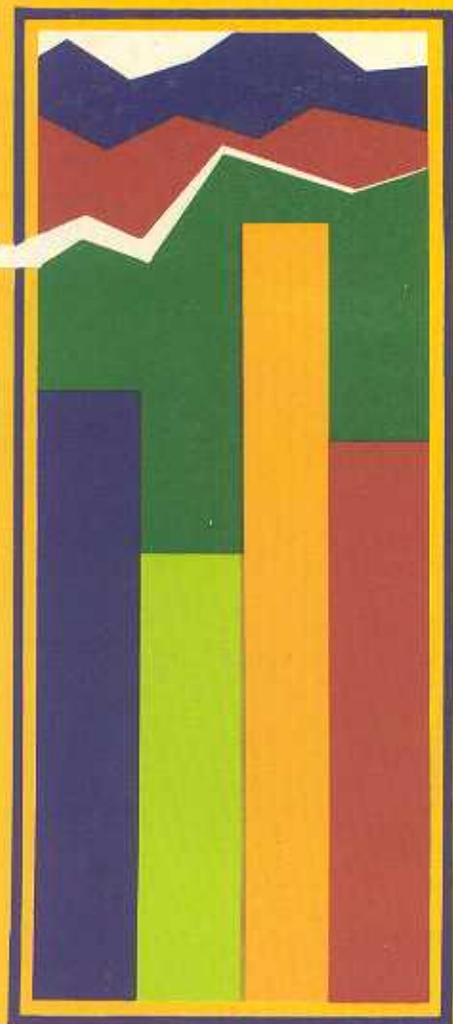


# **CENTRAL BANKING**

**IN A  
DEVELOPING  
ECONOMY**

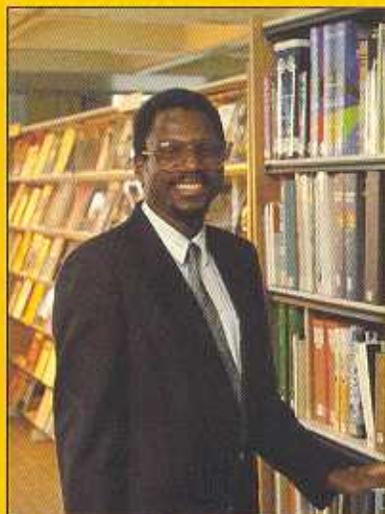


**A Study of  
Trinidad & Tobago  
1964-1989**

**TERRENCE W.  
FARRELL**

### *The Author*

Terrence W. Farrell was born in Trinidad in 1953 and attended St. Mary's College. He obtained his BSc and MSc degrees in Economics at the University of the West Indies, St. Augustine in 1973 and 1976 and his PhD at the University of Toronto in 1979. He lectured in Monetary Economics at the UWI (St. Augustine) before joining the Central Bank of Trinidad and Tobago in 1980, where he is now Senior Manager, Research and Information. He is also Chairman of the Reinsurance Company, Deputy Chairman of the Home Mortgage Bank and Vice President of the Trinidad and Tobago Economics Association. Dr. Farrell is married and has two children.



## **CENTRAL BANKING IN A DEVELOPING ECONOMY**

This book examines the difficult roles played by a central bank in a developing economy as it seeks to define its functions, establish a degree of independence, and balance considerations of development and monetary stability. The author suggests that the central bank of Trinidad and Tobago was not always successful in balancing these complex roles and, in particular, failed to contribute adequately to the management of the petro-dollar boom. The author sets out a framework for the analysis of economic policy in which, apart from the usual factors of context, objectives, instruments and theory, other important factors such as timing of policy, systems for policy formulation and the 'personality' of the decision makers are also incorporated. These latter factors turn out to have a significant influence on monetary and financial policy in certain instances.

*"There is no rival work in existence. It is likely that Farrell's... will become the authoritative source."* Professor Compton Bourne

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**CENTRAL BANKING IN A  
DEVELOPING ECONOMY:**  
A Study of Trinidad and Tobago,  
1964-1989

Terrence W. Farrell

Regional Programme of Monetary Studies  
Institute of Social and Economic Research  
University of the West Indies  
Mona

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## PREFACE AND ACKNOWLEDGEMENTS

THE BOOK WAS WRITTEN LARGELY between the end of May 1989 and November 1989. It chronicles and analyses the monetary and financial policy of the Central Bank and the Ministry of Finance over the 25-year history of the central bank and is intended to be one of a series of contributions by the Research Department of the Bank commemorating its 25th anniversary. Other contributions include a history of money and banking, a compendium of selected research papers, a handbook of key economic statistics and a chronology of monetary management, which latter should prove to be a useful companion document to this book.

The study focusses only on the activities of the Central Bank of Trinidad and Tobago and, to a lesser extent, the Ministry of Finance in the sphere of monetary and financial policy. Arguably, it would have profited enormously from a comparative perspective which related the Trinidad and Tobago experience to those of other Caribbean or other developing economies. This would have increased the work and the time involved and the latter has been a scarce resource. In this respect, it is interesting to note that central banks and their activities have proved to be fertile ground for research by academics and even by central bankers themselves and there would have been no dearth of material had I been able to pursue that line of enquiry.

This study is by no means an apologia of the Bank's policies over the years. It is written as my personal view of the events and does not carry official sanction. The task has been in some ways difficult and easy in others. It was difficult because I have been part and parcel of the events described and analyzed in the last nine years of the Bank's life and, indeed, I have played a part in precipitating some of these events. This may make me a less than objective analyst, particularly of the most recent period. I will leave it for the reader to determine my objectivity or lack thereof.

Writing the book has also been quite easy for several reasons. First, as a researcher, I have been in the uniquely fortunate position of being close to the material and some of the personalities and indeed having insights to events which would not normally be available to other researchers of the topic. This unique advantage is a double-edged sword and I have tried conscientiously to protect confidences and the confidentiality of the institu-

tion's work, while at the same time attempting to give the reader some flavour of the enormous complexities of policy formulation. Also, in being close, there is in fact the possibility of missing important points and making incorrect analysis of events. Second, along with colleagues in the Research Department, I have addressed myself to the topic at various times and in various fora over the last several years and these papers have greatly facilitated the progress of the work. It is partly for that reason, and partly because I did not wish to over-burden the study that I did not include detailed statistical series, contenting myself with summary data and trusting that the interested reader will, if necessary, source the data on his own. This task would be much easier for such a reader with the recent publication of the Research Department's *Handbook of Key Economic Statistics*.

In addition, I have had so much interest and encouragement from so many individuals that it was a pleasure writing up the material. In this regard, I wish to thank several persons for their help. Alex N. McLeod, the Bank's second governor, granted me an interview in Toronto in July/August 1989 and made detailed, and insightful, written comments on Chapters Three and Four, as well as suggestions on the other chapters, provided several references and generally displayed a keen interest in the study. Detailed written comments were also forthcoming from Frank Rampersad and Euric Bobb, who corrected several errors of fact and interpretation. Patricia Robinson and Philip Rochford read several sections of the manuscript and made helpful and sometimes enlightening comments. None of these individuals can be held responsible for remaining errors of fact or interpretation. These are solely mine. Penelope Forde set me in motion and has seen to it that I did not stop until the study was finished. She too has saved me from several errors and overly harsh judgments. Cheryl Ann Philip typed the manuscript with an unflinching diligence and developed an amused tolerance for my penchant for changes, corrections and amendments. June Stewart and Hilary David, our librarians, produced material requested with truly professional speed.

Finally, I must thank the Bank for making the whole enterprise possible. It is indeed fortunate that the Bank has had at its helm men such as Alex McLeod, Euric Bobb and more recently, William Demas, who, notwithstanding the hurly-burly of day-to-day central bank management, clearly have a deep appreciation and love for scholarship and have proved always supportive of such pursuit within the Bank, even where the critiques are not always favourable. I am certain that Victor Bruce, too, would have approved.

Terrence W. Farrell  
November 1989

# CHAPTER ONE

## INTRODUCTION

### *Scope*

This monograph is intended to describe and analyse the monetary and financial policies undertaken by the Central Bank of Trinidad and Tobago over the last twenty-five years. Monetary policy is defined in this study as action taken by the monetary authorities (i.e. central bank and/or ministry of finance) in respect of monetary aggregates, interest rates or the exchange rate, or any combination of these variables. Financial policy refers to initiatives which seek to influence or change the institutional basis of financial activity and would include legislative changes, new institutions, new instruments of financial intermediation, or policies which influence the ownership, management and control of financial institutions.

Central banks, especially in developing countries, have functions and concerns which range beyond mere monetary and financial policy. To take the Central Bank of Trinidad and Tobago as an example, its functions include bank supervision, or more accurately supervision of financial institutions, foreign exchange budgeting, advice on external financing and debt operations and exchange control, which latter involves vetting of technology contracts, analysis and approval of investment projects and the regulation of all outflows and inflows of foreign exchange.

Each of these areas warrants separate consideration. Some analysis has been done of bank supervision particularly after the collapse of International Trust Limited in 1982 and the subsequent liquidation of five other finance companies.<sup>1</sup> The history of exchange control and foreign exchange budgeting in Trinidad and Tobago is yet to be written and would make an especially interesting story after 1983.<sup>2</sup> Trinidad and Tobago is just now (1989) entering a new phase. It is in the process of restructuring its debt to banks and official agencies and has also entered into an IMF Stand-by Arrangement which has important implications for the conduct

of monetary and financial policy and as well for exchange control, foreign exchange budgeting and even bank supervision.

Our study of monetary and financial policy in Trinidad and Tobago is more in the nature of a dissertation. It addresses no specific hypothesis on the conduct of monetary and financial policy. Rather, it evinces two underlying themes – the problem of growth and development versus monetary stability and the independence of the central bank. The first theme is applicable to all central banks, but especially those in ‘developing countries’. The second is clearly relevant to central banks everywhere.

### *Development and Stability*

The question which some economists may ask at the outset is whether there is necessarily any conflict between development and monetary stability. An answer to this requires a definition of ‘monetary stability’. It is perhaps easier to say what stability is not than to say what it is. It is not a situation characterized by unchanging values of variables, since the economy is always in motion. A central bank is concerned with ‘rates of change’ of economic and monetary aggregates and ‘stability’ relates therefore to a dynamic situation in respect of a number of variables.

Secondly, a central bank’s concern with stability is not necessarily or only with what is happening today, but also with what is likely to happen tomorrow. The perspective of a central bank spans the immediate short term, the medium term (one to three years) and, particularly in relation to financial policy, the long term as well. A central bank, therefore, has to be forming a view as to how what is happening today is likely to impact on the macro-economy tomorrow and, therefore, what actions need to be taken now to obviate any deleterious effects or correct the course or trajectory of certain variables.

The issue of stability therefore centres around the business cycle and around the fluctuations in economic activity which may be induced by specific development initiatives or by entirely exogenous events. A central bank has to form a view on whether economic activity is proceeding so quickly that it may threaten the balance of payments later on, or whether the rate of inflation is consistent with the desired rate of accumulation of foreign exchange reserves, or whether a decline in the terms of trade is temporary and should be met by reserve decumulation, or is structural and ‘permanent’ and should be met by exchange rate adjustment and/or fiscal policy measures. The central bank or monetary authorities take action in the hope that the action will be corrective of anticipated developments and

with the knowledge that events may well prove them wrong, either in respect of their anticipations or in respect of the policy actions chosen.

If this is not complicated enough in 'developed' economies, it is even more so in developing countries where development usually has first place on the political and social agenda. Development means, invariably, economic growth in the sense of continuous increases in national income, institutional changes and changes to the structure of production and consumption so as to provide a basis for sustaining the growth process. Development so defined is, by its very nature, a disorderly, disequilibrium process characterized by fits and starts and occasional political or social upheaval. Development is also really a very slow process relative to the burgeoning expectations and legitimate desires of most peoples today. Their politicians often become impatient and may view 'money' as the constraining factor and seek to create more of it to finance the acceleration of the development process. This, all too often, creates a great tension between the desire for economic development and the requirement for monetary stability.

In posing the problem this way we do not mean to suggest that development and stability are always conflicting objectives. Monetary stability is not an end in itself. It should be seen rather as a necessary, but not sufficient, condition for ensuring a development process that is as rapid and smooth as feasible. It may well be the tendency for central banks, chastened by hyper-inflationary episodes or protracted periods of balance of payments crises, to want to elevate monetary stability to something more than a necessary condition and to make it an end in itself. It may also be the tendency for governments to want to ignore the constraints of monetary stability in their desire to get on with development. It is how this problem is addressed, if not resolved, on a day-to-day basis, that constitutes the stuff and essence of central banking.

However, in so far as central banks take responsibility for financial development, they create tensions between monetary stability and financial development within themselves. A central bank may well find that economic crisis involves a financial crisis of systemic proportions which may condition or compromise its monetary policy.

In most cases, central banks share power with ministries of finance, which constitute the other part of the monetary authorities and this allows the problem of development versus stability to be managed. What the institutional relationship between a central bank and ministry of finance does is to localize the tension between development and monetary stability in that relationship, in which the central bank may be more or less independent. The question of independence is discussed below.

## *Independence of the Central Bank*

In the course of reviewing monetary and financial policy, we comment as well on the question of the independence of the bank in performing its roles. Central bank independence is a complex and confusing issue even to central bankers. While it is understood most often in respect of the central bank's relationship with the government, it is also the case that central banks' independence must be understood in respect of its relationships with various interest groups in the society - trade unions, business organizations and other interests - which may wish the central bank to pursue particular courses of action and seek to influence it directly or through the government.

There are, arguably, three levels at which independence may be understood. First, there is the level of 'operational autonomy' where the day-to-day activities of a central bank are free of ministerial or governmental intervention, guidance or control. Where this basic level of autonomy is abridged, the central bank becomes de facto a mere department of government.

The second level relates to the ability of a central bank to formulate and execute monetary policy without initial or immediate reference to the government, although it may be expected to consult with the government and such consultation may be enshrined in the enabling legislation. This level poses the greatest difficulty and turns on the question of who is ultimately responsible for monetary policy - the central bank or the central government. In many cases, the difficulty is resolved by a determination that it is the government which is ultimately responsible since it is the government which is elected to run the affairs of a country, including the economic policy. However, a central bank is not merely a delegated authority or agent. It is supposed to originate and devise policy internally. Also, if there is conflict with the government and it is not resolved in the process of consultation, the central bank has the option, and presumably the means, of making its objections known to a wider public. In such circumstance, it is customary for the governor to resign. Such resignation may have the effect of alerting the public that certain aspects of the policy need to be examined closely in their own interest.

The third level of independence occurs where the central bank by legislation can formulate and implement monetary policy without reference at all to the executive arm of the government, although it may be required to report and defend its actions to the legislative arm of government. This is the case, for example, of the Bundesbank and the Federal Reserve System in the United States, both of which are acknowledged to be

the most independent central banks in the world. In these cases, the central bank may persistently pursue monetary policies with which the executive arm disagrees, but can do little or nothing to stop.

Central banks which find themselves at the second level may be in a vast grey area. In the case of Trinidad and Tobago, for example, certain areas, bank inspection and exchange control, have been located for functional expediency within the central bank, although in the case of exchange control the Bank exercises a delegated authority with full operational autonomy and in the case of bank supervision, the Inspector of Banks defers, as a matter of course, to the Governor. In addition, certain instruments of monetary policy may be retained by the government. For example, exchange rate adjustment cannot be done autonomously by the central bank, presumably because of its far-reaching effects. Similarly, the central bank may fix interest rates but the legislation requires that it be done by order of the President, thus placing such action immediately within the scrutiny of Cabinet. Ultimately, what matters most at any level are the skills - technical, 'political' and inter-personal - of the governor in managing the sometimes difficult interface between the government and the central bank.

### *Methodology*

There are several ways in which the study of monetary and financial policy could be addressed. One way would be to indicate a 'preferred' theoretical macro-model, (e.g. Keynesian IS-LM framework), incorporating certain instruments of monetary policy and to judge what was actually done against the 'preferred' model.<sup>3</sup> Such an approach assumes however that, on the one hand, the preferred model is in some sense a correct and immutable standard against which policy action may be assessed and, on the other, that structural and institutional changes which might vitiate the preferred model do not take place. Both of these assumptions are uncomfortable, especially in the context of a developing country.

Another method would be a (naive) historical approach, simply describing what was done without attempting a critique of the various actions and assessing what alternatives may have been possible.<sup>4</sup> The naive historical approach is useful in simply documenting the facts. However, the real usefulness of historical study is to attempt to throw light on the present and to draw out lessons which might serve us in good stead in the future. To do this requires an appreciation of the factors which underlie specific historical events or actions and how these factors are themselves evolving over time. Historical study is made more useful if it can incorporate these

analytical enhancements. The difficulty usually lies in identifying all the relevant factors and avoiding prejudice and unstated value judgments in weighting their contribution to specific outcomes.

A third method would seek to avoid the extremes of the 'preferred model' approach and the naive historical approach. It would embrace no preferred model but recognizes that different theoretical paradigms are dominant at different historical periods and that these paradigms may be more or less 'correct' and/or more or less relevant or appropriate to the specific circumstances of the country under study. It would also attempt to identify the many factors which shape the formation and implementation of policy, but on the understanding that not all these factors may be relevant or important during a given period.

The difficulty with this approach is likely to be a failure to identify a unifying thread throughout the historical period under review, but instead there may be a confusing amorphousness in the study taken as a whole. While this may be so, in reviewing economic policy over time, the unifying thread is that the policy makers are seeking to determine or influence future outcomes by applying certain instruments of policy. The objectives or goals and targets can and do change over time, as do the instruments. To pretend that the theoretical framework or the goals or the instruments are fixed and immutable would clearly be incorrect and misleading.

In order to minimise the potential confusion that may result, my approach seeks to periodise the study such that within any one period the objectives and/or theoretical framework and/or instruments are fairly well defined. Periodisation must be seen as an expository device and great care must be taken in drawing the lines which demarcate the periods, since all such demarcation does some violence to the facts and the essential continuity of historical phenomena.

There is clearly no uniquely correct way of periodising a study such as this. It would be tempting to simply locate the so-called boom years (1974/1982) and periodise the study around these years i.e. 1964/1973, 1974/1982 and 1983/1989. Such an approach would be justifiable for a study which claimed only to be an economic history of Trinidad and Tobago over the past twenty-five years. This study seeks rather to analyse the performance of the monetary authorities and, in particular, the central bank. As such, the periodisation has been influenced by the apparent postures or stance of the Bank at different points in time, conditioned by the scope allowed for active policy by the available instruments of policy. The meaning of 'active' policy and the consequent rationale for the periodisation adopted is outlined more fully in Chapter Two.

Another feature of the methodological approach adopted in this study is that it pays a great deal of attention to the actual context in which policy actions were taken so as to fully appreciate the constraints, political, technical and other, which the policy makers faced at the time. Hindsight is always blessed with 20:20 vision and it is all too easy to criticize past policy for 'failures' of analysis or vision or foresight, which are obvious only *ex post facto*. Methodologically, I seek to put myself in the shoes of the policy makers at the specific period in time and to try to see the world as they might have been seeing it. If this makes my critique less sharp or less provocative, this in my view is preferable to the critic armed with perfect hindsight whose judgments and perceptions are not likely to be very useful in practice. I would submit that this approach is likely to be more useful ultimately to those who wish to grasp something of how the real world of policy making works.

## **CHAPTER TWO**

# **A FRAMEWORK FOR THE ANALYSIS OF MONETARY AND FINANCIAL POLICY**

### *Definitions*

Any economic policy may be completely described by the following factors

- (i) the goals and objectives of policy;
- (ii) the context in which the policy is undertaken;
- (iii) the theory which underpins the analysis;
- (iv) the instruments of policy and their co-ordination;
- (v) the timing of policy;
- (vi) the systems for policy formulation, forecasting and management; and
- (vii) the 'personality' of the decision-makers; and the 'constitution' of the decision making body.

These seven factors are discussed in the context of the analysis of monetary policy and, in the following section in respect of the analysis of financial policy.

It might be useful at this stage, however, to address briefly the question of the definitions of monetary and financial policies. In Chapter One, monetary policy was defined as 'action taken by the monetary authorities in respect of monetary aggregates, interest rates or the exchange rate, or any combination of these variables'. This definition assumes that monetary policy is discretionary and active, whereas in theory, at least, the monetary authorities may elect to operate on the basis of pre-set rules rather than on the basis of discretion.<sup>1</sup> My definition also limits the scope of monetary policy to certain nominal variables associated with the operation of the financial system and, more particularly, the banking system. Monetary policy, as defined, is not directly concerned with savings, investment,

taxation and similar issues, though there is presumably some relationship between the variables of interest to monetary policy and these macro-economic variables.

The definition of financial policy is somewhat more problematic. In Chapter One, it was defined as 'initiatives which seek to influence or change the institutional basis of financial activity and would include legislative changes, new institutions, new instruments of financial intermediation or policies which influence the ownership, management and control of financial institutions'. It will be noted immediately that the focus of financial policy, as defined, is essentially institutional. Some authors, however, define financial policy very broadly as all issues related to the financing of economic growth and development, including monetary policy, fiscal policy and institutional changes deliberately engineered by the authorities. To adopt such a definition in a study whose focus is the activity of a central bank would be inappropriate and I have performed limited the scope of financial policy discussed here to institutional developments influenced by the central bank and/or the government.

### *Monetary Policy*

The objectives of policy refer to the set of conditions described qualitatively which the policy makers wish to have obtain in the economy. Goals may be defined as the quantitative description of the policy objectives defined in respect of certain variables or aspects of the economic system after a specified elapsed time. Macro-economic policy in today's world is held to have essentially four main objectives which are economic stabilization (i.e. the avoidance of inflation, recession and balance of payments disequilibrium), economic growth, full employment and an appropriate distribution of income. In the context of developing countries, a fifth objective is usually added - the promotion of economic development and transformation.

Monetary policy, as a subset of macro-economic policy, is primarily concerned with economic stabilization. The instruments of monetary policy are poorly geared to the achievement of growth or full employment or an equitable distribution of income. In developing countries, it is appealing to assume that monetary policy can and should contribute to economic development directly. However, given the instruments available to the monetary authorities, monetary policy, defined as we have done herein and as distinct from financial policy, can hardly be expected to promote economic development. We may define economic development as the set of processes whereby the structure of the economy is continually

changed or adapted so as to generate sustainable growth, meaningful employment and higher standards of living for the entire population over time.

What, then, is the role of monetary policy? Monetary policy may be viewed as a 'hygiene' or 'climatic' factor. It seeks to create an appropriate set of monetary conditions - low inflation, external balance and credit conditions appropriate to the state of the economy - such that the achievement of fuller employment, growth and development is facilitated. If monetary conditions are not appropriate then the achievement of these other objectives will almost certainly be compromised or frustrated. However, the existence of sound monetary conditions will not necessarily lead to the achievement of fuller employment, growth and development. An appreciation of the limitations of monetary policy is important since central banks may be charged or may charge themselves with doing the impossible.

Policy makers may establish targets and indicators of policy which show whether or to what extent the goals and objectives are being achieved. A target variable is an endogenous variable which is systematically related to the goal variable but which is observable with a relatively short lag, whereas there is a relatively long lag between the policy action and the goal variable. In the Keynesian paradigm, the (real) interest rate would be such a target variable. It is supposed to be related to real expenditure and hence real output and income, but is observable with a relatively short lag in a zero-inflation economy.<sup>2</sup> The target variable is itself an endogenous variable and is, therefore, subject to changes in policy instruments as well as changes in other exogenous variables. It is important to be able to distinguish shifts in the target variable arising from policy changes and shifts arising otherwise. An indicator variable is one which allows the policy maker to distinguish policy-induced changes in the target variable from non-policy-induced changes. Targets and indicators are important in helping us to characterize the stance of monetary policy. This issue is discussed further below.

The context of economic policy, including monetary policy, may have three aspects. The first is the institutional context which encompasses the laws, regulations, conventions and practices which govern the conduct of policy. These determine what general or specific actions may be taken by the authorities, what actions may be prohibited and how certain interventions may be effected. Secondly, there are the domestic economic circumstances existing or impending, including policy measures already in place. Thirdly, there are the international economic and political circum-

stances, existing or impending. In the case of small, developing countries, monetary policy can only react to developments in the international monetary and financial system, whereas in the large, industrialized countries their domestic economic policies may have substantial ripple effects internationally.

It goes without saying that the assessment of the context of policy must be as accurate as possible. The data and information should be reliable, comprehensive and current. Monetary theorists have developed the concept of the 'lags' in monetary policy, distinguishing the 'inside' lag – the time it takes for data to be collected and the 'problem' recognized and analysed, and the time it takes to initiate the policy action, and the 'outside' lag – the time it takes for the policy action to affect the target variables.<sup>3</sup>

The lags in the effect of monetary policy may be characterized more fully as follows: (i) a 'data' lag, being the time it takes for financial institutions to collect, compile and transmit data to the monetary authorities, (ii) a 'recognition' lag, which is the time it takes for the monetary authority to analyse the data and to conclude that there is a need for policy action, (iii) a 'decision' lag, which is the time elapsed between recognition of the need for action and actually taking the required action. The 'data', 'recognition' and 'decision' lags together comprise the 'inside' lag. Following Kareken and Solow, it is possible to distinguish two phases of the outside lag: (i) the 'intermediate' lag, which is the time it takes for the banking system to react to the central bank's policy action and (ii) the 'outside' lag, which is the time it takes for changes in monetary variables – interest rates, credit conditions – to impact on expenditure and output.

Theory refers to the set of understandings that policy makers have about the relationships between and among the key variables and instruments of policy. There may be several competing theories in respect of a particular economic policy. More often than not, policy makers operate with a fairly simple model and focus on a small sub-set of important variables. Central bankers may be reluctant to describe themselves as 'Keynesian' or 'Monetarist' or some other school of thought. Most probably believe themselves to be pragmatic and without fixations on one or other theory. Nevertheless, at any given period of time, there are one or two dominant schools of thought and it would be unusual if central bankers, or policy makers generally, were immune to the influence of the dominant paradigms.

The nature of the instruments available to the policy makers to achieve desired objectives is important. Some instruments may simply not be available to policy makers in certain contexts, or it may be impracticable

or impolitic to use a particular instrument at a given time. Again, the nature of some instruments is such that they may be used only infrequently since their effect is dramatic and coercive. Other instruments are much more subtle, indirect and hortative in their operation and can therefore be used more frequently. An important aspect of the use of policy instruments is that co-ordination which involves putting together an appropriate mix or package of them in order to achieve the objective.

The timing of a policy action is particularly important and deserves separate and special attention. An economy is a highly dynamic organism continuously experiencing endogenous changes and being subject to exogenous shocks and influences. Time is, therefore, itself an important variable for policy makers. If, in the appropriate context, with the right set of properly co-ordinated instruments and the 'right' theoretical model, the timing of the policy action is bad, then the results could be disastrous, or at best, fail to achieve the desired objectives. There is, of course, no foolproof method of determining the right timing of a specific intervention.

Choosing the 'correct' timing is a matter of experience and judgment and many mistakes may be made before the experience is acquired and judgment matures. It is also important to note that there is what one may term 'technical' timing and 'political' timing. Central bankers as technicians may determine that a particular policy action should be taken at a certain point in time. The political directorate, where they directly influence such decisions, may deem the timing politically inappropriate, either because the outcomes are unclear and *ipso facto*, undesirable, or they are not convinced of the political acceptability of the outcomes, even where these outcomes are crystal clear.

An appropriate policy depends critically on the systems which are in place for policy formulation and implementation and the people who operate those systems. If the policy maker's monitoring, analytical and diagnostic capabilities are poor, or if his forecasting capability is not well developed, the result will inevitably be poor policy and/or poor execution of policy. The quality of policy will, therefore, depend on the quality of the people who inform policy, their analytical skills and the degree of sophistication of their data gathering and forecasting techniques. Ultimately, a central bank which has a weak research capability is unlikely to make good policy.

The seventh, and by no means the least important, factor is the 'personality' of the policy maker(s). By personality I mean the psychological make-up of the policy makers, their forcefulness or their avoidance of conflict, their willingness to take risks, or their aversion to risk, their ability

to persuade the political directorate to innovate and to challenge conventional wisdom, or their willingness to accept the *status quo* and received opinion. It is interesting to note, too, notwithstanding the constitutions of central banks and their relationships to ministries of finance, the personality of a central bank governor or president may dominate a particular period or situation. In the United States, Paul Volcker dominated the Federal Reserve and the monetary policy of the United States between 1979 and 1987. By the force of his character and his determination to bring inflation in the USA to heel in the early 1980s, he, virtually singlehandedly, enforced a tight monetary policy that sent interest rates in the USA and worldwide to unprecedented heights and the US economy into recession. The importance of personality in any given situation cannot be gainsaid.

### *Financial Policy*

The discussion of the seven factors in the analysis of economic policy applies as well to the analysis of financial policy. However, some factors need to be especially noted. Given the definition of financial policy adopted here, it will be seen that the goals of financial policy are primarily developmental. The economics profession is well aware of the controversies surrounding monetary theory and policy, especially over the last twenty years as the Monetarists and neo-Keynesians sought to challenge the Keynesian orthodoxy. But there has also been controversy in respect of the theory of financial policy, turning mainly on the McKinnon-Shaw critique of the Keynesian model and which has been adopted by international organizations in their prescriptions of financial liberalization in developing countries. There has also been a so-called neo-Structuralist theory of financial policy expressed in the writings of Taylor, Kapur and others.<sup>4</sup>

The instruments of financial policy are difficult to define. In some cases they may involve the creation of new, often government-sponsored financial institutions which are intended to compensate for the deficiencies of existing institutions in the allocation of financial resources. In other instances, they may involve the encouragement of new institutions by fiscal incentives intended to provide wholly new services by means of new financial instruments. In yet other instances, financial policy may seek to employ monetary instruments in the service of financial development. The issue, therefore, is less one of the nature of the policy instrument than the purpose for which it is intended.

The timing of policy and the systems for forecasting are also relevant and important for financial policy. The authorities must seek to introduce

new institutions and financial innovations at a time when market conditions are likely to be most favourable for their reception and would allow them to flourish. In addition, if it is necessary to subsidise a new institution or innovation, its introduction in favourable macro-economic and market conditions will allow the authorities to eliminate any subsidy more quickly. In this context, it is necessary to forecast what macro-economic and market conditions are likely to be when a new institution or innovation is introduced so as to determine the likelihood of its success.

### *Characterization of Monetary Policy and the Problem of Periodisation*

The foregoing discussion of the elements of monetary policy has abstracted largely from the structural and institutional context of the economy for which policy is to be formulated and implemented. It is important to note, however, the ways in which the character of the economy impose itself on policy formulation and implementation, even as policy seeks to alter the essential character and the underlying relationships in the economy. Structurally, Trinidad and Tobago has been an open, dependent, petroleum economy. Economic activity is dominated by processes related directly or indirectly to international trade in goods and services and international payments flows are a significant part of total financial flows. Resource allocation is influenced importantly by foreign prices (the terms of trade), except where specific fiscal measures are designed to do otherwise. The dependence of the economy derives not only from its production and consumption linkages with the metropolitan countries (structural dependence), but also derives from a 'functional dependence' reflective of a deeper intellectual, cultural and psychological dependence on 'things foreign' in preference to 'things local' and a corresponding tendency toward de-meaning and de-valuing indigenous products, habits and expressions. This functional dependence is reflected, for example, in the maintenance of 'Imperial Preference' in the formulation of trade policy.<sup>5</sup>

To state these factors is not to maintain that nothing has changed culturally, socially and politically. Indeed, the socio-cultural and political systems have undergone profound transformation in many respects over the last twenty-five years, and few would maintain that the society is as colonial in its character today as it was at the time of Independence in 1962. It is also equally important to appreciate that our colonial past has left a legacy of distinct potential advantages, not the least of which is that we can perhaps more readily and quickly appreciate the culture and technology (broadly defined) of the metropolitan countries so as to better discriminate

and determine what elements we wish to select for ourselves and which we would prefer to leave aside. In other words, independence is not to mean the eschewing of everything of metropolitan origin or a closure or involution of the economy. It means rather, and simply, defining one's goals and objectives for oneself and having sufficient freedom to pursue these, employing selectively, rationally and discreetly those elements of other cultures, technologies and lifestyles which can assist in achieving those goals and objectives.<sup>6</sup>

While I may appear to have strayed from a clinical consideration of monetary policy, this perspective does allow me to draw a distinction between an 'independent' policy and a 'dependent' policy, recognizing all the while that 'independence' and 'dependence' are dialectic concepts. A dependent policy is one in which the goals and objectives are framed in reference to or are dictated by factors or events originating outside of the domestic economy. An independent policy, by contrast, is one in which the goals and objectives are framed in reference to factors or events originating inside the domestic economy. This distinction does not arise in the context of the industrial countries, but is of some significance in many developing countries and even certain small, high-income countries, such as Canada.

Given that a fully independent policy, including, and perhaps especially, monetary policy, is not possible in the context of small, open economies, it may be seen to be desirable to shift one's position along the dependence-independence spectrum progressively toward a more independent policy, and that it is important to establish the institutional mechanisms which allow this to occur in a timely fashion. Certainly, independent economic policy does not begin to be formulated immediately with the achievement of a negotiated political independence. Indeed, and paradoxically, political stability may be seen to require a dependent economic policy, at least for a while, until sufficient confidence, commitment and consensus has emerged within the polity.

At another level, some analysts, myself included, have sought to make a distinction between 'active' monetary policy and 'passive' monetary policy.<sup>7</sup> While in some sense appealing, the distinction runs into several problems in its empirical application, largely because of problems of definition. I may, like Demas [1974] seek to define 'passive' policy as measures intended to neutralize or offset or minimise the impact of external-induced events. This definition may lead to the curious situation where 'passive' policy may be really quite 'active'. My own definition of 'passive' policy would suggest that policy is 'passive' if policy makers

perceived they were incapable of taking any action or that any action they took would have no lasting or meaningful effect. But this hardly merits being described as policy at all.

All that can be rescued from this perhaps is that monetary policy may be at times more active, whether pro-active or reactive, than at other times, which of course still begs the question as to why this should be so. A possible explanation may well have to do with the personalities involved and in the special case of monetary policy, the peculiar symbiosis of the central bank and the ministry of finance.

In developing the periodisation used in this study, I have been guided by the foregoing perspectives which, I think, yield an initial distinction between the pre-1970/1971 period and the whole of the subsequent period. The former can be characterized as a period of dependent monetary policy, while the latter may be seen to be a period of independent or at least potentially independent policy made possible by the institution of exchange controls against sterling (May 1970) and more extensive legislated controls from November 1971. The defensive use of the rediscount rate ends in 1971. I consider the first period, therefore, to be 1964/71.

What to my mind distinguishes the post-1971 period is that after a burst of 'active' policy between 1973 and 1974, monetary policy is quiescent and accommodating until 1979/80, when it begins to become quite active. The second period is 1972/1979 and the third period is 1980/1989. Within each of these periods, delineated by the character of monetary policy and the posture of the Bank, I will be able to demarcate several sub-periods according to whether the economy was growing or not. For example, there was the recession and crisis of 1969/1973, the boom of 1974/1982 and the prolonged recession or 'period of structural adjustment' from 1983 to 1989. These sub-periods add colour and lustre to the phases I have outlined and help to throw into relief the stance of monetary and financial policy.

## CHAPTER THREE

# MONETARY MANAGEMENT 1964–1971: CONTEXT, ANTECEDENTS AND ACTORS

### *Introduction*

The Central Bank of Trinidad and Tobago was established by Act of Parliament, Chapter 79:02 (no. 23 of 1964) on 12 December 1964. It was only the second central bank to be established in the English-speaking Caribbean following the Bank of Jamaica which had been established in 1960. Its establishment took place during a period of rapid political change in the Caribbean: the countries of the English-speaking Caribbean had achieved internal self-government in the mid-1950s, moved on to a short-lived West Indies Federation in the period 1958 to 1962, before Jamaica and Trinidad and Tobago sought and obtained political independence in 1962 to be followed by Guyana and most of the rest of the islands in the late 1960s and early 1970s.

C.Y. Thomas, a leading Caribbean economist, has contended that the establishment of central banks in the Caribbean territories was 'more symbolic of intent than achievement'. R.B. Sayers wrote: 'Colonial territories seeking some measure of political independence have tended to regard a central bank as an outward and visible sign of independence, and lack of one as signifying continued subjection'.<sup>1</sup> Independent countries had flags, anthems, coats-of-arms and central banks. A reading of the historical evidence does not, however, suggest such a frivolous reason for the establishment of central banks in the Caribbean.

In the case of Jamaica, an examination of the financial system, first by Graham Towers, a former, and in fact the first governor of the Bank of Canada, and later by Thomas Balogh led to recommendations for a development bank to mobilise savings for investment, while deflecting savings from private financial institutions so as to minimise the leakage of financial resources abroad. Deficiencies in the flow of credit to certain sectors were also noted, as well as the fact that 'in several respects

Jamaica's credit system suffered from a lack of unified controlling influence of the type provided in other economies by a central bank.<sup>2</sup> The one development banking institution recommended by Balogh became two institutions, a development bank and a central bank, the latter having responsibility 'to influence the flow of credit and currency so as to minimise fluctuations in employment, production, trade and prices, to maintain industrial growth and the promotion of the economic and financial welfare of Jamaica so far as this may be possible by the use of monetary policy.'<sup>3</sup> It is important to note here that a distinction began to emerge between the need for financial system reform in the pursuit of economic development and the need for monetary stability as a necessary condition for economic development. Failure to appreciate this distinction and the role of a central bank in meeting these two different imperatives characterises the critical literature on the role of central banks in the Caribbean. The distinction was to emerge as well in the run-up to the establishment of the Trinidad and Tobago Central Bank. This is explored more fully in the next section on the legislative basis of central banking and monetary policy.

### *The Legislative Basis of Central Banking and Monetary Policy*

A major distinction between central banks established before and after World War II was that the latter, influenced no doubt by Keynesian-inspired interventionism, were often explicitly charged by their enabling legislation with responsibility for the conduct of monetary policy. By contrast, the constitution of the Federal Reserve, established in 1913, did not include provisions relating to the conduct of monetary policy. Indeed, pre-war central banks were dominated by concerns about the stability of the financial system and fears of hyper-inflation. However, in the inter-war years the notion of discretionary central bank control over credit grew in importance and the Bank of England and the Federal Reserve in the United States in that period did conduct monetary policy with a view to controlling the price level. Significantly, when the Bank of Canada Act was passed in 1933, it provided therein for countercyclical monetary policy.<sup>4</sup> Post-war prosperity muted concerns about systemic failure and hyper-inflation, but these concerns were to resurface with a vengeance in the difficult years of the 1970s and 1980s.

Having achieved independence on 31 August 1962, it was logical for the government to attempt to consolidate political independence and extend it to the economic sphere. In this regard, it was important that institutions appropriate to an independent state be established. This meant

fiscal reforms, particularly in respect of revenue-raising and financing instruments, the establishment of re-orientation of financial institutions, in particular, the banks and insurance companies, reform of labour law and collective bargaining, development of the system of social security and other areas of economic life.<sup>5</sup> A central bank was seen to be critical to the process of extending and consolidating the country's independence.

In introducing the Central Bank Bill to the House of Representatives on 20 November 1964, the then Minister of Finance, A.N.R. Robinson, pointed out that 'various aspects of monetary policy and management are dealt with by different institutions or not at all'.<sup>6</sup> The Currency Board issued the currency, the Crown Agents in London managed the foreign asset portfolio, exchange control was handled by the Ministry of Finance, the public debt was managed by the Comptroller of Accounts and the Ministry of Finance. Robinson went on to say:

The case for a Central Bank institution exercising some kind of control or management of all these functions therefore rests on the need to rationalize our monetary system and management, on the need to pay a great deal more attention to matters which only sporadic attention or no attention at all has been paid to in the past, and on the need to relate one aspect of financial and monetary management to another so that we do not all unrelentingly pursue conflicting and contradictory goals.<sup>7</sup>

Alongside this very pragmatic rationale for establishing a central bank was placed another higher purpose. In the words of the Minister of Finance:

the main function of a Central Bank of Trinidad and Tobago must be to assist in doing in the monetary field all such things as would promote development, primarily by producing conditions most conducive to the flow of long-term investment capital into the productive sectors of the economy.<sup>8</sup>

This notion of a developmental role for central banks in underdeveloped countries was apparently influential at the time and served to differentiate central banking in these countries from the activities of central banks in the industrialized world. In the words of the Minister of Finance:

the Central Bank must have a great deal of sensitivity to the local environment. It will do no good merely to transplant a central bank with the functions of the Bank of England or the Federal Reserve System of the United States or the Bundesbank of Germany or the Bank of France or any of these Banks which have developed their orientation and techniques in highly industrialized societies...<sup>9</sup>

The developmental role of the Central Bank found expression in Section 3(3) which stated that 'the Bank shall have as its purpose 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) (c) and (d) went on to enjoin the Bank to: 'maintain, influence and regulate the volume and conditions of supply of credit and currency in the best interest of the economic life of Trinidad and Tobago, maintain monetary stability, control and protect the external value of the monetary unit, administer external monetary reserves, encourage expansion in the general level of production, trade and employment.' The problem for the Bank would be how these several objectives, at times conflicting, could be achieved, especially as some of the instruments applicable to the development promoting role were not in the Bank's purview.

The objectives set for the Bank as stated in the Central Bank Bill may not have found full favour with those who had advocated for the Central Bank, a pro-active, promotional role in economic development. A memorandum from the Economic Planning Division commenting on the Central Bank Bill and the Banking Bill stated in rather strong, unequivocal language that: "notwithstanding the tendency in many of the advanced countries to wrap central banking in a mystique and to elevate 'monetary stability' into a deity, the aim of a Central Bank in an underdeveloped country is the promotion of economic development".<sup>10</sup>

Promotion of economic development was to mean increasing per capita income, developing local versus foreign centres of decision making and the need to fill in the many gaps in the financial system in respect of money and capital markets, industrial development banks and housing finance institutions. The role of monetary policy utilizing classical instruments was seen to be 'futile'. It castigated the advice of 'experts' from the International Monetary Fund with their emphasis on 'monetary stability' which it charged had become an end in itself. Uncontrolled inflationary policies were not to be condoned but, equally, the country had to decide on the appropriate degree of openness consistent with the need to mobilise domestic financial resources and alleviating unemployment. These views were to be echoed several years later by C.Y. Thomas in his critique of central banking in the Caribbean.<sup>11</sup>

William Demas, an influential Caribbean economist who at the time of the establishment of the central bank was head of the Economic Planning Division, had this to say on the role of central banks in developing countries. 'While it is conceded that in these countries a central bank cannot do much to insulate the economy from declines in external demand, it is

still felt that there is a positive role for such an institution in providing financial leadership and direction, in developing a local capital market and other financial institutions, and in selectively guiding the flow of credit to the various economic activities.’<sup>12</sup>

The pessimism about the stabilization function of central banks in developing countries is noteworthy and we will return to this notion later.

The actual legislative provisions of the Central Bank Act, while arguably lukewarm in its embrace of a pro-active development role, explicitly emphasized the importance of maintaining monetary stability in a context of economic expansion [Section 3(3) (d)], although the explicit inclusion of a representative of the ministry with responsibility for economic planning may be seen as strong support for at least permitting developmental considerations to influence the operations and policies of the Bank. The Minister of Finance had this to say:

At the same time in pursuing this goal of economic development we have to be careful to strike a balance between conditions of expansion and any possibility of instability. One of the functions of the Central Bank would therefore be to assist in preserving a stable value for the currency.... measures have been inserted into the legislation to ensure that, even at an institutional level, monetary stability will, as far as possible, be preserved.<sup>13</sup>

The critique of the development economists seemed to confuse monetary policy and financial policy and perhaps failed to see clearly the problems and issues that might arise in the very process of creating new financial institutions and instruments. It may also have failed to discern a possible conflict between the central bank’s role as regulator and its putative role as promoter or developer of the financial system in the pursuit of economic development or, as has been suggested, the developmentalists preferred that the central bank should not be ‘neutral’ on the question of development and transformation, but should favour such considerations wherever there was a conflict of policy objectives.

The ‘conservatives’, it would appear, won the day and the legislative provisions which sought to equip the Bank to conduct monetary policy and to limit inflationary excesses were built into the Bill. The Act provides for reserve requirements including differential and/or variable reserve requirements (Section 40); the use of rediscount rate (Section 39) and open market operations (Section 36 (e) and (f)). These are the ‘classical’ instruments of monetary policy designed and intended to influence the volume and distribution of credit in the economy. In addition, the Act provided for the imposition of selective credit controls (Section 42), i.e., the limiting of

particular categories of lending by directive. Selective credit controls were not at the time a classical instrument of monetary policy and it has been suggested that this provision was incorporated over some resistance.

More important, yet, the Act specified clear limits on central bank lending to the government. Section 46 (1) limited outstanding advances to 15 per cent of government revenue estimates for the financial year in which the advances were initially made. In addition, Section 47 placed a limit on holdings of government securities of seven times the Bank's paid-up capital and General Reserve Fund. Section 33(2) (f) also provided that government securities held by the bank should not exceed 50 per cent of the total assets held as backing for the currency in circulation. Adherence to these limits would mean that the scope of central bank money creation to finance fiscal deficits would be reduced, though not eliminated entirely. However, what was eventually seen to be an important lacuna in the provisions of the Act was the failure to prescribe limits on Bank lending to state agencies and utilities which were in turn dependent for support on the Treasury.

### *The Socio-Economic Context*

At the time of the establishment of the Central Bank in December 1964, Trinidad and Tobago was experiencing a slow-down in economic activity following a period of boom between 1955 and 1961. That boom had been fuelled by a tremendous increase in activity in the petroleum sector as annual crude petroleum production expanded from about 22 million barrels in the early 1950s to 48.9 million barrels in 1962. There was also a more than two-fold increase in petroleum refining capacity from 135,000 barrels per day (BPD) in 1956 to 305,000 BPD in 1961. However, the share of the petroleum sector in GDP (current factor cost) fell to 30 per cent in 1961 from 33 per cent in 1956, because there was also strong growth in manufacturing and construction, while agriculture displayed moderate growth. Population growth during the 1950s and early 1960s was high, averaging around 2.9 per cent per annum. Labour force growth was somewhat lower, 1.7 per cent per annum over 1946/1960, since the participation rate was falling.<sup>14</sup> Between 1956 and 1961, employment in large establishments engaging over ten persons grew at an estimated 3 per cent per annum, much slower than the rate of growth of real GDP over the period. The rate of labour absorption was perhaps slower than suggested by the output growth statistics partly because of the higher capital-intensity of the new production and partly because wage rates were growing quickly, averaging 9 per cent per annum over the 1956/1962 period. The estimates of unemployment during the first post-war boom were derived from the

TABLE 3.1: SOCIO-ECONOMIC INDICATORS, 1962-71

	1962-65	1966	1967	1968	1969	1970	1971
Growth of Real							
GDP (fc) (1970 prices)	n.a.	n.a.	2.5	5.4	2.6	3.4	0.3
Inflation Rate	2.2	4.2	2.0	8.3	2.5	2.5	3.5
Fiscal Deficit/GDP (%)	-3.2	-3.1	-3.1	-1.4	-1.1	-4.4	-6.4
Current Account							
Deficit/GDP (%)	-12.6	-8.7	-4.9	-6.8	-6.9	-7.1	-13.1
Unemployment Rate (%)	13.8 <sup>1</sup>	13.9	16.0	14.9	13.1	12.8	12.6
Foreign Exchange							
Reserves (US\$m)	80.7	48.4	49.8	66.1	62.9	53.3	79.7
Crude Oil Production							
('000 bpd)	134.3	152.3	178.1	182.8	157.3	139.8	129.2

SOURCE: Central Bank, Research Department, *Handbook of Key Economic Statistics 1989*.  
NOTE: <sup>1</sup>1963-1965

Population Census of 1960 and a special labour force survey undertaken in 1956/1957 which put the unemployment rate at about 10 per cent of the labour force for both 1957 and 1960 and compared with the 1946 census estimate of 7 per cent. These data appear to confirm that the labour absorption impact of the boom was weak.<sup>15</sup> New job creation just kept pace with increments to the labour force, which was moderating because of declining participation.

The statistics of unemployment are interesting and important, not only for what they suggest about the nature and impact of cyclical upturns in economic activity in small open economies, but also because they go some way in explaining the social and political tensions generated during the 1960s, particularly in labour/government relations, and which culminated in profound social unrest in 1970. High and rising unemployment was not the only factor which triggered the 1970 unrest. It was due in no small measure to heightened expectations of a fundamental change in the circumstances of the lower classes which seemed long in coming and the delay sharpened the perception of social inequity and injustice which a new political dispensation was not addressing quickly or radically enough.

In 1956, 213,930 man days were lost owing to industrial disputes, the main one being in the sugar industry which accounted for 213,600 man days lost. Man days lost fell sharply in the three years following, averaging just 13,300 man days lost, though on a rising trend. From 1960, there was a profound change. Man days lost were as follows: 1960/275,223; 1961/

145,105; 1962/164,657; 1963/204,971. Work stoppages occurred in sugar, petroleum, transport and other sectors, and reflected as well changes in the leadership of several important trade unions. Industrial unrest was an unwelcome development in the context of an industrialization strategy, based essentially on national import substitution, but in which the foreign direct investment was an important element owing to the weakness of the local private sector. The government, therefore, enacted legislation in the form of the Industrial Stabilisation Act (1963) in an attempt to control the incidence of strikes.

After increasing at 10.3 per cent per annum over the period 1956-61, petroleum production more or less stagnated over the 1962-65 period, before rising sharply again from 1966. Over the period 1962-65, nominal GDP grew at just over 5 per cent per annum. There are no official constant price estimates of GDP for this period, but given the rate of price increase over the period, real GDP could not have increased at more than 3 to 3.5 per cent per annum.<sup>16</sup> The inflation rate averaged just 2.2 per cent per annum over the 1962-65 period. However, unemployment continued to increase, rising from the 10 per cent level estimated at the 1960 Population Census to 13.9 per cent in 1966.

On external account, there were persistent deficits on both the trade and services account<sup>5</sup> over the 1962-65 period, with the current account deficits averaging in excess of 12 per cent of GDP (market prices) for 1962, 1963 and 1965, though it was 9.9 per cent of GDP for 1964 owing to a substantial inflow on transfers account in respect of the public sector. These deficits were easily financed by capital inflows on both public and private sector accounts and there was only a small decrease in the net foreign exchange reserves over the period as a whole.

While the external accounts could evince no great cause for concern if capital inflows were expected to be sustained, this was not the case in respect of the fiscal situation. With the exceptions of 1959 and 1961, there had been fiscal surpluses, albeit declining, during the boom years 1955-61. However, over the period 1962-66, growth of recurrent revenue slowed to 5 per cent per annum, while recurrent expenditure grew at almost 7 per cent per annum. There were deficits in every year of the period except 1965 as recurrent expenditure rose strongly due to increases in public sector wages and salaries. These deficits led to a substantial increase in domestic borrowing. This period was also one of significant fiscal reforms, several of which engendered conflicts with the local business community.

## *The Institutional Context*

The establishment of the central bank was itself part of a process of rapid institutional change in Trinidad and Tobago over the period 1961–66. The country had to move quickly to set up administrative structures necessary to and befitting an independent nation and to reform certain institutional arrangements so that they operated in a fashion more nearly consistent with the goals and objectives of an independent people. Not all of the changes and reforms were entirely inspired by these socio-political factors.

Major changes and reforms occurred in the fiscal area. In 1960, the Treasury Bill Act, Chap. 71:40 (no. 28 of 1960) was introduced which provided for the issue of treasury bills to fund the short-term financing needs of the government. This was followed in 1962 by the Government Savings Bond Act, Chap. 71:41 (no. 8 of 1962) which was intended to encourage small savers to invest in government securities and in 1964 by the Independence Development Loans Act, (no. 6 of 1964) and the Development Loans Act, Chap. 71:04 (no. 19 of 1964), both of which permitted the issue of long-term bonds to finance general development.

These pieces of legislation were indicative of the government's perception of its role in the country's economic development. This role was to provide the infrastructure of roads, port and airport facilities, water and sewerage and electricity, and a range of social support services to the population. In order to do this, government expenditure would necessarily be increasing and this would have to be financed by private sector savings. However, the institutional mechanisms for mobilizing savings were rudimentary and biased towards bank deposits and insurance premiums. Because of the institutional organization of the banks and insurance companies, which is discussed later, some of these savings leaked abroad. This put the country in the curious position of having to borrow resources externally while it was itself exporting financial resources.<sup>17</sup> The creation of financial instruments which could assist in mobilizing savings and at the same time assist in financing government expenditure was therefore an important institutional change.

The slow down in economic growth, the exhaustion of accumulated fiscal surpluses, rising unemployment and rapid population growth lent a certain urgency to the pace of institutional reform. It was not enough to provide for the supply of certain financial instruments but to ensure that there was a demand for them as well. The perceived entrenchment of colonial habits and mentalities suggested to the authorities that it would be necessary to introduce legislation that would change behaviour in ways

which were more consonant with the country's development objectives and aspirations.

Beginning with the reform of the tariff structure in the 1962 budget, there were a succession of changes in the tax regime which culminated in the highly controversial Finance Act of 1966, the key provisions of which separated personal from company taxation and imposed a withholding tax of 30 per cent on distribution and payments to non-residents.<sup>18</sup>

The Insurance Act of 1966 provided the framework for the regulation of insurance companies and in particular stipulated the creation of statutory funds and the local asset composition of these statutory funds. The Banking Act of 1964, Chapter 79:01, and the Central Bank Act provided for the regulation of commercial banks and permitted the stipulation of a local assets ratio. A local assets ratio was, however, never introduced for the commercial banks which had been reducing their foreign asset holdings progressively since the early 1960s.<sup>19</sup>

While there is no gainsaying the importance of the institutional changes outlined above, as far as the conduct of monetary policy is concerned, certain critical institutions were left unchanged or could not be changed in the short and medium term. Two such critical institutional arrangements stand out. First, there was the sterling exchange standard and free and full convertibility into sterling. Second, there was the expatriate ownership and control of the banking system.

As a British colony, Trinidad and Tobago was automatically part of the Sterling Area arrangements. Sterling was the principal reserve asset and the colonial monetary arrangements under the British Caribbean Currency Board (BCCB) provided for the free and full convertibility of the local currency into sterling. There were exchange controls instituted under the wartime Defence (Finance) Regulations of the UK Defence of the Realm Act but these exchange controls operated only against non-sterling currencies. Although sterling was itself subject to exchange controls, sterling area countries did have access to the dollar pool and for those countries, therefore, sterling could be considered a convertible currency. Exchange controls, such as they were, were therefore not very meaningful. Not only was convertibility assured but the rate of exchange between local currency and sterling was fixed.

The colonial arrangements placed great store in free and full convertibility and the fixity of the sterling parity. Therefore, independence and the introduction of a central bank, issuing its own local currency, raised real fears in the minds of the colonial business elite and perhaps the general

public as well. So much so in fact that it was seen to be crucially important to allay those fears. In moving the bill to establish the central bank, the minister of finance stated: 'The parity of the Trinidad and Tobago dollar has been fixed .... at the value at which it stood on Independence Day .... It has been fixed by law, and can only be changed by law'.<sup>20</sup> On the question of convertibility, the minister referred to Clause 32 of the Central Bank Bill which provided full convertibility into sterling and stated:

The purpose of this clause is to provide for convertibility, the convertibility which was regarded as such a great virtue of colonial currencies under the Currency Board and the purpose, of course, of the parity clause and the convertibility clause is to provide for that degree of security which will give some assurance to hon. Members opposite who may have some apprehension about the likely policies which the Central Bank may in the future pursue.<sup>21</sup>

Again, at the formal opening of the central bank's premises in March 1967, the minister in his address referred to rumours regarding the government's attitude to sterling and stated: 'I would like to take this opportunity to say that we do not contemplate any change whatsoever in the present situation with respect to sterling transactions. The Trinidad and Tobago dollar is freely convertible into sterling and we propose to keep it so.'<sup>22</sup>

At the time of the establishment of the central bank, all of the banks operating in Trinidad and Tobago were fully owned and controlled by foreign banks.<sup>23</sup> Foreign ownership of the banking industry was to become a raw nerve in nationalist aspirations. Its implications for monetary policy were, however, no less crucial. Operating as branches of foreign banks in a system of free and full convertibility, the banks (branches) operating in Trinidad and Tobago did not need a central bank, neither as leader nor as lender. Unless banks became fully integrated into the embryonic money and capital markets, and unless their access to head office support could be limited, the scope of the more indirect instruments of monetary policy would be severely curtailed.

A final but critical aspect of the institutional context of monetary and financial policy in the 1964-71 period was the paucity of reliable, comprehensive and timely economic data. The Central Statistical Office had begun to function in the early 1950s and by the 1960s was doing a good job, given its limitations. Its efforts were, however, concentrated on estimates of national income and expenditure, population and vital statistics and trade data, although it did collect certain data from the commercial banks. The Bank, therefore, had to concentrate a great deal of its efforts in the early years on instituting data collection and compilation systems so that it could

monitor closely and act in a timely fashion in respect of monetary developments at home and abroad.

By the end of the decade, a great deal had been achieved in terms of improvement in data collection and compilation by the central bank, with some technical assistance from the IMF. The reporting system with the banks was put in place, generating data on the monetary aggregates and interest rates. The Bank began to collect data on production and trade, including the dominant sectors – petroleum, sugar, coffee, cocoa and cement, as well as data on areas such as motor vehicle assembly. The price index was available with a two-month lag. The fiscal data base was, however, comparatively weak although it was possible to monitor cash flows through the central bank. Data were available with a relatively short lag on developments in the main industrial countries and these were monitored very closely over the reference period.

### *The Theoretical Framework of the 1960s*

Monetary theory and policy in the 1960s was dominated by two schools – the Keynesian model and the Radcliffe Committee view. A third school, the Modern Quantity Theorists, who were the forerunners of the Monetarists of the 1970s, was just emerging as a force to be reckoned, but their views had not yet penetrated the halls of central banks where policy was being created.

Keynesian theory, in its Hicksian interpretation, gave a potentially important role to monetary policy in economic stabilization. The key instrument of policy was the interest rate which brought the money market into equilibrium, but which also influenced investment expenditure through its presumed relationship with the expected rate of profits. Central banks could act on the money supply to influence the rate of interest and so affect expenditure and income and other real variables. The degree of effectiveness of monetary policy was contingent essentially on the interest elasticity of the demand for money and the components of aggregate expenditure, but, especially, investment expenditure.

The neo-Keynesians elaborated the Keynesian framework by recognizing money as a component of wealth along with other assets and that the effect of a change in the money supply would impact on real expenditure through a series of portfolio adjustments running through currency, deposits, bonds, equities and physical capital, linked by the relationship between and among the yields on these various assets.

The Radcliffian approach to monetary theory was also rooted in the Keynesian model. It argued, however, that the demand for money i.e.

currency and bank demand deposits was not the relevant variable for policy but rather the demand for 'liquidity'. The Radcliffian view recognized, with the neo-Keynesians, that there was a spectrum of assets between highly liquid money and relatively illiquid physical goods. Some of these assets, while not cash, were highly liquid, for example, time deposits, treasury bills and others, and therefore expectations about the future course of interest rates (bond prices) need not imply a variation in the demand for money, but would be reflected in a change in the demand for liquid assets of which money was but a component. In effect, the amount of money demanded might not increase where the rate of interest fell although the demand for liquidity would increase. The Radcliffian view of monetary theory had the implication for policy that the rate of interest was not (necessarily) the central target variable, but rather policy should seek to influence liquidity more broadly.

Transported into the context of developing countries, the Keynesian (neo-Keynesian) model served to suggest that monetary policy should aim at keeping interest rates low so as to stimulate investment and economic growth. This could be accomplished by ensuring a sufficiently easy money policy. Classical and neo-Classical theory in the context of developing countries would, however, focus on stimulating savings and would, therefore, require that interest rates be sufficiently high. This would require a relatively tight money policy and/or institutional mechanisms which elicit a high propensity to save and causes those savings to be effected in intermediable forms.

The Central Bank of Trinidad and Tobago would also have had a small Caribbean literature on which to draw. The earliest writings, by Hazelwood (1954) and 'Analyst' (1953) focussed on the inappropriateness of colonial monetary arrangements for the economic development of Caribbean countries and argued the case for the establishment of local central banks. Thomas (1963) focussed on the nexus between the balance of payments and the money supply in a colonial monetary economy and the role of the commercial banks in that process. The first article to address monetary policy in the Caribbean and the theoretical framework underlying it was Best and McIntyre (1965). Best and McIntyre, in developing arguments critical of the policies of the Bank of Jamaica, employed a loanable funds model, which, like Thomas's model, focussed on the portfolio allocation decisions of the (expatriate) commercial banks. The Best-McIntyre critique is considered at greater length in Chapter Four.

## *The Actors*

In preparing for the formation of the Central Bank of Trinidad and Tobago, extensive use was made of both foreign and local expertise. Thomas Balogh, who had advised in Jamaica, also advised the Government in Trinidad and Tobago, along with Albert Hart of Columbia University and Charles Kennedy of the University of the West Indies. A special advisor from the International Monetary Fund (Paul Walter) was also employed in early 1963. The preparatory exercise was, however, undertaken largely by a local Committee on Banking and Currency which comprised officials of the ministry of finance and the then planning division, including Patricia Robinson, Winston Fung, then permanent secretary in the ministry of finance, John Harper who was treasury solicitor, and David Weintraub, advisor to the ministry, who had also been involved in the preparation of the Second Five-Year Plan.

The first governor of the Central Bank of Trinidad and Tobago was John F. Pierce, an American, seconded from the Federal Reserve Bank of New York where he had been a bank examiner. Pierce had joined the Committee on Banking and Currency in mid-1964 and was involved in the preparatory work for the start-up of the bank. It is interesting that an American should have been selected. A memorandum advising the government on the establishment of the central bank and presumably written by the then governor of the Bank of Jamaica argued the case for the appointment of an expatriate as the first governor, but stated, *inter alia*, 'in view of Trinidad's currency and banking system and general financial structure, it would be advisable to seek a Governor among Commonwealth Central Banks....'.<sup>24</sup>

Pierce's appointment seemed to have been a compromise based on expediency, though it has been suggested that he had had considerable operational experience in developing countries. There was also a strongly held view that the operational systems and procedures of the new central bank were soundly established.

In the event, John Pierce remained only about thirteen months as governor and was replaced by Alex N. McLeod, a Canadian, who took up duties in May 1966.<sup>25</sup> McLeod, a graduate in mathematics and economics from Queen's University, had obtained a masters in public administration and his doctorate in economics at Harvard in 1946 and 1949, respectively. Between June 1947 and December 1955, he had worked with the International Monetary Fund and had been on missions to Haiti, Honduras, Guatemala, Libya, Nicaragua, Costa Rica and Saudi Arabia. Between 1956 and 1966, he had been chief economist at the Toronto-Dominion Bank.

McLeod brought to the governorship not only many years of practical experience but also a fine scholarly mind evidenced in his several academic publications and other speeches and statements.

Other expatriates who were involved in the formative years were Theodore Walter, bank operations consultant who had been employed in June 1964 by the government as a consultant and Horst Bockelmann who had been employed from May 1964 and who functioned as the Bank's first director of research. Bockelmann had worked previously at the Bundesbank and went on to become the first governor of the Bank of Guyana. Francesco Palamenghi-Crispi, who had worked in the Bank of Italy and had been deputy president of the Somali National Bank, was chief operational adviser from December 1966. He was replaced by another Italian, Luigi Scimia, in March 1968. Both these officials were recruited through the offices of the International Monetary Fund. Roy Jones, a Jamaican, was research adviser from January 1968. He had previously headed the research department at the Bank of Jamaica. A.K. Basu, an Indian national, started the bank inspection function in 1968.

The first board of the bank comprised John Pierce, governor, Joseph Algernon-Wharton, Louis Blache-Fraser, K. Lindsay Grant, David Weintraub, William Demas, representing the economic planning division, and Patricia Robinson representing the ministry of finance.<sup>26</sup> John Pierce, David Weintraub and Patricia Robinson provided continuity between the Committee on Banking and Currency and the management of the new bank. John Harper acted as pro-tem secretary for a few months before he was replaced by Godfrey Codrington who, in turn, gave way to Philip Rochford as Secretary.

Algernon 'Pope' Wharton was one of the country's most distinguished and successful barristers and served continuously on the board from the inception to December 1985. He served briefly as temporary governor between the departure of John Pierce at the end of January 1966 and Victor Bruce's assumption of duty as deputy governor at the end of February 1966, and also served as temporary governor on subsequent occasions when both governor and deputy governor were absent.

Louis Blache-Fraser was, at the time of his appointment, a prominent local businessman with Alstons Ltd. He had, however, been a public servant rising to be financial secretary in the government of Trinidad and Tobago as well as financial secretary of the pre-Federal Organization and Chairman of the public service commission of the West Indies. He served continuously on the board of the Bank up to December 1982. K. Lindsay Grant was also a prominent businessman with T. Geddes Grant (Trinidad)

Ltd. However, he resigned from the Board in 1966 and was replaced by Edmund O'Connor, a retired banker and businessman.

David Weintraub was an American economist educated at New York and Columbia Universities. He had worked in the United States Federal Government and in the United Nations system before becoming the first general manager of the Industrial Development Corporation serving in that capacity from 1959-64. He then became special advisor in the ministry of finance and was a member of the Committee on Banking and Currency.

William Demas was the head of the economic planning division in the office of the prime minister. The Central Bank Act had made explicit provision that one of the non-voting members of the board of directors would be the representative of the area of government responsible for economic planning. Demas had been an island scholar from Queen's Royal College who had gone on to study economics at Cambridge University. After working for a time at Oxford University and in London, he joined the Trinidad and Tobago public service in January 1959 and before long had acquired a considerable reputation as a development economist. He was economic advisor to the prime minister from 1968 before leaving to take up his appointment as Secretary-General of the Caribbean Free Trade Area (CARIFTA) in January 1970.

Patricia Robinson was deputy secretary and director of finance and economics in the ministry of finance. She had had her undergraduate and postgraduate training in economics at Columbia University and had acquired considerable experience at a policy level in the public service having worked closely with the prime minister on several major policy issues including double taxation treaties and with the teams which drafted the First-Five Year Development Programme and the Second Five-Year Development Plan. She had also been a member of the Committee on Banking and Currency which oversaw the drafting and implementation of the several important pieces of financial legislation which were introduced over the 1962 to 1966 period.

Victor Bruce, a Tobagonian, who had had a distinguished career in the Trinidad and Tobago public service, was appointed deputy governor on 1 January 1966 and assumed duties in February 1966. Bruce, who was to become the dean of Caribbean and Latin American central bank governors and a highly respected international figure, had been trained in statistics and economics at the London School of Economics and had worked for a time at the Central Statistical Office. He had subsequently worked in the Ministry of Finance as chief establishment and training officer and was a member of the finance advisory committee. In September 1962, he was

appointed director of personnel administration and in 1963 was appointed permanent secretary in Tobago. Prior to his official appointment as Deputy Governor, Bruce had been sent to the IMF as part of his preparation for assuming the post. He was eventually appointed governor in August 1969 on the resignation of McLeod.

Frank Rampersad served on the board of the Bank as the representative of the economic planning division and ministry of finance from 1966 to 1969. Rampersad had built a substantial reputation in the public service. He had worked at the Central Statistical Office in its formative years and had a sound grasp of the workings of the economy. He had also been Demas' deputy at the economic planning division before moving over to the ministry of finance.

The board of the bank presented an interesting mix of personalities. Pierce, McLeod and Weintraub were expatriates. It has been suggested that Pierce was unable to deal successfully with the government bureaucracy and left the governorship amidst some acrimony. McLeod seemed to have managed the administration of the Bank in its critical formative years fairly well, although there appears to have been a difference of view on the role of monetary policy between McLeod and the Bank on the one hand, and the government representatives on the other. This was probably not surprising. Demas, Rampersad and Patricia Robinson were 'developmentalist' in their thinking and orientation. Monetary policy was to be judged by its impact on the economic development of the country in general and, specifically, on the extent to which it facilitated capital formation and permitted the government to play its 'proper' role in the development process. The Bank on the other hand was apparently inclined to point out that the 'settings' of monetary variables, particularly interest rates, implied by a developmentalist posture might well be inconsistent with the institutional character of the economy and, especially, the relationship between domestic and foreign interest rates. These issues are explored in the next chapter.

### *Character and Independence of the Central Bank*

Notwithstanding this apparent difference of view and approach, the question of the independence of the Bank apparently never arose pointedly. In his speech on 4 March 1967 at the formal opening of the Bank's new premises, the Minister of Finance, A.N.R. Robinson, had this to say:

In this matter of the relations between the Central Bank and Government, the policy of the Government has been to leave the Bank completely free in its day-to-day operations, and there can be no question of any interference with the Bank in the discharge of its

technical functions. The Central Bank Act gives the Bank wide statutory powers, but contains checks and balances on the actions of both Bank and Government. It recognizes the ultimate responsibility of the Government for the peace, order and good government of the country and specifically for the co-ordination of monetary and fiscal policies within the broader framework of the general economic policies of the nation. In this way, it is assured that the Bank will have the maximum degree of independence consistent with responsibility to the community as a whole.<sup>27</sup>

Nonetheless, it seems that there were moments of tension, sufficient to prompt Alex McLeod in his farewell speech as governor in July 1969 to state:

A central bank has a difficult task to perform. On the one hand it must endeavour to cooperate with the fiscal and economic policies of the Government, for clearly it cannot manage the economy all by itself. On the other hand, it must have a strongly independent position in order to discharge its responsibility. It must jealously avoid being suborned into promoting one particular aspect of credit conditions — say cheap and easy financing for the Government — at the expense of others. In general these two aspects of its work — coordination with Government policies, and independence in its own field — are compatible enough. It is a matter of reasonable men on both sides taking a reasonable view of the public interest. But I would be less than frank if I did not admit that things do not always go smoothly.<sup>28</sup>

McLeod purported to speak generally about central banks and his references were oblique, but in the context alluded to above, the thrust of his arguments, with its implied warning, is clear. John Pierce's departure from the Bank amidst some acrimony was due more to clashes of personality and his apparent dissatisfaction with the pace at which things were moving.

But the Central Bank was not about to engage in open conflict with the government. Having emerged from the womb of the ministry of finance, it necessarily had to have a close working relationship with the ministry. This was reinforced by the secondment and the recruitment of a number of staff from within the ministry of finance or the wider public service at the beginning. It appears, however, that the Bank quickly began to mould its own values and character. It acquired premises renovated to its own tastes and standards on the ground floor of the Treasury Building and determined to either purchase the property or eventually acquire its own. It set salaries and benefits for its staff in relation to those of the public service, but somewhat higher, and was careful not to designate job titles in a manner

similar to those in the public service. It was also likely that the presence of the expatriates helped to develop a corporate culture that was distinctive in style and tone from the mainstream public service.

In fact, the Bank straddled, at times uncomfortably, the cultures of private commercial enterprise and the public service. It was not burdened by the set of public service regulations and this made recruitment, selection and discipline easier. As a bank and the provider of exchange control services, there were internal pressures for improved efficiency. However, remuneration of the Governor and Deputy Governor was fixed by the Salaries Review Commission which limited the Bank's ability to reward adequately staff with specialist skills, an issue which was to become of some significance during the boom years. Arrangements for the resolution of industrial relations problems also reflected the Bank's anomalous status. The Bank's staff were deemed to be 'essential' and therefore could not take strike action, yet they did not have access to the special tribunals of the Industrial Court to hear a dispute with the Bank's management. These anomalies posed fresh and interesting challenges for the Bank's management, but are not pertinent to the central theme of this study.

## **CHAPTER FOUR**

# **MONETARY AND FINANCIAL POLICY 1964 to 1971: CONDUCT AND PERFORMANCE**

The previous chapter has described the legislative basis for the activity of the Central Bank, the institutional context, the socio-economic conditions prevailing over the reference period, the ideas which dominated thinking on monetary and financial policy and the key actors who were making or influencing policy at the time. It also alluded to an apparent divergence of view on the appropriate objectives of monetary policy and how it should be conducted. This chapter elaborates on the objectives and instruments of monetary policy from 1964 to 1971 and assesses its results. The final section of the chapter reviews the initiatives taken in respect of financial policy over the period.

### *Objectives and Instruments*

While the Act establishing the central bank outlined its broad aims and objectives and empowered it with certain instruments, the Bank, once established, had to move concretely to determine what its immediate objectives were and how it would set about achieving them. Until August 1966, the Central Bank was not the government's banker, nor were the sections empowering its use of reserve requirements, rediscounting of commercial bank paper and selective credit controls in force. Monetary policy therefore really dates from August 1966.<sup>1</sup>

Essentially the Bank embraced two objectives for its monetary policy.<sup>2</sup> The first was to attempt to insulate the domestic economy from temporary fluctuations in external monetary factors, in particular fluctuations in interest rates, although the Bank acknowledged that, if external influences were persistent, it could seek only to cushion their effects. This objective arose out of the institutional arrangements for the country's

currency which facilitated capital inflows and outflows. It was assumed that these capital movements would be responsive to interest rate differentials, particularly between sterling deposits and local currency deposits. In order to minimise capital outflows arising from such differentials, the Bank took the view that the interest rate structure in Trinidad and Tobago should be related to that of the United Kingdom and, specifically and ideally, interest rates in Trinidad and Tobago as a capital-importing developing country should *ceteris paribus* be higher than in the UK.

The Bank, however, also acknowledged a second objective which was that it was important that the banking system be sufficiently liquid to be able to support the government's development effort.<sup>3</sup> A liquid banking system would mean low interest rates which might be in conflict with the interest rate structure dictated by external factors. A liquid banking system would also put pressure on the foreign exchange reserves through credit-financed capital outflows. To complicate matters further, there was a concern that low rates of interest might compromise the mobilization of savings required to finance investment.

The Bank attempted to meet those objectives by use of the rediscount rate, i.e., the rate at which the central bank is prepared to make advances to the commercial banks by discounting eligible paper.<sup>4</sup> In situations where banks borrow heavily from the central bank, the rediscount rate can be a powerful instrument of monetary policy since it affects the cost of funds to the banking system at the margin and, therefore, influences the whole structure of interest rates. Moreover, in systems where banks borrow from the central bank, the discount rate can be used as a signal of the central bank's desires in terms of rate movements even though banks may not be actively borrowing at the time.

In the Trinidad and Tobago case, the Bank acknowledged that the commercial banks did not need to borrow from the central bank since the banking system was quite liquid and, if necessary, the banks had access to head office funds. Nonetheless, the Bank took the view that the rediscount rate could be used as a signal of the central bank's desires even though there was no history or tradition in this regard. In addition, it appears that the Bank, at least initially, did not take seriously the argument that higher interest rates would necessarily increase savings or reduce investment. Given this scepticism, the Bank's management apparently felt more or less free to pursue its objective of insulating the domestic monetary system from external influences.

The rediscount rate was first set in August 1966 at 6 per cent and was changed six times between August 1966 and October 1968, ranging from

a low of 5.50 per cent in May 1967 to a high of 7 per cent in January 1968. After October 1968, the rediscount rate was moved only once within our reference period, in October 1971, to 5 per cent from 6 per cent. The Bank monitored interest rate levels and movements in the major industrialized countries and in the Caribbean countries. However, the changes in the rediscount rate were usually triggered by changes in the UK bank rate as set by the Bank of England.

The Central Bank's target variable was the structure of domestic interest rates, specifically the treasury bill rate, the prime loan rates of commercial banks and deposit rates on 3-month, 6-month, 12-month term deposits and on savings deposits. Yields on long-term government securities were also closely monitored. The Bank's management was of the view that the treasury bill rate should be related to, and ideally a bit lower than, the rediscount rate.<sup>5</sup> At the same time, the Bank was aware that the treasury bill rate was market-determined, given the amount of funds that the government wished to raise by this means at any given time.<sup>6</sup>

The rediscount rate was not the only instrument employed by the Bank over this period. Since the objective was to limit capital outflows stimulated by 'unjustified' interest rate differentials, the Central Bank sought to increase the transaction cost of acquiring sterling by varying the exchange charges on rates and transactions. The Act allowed a maximum charge of 1 per cent which was applied in March 1968 after the devaluation of sterling when there was heightened speculation. This was reduced, however, to 1/2 per cent in April 1968 and was raised twice thereafter, to 3/4 per cent in March 1969 and 1 per cent in September 1970.

The Bank also records that it made use of the central banker's black box – moral suasion. The efficacy of moral suasion depends largely on the central bank being recognized by the commercial banks in the system as representative of the wider public interest, as a defender of their interests as an industry, when such defence is in the public interest, and as having certain sanctions which may be effectively applied if reasonable co-operation from them is not forthcoming. It appears that meetings with the commercial banking community were held regularly and there are no recorded instances of blatant non-co-operation by the banks. Moreover, it has been suggested that as governor, McLeod's philosophy was to elicit voluntary co-operation by persuasion rather than use of the 'big stick', since this approach facilitated the smooth implementation and conduct of policy. This approach has remained an integral part of the Bank's dealings with the commercial banks.

While the Bank saw the 'insulation' objective as its main concern, it would appear that the developmentalists on the Board and in the govern-

ment technocracy were urging it to attempt to influence the distribution of credit as between production and investment and consumption and were also concerned that the pursuit of the insulation objective should not lead to an interest rate structure that would compromise the investment programme, particularly government's development programme.

The Bank under McLeod would not use its powers of selective credit control in Section 42 of the Act. Rather, the banks and finance companies were persuaded to restrict credit terms for new cars to a minimum down payment of 30 per cent and a maximum repayment period of 18 months. It seems, however, that there were often breaches of the guideline and in 1966 the Bank got the chamber of commerce to publish a code regulating instalment credit. The question of consumer credit was raised in the 1967 budget speech and therein the minister indicated a role for the Central Bank in its regulation and control.

The developmentalists seemed peeved by the Bank's approach to the question of the allocation of credit. The authors of the Third Five-Year Plan complained:

The Bank has not invoked its legal powers with regard to influencing the distribution of commercial bank credit over different types of loans. Lending still goes mainly to financing the Distributive Trades and Personal Consumption. Nor have the Bank's legal powers been exercised to fix a local assets or a liquid assets ratio. As a result, the Bank had no alternative but to follow closely the movement of interest rates in London, which have over the whole period tended to be amongst the highest in the world's money markets. While it can be argued that higher domestic interest rates may have a favourable impact on savings - and the available statistical evidence does not appear to support this - the possible adverse effects of such high interest rates on investment, particularly mortgage financing, the cost of living and the Government debt should in a full assessment also be taken into account.<sup>7</sup>

The planners charged the bank to: 'take more vigorous steps than hitherto to control credit selectively so that lending by financial intermediaries is shifted from consumption purposes to investment purposes'.<sup>8</sup> It was not until 1970 that the Bank acted under its powers in Section 42, but then not to control consumer credit, but to control commercial bank lending to non-residents. The Bank directed the commercial banks that the volume of lending to non-residents should not exceed the level outstanding at 28 February 1970, although banks were free to allocate the available credit among non-

resident borrowers as they saw fit. This particular measure had in fact been contemplated since January 1968.

The Central Bank Act provided for the imposition of a cash reserve requirement at a rate not less than 5 per cent. In August 1966, therefore, when the relevant section (Sec. 40) was proclaimed, the Bank had to determine what level of cash reserve requirement it would establish. There were concerns expressed that the Bank should not, perhaps inadvertently, set the rate too high such that liquidity in the banking system was adversely affected thereby. We have already noted that one of the objectives was to ensure sufficient banking system liquidity to facilitate the financing of government expenditure. The Bank erred on the side of caution and set the cash reserve requirement at 5 per cent, where it remained until February 1973. In the event, the concern that the reserve requirement might impact on banking system liquidity was largely academic owing to the highly liquid position of the system at the time (Table 4.1).

TABLE 4.1: COMMERCIAL BANKS ASSET STRUCTURE, 1966

	\$M	%
1. Cash	11.3	3.8
2. Central bank reserve	12.5	4.2
3. Balances due from banks abroad	12.4	4.1
4. Balances due from other banks	8.1	2.7
5. Treasury bills	12.3	4.1
6. Other investments	22.1	7.4
7. Other assets	43.7	14.5
8. Loans and advances	178.1	59.3
9. Total assets	300.5	100.0
Memo:		
Total deposits (\$M)	273.2	
Liquid assets/deposits (%) <sup>1</sup>	20.7	
Liquid assets/total assets (%)	18.9	

SOURCE: CSO., *Annual Statistical Digest*, 1966

<sup>1</sup>Liquid assets are defined here as Items 1-5, and differs from the definition used in Table 4.2

Over the reference period, 1966-71, the commercial banks experienced little difficulty in managing their cash reserve positions. In 1967, the Bank persuaded the commercial banks to hold, voluntarily, a secondary reserve in the form of treasury bills equivalent to 5 per cent of deposits partly

in order to assist them in managing the cash reserve and partly to create an active, expanded treasury bill market. In 1968, the Bank instituted an interest-earning special deposits account for the commercial banks which was eligible for inclusion in the secondary reserve. The cash and secondary reserve requirements were to become the centrepiece of monetary policy instruments in later periods. In the establishment phase, however, these potentially powerful instruments remained unused.

The Bank also elected not to institute a liquid assets ratio or a local assets ratio for the banks. The available data suggest that this was a wise decision in that the local assets ratio of the banks had risen dramatically between the late 1950s and the mid-1960s, while the liquid assets ratio had declined from as high as 70 per cent to 20-25 per cent in the mid-1960s. Both trends stemmed from the sharp decline in balances due from banks abroad and a corresponding increase in domestic loans and advances (Table 4.2).

TABLE 4.2: LIQUID ASSETS AND LOCAL ASSETS RATIOS  
OF COMMERCIAL BANKS (SELECTED YEARS)  
(Percentage)

	Liquid Assets/ Total Deposits <sup>1</sup>	Local Assets/ Total Assets
1957	73.4	29.8
1960	51.9	48.4
1963	38.5	60.8
1966	28.8	80.3

SOURCE: CSO., *Annual Statistical Digest*, 1966

<sup>1</sup>The definition of liquid assets is the CSO's and differs from that calculated in Table 4.1

### *Assessment and Critique of Monetary Policy*

In assessing the conduct of monetary policy over the period 1966-71, there appears to have been a considerable variance between the theoretical conceptions which the Bank's management embraced, at least up to 1969, and what was in fact practised. The approach articulated by McLeod and expressed in the objectives stated in the earliest annual reports should perhaps have led the Bank to engineer an interest rate structure in which the levels were on average higher than those in the United Kingdom. In the event, the levels of interest rates in Trinidad and Tobago were consistently below those in the UK. The reasons for this were almost certainly the high

levels of liquidity prevailing in the banking system despite a rapid expansion of loans and advances and investments in government securities, and the pressure from the government, through its representatives on the board, to keep interest rates low.

The Bank could not make use of open market operations in a context in which the money and capital markets were rudimentary. The Bank elected not to use reserve requirement variations since it wished the commercial banks to grow accustomed to managing their reserve accounts and it sets the initial reserve requirement at the statutory minimum so as not to disrupt the banks or create disaffection by setting the initial reserve requirement at too high a level. This left only moral suasion and the rediscount rate in the package of policy instruments, since the Bank was not convinced of the efficacy of selective credit controls and, in any event, took the view that restraint of consumption expenditure was better achieved by fiscal instruments than by credit policy.

When the rediscount rate was to be first set in August 1966, there was a crisis in sterling and, in an effort to defend the pound, the UK Bank Rate had been increased in July 1966 to 7 per cent, an extremely high level at that time. It was an unpropitious time for the Central Bank to be setting its own discount rate, which could have only a signalling effect to the local banking system. Looking retrospectively at the decision, McLeod stated:

Had we been free to consider domestic factors alone, we would have preferred to follow an easy money policy because of our uncomfortably high level of unemployment – not that easy money or low interest rates in themselves are a sure (cure) for unemployment, but in order to encourage productive investment as much as possible. To have followed such a policy in these circumstances, however, would simply have starved Trinidad and Tobago of capital, brought on an exchange drain and made the employment situation worse instead of better.<sup>9</sup> The rediscount rate was set at 6 per cent, although the developmentalists would have preferred to see the rate set lower. At the time, rates on 3-month time deposits were around 4 per cent and on 12-month time deposits, about 5 per cent. The average discount rate on treasury bills was about 5.1 per cent, though on a rising trend.

Notwithstanding the attempt to use variation in the outward exchange charge in support of its policy objective, monetary policy over the period 1966–69 suffered from failure to satisfy the Tinbergen criterion, i.e., the one instrument of policy – the rediscount rate – was being employed to meet two objectives: the ‘insulation’ and the ‘investment encouragement’ objectives and which were, in the prevailing circumstances, contradictory and conflicting.

Although monetary policy in this period raises several interesting issues, I would focus here on what I consider to be the three major issues which emerged. First, there is the question of the adequacy of the theoretical basis and validity of the 'insulation' objective embraced by the bank. Second, there is the question of the appropriateness or otherwise of the rediscount rate in achieving that objective and, relatedly, the effectiveness of the rediscount rate as a signal and, thirdly, there is the question of the theoretical and empirical validity of the 'investment encouragement' objective embraced by the developmentalists within the technocracy and taken initially by the Bank to be a secondary objective, or at least, a constraint on its principal objective.

The insulation objective was apparently based on a theoretical framework which may be described thus: because of free convertibility to sterling at a fixed rate with low transaction costs (mainly the exchange charge), the demand for (domestic) money would be sensitive to the yields on comparable investment vehicles in the UK or the wider sterling area. Therefore, if interest rates and yields went up in the UK relative to rates in Trinidad and Tobago, there would be some incentive for movement out of idle local currency balances and into sterling assets. There would therefore be a fall in the demand for money at prevailing local interest rates. In addition, there would be two effects on the supply of money. First, capital inflows from sterling sources, or elsewhere for that matter, would decline to the extent that local rates became less attractive and this would thus reduce the flow supply of money. Secondly, the surrendering of domestic currency for sterling would directly lower the money supply. The net effect of these changes might or might not leave the local interest rate structure unchanged, depending on the extent of the shifts in money demand and supply, but would certainly cause liquidity in the system to be lowered and, to the extent that the availability of credit was important to investment expenditure, the rise in the UK rates could adversely affect economic activity in Trinidad and Tobago.

When UK rates rose therefore (or might be expected to rise on account of an increase in the UK bank rate, and this increase in rates was expected to persist), the central bank's rediscount rate should be raised as well so that local interest rates would be induced to rise. This would maintain or minimise the size of the increase in the interest rate differential, thus minimizing the outflow of funds and hence the decline in the domestic money supply and liquidity. This kind of intervention would be appropriate where the differential between UK and local rates was, in some sense, 'unwarranted'.

Best and McIntyre (1965) in their critique of the Bank of Jamaica which pursued the same objective as the Central Bank of Trinidad and Tobago, using the same instrument, argued that the defensive use of the rediscount rate in the fashion described above would not be effective in preventing an outflow of funds because of the way in which the banks were likely to behave. Using a loanable funds model of commercial bank portfolio behaviour, Best and McIntyre argued that, given the expectations held by borrowers, the demand for loanable funds was highly elastic. Therefore, if local lending rates increased as a result of an increase in the rediscount rate, the banks would experience an excess supply of funds which they would seek to invest abroad, thus creating the outflow of funds the monetary authorities were seeking to avoid. The Best - McIntyre critique raised certain interesting issues, not the least of which is whether the problem should be modelled in terms of the behaviour of the banks in the tradition suggested by Thomas (1963), or in terms of the traditional money market approach which models the behaviour of the non-bank public, with bank behaviour only implicit. Best and McIntyre may also have exaggerated the expectations effects and, therefore, the high elasticity of demand for loanable funds.

The Best - McIntyre critique was supported by the view of William Demas who argued that it was difficult for monetary policy to insulate an open, dependent economy from externally-induced fluctuations. Swings in exports may be so large that they could not be compensated by domestic monetary expansion. Moreover, the fact that the local banks were branches of expatriate banks and, because of free convertibility and the absence of controls against metropolitan countries, the difficulty of insulating the economy was further compounded.<sup>10</sup>

I would submit that the theoretical basis for the insulation objective was sound. In the absence of suitable defensive policies, a capital outflow, engendered by circumstances prevailing outside the domestic economy and unrelated to it, could affect adversely domestic economic activity. The real issues were whether the putative effects were significant enough to warrant a policy response and what instrument(s) were best suited to addressing the problem. As far as the first question is concerned, it would have been entirely reasonable for the Bank to assume that the capital movements could be large, and indeed it would have been irresponsible of it to assume otherwise. This brings us to the question of the appropriateness of the rediscount rate as the best available instrument for achieving the insulation objective, and if it were, whether it was used effectively.

The Bank's management saw the rediscount rate affecting short-term interest rates through the treasury bill rate and a chain of asset substitution

effects along neo-Keynesian lines.<sup>11</sup> However, the Bank was not entirely certain that changes in the rediscount rate would always or necessarily work, and appeared to rely as well on changes in the rediscount rate being read by the commercial banks as an indicator of the Bank's wishes.

The Bank's 1967 annual report traced the changes in rediscount rate from December 1966 to January 1968 as well as movements in commercial bank deposit and loan rates over the same period and made bold to say: 'the reductions in the rediscount rate earlier in the year (1967) were intended to influence changes in the domestic short-term rates and did have the intended effect'.<sup>12</sup> The Bank moved the rediscount rate six times between March 1967 and October 1968, mainly in response to changes in the UK bank rate (Table 4.3).

An analysis of interest rate movements over the 1966-68 period does lend credence to the view that commercial bank deposit and loan rates did

TABLE 4.3: MOVEMENTS IN REDISCOUNT RATE AND U.K. BANK RATE 1966-1971  
(percentage)

	T & T Rediscount Rate	UK Bank Rate
1st August 1966	6.00	7.00
31st December 1966	6.00	7.00
January 1967	6.00	6.50
17th March 1967	6.00	6.00
25th March 1967	5.75	6.00
10th May 1967	5.50	5.50
16th November 1967	6.50	8.00 <sup>a</sup>
31st December 1967	6.50	8.00
11th January 1968	7.00	7.50 <sup>b</sup>
10th July 1968	6.50	7.00
16th October 1968	6.00	7.00
31st December 1968	6.00	7.00
31st December 1969	6.00	8.00
31st December 1970	6.00	7.00
21st October 1971	5.00	5.00 <sup>c</sup>
31st December 1971	6.00	7.00

SOURCE: Annual Report (various issues), IMF, International Financial Statistics.

<sup>a</sup>The UK bank rate was 5.50 per cent up to the 30 September 1967. It was increased to 8 per cent in three stages on 19 October, 9 November and on 18 November as part of the devaluation package.

<sup>b</sup>This rate prevailed at the end of the quarter.

<sup>c</sup>The UK bank rate was changed to 6 per cent in the second quarter of 1971 and to 5 per cent in the third quarter.

move in sympathy with changes in the rediscount rate, though the downward movements occurred with a longer lag than the upward movements which followed the November 1967 devaluation of sterling.

In Table 4.4 I show that over the period 1965–71 both deposit and loan rates trended upward albeit slowly, given the rise in the inflation rate over the period. I have calculated coefficients of variation for three sub-periods. The first sub-period spans 1965–I to 1966–II before the rediscount

TABLE 4.4: ANALYSIS OF INTEREST RATE MOVEMENTS<sup>1</sup> 1965–1971

	1964-I – 1966-II	1966-III – 1968-IV	1969-I – 1971-IV
1. Average Deposit Rate	3.67	4.07	4.84
2. CV (Deposit Rate) (%) <sup>2</sup>	16.7	25.2	20.9
3. Average Loan Rate	7.11	7.92	8.46
4. CV (Loan Rate) (%) <sup>2</sup>	2.9	13.7	9.7

SOURCE: Central Bank, *Monthly Statistical Digest*, various issues.

<sup>1</sup>Data are calculated from quarterly, end of period, weighted averages

<sup>2</sup>CV - Coefficient of Variation

rate was instituted. The second sub-period spans 1966–III to 1968–IV when the rediscount rate was changed six times and the third sub-period, 1969–I to 1971–IV, is marked by only one change in the rediscount rate. I surmise that if deposit and loan rates did react to the movements in the rediscount rate, the variability of these rates would be higher in the second sub-period than in the other two sub-periods. The data appear to bear this out.

What then explains the virtual abandonment of the rediscount rate as an instrument of policy after 1968, despite continued variation in the UK bank rate? The answer appears to lie, in part, in a gradual re-ordering of the objectives of monetary policy in which mobilizing ‘...the local savings of the public and making the most effective use of them for financing public and private capital formation in support of the government’s development programme’ became the principal objective.<sup>13</sup> This meant that interest rates were to be kept low. Thus, the sharp increase in the UK bank rate from 7 per cent to 8 per cent in February 1969 evoked no response in the local rediscount rate, nor did any subsequent movements in the UK bank rate. The change in the UK bank rate in February 1969 did, however, prompt the Bank to increase the outward exchange rate to its statutory maximum of

1 per cent and caused the Bank to review the operation of the foreign exchange market in the country and, with the agreement of the commercial banks, to exercise greater control over foreign exchange transactions among authorized dealers. The control was further extended in May 1970 when sterling was declared a foreign currency and exchange controls strengthened after 1971.<sup>14</sup>

Another reason the rediscount rate instrument fell into desuetude after 1968 was probably that the defensive maneuvering was eventually seen to be superfluous. In the first place, throughout the period, the banking system was very liquid which served to keep the interest rate structure low. Secondly, the commercial banks and other investors had been reducing their foreign balances and investments in an effort to match their local assets and liabilities. Investors faced two kinds of risk or uncertainty. There was the uncertainty engendered by the crisis in sterling (which had begun in 1964 and, in fact, continued into the early 1970s) as well as the general international monetary crisis. There was also the uncertainty surrounding a newly-independent country with strongly nationalist postures in some areas and with the power, if not the will, to act independently in respect of its monetary and fiscal affairs. Prudence and profitability over the long term dictated that local assets and liabilities be matched as far as possible. Thus, commercial banks' net foreign assets which had been on average positive in 1966 and 1967, were on average negative in 1968 and 1969 and thereafter. The inflow of funds accelerated after the 1967 devaluation and contributed to increasing the liquidity of the banking system. It is likely, therefore, that the risk-adjusted interest-rate differential never became large enough over the period to induce the banks to reverse the process of reducing their foreign exposures.

I am suggesting that by 1969 the validity of insulation objective began to wear thin and the Bank shifted its focus to the investment encouragement objective.<sup>15</sup> The theoretical basis of this objective was tenuous, being predicated on the assumption that investment expenditure was 'interest sensitive' but savings were not. Indeed, the motivation behind the reduction in the rediscount rate in October 1971 was to encourage investment in a recessionary economy by lowering lending rates in the context of a highly liquid banking system, notwithstanding the tenuous link between credit expansion and investment and the well-known asymmetry in the response of the public to upward and downward movements in interest rates, encapsulated in the dictum that 'you can pull a string, but you cannot push on it'.

A low interest rate policy intended to encourage investment necessarily had to have a supporting mechanism which directed incremental credit

away from consumption expenditure and into investment expenditure. It would not be enough merely to lower interest rates and induce credit expansion, if it could. The developmentalists did recognize this problem and, as we have noted, urged the bank to institute selective credit controls against credit-financed consumption. But such direct controls were not instituted in this period and the low interest rate policy was almost certainly self-defeating. The more appropriate way of looking at the issue is that the objective really was to keep the cost of government domestic borrowing as low as feasible, based on the notion that the government's development programme expenditures were key to the growth and transformation of the economy and these expenditures should be financed as inexpensively as possible from domestic resources.

### *Financial Policy*

From the time of independence, the government and its technocrats had seen the need for sweeping institutional changes in the fiscal and financial area and had set about this task with considerable energy and enthusiasm. The results of these early efforts are outlined in Chapter Three above.

However, once some of the key pieces of legislation were enacted, the pace of institutional reform seemed to slow somewhat. There were several pieces of legislation or institutional innovations which were on the drawing board – a securities act to establish a stock exchange legislation to regulate non-bank financial institutions, establishment of a secondary mortgage market, unit trusts and a development bank, and reform of the company law, among others.<sup>16</sup> In the event, most of these were rather long in coming. This may have been because of scarce manpower which was consumed in running the new institutions which had been created leaving little time for developmental work. It is also possible that the pace of reform had been so rapid in the 1962–1966 period that the country itself wanted time to digest the changes and settle down.

The major institutional developments over the 1966–1971 period were nonetheless significant. First, the Central Bank in December 1965 instituted a call exchange. The rationale for its establishment was mainly to address the lack of information about available stocks and stock prices and, in so doing, it might also induce some change away from traditional investor preferences toward equities, reduce the relative attractiveness of readily marketable investments in the United Kingdom and perhaps encourage more public issues. The call exchange mechanism required simply that investors and brokers channel information to the central bank on transactions in bonds, equities, treasury bills, etc. The Bank collated the

data and redistributed the data to all members of the call exchange and also published a report on the transactions.

A related development occurred in 1967 when the Bank took responsibility for issues of government securities other than treasury bills, and in so doing undertook to make a market in those securities and thus provide liquidity to the capital market. This was of tremendous importance given the stipulation that insurance companies increase their holdings of local assets and the changing composition of commercial bank asset portfolio in favour of local assets.

The second major institutional development was the introduction of exchange controls. It was noted that up to 1967, in the midst of the sterling crisis, the Minister of Finance was assuring the public that Trinidad and Tobago would not be changing its relationship with sterling. However, it is more than likely that, at the level of the technocracy, it was clear that it was necessary to make the break with sterling and that this had to be done initially by subjecting sterling to exchange controls and subsequently by reconsidering the sterling peg for the TT dollar.

The notion that it was important to introduce effective exchange controls was already abroad in intellectual circles. Best and McIntyre in their 1965 article had argued strongly the case for giving the Bank of Jamaica power to control foreign payments.<sup>17</sup> The arguments would apply *pari passu* to other Caribbean central banks. Alister McIntyre in an extensive critique of the sterling area arrangements pointed out that the exchange controls which discriminated against non-sterling transactions were not effective and that the West Indian nations might consider imposing non-discriminatory controls over foreign payments.<sup>18</sup>

It appears that the devaluation of sterling by 14.3 per cent on 17 November 1967 caught the monetary authorities by surprise, although sterling had been in periodic crisis for the previous three years. However, although it prompted a defensive devaluation by the same amount and although the central bank agreed in 1968 to be part of the Basle Facility whereby Trinidad and Tobago agreed to hold 80 per cent of its reserves in sterling for a period of three to five years, the monetary authorities, especially at the Ministry of Finance, were becoming increasingly clear on the need to break with sterling. This was accomplished on 19 May 1970 when under the Defence (Finance) Regulations, sterling too was declared a foreign currency subject to exchange controls. However, this initiative, which came apparently from the Ministry of Finance and not the Central Bank, was prompted not only by the growing concern about the sterling peg but moreso by fears of increasing capital flight as the social unrest which

had started in February 1970 continued and culminated in a mutiny by elements of the Regiment and the declaration of a state of emergency.

The declaration of sterling as a foreign currency accomplished, the Exchange Control Bill was presented to Parliament in June 1970, not as a significant element of the government's institutional reform programme but merely as an update and modernising of the old Defence (Finance) Regulations.<sup>19</sup> But, of course, the Exchange Control Act when it was finally proclaimed in November 1971 was much more than an update of the old Defence (Finance) Regulations. It served in the first place to give the monetary authorities considerable power over external transactions, a power which was to be explored more fully later, during the 1980s. Secondly, with the administration of exchange controls delegated to the Central Bank, it served to provide much more effectively the elusive 'insulation' which the Bank had sought in the 1960s and which it had tried to achieve by means of the rediscount rate.

The process of insulating the economy from external monetary influences was also assisted by the transfer of government's banking business from Barclays Bank DCO to the Central Bank in May 1967 and served to shift the locus of major foreign exchange inflows from the commercial banking system to the Central Bank, since government was major source of foreign exchange through its taxation of the petroleum sector. In April 1969, the Central Bank moved to consolidate its role in the foreign exchange market by establishing a basic foreign exchange position for the banks, which, if exceeded, placed an obligation on them to sell the surplus foreign exchange to another commercial bank or to the Central Bank. The Central Bank in turn agreed to provide foreign exchange to the banks to meet their legitimate needs in excess of their own resources since by 1969 the banks had completed the transition from the holding of substantial foreign balances to a situation where their net foreign asset position was persistently negative.

When the Defence (Finance) Regulations were repealed in 1970 by Section 46 of the Exchange Control Act, Regulation 6 was deemed to remain in force. This regulation provided that the Minister of Finance had to authorize the issue of securities and the public offering of securities for sale. Securities were defined in the regulations to include shares, stocks, bonds, debentures, promissory notes and even treasury bills. In July 1970, the Minister of Finance formed the Capital Issues Committee under the chairmanship of the Bank's governor to advise the minister on applications made for the issue of securities.

In this period three important development finance institutions were created. The Trinidad and Tobago Mortgage Finance Company (TTMF)

was established in December 1965 to supply mortgage financing for lower and middle-income families. The Agricultural Development Bank (ADB) was established in 1968 (Chap. 79:07, No. 3 of 1968) to mobilize funds for the development of agriculture and commercial fishing. The ADB succeeded the Agricultural Credit Bank. The Development Finance Company (DFC) was established as a joint venture between government and the private sector in May 1970 with the object of financing the development of the manufacturing industry, hotels and agro-industry. The DFC would also be allowed to take equity participation in enterprises which it supported. An important element in the rationale for the DFC was the inadequacy of the commercial banks as a source of capital for industry.<sup>20</sup>

Exchange control, a significant central bank presence in the nascent capital market, and the reorganization of the foreign exchange market therefore set the stage for a potentially effective monetary policy. In Chapters Five and Six we examine the evolution of monetary policy in the post-1971 period.

## **CHAPTER FIVE**

### **IN THE EYE OF THE STORM: THE CENTRAL BANK IN THE 1970s**

This chapter reviews the events surrounding the conduct of monetary and financial policy in Trinidad and Tobago over the second period which spans the years 1972 to 1979. The closing years of the 1960s and the first half of the 1970s were characterized by great turbulence both at home and abroad. For Trinidad and Tobago, the beneficial effects of the first oil price shock which began to be felt around the middle of the decade posed problems for policy which were no less demanding than those of the earlier years of the decade when the country was in recession, attended by social unrest.

The chapter therefore begins with a review of domestic economic and political developments in the late 1960s and early 1970s. The following section describes the international monetary crisis which culminated in the institution of a regime of floating exchange rates and which precipitated a policy crisis for developing countries. The remaining sections touch on the theoretical framework of monetary policy in the 1970s, especially the growing influence of monetarist thought, various institutional developments over the period which were important for monetary and financial policy and on issues relating to the evolving character of the Bank, its personnel and its relationship with the government.

#### *Socio-Economic Developments*

Over the period 1968 to 1971, economic growth slowed averaging just 2.1 per cent per annum, and only 0.3 per cent in 1971, which meant that with population growth averaging about 2 per cent per annum, real per capita income would barely have grown over the period. The decline in the performance of the economy was due, as before, to developments in the

petroleum sector where crude petroleum production fell from 182.8 thousand barrels per day (bpd) in 1968 to 129.2 thousand bpd by 1971. As the economy weakened, unemployment rose to heights unprecedented in the post-war history of the country, buoyed up by strong population growth and increasing labour force participation. The data on unemployment and labour force participation in these years are not especially reliable. They do, however, suggest that unemployment averaged about 14 per cent in the 1967-1971 period.

The performance of the petroleum sector was also reflected in the balance of payments. The current account deficit increased from 4.9 per cent of GDP in 1967 to 13.1 per cent in 1971 and 13.6 per cent in 1972. The country's net foreign exchange reserves fell from US\$66.1 million at the end of 1968 to US\$32.5 million at year-end in 1973, representing in the latter year an import cover ratio of less than four weeks. During 1973 government's external borrowing amounted to US\$34.4 million which helped to shore up a critical foreign exchange situation. So desperate was the foreign exchange situation that the travel allowance which commercial banks were authorized to approve was reduced from \$2,000 to \$1,200 in February 1973, and, in March 1973, Trinidad and Tobago had to draw down its reserve (gold) tranche position with the International Monetary Fund.

The economic crisis of the 1968-1973 period occurred at the same time as certain social and political forces operated to destabilize the state. Strike action on the part of the labour movement increased in the late 1960s, eventually prompting the replacement of the Industrial Stabilization Act by the Industrial Relations Act in 1972, but in the process contributing to the decline in production in several areas of the economy. Opposition to the government increased both inside and outside parliament, and even within the ruling party itself. In 1970, the Black Power Movement captured the hearts and minds of the disadvantaged groups in the society, while striking fear in the hearts of the upper income groups. For a few months between February and April, when a state of emergency was declared, the government appeared to be adrift.

In the economic sphere, the government's response to the crisis was virtually to abandon the Third Five Year Development Plan in mid-stream and to attempt to introduce programmes that would reach the unemployed quickly. The Unemployment Levy was introduced in June 1970 retroactive to January 1970, in order to provide additional revenue to support the effort, and the government also sought to embrace a policy which gave emphasis to the 'peoples' sector of the economy while the case for

enhancing the government's direct role in the economy was articulated and the strategy pursued with considerable vigour.<sup>1</sup> As part of this process the government began to press harder on the expatriate financial institutions to localize their operations.

In the midst of this crisis, a crude-short American petroleum company, AMOCO, had begun to drill for oil off the east coast and in 1969 was successful in finding substantial quantities of high quality crude. Commercial development of the finds took place over the 1970 to 1972 period and from 1972 Trinidad and Tobago experienced an increase in its petroleum production, which rose from 129.2 thousand bpd in 1971 to 186.7 thousand bpd in 1974, peaking at 229.6 thousand bpd in 1978 (Table 5.1). There was a corresponding increase in petroleum exports from 13,279 thousand barrels in 1972 to 53,496 thousand barrels in 1978. Petroleum prices rose

TABLE 5.1: SOCIO-ECONOMIC INDICATORS, 1972-79

	1972	1973	1974	1975	1976	1977	1978	1979
Growth of Real GDP (1970 mp)	5.8	1.7	3.8	1.5	6.4	9.1	10.0	3.6
Unemployment Rate (%)	n.a.	15.4	15.3	15.0	n.a.	13.4	12.1	11.0
Inflation Rate	9.3	14.9	21.9	17.0	10.3	11.8	10.2	14.7
Current Account Deficit/GDP (%)	-13.6	-2.0	+13.7	+13.5	+10.2	+5.5	+1.1	-0.8
Foreign Exchange Reserves (US\$m) <sup>1</sup>	54.0	32.5	341.7	691.3	917.5	1,372.2	1,691.1	2,081.7
Fiscal Deficit or Surplus/GDP (mp) (%)	-2.7	3.0	10.1	12.1	5.7	9.6	0.4	-3.1
Crude Oil Production ('000 bpd)	139.9	166.2	186.7	215.4	212.2	229.1	229.6	214.3

SOURCE: Central Bank, Research Department, *Handbook of Key Economic Statistics 1989, Monthly Statistical Digest December 1980*.

<sup>1</sup>US dollar equivalent of Net Foreign Reserves as calculated in the Bank's Monthly Statistical Digest converted at end of period exchange rates reported in the IMF, *International Financial Statistics* (Yearbook).

from US\$1.65 per barrel in 1971 to US\$2.70 in 1973 and US\$12.70 in 1978.

The quadrupling of oil prices, together with changes to the petroleum tax regime effected by the 1974 Petroleum Taxes Act, propelled Trinidad and Tobago into a boom. Revenues spurted ahead of expenditures and the

government enjoyed fiscal surpluses over the 1974–1978 period. The higher oil revenues accrued in the form of foreign exchange inflows to the Central Bank and the foreign exchange reserves soared from the desperate levels of 1973 to unprecedented heights, reaching US\$2,081.6 million in 1979, equivalent to 16 months' import cover. The current account deficit on the balance of payments turned to substantial surpluses which reached 13.7 per cent of GDP in 1974. Real GDP grew at 6.2 per cent per annum over the 1974–1979 period.

Because government expenditure did not, initially at least, accelerate as quickly as revenues, and given the importance of government spending as a generator of economic activity, unemployment reacted somewhat slowly to the boom. The unemployment rate rose to average in excess of 15 per cent in the 1973–1975 period before beginning to fall to reach 11 per cent in 1979. There was also substantial inflation. The 1967 devaluation of sterling had led to a sharp increase in prices of 8.3 per cent in 1968, which moderated to 2.5 per cent in 1969, but which had set the economy firmly on a higher inflation path as inflation began to accelerate in the industrial countries and was imported into Trinidad and Tobago. Prices rose by 9.3 per cent in 1972, 14.9 per cent in 1973, 21.9 per cent in 1974 and 17 per cent in 1975, reflecting mainly the sharp increases in import prices in the early years of the decade. Over the 1972–1975 period, the increases in import prices and hence the impact on domestic prices would have been reinforced by the 24 per cent depreciation of the TT dollar in US dollar terms between 1972 and 1976. However, inflation continued, even as import price increases moderated after 1975, due to the strong demand-pull effects on the general level of prices engendered by the petro-dollar boom. Inflation averaged about 12 per cent per annum over the 1976–1979 period.

What is perhaps most remarkable about the performance of the economy over the period was the rapidity with which the boom engendered by the first oil price shock of 1973–74 began to be dissipated. The windfall was saved for about two years, reflected in the substantial fiscal and current account surpluses. But the rate of increase of petroleum exports and oil revenues was not sustained, while consumption and imports as well as investment expenditure began to accelerate after 1975. Increases in consumption and imports, both public and private, once entrained, became a macro-economic juggernaut that proved extremely difficult to stop. The fiscal surpluses and current account surpluses began to fall, such that, by 1979 both accounts had again turned negative, an extremely ominous sign and portent of what was to come in the next decade.

The development strategy experienced a sea-change with the oil bonanza. Development planning 'lost its mystique' and there was no

Fourth Five-Year Plan. Instead, a Co-ordinating Task Force was put together to plan the fuller domestic utilization of the country's hydrocarbon resources so as to forge greater linkages between the energy sector and the rest of the economy and to widen the industrial base. A large number of ambitious projects were identified - fertilizers, iron and steel, LNG, petrochemicals, aluminum smelter, refinery upgrading and expansion, furfural, polyester fibre - to be centred at Point Lisas, along with a number of infrastructure projects which would be needed to complement them.<sup>2</sup>

Once this strategy began to be implemented, other areas of the domestic economy began to be neglected. In his 1975 Budget Speech, George Chambers, who was then Minister of Finance, had commented as follows:

The emphasis on the energy-based and energy-using industries cannot and will not be allowed to distract attention from the development of agriculture or other manufacturing industries, particularly those which comprise the People's Sector which employs large numbers of our labour force. ...if improperly managed, oil can kill both agriculture and other industry and create more problems than it solves.<sup>3</sup>

Chambers was replaced as finance minister and the country's development strategy became increasingly single-minded, focussing on the energy sector and large infrastructure projects to the virtual exclusion of all else.

### *The International Monetary Crisis*

The devaluation of sterling in November 1967 sent shock waves through the international financial community. It signalled at once the demise of sterling as a major reserve currency, the inherent contradiction of the Bretton Woods system, first pointed out by Triffin in *Gold and the Dollar Crisis*, and, importantly, the growing power of private sector participants in the foreign exchange markets. The devaluation had prompted a lively debate in the Caribbean on whether the Caribbean countries should have devalued at all with sterling or by the same amount, and another more serious questioning of the continued appropriateness of the sterling peg and the Caribbean's membership in the Sterling Area. The authorities in the Caribbean territories took a conservative approach on the first question and were persuaded by the British to be part of the Basle Facility, the objective of which was to maintain a residual role for sterling as a reserve currency. Participation in the Basle Facility meant that the Caribbean countries were locked into a relationship with sterling until 1974.

The closure of the gold window by the United States in August 1971 and the Smithsonian Agreement of December 1971 when the US dollar was devalued marked the end of an era. Sterling came under intense pressure in the first half of 1972 and the British authorities floated sterling in June 1972. By March 1973, all the major currencies had begun to float against each other.

Developing countries generally faced the question of the likely impact of a regime of generalized floating on their economies. The view was widely held at the time that a flexible rate regime was of dubious benefit to the industrial countries themselves and certainly of no benefit to the developing countries. There would be greater uncertainty in world trade and payments, it would be much easier to transmit inflationary pressures across national boundaries leading to the kinds of problems which characterized the system in the 1930s and there was likely to be considerable instability caused by speculative capital flows across national capital markets which were becoming increasingly integrated. The events in the period 1973 to 1979 certainly seemed to confirm these fears, as there were considerable fluctuations in the parities among the major reserve currencies.

For developing countries, including Trinidad and Tobago, there were the critical questions of which peg should be chosen, including the 'new' option of a basket peg, how the parity should be managed in a world of floating rates and how domestic adjustment and exchange rate adjustment should be blended in the policy mix. Developing countries were not so sure that the flexible rate regime provided any real assurance that adjustment between surplus and deficit countries would be more symmetric and automatic than before and that, as deficit countries, by definition almost, the new regime would be costly to them in terms of requiring greater domestic adjustment by means of deflationary policies.

The difficulties which developing countries would have in stabilization and adjustment would also serve to enhance significantly the role of the IMF in economic policy in those countries. Indeed, the whole enterprise of the IMF in the post-1973 world of floating rates became one of purveyor of orthodox adjustment policies in the developing world. Its initial responses to the difficulties facing developing countries, which had been compounded by rising import prices, especially energy prices, were constructive. They led to the Oil Facility and the Compensatory Financing Facility which were of significant, direct benefit to developing countries experiencing adverse external shocks. Subsequent responses were not as constructive and, indeed, arguably, have often not been helpful to developing countries.

## *Institutional Developments*

The shock waves of the 1970 social unrest precipitated a significant shift in the stance of government policy in respect of its own role in the economy and in respect of the private sector, local and foreign. Government assumed the role of 'prime mover' in the economy and, to give effect to this, sought to extend its control over a wider field of economic activity including directly productive activities in industry, commerce and the financial sector. The objective was to increase national participation in economic activity.<sup>4</sup>

As far as foreign enterprise was concerned, government urged these enterprises to form local companies and to sell majority shareholding to locals. The banking and finance industry was targeted as one in which the localisation process should occur apace. Over the period, 1972-1979, most commercial banks incorporated locally and sold a significant part of their shareholding to locals.<sup>5</sup>

Another noteworthy development in the financial sector was the rapid growth of non-bank financial institutions. There were two streams of growth. First, the commercial banks formed subsidiary trust companies and finance companies to undertake mortgage financing, trust services, consumer lending and other financial services. Second, particularly during the boom years, a number of independent or non-bank affiliated finance companies were formed. These new non-banks were able to take advantage of the fact that they were not regulated or supervised to enhance their market position and profitability in what, after 1975, was a most favourable environment.<sup>6</sup>

Notwithstanding the several public issues of shares arising from the localisation initiative, the capital market did not deepen significantly over the period. Government domestic bond issues after 1974 were routine and intended to provide instruments which would allow insurance companies and other investors to maintain their local assets ratios. The treasury bill issue did not increase after 1973 and maturing issues were routinely rolled over and were locked into the portfolios of the commercial banks by the 5 per cent secondary reserve requirement. One important development which affected the capital market was the institution of a national insurance scheme in 1972 which provided for compulsory contributions from all employed persons and employers and which would provide a range of benefits to insured persons, including retirement, death and maternity benefits. The resources mobilized by the scheme would be available for investment in government securities, mortgages and other capital market instruments.

Over the period 1972-1979 there were significant changes in the fiscal regime which were to have important implications for economic policy, especially in the period 1980-1989. The Unemployment Levy had been introduced in 1970 to raise revenue to alleviate a worsening unemployment situation. Between 1974 and 1978, however, the changes in the tax regime were all concessionary, partly to compensate for inflation and partly to ease the burden of taxation on individuals, given the higher revenues being secured from the oil sector. The system of tax rebates was extended, allowances were increased in 1975 and in 1978 and, in 1977, the rate/bracket structure was altered such that marginal rates were reduced for all but the lowest and highest income groups. Indirect taxes were also lowered with reductions in purchase taxes and excise duties on gasoline and diesel oil.

There were no major changes to the Central Bank Act over the period. The more significant changes were (i) the 1975 amendment to Section 23 to allow changes in the par value of the Trinidad and Tobago dollar by order published in the Gazette and (ii) the additions to Section 44 in 1978 which permitted the Bank to fix interest rates by means of presidential order. The rationale for the former amendment was clear in that the original formulation of Section 23 specified the par value of the Trinidad and Tobago dollar in terms of gold. This meant that any change in the parity would require that the government would have to return to Parliament to have the Act amended. In a world of floating exchange rates this was clearly impractical, hence the amendment.

The rationale for the granting of the power to fix interest rates was less clear. It can be traced back to the 1974 Budget Speech of the minister of finance who, at the time, was George Chambers and who had Frank Rampersad as his permanent secretary and, before that, to a request by the Bank that it be given statutory power to fix interest rates at commercial banks. The budget speech noted the sharp increase in interest rates internationally and the increase in domestic rates due to tightening liquidity. It offered the view that sharp increases or 'excessively high levels' of interest rates could dislocate domestic enterprises and endanger jobs and price stability. Noting that there was then no legal mechanism for effectively regulating commercial bank deposit and loan rates, the Minister of Finance promised legislation to provide such a mechanism. The 1978 amendment was apparently the end result of that initiative. By the time the amendment was approved, however, circumstances had changed significantly in that liquidity in the banking system was extremely high and interest rates were, in real terms, at least, quite low.

The increased resources available to the government after 1974 served to rekindle interest in institutional reform and development. In May 1976, a large symposium was held on the Mobilization of Domestic Financial Resources. The symposium dealt with a wide-ranging set of issues from tax reform and the quality of life to localization and the development of the securities industry. It was this initiative which renewed the thrust in respect of institution building and its results were seen in the latter half of the decade and in the early years of the 1980s.

Finally, it is important to take note of the efforts toward Caribbean economic integration in this period. The Caribbean Free Trade Area (CARIFTA) had been formed in May 1968 and Caribbean leaders, noting the rapidly changing international environment as well as the need to create viable industries, determined to enhance economic activity and functional co-operation in the region by broadening and deepening the integration movement. The Treaty establishing the Caribbean Community (CARICOM) was signed at Chaguaramas in July 1973 and marked a high point in Caribbean co-operation and the exercise of collective political will. The Caribbean Development Bank was formed in 1970 and was to be an important instrument for the economic development of the CARICOM countries.

One of the main areas of co-operation was the commitment given to prior consultation with the Caribbean countries before major economic policy changes were instituted in any one country. Caribbean monetary authorities already had a history of collaboration and co-operation. The Intra-Regional Payments (IRP) Arrangements had been instituted in 1969 and in the early 1970s the regional central banks were beginning to explore the possibility of deepening those arrangements so as to conserve scarce foreign exchange. Central Bank governors and technicians also met under the auspices of the Regional Programme of Monetary Studies which had been instituted in 1969 by the University of the West Indies, Institute of Social and Economic Research and the central banks, following the successful Regional Conference on Devaluation in February 1968 which had brought academics and central banks together to discuss the implications of the 1967 devaluation of sterling.

By the end of the decade of the 1970s, however, much of the fervour which had marked Caribbean economic co-operation had dissipated, partly due to the difficulties in which the Guyana and Jamaica economies found themselves and partly to a failure of political will. The prime minister of Trinidad and Tobago did not attend meetings of CARICOM heads of government for many years and co-operation constituted a series of

bilateral initiatives whereby Trinidad and Tobago provided loans and grants to Jamaica, Guyana, Barbados and some of the Eastern Caribbean countries. The Caribbean Aid Council was formed in 1978 to manage the Caribbean Aid Project with the governor and deputy governor of the Central Bank as chairman and deputy chairman, respectively. In 1980 the CARICOM Oil Facility was established. Up to 1983, Trinidad and Tobago had extended to the region TT\$376.8 million in various forms of financial support, plus TT\$181.3 million under the CARICOM Oil Facility and TT\$27 million through the Caribbean Aid Council, in addition to extensive support of regional institutions.

The high point of monetary co-operation was the formation of the CARICOM Multilateral Clearing Facility (CMCF) in March 1977 which replaced the bilateral settlements mechanism under the IRP Arrangements with multilateral settlement. Multilateral settlement at quarterly intervals carried an important credit element which was important to countries strapped for foreign exchange. The CMCF Directors' meetings also provided regular opportunities for the CARICOM Central Bank governors to meet and discuss economic problems and issues.

### *Developments in Monetary Theory*

The decade of the 1970s will be recorded as the heyday of Monetarism in terms of its impact on academic circles as well as its influence on the formulation and conduct of monetary policy. As is usual in the world of ideas, the theoretical framework of Monetarism had been developed and articulated long before it achieved academic respectability and it began to influence the actual conduct of policy. Monetarism is usually traced back to Friedman's *Studies in the Quantity Theory of Money* (1956) which contains his re-statement of the Quantity Theory of Money, his *Program for Monetary Stability* (1958), his classic work with Anna Schwartz on *A Monetary History of the United States* (1963) and his paper on "The Optimum Quantity of Money" (1969).

It is, of course, very difficult to summarize the corpus of monetarist thought in a few short statements but my purpose here requires a summary treatment. Essentially, monetarism, in the context of a closed economy, claimed that (i) the demand for money was a stable function of a few variables, (ii) the demand for money was a demand for real money balances and properly located within the general equilibrium of money, output and employment, (iii) the supply of money was exogenously determined by the monetary authorities through their control over the monetary base, (iv) the monetary authorities could affect only the supply of nominal money but

were impotent to determine the level of real money balances, (iv) the supply of nominal money determined the level of prices and did not affect the level of real output and employment except in the short-run, (vi) a distinction had to be made between the real interest rate and the market (nominal) rate of interest and these rates were linked by price expectations, (vii) the real rate of interest was determined in the real economy and not by changes in nominal magnitudes such as the supply of money.

Monetarism sparked a long, interesting and, at times, acrimonious debate with Keynesians which not only challenged monetarist propositions but also fundamentally challenged the complacency of post-war Keynesianism. The implications of Monetarism for policy were that (i) the Keynesian easy money policy designed to achieve low interest rates in order to stimulate investment and growth was held to be misguided since excess money balances would cause higher prices and higher nominal rates of interest and (ii) it was necessary to target certain monetary aggregates rather than interest rates since interest rates were unreliable indicator variables.

Monetarist thought and their public programme did have an impact on policy formulation in the industrial countries. Monetary aggregates were developed, empirically-defined and assiduously targeted from the mid-1970s in most industrial countries.<sup>7</sup> In open economies, especially developing countries, some of the basic assumptions of Monetarism were questionable and there was a need to modify monetarist propositions in the context of open economies.

Monetarism made a critically important contribution to the analysis of inflationary episodes, particularly where the inflation rate was moderate to high. It linked such inflationary episodes with excessive growth of the money supply which in turn was usually caused by financing excessive fiscal deficits by money creation through the central bank. It led to the analytically important distinction between shifts in the price level and inflation, the one due to supply-side shocks which displaced the general level of prices upward and the other to excess rate of growth of the money stock. Monetarism also brought into analytical prominence the question of the exogeneity of the money supply and the determination of the stock of base or high-powered money.<sup>8</sup>

Much of the growing Caribbean literature on monetary economics and the analysis of inflation was however, rooted in neo-Keynesian foundations. The inflation problem tended to be analysed in terms of imported inflation or wage-pushfulness arising from social groups competing to increase or maintain their shares in national income while money growth

merely validated the wage push or the increase in import prices. There was some focus on the empirical estimation of the demand for money and the supply of money but these results were not sufficiently persuasive and mainstream Caribbean macro-economics and monetary economics retained a distinctly Keynesian character.<sup>9</sup> The other Caribbean literature in this period has a strongly institutional focus and included the work of Thomas (1972) on central banking, Odle (1972) on non-bank financial intermediaries and Miller (1970) and McLean (1975) on commercial banking.

The monetary approach to the balance of payments was an attempt to link the key principles of the modern quantity theory and policy in a small open economy. The approach had its roots in the Polak model and the financial programming models of the IMF, but attained fuller flower in the work of Frenkel, Johnson, Mundell and others.<sup>10</sup> Like 'domestic' monetarism, the Monetary Approach postulated a stable demand for money function and assumed that the monetary authorities had some measure of control over the domestic credit component of the monetary base and hence over the money supply. Changes in reserves or the money account of the balance of payments were held to reflect excess flow supply of or demand for money. Since the demand for money was stable, the balance of payments outcome in a fixed exchange rate regime depended on the credit policy of the monetary authorities.

### *Character and Independence of the Bank and its Actors*

Over the 1972-1980 period there were few significant change in the Bank which went through a period of organizational consolidation and functional expansion. The exchange control function expanded significantly because of the new legislation and, in the early years of the period, a scarcity of foreign exchange. The bank inspection function also began to develop in this period, though at a rather more leisurely pace.

Leonard Williams joined the Bank as deputy governor in November 1970. Williams had obtained his first degree in economics from the University of London in 1958 and later obtained his masters from Columbia University. He joined the Economic Planning Division in 1962 after a year of teaching at university in the United States and subsequently worked with the executive secretariat of the Committee on Banking and Currency. He had been slated to come to the Bank's Research Department from his post of senior economist in the ministry of finance. However, he was sent to Washington as Alternate Executive Director in the IMF.

On the board of the Bank, Williams would have met Doddridge Alleyne, who had replaced William Demas as the representative of the planning ministry, George Legall, who had replaced Foster Bissessar who had, in his turn, replaced Frank Rampersad, Wilbert Winchester and John Hunt. Hunt, an accountant, had joined the board in March 1970 and served continuously on it until 1987.

There were several changes on the board in the early 1970s, mainly among the official representatives, until the appointments of Frank Barsotti, as the representative of the planning function, replacing Doddridge Alleyne in 1976, and Ainsworth Harewood as the representative of the finance ministry, who was appointed to the board in May 1973. Apart from a couple of years when he was Alternate Executive Director at the International Monetary Fund, Harewood, who had done his postgraduate work in economics at McGill University, served continuously on the board until 1987. Barsotti, a Cambridge-educated economist who had worked for a time in the private sector, also served continuously until 1986.

A significant appointment was that of Eric St. Cyr in September 1973. St. Cyr, who was Grenada-born, had studied for an external degree at London University after teaching for a number of years at secondary schools. He then went on to Manchester University where he obtained his doctorate in economics under R.J. Ball, who was at the time a noted Keynesian monetary and macro-economist, as well as an econometrician. St. Cyr then joined the staff of the University of the West Indies at St. Augustine. He was the first active academic to be appointed to the board of the Bank and served continuously on it until 1987. He was at the time unique for his strong quantitative skills in statistics and econometrics.

There was therefore considerable stability in the organization at the level of the board which, as in the previous period, included individuals of considerable expertise, experience and competence. It was, however, Victor Bruce's persona and personality which dominated the Bank over this period. His strength was his long years of experience in administration, dealing with politicians, businessmen and technicians at home and abroad. In the turbulent years of international monetary crisis, he was appointed to the Deputies of the Committee of Twenty, the forerunner of the Interim Committee of today and, later on, also became actively involved in the Group of Twenty-Four and in the Latin American and Continental Governors' meetings organized by the Centre for Latin American Monetary Studies.

At home, Bruce was very active in public life. He gave numerous addresses to community organizations and associations on various aspects

of the economy and monetary and financial policy. He was a member of and usually chairman of several government-appointed committees including the Caribbean Aid Council, the Export Awards Committee, the 1981 Fiscal Review Committee, a committee to advise on the type of aircraft to be purchased by the national airline and a committee to examine the problems in the police service. A tall, striking figure, Bruce had the ability to dominate proceedings by his mere presence and bearing. He was a governor's governor.

In my view, the technical capacity of the Bank did not quite keep pace with the rapidly evolving theoretical and institutional context of monetary policy and with the exacting demands of a developing economy in recession and then in boom. Patricia Robinson, who had come to the Bank on secondment from the Ministry of Finance, left as Director of Research in September 1973 and was re-posted to the public service. The systems for research, analysis and policy formulation did not develop quickly enough on the base that had been built in the 1960s and early 1970s, leaving the Bank's management inadequately supported from a technical standpoint, relative to the problems facing the economy. It should be noted, however, that there was a marked improvement in the Bank's economic intelligence and reporting in the 1970s as reflected in the improved quality of its annual reports and its routine statistical and economic publications. The Bank began to publish its statistical data and economic reviews for public consumption in 1970.

Over this period, relationships with the Ministry of Finance were generally quite good, reflecting in part Bruce's excellent political instincts and a very good working relationship with the incumbent ministers with responsibility for finance. Certainly, as well, the Bank had settled down institutionally and its 'turf' was becoming recognized and respected by the finance ministry and the government as a whole.

## **CHAPTER SIX**

# **FROM ACTIVISM TO ACCOMMODATION: MONETARY AND FINANCIAL POLICY IN THE 1970S**

One of the contrasts between the conduct of monetary policy by the Federal Reserve System in the United States and most other countries, particularly those patterned after the Bank of England, is the comparative transparency of Fed policy making. The deliberations of the Federal Open Market Committee are made available to the public shortly after, and the Fed Chairman regularly appears before the House and Senate Banking Committees to explain and rationalize Fed policy. No doubt this is because the Fed is a creature of Congress, whereas the central banks in the British tradition are, to a greater or lesser degree, arms of the executive and are not directly accountable to the Parliament and the people.

The transparency of Fed policy means that it is relatively easy to determine what are the objectives of Federal Reserve monetary policy. For the Central Bank of Trinidad and Tobago one has to rely heavily on statements made in the annual reports and on speeches and other statements made by the Bank's senior management in order to make a determination. In the previous period, it was fairly easy to determine the objectives of the Central Bank's monetary policy and its thinking on policy issues since the annual reports made the objectives reasonably clear and the speeches and statements, particularly by Governor McLeod, were clear in outlining the thinking of the Bank. This was not the case in the second period which spans most of the 1970s.

### *Objectives and Instruments*

A search for a clear and unambiguous statement of policy objectives in this period, especially after 1973, turns up very little, notwithstanding the

highly turbulent international and domestic economic environments. It is as if, as the policy context became more difficult and complex, the Bank became more and more reticent about stating its objectives explicitly.

There were two significant aspects of monetary policy in the 1972–1973 period. First, there was apparently a volte face in respect of the policy stance on credit expansion. In 1971, the Bank was concerned about the slow growth of the economy and the unemployment problem and took the view that the high levels of liquidity then prevailing should be reduced and it therefore sought to encourage credit expansion so as to stimulate economic activity. It was for that reason that the rediscount rate had been lowered to 5 per cent in October 1971, which was followed by reductions in the commercial banks' prime lending rate. Loans and advances rose sharply by 38 per cent in 1972 and liquidity declined. This acceleration in credit expansion proved unacceptable because the incremental credit was being used to finance imports, which were boosted not only by higher import prices but also by the appreciation of the real effective exchange rate. Accordingly, toward the end of 1972, the Bank became increasingly concerned about the rate of expansion of bank credit, particularly commercial credit.

In February 1973, the Bank, noting the rapid expansion of bank credit in the latter half of 1972, raised the reserve requirement from 5 per cent where it had been set in 1966 to 7 per cent, in order to restrict the expansion of credit and to curb the inflationary pressures in the economy. Later in July 1973, the Bank raised the rediscount rate from 5 per cent, where it had been set in October 1971, to 6 per cent in order to assist in curbing inflationary pressures in the economy. The objective of curbing inflationary pressures arose clearly from the sharp increases in import prices which were feeding through to domestic prices and the Bank decided to attempt to address this by restricting demand. In so doing the Bank was mindful of what was happening to the country's foreign exchange reserves which had been falling steadily since the end of 1972, and in the early months of 1973 the Bank was experiencing cash flow difficulties and actively considered accessing lines of credit from foreign banks.

The second feature of monetary policy in the 1972–1973 period is that the Bank seemed to set itself no objective in respect of the exchange rate. There were several reasons for this. First, the Bank was indeed concerned when sterling began to float in June 1972, as were all the other CARIFTA countries. However, it accepted the view that a fixed parity for sterling would be restored before long and may have been influenced in this view by the British, who sent around a mission to the Sterling Area

requesting that the Basle Facility, which was due to expire, be extended. Second, any initiative in respect of exchange rate adjustment lay, not with the Bank, but with the Ministry of Finance and the Bank could do no more than advise, cajole, dissuade or persuade as appropriate.<sup>1</sup>

In January 1973, after considerable speculation in the Caribbean and in Trinidad and Tobago on the possibility of a devaluation, Jamaica, acting with a boldness born of difficult circumstances, severed ties with sterling and pegged to the US dollar. The Central Bank of Trinidad and Tobago was apparently also of the view that the sterling peg was no longer viable, but was unable to persuade the Ministry of Finance, whose thinking on the subject was apparently dominated by a concern to maintain income from sterling sources. The Bank was therefore forced to rely on credit policy to protect the dwindling reserves, rather than use of the exchange rate.

The increases in oil prices and in oil production and exports served to break simultaneously the saving and foreign exchange constraints. The rate of growth of the money supply (M-2) rose from 16.1 per cent per annum in the 1971-1973 period to 29.4 per cent per annum in the 1974-1979 period. Inflation moderated somewhat after 1974, as the price level displacement effects of rising import prices were replaced by demand-side pressures on the price level. The Bank defined for itself the vague objective of attempting 'to mitigate the inflationary effects of the increase in the money supply due to increased revenue mainly from the petroleum sector'.<sup>2</sup> It was in that context that the Bank raised the reserve requirement again in November 1974 to 9 per cent.

There is no other statement of the Bank's monetary policy objectives until the 1977 Annual Report where, apparently uncomfortable with its silence on the matter, it is stated:

The thrust of monetary and credit policy over the last several years has been to ensure an adequate growth in the money supply and the allocation of credit in such a way as to satisfy the needs of the productive sectors of the economy in the first instance as a priority compared to consumer credit requirements.<sup>3</sup>

Several observations on this statement are in order. First, it has a ring of ex post rationalization and, given the context, is rather unconvincing as a policy objective. Second, it suggests that the rate of growth of the monetary aggregates was not perceived to be a problem in and of itself, notwithstanding the fact that the rate of growth of the money supply (M-2) over the 1974-1977 period was 30.3 per cent per annum, and inflation was running at double digit levels, even with extensive price subsidies. Third, it suggests that the primary objective of policy was to achieve an allocation

of credit more favourable to the 'productive sectors' of the economy. The 1977 Annual Report also suggests that the Bank employed moral suasion to attempt to achieve its credit allocation objective.

The assessment and critique of monetary policy will focus on the three central policy issues at the time: (i) stabilization, (ii) exchange rate policy, and (iii) selective credit controls.

### *Stabilization*

The analysis of stabilization policy ranges over three (3) sub-periods. In the first sub-period, 1972-1973, the economy is still in difficulty and the balance of payments is in crisis. The second sub-period, 1974-1975, is characterized by caution and conservatism on the part of the fiscal authorities. The last sub-period, 1976-1979, saw a burgeoning of expenditures in both the public and private sectors. The response of the monetary authorities in each of these sub-periods would have had to have been different.

In the 1972-1973 sub-period, the economy was in recession and experiencing considerable balance of payments difficulties reflected in dwindling foreign exchange reserves. The exchange control system was still fledgling and did not exercise any control over visible imports, nor did the licensing system extend over a sufficiently wide range of visible imports to make import restriction a feasible instrument of balance of payments management.

In such a context, monetary policy ought to have been restrictive, seeking to limit credit expansion and to drive interest rates up with a view to restraining aggregate demand and the demand for imports. However, the Bank's approach to policy was then dominated by 'developmentalist' thinking, so that the Bank in late 1971 reduced the rediscount rate to 5 per cent to encourage credit expansion, and was concerned to expand credit to local business until the latter half of 1972 when it became clear that the expansion of credit was impacting adversely on the foreign exchange reserves position.

When the Bank did move in 1973, the actions were sufficiently bold and decisive. Even so, it was in the nature of a rearguard action since the ministry of finance was refusing to budge on the question of the sterling peg, although it had moved to increase purchase taxes so as to dampen demand in the economy. Interest rates rose sharply during 1973. The weighted average rate on loans rose from 8.18 per cent at year-end 1972 to 10.26 per cent by the end of 1973 while average deposit rates rose from 3.59 per cent to 6.52 per cent. The rate of expansion of bank credit slowed

under the impact of the measures. Loans and advances rose by 15.1 per cent in the first half of 1973 but slowed to 9.2 per cent in the second half as the measures took effect. The deceleration in the rate of credit expansion would certainly have contributed to the stabilization of the reserves situation in the latter half of 1973.

The period 1974-1975 marks a different phase in the evolution of stabilization policy. The net foreign assets of the banking system rose sharply from \$78.1 million at year-end 1973 to \$776.7 million in 1974, and further to \$1,722.9 million in 1975. The stock of base money (M-0) rose by 26.4 per cent between 1973 and 1974, but there was quasi-automatic sterilization of part of the reserves inflow because of conservative fiscal policy and the narrow money supply grew by just 5 per cent while broad money increased by 16.9 per cent. Commercial bank credit (loans and advances) grew by 6.2 per cent and liquidity improved substantially.

The move to increase the reserve requirement further to 9 per cent in November 1974 was also appropriate. Inflation had accelerated to 22 per cent in 1974 as import prices rose and wages also increased. An accommodating posture for monetary policy would almost certainly have fuelled a virulent demand-pull inflation given the increased financial resources available to finance demand in the economy. Notwithstanding the increase in the reserve requirement to 9 per cent, M-1 grew by 48.4 per cent in 1975 while M-2 rose by 35.5 per cent, on the strength of a doubling of the monetary base.

On the basis of these data, the stance of monetary policy might have been to tighten further. Yet the Bank took no action to restrict further the rate of growth of the money supply and credit expansion until 1980. What explains this curious inaction? Admittedly, other economic variables indicated a strengthening of economic performance. The balance of payments was in surplus and reserves were accumulating rapidly, notwithstanding the growth of imports. The economy was growing at a fairly healthy clip and the government was enjoying fiscal surpluses. Such propitious signs would have made irresistible the inclination to become relaxed about the stance of monetary and fiscal policy.

It is possible that the Bank was lulled into inaction by the apparent progress on the inflation front. The rate of increase of prices, as measured by the Retail Price Index moderated after the 22 per cent increase in 1974, to 17 per cent in 1975, and 10-11 per cent over the 1976/1978 period. There was also a view that the problem of inflation could be handled by supply-side policies, i.e. increasing the domestic production of goods and services.<sup>4</sup>

But it would have been appropriate for the Bank to have been monitoring as well other price indices since the retail prices index was likely to be misleading on account of the increasing subsidies given to a wide range of items especially basic food items which loomed large in the weighting scheme of the index.

Wages began to rise appreciably. Real Average Weekly Earnings rose at 7.6 per cent per annum over the 1975/1979 period compared with -3.0 per cent per annum over the 1971/1974 period. The GDP deflator, though having serious measurement problems arising from the method of construction of certain sectoral deflators, rose at an average annual rate of 21.8 per cent over 1973 to 1979, and gives some indication of the acceleration of factor costs. Construction costs and real estate prices soared especially toward the end of the decade. The 1978 budget speech illustrated graphically what was taking place in respect of the cost of land and houses. Between 1973 and 1977 increases in real estate prices ranged from 200 per cent to 450 per cent. In 1972 labour costs as a proportion of total construction cost was 34 per cent, by 1977 this had risen to 55 per cent owing to a more than doubling of the wages of both skilled and unskilled labour. The movements in the Retail Prices Index were therefore, probably a poor indicator of inflationary pressures in the economy at the time. Indeed it was important for the monetary authorities to have appreciated that the sources of inflationary pressure in the 1971/1974 period and the 1975/1979 period were different, and that while little could be done to prevent import price increases from driving domestic prices up, the demand-pull inflation fuelled by excessive monetary growth could be addressed by a sufficiently bold monetary policy.

The inaction of the Bank after 1974 probably has a more mundane explanation. We have already noted in the previous chapter the government's determination to be the 'prime mover' in the economy. The petrodollar windfall gave it the resources with which to play this role, but it had to be convinced that the higher level of resources would be sustained. The fact that oil prices continued to rise helped to entrench the expectation that they would remain high for the foreseeable future. Successive budget speeches over the 1975/1979 period ritualistically observed that oil prices could fall and then proceeded to increase expenditures or increase subsidies or grant further tax concessions. Higher levels of government expenditure could therefore more easily be justified, given those expectations. Nor would it be unimportant or irrelevant to note that 1976 was an election year. Second, there were considerable pressures building politically for the government to spend at a faster rate. The economic and social infrastructure was in need of considerable enhancement and refurbishing and there

was a perceived need to protect the poorer groups from the ravages of inflation while expanding opportunities for small and medium-sized business activity.

The Special Funds device was created initially to save a substantial proportion of the windfall earnings from higher oil prices and production. The appropriation to the Special Funds, which was mysteriously taken to be 'expenditure', soon became a larder to be raided by ministries anxious to get on with their expenditures. Even the Ministry of Finance seems to have lost control of the expenditure process in these years. By the end of the decade, the Special Funds were no more than a convenient fiction which took supplementary budgetary appropriations out of the reach of parliamentary scrutiny.

The 1979 budget speech outlined the cost of the various benefits to the lower income groups in various fiscal measures over the 1973/1978 period. These totalled an estimated \$714 million and ranged over subsidies on several food items (wheat, rice, edible oils, poultry feeds etc.) and subsidies on cement and gasoline, public assistance, mortgage interest subsidy, food stamps, income tax rebates and other benefits.

Could the Central Bank have dared in that kind of fiscal climate to 'lean against the wind' by instituting tighter monetary policies to offset expansionary fiscal policy? Governor Bruce provided the following explanation:

The authorities were satisfied that measures adopted since 1973 - monetary and fiscal - had worked satisfactorily to contain demand pressures but were convinced that further use of similar measures - rising reserve requirements and tightening consumer credit conditions - was not in the long term interest of the economy since considerable adverse welfare effects - unemployment etc. - could result from the intensification of these measures.<sup>5</sup>

The Bank, it would appear, simply accommodated itself to the state of affairs and sat on its hands, while convincing itself that it should be re-directing its focus from the rate of expansion of bank credit and aggregate demand to the allocation of credit as between production and consumption based on the argument that monetary policy should support increased domestic supplies of goods and services.

### *Exchange Rate Policy*

When Trinidad and Tobago eventually severed the sterling parity on 28 May 1976 and pegged to the US dollar, it was among the last of the Sterling

Area countries so to do. Jamaica had severed the link with sterling in January 1973, Barbados in July 1975 and Guyana in October 1975. Moreover, the Basle Facility arrangements had ended in December 1974, allowing the Bank to undertake the diversification of its reserves portfolio. Why did the monetary authorities take so long to change pegs?

The difficulties with sterling had begun in the mid-1960s. The devaluation of the pound in 1967, the closing of the gold window in August 1971, the Smithsonian agreement of December 1971, the flotation of the pound sterling in June 1972, and finally generalized floating in March 1973 constituted a sequence of events which seemed to point to an inevitable re-alignment of forces in the international monetary scene, a re-alignment in which sterling would be relegated from a major reserve currency to a minor reserve currency and in which it would be increasingly important to explore ways of minimizing fluctuations in the exchange rates of reserve currencies in domestic economies. The choice of peg, and the concept of the effective exchange rate became of crucial importance in macro-economic management.

The importance of the United Kingdom in Trinidad and Tobago's trade and payments had been declining rapidly since the 1960s. In the early 1970s the United Kingdom accounted for less than 10 per cent of total merchandise imports (adjusted) and about 5 per cent of total merchandise exports (adjusted). While these percentages probably understate the importance of sterling in payments flows, it is certainly the case that by the early 1970s, the external transactions of Trinidad and Tobago were dominated by the United States. It can be argued that variations in income from sterling sources, essentially exports of sugar and other agricultural commodities, would have a greater social impact given the large percentage of the labour force than employed in and dependent on those industries. Indeed this was one of the major planks in the argument advanced in favour of the 1967 devaluation of the Trinidad and Tobago dollar with sterling.<sup>6</sup> This argument wore increasingly thin with the passage of time and, in any event, it can be argued that it represents a failure to effect the necessary adjustments in the structure of production and exports and seeks to delay the adverse impact of such adjustment.

In the period 1970/1973 there was a marginal appreciation of the nominal US dollar exchange rate of about 2 per cent, although the appreciation in real terms would have been much greater given the rate of increase of domestic prices relative to the prices of trading partners. This appreciation would certainly have contributed to the worsening of the balance of payments over that period and was due to the depreciation of the

US dollar relative to sterling in that period and, of course, domestic price performance.

In the 1973/1976 period, there was a substantial depreciation of sterling. The Trinidad and Tobago dollar value of the US dollar went from \$2.07 at year end to \$2.37 at the end of 1975 and to \$2.75 in May 1976, a depreciation (in US dollar terms) of 24.4 per cent. This rate of depreciation helped to drive domestic prices up further and the instability of the exchange rates in terms of currencies in which the majority of transactions were dominated would have had an adverse effect on business activity and expectations. Indeed these very arguments were put forward by way of explaining the switch to the dollar peg in the 1977 budget speech. The Minister of Finance (Eric Williams), after opining that sterling was unlikely to show any improvements, stated:-

It is clear that had Trinidad and Tobago continued to float with the UK pound we would have been faced with escalating rates of inflation [which] would have had a severe impact in the cost of living and would have created hardships on the consuming public. Equally important is the fact that the instability and uncertainties caused by the continuing fluctuation in the value of the Trinidad and Tobago dollar have now been eliminated by the fixing of the parity. Therefore, it is expected that investment planning can proceed more smoothly during 1977 in an atmosphere of greater certainty and stability.<sup>7</sup>

The long delay in arriving at the conclusion that sterling was dead as reserve currency may be explained perhaps in terms of the 'functional dependence' of the political directorate or the poor diagnostic and prediction capabilities of the technocrats at the Bank and the Ministry of Finance. It has already been noted that as early as 1973, the Bank and the Ministry of Finance had parted company on the question of the appropriate peg. This suggests that the answer to the conundrum lies in the political judgments made at the time. It is likely that the political directorate found the idea of the crippling of the sugar industry too difficult to contemplate, let alone to effect by a means so simple as a switch of exchange rate peg. Support for this judgment on the importance of the sugar industry comes from Victor Bruce who wrote:-

The bulk of our exports go to the United States and in fact since 1974 only about 5 per cent or less has been going to the United Kingdom. There is, however, an important sector of which a large proportion of output still goes to the United Kingdom, sugar, and this is responsible for a high level of employment in the country.<sup>8</sup>

When the petrodollar resources began to flow, however, the extensive and politically necessary subsidisation of the sugar industry became feasible and it was therefore easier to effect the long overdue switch to a dollar peg.

It has been suggested that this was not the real explanation for the delay. Rather it was because of the aversion of the political directorate to changing the parity but also because some technicians thought that pegging to a weak currency would be strategically better, if the country were pursuing an export-led development strategy. Further, the amount of trade denominated in the peg currency is largely irrelevant to the choice of peg.<sup>9</sup> We agree that the political directorate was averse to changing the parity and that any change was a traumatic event, but it is also clear that a change had to be made and this was recognized and acted upon by other, equally averse Caribbean governments. The notion of the pursuit of an export-led strategy in the mid-1970s cannot be embraced with conviction since this was the hey-day of the statist approach to economic development in which import substitution was key, with an unwelcoming posture to foreign investment. Finally, the proportion of trade transacted with the peg currency country is of great importance to the choice of peg decision since an important reason for choosing a peg is to minimise fluctuations in the nominal effective exchange rate and the greater the share of the peg currency country trade in total trade, the smaller the fluctuations, *ceteris paribus*.<sup>10</sup>

### *Selective Credit Controls*

The monetary authorities, particularly the technocrats at the ministries of finance and planning, had been concerned from the very outset of central banking that the Bank should seek to influence directly the allocation of credit by the banking system. This was consistent with developmentalist thinking that interest rates should be kept low so as to encourage investment expenditure, but that low interest rates would also encourage consumption and imports unless this was prevented administratively. Note that the Bank in the 1960s elected not to employ direct selective credit controls, although it did get the chamber of commerce to publish a code specifying instalment credit terms. There were, however, regular breaches of the code.

In March 1973 the Bank introduced a set of guidelines in respect of instalment credit in order to curb its growth. The guidelines specified the minimum downpayment and maximum repayment for loans for furniture, motor cars and other consumer durables. The basic difficulties with the guidelines were that (i) they could be enforceable only in respect of the commercial banks, although other institutions, which were not under the

Bank's regulatory control, also extended instalment credit for consumption purposes, and (ii) bank lending to firms in the retail sector could be channelled into hire purchase loans by those firms themselves, which had only the chamber of commerce code and the Bank's moral suasion to influence them.

Although it has been suggested that moral suasion was employed in the 1973/1979 period to influence the allocation of credit as between consumption and production, the evidence indicates that it was not successful. The share of non-business loans in total loans rose from 30.7 per cent at year-end 1973 to 46.7 per cent at year-end 1976, before declining somewhat to 41 per cent at the end of 1979. In other words, non-business lending absorbed 44 per cent of total incremental bank lending over the 1973/1979 period.

Finally, in 1979, the Bank moved to introduce a selective credit control guideline which restricted incremental lending for non-business purposes to 30 per cent with a base date of 30 September 1979. The operation and efficacy of this measure is examined later on.

As reported in Chapter Three, the Bank had moved in February 1970 to introduce a selective credit control in respect of non-resident borrowing from the banking system. At the time the measure was introduced, non-resident borrowing constituted about 20 per cent of total loans and advances. The ceiling on loans to 'regulated borrowers' was increased several times in the early 1970s and modifications were introduced to accommodate CARICOM businesses. Indeed, in May 1972, the allowable ceiling was increased by 20 per cent to encourage banks to reduce their excess liquidity. Over the period, however, the share of non-resident borrowing in total bank lending declined, largely because of the rapid expansion of lending to local businesses and individuals and also because of the disappearance or reduced activity of foreign enterprises in the face of government's less welcoming posture to foreign investors.

### *Assessment and Critique of Monetary Policy*

In my view the Bank's approach to monetary policy in the 1972/1973 sub-period was appropriate to the circumstances. It recognized, albeit late, that the credit expansion of 1971/1972 had to be checked in order to stem the loss of foreign exchange reserves and when it did act between February and July 1973, its actions were decisive and its choice of instruments correct. Especially important was its preparedness to see interest rates rise sharply as a means of restraining demand.

The turnaround in the fortunes of the economy after 1974 posed policy problems which were just as large as the recession and balance of payments crisis of the earlier period. The Bank correctly identified inflation control as a major policy objective. It should have inclined naturally to credit restraint as the appropriate policy in the circumstances if it were fully appreciated that the inflation in the 1974/1979 period was being driven by wage-pushfulness and demand-side pressures from an expansionary fiscal policy. The increase in the reserve requirement to 9 per cent in November 1974 was largely reflective of a desire to do something positive and meaningful, but in the event became a token gesture.

The Bank was persuaded, or persuaded itself, that inflation control could be achieved by stimulating supply. This approach to the objective foundered on several grounds. First, it took the issue of control largely out of the hands of the Bank, except for the influence of its selective credit controls, and placed it in the responsiveness of the private sector and the state enterprise sector to the subsidies and incentives enmeshed by fiscal policy. However, the disincentive effects of industrial unrest and rising real wages and an appreciating real effective exchange rate after 1976 proved more powerful and the key sectors which would have vindicated the supply strategy – agriculture and manufacturing – languished amidst a rising tide of imports.

Second, the mix of economic activity encouraged was inappropriate to the objective of inflation control. Preparation of a fourth five-year plan was shelved in favour of a development strategy which focussed almost exclusively on the energy-based industries, which were all export-oriented, and the infrastructure required to support them. Little or no emphasis was placed on agriculture, small-scale manufacturing and services. Production of non-wage goods was encouraged while wage goods were increasingly supplied by imports which further entrenched foreign taste patterns and would make downward adjustment all the more difficult.

The inertia of monetary policy after 1974 reflects an accommodation to the government's development strategy which must be questioned. The Bank should have appreciated that the balance of payments situation was delicately poised and that first priority should have been given to the accumulation of reserves. In a context of high unemployment, there were risks in pursuing a tight money policy, with the attendant high interest rates, in order to maximize reserve accumulation, based on a view that the higher oil prices could not be sustained. Such a stand by the Bank would almost certainly have been unacceptable to the political directorate, especially after 1975, but it would have been the correct approach to take from the policy view point.

This raises three issues: the forecasting capabilities of the Bank, the extent of its independence, and its involvement in the formulation of development strategy. The Bank did not have in the 1970s the capacity to make independent forecasts of likely developments in the international petroleum industry although it would have had access to the forecasts of the International Monetary Fund, the World Bank and other international agencies. Most of the projections at the time suggested that prices would have continued rising, and the Bank cannot be judged harshly for accepting those projections.

It can be argued, however, that taking a medium-term perspective and seeing the evidence that the sterilization effect of the special funds mechanism was breaking down, leading to high excess liquidity and rapid growth of money and credit, and seeing as well that inflation was still double-digit, the Bank should have moved by 1976 or 1977 to tighten credit and lean against the wind that was blowing into a gale of profligacy. It is rare that central bank governors survive such a posture of independence unless (as with Paul Volcker a few years later or the President of the Bundesbank) the constitution of the central bank protects the governor from the political directorate. In the British tradition, the governor must seek to persuade and, if unsuccessful, he must resign and hope thereby that public awareness of the inappropriateness of fiscal policy would be heightened. The Bank, however, seemed to acquiesce in the thrust of fiscal policy and hoped that the supply-side responses would be forthcoming to bring inflation under control. It can be argued that the Bank should have had a role in the formulation of the development strategy, though given the enthusiasm with which the energy-based strategy was apparently embraced by the Bank, this would not have made any difference.<sup>11</sup>

The Bank's selective credit controls, which were intended to encourage supply, were completely inadequate. It has already been noted that non-business loans rose as a proportion of total loans over the period, notwithstanding the Bank's moral suasion. Selective credit control also carried within it a serious contradiction. The business activity it intended to stimulate was import substituting industry which, by and large, produced consumer goods for the domestic market and which had a high import content. To the extent that loans to business were encouraged, imports were increased indirectly. Moreover, these were intermediate imports and when it would become necessary later on to bring the level of imports down, it would prove extremely difficult because of the rigidity of the structure of imports and the fact that employment would be threatened if these imports were cut drastically.

Exchange rate policy over the 1972/1976 period also in my view evidences the primacy of political considerations over purely technical economic considerations. Only domestic political factors can adequately explain the long delay in switching from the sterling peg to the US dollar peg. The choice of the parity sought to balance the adverse price level effect of a low exchange rate, with developmental considerations which suggested that a low rate would encourage exports and improve the balance of payments. The rate actually chosen (TT\$2.40/US\$1) was an inelegant compromise. It represented a revaluation compared to where the rate had been just prior to the switch of pegs and a devaluation relative to the US dollar rate of the 1970/1974 period. The strong balance of payments performance in the post-1974 period, if anything, engendered pressures for a revaluation of the US dollar exchange rate, which the Bank correctly ignored. It would have been more important for the Bank to pay attention to the real effective exchange rate as an indicator of competitiveness but this measure was at the time not yet in vogue, although the theoretical concept was already abroad in academic and other circles.

### *Financial Policy*

The major activity in the area of financial policy in the 1972/1979 period was the localization of the commercial banking industry. The impetus for this process had actually started in the 1960s and reference to the localization of decision-making can be found in the Second Five Year Plan and the Third Five Year Plan. At that time it was felt that local ownership and control were critically important to ensuring that the decisions of the private sector were in the best interests of the national community. It was also felt that the banking and finance industry was central to the development effort and therefore it was an appropriate place to begin the localization process. The government was perhaps emboldened by the judgment that the knowledge and skills required to run a bank or insurance company successfully were by no means beyond the grasp of nationals.

The social unrest of 1970 forced the government to quicken the pace of local participation in the economy and in the banking industry. The National Commercial Bank (NCB) was formed in 1970 and took over the assets and undertakings of the Bank of London and Montreal (BOLAM) to create the first locally-owned commercial bank. This was followed by the formation of the Workers' Bank in November 1971 by the trade union movement, but with significant government financial support and encouragement. While the NCB was fortunate to have acquired personnel and systems with the acquisition of BOLAM, the Workers Bank was literally

starting from scratch. Both lacked a network of foreign correspondents, although NCB, partly because of the BOLAM connections, built up such a network, while the foreign exchange business of the Workers' Bank remained rudimentary. Later on in 1976, the Trinidad Co-operative Bank was granted a commercial banking licence.

By the end of 1973, Royal Bank, Bank of Nova Scotia and Barclays had incorporated locally and sold some of their shareholding to locals. These banks made further sales of shares on the local market over the 1975/1978 period. The Bank of Commerce (CIBC) localized in 1980. In order to reinforce and accelerate the process of localization, the Minister of Finance, who at the time was George Chambers, announced in the 1974 budget speech that foreign banks would be required to hold ascribed capital of not less than 5 per cent of their deposit liabilities and, except for special circumstances, majority-owned foreign banks would not be allowed to extend their branch network.

Localization was resisted by the two American banks - Citibank and Chase Manhattan. The latter eventually sold out its business to NCB while Citibank undertook to localize its operations. This came after both banks failed to meet the Finance Ministry's stipulation that they localize their operations by 31 December 1980. They were given conditional licences from 1 January 1981 and their deposit base was frozen and was to be reduced by 8 per cent per month so that by the end of December 1981 they would have had no deposits. In the face of this tough stand, the American banks had little choice, either to stay and localize, or to leave.

In the latter half of the 1970s, emanating largely from the initiative of the symposium of the Mobilization of Domestic Financial Resources held in 1976, a number of institution-building initiatives were started by the monetary authorities. These involved the creation of a unit trust, a stock exchange and attendant securities industry legislation, a secondary mortgage market institution, and a national re-insurance company, among others. Another attempt at company law reform was also started toward the end of the decade, which eventually proved abortive as was the first attempt in the late 1960s. These initiatives came to fruition in the later 1970s and early 1980s and in the next chapter their development and impact in a period of structural adjustment will be reviewed.

In Chapter Five the proliferation of non-bank financial institutions during the 1970s offering trustee services, mortgage financing, instalment credit and other loan facilities was fully described. These institutions were not subject to any licensing or supervision or regulation. By 1978, there were 12 finance companies and 7 trust and mortgage finance companies,

compared with 3 finance companies and 4 trust and mortgage finance companies in 1973. It was necessary to bring these institutions under control since they were becoming significant mobilizers of deposits, particularly in the boom conditions after 1975 and their operations subverted the Bank's monetary policies, such as they were.

In December 1979, the Financial Institutions (Non-Banking) Act was passed. However, the regulations to the Act were not available until May 1981, at which time the Act was proclaimed and came into force. Important features of the legislation were the restrictions placed on the taking of deposits, the making of loans and undertaking foreign exchange business which clearly separated the NFIs from the banks. These institutions and the adequacy or otherwise of the legislative basis under which they were operating became critical issues for policy in the next decade.

## CHAPTER SEVEN

# THE PROBLEM OF ADJUSTMENT AND THE APPROACH FOR A SOFT LANDING

### *Introduction*

The 1970s had begun with growing economic difficulties and social unrest which by 1973 had deepened to a profound crisis reflected in the near exhaustion of foreign exchange reserves. The decade ended in an unprecedented boom, if one is willing to ignore the prodromes of 1979 which took the form of small fiscal and current account deficits. The decade of the 1980s was the (reverse) mirror image of the 1970s. It began in boom conditions with social tensions at perhaps an all time low as the unemployment rate fell to its lowest level since the 1950s and has ended with the economy at a nadir after a prolonged slump and with considerable social and political tension.

For the political directorate and the monetary authorities, this decade has proved to be a stern test of their mettle. The situation has demanded superior technical capacity and foresight and boldness and skill in the use of the instruments of policy. This chapter traces the evolution of the economy over the 1980-1986 period and the design of the stabilization and adjustment programmes, with only brief consideration of institutional developments and theoretical issues, since it is the economic context, domestic and international, which is the major determinant of policy in this period.

### *Socio-Economic Developments*

In the period 1975-1978, the government and the society as a whole became increasingly emboldened in their expenditures as expectations that

oil prices would remain high became entrenched. There were doubts, however, and in the absence of a long-term development plan the government employed the device of the ad hoc committee to examine and report on areas of specific concern. A committee led by Euric Bobb, newly appointed Deputy Governor of the Bank and a fiscal expert, was appointed in 1978 to report on government expenditure which was already threatening to get out of control.<sup>1</sup> The Report noted that over the 1973–1977 period there had been a shift toward capital expenditure as about 50 per cent of incremental expenditure over the period had been directed to capital formation or asset acquisitions with the share of capital expenditure rising from 19 per cent in 1973 to 42 per cent in 1987. However, there had also been an increase in ‘welfare’ expenditures such as old age pensions, social assistance, school feeding, food subsidies, etc., as well as low tariffs for the various public utilities – public transportation, water – which meant large transfers to these entities.

The Committee pointed out in its report that the pattern and rate of growth of government expenditures were unsustainable, especially as oil prices could not be expected to continue rising and oil production seemed to have peaked. The Committee recommended that new welfare programmes should not be adopted and the real value of existing programmes be maintained. Further, it suggested that there be a moratorium on further tax reduction from the 1979 fiscal year and that the scope for additional taxation and higher utility tariffs should be examined.<sup>2</sup> The fiscal and

TABLE 7.1: SOCIO-ECONOMIC INDICATORS, 1980–1986

	1980	1981	1982	1983	1984	1985	1986
Growth of Real GDP (1970 prices)	10.4	4.6	4.0	-9.2	-6.0	-4.5	-3.3
Growth of Real GDP of Non-Oil Sector	12.4	7.2	4.5	-9.1	-8.8	-8.1	-3.0
Unemployment Rate (%)	9.9	10.5	9.9	11.1	13.3	15.7	17.2
Inflation Rate	17.5	14.3	11.4	16.7	13.3	7.7	7.7
Current Account Deficit/GDP (%)	7.6	5.8	-8.4	-13.2	-7.1	-1.5	-13.2
Foreign Exchange Reserves (US\$m)	2,640.3	3,203.0	2,983.4	2,082.7	1,187.5	994.4	330.7
Fiscal Deficit or Surplus/GDP (%)	2.4	0.02	-14.4	-13.1	-11.9	-7.5	-8.0

SOURCE: Central Bank, Research Department, Handbook of Key Economic Statistics 1989; Annual Economic Survey, 1988.

balance of payments out-turns for 1979 served to confirm the fears and concerns of the Committee. However, in late 1979, oil prices were again hiked by OPEC from about US\$14.50 in 1978 to almost US\$22 for Trinidad and Tobago's export crude and up again to US\$36 in 1980. With this development, any notion of restraint went by the board and expenditures in both the public and private sectors continued their upward march as the new decade began.

In absolute terms, the increase in oil prices between 1979 and 1980 was greater than the increase between 1973 and 1974 but the increases could not be sustained, largely because the long-run elasticity of demand for oil proved to be much greater than the short-run elasticity which was near zero and, as a result, the increase in oil prices in the second oil price shock was relatively short-lived. Oil prices peaked in 1982 when the price of the marker crude at that time (Saudi Arabian Light) was at US\$34 per barrel. Trinidad and Tobago's average export price peaked at almost US\$40 in 1981 before falling to US\$36 in 1982 and US\$30.70 in 1983. Oil production and exports had been falling since 1979 and by 1983 oil production of 159.8 thousand bpd was 30 per cent lower than in 1978, while oil exports were 36 per cent lower. Lower prices and production combined to

TABLE 7.2: OIL PRICES, OIL REVENUES AND OIL EXPORTS

	(1) Oil Prices <sup>1</sup> (US\$/b)	(2) Oil Production ( <sup>0</sup> 000 bpd)	(3) Government Oil Revenues (\$M)	(4) Total Revenues (\$M)	(5) (3)/(4) (%)	(6) Oil Exports (\$M)	(7) Total Exports (\$M)	(8) (6)/(7) (%)
1980	36.00	212.0	4,136.5	6,202.4	66.7	3,924.2	6,614.8	59.3
1981	39.61	189.3	4,253.0	6,818.6	62.3	3,869.6	6,336.3	61.1
1982	36.00	177.0	3,274.2	6,824.7	48.0	2,679.2	5,561.6	48.2
1983	30.70	159.8	2,461.4	6,438.8	38.2	2,638.6	5,632.1	46.8
1984	30.00	169.1	2,759.7	6,548.4	42.1	2,293.0	5,216.2	43.9
1985	28.90	176.3	2,457.1	6,361.2	38.6	2,450.3	5,247.1	46.7
1986	15.64	168.9	1,690.6	5,234.6	32.3	1,986.5	4,988.6	39.8

SOURCE: Central Bank of Trinidad and Tobago, Handbook of Key Economic Statistics, 1989.  
<sup>1</sup>Estimated Export prices of Trinidad and Tobago Crude.

impact adversely the fiscal accounts and the balance of payments from 1982 (Table 7.2).

Although the oil sector was contracting, the non-oil economy continued to experience growth for some time on account of the sustained high

levels of government expenditure. As a result, unemployment continued to fall up to 1982 when it reached 9.9 per cent. In Port of Spain the unemployment rate was just 3.9 per cent in 1982, reflecting a state of full or near-full employment, although in rural areas such as Nariva-Mayaro the unemployment rate remained double-digit throughout the boom period and was as high as 18 per cent in 1982.

The industrial relations climate was perhaps better than at any other time in the country's post-Independence history. High rates of profit made employers pliant and they could pass on the generous wage increases easily in a situation of buoyant demand. The public service unions negotiated wage increases ranging from 62 per cent for the higher ranges to 86 per cent for the lower ranges for the period 1981-1983, and in 1982 alone, the wage bill of the Central Government rose by 121.2 per cent owing to payment of wage increases retroactive to 1981. Sugar workers obtained wage increases for the 1980-1982 period of 94 per cent. Bus workers won wage increases totalling 48 per cent over three years while telephone company workers won wage increases of 65 per cent for the period 1981-1983. Over the 1980-1984 period, average weekly earnings were rising at 17.8 per cent per annum. However, real average weekly earnings rose at 3.4 per cent per annum over the 1980-1984 period owing to the high inflation rate (14 per cent per annum) over that period.

Demand-side pressures intensified as consumption expenditures rose by 20 per cent in 1980, 19 per cent in 1981 and 47 per cent in 1982, fuelling significant inflation of 17.5 per cent in 1980, 14.3 per cent in 1981, 11.4 per cent in 1982 and 16.7 per cent in 1983.

In 1982, the country's foreign exchange reserves fell for the first time since 1973 albeit by only 6.9 per cent or US\$218.6 million. However, this concealed a substantial current account deficit of US\$673.2 million or 8.4 per cent of GDP. A capital account surplus of US\$406.3 million helped to offset in part the current account deficit. A current account deficit of such a magnitude could not be ignored, especially as capital inflows to finance such large deficits could not be assured and in any event would imply a rapid accumulation of external debt.

Not unexpectedly, a substantial deficit also emerged in the fiscal accounts in 1982 as expenditure jumped, due largely to the impact of the wage increases granted to the public service but also due to a 12.7 per cent increase in capital expenditure. Recurrent expenditure rose by 68.7 per cent as the wage and salaries component more than doubled. This massive increase in the wage and salary bill of the central government would return to haunt the policy makers as they struggled with the adjustment process in

the latter half of the decade. The fiscal deficit in 1982 amounted to 14.4 per cent of GDP. Yet even a deficit of such great size could be viewed as only prodromal since it was easily financed by a combination of external borrowing and the drawdown of accumulated surpluses. Both these forms of financing were finite, the former for reasons we explore in the next section and the latter because the accumulated cash balances of the Government were finite, amounting to an estimated \$5,510 million at the end of 1981.<sup>3</sup> If large deficits continued to be incurred, there would inevitably come the time when, given the capacity of the domestic capital market, resort might have to be had to money creation through the Central Bank.

By 1983, the economy had lost all forward momentum and actually began to contract with real GDP declining in both the oil and non-oil sectors. It was the first time that the economy had actually contracted in real terms in the post-war period and the declines have continued up to the present time (1989). There was a consequential rise in the unemployment rate which reached 17.2 per cent in 1986 and is estimated to have risen to over 22 per cent in 1987 and 1988, the highest levels of unemployment on record. By the same token, as the economy contracted, aggregate demand declined and inflationary pressures abated. The inflation rate fell to single digit levels in 1985 and 1986 for the first time since 1972.

Trinidad and Tobago found it relatively easy to borrow on international capital markets in the first half of the decade. Its reserves position, though declining, was still perceived to be strong and its debt servicing capacity was judged to be large, on account of its low debt service ratios in those years. Three significant features of the external borrowing programme may be noted here. First, a significant proportion of the borrowing was done on a floating rate basis at a time when interest rates were high and volatile (see Section 4 below). Second, increasing resort was had to the Japanese private placement bond market which largely obviated the problem of floating interest rates owing to the comparative stability of Japanese interest rates, but raised the degree of exchange rate risk. Third, access to the international capital market by state enterprises and public utilities was not tightly co-ordinated or controlled and, as a consequence, government-guaranteed debt increased quite rapidly, accounting by the middle of the decade for almost half of the total public sector external debt.

In the late 1970s and in the early 1980s the energy-based projects which had been planned in the 1970s began to come on stream. The TRINGEN I ammonia plant had come on stream in October 1977. It was followed by the iron and steel project in 1980, the FERTRIN ammonia

plants in 1981 and 1982, and the urea and methanol plants in 1984. These projects cost about US\$1,200 million and all had high debt equity ratios. They were intended to (i) utilize the country's substantial resources of natural gas; (ii) diversify the export base and sources of foreign exchange earnings and thus provide a cushion for any fall in earnings from the petroleum industry; and (iii) contribute to the development of the manufacturing sector and other industries as activities downstream of these projects developed.

Conceived and implemented at a time when oil prices were high and projected to rise continuously to the end of the decade, these energy-based industries came on-stream in the midst of a world-wide recession and consequently soft markets and experienced escalating debt service costs due to rising interest rates. In some cases there were technical and managerial problems and there was the additional burden of high costs due to cost overruns during construction and operational inefficiencies. While the story of the energy-based industries deserves a volume of its own, it is important for our purposes to note only that they became a severe burden on the fisc and on the balance of payments in respect of debt servicing.

### *The Design of the Stabilization and Adjustment Programmes*

Socio-political developments played a crucial role in the progress, or lack of it, of the economy in the 1980s. Perhaps the most significant political development was the death in March 1981 of Dr. Eric Williams who had been Prime Minister since 1962 and before that, Premier since 1956, having led his party, the People's National Movement, to consecutive victories at the polls over that period. Williams had taken back the Finance portfolio from George Chambers in 1975 and retained it up to his death. The fiscal out-turn over that period therefore reflects his stewardship. While Williams' legacy to the nation of Trinidad and Tobago is, by any reasonable and objective measure, of great significance, his immediate economic legacy to his successor - George Chambers - was singularly unpropitious.

Chambers was, however, a rather more cautious minister of finance than his predecessor and in his previous tenure in that capacity had allowed that caution to find expression in the establishment of the Special Funds, by which means the petrodollar surpluses were to be saved for rainier days and at the same time remove purchasing power from the economy. In the uncertain months following the initial softening of oil prices, Chambers' caution and his apparent profound dissatisfaction with the development

strategy pursued since 1975 impelled him in February 1982 to assemble a team of the country's best technocrats under William Demas to prepare a development plan for the country and to address how policy might best approach a soft landing for the economy.<sup>4</sup>

The Task Force was appointed in February 1982 and included among its members Frank Rampersad, Patricia Robinson, Euric Bobb, Ainsworth Harewood, Eric St. Cyr and Frank Barsotti who were not only among the leading economists in the country but also were or had been associated with the Central Bank.<sup>5</sup> While the main task of the team was to formulate a multi-sectoral plan with emphasis on a Public Sector Investment Programme (PSIP) for the 1983-1986 period, it looked as well at the requirements for the stabilization and adjustment of the economy.

The team recognized that oil production would continue falling over the projection period, but, perhaps consistent with expectations held generally then, took the view that oil prices would be stable in nominal terms and would begin to rise in real terms in the second half of the decade. The need for significant adjustment on the fiscal accounts was demonstrated by the projections, given the objective of achieving a recurrent surplus and a sustainable overall deficit. The fiscal adjustment was seen to require a freeze on the wages and salaries bill after the massive increase in 1982, a reduction in transfers to state enterprises and the public utilities, with consequential increases in utility tariffs, a freeze on transfers to households and a reduction in subsidies. Even with an assumption of stable nominal oil prices, the revenue projections showed deterioration and the team's report suggested that taxation needed to be raised in certain areas and new revenue sources needed to be tapped as well. This recommendation came hard on the heels of the additional tax concessions granted in the 1982 and 1983 budgets which had emerged from the Bruce Fiscal Review Committee of 1981. The Demas Task Force also advocated an incomes policy which would involve a 'wage pause' along with some measure of price and rent control, aimed more at eliminating excessive profit margins.

With these measures, the Task Force reckoned that the projected fiscal deficits, which incorporated a public sector investment programme of reasonable size, could be financed by a combination of decumulation of balances, domestic borrowing designed so as not to crowd out private sector credit, and external borrowing. The approach to external borrowing by the Task Force is noteworthy. It recognized the danger of allowing the debt service ratio to become too high and indeed saw a ratio of 9.5 per cent as a cause for concern and a ratio of 15 per cent as dangerous. Given the size of the PSIP over the plan period, and the constraints on local borrowing,

foreign borrowing would have to account for between 50–56 per cent to the total financing and the debt service ratio was projected to rise to 14.5 per cent, close to the danger point. The adjustment elements in the report were also significant. It called for a review of the role of the State in the economy and rationalization of the portfolio of state enterprises, as well as a range of institutional reforms in the public and private sectors and a fresh commitment to CARICOM. It advocated changes in the structure of production stimulated by a new orientation toward extra-regional markets and the development of linkages downstream of the new energy-based industries, as well as an emphasis on the agricultural sector, tourism and other services. The productive effort was to be boosted by the application of research and development in the production process so as to increase local technological capability and productivity, on which export competitiveness was seen to depend. This in turn was seen to require increased attention being paid to the science and technology infrastructure.

Our lengthy review of the Demas Task Force report is intended to point out that some attention was indeed paid to the question of stabilization and adjustment from as early as 1982/83. Certain significant lacunae in the team's report may be noted since these turn out to be important and are discussed more fully in the next chapter. First, the stabilization elements of the report focussed largely on fiscal stabilization in the context of a viable PSIP and paid little attention to the stabilization of the balance of payments. Arguably, of course, the two are closely related and fiscal adjustment will improve the balance of payments in certain circumstances. The issues here, however, are (i) whether there are exogenous factors impacting on the balance of payments which need to be addressed separately; and (ii) if there is an independent foreign exchange reserves target, whether the timing of the balance of payments adjustment via fiscal adjustment is appropriate for achieving the reserves target.

Secondly, the exchange rate was not raised in the written report, either in relation to the stabilization programme or in the context of assisting in achieving the desired adjustment in the structure of production.<sup>6</sup> Indeed, the report took the view that competitiveness was related to improvements in productivity and control over nominal wages.

In the event, the rapid deterioration of the balance of payments consequent on the fall in oil prices in nominal terms and their collapse in 1986 vitiated the key assumptions underpinning the Demas Task Force Report. The stabilization and adjustment programmes were subsequently pursued in the context of specific budgetary measures and monetary policy measures, which are elaborated in the next chapter.

## *International Economic Developments*

While not having quite the same historical significance as, for example, the closure of the gold window in August 1971 or generalized floating in March 1973, October 6, 1979 was a day of signal importance. Paul Volcker, then only a few months at the Fed and the Fed's Board of Governors, changed the basis of Fed monetary policy from targeting of the structure of interest rates via the federal funds rate to reserves targeting via action on banks' non-borrowed reserves. The significance of this change, deemed by some to be evidence that the influence of Monetarism had finally triumphed, was that interest rates were free to go where they might. In an inflationary environment, interest rates rose rapidly and their variability also increased markedly. Indeed, interest rates in the USA, with sympathetic movements in other industrial countries, attained unprecedented heights. The US prime rate reached 21.50 per cent in December 1980 and was at 15.75 per cent and 11.50 per cent in December 1981 and December 1982, respectively.

There was also increased volatility in exchange rates. The US dollar declined sharply, relative to the currencies of other industrial countries, especially the pound which was buoyed up by the strong performance of the UK economy consequent on its higher oil revenues and stronger balance of payments. The price of gold shot up to reach US\$850 on January 21, 1980.

The US economy slipped into recession, taking the other industrial countries, except Japan, with it. Unemployment in the U.S.A. and the UK rose to double-digit levels in the 1981-82 period. The US dollar began to appreciate from 1981 and this along with recessionary conditions and tight money served to bring the inflation rate down to more acceptable levels by 1982-83. One of the effects of the recession was to precipitate a sharp fall in commodity prices after the commodity boom of the 1970s. The terms of trade of the developing countries swung decisively against them and this, combined with weak demand and growing protectionism in the markets of the industrial countries, was the proximate cause of the international debt crisis.

The debt crisis is now dated from August 1982 when the Mexican authorities declared their inability to meet debt service payments and sought the assistance of the authorities in the industrial countries, the multilateral financial institutions and their creditors in resolving the problem. The medium-term floating rate instruments created by the international capital markets to recycle the petrodollars became nooses around the

necks of the heavily indebted Latin American countries, nooses which tightened sharply as interest rates soared and the prospects for growth dimmed with the collapse of commodity prices, including oil prices, and weak demand in the industrial countries for the exports of these countries.

The primary interest of the authorities in the industrial countries was to ensure that there was no widespread default among debtor nations which might precipitate a collapse of the international banking industry with knock-on effects on a host of smaller regional banks, which could have far-reaching economic consequences. The strategy which evolved was therefore one of containment. It would seek to give the banks time to build-up a cushion of reserves and so strengthen their capital bases. Significantly for Trinidad and Tobago as well, it would keep markets open to creditworthy borrowers where creditworthiness came to be judged on the basis of quantitative and qualitative country risk criteria. Rules of thumb were developed out of the then prevailing experience and based on the expectations for economic growth then held for acceptable debt service ratios, debt/GDP ratios, reserves import cover ratios and other more exotic statistics which purported to gauge a country's debt capacity. Since the rule-of-thumb statistics were based on the experience of the heavily-indebted countries and since forecasting the evolution of a borrowing country is difficult at best, countries like Trinidad and Tobago would, on account of high reserves levels and low debt servicing ratios, continue to have access to international capital markets until the middle of the decade, although borrowing would become increasingly difficult and, as a consequence, the terms would become more onerous.

### *Institutional Developments*

Several of the initiatives taken in the mid-1970s, some arising out of the symposium on the Mobilization of Domestic Financial Resources of May 1976, came to fruition in the early years of the decade with the Central Bank in the role of mid-wife and fairy godmother.

The Trinidad and Tobago Stock Exchange was established in October 1981 under the Securities Industry Act, No. 37 of 1981. The Stock Exchange took over the information dissemination function of the Call Exchange, but went much further in establishing rules and procedures for trading, listing and de-listing of companies and related matters. Equity prices were enjoying a tremendous boom. The localization of banks and other non-financial enterprises had broadened the market compared to the early 1970s and the boom conditions fuelled massive speculation in equities which led to prices which were unrealistic given the fundamentals of the

economy and the managerial strength and profitability of the firms themselves. Public share issues became occasions for widespread speculation as the preferential system for allocation of shares created substantial rents or premiums. Much of the speculative activity was financed by the banks.

A second, related development was the establishment of the Unit Trust Corporation by act of parliament in 1981. The purpose of the Unit Trust was to provide, at one remove from the stock exchange and the capital market, an instrument or investment vehicle for the 'small man' who could, by proxy as it were, participate in the risks and rewards of the capital market and in the ownership of the various public companies. The legislation establishing the Unit Trust Corporation provided for certain tax breaks. Like the Stock Exchange, the Unit Trust has been staffed largely by Central Bank personnel and accesses certain services and overheads provided by the Bank, which has subsidised the institution.

A third institution, the Home Mortgage Bank, was established by legislation in 1985 although it became operational in 1986. Unlike the Stock Exchange and the Unit Trust, however, the Home Mortgage Bank is a private sector institution owned jointly by the Central Bank, the commercial banks and some insurance companies, as well as the International Finance Corporation. The purpose of the Home Mortgage Bank is to assist in the development of the housing finance sector by developing a secondary market in mortgages so as to exert as far as possible, downward pressure on the cost of financing home acquisition for middle-income, first-time home-buyers. The Home Mortgage Bank's enabling legislation allows it to issue bonds on which the interest is tax-free. At the time this was given, it constituted an important incentive for investors who were facing high tax rates. The tax reforms of the latter half of the decade, which are discussed below, served to dilute the usefulness of this incentive.

Indeed, the 1980s will probably be recorded as the decade in which the tax system in Trinidad and Tobago was substantially reformed. The process began with the Bruce Committee in 1981, which, influenced no doubt by higher oil prices and public pressure, recommended a considerable easing of the direct tax burden, much of which was in fact implemented in the 1982 and 1983 budgets. In 1986, the Barsotti Committee was appointed and had suggested substantial reduction in direct taxation by revamping the rate and bracket structure, but also recommended, *inter alia*, that a value added tax be introduced. The report of the Barsotti Committee was leaked to the press and overtaken by events when there was a change of political directorate, although several of its key recommendations have since been adopted and implemented by the new administration. In 1988,

further amendment was made to the individual income tax structure with a reduction in the top marginal rate to 50 per cent although the number of brackets remained high. In 1989, the top marginal rate was reduced to 45 per cent with four brackets but with a removal of all allowances and exemptions, except for mortgage interest, and their replacement with a system of tax credits. Tax incentives for saving have been removed and more disposable income is to be left in the hands of income-earners. The measures are to be supplemented with the introduction of a Value Added Tax in 1990, at which time the top marginal rate for individuals and companies will be reduced to 35 per cent. These tax reforms are consistent with thinking and trends worldwide influenced in part by the so-called supply-side economics.

The tax regime in respect of the petroleum industry was also revised substantially in the 1980s, beginning with the reduction in the Supplemental Petroleum Tax (SPT) on land operations from 35 per cent to 15 per cent in 1981, the revamping of the SPT and the reduction in the rate on marine operations from 60 per cent to 55 per cent with effect from January 1, 1984, and further reduction in the SPT on land and marine operations in 1988, based on a distinction between 'base oil' and 'additional oil', to 5 per cent (land) and 20 per cent (marine) for additional oil.

By the time the Non-Bank Financial Institutions Act was proclaimed in 1981, several of the independent finance companies, i.e. those not affiliated to banks, were already being mis-managed and in contravention of key provisions of the legislation. The downturn in the economy precipitated enormous difficulties for several of these finance companies, beginning with International Trust Limited in 1983 which was put into receivership by the Central Bank following a run. Other finance companies had difficulty complying with the provisions of the Act and the Bank realized that the legislative basis of the financial system was quite inadequate to deal with the problem and to afford some measure of protection to depositors. The crisis of the finance companies was to absorb a great deal of the energies of the Bank in the middle years of the decade.

At the regional level, the integration movement was in danger of becoming unstuck and led to the appointment of a group of 'wise men', including Nobel Laureate Arthur Lewis, Alistair McIntyre and William Demas, who reported on the mechanisms needed to get the movement back on track. However, the grave economic difficulties of Guyana and Jamaica, and the successive devaluations of the latter, provoked a chain reaction of retaliation and recrimination with the result that intra-regional trade declined steadily. As the Trinidad and Tobago economy began to decline, it

too increased protectionist measures which intensified the downward spiral of regional trade since Trinidad and Tobago was by far the largest single market in the region. In 1983, the operations of the CARICOM Multilateral Clearing Facility (CMCF) were suspended as Guyana's obligations to the facility mounted steadily and eventually absorbed the entire US\$100 million limit, at which point the CMCF ceased operation and countries reverted to monthly bilateral settlements.

Trinidad and Tobago's own growing difficulties caused a falling off in its economic assistance to the region, although it continued to allow Guyana to accumulate massive trade arrears until a halt was put to this in 1985.

Over the latter years of the decade, however, there has been a renewed impetus to regional economic co-operation, if not integration, prompted by shared adversity and the manifest threats posed by developments in the international economy.

### *Developments in Monetary Theory*

It would be reasonably safe to say that there have been no developments of significance in monetary theory in the 1980s. Much of the literature, as we see it, has been preoccupied with the empirical testing and verification of various elements of neo-Keynesian and Monetarist theory. Monetarism has lost influence, partly because it has not stood up very well to rigorous empirical testing and partly because of theoretical developments which have sought to challenge some of its conclusions. Much of macro-economic theorising in the last decade has been searching for the micro-economic bases of macro-economic phenomena, a development which has also given some impetus to micro-economic theory itself.

We may note the Rational Expectations school in macro-economics which argues that economic agents make optimal decisions based on available information, which includes 'news' and anticipations of actions to be taken by the monetary and fiscal authorities. This school concludes that monetary and fiscal policy have no real effects even in the short run because economic agents anticipate the policy measures and can effectively nullify them. Needless to say, this school of thought is unlikely to ever become popular within the halls of central banks and treasury departments.

In the Caribbean, the literature evolved away from institutional description to the empirical testing of neo-Keynesian and Monetarist propositions in the Caribbean context. This literature is reviewed by

Farrell and Christopher (1989) and studies specifically on Trinidad and Tobago may be found in Bourne and Ramsaran (1988).

It may be useful to note here the application of the concept of the 'domestic budget balance' to macro-economic analysis of the Trinidad and Tobago economy by the Central Bank in the 1980s. The usefulness of the concept derives from the observation that, in the context of a closed economy and in some open economies, a fiscal surplus is contractionary in respect of income and expenditure and eventually the money supply as well. In the open petroleum economy, however, where a substantial proportion of government revenues accrues in foreign exchange from an enclave petroleum sector, a fiscal surplus may be quite consistent with a domestic budget deficit, i.e. revenues arising from domestic non-enclave sources and paid in local currency are less than domestic expenditures. In terms of assessing the impact on the money supply and the income and expenditure streams, it is the domestic budget balance that is more relevant than the overall fiscal balance.<sup>7</sup>

A second concept which was used occasionally was the 'non-oil balance of payments'. This was based on the notion that oil transactions masked the 'true' state of the external accounts and that, if one measured the balance of payments excluding such oil-related transactions, a substantial deficit would be seen which would indicate the need for corrective action. The Bank actually attempted to estimate a non-oil current account for the 1974-1981 period which was presented in the Annual Report for 1981. While it did reveal a substantial difference compared with the usual presentation, the Bank was not happy with the measurement of the concept since, clearly, so-called non-oil transactions are based on or related to the foreign exchange made available by the oil sector and the separation of oil and non-oil transactions is therefore fraught with problems.

### *The Bank and Its Actors*

In Chapter Five (Section 6) we had noted that there was considerable stability at the level of the Board from the mid-1970s up to 1986, with the membership of Victor Bruce as Governor and Chairman, Eric St. Cyr, Algernon Wharton and John Hunt as directors, and Ainsworth Harewood and Frank Barsotti as the representatives of the finance and planning functions. Leonard Williams had resigned as Deputy Governor in October 1977 to take up an appointment as Deputy Managing Director, and later Managing Director, of Barclays Bank of Trinidad and Tobago, the largest of the local commercial banks. He was replaced in March 1978 by Euric Bobb.

Euric Bobb had won an island scholarship from Presentation College and had proceeded to Cambridge University where he obtained his Ph.D. in 1969 with a dissertation on fiscal policy in Trinidad and Tobago (Bobb 1969). He worked with the World Bank after graduation, with missions to several countries in Central and South America, before taking up an appointment in Liberia as head of the planning unit there under the auspices of the World Bank. An athlete as well as scholar, he had represented Trinidad and Tobago in track events at the Mexico Olympic Games in 1968.

Appointed Deputy Governor at the relatively young age of 35, Bobb brought the discipline of competitive sport and academic scholarship and the high standards of professional work in the international civil service to bear on his work at the Bank and sought actively to infuse these qualities into the work of others at the institution. His energy and enthusiasm for work saw him appointed chairman of the committee to review government expenditure (1978), to the chairmanship of the new Re-Insurance Company and the Food and Agriculture Corporation and to the boards of several institutions including the national airline. He was also a member of the Demas Task Force. He quickly established himself as a key spokesman for the Bank and on matters of economic policy generally and soon had a public profile that ranked with that of Victor Bruce. It was no surprise when, on the retirement of Victor Bruce on July 31st 1984, Euric Bobb was appointed the fourth governor of the Bank.

Under Bobb's professional leadership, the Bank moved during the 1980s to accelerate the build up of its technical capabilities in the areas of statistics, economic research and policy support, based on a view that effective policy formulation in a difficult environment would demand the highest level of skill, knowledge and technique to be brought in support of policy.

In 1987, with a new political party in charge of the administration of the country after the December 1986 elections, an entirely new board was appointed to the Bank, which, with one exception, continues to serve today (1989). Euric Bobb resigned as governor at the end of 1987, though serving up to February 14, 1988 when he was replaced by William Demas. The sweeping changes to the Board and the subsequent resignation of the governor amidst some acrimony and in the context of a change of political administrations may be regarded as unusual and perhaps unfortunate, if it is seen to be desirable that a central bank be at arm's length from the hurly-burly of partisan politics. Others would argue, by contrast, that central bank independence is a fiction (created by devious governments) and that a

central bank is merely an 'arm of the executive'. Presumably therefore if the political directorate changes, the executive of the central bank might be changed as well so that the new political leadership can be assured that their views on monetary and financial policy will be followed unswervingly.

In some contexts this change of administrators or senior technocrats is expected and accepted, although it invariably does not apply to the senior technocrats of the central bank. Central banks are seen to be different from other areas of the administration, perhaps closer to the judiciary in terms of independence and autonomy. While it is possible to force a central bank governor out of office, it is more usual to fail to renew his contract, although this may be problematic if there are still several years left to run. The issues posed here are quite complex and I return to this theme in the concluding chapter.

## **CHAPTER EIGHT**

# **MONETARY POLICY IN THE STABILISATION AND ADJUSTMENT PROGRAMMES: 1980 – 1986**

### *Objectives and Instruments*

If during the 1970s the Bank had become somewhat reticent about stating its objectives and openly defending its policies, this changed in the mid-1980s as the Bank seemed to be prepared to be again more forthcoming in explaining and defending its policies. This was reflected primarily in a more expansive Annual Report especially from around 1984, and various public statements, particularly by the Deputy Governor.

The failure of inflation to respond to 'supply-side' developments in the economy prompted the introduction in February 1980 of the marginal reserve requirement which was set at 15 per cent. This measure meant that given the then prevailing 9 per cent cash reserve requirement, the Bank would take 24 cents out of the incremental dollar of deposits in the banking system. This was intended to put a brake on credit expansion and tackle inflation from the demand-side. The effective reserve requirement rose from 9 per cent in December 1979 to reach 17.27 per cent in November 1984. There was a concomitant decline in excess liquidity in the banking system, mainly on account of the marginal reserve requirement, but also because deposit growth began to slow relative to credit expansion as the economy began to contract (Table 8.1.)

By 1983, the Bank's main policy objective had shifted decisively from inflation control to the protection and stabilisation of the balance of payments. However, this was seen to require essentially the same credit policy as had been pursued in respect of the inflation objective in the 1980-1982 period, supplementing more direct instruments of control on the level and composition of imports.<sup>1</sup>

**TABLE 8.1: SELECTED MONETARY INDICATORS 1980—1986 (%)<sup>1</sup>**

	<b>Effective Cash Reserve<sup>2</sup> Requirement</b>	<b>Excess Liquidity</b>	<b>Deposit Growth</b>	<b>Credit Growth</b>	<b>M-2<sup>3</sup></b>
1980	10.9	6.9	14.6	24.3	35.8
1981	13.6	5.5	21.5	23.3	6.5
1982	16.0	5.3	36.8	22.9	30.9
1983	17.0	2.8	6.6	17.0	17.9
1984	17.0	1.2	8.5	9.5	7.5
1985	17.0	0.8	1.1	3.7	1.1
1986	15.0	0.2	-1.8	2.7	-1.7

SOURCE: Central Bank of Trinidad and Tobago, Annual Report, Annual Economic Survey; Handbook of Key Economic Statistics.

<sup>1</sup>Data for 1980—1983 are calculated from end of period data while for 1984—1987 deposits and credit are the growth rates based on averages of monthly values for the respective years. Credit is defined as total loans, commercial bills and real estate mortgage loans excluding credit to non-residents and the Central Government.

<sup>2</sup>End of Period.

<sup>3</sup>Based on averages of monthly values for the entire period.

The balance of payments objective was taken particularly seriously by the Bank. In June 1981, the then Deputy Governor, Euric Bobb, had pointed to the possibility of fiscal and balance of payments deficits based on what appeared to be reasonable assumptions about the price of oil. His prophetic words were:

...it is very likely that the real price of oil will rise only moderately or even decline in the near future. This, combined with our declining output of crude petroleum and falling refinery throughput — which is itself a reflection of recession in the major economies of the world — will mean, in real terms, declining export receipts and government revenues ... Declining receipts from the petroleum sector and hence falling government revenues, together with continued high levels of imports and government expenditure, may open up the prospect of government budget deficits and balance of payments deficits. The high levels of the country's foreign exchange reserves and government's accumulated surpluses will cushion the adverse effects of these deficits for a period of time, but only for a period of time. The

adjustment to lower levels of expenditure and income, particularly in an inflationary environment, may be difficult and painful.<sup>2</sup>

While the balance of payments deficit was emerging in 1982, the Bank began taking a close look at the balance of payments and the policies that might be appropriate to deal with the massive deficits projected for 1983 and 1984.<sup>3</sup>

Among the options reviewed and rejected was a devaluation and a dual exchange rate mechanism. The Bank elected to implement direct administrative control over visible imports on the arguments that (i) demand in the economy was still strong, given the high level of accumulated reserves and fiscal resources; (ii) a devaluation was not likely to have a significant effect on import levels in the timeframe required and was likely to provoke adverse trade union reaction which might well nullify the nominal devaluation, and (iii) it was necessary to bring consumption imports down quickly without necessarily affecting imports of raw materials and capital goods.<sup>4</sup> The Bank therefore introduced its EC-Zero system of direct controls over visible imports in October 1983.

In November 1983, for the first time since 1973, the Bank moved its rediscount rate from 6.00 per cent to 7.50 per cent. This move was largely symbolic. Interest rates in the banking system had begun to rise as liquidity tightened, and the Bank followed the market up and in so doing, it was validating and endorsing the upward movement of interest rates for the public at large.

By the second half of 1984, the Bank was prepared to enlist exchange rate adjustment in support of the balance of payments stabilisation objective and also to begin to address the adjustment required on the supply side since it was clear that the decline in the terms of trade arising from the fall in oil prices was structural and not temporary and the loss of reserves should be minimised. It noted that deposit growth had slowed and therefore the marginal reserve requirement was not as effective, and indeed it was concerned that although it was not yet time to relax credit policy, a further tightening was also inappropriate on account of the possible effects on a financial system where confidence had been shaken. It was in this context that the Bank in November 1984, removed the marginal reserve requirement, but set the new cash reserve at 17 per cent compared to the effective reserve requirement at the time of 17.27 per cent. In addition, the Bank was of the view that import compression by administrative action was limited in its efficacy and would have to be supplemented or replaced by exchange rate adjustment before long.

The inability of the Bank to persuade the Ministry of Finance that an exchange rate adjustment was necessary, left the burden of balance of payments policy on the system of direct import controls, apart from a 10 per cent levy imposed on foreign exchange sales for vacation and business travel and for emigration purposes in December 1984 as part of the 1985 Budget. It also left in abeyance the structural adjustments on the supply side which must necessarily complement the stabilisation effort. It was not until December 1985, as part of the budgetary measures announced in the 1986 Budget, that the exchange rate was devalued by 33.3 per cent for most items, although the old rate was maintained for a scheduled list of food, drugs, school books and agricultural inputs.

In July 1986, the Bank undertook a comprehensive review of its policies in place and took the view that, notwithstanding the collapse of oil prices and a 41 per cent decline in the foreign exchange reserves in the first half of 1986, and without compromising the all-important objective of balance of payments stabilisation, monetary policy should be more supportive of the objective of supply-side stimulation, or more to the point, limiting the contraction of economic activity. With that rationale, the Bank reduced the cash reserve requirement from 17 per cent to 15 per cent and persuaded the banks to lower the prime loan rate to 11.50 per cent from 12.50 per cent. The Bank also relaxed the installment credit guidelines which had been in place since 1973 by lengthening the maximum repayment periods and waiving the downpayment requirement for a range of consumer durables. The formula for the selective credit control guideline was also changed from the incremental formula put in place in 1979 to an average (30 per cent) of total credit. The interest rate on special deposits was raised from 3 per cent to 4 per cent, with a consequential increase in the average discount rates on Treasury Bills to over 4 per cent, in an attempt to lock some of the reserves released by the reduction in the primary reserve into the secondary reserves. The policy actions of the Bank in 1986 may be seen to be highly controversial, given the developments in the external accounts, and they are critically assessed in the next section.

### *Assessment and Critique of Monetary Policy*

The marginal reserve requirement introduced in 1980 represents a fairly successful use of monetary policy. Intended to bring inflation down by restricting the rate of credit expansion, the outcome was that between 1980 and 1984, the rate of expansion of bank credit, excluding credit to Central Government and to non-residents, grew at 15.3 per cent per annum, compared with an expansion in deposits of 16.9 per cent per annum. This

compared with a rate of growth of deposits of 28.6 per cent per annum in the 1975-1979 period and a rate of growth of bank credit of 31.7 per cent per annum. Excess liquidity declined from an average of 6.6 per cent in 1980 to just 1.2 per cent in 1984 and the rate of inflation fell, albeit slowly, from an average annual rate of 12.9 per cent in the 1980-1982 period to 10.4 per cent in the 1983-1985 period.

With the emergence of stresses in the balance of payments from 1982, the shift in the emphasis of policy from inflation control to balance of payments stabilisation was also timely and appropriate. The maintenance of a tight credit policy was as important to the achievement of the balance of payments objective as to the question of inflation control. However, it was recognised that unless further action were taken to stem the projected loss of reserves, the balance of payments objective would not be achieved quickly enough by credit policy alone.

As liquidity in the banking system declined, interest rates began to rise. Deposit rates which had hovered in the region of 6.00 per cent in the 1979-1982 period, jumped to 6.80 per cent in 1983. Loan rates rose steadily over the period, rising from an average 10.79 per cent in 1979 to 13.31 per cent in 1983. The median prime loan rate had moved from 8.50 per cent in 1978 and 10.00 per cent in 1979 to 11.50 per cent in 1983.

The raising of the rediscount rate in November 1983 by 150 basis points was a useful signalling device in a situation in which it was probably not appropriate to increase the reserve requirement further, even as the efficacy of the marginal reserve requirement waned with the slowdown in deposit growth. The Bank was endorsing a higher cost of credit to the national community as a necessary aspect of the process of adjustment.

The implementation of the system of direct control over visible imports in October 1983 was however, late in coming. The Bank was certainly prepared to implement the measure as early as the second quarter of 1983, but had to await the approval of the Ministry of Finance which has statutory responsibility for exchange control. Since the fourth quarter is a peak period for imports, implementation caught the system 'on the hop' as it were, with Christmas orders on the docks and on the high seas. The ensuing confusion tarnished the public perception of the system and made more difficult the working out of the many bugs in the procedures.<sup>5</sup> In addition, implementation came too late to make a difference to the balance of payments out-turn for 1983 which eventually involved a loss of reserves of about US\$900 million.

There is obviously the argument that the Bank should have pressed for a devaluation in 1983, or even earlier, rather than embrace a system of

import restrictions which arguably, are distorting, sub-optimal, and might precipitate capital flight. Other oil exporting countries, such as Indonesia and Mexico, had in fact devalued in 1982. The Bank was influenced in favour of direct controls by the likely effects of a devaluation at that time. First, it was not generally accepted even then, that the economy had entered a period of structural adjustment. Second, the trade union movement was militant in the belief that any downward adjustment should not fall disproportionately on the working classes and was clearly prepared to agitate on this basis. Third, the political directorate was assessed to be not in favour of devaluation, partly because the exchange rate had always been a 'sacred cow', and partly because of the likely adverse social impact of a devaluation.

These arguments would bear on the timing of a devaluation but not on whether or not the country should have devalued. Once it was appreciated that the decline in the terms of trade was permanent and structural, a policy which involved the running down of reserves in preference to exchange rate adjustment was sub-optimal. In addition, the imposition of tighter exchange controls has a cost in terms of accelerated capital flight, which puts even greater pressure on the reserves. In Trinidad and Tobago most capital flight probably takes place through over-invoicing of imports and compensation deals. In 1984 and 1985, outflows on net errors and omissions account of the balance of payments jumped dramatically to \$351.5 million and \$325.9 million, respectively. These outflows were equivalent to 20 per cent of the total loss of reserves in 1984 and 124 per cent in 1985. It is almost certainly the case that much of this represented capital flight.

An earlier devaluation would certainly have placed the balance of payments in a stronger position sooner, and would also have brought forward in time the necessary structural adjustment. The delay in implementing the exchange rate adjustment and the institution of a dual rate regime lies at the door of the Ministry of Finance, since as we have already noted, the Bank was minded to have the exchange rate devalued from the second half of 1984 and was not in favour of a dual rate regime.<sup>6</sup> It was also poor judgment to announce the devaluation as part of the 1986 budgetary measures since the public subsequently came to associate exchange rate adjustment with fiscal policy and in particular as a means of raising revenue, with the result that there have since been speculative waves as each budget approaches.

While the timing of the devaluation was an error of policy, the extent and form of the exchange rate adjustment put the real effective exchange rate 'in the ball park', there was the possibility that the nominal devaluation

could be quickly nullified in real terms if inflation accelerated to double-digit levels once more. In such circumstances the deeper the nominal devaluation, the greater the chance of a real devaluation being sustained once other supporting policies are in place. Arguably, therefore, the exchange rate adjustment might have been deeper, say 40 per cent to TT\$4.00/US\$1. The counter-argument to this is that the inflation rate had dropped to just 7.7 per cent in 1985 and based on that trend, a 33.3 per cent nominal devaluation could be seen to be adequate.<sup>7</sup>

A more important issue perhaps was the 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 alone as trade credits were unwound and remittances were accelerated. In any meaningful sense, the devaluation of December 1985 did not really take effect until January 1987 when the dual rate regime was abolished and the rates unified, by the new administration, an action which found favour in a beleaguered Central Bank.

We turn now to the set of policies implemented by the Bank in July 1986. In evaluating these policy changes, especially the reduction in the reserve requirement, we must recall that oil prices had already dropped from US\$26.50 per barrel in December 1985 to US\$8.74 per barrel in July. There was a fiscal crisis and the Bank had begun to make advances to the government under Section 46. The fall in foreign exchange inflows and the accelerated outflows owing to the moratorium granted to importers had almost halved the foreign exchange reserves in six months.

The easing of monetary policy in such circumstances was questionable. In the view of the Bank the stabilisation of the economy on internal and external accounts had been reasonably successful. The current account deficit had fallen to just 1.5 per cent of GDP in 1985. The fiscal deficit had been brought down to 7.5 per cent of GDP, albeit at the expense of the capital expenditure programme. Inflation had dropped to 7.7 per cent, the lowest inflation rate since 1971. The government, not unmindful that 1986 was an election year, was concerned that after three years of contraction, and rising unemployment, the economy should be stimulated so as to limit the further contraction of the economy.

The Bank also took careful note of what was happening in respect of interest rates. As the economy began to contract from 1983, the loan portfolios of the banks and non-bank financial institutions deteriorated. In order to compensate, the banks sought to increase the return on the performing loans within their portfolio. As a consequence, the median prime loan rate moved from 11.50 per cent in 1983 to 12.75 per cent in 1984 and 12.50 per cent in 1985, while average deposit rates actually fell from 6.80 per cent in 1983 to 6.26 per cent in 1985 resulting in a widening of the spread to over 7 per cent. The Bank was of the view that the trends in interest rates would be inimical to a strategy of arresting the contraction and, disinclined to use its interest-rate-fixing powers under the 1978 amendment to the Central Bank Act, it took the view that it would contrive an easing of the tight liquidity situation and then 'talk' loan rates down.

The Bank also reviewed its selective credit control policies and installment credit guidelines. The selective credit control guideline introduced in 1979 was based on limiting the share of consumer or non-business loans in total incremental credit to 25 per cent. The policy was reasonably successful even though it was gradual. The average share of consumer loans to total loans had fallen from 41.3 per cent in 1979 to 30.7 per cent in December 1985. Having secured the reduction in the average share, the incremental formulation of the guideline was seen to be no longer appropriate and the guideline was re-cast as a proportionate limit of 30 per cent on consumer loans.

The installment credit guidelines had been in place since 1973 and had remained unchanged for the entire period up to mid-1986. Indeed these guidelines had ceased to be of real significance for monetary policy and may have been monitored only by the Bank Inspection department in its periodic reviews of the compliance of individual banks with prevailing policy. The decision to re-activate and relax the installment credit guidelines was closely bound up with the Bank's attempt to respond to the government's stimulation objective. By waiving downpayment requirements and lengthening repayment periods for a range of consumer durables, the Bank hoped that any credit constraint on the demand for these goods would be eased, thus permitting some expansion of production. Most of the industries producing these goods were however, highly import-dependent and therefore relaxation of the installment credit guidelines could be seen to be in conflict with the objective of stabilising the balance of payments.

Notwithstanding the validity of some of the arguments for the changes in monetary policy, and the real success which had been achieved in stabilising the economy over the 1983-1985 period, it was, arguably,

inappropriate to implement an easier monetary policy even as the balance of payments was collapsing anew. The Bank was certainly acutely aware of the conflict between the objectives of protecting the foreign exchange reserves and facilitating the stimulation of economic activity. It attempted to lock up the reserves released by the reduction in the cash reserve in the secondary reserve by pushing up the Treasury Bill rate. But this was not nearly enough. The Bank was perhaps fortunate that private sector demand for credit was quite weak and that it is much easier to pull on the string than to push on it. In addition, the easier credit conditions made it possible for public sector borrowing to increase sharply by 18.8 per cent as the Treasury could no longer support state enterprises and the utilities as before, and their demand for financing shifted progressively to the banking system. These were mixed blessings however, since they implied the need for other adjustments sooner or later.

Clearly, the Bank in 1986 was overly influenced by the Ministry's objective of stimulating output and employment. Though laudable and understandable, the collapse of oil prices and therefore the basic assumptions underlying the 1986 Budget should have led to a re-thinking of the growth objective and a serious renewed emphasis on stabilisation.<sup>8</sup> However, Bank support by means of advances to government was entirely warranted in circumstances where revenues had collapsed. It is also the case that the Bank should have raised the interest cost of government borrowing by a good deal more than it in fact did. The credit policies of mid-1986 however, may have been interpreted as a return to accommodation. When the new administration took office in December 1986, this perception fostered a climate which saw the Bank enter a phase of progressively icy relations with the Government which culminated in a Section 50 directive from the Ministry of Finance in December 1987, an issue which is taken up in the concluding chapter.

### *Financial Policy*

The difficulties posed for monetary policy in the process of stabilising and restoring internal and external balance would alone have been enough to deal with. Developments in the financial system over the 1983-1986 period added to the headaches of the monetary authorities and indeed may have influenced the approach to monetary policy.

The story of the financial crisis surrounding several finance companies has been recounted elsewhere [Farrell (1989), Farrell (1988), Victor (1987), Bobb (1986)]. Suffice it to say that the implementation of the Financial Institutions (Non-Banking) Act which came into force in May

1981 was too late to obviate the problems inherent within some of the independent finance companies. Moreover, the authorities took the view that the institutions should be given time to put their houses in order, a task which became progressively more difficult and which they were eventually unable to do owing to poor management and the effects of the downturn in the economy.

Confidence in the sector was badly shaken by the run on International Trust Limited in August 1983. In July 1984, the Central Bank, now acutely conscious of its limited powers to intervene under the then existing legislation, organised a \$50 million liquidity support facility with the commercial banks, pending the speedy implementation of amending legislation which would give the Bank powers to intervene in ways other than supervision and application for receivership, and to provide insurance protection for depositors. In the event, the amended legislation was long in coming and in fact was not emplaced until February 1986, by which time the Central Bank had committed \$142 million of liquidity support to the troubled NFIs.

The changes effected by Act No. 2 of 1986 amended both the Central Bank Act and the Financial Institutions (Non-Banking) Act. The amendments conferred special emergency powers on the Bank in situations where, in the opinion of the Bank, the interests of depositors or creditors are threatened, the institution is unable to meet its obligations or the institution is not maintaining high standards of financial probity or sound business practices. The Bank was given special powers of investigation and could also assume control of the business, restructure the business or otherwise dispose of it. The amendments established a Deposit Insurance Fund within the Deposit Insurance Corporation, which is a subsidiary of the Central Bank, and of which all financial institutions must be members.

With the amendments in place, the Bank moved quickly to sort out the problems in the system. It immediately assumed control of the Trinidad Cooperative Bank which had been experiencing difficulty and initiated a restructuring of the assets of that institution. In September 1986, the Bank moved to suspend the operations of five troubled NFIs and in December closed four of them, allowing one to re-open on the basis of a new business plan. This latter institution was eventually closed in 1988 after failure to make a success of the reprieve. Finally, in April 1989, the Bank using its powers under the 1986 amendments, intervened the Workers' Bank and its subsidiary trust company and is in the process of attempting to restructure its operations.

The financial system was severely traumatised in the 1980s. The fruits of the initiatives of the 1970s — the Stock Exchange, the Unit Trust Corporation and the Home Mortgage Bank — have struggled through extremely difficult times. The Stock Exchange has seen a collapse of stock prices from the heady heights of the early 1980s and activity has been depressed now for several years, although a resurgence appears to be underway at the time of writing. The Unit Trust Corporation also suffered as a result of the collapse of the stock market, but its operations have been shored up by high interest rates in the banking system into which a significant proportion of its investments have been channeled, a development not entirely consistent with the conception of the Unit Trust as providing a vehicle for the 'small man' to participate in the equity market. Similarly, the Home Mortgage Bank has confronted a depressed housing market and a capital market that has at times proved difficult, owing more recently to changes in the tax regime which have placed the Home Mortgage Bank's tax-free bonds at something of a relative disadvantage.

Over this period, the Bank has worked at simply holding the system together and trying to rebuild confidence, a task made more difficult by the continuing contraction of the economy.

## CHAPTER NINE

# IN THE EMBRACE OF THE IMF AT THE DOOR OF THE DEBT TRAP

### *Introduction*

If the period 1980 to 1986 may be described as exciting for the Bank and indeed the Ministry of Finance as well, the period since 1986 may be described as frenetic. Fortunately, perhaps, the earlier period proved to be very useful preparation for dealing with the rigours of the more recent period which has involved the negotiation of an adjustment and stabilization programme with the IMF, the negotiation of debt rescheduling agreements with creditor banks and the Paris Club, as well as the negotiation of loan agreements and the associated conditionalities with the World Bank, the Inter-American Development Bank, and a number of bilateral agencies.

This chapter provides a sketch of the events leading up to the situation at the end of 1989. A more complete analysis and description of these years must come later since several of the negotiations are still incomplete at the time of writing and it is as yet uncertain how adjustment and stabilization under the auspices of the multilateral agencies will impact the economy and society, and for the Central Bank as an institution, how the events of the last three years will colour or condition its relationships with the government over the medium term.

### *Crisis in Slow Motion*

During 1987, the Bank was increasingly preoccupied with the foreign exchange reserves. The reserves had fallen to just US\$ 331 million at the end of 1986 representing an import cover ratio of less than 3 months, and although the dual rates were unified in January 1987, the projections were that the Bank's free reserves, i.e. reserves excluding SDR holdings and the reserve tranche, would be exhausted before very long. The Bank formed

the view that it might be necessary to access the IMF's Compensatory Financing Facility (CFF) but acknowledged that, given the outlook for the balance of payments over the medium term, the CFF could not be negotiated without a stand-by arrangement alongside it. The collapse of oil prices also meant that the debt service ratio had jumped suddenly from 11.0 per cent in 1985 to 24.2 per cent in 1987 and the repayment profile clearly showed a bunching of maturities in the 1987-1991 period which was problematic given the prevailing and projected levels of export earnings. The debt service ratio was projected to reach 29 per cent in 1990. The case for a rescheduling of the external debt was therefore also emerging and this too implied a formal programme relationship with the IMF.

The new political administration which took office on December 16, 1986 was, however, rather disinclined to any approach to the IMF. In the 1987 budget speech the Minister of Finance stated that the country had to escape the debt trap and dependence on the IMF at all cost. The 1987 budget introduced several fiscal measures intended to bring about the requisite adjustment in the fiscal accounts.<sup>1</sup> While implementing several of the reliefs advocated in the Barsotti Fiscal Review Committee report, purchase taxes were raised across the board, the excise duty on gasoline was increased and a national recovery impost was levied on high income individuals and corporations. On the expenditure side, the budget suspended cost of living allowances and merit increases for public servants and demanded close control over, and reductions in, transfers to state enterprises and utilities.

In respect of the balance of payments, the exchange rates were unified and an appeal made for restraint in expenditure on non-essentials. In this regard, the authorities were cheered by the fact that oil prices (Average OPEC) had risen from the low levels of July 1986 (US\$6.74) to US\$14.40 in December 1986 and US\$16.88 in January 1987 with the prospect for a further strengthening of prices. This was expected to shore up the balance of payments and the foreign exchange reserves and as well to strengthen the government's revenue position.

In the event, oil prices flattered to deceive as the average OPEC price rose to US\$18.00 in June before over-production by cartel members caused the average OPEC price to fall to US\$15.71 at year end. More important, perhaps, was the 8.4 per cent decline in crude oil production which limited the increase in oil revenues to just 14 per cent, excluding the excise duty on gasoline and the new national recovery impost. Non-oil revenue also performed poorly, the new taxes notwithstanding, while, despite a 13.6 per cent fall in the wages and salaries bill, recurrent expenditure failed to decline owing to a sharp increase in interest charges reflecting higher

interest rates internationally and an increase in transfers and subsidies. As a consequence, there was a deficit on recurrent account equivalent to 2.3 per cent of GDP, the same proportion as in 1986, although the overall fiscal deficit improved to 7.3 per cent of GDP, compared to 8 per cent in 1986, as capital expenditure fell.

Performance on the balance of payments also did not conform with expectations, despite a welcome swing in the merchandise trade balance of almost US\$330 million or about 7 per cent of GDP which resulted in a fall in the current account deficit to 5.2 per cent of GDP from 13.2 per cent in 1986. However, the foreign exchange reserves declined from US\$330 million at the beginning of the year to just US\$80 million, or less than one month's import cover at year end. Despite a significant amount of external borrowing, including two Japanese private placements and drawdowns on external credits, the capital account surplus (inclusive of errors and omissions) was unable to finance any part of the albeit lower current account deficit. In fact, debt repayments offset completely the new resources provided by external loans.

The 1988 budget moved to tackle the problem of the fiscal imbalance. Although the top marginal rate was reduced from 70 per cent (except for petroleum companies which are governed by a special regime), an income tax surcharge of 5 per cent was imposed, replacing the unemployment levy and the national recovery impost, a 1 per cent levy was imposed on the gross sales of businesses, and fees, stamp duties, purchase taxes and excise duties were again increased. Taxes on telephone billings and electricity consumption were introduced. On the recurrent expenditure account, a range of subsidies were reduced or removed, and the allocations to state enterprises were to be cut by 15 per cent. A curiousum of the 1988 budget statement was the failure to mention the precarious state of the foreign exchange reserves and the policies that would be required to address the problem. The Bank's projections indicated that the country would have reached negative net reserves by the third quarter of 1988.

In 1988 oil production fell by 2.1 per cent, significantly slower than the rate of decline in 1987. However, prices slumped as the OPEC countries failed to maintain discipline and average OPEC prices dropped from US\$15.72 in January 1988 to US\$10.28 in October. By the middle of the year, however, after the June debt service payments had been made and had left the reserves depleted, the true extent of the foreign exchange problem was finally appreciated and the government moved to devalue by 15.3 per cent in August 1988 and began exploratory discussions with creditor banks on a debt rescheduling package. Toward the end of 1987, tentative discus-

TABLE 9.1: SOCIO-ECONOMIC INDICATORS, 1986-1988

	1986	1987	1988
Growth of Real GDP (1982 Prices)	-4.5	-6.1	-4.7
Growth of Real GDP of Non-Oil Sector	-5.5	-5.3	-6.3
Unemployment Rate (%)	17.2	22.3	22.1
Inflation Rate (%)	7.7	10.8	7.8
Current Account Deficit/GDP (%)	-13.2	-5.2	-3.5
Foreign Exchange Reserves (US\$m)	330.7	79.6	-5.7
Overall Fiscal Deficit/GDP (%)	-8.0	-7.3	-6.3
Recurrent Deficit/GDP (%)	-2.3	-2.3	-2.2
Growth of Money Supply (M-2) (%)	-3.6	2.5	0.1

SOURCE: Central Bank of Trinidad and Tobago, Annual Economic Survey, 1988.

sions had begun with the IMF on access to the Compensatory Financing Facility (CFF) and these discussions intensified during the annual consultation mission in the second quarter of 1988 at which time exploratory discussions on the outlines of a stand-by arrangement began at the technical level. These discussions were completed in November 1988 and the Letter of Intent was transmitted to the IMF. This allowed the country to access drawings under the Compensatory and Contingency Financing Facility (CCFF), the successor arrangement to the CFF, in November 1988, and cleared the way for the formal stand-by arrangement in January 1989. The following section outlines the principal features of the Stand-by Arrangement and the policy measures it proposes.

### *The Stand-By Arrangement<sup>2</sup>*

The negotiations with the IMF on the CFF and the Stand-by Arrangement were conducted by officials of the Central Bank and the Ministry of Finance. The Fund's team was led by Anthony Elson who had been on missions to Trinidad and Tobago in the mid-1970s and who had been working on the Jamaican programme. Not having had prior experience in negotiating with the Fund in terms of a Stand-by Arrangement, the Bank's governor wisely obtained the services of Ewart Williams, a Trinidad and Tobago national who had been a former central bank economist and was a

Fund official of some 15 years experience, having worked on Jamaica, Barbados, and on several African countries.

The Stand-by Arrangement concluded with the IMF on January 13, 1989 is typical of the genre. It requires the government to move the fiscal deficit from just over 7 per cent of GDP in 1988 to about 4 per cent in 1989 and to 1 per cent in 1991. The instrument chosen by the Trinidad and Tobago government to accomplish these targets were (i) curtailing transfers to state enterprises and utilities and (ii) a reduction in the wages and salaries bill. The specific fiscal instruments employed in these areas have been (i) a 10 per cent cut in the salaries of public servants effected in the 1989 budget and the institution of a voluntary termination of employment scheme which provides incentives for public servants to leave the service, and (ii) close control of transfers to state enterprises from the treasury. However, as in all Fund programmes, the real control over expenditures is exercised from the financing side in the form of limits on net banking system credit to the public sector as a whole, as well as limits on the overall fiscal deficit.

Monetary policy is intended to support the achievement of the balance of payments objectives of the programme which are specified in terms of targets for the net international reserves of the Central Bank. This translates into specific targets for the net domestic assets of the Central Bank, which in turn translates into specific action to control credit to the government and credit to the commercial banks. With lower access to the resources of the banking system, the government would need to approach the non-bank investors for financing to a much greater extent and this would have the effect of causing the cost of government financing to rise with possible knock-on effects on other borrowers in the capital market.

Bank lending to the commercial banks had begun in 1986 when liquidity had become quite tight and had risen to a peak of \$580 million in January 1988, equivalent to 8.3 per cent of deposit liabilities, which effectively nullified the cash reserve requirement which was then 9 per cent. The Bank raised the rediscount rate to 8.50 per cent in July 1988 in an effort to curb bank borrowing and hiked it further to 9.50 per cent in November 1988 as a prior action to the Stand-by Arrangement, such that there was about a 2 per cent differential between the rediscount rate and the average deposit rate at commercial banks. The programme required that this differential be maintained so that the commercial banks are induced to mobilize resources from the public rather than rely on borrowing from the Central Bank.

The programme also requires that the secondary reserve requirement be phased out. The secondary reserve has in fact provided a source of cheap financing for the government by requiring the banks to hold treasury bills among the eligible reserve assets and the Central Bank has then managed the rate on treasury bills through its open bid. In December 1987, this locked-in effect was used to provide additional financing to the government from the banking system when the secondary reserve requirement was raised to 11 per cent from 5 per cent, with a simultaneous reduction in the cash reserve requirement to 9 per cent from 15 per cent, with the banks required to hold an additional \$450 million of treasury bills in their portfolios.<sup>3</sup> The phase-out of the secondary reserve would have the effect of causing government short-term borrowing to be financed either outside the banking system, or if by the banks, at rates which were comparable to what they could receive on alternative instruments. This would in turn mean an increase in the interest cost of government short- and long-term borrowing.

The ultimate effect of these policies would be to drive the whole structure of interest rates upward to the point where real rates were positive, which in the view of the Fund, would assist in the mobilization of financial savings. It would also mean that the Central Bank would have to utilize open market operations to influence credit conditions and that its interest rate policy would have to be significantly modified in the direction of allowing greater upward flexibility in interest rates.

The other elements of the policy package under the Stand-by Arrangement relate to the perceived need to move to a more market-oriented economy. In relation to product markets, the programme requires the reduction in the number of items subject to price control and the more or less automatic pass-through of cost increases. In respect of the trade regime, the programme requires the removal of a specified value of items now subject to quantitative restrictions and their replacement by tariffs. The trade reforms being discussed under the World Bank Structural Adjustment Loan arrangement will piggy-back on those instituted by the Fund and will be ultimately more far-reaching in their effects.

Finally, in order to ensure that the external debt is managed in a fashion which will not contribute to balance of payments problems later on, the programme specifies limits on disbursement of short- and medium-term (up to 12 years) loans. The problem of external debt management is elaborated in the next section.

## External Debt Management

In Chapter Seven, in the course of reviewing the Demas Task Force Report, it was noted that there was already an awareness of a potentiality for a debt problem to emerge and a concomitant resolve to try to avoid such an outcome. The Demas Task Force Report did in fact advocate a carefully designed programme of external financing of the public sector investment programme (PSIP) which would take the debt service ratio up to 14.3 per cent, close to what was then held to be the danger point of 15 per cent.<sup>4</sup>

No one anticipated the complete collapse of the international petroleum market in 1986 and with it the sudden halving of export earnings. This immediately caused the debt service ratio to jump from 11.0 per cent in 1985 to 24.2 per cent in 1987, notwithstanding the fact that no new loans were raised in 1986 and disbursements in that year amounted to only US\$15.6 million. With net repayments of US\$83.0 million in 1986, the external debt stock rose only marginally between year-end 1985 and year-end 1986. In 1987, with reserves corresponding to an import cover ratio of less than three months, two Japanese private placements totalling US\$106.9 million equivalent were raised in February and December followed by another such placement in February 1988, reflecting the receptiveness of the Japanese capital market.

TABLE 9.2: EXTERNAL DEBT-SELECTED DATA, 1980-1989  
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	Central Government	Rest of the Public Sector	Total	Debt Service Ratio <sup>1</sup> (%)	Debt/GDP (%)
1980	436.6	334.3	770.9	3.3	12.4
1981	451.5	516.6	968.1	3.9	14.1
1982	557.5	560.9	1,118.4	5.8	14.1
1983	646.3	660.4	1,306.7	11.0	16.9
1984	838.8	598.8	1,437.6	14.0	18.4
1985	1,033.2	626.0	1,659.2	11.0	33.2
1986	1,061.7	836.3	1,898.0	19.2	39.8
1987	1,057.6	834.4	1,892.0	24.2	45.6
1988	1,213.5	786.2	1,999.7	21.5	51.8

SOURCES: Republic of Trinidad and Tobago - *Information Memorandum*. The First Boston Corporation, Morgan Grenfell and Co. Ltd. - Various Issues.

Research Department, Central Bank of Trinidad and Tobago, *Handbook of Key Economic Statistics*, 1989.

<sup>1</sup>Ratio of total debt service to exports of goods and services. External debts data here do not include leases.

However, other areas of the international capital market were not at all receptive, and the efforts to obtain dollar-denominated euro-credits were unsuccessful. There were successes in obtaining bilateral export credits relating to specific equipment purchases, but the 'commercial' segment of the market was effectively closed to the country.

The Bank's role in the external debt management process has not been central, partly because the institutional mechanisms for debt management were not organized. The Bank did, however, provide advice and support as required and played a useful role in the various 'road shows' over the 1982- 1987 period. The Bank moved later on in 1987-88 to develop an integrated data base on the debt stock and to enhance its capacity for debt projections especially in relation to the balance of payments.

### *Monetary Policy in the Stand-by Arrangement: A Comment*

There are some important differences between the approach to monetary policy under the Stand-by Arrangement with the IMF and the bank's traditional approach to policy. Firstly, policy under the Stand-by Arrangement is considerably less flexible than the Bank has preferred to do things in the past. Examples of this lack of flexibility are the gearing of changes in the rediscount rate to movements in average time deposit rates. This means that the Bank will be a market-follower and will therefore not be in a position to lead the market downward except where the differential has become quite wide, at which point, arguably, such 'leadership' is likely to be cosmetic and meaningless.

A second example is the proposed phase-out of the secondary reserve requirement. Admittedly, the secondary reserve had been used to lock-in a cheap source of financing for the government. It also served the useful purpose in bank portfolio management of providing a liquidity buffer which could be used when needed and the banks could avoid or minimize the high cost of deficiencies on their reserve accounts since the movement of assets was almost automatic. The phase-out is intended to subject government borrowing to market discipline. However, the massive expansion of the treasury bill issue by \$450 million in December 1987 makes it extremely difficult for the volume of bills to be digested by the market, which has also had to contend with a significant increase in government paper of longer maturities which has involved some innovative marketing in more recent times. One consequence of this is that the treasury bill rate has moved from the range of 4.50-5.00 per cent in the latter half of 1988, to 7.50 per cent at the present time, without any significant non-bank

participation in the treasury bill market. Given the differential tax treatment of treasury bills as against bank deposits, which latter now attract only a tax of 15 per cent, treasury bill rates may have to rise even further if the market is to digest such a large amount of bills.

A second area of difference in the approach to monetary policy is the question of interest rate policy. The Bank has never embraced the notion that real rates of interest must be positive in order to mobilize savings more efficiently and effectively. The Bank's position seems to have been that savings, including financial savings, is related much more to income than to interest rates which would, however, have some effect at the margin. The Bank's position on this is perhaps influenced by the comparatively low level of income in the society, relative to the industrial countries, and by institutional factors such as the breadth and depth of financial markets, which means that the vast majority of citizens are seen to be more concerned with capital preservation than with pursuing additional interest income through the financial markets. Moreover, it has found the 'evidence' of the effects of interest rate liberalization in 'financially repressed' economies is not compelling, and in systems such as Trinidad and Tobago where many businesses are heavily dependent on bank financing, nominal interest rates pitched at a level intended to effect positive real rates can prove burdensome to such business activity.<sup>5</sup>

Finally, the IMF is clearly much more enamoured of exchange rate adjustment than the Bank. In the past, the Central Bank has taken the view that exchange rate adjustments should occur when competitiveness indicators have become seriously out of line and that the adjustments should be discrete, large (so as to ensure a real adjustment after inflation) and infrequent. The Fund, by contrast, takes the view that exchange rate adjustments may well need to be frequent if reserves are continually depleted and may be small and continuous as in an auction system or other flexible-type exchange rate arrangement. The Bank's position has been influenced by a perception that the Fund's type of approach to exchange rate management is likely to prove destabilizing since the community will anticipate the depreciation of the rate and take steps to protect themselves thus putting further unintended pressure on the reserves which brings about the depreciation in a self-fulfilling prophecy cycle. In addition, the pervasive effects of an exchange rate adjustment must be noted as it ramifies throughout the economy and forces adjustments which, given the way in which factor markets work, inevitably causes the unemployment of resources, which might be prolonged. Ultimately, of course, such adjustments cannot be avoided, but effects can be better managed if the authorities are in full control of the timing and the extent of the adjustment. Also,

**the monetary authorities must consider the likely socio-political fallout of exchange rate adjustment which could nullify any beneficial effect if not properly implemented.**

## CHAPTER TEN

# CONCLUSION

### *Introduction*

Central Banks are unique institutions in any society. In all countries their *raison d'être* lie in (i) the fact that they provide the best solution to the minimization of the risks inherent in modern banking by providing an efficient lender of last resort function,<sup>1</sup> (ii) they provide an institutional mechanism to minimize or avoid the profligacy of governments in their fiscal roles, and (iii) in a modern economy they have the means of effecting control over monetary variables so as to provide conditions appropriate for improvements in real economic activity. In less developed countries, two (2) additional *raison d'être* of central banks are the 'prestige effect' which attaches to such institutions, and the role they are expected to play in fostering economic and financial development. No other institution in a modern society has these characteristics or performs these roles, but the operations of central banks are not without their conflicts and contradictions.

Indeed, institutions are really mechanisms for conflict management and resolution.<sup>2</sup> Central banks exist to resolve conflicts in financial intermediation, in the government's power over money creation and the conflicts which arise in the normal business cycle which need to be managed, if not resolved, at a macro level. In their role as lenders of last resort, central banks necessarily take a long view. In this role, they are dealing with the insubstantial, fragile and often mercurial factor of public confidence and it necessarily takes time to foster, maintain and, if broken, restore the public's confidence in the country's money or its financial institutions. In its role as macro-economic manager, central banks take a short view. Their concern is to try to smooth out fluctuations in economic activity and where necessary, to assist in adjusting expectations and incomes to structural changes in the domestic or international economy. A major area of conflict or contradiction is that in the modern world, central

banks are creatures of the very governments whom they must often seek to control. Further, they are created by legislation which, in the context of developing countries in particular, often does not take into account, and therefore make provision for, the traditions and conventions which underpin relations between government and central banks in more developed countries on which they may be patterned.

Any review of the activities of a central bank could therefore explore several different paths. In this review of the activity of the Central Bank of Trinidad and Tobago over the last 25 years, the paths we have sought to follow in describing and analyzing monetary and financial policy have been to elucidate the conflicts between the developmental role and stabilization and adjustment role of the central bank and the question of the independence of the central bank.

### *Development vs. Stabilization and Adjustment*

The Act establishing the Central Bank does acknowledge for it a role in promoting economic development. However, the Act is silent on a definition of development, while it is more explicit in defining the Bank's role in fostering and maintaining monetary stability.

In the early years of the Central Bank of Trinidad and Tobago, the key to growth and development was seen to be a high rate of investment which was related in turn to low rates of interest, based on the notion that high rates of interest are a disincentive to investment, though not necessarily an inducement to a higher savings rate. On the other hand, the Bank was motivated by what it perceived to be the need to minimize capital outflows which might be stimulated by unduly large interest rate differentials between London and Trinidad and Tobago in a context in which there was free and full convertibility at a fixed rate of exchange between the Trinidad and Tobago dollar and the pound sterling. The Central Bank's rediscount rate was the principal instrument used to influence the interest rate differential.

The circumstances surrounding the setting of the rediscount rate in 1966 were, however, quite unpropitious. Sterling was under pressure and interest rates in the London market had been rising to unprecedented levels. In the domestic market, banks were accelerating the acquisition of local assets by increasing loans and advances for both consumer purposes as well as for business activity. In addition, the difficult fiscal situation had forced the government to increase its borrowing on the nascent local capital market using treasury bills as well as longer term securities. In this sce-

nario, it was important to the government officials that interest rates be kept low as a stimulus to domestic investment and also to minimize the cost of domestic borrowing for the government.

The Bank under McLeod, while acknowledging the government's development policy objectives, was concerned to stem any capital outflows so as to retain surplus funds within the banking system and protect the foreign exchange reserves. This conflict found expression in the level at which the rediscount rate should be set initially in August 1966 and the size of subsequent changes in the rediscount rate, as well as the implications of the level of the rediscount rate for the yield on treasury bills. The government officials were quite strong in their view that the Bank's setting of the rediscount rate was overly conservative and inimical to economic development. The solution to the problem came ultimately with the institution of exchange controls against sterling in 1970, but the issue had largely dissipated some time before when the November 1967 devaluation of the pound sterling caused local investors to factor exchange rate risk into the interest rate differential between the local market and London. In addition, the repatriation of substantial amounts of funds after the 1967 devaluation improved banking system liquidity to such an extent that some downward pressure was maintained on the local interest rate structure. This was reinforced when the Minister of Finance in late 1967 indicated to the Central Bank his preference that local interest rates be kept down.

The late 1960s and early 1970s were characterized by a growing disillusionment with the results of the development strategy of the 1950s and early 1960s. The social unrest of 1969-1970 served to galvanize the view that there was need for a profound redirection of development policy. This redirection, which was to place emphasis on a so-called 'People's sector' and the principle of self-reliance, had to await the resolution of the foreign exchange crisis and the stabilization of the economy after 1973. Perhaps, unfortunately, before the stabilization process was complete, higher oil prices and oil production boosted export earnings and, along with changes to the petroleum taxes regime, broke simultaneously the savings and foreign exchange constraints on development. The redirection of development policy was never fully implemented and the possibility of a broad-based development policy was swept aside by the sectoral strategy of energy-based industries.

While a great deal can be said about this change in development policy, which occurred against a backdrop of political melodrama, our concern is merely to point out that even with massive foreign exchange inflows and, for a time fiscal surpluses, the problem of stabilization and

adjustment did not disappear. Economic disequilibrium was evident in escalating expectations, the post-1975 demand-pull inflation, the growing deficit on the 'non-oil current account', the rapidly increasing net domestic budget deficit and the speed with which the fiscal surpluses were being dissipated. This was clearly an area in which one might have anticipated a profound conflict between the government and a central bank concerned with stability as a basis for long-term growth, even if it did not feel competent to advise on the appropriateness of the 'sectoral' development strategy. In the event, the Central Bank acquiesced and accommodated itself to the strategy until late 1979 when, under the influence of Euric Bobb as Deputy Governor, it felt compelled to take action.

In the early 1980s, development policy became very confused as George Chambers, who assumed the prime ministership on the death of Eric Williams, and who had cautioned about the dangers of over-reliance on the oil sector in the 1973-1975 period, began to question the strategy and appointed the Demas Task Force to re-think the strategy. At the same time, the international petroleum market was becoming unglued as nominal oil prices fell, and in the local industry, oil production had peaked as early as 1978. The energy-based industries were still being put in place or were just coming on stream and could not replace the lost oil receipts. One might have supposed that in such a climate it would have been easy for the Central Bank to exercise its influence on the implementation of a stabilization programme.

Several factors conspired to make the implementation of a stabilization programme difficult and in the end, late. First, there was the sheer momentum of past policy which, up to as late as 1981 in the Fiscal Review Committee and the public sector wage negotiations, was advocating concessionary policies. Second, there was a great deal of indecisiveness on the part of the policy makers, which was not helped by the indecisiveness of the technical advisers themselves. One area of indecision was the likely evolution of oil prices. Another major area of indecision was the question of exchange rate policy in balance of payments adjustment. In the 1970s there had also been indecision about the change of the sterling peg. The Central Bank took the view that in the short to medium term exchange controls should be tightened. This was based on the arguments that, at that time in early 1983, expectations were still high and that a devaluation would not be successful in an environment in which this was the case, and, secondly, it was necessary to introduce a mechanism which would force consumption down more quickly than reliance on the price effects of a devaluation, especially if those effects were quickly eroded by compensating wage increases. However, the Bank was also clear that the change in the

terms of trade was structural and that therefore a devaluation was inevitable before very long. As in the 1970s, the Bank and the Ministry parted company on the question of exchange rate policy. The introduction of the new exchange control measures was late, the devaluation came over one year later than recommended and when it was instituted it was in the form of a dual exchange rate regime to which the Bank was opposed.

If the government was slow to implement the programme of stabilization and adjustment required by the change in the terms of trade, the Bank in 1986 was perhaps too quick to bring monetary policy in support of the resumption of growth which adjustment was supposed to bring in its train. This judgment of monetary policy in 1986 is based on the fact the Bank was aware that the adjustment programme was incomplete and geared to oil prices prevailing at the end of 1985, rather than the prices of mid-1986. The Bank's policy measures in 1986 were, however, designed more conservatively than might first appear. They were calculated not to cause any adverse impact on the balance of payments and the Bank had managed to lock away from the government's reach the revaluation gains on the exchange rate adjustment of December 1985. Nevertheless, the perception created was that there was an easing of monetary policy, which in fact there was, and at a time of collapse of oil prices the creation of such a perception was counter-productive, given that further and stronger adjustment was indicated.

### *Independence*

It must be noted that the independence of the Central Bank of Trinidad and Tobago is not enshrined in its enabling legislation. The legislation specifies certain roles for the Central Bank. However, there is no clear statement in the Act, except in respect of the issue of notes and coins, that these functions are exclusive to the Central Bank. Indeed, the requirement for consultation with the Ministry of Finance and the important provision in Section 50 that the government may issue a directive to the Central Bank to give effect to *its* monetary policy suggests that the formulation and implementation of monetary policy may not necessarily be the exclusive preserve of the Central Bank. The important function of bank regulation and the recent powers conferred on the Central Bank to deal with emergencies in the financial system all require approval or consultation with the minister. How then is the independence of the Central Bank to be understood?

A useful analogy might be that of an adult living in his parents' home. Such an individual would have freedom to act over a wide sphere of activity and the relationship between himself and his parents would, as a result, be

characterized by mutual respect. Ultimately, however, the home is the domain of the parents and where there is fundamental disagreement over a course of action which the son or the parents wish to take the wishes of the parents will prevail. What is important to understand in this relationship is that there is a large area for disagreement, but an equally large area for negotiation and compromise and that mutual respect underpins the relationship.

To understand how the relationship between the Central Bank and the government has evolved in practice, it is necessary to understand the nature of the government and of the state. The ideology of the Trinidad and Tobago state has been characterized by political and economic nationalism, a strong commitment to democratic practice and a strong desire for economic growth and development based on considerations of equity. These ideological principles are by now fairly deeply rooted and have largely survived the transition from the previous administration to the current administration.<sup>3</sup> Caribbean governments, and the Trinidad and Tobago government has been no exception, acknowledge the rationale for the existence of a Central Bank and the need to create one. However, as in all small societies, the political directorates are typically unwilling to cede political power and the power of patronage to institutions outside of the executive arm of the government.

In the establishment of the Central Bank of Trinidad and Tobago, for example, there was the fundamental question as to whether the British model in which the central bank is part of the Executive, or the American model in which the central bank is part of the Legislature, would be followed. Caribbean executives have rarely ceded power to the parliaments, and the central banks throughout the english-speaking Caribbean are de jure and de facto arms of the executive. However, the British model of the Bank of England is based not only on an Act of Parliament but as well two centuries of traditions and conventions which have been as important in shaping the rules of the game as the actual legislative provisions. In countries such as Trinidad and Tobago, these traditions and conventions are largely absent and, in the vast grey area between legislative provision and praxis, the central bank governors and the ministers of finance and prime ministers have had to shape the nature of their relationship in a context in which prime ministers, who are usually the ministers of finance, are dominant, if not dictatorial. In such a situation the institutionalization of the relationship between the Central Bank and the government has depended largely on the men who have mediated the relationship and, in particular, on the character, personality, competence, public profile, interpersonal skills and the conviction of the Central Bank governor.

Conflicts between the Central Bank and the government may arise over the specific objectives of policy in a given situation, the instruments of policy to be used, the settings of policy instruments and the timing of policy. In the 1960s, conflict between the Central Bank and the government emerged almost immediately when in July 1966 the decision had to be taken on the setting of the rediscount rate. The conflict was specifically between the governor, Alex McLeod, and the government's representatives on the Board of the Central Bank — William Demas, Frank Rampersad and Patricia Robinson. It is interesting to note that this conflict was eventually brought to the attention of the Prime Minister, Eric Williams, who resolved the matter in favour of the Bank. While one might wish to interpret this intervention as giving prime ministerial support to the independence of the Central Bank in policy formulation at a very early stage in its life, there was some reversal of this when, following the November 1967 devaluation of the pound sterling and the rapid run-up in interest rates in the U.K., the Ministry of Finance wrote to the Central Bank indicating that it would prefer that interest rates in Trinidad and Tobago should be kept down. While not a Section 50 directive, the fact that the Minister of Finance was moved to write was an indication of the strength of the sentiments within the Ministry of Finance at the time on the question of the Central Bank's interest rate policy.

As we have seen in Chapter Four, another area of conflict was the Ministry of Finance's annoyance that the Central Bank would not use its selective credit control powers to restrict the allocation of credit for consumer purposes. Governor McLeod was not convinced that the conditions for the use of the selective credit control conditions as set out in the Act had been met and was also of the view that restriction of consumption expenditure should be addressed by fiscal and commercial policy rather than by monetary policy. The Ministries of Finance and Planning failed to move McLeod's Central Bank on this issue. It can be argued that in this period the Central Bank was able to demarcate its turf and to stand its ground against the government in respect of monetary policy, a not insignificant achievement given the calibre of the 'opposition' — Frank Rampersad and William Demas - which it faced.

In the period 1969-1973, Trinidad and Tobago was in social and economic crisis and, policy-wise, the government and the Central Bank were at one. In the subsequent period 1974-1979, we have suggested that the Central Bank adopted an accommodating posture to the government's economic management, which became increasingly incoherent. While technical weaknesses may have contributed to this accommodation, it appears that the political risks in adopting an independent posture were

made extremely high. In this period, Eric Williams had made casualties of several senior public servants and ministers including J. O'Neill Lewis, Eugenio Moore, Doddridge Alleyne, Frank Rampersad and George Chambers. His political style had become increasingly idiosyncratic and it may well be that the Central Bank elected to accommodate rather than to fight in that kind of climate.

The major issues of the 1980s on which the Bank and the government differed related to exchange policy, specifically the timing and extent of exchange rate adjustment and the timing of the introduction of exchange controls. On the issue of exchange policy, however, the Bank can only exercise suasion since the instruments of control rest firmly with the government. The Bank cannot move the exchange rate on its own, nor indeed can it introduce a major change in the administration of exchange controls without the explicit approval or acquiescence of the Ministry of Finance.

Yet it was not an issue of exchange policy which finally brought Section 50 into use in December 1987, but an issue of monetary policy. As we have already noted, relations between the governor and the new administration became increasingly frosty during the course of 1987, partly it would appear because of perception of the political allegiances of the governor, and partly because the government was either cautious about, or suspicious of, the policy advice given by the Bank, which included the suggestion that Trinidad and Tobago needed to seek access to the resources of the IMF under the Compensatory Financing Facility along with a Stand-by Arrangement, when early in its life, major actors in the new administration had stated publicly that there could be no question of adopting a Fund programme under the new government.

As the fiscal imbalances manifested themselves in 1987, it became necessary to find a means of financing the fiscal deficit without causing the Central Bank to break the law in respect of the limitation on advances to the government. The device chosen was to reduce the cash reserve requirement of the commercial banks and simultaneously increase the secondary reserve requirement so that the banks were forced to hold the additional treasury bills issued to finance the deficit. The Bank was of the view that, given the fragile foreign exchange reserves situation, this mechanism constituted a significant relaxation of monetary policy, especially as the commercial banks were already borrowing extensively from the Central Bank and the effective cash reserve ratio would be almost zero. The Bank indicated to the Ministry that it would only implement the policy change if it were given a directive so to do.

The specific issue which prompted the Section 50 directive was really trivial, in that in a context of normal relations between the Bank and the Ministry it would certainly have been resolved without a directive. Relations were, however, far from normal. The governor had already resigned after a bitter and highly publicized conflict with the Minister of Finance, and it was this more than the substantive issue which caused the directive to have to be issued. The experiences of the 1980s have, however, served to clarify the question of the independence of the Central Bank of Trinidad and Tobago.<sup>4</sup>

Finally, we might note some of the practices which sometimes seem to push central banks into a posture of being a mere department of governments. Central Bank governors or senior officials who would defend, as distinct from explain, government policy in politicised circumstances are unwittingly placing their institutions in a supine posture and make it almost impossible for the Bank to take an independent stance on matters of economic policy, especially monetary and financial policy, when it is required to do so. Relatedly, central bank governors and officials should also avoid writing speeches for government officials if these speeches and statements are for narrow party political fora and arguably most statements by a government minister may be viewed as political. Ideally, if government officials respect the independence of central bank officials, they ought not to make such requests in the first place, although the excuse of limited human resources is often made. It is quite a different matter, however, to be asked for technical or professional advice or for data in the possession of the Bank and such requests, properly made, should be met unreservedly.

### *A Look Ahead*

In our view there is no neat solution to the problem of the conflict which often arises between development policy and monetary stability and the conflict is likely to be more pointed in political systems in which the directorate wants to force the pace of growth and transformation and at the same time to ameliorate an inequitable distribution of income. It will arise as well where policies are, for whatever reason, slow to react to structural changes, particularly external shocks.

It would be helpful, however, if the limitations of monetary and financial policy in the promotion of growth and transformation are better appreciated. It is always far easier to throw money at a problem than to deal with the deeper structural issues where solutions and policies are much more difficult to devise. Issues of technology policy, wages and incomes

policies, increasing labour productivity and effecting re-allocation of resources are far more complex than most issues of monetary policy. Yet monetary and financial policies are easier to implement and are more 'visible', in that policy makers appear to be doing something. Yet appropriate monetary and financial policy are only a necessary condition for growth and transformation and arguably not the most important, and are certainly very indirect and uncertain in their ultimate efficacy.

To appreciate this is to appreciate the limitations of a central bank in the promotion of growth and development, and such an appreciation might cause political directorates in developing countries to be more circumspect about burdening the central bank with a direct and explicit developmental role. A central bank must design monetary and financial policy in such a way that growth and development is facilitated and not hindered. The best way a central bank can help in this regard is to ensure monetary stability, i.e. to aim for a low rate of inflation, tight control over money creation for the financing of fiscal deficits and embrace the protection of the balance of payments and reserves accumulation as its over-riding policy objective. Deviation from these policies with a view to encouraging development would be dangerous and in the long term inimical to the very development which it is seeking to promote.<sup>5</sup>

To do this effectively a central bank must be independent of the government as well as of the many sectional interests which will seek to influence it in one way or the other. Given the nature of the state in the Caribbean, it would probably be a good idea to provide some insulation and some recourse in the relationship between the central bank and the Executive in respect of monetary policy and probably in respect of bank supervision and regulation as well. As has been done in New Zealand and Australia, and as obtains in the United States, it would be useful to have the central bank report regularly to a special committee of parliament, probably at the time that the annual report is laid. It would also be useful if in the event of a conflict which prompts a directive from the government that the Bank and the government be required to report to parliament on the issues which led to the difference of opinion, but without parliamentary power to overturn or rescind the policy decision of the government. The objective here would be to promote a wider debate of the issue on which the Bank and the government are divided.

All of this is founded on the premise that a central bank should not merely be an arm of the Executive. It should be seen as an integrative institution, having a quasi-judicial function in the economic sphere and specifically as the guardians of the public interest against the dangers of

monetary profligacy or short-sightedness. Central banks should therefore possess some of the immunities of the judiciary, but being non-elected, they must ultimately bow to the will of the elected government.<sup>6</sup>

These notions may appear radical to some, especially perhaps those in the Executive in Caribbean and other developing countries. Their reaction would be based on the idea that elected officials are responsible for policy and that central banks are merely delegated to carry out a specific area of policy under the direction of the government. Such a view ignores the history of the development of central banks, and the problems which arise when central banks become mere appendages of governments. On the other hand, our views may appear conservative to those others who have witnessed at first hand the damage that elected governments can inflict on an economy as they seek to pursue, not the public interest, but the retention of power at the next election. These commentators would wish that central banks have even greater power than I have advocated here, and perhaps would invest them with the kind of independence enjoyed by the West German Bundesbank. The issue needs to be debated in the Caribbean where we have had experience of central banking for a reasonably long time, such that we can review, on the basis of concrete experience, and with a better understanding of our states and our societies, what kinds of central banks we wish to have.

## NOTES TO CHAPTER ONE

<sup>1</sup> See Victor (1987), Parris (1984) and Farrell (1988).

<sup>2</sup> See, however, Bobb (1983a), Bobb (1983b) and Farrell (1983).

<sup>3</sup> For an example of this approach, see T.J. Courchene, *Money, Inflation and the Bank of Canada*, C.D. Howe Institute, Montreal, n.d. (circa 1976).

<sup>4</sup> It is not really accurate to describe this approach as 'historical' since the essence of modern historical studies is to be analytical and even judgmental. I therefore use the term advisedly to mean an approach weighted more toward description and chronological order than to critical analysis.

## NOTES TO CHAPTER TWO

<sup>1</sup> The classic article here is Henry Simons', 'Rules versus Authorities in Monetary Policy' in *Journal of Political Economy*, February, 1936. Also, Milton Friedman, *A Program for Monetary Stability*, Fordham, New York, 1960, pp. 84-99.

<sup>2</sup> Where there is some inflation and price expectations enter, the real interest rate is not directly observable and its usefulness as a target variable disappears. However, using the nominal interest rate as a target variable is fraught with problems owing to the variability of inflation and hence price expectations and the variability of the real interest rate itself.

<sup>3</sup> J. Kareken and R.M. Solow, 'Lags in Monetary Policy' in William Hamovitch (ed.) *Monetary Policy: The Argument from Keynes' Treatise to Friedman*, D.C. Heath, Boston, 1966. These have also been described as the 'implementation' lag and the 'operational' lag.

<sup>4</sup> See M. Fry, *Money, Interest and Banking in Economic Development*, John Hopkins University Press, Baltimore 1988, Chapters I-IV.

<sup>5</sup> For a perspective on economic dependence in the Caribbean context, see L. Best, 'Independent Thought and Caribbean Freedom' in *Readings in the Political Economy of the Caribbean*, ed. N. Girvan and O. Jefferson, New World, Jamaica, 1971; W. Demas, 'Situation and Change' in G. Beckford (ed.) *Caribbean Economy*, ISER, Mona, 1975 and H. Brewster, 'Economic Dependence: A Quantitative Interpretation', *Social and Economic Studies*, Vol. 22, No. 1, 1973. The concept of 'functional dependence' is attributable to Alister McIntyre, 'Some

Issues of Trade Policy in the West Indies' in Girvan and Jefferson, *op. cit.* (Reading 13), where the concept is applied to the trade policies of the Caribbean countries.

<sup>6</sup>Different types of closure have been advocated by Lloyd Best and C.Y. Thomas, the latter most forcibly in his book *Dependence and Transformation*, Monthly Review Press, New York, 1974.

<sup>7</sup>See Demas (1974) and Farrell (1989).

### NOTES TO CHAPTER THREE

<sup>1</sup>R.S. Sayers, (1958) 'Central Banking in Underdeveloped Countries, Ch. 9, p. 114.

<sup>2</sup>The material here is drawn from *The Central Bank and the Jamaican Economy, 1960-1985*, Kingston, Bank of Jamaica, October, 1985, p. 3.

<sup>3</sup>*Op. cit.*, p. 4.

<sup>4</sup>I am grateful to Professor Alex McCleod for pointing this out to me. See Sayers (1958), Chapters 2 and 3.

<sup>5</sup>On the fiscal policy see Bobb (1969). For a listing of fiscal and financial legislation see Farrell et al. (1989). See also Robinson (1982). On insurance companies and pension funds development, see P. Forde (1989) "The Insurance Industry, Pension Funds and the Social Security System in Trinidad and Tobago", mimeo. Research Department, Central Bank of Trinidad and Tobago (1989). Labour law and collective bargaining is discussed in Thomas (1989) *The Development of Labour Law in Trinidad and Tobago*, Mass.: Calaloux Publications.

<sup>6</sup>Hansard, Vol. 4, 3rd Session, First Parliament, p. 280. The Central Bank Bill was introduced in the Senate for debate by Donald Pierre, the Minister of Education. The Senate debate was, perhaps curiously, quite uninteresting.

<sup>7</sup>*Ibid.*

<sup>8</sup>*Ibid.*

<sup>9</sup>*Ibid.* See also Sayers, *loc. cit.* p. 115, where he argues that, apart from performing certain technical and advisory functions, central banks in underdeveloped countries had the important task of developing the banking system.

<sup>10</sup>Economic Planning Division, Office of the Prime Minister, 'Comments on Central Banking and Commercial Banking Bills', 24 August 1964. It appears that the memorandum was authored by Edwin Carrington.

<sup>11</sup>C.Y. Thomas (1972).

<sup>12</sup>Demas (1965) p. 66. Demas was a member of the board of the central bank from 1964 to March 1970, though he was replaced for a time during 1966 by Frank Rampersad while he was visiting professor at McGill University. He became its fifth governor in February 1988.

<sup>13</sup>Hansard, *loc. cit.*, p. 281.

<sup>14</sup>Government of Trinidad and Tobago, *Draft Second Five-Year Plan, 1964/1968*, p. 148-9.

<sup>15</sup>One does not know how reliable the early national income estimates were. It is possible that the strength of the boom was exaggerated or that the rates of growth were large because of the small bases from which they were calculated. Also, the unemployment rates obtained from the population censuses are not strictly comparable with the rates calculated from the Continuous Sample Survey of Population (CSSP) data.

<sup>16</sup>Government of Trinidad and Tobago, *Third Five-Year Plan 1969/1973*, Appendix IV, p. 399.

<sup>17</sup>Demas (1965) p. 64.

<sup>18</sup>Farrell (1987), Bobb (1969).

<sup>19</sup>See Ramkissoon (1982). However, in 1969 the Central Bank introduced a 'basic foreign exchange position' for the banks which limited their foreign asset holdings. This was not prompted by the need to retain savings locally, but rather to introduce some orderliness in the operation of the foreign exchange markets.

<sup>20</sup>Hansard, Vol. 4, 3rd session, 1st Parliament of Trinidad and Tobago, p. 286.

<sup>21</sup>*Op. cit.*, p. 288. Assurances on the parity and convertibility were also given in the *Draft Second Five Year Plan*, (1965), p. 110.

<sup>22</sup>Address by A.N.R. Robinson, minister of finance on the occasion of the formal opening of the new premises of the Central Bank of Trinidad and Tobago on 4 March 1967.

<sup>23</sup>There were seven banks in the system in 1965 - Barclays Bank DCO (which was also the government's banker), First National City Bank, Chase Manhattan, Royal Bank of Canada, Bank of Nova Scotia, Canadian Imperial Bank of Commerce and Bank of London and Montreal. There were some 67 branches throughout the country.

<sup>24</sup>Memorandum on Currency and Central Banking in Trinidad, dated March 1962. Stanley Payton, who had been an official of the Bank of England, was the first governor of the Bank of Jamaica.

<sup>25</sup>It would appear that McLeod was in fact the first choice as governor but was unavailable at the time.

<sup>26</sup>The first representative of the ministry of finance was Godfrey Codrington who became secretary of the bank in April 1965 and subsequently its manager bank operations.

<sup>27</sup>Address by A.N.R. Robinson, minister of finance on the occasion of the opening of the Central Bank of Trinidad and Tobago, 4 March 1967.

<sup>28</sup>A.N. McLeod, farewell speech 'Some Parting Comments' at a luncheon on 31 July 1969.

## NOTES TO CHAPTER FOUR

<sup>1</sup>It took 18 months to have the remaining sections of the Central Bank Act proclaimed although the Bank's management had hoped that these sections would have been proclaimed and made effective much earlier. It appears, however, that the tensions between Governor Pierce and the Ministry of Finance were an important element in the delay. The remaining sections were enforced within three months of Governor McLeod's assumption of duty.

<sup>2</sup>Our determination of the Bank's policy objectives and approaches are derived largely from statements in its Annual Reports for the period. The Annual Reports for 1968 and 1969 were helpful in this regard although the typical writing style of central bankers requires careful interpretation of the written word. As a central

banker for some 9 years, and having been responsible for some of the Bank's written output, I think I may have a comparative advantage in the interpretation of 'central bankese'.

<sup>3</sup>Alex McLeod has suggested that my ordering and description of the Bank's objectives in this period are incorrect. In his view, the Bank's principal objective at the time was to keep interest rates as low as feasible in order to promote economic development and what I have described as the insulation objective was a constraint on the interest rate objective. Further, the Bank's objective was not to keep the banking system liquid. This, rather was a result of the basic policy pursued, not an objective in its own right. (A McLeod, Comments on Draft Monograph, July 1989).

<sup>4</sup>The rediscount rate is also called the 'discount rate' or 'Bank rate' and the terms are used interchangeably here, although there are in fact subtle differences in meaning. Alex McLeod has pointed out that the term rediscount rate was chosen in preference to 'Bank rate' so as to avoid confusion with the prime lending rate of the commercial banks.

<sup>5</sup>The discussion here has benefitted immeasurably from a paper prepared by Alex McLeod, 'Notes on the Basic Principles of Monetary Policy', dated 23 March 1967 which was prepared for the board of the Bank, as well as a speech by McLeod delivered to the Port of Spain Rotary Club on 18 July 1967 entitled 'The First Year of Central Banking in Trinidad and Tobago' and private communication with the author.

<sup>6</sup>In this period, the Treasury Bill rate was indeed largely market determined, although the Bank managed the tender, partly to ensure that all the bills were taken up and partly to put an upper limit on the rate. 'Excess' Central Bank holdings could be sold in the after-market. See also Farrell and Baball (1981).

<sup>7</sup>Government of Trinidad and Tobago, *Third Five-Year Plan*, p. 425.

<sup>8</sup>*Op. cit.*, p. 45.

<sup>9</sup>McLeod, A., 'The First Year of Central Banking in Trinidad and Tobago', p. 2.

<sup>10</sup>Demas (1965), p. 65-66.

<sup>11</sup>McLeod, 'Notes' (1967). The intention was that the rediscount rate should be kept above the T-Bill rate since the sale of T-Bills was an alternative to bank borrowing from the Central Bank.

<sup>12</sup>Annual Report, 1967, p. 5.

<sup>13</sup>Annual Report, 1969, p. 8. After the November 1967 devaluation there was considerable upward pressure on local interest rates, arising from rising interest rates abroad. The Minister of Finance wrote to the Bank indicating that he would prefer that as far as possible, local interest rates be kept down.

<sup>14</sup>See Section on 'Financial Policy' below.

<sup>15</sup>McLeod would not likely have made this shift willingly and his farewell speech supports this contention. Economic growth was slowing, unemployment was rising inexorably and the price level had risen sharply as a result of the devaluation. It was not a propitious time for a central bank governor to be advocating a monetary policy which appeared to fly in the face of 'reason' and the conventional wisdom of the time.

<sup>16</sup>*Third Five Year Plan, 1969-1973*, p. 45-47.

<sup>17</sup>Best and McIntyre (1965), pp. 359-61.

<sup>18</sup>A. McIntyre 'West Indian Membership of the Sterling Area: A Regional View' in ISER, Regional Conference on Devaluation, February 1968.

<sup>19</sup>Trinidad and Tobago, Parliamentary Debates, Hansard, 4th Session, 2nd Parliament, Vol. 13, No. 31, 12 June 1970, p. 412.

<sup>20</sup>Commonwealth Development Finance Co. Ltd., Report on Proposed Industrial Development Bank for Trinidad and Tobago (Berkoff Report), 6 December 1964.

## NOTES TO CHAPTER FIVE

<sup>1</sup>See People's National Movement, Perspectives for the New Society, November 1970, and Government of Trinidad and Tobago, White Paper on Public Sector Participation, No. 1 (1972) and No. 2 (1975).

<sup>2</sup>Budget Speech, 1976 (Eric Williams, Minister of Finance).

<sup>3</sup>Budget Speech, 1975, p. 667.

<sup>4</sup>Government of Trinidad and Tobago, White Paper on Public Sector Participation, No. 1 (1972) and No. 2 (1975).

<sup>5</sup>See Victor (1983).

<sup>6</sup>Farrell (1988).

<sup>7</sup>Melton has claimed, however, that the Fed did not succumb to monetarism and despite the public targeting of monetary aggregates 'the federal funds rate continued to be the Fed's key operating variable, while the aggregates routinely grew at rates outside the targets'. W.C. Melton, *Inside the Fed*, Dow Jones-Irwin, Homewood, 1985, pp. 29-37.

<sup>8</sup>See D. Meiselman (ed.), *Varieties of Monetary Experiences*, Chicago, University of Chicago Press, 1970, for applications to developing countries. For an early review of the literature, see C.H. Kirkpatrick and F.J. Nixon, 'The Origins of Inflation in Less Developing Countries: A Selective Review' in M. Parkin and G. Zis (eds.) *Inflation in Open Economies*, Toronto, University of Toronto Press, 1976.

<sup>9</sup>See Farrell and Christopher (1989) for a review of the Caribbean literature. The contributions of Compton Bourne, C.J. Bruce and Eric St. Cyr are especially noteworthy in this context.

<sup>10</sup>See Frenkel, J. and Johnson, H.G. (eds.), *The Monetary Approach to the Balance of Payments*, Toronto, George Allen and Unwin, 1976 and International Monetary Fund, *The Monetary Approach to the Balance of Payments*, IMF, Washington D.C., 1977.

## NOTES TO CHAPTER SIX

<sup>1</sup>Exchange rate policy in small economies involves three related decisions: (i) choice of peg, i.e. which reserve currency or basket of currencies the country's currency will be related to; (ii) choice of parity i.e. the rate of exchange with the 'intervention' currency, and (iii) the 'rules' by which changes in the parity and/or peg will be effected.

<sup>2</sup>*Annual Report*, 1974, p. 43.

<sup>3</sup>*Annual Report*, 1977, p. 32. This would actually have been written in March 1978 and more than likely was inserted by the Bank's new deputy governor, Euric Bobb.

<sup>4</sup>V.E. Bruce, 'Recent Economic Trends in Trinidad and Tobago'. Address to Trinidad and Tobago Chamber of Commerce of the USA Inc., April 1977, p. 2 and "Experience with Inflation in Trinidad and Tobago, 1970-1977". Paper presented for 25th Meeting of Governors of Central Banks, September 1977.

<sup>5</sup>V.E. Bruce, "Experience with Inflation in Trinidad and Tobago, 1970-1977". Paper presented for 25th Meeting of Governors of Central Banks, September 1977, p. 5.

<sup>6</sup>See Eric Williams, Devaluation Speeches (to House of Representatives and Radio/TV Broadcast), 22 November 1967, PNM Publishing Co. Ltd., Port of Spain, 1967.

<sup>7</sup>Budget Speech 1977, (Eric Williams, Minister of Finance), p. 714.

<sup>8</sup>V.E. Bruce, "Revaluation of the Trinidad and Tobago Dollar in the Light of the International Monetary Situation", Address to the South Trinidad Chamber of Industry and Commerce, 28 July 1976.

<sup>9</sup>Frank Rampersad has expressed these views in private comments to the author.

<sup>10</sup>See T.W. Farrell, "Choice of Exchange Rate Regime in a World of Floating Rates", mimeo, Research Department, Central Bank of Trinidad and Tobago, August 1982.

<sup>11</sup>The Bank's acquiescence may not have been unrelated to the high number of 'casualties' among ministers and public servants in conflicts with the Prime Minister. Eugenio Moore, Frank Rampersad and George Chambers were among these casualties.

## NOTES TO CHAPTER SEVEN

<sup>1</sup>The other members of the Committee were Joyce Alcantara, V. Dean Maharaj, H. Adams, Richardson Andrews, Radcliffe Yearwood and Carlyle Greaves.

<sup>2</sup>Republic of Trinidad and Tobago (1978), (The Bobb Committee Report) pp. vii-xi and passim.

<sup>3</sup>Budget Speech, 1983, p. 11.

<sup>4</sup>This was the high season of the advisory committee of which Trinidad and Tobago has never lacked. There were the Bruce Fiscal Review Committee and the Committee on the Development of Non-Oil Exports in 1981. In 1982 there was the Demas Task Force and an IMF advisory team on Financial Management as well as the reconstitution of the National Economic Planning Commission. There was a National Consultation on Productivity out of which emerged the National Productivity Council. In 1985 there was a Committee on Public Sector Participation, Foreign Investment and the Role and Growth of Conglomerates and in 1986 the Barsotti Fiscal Review Committee. This phenomenon we think deserves some study and comment by our political sociologists, our calypsonians having already addressed the subject.

<sup>5</sup>Other members of the team were C.J. Bruce, Trevor Boopsingh, Joyce Alcantara, Norbert Masson, Eldon Warner and Patrick Alleyne. Doddridge Alleyne, a former Bank board member, was also appointed but was unable to participate in its deliberations.

<sup>6</sup>We emphasise the 'written report' since it is almost certainly the case that a team of such calibre would have discussed the question of exchange rate adjustment in relation to stabilization and adjustment. It is our judgment, however, that exchange rate adjustment was not seen to be an acceptable instrument of policy to the political directorate at the time and that mention of its potential use might have accelerated capital flight.

<sup>7</sup>The application of the concept of the Bank is due to Euric Bobb. The concept is outlined in R. Chelliah, 'Significance of Alternative Concepts of the Budget Deficit' *IMF Staff Papers*, vol. 20, November 1973, S. Chand, "Summary Measures of Fiscal Influence", *IMF Staff Papers*, vol. 24, July 1977. See also D.R. Morgan, "Fiscal Policy in Oil Exporting Countries, 1972-1978", *IMF Staff Papers*, vol. 26, March 1979 and T.W. Farrell, "The Government Budget and Money Supply in Open, Petroleum Economies: Trinidad and Tobago, 1973-1980", Research Department, mimeo, July 1981, for application of the concept.

## NOTES TO CHAPTER EIGHT

<sup>1</sup>The inflation control and balance of payments objectives are, of course, related since a rate of inflation in excess of the rate of inflation of the country's trading partners causes appreciation of the real effective exchange rate and imports become relatively cheaper.

<sup>2</sup>See E. Bobb, 'The Role of Financial Policies in Economic Development (with special reference to Trinidad and Tobago)'. Address to Port of Spain Jaycees Seminar, June 1981.

<sup>3</sup>In 1982 the Bank's Research Department undertook a series of studies on exchange rate policy which included calculation of effective exchange rate indices and an examination of the appropriate exchange rate regime for Trinidad and Tobago. The Department also made projections of the balance of payments and other key economic variables.

<sup>4</sup>See T.W. Farrell, 'Import Restrictions in Short-Run Economic Management: EC-Zero and the New Exchange Control Procedures', *Central Bank Quarterly Economic Bulletin*, Vol.8, No. 4, December 1983 (Address to Chamber of Industry and Commerce, November 1983).

<sup>5</sup>An amusing footnote to this episode is that the new system sought to control imports at the 7-digit level of the tariff code. This meant a veritable deluge of forms to be approved which was too much for the staff of the Exchange Control Department. As a consequence, senior staff from other areas of the Bank, including the Governor and Deputy Governor, were enlisted to sign boxes of forms. It was many weeks before the system settled down!

<sup>6</sup>The Bank, however, won the struggle with the Ministry to bring public debt service in at the new rate. It also withheld the balance sheet gains from the devaluation from the government.

<sup>7</sup>See E. Bobb and T.W. Farrell, 'Exchange Rate Policy and the Devaluation of the Trinidad and Tobago Dollar'. *Central Bank Quarterly Economic Bulletin*, Vol. X. No. 4, December 1985.

<sup>8</sup>It is indeed difficult to understand, except perhaps in political terms, why a fresh budget was not presented to the country in mid-1966 after the collapse of oil prices. The argument is made that the budget appropriates resources for a stipulated maximum level of expenditure and that if revenues disappoint, expenditure can be scaled back without having to present a fresh budget. The argument is patently weak in that any scaling back of expenditure means that priorities have to be re-ordered and new choices made. Further, the collapse of oil prices represented such a sea-change that the entire fiscal and development strategies needed to be reviewed and restructured.

## NOTES TO CHAPTER NINE

<sup>1</sup>Budget Speech 1987, p. 5, A.N.R. Robinson, Minister of Finance. There was an element of *deja vu* here for Robinson who had become Minister of Finance of a newly-independent Trinidad and Tobago and had been confronted then as well with a difficult fiscal situation.

<sup>2</sup>This section draws in part on T.W. Farrell 'The IMF and the Trinidad and Tobago Letter of Intent' in *ASSET*, vol. 7, No. 2, April 1989. See also Republic of Trinidad and Tobago, Trinidad and Tobago Government's Relationship with the International Monetary Fund, 1988.

<sup>3</sup>This was in fact accomplished by a Section 50 directive from the Minister of Finance since the Bank indicated its objection to this way of proceeding. This remains the only time in its 25 year history that the Bank received a directive from the Ministry, but this must be seen in the context of a conflict which had since emerged with the governor, who had in fact tendered his resignation in November 1987.

<sup>4</sup>The rules of thumb on the appropriate debt service ratio and debt/GDP ratio have been very elastic, stretching upward as the debt crisis has worsened for the indebted countries. There is clearly no universally applicable, appropriate ratio, a point that is particularly relevant to the Trinidad and Tobago situation.

<sup>5</sup>See Farrell, T.W., Najjar A. and Marcelle E. 'Corporate Financing and Use of Bank Credit in Trinidad and Tobago', *Social and Economic Studies*, Vol. 25, No. 4, December 1986.

## NOTES TO CHAPTER TEN

<sup>1</sup>See Charles Goodhart, *The Evolution of Central Banks*, MIT Press, Cambridge, Mass., 1988.

<sup>2</sup>John Powelson, *Institutions of Economic Growth*, Princeton, N.J., 1972.

<sup>3</sup>This is not to say that there have not been occasional challenges to these principles, not least by the government themselves. Trinidad and Tobago has had its share of states of emergency, bills which sought to attack fundamental rights and

freedoms and suggestions for constitutional reform which would politicise the office of President as well as appointees to commissions and boards of state enterprises. The framework of democracy has, however, survived largely intact due to the vigilance of the Press, the trade union movement, the legal fraternity and the public at large.

<sup>4</sup>In the Caribbean countries in recent times we have witnessed central bank governors being 'required' to demit office when a new party comes into power. In our view this is an unfortunate development. In the Trinidad and Tobago case, this 'principle' is being extended to include the President of the Republic, chairmen and boards of service commissions and state enterprises and other appointed officials. Such an approach serves to politicise offices which may not be or should not be political, and is likely to be a divisive force in an already divided society.

<sup>5</sup>These issues are further discussed in T. W. Farrell and E. Bobb, "The Role of the Central Bank in Undeveloped Countries with Special Reference to Latin America and the Caribbean", Central Bank of Trinidad and Tobago *Quarterly Economic Bulletin*, Vol. VIII. No. 4, December 1983.

<sup>6</sup>See E. Bobb, 'The Future of Central Banking', Central Bank of Trinidad and Tobago *Quarterly Economic Bulletin*, Vol. XI, No. 3, September 1986, and F. Rampersad, 'Economic Policy Formulation and Implementation in the Caribbean', lecture delivered to Central Bank Trainees at CEMLA Course, May 31, 1988. Central bank governors must be largely financially independent and the terms of their contracts of service should ensure that they are immune from subornation by governments or interest groups in the society.

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