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Rethinking the Role of the Financial Sector in Economic Growth in CARICOM

Karl Bennett

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by

Karl M. Bennett
Professor Emeritus
Department of Economics
University of Waterloo
Waterloo, Ontario, Canada.

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Abstract

The paper reviews the potential impact of the financial sector on the economic performance of CARICOM economies and indicates some of the institutional reforms which might enhance the sector's performance. It is argued that although institutional reforms are necessary, there are other country specific factors which results in limited productive investment opportunities. Hence, more effective mobilization of funds might not be reflected in more productive investment. Consequently, it is proposed that the concept of the sector's intermediary function in the mobilization and allocation of savings ought to be broadened. Reforms must be geared to having the sector playing a central role in contributing to a more dynamic entrepreneurial environment in the region.

Introduction

The financial sector plays a central role in the mobilization and allocation of savings for investment and consequently, can potentially have a major impact on the economic performance of countries There has been a substantial body of theoretical and empirical work on the role of the financial sector in contributing to economic growth. The results of the empirical studies point to a positive relationship between financial development and economic growth.

Most countries in the CARICOM region have experienced very low rates of economic growth in recent years. This raises the question as to what extent the economic performance of countries in the region might be related to the state of development of the financial sector. In this paper, a review is conducted of the performance of the sector in the mobilization and allocation of savings in the region. This was done to ascertain what reforms might be required to enable the sector to make a greater positive contribution to the growth process.

The paper will be structured along the following lines. In the first section, there will be a review of some of the empirical studies on the relationship between financial development and economic growth. This will be followed by an assessment of the operational features of the sector in countries in the CARICOM region. This will be followed by an evaluation of what has been identified as factors undermining the performance of the sector and the proposed reforms for correcting these deficiencies.. In the final section of the paper there is a discussion on the need for change in the perception of what might be considered an appropriate role for the sector in the economy. It is pointed out that there is a need to direct attention to what role the sector might play not only in mobilizing funds for investment, but in the identification and support of viable investment projects.

Financial Development and Economic Growth

In assessing the relationship between financial development and economic growth, attention might first be directed to the extent to which financial development affects growth through its contribution to the rate of accumulation of physical and human capital. Theoretical arguments have been made that in a situation where there are imperfections in financial markets, such as interest rate ceilings and constraints on the allocation of funds, these could work to inhibit the rate of accumulation of physical and human capital(Greenwood and Javanovic,1990; Bencivenga and Smith, 1991; Banerjee and Newman,1991; and King and Levine, 1993a). It has also been argued that the role of financial development in factor accumulation will be particularly strong for countries with highly unequal income distribution. The more unequal the distribution of income the larger would be the share of population unable to acquire financing for investments in physical or human capital.

The empirical literature on the link between financial development and economic growth in recent periods either follow a time series approach or apply cross- section analysis. Those based on cross - country analysis shed light on the average influence of variables across countries. Those utilizing time series analysis provide a dynamic long run- link between variables of interest and are able to account for individual country circumstances, taking into consideration each country's institutional and policy context. A third method, panel analysis, potentially combines the positive characteristics of the two approaches(Hossein and Kirkpatrick, 2002).

Most empirical studies on the link between financial development and growth rely on the cross- section approach. This is, in part, due to the unavailability of good quality financial development indicators that provide a sufficient length of data for the purpose of time series analysis. In addition, the results based on time series analysis are applicable only to the case under study and cannot be generalized to others. Cross- section analyses, on the other hand, provide results that could be generalized across a large number of countries. The findings of King and Levine(1993b) are representative of the cross country studies establishing a strong correlation between financial development and economic growth. The data set they used for their analysis consisted of a pure cross-section and a pooled cross- section based on data covering the period from 1960 - 1989.

There are problems associated with cross country analysis. Benhabib and Spiegel(2000)point to three shortcomings. There is the possibility that omitted country - specific fixed effects leaves explanatory power attributed to other variables that act as proxies for unobservables. The introduction of fixed effects into the sample eliminates all time - invariant country- specific information. Another issue is the possibility of omitted variable bias. In their extension of the King and Levine investigation of the link between financial development and growth they use panel data to examine the robustness of indicators of financial development to the inclusion of country specific effects. They used the following as measures of financial development from the King and Levine paper; the ratio of liquid liabilities of the financial sector, M2 or M3, to GDP as a proxy for the overall size of the formal financial sector; the ratio of deposit money bank deposit assets to deposit - money bank assets plus central - bank domestic assets; the ratio of claims on the non - financial private sector to GDP. In addition, they incorporated two interactive terms related to financial development, income distribution and initial income.

The results of their study indicated that financial development had a positive impact on rates of investment and total factor productivity growth. However, different indicators of financial development were shown to affect different components of growth. In the case of total factor productivity growth, the liquidity indicator and the ratio of financial assets of the private sector to GDP were found to positively affect growth, after accounting for rates of factor accumulation. When country fixed effects were taken into consideration, only the ratio of financial assets of the private sector to GDP was significant. All the financial development indicators had a positive impact on physical capital accumulation rates with country specific fixed effects excluded. In summary, it was found that the overall debts of the financial sector and the private sector's share of credit relative to GDP both directly affect growth by enhancing total factor productivity. On the other hand, the size of the banking sector was a significant determinant of the rate of physical and human capital accumulation. Initial levels of income and income inequality influenced only the rates of physical capital accumulation.

Operating Features of the Financial Sector and Proposals for Reform

In this section we will employ some of the standard indicators of financial development outlined in the previous section to arrive at an initial assessment of the degree of development of the sector, in a selection of CARICOM countries. The indicators used are the ratio of bank credit to GDP, the ratio credit to the private sector to GDP, and the ratio of quasi - liquid liabilities to GDP. These are set out in Table 1. There is a considerable degree of variance between the various countries. For example, Jamaica and Trinidad and Tobago score considerably below the other countries in terms of the ratio of credit to the private sector as a percentage of GDP, as well as on the liquidity indicator. The CARICOM countries, on the basis of these indicators, on average, reveal a higher level of financial development than that for Latin America. However, their level of financial development is much lower than that of the developed industrial countries in the Euro area, as well the new industrial economies in Asia.

The information in the table highlights some of the potential shortcomings of trying to associate financial development with economic growth. The Eastern Caribbean Currency Area scored highest on all the financial development indicators of the CARICOM countries, with scores close to those of the Asian NICs. Yet while the economic performance of those countries in the past decade has been superior to that of Jamaica, it has not been significantly different than that of most of the other countries in the region or close to that of the Asian NICs in the pre crisis period. There is the need , as pointed out in the previous section, to consider some of the country specific factors which might have an impact on the savings/investment relationship

A number of reviews highlighting potential deficiencies in the structure of the sector in the region which might have affected its performance has been conducted in recent years(World Bank, 1998; Worrell,2001). The proposals for reform emanating from these studies highlighted the need for reform in the following areas. The first broad general area was that of the macroeconomic context in which the sector operates. Attention was directed to the need to contain fiscal deficits, as sound fiscal management was seem as being essential for the maintenance of a robust financial sector. The other problem areas identified were geographical fragmentation and lack of competition in local markets; deficiencies in regulation and supervision of institutions; an inadequate supply of long term finance for businesses and all types of finance for small businesses; low mobilization and inefficient

Table 1
Indicators of Financial Development (2002)

	Domestic bank credit as a percent of GDP	Credit to the private sector as a percent of GDP	Quasi- liquid liabilities as a percent of GDP[1]
Barbados	67	58	83
Belize	52	51	46
Guyana	88	57	71
Jamaica	26	15	44
OECS	104	95	103
Trinidad & Tobago	43	42	46
Average: CARICOM	63	53	65
Average: Latin America	47	31	30
Average: Euro area	137	109	71
Average: Asian NICs[2]	104	111	81

Source: IMF **International Financial Statistics**
[1] M2
[2] Data for 1995

use of contractual savings funds and the limited development of capital markets(World Bank, 1998).

The size of the public debt was seen to have two important negative connotations. The growth in the domestic component of the debt of the debt which occurred in countries, such as Jamaica, during the nineties, was seen as potentially crowding out private investment. Furthermore, government financing requirements might result in indirect forced lending requirements being imposed on financial institutions in the form of high reserve requirements. This imposes a tax on the sector, giving rise to wider spreads between deposit and lending rates, thus discouraging growth and investment..

The lack of competition in the sector was linked to the fragmentation in markets caused by national boundaries and a variety of formal and informal barriers to entry. This has given rise to the emergence of a sector that is dominated by a few large commercial banks in each country. This has led to the occurrence of spreads between lending and deposit rates that appeared to be higher than could be explained only by direct monetary and credit controls(World Bank,1998). Ironically, the financial liberalization initiatives undertaken by a number of countries in the nineties, which might have been expected to increase competition in the sector, has resulted in a reduction in the number of banks operating in the region, as many locally owned banks were amalgamated or consolidated in the process of reform. Foreign banks which started operations in the region more recently , have experienced difficulty in attracting quality customers from established banks and have not continued to operate (Worrell et al., 2001). In the case of Jamaica rapid growth in the sector combined with inadequate supervision resulted in a financial crisis and shrinkage in the number of institutions. With the move towards a single market in the region, any remaining regulatory constraints on intra regional investments by financial institutions will be removed. Whether this occurs and results in a more competitive environment is an open question.

In so far as the matter of supervision was concerned, the view was that the legal regulatory standards were adequate for the commercial banks, but there were shortcomings with respect to the non- bank sector. Jamaica was the only country in the region to experience a major financial crisis. It has been suggested that a major cause of the crisis was that financial liberalization and the subsequent growth in financial conglomerates exceeded the capabilities of the financial supervisory framework. Furthermore, the growth in conglomerates was encouraged by differentials in reserve requirements for different types of financial institutions(Worrell et al., 2001).

A major deficiency of the sector in the region is its inability to satisfy the needs of business for long term finance and all of the financial needs of small businesses. This is in large measure reflective of the dominant role of the commercial banks in the sector. These institutions are geared to provide the working capital needs of firms, mortgage lending and consumer credit for households. Investment capital is financed mainly from retained earnings or from international finance. The failure of the sector to be a major supplier of long term finance has been attributed to macroeconomic instability, deficiencies in the legal system that make enforcement and collection of loans difficult and lax accounting standards that make reliable information costly to obtain. The lack of clear title to real property in many countries acts as a major barrier to small businesses having access to bank loans in that it limits its use as collateral. Furthermore, laws that obstruct foreclosure procedures make it more difficult for small firms to have access to credit. Modernizing the registry of property rights, strengthening the rights of creditors in the legal system and strengthening the standards for information disclosure by firms were identified as essential reforms. Improved supervision and regulation of credit unions, along with additional technical assistance would serve to strengthen these institutions which have been an important source of finance for small businesses(World Bank, 1998).

The limited range of available savings instruments in many countries was seen as having a negative impact on the savings effort and limited the ability of firms to raise investment funds. The existing equity markets in Barbados, Jamaica and Trinidad and Tobago do provide additional investment and savings options, but they are limited, given the low trading volumes. Furthermore, the attractiveness of equity as savings instruments in some countries, Jamaica being a case in point, was undermined by the existence of very high real rates of interest. It was suggested that the development of capital markets would be facilitated by macroeconomic stability allowing for the maintenance of moderate real rates of interest. In addition the volume of trading would be enhanced by the privatization of public enterprises and the elimination of barriers to foreign ownership of assets. There would also be a need to streamline debt- settlement and bankruptcy proceedings and establish improvements in accounting and reporting standards.

Evaluation of the Reform Agenda

The proposed areas for reform highlighted in the previous section are reflective of what might be deemed the orthodox approach to an evaluation of the performance of the sector. There is no question but that effective supervision and capital adequacy are essential if the sector is to play a meaningful role in development. However, in this section, there will be an assessment of the justification for the selection of some of the other factors identified as potentially contributing to undermining the performance of the sector.

The need to ensure macroeconomic stability was cited as a basic requirement to enable the sector to make an effective contribution to economic growth. To the extent that governments avoided large fiscal deficits this would prevent private investment requirements being crowded out by government borrowing requirements. In addition, the additional costs imposed on the financial sector through such measures as high reserve requirements linked to government financing requirements would be avoided.

In Table 2 a summary is provided of the fiscal position of countries operating in the region over the past decade. The government of Trinidad and Tobago operated with close to balanced budgets in all but one year in the period surveyed. The deficits incurred by Barbados were relatively small, slightly exceeding 3 percent of GDP on only two occasions. Belize, Guyana and Jamaica, all recorded large deficits in the latter half of the decade. However, all countries, with the exception of Jamaica operated with surpluses on current account. In these countries, capital expenditures which was responsible for the deficits were mainly financed from sources external to the domestic financial system. It would then appear that governments in the region are committed to operating with a substantial measure of fiscal restraint. Consequently, in looking ahead, there seems to be little chance of fiscal mismanagement being a factor in the performance of the sector. In the case of Jamaica, the large deficits in the latter part of the decade arose when the government intervened in the sector to protect depositors in the face of the insolvency of a number of institutions. This was reflected in a very large increase in the level of domestic indebtedness and the sharp increase in debt service requirements shown in Table 3.

Let us now turn to the issues of the crowding out effect and the potential tax on the sector related to the reserve requirements issue. Legal reserve requirements were high in all countries in the region remaining well above 20 percent over the course of the past 10 years. The rate in Jamaica was as high as 50 percent in 1994 although it had declined to 23 percent by 2002.
To what extent did the high reserve requirements cause institutions in the sector to channel funds to governments which would otherwise have been available for lending to the private sector? Furthermore, would the institutions in meeting these requirements be required to forego more attractive earnings on alternative lending and investment activities?

The relationship of the actual level of reserve holdings, primarily liquid assets in the form of

Table 2
Central Government: Fiscal Balance Percent GDP
Surplus (+) Deficit(-)

Fiscal year	Barbados Cur	Barbados Total	Belize Cur	Belize Total	Guyana Cur	Guyana Total	Jamaica Cur.	Jamaica Total	Trinidad Total[1]
1994/95	4.4	- 0.1	1.9	- 6.0	2.0	- 6.8	5.1	2.8	0.2
1995/96	2.8	- 0.1	2.1	- 3.2	6.5	- 3.3	6.1	1.8	- 0.5
1996/97	2.4	- 3.1	3.2	- 0.1	11.3	- 1.6	- 1.0	- 6.1	0.1
1997/98	4.5	- 1.2	2.6	- 1.3	5.6	- 6.9	- 2.4	- 7.8	- 1.2
1998/99	4.4	- 0.6	2.8	- 1.3	2.8	- 8.1	- 3.9	- 6.7	- 3.1
1999/00	3.9	- 1.4	3.0	- 4.4	4.0	- 2.5	- 1.2	- 4.1	1.6
2000/01	3.9	- 1.8	2.5	- 6.0	- 1.1	-3.5	1.0	- 1.0	- 0.1
2001/02	2.8	- 3.7	3.6	- 9.7	- 1.4	- 9.5	- 3.4	- 5.6	0.3

[1]Calendar years 1994 - 2002

Sources: Central Bank of Barbados, **Annual Statistical Digest**; Bank of Jamaica, **Statistical Digest;** Central Bank of Trinidad and Tobago, **Annual Economic Survey.** Data for Guyana and Belize derived from central bank website.

cash reserves and short term government securities, relative to the legal requirements, is a reasonab guide as to the extent to which there might have been crowding out of lending to the private sector and a tax on the sector. A summary of the liquidity position of commercial banks, the dominant financial institution in the respective countries is set out in Table 4.

In all of the countries, the holdings of liquid assets by the commercial banks exceeded by a substantial margin the holdings required by law. This was true, even in Jamaica, the country in which there was the most rapid increase in the growth of domestic debt. The substantial excess holdings of such assets by these institutions suggest that if there were limitations on access to funds by the private sector, this could not be attributed to forced lending requirements. Furthermore, in all of the countries there was a trend towards a rise in excess liquidity at the same time as there was a downward trend in required holdings, in the late nineties . Given these excess holdings, it seems reasonable to assume that the institutions were not forced to incur a tax by having to forego higher earnings on alternative investment activity. It seems more reasonable to conclude that the holdings in excess of legal requirements reflected a lack of suitable alternatives for placement of available funds.

Table 3
Jamaica: Debt Indicators
Percent GDP

	Domestic Debt	Interest[1]
1994	31.0	8.7
1995	29.3	8.4
1996	32.7	11.1
1997	39.3	9.2
1998	43.9	12.2
1999	59.8	13.5
2000	57.0	12.4
2001	82.4	13.4
2002	82.2	

[1]Fiscal years 1994/95 - 2001/02 Source: Bank of Jamaica, **Statistical Digest**

Let us now turn to some of the other issues highlighted in the reviews of the sector. Specifically, attention will be directed to the ability of the sector to mobilize savings. Furthermore, given the limited range of institutions and savings instruments available in all countries, how might this have affected interest rates offered and the incentive to save? How might the limited degree of competition in the sector have affected lending rates and borrowing and investment decisions?

In view of the fact that commercial banks are the dominant institutions in the sector we begin with an evaluation of their effectiveness in mobilizing savings. We will use as a benchmark changes in the stock of savings held by the commercial banks over the past decade relative to changes in nominal GDP. This information is provided In Table 5. At a minimum, one would expect the growth in the stock of deposits in financial institutions to be no less than that of GDP.

Between 1994 and 2002, the rate of growth in the stock of bank deposits in all countries, apart from Jamaica and Trinidad and Tobago, was significantly higher than that of nominal GDP. In the case of those two countries the growth in the stock of deposits was approximately equal to that of GDP. The relatively slow rate of growth in the stock deposits in the banking system in Jamaica and Trinidad and Tobago relative to the other countries was not influenced by the existence of a wider array of saving institutions in those countries. The growth rate in the stock of savings in non - bank financial institutions was lower that for banks in Jamaica and equal to that of the banks in Trinidad and Tobago.
and Tobago relative to the other countries was not influenced by the existence of a wider array of saving institutions in those countries. The growth rate in the stock of savings in non - bank financial institutions was lower that for banks in Jamaica and equal to that of the banks in Trinidad and Tobago.

Table 4
Commercial Banks: Liquidity Position

	1995	1996	1997	1998	1999	2000	2001	2002	Av.
Barbados liquidity ratio	1.28	1.44	1.65	1.34	1.14	1.31	1.43	1.69	1.41
Belize Liquidity ratio	1.12	1.08	1.08	1.17	1.33	1.61	1.52	1.25	1.27
Excess liquidity % deposits	3.1	2.0	1.9	4.1	7.9	14.6	12.6	11.5	7.2
Guyana liquidity ratio	2.0	1.63	1.71	1.56	1.47	1.52			
Excess liquidity % deposits	21.2	13.1	14.7	14.7	9.8	10.9			
Jamaica Liquidity ratio	1.05	1.06	1.14	1.15	1.35	1.54	1.58	1.64	1.32
Excess liquidity % deposits	2.4	2.6	6.7	7.0	12.8	17.1	16.7	16.1	10.2
OECS Liquidity ratio	1.22	1.20	1.21	1.31	1.19	1.10	1.33	1.29	1.23
Trinidad & Tobago Excess liquidity % deposits	0.0	2.3	3.8	4.8	3.7	13.3	7.3	10.6	5.7

Sources: Computed from data sources from Table 2. OECS data derived from ECCB website.

Table 5
Growth Rate of Deposits & Share of Deposits in GDP

	Growth Rate 1994 - 2002	Share of GDP 1994	Share of GDP 2002
Barbados: Total Dep.	9.0	68.3	92.3
Com. Banks	9.8	58.7	84.2
Trust Cos.	2.7	9.6	8.1
GDP	5.0		
Belize: Total Deposits	8.8	40.5	53.3
GDP	5.1		
Guyana: Total Dep.	13.1	50.0	73.0
GDP	7.9		
Jamaica: Total Dep.	12.2	57.9	57.5
Com. Banks	13.2	38.2	40.8
Non - banks[1]	10.0	19.7	16.7
GDP	12.3		
OECS: Total	9.9	81.0	123.8
GDP	4.3		
Trinidad & Tobago: Total	8.6	48.1	46.9
Com. Banks	8.5	38.1	37.0
Non- banks[2]	8.8	10.0	10.0
GDP	9.0		
Canada: Total Dep	5.0	74.5	73.5
Com. Banks	6.8	55.0	62.1
GDP	5.2		
United States: Total Dep	4.7	43.3	42.2
Com. Banks	5.7	30.2	31.8
GDP	5.0		
Brazil: Com. Banks	14.3	38.4	29.6
GDP	18.1		
Malaysia: Com. Banks	12.4	67.3	92.8
GDP	8.0		

[1] Merchant Banks and Finance Houses, Credit Unions and Building Societies.
[2] Finance Companies and Merchant Banks, Trust and Mortgage Finance Companies and Thrift Institutions.
Sources: IMF **International Financial Statistics** and sources cited fo Table 2.

Nevertheless, on the basis of this benchmark, commercial banks in the region as a whole mobilized deposits at a higher rate than those in industrial countries, such as the United States and Canada and a major developing country such as Brazil and was comparable to that of Malaysia, one of the Asian NICs.

The ability of individuals to accumulate bank deposits will clearly depend on their levels of discretionary income. Given the level of discretionary income, the extent to which interest rates may have a bearing on deposit holdings will depend on what are the major motives for saving. For any given level of national income, the aggregate level of discretionary income will be determined by the degree of equality in the distribution of income. The more unequal the distribution of income the greater would be the amount of discretionary income available for the acquisition of deposits. If a major motive for holding bank deposits is security, then the rate of interest will not exercise a significant influence of deposit holdings. On the other hand, if rates of return are important, then the amount held will be determined the levels and variety of interest options available. Under most circumstances one might expect both security and earnings to be important considerations with the decision to hold deposits arrived at by reaching an appropriate balance between security and earnings. Some central banks in the region, for example, that of Barbados and the Eastern Caribbean Central Bank, exercise control on the rate of interest commercial banks may offer on savings deposits. In Jamaica, on the other hand, the rates are ostensibly determined by conditions prevailing in the domestic market.

Nominal and real interest rates on deposits are set out in Table 6. It is often argued that where deposit rates are not market determined, for example, when there are interest rate ceilings or floors, the resulting distortions could act as a disincentive to savings. Nominal interest rates were highest in the two countries, Jamaica and Guyana which experienced the highest rates of inflation in this period. However there was a broad similarity in the real deposit rates in all of the countries, with the exception of those in the OECS and Belize, where the real deposit rates were significantly higher in the post 1997 period.

One would expect that it is those with high incomes who would most likely be influenced by interest differentials. For example, in Jamaica, the liberalization of the financial sector meant that savers could assess a range of domestic and foreign alternatives when trying to arrive at a decision In this period, the real rate of interest on time deposits in Jamaica between 1996 and 2000, as can be seen from the Table, was competitive with that offered on certificates of deposit in the United States, the place most likely to be considered as an alternative. In summary, whether rates were market determined or subject to some measure of government control, positive real rates of interest were on the whole sustained and rate levels were broadly competitive with those in other jurisdictions within and outside the region.

Nominal lending rates were high in all of the countries. As the data in Table 7 indicates, even in the case of Barbados, the country which on average had the lowest bank lending rates, the real

Table 6
Deposit Rates

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Barbados									
Time Deposit- nom	5.5	6.5	6.0	5.0	5.0	6.5	6.0	4.25	2.75
real	4.8	4.5	3.5	-2.5	6.4	4.8	3.5	1.6	2.6
Belize									
w/av Deposit- nom	6.1	7.2	6.2	6.7	6.0	5.7	5.0	4.3	4.5
real	4.2	3.2	-0.2	5.6	6.96	6.98	4.37	3.1	2.25
Guyana									
Time Deposit - nom	14.3	14.4	9.5	9.3	9.7	10.3	9.4	8.1	4.2
real	0.6	1.96	2.24	5.5	4.87	2.6	3.1	5.36	-1.0
Jamaica									
Time Deposit - nom	27.9	26.2	20.8	14.1	15.5	13.3	12.2	10.1	8.9
- real	0.8	0.5	4.3	4.5	7.1	6.1	5.8	1.2	1.5
OECS									
Time Deposit - nom	8.0	7.0	8.5	9.25	9.25	9.25	9.25	9.25	9.25
- real				6.8	6.0	7.2	7.6	7.3	8.6
Trinidad & Tobago									
Time Deposit - nom	11.5	9.4	10.0	10.0	10.5	10.2	9.8	10.0	9.3
- real	2.5	3.9	6.5	6.1	4.6	6.6	6.0	4.3	4.8
United States	4.6	5.9	5.4	5.6	5.5	5.3	6.5	3.7	1.7

Sources: Same as for Table 2.

lending rate was significantly higher than the prime lending rate in the United States. The high interest rates charged for loans could not be attributed to an imbalance between demand and supply for loanable funds. The substantial holdings of liquid assets over and above minimum legal requirements suggested, as pointed out earlier, that many potential borrowers were unable to satisfy the credit conditions demanded by lending institutions. . However, the very high rates would have resulted indirectly in some rationing of funds with uncertain consequences for the overall performance of the economy. Lending rates in Jamaica, in particular, were exceptionally high although there was a significant reduction in rates over the period. Although the country experienced high rates of inflation in this period , real lending rates ranged between 15 and 21 percent up to the year 2000. The high rates in Jamaica arose from the decision taken by the Bank of Jamaica in that period to rely on the interest rate mechanism as a means of supporting the exchange rate

Table 7
Commercial Banks Lending Rates[1]

	1994	1995	1996	1997	1998	1999	2000	2001	2002
Barbados									
Nominal	11.9	11.8	11.9	11.9	11.6	11.7	11.9	11.1	10.4
Real	11.1	9.7	9.3	3.9	13.1	9.9	9.3	8.3	10.2
Belize									
Nominal	15.0	16.3	16.2	16.6	16.3	16.3	15.8	15.4	14.5
Real	13.0	11.9	9.2	15.4	17.4	17.7	15.1	15.0	12.0
Guyana[2]									
Nominal	19.9	19.1	17.2	16.9	16.6	17.3	17.2	16.8	16.3
Real	5.5	6.1	9.4	12.8	11.5	9.1	10.5	13.8	10.5
Jamaica									
Nominal	45.8	48.6	37.8	31.9	30.1	24.6	22.1	19.5	18.3
Real	15.0	18.3	19.0	20.8	20.6	16.7	15.1	9.8	10.2
OECS									
Nominal	13.0	12.0	12.0	12.5	12.5	12.5	12.0	12.5	12.0
Real				10.1	9.1	10.4	10.3	10.5	11.3
Trinidad &Tobago									
Nominal	13.9	13.4	14.2	13.9	15.2	15.9	15.3	14.5	12.8
Real	4.6	7.7	10.6	9.8	9.1	12.1	11.3	8.5	8.2
United States[2]	7.5	8.8	8.3	8.4	8.4	8.0	9.2	6.9	

[1] Weighted Average lending rate
[2]Prime rate.
Sources: Same as for Table 2.

The impact of high interest rates on borrowing and investment decisions depends on the extent to which it represents a real cost burden. This, in turn, depends on the degree of competition borrowers have to face in the markets in which they operate, as this would be a determinant of their ability to pass through the interest charges. In the CARICOM context, those operating in the domestic market are usually faced with limited competition and hence interest charges would likely be a lesser factor in the borrowing decision. However, the growth performance of countries in the region will increasingly depend on the ability of local firms to be more internationally competitive. As barriers to trade continue to fall and preferential marketing arrangements phased out, not only will firms face more competition in foreign markets, but they will also be exposed to greater competition in home markets. The ability of the sector to make available funds at competitive rates of interest will be an important element in its ability to make a meaningful contribution to the development of countries in the region.

The Reform Challenge

In the previous sector, attention was directed to a subset of features highlighted in previous reviews of the financial sector which were seen as undermining the ability of the sector to perform its intermediary function. Reference was also made to some of the reforms arising from these reviews designed to address these deficiencies. These, by and large, were concerned with measures to ensure stability of the sector, increase the volume of savings, enhance the return to savers and minimize borrowing costs. These are clearly critical to the effective performance of the sector. These measures all seem to be primarily directed at enhancing the supply of savings. However, it is our view that if the sector is to be a major contributor to the growth process, it will also be important to address some shortcomings on the demand side. Why is it that a greater share of the stock of savings is not allocated to productive private investment? What accounts for the fact that many potential borrowers are not able to satisfy the lending requirements of financial institutions? Is it the case that the major cause is the inability of many borrowers to satisfy the collateral requirements of lending institutions? If that is the case, then the proposal to strengthen property rights as a means of broadening the collateral base will certainly be a positive step. However, it is our contention that it might be the limited pool of sound projects as much as inadequate collateral, which might account for the relatively large share of liquid asset holdings by institutions. The reasons why this might be the case are historical inequities in our society reflected in unequal access to such things as education and health, discrimination based on colour and class, have worked to limit growth in the pool of entrepreneurial talent. It is in this sense that it is argued that an effective reform agenda for the financial sector in the CARICOM context has to explicitly address the matter of ways of increasing the number of viable propositions worthy of financial support.

A major objective here is to outline ways in which the sector can play a more important role as a source of finance for investment in capital equipment as opposed to being that of a provider of short term trade credit. In order for this transformation to occur, the institutions in the sector will have to take on a more pro- active role. This would involve institutions not only performing the traditional intermediary function of assessing requests for financial support, but becoming involved in the identification of areas for productive investment and provide visible financial support for investment in these areas. In other words, the reforms should be geared to having a financial sector which is not only working to establish new ways to mobilize savings, but is also actively engaged in finding new ventures for allocating funds.

This proposed change in function carries important implications for the human resource needs of institutions functioning in the sector. In addition to such traditional areas as accounting and finance, institutions within the sector would need to have ready access to those who can interpret trends in technological developments which might be indicative of productive opportunities in new as well as traditional products. In addition, there would be a need to develop in depth knowledge on global marketing trends. This means that private financial institutions in the region will have to be encouraged do something which they have traditionally ignored, but which has been accepted as essential in other jurisdictions, namely, establishment of research departments. Research departments will be required to provide management with an independent assessment of the implications of domestic and internal, economic, political and technical developments on an ongoing basis.

In order for this transformation in the role of the sector to occur, there would have to be what amounts to a major attitudinal change. There is a role for government in facilitating this transformation through the provision of fiscal incentives. Such incentives could be a way of encouraging institutional innovations. Such innovations could be in the form of firms in the sector which would be prepared to take partial ownership positions in new enterprises or in the expansion of existing enterprises. For example, special tax treatment of funds invested in new enterprises, as well as the earnings from such investments, could encourage firms to engage in such ventures.

Tax incentives might also be used as an incentive to encourage the development of independent research activity within the sector. Such activity will be seen as initially entailing a cost with no obvious immediate short term return. To the extent that the costs associated with this activity can be written off in whole or in part, this will reduce the resistance to undertaking such expenditure.

Apart from the provision of tax incentives, government can play a role in bringing about change in the sector through a regulatory environment which encourages the type of innovative activity proposed. Reforms in the regulatory environment could make it possible for institutions to engage in areas of activity from which they have been traditionally barred. This would have to occur in conjunction with adjustments in the supervisory framework in order to ensure the maintenance of stability.

There is also a need for attitudinal change towards the importance attached to small non - traditional business activity. This implies that more attention must be placed on ways of harnessing finance in support of micro - enterprises outside of the traditional institutional setting. This might be achieved with a move towards the establishment of community based micro finance schemes. In this context, the sector would not only be plying the role of a provider of finance but also be a provider of advice to the prospective investor.

In summary, sectoral reforms must be geared to a broadening of the role of the sector beyond that of serving purely as an intermediary between savers and borrowers. Given the relative scarcity of entrepreneurial talent, the sector has to play a role in helping ensure that the full potential of that talent is realized. Institutions in the sector will have to take on a more pro- active role in helping to identify and encourage innovative activity. There also has to emerge within the sector an appreciation of the importance of encouraging a knowledge culture. These are the types of developments which will allow the sector to make a meaningful contribution to development in the region.

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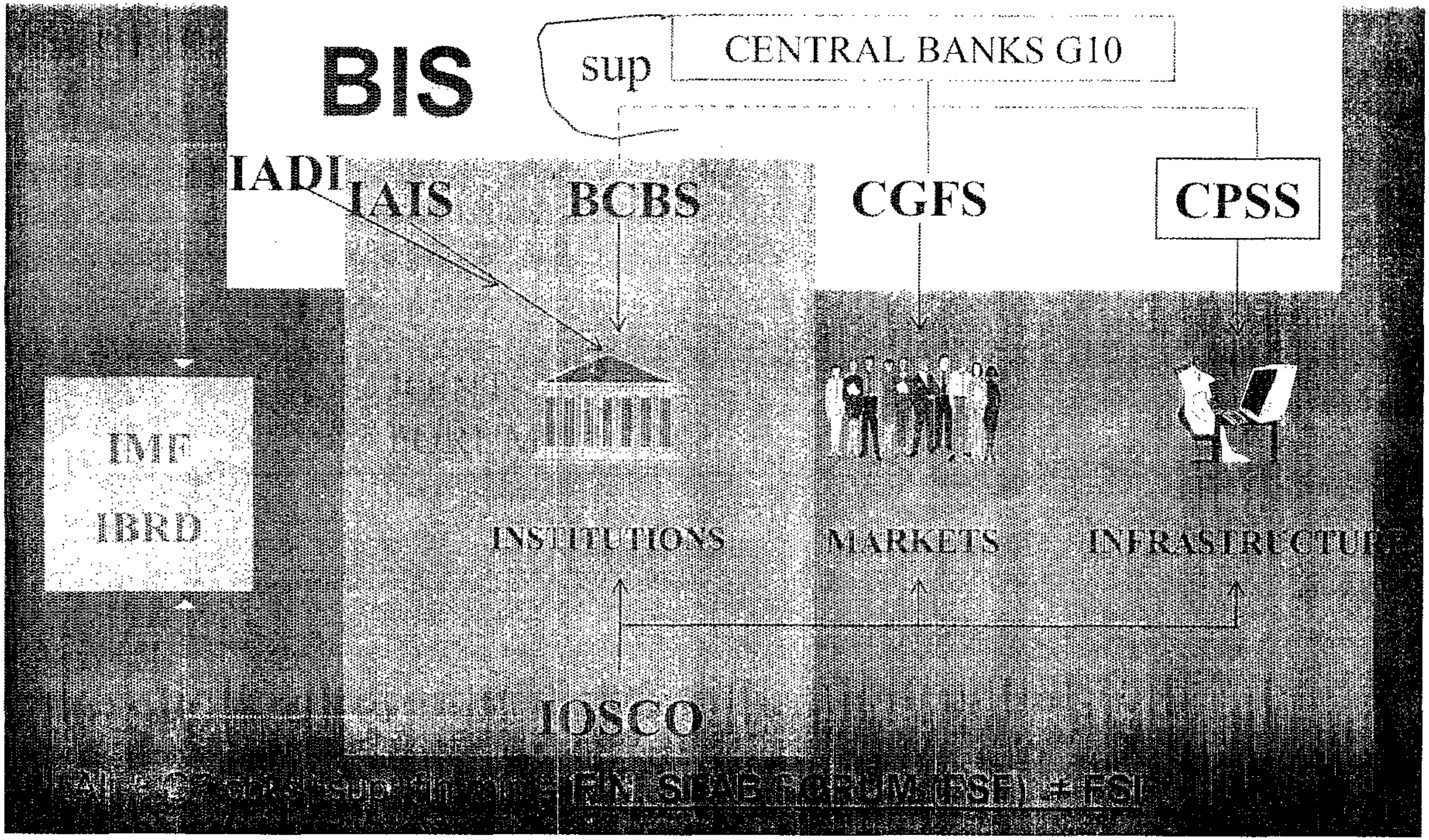
Structure of the new Capital Accord

- Implementation
  - Min. cap. requirements Pillar 1
    - Definition of cap. (88[98])
    - Risk weighted assets
      - Market ri. (98)
      - Credit ri.
        - Standard approach
        - [redacted]
      - [redacted]
  - [redacted]
  - [redacted]

Monetary and financial stability



Who wants it - when ? : The FSI survey

- Bahamas
- Barbados
- BVI
- Cayman Islands
- Jamaica
- ECCU
- Trinidad & Tobago

- >100 wish to adopt BS II
- Caribb: large majortity +
- CHALLENGE: training of supervisors and banks
- cooperation FSI/BCBS/regional groups/BIS rep.off..