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THE STRUCTURE PERFORMANCE AND PROSPECTS OF CENTRAL BANKING IN THE CARIBBEAN

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The structure performance and prospects of central banking in the Caribbean

Clive Y. Thomas

This study has "three major points of reference, *viz*, the relevance and efficiency of existing Central Banks to the economic structure and pattern of growth in the Caribbean, the efficiency of management within whatever limitations might exist, and the directions of necessary reform and adjustment". In pursuit of these aims the author has conducted a comprehensive analysis of the structure, performance and prospects of Central Banking in the Caribbean. Throughout the author has sought to demonstrate that an understanding of the functionings of "superstructural" institutions, such as Central Banks can only be achieved in the context of a thorough and fundamental analysis of the dynamic and structural features of the economies and societies they are designed to serve.

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by

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Institute of Social and Economic Research,
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JAMAICA. 1972

Reprinted 1974

PRINTED BY Unwin Brothers Limited
THE GRESHAM PRESS OLD WOKING SURREY ENGLAND

Produced by 'Uneoprint'

A member of the Staples Printing Group

NOTES

1. The Caribbean refers to the three constitutionally independent English speaking territories, Guyana, Jamaica, Trinidad-Tobago, which had central Banks at the time of writing.

2. The monetary unit used here is the Guyana dollar which is the equivalent of one dollar (Trinidad-Tobago) and 42 cents Jamaica. Wherever convenient, when referring to Jamaica the Jamaican dollar equivalent will be stated [J $].

Preface

An earlier version of this study was presented to a Monetary Conference, held in Guyana in 1969 and sponsored by the University of Guyana, the University of the West Indies and the Central Banks of Guyana, Trinidad-Tobago and Jamaica and the Eastern Caribbean Currency Authority. During that Conference I was fortunate to receive a number of full and critical appraisals of what I had presented. In the course of my revision I have benefited substantially from these. Although it was prepared essentially for presentation to that Conference, this study would not have been written were it not for the Regional Monetary Studies Project. I would like to thank the sponsors of this Project, and in particular Mr. A. McIntyre, Director of the Institute of Social and Economic Research of the University of the West Indies, for their assistance.

I would also like to add a special word of thanks to my students, past and present, as well as my many friends and colleagues who have made the effort to offer me suggestions and comments. As is customary, I alone must take responsibility for what is written here.

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1971.

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CHAPTER ONE

Context and Antecedents

There have been two dominant motives which have so far guided the establishment, and the powers of operation, of institutions of public economic policy in the Caribbean. In the period of direct colonial rule, as soon as a completely *laissez faire* approach to economic development was seen as being destructive to capitalism, the first gropings after a conscious public policy appeared in the establishment of institutions predicated on the assumption that the development of the Caribbean could only be undertaken through the initiative of foreign capital, foreign skills and foreign technology. Consequently, the framework of economic laws and institutions favoured the minimization of any of those risks usually associated with the operation of independent national economic policies, and the maximization of the flow of capital and other resources between the Caribbean and the then dominant metropolitan territory, the United Kingdom. It is in this context that we must appreciate the establishment at that time of the framework of many of our basic economic institutions, such as company laws, foreign exchange regulations, budgetary organization, labour laws, and more specific to our purpose, the Currency Board laws and regulations. The latter set of laws and regulations not only minimized the scope for national discretionary control of the monetary system, but they also served to maximize the area of unfettered action of foreign private investors.

In the period since the attainment of national independence, another motive has come to the fore and merged with the first. This motive is based on the idea that the most effective way to accelerate economic development of under-developed economies is to reform old institutions or establish new ones on the principle of transplanting, as nearly as possible, those institutions of economic policy to be found in the "developed" industralized countries of Europe and America. It is against this background that we must evaluate the establishment of the new-style institutions of public economic policy such as the Central Banks we will be considering. The idea that to develop a poor country it is essential to transplant in as pure a form as possible the economic institutions of developed countries, contains the roots of the paradox between the legal powers and the actual performance of Central Banks in the Caribbean. It also demonstrates the source of the most fundamental of all the weaknesses of these institutions, which is that they are not rooted in the economic realities of the region and are therefore by their very constitutions not geared to operate effectively in the processes of economic development and structural transformation of the region.

Out of this broad analytical position, it follows that a proper and adequate study of such super-structural institutions as Central Banks, must have as one of its major reference points, an understanding of the real factors underlying the functioning of the economy. This point has not been sufficiently appreciated in the relevant literature. It has been customary, when undertaking an examination of monetary systems such as those of the Caribbean, to classify these economies as monetarily dependent; but to do so only after placing emphasis on the examination of super-structural financial institutions. Therefore, one would normally find this classification being attempted in terms of the range of financial institutions available and the relationship of money variables to foreign trade and payments. In particular, the absence of any sort of Central Bank and a strong and resilient indigenous commercial banking sector has often been considered enough to establish *sufficient* conditions for monetary dependence.

The line of argument put forward here is inadequate. It is simply assumed that the absence of a Central Bank, and the presence of an unregulated commercial banking sector lead to an automatic dependence of the money supply on the balance of payments. The explanation is devoid of adequate reference to the real structural determinants of the dependent monetary state of these economies. Mars, writing on the Nigerian monetary system before central banking was introduced there, observed that "the decrements and increments of .... currency are the one item that brings about equality between all the positive and negative items of the balance of payments."[1] Such early analysis contains at least two major areas of confusion. One is to move from such a statement and simply to equate currency with the money supply. The other is, in the absence of sufficient data, to equate the balance of payments with the balance of trade. As soon as the money supply concept is widened to include at least the commercial bank deposits, then the role of these banks becomes critical to the determination of the money supply. Similarly, an expansion of the analysis from the balance of trade to the balance of payments allows for the incorporation of flow and stock effects, and a generalization of the problem to the area of total payments and total receipts.

We may then argue that, in any economy, a surplus or deficit in the balance of payments is matched by a similar surplus or deficit in the relationship between aggregate expenditure and receipts. It is therefore obvious that changes in the balance of payments must have a *primary* impact on the money supply. In the case of a dependent economy with a Currency Board as the note-issuing authority, it can only expand the note issue to the extent of its acquisition of external assets. Thus there can be no multiple expansion of the currency issue. In the case of the commercial banks the situation is complicated. Increases or decreases in their reserves can theoretically lead, either to multiple expansions or contractions in their deposits, or to no change at all. The basis of the commercial banks' response has been analyzed elsewhere.[2] It is clear from that analysis, that the

1 J. Mars, *The Monetary and Banking System and the Loan Market of Nigeria*. Chap. VI: "Mining, Commerce and Finance in Nigeria", ed. Margery Perham

2 See C. Y. Thomas, *Monetary and Financial Arrangements in a Dependent Economy*, ISER, University of the West Indies, 1965; W. F. Crick (ed) *Commonwealth Banking Systems*, Oxford, 1967; and H. A. Des Gunasekera, *From Dependent Currency to Central Banking in Ceylon*, G. Bell and Sons, 1962.

commercial banks do not pay explicit attention to the balance of payments as such in their lending policies, even though they are one of the main sources of accommodating finance. However, although they do not consciously assume the role of a Central Monetary Authority, it is not to be further assumed from this that in their own lending, the state of the balance of payments does not influence 'credit-worthiness' and their reserve positions, and *vice versa*. The establishment of a Central Bank, in theory paves the way for the neutralization, expansion, or contraction, in face of these primary changes in external assets. The usual Central Banking practices, such as open market operations and discount rate policies, can in theory promote the situation desired by the monetary authorities. In practice this cannot and indeed has not been attained in dependent economies because of one basic factor, which is that the structural relations of these economies are sufficiently rigid and skewed as to make the Central Monetary Authorities nearly impotent.

Any analysis or classification which does not focus attention on the limitations posed by the real factors of the economic system is mistaken. Monetary dependence presupposes the existence of certain real conditions which contribute towards a basic and fundamental structural dependence of the economy. These conditions can be described as the existence of certain combinations of economic characteristics, such as: heavy specialization in the production of primary commodities for sale in overseas markets, mainly those of the industralized countries; the dominant control of this specialized production by a few large foreign-owned enterprises; an economy small in terms of market size, population and geographical area, which has a consumption pattern resulting in a high import coefficient. In association with these characteristics, there are usually a large number of familiar economic indices of underdevelopment, such as high levels of unemployment, low per capita incomes and low levels of industrialization. These combinations of economic characteristics lead to certain qualitative differences in economic organization which are important for much of the analysis to follow. Thus, despite high industrialization rates in some of these economies, e.g. Jamaica, the industrial sector not only remains a small proportion of GDP, but is also characterized by certain limitations. Manufacturing is mainly confined to the preliminary processing of crude materials, e.g. sugar, or the simple assembly and fabrication of certain consumer goods, e.g. radios.

In addition, these economies are structurally open and vulnerable. Open, in the sense that foreign trade and payments dominate all economic transactions; and vulnerable, in that specialization of export production is usually confined to one or two main crops. The marketing of these crops takes place either in a world market characterized by repeated imbalances between the rates of growth of demand and supply, or by way of an intra-company transaction of a multinational corporation. In both cases, sales take place almost exclusively to the dominant metropolitan centre(s). As export production is usually nearly equal to total production, imports cover a wide range of commodities, and the price elasticities of demand are normally low. In similar manner, being both small and open, the economy's internal price levels, demand, output and employment are critically dependent on what happens in the rest of the world. Meanwhile, these same conditions, together with the wide spread of imported items, make it impossible for such economies to reciprocate through influencing developments in the rest of the world.

The historical factors which led to these structural relations also gave rise to monetary dependence. The institutional structures which govern banking, foreign exchange legislation and policies, and other financial arrangements, were all originally designed to service this export-oriented production of primary goods by facilitating the flow of goods and investment funds for expansion of output. As many of them were inaugurated during periods of colonial rule, the legal basis of these institutions has been one in which colonial legislation stringently tied the operations of all major local financial institutions to the metropolitan money and capital markets. The results have been that local financial institutions are almost exclusively foreign owned. This, together with certain features of the colonial legislation (reinforced by the usual prejudices), has resulted in a situation where foreign securities holdings dominate the processes of creating and making available local financial claims. It has also meant that the granting of domestic credit has been geared to the servicing of branch-plant exporting firms.

In some of these territories, although Central Banks have recently been established, this has been more symbolic of intent than achievement. In the strictest ways, the money and capital markets of dependent economies are intimately linked with those of their metropolitan centres. Being unable to compete in either "breadth, depth or resiliency", dealings in local savings occur principally through the exchange of these savings for metropolitan assets. At the same time, given the high ratio of foreign to domestically financed capital formation, long-term capital inflows are crucial to the operation of the economic system.

This integration of capital markets naturally favours a high degree of capital mobility between the dependent and metropolitan economies. Many economists believe that wherever this characteristic exists to a significant degree, it dominates the operation of the monetary system.[3] Whilst this characteristic is undoubtedly of great importance, of even greater importance is the combination of attributes to be found in monetary dependent economies, rather than any one separate identifiable characteristic. Indeed many of the individual characteristics are to be found in other typological systems. As a consequence, capital mobility is important in determining monetary dependence not only through its 'financial effects', but because, in addition, it reinforces in a real sense the role of external trade and payments in the economy. Thus for example, long-term capital in-

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3 See for example, R. I. McKinnon and W. F. Oates, *The Implications of International Economic Integration for Monetary, Fiscal and Exchange Rate Policy*, Princeton, Studies in International Finance; J. C. Ingram, "State and Regional Payments Mechanisms" *Quarterly Journal of Economics*, Nov. 1959.

flows into dependent economies are of great importance, because they contribute the bulk of the capital funds which go to finance export production, which in turn dominates output. In these economies, changes in export values contribute more to the determination of income levels and employment, than investment changes in the traditional 'Keynesian type economy'. Thus, it is the combined effects of real, structural, and institutional factors, which make an economy monetarily dependent.

Whilst one may correctly emphasize the real factors which express the basic limitations of super-structural institutions, one cannot at the same time deny a continuing interaction between super-structure and infra-structure. Thus, it is possible for the management of these institutions to see their tasks as confined to a simple servicing of the existing pattern of production and exchange, with adjustments taking place gradually and at the margin of occurrences.

As a result of all this, any study of central banking in the Caribbean must have three major points of reference, *viz.,* the relevance and efficiency of existing Central Banks to the economic structure and pattern of growth in the region, the efficiency of management within whatever limitations might exist, and the directions of necessary reform and adjustment. In pursuit of this aim, this study attempts to appraise the structure of the central banking institutions in the Caribbean,[4] to review their experiences up to the end of 1969, and to indicate the direction of future development which seems to be necessary, if these institutions are to operate with greater relevance to the processes of structural transformation and development of the Caribbean. Unfortunately, since the early work by Best and McIntyre,[5] there have been no further publications which have attempted a general and serious review of the performance of these institutions, although there have been a considerable number of "internal" publications and private communications on monetary issues. This volume hopes to make a small contribution towards filling this void. But, as Best and McIntyre found at the time of their writing, the experience gained so far may still be too limited to allow for confident prognostications.

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4 This refers to three of the constitutionally independent English speaking territories (Guyana, Jamaica, Trinidad-Tobago), which had Central Banks at the time of writing.

5 "A First Appraisal of Monetary Management in Jamaica"—*Social and Economic Studies*, Vol 10 No. 3.

CHAPTER 2

The Structure of Central Banking Laws and Policy Instruments

It is a widely recognized truism that banking laws and institutional structures, no matter how carefully thought out and ideally constructed, cannot by themselves guarantee efficient management and effective policy formation. The reverse proposition also holds true. Nevertheless, an analytical study of the main aspects of the banking laws and institutional structures in the central banking territories of the Caribbean can serve a useful purpose in indicating similarities and contrasts in the various territories, as well as inconsistencies and redundancies which may not have been generally appreciated. And, more importantly, it also permits an evaluation of the structure of these laws and instruments as they relate to the economic circumstances of their operation.

The usual starting point in this type of analysis is a study of the "stated objectives" of the Central Bank in order to determine whether these Central Banks do bring, or can forseeably bring, social benefits to compensate for the fact that they are "expensive luxuries." Indeed the idea that Central Banks are "expensive luxuries" has often been used to resist their establishment in small, poor economies, since, it is argued, they cannot afford such "luxuries." In the narrowest sense of this term, i.e. in so far as the Central Banks are capable of being self-financing entities, it is not generally recognized how profitable Central Banks are. In the region, the Central Banks of Jamaica, Trinidad-Tobago and Guyana have been established with a subscribed capital of $4.8 million dollars (J$2 million), $2 million and $4.5 million respectively. Profits earned by the Central Bank of Trinidad-Tobago totalled $12 million in the four years 1965-69, which is equivalent to a return of 600 percent on paid-up capital. Indeed, in the very first year of its operations the profit obtained by the Central Bank of Trinidad-Tobago was already equal to its paid-up capital. At the end of 1968, expenses incurred in the administration of the Bank averaged 41 percent of income received. In the case of Guyana, we should first of all note that, comparatively speaking, the bank has been highly capitalized. The volume of its business and outstanding liabilities is much smaller than the other Central Banks, in fact being the equivalent of only 40 percent of that of Trinidad-Tobago. Profits for the first three years of operation totalled nearly $5 million, and had therefore already exceeded its paid-up capital. Bank expenses as a proportion of income received, averaged only 20 percent, again a ratio very much below that obtained in the Central Bank of Trinidad-Tobago. In Jamaica, profits for the period 1961-68 totalled $24 million (J$10 million).[1]

[1] In the Annual Reports of the Bank of Jamaica only a summary balance sheet is provided, together with a statement on the General Reserve Fund. It has therefore not been possible to estimate an operating expenses ratio.

Central Banks make their earnings from their dealings in securities, the granting of loans to the Government and to the public (in particular the commercial banks), and through the issue of currency. Why should it therefore be surprising that an institution which makes money should be profitable! In truth, such opposition was merely an attempt to rationalize a particular view of the development process—one which places emphasis on a minimum of administrative discretion over the financial system as being conducive to growth. Discussion about the "stated objectives" of these banks prior to their establishment seemed to imply some planned revolution in institutional management. Experience has shown this to be an unwarranted expectation, and except that they had provoked a reaction from opponents to the establishment of Central Banks in these territories, a comparison of "stated objectives" is generally of very limited usefulness in understanding the function of Central Banks. In Trinidad-Tobago, the principal purpose of the bank is stated to be "the promotion of such monetary credit and exchange conditions as are most favourable to the development of the economy." In Guyana the Central Bank is enjoined "within the context of the economic policy of the Government (to) be guided in all its actions by the objectives of fostering monetary stability and promoting credit and exchange conditions conducive to the growth of the economy." Whilst in Jamaica the objectives are "to issue and redeem notes and coins, to keep and administer the external reserves of Jamaica, to influence the volume and conditions of supply of credit so as to promote the fullest expansion in production, trade and employment, consistent with the maintenance of monetary stability in Jamaica and the external value of the currency, to foster the development of money and capital markets in Jamaica and to act as banker to the Government."

Generally speaking, in the two former territories, the Central Banks are, by stated intention, more growth oriented and less preoccupied with monetary stability, than is the case in Jamaica. As we shall observe in the next chapter, the Central Banks of Trinidad-Tobago and Guyana, particularly in the early period of their formation, have been more responsive to the demands of government credit than has been the case with Jamaica. As a consequence, they might have engendered the likelihood of greater monetary "instability" in their support of growth objectives through accommodating public sector absorption of resources. But it would be wild conjecture simply to infer that the "stated objectives" of these institutions were responsible for these developments. A broader interpretation of events in the various territories would be that the Central Bank of Jamaica has been more tentative, because it was established earlier, at a time when it was highly questionable if territories such as these could manage the "sophisticated" mechanisms of Central Banks! In the case of the other two territories, the establishment of their Central Banks took place at a time when economic and political events at home were forcing the state to expand its role in the economy. In Guyana, this was brought about specifically by the necessity to overcome the depression of economic activity which coincided with the unfavourable political situation in 1962-64. In Trinidad-Tobago, it was brought about by the need to support the public sector drives towards economic diversification, as the Government interpreted this, in order to overcome the depressive consequences of stagnation in the petroleum industry during 1963-65.

This difference in "stated objectives" may be also, in part, a reflection of the role of foreign experts in setting the climate of opinion at the initiation of monetary change in the region. More than any other sphere of the administration of public policy, central banking in the region has been dominated by foreign expertise. Not only have the laws been framed by these experts, but their administration during the earlier years has been in all cases left to foreign experts. Generally, these "experts" have themselves shown changing attitudes. For example, at the time of the changes introduced into Jamaica, the dominant preoccupation was an imitation of an ideal structure, usually the Bank of England, together with stringent controls built into the laws in order to prevent excessive credit creation, particularly through the financing of state activities. It is only in this way that we can explain the fact that the Central Bank legislation in Jamaica maintains the archaic distinction between currency and banking divisions, or, that in all the territories the legislation ensures close control of the use of domestic assets to finance the currency issue. In response to changing national demands and a realization that their worse fears were unwarranted, the later experts have been more flexible in their attitudes to the structure of institutions, although at all times maintaining their preoccupation with what they thought was the Currency Board's chief virtue—its anti-inflationary bias. Despite this, as our analysis will show, the laws are unclear and confusing over the limits of Central Bank credit creation.

For the purposes of ordering the analysis, we shall in what follows, categorize our discussion under two headings—Central Bank control of the Public Sector, and the Commercial Banking Sector.

(i) PUBLIC SECTOR CREDIT

In all three of the territories there are two fundamental methods of lending to the public sector. The first, is the general power to purchase and sell, or discount and rediscount government securities. Purchases of these securities can take place either directly from the governments, or indirectly from the private and/or banking sectors. In none of these territories is there any restraint on the maturity composition of the public debt which the Central Bank may acquire in the course of its public debt operations. This appears to be somewhat surprising, in view of the dominant aim in the framing of these laws to restrain excessive creation of credit by these institutions. The liquidity effect of the Central Bank acquiring short-term debt, e.g. Treasury Bills, can vary significantly from that of acquiring long-dated securities. As a result therefore, much is left to the discretion and power of the Central Bank to influence the liquidity effects of government borrowing within the overall limits established for public debt issues. But if, as is the case, limits on public debt issues are imposed by the laws governing the particular type of debt issue, then they are not directly within the powers of the Central Bank to influence. In such a situation the Central Bank can have no decisive impact on the maturity composition of the government securities they acquire. It is in fact desirable that the situation should remain as it is; but we must be clear that, as a consequence, we are reducing the capacity of the Central Bank to restrain liquidity increases by reference to its *own* enabling powers. The laws and operations of these institutions should therefore permit them to exercise considerable influence at the time a debt issue is being budgeted for. But this is generally not the case.

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

In Trinidad-Tobago the limits on advances are given as:

(1) 15 percent of the estimates of the Government of its annual revenue for the year in question, including in annual revenue, recurrent revenues as well as capital receipts (exclusive of any type of loan).
(2) that repayment should be as soon as possible, subject to the provision that if it is not repaid at the end of the year, then the credit is to be carried over to the next year and deducted from that year's credit.

In Guyana, the advances limit is given as 15 percent of ordinary revenues, but this is based on the average of the three preceding years. Such a limit is more stringent, in that it does not allow for the possibility of inflated estimates being used as the basis for granting credit which, if granted, would of course reinforce whatever inflationary or other balance-of-payments disequilibrating tendencies there might be. The repayment period is specified as 350 days. Consistent with (as we shall see in the next chapter) its observed policy of restraint in financing the public sector, the Central Bank laws in Jamaica limit the advances it can make to the state, to 15 percent of estimated revenue for the particular financial year, and narrow the repayment period to 90 days after the end of the financial year. Of course, with the possibility of renewal, the *de facto* life of these loans can be readily extended within the quantitative limits.

This limit on advances constitutes one brake on credit to the public sector. However, in all the territories, additional limits exist to cope with situations where the credit is provided through the purchase of securities. In Trinidad-Tobago, the Central Bank cannot hold government securities in excess of seven times its authorized capital (which at the end of 1968 would have allowed a holding of $35 million), *or* seven times its paid-up capital and general reserve fund (which at the end of 1968 would have allowed a holding of $49 million). The latter limit is of course more flexible, since there is scope for a regular growth in this fund, to which some of the profits of the Bank are deposited. In Guyana, the limit to the value of holdings of government securities is 30 percent of the average annual revenue collected and accounted for over the three previous years. In Jamaica, the limit to the value of the holdings of government securities is specified separately for the Banking division, and is limited to seven times the authorized capital.

The distinction between Banking and Currency Divisions in Jamaica, highlights dramatically the source of conflict in limits to public sector credit, although a similar conflict exists in the other territories. In all three of the territories, the currency issue has to be backed by a minimum holding of 50 percent foreign assets. When we examine the figures, we observe that in Guyana, the Bank can hold the equivalent to the value of 15 percent of government revenue for advances, and 30 percent for other sources of lending, making a total of 45 percent[2]. For the period 1966-68 this equalled approximately $93 million. We might note here, that these limits are greater, when directly stated—i.e. with reference to the holdings of government securities—than is the case in Jamaica or Trinidad-Tobago. However, if we take the limit that 50 percent of the currency issue must be backed by foreign assets, then this yields at the end of 1968 a required foreign asset holding of $19 million, and a permitted local asset holding of only $36 million. In view of this conflict, which of the two limits can be considered to be the real legal upper limit? Although one would be inclined to guess the external reserve holding, if only because of the tradition of securing the currency issue *first*, it may very well be that the Central Banks may on occasion interpret it as whichever limit is in fact higher. However, in practice these conflicting legal limits are not an immediate source of concern, since the actual holding of government securities in the Bank of Guyana was only $4.2 million.

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

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2 This would be based on an average of the three previous years' revenues.

million. The foreign reserve limit, therefore, permits a greater holding of local assets than do the direct requirements. Again, as in Guyana, these limits are not being approached, as the actual holding of government securities totalled only $27 million.

In Jamaica, the Banking division has an expressly stated limit to its holdings of government securities equal to seven times the authorized capital, which is presently valued at $34 million (J$14 million), plus 50 percent of the currency issue which at the end of 1968 was equal to $49 million (J$20 million), totalling $83 million (J$34 million). The actual holdings of government securities were equal to approximately $10 million (J$4. 2 million). The compulsory foreign reserve holding was equal to $49 million (J$20 million). This would have permitted a local government securities holding of $205 million (J$86 million).

In the case of Jamaica, however the ambiguity is not the same, because the distinction between currency and banking divisions is explicitly formulated, and the government security requirements for each division are clearly stated. In the case of the other territories the distinctions are implicit, and are reflected in the definition of the foreign reserve holdings in reference to the balance-sheet and a particular item there, *viz.*, currency holdings. The solution of possible conflict in the interpretation of limits does not require that Trinidad-Tobago and Guyana make the implicit distinction between currency and banking explicit, and thus revive archaisms; but rather that all the Central Banks consider the feasibility of defining their foreign reserve holdings in some more general way, and not in relation to one of their own balance sheet items. The dangers of such a practice may be a long run consideration at the moment, but as the limits are approached, changes in the banking laws would become necessary to eliminate the source of conflict. In any event, criteria that are more closely related to the general functioning of the economy would seem to be preferable, if only because of the greater realism and flexibility this would permit. Further, such criteria would be of greater support in eliminating possible conflicts in strategy and aims between the Central Banks and the Central Government. Finally, and perhaps most importantly, there is a general danger that once reserve holdings are specified with reference to a key balance sheet item such as currency, they may become frozen and not easily available for use.

(ii) COMMERCIAL BANKING SECTOR CREDIT

The sources of Central Bank control of the commercial banks are more varied and diverse, but in sum, the scope for effective control is not appreciably greater. There are again, two fundamental methods of extending credit. The first is through rediscounting eligible paper.

In general, the eligibility rules favour short-dated instruments such as promissory notes, commercial bills, warehouse receipts and government securities. The usual limit is 180 days, although in the case of Guyana, industrial and agricultural production is encouraged through permitting credit instruments of 270 days to be used. In practice, the instrument most used has been government securities, and the maximum amount of credit obtained in this way is closely linked to the limitation on the holdings of government securities discussed above.

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

The powers of the Central Bank are predicated on the assumption that the local money market and the Bank itself are constituted as adequate sources of financial securities and credit to satisfy the liquidity preferences of the local commercial banks. In practice, this has not been the case and the money market in the United Kingdom has been an important resort of the local commercial banks. There are seven basic techniques of monetary control enshrined in the various laws, *viz.*, open-market operations; variations in Central Bank reserve holdings, including special deposits; variations in the liquid assets ratios; variations in the local assets ratio; changes in the discount/rediscount rate; selective controls; and moral suasion. Each of these techniques has limited scope in the region, although a broad distinction between the market-type techniques and the non-market type would indicate the latter to be of greater relevance.

There are several fundamental features of the general economy and the financial structure which militate against the use of the existing market-type instruments of policy control. In the first instance, because there is no broad and active market for securities, it is impossible for substantial sales and purchases of these securities to be made with minimal effects on security prices. The securities available and actively traded have been exclusively government securities, and these have been further confined to Treasury Bills. This situation is not a product of a deliberate policy of dealing in the short end of the market as a means towards influencing the rate structure. Indeed to all intents and purposes the fractured nature of the securities spectrum, and the limited and spasmodic amounts of medium and long-dated securities available, contribute towards making it impossible for any such "bills-only" policy to have much validity. Dealings in Treasury Bills have been a response to the needs of short-term borrowing of the Government (up to fixed statutory amounts) and of the need of the commercial banks to fulfil their liquidity requirements as specified in the various banking laws, after taking into account the competitive attractions of lending their short-term funds abroad.

In the second instance, the commercial banks do not maintain any more or less fixed ratio of cash to deposits.[3] Flexibility in the cash and liquid assets ratios, characterizes the banking system. In addition, the access which the commercial banks have to overseas balances enhances this flexibility. This access is facilitated by the dominant position of branch-banks of large international concerns in the local banking system, the convertibility arrangements of the Sterling Area, and the operation of the exchange rate so as to maintain the existing parity with sterling. As a consequence, access, strictly construed, means access to the money markets of the United Kingdom with whom the exchange guarantee exists. Thus even the North American banks conduct their business through London. Borrowing from the Central Bank, and the commercial banks' holdings of local Treasury Bills, are therefore directly competitive with their access to overseas money markets. The only countervailing forces on this free dealing in two money markets, are the costs involved in moving from one money market to another. And any effort to make these costs effective forces the Central Banks to adapt and to adjust their interest rate levels to those prevailing in the overseas money markets. As a consequence, market dealings are effectively defensive in their intention, i.e., to support the rate structure dictated by the U.K. money market rates.

A third factor is that, historically, the commercial banks have not operated in such a manner as to maintain a symmetry between their ratios of cash balances and their willingness to lend or grant advances to customers. Lending policies in the area are largely dependent on the commercial banks' interpretation of "credit-worthiness." If their "credit-worthy" criteria are satisfied, the banks would grant loans independent of their prevailing liquidity positions. This appears to be their main portfolio consideration, except in situations where their liquidity holdings are very large (and in particular their overseas balances), or where there is such a shortage of liquidity, that they are forced to accumulate overseas debits with their Head Offices, beyond temporary requirements. Between these limits, the commercial banks' interpretation of "credit-worthiness" is decisive in determining the total volume of commercial bank lending. Whilst this may be more or less inevitable in the present context of banking, it is to be noted that their standards have placed heavy emphasis on the inherent liquidity of their loans and advances rather than on the ability of the borrower to repay. When challenged on this score, the usual response is that the two features occur in the same enterprise, or other borrowing units, in the West Indies. But the absence of these symmetrical responses makes it impossible for a Central Bank to affect the general levels and rates of increase of bank credit through operating on their liquid assets holdings along the lines pursued in the highly industrialized market economies.

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[3] The problem of the Credit Multiplier is discussed in Chapter 4.

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

Of all the market type techniques, the one most frequently used is the discount/rediscount rate. Changes in these rates have occurred largely in response to the changing rate pattern in the United Kingdom.

There are, in the various Central Bank reports, many assurances of the fact that the rates are fixed with internal considerations paramount. In practice, even if this were true, there is little evidence that much can be achieved by so doing. The references to the establishment of this rate so as to balance local investment decisions with the capital funds available locally, are of little significance. In the first place, much of the domestic investment is financed by the use of non-resident capital: (the estimated ratios vary between 60 : 40 and 70 : 30). Non-resident investors are not particularly concerned about the domestic rate structure, since they raise very little funds on the local market. In the second place, much of the actual investment undertaken is financed from the utilization of business savings, i.e. ploughed-back profits and depreciation allowances, in highly specific enterprises, so that the prevailing domestic market price of capital is again of little significance in forming investment plans. Thirdly, in the area of short-term credit, which accounts for the bulk of bank credit, changing price levels, easily encountered or "managed" in situations of buoyant demand, further reduce the significance of the rate of interest. In addition, for short-term credit, interest payments are small in relation to amortization payments. Higher interest rates are therefore unlikely to affect significantly customary inventory/sales (largely imports) ratios. Finally, "availability" considerations have also to be weighed against the "cost" of borrowing, and in the region the former appears to be overwhelmingly decisive. The net effect of these considerations is, as we have argued, to confine interest rate policies to adapting the local economy to the position whereby most enterprises and financial institutions are allowed to operate freely in two money markets of unequal "breadth, depth and resiliency."

Although these fundamental limitations to the statutory powers of control are decisive, there are a number of technical management functions which these instruments of policy permit the Central Banks to perform. Among these are: (i) neutralizing seasonal movements in the level of activity in the economy; (ii) neutralizing the effects of Government financing caused by the fact that tax payments and receipts are not uniquely coincident and, (iii) minimizing the domestic consequences of minor imbalances in the balance of payments. In these situations, whilst a comprehensive policy aimed at correcting any severe destabilizing factors is not possible, a day to day or week to week management of the monetary side of the economy can be effected.

In the case of the non-market controls there are basically two competitive types: those which permit a uniform, across-the-board control of some banking ratio (such as the cash ratio or liquid assets ratio) thereby seeking to establish some degree of "indirectness" and "generality" in their control of bank credit; and those which go directly to limiting the level and size of loans and advances. Among the former types of controls the laws contain some important anachronisms which were adopted uncritically from other banking situations. One of these is the distinction which the laws maintain between fixed deposit and demand deposit liabilities in determining reserve ratios. There is no need to maintain this differential system. Indeed, it is surprising that the commercial banks in the region have never objected to this factor, which serves to reduce their competitiveness *vis-à-vis* other thrift and savings institutions. Another is the treatment of foreign balances in the liquid assets definition. In Jamaica, the law specifically excludes this item from classification as a liquid asset, although the practice shows clearly that the commercial banks operate as if these foreign balances are liquid and the Central Bank has never sought to restrain them from this practice. Usually the law is unclear as to whether the Central Bank should require that the overseas balances with the Head Office be netted out, or not, for purposes of conforming to the ratio. Unless a definite ruling is observed, the danger exists that it is possible, through a simple balance sheet entry, for the commercial banks to alter the size of these balances. Other ambiguities are that the laws do not indicate how these balances are to be treated when they are negative; nor do they make any distinction between liabilities of a monetary and short-term kind (which appear in the item "balances due to overseas banks"), and other liabilities of a long-term capital nature.

Despite these administrative and definitional problems it is plainly intended that variation in reserve requirements should be *the* substitute for traditional open-market techniques. But such a policy instrument, when put into use, immediately runs up against a number of structural problems. In the first place, it is possible through the right combination of items to make the upper limit of various reserve ratios undefined by law! This naturally provides a source of temptation for governments to finance Treasury Bill issues with lack of discretion with regard to their effect on the liquidity of the banking system. In such a case the upper limit is usually that implied in the limits of credit noted above, which were provided to the public sector. Secondly, the policy is unworkable in a situation where, as we observed, banking ratios are unstable and the size of the deposit-creation multiplier of the banks themselves, uncertain. Thirdly, frequent changes in these ratios have not only introduced instability and uncertainty into banking as it is presently conducted, but also have a discriminatory impact on the banks, since their excess reserve positions are not always the same. This problem is very acute in the region, since apart from private consumer accounts there is much evidence that firms, (and it must be remembered that a few of these account for the bulk of output), hold their accounts with a particular bank, striving to develop a good customer relationship. In so far as much of the output of these firms is seasonal, there is a strong likelihood that variations in their accounts will, at most times of the year, be unequal in their incidence on the commercial banks. Fourthly, such policies have divergent responses. Restriction of bank credit is usually easier, and speedier in its effects, once the limits can be made effective, than expansion; the reason being that the latter depends also on the banks' willingness to lend, and their interpretation of "credit-worthiness."

In view of these limitations, it is clear that variation in reserve requirements is a far from satisfactory instrument of monetary control in the Caribbean. It has one advantage over the market weapons, which is that it does not force the Central Bank's holdings and dealings in securities to be large in relation to either excess reserves in the commercial banking sector, or to any foreign exchange inflows which lead to an expansion in the reserve base of the banking sector.

The most direct controls, i.e. those which can be directed in a discriminatory manner to the credit granted by the banks, are likely to be the most effective. However, their effectiveness is likely to be heavily confined to restraints on lending rather than ensuring that bank lending, when it does occur, fulfills the required conditions for growth. In this regard, the overriding need is still direct state provision of "commercial" type banking services, which none of the Central Banking laws envisage.[4] Recent changes in commercial bank lending have tended to favour, (i) the term-loan; (ii) the renewal of advances to permit the more or less permanent financing of working capital; and (iii) some diversification of lending opportunities, outside of the traditional categories of overseas plantations or corporations engaged in export activity, to consumers and professional groups for the purchase of durable goods and equipment. But the changes have not significantly improved the overall position of commercial bank credit.

Moral suasion has perhaps been the most frequently used of the techniques of control. The power to exercise this control is really an integral part of the Central Banking laws, which give to these institutions power over the commercial banking system. It is not an extra-legal authority, as is often assumed, based on purely moral considerations. It is based on power relations between the two sectors of the banking system. So far, in the first flush of nationalist support for central banking institutions and the fear that injudicious acts on their part may tempt governmental indiscretion, as they see it, the commercial banks have made some efforts to be accommodating. The

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4 In Guyana there has been the recent establishment (February 23, 1970) of a National Co-operative Bank which is expected to engage in general commercial banking activity. See also Chapter 4, which discusses strategy for reform of the Central Banking structure.

unclear issue is, however, the extent to which they have succeeded in making a similar and perhaps more extensive encroachment on the original and widely publicized Central Bank objectives. Certainly, it would seem from the encouragement given to new commercial banks, similar to those in existence, to establish themselves in the region, and also from their support of existing commercial banks, that the Central Banks are basically committed to maintaining and fostering the development of this sector as it is currently organized.

Finally, although so far it has not been comprehensively introduced in the Caribbean, there is a strong likelihood that the Central Banks will develop the pre-deposit on import requirements technique[5]. Given the high import leakages and the other "open" characteristics of the economies, it is felt that a policy instrument which is geared to raising the cost of credit, and restricting its availability for import expenditure, is expressly suited to the regional context. But again it is unlikely for a number of structural reasons that such a policy will work. What is likely, is that in the absence of direct controls, existing financial institutions will make the credit available to finance the pre-deposit requirement. Many features of the local economy lead us to anticipate this. Firstly, such loans would be virtually riskless, since the deposit itself guarantees the loan. Secondly, importing houses are given much preferential treatment in obtaining credit. Sometimes this is due to their size and importance in the mercantile and the general community. In other situations, it may be due to the fact that liens on the goods imported constitute an excellent collateral, or that the credit demands of importers (inventory financing) to a great extent match the lending preferences of the commercial banks. Thirdly, many of these importing houses have a long association with foreign exporting firms, and therefore may find it possible to obtain this credit externally. Fourthly, in the case of both domestic and external credit (or indeed resort to financial resources internal to the firm), the larger import-houses are not nearly as much discriminated against as are the smaller ones.

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

(iii) CONCLUSION

The laws and institutional structures which govern central banking in the Caribbean are typical of those found in the ex-colonial territories of the British empire. These laws are not only similar to one another

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5 The 100 percent deposit on letters of credit imposed in Guyana in 1966 is some indication of thinking along these lines.

but are, in the main, copies of an idealized Bank-of-England model. The laws and powers of control and regulation are of the traditional sort. Thus, we have seen that almost all of the instruments of control embodied in the laws have been put there on the assumption that there exist well-developed financial institutions, broad and active capital markets, and a highly differentiated, competitive, and privately controlled economic system—none of which do in fact occur in the Caribbean. As a consequence the Central Banks themselves have found that their activities are mainly confined to dealings with the commercial banks and with their respective Governments in the area of short-term credit regulation. The laws do not provide for what is probably most needed: the development of methods and conditions of dealing in financial claims with the public *as it exists* in the Caribbean. Further, the laws do not permit the Central Bank to deal with the significant range of state-owned or quasi-state-owned financial institutions. The result has been that important financial institutions, e.g. the various Development Corporations and Post Office Savings Banks, are not under the direct control of the Central Banks. Indeed, these institutions, because they are publicly owned, normally have automatic and pre-determined lending rights. They can and do operate in the capital market without fear of prejudice of any central banking regulations. From this it is clear that the legal structures of these institutions and their designated powers of control are inadequate for the tasks at hand. In the next chapter we will review their performance since the time of establishment.

CHAPTER THREE

The Experience of Central Banks in the Caribbean

The experience of central banking in the Caribbean has been relatively limited. The longest functioning Central Bank, that of Jamaica, assumed full operations in 1962, while the Central Banks of Guyana and Trinidad-Tobago had their first full year of operations only in 1966. Nevertheless, the experiences of these Banks are important for our further understanding of the institutional and legal constraints under which they operate, as well as the deep structural rigidities and imbalances in the economy which determine much of the monetary phenomena. In all of the territories, on account of their open economic structures, foreign exchange earned either through export sales, or foreign capital inflows into direct private investment or the public sector, is important for determining the levels and patterns of expenditure by domestic residents. Much of this expenditure is directed to imports. As a consequence, monetary imbalances, depending on their sources, are quickly reflected in a loss of foreign exchange. At the same time, the levels of foreign exchange earned, determine significantly the levels of real expenditure and the levels of excess reserves in the banking system.

Prior to the establishment of Central Banks, these phenomena were observed in the high leakages of bank credit into imports, and in the strong interrelationships between the balance of payments and the money supply. In the absence of Central Banks, the commercial banks performed the central banking function of providing and administering the country's "accommodating finance," and imposing its limits on credit creation in both the private and public sectors. The establishment of Central Banks has resulted in a legal transfer of these functions. Consequently, an appraisal of the performance of the Central Banks must seek to establish the extent to which they are successful in influencing the relevant variables in relation to their objectives. It is taken for granted that these objectives are superior to those of the commercial banks. The latter had performed these functions subject to the over-riding responsibility to earn profits as part of the functions of a banking unit that is itself part of a private multinational banking structure seeking to maximize global profits. As such, the arrangements were never efficient from a national standpoint. The commercial banks themselves, have historically treated the region as a "surplus" area. As a result, until recently the tendency has been to promote a secular outflow of deposits raised locally.

Similarly, their limits to private sector credit were rigidly enshrined in the policy of adopting a lending pattern based on their own internally determined criteria of "credit-worthiness". When applied in practice, this has usually meant that the expansion of credit to the private sector could never seriously endanger the balance of payments. In addition, the Governments of the Caribbean were at the time more or less committed to a policy of balanced budgets, and this facilitated commercial bank control of public sector credit. As far as the private sector was concerned, the Currency Board requirement of maintaining a virtual 100 percent foreign backing for domestic monetary expansion operated as a permanent deflationary drag. And this was helped by the small size and open structure of these economies, which ensured that no significant differentials could develop between local price levels and those prevailing in the territories of their main trading partners—the United Kingdom and North America.

(i) CENTRAL BANKING IN GUYANA

During its four years of full operations the Central Bank of Guyana has had to encounter four major crises. The first of these centered on its ability to impose effective limits on public sector credit. This crisis can be seen from developments in 1966 in which the Central Bank clearly felt, and indeed argued in its Annual Report for that year, that the indiscriminate use of its credit-creating powers had led to huge increases in government deficit financing, which had not been openly inflationary (the price level increased by only 2.4 percent in that year) but had been suppressed and diverted into imports which created a drastic loss in foreign exchange. As the data in Table I show, the foreign assets held in the banking system had fallen during 1966 by $11.3 million, or about 23 percent below the 1965 level. This was accompanied by a large expansion in claims on the public sector—an increase of $12.4 million, or 66 percent (from a 1965 level of $18 million, to $30.4 million). This increase was largely financed through the provision of $8 million worth of advances by the Bank of Guyana to the Government almost immediately after its establishment.

This crisis and the Central Bank's responses, serve to highlight four important central banking issues in the region. The first of these is the complex problem of diagnosis. Whilst it is true that the fall in reserves was accompanied by an expansion in public sector credit, it should also be noted that the overall deficit in the balance of payments was in fact slightly less than that of the previous year, as the data in Table 1 show. The data in Table 2 below also indicate that the trend in imports had not been significantly different during 1966, and that in fact the pressure on imports seen during that year had started at least as early as 1964 when imports rose by $32 million, nearly 30 percent above the 1963 level. By 1965, with a further increase of $10 million (nearly 7 percent), the balance of trade went into deficit after four previous years of large surpluses totalling $116 million. In addition, credit to the private sector by the banking system had also increased significantly at that time. During 1966, it was $10 million above the previous year's level of $30 million, an increase of 33 percent. This was more than three times the rate of increase of the previous year. Further, the money supply in 1966 did not show any substantial increase over the previous year. Finally, the growth in

TABLE 1 Selected Monetary Indicators–Guyana ($M)

	1965	1966	1967	1968	1969
1. Foreign Assets	49.1	37.8	52.0	50.7	45.7
a. Central Bank (including Currency Board)	34.4	29.0	37.7	47.1	41.4
b. Commercial Banks	14.6	8.8	14.3	3.6	4.3
2. Claims on the Public Sector	18.0	30.4	26.8	34.6	47.9
(a) Central Bank	3.3	12.6	7.2	3.2	17.4
(b) Commercial Banks	14.7	17.8	19.6	30.4	30.5
3. Balance of payments[1]					
(surplus +) (deficit –)	–13.0	–12.0	+14.0	–2.0	–9.0
4. Money Supply	44.1	46.6	51.1	56.5	60.6
(a) Currency in Circulation	27.8	28.0	30.7	34.3	36.1
(b) Demand Deposits	16.3	18.6	20.4	22.2	24.5
5. Fixed Deposits of Commercial Banks	57.1	63.3	72.7	82.9	93.6
6. Total Commercial Bank Advances	48.1	53.5	52.5	65.2	78.3
7. Banking System's Loans and Advances to the Private Sector	30.0	41.0	44.1	56.5	67.4

Note 1: defined as net change in foreign assets of the banking system.

Source: Bank of Guyana *Annual Reports; Economic Survey,* Government of Guyana 1968.

fixed deposits exceeded, by substantial amounts, the expansion in advances.

The pressures on reserves which started as early as 1964 had been building up and not making themselves manifest because of the then existing Currency Board arrangements. Relatively liberal Central Bank credit to the public sector in 1966 added to these pressures, but they could not, in view of the evidence of other pressures, be alone accountable for the foreign reserve loss. Prior to the establishment of the Central Bank, the financing of this reserve loss would have occurred almost entirely through changes in the foreign balances of the commercial banks and the currency issue. If either of these had occurred then, the corrective mechanism would have been self-regulating in the case of the currency issue, in so far as expenditures are related to currency supplies. Or, it would have been dependent on the commercial banks' interpretation of the profit/loss position of their portfolio and their capacity to borrow from Head Office. As

TABLE 2 Selected Trade and Payments Statistics—Guyana ($M)

	1961	1962	1963	1964	1965	1966	1967	1968	1969[1]
1. Imports (C.I.F.)	−147.0	−126.3	−118.5	−150.8	−161.0	−202.0	−225.3	−229.2	−238.0
2. Exports (F.O.B.)	+149.5	+164.0	+175.7	+169.4	+177.1	+192.3	+217.7	+238.8	+250.0
3. Balance of Trade	+2.5	+37.7	+57.2	+18.5	−3.8	−9.7	−7.6	+9.7	+12.0
4. Balance on Current Account (including transfer payments)[2]	−19.6	+8.9	+29.2	−11.7	−25.3	−40.2	−40.6	−18.7	−33.1
5. Balance on non-Monetary Capital Account	+17.6	+14.3	+8.9	+12.6	+18.6	+31.3	+45.7	+38.8	+39.7

Notes
1. Estimate provided by Bank of Guyana.
2. Revised figures for later years provided by Bank of Guyana.

Source: Bank of Guyana Annual Reports

things stood, with reserves centralized in the Bank of Guyana, the impulses which were already there merely shifted their location.

Another example of the problems of diagnosis, can be seen in the failure of the Central Bank to anticipate the monetary crisis of early 1970. In its Annual Report for 1969, (which was not released until June 6th 1970) the Central Bank made the following prediction: "The current savings of the community through the banking system should be adequate to support a reasonable expansion of bank credit, thus avoiding any need to draw on foreign reserves." [1] But by the end of December 1969 the reserves during that year had fallen by $5 million, and bank credit to the private sector had increased by $11 million, or 20 percent above the 1968 level (see Table 1). Indeed, for the period 1965-69, outstanding bank credit to the private sector had more than doubled. The consequence of these obvious monetary pressures was that by March 1970 the Central Bank had found its reserves reduced to $37.6 million. To cope with this situation, the Central Bank was forced to make use of its Special Drawing Rights provisions with the International Monetary Fund. Guyana's allocation, which was made in January 1970, was equal to $5.04 million. During March of 1970 an amount of $2 million was borrowed, reducing this total to $3.04 million. The pressure on the Central Bank's foreign reserves continued and by the end of May 1970 its foreign reserve holdings were equal to $31.7 million or about 25 percent lower than the December 1969 level. The only policy measure introduced throughout 1969 and up to the end of June 1970, was the establishment of a Special Deposit account for the commercial banks in February 1969. This account is more liquid (repayable on demand), and carries a lower yield ($2\frac{1}{2}$ percent below Bank Rate, reckoned on the minimum weekly balance) than the Treasury Bill, and it has been principally designed to offer the commercial banks an investment outlet for their liquid funds. It was no serious effort to deal with the incipient pressures.

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

The third issue is the unrelatedness of the Central Banking Law to the realities of Guyana. This manifests itself in two ways. As the Bank itself has observed: "The limit, quite restrictive by international standards, on advances to the Government by the Central Bank in the Bank's statute turned out to be relatively liberal in 1966, as full advantage was taken of the difference between the new limit and the

1 Bank of Guyana *Annual Report*, 1969, p 10.

previous limits imposed by the commercial banks. The internal deficit of the Government ..... was therefore not only largely financed by the Central Bank, but could actually not have been incurred to the same extent without it."[2] One might add that the limit spoken of here is the standard limit which operates in the ex-British Empire territories.

The fourth issue is that the Central Bank as constituted is a subsidiary institution in the positive administration of economic policy. If we accept the interpretation of the Bank of Guyana that the crisis was one of bank credit to the Government, then it is clear that the stage at which its influence ought to have been felt was in the framing of the Annual Budget. Failing that, the law does not permit the Bank much room for manoeuvre in the *restraint* of credit.

The difficulties mentioned here are clearly evidenced in the policies pursued in the 1966 crisis. On 25th July, 1966, the Bank Rate was increased. But as the Bank explained: "it was raised to 6.5 percent mainly in order to allow the treasury bill rate to rise and to remain in line with the London rates, and to ensure that the comparison of different forms of adjustment would not always come out in favour of borrowing from the Bank and against the transfer of foreign balances to the Bank."[3] Thus, although a domestic crisis of public sector credit was diagnosed, it was not until the London bill rate had risen that the Bank of Guyana felt it necessary to implement policy measures, and this was then directed towards automatically adjusting the local Bank rate to bring it in line with the London rates. A further policy pursued in December of that year was an increase in the liquid assets ratio requirements of the commercial banks, from the prevailing levels of 15 percent against fixed deposits and 10 percent against demand deposits, to 20 percent on fixed and 15 percent on demand deposits. The irrelevance of the changes in these ratios are shown in Table 3, where it can be seen that the actual ratios substantially exceeded the required ratios, and that therefore, this policy change had no real significance in affecting commercial bank behaviour.

Finally, the other policy measure introduced was the requirement that a 100 percent deposit be made at the time letters of credit were opened for import purposes. This policy was, on the Central Bank's own admission, also of marginal significance, as the Bank discovered that it only influenced a small area of import financing.

During 1967 the reserves levels began to build up again. However, the forces accounting for this were to a large extent independent of public sector borrowing and independent of Central Bank action. It is true that public sector borrowing fell by about $3.6 million, but this could not explain the substantial ($14.4 million) increase in foreign exchange reserves. The explanation has to be sought in such factors as the return to a balance of payments surplus, the large relative expansion of fixed deposits with the commercial banks, an expansion

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2 Bank of Guyana *Annual Report*, 1966 p. 10

3 *Ibid* p. 33

TABLE 3 Commercial Banks: Liquid Assets Ratio Requirements—Guyana ($M)

Year	Actual	Required	Surplus to Requirements
1965	25.8	14.1	11.7
1966	22.8	14.9	7.9
1967	27.5	16.7	10.8
1968	30.1	18.8	11.3
1969	32.6	21.4	11.2

Source: Bank of Guyana *Annual Reports*

of exports and a nearly 50 percent expansion in net foreign capital inflows. As most of these items were independent of Central Bank activity, the correction therefore occurred without much reference to it, except perhaps slightly in the exercise of restraint on import expenditures. Thus to all intents and purposes, the mechanisms of adjustment responded to private actions with no effective direction from the Central Authorities.

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

Since the devaluation of 1967, two further developments have occurred. In face of its manifest dependence on the sterling exchange standard, the Central Bank started to pursue a policy of independent discount rates. The rate level of 6.5 percent decided on in July 1966 was maintained until 1970; although there were a number of variations in the Treasury Bill rate in response to the higher prevailing United Kingdom rates. Thus for example, between November 1967 and March 1968 the United Kingdom rate was kept at 8 percent, and the average discount rate of Guyana Treasury Bills rose from 6 percent in November to 6.42 percent by the end of March. With the downward adjustment of the United Kingdom Bank rate in 1968 to the level of 7 percent, the local Bank Rate together with exchange commission charges operated as an incentive for an inflow of funds. As a result the banking system has become highly liquid. Despite this, the Central Bank has maintained lending rates at the high levels reached in July 1966 during the crisis. In keeping with this policy, commercial bank deposit rates have also been high and have been maintained at levels of 6 percent and more for a 3-month call account. The further expansion of fixed deposits by $20. 9 million, or about 30 percent, between 1967 and 1969, reflects the attractiveness of these rates. It was during 1969 that the money supply also began to show signs of significant increase. In that year it grew by 10 percent, and in 1969 by a further 7 percent. At the same time, the banking system's holdings of claims on the public sector were also increasing, as the Government had to make suitable securities available for the highly liquid commercial banks, if there was not to be an outflow of funds. Thus, during 1968-69, commercial banks' holdings of Treasury Bills were averaging nearly $14 million.

Over and above these pressures, which made for high levels of liquidity in the banking system, there was the Caribbean-wide phenomenon of an inflow of sterling in response to the devaluation of November 1967. It has been argued that this phenomenon occurred because the commercial banks were seeking to establish a territorial balance in their assets and liabilities, to avoid the "risks" associated with a further devaluation of sterling, which might not be followed by an automatic Caribbean-wide devaluation. Certainly the run down of foreign balances has been very marked since then. But it is perhaps too early to say whether the "risk" factors (i.e. the threat of capital loss) outweigh the "pure profit" advantages, (i.e. comparative security yields, assuming no exchange-rate induced losses) of a portfolio adjustment away from foreign balances and into local Treasury Bills, net of exchange commission charges.

The evidence of the spread between the Jamaican Bank Rate and the United Kingdom rate suggests that the rate structure in Guyana is sufficiently high, when exchange commissions are added, to account for the type of portfolio adjustments which have been occurring. The Jamaican Bank Rate, as a matter of express policy[4], has moved in close sympathy with the United Kingdom Bank Rate. This has been effectively accomplished within a Bank Rate spread of 1. 5 percent-2. 0 percent below the United Kingdom rate. At its maximum point of divergence, i.e., at the peak of the devaluation crisis, the Guyana rate was 2 percent below the United Kingdom rate. The subsequent adjustment in the United Kingdom rate has reduced the rate gap in Guyana's favour. At the moment, therefore, it appears as if the traditional "riskless profit" motives could still be dominant.[5] In this regard, the

4 See the discussion of the Jamaican experience later.

5 One other factor which suggests itself is that the Bank Rate in the United Kingdom is not the comparative rate. A comparison of the Treasury Bill rates in the two countries shows a reduced spread of 1. 18%. Moreover, in so far as the foreign balances are being replaced by local loans and advances, then it is the rate on these that should be compared. As can be

recently concluded Basle Agreements and other Sterling Area arrangements are also reinforcing the traditional trends, in so far as they reduce the risk element in the foreign exchange market for Sterling Area currencies. As a result, it may yet be too early to draw any proof of independence from the Bank of Guyana's much vaunted Bank Rate policies.

The fourth crisis was that of determining the pattern of external relations. The difficulties here are most dramatically highlighted in the exchange rate, and to a lesser extent in the Bank Rate policies discussed above. They are also reflected in the Sterling Area policies of Guyana (together with the recently concluded Basle and other Agreements) and Guyana's participation in the International Monetary Fund. Comments on the Sterling Area arrangements are reserved for the last chapter, where they are more conveniently discussed in relation to all the territories; but here it must be noted that as a token gesture of the independence of the monetary standard, the par value of the Guyana dollar has been expressed in terms of gold. This abandoned the previous Currency Board practice of fixing the exchange rate in terms of sterling. However, as the devaluation of 1967 has demonstrated, there is a *de facto* dependence on the sterling exchange standard, which is perhaps inevitable, given the structure of real production and trade, and of the available financial institutions in the country.

In keeping with their widely published intentions of demonstrating that the new Central Bank was no less "sound" than the previous Currency Board, Guyana immediately acceded to Article VIII, Sections 2, 3, 4 of the International Monetary Fund regulations, which made the Guyana Dollar fully convertible in terms of the Fund requirements. No attempt was made to accept the transitional provisions of Article XIV, Section 2. Thus, Guyana was not in a position to impose restrictions on payment and transfers on current account without prior approval. In lieu of this, a Stand-By Agreement for \$15 million was entered into. Guyana's gold subscription to the fund was approximately \$2.1 million. The Stand-By Agreement was never resorted to, and was in fact reduced, after the first year, to \$8 million. Later, with the revision of the Fund structure, Guyana acquired, as we noted above, \$5.04 million of Special Drawing Rights.

The adoption of this pattern of external relations was again basically defensive. It was designed to engender confidence in the newly formed institution, while at the same time reinforcing the traditional bias of currency and foreign exchange arrangements, which try to ensure that these arrangements maximize the inflow of capital as the dominant condition of growth in real output. In this sense, the policy pursued

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seen from Table 1, between 1965 and 1969 advances grew by about 62%, i.e. \$30 million, whilst Treasury Bills holdings grew by only about \$10m. The nominal rates on advances quoted by the Bank of Guyana in its Annual Report do not indicate the true rate, as practices such as *not* charging interest on a reducing balance are not easily estimated. In any event a prime lending rate of 7.5% is enough to favour an inflow of funds through the commercial banking system.

here stood opposed to the generous credit facilities the Central Bank immediately made available to the Government upon its establishment in 1966, and which led to some of the pressures on the foreign reserve position of the Bank. It also stood opposed to what must have been their awareness of the continuingly worsening situation in the country's balance of payments. However, apart from these basic commitments to observe Fund obligations and the change in the local par value in response to similar changes in the United Kingdom, there were no policy measures to influence directly the foreign exchange position of Guyana. Unlike, as we shall observe, the Jamaican Central Bank, there has been no attempt in Guyana to make frequent use of the exchange commission rate imposed on foreign transactions in order to influence these transactions. The buying and selling rate of sterling remained the same ($^{3}/_{16}$ths of 1 percent) right up until March 1969, when an exchange charge of $^{1}/_{16}$th of one percent was levied for purchases and $^{7}/_{16}$th of one percent for sales.

(ii) CENTRAL BANKING IN TRINIDAD-TOBAGO

The Central Bank of Trinidad-Tobago has also had only four years of full operations.[6] However, as with Guyana, this limited experience is of some usefulness for both evaluating the efficiency of the banking structure and for highlighting certain problems whose solutions are more intractable than might be imagined. As with its Guyana counterpart, the Central Bank of Trinidad-Tobago also ran into what it interpreted to be a very serious financial crisis in 1966, its first year of full operations, and which it attributed to the injudicious use of its capacity to grant credit to the public sector. Between 1965 and 1966 the foreign assets holdings of the Central Authorities and the commercial banks fell from $96 million to $80.4 million, whilst public sector credit provided by the Central Bank expanded from $7.6 million to $22.7 million. The only difference from the Guyana situation is that in Trinidad, the Central Bank credit was provided through the purchase of Treasury Bills rather than the provision of bank advances.

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

6 The Central Bank Act, November 1964.

a loss of foreign reserves."[7] Whilst it is true that excessive credit to the Government can lead to a drain on foreign exchange holdings, the same holds true for excessive credit to any spending unit. The evidence must therefore revolve around the question as to whether excessive credit was in fact provided to the Government, and whether the use of such government credit was the principal source of the foreign reserve drain. As the matter stands, the conclusion one can arrive at is that those who make a glib association between the two are concerned with giving dominance to "price stability" and a "high level of reserve holdings", and have used the occurrences in these countries, which are largely coincidental, as a buttress against governmental pressures to provide credit within the framework of existing laws. This attitude has been reinforced by the fact that the statutory bench-marks for halting credit expansion are at present either unclear or too high. As a result, it is feared that these pressures can in practice be quite considerable.

If we examine the developments during 1966 in Trinidad-Tobago, we will note how complex is the problem of diagnosis (also referred to when considering the Guyana experience), and the dangers inherent in assessing the situation from only two proxy variables, bank credit to the public sector and foreign reserve holdings. In Trinidad and Tobago, the high level of economic activity recorded between 1955-62 (an 11 percent per annum growth in GDP at current prices) was due mainly to the petroleum boom. When petroleum expansion halted in 1962 the growth rate fell off, and between 1963-1965 averaged only 3.4 percent per annum. It was during 1966 that a revival started, with a nearly 50 percent expansion in annual crude production, and a large expansion of domestic manufacturing activity. As the data in Table 4 show, exports increased from $711 million to $753 million, and imports fell from $817 million to $773 million. The balance of trade

TABLE 4 Selected Balance of Payments Indicators—Trinidad-Tobago ($M)

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

Sources: Central Bank, Trinidad-Tobago, Statistical Digest; Other Government Publications.

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

deficit in 1966 fell to one-third of the preceding year's level. The balance of payments went into deficit, as is shown in Table 5, because capital inflows, at $50 million, were 70 percent below the previous year's level of $119 million. The money supply also grew by about 8 percent, whilst fixed deposits rose by $16 million, or nearly 10 percent. At the same time, and of vital significance, we should note that the fall in foreign exchange reserves was almost entirely reflected in the commercial banks. Between 1965 and 1966, the commercial banks' foreign assets fell from $21.2 million to $7.4 million, whilst their advances expanded by nearly 10 percent. There was hardly any change in the Central Authorities' holdings of foreign exchange. If the reserve loss was significant,[8] then it could perhaps be better explained in relation to the excessive provision of private sector credit, and the performance of the commercial banking system.

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

In evaluating the central banking experience in Trinidad-Tobago, it is very significant to note that the first set of policies introduced by the Central Bank was in response to external developments in the United Kingdom money market. "The first setting of the re-discount rate by the Central Bank took effect on 1st August 1966, eighteen days after the increase in bank rate in the United Kingdom .... After taking these considerations into account the Central Bank set its re-discount rate at 6 percent and pursued other complementary policies in an effort to insulate the economy as far as possible from the interest pressures abroad."[9] Such a response underlines the limited and dependent conception of their roles which these Central Banks have.

It has of course been argued that although the local rate was adapted to the change in the United Kingdom rate, this would certainly have

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8 It may be that the foreign exchange "loss" was not significant. As far as the commercial banks are concerned, their gross overseas assets were at the same level as the previous year. The change in their "net" position was due to an increase of their liabilities to overseas banks. It is questionable whether "netting" out is the best procedure. I tend to the Jamaican view that these assets should be given gross, although I have accepted for statistical purposes the definitions used by each country of their official external assets.

9 *Annual Report*—Bank of Trinidad and Tobago 1966 p. 3

TABLE 5 Selected Monetary Indicators—Trinidad-Tobago ($M)

	1965	1966	1967	1968	1969
1. Foreign Assets	96.0	80.4	84.3	129.0	N.A.
A. Central Bank	48.9	50.9	60.6	124.7	120.8
B. Other Government investments and cash balances	25.9	22.1	18.5	20.1	N.A.
C. Commercial Banks (net)	21.2	7.4	3.2	−15.8	−12.9
2. Gross-Claims on the Public Sector	69.2	81.3	65.1	105.1	90.3
(a) Central Bank	7.6	22.7	2.6 (Jan.'68- 17.4)[1]	27.2	29.8
(b) Commercial Banks holdings of government securities and advances to the public sector	61.6	58.6	62.5	78.0	60.5
3. Balance of Payments (surplus +) (deficit −)	+7.3	−9.7	+1.9	+43.8	N.A.
4. Money Supply	120.8	130.2	136.7	138.3	127.8
(a) Currency in circulation (active)	36.2	42.5	47.1	49.0	50.5
(b) Private demand deposits	84.6	87.7	89.6	89.3	77.3
5. Fixed deposits with Commercial Banks	158.6	174.5	196.2	235.1	284.0
6. Total Advances of Commercial Banks	167.4	178.1	191.3	212.5	270.3

Note

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

Sources: Financial Statistics; Statistical Digest, Central Bank of Trinidad-Tobago—1970, and other Government Publications.

had significant domestic repercussions. It would have prevented a reversal of the changes of the commercial banks portfolio, which were at that time favouring local investments at the expense of foreign balances. But the fact remains that it was this very flow to which we should substantially attribute the foreign-exchange pressures. It was the effort to switch their overseas balances into local investments that led to the run down of the commercial banks' foreign balances. A policy designed to favour local investments must lead, in such circumstances, to pressures on reserve holdings. The correction of the foreign exchange loss took place independently of central banking actions. In 1967 the balance of payments went into surplus, and by 1968 the surplus was as high as $43. 8 million. An increase in reserves also occurred, but that was mainly due to the sale of capital assets in the United States during 1968 ($12 million), and the raising of a loan ($7. 2 million) in the United Kingdom money market. Fixed deposits in the commercial banks also grew rapidly by an amount of $61 million, or an increase of nearly 40 percent, between 1966 and 1968. Meanwhile, bank advances expanded by about one-half of the expansion in fixed deposits ($34 million).

Generally speaking, the Central Bank of Trinidad-Tobago has tended to adopt a largely passive policy where the internal regulation of commercial bank credit is concerned; and a largely defensive posture where developments in the money markets are concerned. In response to its own interpretation of the course of monetary disequilibria, which is its own lending to the Government, the Central Bank has enforced rigid limits on public sector credit, as can be seen from its performance during the years 1967-68. (See Table 5). In January, 1968, its holdings of public sector securities were only $17. 4 million, and at the end of 1969 they were $29. 8 million. It has also tended to operate so as to favour an increase in official foreign exchange holdings, and the success of this policy can be seen in the growth of these holdings between 1966 ($80. 4 million) and 1968 ($129 million). The Central Bank has also refrained from imposing any restrictions, for fear of hampering the competitiveness of the commercial banking system.[10] The exception has been the creation of Special Deposits Accounts in 1968, in order to facilitate the employment of the excess liquidity which the commercial banks found themselves with in the post-devaluation period. No restrictions were placed on drawings from these accounts, and they can be considered as "special" only in the sense that they carry a special rate of interest and were introduced as a substitute for an expansion of public sector credit, via the Treasury Bill issue. It may be surmised that the view of the Central Bank is that controls are really unnecessary. The commercial banks are behaving in a manner which they themselves favour, i.e. facilitating an inflow of funds at the expense of their overseas balances. But such a policy must certainly have foreign reserve consequences, and the Central Bank cannot therefore react to these as if they were not anticipated!

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10 The commercial banks' reserve ratio was set at the minimum of 5% in 1966.

The discount rate and exchange rate policies pursued by the Central Bank also have been of a largely defensive kind. The devaluation of 1967 was "forced" onto the Bank, and the policy of sympathetic discount rate movements was similarly, if less forcibly, imposed. Data on these rate movements can be seen in Table 6. The maximum spread which has been maintained between United Kingdom and the local rate has been 1.5 percent (a position held during the month of devaluation, November 1967). The Central Bank has also manipulated the exchange commission charges in order to influence portfolio adjustments in the short-term capital market. Thus, in March 1968 it imposed the maximum permissible charge of 1 percent (the IMF band) on sales of sterling, and adjusted the rate for inward/outward movements of funds from $\frac{1}{16}$th inward and $\frac{1}{2}$ outward, to $\frac{3}{16}$ths inward and $\frac{3}{8}$ths outward. At the time of the devaluation crisis, foreign exchange transactions were centralized in the Central Bank and the commercial banks' "authorised dealer status" was suspended. Sterling was declared a foreign currency and thereby made subject to exchange controls. However, by the end of 1967 all these restrictions were removed. The crisis was over, at least until the next time! During 1969, attempts were made to settle the administration of the foreign exchange market. These aimed at making the exchange levies charged by the Central Bank more effective, and to ensure an adequate flow of foreign exchange through the banking system, so that the Central Bank would become the ultimate settling authority for international payments and receipts. The rate system agreed on for foreign exchange transactions maintained the commercial banks' traditional spread, but the structure of rates was pegged to the official exchange charges[11]. This was a considerable improvement, as under the previous system there would be no assurance that the official rate determined the structure of market rates, as most of the dealings in foreign exchange did not involve the Central Bank.

Post-script—The 1970 crisis

The political and civil upheavals in Trinidad-Tobago in the early part of 1970 have led to the introduction of Draconian measures, aimed at staving off the severe financial crisis which followed immediately after. With the declaration of a State of Emergency in April, it became apparent that there was a flight of local capital, and that foreign inflows were being reduced. As a result, the Exchange Control regulations were tightened and extended to all countries. Controls were also imposed on the ownership of foreign currency and the holding of overseas accounts.

There are no adequate data to analyse these events, but two points seem to emerge clearly. First, the nature and types of financial institutions which a country has, basically reflect the attitudes of the broad mass of the people. In a real sense these superstructural institutions are rooted in the political, social, as well as economic realities of the country. One of the demands of the people of Trinidad-

[11] Information provided by private communication.

TABLE 6 Comparative Rediscount Rates 1961-70

		U.K.		Jamaica		Guyana		Trinidad-Tobago
1961	November	6.0		6.0		—		—
1962	March	5.5	October	5.5		—		—
	April	4.5						
1963		4.0	March	5.0				
			September	4.5				
			November	4.0				
1964	January	5.0	November	5.0				
	November	7.0						
1965	June	6.0		5.0				
1966	July	7.0	July	5.5	March	6.0	August	6.0
1967	January	6.5	May	5.0		6.5	March	5.75
	March	6.0	November	6.0			May	5.5
	May	5.5					November	6.5
	October	6.0						
	November	8.0						
1968	March	7.5	September	5.0		6.5	January	7.0
	September	7.0						
1969	February	8.0	February	5.5				
			May	6.0				
1970	March	7.5						
	April	7.0						

Tobago during the course of the upheavals was aimed at local control of commercial banking. Many of the physical attacks on private property were specifically directed against the commercial banks. Already the Government had, in March, purchased one of the minor foreign-owned banks[12] as the basis for a National Commercial Bank, in response to demands for localizing ownership of the country's resources.

Second, it is clear that in an emergency, the proper administration of Caribbean financial systems requires the imposition of wholesale exchange controls on capital account transactions. The vital question is really, "what constitutes an emergency?" In the next chapter, we argue for the immediate and continuing imposition of these controls as one cornerstone in a policy of structural reform. This argument centres on the fact that there is a real and continuing emergency which is reflected in the poverty, the swelling ranks of the unemployed, and the dispossessed, to be found everywhere in the region.

(iii) CENTRAL BANKING IN JAMAICA

The Central Bank of Jamaica has had the longest experience of the three Central Banks under consideration. Partly on account of this, (in that in its early years of establishment there was a considerable prejudice against Central Banks in "under-developed" economies), the Bank has adopted most completely the traditional role of these institutions. It has been both consistent and rigorous in the pursuit of its traditional objectives along classical lines. The setting of this pattern of development is very clearly perceived in some of its early policy pronouncements, which seem to accept entirely the need to administer its powers of credit creation and regulation in as limited a fashion as its predecessor, the Currency Board. It has also accepted without serious challenge, a more or less long-enduring structural dependence of the Jamaican money market on the United Kingdom's financial markets. This dependence is seen principally as a reflection of the level of development of the Jamaican money and capital markets. It has therefore confined most of its effects to stimulating the development of local money and capital markets, in the belief that this would ensure that savings/investment decisions are made with appropriate consideration for the state of the Jamaican economy.

Proof of this assertion can be seen from comments which the Central Bank has made on its own establishment. "None of this, however, has affected the basic advantage of the sterling exchange system. The whole of the money supply (active currency circulation plus bank deposits) is still effectively backed pound for pound by sterling. The Central Bank has to be prepared to provide sterling to meet on demand any Jamaican currency offered for redemption and this also applies to the commercial banks' deposits with the Central Bank ..... The significance of the existence of the Central Bank and the fiduciary issue is that great care has to be exercised in the creation of money not backed

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12 *BOLAM*—Bank of London and Montreal.

by sterling assets—in other words, Central Bank lending to Government, whether by way of taking up Treasury Bills or by direct advances." [13] Commenting on its foreign-exchange reserve policies, the Bank observed: "Thus there is no necessity for Jamaica to keep reserves in gold or currencies other than sterling because both can be purchased with sterling through the Sterling Area mechanism."[14] It is rare to find such unqualified support for the virtues of the traditional sterling-exchange standard system, and it is indeed rarer to find such support coming from a Central Bank in a developing economy.

The classic orthodoxy of Jamaican central banking is also clearly revealed in its operational aspects, as an examination of the use of its lending powers to the Government shows. As the data in Table 7 indicate, the Central Bank's holding of government securities has been consistently small. In its early years of operations the Central Bank successfully managed to keep these holdings to a minimum. Unlike either the Central Banks of Guyana or Trinidad-Tobago, it did not at its inception behave generously within the limits of its newly found freedom, in providing public sector credit. The Central Bank has continued to maintain this policy of minimal holdings of government securities, and, basically, those government securities which are held, have been mainly for market adjustment purposes. At the end of 1969, its holdings of these securities were only $10. 9 million (J$4. 5 million) almost all of which were Treasury Bills. These holdings represented just about 4 percent of the total resources of the Bank, as compared with 20 percent in Trinidad-Tobago at the end of 1968, and over 30 percent in Guyana at the end of 1969. At its peak holdings (end 1965) the ratio was just under 20 percent. The result has been that the growth in public sector credit has taken place mainly through the commercial banks' purchase of Treasury Bills, and to a much smaller extent (about 12 percent) through its granting of advances to the public sector.

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

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[13] *Annual Report*, Bank of Jamaica 1961, p. 14.

[14] *Ibid.* p. 26.

TABLE 7 Selected Monetary Indicators—Jamaica ($ M Guyana)

	1961	1962	1963	1964	1965	1966	1967	1968	1969
1. Official Foreign Assets	174.7	182.4	241.4	210.2	204.5	229.4	240.0	294.7	298.4
a. Central Bank and Central Government	157.4	159.4	203.0	192.5	189.1	209.8	226.1	289.4	281.3
b. Commercial banks (gross)	17.3	23.0	38.4	17.8	15.4	19.7	13.9	5.3	17.1
2. Claims on Public Sector	38.9	48.0	47.5	59.0	61.9	55.2	55.2	75.8	84.0
a. Central Banks' holdings of Government Securities	23.0	18.2	14.4	23.0	27.8	17.3	12.0	10.6	10.9
b. Commercial bank advances to Public Sector and Treasury Bill holdings	15.8	29.8	33.1	36.0	34.1	37.9	43.2	65.3	73.1
3. Balance of Payments	+6.2	–1.0	+44.2	–6.2	–3.8	+40.3	+34.1	+67.7	–27.6
4. Money Supply	133.0	146.4	144.5	153.1	152.6	170.4	181.0	228.0	265.9
a. Currency with Public	41.2	43.2	47.5	54.2	56.6	61.0	66.7	75.8	87.6
b. Private demand deposits	91.2	103.2	97.0	98.0	96.0	109.4	114.2	152.2	178.3
5. Time deposits with commercial banks	23.0	29.1	45.6	45.0	49.1	67.4	73.0	112.4	150.6
Savings deposits	89.9	103.5	125.4	147.5	169.8	193.0	221.7	275.6	324.2
6. Total advances of commercial banks	203.5	193.9	178.6	250.6	304.8	324.5	349.9	417.1	586.6
7. Gross domestic product	1106.9	1148.2	1227.8	1314.7	1426.1	1548.0	1615.2	1784.2	1969.9

Note (1) $1 Guyana = 42 cents Jamaica

Sources: Economic Surveys; Bank of Jamaica *Bulletins*.

measures were instituted against the commercial banks (apart, as we shall see, from various discount rate changes; and very recently, in November 1969, a limited range of selective controls) can be attributed to the circumstances of the commercial banks during the period. The policies adopted by the commercial banks were "welcomed" by the Central Bank. In several of its Annual Reports, it has been approvingly pointed out that the foreign assets of these banks were being substituted for local assets; indeed, it was pointed out, this run down was so persistent and large that for the first time in 1964 it induced the commercial banks to seek short-term accommodation with the Central Bank, by way of seven-day advances.

Despite the view taken by the Central Bank, there is considerable evidence that during this period much of the commercial banks' lending operations needed close supervision. Thus, for example, between 1962 and 1968, the total value of imports doubled, whilst the value of exports grew by only 40 per cent. Much of this import expenditure was financed by bank advances, which resulted in a dramatic widening of the trade gap (see Table 8). The pattern of control sought by the Central Bank was to restrain, by mutual agreement, hire-purchase credit provided by the finance houses and the commercial banks. Control of lending by the finance houses was in fact resorted to, even before the Central Bank was established, in order to cope with the 1960/61 consumption boom. For almost all of the period up to the end of 1968, the bulk of the increase in bank advances was financed by the public's lending to the commercial banks by way of fixed deposits. As can be seen from Table 7, the change in fixed deposits between 1961 and 1968 was approximately $277 million, (J$116), whilst the comparable expansion of advances was $213 million (J$90 million). During this period the net indebtedness of the commercial banking system never exceeded $12 million, (J$2. 4 million), the level already prevailing in 1961. It is clear, therefore, that the source of funds for commercial bank advances came as a result of their intermediary role, made attractive through a policy of high interest rates induced by developments in the United Kingdom money market.[15]

TABLE 8 Trade Statistics–Jamaica ($M Guyana)[1]

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

Note (1) $1 Guyana = 42 cents Jamaica

Source: Annual Trade Reports, Jamaica.

15 This position was not maintained during 1969. The special circumstances here are treated towards the end of this chapter.

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

In a most fundamental sense, the policies pursued here were really externally oriented. Stable exchange rates, easy and free convertibility of the local currency into sterling, together with minimum state intervention, except for fostering the growth of financial markets which would make private enterprise more efficient, were the foundations of these policies. This approach was also consistent with the Government's views of the development process, which relied heavily on the unencumbered inflow of private foreign capital and unhampered private decisions about the allocation of resources. It was this type of development policy which accounted for the original creation of Currency Boards, and which serves to explain why the Central Bank was so determined to minimize the differences between its powers and those of the Currency Board.

This interpretation of the motivations behind the monetary policy which was pursued, is more readily observable in the directly external actions of the Bank of Jamaica. Unlike the other two Central Banking Acts, that of Jamaica defines the Jamaican currency in terms of its sterling equivalent. This was a direct carry-over from the Currency Board era. In 1966, in response to the pressures on sterling in the international exchanges, the law establishing the par value had to be amended. However, in keeping with its conservatism in these matters, the par value was still expressed in terms of sterling, with the proviso that if sterling were devalued, the Jamaican currency might or might not be devalued, but if it were devalued, the limit would be the amount necessary to restore parity with sterling. If the sterling rate were appreciated the Jamaican currency must be automatically appreciated to the same extent.

There are two very serious problems which this amendment poses, and which are not generally understood. First, in so far as the par value is defined in this peculiar way, it reinforces the *de facto* link between the Jamaican and United Kingdom monetary standard. It is clearly a declaration of intent to copy the pattern of United Kingdom rate changes under most situations. If the definition of the par value had been made in terms of gold, it would not be to the same degree a declaration of similar intent. The consequences of this are numerous. Not only might it facilitate the inflow of capital which the Jamaican Government hopes to encourage, but it could equally well facilitate an outflow, as portfolio decisions can still be made on the assumption of there being little likelihood of devaluation-imposed capital losses. Secondly, the new method of expressing the par value does not anticipate the likelihood that in an unstable foreign exchange market, if the United Kingdom balance of payments problem leads to a devaluation of the £ sterling, this can occur through a series of widely fluctuating rate changes before a new acceptable level is found. This law would tie the Jamaican currency to a similar rate policy, and it would therefore ensure the more or less automatic importation of the destabilizing market situation for sterling. In support of this par-value policy, the Central Bank had upon its establishment immediately accepted IMF Article VIII status. A Stand-By Agreement was negotiated, but this came to an end in June 1964. No recourse was made to the transitional arrangements of Article XIV which the vast majority of countries were adhering to at that time.

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

The devaluation of 1967 very clearly highlighted some of the difficulties of adopting this classic policy in an economy and society such as Jamaica. In defence of the Jamaican currency, the Central Bank was forced to devalue in response to a devaluation of sterling, and thereafter to follow the usual procedures of raising the discount rate, manipulating the exchange commission charges, declaring sterling a foreign currency, establishing Special Deposit accounts, and suspending the "authorized dealer status" of the commercial banks. As the immediate crisis eased itself, these restrictions were relaxed, but for the first time there seemed to be more appreciation of the need to control excessive dependence on sterling. This was reflected in the policy of seeking to alter the composition of the external assets of Jamaica.

As can be seen from the data in Table 7, there was a very significant growth in the official foreign assets holdings. Between 1961 and 1968 these grew by $120 million, or nearly 70 percent. At the time of the devaluation in 1967 the sterling component of foreign assets was equal to 76 percent. By the end of 1968 the proportion had been reduced to 54 percent, entirely on account of incremental diversification into non-sterling securities. The sterling component showed no absolute reduction. Most of this growth took place between November 1967 and June 1968, and two factors seem relevant for explaining this occurrence. To some extent, it seems as if this diversification policy was pursued in anticipation of the Sterling Area negotiations which were to follow on the conclusion of the Basle agreements. Secondly, it was during this period that the Central Bank began to tighten its controls to ensure that non-sterling foreign currencies passing through the economy should be deposited in the Central Bank. With the conclusion of the recently negotiated Sterling Area Arrangements, this diversification policy had to be brought to an abrupt halt as part of the conditions of the new Agreement.[16]

As with Guyana and Trinidad-Tobago, it has been argued by the Central Bank that the build-up of foreign assets in Jamaica after the November 1967 devaluation, is a reflection of the "new" desire of the commercial banks to match their local assets and local liabilities in order to avoid in the future any of the "risks" of devaluation. Again, the information available does not satisfactorily support this view. The Bank of Jamaica has stated: "Early in the year, the Bank noted the heavy inflow of foreign exchange through the banking system and a rapid rise in the money supply. What seemed to be taking place was a change in the policy of the banking system, whereby the commercial banks were stabilizing their foreign position and keeping their surplus liquidity in Jamaican pounds."[17] But this does not appear to be correct. Between 1967 and 1968 the net indebtedness of the commercial banking system increased by only $3.4 million (J$1.4 million). As the data in Table 9 show, the commercial banking system disposed of more foreign exchange than it acquired, and the foreign reserve build-up has resulted from tax payments in foreign currency and overseas borrowing.

TABLE 9 Sources and Uses of Central Bank of Jamaica's Foreign Exchange—1968 ($M Guyana)[1]

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

Note (1) $1G = 42 cents Jamaica

Source: Annual Report, Bank of Jamaica 1968.

16 The Sterling Area will be discussed in the final chapter.

17 *Annual Report*, Bank of Jamaica 1968, p. 8.

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

The increase in the number and range of institutions has helped the general aim of providing an adequate market structure in terms of range and the quantity of dealings in financial instruments. At the end of 1968, the value of trading in equities was just under $23 million (J$ 9. 4 million). However, trading in Treasury Bills, with a value of $ 144 million (J$ 60 million), and the raising of public capital with a value of $ 68. 2 million (J$ 28. 4 million), still virtually dominated the capital markets. Private share issues during 1966 were only $ 7. 2 million (J$ 3. 0 million). The market as it stands is therefore in no position to compete in "breadth, depth and resiliency" with the United Kingdom financial markets. It is also inadequately developed to permit the use of market-type instruments of control of the commercial banking system. And, its efficiency in raising local savings compares unfavourably with the use of business savings for financing the bulk of the recorded capital accumulation. Finally, in an effort to develop the financial markets, the Central Bank has almost perversely aided those pressures which favoured a greater and greater degree of "free" dependence on the United Kingdom market structures, for it has had to combine this policy with one of minimal intervention.

Post-script: The 1969/70 Jamaican financial crisis

The sparing use of the powers of the Central Bank has contrasted strongly with the long-term and basic needs of the Jamaican economy. As the events in 1969 were to show, it has also contrasted strongly with the need to cope with and dampen the short-term disequilibrating features of the financial system.

During 1969, the commercial banks, operating without any effective restraints for much of this period, increased their credit by $ 169. 5 million (J$ 72 million) (See Table 7). This increase was 40 percent above the level of bank credit obtaining at the end of 1968, and came on top of a situation in which during 1968, bank credit had also increased by nearly 18 percent above the 1967 level. By way of contrast, the commercial banks' acquisitions of fixed deposits in 1969 increased by only $87 million (J$36 million), or a little above one-half of the increase in bank credit. In previous years the expansion of bank credit had roughly kept pace with the growth of fixed deposits, and the commercial banks financed much of their credit from the raising of local fixed deposits. In 1969, the commercial banks were forced to finance their expansion of credit through a mixture of borrowing from their Head Office, a reduction of their liquid assets, and support from the Central Bank, on account of the phenomenal rate at which they were lending. Private demand deposits held in the commercial banking system increased by only $16 million (J$6.7 million) because most of the advances were used to finance import expenditure. Consequently, the deposits which these advances created were in the hands of non-residents.

The result of this was a balance of payments deficit of $27.6 million (J$11.5 million) in 1969. This deficit came after three previous years of large surpluses averaging $47.3 million (J$20 million). Despite this, the foreign reserves of the banking system increased slightly, although the holding of the Central Authorities fell a little; but the gross holdings of the commercial banks increased enough to offset this fall (see Table 7). The rapid expansion in commercial bank credit took place almost exclusively in the private sector. At the end of 1969, the Central Bank's holdings of public sector securities were virtually unchanged, whilst the commercial banks' claims on the public sector increased by only $8 million (J$3.3 million).

It was not until May of 1969 that the Central Bank tried to bring its influence to bear on this situation. It sought to exercise moral suasion, but this failed to prevent the situation from deteriorating. By its own admission it asked the banks, in May, to impose a voluntary restraint on credit, but this was not forthcoming. Yet, it was not until October 1969 that the Central Bank felt it necessary to be firmer and to issue a directive to the commercial banks. Meanwhile, throughout the year the money supply was rapidly expanding, and by year-end it had increased by one-sixth above the previous year's level.

The Central Bank's interest rate policy was similarly not pursued with the aim of restraining the pressures created by a rapidly expanding commercial bank credit. On October 28th, 1969, the Bank of Jamaica issued a directive in respect of consumer credit and credit to non-resident controlled companies. The restriction on consumer credit applied to the commercial banks as well as to relevant non-banking financial institutions and dealers. The aim of the directive was to limit the level of instalment credit to that prevailing at the end of October 1969, except instalment credit utilized for, (1) the purchase of motor vehicles for commercial purposes, (2) the purchase of industrial, commercial, agricultural, dental, medical and other professional equipment; (3) the purchase of local products; (4) home purchase and improvement; (5) businesses which do not utilize bank credit to finance credit for consumer durables; and, (6) education.

With respect to foreign-controlled firms operating in Jamaica, the aim was to prevent them from borrowing from the local commercial banks. Throughout the year much of this borrowing had occurred, which the Central Bank attributed to the fact that lending rates in Jamaica were lower than that of the country in which the parent-company was located.

The data are not yet available to analyse the effects this policy has had on the financial crisis. One thing seems clear at this stage: that the Central Bank has been forced to take steps which, in terms of its previous history, suggest a strong departure from its usual non-interventionist role. In particular, its restraint on borrowing by non-resident corporations partly reflects the reality that it is the structure of multinational corporations which militates against the effective operations of traditional Central Bank instruments and techniques of control. What the crisis also serves to remind us of is the severe problem of diagnosis and implementation. The crisis lasted for nearly 10 months before action was taken. And when it was taken, it created a feeling in the financial community of abruptness in the application of the controls. To counteract this, the Governor of the Bank sought to explain away the controls by arguing that the commercial banks themselves would have had to apply them, as they had no resources for further lending: "Mr. Brown warned the businessmen that it was unrealistic for them to assume that credit could increase in 1970 at the same 40 percent rate as it did in 1969. Because the banks had exhausted all their standby facilities, such as borrowing from their Head Offices, and had run down their liquid assets etc, it was obvious that for 1970 they would have to confine net new lending to increased deposits. Without any *official action* being taken, therefore, the amount of extra resources available for lending in 1970 would, of necessity, be much less than in 1969, and make it more difficult to obtain loans than in 1969."[18]

Such a statement is hardly reassuring, although it was clearly intended to be. The statement seems to indicate that the controls imposed were superfluous in their intention, which they could hardly be. But, more dangerously, it seems to suggest that controls are likely to be imposed only when the limits of credit creation are being approached. Taken together with the fact that the controls on borrowing by non-resident controlled corporations are also a temporary, rather than a permanent feature of the system, it serves to remind us that we should not expect very much from the new departures in the management of monetary policy.

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18 Bank of Jamaica *News Release,* March 10th, 1970. *(Our emphasis)*

CHAPTER FOUR

A Programme for Central Banking Reform

The extent to which, perhaps through default, the financial system of the Caribbean is expected to carry the main responsibility for mobilizing and allocating domestic capital funds is not generally appreciated. The fiscal structure of the region is studded with rigidities and archaisms which are not easily dispensed with. Historically, the tax system has depended heavily on the taxation of imports. While this has been primarily a reflection of the open structure of the economies, it is also strongly indicative of the administrative convenience which taxation of this form offers. Also, it is generally difficult to tax the domestic resources used in the production process; firstly, because most of these resources are combined for use in export agricultural activities which are already high cost, and manage overseas sales only through some form of preferential access to the United Kingdom and/or North American markets; secondly, because the firms which have mushroomed to assemble manufactured goods for the local market have generally been granted generous, long-term tax-exemptions as incentives; thirdly, because the other major users of domestic resources, mineral-producing multinational corporations (bauxite and oil), have been established on the basis of taxation and price agreements with the respective governments, which are "sticky" and unresponsive to the demands that should be placed on sectors which command the "heights" of the economy. As regards income recipients, an unusually large number of these are the self-employed, engaging in peasant agriculture or small scale commercial activity. As a result, it is difficult to integrate them fully into the tax system, and, therefore, it is the fixed income and salaried persons who carry the main burden of personal income taxation. Further, the dominant position which plantation agriculture has always held, has served to worsen the inequities of land distribution, and to complicate the question of land titles. The result is that it has become virtually impossible to administer an adequate system of land taxation, short of a rural revolution which would bring to an end the plantation system. Finally, much of public expenditure is heavily committed to financing the maintenance of overheads which form the infra-structure of economic activities, and to maintaining administrative levels.

It is also difficult to envisage a regime of direct controls used to mobilize and allocate savings. For such a regime to work successfully, it is necessary to have high prevailing levels of commitment to the Government and its social and economic programme. Nowhere in the Caribbean does this broadly based commitment exist. As a result of the limitations in the fiscal system and the use of direct controls, the financial system emerges, at least for the time being, as the most flexible instrument of mobilizing and allocating investible domestic funds. This position, however, is not readily recognized, and the Central Banks, as we have seen, approach their responsibilities with the preoccupation of ensuring that the financial system serves principally short-term ends, without endangering stability in the internal and external value of the currency.

(i) BASIC DEFECTS AND ALTERNATIVE STRATEGIES

In the two previous chapters, we have analysed the existing institutional and legal structures upon which central banking has been based, and the experiences of the three Central Banks in the Caribbean. This analysis indicates that there are four over-riding and fundamental defects which limit the scope for effective monetary policy. The first defect is "real", and stems from the structural rigidities and imbalances in these economies which give rise to their poverty, unemployment, lack of sustained development, and the dominance of expatriate enterpris

The second is their practice of maintaining *de facto* and/or *de jure* fixed exchange rates and free convertibility for current and capital-account transactions into sterling. Together, these two defects ensure that private profit-seeking activities of the dominant multinational productive enterprises and multinational financial institutions exaggerate and promote monetary disequilibria. This usually takes place in two main ways. The first is the unencumbered capacity of the multinational corporations to maintain two or more sources of short-term working capital, one of which is in the territory where their physical operations are located. This is directly related to the current flows of savings and investment in these economies. The second involves both flow and stock decisions; spending units (including governments) are facilitated to deal in two money and capital markets of unequal "breadth, depth and resiliency." Decisions about investing the current flow of savings, raised from incomes earned through the disposition of local resources, usually lead to a considerable net outflow of these earnings, particularly through institutions like insurance companies, and it has been necessary to invoke legislative prohibitions against this. But these prohibitions have been confined to the readily discernible and controllable agencies. Similarly, stock-adjustment decisions can be made which lead to an outflow of savings. In response to changes in the net yield in the United Kingdom (and other sterling area) money markets, spending units can adjust their existing portfolios of previously accumulated savings. To avoid this, there has been the constant necessity to manipulate local yields, in order to prevent an outflow of savings because of decisions about the composition of the stock of financial assets.

The third defect is the absence of a stable and predictable commercial banks' deposits expansion process. It is difficult, if not impossible, for monetary management to secure control of the money supply unless the nature of the commercial banks deposit creation process is understood and predictable. Unfortunately, the familiar credit multiplier analysis has little to offer dependent economies. The traditional equation of the deposit creation multiplier is

$$\Delta C_r = \frac{\Delta S}{r} \tag{1}$$

Where ΔC_r equals money "created", r is equal to the reserve ratio of the commercial banks, so that $0 < r < 1$, and ΔS is equal to the amount of change in excess reserves in the banking system. For the above equation to hold, we must assume that there are no leakages from the banking system, no recourse to the Central Bank and that the public is willing to hold any money "created." One leakage has been traditionally incorporated, i.e. the leakage from the banks to the non-banking private sector. If this is represented by c, so that $o < c < 1$, then the limit to the process becomes

$$\Delta C_r = \frac{\Delta S}{1 - (1 - r)(1 - c)} = \frac{\Delta S}{r + c(1 + r)} \tag{2}$$

In the type of economies under consideration here we cannot ignore the overseas leakage, i.e. the extent to which, when bank lending occurs, this leads (through the high leakages brought about from the direct connection between bank lending and the financing of imports) to deposits being created abroad. If we represent this leakage by d then the equation becomes:[1]

$$\Delta C_r = \frac{\Delta S}{1 - (1 - c - d)(1 - r)} = \frac{\Delta S}{r + (c + d)(1 - r)} \tag{3}$$

This model, however, is of little use in understanding the credit expansion process in the Caribbean. There is, in the region, no fixed operating reserve ratio for the commercial banks. Therefore, excess

[1] We can observe the usual cases however, based on this formulation. In addition to the above stated symbols, let ΔB equal the change in overseas holdings, ΔT equal the change in private cash holdings, ΔD equal change in bank deposits and ΔS_b equal the change in cash held by the banking system to cover bank deposits. Then

$$\Delta B = d \,.\, \Delta C_r \tag{1}$$

$$\Delta T = c \,.\, \Delta C_r \tag{2}$$

$$\Delta C_r = \Delta B + \Delta T + \Delta D \tag{3}$$

$$\Delta S_b = r \,.\, \Delta D \tag{4}$$

$$\Delta S = \Delta S_b + \Delta T + \Delta B \tag{5}$$

If we wish to know what values ΔC_r, ΔD, ΔB and ΔS_b will assume given the values of S, r, c and d, then substituting (1) and (2) and (3) above, we get

$$\begin{aligned} \Delta D &= \Delta C_r - (\Delta B + \Delta T) \qquad (6) \\ &= \Delta C_r - (d \,.\, \Delta C_r + c \,.\, \Delta C_r) \\ &= (1 - c - d)\, \Delta C_r \end{aligned}$$

reserves cannot be estimated by simple observation. The ratios c and d are likely to be both very high and very unstable. Currency holding tends on average to be high in relation to demand deposits, but at the margin, the behaviour of the public can vary considerably. Similarly, the overseas leakage is on average very high, but incremental responses vary considerably and unpredictably in a short period of time. Further, since currency issues (*de jure* or *de facto*) are strongly backed by foreign securities purchases, links with the balance of payments are very strong. Finally, since the model depends ultimately on how much the public is willing to hold, the fact that the public may have alternative ways of holding their financial assets, other than commercial banks deposits, must be taken into account, even though in the Caribbean, generally speaking, the alternatives are limited.

At this stage, we may digress slightly to consider whether any of the current monetary research and analysis offers any possible solutions to this problem. There are at least two noteworthy alternative models of the credit expansion process. One is by Orr and Mellon, who approach the analysis from the point of view of the individual bank, and introduce uncertainty more explicitly into the analysis of bank credit expansion via the application of "inventory theory."[2] Uncertainty leads to reserve losses as a bank expands credit. This

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Similarly from (5) above we obtain

$$\Delta S_b = \Delta S - (\Delta B + \Delta T) \quad (7)$$
$$= \Delta S - (d \,.\, \Delta C_r + c \,.\, \Delta C_r)$$

it follows also from (4) above that

$$r = \frac{\Delta S_b}{\Delta D} \quad (8)$$

$$= \Delta S - \frac{(d \,.\, \Delta C_r + c \,.\, \Delta C_r)}{(1 - c - d)\Delta C_r}$$

Solving the above for ΔC_r we have as we saw before

$$\Delta C_r = \frac{1}{r + (c + d)(1 - r)} \Delta S \quad (9)$$

According to 1 and 2 above it follows that

$$\Delta B + \Delta T = \frac{c + d}{r + (c + d)(1 - r)} \,.\, \Delta S \quad (10)$$

And according to (6) above it follows that

$$\Delta D = \frac{1 - c - d}{r + (c + d)(1 - r)} \Delta S \quad (11)$$

2 Orr and Mellon, "Stochastic Reserve Losses and Bank Credit Expansion". *American Economic Review*, 1961.

is then treated as a stochastic process. The result is to restrict bank credit expansion so that the ratio of marginal credit expansion to excess reserves is less than that of total credit expansion to total reserves. And given uncertainty, this permits a centralized banking system to expand more credit than a decentralized one. Orr and Mellon work from the simplified assumption that the bank has two kinds of assets, viz. reserves (which are non-income earning), and loans which earn income, determined by the going rate of interest. Some cost is involved in converting loans to reserves. The decision problem for the individual bank, which is now subject to random changes in its reserves (both positive and negative) and has certain legal reserve requirements, is to determine whether reserves will be sufficient at the end of the "given period."[3] Orr and Mellon chose a normal distribution function to explain their reserve losses. A recent work by Birch and Heineke[4] discusses the relevance of collective risk theory to this approach, with particular reference to the application of the compound Poisson distribution and the Esscher approximation to it.

The other alternative formulation is by Brunner,[5] who chooses as the central feature, the relationship between a bank's surplus reserves and its desired rate of change in its assets portfolio. This is formulated in terms "of a loss coefficient of surplus reserves per dollar of asset expansion." As Brunner admitted in a later article,[6] this work grew out of the Phillips tradition.[7] Surplus reserves are "identified as the difference between actual and desired reserves. The latter is a function of interest rates (including the discount rate) and the volume of deposit liabilities."[8] In this model,

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3 This would occur if the following condition holds at the end of the period:

$$R - L \geq p(D - L) \qquad (1)$$

Where R is equal to excess reserves at beginning of the period, D is equal to the volume of new deposit liabilities created, L is equal to the reserve losses during the period and p is equal to the legal reserve ratio. The largest reserve loss tolerable is therefore expressed when,

$$V = \frac{R - pD}{1 - p} \qquad (2)$$

L is a stochastic variable with probability density ϕL. The bank's profit, P is maximized when

$$P = id - M \int_{v}^{\infty} \phi(L)\,dL - r \int_{v}^{\infty} L\phi(L)\,dL \qquad (3)$$

In the equation i represents the rate of interest on loans and r the rate paid on any funds borrowed to meet reserve losses.

4 Birch, E. M. and Heineke, J. N. "Stochastic Reserve Losses", *American Economist*, Spring 1967.

5 K. Brunner, "A Supply Scheme for Money", *International Economic Papers*, Jan. 1961.

6 See, "Some Further Investigations of Demand and Supply Functions of Money", K. Brunner and A. H. Meltzer, *Journal of Finance* Vol. 19, 1964.

7 cf. C. A. Phillips, *Bank Credit*, New York, (McMillian) 1921.

8 *op. cit.* Brunner and Meltzer, p. 244.

therefore, the banks respond by adjusting assets portfolios, and as a consequence there is some reserve loss. It is the average of this loss that gives the "loss coefficient." There are also secondary adjustments as cash spills over to other banks which induce similar adjustments on their part.[9]

As Johnson has pointed out, current theory departs in three significant ways.[10] Firstly, it operates on the basis of an individual bank. Secondly, banking behaviour is analysed in terms of actual and desired balances. And finally, bank reserve losses are treated as some form of stochastic process. These theoretical developments have been accompanied by a fair amount of empirical analysis. However, they highlight developments in advanced monetary and financial systems, particularly those of the United States. In dependent economies, in addition to the basic limitations of data which limit their operational usefulness, it appears as if these lines of inquiry would not be particularly fruitful. In the traditional credit multiplier model, it is assumed that the banks are integrated into a structure and their pattern of behaviour contains sufficient regularities (traditional and legal) to make the assumptions of an identifiable "system" meaningful. In the recent researches the emphasis is on a "unit" structure which facilitates an analysis of the profit/loss, asset/liabilities structures by units in a "system" with numerous units and a fair degree of competition. In dependent monetary economies such as the Caribbean, the banks are usually multinational corporations. It is difficult, if not impossible, to identify the "bank" or the "territory" for the purposes of either analysis or policy. The identification of the "bank" is made very difficult because of the high degree of capital mobility which exists. This mobility makes meaningless the measurement of a "loss-coefficient" based on bank operations in one territory. Where there are no constraints to balance local assets and liabilities, the central behavioural stimuli must flow from the profit maximizing aims of a corporation operating in a large number of territories, when confronted with a vast variety of economic, political and social conditions. Thus, from the view-point of the Caribbean, it is an understanding of the theory of multinational corporate behaviour which appears to be more relevant.

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9 A general formula is devised expressing the portfolio response to excess reserves as

$$dE = \frac{1}{\lambda - \mu} S$$

where E is the portfolio of earning assets, s the surplus reserves, λ is the average loss coefficient and μ has the form $(1 - n)_p$ "where p denotes the average spillover rate, and n is a linear combination of spill-over rates into currency and time deposits on the secondary level." Finally, "$(\lambda - \mu) - 1$ describes the built-in leverage of the system's response to prevailing surplus reserves. We may refer to it as the monetary multiplier."

10 H. G. Johnson, "Monetary Theory and Policy", *American Economic Review* 1961, pp. 35-38.

Further, given the highly erratic behaviour of the traditional leakages, the commercial banks may prefer to concentrate on these basic occurrences whilst adjusting to credit situations, as and when they do arise. Nevertheless, as those conditions develop in which the banks are forced to operate more as national rather than multinational corporations, then the applicability of these approaches may become somewhat more relevant. Even then, in view of the small market of Caribbean economies, the banking industry would be either monopolistically or highly oligopolistically organized. The behavioural stimuli are therefore likely to differ. The simplifications of recent work, such as the consolidation of leakages and the focussing of attention on legal reserve ratios, could be fundamentally misleading in financial situations such as those of the Caribbean. Indeed, the realistic (although to some it may appear as disheartening) conclusion is that at this time, a knowledge of institutional characteristics and crude empiricism are all that the management of Central Banks really have to go by. Attempts to formalize alternative models will not go far until much more successful research is done on the motivations and behavioural stimuli of multinational corporations.

The fourth basic defect stems from the pressures, partly undiagnosed, which derive from the underlying adjustments taking place in the monetary system. These pressures tend to complicate the operations of the system by making potentially misleading surface manifestations. Two of these adjustments are worthy of note. The first is the secular tendency towards a fall in the holding of "idle" money in the community. This is to be seen in the changing relative position of demand deposits and fixed deposits, as people and firms economize on cash balances. In Jamaica, for example, whilst between 1961 and 1969 demand deposits doubled, the growth in fixed deposits was more than four-fold. This process has been induced by the high level of local interest rates, which in turn is basically a reflection of similar high interest rate levels in the leading money markets of the world. The process of economizing on cash balances is a process of learning which cannot be undone by a simple reversal of the trend in interest rate levels. The second tendency is the substitution of deposits for currency, as a medium of exchange. The propensity to hold currency relative to deposits is decreasing, and the commercial banks, having also been able to increase their holding of fixed deposits, are in a position to reduce the reserve requirement per unit of deposit.

In the face of these basic defects and other complicating phenomena two general strategies have been proposed. The first is to argue that existing Central Banks are incapable of coping with this situation, and that therefore they ought to confine their functions to essentially that of a money-changer. In other words, to require that the Central Banks operate as close to their Currency Board predecessors as possible. Simple rules should therefore guide their management, and usually these should be designed to eliminate their banking functions and to limit their currency issue powers to some fixed, agreed, and pre-determined fiduciary level. Thereafter, the commercial banks would of necessity administer both the foreign and domestic payments system, hold the foreign reserves of the community (outside of the Currency Authority, where the growth would be fixed in terms of the public demand for currency and the fiduciary ratio), and accumulate short-term borrowing powers with their Head-Office. In support of this view, it is argued that the possibility of incorrectly judged intervention by the Central Authorities would be ruled out. This would promote an inflow of foreign capital and ensure that the market system would lead to efficient allocative criteria.

In truth such a policy is an idealization of the Currency Board. It assumes the development process to be one dependent entirely on foreign capital, skills and initiative. It therefore seeks to minimize national discretion in the formation of policy. Apart from its highly questionable politico/social assumptions, it also falls down when we observe the actual historical record in the Caribbean of the manner in which "rules" have operated as a substitute for "authorities." The tendency has been for domestic savings to follow the attractions of the superior United Kingdom market, and for there to be no guidance in attempts to orient policies for national development.

The second basic strategy lies in the direction of fostering the growth of money and capital markets. It is argued that when these markets are well developed they will facilitate the mobilization and dispensation of savings so as to favour their normal retention in the domestic economy. Moreover, once developed, these same markets will provide a fulcrum for control by the Central Bank of the domestic financial institutions. The limitations to this policy, again apart from the politico/social assumptions which are similar to the first proposal, are that such a market situation cannot develop before the "real" economic structure provides a sufficient differentiation in its activities as to sustain a variety of financial claims and instruments. Furthermore, the pursuit of such a policy tends to reinforce the links between the domestic and United Kingdom money and capital markets, because in order to promote market growth the Central Banks have had to respond to prevailing market pressures, to minimize their intervention, and to promote the ease of movement of funds between the local market and the United Kingdom.

The problem of central banking reform lies along different and more radical lines. For a start, it is necessary to see Central Banks as geared to the processes of development and structural transformation. The development of their powers and policies must be based on the intention of leading to *structural* changes in the money and credit industry, and not simply to administering the payments and credit systems as they are. The solution, therefore, involves some very basic institutional and organizational reform.

(ii) THE STRUCTURAL APPROACH TO A SOLUTION

Whatever final forms the domestic organization of the banking and credit industries take, two conditions are necessary, although by no means sufficient, for structural reorganization. The first of these is that exchange controls should be imposed against sterling. Administering an exchange control system for capital transactions, while permitting one set of currencies (some of which are in fact freely convertible into all other currencies) to be exempt from these restrictions, certainly does not serve the purpose intended. While, admittedly, it provides an administrative hurdle, it is one which is easily circumvented and which is far from prohibitive of these transactions. A policy of extending exchange controls to sterling, would permit the proper administration of these controls, which are quite correctly designed to prevent the destabilizing and undesired outflow of local savings. It would ensure a separation between the fixed exchange rate mechanism and the convertibility provisions into sterling. Such a separation is a vital requirement for the reduction of the region's excessive dependence on sterling. With such a policy, spending units would find that their portfolio policies are limited in their scope for both stock adjustments and the investment of current flows of savings. They will be forced to pay more consideration to the fact that with such reforms the scope for the management of an independent exchange rate system is vastly improved.

The second necessary reform is a limitation of the size and share of borrowing that non-resident controlled multinational corporations can enjoy. These enterprises not only have a preferred status in the market for local credit, but given their organizational structure and relative size, shifts in their sources of obtaining working capital requirements are important sources of destabilizing monetary occurrences, which the Central Banks cannot control through the market mechanism. Inability to control this situation derives from the fact that during any period of monetary restraint in their Head Office territory, these corporations can be certain that they would enjoy "availability of funds" in the local credit market. Indeed, in the administration of monetary policy in the Caribbean, these industries are rarely, if ever, expected to comply with restraints, since they are held to be *the* sources of increases in real output. Restraint is usually directed to consumer expenditure, and particularly on imports.[11]

These two reforms, while necessary complements to efforts geared to facilitate Central Bank control of the monetary system even within the present framework, are still not sufficient to overcome the present situation in which the Central Bank (as presently narrowly conceived) is the sole source of monetary policy. To improve on this situation, and to recognize a broader base for implementing monetary policy, co-ordination in four general directions is necessary.

First, there is in the countries concerned, no coordination in the various branches of public policy. Development planning, the administration of fiscal policy and the administration of the Central Bank, are pursued as three separate areas of public policy. As a result,

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[11] Recent experience referred to in Chapter 3 shows that this point may be taken. My suggestion, however, is for a permanent, and not temporary, freezing of their ability to borrow their working capital requirements locally.

there are certain basic and recurring evidences of a failure to co-ordinate. One of these is the frequent manifestation of unexpected and/or undesired impact of government spending and borrowing on the banking system. Another is the under-utilization of appropriated budgets and/or the "forced" pace of spending towards the end of the fiscal year pursued by various government departments, and the impact this has on seasonal swings in the banking system. Then again, there is the contradictory pursuit by the Ministry of Finance and the Central Bank of the maximum accumulation of foreign reserves. This is facilitated because development planning relies heavily on overseas borrowing, and at the same time there is no appropriately planned size for the foreign-exchange gap. Meanwhile, the Ministry of Trade is insistently pursuing policies geared to balancing trade, and thereby reducing the scope for real transfers of borrowed capital. Indeed, long term and short-term policies often occur without reference to each other, and as a consequence administration of fiscal and monetary policy is in no way clearly or consistently linked to the development programme.

The second area of development is the need to co-ordinate and integrate monetary structures. Development banking, deposit banking in the Post Office, rural agricultural credit, co-operative and credit union organizations all function as unit-purpose institutions. Their very growth and establishment has been haphazard, and the unit purpose approach has developed through historical accident rather than conscious planning. As a result, there has been considerable loss of economies in the way in which these institutions have been capitalized, (particularly their acquisition of fixed assets such as branch offices), in their use of skilled personnel, (particularly the fragmentation of research, loan administration, credit analysis), the holding of reserves, and their inability to introduce economical administrative systems (computerized and mechanized accounting systems). Failure to integrate and coordinate these institutions, many of which are publicly owned, has prevented the Government from taking the lead in establishing "relevant" banking standards. As a result there has been no rational disposition of banking services. As they exist they reflect neither sectoral nor spatial priorities in the various development programmes.

The problems of coordinating and implementing monetary policy also can be attributed largely to the administration of policy *within* the Central Banks. The first of these is the problem of diagnosis referred to frequently in the previous chapter. To a large extent this problem derives from the slow flow of statistics. In Guyana, for example, the balance of payments statistics for 1968 show an overall surplus of $12.1 million. Yet one year later the accounts still record an unidentified capital movement of $14.0 million! The absence of statistical information forces the Central Banks to rationalize their continued and unjustified use of proxy variables, e.g. reserves, interest rates etc., instead of "real" performance, as indicators. Solving the problem of statistical lags requires the development of short-term forecasting models to integrate the flow of data. This would enable the

Central Banks to forecast activity and to be continuously aware of the relationships, whatever they might be, of real and money flows.

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

Thirdly, although the administration of monetary policy is by law applicable to non-banking institutions, the Central Banks have nevertheless taken a disaggregated view of the banking system and have acted as if the commercial banks are the main, or primary, areas of monetary concern. Most of the attempts to deal with the non-bank intermediaries have been of a fiscal nature or part of general legislation, e.g. taxes on insurances companies, or *ad hoc* restraints usually on hire-purchase credit, when import expenditure is rising too rapidly. There have been no consistent attempts to act as if the non-banking financial institutions are an integral part of the banking structure in the administration of Central Banking Policy. As a result the dominant position of the non-banking intermediaries is not taken into account. The following ratios of non-bank financial assets to the total of bank and non-bank financial assets for the three territories indicate their importance: Guyana: 0.64, Trinidad-Tobago: 0.54 and Jamaica: 0.55.[12] Finally, in the absence of adequate data and adequate control, the Central Banks should have relied more on their Bank Inspectorate function to monitor and understand the working of the system. Their failure to do this has meant, as we have seen, that there has been little impact on the performance of financial institutions.

(iii) DEVELOPMENT BIAS

So far we have considered three sets of reforms; (i) the abolition of the sterling exchange-standard system and the elimination of non-resident controlled multinational corporate borrowing; (ii) the co-ordination of public policy and the integration of monetary structures; and (iii) the administration of policy from the point of view of diagnosis, decision making, implementation and scope of institutional action. All these are integral elements of any policy aimed at structurally transforming the banking and credit industry. But they are essentially preliminary to certain other more basic and directly developmental re-structurings. An examination of the structure of commercial bank lending shows why this is so. Their lending policies have not been sensitive to central banking pressures in terms of the

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12 See M. A. Odle—*The Significance of Non-Bank Financial Intermediaries in the Caribbean* (forthcoming in the same series)

composition of loans. The data in Table 10 show the current composition of loans. The most notable development during the last ten years has been the expansion of personal loans to the position where, in Jamaica and Guyana, they now account for between one-quarter and one-fifth of total advances, and in Trinidad-Tobago to about 30 percent of total advances. In Jamaica and Guyana, loans to multinational enterprise (mainly industry) are almost as large as personal and professional loans. The distribution sector absorbs almost as much as one-third of advances in all the territories. And, in marked contrast, loans to the agricultural sector account for less than 6 percent of total advances in the three countries.

In other regards, too, the performance of the commercial banks has been quite poor. The growth in fixed deposits has not been accompanied by any attempt on their part to increase the flexibility of use of this liability. There has been no attempt to introduce certificates of deposits or other financial instruments, as their counterpart institutions in the metropolitan territories have found it worthwhile to do. Their tendency to grant personal loans reflects the growth of term-lending and the use of the commercial banks to provide hire-purchase facilities. Since most of this lending leads to a drain on scarce foreign exchange for the purchase of imported consumer durables, this development is also questionable. Their lending has still remained essentially short-term, of the seed-time to harvest variety; and where the length of life of these loans has been extended it is through the maintenance of credit lines to their regular customers. There has been no attempt to adapt lending to the needs and priorities of local development.

TABLE 10 Commercial Bank Loans and Advances by type--($ M Guyana)

	Jamaica		Guyana		Trinidad-Tobago	
	1968	1969	1968	1969	1968	1969
1. Public Sector	8.3	9.9	8.4	10.7	19.0	15.2
2. Financial Institutions	14.8	14.7	3.4	2.6	2.9	4.3
3. Personal and Professional	96.2	127.4	9.7	12.8	58.4	84.7
4. Agriculture	19.3	22.6	2.3	3.7	7.2	5.2
5. Building and Construction	25.4	33.1	3.5	5.1	8.7	11.0
6. Industry	89.9	133.1	10.5 (mainly rice and sugar processing)	12.5	32.2	51.2
7. Distribution	88.4	105.4	17.9	20.0	64.1	76.6

Sources: Various Central Bank Reports and Government Statistical Publications.

This information makes it evident that some direct impact on lending criteria, apart from the usual Central Bank exhortations, is needed. To begin with, there are a number of short-term solutions which can, and indeed should, be attempted. The first of these is widening the range of securities "eligible" for re-discounting by the Central Bank. Some of these securities, e.g. mortgages, industrial debentures etc., would coincide with other priorities in the directly productive field. To complement this, the territories should seek to force two developments on the commercial banks. One would be to require some pooling of their own resources for purposes of development lending based on the use of domestic resources. The second would be to move in the direction of the establishment of separate mortgage departments. Other solutions require direct controls on incremental lending. One of these, referred to above, would be to limit non-resident controlled multinational enterprises borrowing from the local market. Yet others would involve the Central Banks in widening their capital bases by issuing direct securities on themselves, as a prelude to direct banking activities.

Whatever the short-term improvements, they must be integrated into a basic strategy aimed at the national provision of these banking services. Whether in the form of state control, cooperatives, or other forms of national enterprise, the banking system will have to be nationalized before it can play a fundamental role in the growth process. It is necessary for the various countries to have direct control of the fixed deposit increases of the community. The institution best suited to perform this function is the Central Bank itself. And a step can be made by giving it power to enter into the commercial banking field and to finance its activities by acquiring liabilities in its own way. Whether or not this is the method chosen, what is needed is a clearly conceived programme of the sequence of developments, lest a repetition of previous uncoordinated and proliferating unit-purpose financial enterprises takes place.

To make such a policy work, in the context of the heavy dependence of the economy on trade, and the further dependence of this trade on bank finance, it is necessary that the export-import activity of the country be co-ordinated through the establishment of appropriate national trading corporations. This would also simultaneously provide an efficient mechanism for ensuring that both foreign and domestic payments are integrated, and that activities such as export promotion (e.g. export credit guarantees), and the planned rational use of foreign-exchange resources take place. It might be useful to add that the co-ordination of the import-export trade through such corporations is not immediately dependent on the nationalization of all domestic economic activity.[13]

Some of the statements associated with the recent establishment of the Guyana National Co-operative Bank[14] seem to indicate that this problem may be recognized, and that a solution by way of the co-

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13 It would of course be consistent with such a policy if it were developed.

14 Established on February 23, 1970.

operative provision of bank credit is being attempted. However, for success along these lines to be significant, it is necessary to develop a more comprehensive strategy, somewhat along the lines indicated here, rather than simply confining activities to the establishment of a co-operative bank designed to engage in "commercial" banking in the present unregulated banking situation. As things remain, this bank is being asked to compete with firms that have historically grown and taken advantage of their unregulated situation, and to do so without bringing the present power of the Central Bank to bear on the situation. Several years ago this policy might have been thought pragmatic and necessary. But the recent history of nationalizations in India, Uganda, Libya, South Yemen and Tanzania, show that the complications are overstated and that nationalization, although not a *guarantee* of adequate banking, is certainly *necessary* for the development of adequate banking in poor countries.

So far we have concentrated on the structural transformation of the banking and credit industry with reference to the commercial banks. Similar attention needs to be directed to two other sets of institutions: first, the non-banking intermediaries, in particular the insurance companies, the mortgage houses and the institutions providing instalment credit. Again the long-term solution here is the national provision of these services.[15] For, only through a substitution of national priorities for the private global profit considerations of multinational enterprise can we achieve a transformation of function. The other set of institutions to which attention should be directed is the existing public sector developmental and other credit institutions. Here it is necessary to plan the rational organization of these institutions to ensure that they fit into a coordinated national pattern. Presently they are governed by their own enabling statutes which confer automatic and quasi-automatic lending and borrowing powers. Consequently, they are not at the moment amenable to central direction, except in the use of reserve powers conferred to the appropriate Ministers.

Concentration on banking and credit has often led to an important omission in the study of the monetary system in the Caribbean: that is, the administration of the payments mechanism. In the typical Anglo-Saxon tradition, the operation of the domestic payments and clearing systems is linked in the same set of institutions to the provision of short-term credit functions. As far as the commercial banks are concerned, despite high charges, their domestic payments functions are not particularly profitable. The high charges they levy on foreign transfers make their external payments functions profitable, and indeed this may well be currently providing a very important source of banking income. As a result of this, no attempt has been made to cheapen and to spread the use of the credit transfer process and the payments mechanism. Apart from promoting a limited use of the cheque account by persons, the banks have taken no initiative in tackling the problems of an efficient payments system. Their cheque account charges are high, and this, together with the inconvenience of the service and the additional mailing costs, make the payments

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15 For discussion of these problems consult M. A. Odle *op. cit.*

mechanism both inefficient (if only because it reaches a limited part of the population) and very costly. The proposal for dealing with this is to enforce a separation between the credit function and the domestic payments function, and to develop the latter along national lines, in some sort of postal-giro service, which would seek to maximize the economies of a centralized mass distribution service.

The domestic payments mechanism, as it stands, operates on what has been generally recognized as the most inefficient sequence, debtor-creditor-bank flow. A giro system would seek to adopt the more economic debtor-bank-creditor flow. At present, the commercial banks find that the administration of the payments mechanism is less profitable than either providing credit to local enterprises or providing for the transfer of foreign payments. As a result, there necessarily follows a conflict as to where new investment funds and future innovation should be directed. In this conflict, private assessments of costs and benefits override social considerations, and the domestic payments system remains undeveloped. The separation of the domestic payments function from the credit functions would help to free the commercial banks to take on more medium and long-term developmental lending. This, together with the proposal that the Central Bank should provide the present short-term type credit, would create the following profile:

Coordinated Financial Administration
(Monetary, Budgetary and Planning).

National Giro

Central Bank

Regulatory
and Developmental
Functions

Provision
of "commercial" type short-term credit for traders, firms, personal use etc.

Commercial banks (nationalized) providing medium to long-term credit and fixed deposit banking facilities, operating with two subdivisions.

Coordination of present public and quasi-public financial institutions e.g. Development Banks, postal savings, credit unions, rural credit, cooperatives etc.

(i) mortgage lending
departments

(ii) "resource"
based industries
lending department

At the top is an integrated system of financial administration. Below, there is the national giro service and the Central Bank. The latter provides "commercial" type short-term credit, and merges its regulatory and developmental functions. This is facilitated by the nationalization of commercial banking and the integration of existing public and quasi-public financial institutions. The commercial banks are expected to move into medium and possibly long-term credit; this is aided by the removal of the payments function and their concentration on fixed deposits. To facilitate the use of fixed deposits, a secondary market in certificates of deposits can be encouraged. The nationalized "commercial banks" are also expected to administer two special departments, a mortgage lending department and a lending department for "resource" based industry. The Central Bank will be permitted to extend its own resources through raising deposits with the public, or issuing liabilities against itself. Finally, the investments of the National Giro service are expected to be integrated, through the Coordinated Financial Administration, into the developmental priorities.

CHAPTER FIVE

The Sterling Area Arrangements

Our evaluation of the structure, performance and prospects of central banking in the Caribbean would be incomplete if we did not pay attention to some further aspects of existing Sterling Area Arrangements, and particularly those which followed after the devaluation of Sterling in November 1967.

From a study of its origins, the Sterling Area Arrangements in the Caribbean can be accurately described as a direct product of the colonial relationship between the Caribbean and the United Kingdom. It is essentially a monetary expression which grew out of the nineteenth century economic and political ties of the English-speaking territories in the Caribbean to the United Kingdom. During the nineteenth century, gold was accepted as the basic international monetary standard. Despite this, there was even at that time a significant growth of international payments media other than gold, Sterling being the outstanding example. Several factors gave rise to this growing practice. Firstly, there was a saving in costs to be obtained if Sterling was used to settle payments, rather than gold. This cost saving derived from the fact that it was cheaper to move Sterling around than gold, and also because the holding of Sterling conferred an income yield to its holders which the possession of gold did not. Secondly, it was generally assumed that the use of Sterling would facilitate investment by the then dominant United Kingdom investors in the using territory. These developments continued right into the 20th century, and during this period these arrangements were being increasingly reflected in the passing of legislation which governed such matters as exchange rates, capital movements, reserve holding policies, and the structure of financial institutions in the Caribbean.

The continued existence of the Sterling Area Arrangements in the Caribbean into the post-Second World War period is still rationalized and explained in terms of the cost savings which are made in international transactions, and the attraction this practice offers to prospective investors from the United Kingdom. In addition to these two arguments, however, three further arguments seem to have emerged. The first of these is that the Sterling exchange standard system offers a stability to Caribbean currencies which they could not achieve otherwise than by linking their currencies *(de facto* or *de jure)* to an internationally acceptable monetary standard. The second argument is that through participation in the Sterling Area, the Caribbean is able to reap the benefits of being able to improve its trade and payments position, by supporting the application of policies of discrimination as a means of improving the overall trading and payments position of the Sterling Area. Finally, in a part of the world where financial expertise is expected to be scarce, membership of the Sterling Area minimizes the problems of external monetary management.

In truth none of these arguments are convincing, and even where they may contain some valid observations, these apply to exchange standards in general and not to a Sterling exchange standard in particular. The income benefits which the holding of reserves in Sterling is supposed to confer have been less, on account of capital losses through devaluation, than those which would have occurred through the holding of the region's reserves in Dollar securities.[1] Further, if in computing these costs and benefits, we were to recognize that much of the region's holdings of international reserves are probably financed through high cost long-term borrowing abroad which has not been "effectively" transferred, then the yield on the region's reserves would be negative! Similarly, the attraction which the arrangement has had for the overseas investor, has today become even more questionable. Not only has a great deal of the investment in the region been financed largely through the business savings of existing enterprises (replacement provisions and ploughed-back profits), but where new inflows have been generated, these have mainly come from North American investors. Moreover, the very capital mobility which these arrangements are supposed to maintain, has operated in such a way as to support a consistent *outflow* of the region's savings through such major financial institutions as the insurance companies.[2]

The argument that these arrangements confer stability to Caribbean currencies which would not otherwise be forthcoming is also of slight validity. The degree of stability which these arrangements can confer is precisely that which is to be found in the external value of the United Kingdom currency. As is generally known, this currency has not been noted for its stability in the post-war period, or indeed even for the period as far back as the 1930s. Thus, the currencies of the region have been forced to devalue twice since 1945, and to suffer from all the attendant uncertainties focussed on Sterling.

In recent years these uncertainties (apart from the devaluation of November 1967) have had some very serious consequences. As Sterling has tended to slip towards the lower end of the IMF band, the West Indian exchange rates have followed suit. The result has been an increase in the price of non-Sterling imports. And, as Sterling picked up in the exchanges, the importers did not reduce prices *pro rata*. The consequence has been that this has bolstered a slow upward pressure on local price levels, both through the effects on the cost-of-living, the cost of intermediate inputs and capital goods, and the indirect "mark-up" adjustments which this has triggered off in the labour and goods markets. As a result, the management of external monetary policy has been, against expectations, made more complicated. In the period, Central Banks' monetary management has had to cope with the general world destabilizing consequences of using national currencies as international reserves, with Sterling one of

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1 See A. McIntyre's contribution "West Indian Membership of the Sterling Area: A Regional View" in *Regional Conference on Devaluation*, ISER, University of the West Indies, February 1968.

2 See M. A. Odle, *op.cit.*

the principal reserve currencies, as well as with the specific disruptions centring on Sterling. As the experience of the November 1967 devaluation and its aftermath has shown, Central Bank management has failed to anticipate and to deal correctly with these disruptions. Attachment to the Sterling exchange standard has been a source, and a major one, of much of the region's monetary instability.

The importance of the advantages of operating a discriminatory block among the Sterling Area members for payments and trading purposes has receded with the return to post-war convertibility. This drive to return to convertibility was a concerted move of the industrial countries which was accepted by the Sterling Area. Of necessity, it entailed the undermining of one of the basic features of the arrangement. The operation of a successful policy of discrimination is based on the assumption of a continuing complementarity between the industrial structure of the United Kingdom and the primary producing structure of the rest of the Sterling Area. But such an assumption stands in direct contradiction to the self-avowed aims of the rest of the Sterling Area which seek to diversify and to develop industrially differentiated economic structures. Therefore, any arrangement which is based on such assumptions can have no real long-term potential. In any case, the countries of the Caribbean region have had both strong overall balance of payments, as well as large surpluses with the Dollar Area. As a consequence, they have been significant net contributors to the Dollar pool holdings in the Sterling Area. The data in Table 11 show that this small region alone accounts for nearly 13 percent of the total sterling reserves held by New Zealand, Australia, South Africa, India, Pakistan, Ceylon, East, West and Central Africa, and the Middle and Far East, and 10 percent of the total external liabilities of the United Kingdom. The disproportion which these data indicate, means that the Caribbean has a relatively bigger stake in the future of the Sterling Area than any other region in the world—and yet it has probably contributed the least towards reform and change in these arrangements.

In our study of central banking practices in the three territories, we observed that at the time of devaluation a system of comprehensive controls was imposed against Sterling. The convertibility provisions of the various banking laws were abrogated and the commercial banks' "authorized dealer status" suspended. Sterling was legally declared a "foreign" currency in terms of the various Exchange Control Acts. Following on the devaluation, Sterling remained insecure in the world's foreign exchange markets, and there was the likelihood of more disruption if not further devaluation during 1968.

The sources of the disruption stemmed from the disproportionate relation between the United Kingdom's short-term overseas assets and her short-term liabilities. On one classification, these liabilities, or Sterling balances, were distributed among non-resident Sterling Area holders, privately held Sterling balances and the official Sterling balances. The first set of these holders have tended to hold their balances subject to the prevailing degree of confidence in Sterling and interest rate differentials in the world's money markets. As a consequence, their holdings have fluctuated considerably. Private

TABLE 11—UNITED KINGDOM External Liabilities (Sterling Area Holders)—($M Guyana)

Year	Total	New Zealand Australia South Africa	India Pakistan Ceylon	Caribbean Area	East Central & West Africa	Middle East	Far East	Other
1962	12,657.6	2,467.2	859.2	796.8	2,011.2	2,030.4	3,081.6	1,411.2
1963	13,531.2	3,139.2	1,017.6	907.2	1,939.2	1,838.4	3,177.6	1,512.0
1964	13,843.2	3,259.2	859.2	892.8	2,102.4	1,905.6	3,120.0	1,704.0
1965	14,692.8	2,582.4	916.8	1,022.4	2,040.0	2,596.8	3,508.8	2,025.6
1966	14,803.2	2,313.6	676.8	1,089.6	1,939.2	2,668.8	3,696.0	2,419.2
1967	14,313.6	2,208.0	552.0	1,132.8	1,636.8	2,697.6	3,393.6	2,692.8
1968	13,828.8	2,145.6	950.4	1,334.4	1,747.2	1,972.8	3,427.2	2,251.2
1969	15,216.0	1,828.8	1,320.0	1,171.2	2,107.2	2,217.6	4,099.2	2,472.0

Source: Bank of England Bulletins.

balances have increased steadily in response to the growth of trade in Sterling, and the balance of payments surpluses of the Sterling Area outside the United Kingdom. However, the official Sterling balances have not been responsive to the growth in the official reserves of Sterling Area countries, and have remained more or less at the levels reached in the early sixties. In order to deal with the situation of uncertainty in which these balances were held after the devaluation, the United Kingdom Government, in September 1968, negotiated a borrowing facility of $4, 000 million with the Basle group of Central Banks. Under this Agreement the United Kingdom is permitted to draw on foreign currencies, through the Bank for International Settlements, to finance reductions in the Sterling balances (official and private) of overseas Sterling Area countries, below an agreed level. Drawings can be made during the first three years of the agreement, and any such drawings will have to be repaid between the 6th and 10th years. No drawings are permitted to finance a balance of payments deficit.

As part of the package arrangement, the United Kingdom ensured, as a condition of continued membership of the Sterling Area, [3] that the Authorities of the overseas Sterling Area countries would hold specific *minimum* proportions of their reserves in Sterling at all times during the life of the Agreement. The proportion for the three countries under consideration was fixed at 80 percent. [4] In turn, the United Kingdom has guaranteed in terms of U.S. dollars, part of the Sterling holdings of overseas countries. The guarantee applies to that part of each country's official Sterling reserves which exceed 10 percent of its total reserves, and it provides for the United Kingdom to restore the Dollar equivalent of the value of these securities in event of further devaluation. In view of these Agreements, the countries of the Caribbean are committed to remaining members of the Sterling Area, at least until around 1973. These arrangements have generally been described as a mechanism for stabilizing the position of Sterling in the world's foreign exchange markets, through providing confidence by way of Dollar value guarantees to official Sterling holders. This, it is argued, would lessen the pressures developing among the various Sterling holders to diversify their portfolios. Indeed, in our study of Jamaica we had drawn attention to the rapid incremental diversification of official assets which occurred between November 1967 and June 1968.

Usually, it is not readily appreciated that the stability which these arrangements aim at, is one of ensuring that the *proportion* of Sterling held to other forms of international liquidity in the Sterling Area does not fall. This means that there will be absolute increases in the Sterling balances geared to the increases in the overall expansion of reserve holdings in the Sterling Area. In other words, this is not a device to facilitate the abandonment of Sterling as an international

3 This condition was *implicit*. Indeed there were no explicit reciprocal concessions made by the United Kingdom.

4 For the Eastern Caribbean Territories it was fixed at 97%, Australia and Malaysia 40%, and New Zealand 70%.

reserve asset, but one that is designed to serve as a prop to its present position. The assumption being made here is that the Sterling crises of the 1960s are essentially transitory. If this assumption were true, then one can expect that after this phase is over the Caribbean countries will find out there would be no strong pressures to diversify foreign reserve holdings. The risks of devaluation, or the blocking of overseas Sterling accounts, would have disappeared. If this assumption does not hold true, then the United Kingdom will find that there will be increasing pressures on itself to provide guarantees, and other inducements, to ensure that the policy of high incremental investments of the official foreign reserves of the Caribbean (0. 8+) continues to provide an offset for any private disinvestments. At this stage it will become evident that the Sterling Area Arrangements, although discussed in mainly financial terms, are *de facto* part and parcel of a set of comprehensive agreements involving finance, trade (the Commonwealth Preferential System), capital, and labour movements. At that point it will also be clear that in the present overall context the "inducements" which the United Kingdom can command, are considerable.

An examination of the recent performances of the holders of Sterling balances shows that the entire Caribbean area is the fastest growing, and indeed the only consistently growing group of countries in the level of their holdings of Sterling balances. In Table 11 the territorial distribution of the Sterling Area holders of these balances is shown. As can be seen from this table, the only territories that have consistently increased their Sterling balances are those of the Caribbean, where the increase between 1962 and 1969 was roughly one-half. During the same period the total of these balances has fluctuated between $13-$15 billion dollars, with no evidence of consistent growth. A comparison of territorial size also reveals that the Caribbean is a disproportionate holder of these balances. The rapid accumulation of these balances shows how deeply committed the Caribbean is to the Sterling Area. The recent arrangements serve to reinforce this commitment.

It has been argued earlier that exchange controls and a movement towards the abandonment of the Sterling Area are necessary for the structural transformation of the financial industries of the Caribbean. In the long run, such an achievement depends in part on the solution of the problem of the use of Sterling as an international reserve asset. There are a number of schemes which have been recently put forward to solve this problem. One such scheme is related to possible United Kingdom entry into the European Common Market. It suggests that the United Kingdom should encourage the conversion of Sterling into a European reserve currency. If this happened, it is anticipated that the combined industrial and financial strength of Europe would support an exchange standard system without any undue strain. Europe would then be in a position to reap all the "invisible" advantages derived from having its currency widely used in the developing countries, both as a means towards settlement of their debts and as a medium for holding their external liquidity.

There are a number of objections which immediately become evident on examination of this proposal. Perhaps one of the most decisive of these would be the unwillingness of the European countries to enter into any such arrangement. In arriving at this attitude, they might have been chastened by the disastrous experience of the Dollar, in spite of the presumed industrial and financial strength of the United States. But from our point of view, the question we really ought to be asking is, do we want to transfer our dependence upon the United Kingdom to Europe, with at best minor modifications in the arrangements? It seems that the proposals from which we are likely to gain most are those which move in the direction of seeking a transfer of these obligations, which the United Kingdom has historically incurred, to an international institution and not to another set of national territories. Unless we do this, the arrangements will still be subject to the overriding limitations of using national currencies as international reserve media. We would still be over-exposed to the national policies and developments of the country whose monetary standard we adopt.

In this regard, schemes which emphasize the funding of the Sterling liabilities though the mechanism of an international institution and not some other national territory are the most attractive. Funding of the Sterling Balances has been generally discussed in the literature as the lengthening of the redemption period of these liabilities, and a reasonable time horizon has been thought of as lying somewhere around 10-15 years. In a few instances there has even been the suggestion of conversion to irredeemables. One problem which we have to recognize in the implementation of any funding arrangement is whether such funding would bring to an end the practice of holding Sterling. Broster has recently argued that there is nothing to stop this practice: "... if overseas central monetary authorities prefer Sterling as a reserve to Dollars, Francs, Marks and the rest, who or what is to prevent it? The British authorities could discourage them by adopting a floating exchange rate or otherwise abandoning the support of Sterling as a routine, or as an hour-by-hour chore of the Exchange Equalisation Account. But would it be worth it? The same kind of difficulty would apply to any attempt at shedding Sterling's role as a world trading currency, and also the same kind of questionable solution." [5] While there will be difficulties, it seems that Broster may have overstated them; and worse, he has also overlooked one important and unambiguous method of restraint which can be implemented, i.e., the exercise of administrative discretion against non-resident holders of Sterling.

From an examination of the items in the Sterling balances, Broster also arrives at the conclusion that "the U.K. external liabilities in Sterling are either already funded or they are unfundable." [6] This conclusion is arrived at because he still expects the Sterling Area to operate, if only in a modified form. This can be seen in the argument

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5 E. J. Broster, "The Sterling and Non-Sterling Balances," *The Bankers' Magazine* August, 1969 p. 69.

6 *Ibid.* p. 70.

that, "Any attempt to fund that part of the Treasury bill debt used as a backing for local currencies would probably spell the end of the Sterling Area." [7] From our viewpoint, the funding of the Sterling balances should be one element in a comprehensive strategy aimed at bringing to an orderly end the Sterling Area. Consequently, as far as we are concerned, the Sterling balances are fundable, and the best mechanism for achieving this is through the International Monetary Fund. In this regard an excellent suggestion, and one which the Caribbean can support, is the swapping of the United Kingdom's Special Drawing Rights with the Fund for the Sterling balances. This suggestion was made by Perkins[8] before the full details of the Special Drawing Rights scheme were known. But, in so far as the known details of the Scheme show that it has moved in the direction of conferring owned reserves to member countries, thereby replacing the principle of conditional liquidity, it has considerable merits for making it workable.

Whatever the details finally agreed upon, in principle the only feasible solution for the territories of the Caribbean is one geared to phasing out the use of Sterling through some form of orderly funding arrangement with the IMF, and not the *ad hoc* transitory arrangements to which they are presently committed. These *ad hoc* arrangements discriminate against the Caribbean. As core members of the Sterling Area, our terms of access to the reserve pool of the Area are inferior to those which the United Kingdom has recently granted to its other debtors, e.g. the BASLE creditors, the IMF etc. Their terms and conditions of repayment give them a prior claim to Sterling, even before those territories which have borne the brunt of the Area's stormy history. All that we have been offered in exchange for these burdens is access to the United Kingdom's capital market. But this is of doubtful value, given the restrictions to access, the high cost of borrowing and the availability of capital funds from other countries.

In the long term, a solution to the problem of the Sterling Area also depends on changes in the "real" economy, as well as the changes in financial structure referred to above. As steps towards achieving both, it has long been necessary for the region to seek forms of monetary co-operation which would lessen its dependence on Sterling and increase the flexibility, in both the size and the employment of reserves. This would mean the development of facilities complementary to those already existing for trade and development banking.[9] Indeed, the growth of inter-regional trade depends on, and also will provide its own pressures for, regional monetary co-operation. As the matter now stands it appears that the foreign-dominated commercial banks will step in to fill the void through unifying the territories

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7 *Ibid.* p. 70.

8 J. O. N. Perkins, "Sharing the Strain of Fluctuating Sterling Balances," *The Bankers' Magazine*, July 1968.

9 For a discussion of some proposals see T. Somersall, "Monetary Co-operation and Economic Integration in the Commonwealth Caribbean"—in *Regional Conference on Devaluation*, ISER, University of the West Indies, February 1968.

on the basis of their separate *de facto* and *de jure* dependence on the Sterling exchange standard system. If such a development takes place, they will be helped by the fact that the present commitments to hold such high proportions of foreign reserves in Sterling leave little room (at the maximum 20 percent) for official Caribbean cooperation in reserve holdings. Out of this potential 20 percent for diversification purposes, there are the competing pressures to hold deposits with international financial institutions as part of our international obligations, and with the United States banks as counterpart funds for loans raised in the United States money and capital markets.

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

APPENDIX I

The Suspension of Dollar Convertibility, Floating Exchange Rates and Caribbean Central Banking

On August 15th, 1971, the United States Government introduced a composite package of economic measures which, even before they were put into operation dramatized to the entire international community the shaky foundations of the prevailing international monetary and payments arrangements. These measures included on the external side, the suspension of free convertibility of the United States dollar into gold or other reserve assets, a ten percent surcharge on all imports into the United States, except those subject to quota or other special arrangements, and a ten percent cut in foreign aid. On the internal side, there was a ninety day freeze on prices, wages and salaries, cuts in public expenditure and a variety of reflationary measures such as the proposed job development credit. The crisis which the United States Government was responding to was long in the making. During the past twenty-five years the international monetary system has suffered from a combination of the persistent use of national currencies as international reserves, the inflexibility of gold prices, the slow and cumbersome development of a reserve asset through the International Monetary Fund and an adjustment mechanism in which the central feature, i.e. the movement of exchange rates to correct fundamental disequilibria, had become, for mainly non-economic reasons, excessively rigid.

These circumstances were reflected in, and also largely caused by, the differences in economic performances of the major industrial nations, particularly as manifested in their different foreign-trade performances. It was generally accepted that these performances show that the main reserve currencies, the pound sterling and the United States dollar, had become over-valued relative to those of their main competitors, particularly the German mark and the Japanese yen. The consequence of this was that speculative flights from the United States dollar and sterling into gold and other national currencies, had become, and seemed likely to continue as, an endemic feature of the international monetary system, unless an appropriate degree of currency re-alignments took place among the major industrial trading nations. Meanwhile, over the years United States holdings of gold assets fell dramatically while its dollar liabilities grew rapidly, making its own situation particularly precarious as it was evident that that Government was, to say the least, decidedly unwilling to remedy this situation by up-valuing the price of gold, either unilaterally or as part of a package of global re-alignments.

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1 Because of the delay between submission of the original manuscript (June 1970) and the publication of this book, I have taken the opportunity to add this short appendix, which reflects on the far-reaching consequences for the Caribbean, of the suspension of dollar convertibility—Author

The two most important immediate world-wide effects of the announcement of the package of economic measures were the closing of the world's major foreign exchange markets, and the general adoption of a temporary system of floating rates for most of the major currencies. Some countries devised more unique methods of dealing with the problem, such as France's "two-tier" market and the joint controlled float among the Benelux countries. However, from the point of view of day-to-day operations among Caribbean foreign exchange markets, the immediately important developments were the closing of the London foreign exchange market and the introduction of a system of floating rates for sterling, with no upper limits, but with a lower support point of 2.38 United States dollars to the pound sterling. In the Caribbean, this in effect led to virtual chaos in the local foreign exchange markets. Many dealers were unwilling to trade in United States dollars, and among the willing many were unscrupulously over-charging for local currency. From a normal trading ratio of 2 dollars local currency (Trinidad-Tobago, Guyana, Barbados and the Eastern Caribbean Islands) to one United States dollar, there was a situation where the rates ranged from 1.90 : 1 to 1.20 : 1, with at least one prominent non-private bank in the region exchanging at the rate of 1.60 : 1. The commercial banks in some territories, e.g. Trinidad-Tobago, began to quote rates (following on the changes in the sterling price of the United States dollar) which meant an up-valuation of the local currency beyond the limits legally prescribed in that country's Central Banking Act. Further, the regional agreement to exchange all currencies at par, was in some instances unilaterally suspended by the commercial banks as they suspended dealings in intra-Caribbean currencies.

All of these developments draw into stark relief some of the points of analysis made earlier in this book, which have been centred on the short-comings of present Caribbean monetary arrangements. The remainder of this Appendix, will indicate the more important of these, and give some indication of the sort of Caribbean strategy which the situation appears to demand.

As pointed out earlier in the text, the Jamaican policy of fixing the par value of its currency in terms of sterling, with the proviso inserted in 1966, (that if sterling was devalued, the Jamaican currency may or may not be devalued, but if it were devalued then the limit would be the extent of sterling devaluation, and, if sterling were up-valued, so must be the Jamaican currency), could not only be interpreted as a basic re-statement of that country's intention to remain dependent on sterling, but in its formulation failed to anticipate that a change in the United Kingdom exchange rate might occur in the context of a highly unstable and volatile foreign exchange market. If this occurred, the way in which the par value was expressed would prove to be unworkable and harmful to the Jamaican economy. As it happened this was precisely the situation which developed, forcing the Jamaican Government to end the denomination of their currency in terms of sterling.[2]

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[2] *The Daily Gleaner*, Jamaica, August 25th, 1971

This shortcoming, while it has manifested itself in this particular way in Jamaica, more generally serves to highlight the basic weaknesses in the assumption, that if Caribbean countries operate on a fixed and quasi-automatic exchange standard, this would make it easier for the Monetary Authorities to manage Caribbean currencies. Events have shown that the territories of the region are confronted with the problem of managing their currency in relation to an exchange-standard, sterling, which has been characterized by a highly unstable post-war history. In addition, like other countries they are still confronted with the problems associated with the general framework of international monetary arrangements and the way in which this impinges on their economies. They still have to contribute to decisions aimed at reforming these arrangements and so must exercise some choice between stable and floating exchange rates (including wider bands, crawling pegs, etc.), the use of national currencies or an internationally created reserve asset or gold, or some particular combination of these, as international means of settlement. It is true that the region will only minimally influence the world liquidity system finally chosen, since that is almost certain to represent the interests of those developed countries where the major foreign exchange markets are located. But, the problem is that they would still be left with the necessity of having to manage the new system. There is no way this can be easily done.

The second point which recent develipments highlight is the difficulty of operating foreign exchange controls effectively while maintaining exemptions for sterling. Indeed, given the commitment to exchange each other's currencies at par, at the commercial banks, the existence of the Caribbean Free Trade Association, and the multi-national banking structure as well as multi-national productive enterprises which operate in the region, such controls to be effective will not only have to be extended to sterling, but may also very advantageously be operated on a regional basis, if leaks are to be avoided. The Jamaican Government has readily recognized this and the Exchange Control Ordinance has had to be amended accordingly. The Act has also found it necessary to make dealers in foreign exchange report on their commercial transactions, even though the controls apply only to commercial transactions.[3]

A third important factor which the present crisis highlights is the necessity for Caribbean Central Banks to give positive and definite guidance to their respective foreign exchange markets. Some of the initial chaos in the local foreign exchange markets which followed after the United States Government's announcement of the suspension of dollar convertibility, was referred to above. Yet, it was only in Jamaica that the Central Bank seemed to be making definite efforts to give a positive lead and direction to the local financial markets.

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3 On the regional issue it might be noted that this argument implies some movement in the direction of harmonizing regional interest rates. To ensure that this does not operate to the serious disadvantage of some states in other areas of their economic management, such a development ought to be contingent on a deepening of the existing integration arrangements.

As indicated earlier, in Trinidad and Tobago the commercial banks were charging rates which effectively upvalued the local dollar in terms of gold, in direct contravention of the Central Bank Act. That country still retains the practice of commercial banks fixing their buying and selling rates in terms of appropriate "loadings on the London inter-bank rate", despite the fact that the Bank's research staff in their Economic Bulletins have suggested that the Central Bank should fix the dealing rates, after basing their loadings on the par value of the currency.[4] The Jamaican Central Bank did precisely this and published it, thus making it difficult for the situation to be exploited. In a country with a large tourist industry the situation demanded this very necessary innovation.

A fourth area of our analysis which recent developments have served to underscore is the shortcomings of the BASLE Agreement. The minimum sterling proportions which operate in the Caribbean are too punitive. They reinforce the highly disproportionate dependence of the region in holding its international reserves in the form of sterling balances. It is true that these have been guaranteed in terms of the United States dollar, but this is a currency whose value relative to sterling has depreciated since the Agreement, and which is likely to remain depreciated relative to sterling during the remainder of the life of the renewed Agreement (two years). The only concession which has been made to the present predicament which faces the region, is that the United Kingdom Government has agreed to a nominal reduction in the minimum proportions in some of the territories (e.g. in Trinidad-Tobago there was a reduction from 80 to 72 percent)[5]. But this reduction is merely nominal as can readily be seen from an analysis of the operations of the original M S P by one of the Bank's staff members.

> The Sterling Area Agreement has effectively halted, even though temporarily, any diversification of the foreign reserves of the Bank. This has been untimely because the Central Bank has succeeded, after a considerable period, in having the Government arrange to collect a substantial amount of its revenue in foreign currency, notably U.S. dollars. In addition to this, the Bank had agreed with the commercial banks to purchase from them, U.S. and Canadian dollar balances and U.S. and Canadian currency notes for Trinidad and Tobago dollars or sterling.
>
> To summarise:-
>
> (i) The Sterling Area Agreement has indirectly resulted in Trinidad and Tobago holding more than the stipulated Minimum Sterling Proportion of 80 percent as fixed by the Agreement.
>
> (ii) The need to await submission of returns by the Crown Agents is to a large measure reponsible for late reporting of the reserves of Trinidad and Tobago.
>
> (iii) The purchase of substantial amounts of foreign exchage, notably sterling, by the commercial banks from the Central Bank is an

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4 *Economic Bulletin*, Central Bank of Trinidad-Tobago, December 1970

5 And this might have been introduced less in response to the burdens it places on the Caribbean and more in recognition that at the moment these balances are rising significantly, thus contravening the BASLE Agreement.

important factor in the Bank's holding of a cushion over and above the Minimum Sterling Proportion.

(iv) Risk of loss is involved when other foreign currencies have to be converted into sterling to maintain the Minimum Sterling Proportion.

(v) While the portfolio management policies of the Bank regarding the average term of securities held, have not been affected by the Agreement, techniques and flexibility of portfolio management have been affected.

(vi) Last but by no means least, the Sterling Area Agreement has definitely halted, though only temporarily, any attempt at diversification.

On the whole, the guarantee under the Sterling Area Agreement cannot be used as effectively nor can it be considered to be equivalent to the holding of U.S., Canadian or other acceptable foreign assets. [6]

The sum total of all this is that the Sterling Area Agreements continue to be an impediment to the Caribbean territories.

As a final point we can observe that the crisis has also served to emphasize the need for regional cooperation even at the level of day-to-day financial arrangements and practices. A number of details which have emerged seem to indicate this. Firstly, if different loadings on different trading rates are used as the basis for calculating exchange rates then there is the possibility of arbitrage dealings, and the region's Central Banks will have to work in unison to regulate this. Secondly, if the foreign value of Caribbean currencies are subject to different legal definitions, and the commercial banking system as well as productive enterprise continue to be dominated by the multinational firms which operate widely throughout the region, then exchange control surveillance will be extremely difficult unless the various Exchange Control Acts are made broadly uniform, and the effectiveness of national supervision attains a roughly comparable standard within the region. Finally, in so far as the momentum for regional development lies in the present free trade agreement, it is necessary to maintain a regime of payments arrangements which, even at times of severe international liquidity crises, lead to a minimum disruption in regional trade and production.

The problem which remains for us is that of using some of these indicated shortcomings as the basis for devising a regional approach to the present crisis. Such an approach should recognise two fundamental realities. The first of these is that the economies of the area are too small to permit their respective Monetary Authorities either individually or in concert to operate local foreign exchange markets completely independent of all the major currencies. The second reality is that the region as a whole, despite the existence of the Sterling area, has become more absorbed into the United States economy than that of the United Kingdom. The geographical distribution of

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6 "Some Operating Implications of the Sterling Area Agreement" by G. C. Codrington. *Central Bank of Trinidad and Tobago Economic Bulletin*, Vol. 1, no. 2, November 1970

foreign trade, foreign investment and foreign indebtedness, together with the general framework of economic institutions[7] in the region clearly show that the area is far more an enclave of the United States than of the United Kingdom, and that future developments are likely to lead to further incorporation into the United States economy.

Based on these two fundamental factors the following are the key points of a regional strategy. Firstly, the area should in so far as it must operate on an exchange standard, use the United States dollar as the monetary standard rather than the pound sterling. Local foreign exchange markets should be pegged to the dollar, and foreign reserves, in so far as they must be held as national currencies, should be held in United States dollars. This would give financial expression to the underlying structural realities. Secondly, in order to facilitate regionalization the Monetary Authorities of the region should, irrespective of global arrangements operate on fixed parities for intra-regional trade and also maintain a system of reciprocal and mutually reinforcing exchange controls. For this to be effective, if a global system of floating rates is maintained for any length of time, the Monetary Authority of each territory should have wide powers to intervene in the support of the rate structure in its foreign exchange markets for dealings in its own currency, as well as that of each member country. Thirdly, although the region is unlikely to be in a position to exert much influence on future global liquidity arrangements, our own economic interests dictate a strong preference for fixed exchange rates. A system of floating rates will, for a variety of reasons, tend to favour those rich countries where the world's major foreign exchange markets are located.

Fourthly, the region has a long term interest in supporting those schemes which minimize the use of national currencies as international reserves. Our experience with sterling demonstrates this. The long term solution, therefore, is to support measures which aim at the international creation of a reserve asset administered by an international authority such as the International Monetary Fund, and to link the question of liquidity to that of the trading problems of the region. On closer examination it can be seen that all the arguments in the literature show that the real risk attached to this solution is that of a lack of effective control over such reserves in a time of serious national crisis, e.g. war. But the economies of the region have always carried such a risk. They have relied on the accumulation of their foreign reserves in the form of national currencies over which, in times of serious national crisis they could not enforce their rights of access. The fact of size will always ensure that the regional economies will have a limited capacity to reduce threats to the liquidity of their foreign reserves.

Since these developments are long term, as an interim measure, i.e. pending the creation of an international reserve asset, the region should begin to switch its present holdings of sterling and United States dollars into gold. The reason for this is simply that the income

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7 In particular, financial institutions.

and flexibility advantages of gold are at the moment greater than any available alternatives. Both the United States dollar and sterling will continue for some time to be uncertain in the foreign exchange markets, while the monetary authorities of other 'eligible' currencies will continue to dissuade others from holding their currencies in any substantial amounts as foreign reserves. There is also in the decision to hold gold as the bulk of the region's reserves a clear opportunity to link this to a regional production arrangement aimed at stimulating the gold industry in Guyana.

A further key element to any strategy is that the Caribbean territories should seize this opportunity to establish meaningful exchange-rate parities among themselves, and with the rest of the world. This does not mean, as current discussion implies, that the existing intra-regional parities should be preserved. Rather, each territory in consultation with the others should attempt to achieve parities which reflect their present economic realities. In some cases this may mean devaluation relative to sterling and the United States dollar, and in others perhaps upvaluation relative to the United States dollar. An experimental approach to arriving at the new parities might very well be for the countries of the region to devalue ten percent relative to the United States dollar. The effective size of the regional devaluation would then be the weighted average change in parity with all other exchange rates. From this point a temporary controlled float should be operated so that individual currencies can find their appropriate levels based on actual experience. The choice of the particular base point of 10 percent below the prevailing United States rate has been determined by, on the one hand the maximum extent of exchange rate movement required to negate the effect of the United States import surcharge on exports to that country, and on the other, the extent of import price increases which the economies are likely to be able to negotiate without significant increases in the present rate of inflation. Of course for such an experimental approach to yield benefits, the countries of the area should be prepared to yield to the basic direction of any further exchange rate changes which foreign markets seek to dictate. The territories should also be prepared to negotiate some upvaluation in their respective currencies in return for a removal of the United States import surcharge.

Such a strategy caters both for the short term (increased holdings of gold and a devaluation which is negotiable) and the long term (the structure of world liquidity and the introduction of an exchange rate regime based on the economic realities with the Caribbean). As such, it seeks to overcome the chronic pattern of developing our monetary arrangements either in defence or in imitation of overseas monetary developments in the United Kingdom. In other words it seeks to give primacy to Caribbean needs, recognizing fully well that the capacity of institutional arrangements to provide this are limited, if changes in real economic structure are not forthcoming.

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