FINANCIAL INTERMEDIATION AND ECONOMIC GROWTH IN THE OECS

by

Eustace Liburd

and

Laurel Bain

Research Department

Eastern Caribbean Central Bank

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1. INTRODUCTION

That financial policy can have a potent effect on growth and development is a relatively recent notion. Earlier views on the role of finance in development held that the effect of financial policies on growth was benign at best. The prevailing school of thought was that monetary changes affected only prices and wages and had very little impact on production and employment over the business cycle. It was observed that in the process of economic development over time, there was an increase in the number and variety of financial institutions and financial assets in relation to GDP, but this was viewed as an automatic response to the demand for financial services in the real economy.

The change in perception was due in large measure to the work of analysts like John Gurly and Edward Shaw (1960), Edward Shaw (1973) and Ronald Mc.Kinnon (1973) who argued that financial policies have important implications both for the accessibility of domestic savings to domestic investors and for the efficiency with which these savings are allocated to competing investment purposes. The work of Hugh Patrick (1966) is also important in this development. He emphasized the connection between financial growth and economic development by pointing to the important relationship of the stock of financial assets and liabilities to the real capital stock.

This paper will analyse the role of the financial intermediation process in the growth of the OECS countries during the 1980s. Section 2 gives a brief description of the OECS financial system and recent policy initiatives intended to affect its growth, efficiency and diversification. This is followed in Section 3 with an assessment of the size and impact of financial intermediation, while Section 4 examines the savings-investment nexus in the finance of economic growth.

2. FINANCIAL STRUCTURE AND POLICY

The Financial System

The OECS financial system is still relatively underdeveloped in terms of the range of institutions and the range of financial assets available. With the advent of the Central Bank in October 1983, with facilities to deal in short-term securities and power to regulate the operations of the commercial banking system, a fairly well integrated money market has been established. The capital market however is still very much underdeveloped, fragmented and imperfect.

The most important financial institutions in the region are the commercial banks, comprising branches and subsidiaries of foreign banks, which dominate the banking system, and indigenous banks. At the end of 1987, of the thirty-eight commercial banks operating in the area, fourteen were indigenous, while twenty-two were branches and two subsidiaries of foreign banks.

The number of financial institutions other than banks varies considerably among countries. They include credit unions, found mainly in Dominica, development banks, which exist in almost all countries, savings banks, and mortgage and finance houses. One mortgage finance company which operates in a majority of the countries is a subsidiary of one of the foreign commercial banks. A foreign owned finance company also operates in two countries. Except for these, the non-bank financial intermediaries are locally incorporated and operate only in their home territories. Other important types of financial institutions include life insurance companies, predominantly foreign, and the national insurance (social security) schemes both of which mobilise significant portions of financial savings in the area. An important gap in the financial structure of the ECCB countries is the absence of an institution that trades in equities and other long-term securities.

Recent Financial Policy Initiatives

Financial policy embraces all measures intended to affect the growth, utilization, efficiency and diversification of the financial system. In the market-oriented advanced countries, the term financial policy is ordinarily used as synonymous with monetary policy. In developing countries financial policy is typically viewed in much broader terms; monetary policy is part of financial policy but so are measures intended to encourage the growth of savings in the form of financial assets, to develop money and capital markets and to allocate credit between different economic sectors.

Following the establishment of the Central Bank, financial policy in the OECS has been concerned primarily with issues related to interest rates, the efficiency of resource allocations and the establishment of reserve requirements for prudential purposes.

Interest rate policy was geared principally towards narrowing the spread between lending and deposit rates. Accordingly, the bank in January 1985 introduced regulations prescribing a minimum rate of interest of 4% to be paid on savings deposits. Prior to that time, interest rates on savings deposits had remained fairly stable and negative in real terms for a number of years, as the large majority of banks paid nominal rates of just 2.5%. This measure was also intended to assist financial intermediation and reward and encourage savings by small deposit holders. No ceilings have been introduced with respect to lending rates, however, moral suasion has been applied to secure reductions.

Legal minimum required reserves for commercial banks were introduced in April 1984. Previously, commercial banks held reserves with the Monetary Authority on a voluntary basis. An Inter-Bank Market was introduced in 1986 as a mechanism to recycle liquidity in the banking system and provide earning opportunities for excess commercial bank funds held at the Central Bank. Prior to the development of the Inter-Bank Market, commercial banks wishing to adjust their liquidity positions had either to liquidate assets or borrow from the Central Bank at the penalty rate. The introduction of a Treasury Bill Market in

January 1988, extends the range of options available to the banks in the management of the liquidity positions and, as is also the case with the Inter-Bank Market, facilitates the intra-regional flow of money market funds.

To assist resource allocation and investment, the Central Bank established a Pre-Shipment Export Finance Guarantee Scheme in July 1984 to enable exporters to procure finance more easily from commercial banks for the purchase, process or manufacture of goods to be exported against orders. This potential for a more efficient allocation of resources was further enhanced in September 1988, when the Post-Shipment Discounting Guarantee Scheme was introduced. This latter scheme will enable exporters to provide an element of suppliers credit into their market strategy and thereby compete more effectively in overseas markets.

Reference was previously made to the assertion that in the developed market economies, financial markets develop and widen in response to the demand for financial services in the real economy. Patrick (1984) notes, however, that in developing countries, the increased supply of financial services in response to demand may not be automatic, flexible or inexpensive. Imperfections in the operations of the market mechanism may result in an inadequate response to the demand for financial services and thereby inhibit the growth process. He suggests that in such a situation there may be a need for financial institutions and their related services to be created in advance of the demand, to cater especially to the needs of the growth-inducing sectors.

In an effort to foster the development of financial institutions, encourage savings, and lengthen the maturity structure and efficiency of credit, special banks were established in most countries in the region during the 1970s and early 1980s. National commercial banks, which are either wholly publicly-owned or in which government has substantial involvement, have been established in most countries starting in the early 1970s. One reason advanced for their establishment was the desire for a different and new approach to credit evaluation and credit provision to vital sectors of the economy. National development banks were also established in most countries to provide medium and long-term finance for businesses unable to raise funds from other sources on reasonable terms and conditions. The development banks were required to give particular consideration to the financing problems of small enterprises and to make credit available for other activities of a developmental nature, including home building and education.

These national institutions have accounted for an increasing share of financial savings mobilised in the area. The combined loan portfolio of the national commercial banks have differed significantly from that of the other banks in several important respects. The proportion of loans they allocated to the public sector has been substantially higher; their loans to the personal sector have been much lower; while other comparisons show that their loan allocations for manufacturing and agriculture are proportionately higher than is the case for other banks (Liburd and Tempro, 1986).

3. SIZE AND IMPACT OF FINANCIAL INTERMEDIATION

The numbers of the various types of financial institutions do not adequately characterize the structure of the financial market. It would be desirable to examine the relative size of the financial institutions in terms of the proportion of total savings they mobilise, and to discover how these savings are applied between consumption and investment purposes. (Bourne, 1986).

This financial intermediation function is best measured by the use of flow-of-funds matrix which display the uses of finance by different economic sectors together with the sources of savings by sectors. For the OECS region the financial liabilities that most closely correspond to the community's financial savings include currency, the deposits of the non-financial sector with financial institutions, the surrender value of life insurance policies, the actuarial reserves of the social security schemes and pension funds.

Data limitations however do not permit a complete representation of financial intermediary activities in the region. While some information is available on the operations of life insurance companies, it does not include the surrender values of existing policies that are required for this type of analysis. Similarly, no data are available on the reserves of private pension funds, or equities and other long-term finance to industry. A summary of the available data which give a partial, though substantial, indication of the size and impact of financial

intermediation in the OECS, is presented in Table 1. The table illustrates the relative importance of the financial institutions and the markets into which the funds are channelled. As is to be expected, it shows that household units were the majority surplus non-financial sector. Through the financial intermediation process, households provided the majority of funds for the deficit sectors - the business and government sectors. The table also shows that the region provided net financing to the rest of the world, reflecting mainly the net foreign assets of the commercial banks and the foreign reserves held by the Central Bank. The net use of foreign resources by the non-banks reflected the operations of the development banks, for which external funding, particularly from the Caribbean Development Bank, constituted a significant source of finance.

The data in Table 2 indicate the types of instruments used by financial institutions in order to attract funds, and those employed in the financing of the non-financial sector. In terms of the instruments employed on the liabilities side, there was some degree of specialisation within the financial sector, partly by force of legal constraints and partly choice. For instance, the Central Bank is the sole legal authority for the issue of currency, and among the non-banks, the development banks do not normally solicit deposits, and consequently, are more reliant on government, social security and foreign loans. Time and savings deposits and the actuarial reserves of the social security scheme were the principle forms of instruments employed in the mobilisation of savings.

The dominance of the commercial banks is very vividly illustrated. They account for about 67% of the total financial assets represented. About 25% of their assets represented claims on the business sector, 22% constituted claims on the household sector, of which just over half was consumption related, and 14% on each of the public and foreign sectors.

With respect to the financial assets employed, loans and advances were the predominant instruments used. They comprised 61% of total assets; this was followed by foreign assets which accounted for 14%, and reserves and other claims on the Central Bank 9%. Government securities accounted for only 2.3%, as most of the credit made available to the government was in the form of loans. This is due in part to the limited availability of government securities. Commercial bank claims on the productive sectors of agriculture, manufacturing and tourism, which on average contribute almost 50% to GDP, amounted to just 9% of assets. Their long-term lending, essentially in the form of home mortgages and consumer durables, amounted to 30% of assets.

Indicative of the still relatively underdeveloped financial structure, the non-banks account for a modest 8% of financial intermediary activity. Their asset portfolio comprised primarily loans and advances mainly in the form of mortgages. Since the non-banks are comprised mainly of mortgage companies, credit unions and development banks, the proportion of the mortgage market which they share with commercial banks is of particular significance. They are estimated to account for about 44% of total mortgage lending, most of which was for residential building.

The financial savings mobilised by the social security schemes in the region have grown substantially in recent times to account for about 9% of the financial savings represented in the tables. Their total assets grew from about $221m in 1984 to $323m in 1986, or at an annual rate of 20.9%. The data show that about 60% of their funds were held in commercial bank deposits, 25% in government securities and loans, while about 6% were placed with the non-banks. Given the historical preference exhibited by commercial banks for self-liquidating short-term loans, it is unlikely that a substantial proportion of these potentially long-term savings were channelled into long-term productive investment. There is also the actuarial question of whether the funds would generate sufficient resources to meet the long-term claims of the schemes, given the relatively low yield on fixed deposits.

4. FINANCE AND ECONOMIC GROWTH

A vast literature on growth in advanced and in developing countries supports the thesis that capital accumulation is one of the important sources of growth. The importance of capital accumulation applies not only to the private sector, but it is relevant to the public sector as well. The public sector needs to expand capacity in infrastructure to support private investment and productive enterprises located in the public sector itself.

The previous sections of the paper were concerned with policies and instruments aimed at promoting financial savings as an alternative to consumption and to use those savings for productive investment. Patrick (1966) observed that the most important relationship between the financial system and growth-producing real factors, is probably the relationship of the stock of financial assets and liabilities to the real capital stock. It follows that the link between financial savings and growth is capital accumulation or investment. This is facilitated through the intermediation process, whereby the savings of surplus units are transferred to the deficit growth-producing sectors.

It is obvious that the total supply of investment resources is equal to the sum of national savings and net capital receipts from abroad. This can be represented by the familiar equilibrium national accounting identity:

$$Id = S + (M - X)$$

From this it is seen that the supply of investible resources can be augmented by raising the level of national savings (S) and/or by introducing measures to promote the inflow of foreign capital (M - X).

In the late 1970s and early 1980s gross domestic savings declined in most OECS countries (both in nominal dollar terms and as a percentage of GDP) and became negative in the economies that were most severely affected by national disasters (hurricanes in the case of Dominica and St. Lucia and volcanic eruption in St. Vincent and the Grenadines). Gross domestic investment by contrast increased sharply in most

countries during this period, which meant that an increasing proportion of investment was financed by foreign savings (Table 3). While gross investment rose sharply in this period, net investment was unlikely to have been significant in the disaster affected countries as a substantial portion of the expenditure was for the replacement of the devastated infrastructure.

The lingering effects of the disasters were exacerbated in the period 1981 to 1983 by a decline in the terms of trade, as well as a fall in export volumes due to the recession-induced slow-down of world trade and demand for primary commodities. Tourism receipts were also adversely affected as a result of the recession in the major tourist markets. Accordingly domestic savings, investment and economic activity stagnated in most countries of the region in the period 1981 to 1983. The economic conditions improved, with the industrial countries' recovery from recession in 1983/84, and most of the OECS countries have since been able to raise the share of savings in GDP. This was however accompanied by a fall-off in the rate of official capital inflows, leading to a reduction in the ratio of investment to GDP.

Foreign capital inflows to the OECS not only increased resources available for investment by supplementing domestic savings but has also augmented the flow of foreign exchange resources from export earnings. ThIS foreign exchange effect of external capital flows was of particular importance in the early 1980s when the export sector stagnated as a result of the natural disasters and the international recession.

Analysis of the trends in the net flows of foreign capital to the area in the 1980s indicates that official flows were generally in excess of private flows in the earlier periods, although there were variations in individual countries. The reverse situation has obtained since 1985, and private flows have assumed greater importance.

Over the period 1980 to 1986, it is estimated that foreign capital inflows accounted for about two-thirds of gross domestic investment in the OECS. Official capital inflows were directed mainly to infrastructural projects included in the public sector investment programmes, while the private flows were largely on account of direct investment in tourism. In relation to official capital flows, these have traditionally constituted grants and concessionary loans, which are attractive because they do not exert excessive pressure on the future course of the balance of payments. However, Liburd and Williams (1987) has observed that as these sources of finance began to dwindle, the countries have resorted increasingly to foreign financing at commercial terms in order to augment other investment resources and continue to foster internal growth.

CONCLUDING OBSERVATIONS

This paper has sought to analyse the role of financial intermediation in the process of the economic growth of the OECS. Statistical limitations restrict the quantification of the exact magnitude of financial savings, and the interrelationship with the non-financial sectors. The available data do, however, show that these

savings have been substantial; the financialization ratio (the ratio of all financial assets to GDP) is estimated at well in excess of 100 per cent. That difficulties have been encountered in the direction of these financial savings into productive uses is an indication that the mobilization of financial savings is not a sufficient condition for increasing investment and growth. On the contrary the mobilization of savings has to be appropriately linked with complementary measures, some of which extend beyond the financial sector. Some of the inhibiting factors appear to be the following:

(i) The dominance of the commercial banks in the financial system (given their preference for self-liquidating loans) and conversely the fragmented and underdeveloped nature of the capital market.

(ii) Perhaps more importantly, a shortage of entrepreneurial and technical skills, which limits the available number of feasible investment projects.

(iii) The indivisibility of certain essential infrastructural requirements, coupled with the size factor which limits the savings capacity and thereby the amount of resources that can be mobilised domestically to produce basic items of infrastructure necessary for growth and development.

The latter two factors suggest that foreign capital is likely to continue to play a significant role in the financing of economic growth in the OECS.

Table 1

OECS - Financial Assets and Liabilities

At December 31, 1986

Classified by Economic Sectors

(EC$M)

	Commercial Banks		Non-Banks		National Insurance*		Central Bank		Total	
	Assets	Liabi-lities	Assets	Liabi-lities	Assets	Liabi-lities	Assets	Liabi-lities	Assets	Liabi-lities
Household Sector	532	958	(	(	0	309	0	168	532	1435
Private Business	600	257	(194	(128	0	0	0	0	794	385
Public Enterprises	101	228	0	0	14	0	0	0	115	228
Government Sector	228	39	3	21	67	0	154	0	452	60
Other Financial Institutions	456	196	22	18	213	0	3	327	694	541
Foreign Sector	338	112	0	46	1	0	388	5	727	163
Other Assets and Liabilities	122	587	62	68	28	14	11	56	223	725
Total	2377	2377	281	281	323	323	556	556	3537	3537

* Excludes data for Antigua and Barbuda

Table 2

OECS - Assets and Liabilities

At December 31, 1986

Classified by Instruments

(EC$M)

	Commercial Banks		Non-Banks		National Insurance[1]		Central Bank		Total	
	Assets	Liabi-lities	Assets	Liabi-lities	Assets	Liabi-lities	Assets	Liabi-lities	Assets	Liabi-lities
Currency	44	0	13	2	0	0	0	212	57	214
Demand Deposits	0	304	0	6	0	0	0	0	0	310
Time Deposits	0	723	0	44	195	0	0	0	195	767
Savings Deposits	0	560	0	6	0	0	0	0	0	566
Other Deposits[2]	0	251	0	66	0	0	0	0	0	317
Central Bank Balance	279	6	3	0	0	0	0	0	282	6
Actuarial Reserves	0	0	0	0	0	309	0	0	0	309
Shareholders Funds	0	0	0	3	0	0	0	0	0	3
Credit to Non-Financial Sector	1461	0	199	36	80	0	154	0	1894	36
Govt. Securities	55	0	0	0	45	0	68	0	168	0
Public Sector Loans	274	0	0	0	35	0	86	0	395	0
Business Loans	600	0	26	0	0	0	0	0	626	0
Consumer Credit	302	0	5	0	0	0	0	0	307	0
Other Loans	230	0	169	10	0	0	0	0	399	10
Inter-Financial Sector Loans	118	84	20	0	18	0	3	283	159	367
Foreign Instruments	328	112	0	54	1	0	388	5	717	171
Other Miscellaneous	147	337	46	64	29	14	11	56	233	471
Total	2377	2377	281	281	323	323	556	556	3537	3537

1/ Excludes data for Antigua and Barbuda. 2/ Represents Foreign Currency Deposits

Table 3

OECS Region: Savings and Investment

(In Millions of EC Dollars)

	1980	1981	1982	1983	1984	1985	1986
ANTIGUA							
Gross Domestic Savings	20.7	32.4	31.0	59.8	57.0	82.7	n.a.
As % of GDP	8.4	11.8	10.5	18.1	15.4	17.8	n.a.
Gross Domestic Investment	93.5	145.9	146.9	84.6	116.7	151.6	n.a.
As % of GDP	37.7	53.2	49.7	25.5	31.6	32.6	n.a.
DOMINICA							
Gross Domestic Savings	-32.9	-6.1	15.5	29.5	38.9	24.4	51.7
As % of GDP	-22.9	-4.0	9.4	16.5	19.7	10.9	20.4
Gross Domestic Investment	79.7	57.1	54.9	57.6	88.9	73.0	63.6
As % of GDP	55.5	37.3	33.6	32.3	44.9	32.7	25.1
GRENADA							
Gross Domestic Savings	-2.8	26.2	33.9	29.2	32.3	46.7	49.5
As % of GDP	n.a.	13.0	17.2	14.2	14.4	19.0	17.7
Gross Domestic Investment	53.9	94.2	124.1	107.2	88.5	97.1	112.5
As % of GDP	n.a.	47.0	62.8	52.2	39.4	39.4	40.2
MONTSERRAT							
Gross Domestic Savings	-18.1	-17.3	-17.8	-15.1	-9.7	-1.4	8.4
As % of GDP	-31.4	-27.1	-25.1	-19.8	-11.5	-1.6	8.6
Gross Domestic Investment	26.9	33.7	32.1	25.6	26.9	26.2	38.4
As % of GDP	46.7	52.7	45.2	33.5	21.9	30.5	39.2
ST. KITTS AND NEVIS							
Gross Domestic Savings	10.2	33.7	31.0	-0.5	30.6	44.7	36.9
As % of GDP	9.9	28.0	22.4	-0.4	19.4	26.0	17.4
Gross Domestic Investment	49.9	46.1	55.1	49.9	53.3	63.9	69.6
As % of GDP	48.4	38.3	40.0	36.6	29.4	37.2	32.8
ST. LUCIA							
Gross Domestic Savings	20.1	-7.0	44.9	75.5	57.2	n.a.	n.a.
As % of GDP	7.6	-2.3	14.4	23.3	16.2	n.a.	n.a.
Gross Domestic Investment	159.1	164.8	145.3	113.8	126.0	n.a.	n.a.
As % of GDP	60.2	55.0	46.5	35.2	35.7	n.a.	n.a.
ST. VINCENT							
Gross Domestic Savings	-18.6	1.4	27.1	55.9	72.2	64.8	43.6
As % of GDP	-14.1	0.8	14.4	27.3	32.3	25.9	15.5
Gross Domestic Investment	62.8	64.2	68.4	73.7	84.3	86.1	80.0
As % of GDP	47.8	39.0	36.3	36.1	38.9	34.4	24.4

SOURCE: Statistical Departments, OECS Secretariat and ECCB Estimates