of income received. In the case of Guyana, we should first of all note that comparatively speaking the bank has been highly capitalized. The volume of its business and outstanding liabilities is much smaller than the other Central Banks, in fact being the equivalent of only 40% of that of Trinidad and Tobago. Profits for the first three years of operation totalled nearly $5 million and had therefore already exceeded its paid-up capital. Bank expenses as a proportion of income received averaged only 20%, again a ratio very much below that obtained in the Central Bank of Trinidad and Tobago. In Jamaica profits for the period 1961-68 totalled $24 million ($10 million Jamaica). In the Annual Reports of the Bank of Jamaica only a summary balance sheet is provided, together with a statement on the General Reserve Fund. It has therefore not been possible to estimate any operating expenses ratio.

A comparison of stated objectives is of only limited usefulness. In Trinidad and Tobago the principal purpose of the bank is stated to be "the promotion of such monetary

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credit and exchange conditions as are most favourable to the development of the economy". In Guyana the Central Bank is enjoined to "within the context of the economic policy of the Government (to) be guided in all its actions by the objectives of fostering monetary-stability and promoting credit and exchange conditions conducive to the growth of the economy". Whilst in Jamaica the objectives are "to issue and redeem notes and coins, to keep and administer the external reserves of Jamaica, to influence the volume and conditions of supply of credit so as to promote the fullest expansion in production, trade and employment, consistent with the maintenance of monetary stability in Jamaica and the external value of the currency, to foster the development of money and capital markets in Jamaica and to act as banker to the Government".

Generally speaking in the two former territories, the Central Banks are by stated intentions more growth oriented and less pre-occupied with monetary stability than is the case of Jamaica. As we shall observe later the Central Banks of the two former territories, particularly in the early periods of their formation have been more responsive to the demands of government credit than is the case of Jamaica. As a consequence they mighthave engendered the likelihood of greater monetary "instability"in their support of growth objectives through accommodating public sector absorption of resources.

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It is a matter of conjecture as to whether the stated objectives of the laws were responsible for these developments. A broader interpretation of events in the various territories would be that the Jamaican Central Bank was more tentative because it was established earlier, at a time when it was highly questionable if territories such as these could manage the "sophisticated" mechanisms of Central Banks! In the case of the other territories the establishment of Central Banks took place at a time when economic and political events at home were forcing the state to expand its role in the economy. In the case of Guyana this was brought about by the necessity to overcome the depression of economic activity which coincided with the unfavourable political situation in 1962-64 and in the case of Trinidad and Tobago to support the public sector drives towards economic diversification as the government interpreted this, in order to overcome the depressive consequences of stagnation in the petroleum industry during 1963-65.

This difference in stated objectives is also in part a reflection of the role of foreign experts in setting the climate of opinion at the initiation of monetary change in the region. More than any other sphere of the administration of public policy, Central Banking in the region has been dominated by foreign expertise. Not only have the laws been framed by these experts, but their administration in the

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earlier years have been in all cases left to foreign experts. Generally, these "experts" themselves have shown changing attitudes. At the time of the changes introduced into Jamaica the dominant preoccupation was an imitation of an ideal structure, usually the Bank of England, together with stringent controls built into the laws in order to prevent excessive credit creation, particularly through the financing of state activities. It is only in this way that we can explain why it is that the Central Bank legislation in Jamaica maintains the archaic distinction between currency and banking division or why it is in all the territories the legislation ensures close control of the use of domestic assets to finance the currency issue. In response to changing national demands and the non-realization of their worse fears, the later experts have been more flexible in their attitudes to the structure of institutions, while at the same time maintaining their pre-occupation with what they thought was the Currency Board's chief virtue - its anti-inflationary bias. As our analysis will show, despite this the laws are unclear and confusing over the limits of Central Bank credit creation.

For the purposes of analysing the present situation we shall categorize our discussion under two headings - Central Bank control of the Public Sector and the Commercial Banking Sector.

/1. Public Sector Credit..

1. Public Sector Credit

In all three territories there are two fundamental methods of lending to the public sector. The first of these is the general power to purchase and sell, or discount and rediscount government securities. Purchases of these securities can take place either directly from the governments or indirectly from the private and/or banking sector. In none of these territories is there any restraint on the <u>maturity composition</u> of the public sector debt which the Central Bank may acquire in the course of its Public Debt operations. This is indeed surprising in view of the dominant aim of restraining excessive creation of credit by these institutions and the fact that the liquidity effect of acquiring Treasury Bills varies drastically from that of acquiring long dated securities. Much is therefore left to the discretion and power of the Central Bank to influence the liquidity effects of government borrowing within the overall limits established for public debt issues. But, if as is the case, limits on public debt issues are imposed by the laws governing the particular type of debt issue then they are not directly within the powers of the Central Bank to influence. In this case they have no decisive impact on the maturity composition of the government securities they acquire. It is in fact desirable that the situation should remain as it is but we must therefore be clear of the consequence, that is in so doing we are

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reducing the capacity of the Central Bank to restrain liquidity increases by reference to its <u>own</u> enabling powers.

The second method of influencing public sector credit is through the making of loans and advances. In two of the territories the terms and conditions of these advances are subject to mutual agreement, within certain limits, which affect the quantity but not the price of this credit. In the case of Guyana a minimum of 3% is statutorily imposed. The level of advances is of course responsive to the rate of interest since it is competitive with the Treasury Bill issue, other things being equal: such as the state of the short term securities market, particularly the commercial banks demand for Treasury Bills of the various territories. In recognition of this it has been the practice to impose a uniform rate. The limits on credit granted to the public sector by their respective Central Banks differ among them. Further there is a conflict in the laws as to what precisely is the effective upper limit of such credit. In addition, as we shall observe, in none of the territories are any of these limits being approached.

In Trinidad and Tobago the limits on advances are given as

(1) 15 percent of the estimates of the Government of its annual revenue for the year in question, including in annual revenue, recurrent

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revenues as well as capital receipts (exclusive of any type of loan).

(2) that repayment should be as soon as possible, subject to the provision that if it is not repaid at the end of the year then it is carried over to the next year and deducted from that year's credit.

In Guyana the advances limit is given as 15% of ordinary revenues but this is based on the averages of three preceeding years. It is clear that such a limit is more stringent, in that it does not permit the possibility of inflated estimates to be used as the basis for granting credit, which if granted would of course reinforce whatever inflationary or balance-of-payments dis-equilibrating tendencies there might be. The repayment period is specified as 350 days.

Consistent with, as we shall see in the next sector, its observed policy of restraint in financing the public sector the Central Bank laws in Jamaica limits the advances it can make to the state to 15% of estimated revenue for the particular financial year and narrows the repayment period to 90 days after the end of the financial year. Of course with the possibility of renewal the de facto life of these loans can be readily extended within the quantitative limits.

This limit on advances constitutes one brake on credit to the public sector. However in all the territories additional

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limits exist to cope with situations where the credit is provided through the purchase of securities. In Trinidad-Tobago the Bank cannot hold government securities in excess of seven times its authorized capital (which at the end of 1968 would have allowed a holding of $35 million) <u>or</u> seven times its paid-up capital and general reserve fund (which at the end of 1968 would have allowed a holding of $49 million). The latter limit is of course more flexible once there is scope for a regular growth in this fund, to which profits of the Bank are deposited. In Guyana the limit to the holdings of government securities is 30% of the average annual revenues collected and accounted for over the three previous years. In Jamaica the limit of government securities is specified separately for the Banking division and is limited to seven times the authorized capital.

The distinction between Banking and Currency Divisions in Jamaica highlights dramatically the source of conflict in limits to public sector credit, but it is the same for the other territories. In all three of the territories the currency issue has to be backed by a minimum holding of 50 per-cent foreign assets. When we examine the figures this is what we observe. In Guyana, directly stated the Bank can hold, as we observed, the equivalent of 15% of government's revenue for advances and 30% for other sources of lending, making a total of 45%. For the period 1966-68 this would be equal to

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approximately $93 million. We might note here that the limits are <u>greater</u>, when directly stated, i.e. with reference to the holdings of government securities than in Jamaica or Trinidad-Tobago. However if we take the limit that 50% of the currency issue must be backed by foreign assets then this yields at the end of 1968 a required foreign asset holding of $19 million and permitted a local asset holding of only $36 million. In view of this conflict, which is in fact the real legal upper limit? One would be inclined to guess the external reserve holding if only because of the tradition of securing the currency issue <u>first</u>. In practice these conflicting legal limits are not a source of bother since the actual holding of government securities in the Bank of Guyana was only $4.2 million.

The same conflicts exist in Trinidad-Tobago but the legal upper limits reverse themselves. In Trinidad-Tobago 50% of the currency issue is to be accounted for by holdings of foreign assets. This would have totalled at the end of 1968, $30 million and thus permitted a maximum local securities holding of $107 million since total liabilities was equal to $137 million. In terms of the other measure the limits would be 50% of currency as local assets which is equal to $30 million plus either the $35 million or $49 million as calculated above, thus making limits of $65 million or $79 million. The foreign reserve limit therefore permits a greater holding of local assets than the direct requirements permit. Again

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like Guyana these limits are not being approached as the actual holding of government securities totalled only $27 million.

In Jamaica the Banking division has an expressly stated limit to its holdings of government securities equal to seven times the authorized capital which is presently valued at $34 million ($14 million Jamaican), plus 50% of the currency issue which at the end of 1968 was equal to $49 million ($20 million Jamaican) making a total of $83 million. The actual holdings of government securities was equal to approximately $10 million ($4.2 million Jamaican). The compulsory foreign reserve holding was equal to $49 million ($20 million Jamaican). This would have permitted a local government securities holding of $205 million ($86 million Jamaican).

In the case of Jamaica the ambiguity may be less because the distinction between currency and banking divisions is explicitly formulated and the government security requirements for each division are clearly stated. In the case of the other territories the distinctions are implicit and are reflected in the definition of the foreign reserve holdings in reference to the balance-sheet and a particular item there, viz. currency holdings. The solution of possible conflict in the interpretation of limits does not require that Trinidad-Tobago and Guyana should make the implicit distinction between currency and banking explicit and thus to revive archaisms, but in general for all the Central Banks to consider the

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feasibility of defining ~~their~~ foreign reserve holdings in some more general way and not in relation to one of its own balance sheet items. The dangers of such a practice may be a long run consideration at the moment but as the limits are approached, changes in the banking laws would become necessary to eliminate the source of conflict. In any event criteria that are more closely related to the general functioning of the economy would seem to be preferable if only because of the greater realism and flexibility this would permit. Further, such criteria would be of greater support in eliminating possible conflicts in strategy and aims between the Central Banks and the Central Government.

2. Commercial Banking Sector Credit

The sources of Central Bank control of the commercial banks are more varied and diverse, but in sum the scope for effective control is not greater. There are again two fundamental methods of extending credit. The first is rediscounting eligible paper. In general, the eligibility rules favour short-dated-instruments such as promissory notes, commercial bills, ware-house receipts and government securities. The limit is usually 180 days, although in the case of Guyana industrial and agricultural production is encouraged through permitting credit instruments of 270 days to be used. In practice the instrument most used has been government securities and the maximum amount of credit obtained in this

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way is closely linked to the limitation on the holdings of government securities discussed above. The second method is through the granting of loans and advances. The time limit for such credit is usually six months. In the case of Jamaica, the securities accepted as the basis of this credit are only allowed 75% of their current market values. No such stipulation is established in the laws of the other countries, and generally one must expect that such a stipulation would encourage rediscounting and discourage advances. It is also of some significance that the laws in Guyana do not stipulate gold as an eligible security for advances. Finally, the terms and conditions of such credit as is provided is left in all cases to the discretion of the Central Bank. There is no attempt to enforce a rate structure as for example obtains in such places as Nigeria and Uganda, where the rates on loans and advances are to be maintained above the rediscount rate.

The powers of the Central Bank are predicated on the assumption that the local money market and the Bank itself are constituted as adequate sources of financial securities and credit to satisfy the liquidity preference of the local commercial banks. In practice this has not been the case and the money market in the United Kingdom has been an important resort of the local commercial banks.

There are seven basic techniques of monetary control enshrined in the various laws viz. open-market operations,

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variations in Central Bank reserve holdings, variations in the liquid assets ratios, variations in local assets ratio, changes in the discount/rediscount rate, selective controls and moral suasion. Each of these techniques have limited scope in the region, although a broad distinction between the market-type weapons and the non-market type would indicate the latter to be of greater relevance.

There are several fundamental features of the economy and the financial structure which militate against the use of market-type instruments of policy control. In the first instance the absence of a broad and active market for securities makes it impossible for substantial sales and purchases of these securities to be made with minimal effects on security prices. The securities available and traded in actively have all exclusively been government securities and these have been further confined to Treasury Bills. This situation is not a product of a deliberate policy of dealing in the short end of the market as a means towards influencing the rate structure. Indeed to all intents and purposes the fractured nature of the securities spectrum, and the limited and spasmodic amounts of medium and long-dated securities made available continue to make it impossible for any such "bills-only" policy to have much validity. Dealings in Treasury Bills have been a response to the needs of short-term borrowing by the government (up to fixed statutory amounts) and of the need of the commercial banks to fulfil their liquidity requirements as

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specified in the various banking laws, after taking into account the competitive attractions of lending their short-term funds abroad.

In the second instance the commercial banks do not maintain any more or less fixed ratio of cash to deposits. Flexibility in the cash and liquid assets ratio characterizes the banking system. In addition the access which the commercial banks have to overseas balances enhances this flexibility. Borrowing from the Central Bank, and holding local Treasury Bills are directly competitive with access to overseas money markets. The only countervailing forces on this are the costs involved in moving from one money market to another. And, any efforts to make these costs effective forces the Central Banks to adapt and to adjust their interest rate levels to those prevailing in the overseas money markets. As a consequence market dealings are effectively defensive in their intention i.e. to support the rate structure dictated by the U.K. money market rates.

A third factor is that the banks do not operate so that they always maintain a symmetry between their ratios of cash balance and their willingness to lend or grant advances. Lending policies in the area are largely dependent on the commercial banks interpretation of "credit-worthiness". Whilst this may be more or less inevitable in thepresent context of banking, these standards have placed heavy emphasis

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on the inherent liquidity of their loans and advances rather than the ability of the borrower to repay. The usual assumption often being that the two features occur in the same enterprise or other borrowing unit in the West Indies. The absence of these symmetrical responses makes it impossible to affect the levels and rate of increase of bank credit through operating on their liquid assets holdings.

Fourthly, there is not sufficient evidence that the banks do view their balances with the Central Bank or their ability to resort to them for advances as a source of genuine reserve. There is more than a suggestion that the compulsory requirement to hold balances with the Central Bank is treated as a more or less compulsory levy if they are to continue their activities within any given territory. Borrowing from the Central Bank is confined to the essential though trivial occupations of managing their day-to-day cash positions as stipulated by law. Thus numerous borrowings for a few days at a time are resorted to.

Of all the market type policies the one most frequently used is the discount/rediscount rate. Changes in these rates have occurred largely in response to the changing rate pattern in the United Kingdom. There are in the various Bank reports many assurances of the fact that the rates are fixed with internal considerations at the foremost. In practice, even if this were true there is little evidence of what can be achieved by so doing. The references to the

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establishment of this rate so as to balance local investment decisions with the capital funds available locally are of little significance. In the first place much of the domestic investment is financed by the use of non-resident capital. (the estimated ratios vary between 60:40 and 70:30). It is therefore not significant what the domestic rate structure is. In the second place much of the actual investment undertaken is financed from the utilization of business savings i.e. ploughed-back profits and depreciation allowances in highly specific enterprises so that the prevailing domestic market price of capital is again of little significance in forming investment plans. Thirdly, in the area of short-term credit, which accounts for the bulk of bank credit changing price levels, easily encountered or "managed" in situations of bouyant demand, further reduce the significance of the rate of interest. In addition, interest payments are also small in relation to amortization payments. Higher interest rates are therefore unlikely to affect significantly, customary inventory/sales (largely imports) ratios. Further "availability" considerations have to be also weighed against the "cost" of borrowing, and the latter appears to be in the region overwhelmingly decisive.

The net effect of these is to confine, as we have argued, interest rate policies to adapting the position of the local economy to the position whereby most enterprises and financial institutions are allowed to operate freely in two money markets of unequal "breadth', depth and resiliency".

In spite of these fundamental limitations to the statutory powers of control there are a number of technical management functions which these instruments of policy permit the Central Bank to perform. Among these are neutralizing (i) seasonal movements in the level of activity in economy; (ii) the effects of Government financing created by the fact that tax payments and receipts and not uniquely co-incident;

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and (iii) minor imbalances in the balance of payments. In all cases, whilst a comprehensive policy aimed at correcting any severe destabilizing factors is not possible, it allows a day to day, or week to week, management of the monetary side of the economy.

In the case of the non-market controls there are basically two competitive types. Those which permit some uniform, across the board control of some banking ratio (such as the cash ratio or the liquid assets ratio) and thus seek to establish some degree of "indirectness" in their control of bank credit, and those, which go directly to limiting the level and size of loans and advances. Among the former types the laws contain some important anachronisms, copied directly from other banking situations. One of this is the distinction which is made between fixed deposit and demand deposit liabilities in determining reserve ratios. There is no need to maintain this differential system. Indeed it is surprising that the commercial banks in the region have never objected to this factor which serves to reduce their competitiveness vis a vis other thrift and savings institutions. Another, is the treatment of foreign balances in the liquid assets definition. In Jamaica it is specifically excluded as a liquid asset although the practice shows clearly that the commercial banks think these foreign balances are liquid and the Central Bank has never sought to restrain them in these views. Usually it is not clear whether the Central Bank requires that the overseas balances with the Head Office to be netted out or not for purposes of conforming to the ratio. If this is not done the danger is that it is possible through a simple balance sheet entry to alter the size of these balances. Other ambiguities are that the laws do not indicate how these balances are to be treated when they are negative; nor do they make any distinction between liabilities of a monetary and short-term kind

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(which appears in the item balances due to overseas banks), and other liabilities of a long-term capital nature.

Despite these administrative and definitional problems it is plainly intended that variation in reserve requirements is the substitute for traditional open-market-techniques. However it runs up against a number of structural problems. In the first place it is possible through the right combination of items to make the upper limit of various reserve ratios undefined by law. This naturally provides a source of temptation for governments to finance Treasury Bill issues with lack of discretion as regards to its effect on the liquidity of the banking system. In such a case the upper limit is usually that implied in the limits of credit provided to the public sector which were noted above.

Secondly the policy is unworkable in a situation, where as we observed banking ratios are unstable and the size of the deposit-creation multiplier of the banks themselves uncertain. Thirdly, frequency of changes in these ratios not only introduces instability and uncertainty into banking as it is presently conducted, but also has a discriminatory impact on banks since the excess reserve positions are not always the same. This problem is particularly acute in the region since apart from consumer accounts there is much evidence that firms hold their accounts with a particular bank. Given the seasonality of much of the production there is therefore no likelihood that these accounts will at any time of the year be equal in their incidence. Fourthly, such policies have divergent responses. Restriction of bank credit is usually easier, and speedier in its effects once the limits can be made effective, than expansion; the reason being that the latter depends also on the bank's willingness to lend and their interpretation of "credit-worthiness".

In view of these limitations it is clear that

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variations in reserve requirements is a far from satisfactory tool. It has one advantage over the market weapons in that it does not force Central Bank holdings and dealings in securities to be large in relation to either excess reserves in the commercial banking sector or to any foreign exchange inflows which lead to an expansion in the reserve base of the banking sector.

The most direct controls i.e. those directed to credit granted by the banks are likely to be the most effective. However, their effectiveness is likely to be heavily confined to restraints on lending rather than ensuring that bank lending, when it does occur, fulfils the required conditions for growth. In this regard the overriding need is still for the direct state provision of"commercial" type banking services which none of the Central Bank laws envisage.(1) Recent changes in commercial bank lending have tended to favour (i) the term-loan, (ii) the renewal of advances to permit the more or less permanent financing of working capital (iii) some diversification of lending opportunities outside of the traditional categories of overseas plantations or corporations engaged in export activity to consumers and professional groups for the purchase of durable goods and equipment.

Moral suasion has been the most frequently used of the techniques of control. The power to exercise this control is really an integral part of the central banking laws which give to these institutions power over the commercial banking system. It is not an extra-legal authority, as is often assumed, based on purely moral considerations. It is based on power relations between the two sectors of the banking system. So far, in the

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(1) In Guyana there has been the recent establishment (February 23, 1970) of a National Co-operative Bank.

first flush of nationalist support for Central Banking institutions and the fear that injudicious acts on their part may tempt governmental indiscretion, as they see it, the commercial banks have made serious efforts to be accommodating. The unclear issue is however to what extent they have succeeded in making a similar and perhaps more extensive encroachment on Central Bank objectives. Certainly it seems, from the encouragement given to new commercial banks to establish themselves in the region and their support for existing commercial banks, that the Central Banks are basically committed to maintaining and fostering the development of this sector as it is currently organized.

/so far Finally, although/ it has not been comprehensively introduced in the Caribbean there is a strong likelihood that the Central Banks will develop the pre-deposit on import requirements technique[1]. Given the high import leakages and the other "open" characteristics of the economies it is felt that a policy instrument which is geared to raising the cost of credit, and restricting its availability for import expenditure is expressly suited to the regional context. But it is unlikely that such a policy will work for a number of reasons. What is likely, is that in the absence of direct controls, existing financial institutions will make the credit available

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[1] The 100% deposit on letters of credit imposed in Guyana in 1966 is some indication of thinking along these lines.

finance the pre-deposit requirement. Many features of the local economy would lead us to anticipate this. Firstly, such loans would be virtually riskless, since the deposit itself guarantees the loan. Secondly, importing houses obtain much preferential treatment in obtaining credit. Sometimes this is due to their size and importance in the mercantile and the general community, and in other situations it may be due to the fact that liens on the goods imported constitute an excellent collateral or that the credit demands of importers (inventory financing) match the lending preferences of the commercial banks considerably. Thirdly, many of these importing houses have a long association with foreign exporting firms and therefore may find it possible to obtain this credit externally. Fourthly, in the case of both domestic and external credit (or indeed resort to financial resources internal to the firm) the larger import-houses are not nearly as much discriminated against as the smaller importers.

From this it is clear that the technique of pre-deposit requirements does not obviate the need to seek direct controls on the lending of the banks to ensure that the spill-ore into imports and the loss of foreign reserves are not maintained. In this regard we should also observe that as the pre-deposit requirements are met, even though the Central Bank will establish devices to neutralize their monetary impact, this cannot continue indefinitely. At the time the restrictions are abolished there will be the danger of discrete and possibly large increases in liquidity occurring at particular points in time.

SECTION 2

Central Banking Experience in the Caribbean

To date central banking experience in the Caribbean territories has been relatively limited. The longest functioning Central Bank (Jamaica) only assumed full operations in 1962[1]. Nevertheless, the experiences of these Banks are important for further understanding both of the institutional and legal constraints under which they operate as well as the deep structural rigidities and imbalances in the economy which determine much of the monetary phenomena.

In all of the territories, as a result of their open economic structures, foreign exchange (earned either through export sales, or foreign capital inflows into direct private investment or the public sector) is important for determining the levels and patterns of expenditure by domestic residents. Much of this expenditure is directed to foreign imports. As a consequence monetary imbalances, depending on their sources, often reflect themselves in a loss of foreign exchange. At the same time the levels of foreign exchange earned determine significantly the levels of real expenditure and the levels of excess reserves in the banking system.

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[1] The Central Banks of Guyana's & Trinidad and Tobago's first full year of operations was 1966.

Prior to the establishment of Central Banks this was observed in the high leakages of bank credit into imports and the strong inter-relationship between the balance of payments and the money supply. In the absence of Central Banks the commercial banks performed the central banking function of providing and administering the country's "accommodating finance", and imposing its limits on credit creation in both the private and public sector. The establishment of Central Banks has resulted in a legal transfer of these functions. Consequently, an appraisal of the performance of the Central Banks must seek to establish the extent to which they are succeeding in influencing the relevant variables in terms of their objectives, which are by the fact of their existence intended to be superior to those of the commercial banks. The latter performed these functions subject to the over-riding responsibility to earn profits as part of the functions of a banking unit that is itself part of a private multi-national banking structure seeking to maximize global profits. As such the arrangements were never efficient from a national standpoint. The commercial banks themselves have historically treated the region as a "surplus" area. As a result until recently the tendency has been to promote a secular outflow of deposits raised locally. Their limits to private sector credit were rigidly enshrined in their policy of adopting a lending pattern based on their own internally determined criteria of "credit-worthiness".

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When applied this has usually meant that the expansion of credit to the private sector never seriously endangered the balance of payments. In addition, the governments of the Caribbean were at the time more or less committed to a policy of balanced budgets and this facilitated commercial bank controls of public sector credit. As far as the private sector was concerned the Currency Board requirement of maintaining a virtual 100% foreign backing for domestic monetary expansion operated as a permanent deflationary drag. And this was helped by the open structure of these economies which ensured that no significant differentials could develop between local price levels and those prevailing in their main trading partners - the United Kingdom and North America.

A. Central Banking in Guyana

In its first four years of full operations the Central Bank of Guyana has had to encounter four major crises. The first of these may be termed the crisis of inception. This refers to developments in 1966 in which the Central Bank clearly felt, and indeed argued in its Annual Report for that year, that the indiscriminate use of its credit-creating powers had led to huge increases in government deficit financing, which had not been openly inflationary (the price level increased by only 2.4% in that year) but had been suppressed and diverted into imports which created a drastic loss in foreign exchange. As the data in Table I shows the foreign assets held in the banking

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system had fallen during 1966 by $11.3 million or about 23% below the 1965 level. This was accompanied by a large expansion in claims on the public sector - an increase of $12.4 million or 66% (from a 1965 level of $18 million to $30.4 million). This increase was largely financed through the provision of $8 million worth of advances by the Bank of Guyana to the government almost immediately upon its establishment.

TABLE I

Monetary Changes in Guyana $Million

	1965	1966	1967	1968	1969
1. Foreign Assets	49.1	37.8	52.0	50.7	45.7
A. Central Bank (including Currency Board)	34.4	29.0	37.7	47.1	41.4
B. Commercial Banks	14.6	8.8	14.3	3.6	4.3
2. Claims on the Public Sector	18.0	30.4	26.8	34.6	47.9
(a) Central Bank	3.3	12.6	7.2	3.2	17.4
(b) Commercial Banks	14.7	17.8	19.6	30.4	30.5
3. Balance of payments (surplus +) (deficit -)	-9.4	-8.9	+5.1	+12.1	N.A.
4. Money Supply	44.1	46.6	51.1	56.5	60.6
(a) Currency in Circulation	27.8	28.0	30.7	34.3	36.1
(b) demand deposits	16.3	18.6	20.4	22.2	24.5
5. Fixed Deposits of Commercial Banks	57.1	63.3	72.7	82.9	93.6
6. Total Commercial Bank Advances	48.1	53.5	52.5	65.2	78.3
7. Banking systems Loans and Advances to the Private Sector	30.0	41.0	44.1	56.5	N.A.

Source: Bank of Guyana, Annual Reports

This crisis and the Central Banks responses serve to highlight three important central banking issues in the region. The first of these is the complex problem of diagnosis, Whilst it is true that the fall in reserves was accompanied by an expansion in public sector credit, it should also be noted that the overall deficit in the balance of payments was in fact less than that of the previous year as the data in Table I shows. The data in Table 2 below also indicates that the trend in imports had not been significantly different for that year and that in fact the crisis of 1966 had started at least as early as 1964 when the balance of trade went into deficit after four previous years of large surpluses.

TABLE 2

Selected Trade and Pavments Statistics -

Guyana $M

	1961	1962	1963	1964	1965	1966	1967	1968
1. Imports C.I.F.	-147.0	-126.3	-118.5	-150.8	-161.0	-202.0	-225.3	-229.2
2. Exports (F.O.B.)	+149.5	+164.0	+175.7	+169.4	+177.1	+192.3	+217.7	+238.8
3. Balance on trade	+2.5	+37.7	+57.2	+18.5	-3.8	-9.7	-7.6	+9.7
4. Balance on Current Account (including transfer payments)	-19.6	+8.9	+29.2	-11.7	-27.9	-40.2	-36.7	-26.7
5. Balance on non-monetary capital account	+17.6	+14.3	+8.9	+12.6	+18.6	+31.3	+45.7	+38.[illegible]

Source: Bank of Guyana Annual Reports

In addition, credit to the private sector had also increased rapidly. In 1966 it was $10 million above the previous years level, a rate of increase which was more than three times the rate of the previous year. Further, the money supply in 1966 showed no significant increases over the previous year. Finally, the growth in fixed deposits exceeded by substantial amounts the expansion in advances. The pressures on reserves which started as early as 1964 had been building up and not making themselves manifest because of the then existing Currency Board arrangements. Relatively liberal Central Bank credit to the public sector in 1966 added to these pressures but they could not, in view of the evidence of other pressures, be alone accountable for the foreign reserve loss. Normally, the financing of this reserve loss would have occurred almost entirely through changes in the foreign balances of the commercial banks and the currency issue. If either of these had occurred then the corrective mechanism would have been self-regulating in the case of the currency issue in so far as expenditures are related to currency supplies. Or, it would have been dependent on the commercial banks interpretation of the profit/loss position of their portfolio and their capacity to borrow from Head Office. As things stood, with reserves centralized in the Bank of Guyana the impulses which were already there, merely shifted their location.

The second issue is the close relationship between total credit expansion and foreign reserve losses. The banking systems

/increase..

increase in its claims on the public and private sector between 1965 and 1966 was equal to $23.4 million an increase of nearly 50%. This increase was nearly evenly divided between the public and the private sectors. Unless the import content of the expenditures these advances financed are calculated there is no basis for the arbitrary assumption that it was credit to the public sector which in particular occassioned the foreign-reserve drain. That the reserve loss in 1966 had not been greater is mainly due to the expansion of capital inflows from a level of nearly $13 million to $31 million during the years 1964-66.

The third of these issues is the unrelatedness of the Central Banking Law to the realities of Guyana. This manifests itself in two ways. As the Bank itself has observed "The limit, quite restrictive by international standards, on advances to the Government by the Central Bank in the Bank's statute turned out to be relatively liberal in 1966 as full advantage was taken of the difference between the new limit and the previous limits imposed by the commercial banks. The internal deficit of the Government ...... was therefore not only largely financed by the Central Bank, but could actually not have been incurred to the same extent without it".[1] One might add that the limit spoken of is the standard limit in the ex-British Empire territories.

/Secondly..

[1] Bank of Guyana Annual Report, 1966 pp.10

Secondly the Central Bank itself is a subsidiary institution in the positive administration of policy. If we accept the interpretation of the Bank of Guyana that the crisis was one of bank credit to the Government then it is clear that the stage at which its influence is to be felt is in the framing of the Annual Budget. Failing that the law does not permit the Bank much room for manoeuvre in the restraint of credit.

The difficulties mentioned here are clearly evidenced in the policies pursued in this crisis. On 25th July, 1966, the Bank Rate was increased. But as the Bank explained "it was raised to 6.5% mainly in order to allow the treasury bill rate to rise and to remain in line with the London rates, and to ensure that the comparison of different forms of adjustment would not always come out in favour of borrowing from the Bank and against the transfer of foreign balances to the Bank".[i] Further in December of that year the Bank increased the liquid assets ratio from the prevailing levels of 15% against fixed deposits and 10% against demand deposits to 20% on fixed and 15% on demand deposits. The irrelevance of the changes in these ratios are shown in Table 3, where it can be seen that actual ratios, substantially exceed the required ratios.

/Table 3..

[1] Ibid P.33

TABLE 3

Commercial Banks Liquid Assets Ratio - $Million

Year	Actual	Required
1965	25.8	14.1
1966	22.8	14.9
1967	27.5	16.7
1968	30.1	18.8

Source: Bank of Guyana Annual Reports

Another policy measure introduced was to require that a 100% deposit be made at the time letters of credit were opened for import purposes. This policy was also of marginal significance as the Bank discovered that it only influenced a small area of import financing.

By 1967 reserves were building up again. But the forces accounting for this were to a large extent independent of public sector borrowing. It is true that public sector borrowing fell by about $3.6 million but this could not explain the substantial ($14.4 million) increase in foreign exchange reserves. The explanation has to be sought in such factors as the reversal to a balance of payments surplus, the large relative expansion of fixed deposits with the commercial banks, an expansion of exports and a nearly 50% expansion in net foreign capital inflows. As most of these items were independent of Central Bank activity the correction therefore occurred without much reference to it,

/except..

except perhaps in the restraint in import expenditures.

But by 1967 the first of two other important and directly related crises dramatically appeared. These can be termed the crises of independence and refer to the Central Banks capacity to follow independent exchange rate and/or interest rate policies. The devaluation of the £ sterling in November 1967 was quickly followed by an equivalent size devaluation of the Guyana dollar. Previously, during the same year the Central Bank was relying on its own(as it proved optimistic) forecast of a public sector surplus to correct the disequilibrium manifested in the 1966 loss of foreign assets. The 'ineffective' liquid assets ratios were maintained although the equally ineffective letters of credit pre-deposit scheme was abandoned. However the basic corrective forces we observed above were already in operation. The reaction to the devaluation of sterling was therefore purely defensive. It demonstrated that the de jure independence of the monetary standard does not accord with the de facto reality.

Since the devaluation of 1967 two further developments have occurred. In face of its manifest dependence on the sterling exchange standard the Central Bank started to pursue a policy of independent discount rates. The rate level of 6.5% decided on in July 1966 has been maintained until now; although there have been a number of variations in the Treasury Bill rate in response to the higher prevailing United Kingdom rates. Thus for example between November 1967 and March 1968 the

/United Kingdom..

United Kingdom rate was kept at 8% and the average discount rate of Guyana Treasury Bills rose from 6% in November to 6.42% by the end of March. With the downward adjustment of the United Kingdom Bank rate in 1968 to the level of 7% the local Bank Rate together with exchange commission charges operated as an incentive for an inflow of funds.

As a result the banking system has become highly liquid. This increase in liquidity has been further reinforced by an even larger balance of payments surplus in 1968 than that of the preceding year. Despite this the Central Bank has maintained lending rates at the level reached in July 1966 during the crisis. In keeping with this policy commercial bank deposit rates have also been high and have been maintained at levels of 6% and more for a 3 month call account. The further expansion of fixed deposits ($10.2 million or about 14% between 1967 and 1968) reflects the attractiveness of these rates. It was during 1968 that the money supply also began to show signs of significant increases. In that year it grew by 10% and in 1969 by a further 7%. At the same time the banking systems holdings of claims on the public sector were also increasing as the government had to make suitable securities available for the highly liquid commercial banks, if there was not to be an outflow of funds. Thus during 1968-69 commercial banks holdings of Treasury Bills were averaging nearly $14 million.

/Over..

Over and above these pressures making for high levels of liquidity in the banking system there was the Caribbean wide phenomenon of an inflow of sterling in response to the devaluation of November 1967. It has been argued that the commercial banks are seeking to establish a territorial balance in terms of assets and liabilities to avoid the "risks" associated with a further devaluation of sterling. Certainly the run down of foreign balances has been very marked since then. But it is perhaps too early to say whether the "risk" factors (i.e. the threat of capital loss) outweighs the "pure profit", (i.e. comparative security yields, assuming no exchange-rate induced losses) advantages of a portfolio adjustment away from foreign balances and in to local Treasury Bills net of exchange commission charges. The evidence of the spread between Jamaica Bank rate and the United Kingdom rate suggest that the rate structure in Guyana is sufficiently high, when exchange commissions are added to account for the type of portfolio adjustments which have been occurring. The Jamaican Bank Rate, as a matter of express policy[1] has moved in close sympathy with the United Kingdom Bank Rate. This has been effectively accomplished within a Bank Rate spread of 1.5% - 2.0% below the United Kingdom rate. At its

/maximum..

[1] See the discussion of the Jamaican experience later.

maximum point of divergence, i.e., at the peak of the devaluation crisis the Guyana rate was 2% below the United Kingdom rate. The subsequent adjustments in the United Kingdom rate has reduced the rate gap in Guyana's favour. At the moment it therefore appears as if the traditional "riskless profit" motives could still be dominant[(1)]. In this regard the recently concluded Basle Agreements and other Sterling Area Arrangements are also reinforcing of the traditional trends in so far as they reduce the risk element in the foreign exchange market for Sterling Area currencies. As a result therefore we cannot draw any proof of independence from the much vaunted Bank Rate policies of the Bank of Guyana.

The fourth crisis was one of determining the pattern of external relations. The crisis was most dramatically highlighted in the exchange rate, and to a lesser extent Bank Rate, policies discussed above. They are also reflected in the Sterling Area policies of Guyana (together with the recently concluded Basle and other Agreements) and Guyana's participation in the IMF. Comments on the Basle arrangements are deferred to the next section where they are more conveniently discussed in relation to all the territories.

[(1)] One other factor which suggests itself is that the Bank Rate in the United Kingdom is not the comparative rate. A comparison of the Treasury Bill rates in the two countries show a reduced spread of 1.18%. Moreover in so far as the

/foreign..

As a token gesture of the independence of the monetary standard the par value of the Guyana dollar has been expressed in terms of gold. This abandoned the previous Currency Board practice of fixing the exchange rate in terms of sterling. However, as the devaluation of 1967 has demonstrated there is a de facto dependence on the sterling exchange standard. This is perhaps inevitable given the structure of real production and trade, and of the available financial institutions in the region.

In keeping with their widely published intentions of demonstrating that the new Central Bank was no less 'sound' than the previous Currency Board, Guyana immediately acceded to Article VIII sections 2,3,4 of the International Monetary Fund regulations which made the Guyana dollar fully convertible in terms of the Fund requirements. No attempt was made to accept the transitional provisions of Article XIV, section 2. Thus Guyana was not in a position to impose restrictions on payment and transfers on current account without prior approval. In lieu of this a Stand-By Agreement for $15 million was entered into. Guyana's

/gold..

foreign balances are being substituted by local loans and advances, then it is the rate on these that should be compared. As can be seen from Table I between 1965 and 1969 advances grew by about 62% i.e. $30 million, whilst Treasury Bills holdings grew by only about $10m. The nominal rates on advances quoted by the Bank of Guyana in its Annual Report do not indicate the true rate, as practices such as not charging interest on a reducing balance are not easily estimated. In any event a prime lending rate of 7.5% is enough to favour an inflow of funds through the commercial banking system.

gold subscription to the fund was approximately $2.1 million. The Stand-By Agreement was never resorted to, and in fact was reduced, after the first year, to $8 million.

The adoption of this policy was again basically defensive. It was designed to engender confidence in the newly found institution while at the same time reinforcing the traditional bias of currency and foreign exchange arrangements, which is to ensure that these arrangements serve to maximize the inflow of capital as the dominant condition of growth in real output. In this sense the policy pursued here, stood opposed to the generous credit facilities the Central Bank immediately made available to the Government upon its establishment in 1966, and which led to some of the pressures on the foreign reserve position of the bank noted above. It also stood opposed to what must have been their awareness of the on-going worsening situation in the country's balance of payments.

Apart from these basic commitments to observe Fund obligations and the change in the local par value in response to similar changes in the United Kingdom there were no policy measures to influence directly the foreign exchange position of Guyana. Unlike, as we shall observe, the Jamaican Central Bank there has been no attempt to use the exchange commission rate imposed on foreign transactions to influence these transactions. The buying and selling rate of sterling has remained the same (3/16ths of 1 per cent) for the entire period of the Bank's

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operations. The most likely reason for this inaction is that the discount rate at the levels it stood was sufficient to entice and maintain an inflow of short-term funds.

B. Central Banking in Trinidad-Tobago

The Central Bank of Trinidad-Tobago has only had four years of full operations[1]. However, as with the case of Guyana this limited experience is of some usefulness for both evaluating the efficiency of the banking structure and highlighting certain problems whose solutions are more intractable than might be imagined. As with its Guyana counterpart, the Central Bank of Trinidad-Tobago ran into what it interpreted to be a very serious crisis in 1966, its first year of full operations, and which it attributed to the indiscriminate use of its capacity to grant credit to the public sector. Between 1965 and 1966 the foreign assets holdings of the Central Authorities and the Commercial banks fell from $96 million to $80.4 million, whilst public sector credit provided by the Central Bank expanded from $7.6 million to $22.7 million. The only difference from the Guyana situation is that the Central Bank credit was provided through the purchase of Treasury Bills rather than the provision of bank advances.

/As a result..

[1]The Central Bank Act 1964 (Nov.)

As a result of these coincidental occurrences the dangerous assumption has grown that Central Bank credit to the public sector always leads to the quickest and most direct loss of foreign reserves. This view is widely reported in most of the internal communications of the Bank and is to a large extent reinforced by the traditional IMF interpretations of the credit mechanism in open economies. "Each central bank faced the question of what level of domestic assets (claims on government) to hold, and for each the experience was distinctive and perhaps instructive. One central point of each experience was the very close association between granting domestic credit and a loss of foreign reserves"(1).

Whilst it is true that excessive credit to the government, or indeed any spending unit, can lead to a drain on foreign exchange holdings the evidence does not support the view that such excessive credit was in fact provided to the government, or that government credit was the principal source of the foreign reserve drain. The conclusion one can arrive at is that those concerned

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(1) "Monetary Evolution in the Caribbean" by Charles Mansfield, IMF and IBRD Review, Finance and Development Vol VI. These views are of the author's and do not necessarily represent the IMF's views. Nevertheless the publication is an IMF publicity feature and he is a Staff Member who has had considerable experience of Central Banking in the Caribbean and Latin America.

with giving dominance to "price stability" and a "high level of reserve holdings" have used the occurrences in these countries as a buttress against governmental pressures to provide credit within the framework of existing laws. And, since the statutory bench-marks for halting credit expansion are presently either unclear or too high, it is believed that these pressures can in fact be quite considerable.

If we examine the developments during 1966 in Trinidad-Tobago, we also note the complex problem of diagnosis referred to when considering the Guyana experience, and the dangers inherent in assessing the situation from only two proxy variables, bank credit to the public sector and foreign reserve holdings. In Trinidad and Tobago the high level of economic activity recorded between 1955-62 (a 11% per annum growth in GDP at current prices) was mainly due to the petroleum boom. When petroleum expansion halted in the latter year the growth rate fell off and between 1963 - 1965 averaged only 3.4% per annum. It was during 1966 that revival started, with a nearly 50% expansion in annual crude production, and a large expansion of domestic manufacturing activity. As the data in Table 4 shows exports increased from $711 million to $753 million and imports fell from $817 million to $773 million. The balance of trade deficit in 1966 fell to one-third of the preceeding year's level. The balance of payments went into deficit, as is shown in Table 5, because capital inflows at $50 million were as much

/as 70%..

as 70% below the previous year's level of $119 million. The money supply also grew by about 8% whilst fixed deposits rose by $16 million or nearly 10%. At the same time, and of vital significance, we should note that the fall in foreign exchange reserves was almost all confined to the commercial banks. Between 1965 and 1966 the commercial bank's foreign assets fell from $21.2 million to $7.4 million whilst their advances expanded by nearly 10%. There was hardly any change in the Central Authorities holdings of foreign exchange.

TABLE 4

Selected Balance of Payments Indicators -

Trinidad-Tobago $Millions

	1963	1964	1965	1966	1967	1968
1. Imports	644.0	731.0	816.9	772.6	710.1	797.6
2. Exports	595.0	693.4	710.5	752.7	750.2	830.0
3. Balance on Goods and Services	-102.4	-83.9	-143.2	-48.3	-38.4	-39.8
4. Long-term capital inflows	137.4	75.2	119.3	50.3	45.6	63.0

If the reserve loss was significant[1] then it could perhaps be better explained in relation to the "excessive"

/provision..

(1) "It may be that the foreign exchange "loss" was not significant. As far as the commercial banks are concerned their gross overseas assets were at the same level as the previous year.

/The..

provision of private sector credit and the performance of the commercial banking system.

There was no direct Central Banking response to this situation as no attempt was made to involve the use of any of its legal powers. There were, presumably, private efforts to restrain the size of the fiscal deficit for the following year, for as can be seen from the data in Table 5, claims on the public sector showed no further increase in 1967. There was one measure in force at the time to restrain the levels of expenditure. This was the hire purchase control which had been introduced as early as 1965 in response to the huge increase in imports, which totalled $86 million or 12% above the 1964 level. That this did not lead to a balance of payments deficit in 1965 was due entirely to the high levels of capital inflows achieved in that year (see Table 4).

In evaluating the Central Banking experience in Trinidad-Tobago it is very significant that the first set of policies introduced by the Central Bank was in response to external developments in the United Kingdom money market. "The first setting of the re-discount rate by the Central Bank took effect on 1st August 1966, eighteen days after the increase in bank rate in the United

/Kingdom..

The change in their 'net' position was due to an increase of their liabilities to overseas banks. It is questionable whether 'netting' out is the best procedure. We tend to the Jamaican view that these assets should be given gross although we have accepted for statistical purposes the definitions used by each country of official external assets.

TABLE 5

Monetary Variables - Trinidad-Tobago $Million

	1965	1966	1967	1968
1. Foreign Assets	96.0	80.4	84.3	129.0
A. Central Bank	48.9	50.9	60.6	124.7
B. Other Government investments and cash balances	25.9	22.1	18.5	20.1
C. Commercial Banks (net)	21.2	7.4	5.2	-15.8
2. Gross-Claims on the Public Sector	69.2	81.3	65.1	105.1
(a) Central Bank	7.6	22.7	2.6 (Jan.'68-17.4)[1]	27.2
(b) Commercial Banks holdings of government securities and advances to the public sector	61.6	58.6	62.5	78.0
3. Balance of Payments (surplus (+) deficit (-)	+7.3	-9.7	+1.9	+43.8
4. Money Supply	120.8	130.2	136.7	138.3
(a) Currency in circulation (active)	36.2	42.5	47.1	49.0
(b) Private demand deposits	84.6	87.7	89.6	89.3
5. Fixed deposits with Commercial Banks	158.6	174.5	196.2	235.1
6. Total Advances of Commercial Banks	167.4	178.1	191.3	212.5

Note 1. Technical re-purchase agreement at year end accounted for the low values. Relevant January figures given.

Source: Financial Statistics, Statistical Digest, Central Bank of Trinidad and Tobago - 1970, and other Government publications.

Kingdom. .... After taking these considerations into account the Central Bank set its re-discount rate at 6% and pursued other complementary policies in an effort to insulate the economy as far as possible from the interest pressures abroad".[1] It may of course be argued that although the local rate was adopted to the change in the United Kingdom rate this would have certainly prevented a reversal of the changes of the commercial banks portfolio which favoured local investments at the expense of foreign balances. But the fact remains that it was this very flow to which we should substantially attribute the foreign-exchange pressures, since as we have seen this has been confined to a switching from their overseas balances to local investments. The correction of the foreign exchange loss took place independent of Central Banking actions. In 1967 the balance of payments went into surplus and by 1968 the surplus was as high as $43.8 million. An increase in reserves also occurred but mainly due to the sale of capital assets in the United States in 1968 ($12 million), and the raising of a loan ($7.2 million) in the United Kingdom money market. Fixed deposits in the commercial banks also grew rapidly by an amount of $61 million or a nearly 40% increase between 1966-68. Meanwhile bank advances grew by about half as muchof the expansion in fixed deposits ($34 million).

[1] Annual Report - Bank of Trinidad and Tobago 1966 P.3

Generally speaking the Central Bank of Trinidad-Tobago has tended to adopt a largely passive policy, where the internal regulation of credit is concerned, and a largely defensive posture, where developments in the money markets are concerned. In response to their own interpretations of the course of monetary disequilibria, which is their own lending to the government, they have enforced rigid limits on public sector credit as can be seen from their performance during the years 1967-68.(See Table 5). In January, 1968, their holdings of public sector securities were only $17.4 million and at the end of the year it was $27.2 million[1]. They have also tended to operate so as to favour an increase in official foreign exchange holdings and the success of this policy can be seen in the growth of these holdings between 1966 ($80.4 million) and 1968 ($129 million).

The Central Bank has also refrained from imposing any restrictions for fear of hampering the competitiveness of the commercial banking system, except for the creation of Special Deposits Accounts in 1968 in order to facilitate the employment of the excess liquidity the commercial banks found themselves with in the post-devaluation period[2]. No restrictions were placed on drawings from these accounts and they can be considered as'special' only in the sense that they carry a

/special..

(1) For 1969 there was a big expansion but the data is not yet available to explain this.

(2) The commercial banks reserve ratio was set at the minimum of 5% in 1966.

special rate of interest and were introduced as a substitute for an expansion of public sector credit, via the Treasury Bill issue. It may be surmised that the view of the Central Bank is that controls are really unnecessary. The commercial banks are behaving in a manner which they themselves favour i.e. facilitating an inflow of funds at the expense of their overseas balances. But such a policy must certainly have foreign reserve consequences and the Central Bank cannot therefore react to these as if they were not anticipated!

The discount rate and exchange rate policies pursued by the Central Bank have been of a largely defensive kind. The devaluation of 1967 was 'forced' on to it, and the policy of sympathetic discount rate movements was similarly if less forcibly imposed. Data on these rate movements can be seen in Table 6. The maximum spread which was maintained between United Kingdom and the local rate has been 1.5% (a position held during the month of the devaluation November 1967). The Central Bank has also manipulated the exchange commission charges in order to influence portfolio adjustments in the short-term capital market. Thus in March 1968 it imposed the maximum permissible charge of 1% (the IMF band) on sales of sterling and adjusted the rate for inward/outward movements of funds from 1/16ths inward and ½ outward to 3/16ths inward and 3/8ths outward. At the time of the devaluation crisis foreign exchange transactions were centralized in the Central

/Bank...

TABLE 6

Comparative Rediscount Rates 1961-68

		U.K.	Jamaica		Guyana		Trinidad-Tobago	
1961	November	6.0		6.0		–		–
1962	March	5.5	October	5.5		–		–
	April	4.5						
1963		4.0	March	5.0				
			September	4.5				
			November	4.0				
1964	January	5.0	November	5.0				
	November	7.0						
1965	June	6.0		5.0				
1966	July	7.0	July	5.5	March	6.0	August	6.0
1967	January	6.5	May	5.0		6.5	March	5.75
	March	6.0	November	6.0			May	5.5
	May	5.5					November	6.5
	October	6.0						
	November	8.0						
1963	March	7.5	September	5.0		6.5	January	7.0
	September	7.0						

Bank and the commercial bank's "authorised dealer status" was suspended. Sterling was declared a foreign currency and thereby made subject to exchange controls. However, by the end of 1967 all these restrictions were removed. The crisis was over, at least until the next time!

During 1969 attempts were made to settle the administration of the foreign exchange market. These aimed at making the exchange levies charged by the Central Bank more effective and to ensure an adequate flow of foreign exchange through the banking system so that the Central Bank would become the ultimate settling authority for international payments and receipts. The rate system agreed on for foreign exchange transactions maintained the commercial banks traditional spread, but the structure of rates was pegged to the official exchange charges.[1] This was a considerable improvement, as under the previous system there could be no assurance that the official rate determined the structure of market rates, as most of the dealings in foreign exchange did not involve the Central Bank.

C. Central Banking in Jamaica

The Central Bank of Jamaica is the largest established of the Central Banks in the region. Partly on account of this, (in that in its early years of establishment there was a considerable prejudice against Central Banks in "underdeveloped" societies), the Bank has adopted most completely the traditional

/role..

[1] Information provided by private communication.

role of these institutions. It has been very consistent and rigorous in pursuit of its objectives along classical lines. The setting of this pattern of development is very clearly perceived in some of its early policy pronouncements which seem to accept entirely the need to administer its powers of credit creation in as limited a fashion as the Currency Board. It has also accepted without question the structural dependence of the Jamaican money market on the United Kingdom's financial markets and has therefore confined most of its efforts to the development of local money and capital markets in the belief that this would ensure that savings/investment decisions are made with appropriate consideration for the state of the Jamaican economy.

It has commented on its own establishment as follows: "None of this, however, has affected the basic advantages of the sterling exchange system. The whole of the money supply (active currency circulation plus bank deposits) is still effectively backed pound for pound by sterling. The Central Bank has to be prepared to provide sterling to meet on demand any Jamaican currency offered for redemption and this also applies to the commercial banks' deposits with the Central Bank..... The significance of the existence of the Central Bank and the fiduciary issue is that great care has to be exercised in the creation of money not backed by sterling assets --- in other

/words..

words. Central Bank lending to Government, whether by way of taking up Treasury Bills or by direct advances".[1] Commenting on its foreign - exchange reserve policies the Bank observed "Thus there is no necessity for Jamaica to keep reserves in gold or currencies other than sterling because both can be purchased with sterling through the Sterling Area mechanism".[2] It is rare to find such unqualified support for the virtues of the traditional sterling-exchange standard system.

The classic orthodoxy of Jamaican central banking is clearly revealed in an examination of the use of its lending powers to the Government. As the data in Table 7 shows the Central Bank's holdings of Government securities has been very small. In its early years of operations the Central Bank successfully managed to keep these holdings to a minimum. Unlike either the Central Banks of Guyana or Trinidad and Tobago it did not at its inception behave generously within the limits or its newly found freedom, in providing public sector credit. The Bank has maintained this policy of minimal holdings of government securities and those held have been mainly for market adjustment purposes. At the end of 1968 its holdings of these securities were only $10.6 million, almost all of which were Treasury Bills. These holdings represented just about 4% of

/the total..

[1] Annual Report, Bank of Jamaica 1961, P. 14. our emphasis.

[2] Ibid P. 26

Monetary Factors - Jamaica ($ Million Guyana)[1]

	1961	1962	1963	1964	1965	1966	1967	1968
1. Official Foreign Assets	174.7	182.4	241.4	210.2	204.5	229.4	240.0	294.7
A. Central Bank and Central Government	157.4	159.4	203.0	192.5	189.1	209.8	226.1	289.4
B. Commercial Banks (gross)	17.3	23.0	38.4	17.8	15.4	19.7	13.9	5.3
2. Claims on Public Sector	38.9	48.0	47.5	59.0	61.9	55.2	55.2	75.8
A. Central Banks' holdings of Government Securities	23.0	18.2	14.4	23.0	27.8	17.3	12.0	10.6
B. Commercial Bank advances to public sector and Treasury Bill holdings	15.8	29.8	33.1	36.0	34.1	37.9	43.2	65.3
3. Balance of Payments	+6.2	- 1	+44.2	-6.2	-3.8	+40.3	+34.1	+67.7
4. Money Supply	133.0	146.4	144.5	153.1	152.6	170.4	181.0	228.0
A. Currency with Public	41.2	43.2	47.5	54.2	56.6	61.0	66.7	75.8
B. Private demand deposits	91.2	103.2	97.0	98.0	96.0	109.4	114.2	152.2
5. Fixed deposits with commercial banks	181.0	212.6	234.2	262.6	284.2	320.2	365.8	458.9
6. Total advances of commercial banks	203.5	193.9	178.6	250.6	304.8	324.5	349.9	417.1
7. Gross domestic product	1106.9	1148.2	1227.8	1314.7	1426.1	1548.0	1615.2	N.A.

[1] Note $1 Guyana = 42 cents Jamaica

Source: Economic Surveys, Bank of Jamaica Bulletins.

the total resources of the Bank, as compared with 20% in Trinidad and Tobago at the end of 1968 and over 30% in Guyana at the end of 1969. At its peak holdings (end 1965) the ratio was just under 20%. The result has been that the growth in public sector credit has taken place mainly through the commercial banks purchase of Treasury Bills and to a much smaller extent (about 12%) its granting of advances to the public sector.

Similarly throughout the period the Central Bank has behaved with extreme orthodoxy to the commercial banks. It has introduced no controls on any of the banking ratios. Their deposits ratio with the Central Bank has been set at the minimum of 5%, and their liquid assets ratio at 15%. The banks have adhered to the former ratio closely. This was in their own self-interests as these holdings represent a non-earning item in their portfolio. However the liquid assets ratio has been broadly ignored and the banking system has maintained high levels of liquidity. In the original Central Bank Act and Banking Law the foreign balances of the commercial banks were defined as liquid assets. In 1963 this proviso was removed and inland bills of exchange substituted, in an effort to increase the commercial banks holdings of local short-term paper (Treasury Bills and inland bills of exchange). The result has been a build up in the holdings of government short-term paper only, and not private commercial bills as was anticipated.

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The fact that no policy measures were instituted against the commercial banks (apart as we shall see from the various discount rate changes) can be attributed to the circumstances of the commercial banks during the period. The policies adopted by the commercial banks were "welcomed" by the Central Bank. In several Bank Reports it is pointed out that the foreign assets of these banks were being substituted for local assets. Indeed it was argued, this run down was so persistent and large that for the first time in 1964 it induced the commercial banks to seek short-term accommodation with the Central Bank, by way of seven day advances. Despite the view taken by the Central Bank there is considerable evidence that much of the commercial bank lending needed supervision during this period. Between 1962 and 1968, the total value of imports doubled, whilst the value of exports grew by only 40 per cent. Much of this import expenditure was financed by bank advances which resulted in a dramatic widening of the trade gap (see Table 8). The pattern of control sought by the Central Bank was to restrain, by mutual agreement, hire-purchase credit provided by the finance houses and the commercial banks. Control of lending by the finance houses was indeed resorted to before the Central Bank was established, to cope with the 1960/61 comsumption boom. The bulk of the increases in bank advances was financed by the public's lending to the commercial banks by way of fixed deposits. As can be seen from Table 7 the change in fixed deposits between 1961

TABLE 8

Trade Statistics - Jamaica ($ Million Guyana)[1]

	Imports	Exports	Trade Balances
1962	384	312	- 72
1963	389	346	- 43
1964	494	374	- 120
1965	494	369	- 125
1966	537	389	- 148
1967	605	389	- 216
1968	768	437	- 331

[1] Note $1 Guyana = 42 cents Jamaica

Source: Annual Trade Reports

and 1968 was approximately $277 million, ($116 Jamaican) whilst the comparable expansion of advances was $213 million ($90 million Jamaican). During this period the net indebtedness of the commercial banking system never exceeded $12 million,($2.4 million Jamaican) the level already prevailing in 1961. It is clear therefore that the source of funds for commercial bank advances came as a result of their intermediary role, made attractive through a policy of high interest rates induced by developments in the United Kingdom money market.

Although no policy measures were introduced by the Central Bank against the commercial banks there were other periods of fluctuating levels of economic activity which warranted serious action, in particular the consumption boom of the early 1960's and the relative recession of 1967. What in fact occurred, particularly with reference to the 1967 recession was that the Central Bank continued its externally - oriented policy and during 1968 maintained "restrictive" monetary conditions, which fortunately did not work. As it stated in its Annual Report (1968) ... "As a result of the relatively low performance of the economy in 1967, the Authorities were anxious to promote economic expansion in 1968. However, the restrictive monetary policy adopted as part of the devaluation package could not be relaxed while the international situation remain unsettled." Despite intentions, bank advances grew by nearly 18% during 1968, imports increased by 27%, and the money supply increased by as much as 26%.

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In the most fundamental sense the policies pursued were externally oriented. Stable exchange rates, easy and free convertibility of the local currency into sterling together with minimum state intervention, except for fostering the growth of financial markets which would make private enterprise more efficient, were the foundations of these policies. This approach was also consistent with the Government's views of the development process which relied heavily on the unencumbered inflow of foreign capital. That it was this type of development policy which accounted for the original creation of Currency Boards also accounts for the Central Bank's determination to minimize the differences in its powers from those of the Currency Board.

This interpretation is more readily observable in its directly external policies. Unlike the other two Central Banks the Jamaican currency is defined in terms of its sterling equivalent, a direct carry-over from the Currency Board era. In 1966, in response to the pressures on sterling in the international exchanges the law establishing the par value was amended. However in keeping with its conservatism in these matters, the par value was still expressed in terms of sterling with the proviso that if the sterling was devalued the Jamaican currency can devalue (or not devalue) by any amount up to the new par value of sterling. If the sterling is appreciated the Jamaican currency must be automatically appreciated to the

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same degree.

There are two serious problems which this amendment poses. Firstly, in so far as the par value is defined in this peculiar way it reinforces the _de facto_ link between the Jamaican and United Kingdom monetary standard. It is clearly a declaration of intent to pattern United Kingdom rate charges under most situations. A definition of the par value in terms of gold is not to the same degree a declaration of similar intent. The consequences of this are therefore numerous. Not only might it facilitate the inflow of capital the Jamaican government hopes to encourage, but it can equally well facilitate an outflow, as portfolio decisions can still be made on the assumption of little likelihood of devaluation imposed capital losses. Secondly, it does not anticipate the likelihood that in an unstable foreign exchange market, if the United Kingdom balance of payments problem leads to a devaluation of the £ sterling, this can occur through a series of widely fluctuating rate changes before a new acceptable level is found. This law would tie the Jamaican currency to a similar rate policy. It would ensure the automatic importation of a destabilizing market situation for sterling.

In support of this par-value policy the Central Bank had immediately accepted upon its establishment IMF Article VIII status. A Stand-By Agreement was negotiated, but this came to an end in June 1964. No recourse was made to the Article XIV

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transitional arrangements, which the vast majority of countries were adhering to at that time.

Throughout the period of its existence the Central Bank of Jamaica has pursued a discount rate policy which behaved with very sympathetic rate movements in response to rate changes in the United Kingdom. The evidence of this can be seen in the information provided in Table 6 above. It has also combined this policy with one of vigorous variations in its exchange commission charges in an effort to ensure that income incentives would lead to a net inward movement of short-term capital, particularly through the commercial banking system. It is not known to what extent the Bank was enable to ensure that its own rate structure/adopted by the commercial banks but it seemed satisfied that the interest rate levels reached in Jamaica, together with effective commission charges, were sufficient for these purposes.

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The devaluation of 1967 very clearly highlighted the difficulties of this classic policy. In defense of the Jamaican currency the Central Bank followed the usual procedures of raising the discount rate, manipulating the exchange commission charges, declaring sterling a foreign currency, establishing Special Deposit accounts, and suspending the 'authorized dealer status' of the commercial banks. As the immediate crisis eased itself, these restrictions were relaxed, but for the first time there seemed to be some appreciation of the need to control excessive dependence on sterling. This was reflected in the changing

/composition..

composition of the external assets of Jamaica. As can be seen from the data in Table 7, there was a very significant growth in the official foreign assets holdings. Between 1961 and 1968 these grew by $120 million or nearly 70%. At the time of the devaluation in 1967 the sterling component of foreign assets was equal to 76%. By the end of 1968 the proportion had been reduced to 54%, entirely on account of incremental diversification into non-sterling securities - as the sterling component showed no absolute reduction. Most of this growth took place between November 1967 and June 1968 and two factors seem relevant for explaining this occurrence. To some extent it seems as if this diversification policy was pursued in anticipation of the Sterling Area negotiations following the Basle agreements. Secondly, it was during this period that the Central Bank began to tighten its controls to ensure that non-sterling foreign currencies passing through the economy should be deposited in the Central Bank. With the conclusion of the recently negotiated Sterling Area arrangements (discussed in the next section) this diversification policy has been brought to an abrupt halt.

As with Guyana and Trinidad and Tobago it has been argued by the Central Bank that the build-up of foreign assets in Jamaica after the November 1967 devaluation, is a reflection of the 'new' desire of the commercial banks to match their local assets and local liabilities in order to avoid future devaluation'risks'. Again the information available does not

/support..

support this view. "Early in the year, the Bank noted the heavy inflow of foreign exchange through the banking system and a rapid rise in the money supply. What seemed to be taking placa was a change in the policy of the banking system, whereby the commercial banks were stabilizing their foreign position and keeping their surplus liqui ity in Jamaican pounds"(1). In fact between 1967 and 1968 the net indebtedness of the commercial banking system increased by only $3.4 million ($1.4 million Jamaican). As the data in Table 9 below shows the commercial banking system disposed of more foreign exchange than it acquired and the foreign reserve build up has resulted from foreign currency tax payments, and overseas borrowing.

TABLE 9

Sources and Uses of Central Bank of Jamaica foreign exchange - 1968 $ Million (Guyana)

Sources		Uses	
Purchases from bank	68.2	Sales to banks	74.4
Government overseas borrowing	40.8	Redemption of government debt	4.8
Bauxite revenues	28.3	Other	7.2
Purchases from Official Institutions	16.8		
Other	12.0		
Total	166.1		86.4

Note: $1 G = 42 cts Jamaica   Source: Annual Report, Bank of Jamaica 1968

(1) Annual Report, Bank of Jamaica 1968 P. 8. our emphasis

Throughout the entire period of its operations the Central Bank of Jamaica has paid serious and consistent attention to the development of financial markets. At the outset, it sought to coordinate its work with the commercial banks and the finance houses through the establishment of Working Committees, and it also encouraged the establishing of firms of brokers to aid these developments. Three major committees were very early in operation - a Banking Committee, a Finance Houses Committee and a Stock Market Committee. The latter committee included the brokers as well as the commercial banks and other bank trusts. These developments culminated in the establishment of the Jamaica Stock Exchange in 1969. The Central Bank has also encouraged the establishment of more commercial banks, either locally incorporated (Bank of Nova Scotia (Jamaica) Ltd) and/or locally capitalized(the Jamaica Citizens Bank (Jamaica) Ltd). Recently the Central Bank has also played a major role in the establishment of the Jamaica Development Bank designed to provide medium and long term capital for housing, tourism, agricultural credit and industrial development - areas which the Central Bank believes the existing financial system does not adequately cater for.

The increase in the number and range of institutions has helped the general aim of providing a market structure with considerable dealings in financial instruments. At the end of 1968 the value of trading in equities was just under $23

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million ($9.4 million Jamaica). However trading in Treasury Bills, with a value of $144 million ($60 million Jamaica), and the raising of public capital with a value of $68.2 million ($28.4 million Jamaica) still considerably dominated the capital markets. Private share issues during 1966 were only $7.2 million ($3.0 million Jamaica). The market as it stands is in no position to compete in'breadth, depth and resiliency' with the United Kingdom financial markets. It is also inadequately developed to permit the use of market-type instruments of control of the commercial banking system. And, its efficeincy in raising local savings compares unfavourably with the use of business savings for financing the bulk of the recorded capital accummulation. Finally, in an effort to develop the financial markets, the Central Bank has almost perversely aided those pressures which favoured a greater and greater degree of 'free' dependence on the United Kingdom market structures, for it has had to combine this policy with one of minimal intervention.

Section 3

A Program for Central Banking Reform

A. Basic Defects and alternative Strategies

In the two previous sections, we have both analysed the existing institutional and legal structures upon which central banking has been based, as well as the experience of the three Central Banks in the Caribbean. This analysis indicates that there are two over-riding and fundamental defects which limit the scope for effective monetary policy. The first is 'real' and stems from the structural rigidities and imbalances in these economies which give rise to their "open" nature. The second, stems from the practice of maintaining _de facto_ and or _de jure_ fixed exchange rates and free convertibility into sterling. Together these two defects ensure that private profit seeking activities of the dominant multi-national productive enterprise and multi-national financial institutions serve to exaggerate and promote monetary disequilibria.

This usually follows along two lines. The first is the unencumbered capacity of the multi-national corporations to maintain two or more sources of short-term working capital, one of which is in the territory their operations are carried out. This is directly related to the current flows of savings and investment in these economies. The second line involves both flow and stock decisions. Spending units (including governments) are facilitated to deal in two money and capital markets of unequal "breadth", depth and resiliency." Decisions about investing the current flow of savings, raised from incomes earned through the disposition of local resources usually lead to a considerable net outflow of these earnings, particularly through institutions like insurance companies

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and usually it has been necessary to invoke legislative prohibitions against this. But these prohibitions have been confined to the readily discernible agencies. Similarly, stock-adjustment decisions can be made which lead to an outflow of savings. In response to changes in the net yield in the United Kingdom (and other sterling area) money markets, spending units can adjust their existing portfolios of previously accumulated savings. To avoid this, there has been the constant necessity to manipulate local yields, in order to prevent an outflow of savings because of decisions about the composition of the stock of financial assets.

There are two solutions which have been sought to this dilemma. The first is to recognize the incapacity of Central Banks to cope with this situation and thereby confine their functions to essentially that of a money-changer. In other words, to require that the Central Banks operate as close to their Currency Board predecessors as possible. Simple rules should therefore guide their management, and usually these are designed to eliminate their banking functions and to limit their currency issue powers to some fixed agreed and pre-determined fiduciary level. Thereafter, the commercial banks would of necessity administer both the foreign and domestic payments system, hold the foreign reserves of the community (outside of the Currency Authority, where the growth would be fixed in terms

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of the public demand for currency and the fiduciary ratio), and accumulate short-term borrowing powers with their Head-Office. In support of this view, it is argued that the possibility of incorrectly judged intervention by the Central Authorities would be ruled out. This would promote an inflow of foreign capital and ensure that the market system would lead to efficient allocative criteria. In truth such a policy is an idealisation of the Currency Board. Apart from its politico/social assumptions, it also falls down when we observe the long record of how "rules" have operated as a substitute for "authorities."

The second solution lies in the direction of fostering the growth of money and capital markets. It is argued, that when these markets are well developed they facilitate the mobilization and dispensation of savings so as to favour their normal retention in the domestic economy. Moreover, once developed, these same markets provide a fulcrum for control by the Central Bank of the domestic financial institutions. The limitations to this policy, again apart from their politico/social assumptions, are that such a market situation cannot develop before the 'real' economic structure provides a sufficient differentiation in its activities as to promote a variety of financial claims and instruments. Moreover, the pursuit of such a policy tends to reinforce the links between the domestic and United Kingdom money and capital markets.

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For, in order to promote market growth the Central Banks have had to respond to prevailing market pressures, to minimize either intervention, or the ease of movement of funds, between the local market and the United Kingdom.

The problem of central banking reform therefore lies along different and more radical lines. For a start, it is necessary to see Central Banks as aiming to promote development and structural transformation and thereby developing their powers and policies with the intent of leading to structural changes in the money and credit industry, and not simply to administering the payments and credit systems as they are. The problem therefore, is one of basic institutional and organizational reform.

B. The Structural Approach

Whatever final forms the domestic organisation of the banking and credit industries do take, two conditions are necessary, although by no means sufficient, for structural transformation. The first of these is, that exchange controls should be imposed against sterling. Administering an exchange control system for capital transactions and permitting one set of currencies (some of which are in fact freely convertible into all other currencies) to be exempt from these restrictions certainly does not serve the purpose that is intended. It merely provides an administrative hurdle which is easily circumvented and which is far from prohibitive of these

/transactions...

transactions. Such a policy of exchange controls on sterling would permit the proper administration of controls which are designed to prevent the destabilizing and undesired outflow of local savings. It would ensure a separation between the fixed exchange rate mechanism and the convertibility provisions, which are vital requirements for the reduction of excessive dependence on sterling. In this sense, spending units portfolio policies will be limited in terms of stock adjustments, and as regards the flow of savings. More consideration will be given to the fact that with such reforms the scope for the management of an independent exchange rate system is vastly improved.

The second necessary reform is a limitation on the size and share of borrowing that locally un-incorporated multi-national corporations can enjoy. These enterprises not only have a preferred status in the market for local credit, but given their organizational structure and relative size, shifts in their sources of obtaining working-capital requirements are important sources of destabilizing monetary occurrences, which the Central Banks cannot control through the market mechanism. Inability to control this situation arises because during any period of monetary restraint in their Head Office territory, these corporations can be certain that they would enjoy 'availability of funds' in the local credit market. Indeed, in the administration of monetary policy these industries are rarely if ever expected to comply with restraints, since they

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are held to be <u>the</u> source of increases in real output. Restraint is usually directed to consumer expenditure, and particularly on imports.

Movements along these lines while necessary in their efforts to facilitate Central Bank control of the monetary system within the given framework is still not sufficient to change the present situation in which the Central Bank (as presently narrowly conceived) is the sole source of monetary policy. To improve on this situation co-ordination in three broad directions are necessary.

First, there are in the countries concerned no co-ordination in the various branches of public policy. Development planning, the administration of fiscal policy and the administration of monetary policy are pursued as three separate areas of public policy. As a result there are certain basic and recurring evidences of this failure to co-ordinate. One of these is the frequent manifestations of unexpected and/or the undesired impact of government spending and borrowing on the banking system. Another is the under-utilization of appropriated budgets and/or the "forced" pace of spending towards the end of the fiscal year pursued by various government departments and the impact this has on seasonal swings in the banking system. Then again there is the contradictory pursuit by the Ministry of Finance and the Central Bank of the maximum accumulation of foreign reserves. This is facilitated because

/development..

development planning relies heavily on overseas borrowing, and at the same time there is no appropriately planned size of the foreign-exchange gap. Meanwhile the Ministry of Trade is insistently pursuing policies geared to balancing trade and thereby reducing the scope for real transfers of borrowed capital. Indeed long term and short-term policies often occur without reference to each other and as a consequence administration of fiscal and monetary policy is in no way clearly or consistently linked to the development programme.

The second area of development is the need to co-ordinate and integrate the existing monetary structures. Development banking, deposit banking in the Post Office, rural agricultural credit, co-operative and credit union organizations all function as unit-purpose institutions. Their very growth and establishment has been haphazard and the unit purpose approach has developed through default. As a result of this there has been considerable loss of economies in the way in which these institutions have been capitalized (particularly their acquisition of fixed assets such as branch offices), in their use of skilled personnel (particularly the fragmentation of research, loan administration, credit analysis), the holding of reserves, and their inability to introduce economical administrative systems (computerizing and mechanization of accounting systems).

The problems of co-ordination of monetary policy can also be largely attributed to the administration of policy

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within the Central Banks. The first of these is the problem of diagnosis often referred to in the previous section. To a large extent this derives from the slow flow of statistics. In Guyana for example the balance of payments statistics for 1968 show an overall surplus of $12.1 million. Yet one year later the accounts still record an unidentified capital movement of $14.0 million! It is partly the absence of statistical information which forces the Central Banks to use proxy variables, e.g. reserves, interest rates etc., instead of 'real' performance, as indicators. Solving the statistical lags also requires the development of short-term forecasting models which would enable the Central Banks not only to forecast activity but to be continuously aware of the relationship, whatever they might be, of real and money flows.

The second administrative lag lies within the decision-making process itself. Largely because of uncertain economic indicators, the lack of clear direction in economic priorities, and the difficulties of choosing appropriate policy instruments, the problems of diagnosis are compounded by the difficulties of decision-making in an uninformed situation. Furthermore, after decisions are taken as to the appropriate instruments of control the lags in making monetary policy effective are also unpredictable, since there are no estimated parameters of the relationship between monetary and real variables.

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Finally, the administration of monetary policy, although by law applicable to non-banking institutions, the Central Banks have nevertheless taken a disaggregated view of the banking system and have acted as if the commercial banks are the main, or primary areas, of monetary concern. Most of the attempts to deal with the non-bank intermediaries have been of a fiscal nature or part of general legislation e.g. taxes on insurance companies, or ad hoc restraints usually on hire-purchase credit, when import expenditure is rising too rapidly.

C. Developmental Bias

So far we have considered three sets of reforms viz., the sterling exchange-standard system and multi-national corporate borrowing; the co-ordination of public policy and the integration of monetary structures; and the administration of policy from the point of view of diagnosis, decision making, implementation and scope of institutional action. All these are integral elements of any policy aimed at structurally transforming the banking and credit industry. However, certain other more directly developmental re-structurings must occur. An examination of the structure of commercial bank lending shows that their lending policies have not been sensitive to Central Banking pressures in terms of the composition of loans. The data in Table 10 shows the current composition of loans. The most notable development has been the expansion of personal loans

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TABLE 10

Loans and Advances - $ Million

		Jamaica	Guyana	Trinidad-Tobago
		1968	1968	1968
1.	Public Sector	8.2	10.7	19.0
2.	Financial Institutions	14.4	2.6	2.9
3.	Personal and Professional	96.0	12.8	58.4
4.	Agriculture	19.2	3.7	7.2
5.	Building and Construction	24.4	3.2	8.7
6.	Industry	91.2	12.5(mainly rice and sugar processing)	32.2
7.	Distribution	91.0	20.0	64.1

Source: Various Bank Reports and Government Statistical Publications which in Jamaica and Guyana accounts for between one-quarter and one-fifth of total advances and in Trinidad-Tobago is about 30% of total advances. Multi-national enterprise (mainly industry) are almost as large as personal and professional loans in Jamaica, and in Guyana. The distribution sector absorbs almost as much as one-third of advances in all the territories. And, in marked contrast, loans to the agricultural sector account for less than 6% of total advances in the three countries.

This information makes it evident that some direct impact on lending criteria apart from the usual Central Bank exhortations is needed. There are a number of short-term solutions which can, and indeed should be attempted. The first of these is widening the range of securities 'eligible' for re-discounting by the Central Bank. Some of these securities e.g. mortgages, industrial debentures etc., would coincide with other priorities in the directly productive field. Others must involve direct controls on incremental lending. One of these referred to above, would be the limit on multi-national enterprise borrowing from the local market. Yet others would involve the Central Banks in widening their capital bases by issuing direct securities on themselves, as a prelude to direct banking activities.

Whatever the short-term strategy, it must be integrated into a long-term strategy aimed at the national provision of

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these banking services. The state, co-operatives, or other forms of national enterprise, should be directly developed with sufficient incentives and subsidies to take the major share of fixed deposit increases if eventually the banking structure is to be brought substantially under national control. What is needed is a clearly conceived programme /of the sequence of developments, lest a repetition of previous uncoordinated, and proliferating unit-purpose financial enterprise take place. To make such a policy work, in the context of the heavy dependence of the economy on trade, and the further dependence of this trade on bank finance, it is necessary that the export-import activity of the country be co-ordinated through the establishment of appropriate national trading corporations. This would also simultaneously provide an efficient mechanism for ensuring that both foreign and domestic payments are integrated and that activities such as export promotion, (e.g. export credit guarantees) and the planned rational use of foreign-exchange resources take place. It might be useful to add that the co-ordination of the import-export trade through such corporations is not dependent on the nationalization of domestic economic activity(1).

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(1) It would of course be consistent with such a policy if it were developed.

Some of the statements associated with the recent establishment of the Guyana National Co-operative Bank[1] seems to indicate that this problem may be recognized and that a solution by way of the co-operative provision of bank credit is being attempted. However, for success along these lines to be significant, it is necessary to develop a more comprehensive strategy, somewhat along the lines indicated here, rather than simply confine activities to the establishment of a co-operative bank in the present unregulated banking situation. Moreover, this bank is being asked to compete with firms that have historically grown and taken advantage of their un-regulated situation.

So far we have concentrated on the structural transformation of the banking and credit industry with reference to the commercial banks. Similar attention needs to be directed to the non-banking intermediaries, in particular the insurance campanies, the mortgage houses and the institutions providing instalment credit. Again the long-term solution is the national provision of these services[2]. For it is only through a substitution of national priorities for the private global profit considerations of multi-national enterprise, can we achieve a transformation of function.

/Concentration..

(1) Established on February 23, 1970

(2) For discussion of these problems consult M.A. Odle's "The significance of non-banking financial intermediaries in the West Indies", Mimeo.

Concentration on banking and credit has often led to an important omission in the study of the monetary system in the Caribbean. That is, the administration of the payments mechanism. In typical Anglo/Saxon tradition, the operation of the payments and clearing systems is linked in the same set of institutions to the credit functions. As far as the commercial banks are concerned, despite high charges, their payments functions are not particularly profitable. Where it is profitable is in the high charges it levies on foreign transfers and indeed this may well be providing currently, an important source of banking income. As a result of this, no attempt has been made to cheapen, and spread the use of the credit transfer process and the payments mechanism. Apart from the limited use of the checking account by persons the banks have taken no initiative in tackling the problems of an efficient payments system. As a result of their high charges, (plus the inconvenience of the chequing account and the mailing costs). the payments mechanism is very inefficient (as it reaches a limited part of the population) and high cost. The proposal for dealing with this is to enforce a separation between the credit function and the payments function and to develop the latter also along national lines, in some sort of postal-giro service which would seek to maximize the economies of a centralized mass distribution service.

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The payments mechanism as it stands operates on what has been generally recognized as the most inefficient sequence, debtor-creditor-bank flow. A giro system would seek to adopt the more economical, debtor-bank-creditor flow. As it stands, the commercial banks find that the administration of the payments mechanism is less profitable than either credit to local enterprise or the transfer of foreign payments and as a result there necessarily follows a conflict as to where new investment funds and innovation should be directed. In this conflict, private assessments of costs and benefits over-ride social considerations.

D. Sterling Area Arrangements

An evaluation of central banking in the Caribbean would be incomplete if it did not examine the existing Sterling Area Arrangements which followed on the devaluation of November 1967. In our study of central banking practices in the three territories, we observed that at the time of devaluation a system of comprehensive controls were imposed against sterling. The convertibility provisions of the various banking laws were abrogated and the commercial banks' "authorized dealer status" suspended. Sterling became a "foreign" currency, in terms of the various Exchange Control Acts. Following on the devaluation, sterling remained insecure in the world's foreign exchange markets and there was the likelihood of more disruption if not a further devaluation.

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The sources of the disruption grew out of the disproportionate relation between the United Kingdom's short-term overseas assets and liabilities. These liabilities, or sterling balances, were distributed among non-resident sterling area holders, privately held sterling balances and the official sterling balances. The former holders have tended to hold their balances subjected to the prevailing degree of confidence in sterling and interest rate differentials in the world's money markets. As a consequence they have tended to fluctuate considerably. The private balances have increased steadily in response to the growth of trade in sterling and the balance of payments surpluses of the sterling area outside the United Kingdom. However, the official sterling balances, whilst remaining more or less at the levels reached in the early 1960's, have not been responsive to the growth in the official reserves of sterling area countries.

In order to deal with the situation of uncertainty in which these balances were held after the devaluation, the United Kingdom Government in September 1968 negotiated a borrowing facility of $4,000 million with the Basle group of Central Banks. Under this Agreement the United Kingdom is permitted to draw on foreign currencies, through the Bank for International Settlements, to finance reduction in the sterling balances (official and private) of overseas sterling area countries, below an agreed level. Drawings can be made during the first three years of the agreement and any such drawings will have to be repaid between the 6th and 10th years. No drawings are permitted to finance a balance of payments deficit.

As part of the package arrangement the United Kingdom ensured, as a condition of continued membership of the Sterling Area,[1] that the Authorities of the overseas sterling area countries would hold specific minimum proportions of their reserves in sterling at all times during the life of the Agreement. The proportions for the three countries under consideration was fixed at 80%[2]. In turn the United Kingdom has guaranteed in terms of U.S. dollars part of the sterling holdings of overseas countries. The guarantee applies to that part of the various country's official sterling reserves which exceeds, 10% of its total reserves, and it provides for the United Kingdom to restore the dollar equivalent of the value of these securities in event of further devaluation. In terms of these Agreements the countries of the Caribbean are committed to remaining members of the Sterling Area, at least until around 1973.

These arrangements have generally been described as a means of stabilizing the position of sterling in the world's

/foreign..

[1] This condition was implicit. Indeed there were no explicit reciprocal concessions made by the United Kingdom.

[2] For the Eastern Caribbean Territories it was fixed at 97%. Australia and Malaysia 40% and New Zealand 70%.

foreign exchange markets, through providing confidence (by way of dollar value guarantees). This, it is argued, would lessen the pressures developing among the various sterling holders to diversify their portfolios. Indeed, in our study of Jamaica we noticed the rapid incremental diversification of official assets which occurred between November 1967 and June 1968.

Usually, it is not readily appreciated that the stability these arrangements aim at is one of ensuring that the proportion of sterling held to other forms of international liquidity does not fall. This means that there must be absolute increases in the sterling balances. In other words this is not a device to facilitate the abandonment of sterling as an international reserve asset, but one that is designed to serve as a prop to its present position. The assumption being made therefore is that the sterling crises of the 1960s are essentially transitory. If this assumption is true, then one can expect that after this phase is over the Caribbean countries will find that there are no strong pressures to diversify foreign reserve holdings. The risks of devaluation, or the blocking of overseas sterling accounts, would have disappeared. If this assumption does not hold true, then the United Kingdom will find that there will be increasing pressures on itself to provide guarantees, and other inducements, to ensure that the policy of high incremental investments of the official foreign reserves of the Caribbean (0.8+) continues to provide an offset for any private

/disinvestments..

disinvestments. At this stage it will become evident that the Sterling Area Arrangements, although discussed in mainly financial terms, are de facto part and parcel of a set of comprehensive agreements involving finance, trade (the commonwealth preferential system) capital and labour movements. At that point it will also be clear that the "inducements" which the United Kingdom can command are considerable, in the present context.

An examination of the recent performances of the holders of sterling balances will show that the entire Caribbean area is the fastest growing (indeed the only consistently growing) holders of sterling balances. At the moment they are also of vast disproportionate importance in the distribution of these balances. In Table II the territorial distribution of the Sterling Area holders of these balances are shown. As can be seen from this table the only territories that have consistently increased their sterling balances are the Caribbean where the increase between 1962 and 1968 was equal to 68%. During the same period the total balances increased by only about 10%. A comparison of country size also reveals that the Caribbean is a disproportionate holder of these balances.

The accumulation of these balances shows how deeply committed the Caribbean is already to the Sterling Area. The recent arrangements reinforce this commitment. It has been argued earlier, that exchange controls and a movement towards

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TABLE II - UNITED KINGDOM External Liabilities $ Million

Year	Total	New Zealand Australia South Africa	India Pakistan Ceylon	Caribbean Area	East Central & West Africa	Middle East	Far East	Other
1962	12,657.6	2,467.2	859.2	796.8	2,011.2	2,030.4	3,081.6	1,411.2
1963	13,531.2	3,139.2	1,017.6	907.2	1,939.2	1,838.4	3,177.6	1,512.0
1964	13,843.2	3,259.2	859.2	892.8	2,102.4	1,905.6	3,120.0	1,704.0
1965	14,692.8	2,582.4	916.8	1,022.4	2,040.0	2,596.8	3,508.8	2,025.6
1966	14,803.2	2,313.6	676.8	1,089.6	1,939.2	2,668.8	3,696.0	2,419.2
1967	14,313.6	2,208.0	552.0	1,132.8	1,636.8	2,697.6	3,393.6	2,692.8
1968	13,828.8	2,145.6	950.4	1,334.4	1,747.2	1,972.8	3,427.2	2,251.2

Source: Bank of England Bulletins

the abandonment of the sterling area is necessary for the structural transformation of the financial industries of the Caribbean. In the long run such an achievement depends in part on the solution of the problem of the use of sterling as an international reserve asset. The only feasible solution for the territories of the Caribbean is one geared to phasing out the use of sterling through some form of funding arrangement with the IMF.and not the *ad hoc* transitory arrangements they are presently committed to. Such a solution also depends on changes in the 'real' economy as well as the changes in financial structure referred to above. As steps towards achieving both, it will be necessary for the region to seek forms of monetary co-operation to lessen the dependence on sterling and increase the flexibility in both the size and the employment of reserves. This would mean the development of facilities complementary to those already existing for trade and development banking[1].

Indeed, the growth of inter-regional trade will provide its own pressures for regional monetary co-operation. The risk is that the commercial banks will fill the void through unifying the territories on the basis of their *de facto* and *de jure* dependence on the sterling exchange - standard system.

/It should..

[1]For a discussion of some proposals see T. Somersall, *Monetary Co-operation and Economic Integration in the Commonwealth Caribbean* - Papers presented at the Regional Conference on Devaluation, ISER, University of the West Indies.

It should also be noted that the present commitments to hold such high proportions of foreign reserves in sterling leaves little room (at the maximum 20%) for Caribbean co-operation in reserve holdings. Out of this potential 20% for diversification purposes, there are the competing pressures to hold deposits with international financial institutions as part of their international obligations and with the United States banks as counterpart funds for loans raised in the United States money and capital markets.

The present sterling area arrangements, which ensure co-operation in support of sterling as an international reserve asset, are starkly counterpoised to the basic interests of the Caribbean territories. The support of the international asset function of sterling, serves in its entirety the direct national interests of the United Kingdom and leaves the Caribbean over exposed to national decisions made in the United Kingdom. It ensures that the Caribbean territories will continue to lend an increasing amount of resources over which they have claim to the United Kingdom whenever there is a balance of payments surplus and irrespective of the net cost involved in running, the surplus. At the same time it does not give to the Caribbean territories drawing rights on the United Kingdom reserves, when they themselves are in balance of payments difficulties. In sum therefore, the present arrangements will perpetuate the "defensive" and purely "imitative" features which characterize monetary policy in the region.

PART II