Liquidity Management in Barbados

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Sources of Liquidity

- Liquidity changes traced to domestic credit changes and/or foreign inflows
- Domestic credit driven liquidity surges could adversely impact on BOP in fixed x-rate economies
- Fixed x-rates manage liquidity largely to protect the BOP

Sources of Liquidity

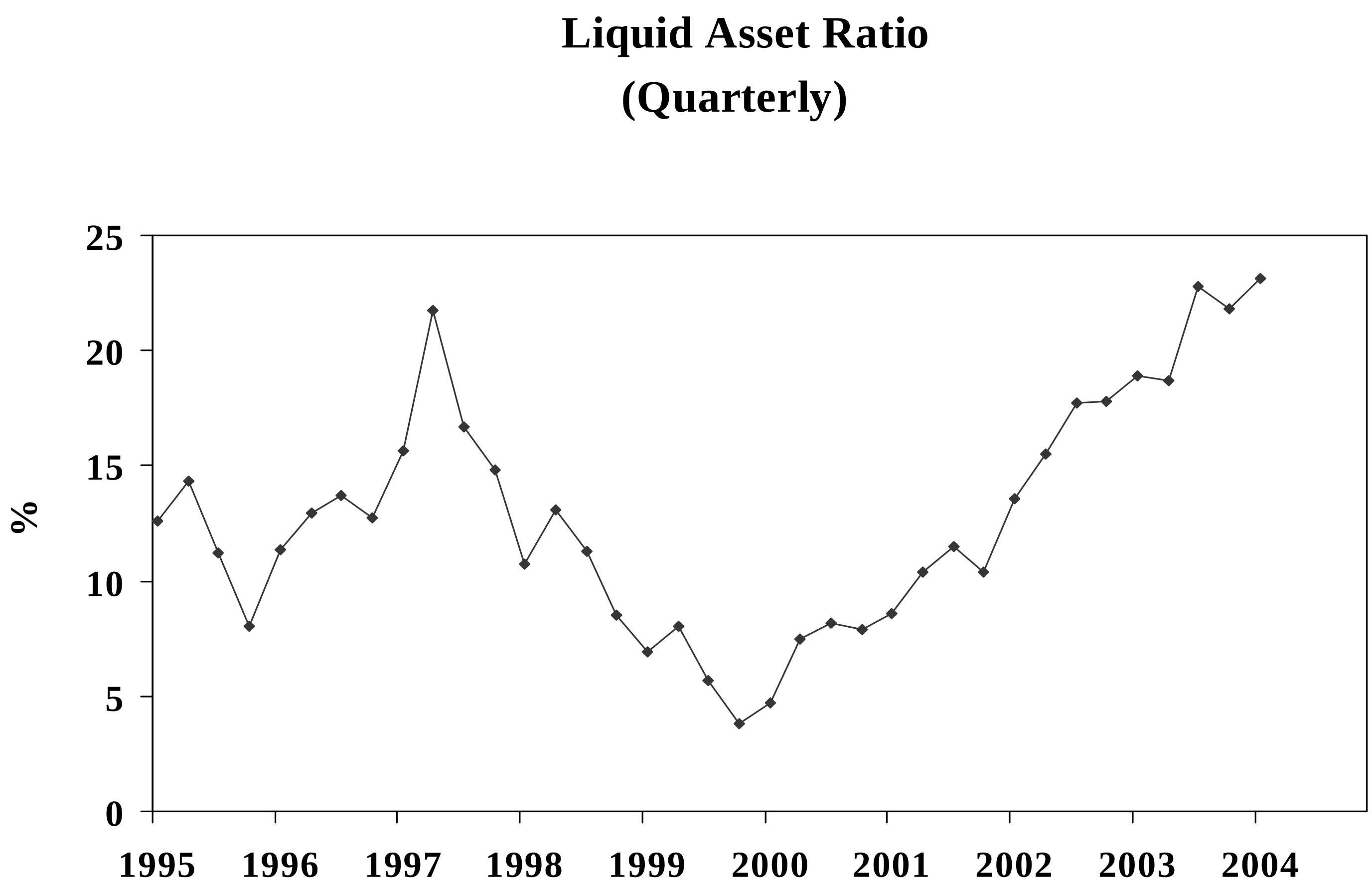
- Five sources and/or reasons for liquidity changes
  - Government's fiscal conditions
  - Large and persistent foreign currency inflows
  - Domestic/foreign interest rate differentials
  - Under-developed money and capital markets
  - Exchange controls

Available liquidity Tools

- The discount rate
  – Does not have much impact on banks’ profitability
- Reserve requirements
  – Usually not large enough to lock in req’d liq. assets
- Interest rate changes
  – Response by banks’ only marginal
- Open market operations
  – Since 1999, no T-bills held by Central Bank
- Credit limits

Liquidity Trends (1992-2004)

- Banks held on avg. 17% liquid assets over period
- Liquid assets reached a high of 23% in 1992 and 20.1% in 2003. Was 14% in 2004
- Liq. usually highest in Q2 (avg. 19.4%) and lowest in Q4 (avg. 17.9%)
- Banks' holdings of liq. assets tend to be counter-cyclical


Liquid Asset Ratio
(Quarterly)
%
25
20
15
10
5
0
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004

Reasons for Liq. Build-up (1993-2004)

- Two periods of sig. Liquidity build-ups: 1996-97 and 2001-03
- For 1996-97; uncertainty in period before VAT
- With pte. sector low ff 9/11, Gov't raised its activity
- Foundation of 2003 high liq. laid in 2002, with sig. fiscal injection (24.8% growth in MB)
- Very weak pte. Sector credit demand (avg. rate 1.5%)

Managing Liquidity (‘98-2004)

- In 1999 the disc. rate and min. dep. rate raised to check sig. growth in agg. demand
- Lending rates shot up and, with int’l. rates rel. low, businesses started utilising trade credits
- As liq. started to build up, CBB reversed policies of previous year, intending to bring down bus. op. costs
- The min. dep. rate lowered by 50 basis points each in Sep. 2000 and April 2001
- Banks’ lending rates moved down only slightly

Managing Liquidity cont’d.

- Between Sep. 2000 and July 2001, the min. dep. rate had been lowered by 1.5 % pts.; lending rates down only 0.4 of % pts
- Indicative lending rate introduced in July 2001
- By April 2003 when the setting of indicative lending rate was discont’d, the WLR had been forced down by 2.9 % pts. (vrs. 1.5 % pts of the MDR)
- Excess liquidity persisted until 2004. Why?
  - Pte. Sector credit demand remained weak
  - The CBB’s own action of reducing RR to further other objectives

Managing Liquidity cont’d

- The CBB introduced the concept of 2nd-tier reserves in 2003
  - Removed approx. $168 million of deposits from system by end-2004
- By end of 2004, excess liquidity had fallen significantly. Liq. asset ratio had fallen to 14.3% from 20.1% at end-2003. Reasons?
  - Increased pte. sector credit demand
  - A sharp cut-back in fiscal injection
  - Declining int’l interest rates

Conclusions

- To what extent could the reduced liquidity levels be attributed to the effectiveness of the tools utilized?
- No clear answers emerge from this article
- The ultimate test lies in how the policy tools impact on decisions made by economic agents in the pte. sector
- Policy effectiveness enhanced if used in tandem with fiscal policy