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CAPITAL MARKETS AND PRIVATE-SECTOR DEVELOPMENT IN THE OECS

Final Report

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PRIVATE-SECTOR DEVELOPMENT IN THE OECS

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PURPOSE

This report addresses two questions:

1. Are the capital markets of the member-countries of the Organization of Eastern Caribbean States[1] sufficiently strong to support the growth and prosperity of the private sector?

2. If the capital markets needs to be strengthened, can and should the Agency for International Development contribute? What form should assistance take?

The study has been commissioned by the Private Sector Office of the Regional Development Office/Caribbean to assist the Office in setting its strategy for private-sector development over the next five years.

BACKGROUND

Capital markets transform a society's savings into long-term investment funds for business and government. Their efficient functioning is vital to a healthy private sector. They mobilize national savings in adequate amounts, attract sufficient overseas

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1.This report concentrates on the six independent nations the OECS: Antigua and Barbuda, Dominica, Grenada, St. Christopher and Nevis (St. Kitts), St. Lucia, and St. Vincent and the Grenadines. See Table 1 for a statistical description.

Table 1
SELECTED INDICATORS OF THE OECS MEMBER-STATES

	Area (km.sq.)	Population (000, 1986)	GDP (EC$m, 1986)	GDP/capita (EC$, 1986)
Antigua	440	81	238	2900
Dominica	750	78	111	1400
Grenada	345	102	103	1000
St. Kitts	269	46	77	1700
St. Lucia	606	140	194	1400
St. Vincent	388	111	98	900

Source: Robert R. Nathan Associates, Inc. and Price Waterhouse, OECS Capital Markets and Financial Institutions Project, Washington, D.C., 1989. Two volumes.

funds, and channel money to businesses at low transactions costs; they package funds for businesses in the desired instruments and maturities, direct funds to those firms that most productively employ them, and attach a cost to the funds that accurately reflects the risk of the use to which the funds are put. The institutions participating in the capital markets include, among others, commercial banks, development banks, insurance companies, pension funds, leasing firms, brokerage houses and investment banks, as well as stock exchanges.

USAID's involvement in capital markets dates back to the agency's early years. Development objectives in health, education, and agriculture were supported through direct lending, loan guarantees, and, to a limited extent, equity investments. USAID assisted intermediate credit institutions initially as a means of extending loans and equity to public enterprises and then increasingly in the 1970s as a means of channeling funds to the private sector. In recent years, the strengthening of financial markets themselves has been adopted as an objective of the agency and as a core component of many of its private sector programs.[2] "Effective capital markets," states a 1988 AID Policy Paper

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2.See Arthur Young and Ferris, Baker, Watts, Inc., Policy and Institutional Considerations in Equity Market Development (1989), a report commissioned by USAID, for a brief history of USAID's capital market programs.

entitled Financial Market Development, "are indispensable to th pursuit of sustained, broad-based economic growth."[3]

From the Policy Paper, USAID's vision of a sound financial syst in a developing country emerges. Such a financial system exhib the following characteristics, characteristics which Mission programs should promote:

The financial institutions are predominantly private, profit-making and competitive;

Interest rates are set by market forces rather than being subsidized or otherwise administered;

Domestic resources are the primary source of capital;

Foreign investment is encouraged;

Credit is allocated by market mechanisms rather than direct by government;

Collateral requirements are not so high as to discriminate against certain classes of prospective borrowers; and

The tax code and other laws and regulations foster savings, efficient intermediation and productive investment.

The Policy Paper calls for Missions engaging in financial-market development to prepare a comprehensive strategy paper to guide their activities. The present report will assist the Mission in that task. Both our analysis and recommendations are informed b the Policy Paper's vision of properly-functioning capital market

The scope of this report is not limited to strategy, however. I recommends to USAID a detailed set of activities to be implement in prosecution of the strategy.

The report builds on, and is indebted to, a 1989 study commissioned by USAID and the Eastern Caribbean Central Bank and carried out by Robert R. Nathan Associates, Inc. and Price Waterhouse.[4] The present report re-examines the conclusions o the Robert Nathan/Price Waterhouse study in light of subsequent developments and recent scholarship.

3.United States Agency for International Development, Financial Markets Development (August 1988).

4.Robert R. Nathan Associates and Price Waterhouse, op. cit.

SUMMARY

The report contains five sections.

Section I describes how OECS businesses typically finance their operations. It reveals a pattern of heavy reliance on debt (especially short-term debt) rather than equity. Such high leverage makes businesses risky and it slows their growth.

In Section II we examine financial institutions and markets, searching for the cause of this distorted pattern of capitalization. We find that the dominance of the financial system by lending institutions (commercial banks in particular), along with the absence of many equity-oriented institutions, contributes to businesses' high leverage. We also trace the problem to a web of governmental policies that compartmentalize the capital markets of the islands, making six somewhat isolated capital markets rather than a single OECS-wide market. Financial institutions, we will see, cannot flourish and evolve in such small, fragmented markets. In particular, compartmentalization blocks the development of a stock market, an institution vital to the provision of equity to OECS businesses.

In Section III we examine the domestic savings rate and the levels of foreign investment. We note the widespread observation that the financial system will be called upon in the coming years to achieve dramatic improvements in its ability to mobilize domestic and foreign savings. Without such improvements, private-sector growth will be slowed by a shortage of capital.

In Section IV we propose an agenda of reform, consisting of five broad goals. They center on the need to provide more equity to businesses, to cut dependence on debt, and to create regional and extra-regional financial markets for these purposes. All reform depends of reversing governmental policies that compartmentalize the island economies.

In Section V, we argue that USAID is particularly well-qualified to contribute to the further development of the region's capital markets, and we lay out a five-point plan of action:

1. Clearing away legal and regulatory barriers to regional integration;
2. Participation in a regional stock market;
3. Further analysis of the savings rate;
4. Financial training for businesses; and
5. Education of business and political leaders.

We argue that USAID should not establish additional loan or equity programs with its own funds. Its efforts should instead be directed at channeling private-sector savings into productive investment, and particularly into equity investment.

Extensive appendices supplement the narrative.

I. THE CAPITALIZATION OF OECS BUSINESSES

To assess the adequacy of the capital markets in supplying funds for business investment, we take the vantage point of a business firm. How does a business finance its operations? Does it typically find sufficient money available, or is its growth constrained by a shortage of cash? Can money be obtained on reasonable terms, or do the terms impose excessive costs, risks, or operating inefficiencies on the business?

The vantage point of the firm is not the only vantage point one could take. Indeed in studies of this kind it is more common to take a systemic perspective, inquiring into the major suppliers and users of funds and exploring the institutions which mobilize savings and transform savings into investment vehicles. We begin this study, however, with a perspective closer to the ground, and we do so for two reasons. First, the questions we are called on to answer center on the ability of the financial system to deliver funds to the private sector. That ability can be assessed most directly by looking at the results: what quantity of funds were delivered, at what cost, and on what terms and conditions? Were these funds what the businesses needed? A second reason for taking this ground-level perspective is that it takes some of the mystery out of the subject. Financial markets are abstractions, the sum of innumerable and widely-dispersed actions that cannot easily be seen or touched; and to many of us, the operations of financial institutions (especially highly specialized ones) are not part of our everyday experience. How much money a business is able to borrow from a bank, on the other hand, or the amount of dividends it pays its shareholders are questions that we can more confidently consider. (The Robert P. Nathan/Price Waterhouse study contains a very useful description of the major institutions.)

A. Sources of Business Finance

Broadly speaking, a business has two sources of permanent capital--debt and equity. A crucial difference between the two, regardless of their particular strain, is that debt contractually obligates a company to make periodic cash payments of interest and principal while equity imposes no such strict requirement. Failure or delay in meeting a debt payment can bring bankruptcy and dissolution of the company. Equity funds, on the other hand, are more forgiving. While dividends may be expected, they are paid only if the firm has earned a profit, and they may be delayed, reduced or canceled without dire consequences. Debt, then, establishes a fixed cost that increases risk; to the extent a business acquires its funds through borrowing, it heightens its vulnerability to swings in its fortunes.

1. The Level of Borrowing

In this section we evaluate OECS businesses' borrowing patterns, amassing evidence from a variety of sources to argue that businesses rely too heavily on debt finance.

Most of the OECS state-owned commercial and development banks will allow firms to borrow, subject to adequacy of collateral and creditworthiness, upwards of 75% of their capital needs (producing a "debt-to-capital ratio" of 75%). The private-sector banks report similar lending patterns. A start-up company can in many cases borrow 50% or more of its initial capital requirements. Once a business establishes a satisfactory history, it might borrow 70% or even 90% of its total capital. (See Table 2.)

Table 2
STATE-OWNED BANKS' DEBT-TO-CAPITAL LIMITS FOR BUSINESS LOANS

Institution	Debt Limit
Antigua Commercial Bank	75%
Grenada Co-operative Bank	60%-80%
Grenada Development Bank	80%
National Commercial Bank of Grenada	(a)
National Commercial Bank of Dominica	(b)
National Commercial Bank of St. Lucia	75%-80%
St. Lucia Development Bank	80%

Notes: (a) same as commercial banks; (b) "negotiable."
Source: U.S. Department of Commerce/Caribbean Basin Division and U.S. Business & Commercial Center/USAID, Eastern Caribbean Financing Directory.

Studies of balance sheets of companies in the region reveal actual levels of borrowing consistent with these lending policies. (Unfortunately, none of the studies focuses exclusively on the OECS.) A United Nations report of 1987[5] found debt-to-capital ratios in a Caribbean-wide sampling of industries generally exceeding 70%. (See Table 3.) Marion Williams of the Barbados Central Bank reported similar debt-to-capital ratios in a survey of small- and medium-sized Barbadian firms.[6] (See Table 4.)

Table 3
DEBT-TO-CAPITAL RATIOS OF SELECTED CARIBBEAN INDUSTRIES

Food processors	73%
Clothing manufacturers	83%
Bottlers	46%
Furniture manufacturers	73%
Printers	99%

Source: Conrad V. Smikle, op. cit.

The debt burdens reflected in these figures are high. Larger companies in both developing and developed economies generally maintain substantially more conservative capital structures, even though their greater size and longer histories might indicate that they are more capable of servicing debt. Barbados' largest companies offer an example. Of the 18 firms listed on the Barbados stock exchange, the average debt-to-capital ratio was 33% in 1989; only five companies had ratios exceeding 50%, only two exceeding 60%, and none exceeding 70%.[7]

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5. Conrad V. Smikle, "A Study of Capital Markets and Caribbean Trade," a paper prepared for the Regional Workshop on Trade in Services, Antigua, 1987.

6. Marion V. Williams, "Venture Capital, New Investment and the Development of Stock Exchanges in the Caribbean," presented at the Conference on Financing Development in the Caribbean, December 1989.

7. Ernst & Young, Performance '90 (Bridgetown, Barbados, 1990).

Table 4
DEBT-TO-CAPITAL RATIOS OF SELECTED BARBADIAN INDUSTRIES

Tourism	70%
Industry	75%
Manufacturing	65%
Fishing	82%
Small Business	67%

Source: Marion V. Williams, op. cit.

Another common yardstick for measuring borrowing levels is the coverage ratio. This is defined in various ways, often as the ratio of (a) annual cash flow before payment of interest and principal to (b) annual interest and principal. The ratio gauges the cushion in a company's profitability. How much cash does the company generate beyond the bare minimum required to pay the bank? Stated differently, by how much could the company's profits deteriorate before its ability to meet its obligations to the bank would be impaired? As with the debt-to-capital ratio, the coverage ratio offers insight into how conservative or liberal a company is in its borrowing. Again we see evidence of the easy availability and the liberal use of credit.

Banks that use the ratio typically call for a minimum coverage of 1.25-to-1. That is, for every dollar due the bank, the business must generate $1.25 in cash from which to make the interest and principal payment. A coverage ratio of 1.25-to-1 is not a stringent lending standard. A few comparisons put it into perspective. This same 1.25-to-1 standard is used by the Caribbean Development Bank in judging the creditworthiness of development banks, institutions that have considerably greater stability in their cash flows than the typical private-sector company. Banks lending to small businesses in the United States commonly use this same standard, even though their clients do not face many of the risks confronting OECS businesses. Larger industrial companies, both in the Caribbean and in more developed economies, generally strive for substantially higher coverage ratios. A ratio of 1.25-to-1 would normally render a publicly-traded company in the United States ineligible for an investment-grade rating on its unsecured debt. Even lenders secured by real estate and a long-term lease by a creditworthy corporate tenant require at minimum a 1.25-to-1 coverage ratio.

2. Loan Maturity and Risk

Business loans are predominantly short-term, and short maturities exacerbate the risk brought on by high leverage.

Borrowing short-term is riskier for most businesses than borrowing long. Amortizing principal over a short period drains cash. Business borrowers can hope to replenish cash by rolling the loan over, but an overdraft or short-term loan comes with no guarantee that the bank will agree to do so. The bank's liquidity position or its sectoral or maturity preferences could change; the creditworthiness of the business borrower could deteriorate.

Short-term loans, as well as longer maturities with an adjustable interest rate, also subject businesses to interest rate risk. A loan that can be serviced at the original interest rate may prove unbearable if rates increase. To the extent that businesses cannot adjust their prices (and profits) as quickly as the interest rate is re-adjusted, they place themselves in a precarious position when they acquire permanent capital at short-term rates.

If an adequate supply of longer maturities were available, more businesses would probably shift their borrowing out of the short maturities.

Commercial banks, however, offer little long-term loan funds to business. The banks do not publish their maturity schedules by type of borrower, but we estimate that approximately one-half of their lending to businesses consists of overdrafts or maturities of under one-year; approximately one sixth has a maturity between one and five years; and about one-third has a maturity of more than five years. Much of the longer-dated maturities in fact combine characteristics of both short- and long-term lending; principal is amortized over an extended period, but the interest rate is subject to frequent readjustment to prevailing rates.

Development banks and National Development Foundations do offer longer maturities, but the total volume of their lending is dwarfed by that of the commercial banks. Bond financing is not commonly used by OECS businesses.

3. The Debt-Bearing Capacity of Businesses

We have described typical debt levels as excessive and risky. Such judgments cannot be made in the abstract, however. A company's debt burden must be measured against its ability to meet required principal and interest payments. That ability, in turn, is a function of the variability of a company's cash flows. Utilities can borrow large sums because demand and price--and therefore cash flows--are smooth and predictable. Electronic component assemblers can borrow relatively little because sales volumes, prices, and costs--and therefore cash flows--are subject to unforeseen change.

The business environment of the OECS is fraught with risk. Speaking very generally, the businesses do not generate highly predictable cash flows, and they cannot safely sustain heavy debt burdens. Businesses are small, and many are in the early stages of development. Young companies are notoriously risky; product, production process, market, management are all unproven. Businesses in the productive sectors--agriculture, tourism, and manufacturing--face the uncertainties of weather, foreign exchange rates, overseas economic cycles, and fluctuations in commodity prices.

Consider the uncertainties agribusinesses face. Between 1980 and 1988, banana prices have experienced year-over-year price changes of more than 10% on five occasions. The price of sugar changed by that amount twice. Variability in growers' income due to foreign exchange rates has been even greater (bananas are priced in pounds sterling; sugar in the European Currency Unit). Finally, variability in the volume of banana and sugar produced has been greater still. Overwhelming all of this is the prospect of a curtailment, with the further integration of the European Community ("1992"), in the concessionary prices afforded sugar and bananas under the Lome IV treaty. One analyst at the Windward Islands Banana Association estimates that in the worst case banana revenues could be cut in half.

Consider the uncertainty in the tourism sector. Between 1980 and 1985, the US dollar (and therefore the EC dollar) appreciated more than 80% against the European currencies. About one-third of the OECS tourists come from Europe, and they were confronted with sharply increased costs. To hold its dollar revenues constant, a hotel in the OECS would have had to raise the price of its rooms from, say, 50 pounds sterling to over 90 pounds. Tourists have choices, and at least one study of the Caribbean industry suggests they are rather price sensitive.[8]

Finally, consider the risks run by manufacturers: competing with substantially larger overseas firms, often depending on tax and tariff advantages that are subject to revision, and driven by the miniscule size of local markets to develop export sales before maturing domestically.

These and other business risks introduce a great deal of variability into the cash flows of OECS businesses. It is axiomatic that variability in cash flows reduces the debt-bearing capacity of a business. In spite of such variability, OECS firms depend heavily on debt, seemingly to more than a prudent degree.

8.For a general discussion of the issue, see Thomas Downing, "Exchange Rates and Financial Stability in the Tourism, Sugar, and Banana Industries of the Eastern Caribbean," 1991, unpublished. Concerning price sensitivity of tourists, see Jeffrey A. Rosenweig, "Exchange Rates and Competition for Tourists," New England Economic Review (Federal Reserve Bank of Boston), July/August 1986, pp. 57-67.

4. Expert Opinion on Business Capitalization

The evidence presented above is strongly suggestive, but it does not conclusively prove our contention that businesses are over-leveraged. One might argue that a 75% debt-to-capital ratio, or a 1.25-to-1 coverage ratio, could very well be sustainable if the lender were sufficiently flexible and accommodating. Typical debt levels do vary substantially from one country to another, depending in part on the banks' willingness to renegotiate debt agreements, to waive covenants, and to withhold enforcement of foreclosure rights.[9]

Conclusive proof depends, however, on data that are not easily available. In their absence, it is useful to consider the conclusions reached by expert observers of West Indian business. Many of them do in fact concur in our judgment that borrowing levels tend to be too high.

The UN study cited above noted that "capital development in the Caribbean is financed largely from loans with very little or no equity."[10] A 1990 study of Trinidad, Barbados and Jamaica observed that scarcity of equity "compels an increased reliance on debt, making enterprises that are relatively new more vulnerable to economic fluctuations."[11] A paper presented at the 1984 Symposium on the Role of Private Enterprise in the Caribbean argued that "[f]ar too many projects are being undertaken with an unduly leveraged capital structure ... it is not sufficient to simply provide loans ..."[12] Finally, in the words of the Robert R. Nathan/Price Waterhouse study, "generally, the less developed a country, the greater the reliance on bank credit. Moreover, most of the credit is short-term, with 90-day 'evergreen' loans being rolled over endlessly to finance fixed plant and equipment as well as working capital."[13]

9.See Mitchell Berlin, "Bank Loans and Marketable Securities: How Do Financial Contracts Control Borrowing Firms?" Business Review (Federal Reserve Bank of Philadelphia, July/August 1987), pp. 9-18, for a discussion of related issues.

10.Conrad V. Smikle, *op. cit.*

11.C. Michael Henry, "Capital Availability, Small Business Formation and Performance in Barbados, Jamaica, and Trinidad: An Empirical Foray," Social and Economic Studies, vol. 39, no. 4 (December 1990).

12.Hugh Henry-May, "Financing Sources and Conditions," Curacao Chamber of Commerce and Industry Symposium on the Role of Private Enterprise in the Caribbean--the 1980s and Beyond, 1984.

13.Robert R. Nathan Associates and Price Waterhouse, *op. cit.*, vol. I, pp. II-13.

Echoing these opinions, many OECS bankers describe their lending as bordering on being too liberal.

Thus while more data would be needed to prove the case of excessive leverage conclusively, we take confidence in our interpretation from the views of the expert observers.

5. The Consequences of Excessive Leverage

What are the consequences of businesses' heavy reliance on debt financing? A company that has borrowed heavily is less adaptable, more vulnerable than one that relies more on equity financing. It is less capable of surviving downturns in its profitability because it must meet the fixed costs of interest and principal. A fall-off in demand, a rise in costs, a drop in price might bankrupt a highly-levered company while imposing only a temporary strain on the equity-financed firm. By reducing its adaptability, a heavy debt burden puts an OECS company out of sync with its environment. As we have seen, the OECS business environment subjects a company to unpredictable challenges and places a premium on adaptive and flexible behavior. The fixed costs of debt undermine the company's ability to cope.

A debt-oriented capital structure reduces the absolute level of profits since interest expense is deducted from the operating margin in determining income. Lower profits make a business less attractive to prospective entrepreneurs and potential equity investors, both of whom are drawn by the prospect of financial reward. At the same time, lower profits heighten a business' need for additional funds: first, because payment of interest and principal represents an outflow of capital, depleting resources; second, because lower profits place a business closer to the point of financial distress. To sustain itself, certainly to grow, the debt-financed firm requires additional capital, but low profits and high risk make attracting capital a difficult task. The consequences include stunted growth and foregone opportunities.

B. Discriminatory Access to Credit

If we grant for the moment the proposition that OECS businesses in general borrow too heavily, we might still ask whether particular subsets of the business community nonetheless suffer a shortage of credit. Observations along these lines are often heard. The subsets most frequently cited are the small- and medium-sized enterprises, businesses in the productive sectors, and businesses lacking collateral. We find little evidence to support these observations. Accordingly we find little reason to limit the generality of our finding on the excessive use of debt.

A finding of the Robert R. Nathan Associates/Price Waterhouse study was that "small and medium-sized enterprises (SMEs) face the most difficulties in accessing medium and long-term financing."

The study proposed a "loan guarantee scheme for the OECS region targeted at the special needs of the SMEs."[14] Our earlier description of the maturities of commercial bank loans supports the notion that the SMEs cannot borrow sufficiently in the desired term. Nor, however, can larger or smaller firms. Micro enterprises, it is true, can borrow in longer maturities from the National Development Foundations (NDFs), while generally SMEs are ineligible, but the total portfolio of the NDFs is just 1% the size of that of the commercial banks. Likewise, larger firms can sometimes borrow long-term from the Caribbean Development Bank (CDB), but again the CDB's direct lending to businesses is not substantial in comparison to that of the commercial banks. In borrowing from the national development banks and the national commercial banks, the other sources of longer maturities, the SMEs are at no disadvantage because of their size. By definition, SMEs typically borrow in amounts ranging from EC$ 25,000 to EC$ 500,000.[15] As Table 5 shows, the average loan size of the national commercial and national development banks falls within this range.

Table 5
SIZE OF CUSTOMERS AND SIZE OF LOANS of
NATIONAL DEVELOPMENT AND NATIONAL COMMERCIAL BANKS
(EC$ 000; various dates)

Institution	......Size of Loan...... ..by Policy	..Actual
Antigua Commercial	0.5 - 4500	4 - 1800
Grenada Cooperative	0.1 - 300	0.5 - 280
Grenada Development	0.2 - 900	122 avg.--ind.& tour. 6 avg.--agric.
Nat'l Comm'l/Grenada	1 -	
Nat'l Comm'l/St. Lucia	0.5 -	76 avg.
Nat't Comm'l/St. Vin.		20 avg.
St. Lucia Dev't	5 - 3000	240 avg

Source: U.S. Department of Commerce/Caribbean Basin Division and U.S. Business & Commercial Center/USAID, Eastern Caribbean Financing Directory.

14.Robert R. Nathan Associates and Price Waterhouse, op. cit. vol. I, page III-5.

15.John O. Schroy, "Venture Capital," in Robert R. Nathan a Price Waterhouse, op. cit., vol. II.

The productive sectors of agriculture, manufacturing and tourism are sometimes said to be denied adequate credit from commercial banks. Banks prefer, it is argued, to lend to the distributive trades with their strong collateral and their rapid turnover of working capital. Indeed the share of loans to agriculture, manufacturing, and tourism is smaller than their share of the gross domestic product (GDP), as Table 6 reveals. These data alone do not permit us, however, to conclude that the productive sectors are inadequately served. The amount of capital required by a company (and by extension, a sector) is not a function of its contribution to the GDP, but rather a function of the net assets it employs.[16] The optimal split of the required capital between debt and equity is a function of the variability of the company's cash flows. Agriculture most likely receives a share of bank credit smaller than its share of GDP because its debt-bearing capacity is limited, not because of discriminatory or irrational behavior on the part of commercial lending officers.

A recent analysis of agricultural lending in Trinidad makes the point nicely, although unwittingly. Citing an inadequate flow of loan funds to agriculture, the author offers several reasons: "Farmers ... lack training in project preparation, implementation and evaluation ... many small farmers do not have proper land titles ... the lack of good track records is a major stumbling block ..." It gets worse: "investment in domestic agriculture [is] unprofitable." And as though this were not enough, he cites another impediment: "Failure of farmers to repay their debts[!]"[17] Nonetheless, the author goes on to argue for more credit to agriculture, apparently seeing no link between the borrower's ability to repay and the bank's willingness to lend.

A multi-sectoral study by the Bank of Jamaica also points to a disparity in various sectors' share of GDP and share of credit. The study attributes the disparities to bankers' rational risk-avoiding, profit-seeking behavior, and not to irrational or discriminatory preferences. Agriculture's borrowing is limited, the author argues, by the sector's riskiness: uncertainty over weather, disruptions in marketing and distribution, and inadequate collateral. More

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16.The relationship between assets and GDP contribution is a complex one. To compare manufacturing to distribution, for example, we note that manufacturing has a higher ratio of assets to sales, suggesting it needs more financing per sales volume than distribution; however, manufacturing also has a higher ratio of value-added to sales, and this would reduce its relative financing needs as a percentage of its contribution to GDP. Sound complicated? That's the point--no simple conclusion can be drawn by comparing share of credit with share of GDP.

17.F.R. Bissessar, "Financing of Agricultural Investment in Trinidad & Tobago," presented at the Conference on Financing Development in the Caribbean, Barbados, 1989.

broadly, the study finds a positive correlation between sectoral profitability and the banks' willingness to extend credit.[18]

The mismatch between a sector's GDP and its borrowing is not convincing evidence that insufficient credit is being made available. Lack of creditworthiness seems a more plausible explanation. If agriculture, manufacturing, and tourism need more capital, they should probably seek it in the form of equity rather than debt.

Table 6
SECTORAL DISTRIBUTION OF GDP COMPARED WITH
SECTORAL DISTRIBUTION OF COMMERCIAL BANK CREDIT*

	Agric.	Manuf.	Rest.& Hotel	Whse. & Retail
Share of GDP (%) 1985-1988				
St. Kitts	11	12	6	14
Dominica	31	8	2	12
St. Lucia	17	9	8	15
St. Vincent	18	10	3	12
Grenada	18	5	6	13
Antigua	6	6	17	9
Share of Commercial Bank Credit (%) 1990				
OECS	3	5	7	14

*Categories are probably not consistently defined between the GDP and the lending data. Use data only for indications of broad patterns.

Sources: For share of GDP, World Bank, Long-Term Economic Prospects of the OECS Countries, Washington, D.C., 1990. For lending data, Eastern Caribbean Central Bank.

18.See Eric A. Shaw and John W. Robinson, "Commercial Bank Credit and Sectoral Performance: Some Emerging Patterns in Jamaica, 1981-1988," prepared for the 21st Annual Conference--Regional Program of Monetary Studies, Barbados, 1989.

Another commonly-noted source of discrimination in access to credit are high collateral requirements. USAID's Policy Paper on financial markets, for example, observes that lenders "frequently establish loan collateral requirements that effectively direct credit to favored groups of individuals or enterprises." In the OECS, however, it seems just as likely that banks' reliance on collateral widens rather than restricts the field of eligible borrowers. The principal alternative to collateral-based lending is cash-flow-based lending. Today commercial banks consider both collateral and projected cash flow in their credit decisions (along, of course, with character and skills of the borrowers and soundness of the business plan). Were the emphasis to shift in favor of cash flow, banks might become more conservative, not less. Young businesses, without a track record, would find it difficult to obtain credit; those without proper accounting records would be similarly disadvantaged.

By developing-world standards, the OECS collateral requirements are not onerous. The model banking act calls for minimum collateral of 120% of the amount borrowed, and bankers cite average actual coverage of only slightly more than that. These figures are comparable to those cited by United States bankers lending to small businesses, and they are below the 150% to 200% cited in the USAID Policy Paper as typical of most developing countries. Giving emphasis to collateral probably permits lending to some businesses that would not qualify on cash flow alone. Businesses that lack both cash flow and collateral cannot properly complain of being shut off from credit. They are not creditworthy. Their capital should come in the form of equity.

* * * * * *

In summary, this section has described how OECS businesses finance their operations. Five points bear emphasis:

1. As sources of permanent capital, businesses depend too heavily on debt and insufficiently on equity.

2. Debt maturities tends to be short, heightening the risk inherent in debt financing.

3. Businesses in the OECS face a host of risks arising from their size, the isolation of their markets, the weather, currency, and world-wide economic conditions. The riskiness of the business climate limits the amount of debt that businesses can prudently bear.

4. Little evidence supports the oft-heard contention that significant subsectors of the business community are

denied adequate credit. Many companies need more capital, but, generally speaking, loan funds seem to be available to the extent of the borrowers' creditworthiness.

5. Excessive borrowing increases OECS businesses' risk and constrains their growth and prosperity.

II. CAPITAL MARKET INSTITUTIONS

In this and the next section, we shift from description of how businesses finance themselves to a search for causes. If too much debt can be harmful, why do businesses over-indulge? If short-term borrowing is particularly risky, why do businesses not seek out longer maturities? And if too much debt implies too little equity, what accounts for such a shortage? In our search for answers, we examine capital-market institutions and governmental policy on capital-market development.

A. An Overview of Capital-Market Institutions

The total debt and equity from domestic sources invested in OECS private-sector businesses approximates EC$ 1.6 billion. Table 7 identifies the institutions providing this finance and estimates their contribution to the total. Table 8 takes a broader view of the financial system. It identifies all financial institutions and estimates their total holdings of financial assets, including assets used to finance government and private consumption as well as businesses. The table compares the institutional structure of the OECS financial system with those of Trinidad, Jamaica and the United States. (Appendix A offers additional related data.)

Scanning these tables, we note several features of the institutional landscape that begin to explain why OECS businesses finance themselves as they do.

First, we see the dominance of credit institutions. Table 7 reveals that three-quarters of the domestic capital invested in businesses (EC$ 1.2 billion of EC$ 1.6 billion) comes from institutions that make debt rather than equity investments. Within the lending group, commercial banks account for three-quarters of the loan funds (EC$ 0.9 billion of EC$1.2

billion). The other lending institutions are quite small in comparison to the commercial banks. The largest of them, the

Table 7
DOMESTIC SOURCES OF PRIVATE SECTOR FINANCE
(EC$ Millions--1990)

DEBT	EC $	%
Commercial Banks	900	56
Commonwealth Development Corporation	100	6
Development Banks	100	6
Caribbean Financial Services Corp.	50	3
Credit Unions	25	2
Agricultural Venture Trust	17	1
National Development Foundations	10	1
Caribbean Development Bank	10	1
Subtotal	1212	76
EQUITY		
Private Ownership and Retained Earnings	150--300	14
Publicly-Held Shares	140	9
Agricultural Venture Trust	20	1
Caribbean Financial Services	5	0
Subtotal	315--465	24
TOTAL........................	approx. 1600	100

Sources: Eastern Caribbean Central Bank; Annual Reports of Development Banks; Robert R. Nathan/Price Waterhouse; interviews.

development banks, are only one-ninth the size of the commercial banks; national development foundations only one-ninetieth their size. The disparities in size remind us that the lending practices of the commercial banks are of paramount importance in understanding OECS business finance and that supplementary services or differing practices of the other institutions may not materially alter the choices available to the typical OECS business. Table 8 illustrates the relative institutional simplicity of the OECS financial system. The more developed financial systems are heavily populated by specialized institutions. The institutions of the OECS, and particularly the commercial banks, are called on to be generalists.

Second, we note the relative dearth of institutions that invest in equity. Only one-quarter of domestic investment funds come in the form of equity. Absent from Table 7 are pension funds and insurance companies, institutions that invest heavily in the equity markets of more developed economies but that hold almost no

Table 8
INSTITUTIONAL COMPOSITION OF CAPITAL MARKETS
(various dates*)

Intermediary Institution	Percentage of total assets of . . . OECS	Trinidad	Jamaica	U.S.
Commercial banks	80%	45%	62%	33%
Savings and loan ass'n		9%	8%	15%
Life & caus. ins.		22%	12%	15%
Pension funds	11%	10%		17%
Mutual funds			6%	6%
Finance companies		2%	3%	5%
Savings banks				3%
Money-market funds				3%
Credit unions	2%	6%		2%
Development banks	3%	4%	4%	
Non-banks	4%		5%	
Total	100%	100%	100%	100%

Notes: Blank spaces should be interpreted to mean either that data are unavailable or that the figures are included elsewhere. Data are taken from several sources. Categories are probably not consistently defined.

* OECS and US--1986; Jamaica--1984; Trinidad--1987.

Sources: Clive Y. Thomas, "Financing Development: The Mobilisation of Savings in the Commonwealth Caribbean," paper presented at the Conference on Financing Development in the Caribbean, Barbados, 1989; George G. Kaufman, The U.S. Financial System: Money, Markets, and Institutions, 4th ed. (Prentice Hall: New Jersey, 1989), p. 170.

equity in the OECS. Missing, too, are funds held off-shore (much of it "flight capital"), unavailable for equity investment. The OECS does not have an organized and liquid stock market. Its 23 publicly-owned companies trade only over the counter and only infrequently.[19]

A third theme we will want to pursue is the policy of the island governments toward the development of capital-market institutions. In general, we will find that the laws and regulations of the OECS countries have hampered the development of regional institutions. Without easy access to funds and investments outside their own island, financial institutions have been constrained in their growth and in the developmental role they might otherwise play.

The following sections elaborate on these three themes, to wit, the dominance of commercial banks, the shortage of equity, and role of governmental policy.

B. Dominance of Commercial Banks

Tables 7 and 8 permit a simple explanation of the high leverage of OECS businesses. The great bulk of savings in the OECS is controlled by institutions--commercial banks--that can transform savings only into loans. Institutions and individuals that could, in principle, channel savings into equity investments--pension funds, insurance companies, and wealthy individuals--either do not command control over large pools of savings or choose to place those savings with commercial banks rather than in equities. This situation is not unique to the OECS. Throughout the developing world, commercial banks and central banks held 68% of the financial assets in 1985 (as compared to 39% in developed countries), while long-term debt securities and equities represented only 21% of developing-country financial assets (47% in developed countries).[20]

19.Table 7 does not include the direct investment of foreign funds, except as they form an unknown portion of the retained earnings and public shares. National accounts of the OECS countries do not disaggregate foreign inflows sufficiently to permit identification of direct investment. We do know that the figure is large, representing more than 50% of total investment in the private-sector economy. In 1987, foreign direct investment totaled approximately US$ 83 million, an amount equal to about 15% of the total capitalization of the OECS private sector. Much of the foreign direct investment is in large tourism projects. Foreign capital is discussed again in connection with the savings rate below.

20.James A. Austin, _Managing in Developing Countries_ (The Free Press: New York, 1990), p. 214. Liburd and Bain put the comparable figure for the OECS at 67% in 1986. See Eustace Liburd and Laurel Bain, "Financial Intermediation and Economic Growth in the OECS," _Social and Economic Studies_, vol. 38, no. 4 (1989), p. 208.

The liquidity of the OECS banking system has perhaps encouraged borrowing. Bankers indicate that the high liquidity of their institutions has created pressure to make loans to all vaguely-creditworthy applicants. Excess liquidity dampens bank profits, as funds which are available but not used for loans are parked in low-yielding instruments. Throughout the past decade, the banking system has in general exhibited high liquidity. In September 1990, for example, the average loan-to-deposit ratio for the OECS (excluding Antigua) stood at 77%, against a target of 80-85% (see Table 9). A number of bankers describe the lending practices spawned by this excess liquidity as uncomfortably aggressive.

Table 9
LIQUIDITY OF THE OECS COMMERCIAL BANKS
Loan-to-Deposit Ratio--Indigenous and Overseas Banks
As of September 30

	1990	1989
St. Vincent	64%	65%
Dominica	77%	67%
St. Kitts	80%	80%
St. Lucia	82%	79%
Grenada	84%	81%
Antigua	97%	93%
OECS	81%	78%
OECS excluding Antigua	77%	74%

Source: Eastern Caribbean Central Bank

The tendency of businesses to borrow on short maturities reflects the sources of commercial bank funds and, in some cases, governmental credit allocation policies. As indicated in Table 10, the majority of OECS commercial bank deposits have short maturities. As the deposits are subject to withdrawal, only a portion of them can fund long-term lending; and as the deposits are subject to interest-rate adjustment, they cannot support fixed-rate lending at all. In seeking the longer-term, fixed-rate loans that are funded by the banks' time deposits, businesses face competition from mortgage borrowers. Competition is keen since time deposits are limited; moreover, businesses compete at a disadvantage since in several countries banks have a tax incentive to lend for home mortgages, and mortgage borrowers generally are able to deduct interest from taxable income.

The widespread criticism of commercial banks can best be understood in light of their dominant size. Commanding such a high proportion of the resources and operating in a financial system largely lacking more specialized intermediaries, commercial banks are called on to solve a very wide range of economic problems indeed. They are criticized for collateral-based lending and asked to help their clients create record-keeping systems needed to support cash-flow-based lending. They are criticized for placing creditworthiness above the government's sectoral

Table 10
COMMERCIAL BANK DEPOSITS BY TYPE
(1989)

Type of Deposit	Percentage of Total
Demand	18%
Savings	40%
Time	36%
Foreign currency	6%
Total	100%

Source: Eastern Caribbean Central Bank.

development targets in making loan decisions. They are criticized for maintaining credit standards and asked to finance more risky ventures. These are roles more properly filled by, respectively, the public accountant, the development banker, and the equity investor. In resisting these roles, the bankers are acting rationally and responsibly. A freer flow of credit would fill institutional gaps better filled by others; it would provide funds that would be better provided by other sources and in different form. Many of the calls for more bank credit should be transformed into calls for more equity; and many of the calls for expanding the role of the commercial banks should be transformed into pressure for the development of institutions that make equity investments.

C. The Shortage of Equity

Some commentators attribute the shortage of equity to a lack of takers--too few entrepreneurs and too few good ideas. The problem seems more one of supply, however. The problem, that is, resides in the inability of financial institutions to transform savings into adequate quantities of equity rather than in any inability of business to generate opportunities to employ equity.

At every turn in a business's evolution, the owner confronts barriers to attracting equity capital.

At start-up, the normal source of capital is the savings of the entrepreneur, supplemented in many cases by savings of family and friends. These savings are invested in the firm predominantly as equity. In the OECS, however, even start-up businesses make heavy demands on bank credit. The low savings rate of the OECS populations (a topic explored in Section III) means that personal and family savings are scarce. Prospective investors might also be tempered in their enthusiasm by the daunting challenges a business faces in these tiny and underdeveloped markets. The prospective investor must also consider carefully how he will ultimately recover his investment. Because the financial system lacks most of the institutions that provide equity financing at later stages of a company's growth, the investor has no obvious exit strategy. The entrepreneur, in soliciting equity investors, has a difficult selling job under these circumstances.

In later stages, businesses typically depend on reinvested profits to provide most of the financing for expansion. Reinvested profits are, of course, a form of equity ("retained earnings" in accounting terminology), and they do not place the burden of fixed repayments on the fledgling business. In the United States, some 70% of expansion funds for small businesses come from reinvested earnings.[21] A world-wide sampling indicates that on broad average small firms tend to reinvest one-half to two-thirds of their earnings (though the pattern may vary widely by country).[22] There is much anecdotal evidence, though no systematic research, to suggest that the OECS businesses might earn less and reinvest less than firms in other areas. An analysis of the business climate reveals many limitations on profitability, beginning with small markets, modest purchasing power of local customers, and the difficulties of competing internationally without a strong domestic base. Impressions gleaned from causal reviews of business accounting records and discussions with bankers and accountants confirms the notion that many businesses do not show strong profits. Discussions also reveal a widespread belief that owners redirect a large share of earnings away from the business to support personal and family needs. To the extent that these observations are accurate, businesses again face a shortage of equity funds.

In more developed markets, companies of middle size--beyond infancy but too small to issue public shares--often turn to institutional investors for private placements of equity. Such institutions include pension funds, venture capital funds, trust departments of banks, and insurance companies. In the OECS, however, few institutional investors offer private-placement

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21.John O. Schroy in Robert R. Nathan Associates and Price Waterhouse, vol. II, page 23.

22.Philip Nech, "Africa," in David J. Storey, ed., The Small Firm; An International Survey (Croom Helm Limited: London, 1983), p. 255.

equity funds. Beyond the Agricultural Venture Trust and the Caribbean Financial Services Corporation (two USAID-supported organizations holding modest equity portfolios), no venture capital firms operate. Private insurance companies and the national insurance schemes (N.I.S.) do not generally invest in equities or in long-term company debt.

Insurance and pension funds are in some senses natural sources of equity and long-term debt.[23] In more developed economies, these funds invest in corporate debt and equity in an effort to earn higher yields than those available on government bonds. Equity, in particular, offers the opportunity to earn a rate of return matching or exceeding the rate of increase of future pension and insurance liabilities. Moreover, equities and long-term debt match the long maturities of life insurance and pension liabilities. In Jamaica, insurance companies have become a major source of long-term debt and equity finance for private-sector development. Their investments in tourism and export industries are particularly notable.[24] In the United States, too, these institutions are major participants in private capital markets. The unwillingness of the insurers and pension funds of the OECS to invest in private-sector business is one of the causes of distortion in companies' financing methods. (The investment portfolios of US and OECS institutions are compared in Table 11. Data on insurance company investments in the OECS are lacking; interviews indicate that little is invested with private sector businesses.)

The pension funds and the private insurers shun private placements in private-sector firms for two reasons. First, the OECS capital markets offer equity investors no simple exit vehicle. Investors generally will want to be assured of the ability to liquidate their investment and recapture their capital in response to changes in market yields, the company's prospects, or their own liquidity requirements. An active stock market could provide such liquidity, but the OECS does not have such an institution. Thus, should the N.I.S. or an insurance company put money into a company, it faces the prospect of holding the equity in perpetuity. Second, the financial markets are too small to allow the investor to diversify. To induce an institution to buy

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23.See Wendell Samuel, "National Insurance/Social Security Schemes in the OECS Region," in Robert R. Nathan Associates and Price Waterhouse, vol. I. Liburd and Bain make a similar point; op. cit., p. 210. So, too, does Sebastian. See St. Bernard J. Sebastian, "The Role of the Securities Market in Mobilizing Resources for the Region," Social and Economic Studies, vol. 38, no. 4 (1989), p. 119.

24.See Paul Chen-Young, "The Jamaican Financial Sector," pape presented at the Conference on Financing Development in the Caribbean, Barbados, 1989, pp. 16-17.

Table 11
INVESTMENT PORTFOLIOS OF U.S. AND OECS PENSION FUNDS AND INSURERS
(c. 1985)

Investment	OECS N.I.S.	U.S. Insurance	U.S. Pension
Comm. Bank Deposits	65%	0%	0%
Corp. Bonds & Loans	0%	32%	22%
Government Paper	30%	24%	20%
Mortgages	*	16%	2%
Equity	0%	13%	46%
Other	5%	15%	10%
Total	100%	100%	100%

*A portion of the investments in both government paper and commercial banks fund residential mortgages.

Sources: Kaufman, _op. cit._, p. 170; and Schroy, _op. cit._; Liburd and Bain, _op. cit._

equity, the financial markets must allow the investor to hold securities of a large number of companies spread across several different industries. In this way, the investor gains protection against setbacks affecting an individual firm or a subsector of the economy--a depression in regional real estate markets, a rise in energy prices, labor turmoil, to cite a few examples. The universe of equity securities in the OECS is not large enough, however, to afford such diversification. In most of the countries, only a handful of companies have offered shares to the public. Moreover, the countries are so small that diversification would require holdings to be spread across a number of countries. Numerous impediments (to be discussed below) stand in the way of such cross-border diversification.[25]

25.The Agricultural Venture Trust (AVT) and the Caribbean Financial Services Corporation (CFSC) do have money available for private placements of equity. In addition, the European Investment Bank (EIB) has set aside some funds for equity investment by national development corporations. Disbursement has been slow, however. The CFSC has placed much of its available resources as debt rather than equity. Several of the development corporations have not used the EIB funds at all. Some analysts have interpreted this state of affairs as an indication that the OECS suffers an over-supply of equity funds and a shortage of takers. This argument over-reaches the data. The total portfolios of the AVT and CFSC combined represent less than 5% of the domestic capitalization of the OECS private sector, and so

Even the largest companies do not have a satisfactory method of attracting equity funds. Public shares play only a small role in the capitalization of the private sector. Book value of public shares totaled EC$ 142 million as of August 1991, comprising less than 10% of the total private-sector domestic capitalization (see Table 12 for a list of 23 public companies).[26]

For the same reasons that they avoid private placements, pension funds and insurers do not invest in public shares: their shareholdings would not be liquid, and they cannot construct diversified portfolios. Commercial banks are limited by statute in the amount of equities they can buy. And non-residents face regulatory and tax barriers to equity ownership (see next section).

In the absence of active buying and selling, stock prices are not bid up and down to reflect the market's expectation of future performance. Static prices limit the effectiveness of public shares as a means of raising equity capital. Investors are less attracted to private placements in companies before they go public, since they cannot anticipate reaping gains through a later public offering. Owners' motivation to take their companies public is dampened if company law permits the initial shares offering to be made only at a par value that is often below the owners' perception of intrinsic worth. Finally, investors' reliance on dividends rather than capital appreciation forces companies to pay out, rather than reinvest, much of their earnings, contributing perversely to a decapitalization of the firms.[27]

(Footnote 25 continued from previous page) extrapolation is chancy. Both CFSC and the development corporations have limited their equity investments for reasons of policy and administration that are unrelated to market demand, the latter institutions in some cases due to the specialized skills required in selecting and monitoring investment candidates.

26.A common measure of the significance of public shares is the ratio of stock value to GDP. For the OECS, this figure is 6%; for the 20 largest stock markets of the developing world, the figure is 32%; and for the 13 largest market economies, the figure is 46%. See International Finance Corporation, Emerging Stock Markets Factbook, 1991 (IFC: Washington, 1991).

27.Barbadian public companies, which do offer the prospect capital appreciation, paid out 40% of their profits in 1989. Ernst & Young, op. cit. An Asian Development Bank study showed some companies making dividends exceeding profits. Asian Development Bank, Capital Market Development in Selected Developing Member Countries of the Asian Development Bank (1985), as cited in Arthur Young and

Table 12
OECS PUBLIC COMPANIES AND THEIR EQUITY CAPITALIZATION
(August 1991)

Territory	Companies	Equity Capital
Anguilla	National Bank of Anguilla National Investment Co. Anguilla Electric Co.	EC$ 24 million
Antigua	Antigua Commercial Bank	4
Dominica	Dominica Coconut Products Dominica Electricity Services	11
Grenada	Jonas Browne & Hubbard's Grenada Breweries	13
Montserrat	none	0
St. Kitts	St. Kitts-Nevis-Anguilla National Bank Nevis Cooperative Bank St. Kitts Bottling Company St. Kitts Breweries St. Kitts-Nevis-Anguilla Trading & Development S. L. Horsford St. Kitts Nevis Telecommunications Economy Trading Company The Bank of Nevis	44
St. Lucia	St. Lucia Cooperative Bank Minville and Chastanet Copra Manufacturers Windward & Leeward Breweries	7
St. Vincent	Diamond Dairies St. Vincent Breweries	39
Total		EC$142 million

Source: Eastern Caribbean Central Bank, "ECCB Financial Newsletter," September 1991.

(Footnote 27 continued from previous page)
Ferris, Baker, Watts, Inc., op. cit.

In sum, then, we see a shortage of equity afflicting OECS businesses at every stage of their development, and we find the institutional weakness of the financial system as a primary cause. Businesses in their early stages cannot draw on sufficient savings. At later stages, they cannot attract funds from institutional investors since the financial markets offer neither adequate liquidity nor the opportunity to diversify. Larger companies can sell shares to the public, but again the absence of key investors dampens demand and, at the same time, forces companies to disgorge a large proportion of their earnings. Lack of a stock market hurts not only those companies large enough to issue shares. It hurts the smaller companies as well because the smaller companies depend on the promise of going public in the future to attract private placements of equity at earlier stages of their growth.

D. Governmental Policy and the Compartmentalization of OECS Financial Markets

Governmental policy, as expressed primarily through laws and regulations, has contributed to the patterns of business capitalization and to the institutional weaknesses we have described above.

1. Barriers to Regional Integration

Governmental policy is in many ways supportive of the private sector, and within the boundaries of each country, government policy has not been inimical to financial institutions. This, however, is not enough. Financial institutions and markets cannot flourish when confined within national boundaries of individual OECS states; properly-functioning financial markets must span the OECS region and beyond. Governmental policy, however, has impeded the natural evolution of the financial system toward regional integration. The chief culprits are the foreign exchange regulations, the alien landholding acts, the tax codes, and company law. These laws and regulations have compartmentalized the OECS financial markets and, in the process, they have reduced the efficiency of financial institutions, crippled the development of an equity market, and imposed burdens on the foreign investor.

Throughout this paper we have referred to an "OECS capital market" and an "OECS financial system." The terms serve the needs of stylistic convenience more than precision, however, since in important respects these are six segmented markets.

Foreign exchange regulations have separated the national markets. Bank lending between islands has generally been complicated, as both borrowing and repayment across borders has required governmental approval. Funds flows relating to equity investments as well have been subject to administrative review. New rules promulgated in 1991 promise the free flow of the EC dollar within the OECS, thereby easing cross-border investment. The full ramifications are yet to work themselves out. (See Appendix B for an analysis of foreign exchange regulations.)

Alien landholding acts continue to isolate the national economies. Varying from island to island, the legislation governs foreign ownership of both land and securities by nationals of other islands of the OECS as well as by more distant nationals. Government approval of purchases is required, and two countries impose a stiff tax. Alien landholding acts may also inhibit inter-island lending by complicating the use of land as collateral. (See Appendix C for an analysis of alien landholding laws.)

Different tax regimes further compartmentalize the islands' markets. Tax rates on both corporate and personal income vary substantially, and one island (Grenada) does not tax much corporate income at all. Differing taxation of financial instruments produces differing after-tax yields. This condition would complicate cross-border trading since, at least in principle, a security's value would vary by jurisdiction. (Appendix D explores the connection between the tax codes and the development of the capital markets.)

Compartmentalization of the financial markets leads to inefficiencies in the employment of savings. Imbalances of supply and demand for funds cannot be resolved through cross-border movement of funds. Thus Antigua banks have had to restrain credit because of their illiquidity while banks in St. Vincent were lending only 64% of their deposits.

Compartmentalization also prohibits development of an active stock market. To offer any meaningful liquidity, a stock market must have at least several hundred million US dollars in capitalization and probably several billion dollars. As of 1990, only 13 stock markets in the world had less than one billion US dollars in capitalization (see Table 13), and many of these have been only marginally functional.[28] At today's capitalization of US$ 60 million, an OECS stock market would be the smallest stock market in the world, save that of Yugoslavia.

In a stock market confined to the OECS, liquidity would be virtually absent. The world's smallest markets have an average annual trading volume of about 10% of capitalization (with wide variations). If this average were to hold for an OECS market, trading volume would be about one million US dollars per week. This would not be sufficient to permit institutional investors to play any significant role in the equity market. Were the national insurance schemes, say, to place 30% of their portfolios in stocks, it would take them more than six months to fill their portfolios even if they purchased every single share offered on

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28.Data cited in this paragraph are from the IFC, <u>op. cit.</u>

Table 13
MARKET CAPITALIZATION OF THE WORLD'S SMALLEST STOCK MARKETS
(1990; US$ billion)

Country	Capitalization
Morocco	1.0
Sri Lanka	0.9
Jamaica	0.9
Peru	0.8
Trinidad	0.7
Cote d'Ivoire	0.5
Tunisia	0.5
Kenya	0.4
Mauritius	0.3
Barbados	0.3
Bangladesh	0.3
Botswana	0.2
Yugoslavia	0.04

Source: IFC, *op. cit.*

the market during that period. Adjusting their portfolios periodically--and all portfolios must be periodically adjusted--would be correspondingly laborious. A stock market of this size would not function.

To achieve minimal working scale, a stock market would have to embrace an economic area far larger than the OECS. As we have seen, however, foreign exchange regulations, alien landholding acts, and tax codes prevent integration even within the OECS. Links beyond the OECS confront even higher barriers. To cite just one, OECS nationals are not permitted to hold non-EC dollar securities. (See Appendix E for a more detailed description of the regional stock markets.)

The development of equity markets finds additional obstacles in the form of the companies acts. In the last two decades, these laws have come under scrutiny by political leaders, lawyers, and business people, and their inadequacies have been well documented. The necessary legislative remedies have yet to be applied, however. Existing company law generally does not provide for adequate disclosure of financial information and does not contribute to building confidence among prospective investors. The law limits the ability of companies to repurchase their own shares, thereby complicating a common means of offering liquidity to minority investors. Some of the companies acts make it difficult to issue new shares at prices other than par value, a figure often far lower than the owner's perception of true market value. Protection of rights of minority shareholders can be afforded only through cumbersome and costly proceedings. Finally, many of the companies acts do not contain provisions governing the issuance of shares to the public. (Appendix F evaluates company law in greater detail and contains bibliographic references.)

2. Barriers to Foreign Participation

The same provisions of OECS laws and regulations that block regional integration also throw up obstacles in the way of foreign investment. This, despite the general receptivity to such investment on the part of governmental leaders. Alien landholding acts are an impediment with their required approvals and fees. Withholding taxes raise the cost of investments as does a patchy double-taxation treaty network. Foreign exchange regulations increase both the risk and cost of investment. Conversion of EC dollars into the home currency is taxed, in some countries at a high rate. The right of repatriation is usually guaranteed in a written agreement, but large dividends or other transfers can be phased, in some cases over ten years. Foreign exchange regulations, along with alien landholding acts, make portfolio investment in OECS securities economically impractical. The fees would materially eat into the yield on the stocks, and the required approvals would interfere with liquidity.

Foreign exchange regulations generally prevent foreign investors from raising permanent capital on local markets, local borrowing being limited to working capital needs. The investor is forced to bring capital in from abroad, and this in some circumstances will increase costs.

Limitations on local borrowing also heightens foreign exchange exposure of the foreign investor. If permitted, many foreign-owned companies would borrow locally to hedge their operations. The EC-dollar debt service would offset, to some extent, the firms' EC-dollar revenues. In the absence of local borrowing, companies face a mismatch of EC-dollar revenues and hard currency debt costs. Profits are subjected to variability due to movement of the exchange rate.

A foreign investor from outside a US-dollar area might want to hedge the EC dollar against the home currency, but this is difficult to do. Foreign exchange regulations require governmental approval to hedge through the forward sale or purchase of foreign currency. The regulations generally prohibit the foreign investor from converting idle EC-dollar balances into the home currency and holding them as a hedge. No other vehicle exists to hedge the risk of an EC-dollar devaluation. All of these restrictions cause added risk, administrative cost, and frustration.

* * * * * *

In this brief review, we see the variety of ways that OECS laws and regulations inhibit the cross-border flow of capital, a flow that is essential for efficient employment of savings, for the development of equity instruments and markets, and for the continued attraction of foreign investment.

With these comments on laws and regulations, we have concluded our analysis of the structures and institutions of the OECS financial system. We undertook the analysis to understand why businesses in the OECS finance their operation in such a risky manner: Why such heavy borrowing? Why the reliance on short-term rather than long-term debt? Why the shortage of equity? Our analysis revealed that capitalization practices are shaped by the structure, institutions, and rules of the financial system; that weaknesses in companies' capital structures reflect weaknesses in the financial system. In summary, we found the following features of the OECS financial systems distorting business capitalization:

1. The institutional dominance of lending institutions, particularly commercial banks;

2. The lack of a stock market;

3. The absence of private placement equity investors, and the absence of equities in the portfolios of institutional funds; and, finally,

4. A web of laws and regulations that compartmentalize national financial markets, stunt the growth of regional markets, and discourage foreign investors.

III. SOURCES OF CAPITAL: DOMESTIC SAVINGS AND FOREIGN INVESTMENT

In the foregoing sections we have evaluated the ability of the financial system to transform savings into instruments appropriate for business investment. In this section we analyze the quantity of savings that the financial system is able to mobilize.

The savings rate is a crucial issue in economic development since the amount of investment an economy is able to undertake is limited to the sum of its savings and the capital it can attract from abroad. Many economists believe that developing countries must achieve a gross investment rate of at least 16%-20% of GDP to sustain broad economic advance.[29] As Table 14 indicates, the OECS countries have been investing at nearly double this level. "In broad terms," a World Bank study observed, "the investment to GDP ... ratio is very high (or at least high) for all countries and has been so since 1977."[30]

29.See, for example, E. Wayne Nafziger, The Economics of Developing Countries, 2nd ed. (Prentice Hall: Englewood Cliffs, New Jersey, 1990), pp. 302-304, who refers to Walter Rostow and W. Arthur Lewis; The Commonwealth Community Secretariat (main author: Compton Bourne), Caribbean Development to the Year 2000: Challenges, Prospects and Policies (London and Georgetown, Guyana, 1988), p. 54.

30.The World Bank, op. cit., p. 18. The high levels of gross investment reflect, to some degree, the need to rebuild after natural disasters. The gross investment target of 16%-20% of GDP assumes that 6%-10% of GDP is used for replacement. For the OECS during the past decade the figure was undoubtedly higher.

Substantially more than half of OECS investment has depended on foreign rather than domestic savings.[31] These funds have been made available in the form of loans and grants to governments as well as direct investment in the private sector. Subsidized prices paid for bananas and sugar under the Lome Convention represent, in effect, another large inflow of foreign savings.

Dependence on foreign savings creates vulnerability, particularly as the OECS suffers disadvantages in competing for foreign capital.[32] Were foreign inflows to fall, domestic savings, at least at their current levels, could not fill the gap. As Table 14 reveals, in only two of the six OECS countries have domestic savings exceeded 10% in recent years, and in three, dissavings has occurred.

Table 14
AVERAGE RATES OF GROSS INVESTMENT AND SAVINGS
(as a % of GDP)

Country	Period	Investment	Savings
Antigua	1977-85	36	
	1982-85		11
Dominica	1977-85	37	-4
Grenada	1980-85	43	2
St. Kitts	1977-85	39	
	1983-85		-6
St. Lucia	1977-85	46	13
St. Vincent	1977-85	40	-5

Source: Compton Bourne, *op. cit.*, p. 143.

World Bank projections on these points are disturbing. Long-term capital flows, which brought US$ 189 million into the region in 1987, are expected to reverse direction during the next decade.

31.Bourne, *op. cit.*, p. 55.

32."International financial market developments are now less favorable for the Caribbean Community countries than during the 1970s," warned the Commonwealth Secretariat in its study of economic prospects for the coming decade. The study cited a decline in concessional lending, a decline in commercial bank lending to developing countries, and a movement toward securitization of international debt, which makes lending in small denominations less cost-effective. Compton Bourne, *op. cit.*, p. xxx.

Foreign direct investment is expected to fall from US$ 83 million in 1987 to US$ 33 million in the year 2000. Loans, which brought in US$ 74 million (net) in 1987, will require a net outflow of US$ 85 million in 2000. The investment rate in five OECS countries is expected to drop markedly from the rate achieved in the past decade, though the World Bank still expects investment rates to exceed 20% in all cases. To maintain even these diminished (albeit respectable) rates of investment, the Bank foresees a dramatic increase in the domestic savings rate.[33] (See Table 15.)

Table 15
WORLD BANK PROJECTIONS OF INVESTMENT, SAVINGS AND LONG-TERM CAPITAL INFLOWS

	INVESTMENT (% of GDP)		SAVINGS (% of GDP)		FOR. CAP. INFLOWS (US$ millions)	
	2000	Prev.*	2000	Prev.*	2000	1987
Antigua	23	36	31	11	-65	69
Dominica	25	37	15	-4	19	23
Grenada	25	43	20	2	-5	31
St. Kitts	24	24	24	-6	1	16
St. Lucia	28	28	26	13	9	20
St. Vincent	28	40	17	-5	19	20

*"Prev." denotes previous period shown in Table 14.

Source: Compton Bourne, op. cit., p. 143 and World Bank, op. cit.

Building up the domestic savings rate and fostering the continued flow of foreign capital represent major challenges for the OECS financial system in the coming years. The challenges are interrelated, and they face a number of common obstacles. Of these obstacles[34], three in particular concern us here.

First, the institutional simplicity of the financial system limits its effectiveness in mobilizing savings and attracting foreign

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33.World Bank, op. cit., pp. 262-273.

34.In addition to those discussed below, causes of the low savings rate include governmental deficits, low personal incomes, and perhaps a low level of business profits. Additional factors limiting foreign investment are discussed in Bourne, op. cit.

investment. Among the main determinants of a society's propensity to save is the variety and convenience of access of financial instruments and institutions. A financial system dominated by commercial banks, lacking institutional investors, lacking a stock market, and lacking specialized savings and investment vehicles does not offer the requisite variety. The development of such structures would provide potential savers a better match with their own preferences for risk, maturity, liquidity, and geographical and industry concentration, and in so doing, it would induce more savings. (See Appendix G for a discussion of banking regulation and the mobilization of savings.)

A wider range of investment vehicles could help to attract the foreign investor as well. Tied to a regional stock market, the OECS could appeal to foreign portfolio investors, i.e., those wishing to hold a broadly-diversified set of equity securities. The region's existing trade with Europe creates opportunities to fashion specialized financial instruments that could overcome obstacles related to currency. Some 30% of OECS tourists are European, and nearly 100% of the banana and sugar crops are sold to Europe. If overseas investments in tourism and agriculture could be linked to the foreign exchange earnings of these sectors, foreign investors might be permitted to bypass foreign exchange controls and to avoid risks of currency fluctuation.[35]

Second, fears that the EC dollar will not hold its value depress both domestic savings and foreign investment. Here we do not refer only to fear of imminent devaluation; we also refer to possible devaluation over the savers' and investors' distant planning horizon, and we refer to the fear that EC dollars may be trapped within the OECS, unavailable for repatriation or conversion.

In the face of these fears, some residents move capital overseas. Though its magnitude is difficult to estimate, capital flight has undoubtedly shrunk the pool of investment funds by a material amount.[36] An unreliable currency also deters foreign investors,

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35.For a discussion of the broader issue of forging financial instruments to match the investor's risk-bearing capacity, see Donald R. Lessard, "Recapitalizing Third-World Debt: Toward a New Vision of Commercial Financing for Less-Developed Countries," Midland Corporate Finance Journal.

36.For Jamaica, Trinidad, and Barbados, the most thorough study available pegs capital flight at about 13%, 20% and 3% of GDP respectively during the period 1981 through 1986. If the lowest of the three rates held for the OECS, some EC$ 70 million would flow off-shore annually, producing an overseas stock of flight capital of several hundred million EC dollars. This amount, to put it in perspective, would be several times larger than the total equity of the OECS particularly as they cannot conveniently hedge their currency exposure. To mobilize more domestic and foreign savings, governments need to pursue policies generally that bolster the currency and offer assurance of conversion. In addition, adjustments to regulations and creation of new instruments to permit hedging can also play a constructive role.

Third, limitations on returns will dampen domestic savings and foreign investment, since the purpose of savings and investment is to earn a profit. In the OECS, such limitations are numerous. With respect to domestic savings they include interest rate ceilings in two countries, the generally low interest rates caused by excess bank liquidity, and the prohibition on holding foreign securities. Impediments to foreign investment--and limitations on its return--have been catalogued above. These include the tax and administrative costs imposed by foreign exchange controls, withholding taxes, and alien landholding acts, the heightened risks imposed by foreign exchange controls, and the increased financing costs imposed by restrictions on local borrowing. Removal of these impediments to savings and investment is largely a matter of governmental policy reform.

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If World Bank projections prove even modestly accurate, the financial system of the OECS will face a daunting challenge in mobilizing sufficient funds to support continued economic development. In this section, we have identified three obstacles that governmental and business leaders will have to overcome:

1. The existing financial system does not offer savers and investors an adequate variety of instruments to match their preferences.

2. Some domestic savers and foreign investors may be uncertain about the long-term value of the currency and the ability to convert and repatriate it.

3. Legal and regulatory limitations on returns dampen incentives to save and to invest.

In the next section, we lay out an agenda for reform, an agenda that points the way to solving the problems described in this and the previous section.

(Footnote 36 continued from previous page)
public companies. On the Jamaica, Trinidad, and Barbados figures, see Karl M. Bennett, "Capital Flight and Its Implications for Caribbean Development," a paper presented at the Conference on Financing Development in the Caribbean, Barbados, 1989.

IV. AN AGENDA FOR REFORM

The agenda for reform consists of five broad goals. Their achievement would produce a financial system more capable of supporting a stable, resilient and growing private sector. The agenda flows from the foregoing analysis of weaknesses in private-sector finance. The over-arching themes are the increased availability of equity capital and the reduced dependence on debt, both made possible through the integration of regional financial systems and the growth of regional and extra-regional financial institutions.

The agenda consists of goals rather than programs. Programmatic recommendations for USAID are set forth in Section V.

A. The Agenda

Goal #1: A richer diversity of financial institutions, particularly those providing equity funds.

A financial system so dominated by commercial banks cannot offer potential savers the variety of vehicles needed to attract adequate quantities of investible funds, nor can it supply funds in the variety of instruments needed to finance healthy growth. The institutions most sorely needed are those which transform savings into equity capital: a stock market, institutional investors, venture capitalists, and, for the benefit of the smallest companies, individual investors with adequate savings. Equity instruments that allow the overseas investor to avoid some currency risks might attract more foreign capital. As a second priority, institutions need to be encouraged to supply long-term debt.

Goal #2: Regional integration of financial systems.

There can be no stock market without integrating the OECS and at least some neighboring economies. Without a stock market, institutional investors shun equities, and the private sector's dependence on debt cannot be broken. A thicket of law and regulation has to be cleared to make way for regional integration. A regulatory framework for participation in a regional stock market must be constructed.

Goal #3: An increased rate of savings.

The region is likely to face a shortage of investible funds in the next decade unless savings rates are substantially increased. The financial systems must become better able to mobilize domestic savings, to discourage capital flight, and to attract foreign inflows.

Goal #4: Higher business profits.

Though no systematic study of the issue has been undertaken, it appears that business profits may, in general, be low. Low profits would contribute to the shortage of equity: the prospect of low profit would make it difficult initially to attract investors; with low profits, a business would have little to reinvest, and for most businesses reinvested profits are the largest source of funds; and, finally, low profits would depress national savings, a major source of new equity capital.

Goal #5: An informed and engaged elite.

Achieving the goals on the agenda will require controversial and risky actions in realms that are complex and not widely understood. To cite a few examples: a relaxation of alien landholding laws raises the specter of lost independence; capital inflows permitted in an integrated capital market create fears of foreign domination of local companies, while capital outflows create the fears of a diversion of the national savings into the development of foreign countries; liberalization of foreign exchange rules runs the risk of encouraging capital flight; and, finally, harmonization of tax regimes creates groups of winners and losers as the tax burden is shifted. To run this course successfully, the business and political elite must possess a firm, well-informed commitment to a competitive and open capital market. A substantial upgrading of the leaders' understanding of business finance and capital markets is prerequisite to cementing such commitment.[37]

B. Items Not on the Agenda

Our analysis persuades us to argue against several recommendations frequently made to advance capital-market development. The recommendations described in this section, then, are not included on our agenda.

Donor and assistance agencies are frequently advised to establish credit facilities for private businesses.[38] Our analysis points, however, to a general surplus of loans funds, and we find little support for the common observation that significant subsectors of the economy are deprived of adequate credit. Large pools of indigenously-earned cash are potentially available for productive investment in the OECS but are not fully tapped. These include

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37.The Robert R. Nathan Associates/Price Waterhouse study found widespread confusion over the roles of different financial instruments and institutions. Our interviews revealed the same.

38.Our emphasis on the need for equity rather than debt differs from the premises on which many of the private-sector programs of the major donors have rested. These programs, including those of USAID as well as the Caribbean Basin Initiative,
have focused on providing loan funds to businesses.

Robert Nathan and Price Waterhouse also give more attention to debt than to equity. They recommend establishment of a loan guarantee scheme for small- and medium-sized enterprises. (With respect to a stock market, they recommend listing OECS shares on a regional market as we do here.)

Others observers share our emphasis on equity. Courtney Blackman describes a stock market as "a _sine qua non_ of economic growth in capitalist or mixed economies," and he urges dismantling of the regulatory inhibitors to the free flow of equity and other capital within the region. "The OECS should seek listing for their eligible enterprises on the Securities Exchange of Barbados. ... [and] Caricom Member States should commence discussions toward the integration of regional Stock Exchanges within five years." [Courtney N. Blackman, "The Development of Equity Markets in the Caricom Caribbean," a paper presented at the Conference on Financing the Caribbean, Barbados, 1989]. The Eastern Caribbean Central Bank likewise has placed emphasis on development of an OECS-wide stock market, though they see integration beyond the OECS only as a medium-term goal.

off-shore flight capital, the excess liquidity of banks, and a portion of the funds of the national insurance schemes and the private insurers. To the extent that the donors' provision of outside funds reduces the pressure and incentive to bring these under-employed local funds into productive investments, the donor funds will have an undesirable effect.

Neither are loan-guarantee facilities (as distinct from loan funds) desirable, but for a different reason. USAID's policy on financial market development discourages subsidized credit. Loan guarantees inherently involve subsidies as they enhance the creditworthiness of the borrower without causing the borrower to pay for the value received. (This is why guarantees are sometimes subject to tax.)

Aside from these objections, loan funds of the size likely to be provided by USAID or similar donor would not be large enough to have a material effect on total funds available. As we have seen, domestic credit in the OECS totals some EC$ 1.2 billion, or approximately US$ 450 million. A loan fund of US$ 20 million would represent less than 5% of total credit. A loan guarantee program could free up much more money, but foisting all that much more debt on companies that do not qualify for credit on the basis of their own financial strength is not likely to contribute to sustainable growth.

We do not recommend an equity fund because, again, the amount of money USAID or another donor could supply would have only a marginal effect on the total supply of funds. Moreover, USAID policy discourages the Missions from taking equity ownership.

Another oft-heard recommendation that we have not included on our agenda calls for the rapid creation of a bond market. A government bond market would not provide financing for the private sector (indeed it would probably compete for funds), and so it is outside the scope of our inquiry. A corporate bond market would be useful. The need, however, is not urgent. The issuers in a bond market would be the region's largest and most creditworthy companies. No evidence suggests that these firms are suffering a lack of credit; some suggests just the opposite.[39] The firms would probably benefit from a lower interest rate and greater available of longer maturities.

Further investigation might well reveal that commercial banks could provide the longer maturities more simply, perhaps prodded by tax incentives or by the opportunity to place long-maturity CDs with the national insurance schemes. Creating a bond market today might divert resources more urgently needed elsewhere, and it should be encouraged only if the simultaneous development of a bond and a stock market accelerated the growth of both.

39.See, for example, Robert R. Nathan Associates and Price Waterhouse, op. cit.

Finally, we do not support calls for mass education on the merits of investing in the stock market. Equity investments are risky. Prices can be volatile, and investors can lose money. Publicly-traded equity is generally not a wise and prudent investment for an individual of less than substantial personal wealth. Risks can be brought down to reasonable levels for the individual only through broad portfolio diversification. Such diversification cannot be achieved on a small, regional stock market. Even if a much wider variety of stocks were made available for purchase (perhaps through linkage of an OECS markets to markets throughout the Caricom), only the wealthiest individuals could afford to purchase enough shares to achieve proper diversification.

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The foregoing, then, represents an agenda for reform. We next ask whether USAID can and should help in advancing the agenda.

V. A PLAN OF ACTION FOR USAID

In this final section of the report we first ask whether a USAID program of capital-market development is likely to be successful. Answering that question in the affirmative, we go on to propose plan of action.

A. The Likely Success of a USAID Program

The wisdom of embarking on a program of capital-market development can be tested against these five questions:

1. Is the region ready to benefit from the effort?
2. Does USAID have the necessary capabilities and the resources?
3. Will substantial progress be made even without USAID's participation?
4. Will a successful program make a tangible difference?
5. How do the anticipated benefits of a successful program in capital markets compare with those of alternative programs of private-sector development?

On the first question, the Arthur Young/Ferris, Baker, Watts study cited above offers guidance. The study sets out criteria for categorizing countries according to their readiness to benefit from a USAID capital markets program. There are only five or six countries in the world in the "strong prospects" category according to the consultants. The OECS seem to match the criteria of the "potential candidates," which include: pursuit of an export-led growth strategy, potential for growth of manufacturing and processing industries, support of the private sector, and immature capital markets.[40] In addition, one might note the political stability of the area, the budding diversity of the economies, and the relatively small size of the government sector. Important governmental leaders support the development of an equity market, and the Eastern Caribbean Central Bank has begun to study its feasibility.

On the second question, USAID seems uniquely endowed to take on a program of this nature. Major cash outlays are not required, costs consisting principally of salaries and consultants' fees. USAID has the requisite expertise, or easy access to it. The local Mission has had several years' experience with two regional financial institutions, the Agricultural Venture Trust and the Caribbean Financial Services Corporation, both of which have made some equity investments. Through its funding of the Small Enterprise Assistance Project, the Mission has access to detailed and current information on the needs of small businesses. The Centre of Management Development could participate in training and technical assistance, and the Caribbean Law Institute could perform much of the legal and regulatory analysis as it has done in the past for company law (both institutions have been funded by USAID). The high profile of the US Embassy is also an asset, as policy advocacy among political leaders will form a core element of the project. Access to the United States capital markets is a distinguishing qualification of USAID, as compared to other donors, because these markets are considered by many to be the most sophisticated in the world. Finally, since capital-market development is a program sanctioned and promoted by USAID policy, the Mission can expect support from Washington and hope to benefit from the experience of other Missions.

The third question asks whether adequate progress would be made without USAID's involvement. This question should be continually monitored as other agencies may participate in development of the OECS capital markets. The International Finance Corporation has held discussions on assisting the Eastern Caribbean Central Bank, but it has not been formally engaged. Several other agencies operate private sector promotion activities in the region, though none focuses on capital market development. The Caribbean Development Bank expects to receive a grant from the Inter-American Development Bank to study the needs of the OECS private sector. Coordination among those agencies and USAID is clearly called for. (See Appendix H for a more extensive treatment of the activities of other development and donor agencies.)

The fourth question asks whether a successful program would produce tangible, measurable results. Results to be expected include the following: the listing of OECS stocks on a regional exchange and the corresponding changes in law and regulation, the growth in capitalization and in trading volume of the stock

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40.Arthur Young and Ferris, Baker, Watts, op. cit.

exchange, an increase in the savings rate, a decline in the portion of financial system's assets held by commercial banks, and the participation of insurance funds in the equity market. The most general goal would be harder to observe directly and to attribute to the project, but it is worth bearing in mind: more resilient, faster growing, more profitable companies.

The fifth question asks why USAID should direct its efforts to capital market development rather than to other private-sector promotion activities. Compared to other programs, work in the capital market has attractive attributes. A successful program will produce self-sustaining improvements, since the major contribution will be to enable the financial system to better use the OECS society's own resources. The program will promote regionalism, indeed it depends on regional integration, and regional integration is widely thought to offer more general economic benefits.

B. The Plan of Action

The plan consists of five program elements:

1. Clearing away legal and regulatory barriers to regional integration;
2. Participation in a regional stock market;
3. Further analysis of the savings rate;
4. Financial training for businesses; and
5. Education of business and political leaders.

These are the tactical steps needed to achieve the goals described in the agenda for reform. Each element of the program is set forth below.

Program Element #1: Clearing away legal and regulatory barriers to regional integration.

Objectives: 1. To identify, and to help OECS leaders remove, the legal and regulatory barriers to the integration of the regional capital markets and the listing of OECS shares on a regional stock exchange. Laws and regulations involved at a minimum include: foreign exchange controls, alien landholding acts, companies acts, banking acts, and the tax codes. 2. To assist OECS leaders in considering stimulation of share ownership and long-term lending through tax incentives. 3. To stimulate financial institutions to create a wider variety of vehicles to attract and support investment.

Rationale: The referenced laws and regulations compartmentalize the financial systems of nations of the OECS, dooming them to inefficiency. Regional markets must be established. Removal of inhibiting legislation and regulation is a precondition.

Target: In a narrow sense, the task is a legislative one. More broadly it is political in that the existing laws were put into effect to promote or protect some interest, and in many cases that interest will be threatened by reform. Thus the target includes potentially most groups in the society that are affected by the contemplated change. (Note that company law reform was formally inaugurated 20 years ago by the Commonwealth Secretariat and has yet to bear fruit in the OECS.)

Method: 1. Understand the technical dimensions of the international capital flows that are envisioned and, thereby, the manner in which laws and regulations need to be changed. 2. Understand the original purpose of the legislation as well as who will benefit and who stands to lose by reform. 3. Pass along insights to OECS leaders to assist them in forging consensus. 4. Pass along insights to participants in the elite education activities (program element #5) 5. Support the drafting and consideration of model legislation.

Resources: Caribbean Law Institute for technical studies; stock market specialists as consultants; convocations of bankers and accountants to flush out technical and political issues; experience of Barbados, Trinidad, Jamaica.

Program Element #2: Participation in a Regional Stock Market

Objectives: 1. To assist the governments of the OECS to list the shares of public companies on a regional stock market. 2. To draw institutional funds into equity investment.

Rationale: A healthy financial system depends on a properly-functioning stock market. To achieve adequate liquidity, a stock market has to be substantially larger than a market confined to the OECS would be.

Target: National governmental leaders, the Eastern Caribbean Central Bank, and governmental leaders of the host non-OECS stock market are the key implementers since most impediments are of a legislative or regulatory nature.

Method: 1. Convince leaders of the need for regional integration. 2. Identify legislative and regulatory impediments, and encourage their removal (program element #1). 3. Select host regional market and gain approval of host market government. 4. Assist national governments and regional institutions in devising a regulatory framework for operation and supervision of the market. 5. Build a corps of broker-dealers, underwriters and other institutions, this to be accomplished by a combination of training of OECS financial participants and attraction of foreign institutions. 6. Persuade institutional funds to invest in stocks. 7. Identify potential foreign investment funds (e.g., venture capital) that could be induced to invest in a regional market. 8. Through program element #4, ensure that small business owners understand the implications of the availability of the stock market for the future liquidity of investments in their own company.

Resources: Economic studies may be needed to ensure choice of right market; specialists in stock market operations may be needed to work along with host stock exchange; lobbying and perhaps some studies may be needed to bring institutional investors into the market; operation of a regulatory function may involve material costs for OECS; technical assistance might be provided by USAID.

Program Element #3: Further Analysis of the Savings Rate

Objectives: To assist OECS governments and financial institutions in devising a program to increase the pool of investible funds.

Rationale: The region's economic growth depends on the financial system's success in mobilizing sufficient funds. A serious challenge appears to be looming with the anticipated fall-off in foreign capital inflows. Program elements #1 and #2 should strengthen the ability of the financial system to mobilize savings and attract foreign capital. Whether those improvements will prove sufficient is impossible to predict.

The adequacy of the savings rate is intertwined with capital flight and foreign capital inflows. These are complex subjects, not treated in depth in this engagement. The success of USAID's capital-markets program may depend, however, on having more than a causal acquaintance with the issue; indeed additional steps beyond those described in this report may be required to attract sufficient savings. This program element #3 is intended to accumulate the knowledge needed to evaluate that next step.

Method: 1. Commission a study of the sufficiency of investment funds over the next decade. 2. Determine whether the capital-markets program should be supplemented with a program element on the matter.

Resources: Retention of a consultant.

Program Element #4: Financial Training for Businesses

Objectives: To build management skills in local companies for purposes of improving viability and profitability.

Rationale: First, reasonable profits underpin any successful capital market; OECS profits may be below par. Second, increased efficiency in a business reduces the amount of equity required because it simultaneously reduces the amount of assets employed and increases the firm's debt-bearing capacity.

Target: Business owners of all sizes and industries.

Methods: 1. Continue to rely on traditional delivery vehicles, e.g., the National Development Foundations. 2. Supplement course content to include capital-market issues: improved asset management to minimize the need for capital; the proper roles of debt and equity; the implications for small-company finance of the existence of a stock market.

Resources: Traditional delivery vehicles; Centre for Management Development; local accountants and bankers.

Program Element #5: Education of the Business and Political Leaders

Objectives: 1. To build the requisite knowledge on the part of leaders to facilitate a productive public debate and, subsequently, an informed commitment to a program of reform. 2. For USAID to learn of obstacles to reform.

Rationale: The level of sophistication in leaders' knowledge of the financial system today will not sustain a productive public discussion and effective implementation of a program of reform. Leaders will make many false starts and reform efforts will be muddled until additional expertise is built up. Many obstacles stand in the way of reform. USAID needs to understand the perspectives and motivation of the leaders.

Target: Leaders of government and the business community; leaders of regional governmental and industry associations.

Method: 1. Personal discussions between US embassy and USAID, on the one hand, and governmental and business leaders on the other. Topics should center on the following: the weaknesses of the OECS financial systems; World Bank projections of the fall-off of investment funds; the need for regulatory reform; and the need for regional integration. 2. Seminars and confabs of leaders; same subjects. 3. Visits of leaders to financial institutions in the US. 4. Attendance of leaders at two- and three-week programs offered by some excellent US business schools. 5. Coordinating discussions with any of the donors involved in similar efforts.

Resources: Little spending is required. The Centre for Management Development could be brought in for seminars. Bankers, accountants, and economics professors at the University of the West Indies should be encouraged to stimulate a public discussion of the issues.

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Appendix A
FURTHER NOTES ON THE SUPPLY AND DEMAND FOR CREDIT

This appendix offers a quantitative view of selected aspects of lending to OECS businesses.

I. SUPPLY OF FINANCE

Commercial Banks

The level of deposits in the commercial banking system of the OECS at the end of 1990 was EC$3,185 million.

Deposits by type. The value of deposits by type are shown below:

DEPOSITS BY TYPE
(EC$ millions; at December 31)

	1990	1986
Demand	541	312
Savings	1,210	651
Time	1,230	758
Foreign Currency	204	121
TOTAL	3,184	1,842

Over the period 1986 to 1990, total deposits increased by EC$1,343 million. Each type of deposit experienced an increase.

INCREASES IN DEPOSIT BY TYPE, 1986-90
(EC$ millions)

Demand	$230
Savings	559
Time	471
Foreign Currency	83
TOTAL	$1,343

Deposit ownership. Individuals owned the majority of deposits, with 33% in 1990 and 49% in 1986. Statutory corporations, mainly the national insurance schemes, accounted for the next largest share of deposits, with 13% in 1990 and 12% in 1986.

DEPOSITS OUTSTANDING BY OWNER
(EC$ Million; at December 31)

	1990	1986
Government	85	39
Statutory & Govt Corporations	398	228
Individuals	1,683	907
Business Firms	369	25
Non-bank financial Institu.	142	122
Foreign currency	169	70
Total OECS residents	2,846	1,587
Non residents	339	251
TOTAL DEPOSITS	3,185	1,838

Credit Unions

At the end of 1990, the credit unions in the OECS had shares and deposits of EC$ 124 million as compared with EC$ 43 million at the end of 1986.

Dominica accounted for more than half (54%) of credit unions' shares and deposits at the end of 1990 with St. Lucia a distant second with 13%.

General Trends and Patterns

Annual Credits. Some EC$ 259 million in net new credits were made available to businesses in 1990. By far the largest contributor was the commercial banking sector. The distribution of identified net new credit was as follows:

COMMERCIAL CREDITS MADE DURING 1990
(EC$ millions)

Commercial Banks	158	70%
CDB	35	16%
DFCs	15	7%
CFSC	5	2%
NDFs	5	2%
Credit Unions	4	2%
AVT	3	1%
TOTAL	226	100%

The figures above do not include lending for investment in housing or lending for student loans.

Private Versus Governmental Ownership/Focus of Institutions.

Almost all of the institutional funding sources identified above make their credits primarily or entirely to the private sector. The exception is the CDB which makes most of its credits to the government sector.

Some of the institutions are privately owned. Those owned by governments include CDB, the CFC, the CDC, the DFCs, the AVT, the EIB, the IFC and six (6) of the commercial banks. The AVT is a trust fund established by USAID but run by trustees who all work in the private sector and the institution is run as if it were a private corporation. The other government-owned institutions, with the exception of the DFCs, are also run as if they were private economic and business development corporations even though their boards are appointed by the owner governments. Most of the DFCs used to be operated less as private economic/business corporations than government departments, though increasingly stringent budgetary conditions faced by the OECS governments have forced a greater focus on self-sustainability on the DFCs in more recent years.

Geographical Ownership of Institutions Providing Commercial Financing. A large proportion of the institutions providing commercial financing in the OECS is foreign-owned. Most of the commercial banks and trust companies are branches of foreign banks; the large insurance companies are all foreign owned as are the finance companies and the sole venture capital institution. The CDB, CFSC and the CFC are majority foreign-owned, and the EIB, CDC, and IFC are all owned by non-OECS residents.

Geographical Source of Funding. Despite the high proportion of non-OECS ownership of these institutions providing commercial credits to the OECS countries, most of the credits are sourced within the OECS area. Very nearly all the commercial banks credits, all the credit union loans and most likely all the insurance companies and pension fund investments are sourced from the local economies. Of the identified credits made in 1990, perhaps as much as 75% would have been sourced from the OECS economies.

Funding for the credits from the NDFs and the AVT came primarily from USAID in the case of the former and entirely in the case of the latter. Credits from the DFCs have funded by the CDB and these credits along with CBS's own credits have been funded primarily from a range of foreign sources. Credits from the CFSC have also been funded from a range of non-OECS sources.

II. DEMAND FOR FINANCE

Commercial Bank Lending

Total loans and advances of the commercial banking system nearly doubled between 1986 and 1990, standing at EC$2,629.9 million at the end of the period. The annual rate of growth of loans and advances was 17%.

GROWTH IN LOANS AND ADVANCES OF COMMERCIAL BANKS
1990 VS 1986
(EC$ millions)

	Amount	Annual Rate
Anguilla	106	43.%
Antigua	251	14
Dominica	135	21
Grenada	134	15
St. Kitts	127	13
St. Lucia	323	19
Montserrat	54	27
St. Vincent	105	13
TOTAL/AVERGE	1,235	17

Within the private sector, all industries increased their loans and advances, all at a rate at or above the average rate for all borrowers.

SECTORAL GROWTH OF LOANS AND ADVANCE OF COMMERCIAL BANKS
1986 - 1990
(EC$Million)

	Amount	Annual Rate
Agriculture	47	22%
Manufacturing	77	29
Distribution	178	17
Tourism	175	30
Enter. & Catering	14	22
Transport	41	12
Public Utilities	42	41
Constr. & Develop.	87	18
Government	-31	-3
Services	60	43
Financial Instns.	23	59
Personal	527	19
TOTAL/AVERAGE	1,235	17

Distribution of outstanding loans and advances by sector was as follows:

SECTORAL SHARE OF
COMMERCIAL BANKS LOANS AND ADVANCES
(at December 31)

	1990	1986
Agriculture	3.3%	2.8%
Manufacturing	5.2	4.6
Distribution	14.3	14.2
Tourism	10.3	6.8
Entertainment & Catering	1.0	0.8
Transport	4.4	5.3
Public Utilities	2.1	1.0
Construction & Development	6.8	6.6
Government	8.5	18.2
Services	3.0	1.3
Financial Institutions	1.0	0.3
Personal	40.2	38.0

Loan Maturities to the Business Sector. The distribution of loan maturities to all borrowers (not only businesses) was as follows.

DISTRIBUTION OF THE MATURITIES
OF LOANS AND ADVANCES BY COMMERCIAL BANKS
(as percentages; at December 31)

	1990	1986
Overdraft	29	35
Up to 1 year	7	6
1 - 5 years	27	12
Over 5 years	37	47
Total	100	100

Of the total loans and advances to businesses at the end of 1990, approximately 30% had maturities over five years; 20% had maturities between one and five years; and 50% were overdrafts or had maturities of less than one year. In recent years, each maturity has grown in absolute terms. The longer maturities have grown fastest.

A large part of overdraft is almost permanent capital in most businesses and indeed often finances long-term assets. With this in mind, and the high growth in business loans in the "over 5 year" category, it appears that the commercial banks may be making close to 50% of their loans and advances to businesses for relatively long term assets (i.e over 5 years).

Credit Unions

Credit unions lend primarily for consumer durables and residential housing. Increasingly, they are also financing business through loans to members. At the end of 1990 outstanding loans of all types totalled EC$ 124 million, having experienced rapid growth in the late 1980s.

Dominica has recently recorded the highest growth. Dominica's credit unions account for the majority of credit union loans (55% at the end of 1990). St. lucia accounted for the second largest share of these loans (20% in 1990).

In Dominica, as much as 30% of loans by the unions are made for business activities such as agribusiness, fishing, forestry, manufacturing, tourism, entertainment and catering transport and professional services. The credit unions of the other territories do not all have this business focus; in some, very little is lent for business. Reliable data are not readily available on all portfolios. In Barbados, where data are available, around 12% of credit union loans are made for business. Based on these scattered indicators, it is reasonable to assume that 20% of OECS-wide credit union loans are made for business. On this assumption, one may estimate that business loans of credit unions grew from EC$ 10 million at the end of 1986 to EC$ 25 million at the end of 1990.

Caribbean Financial Services Corporation

The Caribbean Financial Services Corporation (CFSC) has also emerged as a significant provider of loan funds and a small amount of equity funds. At March 31, 1987, the CFSC had made loan and equity commitments of EC$ 15 million to OECS countries. CFSC's commitments in the OECS have grown by 216% over the period March 1987 to March 1991 to a total of EC$ 46 million.

Most of CFSC's commitments have continued to be in the tourism sector which received 42% of these commitments on March 1987 and 63% by March, 1991.

Most of the funds made available by the CFSC to the OECS business sector come from sources outside the OECS, principally USAID and the European Investment Bank (EIB).

National Development Foundations

National Development Foundations (NDF) have been established in the OECS countries to provide loans for the micro-business sector. With the assistance of USAID, funds have been channeled through the Caribbean Association of Industry and Commerce to NDFs for on-lending to many micro-businesses.

At June 30, 1991, the portfolio of these NDFs was EC $9 million, and the NDFs had for the first half of 1991 disbursed loans valued at EC$2.7 million. Loans are normally of short term, i.e., less than two years' maturity.

St. Kitts-Nevis accounted for most (24%) of the NDF's loan portfolio with Grenada and St. Lucia each accounting for 16%.

Caribbean Development Bank

For the last two decades, the Caribbean Development Bank (CDB) has been a significant lender of funds within the OECS region. The CDB's emphasis, however, has been more on the governmental loans than on the private sector loans, though they have continued to provide significant amounts of funds to the private sector through the development finance corporations.

Approvals by the CDB of loans for the private sector--the great majority of them indirect--have been as follows:

CARIBBEAN DEVELOPMENT BANK'S PRIVATE SECTOR LENDING
1986 TO 1990
(EC$ million)

	1986	1987	1988	1989	1990	TOTAL
Anguilla	5.7					5.7
Antigua						-
Dominica			10.8		14.8	25.6
Grenada		1.6	13.5		10.8	25.9
Montserrat		1.4	4.0		5.4	
St. Kitts		10.8			10.8	
St. Lucia	9.4			2.7	12.1	
St. Vincent			4.0	6.8	10.8	
TOTAL	5.7	11.0	40.5	4.0	35.1	96.3

Thus over the period the CDB has comitted EC$ 96.3 million to private sector lending, primarily through the development finance corporations. (Table 6 in the text reports the indirect portion of CDB lending under the heading of the DFCs, the direct lenders.)

Appendix B
FOREIGN-EXCHANGE REGULATIONS

Each of the OECS territories, with the exception of Anguilla, tightly controls transactions in foreign currencies. The purpose of foreign-exchange regulations is two-fold: (1) to ration the use of scarce foreign currency; and (2) to retain investment funds within the region. The broad macro-economic effect of such regulations, as well as the question of their ultimate wisdom, is beyond the scope of our study. On the narrower question of the regulations' effect on the development of the capital markets, we note that the regulations have worked some hardships:

(1) The foreign-exchange regulations isolate the financial markets of the OECS from those of the rest of the world, with several undesirable consequences;

(2) They impose complications on foreign investment; and

(3) They increase the risk of operating a business, both indigenous and foreign-owned.

After briefly describing the provisions of the regulations, we will elaborate on these consequences.

The Regulations

Each of the territories has its own set of exchange controls, but with the exception of those in Anguilla, they contain broadly similar provisions. The ECCB has drafted a model exchange-control act that would have the benefit of establishing uniformity throughout the region. It would carry forward the essential features of current legislation as described below.

Generally, without special approval:

(1) Residents (including companies) may not borrow in foreign currency;

(2) Residents may not hold foreign-currency securities or real estate;

(3) Non-residents may not borrow locally except to finance working capital; and

(4) Companies are permitted to hold foreign currency only to the extent of the foreign-currency proceeds of their exports.

Profits, fees, interest and capital gains may be repatriated to foreign investors subject generally to an agreement entered into by the foreign investor and the cabinet of the government. Most territories provide for phased withdrawal of profits and capital if the amounts are large. The model bill allows the government to require phasing over a ten-year period.

Within the OECS, the EC dollar can in principle move relatively freely. Other laws impinge on the practical ability to move funds, however. As noted in the text, for example, cross-border lending is impeded by the alien landholding acts which require permits and taxes for transfer of debentures and which complicate the mortgaging of property for the benefit of a non-resident lender.

Effects on Financial Markets and Private Sector Financing

Rules prohibiting the free flow of capital have the effect of compartmentalizing financial markets. With residents not free to invest and borrow abroad and with non-residents not free to borrow locally, the financial markets become isolated from those of the rest of the world.

One consequence of such compartmentalization is that interest rates in the OECS do not match those of the US dollar to which the EC dollar is pegged. Both investing and borrowing rates can deviate from free market rates, with consequent loss of efficiency in the use of funds.

Compartmentalization also leads to imbalances in supply and demand for funds. In the absence of exchange controls and administered interest rates, both debt and equity funds would flow in and out of the region to match supply and demand. Without such free flow, a shortage or excess of funds can persist for some time.

Exchange controls pose challenges to prospective foreign investors. Many foreign investors would prefer to borrow locally in EC dollars rather than borrowing in their home markets. By borrowing locally, they hedge their EC dollar revenues with an EC dollar outflow for debt service, thereby reducing their exposure to the risk of a devaluation of the EC dollar against the US dollar (and, for foreign investors from outside the US-dollar economies, of movement of the US/EC dollars against their home currency). In preventing such a hedge, exchange controls drive up the risk of foreign investment.

Many exporters (foreign-owned as well as indigenous) would like to hedge as well and they too find themselves blocked by foreign-exchange regulations. Agricultural associations selling bananas or sugar might wish to lock in the EC-dollar value of these sales months or years ahead of the point of collection. With some difficulty (and with ministry of finance approval) protection against a fall in the US dollar relative to sterling or the European Currency Unit (the ECU) can be arranged. Protection against devaluation of the EC dollar relative to the US dollar cannot be achieved, however, due to limitations on creating EC dollar liabilities (bank borrowings) and on converting EC dollar assets (especially cash) into foreign currency. Unable to protect themselves, businesses bear bigger risks. In principle, their borrowing capacity falls as risk rises, calling for a higher proportion of equity in their capital base. And, in principle, with greater risk, the investors require greater profits in compensation. Through these mechanisms, the exchange regulations narrow the range of investment prospects that meet foreign investors' minimal standards of expected returns.

Insurance companies and pension funds would benefit by the ability to invest overseas. They could diversify their portfolios, diminishing their exposure to the risks of the small OECS economies. They would be better able to seek out investments that matched their long-term investment horizon and that offered higher returns. With their portfolios diversified through overseas investments, they might be willing to invest some portion of their funds locally in equity shares, thereby alleviating the region's chronic shortage of equity capital. Foreign-exchange controls, however, limit these funds to investments within the OECS. With such a narrow range of investment opportunities available, the funds remain quite conservatively invested, with most of their funds in commercial bank deposits and loans to the government.

Some economists argue that the exchange controls cause an outflow of capital, ironically having the opposite effect of that intended. By exaggerating the scarcity value of foreign currency, exchange controls increase demand. The fear of devaluation is thought by many to be the primary motive behind capital flight.[41] Exchange controls play to this fear, both by depriving firms the ability to hedge devaluation risk and by weakening businesses and, in consequence, weakening the currency.

41.See Karl M. Bennett, "Capital Flight and Its Implication for Caribbean Development," a paper presented at the Conference on Financing Development in the Caribbean, Barbados, 1989.

Appendix C
ALIEN LANDHOLDING LAWS

Alien landholding laws are the single largest barrier to expansion of capital markets and integration of the OECS countries' financial systems. Extant in each territory, these laws regulate the ownership of land, property, stock, debentures and other financial instruments. They represent both a financial as well as an administrative barrier to the formation and flow of capital within the OECS region. Liberalization of these laws has been discussed over many years. The political will to effect reform has not, however, materialized.

Alien landholding laws have impeded the formation of large, intra-regional companies, encouraging small closely-held companies instead. Use of venture capital has been limited. And foreign investment has been made more complicated, and has probably been slowed. Nonetheless, many governments have not seen the Acts to be inconsistent with the growth of the private sector and the attraction of foreign investment.

The alien landholding laws were adopted during colonial rule to prevent real estate speculation by foreigners. This remains a major concern today, given the continued importance of land in the OECS economies. Many of the laws were strengthened during the times of strong nationalist feelings in the 1970s. Licenses issued under the alien landholding acts originally controlled the ownership of land, but recently their scope has been broadened to encompass the use of land as well, including start and completion dates for projects. Financial instruments were brought within the purview of the laws to foil circumvention of the laws' original intent.

The term "alien" generally applies to non-citizens of a country. A citizen of one OECS island nation is an alien in all of the others. Purchase of land or shares by a Kittitian in Dominica would require government approval and payment of a license fee. Dominica's law is the strictest in many regards. There, the holding of one share of stock by an alien qualifies the entire company as an alien company. Operations of alien companies are greatly limited in most OECS countries. In the other OECS countries, generally a one-third ownership by aliens qualifies the company as an alien company.

The Alien Landholding Acts have become significant revenue sources for many governments. The license fee charged is a percentage of the market value of the land, ranging from 2% to 10%. Fees for stock transfers range from 0.5% to 4%. The requirement of obtaining government approval for transfer of land or stock compounds the direct financial cost with administrative burden.

To promote regional integration, the OECS heads of government have agreed in principle on a number of occasions to waive or modify the alien landholding laws with respect to OECS nationals. They have agreed to waive, on a reciprocal basis, alien landholding licenses (and fees) although approval of land purchase would still be required. Dominica is the only country to adopt this recent agreement to date, although Grenada has had this reciprocal provision since 1968.

Appendix D
TAXATION

In this appendix we take a brief look at taxation in the OECS countries with a view to determining whether the tax regimes foster the development of efficient financial markets and to identifying opportunities for reform. A thorough analysis of the tax codes is outside the scope of this report.

Taxation has a pervasive influence on the operation, profitability and growth of private businesses and thereby on the development of financial markets. Our focus here, however, is more narrow. In four areas, taxation has a direct effect on financial intermediation and investment: taxation of foreign investors; tariffs and duties; taxation of equity investments; and taxation of intermediaries. We have dealt with the last topic in the appendix on banking regulation. Here we look at the three other areas.

Foreign Investment

The territories court foreign investment with generous tax holidays for qualifying projects. Holidays can extend to 15 years. Exemption from a variety of regulations and guarantees of rights of repatriation are a normal part of an incentives package.

In other regards the tax systems of several of the territories discriminate, at least mildly, against foreign investment. All of the countries impose withholding taxes on dividends, interest, royalties and other payments to foreigners. Several countries impose the withholding tax on profits accrued to non-residents, whether or not distributed. The alien landholding acts generally impose a tax as well as other restrictions on foreign purchase of land. The rates range up to 10% of the value of land in the case of Dominica. Tax on purchase of foreign currency (ranging as high as 5% in Grenada) applies both to residents and non-residents but may fall more heavily on foreign investors to they extent they have more foreign currency transactions. St. Kitts applies a withholding tax on aliens' bank borrowing of 2.5 to 5.0%

The net effect of the taxation of foreign investment is hard to determine. Clearly the discriminatory provisions cut in the opposite direction from the fiscal incentives. Their removal should be considered as a means of stimulating foreign investment.

Tariffs and Duties

Several analysts have noted that the OECS's heavy reliance on tariffs and duties increases the financing requirements of business. Tariff and duties must be paid at the front-end of the production cycle, increasing a firm's inventory and accounts receivable. Even though a firm may recover the taxes through the sales price, their cost must be financed between payment of tax and collection of the customer receivable. Thus such taxes increase the financing requirements of businesses.

Taxation of Equity Investments

The present study has cited a shortage of equity investment in OECS companies.

Within the confines of each country, the tax codes appear to treat equity investments even-handedly, if not favorably. Tax incentives to hold equity include the following:

(1) Dominica permits deduction from taxable income of up to EC$ 5000 for qualifying investments in equity; St. Lucia offers a more restrictive incentive;

(2) In some countries dividends received by individuals and companies are tax-free; in others they attract a reduced rate of tax. Taxes paid by the corporation in many cases are credited by the recipient of the dividend. (Contrast this with the double taxation of dividends in the United States, where profits are taxed as earned by the company and taxed again when received by the shareholder.); and

(3) Most territories do not tax capital gains.

Trading equities between countries, on the other hand, meets a number of tax barriers, including the following:

(1) Due to different bases and rates of taxation, the after-tax yields would differ by jurisdiction, producing, at least in principle, differing prices in each jurisdiction;

(2) The alien landholding acts impose prohibitive costs, both in cash and in administrative effort; and

(3) Foreign exchange regulations also add costs (generally of 1 to 2%, but, as noted, 5% in Grenada) and administrative burdens.

Appendix E

MECHANICS OF OECS STOCK TRADING ON BARBADOS EXCHANGE

Development of an OECS capital market in conjunction with the Barbados Stock Exchange has been discussed over a two-year period. Currently, the preference within the OECS is to develop their own stock exchange with future integration with other CARICOM stock exchanges.

There are two basic options with respect to an OECS and Barbados stock trading relationship:

1. The establishment of an OECS trading floor on the Barbados stock exchange wherein only OECS citizens could participate using the established systems and brokers in Barbados.

2. The establishment of an integrated Barbados/OECS trading floor where nationals of all countries could trade securities.

From a technical basis, both of these options could be implemented in three to four months. A number of regulatory and tax barriers exist which need to be addressed before implementation of either option.

Currently, the Barbados stock exchange trades Barbados government securities and the equity of Barbados public companies. Agreements have been developed allowing trading of equities between the Jamaican, Trinidadian and Barbados stock exchanges. To date, most trading has been between Trinidad and Jamaica. Expansion of this concept to include OECS companies has been also been considered but not widely embraced by the OECS.

Discussions have been held between the ECCB and the Barbados stock exchange about establishing an OECS floor on the Barbados exchange. The mechanics of this type of operation are straightforward:

1. Alien landholding laws between the OECS countries would need modification to eliminate government approval and taxation of stock purchases.

2. Establishment of local brokers in the OECS countries to confirm transactions, certify compliance with regulations, and collect and disperse proceeds. These brokers would work with the Barbados brokers in carrying out transactions through the Barbados exchange.

3. Establishment of a clearing facility probably in the ECCB for all transactions with only a trading commission

going to Barbados.

4. Establishment of a regulatory body, also probably within the ECCB or as part of the Barbados exchange regulatory process, to oversee trading activities.

Many observors feel an OECS floor on the Barbados exchange makes little sense. If the only activity occurring in Barbados is the trade, an OECS exchange might as well be established.

The second option, a joint Barbados - OECS trading facility would require the same steps described above for the OECS only option. In addition, the Barbados stock exchange regulations might have to be modified with the necessary government approvals. Also, a clearing facility would be necessary to settle transactions between the two currencies. A clearing facility has been established for trading between Jamaica, Trinidad and Barbados which is structured as follows.

1. All trades must be settled in US dollars.

2. A client places an order with a broker who purchases the stock and pays the exchange in local currency.

3. The exchange purchases US dollars from the Central Bank who makes the transfer to the Central Bank in the second country.

4. The Central Bank pays the local exchange, which pays the broker, which pays the seller, all in local currency.

5. The Jamaica Central Bank has set aside $5 million US for this purpose, the Trinidad Central Bank has granted preference for settling stock purchase transactions, and the Barbados exchange has applied for a $1 million limit with the Central Bank of Barbados.

   A similar program could be established between Barbados and the OECS, although it has been recommended that settling in US dollars may not be necessary. The Barbados exchange has begun discussions with BARTEL to establish a modem link to the OECS for trading information and data. This would not be an electronic trading medium - simply an information transfer system.

   It is widely believed that a joint Barbados - OECS stock exchange may be the most logical approach for the development of an OECS capital market. Recently, the OECS countries have stated a strong preference for establishing their own stock exchange and gaining experience in capital markets before moving to integrate with the Barbados or other CARICOM exchanges. The ECCB has stated the need for any OECS exchange initially to trade government securities followed by corporate debentures and finally corporate equities.

Withholding taxes and foreign exchange duties represent a major obstacle to development of regional stock markets. In many cases, they represent a double and triple taxation of earnings. This will strongly inhibit the development of equity markets in the OECS and throughout the region.

Appendix F
COMPANY LAW

Antiquated company law in the OECS is widely considered to be an impediment to business development. With respect to financing business growth, the companies acts of the territories inhibit equity investments in private companies, complicate access of companies to public equity investors, and may dampen foreign investment.

The purpose of company law is described by the noted writer H.W. Ballentyne as follows:

> They are enabling acts to authorize businessmen to organize and to operate their business, large and small, with the advantage of the corporate mechanism; they are drawn with a view to facilitate efficient management of business and adjustment to the needs of change. They provide the legal frame and financial structure of the intricate corporate device by which businesses can be carried out ...[42]

Company law in the Commonwealth Caribbean has for the most part been based on the company law of the United Kingdom. While the law of the UK has undergone continuous modification and development, the acts of many of the Caribbean countries remain tied to a distant point in this evolution. The companies acts of Montserrat and St. Kitts, for example, are modeled after the 1844 English law; that of St. Vincent on the 1862 Act; that of Guyana of the 1908 Act.[43]

Recognizing the deficiencies in the Commonwealth Caribbean's legislation, the Council of Ministers of the Caribbean Free Trade Association embarked on a project of research and reform in 1971. Eight years later, the Working Party produced a report on harmonization and modernization as well as a piece of model legislation (knows as the "Caricom bill"). Barbados meanwhile had established its own committee, which produced a bill leading to

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42.Quoted by Denys Williams, "Overview of the Companies Act of Barbados (Chapter 308)," Caribbean Law and Business, volume 2, number 1 (April 1990).

43.See Velma Newton, "The Company Law Project--A Progress Report," Caribbean Law and Business, volume 2, number 1 (April 1990).

the Barbados Companies Act of 1982. The territories of the OECS have yet to act on the two models available to them.

The United States Agency of International Development also recognized the role modern company law could play in promoting business development when it joined with Florida State University to establish the Caribbean Law Institute. One of the Institute's first charges was to conduct a Company Law Conference, held in May 1988.

A number of studies published by the Caribbean Law Institute[44] document the manner in which company law fails to foster the full development of financial markets, especially equity markets. Specific deficiencies in the acts, along with their likely consequences for financial markets, are described below under four headings: disclosure of financial information; protection of minority investors; share repurchases and par values; and public equity offerings.

Disclosure of Financial Information

Existing companies acts do not adequately provide for disclosure of the financial condition of companies. As a result, prospective investors and creditors face greater uncertainty than they would under a regime of fuller reporting. From an investor's point of view, limited disclosure heightens risk. Limited disclosure curtails the availability of funds. It discourages public trading of equities; it favors short-term over long-term lending; and it increases the risk (and therefore the cost and minimum required returns) of funds invested in business. The Caricom bill and the Barbados Act strengthen disclosure in these areas: directors' remuneration; directors' dealings with the company through contracts, loans, and shares; specification of the nature and standards of financial statements; and appointment and responsibilities of the independent auditor.

Protection of Minority Investors

Protections afforded minority shareholders are generally weak, and this weakness may inhibit private placements of equity as well as share purchases. The Caricom bill and the Barbados Act strengthen minority rights in several ways: by extending the definition of "oppressive" conduct by the majority and creating more workable means of redress by the minority; by expanding the right of the

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44.Sources for this appendix include a number of useful articles in Caribbean Law and Business, volume 1, number 3 (December 1989), volume 2, number 1 (April 1990), and volume 2, number 2 (August 1990).

individual shareholder to bring suit to influence company action; and by protecting the rights granted to different classes of securities.

Share Repurchases and Par Values

Company law in the OECS restricts a company's ability to repurchase or redeem shares and to sell new shares at prices below par value. The objective of these restrictions is to protect creditors and other investors from adverse effects of improper decapitalization. Reformers have found that the restrictions complicate a company's effort to attract equity investors. Three complications may be cited.

First, in attracting equity investors (often friends and relatives) a private company must offer the investor a mechanism by which he or she will recover the investment and earn a profit. In one common means of doing so in developed markets, the company agrees to repurchase the investor's shares at a given price at a future date. OECS company law makes such an agreement difficult to effect.

Second, foreign investors have shown a tendency to minimize the equity component of their investment and to maximize the debt component. Debt is relatively easy to withdraw, while repatriation of equity share capital generally requires court approval.

Third, some of the territories' companies acts require that new shares be issued at par value. If its current market value were above par value, a company would find a new issue unattractive; if it were below, it would find few buyers.

Public Equity Offerings

OECS companies acts based on pre-1927 UK law contain no provisions governing the manner in which companies may make offerings of shares to the public.

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An accountant reviewing the benefits of Barbados' new Companies Act of 1982 found that they extended beyond correcting the particular flaws enumerated above. The modern act "gives us a lot more credibility when dealing with business people, especially overseas clients. ... our image must be enhanced. We would be seen as 'with it' instead of being thought of as 'dinosaurs.'"[45]

45.Rosalind Jackson, "Barbados Company Law Reform with Special Reference to Accountancy/Audit and Company Secretarial Practice," Caribbean Law and Business, volume 2, number 1 (April 1990).

Appendix G

ASPECTS OF DOMESTIC BANKING REGULATION

Commercial banks dominate the financial systems of the OECS, controlling more than two-thirds of the countries' financial assets. The health of the private sector depends on the success of commercial banks in mobilizing and in channeling credit.

Governments throughout the world regulate the banking sector extensively. The efficacy of this regulation is a key determinant of the banks' ability to perform their developmental role. USAID policy draws the Missions' attention to the costs of governmental failure in this sphere. In the words of the Financial Markets Development Policy Paper,

> To the extent that government involvement in financial systems is misdirected, the development of efficient financial markets will be inhibited and the costs of financial intermediation will be increased. Monetary and financial regulatory policies that stifle financial intermediation, creating 'financial repression,' are the policies primarily responsible for poorly functioning domestic monetary systems and capital markets, and thus for poor rates of growth. Interest rate ceilings on deposits and loans, combined with inflationary rates of monetary expansion, are the most important policies creating financial repression. Other policies adding to the repression are exchange controls, taxation, credit allocation, and heavy reserve requirements.

In the OECS the laws and regulations that impinge most directly on the functioning of commercial banks are the banking acts, tax codes, foreign exchange regulations, alien landholding acts, and agreements and acts concerning the Eastern Caribbean Central Bank.

This appendix evaluates government policy, as expressed through these various enactments, with a view to its effect on the ability of the commercial banks (a) to mobilize savings, (b) to provide credit efficiently to business, serving all sectors adequately within the constraints of prudent lending policies, and (c) to earn a reasonable profit for the banks' owners.

Mobilization of Savings

In the short term, domestic savings are producing adequate bank deposits to provide credit to the private sector. Commercial banks have in general been rather liquid for a number of years. In the longer run, the savings rate must increase markedly to support even a reduced level of investment.

As indicated in the text, primary impediments to a higher domestic savings rate are (a) low personal incomes, (b) low business profits, (b) the limited variety of instruments and institutions competing for savings, which in turn reflects the compartmentalization of OECS financial markets, (d) capital flight, and (e) government deficits.

Interest rates are another determinant of savings.

Government policy on interest rates probably has a mixed effect on savings. At least a portion of interest earnings is generally exempt from taxes. The level of interest is left to market forces, but only within bounds. The ECCB has set a floor on interest on deposits of 4%. Two countries (Grenada and St. Vincent) have established caps on the lending rate, and these caps have the effect of placing a (somewhat lower) cap on deposit rates. At present, these caps has no practical effect, since deposit rates are close to the floor, but they could dampen savings during periods of high inflation. A broader limitation on the operation of market forces on interest rates is found in the complex of laws and regulations which inhibit capital flows in and out of, as well as within, the OECS. Such barriers to capital movement decouple the OECS from the world-wide interest rate regime. Within these significant constraints, the actual level of interest rates on deposits moves in response to supply and demand for funds.

The tax codes for a number of developed countries favor debt investments over equity investment by taxing equity returns twice--once as company profits and a second time as dividends. This bias is generally not present in the OECS. Most countries permit the dividend recipient to claim a tax credit relating to the company's tax payment on earnings.

Efficient Provision of Credit

Sectoral preferences. Governments of the OECS give some sectors privileged access to credit. Such sectorial preferences are thought by many to breed inefficiency, a view taken by USAID policy.

Regulation generally favors government and private housing in the competition for funds through favorable treatment of the interest earned on lending to these sectors as well as the deductibility, in the case of housing, of mortgage interest.

The model banking act permits governments to require the commercial banks to hold as much as 40% of their assets in instruments designated by government. Such instruments include government and statutory-body debt. At present, this power is not being invoked and government debt as a percentage of total assets of the commercial banks stood at 11% on December 31, 1989.

Outside the commercial banking sector, credit is allocated to government and housing more directly. The national insurance schemes, for example, generally hold much of their assets in government paper and residential mortgages.

Security Requirements. The security requirements banks impose on borrowers is often thought to discriminate improperly among classes of borrowers, introducing unfairness and inefficiency in the provision of credit. In the words of USAID's Policy Paper, "Formal lending institutions ... frequently establish loan collateral requirements that effectively direct credit to favored groups of individuals or enterprises." Business and political leaders vigorously support this view.

Several qualifications to this criticism are necessary, however. To the extent that high collateral requirements are indeed discriminatory, the government rather the banks are the culprits, as the ECCB model banking act limits the size of unsecured loans and requires 120% security for loans exceeding the limit. Moreover, the security practices of banks in developed markets are similar to those in the OECS.

It is difficult to envision an alternative basis of lending that would treat small borrowers more favorably.

Commercial banks in the United States place somewhat more emphasis on projected cash flow than on security. Like their OECS counterparts, they seldom have audited financial statements available to judge cash flow. Instead, many rely on federal tax returns. No bank in the OECS mentioned tax returns as a source of information about borrowers. Were such returns available, less reliance might be placed on security.

Profitability

Government regulation can inhibit the development of financial intermediation by depriving banks the opportunity to earn reasonable profits.

The cap on lending rates in two countries can limit profitability, especially in periods of high inflation.

Profitability can be constrained as well by taxation. Here, the OECS governments appear not to impose excessive burdens on banks. Commercial bank profits are taxed at the same rate as other businesses.[46] Reserve requirements, which have an effect similar to that of a tax, are not excessive at 6%. As noted, governments do have the right to impose substantial government debt on banks. This right, though unused to date, represents a threat to profitability.

Finally, some foreign banks operate under a disadvantage relative to indigenous and other foreign banks in that they must pay withholding tax if the head office is domiciled in a country that does not have a double taxation treaty with the OECS country.

46.The Robert R. Nathan/Price Waterhouse study finds, however, that the "corporate income tax rates appear to be structured in such a way that the effective rate of taxation on the income of financial institutions is relatively higher than on the corporate sector." Op. cit., vol. I, p. II-27.

Appendix H

DONOR AGENCY ACTIVITIES

Donor agencies and international finance institutions have played a large and varied role in the development of the OECS countries over the last twenty years. They have provided assistance in the forms of policy dialogue, technical assistance, training, project development, grants, loans and equity participation in projects. This assistance has supported a wide range of activities including technical assistance to both public and private sectors, institutional development, infrastructure development, training programs, and structural adjustment programs. The donor organizations working in the OECS region have occasionally coordinated their activities, but achievement of a considerably higher level of coordination should become a major goal.

Historically, the development assistance efforts of the collective organizations have focussed on import substitution development strategies along with large infrastructure development programs. This has led within the OECS to the development of highly protected economies with considerable distortion in government policies and private sector activities.

Within the past five years a major change in development assistance policy has occurred amongst all the donors. Open, export-led economies have become the agreed goal for assistance activities. Donor programs have focussed on developing export and other forms of government interference in the market place have been discouraged. Program and policies have been aimed at promoting an environment where the private sector and market activities can operate in an open and competitive manner. Jamaica is a good example of donor agencies' cooperating to promote the reduction of government's market-distorting activities. USAID and the World Bank, in particular, have worked together closely on these issues.

The overall level of donor assistance to the OECS countries is expected to decline. The region is seen as fairly well off relative to many other regions of the world. It is generally agreed that many of the region's problems could be solved without additional assistance given the political will. Of particular importance to the region will be the removal of the protective tariffs in 1992 under which OECS bananas are imported into the UK. The price paid for OECS bananas is considerably higher than the world market price for bananas. This action will reduce the earnings potential of OECS bananas. Earnings from banana exports have been in large part responsible for the boom in the local economies and the high liquidity in the banking system over the last five years.

The World Bank and the Interamerican Development Bank (IADB) currently operate through the Caribbean Development Bank (CDB) for their activities in the OECS countries. CDB acts as a conduit and implementing agency for their funds and activities.

Neither the World Bank or the Inter-American Development Bank have a comprehensive privatization plan for the OECS region. The opportunities are perceived to be small, relative to other countries in the hemisphere. Privatization is encouraged but normally is treated on a case-by-case basis. They would be receptive if a government were to approach them (or the CDB) with a comprehensive plan for privatization. Given that much of the finance involved in these transactions is by definition private, it is likely that the International Finance Corporation and Inter-American Investment Corporation would play the major role.

World Bank

The OECS countries are within the same department as the rest of CARICOM and Haiti and the Dominican Republic within the World Bank. They are generally considered along with Barbados and Trinidad in the Bank's planning process. The Bank has traditionally supported large infrastructure and education programs in the region through CDB. They have also been involved in factory shell construction programs and in establishing industrial development or credit funds with the Central Banks in the region. The Bank is currently reviewing their activities in the region. Current and planned activities in the region include:

1. Missions to the OECS countries to prepare country economic reports. These missions will also be assessing the reeds of the private sector and identifying opportunities for Bank involvement.

2. General support for environmental activities and projects have been identified as a Bank priority in the region.

3. The IFC has been asked by the Eastern Caribbean Central Bank to support the development of an OECS stock market. The IFC, while favoring the development of a regional stock market, has agreed to assist the Central Bank in assessing the need for a stock market.

4. The IFC is supporting the establishment of a CARICOM-wide venture capital fund with a $4.5 million US investment in their Allied Caribbean Investment Fund.

5. In Jamaica, the Bank is supporting the development of private sector electric power plants. The Bank has also worked closely with USAID in Jamaica to reduce government interference in the operation of the private sector and a free market.

6. The Bank is planning a large privatization program in Jamaica which will include technical assistance and financial support.

7. The IFC is providing support for the BWIA and LIAT privatization efforts with investment possibilities.

Inter-American Development Bank (IADB)

The IADB has become the dominant donor lender in the OECS region. Although the OECS countries are not members of the IADB, the Bank operates in the region through the CDB. The Bank is involved in a wide range of infrastructure, social development and structural readjustment programs. The Bank will continue to play a large role in the region through their role in the Enterprise for the Americas Initiative. They are being pressured to develop the Multi-lateral Investment Fund component of the EAI as quickly as possible. This fund will play a key role in the regions' efforts to develop open economies. The Banks direct activities in the Eastern Caribbean include:

1. A major loan package to Barbados (in final negotiation) that will include road building, Southwest sewage project, restructuring of the education ministry, and some component of a structural adjustment loan.

2. Support by the Inter-American Investment Corporation (IIC) for the Allied Capital Investment Fund through a $4 million investment.

3. Provision of an IDB grant through CDB to carry out an assessment of the private sector in the OECS. This assessment will result in recommendations for IDB lending to improve the private sector in the OECS countries.

4. A request from Barbados to carry out a private sector impediment study which may be done through IIC.

5. The IIC has provided some technical assistance for privatization in the non-CARICOM Caribbean. They are

interested in participating in privatization projects.

Caribbean Development Bank

The Caribbean Development Bank, in addition to implementing World Bank and IADB lending programs, has a range of activities of its own. They have a large number of sector loans to the OECS governments that are mixed-source funds.

USAID - Washington

USAID Washington is currently reviewing the Caribbean strategy with the likely outcome that regional missions will be downsized and the range of program activities reduced. This strategy review is expected to be complete by December 1991. The strategy is likely to focus on assisting with the implementation of the EAI. Programs will need to focus on regional integration and be carried out with lower levels of USAID oversight. Private Sector activities will have a major focus in the new strategy. The overall move will be away from traditional activities and towards programs encouraging regional integration. Trade issues will loom larger issues with close coordination with the Department of Commerce required. This is based on the idea that healthy local economies are key for two-way trade to develop freely. Environmental initiatives will also be favored in the new strategy.

Canadian International Development Agency

CIDA will continue its focus on environmental issues and programs. They are actively trying to establish a venture capital fund in Trinidad with the assistance of the Bank of Nova Scotia. This is seen to be a model for, or precursor to, a CARICOM-wide venture capital fund.

Summary

A considerable level of activity by the donor institutions is taking place in the OECS countries. Donor coordination of these activities is essential to ensure maximum yield of the dollars available to the OECS. For example, including this AID study, three private sector assessment teams will have visited the OECS countries by year's end. Close coordination of the programs that result is essential. This should be carried out in the first instance at the level of Office Director.

No organization seems to have a comprehensive privatization effort in the OECS region. CDB will play a key role in OECS privatization efforts as the conduit for the World Bank and IADB funds.