

FINANCIAL STRUCTURE IN THE CARIBBEAN: RETROSPECT AND PROSPECT

by

Clive Y. Thomas  
Director, IDS, University of Guyana

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## Part I: Retrospect

### A. Introduction:

I have interpreted the mandate set me by the Coordinator of the Regional Monetary Studies Programme as requiring a stocktaking of past developments in the theory and behaviour of the financial structure of Commonwealth Caribbean countries, with a view to identifying the main issues which should be of concern to policy makers in the future. In other words my reflection on previous events should serve as a guide to framing the future research agenda. One major difficulty I have had in executing this mandate is that the short notice I received did not offer enough time to undertake statistical measures of the major components of the region's financial structure. Indeed this absence of routinely computed and pre-packaged data suitable for individual country time series analysis and cross-country comparisons already hints at one serious lacuna in the past research agenda.

The main signposts in the literature of financial structure are well known. At both the theoretical level and comparative analysis on a global scale, the pioneering work of Goldsmith in the late 1960s stands out. So too are the contributions of such other authors

as J. G. Gurley and E. S. Shaw (1956;1957;1960) and H. Patrick (1966). At the empirical level, persons connected with the IMF have produced a series of works published in its two house journals: IMF Staff Papers, and Finance and Development. At the regional level, combining both ~~theoretical~~ and empirical work, the major signposts are provided by such authors as Compton Bourne, Simon Jones - Hendrickson, Wendell McClean, Maurice Odle, Clive Thomas and DeLisle Worrell, to name a few.

What can be deduced from all this work? I shall try to respond to this in three stages. First, I shall look at the definitional issue, which is determining what are, (or ought to be) the main elements/functions of the financial structure. Second, I shall respond to the judgemental consideration: how important is a country's financial structure to its development. Finally, I shall respond to the analytical issue by identifying the main factors which shape the long run development of the region's financial structure. Having completed this I shall turn to the forward - looking dimension of my mandate in Part II.

#### B. Elements, Functions and Relevance to Policy

While none of the authors cited above may have defined it in the way I propose, I believe it would be safe to say that the financial structure of the region comprises six major elements, namely; financial institu-

tions (both formal and informal); financial instruments; interest rate structure (in nominal, real, and expected values); laws and regulations governing dealings in financial claims; community habits, (e.g. willingness to save, attitude towards "external" financing of economic activity by various economic units, attitudes to interest rates), the economic environment particularly as manifested in the rate and pattern of economic growth, the degree of concentration of wealth, the extent of the separation of savers from investors, and the extent to which social and economic life is commercialized. There are six essential functions of the financial structure.

These are:

- to administer the payments mechanism, the development of which is vital to the spread through space and time of commercial activity;
- to create money in quantities adequate to ensure the efficient development of the payments mechanism and to promote real economic activity;
- to mobilize resources available from surplus spending units and to encourage their saving;
- to allocate resources in a manner which improves their social returns and facilitates the process of structural transformation and development.

The third and fourth items are a reflection of the degree of development of money and capital markets, or, alternatively, the extent to which the process of intermediating through financial and/or accounting devices between those who save and those who invest, is developed.

Put in this general way all these functions are inevitably affected by government policies since these invariably establish or lead to limits on credit, introduce selective allocations of scarce resources, and so on. Arising out of this two further functions become important:-

- facilitating adjustment of the national economy whenever and for whatever causes macro-economic imbalances arise;
- ensuring the spread of the formal financial sector relative to the informal, since in theory at least the former is more susceptible to public management in the public interest.

The sixth function listed above is of similar structural significance as that given in the 1950s and the 1960s to the "destablizing potential" of non-banking financial intermediaries, in a world which until then had concentrated almost exclusively on the Central Bank and the commercial banks as the main areas of operation of monetary policy.

Not surprisingly the wide ranging roles attributed to financial structure did not produce unanimity in views expressed about its role in economic development. Some persons came close to asserting that an efficient financial structure was necessary and sufficient in itself to ensure rapid economic development. At the other extreme, others felt that economic development is so highly dependent on real elements (structure of

production, social attitudes, the political environment, and so on) that the financial structure was largely irrelevant; the development of this sector being in effect a by-product of growth and not its cause. At this stage it would be prudent to assert no more than that experience suggests:

- (i) an efficient financial structure is conducive to growth, and
- (ii) an inefficient one, or one badly managed, could disrupt the process of growth and income creation.

This position stresses the capacity of the financial system to disrupt the process of growth and income creation if badly managed, while down playing claims that of itself it is the major contributory factor in the development process.

Analytically we may claim that the literature, as well as past behaviour, suggest that three general considerations have dominated the evolution of the region's financial structure. These are its underdevelopment, small size, and the historical - cultural traditions of British colonialism in the Caribbean. For the remainder of Part I we shall examine each of these in turn.

### C. Financial Structure and Underdevelopment

Underdevelopment (and its related systemic - structural - cyclical - and other periodic behaviour characteristics) has inevitably influenced the development of the region's financial structure. Work in this

area has followed two lines of analysis, namely the process of monetization and the Goldsmith-type work on financial structures. Monetization refers to the spread throughout the economy of the use of monetary instruments to facilitate exchange, measure, and store value. The inverse of this is the decline in the share of the non-monetized sectors of the economy (barter exchanges, subsistence production on the farm and among artisans, and household services). The monetization ratio is therefore the proportion of the output of goods and services and the payment of factor incomes that takes the form of money. While the size of this ratio is dependent on the level of development, as Chandavarka (1977) points out this phenomenon is different from commercialization, which measures the extent to which gain or profit maximization motivates economic activity and so markets for purchase and sale of goods and services develop. The larger the proportion of output traded in markets the greater the degree of commercialization. In this sense we can therefore say that commercialization implies monetization, but is not reducible to it. Parts of the economy may be monetized but not commercialized. Similarly (as we shall appreciate more fully later) monetization is not the same as financial intermediation, since the latter refers to the institutions/instruments through which primary savers and lenders and ultimate borrowers are brought together. The latter concept seeks to express the depth and variety of the financial system, whereas monetization seeks to



express the geographic and economic spread of money in a given national economy. Again financial intermediation presupposes monetization but is not reducible to it.

At the same time we argue that the extent of monetization is influenced by the degree of economic development, successful monetary policy to promote that development depends on:

- a) our ability to estimate the money demand function; and
- b) the stability of the function (Laumas and Porter-Hudak, 1986).

As Laumas (1978) has pointed out rapid monetization does not necessarily affect the stability of the money demand function be estimated. Sims (1972) had argued after a number of tests that "one clearly should not estimate the demand for money relation ... by treating GNP as exogenous with money on the left-hand side, no evidence appears to contradict the common assumption that money can be treated as exogenous in a regression of GNP on current and past money" (Sims, 1972 p. 550).

Laumas and Porter-Hudak challenged this view in the context of underdevelopment, pointing out that Sims' work was based on US data. They also added the rate of interest as an additional determinant of the demand for money function.

In the region policy seems broadly designed to vary money supply with the level of output, the latter being determined by real forces. No real answer to the problem of exogeneity of the money supply in the context of rapid

monetization has been forthcoming. Yet this consideration, together with external shocks, natural disasters, and political and social unrest in the region, may well have yielded a situation in which there has been an independence between money and the level of output. This would be similar to the experience of other Third World countries. The consequence of all this may well have been that monetary policy has been designed for a scenario which has not existed. The operationalizing of these exogeneity tests therefore remain an **urgent** task. In the **region** however, the difficulties of deriving satisfactory real output series, the limitations of the national accounts data, (particularly their large feed-back element), the problems of devising reliable price indices, as well as those of ~~determining~~ determining appropriate interest rate and money supply measures all combine to make the job at hand an exceptionally difficult one.

The Goldsmith - type work on financial structure sees the long term development of the superstructure of financial instruments as a correlate of the development of the infrastructure of real wealth. Countries, however, differ in the character and behaviour of their financial infrastructures. These differences reflect among other things, differences in the levels of economic and technical competences, the rates of growth and composition of output, cultural and social attitudes to economic activity, and so on. Even within any given country there

are differences in the financial superstructure through time, reflecting among other things different rates and patterns of growth of income and wealth. In the analysis, financial instruments are classified as claims or equity securities (corporate-stock), with three major groups of issuers: business enterprises, Government, and the household sector. Claims in turn can be divided into three categories: those held against domestic non-financial sectors, those held against domestic financial institutions, and those held against foreigners. Financial institutions are then classified into five types: Central Banks, private deposit banks, thrift institutions, insurance companies, and a residual category of "other" non-bank financial intermediaries (e.g. development banks). Based on these broad categorisations the financial structure may be measured on both a stock and flow basis in terms of four major coefficients:

- i) The relation of total financial assets to total tangible assets:
- ii) the distribution of total financial assets and liabilities among various instruments;
- iii) the distribution of total financial assets and liabilities among financial and non-financial economic units; and
- iv) the position of financial assets and liabilities in the accounts of various economic units.

Using Goldsmith's familiar notation we derive from the above the financial interrelations ratio (FIR) given as:

$$\text{FIR} = \frac{F}{W} = \beta^{-1} \alpha \varepsilon (1+V) \dots \dots \dots (1)$$

where F is total financial assets, W is national wealth, r is the rates of the sum of the geometric series for n years to the infinite series increasing at the same rate, and  $\beta$  is the average capital ratio.  $\alpha$  is the multiplier, i.e.,  $(1 + \pi + \pi Y)^{-1}$ , where Y is the annual rate of growth of real income,  $\pi$  is the annual rate of growth of the price level.  $i$  is the ratio of all net new issues of GNP and V is the ratio of valuation change to net issues, i.e.  $\theta [(1 + y)^{1/\lambda} - 1]$  where  $\theta$  is the share of equities in the total issues of non-financial economic units,  $y$  is the average rate of change of price sensitive assets, and  $\varepsilon = [KN + \bar{\theta}(1 + \lambda) + \beta]$  where KN is the ratio of gross capital formation to national product for domestic non-financial sectors,  $\bar{\theta}$  is the adjusted ratio of issues by financial units to GNP,  $\lambda$  is the financial layering ratio, and  $\beta$  is the ratio of foreign issue to GNP.

There is also the financial intermediation ratio:  $\theta (\bar{\theta} + \beta)$  where  $\bar{\theta}$  is equal to KN (defined above) and  $\theta$  and  $\beta$  are also the same as given above. In analytical terms this is a more significant ratio than the level of FIR, since its main components, the ratios of the issues of non-financial economic units and of financial units to national product, are crucial for long term analysis of

the behaviour of the financial superstructure in relation to real economic activity. Over the long run this ratio tends to rise, but when the value reaches between 1 and  $1\frac{1}{2}$  it tends to level off. The critical factor in determining the size of this ratio seems to be the extent and effectiveness of the separation of the functions of savers and investors in the economy. This reflects the extent to which the dominant economic units in any financial system resort to "external financing" whether by means of borrowing or issuing financial securities to finance imbalances between planned expenditures and planned savings.

From the above a number of familiar generalisations arise; e.g. the changing shares of the assets of commercial banks and non-bank financial intermediaries in the financial structure; the increasing similarity of banks and non-bank intermediaries in the deposit creation process, and the use of their liabilities as money; the increasing differentiation of financial institutions and instruments; the decline of the informal financial sector; increased density of financial institutions, and so on.

Apart from intra - government studies the major empirical work along these lines are those of Odle (1972) and Bourne (1982). The former is about a decade and a half old, while Bourne looks at the experience of Trinidad - Tobago in the context of "a sudden, exogenously determined increase of income and wealth" with the

state being the major beneficiary of the windfall and price inflation being a notable result of these changes. Both of these studies produced results which supported the Goldsmith-type propositions, and where they did not they could readily be explained by country specific experiences. Thus, despite the particular context of Bourne's work, he found evidence of increased financial deepening and financial layering, reduced income velocity of money, and a decline in the weight of the money stock in total financial assets. The institutional changes before and after 1974 also conformed to expectations. Similarly, the changing mix of financial instruments and his sectoral analyses of financial surpluses and deficits, seemed to satisfy analysis along the lines of Goldsmith. In all this Bourne was careful to point out only some of the connections between real sector growth and financial changes were identified, and that "the treatment is neither exhaustive nor definitive. In terms of explanation of financial change as well as in terms of analysing the consequences of those changes, there is much to do. These notes merely define a starting point" (Bourne, 1982, p. 10)

#### D. Size and Financial Structure

Economic analysis of small size and economic performance, when combined with the results of the large number of financial studies conducted in the region suggest a significant number of behavioural postulates, all of which can and should perhaps be directly tested.

Among these, the most important are:

- i) Smallness leads to diseconomies of scale which in turn limits or makes high cost the development of the domestic payments system, the development of capital and credit markets, and produces restraints on competition. The last item is reflected in collusion, implicit or explicit, in the prices of financial services. The first two help to explain the relatively reduced role of indigenous institutions in the financial structures of the region's economies, taken as a whole.
- ii) Smallness is partly compensated for by "openness", but this in turn is not an unmixed blessing. Excessive openness facilitates the penetration of transnational capital and its financial institutions in the region's financial structure. It also hampers the development of indigenous financial markets and provides a strong bias in favour of financial activities like off-shore banking. All this is apart from the influences of a large ratio of foreign trade to domestic trade in the national economy, and a high ratio of foreign capital to domestic capital in the process of accumulation. In general, smallness is a key variable in generating dependent financial structures producing as it were a parallel to the real structural dependences of the region's economy.
- iii) The high ratio of foreign trade in the national economy makes the overall price level highly dependent on the prices of foreign goods. When combined with many of the existing marketing arrangements for exported products, the regional economies become largely price-takers and not price-makers. This operates as an "exogenous" element in the growth and development of the region's financial structure.
- iv) Small size with its concomitant high foreign trade ratio, and the high product and market concentration ratios in export activities which this produce, exposes the region to greater risks in the transmission of external shocks. This generally raises the social costs of adjustment in an inter-dependent global economic system and specifically raises the social costs of developing an effective or efficient financial structure. Thus there are diseconomies in financial management as Helleiner (1982, p. 179) observes, deriving from the lumpiness of informational systems, the high cost of management, and the high unit costs of portfolio diversification.

- v) Smallness as elaborated in (1-1V) above has critical implications for the role of wages and domestic profits in internal price formation, as well as for the effects of currency movements in the external adjustment process. Both of these speak not only to the high cost of adjustment, but the burdens placed on a financial structure weakened by the behavioural constraints of these two sets of variables.
- vi) It is sometimes argued that smallness is not all negative as far as the financial system goes. For one, when a country is small "a little goes a long way" meaning that what is small relative to the resources of potential or actual holders of concessionary finance could mean a lot to a small country. In other words any given absolute value of concessionary finance made available would have a higher per capita value for a small country than a large one. It is suggested that this effect already operates in the disbursement policies of multilateral institutional sources of concessionary finance (Helleiner, 1982, p. 167-171).

This point is sometimes extended to claim that any movement towards reform of the international economic system along the lines of the call for a New International Economic Order, would make small countries disproportionate beneficiaries.

While some of all of these points (and others) are touched on, or even debated regionally very little systematic analysis exists of the links, (implicit and explicit) between size and the development of the financial structure. This is not to say that this factor has not entered the analysis of the regional financial system. It does, since going as far back as the debates on the currency board systems and the monetary and financial dependence framework of Thomas this issue was explicitly recognized. The point being made here is to restate the need for on-going analysis of the association between small size and financial structure.



E. Social Structure and Financial Structure

Of all the factors which impinge on the development of the financial structure, elements of the social structure have received the least attention. This is regrettable as increasingly it is obvious that the cultural influences coming out of our history as British colonies, and more recently the impact of United States traditions and policies have made their mark on the region's financial structure. Consider the following examples:

- i) the effects of specific regulatory and institutional practices developed in the USA on the growth of the region's off-shore banking industry;
- ii) the impact of British traditions which treat finance as the exclusive zone of operation of gentlemen whose "word is/bond" and the resulting/their "absence" of explicit laws and regulations in the region with which to enforce arms-length dealing;
- iii) the structure of the region's domestic payments mechanism and the foreign exchange control legislation which regulates the international payments system are both direct legacies of British colonialism. As Thomas (1972) pointed out it is part of the Anglo-Saxon tradition that the operation of the domestic payments and clearing system is linked in the same set of institutions to the provision of short-term credit functions. The result is that it "operates on what has been generally recognized as the most inefficient sequence, debtor-creditor-blank flow." (Thomas, 1972, p.59). Thus the continental giro system operates on the debtor-bank-creditor flow;
- iv) similar observations about the cultural factor can be made about the region's financial markets for mortgages, the method of creation of joint-stock companies, the administration of consumer credit (hire-purchase) and small loans by commercial banks and financial houses, and the branch banking system and its biases to short-term lending.

Part II: ProspectA. Financial Supermarkets?

What are the implications of my observations so far, for future policy and directions of change in the financial structure of the region? To those who see in the developed market economies of today the image of the region's future, the answer is simple: reduced emphasis on governmental intervention in financial markets in order to facilitate the emergence of "financial supermarkets". In recent times, particularly in the USA, there has been a striking transformation in the financial structure of the developed market economies. This is reflected in the rapid disintegration of the traditional specialisms of various financial institutions and their replacement by institutions all of which offer a wide variety of financial services. Thus it is possible now for the individual customer to hold chequing and savings accounts, have a credit card, secure loans for the purchase of houses, motor cars, or other purposes, and deal in the stock exchange for government or private securities through any one of a number of financial institutions: commercial bank, savings and loan association, credit union, mutual savings bank, money market mutual fund, and so on. By offering a "one-stop" financial service these institutions have aptly been termed financial supermarkets, that is, they offer their "customers the traditional virtues of the supermarket grocery - namely, diversity of product and the convenience of one-stop shopping" (Collins and Horiguchi, 1984, p. 20)

This transformation is the product of important micro-changes. Thus while the commercial banks have more or less held on to their traditional share of the liquid end of the financial market, the shares of traditional demand and savings deposits have declined, and the share of accounts bearing higher rates of interest such as CDs, NOW and Super-NOW accounts has increased. Recent efforts to consolidate these accounts into one "super" account with cheque privileges as well as higher rates of interest have also had important consequences for the deposit structure of the banks. On the assets side the banks have moved into mortgage financing, while increasing the range of non-banking financial services which they offer (discount brokerage, credit-related life insurance, and so on). At the same time as the above has occurred thrift institutions are also now offering a range of services as wide as the commercial banks. Side by side with this development has been the growth of the money market mutual funds which have turned out to be major competitors of the banks in the liquid end of the market.

Along with the growth in the variety of services offered by each institution has come the emergence of "financial conglomerates", which as the name suggests combine two or more types of financial institutions into one grouping. This concentration and consolidation of capital in the financial industry has not eliminated in its entirety the growth of all specialist institutions. Some observers see a place for what are called "financial

boutiques" offering highly specialized and quality service, as well as "community" based institutions which can provide personalized service among special consuming groups or in particular geographic areas.

Two major considerations underlie this transformation of financial structure. One has been deregulation and the other has been technological. Much of the existing regulatory framework for financial institutions in the USA grew out of the fears of another depression on the scale of the 1930s. Thus the Banking Act of 1933 sought to eliminate the unsound banking practices which were held "responsible" for the collapse of the financial system. Similarly interest payments on demand deposits were disallowed and the Federal Reserve given the authority to fix the ceilings on interest rates paid on time and savings deposits. This price regulation it was hoped would reduce the scope for cut-throat price competition. The Glass-Steagall Act separated banking services from activities in the securities market in order to protect depositors funds from being diverted into speculative ends. The Homeowners Loan Act placed restrictions on the loan portfolios of thrift institutions in order to narrow the gap between their long term lending and short-term borrowing. Interestate banking was prohibited by the Mc Fadden Act in order to protect depositors, while the Federal Reserve was given an array of supervisory and inspectorate functions.

With changed economic circumstances and the rise of Reaganomics a Depository Institution Deregulation and

Monetary Control Act 1980 was passed. This act phased out interest rate ceilings, relaxed restrictions on the portfolios of federally chartered thrift institutions, and set in place the mechanism for uniform treatment of the reserve requirements of all depository institutions. This was supplemented by the Garn - St Germain Depository Institutions Act of 1982 which paved the way for the introduction of the money market deposit account in banks in order to allow them to compete with the rapidly growing money market mutual funds.

The rationale behind all this is that deregulation would stimulate competition. In turn competition would stimulate efficiency, and out of increased efficiency the country as a whole would benefit. If along the way bank failures became more frequent, and the oligopolization of the banking system became more evident, these were to be taken as the inevitable consequences of progress. Specifically it is argued that competition permits the exploitation of scale economies and facilitates institutional rearrangements such as shared financial services, e.g., credit rating, data acquisition, market analysis, etc. Supermarket financial services also encourage the diversification of portfolios which reduces risk because of the increased spread of each institution's activities.

To be sure none of these developments would have been possible without the rapid emergence of the new technologies associated with the information revolution. These have made possible the routine use of electronic fund transfers, the

widespread use of credit cards among the population, the development of extensive information retrieval systems, the introduction of automated tellers, and so on. In the process it appears as if it has reduced the cost of financial operations.

This is not the place to question the rosy implications of this line of analysis. Suffice it to say that the soundness of many financial institutions has been called into question in recent years. Even the giant firms face precarious times because of their imprudent expansion of loans to some newly industrializing countries (Brazil, Argentina, Mexico, Peru, etc.) during the recent past. What is crucial to my immediate task, however, is to observe that present conditions do not permit the easy replication of financial supermarketing in the region. There is scope for the rational adaptation of new technologies in banking, and the obvious need to reduce the many monopolistic practices which prevail in the financial structure. But this observation is a very far way off from seeing the immediate possibilities of an early advent of one-stop convenience financial service units in widespread use in the region. What may be possible at this stage is limited advances in the direction of universal banking, or multi-purpose banking. Several advantages are claimed for this approach in small developing countries (Fry , 1982 and .hatkhale and Riechel, 1980). Among them are the promotion of entrepreneurship, improved provision of long term finance, reduced risk, and lower unit costs of operation.

What is of immediate concern here is a study of the extent to which existing regulatory and legislative provisions in the region actively discriminate against multi-purpose banking.

B. Monetary Substitution: "Good" Money Drives out "Bad" Money

Of immediate importance to the region's financial structure is the growth of monetary substitution. This has been fuelled by legal and institutional considerations as well as by economic circumstances. Under the former we can classify: the widespread use of foreign exchange controls in many territories which affects the domestication of foreign earnings; the limited variety of domestic financial instruments appropriate to the needs of domestic investors; easy access by residents to such highly flexible non-resident assets as credit cards of overseas banks; and, the low real rates of interest institutionally permitted by the region's central monetary authorities. Under the latter we can classify: the high rates of domestic inflation; real shortages of foreign exchange; and, fear of devaluation and generalized economic uncertainty. All of the latter have direct expenditure effects. Both these sets of factors affect the underlying production-consumption relations in the economy and can therefore fuel the emergence and perpetuation of severe macro-economic imbalances.

In the past these circumstances have encouraged spending units to make both stock and flow decisions which give preference to overseas financial instruments. Given the

openness of the region's economies, and the important role of such activities as tourism in the national economy, pressures in the direction of monetary substitution are especially formidable.

Monetary substitution is a negative occurrence. It inhibits the development of the local financial structure, and in so doing it entails the following:

- the loss of resources;
- loss of control of the money supply as an instrument of policy for use by the central monetary authorities;
- loss of control by the central authorities of foreign exchange allocation, despite the fact that the principal motivation of some of the legal-institutional mechanisms is precisely to bring about this control;
- produces deflationary pressure on the domestic economy, because foreign asset holdings substitute for domestic expenditure, and,
- facilitates the emergence of a "black market" and an underground rate of exchange for the domestic currency.

In light of the above, monetary substitution clearly emerges as a priority area for research as well as for the development of effective policy instruments.

### C. Black markets and the Underground Economy

An extension of the phenomenon of monetary substitution is the emergence of highly developed blackmarkets for foreign financial instruments and an underground economy responsible for a very significant share of economic activity. Guyana is the region's best example of the emergence of this extension of the phenomenon of monetary



substitution. In Guyana, black markets accounts for the bulk of the country's capital transfers. The underground economy provides the bulk of imported food, consumer items, raw materials and other industrial inputs, spare parts, and even invisibles (travel). The black market rate of the currency has also reached peaks of 4-5 times the official rate.

As the above developed, high levels of external indebtedness, huge payment arrears, declining export output, excessive and dysfunctional controls on economic activity have combined to reverse most, if not all of the gains which followed on the dismantling of the colonial currency board and expatriate branch banking system which took place soon after independence. Because of extensive controls the economy in general and the financial structure in particular have become overly layered with bureaucratic corruption, and administered price distortions. At the same time the widespread blackmarkets, has meant, at least in technical terms, the equally widespread "criminalization" of the population at large since most of them are forced to deal in these markets. The context is clearly not conducive to financial growth, given the role that confidence plays in a financial system. Indeed it may be argued that the financial structure has not grown qualitatively since independence. Following on this it would seem logical to treat this as a priority area for research and the development of appropriate policy instruments.

D. The rise of barter

Another area of future significance to the region's financial structure is the rise of barter transactions in international trade. As some of the region's economies have run into sustained macro-economic imbalances, resort has been made to a variety of forms of counter-trade as a means of sustaining output levels in the export sectors, securing foreign exchange and thereby facilitating imports. While counter-trade arrangements come in a variety of types, generally they serve to reduce the growth and diversity of financial transactions. This is an effect quite apart from their high costs (caused by the time consuming nature of negotiations in such deals as against open market purchases, the weak bargaining position of the country in difficulty relative to the foreign supplier, the risk premium which must be paid because of the country's economic circumstances, and so on), and the restriction they place on the growth of multilateralism.

If as macro-economic imbalances emerge policies are put in place which do not seek to remedy them but to mask their symptoms, these will eventually be counterproductive to the growth of the economy in general and the financial structure in particular. To the extent that these policies can be identified they should be the subject of systematic study and evaluation. The effects of counter-trade, payments arrears accumulation and extreme reliance on foreign borrowing on the financial structure of the region would seem to be another priority area of research.

## E. Government And Financial Structure

One of the most striking features of the period after independence in the Commonwealth Caribbean countries is the leading role played by the state in economic activity and its articulation of a definite "economic function". This role is all encompassing and is not adequately reflected in such conventional indices as the share of the state in total output, consumption, investment, including R & D, and employment. This "economic function" of the state may be for the purposes of the present analysis, broadly classified in three areas, namely:

- the role of government economic activity in the operations of the major macro-economic variables (the short-period Keynesian elements);
- short-period government stabilizing/adjustment activities operating through such policy instruments as interest rates, exchange /rates, /deficit/surplus financing of state activities, reserve management, taxation and income transfer policies, income-wage-price policies, money supply and credit management policies, and so on;
- the role of the state in shaping economic priorities and the orientation of the economic system. This encompasses its development strategy in the broadest sense and what may be termed "planning", as well as the weight it gives to various actors (classes, groups, and other social strata) in the economic system. It would therefore embrace socio-political considerations such as the long run distribution of wealth, income, decision-making and other forms of economic power, as well as the degree of popular participation in the social system, and the level of integration of social and ethnic groups.

These wide ranging functions inevitably require that

the state plays a leading role in the development of the region's financial structure. This leading role is independent of the ideological orientation of the government. Thus analysis would show that governments with such widely differing outlooks as those in Guyana, Trinidad - Tobago, and Jamaica under the Seaga regime all have managed to dominate the development of their country's financial structure.

Thus in Guyana, by deliberate choice, state financial institutions are the major ones and state employment is the principal factor shaping income formation in the household sector which accounts for the bulk of domestic savings. In Trinidad - Tobago, the unexpected windfall gains from oil price increases were principally appropriated by the state. Following on this state policies in such areas as wages, investment, income transfers and foreign reserve management, became the principal elements in shaping the growth of that country's financial institutions and instruments. Similarly, the Seaga regime with its explicit deregulation, market development, private sector orientation has still managed through its policies of macro-economic regulation, and the search for foreign capital to stimulate domestic growth, to shape the evolution of financial instruments and institutions in Jamaica.

Because this influence of the state on the financial structure operates to a large extent independent of ideology (although ideology can influence it) it would seem

to me to be an urgent area of future work. Like monetization and other exogeneous elements, its role in the region's financial structure should be carefully assessed to ensure that policies are framed in the context of the realization of both the limits and potential of their successful implementation.

F. The Ethical Factor in the Financial Structure

All financial institutions are ultimately founded on trust and confidence in their prudent management. As part of the British tradition this trust is assumed to reside in a particular class or group which constitutes the financial elite. Self-regulation by this elite is taken to be the best guarantee that this trust is not abused and that the ethic of a "gentleman's word is his bond" prevails. This is clearly not the place for me to delve into the accuracy of this view. It is my concern, however, that it is not naively assumed that as ex-British colonies this situation can be replicated in the region. Already evidence abounds that important sections of the region's indigenous financial elite have been systematically diverting public deposits to individuals and enterprises with which they have shared financial or political interests.

A study of non arms-length dealing, secrecy violations, insider trading, funds laundering, and tax-avoidance/ evasion activities would be very revealing. By its nature such a study by an individual researcher would find extreme difficulty in generating the required data. It is therefore

urged that national commissions (or a regional one sponsored by the monetary authorities) be established with a mandate to examine this problem and produce guidelines for regulatory and oversight provisions which would root out this evil. I have only to refer to the numerous off-shore banking scandals, the finance houses scandal in Trinidad - Tobago, or the charges of favouritism and discrimination against state owned institutions in the region (and in particular Guyana) for us to appreciate the urgency of this issue. The level of public disclosures although high and increasing at a rapid rate, may still only represent the tip of the iceberg!

G. Transmission Mechanisms, Interest Rates, Exchange Rates, Money Demand, Size and the Informal Market

In various places during the analysis of Part I, I have already hinted at a number of areas where research work and policy are required. I will conclude this paper by briefly recapitulating on these. First, the regular provision of data along the lines of the Goldsmith-type analysis is clearly needed to facilitate time series analysis of individual territories as well as cross-country comparisons. Second, the transmission mechanisms through which external shocks affect the functioning of the financial structure need to be identified and workable models for each country developed, in order to enhance the efficacy of public policy. Third, the effect of interest rates on saving and resource allocation in the region needs

to be determined. As Worrell (1986) has pointed out "available estimates are dominated by relationships in the earlier years when rate changes were small" ... At that time it may have been presumed that there was no significant link between interest rates and financial structure. In more recent years interest rate changes have been more in evidence, signifying at the very least a formal abandonment of the earlier position. As yet, however, there is no clear analytical or operational separation between interest rate changes and exchange rate changes, (actual and anticipated), /and changes in the wage-price-productivity relation, and general expectations about the economic outlook. As is well known the last of these considerations significantly affects the flow of trade credit, the level of profit repatriation, and the degree of development of blackmarkets for foreign currency. With the existing rudimentary capital markets in the region it is unlikely that the rates of interest which prevail "satisfy" borrowers and lenders to the extent that we can say with any degree of certainty that the rate of return on financial saving is equal to the cost of capital.

Fourth, the many sided influences of the exchange rate on financial structure are obvious. For our immediate purposes it should be recognized that it affects the behaviour of the demand function for money and the exogenous processes of monetization. It is therefore important that research work in this area as well as appropriate policy instruments be developed. Fifth, the preponderant

role of the non-corporate sector, non-corporate farm and non-farm enterprises, and the pure household sector as surplus spending units (savers) would seem to require future work aimed at determining the optimal mix of institutions/instruments/policies which would motivate further savings and facilitate the allocation of these resources in activities yielding higher social returns and reinforcing the processes of structural transformation of the region's economies.

Sixth, the relation between the formal and informal money and capital markets needs to be systematically studied in order to ensure that any special attributes of the informal sector are appropriated and modernization is not pursued blindly. Finally, it goes without saying that in the areas recommended further study in Part 2 of this paper, the pervasive influence of size should be isolated and made the object of special consideration.



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