CENTRAL BANK OF TRINIDAD & TOBAGO

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TRANSITION FROM DIRECT TO INDIRECT MONETARY POLICY INSTRUMENTS IN TRINIDAD AND TOBAGO

This Note explains how the Central Bank of Trinidad and Tobago uses monetary policy to keep inflation low, and how and why the Bank has progressively moved from using 'direct' to 'indirect' instruments of monetary policy. The Note is the second instalment in a Public Education Series introduced by the Central Bank to explain important economic concepts and monetary policy actions to a broad public audience in simple, non-technical terms. The Central Bank looks forward to comments and feedback, as well as topic suggestions for upcoming Notes, at info@centralbank.org.tt.

1. Why does the Central Bank bother with inflation?

If prices rise very quickly, the value of a country's currency (that is, the amount of goods or services that a certain sum of money can buy) would drop rapidly. Simply put, one of the main jobs of all central banks is to do all in their power to keep the changes in prices (called inflation) to tolerable levels in order to avoid a rapid erosion of purchasing power. The basis for giving central banks this responsibility is the realisation that they can meaningfully impact financial conditions. For example, if a central bank sees that inflation is getting too high, it can try to tighten financial conditions (by making loans more expensive, less credit available etc.) so that persons and businesses will lower the pace of their spending and put less pressure on prices. Consequently, like all other central banks, a key objective of the Central Bank of Trinidad and Tobago is to maintain low inflation, as primarily represented by the changes in the Consumer Price Index (CPI) of the country's Central Statistical Office (CSO).

2. What does the Central Bank look at when dealing with inflation?

Given the inflation objective, the Central Bank of Trinidad and Tobago starts with the details of the CSO's CPI to gain an understanding of how retail prices have moved. The CPI has a number of components, such as food, education, housing, clothing and footwear, etc. The Central Bank also looks at other indicators of price changes such as the CSO's Producer Prices Index. This is in addition to an array of statistics on financial conditions—credit, interest rates, and data showing how financial institutions and the government (a main actor in the economy) are borrowing, lending or investing. Information on Trinidad and Tobago's financial transactions with the rest of the world, developments in international financial markets, and more generally, evidence on how the local economy is performing are also taken into account.

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3. **What tools does the Central Bank use to conduct monetary policy?**

Basically, the Central Bank can employ five broad categories of tools or instruments on the inflation front: The first is called ‘moral suasion’ whereby the Bank talks to financial institutions to urge them to adjust their operations in a way that would impact conditions in the way that the Central Bank desires. The second involves adjustment in the interest rate at which the Central Bank lends to financial institutions, currently called the ‘repo rate’: in general, a rise in the repo rate will lead banks to themselves charge higher interest rates on loans, which will result in tighter financial conditions and help to lower inflation. Third, the Central Bank can modify the amount it requires financial institutions to deposit at the Central Bank (the ‘reserve requirement’): the more financial institutions have to deposit at the Central Bank, the less they have to lend to their customers. Fourth, the Central Bank can detail where and under what conditions financial institutions can lend to certain sectors (so called ‘selective credit controls’). Finally, ‘open market operations’ through which the Central Bank buys and sells securities (such as government treasury bills) to affect the amount of funds financial institutions are left with to lend out—for example, if the Central Bank wishes to tighten financial conditions, it may sell securities, thereby withdrawing funds from the financial system that would otherwise be used to increase credit.

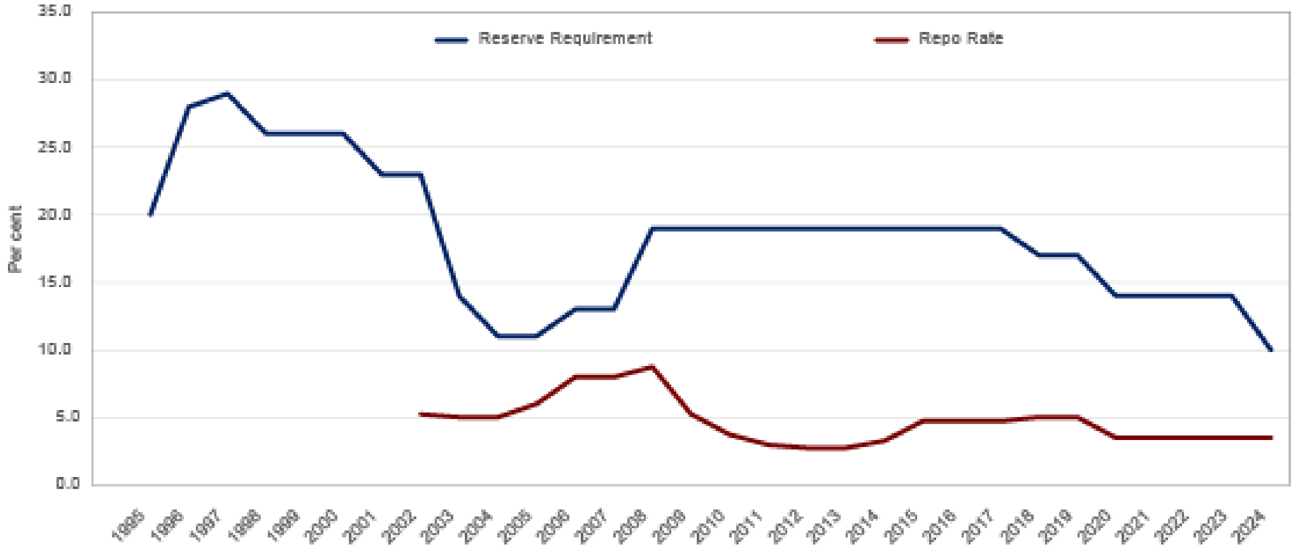
4. **Why the move towards ‘indirect’ and away from ‘direct’ instruments of monetary policy?**

As noted above, the five categories of tools are 1. moral suasion; 2. repo rate changes; 3. changes in reserve requirements; 4. selective credit controls; and 5. open market operations. Categories 1 and 2 are basic Central Bank functions. Categories 3 and 4 can be characterised as ‘direct’ or ‘blunt’ instruments of monetary policy as they do not generally take into account the specific circumstances of individual financial institutions. For example, an increase in the reserve requirement from 5 to 10 per cent of banks’ total deposits (the generally used base for the reserve requirement) must be applied across-the-board. In contrast, the open market operations (OMOs) in category 5 allow for voluntary participation of financial institutions in the purchase and sale of securities with the Central Bank. The market-determined nature of OMOs has this important benefit, and the Central Bank of Trinidad and Tobago has been progressively moving in this direction of employing indirect instruments of monetary policy. (see Chart 1 attached)

5. **How exactly are open market operations conducted?**

The Central Bank has been conducting open market operations as a major policy instrument since 1998, principally via the sale and purchase of treasury bills and notes to financial institutions (so called primary dealers). This requires very active involvement by our Research and Reserves and Domestic Market Operations Departments in data gathering, analysis and interpretation, communication with financial institutions, and liaising with the government to ascertain evolving market conditions. Ultimately, the aim is to assure that such operations contribute successfully to keeping moderate inflation in Trinidad and Tobago.

Chart 1: Evolution of Reserve Requirement and Repo Rate



NB: Reserve Requirement includes the primary and secondary reserve requirements.
Source: Central Bank of Trinidad and Tobago.