THE FINANCIAL STRUCTURE AND THE ALLOCATION OF CREDIT IN BARBADOS, 1977-1987

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Introduction

Financial intermediation is concerned with bringing together surplus and deficit economic entities in order to efficiently allocate financial resources. The financial structure, the system which facilitates intermediation, therefore has some implications for economic development. Some commentators see a sound and efficient financial structure as the key to economic transformation. Others are more cautious, noting simply that an efficient, well-managed financial system "is conducive to growth."[1] Whatever is the strength of that relationship, it can be best exploited only if those features in the financial system which constrain economic growth are removed.

At the start of the decade of the 1970s, regional commentators were highly critical of the existing financial system. It was claimed that the structure and operation of financial entities in the region were not conducive to its economic development (See for example McClean, 1975). Subsequently, attempts have been made to restructure the financial system to make it more responsive to local economic needs. In Barbados, the last decade was replete with official directives, restrictions and incentives in the interest of economic growth[2]. Still, there are several features of the financial system which may act as constraints on the growth process.

This paper firstly describes the extent of the financial structure in Barbados, focusing on the period since 1977. Next it highlights some of the notable financial developments in the last decade and a number of factors which limit the ability of the financial system to facilitate economic growth. Finally there is a section on the sectoral distribution of foreign finance.

<u>Financial Structure</u>

A country's financial structure may be described as its combination of financial institutions and financial instruments. Goldsmith (1969) lists the range of financial instruments which may be found in a typical developed economy. These instruments are in turn associated with a variety of financial institutions which can be classified into four main groups as follows:

1. The Banking System - Central Banks and Commercial Banks.

2. Thrift Institutions - Mutual Savings banks, savings and loans associations (building societies), credit unions and postal savings systems.

3. Insurance Organisations - Life insurance companies, general insurance companies, pension funds and government funds.

4. Miscellaneous Financial Institutions - Finance companies, investment companies, land banks, security dealers, government lending institutions and personal trusts.

Barbados is reasonably well served by type of financial institutions with a financial structure approximating that identified as type 7 by Goldsmith.[3] The private sector has always dominated the financial system even though Government institutions were among the first to start operations (See Worrell and Prescod (1983, p. 10). At present, the public sector has a foothold in areas which had long remained outside of its control, e.g. commercial banking and the general insurance business.

Units of the banking system are the most important of the financial institutions in Barbados. The Central Bank was established in 1972, six years after the attainment of political independence from Britain. Prior to this the British Caribbean Currency Board, then the East Caribbean Currency Authority had functioned as regional monetary bodies. These institutions were concerned primarily with the issue of currency and their legal framework prevented them from functioning in ways which could promote the economic development of the region. McClean (1975) notes in particular the unreasonably high degree of foreign lending (i.e. holding of foreign assets) which these bodies had to undertake (p. 5).

Commercial banks had their origins in the colonial period and primarily facilitated trade in sugar and other commodities between the Caribbean and the UK. Their dominance in the financial system results from their control of credit; they monopolise the financing of imports by the distributive sector as well as the resulting foreign exchange transactions.

At present, there are seven banks, one of which is indigenous, Barbados National Bank (BNB), another regionally-owned (Caribbean Commercial Bank), the oldest is British (Barclays), the newest is Pakistani (Bank of Credit and Commerce International.), and the remaining three Canadian.[4] The BNB is government-owned, and was established in 1978 when the Bank of America pulled out of the domestic financial market. It essentially incorporates the assets of the Barbados Savings Bank and the Sugar Industry Agricultural Bank. During the post-independence period, four US banks established operations in the island, but these never really gained substantial market share, and have all left.

The table below shows the trend in branch banking over the last four decades. The period of the 1970s was a very dynamic one for the banking system, with a more than doubling of bank branches in the island. However, from a high of 50 in 1982, the number of branches have declined to 40 at present, as a number of banks consolidated their operations during the 1980s.

Year	Number of banks	Number of branches
1945	3	3
1959	4	6
1969	5	22
1973	7	41
1978	7	48
1982	7	50
1988	7	40

Source: Central Bank of Barbados.

Thrift institutions date from around the turn of the century with the formation of friendly societies. These were formed by low income individuals who could not qualify for commercial bank credit (See Clarke, 1987 for a discussion). During the late 1940s improving economic conditions allowed workers to put aside some of their earnings in credit unions and workers co-operatives. At present all major workers' unions have credit unions and several others may be found in work-places and churches.

There is a large number of insurance companies and the value of their assets is second only to those of commercial banks. The importance of foreign trade has always provided ready business for companies offering freight insurance.[5] In recent times, rising per capita incomes and the increased demand for mortgages boosted the numbers of life insurance companies; life policies are often required as security against housing loans.[6] The first government national insurance scheme in the region was started in Barbados in 1967, and in 1978 government entered the field of general insurance with the establishment of the Insurance Corporation of Barbados.

Miscellaneous financial institutions include the government development agencies, finance companies, mortgage companies, trust companies, and the fledgling Stock Exchange.[7] Development agencies came to prominence during the post-Independence period, as Government sought to direct funds toward activities which earned foreign exchange. Finance, mortgage and trust companies were set up to fill a need for more specialised services as the needs of consumers became more sophisticated. Several of these enterprises are creatures of commercial banks.

SOME DEVELOPMENTS IN THE FINANCIAL SYSTEM , 1977-87

Indications are that the financial sector in Barbados grew relatively more important during the last decade. A measure of financial deepening, the ratio of financial assets to Gross Domestic Product which had been consant for most the 1970s rose from 1.03 in 1977 to 1.25 in 1987. Banks and non-banks enjoyed buoyant growth in assets but the expansion by government institutions was particularly strong.

(a) THE BANKING SECTOR

The assets of commercial banks grew an average by nearly 13% between 1977 and 1987. During this period the broad asset structure changed somewhat. Loans and advances still accounted for the largest share (54%) at the end of 1987 but this represents a fall of almost sixteen percentage points. Towards the end of the period deposits grew faster than loans and advances and there was an increase in excess liquidity. Much of the liquidity represented excess holdings of government securities whose share in total assets doubled to 12.1% at the end of 1987. The share attributed to claims on the Central Banks and other local banks was unchanged.

In Barbados, the decade ending in 1987 was noted for official attempts to make commercial banking more conducive to economic development[7]. One target area was the sectoral allocation of credit. Ten years of efforts by the Central Bank has not led to any increase in the share of total bank credit to the foreign exchange earning sectors - manufacturing, tourism and agriculture.

In 1977, in order to contain the demand for imports and protect the balance of payments, the Central Bank imposed limits on the amount of credit which could be extended to the distributive and personal sectors. At that time, these two sectors accounted for 42% of outstanding commercial bank credit, compared to a little less than 25% for tourism, agriculture and manufacturing combined. During the period, the ceilings were occasionally adjusted; in addition, Bank had in place several schemes which sought to encourage commercial bank lending to small businesses and exporters by providing some coverage against possible losses. But it is clear that adherence to traditional management practices led the banks to shy away from activities which are least profitable and most risky. When the ceilings on credit were removed completely in 1987, the sectoral distribution was not much different than at their imposition, with distribution and personal sectors accounting for 40% of the total and the export sectors still obtaining just below 25% (see Table I).

For many years, the term structure of loans worked to the disadvantage of the export sectors. In 1977, loans with a maturity of three years or less comprised on average 46.5% of credit outstanding to manufacturing, sugar and tourism. By contrast, distribution (which needs essentially short-term finance) had only 24.3% of loans in that category. There has been some improvement in this aspect of bank lending over the years, and in 1987, exporting sectors had roughly one third of their credit with maturities of less than three years (see Table II).

Commercial bank lending policies opened the way for the state sector to play a more crucial role in the sectoral allocation of credit. The Barbados Development Bank, for example, had to substantially increase its borrowings in order to meet the increased demand for credit. Loan disbursement rose by an annual average of 22% in the decade ending in 1987. Scarce resources have also been allocated by the Central Bank to providing insurance and credit guarantees to make venture capital and export finance more attractive to the private banks. The formation of the Barbados National Bank not only allowed Government a presence in an important foreign-dominated activity, but also facilitated the mobilisation of resources for manufacturing and the sugar industry. The Barbados Mortgage Finance Company, the BNB's Mortgage Agency in 1987 controlled 20% of the market for long-term residential mortgages.

The establishment of the BNB was hailed in many ways. It was noted that banking was so important a tool in the task of economic development that it could not be left exclusively to foreigners. Furthermore, important banking decisions were not necessarily taken in the national interest and the new bank could be a catalyst for change in the banking sector (Blackman (1978) pp. 34-38).

Did any good come out of the entry of government into banking?

When the BNB started operations, it took over the assets of Bank of America, whose portfolio included little credit to manufacturing. The new bank significantly increased lending to manufacturing, whose share in total credit rose to 21% by the end of 1979. The total share of credit going to tourism was 6.4%; construction accounted for another 7%, with 34.1% going to the personal and distributive sectors. Barbados National Bank's loan portfolio has continued to be somewhat different from the average for the banking sector. By the end of the period, the export sectors' share of credit was 26%, but the share going to personal and distribution fell sharply to 19.9%. Over the period, the Bank was the principal source of credit to the sugar industry via its Agricultural division. Outstanding loans increased at an annual average of 10.4% per annum between 1978 and 1987.

Of course, one needs to ask how much manufacturing has grown over the period. Between 1977 and 1987 manufacturing and agriculture contracted at annual average rates of 0.4% and 0.3% respectively. Distribution, on the other hand, expanded at an annual average rate of 3.3%. Tourism's recent spurt - 11% per annum since 1985- raised the average rate over the ten year period to 3.7% per annum.

Tables III and IV show for corresponding periods since the beginning of 1975 comparative data for expansion of bank credit and real output across the major sectors of the economy. The utilities aside, the three major export sectors experienced the highest rates of increase in bank credit during the period 1979-1983; during this time, tourism stagnated while agriculture and manufacturing contracted by annual averages of 0.8% and 0.6% respectively. Credit expansion in manufacturing did not seem to be a constraint on this sector in the years of firstly high energy prices then high interest rates and economic recession.

Government not only controls but also absorbs a significant amount of domestic credit. Loans and holdings of government securities expressed as a percentage of commercial bank assets rose 5 percentage points between 1977 and 1987 to reach 19%. One popular short-term instrument is the Government Treasury Bill; commercial banks' excess holdings of Treasury Bills rose on average by nearly 30% per annum between 1977 and 1987, while required or statutory holdings only grew on average by 18.8% per annum. Since 1981 the National Insurance Scheme (NIS) has become an important source of finance for government; Government securities now account for 54% of total assets, compared to 49% in 1977. Altogether loans and Government paper represented one fifth of the combined assets of commercial banks, trust companies, insurance companies and the National Insurance Fund. As NIS financing grew Central Bank claims on Government fell sharply in the last ten years to account for 16% of the Bank's assets at the end of 1987.

(b) THE NON-BANK SECTOR

It is sometimes felt that possibilities exist for non-banks to correct some of the deficiencies in credit allocation by commercial banks. There are several obstacles to this. In the first place, there are serious gaps in the regulation of non-banks (see Williams, 1988 pp. 3-5). The operations of insurance companies as they relate to the taking of deposits and the fixing of interest on mortgage loans are not covered by existing Banking legislation. The Central bank has no legal authority to impose reserve requirements on trust and finance companies. In the case of the credit unions, the Central Bank has never invoked its legal right to regulate interest rates, minimum security and ceilings on credit, and to inspect the books.

Among the non-banks only insurance and trust companies have the quantum of resources to support venture capital or export credit. Assets of insurance and trust companies grew on average per annum by 28.1% and 37%, respectively, between 1977 and 1986; their combined asset totalled $551 million at the end of 1986. However, they are essentially risk averters - their major assets being mortgages and government debentures (relatively risk-free instruments)[6]. Indeed, these institutions account for 70% of the market for long-term residential mortgages.

Bank balances held by trust companies were never very large, peaking in 1984 at 10% of total assets and falling to 2.3% by the end of 1987. However, cash and other balances have grown steadily through the years to account for nearly one-third of the assets of insurance companies in 1986. This suggests that there is more scope for insurance companies to make a larger contribution to the growth process by investing some proportion of those funds in productive sectors.

Annual average growth of 8.2% was recorded for the assets of finance companies between 1983 and 1987. They offered attractive deposit rates which bid away loanable funds from commercial banks, and also demanded less security for credit. At the end of 1984, vehicle purchase accounted for just over half of their consumer instalment credit facility, with construction and manufacturing absorbing shares of 23.3% and 12.8% respectively. During the last three years there has been a significant decline in lending to manufacturing, with loans for vehicle purchase and construction activity accounting for virtually all the instalment credit. There is some evidence that on occasion some companies abandoned sound lending practices altogether and provided substantial unsecured credit to the riskiest projects in manufacturing. The failure to recover several such loans led to one recent, highly publicised collapse which hurt several investors and may hamper the future of these institutions.

Other institutions which recorded sizeable growth were credit unions and workers co-operatives. These organisations have also diverted personal business away from commercial banks because of their easier borrowing conditions, personalised services and some government incentives; for example, deposits with credit unions are allowed as claims against income tax liabilities. In addition, credit unions operate in a highly captive or "close circuit" market situation. Many credit unions comprise only members from social, or worker organisations or a particular geographical locale.

An analysis of the loan portfolio of the largest of these bodies is typical of the industry over the 1984-86 period. Loans for house repairs, purchase of land and house construction accounted on average for 45% of the total; car purchases absorbed another 29%, and acquisition of household items 7.1%. Credit union financing of car purchase has come in for particular scrutiny because it was increasing during a period of severe pressure on the balance of payments. It intensified the movement to include credit unions with other institutions under a new Financial Institutions Act.

Attempts to more vigorously regulate the credit unions must deal with a number of concerns. First, should the society discourage or penalise organisations whose activities encouraged savings and whose membership comprises largely low-income earners? Would regulation unfairly protect commercial banks from competition in the area of personal lending? Indeed, should there not be definite moves to promote and protect a truly indigenous financial operation?

THE DISTRIBUTION OF FOREIGN FINANCE

Large amounts of foreign capital came into Barbados during our review period. Balance of Payments data show that net long-term inflows to the Central Government and the private sector totalled about $1.02 billion. The public sector absorbed three-fifths of this finance, mainly Euro-dollar borrowings, and project funds. Capital expenditure, which expanded on average by 10.6% per annum, accounted for most of the foreign funds, but there was also some borrowing to meet contracted debt service payments. One third of the inflows to the private sector between 1977 and 1985 was direct investment; three quarters of this was new investment in branches and subsidiaries and the remainder retained earnings. Portfolio investment comprised almost all long-term market loans. Foreign capital in the private sector was concentrated in a few activities - public utilities, manufacturing and oil exploration together accounted for ninety percent of the total.[8]

Roughly 59% of foreign finance in the private sector was for the telephone and electricity companies. The public utilities were in the process of upgrading their facilities, to accommodate increased and more sophisticated consumer demands. The improvements were also part of the general move to stimulate the growth of the tourism and manufacturing sectors. Almost all of the finance represented borrowed funds, with very little from the foreign parent companies. Foreign-owned oil companies attracted 17.8% of the investment, mainly to finance exploration; local oil production rose from one tenth of total oil consumption in 1976 to just over one half of the total in 1985. Wholesale/retail activities accounted for very little of the foreign capital.

The export sectors together absorbed just over 20% of foreign finance. Manufacturing got 13.6%, which was, for the most part, investment wooed by fiscal incentives and other attractions. 79%

of the investment in manufacturing was in the labour-intensive industries, e.g textiles and assembly-type goods.

After years of depending exclusively on local resources, the sugar industry in 1983 borrowed $15 million from a foreign bank to assist in the construction of a new factory; the loan amounted to 3.8% of total inflows during the period. Tourism accounted for just over 3% of total foreign finance. This sector always got substantial financing from the BDB for smaller hotels and apartments. However, during this period, there was no net expansion in luxury hotels, the type of accommodation which usually attracts foreign investors.

CONCLUSIONS

The financial system in Barbados has undergone significant change during the post-independence period, due in large measure to the initiative of government in establishing indigenous institutions to broaden the scope of financial intermediation for economic development.

In some cases, economic growth led to increased financial intermediation (e.g. the growth of credit unions which serviced the needs of workers with respect to home improvement, and insurance companies which provided in their life policies the security required for purchase of large units like houses), while there were clear cases where the expansion of the financial sector served to improve the rate economic growth (in particular the development agencies which had access to foreign resources to enhance activity in the productive sectors).

In many cases however, the deepening of the financial sector has surely led to a higher level of sophistication on the part of Barbadian consumers, while enhancing the infrastructure which enabled Barbados to pursue an industrialisation program encouraging foreign investment.

Still, there are some clear failures within the financial system which acted as constraints to the economy's development, not for any lack of incentives or directives on the part of the authorities. The traditional financial institutions have not done as much as they could to finance the economy's development. This is particularly true of commercial banks which continue to avoid some projects in manufacturing especially, which are considered too risky.

TABLE I

Commercial Banks' Sectoral Credit Distribution

	1966	1973	1977	1987
Agriculture	19.0	5.8	4.2	2.8
Manufacturing	8.8	8.3	8.4	12.1
Distribution	30.2	21.7	17.2	15.8
Tourism	5.4	11.1	12.0	9.5
Pub. Util.				8.4
Construction	5.7	13.2	10.3	3.8
Government	n.a.	--	5.9	--
Residential Mort.		3.8	2.6	3.5
Personal	10.7	21.5	25.1	24.1

TABLE II

Maturity Structure of Loans (%)

	1973		1977		1987	
	(i)	(ii)	(i)	(ii)	(i)	(ii)[1]
Agriculture	87.2		68.5	9.3	35.4	38.2
Manufacturing	65.2	14.5	61.6	30.2	14.1	43.8
Distribution	24.3	44.1	42.9	42.2	55.0	27.9
Tourism	20.4	32.7	9.4	61.5	16.5	61.2
Construction	26.2	38.4	39.2	42.9	47.2	33.8
Personal	61.6	21.0	54.6	21.3	49.4	29.3
Total			43.8	34.8	38.6	45.2

[1](i) refers to loans with maturity structure less than 3 years, (ii) to loans with maturity over 5 years.

TABLE III

Annual Average Rate of Growth in Bank Credit

	1975-78	1979-83	1984-87
Agriculture	21.2	14.5	-6.8
Manufacturing	9.6	25.6	-1.1
Distribution	5.6	10.7	7.4
Tourism	14.5	18.1	-4.1
Pub. Util.	23.8	26.1	8.4
Construction	0.4	-3.1	4.9
Personal	13.9	7.5	10.9
Government	24.3	12.8	3.2
Total	13.3	14.4	5.2

TABLE IV

Annual Average Rate of Growth in Output

	1975-78	1979-83	1984-87
Agriculture	1.3	-0.8	0.3
Manufacturing	9.9	-0.6	-2.5
Distribution	2.3	1.7	5.1
Tourism	7.7	0.2	6.3
Pub. Util.	3.4	4.0	4.6
Construction	-3.2	2.0	2.6
Government	0.6	0.4	3.5
Total	2.7	1.1	3.1

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NOTES

1.See Thomas (1987) p. 15.

2.See Saunders and Wood (1988) for a full listing of these measures.

3.Goldsmith (1969) p.34.

4.They are the Royal Bank of Canada, the Bank of Nova Scotia and the Canadian Imperial Bank of Commerce.

5.See Codrington (1978), p. 26.

6.See Worrell and Prescod (1983) for more on the growth of the insurance industry in the 1970s.

7.See Worrell and Prescod (1983) for an account of these. For example, these authors mention how trust companies in Barbados had their origin in a Canadian law which required separate insittutions to handle trust management and related services. The local branches of the Canadian banks "simply replicated their parent firms' division of labour."

8.The tendency for foreign capital in developing countries to be concentrated in few sectors has been noted by Maddison (1970) pp. 218-220