

Central Banking in Trinidad and Tobago, 1966-1969

ALEX N. MCLEOD

The international setting

From the end of World War II in 1945 until about 1970 the steadily evolving techniques of demand management gave the world as a whole, and most nations individually, the strongest and most sustained period of economic growth and prosperity ever recorded before or since. It was a time of hope and optimism.

That halcyon period came to an end in the 1970s, because demand management (as then practiced) proved incapable of controlling inflation. The effectiveness of monetary and fiscal policies in maintaining high levels of output and employment has been in decline ever since. Most countries sooner or later reverted to neo-classical strategies; monetary and fiscal policies have since been used primarily to combat inflation, and after 1975 they have been applied very vigorously indeed.

After 20 years of trying, the neoclassical strategy has at last substantially lowered inflation rates almost everywhere, and has brought them down to under 2% per annum in a few countries, but at an extremely high cost in terms of lost potential output, high levels of unemployment, spreading poverty, and the exacerbation of many social problems. It has also produced the high government deficits and debts that bedevil most countries, because a depressed economy generates lower revenues and soaring social-service costs. The main objective has now shifted from inflation-fighting to debt and deficit

□ York University, Department of Economics, Toronto (Canada).

reduction, but the basic strategy of restrictive monetary and fiscal policies remains unchanged. In contrast to the optimism and hope of the first two postwar decades, it has been a period of misery and despair.

There are, however, other means of controlling inflation that do not depress the economy, yet are compatible with a free-enterprise money-and-market economy (which price controls are not). Demand management could then be used effectively again to maintain high levels of output and employment, which in turn would solve most of our problems, or at least make them manageable.

In this context, it may be useful to look back at how demand management worked in a small open economy, in anticipation of the day when such policies can be revived. Trinidad and Tobago established a central bank in the mid-1960s, and scored some impressive initial successes with the new techniques. The accumulating troubles that had long been threatening world prosperity eventually disrupted the entire international community, including Trinidad and Tobago, yet in 1966 it was still possible to hope that common sense would eventually prevail and that the international monetary system so carefully crafted at Bretton Woods would gradually realize its full potential.

By way of background to the account of the early policy experiences of the Central Bank of Trinidad and Tobago, certain aspects of the international scene during the 1950s and 1960s should be recalled; in particular the policies of the two leading key-currency countries of that era.

Regardless of the political stripe of the government of the day, Britain's economic policies in those years were remarkably unsuccessful and in many cases shortsighted. The authorities were certainly entitled to every sympathy in the first decade or so after World War II, for the country had suffered severe war damage not only to its physical assets and productive capacity but also to its international financial position. However, some 20 years after the end of hostilities Britain continued to stumble and fumble from one economic crisis to another. Furthermore, her disappointing internal performance is no excuse for such things as the half-hearted support in its early years for the international monetary system agreed to at Bretton Woods, which was undoubtedly a major factor in its ultimate demise.

Some policy decisions in the USA were hardly better, and it sometimes appeared that the two countries were locked in a contest

as to which could be the more irresponsible in discharging the leadership obligations of key-currency countries. The USA is certainly entitled to high praise for the aid given in the first dozen postwar years to the reconstruction of the economies of its major industrial competitors, friend and foe alike. There is no similar instance known to history; it was a courageous demonstration of a belief in the virtues of market principles and the free-enterprise system. After 1957, however, the story changed. By that time the international competitiveness of Japan and many European countries had been largely restored, thanks primarily to their espousal of the free-enterprise policies the USA had advocated. Instead of following its own market-oriented prescription, the USA turned protectionist.

Much more significantly, the authorities in both Britain and the USA were unduly insensitive to the risks of inflation throughout the postwar period. This was understandable enough in the early years, when fear of a relapse into the depression of the 1930s was strong, but it persisted long after that threat had faded. Most of the blame attaches to the economics profession rather than national political leaders, of course, for politicians cannot be expected to be better economists than their economic advisors. Too many economists continued to advocate low interest rates in any and all circumstances, with almost religious conviction. The result was that many countries stoutly resisted any increase in market interest rates until well into the 1970s, even after inflation was making many real interest rates negative.

One inevitable consequence of the softness of official policies towards inflation was that price trends diverged materially from country to country, even in the leading industrialized nations. No fixed-exchange-rate system can indefinitely endure such differences, and the Bretton Woods system proved to be no exception. Repeated international efforts at reform over many years were addressed to the mere mechanics of the system, not to this underlying problem. Not surprisingly, the entire system eventually came apart between 1971 and 1973.

This criticism is not a matter of hindsight on my part. I am a firm believer in fixed exchange rates, but that is only part of the story. More importantly, I am a believer in a domestic policy objective of stable domestic prices; that would make fixed rates automatic, or at least easily attainable. In a Harvard graduate seminar in the 1945-46 academic year I presented a paper that rejected the then-popular idea

that a mild deliberate inflation was a good specific against the risk of renewed depression. In subsequent years, before every audience I could command, I continually opposed the notion that the creeping inflation in evidence almost everywhere was either harmless or at worst a small price to pay for prosperity.

In September 1966 I wrote a working paper entitled "Contentious thoughts on international liquidity" for the information of Trinidad and Tobago's Minister of Finance, offering my personal opinions. Copies were distributed to a few individuals at international meetings in September and November of that year, and a little later a slightly revised version under the imprint of the Central Bank was circulated. The substance of it was that, contrary to received opinions, there was not then, nor likely soon to be, a shortage of international reserves; the main problem was not with the *quantity* but with their *quality* of existing reserves (*i.e.*, the purchasing power of both key currencies was persistently declining).

Developments in central banking theory and practices

Material changes in our understanding of central banking theory and its role in the domestic economy began soon after World War I. In line with classical economic theory's belief in the role of interest rates in equating new capital formation with the flow of savings, the 19th century literature on the evolution of central banking in Britain focused on Bank Rate as the main regulator of domestic economic activity. By the 1920s the emphasis had shifted to the quantitative effects of open-market operations on the money supply, reflecting the introduction of new money-management techniques based on the sophisticated versions of the quantity theory of money that had recently been elaborated by Fisher in the USA and the Cambridge School in Britain.

More fundamental but less obvious changes in central banking theory have also occurred, such as the publication of Plumptre's *Central Banking in the British Dominions*,¹ which in my opinion

¹ A.F.W. Plumptre, *Central Banking in the British Dominions*, University of Toronto Press, Toronto, 1940.

is second only to Bagehot's *Lombard Street* in this field. (Interestingly, in both books the theory evolves as a byproduct of work formally directed to a different goal.) Plumptre's work transformed the theory from little more than a recital of the Bank of England's practices to a systematic structure in its own right. For example I have it on the authority of David Grove that Robert Triffin made extensive use of *Central Banking in the British Dominions* in setting up the many central banks he fathered in Latin America after World War II; Grove assisted Triffin in some of these creations, when both were officials of the US Federal Reserve System.

Regardless of changing fashions in monetary theory, however, good practical central banking has always depended on skillfully combining the use of the full panoply of central-bank instruments: the rediscount facility as a whole (*i.e.* the *availability* of rediscounts *at a controlled price*), open-market operations, moral suasion, management of the government debt, and the rest. What made the major change in central bank practices after World War II was the progressive evolution of demand-management techniques.

The theoretical analysis behind the new techniques, supported by empirical evidence, led to scepticism about both sides of the classical interest-rate equation. The expectation of a net return over and above the rate of interest was usually more important than low interest rates in inducing new capital formation; the argument for low interest rates in slack times was simply that they would encourage new capital spending *if* suitable opportunities arose. It also appeared doubtful that a higher rate of interest would induce more saving; some reasons for saving seemed pretty insensitive to interest rates, or even negatively correlated.

Before World War I the overriding objective of a sound central bank was generally seen to be keeping the currency on the gold standard; the bank was also expected to promote the smooth operation of the domestic economy in general and its financial system in particular, but only as secondary and subservient priorities. In the 1920s some central banks began in addition to use their powers to stabilize the domestic price level – *i.e.* to maintain the internal as well as the external value of the currency. That was the beginning of monetary policy as now understood, but the attempt was only partly and temporarily successful; the two objectives sometimes called for opposing policy initiatives, and the priorities between them were not

always clear. In any event The Great Depression of the 1930s pretty well ended progress in the matter for the time being.

The new demand-management techniques introduced after World War II required the central bank not only to try to stabilize both the external and the internal values of the currency, but also to coordinate its monetary policy with the Government's fiscal policies in order to promote a high level of output and employment, healthy business conditions, and vigorous and sound economic growth. Under favourable conditions the same measures might promote all these objectives reasonably well; under other conditions, however, the measures called for to achieve one objective might have adverse effects on another, so the potential for conflicting policy considerations was much greater than in the 1920s. In the end, persistent difficulty in maintaining both price stability and high levels of output and employment, particularly in the major industrialized countries, emasculated demand management and brought an end to the Bretton Woods exchange-rate system.

There were also other constraints on demand management, including those posed by balance-of-payments considerations. The new techniques operated most efficiently in developed countries with diversified economies, where productive capacity in most lines of business could be expanded fairly quickly when needed; in developing countries the expansion of production and real income usually required the establishment of new firms and even new industries, a much more difficult and time-consuming matter. Also, in small open economies the balance-of-payments constraints operated with particular severity. However, substantial progress had been made by the 1960s in adapting demand-management techniques to their special problems.

The Central Bank of Trinidad and Tobago

For many years the currency of Trinidad and Tobago was issued by a typical British currency board. That system had important advantages, including preferred access to the financial markets in London, and had served the country well in the past. It was certainly far superior to the use of the currency of a major metropolitan area as

the local currency, as the US dollar, the South African rand, the Australian pound (now replaced by a dollar), and some other currencies were (and still are) in several of their economic dependencies. However, a currency-board issue did not lend itself to the new demand-management techniques.

For this reason Trinidad and Tobago decided in the 1960s to set up a central bank, and established a Committee on Banking and Currency to plan for the new institution. In 1963 I was invited to become the Governor of the new bank, but, after careful consideration, I reluctantly declined. My main reason was that, as Chief Economist of The Toronto-Dominion Bank and Chairman of The Canadian Bankers' Association's Economists Committee, I was deeply involved in drafting the Association's brief for the Royal Commission on Banking and Finance (the Porter Commission), in preparation for the decennial revision of Canada's Bank Act. John Pierce, a senior official in the Federal Reserve System of the USA, was then appointed to the post. The Central Bank of Trinidad and Tobago became operational on 12th December 1964, with the proclamation of those sections of the Central Bank Act that dealt with its note-issuing and housekeeping functions; its other functions were to be phased in as progress warranted.

Here it is worth noting that the International Monetary Fund was of material help in the establishment of Trinidad and Tobago's central bank. The Fund's Central Banking Service was only set up about that time, and this Caribbean country was one of the first beneficiaries of its help. The Fund assisted in the drafting of the covering legislation, it recruited Pierce, me, and several other expatriate officers who helped get the Bank through its formative years, and it subsidized our services.

Trinidad and Tobago's Central Bank Act reflected up-to-date thinking on the role of monetary policy. It provided the Bank with all the necessary instruments of monetary control: an established (and variable) cash reserve ratio for commercial banks, rediscounting facilities, open-market capabilities, selective credit controls, local asset ratios, and so on.

However, as in any small open economy, the scope for open-market operations was initially quite limited, for there were virtually no active local financial markets in which to carry them out. That in turn meant that there had previously been little scope for the effective management of the internal government debt. This aspect of mon-

etary policy is widely underappreciated, even in countries with diversified financial markets, where it may be far more important in maintaining the healthy operation of the economy on a day-to-day basis than the pursuit of better-known policy objectives; in a developing country it may be the most important service a central bank can render.

Subsection 3(3) of the Act declares that the purpose of the Bank is to promote "such monetary credit and exchange conditions as are most favourable to the development of the economy of Trinidad and Tobago". Paragraphs 3(3) (c) and (d) read:

[The Bank shall:]

(c) maintain, influence and regulate the volume and conditions of supply of credit and currency in the best interest of the economic life of Trinidad and Tobago;

(d) maintain monetary stability, control and protect the external value of the monetary unit, administer external monetary reserves, encourage expansion in the general level of production, trade and employment [...].

The Bank was thus unequivocally committed to promoting economic development, and to a number of explicit subsidiary objectives. There is no mention of the possibility that there might be difficulties in achieving all of these objectives simultaneously, nor of the fact that the Bank's actions with respect to many of them would have to be in coordination with the Government's fiscal policies, but common sense dictates that these provisions be interpreted subject to the qualifying phrase "so far as may be possible within the scope of monetary action", as had been prudently inserted in the preamble to the Bank of Canada Act in 1933.

In support of this interpretation, it may be noted that the then-Minister of Finance was at pains to emphasize repeatedly, in the parliamentary debates of the Central Bank Act and elsewhere, that a careful balance would have to be struck between conditions of expansion and the possibility of instability. He particularly emphasized the need to preserve a stable value for the currency, and the Government's intention to maintain the link between the Trinidad and Tobago dollar and sterling.

Concern for the stability (both external and internal) of the currency's value was quite understandable under the circumstances. Many reputable economists were then openly critical of fixed-exchange-rate systems, and argued for flexible rates; among other

things, this implied that domestic price stability would not have a high priority. In addition there had already been all too many instances in which newly established central banks had become engines of inflation, and more instances were yet to come. The Minister's insistence on this point was surely necessary in order to reassure the members of the financial community at home and abroad, many of whom were harshly critical of the temerity of the Trinidad and Tobago Government for withdrawing from the currency board that had previously linked the currency firmly to sterling, establishing a central bank, and introducing much other "nationalistic" financial legislation. Public confidence is essential for the success of any currency and any banking system, especially a new one.

The commercial banks operating in Trinidad and Tobago at that time were all branches of foreign banks, directly under their head offices abroad - Barclays Bank DCO, the Bank of London and Montreal, First National City Bank, the Chase Manhattan Bank, the Royal Bank of Canada, the Bank of Nova Scotia, and the Canadian Imperial Bank of Commerce. Their origins in three different countries, with three somewhat different banking practices and traditions, made for some interesting problems in establishing uniform routine procedures and working arrangements, but they were relatively easily resolved by good will on all sides. The seven banks had worked out a *modus vivendi* long before the Central Bank was established, of course, but its creation meant that they had to adapt to new operational requirements. All of them cooperated well with the Bank in this process, though the Bank sometimes found it necessary to intervene in order to counteract any tendency to cosy cartel-like arrangements.

The establishment of the Central Bank made it possible for domestic commercial banks and other financial intermediaries to be established eventually, and for branches of foreign banks to incorporate locally and sell shares to local residents. The dominance of big international banks in political or economic dependencies of major powers (and in many small independent countries without central banks of their own) is not necessarily due to greater competence or probity on their part, nor to undue political interference from their home governments. Rather, it is primarily due to the fact that an international bank has recourse to a lender of last resort in time of crisis - its head office abroad. Local banks, perhaps equally sound and well managed, have no such support. Branches of foreign banks will

therefore survive a liquidity crisis in which even the best local banks will fail; local depositors may not understand why this happens, but they readily recognize the result, and put their money where it is safest. A central bank redresses this imbalance, for it becomes the lender of last resort for domestic banks and for the entire local financial system.

The Bank becomes fully operational

As Pierce's term was coming to an end, I was again contacted informally by officials from Trinidad and Tobago, through the Canadian Government, to see if I would be prepared to become the second governor of the Central Bank.

By that time I was ready to reconsider, since the revision of Canada's Bank Act was still slowly wending its way through Parliament. In December 1965 I received a firm offer through the Central Banking Service of the International Monetary Fund, and took up my duties as Governor on 1st May 1966. The Central Bank was already operating as a going concern in temporary quarters when I arrived in Port-of-Spain, but exercising only its basic note-issuing and housekeeping functions; as already noted, the sections of the Central Bank Act dealing with these matters had been proclaimed effective as of 12th December 1964. By that time Pierce and the Committee on Banking and Currency, between them, had set up the internal organization of the Bank and recruited an excellent staff. Before my arrival they had also arranged the refurbishing of an existing government building on Port-of-Spain's Independence Square into very functional central-bank premises.

Within a few weeks I satisfied myself that all was in readiness for the proclamation of the remaining sections of the Act, which included relations with other banks and with the Government, and so advised the Minister of Finance. The proclamation was made early in July 1966, to be effective on 1st August. On that date the Bank began to exercise its full powers. In due course it took over the operation of the Government's accounts, previously handled by a branch of Barclays Bank, and began to manage the issues of the national debt on behalf of the Ministry of Finance.

As luck would have it, one of the numerous sterling crises that bedevilled the 1950s and 1960s broke out between those two dates. The Bank of England raised its rediscount rate from 6% to 7%.

Nowadays a 7% Bank Rate at the Bank of England may not seem very impressive, but in those days it was a crisis level that had been invoked only twice (1957 and 1964) in over 30 years. The rate had been 2% from the 1930s to 1950; it had then risen irregularly, but had seldom exceeded 5%. The jump to 7% in July 1966 had major repercussions in international financial markets, but particularly in the economies of members of the sterling area like Trinidad and Tobago. It certainly complicated the decision on the rediscount rate that had to be announced on or before 1st August. (We chose to use the term "rediscount rate" rather than "Bank Rate" because we felt it was less likely to be confused with the prime lending rate of the commercial banks.)

Normally, one would expect the interest-rate structure in a sterling-area country to be maintained somewhat above that in London, in order to compete with the many attractions of London's financial markets. On this occasion, however, the pound sterling was under attack on international exchange markets, the Trinidad and Tobago dollar was not, so the normal relationship did not apply. After some soul searching, we set the rate at 6%. We could have backed off quickly if we had had to, but in the event that did not prove necessary.

Our motives, of course, were to shield the local economy as well as we could from pressures originating abroad for reasons that had nothing to do with business conditions in Trinidad and Tobago, but to avoid exposing the country to a serious exchange drain in search of higher yields abroad if our interest-rate structure proved to be uncompetitively low. In this we evidently succeeded quite well, with the cooperation of the nation's commercial banks. By early March 1967 the Bank of England had reduced Bank Rate in two steps to 6%, and we felt we could safely reduce our rediscount rate to 5.75%. In May the London Bank Rate was reduced again, to 5.50%, and we set our rediscount rate at the same level.

As time passed, and sterling encountered continuing uncertainties on international markets, our ability to maintain some degree of independence in our interest-rate structure was confirmed. Rates in London continued to have a restraining influence, but

changes in our domestic rates more and more reflected domestic credit conditions. As it does in most countries, the rediscount rate tended to follow domestic market rates most of the time, rather than the other way around; its signaling role is largely confined to unusual circumstances, in which an abrupt change in the level of interest rates is called for.

The Bank's first permanent premises were ready for occupancy by late February 1967. On 4th March we held the official opening. The offices and public areas were furnished with attractive and functional furniture, most of it designed and made by local craftsmen, and decorated with excellent works of art produced by local artists. Specially invited guests included the IMF staff member who had helped draft the legislation, Mr. Paul Walter. Unfortunately he died in Washington just a few days after his return, in a tragic traffic accident.

The affair was a great success. I must confess that, reflecting the frugal traditions of my Scotch ancestry, my own initial reaction had been that the furnishings and ornamentation of the building were overly elaborate for a relatively poor country like Trinidad and Tobago. The reactions of our visitors showed me how wrong I was, and that the substantial expenditure involved had definitely been a good investment. The result was an extensive demonstration of local capabilities, and all who attended were suitably impressed. One foreign insurance man, who had been one of the harsher critics of the new insurance law, volunteered to me that it had completely altered his opinion of what the country was capable of doing. Other comments were equally laudatory.

Domestic operations

During my governorship the Bank's objectives were unequivocally those spelled out in subsection 3(3) of the Central Bank Act, particularly those enumerated in paragraphs (c) and (d), which have been quoted above. The Bank's independence of action within its proper sphere certainly had to be respected and preserved, as the Minister of Finance also insisted repeatedly, and as any central banker would surely agree, but I saw its role as being clearly to support

economic development as fully as its overall mandate permitted. That included encouraging the private sector to undertake productive new investments; however, the main initiative in this respect lay with the Government, which was responsible for development planning in general and the provision of the necessary economic infrastructure in particular. The Bank's contribution would be primarily to support the financing of the Government's fiscal program.

One possibility was for the Bank to purchase government securities directly for its own portfolio, within the limits specified in the Act. This would provide some immediate financing for development projects; also, as the money was spent it would increase the liquidity of the commercial banks and the general public, some of which might be used to buy additional government issues. In addition, the increased liquidity thus provided would tend to reduce domestic interest rates, which would both encourage private investment and minimize the cost of the Government's development financing.

There was unquestionably some scope for such action, but a strategy that looked no further than that would have offered severely limited promise. Even if the monetary expansion was kept within prudent limits and not allowed to generate inflationary price rises, most of the new spending would quickly leak away in payment for increased imports; very little of it would reappear as new domestic savings available for the purchase of government issues. Instead, we in the Central Bank set out to expand the portion of both old and new domestic savings that would be retained locally, and to attract a substantial portion of them into financing the development program.

It was never any secret that many local people kept a substantial part of their accumulated savings in London, and had always done so. The reasons were simple enough: the normal desire to diversify one's investment portfolio, and to earn a good rate of return. The London market had a wide variety of investment vehicles available, including time deposits of many kinds at various institutions, interest-bearing securities in profusion, equities, and so on, some issued by domestic or foreign government bodies, others by private enterprises, with a corresponding range of riskiness and yield. The market was broad, active, internationally competitive, and readily accessible because of the links between the local currency and the pound sterling. The range and variety of investment vehicles available within Trinidad and Tobago was far more limited.

We set out to remedy this situation as fully as we could. Recent new legislation had been designed to encourage the establishment of local financial institutions, and a "call exchange" had begun to operate under the aegis of the Central Bank – essentially, a periodic exchange of information on local issues wanted or available for purchase, which may be seen as a first step towards an organized stock exchange. However, we thought that much more could be done.

The obvious place to start was to promote domestic government debt issues as an attractive alternative to the possibilities offered in London's financial markets. Part of our strategy was to participate in the weekly auction of local Treasury Bills, and to manage the market in them between tenders, in order to encourage active trading and wider participation. We regularly submitted a series of tenders at increasing yields, so we could usually get the Bills we really wanted yet be sure that the full tender was taken up, and put a cap on the rate. However, we could back off in subsequent weeks if we found we had misjudged the market, and we could usually expect to sell off any surplus acquisitions (at a loss if necessary) in the aftermarket. The Government was thus assured of a definite though prudently-limited source of funds, and movements in the Bill rate could be smoothed out, but the rate was really market-determined.

We also persuaded the commercial banks to hold a certain minimum amount of Treasury Bills as a secondary reserve, in addition to their statutorily required cash or primary reserves. We could, of course, have used the Bank's coercive powers to force them to do so, or have simply raised the primary ratio; the immediate effect would have been exactly the same as far as providing funds to the Government was concerned. However, we preferred to use moral suasion (which some people irreverently call "open mouth operations"), and to win their voluntary cooperation, as being more likely to promote the broader acceptance of government issues we sought. Our argument to the banks was that they could buy and sell Bills in an active market when they needed to make temporary adjustments in their cash reserves, instead of having to rediscount assets with the Central Bank. (Following standard central-bank procedure, we kept the rediscount rate somewhat above the current yield on Bills, in order to discourage unnecessary rediscounting, which might otherwise threaten the Bank's control of credit conditions.)

However, we sought to promote a sound domestic market for all government issues, not just Bills, so they would be attractive to other financial institutions and the general public as well as the banks. We bought longer-dated issues when they were offered, but in this case we took no more than we thought prudent and did not guarantee the sale of the entire issue. We then managed the aftermarket for them by offering to either buy or sell them at posted but flexible rates, which could be quickly changed if the market strengthened or weakened. Thus the yields on these issues were also market-determined despite a certain amount of intervention on our part, and we were firmly in control of how much support we deemed it feasible to offer the market. In practice we found that we could usually reduce our holdings of Bills in order to acquire some longer maturities at issue time, then gradually sell them off to insurance companies and others in the aftermarket and replace them by Bills.

Promoting a broad and active market in government securities, in which third parties besides the Central Bank and the commercial banks participated on a significant scale, also meant creating conditions in which open-market operations could eventually be used more effectively. In the meantime adding gradually to our portfolio of government issues was an effective form of open-market purchasing to expand credit, and open-market sales to contract it were not really necessary: if we found we had over-expanded somewhat, we had only to "hold strain" (as the local idiom has it) until the external exchange drain effected the necessary contraction.

Managing the government-debt market in this way certainly implies that we took a view with respect to interest rates. We sought to influence not only the general level of rates but also the shape of the yield curve, and we tried to keep all rates as low as possible in order to promote economic development. However, we took a pragmatic view of what that meant – we interpreted it as a rate structure that would induce the domestic market to absorb as large an amount of government issues as seemed feasible. Had inflationary pressures mounted, as they undoubtedly did in later years, interest rates "as low as possible" might not have been very low in absolute terms. In practice, the main constraint was the competing attractions of foreign financial markets, particularly the London market.

Other policy decisions were more pedestrian. In the expectation that locally-incorporated banks would sooner or later appear, fairly early in my tenure the Central Bank undertook the establishment of

an effective bank-inspection system. Inspection was not a high priority with respect to foreign-owned banks, since their own head-office auditors could be relied on to a large extent, though ensuring that they were meeting their obligations under the local banking law was a legitimate consideration. For locally-incorporated banks, however, it would be important to ensure that they adhered to sound banking principles.

There seemed to be little scope for the use of selective controls on commercial-bank credit. Section 42 of the Act authorizes their use "when ... necessary to restrict or prevent an undue expansion of credit". However, loans were readily available to any creditworthy borrower at going interest rates even before the influx of funds from London after the 1967 devaluation of sterling, discussed in the next section, and doubly so afterwards; arbitrarily restricting commercial and personal loans would therefore have served no constructive purpose, and would have curtailed legitimate transactions that met the test of market demand.

In my opinion, selective credit controls are of limited effectiveness in any case. When money is tight they can give a preferred borrower with limited resources a better place in the queue, but one with more resources at his or her disposal will probably be able to come up with enough "approved" projects to justify any loan he wants, even if he actually uses the borrowed money for wasteful consumption. Also, he will likely be able to tap other sources of credit besides the commercial banks, which are the only lenders the Central Bank has direct authority over.

At one point the Government became concerned over the volume of consumer credit being used for the purchase of automobiles, and moved to restrict it. I suggested that it would be more effective to put limits directly on spending, rather than on the credit used to finance it. For example, they might limit the frequency with which anyone could buy an automobile, and the type or cost of autos that could be bought. (A number of models were then being assembled locally.) However, this suggestion was not accepted. The Bank then persuaded the commercial banks and the finance companies to require a minimum down payment of 30%, and to require repayment of the loan over 18 months. It also persuaded the Chamber of Commerce to publish a code regulating instalment credit.

Until the 1967 devaluation of sterling, Trinidad and Tobago had been content to participate more or less passively in the sterling-area

exchange-control system; all that was required was some rather routine administrative work, performed by a section of the Ministry of Finance. Soon afterwards, however, the Government began to revise the system and to focus it on the country's own needs. The administration of the revised regulations was assigned to the Central Bank.

International complications

The decisions of the Bank of England on Bank Rate in 1967 illustrate the vagaries of British policies at that time. When the rate was reduced another half-point to 5.5% in May some observers immediately criticized it as unduly low compared to rates in other financial centres, and a too-precipitate decline from the crisis level set the previous summer. Sure enough, a new crisis brought the rate to 8% in October, unprecedented since the early 1930s, and brought a devaluation of the pound in November from US\$ 2.80 to US\$ 2.40. During a routine visit by a Bank of England representative some months later I asked what had possessed the authorities to drop the rate so low in the spring. He laughed, and said he guessed they thought it was their only opportunity to get it down. I replied, in the classic words the signalman used when he saw two trains approaching one another head on in the railway yard where he worked: "Well, that's a hell of a way to run a railroad!"

This devaluation of sterling demonstrated an important advantage of having a domestic central bank in a dependent economy. Under a currency board Trinidad and Tobago would have had no choice but to follow Britain's lead and accept an equal devaluation. As it was, the Government decided to devalue the Trinidad and Tobago dollar in the same proportion. However, the point is that they had a choice, and chose to do so after a careful evaluation of the country's trade pattern and other considerations indicated it would be in the national interest. Some other sterling-area countries also devalued their currencies, but most did not.

The 1967 disturbances in international currency markets, in combination with the fact that Trinidad and Tobago now had an independent currency, brought a substantial inflow of capital from London. The same thing occurred in varying degrees in other

members of the overseas sterling area that were similarly situated. It was a dramatic demonstration of the validity of our objective of repatriating domestic savings from external markets, and greatly enlarged the scope for an independent monetary policy.

The realization that Trinidad and Tobago need not have followed the same path as sterling brought a new factor into the equation: it became clear that there was now an exchange risk in keeping one's funds in London. That made local financial assets look far more competitive than they had before. Securities issued by the Government of Trinidad and Tobago were beginning to appear in some variety, so there was more choice of domestic investment vehicles. Furthermore, there was every reason to expect that local private enterprises would sooner or later issue interest-bearing or equity securities. This expectation soon began to be realized; some branches of foreign banks incorporated locally and sold shares to the local public.

Insurance companies in particular changed their attitudes. About the time the Central Bank was being planned, a new insurance law had been passed that required companies to hold some of their reserves against local liabilities in local assets. This had caused much grumbling at the time, and not without some reason from the companies' point of view: it had seemed more efficient for them to concentrate their reserves against all sterling-area liabilities in London, where there was a wide selection of financial assets. Also, reserves held in local assets may prove illiquid if a major local disaster strikes. Now, however, they too saw that they would be incurring an exchange risk if they continued to keep their reserves abroad, so they became more reconciled to the new insurance law.

The Basle Facility

One of Britain's problems at that time was the fact that large liabilities in sterling had been built up in the course of financing World War II, on top of normal commercial balances held abroad because of Britain's key role in international trade. Most of the new balances were in official hands in sterling-area countries, and the total had remained remarkably stable, though the holdings of some indi-

vidual countries had varied substantially. In fact these overhanging balances were a problem for the international monetary system as a whole, for at every sterling crisis there was a tendency for holders to convert them to dollars, which worsened the crisis. After the 1967 devaluation, not surprisingly, this tendency reasserted itself on a substantial scale and threatened the efforts being made to stabilize the exchange markets.

In June 1966 an attempt had been made to deal specifically with this problem, quite distinct from earlier international cooperation to help meet Britain's balance-of-payments deficits. A number of central banks in other countries provided US\$ 1 billion in short-term credits available to offset the conversion of sterling balances, and renewed these credits in 1967 and 1968. (In those days US\$ 1 billion was a much more impressive sum than it would be now.)

In the summer of 1968 the international community finally undertook to find a definitive solution to the problem. A new and independent credit of US\$ 2 billion was negotiated ("The Basle Facility"), underwritten by 12 central banks and the Bank for International Settlements. This, too, was to support the conversion of sterling balances, not balance-of-payments needs. There were two differences, however.

First, it was a medium-term credit, not short-term. Drawings could be made over three years, and repayments were to be made between 1973 and 1978. Second, these credits were contingent on certain agreements between Britain and individual sterling-area countries. Britain guaranteed the US dollar value of a major portion of their official reserves, while they undertook to keep an agreed minimum portion in sterling. Some of the agreements were for three years, with a possible two-year extension, others were for five years.

The Basle Facility and the related sterling-area agreements made an important contribution to the improvement of the position of sterling in the next few years. (Of course, the fact that Britain achieved a commendable turnaround in its balance of payments was also of major importance.) In addition, they constituted a highly constructive move to improve the functioning of the international monetary system as a whole. They were clearly in the best interests of all concerned. However, there was much in the fine print that needed careful scrutiny. We in Trinidad and Tobago perceived a number of anomalies between what was offered us and what was asked of us. We circularized other members of the sterling area to exchange ideas on

the subject, and representatives of a number of the Caribbean members assembled to work out a common position. These efforts resulted in significant improvements in the terms of our agreements.

Unfortunately, however, new troubles soon arose. By this time periodic speculation against the US dollar had joined periodic speculation against sterling in threatening the international monetary system. New attacks on the dollar broke out in 1971, which led to the "temporary" suspension of its formal convertibility into gold (in practice, convertibility had already been limited for some time). By early 1973 most major currencies were trading at fluctuating rates, a situation which has continued with little change until the present. However, these problems were still in the future when I left the country.

The lender of last resort

Even though a run on an entire banking system seldom happens nowadays, or even a run on an individual bank, the lender-of-last-resort function is still important: the knowledge that the central bank stands ready to perform it if necessary means that it seldom needs to be called on. However, the nature of the function can easily be misunderstood.

An interesting example occurred fairly early in my term as Governor. The manager of the main Trinidad branch of a foreign bank came to me one day, and asked to borrow a substantial sum. He was very surprised when I politely declined, and exclaimed "But you are the lender of last resort!". "That's right", I said, "the lender of last resort, not first resort. When you are in trouble and your Head Office is unable to help you, then come to me and I will see what I can do». What he was really proposing was that he be allowed to lend some of the Central Bank's money, which had nothing to do with the lender-of-last-resort function.

The controlling factor was that the bank in question was then a branch of an internationally-operating institution with its head office abroad. Had it been locally incorporated, even if partly foreign-owned, I could not have declined to help without at least finding out more about the bank's needs, for local incorporation implies certain

domestic rights as well as obligations. I think the answer would have been in the negative anyway, for I am quite sure that he was not experiencing a liquidity problem but merely wanted to expand his loan portfolio.

The typical role of the lender of last resort is to succor a sound bank that is suffering a short-term squeeze in its cash flows, usually because of unexpected withdrawals of deposits; it does not include rescuing a bankrupt institution, nor expanding a bank's profit base. Even if this particular request had met those conditions, however, I would still have looked for help from its foreign parent, as either a substitute for or a replacement of whatever help I was able to give; the resources of the parent bank would undoubtedly be far greater than those of the Central Bank of Trinidad and Tobago, and no international bank would like to see an affiliate get into trouble.

On another occasion the same banker was negotiating with the Government over a possible loan to finance certain projects. He proposed that, as part of the terms of the loan, he be authorized to rediscount it with the Central Bank. I did not have too much trouble persuading the Government to decline this proposal, which would have been another case of him lending the Central Bank's money instead of his own. The extent to which and the terms on which a central bank may lend to its government, aside from any statutory requirements, are matters for negotiation between the two principals only.

Even in a small country, in a *purely domestic* liquidity crisis a central bank can act as the lender of last resort to domestic commercial banks, and through them to the entire financial system, because it can provide an elastic supply of the local currency. What may be more important in practice, within the limits of the resources at its disposal, it can give substantial support when local government security markets turn weak simply because of normal fluctuations in demand. This will help not only the banks but also other financial institutions and the general public, and may prevent a serious liquidity squeeze from developing. What the central bank can *not* do is to meet a strong and persistent demand for *foreign* currency.

It may be noted that a routine application by a commercial bank to rediscount some of its assets with the central bank is a sort of low-key recourse to the lender-of-last-resort function, since it is at the initiative of the borrower. Rediscounting will tend to expand commercial-bank reserves by an equal amount, which will presumably

be in excess of the central bank's target level, so must not be countenanced lightly; that is why the rediscount rate is normally kept somewhat above short-term market rates. In countries with diversified financial structures the expansion may be quickly offset by open-market operations if that is deemed necessary; in a small open economy it will be automatically offset by the external exchange drain it will cause.

Policy differences

A well-known occupational hazard of central banking is the possibility of a serious difference of opinion with the political authorities. Much less serious are differences of opinion between the central bank and various arms of the government service, for they involve senior departmental civil servants rather than elected members of the government. Such differences are likely to occur from time to time, just as they are between government departments, because their officials see what constitutes the public interest from different perspectives. For the most part these differences are matters of emphasis rather than principle, and they are settled by reasonable people on both sides finding an accommodation. This was certainly the case in Trinidad and Tobago during my time.

The Central Bank Act contains a provision that is pretty common nowadays, whereby the Government may give the Bank a policy directive of a general nature, but it was never used during my tenure of office. Such provisions permit the government of the day to take responsibility for the broad aspects of monetary policy in case of disagreement with the central bank, as is its ultimate right. If the disagreement is not too serious, this may be a face-saving solution to the problem. If he feels that a matter of principle is at issue, however, the Governor may resign and appeal to public opinion.

The Bank's relations with the Government were conducted almost exclusively through the Ministry of Finance, under which its governing legislation and powers had been designed. The line of demarcation between their respective responsibilities was crystal clear: economic policies in general were the Government's prerogative, day-to-day monetary matters were the Bank's. The need to

coordinate their actions meant, however, that each was free to offer suggestions that overlapped this boundary, without prejudicing the other's authority.

There was only one instance of a difference of opinion with officials that was formally appealed to the Government. It was on the occasion of the first setting of the rediscount rate in July 1966, in the midst of a sterling crisis. The Act provides for the appointment of two non-voting members of the Board of Directors, one from the Ministry of Finance and one from the department responsible for economic planning (which was directly under the Prime Minister, Dr. Eric Williams.) It is a very sensible provision, designed to facilitate the coordination of fiscal and monetary policies; similar provisions are to be found in many other central-banking laws.

The staff of the Bank proposed a rediscount rate of 6% to the Board of Directors, on the reasoning given earlier, but the two official members argued ably and eloquently for a much lower rate and an independent interest-rate structure. This was perfectly logical from the point of view of encouraging private investment in development projects, and minimizing the costs of financing the Government's development program. I no longer remember just what rate they wanted, but I was quite sure it would be self-defeating, for too low an interest-rate structure would make it impossible to mobilize any significant portion of the country's domestic savings against the attractions of the returns available in London and other foreign financial markets. Also, it would mean that the initiators of any private investment attracted thereby would try to finance their projects as much as possible from Trinidad and Tobago's domestic resources, which were all too scarce; we needed to attract foreign financing to supplement our own savings.

The Board gave both proposals a respectful hearing, but in the end voted unanimously for the 6% rate. The two officials then appealed directly to the Prime Minister, and quite properly so, for it was a policy issue on which they felt strongly. Also, many respected economists at home and abroad would then have supported their position. Clearly, the issue had to be settled at the highest political level.

A meeting was convened before Dr. Williams. Both points of view were fully presented. Dr. Williams immediately and unequivocally decided in favour of the Bank's position.

A task completed

By 1969 I felt that my main task in Trinidad and Tobago was substantially complete: the Central Bank was set on a sound course, and the local staff was capable of operating it successfully. I received the offer of a tenured professorship in the Department of Economics at Atkinson College of York University in Toronto, to start with the 1969-70 academic year. I consulted Dr. Williams, and assured him that the Central Bank was now fully operational and that the Deputy Governor, Victor Bruce, was capable of managing it, whereupon he gave me permission to resign before the end of my statutory term of office and take up the appointment. I had enjoyed my stay in Port-of-Spain, but it was time to move on to other things.