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FINANCIAL INTERMEDIATION AND ITS IMPACT ON CAPITAL FORMATION IN THE CONTEXT OF THE CARICOM SINGLE MARKET AND ECONOMY (CSME)

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Abstract

Caribbean economies are finance deficit economies. The shortage of affordable finance of adequate duration and quality is a severe constraint on business investment. This impinges on the ability of producers and traders to restructure their systems of production and exchange to achieve dynamic competitiveness in the global economy. Financial intermediation has largely been undertaken by the banking sector, as capital markets remain nascent, undercapitalised and illiquid. However, the banking sector, though well suited to financing traditional businesses and other activities, such as real estate and distribution, does not respond well to the needs of new businesses, and particularly to small- and medium-sized enterprises (SMEs). This stems from the high cost of finance, reflected in relatively high interest rate spreads, the limited availability of term finance and high collateral and reputation requirements which all prove inimical to small enterprises, especially young firms.

This study analyses the impact of financial intermediation on capital formation in the Caribbean. It takes the Caribbean Community (CARICOM) Single Market and Economy (CSME) process as a backdrop and examines the influence of the CSME on the link between financial intermediation, business investment and economic adjustment. The study finds that the financial intermediation process in the region remains largely unresponsive to the requirements of structural transformation for building resilient and competitive economies. Moreover, financial services liberalisation under the CSME, although it has catapulted cross-border mergers and acquisition in the financial sector, has done little to change the orientation of financial institutions. Consequently, Caribbean production firms continue to face shortages of good quality finance.

A number of measures are proposed to unstop the financial constraint in the region. Key among these is the introduction of greater competition in the banking sector through further liberalisation to drive down the cost of credit, boost financial innovation and to encourage greater credit flow to more productive activities. Secondly, incentives should be provided to broaden and deepen regional capital markets. These include financial education to encourage companies to cross-list on the regional exchanges, improved regulation and harmonisation of company legislation and more favourable bankruptcy laws. Also, the single economy focus on coordination of macroeconomic policies to achieve benchmark levels of fiscal deficit, debt, inflation and other indicators should be given greater priority to promote a more seamless financial market in the region.

1. Introduction

Classical economists thought that money was neutral in that it did not affect the real, goods-producing sector. Keynes, however, in his seminal work "The General Theory", showed that money was an important influence on real economic activity. Indeed, earlier in his "A Treatise on Money" (1930), Keynes underscored the pivotal role of the banking sector to economic growth when he noted that bank credit is "the pavement along which production travels". Since the general theory, economists have been in no doubt that finance is critical to real sector development. Controversies have flared over whether finance leads or follows real sector development. Levine[1] in a landmark article in 1997 found that financial sector leads to productivity growth and real economic growth.

In the Caribbean, finance has long been a critical catalyst of economic activity and, in fact, boom and bust cycles in the region have often been triggered by the collapse of financing for plantation or major activities. The vital role of adequate and high quality finance at affordable cost for the region, means that financial intermediation, the process by which financial institutions channel funds from agents with surplus funds to businesses and consumers is especially important. Indeed, the structure and conduct of financial institutions determine which activities get financed, and this is an important determinant of productivity and economic growth.

The Caribbean economies are at an important juncture in their evolution. On the one hand, significant advances in knowledge, information and communications technology and financial capital flows across the world present opportunities for carving out dynamically competitive niches in the world economy. However, on the other hand, the erosion of preferential access to the European market for traditional commodities such as sugar and bananas and loss of competitive advantage in tourism in some countries, hasten the need for economic transformation and restructuring to create vibrant systems of production and exchange. Only a timely response to the challenge of competitiveness can ensure the sustainable development of the region.

A reconfigured regional integration platform, the CSME, is being used by the region as the platform for socioeconomic development. The CMSE can be viewed as a vehicle to fashioning dynamic production, exchange and institutional arrangements to smooth the integration of the region into the world economy. Through liberalisation of trade in goods and services, free movement of capital and labour and the coordination of macroeconomic policies, the CSME is expected to foster more competitive producers, workers and institutions. The CSME process is tacit acceptance of the validity of the open regionalism paradigm, which advocates liberalisation and integration within regional blocs as a catalyst for wider multilateral liberalisation. However, more than this, liberalisation within the CSME is seen as a survival strategy based on the premise that small size, vulnerability to shocks and limited policy degrees of freedom provides a rationale for an expanded and integrated market for commodities, finance, labour, technology and other services. This expanded market provides the opportunity for regional firms to learn the "tricks of the trade" in production and exchange and therefore acts as

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[1] See Levine, Ross (1997), "Financial Development and Economic Growth: Views and Agenda", Journal of Economic Literature 35, no. 2: 688-726.

a catalyst for competitiveness in extraregional market thereby facilitating export-led development.

Caribbean economies have been caught up in the global trend of increasing financial liberalisation and market openness, reflecting orthodox thinking on how the economy should operate. Similar to advanced economies and leading emerging markets, financial liberalisation and cross-border capital movements in the Caribbean are driven by increased competition and the quest for higher rates of return, establishment of business presence in the regional and external markets, economies of scale, portfolio diversification and technological innovation, which oils the process.

A key concern is to what extent the quality of the financial intermediation process can be improved to alleviate the financial constraint faced by producers, marketers and workers. This is critical since businesses in the region have listed finance as their most important constraint on expansion and transformation. Any significant amelioration of the financial constraint would require not only a deepening and widening of money and capital markets, but a change in orientation by financiers to given greater priority to longer-term finance, especially for young, dynamic firms both in traditional and new activities.

This study analyses the impact of financial intermediation on capital formation in the region in the context of the CSME.[2] The objective of the study is to discover the extent to which financial intermediation facilitates or hinders capital formation and thereby economic growth in the Caribbean. Further, the study seeks to find out whether the liberalisation and market integration under CSME can catalyse improved intermediation, investment in new activities and the restructuring and transformation of traditional activities. This is important because theory and evidence from field work suggests that financial intermediation is a major influence on capital formation, particularly business investment in productive activities in agriculture, industry and services. The competitiveness of these activities is crucial to economic growth and socio-economic transformation in a region that remains plagued by sub-optimal economic growth and relatively high levels of unemployment and income inequality.

Guided by political economy, the study takes a structure, process and stage approach in tackling some issues and also a structure, conduct and performance approach in dealing with others as best suits a particular issue. These approaches are deemed vital since, the quality and efficiency of intermediation in the region are grounded in historical antecedents that continue to influence which activities are financed and at what costs and terms, the rates of returns in various activities and the business culture and investment incentive framework. Undoubtedly, there has been change over time and the study will seek to account for change, however, this does not void the fact that static forces still influence and the degree to which it can liberate the financial constraint faced by firms in the region.

The study is divided into the following sections. Section 2 below provides an overview of financial intermediation in the Caribbean, underscoring its underdeveloped nature. Section 3

[2] This study is one of three complementary ECLAC studies that analyses key issues and challenges for the region in the context of the CSME. The other two studies are: "Restructuring Caribbean Industries to Meet the Challenge of Trade Liberalization" and "Labour Market Trends and Implications of Regional Integration".

analyses the cost, quantity and quality of finance highlighting the high interest rate spreads in the region, the direction of credit largely to 'non-productive' activity in distribution, personal services and consumption and the shortage of term finance. Section 4 examines market structure as a key influence on the financing of firms, especially the oligopolistic nature of the banking system and the special constraints of SMEs. Section 5 looks at macroeconomic policy as a facilitator or disincentive to quality financial intermediation. Section 6 assesses the impact of capital markets on finance and investment, while Section 7 examines the implications of the CSME for financial intermediation and capital formation. Section 8 provides recommendations for reinforcing the link between intermediation and capital formation. Finally, Section 9 concludes the paper.

2. Financial intermediation in the Caribbean – An overview

Financial intermediation for the purpose of this study means all the avenues through which financial resources are channelled from surplus economic agents to deficit agents to fund business and consumption activities. Both for classification and functional reasons, it is useful to discuss the differences between classical intermediaries and direct financiers. Classical intermediaries or bank-based institutions such as commercial banks, credit unions and insurance companies solicit deposits from savers, pool them and on-lend to firms and households. Direct finance or market-based institutions including stock markets, bond issuers and venture capital funds provide finance directly to those who demand it, without going through an intermediary.

Theory and practical evidence has shown that the structure of the financial system in terms of the relative importance of direct versus intermediary finance impacts on investment and growth. This stems from the fact that the two types of financiers favour different activities in terms of risk profiles, age of the business and assign different weights to reputation and collateral as against the potential viability of the project.

Financial intermediation in the region is grounded in historical antecedents of production and exchange. Financial intermediation to the extent that it occurred in Caribbean plantation economies was geared largely to smooth domestic and external payments arrangements, mobilise savings to be ploughed back into plantations and to facilitate domestic investment and capital transfers to the plantation owners oversees. Why mention these historical preconditions one might ask? Well the reality is that they have had deep-seated impacts on the way in which financial intermediation is conducted even in modern times.

In the Caribbean, fixed investment in agriculture, plant and factories and later in services, such as tourism, have long been financed largely by foreign direct investment from metropolitan centres, while the domestic financial sector have filled the breach in providing consumer loans, mortgage loans, insurance services, some development lending and other forms of finance.

In more recent times, regional financial developments have been marked by greater financial innovation and financial deepening. From the innovation standpoint, a number of new products have been introduced on the market, including mutual funds, stocks, and trust funds among others. In addition, newer financial institutions such as merchant banks, investment banks, money market institutions and even attempts at venture capital funds have entered the

market place. Nevertheless, capital markets in the Caribbean remain nascent at best, hampered by limited division of ownership and control in some companies, inadequate secondary trading on stock markets, weak property rights, especially for the poor, and a preference for debt finance by some of the larger companies. Consequently, the Caribbean financial structure remains largely intermediary-based rather than market-based. However, even though structure matters, the quality and efficiency of financial intermediation could compensate for structure in many cases.

Given that financial intermediation in the Caribbean is largely bank-based, it is useful in this overview to analyse the main trends in the banking sector before looking at capital markets. At a wider level, Caribbean countries have been experiencing increased financial deepening and innovation starting from a low base.

As Table 1 shows, financial deepening as measured crudely by the contribution of the financial sector to GDP increased somewhat over the period 1995 to 2004, moving from nine per cent to almost 11 per cent. Over the decade, the financial sector contributed most to GDP in Antigua and Barbuda (17 per cent), Dominica 13 per cent and Trinidad and Tobago 12 per cent. On the other hand, financial depth remains limited in Guyana (five per cent), and Belize (two per cent) contributions.

In the case of Trinidad and Tobago, the financial sector has attained depth and levels of sophistication that far surpasses that in most other Caribbean countries, with financial innovation and new services being established practice. This suggests a role for the CSME in facilitating greater financial symmetry and harmonisation across the region. Clearly countries such as Guyana, Belize and the some members of the Organisation of Eastern Caribbean States (OECS) need to attain the levels of financial depth and range of instruments to increase domestic finance for development.

In addition, liquidity preference ratios, the ratio of narrow money supply to the broad money stock is an important constraint on financing. This is the case because the higher the liquidity preference ratios, the greater the public demand for cash, checking accounts and other liquid instruments and the lower the level of transformation of bank liabilities into long-term financing. Table 1 below shows that average liquidity preference for the Caribbean was relatively high at around 27 per cent for the period 1995 to 2004. Somewhat surprisingly, liquidity preference was highest in Trinidad and Tobago (35.7 per cent). Therefore, in spite of the higher development of the banking system in Trinidad and Tobago, households still seem to have a relatively strong preference for liquid instruments to maintain their levels of consumption. Liquidity preference was also relatively high in Jamaica, Guyana, Belize and Barbados and might reflect instability in the former two countries and fairly low rates of return on longer-term liabilities such as term deposits in the latter two.

Table 1: Liquidity preference ratios in selected Caribbean economies

Rest of CARICOM											
Barbados	27.0	30.0	29.7	31.2	31.4	31.4	32.5	36.8	36.6	32.8	**31.9**
The Bahamas	23.5	22.2	21.3	21.2	24.1	23.6	21.7	22.1	23.6	26.6	**23.0**
Belize	28.0	28.4	26.2	26.9	30.4	32.1	35.0	33.7	32.8	32.6	**30.6**
Guyana	28.4	27.9	27.0	25.9	28.0	29.1	26.7	26.9	29.0	30.2	**27.9**
Jamaica	31.6	34.3	29.9	29.4	32.5	28.7	31.0	31.2	30.1	32.1	**31.1**
Trinidad and Tobago	31.6	32.0	33.7	31.3	32.8	35.0	38.9	41.9	39.3	40.2	**35.7**
OECS											
Antigua and Barbuda	26.0	24.6	23.5	25.2	23.1	20.5	21.1	19.9	19.8	21.8	**22.5**
Dominica	20.5	19.6	20.0	20.6	23.5	19.6	18.7	20.2	19.8	19.3	**20.2**
Grenada	24.7	23.0	22.6	22.1	21.6	19.9	18.9	19.5	20.7	24.4	**21.7**
St. Kitts and Nevis	20.9	22.2	20.3	20.7	21.7	20.9	19.0	19.7	20.8	21.1	**20.7**
St. Lucia	29.2	27.1	26.9	24.9	24.5	24.3	23.0	22.6	25.0	31.9	**25.9**
St. Vincent and Grenadines	29.2	27.1	29.1	29.2	31.5	33.4	33.5	33.7	35.1	34.4	**31.6**
Average Annual	**26.7**	**26.5**	**25.9**	**25.7**	**27.1**	**26.5**	**26.7**	**27.4**	**27.7**	**28.9**	**26.9**

Source: ECLAC based on Official data

Critically, the intermediation process can be viewed from the viewpoint of the cost of finance and also from the vantage point of non-price/cost factors, including the quantum and quality of finance, competition and concentration in the sector and institutional arrangements among other factors. All of these factors combine to determine the efficiency and effectiveness of intermediation and the extent to which it catalyses business investment and economic growth.

3. The cost, quantum and quality of finance in the Caribbean

Caribbean businesses remain constrained and challenged by the cost, quantity and quality of finance for maintenance of operations, expansion, upgrade and restructuring to face the competition and to capture new markets. Moreover, the quantity and quality of finance are deemed particularly important in an era of globalisation where competitiveness of production hinges as much on the quality of financial intermediation as on factor productivity and technical efficiency.

The most tangible aspect of the cost of finance in the region, given business' heavy dependence on commercial bank finance, is the interest rate on loans, advances and overdrafts. This is compounded by high bank charges and fees for various services. Loan interest rates in the region are high by international standards and are a hindrance to business investment, especially for small firms. High cost of finance in the region is a reflection of some degree of financial fragmentation, inadequate levels of competition, marked by oligopolistic tendencies in the banking system, relatively high average operations cost[3] because of relatively small business volumes, the result of limited minimum efficient scale (size) of financial institutions and macroeconomic difficulties in some countries.

High banking sector interest rate spreads**,** the difference between interest rates on loans and overdrafts and that paid on deposits, are a signal barometer of financial inefficiency and the high cost of finance for businesses. As shown in Table 2 below, at an average of almost nine per cent, interest rate spreads in the Caribbean for the period 1995-2004 were relatively high. Interestingly, the OECS countries had somewhat lower average spread of around 7.4 per cent, even though the smaller size of the banking sector and more limited economies of scale would have affected bank costs. However, the relative macroeconomic stability underpinned by the fixed exchange rate regime might have contributed to lower interest rate spreads in the OECS. This is also suggested by the fact that Jamaica, Suriname and Guyana, countries with relatively greater macroeconomic instability, had the highest average interest rate spreads in the region for the period 1995 to 2004. In Jamaica, the average spread of almost 17 per cent stifled manufacturing and some service activities, making them uneconomical.

[3] In recent times, however, financial innovation, particularly the use of technology (such as Automatic Teller Machines) and improved operations systems have reduced overall operations cost in the financial sector. One concern is the extent to which any lower costs in these areas are partly transferred to consumers in the form of reduced charges and fees.

Table 2: Interest rate spreads in the Caribbean

Barbados	6.60	6.70	7.65	7.37	6.90	7.05	8.00	7.74	7.61	7.30	**7.29**
The Bahamas	9.06	7.46	7.44	6.75	7.35	7.77	7.23	7.22	8.11	7.47	**7.59**
Belize	9.10	10.00	9.90	10.30	10.60	10.80	11.10	10.00	9.30	8.80	**9.99**
Guyana	9.92	10.73	10.93	11.23	9.90	10.40	10.90	12.98	13.23	12.49	**11.27**
Jamaica	30.74	21.06	21.14	18.80	14.90	13.20	11.87	11.38	12.62	11.68	**16.74**
Suriname	0.00	18.40	12.20	10.00	12.60	13.60	12.40	12.90	12.50	11.40	**11.60**
Trinidad and Tobago	9.46	9.71	9.32	11.21	11.17	10.50	9.12	8.64	8.34	6.74	**9.42**
Anguilla	7.95	8.21	7.60	7.37	7.53	7.80	7.20	7.10	8.01	7.89	**7.67**
Antigua and Barbuda	6.05	7.93	7.62	7.86	7.62	6.99	7.13	7.03	8.30	7.35	**7.39**
Dominica	6.35	6.85	6.72	7.16	7.95	6.91	7.00	7.40	8.30	6.80	**7.14**
Grenada	6.40	6.40	7.51	7.56	7.34	7.28	5.88	7.30	8.40	5.90	**7.00**
Montserrat	7.15	9.27	9.94	9.28	8.16	7.97	8.19	8.40	9.30	8.70	**8.64**
St. Kitts and Nevis	7.10	6.65	7.17	7.06	6.92	6.75	6.97	6.60	7.90	6.30	**6.94**
St. Lucia	3.70	8.32	8.13	6.45	8.31	8.13	8.01	8.70	8.50	7.90	**7.62**
St. Vincent and Grenadines	6.00	7.09	7.18	7.02	7.00	7.00	7.34	7.20	7.50	6.00	**6.93**
Average Spread ECCB	**6.34**	**7.59**	**7.74**	**7.47**	**7.60**	**7.35**	**7.21**	**7.47**	**8.28**	**7.11**	**7.42**
Average Spread Caribbean	**8.37**	**9.65**	**9.36**	**9.03**	**8.95**	**8.81**	**8.56**	**8.71**	**9.19**	**8.18**	**8.88**

Source: ECLAC based on Official data

Spreads in Latin America were relatively higher than those in the Caribbean, at around 13 per cent. This, however, stemmed in part from greater macroeconomic instability in a number of countries in Latin America, particularly high inflation rates and banking sector problems. For similar levels of instability, spreads in Latin America are likely to be lower than those in the Caribbean, because of the greater economies of scale that banks benefit from in that region.

The decomposition of the interest rate spread is useful, since it reflects a number of things. It indicates the risk and expectation that borrowers might default on repayment; the levels of efficiency and market power in the banking system; inflation, liquidity, exchange rate and institutional risks; the favourableness of the regulatory regime and taxation of the banking system especially by the monetary authorities. In a study for the OECS countries in 1998, Randall found that when decomposed, the bulk of the spread was due to costs such as operational costs and loan loss provisions and also return on assets or the profit margin. This suggests banks in the subregion remain relatively inefficient in their operations and are able to charge to cover their fairly high operational costs because of their market power in an oligopolistic market. To a lesser or greater degree, this seems to be the pattern across the region.

The Organization for Economic Cooperation and Development (OECD) Harmful Tax Competition law brought to the fore the importance of the offshore banking sector in the Caribbean, particularly in countries such as the Bahamas, the Cayman Islands, Barbados and the British Virgin Islands. Many offshore banks, trust and other companies have remained largely 'brass plate' operations where the major benefit to the region is through tax revenues as they contribute little to employment. Nevertheless, some offshore banks operate as branch banks which manage both offshore and domestic accounts. The challenge for the region is to provide the incentive and regulatory regime for the offshore sector to mobilise more finance for domestic productive activity.

The direction of finance

Although the quantity and cost of finance are crucial to business investment and growth, the activities to which finance flows are also vital. Where the bulk of finance capital is channelled to unproductive activities such as conspicuous consumption, real estate speculation and distribution, there is often an indirect crowding out of finance for import-competing and export-based production in agriculture, industry and services.

The micro and macroeconomic incentive framework plays an important role in determining the kinds of activities financial institutions would have a preference to finance. Banks in the Caribbean typically operate over a short time horizon, seeking to recover their loans before economic fluctuations adversely affect the ability of borrowers to repay. This compounded by lingering macroeconomic uncertainty in some countries, particularly higher inflation expectations on account of economic shocks and exchange rate fluctuations reinforce the incentive to lend to sectors such as real estate, which are well collateralised and distribution, which has a proven track record of high profitability and ability to repay loan obligations.

The distribution of credit by sector provides indications of the lopsided allocation of finance in the region and underscores, in part, the challenge that productive foreign exchange earning or saving activities confront. The mal-distribution of credit is prevalent across the region, but probably no where is the effect more perverse than in the OECS countries, given their urgent need to tailor finance for economic restructuring that would ensure adequate living standards in the subregion.

Across the OECS, the allocation of bank credit displays two alarming trends. The first is the relatively low level of credit relative to GDP and the second is the limited credit allocated to agriculture, manufacturing and productive services, including tourism. Across the OECS, total loans, advances and overdrafts averaged less than 1 per cent of GDP for the period 1990-2004. Moreover, as Table 1 shows, the bulk of credit went to personal activities, including real estate and distribution that accounted for more than half of total credit. Personal services garnered a full 47 per cent of credit, while distribution captured over 12 per cent. Meanwhile, limited loan credit went to agriculture and manufacturing (0.03 per cent of GDP, respectively) and three per cent of total credit allocated. This underscores the underdeveloped state of agriculture and manufacturing in the subregion. In the case of agriculture, the high food import bill, associated with the high food imports both for domestic consumers and for the tourism sector is an important area of concern in the subregion and CARICOM as whole.

With respect to individual countries, total average loans, advances and overdrafts ranged from 0.42 per cent of GDP in Montserrat to 1.30 per cent of GDP in Anguilla. These figures are particularly low given the persistence of high levels of excess liquidity in the banking system in the sub-region.

Table 3: Average share of loan credit to GDP by sector for the OECS 1990-2004

	Anguilla	Antigua & Barbuda	Dominica	Grenada	Montserrat	St. Kitts & Nevis	Saint Lucia	St. Vincent & the Grenadines
Agriculture	0.4	0.5	2.2	1.3	0.7	11.9	2.3	4.7
Sugar	0.0	0.0	0.0	0.0	0.0	11.7	0.1	0.0
Tree Crops (Citrus, Banana, Nutmeg, etc.)	0.0	0.0	1.9	0.8	0.0	0.0	1.3	2.9
Livestock & Dairying	0.0	0.2	0.1	0.2	0.6	0.1	0.3	0.1
Food Crops	0.0	0.1	0.0	0.0	0.0	0.0	0.3	0.0
Forestry	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Other	0.3	0.1	0.2	0.1	0.0	0.2	0.4	1.7
Fisheries	0.3	0.1	0.1	0.4	0.1	0.1	0.2	0.2
Mining & Quarrying	0.6	0.2	1.1	0.3	1.2	0.1	0.4	0.2
Manufacturing	0.9	2.9	5.8	2.9	1.6	3.2	3.3	5.9
Sugar & Molasses	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Food & Non-Alcoholic Beverages	0.2	0.3	1.9	0.8	0.1	1.0	0.7	2.1
Alcoholic Beverages and Tobacco	0.0	0.8	1.1	0.3	0.0	0.2	0.2	1.0
Building Material and Metal Work	0.4	0.6	0.3	0.5	0.2	0.7	0.4	0.3
Electrical Products	0.0	0.1	0.0	0.1	0.1	0.4	0.1	0.0
Clothing & Accessories	0.0	0.2	0.1	0.3	0.1	0.3	0.5	0.2
Furniture & Wood	0.2	0.5	0.6	0.1	0.1	0.0	0.2	0.3
Other Manufacturing	0.1	0.4	1.8	0.7	1.0	0.4	1.2	2.0
Utilities	2.0	1.2	4.3	3.8	0.3	3.6	1.8	0.8
Construction & Land Development	5.2	7.6	3.1	3.4	5.1	6.5	4.5	4.9
Distributive Trade	10.3	13.3	15.1	9.5	13.5	11.4	13.4	12.8
Tourism	24.3	9.2	3.7	5.7	1.8	5.8	10.8	4.0
Entertainment	1.3	1.7	0.6	1.5	1.4	0.9	1.0	0.9
Transport	4.8	1.7	3.4	5.2	1.9	1.2	3.1	3.9
Financial Institutions	0.1	1.5	2.2	0.5	1.2	0.8	0.9	2.2
Professional & Other Services	5.0	6.6	4.1	5.1	4.4	3.3	6.5	3.3
Public Administration	1.9	11.8	12.4	5.4	2.6	13.1	6.1	10.0
Personal	42.8	41.5	41.9	55.0	64.4	38.0	45.9	46.3
Acquisition of Property	24.6	20.4	26.2	32.1	41.8	22.8	23.1	28.7
Home Construction	12.5	10.0	10.7	20.5	21.0	10.4	8.2	14.8
House & Land Purchases	5.5	4.7	6.5	11.6	8.5	4.2	6.4	6.4
Home Const. & Renovation 1\	6.6	5.6	9.0	0.0	12.3	8.2	8.4	7.5
Durable Consumer Goods	6.6	6.4	3.3	4.5	5.7	3.5	6.0	3.9
Other Personal	11.7	14.7	12.4	18.4	16.8	11.7	16.9	13.7
Total Loans, Advances and Overdrafts	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Eastern Caribbean Central Bank

1\ Includes House & Land Purchases prior to June 1995

Table 4 below shows that the situation for Jamaica was similar to that of the OECS. The bulk of the credit allocated, 15.5 per cent of the total went to the personal sector, which entails significant consumer loans for household purchases. Notably, the government sector absorbed the second largest amount of credit (11 per cent), though credit to it was most volatile as measured by the standard deviation (4.6). On the face of it therefore, there might be a case of government crowding out private sector activity in Jamaica. If this is so, it is an important area of concern, as government investment, though necessary, tends to be less productive and growth-inducing than private investment. Further, to the extent that government continues to be a big player in the domestic credit market, it can worsen the financial constraint of enterprises and prevent their restructuring and adjustment to become competitive.

In contrast, agriculture, manufacturing and tourism received on average 2.1 per cent, five per cent and 6.3 per cent of credit, respectively, over the decade 1995-2004. The relatively low allocation of credit to these productive sectors, compared with personal services, government and professional services points to the lopsided nature of the economy, with finance not effectively oiling the productive areas of the economy and therefore proving sub-optimal in contributing to growth, foreign exchange earnings and employment.

Table 4: Jamaica- Credit by Sector as a percentage of total credit

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Agriculture	2.6	2.6	2.7	3.0	2.7	2.4	1.8	1.4	0.9	0.7
production	2.3	2.3	2.5	2.7	2.4	2.2	1.8	1.1	0.6	0.6
Marketing	0.3	0.4	0.3	0.2	0.2	0.2	0.1	0.1	0.1	0.0
Land acquisition	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.1	0.0
Mining	0.5	0.4	0.3	0.3	0.2	0.1	0.1	0.1	0.2	0.1
Manufacturing	8.5	8.6	6.4	6.0	5.0	4.7	3.9	2.6	2.1	2.0
Sugar, rum and molasses	0.9	1.1	1.5	0.2	0.1	0.2	0.4	0.5	0.4	0.1
Food, drink & tobacco	1.3	1.2	1.0	0.9	1.5	1.4	1.4	0.7	0.5	0.7
Paper, printing & publishing	0.9	0.7	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Textile, leather and footwear	0.5	0.8	0.2	0.3	0.2	0.2	0.1	0.1	0.0	0.0
Furniture, fixture and wood products	0.4	0.4	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
Metal products	0.3	0.2	0.1	0.2	0.3	0.2	0.2	0.2	0.1	0.1
Cement & clay products	1.0	1.3	0.6	0.9	0.3	0.5	0.4	0.2	0.2	0.1
Chemical & chemical products	0.8	0.5	0.3	0.3	0.2	0.2	0.1	0.1	0.1	0.1
Other	2.4	2.4	2.2	2.8	2.0	1.6	1.1	0.8	0.7	0.6
Construction and land development	7.8	5.5	4.4	3.8	3.4	3.1	2.9	2.7	4.1	3.1
Construction	6.5	4.4	3.6	3.0	2.6	2.8	2.6	2.4	4.0	2.9
Land development	0.6	0.6	0.6	0.6	0.6	0.2	0.2	0.3	0.1	0.1
Land acquisition	0.7	0.5	0.3	0.2	0.3	0.1	0.0	0.1	0.0	0.1
Financial Institutions	3.3	5.1	7.6	3.9	2.1	1.2	0.2	1.8	0.3	0.3
Transport, Storage & communication	6.1	4.5	4.2	2.8	2.4	2.4	5.5	4.4	4.9	4.7
Electricity, gas & water	0.1	0.3	0.1	0.1	0.1	1.2	1.6	1.5	0.5	0.4
Government services	4.7	6.1	9.5	7.0	8.2	10.3	12.8	18.8	16.8	15.9
Central Government	1.8	3.8	5.9	1.9	2.8	3.7	5.2	5.9	5.8	5.4
Local Government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Selected Public Entities	2.2	1.8	2.1	3.0	3.1	4.9	3.3	3.4	5.0	5.1
Other Public Entities	0.7	0.5	1.5	2.2	2.3	1.7	4.4	9.6	5.9	5.4
Distribution	4.9	4.7	4.1	5.4	4.8	5.5	4.0	3.7	4.4	3.6
Tourism	5.3	5.5	4.7	6.4	6.0	7.3	6.5	5.8	7.3	8.4
Entertainment	0.4	0.3	0.2	0.2	0.3	0.2	0.1	0.2	0.1	0.1
Professional & other services	7.3	7.2	7.7	9.6	7.6	7.3	4.4	3.5	3.2	3.3
Personal	12.4	13.2	12.5	15.9	19.0	16.9	17.3	14.0	15.8	17.8
Local residents	12.4	13.1	12.4	15.7	18.9	16.8	17.2	13.9	15.8	17.8
Overseas residents	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0

With respect to the quality of intermediation, not only the direction of credit, but the efficiency and productivity of the activities financed are crucial. In the first place, much of the financed, including trading, distribution and consumption are unproductive from the standpoint of stimulating growth and export earnings. Conspicuous consumption remains a major problem in the region, leading to significant foreign exchange depletion.

Another critical problem is the efficiency of investment in countries of the region. Even where countries have managed to invest around 20 per cent of GDP, they cannot maintain average growth rates of 3-4 per cent for a decade. The quality of financial intermediation is a contributor to this, as intermediaries continue to show a preference for funding trading, real estate and consumption activities that have low real productive value added.

Moreover, at the macro-level, the distribution of GDP by consumption, saving and investment is a barometer of which activities are favoured by finance. As Figure 1 below for the OECS shows, economic agents consumed a full 79 cents of every dollar GDP between 1995 and 2003, which meant they saved only about 20 cents of each dollar of GDP. Undoubtedly, this high level of consumption has to be financed and much of it is funded by scarce banking sector credit. This underscores the view that what might be good for the banking sector in this instance, might not be good for the economy at large, particularly, Caribbean economies, which need to garner finance for restructuring and diversification.

Figure 1: OECS: Selected saving and investment indicators as percentage of GDP

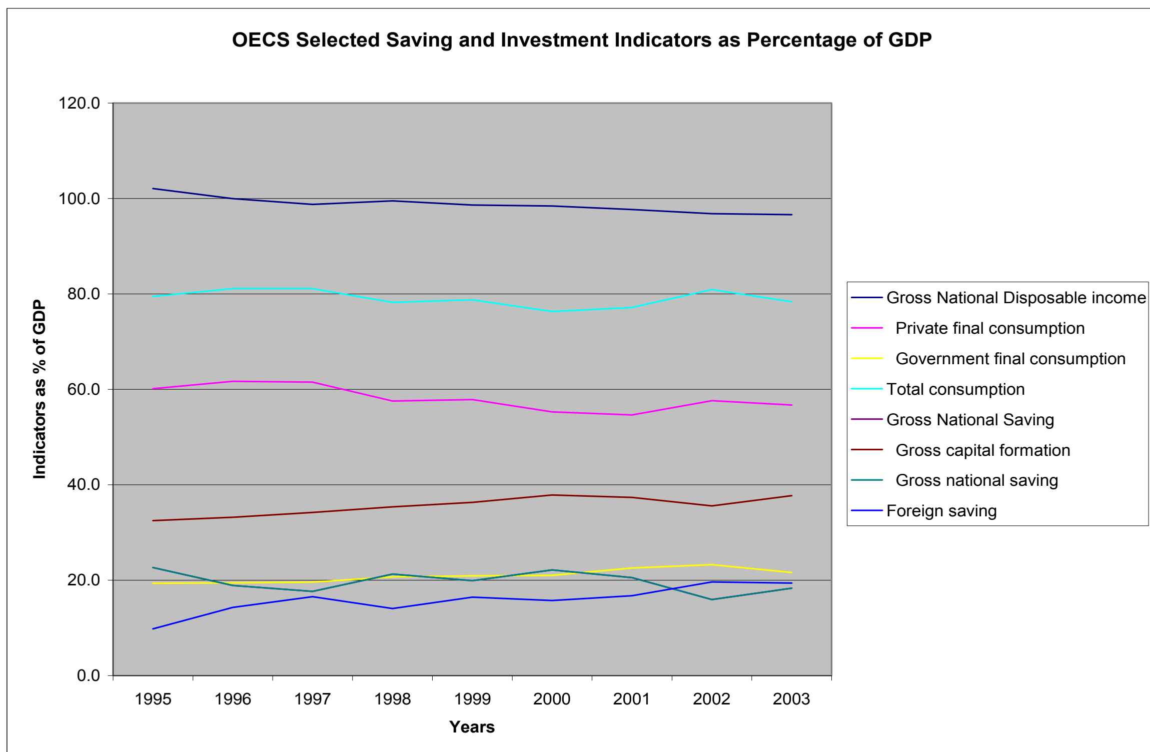
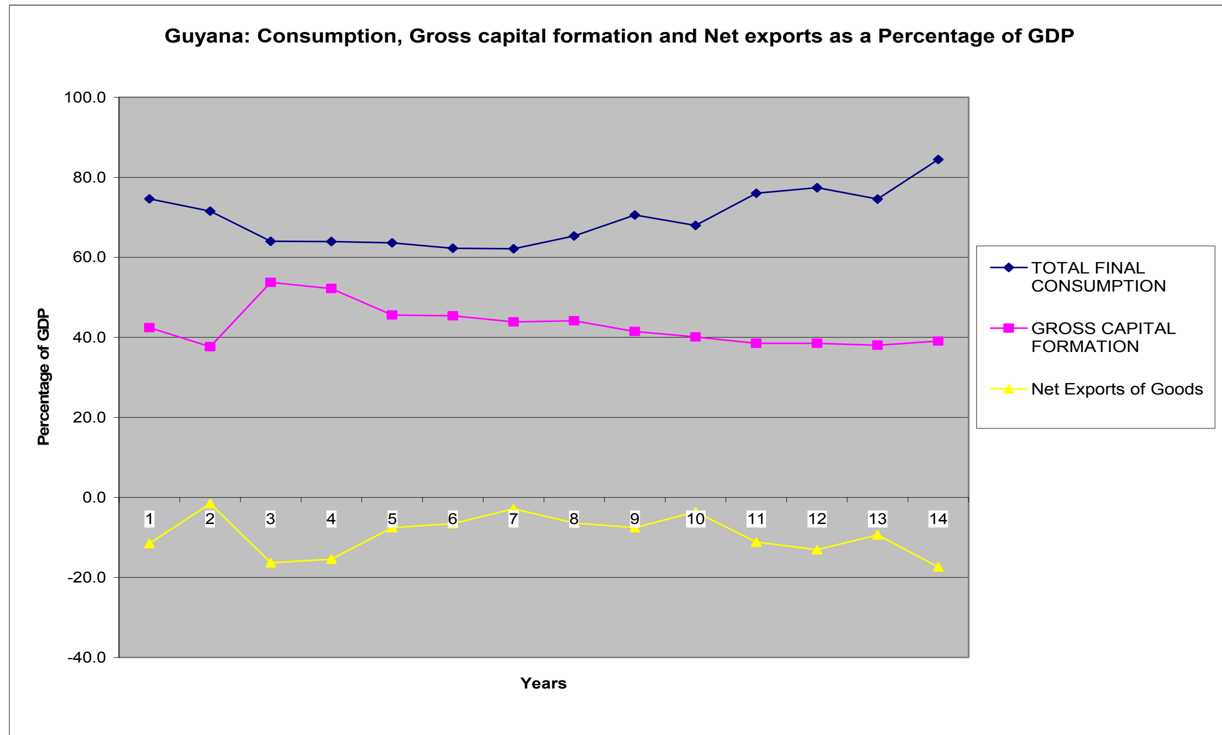


Figure 2: Guyana: Consumption, gross capital formation and net exports as a percentage of GDP



Source: ECLAC based on official sources

In the case of Guyana, as shown in Figure 2, total consumption far exceeds total capital formation and net exports. However, even though capital formation is still relatively high it has not had much impact on competitive net exports to alleviate the foreign exchange constraint. This suggests problems with the efficiency of this investment.

The term finance bugbear

The supply of sufficient term finance at a reasonable price is one of the most intractable financial constraints faced by Caribbean businesses. This has been a major handicap to the development of activities in agriculture, manufacturing and value added services. Financial institutions have provided term finance largely for mortgages. This reflects the high risk-averse culture of these institutions, since with lien on household properties, the default risk on mortgages is relatively low.

The shortage of term finance is a major concern as for instance a World Bank multi-country study in 1998 found that long-term finance tends to be linked with higher firm productivity than short-term finance. This point is important for the Caribbean as the relatively low levels and weak growth in productivity in the region might be linked to the capital structure of most firms. The evidence points to degrees of mismatch between the assets and liabilities structures of firms in the Caribbean. Long-term loans should really be used to purchase long-

term fixed assets such as plant and equipment, while short-term loans should be used to defray working capital expenses such as wages, inventory and utility costs. However, in the Caribbean, a number of firms use overdraft facilities (short-term credit) as a form of long-term financing. These overdrafts are continually rolled over and become virtually permanent. This poses risks to the banking sector because of the mismatch of assets and liabilities and the need for higher monitoring costs. But more importantly, financing business operations by overdrafts is quite expensive and undermines firm profitability and room for competitive expansion and restructuring to meet the international challenge. Moreover, much of the overdraft facilities are used to fund distribution activities rather than manufacturing or agriculture that are required to develop a viable foreign exchange-earning sector. This creates a moral hazard that locks commercial bank credit particularly in the form of these overdrafts into distribution activities, which makes it difficult for banks to restructure their operations to fund productive activity.

The capital structure of firms is also perversely related to firm size. In a kind of Darwinian natural selection process Caribbean large firms, which are already often better placed to compete, have much greater access to long-term finance and on much better terms than small firms. Important factors that account for this include limited or lack of information on the prospects of small firms, weak relations between these firms and creditors that limit their social capital and limited negotiation skills. Consequently, indications are that small firms are often crowded out of the long-term finance market by larger well-established and well-connected firms.

Further, small firms are prevented from leveraging an important strength in the Caribbean. This is the use of their growth opportunities and prospective profits as part of their collateral security (see Myers (1977). This is a crucial constraint, since small firms are often unable to access finance because of lack of real capital collateral security such as land and buildings. Moreover, as the growth in companies in Silicon Valley in the United States so vividly illustrated, Greenfield investment is often made based on expectations of firms future growth and profitability. In effect, entrepreneurs have to take calculated risk. The capital structure discourages this to a fairly large extent in the Caribbean.

The quality of the institutional structure is also an important determinant of the level of term finance that institutions, especially SMEs, can obtain. Where the legal and regulatory regime favours the enforcement of financial contracts, orderly bankruptcy systems and insurance, banks and other financial institutions have a greater incentive to lend long-term at more affordable rates and terms. Arguably, continued weakness in the regulatory and institutional environment in the region is therefore one impediment to provision of long-term finance. This needs to be addressed by improved and more harmonised company legislation, strengthened bankruptcy mechanisms and firmer and timelier contract enforcement. Also, creditor rights[4] in Latin America and the Caribbean has been low, averaging 0.25 on a scale of 0 to 1 in 1998.

[4] See The Inter-American Development Bank (IDB) study "Unlocking Credit: The Quest for Deep and Stable Bank Lending" IPES, IDB, Washington.

Where the market fails to provide sufficient term finance, governments may have to help fill the gap. This is not without its own difficulties, as governments often channel funds to unproductive activity. However, this is a case-by-case matter and examples of successful State provision from countries such as Korea, Japan and Singapore suggest that with the right framework State term finance institutions can be effective. The trick is to enforce reasonable commercial requirements, implement strict performance benchmarks and protect the managers of the financial institutions from public pressure and interference.

4. Market structure, intermediation and business investment the nexus

Market structure as it relates to the degree of competition or concentration in the financial sector is an important influence on cost and quantum of credit and other financial resources. There is a mutual transmission impact between market structure and the performance of financial intermediaries as providers of funds for investment. That is, market structure influences the performance of financial intermediaries in terms of efficiency and effectiveness, and performance in turn affects market structure. For example, in many instances, substandard performance that leads to low profitability provides impetus for mergers and acquisitions in the financial industry for firms to increase market power and their control over the cost of credit and price of other services.

The financial sector in the Caribbean is oligopolistic with relatively high levels of market concentration. Consequently institutions, especially in the dominant banking sector, can influence the price of credit and other services, if not directly then indirectly. Moreover, high levels of concentration tend to correlate with reduced banking sector efficiency, as banks do not have to exert too much effort to make supernormal profits. Sir John Hicks (1935) has noted that such institutions enjoy the "quiet life" of easy profits, instead of the challenge of a real competitive market, where they have to 'earn' their returns. With respect to competition, the wave of mergers and acquisitions suggests that banks in the region benefit from important first mover advantages, which limits market entry. Incumbent banks benefit from economies of scale and scope, asymmetric information and market knowledge and regulations all of which make it difficult for new banks to enter the market. This means that there is a difference between the letter and spirit of financial liberalisation in the region.

In Trinidad and Tobago, for instance, the two largest banks hold 60 per cent of total banking sector assets, while the two largest insurance companies account for 69 per cent of the total assets of the sector. The situation is similar in other Caribbean economies. Indications point to market power attendant on increase in concentration leading to higher interest rate spreads in the region. Although higher concentration has contributed to financial innovation and service quality it does not seem to have led to reduced cost of credit but, on the contrary, to higher costs.

Further, the development of universal type banks in the region that offer insurance, securities, investment banking, leasing and other services mean that failure of one of these large banks could have serious contagion effects on the economy. This could lead to heavy fiscal costs if governments consider these banks as being "too big to fail" and bail them out at the expense of tax payers.

Within the CMSE context, mergers and acquisitions have proceeded apace in the banking, insurance and money market funds sectors. Financial institutions from Trinidad and Tobago, including the Royal Bank of Trinidad and Tobago (RBTT), Republic Bank and Sagicor insurance company have led the way. Also, the Jamaica Money Market Brokers, Grace Kennedy's financial arm and other institutions have moved from Jamaica to other countries in the region. These mergers and acquisitions have helped to consolidate and strengthen some vulnerable banks and insurance companies in the OECS, Netherlands Antilles and other countries. Nevertheless, increased concentration and lack of market knowledge which could lead to even more risk averse lending practices means that businesses in these countries might even be worst off now in terms of accessing sufficient affordable credit.

Concentration and competition are not important in themselves, but because of their impact on the quality of financial intermediation, growth of enterprise and economic growth they affect the development process. Some research, for example Petersen and Rajan (1995) studying the United States, finds that small firms receive more credit in more concentrated financial markets. However, Beck, Demirgüç-Kunt and Maksimovic (2003), using data for countries across the world, show that bank concentration increases the financial constraint and reduces the probability of firms receiving finance. What is more, this adverse result is particularly strong for small firms. Anecdotal evidence from interviews with SMEs in the region seems to support the view of Beck et al. With growth in concentration in the regional banking sector, large, well-established firms seem to be able to continue accessing external bank finance, however, the financial constraint for SMEs has persisted or worsened in some instances.

Apart from the quantum of credit, the volatility of credit is also an important constraint on business investment and restructuring. This is so because firms that are undergoing adjustment and restructuring need not only a good supply of affordable credit, but a smooth and steady supply. Although the Inter-American Development Bank (IDB)[5] finds that the elasticity of credit to GDP and external shocks (that is credit volatility) is lower in more concentrated banking systems in Latin America and other developing countries, this might depend on firm size in the Caribbean. Indications for the Caribbean are that credit to large firms is relatively stable, when corrected for GDP growth and external shocks; however, credit to SMEs is volatile and this hampers their growth and competitiveness.

Finance for small and medium size enterprises (SMEs)

Caribbean economies were founded on plantation agriculture and, since then, a number of the new poles of production have been large scale industries such as petrochemicals in Trinidad and Tobago, bauxite in Jamaica, Guyana and Suriname and some tourism plants in many countries. These large scale industries are very capital intensive by nature and therefore have relatively low elasticities of employment with respect to output. As a consequence, in a number of countries, particularly Trinidad and Tobago currently, we find the anomalous situation of a business expansion and spending boom, but protracted relatively high levels of unemployment relative to growth in GDP. Hence although the situation is not one of jobless growth per se, nevertheless, jobs are not matching economic growth.

[5] See IDB (2005)."Unlocking Credit: The Quest for Deep and Stable Bank Lending", IPES, IDB, Washington.

The paradox in the region is that although SMEs hold immense potential to raise national output, expand employment and generate foreign exchange earnings they have been constrained to do so. Moreover, SMEs have noted that the credit crunch is their major constraint to expansion and competitiveness. Generally, SMEs face peculiar problems due to limited economies of scale, the high cost of lending to small enterprises, since the cost of processing a small loan is high relative to its size, limited collateral and poor projections of business earnings. These are bottlenecks even in some developed countries. However, developed countries have configured specialised lending and technical and institutional capacity-building institutions to alleviate these constraints.

Given that the formal credit market (largely the banking sector in the region) does not serve the credit needs of SMEs well, alternative financing mechanisms catering to their needs have to be strengthened. Caribbean governments have long recognised market failure in this area, and have stepped in to fill the void. This was done through an array of development finance institutions, including development banks, small enterprise development fund, credit unions, both public and private, and of late a few venture capital institutions. For the most part, State-operated development finance institutions (DFIs) in the region have not performed as well as expected. This stems largely from the fact that they were too State-oriented in their approach and failed to give enough weight to market incentives. Compounding this weakness, DFIs were often undercapitalised, suffered from bureaucratic bungling and technical and managerial weaknesses. This does not mean, however, that these institutions do not have a role to play in development finance in the region. What is required is the introduction of more market incentives, greater transparency in lending practices, improved prudential and managerial structures, enhanced capitalisation and better use of information technology for project screening and assessment. Indeed, those DFIs such as Development Finance Limited (DFL) in Trinidad and Tobago and the Development Bank of Saint Lucia, which have been run more like private institutions but still with a development focus, have been most successful.

With the CSME, there is probably need for a regional development finance and capacity-building institution geared to providing financial and technical assistance to SMEs. The Caribbean Development Bank (CDB) could be convoked to provide the funding, which will be channelled to existing successful SME and to new start-ups with strong growth and competitiveness potential.

6. The impact of macroeconomic policy stance

Macroeconomic policy and performance have important effects on the quality and level of financial intermediation. Although most Caribbean countries have achieved improved levels of macroeconomic stability and policy consistency in the last decade and a half, the policy environment still has some way to go to effectively facilitate the channelling of finance into viable productive enterprise. In a number of countries, particularly some OECS countries, there has been a resurgence of fiscal deficits due to the impacts of hurricanes, financing of stagnant sectors and the need for governments to play a more active role in driving growth, giving the limited stimulus coming from the private sector. The upshot of activist fiscal policy has been an alarming growth in indebtedness, particularly in the OECS countries. OECS countries are now

some of the most heavily indebted countries in the world, with average public debt levels almost twice benchmark of 60 per cent of GDP. Unfortunately though, as evidenced by the slow down in growth in the last decade compared with the previous one in the OECS, growth in public investment has not led to higher growth.

Further, to avoid exchange rate and international interest rate risks, some of these countries have been substituting foreign borrowing with domestic borrowing from the domestic banking system. This has led to significant ratios of government borrowing relative to total banking sector credit. Banks' substantial holding of government debt has a number of implications for the quality of intermediation. For one, in a finance-scarce region, the government is likely to be crowding-out some productive private projects, which remain starved of financial capital. This might be partly responsible for the perverse cycle of low private sector activity leading to high government activity to stimulate growth and employment. In Jamaica, for instance, relatively attractive rates on government paper, reflecting the risk premium for holding government debt, has provided an important incentive for banks to hold a disproportionate share of this paper in their portfolio to the detriment of credit to private businesses, especially SMEs.

Moreover, the fiscal stance that has led to the debt overhang has influenced monetary stance in many countries. In some countries, in line with high debt levels interest rates have risen leading to even higher interest rate spreads. This has been the case as the pass through impact of higher interest rates has been largely on loan rates as deposit rates have remained subdued. Deposit rates remain low because abundant supply of deposits in underdeveloped capital markets, where banks dominate the field, means that banks can pay low rates as depositors have limited alternatives. In addition, in the context of high operating costs, banks are reluctant to raise interest costs as it affects their overall profit positions. All of this feeds back to higher cost of capital for businesses and limited business formation and weakened enterprise competitiveness.

However, more than the absolute size of the debt, the activities for which debt is incurred is more important. As countries coming from low development bases, the region needs to incur debt to develop infrastructure such as ports, transport networks, education and training and building institutional capacity. Nevertheless, the development process does not allow countries to separate this from funding for productive activities. What is required is a judicious and balanced mix of infrastructure and institutional development[6], on the one hand, and productive, revenue-generating export-based or import-competing activities, on the other. Presumably, the latter will help fund the former. The fiscal stance is therefore challenged to create a virtuous link between debt finance and development.

Moreover, tight monetary policy has been pursued in countries such as Jamaica and Guyana not only to control debt servicing cost, but to lower inflation and maintain stable exchange rates. This policy has raised the cost of capital, widened interest rate spreads and starved a number of enterprises of capital thereby driving them out of business.

[6] In a number of countries, government debt is overwhelmingly concentrated in infrastructure projects, including roads, ports and office buildings. This leaves little resources for stimulating productive revenue earning activity, leaving some to invoke the maxim "while the grass is growing the cow is starving".

Moreover, inflation has picked up above trend levels in some countries and if this remains the case over the medium to longer term, it could affect overall macroeconomic stability. Added to these, the structural current account deficit of the balance of payments is an area of concern. The services sector has long been the boon for the regional balance of payments, however, as the tourism product in some countries face increasing competition from other destinations, the services surplus might not compensate for the merchandise deficit to the same extent as before in those countries. In addition, slower growth in capital inflows in most countries in recent times, with the exception of Trinidad and Tobago, means that the impetus to growth that has been provided by FDI in the past could diminish, dampening the engine of growth, foreign exchange generation and employment.

6. Capital markets- Challenges and opportunities for business finance

As noted before, this study deals not only with indirect or intermediary finance, but also with direct or capital market-based finance. Capital markets in the region remain underdeveloped and have failed to provide the quantum of long-term finance that is needed. However, coming from this very low base these markets hold potential in the future to liberate the term "finance constraint". Even though the region has a bank-dominated financial system, which affects the development of capital markets since banks and capital markets compete to some extent for funds, with financial development the mix is expected to change over time. The speed of change depends on a number of factors including incentives and the institutional and regulatory system.

Capital markets have the advantage of mobilising long-term finance for more risky, but potentially higher, growth-inducing investments in agriculture, industry and services. Secondly, regional capital markets can promote changes in ownership and control of firms. Equity ownership improves liquidity in the market and critically for the Caribbean holds the potential for galvanising production restructuring. This is the case because shareholders are very keen on firms that they finance being dynamic and competitive so that they could earn good rates of return on their investment. Consequently, they are more inclined to put pressure on firms to adopt new technology, acquire skilled labour and overhaul their production, trading and institutional arrangements to become internationally competitive. Probably one of the reasons for the limited impetus for restructuring among a number of Caribbean firms is their superlative proportion of bank debt and limited equity finance, since banks are not as adept at disciplining and directing business in new growth areas.

Capital markets also provide the indispensable function of risk spreading and diversification. Access to information and the use of technology means that these markets could bunch a portfolio of equities to reduce the risk that would result from an investor's holding of a large portfolio in one firm. In small, relatively undiversified economies of the Caribbean, risk spreading is particularly important, as a natural disaster or an economic shock could undermine the profitability of a number of companies resulting in significant investment losses.

Although the three major stock exchanges in the Caribbean-Jamaica, Trinidad and Tobago and Barbados-have recorded commendable growth in performance indicators such as market capitalisation, volume and value traded and the market index, they have not been very

effective in channelling funds to businesses for new start-ups or expansion. As Table3 shows, market capitalisation[7] in Jamaica has grown markedly from J$146.1 million in 1969 to J$512884.4 million in 2003, similarly, the value traded and number of transactions have grown multiple-fold. Nevertheless, many enterprises in Jamaica remained starved of affordable finance. Moreover, as Demiguc-Kunt and Levine[8] notes in a 1999 study, even though the commercial bank assets were only about 67 per cent of stock market capitalisation in Jamaica at the time, this in no way suggests that Jamaica can be classified as a market-based, as distinct from a bank-based, financial system. What the evidence points to is that Jamaica, like other countries in the region, has an underdeveloped financial system, in spite of Jamaica's being more market-oriented than its Caribbean counterparts.

[7] Market capitalization refers to the value of shares listed on a given stock exchange and is a measure of the size of the exchange.
[8] See Demirguc-Kunt, Asli and Levine, Ross (1999), "Bank-Based and Market-Based Financial Systems: Cross-Country Comparisions", Development Research Group, World Bank.

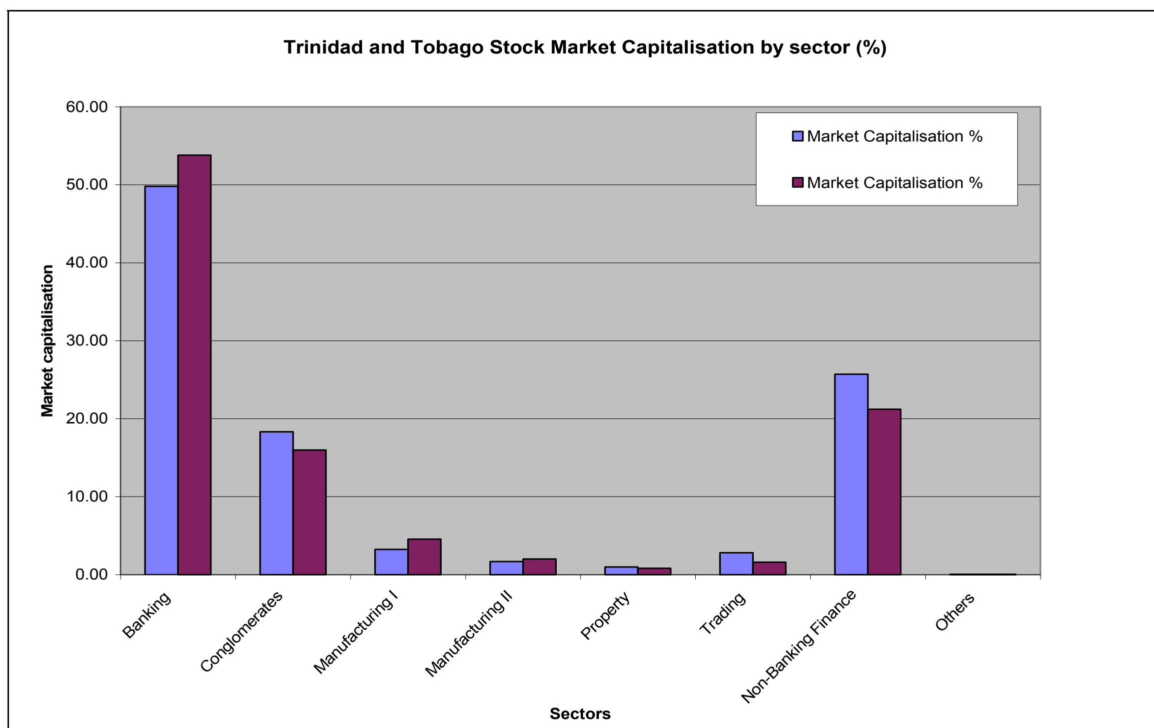
Table 5: Jamaica Stock Exchange indicators

Year	Year end Market capital J$ (million)	No. of listed Companies	Volume traded J$ (million)	Value traded J$ (million)	Year end Market Index	No. of Transactions	No. of Brokers
1969	146.1	34	7.5	6.5	94.98	5156	7
1970	137	38	5.1	3.9	76.26	3756	6
1971	143.2	38	8.4	6.5	77.3	3779	5
1972	157.1	40	12.1	11.5	86	6259	5
1973	203.6	41	9.5	7.8	78.94	4525	5
1974	129.7	40	19.4	10.7	61.97	2679	4
1975	126.5	38	6.9	5.3	66.22	2104	4
1976	106.4	43	5.7	2.8	55.72	1170	4
1977	89.8	43	2.2	1.3	46.99	459	6
1978	93.5	40	13.8	10.1	49.28	583	6
1979	109.6	39	4.8	2.2	59.28	420	5
1980	124.1	41	7.4	5.1	69.83	502	5
1981	225.8	33	4.2	3.3	152.23	799	5
1982	316	32	5.5	10.2	211.16	1375	5
1983	359.2	32	5.2	9.8	240.38	1566	5
1984	697.7	32	9.7	26	461.1	2117	5
1985	1456.6	33	37.6	117.1	941.5	3049	6
1986	3085.8	36	59.3	374.6	1499.87	6691	8
1987	3468.7	41	71.9	400	1515.09	11187	8
1988	4290.3	44	43.5	136.7	1439.22	6446	8
1989	6228.4	44	95.2	516.5	2075.85	13892	8
1990	7321.3	44	58	230.8	2539.36	8691	9
1991	22214.7	44	144.3	1156.6	7681.5	24072	9
1992	76974.3	48	395.6	4687.3	25745.88	49791	9
1993	41879.3	48	567.5	8346.8	13099.68	55519	9
1994	58018	50	741.8	5155.5	16676.74	43144	10
1995	50755.8	51	3565.6	11560.5	14266.99	42600	10
1996	66116.3	50	560.5	4629.4	16615.99	23189	8
1997	79619.6	49	905.4	4594.4	19846.66	18623	8
1998	79038.7	48	604.5	2064.2	20593.33	13748	8
1999	104041.5	45	520.5	2218.7	21892.58	9256	6
2000	160135.7	45	694.9	3441.1	28893.24	21066	6
2001	222006.2	43	2845.2	5948.4	33835.59	20979	10
2002	292297.9	41	1604.6	7636.9	45396.21	26999	10
2003	512884.4	42	4290.4	24237.3	67586.72	35954	10

Source: Jamaica Stock Exchange Annual Report 2003

Figure 3 below provides an indicative picture of part of the root of the problem with regional stock exchanges, that is, the domination of market capitalisation by financial firms and the limited participation of manufacturing and productive service firms. In the case of Trinidad and Tobago, financial firms accounted for an average of over 75 per cent of capitalisation in 2003 and 2004. This point to an alarming pattern for the region when one considers that its manufacturing sector, the most dynamic in the region, had capitalisation over the two years of under 6 per cent.

Figure 3: Trinidad and Tobago stock market capitalisation by sector (per cent) 2003 and 2004



Caribbean stock markets hold potential to help ameliorate the financial constraint faced by enterprises, but must overcome a number of bottlenecks to do so. A key constraint is the limited division of ownership and control in many Caribbean firms. Evidence shows that clear separation of ownership and control provide business managers with degrees of freedom to manage companies in a more enterprising manner. This includes listing the companies on stock exchanges, seeking a better balance between debt and equity capital and raising new capital for business expansion and restructuring through equity issues. Public education, improved regulation and information could help to increase the incentives for the public to demand shares and could encourage more companies to list on the stock exchanges in the region.

Critical to the development of capital market in the CSME is improved harmonisation of company legislation, taxation regimes, accounting standards and credit and risk-rating agencies.

These are often deemed the ‘soft’ institutional aspects of capital market development. However, they are no less vital than the ‘harder’ share trading, cross-listing and other more direct involvement in the market. Information asymmetries remain an important disincentive to the public holding shares in some companies. This stems from the absence of credit rating agencies that can independently evaluate company risks. In addition, varying exchange rate and interest rates tend to further weaken the incentive for firms to cross-list on the three major exchanges. All these factors constrain the amount of capital that can be raised from both primary and secondary issues on regional stock exchanges.

Commercial banks, non-banks and stock markets are not capable of providing the range of finance that the Caribbean needs for economic developing dynamic and competitive enterprises. Countries such as Trinidad and Tobago and Jamaica have developed merchant banks and a few venture capital institutions. Nevertheless, these two risk finance institutions need to be further developed. Venture capital is particularly required for young entrepreneurs with good projects that are potentially viable, but who lack the collateral and reputation in the market and are thus unlikely to be financed by the banking sector.

Except for Puerto Rico, which has benefited from the United States market, venture capital in the Caribbean is still largely underdeveloped. In 2004, there were about 19 venture capital institutions in the region, eight of which were in Puerto Rico. Trinidad and Tobago had five, Barbados three, Jamaica two and Saint Lucia one. However, the total capital raised by these institutions was limited and amounted to only about US$106 million, with the exception of Puerto Rico. This is miniscule as a percentage of these countries aggregate GDP, and points to the untapped potential in this area.

Promoting a venture capital culture is a major challenge for the region. It requires a cultural change in how the public views business failure, as the social opprobrium that attends such failure in the region discourages business venturing. By contrast, in the United States, where the tacit motto seems to be that one has not succeeded in business until he has failed at some venture, venturing is dynamic and flourishing. Secondly, bankruptcy and Chapter 11 type laws are needed to cushion some of the risks that business persons face, so that they can get back on their feet after a business failure. In some countries, governments might have to provide the institutional architecture and some of the start-up funding for venture institutions and then divulge management to private operators. There is a clear case for this, as venturing is a kind of ‘public good’ in these countries and given market failure and private sector risk aversion, might be insufficiently provided by the private sector.

Alongside the stock market, the bond market has an important role to play in catalysing business investment. The bond market is a good potential source of long-term financing for business activity with long maturity. The regional government securities market provides a useful benchmark for further development of the bond market, as these securities are often rolled-over, thus providing longer-term finance. Moreover, the government bond markets have been important avenues for raising finance for government infrastructure and other projects. Indeed with some governments achieving investment grade status from international rating agencies, they have raised capital through international bond issues. The missing link is the weak corporate bond market to provide term finance for private businesses and expand capital

formation. A number of factors adversely affect the development of the corporate bond market in the region. Important among these is a high quality rating agency that assesses company risk and growth prospects, also the high capital adequacy ratios required for issuing corporate bonds in countries such as Jamaica and the general illiquidity of market,

7. Implications of the CSME for financial intermediation and capital formation

As noted before, the CSME provides an important frame of reference for examining the level and quality of financial intermediation in the region. Broadly, the CSME is a kind of survival strategy for the region to build a dynamically competitive economy and society that could consolidate and strengthen gains in living standards that the citizens of the region have come to enjoy. It is therefore self-evident that the financial intermediation process, in so far as it affects enterprise and factor productivity and competitiveness, impinges on the ability of the CSME to meet its expectations as a development framework.

The member States are moving forward with the single market aspect of the integration process. Indeed member States are expected to fully implement the CARICOM Single Market (CSM) by January 2006, while the full CSME that is with the single economy components are expected to come into being in 2008.

The CSME, both in parts and in the sum, can help to reinvigorate the financial intermediation process in the region. Chapter 3 of the Revised Treaty of Chaguaramas provides for right of establishment of enterprises and services in member States on the basis of national or equal treatment. Articles 221 and 222 provide for the removal of restrictions on such right of establishment. Importantly, the Revised Treaty mandates the Council on Trade and Economic Development (COTED) to give priority in removing restrictions to activities in the production of trade in goods and the provision of services, which generate foreign exchange. This is geared to stimulate foreign exchange earning sectors to alleviate this constraint on economic growth. Most member countries have removed most restrictions on the free movement of capital and are now in the final phase undertaking legislative and administrative actions to remove remaining restrictions.

Indeed, as has been noted, cross-border capital movements and mergers and acquisitions, especially in the banking and insurance sector, have been catalysed by the CSME process. Interestingly, the mergers and acquisitions process has not led to the increased levels of competition that was expected, with the knock-on effects on the cost of capital. However, it has spawned financial innovation, with a better complement of products in countries such as the OECS and hopefully this could better meet the needs of business enterprises. Furthermore, the CARICOM Financial Services Agreement is to be finalised in 2006. This agreement will address administrative matters including the standardisation of procedures to promote trade in financial services in the region.

An important issue is the extent to which the CSME facilitates the harmonisation of the domestic (regional) and foreign investment regime. This stems from the view that the domestic and foreign investment regimes should be harmonised so as to eliminate distortions that might dampen the quantity and quality of investment and growth. Moreover, it is believed that a

harmonised incentive regime enables factors of production to reflect their true scarcity values and thereby promotes their use in the most productive activities.

Influenced largely by the Lewisian model of Industrialisation by Invitation, Caribbean governments have long provided a more favourable incentive regime for foreign investors, relative to their domestic counterparts. This was premised on the view that capital scarcity in the region demanded a favourable domestic incentive regime and investment climate to attract capital and know-how from surplus economies abroad. A range of incentives was offered to foreign investors to entice them to establish plants and businesses in the region. The more important among these included tax holidays of up to 15 years or more in some cases, duty free imports of equipment and materials, the use of industrial estates and parks that were provided by the government free of charge or for a nominal fee. Governments also provided accelerated depreciation allowances to assist in the maintenance of plant and equipment.

Given their policy strategy of attracting FDI in exporting sectors such as manufacturing and services, a number of Caribbean countries continue to offer incentives to foreign investors that are more favourable than those offered to domestic investors. Therefore, harmonisation of the investment regime in terms of taxation, exemptions and other allowances, could boost domestic and intraregional investment further.

Progress in CARICOM in implementing a number of regulations and institutions to monitor and ensure the smooth operation of the arrangement should facilitate the intermediation process by promoting a more harmonised financial space. The establishment of National Competition Bodies in Barbados, Jamaica, and movement towards this in other member States, should encourage business investment as the enforcement of competition laws entice new players to enter markets that were previously monopolistic or oligopolisitic. Also, the move to fully implement the CARICOM Regional Organisation for Standards and Quality (CROSQ) will be a major benefit to enterprises. The reality is that a number of businesses cannot capture or maintain market share for the products because of low quality and standards. CROSQ, by helping these businesses to meet certified standards and regulations, could strengthen their competitiveness both in the intraregional and extraregional markets. Moreover, the provision of a good quality, high standard product is a good selling point in negotiating loan financing from commercial banks and other financial institutions. Indeed, as noted, the shortage of such bankable projects contribute to low intermediation, excess liquidity and even disintermediation in the region. In addition, the Caribbean Court of Justice (CCJ) in its original jurisdiction will arbitrate in matters relating to the interpretation and application of the Revised Treaty. This dispute settlement process should help to smooth cross-border investment and exchange.

The free movement of persons (Mode 4 supply under the General Agreement on Trade in Services (GATS)), is probably the most contentious aspect of the CSME. Almost all member States have passed legislation allowing the free movement of university graduates, artistes, media workers, musicians and sports persons. The free movement of the different categories of persons is to be complemented by a National and Regional Accreditation Council. This would provide the mechanism for registering the movement of persons and establishing their qualifications. Free movement has the potential for matching demand and supply of skilled persons, especially business talent across the region, fostering business development in countries

with the greatest shortage of home grown entrepreneurs. The reality is that member countries of the OECS could benefit from the movement of skilled persons and business talent from other countries to develop productive activities that remain undeveloped. This could galvanise the channelling of finance into activities that would otherwise have remained undeveloped. This is particularly important in countries where excess liquidity in the banking system stems from a major lack of bankable projects to finance.

Arguably, the real catalyst for improved financial intermediation with benefits for capital formation is the single economy, rather than the single market. The single economy is aimed at providing a harmonised financial space across the region, buttressed by policy coordination and harmonisation to a large degree. It aims to harmonise fiscal and monetary policies, the coordination of sectoral policies, including production integration and the development of viable regional capital market and labour market. The implementation of the single economy should reduce transaction costs, increase information flows and provide crucial impetus to financial intermediation on a regional scale. In particular, the harmonisation of fiscal incentives and taxes and monetary cooperation should provide for similar costs of doing business in different countries and promote capital movements. Of course, the differential in costs would remain based on economies of scale and resource endowment, but policy-induced cost differentials should be reduced. For instance, customs costs and time for service delivery vary too widely across the region and could be streamlined and harmonised under the CSME.

The demand for finance-the role of entrepreneurship

There is a prevalent tendency to view the link between intermediation and capital formation from the supply side, that is, financial institutions supplying finance to business. However, the counterpart, that is, business demand for finance, is just as important. The financial constraints faced by businesses have been analysed above. There is, however, a counter view advanced by financial institutions in particular, of a severe shortage of bankable projects in the region. This, it is advanced, has historical underpinnings in a relatively weak entrepreneurial culture that is often unfavourable to business start-ups, expansion and restructuring. The crucial question is to what extent does weak demand for available finance affect the quality and level of intermediation? Even without conclusive evidence either way, indicators point to some merit in the view of financial institutions.

One factor pointing to the weakness on the demand side is the long-term trend of excess liquidity in the financial system. Surplus liquidity measured by very high liquid liabilities to total liabilities and high cash to deposit ratios point to inefficient intermediation of the limited pool of financial capital available in the region. The banks claim that they are simply hard-pressed to get potentially viable projects for financing from the public. Given that banks have to operate within prudential regulatory constraints which ensure the safety of depositors' funds and also to guarantee their own profitability, many projects simply fail to meet the screening test. Moreover, in the past, a number of banks have collapsed as a result of funding activities that were unprofitable and unviable. Even now some operate at marginal viability because of the relatively high proportion of bad or doubtful debts on their books. In Guyana, for example,

commercial banks have been quite reluctant to lend to rice sector in recent times because of high levels of non-performing loans to the sector in the past.

A relatively small number of new business start-ups in the region compared with other regions such as the Asian Newly Industrialised Countries (NICS) is also a barometer of weak demand for business finance. As expected Caribbean countries vary in business dynamism, with Trinidad and Tobago being fairly vibrant, Jamaica in somewhat of a recovery following the financial sector crisis and macroeconomic instability of the 1990s, and some stagnation in the OECS countries. Nevertheless, indications, including the view of the financial sector, are that across the region is that viable greenfield and expanding businesses are too few to create sufficient demand for credit. Although fairly high risk aversion by the financial sector is a factor contributing to weak investment demand, weak entrepreneurship is undoubtedly also an important contributor.

Relative risks and rates of return to different activities have long acted as an important constraint on productive investment in the Caribbean. The reality is that long gestation periods, high risks and high opportunity costs (in terms of rates of return in less risky activities) hinder investment in productive activities such as manufacturing, agriculture and value added services. Typically, when countries in the region are undergoing real estate booms, as in Trinidad and Tobago currently, the rates of return from investment in real estate could be upwards of 100 per cent. This compares very unfavourably with margins of around production such as manufacturing and some aspects of tourism. Apart from real estate, investors can also reap high rates of return in distribution-simply buying and selling at a good mark-up and also financial investments in the government debt market, mutual funds and equities. The question then is why should investors undertake the hard work of business investment in production and new services such as informatics, if much more lucrative returns can be gained in alternative activities with much less effort.

This points to the need for diagnostic analysis of the underlying structural and policy factors that are to provide incentives for some types of investment and disincentives for other types. One might find that these issues cannot be tackled within the ambit of strictly conventional economic theories, but must involve political economy issues. Important among these political economy factors might be the structure of the tax, investment and business incentive framework, which might be boosting trading activities at the expense of production.

Further, higher relative costs of doing productive business might also be contributing to the preference of investors for trading activities and financial investments. For instance, high overheads, including electricity costs, labour and material and equipment for manufacturing production relative to most trading activities and some services inclines business to the latter activities.

The CSME can provide a vehicle for boosting regional entrepreneurship and investment demand. If member States could achieve a critical level of harmonisation of business legislation, tax codes, company laws, macroeconomic coordination and other institutional requirements as part of the single economy, this could reduce business transactions cost and facilitate business start-ups. As the situation currently stands, the cost of doing business in the Caribbean is rather

high compared with advanced countries and Asian NICS and even some countries at similar stages of development such as Mauritius. At a practical level, the CSME needs to provide the mechanism for coordination to streamline tax codes to eliminate nuisance taxes, implementing more standardised business registration and licensing fees, business regulation and dispute settlement. Reasonable standardisation at these concrete levels as have been achieved in a number of European countries, would eliminate some of the bottlenecks hindering business development.

In addition, the rights of establishment and national treatment for regional businesses under Protocol II of the Revised Treaty complemented by wider freedom of movement of citizens with in the region should catalyse business development. For one, the expanded market for labour and entrepreneurial skills should allow the movement of these skills from surplus countries to deficit countries. For example, business skills could move from Trinidad and Tobago to Jamaica, Guyana and the OECS and labour skills from Jamaica to Trinidad and Tobago, Guyana and the OECS. This virtuous link, long contemplated by the architects of the integration movement, could help the region to optimise on skills and expertise in the region.

Moreover, entrepreneurship is a tricky business. As Keynes alluded and Schumpeter reinforced, it is often governed by "animal spirits" and depends in part on intuition, hunches and business expectations. This implies that a general economic climate that is rules based, rewards initiative and risk taking and an education system that incorporates on the job training in work-school programmes tend to foster entrepreneurship. There is a sense that a conservative education tradition in the Caribbean, buttressed by a serious social opprobrium at business failure and bankruptcy discourages many would be entrepreneurs from even trying in the first place. This points to the need for cultural changes, which are long-run changes in how a society operates.

A critical aspect of the demand for finance relates to the proportionate flow of funds to different activities. Historically, the bulk of credit financed commodity production, including sugar, bananas, rice and also distributive trades, real estate and other trading activities. Incentives need to be provided, probably selected policies to promote funding for productive export-based activities.

8. Recommendations to strengthen the link between financial intermediation and capital formation in the Caribbean

There are no foolproof measures for guaranteeing that financial intermediation leads to improved business investment, growth and employment. However, there a number of policy strategies and measures that might strengthen this important relationship in the Caribbean. In implementing policy measures, it is important to carefully examine their transmission paths to ensure that different measures do not work at cross-purposes.

One critical consideration is the cost of capital. Although investment activities, for example in real estate as opposed to light manufacturing, vary in terms of their relative interest rate sensitivity, both firm level interviews and research suggest that the absolute cost of capital

remains an important constraint on business start-up and expansion in the region. Policy should focus on ways to reduce the cost of capital, while maintaining the viability of the financial sector, particularly banks. This might entail relatively lower returns to banks and other financial institutions without compromising their profitability and longer-term viability. Effectively, it could be seen as a redistribution of income from intermediaries to final producers (businesses)-an important catalyst for business competitiveness and growth Caribbean economies.

Structural change in the financial sector should be propelled by the opening up of the sector to greater external and intraregional competition. At a practical level, such policies could include more favourable laws and regulations governing the establishment of new financial institutions to break the inherent pre-emptive advantage enjoyed by established institutions. These policies should raise the elasticity of supply of financial services and lower the cost of services (both interest rates and non-interest costs e.g. collateral requirements) and also foster financial innovation. Much of the cross-border activity in the banking sector in the region has been through mergers and acquisitions. In some cases this has led to consolidation rather than increased competition. Although there are issues of ownership and control, the entry of more foreign banks into the region could help to discipline incumbent banks and drive down the cost of capital.

Moreover, as Randall[9]noted, high operating costs (accounting for about 24 per cent of the spread), are an important contributor to high spreads. Therefore, competition, which drives banks and other financial institutions to raise their productivity and lower costs could dampen spreads in the region.

Jamaica and Barbados, among other countries, have been using monetary policy to reduce interest rates to stimulate business investment. In Jamaica, the Central Bank has been reducing the repo rate as a signal to banking sector to lower loan interest rates to reduce the cost of capital. Incidentally, it is accepted that high interest rates contributed importantly to the sharp decline in the manufacturing sector in Jamaica during the 1990s, as the high cost of capital stifled business expansion and restructuring.

High interest rate spreads are made worse by high collateral requirements. In tandem they act as serious disincentives to new investment, especially for activities that depend heavily on bank finance. There is therefore a case for the authorities to use moral suasion to encourage financial institutions to limit collateral requirements to reasonable levels to ensure prudent investments. Indeed, some businessmen are of the view that high collateral requirements in some countries are a form of credit rationing since banks can get much higher returns by buying government paper and hence use high collateral requirements to choke off business demand for funds. There is also the need to factor the prospective strength and viability of projects, especially by SMEs as part of collateral requirements, where these businesses lack real and financial assets to serve as collateral.

Policy authorities need to implement measures to ameliorate the financial constraint faced by SMEs. This is clearly a case of missing or inadequate markets and must be met by non-market solutions. Governments could open a SME window in commercial banks to provide

[9] See Ruby Randall, "interest Rate Spreads in the Eastern Caribbean", IMF WP/98/59.

finance to jump start prospective viable projects in the sector with clearly matching performance targets. In particular, part of the funding provided by the European Union under the Cotonou Agreement for restructuring and adjustment should be channelled to dynamic SMEs, especially those with potential for being competitive on the export market. This should be matched by relevant performance targets such as growth in profits, employment and exports.

Development finance institutions (DFIs)[10] have not met expectations in providing finance for development. These institutions have been hampered by a number of constraints. In the first place, their lending policies were not driven enough by market forces and were too State – directed. This meant that DFIs often funded projects that were of high political priority, but of much lower economic value, such as low income housing and administration buildings. Further DFIs often lacked the incentives to undertake financial innovation in terms of the range of products and services they offered and the mode of delivery. Therefore their share of the market is limited and this dampens their competitiveness.

DFIs have also confronted the moral hazard problem in that SMEs view them as State financers on which they can free ride and avoid servicing the debt obligations to them. Therefore, DFIs should be run by private management, with improved information technology and a focus on financial innovation to reduce operation costs. Further, they should have clear and tight mandates and focus on only a few areas of lending to prevent mission creep and lack of focus. In addition, subsidies from the government should be clearly accounted for and, even though development banks might not aim for maximum profits, they should strive for operational efficiency and reasonable profit to ensure their sustainability. In the end the question is one of balancing their private with their social functions of these institutions.

Further, policy makers must provide incentives for the development capital markets as distinct from financial intermediaries such as banks and non-banks. Capital markets are critical as they are often more adept at financing business start-ups and young innovative firms. The probable tipping point with respect to capital markets is the boosting of cross-border activity on the regional stock exchanges.

A number of measures are required to catapult cross-border trades on the regional stock exchange. First the legal and institutional systems must be modernised and strengthened to build investor confidence and security. Under the CSME, regulators need to speed up the harmonisation of company and bankruptcy laws to ensure a minimum standard platform for operations. This would reduce regulatory “noise’’ and stimulate confidence, since investors would have greater faith in the security of the investments. In addition, efficient settlement systems must be developed at the regional level. The long collapse of the CARICOM Multilateral Clearing Facility left a payments settlements gap in the region, which is only now being filled by a clearance and settlement system in the regional banking sector. Recently, the CSME has made progress in settlement and clearance with the introduction of the real time gross settlement system (RTGS), in which settlements are done through central banks which limit bank credit exposure and risks. Notably, the RTGS enhances the efficiency and timeliness of

[10] Development finance institutions include development banks, development foundations, credit unions and other State or para-statal financial institutions that seek to fill the finance gap that is left by the traditional financial institutions such as banks and non-banks.

settlement of trade in securities and could therefore help to overcome a major impediment to the trade in equities. To catalyse capital markets, the region would need to use the most appropriate information and communications technology to develop a settlement system that promotes the timely trading of shares and other financial instruments.

The region needs to 'grow' new firms to increase new issues of securities. With limited growth in manufacturing, except in Trinidad and Tobago, the impetus will have to come from services such as cultural and entertainment, information and communications technology and agro-processing. Dynamic SMEs in these areas should be provided with the incentive and technical assistance to raise capital for their development on the capital market.

Also the corporate bond market should be developed by strengthening CARICRIS-the regional credit rating organization, and reducing the capital adequacy requirements for sound companies. Indeed, capital adequacy requirements should reflect the varied risk profile and credit worthiness of companies that issue bonds and other securities. Therefore a one size fits all approach might not be suitable.

Institutional savings institutions present a dynamic avenue for strengthening the intermediation and capital formation nexus in the region. These institutions, including social security and pension systems and life insurance schemes present the opportunity to improve intermediation from both the supply and demand sides. The supply, pricing and investment structures of institutional saving vehicles have long been inadequate to meet the development challenges of the region. This stems from the fact that these institutions have been used to provide captive funds for State projects with often low or negative rates of return. In addition, investment decisions prevented pension and investment funds from carrying out the maturity transformation that these long-term funds are capable of doing to provide long-term capital for investment projects with long gestation. Policy authorities must move speedily to provide the legislative mandate for pension funds and other such institutional investors to invest their funds in a more diversified portfolio, particularly viable real sector projects in agriculture, manufacturing and services such as tourism, informatics, cultural and educational services.

Moreover, the inclusion of a defined contribution element to defined contribution pension systems in the region in the mode of 401K in the United States could boost private savings. The reason is that this allows individuals to search out investments with greater returns and could therefore provide capital funding for more dynamic and risky productive activities that are often not funded by the banking sector.

On the demand side, increased flexibility and information disclosure by institutional investors will make them more attractive to the public. This should lead to increased demand for their products because of greater transparency and rates of return. Further with financial innovation, these institutions could securitize some to their products as bundled equities that could be matched with the specific term structure and risk profile of various projects. One critical area in this respect is the provision of catastrophic bonds or equities for disaster impact mitigation and rehabilitation- an issue of major concern for the Caribbean.

9. Conclusion

The quantity and quality of finance remains one of the most important constraint on productive investment in the Caribbean. Regional producers are hindered in their restructuring and adjustment to market competition by this important bottleneck. Financial intermediation in the region continues to be inadequate to their needs for breathing new life into traditional activities and developing dynamically competitive new nodes of production and exchange. Intermediation continues to be driven largely by commercial banks and, given the oligopolistic market structure, the cost of finance remains high and the supply, quality and maturity inadequate for many businesses.

To liberate the financial constraint, the banking sector needs to be opened up to drive down the cost of credit, capital market must be deepened and facilitated to operate regionally. In addition, where they contribute to high interest rate spreads, reserve requirements should be lowered to reduce the implicit tax on the banking sector. Banks should also provide more favourable credit terms to poorer and smaller customers than at present. Also, the policy environment should foster financial sector innovation to reduce operations costs, which contribute to high spreads in a most countries. This could be facilitated by the liberalisation of telecommunication services, the elimination of administrative barriers to cross-border supply of financial services and promotion of a culture of innovation and adjustment to change.

Business firms need to undergo a cultural sea change in their approach to business and finance, especially a focus on raising equity capital to create a better balance between the use of debt and equity finance. Regional equity markets need to be strengthened by improved regulation, harmonisation of company laws and operational procedures to encourage family-owned companies to list on the stock exchanges and also to raise more equity capital. The reality is that there is need for further steps in the division of ownership and control (management) in some of these private companies and the incentive regime and education is required to cede control to independent managers.

Crucially, the quality of financial intermediation must be improved to ensure that the bulk of financial resources are channelled to high productivity, growth-stimulating activities. This requires a policy and incentive framework that favours production and trade more than consumption, especially conspicuous consumption. Macroeconomic policy is essential here, as fiscal deficits that lead to high interest rates on government debt tend to lead to significant household holdings of this debt to the detriment of investment in productive firms. On the other hand easy money and low interest rates could lead to excessive investment in real estate and high consumption, since households perceive that they can draw equity out of these investments to finance such consumption. This could divert investment away from manufacturing and productive services. This seems to have been occurring particularly in Trinidad and Tobago and some OECS countries. High inflation leads to uncertainty about the real value of the return on investments and is therefore a tax on investment, thereby inhibiting business adjustment and change.

Term finance remains a critical constraint on long-term investment projects and must be addressed on different fronts. In the first place, the regional capital markets should be facilitated

to provide more long-term equity capital for businesses. This could be galvanised by increased cross-border activity on regional stock exchanges, a more harmonised regulatory and settlement system and outreach and public education programmes by stock markets. The goal should be to create a unified regional stock market with real time information on companies, prices and earnings, trades and administrative and procedural matters. This is highly possible in this age of advances in information and communications technology, but the institutional and legal systems need to be brought up to speed to achieve a fully harmonised stock market.

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