RETHINKING THE ROLE OF THE FINANCIAL SECTOR IN ECONOMIC GROWTH IN CARICOM

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ABSTRACT

The paper reviews the potential impact of the financial sector on the economic performance of CARICOM economies and indicates some of the institutional reforms that might enhance the sector's performance. It is argued that although institutional reforms are necessary, there are other country specific factors that result in limited productive investment opportunities. Hence, more effective mobilisation of funds might not be reflected in increased productive investment. Consequently, it is proposed that the concept of the sector's intermediary function in the mobilisation and allocation of savings ought to be broadened. Reforms must be geared to having the sector play a central role in contributing to a more dynamic entrepreneurial environment in the region.

Introduction

It is generally accepted that the financial sector plays a central role in the mobilisation and allocation of savings for investment, which consequently, can potentially have a major impact on a country's economic performance. Most economies in CARICOM have experienced low rates of economic growth in recent years. To what extent might the economic performance of regional countries be related to the state of development of their financial sectors? In this regard, the paper reviews the performance of the sector in the mobilisation and allocation of savings in the region to ascertain what reforms might be required to enable the sector to make a greater positive contribution to the growth process.

The discussion is structured along the following lines. The first section briefly reviews the literature on the relationship between financial development and economic growth. This is followed by an assessment of the operational features of the sector in CARICOM countries. The focus is then directed to those factors undermining the performance of the sector and the proposed reforms for correcting these deficiencies. In the final section, the need for change in the perception of what might be considered an appropriate role for the sector in the economy is discussed. It is pointed out that

the role the sector might play is not only to mobilise funds for investment, but also to identify and support viable investment projects.

2. Financial Development and Economic Growth

There is a substantial body of theoretical and empirical work on the role of the financial sector in the economic growth process. Most of these studies conclude that there is a positive relationship between financial development and economic growth.

In evaluating the relationship, a key issue is the extent to which financial development affects growth through its contribution to the rate of accumulation of physical and human capital. Theoretical arguments have been made that in a situation where there are imperfections in financial markets, such as interest rate ceilings and constraints on the allocation of funds (McKinnon, 1973; Shaw, 1973) these could work to inhibit the rate of accumulation of physical and human capital. Similar conclusions were reached in the endogenous growth literature in which services provided by financial intermediaries, such as information collection and analysis, risk sharing and liquidity provision, are explicitly modelled (Greenwood and Javanovic, 1990; Bencivenga and Smith, 1991; Banerjee and Newman, 1991; King and Levine, 1993a). It has also been argued that the role of financial development in factor accumulation will be particularly strong for countries with highly unequal income distribution. The more unequal the distribution of income the larger would be the share of the population not able to acquire financing for investments in physical or human capital.

The empirical literature on the link between financial development and economic growth in recent times either follow a time series approach or apply cross-section analysis. They often use the following as indicators of financial development: the ratio of liquid liabilities of the financial sector, M2 or M3, to gross domestic product (GDP), as a proxy for the overall size of the formal financial sector; domestic bank credit and credit to the private sector, as well as stock market capitalisation as a percentage of GDP. Those based on cross-country analysis shed light on the average influence of variables across countries, whilst the time series studies provide a dynamic long-run link between variables of interest and are able to account for individual country circumstances, taking into consideration each country's institutional and policy context. A third method, panel analysis, potentially combines the positive characteristics of the two approaches (Hossein and Kirkpatrick, 2002).

Most empirical studies on the link between financial development and growth have relied on the cross-section approach. This is, in part, due to the unavailability of good quality financial development indicators of a sufficient length for the purpose of time series analysis. In addition, the results based on time series data are applicable only to the case under study and cannot be generalised to others. Cross-section analyses, on the other hand, provide results that could be applied across a large number of countries. The findings of King and Levine (1993b) are representative of

the cross-country studies establishing a strong correlation between financial development and economic growth. The data set for this study consisted of a pure cross-section and a pooled cross-section of data covering the period 1960-89.

There are problems associated with cross-section analysis. Benhabib and Spiegel (2000) point to three shortcomings: the possibility that omitted country-specific fixed effects leave explanatory power attributed to other variables that act as proxies for unobservables; the introduction of fixed effects into the sample eliminates all time-invariant country-specific information; and there is the possibility of omitted variable bias. In their extension of the King and Levine study (1993b), they use panel data to examine the robustness of financial development indicators to the inclusion of country-specific effects. The measures of financial development utilised were: the ratio of liquid liabilities of the financial sector, M2 or M3, to GDP, as a proxy for the overall size of the formal financial sector; the ratio of deposit money bank deposit assets to deposit money bank assets plus central bank domestic assets; and the ratio of claims on the non-financial private sector to GDP. In addition, they incorporated two interactive terms related to financial development, income distribution and initial income.

The results indicated that financial development had a positive impact on rates of investment and total factor productivity growth. However, different indicators of financial development were shown to affect different components of growth. In the case of total factor productivity growth, the liquidity indicator and the ratio of financial assets of the private sector to GDP were positively related to growth, after accounting for rates of factor accumulation. When country-fixed effects were taken into consideration, only the ratio of financial assets of the private sector to GDP was significant. All the financial development indicators had a positive impact on physical capital accumulation rates with country-specific fixed effects excluded. In summary, the overall debts of the financial sector and the private sector's share of credit relative to GDP both directly influenced growth by enhancing total factor productivity. On the other hand, the size of the banking sector was a significant determinant of the rate of physical and human capital accumulation. Initial levels of income and income inequality influenced only the rates of physical capital accumulation.

3. Operating Features of the Financial Sector and Proposals for Reform

This section outlines some of the conventional indicators of financial development to arrive at an initial assessment of the degree of development of the sector in a selection of CARICOM countries. The indicators used are the ratio of bank credit to GDP, the ratio of private sector credit to GDP, and the ratio of quasi-liquid liabilities to GDP (see Table 1). There is a significant degree of variance among the countries. For example, Jamaica and Trinidad and Tobago score considerably below the other countries in terms of the ratio of credit to the private sector as a percentage of GDP, as well as on the liquidity indicator. The CARICOM countries, on the basis of these

indicators, on average reveal a higher level of financial development than that for Latin America. However, their level of financial development is much lower than developed industrial countries in the Euro area, as well as the new industrial economies in Asia (Asian NICs).

Table 1
Indicators of Financial Development (2002)

Countries	Domestic Bank Credit as a Percent of GDP	Credit to the Private Sector as a Percent of GDP	Quasi-Liquid Liabilities as a Percent of GDP[1]
Barbados	67	58	83
Belize	52	51	46
Guyana	88	57	71
Jamaica	26	15	44
OECS	104	95	103
Trinidad and Tobago	43	42	46
Average: CARICOM	63	53	65
Average: Latin America	47	31	30
Average: Euro area	137	109	71
Average: Asian NICs[2]	104	111	81

Sources: IMF International Financial Statistics.

Notes: [1] M2 is the monetary measure.

[2] Data for 1995.

The information in Table 1 highlights some of the potential shortcomings of trying to associate financial development with economic growth. The Eastern Caribbean Currency Area scored highest on all the financial development indicators of the CARICOM countries, with scores close to those of the Asian NICs. Yet, while the economic performance of those countries in the past decade has been superior to that of Jamaica, it has not been significantly different from most of the other countries in the region or close to that of the Asian NICs in the pre-crisis period. There is the need, as pointed out in the previous section, to consider some of the country-specific factors, which might have had an impact on the savings - investment relationship.

A number of reviews highlighting potential deficiencies in the structure of the financial sector in the region, which might have affected its performance, have been conducted in recent years (World Bank, 1998; Worrell, 2001). The proposals for reform emanating from these studies highlight the need for reform in the following areas. The first broad area is the macroeconomic context in which the sector operates. Attention was directed to the need to contain fiscal deficits, as sound fiscal management was seen as essential for the maintenance of a robust financial sector. The other problem areas identified were geographical fragmentation and lack of competition in local markets; deficiencies in regulation and supervision of institutions; an inadequate supply of long-term finance for businesses and all types of finance for small businesses; low mobilisation and inefficient use of contractual savings funds; and the limited development of capital markets (World Bank, 1998).

The size of the public debt had two important negative connotations. The growth in the domestic component of the debt, which occurred in countries such as Jamaica during the 1990s, was seen as potentially crowding out private investment. Furthermore, government financing requirements might result in indirect forced lending requirements being imposed on financial institutions in the form of high reserve requirements. This imposes a tax on the sector, giving rise to wider spreads between deposit and lending rates, thus discouraging investment and growth.

The lack of competition in the sector was linked to the fragmentation in markets caused by national boundaries and a variety of formal and informal barriers to entry. This has given rise to the emergence of a sector that is dominated by a few large commercial banks in each country, which has led to spreads between lending and deposit rates that appeared to be higher than could be explained only by direct monetary and credit controls (World Bank, 1998). Ironically, the financial liberalisation initiatives undertaken by a number of countries in the 1990s, which might have been expected to increase competition in the sector, have resulted in a reduction in the number of banks operating in the region, as many locally owned banks were amalgamated or consolidated in the process of reform. Foreign banks, which started operations in the region more recently, have experienced difficulty in attracting quality customers from established banks and have not continued to operate (Worrell, Cherebin and Polius, 2001). In the case of Jamaica, rapid growth in the sector combined with inadequate supervision resulted in a financial crisis and shrinkage in the number of institutions. With the move towards a single market in the region, any remaining regulatory constraints on intra-regional investments by financial institutions should be removed. Whether this occurs and results in a more competitive environment is an open question.

Insofar as the matter of supervision was concerned, the view was that the legal regulatory standards were adequate for the commercial banks, but there were shortcomings with respect to the non-bank sector. Jamaica was the only country in the region to experience a major financial crisis. It has been suggested that a critical

cause of the crisis was that financial liberalisation and the subsequent growth in financial conglomerates exceeded the capabilities of the financial supervisory framework. Furthermore, the growth in conglomerates was encouraged by differentials in reserve requirements for different types of financial institutions (Worrell, Cherebin and Polius, 2001).

A major deficiency of the financial sector from a regional perspective is its inability to satisfy the needs of business for long-term finance and all of the financial needs of small businesses. This is, in large measure, reflective of the dominant role of the commercial banks in the sector. These institutions are geared to provide the working capital needs of firms, mortgage lending and consumer credit for households. Investment capital, traditionally, has been financed mainly from retained earnings or from international finance. The failure of the sector to be a major supplier of long-term finance has been attributed to macroeconomic instability, deficiencies in the legal system that make enforcement and collection of loans difficult and lax accounting standards that make reliable information costly to obtain. The lack of clear title to real property in many countries acts as an important barrier to small businesses gaining access to bank loans, as this limits its use as collateral. Furthermore, laws that obstruct foreclosure procedures make it more difficult for small firms to access credit. Modernising the registry of property rights, strengthening the rights of creditors in the legal system and enhancing the standards for information disclosure by firms were identified as essential reforms. Improved supervision and regulation of credit unions, along with additional technical assistance, would serve to strengthen these institutions, which have been an important source of finance for small businesses (World Bank, 1998).

The limited range of available savings instruments in many countries was seen as having a negative impact on the savings effort and limited the ability of firms to raise investment funds. The existing equity markets in Barbados, Jamaica and Trinidad and Tobago do provide additional investment and savings options, but they are limited, given the low trading volumes. Furthermore, the attractiveness of equity as savings instruments in some countries, Jamaica being a case in point, was undermined by the existence of very high real rates of interest. It was suggested that the development of capital markets would be facilitated by macroeconomic stability, allowing for the maintenance of moderate real rates of interest. In addition, the volume of trading would be enhanced by the privatisation of public enterprises and the elimination of barriers to foreign ownership of assets. There would also be a need to streamline debt-settlement and bankruptcy proceedings and establish improvements in accounting and reporting standards.

4. Evaluation of the Reform Agenda

The proposed areas for reform highlighted in the previous section are reflective of what might be deemed the orthodox approach to an evaluation of the performance of the sector. There is no question that effective supervision and capital adequacy are essential if the sector is to play a meaningful role in development. However, in this section, there will be an assessment of the justification for the emphasis placed on some of the other factors identified as potentially contributing to undermining the performance of the sector.

The need to ensure macroeconomic stability was cited as a basic requirement to enable the sector to make an effective contribution to economic growth. To the extent that governments avoided large fiscal deficits this would prevent private investment requirements being crowded out by government borrowing requirements. Furthermore, the additional costs imposed on the financial sector through such measures as high reserve requirements, linked to government financing requirements, would be avoided.

Table 2 presents a summary of the fiscal position of regional countries over the past decade. The Government of Trinidad and Tobago operated with close to balanced budgets, except for fiscal year 1998/99. The deficits incurred by Barbados were relatively small, slightly exceeding 3 percent of GDP on only two occasions. Belize, Guyana and Jamaica all recorded large deficits in the latter half of the decade. However, all countries, with the exception of Jamaica, operated with current account surpluses. In these countries, capital expenditures, which were responsible for the deficits, were mainly financed from sources external to the domestic financial system. It would appear, then, that regional governments are committed to operating with a substantial measure of fiscal restraint. Consequently, in looking ahead, there seems to be little chance of fiscal mismanagement being a factor in the performance of the sector.

In the case of Jamaica, the large deficits in the latter part of the decade arose when the government intervened in the sector to protect depositors in the face of the insolvency of a number of institutions. This was reflected in a large expansion in the level of domestic indebtedness and the sharp increase in debt service requirements (see Table 3).

Table 2
Central Government: Fiscal Balance (percent of GDP)
Surplus (+) Deficit (-)

Fiscal Year	Barbados		Belize		Guyana		Jamaica		Trinidad Total[1]
	Current	Total	Current	Total	Current	Total	Current	Total	
1994/95	4.4	- 0.1	1.9	- 6.0	2.0	-6.8	5.1	2.8	0.2
1995/96	2.8	- 0.1	2.1	- 3.2	6.5	- 3.3	6.1	1.8	- 0.5
1996/97	2.4	- 3.1	3.2	- 0.1	11.3	- 1.6	- 1.0	- 6.1	0.1
1997/98	4.5	- 1.2	2.6	- 1.3	5.6	- 6.9	- 2.4	- 7.8	- 1.2
1998/99	4.4	- 0.6	2.8	- 1.3	2.8	- 8.1	- 3.9	- 6.7	- 3.1
1999/00	3.9	- 1.4	3.0	- 4.4	4.0	- 2.5	- 1.2	- 4.1	1.6
2000/01	3.9	- 1.8	2.5	- 6.0	- 1.1	- 3.5	1.0	-1.0	- 0.1
2001/02	2.8	- 3.7	3.6	- 9.7	- 1.4	- 9.5	- 3.4	- 5.6	0.3

Sources: Central Bank of Barbados, Annual Statistical Digest; Bank of Jamaica, Statistical Digest; Central Bank of Trinidad and Tobago, Annual Economic Survey. Data for Guyana and Belize derived from their respective central bank websites.

Note: [1]Calendar years 1994 – 2002.

Table 3
Jamaica: Debt Indicators
(percent of GDP)

Year	Domestic Debt	Interest[1]
1994	31.0	8.7
1995	29.3	8.4
1996	32.7	11.1
1997	39.3	9.2
1998	43.9	12.2
1999	59.8	13.5
2000	57.0	12.4
2001	82.4	13.4
2002	82.2	n.a.

Source: Statistical Digest, Bank of Jamaica.
Notes: [1]Fiscal years 1994/95 - 2001/02.
n.a. means not available.

Legal reserve requirements were high in all countries, remaining well above 20 percent over the course of the past ten years. The rate in Jamaica was as high as 50 percent in 1994, although it declined to 23 percent by 2002. To what extent did the high reserve requirements cause institutions in the financial sector to channel funds to governments, which would otherwise have been available for lending to the private sector? Furthermore, would the institutions, in meeting these requirements, be required to forego more attractive earnings on alternative lending and investment activities?

The relationship of the actual level of reserve holdings, primarily liquid assets in the form of cash reserves and short-term government securities, relative to the legal requirements, is a reasonable guide as to the extent to which there might have been crowding out of lending to the private sector and a tax on the sector. A summary of the liquidity position of commercial banks, the dominant financial institution in the respective countries, is presented in Table 4.

Table 4. Commercial Banks: Liquidity Position

	1995	1996	1997	1998	1999	2000	2001	2002	Average
Barbados									
Liquidity Ratio	1.28	1.44	1.65	1.34	1.14	1.31	1.43	1.69	1.41
Belize									
Liquidity Ratio	1.12	1.08	1.08	1.17	1.33	1.61	1.52	1.25	1.27
Excess Liquidity % Deposits	3.1	2.0	1.9	4.1	7.9	14.6	12.6	11.5	7.2
Guyana									
Liquidity Ratio	2.0	1.63	1.71	1.56	1.47	1.52	n.a.	n.a.	n.a.
Excess Liquidity % Deposits	21.2	13.1	14.7	14.7	9.8	10.9	n.a.	n.a.	n.a.
Jamaica									
Liquidity Ratio	1.05	1.06	1.14	1.15	1.35	1.54	1.58	1.64	1.32
Excess Liquidity % Deposits	2.4	2.6	6.7	7.0	12.8	17.1	16.7	16.1	10.2
OECS									
Liquidity Ratio	1.22	1.20	1.21	1.31	1.19	1.10	1.33	1.29	1.23
Trinidad and Tobago									
Excess Liquidity % Deposits	0.0	2.3	3.8	4.8	3.7	13.3	7.3	10.6	5.7

Sources: Central Bank of Barbados, Annual Statistical Digest; Bank of Jamaica, Statistical Digest; Central Bank of Trinidad and Tobago, Annual Economic Survey. Data for Guyana and Belize derived from their respective central bank websites. The Organisation of Eastern Caribbean States (OECS) data came from the ECCB website.

Note: n.a. means not available.

In all the countries, the holdings of liquid assets by commercial banks exceeded (by a substantial margin) the holdings required by law. This was true even in Jamaica, where there was the most rapid increase in the growth of domestic debt. The substantial excess holdings of such assets by these institutions suggest that if there were limitations on access to funds by the private sector, this could not be attributed to force lending requirements. Furthermore, in all the countries there was a trend towards a rise in excess liquidity at the same time as there was a downward pattern in required holdings in the late 1990s. Given these excess holdings, it seems reasonable to assume that the institutions were not forced to incur a tax by having to forego higher earnings on alternative investment activity. It appears more reasonable to conclude that the holdings in excess of legal requirements reflected a lack of suitable alternatives for placement of available funds.

Given the limited range of institutions and savings instruments available in all countries, how might this have affected interest rates offered and the incentive to save? How might the limited degree of competition in the sector have influenced lending rates and borrowing and investment decisions?

5. Savings Mobilisation

In view of the fact that commercial banks are the dominant institutions in the sector, this section begins with an evaluation of their effectiveness in mobilising savings. As a benchmark, changes in the stock of savings held by the commercial banks over the past decade relative to changes in nominal GDP will be used. This information is provided in Table 5. At a minimum, one would expect the growth in the stock of deposits in financial institutions to be no less than that of GDP.

Between 1994 and 2002, the rate of growth in bank deposits in all countries, apart from Jamaica and Trinidad and Tobago, was significantly higher than that of nominal GDP. In the case of those two countries, the growth in deposits was approximately equal to that of GDP. The relatively slow rate of growth in bank deposits in Jamaica and Trinidad and Tobago appears not to be influenced by the existence of a wider array of savings institutions in those countries. The growth rate in the stock of savings in non-bank financial institutions was lower than for banks in Jamaica and equal to that of the banks in Trinidad and Tobago.

Nevertheless, on the basis of this benchmark, commercial banks in the region as a whole mobilised deposits at a higher rate than those in industrial countries (the United States and Canada), a major developing country such as Brazil and was comparable to that of Malaysia.

Table 5
Growth Rate of Deposits and Share of Deposits in GDP

	Growth Rate 1994-2002	Share of GDP 1994	Share of GDP 2002
Barbados: Total Deposits	9.0	68.3	92.3
Commercial Banks	9.8	58.7	84.2
Trust Companies	2.7	9.6	8.1
GDP	5.0	n.a.	n.a.
Belize: Total Deposits	8.8	40.5	53.3
GDP	5.1	n.a.	n.a.
Guyana: Total Deposits	13.1	50.0	73.0
GDP	7.9	n.a.	n.a.
Jamaica: Total Deposits	12.2	57.9	57.5
Commercial Banks	13.2	38.2	40.8
Non - banks[1]	10.0	19.7	16.7
GDP	12.3	n.a.	n.a.
OECS: Total	9.9	81.0	123.8
GDP	4.3	n.a.	n.a.
Trinidad and Tobago: Total	8.6	48.1	46.9
Commercial Banks	8.5	38.1	37.0
Non- banks[2]	8.8	10.0	10.0
GDP	9.0	n.a.	n.a.
Canada: Total Deposits	5.0	74.5	73.5
Commercial Banks	6.8	55.0	62.1
GDP	5.2	n.a.	n.a.
United States: Total Deposits	4.7	43.3	42.2
Commercial Banks	5.7	30.2	31.8
GDP	5.0	n.a.	n.a.
Brazil: Commercial Banks	14.3	38.4	29.6
GDP	18.1	n.a.	n.a.
Malaysia: Commercial Banks	12.4	67.3	92.8
GDP	8.0	n.a.	n.a.

Sources: Central Bank of Barbados, Annual Statistical Digest; Bank of Jamaica, Statistical Digest; Central Bank of Trinidad and Tobago, Annual Economic Survey. Data for Guyana and Belize derived from their respective central bank websites. IMF International Financial Statistics for remaining countries.

Notes: [1]Merchant Banks and Finance Houses, Credit Unions and Building Societies.

[2] Finance Companies and Merchant Banks, Trust and Mortgage Finance Companies and Thrift Institutions.
n.a. means not available.

The ability of individuals to accumulate bank deposits depends on their levels of discretionary income. Given the level of discretionary income, the extent to which interest rates may have a bearing on deposit holdings relies on the major motives for saving. For any given level of national income, the aggregate level of discretionary income will be determined by the degree of equality in the distribution of income. The more unequal the distribution of income, the greater would be the amount of discretionary income available for the acquisition of deposits. If a major motive for holding bank deposits is security, then the rate of interest will not exercise a significant influence on deposit holdings. On the other hand, if rates of return are important, then the amounts held will be determined by the levels and variety of interest options available. Under most circumstances one might expect both security and earnings to be critical considerations, with the decision to hold deposits being influenced by an appropriate balance between security and earnings. Some regional central banks, for example, the Central Bank of Barbados and the Eastern Caribbean Central Bank, exercise control on the rate of interest commercial banks offer on savings deposits. In Jamaica, on the other hand, the rates are ostensibly determined by conditions prevailing in the domestic market.

Nominal and real interest rates on deposits are shown in Table 6. It is often argued that where deposit rates are not market-determined, for example when there are interest rate ceilings or floors, the resulting distortions could act as a disincentive to savings. Nominal interest rates were highest in Jamaica and Guyana, which also experienced the highest rates of inflation in this period. However, there was a broad similarity in the real deposit rates in all the countries, with the exception of those in the OECS and Belize, where the real deposit rates were significantly higher in the post-1997 period.

It is expected that persons with high incomes would most likely be influenced by interest differentials. For example, in Jamaica, the liberalisation of the financial sector meant that savers could assess a range of domestic and foreign alternatives. In this period, the real rate of interest on time deposits in Jamaica, between 1996 and 2000, shown in Table 6, was competitive with that offered on certificates of deposit in the United States, the most likely alternative. In summary, whether rates were market-determined or subject to some measure of governmental control, positive real rates of interest were on the whole sustained and rates were broadly competitive with those in other jurisdictions within and outside the region.

Nominal lending rates were high in all countries. As the data in Table 7 indicate, even in the case of Barbados, the country that on average had the lowest bank lending rates, the real lending rate was significantly higher than the prime-lending rate in the United States. The high interest rates charged for loans could not be attributed to an imbalance between demand and supply for loanable funds. The substantial holdings of liquid assets over and above minimum legal requirements suggested, as pointed out earlier, that many potential borrowers were unable to satisfy the credit conditions

Table 6. Deposit Rates

		1994	1995	1996	1997	1998	1999	2000	2001	2002
Barbados										
Time Deposit	- nom	5.5	6.5	6.0	5.0	5.0	6.5	6.0	4.25	2.75
	- real	4.8	4.5	3.5	-2.5	6.4	4.8	3.5	1.6	2.6
Belize										
Weighted/										
Average Deposit	- nom	6.1	7.2	6.2	6.7	6.0	5.7	5.0	4.3	4.5
	- real	4.2	3.2	-0.2	5.6	6.96	6.98	4.37	3.1	2.25
Guyana										
Time Deposit	- nom	14.3	14.4	9.5	9.3	9.7	10.3	9.4	8.1	4.2
	- real	0.6	1.96	2.24	5.5	4.87	2.6	3.1	5.36	-1.0
Jamaica										
Time Deposit	- nom	27.9	26.2	20.8	14.1	15.5	13.3	12.2	10.1	8.9
	- real	0.8	0.5	4.3	4.5	7.1	6.1	5.8	1.2	1.5
OECS										
Time Deposit	- nom	8.0	7.0	8.5	9.25	9.25	9.25	9.25	9.25	9.25
	- real	n.a.	n.a.	n.a.	6.8	6.0	7.2	7.6	7.3	8.6
Trinidad & Tobago										
Time Deposit	- nom	11.5	9.4	10.0	10.0	10.5	10.2	9.8	10.0	9.3
	- real	2.5	3.9	6.5	6.1	4.6	6.6	6.0	4.3	4.8
United States		4.6	5.9	5.4	5.6	5.5	5.3	6.5	3.7	1.7

Sources: Central Bank of Barbados, Annual Statistical Digest; Bank of Jamaica, Statistical Digest; Central Bank of Trinidad and Tobago, Annual Economic Survey. Data for Guyana and Belize derived from their respective central bank websites.

Notes: [1]Calendar years 1994 – 2002.

n.a. means not available.

Table 7. Commercial Banks Lending Rates[1]

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Barbados									
- Nominal	11.9	11.8	11.9	11.9	11.6	11.7	11.9	11.1	10.4
- Real	11.1	9.7	9.3	3.9	13.1	9.9	9.3	8.3	10.2
Belize									
- Nominal	15.0	16.3	16.2	16.6	16.3	16.3	15.8	15.4	14.5
- Real	13.0	11.9	9.2	15.4	17.4	17.7	15.1	15.0	12.0
Guyana[2]									
- Nominal	19.9	19.1	17.2	16.9	16.6	17.3	17.2	16.8	16.3
- Real	5.5	6.1	9.4	12.8	11.5	9.1	10.5	13.8	10.5
Jamaica									
- Nominal	45.8	48.6	37.8	31.9	30.1	24.6	22.1	19.5	18.3
- Real	15.0	18.3	19.0	20.8	20.6	16.7	15.1	9.8	10.2
OECS									
- Nominal	13.0	12.0	12.0	12.5	12.5	12.5	12.0	12.5	12.0
- Real	-	-	-	10.1	9.1	10.4	10.3	10.5	11.3
Trinidad & Tobago									
- Nominal	13.9	13.4	14.2	13.9	15.2	15.9	15.3	14.5	12.8
- Real	4.6	7.7	10.6	9.8	9.1	12.1	11.3	8.5	8.2
United States[2]	7.5	8.8	8.3	8.4	8.4	8.0	9.2	6.9	n.a.

Sources: Central Bank of Barbados, Annual Statistical Digest; Bank of Jamaica, Statistical Digest; Central Bank of Trinidad and Tobago, Annual Economic Survey. Data for Guyana and Belize derived from their respective central bank websites.

Notes: [1]Weighted Average lending rate.
[2]Prime rate.

n.a. means not available.

demanded by lending institutions. However, the high rates would have resulted indirectly in some rationing of funds with uncertain consequences for the overall performance of the economy. Lending rates in Jamaica, in particular, were exceptionally high although there was a significant reduction in rates over the period. Although the country experienced high rates of inflation in this period, real lending rates ranged between 15 and 21 percent up to the year 2000. The high rates in Jamaica arose from the decision taken by the Bank of Jamaica in that period to rely on the interest rate mechanism as a means of supporting the exchange rate.

The impact of high interest rates on borrowing and investment decisions depends on the extent to which it represents a real cost burden. This, in turn, relies on the degree of competition borrowers have to face in the markets in which they operate, as this would be a determinant of their ability to pass through the interest charges. In the CARICOM context, those operating in the domestic market are usually faced with limited competition and hence interest charges would likely be a lesser factor in the borrowing decision. However, the growth performance of countries in the region will increasingly depend on the ability of local firms to be more internationally competitive. As barriers to trade continue to fall and preferential marketing arrangements are phased out, not only will firms face more competition in foreign markets, but they will also be exposed to greater competition in home markets. The ability of the financial sector to make funds available at competitive rates of interest will be an important element in its ability to contribute meaningfully to the development of countries in the region.

6. The Reform Challenge

In the preceding section, the discussion focused on a subset of features highlighted in previous reviews of the financial sector, which were seen as undermining its ability to perform its intermediary function. Reference was also made to some of the reforms arising from these reviews designed to address these deficiencies. These, by and large, were concerned with measures to ensure stability of the sector, increase the volume of savings, enhance the return to savers and minimise borrowing costs. All of these measures seem to be primarily directed at enhancing the supply of savings. However, it is the view of this author that if the sector is to be a major contributor to the growth process, it will also be important to address some shortcomings on the demand side. Why is it that a greater share of savings is not allocated to productive private investment? What accounts for the fact that many potential borrowers are not able to satisfy the lending requirements of financial institutions? Is it the case that the major cause is the inability of many borrowers to satisfy the collateral requirements of lending institutions? If that is the case, then the proposal to strengthen property rights as a means of broadening the collateral base will certainly be a positive step. However, it is possible that it might be the limited pool of sound projects as much as inadequate collateral that might account for the relatively large share of liquid asset

holdings by institutions. The reasons why this might be the case could be linked to such factors as historical inequities in these societies reflected in unequal access to, for example, education and health, discrimination based on colour and class, which have worked to limit growth in the pool of entrepreneurial talent. In this sense, it can be argued that an effective reform agenda for the financial sector in the CARICOM context has to explicitly address the matter of finding ways of increasing the number of viable propositions worthy of financial support.

A major objective here is to outline ways in which the sector can play a more important role as a source of finance for investment in capital equipment, as opposed to the provision of short-term trade credit. In order for this transformation to occur, the institutions in the financial sector will have to take on a more pro-active role. This would involve institutions not only performing the traditional intermediary function of assessing requests for financial support, but becoming engaged in the identification of areas for productive investment and providing visible financial support for investment in these areas. In other words, the reforms should be geared towards having a financial sector which is not only working to establish new ways to mobilise savings, but is also actively engaged in finding new ventures for allocating funds.

This proposed change in function carries important implications for the human resource needs of institutions functioning in the sector. In addition to such traditional areas as accounting and finance, institutions within the sector would need to have ready access to those who can interpret trends in technological developments, which might be indicative of productive opportunities in new and traditional products. Furthermore, there would be a need to develop in-depth knowledge of global marketing trends. This means that private financial institutions in the region will have to be encouraged to do something that they have traditionally ignored, but which has been accepted as essential in other jurisdictions, namely, establishment of research departments. Research departments will be required to provide management with an independent assessment of the implications of domestic and internal, economic, political and technical developments on an ongoing basis.

There is a role for government in facilitating this transformation of the financial sector through the provision of fiscal incentives. Tax incentives might be used to encourage the development of independent research activity within the sector. Such activity will be seen as initially entailing a cost with no obvious immediate short-term return. To the extent that the costs associated with this activity could be written off in whole or in part, this could reduce resistance to the undertaking such expenditure.

Tax incentives might also be employed to encourage institutional innovations geared towards the financial sector taking on a more pro-active role. For example, special tax treatment of funds invested in new enterprises could encourage firms to take partial ownership positions in new enterprises or in the expansion of existing enterprises.

Apart from the provision of tax incentives, government can play a role in bringing about change in the financial sector through a regulatory environment that encourages the type of innovative activity proposed. Reforms in the regulatory environment could make it possible for institutions to engage in areas of activity from which they have been traditionally barred. This would have to occur in conjunction with adjustments in the supervisory framework in order to ensure the maintenance of stability.

There is also a need for attitudinal change towards the importance attached to small non-traditional business activity. This implies that more attention must be placed on ways of harnessing finance in support of micro-enterprises outside of the traditional institutional setting. This might be achieved with a move towards the establishment of community based micro finance schemes. In this context, the financial sector would not only be playing the role of a provider of finance but would also be a provider of advice to the prospective investor.

7. Conclusion

The sectoral reforms outlined above must be geared towards the broadening of the role of the financial sector beyond that of serving purely as an intermediary between savers and borrowers. Given the relative scarcity of entrepreneurial talent, the sector has to play a role in helping ensure that the full potential of that talent is realised. Institutions in the sector will have to take on a more pro-active role in helping to identify and encourage innovative activity. There also has to emerge within the sector an appreciation of the importance of encouraging a knowledge culture. These are the types of developments that will allow the financial sector to make a meaningful contribution to regional development.

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