

project it finances, and the rate of domestic savings will not be correlated with the rate of economic growth.

However, for some countries the political risks as perceived by potential investors are so great as to choke off international funding for profitable projects. Alternatively, a project may have too long a gestation period, or the infrastructure needed for its support may be poorly developed. In these circumstances the country is denied foreign investment for internationally competitive projects and it may be necessary to raise finance locally if investment is to take place. Governments may create similar circumstances by their own policies to limit foreign investment in the interests of national sovereignty or by conditions on the repatriation of profit and capital which make foreign investors shy away. Such policies have little to recommend them; national interests are no better served by poorly informed and inadequately skilled nationals than they are by foreigners, and knowledgeable nationals of great ability may secure the national interest no matter who owns the means of production. The repatriation of legitimately earned profits to foreign owners does nothing to inhibit growth so long as the terms negotiated with foreigners are not exploitative and conditions for ongoing capital inflow are sustained.

Where potential investment may be realised by increasing savings we must identify the financial policies which provide for

additional saving. It is essential that the expected rate of return on financial assets be higher than the expected rate of return on consumption, so there will be an incentive to reduce consumption and hold financial assets. It is equally necessary that the expected rate of return on investment be higher than the expected rate of return on financial assets if there is to be an incentive to invest the surpluses accumulated with financial institutions. If there are no projects for which the returns on investment substantially exceed the expected rate of inflation (which is the measure of the return to consumption), no interest rate policy will succeed in raising the savings rate. Financial assets will be accumulated only to be used by deficit spenders for consumption purposes. If there is a sufficient gap, interest rates in excess of the expected rate of inflation will provoke a shift to savings out of consumption, if the favourable interest rates are expected to persist. It will then suit investors to borrow these funds for investment, provided they may be obtained on suitable terms of risk and maturity.

In situations where there are unexploited opportunities for investment in activities which offer internationally competitive rates of return, and where foreign investment is cut off by policy or structural factors, it is possible to stimulate growth by means of interest rate policy, provided the public's ability to finance consumer goods can be suitably compressed. The authorities would wish to pitch the rate of interest below the

expected rate of return on investment, and to use deflationary policies to ensure that the expected rate of inflation were even lower. But it would be far more effective to remove the barriers to capital mobility instead.

Moreover, the financial institutions whose portfolios are affected by interest rate changes do not play a large role in the finance of capital formation in the Caribbean. The interest rate policy, designed to attract surpluses of households to the financial sector, will succeed in diverting these funds towards working capital for firms, in most cases. There may be a reduction in direct investment by households in enterprise, and direct investment most often is a contribution to capital formation. If the expected return on investment is sufficiently in excess of the return on consumption, householders have an incentive to finance fixed capital formation. Attractive interest rates may divert them from this intention: even though the return from financial institutions is less than is expected from direct finance of firms, there is a compensating reduction in risk.

Like any other price the interest rate is a rationing device, allocating available finance among competing uses. All else being equal, the enterprises which are expected to be more profitable should have more ready access to finance. If no firm has control of its market the more profitable will probably be the more efficient, but almost all domestic markets in Caribbean

economies are led by a few dominant firms which have some power to influence prices. The more profitable ventures are therefore not necessarily the more efficient. Moreover, firms which are mainly engaged in exporting do face competitive markets where they must accept the ruling price. The market for finance therefore discriminates against exports and in favour of non-tradables, a bias which is usually inimical to long-run growth. The ventures which currently appear to have the greatest potential will not necessarily stand the test of time. Since capital formation involves a long gestation period the enterprises which are best able to attract funding in any period will prove to be the most efficient only if markets are fully informed and all participants are knowledgeable. Firms wishing to borrow from the banking system face competition from consumers, who are typically less sensitive to changes in interest rates than are producers. Interest rate policies must therefore be accompanied by policies to limit the spending power of consumers if there is not to be a shift towards consumption. It may also be necessary to curb speculative activities by regulation - particularly real estate - if they are not to claim the lion's share of funds. The regulations must be applied with a delicate touch if they are to be effective.

The argument that interest rate policies may secure a more efficient allocation of finance turns out to be a tenuous one. Even in circumstances where real estate speculation is heavily

taxed and consumer spending power is held on a tight rein, exporters may feel the pinch of higher interest rates while producers of non-competing goods for the home market may pass on interest costs, and oligopolistic firms stand to gain, regardless of their levels of efficiency.

2. Charges in the Financial Structure

There are a number of institutional limitations in the financial system which should be alleviated in order to speed up the process of growth. The financial instruments and arrangements characteristic of Caribbean countries have manifested distinct weaknesses in servicing activities which contribute to development. The Caribbean needs systems to allow greater foreign capital mobility, financial arrangements to cope with the failure of companies, better measures to transform short term liabilities of financial institutions into long-term financial assets, financial incentives for the reform of management, provisions for export finance, and well tailored mechanisms for increasing the liquidity of bonds and similar instruments of direct finance.

Caribbean countries need to encourage the inflow of foreign investment, which brings information systems, sophisticated management and updated technology in its wake. They also need to manage the outflow of finance. In all countries of the western hemisphere there is a strong preference for US dollars over domestic currency. People hold local currency because of transactions costs involved in converting to US dollars, the risk and

inconvenience of the transfer and ignorance of available devices for switching funds. If foreign currency outflows on capital account are subject to a monitoring system which requires all transactions to be recorded in advance with the authorities - who may question or veto any application - there is just a sufficient brake on tendencies for capital flight. The system will serve to inhibit destabilising short-term speculative runs which have their origin in rumours and poorly informed markets, or which reflect irrational market reaction to unexpected economic developments. It is very important that the system not be used to ration capital outflows over any period of time. It is a means of allowing markets to settle in the face of any events which generate nervousness; it cannot staunch any determined, persistent efforts to substitute foreign for local currency holdings. In the short run it is not worth the while of most wealth holders to resort to illegal channels of capital flight, with their attendant risks. However, if the authorities begin to disallow permission for capital outflow on a widespread basis for some time, most wealth-holders will soon put in place illegal arrangements to circumvent the controls. Moreover, rationing of foreign exchange is a strong disincentive to foreigners interested in the potential for investment in the country.

The principal device for ensuring foreign capital mobility seems to be a system of foreign exchange management which monitors foreign currency transactions and provides generous information

so that wealth-holders at home and abroad may make well-informed decisions. If there seems to be unjustified short-term capital outflow sparked by rumour or poorly informed agents, discreet rationing may be applied for a week or two, but that effort must be abandoned if the outflow shows no sign of moderating by then. The exchange management systems must be administered efficiently, with simple procedures, helpful administrators and quick responses.

The financial system must provide a certain proportion of resources for firms which have a high risk of failure. A high failure rate is characteristic of the early development of any economic activity, and financial institutions therefore shy away from new areas and small firms. Financial instruments must be provided to ensure that innovators are not starved of funds. Historically, financial institutions in the industrial countries were often left very much to their own devices, and they shared the losses of the firms they financed. In small countries domestic financial institutions may not readily survive such shake-outs, while branches of international institutions operating in the area have guidelines which make many new ventures ineligible for finance.

The approaches which have so far been tried in the Caribbean are to persuade existing institutions - mainly commercial banks - to devote some portion of their assets to financing new ventures and to establish government-owned banks with a mandate to support such activity. Neither strategy has had much success.

Apart from simple exhortation, central banks have tried to coax commercial banks into lending to new ventures by providing special discounts, preferential interest rate margins, concessions on reserve requirements and other sweeteners. With all this, the proportion of credit to new ventures in most portfolios is tiny. Nationally owned banks have failed because commercial lending criteria have been completely subverted by personal and political considerations, and the scale and priority of lending bears no resemblance to the development contribution of the firms being financed.

The establishment of venture capital institutions has been mooted as one means of dealing with the problem. Such an institution would take equity in new firms on the basis of its own informed judgement of their potential. It would need to sink a great deal of funding into projects, many of which will come to nothing, in the hope that one or two major successes will eventually restore its balance sheet. The venture capital company will quickly lose its way if it does not have well-informed management who have a clear sense of the firm's purpose and the ability and determination to back up their own judgement. The firm will almost inevitably need government participation. Only relatively large private organisations command sufficient resources to commit a significant sum for risky ventures, and the fact that they most often do little in this direction shows that

they do not have strong motivation for it. However, private sector participation should be actively sought in any state-sponsored enterprise of this kind, to ensure that it does not fall under the deadening hand of an official bureaucracy.

A principal function of any financial system is to transform the long term instruments which are necessary for fixed capital financing into the shorter maturities which wealth-owners prefer. The financial systems of the Caribbean, dominated by commercial banks in the British tradition, are poorly equipped to perform this service. It is especially difficult to obtain long-term finance for activities with which bankers are unfamiliar, and all long-term funding dries up when interest rates prove as volatile as they have been in the 1980s. Firms which do get funding under these circumstances are very highly geared and their reserves are so thin that the slightest tremor in their markets threatens them with bankruptcy. No country has yet found a convincing way around the difficulty. Establishment of a venture capital company, encouragement of public share issues by companies, introduction of stock trading facilities and official guarantees for specific kinds of long-term lending together make up a package which goes some way in the desired direction. However, most elements in the package are in place in the larger economies of the English-speaking Caribbean, and the maturity structure of finance for investment remains most unsatisfactory.

The prospect of periodic bail-out of firms or financial institutions by governments of the Caribbean remains. Governments must be prepared to step in with well considered rescue plans where necessary, but they must have strong performance criteria attached as a condition for accommodation. Such episodes offer opportunities - which are seldom taken - to re-orient the thrust of production in directions which are indicated by the growth strategy.

The growth strategy often requires the transfer of control and management of resources from an existing holder or group to innovators, persons with more appropriate skills and higher motivation. Financial institutions may be a catalyst in this transfer. Because they have first claim on the assets of companies which default on loan obligations financial institutions can engineer the disposal of land, premises and equipment which could be put to profitable alternative uses by more able management. The transfer of ownership which the financial institutions arrange will be growth promoting if the financial institutions themselves have sound judgement and are staffed by persons capable of evaluating projects on merit (rather than on the basis of the security which the customers can offer). Government might give some direction by providing special financial support for purchases of firms in receivership by skilled managers of proven ability, on terms which might be conditional on performance.

Growth strategies in the Caribbean depend heavily on rising exports. However, because export marketing is so much more difficult than selling on local markets, exporters are usually regarded as high risk enterprises and they find it difficult to obtain adequate finance from banks. Some Caribbean nations have provided official insurance and guarantees for credit to exporters, with subsidised premiums for the insurance. These schemes have had some effect, but their contribution to the overall finance of exporting firms is not large, and major exporters in non-traditional fields must still rely mainly on foreign funds, principally from head offices and overseas branches. As domestic marketing expertise develops in the Caribbean the demand for export credit may intensify and with it the use of credit insurance; it may be that the current low level of usage reflects the low success rate of domestic efforts at export marketing.

Two English-speaking Caribbean countries have set up stock exchanges. They are intended to give the instruments of direct finance for business liquidity comparable to that of bank deposits and other financial liabilities. Without this liquidity the expected return on stock purchases and other direct finance from households to business must be considerably in excess of the interest rate before people with surplus balances will hold stocks rather than deposits. However, existing stock exchanges have been quite innocuous because of the very low volumes of

traded paper and the scarcity of buyers and sellers. Barbados hopes to provide its stock market with an agent who stands ready to buy and sell for his own account at all times. His price offers will be based on his assessment of the profitability and prospects of each firm; if he has a large enough capital and he makes sound judgement it is expected that he can lead the market and make enough to keep his operation solvent. All market shares will therefore be liquid, though the cash realised from any sale will depend on the market's judgement as to the quality of the issuer, a judgement which will be heavily influenced by the market leader. The rules for operation of the stock exchange may play a large part in its success. For example, if companies with foreign ownership are allowed to participate the market may gain in vibrancy, whereas rules which restrict involvement to wholly local firms may stunt the growth of activity. Well policed regulations and good information requirements are also essential.

3. Summary

The financial arrangements that are most important for the economic growth of Caribbean nations are institutional in nature. Arrangements must be made to facilitate capital flows, involving careful monitoring, judicious short-term controls on outflows, firm avoidance of rationing beyond the very short term, good public information systems and minimisation of red tape. A panoply of special arrangements appears necessary to support new ventures. They include special concessions to financial

institutions for selected types of credit, official guarantees of some kinds of loan, credit insurance at subsidised rates - particularly for exports - a jointly owned public/private sector venture capital firm and a stock exchange supported by a market leader who has some official support. None of this will make much impact unless there is first rate management of the financial institutions themselves, and an understanding of the factors which go to make firms viable, especially those that are involved with new products, new markets and new technologies. In the final analysis government must stand ready to mount tough, well thought out financial rescue operations when all else fails. This is perhaps the most difficult assignment. If it is to be useful, the rescue operation must be selective, weeding out those firms or sectors which have no viable future, and conditions must be imposed on the beneficiaries, tied to their subsequent performance. The manipulation of interest rates, which has absorbed much of the attention of economists who have addressed the issue of finance and growth, is not judged to be crucial.

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