NEW DIRECTIONS FOR CENTRAL BANKING IN THE CARIBBEAN

by Courtney N. Blackman Ph.D.
International Business Consultant

FOR PRESENTATION AT THE TWENTIETH ANNUAL CONFERENCE OF THE

REGIONAL PROGRAMME OF MONETARY STUDIES

Port-of-Spain, Trinidad
November 16-18 1988

NEW DIRECTIONS FOR CENTRAL BANKING IN THE CARIBBEAN

by Courtney N. Blackman Ph.D.
for presentation at the
Twentieth Annual Conference of the
Regional Programme of Monetary Studies
Port-of-Spain, Trinidad
November 16-18 1988

It is now something of a Caribbean tradition that the institution of central banking be reviewed from time to time. Central banking is both science and art, so that improvements in its practice must draw on both systematic academic analysis as well as upon the experience of practitioners.

The first critique of Caribbean central banking was "A First Appraisal of Monetary Management in Jamaica" by Lloyd Best and Alister McIntyre in 1961.1 This brief and tentative study commented on the Bank of Jamaica's reaction to an upward movement in the Bank of England's discount rate and concluded that the existing powers of the Bank were inadequate to cope with the problems of capital flight. It also recommended a devaluation of the Jamaican currency.

The second critique came in 1969 in the form of my own Ph.D. dissertation "Central Banking in a Dependent Economy: The Jamaican Experience 1961-7."2 I complimented the Bank on the financial integrity of its operations. However, I was critical of its traditional concern with the money supply and its narrow focus on commercial bank credit to the neglect of non-bank intermediaries.

I also regretted its neutral stance towards developmental problems. Its preoccupation with the "soundness of the currency" irked me then. It would not today!

Professor C. Y. Thomas, our most distinguished authority on monetary economics, published The Structure, Performance and Prospects of Central Banking in the Caribbean in 1972.3 Thomas' immediate concern was with the inappropriateness and, indeed, the inequity of the Sterling Area Arrangements. He also recommended two reforms - the imposition of exchange controls against sterling and the regulation of borrowing by non-resident controlled multinational corporations - practices now observed throughout the region. His more radical recommendations involving nationalization of financial institutions and the direction of all lending by the central bank were fortunately not generally heeded. I doubt whether Professor Thomas would still stand by the arguments he used then:

> The recent history of nationalizations in India, Libya, South Yemen and Tanzania, show that the complications are overstated and that nationalizations, although not a guarantee of adequate banking, is certainly necessary for the development of adequate banking in poor countries.4

We might add the example of Burma to the above list to hammer home the disutility of a monolithic financial regime of the type recommended by Professor Thomas.

Reviews of central banking performance as organizations in the 'seventies and early 'eighties were generally favourable. Speaking at the 10th Anniversary of the Central Bank of Trinidad and Tobago, Alistair McIntyre, then Secretary General of Caricom, praised the initiatives of Caribbean Central Banks in the development of the Caricom Multilateral Clearing Facility. G. Arthur Brown, the first native governor of a Caribbean central bank, also gave high marks to regional central banks on the occasion of the Central Bank of Barbados' Tenth Anniversary in 1982.

However, Caribbean central banks lost much of their mystique in the 1980's. There have been no rave reviews for them in this decade. In June 1984 the late Prime Minister Adams publicly criticized Caribbean governors for the collapse of the Caricom Multilateral Clearing Facility. Speaking in the House of Representatives in July 1986, the late Prime Minister Errol Barrow savagely attacked the incumbent Governor, blaming him, strangely enough, for the high level of the foreign debt. We also saw the bizarre spectacle of a Barbadian Minister of Finance boycotting the opening of the Headquarters of an institution for which he was responsible. In Port-of-Spain the incoming Prime Minister also publicly criticised the incumbent Governor. About the same time in Jamaica the Opposition was threatening the incumbent Governor with dismissal in case of a P.N.P. victory.

Most serious of all has been the recent critique by Mr. Frank Rampersaud, the retired Permanent Secretary of Finance of Trinidad and Tobago. In assigning responsibility for the current debt problems of the region, Mr. Rampersaud had this to say:

> The Ministry of Finance has to bear major responsibility for it; but vigilant Central Banks could also have been expected to have highlighted the consequences of failure of the Governments to exercise due procedure in their external financial transactions; and there is no empirical evidence to indicate that these Banks did that.5

It may very well be that the recent uneasiness of politicians with central bank governors reflects an unfortunate but episodic clash of personalities and that things will return to normal very soon. Yet we cannot dismiss the critics like Rampersaud when they ask, Where were the central banks when the fiscal deficits were widening; when the currencies were depreciating; when the foreign debts were piling up? To these I will add another question: What institutional changes must we put in train to ensure that central banks are more effective in the future?

The first section of this paper recapitulates our experience with central banking in the Caribbean. Secondly, we develop a comparative model of central banking. In so doing we shall identify three basic types of central banks. These types will be defined in respect of their location at the centre and the two extremes of a continuum registering the extent of the central bank's independence of

the Administration in power. We shall then use this model as a reference for identifying the Caribbean central bank type. Fourth, we shall assess the appropriateness of the existing central banks to our political, economic, social and cultural circumstances. Finally, we shall make suggestions on future directions for central banking in the Caribbean.

The Caribbean Experience with Central Banking

The term "experience" in the heading of this section is used most advisedly. This section does not seek to appraise the monetary policies of regional central banks - that is a task for scholars in the Monetary Studies Programme. Nor does it attempt to evaluate their performance as organizations - although the heavy reliance of governments on their technical and administrative expertise, if not always on their policy advice, suggests that central banks have generally outperformed other government units in respect of organizational efficiency; if anything, Governments have tended to overload them with responsibilities. Rather we seek in this section to identify the respects in which central banking has made a significant difference, for better or for worse, to economic outcomes in the Caribbean. What has been our experience with this alien institution introduced into our region less than thirty years ago?

Central banking came first to the Caricom Caribbean in 1961 when the Bank of Jamaica opened its doors to business. By the end of the decade the Central Bank of Trinidad and Tobago (1964) and the Bank of Guyana (1965) had been established. The Central Bank of Barbados (1972) and the Central Bank of the Bahamas (1974) followed in the 1970's. It was not until the 1980's that the Central Bank of Belize (1982) and the East Caribbean Central Bank (1983) were set up.

Central banks are much more elaborate institutions than the passive currency boards they replaced. They act as banker to the Government and to the banking system; they manage the country's foreign exchange reserves and the national debt; they administer the Exchange Control regulations and advise Government on economic and financial matters. However, the crucial respect in which central banks differ from their predecessors is in their discretionary powers of money creation. The balance sheet of a central bank is infinitely liquid within its national boundaries. It can theoretically purchase all the assets in the national economy. However, and this is too frequently forgotten by the political directorate, they cannot create a single unit of foreign exchange.

This peculiar attribute of a central bank - the infinite liquidity of its balance sheet - makes it a fearsome two-edged sword, to be wielded with both skill and restraint. If properly used, it enables the monetary authorities to significantly improve financial

operations in the economy. The constant danger is that the Administration in power, either in the mistaken view of the developmental advantages of deficit financing, or in pursuit of short-term political advantage, will pressure the central bank into financing its fiscal deficits. The excessive money creation, in turn, will quickly lead to domestic inflation and eventually to the erosion of the external value of the currency. As John Maynard Keynes observed, there is no more certain means of destroying a society than "the debauchment of the currency." More recently Professor Walter Eltis would conclude that "the ultimate effect of the ... deficit-financed expansion is to destroy the balance of payments."6

The Acts establishing Caricom central banks vary in their language but they generally convey five basic purposes:

1. the preservation of the internal value of the currency;
2. the preservation of the external value of the currency;
3. the promotion of economic development;
4. the promotion of a healthy financial system;
5. the development of capital markets.

We may determine the impact of central banks on their respective societies by the extent to which these purposes have been achieved. It will be much easier to identify the negative consequences of central bank activity than the positive contributions. The important consideration is whether the outcomes, positive or negative, are

different from what they would have been under the old currency board system.

The central bank's regulation of money creation is most critical to the preservation of the internal value of the currency. Other things being equal, an increase in money (credit) in excess of productivity gains will result in inflation, thus eroding the internal value of the currency. In small open economies, like those in the region, inflationary pressures will spill over into imports and, if not brought under control, result in a balance of payments disequilibrium which will be corrected either by a formal devaluation or a de facto devaluation manifested by goods and foreign exchange shortages, and by widespread black market operations. For our open Caribbean economies the internal and the external value of the currency are really sides of the same coin.

Up to the mid-1970's the operations of Caribbean central banks produced outcomes not unlike those which would have resulted from currency board operations. Indeed, central banking operations in some countries have changed little since then. The Central Bank of Belize is still in transition from its currency board stage. The East Caribbean Central Bank, for reasons mentioned below, operates very much as if it were a currency board. The Bahamian authorities, too, have identified one-to-one parity of the Bahamian dollar with the U.S. dollar as a parameter of their economic system, and have quite sensibly

designed their economic policies around this motif. This strategy calls for tight control over fiscal deficits and the restraint of consumer credit in their remarkably open economy. The healthy foreign assets ratio of these three central banks, as well as the quite low rates of inflation recorded in their respective countries, reflect the limited use of the money creating powers of their central banks.

The Barbadian authorities exhibited considerable restraint throughout the 1970's with respect to the money creation powers of their central bank. Indeed, there were times in 1978 and 1979 when the amount of government debt held by the central bank was negligible. There was a fall from grace in 1981 when credit outstanding to Government rose by 50 per cent and advances to private financial institutions doubled, but this pattern was reversed by adherence to the conditionalities of the 1982-4 eighteen month Stand-by Agreement with the International Monetary Fund.

For the remainder of the eighties increases in national expenditures in excess of national output were sustained mostly by heavy foreign borrowing. Barbados' foreign debt outstanding rose from just over $US 80 million in 1980 to over US$350 million at the end of 1987, while central bank claims on Government and advances to financial institutions have stabilized below the 1984-5 levels. With the dramatic decline in visible exports since 1984 and only a moderate expansion in tourist arrivals, the preservation of the external value

of the Barbadian currency now rests squarely on the nation's international credit worthiness. Fortunately it remains quite sound.

Similarly, the Trinidad and Tobago Authorities cannot be accused of abusing the money creation powers of its central bank. During the oil-boom years, there was no need to. In fact, Government ran tremendous fiscal surpluses and massive foreign exchange reserves accumulated in the central bank.

The recent balance of payments problems resulting in two successive devaluations of the Trinidad and Tobago dollar rather reflected the collapse of oil prices in the mid-1980's which resulted in the sharp decline in government revenues, and forced the Government to draw down its surpluses. Failure to effect a proportionate reduction in government expenditures led to the swift erosion of an apparently impregnable foreign exchange position.

The cases of Guyana and Jamaica are quite different. In 1975 both Governments, motivated by socialist ideology, embarked on massive programmes of fiscal expansion which were financed primarily by central bank credit. Government borrowing from the Bank of Jamaica rose from J$76.8 million at December 31, 1975 to J$435.8 million by the end of 1977. Bank of Guyana claims on the Government on the comparable dates were G$44.5 million and G$346 million. Both countries were forced to borrow heavily abroad when their foreign exchange reserves were exhausted. Guyana, with an external debt of over US$1.2 billion,

has defaulted on all her foreign loans. Jamaica has rescheduled an average of US$230 million each year since 1981 and now has foreign liabilities of US$3.5 billion. Neither economy has yet recovered from the initial toxic injection of new money in 1975.

As a result, both the internal and the external value of the two currencies have been severely eroded. The World Bank gives an annual rate of inflation of 10.2% for Guyana and 19.8% for Jamaica over the period 1980-6. The Guyanese rate obviously reflects only prices of public sector goods and not those in the informal economy, estimated by some economists to be almost equal in size to the formal economy. The erosion of the external value of their currencies is even more dramatic. The Jamaican currency, valued at J$1.00 = US$1.10 in 1975, now trades at J$5.50 = US$1.00. The Guyanese dollar, worth about 40 US cents in 1975, is now worth ten US cents officially, five US cents at the "open window" and between two and three US cents on the black market. It was the availability of central bank financing which seduced these governments down such alluring but disastrous policy paths.

It is empirically observable that those countries which made excessive use of central bank credit grew more slowly than those which did not. The Jamaican GDP declined at an annual average rate of 2.5% over the period 1973-1985, while Guyana's GDP recorded an annual average rate of negative 1.2% All other countries in the region experienced

positive growth rates ranging from 1% - 3% per annum over the same period. Of the countries which did experience growth, only in Barbados did the Central Bank consciously attempt the allocation of credit to the productive sectors of the economy. It is impossible to determine whether such policies contributed significantly to economic development. However, we can state with considerable confidence that an environment of relative price and currency stability is more conducive to growth than is inflation, repeated devaluations and crushing debt service obligations.

The inflation and currency devaluation deriving from excessive money creation certainly militated against orderly financial operations and the development of capital markets, and stimulated a massive flight of both human and financial capital. In Guyana and Jamaica the foreign exchange markets virtually collapsed. In Guyana tremendous liquidity built up in the commercial banking system for which few investment opportunities could be found, and the nation has actually been dissaving. In Jamaica, the indigenous financial structures so patiently nurtured during the early life of the Bank of Jamaica have just about survived, although there were some financial failures. In Trinidad and Tobago, the sharp fall-off in national expenditures precipitated a number of liquidations in the non-banking sector. In both Jamaica and Trinidad and Tobago, the Bank Supervision Departments of the Central Bank were a welcome force for stability.

The older central banks, i.e. those more than ten years old, have all taken extensive measures to develop capital markets in their economies. The lone exception is Guyana, where the miniaturization or nationalization of foreign financial institutions became the declared government policy. In Jamaica, Barbados, and Trinidad and Tobago, the central banks stimulated the treasury bill market, were prominent in the establishment of stock markets, and promoted various specialized financial activities. The three youngest central banks have all now set up programmes for the extension of capital markets. An export credit insurance scheme is already operating under the aegis of the East Caribbean Central Bank.

A Comparative Model of Central Banking

We can identify three basic types of central banks. These may be seen in terms of their location on a continuum ranging from virtual independence of the Administration in power to supine accommodation to government policy.

The Bank of England, the archetype of central banks, would occupy the centre-point on the continuum registering independence from the Administration in power. The Old Lady of Threadneedle Street was once a law unto herself. Since its nationalization in 1948 the Bank

of England is now viewed as "independent within the framework of government policy". That is, although required to treat government policy as a parameter within which it must operate, it is expected to arrive independently at its conclusions on financial and economic matters and so provide the Administration with a <u>second opinion.</u>

The present Governor, Mr. Robin Leigh-Pemberton, describes the Bank's relationship with Government in the following terms:

> If you have a Treasury that is hellbent on an inflationary programme, I think a central bank has to do its best to reduce the implementation of that policy, to limit as far as possible the damage it does, to advise, to dissuade if possible, to do almost anything except obstruct. I don't think one can obstruct a democratically elected government. If the government decides to go ahead, you have the alternative of executing its policy or resigning.7

This concept of the central bank thus contemplates the possibility of disagreement between the Bank and the Government and, indeed, the possibility that the existence of disagreement may become transparent to the public. But it is expected that the "fighting" will take place between the Governor and the Minister. In this context the political views of the Governor or the Minister are, quite irrelevant; what is important is the cogency of the Governor's argument and his skill in putting it across. The Bank of England, then, is viewed as "not only apolitical, but above politics", to borrow the expression once publicly used by the late Tom Adams to describe the Central Bank of Barbados.

In the more mature societies, debate deriving from a difference of opinion is regarded as essential to the development of sound policy. Mr. Duisenburg, Governor of the Bank of the Netherlands and himself a former Minister of Finance, once described to me his relationship with Dr. Zilstra, former Governor of the Bank of the Netherlands. As Minister of Finance, he met and fought with Zilstra over policy issues once a week for the last two years of Zilstra's first term of office. He re-appointed Zilstra to a second term and resumed his weekly battles until he himself was voted out of office some years later.

West Germany's central bank probably occupies the position farthest to the right on the continuum of independence. The Bundesbank not only offers Government a second opinion, but may actively seek to obstruct an Administration apparently bent on a path of financial and economic disaster. Although no doubt preferring discreet discussion, the President of the Bundesbank would not hesitate to ventilate in public an opinion contrary to that of the Administration. This remarkable independence of the Bundesbank stems from the fear of inflation so deeply etched in the German psyche by their experience of the bizarre hyper-inflations of the 1920's and 1940's. So rapid were price increases in 1923 that workers were sometimes paid twice a day. Their wives took the morning's wages straight to the

market in the certain knowledge that goods would cost much more by nightfall. Farmers paid off their mortgages with a bag of potatoes; life insurance policies matured and could hardly buy a handkerchief.

So determined are the Germans that this nightmare should never recur that they have entrenched the independence of the Bundesbank in the constitution. It is the Bundesbank, independently of the Minister of Finance, which is charged under the constitution of the Federal Republic of Germany with the preservation of the internal and external value of the currency. Appointed for eight years, the President cannot be removed by the Chancellor. The majority of the Directors represent Federal units and are independent of the Administration. It is not surprising then that the rate of inflation commonly remains much lower in West Germany than in any other industrialised country.

During one of his two visits to Barbados the late Dr. Emminger, former President of the Bundesbank, recalled once telling the German Trade Unions that they were free to demand any rate of wage increase they wished. However, should their demands be excessive, the Bundesbank would certainly not expand the money supply at the rate required to validate those increases and they could confidently expect large numbers of their members to become unemployed. The unions took him at his word! Right now Dr. Poehl, Dr. Emminger's successor, is

at loggerheads with the Chancellor over the proposed European Central Bank. He is concerned that the proposed institution might lack the independence of the Bundesbank and could become a tool of profligate governments.

The U.S. Federal Reserve System stands somewhere between the Bank of England and the Bundesbank on the independence continuum. Federal Reserve Governors are appointed by the President for 14 years certain and the Chairman for 4 years certain. The operational autonomy of the institution is not challenged, but its independence is in the gift of the Congress and is not enshrined in the constitution. The President and the Congress, acting together, could clip the wings of a Federal Reserve Board which threatened to become an independent republic.

Dr. Arthur Burns, Chairman of the Federal Reserve System during the Nixon years, apologised for the Fed's inability to halt inflation during his term of office:

> My conclusion is that it is illusory to expect central banks to put an end to the inflation that now afflicts the industrial democracies does not mean that central banks are incapable of stabilizing actions; it simply means that their practical capacity for curbing an inflation that is continually driven by political forces is very limited.8

Mr. Paul Volcker certainly did not accept this view of the Fed's abilities. He instituted such a tight monetary policy that inflation was squeezed out of the American economy in a few short

years, and he made no apology for the recession of 1981-2, the deepest since the great depression of the 1930's. Indeed, Mr. Volcker frequently found himself at odds with the Reagan Administration, complaining all the while about that Administration's widening fiscal and trade deficits. This did not stop Mr. Reagan from reappointing him to a second term, and offering him a third. Volcker declined, allegedly because the President didn't beg him hard enough to stay.

The Bank of Italy would occupy a position on the continuum quite close to the U.S. Federal Reserve System. Its President is appointed for life - like Supreme Court Justices in the U.S.A. The Economist has this to say of that institution:

> .....however ineffective governments may be in Italy, the Bank of Italy remains staunchly independent and highly respected. The central bank has thereby helped to maintain investors' confidence. Governors are appointed for life and so are free from political retribution. There have been 47 governments since the war, but only five governors. Mr. Carlo Ciampi, the present governor, is certainly not afraid of publicly criticising the government's budgetary policy.
>
> The Bank's autonomy from the Treasury was strengthened in the early 1980's. In the 1970's the Bank of Italy was obliged to buy up any debt that remained unsold in the public auctions, thus inflating the money supply. In 1981 the Bank was freed from this obligation, breaking the link between the deficit and monetary creation.9

At the opposite end of the continuum we find those central banks which serve as the passive instruments of irresponsible government fiscal policy. They are geographically located mostly in Africa and Latin America. They serve as mechanisms for the

monetization of massive deficits which have fuelled chronic and spiraling inflations, precipitated massive and frequent devaluations, and have plunged their societies into political chaos. Such central banks are totally politicized and bereft of professional integrity. Governors who venture a second, or any opinion at all, are dismissed and, in one or two tragic instances, assassinated. That is why I warned the Barbados public on my departure from office that a politicized central bank was worse than no central bank at all.

Ironically enough, it is central banks in the highly socialist countries which have pursued the most conservative monetary policies. Since their banking systems are monolithic, with the central bank at the apex, the expansion of commercial bank credit can be rigorously controlled from the centre. Furthermore, communist governments have traditionally balanced their budgets so that the central bank was seldom called upon to monetize runaway fiscal deficits. On a visit to Moscow in 1979, I complained to the Vice President of the Gosbank, the Russian central bank, about my Government's propensity to incur deficits. "You can't have that", he replied sternly. I am afraid, however, that bad capitalist habits are beginning to rub off on the Communists. Both China and the Soviet Union now report central bank financed deficits and accelerating inflation.

> once, twice and thrice. But if having done this, the Prime Minister says, "I have heard you and understand you, but the Government does not agree," he must then see how best the government's decision can be carried out.10

The vagaries of Caribbean politics have exerted continuous pressures which have shifted central banks down stream from their central position on the continuum. Indeed, the central banks in Guyana and Jamaica have drifted dangerously near the wrong extreme of the continuum. Hopefully, these trends will soon be reversed. In Barbados, the Barrow Administration, returning to power in 1986, fired what appeared to be opening salvoes against the autonomy of the central bank. In Port-of-Spain the incoming Prime Minister made similar moves, inducing the early departure of the Governor.

Rampersaud's contention that in the Caribbean context the central bank "is, and is expected to be, independent of the Government" and that both "the laws and the conventions require it to be so" must be rejected. In my judgement, Brown's model represents the convention observed both by Governors and politicians in the region. Certainly neither Dr. Eric Williams, Mr. Forbes Burnham nor Mr. Errol Barrow, nor any other West Indian Prime Minister has ever regarded the central bank as independent of the Government.

The legislation, and certainly the practice, also supports the principle that the central bank is subordinate to the Administration in power. In Barbados the Governor and Directors serve at the

The Caribbean Model of Central Banking

The Bank of Jamaica, the first Caribbean Central Bank, was cast faithfully in the Bank of England mould. Indeed, its first two governors were both seconded from the Bank of England and served for a combined period of seven years. The model which they established was accepted both by their successors and the political directorate. In his address to the seminar marking the 10th Anniversary of the Central Bank of Barbados, Mr. G. Arthur Brown articulated his theory of central banking in terms to which Mr. Leigh-Pemberton could take no exception:

> The first principle to state is that the Central Bank, its Governor and staff exist within the context of a social structure which, in the case of the Caribbean has indicated the broad areas of government policy and economic organization through the electoral system. No central bank can arrogate to itself the direction nor the elaboration of policies out of harmony with the mandate of the government in power... Many critics of central banking policy in the Caribbean appear at times to assume that these banks should have their own economic and foreign policy. A word which is pejorative but aptly describes what these critics advocated, is sabotage.

Brown then went on to spell out his understanding of the Governor's relationship with the Administration in power:

> By his training, knowledge and experience, he must show the consequences of various courses of action. He must be free to propose alternatives and spell out the consequences. In operating in this area, the highest standards of discretion and secrecy must obviously be observed. The Governor cannot resort to writing letters to the press or making speeches against some government policies. His obligation is to tender advice forcefully but objectively. Like the auctioneer, he will advise

discretion of the Minister of Finance and not, as in other Caribbean States, on good behaviour. In Belize, Jamaica and The Bahamas appointments of officers earning more than a certain annual salary must be approved by the Minister of Finance. In Barbados interest rate and credit policy decisions require, by law, the concurrence of the Minister of Finance. Changes in exchange rate parities are certainly outside the powers of any regional central bank. In Jamaica, the access of Government to unlimited central bank credit is assured. Section 37, Part Vl of the Bank of Jamaica Act (as amended 10/1977 5.8) states:

> The Bank shall not in any financial year purchase or otherwise acquire securities issued or guaranteed by the Government of a nominal value exceeding 40 per centum, *or such percentage as the House of Representatives may from time to time by resolution approve.* (Italics are mine.)

Section 49, Part lX of the Central Bank of Barbados Act makes specific provisions for the Government to assume responsibility for monetary policy.

Nor is Rampersaud justified in assuming that central banks failed to advise vigorously against the detrimental policy measures of the political directorate. The conventions which they observed did not permit public opposition and certainly not obstructionism. To my certain knowledge every Caribbean Governor has pointed out the pitfalls of excessive deficit financing to their Ministers. Most conspicuous

was The Report of the Committee to Review Government Expenditure, chaired by Dr. Euric Bobb, then Deputy Governor of the Central Bank, which was submitted in October 1978 to the Trinidad and Tobago Government. The Report strongly recommended a reduction in government expenditures but was not taken as seriously as was warranted.

Even if we reject Rampersaud's charges against the directors of central banks, we can still share his concern about institutional arrangements which have created such havoc in some Caribbean economies through excessive monetary expansion. Indeed, Shadow Minister of Finance, Dr. Richard Haynes, in quite justified criticism of the 1981 Adams election budget, did suggest that constitutional changes be made to entrench the independence of the Central Bank of Barbados:

> I believe strongly that we need to look at the Constitution again, that we need to look at the Central Bank Act and we need to make it a criminal offense for that kind of monetary expansion to take place in Barbados in response to political needs.11

The fact is that, unlike cricket but like most other British cultural exports, the institution of central banking did not travel well to the Caribbean. The Bank of England model of "independence within the Government" is riddled with contradictions which are

resolvable only through the observance of subtle conventions evolving over centuries and for which the British have a special genius. Mrs. Margaret Thatcher's disenchantment with Gordon Richardson during the last four years of his tenure as Governor was no secret to those in the know, but on no occasion did she express her feelings in public. He was made a Life Peer on his retirement from the Bank. In the Caribbean, personal attacks by politicians on Governors are now quite commonplace. Indeed, the paradoxical relationship between Governor and Minister embedded in our prevailing central bank model is beautifully captured in the late Prime Minister Barrow's argument from the floor of Parliament. "Either the Governor advised the former Administration rightly and his advice was ignored, in which case he should resign; or he advised them wrongly, in which case he should resign."12

Another difficulty stems from the small size and unsophistication of our communities. In the Bank of England model the Governor depends on his experience, technical experience and skill to persuade the Minister of Finance. To do so, he must develop a personal relationship with him. The public in the small Caribbean states do not, and some politicians pretend not to understand how a professional public servant can serve an Administration for several years without becoming a political ally. The Governor and the Directors of the Central Bank, as well as the top professional managers of statutory corporations, are now confidently expected to be removed on every

change of Administration. It is feared that they will sabotage the incoming Government! For this the society pays a heavy price in the loss of continuity and the erosion of the morale of the Bank.

Some years ago in Vienna, Dr. Koren revealed to me that he was actually Leader of the Opposition when he was invited to become Governor of the Bank of Austria. The Administration never considered for one moment that Dr. Koren would sabotage their policies while in office. His party affiliation is viewed as irrelevant to the execution of his gubernatorial duties. This is an example which we in the Caribbean should mark and inwardly digest.

Perhaps the most important difference between the central bank environments of the U.K. and the Caribbean is one of institutional and economic vulnerability. There are in the U.K. and other mature societies, many more institutional constraints on the adventurism of governments. As Rampersaud observes in another context,

> ...we in the Caribbean have not had adequate time to entrench certain conventions which operate as surrogates for formal machinery.13

Where excessive money creation in the U.K. might lead to an inconvenient fall in the value of sterling on the foreign exchange market, it may produce, as we have seen, disaster in a Caribbean state. Prevention is the only cure for a balance of payments crisis in small open economies. It is a paradox that the restraining powers of central banks on governments need to be stronger in the small Caribbean states than in mature and wealthy societies.

Whither Caribbean Central Banking?

If we agree that the existing central banking arrangements have not served us well, what kind of a central bank do we need in our current economic, social and cultural circumstances? We should certainly take steps to reverse the drift of our central banks towards that region of the continuum populated by central banks of countries with double- and sometimes triple-digit monthly inflation rates. Yet it would be asking too much of our political directorate to create central banks with the independence of the U.S. Federal Reserve System, not to speak of the Bundesbank! However, with a few amendments to the existing legislation, the efficacy of our existing central banks could be greatly improved and the probability of monetary excesses considerably reduced. Nevertheless, we should be mindful, as The Economist warns, that "no central bank can be sure that it will not be outflanked by politicians."14

Four minimum reforms are required if we are to suppress the intrinsic tendency of our central banks to drift towards the wrong end of the independence continuum. First, the tenure of the Central Bank directorate must be rendered more secure. The governor and directors should serve on good behaviour, the governor for at least seven years certain, and the directors for five years certain, with one director retiring each year.

Secondly, the operations of the Central Bank should be made truly autonomous. The Ministerial veto of appointments other than those of directors, governor and deputy governors should be discontinued.

Third, the central bank, as in the U.S.A., should be made responsible to Parliament rather than to the Minister of Finance, thus ensuring that the viewpoint of the Central Bank is at all times known to the public. In this way the relationship between the Bank and the Government would be institutionalised and the Governor could conduct his business with the Minister in a more formal manner. He would thus feel free to disagree with the Minister publicly. As in the United States, the Governor would periodically appear before the relevant Parliamentary Committee to report on the national finances.

Fourth, the powers of the Administration to resort to central bank financing should be more rigorously circumscribed - ideally by entrenchment in the constitution. The limits on advances to the treasury, and on treasury bills and other public sector bonds held by the central bank should be precisely specified.

Let me anticipate the inevitable objection - that democratic principles require the representatives of the sovereign people to exercise ultimate control over economic affairs. But as Karl Popper has reminded us, "...Nowhere do the people actually rule. It is governments that rule."15 He replaces the question "Who should rule?"

with "How best can we avoid situations in which a bad ruler causes too much harm?" There are few worse things a government can do in a developing country than to precipitate a collapse of the balance of payments. "Hell", I have always maintained, "is when a country has exhausted its foreign exchange reserves." The Constitution of the U.S.A. is based on the premise that democratic election does not confer infallibility on Administrations and that well designed checks and balances are required to minimize their excesses.

In fact, there is a strident school of economists, headed by Nobel Laureate Milton Friedman, who argue for rules which would limit through a constitutional amendment the discretionary powers both of Ministers and central banks to create new money.16 The Economist agrees:

> Depriving governments of the use of the printing press to finance their budget deficits would indeed remove an element of national economic autonomy; but since finance ministries almost always abuse the power to create money, that is entirely desirable. In any case, ample economic sovereignty would remain, and in a somewhat less risky form.17

But there is a neater solution - if we could discover an arrangement which removes from Caribbean governments both the temptation and the option of runaway fiscal deficits, loose monetary policies, and unwarranted wage settlements. Actually the model is right before our very eyes in the example of the East Caribbean Central Bank. The distribution of political control over the East Caribbean

Central Bank among seven governments produces a system of automatic checks and balances within the O.E.C.S. No individual government possesses the licence to monetize its deficits through the Central Bank, and all are forced to conduct their financial, fiscal and incomes policies within the iron constraints of their national income and any available foreign loans and grants. At the same time they may exert discretionary powers through unanimous agreement. It is not accidental that the peoples of the organization of East Caribbean States have been shielded from the devastating reductions in their living standards experienced in the more richly endowed Jamaica and Guyana and that their performance in the area of economic growth, price and currency stability has matched that of other Caricom states.

In short, we need a Federal Reserve System of the Caribbean. The reserves of existing central banks would be pooled: a common currency would be used and a common monetary policy would be pursued. All Governors would come together as a Board and the chairmanship rotated among them every year or two. The establishment of a Caribbean Reserve System could be the centre-piece of any movement towards regional economic integration - the only viable solution to states as small as ours.

In closing, let me say how fitting it is that I should have delivered this paper in Port-of-Spain, the arena of my closest friend in financial circles, the late Victor Bruce, himself a most distinguished central banker and a champion of the independence of central banks.

Courtney N. Blackman
November 11 1988

NOTES

1. Best, Lloyd and McIntyre, Alister, "A First Appraisal of Monetary Management in Jamaica", Social and Economic Studies, Vol.3, September 1961.

2. Blackman, Courtney N., "Central Banking in a Dependent Economy: The Jamaican Experience, 1961-1967", Ph.D. Dissertation, Columbia University, 1969.

3. Thomas, Clive Y., The Structure, Performance and Prospects of Central Banking in the Caribbean, I.S.E.R., University of the West Indies, Jamaica, 1972.

4. Ibid, p.58.

5. Rampersaud, Frank, "Economic Policy Formulation and Implementation in the Caribbean", Lecture delivered to Central Bank Trainees at Central Bank of Trinidad and Tobago, May 31 1988, Unpublished Mimeograph.

6. Eltis, Walter, "The Failure of Keynesian Conventional Wisdom", Lloyds Bank Review, October 1976, No. 122, p.5.

7. As quoted by Fay, Stephen, Portrait of an Old Lady, New York, Viking-Penguin, Inc., 1987, p.177.

8. Burns, Arthur, "The Anguish of Central Banking", International Monetary Fund Per Jacobsson Lecture, 1981.

9. The Economist, February 27 - March 4 1988, "A Survey of the Italian Economy", p.10

10. Brown, G. Arthur, "Central Banking in the Caribbean", The First Decade, Central Bank of Barbados, Bridgetown, 1983.

11. Hansard, Official Gazette, Bridgetown, Barbados, March 14 1983.

12. Hansard, Official Gazette, Bridgetown, Barbados, July 1986.

13. Op.cit.

14. The Economist, June 11-17 1988, p.18.

15. Popper, Sir Karl, "The Open Society and its Enemies Revisited", The Economist, April 23 1988, p.20.

16. The Search for Stable Money, eds. Dorn, James A. and Schwartz, Anna J., University of Chicago Press, 1987.

17. The Economist, June 25 - July 1 1988, p.12.