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Wider Caribbean Financial Sector Review

Increasing Competitiveness and Financial Resource Management for Economic Growth

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Finance, Private Sector & Infrastructure Unit
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Latin America and the Caribbean Region



CURRENCY EQUIVALENTS

(May 21, 1998)

Bahamas Dollar 1.00 = US\$ 1.0	Haitian Gourde 16.95 = US\$ 1.0
Barbados Dollar 2.01 = US\$ 1.0	Jamaican Dollar 36.49 = US\$ 1.0
Belize Dollar 2.00 = US\$ 1.0	E.C. Dollar 2.70 = US\$ 1.0
Dominican Peso 15.05 = US\$ 1.0	S. Guilder 401.0 = US\$ 1.0
Guyana Dollar 145.5 = US\$ 1.0	T & T Dollar 6.2856 = US\$ 1.0

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ACRONYMS AND ABBREVIATIONS

ABSALAC	Association of Bank Supervisors for Latin America and the Caribbean
CARICOM	Caribbean Community
CCMS	Caribbean Centre for Monetary Studies
CCU	Council of Credit Unions
CDB	Caribbean Development Bank
CDs	Certificates of Deposit
CEMLA	Center for Economic and Monetary Studies of Latin America
CGAP	Consultative Group to Assist the Poor
COOPS	Cooperatives Strengthening Project
CSI	Contractual Savings Institutions
CUSOs	Credit Union State Organizations
DFI	Development Finance Institution
ECCB	Eastern Caribbean Central Bank
EU	European Union
FINSAC	Financial Sector Adjustment Company
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
IBRD	International Bank for Reconstruction and Development
IDB	Inter-American Development Bank
LAC	Latin America and the Caribbean
MFN	Most Favored Nation
MIF	Multilateral Investment Fund
NGO	Non Governmental Organization
NICs	Newly Industrialized Countries
OAS	Organization of American States
OECD	Organization for Economic Cooperation and Development
OECS	Organization of Eastern Caribbean States
OTC	Over the Counter
SEC	Securities Exchange Commission
SOE	State Owned Enterprises
WTO	World Trade Organization

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WIDER CARIBBEAN FINANCIAL SECTOR REVIEW

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PREFACE

This study was conducted jointly by the World Bank and the Caribbean Centre for Monetary Studies (CCMS) as part of the FY98 CGCED Sector Work agenda. Funding support for this was also kindly provided by the U.K. via the British Development Division in the Caribbean. The World Bank team consisted of Mr. John Pollner (Task Manager / Financial Management Specialist), Mr. Meir Kohn (Principal Consultant), and Mr. Steven Webb (Senior Economist). The CCMS team was headed and coordinated by Dr. Laurence Clarke (Director, CCMS) during the course of the work. Additional support on financial information and statistical issues was provided by Mr. Sati Achath (Public Sector Consultant) and Ms. Isabelle Daverne (Banking Sector Consultant).

The objective of this regional financial sector review is to demonstrate the common characteristics and constraints of the financial markets and institutions throughout the wider Caribbean, and to identify factors which might improve the availability and security of capital needed to fund productive investment in the region. In this regard, the issues of macroeconomic stability, strengthened supervision of banks and non-banks, and public debt management, are key factors which will generate a business environment conducive towards financial sector development. The study shows the constraints that smaller economies such as those in the Caribbean face in achieving well developed, flexible, and liquid financial markets, and how single country based approaches in the region sometimes result in fragmented, and less efficient financial systems. The study's intention is not to review country-by-country financial systems and institutions -- rather, it points to specific regional examples of best practice and initiatives that need further development to achieve a more common financial space across the region.

The study was initiated prior to the recent financial crisis in South East Asia. However, lessons of that experience, where applicable to the Caribbean, are incorporated in the paper, and issues addressed have also taken into account some of the problems diagnosed during the 1994-95 Mexico 'tequila' crisis, particularly in relation to macroeconomic management and the adequacy of banking regulation and supervision.

The countries covered are The Bahamas, Barbados, Belize, the Dominican Republic, Guyana, Haiti, Jamaica, the OECS countries/territories (Anguilla, Antigua & Barbuda, Dominica, Grenada, Montserrat, St. Kitts & Nevis, St. Lucia, and St. Vincent & Grenadines), Suriname, and Trinidad & Tobago. For a substantial portion of the information, the report has relied on the many recent studies of individual countries and the region completed by the Caribbean Centre for Monetary Studies, the Caribbean Community Secretariat, the Inter-American Development Bank, the World Bank, and the International Monetary Fund. Additional field visits were conducted to update country specific matters relating to legal & regulatory frameworks, institutional structures, and industry practices.

I. EXECUTIVE SUMMARY

Despite many common characteristics, the financial sectors of the Caribbean region differ widely owing to differences in the size and level of development of each economy, the quality of macroeconomic management, the law and practice of regulation and supervision, and institutional histories. Some of the financial sectors have notable strengths. The financial depth of the economies of the Caribbean, measured as the ratio of credit or money to GDP, is greater than in most of Latin America. In every country there is at least one large international bank, setting a standard for conservative, though rarely innovative management.

The financial sector of the Caribbean region manifests problems similar to those encountered in many developing economies. Owing to the small size of the individual economies and their geographical location, however, these countries are more susceptible to economic and financial volatility -- these factors, coupled with limited economic diversification, also explain in part, the higher cost of banking in the region. Salient characteristics of the Caribbean in this regard are: (i) the impact of reserve requirements on the cost of capital of banks and ensuing regulatory "arbitrage"; (ii) the market segmentation and differentiation of roles among foreign, domestic/indigenous, and state-owned banks; (iii) the small size of institutions and assets managed and implications for managing risk; (iv) the lack of long term lending, particularly for small enterprises, (v) the substantial, though declining, state ownership of financial institutions, and (vi) the limited role in capital mobilization, of the region's bond and equity markets .

Looking ahead at the needs for reform, the report concentrates on diagnosing the common problems. The main issues are excessive public debt, geographic fragmentation and lack of competition in local markets, outdated regulation and weak supervision, scant supply of long-term finance or credit for small firms, low mobilization and inefficient use of contractual savings funds, and underdevelopment of capital markets.

The priority and sequencing of reforms should be: macroeconomic stability, banking system safety, and supply of credit. First and foremost, macroeconomic stability and sound fiscal management are the bedrock for a robust financial sector. The next priority includes, adequate banking safety net procedures, well defined and institutionally enforced entry and exit policies, sound licensing procedures, and assurances of minimum capital standards for banks. Macroeconomic stability and sound banking are mutually dependent and provide the foundation for achieving the third priority -- the development of financing mechanisms for long term projects and for small enterprises. The development of reformed pension systems and capital markets would also come in as later stages and goals, after financial sector stability is achieved. These latter areas will require further examination of country specific conditions, market absorptive capacities, as well as methods for reforming regulatory frameworks and their supporting institutions.

Macroeconomic Context

Although the overall public sector deficits and inflation rates have generally declined in the past 5 to 10 years in the Caribbean, in several countries the stock of public sector debt remains large and the domestic component of the debt has increased. The latter is especially burdensome to the financial sector and crowds out private investment. In some cases, high unremunerated reserve requirements or other means of forced lending to the public sector have reduced the growth of public domestic debt held at full market rates. This effective tax on the financial sector

widens the spread between deposit and lending rates, thus discouraging growth and investment. It is also not the most efficient tool for monetary policy purposes. Reductions in reserve requirements, however, must be undertaken in conjunction with fundamental fiscal reform and lowering of the public debt. Furthermore, the appropriate level of reserve requirements, even when remunerated, should take into account the economic characteristics of the region -- higher economic volatility in small economies and often fixed exchange rate regimes. These factors might require building up greater liquidity cushions for the region's financial sectors, particularly during economic 'boom' times.

There are no quick fixes to the problems left by years of deficit financing, but the difficult measures to restore fiscal balance will have large payoffs to the economy. Not only do countries need to continue the reduction of fiscal deficits, but public sector debt management needs improvement, both to minimize macroeconomic imbalances and to encourage development of stable financial markets, as discussed below.

Industry Structure

The Caribbean financial sector, particularly commercial banks which comprise the main and largest component, is fragmented by national boundaries, dominated by a few large banks in each country, and in some countries burdened with inefficient government-owned banks. Fragmentation means that, except for a limited circle of large international banks, most of which have been in the region for decades, both the deposit base and the lending portfolio of banks is usually limited to a small economy with a narrow range of sectors. This tends to make the indigenous banks and other financial institutions riskier and more costly than those operating in larger more diversified financial spaces.

Formal and informal barriers to entry not only perpetuate fragmentation but also restrain competition and lead to lending spreads that are higher than can be explained only by direct monetary and credit controls. Barriers include discretionary non-transparent restrictions on licensing of banks, work-permit rules that hamper mobility of labor and management, and restrictions on foreign ownership of property. High bank margins result in part from segmented regional markets, and measures to increase competition and enhance efficiency should be encouraged. During such transition stages, it is imperative for supervisory authorities to monitor bank profitability and ensure prudential financial management under more competitive environments.

Banks and central banks have taken some steps to upgrade the payments systems of the region, but the rules of the system, and some of the procedures, still date from an era when paper checks were the standard. Increased use of fully electronic transactions, which will accelerate with regional integration and the development of financial markets, expands the potential for discrepancies and even breakdowns in the payments system.

Countries need to reduce discretionary barriers to entry for new indigenous as well as regional or foreign banks that meet prudential standards. They also need to reduce legal barriers to land holding, so that they do not impede transfer of financial assets. Allowing more international competition, both within the region and from outside, will lower costs and result in more diversified and less risky banks. Allowing indigenous institutions to grow multinationally within the Caribbean would increase their scope and diversity, which is necessary to compete in the international market for financial services. To mitigate transaction risks and increase

efficiency, the technology and rules of the payment and settlement systems need to be modernized, moving closer towards real-time clearing which is becoming the international standard.

Regulation and Supervision

Improving regulation and supervision must accompany improvements in the industry structure and globalization of financial markets. This does not however, imply over-regulation; rather, incentives for appropriate market behavior need to be put in place to ensure a high quality of institutions through self-regulation -- both banks and depositors should have stakes in potential financial losses, beyond minimum defined levels of protection provided by governments.

In most of the countries, the legal regulatory standards are adequate for commercial banks, but they do not extend adequate coverage to the non-bank sector. Often regulations are not well supported with supervision, although in a few countries -- such as Barbados, the Dominican Republic, and the Eastern Caribbean -- regulatory standards are relatively well developed and financial tracking systems are in place. A few Caribbean-based banks now operate in more than one country, and there are no arrangements to coordinate supervision across borders.

Adoption and implementation of the Basle core principles for effective banking supervision varies greatly across the region, but they are critical for all countries. The agenda for moving ahead with these policies and practices is not easy and will require much political and technical effort, as reflected in the Joint Ministerial Statement from the Second Western Hemisphere Finance Minister's Meeting in March 1998. The World Bank is committed to support and monitor the implementation of these core principles.

Improving supervision and enforcement of existing regulations is a high priority for enhancing the safety of existing banks and laying a prudential base for more open rules of entry. In some countries, regulations need modernizing, for instance, ensuring minimum risk-based capital and prudent loan loss provisioning requirements. Rules for exit also need clarifying, specifying when authorities can intervene and force an insolvent bank to close or accept merger with another. Regulating the non-bank sector and ensuring a level competitive playing field with commercial banks, in terms comparable reserve requirements on time deposits, is crucial for the safety of the financial system. Improvement in company-wide accounting and auditing is needed, particularly to monitor financial and corporate conglomerates effectively. Supervision teams for banks operating in more than one country should systematically share information with supervisors from other countries where the banks operate. In addition, assurances should be put in place so that regulators and supervisors can enjoy complete independence from political influence, both from the private and public sectors.

Availability of Financing

The largest asset holders of the region, commercial banks, supply mainly short-term credit for trade and government, and some mortgage lending. While banks and other institutions supply some other forms of credit, financing is especially lacking in two areas -- term financing for all businesses, and all types of financing for small businesses. Directed credit to these uses would not result in sustainable growth, would stifle private sector development, and would likely undermine

macroeconomic stability. But various measures could reduce constraints on these types of lending.

The most important factors hindering long-term finance are macroeconomic instability, uncertainty in the tax status of banks in some countries, deficiencies in the legal system that make collection and enforcement of loans difficult, and lax accounting standards that make reliable information costly to obtain.

Small businesses and poverty-affected segments of the economy not only face these hurdles but, as in every economy, face the additional obstacles from banks that wish to avoid expensive processing and collection on small loans. In the Caribbean, lack of clear title to real property particularly in the poorer sectors, weakens its usability as collateral and creates an additional barrier to credit for lower-income segments and small businesses. In some cases, laws that obstruct foreclosure procedures, with the intent to protect borrowers, actually hinder small firms from getting credit.

While additional work and diagnosis is required in this area, an agenda could begin with the removal of some obstacles impeding credit supply to small enterprises and entrepreneurs in low-income sectors. In addressing special needs for credit, governments should not attempt to direct credit, but rather should focus on maintaining macroeconomic stability and removing constraints: This includes modernizing the registry of property rights, strengthening the rights of creditors in the legal system, and strengthening standards for information disclosure by firms. Improved regulation and supervision of credit unions and community funds, along with technical assistance as needed, would strengthen those sectors, which have been good sources of financing for small businesses.

Pension Funds and Social Security

Pensions funds and social security are still in the early stages of development in the Caribbean -- assets are small relative to the economy and most participants are still far from retirement, making liabilities distant. That will change sharply within a generation, because of lower birth rates and longer life spans. There is both a need and an opportunity to reform these contractual saving arrangements, to make them more secure and profitable for participants, and to allow them contribute more to private sector growth.

While detailed review of individual country situations is required prior to prescribing changes in public social security systems, some reforms and options include:

- *Allowing participants more control over how their savings are invested, particularly allowing investments in higher yielding private equity and/or debt instruments.*
- *Reducing government practices of directing social security savings into the public sector.*
- *Promoting the management of pension funds by independent trustees under appropriate regulatory safeguards, and considering arrangements for privatization of the pension system.*
- *Allowing substantial portions of the pension and social security assets to be invested abroad and in other Caribbean countries, to reduce capital risk through diversification.*

Capital Market Development

Middle and upper income households invest their savings in global capital markets, and a few large firms raise funds as well, but most countries have no liquid markets where firms or

governments can raise equity or bond financing directly. Barbados, Jamaica, and Trinidad and Tobago have equity markets with capitalizations worth about one-third of GDP, but trading volumes are also low. Development of capital markets would improve the options for savers and investors although macroeconomic stability and safety of the banking system should be ensured under earlier steps in a sequential reform process.

Policies to encourage the development of capital markets include many of the same items needed for general financial-market development: Macroeconomic stability, moderate positive real interest rates, privatization of public enterprises, elimination of barriers to foreign ownership of assets, streamlining debt-settlement and bankruptcy proceedings, and improvement of accounting and reporting standards.

Specific steps toward capital market development would include development of markets for government paper and mortgage-backed bonds and establishment of a securities and exchange commission. Countries contemplating financial market integration might also consider setting up a multi-country commission in order to obtain adequate expertise, ensure policy neutrality, and realize economies of scale. Both for the regulatory and market players, it might be more profitable and sustainable to strengthen existing financial infrastructure and supervisory bodies rather than to create new institutions. These could require large technical capacities and thus might be more efficient under consolidated supervisory structures.

Liberalization and Enhanced Regional Competitiveness

Central to the macro and institutional reforms prescribed, it is imperative for Caribbean policy-makers to further commit to the WTO process of additional liberalization in financial services. In attempting to define the strategic positions for enhancing the region's competitive strengths, accurate and comprehensive assessments of the current position of the region's financial services industry will be necessary. Factors to take into account during this process include:

- (a) the high degree of concentration of firms in virtually all segments of the region's financial sectors;*
- (b) the relative smallness, fragmentation and inherent fragility of Caribbean economies and their financial markets;*
- (c) the pronounced presence of indigenous financial firms, and past policies which resulted in foreign firms being relatively less aggressive in the Caribbean; and*
- (d) the region's commitment to a single market and economy.*

In this connection, the challenge for the Caribbean will be the extent to which regional governments will be able to respond to the need for increased external and internal competition, while balancing the politically delicate issues of ownership and foreign country participation in the sector.

Lessons from Recent Global Events

A report of this type would not be complete without addressing the recent events which led to the financial crises in the South East Asia region. References to the diagnosis of the problems in that region are made to provide information and allow early recognition of symptoms

which might merit further monitoring. In this context, it is prudent to list some of the factors which impacted the South East Asian situation¹:

- *Lower export earnings and growing current account deficits, coupled with appreciating real exchange rates which were linked to the US Dollar;*
- *High ratios of non-performing loans in the banking system from previous economic boom periods, which generated vulnerability to interest rate hikes or economic slowdowns;*
- *Prevalent cross-ownership arrangements among financial and non-financial institutions with lack of transparency in financial reporting;*
- *Lack of effective prudential regulation and supervision in the banking and non-bank sectors;*
- *Ill-sequenced capital account reforms which allowed nationals to contract external debt, while restricting foreign investment and/or ownership in domestic assets*
- *Bank and corporate holdings of large amounts of short term debt in foreign currency which exceeded available reserves, thus resulting in unhedged mismatched currency positions scheduled for refinancing at the on-set of the crisis.*

While the Caribbean region represents a rather different economic situation than what existed in South East Asia, there are nevertheless enough common elements which should be taken into account when crafting a future financial sector reform agenda for the region. Consideration of these indicators, and subsequent actions to reform the regulatory, institutional, and macroeconomic environments in this context, would result in safeguards to prevent the Caribbean economies from manifesting the dangerous confluence of these now recognized risk factors.

¹ World Bank, Perry and Lederman, 1998.

WIDER CARIBBEAN FINANCIAL SECTOR REVIEW

INCREASING REGIONAL COMPETITIVENESS AND FINANCIAL RESOURCE MANAGEMENT FOR ECONOMIC GROWTH

I. ECONOMIC CONTEXT

The Region's Economies

A brief overview of the economies of the Caribbean provides a context for the subsequent discussion of the state of the financial sector and its potential for development. The region's economies are small: total GDP at the end of 1996 for all of the countries reviewed is US\$35 billion; total population is 21.5 million (excluding Hispaniola, total GDP is \$20 billion and total population 6.4 million - See Table 1). Per capita incomes are generally in the "lower middle income" range. The exceptions are The Bahamas ("high income"), Barbados ("high middle income"), and Guyana and Haiti ("low income").

This report focuses on the impact that the region's governments can play in promoting the development of their financial sectors with particular emphasis given to governmental fiscal management, the promotion of market-based incentives, and sound macroeconomic policies. The role of such policies are emphasized, to assure efficient and stable financial systems for transferring financial resources into productive sectors, at reasonable risks. The report also discusses the major areas where the harmonization of regulatory norms and the emerging integration of the region's financial industry are impacted by factors such as: (a) the level of efficiency of the financial sector and the cost of intermediation; (b) the need for economic and financial diversification to reduce geographic and sectorally concentrated risks, (c) the development of regulatory consistency in supervision across the various financial institutions, to ensure transparency and promote safety in the financial system, and (d) the promotion of an enabling macroeconomic and regulatory framework to develop instruments for mobilizing longer term capital. The issues of diversification in financial assets and instruments, and the potential roles of capital market & pension institutions, are also addressed in this context.

TABLE 1: BASIC STATISTICS

	Bahamas	Bar- bados	Belize	Domi- nican Repub.	Guyana	Haiti	Jamaica	OECS	Suri- name	Trinidad & Tobago
	1996	1996	1996	1996	1996	1995	1996	1995	1996	1996
Pop. '000	280	265	214	7,900	770	7,200	2,500	556	479	1,292
GDP US\$ bn.	3.5	2.0	0.64	11.8	0.6	3.4	5.6	1.9	0.48	5.2
GDP p.c.	12,500	7,500	2,700	1,490	760	380	2,240	3,300	1,600†	4,100

Source: Economics Intelligence Unit (EIU), International Financial Statistics (IFS).

† Includes \$600 in estimated unofficial income and remittances.

Historically, the Caribbean economies were predominantly agricultural—mainly specializing in sugar, rice (Guyana, Trinidad and Tobago, Barbados, Suriname), coffee (Jamaica), and bananas (Jamaica and the OECS) — with mineral extraction important in the larger ones. In recent decades, tourism has developed into an important sector in many countries and financial services have become important in a few such as The Bahamas, Barbados and Jamaica. Manufacturing has generally remained small, limited mostly to the processing of agricultural products and minerals, with some light industry (Trinidad and Tobago, Dominican Republic, and Jamaica). For many countries intra-regional trade is quite small, except for a few commodities, such as petroleum and petroleum products. Table 2 shows the composition of GDP by major sector. The composition of employment is somewhat different: agriculture has a much larger share of employment than of GDP; services (especially financial services) a much smaller share.

TABLE 2: COMPOSITION OF GDP

	Bahamas	Bar-bados	Belize	Domi-nican Repub.	Guyana	Haiti	Jamaica	OECS	Suri-name	Trinidad & Tobago
	1995	1995	1995	1995	1995	1994	1995	1995	1994	1995
Agri. & Fish		6	21	15	49	38	8	9	8	2
Manufact.	3	7	14	14	na	7	18	6	10	9
Mining	-	*	*	1	17	-	9	-	13	28
Tourism (rest & hotel)	40	15	18	5	na	0.2	na	11	na	na
Fin. Serv.	24	20	5	5	3	0.2	15	na	12	12

Source: EIU, and miscellaneous.

* Included with manufacturing

Because of their small size and the importance of agriculture, mineral extraction, and exported services, the economies of the region are very open. Table 3 shows that imports and exports are a very high percentage of GDP. It also shows the importance of trade with the United States. Other important trading partners include the EU (especially the UK) and Canada.

The Caribbean suffers from frequent natural disasters (mainly hurricanes, but also seismic activity). The impact of a natural disaster on a small economy and its financial sector can be far more devastating than it is on a large economy, where the damage is relatively localized. For example, the damage to Jamaica from Hurricane Gilbert in 1988 amounted to about 33% of GDP; to Antigua from Luis and Marilyn in 1995, to about 66% of GDP; to Montserrat of Hugo in 1989, to about 500% of GDP. In comparison, the damage to the United States from Hurricane Andrew in 1992, while much larger in absolute amount, amounted to only about 0.2% of GDP.

TABLE 3: INTERNATIONAL TRADE

	Bahamas	Bar-bados	Belize	Domi-nican Repub.	Guyana	Haiti	Jamaica	OECS	Suri-name	Trinidad & Tobago
	1995	1995	1995	1995	1995	1992	1995	1995	1994	1995
Imports % of GDP	34	36	39	41	90	20	54	56	44	36
% of which from other CARICOM	na	17	4	na	8	na	13	na	26	4
% of which from US	93	39	54	44	29	65	58	na	42	50
Exports % of GDP	7	13	28	26	84	9	37	16	67	47
% of which to CARICOM	na	38	<1	na	5	na	5	na	4	24
% of which to US	81	18	36	45	24	74	45	na	19	43
Current acct. % of GDP	-4	5	-3	-1	-22	-8	-5	-10	13	6

Source: EIU, miscellaneous.

The smallness of the region's economies, their openness, and their vulnerability to natural disasters has at least three important implications:

(i) Because of their small size, the region's economies are at an economic disadvantage with respect to activities that involve significant fixed costs and economies of scale, including government, financial services, transportation, utilities, and much of manufacturing. Correspondingly, there are large potential benefits to cooperation and integration both within the region and internationally.

(ii) The region's economies are particularly susceptible to shocks. Their smallness results in a lack of diversification. Their openness and specialization in cyclically sensitive sectors make them vulnerable to shifting terms of trade. Their location and size expose them to unusually frequent and extensive natural disasters. In light of this exposure to shocks, the stabilization of income and the mitigation of risk, for both the financial and the real sector, are of vital importance. Integration – regional and international -- is thus advantageous.

(iii) Labor has limited mobility in the region, and those who are highly skilled and trained often face limited opportunities to work in their own countries or even within the whole region. This has led to a sizable emigration of trained human resources (particularly from Guyana, Haiti, and Jamaica), a problem that regional integration could help mitigate.

II. THE MACROECONOMIC ENVIRONMENT

The nature of the region's economies -- small and open -- limits their macroeconomic policy options. A fixed exchange rate against the US Dollar is the choice of many, given the preponderance of trade with the United States. (see Table 3). A fixed exchange rate leaves little room for independent monetary policy -- the central bank must focus its efforts on maintaining parity. To ensure the credibility of the commitment to maintaining parity, fiscal policy must be conservative. The countries of the region can be divided into three groups with respect to the degree to which they have adhered to these practices.²

Group I (OECS). Very small, open economies, dependent on tourism, agriculture, remittances, and foreign assistance for foreign exchange; under a monetary union with a common currency and common central bank (the ECCB). The ECCB's multinational character has given it considerable independence, enabling it to maintain a fixed parity with the US dollar and to refrain from monetizing fiscal deficits.

Group II (The Bahamas, Barbados, Belize). Countries that consider themselves large enough to have their own central banks. They have occasionally resorted to monetary financing, but have managed to maintain a fixed exchange rate relative to the United States dollar by ultimately accepting the constraints on macroeconomic policy that this implies.

Group III (Dominican Republic, Guyana, Haiti, Jamaica, Suriname, Trinidad & Tobago). Larger countries, many of them commodity exporters, in which commodity booms led to unsustainable expansions of the public sector. The larger size of these economies fostered unrealistic notions of the capacity for independent monetary policy and monetization of fiscal deficits. These policies led to severe imbalances in the 1980s and early 1990s, characterized by devaluations, the floating of exchange rates, and inflation. All have since undergone stabilization programs; most of these have been successful, although a few remain to be fully carried out. Current indicators of the macroeconomic environment are shown in Table 4.

TABLE 4: MACROECONOMIC ENVIRONMENT

	Bahamas	Bar-bados	Belize	Domi-nican Rep.	Guyana	Haiti	Jamaica	OECS	Suri-name	Trinidad & Tobago
	1996	1996	1996	1995	1996	1995	1996	1995	1996	1995
Inflation %	1.5	2.4	6.4	12.5	4.5	28.0	21.5	2.1	0.4	5.0
Exchange Rate	1.0 f	2.00 f	2.00 f	13.60	141	16.2	35.9	2.70 f	401	5.95
Fiscal Surplus % GDP	-1	-4	0	0	-2.5	-4.8	-9.3	-2.0	0.8	0.4
External Debt % of GDP	14	32	32	36	347	40	52	20-79	23	23

Source: EIU; IMF. f= fixed exchange rate.

The external debt load varies widely among the countries of the region. Those with the highest outstanding debt / GDP ratios have tended to be those countries that suffered most from macroeconomic instability, high inflation, and subsequent devaluations, which exacerbated problems with currency risk on such debt. In addition, the countries with high debt loads also tax the banking system, both through direct monetary control instruments as well as by directing banking credit to the public sector (see Table 8).

Capital controls in the region vary -- some economies (e.g.: Trinidad, Guyana) have open capital accounts while others (e.g.: Barbados) have more conservative regimes requiring authorization for transfers above certain limits. Harmonization of norms, and minimization of discretionary criteria for allowing transfers of capital, would be more conducive for achieving an integrated financial space in the region.

²See The World Bank (1996)

III. AN OVERVIEW OF THE FINANCIAL SECTOR

Regarding the depth of the banking sector and its size relative to the economy -- the Caribbean countries, except for the Dominican Republic and Haiti, compare well with Latin America, though they lag behind the Asian NICs and the OECD (see Table 5, first three columns). The final two columns give an indication of the importance of the stock market. Only Barbados, Jamaica and Trinidad and Tobago have sizable stock markets, and only the latter two have significant turnover, although the Dominican Republic is expected to expand. The most active two markets are comparable in their parameters to the LAC average but lag behind the more developed stock markets of the Asian NICs and the OECD.

TABLE 5: INDICATORS OF FINANCIAL DEVELOPMENT (1995)

	(1) Domestic bank credit as % of GDP	(2) Quasi-liquid liabilities as % of GDP	(3) Credit to private sector ¹ as % of GDP	(4) Stock market capitalization as % of GDP	(5) Stock market turnover ratio
The Bahamas	44	37	45	-	-
Barbados	46	42	40	38	<1
Belize	48	35	40	-	-
Dominican Republic	19	16	24	small	na
Guyana	57	49	30	-	-
Haiti	11	18	13	-	-
Jamaica	36	35	17	32	22
OECS	83	75	70	-	-
Suriname	50	46	44	2	na
Trinidad and Tobago	36	38	44	27	15
<i>Average Caribbean</i>	43	39	37	na	na
Bolivia	43	27	44	2	2
Brazil	34	24	32	21	47
Chile	49	29	51	109	16
Mexico	29	22	32	37	31
Average LAC	26	23	28	23	19
Average Asian NICs	104	81	111	136	47
Average OECD	114	56	88	55	66

Source: Loayza and Palacios (1997), and miscellaneous.

¹ Bank and non-bank credit.

FINANCIAL INTERMEDIATION

In every Caribbean country, commercial banks dominate the financial sector. Their dominance is even greater than their explicit share suggests, as many near banks are in fact subsidiaries or affiliates of commercial banks, established to escape the high regulatory costs imposed on the latter. Typically, commercial banks account for 2/3 to 3/4 of all intermediary assets. This share is higher than in many OECD countries, but lower than in many other developing countries. For example in Mexico, Brazil, and Argentina, commercial banks account for 80-95% of total intermediary assets.

Consistent with the historical experience of today's more developed economies, the share of commercial banking assets in total financial assets has been declining over the past ten years in the Caribbean, giving growing importance to non-banks: thrift institutions, savings banks, credit unions, and

finance companies. In the larger economies, they also include a substantial increase in the merchant bank and multi-service banking industry. The Eastern Caribbean states have less elaborate financial structures and depend more on commercial banks than other Caribbean economies. Contractual savings (social security reserve funds, life insurance, and private pension funds) are significant in most countries and account for 15-25% of total intermediary assets.

TABLE 6: FINANCIAL INTERMEDIARIES: PERCENTAGE SHARE OF TOTAL ASSETS

	Bahamas	Bar- bados	Belize	Domi- nican Repub.	Guyana	Haiti	Jamaica	OECS	Suri- name	Trinidad & Tobago
	1995	1996	1996	1992	1995	na	1994	1995	na	1993
Com. banks	69	55	69	68 ²	64		65 ²	72		51
Near banks ¹		18	1	22	11		28	-		14
Dev. banks	11	1	7	9	8		5	3		4
Credit Union		2	8	na	0.1		2	5		5
Insurance		11	2	na	8		na	4		14
Soc. Sec.	20	13	14	na	9 ³		na	16		10
Total	100	100	100	100 ²	100		100 ²	100		100 ⁴

Sources: CCMS, Miscellaneous.

¹ Thrifts, trust and mortgage finance companies, merchant banks, etc.

² Percentage share of total depository institution assets only.

³ Social security 4%; private pensions 5%.

⁴ Includes Home Mortgage Bank (secondary mortgage institution) 1%; Unit Trust 2%

IV. FINANCIAL INTERMEDIATION INEFFICIENCIES

Although access to financing in the aggregate is not a key problem in the Caribbean compared to other developing countries, there are concerns about its *quality*. The availability of finance varies from country to country in the Caribbean (see Table 5, column 3). However, two fundamental problems – fragmentation and financial repression – compromise the efficiency of the financial sector and its stability in most countries.

Financial Fragmentation and Isolation

The financial sector of the region is highly fragmented (though increasingly less so in recent years), with the financial sectors of different countries still operating largely in isolation. Most Caribbean-based financial institutions operate in only a single country although a number of foreign commercial banks continue to operate branches -- this is particularly true for British and Canadian banks. Nevertheless, there is little movement of funds from one country to another, either within financial intermediaries or through securities markets. Financial sectors of individual countries are isolated not only from each other, but also from the international financial system. It is not only the financial sector that is fragmented: few businesses of any kind operate across national borders.

Financial fragmentation results from a number of factors: exchange controls and exchange-rate uncertainty in many countries; government pressure, formal and informal, on financial institutions to restrict their lending to the home country; restrictions on the foreign ownership of domestic assets, real and financial; and differential tax policies across borders and types of market players. Financial fragmentation and isolation not only reduce overall economic efficiency; they also harm the efficiency and stability of the financial sector itself, and prevent the financial system from playing its proper role in spreading risk.³

Allocation of resources

Significant differences in interest rates and in liquidity across countries indicate that financial flows are not taking place -- intra-regional and with the rest of the world -- as these have not sufficed to equalize borrowing and lending rates. Table 7 shows significant differences across the region in deposit and lending rates. There are significant differences when adjusted for inflation, in real deposit rates (from -4% to 5%) and in real lending rates (5.4% to 18%). While these differences also reflect perceptions of risk in each country, they are clearly also a result of segmented markets. Excess liquidity exists in some countries and some market segments, even while other countries and sectors have shortages. For example, in late 1997, banks in Barbados had excessive liquidity, for which they blamed a lack of suitable domestic lending opportunities. Lending in the region or abroad was not considered a viable alternative; obstacles cited included exchange-rate risk, a lack of intermediation partners, and exchange controls on financial flows.

TABLE 7: AVERAGE INTEREST RATES (NOMINAL - 1996)

	Bahamas	Bar- bados	Belize	Domi- nican Repub.	Guyana	Haiti	Jamaica	OECS	Suri- name	Trinidad & Tobago
Inflation	1.4	2.4	6.4	13.0	4.5	20.6	21.5	2.0	-0.7	3.4
Prime loan rate	6.8	10.0	16.3	15.0	17.8	24.0	44.0	10.3- 12.3	27.0	15.8
Deposit rate	5.1	5.2	9.1	8.0	10.5	13.0	25.2	4.0- 7.0	12.0	7.7
Lending spread	1.6	4.8	7.2	7.0	7.3	11.0	18.8	6.3	15.0	8.1

Source: IMF, International Financial Statistics; and miscellaneous.

³See, The World Bank (1997) for a general discussion of the benefits of financial integration.

Efficiency and stability of the financial sector

Fragmentation and isolation also results in small financial sectors and small financial institutions. The higher operating costs (relative to the value deposited) of smaller financial institutions means worse terms for borrowers and depositors: high costs are one reason for the relatively large lending spreads (see Table 7). Other reasons include the effect of high reserve requirements on banks' returns and the effect of non-performing loans on relatively small portfolios. It is conservatively estimated, based on available data, that at least 10% of loan portfolios in the Caribbean on average, are in non-performing status -- this ratio is over three times higher than that of the larger industrialized country (OECD) banks, and was one of the factors which in South East Asia adversely contributed to that region's recent financial crisis, given the subsequent economic slowdown which resulted in widespread defaults.⁴ The financial institutions in the region that are branches or subsidiaries of large multinationals have lower costs because they generally share in the economies of scale of the parent institution. However, the *diseconomies* of small scale are severe for the many indigenous financial institutions, which are frequently extremely small by international standards.

Fragmentation and isolation also reduces competition, another reason for the relatively large lending spreads. It also reduces potential diversification for small indigenous financial institutions. Because their lending is largely limited to the local economy, the covariance of default risk on their loans is high. A shock to the local economy, a common occurrence, is likely to lead to simultaneous problems with a large proportion of an institution's loans. This also explains the higher levels of liquidity which banks in the region keep -- if loan assets are more risky, prudent banks will tend to diversify into shorter-term liquid assets for protection.

The ability of the financial sector to mitigate risk

Fragmentation and isolation are also harmful because they prevent the financial sector from mitigating risk to depositors. As noted, this is a function of special importance in the region. A recent study of the United States economy illustrates how the financial sector can help to mitigate risk.⁵ It investigated the mechanisms that enable residents of individual United States to maintain their consumption in the face of shocks to their state economies. It found that the most important mechanism (smoothing 39% of shocks to state income) was the cross-ownership of productive assets. If households derive investment income mainly from productive assets in other states, a shock to one state's income has little effect on its own residents' investment income: the effect is spread out over other states. The second most important mechanism (smoothing 23% of shocks to state income) was borrowing from residents of other states and the sale to them of financial assets. In comparison, the federal government, through its system of taxes and transfers, smoothed only 13% of shocks to state income. In the Caribbean, however, risk mitigation in this sense remains insufficient, as most financial investments are held by institutions in the domestic economies, thus making such investments much more vulnerable to exogenous shocks.

Financial repression

Governments can suppress market-driven financial activity mainly through involvement in the financial system and by sub-optimal management of government finances. High unremunerated reserve requirements act as an effective tax on commercial banks that results, in most instances, in passing these costs on to customers. Reserve and liquid asset requirements, together with interest-rate and credit controls, have been the traditional instruments of monetary policy in the region. Central banks raise the level of these requirements to reduce bank liquidity, which tightens the availability of credit and reduces private sector spending. This moderates domestic inflation and reduces pressure for depreciation of the exchange rate. Barbados, Belize, and Suriname continue to rely on these instruments. In The Bahamas and the OECS on the other hand, central banks function in ways similar to currency boards, so that monetary policy in normal times is largely automatic and results from the accumulation of net foreign assets. The Dominican

⁴ Perry and Lederman, World Bank (1998).

⁵ Asdrubali, et al. (1996).

Republic, Guyana, Haiti, Jamaica and Trinidad and Tobago have all made efforts to switch from direct instruments of monetary control to indirect methods, with increasing reliance on open-market operations.

Governments are also directly involved in the financial system through ownership of various banks and financial intermediaries and through management of social security reserve funds. It is recognized that in particular instances, government involvement may have indeed spurred the development of successful indigenous industries which might have otherwise had little or no access to funds. Nevertheless, governments also impact on the activities of private financial institutions through "moral suasion" to lend to favored projects, or through other means including: interest-rate and credit controls; taxes on financial intermediation; and exchange controls, especially on capital movements. Lending based on non-commercial criteria, particularly undermines economic efficiency and the stability of the financial system, through accumulation of bad debts. Taxes, restrictions, and requirements distort the financial system, alter the composition of financial institutions and instruments, and reduce efficiency and stability. This leads to a proliferation of non-bank financial companies set up to avoid the regulatory enmeshment requirements. Such companies, while attempting to intermediate at more reasonable costs, also tend to engage in riskier, unregulated lending. In addition, they at times compete unfairly with commercial banks, given their lower or absent reserve requirements on deposits. While some countries have taken remedial action by incorporating proportional reserve requirements for such non-banks, the non-bank sector still remains largely unsupervised.

Improving Financial Efficiency

Creating a *conducive* environment for financial development requires that governments remove impediments and address the problems identified above, including completing the process of domestic financial liberalization, removing obstacles to financial integration, and strengthening regulation. Increased efficiency in the region's financial sectors, supported by appropriate regulatory reforms, not only encourages the process of regional financial integration (by developing domestic competitiveness in financial services as a precursor to liberalizing the sector), but also promotes a process for regional financial institutions to become internationally competitive.

A prerequisite in every case is for governments to *ensure macroeconomic stability*. Besides the fiscal management issues that this implies, some of the direct effects on the financial sector from unstable macroeconomic conditions include interest rate distortions and asset instability due to inflation. In addition, deficit financing crowds out private credit availability and direct monetary control instruments such as high unremunerated reserve requirements, tax bank profitability and raise the overall cost of credit. Governments interact directly with the financial system at a various points, which they can more appropriately use to stimulate financial development. Affected areas include public sector borrowing, public provision of retirement income (especially if funded over the life of the would-be pensioners), and regulatory and supervisory practices. These are addressed below.

Financial Liberalization and Integration

Governments throughout the region have taken steps to reduce financial repression and liberalize their financial systems. CARICOM member countries have agreed to introduce free convertibility among their national currencies. In fact, free convertibility is already a reality in some countries. Moreover, Protocol II, which amends the treaty establishing the Caribbean Community in the areas of rights of establishment, provision of services, and movement of capital within CARICOM, has been signed by all member countries except The Bahamas and Montserrat. This Protocol addresses the problem of Alien Landholding legislation and thus, when implemented, would open the door for the free movement of capital within the region, an important determinant of an integrated financial market. Countries in the region with Alien Landholding laws (including most OECS countries) are in the process of reviewing these and redefining the term "alien" so that it does not hinder CARICOM nationals.

However, much yet remains to be done. Many direct controls and restrictions still impact activities of financial institutions, and the privatization of government-owned financial institutions is far from complete.

Interest-rate controls have been eased: In recent years, maximum rates on bank loans have largely disappeared, but many countries (Barbados, Belize, and the OECS) still have minimum rates on savings deposits. Similarly, there has been a significant easing of direct controls on the allocation of bank credit. Those that remain generally restrict lending to non-residents (e.g., in Trinidad and Tobago and the OECS). Exchange controls, too have been eased: see Table 10 below. Over the past decade, there has been a general reduction too, in required holdings of unremunerated reserves and specified liquid assets (these are usually interest-bearing deposits at the central bank, and government securities). The trend can be seen from Table 8. However, Table 8 also shows that levels of required reserves and liquid assets remain relatively high. There are two obstacles to further reduction: the fiscal cost of utilizing alternative instruments of monetary policy, and the need to supplement these costs with a larger overall revenue effort.

TABLE 8: INDICATORS OF FINANCIAL REPRESSION

	Baha- mas	Bar- bados	Belize	Domi- nican Repub.	Guyana	Haiti	Jamaica	OECS	Suri- name	Trinidad & Tobago
<u>Reserve/deposit ratio indicators %:</u> 1996 Legal Requirement (cash & liquid assets)	15	25	26	20	15	26	47	6	23	24
1996 Actual cash reserves ⁶	6	11	11	22	21	35	28	10-13	25	19
<u>Share of bank credit to the public sector %:</u> 1985	14	22	18	19	74	3	34	12-47	15	14
1996	13	32	7	10	34	0.1	31	10-33	2	22

Source: IMF, International Financial Statistics.

Requiring banks to hold reserves and liquid assets usually forces them to lend to the government at below market rates, either directly or through the central bank. Removing these requirements therefore increases the interest cost of public debt, which is not an attractive prospect for governments under severe budgetary pressure. For example, Jamaica had greatly reduced its reserve and liquid asset requirements by 1988, but was forced to raise them sharply as a result of the fiscal (and monetary) impact of Hurricane Gilbert in 1989; requirements have remained high since, and the fiscal demands of the current financial crisis make their early lowering unlikely.⁷ Making the financial sectors of the Caribbean robust, will require eliminating direct borrowing from the central bank and reducing reserve requirements to allow banks to lend at internationally competitive rates. Where governments have relied on captive finance from the banks, fiscal adjustment must precede and/or accompany liberalization.

TABLE 8A: MONETARY AUTHORITIES' NET FOREIGN ASSETS (NFA) AS % OF M2

	Bahamas	Bar- bados	Belize	Domi- nican Rep.	Guyana	Haiti	Jamaica	OECS	Suri- name	Trinidad & Tobago
NFA / M2	8	23	19	6	-27	17	30	13-19	51	29

1996. Source: International Financial Statistics.

⁶Includes bank margins for non-mandatory reserves maintained for fund clearing purposes.

⁷See Gulde, et al. (1997).

While unremunerated reserve requirements should be reduced in order to minimize taxation⁸ of the financial sector, requiring a cushion of 'remunerated' reserves would be prudent for small economies in vulnerable economic environments. Such remunerated reserves should not be limited to domestic government debt -- hard currency reserves or securities would be beneficial -- and the required level should be raised during boom times to provide scope for lowering them in the event of future economic shocks. One additional lesson emanating from the recent South East Asian crisis, was the lack of banking foreign exchange reserves, which in that instance, provided an insufficient cushions to cover maturing foreign exchange liabilities.

Open-market operations -- the central bank's purchase and sale of government securities in a free (open) market, have proven to be beneficial for financial sector development. The effect of such purchases and sales is to decrease or increase, respectively, the monetary base available for bank reserves and thus the ability of banks to expand their lending. In principle, purchases and sales of any securities will do, but it is important that the securities be traded in a free market. This allows their price (the interest rate) to provide both the central bank and the economy with an indicator of the stance of monetary policy. As a rule, central banks conduct open-market operations in the market for T-bills (short-term government securities). In most cases, this is the largest and most liquid securities market. If the central bank has a clear mandate to focus on currency and monetary stability, then by using open market operations the government creates for itself an environment that encourages good fiscal management.

Countries in the region must overcome several obstacles in order to switch from direct to indirect instruments of monetary policy. The first is the absence in most, of a relatively free market in government securities in which the central bank could conduct open-market operations. Jamaica and Trinidad and Tobago are the only countries that approximate such markets, though Barbados and Guyana have recently successfully used Treasury bills to absorb excess liquidity. Some central banks have substituted for the lack of a government securities market by selling their own paper: the central banks of the Dominican Republic and Haiti do this at their own expense, however. The second obstacle by way of switching to an indirect monetary policy is the fiscal cost. Having to pay free-market interest rates, whether on T-bills or on central bank bills, generally raises the cost of government borrowing. A government under fiscal pressure will find it difficult to bear the additional cost.

Creating macroeconomic stability

Macroeconomic stability in the region has improved significantly in the last decade, but in some countries considerable uncertainty remains about the future -- in particular, about future exchange rates. Countries with fixed exchange rates account for only about 25% of regional GDP (40% for the English-speaking Caribbean). Except for Jamaica and Suriname, floating exchange rates also have been relatively stable in the last three years, but their continuing stability depends on the determination of the countries to maintain sound fiscal policies.

The ECCB has been successful in promoting macroeconomic stability in the countries of the OECS and in supporting a credibly fixed exchange rate. An independent central bank, by eliminating the option of monetizing fiscal deficits, has promoted the necessary fiscal discipline. This macroeconomic stability has facilitated capital inflows, especially foreign direct investment (see Table 9).⁹ The success of the ECCB model has inspired plans for region-wide emulation. In 1992 the CARICOM Heads of Government adopted a plan for a Caribbean Monetary Union, under which member countries would share a common currency to be administered by a regional central bank, the Caribbean Monetary Authority. The plan was

⁸Countering this argument, there is the proposition that, given the monopolistic/oligopolistic nature of the banking industries in small economies, the reserve "tax" actually brings banking profitability down to an equilibrium level and serves the economic interests of the public in terms of the resulting price of banking services. However, insufficient analysis of this proposition exists to determine whether the "taxing" effect does indeed result in a more optimal equilibrium or whether it has more beneficial effects versus the potential distortionary impacts of high reserve requirements.

⁹McCarthy and Zanalda (1995) documents the superior macroeconomic performance of the ECCB area and attributes to it higher rates of economic growth.

recast in 1993, however, because Trinidad and Tobago decided to float its exchange rate, and the rates in major floating rate countries were volatile.¹⁰ The process is currently focusing on achieving suitable macroeconomic convergence, and restoring convertibility of the currencies in the region.

Partial dollarization has already occurred where the value of the local currency is uncertain¹¹. For example, in Haiti, Trinidad and Tobago and Jamaica, about 25% of bank deposits are denominated in US dollars. (Banks seem to be lending in local currency against these deposits, bearing the exchange-rate risk themselves – a highly dangerous practice.). In countries with significant tourist industries, US currency circulates freely. Credible commitment to exchange-rate stability and fiscal discipline would facilitate financial integration¹².

TABLE 9: CAPITAL FLOWS AND FOREIGN DIRECT INVESTMENT (AVER. 1991-93)
(% of GDP)

	Bahamas	Bar-bados	Belize	Domi-nican Repub.	Guyana	Haiti	Jamaica	OECS	Suri-name	Trinidad & Tobago
Net capital inflows	2.0	-1.3	5.3	-0.6	18*	-1.1	7.3	16	-0.4	-1.6
Direct investment	0.4	0.6	2.6	1.6	22*	na	3.2	10	-0.4	4.9

Source: IMF, International Financial Statistics

*1992-3

The Transactions Infrastructure

A sound *payments system* is important for mitigating financial risk. Financial transactions are particularly sensitive to transactions costs, and an inadequate payments system can raise these costs significantly. The most detailed evidence available is on the OECS, and the state of technology, compared to the volume of financial transactions, is not reassuring. While check-clearing within each country in the sub-region is generally efficient, inter-country clearing is inefficient: for checks; delays of up to two weeks are common and collection charges very high. Checks drawn in US dollars often face delays of up to six weeks and collection charges in excess of 50%.¹³ If this picture is at all typical of inter-country payments in the rest of the Caribbean, it represents a serious barrier to integration and to adopting common financial operating standards in the region and internationally.

Removing specific legal and regulatory barriers

Restrictions remain in many countries on the foreign ownership of financial institutions, non-financial businesses, and land (see Table 10), although there are far fewer restrictions today than there were a decade ago and some of the existing restrictions are routine licensing requirements. Exchange controls on capital transactions have been removed in many countries, and where they remain are often not very restrictive. Governments are well aware of the importance of further liberalization and several are in the process of doing this.

TABLE 10: RESTRICTIONS ON FOREIGN INVESTMENT AND LAND ACQUISITION

	Bahamas	Bar-bados	Belize	Domin. Repub.	Guyana	Haiti	Jamaica	OECS	Suri-name	Trinidad & Tobago
Foreign ownership restrictions: financial institutions	Y	Y	N	Y	N	N	N	N	N	Y
Restriction on foreign ownership of other businesses	Y	Y	N	Y	N	Y	L	N/Y	Y	Y
Restrictions on foreign ownership of land	Y	N	Y	Y	N	na	N	Y	Y	Y
Exchange controls on capital transactions	L	L	L	N	N	na	N	L	Y	N

Sources: (1994) Table 3.1, IMF

Y: yes.

L: yes, but liberal.

N: no.

¹⁰See Chuppe and Shirley (1996) for a history of plans for the Caribbean Monetary Union.

¹¹Anthony and Hallet (1997) argues that dollarization is a more promising approach.

¹²See The World Bank, (1997) for a general discussion of the prerequisites for successful financial integration.

¹³Commonwealth Secretariat, et al (1997)

Differences in legal and regulatory structures and business practices across countries impede cross-border activity, both financial and non-financial. Harmonization of laws and regulations is therefore highly desirable. Indeed, efforts are being made in this direction within the framework of CARICOM (and the OECS). There are currently projects to harmonize bank regulation and supervision, financial reporting, securities regulation, and taxation.

Steps towards financial integration within the region should not be seen as a substitute for full international integration but rather as a first step towards that goal. The inevitability of full international integration is underlined by the December 1997 agreement of the World Trade Organization on the eventual removal of barriers to free trade in financial services. As noted, a prerequisite for successful international integration is a healthy domestic financial sector. Financial integration intra-regionally can help the region meet that prerequisite.

RECOMMENDATIONS

While much additional work and diagnostics for designing institutional reform efforts are needed, the following identifies key programs for consideration by regional governments to undertake projects supporting transparent and sound financial sector practices and norms. These measures would help promote sustainable long term investment and allow better capital mobility in the economies:

A. Macroeconomic Measures and Management of Public Finances

To ensure sound operation of the financial sector, governments need to focus on fiscal discipline and macroeconomic stability as a first step in reducing public sector dependence on the financial sector, in the form of either credit absorption or direct controls on the banking system. The following steps would support this process, while providing financial institutions additional leeway for investing their capital in productive economic investments:

(i) Strengthen public budgeting and monitoring systems with implementation of public sector delivery indicators. This will augment governments' capacities to evaluate public expenditures and assure adequate economic returns on public investments and services. It will also promote fiscal sustainability while supporting private sector activity. Capacity building in these areas has been undertaken in number of countries and a few programs of this type are in effect in the Caribbean.

(ii) Reform the tax collection process and institutions. This, coupled with incentives such as phased lowering of corporate tax rates and reductions in bank reserve requirements, will provide momentum for achieving higher revenue proceeds. Computerization of the tax administration system will allow the authorities to more easily verify expected versus actual tax proceeds from economic activity. Such efforts can be modeled on existing projects on-going in a number of countries.

(iii) Institutionalize and strengthen management of both external and internal debt. This should link to the budget process, to ensure sound fiscal management and enforcement of limits for contracting debt to finance fiscal expenses. As part of achieving macroeconomic stability, the prudent management of public sector debt will (a) encourage private domestic investment activity within a less constrained financial system, and (b) lower sovereign risk (as assessed by external creditors/investors), allowing an increased supply of external funds to finance new investment in productive enterprises.¹⁴

¹⁴This of course should not imply stand-alone real estate investments which, as evidenced from the South East Asian crisis, and previous US experience, can easily lead to inflated asset values and subsequent loan defaults.

B. Harmonization of Financial Sector Norms with Supporting Regulations and Institutions

Harmonization of financial sector and related regulations in a number of areas is needed. While the OECS countries have implemented this at the banking sector level, and the CARICOM group of countries has pledged to achieve harmonized legislation in this regard, much is yet to be done. Movement towards implementation of the Basle core principles for effective banking supervision should be given priority -- initial steps which take into account the characteristics of the region's financial sectors are listed:

- (i) Apply consistent technical definitions of non-performing assets (using the 90-day non-accrual rule) and proper and consistent classification of loans for provisioning purposes. This will require an adequate banking inspection capacity as well as implementation by the private audit profession, of portfolio sampling techniques to verify compliance during the annual audit process.
- (ii) Lessen or remove legal barriers to landholding. The restrictions on majority ownership of financial institutions and equity in domestic companies hinder investment flows into the economies, and help maintain fragmented markets.
- (iii) Establish clear foreclosure and bankruptcy proceedings under special-purpose judicial/court procedures. Lack of legal recourse for compensation by defaulting borrowers or bankrupt institutions undermines the solidity of the financial system by obviating any realizable collateral, and thus effectively increases the riskiness and solvency of lending portfolios.
- (iv) Establish efficient registries for companies, properties and deeds. This will facilitate transfer of ownership transactions, which are crucial for the efficiency of the financial system and the legal recourse to collateral in the form of real property or financial securities. Manageable and effective projects supporting the financial sector include modernization and computerization of registries, with the upgrading of technical staff.
- (v) Modernize the payments and settlement systems, to provide better transaction guarantees in the financial system. International experience and automated payment mechanisms are available for application in the Caribbean context. Upgrading of this aspect of the payments infrastructure will not only encourage confidence for integration of the Caribbean financial systems, but also with the international financial credit markets. In addition, more reliable and transparent transactions in other sub-sectors such as the securities markets (both fixed income and equity) require prompt confirmation of ownership changes, and subsequent electronic payment verification.

V. FINANCIAL SECTOR STRUCTURE: REGULATION FOR RISK MITIGATION

Commercial banks dominate the financial sector in all the Caribbean countries. The health of commercial banking is, therefore, of vital concern. Before making some recommendations, a review of the structure of the industry and the state of regulation and supervision is presented.

THE STRUCTURE OF THE INDUSTRY

Banking is relatively well developed in the region. Table 5 showed that the ratio of domestic bank credit to GDP is generally high—comparable to that in the financially more developed Latin American economies. The numbers are lower in the Dominican Republic, Haiti, and Jamaica, partly as a result of inflation in these countries (although the number for Jamaica understates the true size of the sector because of the importance of banks' near-bank subsidiaries and affiliates, created to avoid regulatory costs). Some indicators of the structure of the industry are shown in Table 11.

TABLE 11: STRUCTURE OF COMMERCIAL BANKING

	Bahamas	Bar- bados	Belize	Domi- nican Repub.	Guyana	Haiti	Jamaica	OECS	Suri- name	Trinidad & Tobago
	1996	1994	1995	1997	1996	1997	1992	1996	1997	1997
No. of indig. banks	3	2	1	13	4	12	8	18	4	3
No. of foreign banks	7 ¹	5	3	2	3	2	3	6	2	2
Total no. of banks	10 ²	7	4	15	7	14	11	24	6	5
Total no. of branches	na	na	na	na	23	68	201	na	na	117
Largest 3 banks share of assets	na	70%	na	60%	79%	45%	64%	na	85%	58% ³

Source: Miscellaneous.

¹Additionally, there are some 400 active foreign banks engaged purely in offshore business.

²Resident banks dealing only in Bhs\$.

³ Early 1990s.

Foreign banks

Foreign banks are present in all countries in the region, but they have the largest presence in the banking sectors in Barbados, Belize, and the OECS. Their presence in other countries is more modest not because they have been excluded. With the exception of Jamaica and Trinidad & Tobago, which pursued active policies of localization in the 1970s and 1980s, there have been no significant barriers to entry of foreign banks. Rather, foreign banks have withdrawn from many countries in the region because of lack of profitability – the result of financial repression, diseconomies at the operational scale, and macroeconomic instability. It is no coincidence that the presence of foreign banks is strongest in those countries with the least financial repression (see Table 8) and with the greatest macroeconomic stability, and where branch banking is permissible (see Table 4).

Indigenous banks

There are some 60-70 indigenous banks in the region. A few are of medium size (assets of over US\$1 billion), some are small (US\$100 million - US\$1 billion), and most are very small (under \$100 million).¹⁵ Because banking is subject to significant economies of scale, the small size of most indigenous banks is a serious economic handicap. A large part of a bank's costs are indivisible fixed costs – for example, the bank's offices and equipment, management, and specialized personnel. Amortizing these fixed costs over a small volume of business makes for higher average operating costs. Additional financial benefits of scale include large pools of deposits that provide better liquidity, and large portfolios of loans that are better diversified and so less risky. Better liquidity and lower risk both reduce costs and increase bank safety.

¹⁵Clarke (1997) lists 30 indigenous banks in the region of which 2 are of medium size (Republic Bank and Royal Bank, both of Trinidad and Tobago), 12 are small, and 16 are very small.

Conscious of these economies of scale, indigenous banks are undergoing consolidation – most notably in the Dominican Republic and in Trinidad and Tobago. In countries that have encouraged localization of banking, banking laws have often been amended to facilitate mergers. Of course, consolidation, while it offers potential economies of scale also increases concentration, which may restrain competition. There is no anti-trust legislation to prevent this.

Some indigenous banks have attempted to capture economies of scale by expanding into other countries in the region. The most active in this respect have been the Trinidad & Tobago banks, which have established a presence in Barbados and the OECS, as well as in the Caymans, St. Maarten, Venezuela, and recently Guyana. One Jamaican bank has established a presence in Guyana and in the Caymans. A few banks in the OECS have established a presence in territories outside their own. Nonetheless, the extent of cross-border activity of the indigenous banks remains small. Bankers complain that the process of licensing and approval involves too much red tape and that it is not sufficiently transparent: the authorities have too much discretion in allowing, or not allowing, entry.

Economies of scope

Economies can also be achieved by combining banking with other financial activities. There is a tendency in the region towards expanding the scope of banking activities. This is partly the result of regulatory changes that expand the range of permitted activities (e.g., in the Dominican Republic and Trinidad and Tobago). In the Dominican Republic, regulators have tried deliberately to create universal banks. The expansion of banking activities is also the result of the development of financial conglomerates that include both bank and non-bank financial institutions. In Jamaica, Trinidad and Tobago, and the Dominican Republic, the countries with the largest and most dynamic indigenous banks, most banks are part of financial conglomerates that include a variety of other financial institutions (finance companies, merchant banks, building societies, trust companies, insurance companies). Banks in these countries have been trying to become “one-stop financial supermarkets” and have been quite innovative in creating new financial products (e.g., banks in Trinidad & Tobago offer retirement savings plans that are very similar to the annuities offered by insurance companies). Several are themselves offering collective investment vehicles such as unit trusts, which in larger economies are often specialized entities in their own right. Making such economies of scope explicit will actually facilitate and centralize supervisory oversight, thus avoiding cross-ownership risks from institutions under separate regulatory jurisdictions (as became evident in Jamaica in 1995-97, and in South East Asia during 1997-98).

Government ownership

Although new indigenous banks continue to spring up, most were founded in the 1970s and 1980s, either *de novo* or by localization of foreign banks. Many indigenous banks were established by governments in response to what they saw as the failings of the foreign banks: a preference for financing trade rather than “productive” enterprise, a preference for short-term lending, and an unwillingness to lend to small enterprises. However, these “failings” generally reflected prudent and profitable banking practice. Some of the indigenous banks require government subsidies and other support. Many adjustment and reform programs in the region since the 1980s have included privatization of state-owned banks: Bank of Bahamas (1994-5), Guyana Bank for Industry and Trade (1991, 1994), National Bank for Industry and Commerce (Guyana, 1985, 1997), National Commercial Bank of Jamaica (1986, 1993), Workers Savings and Loan Bank (Jamaica, 1991), National Commercial Bank of Grenada, and National Commercial Bank of Trinidad & Tobago (this latter one was merged with two other indigenous banks).¹⁶

Nonetheless, government ownership of commercial banks remains significant, especially in Suriname and some of the OECS countries. It is striking to observe the extent to which local majority ownership in many Caribbean banking sectors is in fact synonymous with state ownership and control, as opposed to local private or public ownership. This is particularly noticeable in most of the OECS countries, in Suriname, and to some extent Guyana. A marked exception to this phenomenon, however, is in Trinidad &

¹⁶Clarke (1997)

Tobago and the Dominican Republic, where most indigenous banks are privately owned. One implication of this for the region is that there still appears to be some scope for privatization in the region's banking systems, with the prospect of both new foreign entrants and greater local shareholder participation.

Some of the privatizations to-date have been only partial, with governments retaining a substantial interest, and many institutions are still wholly owned by governments. Data on the Caribbean region's current share of state-owned banks is limited, but based on available statistics, that share is unlikely to be higher than the average for Latin America (circa 36%). Financial liberalization requires that full privatization be achieved as rapidly as possible: state-owned banks everywhere play a disproportionate role in bank insolvencies and banking crises.¹⁷

Regulatory Arbitrage in the Financial Sector

Financial repression has greatly increased the cost of commercial bank intermediation -- getting funds from ultimate lenders to ultimate borrowers via commercial banks. As a result, in a number of countries, a significant fraction of lending and deposit taking has been redirected to avoid these costs. There has been both re-intermediation -- indirect lending through financial intermediaries other than banks -- and disintermediation -- direct lending by ultimate lenders to ultimate borrowers that does not pass through the balance sheet of any financial intermediary (one example is the significant growth of commercial paper in Jamaica and the Dominican Republic, and to a lesser extent Trinidad & Tobago in recent years). Often, the commercial banks themselves have orchestrated both re-intermediation and disintermediation.¹⁸

Near banks (non-banks)

In several countries, most notably Jamaica and Trinidad & Tobago (but also the OECS), banks have established non-bank subsidiaries (near banks) in the form of trust companies, finance companies, building societies, etc. These differ from banks principally in that they do not accept transaction deposits (in some cases, their time deposits must be of a certain minimum maturity--for example, one year in Trinidad & Tobago). Near banks are subject to less stringent regulation and to less onerous reserve and liquid asset requirements. Banks use their near-bank subsidiaries to raise funds at lower cost and to support their longer-term lending (principally mortgage and installment credit). In addition to those near banks established by commercial banks, there are also independent near banks -- most notably, in the Dominican Republic, with its large number of 'financieras', but also recently in Haiti and, to a lesser extent, in other countries. These independent near banks have often exerted competitive pressure on the commercial banks and their associated near banks.

The money market

Banks can also avoid regulatory costs by taking their lending 'off balance sheet'. For example, rather than taking in deposits and making loans, they can help their borrowers sell commercial paper directly to investors. They help by guaranteeing and placing the paper. Since such transactions do not appear on the bank's balance sheet, they avoid the regulatory impositions of intermediated lending, lowering costs for borrowers and raising returns for lenders. The bank still profits, but from fees and commissions rather than from lending margins. The bank, if it guarantees the paper, is still at risk if the borrower defaults. Moreover, since banks tend to direct their best borrowers to the commercial paper market, the average quality of the loans that remain on their balance sheets tends to be lowered by the practice. The money market is most developed in Jamaica, where banks guarantee some 90% of the commercial paper and banker's acceptances issued. Banks also issue their own paper (CDs) in this market. Banks and money market brokers place the paper, and brokers offer money market mutual funds to investors. There are more limited and less well organized markets for commercial paper in Trinidad & Tobago and in the Dominican Republic. In the OECS, some non-financial firms offer commercial paper directly to investors. This market, however, is virtually non-existent in Haiti, Belize, and Suriname.

¹⁷The World Bank (April 1997) notes that in Latin America the proportion of non-performing loans is commonly much higher for state-owned banks. This is generally equally true for several Caribbean banks.

¹⁸In addition, banks in Haiti have responded to financial repression by switching their deposits to US dollars, such deposits not being subject to the same reserve and liquid asset requirements.

Competition

The lack of competition and the diseconomies of small scale combine to produce high operating costs and large lending spreads. In 1992 the ratio of operating costs to total assets averaged 20% in Jamaica, 11% in Trinidad & Tobago, and 10% in Barbados; lending spreads (in 1996) were 18.8%, 8.1%, and 4.8% respectively.¹⁹ In comparison, in Latin America operating costs averaged 3.0-8.5% and lending spreads 5.1-9.2%; in the Asian NICs and the OECD, operating costs averaged 0.8-3.7% and lending spreads 1.1-3.0%.²⁰

Regulation and Supervision

In most Caribbean countries, the responsibility for regulation and supervision of commercial banks rests with the Central Bank. In the OECS, the Ministry of Finance of the individual territory regulates, while the ECCB (the common central bank) supervises. In the Dominican Republic there is a separate agency responsible for bank supervision (the *Superintendencia*) outside of the central bank or monetary authority. Regulation and supervision in the region have improved in recent years: dates of major recent banking legislation are shown in Table 12. A regulatory harmonization project jointly sponsored by the IMF and the CARICOM Central Bank Governors standardized supervision practices. This covered the areas of: regulatory framework; capital and other prudential criteria; loan classification & loss provisioning guidelines; supervision of offshore banks; training of regional inspectors; deposit protection and on-site & off-site inspection procedures. In countries in which offshore banking is important (The Bahamas, Barbados, Antigua & Barbuda) there are concerns about money laundering, and some have tightened regulation and supervision of offshore banks.

TABLE 12: IMPROVEMENTS IN REGULATION AND SUPERVISION

	Bahamas	Barbados	Belize	Dominican Rep.	Guyana	Haiti	Jamaica	OECS	Suriname	Trinidad & Tobago
Major legislation	na	1992, 1997	1996	1992, 1996	1991, 1995	pend-ing	1992	1990-1991	pend-ing	1986, 1993

Source: Miscellaneous.

Regulation of Near Banks

An important regulatory issue has been the treatment of near banks. In the past, these have generally been either unregulated or subject to much less stringent regulation than commercial banks, with supervision outside the responsibility of the central bank. This situation, coupled with the financial repression of commercial banks, has led to an explosion of near banks, as discussed above. In the countries where this phenomenon has been most pronounced (Jamaica, Barbados, the Dominican Republic, and Trinidad and Tobago), recent legislation has extended banking regulation to near banks and given the central bank the power to supervise them. In other countries, such as Haiti, Guyana, the OECS, and Suriname this remains to be done. As recommended in the previous chapter, the technical reserve requirements for near banks should, at a minimum, be equivalent to that of banks in terms of the proportional reserves required on time deposits held by both banks and near banks. While not presently a problem, this will prevent institutional arbitrage and ensure a consistent regulatory playing field. It could also avoid unmonitored accumulation of potential short term foreign exchange liabilities, one of the primary causes of the South East Asian crisis.

The Offshore Banking Sector

There is much interest from Caribbean governments in developing the offshore sector as a means of augmenting fiscal revenues. Offshore banking is generally set up under three alternative arrangements in

¹⁹See Williams (1996) and Table 7 above.

²⁰Goldstein and Turner (1996).

the host country -- these include: (a) accounting/legal 'brass plate' banks or trust accounts, (b) specialized deposit centers which hold only foreign currencies, and (c) domestic or branch banks which manage both offshore as well as domestic deposit accounts. The latter option, while providing additional employment and transfer of know-how to the domestic economy in addition to offshore licensing fees, also requires more intense supervision to prevent among other issues, the potential for money laundering. The British Virgin islands, the Cayman islands, and The Bahamas have well developed offshore industries supported by prudent regulations and robust supervisory capacities. While development of the offshore sector is an attractive proposition for many countries, the competitive drive to gain additional market share in the industry should be mitigated by development of prudential norms and safeguards to avoid infiltration of illicit funds. These efforts should be coupled with adequate supervisory capacities, and adoption of regional regulatory standards in line with those used by the well established offshore centers. This would ensure prudent segregation of offshore activity and maintain safe functioning of domestic financial systems.

Experience with Banking problems

The region has had its share of banking problems. In the 1980s, several commercial banks and other financial institutions in the Dominican Republic collapsed, with significant losses to depositors. Trinidad and Tobago, too, experienced a crisis in the 1980s: seven finance companies were closed by the central bank and two banks restructured. In 1997, several unregulated underground banks in Suriname succeeded in attracting, over a short period, deposits of some US\$100 million (equivalent to half the amount deposited with commercial banks or 20% of GDP). Their popularity was due to the rates they were paying – about 10% per month. Unfortunately, the high rates proved to have been sustained by a pyramid scheme and the institutions have collapsed. In Jamaica, the current, continuing crisis began in 1994 and has involved an increasing number of the country's financial groups: both banks and insurance companies have failed.

The response to these crises, and to the occasional bank failure in other countries (Barbados, the OECS) has varied. In a few cases, depositors have taken losses, but generally they have been compensated at taxpayer expense (often, however, only after considerable delay). In Trinidad & Tobago, the crisis led to regulatory reform and to the establishment of formal deposit insurance. In Jamaica, the government has committed itself to compensating all depositors. The cost to date is some US\$700 million, with additional short-term costs estimated at US\$500 million (totaling over 20% of GDP); there are likely to be additional costs in the long term. These arrangements have been executed under the Financial Sector Adjustment Company (FINSAC), the Government's financial sector resolution agency which has been key in implementing a number of actions to stem the crisis, including: (i) prompt legislative reforms strengthening the prudential norms, (ii) conducting forensic audits to determine fraudulent activities, (iii) injection of fresh capital into ailing institutions, funded primarily via the issuance of FINSAC/Government bonds, (iv) assuming controlling equity ownership and/or Board seats in the affected institutions, (v) executing institutional and financial restructuring & rehabilitation programs, and (vi) at a future phase, divesting the rehabilitated institutions through resale to the private sector. The servicing of the resulting debt, however, is already absorbing over half of government revenue. A deposit insurance scheme is also being developed to avoid future moral hazards and clearly define the limits of depositor protection.

Banking problems in the Caribbean have the same origins as banking problems elsewhere. A recent study of 29 banking crises in different countries found that "...in all of them, deficient management, faulty supervision and regulation, government intervention, and/or some degree of connected or politically motivated lending are cited as *primary* factors behind bank insolvency".²¹ The study also found that macroeconomic instability, while not the fundamental cause, was often the proximate cause of collapse. These factors (connected lending, weak supervisory oversight, and external macro accounts), while not the only causes, also played key roles in the development of the South East Asian crisis. Since the Caribbean is subject to an unusual degree of external shocks, systemic problems are more likely to result from the structural weaknesses noted earlier: small, indigenous banks with undiversified portfolios that are heavily

²¹Caprio and Klingebiel (1996), italics in original. See also Goldstein and Turner (1996).

dependent on the local economy; significant government ownership of banks and influence over lending decisions; financial repression, and the proliferation of near-bank and other financial subsidiaries that are not subject to sufficient regulation and supervision.

The limits of regulation and supervision

In trying to ensure a safe and sound banking system, it is a fundamental error to rely on regulation and supervision alone. If the banking system is structurally vulnerable and if the economic environment is highly volatile, no amount of regulation and supervision can prevent banking problems. Minimizing macroeconomic volatility through sound fiscal and monetary policies, is the basis for a sound financial sector. It is no coincidence that the economies that have achieved macroeconomic stability also have the healthiest banking systems.

Improving the structure of the banking system

There are three elements to strengthening the region's banking system: consolidation of the indigenous banks; privatization of state-owned institutions; and increasing the presence of non-regional foreign banks. Regarding consolidation of the indigenous banks, the economics of banking is inescapable - larger banks tend to be safer and more efficient. Consequently, banking systems, when allowed to do so, undergo a natural process of consolidation. This is happening today, as barriers are removed, in the United States and in Europe. Obstacles to consolidation should be removed, so that the process is made as easy as possible. As suggested, harmonization of banking regulation and licensing standards would allow branching, mergers, and acquisitions to take place with the minimum of difficulty. Another prerequisite for consolidation of the indigenous banks is privatization of state-owned banks.

Foreign non-regional banks: One key element in improving the structure of the region's banking system is increasing the presence of foreign banks. The large multinational North American and European banks are the most efficient and safest in the world. They can provide better banking services and at lower cost. Given the vital importance of banking to the rest of the region's economy, it should 'import' the best banking services available. Doing so has little cost in terms of jobs: foreign banks employ predominantly local personnel. The entry of foreign banks would spur consolidation of indigenous banks both directly and indirectly. Directly, acquisition of existing local banks is often the easiest way to enter a market. Indirectly, competition from foreign banks would increase the pressure on the remaining indigenous banks to improve their efficiency and safety through consolidation. Foreign banks, if allowed to do so, can also facilitate the integration of the region into the international financial system. With banks operating across national borders, however, the questions would arise (especially for the remaining indigenous banks) of which government would be responsible if the bank fails²². "Narrow deposits" could provide one solution: foreign banks would offer guaranteed narrow deposits in each country, backed by government securities of that country. Other liabilities of these banks would not be guaranteed (New Zealand has no deposit guarantees of any sort).

RECOMMENDATIONS

Because of its central role in the region's economies, the efficiency and stability of the banking system must be the primary goal of financial sector policy. In addition to continuing the pursuit of macroeconomic stability, this calls for: (a) structural reform of the banking sector, and (b) further improvement in regulation and supervision. Further work examining individual country requirements needs to be conducted to identify the appropriate regulatory reforms, though some specific mechanisms to achieve these objectives should include:

²²See Reserve Bank of New Zealand (1997) for details on inter-country cooperation in supervision. This document can be downloaded from <http://www.rbnz.govt.nz/fin/title1.htm>.

A. Capital standards for small banks

The goal in improving regulation and supervision has generally been to bring practices in the region up to 'international standards'. However, it is far from clear whether the standards of the developed countries provide a suitable model.²³ Regulatory standards appropriate for large banks in a stable environment are not stringent enough for small banks in a volatile environment. For example, the Basle standard for Tier 1 capital of 4% is much too low for the situation of Caribbean banks. OECS regulation recognizes this, requiring 8%, which many banks exceed voluntarily. Therefore, a technical analysis (including statistical trend analyses of loan performance) on the adequacy of risk-weighted capital standards in the region should be a current priority: this would provide better indications of specific regional risks which bank portfolios are subject to (e.g.: natural disasters, sectoral concentrations, cyclical effects), and allow bank supervisors to propose capital standards commensurate with experience in portfolio performance.

B. Reducing Sub-sector Arbitrage: Regulation of Near-Banks/Non-Banks

As seen earlier from table 6, near banks (non-banks) represent in number, a substantial portion of the financial sector, if not in asset size. In the Caribbean, the near bank industry is not subject to reserve requirements as is the banking industry (with a few exceptions such as Trinidad & Tobago, and Jamaica). This generates incentives for banks or major holding companies to set up near banks to attract customer time deposits while generally avoiding close scrutiny of their lending activities. A potentially larger problem is the fact that in most Caribbean nations (the Dominican Republic being a clear exception), near banks are not adequately supervised, if at all. Therefore, a priority for policy makers and supervisors must be to:

(i) Set up equivalent regulatory provisions for near banks with respect to their deposit-taking activities. As per the Trinidadian model, this should include applying proportional reserve requirements on time deposits of near banks, commensurate with similar requirements made on banks, and

(ii) Establish consolidated supervisory procedures (within the central bank) to monitor non-banks' portfolios, loan quality and balance sheets, alongside those of banks and their non-bank subsidiaries.

Changes in regulation are relatively straightforward and would prevent non-banks from attracting funds due to regulatory advantages and utilizing them for less than prudent lending activities (recall the issue of finance companies exposed to foreign exchange and real estate in Korea and South East Asia). Following revised regulation, however, is the need for generating institutional capacity to supervise and monitor such institutions. In this respect, the Dominican Republic provides examples where modernization and automation of supervisory procedures, allows regular monitoring of the non-bank sector.

C. Handling banking problems

The treatment of banking problems in the region is *ad hoc* and often inconsistent, with insufficient long-term planning.²⁴ Bailing out depositors at taxpayer expense is politically understandable in the heat of a crisis, but it creates expectations that governments will continue to bail out depositors in the future. This destroys incentives for depositors to monitor banks, encouraging riskier behavior on the part of managers and owners. Since guarantees are provided free of charge, they also represent implicit subsidies to banks.

Trinidad and Tobago is the only country that has replaced this sort of implicit guarantee with explicit deposit insurance. One advantage of doing this is that the extent of the guarantee can be clearly specified and *limited*. For example, small depositors can be covered but not large depositors: in Trinidad & Tobago, maximum coverage is US\$8,400 per depositor. A second advantage is that banks can be made to pay for the guarantee: in Trinidad & Tobago, all depository institutions pay a premium of 0.2% of covered deposits. A third advantage is that a well-managed deposit insurance scheme can eliminate the delays and uncertainty that characterize resolution of bank failures under the current *ad hoc* procedures. A remaining problem is that when banks do pay for deposit insurance, it is overpriced for the larger, safer banks and underpriced for the smaller, less safe ones. Historically, failures of small banks have been a strong force for consolidation of banking systems as depositors switched to larger, safer banks.

²³See Caprio and Klingebiel (1996) for a more extended discussion.

²⁴See Silverberg (1994) for a discussion.

Bank regulators and policymakers in the region need to develop clear, pre-announced policies regarding central bank roles in the event of banking crises. These might include: (a) explicit, but substantially limited levels of deposit insurance protection, (b) financial indicators of bank distress that would mandate central banks to close faulty institutions and/or replace management for restructuring purposes (i.e.: closure, exit, takeover policies), and (c) explicit and limited last resort financing facilities with above-market interest rates for solvent banks. Such defined measures and adherence to them, would encourage self-regulating market mechanisms, while limiting governmental liabilities that could lead to greater macroeconomic instability during periods of banking distress.

D. Regulation and Supervision - Harmonizing Bank Accounting Norms and Supervisory Cooperation

Much progress has been made in improving regulation and supervision in the region though some areas remain for further improvement. Despite adoption of Basle standards in many countries in the region, the treatment of non-performing loans varies greatly across countries. While application of the international standards for placement of loans in non-accrual status once past 90 days due, is becoming the norm, the classification of loans as 'doubtful' or 'loss' still remains subject to much judgment regarding the quality of security or collateral of borrowers. In this respect, banking supervisors need to take a more aggressive stance to coordinate regionally and assure consistent risk classifications standards, as well as to enforce prudent provisioning requirements during inspections of financial institutions with doubtful assets on their books. Increased central bank autonomy and independence is also required for enforcing such practices, particularly where tax authorities have incentives to maximize revenues and thus put pressure on banks to under-report losses or provisions.

The OECS provides a model for regional supervision and regulatory harmonization. In 1990-91, each member country passed a uniform banking law that delegated to the ECCB, the common central bank, the authority to supervise the country's banks.²⁵ Implementation of consistent regional regulatory norms and supervision practices throughout the region should be coordinated with institutions such as the Center for Economic and Monetary Studies of Latin America (CEMLA), and the Association of Bank Supervisors for Latin America and the Caribbean (ABSALAC) which includes the Caribbean Sub-Committee. There is ample best practice experience in these areas, and multilateral development institutions could also support regional initiatives to meet these objectives under the agenda of the Western Hemisphere Finance Ministers.

²⁵There is a long history in the region of schemes for regional cooperation in regulation and supervision. See The World Bank (April 1994) for details.

VI. LACK OF TERM FINANCE AND FINANCING FOR SMALL ENTERPRISES

Although banks in the Caribbean generally provide adequate short and medium-term financing, long-term financing is in short supply. Nevertheless, banks' excess liquidity in many markets is evidence of more than an adequate supply of funds for term finance. This points to a key issue and apparent failure in the financial/real sector nexus in matching investment and enterprise needs with appropriate financing sources. Banks do lend for 7 to 15 years, but almost exclusively in the form of mortgage loans. Additional long-term finance is provided by foreign direct investment (see Table 9) and some by contractual savings institutions, mainly against real collateral. This chapter, thus, addresses the issues and reasons why existing financial institutions have not undertaken the role of offering long-term and small enterprise finance, and identifies institutional structures which might be more appropriate for this purpose. Since this subject is discussed in the context of private sector financial institutions and their development, it does not address the financing activities of regional or international agencies (e.g.: CDB, IDB, IBRD, and donors) since these are government owned, and do not constitute a part of the region's domestic financial sectors.

Although six of the region's economies have set up or begun some level of stock exchange operations (Bahamas, Barbados, Dominican Republic, Jamaica, Suriname, and Trinidad and Tobago); their aggregate capitalization at the end of 1997 was less than US \$2 billion, less than 1% of all emerging markets. This source of potential long term financing for the region, while growing, is still far from effective. Businesses that lack mortgage collateral, as is often the case in the service sector, frequently finance long term by rolling over short-term bank credit: "permanent" overdrafts are the predominant form of business finance in Jamaica, Trinidad & Tobago, and Suriname. This practice is, of course, hazardous both to banks and borrowers. The lack of term finance is particularly acute for small businesses and for farmers. In the Dominican Republic the unavailability of long-term finance is one explanation for the decline in agriculture.

The shortage of term finance found in the region is a typical problem in developing countries. Caprio and Demirgüç-Kunt (1997) find that lack of term finance in the manufacturing sector is associated with lower productivity. The significance of this finding for the Caribbean may be limited, however, given the relatively minor importance of manufacturing in most countries (see Table 2) and the significant scale of foreign direct investment (see Table 9) which comes with its own funding. Nonetheless, an improvement in the availability of term finance seems a desirable goal. To improve the availability of term finance, governments need to address the root causes for its shortage. In the past, the shortage of term finance has often been seen as a consequence of "market failure" and the preferred remedy has been term lending by government-controlled development finance institutions (DFIs). It is now generally recognized that this approach has not been fruitful: Caprio and Demirgüç-Kunt also find that additional term finance when provided by governments has *no* beneficial effect on productivity. Moreover, the availability of government-sponsored finance at concessionary rates hinders the development of private lending.

The importance of macroeconomic stability

The greatest enemy of term finance is macroeconomic instability. Term finance involves a long-term contract between borrower and lender. Only when the future macroeconomic environment is relatively certain can the parties have some confidence that the transaction will be a beneficial one. Unexpected increases or decreases in inflation can transform a loan that seemed fair to both parties into a bonanza for one and a disaster for the other. Fixed and variable rate loans both have adverse consequences for lenders and borrowers respectively. Similarly, an unexpected economic contraction can convert a loan that appeared safe into one that is very risky. Consequently, in economies that have experienced great macroeconomic instability (such as Haiti, the Dominican Republic, and Jamaica), long-term loans are simply not made.

Facilitating the finance of small enterprises

Small enterprises, urban and rural, find it particularly difficult to borrow. It is essential, first of all, to realize that this is not a market failure: it is *normally* difficult for small enterprises to borrow given their high credit risk. Lending to small enterprises, particularly in the poorer low-income sectors, is extremely costly: credit information is poor; good collateral is often absent; and, because the cost of making a loan is largely independent of the size of the loan, the cost of making a small loan is high relative to the amount of the loan. Because lending to small enterprises is so costly it is generally uneconomical. Consequently, small enterprises and the lower income sectors of the economy, in developed as well as in developing countries, rely largely on their own internally generated funds and on informal finance.

Governments trying to make up for the "deficiency" in small-enterprise finance typically ignore the good economic reasons why there is so little of it. It is not surprising that government-sponsored programs such as DFIs which add the inefficiencies of an uncompetitive bureaucracy to an already uneconomic activity, have generally been unsuccessful. Having said this, it should be recognized that there have been some successes in the region's development banking activities (e.g.: Trafalgar Development Bank in Jamaica, Development Finance Limited (DFL) in Trinidad & Tobago, the Banco Dominicano de Desarrollo (BDD), in the Dominican Republic, as well the development banks of Dominica and St. Lucia). Nevertheless, it should be noted that these successes, particularly in the case of DFL, Trafalgar, and BDD, are for the most part due to the private ownership structure of those banks, and their strict adherence to commercially-based lending and investment criteria.

As with term finance, the most important contribution governments can make is to create a conducive environment. This means macroeconomic stability, an adequate legal framework, and freedom of the financial system from unnecessary constraints and burdens (e.g.: usury laws, interest-rate ceilings, directed lending, etc.). Given a conducive environment, appropriate financial institutions can emerge to meet the needs of small enterprises *to the extent possible*. Even in the best of circumstances, however, small businesses will continue to complain of inadequate access to finance. In general, commercial banks are *not* the appropriate institutions for financing small enterprises: their costs are too high and they lack the necessary capacity for close monitoring. Small entrepreneurs can raise some financing from banks through mortgages on their homes. Banks can also lend to small enterprise through leases, when the legal framework is adequate. Leasing seems to be important in Trinidad and Tobago.

Private development finance

There are in the region, especially in Jamaica and in Trinidad and Tobago, a number of private institutions that provide modest funding to small enterprises, including equity finance -- venture capital funds. Only limited information is available on these operations, but the venture capital seem to be going to mid-sized rather than micro enterprises. In Trinidad & Tobago, a venture capital program with strong fiscal incentives to participants was initiated in 1995, but has so far produced few final investment agreements. Although there is much enthusiasm for venture capital funds in the Caribbean, their potential seems limited. Venture capitalists invest in, and manage, a portfolio of young companies in the expectation of very large capital gains on a few of them. It is hard to conceive that there are many companies with this sort of potential in the region: there is no high-tech industry, and the small-size and fragmentation of the region's economies make rapid growth of service-sector companies unlikely, although in Trinidad & Tobago some venture firms have experienced a significant "deal" flow of proposals. Nevertheless, venture capital is a significant factor in only a very few countries, even within the OECD, and its success in those countries has not been easily emulated.

There may be room for some long-term private equity finance of companies that are not publicly traded. This type of finance is common in many countries as an outlet for some funds from contractual savings institutions. As contractual savings institutions continue to develop in the region, this type of equity investment may expand. Governments should not set constraints on these developments with excessively restrictive regulation on the types of assets permitted for these institutions. While prudential

portfolio limits should be set for the riskier investments, this does not justify the prevalent practice where public pension institutions hold mostly government paper, which generally accrues little or no capital gain and does not assist in transforming long term savings into productive long term assets. This issue is addressed in more detail in chapter VII.

RECOMMENDATIONS

Removing the obstacles to the availability of term finance and of finance for small enterprises should avoid following the traditional routes of government subsidies for directed credit which, based on experience, have not delivered the intended results. Rather, the approach should focus on regulatory effectiveness and supporting institutions which will generate an environment to allow private market transactions to generate the intended outcomes. Additional work and design of programs to effectively tackle these issues needs to be developed. In this context, the following recommendations are made:

A. The Legal System and its constraints on Term Lending

Lending, especially long term lending, requires the ability to create, improve, and enforce security interests. This means clear property rights, a functioning registry, and speedy foreclosure proceedings. These are even more crucial for more sophisticated forms of lending such as securitization and leasing. Lending also requires effective bankruptcy procedures. Deficiencies in the region's legal systems are a significant impediment to term lending, indeed to lending in general.²⁶ The civil-code countries (the Dominican Republic, Guyana, Haiti, and Suriname) often lack the necessary legal framework. Multilateral institutions are supporting efforts to improve the situation under a public sector development project in the Dominican Republic and private and financial sector projects in Guyana, as well a financial program in Haiti. There are problems too in the common-law countries: even where the necessary laws exist, long delays in the judicial process make lending to risky borrowers unattractive.²⁷

Thus, as recommended earlier, a first step would be to upgrade and modernize the Registrars of companies, deeds, and property titles. Such institutions, to be effective, need to provide quick turnaround for title searches and recording ownership changes. Improvements in the modernization of legal and case information databases of the Judiciary, and the development of structured rules for settling lending/debt disputes, would help reduce legal delays that now deter financial institutions from extending collateralized or securitized long-term lending.

B. Disclosure and the Tax Regime

A prerequisite for lending is good information on the creditworthiness of the borrower. If this information is unavailable or too costly to acquire, then lending becomes uneconomical because transactions costs are too high or because the dangers of asymmetric information, moral hazard and adverse selection, are overwhelming. In developed countries, such information is available through generally reliable business accounts. From the regulator's viewpoint, enforcement and monitoring of international accounting standards, particularly for the financial reporting by banks, is key. In the Caribbean, business accounts are frequently not usable as a basis for credit assessment, because they are often seriously distorted for purposes of tax evasion.²⁸

Improvement of this situation requires a combination of (a) a reduction of high corporate tax rates which currently provide incentives to distort accounts (rates typically range from 33-50%) and (b) a tightening of enforcement to prevent distortions in financial disclosure.

C. Institutions for Lending to Small Enterprise

(i) Micro-Credit Lending: Institutions that are better suited to lend to small enterprises are either informal or mimic the mode of operation of informal lenders.²⁹ Informal credit is particularly well developed in Guyana, where it includes borrowing from family and friends, trade credit from suppliers or

²⁶See The World Bank (April 1994) for a review of DFIs in the region.

²⁷Jamaica in particular, see The World Bank (April 1994).

²⁸See The World Bank (April 1994).

²⁹See The World Bank (1997) for more discussion.

purchasers (especially rice mills), shop credit, and borrowing and lending pools. Group lending by 'Grameen-type' institutions is closest to informal lending. These have been highly successful in Latin America and South Asia. Their introduction in the Caribbean is to be encouraged, especially in the poorer and more rural economies -- the Dominican Republic, Guyana, Haiti, and Suriname.³⁰ Successful experiences as well as bad practices on 'micro-credit' can be accessed via the World Bank Consultative Group to Assist the Poor (CGAP) program which documents and coordinates with various global NGOs involved in developing micro-credit institutions.

(ii) The Credit Union (Cooperative) Sector: Credit unions are also a promising source of finance for small enterprise. Non-remunerated work by credit-union members lowers the costs of these institutions; community information and social pressure reduce their default rate much as it does for informal lending. Although only a small part of credit union lending is categorized as business lending, a large part of their consumer and mortgage lending does in fact go to finance small enterprises. Credit unions are a significant part of the financial system in several countries in the region--Barbados, Belize, Jamaica, several members of the OECS, and Trinidad and Tobago (see Table 6).³¹ Their importance for small enterprises is in fact greater than these numbers suggest: their share of retail business is much higher than their share of overall assets (e.g., in Belize they account for about a third of retail deposits); they often provide the only banking facilities outside the major urban areas; and in several countries they are growing rapidly.

Inadequate regulation and supervision is a problem of credit unions in many countries. Typically, credit unions are supervised by a Registrar of Cooperatives or similar offices with little capacity for overseeing financial institutions. As a result, there have been significant problems with the sector, especially in Belize and in Trinidad & Tobago -- one key problem has been lack of timely and consistent statistics reporting on their activities. A 1996 IDB technical cooperation agreement is aimed at reforming the sector in Trinidad and Tobago, and the Canadian-funded COOPS project is working to improve the institutional capability of supervisors in the OECS and elsewhere. Given the importance of credit unions to households and small enterprises, a region-wide approach to the sector might be desirable, perhaps building on the existing Caribbean Conference of Credit Unions. Appropriate goals should include:

- (a) Consolidation among some of the smallest credit unions;
- (b) Establishment of joint apex institutions to capture economies of scale (financial and operational) modeled on CCUs and CUSOs in the United States. The World Council of Credit Unions (Wyoming, USA) can be tapped for assistance in these matters.
- (c) Establishment of a supervisory body or a monitoring unit under the Central Bank;
- (d) Technical assistance in developing credit unions in countries where they are not currently significant; and
- (e) Integrating the activities of credit unions with informal rotating saving schemes, wherever possible.

³⁰The Scotia Enterprise Fund in Guyana does provide some group financing.

³¹Credit unions were once important in Guyana, but the sector was practically eliminated by controls on lending and deposit rates.

VII. SAVINGS AND ASSET GROWTH: THE ROLE OF CONTRACTUAL SAVINGS INSTITUTIONS

The principal contractual savings institutions (CSIs) in the Caribbean are social security schemes (which include public pensions and other benefits), life insurance, and private pension funds. CSIs typically accumulate large financial reserves: we saw earlier that in the countries of the region, following commercial banks, CSIs account for most of the remaining intermediary assets (from 15-25%). Because their liabilities are long-term, CSIs should normally invest them in long-term assets, making them an important source of term finance and a key player in the capital market. In recent years, social security schemes have faced increasing difficulties as a result of worsening demographics and poor design. As a result, there has been increasing interest in the 'privatization' of contractual saving. The lead in this has been taken, not by the OECD countries, but by those of Latin America.

In the Caribbean, many countries still rely to a significant extent on traditional methods of consumption smoothing. All have social security schemes (national insurance): in the English-speaking Caribbean these cover most employees and some of the self-employed; in the Dominican Republic and Haiti coverage is much less extensive. Generally, there is only limited public interest in private CSIs, except in the higher-income countries and where social security schemes have been seriously eroded by inflation.

Social security

Variations in the health of social security schemes largely reflect countries' differing macroeconomic histories. In countries that have enjoyed macroeconomic stability (Barbados, Belize, the OECS), the schemes are generally robust.³² In countries that have experienced macroeconomic instability, social security schemes have often been eroded by inflation (Guyana, Jamaica, Dominican Republic and Trinidad & Tobago): benefits have fallen in real terms to insignificant levels. In the Dominican Republic the social security scheme has a significant fiscal cost, and in Trinidad & Tobago the fiscal load has increased, particularly due to separate budget funding allocated for the minimum old-age pension scheme.

In the countries with sound social security schemes, many have accumulated substantial reserve funds (see Table 6). All the schemes are 'pay-as-you-go' (current premiums of the young pay current benefits of the old), as is the practice in most of the world. However, since populations in the Caribbean are young and the schemes relatively new, they accumulate surpluses even when they are actuarially unsustainable. Typically the surplus funds are invested in government securities, in time deposits with banks and other financial institutions, and in mortgages. In some cases, governments regard the surplus funds as a useful source of funding for fiscal deficits, for special projects, and for political patronage. Common practices include investment in government securities at below market rates, lending to development banks otherwise starved of funds, and financing of subsidized housing, in some cases for political supporters. In addition to these sub-optimal uses of resources, the ability of social security schemes to invest in more profitable and socially useful ways is limited by the shortage of good domestic long-term assets and, usually, by the prohibition of foreign investment.

Table 13 shows some relevant indicators for countries in the region and some comparison countries. The percentage of population over 60 indicates the scale of demand for pensions. The dependency ratio (the ratio of population over 60 to population 20-59) indicates the 'terms of trade' faced by a pay-as-you-go scheme. The percentage of public pension spending in GDP indicates the fiscal pressure for reform of public pensions. The OECD countries are currently in the worst shape, with old populations, high dependency ratios, and high public pension spending. In general, countries in the Caribbean have much younger populations, lower dependency ratios, and much lower public pension spending. However, the demographics in some (Barbados, Jamaica, the OECS, and Trinidad and Tobago) are less favorable –

³²The Bahamas probably fall in this category, but limited information on social security was available.

comparable to the demographics in Chile and Argentina -- and in most the demographics are expected to worsen from the viewpoint of social security (as shown by the percentage of population over 60 projected for 2020). The fiscal pressure of public pension spending in the region is generally low because of young populations, relatively new social security schemes, and the erosion of many schemes by inflation. However, public pension spending in Trinidad and Tobago is approaching the level of Chile and Argentina.

With the possible exception of Trinidad and Tobago which has outlined plans in its 1998 budget to address this issue, there is no great political pressure for social security reform. However, pressure is likely to increase in the future, and the current state of social security schemes makes reform much easier to implement now than it will be later. In the meantime governments are faced with growing contingent liabilities for these unfunded public pension obligations. Full funding and privatization are easier presently, because with young populations there is no large overhang of accumulated pension rights that must be bought out. Since many existing social security schemes have been eroded by inflation, or are anyhow very modest, the politically difficult task of reducing the generosity of social security is not necessary.

Table 13: Demographic Indicators and Public Pensions

	% population over 60	Pop. over 60 / pop 20-59 %	Pop. over 60 in 2020	Public pension spending / GDP
The Bahamas	6.7	13.6	12.9	na
Barbados	14.8	28.6	21.9	3.0
Belize	6.4	16.7	6.2	1.1
Dominican Republic	5.5	11.9	11.7	0.1
Guyana	6.4	13.5	11.7	1.4
Haiti	6.2	14.4	6.7	na
Jamaica	8.9	19.7	19.6	0.7
OECS	7.6-20.0	18.2-50.0	5.4-14.9	na
Suriname	6.7	14.3	10.8	na
Trinidad and Tobago	8.3	16.9	14.9	3.4
Chile	8.7	17.0	16.1	5.7
Argentina	13.1	26.9	17.2	4.2
Avg LAC	6.9	14.9	12.2	2.0
Asian NICs	5.3-13	11.9-22.4	10.1-27.3	0.1-2.2
Avg OECD	18.2	32.9	27.0	9.2

Source: Gov't. Social Security Financial Reports,(1990-1994)

Life insurance

A commonly-used measure of the importance of life insurance in a country is the ratio of premiums to GDP. In 1995, this ratio was 3.6% for North America, 3.4% for Europe, and 7.9% for Asia. For Latin America it was only 0.43% (from 0.11% in Peru to 1.8% in Chile): to a significant extent, this is a result of the long period of high inflation that has made any long-term financial contract unattractive. With greater macroeconomic stability, Latin America is now seen as an area of great potential for the growth of life insurance and there is increasing interest on the part of foreign insurance companies. In many Caribbean countries, life insurance is far more developed than it is in Latin America. The premium to GDP ratio is 2.8% in The Bahamas and reached 8.5% in Jamaica in the mid 1990s – largely because regulatory and tax loopholes make insurance policies an attractive savings instrument and a useful way for financial conglomerates to raise quasi-deposit funds. Life insurance is also well developed in Barbados and in Trinidad and Tobago. There are a number of quite successful indigenous life insurance companies, especially in Barbados, Jamaica, and Trinidad and Tobago; several are active outside their home countries.

One difficulty faced by life insurers is a low return on assets. The cost of life insurance is inversely related to the return that can be earned on invested premiums. If the return is low, insurance is expensive and therefore harder to sell. As noted already, there is a dearth of good domestic long-term assets. There are generally restrictions on foreign investment, although these are not always enforced. The life insurance industry is at the other extreme as the general insurance sector -- there is little competition and high concentration of the business by a few primary operators.

Private pensions

Private pension plans exist in most countries and are well developed in several. In The Bahamas, about 21% of the labor force is covered by some sort of plan (most of them defined-benefit plans); this compares to 30% coverage in the U.K. and 46% in the United States. In Jamaica and Trinidad and Tobago, private pension plans have grown rapidly as social security pension benefits have become increasingly inadequate. Pension funds are usually managed by trustees -- typically life insurance companies or trust companies. As with social security surplus funds and life insurance, pension funds complain of a lack of suitable potential investments; they too are restricted from making foreign investments.

For the most part, private pension funds in the Caribbean are largely unmonitored, though regulations for their operation exist. Enforcement of reporting requirements seems to be inadequate and as a result, accurate and complete data are not easily available. Trinidad & Tobago and Guyana show substantial diligence as regards to monitoring and supervision of the private pension fund industry. In the Dominican Republic, the increasing 'universalization' of financial institutions has led to the emergence of defined-contribution pension funds managed by previously commercial banks, the largest of which have now become multi-service financial conglomerates. Barbados has private pension funds managed almost solely by the life insurance industry, but like Jamaica, no formal monitoring systems are in place.

RECOMMENDATIONS

While country-specific circumstances need to be examined in depth to determine the optimal strategies for regulatory and institutional reforms in this area, there are several recommendations regarding the region's contractual savings institutions which can be considered based on recent experience worldwide:

- Consideration should be given to having social security funds managed by independent private trustees;
- Restrictions on investment in foreign assets should be liberalized;
- CSIs should be permitted to diversify and invest in private debt and equity instruments;
- Regulation and supervision of CSIs should be improved; and
- Consideration should be given to privatization of the social security system.

A. Independent trustees for Managing Social Security Surplus Funds

At the moment, most CSIs in the Caribbean are publicly managed with strikingly sub-market yields and returns on investments. As in a growing number of Latin American countries (Chile, Mexico, Brazil, Bolivia), the management of social security surplus funds might meet many objectives if they were placed in the hands of independent trustees. This function would most naturally be filled by trust companies, life insurance companies or experienced private asset managers, which could provide more professional management. This would lower the cost of administration and yield better returns on assets than if continued to be managed by less trained government employees. In addition, it would assist in the development of capital markets and increase intermediation and allocation of long term funds. The region, or sub-regions within the Caribbean might consider a trustee institution to jointly manage their social security funds.

B. Removing restrictions on foreign assets

Remaining restrictions that prevent CSIs from investing in foreign assets should be removed. These restrictions are harmful for two reasons: First, as noted earlier, the dearth of suitable domestic assets means that the rate of return on CSI assets is lower than it could be. This reduces the attractiveness of

contractual savings, leaving households less protected than they could be. Second, given the small size and volatility of individual economies in the region, diversification into foreign assets is key, to ensure protection against cyclical economic downturns or financial sector disruptions caused by natural disasters.

C. Investment by CSIs in Private Equity and Debt

CSIs can play an important role as investors in private equity and debt (i.e., shares and bonds that are privately placed with CSIs rather than being purchased by them after having been publicly issued). Small and medium enterprises are not well suited to the public issue of capital market securities. The costs of a public issue are largely indivisible and make a public issue prohibitively expensive for small amounts. Moreover, because the risk is high, investment in the debt or equity of small and medium enterprises is economical only if it can be accompanied by close monitoring. This is difficult to achieve with a public issue, but much easier with a private placement. CSIs can therefore play an important role in providing term lending and equity to small and medium enterprises. They can only do so, however, if they are allowed to under law. For example, the venture capital industry took off in the United States only after pension funds were allowed to invest a part of their assets in venture capital partnerships. Governments in the region should lessen excessively restrictive regulation on the types of assets permitted for CSIs, while maintaining prudential portfolio exposure limits.

D. Regulation and Supervision

The regulation and supervision of non-bank financial intermediaries, including CSIs, needs improvement. While the supervisors of banks, commonly the central banks, are typically competent, the government agencies charged with supervising other types of financial institutions (Supervisors of Insurance, Supervisors of Cooperatives, Registrars of Pensions) are much less so. They are often under-trained and under-staffed—particularly where (as in Trinidad & Tobago and Jamaica) the institutions for which they are responsible have experienced rapid growth.³³ Given the potential economies of scale and scope, it would seem logical to place the supervision of non-bank financial intermediaries under the same agency that supervises banks. For example, in Singapore the Monetary Authority also supervises some capital market activities and non-banks. For large economies like the United States, there is probably little loss in efficiency by having separate regulators and perhaps some gain from regulatory competition. However, in very small economies the considerations are different. Initially, the single supervisor would be the respective central bank; in the long run countries with similar monetary and fiscal policies might consider regional supervisory institutions.

E. Privatization of social security

The countries of the region could consider privatizing their social security schemes along the lines pioneered by Chile and emulated by several other Latin American countries. The Chilean model consists of three 'pillars': the first pillar is a modest publicly-managed, tax-funded scheme to provide a safety net and reduce poverty among the elderly; the second (main) pillar is a mandatory privately-managed, fully-funded pension plans; and the third pillar is voluntary additional saving for those who want more protection. International experience has shown that private provision is preferable for pensioners and, *especially*, for public finances: removing the provision of retirement income from the public budget would eliminate a potentially major problem in the future. Another benefit of a privatized pension regime is the impetus that it provides to the development of the capital market. In Chile, where privatization is now some 16 years old, the assets of private pension funds have grown to 40% of GDP. Their investments, initially in government and corporate bonds and later in equities, have driven the rapid development of the Chilean capital market. Privatization of pension provision in the Caribbean could be expected to have similar effects. A key factor to take into account, however, is the potential for profitability of private operators in small markets -- lack of such on an individual country basis may merit consideration of setting up regional funds which might attract private administration more readily. Finally, increased private funding through contribution-defined systems, with reduced public funding of social security, would free up more resources for other government social programs and investments.

³³See Craigwell and Abraham (1997) for more details on the situation in Trinidad and Tobago.

VIII. CAPITAL MARKET DEVELOPMENT: FINANCIAL INSTRUMENTS AND RISK DIVERSIFICATION

The Market for Government Securities

Markets for government securities in the region are generally not well developed. Historically, governments have financed their deficits predominantly with foreign borrowing (much of it concessionary) and with forced domestic borrowing (obtaining credit from the private sector, high reserve requirements, non-remunerated bank reserves, etc.). There has been little reliance on free domestic markets for government debt. The Dominican Republic, Haiti, and Suriname have virtually no markets for government debt, although the central banks in the former two countries do issue short-term bills. In The Bahamas, Belize, and the OECS, governments issue debt at fixed or reservation prices; in Barbados treasury bills are auctioned. Only in Guyana, Jamaica, and Trinidad and Tobago, do governments sell their securities by auction at approximate market rates (though in Trinidad and Tobago, auctions are used only for short term debt).

Jamaica is the only country presently with a genuine secondary market. A group of commercial banks, merchant banks, and money market brokers make the market. They also act as 'primary dealers', providing underwriting support for new issues. The Bank of Jamaica conducts open-market operations with these dealers, mainly through repurchase agreements. In several other countries (The Bahamas, Barbados, the OECS, and Trinidad and Tobago) central banks are ready to discount T-bills at a set rate. In Barbados and Suriname, government securities are listed on the stock exchange, but rarely trade.

The principal holders of government debt are central banks (for monetization), commercial banks (to satisfy liquid asset requirements, but also due to lack of good lending opportunities), social security surplus funds, and private CSIs. The proportions vary across countries. Households generally do not hold government securities directly. Jamaica is the country with the most developed government securities market, but even there the market is not completely free: liquid asset requirements still create a captive demand for government securities, distorting the market. Trinidad & Tobago's market is the next most developed, and Barbados and the OECS have recently embarked on programs to develop their markets. Most other countries are interested in developing their government securities markets and are in various stages of studying the issue.

A well-functioning government securities market is essential for the development of a healthy financial sector and should be encouraged for several reasons:³⁴

(a) It is essential for achieving macroeconomic stability: First, borrowing in a free domestic market provides governments with a less distorting method to finance their deficits. In particular, it reduces their reliance on monetization, with its consequent inflation. For example, it has proven useful to the Jamaican government in financing the support and rehabilitation of its financial sector. Second, a market for government debt allows the central bank to conduct open-market operations without issuing its own interest-bearing liabilities. When central banks issue their own liabilities, as at times in Jamaica and the Dominican Republic, it impairs money management and usually leads to central bank losses. Third, a free market provides a barometer of confidence in government fiscal and monetary policy and therefore helps to discipline government behavior, which may explain why some governments are reluctant to rely on this mechanism.

(b) It is essential for reducing financial repression: Borrowing in a free domestic market provides governments with an alternative to having banks to lend at below-market rates through liquid asset

³⁴For a thorough discussion, see Fry (1997).

requirements. A good secondary market in government debt is necessary for conducting monetary policy through open market operations rather than through direct controls.

(c) It facilitates integration into the international financial system: A well-functioning domestic market for government debt allows governments to reduce their reliance on foreign borrowing. Excessive foreign borrowing by governments 'uses up' country lending limits of international lenders, making it harder for private borrowers to access international financial markets, and also exposing governments to foreign exchange risks. Government default on external debt increases measures of country risk and therefore the premiums that private borrowers must pay over international rates. Reducing the reliance on external debt for routine government finance has the additional advantage of increasing government access to the international market in times of emergency.

(d) It facilitates the development of other securities markets: Setting up a securities market is expensive: it involves a large fixed cost that is justified only if the expected volume of trading is large. In a developing economy, this condition is unlikely to be satisfied for private securities alone: government securities are more likely to provide the necessary volume. Once a market for government securities is established, the marginal cost of adding markets for private securities is much smaller. In most developed countries, government securities markets developed first historically, and private securities followed. The existence of a well-functioning secondary market for government securities can facilitate the pricing and thus the issue of private securities, by providing benchmark rates.

(e) It facilitates the development of financial intermediaries, especially contractual savings institutions (CSIs): It has been seen that a major obstacle to the growth of CSIs is the lack of attractive financial assets. Government debentures issued at market rates and tradable in a well-functioning secondary market can provide CSIs with the financial assets they need. Similarly, liquid T-bills can provide banks with suitable secondary reserves and with good collateral for interbank lending. The availability of good financial assets – the government securities themselves or, more likely, the liabilities of intermediaries investing in government securities – will encourage financial saving by households. This may promote household saving or, at least, reduce socially wasteful accumulation of low-return real assets.

A free market in government debt and macroeconomic stability are mutually dependent: macroeconomic instability – high inflation and a lack of fiscal discipline – can make it difficult or impossible for a government to issue long-term debt.³⁵

The Private Sector Capital Market

Equity Markets

Barbados, Jamaica, and Trinidad and Tobago are the only countries with active equities markets. Suriname and The Bahamas also have stock exchanges, albeit with very limited trading activity. All except Suriname, have government-established stock exchanges. Table 14 shows that for the major three, market capitalization is substantial. Listed firms are mainly financial firms and utilities -- in Trinidad & Tobago, banks account for 65% of market capitalization. Even in the more active Caribbean markets, liquidity is generally poor, as trading volumes are small by international standards (see Tables 5 & 14); trading sessions are few, many stocks do not trade in a given session, and trading costs are high: 4% on a round trip versus under 1% in the United States. The amount of funds raised from new issues is modest.

In most of the remaining countries in the region, there is some sort of informal market in stocks – typically over the counter at trust companies or central banks that act as transfer agents and registrars for public companies. Many countries have plans to establish organized exchanges or to revive existing ones that are inactive. In The Bahamas, there are plans to establish a stock exchange in 1998, but it is expected

³⁵Fry (1997) discusses how macroeconomic instability hampered the development of the government securities market in Jamaica.

to mainly trade global depository receipts, serving the country's large offshore financial sector. In Belize, plans exist for the central bank to establish an OTC trading facility, but as of 1995 they had not been executed. The Dominican Republic reopened its Bolsa in 1991; as of 1997 it traded only commercial paper and bonds, although there were plans to extend trading to equities. The central bank of Guyana set up a call exchange in the early 1990s, but it is no longer active; there are now plans to set up an OTC market. In the OECS, the central bank plans to establish a call exchange. Suriname established an exchange in 1994, but it attracts little business.

TABLE 14 THE REGION'S TOP EQUITY MARKETS (1996)

	Barbados	Jamaica	Trinidad & Tobago
No. of companies listed	19	45	27
Market capitalization (US\$ millions)*	770	1,530 ('95)	1,475
Mkt cap/GDP	38%	32%	27%
Trading volume (US\$ millions)	12	125	108
Turnover ratio	<1%	8%	7%
Trading days	Tu, F	M-Th	Tu, W, F
Funds raised from new issues (US\$ millions)	24	50 (aver. '92-'95)	124**

* There is considerable double counting since CIBC WI Holdings, with a market value of some \$300 million is listed on all three exchanges.

** 1996 saw an unusually large volume of new issues in Trinidad & Tobago (four: equal to the whole of the preceding decade).

Source: Stock exchange reports, miscellaneous.

In 1989, CARICOM adopted a program for a Single Market and Economy, including plans for capital market integration. Cross-border trading began in 1991 for the existing three exchanges, but its volume has been low. Volume has in fact declined over the years, from 8.9 million shares in 1993 to 0.5 million in 1995; in 1996 cross-border volume involving Barbados (the only country for which data is available) amounted to US\$282,000 or about 2% of that country's already very small total trading volume. In an IDB/OAS funded project, there are plans for integrating and harmonizing Caribbean stock exchanges, including the fixed-income securities market of the Dominican Republic.

Other Financial Instruments and Innovations

The emergence of new financial instruments and innovations in the Caribbean has been driven mainly by competitive pressures, technological change, and the desire of financial institutions to increase revenues in areas not yet restricted by regulation. In the larger economies of the region -- Jamaica, Dominican Republic, Trinidad & Tobago, and Barbados, new financial products, some of them already available globally, include money market mutual funds, foreign asset mutual funds, foreign currency options, repurchase agreements, bankers acceptances, stripped bond coupons, securitized receivables, foreign currency insurance policies, and loan sales. While competition seems to be the driving force, differences in economic structure and policy frameworks matter: the more competitive markets with greater numbers and variety of participants, and the jurisdictions with more liberalized policy regimes tend to spawn more innovation, aimed primarily at increasing fee income, reducing risk, and enhancing the rate of return for savers and investors.

Bond Markets

Caribbean bond markets are less well developed than equities markets. There is almost no public issuance of long-term corporate debt, although, as noted earlier, markets for short-term commercial paper are active in several countries. There is some private placement of corporate debt in Barbados, the OECS, the Dominican Republic, and Trinidad & Tobago.

The most active part of the bond market is in mortgage-backed bonds. With some support from the International Finance Corporation, the Home Mortgage Bank (HMB) in Trinidad & Tobago was established in 1986 as a secondary mortgage facility and has issued bonds regularly to finance its

purchases of mortgages. Another mortgage institution, the Trinidad and Tobago Mortgage Finance Company, also issues bonds, as does the privately owned Development Finance Ltd., which regularly goes to the local market for such funding. HMB bonds trade on the exchange, where they accounted for the bulk of the US\$4.5 million in bond trading volume in 1996. The success of HMB has prompted imitation: in 1996, the OECS established the Eastern Caribbean Home Mortgage Bank, modeled on the Trinidad & Tobago institution and designed with its assistance. Barbados is contemplating setting up a similar institution.

The Role of the Capital Market

It is a common mistake to believe that the *principal* role of the capital market is to mobilize savings and channel them into business investment. This is generally not the case. There are three basic facts about business investment throughout the developed world³⁶:

- business investment is mostly financed with internal funds. External funds provided by the financial system play only a secondary role;
- generally, the principal source of external funds is not the capital market but commercial banks;
- to the extent that the capital market does provide funds for business investment, it is mainly in the form of bonds rather than equity.

The limited role of capital markets in financing business investment is not, therefore, a phenomenon peculiar to the Caribbean or even to developing economies: it is widespread. Nor is the limited role of capital markets a “failure” that government should attempt to rectify: it makes perfectly good economic sense given the inherent difficulty of long-term finance. Consequently, governments should not be disappointed at the small amount of funds mobilized by the region’s stock markets³⁷. The amount raised from new issues of equity is comparable, relative to GDP, to the amount raised in the US (which is also quite modest). On the other hand, there is more reason to be disappointed with the region’s bond markets, which could make a greater contribution.

If capital markets, especially the equity market, do little to mobilize savings, what do they do? First, equity markets facilitate changes in ownership. This provides owners of equity with liquidity, makes industrial restructuring easier, and can provide a mechanism of corporate governance. Better liquidity makes the holding of equity more attractive and so, indirectly, encourages equity investment. However, the investment in question comes mainly from internal funds, not from new issues of shares. Most of the activity in equity markets revolves around restructuring – whether industry consolidation (as in the current wave of mergers and acquisitions in the United States and Europe) or privatization (Europe, the transition economies, and Latin America).³⁸ In some countries (the English-speaking OECD countries in particular), equity markets play an important role through the threat of takeover, in disciplining managers.

The second fundamental function of equity markets is the spreading of risk. Since equity represents the residual claim on business revenue, it is risky: this risk can be borne more easily if it is spread. A well-diversified portfolio of equities, with relatively small stakes in each company, is a much more attractive asset than a large, undiversified holding in a single company. The existence of an equity market makes it possible for owner-managers to reduce their individual exposure by selling shares to the public while providing the public with a high-return, moderate-risk financial asset. One aspect of risk-spreading that is of particular importance in the context of the Caribbean is the intra-regional and international spreading of risk. As noted, the region’s economies are unusually volatile and the risk associated with the ownership of

³⁶See, for example, Mayer (1990).

³⁷Cf. This seemingly disappointed observation on the Trinidad equity market: “the establishment of a formal stock market [in Trinidad] has not resulted in any substantial mobilization of new investment funds”, Clarke and Danns (1997) p 474.

³⁸Cf. The seemingly disapproving comment on the Jamaican equity market: “to-date, such markets seem to primarily serve the investment needs of large industry players for exchanging and holding shares in other industries”.

enterprise is therefore unusually great, making the spreading of that risk especially important. Moreover, it is crucial that the risk be spread outside the home country. Investors in a small country should hold a very limited diversified portfolio of domestic equities, because the systemic risk of such a portfolio is highly correlated with the risk of their own regular economic income. To spread the risk, investors in a small country should predominantly hold foreign equities, while domestic equities should be mostly held by foreigners.

The Supply of Capital Market Securities and the Potential for Capital Market Development

To assess the potential for capital market development one needs to consider both the potential supply of capital market securities and the potential demand. The largest potential source of new issues in the near term is the privatization of state-owned enterprises (SOEs). Most countries in the region have begun to privatize their state-owned enterprises and plan to continue. The Bahamas has, since 1992, privatized some hotels and a bank, and plans to privatize its utilities. As part of its 1991 structural reform, Barbados has gradually been privatizing its SOEs. Belize has had quite an active program since the early 1990s. The new government in the Dominican Republic is committed to privatization of SOEs. In Guyana, there has been substantial privatization, reducing the SOE share of GDP from 75% in the 1980s to 40% in 1994; efforts to privatize the remaining SOEs were intensified in 1997. In Haiti, privatization is an important part of the recent reform program, and is beginning to be pursued more actively. In Jamaica, privatization of banks, utilities, and other SOEs has provided a major stimulus to the local equity market. In the OECS, there has been some privatization of banks and utilities. In Suriname, not much has yet been done, although the government has expressed interest in some degree of privatization. In Trinidad & Tobago, there has been an active program of SOE privatizations which at their peak, employed one third of the labor force.

Of course, privatization need not mean the sale of securities to the public. In fact much of the region's privatization (for example, in Trinidad & Tobago) involves direct sale of enterprises to foreign strategic investors. Such privatization by direct sale is sometimes criticized because it lacks the beneficial effect a public issue can have in expanding the stock market.³⁹ This criticism, however, is misguided. Direct sale to a strategic investor is likely to have a far more beneficial effect on the management of the enterprise than the issuing of shares to a large number of small shareholders. It should be remembered that improved management is the primary motivation for privatization. Moreover, the risk-spreading considerations discussed above strongly favor some degree of foreign ownership. This is more likely to be achieved through direct sale (foreign direct investment) than through the sale of publicly issued equities (foreign portfolio investment). Therefore, the pattern of privatization that might provide the best combination of benefits is direct sale of a majority stake to a foreign strategic investor, combined with the public issue of the remaining stakes (perhaps as preferred shares).

The second potential source of capital market securities is private companies. The potential here may not be great. To begin with, the sectoral composition of the region's economies is not particularly favorable (see Table 2). There is relatively little manufacturing compared with the Latin American and Asian economies that have more developed capital markets. Existing manufacturing and mining is often either state-owned or foreign-owned. Given the small size of the region's economies, the potential for additional manufacturing is limited, and it is likely to be financed by foreign direct investment rather than by the creation or expansion of domestic companies. The main prospect for growth lies in services and, as the area's economies grow and incomes rise, in commercial and residential construction. There is therefore likely to be a need for term finance of residential and commercial structures (including hotels) and infrastructure. The most suitable form of finance for these purposes is not equity but debt-mortgage loans from financial institutions and bonds. Financial institutions themselves, on the other hand, are potentially major issuers of equity, especially if the industry undergoes the sort of consolidation recommended.

³⁹ "Privatization policy has not focused sufficiently on the benefits of using the capital market to foster widespread public ownership of former SOEs and on the relationship between privatization and capital market development," CARICOM (1995) p 37. In Trinidad, it was the indigenization program of the 1970s, which required the sale of a majority of shares to locals, that provided a big boost to the equities market.

The Demand for Capital Market Securities

There are two potential sources of demand for capital market securities – institutions and individuals. Of these, institutions seem the more promising. As seen, CSIs are already of a substantial size in the region. If the recommendation to privatize social security is followed, they will grow significantly larger (in Chile, private pension funds have grown to a size comparable to that of the commercial banks). At the moment, the region's CSIs are largely invested in mortgages, real estate, and government securities: their investment in corporate securities is largely limited by availability. In the countries with developed equities markets, CSIs play an important role in those markets. While increased investment by CSIs in capital market securities is desirable in order to raise their return on assets, that investment must be diversified in order to control risk.

Apart from CSIs, another potentially important category of institutional investor is mutual funds or unit trusts. Unit trusts already exist in Barbados, Jamaica, and Trinidad & Tobago and have been quite successful there. They were generally established by governments and initially given tax advantages, which made them more attractive and contributed to their success; however, their tax advantages also made it difficult for private mutual funds to compete with them. In Trinidad & Tobago, the tax advantages have recently been phased out, allowing several private mutual funds to be established. Further growth of mutual funds requires removal of restrictions on investment in foreign securities and integration of the regional capital market. The potential for the direct purchase of capital market securities by individuals is limited. Even in the developed economies, the relative importance of institutional investors has grown as individuals have increasingly preferred to invest in capital market securities indirectly through pension funds and mutual funds.

Promoting capital market development

Many of the obstacles to capital market development are of government creation. While macroeconomic instability is always harmful to financial development, it is especially harmful to the development of the capital market. Capital market securities are long-term contracts: uncertainty about the future macroeconomic environment makes such long-term commitments very risky. Unexpected changes in inflation can transform an investment that seemed fair to both parties into a windfall for one and a disaster for the other. Similarly, an unexpected economic contraction can drive a promising company into insolvency. Thus, macroeconomic stability is a precondition for development of a healthy capital market.

Improving market structure

Deficiencies of market structure make the issuance and holding of capital market securities unattractive. Clearing, settlement, and transfer of ownership are generally manual and very slow (taking from weeks to months): this raises both the cost of transactions and the risks involved.⁴⁰ High issuance costs partly reflect a lack of underwriting capacity. Poor liquidity is partly the result of a lack of market makers. Poor information on issuers is partly the result of a lack of analysts and rating agencies. These institutional deficiencies cannot be attacked directly in the same way as the technical deficiencies, because they are an expression of the fundamental diseconomies of small markets. There is a lack of underwriters, market makers, analysts, and rating agencies because the markets in question do not generate – and probably cannot generate – a volume of business that would make such activities profitable. A promising approach to the problem of scale is to attack it directly by unifying small national markets into a larger regional market. This is elaborated below:

Removing the obstacles to a regional capital market

The first steps towards the creation of a regional capital market were taken in 1991. As seen, the volume of cross-border trading has been disappointing. In 1994, CARICOM, with the assistance of the OAS and IDB, formulated plans to address some of the technical and regulatory obstacles that impede cross-border trading. At that time, CARICOM established a Working Group on Financing for Caribbean Development, and IDB approved a program of technical assistance through its Multilateral Investment

⁴⁰For details see CARICOM (1995), Appendix.

Fund (MIF). The CARICOM Working Group presented recommendations in 1995 which were endorsed by the Heads of Government and which addressed various issues including measures to (a) promote private domestic savings, (b) accelerate the development of the regional capital market, and (c) increase access to foreign portfolio investment.

Under the MIF program, The Bahamas, Barbados, the Dominican Republic, Jamaica, the OECS, and Trinidad and Tobago are to develop a common electronic trading system and central securities depository to automate, clear, settle, and guarantee trades. First, each country is to establish its own automated trading and central depository systems, and these are to be linked electronically. Arrangements have already been put in place for cross-border trading and securities listings among the Jamaica, Trinidad & Tobago, and Barbados exchanges, as well as the earmarking of foreign currency to ensure prompt settlement of such trades. A planned third phase would extend the system to the remaining countries of the region and coordinate it with trading systems in the G-3 countries (Mexico, Colombia, and Venezuela) and with a proposed regional system for the countries of Central America.

In addition to the technical obstacles, there are legal and regulatory obstacles to the creation of a regional capital market. First, there are direct barriers: exchange controls prevent nationals from acquiring foreign securities; legal restrictions (often as part of Alien Landholding Laws) prevent foreigners from acquiring domestic securities. These barriers are slowly being removed, and this tendency is to be encouraged. Second, there are indirect barriers in the form of domestic regulatory regimes that fail to provide investors and traders—including foreign investors and traders—with the protection they require. This discourages foreigners from holding and trading domestic securities. The regional program for capital market integration recognizes this problem and includes plans for each country to establish a self-regulatory organization for its exchange, to oversee trading and to ensure disclosure by listed companies.

It has been argued above that the larger scale of a regional market would facilitate the emergence of the necessary institutional support structure (underwriters, market makers, etc.). To this end, it is important to make it as easy as possible for financial institutions to operate across borders: as with banking, this implies harmonization of regulation, supervision at a regional rather than a national level, and a 'single license procedure', whenever possible. As with all aspects of regional integration, one must not forget the importance of macroeconomic stability. Exchange-rate uncertainty makes investment in foreign securities less attractive. Macroeconomic instability makes capital market securities more risky and so less attractive to foreign investors.

Capital market regulation

Capital market regulation addresses two concerns of investors and traders. The first is that there exist mechanisms of *corporate governance* to ensure that the suppliers of finance receive a return on their investment. The second concern is that trading of capital market securities be fair and free from manipulation. Effective corporate governance requires disclosure of information, legal protection of investors, and concentration of ownership. Disclosure is essential: unless investors know what is going on, they cannot defend their interests. Of course, disclosure also improves management directly. Disclosure requirements generally necessitate improvements in internal information systems, so that managers too are better informed and perform accordingly.

The legal protection of investors in the region is generally weak: laws are often inadequate and enforcement lacking. Efforts are being made to improve company and securities laws. Jamaica passed its Securities Industries Act in 1993 (modeled on Canadian and Australian laws); other countries have followed suit or are planning to do so. The Bahamas, Barbados, and the OECS have brought their companies laws up to date and other countries are in the process of doing so. Of course, the best laws mean little if they are not enforced. As noted earlier, the region's court systems are often weak and plagued by delays. The new securities laws generally provide for the establishment of an SEC-type regulator to oversee the capital market, but so far only Jamaica has actually established a Securities Commission.

Another key element of corporate governance is concentration of ownership. If small investors feel that firms are poorly managed or that insiders are taking advantage, the logical response is for them to sell their securities or to refrain from buying them. However, for investors with a sufficiently large stake in a company, it may make more sense to try to rectify the problem – to monitor managers and to police insiders (of course this is possible only if the law provides the necessary authority and if disclosure provides the necessary information). In many OECD countries, universal banks play the role of concentrated owners, but it is not clear if the authorities in the Caribbean have a strong enough supervision capacity to handle such institutions, and the banking laws often prohibit or restrict bank holding of equity. Foreign strategic investors are another possible source of concentrated ownership: this is an important argument in favor of privatization by direct sale of at least a controlling stake.

In the enthusiasm for improving capital market regulation, it should be remembered that regulation is costly. First, the direct costs can be substantial. For example, a recent study proposed that Trinidad & Tobago establish a securities commission consisting of nine professionals plus clerical staff, perhaps 25 people in all. Suppose the annual cost of this, say \$1 million, were to be recovered from a fee on trading. Then given the roughly \$100 million trading volume, the fee would have to be around 1% of the value of trading – a substantial increase in trading costs that would certainly impair liquidity (and reduce trading volume). If a similar commission were to be established in Barbados, because of the much lower trading volume there, the fee would have to be around 9%. Of course, because of indivisibilities, there are significant potential economies of scale in market supervision: a *regional* securities commission could be financed with a much smaller fee on trading.

In addition to the direct costs, there are indirect costs. Compliance with regulations is costly for issuers, making it less attractive for them to issue securities. Since many issue costs are indivisible, they weigh particularly heavily on those wishing to raise relatively small amounts. So increasing regulation tends to close smaller companies out of the market. Furthermore, companies do not want interference in their affairs by regulators and investors. Some degree of interference may be a reasonable price to pay for access to the capital market. But too much interference -- and companies will rather forego this source of finance. Getting capital market regulation right – the right laws, effective enforcement, the right balance between too much regulation and too little – is not at all easy. Indeed, few countries in the world can claim to have succeeded. Consequently, current initiatives in the region are likely to have, at best, modest success.

Promotion without Distortion

Establishing a well-functioning capital market is extremely difficult. The problem is greater for securities issued to the public than for private placements: small investors need much more protection than large investors. It is also greater for equities than for debt: information requirements are greater for the former and there is greater demand on governance mechanisms. Consequently, private placements with CSIs may be initially a more promising avenue than the market for public issues. Governments should not, therefore, discriminate against private placements, as some governments do in the region (imposing a stamp duty on the transfer of shares of unlisted companies, but not of listed companies; and subsidizing the stock market by paying much of its operating expenses). Similarly, there should be no artificial incentives for the issuance of equities as opposed to debt; such incentives are present in some Caribbean countries as in other developing countries.

RECOMMENDATIONS

For the reform of capital market institutions and their regulation, individual country conditions need to be studied and examined to determine the appropriate solutions both for in-country and intra-regional arrangements, which would be relevant to the development of capital markets in each economy. Resolution of some common issues, however, would assist the process of capital market development. As mentioned earlier in the report, however, first priorities should be given to achieving macroeconomic stability and

assuring sound banking systems -- the development of capital markets will only succeed after having achieved such economic and financial robustness.

A. Development of the Government Securities Market

As discussed earlier, the development of a government securities market can only be undertaken within the context of macroeconomic stability and strong fiscal positions. Since the government securities market traditionally sets the risk-free benchmark rate in the fixed income market, the safety and credit risk on such securities can only be viable once the government has proven its track record in regularly repaying government debt without rollover or forced refinancing. Once these preliminary conditions are met, the government securities market is vital for spurring the development of the overall capital market for the following reasons: (i) The volume of trading in government securities allows the creation of significant market depth, which makes trading profitable for market-makers, and thus permits the entry of new financial instruments; (ii) The financial and trading infrastructure needed for buying and selling government securities (particularly in the secondary market) is more likely to develop with a viable government securities market, and once established, such infrastructure can be deployed with marginal modifications, to handle other fixed income and equity securities; and (iii) As already mentioned, the government securities market provides a benchmark rate from which other securities can be more easily priced, thus generating a market yield curve with which participants can more easily price the risk profiles of differing instruments.

B. Removing Regulatory Obstacles to Capital Market Development

While the governments in the region generally support the development of local capital markets, sometimes existing regulations generate costly or even insurmountable obstacles.

(i) For example, in one country, the Moneylenders Act makes interest rates over 12.5% legally unenforceable (except for financial institutions). However, since market rates are much higher, this puts the corporate bonds in an uncertain legal position. Such unnecessary regulatory barriers should be identified and removed.

(ii) Specific taxes can also be an obstacle, or at least a disincentive. For example, excessive corporate tax rates give companies an incentive not to disclose accurate financial information; as a result, potential investors lack the information they need.

(iii) Other taxes such as those on security market transactions (stamp duties) raise transactions costs and so reduce liquidity and attractiveness of capital market securities.

(iv) Regulations can compound the difficulties: for example, in Trinidad & Tobago it is illegal to trade a security not in one's physical possession. The introduction of modern technology (for electronic book-entries and securities custody) and reforming such laws, can remedy such deficiencies at relatively low cost.

C. Institutions and Efficiencies of Scope for Conducting Capital Market Transactions

The cost of engaging in securities trading and underwriting can be reduced to some extent through economies of scope. Existing financial institutions, especially commercial banks, should not be prevented by restrictive regulation from performing these functions. They can do so at lower cost than special-purpose institutions set up from scratch. Also, the establishment of a market for government securities can provide a volume of business sufficient to support profitable underwriting and market making. Once established, these activities can be expanded to encompass corporate securities at much lower cost. Within the region, the Dominican Republic has experience in setting up multi-purpose universal banks, which avoid the fragmentation of regulatory functions, and increase supervision synergies across financial sub-sectors.

D. Disclosure and Financial Reporting

Efforts are being made in the region to improve disclosure, both through improvements in companies laws and through the imposition of more stringent listing requirements by exchanges. These efforts are key to ensuring continued participation of the private sector in economic activity. It must be noted, however, that disclosure requirements are unlikely to have much effect when companies have strong incentives *not* to

disclose information (see tax issues in 'B(ii)' above). Nevertheless, updating of Companies regulations, increasing local skills in evaluating company financial reports, strengthening the audit profession, and improving the reliability of public repositories of company data represent basic steps to ensure a solid information infrastructure. Such improvements could be undertaken with institutional modernization projects to support private sector development.

E. Development of the Credit Rating Industry

Following up on the disclosure theme, second generation steps would include the development of a regional credit rating industry. Credit rating companies provide a valuable role in ensuring that both the public sector and private firms disclose transparent accounts of their financial operations, while promoting greater financial/fiscal discipline, at times through 'competitive' disclosure. The rating process itself provides incentives for self-discipline and self-regulation, so that companies or governments seeking favorable financing terms are forced to ensure that their financial management capacity is credible and documented according to standard credit rating methodologies. U.S., Latin American, or other established country credit rating agencies frequently pair-up with prospective agencies in countries with emerging capital markets -- these can sometimes receive technical assistance in exchange for joint-venture arrangements in new markets.

F. Risk Mitigation in Capital Market Transactions

Capital market regulation also aims to prevent abuses in the trading of securities, such as market manipulation, insider trading, and broker abuses of clients. The new securities laws that have been or are being enacted, together with the regulatory bodies that they establish, address this concern. Of course, effective market surveillance requires accurate and timely information: the new electronic trading systems will help considerably in this respect. Securities market regulators should take advantage of relatively low cost technological applications to monitor market behavior and detect potential insider trading (e.g.: based on timing of transactions and bulk portfolio movements). The Securities and Exchange Commissions of a number of countries, including the United States, the U.K, or Chile can likely provide technical assistance via twinning arrangements with regional regulators, in order to transfer know-how and technological configurations, to effectively monitor and guard the safety of budding securities markets.

G. Utilizing the International Market Infrastructure to Promote Domestic Securities

One way to avoid the difficulties of establishing a domestic stock market is to 'import' this service by relying on long-established foreign markets. To an increasing extent, this is what is happening in the major Latin American economies: in 1996, some 40% of the total trading of Latin American stocks took place in US markets.⁴¹ Thus, governments and regulators in the Caribbean should carefully weigh the consequences of various regulations, and clear obstacles for companies which might prefer an international issue or be listed in foreign as well as domestic exchanges.

⁴¹See Hargis (1997) for a discussion of the relative merits of reliance on domestic markets, regional markets, and international financial centers.

IX. LIBERALIZATION AND ENHANCED REGIONAL COMPETITIVENESS: SOME STRATEGIC IMPLICATIONS

Chapters I-VIII of this report attempted to delineate aspects of the current environment, structure, performance, prospects, and shortcomings of the financial services industry in the wider Caribbean region. It emphasized 'inter alia' the critical nature of macroeconomic stability in facilitating sustained market-based financial development in the region in the face of a growing climate of sectoral liberalization. The opening up of markets has been driven largely by requirements of membership of the World Trade Organization (WTO) and a broader pattern of globalization of financial services over the past decade. These shifting paradigms are expected to persist in the remaining period, to the start of the next millennium and well beyond.

Earlier chapters also underlined the urgency for the region to bolster its financial regulatory frameworks, enhance the efficiency of its intermediation processes, create an appropriate climate to facilitate the innovative development of longer term financial instruments (for deepening its resource mobilization efforts especially via the relatively unexploited contractual savings institutions), intensify the development of the region's capital market capacity, and upgrade its human resource capacity.

Central to these macro and micro-institutional structural prescriptions, is the imperative for Caribbean financial policy-makers to further commit to the WTO process of additional liberalization. This would imply a continuing need to define and formulate practical strategies not only for retaining a competitive edge in applicable niches in the face of growing and intensifying market-driven pressures, but continuing to build on such efforts to ultimately deliver more efficient products to a clientele growing rapidly aware of available financial substitutes and alternatives. Some such alternatives are also increasingly more directly accessible via technology from outside the region's borders.

The GATS Process

Global multilateral negotiations for financial services which began with the General agreement of Tariffs and Trade (GATT) Uruguay Round in the mid-1980's, resulted in firm offers by a number of countries in 1994 and 1995. Related negotiations progressed substantially over the past year, with significant new commitments concluded by some 70 nations on December 12, 1997 in the form of the Fifth Protocol of the General Agreement on Trade in Services (GATS). This Protocol which covered the three major segments of the financial services industry: (i) banking and related financial services; (ii) insurance and insurance-related activities; and (iii) securities-related financial services; evidenced commitments in varying degrees by participating countries to abolish restrictions on right of access of financial service companies to local markets. Commitments also included increasing the level of foreign equity participation in local firms, increased commercial presence and cross-border supply, providing enhanced access by foreign nationals to domestic services and vice-versa (physically or electronically), and facilitating access by foreign managerial, technical and other skilled personnel to local financial operations. Agreements and commitments were broadly structured within the more established framework under the earlier GATT arrangement of National Treatment and Most-Favored Nation (MFN) Treatment. The basic rationale for greater commitment by member governments to liberalization and more competitive financial services promoted by the GATS/WTO, is the likelihood of increased specialization in service delivery, based on respective comparative advantages, enhanced efficiency, and ultimately overall welfare improvement.

The Caribbean Experience

The Caribbean's role and involvement in the liberalization process for its financial sector has so far been very limited. In 1994, some 12 Caribbean countries⁴² in total made commitments under the Uruguay Round, nine almost entirely in the area of reinsurance. This reflected the exigencies at the time of disaster protection and reparations. Jamaica also committed to liberalizing aspects of non-life, accident and

⁴² Antigua & Barbuda; Barbados; Belize; Dominica; Dominican Republic; Grenada; Guyana; Jamaica; St. Lucia; St. Vincent, Suriname, Trinidad & Tobago.

health insurance, while Guyana committed to liberalizing its banking and other financial services. At that time commitments were made by the Dominican Republic allowing limited commercial presence in the areas of banking, insurance, leasing, pensions, and securities.

Partly driven by a decision to pursue a regional approach in preparing a strategy following the just concluded December 1997 GATS negotiations, only one CARICOM country (Jamaica) made an offer, again related to life and non-life insurance and for the first time, for selected aspects of banking and other financial services as well as a narrow area of securities. The Dominican Republic also recommitted itself to the 1995 agreements involving commercial presence. However, a detailed study by a technical team under the auspices of the CARICOM Secretariat has substantially advanced recommendations for a more comprehensive and eclectic regional strategy, which will present individual and collective positions of Caribbean member countries, in time for the closing date for ratification of the Fifth Protocol (January 29, 1999)⁴³. This would represent the last window for countries such as those in the Caribbean, for indicating their commitments under the new Protocol.

In attempting to define the strategic positions for enhancing the region's competitive strengths, accurate and comprehensive assessments of the current position of the region's financial services industry will be necessary. Factors to take into account during this process, will include:

- (a) The *high degree of concentration of firms* in virtually all segments of the region's financial services industry, with generally a few firms often accounting for over two-thirds of market share of assets and liabilities, especially in commercial banking and to a lesser extent in merchant banking and the insurance industry. This phenomenon has intensified in recent years by a growing number of consolidations and mergers, especially in Jamaica, Trinidad & Tobago and Guyana;
- (b) The *relative smallness, fragmentation and inherent fragility* of Caribbean economies and their financial markets;
- (c) The *pronounced presence of indigenous financial firms*, arising partly from intense waves of political and economic nationalism in the 1960's and 1970's, with these firms now generally possessing more intimate knowledge of these markets;
- (d) In part due to (b) and (c) above, the past tendency *of foreign firms to be relatively less aggressive* in the Caribbean. It is, however, likely that with necessary commitments to further liberalization, this will change;
- (e) The *imperfectly competitive nature of markets* in most Caribbean countries, their operational tendency to limited asset portfolio diversification, high interest rate spreads, and relatively high profit margins;
- (f) Partly reflecting (e) above, *historical behavior and practices*, actively or indirectly, have reinforced collusive behavior in some market segments, especially banking. This occurred with "unintended support from central banks which, in pursuit of prudential objectives and balance of payments or exchange rate objectives, sought agreement among commercial banks on aspects of market behavior such as purchase & sale prices for foreign exchange, inter-bank allocation of foreign exchange, and bail out of distressed banks."⁴⁴ Favorable treatment by national governments towards indigenous firms through equity participation and superior knowledge of local circumstances, have also been realities which indirectly reinforced these market imperfections, notwithstanding the presence of some product differentiation within and across segments of the industry.

⁴³ A draft strategy consisting of ten elements for dealing with the negotiating position of the region is set out in the unofficial CARICOM Secretariat document entitled "Competitiveness of Caribbean Financial Services and WTO Negotiating Strategies" (1998)

⁴⁴Bourne (1998).

(g) The region's firm commitment to a *Single Market and Economy*, with the related effort to date towards a *Common Currency Area* (i.e.: as applied to the CARICOM area).

The Regional Challenge

In seeking to alter and reshape existing competitive structures and profiles of the Caribbean financial sector, regional governments will therefore need to recognize that, while there have as yet, been no strong and sustained indications of a resurgence in foreign participation in recent years, with local ownership predominating in banking and insurance in most regional economies, (few new foreign banking or insurance licenses have, for instance, been granted in recent years), the growing WTO process of liberalization will most likely create new pressures for increased openness of the region in the future. As a consequence, serious rethinking on will be required regarding:

(i) Existing policies by regulatory authorities with respect to new entrants, and the methods for regulation and monitoring of overall operating performance by financial institutions;

(ii) The extent to which financial services substitution will be permitted and encouraged, for example via 'specialist' structures or 'universal' financial structures; and the extent to which financial firms will be expected to expand their competitive strengths through multi-product services and/or conglomeration. Related to this, will be an assessment of current policies on branching and subsidiaries, and ensuring an adequate regulatory framework to handle greater complexity in institutional financial arrangements.

Even considering the above, however, it would appear that "the Caribbean competitive structure and performance of banking, insurance and the securities industries, are not likely to be affected in the short run by liberalization or openness of the sector under the WTO rules, largely owing to the strong roots of imperfect competition throughout the region and because potential entrants will initially face substantial entry barriers of a non-regulatory nature."⁴⁵

RECOMMENDATIONS

The very process rapid growth of the region's industry and its high profitability, particularly in the banking area, coupled with the growing global momentum for cross-border financial activity, will eventually move the region's financial authorities to consider: (i) greater intra and extra-regional operational and strategic alliances in the sector, (ii) increased mergers and consolidations where economically defensible without generating issues of an antitrust nature, (iii) better branching and networks, (iv) improved banking technology, (v) more financial product innovation and substitution to better capture economies of scale and scope, (vi) increased cross-border activity, especially in banking, and to a lesser extent, in the insurance and securities markets, and (vii) sustained development of human resource capability especially in the technology-intensive aspects of the financial services industry.

In this connection, the challenge for the Caribbean will be the extent to which regional governments will be able to respond to the need for such increased external and internal competition, while balancing the politically delicate issues of degree-of-ownership and foreign country participation in the sector. This will need to consider the continued healthy operation of indigenous firms whose failure could have repercussions on financial and real sector concerns, while simultaneously responding to the realities and capacities of local business communities to more profitably insert themselves in the wider international marketplace. These latter issues point to ever present considerations which national and regional authorities in the Caribbean will need to directly confront.

⁴⁵Bourne, op. cit.

X. CONCLUSIONS

The increasingly open economies in the Caribbean region and the emerging competition in financial services require prompt and sober examinations of the efficiency, asset quality, risk mitigation characteristics, and regulatory harmonization of the region's financial institutions and systems. The recommendations in this report address six main areas: (i) the macro and fiscal environment, (ii) institutional structures and regulations in the financial sector, (iii) obstacles to long-term and small enterprise finance, (iv) contractual savings institutions, (v) capital market development, and (vi) competitiveness in the context of global trade liberalization.

Financial sector development must start with the achievement of macroeconomic stability via sound fiscal policy and prudent debt management. The safety and soundness of the banking system, supported by robust regulatory safeguards including, inter alia, well defined safety net procedures, accountability from market participants, and rigorous enforcement of prudential operating requirements, represents a key step. As the crisis in South East Asia clearly demonstrated, the existence of a profitable banking sector and updated regulatory standards does not guarantee adherence to sound commercial practices -- these manifestations become extremely fragile under situations of macroeconomic stress, and frequently reveal the existence of widespread non-prudent business practices.

Regional and hemispheric initiatives & task forces, and recent World Bank mandates agreed with the Western Hemisphere Finance Ministers can offer timely resources for upgrading financial and regulatory systems, including standardization of Basle norms and seeking an optimal framework for cross-border and regional/foreign institutional participation in the financial sector. In the Caribbean context, supervisory oversight should include provisions not only to ensure the safety of domestic banking systems, but also safeguards in the development of the offshore sector and prevention of money laundering activities. Once the above major safeguards are achieved, the provision of longer term finance, small enterprise finance, and subsequently pensions and capital market development, represent second generation sequential steps in the reform process. These latter areas, while of strong interest to many governments in the region, will be achievable only under conditions of stable economic performance and a robust banking framework.

For each of the areas addressed, the main issues are identified below in priority order. While many of these issues are common to the economies of the region, it is also imperative that individual country conditions take account of the appropriate refinements in the design of relevant policy reforms and institutional building efforts.

a. *Creating a conducive environment for financial development.* Maintenance of macroeconomic and fiscal stability supported by budgeting and debt management systems is the first priority, followed by development of regulatory mechanisms to assure sound banking systems -- the latter, however, should not imply over-regulation of the sector, but rather, putting in place incentives conducive to increased self-regulation by the market. An examination is needed on the appropriateness and the effects of direct controls and reserve requirements, which may not be the most efficient tools for monetary policy, and may generate distorted incentives in the sector. Priority, however, should also be given to the establishment and definition of clear regulations governing entry, exit, and crisis procedures, as well as promoting transparency in financial transactions. The latter involves ensuring a proper payments system intra-regionally, implementing modernized property and company registries, privatizing state-owned banks to promote competition, and harmonizing regulations for non-banks, foreign ownership allowances, exchange & capital controls, and loan loss reporting standards.

b. *Encouraging institutional consolidation and consistency in regulatory policies to ensure efficiency and stability in the financial sector.* Regulatory norms need to consider the benefits and costs of multi-service banking institutions in small economies, the adaptation of international banking standards to local conditions, setting clear bank crisis procedures a priori, and deciding on the option for explicit, albeit

limited deposit insurance. While avoiding concentration of industry structures, consolidation should be explored as a way to improve the efficiency and robustness of financial institutions. Though not advocating excessive foreign ownership of the financial sector, a healthy proportion of such market players can greatly improve the safety and shock-absorbing capabilities of the system. For the non-bank market, immediate steps are needed to eliminate regulatory arbitrage and improve consolidated supervision, to ensure proper monitoring of that sector.

c. *Removing obstacles to long term finance.* Development of long-term finance requires not only macroeconomic stability, but also streamlining and increasing the capacity of the judicial system to promptly resolve debt contract issues. Addressing the poverty sector and reaching lower-income entrepreneurs involves modernizing the property rights / cadastre systems which are essential to support micro-credit development, and supporting the development (and disclosure practices) of community-based credit institutions. Equally important for developing transparency in financial information in all sectors, is the strengthening of the tax regime coupled with initiatives to improve corporate disclosure and standardize accounting reporting norms, in both financial and non-financial institutions.

d. *Developing contractual savings institutions.* Reforms in contractual institutions could improve their contribution to investment funding and household security. This includes further allowances for pensions investments in foreign assets, domestic private debt, and equity instruments, to improve risk diversification and returns, while strengthening supervision. The operation of social security funds by independent trustees, and privatization of such, should be considered to ensure fiscal sustainability.

e. *Promoting Sustained Capital Market Development.* Development of the government securities market benefits the financial system by releasing it from indirect forms of fiscal funding, and reducing government reliance on foreign borrowing. This market helps establish risk benchmarks for other securities, and develop markets for longer term assets, which are needed by savings institutions particularly pension funds. The viability of a private equities market depends on its size -- to allow market players, underwriters and institutional support mechanisms (e.g.: stock exchanges) to be profitable. Integration of the region's equity markets while utilizing existing domestic and international market institutions, are promising ways to augment the liquidity of equities, especially if shares of state-owned enterprises are offered on the market. While private bond markets are not well developed, pooled mortgage banks have made initial successes, based on the reliability of payment from the underlying securities. From a regulatory perspective, liquidity constraints such as stamp taxes or required physical possession of securities, need to be abolished to ensure equal footing of this market with other financial instruments.

f. *Liberalization and Increasing Competitiveness.* Most Caribbean financial institutions, particularly banks, are gradually improving efficiency through consolidation, improving economies of scale, modernization of technology, and reformed regulations. Nevertheless, the cost structures and risks of such institutions remain weak points, especially compared to rapid changes in the sector at the global level. The ability of Caribbean financial institutions to effectively compete in the international arena, therefore, is likely to be a persistent issue, to be addressed in the context of the GATS WTO negotiations.

While financial sector reforms would ideally be conducted on a regional basis as a first step towards establishing global links with international financial markets, experience has shown that it is difficult to implement reforms simultaneously. For this reason, countries should begin a process of harmonization through reciprocal liberalization of tax, legal, capital, and other regulations, while standardizing financial sector regulations and their enforcement. This will begin to open the door for financial sector competition and integration in the region. Progress in these areas is typically incremental, and while the promotion of Caribbean-wide regional initiatives appears promising, it might be more effective to begin with blocks of countries which are more prepared to take the steps sooner. Once the benefits of such pilots are observed, further integration of other regional economies will be naturally encouraged by market demand and pressure from political constituencies.

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