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SPEECH NOTES re:
"Financial Architecture and Liquidity Management"

at the

9th Annual Senior Level Policy Seminar hosted by
The Caribbean Centre for Monetary Studies (CCMS) : "Liquidity Management and Business Opportunities in CSME and Beyond"

by

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You would be hearing a lot about liquidity and liquidity management in these two days and for the most part liquidity will not be precisely defined. It would mean different things in different context. It is a very fluid word.

My theme is entitled "***Financial Architecture for Liquidity Management***". It is very broad and I will use some of this latitude. What I would like to do is to touch on how we are seeking to put modern financial infrastructure in place to deal with liquidity issues in their various manifestations.

I would therefore talk a bit about: monetary policy : on-going reforms in the government securities market : improvements in our payments systems which could have a beneficial impact on monetary management as well as on government securities market. I would also briefly touch on liquidity problems in our equity markets.

My comments will largely focus on the experience of Trinidad and Tobago, though I will make reference to the rest of the region.

Challenges in Liquidity Management - The Central Bank

As you know, Trinidad and Tobago has enjoyed a fairly long period of robust economic growth. Real GDP averaged just under 4 percent per year between 1994 and 1999 and accelerated somewhat to about 7 percent a year since then. Growth has been propelled by the energy sector whose main linkage with the rest of the economy is through government revenue (energy sector revenues account for about one-third of total revenues). As the energy sector is so large relative to the rest of the economy it determines the overall pace of economic activity directly and indirectly.

Thus for example, when oil and gas prices are high and production is increasing the overall economy does well because (in addition to the increase in value added in the energy sector) tax revenues rise, government expenditure increases and output and incomes are stimulated in the non-energy sector.

The bulk of tax payments from the oil sector are paid in foreign exchange by foreign oil companies. These are invariably sterilised in the Central Bank and form our significant foreign reserve cushion which now amounts to about US$3 billion.

Given this economic structure, we have two major sources of liquidity expansion in the Trinidad and Tobago economy. The rapid rate of growth is a major source of liquidity expansion as incomes and employment rise, the demand for liquidity far increases, secondly the significant non-oil fiscal deficit (which has averaged seven to eight percent of GDP in the past five years) is a major source of liquidity injection.

This situation of chronic excess liquidity creates a myriad of challenges (and perhaps a few opportunities) for the economy. It certainly creates challenges for the Central Bank in its implementation of monetary policy. The very liquid banking system creates prudential and regulatory challenges and while abundant liquidity creates opportunities for the development of our domestic capital markets, other factors limit the progress we have made in this area.

We have tried to deal with the challenges by improving our financial architecture in several areas --- some of which I would like to discuss.

Minister Enill in his opening statement touched at several aspects of our financial infrastructural development. I would try to avoid going over that ground … thus for instance, I will not touch the RSF which is a most important element.

Monetary Policy

Up to recently the Central Bank's monetary policy was implemented largely through reserve requirements which were used to sterilise bank liquidity and control the credit expansion of commercial banks. In 1996, we had a cash reserve requirement of 23 percent which was non-remunerated, and a supplemental reserve requirement of 5 percent which could be held in treasury.

The Bank started reducing the reserve requirement in 1998 (as it started to make greater use of open market operations). In 2002, there was an important change in the monetary policy framework which shifted from a system where the supply of reserves was the target, to one in which the Central Bank announced the price of reserves the Repo rate and supported this by more actively managing the supply of reserves through open market operations.

In 2003, the Central Bank announced a phased reduction in reserve requirements from 18 percent to 9 percent (which would equalise reserve requirements between banks and non-banks).

What has happened in fact is that as our money markets have become deeper we have developed a more sophisticated architecture to facilitate monetary policy implementation. It involves estimating the banks' demand for reserves (to meet the lower reserve requirement and for settlement balances) and supplying these reserves through open market operations. Having satisfied the estimated demand for liquidity for the system as a whole, any bank with a shortfall, is expected to meet its requirements in the inter-bank market.

The final element in the infrastructure is the repo rate at which the Central Bank is prepared to provide liquidity (through a repurchase transaction) to any bank to meet its reserve needs. The way the system is supposed to work is that the repo rate is expected to influence the inter-bank rate which in turn influences other short term rates in the system. That essentially is the monetary framework. The Repo rate is also the Central Bank's mechanism for signalling the desired stance of monetary policy.

The reserve requirement has been lowered because of its distortionary impact on the intermediation margin and interest rates. However, **reserve requirements** will continue to be an important element of our policy framework, both for prudential and monetary policy reasons. As regards the latter, the reserve requirement will help the Central Bank establish a minimum demand for reserve balances; also recognising that our markets are thin, the reserve requirement will always remain available for emergency situations.

Controlling Liquidity through Foreign Exchange Intervention

It is to be noted that, in our particular circumstances, the Central Banks' foreign exchange intervention policy also facilitates liquidity management.

In most countries with flexible exchange rate regimes the overwhelming bulk of the foreign exchange is available for direct trading in the market. In these cases, central bank purchases are largely for public sector purposes and central bank intervention is a residual. In our case, a significant part of the foreign exchange comes directly to the Central Bank and thus the Bank has a responsibility to help meet private sector demand. Over the last two years, liquidity absorption through foreign exchange intervention by the Central Bank averaged US$375 million per year, close to 5 percent of GDP.

The Government Security Market

Activities in the Government bond markets are directed at multiple objectives: **debt management**, **market development** and **liquidity management**. Last year the Central Bank and the Government collaborated on important steps towards improving the architecture of the market.

The reform involved the introduction of an auction system for government bonds to replace the prevailing under-writing system in the primary market. The specific purpose of the reform was to create a more transparent, market-based system of price determination; one that encourages broader investor participation and establishes an efficient yield curve to fulfill a bench-marking function.

The architecture in the Government securities market has been further enhanced by the establishment of the electronic Government Securities Settlement (GSS) system. The new system, which is comprised of an on-line auction system and an integrated securities depository, is linked to the Real Time Gross Settlement System (RTGS), facilitating the real time settlement of government securities transactions and simultaneous recording of ownership of securities in the depository.

The next step in the establishment of efficient infrastructure for the capital market is the development of a liquid secondary market. This is normally difficult for most developing economies as it requires a number of financial institutions who are prepared to "make a market". These institutions need to demonstrate the commitment, technical skills and capital backing and be prepared to go out and actively trade in government bonds.

Foreign Currency Securities Market

The market has also developed its own ways of managing liquidity. One of these is the creation of a **foreign currency securities market**.

Given our strong balance of payments situation, households and firms have began to hold more of their assets in foreign exchange (creeping dollarisation) and a sizable market for foreign currency debt has developed in Trinidad and Tobago. This market essentially involves private placement of foreign currency denominated securities by regional governments and corporations.

In principle, under conditions of sizable capital inflows, the accumulation of foreign assets is considered a desirable mechanism of liquidity management. Moreover, over the medium term, these placements result in re-flows of interest and dividends, further boosting our foreign exchange reserves. The Trinidad and Tobago market has intermediated more than US$1 billion in bond placements over the past four years.

There are questions as to whether this foreign currency bond market has the appropriate infrastructure. In particular, these securities are invariably not rated and the level of risk involved is not sufficiently appreciated. The economic and debt servicing difficulties being faced by some regional sovereign issuers have brought this issue into stark relief.

I would like to comment on one other area where our financial architecture urgently needs to be improved. This is an area in which the problem is one of insufficient liquidity, though of a different dimension. This is the area of our **equity markets**.

This market has shown limited development over the last several years and continues to be characterised by limited liquidity, reflected in a shortage of both issuers and investors.

Several factors have been advanced to explain this situation, these include:

(i) The bias in the fiscal system towards debt as opposed to equity financing.

(ii) A reluctance by private companies to dilute control and to disclose sensitive information to outsiders.

(iii) An individual investor population that is risk averse and lacks confidence in the market.

(iv) An archaic share settlement system, based on the physical delivery of share certificate, which involves a protracted time period for the transfer of ownership.

(v) A lack of confidence in the mechanism of share price determination of the Stock Exchange. This would seem to be perhaps the major problem.

Several steps are being taken to spur the development of the market.

Firstly, in January 2003, the Trinidad and Tobago Stock Exchange implemented the first phase of its development programme, with the establishment of the **Central Securities Depository**. This system enables securities currently traded on the exchange to be cleared and settled without the necessity of the physical delivery of certificates. **Change in beneficial ownership is made via electronic book entry**.

Secondly, The Exchange recently introduced an **automated trading system**. This system, along with the central depository system, constitutes a new securities trading, clearing and settlement platform which rely on a set of rules to automatically match orders entering the system from trading workstations resident on the trading floor or from a brokerage house. **The rules will allow more efficient price discovery and trade execution and will also keep the public informed as to activity in and the price of transactions in the market place**.

We are in the process of **enhancing the regulatory framework** for the capital market through amendments to existing legislation, which will:

(i) introduce international standards for disclosure (the plan will be to move to quarterly reporting for listed companies instead of semi-annual reporting as currently exists). **Incidentally both Jamaica and Barbados already have quarterly reporting**;

(ii) improve corporate governance; and

(iii) increase taxes on off the floor transactions.

The new legislation would also give the SEC additional and enhanced powers to prevent unsafe and unsound practices in the conduct of the securities market; to conduct routine on-site inspection and off-site monitoring of securities companies and investment businesses, to supervise collective investment schemes and those acting as arrangers and sales agents; and to detect, investigate and enforce the provisions of the SIA in respect of market abuses in the shares of public companies.

The regionalisation of the Stock Exchange has been advanced as one way of addressing the smallness and illiquidity of national stock exchanges. This could present major challenges because of differences in legal systems, foreign exchange restrictions in some countries, and differences in accounting and reporting standards. In the meanwhile, efforts need to be made to increase the number of cross-listings (we currently have three such) and to integrate the individual country trading platforms.

One element of the liquidity debate that I will like to touch on before I conclude (and this is relevant, not only to Trinidad and Tobago but to the entire Caribbean) is the **chronic presence in the banking system of excess loanable funds (excess liquidity) alongside high unemployment.** This is often put down to a number of factors including a shortage of entrepreneurial initiative; insufficient bankable projects; unreasonable standards of credit-worthiness and the insistence on the part of banks on traditional collateral standards. Banks are sometimes accused of being too risk- averse and criticised for a perceived preference for consumer credit and instalment loans.

Most banks have now instituted modern risk management systems which allow them to rate and price loans in accordance with the risks involved. The recent establishment of the automated credit rating bureau and the credit rating agency should also help financial institutions in the assessment of credit risks.

While these mechanisms have exposed a larger group of borrowers to loan finance from traditional financial institutions there still remains a reluctance for traditional financial institutions to lend to certain sectors – for instance small business and agriculture. Several regional governments have sought to address this problem through the establishment of guarantee schemes administered by state-owned institutions. In Trinidad and Tobago, we have the Business Development Corporation involved in such activities. These schemes, if carefully designed, can be useful in channelling credit to preferred sectors and in helping small businesses build up their credit histories.

Ladies and Gentlemen …. I have tried to focus on what's being done in the on-going development of our financial architecture. The initiatives are all in the context of the Government's strategy for financial sector reform, specified in the White Paper. Behind the strategy is the notion that financial resources (liquidity) are a necessary but not sufficient condition for sustainable growth and development. We also need the right infrastructure, a trained labour force and an appropriate climate for private sector initiative.

I thank you.