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*FOREIGN CAPITAL FLOWS IN
TRINIDAD AND TOBAGO:
EXPERIENCE, MACROECONOMIC IMPACTS,
AND POLICY RESPONSES*

by

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FOREIGN CAPITAL FLOWS IN TRINIDAD AND TOBAGO :

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Arjoon Harripaul*

I. Introduction

In recent years, there has been a surge of international capital flows to many developing countries. For a number of these countries this has served to relieve some of the problems associated with limited capital resources and a deficiency in foreign exchange. Calvo et al (1994) estimate that about US \$670 billion of foreign capital has flowed to developing countries during 1990-94, almost five times the US \$133 billion of the previous five years. For many of the world's emerging markets, private flows have become the major source of external financing, and account for three-quarters of all long-term resource flows. The developing economies of the Asia-Pacific Economic Cooperation Council (APEC) have been the recipients of a considerable volume of capital inflows in the 1990s. For example, in 1993 capital inflows to the APEC countries accounted for about 85 per cent of the capital that went to developing economies. During 1990-93, developing economies in Asia received a net capital inflow of US \$151 billion, more than double the amount recorded for the previous four years. Latin America and the Caribbean, have also been attracting large amounts of foreign capital during the present decade accounting for about 25 per cent of flows into developing countries in 1996. Most of the foreign direct investment

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(FDI) flows to CARICOM have gone into Trinidad and Tobago, which received over 60 per cent of the flows into the region during 1990-96, and Jamaica which received over 20 per cent of the flows in 1995.

These developments represent a major turning point from the previous decade, when, because of the debt crisis, little capital flowed to most developing countries. The debt crisis of 1982 was precipitated by a swift decline in capital inflows at a time when highly indebted developing countries were facing a slowdown of the world economy, a large increase in international interest rates, and a sharp loss in terms of trade. Capital flight, weak economic policies and institutions in many developing countries exacerbated the effects of these shocks. During the decade following the initial shock, most of these countries set about adjusting their policies and institutions to the new situation of severely restricted external financing. For the first few years after the debt crisis, most lending to these countries took the form of official loans from international financial institutions to support the reforms necessary to achieve sustainable balance of payments and at the same time laying the foundations for economic growth. However, the recent flow of capital has been of a much different composition than the 1970s spate of financing which preceded the debt crisis. Whereas the earlier flows were dominated by loans from large commercial banks, the new round of financing has a much higher content of portfolio equity, bonds and FDI. Therefore, in addition to relaxing the severe financial constraint the new wave of capital has the added advantage in that the flows are going to the private sector and are predominantly in the form of equity capital rather than debt financing.

II. The Theoretical Framework

Definition

Total international capital flows include both private capital flows and official or government capital flows. *Private capital flows* are composed of four elements. Portfolio investment is made by foreign investors in the stocks or bonds issued by developing countries. Direct investment is made by foreign investors in an enterprise in the developing country and is usually accompanied by the active participation of the foreign investor in the operations of the enterprise. Commercial bank loans to developing countries provide export credits or cash loans. Private grants are made by private charitable organizations in the form of financial aid, goods and services provided to the developing countries. *Official capital flows* come from two sources : governments and international financial institutions. Official capital flows from governments are referred to as bilateral loans and grants. Official capital flows from the international financial institutions, like the International Monetary Fund (IMF) and World Bank, are referred to as multilateral loans and grants.

This section seeks to find an appropriate theoretical framework for analyzing capital inflows in a small developing country. Standard neoclassical theory suggests that capital flows to developing countries have its impact on both the macro and the micro economy. On the micro level most economies experience a boom in bank lending as well as expansion in certain sectors following huge capital inflows. However, because of data constraints no attempt will be made to model the micro

issues. As far as the macro economy is concerned, internal as well as external variables can be affected.

Perhaps the most applicable model for Trinidad and Tobago is the one adopted by Frankel (1994) which makes use of a standard textbook example of an open economy model under conditions of less than perfect capital mobility. We will look at the question of the ability of various policy measures to achieve internal and external balance with imperfect capital mobility.

Consequences of Capital Inflows under conditions of Imperfect Capital Mobility¹

The scenario of perfect capital mobility is rarely observed. For most countries and time periods, the degree of capital mobility is intermediate. Investors do respond to international changes in interest rates by altering the compositions of their portfolios. However, the responses may not be instantaneous, many investors may prefer assets denominated in certain currencies, and government policies may partially restrict mobility. Capital mobility may also be less than perfect due to transactions costs, default risk, foreign exchange risk, or perceived risk of future capital controls. This case is probably the more realistic one for most newly industrializing countries, despite financial liberalization. The imperfect capital-mobility case provides the correct framework of analysis for an economy like Trinidad and Tobago that does not play a dominant role in international financial markets, does not have a well-

¹The analysis extending the standard IS-LM model to the open economy under perfect capital mobility has a special name, the Mundell-Fleming model. Mundell and Fleming developed the analysis in the 1960s, well before flexible exchange rates came into existence.

established domestic capital market and where macroeconomic policies do not affect world interest rates.

When capital is imperfectly mobile, a question arises concerning the relative slopes of the LM and BP curves. The BP curve is now an upward-sloping relation between income and the interest rate. An increase in income draws in imports; if the overall balance of payments is to be zero, the interest rate must rise to attract capital to offset the deficit on the current account. The more mobile capital is, (that is, the more sensitive capital flows are to the interest rate) the smaller the required rise in the interest rate and the flatter the BP curve. We will examine the case in which the BP curve is flatter than the LM curve, that of fairly high capital mobility.

We now consider four possible sources of a reserve inflow. Firstly, the exogenous fall in world interest rates. At point S in figure 1, Panel A, the reserve inflow is sterilized. As long as the central bank is prepared to sell bonds to sterilize the inflow, the interest rate is kept above the world level. Eventually, the authorities would have to let the money supply increase. When this happens the economy begins to move to the right until it reaches point M. If the central bank chooses to let the currency appreciate, the outcome is A. As would be expected, the increase in demand for domestic bonds lowers the domestic interest rate, regardless of the degree to which the authorities respond by allowing the currency value or money supply to increase.

Figure 1, Panel B, illustrates the case of an improvement in the trade balance perhaps due to an exogenous commodity boom or a real devaluation. An

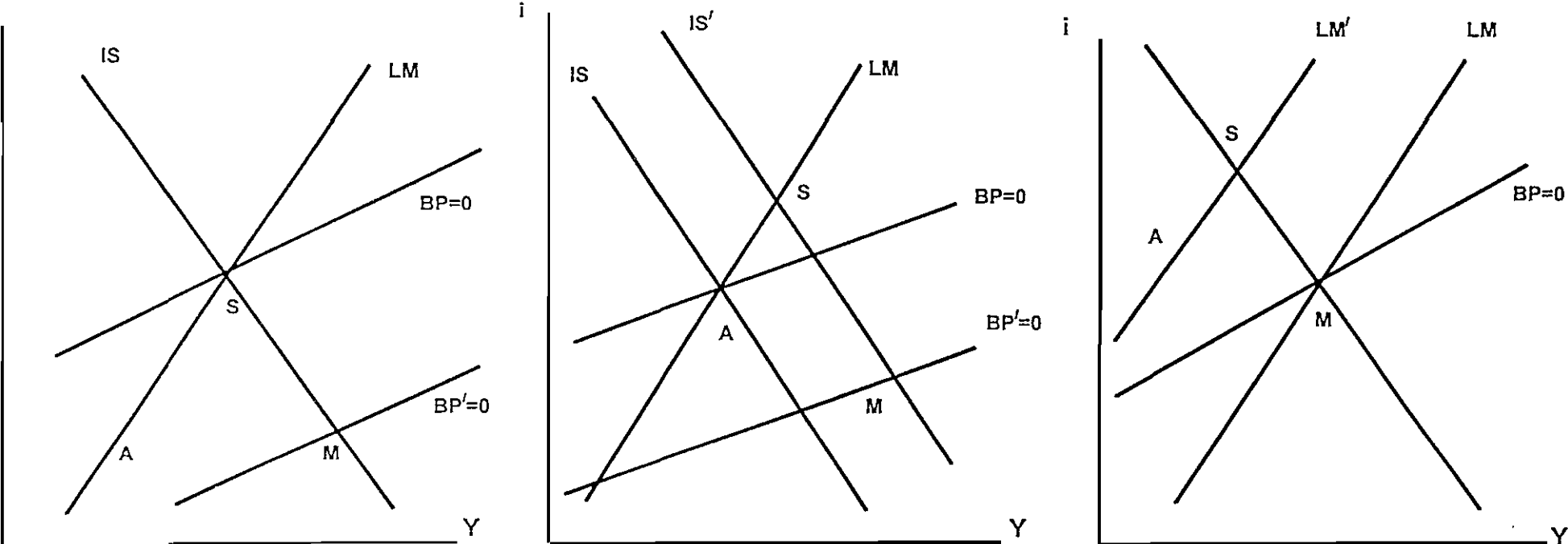
improvement in the trade balance shifts the IS curve to the right, putting upward pressure on the interest rate and therefore on the capital account. If the exchange rate is fixed, sterilization can succeed in holding the interest rate up at point S for a while, although allowing full accommodation to the increase in demand for domestic output will eventually move the economy toward M. However, if the central bank wishes to keep the money supply fixed and abandon the exchange rate peg, the currency appreciates far enough to return the trade balance, the IS curve, and income to equilibrium at their starting points at A. Like the first case, the real appreciation can be engendered through a nominal appreciation or through higher inflation. (The attempt to devalue, if that is what shifted the IS curve outward in the first place, is not successful).

The third experiment, a deliberate contractionary monetary policy to fight inflation moves us to point S in Figure 1, Panel C. Because capital mobility is merely high, but not perfect, sterilization of the inflow so as to remain at point S for a while is a viable option. As long as the central bank continues to sterilize, it can maintain the interest rate at the higher level. If it chooses to stop the sterilization, money will flow in through the balance of payments and the economy will move down the IS curve toward the starting point M. If the central bank chooses to abandon the exchange rate peg, the currency appreciates, rendering producers less competitive on world markets and reducing net exports. The result is to shift both the IS curve and the BP curve to the left, until all three curves intersect at point A.

The final experiment, the increase in demand for money, is examined under conditions of imperfect capital mobility in Figure 1, Panel C. The sterilization point S entails needlessly high interest rates and a contraction of economic activity. It is better in the circumstances not to attempt sterilization, but rather let the money that residents want to hold gradually flow in so as to return the economy to M. It would be better still to increase domestic credit deliberately to return the economy to its starting point right away.

Although the simple open economy model is limited in a number of respects, it does suggest that a surge in capital inflows is likely to be accompanied by a rise in consumption and investment, an increase in real money balances and foreign exchange reserves, a real exchange rate appreciation, and a widening of the current account deficit. Including other assets into the model is likely to indicate that new inflows would be associated with higher equity and real estate prices. This very simple framework suggests that sterilization is not necessarily a better solution, and when implemented it is only under very particular conditions that the result is an increase in domestic interest rates.

Figure 1. The Effects of a Capital Inflow : Imperfect Capital Mobility



Panel A
Fall in Foreign Interest Rate

Panel B
Increase in Exports

Panel C
Monetary Disturbance

III. Capital Flows: A Review of the Literature

Causes of the Capital Inflows

Private capital flows, as defined in this paper, have two major components : FDI and private borrowing. The issue of whether the inflows were primarily driven by sound domestic policies and market-oriented reforms - the “pull” factors - or declining international interest rates and poor returns in stock markets in industrial countries - the “push” factors - became a focal point of the policy discussions. If external conditions played a key role in inducing the inflows, it has been argued, then there is cause for greater concern, as a change in the international environment could prompt a reversal of the flows. On the other hand, if these inflows were responding primarily to conditions in the recipient countries, there is less reason to be concerned about swift reversals. Therefore, according to Khan and Reinhart (1995), policies would thus need to be set according to which factors appeared dominant. History has also shown that external factors tend to have an important cyclical component, which has given rise to repeated booms and busts in capital inflows.

The recent surge in capital inflows was *initially* attributed to domestic developments, such as effective stabilization programs, liberalization of the capital and trade account and credibility in the conduct of macroeconomic policy, of some countries. Eventually it became clear that the phenomenon was widespread and this suggested the existence and interplay of important global factors. Reisen (1993) argues that the revival of capital inflows in Latin America can be seen as home-made : balanced budgets, lower inflation, privatization and deregulation, trade liberalization,

and the restructuring of the external debt. In this context there is little reason to expect an early reversal of the capital inflows which Latin America is now enjoying. However, this is not the first time in this century that there have been substantial capital inflows to that region. The most recent was in the period 1978-82 which led to the Latin American debt crisis. Prior to that there was another important period in the 1920s. Both periods saw huge capital inflows from the United States, and in both periods the flows were reversed leading to major crises. Many Asian countries building on sound economic policies and strong performances in the latter half of the 1980s continued to attract rising levels of net inflows, especially FDI.

Several factors and trends interacted in the early 1990s to make developing countries a fertile territory for the renewal of foreign lending. First, the sustained decline in world interest rates, coupled with a recession in several of the industrial countries stimulated investor interest in relatively higher-yielding developing country securities. In fact, by late 1992 US short-term interest rates were at their lowest level since the early 1960s. The lower interest rates also improved the creditworthiness of debtor countries, reducing default risk, an improvement which is reflected in the marked rise in secondary market prices of bank claims on most of the heavily indebted countries. Second, there has been a trend towards international diversification of investments in major financial centers. Increasing amounts of funds managed by institutional investors such as life insurance companies and mutual funds have entered emerging markets. Regulatory changes in the United States have also made it easier for foreign firms to place their equity and bonds under more attractive conditions to investors. Third, many heavily-indebted countries made significant

progress towards improving relations with external creditors. Fourth, several countries began to adopt sound monetary and fiscal policies as well as market-oriented reforms that have included trade and capital market liberalization. There may also be contagion or bandwagon effects, such as when adverse news about one country's creditworthiness alters international investors' perception of others'. Given this mix of domestic and external factors, the empirical evidence seems to suggest that external forces have been quite important impulses to capital flows in the first half of the 1990s.²

In terms of FDI, the scholarly literature gives several reasons why these flows to developing countries are on the increase. Among these are : the advantage of FDI in providing capital, technology and market access; the changing perceived role of FDI and the marked liberalization of policies towards FDI; and recognition of the exposure of the economy to the volatility of short-term capital flows. In addition, transnational corporations (TNCs) seeking cost and geographical advantages developed a heightened interest in FDI to developing countries. Shocks to foreign investment may also result from actual or anticipated changes in regional trade arrangements; for example the North American Free Trade Area (NAFTA) may have created a substantial incentive to invest in Mexico to produce for the North American market. Amirahmadi and Wu (1994) identified four sets of factors that are the most critical and directly relevant as underlying the trend toward the sustained FDI flows since 1982. These are: the paradigmatic shift in development thinking; the domestic

² Calvo, Leiderman and Reinhart (1993) indicate that foreign factors accounted for 30 to 60 per cent of the variance in real exchange rates and reserves in a sample of ten Latin American countries. Similarly, Chuhan, Claessens and Mamingi (1993) find that external variables account for about one third of bond and equity flows in Asia.

urgency for economic growth in developing countries; the globalisation of production and services; and the changing international environment. It may be accurate to say that these developments are themselves the product of complex social, economic and political changes that are taking place at both the national and the international levels.

Macroeconomic Impact of Capital Inflows

According to Reisen (1993) surges in capital inflows in many countries are a mixed blessing. He saw that large capital inflows into some Latin American countries since 1990 have held the promise of significantly increasing investment and growth but can also pose the threat of financial instability. Schadler et al (1993) found that capital inflows ease the external constraint, push down domestic interest rates, and often afford higher investment and growth³. However, they indicated that when large capital inflows result in overheating the economy, they become a policy concern. Large inflows can result in macroeconomic instability by contributing to an acceleration in monetary and credit expansion, inflationary pressures, a deterioration of the current account of the balance of payments, real exchange rate appreciation and a loss of competitiveness. In addition, if these inflows are not properly intermediated they have the potential to destabilize real estate and financial markets. In these circumstances, it is imperative that policymakers fashion an appropriate policy response. One that attempts to balance the much needed growth and investment afforded by the inflows and adequately curbs their destabilizing effects. In terms of

³They reviewed the experiences of six countries that have had recent surges in capital inflows, Chile Colombia, Egypt, Mexico, Spain, and Thailand

the latter, the conventional wisdom on policies used to be to exercise fiscal constraint to stem pressures on prices and the real exchange rate; accept some real appreciation through a change in the nominal exchange rate; and avoid sterilization (which only keeps domestic interest rates high and accelerates inflows). Yet, when policymakers in Latin American and Asian countries confronted surges in inflows, the prescriptions did not answer many practical questions.

Not surprisingly, the magnitude of capital inflows to developing countries since 1990 has generated considerable interest in understanding their causes, patterns and nature. The most serious concerns about capital flows stems not from the inflows themselves, but from the possibility that they might, for reasons internal or external to the recipient countries, abruptly slow or even reverse themselves, thus forcing a potentially abrupt and painful macroeconomic and financial adjustment. These concerns were proven legitimate in 1994 when the rate of capital flow to Mexico slowed sharply and toward the end of the year reversed itself. By the beginning of 1995 the reduction in capital inflows became more generalized, contributing to financial instability in much of Latin America, and major financial crises in Mexico and Argentina.

The recent episode of capital flows has been associated with an acceleration of economic growth in the regions of Latin America and Asia. During the period 1991-94 real economic growth of about 3.5 per cent per annum in Latin America was accompanied by capital inflows of around 6 per cent of GDP (Gavin et al, 1995). Interestingly enough is the fact that when net capital inflows averaged less than 1 per

cent of GDP in the period 1982-90, real GDP growth was less than 1.5 per cent per annum. This relationship is of course in part noncausal, as both depend upon similar aspects of the economic environment. Moreover, the causality that does exist clearly runs in more than one direction, as investors tend to search for regions in which rapid growth can be expected. Nevertheless, this empirical example illustrates what theory would lead one to expect : capital inflows can provide a strong expansionary impulse to the domestic economy (and the opposite also holds true).

Henry (1996) argues that real investment may or may not increase as a result of foreign capital inflows. This, he suggests, will largely depend on the level of consumer confidence, the tax regime in place, or the level of credit rationing by banks. The evidence is inconclusive. The Asian countries showed increased savings and investment during the recent period of capital inflows. Private savings increased from an average of 16.8 per cent of GDP in the period 1983-89 to 22.4 per cent of GDP in the period 1990-94. The ratio of investment increased by almost 5 percentage points over the comparative period to 30.7 per cent of GDP. In the Latin American countries, on the other hand, private savings declined by about 5 percentage points over the same period while their ratio of investment to GDP was only 0.8 percentage points higher.

Capital inflows can also finance private consumption which may increase on account of greater aggregate demand. The ratio of private consumption to GDP for the Latin American countries increased by over 3.5 percentage points in the period 1990-94 compared with the years 1983-89. This increase in consumption resulted in a

widening of their current account deficit from 0.9 per cent of GDP in the period 1983-89 to 2.4 per cent in the period 1990-94. On the other hand, the ratio of private consumption to GDP for the Asian countries decreased by more than 4 percentage points over the same period reflecting the effectiveness of their economic policies in depressing aggregate demand.

Calvo et al (1992) observe that capital inflows are typically accompanied by real exchange rate appreciation. They noted that surges in capital inflows result in an appreciation of the real exchange rate which often leads to a deterioration of the trade and current accounts. High interest rate differentials between domestic and foreign time deposits can generate arbitrage opportunities for foreign investors. Foreign funds will flow into the economy with resultant upward pressure on the nominal exchange rate. For given prices, this will result in a real exchange rate appreciation with implications for the current account balance and the traded goods sector. The real exchange rates in the Asian countries which operate floating exchange rate systems appreciated by 6.3 per cent in the period 1983-89 but in the years 1990-94 the rate appreciated by only 3.3 per cent. These authors also observe that capital inflows are often associated with stock market booms. Empirical evidence for Latin America suggests that while part of the booms can be accounted for by the same fundamental factors that give rise to capital inflows, "speculative bubbles" may have played an important role in these booms.

In most models, consumption and investment booms will be accompanied by a rise in money demand. Under a fixed exchange rate regime, money market

equilibrium will be achieved via an accumulation of international reserves at the Central Bank and a rise in the money supply. More generally, the degree of monetary expansion following a rise in capital inflows depends on the extent of sterilization of the inflows and on the degree of exchange rate flexibility. In the short run there is an inverse relationship between the expansion in money supply and the degree of sterilization and of exchange rate flexibility. In a small open economy operating under a free float, capital flows will be associated with a nominal exchange rate appreciation and no change in either reserves or the money supply. Because sterilization was more successful in Asia, money supply among these countries increased on average at slower rates of 18.1 per cent between 1990-94 and 20 per cent between 1983-89. In Latin American countries, however, money supply increased at an average rate of 258.1 per cent in the period 1990-94, even faster than the average rate of 200.5 per cent in the years 1983-89 reflecting limited sterilization of the capital inflows. Growth in money supply is often translated into increasing domestic price levels. Concomitant with the growth in money supply of well over 200 per cent in Latin America, the inflation rate accelerated from an average annualized rate of 193.7 per cent in 1983-89 to 222.9 per cent between 1990-94.

When changes in external conditions dominate, surges in inflows tend to push interest rates down. Of course, a reduction in capital flows will typically generate an increase in domestic interest rates and a decline in asset value. This will have adverse implications for domestic investment, and may generate a sharp contractionary impulse to the economy. When inflows are attracted principally by a tightening of

domestic credit policies, their effects are largely confined to increasing official reserves, often thwarting the effort to lower money growth and inflation.

IV. Capital Inflows and Macro-Economic Developments in Trinidad and Tobago

By definition, net capital inflows represents the increase in net indebtedness of the country, and are measured somewhat imprecisely by the surplus on the capital account of the balance of payments. Thus, increases in capital flows can be identified with larger current account deficits and/or an accumulation of reserves. Table 1 presents a breakdown of Trinidad and Tobago's balance of payments into its three main accounts, emphasizing the composition of the capital account. Capital inflows since 1993 has resulted in significant strengthening of the capital account in Trinidad and Tobago; surpluses were recorded in two of the last four years with very small deficits in the other two years. This conforms with the experiences of countries in Latin America and Asia where capital inflows have been associated with capital account surpluses. Table 1 also shows that the country's foreign reserves position strengthened considerably in this period, as the Central Bank realized large inflows of foreign exchange from government's divestment program and international borrowing activity. In Trinidad and Tobago a substantial amount of the inflows has been channeled into reserves, which increased by US \$596.7 million in 1993-96.

Table 1
Trinidad and Tobago : Balance of Payments, 1991-1996.
/US \$ Mn/

Items	1991	1992	1993	1994	1995	1996
Current Account	-66.7	32.5	-107.8	221.4	269.9	53.0
Capital & Financial Acct. (Net)	-261.9	-172.5	91.5	-32.5	-27.5	44.2
Official Borrowing	-166.1	-101.9	19.8	-7.3	-97.6	24.8
Official Loans	-5.2	0.0	0.0	0.0	0.0	0.0
State Enterprises	-145.3	-105.2	-83.3	-107.6	-69.3	-24.4
Direct Investment	144.1	171.0	372.6	521.0	295.7	402.4
Commercial Banks ¹	-	-	-85.4	-120.6	88.5	-23.1
Other Capital Flows	-89.4	-136.4	-132.2	-318.0	-244.8	-335.5
Errors & Omissions	-3.6	23.2	167.6	-7.9	-209.9	113.8
Change in Reserves (Minus means increase)	184.1	40.1	-158.7	-186.5	-40.5	-211.0
Exceptional Financing	148.1	76.7	7.4	5.5	8.0	0.0

Source : Central Bank of Trinidad and Tobago

Notes : (1) As a result of changes in the exchange rate regime in 1993 commercial banks are classified as part of private sector capital.

During the period 1990-96, Trinidad and Tobago experienced a nearly unprecedented inflow of foreign capital, coming after a period - coinciding with the debt crisis - when net inflows had all but dried up. After averaging about US \$397 million annually during 1983-87, capital inflows rose to US \$503 million in 1992 and US \$827 million by 1996. Relative to the Trinidad and Tobago gross domestic product (GDP), these inflows increased from an average of about 7 per cent during 1987-91 to an average of around 13 per cent during the last five years. The inflows, however, were distinctive in terms of the greatly increased importance of FDI and the greatly decreased importance of bank borrowing.

Since the decade of the 1970s when the drive was nationalization, successive political administrations have identified the need for foreign capital and have since invited and encouraged the return of multinational corporations (MNC)⁴. The changed ideological position towards private-sector-led growth and development, and the pursuit of structural adjustment measures, in particular trade liberalization and privatization of public enterprises, have resulted in a resumption of capital inflows. Flows of FDI to Trinidad and Tobago have recorded a steady increase during 1988-95. In 1989, during the first year of the reform program, FDI flows more than doubled from the previous year. In the period 1993-96 the most significant source of capital inflows was the proceeds from divestment. Eight state enterprises were divested during this period accounting for almost US \$400 million. Consequently, FDI attained unprecedented levels during this period.

Table 2
Trinidad and Tobago : Recent Divestment - Foreign.

Company	Date Divested	Principal Investor	Value (US\$mn)
TSTT (49 %)	Dec. 1989	Cable & Wireless	85.0
Fertrin/TTUC (100 %)	Mar. 1993	Arcadian	132.1
T&T-Methanol (31 %)	Jan. 1994	Ferrostaal/Helm	47.0
Trinidad Cement (20 %)	Aug. 1994	CEMEX	10.8
Power Generation Company (49 %)	Dec. 1994	SEI/Amoco	107.5
ISCOTT (100 %)	Dec. 1994	ISPAT	70.1
BWIA (51%)	Jan. 1995	Acker Group	20.0
T&T-Methanol (69 %)	May 1997	Ferrostaal/Helm/CMC	100.0

Source : Divestment Secretariat of Trinidad and Tobago

⁴The UNECLAC study found that the form in which capital was invested during the last seven years gradually shifted in composition from reinvestment of earnings to new equity capital by multinational corporations.

Trinidad and Tobago is one of three regional countries that have accessed funding in the international private capital market. The country completed fifteen bond issues in the international capital markets since 1982. After a five-year absence, the country re-entered the international capital market in 1992 raising US \$525 million in bonds during 1992-96. A further US \$75 million was raised on the regional capital market during 1993-94. Furthermore, Trinidad and Tobago accessed over US \$162 million in capital inflows from multilateral agencies in 1992-93. Table 3 presents a schedule of the characteristics of the outstanding issues since 1982.

Table 3
Trinidad and Tobago : Outstanding Bond Issues, 1994.

Issues Date	Principal Amount	Coupon	Maturity
May 1984	£ 31.8 million	12.25 %	May 2009
October 1984	¥ 5.0 billion	8.1 %	October 1994
December 1987	¥ 7.5 billion	6.7 %	December 1994
November 1992	US \$100.0 million	11.5 %	November 1997
July 1993	US \$25.0 million	10.25 %	July 1996
November 1993	US \$125.0 million	9.75 %	November 2000
August 1994	US \$50.0 million	10.83 %	August 1997
October 1994	US \$ 150.0 million	11.75 %	October 2004
December 1996	US \$150.0 million	8.0 %	December 2006

Source : Central Bank of Trinidad and Tobago

Portfolio investment flows have not been very significant in Trinidad and Tobago, given the relatively underdeveloped domestic capital market among other factors. Cross border trading among the three regional Stock Exchanges (Jamaica, Barbados, and Trinidad and Tobago) commenced in April 1991, providing another source of portfolio capital movements. Initially trading was heavy but by mid-1992,

the initial enthusiasm waned, on account of economic uncertainties in the respective economies.

Various factors, both domestic and external, explain the resurgence of capital inflows into Trinidad and Tobago during the 1990s. On the domestic side the perceived riskiness of Trinidad and Tobago investments was reduced, and the expected rate of return increased, by a series of reform and stabilization measures undertaken during the latter part of the 1980s and the early 1990s. Structural reforms undertaken during this period included the lowering of trade barriers, the liberalization of the financial system, privatization of state-owned enterprises that had been nationalized since the 1970s, and the elimination of the fiscal deficit. These reforms were coupled with a stabilization program, initiated in 1988, aimed at correcting the imbalance in the external account. Evidently, the stabilization program was initially very successful in several respects. The exchange rate was relatively stable, the rate of inflation declined from 10.8 per cent in 1987 to 3.3 per cent in 1996, while GDP growth, which on balance had been nearly flat for the 1989-93 period, showed positive growth for three consecutive years beginning 1994.

The stabilization program alone, however, cannot explain the surge in capital inflows, since this surge began well before inflation had come down and output had begun to recover. A second important factor in stimulating capital inflows may well have been the Standby Agreements signed with the IMF which allowed the successful negotiation of debt rescheduling agreements which Trinidad and Tobago signed with its commercial bank creditors in 1989.

Table 4
Trinidad and Tobago : Selected Economic Indicators, 1990-1996.
/Per cent of GDP unless otherwise stated/

Indicators	1990	1991	1992	1993	1994	1995	1996
Growth Rate of Real GDP	-0.1	2.9	-1.1	-2.6	5.2	3.1	2.8
Current Account Balance	7.8	-1.3	0.6	-2.4	4.5	5.2	1.0
Capital Account Balance	-10.3	-4.9	-3.2	2	-0.7	-0.5	1.8
Overall External Balance	-3.7	-6.3	-2.1	3.3	3.7	0.6	3.9
Direct Foreign Investment	2.2	2.7	3.1	8.1	10.5	5.7	7.3
Inflation Rate (%)	11.1	3.8	6.6	10.8	8.8	5.3	3.3
Exchange Rate (TT\$/US\$)	4.25	4.25	4.25	5.34	5.87	5.89	5.99
Public Sector External Debt	49.7	45.9	40.7	45.8	42.2	36.7	34.2
Gross National Savings	21.1	15.9	16.0	11.9	19.1	21.7	16.4
Overall Fiscal Balance	-1.3	-0.2	-2.7	-0.2	0.0	0.2	1.4
Gross Capital Formation	12.6	13.8	13.8	14.3	14.5	16.5	15.4
Net International Reserves (US\$Mn)	187.5	3.4	-36.7	206.3	514.5	460.2	701.1

Source : Central Bank of Trinidad and Tobago

A new political administration assumed office at the end of 1986 and, while initially repudiating the notion of an approach to the IMF, quickly moved to unify the exchange rate as a critical element of its stabilization program. However, the magnitude of the prevailing fiscal and external deficits made it increasingly clear that these could not be successfully addressed outside of the framework of an IMF stabilization program. This was particularly true of the external deficit as successful balance of payments adjustment was seen to depend critically on external debt rescheduling which, as a practical matter required the adoption of a Fund program. In November 1988, the IMF approved a SDR 85.05 million loan to Trinidad and Tobago under the Compensatory Financing Facility (CFF). During the next two years the country underwent two Stand-by adjustment programs with the IMF which reduced the rate of economic decline toward the late 1980s and early 1990s.

The management of public sector external debt over the period of adjustment involved the use of various options, principally the rescheduling of commercial and official creditor debt within the context of official standby arrangements with the IMF, greater recourse to multilateral financing and, more recently, debt conversion. The rescheduling of US \$799 million between 1988-92 created a heavy bunching of debt service obligations between 1992-94. Repayments of the IMF loans also became due in 1992. The government has eschewed the option of any further rescheduling and has elected to meet these obligations through refinancing and from the proceeds of the divestment of state enterprises.

The need to close the external payments gap and to supplement the declining level of national savings led to the growth in the external public sector debt at a rate of 15 per cent per year after 1982, with the ratio of external debt to GDP rising to 55 per cent in 1989 before declining to 34 per cent by 1996 (See Table 4). Despite the high levels of external borrowing, the country's net external reserves fell almost continuously from US \$3213 million in 1981 to negative US \$37 million in 1992. The weak savings effort in turn constrained investment, which fell from 28 per cent of GDP in 1980 to 15.4 per cent of GDP in 1996.

Finally, the inflow of capital into Trinidad and Tobago undoubtedly was spurred by the decline in US interest rates. The search for higher rates of return outside the US, coupled with the discrediting of direct bank lending in the aftermath of the debt crisis, probably explains much of the shift from bank lending to FDI in the

composition of capital inflows into Trinidad and Tobago and other emerging market economies.

The domestic as well as the international economic realities were crucial factors accounting for a complete paradigmatic shift in developing thinking in Trinidad and Tobago. The dependency theory began losing its grip over development thinking in the 1980s when the rival interdependence theory emerged. The whole context of the policy debate has gradually shifted away from the confrontational approach to FDI and Multinational Corporations (MNCs).

A second paradigmatic shift is reflected in a growing tendency for privatization in many developing countries. Just as the 1960s and 1970s were characterized by rapid expansion of public sectors, the 1980s and 1990s witnessed widespread attempts to curtail the economic role of the State. The privatization of State assets in Trinidad and Tobago began in 1989, with the proceeds from divestment being used for external debt repayment and the accumulation of foreign reserves. This country has become the single largest recipient of direct foreign investment in the Caribbean in the 1990s. The paradigmatic shift has also been influenced by the demonstration effects of certain successful strategies followed by a few developing countries, the so-called NICs in particular.

V. Policy Responses to Capital Inflows

Khan and Reinhart (1995) argue that while international debt issues dominated the policy discussions of the 1980s, the design of effective economic policies for managing capital inflows, and for ensuring their durability, has become a key economic policy issue in recent years. Although developing countries have always historically been vulnerable to cycles of booms and busts in capital inflows, a sudden shift in the availability of external finance entails a process of macroeconomic adjustment that is not necessarily trouble-free. Integration into world financial markets hold enormous promise for the economic development of many LDCs. But the policy problems created by volatile capital flows are serious as well, which raises the question whether some regulation of such flows is called for, and if so, how it should be structured.

During the 1993-94 period there were several major structural and legislative changes to the financial system of Trinidad and Tobago. These changes had its impact on the commercial banking industry, the system of exchange control as well as on the regulation of the financial system. In April 1993, within the context of trade and financial liberalization, the Trinidad and Tobago authorities floated the TT dollar such that its value was to be determined within an interbank market. After experiencing an immediate depreciation of 26 per cent in April 1993 the rate has adjusted to the approximate inflation differential between Trinidad and Tobago and its international trading partners. The virtual removal of all current and capital controls and the liberalization of the foreign exchange system forced changes in the traditional

approach to monetary policy. In the 1990s the focus is on managing liquidity and on interest rate policy aimed at containing the rise in the domestic price level and therefore minimizing pressure on the exchange rate. This approach became increasingly important in the context of increased capital inflows subsequent to liberalization. The policy challenge is to reduce the country's vulnerability to economic shocks occasioned by capital inflows as a result of the increased levels of integration into international capital markets.

One of the major policy measures in this context is the liberalization of the investment regime and promotion of investment flows. Some of the investment promotion initiatives adopted were:

- Continuous legal and institutional reform to stimulate foreign investment
- Dismantling of price controls
- Exchange control liberalization
- Free trade zone legislation
- Cross-border trading between Trinidad and Tobago, Barbados, and Jamaica Stock Exchanges
- Development of a competition policy
- Recognition of foreign arbitral awards

In addition, Trinidad and Tobago signed double taxation treaties with a number of countries including Caricom, Canada, USA, UK and other European countries. Under the terms of the treaty relationships tax relief is available on a reciprocal basis to the full extent of taxes paid. Investment and promotion and protection agreements were also established with the UK and France in 1993 and the USA in 1994. Trinidad and Tobago also established an Intellectual Property Rights Agreement with the USA in 1994.

The recent increases in private capital flows have been highly welcome, but the size of these inflows has raised concerns about the consequences for domestic macroeconomic stability and external competitiveness. It is tempting to assume that surges in inflows are rooted in common causes, have common effects, and that policy responses can be guided by a common formula. However, the appropriate policy response to capital inflows clearly depends on the composition of the inflows (that is, whether they are short or long term), the availability and flexibility of various policy instruments, and the nature of domestic financial markets⁵. In addition, the prevailing policy environment and the extent of policymakers' credibility are key determinants of the form and timing of the appropriate policy response.

The Central Bank of the recipient economy can react to increased capital inflows in various ways, depending mainly on the prevailing exchange rate regime. Under a pure float, the increased net exports of assets in the capital account finance an increase in net imports of goods and services. In this case the authorities do not intervene in the foreign exchange market, and the inflows of capital from abroad are not associated with changes in central bank's holdings of official reserves. At the other extreme, the domestic authorities can actively intervene to maintain a fixed exchange rate. In the presence of a capital inflow, they would purchase the foreign exchange that flows in, and the increase in the capital account surplus would be associated with an increase in official reserves.

⁵Unfortunately, the policy choice is often complicated by data that do not reliably differentiate between short-term and long-term inflows.

Intervention in the foreign exchange market is usually followed by the policy question of whether or not the intervention should be sterilized. Nonsterilized intervention may be desirable if the demand for money is perceived to increase owing, for example, to a successful inflation stabilization program that the authorities wish to accommodate. From an overall macroeconomic perspective, nonsterilized intervention is a more attractive option for a banking system with less capability or willingness to increase loans to the private sector, particularly for consumption purposes. Additional capital inflows in the face of excess liquidity in the banking system will exert a strong downward pressure on interest rates, slowing the pace of inflows and lowering the fiscal costs of the outstanding domestic credit.

Sterilization policies affect capital flows through their impact on domestic interest rates. Of course, there is the risk that sterilized intervention will keep domestic interest rates higher than they would otherwise be. At worst, this may provide incentives for further short-term inflows. In addition, sterilization results in an increase in the public debt and entails quasi-fiscal costs to the extent that the interest rate on domestic bonds is higher than that on foreign exchange reserves. The evidence reveals that sterilized intervention has been the most common policy response to capital inflows in both Asia and Latin America. Sterilization policies have taken a variety of forms but there are three main types: open market operations, changes in reserve requirements, and the management of Government deposits.

The Central Bank of Trinidad and Tobago has relied on variations in the reserve requirements to partially sterilize the effects of the inflows. As the economy

experienced growth in 1994 the resulting high levels of liquidity prompted increases in the cash reserve requirement for commercial banks from 16 per cent to 18 per cent in April 1994, and later to 20 per cent in July. Furthermore, a sustained build-up of liquidity in the latter half of 1995 prompted the central bank in December 1995 to request commercial banks to collectively hold an additional TT \$100 million in reserves. This action could lead to a reduction of the rates commercial banks pay on these deposits, which in turn may provide incentives for asset holders to shift to longer-term deposits, although it may also simply divert the flows altogether. This option is especially relevant in countries where capital inflows take the form of substantial increases in local bank accounts. A drawback of this policy is that it is a onetime measure, and it may ultimately promote disintermediation⁶. Moreover, increasing bank reserve requirements amounts to a reversal of the underlying trend of financial liberalization that has been occurring in Trinidad and Tobago, under which these requirements are expected to fall towards the level observed in industrial countries.

Fiscal policy has complimented monetary and exchange rate policies in Trinidad and Tobago, although many of the fiscal austerity measures undertaken in the early 1990s were part of domestic inflation stabilization plans, privatization efforts and adjustment associated with IMF programs and not a response to rising capital inflows perse. The fiscal balance has moved from an average deficit of 5.4 per cent of

⁶The effectiveness of reserve requirements depends on whether investors are able to circumvent them. In many countries investors can avoid reserve requirements by acquiring financial assets that are close substitutes for bank deposits, such as money market mutual funds, and thereby render sterilization ineffective. In most developing countries, however, these do not exist and so reserve requirements can often be used as an effective sterilization tool.

GDP between 1986-90 to virtual balance in 1994 culminating in moderate surpluses in the last two years (See Table 4). Fiscal policy is generally a useful instrument in managing capital inflows, since a larger budget surplus can mitigate inflationary pressures and avoid a real appreciation. Lower government expenditures, particularly on nontraded goods, directly reduce demand and therefore have a stronger effect on inflationary pressures than increases in revenue. However, contraction of government expenditure is always a sensitive political issue and cannot be undertaken on short notice. Delaying fiscal restraint, however, increases the risk that, ex post, the policy is procyclical. Moreover, fiscal policy is usually set on the basis of medium- or long-term considerations rather than in response to what may turn out to be short-term fluctuations in international capital movements.

Most developing countries that experienced heavy capital inflows in the early 1990s tried to resist the nominal appreciation that tend to accompany such inflows. The main approach was to use monetary or fiscal policy to offset the pressure on the currency to appreciate. Appreciation of the currency was considered to have an adverse effect on international competitiveness, and, therefore, it was worthwhile to attempt to offset the pressures on the exchange rate associated with capital inflows. By the end of 1995, the real effective exchange rate (REER) had depreciated by almost 15 per cent against the US dollar compared to the level of 1990-91.

A country that experiences a capital inflow may opt to let the nominal exchange rate appreciate. This option has three main virtues. First, it insulates the money supply, domestic credit, and the banking system from the expansionary effects

of the inflows. Exchange rate flexibility grants the monetary authorities a greater degree of independence and permits them to exercise more control over monetary aggregates. Furthermore, in the event of capital outflows, exchange rate flexibility takes pressure off foreign exchange reserves to accommodate the outflows. This is particularly desirable if the inflows are perceived to be easily reversible, banking supervision is weak, or there are inefficiencies in pricing risks. Second, because of a pass-through from the exchange rate to domestic prices, it may help reduce inflation. If economic “fundamentals” warrant a real exchange rate appreciation, the adjustment comes via the exchange rate and not via higher inflation. Third, allowing the exchange rate to fluctuate introduces uncertainty, which may well discourage some of the purely speculative (and highly reversible) inflows. Exchange rate uncertainty creates a bias towards domestic assets, dampens the sensitivity of the current account to most types of shocks, and reduces net capital flows.

The main disadvantage of a pure float is that massive capital inflows may induce abrupt and large movements in the real exchange rate. In turn, this could impose a substantial adjustment burden on the economy. Concern with the nontraditional export sector of the economy has indeed been a key motivation in many developing countries for not allowing much flexibility in the nominal exchange rate. Another disadvantage of greater exchange rate flexibility is that it may also deter medium-term capital flows, such as foreign direct investment, in addition to deterring the growth of nontraditional exports. It is difficult to determine the impact of greater exchange rate variability on short-term capital flows even in cases where the variance of the exchange rate changes considerably.

We now address the question of whether or not a special policy mix is essential for managing the inflows of foreign capital. The foregoing discussion has highlighted that the risks associated with capital inflows create policy dilemmas. However, the overall picture is not so gloomy, as many developing countries have used the inflows to finance productive investment and achieve higher growth. There is no universal prescription for managing the inflows; the appropriate policy mix will depend on the nature of the inflows, their causes, and the macroeconomic and policy climate of the recipient country. There is no question that a key ingredient is that policymakers must be able to maintain a high degree of credibility and must be prepared to support clear market-oriented policies.

Although no single policy recipe exists for all countries, to limit some of the risks associated with short-term flows, a reasonable sequencing of policies would consist in initially limiting the intermediation of those flows through sterilized intervention, greater exchange rate flexibility, and/or increased marginal reserve requirements, followed by a gradual magnetization of these flows, accompanied perhaps by an appreciation of the currency. Finally, it seems essential for countries to have flexible policy instruments that can respond quickly to adverse events, such as an abrupt reversal of capital flows. Holding an appropriate level of reserves and allowing for some degree of exchange rate flexibility is absolutely crucial in this regard.

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