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Chapter 1

THE EAST CARIBBEAN CURRENCY AUTHORITY\*

Historical Origins

The East Caribbean Currency Authority was established in 1965 in accordance with an agreement made between the Governments of Barbados, the Leeward Islands and the Windward Islands, with the exception of Grenada.<sup>1</sup> At the end of 1967, the Government of Grenada applied for and was subsequently granted membership in the East Caribbean Currency Area.<sup>2</sup>

The establishment of the East Caribbean Currency Authority was occasioned by the dissolution of the British Caribbean Currency Board; and, therefore, a knowledge of the circumstances surrounding the establishment and dissolution of the latter is essential to an appreciation of the present structure and function of the East Caribbean Currency Authority.

At the beginning of this century, the principal medium of exchange, in the West Indies and elsewhere in the British Colonial Empire, was United Kingdom coin. It soon became apparent that this

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<sup>1</sup>Cf. 1965 Currency Agreement.

<sup>2</sup>Cf. East Caribbean Currency Authority: Third Annual Report, 1968, p.8.

170 Regional Monetary Studies Conference

arrangement was defective. The two major defects of this system were: an absence of satisfactory arrangements for redeeming redundant coin; and the United Kingdom's retention of the seignorage on the coin issued in the colonies. In regard to the former, G.L.M. Clauson writes: "...the United Kingdom Government's transactions in silver coin were a one-way traffic only. The Government were prepared to deliver silver coins in the colonies in unlimited quantities for its face value, but legal tender of such coins in the United Kingdom was limited to forty shillings, and they did not hold themselves out to buy the coins back again at its face value or, indeed, at any value at all."<sup>3</sup> Clauson goes on to point out that the net effect of these two defects were "Dependencies were buying large quantities of coins from the United Kingdom at a price much above its intrinsic value, and had no assurance of getting their money back if they wanted to".

It was partly in response to this situation that legislation was introduced authorising Colonial Governments to issue currency notes, with the obvious intention of economizing on the use of United Kingdom coins, thereby minimizing future issues of such coins. "In 1902 the first steps in this direction were taken in the West Indies with the issue of Government currency notes in the Turks and Caicos Islands. The second issue of similar notes was made by Trinidad in 1906".<sup>4</sup> By 1941, experiments of currency issues by Colonial

<sup>3</sup>G.L.M. Clauson: "The British Colonial Currency System"; Econ. Jour. April 1944.

<sup>4</sup>Ida Greaves: "Money and Currency in Barbados"; The Journal of the Barbados Museum and Historical Society, Vol. p. 12.

Governments in the British West Indies, and an agreement between Barbados, British Guiana and Trinidad and Tobago, resulted in the currency arrangements which preceded the establishment of the British Caribbean Currency Board.

During the 1940's, throughout the region covered by this study, British coin and the Government currency notes of Trinidad and Tobago were legal tender. In addition, the Government of Barbados had their own issue of currency notes, and currency notes issued by the Government of British Guiana were also legal tender in Barbados. Bank notes issued by the British and Canadian commercial banks operating within the region circulated freely throughout the islands. These bank notes were issued under licence up to specified amounts.

In May 1946, a West Indian Currency Conference was held in Barbados. This Conference recommended "the establishment of a Regional Currency Board and the Unification of the Currency of the Eastern Group of the West Indies on the basis of the British West Indian dollar worth four shillings and two pence, sterling".<sup>5</sup> As a result of these recommendations the British Caribbean Currency Board was established and given the sole right to issue currency in Barbados, British Guiana, the Leeward Islands, the Windward Islands and Trinidad and Tobago. British Caribbean currency notes were first issued on 1st August, 1951, and British Caribbean coins on 15th November, 1955.

<sup>5</sup>Colonial Office Report on Barbados, 1947.

From the standpoint of monetary policy the establishment of the British Caribbean Currency Board did not constitute any significant improvement upon the currency arrangements which existed in the region prior to 1951. The B.C.C.B., like the three Boards which it replaced, was a mere instrument of Colonial policy. Its function was that of a money-changer, issuing physical currency on demand in exchange for bank payments made in sterling, or redeeming it when called upon, by payments of sterling for immediate delivery in London. The operations of the Board in this respect were automatic and were performed in accordance with the 1950 Currency Act.

The lack of discretionary power which characterised the Board's operations in regard to the issuing and redemption of currency was equally manifest when it came to portfolio management. The B.C.C.B. was legally required to maintain a reserve fund of not less than one hundred per cent of the face value of its currency notes and coins in circulation. The Board's singular lack of discretion in the investment of this reserve fund was revealed by Article 4 of the First Schedule to the 1950 Currency Act which stated that "the Fund may be invested in sterling securities of or guaranteed by the Government of any part of the British Empire (except the participating Governments) or such other securities as with the approval of the Secretary of State, may be selected by the Crown Agents:

Provided that a proportion of the Fund shall be held in London in liquid form and such proportion may be determined and varied from time to time with the approval of the Secretary of

State by the Board".

The preamble to the agreement which constitutes the First Schedule of the 1950 Currency act alludes to the desirability of establishing "a Board of Commissioners to provide for and control the supply of currency to the territories administered by the Governments participating in this agreement". However, on no meaningful interpretation of the word "control" can it be said that the B.C.C.B. was empowered to control the supply of currency. The power to control the supply of currency is suggestive of a position of dominance in the monetary system. But the dominant institution under the Currency Board system was commercial banking.<sup>6</sup> The British Caribbean Currency Board was a passive institution which was activated at the instance of commercial banks operating within the region.

After Trinidad and Tobago and Guyana obtained their political independence from the United Kingdom, these two countries elected to withdraw from participation in this classic colonial institution, and established their own central banking institutions. The withdrawal of these two countries from participation in the British Caribbean Currency Board led to its dissolution and the establishment of the East Caribbean Currency Authority.

In terms of its formal-legal structure, the East Caribbean Currency Authority is a slightly modified Currency Board, and still retains a strong colonial bias. However, the revolution of expectations which led Guyana and Trinidad and Tobago to establish their own Central Banks was no less evident in Barbados, the Windward

<sup>6</sup>For further elucidation of this point cf. chapter on Money.

Islands and the Leeward Islands. Consequently, in the preamble to the East Caribbean Currency Agreement 1965, it is suggested that the E.C.C.A. was formed because of a desire "to establish a common currency and to establish an authority to issue and manage that currency, to safeguard its international value and to promote monetary stability and a sound financial structure in the territories of the participating Governments". As a result, the E.C.C.A., though organized along lines consonant with the British Colonial Currency System, is expected to perform in a way befitting the aspirations of an independent people; and was conceived to function as nothing less than a Central Bank.

#### The E.C.C.A.'s Performance

The East Caribbean Currency Authority made its first issue of currency on 6th October, 1965. During its short period of existence the E.C.C.A. has experienced a considerable rate of growth in its financial resources. At the end of 1965 the assets of the E.C.C.A. stood at E.C.\$26,546,000. By the end of 1968 this amount had increased to E.C.\$84,709,816; an increase of 219.1 per cent over December 1965. This increase is almost entirely accounted for by increases in the Authority's holding of external assets. In March 1966 this percentage rose to 90.1 and has seldom fallen below this level since. United Kingdom securities comprised virtually all of the E.C.C.A.'s external assets.

At the end of 1965 the Authority's assets were matched on the other side of the balance sheet by an outstanding currency issue amounting to E.C.\$26,171,000 and a loan from participating

Governments of E.C.\$375,000. Since then the liability structure of the E.C.C.A. has been diversified to an appreciable degree. In December 1965 notes in circulation represented 98.6 per cent of the total liabilities of the E.C.C.A. By December 1968 this percentage had fallen to 50.7. The major growth elements in the E.C.C.A.'s liabilities were bankers' balances and bankers' deposits. Bankers' balances represents the E.C.C.A.'s indebtedness to commercial banks and the Central Banks of Guyana, Jamaica and Trinidad and Tobago, for the redemption of the E.C.C.A. notes. Consequently, a change in this item represents a change in the E.C.C.A.'s liability structure, rather than a change in its liabilities. On the other hand, bankers' deposits represent Money at Call deposits from commercial banks and, therefore, an increase in this item represents an increase in the assets and liabilities of the E.C.C.A. Consequently, bankers' deposits are not only a major growth element in the E.C.C.A.'s liabilities, but are also mainly responsible for the rapid growth of its assets. In December 1965 the E.C.C.A. held no bankers' deposits. By December 1968 bankers' deposits accounted for 43.4 per cent of the E.C.C.A.'s liabilities. This amount also exceeded the total liabilities of the E.C.C.A. as at 31st December 1965 by 38.4 per cent.

Apart from the issuing and redemption of currency, and the management of a portfolio of assets the only other area in which the E.C.C.A. has been involved in the financial sector of the East Caribbean economy is through the operation of a cheque clearing system for commercial banks operating in Barbados. Under this system the E.C.C.A. maintains accounts in its books for each of

the commercial banks and settlement can be made in sterling or in East Caribbean dollars whenever the net balance on any bank's account exceeds E.C.\$25,000."<sup>7</sup> This system has been in operation only since 1st February 1969, and it is still being conducted on an experimental basis.

In assessing the E.C.C.A.'s efficiency we must first remark on its limited involvement in financial arrangements within the region. An explanation of this occurrence will be advanced below. However, before looking into the reasons why the E.C.C.A. has been so inactive, an attempt will be made to appraise the quality of its involvement in East Caribbean Area monetary and credit arrangement. Because of the very recent introduction of the cheque clearing system, no attempt would be made to appraise the performance of the E.C.C.A. in this respect.<sup>8</sup> The E.C.C.A.'s role in the issue and redemption of currency is purely passive,<sup>9</sup> and so the only basis on which we can appraise its activity (as opposed to inactivity) is by an evaluation of the efficiency of its portfolio policy. In this regard, it should be noted that sound portfolio policy entails maximizing the return on investments consonant with tolerable levels of risk and minimum liquidity requirements. In the case of a central

<sup>7</sup>Cf. East Caribbean Currency Authority: Annual Report and Statements of Accounts for year ended 31st March, 1969; Page 7.

<sup>8</sup>However, clearing arrangements will be discussed in a later section of this chapter; and the inadequacy of the present system as operated by the E.C.C.A. will be revealed.

<sup>9</sup>Reasons will be advanced for this assertion later.



banking institution operating in an underdeveloped country or area, there is the added dimension of maintaining external assets at the lowest level consonant with balance of payments requirements. The latter index of efficiency may or may not conflict with income maximizing criterion. However, in the event that there is conflict, the minimizing of external assets (or the maximizing of local assets) must be given priority. This ought to be so because, characteristically, underdeveloped countries are capital scarce countries, and the central banking institution can assist in the development effort by releasing as much of the resources which it controls to persons and institutions within the domestic economy for investment purposes i.e. by keeping foreign lending (its holding of foreign assets) to a minimum.

In assessing the efficiency of the E.C.C.A.'s portfolio policy we must therefore take into consideration (1) the level of foreign assets maintained by the E.C.C.A.; (2) the liquidity structure of these assets, and (3) the distribution of foreign assets according to country of origin.

In December 1965 the E.C.C.A.'s external assets were equivalent to 92.2% of her demand liabilities. Since then there has been a persistent increase in this ratio. In December 1968 external assets amounted to 101.1%. When we stop to consider that all external assets represents a drain on a country's financial resources; and that the rationale for holding foreign securities derives from the need to accommodate balance of payments deficits, it becomes evident that the E.C.C.A. has been maintaining excessive reserves. The E.C.C.A.'s maintaining foreign reserves in excess of 100 per cent could

only make sense if there was so much as a theoretical possibility that persistent deficits in the balance of payments could lead to a situation where the total money supply in the Currency Area, along with the E.C.C.A.'s other demand liabilities, could be wiped out. Such a possibility runs counter, not only to every known theory of balance of payments adjustments, but is also repugnant to common-sense. Consequently, we can conclude that, in this respect, the E.C.C.A.'s portfolio policy leaves much to be desired.

However, this is not to say that those officers who are responsible for administering the E.C.C.A.'s portfolio stand incriminated of gross negligence. Although they cannot be exonerated entirely, much of the blame must be placed on the legal strictures imposed upon the E.C.C.A.,<sup>10</sup> as well as on the policy of the regional governments. In regard to the latter, governments have altogether made too little use of the E.C.C.A. Given the limited range and volume of local private securities, government must be the main recipient of loans if the E.C.C.A. is to repatriate any of its accumulated financial resources.

The liquidity structure of the E.C.C.A.'s portfolio of foreign assets, like the desired level of foreign assets, is also dictated by balance of payments requirements. However, the optimal level of reserves must be based upon estimates of possible cyclical variations in the balance of payments position, while the liquidity requirement ought to be based on seasonal considerations. Because the return on securities with a longer term to maturity is normally

<sup>10</sup>This point will be developed in greater detail below.

greater than on short dated paper, it therefore constitutes sound policy to keep liquid assets to the lowest level consonant with expected seasonal deficits in the balance of payments.

When the E.C.C.A.'s portfolio policy is evaluated in accordance with the foregoing principles considerable inefficiency in the management of the portfolio of foreign assets is revealed. The E.C.C.A.'s liquidity position for the fiscal years ended March 1966-69 is shown in the following table:-

Table 1.1

E.C.C.A.'s Liquid External Assets Ratios; 1966-69

Liquid External Assets as % of Total External Assets	<u>1966</u> 71.3	<u>1967</u> 57.8	<u>1968</u> 53.4	<u>1969</u> 79.3
Liquid External Assets as % of Total Assets	65.7	54.3	49.5	76.0
Liquid External Assets as % of Demand Liabilities	55.5	57.1	54.0	80.9

Source: East Caribbean Currency Authority: Annual Report; for the year ended 31st March, 1969.

Rows (1) and (2) in the above table give an indication of the low return which the E.C.C.A. has been receiving on the majority of her assets. Row (3) reveals that it was totally unnecessary for the E.C.C.A. to maintain such a high degree of liquidity. The E.C.C.A.'s liquid foreign assets are almost entirely made up of current accounts and money at call in London, and U.K. Government Treasury Bills. Consequently, the E.C.C.A.'s maintaining a liquid assets to demand deposits ratio of 80.9 per cent can be logically justified only if there was the reasonable possibility that the

liabilities could be reduced by 80 per cent in a period of three months; and even this would only be true if we made the assumption that the E.C.C.A. was 100% averse to taking risks. For any willingness to trade off risk against profits would suggest that the E.C.C.A. should balance expected capital losses from a given portfolio against the yield from her assets. The extreme nature of these assumptions suggests that the E.C.C.A. has been unnecessarily sacrificing income by maintaining excessive liquid foreign assets ratios.

Table 1.1 shows also that the E.C.C.A.'s management of its reserves has deteriorated rapidly since March 1968. This conclusion is verified by an analysis of the composition of the E.C.C.A.'s liquid foreign assets since March 1968. As mentioned above, the E.C.C.A.'s external liquid assets are made up of current accounts and money at call in London, and U.K. Government Treasury Bills. Rationally the former category of assets should be held only to accommodate daily or weekly reductions (if and when these should occur) in the E.C.C.A.'s demand liabilities. The following table shows current accounts and money at call in London as a percentage of (1) total external assets, and (2) demand liabilities since March 1969.

Table 1.2 reveals that in the short space of a year the composition of the E.C.C.A.'s external assets had changed from a position where the E.C.C.A. was earning at least the British Treasury Bill rate on some 90 per cent of her total foreign assets, to a position where earnings on 47 per cent of its total assets were

Table 1.2

The E.C.C.A.: Current Accounts and Money at Call as percentage of (1) External Assets, and (2) Demand Liabilities: Monthly, March 1968-March 1969.

	(1)	(2)	(3)	(4)	(5)
	Current A/Cs and Money at Call in London	Total External Assets	Col. (1) as % of Col. (2)	E.C.C.A.'s Demand Liabilities	Col. (1) as % of Col. (4)
1968 March	950,498	32,484,260	2.9	34,691,978	2.7
April	1,330,211	34,161,263	3.9	35,555,277	3.7
May	1,068,515	35,329,385	3.0	35,660,877	3.0
June	1,487,634	40,865,865	3.6	40,463,625	3.7
July	1,403,875	49,264,197	2.8	50,330,277	2.8
August	15,663,294	65,604,118	23.9	63,435,977	23.9
September	16,151,620	66,465,295	24.3	65,653,777	24.5
October	16,552,403	66,080,141	25.0	65,992,327	24.5
November	33,565,813	83,505,046	40.2	83,950,577	40.0
December	33,211,901	76,862,815	43.2	79,838,277	41.6
1969 January	35,456,465	77,985,522	45.5	79,506,097	44.6
February	38,788,304	82,756,636	46.9	82,840,547	46.8
March	38,548,085	81,811,720	47.1	82,233,028	46.9

Source: East Caribbean Currency Authority: Annual Report, for the year ended 31st March, 1969.

either non-existent or infinitesimal. In March 1968 2.7 per cent of the E.C.C.A.'s demand liabilities were matched by current accounts and money at call in London. By March 1968 this percentage had climbed dramatically to 46.9%. The logic of this policy can be subject to serious questioning. This is doubly true when it is realized that this increase in the E.C.C.A.'s non-earning assets is paralleled by a similar increase in Bankers' Deposits, the only interest bearing component in the E.C.C.A.'s liabilities. This situation is depicted in Table 1.3.

Table 1.3

E.C.C.A.: Monthly Changes in (1) Current Accounts and Money at Call, and (2) Bankers' Deposits; June 1968-March 1969.

Month	Change in Current Accounts & Money at Call in London	Change in Bankers' Deposits
1968 June	419,119	4,800,000
July	- 83,759	9,600,000
August	14,259,419	14,400,000
September	488,326	No change
October	400,783	No change
November	17,013,410	16,972,000
December	- 353,912	- 9,022,000
1969 January	2,244,564	2,600,000
February	3,331,839	2,460,000
March	- 240,219	- 3,115,000

Source: East Caribbean Currency Authority: Annual Report, for the year ended 31st March, 1969.

The E.C.C.A.'s questionable handling of its portfolio of assets with respect to its liquidity structure has been compounded with its failure to establish any type of balance between asset yield and the risk of capital loss through devaluation of a foreign currency. It has been the E.C.C.A.'s expressed policy to maintain all of its external assets in the form of sterling securities; mainly U.K. Government securities.<sup>11</sup> It can be proved mathematically that diversification of a portfolio tends normally to reduce the risk and uncertainty attaching to any rate of return from that portfolio.<sup>12</sup> However, this point can also be appreciated heuristically by contemplating the fate of the man who had all his eggs in one basket, or that of the E.C.C.A. on the occasion of the 1967 devaluation of sterling, when it suffered a 14.3% reduction in the value of its external assets.

If it is difficult to formulate a reasonable case for the policies which the E.C.C.A. has been pursuing in regard to (1) the liquidity, and (2) the spatial distribution of its foreign assets; it is futile to attempt to reconcile these two strands of the E.C.C.A.'s portfolio policy. As has been argued above, any attempt at a logical defence of the E.C.C.A.'s liquidity policy must be based on the assumption that the E.C.C.A. is totally averse to taking risk. On the other hand, the spatial distribution of the E.C.C.A.'s foreign assets can only be rational if it is assumed that risk avoidance is not one of the objectives of the E.C.C.A.

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<sup>11</sup>Cf. East Caribbean Currency Authority: Third Annual Report, 1968, pp. 10-11.

<sup>12</sup>The only exception to this rule occurs when there is perfect correlation between security returns. For a thorough presentation of the effects of diversification see Harry M. Markowitz; Portfolio Selection: Efficient Diversification of Investments (New York, 1959).

## The E.C.C.A.'s Inadequacy: A Suggested Interpretation

The E.C.C.A.'s limited involvement in the monetary and financial affairs of the region has been mentioned in the preceding section. To date the Authority has functioned almost exclusively as a money changer. Although the E.C.C.A. has been granted enlarged powers, there is little to distinguish it, in terms of its present operation, from the British Caribbean Currency Board, which it has in part replaced. In this section an explanation of this occurrence will be advanced.

The inability of the E.C.C.A. to move beyond the mere issuing and redemption of currency, and actively promote the ends for which it was established, can, perhaps, be partly explained by the fact that it is acutely short of staff versed in the theory and techniques of monetary management as it applies to small, open, underdeveloped economies. Of greater significance, however, is the fact that the orthodox central banking powers with which the E.C.C.A. has been invested, are not operational in the financial environment of the East Caribbean Currency Area.

The general powers granted to the E.C.C.A. and the specific restriction imposed upon it are enumerated in Articles 19 and 20 of the Currency Agreement. The powers granted to the E.C.C.A. correspond to the powers which a Central Bank in a developed monetary economy would need to enable it to pursue the orthodox techniques of monetary control: Bank Rate policy and open market operations. The E.C.C.A. has the power to grant advances to, open accounts for, and accept deposits from commercial banks. It can also purchase and sell a specified list of securities.



The restrictions placed upon the E.C.C.A. have the effect of ensuring that it cannot deviate significantly, by way of acts of commission, from the established practices of orthodox central banking. The most significant of these restrictions are: The E.C.C.A. may not grant loans upon the security of any shares; draw or accept bills payable otherwise than on demand; grant advances to financial institutions other than banks.

Thus it is that, on the one hand, the Currency Agreement inhibits the E.C.C.A. from operating in any manner which does not conform to orthodox central banking techniques; while on the other our financial environment makes the use of these techniques futile, if not impossible. Essential to the successful application of Bank Rate policy is a situation where commercial banks regard the Central Authority as lender of last resort. However, the commercial banks operating in the East Caribbean Currency Area are branches of foreign banks with resources far in excess of those at the command of the E.C.C.A. At present these banks rely on their overseas head-offices for emergency loans. To them, the rate at which the E.C.C.A. is willing to rediscount Treasury Bills and other first class bills borders on the irrelevant.<sup>13</sup>

Open market operations seek to regulate economic activity by influencing the liquidity position of the commercial banks in such a way as to force or encourage bankers to adjust their portfolios, thereby altering the volume of credit in a way desired by the Central

<sup>13</sup>Indeed, up to the time that this study was undertaken commercial banks in the region had never availed themselves of this rediscounting facility.

Authority. The rationale for open market operations derives from the theory that commercial banks seek to maintain cash and liquidity ratios which would establish a desired balance between making profit and taking risks. However, because of the peculiar circumstances of our dependent monetary economy, banks operating within the region find it unnecessary to maintain fixed cash or liquidity ratios. As a consequence, open market operations cannot influence the behaviour of commercial banks in the East Caribbean Currency Area by influencing their liquidity position. But the most obvious reason why open market operations cannot work in the East Caribbean derives from the fact that the area does not have a money market of any significance in which the E.C.C.A. can operate.

Given the present structure of the East Caribbean economy, it is pointless to conceive of the E.C.C.A. as a miniature Bank of England. To the extent that the E.C.C.A. possesses the ambition to conform to the orthodox model of a Central Bank, there is little hope of its developing into an institution capable of promoting "monetary stability and a sound financial structure". Moreover, irrespective of the desires of the officers of the E.C.C.A., if it is equipped with traditional instruments only, it will certainly remain ineffectual. The orthodox techniques of monetary control were fashioned to meet the requirements of a particular type of economic environment. We in the Caribbean must seek to develop techniques which are suited to the social, economic and political realities of our situation. Indeed, we must apply our minds to the basic problems of defining in specific terms, the role of a Central Bank in a dependent economy.

## On Central Banking in the East Caribbean

In this section an attempt will be made to define what ought to be the specific objectives of central banking policy in the East Caribbean Currency Area. In doing this it will be accepted as a datum that ultimately, the role of the E.C.C.A. ought to be the maintenance of external and internal monetary stability and the promotion of 'a sound financial structure', then specific content will be given to these general objectives by relating them to economic conditions and political aspirations in the region.

In regard to economic conditions in the region, the most significant features are a low level of development, extreme openness and a dependent monetary system. The economic implications of these phenomena have been given detailed treatment by others.<sup>14</sup> For the purposes of this study, however, the significant characteristics deriving from these features are a high import coefficient, and monetary and credit systems that are highly integrated with British and other North Atlantic systems.

### Monetary Stability

In any economy the problem of maintaining internal monetary stability can be subdivided into: (a) the problem of maintaining confidence in the value of the currency; and (b) the problem of maintaining confidence in financial institutions. In a developed monetary economy the problem of maintaining internal monetary stability is essentially the problem of maintaining a stable price level. This

<sup>14</sup>For a detailed discussion of monetary dependence, See C. Y. Thomas: "Monetary and Financial Arrangements in a Dependent Monetary Economy", I.S.E.R., 1965.

is so because confidence in financial institutions can, by and large, be taken for granted.

However, in an open dependent economy such as the East Caribbean, control of the price level is beyond the immediate competence of the Currency Authority. Moreover, the high import coefficient which is a characteristic of our economy, acts as an automatic adjustment mechanism to keep our price level in line with the rest of the world.<sup>15</sup> In the East Caribbean, therefore, the problem of maintaining internal monetary stability essentially becomes the problem of maintaining confidence in financial institutions rather than that of maintaining confidence in the value of the currency.

In regard to external stability, ours is a similar problem to the one confronting developed countries.<sup>16</sup> The promotion of external stability involves the long-term objective of maintaining balance between current account transactions and the net flow of long-term capital. It also involves taking the teeth out of speculation against the currency.

#### Sound Financial Structure

Our view of what constitutes "a sound financial structure" in an East Caribbean context must not only be derived from economic

<sup>15</sup>The degree to which our price level can vary from the price level in the North Atlantic is a function of transport costs, the percentage mark up of the commercial sector, the degree of protection afforded local industry, and differences between local and North Atlantic consumption and production patterns.

<sup>16</sup>It should, however, be noted that this similarity is only at the most proximate level. The disequilibrating influences on the Balance of Payments are not the same in the West Indies as in developed countries.

conditions in the region, but must also be consonant with the aims and aspirations of the region. In regard to the latter, we will proceed on the assumption that economic development is the overriding consideration. The further assumption will be made that there is a commitment to the idea of regional integration as a strategy of development. Thus, on the basis of these assumptions, it is being postulated that the criteria by which the "soundness" of our financial system must be judged should in some way relate to the efficiency with which the system mobilizes and allocates loanable funds on a regional basis, to those sectors of the economy that are deemed to be strategic to the development process.

Viewed in this light, the development of a sound financial structure involves the regulation of existing intermediaries and the development of such additional intermediaries as are necessary to provide for the efficient transmission of loanable funds from surplus spending units to deficit spending units. It also involves the financial integration of the region.

The foregoing leads to the conclusion that the East Caribbean Currency Authority should be pursuing policies oriented toward two separate but related goals. First, but not necessarily foremost, the E.C.C.A. should concern itself with financial reconstruction. The E.C.C.A. should be pursuing policies designed to reduce the degree to which our financial system is integrated with North Atlantic systems, whilst imparting a regional bias to our financial institutions. The E.C.C.A. should also seek to promote the development of such additional institutions as are necessary to

cater fully to the present and future credit requirements of a developing region.

The E.C.C.A.'s second area of concern should be the regulation of the allocation of loanable funds. It should seek to place itself in a position where it is able to exercise quantitative and qualitative control over the portfolio preferences of financial institutions. However, far reaching changes in the powers and organizational structure of the E.C.C.A. must take place before it is equipped to function in the manner suggested.

#### Problems in the Development of Central Banking in the East Caribbean

On this view of the role of a central banking institution in the East Caribbean, there arise at least seven major problems which will have to be solved:

- (1) How can the E.C.C.A. contribute to the maintenance of confidence in financial institutions?
- (2) How can the E.C.C.A. equip itself so as to be able to ensure the external value of the currency?
- (3) How best can monetary dependence on North Atlantic economies be broken?
- (4) How can a regional bias be imparted to financial institutions in the area?
- (5) What new financial institutions should be encouraged?
- (6) How can the E.C.C.A. influence the portfolio preferences of banks and other financial institutions?
- (7) How can the E.C.C.A. determine what is an optimal allocation of financial resources?

Cutting across all of the foregoing is the more general problem of operating a multi-national central banking institution in

a context of uncoordinated national policies, and in a region characterized by different levels of development in the constituent territories. This section will be devoted to a brief discussion of these eight problems.

### Confidence and Financial Institutions

The major threat to confidence in our financial institutions is posed by the possibility that, at times, an institution can experience difficulty in honouring its short-term obligations. Sound portfolio management requires that financial institutions maintain some level of liquidity in their asset holdings which is consonant with their liability structure. However, unless an institution keeps all its assets in liquid form, there is some degree of probability that it will, from time to time stand in need of emergency loans in order to meet its short-term obligations. If there is no source from which financial institutions can obtain this kind of loan, the occasional failure of an institution must be expected. The E.C.C.A. should therefore assume the role of lender of last resort, not only to commercial banks, but to all other financial institutions operating in the area.

The problem outlined in the preceding paragraph is particularly severe in the case of institutions such as building societies. A building society is an institution which specializes in making long-term loans. However, a significant amount of its liabilities are essentially short-term. Building societies are able to perform the important function of translating short-term loans into long-term loans, because of the averaging benefit of the law of large numbers. Given the portfolio preferences of surplus spending units and the rate

of saving in the economy, building societies can normally expect an inflow of new loans which will tend to off-set, if not exceed the demands made on them for repayment of loans. Of course the analogue to this is that we can occasionally expect the inflow of new loans to fall short of demands for repayment. The frequency with, and degree to which this latter situation will occur will depend on the probability density functions of the two flow variables. A strong 'a priori' case can be made in support of the view that in the East Caribbean, institutional and structural parameters will lead to a high degree of variability in these flows,<sup>17</sup> and to the relatively high probability of a building society's experiencing a liquidity crisis.<sup>18</sup>

At the moment the E.C.C.A. is prohibited by law from lending money to building societies. Should it prove desirable to encourage the growth of this type of financial institution, in the region, the E.C.C.A. should be permitted to grant loans to them, in cases of emergency. To be able to do this, the E.C.C.A. should be empowered to rediscount mortgages, as well as to grant loans on the security of mortgage instruments.

<sup>17</sup>Such a case would lean heavily on two assumptions:  
(1) that East Caribbean is a mini economy, and  
(2) that the East Caribbean is undergoing structural and institutional change.

<sup>18</sup>The probability that a financial institution will experience a liquidity crisis depends on the distribution of reserve losses, as well as on the level of liquid reserves maintained by the institution. Building societies can, therefore, reduce their risk of failure by maintaining high cash reserves. However, this policy reduces their capacity to transform short-term credit into long-term credit.



## External Stability

As mentioned above, the problem of maintaining external stability involves the maintenance of balance, over time, in the autonomous transactions on the current and capital accounts of the balance of payments, including speculative movements against the currency.

At the moment the E.C.C.A. is singularly ill equipped to stave off any threats to the external value of the currency. Article 11, of the 1965 Currency Agreement, compels the E.C.C.A. to buy and sell sterling on demand "for immediate delivery in London". In addition to this, the E.C.C.A. has absolutely no say in the administration of foreign exchange controls against non-sterling currencies.<sup>19</sup> Consequently, the E.C.C.A. is in no position to regulate trade and payments with the rest of the world.

As a minimum approach to the problem of external stability, the E.C.C.A. should be empowered to issue general directives to the financial ministries in regard to the exercise of foreign exchange controls; and should also be relieved of its obligation to buy and sell sterling on demand. In regard to the latter, it must be pointed out that there is no logical or causal necessity for the establishment of a fixed parity with sterling to be accompanied by free convertibility into sterling. Indeed, from the point of view of maintaining balance in our trade and payments position with the rest of the world, including the rest of the sterling area, it is

<sup>19</sup> Foreign exchange controls against non-sterling countries are exercised by the various ministries of Finance within the region. Decisions in this regard are still made in conformity with Bank of England directives, rather than in accordance with local requirements.

logically possible that fixed parity with sterling can be inconsistent with free convertibility into sterling. In fact, to the extent that there is substitutability between transactions (both on current and capital account) with the sterling area and transactions with the non-sterling area, free convertibility arrangements with sterling makes nonsense of the imposition of exchange controls against the non-sterling area, and amounts to little more than discrimination in favour of British goods and British financial instruments.

In regard to the imposition of restrictions on convertibility, it is worthwhile to distinguish between restrictions on current account transactions and restrictions on the movement of loanable funds. The regulation of current account transactions usually involves interference in the pattern of trade and production. The greatest care must, therefore, be taken to ensure that restrictions on current account transactions are consistent with national development policy.

The influence of international capital flows on trade and production is more diffused and consequently less disruptive. In order to be in a position to regulate these flows the E.C.C.A. should be empowered to fix local asset ratios for commercial banks and other financial institutions.

So far we have been concerned with instability deriving from imbalance in our trade and payments. However, there is another source of instability which derives from our operating a sterling exchange standard. As long as we should fix the par value of our

currency in terms of sterling, the external value of our currency can be no more stable than the value of sterling. Legislation should be introduced to empower the E.C.C.A. to alter the parity with sterling in the event of a devaluation or revaluation of that currency.

#### Structural Re-orientation

The breaking of monetary dependence on the North Atlantic and the imparting of a regional bias to our financial institutions can be regarded as two aspects of a more general problem; the problem of re-orienting our financial structures. Essentially, it involves the breaking of the branch firm relationship between commercial banks and insurance companies in the region and their overseas head-offices. Decision making units such as Barclays Bank D.C.O. will have to be replaced by regional organizations which are given the highest possible degree of autonomy in so far as relations with the North Atlantic are concerned.

However, the question of decision making is only one aspect of dependence. Our present monetary dependence derives not only from the fact that our major financial institutions are foreign-owned and controlled, but also from the fact that these institutions are unable to obtain securities of a wide enough variety to enable them to operate a balanced portfolio on the basis of local financial assets.<sup>20</sup> Simultaneously with the attempt at structural re-orientation, the E.C.C.A. must, therefore, take steps to increase the variety and volume of available local securities.

<sup>20</sup> Another source of monetary dependence is free convertibility with sterling.

## New Financial Institutions

The question of what new financial institutions should be encouraged is essentially an empirical problem. This question can only be answered in the light of careful research into the credit requirements of the region, as well as the potential sources of loanable funds. Credit requirements will have to be estimated not only on the basis of demands currently made on the system, but also on the basis of projected growth rates in the various sectors of the economy. The type and volume of loanable funds that can be obtained from primary sources can be established through a careful examination of income and expenditure patterns within the region.

It is therefore evident that it is beyond the scope of this study to make a definitive statement concerning the type of financial institutions that are required in the East Caribbean. However, there is adequate theoretical justification for holding the view that the region stands in need of an organized market for equities. At present, equities have a low priority ranking in the portfolio preferences of the majority of surplus spending units within the region. This low priority ranking is in part a reflection of the fact that local equities are not very liquid and are, consequently unable to compete with money, bank deposits and treasury bills as the temporary abode of purchasing power.

In places such as London and New York, equities have a relatively high degree of liquidity because of the high level of activity on the stock market. Because of the small size of the East Caribbean, it is unlikely that any market in the region will ever develop the volume of activity which is necessary to impart a

high degree of liquidity to equities. Unless some other device is used to impart liquidity to equities, they will continue to have limited attraction for savers. This in turn would act as a serious brake on the development of a market for equities, on the mobilization of resources for development, and on the degree of popular participation in economic activity. It is my view that these problems would be obviated if the E.C.C.A. should engage in the buying and selling of equities, and if it should undertake to make loans against the security of equities.<sup>21</sup>

It should be noted, however, that the low level of demand for equities is only one of the factors inhibiting the growth of a stock market. There is also a severe limitation on the supply side. At the moment, most of the firms operating in the region are either family firms, or international concerns with little or no interest in the issuing of shares on the local market. "Pari passu" with attempts at stimulating demand for equities, attempts should be made to augment the supply of this kind of paper by encouraging the formation of more public companies.

#### Credit Control

Techniques of credit control can be classified as direct and indirect. Two examples of direct control are moral suasion and the imposition of legal reserve ratios. In both cases a direct attempt is made to influence the institution's portfolio policy. The institution is persuaded or coerced into acting in the manner desired by the

<sup>21</sup>The suggestion that Central Banks should hold equities is not a new one. Professor Kennedy has made such a suggestion. However, Kennedy's case for the holding of equities was based upon income considerations, and was limited to the holding of foreign assets. Cf. Charles Kennedy: "The Case of Equities as a Part of Official External Assets". Social and Economic Studies, Vol. 14, No. 3, September, 1965.

Central Authority, irrespective of the private profitability of the act.

Bank rate policy and open market operations are examples of indirect controls. Indirect policies attempt to alter the data upon which financial institutions base their calculations in regard to the optimal distribution of their portfolios. Indirect controls derive their validity from the postulate that financial institutions behave rationally in the pursuit of a clearly defined objective. In the case of commercial banks, in developed countries, this objective is usually taken to be the maximizing of expected profits. Indirect controls, therefore, involve the dangling of carrots or the setting of snares to induce financial institutions to re-adjust their portfolios in a way desired by the Central Authority.

It should by now be obvious that indirect controls require a higher degree of expertise on the part of central bankers than direct controls require. The central banker must be clear on how a wide range of economic variables can influence the portfolio preference of financial institutions. He must also be sure of his ability to manipulate these variables with great precision. A necessary prerequisite for the use of indirect controls is accurate and comprehensive information on most aspects of economic activity.

In the absence of adequate information and expertise, direct controls will probably prove superior to indirect controls.<sup>22</sup> At the moment the E.C.C.A. is empowered to collect information from commercial banks only. It is also acutely short of staff. Indeed, unless the

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<sup>22</sup>This is not to suggest that the exercise of direct controls requires little information, and no expertise.

E.C.C.A. is granted the power to collect information from all types of financial intermediaries, and unless it takes steps to acquire additional qualified staff, it would be dangerous for it to attempt to exercise control of any nature over financial institutions.

#### Allocation of Financial Resources

There are two aspects of the problem of efficiently allocating a country's financial resources. First there is the question of the holding of foreign reserves, and then there is the question of allocating available loanable funds to the various sectors of the economy.

The 1965 Currency Act stipulates that the East Caribbean Currency Authority "shall at all times maintain a reserve of external assets consisting of gold, sterling or currencies convertible into gold or sterling for an amount not less than seventy per cent of the value of its notes and coins in circulation and other demand liabilities..." The Act goes on to state that this minimum percentage may be reduced to sixty per cent if each of the participating Governments give its written agreement. In practice, however, the E.C.C.A. has been maintaining an external assets ratio of somewhat over one hundred per cent. In December 1968, the proportion of external assets to demand liabilities was 101.1 per cent. As has been argued in an earlier section, this is an altogether unsatisfactory situation.

Strictly speaking, the rationale for holding foreign reserves should relate to the need for settling balance of payments deficits. The decision as to what constitutes an optimal level of foreign exchange should be based on an understanding of the determinants of the balance of payments. Moreover, the level of foreign reserves

which the E.C.C.A. should maintain should be tied to its demand liabilities only if it has been indicated that the demand liabilities of the E.C.C.A. provide the best indicator of changes in our balance of payments position. In any event, a hundred per cent external assets ratio is altogether too high. As Nevin points out, "The maintenance of a 100% foreign backing to a currency can be justified logically only on the assumption that the possibility exists that every single currency note outstanding might be presented to the issuing authority for conversion into some other currency."<sup>23</sup>

The view has been expressed that high foreign reserves serve the purpose of maintaining foreign investors' confidence in the currency. In this connection, the question must be asked whether confidence is a variable directly correlated with the level of foreign reserves, or whether there is some critical minimum level of foreign reserves that is consonant with confidence. It will also be worth establishing whether the benefits derived from foreign investment can outweigh the costs involved in maintaining otherwise excessive foreign reserves.

However, concern with the problems mentioned in the preceding paragraph rests upon the assumption that we consider our holding of foreign reserves as one of the key variables which determine the volume of investment flowing into the region. This assumption is far from obvious and should only be accepted in the light of empirical evidence. On "a priori" grounds a much stronger case can be made out for the influence of political factors and real economic variables on the rate of foreign investment.

<sup>23</sup>Cf. Edward Nevin: Capital Funds in Underdeveloped Countries. London, Macmillan, 1961: Chapter 1.



In its programme of research, the E.C.C.A. should give priority to the problem of determining what constitutes an adequate level of foreign reserves. However, whatever the optimal level of reserves will prove to be, one thing is certain: the present level is too high, and leads to a situation where we in the Caribbean are continually lending our money to Britain at relatively low, short-term rates of interest, and are at the same time borrowing from abroad at higher long-term rates of interest.

So far we have been discussing the quantitative aspect of the problem of foreign reserves. This problem also has a quantitative dimension. Apart from the problem of establishing the optimal level of foreign reserves, there is also the problem of attaining an optimal distribution of the portfolio of foreign assets. These two problems are not mutually exclusively, but it is methodologically advantageous to make a distinction between them for purposes of analysis.

The type of assets which comprise the E.C.C.A. portfolio should display a liquidity structure which harmonize with the demand liabilities of the E.C.C.A., and the behaviour pattern of persons and organizations who hold these claims against the E.C.C.A. In addition to liquidity considerations, foreign assets must also be evaluated in accordance with yield and risk. Those responsible for administering the portfolio of the E.C.C.A. must establish a delicate balance between the rate of return on various types of assets and the risk of capital loss on these assets. The rational response to this problem will, in all probability, result in the E.C.C.A.'s diversifying its assets, not only with respect to liquidity, but also with respect to country,

On September 25, 1968 the East Caribbean Currency Authority entered into an agreement with the United Kingdom Government, which requires the E.C.C.A. to hold all of its external reserves in sterling. Despite the fact that the E.C.C.A. was given a dollar guarantee on 90% of its reserves held in sterling, it is safe to conclude that this agreement runs counter to sound portfolio management on the part of the E.C.C.A.

In regard to the second aspect of the allocation problem, the decision as to how financial resources should be allocated to various sectors of the economy; this is essentially a problem in economic planning and takes us somewhat beyond the exclusive domain of central banking. This decision would have to be taken in collaboration with those departments that are responsible for development planning. In fact these departments and the E.C.C.A. should collaborate in the drawing up of an annual monetary plan aimed at integrating monetary with general economic policy.<sup>24</sup>

#### Problems of a Multi-National Central Banking Institution

The problems discussed above are by no means peculiar to the East Caribbean Currency Authority. Indeed, the foregoing remarks could apply in large measure to any of the Central Banks in the Commonwealth Caribbean. However, in the case of the E.C.C.A., an added dimension is given to these problems by virtue of the multi-national nature of this institution. Any discussion of the problems confronting the E.C.C.A. would be incomplete unless some mention is made of the problem of operating a multi-national central banking

<sup>24</sup>Cf. Xenophon Zolotas: "Monetary Planning"; Bank of Greece Papers and Lectures, No. 22, 1967.

institution in a context of unco-ordinated national policies, and in a region characterised by different levels of development in the constituent territories. We turn now to a brief discussion of this problem.

The problems posed by the multi-national nature of the E.C.C.A. are all questions of management, which can be analytically separated into problems of portfolio management and problems of internal monetary and credit policy. In regard to the former, the problem of ascertaining what constitutes an adequate level of foreign reserves is aggravated by the varying levels of development and the absence of co-ordinated economic policies within the region. This study has not advanced a method for calculating an optimal level of foreign reserves. Nonetheless, it is safe to say that any attempt to calculate an optimal level of foreign reserves must revolve around an attempt to link reserve losses to economic aggregates such as National Income and the Stock of Money, as well as to the income and expenditure patterns of decision making units. In attempting to calculate an optimal level of reserves for the E.C.C.A., cognizance will have to be taken of the national differences mentioned above.

In regard to internal monetary and credit policy, economic and political reality dictates that there should be no single unified set of policies which apply without discrimination throughout the entire region. The region must be divided up into discrete policy areas. In the limiting case, they could be as many policy areas as there are separate territories. However, islands at a similar level of development, and pursuing a similar economic strategy can be grouped together. Thus one can envisage the E.C.C.A.'s applying relatively

sophisticated techniques of monetary control in Barbados, whilst at the same time, operating in Montserrat in the traditional Currency Board manner.<sup>25</sup> One can also envisage the application of one rate of rediscount in Barbados, and another rate in Antigua. In order to facilitate this approach to monetary and credit control, the E.C.C.A.'s organizational structure should provide for separate Area Committees, each charged with the responsibility of administering a policy area.<sup>26</sup>

#### SUMMARY

An analysis of the structure of the E.C.C.A., and an appreciation of the circumstances surrounding its establishment reveal a distinct incongruity between the formal-legal structure of the E.C.C.A. and the role which it is expected to perform. In regard to the former, the E.C.C.A. possesses all the essential features of a colonial institution, and is thereby constrained to act as an instrument of economic colonialism. On the other hand, rising expectations have resulted in the situation where it is anticipated that the E.C.C.A. should function strictly in accordance with the better interest of the Currency Area. That the present structure and organization of the E.C.C.A. constrains it to perform inefficiently has been verified by an analysis of its

<sup>25</sup>This possibility renders Barbados' recent decision to establish their own Central Banking institution at once unnecessary and unfortunate.

<sup>26</sup>This approach will undoubtedly engender problems of co-ordination and reconciliation. These and other aspects of multi-national Central Banking will form part of a wider study of "The Economics of Financial Integration in the Commonwealth Caribbean", which is being undertaken by the same author.

portfolio policy.

A recurring theme throughout this chapter has been the need for a break with orthodoxy if the E.C.C.A. is ever to come to grips with the problems which will confront it as it strives to promote the ends for which it was established. In particular it has been argued that the E.C.C.A. should stand ready to lend to all 'bona fide' financial institutions in cases of emergency. It has also been suggested that the E.C.C.A. should venture beyond a mere concern with short-term stability and seek to promote structural re-orientation of our monetary and credit systems.

The need for meaningful research into economic conditions in the region has also been emphasized. The policies which the E.C.C.A. pursues should be informed with a knowledge of the structure and working of the East Caribbean economy. The E.C.C.A. must have at its disposal detailed information on all financial institutions operating within the economy. Detailed research must be undertaken into the income and expenditure patterns of decision making units, as well as into their portfolio preferences. The E.C.C.A. must also be fully cognizant of the development plans of the various governments. Indeed, it is desirable that the E.C.C.A. should participate in the formulation of such plans.

The implications of these proposals for alterations in the present powers and structure of the E.C.C.A. are evident. Legislation must be introduced to enable the E.C.C.A. to break out of the straight jacket of orthodoxy, and the staff of this institution must possess the expertise and the desire to rely less on tradition and more logic and sound financial principles as they strive to mould the E.C.C.A. into an institution capable of living up to the demands made on it in the 1965 agreement.

CHAPTER 2

COMMERCIAL BANKING

Growth of Commercial Banking

An analysis of activity in the commercial banking sector in the East Caribbean Currency Area, since the Second World War reveals different patterns of expansion in Barbados, the Windward Islands and the Leeward Islands. Diagram 2.a depicts the growth of assets of commercial banks. In the case of Barbados, two phases of growth are identifiable, 1946-1954 and 1956-68. In both of these periods, the rate of growth of commercial banks' assets was similar. The average rate of growth during the period 1946-54 was 11%, and in the period 1956-68 it was 10.6%.<sup>1</sup> The sharp decline in the assets of commercial banks during the two year period 31st December, 1954-1956, (a decline of 8.6 million dollars) can, perhaps, be explained in terms of the ravages of hurricane Janet which struck Barbados in September 1955.

Data for the period 1946-52 are not available for the Windward Islands and the Leeward Islands. However, an analysis of the data for subsequent years reveals that in the Windward Islands, commercial banks' assets have been growing consistently at an average rate of about 5.2 per cent. In the case of the Leeward Islands, two reasonably distinct phases of growth are discernible. During the first, which ended around 1959, commercial bank assets grew at a rate

<sup>1</sup>In obtaining average growth rates, it was postulated that the growth equation was of the form  $Y=Ae^{bt}$ , where  $b$  represents a constant growth rate. The method of least squares was then used to derive the Regression equation  $\text{Log}_e Y = a + bt$ , where  $a = \text{Log}_e A$ .

Diagram 2.a

LogeY

Growth of Commercial Banks' Deposits

$(Y = \text{F. C. \$,000})$

12..

11..

10..

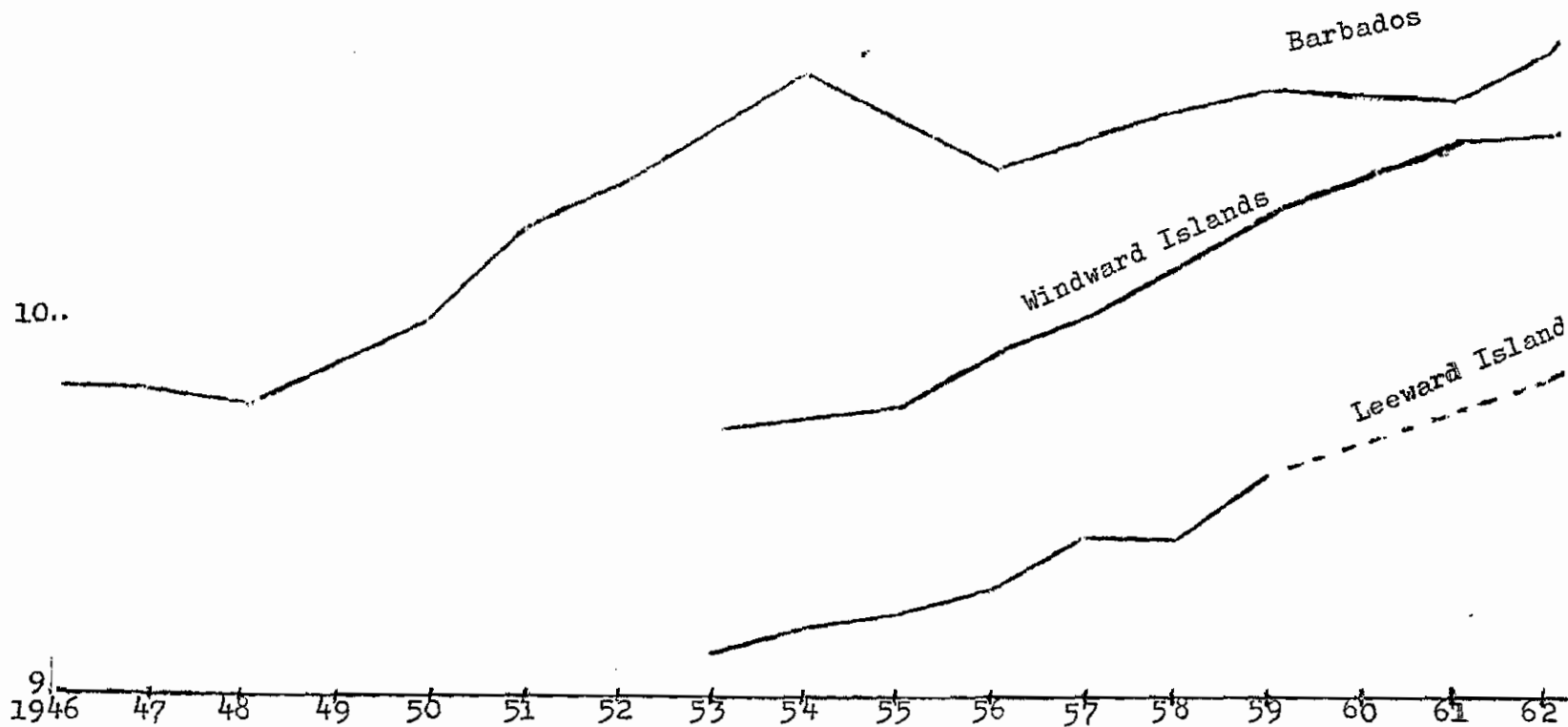
9.

1946 47 48 49 50 51 52 53 54 55 56 57 58 59 60 61 62

Barbados

Windward Islands

Leeward Island



of 12.8 per cent. In the second phase, which started around 1962, the rate of growth increased to 18.7 per cent.<sup>2</sup>

The pattern of growth of commercial bank assets outlined above contrasts sharply with the post-war physical expansion of banking facilities. Table 2.1 shows the distribution of commercial bank offices in the East Caribbean Currency Area as at the end of 1945, 1959 and 1968. This table reveals that during the immediate post-war period, there was only a modest increase in the number of banking offices in the Currency Area. In fourteen years the total number of new offices opened in the eight territories which now comprise the East Caribbean Currency Area, was ten. Three of these offices were opened in Barbados, four in the Windward Islands and three in the Leeward Islands. However, in the nine year period 1960-68, inclusive, Barbados and the Windward Islands experienced rapid expansion in banking facilities, whilst the rate of expansion remained modest, in the case of the Leeward Islands. In Barbados, the number of banking offices increased dramatically during this period. In nine years the number of bank offices in Barbados increased by sixteen, from six to twenty-two. The number of new offices opened in the Windward Islands and the Leeward Islands during the same period were eleven and five, respectively.

A comparison of the data depicted in diagram 2.a and table 2.1 reveals that there is little or no correlation between the rate of growth of commercial bank assets in the East Caribbean Currency Area,

<sup>2</sup> Data for the years 1960 and 1961 were unavailable.



Table 2.1

Distribution of Commercial Bank Offices in the  
East Caribbean Currency Area

Name of Bank	Location of Head Office	Year	Number of Bank Offices			
			Barba-dos	Wind-ward Islands	Lee-ward Islands	East Caribbean Currency Area
Barclays Bank D.C.O.	England	(1945)	1	4	3	8
		(1959)	3	8	6	17
		(1968)	9	11	7	27
Royal Bank of Canada	Canada	(1945)	1	2	4	7
		(1959)	1	2	4	7
		(1968)	4	4	4	12
Canadian Imperial Bank of Commerce	Canada	(1945)	1	-	-	1
		(1959)	1	-	-	1
		(1968)	4	2	1	7
Bank of Nova Scotia	Canada	(1945)	-	-	-	-
		(1959)	1	-	-	1
		(1968)	4	4	1	9
First National City Bank of America	U.S.A.	(1945)	-	-	-	-
		(1959)	-	-	-	-
		(1968)	1	-	-	1
Bank of America	U.S.A.	(1945)	-	-	-	-
		(1959)	-	-	-	-
		(1968)	-	-	2	2
Total Number of Offices		(1945)	3	6	7	16
		(1959)	6	10	10	26
		(1968)	22	21	15	58

Sources: (1) Federal Statistical Office; Financial Statistics, No. 1 of 1960.

(2) Information supplied by Research Department of East Caribbean Currency Authority.

and the rate of expansion of physical banking facilities. However, such a comparison reveals that there is a high degree of association between the absolute level of commercial bank assets and the rate of expansion of physical facilities.

#### Sources and Causes of Growth

The liabilities of the commercial banks provide the analytical key to the growth in their assets. Normally the size of a bank's portfolio of assets depends mainly on the amount of paid-up capital, the level of undistributed profits, and on its total deposit liabilities. Deposits are by far the most important of these three sources of growth. However, because commercial banks in the Currency Area are all branches of foreign banks, the assets and liabilities of local banks can be augmented by a transfer of funds from overseas head-offices, to local banks. This type of expansion is largely illusory. True growth in the banking sector must rest upon the savings habits and portfolio decisions of local wealth owning units, as manifested in the deposits which they hold with commercial banks. Consequently, the proximate reason for the growth in the assets of commercial banks is to be found in the growth of their deposit liabilities.

A comparison of the rates of growth of assets and deposits (Table 2.2) reveals that there was a high degree of similarity between these two growth rates in the case of Barbados and the Windward Islands. However, in the case of the Leeward Islands, the rate of growth of deposits has been significantly lower than the rate of growth of assets. The implication here is that, whilst the growth of the banking sector in Barbados and the Windward Islands has been rooted in the performance of these economies, and consequently display characteristics of permanence

the expansion in the Leewards has been induced, to a significant degree by foreign borrowing.<sup>3</sup> It is, therefore, to be expected that there will be a decline in the presently phenomenal rate of expansion in the assets of commercial banks operating in the Leeward Islands.

Table 2.2

Average Growth Rates of Commercial Banks' Assets and Deposits

Growth Rate of	BARBADOS		WINDWARD ISLANDS	LEEWARD ISLANDS
	1946-54	1956-68	1953-66	1953-59 1962-68
Assets	11%	10.6%	5.2%	12.8% 18.7%
Deposits	11.8%	10.5%	4.9%	8.1% 14.9%

Sources: See Statistical Appendix

It has been argued above that the growth in deposits provides the basis for permanent growth in the commercial banking sector. It would, therefore, be instructive to investigate the relative importance of the various sources of commercial banks' deposits liabilities. Available data do not classify commercial bank deposits in a way which would readily reveal these sources. However, discussions with bank executives have confirmed the hypothesis that demand deposits are held mainly by businesses, while savings deposits and time deposits are

<sup>3</sup>At the end of 1968, 36.8% of the total liabilities of commercial banks in the Leeward Islands were balances due to banks abroad.

held predominantly by households. Having regard to the foregoing hypothesis, an analysis of the changing composition of commercial banks' deposits (table 2.3) leads to the conclusion that the expansion of the commercial banking sector has, in large measure, been made possible, on the supply side, through the ability of the banks to attract an increasing amount of household savings. Throughout the Currency Area, demand deposits have been constituting a declining percentage of total deposits.

Theoretically, the growth in commercial bank deposits, and consequently the growth in commercial bank assets, could be the result of any combination of the following:- (1) an increase in savings within the Currency Area; (2) a net shift in the preferences of wealth owners towards the holding of bank deposits; (3) the intensification of financial intermediation. These three processes are not necessarily mutually exclusive, but it is useful analytically to make a distinction between them. Increased savings can be the result of an increase in income, an increase in the average propensity to save, or both. A shift in the assets preference of wealth owners in favour of commercial banks would be reflected in a change in the 'community portfolio-mix'<sup>4</sup> and a concomitant change in the relative importance of financial institutions. Intensification of financial intermediation is used here to refer to the process whereby the rate of growth of financial intermediation outstrips the rate of growth of Gross Domestic Product. A possible index of the intensity of financial intermediation is the ratio of

<sup>4</sup> A term used here without any known precedent to refer to the aggregation of the financial portfolio of all wealthy owners in the community.

Table 2.3

Growth in Deposit Liabilities of Commercial Banks  
in East Caribbean Currency Area; 1953-68

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Date	Total Deposits	Demand Deposits	Col.(2) as % of Col.(1)	Time Deposits	Col.(4) as % of Col.(1)	Savings Deposits	Col.(6) as % of Col.(1)
	\$000	\$000		\$000		\$000	
<u>31st Dec.</u>							
1946	18,533	10,325	55.7	318	1.7	7,890	42.6
1947	18,341	9,975	54.4	859	4.7	7,507	40.9
1948	17,807	8,776	49.3	1,481	8.3	7,550	42.4
1949	19,564	9,004	46.0	2,557	13.1	8,003	40.9
1950	22,536	10,066	44.7	3,562	15.8	8,908	39.5
B 1951	27,893	13,916	49.9	4,538	16.3	9,439	33.8
1952	31,650	13,686	43.2	8,950	28.2	9,014	28.5
A 1953	36,771	13,956	38.0	13,061	35.5	9,754	26.5
R 1954	43,612	15,656	35.9	18,037	41.4	9,919	22.7
B 1955	38,646	14,555	37.7	13,693	35.4	10,398	26.9
1956	34,498	12,500	36.2	9,286	26.9	12,712	36.8
A 1957	37,687	14,781	39.2	8,564	22.7	14,342	38.1
D 1958	39,136	15,633	39.9	8,159	20.8	15,344	39.2
O 1959	42,081	19,552	46.5	6,276	14.9	16,253	38.6
S 1960	40,950	19,068	46.6	4,730	11.6	17,152	41.9
1961	41,037	16,276	39.7	5,336	13.0	19,425	47.3
1962	48,921	18,259	37.3	8,149	16.7	22,513	46.0
1963	60,253	22,094	36.7	12,574	20.9	25,585	42.5
1964	66,046	21,204	32.1	16,896	25.6	27,946	42.3
1965	71,513	24,272	33.9	16,184	22.6	31,057	43.4
1966	82,408	31,306	38.0	17,470	21.2	33,632	40.8
1967	99,598	34,065	34.2	27,267	27.4	38,266	38.4
1968	128,520	43,396	33.8	38,943	30.3	46,181	35.9

- Sources: (1) Federal Statistical Office; Financial Statistics, No. 1 of 1960.  
(2) East Caribbean Currency Authority; Annual Report, for year ended 31st March, 1969.  
(3) Barbados Statistical Service; Abstract of Statistics, No.5 1965.  
(4) Government of Grenada Statistical Unit; Bulletin No. 6, Jun 1966.  
(5) Information submitted by commercial banks.

(Table 2.3 contd.)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	
Date	Total Deposits	Demand Deposits	Col.(2) as % of Col.(1)	Time Deposits	Col.(4) as % of Col.(1)	Savings Deposits	Col.(6) as % of Col.(1)	
	\$000	\$000		\$000		\$000		
<u>31st Dec.</u>								
W I N D W A R D	1953	16,974	7,072	41.7	1,002	8,900	52.4	
	1954	17,292	5,996	34.7	1,228	10,068	58.2	
	1955	18,063	6,261	34.7	1,623	10,179	56.3	
	1956	21,180	7,432	35.1	2,190	11,558	54.6	
	1957	23,194	7,554	32.6	1,776	13,864	59.8	
	1958	26,995	7,490	27.7	3,385	16,120	59.7	
	1959	31,151	8,359	26.8	4,531	18,261	58.6	
	1960	34,048	8,183	24.0	4,616	21,249	62.4	
	I S L A N D S	1961	36,702	8,447	23.0	5,389	22,866	62.3
		1962	36,359	7,450	20.5	6,141	22,768	62.6
1963		40,269	8,326	20.7	7,201	24,742	61.4	
1964		45,031	9,453	21.0	7,415	28,163	62.5	
1965		54,453	11,062	20.3	11,585	31,806	58.4	
1966		59,962	12,376	20.6	13,318	34,268	57.1	
L E E W A R D S	1953	8,960	3,450	38.5	188	5,367	59.8	
	1954	9,996	3,670	36.7	332	5,994	60.0	
	1955	10,357	3,920	37.8	381	6,056	58.5	
	1956	11,271	3,759	33.4	405	7,107	63.1	
	1957	12,838	4,340	33.8	582	7,916	61.6	
	1958	14,108	4,543	32.2	793	8,772	62.2	
	1959	15,243	4,875	32.0	866	9,502	62.3	
	1960	..	..	..	..	..	..	
	I S L A N D S	1961	..	..	..	..	..	..
		1962	19,680	..	..	..	..	..
1963		22,080	..	..	..	..	..	
1964		24,960	..	..	..	..	..	
1965		32,160	..	..	..	..	..	
1966		35,311	7,799	22.1	6,378	21,134	59.9	
1967		38,490	8,130	21.1	7,644	22,716	59.0	
1968		48,466	9,844	20.3	10,868	27,754	57.3	

'indirect' debt<sup>5</sup> to Gross Domestic Product.

The present paucity of statistics on savings and financial assets in the Currency Area makes it difficult to establish the relative weight of these possible influences on the growth of commercial banks' assets and liabilities. However, an appreciation of the foregoing outline of the way in which these processes alter the balance between certain economic aggregates for which we can obtain some kind of estimate, will enable us to make a more precise statement than the foregoing, on the causes of growth in the commercial banking sector.

A comparison of the exponential rate of growth of Barbados' Gross Domestic Product, for the period 1961-68, with the corresponding growth rate of incremental deposits, (table 2.4) reveals that, on average, net new deposits with commercial banks operating in Barbados have been growing more than thrice as fast as Barbados' Gross Domestic Product. The average rate of growth of Barbados' Gross Domestic Product and of incremental deposits during this period were 8.4 per cent and 26.4 per cent respectively.

<sup>5</sup>The term 'indirect' debt has been coined by John G. Gurley and E. S. Shaw to refer to debt issued by financial institutions, and to distinguish it from the debt of deficit spending units, which they called 'direct' debt. Cf. John G. Gurley and E. S. Shaw: Financial Aspects of Economic Development, The American Economic Review, Sept., 1955.

Table 2.4

Barbados: Comparison of G.D.P. and Commercial Banks' Incremental Deposits - Annually, 1960-68.

Year	(1) Gross Domestic Product \$000,000	(2) Total Commercial Bank Deposits \$000	(3) Annual Increments in Comm. Bank Dep. \$000
1960	119.8	40,950	-
1961	128.7	41,037	87
1962	133.1	48,921	7,884
1963	152.9	60,253	11,332
1964	150.0	66,046	5,793
1965	158.2	71,513	5,467
1966	169.6	82,408	10,895
1967	189.2	99,598	17,190
1968	216.7	128,520	28,904
Growth Rate	8.4%		26.4%

- Sources: 1) Barbados Statistical Service: Abstract of Statistics, No. 5, 1965.  
 2) Barbados Development Plan; 1969-72.  
 3) East Caribbean Currency Authority: Annual Report, for year ended 31st March, 1969.

Discounting the possibility of a substantial and continuing inflow of foreign capital held in the form of bank deposits, the situation outlined above could be the result of any combination of the following: an increase in the average propensity to save, a shift of the assets preferences of wealth owners in favour of commercial banks,



or intensification of financial intermediation. An increase, over-time in the average propensity to save is consistent with elementary consumption theory which admits of the possibility of a declining marginal propensity to consume. To the extent that there has been an increasing average propensity to save, this would permit incremental bank deposits to grow faster than G.D.P., without any accompanying structural change in the financial system. However, as has been mentioned above, any shift in the assets preferences of wealth owners in favour of commercial banks must be reflected in a change in the 'community portfolio-mix', and a concomitant change in the relative importance of financial institutions. Intensification of financial intermediation alters the structural relationships between the real and financial sectors of the economy, but does not of necessity alter the weight of any given financial institution vis-a-vis the rest of the financial system.

In the absence of adequate data on savings and financial assets, it is possible to evaluate the relative importance of the three influences which have been isolated only if we can find a way of estimating the relative rate of growth (or decline) of commercial banking vis-a-vis the total financial system, and (2) if we can estimate the degree of financial intensification, if any, that has taken place.

In regard to the relative importance of commercial banking, it must be noted that commercial banks play a two-fold role: (1) they are a part of the monetary system, and (2) they intermediate between lenders and borrowers. These two functions are not mutually exclusive, but it is analytically useful to make a distinction between them.

With respect to (1) above, commercial banks through the operations of a cheque system, provide a service equivalent to that provided by currency notes and coins, when these are used as a medium for settling debt. Consequently, by focussing upon the medium of exchange function of money, it becomes apparent that demand deposits share the distinction with notes and coins, of comprising part of the money supply.

In regard to the second role of commercial banking, the deposits liabilities of commercial banks represent savings of surplus spending units. As has been mentioned above, deposits determine the size of a bank's portfolio, and constitutes the basis on which banks can extend credit to deficit spending units. Commercial banks intermediate between surplus and deficit spending units by issuing indirect securities (in the form of deposit accounts) to surplus spending units, and accepting the primary securities of deficit spending units. In this respect the operation of commercial banks is analogous to that of any other financial intermediary.

#### Commercial Banks and the Monetary System

'Ceteris paribus', changes in the ratio of demand deposits to the money supply would give us an indication of the changing importance of commercial banks with respect to the monetary system. Table 2.5 shows adjusted demand deposits as a percentage of the total money supply in Barbados for the period 1960-68.

Table 2.5

Barbados: Demand Deposits (adjusted as a percentage of Money Supply, 1960-68)

Year	(1) Adjusted Demand Deposits	(2) Total Money Supply	(3) Col.(1) as a % of Col.(6)
1960	18,977	24,270	78.1
1961	16,048	21,665	74.0
1962	17,531	21,369	82.0
1963	20,753	24,203	85.3
1964	19,852	22,672	87.6
1965	23,685	32,738	72.3
1966	28,983	40,764	71.0
1967	51,987	46,083	69.4
1968	51,103	67,999	75.2

Sources: (1) East Caribbean Currency Authority; Annual Report, for year ended 31st March, 1969.

(2) Barbados Statistical Service; Abstracts of Statistics, No. 5, 1965.

This table shows that the demand liabilities of commercial banks constitute the greater part of the money supply in the East Caribbean Currency Area, but it does not reveal any significant upward or downward trend in the ratio of demand deposits to the money supply. Consequently, this particular comparison is suggestive of relative constancy in the importance of commercial banks in the monetary system.

Strictly speaking, however, it is not the abundance of any particular medium of exchange, but the degree to which it is used that

is indicative of its importance in the monetary system; and so, we ought to weight the value of demand deposits, and the value of notes and coins held by the public with an index of their respective velocities of circulation, before we can compare their relative importance. In other words, a change in the relative importance of these two components of the money supply can be reflected in a change in their relative values, a change in their relative velocities, or both. Again, the lack of satisfactory statistics constitutes a barrier to empirical analysis. Available statistical data is not suitable for the estimation of velocity functions. Consequently, we cannot make a strong statement regarding change in the importance of commercial banking in the monetary system. However, a strong 'a priori' case (based on the apparently increasing use of cheques in day to day transactions) can be made out to support the hypothesis that the velocity of demand deposits is increasing relative to that of notes and coin. Consequently, it is reasonable to conclude that the commercial banking sector in Barbados is increasing in importance relative to the monetary system.

#### Commercial Bank Intermediation

Ideally, any attempt to evaluate the relative importance of commercial bank intermediation should be based upon an analysis of the portfolios of commercial banks and other financial intermediaries. However, for familiar reasons (i.e. the paucity of data) this is not a practicable undertaking. However, if one assumes constancy over time in the ratio of institutional credit to Gross Domestic Product, (i.e. constant financial intensity) it would be possible to compare the growth rate of the annual flow of commercial banks' loans and advances with the growth rate of G.D.P. to determine any change in the relative

importance of commercial banking vis-a-vis other forms of financial intermediation.<sup>6</sup>

From the point of view of methodology, it would be more appropriate to compare the gross flow of loans and advances with G.D.P. However, no data is available on the gross flow of loans and advances; consequently, our analysis must be based upon a comparison of the net flow of loans and advances with G.D.P. This comparison (table 2.6) reveals that, in Barbados, the net annual flow of loans and advances has been growing approximately 3.5 times as fast as the rate of growth of G.D.P.

Table 2.6

Barbados: Comparison of G.D.P. and Commercial Banks' Loans and Advances; Annually, 1960-68

Year	(1) Gross Domestic Product \$000.000	(2) Commercial Bank Loans & Advances \$000	(3) Net Annual Flow of Comm. Bank Loans & Advances \$000
1960	119.8	37,700	-
1961	128.7	41,332	1,632
1962	133.1	46,100	4,768
1963	152.9	42,276	(-3,824)
1964	150.0	48,566	6,290
1965	158.2	59,044	10,478
1966	169.6	66,696	7,652
1967	189.2	72,201	5,505
1968	216.7	85,446	13,245
Growth Rate	8.4%		29.2%

- Sources: (1) Barbados Statistical Service; Abstract of Statistics, No. 5, 1965.  
 (2) Barbados Development Plan; 1969-72.  
 (3) East Caribbean Currency Authority; Annual Report, for year ended 31st March, 1969.

<sup>6</sup>The term financial intermediary is used in this study in a way which includes institutional arrangements such as the Sou-Sou or Meeting.

On the basis of the assumption of constant financial intensity this situation would be indicative of a very substantial increase in the relative importance of commercial banks in the financial system.. A structural shift of this magnitude would be enough to explain the rate of growth in the banking sector. However, the assumption of constancy over time in the ratio of institutional credit to Gross Domestic Product conflicts with financial theory and the experience of other countries, both of which tend to suggest that, at this stage in the development of the East Caribbean economy, institutional credit is most likely to grow at a faster rate than G.D.P.<sup>7</sup> To the extent that this is true, this would lead to an upward bias in our estimate of the relative importance of commercial banking vis-a-vis other financial intermediaries.

The foregoing analysis leads to the conclusion that the growth in Barbados' commercial banking sector, during the period 1961-68, was made possible on the supply side by: (1) a shift in the portfolio preferences of wealth owners towards the holding of bank deposits, and (2) a general intensification of financial intermediation. However, it is still not possible to rank these two influences in order of importance. A careful reading of the data on the other territories and for the rest of the period to which this study is confined suggests that it may be possible to generalise the above findings.

<sup>7</sup>See, for example, (1) John G. Gurley and E. S. Shaw: *op. cit.*  
(2) Raymond T. Goldsmith: *The Determinants of Financial Structure.* Development Centre of O.E.C.D., Paris 1966.  
(3) Raymond T. Goldsmith: *The Share of Financial Intermediaries in National Assets, 1900-1949;* National Bureau of Economic Research, Inc., *Studies in Capital Formation and Financing, Occasional Paper 42.*

N.B.

IT HAS NOT BEEN POSSIBLE TO FINISH THIS CHAPTER, AS WAS HOPED, IN TIME FOR THE CONFERENCE. WHAT FOLLOWS REPRESENTS A MERE LISTING OF THE MAJOR POINTS TO EMERGE FROM A FIRST ANALYSIS OF THE DATA COLLECTED. THE PURPOSE OF THIS EXERCISE IS TO GIVE THE CONFERENCE AN INSIGHT INTO THE DIRECTION IN WHICH THE STUDY IS DEVELOPING, AND TO PROVIDE THE BASIS FOR DISCUSSION.

## DISCUSSION NOTES

### Portfolio Management

In this section an attempt will be made to analyse and evaluate the portfolio performance of commercial banks. However, before this can meaningfully be done, it is necessary to appreciate certain institutional and behavioural characteristics of commercial banking in the East Caribbean. In this respect, the single most important characteristic is the nature of ownership and control. A look at table 2.1 reveals that all of the commercial banks operating in the East Caribbean Currency Area are branches of North Atlantic banks. Of the six commercial banks operating in the Area as at the end of 1968, three were Canadian, two American, and one British.

Two important features of banking practice in the East Caribbean derive from this situation: (1) the portfolio of any bank in the East Caribbean Currency Area is managed in a way consistent with the maximization of profits accruing to a trans-national firm, rather than in a way which would maximize the earnings of local branches; and (2) Caribbean banking tradition is a direct transplant of North Atlantic banking practice. The implications of the foregoing shall become evident as we analyse the portfolio performance of commercial banks. The three aspects of portfolio policy which will be analysed are: (1) liquidity policy; (2) policy in regard to loans and advances; and (3) foreign lending.

#### Liquidity Policy

The branch-firm relationship and existing currency arrangements obviate the need for any precise policy in regard to the liquidity structure of local banks. This had led to the maintenance



of very low cash ratios. Low cash ratios, though advantageous to the banks, is a cost to the local economy, because commercial banks are economising on their holding of local currency and transferring these resources to London.

The liquid assets ratio has been high in the Windwards and Leewards and relatively low in Barbados. The major element in liquid assets is foreign balances. The difference in the liquid assets ratio between Barbados and the rest of the Currency Area is consistent with the view that this ratio is a residual relationship, and depends on the extent to which the banks find it worthwhile to extend loans and advances. The dominant constraint on the granting of loans and advances is credit-worthiness. Banks apply similar standards of credit-worthiness to the obtaining in the North Atlantic. The reason why the liquid assets ratio is low in Barbados is because there is a relatively large demand for loans from persons meeting the banks' standards of credit-worthiness. These standards effectively restrict credit in the Windward and Leewards.

#### Loans and Advances

Loans are mainly short-term, and are granted mainly to distributive trades and private individuals.

Two sets of factors are responsible for the above:

- (1) The standards of credit-worthiness which apply, and
- (2) The degree of linkage which the various sectors have with the commercial banking sector.

The standards of credit-worthiness which are applied relate to capital, character and capability.

### Foreign Lending

Foreign lending has displayed a high degree of variability, and reflects the relative profitability of the trans-national firms' investing in the Currency Area or elsewhere. However, a portion of foreign balances must be regarded as clearing balances.

### Interest Rate Policy

There is a high degree of association between commercial bank lending and deposit rates and the U.K. Bank Rate. The prime lending rate has traditionally been set at one per cent above the U.K. Bank rate. However, this has not been so much a rule of thumb as a consequence of economic forces.

The main factors influencing commercial banks' lending rates are: (1) the degree of substitutability between local and foreign lending, and (2) the mix of total deposits. In a fundamental sense, therefore, commercial banks' lending and deposit rates are mutually determined by forces of supply and demand.

### The Social Efficiency of Commercial Banking

In assessing the social efficiency of commercial banking the following must be considered:-

- (1) Loans and advances of commercial banks (e.g. their liquidity structure and sectoral distribution).
- (2) The requirements of the economy.
- (3) The contribution (both actual and potential) of other financial institutions.
- (4) The nature of the resources (i.e. deposit liabilities) at the disposal of commercial banks.