

NINETEENTH ADLITH BROWN MEMORIAL LECTURE

THE **M**ONETARY AND
FINANCIAL **A**UTHORITY OF THE
EASTERN **C**ARIBBEAN:
A **M**ODEST **P**ROPOSAL

Dr. DeLisle Worrell

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The Late Dr. Adlith Brown

The Annual Adlith Brown Memorial Lecture honours the memory of Dr. Adlith Brown, Co-ordinator of the then Regional Programme of Monetary Studies from 1980 to 1984.

Although born in Jamaica, Dr. Brown could truly have been described as a Caribbean woman. Her sense of regionalism was nurtured on the Mona Campus of The University of the West Indies where she did her undergraduate work for the B.Sc. (Economics). She subsequently completed her Master's (with distinction) as well as her Doctorate from McGill University.

Adlith returned to teach at the University (St. Augustine Campus) in 1969 and in 1971 was transferred to the Mona Campus where she taught Monetary Economics in 1976 and was one of the main anchors of its research programmes. She co-ordinated, firstly, the Caribbean Public Enterprise Project and secondly, in 1980, the Regional Programme of Monetary Studies. In this period, she was also promoted to the position of Senior Research Fellow and in 1982 to the position of Acting Deputy Director - a position which she held until her death. These latter years demonstrated most her capacity for intellectual leadership and for creative management.

Adlith revelled in the realm of ideas. It is therefore understandable that she was fast developing a reputation for being an outstanding economic theorist as her writings attest. Indeed, she was an ideal person to co-ordinate the Regional Programme of Monetary Studies, given her passion for regionalism, her intellectual standing and her understanding of the process and problems of policy-making with which her colleagues in the Regional central banks had to cope.

Each year an eminent Caribbean scholar is invited to deliver the Memorial Lecture, during the Annual Monetary Studies Conference of the Caribbean Centre for Monetary Studies (CCMS), in tribute to the life and work of Adlith Brown.

THE MONETARY AND FINANCIAL AUTHORITY OF THE EASTERN CARIBBEAN: A MODEST PROPOSAL

by

Dr. DeLisle Worrell¹

Senior Economist

Monetary and Financial Systems Department

International Monetary Fund

Introduction

It is an honour and privilege to contribute to this lecture series, which perpetuates the memory of Adlith Brown, a friend and colleague, who helped to lay the foundation of what was to become the Caribbean Centre for Monetary Studies, among the most durable and influential policy institutions of CARICOM. This lecture offers an opportunity to return to a theme that continues to be a major preoccupation of mine, the need for currency stability and currency unification within

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1. The views expressed in this lecture are those of the author, and do not in any way reflect IMF policy. Thanks for their comments to Ritu Basu, Antonio Furtado, Patrick Honohan, Rudolfo Maino, Ratna Sahay and Piero Ugolini, and members of the audience at the lecture, all of whom have helped to clarify points of the argument.

CARICOM. In 1992 the West Indian Commission published my Occasional Paper “A Common Currency for the Caribbean,”² and I followed up those ideas in the book *Caribbean Monetary Integration*,³ which I edited with Terry Farrell. More recently, I returned to the issue with a Working Paper published by the IMF in February this year, “A Currency Union for the Caribbean.”⁴ That paper contained a section entitled “The Path to Currency Union”, which is what I propose to focus on tonight.

Fifty years ago, the English-speaking countries of the Eastern Caribbean used a single currency, administered by a currency board, and fully backed by an international currency. Its value was stable, in terms of the U.S. dollar,⁵ and people had confidence in it. That era ended in the 1970s, as most of the currencies that replaced those issued by the currency boards fell prey to repeated devaluation or threats of devaluation. The message of this lecture is that the uncertainty of the U.S. dollar value of our currencies is not a fact of life. It may be remedied

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2. St. Michael, Barbados: The West Indian Commission.
 3. Port-of-Spain, Trinidad: Caribbean Information Systems, 1994.
 4. IMF WP/03/35, February 2003.
 5. The currency was pegged to sterling, but in that era of pegged exchange rates, the sterling-U.S. dollar rate was fixed.

by reinstating the currency board, in modern guise. There is every reason a region as small as the Caribbean should have a single currency, provided its value is stable, in terms of the U.S. dollar, the usual international standard of value in this region. The central banks of the Eastern Caribbean – of Barbados, the Eastern Caribbean Currency Union (ECCU) and, recently, of Trinidad and Tobago – have demonstrated the will to maintain a stable U.S. dollar value of their currencies, and an institutionalised currency board offers them the means to make the commitment credible. The proposal is for a new currency to be issued at par with the U.S. dollar, backed fully by U.S. dollar assets. It would be issued by a monetary and financial authority, which would also be the regulator and supervisor of banks.

Antecedents

Perhaps the only time the English-speaking Caribbean has had a stable currency, in adequate supply, was during the currency board era. From the time of the first European settlement, up to and including the period of introduction of commercial banks, in the mid-nineteenth century, there were numerous and persistent complaints of an inadequate supply of money, a confusing mix of monies of different origins, the debasement of money, and counterfeiting. The problems were somewhat alleviated by the issue of currency notes by the

treasuries of colonial administrations, in the early twentieth century. However, it was only with the establishment of currency boards in the last century that the region boasted an ample supply of notes and coins, in usable denominations and with dependable value. In the period after World War II, up to the early 1970s, these countries avoided crises of finance and external payments, in spite of episodic jumps in import prices, changes in the composition of their exports, changes in export demand, changes in world oil prices, the onset of stagflation and the collapse of fixed exchange rates among major currencies. Financial crises were avoided, even after the currency boards were replaced by central banks, so long as the new central banks behaved much as the currency boards had before them: issuing domestic currency in exchange for foreign currency, and maintaining a backing in foreign exchange sufficient to redeem most of the domestic currency issue. This period of financial and economic stability came to an end, for some CARICOM countries, with the introduction of central banks, and the expansion of money.

Credibility and Active Monetary Policy

The rationale for the establishment of central banks was, presumably, the desire to pursue an active monetary policy, that is, to depart from the currency board rule that the domestic currency be fully backed by foreign exchange. However,

experience suggests that active monetary policy in the very open economies of the English-speaking Caribbean has been counter-productive: it tends to erode credibility in the stability of currency values and prices, without sheltering the economies from the need to adjust to changes in prices, demand and supply for the goods they import and export. When there was an export windfall, for example, as in the mid-1970s in sugar-producing countries, it was pointless for the monetary authority to absorb liquidity by raising interest rates, because the more attractive returns (*vis-à-vis* comparable U.S. interest rates) would have attracted even more liquidity, through inflows from abroad. It would have been preferable to allow excess liquidity to drive interest rates down, as would occur under the currency board regime, and drain away the liquidity abroad. This financial outflow creates no problem of scarcity of finance to meet domestic credit demand, because it continues only so long as domestic demand for credit is weak. As domestic credit demand rises, the fall in domestic interest rates is arrested, and the windfall gains no longer leak abroad.

Contrast this with activist monetary policy. Typically, the monetary authority exhausts its supply of government securities available to sell to commercial banks in order to absorb their excess liquidity, and it must issue paper of its own. This policy is very costly for the central bank, which pays higher rates on the securities it sells than it earns on the foreign exchange it has

acquired as a result of the windfall. Alternatively, the central bank stops buying foreign exchange and allows the exchange rate to appreciate, making tourism services and exports more expensive. The public realises, sooner or later, that neither of these policies is sustainable. Eventually, something will trigger a change in sentiment, and when this occurs, the inevitable response is a swift flight of capital, and a reversal of price and interest rate trends, thereby increasing the volatility of money, prices and exchange rates.

There is no benefit from an active monetary policy that justifies this risk of instability. Whether the exchange rate is pegged or flexible, monetary policy in the small nations of the Caribbean is effectively determined by the U.S. Federal Reserve. Real domestic interest rates everywhere are the same as for the U.S.A., except for transactions and information costs, after domestic rates are discounted for exchange rate risk and country risk premiums. Any attempt to drive Caribbean rates higher results in an unwanted capital inflow, and lower rates cause an outflow. However, the relationship is not precise or instantaneous; it usually takes a month or two before the market decides whether changes in U.S. rates are permanent or temporary, and large enough to cover the transactions costs that would be incurred in reacting to them. These adjustment lags may be much longer when U.S. rates are exceptionally high (as in the early 1980s), or exceptionally low, as at present.

The existence of capital controls offers little insulation for the domestic monetary system. Capital controls are a useful mechanism – some would say an essential tool – in deterring purely speculative financial flows, especially at very short term, but even a rigid capital control regime has little effect on longer-term flows, in countries where the financing of external commerce is a major activity of banks. Banks, companies and individuals with interests in the Caribbean and abroad routinely make decisions which determine the magnitude and direction of financial flows. If domestic rates are too high, they will accumulate funds at home and borrow abroad (for example, using trade credits), resulting in a capital inflow, and vice versa when rates are too low.

In these circumstances, it is better to accept the impotence of domestic monetary policy, and to borrow credibility for the domestic economic strategy from the Federal Reserve than to seek to manage domestic liquidity. Domestic monetary management invariably fails in its real objective, to influence aggregate spending, because the reaction of borrowers to changes in interest rates is sluggish, except for mortgages, and takes many months to appear. Furthermore, there is no reaction if the market thinks the changes are temporary. For example, when there is a temporary surge in oil prices, as at the time of the first Gulf War, the balance of payments (of oil importing countries) deteriorates, foreign exchange reserves decline –

and with them the money supply – and interest rates tend to rise. That will not affect spending immediately, but it will probably bring a capital inflow, by way of more trade credit and less domestic borrowing by importers. If the slump does prove to be temporary, the capital inflow serves to finance the temporary increase in the balance of payments deficit. There is no need for, and no benefit from, an activist policy to “cushion the shock” by, for example, open market purchases by the central bank. Such purchases would lower interest rates, reducing the incentive for capital inflow and hence the financing available to close the balance of payments gap.

The argument for monetary policy is no stronger where the external shock is a permanent one, such as the change in marketing arrangements which have reduced export prices for Caribbean bananas and sugar (It is rather a misnomer to call these changes “liberalisation”, since the new arrangements are as hedged about with *ad idem* conditions as were the old). If previous aggregate expenditure levels are maintained in the face of this loss of income, the demand for finance to close the gap drives up interest rates. The resulting divergence with foreign interest rates attracts financial inflows to close the balance of payments gap, without any need for intervention by the monetary authority. Eventually, the interest rate increase helps to achieve the necessary reduction in aggregate expenditure and restore an equilibrium, by cutting the demand for mortgages

and forcing a reduction in government expenditures or an increase in taxation, in order to secure a sustainable fiscal deficit.

Active monetary policy in these circumstances is counterproductive. Open market purchases of securities increase the financing available to government, reducing the need for fiscal adjustment, and reduce the upward pressure on interest rates, sustaining the demand for mortgages. At the same time, they reduce the incentive for capital inflow, and financing for the balance of payments. If the monetary authority trades at a pegged rate, intervention causes a loss of foreign reserves, effectively financing the replacement of foreign assets by domestic assets, a process which, if sustained, makes exchange rate devaluation inevitable. If the monetary authority has a flexible exchange rate policy, allowing foreign currency to be traded at interbank rates and intervening in the foreign exchange market at its own discretion or not at all, the exchange rate depreciates immediately. In neither case can output, employment and spending be sustained by use of monetary policy.

Other Objections to the Currency Board

Two arguments, not related to the use of monetary policy as a shock absorber, are advanced against the currency board: the loss of seignorage and the absence of a lender of last resort

(LOLR). It seems irrational for relatively underdeveloped economies to offer the government of the U.S.A. the benefit of seignorage. It is equivalent to making a loan to the U.S.A. of the transactions balances which economic agents must maintain in liquid form in anticipation of, or in the process of, settlement. In practice, issuers of currency in the Caribbean region get the benefit of seignorage only to the extent that the holders of their currency believe them to be willing and able to maintain its U.S. dollar value. Whenever there is a lack of confidence in the ability of the domestic currency to retain its U.S. dollar value, substitution in favour of U.S. dollars occurs. The problem for the issuers of Caribbean currencies is that this confidence has to be bought, by holding assets in U.S. dollars. What is more, in the era of flexible exchange rates between reserve currencies, countries with fixed pegs typically hold foreign reserves equivalent to 100 percent or more of their currency issue, and countries with flexible exchange rates hold even more. This implies that pure seignorage revenues – that is to say, the difference between the cost of producing and distributing the currency, and its purchasing power – are no longer available. Nevertheless, the return on its foreign asset holdings does enable a currency-issuing authority to obtain a share of this seignorage, as compared with a country which uses the U.S. dollar for domestic transactions.

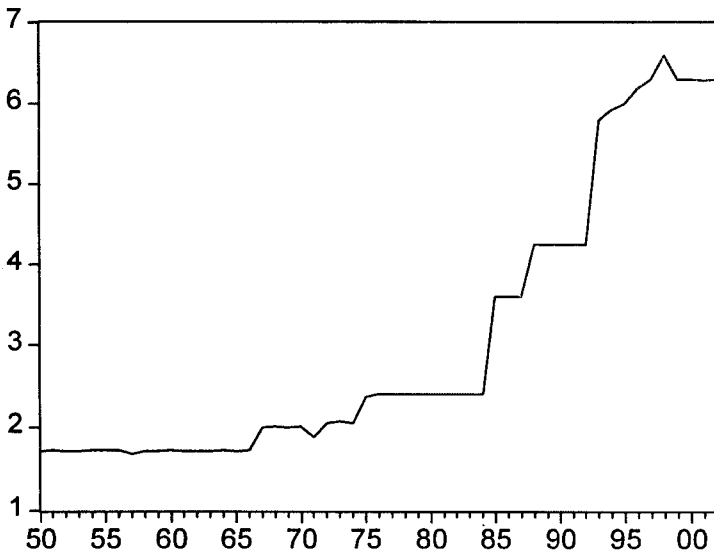
A pure currency board may not issue domestic currency assets, and therefore cannot lend to a domestic bank faced with a liquidity shortage. If the illiquid bank is insolvent it will have to be resolved in one way or another, and there is no case for emergency lending. The need for an LOLR arises in the case of solvent but illiquid banks. It is on these grounds that a case is made, in this essay, for the MFA to be also the supervisor and regulator of banks, and to have sound and effective supervisory and regulatory instruments and policies in place. The MFA is then in a position to arrange interbank market support for any bank that is solvent but temporarily illiquid, since it can assure potential lenders of the borrower's ability to repay. Moreover, such lending may only be a temporary expedient, to allow time to negotiate the sale of assets of the cash-strapped bank, to match the liabilities it has lost.

Exchange Rate Flexibility

A stumbling block in the path of a monetary union for the eastern Caribbean is a difference of view, officially, between the government of Trinidad and Tobago on the one hand, and the authorities in the ECCU and Barbados on the other, about the exchange rate peg. The latter have recorded commendable economic performance with the fixed peg over the past three decades, and there is widespread support for maintaining it. In

Trinidad and Tobago, although the currency is not officially pegged, the rate has remained unchanged for the past three decades, except for three discrete devaluations, in 1985, 1988 and 1993, and a period when the rate depreciated slowly, from 1993 – 1997 (see Figure 1).

**FIGURE 1.
EXCHANGE RATE OF THE
TRINIDAD AND TOBAGO DOLLAR
(TT Dollars per US Dollar)**



Source: International Financial Statistics.

It is because of the experiences of 1985 and 1993 that the Trinidad and Tobago authorities are unwilling to give up the exchange rate as a policy tool. In 1985 the government devalued to correct an entrenched and unsustainable fiscal imbalance, which the administration was too weak to correct by tax or expenditure policy. Because government derives most of its revenue from taxes on the export of petroleum products (and now natural gas), Trinidad and Tobago is in the unique position in CARICOM where a devaluation improves the budgetary balance. The 1985 devaluation cut the budget deficit which had become unmanageable after the 1981/1982 oil price collapse, and had remained unresolved since then. The decision to devalue was in effect an admission of the failure to achieve a national consensus on the necessary adjustment in the budget. Unsurprisingly, there was a cost to this arbitrary solution, in terms of a lasting loss in government policy credibility.

The 1993 devaluation came immediately after many food processing and manufacturing firms in Trinidad and Tobago had completed major investment in plant modernisation, using imports purchased at the old exchange rate. In addition to productivity gains from the new investment, these firms now benefited from a one-third increase in the local currency price of their exports, part of which could be invested in export marketing, to complement the recent investment. The fortuitous timing of the devaluation appears to have been an accident,

and it would be difficult to repeat it in such a way as to reap similar benefits in the future. Moreover, because the devaluation was equivalent to a non-transparent export subsidy, it again eroded policy credibility, though the effect was mitigated because part of the windfall apparently went to moderate the devaluation-induced increase in domestic inflation.

In both these cases the devaluation was a second best policy, surprising the general consumer with an import tax to fund government expenditure in the first instance, and export industry in the second. While such a transfer might have been essential, it would have been more transparent to achieve it via budgetary measures, on the basis of an agreed compromise, rather than by surprise devaluation. Surprise devaluations have a high credibility cost: interest rates, prices and financial flows become more volatile, as the market tries to anticipate future surprises. As a result, devaluation can be used only infrequently, even in cases like Trinidad and Tobago where it is sometimes effective. The volatility costs may be warranted where there is no alternative, but in both cases cited it may be argued that there were better alternatives available for achieving similar results without loss of confidence. After three surprise devaluations in less than two decades, a commitment to a peg on the part of the Trinidad and Tobago authorities is probably not credible. However, a commitment to a peg on the part of the monetary authority of a currency union, in association with

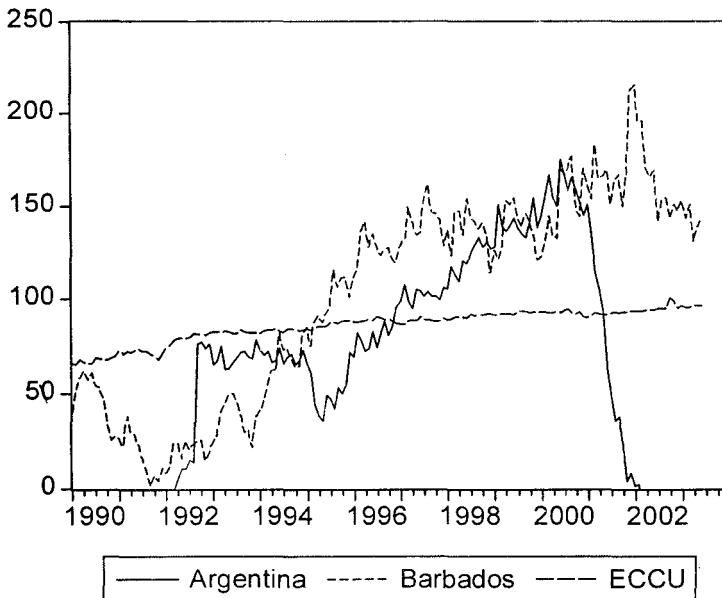
two other members who have both sustained credible pegs, and in the context of a fully backed currency board, might well lend the desired credibility.

In principle, there is nothing to prevent the currency board altering the value of the U.S. dollar at which it buys and sells foreign exchange. A monetary authority that is as large as that of Hong Kong, for example, may well choose to retain that option. However, for countries that are as small as those of the Caribbean, the possibility of a change in parity goes to the heart of public confidence in the currency. Barbados and the ECCU would not be interested in a common currency unless the peg was as secure as their own, and the prospect of a credible peg, not subject to surprise devaluation, would be the main attraction for Trinidad and Tobago.

The suggested monetary authority would be credible, because it would be a pure currency board, as is the case for the Baltic States and some countries in south-eastern Europe. A pure currency board always has foreign currency assets sufficient to redeem 100 percent of the domestic currency, at the official peg. No volume of capital flight, however large, may exhaust the foreign exchange reserves of the monetary authority, without at the same time extinguishing the domestic currency issue. There would be no parallel with the Argentinean case. The Argentine central bank did not operate a fully backed

currency board for much of the period of the pegged exchange rate. In fact, for much of that time, the Eastern Caribbean Central Bank (ECCB) and the Central Bank of Barbados (neither of which admits to being a currency board) maintained reserve backing at levels, relative to their currency issues, that were equal to, or higher than, those for Argentina (see Figure 2). A more appropriate comparison is with the currency boards

FIGURE 2.
FOREIGN EXCHANGE RESERVE COVER,
ARGENTINA, BARBADOS AND THE ECCU
(Percentages)



Source: Author's calculations, based on data from International Financial Statistics.

of Bosnia and Herzegovina, Brunei Darussalam, Bulgaria, the Hong Kong SAR, Estonia and Lithuania, which have all shown remarkable stability.

The Monetary and Financial Authority

The pursuit of active monetary policy in the Caribbean appears to have been a failure, suggesting a reversion to the autonomic monetary adjustment of the currency board. However, important improvements in policy making and in the supervision of the financial sector have come with the establishment of central banks, and these should be retained in the new currency board arrangements. Moreover, because monetary policy is ineffective, there is no benefit to maintaining separate national currencies. If it were possible, by reducing interest rates in the Organisation of Eastern Caribbean States (OECS) to compensate for the slump in bananas, or to hasten adjustment to that decline, there might be a benefit in having an EC dollar separate from the currencies of Barbados and Trinidad and Tobago, countries which do not export bananas. However, as we saw earlier, OECS production cannot be boosted by means of interest rates or other monetary policy, so there is no need for separate currencies. Unifying the currencies would eliminate the currency conversion costs involved in current intra-regional transactions, and would be a major step in creating a single economic space

within the region. A single currency would be a major incentive for increased intra-regional financial and investment flows, to take advantage of the most competitive investment opportunities, removing a brake on the already increasing volume of cross-border investment within the region.

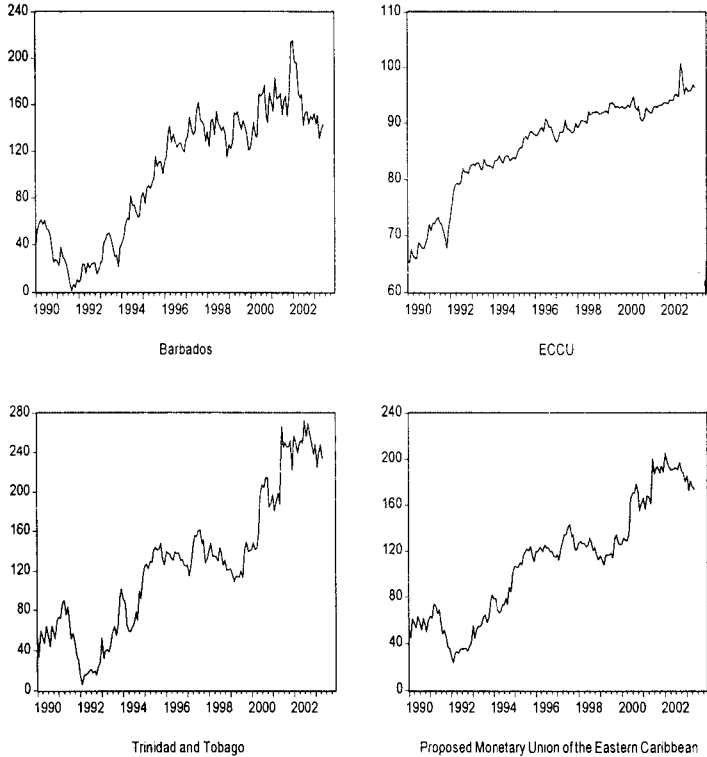
However, for practical reasons it is not possible to unify all the currencies of CARICOM countries at this time. The suggested monetary and financial authority of the Eastern Caribbean (MFA/EC) would therefore replace the currencies of Barbados, the ECCU and Trinidad and Tobago, in the first instance. Four CARICOM countries would not be eligible to join at present because they do not have stable, credible pegs to the U.S. dollar – Haiti, Guyana, Jamaica and Suriname. Of the remaining, economic links among The Bahamas and Belize, and between them and the rest of CARICOM, are so weak that intra-regional currency costs are of no significance.

The MFA/EC would have no monetary functions and could not lend to banks or governments, but it would have research and information functions, it would coordinate with the treasuries in the formation of fiscal policy, it would be governments' advisor on debt strategy and financing, and it would be the supervisor of banks.

The three central banks have more than enough foreign exchange to fully redeem the domestic currency issue and replace it with a common currency (see Figure 3). The fact that the Central Bank of Trinidad and Tobago has not committed to an exchange rate peg is the major obstacle to the establishment of an MFA/EC, because the net foreign assets of Trinidad and Tobago are about two-thirds the total for the three currency areas combined (see Figure 4). With net foreign reserve cover which has been in excess of 100 percent since 1994, and which in May 2003 stood at 234 percent, the Central Bank of Trinidad and Tobago is in a position to commit to an exchange rate peg, if necessary with the help of legislation mandating the currency board rule, and mechanisms to make it effective. Trinidad and Tobago has the greatest incentive to participate in the MFA/EC: it has the largest share of intra-regional trade and finance in CARICOM, and therefore stands to make the largest gains from the elimination of currency conversion costs on these transactions.

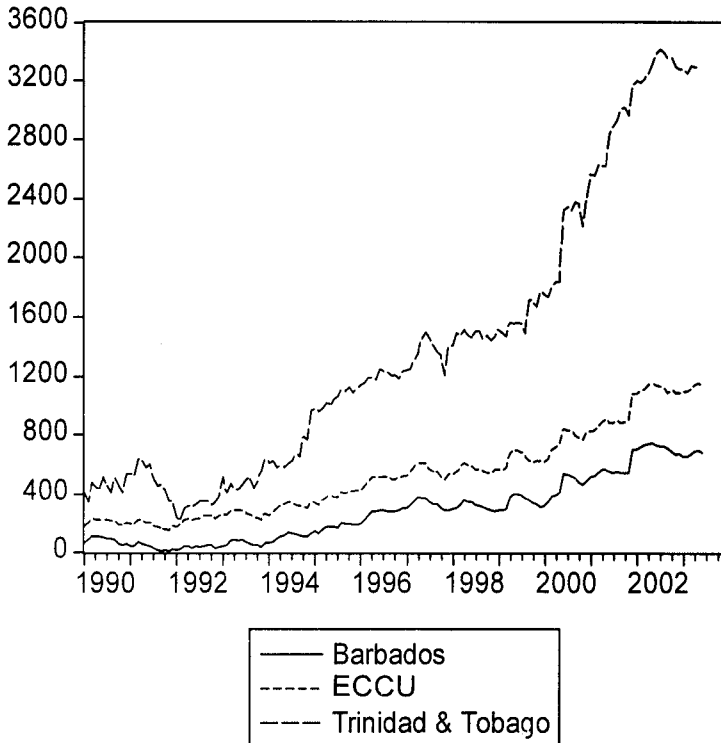
The lack of coordinated capital controls is sometimes cited as an obstacle to currency union, but it is not necessary to have a uniform capital control regime in the union, as ECCU experience reveals. All that is needed is that each member have in place an effective deterrent to short-term speculative financial flows. The three potential members of the MFA/EC all monitor financial flows, although Trinidad and Tobago's arrangements

FIGURE 3.
FOREIGN RESERVE COVER: COMPARISON OF
PROPOSED EASTERN CARIBBEAN MONETARY UNION
AND ITS MEMBERS
(Percentages)



Source: Author's calculations, based on International Financial Statistics data.

FIGURE 4.
NET FOREIGN ASSET CONTRIBUTIONS TO
PROPOSED MFA/EC
(Cumulative Contributions, in
U.S. Dollar Equivalent)



Source: *International Financial Statistics.*

may need to be made more effective in the context of a currency union.

Membership of the monetary union would imply a commitment to responsible and transparent fiscal policy, and an absence of fiscal surprises. The kind of fiscal adjustment undertaken by the Government of Trinidad and Tobago in 1985 and 1993, via the exchange rate, would no longer be possible. Well-designed institutional arrangements, and systems for accountability, would be a necessary feature of the monetary and financial authority. Those are technical and detailed questions which cannot be adequately ventilated in this lecture. However, membership of the monetary union would not entail a convergence of fiscal policy, whether defined as uniform deficits or surpluses, fiscal outcomes that trended in the same direction for all members, or tax and expenditure structures that are similar. The fiscal requirement for members is the same as for countries individually, that the fiscal outcomes be sustainable in the medium term. No mechanism for sharing any member's fiscal burden among others is possible, since the monetary authority cannot lend, and no such mechanism is desirable, in the absence of federal government machinery.

The establishment of an MFA/EC, and the replacement of the existing currencies with a new dollar, would involve no change in policy on the part of any participant, and should

occasion no changes in prices or incomes. The ground would have to be carefully prepared, however, with full discussion and explanation of how the MFA would be implemented, and how it would operate. The details of the changeover would have to be worked out, and plans announced well in advance. It would be advisable to identify and resolve any major weaknesses in the financial sector before unification, to ensure greatest confidence. A comprehensive campaign of market information would be required, prior to the implementation date. Fortunately, there is experience to draw on, not only from the European experience with the introduction of the euro, but from the participating central banks' own experiences, since each of them has successfully introduced a new currency in the past.

The establishment of the MFA/EC might well bring closer the implementation of a common currency for most of CARICOM, as suggested in my recent IMF working paper.⁶ Guyana and Suriname have a strong incentive to replace their weak currencies. Once they met the criteria set out in the working paper they could be readily absorbed into the MFA area, since their money supplies would together add about 20 percent to the sub-regional total. The stability of the new EC

6. Worrell, DeLisle, 2003, "A Currency Union for the Caribbean," IMF WP/03/35, February.

dollar might prove attractive to Jamaica and Belize, in view of the recurring exchange rate crises in the former and repeated threats to the parity of the latter. However, Haiti and The Bahamas are likely to remain outside the union for the foreseeable future, Haiti because of an unstable polity, and The Bahamas because their potential savings in transactions costs are insignificant.

Conclusion

CARICOM countries do not need to resign themselves to currency instability and uncertainty about the U.S. dollar values of domestic currencies. Stability may be achieved by reverting explicitly to currency board arrangements, with a domestic currency pegged to the U.S. dollar and backed 100 percent by U.S. dollar assets. The currency authority would have no lending function. It would have economic research, economic policy and debt management capabilities, and it would advise and coordinate with treasuries on fiscal policy, and provide public economic information. It would also be the supervisor of banks. A monetary union of Barbados, the ECCU and Trinidad and Tobago, which replaces their central banks with a MFA/EC, to issue a common currency for the sub-region, might form the core on which a wider monetary union might be built. However, at least two CARICOM members are likely to remain on the periphery of any monetary union, for the foreseeable future.

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