FINANCIAL INTEGRATION AND EFFICIENCY OF THE FINANCIAL SECTOR IN THE ECCB AREA

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Holding Legislation of the member countries and uniform Companies legislation. However, all of this can be thwarted by the behavior of financial institutions and economic agents which are reluctant to widen their economic horizons beyond their own coastlines. This is not a peculiar trait of the Caribbean but a characteristic of island peoples throughout the world. The change in attitudes would require an extensive education effort on the part of the ECCB.

Section I of the paper discusses the meaning of market efficiency and financial integration while section II tries to measure the extent of financial integration in the ECCB area and compares it with financial integration internationally. Section III identifies some of the major actions which would be necessary to enhance financial integration and hence the efficiency of financial markets in the ECCB area. It also discusses the ECCB approach to this issue. The final section of the paper presents some concluding remarks.

Efficiency and Financial Integration Defined

A market is efficient if scarce resources are allocated to their most productive uses. In every situation buyers who are willing and able to pay the highest prices for each resource would receive the resources they require. In a perfectly efficient financial market the prices of debt instruments and securities are always in equilibrium but will fluctuate randomly around their intrinsic values. Temporary deviations from equilibrium are instantaneously corrected.

The Hypothesis of efficient markets has two components: the hypothesis that individual avoid knowable forecasting errors given current information and the hypothesis that any discrepancy between expected rates of return on different assets is quickly arbitraged to eliminate expected supernormal profits. As Grossman and Stiglitz (1976) and (1980) emphasize, it is the possibility of obtaining supernormal profits in the course of arbitraging which provides the incentive to collect and process new information. It cannot mean that market prices literally reflect all information at every instant.

Although the Efficient Markets model has experienced a resurgence with the advent of the Rational Expectations Hypothesis which was first stated formally by Muth (1961), empirical tests of the of the hypothesis dates back to Bachelier (1900). The earlier tests of the Efficient Market Hypothesis surveyed by Fama (1970) focussed on the effects of arbitrage which eliminates price differentials while the more recent ones test the rationality of expectations. In this paper reference is made to Cointegration tests of convergence of interest rates which provides indirect evidence of the effects (or lack thereof) of arbitrage (Samuel et al (1994).

Financial markets refer to the complex of institutions and relationships which economic agents utilize when they need to issue financial liabilities, which are either in the form of debt or equities. This activity, which reconciles the differing preferences of ultimate savers and ultimate investors is called financial intermediation. Financial integration refers to the process of linking national financial markets so that eventually they function as if they were a single financial market. A fully integrated financial market can be defined in terms of the efficient market hypothesis. In a perfectly efficient financial market with no market imperfections, low transaction and communication costs and efficient processing of information, adjustment will be almost instantaneous. Savers would switch funds from low-return to high-return locations and borrowers would shift seamlessly from high-cost to low cost sources of financing. Market interest rates and yields on investment, adjusted for risk premiums, would be equalized across all locations.

A perfectly efficient, integrated financial system is analogous to a reservoir filled with water. If liquid is removed from one section of the reservoir, the general level of the reservoir is reduced as liquid moves to take up the space which was emptied. If there are market imperfections (e.g. distortionary taxes and regulations), high transaction and or communication costs or incomplete information processing, the process takes on the character of a liquid of greater viscosity which would prolong the adjustment process.

In the short run, the level need not be uniform across the entire reservoir and deficits or surpluses may occur. For example if the tourism sector in one of the OECS countries begins to boom, that country would have an excess demand for savings (withdrawals from the reservoir would exceed inflows). That country would pull in financial resources from the rest of the region as investment in projects with higher than average returns would bid funds away from low-return projects in other parts of the region. Investment in the booming economy would not be limited to the current flow of domestic saving, since there would be a net inflow of funds. Eventually, real rates of return, adjusted for risk premium will converge. However as long as expected rates of return are higher in the booming region, the level of the reservoir will not be uniform and funds would flow into that economy.

If the imperfections in the markets are acute enough to create barriers between the financial markets, then instead of a single large reservoir, there would be a series of national reservoirs. Capital movements in that context would involve the 'ladling' of funds between national reservoirs. In fact, none of the benchmark situations described above accurately describes the real world. It is more likely an amalgam of all three scenarios. Some flows are relatively frictionless, others are more torpid like molasses, while still others are restricted by national policy. Unfortunately the characterization of the ECCB area is more akin to the series of national reservoirs. High transaction and communication costs have increased the economic distances between the countries. Developments in telecommunications and informatics have tended to reduce the economic distances between the individual member countries and the developed world more than between the member countries. This has tended to reinforce the effects of the limitations of the financial structure, inertia on the part of economic agents and the regulatory framework.

The movement towards the integration of financial markets is usually explained in terms of the effect of three sets of impulses. They are:

1. **Financial activity following Real sector transactions.**

2. **Financial activity leading Real-Sector Transactions.**

3. **Regulatory, Tax and Supervisory Explanations.**

On all three counts, the effects of these impulses have tended to act perversely in the member countries of the ECCB. They have tended to strengthen their links with the rest of the world and weaken the links between the member countries.

The financial activity following explanations stress the need for finance to follow cross-border trade in goods and services. Rapid expansion in trade require trade finance and current account deficits would prompt a cross-border flow saving. On this count, the structure of trade relations even after 20 years of regional integration is still highly skewed to the developed countries. Intra-trade in CARICOM as a whole accounts for only 10 percent of total trade. The ratio for OECS is even less amounting to only 6 percent.

A second avenue through which finance following real sector activities arises when non financial firms establish branches abroad. Financial institutions have tended to follow in order to provide/improve services for their existing non-financial customers. The record on this has been in favour of stronger external linkages as opposed to intra-ECCB. Even in recent times there has been a proliferation of firms from other CARICOM countries in the ECCB area but no truly OECS wide companies have emerged since one prominent merchandiser in the 1950s.

In the case of finance leading real activity, financial institutions perceive opportunities for the arbitrage of funds across different financial markets. Technological advances in the area of telecommunications and information technology not only increased the capability of market actors to take advantage of arbitrage opportunities, but also increased the incentives for such activities by reducing transaction and communication costs. These cross-border flows of savings are totally autonomous and are unrelated to trade or movements of real sector activity. The absence of appropriate financial infrastructure has limited the exploitation of arbitrage opportunities in the ECCB area. Thus such flows have been largely asymmetric and skewed towards the developed countries. This maybe partly related to the pricing of telecommunication services in the sub-region. Since 1980 the cost of an average long distance call in the USA has declined by almost 50 per cent, while the cost of telephone calls between the OECS countries, in most cases, has risen. More importantly intra-OECS financial flows have been severely restricted by the absence of the enabling financial institutions.

The action of foreign based commercial banks has long being recognized as the most dynamic forces in financial integration. Bryant (1987) states,

> "The primary mechanism for that transmission has been the establishment within host regions of financial institutions managed by 'foreigners' ..... Local offices of foreign commercial banks have often been the single most important catalytic influence". (p.13).

This has been no less true in the case of the ECCB member countries with respect to linkages with international financial markets. However, it is doubtful whether the linkages within the currency union were pursued with the same amount of ardor. Given the orientation towards their head offices stronger links were naturally forged with the developed countries. In more recent times, the indigenous banks were forced by the absence of head offices to rely more on their counterparts in the other ECCB territories. One concrete example is their joint venture in the issue of credit cards.

The regulatory framework acted as both a push and a pull factor in international financial integration. National regulations and taxes forced some financial institutions to develop international affiliates which provided them with opportunities for integrating international financial markets without the encumbrances of domestic regulations. In more recent times the tendency for the liberalization of economic relations has served as a strong pull factor for the integration of international financial markets.

In the ECCB area the establishment of offshore financial institutions has also resulted in the strengthening of international linkages at the expense of linkages within the currency union. The local regulatory framework has also not assisted financial integration in the region. The Alien Land Holding Regulations have deterred the movement of capital and has discouraged cross-border loans by financial institutions. Moreover, foreign exchange taxes which put the EC dollar at a disadvantage, encourages the holding of US dollar deposits rather than EC dollar deposits in other ECCB member territories.

Empirical evidence in the international financial markets suggests that, of the three sets of considerations, autonomous financial activity seems to have had the most powerful influence on financial integration. Thus, the ECCB capital markets development strategy emphasizes the creation of the financial infrastructure and the regulatory environment which would encourage that activity. These will be supported by an intensive education programme to foster financial literacy and effective use of the financial system.

Section II

The level of interbank deposits is a good indicator of the degree of financial integration. Internationally interbank deposits represents about two thirds of all deposits which have an international element. It provides the easiest way for financial institutions to make international investments. A foreign based bank is unable to accurately assess the credit worthiness of the borrower or do an accurate assessment cost effectively. Furthermore, there can be complications related to the holding of collateral by foreign financial institutions. Making an interbank deposit in the local institution gets around both of these problems. The local institution is on the ground and can better asses the risk and avoids the complications related to collateral.

To get a preliminary sense of the degree of financial integration in the ECCB area one can examine the consolidated balance sheet of the commercial banks. For this purpose, Table I presents some key elements of the ECCB area consolidated balance sheet while Table II presents the respective percentages.

As is evident in Table 1, total assets went from $3.1 billion in 1988 to $44.7 billion in 1992. As can be expected, loans and advances and bills discounted was the major component of assets. It constituted 59.3 per cent in 1988 and by 1992 it amounted to 67.5 per cent. Of interest with respect to financial integration in the ECCB area are the items due from banks in other ECCB territories (on the assets side) and due to banks in other ECCB territories (on the liabilities side). In 1988 due from banks in other ECCB territories was 2.2 per cent of total assets of the commercial banking system and did not go beyond that level during 1988 to 1992. In 1992 it accounted for 2.1 per cent of total assets. These can be compared with the items due from banks abroad on the assets side. The item due from banks abroad was as high as 18.0 per cent in 1988 but declined to 10.1 per cent by 1992.

On a country by country basis, commercial banks in Grenada had the largest proportion of their assets in the item due from banks in other ECCB territories. It accounted for 4.35 per cent of the total assets of commercial banks in Grenada in 1992, compared to 0.7 per cent in 1988. Grenada was followed by Anguilla with 3.6 per cent and Antigua with 2.89 per cent in 1992 compared with 2.8 per cent and 1.6 per cent respectively.

Dominica and Montserrat provide a contrasting situation. In 1988 commercial banks in Dominica held 6.6 per cent of their assets in the form of balances with banks in other ECCB territories while Montserrat held 7.0 per cent in the same year. These figures represent the highest proportion of assets held in that form by commercial banks in any country of the ECCB area between 1988 and 1992. On the other side of the balance sheet, of all the ECCB member countries, St Kitts' liabilities to banks in the other ECCB territories were the highest of its total liabilities. It was 4.4 per cent in 1992 falling from 8.6 per cent in 1988. St Kitts was followed by Antigua with figures of 5.4 per cent and 4.3 per cent for the respective years. Liabilities in that form was lowest in Grenada in 1992 when it was only 0.02 per cent.

These figures compare poorly with the assets and liabilities positions of commercial banks in each member country with respect to their operations with banks outside of the ECCB area. The most dramatic case is Anguilla, where commercial banks held 41.86 per cent of their assets in banks outside of the area in 1988. However this fell to 17.5 per cent by 1992. The second highest was St Kitts with 25.31 per cent and 16.09 per cent in the respective years. Following St Kitts was St Vincent with proportions of 19.84 per cent and 11.72 per cent respectively. Over the period 1988 and 1992 there has been a downward trend in commercial banks of the area holdings of balances in banks outside of the ECCB area. On the liabilities side a dramatic swing was noticeable in Anguilla where the item due to banks abroad grew from 0.82 per cent of commercial banks total liabilities in 1988 to 16.12 per cent in 1992. In St Kitts it went from

3.11 per cent to 8.57 per cent in the respective years. In general there has been a tendency for this item to increase over the period in the ECCB area.

Another possible approach to ex~~amining the depth of~~ financial integration within the ECCB area is the cross regional flows of credit and investment disbursed bv the commercial banks. From the standpoint of the collective area, of a total of $1.94 billion of credit and investment in 1988 only 0.54 per cent was intra ECCB area while 2.16 per cent was outside of the area. By 1992, the respective figures wee 1.05 per cent and 3.68 per cent. The situation is more revealing when one considers similar categorical proportions for total non-resident credit and investment. In 1988 the total disbursed credit and investment of commercial banks to non-residents stood at $52.63m of which 20.07 per cent was disbursed within the ECCB area while 79.93 per cent went outside of the area. Much change has not taken place since then and by 1992 the proportional distribution between those two categories were 22.26 per cent and 77.74 per cent respectively.

On the basis of the relative distribution of credit and investment between ECCB area and outside the area, St Lucia and Grenada seem to have been more integrated with the rest of the ECCB area than the other member countries in 1988. In that year credit and investment that went outside of the area was higher than those disbursed within the area by 0.6 percentage points in Grenada and St Lucia. The difference between the two was highest in Montserrat where it was 12.44 per cent. By 1992 St Kitts and Nevis had the best disposition. Here, credit and investment within the area exceeded those outside of the area by 0.08 percentage points. Montserrat continued to have higher credit and investment outside of the area than credit and investment within the area (by 5.28 percentage points).

With respect to the total of credit and investment disbursed to non-residents, the available data indicate that in 1988 20.07 per cent was within the ECCB area while 79.93 per cent was outside of the area. The respective percentages were 22.26 and 77.74 in 1992. For Dominica in 1988, of the total amount of credit and investment that went to non-residents ($13.44m) 42.72 per cent was allocated to non-residents within the ECCB area. Dominica had the best distribution insofar as financial integration within the region is concerned. For the same year, the situation was worst in Montserrat with distributions of 0.75 per cent and 99.25 per cent respectively.

There was some improvement in the situation by the year 1992. For the area as a whole, of the credit and investment that went to non-residents, 26.26 per cent went to non-residents within the area while 77.74 per cent were disbursed to non-residents outside of the area. In that year, St Kitts and Nevis had the best distributions with 51.22 per cent going to non-residents within the ECCB area and 48.78 per cent to non-residents outside of the area. Montserrat had the least encouraging distribution with 3.34 per cent and 96.66 per cent respectively.

A third way of looking at the issue given the available data is through the ownership structure of deposits. According to the data, in 1988 only 1.2 per cent of the total deposits held by commercial banks were owned by non-residents within the ECCB area while 9.9 per cent was held by non-residents outside the area. The proportions have remained virtually the same by 1992. In addition, of the total non-resident deposits, 10.83 per cent was held by ECCB area non-residents while 87.17 per cent was owned by non-residents outside of the area. By 1992, the figures were 16.9 per cent and 83.1 per cent respectively.

On a country basis, non-ECCB area non-residents' deposits, as a percentage of total deposits, exceeded that of ECCB area non-residents by the lowest (5.07 percentage points) in St Lucia in 1988. The highest, 19 percentage points, was in Anguilla. In 1992 there was a shift with Antigua having the lowest difference, 4.35 percentage points, while Dominica had the highest of 14.79 percentage points.

The deposits held by non-ECCB area non-residents was 89.17 per cent of total non-residents deposits in 1988 while that of ECCB area non-residents was 10.83 per cent. By 1992 the respective figures were 83.10 per cent and 16.90 per cent. In terms of individual countries, the lowest by which non-ECCB area non-residents deposits as a percentage of total non-residents deposits exceeded ECCB area non-residents deposits was 49.04 percentage points in 1998 in Anguilla. The highest was in Dominica where it was by 96.88 percentage points. Anguilla remained the lowest in 1992 with a 35.20 percentage points difference while the highest was 94.3 percentage points in St Kitts and Nevis.

The data presented above are only indicative of the lack of financial integration since they deal only with stocks. A more accurate measure of financial integration would be the actual flows, however that data is not available. Never-the-less, what the evidence seems to suggest is that financial integration within the ECCB area is not that deep insofar as the relative distribution of assets and liabilities, the flow of credit and investment within and outside of the ECCB area, and the ownership structure of deposits are concerned. Only a small fraction of all assets in all member countries is held in banks in other ECCB territories. More assets are held with banks outside of the ECCB area. Over the period 1988-1992 there was a clear tendency for credit and investment to flow outside of the ECCB area as opposed to within the area. Similarly throughout the period the structure of deposits ownership indicated a trend towards the outside as non-residents outside of the ECCB area held more deposits in ECCB area commercial banks than did ECCB area non-residents.

The absence of large financial flows does not necessarily indicate a absence of financial integration. On the contrary it may imply that financial integration may have already been achieved and all exploitable opportunities for arbitrage have been undertaken. However if this were the case interest rates among the countries would be equalized, execept of differences in country specific risks. Similarly inflation rates will be equalized. Samuel et al (1994) report evidence that although inflation rates in the ECCB member show short run divergences, there is a long run tendency for convergence. On the contrary, interest rates differ significantly and there was no evidence of a tendency to converge. The convergence of inflation rates is a result of convergence to the US inflation rate as a common core under fixed exchange rates.

The Inter Bank Market

The absence of financial integration in the ECCB area is further illustrated by the low level of activity on the Interbank Market. All Commercial Banks operating in the ECCB area, which are members of the Clearing House, are eligible to make use of the Inter Bank Market. Commercial banks are supposed to indicate, on a daily basis, the amount of surplus cash it wishes to place on the money market, or the amount of cash it wishes to borrow from the market. Amounts are offered or accepted for a minimum of 3 working days and a maximum of 30 working days. Funds are allocated first and foremost to cover local demand, only the surplus from one territory is made available to banks in other territories.

Banks which participate in the Inter Bank Market are required to maintain with the Central Bank, Fixed Deposits, Treasury Bills and or private paper acceptable to the Central Bank. Advance are made up to 90 percent of the face value of such investments in the case of Treasury Bills and Fixed Deposits and 75 percent in the case of acceptable private paper.

The Central Bank fixes both the lending and deposit rates. Currently both the deposit and lending rates are 5 percent per annum plus a 0.25 percent Commission Charge to the borrowing banks.

In July of 1993 the rules here changed in an attempt to stimulate greater activity after a prolonged period of dormancy. The main changes were as follows:- Providing there is a bid, the ECCB actively sources funds from the three Commercial Banks with the highest balances in the bidder's territory, the bank with the highest balance being approached first. If none of these banks are willing to offer funds, the next bank to be approached is that with the next highest balance irrespective of the territory.

Despite these changes the volume of activity in the Inter Bank Market has remained rather thin. Only one of the regional Bank actually place bids in the market. Further developments would include the market being operated on the basis of an auction, with interest rates being determined by market forces rather than being fixed by the Central Bank. In addition, initial sourcing of funds can be regionalized, rather than the current practice of first trying to source funds in the bidders territory. This would allow for greater competition in the market and also promote the more efficient utilization of Funds.

The Efficiency Of the Clearing System in the Banking Sector

Another indicator of the low level of financial integration is the absence of Intra-regional cheque clearing system. In terms of the efficiency of the clearing system a number of issues need to be raised. This first is need to reduce the cost of originating, tendering and collecting cheques in the region. While there is no information available on the actual cost of providing a chequing service, non interest expenses, exclusive of provisions for loan losses, amount to roughly 6 percent of total assets, about double the ratios for similar sized institutions in the United States. A lot of the Circumstantial evidence suggest that a large component of these cost may be associated with the payments system.

At present there is no region wide Clearing System but rather clearings take place on a territorial basis. This tends to lead to lengthy delays in the clearing process, which may range from five to seven days. In addition, there are Government imposed regulations which tend to lead to bottlenecks in the System. Cheques which are drawn on banks in St Vincent and the Grenadines are not negotiable outside the territory, with the result that the bank of deposit can accept such cheques on a collection basis only, resulting in a process that may take from ten to fourteen business days. This entails incremental costs to the payee.

Cash Management

In spite of the lack of financial integration implied by the low levels intra-regional financial flows there are some developments which augur well for the future. One of these is the recent tendency by foreign based commercial banks which have branches in different territories to manage their excess funds centrally. At any time we may find some banks with fairly liquid positions while others may have fairly tight liquidity levels. A few of the regional branch networks have utilized the technique of the cash concentration account, where by surplus funds at various branches in the region at pooled at the St Kitts branch for deployment in the most profitable use. This allows for the more efficient management of funds by these banks.

Section III

How Can The Level Of Financial Integration Be Increased

We start with the proposition that the efficiency of the financial system will improve with an increase the level of financial integration in the region. If a nation's residents could not trade with foreigners, the pattern of national spending would have to be in conformity with the goods and services produced at home. So long as relative prices differ at home and abroad, the nation's residents can unambiguously improve their consumption possibilities by exchanging goods with foreigners. Furthermore, such "exchange gains" can be augmented by "production gains". Production gains result when the structure of production in a nation becomes specialised along the lines of comparative advantage. Resource and factor endowments are used more efficiently when production is specialised, permitting the nation to sell domestic production at favourable relative prices abroad, which in turn raises national consumption possibilities still further.

The gains from trade are not exclusively confined to goods transactions. They relate to other cross border transactions. A country with better than average investment prospects can assume greater risks by importing capital funds and real resources from the rest of the world, thereby raising future consumption possibilities for the nation as a whole. With individual countries being able to alter the inter-temporal profiles of their consumption, the region as a whole can attain an improved allocation of savings and investment, with countries with ex ante excess savings employing them in nations where the ex ante return on investment is higher.

With greater financial integration, national financial systems tend to respond promptly and fully to new information. Organized markets of any sort have this capacity to provide information signals to help achieve a more efficient allocation of resources. The prompt transmittal of information through financial markets helps to generate exchange and production gains from cross border transactions. Having identified some of the gains from greater financial integration we now discuss what can be done to increase the level of financial integration in the region. The discussion will proceed along four broad headings. These are:

(a) the adoption of modern technology;
(b) increasing the level of intra-regional trade;
(c) the removal of barriers or the lowering of separation fences; and
(d) increasing public awareness.

(a) The Adoption of Modern Technology

The shrinking of the effective economic distances between countries of the region can be effected through the adoption of new technology. The introduction of electronic equipment - computers, switching devices, telecommunications satellite, etc. - would permit the processing and the transmission of information, the confirmation of transactions and the making of payments for transactions in a progressively less costly manner. Sophisticated methods of using new equipment - such as computer software for the electronic funds transfer and accounting - would revolutionize the delivery of financial services.

At present, most inter-regional transactions could only be executed during conventional business hours. With the more widespread use of modern technology, transactions could be consummated twenty-four hours a day. With the implementation of modern technology, information about financial opportunities in other ECCB countries would become much more readily and cheaply available. Saving units in one country may decide to take advantage of higher expected yields on financial assets throughout the region by purchasing regional assets or making loans to nationals in other countries rather than investing at home. Investing units could borrow from other institutions in the region if they could obtain more favourable loan terms than at home.

At present the branches of foreign commercial banks may be best equipped to initiate greater financial integration. It is relatively easy to adopt financial innovation with their integrated computer network, so that there is the potential for new instruments region wide such as negotiable certificates of deposits and syndicated loans. Some of the foreign banks in the region have introduced an ATM card which allows the holder in one country to make deposits and withdrawals in another country. This being made possible through the adoption of modern technology. This is a small step in the right direction, however careful attention would have to be paid to the pricing of these services, since an inappropriate pricing structure would only reinforce the inertia.

The introduction of modern technology has far reaching implications for financial activity. Economic agents would have an improved capacity to take advantage of incentives for arbitrage among the different countries of the region. A reduction in the cost of intra-OECS telecommunications would provide a fillip to financial integration. Governments may need to have dialogue with the telecommunication companies on the pricing structure of telecommunication services, not only for the development of financial services but the entire service sector.

(b) Increasing the Level of Intra-Regional Trade

Through increases in the level of intra-regional trade, there would be a concomitant rise in the level of cross border financial activity. In order to pay for the cross border shipments of goods and services, a nation's residents would need to hold, borrow or otherwise acquire cash balances in other countries. Thus the transactions, balance requirements of trade alone would probably lead to a significant increase in regional assets and liabilities. Although the greater efficiency may reduce the level of required transaction balances, this would only moderate the trend.

Among other things, the OECS economic development strategy encourages the formation of an OECS single market and the establishment of more regional companies which would be engaged in production and marketing. These two initiatives have the potential to encourage some amount of financial integration. The increased flow of goods and services, within a larger economic space, unimpeded by trade restrictions, would create a concomitant need for intra-OECS financing to service the increased trade flows. Furthermore any reductions in the relative price of intra-regional travel may indirectly induce greater financial integration through increased cross border trading activity.

The OECS development strategy encourages OECS-wide companies and joint production activities to provide the critical mass which is necessary to assist these small countries to become internationally competitive. Joint production activities are suggested in the areas of agricultural production, manufacturing, and services. Such cross border real economic activity would tend to deepen financial integration as more creative forms of financing will have to be devised. This include consortium lending, regional issue of bonds and equity etc. Moreover, some of the lending and borrowing transactions of trans-OECS companies would be booked on the balance sheet of regional financial institutions as cross border activities.

As noted earlier, the influence of real activity encouraging financial integration has not been significant. The nature of the OECS economies suggests that the situation would not be different. Given the structure of the economies, even with a fully functioning single market, intra-trade is unlikely to become very significant. Thus emphasis of the policy towards financial integration would have to be placed on the other activities, i.e. filling the gaps in the financial infra-structure, creating an enabling regulatory environment and public education.

(c) The Removal of Barriers or the Lowering of Separation Fences

From the perspective of the private sector the existence of government erected separation fences around the domestic financial system imposes an extra cost on cross border financial activity. The effect of a very high separation fence is to make the cost of transferring funds in or out prohibitive. Any attempt by the governments of the region to lower separation fences would cause a decline in the differential costs required to get across the fence, thereby enhancing incentives for the cross border flow of funds.

In terms of lowering the separation fence in the region, the Alien Land Holding License which require non-nationals to obtain a license in order to hold shares, stock or debentures in a company which is incorporated in that country, needs to be reviewed. This Alien Land Holding license is currently required by OECS nationals in six of the eight member territories and effectively limits the cross border flow of funds.

A very important part of the separation fence is the existence of foreign exchange laws which hinder the free movement of funds within the region. At present, approval has to be obtained from the Ministry of Finance before a commercial bank can grant a loan to someone in another part of the ECCB region.

The exchange control ordinance of some countries also place restrictions on the sale and transfer of securities and also on the payment of dividends and interest on these securities. In respect of a greater level of financial integration in the region what is needed is that the concept of residency be applied region-wide so that no distinction is made between persons on two different islands.

Government taxation policy serves to affect the height of the separation fence. Most of the islands have in place a withholding tax on the payment to non-residents of profits, management fees, accounting and auditing expenses, royalties and insurance premiums. This acts as a disincentive to the free movement of capital within the region. In addition to the withholding tax, companies are faced with the prospect of pay taxes in their home country. What is urgently needed is for some kind of double taxation agreement between the different countries, in order to obviate the incidence of companies having to pay taxes in two countries.

The corporate income tax laws in some countries serve to discriminate in favour of local companies and against foreign companies, wherein domestic companies are allowed a wider range of deductions in the computation of profit for tax purposes than is permissible for foreign companies. What is being implied here is that policies which inhibit integration in production will necessarily impose limits on financial integration if we accept that financial activity follows real sector activity.

The lack of uniformity with respect to taxes which are levied on the interest earned on deposits is another factor which needs to be addressed if the separation fence is to be lowered. The existence in St Vincent and the Grenadines of a tax on the interest which is earned from the credit balance on all interest bearing accounts serves as a disincentive to the inflow of funds from another island in the region.

In light of the regulatory barriers identified above, two recommendations are suggested. The first is that there should be greater convergence in the tax systems of the ECCB member countries. The results of a study of the tax system being currently conducted by the ECCB could inform this exercise. The Second is the need for the extension of the concept of resident to include economic agents resident in all of the ECCB member countries. This is the approach which is being taken in the review of the exchange control regulations in preparation for a more liberalized regime.

(d) Increasing Public Awareness

Increasing the level of public awareness is crucial for greater financial integration. This is particularly true in a region like the OECS where for a long time people have had a rather insular focus. So that what the public awareness program will seek to achieve is to set economic agents to think in terms of region rather than in terms of country.

The public awareness campaign should also seek to inform economic agents about the attributes of the new assets which may come about with greater financial integration. It is one thing to revolutionise the delivery of financial services, the general public must be sufficiently informed for us to take advantage of those opportunities.

In the OECS region there is a preponderance of family owned businesses. Greater financial integration could be achieved if these companies which are presently family owned are transformed into regional-wide public companies. It may also be desirable to have companies which have operations in several islands. This requires a change in attitude particularly with regard to outside equity. One way in which the required change of attitude could be achieved is through some education or awareness campaign.

ECCB Approach to Financial Integration

The general approach of the ECCB towards the development of financial markets and financial liberalization can be described as an iterative approach which draws on the theory of options (Henry 1994). It starts with the assumption that the goal of economic activity is the improvement of the quality of life of the citizens of the society. That requires growth in real output which necessitates among other things more investment. Investment can be financed by domestic and foreign saving. Opening up of the economies to fully liberalized capital flows with, the already identified gaps in the financial infrastructure carries several risks. These include capital flight. instability due to short-term movements of money, a surfeit of capital inflows which cannot be sterilized etc. Thus, the first step is to improve the microeconomic efficiency of the financial markets by creating the necessary institutions and improving the regulatory framework, while encouraging some inflow of foreign investment. This would stimulate domestic investment and hence real output.

Having undertaken this set of policies and investment is still deficient a second step would be complete liberalization with respect to the rest of CARICOM. This may require a further realignment of domestic policies to ensure market efficiency. All things being equal, investment would again increase and a further assessment would be done to determine the next set of policy changes which would be required. This approach avoids the instability associated with large shifts in policy and allows the authorities to assess progress along the way. Like in options theory policy decisions are effected in light of the outcomes.

At this time the ECCB is in phase I, in which the financial infrastructure and regulatory framework is being addressed. Consequently, the Eastern Caribbean Central Bank (ECCB) is currently involved in a wide range of research and development initiatives on Money and Capital Market Development. The approach to phase one (1) can be characterized by the following major sets of activities namely:

1) The development and implementation of a comprehensive education programme to enhance the financial literacy of the general public, and the sophistication of key financial market participants.

2) The research and analysis for the conceptualization and articulation of issues, initiatives, and strategies for the development of the Money and Capital Markets through a process of wide range detailed consultation with potential players or participants.

3) The development and promotion of legislative and regulatory reforms which would facilitate the orderly functioning of the Money and Capital Markets, such as the Aliens Landholding Laws, the Uniform Companies, Securities, Insurance

Companies, and Development Banks Laws, as well as accounting, reporting, and disclosure standards.

4) The development of the Money and Capital Markets and the Government Securities Market via the establishment and expansion of secondary market mechanisms or arrangements for these securities.

5) The development and implementation or operationalization of key Capital Market institution; such as: the Eastern Caribbean Home Mortgage Bank (ECHMB), a secondary market institution for residential mortgages; the Eastern Caribbean Stock Market (ECSM), a secondary market for equities which will be developed in two stages (an interim Over-The-Counter Call Exchange arrangement and a formally organized Stock Exchange); the Eastern Caribbean Enterprise Fund (ECEF), an omnibus investment/venture capital fund; and the Eastern Caribbean Unit Trust Company (ECUTC), a regional mutual fund investment company.

Conclusion

There are some clear signs that the ECCB area is approaching a new era in financial integration. Not only are the Central Bank's efforts about to change the way financial activities are effected, but there are imminent changes in the area of consumer finance. Regional Debit Cards, regional networks of ATMs and international ATM networks like PLUS and CIRRUS have either been introduced or are being contemplated. The issuance of a credit card by a network of indigenous commercial banks is the first in a line of EC dollar credit cards which are at various stages of implementation. These developments, by their mass appeal can usher in a new era of financial maturity in the sub-region, as the important players jostle for ascendancy in a very competitive industry. Moreover, they have the potential to initiate the collapse of the barriers which, up to now, have served to fragment the financial markets in the currency union. The authorities may well find that archaic restrictions are redundant and ineffective in a more modern environment. The adoption of modern technology could significantly enhance financial integration even in the absence of changes in the separation fences.

There is need for some kind of convergence of the tax regimes in the different islands. This would have the effect of levelling the playing field. Investors in one country would know that they face similar treatment with respect to taxes if they decide to shift their funds across borders. The concept of residents needs to be defined in terms of OECS nationals both with regards to tax laws and foreign exchange regulations.

TABLE I

Balance Sheet of the ECCB Area Commercial Banks 1988 – 1992
(All Figures in EC$ '000)

Year	1988	1989	1990	1991	1992
ASSETS					
(of which):					
a Loans, Advances & Bills Discounted	1,869,721	2,315,809	2,630,114	2,877,521	3,159,939
b Due from ECCB	236,967	238,903	280,923	286,240	368,770
c Due from Banks in Territory	42,534	49,526	52,747	54,991	53,423
d Due from Banks in Other ECCB Territory	69,136	52,832	54,467	61,517	97,799
e Due from Banks Abroad	565,293	466,428	421,084	474,798	471,657
TOTAL ASSETS	3,151,870	3,560,354	3,930,564	4,198,868	4,679,757
LIABILITIES					
(of which):					
a Deposits	2,507,203	2,868,142	3,184,888	3,457,902	3,794,701
b Due to ECCB	7,163	9,212	3,509	4,647	1,425
c Due to Banks in Territory	22,958	29,447	29,446	15,408	28,404
d Due to Banks in Other ECCB Territory	78,430	67,061	48,100	54,401	97,034
e Due to Banks Abroad	92,118	111,957	142,565	142,414	217,071
TOTAL LIABILITIES	3,151,870	3,560,354	3,930,564	4,198,868	4,679,757

TABLE II

Each element of Balance Sheet as a percentage of Total Assets/Liabilities 1988 – 1992

Year	1988	1989	1990	1991	1992
ASSETS					
(of which):					
a Loans, Advances & Bills Discounted	59.32%	65.04%	66.91%	68.53%	67.52%
b Due from ECCB	7.52%	6.71%	7.15%	6.82%	7.88%
c Due from Banks in Territory	1.35%	1.39%	1.34%	1.31%	1.14%
d Due from Banks in Other ECCB Territory	2.19%	1.48%	1.39%	1.47%	2.09%
e Due from Banks Abroad	17.94%	13.10%	10.71%	11.31%	10.08%
LIABILITIES					
(of which):					
a Deposits	79.55%	80.56%	81.03%	82.35%	81.09%
b Due to ECCB	0.23%	0.26%	0.09%	0.11%	0.03%
c Due to Banks in Territory	0.73%	0.83%	0.75%	0.37%	0.61%
d Due to Banks in Other ECCB Territory	2.49%	1.88%	1.22%	1.30%	2.07%
e Due to Banks Abroad	2.92%	3.14%	3.63%	3.39%	4.64%

SOURCE: ECCB (Statistical Unit)

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TABLE V

ECCB Area Commercial Banks Deposits by Owner and Type 1988 – 1992
(All Figures in EC$ '000)

Year	1988	1989	1990	1991	1992
1. RESIDENTS					
a Private Businesses	338,288	391,636	419,315	434,137	422,362
b Households	1,355,672	1,587,963	1,784,562	1,974,861	2,155,209
c Other	533,913	579,981	641,682	680,664	789,683
TOTAL RESIDENTS	2,227,873	2,559,580	2,845,559	3,089,662	3,367,254
2. NON-RESIDENTS					
a Other ECCB Territories	30,254	36,034	46,834	59,585	72,238
b Other Countries	249,076	272,528	292,495	308,654	355,209
TOTAL NON-RESIDENTS	279,330	308,562	339,329	368,239	427,447
GRAND TOTAL	2,507,203	2,868,142	3,184,888	3,457,901	3,794,701

TABLE VI

Each element of Deposit as a percentage of Grand Total 1988 – 1992

Year	1988	1989	1990	1991	1992
1. RESIDENTS					
a Private Businesses	13.49%	13.65%	13.17%	12.55%	11.13%
b Households	54.07%	55.37%	56.03%	57.11%	56.80%
c Other	21.30%	20.22%	20.15%	19.68%	20.81%
TOTAL RESIDENTS	88.86%	89.24%	89.35%	89.35%	88.74%
2. NON-RESIDENTS					
a Other ECCB Territories	1.21%	1.26%	1.47%	1.72%	1.90%
b Other Countries	9.93%	9.50%	9.18%	8.93%	9.36%
TOTAL NON-RESIDENTS	11.14%	10.76%	10.65%	10.65%	11.26%
GRAND TOTAL	100.00%	100.00%	100.00%	100.00%	100.00%

SOURCE: ECCB (Statistical Unit)