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## **Central Banking In Practice: Some Experiences from Trinidad and Tobago**

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CENTRAL BANK OF TRINIDAD AND TOBAGO

**CENTRAL BANKING IN PRACTICE:  
SOME EXPERIENCES FROM TRINIDAD AND TOBAGO**

Penelope Forde

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# CENTRAL BANKING IN PRACTICE: SOME EXPERIENCES FROM TRINIDAD AND TOBAGO

Penelope Forde\*

## Introduction

Central Banks and central banking have come of age in the post war period in both the developed and developing countries. As policymakers place greater reliance on macro economic policy to achieve growth and economic development, the practice of central banking has been greatly refined. Central Banks in the Caribbean are relatively young, since the oldest, the Bank of Jamaica is in her late thirties. Nevertheless the wealth of experience that has been built up over the years is extremely instructive.

Most of us are of course familiar with the functions of a central bank - the traditional ones and certainly in the case of Caribbean central banks, the developmental type functions. Each and all of the Caribbean central banks have pursued these functions, some more assiduously than others. For example the Bank of Jamaica (BOJ), the Central Bank of Trinidad and Tobago (CBTT) and, more recently, the Eastern Caribbean Central Bank (ECCB) have been in the forefront in the development of money and capital markets. The CBTT has had one of the earliest experiences with the lender of last resort function but over the last couple of years the BOJ has had to grapple with this issue.

When a central bank functions efficiently and there are no financial crises, central banking is as it were almost invisible. When problems develop and there are strains on the financial system, there is in general much debate and criticism and the issue of independence

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rises to the fore. Over the past decade the issue of autonomy and the independence of central banks has surfaced again and again and institutions once conceived to be good examples of independent central banks have had subtle reductions in their sphere of authority. As recent experiences have shown, the German central bank (Bundesbank) usually considered to be a good example of an independent central bank, had to reverse its position on matters related to the German unification. Similarly, some members of the United States Congress are intent on sponsoring legislation which would reduce the relative independence of the Federal Reserve Chairman.

Twenty-six years after C.Y. Thomas's classic and pioneering work on central banking in the Caribbean a relatively rich literature has accumulated on the Caribbean experience as any cursory glance at the RPMS/CCMS bibliographies will show.<sup>1</sup> Thomas (1972) examined the structure and performance of the regional central banks against a background of relatively newly independent territories. One quarter of a century later, the world economic order has changed fundamentally and central banking is now practised in a liberalised environment with the prevailing economic paradigm one in which the *market* is considered supreme. Between then and now, almost all of the CARICOM economies have undergone structural adjustment programmes, either domestically generated or under the auspices of the international financial institutions with the usual built in conditionalities. These programmes have been followed by trade, financial and in some cases exchange rate liberalization and what is now usually referred to as first generation reforms or '*the Washington Consensus*'.<sup>2</sup> Some of the CARICOM economies have had to embrace all of these reforms sequentially, while others have been relatively fortunate to be able to choose the **pace** and **timing** of their own reform process. This process has impacted both the real and financial sectors so that while the traditional central banking issues remain the same, the way in which they may be resolved has now been altered.

Farrell (1995) identifies four key issues which faced Caribbean central banking over the years: growth and development versus stability; instruments of monetary control; relationships with governments; and lender of last resort. Over the past four decades each regional central bank has come face to face with one or more of these issues. The importance of the lender of last resort function was extremely critical in Trinidad and Tobago following the non-bank financial institutions (NFIs) crisis in the 1980's. In the pursuit of monetary policy objectives the goals of several regional central banks changed from monetary stability to development type objectives and vice versa, as the absence of capital market institutions were seen as inhibiting the development process. The structural adjustment experience in the region ensured that most of the economies at one time or another followed a 'financial programme' with emphasis on monetary targets. In this paper the practice of central banking will focus on two of the issues described above with special reference to the experiences in Trinidad and Tobago.

The paper is divided into four sections the first of which gives a brief description of the recent economic developments which form the background to the central banking experience. Section Two examines the relationship between the central bank and the government, at the heart of which lies the question of the independence of the central bank and its meaning in a Caribbean context. The third section of the paper provides a first look at a new policy instrument, the use of open market operations. The paper closes with some comments on the experiences and suggests what new central banking issues if any will emerge beyond 1999 for Trinidad and Tobago.

## **I. The Economic Background**

The Trinidad and Tobago (TT) economy experienced a boom in the 1970's which was fuelled by the economic rents associated with higher crude oil prices. Following the second oil shock, the economy contracted sharply in 1983 and underwent eight years of

uninterrupted declines in income, output and employment. There was an early attempt to follow an informal adjustment programme when the authorities implemented some of the policy prescriptions which were enunciated in The Report of the Demas Task Force.<sup>3</sup> Between 1988 and 1991 however there were two formal adjustment programmes with the International Monetary Fund (IMF) and a Structural Adjustment Loan (SAL) from the World Bank (IBRD). There was a return to positive real growth in 1991 although this was followed once more by declines in real GDP in 1992 (-1.1 per cent) and 1993 (-2.6 per cent). Nevertheless some signs had already emerged that the transition to economic recovery had begun by 1994.

The recovery underway in Trinidad and Tobago since 1994 entered its fifth successive year in 1998 as the economy continued along a path of non-inflationary growth. Real GDP growth averaged 4 per cent between 1994 and 1998 compared with declines in real output averaging around 2 per cent between 1983 and 1993 and real increases of about 6.2 per cent during the boom period (1974-1982). This growth has been accompanied by relatively low levels of inflation (5 per cent), falling levels of unemployment (14 per cent in 1998), a reduction in the country's external debt and debt service ratio and a rebuilding of the foreign exchange reserves (Table 1). The change in the macroeconomic fundamentals in the second half of the 1990's reflects in large part the positive results of adjustment and stabilisation. Trinidad and Tobago was not the only CARICOM country to undertake such policies under the auspices of the international financial institutions, but the nature and timing of the measures differed from one country to the next. Moreover, with different initial conditions at the onset of the individual programmes each economy will have emerged with somewhat different final outcomes.

TABLE 1  
SELECTED ECONOMIC INDICATORS 1991-1997

Item	1991	1992	1993	1994	1995	1996 <sup>r</sup>	1997 <sup>p</sup>
Changes in Real GDP (factor cost) (1985=100)	2.9	-1.1	-2.6	5.0	3.2	2.8	2.9
Inflation Rate (%)	3.8	6.6	10.8	8.8	5.3	3.3	3.7
Unemployment Rate (%)	18.5	19.6	19.8	18.4	17.2	16.3	14.9
Fiscal Balance/GDP (%)	-0.0	-2.8	-0.2	0.0	0.2	-0.5	0.9
Current Account/GDP (%)	-0.4	0.6	-2.4	4.4	5.0	1.2	-12.2
Overall BOP/GDP (%)	-6.3	-2.2	3.3	3.6	0.6	3.8	2.7
External Public Debt (US\$m)	2,437.9	2,215.0	2,102.1	2,063.5	1,905.2	1,875.8	1,526.8
Debt Service Ratio (%)	21.9	29.7	30.6	25.5	20.2	13.2	16.4
W.T.I. (US\$/barrel)	21.62	20.57	18.45	17.19	18.44	22.20	20.35
Gross International Reserves (US\$m)	439.7	316.1	446.0	678.9	652.3	937.7	1,105.3
Exchange Rate (TT\$/US\$) <sup>1</sup>	4.27	4.27	5.67	5.87	5.89	5.99	6.25

<sup>1</sup> This rate represents the mid-point of the period average of the buying and selling rates of the TT/US dollar

As Trinidad and Tobago emerged from the period of severe macroeconomic disequilibrium the structure of the economy has been significantly altered following the implementation of these first generation reforms, i.e. trade liberalisation, tax reform, financial reform and capital account liberalization. These structural changes were designed to make the economy more competitive and market oriented. In respect of trade liberalisation measures, the removal of the negative list and the reduction of the common external tariff led to an open trade regime in which the domestic manufacturing sector has been able to compete with foreign imports fairly successfully. Simultaneously, domestic manufacturers who took advantage of certain incentives were able to retool and have now penetrated both CARICOM and extra CARICOM markets in Central and South America.

One major component of the adjustment effort was the reform of the public finances to allow the process of fiscal consolidation to commence. During the 1970's and early 1980's the public finances had been weakened with undue reliance on a wide array of tax expenditures as well as the dependence on oil revenues. Over time this resulted in a burgeoning fiscal deficit which peaked at 13.1 per cent of GDP in 1983. Fiscal reform involved the removal of some elements of budgetary subsidies, a temporary cut in public sector wages, a reform of the income tax structure, the introduction of the Value Added Tax (VAT) as well as the divestment of several state enterprises. These changes provided the impetus for a slow and steady improvement in the overall public sector finances and the central government was able to achieve a balanced budget by 1994.

Discussions on financial reform in Latin America and the Caribbean usually focus on the need to eliminate financial repression. In the case of Trinidad and Tobago this reform involved the removal of credit ceilings and other direct controls and a general movement towards more market-oriented policies. While the evidence of financial repression in Trinidad and Tobago is weak at best (Watson and Ramlogan 1991) there was also the need to eliminate or reduce the practice of lending to the government at subsidized interest rates via the secondary reserve requirement. Financial reform culminated with the removal of exchange controls in 1993, the modernization of the commercial banking legislation with the introduction of the revised Financial Institutions Act (FIA 1993) and amendments to the Central Bank Act (1994). These revisions strengthened the supervisory framework by providing greater enforcement powers to the Inspector of Banks , and also required that commercial banks be appropriately capitalized. In addition, the law unified the legislation under which all licensed financial institutions operate.



## II. The Central Bank and its Shareholder

In the modern era of corporate finance there are many compelling case studies of the relationships among shareholders and between shareholders and the management of a company. Indeed Trinidad and Tobago in the 1990's recently witnessed several interesting episodes in which shareholder behaviour - majority as well as minority shareholders - has been a cause of concern.<sup>4</sup> The world of central banking is not that different as the relationship between a central bank and its owner can be comfortable at times and uneasy at other times.

The enabling legislation, the Central Bank Act, defines this relationship in a strictly legal sense but in practice actual outcomes may depend on the particular external economic environment, the monetary policy stance and even the personalities of the key players. In the discussion which follows below we shall consider some aspects of the Central Bank's functions as banker to government and the quasi-fiscal activities which are carried out by Central Banks. In the past more attention has been paid to the consequences of the overdraft facilities extended to governments; more recently however there has been a greater focus on quasi-fiscal activities which have the potential to erode a central bank's capital base.

### *The Relationship Between the Central Bank and the Government*

Act No.23 of 1964 which established the Central Bank of Trinidad and Tobago outlined the objective of the Bank as follows:-

*" . . . the promotion of such monetary credit and exchange conditions as are most favourable to the development of the economy of Trinidad and Tobago."*  
Section 3.3

In line with this objective there are clearly a number of functions which the Bank must carry out - for example issue and redeem currency, inspect banks and other financial institutions,

manage the foreign exchange reserves. Here however, we are concerned primarily with the typical banker - client relations which Sections 45-50 of the Act specifically addresses. Sections 45 and 46 of the Act spell out the "banker" functions which the Bank carries out for the government. The Central Bank is empowered to act as an agent for the government in respect of the management of the public debt; it can undertake any banking business entrusted to it locally or abroad e.g. accept fixed deposits, provide letters of credit and as any banker the Bank can provide overdraft facilities for its client. These overdraft facilities are covered under Section 46(i) of the Act which states:-

*"The Bank may make temporary advances to the Government on such terms and conditions as may be agreed upon between the Bank and the Minister"*

Section 46(2) and 46(3) spell out the limits of the relationship by constraining the advances to a fraction of current revenues (15 per cent) in any one year and indicating that this should be paid back before additional amounts can be borrowed. It must be pointed out that this facet of the Act is not unique to Trinidad and Tobago and can be found in virtually all central banking legislation in the Caribbean and beyond.<sup>5</sup> The framers of the legislation recognised that from time to time governments can have cash flow problems and would need temporary advances. Trinidad and Tobago has had some recent experience with the use of overdraft facilities by the government, but it is important to note that the provision of an overdraft for government was in existence before the establishment of the Bank.

#### *The Use of the Overdraft Facilities*

Before we examine the recent use of the facilities it may be useful to put into perspective what obtained prior to 1964. Dating back to the eighteenth century the Colonial Bank enjoyed the role as banker to the government. The relationship continued well into the middle twentieth century and with the transformation of the Colonial Bank into Barclays Bank D.C.O. Barclays Bank retained its role as banker to the government. Following the

establishment of the Central Bank, it maintained accounts for the government until 1967 when the main accounts were transferred to the Central Bank.

When Barclays Bank acted as banker to the government, the government had access to overdraft facilities which were provided for under the Exchequer and Audit Act, (Act 20 of 1959). By a resolution of Parliament, an authorised limit was specified for these facilities (See *Government Notice 59 of 1962*, June 21, 1962). This limit was not to exceed the sum of \$25 million. What is instructive is that the limit was an absolute one with no relation to the size of government's revenue although one can appreciate the order of magnitude as this represented about 18 per cent of government's revenues in 1959. There appears to be no documented evidence that these facilities were ever utilized and since the resolution has not been replaced, then it may be deemed to be still on the statute books.

During the late 1960's and early 1970's government temporary financing requirements were met primarily by treasury bills and bonds with a 1-3 year maturity. The issue of these bills and bonds were clearly intended to synchronize government receipts and expenditure, given the lumpiness of receipts and the evenness of expenditure flows. The period of the oil boom which intervened between 1974 and 1982 witnessed a dramatic transformation during which time the government built up deposits at the Central Bank. There appeared to be little need for recourse to Central Bank advances and indeed even treasury bill financing; in this regard the overall borrowing limit on treasury bills remained unchanged at \$125 million between 1973 and June 1983, when it was increased to \$500 million. The onset of the third oil shock in 1986 changed this approach and the process was activated to allow the Central Bank to provide temporary advances to meet planned budgetary commitments. Detailed terms and conditions are not spelt out in the Act e.g. interest rate applicable; when the interest should be paid and when it would be charged, but in practice the Bank Rate has been deemed

to be most appropriate. Table 2 below details data on balances outstanding over the period 1986-1994 during which time the central government used this financing facility. Average monthly balances outstanding rose from \$464.9 million in 1986 to \$1,954.8 million in 1990 declined somewhat and rose sharply in 1993. Over this same period the Bank rate rose from 7.50 per cent to 13.00 per cent.<sup>6</sup> This would suggest annual interest payments of between \$34 million and \$300 million for the later years when the interest rate had risen. Indeed by 1992 the interest on the overdraft accounted for just over one third of domestic debt interest costs.

TABLE 2  
SELECTED DATA ON CENTRAL BANK  
ADVANCES TO GOVERNMENT  
1986-1994

Year	Balances Outstanding At the End of the Period (\$M)	Average Balances During the Year (\$M)	Bank Rate (%)	Treasury Bill Rate (%)
1986	1,003.2	464.9*	7.50	3.98
1987	808.6	923.4	7.50	4.71
1988	1,153.0	1,035.2	9.50	5.07
1989	1,519.1	1,394.5	9.50	7.19
1990	1,536.9	1,954.8	9.50	7.51
1991	1,426.6	1,400.0	11.50	7.55
1992	2,092.4	1,972.0	13.00	9.26
1993	1,321.8	2,092.0	13.00	9.46
1994	767.6	1,832.0	13.00	9.87

SOURCE: *Monthly Statistical Digest*, Central Bank  
*Annual Report*, Central Bank

\* Average of four months.

The typical analysis of overdraft financing usually centres on the monetary consequences of such activities, but the Trinidad and Tobago experience brought into sharp focus the impact of this type of financing on the Bank's balance sheet and the need to ensure that the capital base was not eroded. Given the collapse in oil prices in 1986 and the consequent fiscal crisis the then government had little choice but to resort to overdraft

financing and ensure that these advances were as temporary as possible. Alternative sources of financing the fiscal deficit were not immediately available, given the limits on the size of the treasury bill issue and the fact that the domestic capital market had been used infrequently as a source of government financing.<sup>7</sup> As the fiscal crisis continued into 1987, additional funds became available by a change in the mix of the primary/secondary reserve requirement of the licensed financial institutions. In this regard the secondary reserve requirement was raised to 11 per cent from 5 per cent while there was a simultaneous reduction in the cash requirement from 15 per cent to 9 per cent. This change resulted in commercial banks holding just under \$500 million more in treasury bills in their portfolios. What is of much more significance however is that this policy change occurred by way of a direct order to the Central Bank from the Minister of Finance (Section 50), the first time in the Central Bank's history that the sole shareholder had issued a directive.

Despite the fact that the Act recognises that advances are temporary Table 2 suggests that the facilities lasted until 1994 when the government began to rebuild its deposits at the Bank. There are no legal penalties enforceable for breaches of the Act although in at least one instance in the Caribbean when an infraction occurred the rules of the game were altered *ex post* to bring them into conformity. Limiting central bank credit to the government and ensuring that the limits are observed requires a certain level of political maturity which may not be immediately achievable in the current regional context. As the Trinidad and Tobago experience suggests any attempt to ensure that breaches do not occur may well result in an invocation of Section 50 of the Bank Act. Despite all the analyses in the voluminous literature on central bank independence, as long as central banks are creatures of statute there can be no independent central bank and whatever degree of independence exists depends on the political reality of the day.

The period of overdraft financing coincided for the most part with the country's accession to an IMF adjustment programme (1988-1991). This was the standard programme consisting of the usual conditionalities, expenditure switching and expenditure reducing measures and a commitment to more market oriented policies. An important consequence of the adjustment measures was a closer scrutiny of subsidy type arrangements which related to all aspects of government as well as central bank activities. The adjustment measures therefore provided an impetus for the Bank to re-examine some of the quasi-fiscal operations in which it had been engaged and in particular the changing structure of its balance sheet.

As the economy moved from boom to recession and the foreign exchange reserves declined rapidly there was a clear effect on the Central Bank's balance sheet. The loss in reserves signalled a change in reserves management strategy from asset to liability management. The Bank recognized that not only had the structure of its earning assets changed, but that several of its quasi-fiscal activities had the potential to impair the balance sheet. In respect of its earning assets, income from foreign sources which amounted to well over 90 per cent of operating income fell from TT\$818 million in 1981 to TT\$154 million in 1988; in contrast interest income from domestic sources reached TT\$271 million by 1994 or 48 per cent of operating income. A major contributor to domestic income was the interest earned from this method of financing the fiscal deficit. However the Bank made a strong commitment to an elimination of the overdraft mindful of its income effect, but conscious of the need to ensure that the capital base was not eroded.

#### *Central Bank and Quasi Fiscal Activities*

Within the recent past several analysts have placed greater attention on the quasi fiscal activities of central banks. The discussion developed in response to measurement issues surrounding the fiscal deficit or in respect of the treatment of central bank capital, and central bank losses.<sup>3</sup> In the practice of central banking one can distinguish between activities

which may be considered to be 'purely monetary'- that is conducted in the pursuit of monetary policy objectives - and activities which are indirectly related to monetary policy. The distinction can be made between the traditional functions (clearings, settlements, foreign reserve management etc.) and activities which derive from the statutory monopoly status of a central bank (currency issue, lender of last resort, bank supervision). In many developing countries, however, central banks become directly involved in other activities on behalf of the government which can be described as quasi fiscal. These may include debt management, the provision of subsidized credit to priority sectors, exchange rate subsidies or guarantees on particular transactions. The CBTT is no exception and has had a fairly extensive experience in this area, e.g. the promotion and establishment of specialized financial institutions, the management of exchange control and in particular the dual exchange rate system of December 1985 - January 1987; the NFI crisis and subsequent introduction of the Deposit Insurance Corporation (DIC); the establishment of a subsidized credit facility for Port of Spain merchants to repair and rebuild their businesses in the aftermath of the 1990 insurrection (DOMA facility); and more recently the introduction of OMO operations.<sup>9</sup>

Perhaps the most highly visible of these activities has been the management of exchange control and especially the management of the dual exchange rate regime. As Farrell (1990) pointed out:

“..... appropriateness of a dual exchange rate regime. The dual rate regime was put in place in order to cushion the impact of the devaluation on the lower income groups. *However it would be the Central Bank which would bear the cost of this subsidy and not the fisc directly.* The devaluation was further compromised when the Ministry of Finance agreed, over the objections of the Bank, to allow a moratorium for importers to pay for goods landed up to the end of their credit terms or June 30, 1986 at the previous exchange rate. this arrangement too allowed a subsidy to importers and contributed to a massive 41 per cent decline in the foreign exchange reserves in the first half of 1986”  
p.107

In the final analysis one may argue that the cost of managing the dual rate was ultimately borne by the government to the extent that the surplus transferred was lower than would have obtained in the absence of the subsidy. However the immediate impact is on the Bank's balance sheet.

The 1970's boom had provided a background as well as the resources for the Central Bank to engage in the promotion and establishment of several new financial institutions e.g. the Stock Exchange, the Unit Trust Corporation (UTC), the Home Mortgage Bank (HMB). This involved the provision of initial capital and operational subsidies (accommodation, staffing, etc.) to ensure that the institutions could survive their infancy. During the early 1990's however there began a process of weaning these institutions from the subsidies to ensure that they could become viable and profitable over a particular time frame. By the mid 1990's both the UTC and the Stock Exchange were able to make the appropriate adjustment and have become operationally viable no longer dependent on the Bank for subsidies.

The experience of the structural adjustment programme set in motion the whole process of active management of the balance sheet and where necessary the elimination of non-performing assets. Subsequent management and appropriate provisioning ensured that recapitalization never became an issue. Nevertheless the Bank used the opportunity of the amendment of the Central Bank Act in 1994 to ensure that the capital base would be increased over time.

In the aftermath of the Asian and other financial crises in Latin America (Mexico, Venezuela) the lender of last resort function and the bailout of ailing financial institutions have become topical issues. The Trinidad and Tobago experience is unique and instructive partly because this was the first of its kind among the then CARICOM central banks and partly because the episode occurred against a background of recession and adjustment. The



nature, origins and final outcome of the NFI crisis have been well documented elsewhere.<sup>10</sup> The approach adopted by the Bank was a mixture of support for the ailing institutions and legislative reform. In respect of the latter, this included the establishment of the DIC in 1986 and further strengthening of the supervisory powers in the form of the FIA 1993. The Central Bank together with the commercial banks provided liquidity support to these ailing institutions which amounted to TT\$142.7 million or 0.8 per cent of GDP. This support was directed towards meeting the costs of maturing deposits in order to keep the system intact until the DIC came into being. Once established this allowed the Bank to close those institutions which were deemed insolvent, liquidate assets and pay depositors out of the Insurance Fund of the DIC.<sup>11</sup>

The DIC was formed in 1986 as a wholly owned subsidiary of the Central Bank, with funding consisting of a long term loan from the Central Bank and insurance premiums from the licensed members of the DIC. The Bank's solution ensured that the cost of these bailouts were borne by both depositors and shareholders. Depositors of closed institutions were paid up to a maximum of TT\$50,000 and not the full value of their deposits. This approach has been in sharp contrast to that taken in the Latin American and Caribbean region in response to recent crises.

### **III. Open Market Operations in Trinidad and Tobago: A First Appraisal**

The movement away from a fixed exchange rate regime in April 1993 was the culmination of a long process of financial reform and liberalisation which had begun with the IMF adjustment programmes of 1989-1991. The removal of all controls on current and capital transactions of the balance of payments ushered in a more difficult period for the conduct of monetary policy. Monetary policy had always been directed towards the preservation of the value of the currency and the protection of the balance of payments; with

the change in the exchange rate regime the immediate focus of policy was the control of inflationary pressures and liquidity management although no formal inflation targets were announced. The influence of the Washington based international financial institutions had led to a gradual deemphasis of the traditional instruments (selective credit controls, reserve requirements, interest rate and exchange rate controls) and instead there was a shift towards market based instruments i.e. open market operations (OMO).<sup>12</sup>

The extensive theoretical and empirical literature on the inefficiency of direct instruments of control also appears to have influenced the Bank's policymakers to begin to use a combination of OMO and changes in reserve requirements. For example the secondary reserve requirement (SRR) in existence since 1967 had been viewed as a cheap source of government financing since the commercial banks were required to hold treasury bills in part to meet this ratio. As earlier indicated the SRR had risen in 1987 to 11 per cent but had been gradually lowered and was finally eliminated in 1991, while selective credit control guidelines had been gradually phased out by early 1994. While the literature argues that reserve requirements are a tax on the financial system, the Bank acknowledged that in certain circumstances the instrument was extremely effective. Issues of regulatory arbitrage between banks and non banks and the impact of financial innovation had not yet come to the fore. The ideal mix of policy instruments would therefore be some combination of OMO and reserve requirements.

When practised, open market operations involve the purchase and sale of securities by the Central Bank to add liquidity to or drain liquidity from the financial system. These operations should impact on demand conditions through changes in short-term interest rates, money and credit conditions and ultimately the price level. The successful use of open market operations (OMO) in the conduct of monetary policy requires at a minimum certain structural features, a particular institutional framework and an appropriate mix of securities.

In the developed economies the existence of primary dealers or jobbers for example is an important critical success factor. These dealers transact directly with the central bank and provide liquidity to the financial markets by their readiness to buy and sell securities. Because the nature of their activities requires large capital outlays, these agents generally have lines of credit with the central bank. Nonetheless, despite the recent amendments to the Central Bank Act in Trinidad and Tobago, the Bank is constrained from extending credit along these lines. It was recognized, therefore, that as the operations commenced such dealers were not likely to emerge. In well developed capital markets the depth and breadth of the securities markets provide a wide array of instruments to be bought and sold. Finally, open market operations are usually intended to deal with periodic fluctuations in liquidity and not necessarily those caused by a net domestic budget deficit.<sup>13</sup>

Open market operations formally commenced in Trinidad and Tobago on September 24 1996 at which time TT\$75 million was offered at auction and allotted to the commercial banks at an average discount rate of 9.95 per cent. However, prior to these events certain legislative changes were needed to ensure that the new policy instrument could be implemented. The first change was an amendment to the Treasury Bill Act to allow for the issue of new securities.<sup>14</sup> Without the appropriate legislative amendment, there would have been a dearth of securities for use in OMO, especially since the decision had been taken to desist from the use of central bank paper. An important feature of the new arrangement was the fact that the central government would bear the cost of OMO rather than the Central Bank. The Bank was determined not to follow this particular path given its potential for creating quasi-fiscal deficits as had occurred elsewhere in Latin America and the Caribbean.<sup>15</sup>

There were several teething problems which surfaced during the first few months of operationalizing the new policy instrument. Firstly there was some concern about the liquidity of the OMO bills as the new bills as initially they were perceived to be less liquid

than the traditional debt management bills. At the outset the Bank had recognised that in the absence of primary dealers there would be a need to maintain the liquid characteristics of the instruments and so the Bank would continue to provide a secondary market for these securities. However to ensure that its policy objectives were not derailed access to the secondary market would be obtained by means of a deep discount. Over the first twelve months of operations the market showed a preference for three month rather than six month bills while the auctions tended to be much more successful as participants became used to the process (Table 3 below). For some period of time there was a differential of 141 basis points between the discount rate for OMO bills and debt management bills; however the differential narrowed considerably (22 basis points) as participation at the auctions widened and there was a greater understanding of the process.

TABLE 3  
RESULTS OF OPEN MARKET AUCTIONS  
SEPTEMBER 1996 - DECEMBER 1997

Date of Auctions	Maturity (Days)	Face Value Offered \$M	Face Value Allotted \$M	Average Discount Rates %
1996				
September	91	75	75	9.95
September	180	75	15	10.85
October	91	40	-	-
October	170	60	-	-
December	91	75	75	11.30
1997				
February	91	200	145	10.03
April	91	375	274	9.55-9.90
May	91	255	255	9.74-9.99
June	92	61	61	10.02
July	91	281	223	9.48-9.57
August	91	505	332	9.50-10.75
October	91	213	213	10.76
November	91	377	377	10.84-10.93

In the absence of primary dealers the Central Bank has conducted operations with the six commercial banks and during 1998 widened the market to include NFIs and other financial institutions. The initial response from the commercial banks precluded any one

institution from emerging as a primary dealer; however as the market gains in experience it may be possible for one institution to assume the role especially if profitable opportunities begin to emerge. Nevertheless while the existence of primary dealers may not be a sufficient condition for successful OMO activity it is still not yet possible to determine whether their absence may affect unduly the ability of policymakers to meet their desired objectives.

Despite these institutional rigidities a major structural problem in the implementation of OMO has been the size of the liquidity injections which monetary policy had been required to sterilize over the 1997-1998 period. Designed to deal with the ebb and flow of fluctuations in liquidity, the effectiveness of OMO will be limited if it is used to correct persistent imbalances deriving from a domestic budget deficit. This characteristic of the local economy may prove to be the major challenge for effective utilization of the policy instrument. When OMO commenced in 1996 this was just one in a series of policy measures designed to deal with recurrent large build-ups of liquidity, which continued to put pressure on the exchange rate. These measures had included *inter alia* a special reserve ratio equivalent to 5 per cent of deposit liabilities which resulted in a combined statutory and non-statutory reserve requirement of 26.1 per cent of deposit liabilities. However partly because of the persistence of these high liquidity levels and partly because of the initial problems with the auction process the Bank resorted once more to changes in the reserve ratios. Thus at the end of 1996 commercial banks were holding a combined reserve ratio of 28 per cent of deposit liabilities.

In 1997 the Bank began to dismantle the structure of unduly high reserve ratios while there continued to be large fiscal injections which contributed once more to excessive liquidity growth. At first the OMO auctions were relatively more successful in dealing with the injections but when this proved to be inadequate there was recourse once more to an increase in the statutory reserve requirement.

The Trinidad and Tobago experience is too short a period of time on which to make definitive conclusions, nevertheless the initial evidence suggests that the instrument may not be a perfect substitute for changes in reserve ratios if immediate action is needed.

#### **IV. Some Concluding Comments**

The Trinidad and Tobago experience described in the paper suggests that fiscal discipline is key to ensuring that monetary policy is not unburdened unduly to correct for any indiscipline. Recent economic history shows that the CARICOM economies are extremely vulnerable to external shocks which in turn impact on a government's fiscal position. In this regard a resort to overdraft financing to ease temporary revenue shortages is appropriate but all efforts must be made to reduce the inflationary consequences of such action. In respect of quasi fiscal deficits the major lesson for younger central banks is that institution building is beneficial over the long term but any costs associated with this activity should be transparent and reduced over time. The Trinidad and Tobago authorities, in recognition of the impact of quasi fiscal deficits on a central bank's balance sheet made a determined effort to reduce the dependence of its 'satellite' organizations on itself. In addition a process was put into place to allow for an increased capital base over time to deal with future crises. A strong capital base adds to the credibility and effectiveness of monetary policy.

As Trinidad and Tobago approaches the next century there will be many forces at work to ensure that the authorities address the first round of second generation reform. Nevertheless fiscal indiscipline and its effects may well reemerge in the immediate near term as there appears to be a reversal of past gains with a weakening of the public finances. While the domestic capital market may be able to fill some of the gaps this may be at the expense of fairly high rates of interest and crowding out may be one consequence of this. Effecting limits on central bank lending may be one of the more difficult tasks in the medium term

since central bank independence is dependent ultimately on the nature of the political directorate.

## ENDNOTES

- 1 See Stewart and Payne (1988) and Stewart (1996) for example.
- 2 See for example Paul Holden and Sarath Rajapatirana "Emerging Issues In Latin America: A Second Generation Agenda", Paper presented at a seminar: *The Caribbean Quest: Directions for the Reform Process*, UNECLAC, Port of Spain, Trinidad, June 25-26 1997.
- 3 *The Imperatives of Adjustment: Draft Development Plan 1983-1986*. Report of Task Force Appointed by Cabinet to Formulate A Multi-Sectoral Development Plan for the Republic of Trinidad and Tobago, 1983, GOTT.
- 4 These case studies include experiences of companies which are publicly owned and quoted on the Stock Exchange as well as those owned in part by the State e.g. the CLICO - Republic - Commerce saga, the appointment of the board of directors at PLIPDECO and more recently the National Flour Mills debacle.
- 5 One notable exception is the newly established European Central Bank. The Maastricht Treaty however forbids any automatic access to central bank credit and the European Central Bank can finance the government only indirectly by the purchase of government securities from the market through open market operations for example.
- 6 The oil shock of 1986 had also affected the banking system to the extent that commercial banks had been borrowing extensively from the Central Bank. To discourage this process the rediscount rate had been increased to 8.50 per cent in July 1988 from 7.50 per cent which had stood unchanged since 1983; there was a further increase in November 1988 to 9.50 per cent.
- 7 This period also witnessed a rise in its contingent liabilities as the government embraced the concept of design, finance and construct facilities which allowed infrastructure developments to be financed while there was a delay in the creation of financial liabilities.
- 8 Robinson and Stella (1993); Beckerman (1997) for example.
- 9 The Bank has argued that this is a quasi-fiscal activity and that the costs should be borne by the central government.
- 10 See Victor (1987); Farrell (1988) and Forde (1996) for example.
- 11 Forde (1994) provides a first assessment of the DIC in operation.
- 12 In the *Letter of Intent to the IMF* the Trinidad and Tobago authorities had indicated their willingness and intentions to move to more market oriented policies in respect of monetary and balance of payments policies.
- 13 In an open economy such as Trinidad and Tobago, which is dominated by energy based industries and where the government receives a substantial amount of its revenue in foreign exchange, the more appropriate fiscal balance concept is that of the domestic budget balance. A domestic budget deficit, where domestic revenues from the non-energy sector



paid in local currency are less than domestic expenditures, is not inconsistent with an overall budget surplus. This concept and its associated inverse - the fiscal injection (domestic expenditure minus net domestic borrowing minus domestic revenue) are important in determining the impact of budgetary activities on the money supply as well as on aggregate demand.

- 14 Act 14 of 1995, The Treasury Notes Act. The Act allowed for the issue of Treasury Notes and additional Treasury bills to an amount of \$2,000 million whose maturity would be less than one year and would be set at the auction time.
- 15 In practice the cost of the OMO amounted to TT\$1.5 million in 1996 and TT\$42.4 million in 1997.

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