



**The Role of Development Finance Corporations in the
Commonwealth Caribbean by Compton Bourne**

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**THE ROLE OF DEVELOPMENT FINANCE CORPORATIONS
IN THE COMMONWEALTH CARIBBEAN**

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Development Finance Corporation (DFC) is the label generically applied to institutions established for the specific purpose of providing finance for economic development. DFCs have also been described as development banks, specialised credit agencies, and "credit boards". Although their primary function is finance, DFCs in many instances have been assigned other functions, including investment promotion services and technical assistance in the production operations of their clients.

Development finance corporations have a firm place in the financial sector of Commonwealth Caribbean economies. Every country has at least one DFC. This type of financial institution has been in existence for a considerable length of time in a few economies, notably Jamaica where the first DFC was established in 1951⁽¹⁾, but in most cases its origin does not extend beyond the early 1970s. With few exceptions in the Caribbean, DFCs are public enterprises - with statutorily defined goals, objectives and functions; with senior management appointed by the political directorate, and with overall operations subject to ministerial control; and with much of their loanable resources provided by government or guaranteed by government.

The present decade has witnessed quite substantial changes in the financial sector of the Commonwealth Caribbean. New financial institutions, new ⁽ⁱ⁾ financial instruments, and new ⁽ⁱⁱ⁾ financial services have been introduced with important implications for the structure, organisation and functioning of the financial sector.⁽²⁾ In relation to DFCs, several privately owned DFCs have been established.⁽³⁾ Furthermore, the organisation of the government-owned DFCs has

undergone substantial change in some countries, notably Jamaica and Trinidad and Tobago.⁽⁴⁾ These developments of recent vintage invite reconsideration of the role and operations of DFCs in the Commonwealth Caribbean.

Rationale for DFCs

The raison d'être for development finance companies is to be found in the discordance between the financial requirements of rapid and sustained economic development and the credit allocation practices of private financial institutions. One cannot fully comprehend the appeal of development finance companies in developing countries without an appreciation of the concept of development finance.

One dimension of development finance is the provision of financial capital to remove or at least ⁽ⁱ⁾ relax the savings constraint on physical capital accumulation. Another important dimension is the ⁽ⁱⁱ⁾ quality of financial services. The specific qualitative attributes are the term-to-maturity of financial obligations and the extent of risk-bearing by financial institutions. These derive from the long-term investment capital requirements of new ventures and production innovations and the greater than normal perceived riskiness of such activities. Financial flows to development enterprises or projects would tend to be less liquid and more risky than flows to already established enterprises and projects. A third dimension to the concept of development finance is the use of ⁽ⁱⁱⁱ⁾ "social cost-benefit" criteria instead of "financial rate of return" criteria in credit allocation decisions. Social cost-benefit criteria take explicit account of externalities associated with the project as well as established internal performance standards not necessarily measured or measurable in market prices or not necessarily generating project income. Financial rate of return criteria disregard externalities and calculates

only those outcomes that impose project costs or yield project income. In many cases, the two sets of criteria lead to conflicting financing decisions.

The fourth aspect of development finance is the widespread policy of subsidized interest rates. Several arguments are frequently advanced in support of interest rate subsidies. One is that low interest rates are a necessary incentive to investment and to adoption of new technologies. Another argument is that new projects are unlikely to generate sufficiently high financial rates of return to be feasible at market rates of interest. It is also claimed that low interest rates are required to compensate for disincentives and distortions elsewhere in the economic system. These arguments are questionable on several counts. Credit supply constraints rather than price incentive effects on credit demand might be dominant, so that the critical policy consideration should not be the use of interest rates to induce loan demand but the establishment of an institutional and economic framework supportive of an expanded loan capacity and loan supply. Furthermore, adding interest rate distortions to existing distortions in production and trade is not self-evidently second-best policy and might in fact increase allocative inefficiency and encourage adoption of inappropriate capital-intensive production technologies.

In reality, the situation has been evolving in the direction of greater participation in development finance by the major private credit institutions. The term structure of commercial bank lending is now considerably longer than it used to be. For example, the Eastern Caribbean Central Bank reports that long term loans comprised 74% of commercial bank loans in the OECS economies in December 1967, compared with 51% in 1962. As another example, the percentage of Barbadian commercial banks

term loans with maturity greater than 5 years increased from 26% in 1975 to 45% in 1987. The growth of non-bank financial intermediaries, especially merchant banks and finance companies has also resulted in an expanded supply of venture capital, unsecured lending, and capital equipment leasing services all of which generally enhance the quality of finance.

However, the pace and nature of the spread of financial services are not entirely satisfactory. Financial resource flows favour well-established enterprises vis-a-vis new entrepreneurs. Key economic sectors appear to be relatively neglected. Credit allocation decisions are guided by financial rate of return criteria and do not reflect social benefit-cost considerations. Furthermore, there is an underlying fragility to much of the unsecured lending resulting from the lack of transparency in lender-client relationships and the close corporate interrelationship between some financial institutions and their credit customers.⁽⁵⁾

DFCs are an institutional device for ensuring greater convergence between the supply side of domestic finance and the demand for development finance. DFCs are required to specialize in longterm lending, to adopt social benefit-cost criteria in credit allocation decisions, and to charge concessionary rates of interest. Frequently, also, DFCs are required to undertake other supportive activity of a developmental nature not usually conducted by other financial institutions. These include provision of technical assistance, investment promotion, and equity financing. There is also typically some credit targetting of particular categories of potential loan beneficiaries. The rest of this paper provides a detailed discussion on these aspects of the role of DFCs.

Goal Setting or Goal Ascription

Development finance corporations are ascribed a set of statutorily

defined objectives which they should seek to attain by manipulation of the credit resources and other resources of their command. In theory, these objectives define the preference functions of DFCs. The objectives have been variously defined in terms of economic development, employment creation, generation of national income, import-substitution, export earnings, and wealth creation at national sectoral or sub-sectoral levels. In essence, the preference functions ascribed to development finance corporations are social preference functions. Theophilus (1986) maintains that there are contradictory public and political expectations of DFCs. They are expected to yield commercial returns on their operations as well as to function as instruments of social and welfare policies.

DFCs and Borrowing Costs

The cost of credit obtained by borrowers in formal financial markets is comprised of explicit interest rate charges, implicit interest charges, and transactions costs. Transactions costs include transportation and related expenses incurred in sourcing and servicing the loan, the opportunity cost of waiting time, and expenses (such as legal fees, costs of forms, application fees) associated with the processing of the loan application. Official attention is mainly focussed on explicit interest rates, even though it is readily appreciated that implicit interest charges, e.g. through compensating balances requirements, must be incorporated in accurate estimates of true interest costs.

Development finance corporations impose explicit interest charges considerably below those prevailing at commercial banks and other financial intermediaries. In most Commonwealth Caribbean countries, DFCs' loan rates are less than 8% per annum while commercial bank loan rates range from 10% to 15%, and the latter institutions seem no less prone to implicit interest charges than the DFCs. Through their

concessionary or "below market" loan rates of interest, DFCs may lower average loan rates within the formal financial sector provided the loan market is segmented and there is no credit arbitrage between the two segments. The extent to which DFCs interest rate practices increase the interest rate elasticity of the credit supply function of the entire market would vary directly with the share of the DFCs credit portfolio in the total supply. Because DFCs are a small part of the total formal financial sector, this role is rather limited in a quantitative sense.

Concessionary rates of interest may be rationalised in qualitative terms. One possibility is that in the absence of interest rate subsidies the net operating revenues of new entrepreneurial activities would be insufficiently attractive either because their unit operating costs are high during the learning phase. Figure 1 illustrates the positive impact of credit subsidies on loan demand and investment. The marginal revenue curve MR represents the loan demand-interest rate relationship defined by the borrower's net operating revenues. MC is the DFC's loan offer function. The socially desired level of loans, L^* , will only be demanded at interest rate r^* which is less than the concessionary rate r . However, it is worth noting that interest rate subsidies are not the only means of socially optimal loan demand. Direct fiscal transfers, tax allowances, and higher commodity prices are options. Either of these increase marginal revenue (say from MR to MR_1), permitting higher affordable rates of interest. The second justification for concessionary interest rates is along the following lines. DFCs have unusually high unit lending costs in their early years of operations when their staff might be inexperienced, systems are new or untried, and loan volume is small. However, both risk costs and administrative costs would be expected to decline because of learning by doing and economies of scale (Anderson and Khambata, 1985). These

unusually high lending costs should not be passed on in their entirety to credit customers. The subsidy policy is thus defended in terms of moral restraint in the exercise of market power. Moreover, it can be expected to diminish as lending costs approach their normal level. Figure 2 depicts the early phase marginal cost curve as MC and the "mature" phase marginal cost curve as MC_1 . When MC_1 prevails, the equilibrium loan rate is R_1 and loan amount is L_1 whereas when MC prevails the loan rate is R (greater than R_1) and the loan amount is L (less than L_1). The maxim is to price on the basis of MC_1 .

It is possible that interest rate concessions are negated considerably by transactions costs incurred by DFC customers. Little attention has been paid to transactions costs as a component of total borrowing costs in appraisals of Caribbean DFCs despite widespread complaints among credit applicants about protracted and expensive credit appraisal procedures and long disbursement lags. Evidence drawn from other countries indicates that transactions costs do outweigh interest costs in development financing and might dissuade credit demand. (6)

DFCs as Agents of Technical Change

Almost invariably, DFCs provide technical assistance services to their credit customers. There is thus a combination of financial assistance and technical assistance. The latter set of activities may be an expression of the explicit technical change promoting role of DFCs. Not only do they provide credit, they may also seek to introduce improved production practices, upgrade capital equipment, and increase managerial knowledge and skills among their credit clientele. The provision of credit is itself a vehicle for technological improvement given the bias in investment expenditures towards capital goods and given the embodiment

of technology in those goods.

However, some scepticism may be entertained about the role of DFCs as agents of technical change. First of all, technical assistance activities in practice are in more in the nature of credit supervision intended to reduce the incidence of credit diversion and to enhance loan repayment performance. Secondly, DFCs are so thinly staffed with the requisite production, marketing, and enterprise management expertise that their technical services must be deficient in both scope and quality. A considerable expansion in technical resources would be required to make the technological progress role meaningful. It is not self-evident, however, that technical assistance is necessarily the business of DFCs and that DFCs can have a comparative advantage in this sphere. It might be more efficient to transfer these functions to specialist agencies.

Funding and the Availability of Credit

The major contributions DFCs are expected to make is in the supply of credit. DFCs are intended to increase the availability of credit to development enterprises in general or to particular sectors, industries, or types of eligible enterprises classified by production, income, or net worth. The extent to which they do so depends upon the strength of their own finances, their credit allocation policies and practices, and the loan repayment performance of their credit customers. Each of these warrants discussion.

To begin, one may note that the loan portfolio of most DFCs have grown significantly during the present decade. Table 1 presents some details on disbursements for a sample of DFCs. In some instances, there has been a decline since 1985. Despite their recent expansion, the DFCs have not made a major quantitative impact on the total provision of loanable funds in their respective economies. Table 2 shows that DFCs

loans are no more than 12% of the loan balances of commercial banks alone, not to mention the entire commercial loan system.

The loan volume of DFC credit activities is mainly a consequence of their funding policies. Their main sources of funds are the local government, regional and extra-regional multilateral financial institutions, and foreign governmental agencies. Table 3 presents some approximate data on the liability structure of a few DFCs in recent years. Share capital and accrued reserves typically comprise between 10 and 20 per cent of total liabilities. Government loans and grants include receipts from the central government and from government-owned commercial banks, and national insurance funds. The Caribbean Development Bank is a major funding agency for DFCs in the OECS member countries, the Virgin Islands and Belize. The main extra-regional multilateral funding agencies are the Inter-American Development Bank, the World Bank, and the European Investment Bank, while the main foreign governments contributing to DFCs are the USA and Canada.

It is clear that DFCs have built up experience in intermediating between international financial institutions and foreign governmental agencies and the local borrowing community. This role is highly important in situations where economic development is constrained both by a savings gap, i.e. insufficiency of national savings relative to warranted investment, and by a foreign exchange gap, i.e. an insufficiency of foreign exchange resources relative to that warranted by investment and production plans.

However, the exercise of this function is not without its problems. Bourne and Graham (1980) have highlighted the inordinable and restrictive influence of funding agencies on credit portfolio choice, maturity structure of the credit portfolio, and interest rate practices. In brief,

funding agencies exclude segments of the potential credit market on the basis of type of production activity and income or wealth status, prohibit the financing of working capital or refinancing of debt with their credit tranches, and stipulate both the interest rate spread and on-lending loan rate of interest. These limit the ability of the DFCs to engage in portfolio diversification by enterprise type or activity or by loan maturities, and limit the scope for cost-recovery. Furthermore, there are considerable exchange rate costs associated with foreign currency funding in those Caribbean economies characterised by persistent and large exchange rate depreciations. In cases where the costs are borne by the credit customer, loan delinquency may escalate to crippling proportions, as the Jamaican experience of the late 1970s demonstrates (Bourne and Graham (1983)). In some cases, the foreign exchange rate risks are legally borne by the local government but, as Theophilus (1986) notes ruefully, in practice the DFCs "carry the can". In such instances, the damaging effect on the DFCs' balance sheet is more immediate and certain.

Difficulties related to portfolio restrictions and interest rate policies also ensue from local governmental funding. A pervasive problem closely linked to the dependence of DFCs on government finances as well as on foreign agencies capital guaranteed by the local government is the widespread perception among credit clientele that DFCs are agencies for providing financial grants de facto as distinct from credit which intrinsically carries repayment obligations. A grants syndrome prevails in which DFCs are the almost helpless victims. The perception that DFCs are grants institutions rather than credit institutions is reinforced by several features of their operating milieu: their own weak loan enforcement systems; the extreme tardiness and prohibitively expensive nature of the Caribbean judicial machinery; community approbation of property

repossession and sale; and political interference with DFC management.

There is an element of temporal fragility in the specialisation of DFC funding. Bourne and Graham (1980) have commented on the discontinuity of funding and the short, episodic life cycles which seem to characterise rural development banks. The underlying reasons are the fragility of public finances in primary commodity exporting economies, loss of confidence among funding agencies, the shifting balance of forces in political competition for public sector financial resources, and the corrosive effect of loan defaults.

Commonwealth Caribbean DFCs have had little experience with domestic resource mobilisation from private institutions and individuals. This is so despite the fact that the statutes of most DFCs envisage and permit domestic issue of financial liabilities. Only the Barbados Development Bank and the Virgin Islands Development Bank have made sustained efforts at bond financing or deposit financing. DFCs may be able to stabilise their funding and even increase the volume of their financial resources by deposit mobilisation, issues of bonds and shares, and by collaboration with other financial institutions on various methods of indirect financial intermediation.

Deposit mobilisation offers not only the prospect of enhanced funding, but also the possibility of sizeable economies of scope. One important source of cost complementarity is the financial information assembled on depositors who are also credit customers, thereby enabling better and less costly appraisal of creditworthiness. Commonwealth Caribbean DFCs have been largely resistant to the expansion of their functions to include deposit services. A frequent objection is that these services would be too costly for the DFCs and would be uncompetitive with the commercial banks and other established depository institutions.

Another objection is that it would compromise their developmental mission. With respect to the matter of competitiveness, it should be noted that new entrants to the deposit market have in fact succeeded in attracting deposits, mainly on the basis of interest rate competition with the commercial banks. True enough, the corollary is higher loan charges, but if the binding constraint on potential development projects is the availability of funds (as maintained by say, neo-liberalists), then the case for deposit mobilisation remains strong. Evidence from the wider Caribbean also suggests that Commonwealth Caribbean DFCs might be unduly pessimistic about their prospects in the deposit market. Despite low per capita incomes among their clientele, rural development banks in the Dominican Republic succeeded in attracting a large number of savings accounts and sizeable deposit balances (Gonzalez-Vega et al, 1988; Poyo, 1988).

The growth of demand for corporate equity, particularly those of financial institutions, presents additional opportunities for financial innovation by DFCs directed towards improving their capitalization and increasing their lending resources. Development finance corporations may issue bonds. This has been done successfully by the Barbados Development Bank. A great deal depends upon the financial history of the DFC and upon the overall stability of the financial system. DFCs that do not have a reputation for financial soundness and profitability are likely to experience difficulties in persuading potential investors to hold their debentures. Similar problems would confront stock issue. However, whereas confidence in DFCs bonds may be strengthened by government guarantees, such a possibility is absent for stock issues.

Another seemingly difficult problem arises in relation to stock issue, namely the retention of the predominant model of government

ownership. Stock acquisition by private enterprises and individuals would constitute a departure from this model. However, it is perhaps time for reconsideration in the light of two factors. First, the public ownership model is not universal, and already within the Caribbean privately owned DFCs are beginning to appear. Secondly, some degree of divestment of State ownership has started in several countries on quite pragmatic economic grounds. Public ownership may not be necessary to ensure that DFCs pursue their development mandate.

The final set of domestic resource mobilisation opportunities involve intermediation between the DFC and other financial institutions. This indirect intermediation takes the form of DFCs accruing financial liabilities to the other domestic financial institutions. One possibility is DFC indebtedness to commercial banks. Commercial banks, as already noted, are the major mobilisers of domestic financial savings, but display an aversion to long-term, risky loans to development enterprises. DFC on-lending of funds provided by commercial banks can bring about an improvement in the social efficiency of financial intermediation without compromising the solvency and profitability of commercial banks. Commercial banks are concerned with the liquidity of their asset portfolios. Liquidity targets are principally met by statutory reserves and short-term money market instruments. However, a second line of defence is the short-term nature of commercial loans. An important consideration, therefore, is the extent to which loans to DFCs will have the requisite liquidity. One mechanism for achieving this is to include them in the set of commercial bank assets eligible for rediscounting by the Central Bank. This involves no deviation from the Central Bank's role as lender of last resort, but instead takes advantage of that role by extending it beyond the traditional short-term government securities and

commercial paper.

Another mechanism relies upon the existence of statutory reserve requirements imposed upon commercial banks. Some proportion of those reserves may be earmarked for on-lending by the Central Bank to DFCs. In this scheme, the commercial banks have claims on the Central Bank not on the DFCs, and the Central Bank has claims on the DFC. There is therefore no danger of capital loss to the commercial banks as a barrier to their participation in the scheme. Indeed, since the reserves are statutory, they have no option but to participate. There may be a practical difficulty presented by a tendency for Ministries of Finance to treat government recurrent budgetary requirements as a priority claim on statutory non-cash reserves. The scheme also requires the Central Bank to take a more activist developmental role.

A small proportion of commercial bank assets can make a big difference to the on-lending resources of DFCs. For instance, 1% of commercial bank assets would add another \$9.4 million to the Bahamas Development Bank's loan portfolio, \$100 million to the Trinidad and Tobago's ADB and DFC, \$3.4 million to the St. Kitts-Nevis Development Bank, \$31.6 million to GAIBANK, \$15 million to the Barbados Development.

Similar mechanisms can be applied in the case of other institutions falling under the regulatory purview of central banks. Institutions such as trust companies and merchant banks are also large mobilisers of long-term deposits. For instance in Barbados in 1986, deposits in trust companies were a fifth of those mobilised by commercial banks.

It is also useful to consider their application to institutions outside of the central bank's regulatory framework. The main ones are the life insurance companies, pension funds, and national insurance funds which are vehicles for contractual savings. In the case of national insurance

funds, some lending to DFCs already occurs in some countries. The Dominica Security Fund has provided loans to the Dominica AIDB; the Bahamas National Insurance Board to the Bahamas Development Bank; and the Barbados NIB to the Barbados Development Bank. However, there is need to impart a greater degree of reliability or stability to these loan arrangements. Market persuasion or inducement may be usefully reinforced by use of statutory reserve requirements. Since the specialist long-term lenders of contractual funds operate primarily in the mortgage market, one may expect some resistance from demanders of mortgage finance to any switch of funds towards production enterprises.

Finally on the matter of indirect financial intermediation, there is the possibility of central bank rediscounting of DFC financial assets. At present, central bank rediscounting is limited by law to institutions within their regulatory jurisdiction. Extension of rediscounting facilities to DFC would necessitate similar regulatory treatment.

Credit Risks, Lending Costs, and Credit Rationing

The Caribbean DFCs experience high lending costs where lending costs are defined as the sum of interest and non-interest costs of funds, loan administration costs, and risk costs. Because of the large grant element in external funds and the non-commercial nature of most loan capital provided by local governments, interest costs are not a large proportion of total lending costs. In contrast, administrative costs are a significant component, amounting to somewhere between 30% and 60% of total lending costs in some DFCs. Risk costs are the loss of loan capital and income resulting from loan delinquency. These costs are a major danger to DFCs. Loan default costs crippled the Jamaica Development Bank in 1980, forcing a redesign of the institutional framework for providing development finance. Similarly acute problems were experienced by DFCs

in St. Vincent, Grenada, St. Kitts-Nevis, and Trinidad and Tobago during the 1970s and early 1980s. High lending costs combined with policy determined concessionary loan rates of interest undermine the financial viability of DFCs and ultimately impair their ability to expand or maintain the supply of credit. At the same time, some credit practices intended to ensure viability by reducing administrative and risk costs result in reduced access to credit. This dilemma and the solutions to it warrant closer analysis.

Loan administration costs arise in processing loan applications, disbursing loans, and recovering loans. There is an element of fixity and discontinuity in several of these costs e.g. minimum levels of capital stock and staff. Furthermore, the unit costs of loan appraisal, disbursement and recovery decrease with the average loan size. DFCs can force a reduction in unit costs by increasing the sizes of individual loan accounts i.e. by rationing out small borrowers. Risks costs can also be reduced by credit-rationing - by minimising credit to new ventures and potential new clients. To the extent that enterprises rationed out of the loan market have higher rates of return than those accommodated by the DFCs, allocative efficiency and economic growth are adversely affected. From a national welfare perspective, one must seek other solutions to the problems of administrative costs and risk costs.

With respect to administrative costs, it is possible to achieve economies of scale by increasing portfolio size. An increase in the total volume of lending activity enables the spreading of overheads including the more intensive utilization of staff over a larger number of loan accounts. Another possibility is economies of scope through spreading costs over a wider range of output. This requires DFCs to add other financial services such as commercial banking and financial advice to

those they currently provide.

The²⁾ problem of loan default costs may be less tractable. Borrowers may involuntarily default because of structural weaknesses in the production environment, marketing failures, inflation, or foreign exchange problems.

Within the agricultural sector, adverse weather conditions, pests and diseases, and seed failures are fairly common problems in less developed countries. While the first two are susceptible to control through investments in irrigation and drainage, and applications of chemicals, their role is limited in the present context of Caribbean agriculture. The small sizes and fragmentation of farm holdings seems to render capital investment in drainage and irrigation uneconomic from the perspective of the farm operator. The availability of imported improved inputs is subject to the vagaries of the country's foreign exchange situation, and their costs are influenced by unanticipated exchange rate depreciations. The noteworthy feature of these potential sources of production failure is that they are structural, i.e. they arise from either the structure of the agricultural sector or from the structure of the economy. Being structural in nature, these sources of production failure are not unique to individual enterprises and will tend to affect many enterprises at any point in time. As a consequence, there is rather limited scope for reducing these kinds of credit risks by increasing the number of loan accounts within the sector. In other words, portfolio diversification by DFCs may not help much.

Other sectors and industries are also susceptible to structural sources of production failures. Manufacturing output has a high import content, as does tourism even in economies with sizeable domestic food production capacity. These sectors are therefore vulnerable to

structurally determined movements in the price and availability of inputs. Jamaican experience in the second half of the 1970s and Trinidad and Tobago experience in 1986 and 1987 reveal how sensitive is manufacturing output to national foreign exchange resources and exchange rate policy. In both countries, manufacturing output decreased sharply and production costs rose when foreign exchange restrictions tightened and the foreign exchange rate was devalued.

To the extent that the balance of payments has a pervasive effect of production in small economies, one should have modest expectations of the scope for credit risk minimisation through portfolio diversification across sectors. This is not to say that there are no gains to be had. Since not all production risks will be positively correlated inter-sectorally, pooling of loans across sectors will tend to reduce the overall variance in expected returns on the loan portfolio. The point being made, however, is that to a large extent individual variances are likely to be correlated under certain structural conditions.

It should not be difficult in all countries to identify many DFC loan projects where market performance has turned out to be considerably poorer than projected. This negative divergence is termed marketing failure. The reasons include errors in estimation of potential commodity demand, unanticipated commodity price depression, insufficient knowledge of and accounting for competing supply, and fluctuations in domestic purchasing power. It is possible for DFCs to reduce credit risks associated with market failure by improving upon their methods of estimating demand and future price trends. It is also possible to improve information systems with respect to competitive supply. However, there are likely to be persistent information deficiencies in relation to the production and supply plans of non-client enterprises within the domestic

economy and moreover those located in other countries including members of the Caribbean Community.

Moreover, ⁽¹⁾ shifts in foreign trade policies can impact adversely on market prospects. Import liberalization in particular and commodity and programmes (e.g. sale of US surplus grain, milk, and dairy products) can present acute shortterm problems in marketing of domestic output. Fluctuations in consumer incomes or reversal of growth trends also affect market performance. For domestically marketed output, the pertinent income variables are national income and its distribution. Although frequently ignored, the distribution of income is important because changes in the functional distribution of personal income and also changes in the distribution of income between government and the personal sector influence both the level and composition of consumption expenditures. For export commodities, including tourism services, it is the trend in foreign income which matters. Its significance can be appreciated for instance by the slump and recovery in the tourism industry during the 1970s synchronously with economic recession and recovery in the U.S.A.

For the export industries, exchange rate policy also may be influential because the local currency price of output is the product of the exchange rate and the exogeneous foreign currency commodity price. To the extent that home goods are substitutable for foreign goods in domestic production and consumption and to the extent that the prices of home goods are independent of the exchange rate, ⁽ⁱⁱ⁾ exchange rate policy may also affect market outcomes for domestically marketed output. In practice, the structure of Caribbean economies is such that the elasticity of substitution between home and foreign goods is weak and there is a strong causal relationship between the exchange rate and prices of home goods. As a result, the scope for improving market viability of home goods by

exchange rate devaluation seems quite limited.

The third type of credit risk to be considered is inflation. One linkage is through the divergence between capital approvals and actual investment costs in the context of unanticipated inflation or erroneous inflation forecasts. This can be a serious problem if disbursement is protracted and supplementary financing is not readily available. Another linkage is the effects of the inflation rate on relative commodity prices. The structure of relative prices tends to be preserved under mild inflationary conditions and to be seriously distorted under rapid inflation. This implies that relative profitability changes under conditions of rapid inflation. Evidence for non-Caribbean countries indicates that the dispersion of profits shifts in favour of real estate, construction, and services and against manufacturing and agriculture. If those findings are applicable to the Commonwealth Caribbean, then it may not be unreasonable to surmise that annual inflation rates in the region of 15% to 20% may have hurt those industries particularly favoured by DFCs.

The final source of involuntary default to be discussed here is exchange rate ^(iv) costs. Some attention has already been paid to exchange rate effects on commodity prices and production costs. We now turn to exchange rate effects on debt service (including amortization). In most cases where the DFCs line of credit is funded in foreign exchange, credit to a domestic client is a foreign currency obligation. The debtor is required to amortize the fixed foreign currency value of the loan. This means that the local currency obligation varies with the foreign exchange rate. Because the interest rate is a fixed percentage of loan balances, interest payments in local currency would also vary with the foreign exchange rate. Credit customers therefore face the risk of substantial unanticipated increases in debt service obligations, depending upon the

magnitude and frequency of currency devaluations. With devaluations of the order of 30 and 50 per cent cumulatively and commodity price rigidity, foreign exchange risks are unlikely to be manageable by individual enterprises, especially small ones. Another kind of exchange rate risk arises in the context of generalised floating of the world's major currencies, especially the U.S. dollar and the £ sterling. Since the Commonwealth Caribbean countries, except Guyana, peg their currencies to the U.S. dollar, their multilateral exchange rates adapt passively to movements in the U.S. multilateral exchange rate. To the extent that commodity prices are quoted in a depreciating currency and inputs are purchased in an appreciating currency, multilateral exchange rate movements introduce a further profit risk and therefore another source of credit risk. This point, it is claimed, has some force in the OECS economies where the main agricultural exports are £ sterling denominated. Certainly the £ sterling depreciated relative to the U.S. \$ between 1981 and 1985. However, as events during 1986 and 1987 show, the £/US \$ rate may also appreciate. Generalised floating presents opportunities for both loss and gain.

Many of the credit risks discussed inhere in the economic structure of Caribbean countries and are largely outside of the direct control of the DFCs. The pursuit of financial viability therefore requires considerable attention to general economic policy. Some illustrations are appropriate. First, production risks emanating from input supply irregularities have their fundamental solution in the foreign exchange capacity of the economy, in the development of production technology favouring local resources, and in the production of local inputs. Second, marketing risks may be alleviated by rationalisation of industrial activities both domestically and regionally; by the harmonization of foreign trade policy,

exchange rate policy, and industrial and agricultural production policy; and by economic stabilization. As a third example, exchange rate policy and factor cost policy could be employed to influence the domestic price level. Since one cannot realistically expect exchange rate policy to be tailored to the debt service obligations of DFC customers or even the DFCs themselves, this aspect of viability is perhaps better pursued by developing mechanisms for transferring foreign exchange risk to the government or to the Central Bank.

The preceding discussion of the general economic policy requisite for DFC viability is not intended to absolve the DFCs of responsibility for improving their own systems of credit risk evaluation and management. But the point has to be stressed that the viability of the economies per se, and that policies affecting the economy as a whole have strong, pervasive effects on DFC viability.

The prospects for loan repayment are not unrelated to the strength of incentives to repay. One important incentive is the sanctions which lenders can impose in order to enforce compliance with repayment obligations. Enforceability is partly a legal matter; it is also a matter of social mores and political attitudes. Recent work on credit markets identify expectations of future credit flows as an important incentive to repayment. If expected flows exceed repayment flows, loan delinquency and default is less likely. For rational debtors, these expectations would reflect not only their judgement about the willingness of lenders to terminate a line of credit and the existence or lack of debt morality among the collective of debtors, but would also reflect their assessment of future funding prospects of the lender. A vicious circle may well ensue: financial fragility causing loan default which then further intensifies fragility. Matters are further complicated for DFCs by their emergent

tradition of fixed capital as opposed to working capital lending. If there is no working capital relationship, credit flows to any borrower cease with the final disbursement on the investment project. Expectations of future flows are then zero, unless new investment projects are contemplated in the immediate future which is hardly likely. Rural financial market specialists also point to frustrations and costs experienced during loan negotiation and disbursement as additional reasons for loan delinquency. The poor quality of the credit service destroys the debtor's goodwill towards the lender and undermines the willingness to repay. Although "poor quality of service" may be a somewhat self-serving argument for loan default, interviews with loan customers do indicate considerable dissatisfaction among the DFCs clientele.

The establishment and maintenance of a continuing, harmonious relationship between DFCs and their credit customers would involve a change in credit policy to permit greater working capital financing expansion of the menu of services actually provided by DFCs, simplification and speeding up of loan appraisal and disbursement procedures, and strengthening of their loan capacity.

Income and Wealth Distribution Roles of DFCs.

The last role to be discussed in this paper is that of achieving a more egalitarian distribution of income and wealth. Credit programmes may influence income and wealth distribution through two distinct mechanisms. They may increase utilisation of productive inputs and productivity of credit beneficiaries vis-a-vis non-beneficiaries. Furthermore, the substantial credit subsidies accrue only to credit recipients and raise their income and wealth by amounts directly proportional to the credit received. Whether this credit role reduces or

increases inequality of income and wealth depends upon the differential access of credit applicants classified by income and wealth status. There is considerable scepticism on this count. Many persons believe that political influence and privilege reinforced by social class and kinship ties result in disproportionate access by the already wealthy to the financial resources of DFCs. This is a matter that requires careful study. The only empirical analysis of this issue for Jamaican rural financial markets establishes an unambiguous egalitarian influence (Bourne, 1983), but this result is not necessarily generalisable elsewhere, not even to the Jamaican financial sector as a whole.

DFCs as Credit Wholesalers

Jamaican DFCs have had a new modus operandi since the early 1980s. Wishing to sidestep the problems of loan delinquency and high administrative costs in direct lending to development enterprises, the Jamaican economic authorities in 1981 refashioned the Jamaica Development Bank into two new institutions, the Agricultural Credit Bank and the National Development Bank. Unlike their predecessor, the two new institutions do not lend directly to development enterprises. Instead, they provide credit tranches to commercial banks, selected community level agricultural banks (i.e. some People's Cooperative Banks), and other private financial institutions for on-lending. This new operational system has considerably lowered lending costs for the two Jamaican DFCs. It does mean, however, that DFCs operating as credit wholesalers are not in a position to apply social-cost benefit criteria at the level of the individual enterprise since the micro-level loan decision is taken by the on-lending institution.

CONCLUSIONS

DFCs have been ascribed an important role in the financial sector

and economic development policies of many Commonwealth Caribbean countries. Their actual quantitative significance has tended to vary both across countries and over time. The status of DFCs is greater in those countries where the financial sector has not grown greatly and is not extensively layered. DFCs also seem to lose significance in the complex of government institutions and policies when there is less need of foreign grant funds.

The general funding capacity of DFCs is a dominant factor in determining whether they can play a major role in expanding the volume and improving the quality of credit, or occupy a position on the fringe of the financial sector. Their dependence on resource flows from the local government and from international agencies is a source of financial fragility which can be overcome by diversification of funding activities to include local deposit mobilisation, bond issue, and debt instruments to other local financial institutions.

DFCs also have to direct attention towards reducing the level of their lending costs and increasing their rates of return. Considerable progress can be achieved through improvement in the DFCs operational policies and practices, and by institutional reorganisation. However, financial viability of DFCs is critically dependent on overall economic policy, on the policies laid down by their predominant contributors of loan capital, and by public perception of DFCs as welfare dispensing agencies. Removal of these constraints is necessary for realization of the intended role of DFCs as promoters of economic development.

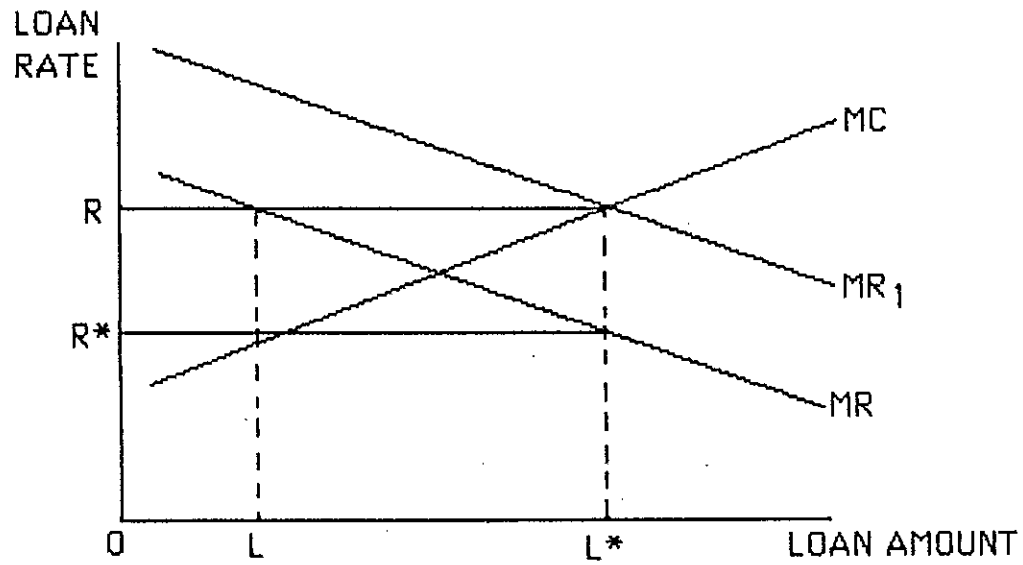


FIGURE 1. INTEREST RATE SUBSIDIES AND NET OPERATING REVENUES EFFECTS ON LOAN DEMAND

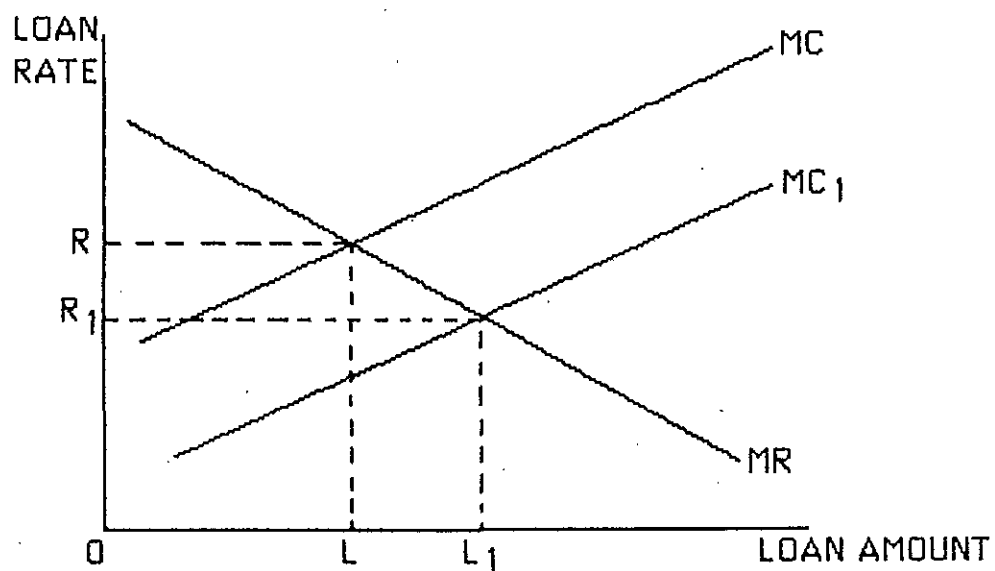


FIGURE 2. : LOAN PRICING AT RUN MARGINAL LENDING COSTS.

TABLE 1

**DISBURSEMENTS BY DFCs:
\$m (local currency)**

<u>DFC</u>	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
Barbados Dev. Bank	5.0	11.0	20.6	15.7	14.9	19.0	21.6
Dominica AIDB	0.9	2.0	2.6	3.6	4.2	5.1	6.4
GAIBANK		23.3	24.6	29.4	40.5	28.8	n.a.
T&T ADB		41.3	61.3	26.4	24.8	24.7	19.7
T&T DFC	49.1	81.8	80.4	87.4	57.0	50.8	71.2
V.I. Dev. Bank	0.15	0.34	0.37	0.58	1.09	1.31	n.a.

TABLE 2

**DFC LOANS OUTSTANDING AS PERCENT
COMMERCIAL BANK LOANS OUTSTANDING**

<u>DFC</u>	<u>YEAR</u>	<u>%</u>
Jamaica ACB	1985	4.0
Barbados Development Bank	1986	11.7
Dominica AIDB	1986	12.2
GAIBANK	1985	0.5
T&T ADB	1983	3.1
T&T DFC	1984	3.1
Bahamas Development Bank	1986	1.3

TABLE 3
PERCENTAGE STRUCTURE OF LIABILITIES OF
SELECTED DFCs

<u>DFC</u>	<u>YEAR</u>	<u>CAPITAL</u>	<u>LOCAL GOVT. GRANT/ LOAN</u>	<u>CDB</u>	<u>MF1</u>	<u>FOREIGN GOVTS.</u>	<u>OTHER</u>	<u>TOTAL</u>
Jamaica ACB Ltd.	1986	14.9	23.9	3.0	17.4	37.1	3.7	100.0
Barbados Dev. Bk.	1986	10.7	9.4	1.6	31.9	-	46.4	100.0
Dominica AIDB	1986	7.9	7.9	55.6	26.8	-	1.8	100.0
GAIBANK	1985	10.6	-	-	-	89.4	-	100.0
T&T ADB	1983	11.4						
T&T DFC	1984	14.2	66.8	-	12.8	-	6.2	100.0
Bahamas Dev. Bank	1986	47.0	26.4	18.0	-	-	8.6	100.0
V.I. Dev. Bk.	1985	15.4	24.4	58.2	-	-	2.0	100.0

NOTES

1. Callender (1965) reports that Jamaica established the Agricultural Development Corporation in 1951. However, development financing was being provided through the Agricultural Loan Societies Board from as early as 1912.
2. Among the new institutions are privately owned finance companies specialising in medium and long term lending, mortgage finance companies, and merchant banks. Secondary mortgage markets, unit trusts, and stock exchanges have been established in several countries.
3. The institutions called "national development foundations" have been established as adjuncts of United States foreign assistance programmes and have been funded with the financial proceeds of PL 480 commodity sales.
4. Jamaica moved from a policy of credit retailing through its major DFCs to one of credit-wholesaling. Trinidad and Tobago is in the process of revamping the operations of its Development Finance Corporation and Agricultural Development Bank.
5. The solvency problems of finance companies in Trinidad and Tobago and in Barbados are salutary. For detailed discussions of the Trinidad and Tobago, see Bourne (1986) and Farrell (1988).
6. See for instance, Adams and Neyman (1979) and Saito and Villanueva (1981).

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