The Evolution and Development of the Financial System in the Eastern Caribbean Currency Union (ECCU)

By

Sir K Dwight Venner, Governor, ECCB

(22 October 2001)

The financial system in the Caribbean as a whole and in the Eastern Caribbean Currency Union (ECCU) in particular has played and will continue to play a vital role in the development of the region. This paper will address the specific role of the financial system as it has evolved in recent times and the expectations of its performance in an increasingly liberalised and globalised environment.

The financial system in the ECCU can be described as underdeveloped but modern.

The level of monetization is extremely high with the ratio of M2 to GDP being in the range of 73 per cent. There is no barter system and no curbside markets for foreign exchange.

At the apex of the system is a common monetary authority, the Eastern Caribbean Central Bank (ECCB). This institution issues a common currency, the Eastern Caribbean (EC) dollar for the eight members of the Currency Union, of which six are independent countries and two are dependent territories of the United Kingdom.

The commercial banking sector is the dominant element of the system with 44 banks in the system with total assets of EC$9 billion. There are 23 foreign banks with the domestic banks being both private and government owned.

There is a fairly extensive insurance industry comprised of both life and general insurance companies. There is a fair mix of local and foreign companies with regional companies being fairly dominant in the life sector.

The Credit Union has been a very significant socio-economic institution in the Currency Union catering to a large section of the population which had limited access to commercial banks for borrowing purposes.

There are a number of credit institutions comprised mainly of Finance Companies, and Building Societies which are small in comparison to the other institutions. Almost every member of the Currency Union has a Development Finance Institution which is government-owned and provides loans on special terms to the productive sectors (Agriculture, Industry, Tourism) as well as for Housing and Student Loans.

Finally, the Social Security Schemes are the largest mobilisers of savings and have a very significant impact on the financial system.

The financial system of the ECCU evolved as part of a wider set of arrangements covering the entire English-speaking Caribbean. This system was, in turn, a part of the wider sterling area arrangements associated with the British colonial domination of the region.

The currency and monetary arrangements were characterised by the currency board system which came out of the Emmott Committee Report of 1916 which analysed conditions in the then British colonies in Africa. This arrangement was meant to give to the colonies the seigniorage from the issue of a local currency which was backed 100 per cent by sterling securities. This system facilitated both public and private sectors borrowing in the London market and of course gave British banks a considerable advantage in providing services to the territories. The post World War II period saw very significant changes in the region. Firstly, there was a marked shift in the direction of trade and investment from the United Kingdom to the United States. This was not only a matter of geography but more importantly was a reflection of the emergence of the United States as the major economic power and the dollar as the predominant international currency.

Secondly, the attainment of political independence placed the responsibility for economic development in the hands of local political forces who saw the financial system as a major instrument in the attainment of this objective.

The countries, on the attainment of independence, inherited structurally unbalanced economies which were largely dependent on primary agricultural products which had preferential access to metropolitan markets. The economies were extremely open with most production being export oriented and almost all consumption being imported.

Apart from agriculture there was a rudimentary manufacturing sector involved with the processing of agricultural raw materials, import substitution of basic goods, and low wage export activities such as clothing. Tourism was also becoming a significant activity using the natural climatic advantage of the islands.

The distribution sector was extremely important given the strategic importance of imports, and the banking system facilitated this import/export orientation of the economy to the exclusion of most other sectors.

At this juncture, it would be useful to reflect on the perceived role of finance in development which has generated a very large and sometimes controversial literature. The superiority of monetary and currency arrangements over barter has long been accepted and need not be dealt with here except to say that its re-emergence would be symptomatic of a breakdown of the economic and financial systems. The more relevant question, as posed by Professor Rondo Cameron, is whether financial institutions are put in place ahead of economic development, that is, would supply lead or follow that process. The approach and the circumstances naturally differ with different countries, but economic historians of banking have sought to point out the relevance of particular banking systems to the development of certain societies. Scottish banking for example has exhibited a certain distinctiveness and up to today Scottish banks and bankers still hold a special comparative advantage in this sector.

Developing countries like those in the Caribbean and the ECCU were confronted with the need to address the role the financial sector would play in their development. This was quite obvious from the fact that the financial sector supported the structurally unbalanced economy and therefore either the economy would have to be changed and the financial system realign itself or the financial system could be used to facilitate the change in the economy.

A common response of countries in this position is to carry out some sort of gap analysis. The approach is to view the structure of the financial system of the developed countries as the ideal and to establish such institutions in their own countries which are currently not in existence. Two particular institutions have been very prominent in these circumstances, central banks and stock exchanges.

Having one's own currency and an institution which can exercise monetary policy is a critical element of a country's sovereignty and its ability to influence its economic and financial circumstances.

A stock exchange for those countries, which accept a market-oriented economy, is the epitome of a capitalist economy.

The arguments and circumstances now turn on the type of intervention or lack of such in shaping the type of financial system necessary for economic development. In a situation where market forces are weak and markets are by definition far from perfect there is a necessity for guidance and institution building. In short, market forces need to be supported by discouraging monopolies and oligopolies and giving incentives to encourage competition between financial institutions.

Therefore, regulatory framework for both the financial sector and the real sector needs to be established to create the ground rules for economic intercourse in a market environment.

In such circumstances central banks have been given greater responsibilities than in more mature and established financial systems. The stability function is now widely established following the major battles between monetarist and structuralists over the causes and cures of inflation. The promotional and regulatory functions of central banks are now critical in all developing countries. The challenge they face is to encourage the establishment of the type of financial system which would be appropriate to the country at critical and successive phases on its development path. One could argue for the creation of institutions which fill a particular niche as indicated by the perceived potential of such an entity. One could also argue for more direct methods of monetary policy interventions in the absence of the appropriate market environment.

In the Caribbean, the countries were presented with the classic export/import economic structure and financial systems dominated by foreign owned commercial banks operating in the Anglo Saxon tradition of short term working capital lending. It was argued, quite correctly that there was an anti developmental bias in the arrangements which needed to be altered. The commercial banks accounted for more than 80 per cent of the financial resources of the economy which were lent for short term purposes. What the economy needed was medium to long term capital on reasonable terms to encourage new sectors and diversify the economies. The lending patterns of the dominant foreign commercial banking sector was in the circumstances discriminating towards new and merging entrepreneurs operating outside of the traditional import/export economy. The approach to this problem in the Caribbean was two-fold. Firstly, a policy of industrialisation was established following two critical policy papers by the St Lucian economist and Nobel Laureate Sir William Arthur Lewis. The paper of particular interest to the region was entitled "***The Industrialisation of the British West Indies*".** In this paper, Lewis argued for incentives to encourage foreign investors to develop labour intensive industrial enterprises. There was a strategy of sequencing these industries so that an integrated structure would develop in which local entrepreneurs would find a place in the system. The second element which occurred later and separately was the conscious effort to reorient the commercial banking sector through a combination of policies, namely:

1. Nationalisation or the outright taking over of these entities by the Government.

2. Localisation, which meant taking a major shareholding in the enterprise either directly by the Government or by local shareholders.

3. Establishing new banking enterprises using the Government Savings or Post Office Banks which had operated out of the local treasuries.

Reorientation and redistribution of credits to targeted sectors thus become a major factor in changing the allocation of credit between various sectors.

Another policy to change the allocation of credit was the establishment of development banks following the policy advice of the World Bank. Development banks provided subsidised credit to identified sectors with potential growth prospects. Interest rates were below market rates, repayment periods were medium to long term, and there were moratorium on repayments thus allowing the enterprise to get into stride before having to make repayments of principal and interest.

Stock exchanges were introduced in the larger Caribbean islands to provide equity financing to larger enterprises. Equity financing is different to bank financing in that it allows for the enterprise to achieve some level of viability before repayments are due. Stock exchanges had another objective in that they allowed for a broadening of the base of ownership of the productive sector and encouraged a shareholding democracy. The structure and ownership of enterprises which operated in the local economies militated against the rapid development of such institutions. The major export industries were in the main owned by foreign entities, and local enterprises were family owned and not amenable to losing control of their businesses. In many instances the privatisation of government owned enterprises and the localisation of foreign owned banking and insurance institutions provided initial product for the local exchanges.

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The Caribbean financial system continues to be dominated by the commercial banking sector. This is easily corroborated by the proportion of financial resources still controlled by this sector. This is both a strength and a weakness in the particular circumstances of these countries of this juncture. On one hand, the sector has become highly sophisticated and provides most if not all of the services provided by banks in developed countries. The Caribbean banking sector is well integrated into the international financial system through correspondent banking in the case of locally owned banks and head offices in the case of foreign banks operating in the region. In the cases where foreign banks have retained a significant presence this has proved both a competitive challenge to the domestic banking institutions as well as a signal to the international financial system of the country's adherence to particular banking standards. On the other hand, two dilemmas continue to face the banking sector in the region, namely the inability to change in a more comprehensive manner the patterns of credit allocation, and the philosophic concept of either having unit or universal banks.

With respect to the allocation of credit both in maturity and lending to productive as opposed to consumption oriented sectors there is still a significant problem and dilemma.

How long should banks lend for, with short term deposits as a base, to more long term risky areas? Should banks be forced to lend to preferred sectors? These are dilemmas which are painfully exposed in the light of bank regulators responsibility to ensure that banking institutions do not expose deposits funds to unnecessary risks. The reality of this dilemma can be seen from the banking crises which have occurred in both developing and developed countries over the last fifteen years and in the larger countries in recent times. Banks have found themselves in great difficulties pursuing very risky projects in such sectors as real estate.

This has come about in some measure to inadequate supervisory capacity and deficiencies in the legal framework. The ambiguity of the authorities in many cases has exacerbated what have been fundamental inconsistencies in banking practices. The environment in which banking business was conducted must also come in for some criticism. The need for banking institutions to be more innovative when operating in countries striving for development goes without saying. However, an atmosphere in which the impression that unbridled market forces are a panacea for progress is clearly with hindsight not conducive to a stable banking system. Unbridled liberalisation of the banking system even in developed countries has led to some very severe crises which developing countries by definition are not in a strong position to contain.

The issue of the type of banking institution which should emerge to provide banking and financial systems conducive to development is one rooted in the traditions of banking in a particular country and the laws and negotiations which govern the sector. As we pointed out above, the Caribbean inherited the Anglo Saxon tradition of banking which is based on unit banking. The question to be posed is whether in the light of the cross over in the provision of financial service by banks and insurance companies should universal banking be advocated in the Caribbean's circumstances?

Strong arguments can be made on the grounds of economies of scope and scale, scarce managerial and technical resources and efficiency in information gathering for a system of universal banking. The major counter argument would be the strength of the regulatory regime and the level of competition that would meaningfully be developed in the circumstances of what in some cases are very small economies.

In the case of a regulatory regime a similar case can be made for a mega regulator even in the absence of a universal banking system. Reference can be made to a small European country in which consolidated financial groups have emerged and which has a consolidated regulatory system. Recent events in a very large country, the United States, in which the barriers between financial institutions are being removed point to a universal trend in financial consolidation. Within and between different sectors of the financial system, banks, insurance companies, etc there is a drive for consolidation which is being inspired by the competitive forces unleashed by a more liberalised environment.

The question then becomes whether these new structures, in the Caribbean context, will deliver the kind and quantity of financial resources which will facilitate economic and social development. One of the first things to note in this case is the mismatch between the financial and real sectors. In the Caribbean, the financial sector on the whole and particularly the commercial banking sector is better endowed than the real sector in terms of capitalisation, management, automation, training facilities, access of information and integration with the international financial and economic systems. In the case of capitalisation this is prescribed by law and backed up by international standards, (the Basle Accords).

The management of a banking or a financial institution has requirements which stipulate not only qualifications but experience as well as responsiblities which are like capital requirements defined in law or regulations. Management of such institutions carry a certain amount of prestige which is not accorded to managers in the real sector. The financial system has distinguished itself by the application of information technology and the use of computers and telecommunications.

Training facilities and opportunities seem to abound and become an integral part of the financial services sector in a way that is not the case in the real sector. It is in the areas of access to information on the domestic economy and integration into the international economy that the financial sector is a particularly formidable entity. The financial sector gathers information from both savers and investors in its role as intermediary and is well positioned to leverage this information for its own advantage and that of the economy.

In the case of the external links generated by foreign ownership of branches or correspondent relationships these are critical to what are externally oriented economies.

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The contrast with the real economy in the Caribbean is extremely marked. Apart from a few firms which are foreign owned or externally oriented, the domestic real economy consists of enterprises which are deficient in management, training, automation, access to information and connection with, as well as an understanding of the international economic system.

An examination of the structure of enterprises across sectors indicates that businesses fall predominantly into the category of small and medium enterprises. One should note that these do not have the same meaning or definition as such entities in developed countries and are essentially much smaller in size.

Size of enterprises and size of economy become crucial issues when envisaging the role of the financial system in Caribbean countries. Since the domestic market by definition would be a limiting factor to growth, expansion and competitiveness, there is a need to be externally oriented both regionally and internationally. The financial sector then has to define for itself a role which takes into consideration the structure and circumstances of firms as outlined above as well as the domestic, regional and international market environments. Innovation would mean structuring financial products and packages appropriate to these particular circumstances taking into consideration the amount of risk which is tolerable for the particular financial institution and the economy as a whole.

The question is, can individual institutions with limited skills and resources take on this challenge? Or should larger consolidated institutions which span the areas of commercial banking, investment banking and insurance be given this task? Or should there be an ultimate back-up at the level of the state or government that provides:

(1) An appropriate regulating framework to ensure that inappropriate risks are not undertaken;

(2) Lender of last resort facilities in the case of a crisis;

(3) Incentives and subsidies in terms of export credit, insurance and the facilitation resources for the productive sectors in collaboration with the financial sector?

The issue comes down to how intrusive both the government and financial institutions should be in providing credit to the real sector. The two extreme positions, namely a command style arrangement on the one hand and a completely unfettered arrangement on the other can both be ruled. The circumstances of the time (the collapse of state systems in the Soviet Union and Eastern Europe) and the circumstances of developing countries, call for what can be termed intelligent interventions.

The case of East Asia prior to the crisis of 1997 is one of significant interventions by the state starting with Japan in the immediate post World War II period. In the case of Japan, the

Reconstruction Finance Bank (1947) and the Japan Development Bank which succeeded it in 1952 were the institutions selected to provide long term capital to particular sectors of the economy. The Export-Import Bank of Japan was another institution with specific developmental objectives. The reorganisation of the long term credit banks and trust banks in this period was also part of the strategy to mobilise finance to reconstruct the Japanese.

The case of Malaysia is even close to a Caribbean type environment as it was a typical commodity exporting economy with significant levels of underdevelopment and poverty and a significantly disadvantaged section of its population. Significant efforts were made to reorient the commercial banking sector and great emphasis was placed on the establishment of development finance institutions to provide finance for the medium to long term as well as to particular groups, industries and areas of the country.

Caribbean financial systems have made considerable strides in sophistication and coverage but still remain dominated by the commercial banking sector. In some areas the specific role of development finance institutions has been questioned and downplayed. Stock exchanges have not been major providers of start up capital. The small and medium enterprises have not had access to funds on appropriate terms as venture capital funds have not been forthcoming. Some countries in the region started from fairly intrusive positions in the financial system and then moved to the other extreme of liberalisation as conditions of structural adjustment programmes with the Fund and the Bank.

In the ECCU, the decision was taken to pause and reflect on the nature of the development of the financial system. The analysis confirmed that there had been currency and financial stability over a number of years with modest growth and stable inflation (3 per cent). The economies were undergoing a significant transition from primary agricultural producers to services, mainly tourism. However, levels of unemployment were at unacceptably high levels and the economies required extensive transformation to ensure sustainability.

The strategy which evolved was based on building on the platform of stability of the currency and banking arrangements. The ECCU has a common currency and a common central bank but eight separate markets. The guiding principle of financial reform was seen as the integration and development of markets within a single financial space.

The ECCB became the driving force behind reform and underwent significant internal reform in order to fulfill its mandate under the Agreement establishing the institution. Under the Eastern Caribbean Central Bank Agreement 1983 Article 4, the purposes of the Bank are:

1. to regulate the availability of money and credit;

2. to promote and maintain monetary stability;

3. to promote credit and exchange conditions and a sound financial structure conducive to the balanced growth and development of the economies of the territories of the Participating Governments;

4. to actively promote through means consistent with its other objectives the economic development of the territories of the Participating Governments.

Having established a fair level of stability in currency and banking arrangements, the Bank is now moving vigorously to address Articles 4 (3) and 4 (4).

On the legal front, the Bank has moved to have common and uniform legislation in the areas of banking, insurance, credit unions and shortly, securities, to cover all member Governments. At the present the institution is setting the stage for the introduction of an integrated and coordinated regulatory framework across all financial institutions and all member territories.

The process of market development across the whole currency union has begun with the establishment of a vibrant interbank market, to be followed shortly by a Government securities, a market for equities and one for corporate debt.

New institutions are being introduced on a regional basis starting with a secondary mortgage bank, the Eastern Caribbean Home Mortgage Bank which is now in its fifth year of operation and paid a dividend to its shareholders this year. This is to be followed by the Eastern Caribbean Securities Exchange (ECSE) which will have two subsidiaries, the Eastern Caribbean Securities Depository (ECSD) and the Eastern Caribbean Securities Registry (ECSR). The next institution slated to be established will be the Eastern Caribbean Enterprise Fund (ECEF) which will be an omnibus institution with elements of venture capital lending, long term lending, export credit and insurance, and technical assistance to small and medium enterprises. Finally, the Eastern Caribbean Unit Trust will be established to provide the opportunity for small investors to participate in ownership of financial instruments.

The Central Bank has taken initiatives in the area of institutional strengthening by facilitating the establishment of the Eastern Caribbean Institute of Banking and Finance which has been holding a series of workshops, seminars, and educational initiatives in the banking and financial spheres.

It has made important links with other institutes in the region and the hemisphere and is in discussions with institutions of higher learning to secure accreditation for its certificates.

The Central Bank has also been instrumental in bringing members of the accounting profession together across the member countries to form an Institute of Accounting which will be established by common legislation.

With the removal of legal and administrative barriers to the creation of a single financial space, the environment would then be conducive to the rationalisation of financial institutions across the entire currency union. Banking and insurance institutions would be in the forefront of this process but other institutions, like credit unions, would also feature. The increase in space and activities will provide niches for providers of specialised services which would not have been viable in a single state. The consequences of this shift to a single financial space would be mobilisation of a larger part of financial resources, a more efficient allocation of these resources, and the greater spreading of risk across the currency union.

The consolidation of the markets of the currency union and the rationalisation of the financial institutions, will allow the area to make strategic efforts at integration into the wider regional and hemispheric areas and subsequently the international financial system.

The currency union is strategically aiming at leveraging its stability and modernisation into an attraction for external capital as it effects this sequential integration into the international economy and financial system.

It is clear that to survive and prosper in the post cold war, liberalised and globalised economy, small developing countries must accept that they now exist in a new and extremely competitive environment. Innovations in information technology and telecommunications have made the financial sector one of the most dynamic in the international economy. At the press of a button, billions of dollars flow around the world. In terms of magnitudes the daily foreign exchange transactions are the equivalent of US dollars 1.3 billion. Development of financial products is a constantly evolving enterprise. The growth of services as a whole exceeds that of commodities. Telecommunications and computers have changed the economics of location and in some ways can change the dispersion of economic activities between countries. E-commerce is experiencing explosive growth and has very significant implications for international trade. The implications for small countries like those in the currency union are significant on two counts. They can aggressively seek to leverage these changes to come out richer for themselves or they can allow themselves to be stunted to the sidelines in the new dispensation.

In these circumstances serious thought has to be given to the conceptualisation of a financial system which can address the needs of domestic intermediation on one hand and strategic integration into the international financial system. The policy makers in the ECCU have concluded that a financial system that fits these criteria is the sensible and strategic path to follow.