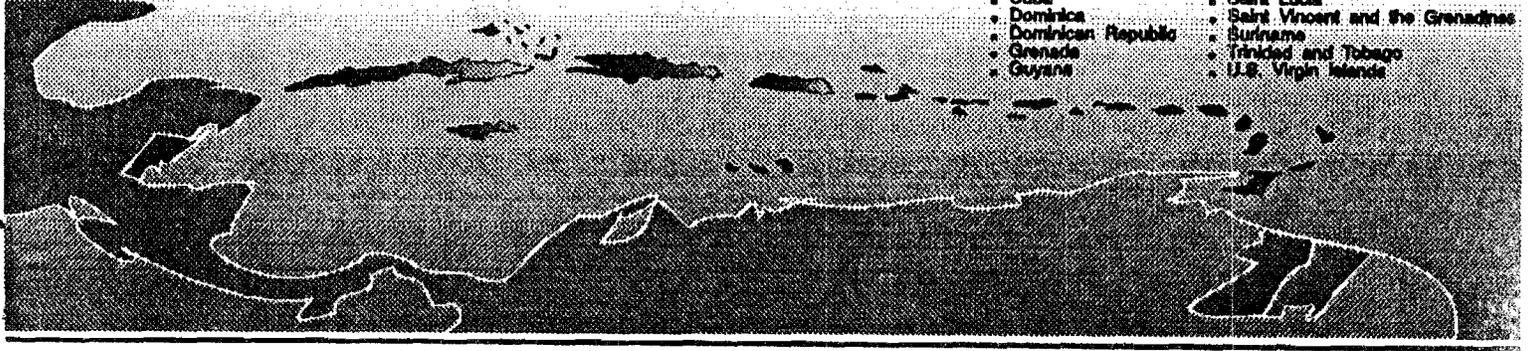




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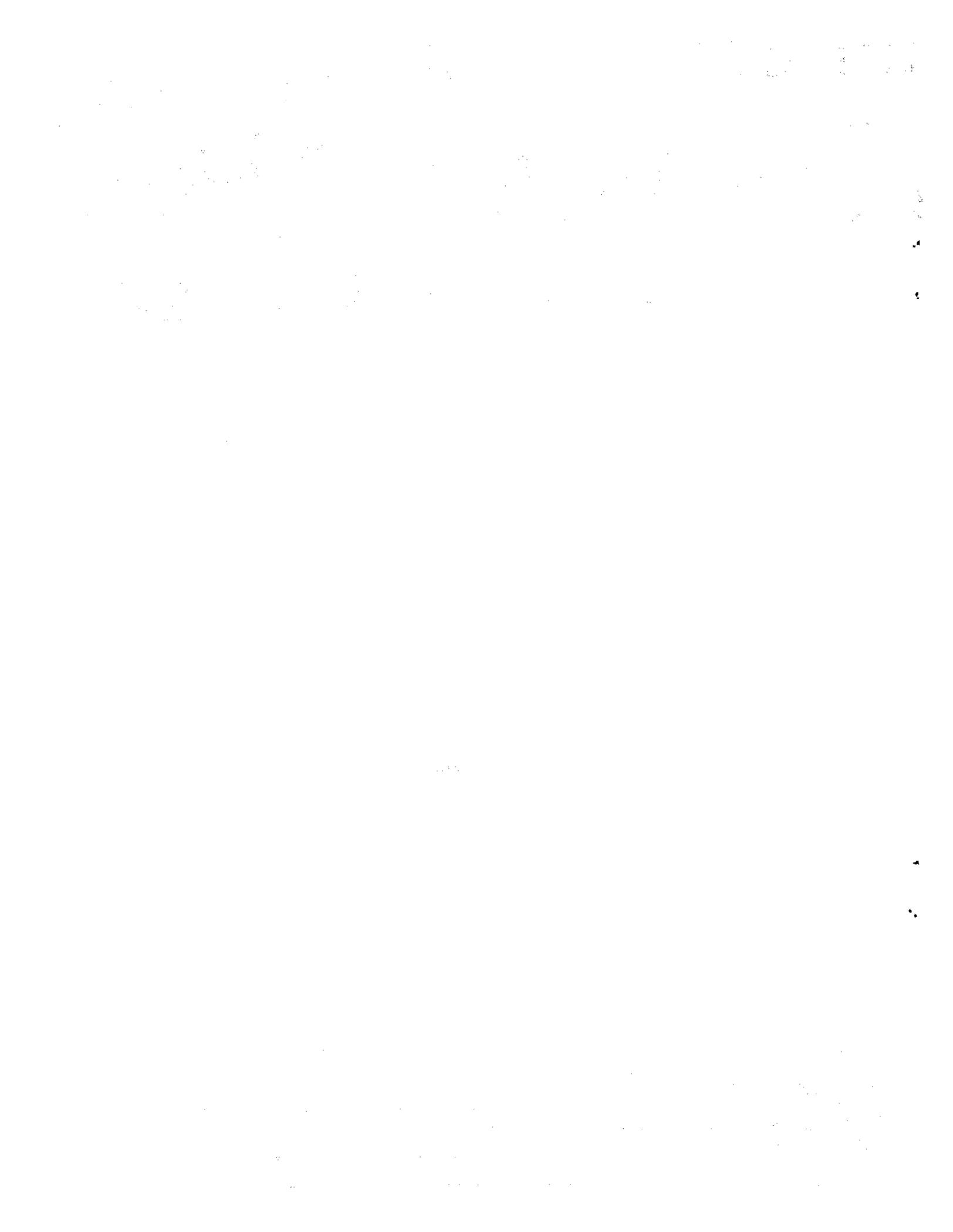


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**FINANCIAL LIBERALISATION:
ITS RELEVANCE AND EXPERIENCES IN THE CARIBBEAN**



UNITED NATIONS
ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN
Subregional Headquarters for the Caribbean
CARIBBEAN DEVELOPMENT AND COOPERATION COMMITTEE



FINANCIAL LIBERALISATION: ITS RELEVANCE AND EXPERIENCES IN THE CARIBBEAN

Introduction

Financial liberalisation was widely implemented in most industrial countries over the last three decades. It resulted in the breakdown of barriers between the financial systems of these countries and those established in offshore centres around the world. These developments led to an increase in the pace of integration of financial markets through freer movements of financial resources. This trend has been reinforced in the 1980s and early 1990s by an increase in the rate of implementation of trade liberalisation programmes and the rapid increase in trade-related payments associated with the high rates of growth in world trade. These factors, together with the rapid technological developments which have greatly improved trade in financial instruments, served to strengthen the emergence of a global capital market. The increase in the liberalisation of restrictions on both domestic and international financial transactions is aimed at bringing about a number of benefits, including better opportunities for risk diversification, more possibilities to increase the rate of investment beyond the constraints of domestic savings and a more efficient mobilisation and allocation of resources in more competitive markets.

More recently, developing countries, including some Caribbean countries, adopted policies aimed at liberalising their financial systems mostly as part of the economic stabilisation and structural adjustment programmes. The adoption of financial liberalisation policies reflected efforts to improve competition in the domestic financial systems and attract more capital with the objective of establishing a more efficient system of mobilisation of resources as well as a better and more efficient allocation of these resources in the economies. The overall objective being to achieve higher rates of production and employment and higher standards of living.

In addition to the search for efficiency in the mobilisation and use of both foreign and domestic resources, liberalisation may have been encouraged by the realisation that the policies used to insulate the economies from international financial markets were becoming increasingly ineffective, especially those designed to retain resources in the countries. It is well known that large amounts of capital left developing countries despite the implementation of controls on both current and capital accounts of the balance of payments. Recent financial liberalisation policies may be reflecting attempts by the countries to adjust policies to the realities of the international financial environment.

Immediately after their independence, most developing countries, including those of the Caribbean, thought that their underdeveloped financial systems would not necessarily respond to their development needs. Consequently, they decided to intervene heavily in their domestic financial systems in order to ensure that the financial resources available went towards the financing of the priority areas identified in their development plans and/or to serve the needs of the low income sections of their populations, for example, small farmers, and assist in their policies of redistribution of resources. Interventions in the financial systems consisted mainly in directing credit towards particular industries, regions, a variety of State-owned enterprises, medium- and small-scale firms as well as low income communities in both rural and urban areas.



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The instruments used to give effect to these credit policies included subsidised interest rates, quota allocation of bank loans and credit guarantees, among others. At the same time, extensive controls of capital flows were widely implemented to ensure that the internal system of controls did not break down as a result of competition from international financial institutions and that domestic financial resources were exclusively used to finance the priority projects identified in the development plans. Foreign exchange controls were also widely used and foreign exchange was allocated only to those imports which were deemed essential to the development of the countries.

In the early 1980s developing countries, including those of the Caribbean, became increasingly unable to finance their worsening balance of payments and fiscal deficits because of major changes in the international financial environment, which involved, among other things, a sharp increase in interest rates. In an effort to remedy their macroeconomic disequilibria, these countries implemented structural adjustment and reform programmes supported by the International Monetary Fund (IMF), the World Bank and the Inter-American Development Bank (IDB). These reforms included policies designed to liberalise the domestic financial systems of these countries and, in some cases, included the lifting of restrictions on capital flows and the floating of exchange rates. Guyana, Jamaica and Trinidad and Tobago are some of the Caribbean countries which have been implementing extensive financial liberalisation programmes as part of their economic reform programmes. This paper examines the policies of financial restrictions and some of their economic implications. It also looks at the interrelationship of these restrictions with macroeconomic policies, with particular reference to Guyana, Jamaica and Trinidad and Tobago. It then considers financial liberalisation in these three countries and draws some conclusions.

I. Intervention in the financial system: A widely used approach

The existence of externalities and other market failures and the widely held belief that these could be remedied by government action served as a basis for wide ranging interventions in the economies of both developing and developed countries. However, these interventions seem to have been used more extensively in developing countries. Some of the most popular interventions consisted of the imposition of numerous restrictions on trade and direct control of the State in many sectors of the economy. In the area of finance, the existence of a segmented market, the absence of a market for long-term finance, the rudimentary state of the financial sector, in general, prompted many developing countries to intervene extensively in their financial markets to stimulate investment and accelerate economic growth. The idea being that with sufficiently low interest rates, investment and its productivity would increase in the already identified key sectors and would contribute to the acceleration of economic growth and an increase in the general level of income in the countries.

The implementation of the programmes of intervention in the financial sector was intended to give the governments the power to allocate large proportions of bank lending in some of these countries. For example, 70 per cent of new bank lending in Pakistan in 1986 was directed by the

Government and in Brazil Government credit programmes accounted for 70 per cent of credit outstanding to the public and private sectors in 1987. Credit programmes which were established as a result of the various systems of allocation of credit by governments were extensive and diverse and included discriminatory rates of interest, different maturities and grace periods. The targets of these programmes were also diverse and encompassed agriculture, industry, tourism, housing, etc. These systems of intervention usually grew more complicated over the years and became increasingly hard to manage.

The means of intervention used by governments to direct credit generated in the financial system towards its already determined priorities included directives issued to banks to allocate a given percentage of their loan portfolio to a particular sector, for example, agriculture, industry, etc., or to fix interest rates usually at low levels for loans to particular priority sectors. In many instances, governments also established development finance institutions usually dealing with specific sectors, such as, agriculture, industry, etc., and specially oriented towards the provision of medium- to long-term credit to the sector under their responsibility. In some instances, the intention was clearly to discriminate against the private sector in favor of the public sector with regard to the allocation of funds in the economy.

In addition, as part of their monetary policies some governments issued directives to banks to maintain a large portion of their assets at the Central Bank at very low or zero interest rates or buy government paper. These low interest rates inevitably affected deposit and loan rates in the rest of the economy and although they may have reduced the domestic component of debt service payment of the government, they may have served to reduce savings and promote inefficient investment. In some instances, the creation of money through lax monetary policies was used to finance fiscal deficits and served to fuel inflation in some of the countries, especially those in Latin America.

These government policies which were designed to allocate credit to priority sectors in the economy may have succeeded in ensuring access to credit by the targeted industries or entities. For example in Guyana, 56 per cent of non-governmental borrowing from domestic banks went to State-owned enterprises between 1983 and 1985. The same State-owned enterprises seem to have benefited from most of the foreign finance which was available to the countries and this is reflected in the share of these entities in the debt obligations of some developing countries. For example, it was estimated that more than half of the foreign debt of the Philippines and Zambia was accounted for by the State-owned enterprises of these countries¹.

Credit directed towards export development was estimated to have increased substantially. In some instances, however, the target programmes may not have reached the intended beneficiaries because the system of subsidized interest rates resulted in credit rationing which usually favours the

¹ World Bank, World Development Report, 1989.

bigger and better known borrowers². In the cases where resources reached their intended beneficiaries, their efficient utilisation was open to question. In the case of credit oriented towards export, for example, the anti-export bias which was prevalent in most countries, especially those with highly restrictive trading policies, may have worked against the development of export industries in these countries. The allocation of financial resources to projects which were not necessarily the investment with the best returns resulted in the misallocation of resources in the economies, while at the same time crowding out the sectors and projects which were not designated a priority.

At the level of the financial systems, the extensive intervention programmes for credit allocation and subsidized interest rates suppressed competition in the system by weakening both its allocation and mobilisation of resources functions. These measures, in turn, resulted in the weakening of the financial system and discouraged its development. The effects of these measures were reinforced by the wide use of foreign exchange and capital controls which acted as barriers against international capital markets. These controls were not very effective since they allowed large amounts of capital to flee the countries as a result of the search by citizens of these countries for asset diversification. They also seem to have played a role in discouraging capital flows to these countries.

Although economic growth is a complex process with many contributing factors, it is generally believed that administratively fixed low or negative interest rates, however attractive they may be to governments, are an inferior alternative to market related sufficiently positive real interest rates which are considered to be essential to the attainment of economic growth. Market related interest rates are the best option to achieve the three broad objectives of financial sector policies, namely to mobilise adequate amounts of resources both domestically and internationally, to provide a stable financial environment which will encourage development and to allocate credit to its socially most productive use³. However attempts to assess the effects of distorted capital markets on economic growth, taking distorted interest rates as a proxy, have not been conclusive. Some found a negative correlation between a measure of distorted interest rates and economic growth⁴ while others do not find any statistically significant relationship between real interest rates and GDP growth⁵.

² C. Gonzales Vega. "Credit rationing behaviour of agricultural lenders: The iron law of interest rate restrictions" in D.W. Adams et al., *Undermining Rural Development with Cheap Credit*, (Special Studies in Social, Political And Economic Development Series), Boulder, Colorado, Westview, 1984.

³ See James A. Hanson. and Craig R. Neal, "Interest rate policies in selected developing countries, 1970-1982", Washington D.C., World Bank, 1986.

⁴ R. Agarwala. "Price distortions and growth in developing countries", Washington D.C., World Bank Staff Working Paper N° 575, 1983.

⁵ D.R. Khakhate, "Assessing the Impact of interest Rates in Less Developed Countries", IMF, Washington D.C., mimeo., 1985

In some cases like Korea, directed credit programmes may have been successful to some extent but in most cases and especially in countries with extensive and complicated trade protection systems and an unstable macroeconomic environment, they may only have served to worsen the existing distortions in the economies and increase the economic costs associated with such distortions. In addition, these targeted credit programmes and subsidised interest rates may have discouraged the intermediation process and the creation of capital markets in these countries and weakened the financial system in general. One of the indications of these negative developments was to surface later in the form of unsustainably high levels of non performing loans in the banking system and financial development institutions which led to the many interventions of the central banks to rescue financial institutions which had clearly become insolvent. Directives given to both the banking systems and the development finance institutions to provide long term finance may have served to discourage the creation of capital markets in these countries.

Financial liberalisation, like financial restriction, has not been implemented without problems. The most widely quoted cases of financial liberalisation programmes running into trouble being those of Chile, Argentina and Uruguay in the late 1970s where the implementation of financial liberalisation policies led to high real interest rates, bank insolvencies, appreciation of the exchange rate and a deterioration of the balance of trade prompting all three countries to abandon their financial reforms. The failure of these financial liberalisation experiences was generally attributed to the implementation of financial liberalisation policies in the context of unstable macroeconomic environments and inadequate prudential and regulatory systems of the financial sector in the presence of moral hazard⁶.

II. Intervention in the financial sector: The experiences of Guyana, Jamaica and Trinidad and Tobago

The financial systems of Guyana, Jamaica and Trinidad and Tobago closely resembled those which existed in other developing countries at a similar stage of development. These systems comprised few financial institutions, usually commercial banks, providing mostly short-term finance for import and export purposes. Sources of medium- to long-term finance were either scarce and expensive or non-existent. The underdevelopment of the formal financial sector created a favourable environment for the establishment of informal financial systems characterised by high costs of capital. Regulations and supervision of the financial systems which existed in most cases were either poorly enforced or not adequate for the purpose.

Also the policies adopted and implemented to deal with these problems of the financial sector were by and large similar to those adopted in other developing countries to ensure that the financial resources available were channeled towards the implementation of their development plans. The stimulation of investment through easy access to credit was at the time thought to be more important for the attainment of economic growth and development than economic stability. The policies implemented included interest rates and credit controls, the allocation of credit to priority sectors, the

⁶ Carlos Diaz Alejandro. "Goodbye financial repression, hello financial crash", Yale University Economic Growth Centre, Discussion Paper No. 441, May 1983.

creation of financial development institutions and in the case of Jamaica and Trinidad and Tobago, the establishment of stock exchanges to create a market for long-term finance.

Guyana, Jamaica and Trinidad and Tobago have over the years implemented various systems of interventions in their financial systems which included programmes of allocation of financial resources to various priority sectors and projects in their economies. These interventions were much more pronounced in Guyana where State control assumed much greater proportions than in the other two countries. The following section of the paper looks briefly at some aspects of these countries financial policies before the implementation of their recent financial reform programmes.

Before and during the implementation of its Economic Recovery Programme which started in 1988, deposit and lending interest rates as well as rates of treasury bills in Guyana⁷ were administratively determined and were largely negative in real terms, inflation rates having been always higher than the rates of interest. National deposit rates were 11.10% in 1987, 12 per cent in 1988 and 15.8 per cent in 1989, largely exceeded by the inflation rates which stood at 29.4 per cent, 43.1 per cent and 61.3 per cent in 1987, 1988 and 1989, respectively. The Guyanese financial system included banks especially geared towards the financing of specific sectors of the economy or providing financial services to communities deemed not well served by other banks. In that context, the Guyana Cooperative and Agricultural Development Bank provided credit and technical assistance to industrial and agricultural projects using mainly government and donor funds. The Guyana National Cooperative Bank had objectives which included, among others, the extension of financial services to communities, mainly those in the rural area not served by the rest of the banking sector.

The system of supervision of the financial sector in Guyana was split between the Bank of Guyana whose responsibility included the supervision of the commercial banks and a body called the Cooperative Finance Administration (COFA) whose responsibilities included the supervision of the non banking financial institutions. There have been very few inspections carried out by either the Central Bank or COFA⁸. The Bank of Guyana comes under the authority of the Ministry of Finance and many of its decisions have to be approved by that ministry. There were no restrictions imposed on the Bank with regard to its lending to the government and this was used to facilitate government borrowing to finance its fiscal deficits. In addition, a large proportion of credit in the country was accounted for by the Government or the State-owned enterprises. Public sector credit represented more than 85 per cent of domestic credit for every year throughout the 1985-1995 period. Private sector credit, although not representing a high proportion of domestic credit has nevertheless been increasing over recent years.

The trade regime in Guyana was highly restrictive. In addition to the implementation of various structures of the Common External Tariff (CET) of CARICOM, Guyana's trade regime

⁷ Data on Guyana taken from Inter-American Development Bank, Social and Economic Progress in Latin America, various issues

⁸ See World Bank, Guyana: From Economic Recovery to Sustained Growth, April 1992

included a complicated system of other charges as well as a number of tariff exemptions which were either part of the fiscal incentives offered and published or were at the discretion of the Ministry of Finance. Trade prohibitions as well as quantitative restrictions and licensing for both exports and imports were also in operation at various times before the economic reforms of the 1980s. Moreover, the exchange rate was fixed and became highly overvalued leading to substantial amount of capital flight despite the implementation of strict foreign exchange controls on both the current and capital accounts of the balance of payments.

The financial system of Jamaica was also the subject of numerous and elaborate systems of restrictions and regulations before the implementation of the latest set of financial liberalisation policies in the early 1990s. Interest rates in the country were administratively determined and floors and ceilings for these rates were fixed. Interest rates were sometimes below inflation rates like in 1985 when the national deposit rate stood at 21.31 per cent while the inflation rate was at 26 per cent. Specific sectors which were considered priority sectors by the Government were identified to benefit from preferential interest rates administered by specialised institutions or benefiting from a special refinancing scheme operated by the Bank of Jamaica. Various directives were given with the objective of discouraging the allocation of credit for consumption purposes and orienting financial resources towards targeted sectors such as tourism and agriculture. At one point in time, a preshipment financing scheme was established in Jamaica with the objective of promoting exports through the provision of easy credit. This was implemented together with an export guarantee scheme, however both were later abandoned. Jamaica established a Stock Exchange in 1969 as well as a number of development finance institutions to provide the missing market of long-term finance necessary for the development needs of the country.

The trade regime in Jamaica was restrictive. It operated a complicated system of tariffs and non-tariff barriers including the operation of a negative list, quantitative restrictions and licensing requirements. Payments restrictions on current account and controls on capital flows were used extensively. Jamaica experimented with a fixed exchange rate regime as well as a dual exchange rate regime. A system of auction of foreign exchange to stabilise the exchange rate was later adopted and then abandoned in the face of pressure in the foreign exchange market. The present system of floating exchange rate was subsequently adopted. Jamaica experienced serious external and internal deficits which became increasingly difficult to finance. The financing of fiscal deficits through monetary expansion and public sector borrowing was tried and abandoned at various points in time after it became clear that it was having negative effects on public debt and inflation. Public sector credit was over 57 per cent of total domestic credit for both 1985 and 1986. Since then it declined steadily.

The difficulties and complexities of financial reform were reflected in the country's attempts to reform its financial sector. For example, in 1985, a financial sector reform was implemented with the removal of restrictions on credit allocations and the levels of interest rates. However, pressure from rapid credit expansion, underpinned by undue expansion of money supply, brought about the reimposition of both credit and interest rate restrictions in 1989. The present reforms started in 1991 and are still continuing.

In Trinidad and Tobago, there was active government intervention in the financial sector. Interest rate controls were applied with maximum deposit rates and minimum lending rates administratively determined. Guidelines were issued to allocate credit to priority sectors and limit loans to non-business purposes. There were also limits on loans to foreign-owned companies and lending to such entities were closely monitored by the authorities. In addition, a number of specialised financial development institutions, such as the Industrial Development Corporation, the Development Finance Company and the Agricultural Development Bank, promoted, through subsidise financing, small scale businesses, larger firms and agricultural businesses, respectively. An Export Development Company was also established to provide financial assistance and export financing at subsidised rates. In Trinidad and Tobago, the supervision of the deposit taking financial institutions as well as the non-bank financial institutions is the responsibility of the Central Bank of Trinidad and Tobago. More recently the country has established a Deposit Insurance Scheme to which all deposit taking institutions must contribute.

Credit to the public sector never represented a high proportion of total domestic credit but it seems to have been on the increase from the middle of the 1980s onwards. Loans from the Central Bank were used in certain cases to finance the budget deficit. Foreign exchange controls, though always in existence, have usually been employed more strictly during periods of balance of payments difficulties. These controls required the surrender of foreign exchange to the authorities and included guidelines for the allocation of foreign exchange sometimes by product category. Foreign investment and the repatriation of dividends and capital were subject to government approval. Trade protection was also widely applied as part of the import substitution model being pursued. The trade restrictions employed included the use of negative lists, licensing requirements, quantitative restrictions as well the prohibition of the imports of certain goods. Trinidad and Tobago operated a single fixed exchange regime most of the time except for the period 1985 to 1987 when a dual exchange rate was in operation. A floating exchange rate was introduced in 1993.

Putting aside the various differences between the three countries, it was clear that wide ranging interventionist financial policies were implemented in Guyana, Jamaica and Trinidad and Tobago with the objective of channeling financial resources to pre-identified uses which were thought to favour improvement in productivity and the acceleration of development. These policies were also aimed at the development of the domestic financial sector and the improved access to finance by those sectors or groups of people, such as the rural poor. There is little doubt that in all three countries, financial resources were channeled towards those sectors, enterprises or projects which the government had selected. In addition, a large amount of financial resources went to the governments through high levels of reserve requirements or the purchase of government paper or borrowing from the central banks. Although it is difficult to assess the effectiveness of these policies, there was widespread belief that these funds may have served to finance parts of the public deficits which these countries have been running over the years. Public deficits were particularly high in the case of Guyana where they stood at 58.8 per cent and 42.2 per cent of GDP in 1986 and 1987, respectively. The various schemes of subsidies through the financial system which were in operation in the three countries may have compounded their fiscal problems. The consistent and large deficits in the current account of these countries' balance of payments required a steady flow of external

resources which were becoming increasingly difficult to find. Also the low or negative rates of interest combined with the extensive programmes of directed credit may have led to suboptimal domestic savings which were inadequate to finance the required level of investment in the economies and which were reflected in the current account deficits of the balance of payments of these countries

Financial savings do not seem to have been encouraged by the low or negative interest rates which have existed in the countries. In fact, these may have encouraged the use of savings in the countries for the acquisition of physical assets. With regard to investment, the low or negative interest rates and the allocation of credit may have led to the financing of suboptimal investment because of the arbitrary selection of the investment projects. Since interest rates were usually held down artificially, some substantially loss making investment may have become profitable leading to the demand for credit outstripping its supply. This may have resulted in credit rationing which was usually carried out by administrative actions (rather than by prices) with the end result that less productive investments were approved and implemented. It has been estimated that the productivity of investment is higher in the countries with positive real interest rates than those with negative real interest rates⁹.

Distortions in these economies which may have been brought about by the trade restrictions implemented in the countries, added to the distortions resulting from intervention in the financial system, may have led to the channeling of financial resources to the less productive and sometimes value added subtracting investments. Low or negative interest rates combined with the fixed and overvalued exchange rates that the three countries were operating may have contributed to heavy outflows of capital despite the strict controls which were in operation in all three countries. It was estimated that the outflows of capital amounted to more than US\$600 million for Guyana and US\$837 million for Jamaica and US\$896 million for Trinidad and Tobago between 1980 and 1986¹⁰. Taken together, these policies did not serve to strengthen or diversify the financial systems as intended. Some banking institutions were on the verge of collapse, for instance, the Guyana National Cooperative Bank had to write off 1.4 billion Guyanese dollars or an amount much larger than its equity. Another Guyanese bank, the Guyana Agriculture and Industrial Development Bank of Guyana, carries 65 per cent non productive assets in its portfolio. Also, some commercial banks in both Jamaica and Trinidad and Tobago run into difficulties and had to be closed or restructured.

The Industrial Development Corporation, the Development Finance Company and the Agricultural Development Bank of Trinidad and Tobago experienced difficulties resulting from various factors including misallocation of funds, mismanagement and lax systems of controls etc. Nor were they as effective as they set out to be in meeting development objectives. In Jamaica and

⁹ See Alan Gelb and Patrick Hanohan, 1989. Financial Sector Reforms in Adjustment Programmes. Policy, Planning and Research Working Paper 169, Washington D.C., World Bank, Country Economics Department. Processed.

¹⁰ Karl Bennet, Capital Flight and Caribbean Economic Policy. Paper delivered at the Workshop: Caribbean Economic Policy, Foreign Investment and Capital Flight. Institute of International Relations and the Monetary Studies Programme 28-29 October 1994, U.W.I. St Augustine

Trinidad and Tobago, stock exchanges have been established with the objectives of providing and strengthening a market for long-term finance and serving to fill a gap in the financial systems of these countries. These two stock exchanges are not yet well developed judging by the number of companies listed on the exchanges and the number of securities traded¹¹. This is despite the fact that the Jamaican Stock Exchange has been in existence for more than two decades. The existence of these exchanges is nonetheless important for the future development of the financial system in these countries. The underutilization of the stock exchanges might be linked to the ownership structure of firms in the countries and their relatively easy access to bank credit. But macroeconomic policies and restrictions placed on the financial sector also played a role. The availability of external finance in the 1970s at low interest rates not only allowed the countries to ignore their worsening macroeconomic disequilibria, but also encouraged them to further worsen them. Most of the external financial resources were usually going to the public sector with government guarantees rather than the private sector on commercial criteria.

In the 1980s after experiencing major fiscal and balance of payments disequilibria and mounting external debt, caused by inappropriate economic policies including those related to finance and major changes in the international economic and financial environment - such as the oil price rises, the rise in interest rates, the decline in export commodity prices including oil and world recession¹² - Guyana, Jamaica and Trinidad and Tobago implemented stabilisation and structural adjustment programmes which included financial liberalisation. The following section of the paper will examine briefly some aspects of the financial liberalisation in these three countries.

¹¹ See Kelvin Sergeant, "The Trinidad and Tobago Stock Exchange: Market Performance and Suggestions For Further Developments in" Insights Into An Emerging Financial Structure: The Experience of Trinidad and Tobago," edited by Ramesh Ramsaran.

¹² For a detailed analysis of the genesis of the macroeconomic disequilibria in Guyana, Jamaica and Trinidad and Tobago see LC/CAR/G.404, Structural Adjustment and Privatization: An Examination of their Relationships in Four Caribbean Countries, December 1993.

III. Some aspects of financial liberalisation in Guyana, Jamaica and Trinidad and Tobago

Guyana, Jamaica and Trinidad and Tobago are the three Caribbean countries which have gone furthest with financial liberalisation. Among the three countries examined, Guyana¹³ is the one where State control was most prevalent. Here, like the other two countries, financial sector reform was undertaken along with other economic reforms. Guyana liberalised its interest rates which rose towards levels above that of inflation levels in certain years but remained negative in others. For example, the national deposit rate was at 15.8 per cent in 1989, well below the inflation rate for that year which stood at 61.3 per cent; in contrast it was at 22.5 per cent in 1992 well above the inflation rate for that year, which stood at 14.2 per cent. The treasury bill rate which came about with the start of treasury bills auction in June 1991 served as an anchor to interest rates in the country. The restructuring of the financial institutions, together with their privatization, was being implemented.

In addition, Guyana is implementing a vast programme of trade liberalisation and has liberalised transactions in both its current and capital accounts.

Fiscal policy in Guyana went through fundamental changes, including attempts to broaden the tax base and improve tax collection through, for example, an improvement in the functioning of the customs and excise department. These efforts at fiscal reforms, together with efforts to curtail spending, were showing some positive results. In 1993, the central government fiscal position improved significantly with an increase in current revenues of 16 per cent of GDP and a decrease in government expenditure of over 10 per cent of GDP. The result was a central government current account surplus of 2 per cent of GDP. However, the overall deficit, although decreasing, remained high at 7 per cent of GDP in 1993 but lower than 1992 where it stood at 17 per cent of GDP. More prudent monetary policies were applied as part of the stabilisation programme with treasury bill sales used to manage credit and money in the economy.

¹³ Data on Guyana taken from the Inter-American Development Bank, *Economic and Social Progress in Latin America*, various issues

Table 1
Selected Economic and Financial Indicators
Guyana

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
% change in GDP ^{1/}	1.0	0.2	0.7	-3.0	-4.8	-3.1	6.1	7.7	8.2	8.5	5.1
Rate of Inflation	15.0	8.2	29.4	43.1	61.3	64.9	70.3	14.2	7.7	16.1	8.1
Balance of Payments ^{2/}	-96.6	-141.1	-109.5	-93.0	-113.3	-147.8	-118.0	-146.7	-137.9	-100.8	-94.9
Fiscal Balance ^{3/}	-56.1	-58.8	-42.4	-31.6	-6.6	-22.9	-15.6	-17.1	-6.0	-2.6	
Exchange Rates ^{4/}	4.3	4.3	9.8	10.0	27.2	39.5	111.8	125.0	126.7	138.3	142.0
Lending rates	15.0	15.0	15.0	15.1	18.9	32.8	33.6	28.7	19.4	18.4	19.2
National deposit rates	12.0	12.0	11.1	12.0	15.8	29.2	29.5	22.5	12.3	11.4	12.9
% change of money supply	18.9	19.0	51.3	57.1	39.5	54.5	65.5	31.5	32.0	10.4	16.7
Private sector credit as a % of total domestic credit	9.7	10.9	12.1	12.0	8.5	10.3	8.2	7.2	8.4	11.2	15.1
Public sector credit as a % of total domestic credit	90.2	89.1	87.8	87.9	91.4	89.7	91.8	92.8	91.6	88.8	84.9

^{1/} (At constant prices)

^{2/} Current Account (in US\$M)

^{3/} (as a percent of GDP)

^{4/} Exchange Rates to US\$

Source: IMF Financial Statistics, ECLAC and National Data

Money supply has grown less rapidly over recent years. It grew by 10.38 per cent in 1994 and 16.73 per cent in 1995 compared to 32.02 per cent in 1993. The fiscal position of the Government allowed it to become a net creditor to the Bank of Guyana. Exchange rate policy went through a fundamental change with the legalisation of the parallel market rate in 1990 and later the unification of the exchange rate in 1991. The Guyana dollar depreciated significantly, going down from G\$39.5 to US\$1 in 1990 to G\$111.8 to US\$1 in 1991 and G\$142 to the United States dollar in 1995. Although it has fluctuated throughout this period, the Guyana dollar has been depreciating against the United States dollar. The Central Bank has been managing these fluctuations through interventions in the market either to sterilise flows or to inject foreign exchange in the market. In addition, reserve requirements have been used extensively by the Bank of Guyana to manage credit and money in the economy. These have been increased in 1994 from 11 per cent to 16 per cent of demand deposits and from 9 per cent to 14 per cent of time deposits reflecting a desire by the Central Bank to decrease the supply of money. Efforts by the Government to tighten monetary and fiscal policy over recent years seem to be succeeding in reducing the rate of inflation which increased substantially at the beginning of the reforms. It increased from 64.9 per cent in 1990 to 70 per cent in 1991 but then declined to reach 8.1 per cent in 1995.

With regard to the supervision and regulation of the financial system which has been a major problem in Guyana, some measures have already been taken to strengthen this important area. Some of these measures were designed to improve the information from banks to allow for the control of prudential variables, while others concerned the recruitment of more qualified staff to undertake the supervisory functions necessary for the stability of a liberalised financial system. Guyana is also giving priority to the institutional reform of its financial sector. In that context, a Financial Institutions Act was passed which included guidelines for new bank licensing and limits on loans to any one single borrower. The legislation also aims at strengthening the financial system and encouraging the establishment of new banks and the more active participation of the private sector in the ownership of financial institutions. In fact two new banks, Demerara Bank and Citizens Bank, started operations in 1993. The Government of Guyana has also embarked on a vast programme of restructuring and privatisation of its financial sector. For example, steps are being taken to privatize the Guyana Bank of Trade and Industry.

In Jamaica¹⁴, the challenge seems to have been related to attempts to delink monetary policy from the financing of increasingly expanding government expenditures. In 1985-1986, policy decisions were taken to reform the financial sector. These policies included the removal of secondary reserve requirements and the use of government issued paper to finance the budget deficit. At the same time policies to improve the fiscal position of the country were implemented. Interest rate controls were removed as well as credit ceilings. In addition, the certificates of deposits which were introduced by the Bank of Jamaica in 1985 allowed the Bank to engage in open market operations during the period 1986-1988 mainly through the sale of these certificates to reduce money supply and reduce pressure on the exchange rate and the balance of payments.

¹⁴ Data on Jamaica taken from the Planning Institute of Jamaica, Economic and Social Survey and the Bank of Jamaica, Statistical Digest. Various issues.

Table 2
Selected Economic and Financial Indicators
Jamaica

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
% change in GDP ¹	-4.7	1.9	5.2	1.5	4.6	4.8	0.7	1.4	1.4	0.8	0.5
Rate of Inflation	26.0	14.7	8.4	9.2	16.5	22.0	8.4	17.9	34.7	46.5	16.1
Balance of Payments ²	-304.4	-40.2	-137.0	32.1	-297.5	-340.1	-255.8	10.9	-194.2	18.3	-255.1
Fiscal Balance ³	-3.8	0.7	-2.3	-0.6	-2.8	-5.1	8.2	-3.4	-4.3	-2.4	
Exchange Rates ⁴	5.6	5.5	5.5	5.5	5.7	7.2	12.1	23.0	24.9	33.1	35.1
Lending rates	21.9	23.0	23.0	23.0	25.2	30.5	31.5	44.8	43.7	49.5	43.6
National deposit rates	21.3	19.0	17.5	17.9	16.0	23.9	24.7	33.6	27.6	36.4	23.2
% change of money supply	15.23	40.78	5.23	52.97	-8.47	27.37	94.67	71.28	26.22	25.72	37.96
Private sector credit as a % of total domestic credit	40.3	41.4	59.4	81.2	95.9	111.9	139.1	115.1	114.4	117.3	103.0
Public sector credit as a % of total domestic credit	57.7	57.6	39.5	17.6	4.1	-12.0	-39.1	-15.1	-14.4	-17.3	-3.0

¹ (At constant prices)

² Current Account (in US\$M)

³ (as a percent of GDP)

⁴ Exchange Rates in US\$

Source: IMF Financial Statistics, ECLAC and National Data

Other measures taken during this attempt at financial sector reforms included the removal of stamp duties on transactions on securities as well as the elimination of withholding taxes on dividends. Also, a securities commission was established and a secondary market for government securities was created. However, this attempt at financial reform faltered in 1989 when secondary reserve requirements were reimposed together with credit ceilings most probably following pressure on the exchange rate and rapid expansion of credit in the economy. Another attempt at financial reform took place in 1991 when credit ceilings were removed again. Secondary reserve requirements were abandoned, but statutory reserve requirements were fixed at the very high rate of 50 per cent, a clear indication of the desire of the authorities to keep the money supply in check. The latter financial reform included the liberalisation of the exchange control regulations.

There were efforts to improve competition in the system and enhance the quality and range of financial services available in the country. In that context, many non bank financial institutions, such as merchant banks and finance houses, were established most probably as a result of the adoption of more liberal policies towards the establishment of financial institutions. The operations of these institutions in the financial markets may have helped to decrease the concentration of assets

in the financial sector. The assets of the three largest commercial banks which were still high went down from 73.8 per cent of total assets to 64 per cent in 1994¹⁵. However, the involvement of commercial banks in the ownership of other financial institutions may run counter to the objective of improving competition in the financial sector. Trade liberalisation has also been implemented in Jamaica opening up the current account of the balance of payments and allowing the free movement of capital. In 1991, there was a further liberalisation of exchange controls and the free convertibility of the Jamaican dollar was allowed.

Expansionary monetary and fiscal policies implemented at the same time as the liberalisation of exchange controls and the floating of the Jamaican dollar resulted in high rates of growth in money supply, high level of inflation and rapid depreciation of the local currency vis à vis the United States dollar. This loosening of both monetary and fiscal policies took place at a time when there was a fixed interbank exchange rate resulting in the creation of a parallel market for foreign exchange. At the end of 1993, action was taken to make the foreign exchange market more competitive through the removal of the fixed interbank exchange rate. This resulted in the disappearance of the parallel market. Since then, the Jamaican dollar has continued to depreciate mainly because of inconsistencies and sometimes reversals in fiscal and monetary policy. The floating Jamaica dollar does not seem to have stabilised even after the abolition of the interbank fixed exchange rate and attempts to tighten both fiscal and monetary policies. It depreciated from an average of J\$33.08 to US\$1 in 1994 to an average of J\$35.14 to US\$1 in 1995. Also, inflation remained high at 16.1 per cent in 1995 although substantially lower than its 1994 level of 46.5 per cent.

Interest rates, although fluctuating, remained very high reaching 67 per cent in April 1994 in the case of lending rates. Average annual lending rates in Jamaica were 44.8 per cent in 1992, 43.71 per cent in 1993, 49.46 per cent in 1994 and 43.58 per cent in 1995. The spreads between deposit and lending rates have also remained very high probably because of high reserve requirements some of which were maintained in non interest bearing instruments and high intermediation costs as well as oligopolistic conditions in the financial sector. The demise of the Blaise Merchant and Trust Bank, because of financial and supervisory problems, put into focus the need to look more carefully at the regulations and supervisory framework of the financial sector in Jamaica.

Jamaica did not seem to have been able to delink its monetary policy from its fiscal policy or to implement consistent macroeconomic policies. For example in 1993, fiscal policy was loosened considerably to pay for substantial wage increases awarded to certain categories of public employees. This decision along with others, such as the lowering of tariffs on imported vehicles and a decrease in income tax, contributed to an increase in the budget deficit which was eventually financed through the loosening of previously tight monetary policy. Money supply grew by 71.28 per cent in 1992, 26.22 per cent in 1993, 25.72 per cent in 1994 and 37.96 per cent in 1995. The targeting of the growth of a monetary aggregate (M3) was largely overshoot in 1993. Instead of the target of 16 per cent growth, M3 experienced a 36 per cent growth.

¹⁵ See Peart Kenloy: Financial Reform and Financial Sector Development in Jamaica in Social and Economic Studies, Vol. 44, 1995 Special Issue.

Since the liberalisation of its capital account, Jamaica experienced at times inflows of foreign exchange which was mostly sterilised by the Bank of Jamaica to limit the growth of money supply and prevent pressure on the exchange rate. The sterilisation operations of the Bank of Jamaica, together with its sale of treasury bills to remove excess liquidity brought about by the sudden large increases in government expenditures, increased the level of domestic debt and pushed up the interest rates. In 1994, relatively more prudent fiscal and monetary policies were implemented leading to a decline of the yields of treasury bills from 52 per cent in early 1994 to 30 per cent at the end of that year. Commercial bank lending rates also declined from 60 to 46 per cent but were still very high. The high levels of reserve requirements which were fixed at 50 per cent for commercial banks, half of which have to be held in cash reserves, may have contributed to the high levels of interest rates prevailing in the country. The non bank financial institutions reserve requirement was fixed at 17 per cent of their deposit.

Trinidad and Tobago¹⁶ also undertook wide ranging financial reform measures as part of the stabilisation and structural adjustment programmes implemented in the country. The 1988 structural adjustment programme implemented in Trinidad and Tobago included some credit and monetary policies stipulations, such as constraints on credit to public sector entities and the progressive decrease in secondary reserve requirements from 11 per cent to 8 per cent. A restructuring of the banking and non-banking sector was initiated in 1989 when the Central Bank took over the operations of Workers Bank and its Trust subsidiary and most government shares in the Development Finance Company were sold. Later in 1993, three banks, the National Commercial Bank, Workers Bank and the Cooperative Bank were merged into one bank, First Citizens Bank. Interest rates controls have been eliminated and interest rates in Trinidad and Tobago are now largely determined by the rediscount rate of the Central Bank of Trinidad and Tobago and credit conditions in the economy.

¹⁶ Data on Trinidad and Tobago taken from various issues of the Annual Economic Survey of the Central Bank of Trinidad and Tobago.

Table 3

**Selected Economic and Financial Indicators
Trinidad and Tobago**

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
% change in GDP ¹	-4.5	-1.0	-6.1	-4.7	-3.9	-0.2	2.6	-0.5	-1.2	4.7	1.9
Rate of Inflation	7.7	7.1	10.8	7.8	10.5	11.4	3.8	6.5	10.7	9.4	5.4
Balance of Payments ²	-83.1	-433.5	-239.2	-117.8	-66.8	404.4	-20.7	122.6	67.3	239.4	193.0
Fiscal Balance ²	-5.1	-5.9	-5.9	-5.7	-4.2	-1.2	-0.2	-2.8	-0.2	0.0	0.4
Exchange Rates ³	2.45	3.60	3.60	3.84	4.25	4.25	4.25	4.25	5.35	5.92	5.94
Lending rates	12.7	12.0	11.5	12.5	13.3	12.9	13.2	15.3	15.5	16.0	15.2
National deposit rates	5.3	6.0	6.0	6.3	6.0	5.8	7.0	7.1	6.9
% change of money supply	-1.46	-8.28	4.68	-12.80	13.20	20.16	13.42	-7.72	16.33	19.50	4.67
Private sector credit as a % of total domestic credit	96.4	78.4	66.8	62.1	63.1	65.1	69.7	69.0	72.5	79.6	75.8
Public sector credit as a % of total domestic credit	-8.2	10.4	22.0	23.7	36.8	34.8	30.2	30.8	27.3	20.2	24.0

¹ (At constant prices)

² Current Account (in US\$M)

³ (as a percent of GDP)

⁴ Exchange Rates in US\$

Source: IMF Financial Statistics, ECLAC and National Data

In 1994, more restrictions on the credit market were removed. These included the need for the approval by the Central Bank of lending to public sector institutions, restrictions on consumer loans, the removal of caps on commercial banks' lending rates which were fixed at a maximum of 4 per cent above prime lending rate and the stipulation for minimum downpayments and the maximum repayment period for instalment credit. In addition to these financial reform measures, a vast programme of trade liberalisation, which included the progressive elimination of the negative list and reductions in tariffs, was implemented and both payments on current and capital account were liberalised further.

The exchange rate liberalisation in Trinidad and Tobago was progressive starting with the removal of exchange controls on trade in services and capital flows in 1991. Most trade in goods was already free from exchange controls. The Trinidad and Tobago dollar which was floated in April 1993 seems to have acquired a measure of stability after an initial depreciation. This stability was probably facilitated by the consistently tight fiscal and monetary policies pursued by the Government

and the activity of the Central Bank, whose main focus has clearly shifted towards price stability including exchange rate stability. In 1993, this may have been achieved at the cost of a decline in Gross Domestic Product which registered a decline of 1.2 per cent in 1993. Inflation in Trinidad and Tobago increased from 6.5 per cent in 1992 to 10.7 per cent in 1993 most probably due to the depreciation of the exchange rate which took place immediately after it was floated. It then declined in both 1994 and 1995 where it stood at 9.4 per cent and 5.4 per cent, respectively. The tight fiscal policy pursued by the Government and the fiscal reforms undertaken resulted in an improvement of the Government fiscal position. This resulted in a deficit of 3 per cent of GDP in 1992 turning into a much smaller deficit of only 0.2 per cent in 1993 and a surplus of 0.4 per cent in 1995. The improvement in central government finances resulted in a decrease in the Central Bank's credit to the Government and a decrease in domestic indebtedness. The growth of money supply over recent years has been moderate. It contracted by 7.72 per cent in 1992 and increased by only 4.67 per cent in 1995.

The instruments used for the management of a tendency of credit and money to increase in the economy were mainly the changing of the reserve requirements and the discount rate which stood at 13 per cent in 1993. In addition to the sale of treasury bills, reserve requirements were raised three times during 1994 from 16 per cent to 18 per cent of deposits and then from 18 per cent to 20 per cent with the objective of reducing liquidity in the economy. These actions were also aimed at relieving the pressure from the exchange rate. Over recent years, Trinidad and Tobago experienced a large inflow of capital resulting from the large foreign investment in gas, oil and petrochemical industries as well as foreign participation in the privatisation of public enterprises. But the recurring high levels of liquidity in the economy and the tendency of interest rates to decline may have led to an expansion of credit and higher levels of demand for foreign exchange putting downward pressure on the exchange rate from time to time, prompting intervention from the central Bank through moral suasion, the manipulation of reserve requirements and the sale of foreign exchange on the market. Interest rates have changed moderately over the years, experiencing a slight decline over recent years. Lending rates declined from 16 per cent in 1994 to 15.2 per cent in 1995 and deposit rates declined from 7.1 per cent in 1993 to 6.99 per cent in 1994. It is significant, however, to note that deposit rates in Trinidad and Tobago were below the inflation rate for both 1993 and 1994.

In an effort to strengthen the supervision and regulations of the financial system in the country, a Financial Institutions Act was passed in 1993 to enhance the regulations covering the banks and other financial institutions. In 1994, other legislative measures were taken to further strengthen the supervision and regulations of the financial system. These were the Financial Institutions (Prudential Criteria) and the Central Bank Amendment Act whose objectives were, in the case of the first, to ensure the safety and soundness of the financial system through the stipulations of limits and constraints on the activities of financial institutions in the country. In the case of the second, the objective was the strengthening of the supervisory functions of the Central Bank.

Conclusion

Guyana, Jamaica and Trinidad and Tobago implemented restrictive financial policies with the aim of strengthening their financial sectors and channeling the financial resources available to those investments which were considered more productive and more likely to increase output, employment and the standard of living of their people. Increased investment through easy and low cost access to financial resources was considered the best medium to rapid industrialisation and economic growth. Controls on credit and interest rates were used extensively not so much to stabilise the monetary and financial system but to promote investment in the economies. These various interventions in the financial sector which were part of a wider system of intervention in the economies proved unsustainable since the allocation of funds to the most productive sectors was not the priority. Accordingly, banks and development finance institutions which play an important role in the development process of the countries found themselves saddled with debt and carrying large portfolios of non-performing loans. Credit was still not available to targeted sectors, especially the small- and medium-scale firms and the low income groups of the community; inflation rates reached high levels in both Guyana and Jamaica; exchange rates were overvalued and had to be devalued many times leading to unstable prices and capital flight. It is as a result of these countries' economic problems that adjustment and economic reform programmes, including financial liberalisation, were implemented. This time macroeconomic stability became the main objective of monetary and fiscal policies, since that stability was now generally considered to be essential for the effective performance of the financial system and long term economic growth.

Financial liberalisation in Guyana, Jamaica and Trinidad and Tobago is still in its early stages and there is little doubt that policies implemented to carry out this liberalisation have contributed to the tensions of various intensities experienced by the economies of these three countries. Jamaica is still grappling with macroeconomic instability and changes in the direction of its monetary and fiscal policies seem to have put into question the credibility of these policies. In addition, that country is still experiencing balance of payments and fiscal deficits of various magnitudes. The exchange rate of the Jamaican dollar has not yet stabilised and the high levels of interest rates and high spreads between lending and deposit rates which exist in the country cannot be favourable to investment and economic growth. Moreover, inflation is still high and prices unstable. The financial liberalisation programme of Trinidad and Tobago seems to have fared better, so far. The country had applied consistently tight monetary and fiscal policies since the start of its economic and financial reforms. The budget deficit seems to be under control and the current account of the balance of payments has been positive since 1992. But despite these policies, there seems to be a recurring downward pressure on the exchange rate requiring frequent interventions of the Central Bank.

In Guyana, macroeconomic policies seem to have tightened considerably and the change from a State controlled to a market economy seems to be progressing well. Reforms are clearly bearing fruit and this is reflected in the lower fiscal deficits, lower growth of money supply and lower inflation rates especially in the last two years. However, both the fiscal and balance of payments account remain in deficit and the exchange rate seem to be still depreciating against the United States dollar.

The central banks of Guyana, Jamaica and Trinidad and Tobago do not possess a high level of independence and their financial systems are not fully developed and display inefficiencies, such as credit market segmentation and cartelisation. All three countries have taken steps to deepen their financial systems through the creation of new markets and the introduction of new financial instruments. Jamaica and Trinidad and Tobago being more advanced than Guyana in that respect. Although exchange rates of the three countries are officially floating, their central banks seem to be intervening frequently in an attempt to maintain the exchange rate stability vis à vis the United States dollar. Most of the interventions seem to be aimed at preventing the exchange rates from depreciating too much against the United States dollar. This may indicate the use of the exchange rate as an anchor to the price system although Jamaica targeted a measure of monetary aggregate (M3) in 1993. The use of the exchange rate as an anchor to the price system may reflect the tight relationship which is thought to exist between the exchange rate and the price system in high import dependent economies. In addition, all three countries have taken steps to restructure and strengthen the supervisory and regulatory framework of their financial systems.

Financial liberalisation seems to have been widely implemented around the world, further strengthening the globalisation of financial markets. It is generally believed that the liberalisation of both the domestic financial sector and financial flows with the outside world are essential if a country is to take full advantage of the opportunities available in a global financial market. However, financial liberalisation entails transitional costs which will be greatly increased if policies are not properly sequenced and coordinated. The lack of success of some experiences with financial liberalisation and the difficulties experienced by Guyana, Jamaica and Trinidad and Tobago in managing their financial liberalisation programmes hold useful lessons for those Caribbean countries which seek to embark on their own liberalisation which will become increasingly necessary.

The countries of the Caribbean which are already highly integrated in the world economy judging by their generally high levels of trade to GDP may gain from orienting their reforms towards a more competitive domestic financial sector and a more open external financial sector. This should not mean that countries should rush towards the liberalisation of their financial sectors, but rather that they should carefully plan the policies which are likely to minimise the disruptive effects of the liberalisation process while allowing them, at the same time, to take advantage of the opportunities which may be made possible by the emerging global capital market. It is generally agreed that a liberalisation programme should not be undertaken until a large measure of macroeconomic stability has been achieved, including careful and effective management of the money supply and the fiscal account. This should then be followed by the liberalisation of trade and the domestic financial sector and finally the liberalisation of the capital account. Regulatory and supervisory functions assume a special importance in ensuring the stability and soundness of a liberalised financial system. Also, such a system requires more independent central banks staffed by highly qualified staff to carry out the necessary supervisory and regulatory functions and run monetary policy in an increasingly sophisticated financial world.

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