



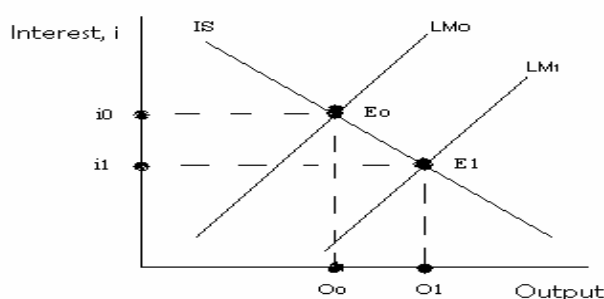
Monetary Policy or Fiscal Policy?

Governments and central banks use a combination of monetary and fiscal policies to manage the economy. These policies are adjusted to suit the economic environment to ensure that the country's finances are properly managed, especially with respect to trade, investments and capital. However, depending on existing policies, (exchange rate regimes and interest rates) new policies or adjustments may not have the intended positive effect to suit the changing environment.

Capital flows into and out of a country arise because capital is sensitive to interest rates. In countries where capital mobility is high, capital will quickly leave or enter depending on the returns that the investor can earn. Under a fixed exchange rate regime, the central bank has the challenge of maintaining an exchange rate that must keep its value relative to another currency. High capital mobility demands that the central bank act quickly in order to preserve the imposed exchange rate.

The IS/LM model demonstrates the relationship between interest rates (y-axis) and output (x-axis) using two curves, the LM curve and the IS curve (See figure 1). The upward sloping LM curve represents the equilibrium between liquidity preference (willingness to hold cash vs. securities) and money supply, and it basically represents the monetary side of the economy. The downward IS curve represents the equilibrium where private investment equals total savings and it represents the fiscal side of the economy. These lines intersect at a point where there is equilibrium in all markets in the economy (E_0). The initial equilibrium point, E_0 can be regarded as the point at which monetary and fiscal policies are in sync.

Figure 1 – The IS/ LM Model



Under expansionary monetary policy, the LM curve, shifts to the right (LM_1) and the new equilibrium level moves to a point (E_1) where the national income level is higher and the interest rates are lower than before.

Theoretically, at point E_1 , consumers now have more income and aggregate demand, including import demand will rise, causing the trade balance to deteriorate. Also, the lower interest rate (i_1) causes investors to move their capital out of the country in order to gain a higher return on their capital. As capital mobility is high, these situations occur quickly and put heavy downward pressure on the domestic currency as both consumers and investors will sell off their domestic dollars and buy foreign dollars to satisfy higher import demand and to invest at higher interest rates internationally. Within the fixed exchange rate regime, the central bank has to use its reserves and act opposite to consumers and investors in order to decrease this downward pressure on the domestic dollar. It does this by selling off its foreign currency reserves and buying the domestic currency in the hope of netting the effect caused by the investors and consumers. The central bank may supplement those reserves by borrowing from markets or from other central banks through swaps, but both these sources of additional foreign currencies are likely to be limited on creditworthiness grounds. Given that higher capital mobility will result in further depletion of the central bank's limited reserves, it will have to initiate contractionary monetary policies (the intervention reduces the money supply, assuming non-sterilisation) by increasing the interest rate level in order to preserve the exchange rate. The higher interest rate causes investors to invest their money within the country again, thus creating more capital inflows.

This new interest rate also decreases the income available to consumers as the cost of borrowing has increased, thus the demand for imports decreases as this occurs. This automatic adjustment mechanism causes consumers and investors to stop selling off the domestic currency. As the downward pressure decreases, the central bank reduces its reserve depletion rate. As a result the LM curves shifts leftwards back to its original position (LM_0). It is at the point where the equilibrium between interest rates and the income level creates a balance where the central bank can manage its reserves against the country's consumers and investors' needs. Here the mandated exchange rate can be preserved. This means that the central bank is constrained in its ability to use monetary policy as a tool.

The Case of Trinidad and Tobago

The assumption of high access to foreign currency (USD) does not completely hold true in the case of Trinidad and Tobago. Purchasing large quantities of USD frequently for purposes other than trade is very difficult as banks do not have the supply available to them all of the time. This is exacerbated by the fact that most of the country's foreign exchange earning sectors are currently experiencing some degree of a slowdown. In fact, for the first seven months of 2009, the Central Bank of Trinidad and Tobago sold USD1.1 billion, which is more than twice the amount sold in the same period of 2008. Therefore, it is evident that the central bank does sell USD into the economy via the banking system; it is just done on a controlled basis.

Trinidad & Tobago currently has a relatively high level of foreign exchange reserves, falling interest rates and some (weak) signs of moderating inflation. I mentioned some months ago in a previous article that I believe that given the country's economic conditions, that our currency was not likely to undergo any large scale depreciation. The large capital account deficit on Trinidad and Tobago's balance of payments shows that there is a relatively high degree of capital mobility; and we therefore ought to be wary of the policies adopted by the government as well as the central bank.

Our currency is defined as a 'managed' float for all intent and purposes, although the central bank manages the currency within a narrow band between five to six cents. Hence it really operates more like a "fixed-rate" or crawling-peg exchange rate system. We have seen from above that with high capital mobility and a fixed exchange-rate, monetary policy is deemed ineffective in the long-run. Currently, the central bank is using monetary policy in its attempt to aid growth. However, based on the above argument it is clear that the government will have to also use fiscal policy to help avoid a full-blown recession. Fiscal stimulus occurs in the form of government spending and tax cuts as we have seen in the larger economies of the world in the form of the much debated stimulus packages.

If we assume that our country is heading into a recession then the government may be justified in its attempt to stimulate the economy by running fiscal deficits. It would follow that fiscal policy will be the more effective instrument to be used for the long-term in getting the country "back on its feet". In this sense, the planned spending on the projects that government has already begun should be continued. The other side to this argument would be, as some members of the government have suggested, that the Trinidad and Tobago economy is not heading into a recession and that growth is on its way back on the upswing. This would then suggest that expansionary fiscal policies should be moderate and that the degree of government spending should be slowed. Either way, the authorities need to act responsibly as these policies affect us all. There should be a high degree of consensus of where our economy stands and in what direction it is heading. This will provide for better discussions on the appropriate policies that are needed to propel us forward.

FINANCIAL & ECONOMIC INDICATORS

As at 27 August, 2009

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	93.52	94.19
Euro	1.43	1.43
Jamaica	89.02	88.65
Guyana	205.50	204.90

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	72.49	72.54
Natural Gas (US\$/mmbtu)	2.75	3.02
Gold (US\$/Troy Ounce)	948.15	940.65

Eurobond Indices (As at 27-Aug-09)

Lehman Brothers Global Aggregate Index (Return % YTD)	4.91
JP Morgan EMBI+ (Basis points)	373
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	24.30

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0.11	0.16
Euro Zone	1.00	1.00
Japan	0.11	0.10
Brazil	8.75	8.75
Trinidad	7.25	7.25
Jamaica	13.50	13.50
Barbados	2.50	2.50

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.14	0.16
US 10-Yr Treasury	3.46	3.43
3-month UK Libor	0.69	0.73
Japan 90-day T-Bill	0.33	0.33
Brazil 90-day T-Bill	8.97	8.96
TT 90-day T-Bill	2.33	2.46
Jamaica 90-day T-Bill	16.72	18.46
Barbados 90-day T-Bill	3.62	3.69

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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