An Alternative Approach to Interest Rate Policy in CARICOM

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Abstract

It is argued in this paper that the interest rates on loans, as well as rates on debt instruments issued by central governments are high and impose a significant constraint on efforts to promote economic growth in the region. The high interest rates create difficulties for private sector producers in two ways. First, by imposing an additional cost burden, it weakens their international competitive position. Second, high interest rates on government debt instruments deflect funds away from directly productive investment in the private sector. High interest rates have also made it more difficult, especially for governments with significant levels of domestic debt, such as Jamaica and Guyana, to meet debt service obligations and maintain an adequate level of public services. It is suggested in this paper that the structure of the financial sector in all countries in the region consisting of a small number of institutions with commercial banks playing a dominant role, makes it possible to establish lending rates through direct negotiations between the central bank and the commercial banks. Accordingly, emphasis should be placed on moral suasion as the primary policy instrument in the management of interest rates. There is a discussion on possible approaches to the establishment of appropriate goals for deciding on the appropriate levels for interest rates and the complementary changes in the regulatory environment required to realize these goals.

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Introduction

The high level of interest rates in several CARICOM countries since the nineteen eighties has given rise to concerns that the maintenance of such rates will have a negative impact on the economies of countries in the region. In a recent report (CARICOM Secretariat et al; 2003), it was pointed out that interest rates on loans to businesses and consumers averaging around 20 percent, meant that few activities, apart from the more speculative ones, could expect to earn a matching high rate of return. Accordingly, lower interest rates are seen as necessary to assist producers in the region in improving their competitive position. In addition, lower rates would help to alleviate the debt management problems faced by the governments of the more heavily indebted countries.

The general view held by the financial authorities is that the evolution of interest rates over the period reflects the outcome of the operation of market forces. Consequently, emphasis is placed on what role they can play in bringing about the types of changes in the market environment which will lead to lower interest rates. For example, in a country, such as Jamaica, where there has been a sharp increase in government borrowing on the local market since the mid nineties, the high interest rates is attributed to demand pressure emanating from the heavy borrowing. Accordingly, it is argued that lower interest rates will be realized when the government succeeds in reducing its borrowing requirements. This will require governments to reduce or control non interest expenditures as well as enact measures to increase revenue. In addition, correcting deficiencies in the administration of the tax system is seen as making an important contribution to enhancing revenue.

In this paper it is argued that a new approach is required on the part of the monetary authorities in the region towards interest rate policy. Specifically, there is a need for more direct interaction between the monetary authorities and the commercial banks, the principal financial intermediaries, in the setting of interest rates, for the private sector, as well as, on government borrowing instruments. The paper will be organized as follows. In the first section, there will be a review of interest rates on government borrowing instruments, as well as lending rates to business for a selection of countries in the region. These rates will be compared with those prevailing in the major extra regional financial centres with a view to gaining insights into the how much of an excess interest burden is borne by private and public sector borrowers in the region. In the second section, attention will be directed to an assessment of the possible distortion in the allocation of funds for investment and the impact on fiscal management arising from the high interest rates. In the final section, there will be an outline of an alternative approach to interest rate policy emphasizing the role of direct interaction between the monetary authorities and private institutions in administering interest rates.

A Review of Intra – Regional Interest Rates

In view of the fact that government borrowing rates traditionally provides the basis for lending rates for the economy as a whole, we will start with a review of treasury bill rates in the respective countries. Table 1 set out the rates for a selection of CARICOM countries, as well as those for the United States and Canada, covering a period from 1994 to 2003. The rates for Jamaica were significantly higher than that of its CARICOM partners. The rates for Barbados and Belize were the lowest over the period and in the case of the former was close to that of the United States. The rates for Belize, prior to 2000 were lower than that for the United States and Canada.

Table 1
Comparative Treasury Bill Rates[1]

	Barbados	Guyana	Jamaica	Trinidad/Tobago	Belize	US	Canada
1994	7.53	17.18	33.97	9.60	4.30	4.50	6.13
1995	8.08	17.05	25.42	8.58	4.10	5.41	6.73
1996	6.58	10.82	31.08	10.48	3.80	5.06	4.12
1997	3.63	8.88	18.81	9.71	3.50	5.05	3.40
1998	5.63	8.40	22.37	11.91	3.80	4.80	4.77
1999	5.85	11.80	18.09	10.25	5.90	4.76	4.75
2000	5.02	9.80	16.66	10.66	5.90	5.82	5.49
2001	3.00	10.20	15.08	8.36	5.80	2.88	4.06
2002	2.00	4.80	14.33	4.83	3.50	1.59	2.65
2003	1.50	3.20	23.61	4.82	3.20	0.97	2.87

1. End of quarter averages.
Source: Bank of Jamaica, ***Statistical Digest***; Central Bank of Barbados, ***Economic and Financial Statistics***.

To what extent might the differences in rates be attributed to differences in the fiscal situation in the respective countries? Guyana is one of the most heavily indebted countries and has qualified for debt relief under the Heavily Indebted Poor Country Initiative. It has clearly been in the weakest fiscal situation and has operated with the highest deficit/ GDP ratio over the past decade. Since the financial crisis of the mid nineties Jamaica has experienced a significant weakening in its fiscal position with its deficit /GDP ratio averaging 6 percent. All of the countries, with the notable exception of Trinidad and Tobago, have operated with higher deficits to GDP ratios since the beginning of the millennium, with the most significant change occurring in Belize. A summary of the fiscal situation for a representative group of countries in the region is provided in Table 2. The differences in the fiscal situation between Jamaica and the other countries would not appear on the surface to justify the amount by which the yield on that country's treasury bills exceeded that of the other countries.

Potential buyers of Jamaican treasury bills in deciding what would be an acceptable yield would, like buyers in other CARICOM centres, take into consideration the returns available on comparable instruments in international financial markets. In this context,

Table 2
Central Government: Fiscal Balance Percent GDP

Surplus (+) Deficit (-)

Year	Barbados	Belize[1]	Guyana	Jamaica	Trinidad/Tobago
1994	-2.8	-6.0	-8.1	3.1	0.0
1995	0.9	-3.2	-3.9	2.0	0.2
1996	-3.8	-0.1	-1.9	-6.7	-0.5
1997	-1.1	-1.3	-8.2	-8.3	0.1
1998	-1.0	-1.3	-9.7	-7.5	-1.2
1999	-2.8	-4.4	-2.9	-4.6	-3.1
2000	-1.8	-6.0	-4.2	-1.0	1.6
2001	-4.3	-9.7	-11.3	-5.6	-0.1
2002	-7.6	-7.5	-8.4	-7.6	0.3
2003	-3.8		-7.7	-6.6	2.7

1 fiscal years 1994/95 – 2002/03.

Sources: Central Bank of Barbados, ***Annual Statistical Digest;*** Bank of Jamaica, ***Statistical Digest;*** Central Bank of Trinidad and Tobago, ***Annual Economic Survey;*** Data for Belize and Guyana derived from central bank website.

given the proximity to the United States, the decision might be strongly influenced by the yield on US treasury bills. In addition, given the fact that Jamaica operated under a flexible exchange rate regime and had experienced periodic significant depreciations, decision makers would also have to take exchange risk into account. Specifically, purchasers of Jamaican treasury bills would demand a premium on the US rate to offset exchange risk.

The premium on Jamaican treasury bills in percentage terms relative to that of US treasury bills is set out in Table 3. They were on the whole extremely large averaging several hundred percent. However, a more relevant measure, given the fact that the real rate of return would be the basis for decision making, is the inflation adjusted premium. In view of the fact that several studies have established that exchange rate depreciation has been a major determinant of the rate of inflation, an inflation adjusted risk premium would incorporate exchange risk

Table 3
Jamaica: Treasury Bill Premium on US Treasury Bills
Percent

Year	Nominal	Inflation Adjusted
1996	514.2	160.9
1997	272.5	74.3
1998	366.0	179.2
1999	280.0	122.7
2000	186.3	71.9
2001	423.6	101.4
2002	801.2	315.1
2003	2334.0	755.7

In the post 1996 period, the inflation adjusted premium was never less than 70 percent and on all but two occasions was well in excess of 100 percent. It should be noted that over this same period the highest rate of currency depreciation was 19.5 percent, which occurred over the 2003 calendar year. Taking all of these factors into consideration, it would appear that the Jamaican government paid an excessive premium on its Treasury bills. This meant that funds which would otherwise been available for funding programmes in the areas such areas as health and education had to be redirected to debt service.

Let us now turn to a consideration of the level of lending rates to the private sector. Commercial bank lending rates for a representative group of countries in the region are set out in Table 4

Table 4
Commercial Bank Lending Rates[1]

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Barbados										
Nominal	11.9	11.8	11.9	11.9	11.6	11.7	11.9	11.1	10.4	10.0
Real	11.1	9.7	9.3	3.9	13.1	9.9	9.3	8.3	10.2	8.9
Belize										
Nominal	15.0	16.3	16.2	16.6	16.3	16.3	15.8	15.4	14.5	14.2
Real	13.0	11.9	9.2	15.4	17.4	17.7	15.1	15.0	12.0	11.3
Guyana[2]										
Nominal	19.9	19.1	17.2	16.9	16.6	17.3	17.2	16.8	16.3	14.9
Real	5.5	6.1	9.4	12.8	11.5	9.1	10.5	13.8	10.5	8.5
Jamaica										
Nominal	45.8	48.6	37.8	31.9	30.1	24.6	22.1	19.5	18.3	19.3
Real	15.0	18.3	19.0	20.8	20.6	16.7	15.1	9.8	10.2	4.6
Trinidad/Tobago										
Nominal	13.9	13.4	14.2	13.9	15.2	15.9	15.3	14.5	12.8	11.7
Real	4.6	7.7	10.6	9.8	9.1	12.1	11.3	8.5	8.2	7.6
United States[2]	7.5	8.8	8.3	8.4	8.4	8.0	9.2	6.9	4.7	4.1

1. Weighted average lending rates.
2. Prime lending rate.

Sources: Same as for Table2.

Lending rates, as stated earlier, have remained high in all of the countries over the past decade. The highest rates were in Jamaica; where in the pre 2000 period, nominal lending rates by commercial banks were on average well in excess of 20 percent. In all of the countries in the region real lending rates rarely fell much below 10 percent. In the post 2000 period, with a trend towards declining interest rates internationally, this has resulted in a widening of the gap between lending rates in the region and other major financial centres. The high interest rates charged for loans, as pointed out in an earlier study (Bennett, 2004) could not be attributed in an imbalance between the demand and supply for loanable funds. All of the commercial banks in the region maintained holdings of liquid assets well in excess of the minimum legal requirements. This occurred in spite of the fact that these requirements were high in all of the countries, remaining well above 20 percent. The high rates of interest may then be linked to other factors arising from the limited degree of competition within the sector.

The Economic Impact of High Interest Rates

The economies of most of the member countries of CARICOM, with the notable exception of Trinidad and Tobago, have performed poorly since the mid nineties. In this section we turn to a consideration of the role that interest rates might have played in contributing to this poor performance. In view of the fact that a variety of factors, in addition to the cost of funds would have had a bearing on the investment decision, the arguments which are outlined below are not intended to establish a definitive relationship, but are suggestive of possible linkages. High interest rates could have contributed to a lowering in the quality of investment undertaken. This could have arisen from the fact that the high cost of funds would eliminate a range of productive activities where the expected rate of return could not justify such significant cost outlays. Funds might then be deflected into less productive areas such as real estate and the distributive trades. For example, , in both Barbados and Jamaica there was an absolute decline in the overall output of the agricultural and manufacturing sectors between 1994 and 2003, while that of construction, real estate and the distributive trades increased.

In both Guyana and Jamaica there was heavy borrowing by government on the domestic market in the post 1997 period. This borrowing could have had an impact on the quantity and quality of investment carried out by the private sector for the following reasons. The competition by governments with the private sector for loanable funds potentially limited the amount available to the private sector. In addition, government borrowing meant that there was available to investors a large quantity of high yielding, low risk financial assets. The acquisition of such assets provided an attractive alternative to investments in other forms of directly productive activity embodying more risk with no greater expected yield.

In summary, the high cost of funds could have had a dampening impact on the quantity of productive investment. In addition, it could contribute to an investment bias toward the acquisition of financial assets as opposed to directly productive investment.

Let us now turn to an examination of the impact of high interest rates on government capital expenditure. High interest rates could impose a constraint on government capital expenditure to the extent that it limits the amount of revenue available for spending on such items, after allocations for debt service. The influence of government capital expenditure on the performance of economies in the region rests on the complimentary relationship between such expenditures and private capital outlays. Inadequate capital expenditure by government could work to undermine the productivity of private capital expenditure.

All of the governments in the region, with the exception of Jamaica, have been able to avoid a reduction in capital expenditure. Such expenditures were supported in all instances, except for Trinidad and Tobago, by incurring deficits which were financed from external sources. In the case of Jamaica, there was a dramatic increase in the level of borrowing by government on the domestic market in the post 1997 period. The domestic debt/GDP ratio rose from 39 percent in 1997 to 87 percent, approximately, in 2003. Given the high interest rates on government debt instruments, interest payments on domestic debt which absorbed 30 percent of government revenue in 1997, by 2003 had risen to 45 percent. The largest increases occurred in the last two years reflecting the rise in Treasury bill rates. Furthermore, as shown in Table 5, by that time interest payment on domestic and foreign debt absorbed close to 60 percent of total government revenue.

Table 5
Jamaica: Debt Indicators

	Domestic Debt % GDP	Interest on domestic Debt % Government. Revenue	Total Interest % Government Revenue
1997	38.6	29.2	38.9
1998	42.5	34.8	44.9
1999	58.4	38.1	46.7
2000	55.4	36.4	44.0
2001	79.3	36.3	48.8
2002	86.1	41.0	53.9
2003	86.7	45.2	58.2

Source: Bank of Jamaica, ***Statistical Digest.***

These developments were not related in any way to government expenditure on capital. The large share of government revenue which had to be allocated to servicing debt meant that the government experienced great difficulty in satisfying other essential expenditures without resorting to further borrowing. At the same time, further borrowing would lead to unsustainable levels of debt. In order to contain further growth in the level of debt there was a great deal of pressure on the government to operate with large primary surpluses. For example, the Government of Jamaica had set as a goal for the fiscal year 2005/2006, the realization of a primary surplus of 13.6 percent of GDP. Primary surpluses of a particular level could in principle be realized through a combination of expenditure reduction and revenue enhancing measures. In reality since revenue enhancing measures will take time to show results, the emphasis is on expenditure reduction.

In the recent IMF review of the country's fiscal situation it was recognized that it would not be easy to realize the reductions in spending planned as part of the strategy for attaining the targeted primary surplus. It was acknowledged that lower interest would make it easier to achieve the overall fiscal targets. However, the IMF team argued against any attempt to bring about significant reductions in interest rates. They based their argument on the fact that domestic inflation rates exceeded international rates and that there was also the prospect of a global hike in interest rates (IMF, 2005). This would be a cause for concern if a reduction in interest rates in these circumstances would automatically result in an elimination of the domestic interest rate premium. However, given the magnitude of the premiums outlined in the first section of the paper, lower interest rates could be seen as helping to bring down the domestic premium to more reasonable levels.

The effort of the Jamaican government since the mid nineties to meet its debt service obligations and control the overall level of debt has meant that capital expenditures have been severely restricted. There has been a significant fall in expenditure since the 1997/98 fiscal year. Nominal expenditure was never more than three quarters of the level attained in that year and in the 2003/2004 fiscal year with a targeted primary surplus of 11.2 percent; the allocation for capital expenditure was one third of that for the 1997/98 fiscal year.

In a recent World Bank review of the Guyanese economy (World Bank, 2003) it was pointed out that the progress the country had made in reducing the public debt burden arising from the relief granted under the Heavily Indebted Poor Country Initiative, HIPC, had been partly offset by a rapid growth in domestic borrowing between 1997 and 2002. Consequently, there were significant increases in the amount of funds directed towards interest payments on domestic debt with such outlays rapidly approaching that required to meet external debt obligations. Nevertheless, domestic debt amounted to no more than 14 percent of total debt in this period. Furthermore, as shown in Table 6, interest payments, although significant, did not absorb the extraordinary share of government revenue as was the case in Jamaica. Interest payments on domestic and foreign debt never absorbed more than 25 percent of government revenue. Nevertheless, the overall high level of government debt indicates that the level of interest rates could play an important role in the ability of the country to service its debt and meet essential spending requirements.

Table 6
Guyana: Debt Indicators

	Total Debt % GDP	Domestic Debt % Total Debt	Interest payments % Govt. Revenue	Interest on domestic debt % Govt.Revenue
1997	211.2	13.4	25.0	9.0
1998	243.3	13.0	25.0	8.7
1999	201.0	12.1	22.9	8.6
2000	192.9	12.2	23.3	9.9
2001	193.8	12.5	22.4	9.3
2002	194.7	13.7	19.4	7.6

Source: World Bank, ***Guyana: Development Policy Review. Report No.25460- GUA***, November, 2003.

An Alternative Approach to Interest Rate Management

The structure of interest rates in the region is seen as being reflective of institutional, legal and operational features of the financial sector (CARICOM Secretariat et al; 2003). Consequently, reforms are required in all of these areas if the goal of lower interest rates is to be realized, and priority is attached to addressing the following issues. There is the matter of the high liquid asset requirements imposed on the commercial banks by the regulatory authorities. These requirements force the banks to adopt a lending rate structure which will allow them to offset the costs incurred in satisfying these requirements. A second factor cited is the high rate of interest paid on deposits. This was attributed to the tacit encouragement by the central bank authorities to prevent capital flight, as well as shortcomings in the ability of the banks to mobilize savings. Positive initiatives might involve an interest rate reduction incentive incorporated in the tax system. Finally, it was suggested that there is need for more emphasis to be placed on the development of alternative sources of capital, specifically, equity markets to reduce demand pressure in the credit market, leading to an easing of interest rates.

While these are clearly all worthwhile initiatives, the limited number of financial institutions, the dominant role played by the commercial banks in the sector, and the large share of the market controlled by the dominant firms, are all indicative of the fact that a more direct and less passive approach might be adopted by the authorities in interest rate management.

As indicated above the commercial banks are the dominant financial institutions in the region. As the data in Table 7 reveals, there are no more than seven commercial banks in any of the larger countries in the region. Apart from the limited number of banks a significant share of the commercial banking business is controlled by one or two banks in all the countries with the exception of Guyana. The highest degree of concentration occurs in Jamaica, where the two leading banks, the National Commercial Bank and Scotia Bank held almost 80 percent of deposits and loans extended by the banking system in 2004. In the other countries the two dominant banks account for more than one half of the loans extended by the banking system and hold a similar share of deposits.

Table 7
Structure of the Commercial Banking System 2004

	Barbados	Belize	Guyana	Jamaica	Trinidad/Tobago
Number of Banks	6	5	7	6	6
Share of Loans[1]	57	63	32	77	59
Share of Deposits[1]	57	63	32	80	53

1. Barbados: Barbados National Bank, First Caribbean International Bank; Belize: Belize Bank, Scotia Bank; Guyana: Guyana Bank of Trade and Industry, Demerara Bank; Jamaica: National Commercial Bank, Scotia Bank; Trinidad and Tobago: Republic Bank, Scotia Bank.

Sources: Data for the respective banks derived from Annual Reports, data for the sector derived from central bank sources.

Given the very small number of institutions it should be fairly simple to conduct interest rate policy through direct negotiations between the central banks and the commercial banks. In Barbados, there already exists a situation in which the central bank provides indicative targets for average lending rates by the commercial banks. Furthermore, apart from Jamaica, most of the countries in the region continue to maintain the practice of regulating lending rates.

If interest rates are to be administered, the question arises as to what would be the appropriate benchmarks for arriving at an appropriate level for the rates for borrowing by government and the private sector. With respect to public sector borrowing, since the Treasury bill rate is usually the minimum rate at which the government can raise funds, what principles should be adopted in negotiating an appropriate rate? In the first section of the paper it was suggested that in the case of Jamaica, the rate on domestic bills compared to that in the United States and Canada embodied an excessive premium. The issue then revolves around what constitutes an appropriate premium.

The premium should be based on the following considerations. Holders of Treasury bills should secure a rate of return no less than that available in the United States taking into account inflationary trends. In addition, for those countries operating under a flexible exchange rate regime, consideration should be given to the most recent movements in the exchange rate. At the same time, in the negotiations both parties would have to accept the principle that there is an upper limit to the share of government revenue to be allocated to servicing debt. Minimizing the cost of debt service should be seen as being beneficial in that it enables government to provide an adequate level of services in such areas as public health and education, as well maintain essential infra structure. Moreover, lower borrowing costs reduce government borrowing requirements potentially making more loanable funds available for the private sector at a lower cost. It seems that so often in discussions about the need to exercise fiscal discipline centered on the need to contain expenditure, there is a failure to acknowledge the fact that even with spending contained high interest rates can lead to a higher level of indebtedness.

With respect to the matter of the appropriate level of lending rates for the private sector, the central issue would be that of identifying a set of rates which would not work to undermine the competitive position of domestic producers. A starting point of reference in this regard could be the lending rates in countries in the Central, South America and the Caribbean area whose producers could be seen as potential major competitors to those located in CARICOM. However, in the final analysis, the rates would have to be reflective of the unique circumstances of the individual countries. The negotiation of lending rates would have to be conducted simultaneously with deposit rates in order to assure the maintenance of an appropriate spread.

In essence what is being proposed here is an approach to monetary management in which the central banks and the commercial banks function as partners in the management of interest rate policy. Given the small number of institutions, it should not be difficult for all parties to identify common goals and come to an agreement as to the most efficient manner in which such goals might be realized.

It is often argued that the high interest rate arise from shortcomings in the regulatory environment imposing a cost burden on the institutions which has to be offset in the form of higher rates. The continuous broad interaction between the monetary authorities and the commercial banks embodied in this proposal should make it easier to identify and correct those shortcomings in the regulatory system which might impose an unnecessary cost burden.

In summary, priority should be given to bringing about a reduction in interest rates in the region. Interest rates in nominal and real terms have remained at high levels over the past decade. These high rates have imposed an excessive cost burden on producers in the region and helped to undermine their international competitive position. It has also made it more difficult for the more heavily indebted countries to maintain an adequate level of essential expenditures and maintain a sustainable debt burden. There appears to be scope for bringing about a reduction in interest rates through direct negotiations between the monetary authorities and the commercial banks. Such a reduction would yield major benefits to the economies of the region.

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